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Note to Investors: Thoughts on The Most Important Moat

Dear Investment Partner:

I did a talk last month in Omaha that I called "The Most Important Moat". I thought I'd pass along my slides and some thoughts because this concept of thinking about the various competitive advantages of businesses in today's world is extremely important in investing. The core concept of value investing is (and always will be) the same as it always has been – buying an asset for much less than a reasonable estimate of what that asset is intrinsically worth is an investment approach that works over time.

That said, a key part of determining that value is to understand the strength and the durability of the competitive advantages of the company in question. I think this is where some investors get tripped up – they are looking at advantages that were very strong in years past and assume that those advantages are just as strong today. In fact, barriers to entry have declined (in part because of technology), products can be sold directly to consumers on the internet without a middleman (i.e. a wholesale partner or retail store), companies can gain scale much more quickly and acquire new customers more cheaply, switching costs have generally declined, and the list goes on and on. Some advantages have gained strength, but many others have deteriorated.

An example I used in my talk was Gillette vs. Dollar Shave Club. Gillette used to own a significant majority of the shaving market, and had massive gross margins (the difference between the sales price of the razor blade and the cost to make that blade). This high markup gave Gillette a big advertising budget, which further entrenched its position. Over time, the high margins and trusted brand name resulted in Gillette enjoying prime shelf space at the grocery store (not to mention low competition: you had only a few choices if you wanted a razor). Before the internet and social media, it would have been difficult to compete with Gillette if you wanted to establish a razor blade startup business. Getting your products into the store would be difficult enough, let alone trying to go head to head with Gillette's low cost production capabilities, economies of scale, and huge advertising budget.

But now, Harry's and Dollar Shave Club have grabbed nearly a fifth of the market and are growing rapidly. They provide a decent razor blade at a fraction of Gillette's cost, and they deliver it more conveniently (they mail you refills automatically, saving you a trip to the store). These upstarts can compete by cutting out the middleman (no retail markup), as well as using social media (Youtube, Facebook, Instagram, etc...) to advertise the product.

The upstarts are attacking Gillette and succeeding, by providing better value to the customer. The customer no longer has to settle for overpriced razor blades, produced by a company that was living off an incumbent distribution advantage. In other words, I don't believe Gillette had a "brand" that consumers demanded, it had shelf space at the grocery store with few customer alternatives. It also had a big ad budget, and huge profit margins. And it was a great business for many decades. But it wasn't providing significant value to the customer. No one ever felt like they were getting a deal when they walked out with a $15 refill of razor blades.

Dollar Shave Club found a better way to deliver value to the customer, and they took market share from Gillette (and got a big valuation in the private markets). Gillette has since tried to cut its prices in an attempt to stem the market share losses, but this is likely "too little, too late". Once someone leaves Gillette for a cheaper blade that comes to your house without you even thinking about it, it's unlikely those customers switch back to a more expensive, less convenient solution.

Most Important Moat:

The point here is not that Dollar Shave Club (if it were publicly traded) would make a good investment. That company in particular may or may not be able to produce lasting profitability, and to produce lasting customer value, you need to stay in business. The point is to think about investing in companies that have a durable business model that can produce both stable profitability and significant value to customers. Companies that achieve the former by extracting value from its customers are doomed to be attacked by someone who will find a way to provide better value.

In summary, I think it's helpful to keep the following concept in mind: **Value to the customer is one of the most important things to consider when analyzing companies**.

No longer can companies use a distribution advantage, a regulatory advantage, market share dominance, or some other barrier to entry that insulates them from competition. Those advantages can still be significant moats, but only if the end-customer is getting a good deal. If not, a competitor will spring up, gain scale in a shockingly quick manner, and figure out a way to meet the needs of that end-customer. Change happens more rapidly, customers have more choice (and more information), and barriers to entry are too low for big incumbents to rest on their laurels.

So there are very few places to hide in today's business world if your business does not possess a strong customer value-proposition, and that's why I think it's so important to invest with a long-term oriented management team that is focused on variables that will impact the long-term value of the company (not the short-term quarterly profit margins). Long-term focus with an emphasis on customer value is imperative to ensuring the long-term value for business owners (which is what we are as shareholders).

All three of these companies (Gillette, Dollar Shave Club, and Harry's) are owned by large conglomerates or are private, so I am using them just as an example to illustrate how important it is to provide value to customers.

I thought I'd send out this note to my investors just to let you know I've been thinking about this for some time, and it plays a major role in the companies I decide to invest in.

- Most Important Moat (Brief Slide Summary)
- Thoughts on Most Important Moat and Berkshire Meeting

The talk I did was very brief and so these slides only scratch the surface of this idea, but the post above discusses more thoughts I have on this topic. The post was a summary of the Berkshire meeting, but also dovetails with the topic of thinking about competitive advantages (the "most important moat") in today's business world. Buffett touched on this briefly at the meeting as well, when he spoke about how great companies today are much different from great companies of a century ago.

I'll have more comments on this topic, but thought I'd pass along these notes from the meeting last month in case you didn't get a chance to read them on my website yet. I will be sending out my mid-year letter sometime around late July or early August, as usual. Between now and then, I hope you enjoy the first part of your summer.

I'd like to thank you for your investment with Saber Capital. Your partnership is very valuable to me, and I consider myself quite fortunate to be managing a portion of your capital.

As always, feel free to reach out anytime with any questions.

Your Partner,

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