

The margin of safety principle and corporate strategy

Joseph Calandro Jr

Joseph Calandro Jr is the author of *Applied Value Investing* (NY: McGraw-Hill, 2009) and a Finance Department faculty member of the University of Connecticut (Joseph.Calandro@business.uconn.edu).

When Seth Klarman wrote the *Margin of Safety* twenty years ago (NY: HarperBusiness, 1991) it was largely ignored by the business community. As Klarman built a reputation for making successful investments following the precepts of his book, it became an investment classic. Now a used copy in good condition sells for as much as \$2,500. Klarman, the President of a private investment partnership, has become a renowned “value investor,” a person who practices the investment approach introduced by Benjamin Graham and David Dodd.[1] This article examines key insights from *Margin of Safety* and shows how they can facilitate strategic decision-making. As Klarman explains:

Because investing is as much an art as a science, investors need a margin of safety. A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world. According to [Benjamin] Graham, “The margin of safety is always dependent on the price paid. For any security, it will be large at one price, small at higher price, nonexistent at some still higher price”.[2]

All value investors operate in a manner consistent with this principle; for example, Warren Buffett stated that both he and Berkshire Hathaway’s Vice Chairman insist “on a margin of safety in our purchase price. If we calculate the value of a common stock to be only slightly higher than its price, we’re not interested in buying. We believe this margin of safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success.”[3] In his book, Mr Klarman discusses how a margin of safety is achieved:

By always buying at a significant discount to underlying business value and giving preference to tangible assets over intangibles. (This does not mean that there are not excellent investment opportunities in businesses with valuable intangible assets.) By replacing current holdings as better bargains come along. By selling when the market price of any investment comes to reflect its underlying value and by holding cash, if necessary, until other attractive investments become available.[4]

This quote is clearly investment-based, which may help to explain why the margin of safety principle, and book of the same name, have thus far not received the level of attention they should from the business community. However, corporate strategy inherently involves investment. As the late Bruce Henderson observed: “In all strategy the ultimate objectives tend to be access to and control of required resources.”[5] Professor Pankaj Ghemawat goes further and actually defines “strategic” by the level of commitment an initiative or capital expenditure (i.e., investment) requires.[6] We will therefore analyze the above quote phrase-by-phrase in a strategic context, and by so doing demonstrate the applicability of the margin of safety principle to corporate decision-making. First, however, we will review how value investors approach the process of valuation, which will help to put our analysis into context.

Author’s Note: The author would like to thank Seth Klarman, President of The Baupost Group, for helpful questions, comments and suggestions on this paper.

“Strategists typically approach valuation using either discounted cash flow (DCF), multiples-based and/or comparables-based forms of analysis. Value investors approach it differently.”

Value investing overview

Strategists typically approach valuation using either discounted cash flow (DCF), multiples-based and/or comparables-based forms of analysis. Value investors approach it differently:

- First, they reproduce a firm's balance sheet to derive a more economically-consistent net asset value (NAV). In contrast, the three preceding approaches generally involve no rigorous balance sheet analysis.
- Earnings power value (EPV) is then estimated based on a level of past earnings that are expected to be sustainable. Because future forecasts are not made, EPV is generally much more conservative than DCF.
- The relationship between EPV and NAV is then examined. If EPV significantly exceeds NAV the sustainable competitive advantage driving the spread is thoroughly analyzed. Thus, strategic considerations are included in the valuation framework, in contrast to DCF, multiples and comparables.
- Growth is estimated last and only if a sustainable competitive advantage has been identified.

While many studies have been published on the problematic track-record of corporate M&A, there is no modern research that thoroughly catalogues and compares the validity of various valuation methodologies. While researchers contemplate such a study, strategists would be well advised to consider the valuation approach that value investors use (outlined above). Doing so will facilitate the successful application of the time-tested margin of safety principle to corporate initiatives as discussed below.

Buying at a significant discount to underlying business value

The margin of safety principle inherently involves buying at a discount to estimated value, and as such reconciles with the “low cost” foundation of business strategy.[7] And yet, executives continue to undertake initiatives at high prices. For example, in the first quarter of 2011 executives “paid the most for takeovers since before the collapse of Lehman Brothers Holdings, Inc.”[8] With regard to Lehman, prior to its historic failure it engaged in numerous acquisitions “at the top of the market” thereby paying premium prices. Contrast this activity with the acquisition track record of Berkshire Hathaway which, as noted above, was built on the margin of safety principle.

Lehman also bought back shares of its own stock at very high prices; so high were those prices, in fact, that some Lehman employees felt the firm should have been selling its stock rather than buying it.[9] Contrast Lehman's buybacks with those of the late Henry Singleton, founder of Teledyne Corporation. An exemplary leader, Singleton bought back his firm's stock when it was undervalued by the market, and by so doing he created significant value for his firm's shareholders.[10]

Economical buying also pertains to hedging and risk management. For example, many financial models include a volatility component, and therefore when volatility is low financial instruments can be priced very cheaply.[11] Hedging at such times can be very economical; and yet, this form of strategic opportunity is rarely exploited by executives. Perhaps a reason for this is a focus on meeting short-term earnings estimates, many times to the penny, rather

than on economical, longer-term strategic initiatives (including strategic risk management initiatives). Whatever the reason(s), many firms do seem to engage in hedging after volatility, and thus pricing spikes.[12] In contrast, consider that “Klarman buys put options and credit-default swaps, which he calls ‘cheap insurance,’ to protect Baupost [his investment firm] against risks such as a steep fall in the stock market or a surge in inflation . . . In an October 2008 letter to shareholders, the firm said it benefited from credit-default swaps, without saying what the swaps were meant to protect against.”[13] According to Michael Lewis’ best-selling book, *The Big Short*, Mr Klarman was one of the few investors who shrewdly purchased favorably priced credit default swaps during the boom that preceded the 2007-2008 credit crisis.[14]

Giving preference to tangible assets

Applied to corporate strategy, “giving preference to tangible assets” can be restated as “protect and manage your balance sheet.” Modern financial economics holds that capital structure is irrelevant,[15] but as the recent credit crisis has once again demonstrated, capital structure and balance sheets are incredibly relevant. For example, before it failed Lehman Brothers’ debt-to-equity ratio was a staggering forty-four-to-one,[16] and thus it obviously did not protect its balance sheet. Incredibly, during the boom that preceded Lehman’s failure some financial executives did not even understand their companies’ balance sheets; for example, one of the traders profiled in “The Big Short” would “go to meetings with Wall Street CEOs and ask them the most basic questions about their balance sheets, ‘They didn’t know,’ he said. ‘They didn’t know their own balance sheets.’”[17]

Conversely, balance sheet analysis has been at the center of value investing since its founding; according to one economic scholar, “The special importance that [Benjamin] Graham and [David] Dodd placed on balance sheet valuations remains one of their most important contributions to the idea of what constitutes a ‘thorough’ analysis of intrinsic value.”[18] To understand why, consider the following extended quote from *Margin of Safety*:

Historically investors have found attractive opportunities in companies with substantial “hidden assets,” such as an overfunded pension fund, real estate carried on the balance sheet below market value, or a profitable finance subsidiary that could be sold at a significant gain. Amidst a broad-based decline in business and asset values, however, some hidden assets become less valuable and in some cases may become hidden liabilities. A decline in the stock market will reduce the value of pension fund assets; previously overfunded plans may become underfunded. Real estate, carried on companies’ balance sheets at historical cost, may no longer be undervalued . . . [19]

Executives who actively manage their firms’ balance sheets can move to efficiently close a value gap created by a hidden asset, or mitigate the value destruction of a hidden liability through proactive strategic initiatives and shareholder communications. To demonstrate how, consider the acquisition of Sears by hedge fund manager Eddie Lampert. In that deal, Lampert identified real estate that was carried on Sears’ balance sheet below its market value, as well as operational efficiencies, which presented a margin of safety-rich target that he acquired.[20] One wonders why Sears’ executives at the time did not see what Lampert did, or if they did, why they were unable to effectively act on it. Executives like this who are not effective stewards of capital risk not only the takeover of their firm,[21] but also pressure from activist investors and short-sellers.[22] Balance sheet management can serve as the

“Strategists would be well advised to consider the valuation approach that value investors use. Doing so will facilitate the successful application of the time-tested margin of safety principle to corporate initiatives.”

“The margin of safety principle inherently involves buying at a discount to estimated value, and as such reconciles with the ‘low cost’ foundation of business strategy.”

first line of defense in situations like this in a manner much more value-oriented than poison pill-like defenses;[23] in other words, in a manner that facilitates value creation rather than the protection of inefficient managers like Sears’ prior management.

There are opportunities in businesses with valuable intangible assets

Intangible assets create wealth to the extent those assets contribute to competitive advantage. The concept of competitive advantage is the foundation of corporate strategy; however, it can be very difficult to value given its intangible nature and indefinite lifespan.[24] Firms that are able to create and sustain a competitive advantage, though, can present a lucrative acquisition opportunity, if available at a reasonable margin of safety. The classic value investing example of this is Warren Buffett’s 1995 acquisition of GEICO, the personal lines automobile insurer, which created significant value as both a margin of safety-rich acquisition and as a long-term growth business.[25]

Replacing current holdings as better bargains come along

According to Bruce Henderson, “Although there is a real question whether most companies have an adequate control over the deployment of their financial resources, redeployment of financial resources is the cornerstone of all business strategy.”[26] There are various ways to address resource redeployment, two of which are profiled here. The first involves the distribution of a significant portion of a firm’s equity to shareholders, by way of special dividend, that is replaced with debt. This form of capital redeployment forces the kind of performance dynamics and pressures commonly found in a leveraged buyout. For example, Sealed Air Corporation redeployed its capital in this manner in 1989 with the express objective of using “the company’s capital structure to influence and even drive a change in strategy and culture.” Their objective was achieved as the firm “outperformed the S&P 500 by almost 400% (or by almost 30% per year).”[27]

Another alternative is strategic resource redeployment, which pertains to a fundamental shift in the offerings of a firm. One of the most significant examples of such a redeployment occurred in the mid-1980s when Intel redeployed resources from its historically strong memory chip business into the then nascent microprocessor business. This redeployment optimally positioned Intel to capitalize on the technology boom that began in the 1990s,[28] and continues into the present.

Selling when the market price reflects underlying value

It is well known that management has a fiduciary duty to maximize a firm’s value, but what is less well understood is what is meant by the term “maximize.” For instance, maximize could be interpreted to mean the highest possible price that can conceivably be achieved or it could mean a fair price established over a relatively well defined range. The difference between these two interpretations is significant because striving for the highest possible price, all the time, is not sustainable and fraught with risk (consider the cases of Enron, Worldcom, etc.). On the other hand, striving for a fair price range is much more sustainable, but it requires an insightful view on a firm’s value, as well as efficient policies to manage and communicate that value over time. The later approach is practiced, for example, by Berkshire Hathaway as its Chairman and CEO has explained:

To the extent possible, we would like each Berkshire shareholder to record a gain or loss in market value during his period of ownership that is proportional to the gain or loss in per-share intrinsic value recorded by the company during that holding period [. . .] we would rather see Berkshire's stock price at a *fair* level than a *high* level. Obviously, Charlie and I can't control Berkshire's price. But by our policies and communications, we can encourage informed, rational behavior by owners that, in turn, will tend to produce a stock price that is also rational. Our it's-as-bad-to-be-overvalued-as-to-be-undervalued approach may disappoint some shareholders. We believe, however, that it affords Berkshire the best prospect of attracting long-term investors who seek to profit from the progress of the company rather than from the investment mistakes of their partners[29](emphasis added).

Striving for a fair long-term market valuation also facilitates divestment decision-making. Consider the case of Henry Singleton's divestments of Teledyne's Argonaut and Unitrin subsidiaries: the decisions behind these divestments were made based on fundamental financial strategic considerations, and thus were extremely well received by the investment community.[30] This example is potentially significant today as 2011's "surge in spin-offs and the rise in the conglomerate discount certainly suggest that new diversifications are likely to be far outweighed by corporate break-ups." [31]

Holding cash, if necessary, until attractive investments become available

Cash is generally ignored strategically; for example, "excess cash" – or cash and marketable securities greater than the short-term needs of a business – is frequently not included in discounted cash flow (DCF) valuations.[32] and it tends to be spent quickly on acquisitions or stock buybacks even at high price levels.[33] In contrast, value investors "are willing to hold cash reserves when no bargains are available . . . The liquidity of cash affords flexibility, for it can quickly be channeled into other investment outlets with minimal transaction costs." [34] For example, Mr. Klarman's fund is one of the top performing even though its cash holdings have averaged 30 percent over time.[35] As another example, consider the "2010 Berkshire Hathaway Annual Report," which states that the firm has "pledged that we will hold at least \$10 billion of cash, excluding that held at our regulated utility and railroad businesses. Because of that commitment, we customarily keep at least \$20 billion on hand so that we can both withstand unprecedented insurance losses (our largest to date having been about \$3 billion from Katrina, the insurance industry's most expensive catastrophe) and quickly seize acquisition or investment opportunities, even during times of financial turmoil."

Guiding principles and conclusion

There are a number of value investing principles that can help facilitate a value-oriented approach to strategic decision-making. First and foremost, value investors strive to preserve capital, and therefore they intensely focus on managing the risk of loss.[36] In this context, risk management is not a separate activity but rather is imbedded within the investment process, including how investment performance is measured. Many investors (and executives) are assessed on a relative basis, which "involves measuring investment results, not against an absolute standard, but against broad stock market indices, such as the Dow Jones Industrial Average or Standard & Poor's 500 Index, or against other investors' results." However, those who assess performance this way "may lose sight of whether their

“ Executives who actively manage their firms’ balance sheets can move to efficiently close a value gap created by a hidden asset, or mitigate the value destruction of a hidden liability through proactive strategic initiatives and shareholder communications. ”

“Intangible assets create wealth to the extent those assets contribute to competitive advantage.”

investments are attractive or even sensible in an absolute sense.”[37] In contrast, value investors focus on absolute performance because, simply put, “absolute returns are the only ones that really matter; you cannot, after all, spend relative performance.”[38]

“Good absolute performance” is achieved by managing to the long-term. A compensation for the longer-term focus is that margin of safety-based initiatives “carry less risk of loss.”[39] Value investors assess both risk and reward via bottom-up analysis; not through a model or other form of top-down analysis.[40] Bottom-up analysis involves the careful review of all relevant information in a manner blended with “skepticism and judgment,”[41] which obviously takes time and significant effort to apply. Top-down analysis, on the other hand, is often much faster and easier to apply (especially if quantitative models are used). The difference between these two approaches is significant, and in many ways is at the core of the issues that emerged in the recent credit crisis.

For example, consider the former CEO of Citigroup’s infamous statement to the *Financial Times* in July of 2007 – right before the onset of the credit crisis – that “As long as the music is playing, you’ve got to get up and dance. We’re still dancing.”[42] Citigroup employed various forms of top-down analyses at the time including modeled output, significant reliance on credit ratings and macroeconomic analysis; nevertheless, it would have failed during the crisis (or once “the music stopped”) but for the intervention of the US government. Contrast this experience with that of Michael Burry who, like Klarman, is a value investor who earned significant profit during the crisis as a result of investments derived from rigorous bottom-up analyses.[43]

Bottom-up analysis is not a panacea as everyone is subject to error. Value investors control for error by approaching analysis conservatively, as explained in *Margin of Safety*:

Since all projections are subject to error, optimistic ones tend to place investors on a precarious limb. Virtually everything must go right, or losses may be sustained. Conservative forecasts can be more easily met or even exceeded. Investors are well advised to make only conservative projections and then invest only at a substantial discount from the valuation derived therefrom [or at a margin of safety].[44]

It is worthwhile to reflect on what would have happened to Lehman Brothers, Citigroup, AIG, etc., if executives at those firms: (1) intensely focused on managing the risk of loss, (2) managed to absolute rather than relative performance, and (3) made decisions based on conservatively derived bottom-up analyses that were (4) influenced by the margin of safety principle.

Looking ahead, the global economy is currently highly uncertain given sovereign debt levels, commodity price levels, protracted warfare, and a variety of other factors that executives and strategists must respond to. When doing so it is crucial that they not “enhance [the uncertainty] by taking unpredictable or ill-considered actions.”[45] As demonstrated here, the margin of safety principle, as explained in Klarman’s book, can be used to enhance strategic decision-making over time.

Notes

1. Joseph Calandro Jr, “Lessons for strategists in Graham & Dodd’s *Security Analysis*, 6th edition,” *Strategy & Leadership*, Vol. 37, No. 2 (2009), p. 46.
2. Seth Klarman, *Margin of Safety* (NY: HarperBusiness, 1991), p. 92.
3. *1992 Berkshire Hathaway Annual Report*, <http://www.berkshirehathaway.com/letters/1992.html>
4. Klarman (1991), p. 94
5. Bruce Henderson, *The Logic of Business Strategy* (Cambridge, MA: Ballinger, 1984), p. 9.

6. Pankaj Ghemawat, *Commitment: The Dynamic of Strategy* (NY: Free Press, 1991), p. 43.
7. Walter Kiechel, *Lords of Strategy* (Boston, MA: HBS Press, 2010), especially chapters three and eleven. Also note Henderson's (1984) comment that, "Cost effectiveness analysis optimizes value relative to cost" (p. 25).
8. Zachary R. Mider, "New deal rush pushes takeovers to most expensive since Lehman," *Bloomberg*, March 30, 2011, <http://www.bloomberg.com/news/2011-03-30/new-deal-rush-pushes-takeovers-to-most-expensive-since-lehman.html>
9. Lawrence McDonald and Patrick O'Brien, *A Colossal Failure of Common Sense* (NY: Crown, 2009), pp. 223-224.
10. For more information see Joseph Calandro Jr, "Henry Singleton: a pioneer of corporate strategic leadership and value creation," *Strategy & Leadership*, Vol. 38, No. 6 (2010), pp. 29-37
11. Note also Warren Buffett's comments in the *2010 Berkshire Hathaway Annual Report*, pp. 21-22.
12. For example, note the last paragraph of: Dana Mattioli and Chana Schoenberger, "For some, currency hedging is no gain," *Wall Street Journal*, February 19, 2011, <http://online.wsj.com/article/SB10001424052748703803904576152442756363116.html>
13. Charles Stein, "Klarman tops Griffin as hedge-fund investors hunt for 'margin of safety,'" *Bloomberg*, June 11, 2010, <http://www.bloomberg.com/news/2010-06-11/klarman-tops-griffin-as-hedge-fund-investors-hunt-for-margin-of-safety-.html>
14. Michael Lewis, *The Big Short* (NY: WW Norton, 2010), p. 105.
15. Franco Modigliani and Merton Miller, "The cost of capital, corporation finance and the theory of investment," *The American Economic Review*, Vol. 48, No. 3 (June 1958), pp. 261-297. Subsequent works qualified the extent of irrelevance, but the theory incredibly remains a staple of finance to this day. See, for example, Donald MacKenzie, *An Engine, Not a Camera: How Financial Models Shape Markets* (Cambridge, MA: MIT, 2006).
16. McDonald and O'Brien (2009), p. 263. These authors note that, "There is an army of eagle-eyed hedge funds on the lookout for misplaced hubris and out-of-touch management, especially when there's crushing debt" (p. 224).
17. Lewis (2010), p. 174. For another example, see Gregory Zuckerman, *The Greatest Trade Ever* (NY: Broadway, 2009), p. 256.
18. Bruce Greenwald, "Deconstructing the balance sheet," in Benjamin Graham and David Dodd, *Security Analysis*, 6th ed. (NY: McGraw-Hill, 2009 [1934]), p. 539.
19. Klarman (1991), p. 91.
20. Joseph Calandro Jr, *Applied Value Investing* (NY: McGraw-Hill, 2009), Ch. 2.
21. William Fruhan Jr, "Corporate raiders: head'em off at value gap," *Harvard Business Review*, July-August (1998), p. 63.
22. See, for example, McDonald and O'Brien (2009), p. 224.
23. "Once viewed as long-term insurance policies against corporate raiders, shareholder rights plans are more commonly used today as short-term stopgaps against a threat. For example, J.C. Penney implemented a one-year plan last fall after hedge-fund manager William Ackman upped his stock stake in the retailer above 15%. This year, 8 of the 11 poison pills implemented between January and March were adopted in response to an activist investor's acquisition offer or to preserve the value of net operating loss carryforwards (which, for tax purposes, could be reduced when ownership of a company changes), according to research firm FactSet Research Systems." Source: Sarah Johnson, "Poison pills haven't lost their potency," *CFO*, March 10, 2011, <http://www.cfo.com/article.cfm/14560978>
24. Ghemawat (1991, Ch. 5) found that competitive advantages tend to have life expectancies of approximately ten years, on average.
25. On the GEICO acquisition see Calandro (2009), Ch. 3. On GEICO as a long-term growth business see Joseph Calandro, Jr., "Growth-based franchise opportunities: lessons from the Geico acquisition," *Journal of Private Equity*, Spring 2011, pp. 6-17.

26. Henderson (1984), p. 104.
27. Karen Hopper Wruck, "Financial policy as a catalyst for organizational change – Sealed Air's leveraged special dividend," *Journal of Applied Corporate Finance*, Winter 1995, p. 21.
28. Andrew Grove, *Only the Paranoid Survive* (NY: Currency: 1999 [1996]), Ch. 5.
29. *Berkshire Hathaway Owners' Manual*, <http://www.berkshirehathaway.com/ownman.pdf>, p. 4.
30. Calandro (2010), p. 34.
31. "Starbursting: breaking up companies is back in fashion," *The Economist*, March 24, 2011, <http://www.economist.com/node/18440915>
32. Tom Copeland, Tim Koller and Jack Murrin, *Valuation*, 3rd ed. (NY: Wiley, 2000 [1990]), pp. 160-161. According to Ghemawat (1991), strategy "is concerned with what seems to be the real *locus* of action: the numerator of DCF analysis" (p. 72).
33. Note also Lynn Thomasson and Whitney Kisling, "CEOs tap record \$940 billion cash for dividends as M&A at post-Lehman high," *Bloomberg*, March 28, 2011, <http://www.bloomberg.com/news/2011-03-27/ceos-tap-record-940-billion-cash-for-dividends-as-m-a-at-post-lehman-high.html>
34. Klarman (1991), p. 109.
35. "Profile of Seth Klarman & Baupost Group," *Marketfolly*, June 11, 2010, http://www.marketfolly.com/2010/06/profile-of-seth-klarman-baupost-group_11.html, and "Absolute Return interviews Seth Klarman," Greenbackd, June 7, 2010, <http://greenbackd.com/2010/06/07/absolute-return-interviews-seth-klarman/>
36. Klarman (1991), p. xix.
37. *Ibid*, p. 39.
38. According to *ibid*, "For most investors absolute returns are the only ones that really matter; you cannot, after all, spend relative performance" (p. 109).
39. *Ibid*.
40. Seth Klarman, "The timeless wisdom of Graham and Dodd," in Benjamin Graham and David Dodd, *Security Analysis*, 6th ed. (NY: McGraw-Hill, 2009 [1934]), pp. xxxviii-xxxix.
41. *Ibid*, p. xviii.
42. "Investment banking revenues," *Financial Times*, July 10, 2007, <http://www.ft.com/cms/s/3/e8181a38-2e19-11dc-821c-0000779fd2ac.html>. There is historical precedent for this type of behavior; for example, Klarman (1991) observed that "Neither cash-hungry issuers nor greedy investors necessarily analyze the performance of each financial market innovation under every conceivable economic scenario. What appears to be new and improved today may prove to be flawed or even fallacious tomorrow" (pp. 29-30).
Former Federal Reserve Chairman Alan Greenspan referred to the boom that preceded the recent credit crisis as the "new paradigm" because he thought it presaged "an era of technology-enabled noninflationary growth," which it obviously was not. Source: Charles Morris, *The Trillion Dollar Meltdown* (NY: Public Affairs, 2008), p. 32.
43. For more information see Lewis (2010) and Zuckerman (2009). Strategy in general requires bottom-up analysis as it stems "from the specifics of [a] situation" (Ghemawat 1991, p. 70).
44. Klarman (1991), p. 125.
45. *Ibid*, p. 146.

Corresponding author

Joseph Calandro Jr can be contacted at: Joseph.Calandro@business.uconn.edu

To purchase reprints of this article please e-mail: reprints@emeraldinsight.com
Or visit our web site for further details: www.emeraldinsight.com/reprints