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MARGIN OF SAFETY

A MULTI-DIMENSIONAL INVESTMENT PRINCIPLE

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The assertions in this paper are based on Fenimore Asset Management's opinion. Fenimore Asset Management is the manager of the FAM Funds.

Highlights Include:

- The market's typical characterization of margin of safety as one dimension.
- The forgotten sources of margin of safety and their impact on investing.
- Fenimore's multi-dimensional investment approach.

In the investment classic, *The Intelligent Investor*, Benjamin Graham builds upon the concept of "Margin of Safety" following his prior reference in the 1934 edition of *Security Analysis*. At Fenimore, our investment process parallels these early analytical insights making this masterpiece required reading for our firm. To expand on the concept, Graham penned an entire chapter in the 1973 version of *The Intelligent Investor* titled, "Margin of Safety as the Central Concept of Investment." Showing its critical application to his investment framework, Graham states that, "Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY."

Fenimore's research team finds that this investment principle is most frequently thought of in one dimension, often treated as synonymous with "discount to appraised value." Investing, though, is multi-dimensional. It is 3D-chess — not checkers. What is lost in translation are the multiple elements that Graham applies in describing the Margin of Safety. These include factors encompassing balance sheet strength, growth, and business quality. Given our own multi-dimensional approach to Margin of Safety, we seek to elaborate on these elements – all forgotten sources of Margin of Safety.

Price-to-Intrinsic Value

Why is Margin of Safety synonymous with discount to appraised value? Most likely, because Graham asserts succinctly, "A favorable difference between price on the one hand and indicated or appraised value on the other… that difference is the safety margin."

Graham continues, "The margin of safety is always dependent on the price paid." All else equal, we agree that the greater the discount paid versus appraised value, the greater the protection should be from loss (and the higher the expected return). In fact, at Fenimore we go to great lengths to calculate the price-to-intrinsic value for each of our owned and followed securities. We also continuously measure the premium/discount that the security trades at versus our appraised value.

The Forgotten Sources

Price is an important factor, but it is only one dimension. Graham intended, and we believe, that the Margin of Safety encompasses a broader set of criteria — the forgotten sources of Margin of Safety. We define these sources as:

- Balance Sheet Strength
- Sustainable Growth
- Competitive Moat

Balance Sheet Strength

Graham introduces the concept by describing an analysis of fixed charge coverage and balance sheet leverage "to protect the investor against loss or discomfiture in the event of some future decline in net income… for an investor to feel sufficiently protected against the vicissitudes of time." Although this example is provided in context of a bond investment, Fenimore maintains that balance sheet strength provides the first layer of safety when investing in equities and it is a key tenet of our philosophy.

The past decade has reinforced this view, as many companies did not have the capital strength to survive the aftermath of the financial crisis, the severe drop in oil in 2015/2016, and the economic shutdown due to COVID-19. The key to protecting against loss and benefiting from future gains, first and foremost, is survival. Additionally, the financial flexibility resulting from balance sheet strength reduces reliance on capital markets to raise new funds and allows organizations to play offense at opportune moments. Over time, businesses that can effectively utilize an under-levered balance sheet or internally generated cash should produce upside value creation, or a margin, above an initial appraised intrinsic value.

Sustainable Growth

Growth, and more particularly sustainable growth, can also be a source of Margin of Safety. Graham adds, "The growth-stock approach may supply as dependable a margin of safety as is found in the ordinary investment — provided the calculation of the future is conservatively made, and provided it shows a satisfactory margin in relation to the price paid." Fenimore seeks to avoid companies that are in secular decline and favors those that have an ability to exhibit sustainable organic growth. Oftentimes, we find that our conservative approach to financial modeling leads to realized future growth that exceeds our expectations. Furthermore, reinvested cash flows — whether toward acquisitions, expansionary capital expenditures, or intelligent stock buyback — can enhance the growth of a company's earning power when effectively utilized by adept management teams. For businesses with sustainable growth, what initially may look like an expensive price in the end may turn out to be a bargain.

Competitive Moat

The competitive moat is another important source of Margin of Safety. Graham touches on this when he states, "The risk of paying too high a price for good-quality stocks — while a real one — is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities…"

Fenimore believes that one of the best indicators of business quality is the strength of the competitive moat. Why? It is not enough to have a strong balance sheet and attractive growth profile if the business cannot endure changing industry dynamics and competitive attacks. Companies with strong and enduring competitive advantages tend to have the ability to improve margins and returns on invested capital to a greater degree, and for longer time periods. Once again, this can contribute to potential upside, or a margin, versus an initial appraised intrinsic value.

Fenimore's Multi-Dimensional Approach

Graham emphasizes, "A true margin of safety is one that can be demonstrated by figures, by persuasive reasoning, and by reference to a body of actual experience." Investing is indeed multi-dimensional and so is Fenimore's approach to evaluating investments. Fenimore's hands-on due diligence starts with evaluating the balance sheet and past fundamental performance, determining business quality, and communicating with management, customers, and industry experts. It is only after completion of this intensive due diligence, including evaluation of the forgotten sources of Margin of Safety, that we turn our attention to price and valuation. While each security has a different mix of attributes, we use our combined experience to purchase shares in businesses that we think comprise a combination of factors that create a Margin of Safety. Over long periods of time, our research team believes this discipline has and will continue to serve our investors well.

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