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Charlie Munger on Moats (First of the Four Essential Filters)

Posted by *trengriffin*

If there is anything fundamental about what Charlie Munger has learned about business it is this:

"The difference between a good business and a bad business it is that good businesses throw up one easy decision after another. The bad businesses throw up painful decisions time after time." http://bit.ly/S5iN7K

Why do some businesses create easy decisions? The answer lies in microeconomics: if there is no significant "barrier to entry" which creates what Harvard Business School Professor Michael Porter calls a "sustainable competitive advantage" (a "moat" in Berkshire parlance), competition will cause return on investment for that business to drop to opportunity cost and there will be no economic profit for the producer. The analogy they use at Berkshire is that the business itself is the equivalent of the "castle" and the value of that castle will be determined by the strength of the "moat."

The need for a business to have a "moat" is so strong that Munger has made it one of the **"four essential filters"** he uses in deciding whether to invest in a given business. The **four essential filters** are:

1. A business with a moat,
2. A business that can be understood by the investor,
3. Management in place with integrity and talent, and
4. A business that can be bought at an attractive price that gives an attractive margin of safety. http://www.psyfitec.com/2009/10/buffett-and-munger-on-bbc.html

Before examining each of these **four essential filters** one-by one, it is important to point out that these **"four skills"** below which relate to moats are very different that the **four essential filters** themselves:

1. **Creating a moat** which is something that people like Ray Kroc, Sam Walton Estee Lauder, Mary Kay Ash and Bill Gates have accomplished. Moat creation requires superior management skill always combined with some degree of luck. It is theoretically possible to acquire a moat with no management talent and just luck but I can't think of an example of this ever happening. Sometimes people who are fantastic managers who have the ability to create a moat have very poor skills when it comes to investing. Stock promoters love these people since they are big targets for scams.
2. **Identifying a moat that others have created** which is something that people like Charlie Munger and Warren Buffett can do. Munger admits that he and Warren Buffett buy moats rather than build them since building them is not something they do particularly well. In addition to a moat Charlie insists that there be a talented management team already in place. For an investor who buys moats instead of creating one, the existence of a moat has special value since they can sometimes survive financially even if management talent does not deliver as expected or if they leave the business.
3. **Identifying a startup that may acquire a moat before it is evident** which is something that some venture capitalists can do at a sufficiently high level of probability that they can generate an attractive return on capital overall. This skill is very rare as evidenced by the fact that the distribution of returns in venture capital is a power law. Moats that emerge from complex adaptive systems like an economy are hard to spot since a moat is something that greater than the sum of the parts emerging from something else that is greater than the sum of its parts. In contrast, a moat being destroyed is easier to spot since it is a process of something transforming into nothing.
4. **Describing a moat in academic terms which** is something that someone like Michael Porter can do. Why this is a rare talent in academia is a puzzle. The reason for this is that simple theories are not the sort of things that will get a person a tenured faculty position. This essay could go on for many pages quoting Munger railing about deficiencies in academia. Here are just two:

"I was recently speaking with Jack McDonald, who teaches a course on investing rooted in our principles at Stanford Business School. He said it's lonely — like he's the Maytag repairman." http://www.fool.com/boringport/2000/boringport00051500.htm "

Warren once said to me, "I'm probably misjudging academia generally [in thinking so poorly of it] because the people who interact with me have bonkers theories." … We're trying to buy businesses with sustainable competitive advantages at a low – or even a fair price. The reason the professors teach such nonsense is that if they didn't], what would they teach the rest of the semester?" http://www.tilsonfunds.com/motley_berkshire_wescomeetings.php (2004)

Each of these four skills which relate to moats is very different and it is unusual for a person to have all four skills. Many people just have one. More importantly, well over 90% of the population of the world has none of these skills. Tragically for them, the population that thinks they have this set of skills is far higher than 10%. For society, this overconfidence is valuable since "even a blind squirrel finds a nut once in a while" via luck.

Merely because a person can identify that a given company has a moat does not mean that they have any ability to create a moat as a manager. At the 2012 Berkshire meeting Munger admitted that the brand-based moats which Berkshire has are bought rather than created. The ability to spot a moat that someone else created is very different from the ability to create a moat, believes Munger. You don't need to know how to make hamburgers to spot that McDonald's' has a moat, but don't try to build a business like McDonald's without the abilities that Ray Kroc had.

At the 2012 Berkshire meeting Charlie said:

"We buy barriers. Building them is tough… Our great brands aren't anything we've created. We've bought them. If you're buying something at a huge discount to its replacement value and it is hard to replace, you have a big advantage. One competitor is enough to ruin a business running on small margins." http://gongol.com/research/berkshire/2012/

Sometimes great managers can transition to become great venture capitalists and sometimes not. As another example, Michael Porter has done a great job taking some fundamental ideas from microeconomics and introducing it to business schools, but I would not give him five cents to start a business or invest money on my behalf. Perhaps he is a good manager or investor but I have zero data to indicate that this might be true other than he has described some important principles in an academic way.

Recently someone argued on a blog that because some academics affiliated with Michael Porter's theory on sustainable competitive advantage do not have the management skill required to create a moat themselves, that "sustainable competitive advantage simply doesn't exist" other than created by government regulation. http://www.forbes.com/sites/stevedenning/2012/11/20/what-killed-michael-porters-monitor-group-the-one-force-that-really-matters/ First and most importantly, as will be explained below, the test of whether a moat exist is quantitative (it is a 100% math-based test). The simple of mathematics reveals that many companies have moats in many sectors of the economy that have existed for many years. Second, as I have explained above, not everyone has all **four skills** that relate to moats. That a team of academics can't create a moat does not mean sustainable competitive advantage does not exist. The act of successfully creating a moat is a rare event. Berkshire's portfolio of companies alone (e.g., See's Candies) proves that moats are sustainable for a very long time. Google and Oracle are just two of many companies that have generated **sustained** profitability that meets the test for a moat.

The blogger's own thesis is that companies should continuously innovate instead. That Porter's work would not support the need to constantly innovate, create new value or disrupt your own business is a baffling conclusion. The two issues are orthogonal. The thesis that Clayton Christensen's work invalidates the work of his fellow professor at Harvard Business School Michael Porter is simply false. That profit is **hard** to sustain does not mean that it is **impossible** to sustain. Nowhere does Michael Porter say that a moat can be maintained forever.

The blogger's thesis also suffers in that it has no predictive power. It is consistent with the sort of promotion that you see around hyped IPOs. "It's disruptive!" is not a substitute for profit unless your goal is to flip the business to someone else. Disruption alone without anything behind it is the management equivalent of EBITDA.

Clayton Christensen's work around disruptive innovation is super important and wise (you will see links to it below), but don't kid yourself that disruption without a moat will necessarily lead to actual GAAP profit. Disruption is a fantastic place to look for profit whether the business is a startup or an established business, but sometimes profit is just not there. If you don't have a moat somewhere and are unable to flip your company to a greater fool or a company that is already profitable who needs it for defensive reasons, you will soon fall prey to the only unforgivable sin in business: running out of cash. Giving away everything for free while generating zero profit is at best an interim strategy or a description of the Java business model that Sun adopted.

Do some companies create something so disruptive that benefits consumers so much that someone must buy that service or product to stay competitive even though it generates no incremental profit? Absolutely. But in such a case only consumers benefit since only positive outcome is the creation of **consumer** surplus. **Producer** surplus for that disruptive innovation can be zero or less than zero. That is part of the reason why capitalism benefits consumers. To offer a "loss leader" you must in the medium term at least have a base business that generates a profit that is tied to that loss. But I am getting ahead of myself. You can read more on disruption in a futurepost.

Returning to the discussion of the four essential filters, whether a business has a durable moat is without question the most important filter for an investor like Charlie whose chosen profession is buying moats. For example, Charlie describes a moat in three different ways immediately below, each emphasizing the importance of the moat being able to maintain itself over time.

“We have to have a business with some inherent characteristics that give it a **durable competitive advantage**.” http://www.youtube.com/watch?v=3XlBrohrIUc

“The number one idea is to view a stock as an ownership of the business and to judge the **staying quality** of the business in terms of its **competitive advantage**.” http://www.valuewalk.com/charlie-munger-page/

“We’re trying to buy businesses with **sustainable competitive advantages** at a low – or even a fair price.”

Charlie may reference another of the four essential filters in a statement but invariably the requirement of a moat is present in his statement. My belief is that of the four filters, nothing is more essential than moat. The second filter is about reducing the number of mistakes made and filters three and four essentially layer on a “margin of safety” when making an investment. In other words, moats are the foundation of Munger’s investment process and methodology. Everything starts with the moat (or lack of a moat) for Charlie because he does not create moats, he buys them.

Components of a Moat:

Munger has not explained his theories on what causes a moat as comprehensively as Warren Buffett, but he has made some comments that point people in the right direction. In addition there are all the companies in the Berkshire portfolio that illustrate what a moat is, like Geico, Burlington Northern, See’s Candies.

The primary components of a moat that Charlie has talked about are as follows:

1. Supply-Side Economies of Scale

There are two types of “economies of scale” and the first is supply-side economies of scale. A large firm that is part of an oligopolistic market will generate significant supply-side economies of scale in its production of goods and services as per-unit costs fall with increasing output. Due to factors like the difficulty of managing large firms, economies of scale ar exhausted well before those firms from dominate the entire market.” The economists Varian and Shapiro in their book *Information Rules* write about supply-side economies of scale via an example: “Despite its supply-side economies of scale, General Motors never grew to take over the entire automobile market.”

Samsung is reaping the benefits of supply-side economies of scale as does Intel. Clayton Christensen argues that the worship false accounting gods like RONA have caused many companies to outsource tasks like the semiconductor fabrication and lose important supply- side economies. He argues that outsourcing has harmed many companies in the long-term even though in the short-term it may have seemed wise.
http://gartner.mediasite.com/mediasite/play/9cfe6bba5c7941e09bee95eb63f769421d

In Charlie’s view Wal-Mart has massive supply-side economies of scale through its investments in distribution and other systems. These and other Wal-Mart investments have given the company a moat. Wal-Mart also possesses a high degree of operational effectiveness which adds it its profitability. Like Wal-Mart companies which operate huge steel plants and shipyards can have supply-side economies of scale. Markets like these tend to end up as part of an oligopoly since supply-side advantages only go so far to consolidate an industry.

Munger described two different supply-side economies of scale below:

“On the subject of economies of scale, I find chain stores quite interesting. Just think about it. The concept of a chain store was a fascinating invention. You get this huge purchasing power — which means that you have lower merchandise costs. You get a whole bunch of little laboratories out there in which you can conduct experiments. And you get specialization. If one little guy is trying to buy across 27 different merchandise categories influenced by traveling salesmen, he’s going to make a lot of dumb decisions. But if you’re buying is done in headquarters for a huge bunch of stores, you can get very bright people who know a lot about refrigerators and so forth to do the buying. The reverse is demonstrated by the little store where one guy is doing all the buying. So there are huge purchasing advantages.

Some [supply-side advantages] come from simple geometry. If you’re building a great circular tank, obviously as you build it bigger, the amount of steel you use in the surface goes up with the square and the cubic volume goes up with the cube. So as you increase the dimensions, you can hold a lot more volume per unit area of steel. There are all kinds of things like that where the simple geometry – the simple reality – gives you an advantage of scale.” http://ycombinator.com/munger.html

Munger explains below how changes that have taken place in the advertising industry, which perhaps explain why Procter & Gamble has started to struggle more than it has in the past in delivering the same level of profitability:

“You can get advantages of scale from TV advertising. When TV advertising first arrived – when talking color pictures first came into our living rooms – it was an unbelievably powerful thing. And in the early days, we had three networks that had whatever it was – say 90% of the audience. Well, if you were Procter & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so damn many cans and bottles. Some little guy couldn't. And there was no way of buying it in part. Therefore, he couldn't use it. In effect, if you didn't have a big volume, you couldn't use network TV advertising – which was the most effective technique. So when TV came in, the branded companies that were already big got a huge tail wind.” http://ycombinator.com/munger.html

This may also explain in part why Berkshire has dropped its stake in Johnson and Johnson to very low levels. Johnson and Johnson has been a lagging performer for Berkshire and is now out of favor with Munger and Buffett.

Although Berkshire was a bit late to appreciate the attractiveness to an investor of the railroad business, Munger and Buffett clearly value the moat that supply-side economies scale creates in the railroad business. A new competitor in the railroad business is highly unlikely. As the public roads deteriorate as the United States underinvests in infrastructure and energy prices rise, railroads will get even more competitive. Munger has said:

“Do you know what it would cost to replace Burlington Northern today? We are not going to build another transcontinental. And those assets are valuable, have utility. Now they want to raise diesel prices on trucks. … We finally realized that railroads now have a huge competitive advantage, with double stacked rail cars, guided by computers, moving more and more production from China, etc. They have a big advantage over truckers in huge classes of business. http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf

Railroads are interesting in that long ago they were a growth industry that both created great fortunes and great busts in the aftermath of that success. There were times in history when railroads were very lousy investments.

Regarding the impact of supply-side economies of scale Charlie has pointed out:

“In some businesses, the very nature of things cascades toward the overwhelming dominance of one firm. It tends to cascade to a winner take all result. And these advantages of scale are so great, for example, that when Jack Welch came into General Electric, he just said, ‘to hell with it. We're either going to be number one or two in every field we're in or we're going to be out’. That was a very tough-minded thing to do, but I think it was a correct decision if you're thinking about maximizing shareholder wealth.”

Berkshire has recently sold nearly all of its shares in GE, which is a reminder that moats come and go as time passes and conditions change. People who follow Munger and Buffett might have laughed not too long ago if someone were to have predicted that GE would lose favor with Berkshire.

2. Demand-side Economies of Scale (Network Effects):

Demand-side economies of scale (also known as “network effects”) result when a product or service becomes more valuable as more people use it. Unlike supply-side economies of scale, network effects can be (1) nonlinear and (2) continue to accrue to benefit the company for far longer. Given a choice between supply-side economies of scale and demand-side economies of scale, it is preferable to have the latter. Varian and Shapiro in their book *Information Rules* write: “Unlike the supply-side economies of scale, demand-side economies of scale don't dissipate when the market gets large enough.”

eBay, Craigslist, Twitter, Facebook and other multi-sided markets have demand-side economies of scale that operate on their behalf. My view is that ESPN also has demand-side economies of scale, most notable for Sports Center, since the more people who watch the ESPN channels, the more valuable the channels are to each user since those particular images will be the basis of discussion for sports fanatics. Fox and other sports channels just can't replicate that demand side effects since when someone says “did you see X do Y in the Z game?” If you watched Fox version of Sports Center, you may not have seen the particular video clip.

Google has at least two beneficial demand-side economies of scale (one for search and one for advertising targeting) that are mutually reinforcing that give it a strong moat according. Munger has said:

“Google has a huge new moat. In fact I've probably never seen such a wide moat.” http://seekingalpha.com/article/140485-would-buffett-consider-google-a-great-investment

“I don't know how you displace Google but a lot of the other companies will have competitive troubles.” http://www.investingdaily.com/11313/google-up-13-on-great-earnings-and-google-is-facebook-in-trouble

Some companies have both demand and supply-side economies of scale. Amazon has both supply-side and demand-side economies of scale and they reinforce each other. For example, the more people who provide comments on Amazon the more valuable it becomes to other users due to demand-side economies. Amazon also has huge advantages on warehouses and the supply chain on the supply-side.

There are both weak and strong supply-side demand-side economies of scale and they fall along a continuum in terms of relative strength. Most companies have both supply-side and demand-side economies. The "holy grail" for an entrepreneur is demand-side economies of scale that can cause a market to "tip" and give almost the entire market to one company. The reality is that most demand-side economies do not cause a market to "tip." For example, GM's cars were better to a degree at one point since the more people who owned the cars, the easier auto parts were to get, but weak demand-side economies like that were not strong enough to make the market "tip."

If a market does "tip" and a competitor is the one to reap those benefits, things can go really wrong, really fast. For example, MySpace started to monetize before the social networking market "tipped" and MySpace paid the price and Facebook reaped the rewards. Facebook held off monetizing until its moat was secure. Zuckerberg was patient about waiting for the market to tip and Rupert Murdoch was not.

One illustrative example can be found in the cement industry. Cemex's cement business gets better the more trucks it has in play in a given geographic area. The service gets cheaper with supply-side scale due to lower COGS (e.g., less gas consumed), it gets better (faster delivery times) due to demand-side economies. And that combination of supply and demand-side economies creates a barrier to entry that helps Cemex.

Which came first, the faster supply of cement to contractors due to more plants (the egg) or greater demand from contractors due to faster delivery times (the chicken)? I believe Cemex intentionally created an egg, knowing there would be greater demand for the service. This solution to the "chicken and egg" problem is typical in multi-sided markets. However, in this case the Cemex demand-side economies were not strong enough to make their market for cement tip.

My thesis about Chinese restaurants is similar: When you have more customers for Chinese food, the food turns over faster and so it is fresher and better, holding the level of cooking constant. More customers for Chinese food not only lowers cost of goods sold (COGS) since they buy in volume, but increases quality. But a market like this is not going to tip

As another example, Costco is a better value the more its "store geographic scope" and density increases since I can, for example, use it when visiting relative in another state. Costco also has supply-side economies of scale. Since a market like Costco is in is not going to tip and so oligopoly is likely.

It could be argued that Cemex, GM and Chinese restaurants with high volumes have some demand-side economies of scale in addition to their supply-side economies of scale. But the demand-side economies are not strong enough to tip to one dominant supplier. Lots of other industries are similar. Credit card markets did not tip enough to prevent multiple providers. Car rentals did not tip and are instead an oligopoly.

Supply-side economies of scale can be really powerful. The jet turbine makers have supply-side advantages that makes them very profitable. Are there advantages to customers of easier access to parts if they buy a Rolls Royce jet turbine that might create some demand-side benefits? Sure. But can China open its checkbook and create a new jet engine competitor? I think so. In the case of jet turbines supply-side benefits are strong, but demand-side benefits are weak.

American Express is another company in the Berkshire portfolio with demand-side economies of scale since the more merchants accept their card the more valuable the service gets and the more people who use the card the more valuable the services is for merchants. Munger continues to believe American Express has a moat despite the rise of upstarts like Square.

"It would be easier to screw up American Express than Coke or Gillette, but it's an immensely strong business."
http://www.fool.com/boringport/2000/boringport000501a.htm

Visa has a similar moat to American Express as does PayPal. But challengers like Square may change the game enough to take significant share. eBay's moat is definitely demand-side driven on its original business as well.

A company having beneficial network effects is only one dimension that impacts profit. Sometimes network effects are there but the market is small since it is a niche. Amazon's market is bigger and that matters greatly in terms of the market capitalization it can generate. Some network effects are very strong like Google's and sometimes they are weaker like for web sites that crowd source reviews which contain a lot of noise that is hard to automate out.

3. Brand

At the 2011 meeting of Wesco held just before it was merged into Berkshire Hathaway, Munger admitted that he and Buffett really did not understand the value of a brand until they bought See's Candies. The two investors found after they bought See's Candies they could regularly raise prices and customers did not seem to care. Buffett and Munger call this ability "pricing power." Munger notes that before See's Candies:

"We didn't know the power of a good brand. Over time we just discovered that we could raise prices 10% a year and no one cared. Learning this changed Berkshire. It was really important." http://theinvestmentsblog.blogspot.com/2011/07/final-wesco-meeting-morning-with.htm

See's Candies is also a great A/B test on brand power. To illustrate, if you grew up in a home that bought See's Candies (mostly on the West Coast, especially in California) and experiences around that candy have very favorable associations, you will pay more for that boxed candy brand.

Someone who grew up in the east cost of the United States is going to shop for boxed candy and not attribute much value to the brand since they do not have those same experiences. For this reason, See's has found it hard to expand regionally and has done so very slowly..

See's Candies can also only sell so much candy at that price given the choices it has made. People don't usually go to a See's Candies store because they are hungry for food. The box/gift candy business is very seasonal. What See's sells is not just food, but rather an experience. See's generates losses two quarters a year and makes all its profit in the other two quarters around three holidays.

Buffett talks about the fact that building some brands took many decades:

"When you were a 16-year-old, you took a box of candy on your first date with a girl and gave it either to her parents or to her. I California the girls slap you when you bring Russell Stover, and kiss you when you bring See's."… "I don't think See's means anything to people on the East Coast, where people are also exposed to higher-end chocolate products." http://management.fortune.cnn.com/2012/08/22/sees-candies-buffett-berkshire/

While some of the power of a brand can come from taste, modern "flavor" firms can replicate most any taste. Trade dress and presentation of a good or service matters more than ever. A lot of Tiffany's brand power is the blue box the jewelry comes in. Coke made a massive mistake thinking it was flavor in a blind taste test that mattered when it introduced the New Coke. When the taste test is not blind Coke wins and when it is blind Coke does not win. Munger said once about the New Coke episode:

"[Coke spent] 100 years getting people to believe that trademark had all these intangible values too. And people associate it with a flavor…. Pepsi was within weeks of coming out with old Coke in a Pepsi bottle, which would've been the biggest fiasco in modern times. Perfect insanity." http://www.rbcpa.com/Mungerspeech_june_95.pdf

Although it is not currently doing as well financially as it has in the past, Charlie has admired Procter & Gamble since:

"They just make a fortune on some of the body products. Some of these brands, I mean, if you can make something that actually improves the skin, wow. That's the last thing people will give up". http://management.fortune.cnn.com/2012/08/22/buffett-munger-berkshire

As was noted above, it can be argued that TV does not give Procter & Gamble the same benefits supply-side economies in television since post Internet there are so many ways to advertise that do not require supply-side scale. The argument would be that smaller firms and store brands are making big inroads by using new forms of marketing and Procter & Gamble suffers from that new competition as their brand is weakened.

As another example, Charlie said once that customer loyalty to Costco is a big part of their moat:

"If you get hooked on going to Costco with your family, you'll go there for the rest of your life." http://bitly.com/YsZny5

I am skeptical that "getting hooked" is a brand advantage and instead suspect that Costco's moat is more about great business execution by Costco plus supply-side economies of scale. The Costco brand is valuable, but not enough by itself to fully explain its profitability. Most moats are caused by multiple factors. Clayton Christensen makes a very powerful argument that companies like Costco, Zara and Ikea create a moat by integrating around "a job" that a customer need to get done. You can hear Clayton make that argument here in this video: http://gartner.mediasite.com/mediasite/play/9cfe6bba5c7941e09bee95eb63f769421d It sounds similar to arguments that Michael Porter makes about the value of integration of all the aspects of what a company does, but around a task. Perhaps Berkshire believes that this is a source of a moat for Well Fargo.

A moat powered by a brand is something very different from one created via supply-side economies of scale. For example, Warren Buffett has said that for a company like Disney when the brand is mentioned in conversation "you have something in your mind." He adds:

"How would you try to create a brand that competes with Disney? Coke is a brand associated with people being happy around the world. That is what you want to have in a business. That is the moat. You want that moat to widen." http://investdigest.blogspot.com/2005/12/untapped-pricing-power-and-share-of.html

One company that is puzzling is the eyeglass maker Luxottica's (brands like Ray-Ban, Oakley, Persol and other major brands). How that eyeglass company can have that much market share since it has so many brands is unusual. There must be supply-side economies that are driving that business. I just don't see any real significant demand-side economies that might explain Luxottica's level of success. Could is be that they reap a lot of benefits from organization around a job a customer need to get done. Perhaps, but that seems to be a stretch.

Brands of course can fail over time. Put a luxury brand on a table or shelf in Costco as some have done and that luxury brand is damaged. License it too broadly and the brand is also damaged. Buffett and Munger see attracted to brand that they use in their own lives. See's and Dairy Queen are just two examples.

Some brands incur problems with their brand that are completely self-inflected. Buffett went on to say about one his most favorite brands:

"Take See's candy. You cannot destroy the brand of See's candy. Only See's can do that. You have to look at the brand as a promise to the customer that we are going to offer the quality and service that is expected. We link the product with happiness. You don't see See's candy sponsoring the local funeral home. We are at the Thanksgiving Day Parades though." http://www.buffettfaq.com/

Regarding brand power, the two Berkshire leaders have often cited Wrigley's as a brand that creates strong moat. Munger has pointed out:

"The informational advantage of brands is hard to beat. And your advantage of scale can be an informational advantage. If I go to some remote place, I may see Wrigley chewing gum alongside Glotz's chewing gum. Well, I know that Wrigley is a satisfactory product, whereas I don't know anything about Glotz's. So if one is $.40 and the other is $.30, am I going to take something I don't know and put it in my mouth – which is a pretty personal place, after all – for a lousy dime? So, in effect, Wrigley, simply by being so well-known, has advantages of scale – what you might call an informational advantage.

Everyone is influenced by what others do and approve. Another advantage of scale comes from psychology. The psychologists use the term "social proof". We are all influenced – subconsciously and to some extent consciously – by what we see others do and approve. Therefore, if everybody's buying something, we think it's better. We don't like to be the one guy who's out of step. Again, some of this is at a subconscious level and some of it isn't. Sometimes, we consciously and rationally think, "Gee, I don't know much about this. They know more than I do. Therefore, why shouldn't I follow them?" All told, your advantages can add up to one tough moat." http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf

A very important test for Buffett and Munger in determining the strength of a brand- based moat is whether a competitor can replicate or weaken the moat with a massive checkbook. As just one example, here is what Buffett said about Coke at the 2012 Berkshire meeting: "If you gave me $10, $20, $30 billion to knock off Coca-Cola, I couldn't do it."

Firms like Nike and BMW each have brands that help maintain their moat that were hard to get and super valuable to have. The creation of a great brand is a rare thing and requires considerable skill and arguably a big dose of luck as well. Charlie has pointed out: "China has great companies already. Just not great brand names yet." I would quibble with Munger's conclusion in that the Huawei brand is already strong already in certain business markets. And Chinese firms ZTE and Huawei are making brand inroads in mobile phones. China will in my view surely have many strong global brands over the long-term.

4. Regulation:

There are certain businesses which have created a competence with regard to regulation that is so high that regulation actually serves as a barrier to entry/moat for their competitors. Rather than helping consumers in these cases on a net basis regulations can end up protecting producers and creating a moat. For example, some people believe banks have created such a powerful layer of regulatory expertise that the regulators have become "captured" by the industry they regulate. There are a number of professional; guilds like lawyers who have been able to use regulation to limit supply.

For Berkshire, the regulation-driven moat that Moody's had in the bond rating business was a big attraction. To issue bonds regulators actually require that the issuer get an opinion from a very small number of bond rating firms which means the rating firms Moody's, S&P and Fitch have a moat. Fannie and Freddie also had regulatory created moats, but the result for them in the end was not good.

When regulation disappears, it often becomes quickly evident that it was a major factor in industry profitability. You find out who is otherwise swimming naked when the regulatory-driven moat disappears. For example, said Munger:

"[Airline] Competition was so intense that, once it was unleashed by deregulation, ravaged shareholder wealth in the airline business" http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf

Munger once described airlines as "marginal cost with wings." http://bitly.com/RzDIys People talk about Virgin Airlines having a great brand and better service, but where are the profits? How long will it be before other airlines begin to imitate the Emirates strategy? Where is the barrier to entry for an airline? You can lease jets and gates. Munger and Buffett have said repeatedly over the years that they hate a commodity business. They learned this lesson the hard way by investing in firms like the New England textile manufacturer that gave Berkshire its name. Buffett ignores insurance lines that are commodities as another example

Returning to the subject of regulatory capture, Berkshire invests so much money in Well Fargo is interesting since arguably the sorts of banking that Wells Fargo does is a commodity business. It can be argued that Wells Fargo benefits from regulation since it is "too big to fail" and therefore has a lower cost of capital than it would otherwise which gives it a moat. We will discuss Wells Fargo again in a future post when the subject of management is covered.

5. Patents and Intellectual Property

Companies which have been granted a patent or other type of intellectual property by a government have in effect been given a legal monopoly. While the justifications for doing so are not the subject of this discussion, this barrier to entry can create a substantial moat for the holder of the intellectual property. Munger has said:

"… In microeconomics, of course, you've got the concept of patents, trademarks, exclusive franchises and so forth. Patents are quite interesting. When I was young, I think more money went into patents than came out. Judges tended to throw them out – based on arguments about what was really invented and what relied on prior art. That isn't altogether clear. But they changed that. They didn't change the laws. They just changed the administration – so that it all goes to one patent court. And that court is now very much more pro-patent. So I think people are now starting to make a lot of money out of owning patents. But trademarks and franchises have always been great. Trademarks, of course, have always made people a lot of money. A trademark system is a wonderful thing for a big operation if it's well-known." http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf

Qualcomm is an example of a company which has created a moat mostly via intellectual property. Qualcomm has so many patents and has managed to get them embedded inside enough important wireless industry standards which have their own demand-side economies of scales, that the company has created a substantial moat.

One example of a company that Berkshire values higher due to intellectual property patents is Lubrizol. Initially Buffett said:

"It struck me as a business I didn't know anything about initially. You know, you're talking about petroleum additives… Are there competitive moats, is there ease of entry, all that sort of thing. I did not have any understanding of that at all initially. And I talked to Charlie a few days later…and Charlie says, 'I don't understand it either.'" http://advisoranalyst.com/glablog/tag/cnbc-interview/

But eventually Buffett was won over and made the Lubrizol purchase.

"I decided there's probably a good size moat on this. They've got lots and lots of patents, but more than that they have a connection with customers." http://advisoranalyst.com/glablog/tag/cnbc-interview/

At the 2011 Berkshire meeting Buffet reiterated that he decided to go ahead since he thought that the more than 1,600 patents held by Lubrizol would give the company "a durable competitive advantage."

Another example of intellectual property proving its value for Munger occurred in the 1970s when Russell Stover Candies started to open stores in markets served by See's Candies with very similar appearance. The use of the distinctive "trade dress" of See's Candies was enough of a violation of the law that Munger was able through threat of litigation to get agreement from Russell Stover Candies to stop what they were doing and the moat was proven to be durable.

The Nature of Competition and Moats:

In Charlie's view, even if you currently have a good business that does not mean you will have it for very long. This puts the durability of a given moat at risk. The process of what Joseph Schumpeter called "competitive destruction" is as powerful as anything in business. Having a moat is the only way to fight against the tide of competitive destruction.

Michael Mauboussin, in what is arguably the best essay ever on moats, writes:

"Companies generating high economic returns will attract competitors willing to take a lesser, albeit still attractive, return which will drive down aggregate industry returns to the opportunity cost of capital." http://www.capatcolumbia.com/Articles/measuringthemoat.pdf

For example, if you open a successful clothing store that success will attract imitators and competitors. Through a process of "competitive destruction" some clothing stores will adapt and survive and thrive and others will fail. The consumer wins because the products and services offered to them get better and better. But this is a painful process for an investor since the outcome can be highly uncertain. It is also the hardest part for a businessperson since failure is an essential part of capitalism.

Given the inevitability of relentless competition, the question to ask is according to Munger:

"How do you compete against a true fanatic? You can only try to build the best possible moat and continuously attempt to widen it." Poor Charlie's Almanack at 59; http://www.scribd.com/doc/76907884/MOATS-abridged-1-5-70-chapters-a-preview

Jim Sinegal of Costco is just such a fanatic which is why Charlie serves on their board. The founder of Nebraska Furniture Mart "Mrs. B" would be another fanatic. Charlie loves the management team at Iscar. Going down the list of Berkshire CEOs reveals a long list of fanatics.

That moats are hard to create and usually deteriorate over time is one very important reason why capitalism works. What happens over time is so-called "producer surplus" is transferred into "consumer surplus". Charlie describes the competitive process and why it benefits consumers as follows:

"The major success of capitalism is its ability to drench business owners in feedback and allocate talent efficiently. If you have an area with 20 restaurants, and suddenly 18 are out of business, the remaining two are in good, capable hands. Business owners are constantly being reminded of benefits and punishments. That's psychology explaining economics." http://www.fool.com/investing/general/2011/07/02/charlie-mungers-thoughts-on-the-world-part-1.aspx

Munger's views on the nature of business competition are Darwinian: Capitalism does not pull its punches in markets that are genuinely competitive:

"Over the very long-term, history shows that the chances of any business surviving in a manner agreeable to a company's owners are slim at best." http://www.valuewalk.com/charlie-munger-page/

"Capitalism is a pretty brutal place." http://ycombinator.com/munger.html

When it comes to moats, durability matters. Munger wants to avoid a business that has a moat today, but is gone tomorrow. Some moats atrophy gradually over time and some much more quickly. This is not a completely new phenomenon. As Ernest Hemingway once said in his book *The Sun Also Rises*, a business can go bankrupt in two ways: gradually and then suddenly. The speed of moat destruction has accelerated over time due to advances in technology and the way it spreads information. For some people this increase in speed can at times be disorienting. For example, the speed at which a companies like Kodak or Nortel lost their moats has been shocking to many investors who grew up mostly in another era.

The speed at which a moat disappears should not be confused with cases where a company never had a moat at all like Groupon. Hype about a sales "boiler room" selling coupons online is not a moat. Instead, that is an example of crowd folly (social proof + fake scarcity). Did Zygna ever have a moat or did it just evaporate quickly? It is hard to say. Sometimes causes are hard to tease apart. Facebook definitely has a moat, but once it ceased letting Zynga acquire customers cheaply by leveraging the Facebook moat, the tide arguably turned against Zynga. "To borrow someone's moat is not to have a moat" might be the lesson of Zynga, since what is borrowed can be taken away.

How long your moat lasts is called your "Competitive Advantage Period" (CAP) writes Michael Mauboussin. http://www.capatcolumbia.com/Articles/FoFinance/Fof1.pdf The speed of moat dissipation will be different in each case and need not be constant. The rate at which a moat atrophies is similar to what academics call "fade" argues Mauboussin.

Even the very best companies can see competition make their moats shrink or even disappear. Charlie has said:

"Frequently, you'll look at a business having fabulous results. And the question is, 'How long can this continue?' Well, there's only one way I know to answer that. And that's to think about why the results are occurring now – and then to figure out what could cause those results to stop occurring." http://bitly.com/S5iN7K

Sometimes what shrinks a moat is a shift of what Michael Porter has called "the Five Forces". http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/ar/1 One such force is the power of distributors in a value chain:

"Kellogg's and Campbell's moats have also shrunk due to the increased buying power of supermarkets and companies like Wal-Mart. The muscle power of Wal-Mart and Costco has increased dramatically." http://www.tilsonfunds.com/motley_berkshire_brkmtg01notes.php3

When someone, such as a downstream distributor, takes a bigger slice of the amount of profit in the "profit pool," bad things can happen if you are upstream. Whether that happens will depend on who has more bargaining power in that supply chain.

A blogger in an essay discussed above recently argued that the **Five Forces** do not matter since consumers have more power. Consumers are one of the **Five Forces** so the argument is even at that level deeply misguided. Suppliers are also a potential problem. Try arguing that the **Five Forces** do not matter to the many music subscription companies that went bust due to the wholesale transfer pricing power of music suppliers. A restaurant owner who has had a landlord triple their rent knows very well that supplier bargaining power can be a huge problem. Yes, delighting customers is super important, no that does not help if your sole supplier is raising wholesale prices to take your profit.

Sometimes it is buyers that have the ability to "holdup" the seller and sometimes it is the reverse depending on who has the bargaining power. Every aspect of a given business can be made worse if some firm or person in the value has more bargaining power. As an example, big movie stars have had huge wholesale transfer pricing power over the movie business value chain ever since the Hollywood studio system ended.

Newspapers are a good example of an industry which once had a fantastic moat, which is now in decline. Unfortunately for newspapers, changes in technology have been taking down their moat in rather dramatic fashion. Charlie:

"The perfectly fabulous economics of this [newspaper] business could become grievously impaired." http://www.fool.com/BoringPort/2000/boringport00051501.htm

Munger saw this deterioration before many other people did, mostly likely because Berkshire owned newspaper properties like *The Washington Post* and *The Buffalo News*. Berkshire has not given up on all types of newspapers. Papers that cover local news, particularly in a city with a strong sense of community are still attractive for Berkshire even in 2012. They said at the 2012 Berkshire meeting that they may buy more newspapers. These small city newspaper purchases seems to me like a Ben Graham "cigar butt" style investment and for that reason a reversion to an old investing style. But Berkshire have a *lot* of cash to put to work and only so many quality businesses to buy. Too much cash is, as some people say "A high quality problem." Munger adds: "Excess cash in an advantage, not a disadvantage". As a pool of investment dollars gets bigger it gets harder to find companies to buy or invest in that have a moat. In this sense size works against investment performance. More than one fund manager has suffered from this problem since the tendency is to ignore the need for a strong moat so you can get large amounts of money put to work.

Kodak is a company which once had a strong moat and then began to lose it in dramatic fashion. Munger describes the competitive destruction that hit the photography business:

"What happened to Kodak is a natural outcome of competitive capitalism." http://www.businessinsider.com/munger-on-buffetts-cancer-the-fed-berkshires-investment-strategy-2012-5#ixzz2CB0ay5jG

It is true that what happened to Kodak was rough, but the full story according to Munger should take into account that there was a part of Kodak that did have a moat and will survive:

"People think the whole thing failed, but they forget that Kodak didn't really go broke, because Eastman Chemical did survive as a prosperous company and they spun that off." http://management.fortune.cnn.com/2012/08/22/buffett-munger-berkshire

Why did Eastman Chemical survive? Most probably Eastman survived due to supply-side economies of scale and intellectual property. Kodak probably has some great patents for chemically-based photography too. But in the case of Kodak and photography the entire process changed to digital and the Kodak moat was swiftly gone.

Research in Motion losing its Blackberry moat is another example of competitive destruction. Will they recover? The challenge the Blackberry faces is substantial. Once a feedback loop turns negative, it is hard for any company to regain what it once had. What builds you up can tear you down. And if the ride up was nonlinear, it is very possible that the ride down will be nonlinear as well.

As another example, Munger has said that department stores in downtown areas once had a very strong moat given economies of scale and a central location near mass transit. But then the way people lived started to change as cars became more affordable and people migrated to suburbs with shopping centers. The arrival of Amazon.com has further damaged the moat of the big-box retailers of all kinds whether in the city or the suburbs.

How Can the Quality of the Moat be Quantified?

The test of whether you have a moat with a given company is **quantitative** (i.e., it's a math-based test). If (1) you are earning profits that are greater than your weighted average cost of capital (WACC) and (2) that level of profitability has maintained for some reasonable period measured in years, you have a strong moat. If the size of the positive difference between ROIC and WACC is large and if that "spread" is persistent over time, your moat is relatively strong. Mauboussin is the one to read on this as is usual. The essay: ***Measuring the Moat*** at http://www.capatcolumbia.com/Articles/measuringthemoat.pdf is a classic. Exactly how long the moat must be persistent to meet this test is an interesting question. If it is not a period of at least two years you are taking a significant risk. Five years of supporting data give you more certainty that you moat is sustainable. For a look at this see:

What determines whether a business a company has a moat is **qualitative** (e.g., supply-side and demand-side economies of scale, brand, regulation and intellectual property) but how you test to determine the strength of your moat is **quantitative** (i.e., it's a mathematical exercise). Mathematical formulas won't tell you how to get a moat but they can help prove that you have one, at least for now.

A company like Salesforce.com has not yet passed this quantitative test since management has been running their business at a loss or a tiny profit. Management at Salesforce.com can argue that they are doing this intentionally which seem to be true. But until Salesforce.com proves that it can pass the moat test with evidence that the mathematics satisfy the test, the assertion that the company has a moat is an unproven thesis. In other words, whether Salesforce.com has significant pricing power right now is just a theory. Until GAAP profit margins rise and stay high for a significant period the jury is still out. Any claims that prop0fiost have been earned non-GAAP basis or that the business generated or EBITDA (jokingly referred to by many people as "earnings before everything bad") should be ignored. On this Munger has said: "I don't even like to hear the word EBTDA." He suggests inserting the word "bullshit" whenever you hear the term EBITDA

Spotting the existence of a moat that has not been fully taken advantage of by its current ownership in terms of raising prices can be profitable for an investor buying that business. Warren Buffett points out:

"There are actually businesses, that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices—and yet they haven't done it. So they have huge untapped pricing power that they're not using. That is the ultimate no-brainer. … Disney found that it could raise those prices a lot and the attendance stayed right up. So a lot of the great record of Eisner and Wells … came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies… At Berkshire Hathaway, Warren and I raised the prices of See's candy a little faster than others might have. And, of course, we invested in Coca-Cola—which had some untapped pricing power. And it also had brilliant management. So a Goizueta and Keough could do much more than raise prices. It was perfect." http://ycombinator.com/munger.html

Starting with See's Candies, Munger and Buffett learned that when you have a great moat (in this case driven by a powerful but primarily regional brand), the business can raise prices to improve profitability. On the December 29 of the year that they bought See's prices were raised 20-30 cents a pound. They also learned that some brands translate less well to new markets and there is a limit on how many stores one can profitably build in a given geographic area.

Buffett has said that Kellogg's has at times pushed their pricing too far and damaged their moat. Buffet believes that they didn't have the moat they thought they had versus General Mills and other major breakfast cereal competitors.

At a very practical level the discussion above illustrates that there are some rules of thumb one can use to test the strength of a moat. At the top of the list is whether the business has pricing power. For example, if you must hold a prayer meeting before you try to raise prices, then you don't have much of a moat, if any, argues Buffett.

Finally, it should be emphasized that is nothing sinister about the term "moat." Business is, by its very nature, a competitive process. Even a small restaurant selling barbecue can have a moat. A company that has a return on capital significantly greater than their opportunity cost over time has a moat whether they know it or not. That's enough about moats for now. The next post will be about **Munger's Investment Filters Two and Three: Circle of Competence and Management with Integrity and Talent.**

SEATTLE, WA

This is a blog about business models, the economy and economics, investing, technology, economic development, policy, science, and other aspects of life that I find interesting. ~~Boring~~

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Charlie Munger On Buffett's Cancer Diagnosis, The Fed, Berkshire's Investment Strategies, And Not Using A Cellphone

Mamta Badkar | May 4, 2012, 4:53 PM | 1,563 | 2

Berkshire Hathaway has its annual shareholder meeting this weekend. Ahead of that Berkshire's Charlie Munger sat down with CNBC's Betty Quick for an interview. Here are some of the highlights:

- **On Buffett's cancer diagnosis** - "I regarded it as a total non-event. I would bet a lot of money that I have more than he does, I don't event allow them to check for it. …So when my doctor puts down PSA test I just cross it out."
- **On Berkshire's succession plans** - "I've never been more comfortable about succession or duration of culture than I am right now. Our new investment people show enormous promise and it's good that we were provoked into doing that by Lu's retirement. I have enormous confidence in the continuation of the culture."
- **On investment Deja Vu's** - "Well it's always a little different. People are always quoting Mark Twain perhaps the comment was apocryphal that history doesn't repeat itself but it rhymes. So sure a lot is the same. The panic that came as a predecessor to the Great Recession had common themes that are always the same - the crazy greed, the crazy leverage, the crazy delusions and I think we were very lucky that the outcome wasn't worse."
- **On easy central bank policy** - "What was wrong was not the central bank reaction, which I think was correct. They don't have an unlimited number of weapons we'd be in way worse shape if both political parties hadn't backed huge central bank intervention. The big mistake was made by allowing the boom to go so crazy and allowing the evil and folly to run so rampant. Greenspan to his credit and since recognized that he was wrong. He's the only one who's done that.
- "An economy with a certain amount of basic virtue like a bunch of Germans or Japanese or something can resort to a lot of extreme Keynesian intervention and help things. But if your whole cultural system disintegrates, say the way it did in Greece where everybody wants an easy living with no work and a lot make believe and fraud and what have you, then the Keynesian stuff won't work. So what happens is all this intervention helps if you have a lot of merit, a lot of credit in the bank so to speak which you've earned by deserve it. And of course we've used up some of our store of credit. So we're more dangerous that we used to be."
- **The U.S. still has a lot of virtue left.**

- Munger said he had no quarrels with the Fed though it was **blind not to step on the boom.** Greenspan and everyone else in the Fed "overdosed" on Ayn Rand.
- Responding to a question on **Einhorn saying he's buying gold** because he doesn't trust the Fed, Munger said: "I think gold is a great thing to sew in to your garments if you're a Jewish family in Vienna in 1939 but I think civilized people don't buy gold."
- **On Berkshire's IBM holding and investment portfolio**: "It's a very Buffett style play... The investment portfolio, when we used to have these meetings decades ago, there would be more in common stock value in the portfolios of Berkshire than the market capitalization of the whole company and that went on year after year after year. That has radically changed. Now most of the value is in controlled businesses and the investment portfolio is something that looks like the normal portfolio of an insurance company."
- Munger doesn't tweet and doesn't use a cellphone.
- He gave insights on some of Berkshire's investment strategies, like: "We always said that what he liked best was owning a wonderful business outright and second best we liked good ideas and securities, that has never changed."
- Berkshire culture always operates as though we're already in a recession.
- **On the decline of American manufacturing:** "It's just amazing what's happened to American manufacturing… I think that kind of creative destruction happens in capitalism with free trade and it's very painful for the people that get by it. But its painful for Kodak when the technology changes and i don't think you should look for a villain. What happened to Kodak is a natural outcome of competitive capitalism."
- General Motors should not have wiped out its shareholders. "It was a huge failure of management."
- There's plenty to regret in the Republican party but there's a lot to regret in the Democratic party. **Munger said "the nutcases in each party have come to power and hate each other, and I remember a more bi-partisan world with affection."** He isn't enthusiastic about America politics at the moment and thinks Mitt Romney is by far the best Republican candidate.
- If investors don't know very much they should buy an index.
- The U.S. has no alternative but to be friendly with China and China has no alternative but to be friendly with the U.S. **Munger thinks China continues to do well with its policies.** "They have some of the merit of Singapore in modern China. They copied it on purpose and I regard what happened in Singapore as the best example of successful in governance in the history of the world. To take a handful of people in a malarial swamp and turn them into a meritocratic civilization that works as well as Singapore does is a huge stunt and I think China to some extent has copied Singapore. And I think they deserve some admiration."
- His favorite thing about the Berkshire Hathaway annual meetings is going back to the city where he was raised, driving by his high school and seeing friends of his youth that are still alive.
- "Ask Warren how he wants to be remembered, he wants to be remembered as a teacher. Who in the hell is saying that from the top of a company?"
- Munger said Wall Street would have functioned better if it had emulated his great grandfather Ingham.

Watch the entire int

Read more: http://www.businessinsider.com/munger-on-buffetts-cancer-the-fed-berkshires-investment-strategy-2012-5#ixzz2EJVuI2hR

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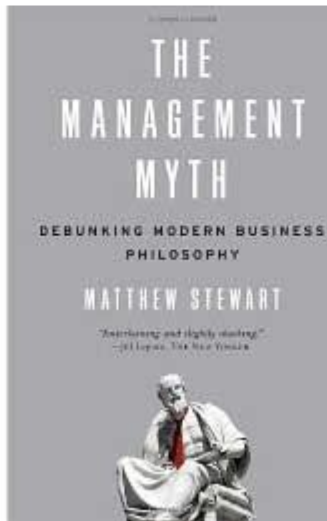
What Killed Michael Porter's Monitor Group? The One Force That Really Matters



What killed the Monitor Group, the consulting firm co-founded by the legendary business guru, Michael Porter? In November 2012, Monitor was unable to pay its bills and was forced to file for bankruptcy protection. Why didn't the highly paid consultants of Monitor use Porter's famous five-force analysis to save themselves?

What went wrong?

Was Monitor's demise something that happened unexpectedly like a bolt from the blue? Well, not exactly. The death spiral has been going on for some time. In 2008, Monitor's consulting work slowed dramatically during the financial crisis. In 2009, the firm's partners had to advance $4.5 million to the company and pass on $20 million in bonuses. Then Monitor borrowed a further $51 million from private equity firm, Caltius Capital Management. Beginning in September 2012, the company was unable to pay monthly rent on its Cambridge, Mass., headquarters. In November 2012, Monitor also missed an interest payment to Caltius, putting the notes in default and driving the firm into bankruptcy.

Was it negligence, like the cobbler who forgot to repair his own children's shoes? Had Monitor tried to implement Porter's strategy and executed it poorly? Or had Monitor implemented Porter's strategy well but the strategy didn't work? If not, why not?

Was it missteps, such as chasing consulting revenue from the likes of the Gaddafi regime in Libya? Or had the world changed and Monitor didn't adjust? Or was it, as others suggested, that Monitor had priced itself out of the market? Or was Monitor's bankruptcy, as some apologists claimed, merely a clever way of selling its assets to Deloitte?

Or was it, as Peter Gorski wrote, that "even a blindfolded chimpanzee throwing darts at the Five Porter Forces framework can select a business strategy that performs as well as that prescribed by Dr. Porter and other high-paid strategy consultants?" If so, are other strategy consulting firms also doomed?

A very strange tale

The answers to these intriguing questions are strange and troubling. We can find some of them in the work of consulting insider, Matthew Stewart, and his enlightening, but misleadingly-titled, book, *The Management Myth* (Norton, 2009).

In his book, Stewart tells how in 1969, when Michael Porter graduated from Harvard Business School and went across the river to get a PhD in Harvard's Department of Economics, he learned that excess profits were real and persistent in some companies and industries, because of barriers to competition. To the public-spirited economists, the excess profits of these comfortable low-competition situations were a problem to be solved.

Porter saw that what was a problem for the economists was, from a certain business perspective, a solution to be enthusiastically pursued. It was even a silver bullet. An El Dorado of unending above-average profits? That was exactly what executives were looking for—a veritable shortcut to fat city!

Why go through the hassle of actually designing and making better products and services, and offering steadily more value to customers and society, when the firm could simply position its business so that structural barriers ensured endless above-average profits?

Why not call this trick "the discipline of strategy"? Why not announce that a company occupying a position within a sector that is well protected by structural barriers would have a "sustainable competitive advantage"?

Why not proclaim that finding these El Dorados of unending excess profits would follow, as day follows night, by having highly paid strategy analysts doing large amounts of rigorous analysis? Which CEO would *not* want to know how to reliably generate endless excess profits? Why not set up consulting a firm that could satisfy that want?

The Aristotle of business metaphysics

Thus it was that in March/April 1979, Michael Porter published his findings in Harvard Business Review in an article entitled "How Competitive Forces Shape Strategy" and followed it up the next year with a long and unreadable book. The writings started a revolution in the strategy field. Michael Porter became to the new discipline of strategy "what Aristotle was to metaphysics".

Better still, the new-born discipline of strategy was able to present itself as “the discipline that synthesizes all of the other functional sub-disciplines of management into a meaningful whole. It defines the purpose of management and of management education.”

In 1983, Porter co-founded his consulting company, the Monitor Group, that over the years generated hundreds of millions of dollars in fees from corporate clients (as well as from clients in the nonprofit sector), and also providing rich livelihoods for other large consulting firms, like McKinsey, Bain and BCG.

“Among academics,” writes Joan Magretta in *Understanding Michael Porter*, “he is the most cited scholar in economics and business. At the same time, his ideas are the most widely used in practice by business and government leaders around the world. His frameworks have become the foundation of the strategy field.”

No basis in fact or logic

There was just one snag. What was the intellectual basis of this now vast enterprise of locating sustainable competitive advantage? As Stewart notes, it was “lacking any foundation in fact or logic.” Except where generated by government regulation, sustainable competitive advantage simply doesn’t exist.

Porter might have pursued sustainable business models. Or he might have pursued ways to achieve above-average profits. But sustainable above-average profits that can be deduced from the structure of the sector? Here we are in the realm of unicorns and phlogiston. Ironically, like the search for the Holy Grail, the fact that the goal is so mysterious and elusive ironically drove executives onward to continue the quest.

Hype, spin, impenetrable prose and abstruse mathematics, along with talk of “rigorous analysis”, “tough-minded decisions” and “hard choices” all combined to hide the fact that there was no evidence that sustainable competitive advantage could be created in advance by studying the structure of an industry.

Although Porter’s conceptual framework could help explain excess profits in retrospect, it was almost useless in predicting them in prospect. As Stewart points out, “The strategists’ theories are 100 percent accurate in hindsight. Yet, when casting their theories into the future, the strategists as a group perform abysmally. Although Porter himself wisely avoids forecasting, those who wish to avail themselves of his framework do not have the luxury of doing so. The point is not that the strategists lack clairvoyance; it’s that their theories aren’t really theories—they are ‘just-so’ stories whose only real contribution is to make sense of the past, not to predict the future.”

The goal of strategy is to avoid competition?

How did all this happen? Porter began his publishing career in his March-April 1979 Harvard Business Review article, “How Competitive Forces Shape Strategy”, with a very strange sentence: “The essence of strategy is coping with competition.” Ignoring Peter Drucker’s foundational insight of 1973 that the *only* valid purpose of a business is to create a *customer*, Porter focused strategy on how to protect businesses from other business rivals. The goal of strategy, business and business education was to find a safe haven for businesses from the destructive forces of competition.

By defining strategy as a matter of defeating the competition, Porter envisaged business as a zero-sum game. As he says in his 1979 HBR article, “The state of competition in an industry depends on five basic forces… The collective strength of these forces determines the ultimate profit potential of an industry.” For Porter, the ultimate profit potential of an industry is a finite fixed amount: the only question is who is going to get which share of it.

Sound business is however unlike warfare or sports in that one company’s success does not require its rivals to fail. Unlike competition in sports, every company can choose to invent its own game. As Joan Magretta points out, a better analogy than war or sports is the performing arts. There can be many good singers or actors—each outstanding and successful in a distinctive way. Each finds and creates an audience. The more good performers there are, the more audiences grow and the arts flourish.

What’s gone wrong here was Porter’s initial thought. The purpose of strategy—or business or business education—is not about coping with competition–i.e. a contest in which a winner is selected from among rivals. The purpose of business is to add value for customers and ultimately society. There is a straight line from this conceptual error at the outset of Porter’s writing to the debacle of Monitor’s bankruptcy. Monitor failed to add value to customers. Eventually customers realized this and stopped paying Monitor for its services. Ergo Monitor went bankrupt.

Making profits without deserving them

In the theoretical landscape that Porter invented, all strategy worthy of the name involves avoiding competition and seeking out above-average profits protected by structural barriers.

Strategy is all about figuring out how to secure excess profits without having to make a better product or deliver a better service.

It is a way of making more money than the merits of the product or service would suggest, or what those plain folks uncharitable to the ways of 20th Century business might see as something akin to cheating. However for several decades, many companies were ready to set aside ethical or social concerns and pay large consulting fees trying to find the safe and highly profitable havens that Porter's theory promised.

Although Michael Porter, the human being, appears to be a well-meaning man of high personal integrity, his framework for the discipline of strategy isn't just an epistemological black hole; in its essence, it's antisocial, because it preserves excess profits, and it's bad for business, because it doesn't work. It accomplishes the unlikely feat of goading business leaders to do wrong both to their shareholders and to their fellow human beings.

It is only recently that Porter's writing has begun to include any awareness that creating safe havens for businesses with unending above average profits protected by structural barriers is not good for customers and society, with his advocacy of shared value. This recognition has come, however, without yet jettisoning any of the toxic baggage of sustainable competitive advantage.

No competitive advantage is sustainable

The disastrous consequences of thinking that the purpose of strategy, business and business education is to defeat one's business rivals rather than add value to customers has of course been aggravated by the epic shift in the power of marketplace from the seller to the buyer. In the studies of the oligopolistic firms of the 1950s on which Porter founded his theory, it appeared that structural barriers to competition were widespread, impermeable and more or less permanent.

Over the following half century, the winds of globalization and the Internet blew away most of these barriers, leaving the customers in charge of the marketplace. Except for a few areas, like health and defense where government regulation offers some protection, there are no longer any safe havens for business. National barriers collapsed. Knowledge became a commodity. New technology fueled spectacular innovation. Entry into existing markets was alarmingly easy. New products and new entrants abruptly redefined industries.

The "profit potential of an industry" turned out to be, not a fixed quantity with the only question of determining who would get which share, but rather a highly elastic concept, expanding dramatically at one moment or collapsing abruptly at another, with competitors and innovations coming out of nowhere. As Clayton Christensen demonstrated in industry after industry, disruptive innovation destroyed company after company that believed in its own sustainable competitive advantage.

The only safe place

The business reality of today is that the only safe place against the raging innovation is to join it. Instead of seeing business—and strategy and business education—as a matter of figuring out how to defeat one's known rivals and protect oneself against competition through structural barriers, if a business is to survive, it must aim to add value to customers through continuous innovation and finding new ways of delighting its customers. Experimentation and innovation become an integral part of everything the organization does.

Firms like Apple [AAPL], Amazon [AMZN], Salesforce [CRM], Costco [COST], Whole Foods [WFM] and Zara [BMAD:ITX] are examples of prominent firms pursuing this approach. They have shifted the concept of the bottom line and the very purpose of the firm so that the whole organization focuses on delivering steadily more value to customers through innovation. Thus experimentation and innovation become an integral part of everything the company does. Companies with this mental model have shown a consistent ability to innovate and to disrupt their own businesses with innovation.

Thus what is striking about continuous innovation is that the approach is not only more innovative: it tends to make more money. The latter point is important to keep in mind. For all the hype about innovation, unless it ends up making more money for the firm, ultimately it isn't likely to flourish. Making money isn't the goal, but the result has to be there for sustainability.

Is continuous innovation sustainable? Firms like those I mentioned have been at it for one or more decades with extraordinary results. What's interesting is that they are consistently disrupting others, rather than being disrupted themselves. Will they survive for 50 or 100 years? Time will tell. What we do see is that they are doing a lot better than firms pursuing shareholder value or focusing merely on defeating rivals.

Monitor had no place in the emerging world

In this world, Monitor's value proposition of a supposed sustainable competitive advantage achieved by studying the numbers and the existing structure of the industry became increasingly implausible and irrelevant. Its consultants were not people with deep experience in understanding what customers might want or what is involved in actually making things or delivering services in particular industries or how to innovate and create new value.

They were part-time academics who promised to find business solutions just from studying the numbers. They had no idea how to build cars or make mobile phones or generate great software. They were numbers men looking for financial solutions to problems that required real-world answers.

The important question is not: why did Monitor go bankrupt? Rather, it is: how were they able to keep going with such an illusory product for so long? The answer is that Porter's claim of sustainable competitive advantage, based on industry structure and the numbers, had massive psychological attractions for top management.

The strategist CEO as a kind of warrior god

Porter's theory thus played to the image of the CEO as a kind of superior being. As Stewart notes, "For all the strategy pioneers, strategy achieves its most perfect embodiment in the person at the top of management: the CEO. Embedded in strategic planning are the assumptions, first, that strategy is a decision-making sport involving the selection of markets and products; second, that the decisions are responsible for all of the value creation of a firm (or at least the "excess profits," in Porter's model); and, third, that the decider is the CEO. Strategy, says Porter, speaking for all the strategists, is thus 'the ultimate act of choice.' 'The chief strategist of an organization has to be the leader— the CEO."

Strategy leads to "the division of the world of management into two classes: "top management" and "middle management." Top management takes responsibility for deciding on the mix of businesses a corporation ought to pursue and for judging the performance of business unit managers. Middle management is merely responsible for the execution of activities within specific lines of business.

The concept of strategy as it emerges defines the function of top management and distinguishes it from that of its social inferiors. That which is done at the top of an organizational structure is strategic management. Everything else is the menial task of operational management.

Two classes of management

Practitioners of strategy insist on this distinction between strategic management and lower-order operational management. Strategic (i.e. top) management is a complex, reflective, and cerebral activity that involves interpreting multidimensional matrices. Operational management, by contrast, requires merely the mechanical replication of market practices in order to match market returns. It is a form of action, suitable for capable but perhaps less intelligent types.

This picture of CEO-superdeciders helps justify their huge compensation and the congratulatory press coverage, and yet again, it also has little foundation in fact or logic. The strategy business thus lasted so long in part because it supports and advances the pretensions of the C-suite.

Porter's strategy theory is to CEOs what ancient religions were to tribal chieftains. The ceremonies are ultimately about the divine right of the rulers to rule—a kind of covert form of political theory. Stewart cites Brian Quinn that it is "like a ritual rain dance. It has no effect on the weather that follows, but those who engage in it think that it does."

The future of strategy consulting

Does strategy consulting have a future? When rightly conceived as the art of thinking through how companies can add value to customers–and ultimately society–through continuous innovation, strategy consulting has a bright future. The market is vast because most large firms

are still 20th Century hierarchical bureaucracies that are focused on “the dumbest idea in the world”: shareholder value. They are very weak at innovation.

Consultancies that can guide large firms to move into the world of continuous innovation in the 21st Century have a bright future. To succeed in this field, however, consultants need to know something both about innovation and about the sectors in which they operate and the customers who populate them. Merely rejiggering the financials or flattering the CEO as the master strategist is not going to get the job done. Managers and consultants are going to have to get their hands dirty understanding what happens on the front lines where work gets done and where customers experience the firm’s products and services. To prosper, everyone has to become both more creative and more down-to-earth.

What has no future is strategy conceived as defeating rivals by finding a sustainable comparative advantage simply through studying the structure of the industry and juggling the numbers.

Since Monitor had no other arrow in its strategy quiver, it was doomed from the outset. Its embarrassing debacle marked the beginning of the end of the era of business metaphysics and the exposure of the most over-valued idea on the planet: sustainable competitive advantage.

Monitor was killed by the dominant force: the customer

Eventually even attractive illusions come to an end: people see through them. Ceremonial rain dances come to be viewed for what they are. The financial crisis of 2008 was a wake-up call that reminded even entrenched firms how vulnerable they were. Today, large firms have little interest in paying large fees to strategists to find sustainable competitive advantage just from studying the numbers.

Monitor eventually learned the hardest lesson of all: strategy, business and business education are not about pursuing the chimera of sustainable competitive advantage.

Monitor wasn’t killed by any of the five forces of competitive rivalry. Ultimately what killed Monitor was the fact that its customers were no longer willing to buy what Monitor was selling. Monitor was crushed by the single dominant force in today’s marketplace: the customer.

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