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Disciplinary Moats and Super Moats: Insights Into Contemporary Formations of Structural Advantage

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Replay Jonathan's session at Wide-Moat Investing Summit 2019.

Using the work of the French philosopher Michel Foucault as a theoretical tool, in previous writings I identified the proliferation of discipline from the sites of contact Foucault discusses into numerous economic relationships from our daily life.[1] I call the structural advantage that binds us to these economic relationships a "disciplinary moat." This essay will discuss my current, still emergent understandings, brought forth through explorations of the social psychologist Stanley Milgram's concept of obedience and the anthropologist Grant McCracken's "Diderot effect."[2] Using McCracken's concept of "Diderot unities" as a template, I will discuss an ordering force for disciplinary moats, which I call a "super moat."[3] While this is an experimental essay, I do include a list of the economic commonalities of companies with disciplinary moats that non-theoretical readers may enjoy. With that said, and without fully ruining the surprise, let's begin.

Disciplinary moats are Warren Buffett's main form of moat; they are "the easy cases… sitting in plain sight."[4] Buffett's "easy cases" may be – today – companies with disposable, consumable, or maintenance-related functions, and companies who have a dominant market presence towards a consumer base that is prone to inertia. Furthermore, industry-specific rules, regulations, and traditions can serve to limit the field of competitors for these companies and make such cases even "easier."

Disciplinary moats are born through the operative conditioning of a consumer to repeat a site-specific function until it is frozen into a feedback loop. The frozenness of feedback loops, in my interpretation of Buffett, allows for a "reliable" judgment of the loop's "long-term economics."[5] The loop's resilience appears demonstrable, both in daily life and through an analysis of the historical financial statements where its powers over reality are embedded.[6]

Disciplinary moats operate through the elimination or the reduction of the processing cost of reality. Oftentimes, they are linked up with a social order, a regulatory order, or other structuring forces imbued with authority. The more the act of looping appears as a "non-discretionary" action—one that is vital, as if life itself depended on it, and not impulsive — the more resilient the disciplinary moat is to the subtleties and mood swings of the immediate environment. The more the disciplinary moat operates through a sleepwalking-type of economics, the less the participant is likely to view the product in a new, critical way at each encounter. Stanley Milgram suggests, in his experiments discussed in *Obedience to Authority: An Experimental View*,[7] that as situational identity replaces an "autonomous" participant capable of a critical position, the participant becomes a vessel "tuned" for the prescriptions of authority towards the completion of an already-defined set of procedures.[8]

In Milgram's experiment, a "teacher" is instructed to shock (indirectly) a "learner" when the learner answers incorrectly.[9] Meanwhile, an "experimenter," endowed with authority, monitors the situation. While the "expected" behavior is that the teacher will quickly stop shocking the learner,[10] in reality, the rules imparted by the situation quickly replace the humanity of the autonomous individual,[11] leaving in the individual's wake a "rigid mask" exhibiting "quiet satisfaction at doing his job properly."[12] Instead of exhibiting empathy, the teacher becomes a cog in the apparatus of authority.[13] In this subject-position, the teacher is overcome with what Milgram calls an "agentic state," characterized by "openness to regulation from an authority."[14]

The "agentic state," where a subject finds satisfaction in being the identity that the situation prescribes, is another way to describe what is happening with the experience of disciplinary moats by consumers. In the consumer's experience of disciplinary moats, as well as in the teacher's typical experience within Milgram's experiment, a subject position is codified through compliance with authority. The results of Milgram's experiment should have been less shocking, perhaps, as the participants were already trained for this discipline before entering the laboratory. When obedience is produced in the laboratory, it is because it has already been produced elsewhere, in schools, in product design, in the supermarket. Regardless of their site-specific locations, discipline functions in a similar manner, and our familiarity with it creates a redundancy that welcomes and rewards our continued discipline.

While disciplinary moats operate through a general familiarity imparted by society for cultivating disciplined subjects, their structural advantages are not without risk. The main risk of disciplinary moats involves their partial character; they are only part of a larger environment and, as such, shifts in reality can create conditions that do not integrate with the specificity of their chains of routine. This can "wake up" the sleepwalking economics of disciplinary moats as cognitive dissonance jars seemingly stabile structural relationships into unknown territories of potential opportunity, but also of potential destruction.

Since disciplinary moats exist in life among other disciplinary moats (as a trip to the store may reveal for a consumer, or a trip to a distributor may reveal for a business owner), multiple disciplinary moats can exist as part of a denser structure that we can call a "super moat." In his work *Culture and Consumption: New Approaches to the Symbolic Character of Consumer Goods and Activities*, Grant McCracken discusses Diderot unities as an explanation for how seemingly disparate products band together in the common refrain of a shared consumer identity.[15] McCracken gives the example of Yuppies uniting the Rolex with the BMW into a common order.[16] Both the Rolex and the BMW are, in the context of a Yuppie, "product complements" operating in a "general system of correspondence" as "lifestyle unities."[17] There is a "redundancy" between the two products, and they are united by their "symbolic properties" into a greater form of order.[18]

Diderot effects reinforce this greater form of order by imploring a "cultural consistency" among the individual's "complement of consumer goods."[19] Diderot effects " protect individuals from the intrusion of destabilizing objects into their lives" and promote "continuities of the experience and self-concept of the individual."[20] Through Diderot effects, the Yuppie establishes a Diderot unity of goods that makes the Yuppie a Yuppie. We can see how such Diderot unities can be, in the context of structural advantages, a "super moat" for seemingly disparate disciplinary moats that serve a common lifestyle, identity function, or other form of shared organization.

While Diderot effects are often an agent of self-similarity, they also have a potentially transformative function when a new good is introduced into a previously defined set of goods.[21] Here, the new good forces the other goods to become consistent with it.[22] This is how a "whole new me" can be constructed.[23] Thus, while Diderot effects have qualities geared towards maintaining order, they also have the potential to uproot codified relationships and promote a revaluation of these relationships. As I have mentioned previously, since disciplinary moats cannot control the wider environment, they are along for the ride when environments shift. While some may be integrated into new formations, there is the inherent risk that a "whole new me" will not include certain chains of routine, and that these chains will be broken (and replaced by new ones).[24] Thus, Diderot effects can be identified as the ways in which disciplinary moats maintain themselves, as well as the ways in which disciplinary moats are forced into new frameworks of reality, and also how they may become extinguished.

It is often prudent to attach a time decay element to structural advantages that are inflexible to changing landscapes, or whose dominance is confined to a certain matrix of relationships. In this sense, it may be specious to think that we can have a sense of the long-term economics of disciplinary moats apart from coming to terms with the moat's exposure to the whims of Diderot effects. Or rather, we may assign a ticking alarm clock to all but the most fluid and redundant of structural advantages, those structural advantages that, on a personal or product design level, can produce a plenitude of new realities, shapeshifting seamlessly with evolving environments.

To end this essay, I will make a (likely incomplete) list of the economic commonalities of companies with disciplinary moats.[25]

> 1) A low historical operating standard deviation. Operating standard deviation is defined as the standard deviation of the percent change in year-over-year sales, owner earnings, or another relevant measure of operating performance, throughout a business cycle or, preferably, throughout multiple business cycles.[26]
> 2) Persistently high ROIC over time. Based on appropriateness to the specific company, "ROIC" may mean cash ROIC, return on net tangible assets (Joel Greenblatt's "Return on Capital"),[27] and/or another appropriate measure of return on capital. For companies with disciplinary moats, variations in ROIC over time may tend to be more about company-specific productions than about the company's exposure to market conditions.
> 3) Two summations from Warren Buffett about retained earnings:
> a) "For every dollar retained by the corporation, at least one dollar of market value will be created for owners."[28]
> b) Returns on retained earnings are "equal to, or above those generally available to investors."[29]
> 4) The ability to grow owner earnings without (substantially) growing net tangible assets (this is another interpretation of Warren Buffett).[30] For acquisitive companies, one may want to compare the growth in owner earnings to the growth in the sum of net tangible assets, intangible assets, and goodwill. For acquisitive companies, one may also want to have a long enough time image of the company's financials in order to avoid reaching false conclusions.

Note: References to Buffett's investor letters are taken from *Berkshire Hathaway Letters to Shareholders*, 1965-2014, a collection of the annual reports compiled by Max Olson (Explorist, 2015). Page numbers are, according to Olson's book, original to the documents issued by Berkshire Hathaway. See the introduction of the aforementioned compilation for more information. In Buffett's investor letter citations, I list the page number of the original document followed by the page number of Olson's text in parenthesis. For example, Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 1986, 21-25 [194-198], means that pages 21-25 are from the original document, and pages 194-198 are from Olson's text.

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[1] Regarding Michel Foucault, see, for instance, Michel Foucault, *Discipline and Punish: The Birth of the Prison*, Second Vintage Books ed. (New York: Second Vintage Books, 1995). Of particular interest is the section entitled "Discipline" (135-228). Regarding Jonathan Isaac's previous work, see Jonathan Isaac, "Moats of Discipline, Moats of Control: Investing Beyond The Castle," June 9, 2018, MOI Global, *Wide-Moat Investing Summit 2018*. See also Jonathan Isaac, "Warren Buffett's Owner Earnings and Business Quality: A Path Forward in the Societies of Control," April 17th, 2019, Quilt Investment Management, LLC 2018 Annual Letter. Furthermore, see Jonathan Isaac, "The Birth of Extrinsic Value," March 4th, 2018, Quilt Investment Management, LLC 2017 Annual Letter.

[2] For a discussion of the Diderot effect, see Grant McCracken, C*ulture and Consumption: New Approaches to the Symbolic Character of Consumer Goods and Activities* (Bloomington and Indianapolis, Indiana: Indiana University Press, 1990): 118-129.
[3] For a discussion of Diderot unities, see Ibid.
[4] Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 1993, 11 [329]
[5] Ibid.
[6] While daily life may offer false positives regarding whether a company has a disciplinary moat, the information in financial statements may reveal the true character of the situation when also bundled with a deep understanding of the situation's qualitative aspects.
[7] Stanley Milgram, *Obedience to Authority: An Experimental View,* Harper Perennial Modern Thought ed. (New York, New York: HarperCollins Publishers, 2009)
[8] Milgram, 31, 144.
[9] Milgram, 10-11.
[10] Milgram, 27-31.
[11] Milgram, 30-31
[12] Milgram, 46.
[13] See, for instance, Milgram, 35.
[14] Milgram, 148.
[15] McCracken, 121.
[16] McCracken, 121.
[17] McCracken, 121, 123.
[18] McCracken, 121.
[19] McCracken, 123.
[20] McCracken, 124.
[21] McCracken, 125.
[22] McCracken, 119.
[23] McCracken, 127.
[24] As a reminder, a "whole new me" is McCracken's phrase from McCracken, 127.
[25] This list is likely incomplete and should not be viewed as a "complete" document regarding disciplinary moats.
[26] "Owner earnings" is a concept discussed by Warren Buffett in the appendix, "Purchase-Price Accounting Adjustments and the 'Cash Flow' Fallacy," to the Berkshire Hathaway 1986 Annual Letter. Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 1986, 21-25 [194-198].
[27] See, for instance, Joel Greenblatt, *The Little Book That Still Beats The Market: Updated with New Introduction and Afterword* (Hoboken, New Jersey: John Wiley & Sons, Inc., 2010): 166.
[28] Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 1984, 18 [147].
[29] Ibid.
[30] See, for instance, Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 2007, 7 [584] and Warren Buffett, "Berkshire Hathaway Inc. Annual Letter," 2009, 9 [627]. For further discussion of this quality, see Jonathan Isaac, "Warren Buffett's Owner Earnings and Business Quality: A Path Forward in the Societies of Control," April 17th, 2019, Quilt Investment Management, LLC 2018 Annual Letter.

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