

THE LITTLE BOOK



THAT
BUILDS
WEALTH

*The Knockout Formula
for Finding Great Investments*

PAT DORSEY

FOREWORD BY JOE MANSUETO
FOUNDER, CHAIRMAN, AND CEO OF MORNINGSTAR, INC.



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John Wiley & Sons, Inc.

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Little Book Big Profits Series



In the *Little Book Big Profits* series, the brightest icons in the financial world write on topics that range from tried-and-true investment strategies to tomorrow's new trends. Each book offers a unique perspective on investing, allowing the reader to pick and choose from the very best in investment advice today.

Books in the *Little Book Big Profits* series include:

The Little Book That Beats the Market, where Joel Greenblatt, founder and managing partner at Gotham Capital, reveals a “magic formula” that is easy to use and makes buying good companies at bargain prices automatic, enabling you to successfully beat the market and professional managers by a wide margin.

The Little Book of Value Investing, where Christopher Browne, managing director of Tweedy, Browne Company, LLC, the oldest value investing firm on Wall Street, simply and succinctly explains how value investing, one of the most

effective investment strategies ever created, works, and shows you how it can be applied globally.

The Little Book of Common Sense Investing, where Vanguard Group founder John C. Bogle shares his own time-tested philosophies, lessons, and personal anecdotes to explain why outperforming the market is an investor illusion, and how the simplest of investment strategies—indexing—can deliver the greatest return to the greatest number of investors.

The Little Book That Makes You Rich, where Louis Navellier, financial analyst and editor of investment newsletters since 1980, offers readers a fundamental understanding of how to get rich using the best in growth investing strategies. Filled with in-depth insights and practical advice, *The Little Book That Makes You Rich* outlines an effective approach to building true wealth in today's markets.

The Little Book That Builds Wealth, where Pat Dorsey, director of stock research for leading independent investment research provider Morningstar, Inc., guides the reader in understanding “economic moats,” learning how to measure them against one another, and selecting the best companies for the very best returns.

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Foreword



WHEN I STARTED Morningstar in 1984, my goal was to help individuals invest in mutual funds. Back then, a few financial publications carried performance data, and that was about it. By providing institutional-quality information at affordable prices, I thought we could meet a growing need.

But I also had another goal. I wanted to build a business with an “economic moat.” Warren Buffett coined this term, which refers to the sustainable advantages that protect a company against competitors—the way a moat protects a castle. I discovered Buffett in the early 1980s and studied Berkshire Hathaway’s annual reports. There Buffett explains the moat concept, and I thought I could use this insight to help build a business. Economic moats made so much sense to me that the concept is the foundation for our company and for our stock analysis.

I saw a clear market need when I started Morningstar, but I also wanted a business with the potential for a moat. Why spend time, money, and energy only to watch competitors take away our customers?

The business I envisioned would be hard for a competitor to replicate. I wanted Morningstar’s economic moat to include a trusted brand, large financial databases, proprietary analytics, a sizable and knowledgeable analyst staff, and a large and loyal customer base. With my background in investing, a growing market need, and a business model that had wide-moat potential, I embarked on my journey.

Over the past 23 years, Morningstar has achieved considerable success. The company now has revenues of more than \$400 million, with above-average profitability. We've worked hard to make our moat broader and deeper, and we keep these goals in mind whenever we make new investments in our business.

Moats, however, are also the basis of Morningstar's approach to stock investing. We believe investors should focus their long-term investments on companies with wide economic moats. These companies can earn excess returns for extended periods—above-average gains that should be recognized over time in share prices. There's another plus: You can hold these stocks longer, and that reduces trading costs. So wide-moat companies are great candidates for anyone's core portfolio.

Many people invest by reacting: "My brother-in-law recommended it" or "I read about it in *Money*." It's also easy to get distracted by daily price gyrations and pundits who pontificate about short-term market swings. Far better to have a conceptual anchor to help you evaluate stocks and build a rational portfolio. That's where moats are invaluable.

While Buffett developed the moat concept, we've taken the idea one step further. We've identified the most common attributes of moats, such as high switching costs and economies of scale, and provided a full analysis of these attributes. Although investing remains an art, we've attempted to make identifying companies with moats more of a science.

Moats are a crucial element in Morningstar's stock ratings. We have more than 100 stock analysts covering 2,000 publicly traded companies across 100 industries. Two main factors determine our ratings: (1) a stock's discount from our estimated fair value, and (2) the size of a company's moat. Each analyst builds a detailed discounted cash flow

model to arrive at a company's fair value. The analyst then assigns a moat rating—Wide, Narrow, or None—based on the techniques that you'll learn about in this book. The larger the discount to fair value and the larger the moat, the higher the Morningstar stock rating.

We're seeking companies with moats, but we want to buy them at a significant discount to fair value. This is what the best investors do—legends like Buffett, Bill Nygren at Oakmark Funds, and Mason Hawkins at Longleaf Funds. Morningstar, though, consistently applies this methodology across a broad spectrum of companies.

This broad coverage gives us a unique perspective on the qualities that can give companies a sustainable competitive advantage. Our stock analysts regularly debate moats with their peers and defend their moat ratings to our senior staff. Moats are an important part of the culture at Morningstar and a central theme in our analyst reports.

In this book, Pat Dorsey, who heads up our stock research at Morningstar, takes our collective experience and shares it with you. He gives you an inside look at the thought process we use in evaluating companies at Morningstar.

Pat has been instrumental in the development of our stock research and our economic moat ratings. He is sharp, well-informed, and experienced. We're also fortunate that Pat is a top-notch communicator—both in writing and speaking (you'll often see him on television). As you're about to find out, Pat has a rare ability to explain investing in a clear and entertaining way.

In the pages that follow, Pat explains why we think making investment decisions based on companies' economic moats is such a smart long-term approach—and, most important, how you can use this approach to build wealth over time. You'll learn how to identify companies with moats and gain

tools for determining how much a stock is worth, all in a very accessible and engaging way.

Throughout the book, you'll learn about the economic power of moats by studying how specific companies with wide moats have generated above-average profits over many years—whereas businesses lacking moats have often failed to create value for shareholders over time.

Haywood Kelly, our chief of securities analysis, and Catherine Odelbo, president of our Individual Investor business, have also played a central role in developing Morningstar's stock research. Our entire stock analyst staff also deserves much credit for doing high-quality moat analysis on a daily basis.

This book is short. But if you read it carefully, I believe you'll develop a solid foundation for making smart investment decisions. I wish you well in your investments and hope you enjoy our Little Book.

—JOE MANSUETO
FOUNDER, CHAIRMAN, AND CEO, MORNINGSTAR, INC.

Acknowledgments

ANY BOOK IS A TEAM effort, and this one is no exception.

I am very lucky to work with a group of extremely talented analysts, without whom I would know far less about investing than I do. The contributions of Morningstar's Equity Analyst staff improved this book considerably, especially when it came to making sure I had just the right example to illustrate a particular point. It's a blast to have such sharp colleagues—they make it fun to come in to work every day.

Special thanks go to Haywood Kelly, Morningstar's chief of securities analysis, for valuable editorial feedback—and for hiring me at Morningstar many years ago. I'm also grateful to director of stock analysis Heather Brilliant for quickly and seamlessly shouldering my managerial duties while I completed this book. Last but not least, Chris Cantore turned ideas into graphics, Karen Wallace tightened my prose, and Maureen Dahlen and Sara Mersinger kept the project on track. Thanks to all four.

Credit is also due to Catherine Odelbo, president of securities analysis, for her leadership of Morningstar's equity research efforts, and of course to Morningstar founder Joe Mansueto for building a world-class firm that always puts investors first. Thanks, Joe.

No one, however, deserves more gratitude than my wife Katherine, whose love and support are my most precious

assets. Along with little Ben and Alice, our twins, she brings happiness to each day.

Introduction



The Game Plan



THERE ARE LOTS OF WAYS to make money in the stock market. You can play the Wall Street game, keep a sharp eye on trends, and try to guess which companies will beat earnings estimates each quarter, but you'll face quite a lot of competition. You can buy strong stocks with bullish chart patterns or superfast growth, but you'll run the risk that no buyers will emerge to take the shares off your hands at a higher price. You can buy dirt-cheap stocks with little regard for the quality of the underlying business, but you'll have to balance the outsize returns in the stocks that bounce back with the losses in those that fade from existence.

Or you can simply buy wonderful companies at reasonable prices, and let those companies compound cash over long periods of time. Surprisingly, there aren't all that many money managers who follow this strategy, even though it's the one used by some of the world's most successful investors. (Warren Buffett is the best-known.)