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The first rule of investing- Ask for Your Margin of Safety

As the Nasdaq Composite index (8434 points as at 06/11/19) and S&P 500 index (3074 points) trade at their respective all-time high, it is perhaps an opportune time to examine whether our portfolio holding would cushion us with an acceptable margin of safety in the event of severe market stress.

Sun Tzu, the great war strategist, was often quoted to say that we should first position ourselves beyond the possibility of defeat before waiting for the opportunity to defeat our enemy. As it is in a war, it is also so in the investment game.

Now is perhaps a good time to ask the difficult question about the possibility of our portfolio taking a 30 to 50 percent haircut and how it would impact our mental health and existing lifestyle. If we were to lose our job at the same time as when our portfolio value takes a plunge, would that have any bearing on our standard of living?

Bear in mind that some disruptor stocks like Amazon has risen from $290 in Jan 2014 to over $1800 per share today for a 6 folds gain. Netflix has risen 7 folds over the same period. Many of these hot stocks can drop more than 30 percent and we could still argue that they remain in their respective long-term bull trends.

The last market correction was just over a year ago, but the pain seems to be long forgotten. Many financial advisors are again singing the siren's song of the value of long term investing and coaxing investors to part with their money at arguably the worst possible time when many economic indicators are pointing down. At the very least, current environment should call for an exercise to examine the margin of safety of our portfolio.

The exercise of asking for a good margin of safety in our investment is effectively trying to limit our risk exposure in a proactive manner before a loss cycle hit. This allows us to not lose too much money and even perhaps be places in a liquid position to buy investment assets at fairer values. This will ensure that we do not have to waste years just to par our previous losses.

The concept of margin of safety in investment is discussed extensively in the book The Intelligent Investor by Benjamin Graham. It states that you practise the margin of safety when you buy assets at prices far below valuation, so that even if it becomes cheaper in the short run, your downside risks will be cushioned as you had bought your position at very cheap prices.

Valuation is the primary determinant of long-term returns. Therefore, investors should always try to buy asset at fair or cheap valuation to enjoy a certain margin of

safety. This is because valuation metrics used to estimate the fair value of an asset class is not an exact science. Assumptions could easily go wrong. So even if we are right about an asset class, we could be wrong about the broader systematic risks. Therefore, as investors, we should cushion ourselves as best as we can get against any possible errors and calamities.

For example, while buying low PE stocks may not always be a winning strategy, buying high PE stocks will surely introduce a real risk of permanent capital impairment as there is little margin for error. Investors who bought some of the hot stocks with PE of over 100 during the dot-com boom like Nokia, Nortel, Enron, Cisco and Morgan Stanley, have had to, unfortunately, learn this fact the hard way.

Stock bubbles usually give investors ample warnings before they burst. For example, in the late stages of an extended bull run, the advances would be supported by fewer and fewer stocks. There would likely be as many stocks clocking new lows as there are making new highs. In other words, the breadth of the market will start to deteriorate way before the market takes a serious plunge.

Sir John Templeton once said that “this time is different” are the four most dangerous words in investment. To fan the hopes that are needed to support the valuation of mega-bubbles, investors must come to believe that things will indeed be quite different this time around.

Hence, to resist buying into the “this time is different” mantra, it pays to constantly remind ourselves that markets are never linear, which means that no investment is a 100 per cent risk free. As such, the greater the safety when we establish our positions, the firmer our cushion would be against downside risks if we are way too early in our positioning. This would increase our holding power and reduce mental stress if the market continues to move against us for an extended duration.

In conclusion, the aim of a prudent investor is to always invest with a good margin of safety. Once we establish that the margin of safety for an investment is high, it will give us the confidence we need to act swiftly to take advantage of the opportunity.