Study Notes on Margin of Safety (With Calculations) | Marginal Costing

What Is Margin of Safety?

Margin of safety is a principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value. In other words, when the market price of a security is significantly below your estimation of its intrinsic value, the difference is the margin of safety. Because investors may set a margin of safety in accordance with their own risk preferences, buying securities when this difference is present allows an investment to be made with minimal downside risk.

Alternatively, in accounting, the margin of safety, or safety margin, refers to the difference between actual sales and break-even sales. Managers can utilize the margin of safety to know how much sales can decrease before the company or a project becomes unprofitable.

KEY TAKEAWAYS

- A margin of safety is a built-in cushion allowing for some losses to be incurred without major negative effect,
- In investing, margin of safety incorporates quantitative and qualitative considerations to determine a price target and a safety margin that discounts that target.
- By purchasing stocks at prices well below their target, this discounted price builds in a margin of safety in case estimates were incorrect or biased.
- In accounting the safety margin is built into break-even forecasts to allow for some leeway in those estimates.

Understanding Margin of Safety

The margin of safety principle was popularized by famed British-born American investor Benjamin Graham (known as the father of value investing) and his followers, most notably Warren Buffett. Investors utilize both qualitative and quantitative factors, including firm management, governance, industry performance, assets and earnings, to determine a security's intrinsic value. The market price is then used as the point of comparison to calculate the margin of safety. Buffett, who is a staunch believer in the margin of safety and has declared it one of his "cornerstones of investing," has been known to apply as much as a 50% discount to the intrinsic value of a stock as his price target.

Taking into account a margin of safety when investing provides a cushion against errors in analyst judgment or calculation. It does not, however, guarantee a successful investment, largely because determining a company's "true" worth, or intrinsic value, is highly subjective. Investors and analysts may have a different method for calculating intrinsic value, and rarely are they exactly accurate and precise. In addition, it's notoriously difficult to predict a company's earnings or revenue.

Example of Investing and Margin of Safety

As scholarly as Graham was, his principle was based on simple truths. He knew that a stock priced at $1 today could just as likely be valued at 50 cents or $1.50 in the future. He also recognized that the current valuation of $1 could be off, which means he would be subjecting himself to unnecessary risk. He concluded that if he could buy a stock at a

discount to its intrinsic value, he would limit his losses substantially. Although there was no guarantee that the stock's price would increase, the discount provided the margin of safety he needed to ensure that his losses would be minimal.

For example, if he were to determine that the intrinsic value of XYZ's stock is $162, which is well below its share price of $192, he might apply a discount of 20% for a target purchase price of $130. In this example, he may feel XYZ has a fair value at $192 but he would not consider buying it above its intrinsic value of $162. In order to absolutely limit his downside risk, he sets his purchase price at $130. Using this model, he might not be able to purchase XYZ stock anytime in the foreseeable future. However, if the stock price does decline to $130 for reasons other than a collapse of XYZ's earnings outlook, he could buy it with confidence.