The Morningstar® Economic Moat™ Rating

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—a structural competitive advantage that allows a firm to earn above-average returns on capital over a long period of time—are able to hold competitors at bay.

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.

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 deteriorating. A firm must have 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 that 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 diminish over time due to competition. 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 consists of the 20 stocks that are trading at the largest discounts to our analyst's fair value estimates. The index is reviewed quarterly.

Performance Record	Trailing 1-Year	Trailing 3-Year*	Trailing 5-Year*	Trailing 10-Year*	Since Inception* (9/30/2002)
Morningstar Wide Moat Focus	9.7	21.5	15.8	11.6	15.7
S&P 500 (Cap Weighted)	13.7	20.4	15.5	7.7	9.9

Source: Morningstar. Time-weighted returns through December 31, 2014.
*Annualized percentage returns.

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Economic Moat
The Five Sources of Sustainable Competitive Advantage

	Wide Moat	Narrow Moat	No Moat
Intangible Assets	Coca Cola It's just sugar water, but consumers pay a premium	Dr Pepper Snapple Good brands, but a lack of scale hurts return	United Continental Name recognition doesn't result in sufficient pricing power
Switching Costs	Oracle Switching from Oracle's tightly integrated databases could cause massive disruptions	Salesforce.com A popular product, but switching costs are low for users	Macy's Consumers easily pick and choose among many retailers
Network Effect	eBay 145 million active buyers and sellers present a classic network effect	United Health Sizable membership and solid provider network allows firm to scale its fixed costs	Deutsche Telekom Despite its scale, it has not been able to generate returns above its cost of capital
Cost Advantage	UPS Ground delivery network has low marginal costs and high returns on capital	FedEx The high fixed-cost air express segment is still a large portion of revenue	Alcoa Low-cost bauxite resources can't offset industry oversupply
Efficient Scale	Canadian National Cost advantages, efficient scale, and network effect form a steep barrier to entry	Southern Company Utilities have natural geographic monopolies, but regulations restrain returns	Sprint Lacking scale versus AT&T and Verizon eliminates economic profit