On the Money: Buy value for a margin of safety

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Stock market volatility, particularly on the downside, has reinforced the notion that investors should adopt a philosophy to limit the risk of permanent capital loss – that is, paying too high a price and being forced to sell for a loss.

To both limit principal risk and achieve satisfactory long-term investment returns, there is no better approach than value investing.

Value investing is the process of buying stock in a company at a price substantially below its estimated worth, to achieve the highest return on invested capital, consistent with preservation of capital. The estimated worth of a business– its intrinsic value – is the present value of all the cash the business produces in its lifetime.

This approach to investing has produced exceptional results in the stock market since the early 1920s. Value investing is based on proven principles pioneered by the late Benjamin Graham and advanced by seasoned investors like Warren Buffett of Berkshire Hathaway Inc. Buffett, arguably the world's most successful stock market investor over the past 55 years, was Graham's most gifted student and a business partner at Graham's hedge fund in the 1950s.

Value Investing has three key benefits:

1. High returns. You earn exceptional investment returns by owning a small group of profitable, growing companies at prices considerably below the estimated value of their underlying businesses. Over time, wealth increases as stock prices move up toward their companies' rising business values.
2. Preservation of capital. You preserve wealth by owning stocks of financially strong companies at bargain prices. The favorable difference between a stock's price and its estimated worth is called margin of safety. The safety margin minimizes the risk of permanent loss.
3. Low costs and tax efficiency. You earn exceptional returns through low turnover and by minimizing brokerage fees. You minimize taxes through the creation of long-term capital gains.

Many investors fret about volatility in the marketplace, and value investing doesn't necessarily limit short-term price fluctuations. In fact, volatility is a friend of the value investor, because it allows him to buy stocks when they sell at huge discounts to intrinsic worth. Instead, value investing's main function is to minimize the odds of permanent capital losses. If you limit downside risk by buying bargain stocks, the upside takes care of itself over time.

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