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Investor Education Centre

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Wide moats – keeping out the enemy

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A savvy reader has asked about 'wide moat investing' – a term that is used widely in the United States, but less so here. I love this question because it lies at the heart of what we search for in every investment.

The term *economic moat* was coined by investment guru Warren Buffett. It refers to the sustainable competitive advantage that a company might have over other companies in its industry. Like a moat around a castle, an economic moat protects a business from its enemies - the enemy being competition. Competitors can force you to reduce the price at which you sell your goods and services, and they can take customers away from you, which can clearly lead to reduced profits over time.

Having a wide moat gives a company much more control over its own destiny and means it will be more profitable. As investors we like that because it is the profitability of a business that ultimately drives its share price.

So how do you identify a company with a wide economic moat? Unfortunately there is no simple formula that provides an instant answer – like most good things in life, it takes a little searching.

We begin by looking at how much a company earns on its capital, its *return on invested capital*. Profit margins are another guide. Companies with a wide moat tend to generate higher returns on capital and have higher profit margins than those that operate in a very competitive sector. A good New Zealand example is Fisher & Paykel Healthcare versus Fisher & Paykel Appliances. F&P Healthcare produces specialised medical equipment and has only a handful of competitors, whereas F&P Appliances manufactures appliances and competes with hundreds of firms around the world.

F&P Healthcare achieved a 22.5% return on invested capital and a profit margin of more than 21% in the last year, compared with F&P Appliances' return on capital and profit margin of below 5%. F&P Healthcare's technological edge and the specialised nature of its business give it a wider moat than F&P Appliances.

A sustainable competitive advantage is not just about being better than competitors; it is also about having something different to competitors. A competitive advantage might be a dominant brand or a patented product (how do you compete with Microsoft or Coca-Cola?), or barriers to entry (try opening another airport in Auckland!).

Companies with wide moats are rare, and moats don't always last. High profits will always attract competitors and over time, new technologies, customer preferences, and ways of doing business will emerge. Even so, an investor should always begin their search by questioning "what makes this company better than its competitors?"

If you find a company without a particular competitive edge, find out which competitor they most want to beat ... you might just find a moat, and that will be the company most likely to deliver investment returns.

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