

FUNDAMENTAL PRINCIPLE IN VALUE INVESTING

# RELEVANCE OF MARGIN OF SAFETY

**T**HE margin of safety is a fundamental principle in value investing that plays a crucial role in making informed and prudent investment decisions in the stock market.

It represents the difference between the intrinsic value of a stock and its market price. In essence, it acts as a cushion for investors, providing a safety net in case of adverse market conditions or misjudgments in the valuation of a company.

Investing in the stock market involves assessing the potential risks and returns associated with each investment.

The margin of safety is a rule of thumb that guides investors to minimise the downside risk and preserve capital. It is of paramount relevance when it comes to successful investing in the stock market. Fundamental investors disregard its relevance at their peril.

## Definition and calculation of margin of safety

The margin of safety is the difference between the intrinsic value of a stock and its market price. It is typically calculated using various valuation methods like discounted cash flows, earnings multiples or asset-based valuations. It provides an investor



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an edge.

Everyone is entitled to, and will, arrive at their intrinsic value of a share; how close you are to the actual value of the share will correspond to how much profit you reap from the stock market.

## Protection against market fluctuations

Stock prices are volatile and can fluctuate due to various factors such as economic conditions, market sentiment or company-specific events.

The margin of safety provides a buffer against these market swings, ensuring that the investor does not suffer significant losses even if the market price declines. Think of it as a safety net for a trapeze artiste — the wider the net, the greater the protection.

## Risk mitigation

Investing always carries inherent risks. The margin of safety acts as a risk mitigator by allowing investors to buy stocks at a price significantly below their intrinsic value. This reduces the risk of overpaying for a stock and potentially losing money. With intrinsic value, the greater the protection from downside risk, the greater the potential for upside rewards.

## Margin for error

Investors may make mistakes in their assessment of a company's true value. Margin of safety provides a cushion or margin for error in these judgments. Even if the intrinsic value is slightly miscalculated, the margin of safety helps protect against significant losses. Where the margin of safety is wide, you can afford to make slight errors in the computation of the intrinsic value. A slight under- or over-computation of the intrinsic value will still leave you with a reasonably handsome profit.

## Long-term perspective

Value investors focus on the long-term potential of a stock. The margin of safety aligns with this approach by providing a long-term buffer, allowing investors to hold onto their invest-

ments during market downturns and wait for the market to recognise the stock's true value.

## Provides psychological comfort

Knowing that you have bought a stock below its intrinsic value provides psychological comfort to investors during turbulent market conditions. This confidence can prevent impulsive selling or panic reactions in response to short-term market fluctuations. With all things being equal when it comes to fundamental analysis, it is the psychology that gives the edge.

## Enhances return potential

Buying stocks with a margin of safety increases the potential for higher returns when the market re-evaluates the company's true worth, and the stock price converges toward its intrinsic value. Investors can capitalise on this price correction for profitable exits. A risk-averse investor will provide a discount to his intrinsic value, thereby building a further buffer unto himself. Do not wait to sell at your intrinsic value but sell at a discount, say five per cent, to your intrinsic value.

## Contrarian investing

Contrarian investors often seek opportunities in undervalued or

out-of-favour stocks. The margin of safety is a critical component of contrarian investing, as it allows investors to buy when a stock is undervalued and sell when it approaches its intrinsic value. It is about courage and comfort. Contrarian investing requires confident courage while herd investing provides illusive comfort.

## Resilience during economic downturns

During economic downturns or recessions, the margin of safety becomes even more important. It provides a cushion against market crashes, ensuring that the investments are better positioned to withstand adverse economic conditions. You can withstand the bearish sentiments of the market knowing that you have a deeper margin of safety.

The margin of safety is a fundamental principle that underpins sound investment strategies.

It helps investors navigate the volatility of the stock market, make informed decisions, and ultimately, achieve their long-term financial goals while preserving capital and minimising risks.

The writer is chief executive officer of Minority Shareholders Watch Group.