Exclusive Interview with Pat Dorsey on Moats

We had the pleasure of speaking with Pat Dorsey on the topic of moats recently. Pat is President of Sanibel Captiva Investment Advisers, where he leads the investment team and helps guide capital allocation. Pat was previously Director of Equity Research at Morningstar for over ten years, where he was responsible for the direction of Morningstar's equity research effort. He led the development of Morningstar's economic moat ratings as well as the methodology behind Morningstar's framework for competitive analysis. Pat is the author of *The Five Rules for Successful Stock Investing* and *The Little Book that Builds Wealth.*

This interview is posted as a video in the MOI Members Area at http://members.manualofideas.com.
The transcript included here has been lightly edited for clarity and readability.

The Manual of Ideas: Please tell us about your background and how you became interested in the topic of moats.

Pat Dorsey: I was director of equity research at Morningstar for about 10 years. I basically built the equity research team and process there, starting with about 10 analysts and building it to about 100 analysts when I left. I formed the intellectual framework that we use to evaluate companies. A big part of that is a focus on a competitive advantage, or an economic moat. I became interested in the topic because some companies essentially defy economic gravity and manage to maintain high returns on capital despite competition.

It's a fascinating topic because economic theory suggests that all companies should just revert to mean over time. Competition shows up, capital seeks excess profits, and you drive returns down. But, both empirically and intuitively, we all know that's not the case. We can all name a dozen companies off the tops of our heads who have basically defied the odds and maintained high returns on capital for decades at a stretch. What frustrated me when I got into the topic is that most of the literature on competitive advantage is written from a strategy standpoint. Most of your readers are familiar with Michael Porter's Five Forces model, which is very useful and a great starting point, but it's always from the perspective of a manager of a business. In other words, I manage a company or a unit of a company, and what can I do to make that piece of that company better? So, it's all about maximizing the assets that you have.

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As investors, we have a different challenge. We're not stuck with a set of assets of which we need to maximize the value; we can choose from thousands of different sets of assets called companies. So we need more objective characteristics by which we can assess the quality of competitive advantage and then make some judgments about whether a company is likely to have high returns on capital in the future or not.

MOI: Let's start from the beginning. Can you define what you mean by moat?

Dorsey: When you think of an economic moat—and let's be clear I stole the term from Warren Buffett; he's the one who coined it. If you're going to steal, steal from the smartest guy around—a moat is structural and sustainable. I think those are the two key things for investors to think about. It's structural in that it's inherent to the business. The Tiffany brand is inherent to **Tiffany** [TIF]; you can't imagine Tiffany without it. The switching costs of an **Oracle** [ORCL] database are inherent to the way databases are used in business. Contrast that with a hot product or a piece of a hot technology that may come or go.

Moats are also sustainable. They are likely to be there in the future. As investors, we are buying the future. Look at the investments we make today. How they turn out will depend largely on what happens three years from now, five years from now, or ten years from now. So, we need to think about sustainability of a competitive advantage. A company with a very hot product and a cool brand right now may have very high returns on capital, but the sustainability is in question. Whereas you can look at a railroad or a pipeline that would not have as high returns on capital as an **Abercrombie & Fitch** [ANF], but it's very sustainable because you can predict the likelihood of that competitive advantage sticking around for many years, and that makes the investment process easier.

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MOI: So it sounds like, almost by definition, good management would not qualify as a moat. Is that right?

Dorsey: Not by itself. There's a wonderful quote from Buffett on this: "When management with the reputation for brilliance meets a company with a reputation for bad economics, it's the reputation of the company that remains intact." But there's another one that I think people are less familiar with that "Good jockeys will do well on good horses, but not on broken down nags." That's how investors should think about competitive advantage. The smartest manager in the world will not make an airline have the economics of a software company or an asset manager; it's physically impossible.

Smart management is a wonderful thing to have; I'd rather have smart people running my companies than dumb people. Smart managers can build moats; they can enhance moats; they can destroy moats, but they are not moats themselves because management comes and goes. Corporate CEO turnover is higher today that it has been in the past. Getting back to this idea of buying the future, the economics of businesses change slowly. Airlines don't suddenly overnight become wonderful businesses. Software companies don't overnight become bad businesses, whereas managers can come and go. It's hard to make a confident bet, in most cases, absent high managerial ownership or a family position, that the guy who's in charge today will be there five years from now.

MOI: What about people in general in an organization? A lot of companies say, "Our biggest advantage is our people," and there are, in fact, a lot of businesses where that's the case, where the assets essentially walk out the door at night and walk in in the morning. Can that be described as a moat, or do you feel that those people will find ways to extract the economics for themselves if they are, in fact, the asset of the company?

Dorsey: That's a fascinating question. You see the people extracting the rents when they are unique. So this is why, for example, in the entertainment industry, usually it is the producer, the director, or the actor who extracts the economic rents, not the minority shareholder of a movie studio. That's typically the case because there's only one Tom Cruise; there's only one Ridley Scott. So they will extract all the economic rents they can.

But then if you look at **Southwest** [LUV], for example, which arguably did create a corporate culture that, for a time, gave it something of an edge over the competition. Those individuals did not extract excess economic rents from Southwest, and I think it's reasonable to say that was a factor in Southwest's success. Was it a more important factor than Southwest being one of the first airlines to do point-to-point, fast-turn, single-model aircraft, and all the other issues and attributes people are familiar with? I think it's hard to say; the two go together. I would say that corporate culture as an economic moat is very fuzzy, and unless you're prepared to get to know a company incredibly deeply, it can be hard to qualify as a competitive advantage.

MOI: You mentioned that moats are structural, and it almost seems like they've been there forever. How do moats actually come into being? How are they born at a company?

Dorsey: You can build moats over time. We're not talking only about businesses that have been around for 50 years, like a **Coca-Cola** [KO] or **Procter & Gamble** [PG]. It's important for the management of the company to be thinking about how it builds competitive advantage. One example might be, in addition to selling a product, you sell a service relationship along with the product. Look at the way jet aircraft engines are sold today. Rolls-Royce will often price engines by hours used, so you're really buying a service more than you are buying a big chunk of metal you stick underneath an airplane. That increases the switching costs tremendously.

You're seeing a lot of manufacturers of mission-critical equipment, start to realize that if they sell a service relationship along with the product, they can really increase customer loyalty and thus increase customer switching costs down the road. If a company moves from just selling a thing — and things can be swapped out — to selling a relationship or service, it's a stickier proposition. That's what you would do if your goal is to create a network effect.

A good example here might be **CoStar Group** [CSGP], which is basically the **FactSet** [FDS] or Bloomberg of commercial real estate. If you're **C.B. Richard Ellis** [CBG], you can't live without CoStar's data. What they did is they scaled very quickly because they realized that if they could stitch together a lot of very fragmented databases of commercial real estate information from different parts of the U.S. and different parts of the world, that would give them an advantage over the competition because they would benefit from a network effect, where the more users they have, the more data they have and so forth. For them, the key was scale. You wanted them to get big fast. That's not always what you want from a company, but given the moat they were trying to build, it made sense for them.

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MOI: In your book *The Five Rules for Successful Stock Investing* you also talk about moats. You state that companies generally build sustainable competitive advantage through either product differentiation, real or perceived, driving costs down, locking in customers with high switching costs, or locking out competitors through high barriers to entry. Can you tell us what type of moat you prefer, and which are generally more sustainable?

Dorsey: I'm not sure one is better than another. I get this question a lot, and I thought about it quite a bit. I would say that there are weak and strong brands. There are weak and strong switching costs. There are cost advantages that are very durable and some that are a little bit more ephemeral. I'm not sure that I would regard one type of moat as stronger than another, with the possible exception of a network effect, which you see in financial exchanges, credit card processors like **Visa** [V] and **MasterCard** [MA], and businesses that tend to get more powerful the more users they have because the way a potential competitor would need to try to articulate their economic profits is essentially by creating a similarly sized network, and that can be a very difficult thing to do. Generally speaking, if you can identify a true network effect and it's a business that is reasonably priced and has a lot of room for reinvestment of capital at high marginal returns on capital, you've probably found a business that's going to have high returns for some time to come. But that would be the exception more so than anything else.

MOI: Would you consider businesses that are, in a sense, natural monopolies or essentially have this virtuous cycle of volume and price like a **Wal-Mart** [WMT], related to the network concept because the more customers they have the cheaper they can sell things. Is that a good moat? Is that sustainable?

Dorsey: It's interesting to characterize Wal-Mart as benefiting from a network effect, and I would say that for Wal-Mart simply buying more stuff isn't what gives them the lower costs so much as it is efficiently moving that stuff around. If I had to think about Wal-Mart and think of it just as pure volume versus efficient use of capital, in other words, the hyper-efficient distribution system driving down working capital as much as possible, I would say the latter is more important than sheer size. If you think about it, we use Visa or MasterCard because lots of other people do, and that's why it's accepted at lots of merchants. We trade securities on a particular exchange because we get a tight spread and a deep level of volume, and we get that benefit because of the people who are there, too. We don't care that lots of people shop at Wal-Mart; we just want the lowest price. Wal-Mart happens to get that low price by being very, very efficient, but the simple fact that you can frequently see is that there are people who can undercut Wal-Mart. We just wind up going to Wal-Mart because they have everything in one spot. It's an interesting question, but I would say that, generally speaking, I don't think that the network effect is always driving down costs because usually it's what you do with that buying power that tends to matter more than simply having to share buying power.

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MOI: We also posed this question of moats to some of our members, and Josh Tarasoff of Greenlea Lane Capital wrote that his least favorite moat is customer captivity because it tends to be kind of static and it doesn't really imply progress for a business and may actually make it harder to win new customers if they know they're going to become captive for a long time. It also seems to me that if that's your moat, you may not have a very happy customer base; you just may kind of have them by the guts and they can't get away, but the minute they see an alternative they might jump at it because they're not very happy. They're just there because they're captive.

Dorsey: I don't know about that. It's true that you see very strong switching costs. You often see that in more mature areas. So, you think of a **Jack Henry** [JKHY], which does back office processing for banks, usually smaller ones. The customer retention rate is in the high 90s. Of course, the number of banks isn't growing a lot year to year, so they're not losing anybody but not gaining anybody either. Oracle is a pretty similar business. Oracle doesn't lose much market share, but databases are a very mature business; it doesn't grow a lot from year to year. Oracle mainly grows the core database business by raising the price a little bit from year to year.

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There is probably a decent correlation between the strength of a switching cost and the maturity of a market; I think that's a reasonable thing to say. But just because a market isn't mature doesn't mean that the business isn't a quality business and can't be mispriced. If it's being valued as a declining business, for example, look at the elevator companies, whether it's Otis [owned by **United Technologies**, UTX], **Schindler** [Frankfurt: SHR] or **Kone** [Helsinki: KNEBV], despite the very high switching costs of an elevator or escalator — once it's in the building you typically don't rip it out and put another one in — they've experienced pretty reasonable levels of growth as you've seen the urbanization of China and other areas of the world. I guess I wouldn't say that it's my least favorite kind of moat. You do tend to see it more often in mature businesses, so you have to be a little more careful of what you pay for those, obviously. I think being able to raise prices every year on your customers is a pretty good thing. The key there is to not abuse it.

If you want to think about a business that really does have some of its customers by the short hairs, CoStar would be a good example. CB Richard Ellis, **Jones Lang** [JLL] and other big commercial real estate brokers literally can't live without this data. Morningstar hosted the CEO of CoStar at their conference, and I remember asking how he thinks about pricing because he has a lot of pricing leverage over customers. He obviously thought about it very carefully. He said, "We're interested in long-run profit maximization, not in angering our customer base." I think that's how you have to think about it if you're a business with a product that is critical to a customer's business where you have enormous pricing power. If you really do that in a very strong and aggressive fashion, you will invite competition, as Josh was implying—that the customers are going to want to go somewhere else. But if you balance the value you're delivering versus the cost to the client, you can keep that going for quite a while without really making the customer want to go somewhere else.

MOI: When you talk about a business that has a moat through network effects, those network effects directly make the customer experience better. There's just more value to each customer from the network. With something like customer captivity, it seems to have the connotation that if the customer could decide every day to make a blank-slate decision where it would want to take its business and there would be no switching cost, it might actually go to a competitor because they might have a better product or a better price. Even if a competing offering is better, the customer captivity makes a customer stay there and there's that gap…

Dorsey: Exactly. You could call up a bunch of the smartest engineers you know and create "The Manual of Ideas Database." Maybe it's 15% faster and 20% cheaper than anything Oracle has on the market, and you walk over to Procter & Gamble or Amazon.com and say, "I think you should buy my new MOI database; it's really cool." They're going to have to invest tens of millions of dollars and how many hundreds of thousands of man-hours to rip out their current one and install yours. If you had something that was 80% faster and 80% cheaper, they might do it. There is some point at which you do switch, but it's scientifically a pretty high one.

MOI: Ideally, you have a moat and it's sustainable for a very long time. Buffett has been great at finding businesses like that and investing for the long term. Do you think that consumer-facing businesses that essentially build up mindshare in the consumer, like a Coca-Cola, have the most sustainable moats, or do you think business-to-business companies can have similarly sustainable moats?

Dorsey: What matters less is who your end customer is, a business or consumer. It's more about the speed of evolution of the product set. Soda doesn't evolve; soda doesn't change a lot from year to year. Software does. If I had to make a bet today as to who is more likely to have high returns on capital ten years from now, I'm going to bet on a soda company before a software company simply because there's less stuff that's likely to change over the next decade, so that's what's important. It's more about, what is the product and not about who is the end customer.

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The thing with brands is they take constant care and feeding. Brands don't just run themselves. Management teams can try to destroy brands. Do you remember Schlitz? Schlitz was number one or number two in market share in the U.S. beer market from the mid-50s to the early 70s. It was number one or two for each year. What did they do? They changed their recipe. Well, that's not smart. You have the number one beer and you change the recipe. You can't tell what stupid management teams are going to do. Remember New Coke? My point is that these things don't run on autopilot; they require constant care and feeding. You can look at some consumer product categories. Would you imagine ten years ago that there would be private-label beer? Kirkland. **Costco** [COST] sells private-label beer, and it's not bad. It's not great, but it's not bad. That's an area where I think it's hard to say it's not all about whether it's consumer or business. If you had asked me ten years ago what product categories would be least susceptible to private-label competition, I probably would have put alcoholic beverages and confections as number one and number two. I would have been wrong on one of them. Now I'm waiting for Kirkland-brand chocolate. That's probably not going to happen.

That's kind of a long answer to a very interesting question. It's more about the speed with which a product category changes than really anything else.

MOI: It seems that in the business-to business market the customer is pretty rational; they're going to weigh the costs and so forth. Does it matter how rationally the customer makes his or her decision?

Dorsey: You're right, there's less of an emotional standpoint. But there are, sometimes, emotional reputational factors. Remember the old quote: "You don't get fired for buying IBM." Reputation in brands can matter in a business-to-business market as well. But the key thing to look at is — and this gets back to your initial point about mindshare — does the brand change customer behavior? Does it make the customer act differently? It can do that in one or two ways. It can either increase the customer's willingness to pay. You pay more for Coke than you do for President's Choice Cola. You pay more for **Hershey's** [HSY] than you do for lower-end chocolate. Or does it reduce search costs? You become familiar with a product. You don't want to compare prices all the time on a stick of gum; so you just buy Wrigley [owned by privately held Mars]. You buy Wrigley because it's what you want, and it's a $0.50 pack of gum. I'm not going to sit here comparing 50 cents. You've reduced my search costs.

"The Sony brand is incredibly well known. It's one of the top 20 most valuable brands in the world, according to Interbrand. But would anyone reading this pay 20% more for a Sony DVD player relative to one from Philips or Panasonic?"

But if the brand doesn't change my behavior one of those two ways, I would argue it's not worth a dime. Think of the **Sony** [SNE] brand. The Sony brand is incredibly well known. It's one of the top 20 most valuable brands in the world, according to the big annual Interbrand survey. But would anyone reading this interview now pay 20% more for a Sony DVD player relative to one from **Philips** [PHG] or **Panasonic** [PC]? I doubt it. So, there you have a company with mindshare. Sony has mindshare. We've all heard of it; we know Sony well, but it doesn't change our behavior. So what good is the brand?

"It's not the [Apple] brand; it's the network effect. Pure and simple. I get this question all the time. People think that Apple buyers are all just about the brand and looking cool and having the little white threads dangling out their ears. It's the network effect."

MOI: If we flip that around and let's take **Apple** [AAPL], which is doing phenomenally well right now…

Dorsey: It's not the brand; it's the network effect. Pure and simple. I get this question all the time. People think that Apple buyers are all just about the brand and looking cool and having the little white threads dangling out their ears. It's the network effect. The iPhone does have a wonderful user interface and lots of good features, but it also has tens of thousands of apps. Why does it have tens of thousands of apps? Because developers want to write for the platform with the most users, and the users want to buy the phone with the most apps. It's a beautiful network effect, and we can validate this by looking at initial iPod sales.

When the iPod first came on the market, remember the Zune [sold by **Microsoft**, MSFT] was on the market at the same time. In the first year or two of the iPod's existence, that was before iTunes, and the iPod sold reasonably well, but it wasn't a huge hit. Then iTunes came along and suddenly you could buy songs by the drink, but only if you had an iPod. Hockey stick growth. If you're a music publisher, why do you want to be on iTunes? Because you have all those people with iPods out there. Why, as a user, do you want to buy an iPod? Because it's the only thing I can use to buy songs one by one legally — this is before they shut down Napster — it's a network effect for Apple.

When I look at Apple and when I think about Apple as a business — and it's in the portfolio — I'm far less concerned about nice advertising or cool design than I am about anything that increases the switching costs, anything that increases the difficulty I would have of switching from my iPhone to an Android, anything they can do to make that path dependence stronger — that once I have an iPhone, I want the next generation and next generation. That's what strengthens their moat more than anything else.

MOI: Could you tell us a few examples of companies that you consider have strong durable moats? Perhaps some names that are not as well-known as maybe some of the **Berkshire Hathaway** [BRK] holdings.

Dorsey: I always want to try to go off the beaten path when I can. It's not the easiest thing. What's cheap now and what's been cheap for a while has been the big stuff, so that's what I've been focusing on. Do these need to be well-priced right now or just have good moats?

MOI: Let's just have good moats for now.

Dorsey: Good, because the smaller stuff tends to get more expensive. CoStar, which I mentioned before, has data on property and tenants for commercial real estate users. Commercial real estate is much more differentiated than residential real estate because each office building is unique. Having a rich set of data gives them an enormous advantage. They have about 90% client retention and usually inflationary price increases. To replicate this database you would basically need to spend everything that CoStar has been acquiring over the past eight years, and even then you would have a hard time doing it because typically what they've done is bought the best regional commercial property databases, and so there isn't another one out there. So you would need to replicate this from scratch, which would be very difficult. So that's a very interesting little business that I don't think people know as well.

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What would be another really interesting one? **Express Scripts** [ESRX] or **MSCI** [MSCI]. The latter is in the financial business. It spun off from Morgan Stanley a while back. They own the MSCI indexes, which is a pure index licensing business model that's just gorgeous because every time a Brazil ETF launches, they need to license MSCIs. That generates them a fairly small but essentially no-cost revenue stream, and that's just an unbelievably beautiful business. They also have a business called Barra that is basically the gold standard for risk management software for asset managers. An asset manager will often get asked "What's your Barra risk?" or "Show me your Barra printout." And even if they don't believe in Barra and even if they don't think Barra's philosophy of assessing risk based on volatility is worth a hoot, it doesn't matter because the consultant is going to want to see it, so you're going to have to have it. So, they have about an 85% renewal rate, which is pretty good. That's a wonderful little business.

MOI: Do **Moody's** [MCO] and S&P Ratings [owned by **McGraw-Hill**, MHP] have a moat?

Dorsey: Their returns on capital and margins certainly suggest that they do. You don't have to love them. Last quarter, Moody's operating margins are still running in the high 30s. That's down from the mid-50s, but it's not chopped liver by any stretch. I wouldn't mind having those kinds of margins. I would say they do. At the end of the day, the nature of the bond rating market lends itself to a natural oligopoly. Sean Egan at Egan-Jones has had some wonderful calls. He's a controversial guy, but they've done good work. They really haven't gained much market share at all.

It's a business that is not particularly cheap right now, and I think it's pretty hard to figure out what the growth rate looks like going forward. I think the hard thing with Moody's is not figuring out whether they still have good margins five years from now, but figuring out, how big is the business. That's the hard thing. In terms of is it a natural oligopoly and will it retain its high returns on capital, I don't think there's much question of that. I think a much harder thing is figuring out what the size of that business is and then how you price that cash flow stream. I can't do that, which is why I don't own it.

MOI: Do you think **American Express** [AXP] or Visa/MasterCard have a wider moat? What I'm alluding to is the closed-loop model of American Express versus the more open model of Visa and MasterCard.

Dorsey: It's close, but they're also different businesses. AmEx is lending money, whereas Visa and MasterCard are not. I think it's an important distinction to make because you saw that in the run-up to the credit crunch, AmEx had some serious underwriting mistakes. Some of their underwriting metrics were based on home prices, and that came back to bite them. The nice thing about credit cards, unlike mortgages, is that the problem loans run off pretty quickly; they reprice pretty fast. So, it didn't kill it because it was a well-capitalized business, but you saw that sub-optimal underwriting really did damage to them. Visa and MasterCard are not lending money to anybody, so it's a much less risky business in that sense. I think that the scope for management to mismanage those businesses is a lot lower than AmEx. AmEx has learned from its mistakes; certainly it's gotten better at the underwriting.

The hard thing with MasterCard and Visa right now is that you are seeing some chance of technological disruption with the emergence of PayPal [owned by **eBay**, EBAY] and other mobile platforms. How likely are they to really hurt things is hard to say, but you have more risk of disruption than you would with a Coca-Cola or Budweiser [owned by **Anheuser-Busch InBev**, BUD].

The other difficulty they're facing is that you're seeing a bit of a price war emerging where they are engaging in these rewards programs, and it's almost like, who can give the most rewards out, and that's how consumers are starting to choose what card they use. That's probably, in the long run, not a great thing for the business. I don't think they're losing sleep over it, but I don't think it's a great thing in the long run.

MOI: What do you think of major pharma? Those businesses have high returns and have always had high returns, but it seems that if you have a blockbuster drug, it's all about when the patent expires. Do you feel that those really big pharma companies have sustainable competitive advantage?

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Dorsey: Yes. Again, it's a little bit like Moody's. The margins are there; it's the growth that's hard. I think big pharma was very slow to realize that the business model had changed. Two decades ago, even one decade ago, it was all about bringing out big blockbuster drugs that treated chronic conditions: high blood pressure, depression with Lexapro, and drugs like that. These are drugs where it's a chronic condition and so you need to get it out to lots and lots of potential patients at a relatively low marketing cost. So, what do you need? You need an army of salespeople. So that was a business model 15-20 years ago.

Then, as we got what you would call "good enough" products for treating high blood pressure, cholesterol, depression, and those went generic, the opportunity to improve upon the prior drug is very small, so you would see the business model shift to higher-priced drugs, especially in oncology. They're higher priced drugs, but you need to market to a much more specialized set of doctors. So you don't need tons and tons of salespeople; you need a smaller number of very highly-trained salespeople. That business model shift took some time, and it was only really a couple of years ago after one of the two big pharma mergers that you started to see sales forces really come down. There were big cuts in sales forces, and I think that was an important moment because it meant that big pharma was sort of realizing that the world had changed a bit.

I think of big pharma almost as a distribution platform more than anything else. Part of their value is, to some extent, those giant R&D labs, but so much of the innovation is happening in large molecule drugs and in biologics right now. You hear the big pharma companies buying the more innovative smaller businesses and that the value a big pharma company generates is in having this massive distribution platform, trusted relationships with tens of thousands of practitioners around the globe, and that's going to be very hard to replicate, much more so than having a new innovative molecule.

MOI: Buffett talks about how he wants Berkshire subsidiaries to essentially just think about how they can widen the moat every day. What would be your advice to companies and CEOs on what they can do to widen the moat of their companies?

Dorsey: I think it really depends on what kind of moat you're trying to build. If I had to think about a few themes, one would be that you tend to see commoditization is correlated with management impact. If you're the manager of a retailer, an insurance company, a commodity company, a miner, or a bank, you can have a huge impact on whether your business is great or good. If you're managing a business that already has a wide moat, you're more of a caretaker. Your job is to not screw up. Your job is not to roll out New Coke. Your job is to keep the business going the way it is. But waking up every morning — this goes back to what have you done to widen the moat — whatever your moat is should constantly inform every business decision that you make.

We began this conversation with Wal-Mart. Think about five to seven years ago when Wal-Mart started to try and compete with **Target** [TGT] in fashion. Did it work? Not really because you don't go to Wal-Mart for hot clothes; you go there for cheap club prices. They got off-strategy; they forgot the reason why their customers shopped there, and then they kind of retooled and that laser focus on low prices is what matters to them.

Think about **LVMH** [Paris: MC] and their focus on exclusivity. They'll actually destroy unsold bags. They'll take a $2,000 bag and just shred it to keep that scarcity out there.

"…think about Amazon.com's laser focus on the customer experience. That drives everything they do; it's how can they make the customer experience better. That really is what created their moat…"

Or my favorite example — because it's one that I got wrong — think about **Amazon.com**'s [AMZN] laser focus on the customer experience. That drives everything they do; it's how can they make the customer experience better. That really is what created their moat and wasn't anything else, because Jeff Bezos realized early on that online shopping is different than offline shopping. With offline there's no trust involved. If I walk into a store, I hand somebody cash and they had me a product. Our relationship is finished; there's no trust. But online I have to trust you'll send me the right product; I have to trust you won't steal my credit card; I have to trust you send it to me in the time you say you're going to send it to me. There's a lot of trust there, so brand matters more online. I think Bezos figured it out very early on. Everything Amazon does is about making the customer experience better, and that's why people use it. I've probably given 50 talks on moats around the world, and I always ask the audience how many people have bought something off Amazon without checking the price anywhere else. Usually over three-quarters of hands go up, which is an amazing statement when you think about the ease of checking the price somewhere else. So focus matters, not diversifying.

You frequently see CEOs have a good but slower-growing business that has a great moat and high returns on capital, and then they say, "My gosh, we still have to grow." Then they take the capital and they basically set it on fire, investing in a business where they have no competitive advantage, like when **Cintas** [CTAS] moved from uniform rental to fire safety and document management. Stupid. **Cisco** [CSCO] moving into set-top boxes and buying the Flip. Stupid. **Garmin** [GRMN], the GPS company, trying to expand into handsets and competing with **Nokia** [NOK] and **Samsung** [Korea: 005930].

Stupid. In all three of those cases, the company would have been far better off just sticking with what it did best and then taking whatever capital it couldn't reinvest in the core business and returning it to shareholders. But, of course, because CEOs of bigger companies get paid more than CEOs of smaller companies, the institutional imperative for growth is always there and always a risk to a minority shareholder.

MOI: Is there anything that we haven't touched on that you like to mention in your talks and maybe highlight here?

"Fastenal still has single-digit market share and maybe even double-digit, but they certainly have plenty of runway ahead of them. Both Expeditors and C.H. Robinson, which are in different parts of the freight forwarding market, have plenty of runway ahead of them right now. I think Visa and MasterCard have that attribute."

Dorsey: When people are thinking about how to value a moat, and when a moat is really valuable and when it is less valuable, the key to think about is the length of the runway. What are the reinvestment opportunities that a company has? So Visa or MasterCard or a **Chicago Mercantile Exchange** [CME] or a **C.H. Robinson** [CHRW] or **Expeditors** [EXPD], these are all companies that are in growing markets or in mature markets with very small market shares. There's a lot of opportunity to reinvest capital at a high incremental rate of return, and that moat and that ability to reinvest for ten years before someone really wanted to steal your competitive lunch are incredibly valuable.

Contrast that with a **Microsoft** [MSFT] or a **McCormick** [MKC], both of which have very strong moats, but the volume of Windows isn't going up much year to year; the volume of spice consumption in the U.S. is not increasing much year to year. McCormick's moat doesn't really add a lot of economic value; it adds stability and predictability, but it's not worth paying a ton of money for because it doesn't allow the company to grow all that much. Whereas the moat for a business that has reinvestment opportunities is very, very valuable. That's often how I think about the "when do I want to pay up for a moat" question, is whether that moat is actually going to allow the company to reinvest a lot of capital at a high rate of return, or does it just add stability and predictability.

MOI: Do a few companies come to mind that fit the bill of having a wide moat and ability to reinvest a lot of capital.

Dorsey: I think **Fastenal** [FAST] still has that characteristic. They still have a single-digit market share and maybe even a double-digit, but they certainly have plenty of runway ahead of them. Both Expeditors and C.H. Robinson, which are in different parts of the freight forwarding market, have plenty of runway ahead of them right now. I think Visa and MasterCard have that attribute. Although their market shares are unlikely to grow, the evolution of payment from paper or check to plastic is not as far advanced as you might think. So they have a nice secular tailwind behind them, even if they don't wind up gaining much market share from one another. So those would be a few examples. There are plenty of other ones, but those would be the ones that come immediately to mind.

MOI: Pat, thank you very much for sharing your insights with our members.

To listen to a recording of our exclusive interview with Pat Dorsey, visit the Manual of Ideas Members Area at http://members.manualofidea.com.