



Why A Margin Of Safety Is Crucial For All Investors

Description

A margin of safety is arguably one of the most misunderstood aspects of investing. It's something which many investors are familiar with, but as a concept its importance is often underestimated. Similarly, it is often over-complicated, which can lead to confusion and a less optimum investment strategy. However, by utilising a margin of safety effectively, it can lead to lower risks and higher potential rewards in the long run.

Simplicity

A margin of safety is simply seeking to buy a company at a discount to its intrinsic value. In other words, if an investor believes a company is worth \$1 per share, buying it at \$0.80 would represent a margin of safety of \$0.20 per share. Put simply, it is a means of factoring in potential challenges which may face the company, both internal and external, and which may affect its share price in future.

Effect on risk and return

By seeking to buy shares for less than they are worth, it may be possible to reduce risk. Clearly, no investment is risk-free, and shares will usually experience some periods of high volatility when held for the long term. However, a stock which trades for less than it is worth may have less downside risk than its sector peers, since the market may have already priced in potential challenges.

Similarly, a wide margin of safety may mean potential rewards are also increased. If an investor is able to purchase a company for less than it is worth, then clearly their gains may be higher than for an investment in a company which is purchased at fair value.

Valuation

Of course, estimating the intrinsic value of a company is never a straightforward exercise. It is hugely subjective and the methods used vary greatly between different investors and different industries.

However, when one investor applies a consistent method of valuing a business across a sector or even an index, it can mean they are able to judge which stocks offer the greatest margins of safety. By focusing on those shares above others, it may be possible to generate a wide margin of safety for an entire portfolio and improve its overall risk/reward ratio. In time, this may lead to improved investment performance.

Psychology

Seeking a wider margin of safety may also help an investor's mental state. Through buying stocks for what they view as a discount to their intrinsic value, an investor may feel more relaxed even during periods of financial stress when share prices fall. Knowing they have bagged themselves a bargain based on the quality, prospects and financial strength of a business may allow an investor to stay calm during bear markets. It may also enable them to avoid overpaying for a company towards the end of a Bull Run.

Clearly, seeking a margin of safety is a relatively simple idea. However, it can lead to better investment prospects across indices, industries and stocks. As such, it seems to be a crucial part of investing for even the most experienced investors.

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