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Ahead of the Crowd

Top-Rated "Wide-Moat" Stocks

Companies that can best defend their profits from competitors should pack on more gains. Which stocks to buy and sell.

By JACK HOUGH

So-called wide-moat stocks are racking up impressive gains and should continue to do so.

Recent analysis by Morningstar, the investment research company, suggests Express Scripts (ticker: ESRX), Oracle (ORCL) and Berkshire Hathaway (BRKB) are poised to outperform, while Cooper Tire & Rubber (CTB) and home builder Lennar (LEN) are best avoided.

An economic moat is a barrier that protects a company from competition. It can come in many forms. Drug makers have patents. Ebay has the "network effect," whereby the auction site is the one to use simply because it has so many sellers, which begets more buyers and so on. Airplane makers have massive scale. Some software companies have high "switching costs," meaning it's expensive or cumbersome for their customers to defect.

Competition drives profit margins lower, but companies with wide moats can sustain healthy margins over the long term, resulting in handsome gains for shareholders. The key is to accurately tell wide moats from narrow ones.

Morningstar has a committee of analysts that sizes up moats, and an index of wide-moat stocks with reasonable valuations. Results so far are good. The index has returned 11.2% a year since inception in 2007 through the end of 2012, versus 1.7% for the Standard & Poor's 500 index.

"It doesn't outperform over every short-term period, but over the long term I think it's an enduring investment theme," says Heather Brilliant, global equity research director at Morningstar. The approach borrows a page from Warren Buffett, who has used the term "moat" at least 20 times over the years in his annual letters to Berkshire Hathaway shareholders.

Last April, Van Eck, a mutual-fund company, launched Market Vectors Morningstar Wide Moat Research (MOAT), an exchange-traded fund based on Morningstar's index. The fund has returned 15.3% since inception, versus 9.2% for the S&P 500 during the same period. It costs $49 a year per $10,000 invested, plus a standard stock commission to buy and sell.

Some wide-moat stocks are too expensive for value-minded investors. LinkedIn (LNKD) has a unique network of professional workers but traded recently at a 42% premium to its fair value, according to Morningstar. On the flip side, General Motors (GM) gets a moat rating of "none" but sells for about $28 a share, well below its fair-value estimate of $52.

The worst-positioned companies are those that are both pricey and difficult to defend from competitors. The numbers bode poorly for Cooper Tire & Rubber and home builder Lennar after both stocks nearly doubled in the past year.

On the other hand, six companies got added to the Morningstar Wide Moat Focus Index in the latest quarterly rebalancing. Berkshire Hathaway is a collection of businesses handpicked by Buffett for their competitive advantages and strong cash flows. Oracle's database software has high switching costs. Express Scripts, a drug-plan manager, uses its scale to get attractive prices from suppliers.

Intel (INTC) and Microsoft (MSFT), long dominant in chips and software for personal computers, are investing their vast cash flows into products for mobile devices. John Wiley & Sons (JWA), a book publisher, may seem a controversial index addition given the weak trends among booksellers. But it gets most of its profit from scientific journals that are a must-have for institutions.

Holdover index members include a few Barron's has recommended of late, including National Oilwell Varco (NOV), Western Union (WU) and Exelon (EXC). (See Feature, "Sitting on a Gusher of Opportunity;" Feature, ""The New Safe Stocks;" and Ahead of the Crowd, "When a Dividend Cut Says 'Buy'.")

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