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, students will start to see that knowledge pay off as they begin to evaluate companies. Encourage students to begin thinking about for the YIS Stock Pitch Competition.

DESCRIPTION

Unit 3 will teach students what makes a business last, it's competitive advantage or economic moat. 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 economic moats and applying their knowledge to investing situations.

Approximately 90 minutes, split up into three (3) 30 to 40-minute lessons.

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 Investment (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 (Activity)

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

ABOUT YOUNG INVESTORS SOCIETY

Young Investors Society (YIS) is a non-profit organization dedicated to preparing the next generation of investors. Flagship programs include the YIS Global Stock Pitch Competition, the Dollar-a-Day Challenge with Free Money Match® scholarships and the Certified Young Investment Analyst (CYIA®) Designation. Learn more at https://www.seedasdan.org/yis/

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.

CEE NATIONAL STANDARDS FOR FINANCIAL LITERACY (councilforeconed.org)

Standard V: **Financial Investing** Financial investment is the purchase of Financial assets to increase income or wealth in the future. Investors must choose among investments that have different risks and expected rates of return. Investments with higher expected rates of return tend to have greater risk. Diversification of investment among a number of choices can lower investment risk.

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

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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
- Learning Material: https://www.seedasdan.org/yis/– curriculum, videos and lesson plans
- YIS Glossary of Terms (full database at yis.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.*
- 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 competitive advantages and the four types of economic moats.

LESSON SUMMARY

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

Learning Activity: Students will participate in a business creation competition.

Wrap-Up: Students will illustrate understanding of the basic concept of an economic moat by giving examples of economic moats.

OBJECTIVES

Students will be able to:

- Recognize and explain the characteristics that define a good business.
- Define the four types of economic moats

MATERIALS AND PREP

- Copies of Handout 3.1
- YIS Video Unit 3.1

RESOURCES

- Learning Material: https:/ www.seedasdan.org/yis/

Handout 3.1

Types of Economic Moats

- **Intangible Assets (Brands):** 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. A strong brand can take decades to create though spending on advertising and delivery a quality product or service.
    - *Examples: Apple, Coca Cola.*
- **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.
    - *Examples: Banks, Tax Software*
- **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.
    - *Examples: Facebook, Amazon, Netflix*
- **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.
    - *Examples: Wal-Mart, Exxon Mobile (access to low-cost oil reserves)*

Activity explanation:
After showing the Prezi in which economic moats are explained and examples are given, students should be prepared to complete the following activity. The students will come up with their own companies with economic moats and compete for "funding" from mock investors.

Instructions:

- Get into five groups: one group of investors and four groups of entrepreneurs
- Each group of entrepreneurs is given an economic moat and its explanation: intangible assets, high switching costs, network effect, and low cost advantage
- Each group should create a completely original company idea that incorporates the economic moat they were given
- Each team should create a two to four minute pitch describing their product or service, brand, and economic moat. Get as creative as you want, using props if necessary
- After each pitch presentation have the investors give each group a score for their company idea and presentation each out of 5 and total them to see which team has the most points
- Award the "funding" to the winning team, you may choose to give them cookies, donuts, etc.

LESSON TWO: WHATEVER FLOATS YOUR MOAT

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 Video Unit 3.2

RESOURCES

- Learning Material: https:/ www.seedasdan.org/yis/

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Handout 3.2

Types of Economic Moats (same as Handout 3.1)

- **Intangible Assets (Brands):** 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. A strong brand can take decades to create though spending on advertising and delivery a quality product or service.
    - *Examples: Apple, Coca Cola.*
- **High Switching Costs:** The products or services that a company sells may be hard or a pain for customers to give up, which creates customer switching costs that give the firm pricing power.
    - *Examples: Tax Software, SAP software*
- **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.
    - *Examples: Facebook, Amazon, Netflix*
- **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.
    - *Examples: Wal-mart, Exxon Mobile (access to low-cost oil reserves)*

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) Johnson and Johnson

2) Bank of America

3) Google

4) Samsung Electronics

5) BHP Billiton (a global mining company)

LESSON THREE: PREDICTING THE FUTURE - ACTIVITY

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 Video Unit 3.3

RESOURCES

- Learning Material: https:/www.seedasdan.org/yis/

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Handout 3.3 – Predicting the Future Activity

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 advantage. One of the ways you can measure if a company has a sustainable advantage is to see if their returns (ROE) can remain high.

Can you identify which company can retain a high ROE over the following 10 years? Your life depends on it. 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 economic 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?

Problem #1:

Walt Disney: ROE of 12.6% (1995-2004)

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

2005-2014: Could they sustain the ROE?

Nintendo: ROE of 15.1% (1995-2004)

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

2005-2014: Could they sustain the ROE?

LESSON FOUR: THE SWOT ANALYSIS

OVERVIEW

In the fourth lesson of Unit Three, students will be introduced to SWOT analysis. SWOT is an acronym for Strengths, Weaknesses, Opportunities and Threats. SWOT analysis is a basic framework used to assess the overall strategic position of a business and its environment. Students will learn how to identify strengths, weaknesses, opportunities and threats for a variety of businesses. They will apply their knowledge as they identify and analyze the four components of SWOT for two given companies.

LESSON SUMMARY

Warm-up: Students will discuss the strengths and weaknesses of specific companies they've researched.

Learning Activity: Students will identify and discuss the components of SWOT for two sample companies.

Wrap-Up: Students will illustrate understanding of the basic concept of SWOT analysis by identifying one strong business and one weak business based on their SWOT analysis of the chosen companies

OBJECTIVES

Students will be able to:

- Create a SWOT analysis on a company and industry.

MATERIALS AND PREP

- Internet access
- Computers or smartphones for research
- Copies of Handout 3.4
- YIS Video Unit 3.4

RESOURCES

- Learning Material: https:/ www.seedasdan.org/yis/

YOUNG INVESTORS SOCIETY

Handout 3.4

SWOT Analysis

SWOT analysis is a tool for analyzing the strategic position of a company and its internal environment (strengths, weaknesses) and external environment (opportunities, threats). An overview of the four factors: Strengths, Weaknesses, Opportunities, and Threats is given below.

- **Strengths:** A firm's strengths are its unique capabilities or resources that give it a competitive advantage.
    - Examples: Patents, cost advantages from proprietary knowledge, exclusive access to natural resources, good reputation, financial resources, strong brand names, favorable access to distribution networks
- **Weaknesses:** Qualities that prevent the firm from achieving its goals (controllable)
    - Examples: Lack of patent protection, poor decision-making, a weak brand name, high fixed costs, poor reputation, high employee turnover, large amount of debt
- **Opportunities:** A firm may have new opportunities for profit and growth as a result of changes in its operating environment
    - Examples: New technologies, increasing demand, loosening of regulations, removal of trade barriers, undiscovered customer needs or preference
- **Threats:** Changes in the external environment may present threats to the firm that have the potential to jeopardize the business (not controllable)
    - Examples: Emergence of substitute products, price wars, shifts in consumer tastes, new regulations, increased trade barriers

Below is an example of a simple SWOT analysis:

Matt's Bike Shop: The Case for Expansion

Matt's Bike Shop is a wholly owned bike shop that leverages Matt's long-time experience with riding, selling, and repairing bikes. Matt's company is profitable with strong margins on its premium-priced bikes, but Matt is considering opening a new store to increase growth and profits.

Strengths:

- 25 year history, which has created a strong and loyal customer base
- Sells superior bikes and has strong relationships with national brands
- Strong sales growth and generous profit margins

- Deep knowledge about product line and skilled repair technicians

Weaknesses:

- Limited capital for expansion
- Hard to find skilled bike salespeople and technicians
- Limited market penetration due to a single location and a lack of web presence
- High employee turnover amongst junior employees

Opportunities

- Open a second location in order to gain more customers
- Partner up to access more capital
- Sell lower-priced bikes in order to access new buyers
- Increase repair space in new shop in order expand bike repair business
- Start an internship program in order to attract, train, and recruit employees
- Increase advertising spend in order to increase awareness about Matt's Bikes

Threats

- Online sales are gaining traction and cutting into profitability
- A competitor has talked about opening another shop down the street
- Consumers are buying more e-bikes
- Bikes have become more expensive as parts suppliers raise prices
- Competitors are spending more on marketing

For both of the following companies, identify two strengths, weaknesses, opportunities and threats and discuss with the group

1) Nike
    a. Strengths:
        i.
        ii.
    b. Weaknesses:
        i.
        ii.
    c. Opportunities:
        i.
        ii.
    d. Threats:
        i.

ii.

2) Home Depot

a. Strengths:

i.

ii.

b. Weaknesses:

i.

ii.

c. Opportunities:

i.

ii.

d. Threats:

i.

ii.

ANSWER KEY

Handout 3.1

Answers will vary.

Handout 3.2

1) Johnson & Johnson – Brand, Patents, Low Cost (Distribution around the world)

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

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

4) Samsung Electronics - Low Cost (Samsung makes the components at a large scale (semiconductors, OLED screens) that go into their smartphones and Brand

5) BHP Billiton - Low Cost (BHP has low-cost copper and iron mines)

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%.

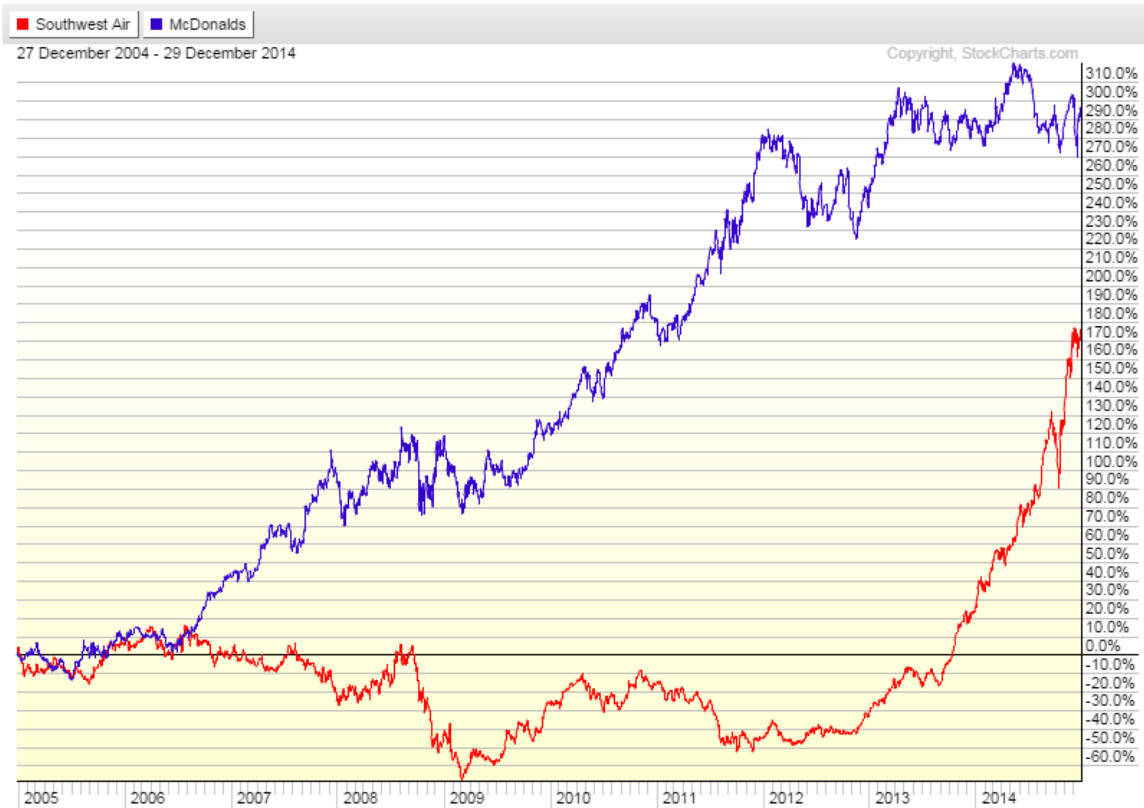
Rationale: Walt Disney Corporation has a strong brand of characters and theme parks; not to mention that ESPN is the most profitable television stations in the world. Their **brands** are about as strong as they come, just ask any kid under the age of 10. Nintendo, on the other hand, does have a decent 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.



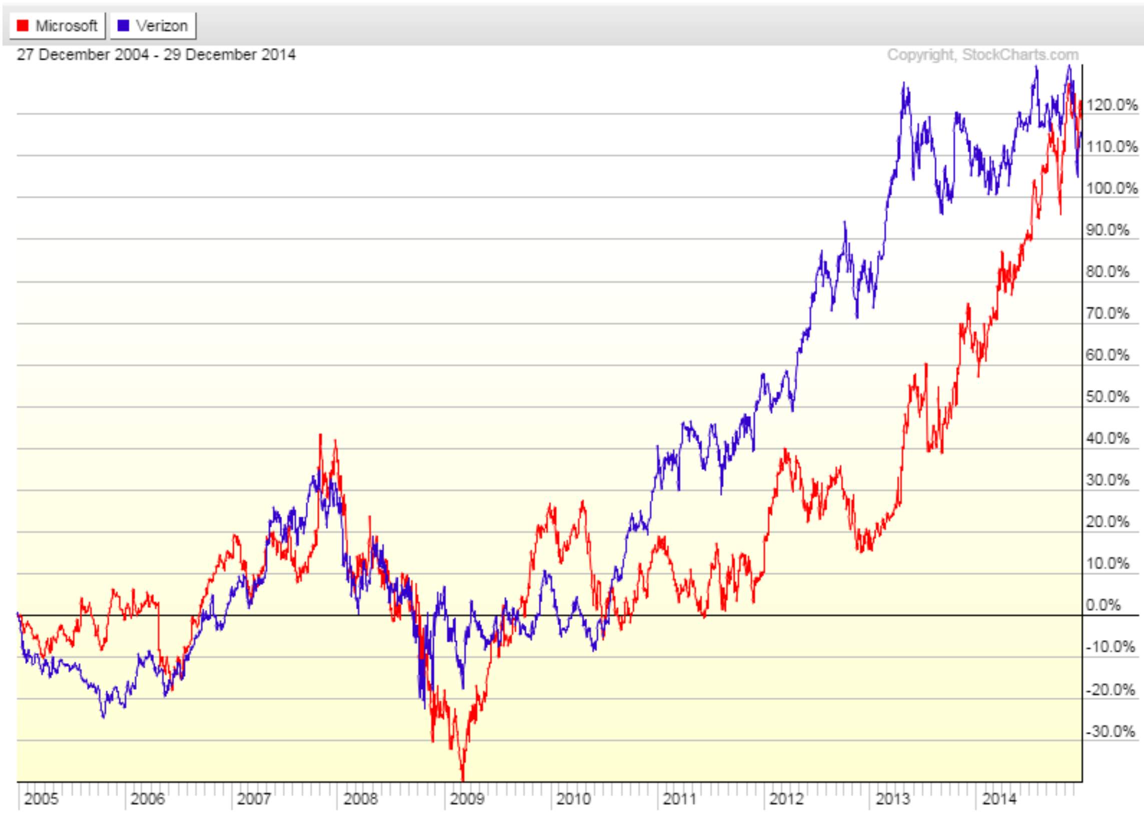
Comparative Stock Charts using StockCharts.com

Question 4: Microsoft vs. Verizon?

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.

Handout 3.4

Answers will vary for Nike and Home Depot