Thought Piece: *Moat Race*

What do Maradona, Ivan Boesky and Warren Buffett all have in common? In 1986, all three were instrumental in introducing new phrases to the everyday lexicon. As catchy expressions go, 'Hand of God' and 'Greed is good' are hard to beat, but Buffett's adoption of 'Moat' as a business descriptor passes the test of time very well too.

The origin of Moat as a popular metaphor to neatly describe competitive advantage is attributed to Mr Buffett's 1986 letter to shareholders. In that 1986 letter, Buffett first used the term in writing to highlight the advantageous gap between Geico's cost base and that of its competitors.

> *"The difference between GEICO's costs and those of its competitors is a kind of moat that protects a valuable and much-sought-after business castle."*

We count eleven Berkshire Hathaway annual letters since 1986 in which Buffett uses his great metaphor with varying intensity. Whilst Geico was the original and remains the most-cited Berkshire company used to illustrate the metaphor, in 1993 after a gap of six annual letters, he added Coke and Gillette highlighting their "brand names, the attributes of their products, and the strength of their distribution systems ". American Express was added in 2007. These new examples possibly also reflected Buffett's evolving and increasing recognition of the power of brands in creating moats. Netjets' freshly dug moat got a mention in 2011 and notably in 2013, Mr Buffett introduced the adjective 'enduring' for the first time. Moats were discussed in each successive year from 2011 until 2016 and then, since 2016, not once. Moats have not been mentioned in any Berkshire letters any year since. Some might find it curious that the absence of any Moat discussions in Berkshire letters since has also coincided with a period of noted under-performance of its poster child, a period when real question marks arose about arch-rival Progressive Corporation breaching its moat.

Amongst his many skills, Buffett is an accomplished wordsmith - bear in mind too, it is he personally, not Berkshire Hathaway that actually owns the copyright on all the annual letters. He chooses his written (and unwritten) words very carefully. It seems to us that his addition of the word enduring is a nod to the importance and impact of time in any assessment of business' moat. As important as identifying a moat's existence is the determination of whether it is likely to widen or narrow over time.

An interesting case study today is Nvidia, a business that seems to have built a massive moat derived from its long head start in the design of specialist graphics semiconductor chips which are now essential for AI computation. As important, is its proprietary software development ecosystem called Cuda. Judging by its market capitalisation, Mr Market seems sanguine about the company's impregnable moat, and with some justification given its incredible pricing power of late. More pertinent, from our perspective, is whether the moat will prove enduring. Will it last? As Buffett said in 2007 (a peak year for number of Moat mentions in his letters) *"the dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns".*

Li Lu really gets this point about time. When Charlie Munger's friend and personal fund manager was *asked 'what are the most important sources of a company's moat?'*, Lu astutely answered *"this all depends on your investment time horizon"*. Elaborating, Lu explained *"the* *longer your investment horizon, the more important industry dynamics become for protecting your moat. The shorter your investment horizon, the more important people become".* Given the unprecedented increase in the pace of change in the technology sector of late, surely few industries are as hard to assess regarding long term competitive dynamics.

It sounds then, that moats are also greatly impacted by time, people and industry dynamics. In one of his very rare interviews serial acquirer Mark Leonard had a great line on judging the impact of people on a business.

> *"(regarding) your question about management attributes. I despair of answers that are some version of "intelligent, energetic, ethical" I know some great business builders who didn't win the genetic lottery in the intelligence category but compensated with hard work and determination. Energy can be poorly channelled. Ethics seem to get pretty elastic under enough carrot and stick stress. I'd rather use a track record of consistently happy and loyal customers and employees to judge a team!"*

So, to steal this idea, could consistently happy and loyal customers and employees over a sufficient timeframe offer a shortcut in identifying a moat's resilience? Actually, Buffett himself has alluded to a similar way of thinking - asking how are all stakeholders treated by a company? Specifically, in his 2004 letter, Buffett brought attention to the extent to which all of GEICO stakeholders shared in the success of the business.

> *"Indeed, GEICO delivers all of its constituents major benefits: In 2004 its customers saved $1 billion or so compared to what they would otherwise have paid for coverage, its associates earned a $191 million profit-sharing bonus that averaged 24.3% of salary, and its owner – that's us – enjoyed excellent financial returns."*

Great companies do share the spoils of their efforts to the great benefit of their competitive resilience, their longevity. Such companies obsess on customers, foster strong employee culture and act like owners. Combining both perspectives, maybe we can offer a shortcut for moat identification? What Leonard and Buffett are both saying, in their own inimitable way - is that the best businesses are also run in a way that benefits all three core stakeholders: customers, employees and shareholders. Yes, constant learning, lowest cost, brands, network effects, and proprietary technology all matter - greatly - but so does managing the business for the long term. Maintaining that balance thus seems also a key factor in defending the moat. Buffett identified this at Geico. Munger lauded its existence at Costco.

One of the great investors and organisation builders of the 20th century was once asked towards the end of his life what he worried about, "what could really hurt Capital (Capital Group)?", the business he founded.

> *"His answer was as brief as it was swift: Greed!. Greed could come, of course, from individuals or from a group. Greed is always a threat."*

Greed is the contra to 'sharing the spoils', creates the imbalance that puts stakeholders and businesses out of kilter and seems one sure-fire way to gradually drain a moat.