Summer 2024

Financial markets, generally speaking, work very well until they catastrophically come off the rails.
— Ken Griffin.

"You don't necessarily get a lot of warning that there's about to be a big event. The crash of '87 is a great case study. That day, I woke up, I was in my dorm room trading then, and the stories of the day were about a small skirmish in the Middle East, of frankly no consequence, and the health of First Lady Nancy Reagan. And yet, we ended that day with the stock market down twenty-some percent, and a number of American financial institutions literally on life support or near death. It happened in one day. One day. There was no big story that morning that would make you think that that day might of been the end of the U.S. capital markets as we knew them. There was no warning. And so I worry that the debt crisis may have a similar construct. That there'll simply be a day where a major auction fails, and then you see a panic start to brew in the Treasury market. And the question will be, how fast will the Fed intervene? What panic will that induce? Because government intervention under duress often creates more panic." Ken Griffin.

Funny, and at times very scary, things can indeed happen in the stock markets. On Monday, June 3, 2024, a glitch on the New York Stock Exchange (NYSE) caused a temporary issue with Berkshire Hathaway's stock price.

Berkshire Hathaway's Class A share price displayed a dramatic drop of 99.97%, plummeting from its previous Friday closing of $627,400 to $185.10 per share. This significant decrease was obviously not a real reflection of the company's performance but a "technical error." The NYSE identified and resolved the glitch within a couple of hours, and trading for Berkshire Hathaway resumed at a price of around $648,000. Any trades executed during the glitch at the abnormal price were ultimately canceled by the NYSE.

Imagine the potential chaos if a high-frequency trading algorithm had been activated by this "technical error." These programs assess markets at incredible speeds and make trades based on complex formulas. If they detect a sudden sell-off, they might automatically place additional sell orders, amplifying the situation and creating a snowball effect with potentially catastrophic consequences for the entire market. Thankfully, that scenario did not unfold.

Robots

In the attachment, you'll find the latest results of the China and India robots. The benchmark iShares MSCI China Small-Cap ETF dropped almost 30% between the first trading day in August 2023 and the last trading day in July 2024. However, for the first time in five years, one of the China robots, Q25, achieved an impressive annual performance of 30.3% gross.

Unfortunately, over the past five years, none have achieved a compound annual growth rate (CAGR) exceeding 15%. This consistent underperformance raises questions about the underlying causes, for which I have no clear explanation.

The disappointing results of the China robots stand in stark contrast to the high-performing India robots. Over the past five years, all of them have significantly exceeded a 5-year CAGR of 15%, with the top performer, Q32, achieving a remarkable 5-year CAGR of 54% gross. If I were a Chinese government official overseeing the economy, I would definitely seek to understand what went wrong in China over the past five years and why neighboring India has seen a booming market for small-cap stocks.

Wingardium Leviosa! Here are the 2025 constituents, which should be purchased on the first trading day of August 2024 and sold on the last trading day of July 2025, or earlier if any of the automatic selling conditions are met.

Robot	Constituents
Q19 - Q25	Binjiang Service Group Co, Mobvista Inc, Zengame Technology Holding Ltd.
Q26 - Q32	Brightcom Group Ltd, Gabriel India Ltd, J. Kumar Infraprojects Ltd.

Binjiang Service Group Co. is a property management company in China. They handle the essentials like security, cleaning, and maintenance for residential properties. Additionally, they offer value-added services such as interior design and property agent services.

Mobvista, Inc. is a mobile advertising technology company. They help businesses advertise to users on various mobile platforms by providing targeted advertising solutions.

Zengame Technology Holding Ltd. is a mobile game developer and publisher. They create and distribute games specifically designed for mobile devices.

Brightcom Group Ltd. is an IT solutions and services provider. They offer a variety of services, including cloud computing, network security, and system integration, to businesses.

Gabriel India Ltd. is a manufacturer of suspension and shock absorbers for the automotive industry. Their products contribute to a vehicle's ride control and handling.

J. Kumar Infraprojects Ltd. is a civil engineering and construction company. They focus on building infrastructure projects such as roads, bridges, and power plants.

Moats

On September 15, 2022, Morgan Stanley published a study titled “Market Share: Understanding Competitive Advantage through Market Power,” authored by Michael J. Mauboussin and Dan Callahan. The study explores whether analyzing market share and related concepts can help identify if a company possesses a sustainable competitive advantage. This comprehensive investigation delves into life cycles, market share, concentration, markups, intangibles, and "superstars." It’s definitely worth your time.

The authors define sustainable competitive advantage as a company’s ability to generate returns on investment above the cost of capital and higher than its competitors for an extended period. I rarely use the weighted average cost of capital (WACC). WACC assigns weights to debt and equity based on a company's capital structure, which, while reflecting the average cost of capital for the firm, may not always represent the true cost of capital for individual investments. WACC is not a perfect science. Real-world business evaluation involves a deep understanding of the company’s future prospects rather than just relying on historical data or financial models.
I most certainly use returns on invested capital (ROIC) for competitive analysis. However, estimating ROIC is not as straightforward as many might believe. Companies have always invested in both tangible and intangible assets. Intangible investments have grown at a much faster pace than tangible ones over the decades. As the study shows, a company’s ROIC is lower after adjusting for intangible investments. For instance, they estimate that Microsoft’s ROIC (using average invested capital) for fiscal 2022 decreases from 49 percent to 34 percent with adjustments.

Identifying sustainable competitive advantages is challenging. The business world is dynamic. New disruptive technologies, changing consumer preferences, and innovative competitors can quickly erode an advantage that seemed secure. What gives you an edge today might be easily replicated tomorrow.

The appendix of the Morgan Stanley study includes a list of 98 companies with wide economic moats based on market share. This group of businesses has posted CFROIs (Cash Flow Return on Investment) that are substantially higher than the average of companies in popular stock market indices. I analyzed this list to determine which of these companies are the best value creators according to my approach. Additionally, I aimed to identify if any of these companies currently trade well below their intrinsic value, making them attractively priced. Out of the original list of 98 wide moat companies, 25 were identified as Hyper Value Creators (HVCs). Here they are:

Company	VCE	RR
NVIDIA Corp	109,0	1
Grupo Aeroportuario del Pacifico SAB	96,8	1
Rightmove PLC	88,0	1
ASML Holding NV	84,2	1
Evolution AB	80,4	2
Autodesk Inc	78,9	1
Mastercard Inc	78,7	1
Tesla Inc	77,4	2
Jumbo Interactive Ltd	76,9	1
Visa Inc	76,7	1
RELX PLC	74,8	1
Aena SME SA	73,6	2
IDEXX Laboratories Inc	72,8	1
Verisk Analytics Inc	69,9	1
Hermes International SA	68,7	1
Diageo PLC	68,6	1
Cadence Design Systems Inc	61,8	1
Moody's Corporation	61,0	1
Adobe Inc	60,0	2
Zoetis Inc	59,6	2
Christian Dior SE	59,4	2
Microsoft Corp	56,3	2
Johnson & Johnson	53,2	2
Alphabet Inc	51,8	2
Intuit Inc	51,4	2

- *VCE: Value Creation Engine, a for growth adjusted ROIC measure.*
- *RR: Risk Rating. 1 = Very Low Risk. 5 = Very High Risk.*

Finally, let's discuss valuation. No company has an infinite price, so the goal is to purchase it as affordably as possible. However, achieving this is often challenging. If you aim to buy a high-quality compounder at a very low price, you might miss the opportunity altogether because the market may never offer that price. On the other hand, if you purchase it at a high price to ensure you get in on time, you risk significant regret if the market collapses by 50% shortly afterward.

A stock's value is determined by the present value of its future cash flows. When evaluating a stock, consider the probability that these projected cash flows of the business will materialize (risk), the potential size of these cash flows (growth), the amount of investment required to maintain operations (return on capital), and the duration for which the business can produce excess profits.

There are many ways to assess valuation, and often there are different views and outcomes. One simple and effective method, which I believe should never be used in isolation, is to examine the price-to-sales ratio. Generally, a price-to-sales ratio of 8 is the maximum I am willing to pay, although I must admit that I find that already outrageously expensive. It's also often insightful to compare the current price-to-sales ratio with those from the past 10 years. If the current price-to-sales ratio is in the lower 10% of that range, the stock might be a bargain.

My analysis suggests that two companies, Grupo Aeroportuario del Pacífico SAB and Diageo PLC, might be good investment opportunities at present. These companies are trading at historically low prices relative to their sales and cash flow generation, based on ten-year data. Additionally, both companies have consistently maintained strong margins over the past decade.

Notably, Diageo PLC appeared in Berkshire Hathaway's 13F filing. There used to be some confusion about Berkshire Hathaway's holdings due to its subsidiary, General Re. Historically, General Re reported its own 13F filings separate from Berkshire Hathaway.

In May 2023, Berkshire Hathaway announced they would be consolidating General Re's holdings into their own 13F filing. Therefore, seeing Diageo on Berkshire Hathaway's 13F filing is now accurate. According to ChatGPT, Diageo was not a Berkshire Hathaway holding before May 2023; it was a holding of General Re before that time. Case settled.

According to Morningstar, a company can possess an economic moat if it has one or more sustainable competitive advantages that protect it from competitors. Morningstar identifies five primary sources of economic moats:

- **Network Effect**: This occurs when a product or service becomes more valuable as more people use it, creating a self-reinforcing cycle. Examples include social media platforms like Facebook and online marketplaces like eBay.
- **Intangible Assets**: These include patents, brands, regulatory licenses, and other intellectual properties that protect a company from competition. Companies like Coca-Cola, with its strong brand, and pharmaceutical companies with patented drugs exemplify this source.
- **Switching Costs**: These are costs that customers incur when switching from one product or service to another. High switching costs make it difficult for customers to change providers, thereby securing a stable customer base. Software companies like Microsoft benefit from high switching costs, as businesses find it costly and disruptive to switch operating systems or office software.
- **Cost Advantage**: Companies that can produce goods or services at a lower cost than their competitors can price more competitively or enjoy higher margins. Walmart, with its efficient supply chain and economies of scale, is an example of a company with a cost advantage.
- **Efficient Scale**: This occurs in markets that are effectively served by one or a few companies, discouraging new entrants. Utility companies often benefit from efficient scale as the infrastructure costs to enter the market are prohibitively high for new competitors.

These traditional moats enable companies to maintain profitability and ward off competitors over the long term, which is essential for successful long-term investments. In my opinion, a robust financial position and consistent cash flow generation are critical yet often overlooked components of sustainable competitive advantage.

It's not just about enduring tough times; it's the fuel that drives investment in promising new ventures. While other competitive advantages are often qualitative, a strong financial foundation offers the quantitative strength needed to seize opportunities.

Here are some of the most important qualitative, durable competitive advantages across the companies we discussed:

- **Technological Leadership and Innovation:** This is a common thread across all the companies. Consistent investment in R&D and a culture of innovation allow them to stay ahead of the curve, develop cutting-edge technologies, and bring new features and products to market that meet evolving customer needs. This creates a barrier to entry for competitors who may struggle to keep pace with rapid advancements.
- **Strong Brand Recognition and Reputation:** Building a strong brand takes time and consistent effort, but it pays off in the long run. A trusted brand name associated with quality, reliability, and innovation fosters customer loyalty and makes it easier to attract new users. Customers are more likely to choose a brand they recognize and trust. Coca-Cola is a classic example of a brand with strong pricing power. Coca-Cola can raise prices on its products and customers continue buying its products.
- **Diverse Product Portfolio and Ecosystem:** Offering a wide range of products and services that cater to different customer needs and integrate seamlessly with each other creates a valuable ecosystem. This can lock customers into a company's offerings and make it difficult for them to switch to competitors who may only offer a limited selection of products.
- **Data-Driven Strategies and Analytics:** The ability to collect, analyze, and leverage vast amounts of user data can be a game-changer. Companies can use this data to personalize user experiences, improve product offerings, develop targeted marketing strategies, and gain valuable insights into customer behavior. This data advantage can be difficult for competitors to replicate.
- **Focus on Customer Satisfaction and Retention:** Companies that prioritize customer satisfaction and build strong relationships with their customers are more likely to retain them in the long run. This can be achieved through excellent customer service, user-friendly products, and a commitment to continuous improvement. Loyal customers are less
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- likely to be swayed by competitors' offerings.
- **Strategic Acquisitions and Partnerships:** Smart acquisitions and partnerships can be a powerful way to expand a company's product portfolio, enter new markets, and access new technologies. This allows companies to grow quickly and efficiently without having to develop everything in-house.

By prioritizing these areas, companies can cultivate a resilient foundation for enduring success within their industries. These newly identified sources of durable competitive advantages, or perhaps a better phrase for it is "more holistically defined moats," seamlessly integrate with the more traditional Morningstar economic moats. Let's delve into how each aligns.

1. Technological Leadership and Innovation

- Intangible Assets: Continuous investment in R&D and a culture of innovation often lead to the development of intellectual properties such as patents. These patents protect the company's innovations, making it difficult for competitors to replicate their technology.
- Cost Advantage: Advanced technologies can lead to more efficient production processes, reducing costs over time.
- Network Effect: Cutting-edge technologies can enhance the user experience, attracting more users and thereby creating a self-reinforcing cycle of adoption.

2. Strong Brand Recognition and Reputation

- Intangible Assets: A strong brand is a significant intangible asset. It takes time and consistent effort to build a brand associated with quality and reliability, which in turn creates customer loyalty and trust.
- Switching Costs: Customers are more likely to stick with a brand they trust, as switching to a lesser-known competitor might entail risks and uncertainties about quality and service.

3. Diverse Product Portfolio and Ecosystem

- Switching Costs: When customers use multiple products and services within a single ecosystem, the integration and convenience create high switching costs. For example, Apple's ecosystem of devices, software, and services makes it inconvenient for users to switch to competitors.
- Network Effect: A comprehensive ecosystem can attract more users, which in turn makes the ecosystem more valuable and can create a network effect. For example, more users on a platform can lead to more developers creating compatible applications, enhancing the overall value.

4. Data-Driven Strategies and Analytics

- Network Effect: Data-driven strategies can enhance user experiences and lead to improved products and services, which can attract more users, creating a self-reinforcing cycle.
- Cost Advantage: Efficient use of data analytics can streamline operations and reduce costs by optimizing processes and resources.

5. Focus on Customer Satisfaction and Retention

- Switching Costs: High levels of customer satisfaction and strong relationships can lead to high switching costs, as customers are less likely to leave a company they are happy with.
- Intangible Assets: Reputation for excellent customer service and user-friendly products can be considered an intangible asset that attracts and retains customers.

6. Strategic Acquisitions and Partnerships

- Efficient Scale: Acquisitions and partnerships can help a company achieve scale quickly, allowing them to serve markets more effectively and discourage new entrants.
- Intangible Assets: Acquiring companies with strong brands, technologies, or customer bases adds to the acquiring company's intangible assets.
- Cost Advantage: Acquisitions can lead to synergies and cost efficiencies, such as

streamlined operations or expanded economies of scale.

So here we are.

To become a great chess player, you need to study and practice extensively until you develop a specific "chess neurochemistry" in your brain, which you must then continuously reinforce through daily practice and learning. Similarly, identifying great businesses with durable competitive advantages is a skill that must be acquired through experience.

Hopefully, you found some clues to becoming a better spotter of great businesses by reading this letter. As demonstrated, each of these broadly defined qualitative competitive advantages can be directly associated with one or more of the traditional Morningstar economic moats, creating robust and durable competitive positions. Refining your understanding of these qualitative factors will undoubtedly enhance your ability to identify strong and enduring competitive advantages.

Wayne Gretzky's famous quote, "Skate to where the puck is going to be," captures the essence of Warren Buffett's investment philosophy. This emphasizes the importance of looking forward and understanding the long-term dynamics of the competitive landscape rather than simply focusing on past performance and evaluating historical WACC and ROIC.

And finally, Buffett emphasizes the importance of knowing as much as you can about the person who's running the business, the leadership team as a whole, and how they think about the business and what's really going on in that industry.

"If we own stock in a company and there are eight other companies that are in the same industry, I want to read the reports of all of these nine companies, because I can't understand how my company is doing unless I understand what the other eight are doing. I want to have a perspective in terms of market share, what's going on in the business, the margins, the trend of margins, etc. I can't be an intelligent owner of a business unless I know what all the other businesses in that industry are doing." — Warren Buffett.

It takes a long time to read an annual report, even if it is a relatively simple business. Trying to understand it through the lens of durable competitive advantages and the future dynamics of the competitive landscape is not easy.

I appreciate you taking time to read this edition. It has been a great pleasure writing it.

Peter

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