

## Q23 ? Is there enough Margin of Safety?

### Objective:

Warren Buffett has said that the three most important words of equity investing are “Margin of Safety”. He has also said, “Price is what you pay, value is what you get.” Simply put, Margin of Safety is the difference between the intrinsic value of a stock and its market price i.e. Value-Price gap. The greater the difference the better it is for the investor.

The need for Margin of Safety is that the future is highly uncertain. Many of the assumptions which go into determining a stock’s value may not play out precisely as expected. Thus, as Benjamin Graham (the originator of the concept of Margin Safety) writes in *The Intelligent Investor*, “**the function of Margin of Safety is, in essence, that of rendering unnecessary an accurate estimate of the future.**”

Graham’s original measure of Margin of Safety was buying stocks whose earning (or expected earning) power on price (i.e. Earnings yield or  $1 \div P/E$ ) is considerably higher than the going rate for same-quality bonds. This is what may be traditionally called “Value Investing”.

However, Graham has expanded his idea Margin of Safety to encompass “Growth Investing” as well. He writes, “The growth stock buyer relies on an expected earning power that is greater than the average shown in the past ... In investment theory, there is no reason why carefully estimated future earnings should be a less reliable guide than the bare record of the past ... Thus, the growth-stock approach may supply as dependable a Margin of Safety as is found in the ordinary investment – provided the calculation of the future is conservatively made, and provided it shows a satisfactory margin in relation to the price paid.”

Other highly relevant extracts from Chapter 20 of *The Intelligent Investor* –

- ◆ “The Margin of Safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price.”
- ◆ “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.”

