

Investing with a margin of safety

By Tom Stevenson, 23 September 2009

Backing an attractive theme or story is only part of a successful investment approach – paying the right price matters too.

People like stories. They are how we make sense of the world and, for an investor, they are a key part of the process of deciding where to put our savings to work.

The emerging markets story, for example, tells us that the economic growth rates, and so profit potential, of the developing world are very likely to be higher than those of the developed world for the foreseeable future.



“People tend to pay more attention to an attractive story than an attractive valuation.” Tom Stevenson

Many investors believe this story to be true and are backing it with their savings, investing in funds focused on Asia or Latin America, for example. Other popular themes today include the commodity super-cycle, which argues that demand for raw materials is likely to rise faster than supply for many years to come, pushing prices higher in the long run.

Seductive investment arguments like these are always based on an underlying economic truth but, for an investor, this truth is only ever half the story. Just as important as the growth potential of an investment is the price an investor pays for it. Even the best growth story can become too expensive if enough investors buy into it.

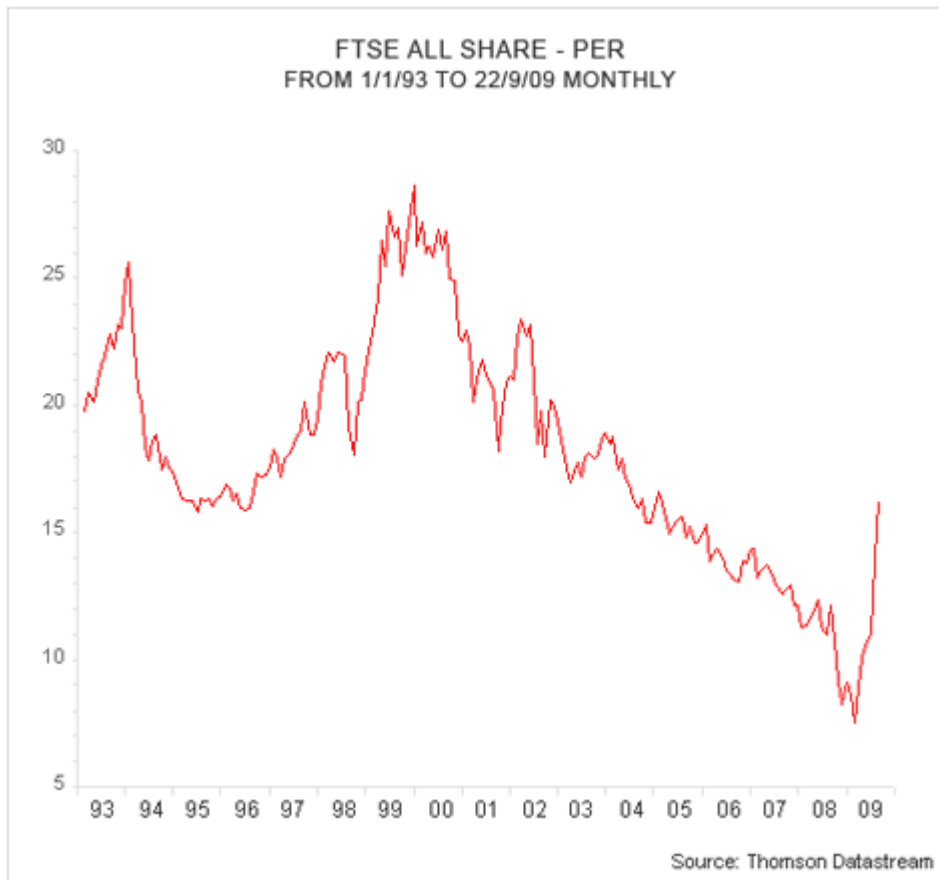
Because people are better at understanding words than numbers, they tend to pay more attention to an attractive story than an attractive valuation. This bias also reflects the fact that good stories tend to circulate when confidence is high while good valuations are typically only available when the outlook is grim and confidence is consequently low.

Recent examples of this include the dot.com bubble in the late 1990s when investors were seduced by a fundamentally true story about the power of the internet and telecommunications to transform our lives but blinded to the fact that valuations had become unhinged from reality.

History shows that the best returns from investment are not to be had by backing the best growth stories – the classic example of this is the airline industry, which according to some estimates has failed to make a profit in aggregate over the past hundred years or so.

More important is making investments at a price which fully accounts for the risks involved. Investors should always look for a margin of safety.

The chart below shows how this margin of safety can change substantially over time. It plots the average price of a share as a multiple of its most recent earnings. Called the price-earnings ratio, this is one of the most widely used investment statistics and provides a rough and ready measure of the attractiveness of an investment.



What the chart shows clearly is that shares became very expensive relative to their recent history during the dot.com bubble in 2000 and very cheap at the recent market low in March 2009. What they also show is that the valuation of shares on this measure has moved sharply higher during the recent rally, although in part this simply reflects a lag between share prices moving higher and analysts upgrading their earnings forecasts as the economy emerges from recession. This tends to happen because the stock market anticipates future events very quickly and the rest of the economy can take a while to catch up. Paying attention to valuation measures like this price-earnings ratio is important because they can turbo-charge investments in both directions. A cheap share which can demonstrate growing earnings will tend to be rewarded with a higher ratio which will magnify the rise in its price attributable just to higher profits. It's a kind of double whammy. But it cuts both ways. A highly-rated company which disappoints on the earnings front will also be punished by the market with a lower ratio and this will magnify any share price fall. One of the hardest things in investment is not being seduced into believing that a high-flying share is somehow "worth" a higher rating. Attention to valuations is one of the major arguments for investing in an actively managed fund rather than a passive fund such as a tracker or an ETF. By looking for growth at an attractive price, a fund manager can benefit from situations where a share is re-rated upwards and avoid those painful cases where a company is downgraded by a disappointed market.

Performance over 5 years

	Aug 04/ Aug 05	Aug 05/ Aug 06	Aug 06/ Aug 07	Aug 07/ Aug 08	Aug 08/ Aug 09
FTSE ALL SHARE	20.1%	13.1%	8.4%	-12.0%	-12.1%

Source: Datastream, years from 31.08.04 to 31.08.09

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