October 15, 2024

Dear Client,

Banyan's equity composite gained 11.5% through the third quarter of 2024 versus the S&P 500's total return of 22.1%. Since the start of 2019, when yours truly officially took the helm, Banyan's equity composite has compounded at 14.4% per year versus the S&P 500's compounded total return of 17.5% per year. For more details about our composite, please click here.

Consumer Selection & Competitive Advantages

We shared the seven attributes of an ideal investment in our Q2 2023 letter (available here). To refresh your memory, we defined an ideal investment as a business that is:

(1) understandable;
(2) well financed;
(3) earning a high return on tangible capital employed;
(4) producing a superior product with durable competitive advantages;
(5) serving a growing market so earnings can be reinvested within the business;
(6) managed by smart and honest people who wisely allocate capital; and
(7) available at a bargain price that provides an adequate "margin of safety."

We discussed the third attribute – high returns on tangible capital employed – in our Q1 2024 letter (available here). We also touched on the fourth attribute in that letter, but it deserves more attention. In fact, analyzing competitive advantages is the "key to investing" according to Warren Buffett:

> "The key to investing is . . . [in] determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."[1]

Why are competitive advantages so important? Imagine a firm that satisfies the third attribute of an ideal investment but not the fourth. It earns high returns but lacks any advantage. The firm has created wealth for its owners since every dollar employed by the firm is worth more than a dollar in market value. Without a competitive advantage, however, its owners' wealth will prove fleeting.

Competitors will rush into the profitable firm's niche. They will replicate its product's key traits, introduce new product traits, and charge a lower price. The firm's returns will decay as business is lost to new competitors or it responds in-kind. The firm's owners will see their wealth decay along with the firm's returns. To avoid this outcome, a firm *must* possess a competitive advantage.

[1] Warren Buffet, "Mr. Buffett on the Stock Market," *Fortune Magazine*, November 22, 1999, available at: https://www.berkshirehathaway.com/1999ar/FortuneMagazine.pdf.

But what are competitive advantages, and how should investors think about them? Buffett's above quote provides a clue. In the second sentence, he focuses our attention on a firm's product or service rather than the firm itself. And Charlie Munger tells us to think in evolutionary terms:

> "[I]nvestors can make money by predicting the outcomes of practice evolution. You can't derive this by fundamental analysis – you must think biologically."[2]

Taken together, these quotes provide a framework. When analyzing competitive advantages, we should (1) think in evolutionary terms and (2) focus on products. We made this argument in a recent CFA Institute article (available here) and a follow-up podcast (available here).

Think of a firm as a commercial animal whose survival depends on consumers selecting its product over alternatives. A firm has a competitive advantage in the "struggle for survival" if it produces a superior product. To remain superior in the eyes of consumers, however, it must be hard for others to replicate the product's unique traits. Otherwise, the firm will lose its competitive advantage.

Hence Buffett's focus on products and Munger's evolutionary thinking. A firm lacks a competitive advantage if it lacks a superior product, and a product cannot be superior without unique traits that consumers value. A product-line therefore has a "wide, sustainable moat" around it if its valuable traits are *durably unique*. Only then will a firm possess a *durable* competitive advantage.

A firm possesses a *durable* competitive advantage, therefore, *only* if it is difficult, if not impossible, for competitors to replicate the unique traits of its product. Replication of a product's unique traits can be made difficult for numerous reasons, but two examples will prove the point:

1. **Forbidden Entry** | Steamboat monopolies were the titans of America's pre-Gilded Age. States granted monopolies to politically connected families. Only their steamboats could run along a given route. The traits of efficiency and speed differentiated their product, and it was illegal to replicate these traits. Then, in *Gibbons v. Ogden*, the Supreme Court declared these monopolies unconstitutional.[3] The routes were suddenly open to all. New entrants quickly replicated the incumbents' product traits. Having grown lazy, the ex-monopolists could not compete with hungry entrepreneurs like Cornelious Vanderbilt who "was economical almost to extremes."[4] His early employer, Gibbons himself, was right to be "afraid of this man," as the ex-monopolists soon learned.[5] As Vanderbilt gorged on their fattened carcasses, one ex-monopolist cried, "[He] is gnawing at our very vitals."[6]

2. **Difficult Entry** | Vontier's primary business, Gilbarco-Veeder Root, sells fuel dispensers and ancillary items to gas stations. The fuel dispenser is the heart of a gas station. If it fails, traffic declines, and the gas station business suffers. Environmental liability can also be huge if there is a leak. Yet, a fuel dispenser operates for years, if not decades, and cannot be easily tested before purchase. Thus, it is risky for gas station owners to experiment with a new entrant's fuel dispenser. A discounted price will not overcome the risk. As the oldest incumbent, Gilbarco-Veeder Root has a great brand reputation for reliability, which is the

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[2] The Best of Charlie Munger: 1994-2011, page 144 (notes of Witney Tilson at the Wesco Annual Meeting on May 15, 2000), available at: http://www.valueplays.net/wp-content/uploads/The-Best-of-Charlie-Munger-1994-2011.pdf
[3] *Gibbons v. Ogden*, 22 U.S. 1 (1824).
[4] T.J. Stiles, *The First Tycoon: The Epic Life of Cornelius Vanderbilt* (New York: Vintage Books, 2010), 117.
[5] *Id*. at 59.
[6] *Id*. at 141.

main trait its consumers select for. Anyone can enter the fuel dispensing niche, but they cannot replicate Gilbarco-Veeder Root's trusted brand. It is a *durably unique* product trait of Gilbarco-Veeder Root's fuel dispenser line. Thus, new entry is virtually nonexistent.

Steamboat monopolies had a huge competitive advantage pre-*Gibbons*. Entry into their niche was forbidden. Their advantage was *artificial*, however, and their fast demise post-*Gibbons* shows the danger of relying on such an advantage. Vontier's *natural* advantage, on the other hand, merely makes life difficult for new entrants. Although less formidable, such advantages are more durable.

To summarize, a firm must possess a competitive advantage, or "moat" around its product, if it is to sustain high returns and its owners' wealth. As Munger taught us, an evolutionary lens is needed in this analysis, and Buffett rightly focused the lens on products, not firms. This perspective helps us identify firms with *durable* advantages, and only *durable* advantages ***build permanent wealth***.

Sincerely,

Drew Estes, CFA, JD
Portfolio Manager