Chapter 20:
"Margin of Safety" as the Central Concept of Investment

“Margin of Safety” Introduction

1. All experienced investors recognize that the margin-of-safety concept is essential to the choice of sound bonds and preferred stocks. This past ability to earn in excess of interest requirements constitutes the margin of safety that is counted on to protect the investor against loss or discomfiture in the event of some future decline in net income.
2. The bond investor does not expect future average earnings to work out the same as in the past; Here the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future. If the margin is a large one, then it is enough to assume that future earnings will not fall far below those of the past in order for an investor to feel sufficiently protected against the vicissitudes of time.
3. The margin of safety for bonds may be calculated, alternatively, by comparing the total value of the enterprise with the amount of debt. (A similar calculation may be made for a preferred-stock issue.)
4. So much for the margin-of-safety concept as applied to “fixed value investments.” Can it be carried over into the field of common stocks? Yes, but with some necessary modifications.

“Margin of Safety” Introduction – cont.

5. There are instances where a common stock may be considered sound because it enjoys a margin of safety as large as that of a good bond. This will occur, for example, when a company has outstanding only common stock that under depression conditions is selling for less than the amount of bonds that could safely be issued against its property and earning power.

6. In the ordinary common stock, bought for investment under normal conditions, the margin of safety lies in an expected earning power considerably above the going rate for bonds.

7. The risk of paying too high a price for good-quality stocks—while a real one—is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions. The purchasers view the current good earnings as equivalent to “earning power” and assume that prosperity is synonymous with safety.

“Margin of Safety” Introduction – cont.

8. The danger in a growth-stock program lies precisely here. For such favored issues the market has a tendency to set prices that will not be adequately protected by a conservative projection of future earnings. (It is a basic rule of prudent investment that all estimates, when they differ from past performance, must err at least slightly on the side of understatement.) The margin of safety is always dependent on the price paid.
9. The buyer of bargain issues places particular emphasis on the ability of the investment to withstand adverse developments. For in most such 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. But the field of undervalued issues is drawn from the many concerns—perhaps a majority of the total—for which the future appears neither distinctly promising nor distinctly unpromising. 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.

Theory of Diversification

1. There is a close logical connection between the concept of a safety margin and the principle of diversification. One is correlative with the other. Even with a margin in the investor’s favor, an individual security may work out badly. For the margin guarantees only that he has a better chance for profit than for loss—not that loss is impossible. But as the number of such commitments is increased the more certain does it become that the aggregate of the profits will exceed the aggregate of the losses. That is the simple basis of the insurance-underwriting business.
2. Diversification is an established tenet of conservative investment. By accepting it so universally, investors are really demonstrating their acceptance of the margin-of-safety principle, to which diversification is the companion.

A Criterion of Investment versus Speculation

1. We suggest that the margin-of-safety concept may be used to advantage as the touchstone to distinguish an investment operation from a speculative one.
2. Probably most speculators believe they have the odds in their favor when they take their chances, and therefore they may lay claim to a safety margin in their proceedings.
3. By contrast, the investor’s concept of the margin of safety—as developed earlier in this chapter—rests upon simple and definite arithmetical reasoning from statistical data. We believe, also, that it is well supported by practical investment experience.
4. Thus, in sum, we say that to have a true investment there must be present a true margin of safety. And a true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience.

Extension of the Concept of Investment

1. Conventional investments are appropriate for the typical portfolio. Under this heading have always come United States government issues and high-grade, dividend paying common stocks. We have added state and municipal bonds for those who will benefit sufficiently by their tax-exempt features. Also included are first-quality corporate bonds when, as now, they can be bought to yield sufficiently more than United States savings bonds.
2. Unconventional investments are those that are suitable only for the enterprising investor. They cover a wide range. The broadest category is that of undervalued common stocks of secondary companies, which we recommend for purchase when they can be bought at two-thirds or less of their indicated value. Besides these, there is often a wide choice of medium-grade corporate bonds and preferred stocks when they are selling at such depressed prices as to be obtainable also at a considerable discount from their apparent value.

Extension of the Concept of Investment – cont.

3. It is our argument that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity— provided that the buyer is informed and experienced and that he practices adequate diversification. For, if the price is low enough to create a substantial margin of safety, the security thereby meets our criterion of investment. Our favorite supporting illustration is taken from the field of real-estate bonds.
4. The whole field of “special situations” would come under our definition of investment operations, because the purchase is always predicated on a thoroughgoing analysis that promises a larger realization than the price paid. Again there are risk factors in each individual case, but these are allowed for in the calculations and absorbed in the overall results of a diversified operation.
5. To carry this discussion to a logical extreme, we might suggest that a defensible investment operation could be set up by buying such intangible values as are represented by a group of “common stock option warrants” selling at historically low prices.
6. A sufficiently enterprising investor could then include an option-warrant operation in his miscellany of unconventional investments.

To Sum Up

1. Investment is most intelligent when it is most businesslike. It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. Yet every corporate security may best be viewed, in the first instance, as an ownership interest in, or a claim against, a specific business enterprise. And if a person sets out to make profits from security purchases and sales, he is embarking on a business venture of his own, which must be run in accordance with accepted business principles if it is to have a chance of success.
2. The first and most obvious of these principles is, “Know what you are doing—know your business.”
3. A second business principle: “Do not let anyone else run your business, unless (1) you can supervise his performance with adequate care and comprehension or (2) you have unusually strong reasons for placing implicit confidence in his integrity and ability.”

To Sum Up – cont.

4. A third business principle: “Do not enter upon an operation— that is, manufacturing or trading in an item—unless a reliable calculation shows that it has a fair chance to yield a reasonable profit. In particular, keep away from ventures in which you have little to gain and much to lose.” For the enterprising investor this means that his operations for profit should be based not on optimism but on arithmetic.
5. A fourth business rule is more positive: “Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it— even though others may hesitate or differ.” (You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.) Similarly, in the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand.
6. To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks.