The secret of Graham-and-Buffettsville

INTELLIGENT INVESTOR

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Risk is an occupational hazard for all investors. How, then, do successful value investors from Graham-and-Buffettsville (i.e., those who follow Benjamin Graham and Warren Buffett's investment philosophy) handle it? The successful handling of risk is the main reason for higher returns of successful value investors. As Charlie Munger, Warren Buffett's partner, said: "All intelligent investing is value investing."

Risk is one of the most critical concepts in investing. However, the concept of risk is steeped in confusion. Consider the definition of risk according to Aswath Damodaran of New York University: "Risk in finance is defined in terms of variability of actual returns on an investment around an expected return, even when those returns represent positive outcomes."

Elroy Dimson of London Business School defined it more simply: "Risk means more things can happen than will happen."

Finance academics have quantified the concept of risk in the form of beta and volatility. Unfortunately, these definitions cause more confusion than clarity for lay investors. Risk in the common perception is clearly associated with danger or possibility of loss. The Merriam Webster dictionary defines risk thus: "Risk (noun): the possibility that something bad or unpleasant (such as an injury or a loss) will happen." And all the super-investors of Graham-and-Buffettsville would define risk the same way: "The likelihood of a permanent loss of capital."

The problem with the academic finance definition of risk is that it mixes up the possibility of a higher-than-expected return with a lower-than-expected return, including the possibility of a loss of capital. As far as the investor is concerned what needs to be avoided or reduced significantly is the possibility of permanent loss of capital; all other possibilities are acceptable.

Evaluating the possibility and likelihood of a permanent loss of capital is the most important aspect of investment analysis. This does not mean that one is relegated to investing in fixed income government securities.

There are several steps. First, one should invest in only productive assets, i.e. assets that generate—or have a reasonable promise of eventually generating—positive cash flows. For example, companies with positive earnings and cash flow, rent-generating real estate, and so on.

Further, these assets should be evaluated for the possibility of low business risk. There should be a high likelihood of the company's business generating positive cash flows for a long time.

Next, the financial risks should be low. This means that the company should be financed conservatively with low or no debt. If a company does not have debt, it can't go bankrupt.

The price-risk should be low. This means that the company should be bought at a reasonable discount to its conservatively estimated intrinsic value.

It's important to remember that however carefully one has chosen a company, there is always some likelihood of its intrinsic value eroding. To reduce the risk of a particular company, industry or sector significantly reducing in intrinsic value due to socio-economic trends or regulations or other similar causes, one should invest in several companies from different sectors chosen based on criteria similar to ones enumerated above. Such a portfolio will have a very low likelihood of permanent loss of capital.

What is the margin of safety?

If risk is one side of the coin, then margin of safety is the other side. The idea of risk can also be viewed from the perspective of a margin of safety. This is borrowed from an engineering concept called the safety factor. Typically, when you are inside a lift or an elevator, you will see a notice mentioning that it is designed for six people. The engineers would design it to allow for slightly more, possibly, seven people. This extra margin is called the safety factor or margin of safety.

Since engineering puts people's lives at risk, if anything is wrongly designed and constructed, it is a more challenging discipline. Graham borrowed this concept for investing. So, if one calculated that a company's intrinsic value was ₹100, one would buy it only when it was available for ₹70; the margin of safety is ₹30 or 30%.

One can look at these risk management steps and see that each is adding a margin of safety. By buying only productive assets, one adds safety against the risk of not being able to find a buyer. In absence of a buyer, the owner of the productive asset enjoys cash flows from the produce.

Companies with long histories and low risk of future long-term impairment of business have a further margin of safety as these are likely to generate cash flows and earnings for a long time. Companies that have low or no debt have an added margin of safety from the risk of going bankrupt. Shares bought at a discount to such companies' intrinsic value have an additional margin of safety. Finally, a portfolio of several companies from different industries and sectors provides further safety. Buying with a long-term holding period gives added flexibility and safety margin to the investment.

While evaluating risk will always remain tough, the concept is simple. And margin of safety is not a one-dimensional concept of discount to intrinsic value but a multilayered one.

So, the lower the risk, the higher the margin of safety, and then the higher the potential returns. Hence, low risk, high margin of safety and high returns; this is the essence of value investing.

"If you were to distil the secret of sound investment into three words, we venture the motto, margin of safety," said Graham.

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