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WARREN BUFFETT STRATEGY

THE 'MOAT AND LORD' APPROACH

IN the days of yore across Europe, there were many castles. And many castles had moats. In fact, not only did castles have moats, even forts and towns had moats.

A moat is defined as a deep, wide ditch surrounding a castle, fort or town, typically filled with water, and intended as a defence against an attack. Having a moat was primarily a defensive move to thwart attacks.

Warren Buffett, the world-renowned fundamental investor, when evaluating potential investments, is always on the lookout for whether or not a company has a moat around the business.

He has been referring to his moat analogy for decades. He says one of the sure signs for a company to be successful is the presence of a definite moat. The moat in this context is akin to a competitive advantage that allows it to maintain pricing power and better-than-average profit margins.

These factors usually result in more significant returns for investors over the long term as companies can return more capital to their shareholders.

Businesses with durable competitive advantages do not have to invest much back into the enterprise to maintain this competitive advantage.

Buffett said "if you are evaluating a business year-to-year, the No. 1 question you want to ask yourself is — could the competitive advantage have been made stronger and more durable before — and that's more important than the profit and loss for a given year".

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The moat principle

Buffett explained his moat principle at the 1995 Berkshire Hathaway shareholders' annual meeting.

"We're trying to find a business with a wide and long-lasting moat around it, protecting a terrific economic castle with an honest lord in charge of the castle," said the chief executive officer of Berkshire to a question from the audience.

Buffett's mention of "an honest lord" should not be lost in translation. The best of moats can be ineffectual in the hands of a dishonest or incompetent lord (board).

He then went on to explain some key traits a company with a moat must have.

"What we're trying to find is a business that, for one reason or another, it can be because it's the low-cost producer in some area, it can be because it has a natural franchise because of surface capabilities, it could be because of its position in the consumers' mind, it can be because of a technological advantage, or any kind of reason at all, that it has this moat around it."

When he has found a business with a large moat around it, the next stage in Buffett's process is to try and figure out what is keeping the moat intact.

"But we are trying to figure out... why is that castle still standing? And what's going to keep it standing or cause it not to be standing five, 10, 20 years from now.

"What are the key factors? And how permanent are they? How much do they depend on the genius of the lord in the castle?"

Once Buffett and his right-hand man, Charlie Munger, have established the above factors, the next stage is to try and establish how capable the company's manager is.

"And then if we feel good about the moat, we try to figure out whether, you know, the lord is going to try to take it all for himself, whether he's likely to do something stupid with the proceeds, etc."

The three-step process

That's the three-step process Buffett said he had used to evaluate businesses since 1995.

First, it revolves around finding businesses that have a strong moat or competitive advantage. The next step is to establish how strong the moat is and whether the company will still be standing one or two decades down the line. The third stage is to assess the quality of management.

If all three provide a positive result, Buffett will look to invest in a business at a discount valuation. He wants to be sure that the companies will still be around after several decades and throwing off cash for the shareholders of Berkshire.

This strategy isn't particularly easy and requires effort. Nonetheless, the results have been nothing short of outstanding, for Buffett, at least. So, the key takeaway is to search for the moat and see who is the lord of the castle.

Investors may want to make the "moat and lord" approach an integral part of their methodology. It does make sense.

The writer is chief executive officer of Minority Shareholders Watch Group