

How Margin of Safety Investing Opportunities Arise

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“In the short-term, the market is a voting machine. In the long-term it is a weighing machine.” Benjamin Graham

Executive Summary

This regular update is intended to be used as talking points with clients.

- A Margin of Safety exists when a security sells below its conservatively derived intrinsic value.
- The Trick to Capitalizing on a Margin of Safety is to calculate a security's intrinsic value in advance and then to wait for the market to vote the price down irrationally before buying.
- Demonstrated inefficiencies cause prices to fall irrationally and create buying opportunities.
- Managers following the Margin of Safety strategy have historically recovered quickly. This makes sense because the investments they purchase are intended to work within 3-4 years.

What is Margin of Safety?

A Margin of Safety arises when the price of the security falls substantially below a conservatively derived intrinsic value. The intrinsic value of a security is the value an outside investor would pay for it based on future income the security will generate (from distributions and capital gains) generally over a reasonable time period of 3-5 years. A margin of safety can be found in any security. For stocks, the most important question is whether the company will continue to function as a going concern in a potentially difficult competitive and economic environment and whether its enterprise value will be permanently impaired. The same news events can occur that create a Margin of Safety (or discount to intrinsic value) for a bond or for a stock.

In the case of stock investments, the growth rate of the economy where the company does its primary business is typically used for its earnings growth rate to determine a conservatively derived intrinsic value. This is where Margin of Safety investing is often confused simply with Value investing, which although correct on one level is insufficient because value is often confused with price.

Where Can I Find Margin of Safety?

Benjamin Graham believed an investor should buy stock in a sound company if the earnings yield (earnings divided by price) is higher than the yield of a bond of a high quality company. As an example, Johnson and Johnson is a sound company with low debt and a sustainable business model. Using very simple math, JNJ has an earnings yield of about 7.7%. In August of 2010, JNJ issued 10 year bonds yielding 3.0% and 30 year bonds at 4.5%. JNJ appears attractive from this simple metric irrespective of its 3.7% dividend yield.

Margin of Safety can also be found on a company's balance sheet. Most analysts spend the bulk of their time analyzing income statements and do not conduct an analysis of its balance sheet. Moreover, conservative companies, who do not need to raise capital from Wall Street, often have hidden assets on their balance sheet because the book value understates the true value of those assets. This affords a Margin of Safety because these assets can be sold, generating future income in addition to the income the company earns. This principle was well articulated by Marty Whitman in his book [Value Investing](#).

How Do I Capitalize on Margin of Safety?

It takes a lot of work to capitalize on this and is frankly very difficult for an individual investor to do on his own. The first step is to calculate a company's intrinsic value and have a list of companies you would like to own. At any given time, there are almost always some companies, of some size, somewhere in the world, that sell at a discount to their intrinsic value. Calculating intrinsic value is a subject for another day.

Demonstrated Inefficiencies Cause Prices to Fall Irrationally

Broad Brush Sector *MIS*Pricing

Periods of high volatility often result in securities being substantially mispriced. For example, during the banking crisis of 2007-2009, the share prices of nearly all financial stocks fell dramatically, even though many of them were not banking stocks which clearly were at risk of permanent loss of capital. Some of them were actually operating companies and were not subject to any credit risk. For example, during the 4th quarter XLY, the financial spider, and MA (MasterCard) both fell in price by about 40%. Of course the financial spider contained all of the large banks as well as operating companies like MasterCard and clearly there was a permanent impairment to capital. However, an enterprising investor, having calculated the intrinsic value of MasterCard based on its going concern value as an operating company (which our managers did) that purchased MasterCard after this fall, would have made a 95% return from the end of 2008 until today (4/28/2011) whereas an investor in XLY would have made 39%. Since the investor in XLY already lost over 40%, today he would still be down about 16%. Investors could also have bought American Express, also an operating company misclassified as a financial company.

Mispricing due to Poor Analysis

In September of 2009, Hertz's financials appeared so dire that a company called Audit Integrity identified Hertz as a primary bankruptcy candidate. Hertz responded, and then sued Audit Integrity for defamation. This is of interest because at that time the Fairholme fund owned over 46 million shares of Hertz, representing 4% of the fund and 11% of shares outstanding. In March, Bruce Berkowitz detailed the disconnect between the apparent financial condition of Hertz and its real condition, specifically that Hertz generates about \$1 per share of free cash flow according in sharp contrast to Bloomberg/ Morningstar data showing negative cash flow generated of over \$8 billion in 2007. The reason for this disconnect is that public data is reported according to GAAP accounting rules which cause real cash flow to be underreported, i.e. cash flow as reported included depreciation according to the tax schedule which is substantially higher than the operational use schedule at steady state (without invested in additional new equipment for expansion purposes).

More importantly for investors in the Fairholme fund, Bruce picked up shares as low as \$2 per share, unloading them for over 5 times that value.

Index Inclusion/ Exclusion

Since the beginning of the financial crisis, there has been an enormous move into ETFs. From March of 2009 to present assets in ETFs have grown from less than \$500 million to over \$1,000 million. Investors have increasingly sought indexes as investment vehicles. Indexing has the effect of including companies that have greater liquidity and excluding companies that don't. As more investors enter the index space, this has the effect of lifting the share prices of companies included in the indexes; similarly as they exit, it has the effect of reducing the price of companies there. Moreover, the price of a poor company, held in an ETF which is experiencing inflows, may be supported by its inclusion in the ETF and trade at an abnormally high valuation.

The implication of this is that a Margin of Safety is more likely to be found in less liquid companies with less broad-based analytical coverage. This creates an opportunity for a Margin of Safety Investor to purchase these companies, which as a pleasant side effect, are likely to be far less volatile than the index when an inevitable correction occurs

This year in particular, companies like this are underperforming and funds owning companies like this are also underperforming. Margin of Safety investors are willing to suffer short-term underperformance during such situations and wait for the inevitable volatility to follow and allow these managers to shine as they did during the last two major bear markets. What remains to be seen is whether the imminent correction will be more in line with the 2000 bear market, where many of these managers actually showed positive returns or like the 2008 bear market where they too suffered short-term losses but generally 1/3 less than the broad market.