

Comment

February 2026

Bricks and bytes

How deep is your moat?



LATITUDE
INVESTMENT MANAGEMENT

BRICKS & BYTES

2026 | How deep is your moat?

EXECUTIVE SUMMARY

“Quality” became narrowly defined as capital-light, high-growth, high-ROIC, subscription-based businesses — a definition reinforced by the post-GFC, zero rate era.

Management incentives to deliver these target metrics leaned on price to drive growth — but pricing power borrowed against, rather than built, competitive moats—and underinvestment quietly eroded the durability it was meant to demonstrate.

Valuations embed high confidence in distant cash flows: at market multiples, c. 70% of value lies beyond year 10.

Falling interest rates were a major tailwind to “quality-growth” capitalising distant cash flows at ever lower discount rates. Outperformance over the last 15 years was driven meaningfully by multiple expansion, not unusually strong earnings growth.

The environment has changed: interest rates are unlikely to return to zero, AI introduces new uncertainty for pricing power, and a real cost of capital improves the relative attractiveness of physically moated businesses.

“Great business” does not equal “good investment”. High-quality companies can continue growing earnings and still deliver poor returns if valuations fail to reflect emerging risks.

Investors are insufficiently diversified: broad indices combine record valuations, concentration and margins, while many “diversified” portfolios share the same underlying AI and valuation risks.

In this environment, physical moats (“bricks”) may be more durable than intangible moats (“bytes”), offering comparable earnings growth with greater certainty and more attractive starting valuations.

Many quality-focused strategies have experienced a tough time in recent years, and as fellow quality investors, we’ve fielded a lot of questions as to why this might be.

We think the environment has changed and investors need to embrace a broader definition of quality, moving beyond the recipe for last decades winners: *high revenue growth, asset light, subscription businesses, with high return on invested capital.*

We fundamentally like the characteristics of capital-light businesses, owning several within our portfolio and believe some will prove great investments going forward.

However, we have identified what we think has been a change in *relative competitive positioning* among companies principally moated by physical attributes rather than intangible characteristics (“bricks versus bytes”), which *combines with* a potential change in *relative valuations*.

Many investors have skewed their portfolios significantly in favour of a cohort of capital-light businesses moated in the main by intangible assets; they risk being inadequately diversified in our view. Behaviourally, acknowledging this is a hard feat, requiring investors to overcome recency bias and endowment effects of what has worked over the last 15 years.

AMAZON: WHAT’S NOT GOING TO CHANGE IN TEN YEARS?

While building Amazon, Jeff Bezos is famously quoted as saying:

“I very frequently get the question: ‘What’s going to change in the next 10 years?’ I almost never get the question: ‘What’s not going to change in the next 10 years?’

And I submit to you that that second question is actually the more important of the two.”

“Customers are always going to want low prices, fast delivery, and vast selection - and I know that’s going to be true 10 years from now.”

We agree with Bezos’s judgement, and it’s a question we continually ask ourselves when assessing the *durability* and *knowability* of businesses and the industries within which they operate.

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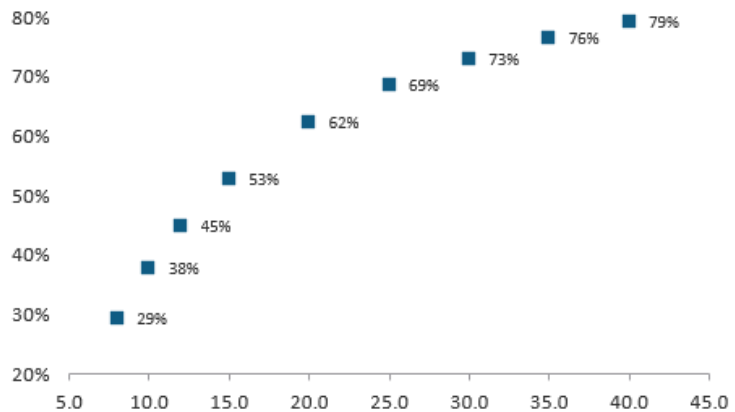
It's also the question investors *should be asking* when considering the future earnings prospects of the cohort of past quality winners.

In a period of undoubted rapid technological change, fuelled by vast pools of capital, we believe investors must retain the intellectual honesty and humility to be able to conclude "I don't know". Or at the very least, "I'm less certain than I was".

MOST VALUE SITS BEYOND 10 YEARS

This matters because when you pay 25x earnings for a stock, roughly 70% of the value resides in the cash flows *beyond* year 10. In owning such a stock, you're expressing a high degree of confidence in the growth and durability of earnings over a decade away.

Proportion of value beyond year 10 given at each starting multiple (discount rate = 8%)



“...when you pay 25x earnings for a stock, roughly 70% of the value resides in the cash flows beyond year 10.”

By definition, it's *assumed* that *quality* stocks are precisely those that possess the attributes that allow you to express confidence far into the future: durable growth with high profitability, protected by strong moats.

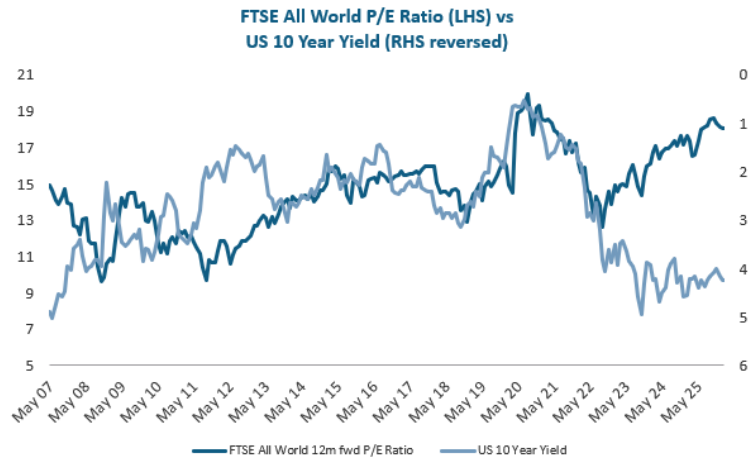
THE ROLE OF INTEREST RATES

Readers will be familiar with the fact that an added tailwind to quality companies with presumed long-duration cash flows was the decline of interest rates in the period following the global financial crisis. Lower interest rates pull forward greater present value to future profits, especially those sitting beyond year 10.

The chart below shows the forward earnings multiple of the FTSE All World against the US 10-year yield (reversed), showing how higher valuations correlated with lower yields.

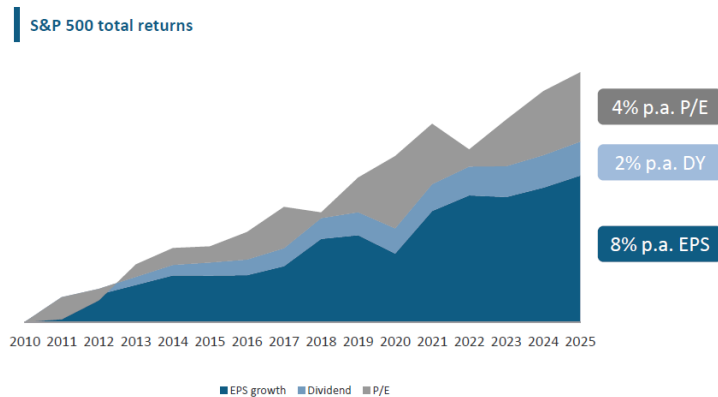
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The chart below disaggregates the total return of the S&P 500 index over the last 15 years; it isn't the case that growth has been materially higher than history.

“Earnings growth has not been unusually strong. From 2010-2025, multiple expansion has made an outsized contribution to market returns. Investors should be careful not to conflate higher historic realised returns with high quality.”



Since 2010, of the c.14% p.a. total return from the S&P 500, 8% has been derived from earnings growth, 2% from dividends reinvested and 4% from multiple expansion. This compares to 11% p.a. since the 1950s: 7% earnings growth, 3% from dividends and 1% from multiple expansion.

Earnings growth has not been unusually strong. From 2010-2025, multiple expansion has made an outsized contribution to market returns. Investors should be careful not to conflate higher historic realised returns with high quality.

ZOMBIES AND DISRUPTORS

The attraction of capital-light, quality compounders was itself significantly a function of the prevailing interest rate regime. They require only modest incremental capex (capital expenditure) to grow and low capital intensity implies large terminal cash flows.

Falling interest rates capitalised those distant cash flows at ever-lower discount rates, pulling value forward into the present. Businesses

COMMENT

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“High-innovation industries — technology, software, marketplaces, platforms, payments, advertising and e-commerce — occupied the sweet spot of growth: high revenue growth with low incremental capital.”

moated primarily by intangible assets proved the most interest rate sensitive and exhibited the strongest valuation and price momentum — even where reported earnings growth was not demonstrably superior.

High-innovation industries — technology, software, marketplaces, platforms, payments, advertising and e-commerce — occupied the sweet spot of growth: high revenue growth with low incremental capital. Low interest rates were oxygen for disruptive upstarts: food delivery, short-haul aviation, consumer fintech and buy-now-pay-later. They permitted challengers to subsidise customers, endure prolonged losses, and outlast incumbents whose economics depended on capital discipline and scarcity.

Conversely, **zero interest rate policy (ZIRP) penalised businesses moated by physical attributes**, requiring capex. Examples include airlines, energy, retail, infrastructure, logistics and distribution.

The penalty was both absolute and relative. In *relative* terms, their valuations were less sensitive to the lower interest rate regime. In *absolute* real-world terms, ZIRP allowed for the survival of ‘zombie’ unproductive capacity, so long as variable costs and debt could be financed. Very low financing costs weighed on industry economics as surplus capacity remained online, dumping products at marginal cost, suppressing pricing and returns — *even for good operators*. **Strong balance sheets went unrewarded, discipline was punished, and consolidation was delayed.**

Examples include airlines, where legacy flag carriers retained fundamentally uncompetitive fleet. It also impacted retail, and businesses with physical real estate networks.

“...zero interest rate policy (ZIRP) penalised businesses moated by physical attributes...valuations were less sensitive to the lower interest rate regime [and it permitted] the survival of ‘zombie’ unproductive capacity”

INCENTIVES DRIVE OUTCOMES

The environment and management incentives structures rewarded management teams who could show steady revenue growth, margin expansion and return on capital investment. Minimising capital deployment and maximising price realisation became the optimal strategy. These metrics *rewarded* restraint on investment and *punished* capital intensity—even when that investment **was precisely what was required to deepen the moat.**

In *enterprise software*, beneath polished dashboards, much of the underlying code is decades old. AI-native competitors (and increasingly, AI agents that sit *on top of* and *replace* legacy workflows) don't inherit that technical debt.

High friction switching costs provided an umbrella for price, which in turn was cited as evidence of strong competitive moats; but pricing power borrowed against, rather than built, competitive moats and

COMMENT

BRICKS & BYTES: HOW DEEP IS YOUR MOAT?

underinvestment quietly eroded the durability it was meant to demonstrate.

It remains to be seen which moats will prove able to withstand the AI-led wave of innovation.

RECOGNISING THE ENVIRONMENT HAS CHANGED

For 15 years, capital-light quality compounders outperformed consistently, had shallower drawdowns and recovered faster – continually being validated by falling rates at every wobble. Behaviourally, investors must overcome both the *endowment effect* and *recency bias* of what has worked for so long.

In 2022, interest rates lifted off and valuation multiples compressed from 22x to 15x forward earnings. In November 2022, OpenAI's ChatGPT launched, igniting the AI boom we presently find ourselves in and sending markets back to their valuation highs.

We think the environment has changed for capital-light quality stocks in at least three ways:

1. Interest rates are unlikely to return to zero bound and therefore are no longer the tailwind they were in the last decade
2. The advent of AI has introduced greater uncertainty for a large cohort of the last decades high innovation industries; spanning software, payments, ecommerce, platforms and professional services.
3. A true cost of capital has made businesses moated by physical assets, *relatively* more attractive.

HIGH INNOVATION INDUSTRIES – AI BYTES

We are undeniably living through an era of high technological innovation. Innovation wields a double-edged sword: great improvements may yield vast fortunes in some industries, whilst simultaneously decimating others.

Innovation's losers are usually apparent well before the long-term winners emerge and there are typically more victims than victors - despite the protestations and reassurances of incumbents. Exceptions to the historical pattern are rare.

We view with scepticism the 'knowability' of high-innovation industries, especially because they are often characterised by optimistic forecasts and lofty valuations, embedding dangerous wrong way risk should disappointment arise.

“Behaviourally, investors must overcome both the endowment effect and recency bias of what has worked for so long.”

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COMMENT

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As we previously noted, management teams leaned on price to deliver steady growth, margin expansion and high returns on capital, but high returns on capital inevitably invite competition – here and now, from AI.

Today, questions are being asked of a cohort of AI-facing industries encompassing many of the last decades high-quality, capital-light winners, spanning software, ecommerce and information services.

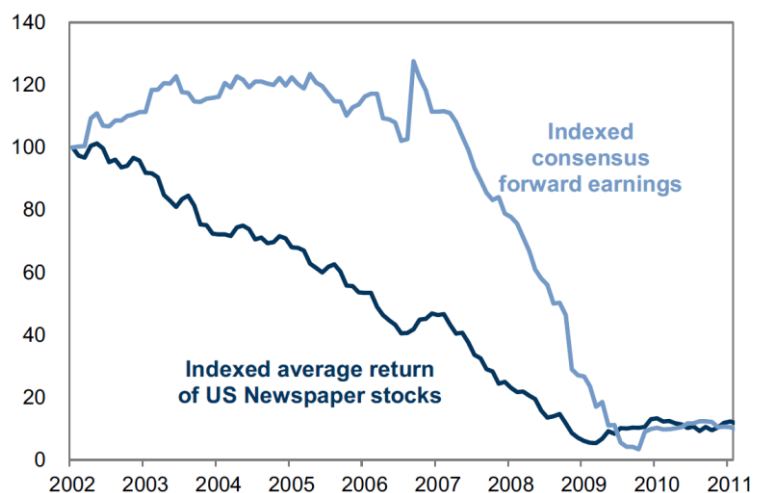
AI threats manifest in two ways, and investors must price for both:

1. **Product displacement:** AI creates superior alternatives (customer churn)
2. **Economic erosion:** AI reduces the ability to rely on price as a growth lever, or requires increased investment – squeezing margins.

You don't need certainty about which will occur or even *when* – the possibility of either compresses multiples when over two-thirds of value sits beyond year 10. The question is not an absolute one – it's a *relative* one. Are moats stronger or weaker, shallower or deeper?

To give a specific example of this dynamic, take the newspaper stocks in the 2000s, another industry built on the distribution of information; earnings were 'resilient' for five years before their eventual collapse and that didn't prevent the stocks steadily underperforming in the interim. The market is *usually right* and reacts well ahead of downgrades materialising.

Newspaper share prices troughed *slightly* ahead of consensus earnings estimates



Source: Goldman Sachs

A much more cautious stance on who wins from fast-paced innovation is why, in our view, stronger relative opportunities can be found in optically stodgier industries.

You don't need certainty about how disruption occurs or even when – the possibility of either compresses multiples when two-thirds of value sits beyond year 10. Earnings may remain resilient before their eventual collapse – that doesn't prevent stocks steadily underperforming in the interim.

COMMENT

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It is a choice for investors to participate in the AI disruption debate. In such times, we find more mature businesses, characterised by a slower pace of industrial and technological change, more knowable and offering greater stability. Here one may have a better chance of answering Jeff’s question with accuracy “what isn’t going to change in ten years?”.

ARE INVESTORS SUFFICIENTLY DIVERSIFIED?

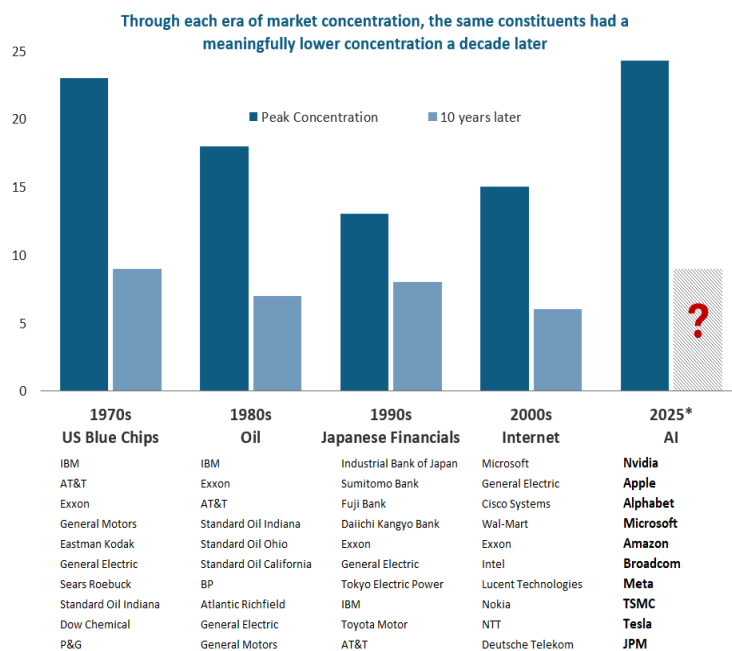
Today broad market indices sit at:

1. record valuations,
2. record concentrations and,
3. record margins.

We see risks to all three.

At 22x P/E, we believe markets embed a negative asymmetric risk. Simply put, **spot valuations are more of a risk than an opportunity to investors.**

Markets are also record concentrated, illustrated by the proportion of the MSCI World represented by the top 10 constituents. This has happened at various points over prior decades, and in every subsequent decade the same 10 stocks have comprised of dramatically lower weightings. *Caveat emptor.*



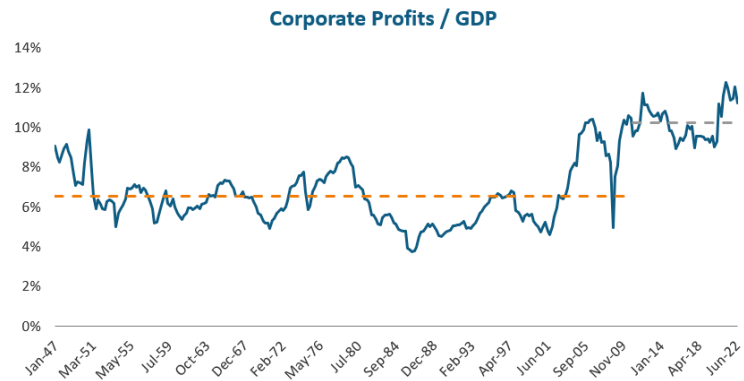
Corporate margins, illustrated here by corporate profits as a share of GDP, are also at record highs. While high-margin technology companies have no doubt driven margin expansion, we would also encourage investors not to forget the role of corporate tax rates (President Trump

COMMENT

BRICKS & BYTES: HOW DEEP IS YOUR MOAT?

cut the federal tax rate from 35% to 21% in 2018 – which won't reoccur) and interest rates which fell until 2022, but now represent a headwind as corporate debt reprices.

“Investors in broad market indices are therefore uncomfortably exposed to the combination of record high valuations, concentration and margins.”



For hyperscalers leading the charge on AI, we've [already noted](#) that once capital-light companies are now looking decidedly *capital intensive* with capex eclipsing 40% of sales. Where capex leads, *depreciation and amortisation* will follow.

For many of the capital-light winners of the last decade, there remains the uncomfortable question of whether AI may disrupt high incremental margin revenue streams, or impose greater investment costs, or both?

Investors in broad market indices are therefore uncomfortably exposed to the combination of record high valuations, concentration and margins.

Recently, the so-called “*SaaSocalypse*” drew headlines as AI disruption fears gripped software companies with a dramatic sell-off coincident with Anthropic's latest release of Claude Cowork.

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iShares Expanded Tech-Software Sector ETF

\$81.78 ↓ 21.37% -22.22 1Y

Pre-market: **\$82.23** (↑ 0.55%) +0.45

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1D 5D 1M 6M YTD 1Y 5Y MAX



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We should highlight that the tech-software sector has been underperforming for several months already and the moniker doesn't really capture the *breadth* of the sell-off.

You could have owned a publisher, online travel agent, exchange, information services company, B2B software company, consultancy, credit bureau, and payment services provider and think you were adequately diversified and *you would be wrong*.

We like some of these businesses and suspect some of them will prove resilient to AI disruption, but this misses the broader and more important point: **many portfolios are inadequately diversified for this emerging risk, and disruption to business models doesn't have to materialise to make these poor investments.**

Quality investors will reassure clients they own great businesses, pointing to strong moats, high returns on capital and pricing power, but the price paid for growth matters. High returns attract competition and AI's pace of innovation and capital deployment is forcing a critical question: **are many highly regarded companies on the cusp of disruption?**

Candidly, we're not sure. Many great businesses now share a common risk. Inverting Bezos's question — *what's not going to change over the next 10 years?* Can we have the same confidence in industry size and profit pools on a five, or even three-year, view? Caution is warranted, though loss aversion, recency bias and endowment effects will work powerfully against that conclusion.

LATITUDE'S ALTERNATIVE APPROACH

We consider ourselves quality-focused investors. We define quality through the lens of companies in which we believe we can have a high degree of confidence will deliver realised earnings growth, which converts to cash flow, and is available for either return to shareholders or reinvestment at an attractive rate of return.

Our objective is to:

1. maximise portfolio earnings growth,
2. in a diversified way,
3. at the lowest price possible.

We only invest where we believe there is a high probability of realising double-digit fundamental value growth (defined as earnings per share plus dividends reinvested). We do not assume valuation re-rating to achieve our target returns, preferring to view it as a margin of safety.

These three principles act as important guardrails to our investment process.

"You could have owned a publisher, online travel agent, exchange, information services company, B2B software company, consultancy, credit bureau, and payment services provider and think you were adequately diversified and you would be wrong."

"We have sought and found high-quality businesses moated by physical assets, infrastructure, scale, and oligopolistic market positions."

COMMENT

BRICKS & BYTES: HOW DEEP IS YOUR MOAT?

We noted earlier that the market has only grown earnings and dividends at 10% over the last decade, by setting our hurdle higher than this, we give ourselves the opportunity for *absolute* outperformance.

By minimising exposure to any one risk, we have remained open to a broader cohort of high-quality companies, with moats built with bricks as well as bytes.

We have sought and found high-quality businesses moated by physical assets, infrastructure, scale, and oligopolistic market positions.

Examples in our portfolio¹ include industries viewed traditionally as more mature; retail (**Tesco**, **Dollar Tree**), banking (**JP Morgan**), locks (**Assa Abloy**), industrial gases (**Air Liquide**), infrastructure assets (**Vinci**, **Eiffage**), oligopolistic distribution (**McKesson**, **Cencora**, **AutoZone**). We've written on the attractions of [utilities](#) and food retail (**Tesco**). **Ryanair** operates the youngest, most fuel efficient, and lowest cost fleet in Europe.

Since our launch in 2016, the portfolio has compounded earnings and dividends reinvested at 15% p.a., c.50% ahead of the market while presently trading on 15x earnings, a 30% discount to the market.

The breadth of our portfolio, including the limited exposure to current market themes of AI, is an intrinsic strength, and means we are taking less risk (valuation, concentration and earnings) to generate superior returns to the market.

CONCLUSION

For fifteen years, capital-light "quality-growth" businesses were the right answer to the wrong question. Falling rates, abundant capital and slow disruption made distant cash flows ever more valuable — multiple expansion did much of the heavy lifting.

Conversely, zero rate policy kept excess physical capacity alive, suppressing returns in more capital-intensive industries. Physically moated businesses - airlines, infrastructure, retail, utilities, distribution - were doubly penalised; their cash flows were shorter duration and less sensitive to falling discount rates. Cheap capital allowed weaker competitors to survive, delaying consolidation and suppressing pricing power.

Investment outlook	Intangible moat 'Capital light' businesses	Physical moat businesses
Interest rate environment	✗	✓
Competitive position	↘	↗
Protection from disruption	↘	↗
Valuation risk	✗	✓

¹ Read more on our portfolio holdings in our recently published [Annual Report](#)

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COMMENT

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Today's environment is different. Interest rates are unlikely to return to zero. AI has accelerated innovation and lowered barriers to competition. Price is unlikely to be as reliable a lever going forward.

This shifts the relative competitive positioning of businesses moated by tangible versus intangible assets. At current market multiples, roughly 70% of your value lies beyond year 10 — you are not buying earnings growth, you are underwriting durability. Disruption does not need to fully manifest for returns to disappoint; it only needs to impair confidence in the future mirroring the past.

Many portfolios today combine record valuations, concentration and peak margins — precisely as AI asks questions of intangible moats. In a more normal cost-of-capital world, physically moated businesses may offer stronger growth with greater knowability and more attractive starting valuations.

The critical question is not: who will win from AI? It is: what is unlikely to change in ten years? **Quality investing** was never about owning the most exciting businesses. It was **about owning the most durable earnings streams — at the right price**. Today, quality may increasingly be found in bricks as much as bytes.

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