Follow the Buffett Strategy

Investors try to cut risk with funds that look for entrenched businesses

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August 2, 2012, WSJ

Raise the drawbridge and man the parapets. Some investors are looking to defend their portfolios with help from mutual funds and exchange-traded funds that buy stocks of companies with "wide moats"—meaning barriers to entry that their competitors find extremely difficult to overcome.

"Moat" is Warren Buffett's description of such an advantage. The famed investor has said that he seeks "economic castles protected by unbreachable 'moats.' " The idea is to buy, when they are reasonably priced, shares of companies that dominate their industries and show clear potential to maintain their superiority over decades.

"A company that has a greater duration of competitive advantage is simply worth more," says Paul Larson, chief equity strategist at investment researcher Morningstar Inc., which since 2002 has made moat ratings a cornerstone of its stock grading. Wide-moat companies, he adds, "should be able to parlay that into higher returns on invested capital."

The Five Moats

What affords one company a wide moat while others have a narrow moat or none at all? Morningstar describes five ways moats develop. In the first, the so-called network effect, a service becomes increasingly valuable as more people adopt it. Second, customers lack incentive to embrace a competing product. A virtual monopoly or control of a limited market can be a third type of moat, such as an airport-services provider would command. A fourth consists of proprietary brands, patents and licenses that create consistent cash flow. And a final advantage is pricing, or the ability to sell a better product cheaply, generating higher profit margins.

"A wide-moat business, purchased at the right price, is the ultimate 'sleep well' kind of investment," says Jason Subotky, co-manager of the $7 billion Yacktman Fund, which holds many companies that the managers consider wide-moat, such as Procter & Gamble Co., Coca-Cola Co. and Microsoft Corp. Says Mr. Subotky: "We look for as much stability, predictability, and quality of earnings and free cash flow as you can get."

Even wide-moat firms are challenged in economic downturns, but a company's strength and flexibility can work to keep it afloat and poised for growth when conditions improve.

The larger the moat, the stronger the company, says Eric Schoenstein, co-manager of Jensen Quality Growth, which considers many of the stocks in its value-oriented portfolio to have wide moats, including Praxair Inc., http://online.wsj.com/public/quotes/main.html?type=djn&symbol=PX?mod=inlineTickera supplier of industrial gases, and Varian Medical Systems Inc., http://online.wsj.com/public/quotes/main.html?type=djn&symbol=VAR?mod=inlineTickera maker of devices and software for treating cancer and other illnesses.

Companies with wide moats produce a lot of cash, Mr. Schoenstein says, which places them "in a better position to invest in new products, new advertising, to create more demand."

Morningstar in 2007 created its Wide Moat Focus Index, composed of what Morningstar considers to be the 20 least-expensive wide-moat stocks among a universe of 1,200 U.S. stocks. Most are large companies with a broad customer base. Nowadays the biggest stakes are in technology, materials and financial-services stocks, with notably little in the consumer sector.

The index, which is redrawn every three months, currently includes Google Inc., General Electric Co., Bank of New York Mellon Corp., Oracle Corp. and Cisco Systems Inc.

The strategy has paid off. For the five years through July, the equal-weighted index (each position gets 5% of the portfolio in a quarterly rebalancing) gained 7.4% annualized, with dividends, versus a total return of 1.1% for the Standard & Poor's 500-stock index and 2.6% for an equal-weighted version of the S&P 500, Morningstar says.

In a truly efficient market, wide-moat stock prices would reflect their advantage. But markets aren't 100% efficient, Mr. Larson notes. When a wide-moat company runs into difficulty, investors tend to underestimate its ability to rebound and undervalue the shares. "When you add the valuation layer, that's where the real performance comes from," he says.

The wide-moat index is used in two exchange-traded products—Market Vectors Morningstar Wide Moat Research ETF (ticker: MOAT) and Elements Morningstar Wide Moat Focus exchange-traded note. The ETF, launched April 25, recently had $38 million in assets. The ETN, begun in 2007, had close to $15 million. The ETF is cheaper, with an expense ratio of 0.49% compared with 0.75% for the ETN.

The two have some key differences. The ETN's return matches the index, though as an unsecured debt obligation it is exposed to the credit risk of the issuer, Deutsche Bank. The ETF, meanwhile, typically will display some index-tracking error but owns the underlying stocks.

Many Choices

Investors looking for ETFs with an abundance of what Morningstar considers wide-moat stocks have many other choices, some quite inexpensive. SPDR Dow Jones Industrial Average and Schwab U.S. Dividend Equity, for example, charge just 0.17% in expenses, while Vanguard Dividend Appreciation ETF charges 0.13%.

Highly rated mutual funds with above-average wide-moat holdings and below-category-average expenses include Yacktman, Vanguard Dividend Growth, John Hancock U.S. Global Leaders Growth, Dreyfus Appreciation and Pioneer Fundamental Growth, according to Morningstar.

Yacktman's Mr. Subotky says, "It's great to have these kinds of franchises that have durability and are resistant to difficult times."

Investors should remember, though, that even wide-moat companies can eventually lose their edge to a better-run rival or a costly mistake. In other words, moats can be a big plus, but they don't last forever.

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