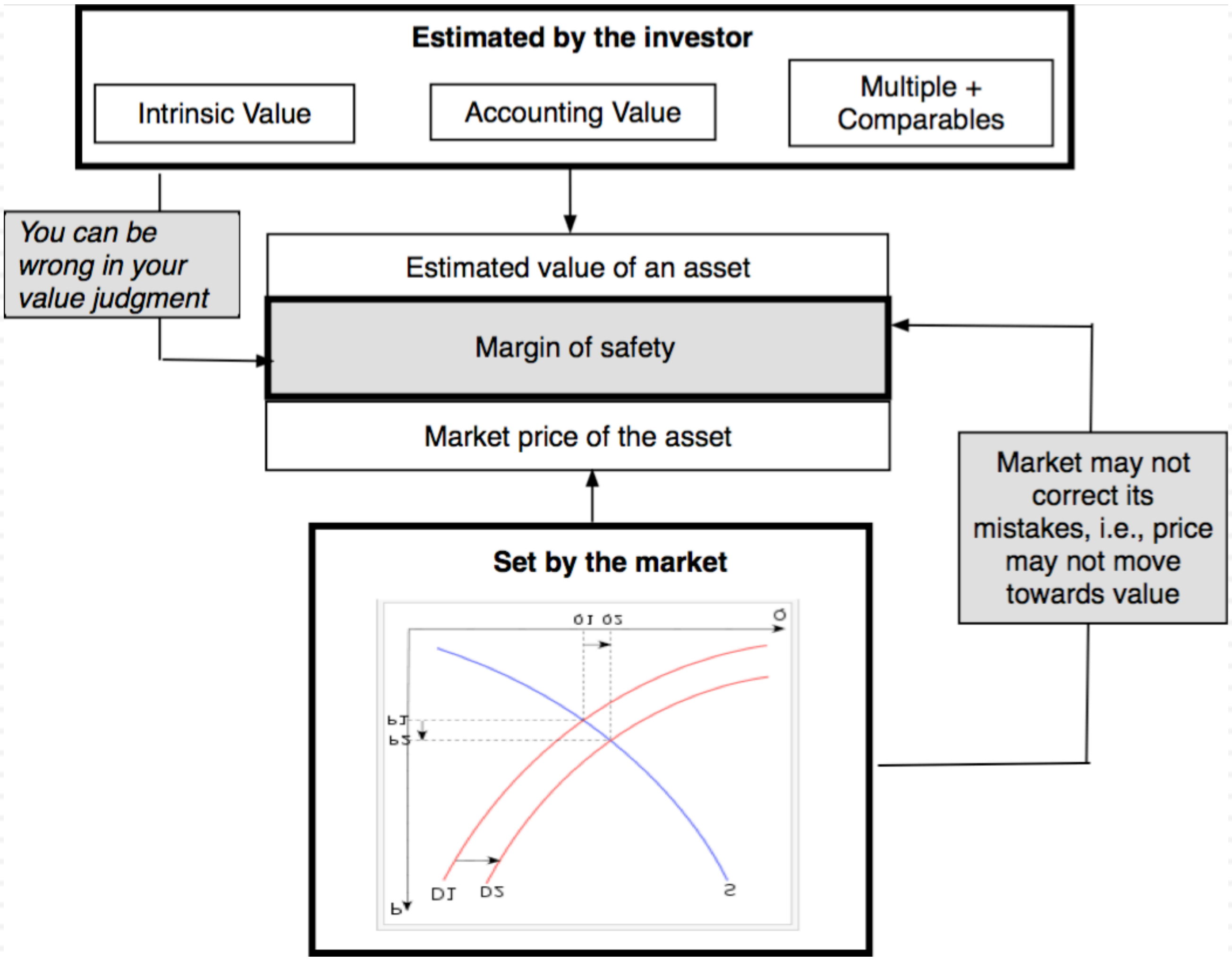
THE MARGIN OF SAFETY: TOOL FOR ACTION OR EXCUSE FOR INACTION?

You can be too conservative!!

The Margin of Safety



Why have a MOS?

- Reasons
  - Your value estimates have error in them. You can be wrong and very wrong, in some cases.
  - Even if your value estimates are right, the market price may not move towards that value.
- Potential Benefits
  - Less likely to invest in over valued stocks, because you have a buffer of safety.
  - Less likely to invest in assets that have significant downside risk.

MOS: Differences across investors

1. Value Approach: The way in which investors can estimate value can vary:
    a. Intrinsic Value, estimated from a discounted cash flow model.
    b. Asset-based Value, usually estimated from accounting balance sheets but perhaps also from liquidation estimates.
    c. Relative Value, estimated using a multiple and peer group pricing.
2. Magnitude: The magnitude of the MOS used can vary across investors, increasing with how conservative they are.
3. Fixed or Variable: Some investors have difference MOS for different assets, whereas others used a fixed MOS, no matter what they are investing.

Myth 1: Using a MOS is costless

		The Truth	
		Stock is under priced	*Stock is over priced*
Your Analysis	*Stock is under priced*	A Good Buy	Type 1 investment error: Buy the wrong stock or fail to sell the right stock.
	Stock is over priced	Type 2 investment error: Fail to buy the right stock or sell the wrong one.	A Good Sell

Reduce the likelihood of Type 1 errors

Increase the likelihood of Type 2 errors

Price

Increase the MOS

Value

Does the trade off work in your favor?

1. Are you more invested in cash than you would like to be?
2. Do you earn a return on your portfolio (cash included) that is more than you would have made investing passively?

Myth 2: If you use a MOS, you can afford to take valuation short cuts

- A MOS is only as good as the value that it is based off. If your value estimates are wrong, your MOS is just a percentage variation on a random (or close to random) number and can only damage you as an investor.
- If you are conservative in your value estimates, your values will be biased down and attaching a MOS to this “conservative value” is double counting or even triple counting risk.

Myth 3: The MOS should be the same across all investments..

- On an investment where you can estimate value with certainty and price differences are guaranteed to disappear at a finite point, you should not have and should never use a MOS.
- On any other investment, your MOS should vary across investments, increasing with riskier investments (and less efficient markets) and falling with safer ones (and more efficient ones).

Myth 4: MOS of the Sum = Sum of the MOS of the Parts

- The MOS for a stand alone investment will be larger than the MOS for that same investment in a portfolio, for the same reasons that the variance of a stock as a stand alone investment will be higher than the variance it adds to a portfolio.
- It follows then that using a MOS to accept or reject individual investments will bias you away from stocks that derive the bulk of their risk from company-specific risk factors.

Myth 5: The MOS is an alternative to other risk measures

- If you don't like conventional portfolio-theory based risk measures (like beta or betas), you should look for an alternative measure of risk to use in valuing assets.
- The MOS cannot be that measure, since it comes into the decision process after you have estimated value, not before.

If you want to use MOS..

1. Self Examination: Make sure the MOS fits your needs as an investor, given your
    a. Portfolio Size
    b. Investment Philosophy
    c. Concentration/Diversification
    d. Beliefs about market
2. Sound Value: Spend time developing a valuation approach that yields a reasonable and an unbiased estimate of value.
3. Be Flexible: Try to create a MOS measure that is flexible and varies across investments.

MOS Determinants

1. Valuation Uncertainty: The greater the uncertainty in estimating value, the higher the MOS.
2. Source of Uncertainty: The more company-specific the uncertainty, the lower the MOS, with the drop a function of how diversified you are.
3. Market Efficiency: The more efficient a market is at correcting its mistakes, the smaller the MOS.
4. Pricing Catalysts: The greater the likelihood of a price catalyst (that will cause the price-value gap to close), the smaller the MOS.