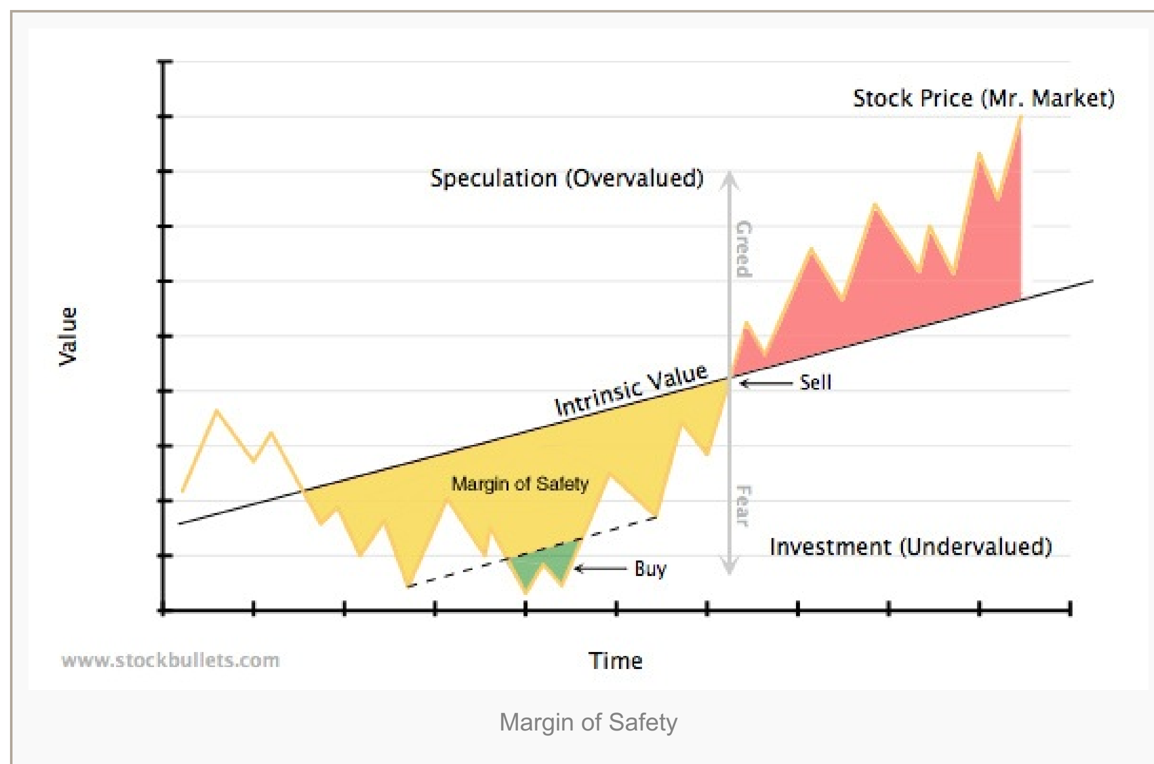
Why Margin Of Safety Is Misunderstood And Not Used Enough

Margin of safety are the 3 most important words in investing.

Here's an image that explains it very well.



Margin of Safety

But do you really understand what margin of safety means?

Here are some definitions and references to a few greats.

> *Margin of safety is the difference between the intrinsic value of a stock and its market price. Another definition: In Break even analysis, margin of safety is how much output or sales level can fall before a business reaches its break even point. – Wikipedia*

> *A principle of investing in which an investor only purchases securities when the market price is significantly below its intrinsic value. In other words, when market price is significantly below your estimation of the intrinsic value, the difference is the margin of safety. This difference allows an investment to be made with*

> *minimal downside risk. -Investopedia*
>
> *A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world. – Seth Klarman*
>
> *You have to have the knowledge to enable you to make a very general estimate about the value of the underlying business. But you do not cut it close. That is what Ben Graham meant by having a margin of safety. You don't try to buy businesses worth $83 million for $80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000 pound trucks across it. And that same principle works in investing. – Warren Buffett*

The Single Most Important Factor

Simply put, you practice margin of safety by buying an investment at a lower price than the valuation.

However, when margin of safety is mentioned, most investors link it to quality over price. Buy a quality asset that will be around for 20-30 years and you are set. But quality isn't mentioned once in the above definitions.

Quality doesn't ensure safety.

High quality assets can be risky, while low quality assets can be safe.

In all four quotes, there is only one common theme that addresses safety.

The price you pay.

Not the business, not how shareholder friendly the management is and certainly not the growth upside.

Margin of safety is all about price. Margin of safety is designed to make you money by not losing money.

> *Rule No.1: Don't lose money*

> *Rule No.2: Don't forget rule no.1*

This is Buffett's adaptation of margin of safety for the masses.

Bottom Up Investing

I admit it. I speculate here and there.

Who doesn't? When you think that Apple's iWatch will be a hit, it's speculating.

When you come up with theories of how Tesla will revolutionize the car industry, that's speculating.

But a margin of safety investment framework starts with assessing risks and the downside before focusing on potential returns.

> *Our disciplined risk aversion throughout 2011 enabled us to avoid dangerous temptations and remain focused on investments in our areas of strength and competitive advantage. – Seth Klarman*

Outside of investing, it's a fundamental core to many applications. Funny how it gets so out of whack when applied to investing.

> *In engineering, people have a big margin of safety. But in the financial world, people don't give a damn about safety. They let it balloon and balloon and balloon. It's aided by false accounting. – Charlie Munger*

Valuation is Most Important

Valuation is important, but every valuation method has assumptions.

I use multiple valuation methods to cover my bases because I don't believe a single valuation method is suitable for every company.

You wouldn't use a hammer to fix everything in your home. You may need a drill, a saw, a broom. That's how valuation should be.

Here are my methods of choice:

- a **DCF** for companies with strong and consistent cash flows
- **Reverse DCF** to find out what assumptions the market is pricing in
- the **Graham formula** to find the intrinsic ranges using EPS and for growth stocks
- **EBIT multiples** for relative valuation using EV/EBIT
- **Absolute PE** to calculate what information the current PE is providing
- **Earning Power Value** to value the competitive strength and to calculate a no growth value based on earnings strength
- A **net net calculation** where I want to figure out the asset value of a stock

However, no matter how few variables there are in your favorite stock valuation method, you always end up making assumptions.

But what if those assumptions go wrong? How do you limit the damage?

It comes back to the price you pay.

> *Valuation is the closest thing to the law of gravity that we have in finance. It is the primary determinant of long-term returns. However, the objective of investment (in general) is not to buy at fair value, but to purchase with a margin of safety. This reflects that any estimate of fair value is just that: an estimate, not a precise figure, so the margin of safety provides a much-needed cushion against errors and misfortunes. When investors violate [this principle] by investing with no margin of safety, they risk the prospect of the permanent impairment of capital. – James Montier*

Take Tesla for example. Awesome car. Awesome company. Awesome CEO.

However, for all the grand plans and world changing ideas being introduced, as an investment, there is a real risk of loss. 10 years down the line, Tesla may very well be worth $1,000, but today, the valuation has zero margin of safety.

As value investors, margin of safety is a familiar concept. Sure it's misunderstood at times, but outside the small community of value investors, margin of safety is a foreign language.

> *If you were to distill the secret of sound investment into three words, we venture the motto, **MARGIN OF SAFETY.**- Benjamin Graham*