

Bringing economic moats to quantitative investing

Federated Hermes MDT Advisers

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Key takeaways

- Channeling the results of successful investors like Warren Buffett through a quantitative process has been problematic.
- Popularized by Buffet, companies with a wide “economic moat” that can help reduce competitive threats is appealing as an enhancement to traditional value investing.
- In 2023, Federated Hermes MDT began incorporating an industry moat factor to help identify companies whose out-of-favor status is likely only temporary.
- We believe this factor can help us identify companies that are more likely to overcome negative sentiment/momentum and potentially generate strong future returns.

Value investing in the US has gone through a rough stretch in recent years. Over the five years ending September 30, 2024, the Russell 3000® Growth Index outperformed the Russell 3000® Value Index by 8.48% annually. Tech giants with generally rich valuations dominate the list of the largest stocks in the US by market capitalization and have driven these returns. The largest stock that most investors would consider to be a value stock has only about one-third the market capitalization of the largest growth stocks. Interestingly, that value stock is none other than Berkshire Hathaway, the conglomerate run by Warren Buffett, perhaps the world’s best-known value investor. But even Buffett has long moved on from buying fair companies at a wonderful price to buying wonderful companies at a fair price.

What makes a company wonderful? An investing concept widely associated with Buffett — though he would credit his longtime friend and business partner, Charlie Munger — is to find companies with a wide economic moat, where a company has developed advantages that allow it to defend its profitability against encroaching competition. Brand identity (created through advertising and marketing spending) and patents (created through research and development spending) are two ways companies typically accomplish this. Coca-Cola, which Berkshire Hathaway has had a long-standing stake in, is a notable example of the former. Patent protection for pharmaceutical companies, an example of the latter, enables them to invest in the costly endeavor of developing new drugs so that competitors cannot imitate them.

Some wide-moat firms could be mispriced because standard accounting treatment generally expenses “moat building”. This lowers a firm’s income and appears at first glance as value destruction, not value creation.

One reason to suspect that wide moat firms might be mispriced in the market is that standard accounting treatment generally expenses “moat building” in the current period versus capitalizing the cost over a period of years. This lowers a firm’s income and thus appears at first glance as value “destruction,” not value creation. A more enlightened accounting treatment appreciates that such spending can create lasting value for the firm and possibly improve profitability for many years. Just think of all the decades-old advertising pitches and jingles the average consumer has rattling around in the back of their mind.

The challenge: Defining a moat

With this in mind, in recent years many systematic investors have tried to improve standard value factors by adjusting them to incorporate the ongoing value of economic moat-oriented spending. However, a lack of consensus indicates the elusiveness of replicating Buffett.^{1,2}



MDT has favored a different approach. Because we use decision trees in our stock-picking, we can introduce an economic moat as a standalone factor and let the data drive the specific contexts where using economic moats can help improve our investment decision-making. The premise of this process is that certain factors — or more importantly, combinations of factors — will be more relevant to certain company types than other factors.

In September 2023, we added an economic moat factor to our model that seeks to capitalize on a company's spending on potential moat-building activities. We aggregate estimated moats across a company's industry to smooth out inequalities in individual company data reporting, and call the resulting factor "industry moat." When added to our stock selection models, we found industry moat to be an additive source of excess returns.

The industry moat factor can help us most in improving stock selection among highly out-of-favor stocks — which are not precisely the same as value stocks, although there tends to be a substantial overlap. Our research has indicated that the stronger return potential among those stocks is associated with companies having a wider economic moat. In other words, companies in narrow-moat industries that offer a commoditized good or service with low value-added features (e.g., banks, airlines, mining) are less likely to rebound from a negative shock than those in wide-moat industries (e.g., software, retailing, pharmaceuticals).

Even successful companies can fall out of favor. An established moat can help out-of-favor companies keep competitors at bay, while it re-establishes operating results.

Applying the concept

We believe the industry moat factor works particularly well within our decision tree process. Companies with high market sentiment, those that have beaten earnings estimates quarter after quarter or those with other strong quality characteristics are typically already well appreciated by the market. So, the presence (or lack) of a wide economic moat tends not to have significantly impacted expected returns for those companies.

However, even successful companies can fall out of favor for various reasons, some within their control, but others beyond their control. An established moat can help out-of-favor companies keep competitors at bay while re-establishing operating results. Thus, we have begun to use this factor to help identify those companies that may be more likely to overcome negative sentiment/momentum to return to in-favor status, seeking to avoid companies whose stock prices continue to tailspin. To paraphrase Buffett, we believe it helps us identify wonderful companies at wonderful prices.

The quantitative advantage

While Warren Buffett comes across as the furthest thing from a quantitative investor, there is no doubt that there are systematic components to his investing process, even as his concept of value remains challenging to define. With Federated Hermes MDT's decision-tree-based quantitative process, portfolios can gain exposure to the concept of value without a fixed exposure to the systematic value factor, where investors' portfolios will tend to be overweight all cheap stocks and underweight all expensive ones. More importantly, decision trees can find opportunities within particular combinations of factors that simple factor tilts cannot. Every investor should be looking for the key that unlocks value. With a nod toward Omaha, we think the industry moat factor has helped us unlock value in certain overlooked companies that are temporarily out of favor.

¹ Feifei Li, *Intangibles: The Missing Ingredient in Book Value* (April 29, 2021). Available at SSRN: <https://ssrn.com/abstract=3686595> or <http://dx.doi.org/10.2139/ssrn.3686595>.

² Savina Rizova and Namiko Saito, *Internally Developed Intangibles and Expected Stock Returns* (July 27, 2021). Available at SSRN: <https://ssrn.com/abstract=3697452> or <http://dx.doi.org/10.2139/ssrn.3697452>.

There is no guarantee that any particular investment style will be successful.

This should not be construed as a recommendation for any particular sector or security.

The quantitative models and analysis used by Federated Hermes MDT may perform differently than expected and negatively affect performance.

Investing in equities is speculative and involves substantial risks. The value of equity securities will rise and fall. These fluctuations could be a sustained trend or a drastic movement.

Due to their relatively high valuations, growth stocks are typically more volatile than value stocks.

Value stocks tend to have higher dividends and thus have a higher income-related component in their total return than growth stocks. Value stocks also may lag growth stocks in performance, particularly in the late stages of a market advance.

Russell 3000® Index: Measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.

Russell 3000® Value Index: Measures the performance of those Russell 3000® Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 3000® Growth Index: Measures the performance of those Russell 3000® companies with higher price-to-book ratios and higher forecasted growth values.

Past performance is no guarantee of future results.