Ignore This Principle and You’ll Destroy Your Real Estate Career

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I learned an important Buffettism before I’d ever heard of Warren Buffett. I hope you already know about it—in name or in practice—but if you don’t practice it, you’re sure to come to financial ruin. It’s called *the margin of safety*.

What Is the Margin of Safety?

The margin of safety is a principle of investing in which an investor only purchases assets when their purchase price is significantly below their estimate of intrinsic value.

In other words, when the purchase price of an asset is significantly below your estimation of its intrinsic value, the difference is the margin of safety. Because investors may set a margin of safety in accordance with their own risk preferences, buying assets when this difference is present allows an investment to be made with lower downside risk. Thus sayeth [Investopedia](https://www.investopedia.com/terms/m/marginofsafety.asp).

What Does Warren Buffett Think?

“Well, if you’re driving a truck across a bridge that holds—it says it holds 10,000 pounds—and you’ve got a 9,800-pound vehicle, you know, if the bridge is about six inches above the crevice that it covers, you may feel OK. But if it’s, you know, over the Grand Canyon, you may feel you want a little larger margin of safety, in terms of only driving a 4,000-pound truck, or something, across. So it depends on the nature of the underlying risk.” —[Berkshire Hathaway Annual Meeting 1997](https://buffett.cnbc.com/video/1997/05/05/afternoon-session---1997-berkshire-hathaway-annual-meeting.html?&start=2590&end=2760)

This really did remind me of engineering school. When designing drilling rigs or bridges, we had to design all of the components to withstand all of the forces that could be involved. When all the calculations were done, we had to slap on a margin of safety or safety factor. If the safety factor was 3.2, we had to make it 220% stronger than it “needed” to be. (That would mean a margin of safety of 2.2, but that is getting technical.)

To a 19-year-old punk, this seemed like a needless waste. *“Wait… the biggest semi-truck allowed on this road weighs 80,000 pounds. But we have to design the bridge to withstand 256,000 pounds? Isn’t that a huge waste?”*

I didn’t know that one in four U.S. bridges failed in the 1800s. This makes a lot of sense to me now.

But I hadn’t thought of this engineering term when making investments—the widely-read Buffett connected the dots for me.

The margin of safety is a key concept for us to understand when making an investment in something that has inherent unknowns. Which is every investment I can think of. The margin of safety is a risk management concept that forces us to think about our purchase price relative to our estimate of intrinsic value.

Using non-financial examples, like Buffett’s bridge, really drives the point home for me. Having a margin of safety is an intuitive concept when deciding to cross a bridge (unless you’re a daredevil) but can be more difficult to “see” when studying, say, a [pro forma](https://www.biggerpockets.com/blog/2014/02/19/building-pro-forma-skills/) analysis of a potential investment.

Real Estate Investment and the Margin of Safety

Real estate has numerous unknowns. Your floating debt may change based on unpredictable factors. Your local economy may suffer layoffs. Your [property manager](https://www.biggerpockets.com/rei/glossary/property-manager?itm_source=ibl&itm_medium=auto&itm_campaign=glossary) may make bad decisions. Your turnaround plan may suffer from unforeseen tariffs on raw materials. The list goes on.

The challenge is to not focus on accurately calculating a margin of safety for all of these unknowns. You just can’t do this effectively. (Check out [this article](https://www.biggerpockets.com/blog/how-to-become-a-billionaire-by-being-approximately-right/) on becoming a billionaire by being approximately right on *a few* key variables.)

The key is to purchase real estate at a price that allows for a safety net in the event that some random combination of these unknown events occur.

Some Practical Examples

Ensuring that your investment property has adequate [debt service coverage (DSC)](https://www.investopedia.com/terms/d/dscr.asp) is a great example of why building in a margin of safety is crucial. You must ensure that your cash flow is sufficient to cover your debt obligations.

But should you simply make sure that it covers it by just 100%? Or should you make sure that you cover debt service by more than 100%?

You know the answer. You don’t want to risk some unknown occurrence that would increase your operating expenses and leave you unable to pay your mortgage. That’s a good way to learn a very hard lesson in real estate.

You’ll be glad to know your banker won’t allow this to happen. They insist on a margin of safety of at least 25% (debt service coverage ratio of 1.25x—you should aim for much higher than this).

Another great example is forecasting occupancy and rent rates on [multifamily](https://www.biggerpockets.com/blog/2013-04-09-how-to-buy-a-small-multifamily-property?itm_source=ibl&itm_medium=auto&itm_campaign=opt) properties. You can easily find data that show average occupancy and rent rates for comparable properties. When you do, should you simply use those averages for your forecasting purposes?

No.

When applying a margin of safety, you’ll want to forecast your occupancy below market averages—and the same for rent rates. This is often described as being conservative, but really you’re adding a margin of safety in the event your property suffers low occupancy or your forecasted rent rates are not happening. Your investors will thank you, trust me.

Why I’m Not Investing in Multifamily Right Now

As the author of an arrogantly titled book on multifamily investing, I’m frequently asked why I’m not (or why I’m rarely) investing in multifamily right now. And why our company has expanded to self-storage and mobile home parks. It’s a fair question that deserves an answer.

My response involves the margin of safety. As I’ve said in [several BiggerPockets posts](https://www.biggerpockets.com/blog/author/paulmoore/), most anyone in the multifamily world knows prices are crazy overheated right now. Yet there are still plenty of eager buyers, seemingly eager to overpay. It is obviously continuing to drive prices higher. And I have [some theories](https://www.biggerpockets.com/blog/why-are-so-many-overpaying-multifamily/) on why this is happening.

I hope you’re not one of these overzealous buyers, but if you are, I urge you to [STOP IT](https://www.biggerpockets.com/blog/stop-overpaying-for-multifamily/)! My firm is still reviewing multifamily opportunities, but we believe that most of them will be on the other side of a market correction.

*Correction? When?*

That would require a crystal ball to predict. And those who live by a crystal ball are destined to eat ground glass. Buffett won’t even predict the timing of these downturns. But he has learned to act appropriately at each point in the cycle. And that’s what we must do, too.

I was at a large conference in Miami a few years ago, and one of America’s most famous multifamily syndicators challenged my thinking. He has been incredibly successful during this nearly decade-long run-up in prices, and he’s earned the right to be heard.

He said, “Don’t worry about overpaying for multifamily. Just find a great property in a great location.”

He went on to explain his reasons. (I’m not naming him because I didn’t catch the exact quote, and I don’t want to make him look bad.)

My friends, my mind drifted quickly to Mr. Buffett, who has been massively successful since about the year this guy was born. Through many recessions, wars, and more, Buffett has amassed one of history’s most enviable fortunes. And he’s given us his wisdom all along the way.

Would Warren Buffett ever say this? Would he say, “I’m fine with consistently overpaying for companies I buy”?

Not on your life.

Buffett clearly looks for companies that are undervalued, with latent potential that is yet unrealized. Buffett had the guts to buy financial equities when the financial markets were in a free fall in 2008. Buffett has consistently said no to buying at the top of the market.

Buffett lives by the margin of safety. We would do well to do likewise.