Laurus
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"In business, I look for economic castles protected by unbreachable moats."

-- Warren Buffett

Webster's dictionary defines a moat as "a deep, wide ditch that is usually filled with water and that goes around the walls of a place (such as a castle) *to protect it from being attacked*" (emphasis added). Obviously, the wider and deeper the moat, the more easily the place can be defended.

It has become commonplace in the investment industry to declare "we only invest in companies with moats". In truth, an economic moat erodes over time as competitive forces drive returns toward the cost of capital. As a company matures, typically the moat deteriorates along with the prospect for sustainable value creation. And while there are some examples of mature businesses with very long term high returns on capital, they are the exception rather than the rule.

So the role of a portfolio manager is not just to quantify the value created, but also to determine the length of time in which the business can sustain the value creation. Peter Lynch once quipped "Go for a business that any idiot can run because, sooner or later, any idiot probably is going to run it."

Determining the economic moat of a business takes patience and considerable investigation. It is possible for one to simply quantify the expansion or contraction of the moat by tracking the ratio of book value growth to the growth in net income. This measure (over time) provides an indication of how much of the proportionate change in net income has been reinvested to generate future profits. But, like all statistical measures, the calculation is quite end-date sensitive.

So how does one uncover the moat in the first place? Understanding competitive advantage is a good first step to measuring the sustainable value creation of a business. And to measure its advantage, one would have to clearly understand the industry in which the business competes. At Laurus, the investment team uses a version of Porter's Five Forces model. Developed by Harvard professor Michael Porter, the model provides a reasonable framework for assessing and analyzing the competitive strength and position of a business.

In brief, the five forces are:

Threat of new entrants. Business markets that yield high returns will attract competition, and increased competition will decrease profitability for everyone. Markets with high barriers to entry – patent requirements, capital requirements, access to distribution, and/or brand equity as examples – have higher margins and higher equity returns.

Threat of Substitution. A business faces a substitution threat if its prices are not competitive and if comparable products are available from competitors. If it is inconvenient or expensive for a customer to switch to a competitor's product, a business is likely to have the ability to charge a premium.

Bargaining power of customers. If the buyer has too many alternatives, then the business does not have pricing power. Of course, if the market is comprised of a few very large buyers, then pricing pressure is at its highest.

Bargaining power of suppliers. This is the measurement of how the suppliers' markets affect the business and the potential for input costs to rise or quality to deteriorate.

Competitive rivalry. Studies have found that industries with a concentrated number of competitors earn higher profits than less concentrated industries. Nevertheless, a growing industry can sustain a greater number of competitors without undermining profits.

While not part of Porter's model, our team also evaluates the potential for an industry to be disrupted. There are thousands of examples of disruptors – Amazon, Southwest Airlines, and Apple, are some well-known examples; the new "robo-advisor" that is presently all the rage in the media could pose a disruptive threat to the investment industry. Disruptors achieve market gains through low price, essentially forsaking profitability to capture market share.

For speculative investors who bet on short term shifts in the market sentiment of a security, understanding the competitive nature of its industry is not required. At Laurus, we view each of our investments as a part ownership in a business – fully understanding how value is created and how long it can be sustained is an integral part of our process.

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