

October 2021

Michael Anderson
Chief Investment Officer

At Hi-Line Capital Management, our intrinsic-value philosophy and decision-making principles drive how we approach investing and provide guard rails for thinking during periods of extreme uncertainty and volatility. Our piece, *Foundational Decision-Making Principles*, details the seven pillars of our decision-making process and its critical function in long-term success and rationality.

ABOUT HI-LINE CAPITAL MANAGEMENT

Hi-Line Capital Management, LLC (“HLCM”), based in Watertown, SD, provides investment management and advisory services for institutional and individual clients. The firm was founded in July 2009, became a registered investment advisor (RIA) with the U.S. Securities and Exchange Commission (“SEC”) in March 2010.

MARGIN OF SAFETY

EXECUTIVE SUMMARY

- Margin of safety is the shock absorber of investing
- Adequate diversification is not achieved by number of holdings, but by diversification of industry exposure.
- Margin of safety is an important tenet of successful investing and is largely comprised of determining the price at the individual security level and adequate diversification.

BEN GRAHAM, THE FOUNDING FATHER OF INVESTING, DESCRIBED THE SECRET OF SOUND DECISION-MAKING IN THREE SIMPLE WORDS.....MARGIN OF SAFETY.

MARGIN OF SAFETY = SHOCK ABSORBER

The pursuit of investing is to obtain a satisfactory return on principle and a return of principle. But, the future is uncertain and investors must face several potential realities including;

- Potential mistakes that may be made
- Bad luck that may be experienced, and
- The wide range of future outcomes that exist.

Therefore, by seeking and pursuing a margin of safety, an investor may be able to incorporate a shock absorber to the portfolio. A margin of safety can be pursued in several ways including;

- Ensuring the price paid is substantially lower than estimated intrinsic value
- Stress testing businesses and securities for adverse outcomes
- Using realistic and cautious assumptions.

Conservative investors will act when wide levels of margin of safety appear to exist while aggressive investors or speculators will demonstrate little or no concern towards adequate levels of margin of safety.

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MARGIN OF SAFETY CONT’D

ADEQUATE DIVERSIFICATION = INSURANCE

A poor outcome may occur at the individual security level even though an adequate margin of safety appeared to exist. But as the number of holdings increases, the more certain it becomes that the aggregate performance will result in positive outcomes over time. The element of diversification is the same basis as insurance underwriting.

Great attention is given to diversification but no common method of defining diversification exists. Equities are classified among 12 different sectors and approximately 160 different industries. But not all industries are equal in size nor advantageous in benefits accruing to the business owner. The best industry or business will contain some form of sustainable competitive advantage where the economics accrue to the benefits of the owner.

Therefore, a portfolio represented by holdings in 10 different and unrelated industries that each possess sustainable competitive advantages with favorable economics to the business owner exhibit much better diversification than a portfolio with 20 securities of the same industry. The number of securities does not determine adequate diversification, the diversity of business and economic exposure determines diversification adequacy.

CONCLUSION

The pursuit is adequate holdings across many different industries where the economic results are not directly correlated with each other. The margin of safety principle is an important element necessary for a successful investment operation and is largely determined by price at the individual security level and diversifying with a collection of individual securities representing favorable probabilities.

Margin of Safety: excerpt from *The Intelligent Investor*.

“...The margin of safety concept begins with a conservative evaluation of future prospects. It should be a basic rule that all estimates, when they differ from actual performance, must err on the side of understatement. The margin of safety is always dependent on the price paid, it will be large at one price while nonexistent at another price. Since the margin of safety is available to absorb the effects of miscalculations or bad luck, the buyer of securities with a margin of safety has placed emphasis on the ability of the investment to withstand adverse developments while still leaving potential for moderate investment returns or only minor capital loss.”