Margin of Safety

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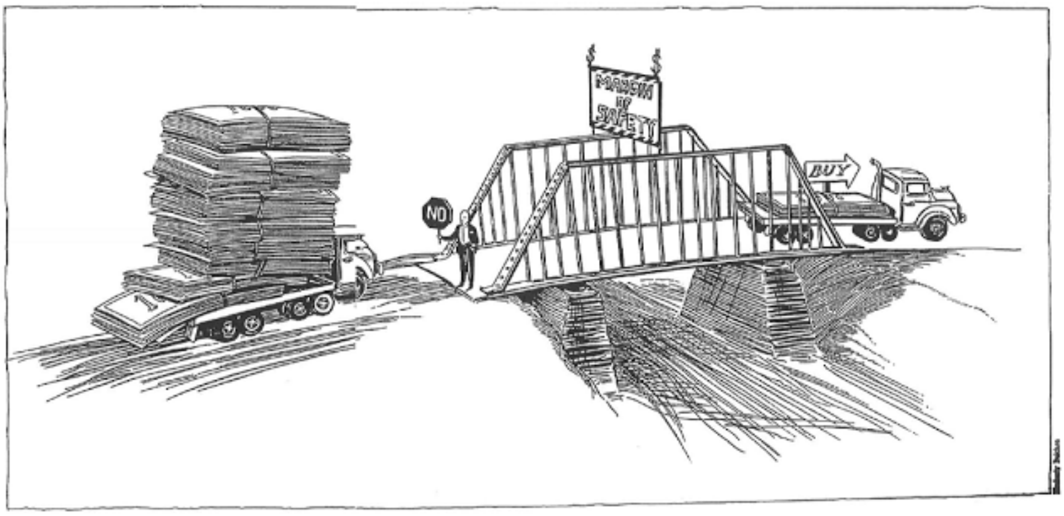
The concept of Margin of Safety is a core tenet of sound investing and engineering. In investing, it means the difference between the price paid and your assessment of fair value. The greater the differential, the greater the Margin of Safety. Warren Buffett compares it to driving across a bridge:

> *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.*



Chapter 20 of The Intelligent Investor by Ben Graham is the definitive chapter on this topic. Here Graham writes:

> *Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto,* ***Margin of Safety.***
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> *…*
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> *We have here, by definition, a favorable difference between price on the one hand and indicated or appraised value on the other. That difference is the safety margin. It is available for absorbing the effect of miscalculations or worse than average luck. The buyer of bargain issues places particular emphasis on the ability of the investment to withstand adverse developments. For in most cases he has no real enthusiasm about the company's prospects. True, if the prospects are definitely bad the investor will prefer to avoid the security no matter how low the price…If these are bought on a bargain basis, even a moderate decline in the earning power need*

not prevent the investment from showing satisfactory results. The margin of safety will then have served its proper purpose.

Graham warns us that we must not only focus on the upside, but must also ensure against loss if our analysis turns out to be wrong. Even the best investors get it wrong approximately 1/3 of the time. The good news is that we can control the consequences of being wrong by demanding a huge margin of safety in our investments.

Graham's Margin of Safety

- Low entry price (cheapness)
- Wide diversification

Graham practiced 'cigar-butt' investing – buying low-quality businesses cheaply. He would buy stocks of companies which were selling below net working capital or at multiples reflecting no growth. Due to the low quality of these businesses, he didn't know which of his investments would pay off. Therefore, he practiced wide diversification.

For example, a Graham investor would consider buying the stock of a company selling below net cash if the operating business was not losing money. Even if the business was a mediocre one, he was getting it for free.

For Graham, there were no good or bad businesses – only good or bad investments. Graham was a statistical bargain hunter and his investment operation depended on reversion to the mean.

He operated much like a casino would:

- Each bet has an expectancy of a profit even though some will inevitably result in a loss
- Wide diversification – any one player's outsized winnings cannot bankrupt a casino
- Cap on maximum bet size – no player can keep increasing their bet size to harm the casino in case he gets lucky on an oversized bet

Buffett's Margin of Safety

The sources of Margin of Safety for a Graham-type investor are different from a Buffett-type investor. For Buffett, the Margin of Safety resides in 3 things:

- Superior business models
- Strong capital structure
- Quality managers

Over the years, I have slowly made changes in my investment framework. Today, my emphasis is on 3 things – business, people and then price – in that order.

It is very hard to lose money in a great company, run by ethical managers, except when you have grossly overpaid for it. Even if you overpay slightly, you'll still do okay in the long run.

The ultimate sin is to buy into low quality businesses run by fools/crooks at high prices.

Conclusion

There is no 'correct' style of investing. There are many styles and you need to pick one which suits your personality and temperament.

My view is that investors should start off with wide diversification before taking more concentrated positions.

While investing in quality businesses sounds like a great idea, the difficulty with this approach is that everybody recognizes a great business and it is often priced for perfection. The aim is to not buy only good things, but to buy good things well – which is a lot harder than it sounds.