MINORITY SHAREHOLDERS WATCH GROUP
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KEY INVESTING CONCEPT

CONSIDER MARGIN OF SAFETY

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IN investing, the margin of safety is often associated with the value investing approach, popularised by Benjamin Graham and Warren Buffett. The core principle of value investing is to buy securities when they are priced below their intrinsic value.

The difference between the intrinsic value and market price provides a built-in margin of safety — a degree of safety or cushion available to an investor.

The margin of safety provides protection against potential losses and serves as a buffer against unexpected market fluctuations or unfavourable circumstances. This approach aims to protect investors from potential downside risks and provides room for error or unforeseen events.

To understand the margin of safety, one must first understand the concept of intrinsic value.

Intrinsic value

Also known as fundamental value, an intrinsic value is the perceived or calculated value of a company based on its underlying characteristics, financial performance and future cash flows. It is the true or fair value of the company or its shares, independent of its market price.

According to the words of Buffett, "Price is what you pay, value is what you get".

The intrinsic value of an investment is determined by analysing various factors, such as the company's financial statements, earnings potential, growth prospects, competitive advantage, industry conditions and macroeconomic factors.

Different valuation methods can be used to estimate the intrinsic value.

We should all have a methodology for investing, a checklist of sorts. And we must stay true to our methodology. Tweak the methodology by all means, but stay true to the process.

It is important to note that intrinsic value is subjective and can vary depending on the assumptions and inputs used in the valuation process. Analysts or investors may arrive at different estimates of intrinsic value based on their perspectives and methodologies.

Additionally, market prices may not always reflect intrinsic value due to factors, such as investor sentiment, market inefficiencies or short-term fluctuations.

The concept of intrinsic value is widely used in fundamental analysis, which is an approach to investing that focuses on evaluating the underlying value and financial health of a company or asset.

By comparing the intrinsic value with the market price, investors can identify potential investment opportunities where the market price is lower than the estimated intrinsic value, indicating a potential undervaluation.

In summary, intrinsic value represents a company's true or fair value based on its underlying characteristics. It is estimated through various valuation methods and serves as a reference point for investors to assess potential investment opportunities.

Margin of safety

The margin of safety can be calculated in different ways, depending on the specific investment or valuation method being used.

One common method is to calculate the margin of safety as a percentage, by dividing the difference between the intrinsic value and the market price by the intrinsic value and multiplying by 100.

For example, if a stock's intrinsic value is estimated at RM10 and its market price is RM8, the margin of safety would be 20 per cent (RM2/RM10 x 100).

All value investors need to understand that the margin of safety is only an estimate of a stock's risk and profit potential.

Buffett likes a margin of safety of over 30 per cent, meaning the stock price could drop by 30 per cent, and he would still not lose money.

Another way to conceptualise the margin of safety is by comparing it to a safety net. Just as a safety net provides a cushion to protect someone from falling, the margin of safety provides a cushion to protect investors from potential losses.

By investing with a margin of safety, investors aim to reduce the risk of permanent capital impairment and increase their chances of generating satisfactory returns.

While the margin of safety is a widely recognised concept in investing, it is important to note that it is not a fool-proof strategy for success.

It was economist John Maynard Keynes who reminded us that "markets can remain irrational longer than you can remain solvent".

Market conditions and investor sentiment can change, and even investments made with a margin of safety can incur losses. Therefore, thorough analysis, careful consideration of risks and ongoing monitoring of investments are crucial for successful long-term investing.

In conclusion, the margin of safety is a key concept in investing that provides a measure of protection against potential losses. It represents the difference between an investment's intrinsic value and market price and acts as a cushion or buffer against unforeseen circumstances.

By investing with a margin of safety, investors minimise risk and increase the likelihood of achieving satisfactory returns.

However, it is important to recognise that investing always carries some degree of risk, and thorough analysis and ongoing monitoring are essential for successful investing.

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