Chapter 20: "Margin of Safety" as the Central Concept of Investment by Benjamin Graham

In the old legend the wise men finally boiled down the history of mortal affairs into the single phrase, "This too will pass." Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY.[1] This is the thread that rounds through all the preceding discussion of investment policy--often explicitly, sometimes in a less direct fashion. Let us now, briefly, to trace that idea in a connected argument.

All experienced investors recognize that the margin of safety concept is essential to the choice of sound bonds and preferred stocks. For example, a railroad should have earned its total fixed charges better than five times (before income tax), taking a period of years, for its bonds to qualify as investment-grade issues. This past ability to earn in <u>excess</u> of interest requirements constitutes the margin of safety that is counted on to protect the investor against loss or discomfiture in the event of some future decline in net income. (The margin of above charges may be stated in other ways—for example, in the percentage by which revenues or profits may decline before the balance after interest disappears—but the underlying idea remains the same.)

The bond investor does not expect future average earnings to work out the same as the in the past; if he were sure of that, the margin demanded might be small. Nor does he rely to any controlling in his judgment as to whether future earnings will be materially better or poorer than in the past, if he did that, he would have to measure his margin in terms of a carefully *projected* income account, instead of emphasizing the margin shown in the *past* record. Here the function of the margin of safety is, in essence, that of rendering <u>unnecessary an accurate estimate of the future</u>. If the margin is a large one, then it is enough to assume that future earnings will not fall far below those of the past in order for an investor to feel sufficiently protected against the vicissitudes of time.

The margin of safety for bonds may be calculated, alternatively, by comparing the total value of the enterprise with the amount of debt. (Ditto for preferred stock issue) If the business owes $10 million and is fairly worth $30 million, there is room for a shrinkage of two-thirds in value—at least theoretically—before the bondholders will suffer loss. The amount of this extra value, or "cushion," above the debt may be approximated by using the average market price of the junior stock issues over a period of years. Since average stock prices are generally related to average earning power, the margin of "enterprise value" over debt and the margin of earnings over charges will in most cases yield similar results.

So much for the margin-of-safety concept as applied to "fixed-value investments." Can it be carried over into the field of common stocks? Yes, but with some necessary modifications.

There are instances where a common stock may be considered sound because it enjoys a margin of safety as <u>large as that of a good bond</u>. This will occur, for example, when a company has outstanding only common stock that under depression conditions is selling for less than the amount of bonds that could

[1] Buffett has been quoted as saying these three words (Margin of Safety) are the most important concept in investing. Your mindset is important. The investor allows for being wrong; for having a margin of error built into his/her process.

safely be issued against it property and earning power[2]. That was the position of a host of strongly financed industrial companies at the low price levels of 1932-33. In such instances the investor can obtain the margin of safety associated with a bond, *plus* all the chances of larger income and principal appreciation inherent in a common stock. (The only thing he lacks is the legal power to insist on dividend payments "or else"—but this is a small drawback as compared with his advantages.) Common stocks bought under such circumstances will supply an ideal, through infrequent, combination of safety and profit opportunity. As a quite recent example of this condition, let us mention once more *National Presto Industries Stock*, which sold of a total enterprise value of $443 million in 1972. With its $16 million of recent earnings before taxes the company could easily have supported this amount of bonds.

In the ordinary common stock, brought for investment under normal conditions, the margin of safety lies in an expected earning power considerably above the going rate for bonds. In former editions we elucidated these points with the following figures:

Assume in a typical case that the earning power is 9% on the price and that the bond rate is 4%; then the stock buyer will have an average annual margin of 5% accruing in his favor. Some of the excess is paid to him in the dividend rate; even though spent by him, it enters into his overall investment result. The undistributed balance is reinvested in the business for his account.
In many cases such reinvested earnings fail to add commensurately to the earning power and value of his stock. (That is why the market has a stubborn habit of valuing earnings disbursed in dividends more generously than the portion retained in the business.)* But, if the picture is viewed as a whole, there is a reasonably close connection between the growth of corporate surpluses through reinvested earnings and the growth of corporate values.

Over a ten-year period the typical excess of stock earning power over bond interest may aggregate 450% of the price paid. This figure is sufficient to provide a very real margin of safety—which, under favorable conditions, will prevent or minimize a loss. If such a margin is present in each of a diversified list of twenty or more stocks, the probability of a favorable result under "fairly normal conditions" becomes very large. That is why the policy of investing in representative common stocks does not require high qualities of insight and foresight to work out successfully. If the purchases are made at the average level of the market over a span of years, the prices paid should carry with them assurance of an adequate margin of safety. The danger to investors lies in concentrating their purchase in the upper levels of the market, or in buying non-representative common stocks that carry more than average risk of diminished earning power.

As we see it, the whole problem of common-stock investment under 1972 conditions lies in the fact that "in a typical case" the earning power is now much less than 9% on the price paid.[3] Let us assume that by concentrating somewhat on the low-multiplier issues among the large companies a defensive investor may now acquire equities at 12 times recent earnings—i.e., with an earnings return of 8.33% on cost. He may obtain a dividend yield of about 4%, and he will have 4.33% of his cost reinvested in the business for

[2] "Earning power" is Graham's term for a company's potential profits or, as he puts it, the amount that a firm "might be expected to earn year-after-year if the business conditions prevailing during the period were to continue unchanged" (Security Analysis, 1934 ed., p 354). Some of his lectures make it clear that Graham intended the term to cover periods of five years or more. You can crudely approximate a company's earning power per share by taking the inverse of its P/E ratio; a stock with a P/E ratio of 11 can be said to have earning power of 9 or 1 divided by 11.

[3] Graham elegantly summarized the discussion that follows in a lecture he gave in 1972: "The margin of safety is the difference between the percentage rate of the earnings on the stock at the price you pay for it and the rate of interest on bonds, and that margin of safety is the difference which would absorb unsatisfactory developments. At the time the 1965 edition of the Intelligent Investor was written, the typical stock was selling at 11 times earnings, giving about 9% return as against 4% on bonds. In that case you had a margin of safety of over 100 per cent. Now in 1972 there is no difference between the earnings rate on stocks and the interest rate on stocks and I say there is no margin of safety…you have a negative margin of safety on stocks….

his account. On this basis, the excess of stock earning power over bond interest over a ten-year basis would still be too small to constitute an adequate margin of safety. For that reason we felt that there are real risks now even in a diversified list of sound common stocks. The risks may be fully offset by the profit possibilities of the list; and indeed the investor may have no choice but to incur them—for otherwise he may run an even greater risk of holding only fixed claims payable in steadily depreciating dollars. Nonetheless the investor would do well to recognize, and to accept as philosophically as he can, that the old package of good profit possibilities combined with small ultimate risk is no longer available to him.

However, 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 at time of favorable business conditions.** The purchasers view the current good earnings as equivalent to "Earning Power" and assume that prosperity is synonymous with safety. It is in those years that bonds and preferred stocks of inferior grade can be sold to the public at a price around par, because they carry a little higher income return or a deceptively attractive conversion privilege. It is then also, that common stocks of obscure companies can be floated at prices far above the tangible investment, on the strength of two or three years of excellent growth. *(Graham speaks of the growth illusion and the dangers of paying a price for a franchise—paying over asset or replacement value—because investors confuse the continuation of high earnings during rosy economic times with the average earnings power of the company. For example, paying peak earnings for a cyclical company is usually a disaster).*

These securities do not offer an adequate margin of safety in any admissible sense of the term. Coverage of interest charges and preferred dividends must be tested over a number of years, including preferably a period of subnormal business such as in 1970-71. The same is ordinarily true of common-stock earnings if they are to qualify as indicators of earning power. Thus it follows that most of the fair-weather investments, acquired at fair-weather prices, are destined to suffer disturbing price declines when the horizon clouds over-and often sooner than that. Nor can the investor count with confidence on an eventual recovery-although this does come about in some proportion of the cases—for he has never had a real safety margin to tide him through adversity.

The philosophy of investment in growth stocks parallels in part and in part contravenes the margin-of-safety principle. The growth stock buyer relies on an expected earning power that is greater than the average shown in the past. Thus he may be said to substitute these expected earnings for the past record in calculating carefully estimated future earnings should be a less reliable guide than the bare record of the past; in fact, security analysis is coming more and more to prefer a competently executed evaluation of the future. Thus 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. *(This concept is critical for growth investors).*

The danger in a growth-stock program lies precisely here. For such favored issues the market has a tendency to set prices that will not be adequately protected by a conservative projection of estimates, when they differ from past performance, must err at least slightly on the side of understatement. The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price. If, as we suggest, the average market level of most growth stocks is too high to provide an adequate margin of safety for the buyer, then a simple technique of diversified buying in this field may not work out satisfactorily. A special degree of foresight and judgment will be needed, in order that wise individual selections may overcome the hazards inherent in the customary market level of such issues as a whole.

The margin of safety idea becomes much more evident when we apply it to the field of undervalued or bargain securities. We have here, by definition, a favorable difference between price on the one hand and indicated or appraised value on the other. That difference is the safety margin. It is available for absorbing the effect of miscalculations or worse than average luck. They buyer of bargain issues places particular emphasis on the ability of the investment to withstand adverse developments. For in most such cases he has no real enthusiasm about the company's prospects. True, if the prospects are definitely bad the investor will prefer to avoid the security no matter how low the price. But the field of undervalued issues is drawn from the many concerns—perhaps a majority of the total—for which the future appears neither distinctly promising nor distinctly unpromising. If these are bought on a bargain basis, even a moderate decline in the earning power need not prevent the investment from showing satisfactory results. The margin of safety will then have served its proper purpose.

THEORY OF DIVERSIFICATION

There is a close logical connection between the concept of safety margin and the principle of diversification. One is correlative with the other. Even with a margin in the investor's favor, an individual security may work out badly. For the margin guarantees only that he has a better chance for profit than for loss—not that loss is impossible. But as the number of such commitments is increased the more certain does it become that the aggregate of the profits will exceed the aggregate of the losses. That is the simple basis of the insurance-underwriting business.

Diversification is an established tenet of conservative investment. By accepting it so universally, investors are really demonstrating their acceptance of the margin-of-safety principle, to which diversification is the companion. This point may be made more colorful by a reference to the arithmetic of roulette. If a man bets $1 on a single number, he is paid $35 profit when he wins—but the chances are 37 to 1 that he will lose. He has a "*negative* margin of safety." In his case diversification is foolish. The more numbers he bets on, the smaller his chance of ending with a profit. If he regularly bets $1 on every number (including 0 and 00), he is certain to lose $2 on each turn of the wheel. But suppose the winner received $39 profit instead of $35. Then he would have a small but important margin of safety. Therefore, the more numbers he wagers on, the better his chance of gain. And he could be certain of winning $2 on every spin by simply betting $1 each on all the numbers. (Incidentally, the two examples given actually describe the respective positions of the player and proprietor of a wheel with a 0 and 00.)[4]

A CRITERION OF INVESTMENT VERSUS SPECULATION

[4] In "American" roulette, most wheels include a 0 and 00 along with numbers 1 through 36, for a total of 38 slots. The casino offers a maximum payout of 35 to 1. What if you $1 on every number? Since only one slot can be the one into which the ball drops, you would win $25 on that slot, but lose $1 on each of your other 37 slots, for a net loss of $2. That $2 difference (or a 5.26% spread on your total $38 bet) is the casino's "house advantage," ensuring that, on average, roulette players will always lose more than they win. Just as it is in the roulette player's interest to bet as seldom as possible, it is in the casino's interest to keep the roulette wheel spinning. Likewise, the intelligent investor should seek to maximize the number of holdings that offer "a better chance for profit than for loss." For most investors, diversification is the simplest and cheapest way to widen your margin of safety.

Since there is no single definition of investment in general acceptance, authorities have the right to define it pretty much as they please. Many of them deny that there is any useful or dependable difference between the concepts of investment and of speculation. We think this skepticism is unnecessary and harmful. It is injurious because it lends encouragement to the innate leaning of many people toward the excitement and hazards of stock-market speculation. We suggest that the margin of safety concept may be used to advantage as the touchstone to distinguish an investment operation from a speculative one.

Probably most speculators believe they have the odds in their favor when they take their chances, and therefore they may lay claim to a safety margin in their proceedings. Each one has the feeling that the time is propitious for his purchase, or that his skill is superior to the crowd's, or that his adviser or system is trustworthy. But such claims are unconvincing. They rest on subjective judgment, unsupported by any body of favorable evidence or any conclusive line of reasoning. We greatly doubt whether the man who stakes money on his view that the market is heading up or down can ever be said to be protected by a margin of safety in any useful sense of the phrase.

By contrast, the investor's concept of the margin of safety—as developed earlier in this chapter—rests upon simple and definite arithmetical reasoning from statistical data. We believe, also that it is well supported by practical investment experience. There is no guarantee that this fundamental quantitative approach will continue to show favorable results under the unknown conditions of the future. But, equally, there is no valid reason for pessimism on this score.

Thus, in sum, we say that to have a true investment there must be present a true margin of safety. And 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.

EXTENSION OF THE CONCEPT OF INVESTMENT

To complete our discussion of the margin of safety principle we must now make a further distinction between conventional and unconventional investments. Conventional investments are appropriate for the typical portfolio. Under this heading have always come United States government issues and high grade, dividend paying common stocks. We have added state and municipal bonds for those who will benefit sufficiently by their tax-exempt features. Also included are first-quality corporate bonds when, as now, they can be bought to yield sufficiently more than United States saving bonds.

Unconventional investments are those that are suitable only for the enterprising investor. They cover a wide range. The broadest category is that of undervalued common stocks of secondary companies, which we recommend for purchase when they can be bought at two thirds or less of their indicated value. Besides these, there is often a wide choice of medium grade corporate bonds and preferred stocks when they are selling at such depressed prices as to be obtainable also at a considerable discount from their apparent value. In these cases the average investor would be inclined to call the securities speculative, because in his mind their lack of a first-quality rating is synonymous with a lack of investment merit.

It is our argument that a sufficiently low price can turn a security of mediocre quality into a sound investment opportunity provided that the buyer is informed and experienced and that he create a substantial margin of safety, the security thereby meets out criterion of investment. Our favorite supporting illustration is taken from the field of real estate bonds. In the 1920s, billions of dollars' worth of these issues were sold past par and widely recommended as sound investments. A large proportion had so little margin of value over debt as to be in fact highly speculative in character. In the depression of the 1930's an enormous quantity of these bonds defaulted their interest, and their price collapsed—in some case below 10 cents on the dollar. At that stage the same advisors who had recommended them at par as safe investments were rejecting them as paper of the most speculative and unattractive type. But as a matter of fact the price depreciation of about 90% made many of these securities exceedingly attractive and reasonable safe—for the stated values behind them were four or five times the market quotation*

*Graham is saying that there is no such thing as a good or bad stock; there are only cheap stocks and expensive stocks. Even the best company becomes a "sell" when its stock price goes too high, while the worse company is worth buying if its stock goes low enough. *(James Grant of Grant's Interest Rates Observer says there are no bad bonds just bad bond prices). A company may be a great investment when its stock price is depressed relative to its normal earnings power and asset values while becoming a terrible investment at another high price of its stock. Look at the lesson of the "Nifty Fifty" from the Go-Go years of the late 1960s and early 1970s. Those high quality companies like Avon, IBM, P&G became one decision stocks to be held forever even at absurdly high prices. This concept was crushed during the bear market of 1973/1974 when stock prices of those companies declined 50% to 80%.*

The fact that the purchase of these bonds actually resulted in what is generally called "a large speculative profit" did not prevent them from having true investment qualities at their low prices. The "speculative" profit was the purchasers' reward for having made an unusually shrewd investment. They could properly be called investment opportunities, since a careful analysis would have shown that the excess of value over price provided a large margin of safety. Thus the very class of "fair weather investment" which we stated above is a chief source of serious loss to naïve security buyers is likely to afford many sound profit opportunities to the sophisticated operator who may buy them later at pretty much his own price. (The very people who considered technology and telecommunication stocks a "sure thing" in late 1999 and early 2000,when they were hellishly overpriced, shunned them as "too risky: in 2002—even though, in Graham's exact words from an earlier period, "the price depreciation of about 90% made many of these securities exceedingly attractive and reasonably safe. Similarly, Wall Street's analysts have always tended to call a stock a "strong buy" when its price is high, and to label it a "sell" after its price has fallen—the exact opposite of what Graham and simple common sense would dictate. As he does throughout the book, Graham is distinguishing speculation—or buying on the hope that a stock's price will keep going up—from investing, or buying on the basis of what the underlying business is worth.

The whole field of "special situations" would come under our definition of investment operations, because the purchase is always predicted on a thoroughgoing analysis that promises a larger realization than the price paid. Again there are risk factors in each individual case, but these are allowed for in the calculations and absorbed in the overall results of a diversified operation.

To carry this discussion to a logical extreme, we might suggest that a defensible investment operation could be set up by buying such intangible values as are represented by a group of "common stock option warrants" selling at historically low prices. (This example is intended as somewhat of a shocker.)[5] The

[5] Graham uses "common stock option warrant" as a synonym for "warrant," a security issued directly by as corporation giving the holder a right to purchase the company's stock at a predetermined price. Warrants have been almost entirely superseded by stock options. Graham quips that he intends the example as a "shocker" because, even in his day, warrants were regarded as one of the market's seediest backwaters.

entire value of these warrants rests on the possibility that the related stocks may some day advance above the option price. At the moment they have no exercisable value. **Yet, since all investment rests on reasonable future expectations**, it is proper to view these warrants in terms of the mathematical chances that some future bull market will create a large increase in their indicated value and in their price. Such a study might well yield the conclusion that there is much more to be gained in such an operation than to be lost and that the chances of an ultimate profit are much better than those of an ultimate loss. If that is so, there is a safety margin present even in this unprepossessing security form. A sufficiently enterprising investor could then include an option-warrant operation in this miscellany of unconventional investments.

To Sum Up

Investment is most intelligent when it is most *businesslike*. It is amazing to see how many capable businessmen try to operate in Wall Street with complete disregard of all the sound principles through which they have gained success in their own undertakings. Yet every corporate security may best be viewed, in the first instance, as an ownership interest in, or a claim against, a specific business enterprise. And if a person sets out to make profits from security purchases and sales, he is embarking on a business venture of his own, which must be run in accordance with accepted business principles if it is to have a chance of success.

The first and most obvious of these principles is, "Know what you are doing—know your business." (*circle of competence*). For the investor this means: Do not try to make "business profits" out of securities—that is, returns in excess of normal interest and dividend income—unless you know as much about security values as you would need to know about the value of merchandise that you proposed to manufacture or deal in.

A second business principle: "Do not let anyone else run your business, unless (1) you can supervise his performance with adequate care and comprehension or (2) you have unusually strong reasons for placing implicit confidence in his integrity and ability." For the investor this rule should determine the conditions under which he will permit someone else to decide what is done with his money.

A third business principle: "Do not enter upon an operation—that is, manufacturing or trading in an item—unless a reliable calculation shows that it has a fair chance to yield a reasonable profit. In particular, keep away from ventures in which you have little to gain and much to lose." For the enterprising investor this means that his operations for profit should be based not on optimism but on arithmetic. For every investor it means that when he limits his return to a small figure--as formerly, at least, in a conventional bond or preferred stock—he must demand convincing evidence that he is not risking a substantial part of his principal.

A fourth business rule is more positive: "Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ." (You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.) Similarly, in the world of securities, courage becomes the supreme virtue *after* adequate knowledge and a tested judgment are at hand.

Fortunately for the typical investor, it is by no means necessary for his success that he bring these qualities to bear upon his program—provided he limits his ambition to his capacity and confines his activities with the safe and narrow path of standard, defensive investment. To achieve satisfactory investment results is easier than most people realize; to achieve *superior* results is harder than it looks.

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What is risk?

While its meaning may seem nearly as fickle and fluctuating as the financial markets themselves, risk has some profound and permanent attributes. The people who take the biggest gambles and make the biggest gains in a bull market are almost always the ones who get hurt the worst in the bear market that inevitable follows. (Being "right" makes speculators even more eager to take extra risk, as their confidence catches fire.) And once you lose big money, you then have to gamble even harder just to get back to where you were, like a racetrack or casino gambler who desperately doubles up after every bad bet. Unless you are phenomenally luckily, that is a recipe for disaster. No wonder, when he was asked to sum up everything he had learned in his long career about how to get rich, the legendary financer, *J.K. Kingenstein* of Wertheim & Co. answered simply: **"Don't lose."**

Losing some money is an inevitable part of investing, and there is nothing you can do to prevent it. But, to be an intelligent investor, you must take responsibility for ensuring that you never lose most or all of your money. The Hindu Goddess of wealth, *Lakshmi*, is often portrayed standing on tiptoe, ready to dart away in the blink of an eye. To keep her symbolically in place, some of *Lakshmi's* devotees will lash her statue down with strips of fabric or nail its beet to the floor. For the intelligent investor Graham's "margin of safety" performs the same function: By refusing to pay too much for an investment, you minimize the chances that your wealth will ever disappear or suddenly be destroyed.

Consider this: Over the four quarters ending in Dec. 1999, *JDS Uniphase Corp.*, the fiber-optics company, generate d$673 million in net sales, on which it lost $313 million, its tangible assets totaled $1.5 billion, Yet on March 7, 2000, *JDS Uniphase's* stock hit $152 a share, giving the company a total market value of roughly $143 billion. And then like most "New Era" stocks, it crashed. Anyone who bought it that day and still clung to it at the end of 2002 faced these prospects: 10.2 years to break-even at 50% CAGR. Even at a robust 10% annual rate of return, it will take more than 43 years to break even on this overpriced purchase!

THE RISK IS NOT IN OUR STOCKS, BUT IN OURSELVES

Risk exists in another dimension: inside you. If you overestimate how well you really understand an investment, or overstate your ability to rise out a temporary plunge in prices, it doesn't matter what you own or how the market does. Ultimately, financial risk resides not in what kinds of investment s you have, but in what kind of investor you are. If you want to know what risk really is, go to the nearest bathroom and stop up to the mirror. That is risk, gazing back at <u>you</u> from the glass.

As you look at yourself in the mirror, what should you watch for? The Nobel-prize-winning psychologist Daniel Kahneman explains two factors that characterize good decisions:

Well-calibrated confidence" (do I understand this investment as well as I think I do?)

Correctly-anticipated regret? (How will I react if my analysis turns out to be wrong?)

To find out whether your confidence is well calibrated, look in the mirror and ask yourself: "What is the likelihood that my analysis is right?" Think carefully through these questions:

How much experience do I have? What is my track record with similar decisions in the past?

What is the typical track record of other people who have tried this in the past?

If I am buying, someone else is selling. How likely is it that I know something that this other person or company does not know?

If I am selling, someone else is buying. How likely is it that I know something that this other person or company does not know?

END

Benjamin Graham's view of Margin of Safety[6]

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Benjamin Graham, frequently referred to as "the father of value investing" defines margin of safety as:

earning power of the company - return on long-term risk-free bonds

Where a company's earning power is calculated by taking the company's average earnings per share over the last several years, and dividing this by the share price. For example, suppose Jack's Furniture Company (not a real company) trades at $17.5 per share, and suppose its earnings per share over the last several years have been:

$1

[6] Source: http://www.bronsteinreport.com/grahammos.htm

$1.2

$1.3

$1.65

$1.75

From these results, it looks like this company is growing at approximately 15% per year and is trading at a P/E ratio of 10. Graham, however, would suspect that the company's earnings only grew because of temporary factors. For example, perhaps the economy is doing particularly well at the moment, leading people to purchase more furniture than usual. Graham might expect that in the future, the company's earnings will fall to a lower level.

He would likely say, the earning power of the company is the ***average*** of the company's earnings over the last several years, or:

$$\frac{1 + 1.2 + 1.3 + 1.65 + 1.75}{5} = \textbf{\$1.38 per share}.$$

Dividing $1.38 into the share price of 17.5, we get an earnings yield of 7.8%.

If long term treasury bonds are returning 5%, the company is trading at a margin of safety of 7.8% - 5%, which is 2.8%. This means, the company's earnings yield is 2.8 percentage points higher than is necessary for the stock to perform as well as risk-free bonds. If the company performs worse than we expect, and the company's earning power turns out to be only $0.88 per share, the return on the stock will likely be roughly equal to the return on 30-year treasuries. So, according to Graham's theory, Jack Co is likely a better investment than long-term bonds, even if the company's earnings fall significantly.

This concept of "margin of safety" is quite conservative, but that doesn't make it useless. It might be worth considering.

For more information on this approach, see chapter 20 of the Graham's classic value investing book, The Intelligent Investor.