UNIT 3: WHAT MAKES A GOOD BUSINESS?

Welcome to Unit 3! Now that you have learned many of the basics of sound investing it is time to start digging deeper. Throughout the next units, you will be gaining substantial knowledge enabling you to make sound investment decisions. You will gain confidence as you work through the YIS units.

DESCRIPTION

Unit 3 will teach students the importance of economic moats. Students were introduced to the concept of economic moats in Unit 2. In Unit 3, students will learn how to identify the different types of moat and understand the concept of wide and narrow moats. Unit 3 includes several fun activities to help students gain confidence in identifying moats and applying their knowledge to investing situations.

CORE OBJECTIVES

Lesson One: How do I know if a company is a good business?

- Recognize and explain the characteristics that define a good business.
- Explain the importance of Return on Equity (ROE).

Lesson Two: Whatever Floats Your Moat

- Identify the main types of "economic moats" or competitive advantages that companies have.
- Understand the link between a good investment and a good business.

Lesson Three: Predict the Future

- Correctly predict which companies are most likely to succeed over the long run.

LENGTH

Approximately 90 minutes, split up into three (3) 20 to 40-minute lessons.

CONTENT STANDARDS

LESSON ONE

D2.ECO.1.9-12. Analyze how incentives influence choices that may result in policies with a range of costs and benefits for different groups.

CCSS.ELA-LITERACY.RI.11-12.7

Integrate and evaluate multiple sources of information presented in different media or formats (e.g., visually, quantitatively) as well as in words in order to address a question or solve a problem.

CCSS.ELA-LITERACY.SL.11-12.1

Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 11-12 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.

LESSON TWO

D2.ECOo.3.9-12. Analyze the ways in which incentives influence what is produced and distributed in a market system.

CCSS.ELA-LITERACY.RI.11-12.7

Integrate and evaluate multiple sources of information presented in different media or formats (e.g., visually, quantitatively) as well as in words in order to address a question or solve a problem.

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LESSON THREE

D2.ECOo.3.9-12. Analyze the ways in which incentives influence what is produced and distributed in a market system.

CCSS.ELA-LITERACY.SL.11-12.1

Initiate and participate effectively in a range of collaborative discussions (one-on-one, in groups, and teacher-led) with diverse partners on grades 11-12 topics, texts, and issues, building on others' ideas and expressing their own clearly and persuasively.

ADDITIONAL RESOURCES

- Access to Computers and Internet is preferred, but not required
- YIS Website www.younginvestorssociety.org – curriculum, videos and lesson plans
- YIS Glossary of Terms (full database at younginvestorssociety.org/resources)
- Zacks.com – for company research including ratios and screens
- Morningstar.com -- for company research including ratios and screens
- Gurufocus.com -- for company analysis
- Y-Charts – for company analysis and stock graphs.
- Wallstreetsurvivor.com -- for basic stock concepts
- Yahoo Finance and Yahoo Finance App -- for stock charts and basic company information

- Greenblatt, Joel. *The Little Book That Beat the Market.*
- Guest Speakers -- Write Contact@younginvestorssociety.org if you want help arranging a financial professional to come to your class
- Seeking Alpha – online portal of stock research reports (www.seekingalpha.com)
- Motley Fool – great daily content and stock picks (www.motleyfool.com)
- Investopedia.com – the “Wikipedia” of Investing, great online glossary of terms
- Stockcharts.com – for tracking stock market performance and comparison between stocks.

LESSON ONE: HOW DO I KNOW IF A COMPANY IS A GOOD BUSINESS?

OVERVIEW

The first lesson of Unit 3 will introduce students to the concept of Return on Equity (ROE). Students will learn how a high ROE leads to market forces will react to reduce those returns. Students will be reintroduced to the concept of economic moats.

LESSON SUMMARY

Warm-up: Students will discuss examples of companies that fail.

Learning Activity: Students will discuss and create hypothetical examples of businesses which have the potential of producing a high ROE.

Wrap-Up: Students will choose businesses they think are good investments.

OBJECTIVES

Students will be able to:

- Recognize and explain the characteristics that define a good business.
- Explain the importance of Return on Equity (ROE).

MATERIALS AND PREP

- YIS Prezi Unit 3.1

RESOURCES

- YIS Website www.younginvestorssociety.org

TEACHING GUIDE

Warm-Up: Ten Minutes

1. Prior to this class, assign each student the following task: Research one company that has gone bankrupt or failed in the past 20 years and briefly write down the reason why the failure occurred.
2. Have Prezi Unit 3.1 up when students enter the classroom.
3. Students will break into small groups of four and take turns presenting the company they researched to the group.
4. When groups are finished, explain that given the examples shared in the groups it is clear that many successful businesses eventually fail.
5. Ask students to discuss in their groups why they think some businesses succeed while others fail. Each group should share one thought with the class.
6. Ask students to discuss in their groups how we can identify the winners from the losers for investment purposes. Each group should share one thought with the class.
7. Explain to students that they will be learning some methods for identifying successful businesses in this unit.

Learning Activity: 20 minutes

1. Ask students to imagine they have two friends opening small businesses. Jack wants to open a candy store called Jack's Candy Shop. His startup costs are $2000 and each location will earn him $1,000 a year in profits. That is a 50% return on investment. He will make his investment back in two years and will double his money in four years as long as his shop stays profitable.
2. The other friend, Jill, is going to open a specialty pet store called Just Rodents. Her startup costs are also $2000. But the rat business model does not seem as destined for success. Also it only makes $40 a year in profits, which is a 2% return on investment.
3. Both owners want you to invest in their new businesses. Which business will you invest in?
4. Explain to students that a business that earns a high return on capital (or sometimes called return on equity or ROE) is always the best business. The ROE is the amount the business gives back to you each year as a shareholder. But not every business that has a high ROE today is a better investment than a business with a lower ROE.
5. Ask students if they would rather have $20 today and then $10 a day for the rest of their lives? Or $15 today and then $15 a day for the rest of their lives?

6. When making investment decisions, you have to consider if the business can keep making high returns in the future? Ask students what could happen to Jack's Candy Shop to bring down profits? What could happen to Just Rodents to increase profits?
7. Explain to students that any time a business like a candy shop earns exceptionally high returns, forces will come in to reduce those returns. If a shop is earning a 50% return on capital, like a magnet, this will attract more people to open candy shops, charge lower prices, advertise more, and eventually those returns will be reduced. High returns end up being whittled down to average over time. Unless, however, this company has something unusually powerful that others can't imitate. Warren Buffett called this an **"economic moat".** The best companies are the ones that provide high returns on capital, but are also able to protect and grow those returns through a unique protection (moat) that makes it very difficult for competitors to take them away.
8. Ask students to divide into partners. Each pair will come up with an imaginary business that they believe will earn a high ROE. Students need to consider what their economic moats will be.
9. Give pairs 10 minutes to come up with their ideas.
10. Each pair will present their business idea to the class and convince their classmates it is a good investment.

Wrap-Up: Ten minutes

1. Conduct a class vote to decide which of the imaginary businesses is the most likely to do well long-term.
2. Pass out copies of the Kodak article and ask students to read before the next meeting.
   http://blogs.wsj.com/source/2012/02/26/the-demise-of-kodak-five-reasons/

OVERVIEW

In the second lesson of Unit Three, students will gain a basic understanding of the different types of economic moats and what happens when businesses do not have economic moats. Students will practice identifying types of economic moats and develop an understanding of the relationship between a good investment and a good business.

LESSON SUMMARY

Warm-up: Students will read about companies lacking economic moats.

Learning Activity: Students will identify the different types of moats and research the economic moats of a variety of businesses.

Wrap-Up: Students will use their own knowledge to identify companies with wide moats, narrow moats, and no moats.

OBJECTIVES

Students will be able to:

- Identify the main types of "economic moats" or competitive advantages that companies have.
- Understand the link between a good investment and a good business.

MATERIALS AND PREP

- Internet access
- Computers or smartphones for research
- Copies of Handout 3.2
- YIS Prezi Unit 3.2

RESOURCES

- YIS Website www.younginvestorssociety.org

TEACHING GUIDE

Warm-Up: Ten Minutes

1. Have Prezi 3.2 up when students enter the classroom.
2. Ask students to take out the Kodak article
   http://blogs.wsj.com/source/2012/02/26/the-demise-of-kodak-five-reasons/
3. Divide students into groups to discuss the article. Student discussion should focus on the following questions.
   Why did Kodak declare bankruptcy?
   Do you think Koday could have prevented this demise? How?
4. Give students examples of other companies which have failed because of a lack of an economic moat. For example, IBM had a huge share of the PC market at one time, Netscape was the number one internet browser, General Motors dominated car sales but had to declare bankruptcy, and Corel was once a well-known word processing software.

Learning Activity: 20 minutes

1. Pass out Handout 3.2.
2. Students may work in partners or groups to complete the handout and will need computer access or smartphones to research.
3. Allow students 15 minutes to complete the handout. Circulate during activity to help answer questions and keep on task.
4. Review the answers to Handout 3.2 with entire class.

Wrap-Up: Ten minutes

1. Ask students to form groups of three.
2. Groups should work together to answer the following questions. They may use examples from previous classwork or come up with new ideas.

Name one business that you think has a "wide moat"? (one that is unlikely to have its competitive market position eroded 10 years from now). **Answer:** Many examples: Coca Cola (brand), Apple (brand, high switching costs), Exxon (low-cost oil), Google (network effect), Heinz (brand), Nestle (brand) are a few examples.

Name one business that you think has a "narrow moat" (one that has a good business today, but whose high returns are unlikely to last 10 years from now). **Answer:** Example include "hot products" such as FitBit, Biotech pharmaceutical companies that have "one-hit wonder" drugs, Zynga (mobile games), Target or most fashion retailers are here today gone tomorrow.

Name one business that you think has “no moat” (one that is a highly competitive, bad business today and in the future as well). **Answer:** Examples include most fad companies, airlines, price competitive retailers such as Best Buy, commoditized tech companies, most resource and materials companies, unless they can retain their low cost advantage. Often companies that are heavy on fixed assets (capital is the denominator) find it harder to make an exceptional return on capital.

3. Each group will briefly present their businesses to the class and explain why they chose each one.

Handout 3.2

Types of Economic Moats

- **Intangible Assets:** A company can have intangible assets, like brands, patents, or regulatory licenses that allow it to sell products or services that can't be matched by competitors.
- **High Switching Costs:** The products or services that a company sells may be hard for customers to give up, which creates customer switching costs that give the firm pricing power.
- **Network Effect:** Some lucky companies benefit from network economics, which is a very powerful type of economic moat. It says that the more people you have on your platform or in your distribution system, the better the value for them, which creates a virtuous cycle.
- **Low Cost Advantage:** Finally, some companies have cost advantages, stemming from process, location, scale, or access to a unique asset, which allow them to offer goods or services at a lower cost than competitors.

The following companies have stood the test of time, which probably indicates they have some sort of economic moat. Using the list about, identify what their economic moats are. There can be more than one per company and make sure to explain your evidence.

1) Coca Cola

2) Bank of America

3) Google

4) Wal-Mart

5) Exxon Mobil

OVERVIEW

During the third lesson of Unit Three, students will review the types of economic moats from the previous lesson. They will apply their knowledge of economic moats by making predictions about successful companies.

LESSON SUMMARY

Warm-up: Students will list companies with strong economic moats.

Learning Activity: Students will play a game to practice applying their knowledge of economic moats to predicting a company's potential for success.

Wrap-Up: Students will create a list of attractive investment ideas using knowledge of economic moats.

OBJECTIVES

Students will be able to:

- Correctly predict which companies are most likely to succeed over the long run.

MATERIALS AND PREP

- Internet access
- Computers or smartphones for research
- Copies of Handout 3.3
- YIS Prezi Unit 3.3

RESOURCES

- YIS Website www.younginvestorssociety.org

TEACHING GUIDE

Warm-Up: Ten Minutes

1. Have Prezi 3.3 up when students enter.
2. Have this chart on the board, on paper, or on the smart board.

Intangible Assets	High Switching Costs	Network Effect	Low Cost Advantage

3. Divide students into equal sized groups. Assign each group a color. This can be a marker, post-it notes, or font on the smart board.
4. The groups will race against each other to fill in the chart with examples of companies that possess each type of economic moat. Once one group has put down a company on the chart, another group cannot put the same one up in the same column. Remember some companies have more than one type!
5. Give students five minutes to add companies. At the end of five minutes, the group with the most companies on the chart wins.

Learning Activity: 20 minutes

Introduction:

1. Have students break into groups of four.
2. Explain to students that good businesses have something unusual about them. They retain their advantage for many years because they have unique characteristics such as a product or brand image that cannot be replicated.
3. Tell students to imagine it is the year 2005. Youtube and Facebook have just launched. American Idol was brand new and Brad Pitt was married to Jennifer Anniston.
4. If students had to guess which of the two companies below would keep their return on capital (ROE) over the next decade in line or higher than the previous 10 years, which would they choose?

   Apple: 13.7% ROE (1995-2004)
   Company Background: *Makes computers, phones, sells software and apps, and operates retail stores*

Or

Hewlett Packard: 12.2% ROE (1995-2004)
Company Background: *The largest computers company in the worlds. Also sells software services*

5. Have student groups take a minute to discuss and debate the question in their groups. Each group will give their answer with explanation.
6. Explain to students that the answer is Apple. Explain to students the following reasons for Apple's dominance.
   a. Apple increased from 13.7% to 30.9% return on equity (ROE) compared with HP whose ROE decreased from 12.2% to 10%.
   b. People like iPhones more than PCs, and Apple has a much stronger brand image, ecosystem around its products, and quality of design than HP.
   c. Apple benefits from the economic moats of a **strong brand** (they price their products at a premium) and **high switching costs** (the Apple ecosystem makes it costly to switch to Android or Windows once you've bought movies, music and apps on iTunes).
   d. Stock performance follows company performance, so Apple's stock increased 975% while HP increased by 40% over the time period.

Learning Activity:

1. Each group should select one person to act as portfolio manager and the rest of the group members will be stock analysts.
2. Distribute Handout 3.3 and give groups 15 minutes to make their choices.
3. Each portfolio manager will present their group's decisions and rationale to the class.

Wrap-Up: Ten minutes

1. Review the correct answers with the class. Each group should keep track of which ones they got correct and which ones were incorrect.
2. Each group should take five minutes to discuss where they went right and where they went wrong with their predictions.

Handout 3.3

Situation:

The year is 2005, and Aliens have invaded earth! They are going to destroy every human in the world, except they notice something they don't understand: how is it possible that some imaginary creatures, called "Companies" can be so dominant. They assume it will lead them to universal domination if they can discover the secret. So they make all humans a wager: if anyone is smart enough to know the secret of how to identify what companies will continue to make the same or higher return on equity over the next decade, then you get to live. If you can't, you die!

You will have a series of four tests. Only one of the two companies on each list could be defined as highly defensible, exceptional businesses that can protect its return on capital. Can you identify it? Your life depends on it. The aliens want to speak to "your leader" so you should debate on what to pick within the club, and eventually the portfolio manager will decide which stock to choose for the group. Ready earthlings!?

Here are some questions to consider as you debate the companies:

- What were the main things that happened to each company during the next decade (2005-2014)?
- What could you identify as each company's moat?
- Did demand for what they are selling increase or decrease?
- What makes one company more resilient than another?
- What is it about that businesses that makes them sticky? Is one "stickier" than the other?

1:

Walt Disney: 12.6% (1995-2004)

Company Background: *Operates Theme Parks, Makes Movies, Sells Merchandise, owns ESPN Networks and Disney Channel.*

2005-2014: ?

Nintendo: 15.1% (1995-2004)

Company Background: *Makes video game systems, video games, including Nintendo Wii, and Nintendo DS.*

2005-2014: ?

2:

Abercrombie & Fitch: 55.0% (1995-2004)

Company Background: *The most popular clothing retailer for teenagers, with very strong brand appeal*

2005-2014: ?

Coca Cola: 17.9% (1995-2004)

Company Background: *The leading beverage company in the world with the brands Coca Cola, Sprite, Fanta, PowerAde*

2005-2014: ?

3:

Southwest Airlines: 13.2% (1995-2004)

Company Background: *A well-run airline that is known for low-cost airfare.*

2005-2014: ?

McDonalds: 17.1% (1995-2004)

Company Background: *The leading fast food operator in the world.*

2005-2014: ?

4:

Microsoft: 25.2% (1995-2004)

Company Background: *Maker of Computer Software: Windows, Microsoft Office and Xbox Vid.*

2005-2014: ?

Verizon: 20.8% (1995-2004)

Company Background: *Leading cell phone operator in the US. Operates cable and fiber optic networks.*

2005-2014: ?

ANSWER KEY

Handout 3.1

1. Wal-Mart would likely be a formidable competitor to Jack's Candy Shop. They would have greater buying power from the Candy companies so they could likely achieve lower prices, and their nationwide rollout would create brand presence, leveraging Wal-Mart's "Every day low price" reputation they have built over decades. In general, the Candy business has little barriers to entry, which will make for a more competitive market for Jack. This makes defending Jack's current profitability difficult and it appears unlikely that he could maintain those exceptional returns on equity and profitability metrics. That being said, Jack may have a couple of attributes that Wal-Mart may not be able to match, such as a specialized, exclusive, or local candy, being closer to the customer, and creating a nostalgic brand to compete against Wal-Mart's "Big Box retail" brand. But, more likely than not, Jack's returns are going to come down. Candy Stores don't have much of a barrier to entry.
2. Answers will vary.

Handout 3.2

1) Coca Cola – Brand, Network Effect (Distribution around the world)

2) Bank of America - High Switching costs, (It's a pain to switch banks, so most people don't).

3) Google - Network Effect (the more people that use Google search, the better it becomes)

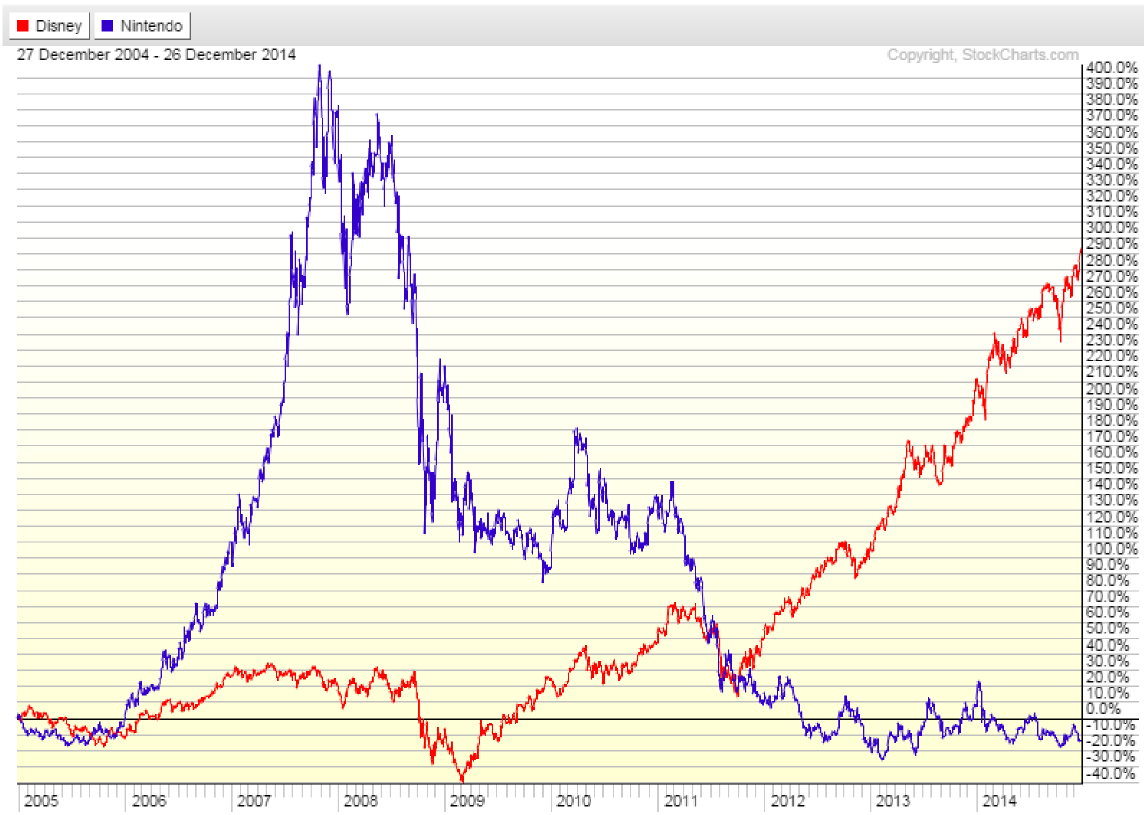
4) Wal-Mart - Low Cost (Wal-Mart's buying power allows them to buy products at the lowest cost) and Network Effect (Superior distribution and supply chain).

5) Exxon Mobil - Low Cost (Exxon has low-cost oil fields that make money in almost any oil price)

Handout 3.3

<u>Question 1: Walt Disney vs. Nintendo?</u>
Answer: Walt Disney
Results: Walt Disney went from 12.6% ROE (1995-2004) to 13.01% (2005-2014) while Nintendo went from 15.1% ROE (1995-2004) to 9.4% (2005-2014). The stock prices? Disney was up 298% and Nintendo was down 11.5%.

Rationale: Walt Disney Corporation has a strong brand of characters and theme parks; not to mention that ESPN is the most profitable television stations in the world. Their **brands** are about as strong as they come, just ask any kid under the age of 10. Nintendo, on the other hand, does have a decent brand, but video games are a hit and miss business. Nintendo actually lost money in 2011 and 2013 because of poor sales.



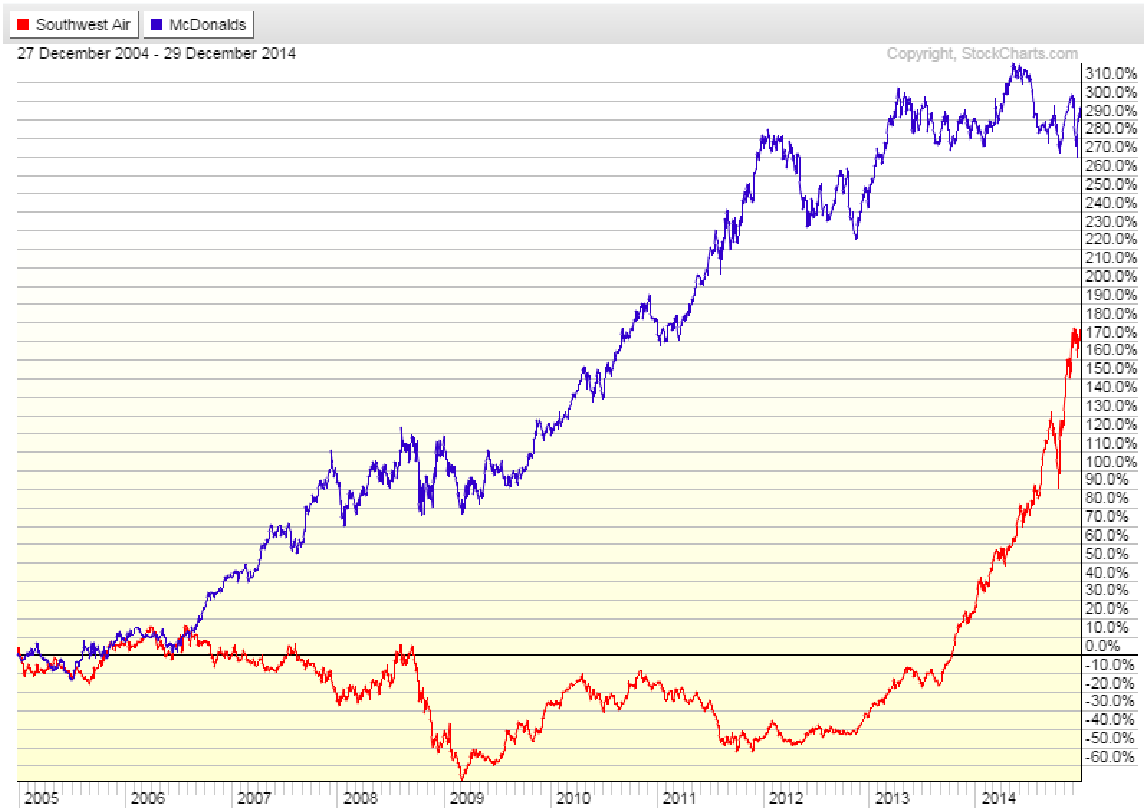
Comparative Stock Charts using StockCharts.com

<u>Question 2: Abercrombie & Fitch vs. Coca Cola?</u>
Answer: Coca Cola
Results: Coca Cola went from 17.9% ROE (1995-2004) to 29.5% (2005-2014) while Abercrombie & Fitch went from 55% ROE (1995-2004) to 16.4% (2005-2014). The stock prices? Coca Cola was up 110% and Abercrombie & Fitch was down an astonishing 56%.
Rationale: Coca Cola is probably one of the strongest **brands** ever built. They also have a **distribution advantage** (network effect) throughout the world as they dominate the soft drinks industry with over 50% of global sales. Abercrombie & Fitch is a clothing retailer, which is a very difficult business. Just think about going into a mall, there are hundreds of competitors, and the viability of the business in the future depends on staying "cool" and being on the cutting edge of fashion. Very tough to predict given the high amount of competition.

Both companies would have a “brand” but this shows that one brand is much stronger than the other.

Comparative Stock Charts using StockCharts.com

<u>Question 3: Southwest Airlines vs. McDonalds?</u>
Answer: McDonalds
Results: McDonalds went from 17.1% ROE (1995-2004) to 29.3% (2005-2014) while Southwest Airlines went from 13.7% ROE (1995-2004) to 7.5% (2005-2014). The stock prices? McDonalds rose 178% and Southwest Airlines actually held in there ok, up 157%.
Rationale: Although you might not care for Big Macs, McDonalds is still a legendary **brand**, especially overseas where it is a symbol of the American lifestyle. Their greater scale also enables them a **cost advantage** relative to other fast food chains. Southwest Airlines, is the best of a really terrible business: Airlines. It’s an example of the investment adage “it’s better to bet on a good horse than a good jockey,” meaning a bad business with great managers is likely a losing bet. Airlines are capital intensive (planes are expensive!) and are highly competitive on price. During this decade, Delta Airlines, Continental, and American Airlines all went bankrupt, so at least Southwest didn’t go bankrupt.



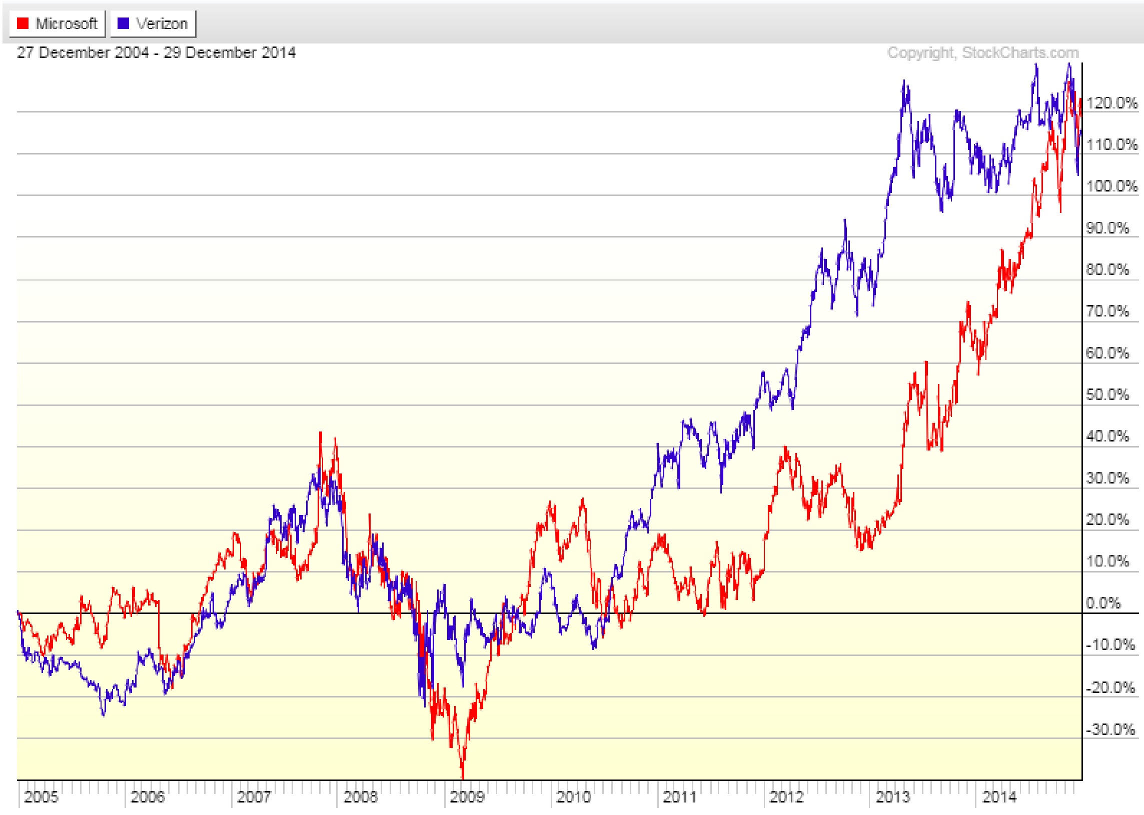
Comparative Stock Charts using StockCharts.com

<u>Question 4: Microsoft vs. Verizon?</u>

Answer: Microsoft

Results: Microsoft went from 26.2% ROE (1995-2004) to 35.1% (2005-2014) while Verizon went from 21.2% ROE (1995-2004) to 15.0% (2005-2014). The stock prices? Microsoft rose 78% and Verizon rose 73%.

Rationale: Microsoft benefits from one of the most powerful economic moats, the **network effect**. People use their office products (Microsoft Word, Excel) because everyone else does, which makes it the standard. Windows is also the standard operating system for most businesses. One could argue that Microsoft was one of the poorest run companies during this decade (throwing away billions of dollars into Nokia, mobile phones, Bing), but it didn't matter. The network effect was too powerful for even incompetent management to break. Verizon, is not a bad business, with a pretty good brand and a network effect (the more friends and family that are on Verizon the more valuable it is to you), but owning fiber optic cables and towers is a very capital intensive business so high returns are tougher to sustain. Not to mention Verizon was late to get the iPhone.



It could also be useful to have the students go to Zacks.com and research the company's income statement and financial ratios over time, and see which ones were the most stable.