MARGIN OF SAFETY

Risk-Averse Value Investing Strategies for the Thoughtful Investor

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Acknowledgments

While always interested in the workings of Wall Street, I was extremely fortunate in my first real job to have the opportunity to work alongside Michael Price and the late Max L. Heine at Mutual Shares Corporation (now Mutual Series Fund, Inc.). My uncle Paul Friedman always encouraged my interest in investing and helped me land that job. I look back on my experience at Mutual Shares very fondly. My learning in the two years working with Max and Mike probably eclipsed what I learned in the subsequent two years at Harvard Business School. It is to Max's memory that I dedicate this book.

After earning my MBA at Harvard, I was faced with several exciting career choices. The unconventional offer to join a start-up investment-management firm in Cambridge, Massachusetts, presented the opportunity to begin building an investment track record early in my career. And so it was that I joined Bill Poorvu, Isaac Auerbach, Jordan Baruch, Howard Stevenson, and Jo-An Bosworth in forming the Baupost Group. Each of my colleagues—Howard in particular—went out on a long, thin limb to bet on me and my abilities, not only to manage their own money but also that of their families and close friends, which was perhaps the greater act of faith. It has been my great privilege to be associated with such knowledgeable, energetic, warm, and caring people. Together we have built something to be proud of.

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Introduction

Investors adopt many different approaches that offer little or no real prospect of long-term success and considerable chance of substantial economic loss. Many are not coherent investment programs at all but instead resemble speculation or outright gambling. Investors are frequently lured by the prospect of quick and easy gain and fall victim to the many fads of Wall Street. My goals in writing this book are twofold. In the first section I identify many of the pitfalls that face investors. By highlighting where so many go wrong, I hope to help investors learn to avoid these losing strategies.

For the remainder of the book I recommend one particular path for investors to follow—a value-investment philosophy. Value investing, the strategy of investing in securities trading at an appreciable discount from underlying value, has a long history of delivering excellent investment results with very limited downside risk. This book explains the philosophy of value investing and, perhaps more importantly, the logic behind it in an attempt to demonstrate why it succeeds while other approaches fail.

I have chosen to begin this book, not with a discussion of what value investors do right, but with an assessment of where other investors go wrong, for many more investors lose their way along the road to investment success than reach their destination. It is easy to stray but a continuous effort to remain disciplined. Avoiding where others go wrong is an important step in achieving investment success. In fact, it almost ensures it.

You may be wondering, as several of my friends have, why I would write a book that could encourage more people to become value investors. Don't I run the risk of encouraging increased competition, thereby reducing my own investment returns? Perhaps, but I do not believe this will happen. For one thing, value investing is not being discussed here for the first time. While I have tried to build the case for it somewhat differently from my predecessors and while my precise philosophy may vary from that of other value investors, a number of these views have been expressed before, notably by Benjamin Graham and David Dodd, who more than fifty years ago wrote *Security Analysis*, regarded by many as the bible of value investing. That single work has illuminated the way for generations of value investors. More recently Graham wrote *The Intelligent Investor*, a less academic description of the value-investment process. Warren Buffett, the chairman of Berkshire Hathaway, Inc., and a student of Graham, is regarded as today's most successful value investor. He has written countless articles and shareholder and partnership letters that together articulate his value-investment philosophy coherently and brilliantly. Investors who have failed to heed such wise counsel are unlikely to listen to me.

The truth is, I am pained by the disastrous investment results experienced by great numbers of unsophisticated or undisciplined investors. If I can persuade just a few of them to avoid dangerous investment strategies and adopt sound ones that are designed to preserve and maintain their hard-earned capital, I will be satisfied. If I should have a wider influence on investor behavior, then I would gladly pay the price of a modest diminution in my own investment returns.

In any event this book alone will not turn anyone into a successful value investor. Value investing requires a great deal of hard work, unusually strict discipline, and a long-term investment horizon. Few are willing and able to devote sufficient time and effort to become value investors, and only a fraction of those have the proper mind-set to succeed.

This book most certainly does not provide a surefire formula for investment success. There is, of course, no such formula. Rather this book is a blueprint that, if carefully followed, offers a good possibility of investment success with limited risk. I believe this is as much as investors can reasonably hope for.

Ideally this will be considered, not a book about investing, but a book about thinking about investing. Like most eighth-grade algebra students, some investors memorize a few formulas or rules and superficially appear competent but do not really understand what they are doing. To achieve long-term success over many financial market and economic cycles, observing a few rules is not enough. Too many things change too quickly in the investment world for that approach to succeed. It is necessary instead to understand the rationale behind the rules in order to appreciate why they work when they do and don't when they don't. I could simply assert that value investing works, but I hope to show you *why* it works and why most other approaches do not.

If interplanetary visitors landed on Earth and examined the workings of our financial markets and the behavior of financial-market participants, they would no doubt question the intelligence of the planet's inhabitants. Wall Street, the financial marketplace where capital is allocated worldwide, is in many ways just a gigantic casino. The recipient of up-front fees on every transaction, Wall Street clearly is more concerned with the volume of activity than its economic utility. Pension and endowment funds responsible for the security and enhancement of long-term retirement, educational, and philanthropic resources employ investment managers who frenetically trade long-term securities on a very short-term basis, each trying to outguess and consequently outperform others doing the same thing. In addition, hundreds of billions of dollars are invested in virtual or complete ignorance of underlying business fundamentals, often using indexing strategies designed to avoid significant underperformance at the cost of assured mediocrity.

Individual and institutional investors alike frequently demonstrate an inability to make long-term investment decisions based on business fundamentals. There are a number of reasons for this: among them the performance pressures faced by institutional investors, the compensation structure of Wall Street, and the frenzied atmosphere of the financial markets. As a result, investors, particularly institutional investors, become enmeshed in a short-term relative-performance derby, whereby temporary price fluctuations become the dominant focus. Relative-performance-oriented investors, already focused on short-term returns, frequently are attracted to the latest market fads as a source of superior relative performance. The temptation of making a fast buck is great, and many investors find it difficult to fight the crowd.

Investors are sometimes their own worst enemies. When prices are generally rising, for example, greed leads investors to speculate, to make substantial, high-risk bets based upon optimistic predictions, and to focus on return while ignoring risk. At the other end of the emotional spectrum, when prices are generally falling, fear of loss causes investors to focus solely on the possibility of continued price declines to the exclusion of investment fundamentals. Regardless of the market environment, many investors seek a formula for success. The unfortunate reality is that investment success cannot be captured in a mathematical equation or a computer program.

The first section of this book, chapters 1 through 4, examines some of the places where investors stumble. Chapter 1 explores the differences between investing and speculation and between successful and unsuccessful investors, examining in particular the role of market price in investor behavior. Chapter 2 looks at the way Wall Street, with its short-term orientation, conflicts of interest, and upward bias, maximizes its own best interests, which are not necessarily also those of investors. Chapter 3 examines the behavior of institutional investors, who have come to dominate today's financial markets.

Chapter 4 uses the case study of junk bonds to illustrate many of the pitfalls highlighted in the first three chapters. The rapid growth of the market for newly issued junk bonds was only made possible by the complicity of investors who suspended disbelief. Junk-bond buyers greedily accepted promises of a free lunch and willingly adopted new and unproven methods of analysis. Neither Wall Street nor the institutional investment community objected vocally to the widespread proliferation of these flawed instruments.

Investors must recognize that the junk-bond mania was not a once-in-a-millennium madness but instead part of the historical ebb and flow of investor sentiment between greed and fear. The important point is not merely that junk bonds were flawed (although they certainly were) but that investors must learn from this very avoidable debacle to escape the next enticing market fad that will inevitably come along.

A second important reason to examine the behavior of other investors and speculators is that their actions often inadvertently result in the creation of opportunities for value investors. Institutional investors, for example, frequently act as lumbering behemoths, trampling some securities to large discounts from underlying value even as they ignore or constrain themselves from buying others. Those they decide to purchase they buy with gusto; many of these favorites become significantly overvalued, creating selling (and perhaps short-selling) opportunities. Herds of individual investors acting in tandem can similarly bid up the prices of some securities to crazy levels, even as others are ignored or unceremoniously dumped. Abetted by Wall Street brokers and investment bankers, many individual as well as institutional investors either ignore or deliberately disregard underlying business value, instead regarding stocks solely as pieces of paper to be traded back and forth.

The disregard for investment fundamentals sometimes affects the entire stock market. Consider, for example, the enormous surge in share prices between January and August of 1987 and the ensuing market crash in October of that year. In the words of William Ruane and Richard Cunniff, chairman and president of the Sequoia Fund, Inc., "Disregarding for the moment whether the prevailing level of stock prices on January 1, 1987 was logical, we are certain that the *value* of American industry in the aggregate had not increased by 44% as of August 25. Similarly, it is highly unlikely that the *value* of American industry declined by 23% on a single day, October 19."[1]

Ultimately investors must choose sides. One side—the wrong choice—is a seemingly effortless path that offers the comfort of consensus. This course involves succumbing to the forces that guide most market participants, emotional responses dictated by greed and fear and a short-term orientation emanating from the relative-performance derby. Investors following this road increasingly think of stocks like sowbellies, as commodities to be bought and sold. This ultimately requires investors to spend their time guessing what other market participants may do and then trying to do it first. The problem is that the exciting possibility of high near-term returns from playing the stocks-as-pieces-of-paper-that-you-trade game blinds investors to its foolishness.

The correct choice for investors is obvious but requires a level of commitment most are unwilling to make. This choice is known as fundamental analysis, whereby stocks are regarded as fractional ownership of the underlying businesses that they represent. One form of fundamental analysis—and the strategy that I recommend—is an investment approach known as value investing.

There is nothing esoteric about value investing. It is simply the process of determining the value underlying a security and then buying it at a considerable discount from that value. It is really that simple. The greatest challenge is maintaining the requisite patience and discipline to buy only when prices are attractive and to sell when they are not, avoiding the short-term performance frenzy that engulfs most market participants.

The focus of most investors differs from that of value investors. Most investors are primarily oriented toward return, how much they can make, and pay little attention to risk, how much they can lose. Institutional investors, in particular, are usually evaluated—and therefore measure themselves—on the basis of relative performance compared to the market as a whole, to a relevant market sector, or to their peers.

Value investors, by contrast, have as a primary goal the preservation of their capital. It follows that value investors seek a margin of safety, allowing room for imprecision, bad luck, or analytical error in order to avoid sizable losses over time. A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss.

If investors could predict the future direction of the market, they would certainly not choose to be value investors all the time. Indeed, when securities prices are steadily increasing, a value approach is usually a handicap; out-of-favor securities tend to rise less than the public's favorites. When the market becomes fully valued on its way to being overvalued, value investors again fare poorly because they sell too soon.

The most beneficial time to be a value investor is when the market is falling. This is when downside risk matters and when investors who worried only about what could go right suffer the consequences of undue optimism. Value investors invest with a margin of safety that protects them from large losses in declining markets.

Those who can predict the future should participate fully, indeed on margin using borrowed money, when the market is about to rise and get out of the market before it declines. Unfortunately, many more investors claim the ability to foresee the market's direction than actually possess that ability. (I myself have not met a single one.) Those of us who know that we cannot accurately forecast security prices are well advised to consider value investing, a safe and successful strategy in all investment environments.

The second section of this book, chapters 5 through 8, explores the philosophy and substance of value investing. Chapter 5 examines why most investors are risk averse and discusses the investment implications of this attitude. Chapter 6 describes the philosophy of value investing and the meaning and importance of a margin of safety. Chapter 7 considers three important underpinnings to value investing: a bottom-up approach to investment selection, an absolute-performance orientation, and analytical emphasis on risk as well as return. Chapter 8 demonstrates the principal methods of securities valuation used by value investors.

The third section of this book, chapters 9 through 14, describes the value-investment process, the implementation of a value-investment philosophy. Chapter 9 explores the research and analytical process, where value investors get their ideas and how they evaluate them. Chapter 10 illustrates a number of different value-investment opportunities ranging from corporate liquidations to spinoffs and risk arbitrage. Chapters 11 and 12 examine two specialized value-investment niches: thrift conversions and financially distressed and bankrupt securities, respectively. Chapter 13 highlights the importance of good portfolio management and trading strategies. Finally, Chapter 14 provides some insight into the possible selection of an investment professional to manage your money.

The value discipline seems simple enough but is apparently a difficult one for most investors to grasp or adhere to. As Buffett has often observed, value investing is not a concept that can be learned and applied gradually over time. It is either absorbed and adopted at once, or it is never truly learned.

I was fortunate to learn value investing at the inception of my investment career from two of its most successful practitioners: Michael Price and the late Max L. Heine of Mutual Shares Corporation. While I had been fascinated by the stock market since childhood and frequently dabbled in the market as a teenager (with modest success), working with Max and Mike was like being let in on an incredibly valuable secret. How naive all of my previous investing suddenly seemed compared with the simple but incontrovertible logic of value investing. Indeed, once you adopt a value-investment strategy, any other investment behavior starts to seem like gambling.