Dividend Discount Models

Margin of Safety

Margin of safety (MoS) refers to the practice of buying securities at a discount to their estimated intrinsic value.

Importance of the MoS

> "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, or rapidly changing world."
>
> *– Seth Klarman in "Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor"*

You should always use a margin of safety for stock valuations to **reduce downside risk** and **improve return potential**.

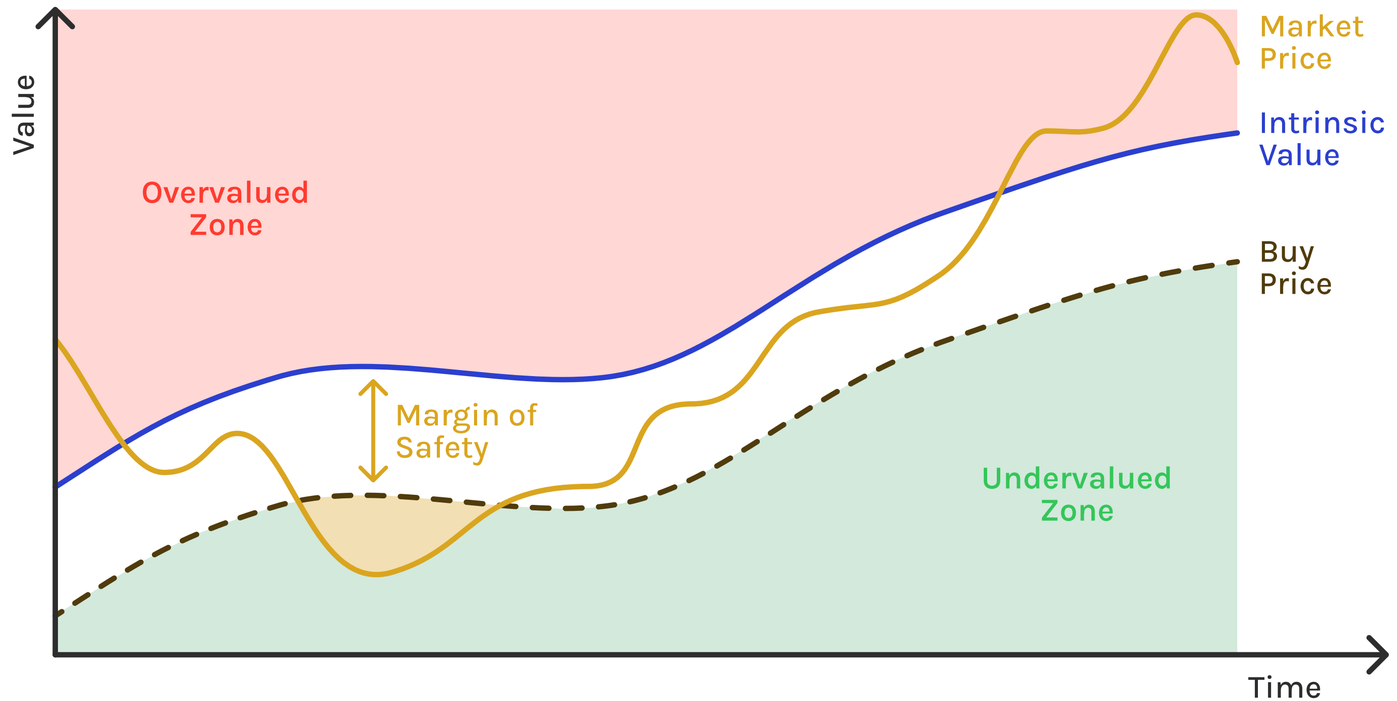
Relationship Between the MoS, Investor Confidence, and Stock Valuations

- **Higher MoS** = Lower Valuation Confidence = Stock Appears More Overvalued
- **Lower MoS** = Higher Valuation Confidence = Stock Appears More Undervalued

How to Apply the MoS to Calculate Buy Price

$$\text{Buy Price} = \text{Implied Share Price} \times (1 - \text{MoS \%})$$

Margin of Safety



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Determine Valuation

The buy price can be compared to the company's market price to determine its valuation:

- **Undervalued**: Buy Price > Market Price
- **Fairly Valued**: Buy Price ≈ Market Price
- **Overvalued**: Buy Price < Market Price

The degree of mispricing can be quantified using the following formula:

$$\text{Premium (Discount) to Current} = (\text{Buy Price} \,/\, \text{Market Price}) - 1$$

A positive percentage indicates potential undervaluation, while negative suggests overvaluation.

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