THE MANUAL OF IDEAS™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

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When asked how he became so successful, Buffett answered: "We read hundreds and hundreds of annual reports every year."

Top Ideas In This Report

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Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

THE WIDE-MOAT ISSUE

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Exclusive Interview:

Pat Dorsey,
Chief Investment Officer,
Dorsey Asset Management

With compliments of
The Manual of Ideas

Pat Dorsey, Founder, Dorsey Asset Management

In late April, we had the pleasure of sitting down for another exclusive interview with Pat Dorsey, chief investment officer of Dorsey Asset Management and author of *The Little Book That Builds Wealth* and *The Five Rules for Successful Stock Investing*.

Prior to starting Dorsey Asset, Pat was director of research for Sanibel Captiva Trust, an independent trust company with $1 billion in assets under management serving high net worth clients. From 2000 to 2011, Pat was director of equity research for Morningstar. Pat developed Morningstar's economic moat ratings, as well as the methodology behind Morningstar's framework for analyzing competitive advantage. Pat holds a master's degree in Political Science from Northwestern University and a bachelor's degree in government from Wesleyan University. He is a CFA charterholder.

(The following is an edited transcript of a video interview and may contain errors. The transcript has been lightly condensed for clarity and readability.)

"[We] know intuitively and empirically that there are some companies that manage to maintain high returns on capital for very extended periods of time, even decades, and the way they do this is by creating some kind of structural advantage."

Oliver Mihaljevic, The Manual of Ideas: The topic is economic moats and we're going to talk about your investment strategy around an understanding of moats. Before we get into all the discussion about investment strategy, it would be helpful to go back to basics and hear from you a bit about what a moat is…

Pat Dorsey: The easiest way to think about an economic moat is a structural advantage that helps insulate a firm from competition. As we know, capitalism works, it works pretty well, and firms with high returns on capital generally see those returns on capital competed away over time. This is intuitively true and it turns out to be empirically true if you look at the data. However, we also know intuitively and empirically that there are some companies that manage to maintain high returns on capital for very extended periods of time, even decades, and the way they do this is by creating some kind of structural advantage. Some aspect of their business, it's not just a great manager, but it's inherent to the business that makes it hard for other companies to come in and compete away their profit pool.

MOI: You talked about the structural attributes of moats; those are really structural attributes. Tell us what you mean by that.

Dorsey: Well, you can't imagine Tiffany without the Tiffany brand. The blue box is part and parcel of Tiffany. The Louis Vuitton logo is part and parcel of LVMH. The two don't exist without one another. It's difficult to switch out of an Oracle database if you happen to have an Oracle database installed at your firm. That's part of Oracle's business. It's not simply a great product or a smart manager who might be in charge. It's an inherent aspect of the business itself.

MOI: Is there any other way to think about moats or have you found that is that the best classification of moats?

Dorsey: Thinking of a business as a static entity, certainly. As we've seen, great managers can create moats over time. Buffet started with an ailing textile mill and did okay over time. Those managers are few and far between. You're looking at three, four sigma events in finding these kinds of managers. If you look at what Buffet has done, you look at what Selim Bassoul has done at Middleby, what the Rales Brothers did at Danaher & Colfax, there are those individuals out there that are able to start with an unattractive set of assets and deploy them in such a way that they create a structural advantage over time, but they still have to create that structural advantage. Otherwise, it's not really a moat. If you just have a great manager who's running a business well, that could be an attractive business to own, but it's not necessarily a structural advantage, because the quality of the business is tied to things that are ephemeral, things that could go away if that manager gets hit by a bus or if a product manages to not perform well.

MOI: Let's touch on some of these various types of moats that you've alluded to earlier. If you could briefly explain to us the brands. Everybody tends to think of a brand as a moat, but we see a lot of companies that have perceived brands that don't turn out to have strong moats, so give us a sense of the different types.

Dorsey: A brand has to change consumer behavior, that's the key point. We can think of Sony as having a great brand, but really, the Sony brand name doesn't influence your decision to pay more for a DVD player because the DVD player at this point is truly a commodity product. That wasn't the case 20 years ago, but it's certainly the case today. A brand has to change consumer behavior and it typically does that by doing one of two things. One is it could reduce your search cost, so when you want to go out and buy Heinz Ketchup you say, "Oh, Heinz, I like that. I'm going to buy that," because it gives you a consistent experience and you don't have to sit there sorting through the ketchup shelf all the time, which is not really worth your time.

"Brands do require constant care and feeding, shall we say. Brands don't just go off on their own and maintain themselves…"

The other advantage a brand can give is typically when you're selling what's called a Veblen good where basically demand increases with the increase in price and so it increases your willingness to pay. That would be an example with an LVMH or a Tiffany or a Coca-Cola, one could imagine. You pay more for Coke relative to President's Choice cola or an off-brand cola, but the key nugget here is in both cases, whether it's decreasing your search costs or increasing your willingness to pay, it changes your behavior. If the brand doesn't change your behavior, frankly, it doesn't add a lot of value to the company as a moat.

MOI: We're going to touch on the global aspects in a minute when we talk about investment strategy. People tend to talk about the global brands and, especially, there seems to be a craze around global luxury brands. You mentioned LVMH and their portfolio. What do you think is something that is underappreciated or are there any risks to these types of brands? It seems that people really have embraced those global luxury brands and are willing to pay up so much for them. What's your take on that?

Dorsey: Brands do require constant care and feeding, shall we say. Brands don't just go off on their own and maintain themselves, so you can think about Tiffany, for example. Some years ago – this is going back a decade or more – they really overexposed themselves in low-end silver jewelry in Japan that damaged the brand to some extent. They also put a lot of capital into a pearl chain called Iridesse, which didn't leverage their main asset, their brand. If you're Tiffany, why would you start up a chain not called 'Tiffany?' It doesn't make a whole lot of sense. LVMH, you've seen this where they've been pulling back on their wholesale channel and wanting to control the consumer experience and so selling more product through LVMH-branded stores. Again, you have to control that customer experience, make sure you have exclusivity, because if you distribute too much or you bring the price down or you see discounting or knockoffs, it really can damage the brand tremendously.

You saw this in the U.S. It's not a luxury brand, but going back ten, fifteen years, the Tommy Hilfiger brand in the US, which was a very high-end, preppy brand very akin to Polo. But then they over-distributed through department stores. You saw a lot of markdowns, a lot of knockoffs and the brand value became damaged through that. If you are the owner, the custodian of a brand, you have to control that customer experience and your distribution network. What you want to aim for is a brand like Patek Philippe where you see on the back of The Economist, they always have a good ad there and it says, "You don't own a Patek Philippe, you take care of it for the next generation." I mean that is a wonderful way to communicate the longevity and the strength and the experience of this brand in a way that would be harder if you started seeing Patek Philippes all over the place. If you could walk into your local department store and buy one at a knockoff price, that would damage the brand considerably.

MOI: You group brands in the larger category of moats, which is intangible assets. Give us a sense of what else falls into that category.

Dorsey: The two other main things would be patents, which are obviously legal monopolies, but they're subject to either expiration or piracy. Patent lawyers, at least in the US, drive really nice cars and there's a reason for that, which is that patents are very valuable to challenge and break that monopoly. Typically, when I think about a firm that has dug a moat around itself using patents, it's got a portfolio of patents. You can think of a Qualcomm with a massive portfolio of patents around LTE, 3G and 4G where challenging any one patent wouldn't destroy the firm. By contrast, a specialty pharmaceutical company, which really has one drug accounting for the bulk of its profits, that one patent challenge really destroys your EBIT stream, so that's not much of a moat.

Then we also have licenses and regulatory approvals. You can see those in casinos, waste management. Aircraft parts is a wonderful industry based around getting all your parts on an aircraft certified and the only thing you really need to be aware of there is, of course, regulatory issues are very sensitive to the local regulatory environment. You want to know who the regulators are, the likelihood that they'll change their mind because regulatory fiat, especially if you're dealing in a country with a less stable political regime, can be a big issue, because the guys who make the rules can also change the rules.

"…if I have a plane that has standardized on a brake from Meggitt, which is a UK aerospace company that we own, and they make the carbon pads for the brakes, well, I can't change that brake without getting the entire brake system recertified by the aircraft manufacturer and the aviation authorities."

MOI: Now moving onto switching costs, you talk about three different subcategories. Can you give a sense of what they are?

Dorsey: You can incorporate yourself into a business model. You become part and parcel of the company. You have databases, data processors. That's a typical example there where the usage of a data processing system or a database with enterprise software, like SAP, it becomes part of the fabric of someone's business and so tearing it out is like ripping the organ out of a person. Very difficult to do and so your switching costs become very high and your pricing power thus becomes good as well. You usually raise prices a few percentage points a year. The other way to do it is to basically give away the product and make money off the service relationship. You see this with elevators, for example. They don't give them away, but you make much better margin if you're Cohen or Schindler or Otis on the aftermarket stream.

In aerospace, you actually do give away the product. You literally provide the engine part or the brake system for a regional aircraft for free. You just give it away to the OEM and then you make 38-40% margins on the aftermarket as long as that plane is flying. One way you take a hit here and so if production's really increasing for that kind of a business, you actually see a margin hit, but then of course, what they're buying a 20- to 30-year-long annuity stream.

MOI: When it comes to switching costs, it seems to me that this integration with client processes would be a better type of switching cost moat than the one you just described. Is that fair?

Dorsey: No, I think they're two sides of the same coin. If I'm selling an Oracle database, for example, it's very hard to rip it out of my business, but also if I have a plane that has standardized on a brake from Meggitt, which is a UK aerospace company that we own, and they make the carbon pads for the brakes, well, I can't change that brake without getting the entire brake system recertified by the aircraft manufacturer and the aviation authorities. That's a pretty hard thing to do, so it's not necessarily a better moat. Just on one, you're making money more from the renewals and the service revenue in the Oracle model. In the aircraft model, you're making your money from part sales for the most part. The switching costs are pretty high on both fronts and the interesting thing there is the customer, people often know it.

If you look at aerospace, for example, you often have these 38-40% margins, but your returns on capital are only in the low teens because typically you have to pay a very high entry fee to become part of the program. If I want to supply brakes to Bombardier Jets, I need to pay Bombardier a pretty big hunk of change to get on that platform. If I'm MTU Aero, which makes critical subsystems for jet engines, I need to pay Pratt & Whitney a big chunk of change that sits on the balance sheet as an intangible. That drives down returns on capital. The 38-40% margin sounds great, but then the entry cost is quite high, but you get some certainty with that. Like most things in life, there's no such thing as a free lunch. You give with one hand and you take with the other.

MOI: Of course, it's nice to provide benefit to the customer that's much greater than the cost. You talk about the switching-cost-based moat that comes from a high benefit-to-cost ratio…

"Ecolab basically provides food safety training and hand soap dispensers and suchlike to restaurants. If you think about it, this doesn't sound very exciting, but if you're a restaurant owner, having a clean kitchen is the cost of doing business."

Dorsey: You can think of a case where part of the value chain of a product chain or service delivers of value of the end product, but doesn't cost a lot. Think about a critical ingredient for a piece of snack food that might be made by a Symrise or a DSM or Kerry, one of the food and flavoring companies. Without that key ingredient, the food tastes different and so the consumer isn't going to like it very much, but the total cost of getting that package of Cheetos on the shelf of a convenience store, it's not really high and so if the ingredient maker wants to raise prices a little bit, you don't really worry about it a whole lot. Same thing, the classic example we've seen in the U.S. was a company called Ecolab. Ecolab basically provides food safety training and hand soap dispensers and suchlike to restaurants. If you think about it, this doesn't sound very exciting, but if you're a restaurant owner, having a clean kitchen is the cost of doing business.

No one's going to go to your restaurant because you have a cleaner kitchen, but they will definitely not go if the kitchen is dirty or if the health authorities certify you. That's not a big part of your cost structure; it's a thing you have to get done, so if Ecolab says, "We're going to raise your prices 3% this year for making sure your kitchen is clean, your employees are up to certification for the various things they need to be certified on and you've got soap in all the right places," you say, "The guy who sells me beef just raised prices 5%. I'm not worried about this," and you just pay them and move on.

MOI: Let's talk about the network effect, which is the third category of moats. It seems the network effect has nice implications in sectors that value investors typically tend to shun in the technology space.

Dorsey: The key is thinking about does the value of this product or service truly increase with the number of users? Credit cards and financial exchanges are the classic model. If I've got a lot of people buying and selling futures on the Chicago Mercantile Exchange (CME), that helps me as a user because liquidity is higher and spreads are driven down. Same with Visa, MasterCard, AMEX. If it's accepted everywhere, odds are lots of people are going to carry it and vice versa. Where I think people can get trapped with this is confusing the two types of networks that I just mentioned, which are very interactive networks. Each node connects to another node, with what are called radial networks where you have one hub and then many, many spokes coming off of it because there it's easier to compete. Western Union would be a good example here.

"Western Union likes to say, 'We have the most locations in the world to send money from one place to another.' Well, that's true, but each of those locations doesn't add value to all the others."

Western Union likes to say, "We have the most locations in the world to send money from one place to another." Well, that's true, but each of those locations doesn't add value to all the others. Lots of people send money from Chicago to Mexico City, Mexico City to Chicago or from Chicago to, say, various cities in India. We have a large Indian population in Chicago. There are not a lot of folks in Mexico City sending money to India or vice versa, so it's a hub and spoke. It's channel-based. What that means is a competitor doesn't have to take out the whole network like they would for a Visa or a MasterCard. They just have to take out one channel. They just have to take out one leg of that network, which means that the moat is not as robust. Doesn't mean it's nonexistent, but it's not as robust as one where each node adds value to every other node. In that case, you have these channels, which can get picked off by lower cost competition.

MOI: What about in the financial services industry with the big banks, their branches. It's often been said in the past that it was really convenient to have lots of branches and a customer can enjoy going to a branch in Chicago and then New York and various other places, but with the importance of Internet to banking, how do you see the value of that branch network?

Dorsey: Certainly, Internet access disintermediates the local branch networks, but for the local branch networks, local density always mattered more than national density, because for most people, knowing I can get to a bank near my home, near my office, on the way to take the kids to soccer, that matters a lot more than "Is there going to be one when I visit Aunt Minnie once a year in a different town?" That local density typically is what matters a lot more and you see that a lot with companies where oftentimes it's that local density that matters a lot more than national scale. National scale or global scale, it might drive down cost for business overall, which is great, but if being global doesn't matter to 95% of your customers, then it's not really conferring them a huge benefit.

MOI: These branch networks, whether it's banks or other types of businesses, would you place them more into this radial hub and spoke?

Dorsey: Typically and certainly for a retailer, because what matters to you is local convenience. It's a really interesting question. It might be a little bit different for a McDonald's where you want that consistent experience everywhere you go. People, they travel, they see a McDonald's, they know what they're going to get when they walk in the door. Probably less the case with a retailer where you're typically not buying toilet paper when you're traveling. It's usually provided for you and so fast food is something you consume when you're away from your local network. Clothing, consumer packaged goods, typically something you're buying more towards your home. That's why in the U.S., despite the rise of Whole Foods, you still have grocery chains like H-E-B in Texas or Wegmans in the Northeast that have maintained a lot of regional strength despite the advent of whole foods, because people aren't buying a slab of raw salmon when they go on vacation. They're doing it in their local area.

MOI: What about the technology sector? The network effect has been touted as really the key reason why Apple is different this time… Is the network effect really as robust as people tend to paint it in this fast-changing sector?

Dorsey: That's a really good question. I think you have to look at each one individually and ask, "What is my incentive to move away from the network if a larger network came up?" Take credit cards, for example. If someone suddenly showed up with a credit card that didn't charge me any interest, my cost of switching to it away from Visa and MasterCard is very low, but where can I use it? Not very good. Whereas if you think about online, let's say a Facebook competitor popped up and had lots and lots of better features than Facebook. Now getting the first couple hundred thousand users is going to be tough, but if it truly is a better product than Facebook, people might migrate to it. Now, again, you have to ask, "What's the likelihood of that happening?" Probably low and then the question would be, "What can I move over? What can I port over?" If all I'm importing over is the network and the other people move, too, well, that's what killed Myspace because for a long time Myspace had a much higher user base than Facebook until News Corp. bought it and basically killed it.

"A scale-based advantage like you would see at a UPS or an Aggreko tends to be more durable, because to replicate that cost structure, you need to achieve the scale of that incumbent, although relative scale does matter more than absolute scale."

The user experience became qualitatively worse after News Corp. bought it and so you saw this migration, but part of that's because people weren't leaving a lot behind. That idea of social network was very new, so there wasn't a lot of data, a lot of links they were leaving behind. I would argue that it's probably harder for that to happen now as social networking has become more embedded in people's lives. It's harder to leave an existing network, but I would say it's probably easier in that case than, say, in a LinkedIn case, because in LinkedIn, this is your job. This is your livelihood, so you're going to think twice about where you move to. Does it have the right context for me as opposed to "Is Aunt Minnie there to get pictures of my pet cat?"

MOI: Let's move onto the last one in the four categories of moats – the cost advantages. Give us a sense of this type of moat.

Dorsey: Yeah, so you typically have two kinds. You can have process or scale. Process, the classic examples would be Dell or Southwest, which weren't bigger than the incumbents, but they invented a cheaper way of delivering a product or service. In Southwest's case, specializing on one plane, point-to-point versus hub and spoke, very fast turns. Tons of books have been written on this. Dell, build to order, cut out the value-added resellers and so they weren't bigger; they just invented a better way of delivering the product.

Inditex is similar. Inditex now is pretty big, but ten years ago, it was not one of the world's biggest retailers, but basically with the idea of fast fashion and shrinking the length of the value chain, locating the manufacturer much closer to the point of sale as opposed to in Bangladesh or Sri Lanka or wherever, they were able to deliver fashion at a rapider pace than the incumbents. Again, that was a process-based advantage. Process-based advantage can last for a while. If you bought Dell early, you bought Southwest early, you made a lot of money. The problem, capitalism being what it is, is that in time they get copied. You have other upstart jet airlines, you had others copy Dell's business model.

A scale-based advantage like you would see at a UPS or an Aggreko tends to be more durable, because to replicate that cost structure, you need to achieve the scale of that incumbent, although relative scale does matter more than absolute scale. You can see where GM was the biggest, but it was not the cheapest back in the day and a lot of that's because your cost structure in the auto manufacturing industry, it's almost more at the plant level than it is at the market share level. The fact that they had more market share than Toyota didn't have that much more buying power, because so much more of it's about what cost structure do you get at any individual plant. I would say when you're thinking about "Does this company have a scale advantage?" think about how big they are relative to the competition. If an industry only has three players and they've all got 30%, well, okay, 30% market share sounds good, but everybody else does, too, where as if it's an insanely fragmented industry and you've only got 5% market share that's three times bigger than the next guy, there's probably something interesting going on.

"You think about McCormick, the big spice company; Americans are not going to consume 30% more spice next year. It's just not going to happen."

MOI: You have talked about these four types as the structural attributes of moats. Are there any types, thinking of moats in general? Is there anything else or is this really it, these four?

Dorsey: I think these are the four biggest buckets. Obviously, this is an art, not a science and so where these four came from is back when we were starting our investment philosophy at Morningstar, we went back over history and looked at every company that had maintained high returns on capital for, I think, it was more than 15 years at a go – I can't remember the exact number we used – and tried to sort them into some reasonable number of buckets. This is what we came up with, but certainly, if it looks like a duck and quacks like a duck, it's probably a duck. If it looks like a moat, feels like a moat, it's structural and returns on capital are high, it's probably a moat. I would say those four buckets probably encompass 80%, I don't know, some high proportion, but obviously, like everything in life, don't get locked into one framework on this. Think about company culture. It can be a very sustaining thing for a lot of businesses. It just requires an insanely deep knowledge of the company to understand how that culture really is creating a moat if it is in the case of some companies.

MOI: Let's say Berkshire Hathaway. Of course, on the holding level, one could argue that that culture is also an additional moat.

Dorsey: The culture matters, certainly, and I think this is what's going to be the interesting test of Berkshire. When the sad day comes that Warren goes to the land of capital allocation in the sky, how much of that reputation is tied to him and how much is tied to Berkshire? That obviously won't matter with regard to MidAmerican, with regard to BNSF, with regard to a lot of the individual operators, with regard to GEICO. They will go on as before. Those are structural moats right there. Where it starts to matter is when the next financial crisis hits. Will people go to his successor the way they went to him and trust that he's the guy who can back and help them and he'll write the check on Monday morning and that they can write a one-page contract and it will be honored?

I don't know, that's an open question right now. That's one of the reasons we've seen over the past decade more and more of Berkshire's capital has become tied up in these capital-sucking businesses than asset-like businesses where you have a lot to deploy every year, because what he's doing is basically saying, "If I can lock a lot of our capital into an attractive 10%, 12%, 15% return at a utility, at a BNSF, then basically there's less scope for my successor to mess things up, whereas if Berkshire today looked like it did 15 years ago where the bulk of the value is coming more from the asset allocation into the individual holding on businesses or minority stakes, that leaves a lot of scope for error, frankly.

MOI: You say the value of a moat is dependent on reinvestment opportunities, so everything we've talked about so far is just maybe half the story?

Dorsey: Exactly, exactly. Having a moat is no good if you don't know what to pay for it. You think about a Microsoft or a McCormick, the big spice company; Americans are not going to consume 30% more spice next year. It's just not going to happen. You're not going to have a turmeric craze; I can't see it happening. Because of that, McCormick doesn't have a lot of room to take its cash flow and reinvest back in its core business. It has to pay out a lot, but that's exactly what you want it to do. Because of that, if you just work through the valuation math, that moat doesn't add a ton of value to McCormick. Doesn't mean you want to pay 40x for McCormick. It adds a lot of stability to it. It tightens your confidence interval around your value estimate, because you can be confident that those returns on capital will be sustained and you can model that out, but they only need so much cash to reinvest and once they're done with that, they just pay it out.

You contrast that with a Fastenal, which has 3-4% market share in the industrial distribution market in the U.S. or an XPO Logistics, which has been rolling up the truck brokerage industry in the U.S. much like CH Robinson, replicating that business model where you can reinvest a lot of capital at a high incremental rate of return and there's a lot of runway ahead of you. You have a lot more market share to take, a lot more business you can do over the next 10, 15, 20 years. There, the moat adds an enormous amount of value, because the cash that you generate, you can reinvest at a 20-30% incremental rate of return, which is way better than you could get in the public market—way better than you could get by giving it back to me, the shareholder. There, the moat adds an enormous amount of value because you are looking at what Buffet calls compounding machines. That's why when you find those businesses that have that ability to reinvest capital at a high rate of return for a long period of time, that's when light bulbs need to start going off and you start thinking about this is a business that's worth much more than the average multiple.

"…finding a business where the value today is one-fifth, one-tenth it could be ten years from now, that's not in a database. You have to go out and do the work and that's where the inefficiencies can come from…"

MOI: Now as investors, we are looking for moats. We're looking for long runways, we're looking for great capital allocators at the helm and we're going to do that globally, which is mandated at Dorsey Asset Management. Give us a sense of what you look for. How do such attributes become mispriced?

Dorsey: That's an interesting question. Obviously, I think a lot of it is because everything we've been discussing is qualitative. You can't screen for switching cost. There's no check box on Bloomberg for that. I hope there never is. If there is, I'm in deep trouble, but you can screen for a good capital allocator. You've got to get in front of the guy or woman and understand how they think about allocating capital in terms of the growth potential of the business, the runway, as we talked about earlier. Again, you can't screen for that. You've got to go out and do the work. There's a great quote from, I think, Bill Miller. I'm not sure. "All of the information is in the past, but all of the value is in the future."

All that screening people are spending all this time doing in Cap IQ or whatever, it's great. It's all in the past, every bit of it and so certainly, if you can find a business that is mispriced based on where it is today, you could make plenty of money. You could arbitrage the difference between price and value, but finding a business where the value today is one-fifth, one-tenth it could be ten years from now, that's not in a database. You have to go out and do the work and that's where the inefficiencies can come from because, frankly, not everyone likes to do the work. It's much easier to sit in your office and run a screen than to get on a plane and go talk to people and deeply understand the business.

There's an institutional inefficiency here, too. If you think about a lot of capital allocators, they want to see, "What's your process?" "Oh, our process is we do this, then we do this, we do this and we have a nice inverted pyramid. We start with this universe, then we go down to here." How many inverted pyramids have you seen? I swore to myself I would not put an inverted pyramid in my investor presentation, because it just doesn't make any sense to me. You just have to go turn over a lot of rocks. Very big picture, that's where the inefficiencies come from. Once you get outside the U.S. and look globally, they come up even more, because you get geographic disparities. You get the analyst in Country X only covering the companies in that country and not looking at their global competitors, especially as you move down from the mega-caps.

"You have to go and look at the industries that have structurally attractive characteristics and then follow value chains. That's how we run across several of our ideas…"

MOI: Before we talk more about some of the differences one needs to be more aware of stepping outside the U.S., I'm curious: This question of identifying moats and investing in moats before they become obvious versus investing in moats that everybody knows they're there, give us a sense of the challenge there. How should an investor go about finding out about Coke 20-30 years ago?

Dorsey: It requires a lot more digging, because these are not going to be in Buffet's portfolio at this point. That's not faulting him or Ted. It's just because they have a huge pool of capital to work with and so they're going to be buying big businesses. They've done a pretty good job over the past couple of years finding mispriced, big businesses, to their credit. A lot of it is going out and fishing where the fish are. You don't fish in a dried-up stream, you fish where the fish are. Don't be digging into commodity companies; don't be digging into chemical companies. Retailing, at least in the U.S., can be a pretty tough business. Outside the U.S., retailing gets pretty interesting, because it doesn't cross borders very well and so you can get two or three retailers dominate like in Australia or South Africa and create wonderful little, efficient scale moats there.

You have to go and look at the industries that have structurally attractive characteristics and then follow value chains. That's how we run across several of our ideas… You might start with Company 1, but then you look at the supplier and you go, "Wow, that's actually a better business than the one we started with," and you have to be willing to discard your assumption. You start doing the work on something and just because you've spent three days looking at it; that does not mean it's a good business. It just means you've spent three days looking at it. You have to be willing to take in data as it comes in and say, "Actually, the supplier is a better business," or "Actually, this other competitor that we didn't look at before, that's a better business than what we started with." It's that constant "pulling on the threads," I think people have called it. I can't remember who said that.

Pulling on the threads, uncovering lots of rocks, that's something a lot of people don't do enough of, frankly. They think they have to know everything about a particular company, they have to know the name of the CEO's dog and that really is going to make them an expert on the company, but does that mean you're going to make a better investment decision? I'm not sure. I think one of the values that the great investors possess is knowing where that curve of diminishing returns tails off, where an extra hour of research does not add to your confidence level in the business. Knowing where to cut that off and say, "I know enough to make an investment decision," and then move on. There's tens of thousands of companies out there, so once you know enough to make the investment decision, great. Make the decision and start turning over more rocks.

MOI: What do you think are the key questions then to ask of these younger businesses that don't have obvious moats yet, but have the potential to have higher, stronger moats than they have today? What are the key questions to ask to identify those situations as an investor?

Dorsey: You apply the same structural analysis and they're not necessarily younger businesses. One of our holdings is MTU Aero, which is about a €3.5 billion market cap company. They've been around since before World War II and they've been making the jet engine modules that they make now for at least 25-30 years. They're not young by any stretch. They're just an odd duck because two of their main competitors, one is Captiva Rolls-Royce; one was bought by GE last year. They're not as big as Pratt and GE and the big Saffran and the big integrators, but they're not a parts supplier like a Precision Castparts. They're an integrator here in the middle, so there's no real good comp with them. They're not really young; they're an oddball in the industry. But you'd apply the same analysis to them as you would to any aerospace company in terms of what are you paying to get on a platform, what platforms are you on?

"If I walk into a convenience store and buy a Coke, I give you money, you give me the Coke and I walk away and we're finished. I don't need to trust you. If I'm buying something online, I have to trust you…"

Are the platforms that you're on, are the planes getting parked or do they still have a lot of life in them because your service cycle only starts eight years after a plane is launched? It's the same analysis, but if you're talking about a truly young business, the one that is really is just starting out, what you want to ask is what are they doing to really build their moat? How is management allocating capital? Buffet's mentioned that the one question he asks management every year or would like to ask management is what have you done in the past year to build the moat? I think that's a pretty good question to ask management. If they don't know what a moat is, probably you need cut the conversation short and move on. If you look at Amazon in the US: everything Amazon has done from Day 1 has been about building Amazon's moat whether it's building out the scale and building out big distribution centers or – and I think this is a vastly underappreciated part of Amazon – improving the customer experience, because it matters more online than offline.

If I walk into a convenience store and buy a Coke, I give you money, you give me the Coke and I walk away and we're finished. I don't need to trust you. If I'm buying something online, I have to trust you don't steal my credit card. I have to trust you'll deliver me what you told me you'd deliver, I have to trust you're going to do it when you tell me you're going to do it. Amazon has invested from Day1 in tons of things that improve the customer experience and it's very clear that they're continuing to do that. Is that the right thing? Is the valuation good? I don't know. What I do know is that I would not want to be competing with Amazon right now.

"…when you're running a network effect business, when you're running any kind of distribution business, you always have to ask yourself, 'Is there a large customer, a non-fragmented piece of my customer base that could disintermediate me, that could create a competitor?'"

MOI: If we take an obvious moat, S&P, McGraw-Hill in the S&P business or Moody's in the financial crisis, everybody can point to [it and say] "Okay, this moat is now under threat." Give us the key question an investor needs to really think through in that category of opportunities. You have a moat. It's just under threat and determining whether it's temporary or permanent, how does an investor go about that?

Dorsey: I would say, not having done a ton of deep digging on either one, but I'll give you my impression is that one was threatened with disintermediation and one was not. Let's think about S&P for a moment. The bonds rating business is probably what you were referring to. There was a reputational issue there. S&P obviously did not police its internal ethics well enough on the bonds side, but was there any real alternative to S&P? No and the customer universe is very fragmented. It's every corporate bond issue; it's every corporate bond issuer. That's a really fragmented group that can't really gang up on S&P, so even though they caught a lot of flak, had some bad headlines and the demand level, you could argue, would go up or down based on the volume of new bond issuance, I don't think their moat was ever really under threat unless it turned out the ethics allegations were worse than they wound up being.

MSCI is a different ball of wax. Vanguard decided to basically take MSCI off its international index funds and replace it with [other] indices. The reason they were able to do that is that Vanguard is a huge player. They could say, "Let's go create our own indexes and that our financial advisors, our users of Vanguard funds don't care. They want an index fund. They don't care if it's tied to the MSCI. They just want a cheap index fund." There, that was a bit of a threat to MSCI's business, because you had this giant player who could exert that kind of influence. I don't think, to my knowledge, the same analog exists in the bond rating market where you have one corporate bond issuer who is 10% of the entire corporate bond market and can say, "You know what? We're going to fund another player."

You saw those with Nasdaq as well. Remember when BATS got started, Better Automated Trading Systems? That was, if I'm remembering rightly, funded by a bunch of the I-Banks who basically said, "Okay, we're a big chunk of Nasdaq's volume. We think this can get done better, let's go fund a competitor." I think when you're running a network effect business, when you're running any kind of distribution business, you always have to ask yourself, "Is there a large customer, a non-fragmented piece of my customer base that could disintermediate me, that could create a competitor?" With S&P, not so much; MSCI, but then you have to not overreact. Everybody freaked out when this happened with Vanguard and it replacing MSCI. How many Vanguards are out there? Not so many. Who else a) had the resources to basically create their own indices and b) has the trust of their investor base to say, "Just go ahead and switch along with us?"

I'm not sure there's many out there and I'll say, I got worried when that MSCI thing happened, but the more I thought through it – and I missed the dip in the stock, stupid me – it looks like it's a one-off. There are not many Vanguards out there that could do that. Anyway, that's a long answer to your question, but I think it's an interesting thing. I think it's a good question because none of this stuff is static and none of this stuff is, "Okay, you're in this moat bucket and I'm going to leave you alone." There's nuances there where you've got to understand the business well to be able to figure out "Is this a threat or is this not a threat?"

MOI: What do you think is harder then, for an investor to identify these situations and make a determination whether it's a permanent or temporary threat and make the investment case based on that or going out and turning over stones and finding that gem that nobody has discovered that has a moat and long runway in a country like Thailand, let's say?

Dorsey: Well, there's a lot of answers to that. Starting with the last part of your question first, there's certainly the knowing what you don't know. We looked at a Thai media company a couple months ago. I can't remember the name of it off the top of my head, but they basically owned Thai-language media. They're the Televisa or the Globo of Thailand. It's a Thai language newscast, a soap opera. You name it; this company does it. Thailand's growing very quickly; the odds that a News Corp. is going to suddenly show up and start producing Thai language soap operas, not so high I would guess, but here's the issue. From sitting here in Chicago and not speaking Thai, first of all, I have no idea if the content's any good or not, I don't speak Thai and, secondly, the company is owned by one family that is very politically connected in Thailand.

"One of my big learning experiences at Morningstar, when we moved from our initial coverage universe in the early 2000s that was largely U.S. to globalizing our coverage universe, was figuring out that retail is not always a bad business."

Trying to figure out Thai politics is a bit of a trick, not one that I want to engage in and so that one, structurally, I say "great," because emerging market, rising middle-class. The biggest incremental use of dollars as your living standards go up is leisure. Fabulous, I want to own this. Wait, take a step back and think, "Can I really honestly assess this business?" and then there's this additional layer of it's a regulated industry owned by a family that is very politically connected. Could the licenses be taken away if they get a foul on the wrong side of politics? I don't know; I can't know from sitting here in Chicago and so that one has to go in the too hard bucket. In terms of the other part of your question, when moats become structurally impaired or not, that's a tough one and that's when you can find some great opportunities – when the market thinks the moat has been impaired, but it hasn't been.

There's a company we're working on now called Aggreko, which is the world's largest provider of temporary power for everything from the London Olympics to Fukushima to countries that haven't been able to build enough power plants for themselves. They recently lost the CEO Rupert Soames, who'd been in charge for about eight years and really had brought the business to where it is today. There's some real soul-searching that had to go on in terms of how much of this business truly is structural with their scale advantages and how much is you had a couple smart guys running it for a while? That's a tough thing to figure out. We're leaning more on the structural side, that this is not a business that's been materially impaired by losing Rupert Soames. You look at Ashmore, the emerging market specialist based in the UK. If they lost Mark Coombs, the 50% owner and kind of founder of the business, despite the attractive characteristics and structural aspects of asset management, how many assets would leave if he got hit by a bus? I don't know. We haven't answered that question yet.

MOI: That actually reminds a bit of Sotheby's. It's a great brand, great moat, but you've got this people aspect that makes it difficult for an investor. The question there perhaps is more around when brands or moats are not exploited economically to the extent that they could be, are those situations interesting for an investor? What are the key questions there?

Dorsey: Part of the key question is can the moat withstand bad management, and how long? Let's say somebody got in charge of LVMH – I can't imagine they would, because Bernard Arnault's got a lock on the thing – and suddenly you saw Louis Vuitton bags at Wal-Mart. The value of that brand would decline pretty darn fast. It's not very likely, right? But brands need care and feeding and you can destroy that pretty quickly, whereas in the case of Microsoft, I think one could argue Steve Ballmer shoveled dirt into that moat for quite a number of years, but that moat was so darn wide that even Steve couldn't destroy it and they've come out the other end with someone who I think looks like a better capital allocator and they're doing okay. Obviously, this is not a fast-growth business anymore. You have some disruption with Office 365 replacing Desktop office; you've got the shrinking PC base in the world. These are all headwinds, right, but Azure is growing by double digits. Office 365 I think moved even faster last quarter, they reported a couple days ago.

That's a business where, I would argue, not awful, but suboptimal stewardship didn't destroy it, but there are plenty of cases where management can shovel dirt in the moat by investing outside of it. SynTos would be a great example. They had this wonderful core uniform business, uniform rental and providing floor mats to buildings and whatnot and they decided to go into document destruction. It was capital-intensive and there were very little scale benefits to it, except on a local level. They started to go into fire safety and competing with ADT. The core business stayed fine, but it was shrinking as manufacturing in the US shrinks. You don't see dudes in industries, the software programmers wearing uniforms. The demand for uniforms is going down, but they're taking that cash flow and doing dumb things with it. As an investor, I can't just buy the part of the business I want. I've got to buy the whole thing and so they were diversifying it and driving over all returns on capital now.

MOI: Now for a global investor in moats, what do you think is really the opportunity outside of the United States? Give us a sense of what are some of the subtle differences and what investors should be aware of.

Dorsey: Some of it is, of course, just being aware of local situations. One of my big learning experiences at Morningstar when we moved from our initial coverage universe in the early 2000s that was largely U.S. to globalizing our coverage universe — and Morningstar covered about 400-500 non-U.S. companies by the time I left — was figuring out that retail is not always a bad business. In the U.S. it's not a great business because you can only create a scale economy if you're Wal-Mart or if you're Costco, if you're huge. The odds of new entrants coming in are always very high, but you look at like a South Africa, you look at an Australia and the returns on capital of the retailers there will knock your socks off and it's because they dominate what's a fairly small market, you have a much more oligopolistic structure and the odds of competition coming in are fairly low, because they're not terribly big markets.

"Part of the key question is can the moat withstand bad management, and how long?"

I'm Wal-Mart or whoever, I mean Wal-Mart's bought Massmart very recently, but for a long time they were just not really big enough for a global competitor to come in. Besides which, cross-border retailing typically hasn't worked out so hot. It's a structurally better business in these smaller markets where the retailers can cater to local cultural norms better than a global company could. Then you have local differences. In Germany, you can't wash your car on the street. I remember I was floored when I found this out, that you cannot wash your car yourself because of the chemicals getting into the waste water stream and so car

"Oracle does not grow a whole lot, and people often pillory them for not having much of a dividend, but they have been buying back shares. At 12% free cash yield, you buy back shares all you want, my friends. That's intelligent capital allocation."

washes get used a lot more in Germany than they do in the States, because that's the only place to wash your car and so there's a small company called WashTec that has a pretty good market share in supplying the original equipment and the spares and also the chemicals for car washes.

In the U.S., I would say, "So what?" Germany, it's pretty dense, so you can get some good local scale economies and also you have a local structural issue that prevents people from doing it themselves. Well, that's pretty unique and so you have to be attuned to these local things. Another one is Domino's UK. Domino's UK is a wonderful franchise, just killed it in the UK. They've had some difficulties going into Germany. You know what one of the reasons is? Germans don't like to share pizza. That's something they didn't get right. According to Domino's when we talked to them, they tend to prefer individual pizzas much more so than everybody reaching in and grabbing a slice. It took them a while to figure that out. Again, people are different everywhere and finding businesses that can adapt to those local differences, you can find some fun stuff.

MOI: It's interesting. You mentioned the example of WashTec in Germany. I was thinking about this rather lack of runway here. Of course, everybody wants a great business with long runways, great management.

Dorsey: Yeah, we all want to play basketball like Michael Jordon, too.

MOI: But you do say that a wide moat and good capital allocation can compensate for a lack of compounding potential and make it interesting for an investor still. Would that be a good example of that, WashTec?

Dorsey: WashTec, they've done a decent amount of investment outside of their core European market. Europe's like 75% of sales for them. They really did move into the U.S. market as well and I'm not sure how well that's worked out for them, but when I think about that a wide moat and good capital allocation can compensate for a lack of runway, I think a good example there would actually be Oracle. Oracle does not grow a whole lot, and people often pillory them for not having much of a dividend, but they have been buying back shares. At 12% free cash yield, you buy back shares all you want, my friends. That's intelligent capital allocation. That's what I want you to be doing with that money. You're not going out and doing dumb stuff with it. They do do acquisitions, most worked out pretty well for them. Plugging in to the larger suite of product that they offer. I think when you have this wide moat and you don't have a lot of compounding potential, what you want to see at the top is discipline.

General Dynamics is another good example. They're a corporate jet business, which makes the Gulfstreams. Perhaps somebody watching this owns a Gulfstream, but we don't. I swear there's a hedge fund guy who owns a G6. Wonderful franchise, but of course, they've got defense businesses that don't grow very much and their new CEO, Phebe Novakovic, who is just an absolute pistol, was asked on one of their earnings calls early last year about their marine segment, which builds destroyers and nuclear subs, pretty moaty business, not a lot of folks can do this. Doesn't grow a whole heck of a lot given where defense spending is in the U.S. Someone said, "What about the marine business, it's not growing very much?" She just cut him off at the knees and said, "Well, if it's not going to grow, you don't pretend like it's going to grow. You manage it for cash."

Yes, that's exactly the attitude you want, but how often have you seen CEOs who their not comfortable saying, "We can't grow. We will buy back shares, we will do a big dividend," whatever it might be? Very frequently, they're incented to grow because, by and large, CEOs of bigger companies get paid more than CEOs of smaller companies. That's what you want when you have that wide moat and that lack of runway, you want very, very disciplined capital allocation at the top and a management team that is comfortable not growing, but delivering shareholder value in other ways.

MOI: I'm glad you mentioned growth in this context of moats. Isn't it that a lot of participants in the market – investors – they confuse growth with moat, especially perhaps in emerging markets. I guess what's there to say about that and how do you really identify/discern a moat in a company benefiting from some of these structural tailwinds in emerging markets?

Dorsey: That's a great question because there's been some great work done showing actually over time it's countries with a lower GDP growth rate that have delivered better returns than the higher GDP growth rate. There's a valuation effect there and you have the glamour effect. A friend of mine who does a lot of emerging market investing jokes to me about China in terms of returns on capital, "A lot of capital, not a lot of return." I think that's where people mistake growth for having a moat. Anyone can grow. Anyone can grow by building new stores, by underpricing a product. That doesn't mean it's sustainable and as investors, we're buying a future and so that's sustainability that really matters. There's a competitor to Aggreko, a company that we've been doing a lot of work on now called APR Energy, which is UK-listed, but based in Jacksonville, Florida, and they have been winning some deals from Aggreko – we're pretty sure – by underpricing.

"There's a competitor to Aggreko, a company that we've been doing a lot of work on now called APR Energy, which is UK-listed, but based in Jacksonville, Florida, and they have been winning some deals from Aggreko – we're pretty sure – by underpricing."

They're growing at a much faster pace than Aggreko right now even though they're smaller. They've reported much better order growth the past couple of quarters, but they don't have the balance sheet that Aggreko does. They typically will lease newer generators and then sell them and buy other new ones, whereas Aggreko has a much lower capital investment rate because they have older Cummins generators that they maintain very well, so how long is this underpricing sustainable? I'm not so sure, but you're right. It's very easy to get seduced by a high growth rate. What I would say is if that growth rate isn't going to be around, you're probably overpaying.

MOI: I want to come back to one of the statements earlier about moats in smaller markets such as Australia, South Africa. Well, not very small markets, but smaller than the US. You say it can be easier to build a moat in smaller markets. What type of moats?

Dorsey: We mentioned retailers earlier. It's easier to gain what's called minimum efficient scale, so sometimes whether it's an industry or a country in these cases, the market economics will only support two, three players, maybe four or whatever the number is and the entry of another player drives returns on capital down for everybody to such an extent that the potential new entrant is kept out. It doesn't enter that smaller market. That can be the case when you have a geographically delimited market or globally in a niche market. There's a company called Blackbaud that does basically fundraising software for nonprofits. Not a real big market.

"There's a German bio-manufacturing company that we want to own at a lower price that makes filters for bio-manufacturing. Wonderful business, competes with Merck Millipore, competes with Thermo Fisher, but if you look at the Germany-based analysts who cover it, they typically cover other German 'healthcare companies,' which don't compete with these companies at all."

There's another great business that does employment software in Germany. Germany employment laws are a little complex to put it mildly and so this company pretty much owns the market. If you're a decent-sized company in Germany, you've got them helping you manage all the different regulations and people scheduling and everything else. They can't really go anywhere outside Germany, but basically the idea that a software company would invest the capital and try and take what's not a very big market away from them, that's a minimum efficient scale and so that's what I meant. In the US, again, for the US-based investor, we're used to the idea that this, man, this is huge greenfield, just always, always competition out there. Well, sometimes, you get into a small niche whether it's industry niche, geographic niche, you can create a nice, little moat for yourself. You probably won't be able to grow very much, but you can dig a nice little moat for yourself by dominating a smaller market.

MOI: You also say that moats are often not as well analyzed outside the United States, so that's a good example of that issue globally for investors.

Dorsey: It can be and I think some of it also is that the U.S. is just a big pond and so if you're analyzing companies in the U.S., you're probably covering a bunch of their competitors, but if you're covering companies domiciled in other countries, odds are higher that their competitors are not listed in that country. They're listed elsewhere, but if I'm an analyst sitting in a certain country, my coverage list may not be delimited by a value chain. It might be delimited by geography. There's a German bio-manufacturing company that we want to own at a lower price that makes filters for bio-manufacturing. Wonderful business, competes with Merck Millipore, competes with Thermo Fisher, but if you look at the Germany-based analysts who cover it, they typically cover other German 'healthcare companies,' which don't compete with these companies at all. That's a case where it just doesn't make sense.

You look at the European-based analysts who cover the testing and certification companies like SGS and Intertek and Bureau Veritas, almost none of them cover a company in Australia called ALS, which has been rapidly diversifying out of mining to start bumping into those companies globally. Globally, they do compete, but because it's based in this faraway country called Australia and used to not compete, used to be one of the mining companies in terms of testing, you don't see the coverage of that lab as much. You can find some fun inefficiencies like that if you poke around, because the folks looking at the business, they're looking at it from a geographical lens, especially if a capital that they manage is geographically limited. If I'm in Country X and I have a mandate that says, "You can only invest in companies listed in Country X," well, what's my incentive to go look at the value chain outside the borders? It's not terribly high and so if you take a global perspective, sometimes, not always, you can see things that the local folks don't.

MOI: Taking a global perspective also means that you do find out about some businesses in industries you don't actually find here in the United States and it's one of your points about looking globally.

Dorsey: We just mentioned testing and certification; none of them are based here. They're all based in Europe, or ALS is in Australia. Flavors and fragrances, whether it's Symrise or Chr. Hansen, which is a fabulous business, Kerry is an Irish company, IFF is U.S.-based. That's about it. That's an entire industry that has customers in the U.S., it's important on a global scale. U.S.-based investors don't really look at it because if you have to own companies

"…some of it is figuring out who the competition is. It's not like you just go down a GICS table and say, 'Oh, look, the competition is right here, okay.' It's often much more subtle than that and so you don't even know who else to look at until you've had a chance to talk to the company in-depth…"

listed in the U.S., well, the industry isn't one of them. Broadening that perspective and getting outside the U.S., you can see stuff. I did this screen recently. Of all the global companies over USD $1 billion market cap, 70% are listed outside the U.S. That's a pretty big pool of opportunity.

MOI: How often do you come across true compounders in markets outside the United States? Give us a flavor for what it is like to look for these moaty businesses with great managements outside the United States.

Dorsey: It's not like they're easier to find. They're just as hard to find outside the U.S. as they are in the U.S. and the trick is, you need to find managers who really are comfortable thinking big, who are thinking about how big can I make this company? How much capital can I keep reinvesting? There's a really neat Singapore-based software company that we've been working on – it's too expensive right now – called Silverlake Axis and they make core banking systems, so basically the core processing system that drives your general ledger that does everything for the company. In the US, this would be companies like Fiserv. Temenos is a European-based company that does these kinds of systems. Typically, it's a very slow-growth business because once a bank has it, they don't switch out of it and, of course, you don't have a lot of new banks showing up and they all already have one, so the switching cost works against you from a growth perspective.

In Southeast Asia because banks, generally speaking, are just younger than they are in the developed world, more than a few are still on green screens and old legacy systems, so there's more scope for growth there and Silverlake dominates Malaysia and is really starting to dominate Singapore. There, they could just say, "Ah, that's fine. We've got these two great markets. We're just going to milk it, we're done." But what they're thinking about very proactively is we need to move into North Asia – Korea, Japan, China – and so China, of course, right now you've got some state-owned banks, you've got a few non-state banks that have branches there, so you could get in a little bit there, but once the implementation happens, if they ever get a contract there, they're going to have a ton of work getting it implemented. What they did is they bought an IT service firm two, three years ago based in China to basically make sure they could train them and get them up to speed for whenever that contract shows up.

That's a very forward-thinking attitude you want to see, that "We're not going to go after this, but let's prepare for this. Let's spend the capital ahead of time so that we're there when the opportunity comes." I would say that's what you want to look for in any business, but especially I think when you go outside the US and you have companies that need to cross borders a lot of times for growth and once they get their own market, they need to cross the border, thinking about "How do I do that? What do I need to build out ahead of time, what local resources do I need to have?"

MOI: What would you say is the key challenge to investing in "moaty" companies globally, outside the U.S. especially?

Dorsey: That's a good one. Time zones are fun. I'm joking, but I think some of it is figuring out who the competition is. It's not like you just go down a GICS table and say, "Oh, look, the competition is right here, okay." It's often much more subtle than that and so you don't even know who else to look at until you've had a chance to talk to the company in-depth and you really know, "Oh, I need to be looking at these guys as the competitors," because it's just not quite so obvious, because they might be private, they might be listed in different countries and the data doesn't always match up quite well. That just requires more work, frankly. It's doable, but you can't just pull up your little comps table on Bloomberg and say, "Oh, okay, I know exactly how they should be trading." It just requires more peeling back of the onion, I would say. That understanding the competitive landscape cross-border, it's a trickier process, it requires more digging.

MOI: What about the nature, the quality of the moats, the compounders that one comes across in Europe or Asia, other parts in the world? One thing that strikes me is how often one comes across compounders, but then there's a real estate business, there is something else around there…

Dorsey: Things are cleaner in the U.S. We typically only have one class of shares; the holding company structure is not very common here. Family ownership is less common here, so that kind of complexity can be problematic, but again, it also creates opportunity. This German filter company I mentioned earlier, the parent is listed in Germany. The bioprocessing piece is listed in France and is 75% owned by the Germans and so you get this interesting cross-border thing and sometimes one piece is cheaper than the other. BMW, a lot of good value investors own BMW typically via preference shares, which don't have as many voting rights, but I think corporate stewardship there has been pretty good anyway, so why worry about it? I think the preference shares have been running 15% cheaper, about 20% cheaper than the regular ones. You don't see that kind of structure so often here.

"One thing I love to do when I talk to analysts and portfolio managers who are deeply rooted in a local country is ask them flat-out, 'Who are the three best capital allocators in your country? If you just gave them a pot of money, you're pretty sure it's going to be bigger ten years from now?' I've found some great businesses that way."

Christian Dior, which we own, the bulk of its value comes from its LVMH holding, but because it's less liquid, you get LVMH for about 20% cheaper than you would just buying LVMH directly. You don't really get those opportunities in the US as much to arbitrage different share classes and find value by poking around the corporate structure, but outside the US, because of these different share classes, different corporate structures, different listing requirements, you can find fun stuff sometimes.

MOI: Pat, is there anything that we haven't discussed that you feel is really important to global wide moat investing?

Dorsey: I need to think for a second. I've been pretty clean so far. I would say the biggest thing is just get out there and do the work. I mean that sounds simple, but the fun of looking globally and finding these wonderful businesses that may not even understand just how wonderful a business they have is they don't just show up on your screens very easily, they don't pop up very easily. You've got to peel back the onion. Silverlake Axis, the company I mentioned before, the Singapore-based banking company, bank software company, I found that by pulling up the entire Singaporean market, which is not that big and going down company by company by company to see what each one of them did. Trading company, real estate company, not so interested and I came across this one. I don't think I would have come across it any other way, so you've just got to go digging and, as Buffet said, build that mental database.

If you're a U.S.-based investor, get out of the U.S. If you're a Europe-based investor, get out of Europe. Go looking. When you talk to companies, ask them who their competition is, whom they respect. One thing I love to do when I talk to analysts and portfolio managers who are deeply rooted in a local country is ask them flat-out, "Who are the three best capital allocators in your country? If you just gave them a pot of money, you're pretty sure it's going to be bigger ten years from now?" I've found some great businesses that way. Sometimes they're portfolio managers, but sometimes they're companies, just companies where the management may have a pretty conglomerate, weird-looking group of companies, but when you dig back into the value they created, you say, "Wow, this is someone who understands much like those outsider folks, Bill Stiritz, The Rales Brothers—he understands how to deploy capital to generate an absolutely phenomenal return. You don't find them by looking on a screen; you find them by going out and asking questions.

MOI: Do you care to share any capital allocators you've come across internationally or companies or even countries where you've really found, to your surprise, more compounders, more opportunities than elsewhere?

Dorsey: I would say the place that people often shuffle off to Buffalo with bad, poor reasoning is South Africa. They think that the macro is horrible, which it is, they're all mining companies, which they're not. I think about 23% of the JSC is mining. Okay, that's a lot. That's higher than the 3% it is in the U.S., but that still leaves 75% of companies not doing mining, so let's start looking. There's a company down there called Bidvest run by a guy named Brian Joffe. You look at the annual report and this is the weirdest conglomeration of businesses I ever saw, but if you look at what he's done over time and the entrepreneurial spirit and culture that he's maintained in that conglomerate, it's incredible. He's a fabulous capital allocator.

"When investing in companies with an economic moat, the competitive advantage period is a key factor."

Then there's another one in South Africa called PSG Group that was started by an ex-stockbroker who got fired. He actually has a great book called *And Then They Fired Me*. Their three biggest holdings are South Africa's fastest-growing private education company, the first new South African bank to get a license in 30 years called Capitec and then a financial advisor network. Since they listed in '97, he's compounded value at something like low-40s percent. It's mind-blowing. I found that company by asking a fund manager in South Africa, a gentleman that manages South African capital, who are the best capital allocators down here and he just mentioned this company and said that I should go look at it. They're out there. It just takes some digging to find them.

MOI: On that note, Pat, I want to thank you so much for taking the time to share your experience and insights.

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