Margin of Safety

Author: Seth Klarman

Book Summary

Taking a leaf out of Benjamin Graham's book, Seth Klarman's "Margin of Safety" discusses in detail not only the philosophy of value investing but also the logic behind it. It is a book that compels the reader to think deeply about investing and understand the rationale behind the guiding principles of value investing. "Margin of Safety" is one of the most coveted books in the investment community. Seth Klarman is the co-founder of Baupost Group where he and his partners have ensured a 19% annual return since 1982.

Key Takeaways

- Risk is equally, if not more important, than return. Investors tend to primarily focus on returns and often pay little heed to risk management. The key to successful investing is to focus on downside risk first, then consider the return perspective.
- Do not deploy cash unnecessarily. When there are no bargains available in the market, it is better to sit back and wait for the perfect pitch: the security with the highest margin of safety that is located within your circle of competence and possesses an array of catalysts that can push the price towards intrinsic value.
- The value investing philosophy is made up of three central elements: 1) it's a bottom-up approach to analysis; 2) one's results are measured in absolute terms rather than relative; 3) it's a risk averse strategy

Where Most Investors Stumble

Investors are frequently lured by the prospect of quick and easy gains and fall victim to the many fads of Wall Street. When it comes to investing in the stock markets, most investors are primarily focused on return, how much they can make, and pay little attention to risk ie. how much they can lose. However, avoiding losses should be the core goal of any investor. The avoidance of loss is the surest way to a profitable outcome. An investor is more likely to do well by achieving consistently good returns with limited downside risk than by achieving volatile and sometimes even spectacular gains but with considerable risk of principal. Rather than targeting a desired rate of return, even an eminently reasonable one, investors should target risk.

For example, an investor who earns 16 percent annual returns over a decade, might, perhaps surprisingly, end up with more money than an investor who earns 20 percent a year for nine years and then loses 15 percent in the tenth year.

A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. Value investors invest with a margin of safety that protects them from large losses in declining markets. Value investing, the strategy of investing in securities trading at an appreciable discount from underlying value, has a long history of delivering excellent investment results with very limited downside risk. Investors adopt many different approaches that offer little or no real prospect of long-term success and considerable chance of substantial economic loss. Once you adopt a value-investment strategy, any other investment behaviour starts to seem like gambling. In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking. It is vitally important for investors to distinguish stock price fluctuations from underlying business reality.

Prices move up and down for two basic reasons: to reflect business reality (or investor perceptions of that reality) or to reflect short-term variations in supply and demand. The actual risk of a particular investment cannot be determined from historical data. It depends on the price paid. This is where value investing comes into play.

The Value Investment Philosophy

Value investing is the discipline of buying securities at a significant discount from their current underlying values and holding them until more of their value is realized. The core premise of this philosophy is that an investment must be purchased at a discount from its true value. A market downturn is the true test of an investment philosophy. A notable feature of value investing is its strong performance in periods of overall market decline. Whenever the financial markets fail to fully incorporate fundamental values into securities prices, an opportunity arises for investors to buy stocks at prices that do not fully reflect their value.

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Because investing is as much an art as a science, investors need a margin of safety. 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. According to Graham, "*The margin of safety is always dependent on the price paid. For any security, it will be large at one price, small at some higher price, non-existent at some still higher price.*"

How can investors be certain of achieving a margin of safety?

By always buying at a significant discount to underlying business value and giving preference to tangible assets over intangibles. (This does not mean that there are not excellent investment opportunities in businesses with valuable intangible assets.) By replacing current holdings as better bargains come along. By selling when the market price of any investment comes to reflect its underlying value and by holding cash, if necessary, until other attractive investments become available.

The three-pillars or value investing

There are three central elements to a value-investment philosophy.

1. Value investing is a bottom-up strategy entailing the identification of specific undervalued investment opportunities.
2. Value investing is absolute performance, not relative-performance oriented.
3. Value investing is a risk-averse approach; attention is paid as much to what can go wrong (risk) as to what can go right (return).

The entire strategy can be concisely described as "buy a bargain and wait." While a great many methods of business valuation exist, there are only three that are useful.

- The first is an analysis of going-concern value, known as net present value (NPV) analysis. NPV is the discounted value of all future cash flows that a business is expected to generate.
- The second method of business valuation analyses liquidation value, the expected proceeds if a company were to be dismantled and the assets sold off.
- The third method of valuation, stock market value, is an estimate of the price at which a company, or its subsidiaries considered separately, would trade in the stock market. Less reliable than the other two, this method is only occasionally useful as a yardstick of value.

How do value investors deal with the analytical necessity to predict the unpredictable?

The only answer is conservatism. Since all projections are subject to error, optimistic ones tend to place investors in a difficult position. The assumption is that everything must go right in order to make money. Conservative forecasts can be more easily met or even exceeded. Investors are well advised to make only conservative projections and then invest only at a substantial discount from the valuations derived therefrom.

Value investors are absolute-performance oriented; returns are primarily a means for them to attain their own investment goals and not a comparison metric with the rest of the market. Absolute-performance-oriented investors are willing to hold cash reserves when no bargains are available. Cash is liquid and provides a modest, sometimes attractive nominal return, usually above the rate of inflation. The liquidity of cash affords flexibility, for it can quickly be channelled into other investment outlets with minimal transaction costs. Finally, unlike any other holding, cash does not involve any risk of incurring opportunity cost (losses from the inability to take advantage of future bargains) since it does not drop in value during market declines.

While most other investors are preoccupied with how much money they can make and not at all with how much they may lose, value investors focus on risk as well as return. Risk and return must, however, be assessed independently for every investment. It is only when investors shun high-risk investments, thereby depressing their prices, that an incremental return can be earned which more than fully compensates for the risk incurred. By itself risk does not create incremental return; only price can

accomplish that. Unlike return, however, risk is no more quantifiable at the end of an investment than it was at its beginning. Risk simply cannot be described by a single number. There are only a few things investors can do to counteract risk: diversify adequately, hedge when appropriate, and invest with a margin of safety.

The trick of successful investors is to sell when they want to, not when they have to. Investors who may need to sell should not own marketable securities other than U.S. Treasury bills. If what you hold is illiquid or unmarketable, the opportunity cost increases further. The most important determinant of whether investors will incur opportunity cost is whether or not part of their portfolios is held in cash. Maintaining moderate cash balances or owning securities that periodically throw off appreciable cash is likely to reduce the number of foregone opportunities. Another way to limit opportunity cost is through hedging. A hedge is an investment that is expected to move in a direction opposite to that of another holding so as to cushion any price decline. If the hedge becomes valuable, it can be sold, providing funds to take advantage of newly created opportunities.

The Value Investment Process

For every business that cannot be valued, there are many others that can. Investors who confine themselves to what they know, as difficult as that may be, have a considerable advantage over everyone else.

The first and perhaps most important step in the investment process is knowing where to look for opportunities. Investors cannot assume that good ideas will come effortlessly from scanning the recommendations of Wall Street analysts, no matter how highly regarded, or from punching up computers, no matter how cleverly programmed, although both can sometimes indicate interesting places to hunt.

By identifying where the most attractive opportunities are likely to arise before starting one's quest for the exciting handful of specific investments, investors can spare themselves an often fruitless survey of the plethora of investments available in the markets.

Value investing encompasses a number of specialized investment niches that can be divided into three categories:

- securities selling at a discount to breakup or liquidation value
- rate-of-return situations and
- asset-conversion opportunities

Value investing by its very nature is contrarian

Out-of-favour securities may be undervalued; popular securities almost never are. What the herd is buying is, by definition, “in favour”. Securities in favour have already been bid up in price on the basis of optimistic expectations and are unlikely to represent good value that has been overlooked.

Since they are acting against the crowd, contrarians are almost always initially wrong and likely for a time to suffer paper losses. By contrast, members of the herd are nearly always right for a period. Information generally follows the well-known 80/20 rule: the first 80 percent of the available information is gathered in the first 20 percent of the time spent. The time other investors spend delving into the last unanswered detail may cost them the chance to buy in at prices so low that they offer a margin of safety despite the incomplete information.

The presence of a catalyst serves to reduce risk. If the gap between price and underlying value is likely to be closed quickly, the probability of losing money due to market fluctuations or adverse business developments is reduced.

An investor's portfolio management responsibilities include maintaining appropriate diversification, making hedging decisions, and managing portfolio cash flow and liquidity. All investors must come to terms with the relentless continuity of the investment

process. Although specific investments have a beginning and an end, portfolio management goes on forever.

Even relatively safe investments entail some probability, however small, of downside risk. The damaging effects of such improbable events can best be mitigated through prudent diversification. The number of securities that should be owned to reduce portfolio risk to an acceptable level is not great; as few as ten to fifteen different holdings usually suffice. In general, an investor is better off knowing a lot about a few investments than knowing only a little about each of a great many holdings. The fact is that a diverse portfolio of overpriced, subordinated securities, about each of which the investor knows relatively little, is highly risky. Diversification, after all, is not how many different things you own, but how different the things you do own are in the risks they entail.

Investing is in some ways an endless process of managing liquidity. When investors do not demand compensation for bearing illiquidity, they almost always come to regret it. Because the opportunity cost of illiquidity is high, no investment portfolio should be completely illiquid either. Most portfolios should maintain a balance, opting for greater illiquidity when the market compensates investors well for bearing it. When your portfolio is completely in cash, there is no risk of loss. There is also, however, no possibility of earning a high return.

When the securities in a portfolio frequently turn into cash, the investor is constantly challenged to put that cash to work, seeking out the best values available.

There is nothing inherent in a security or business that alone makes it an attractive investment. Investment opportunity is a function of price, which is established in the marketplace. The single most crucial factor in trading is developing the appropriate reaction to price fluctuations. There is only one valid rule for selling: all investments are for sale at the right price. Decisions to sell, like decisions to buy, must be based upon underlying business value.

Once you choose to venture beyond U.S. Treasury bills, whatever you do with your money carries some risk. Don't think you can avoid making a choice; inertia is also a decision. It took a long time to accumulate whatever wealth you have; your financial well-being is definitely not something to trifle with. For this reason, I recommend that you adopt a value-investment philosophy and either find an investment professional with a record of value-investment success or commit the requisite time and attention to investing on your own.