Financial Voyage

Warren Buffet “Big Moats” principle.

Warren Buffet likens the companies he invested in as castles with deep and wide moats. These are businesses that competitors would have huge difficulties overcoming.

This is the first of two maps we are planning on Warren Buffet’s ideas on investing.

We offer you Warren Buffet moat principle here. For experienced readers of our maps, you will discover that the principle captures some basic map forms that is applicable to other situations.

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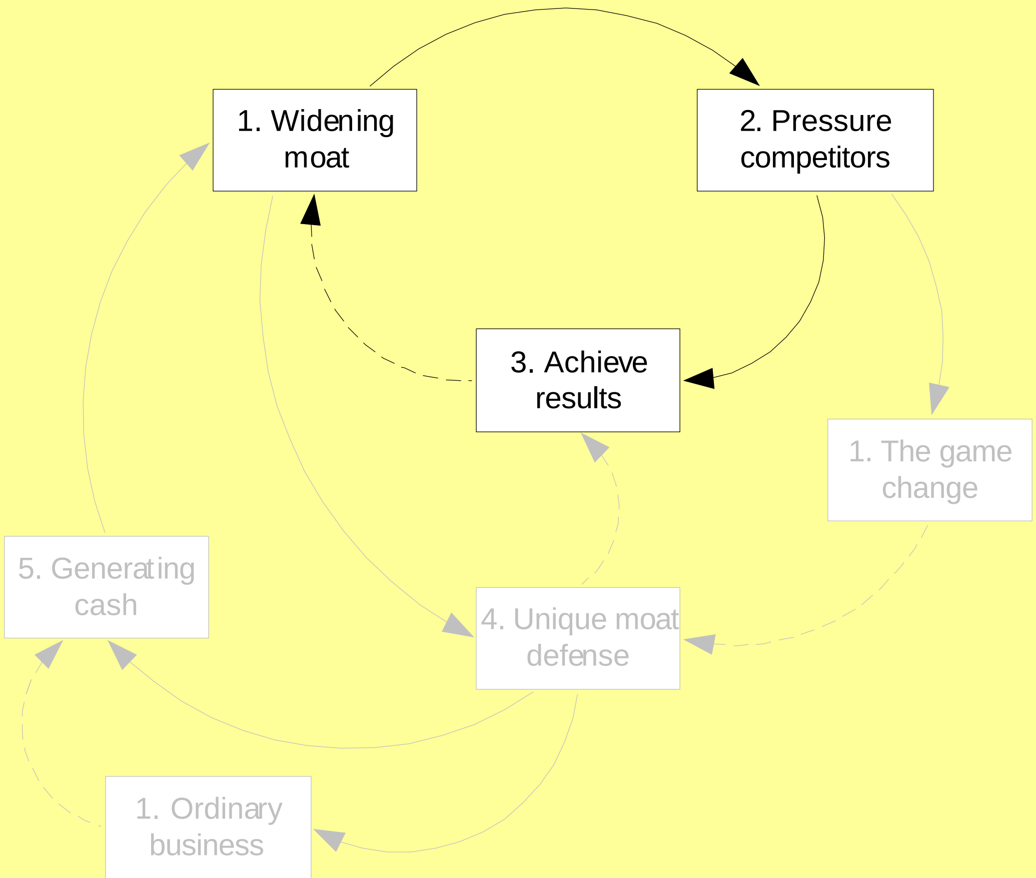
1. A business that is able to widen its moat, i.e., raise its entry barriers to others (box 1) successfully will create additional competitive pressure on others playing in the same space (box 2) – they want to share your booty. It will achieve handsome results (box 3), which over time has the effect of reducing the effectiveness of the moat (box 1), i.e., they think it is sufficiently worthwhile to attack your castle despite the moat.

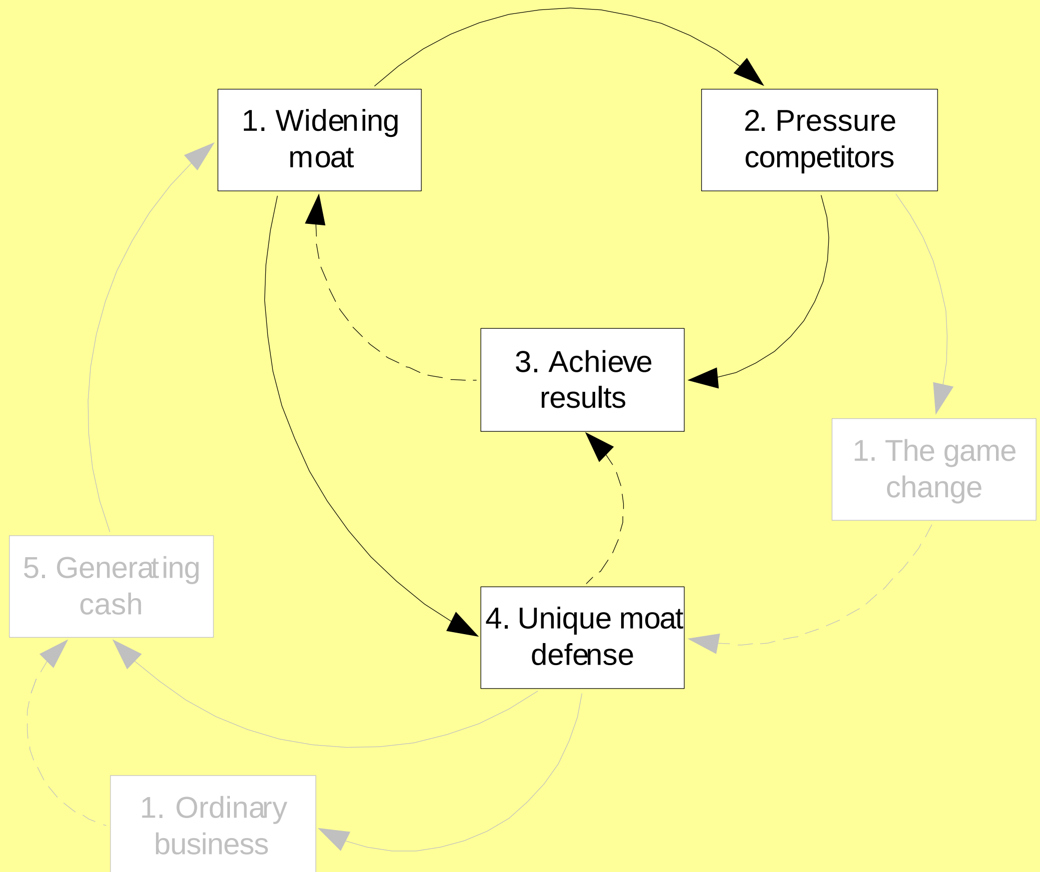
It is useful to explain the relationship between box 3 and box 1 with an example.

Few companies can claim to have competed successfully against Microsoft. Palm Computing was one such example, and the margins are huge too. But with overwhelming success (box 3), the market opportunity becomes so attractive, that new players are not discouraged by the moat (the dotted line from Box 3 to Box 1). Although the jury on Palm's fate is still out, we are not optimistic.



2. The very good ones, those that eventually qualify to form part of Berkshire Hathaway portfolio is able to create moat defense that are unique (box 4) – read hard to breach. That is what Buffet means when he says some companies appear like they can maintain their edge for 20 years or more.

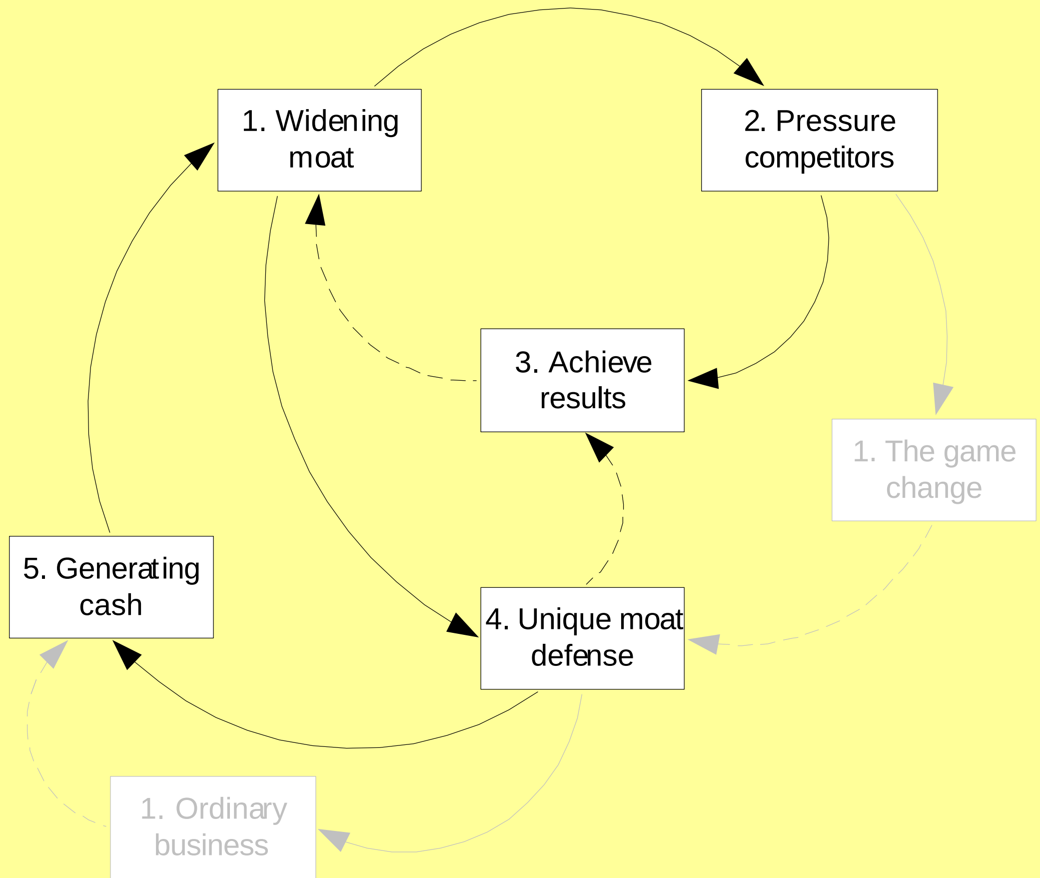
Box 4 takes away the dotted line from Box 3 to Box 1, i.e., we could have removed Box 3 and Box 4 and just have a simple reinforcing loop between Box 1 and Box 2. (Note: dotted line between Box 4 and Box 3 is not a mistake) But we should not make the simplification, because Box 3 and Box 4 are meaningful. The map shows the twist that makes it difficult to identify such companies. Everyone can understand and pursue a simple positive reinforcing loop.



3. Here is why Box 3 and Box 4 are necessary.

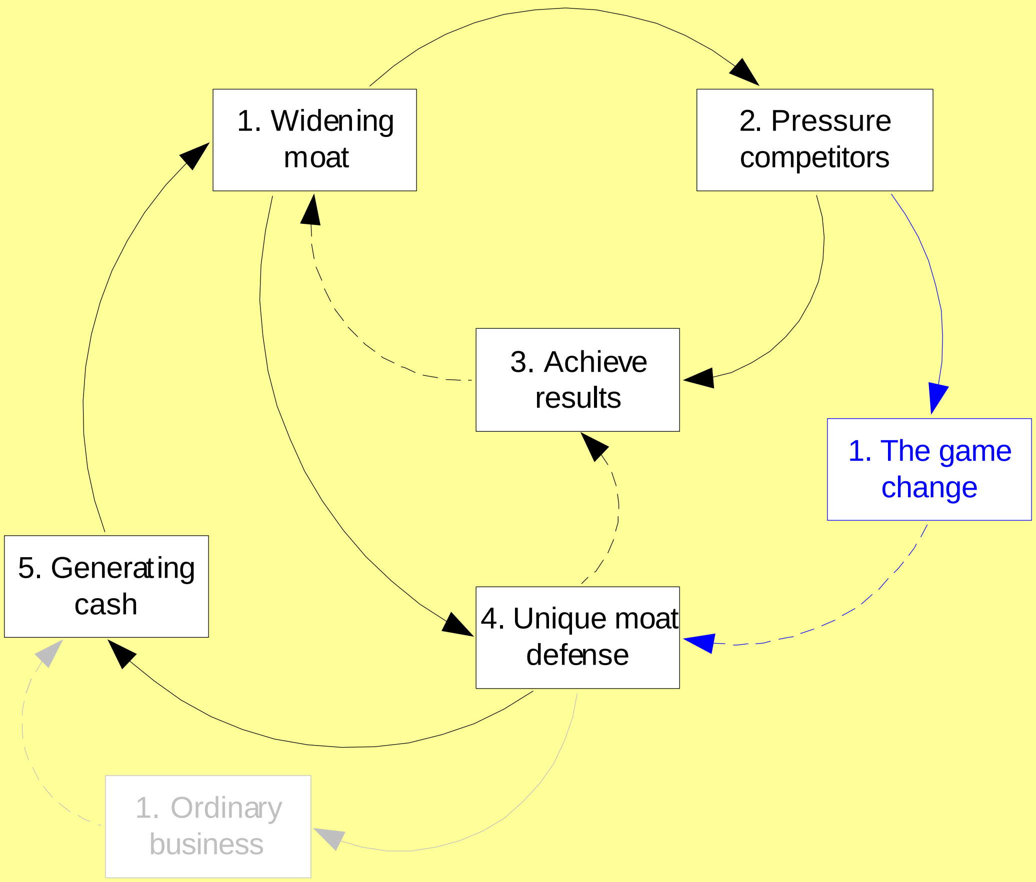
Firstly, it separates the companies that enjoy a temporary competitive advantage to those that enjoy a more permanent edge.

Secondly, it creates the reinforcing loop as shown linking Box 1, Box 4 and Box 5. This is accelerative and that is the secret to the outstanding performance of Buffet invested or owned enterprises.



4. But nothing stays still forever, especially for technology type businesses. The game eventually changes (box 1) and threaten Box 4.

Buffet tries to unload his investment before this happen. As the moat does not disappear suddenly, there is usually ample time to act as long as you know what to look at. This is “easy”. It is the reverse of the reason why the investment was made in the first place.



5. It takes a lot of effort from the managers of these outstanding enterprises to remain in their premium position. But if Box 4 is destroyed, the business becomes ordinary (box 1). At best we could hope for is a business that is a simple reinforcing loop between Box 1 and Box 2, which is not sustainable.

<u>Conclusion</u>

Most people look for good businesses as a simple reinforcing loop between Box 1 and Box 2. You will not find any, because the advantage is transient, often it could be given temporarily by a supportive environment, especially when demand exceeds supply.

Most people cannot identify a situation as in Box 1 to Box 5 here. There are many such opportunities out there, but Warren Buffet cannot take advantage of them because Berkshire Hathaway has become too big. And given his size, he is not afraid of sharing his secret of success with us either. That is his contribution to society on how to allocate assets better.