The Morningstar® Economic Moat™ Rating

The concept of economic moats is a cornerstone of Morningstar's investment research philosophy and methodology. To us, buying a share of a stock means buying a small piece of a business, and successful investing involves a thorough evaluation of whether a business will stand the test of time. An economic moat is a structural competitive advantage that allows a firm to earn above-average returns on capital over a long period of time.

What's a Moat?

In a free-market economy, capital seeks the areas of highest return. Whenever a company develops a profitable product or service, it doesn't take long before competitive forces drive down its economic profits. Only companies with an economic moat are able to hold competitors at bay and generate economic profits over an extended period of time.

To help investors identify companies that possess a moat, we assign one of three Economic Moat™ Ratings: None, Narrow, or Wide. There are two major requirements for firms to earn either a Narrow or Wide rating: 1) The prospect of earning above average returns on capital; and 2) Some competitive edge that prevents these returns from quickly eroding.

A firm must possess a competitive advantage inherent to its business in order to possess a moat. Great management, size, dominant market share, easily-replicable technology or efficiencies, and hot products are advantages to any businesses, but none of them is a structural advantage that can sustain high returns over a long period of time.

Why Do Moats Matter?

Higher Intrinsic Value: The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. A company that is likely to compound cash flow internally for many years is worth more today than a company which isn't. Therefore, when comparing two companies with similar growth rates, returns on capital, and reinvestment needs, the company with a moat has a higher intrinsic value.

Investment Discipline: High returns on capital will always be competed away eventually. For most companies (and their investors), the regression to the mean is fast and painful. However, a few generate excess returns for many years, and moats give us an analytical framework for selecting them.

Greater Resilience: Moreover, if a firm can fall back on a structural competitive advantage, it's more likely to recover from temporary troubles. Moats provide a margin of safety because if you're confident in the moat, it's easier to average down if you initiate a position too early.

Mispriced Moats: Often, the benefits conferred by a moat are not fully factored into stock prices for several reasons. Most market participants own securities for short time periods, and moats matter much more in the long run than over the short run. Also, recency bias causes most investors to assume that the current state of the world persists for longer than it usually does. Our performance record suggests that waiting for wide moat stocks to become cheap is a compelling strategy.

From the Economic Moat™ Rating to the Morningstar® Wide-Moat Focus™ Index

Given our universe of stocks receiving an Economic Moat Rating of Wide, Morningstar has created an index that comprises the 20 stocks that are trading at the largest discounts to our analysts' fair value estimates. The index is reviewed on a quarterly basis.

The Morningstar® Economic Moat™ Rating

Economic Moat: The Five Sources of Sustainable Competitive Advantage

Moat Sources:	Intangible Assets	Switching Costs	Network Effect	Cost Advantage	Efficient Scale
Wide Moat	Coca-Cola: It's just sugar water, but consumers pay a premium.	Oracle: Switching from Oracle's tightly integrated databases could cause massive disruptions.	Chicago Mercantile Exchange: Its clearinghouse function keeps volume captive.	UPS: Ground delivery network has low marginal costs and high returns on capital.	International Speedway: Most metro areas can support just one NASCAR track.
Narrow Moat	Dr. Pepper Snapple: Good brands, but a lack of scale hurts returns.	Salesforce.com: A popular product, but switching costs are low for users.	NYSE Euronext: Equity volume is interchangeable, and competitors have been stealing share.	FedEx: The high fixed-cost air express segment is still a large proportion of revenue.	Southern Company: Utilities have natural geographic monopolies, but regulators restrain return.
No Moat	Cott Corporation: Private-label beverages are a commodity, with no brand loyalty.	TIBCO: High-end software "plumber" seeing competition from all-in-one solutions.	Knight Capital Group: Few network benefits from being an order-taker or market-maker.	Con-way: Trucking industry is very fragmented, making it tough to build scale and dig a moat.	Valero: Refiner is a price-taker with fungible commodities on both inputs and outputs.