

Masterclass: Phil Fisher



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The ‘growth’ investment philosophy of Philip A. Fisher

The late Phil Fisher is ranked among the most influential and successful investors of all time and yet few people have ever heard of him. Here, you’ll learn about his background, his outstanding performance and the techniques he employed to achieve it.



Philip A. Fisher was born, educated and, apart from a stint of military service in the Second World War, lived his whole life in the San Francisco Bay area, California.

The gifted son of a medical doctor, Fisher entered university at the age of 15 years in 1922, and in 1927 enrolled in Stanford University’s newly established Graduate School of Business. After less than a year, and with the intention of returning to his studies, he accepted a ‘temporary’ job as a statistician (the forerunner of the modern securities analyst) at the Anglo–London and Paris National Bank. In less than two years he became the head of the bank’s statistical (research) department; and it was from there that he witnessed the Crash of 1929.

Shortly afterwards he moved to a local brokerage firm, but lost his job when it was destroyed by the Depression. In 1932, he founded his own investment business.

At that point, when the slump was at its worst, executives had little to do and were happy to talk extensively to him about their companies and competitors. On the pillars of such intensive research, for a select few clients, he built up and managed Fisher & Co. until he retired in 1999. He died not long after in March 2004.

Philip Fisher ranks among the most successful and influential investors of the twentieth century. He was one of the first to invest almost exclusively on the basis of non-numeric factors such as the superiority of a company’s management and its prospects for spectacular long-term growth.

He has been acclaimed as one of the earliest proponents of ‘growth investing’. Fisher sought only the best companies with the most outstanding prospects, and disdained all others. His speciality was researching the type of enterprises for which the San Francisco Bay area has become famous—the innovative ‘tech’ companies driven by intensive research and development—and he developed this speciality almost 40 years before the phrase ‘Silicon Valley’ was coined.

The firms he selected during the 1930s and 1940s, such as Food Machinery Corp. and Dow Chemical Co., were gradually recognised, after he bought their shares, as leading ‘high-tech’ firms of that era. Later, he was among the first to spot the potential of electronics firms such as Hewlett Packard, Motorola, and Texas Instruments.

Texas Instruments is perhaps his most successful investment. He was able to buy a large slice of TI for his clients in 1956, long before it became a public company in 1970. Adjusted for its many splits in the past 30 years, it

was first quoted on the stock exchange at about US\$2.70, and subsequently increased to more than US\$200—a rise of 7,400% (not counting dividends). Because he bought the shares privately and years before they were listed, it is likely that Fisher’s results were even better than that.

Fisher was the first investor to publish a coherent and justifiable method of judging whether a given company was a ‘growth company.’ He believed that:

- outstanding businesses are characterised by their ability over the years to maintain and extend a significant competitive advantage
- technological and marketing expertise underlies such an advantage
- this advantage enables these businesses to increase their sales and earnings spectacularly
- the advantage cannot be meaningfully gauged with numbers and mathematical formulas.

Accordingly, Fisher was a masterful practitioner of what he dubbed the ‘scuttlebutt’ method of investing. He invested only after he had meticulously sifted through scores of trade journals and other literature and conducted long and detailed interviews with relevant people. To properly understand a company and appraise its operations, argued Fisher, investors must talk not only to its managers but also to its staff, suppliers, competitors and customers; they must also attend trade fairs and devour any and all relevant industry information; and most generally, they must keep their eyes and ears open to any developments that might affect a company’s long-term prospects.

Fisher had an unconventional and contrarian turn of mind that he used to spot outstanding value well before the crowd. Most investment professionals, inadvertently or otherwise, speculate relentlessly by betting on ‘tips’, today’s news and other short-term information. In sharp contrast, Fisher sought to minimise risk and maximise results by holding on to the shares of those select companies that were best positioned to achieve outstanding long-term growth. He eschewed short-term trades for quick profit and instead held his most successful investments for decades. Because very few companies are growth companies in his sense of the term, and because their shares can seldom be bought at attractive prices, Fisher was also an early proponent of portfolios that contain only a handful of companies. His portfolio never held more than 17 companies, typically held fewer than 10, and three holdings often made up 75% of his total assets under management.

If the job has been correctly done when a common stock is purchased, the time to sell it is—almost never.

It has been widely acknowledged that since the 1960s Fisher's philosophy has greatly influenced other prominent and successful investors. Perhaps most notably, Fisher prompted Warren Buffett to evolve from a strict disciple of Benjamin Graham (who focused almost exclusively upon the analysis of a company's financial statements, eschewed 'scuttlebutt' and forbade his employees to speak to companies' managements) into an investor who also recognises the qualitative value of fine management and a durable competitive advantage. Fisher and Buffett both believed that these ingredients promote the rapid growth of a company's earnings over the years.

Buffett has called Fisher a 'giant' of investing and is 'an eager reader of whatever Phil has to say.' 'I sought [him] out after reading his *Common Stocks and Uncommon Profits*. When I met him, I was as impressed by the man as by his ideas. A thorough understanding of the business, obtained by using Phil's techniques ... enables one to make intelligent investment commitments.' Most notably, it was from Fisher that Buffett 'learnt the value of the "scuttlebutt" approach: go out and talk to competitors, suppliers [and] customers to find out how an industry or company really operates.' On several occasions Buffett has stated that his approach to investment was '15 percent [Phil] Fisher and 85 percent Benjamin Graham.'

Fisher's six formative influences

In his first year of business, Fisher earned about the same as a newspaper hawker. And yet he describes this time as the most profitable of his life.



Stanford University's Graduate School of Business

Philip Fisher's approach to investment was not born fully formed. Like an infant, it possessed distinguishing features from an early age, crawled and stumbled before it walked, gradually finding its feet but nonetheless requiring years to mature. According to Fisher, 'no investment philosophy, unless it is just a carbon copy of someone else's approach, develops in its complete form in any day or year. In my own case, it grew over a considerable period of time, partly as a result of what perhaps may be called logical reasoning, and partly from observing the successes and failures of others, but much of it through the more painful method of learning from my own mistakes.'

Fisher's first interest in business, finance and investing was sparked one afternoon when, at about 10 years of age, he overheard his uncle and grandmother discussing business conditions and how they might affect the companies whose stocks she owned. As Fisher recalls it, 'years later I was to realise how very few were the shares she owned and how extremely superficial were the comments I heard that day, but the interest that was kindled by that conversation has continued all during my life ... A whole new world opened to me ... I thought the whole subject of judging what makes a business grow an intriguing one, and here was a game that if I learnt to play it properly would by comparison make any other with which I was familiar seem drab, meaningless and unexciting.'

A second formative influence occurred ten years later. During the 1927–28 academic year Fisher was enrolled as a first-year student in Stanford University's then-fledgling Graduate School of Business. One day per week was devoted to visits to some of the largest businesses in the San Francisco Bay area, under the direction of Professor Boris Emmett. Students did not simply visit a company and inspect its plant and equipment; rather, they also listened intently while Professor Emmett

subjected its executives and managers to long, detailed discussions about the business's strengths, weaknesses and prospects.

Fisher recognised that these visits provided a learning opportunity of just the type that he sought, and he was able to manoeuvre himself to take particular advantage of them. Fisher recounts 'in that day ... when the ratio of automobiles to people was tremendously lower than it is today, Professor Emmett did not have a car. I did. I offered to drive him to these various plants. I did not learn much from him on the way over. However, each week on the way back to Stanford, I would hear comments of what he really thought of that particular company. This provided me with the most valuable learning experiences I have ever been privileged to enjoy.'

A third seminal event occurred during the northern summer of 1928. Unlike the hundreds of students who enrol today in every major business school and the scores who focus on finance, in Fisher's day Stanford (whose Business School rose rapidly to become one of America's most reputable) enrolled just 19 students, only a handful of whom studied finance and investment. During the 'roaring twenties' these students were quickly hired by firms in New York. In that fateful summer, a local bank sought from Stanford a graduate trained in investments. The school was anxious to meet this request because it might provide a forerunner for more placements in the future. Alas, Stanford had no graduates to send. As Fisher recalls, 'it was not easy to do, but when I heard of this opportunity, I finally persuaded the school to send me with the thought that if I were to make good, I would stay there. If I could not fill the job, I would come back and take second-year courses, with the bank realizing that the school had made no pretense of sending them a completely trained student.'

Fisher's first interest in business, finance and investing was sparked one afternoon when, at about 10 years of age, he overheard his uncle and grandmother discussing business conditions and how they might affect the companies whose stocks she owned.

Fisher's approach to investing gelled as he learnt from both his successes and grievous mistakes of the late 1920s. He learnt that, while a stock might be attractive if it had a low price-to-earnings ratio (PER), a low PER by itself indicated little, and guaranteed nothing—and indeed could be an indicator of the company's weakness.

The work was extremely simple. In Fisher's opinion it was also intellectually dishonest. His employer's investment arm participated in underwriting syndicates that earned very high commissions from the sale of new issues of what today would be called 'junk bonds'. ('Junk' bonds are issued by firms that lack strong credit ratings and, to compensate investors for the risk they entail, bear high rates of interest.) No real attempt was made to evaluate the quality of these bonds, yet the bank's salespeople told customers that its statistical department would survey customers' holdings and provide a report on each security they owned. According to Fisher—in a passage that also aptly describes recent shenanigans and demonstrates how little really changes in investment markets—'what was actually done in those "security analyses" was to look up the data on a particular company in one of the established manuals of the day, such as Moody's or Standard Statistics. Then someone like myself, with no further knowledge than what was reported in that manual, would simply paraphrase the wording of the manual to write his own report. Any company that was doing a large volume of sales was invariably reported as "well managed" just because it was big. I was under no direct orders to recommend that customers switch some of the securities I "analysed" into whatever security the bank was attempting to sell at the moment, but the whole atmosphere was one of encouraging this type of analysis.'

The superficiality and dubious morality of this procedure quickly prompted Fisher to conclude that there must be a better way. Fortunately, his immediate superior empathised with his dissatisfaction and granted him the time to conduct an experiment. This experiment and its results formed the fourth formative influence upon the development of Fisher's approach to investment.

This event happened during the northern autumn of 1928, when speculative interest in radio stocks engulfed America. Fisher, drawing upon his experience at Stanford, introduced himself to the purchasing agents of major electronics retailers in San Francisco. He, as a representative of his employer, sought the agents' views about the three major competitors in the 'hot' wireless communications industry. Each of the agents gave Fisher surprisingly uniform views about the three radio firms. One, which was privately owned, was very well regarded and was progressing rapidly. The second, the market leader Radio Corporation of America, was holding its own but feeling the pressure from the private up-and-comer; and the third, a stockmarket favourite at the time, was slipping drastically and showing signs of severe and perhaps terminal operational difficulties.

Fisher's employer did not underwrite or trade the securities of radio companies and so his research was of no particular interest to most of its officers and staff. Several of them, however, traded the shares of the two listed radio companies for their own accounts—and nowhere in the material they received from Wall Street firms was there a word about the operational difficulties that Fisher concluded would shortly overwhelm the market darling. According to Fisher, 'in the ensuing

12 months, as the stock market continued on its reckless but merry way with most stocks climbing to new highs, I noticed with increasing interest how the stock I had singled out for trouble was sagging further and further in that rising market. It was my first lesson in what later was to become part of my basic investment philosophy: reading the printed financial records about a company is never enough to justify an investment. One of the major steps in prudent investment must be to find out about a company's affairs from those who have some direct familiarity with them.'

The lesson Fisher learned from interviewing the radio agents was quickly followed by a salutary fifth lesson. Fisher writes, 'In August of 1929 I issued another special report to the officers of the bank. I predicted that the next six months would see the beginning of the greatest bear market in a quarter of a century. It would be very satisfying to my ego if at this point I could alter drastically the tale of just what happened and leave the impression that, having been exactly right in my forecasting, I then profited greatly from all this wisdom. The facts were quite to the contrary.'

Fisher's head told him during the northern summer of 1929 that the market as a whole was dangerously high, but his heart enticed him towards those few stocks 'that were still cheap' and were surely worthwhile investments 'because they had not gone up yet.' He drew upon the meagre profits from trades he had conducted before he entered university, and combined them with money he had earned while studying and the money he had saved from his employment at the bank. These funds he divided roughly equally among three stocks which he thought were still undervalued. Alas, 'in spite of my success in ferreting out what was going to happen to the radio stocks, I just did not have the sense to start making similar enquiries from people who knew about these [other] ... enterprises, even though obtaining such information or even getting to meet the people who ran these businesses would have been relatively simple, since they were close at hand.' As Fisher recalls painfully, by 1932 'only a tiny percentage of my original investment was represented by the market value of the shares in these companies.'

A wise person is one who makes a particular mistake only once. ('If you fool me once', say people from Texas, 'then shame on you; fool me twice, shame on me'.) Wise people quickly recognise their errors, study them, correctly identify their causes and take immediate steps to ensure that the same mistake does not recur. It also helps if, like Fisher, they hate to lose money. Fisher's approach to investing gelled as he learnt from both his successes and grievous mistakes of the late 1920s. He learnt that, while a stock might be attractive if it had a low price-to-earnings ratio (PER), a low PER by itself indicated little, and guaranteed nothing—and indeed could be an indicator of the company's weakness. He realised, Wall Street opinion to the contrary, that 'what really counts in determining whether a stock is cheap or overpriced is not its ratio to the current year's earnings, but its ratio

The grim news of my associates was to prove one of the most fortunate business developments, if not the most fortunate, of my life.

to the earnings a few years ahead. If I could build up in myself the ability to determine within fairly broad limits what those earnings might be a few years from now, I would have unlocked the key both to avoiding losses and making magnificent profits.'

Early in 1930 Fisher changed employers. This change itself was relatively unimportant but it started a chain of events that produced the final formative influence upon his philosophy of investment—the one that enabled Fisher to put it into practice. A local brokerage firm made him an offer that he could not refuse: in addition to a hefty increase in salary, he would use his emerging criteria and methods to identify and purchase the shares of particularly attractive companies. Alas, during the remainder of that year President Hoover's interventionist policies, together with the disastrous policies the Federal Reserve followed during the late 1920s and early 1930s, did much to turn the recession and market crash of late 1929 into the decade-long Great Depression. As a result, his employer's business, like thousands of others, shrivelled. Just before Christmas it was declared insolvent and suspended from the San Francisco Stock Exchange (a forerunner of today's Pacific Stock Exchange). Fortunately, Fisher was able to make the best of this dire situation. In his words, 'the grim news of my associates was to prove one of the most fortunate business developments, if not the most fortunate, of my life.' During 1930 Fisher had thought to

himself that when prosperity returned he would start his own business. Using his rapidly developing philosophy, he resolved to manage others' capital in exchange for a fee.

As it happened, he did not wait for prosperity to return. Unable to find employment in the interim, Fisher opened the doors of Fisher & Co. (a partitioned and windowless area, sub-leased from a desperate lessor, and barely big enough for a desk and a visitor's chair) at the lowest ebb of the Great Depression in 1932. In that awful year he earned an average of \$2.99 per month after expenses—a paltry amount even by the standards of that desperate time. In 1933, also a very tough year, although his average monthly earnings increased by 1,000%, the result was little more than \$29. This, Fisher recalls, was about what he could have earned as a newspaper hawk.

Recall, however, that Fisher's genius was to buy a company into his portfolio, not on the basis of its earnings today or tomorrow, but on the basis of the vastly increasing earnings that he expected it would generate for years into the future. He used the same logic to evaluate the hardship of his first years on his own: '... in what those years were to bring me in the future, they were two of the most profitable years of my life. They provided me with the foundation for an extremely profitable business and with a group of highly loyal clients by 1935.'

Early triumphs: Food Machinery Corp and Dow Chemical Co

Using his stint in the military as a period in which he could refine his investment approach, Fisher left active service with two great stock recommendations.



Food Machinery Corporation was the first major selection for Fisher & Co.'s clients' portfolios. He described this company, 'as it existed in the depths of the Great Depression, [as] a microcosm of the type of opportunity I was to seek in the years ahead.' The firm was the product of the merger of three agricultural machinery companies, and it appealed to Fisher on several grounds. It was, firstly, one of the biggest, strongest and lowest-cost manufacturers in its field. Further, thanks to an outstanding marketing division and a 'superbly creative research or engineering department' it possessed not just a formidable position in a number of niche markets, it was also likely that its constant stream of new products and innovations would maintain and extend its competitive advantage well into the future.

Moreover (and, by Fisher's way of thinking, perhaps most importantly), he trusted and admired the company's management. 'As I saw the situation in those dark days

of the deep depression, and as I see it now after all these years, this infant Food Machinery Corporation was unusually attractive from the "people" standpoint. [Its founder and president] was not only an extremely efficient operating head and highly regarded by his customers and his employees, but also he was a deeply religious man who scrupulously lived up to a high moral code.' Accordingly, employees from the president to the most junior clerk possessed a genuine sense of trusteeship with respect to shareholders' funds, and took great care to ensure that shareholders received the rewards that, as the owners of the company and its ultimate bearers of risk, were due to them.

Food Machinery Corp. was one of a large number of companies that listed during the late 1920s. Unfortunately for most other investors, but very fortunately for Fisher, 'it was thought to be just another of the many "flaky" firms which were sold to the public at the height of a speculative orgy ... [accordingly, during the ensuing Depression]

it was possible to buy these shares in quantity at the ridiculous price to which they had sunk.' Fisher did just that on his clients' behalf: 'With a deep conviction that Food Machinery Corporation would vastly outperform the market as a whole, I bought my clients every share that I was able to convince them to hold. I [also] made the possibilities of this business the spearhead of my approach in talking to any potential clients I could reach.'

The progress of Fisher's career was suspended during his service in the US Army Air Corps from 1942 to late 1945. His assignments ('desk jobs' at various locations within the US which alternated between short intervals of frenzied paper-shuffling and long periods of idleness) provided an excellent opportunity to plan the resumption of his investment business. During those years his approach to investment, already very distinct, took its final form. He decided, for example, that there was little or no future in 'in-and-out-trading' (he engaged less and less in this during the 1930s) and resolved to banish it from his repertoire. He also decided to concentrate not just upon a particular type of company but upon a particular type of investor. Before the War he had served all types of clients, large and small, who had very different objectives. Most but not all of Fisher & Co.'s business had focused on finding companies that would enjoy significantly above-average growth. After the War he limited his clientele to a small group of large investors who shared the same objective: the concentration of their holdings upon a

very small number of outstanding 'growth' companies.

Finally, during his military service, Fisher decided to learn as much as he could about America's chemical industry. He was convinced that when the US economy resumed peacetime production, the firms in this industry would possess excellent potential for long-term growth.

In 1947, his research concluded, he invested a substantial portion of his clients' funds in Dow Chemical Co. It appealed because its efforts to become the lowest cost producer in several major and rapidly growing markets were showing significant results. Like Food Machinery Corp., Dow Chemical also emphasised the 'people factor.' Just after the War, when Fisher asked Dow's president what he thought would be its biggest problem in the future, the president replied that he worried that Dow would become a more 'military-like organization.' The president's competence, prescience and sincere concern for employees and customers, together with the results of the exhaustive research about the company and industry that Fisher had conducted, convinced Fisher that Dow would be able to increase its profits steadily and substantially during the next several decades. From his subsequent—and very happy—experience with Dow Chemical, Fisher derived another principle: 'even if the stock of a particular company seems at or near a temporary peak and that a sizable decline may strike in the near future, I will not sell the firm's shares provided I believe that its longer-term future is sufficiently attractive.'

To be a truly conservative investment a company—for a majority if not for all of its product lines—must be the lowest-cost producer or about as low a cost producer as any competitor.

Fisher's philosophy in practice

During Fisher's career, which spanned more than 60 years, a number of specific themes emerged. These included a checklist of 15 criteria against which he would measure every potential investment. Let's take a look at the themes which constitute Fisher's philosophy in practice, including a close look at the 15 criteria.



ADOPT CLUES FROM THE PAST

Throughout his career, Fisher constantly studied the results of his and others' investment operations. 'It seems logical,' he stated more than once, 'that before even thinking of buying any common stock the first step is to see how money has been most successfully made in the past.' From these ongoing studies he concluded 'that the greatest investment reward comes to those who by good luck or good sense find the occasional company that over the years can grow in sales and profits far more than industry as a whole. It further shows that when we believe we have found such a company we had better stick with it for a long period of time.'

THE CENTRALITY OF SCUTTLEBUTT

In its everyday sense, the word 'scuttlebutt' refers to vague and unsubstantiated rumour. Fisher's use of the term is far more systematic and precise. 'It is amazing what an accurate picture of the relative points of strength and weakness of each company in an industry can be obtained

from a representative cross-section of the opinions of those who in one way or another are concerned with any particular company.' Given its centrality to his investment approach, Fisher wrote surprisingly little about scuttlebutt (his most important book devotes only three pages to it); yet it permeates virtually everything he wrote and did as an investor. Most notably, it is the basis of a generalization that Fisher demonstrated again and again between the 1920s and 1990s: 'go to five companies in an industry, ask each of them intelligent questions about the points of strength and weakness of the other four, and nine times out of 10 a surprisingly detailed and accurate picture of all five will emerge.'

THE IMPORTANCE OF R&D AND MARKETING

Fisher found again and again that an outstanding company's research and development (R&D) contributes mightily to its above-average growth of sales and profits. Even a 'non-technical' business, he noted, often needs considerable research to produce better products and

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.....

more efficient services. In addition to R&D, Fisher also subjected a company's sales organisation to close scrutiny. A company might develop outstanding products and services but, unless they were expertly merchandised, the superior R&D would never translate into revenues and profits—salespeople are responsible for helping customers understand the benefits of a company's products and services. An expert sales and marketing organisation, Fisher also noted, monitored its customers' buying habits and was able not just to spot but even to anticipate changes in their needs. Fisher's outstanding companies demonstrated repeatedly that marketing is the invaluable link between R&D and profit.

WHAT TO BUY: FISHER'S 15 CRITERIA

Fisher believed that investors should focus on 15 criteria when deciding where to place their money. The more criteria a given company can meet, the better. 'A company could well be an investment bonanza if it failed fully to qualify on a very few of them. [But] I do not think it could come up to my definition of a worthwhile investment if it failed to qualify on many.'

1. Does the company produce goods or services whose sales are likely to increase substantially for at least the next several years? Fisher was interested not in 'one-off' growth, nor necessarily in steady, year-after-year increases in growth, but rather in 'greater-than-normal growth not only for the next several-year period, but for a considerable time beyond that.' Fisher does not just extrapolate past sales growth: he seeks to understand how, and therefore to confirm that, past growth can continue into the future.

2. Is management determined to develop new goods or services? According to Fisher, 'companies which have a significant growth prospect for the next few years because of new demand for existing lines, but which have neither policies nor plans to provide for further developments beyond this, may provide a vehicle for a nice one-time profit. [But] they are not apt to provide the means for the consistent gains over 10 or 25 years that are the surest route to financial success.'

3. How effective is a company's research and development? 'If quantitative measurements—such as the annual expenditures on research or the number of employees holding scientific degrees—are only a rough guide and not the final answer to whether a company has an outstanding research organisation, how does the careful investor obtain this information? Once again it is surprising what the "scuttlebutt" method will produce.'

4. Does the company have an above-average sales organisation? The sale of goods and services is the most basic activity that a business undertakes; yet the effectiveness of a company's sales, advertising and distribution receives far less attention from investors than it should. Here, too, Fisher relies heavily upon scuttlebutt: 'of all the phases of a company's activity, none is easier to learn about ... Both competitors and customers know the answers. Equally important, they are seldom hesitant to express their views. The time spent by the careful investor

in inquiring into this subject is usually richly rewarded.'

5. Does the company have a worthwhile profit margin? Although they need not necessarily rise over time, Fisher seeks companies with the largest possible operating margins. Accordingly, whether the company is large or small, new or well established, 'investors desiring maximum gains over the years had best stay away from low profit-margin or marginal companies.'

6. What is the company doing to maintain or even improve its profit margin? Simplified drastically, companies can either raise their prices or reduce their costs. Fisher is somewhat sceptical of the company that maintains or improves its margins exclusively by increasing its prices, and looks for those that also maintain a keen eye towards production, marketing and other cost efficiencies, capital improvements and other innovations.

7. Does the company boast outstanding labour and personnel relations? Fisher's interest in technological excellence and innovation led him towards companies whose employees tended not to be members of a trade union. Further, 'the company that makes above-average profits while paying above-average wages for the area in which it is located is likely to have good labour relations. The investor who buys into a situation in which a significant part of earnings comes from paying below-average wages for the area involved may in time have serious trouble on his hands.'

8. Does the company have outstanding executive relations? 'The company offering [the] greatest investment opportunities will be one in which there is a good executive climate.' By this Fisher meant (among other things) that executives have confidence in their president and CEO, and that salary and promotion are based upon ability and results. 'The further a corporation departs from these standards, the less likely it is to be a really outstanding investment.'

9. Does the company have more than a handful of talented managers? The less an organisation's survival and success depends on one or a small number of personalities, and the less one executive interferes with the job of another, the better. 'The organisations where top brass personally interfere with and try to handle routine day-to-day operating matters seldom turn out to be the most attractive type of investments. Cutting across the lines of authority which they themselves have set up frequently results in well-meaning executives significantly detracting from the investment calibre of the companies they run.'

10. How good are the company's methods of cost analysis and accounting? No company will create outstanding success or continue it for any period of time if it does not know its costs in such detail that it is able to distinguish its most profitable activities (which it should continue and possibly expand) from its least profitable and unprofitable activities (which it should either improve or discontinue).

11. Are there other aspects of the business, somewhat peculiar to the industry involved, which will give the investor important clues about how outstanding the company may be compared with its competitors? In retailing, for example, the way a company handles matters such as the location and duration of leases is very important. In the 'tech' field, it is not just the innovations themselves but also their degree of patent and other protection 'which is a major factor in appraising the attractiveness of a desirable investment.'

12. Does the company have a short- or a long-range outlook? Some companies conduct their affairs to gain the greatest possible profit today. Others deliberately don't take jam today so that they can enjoy more jam tomorrow. Fisher seeks the latter and avoids the former type of company. If executives focus too much on the here-and-now, for example in their treatment of customers and vendors, they might make poor long-term decisions.

13. Will the company's growth require so much equity finance that the much larger number of shares outstanding will largely cancel the benefit from this anticipated growth? Fisher seeks companies whose growth relies mostly upon their own existing resources (shareholders' funds and retained earnings) and only incidentally upon external resources. In other words, he rejects companies that borrow heavily or issue large amounts of equity to finance their operations. **14. Does the management talk freely to investors about its affairs when things are going well but become mute when troubles occur?** The investor will do well to exclude from investment any company that withholds or tries to hide bad news.'

15. Does the company have a management of unquestionable integrity? Fisher noted that a company's executives will almost always be much more familiar with a company's affairs than its shareholders are. For this reason, managers can benefit themselves at the expense of shareholders in many ways. Decades before most others, Fisher recognised that 'probably most costly of all to the investor is the abuse by insiders of their power of issuing common stock options.' Fisher's response? 'There is only one real protection against abuses like these. This is to confine investments to companies [whose] managements have a highly developed sense of trusteeship and moral responsibility to their stockholders. This is a point concerning which the "scuttlebutt" method can be very helpful.'

WHEN TO BUY

Virtually any time can be a good time to buy. Fisher sought to buy shares of 'outstandingly desirable' companies, usually 'working on the very frontiers of scientific technology,' whose per share earnings would grow spectacularly in the years and decades ahead. He reasoned that these companies could resist the storms and rip tides of the business cycle almost regardless of general economic conditions. In other words, the companies that Fisher sought would be able to generate excellent results. Hence he ignored forecasts of general business and macroeconomic conditions. He did not, as do so many others, use these forecasts to anticipate

general conditions, infer how they will influence individual companies and time his purchases and sales based on that information.

Immediately after the Second World War, when most others cowered in fear of a depression like the one that followed the First World War, Fisher doggedly sought and bought great companies; so too during the next 20 years, which were characterised by a huge upswing in prosperity and a commensurate increase in asset prices. He continued with this policy during 1971–81, a period which witnessed a bear market that was in many respects as severe as the one during the Depression.

Fisher also ignored forecasts because in his view 'the economics which deal with forecasting business trends may be considered to be about as far along as was the science of chemistry during the days of alchemy in the Middle Ages.' He adds an important insight: 'the amount of mental effort the financial community puts into this constant attempt to guess the economic future from a random and probably incomplete series of facts makes one wonder what might have been accomplished if only a fraction of such mental effort had been applied to something with a better chance of proving useful.' Bearing in mind Fisher's stature, that 'something' might well be Fisher's approach to investment.

Fisher liked to buy the shares of an outstanding company when its earnings and the price of its shares were (he believed temporarily) depressed. Earnings and price might be depressed because others do not consider general economic conditions to be favourable. In this situation, 'in contrast to guessing which way general business or the stock market may go, [the investor] should be able to judge with only a small probability of error what the company into which he wants to buy is going to do in relation to business in general.' The earnings and price of an outstanding company might also be temporarily depressed because a major new product or process, one which has required significant resources for research, production and marketing but will not contribute immediately to earnings, has just been launched.

BUY BEFORE AND DURING THE SOUND OF CANNONS

Fisher beseeched investors to overcome their fear of 'buying on a war scare.' He notes that 'at the conclusion of all actual fighting—regardless of whether it was World War I, World War II, or Korea—most stocks were selling at levels vastly higher than prevailed before there was any thought of war at all. Furthermore, at least 10 times in the last 22 years, news has come of other international crises which gave threat of major war. In every instance, stocks dipped sharply on the fear of war and rebounded sharply as the war scare subsided.' More generally, 'war is always bearish on money. To sell stock at the threatened or actual outbreak of hostilities so as to get into cash is extreme financial lunacy. Actually just the opposite should be done. If an investor has about decided to buy a particular common stock and the arrival of a full-blown war scare starts knocking down the price, he should ignore the scare psychology of the moment and definitely begin buying.'

The company offering [the] greatest investment opportunities will be one in which there is a good executive climate ... The further a corporation departs from these standards, the less likely it is to be a really outstanding investment.

WHEN TO SELL

Only three reasons can possibly justify the sale of a common stock that has been originally selected according to Fisher's principles and, even then, a sale should occur only infrequently.

The first reason is a mistake—that is to say, a company thought to meet his criteria actually does not. The second is a fundamental change of circumstances: a company that met Fisher's criteria at the time of purchase subsequently ceases to do so. The third is when an outstandingly attractive investment opportunity arises and another stock must be sold to finance it.

TOO MUCH ADO ABOUT DIVIDENDS

Having located an outstanding company with outstanding prospects, and assuming that over the years this company fulfils the expectations that prompted the investor to buy its shares, Fisher preferred the company to retain and reinvest its earnings rather than pay them to shareholders as dividends.

Individuals' marginal rates of tax tend to be higher than the corporate rate. Accordingly, it is far more likely that the company can reinvest its retained earnings at a higher rate than the investor could by reinvesting the dividend. At the same time, however, Fisher was wary of two reasons why earnings are retained and no dividends are paid. The first is when executives accumulate cash as a nest-egg for a rainy day; and the second occurs when 'substandard managements can get only a subnormal return on the capital already in the business, yet use the retained earnings merely to enlarge the inefficient operation rather than to make it better.'

Fisher believed that 'regularity or dependability' are most important in a company's dividend policy. He illustrates his claim using the restaurant parable that Warren Buffett subsequently cited. 'There is perhaps a close parallel between setting policy in regard to dividends and setting policy on opening a restaurant. A good restaurant man might build up a splendid business with a high-priced venture. He might also build up a splendid business with an attractive place selling the best possible meals at the lowest possible prices. Or he could make a success of Hungarian, Chinese, or Italian cuisine. Each would attract a following. People would come there expecting a certain kind of meal. However, with all his skill, he could not possibly build up a clientele if one day he served the costliest meals, the next day low-priced ones, and then without warning served nothing but exotic dishes. The corporation that keeps shifting its dividend policies becomes as unsuccessful in attracting a permanent shareholder following. Its shares do not make the best long-range investments.'

DON'T SUCCUMB TO COMMON FALLACIES

Fisher believed that 'the typical investor has usually gathered a good deal of the half-truths, misconceptions, and just plain bunk that the general public has gradually accumulated about successful investing.' One of the most pervasive—and damaging—is that that only a 'bookish genius' can generate good results. Fisher disagrees: 'the

most skilled statistical bargain hunter ends up with a profit which is but a small part of the profit attained by those using reasonable intelligence in appraising the business characteristics of superbly managed growth companies.'

Fisher seeks firms with at least one year of operational profit, and two to three years of business, before he buys their shares. No matter how 'hot' and avidly spruiked by brokers, he avoids any initial float of 'promotional companies', companies that have been formed to promote a founder's insight or idea. 'When a company is in a promotional stage ... all an investor or anyone else can do is look at a blueprint and guess what the problems and strong points may be.' Further, 'there are enough spectacular opportunities among established companies that ordinary individual investors should make it a rule never to buy into a promotional enterprise.'

Fisher also believed that investors should not 'ignore a good stock just because it is traded "over the counter"'. In an Australian context, he would not ignore a company simply because it is owned by a few private individuals rather than the general public; or, if it is listed, is traded irregularly and in small parcels. Further, 'don't buy a stock just because you like the "tone" of its annual report ... The annual report may ... reflect little more than the skill of the company's public relations department in creating an impression about the company in the public mind.' Also 'don't quibble over eighths and quarters.' By this Fisher means that if you have been lucky enough to locate a truly outstanding company, are prepared to pay \$1.00 per share and its shares are available for \$1.03, then do not quibble: 'if the stock seems the right one and the price seems reasonably attractive at current levels, buy "at the market".'

Unlike most investors, and virtually all investment institutions, Fisher focuses rather than diversifies his portfolio. To the crowd, diversification is a mantra; but to Fisher it is a vexation. Diversification 'is the disadvantage of having eggs in so many baskets that a lot of the eggs do not end up in really attractive baskets, and it is impossible to keep watching all the baskets after the eggs get put into them.' Further, 'investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others about which they know nothing at all. It never seems to occur to them, much less to their advisors, that buying a company without having sufficient knowledge of it may be even more dangerous than having inadequate diversification.'

Finally, do not automatically follow the crowd. Just as in popular music and clothing, there are fads and fashions on the stockmarket. These can—sometimes for several years at a time—produce severe distortions in the relationship between market prices and underlying values. Fisher witnessed both the 'roaring twenties' and the 'tech mania' of the 1990s, and notes that 'the ability to see through some majority opinions to find what facts are really there is a trait that can bring rich rewards in the field of common stocks. It is not easy to develop, however, for

THE TEN DON'TS FOR INVESTORS

1. Don't buy into promotional companies.
2. Don't ignore a good stock just because it is traded 'over the counter'.
3. Don't buy a stock just because you like the 'tone' of its annual report.
4. Don't assume that the high price at which a stock may be selling in relation to earnings is necessarily an indication that further growth in those earnings has largely been already factored into the price.
5. Don't quibble over eighths and quarters.
6. Don't overstress diversification.
7. Don't be afraid of buying on a war scare.
8. Don't rely on superficial financial numbers.
9. Don't fail to consider time as well as price in buying a true growth stock.
10. Don't follow the crowd.

the composite opinion of those with whom we associate is a powerful influence upon the minds of all of us.'

HOW TO FIND A 'GROWTH STOCK'

Fisher acknowledges that no single investor, or even an industrious team of like-minded investors, could possibly investigate more than a modest number of potential investments. How, then, to locate outstanding growth stocks? Roughly 20% of Fisher's initial investigations of prospective investments were prompted by information from friends in various industries, and 80% from 'a small number of able investment men.' From this stream of inputs Fisher then made 'frankly a fast snap judgment on which companies I should spend my time investigating and which I should ignore.'

After a brief scrutiny of a few key points in each company's prospectus or most recent annual report, he would then 'seek "scuttlebutt" aggressively, constantly working towards how close to our 15-point standard the company

comes.' Because very few companies can survive this 15-point challenge, Fisher then discards most of his prospects from consideration. Some he rejects because he has enough information to conclude that they are not the outstanding companies that he requires; others he rejects because he cannot collect enough information to draw a conclusion one way or the other. 'Only in the occasional case when I have a great amount of favourable data do I then go to the final step of contacting the management. Then if after meeting with management I find my prior hopes pretty well confirmed and some of my previous fears eased by answers that to me make sense, at last I am ready to feel I may be rewarded for all my efforts.' Fisher has estimated that out of every 250 companies that he investigates, he rarely invests in more than one. Interestingly—and testimony to the bulk of his investigation and sleuthing occurring beforehand—he will invest in one company per 2.5 company visits.

Fisher-style stocks in Australia

Applying Fisher's 'rifle-shot' investment approach in the Australian market isn't easy but there are a few stocks that may have caught his eye.

In the US there are around 7,000 listed companies but in Australia there are just 1,474. That makes the pool of potential Fisher-style stocks that much smaller, although the following three companies may have found their way into a Phil Fisher Aussie portfolio.

The first is **ARB Corporation**. ARB manufactures components for four-wheel-drive vehicles and, according to our research, satisfies almost all of Fisher's 15 points. Its financial record is outstanding and Fisher would most likely have been onto the stock at some stage in the last decade. Incidentally, the stock rose more than tenfold in the decade from 1994. Shareholders have also received regular dividends on top of that exceptional capital growth.

The following quote, from an article originally printed in *Bushdriver Magazine*, nicely showcases the way ARB satisfies several of Fisher's 15 criteria:

New methods of production are continually trialled for the purpose of making the end products more durable, but not necessarily more lucrative financially. An unusual approach for a company with shareholders to satisfy, and yet the combination of state-of-the-art equipment, coupled with what can only be described as an old-fashioned business approach, certainly seems to work.

Such an approach is even more impressive when you consider that ARB produced a pre-tax profit margin of 17% in the 2004 financial year and a stunning return on shareholders' equity of more than 26%.

That contrasts with a company like Coates Hire, which Fisher would have most likely ruled out faster than you could blink. This equipment hire business reported a pretax profit margin of 15.7% in 2004 and a return on equity of 13.5% in what was an absolute boom year. And the number of shares on issue exploded from 68 million to 104 million in the three years to 30 June 2004. That would disqualify Coates under Fisher's criterion #13 as this company has not financed its growth with its own cash flows. On that point, we suspect Fisher would be quite impressed by Macquarie Bank but would probably reject Australia's largest listed investment bank because of the large slabs of options it issues to executives. Each year this effectively waters down outside shareholders' slice of the Macquarie Bank pie.

Bionic ear implant manufacturer **Cochlear** is one that Fisher would certainly consider. In terms of shareholder returns, the story is remarkably similar to that of ARB. Since being spun-off from Pacific Dunlop in 1995, Cochlear's share price has risen more than tenfold and dividends have grown strongly, too. We suspect Fisher would have cast a careful eye over it relatively early on.

Even in a tough year like 2004, the company produced a pre-tax profit margin of 16.5% and a return on equity of more than 25%. The company's longer-term averages are even more impressive. Cochlear is by far the global leader in its market and, according to our research, has many years of growth ahead of it. Compare that to a business like newspaper publisher Fairfax. With targeted internet sites like www.seek.com.au attacking Fairfax's lifeblood of classified advertising, it is fighting an uphill battle to

We suspect Fisher would be quite impressed by Macquarie Bank but would probably reject Australia's largest listed investment bank because of the large slabs of options it issues to executives.

stand still, let alone produce long-term growth. It would fail Fisher's first criterion as it is not at all clear that Fairfax is capable of producing genuine growth, especially since it seems the company is not overflowing with management talent (criterion #9). Those who've patiently held the stock over the years have not been handsomely rewarded.

The third stock we think might have caught Phil Fisher's eye is Infomedia. Its core electronic parts catalogues business is extremely profitable. Pre-tax margins in 2004 clocked in at more than 40%, as did return on equity. Our investigations indicate that the company has depth in its management ranks (criterion #9) and there is a strong focus on developing new products, which fulfils criterion #2. Infomedia is undeniably a success story but it floated only in late 2000 and so has had a comparably short

listed life. To date, the returns have been disappointing but, with such strong underlying economics and good growth prospects, we expect that situation to change in the coming years.

Other stocks we consider to be 'Fisher probables' include **Computershare, ASX, SFE Corp., Cabcharge** and **MYOB**. He probably would have investigated each of these to some extent, although there are arguments against each which may have dissuaded him from investing.

Further reading

Fortunately, Philip Fisher wrote several investment books of his own, meaning you don't have to rely on someone else's interpretation of his philosophy.

Fisher's approach to the allocation of capital was formulated during the 1920s and 1930s, and since the late 1950s his books have made it readily available to the general public. His first book, entitled *Common Stocks and Uncommon Profits* and originally published in 1958, outlined his investment philosophy. It is very readable—indeed it was the first investment book to appear on the New York Times' best seller list. Fisher elaborated his philosophy in *Paths to Wealth Through Common Stocks* (1960), *Conservative Investors Sleep Well* (1975), and *Developing an Investment Philosophy* (1980), which describes the experiences that forged Fisher's philosophy of growth stock investing. All except *Paths to Wealth* were republished by John Wiley & Sons in 1996 under the title *Common Stocks and Uncommon Profits and Other Writings by Philip A. Fisher*.

Fisher's youngest son, Kenneth L. Fisher, is CEO and chief investment officer at Fisher Investments (www.fi.com). Ken's approach to investment differs significantly but not radically from his father's. Ken is a 'value' investor, but the process he uses to make investment decisions draws heavily upon 'scuttlebutt' and Philip's 15 points. For that

reason Kenneth's three books, *Super Stocks* (1984), *The Wall Street Waltz* (1987) and *100 Minds That Made the Market* (1994), are worthwhile reading.

Kenneth is perhaps best known for his long-running (20-plus years and still going) column, 'Portfolio Strategy' in *Forbes magazine*. During the early 1970s he conducted important research which established a tool known as the Price to Sales Ratio (PSR) as a core part of the financial curriculum. One of Ken's more recent articles, Cognitive biases in market forecasts, appeared in the March 2000 issue of *The Journal of Portfolio Management* and won that magazine's prize for the outstanding article of 2000–01.

Finally, John Train's book *Money Masters of Our Time* provides valuable insights into a number of the twentieth century's most successful investors—including Benjamin Graham, Warren Buffett and Philip Fisher. Train describes and distinguishes the unique style that made each a master of his craft.

“**Fisher's approach to the allocation of capital was formulated during the 1920s and 1930s, and since the late 1950s his books have made it readily available to the general public.**”

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The amount of mental effort the financial community puts into this constant attempt to guess the economic future from a random and probably incomplete series of facts makes one wonder what might have been accomplished if only a fraction of such mental effort had been applied to something with a better chance of proving useful.

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A SUMMARY OF PHILIP FISHER'S PHILOSOPHY

- Read everything you can.
- Interview those who are in a position to know, such as managers and employees, but don't forget to also talk to suppliers, customers and competitors.
- If possible, visit various company sites (and not just headquarters).
- Act only after you have collected sufficient information and have thoroughly evaluated a situation.
- Have the moral courage to act against the crowd when your judgment tells you that you are right.
- Buy stocks of companies that are likely to generate dramatic long-term growth of both revenues and profits.
- Buy with particular gusto when stockmarket conditions are not favourable or other investors do not properly perceive these companies' true worth.
- Retain the investment in such a company as long as its advantage over competitors remains intact, and never sell for short-term reasons.
- If your primary investment goal is the substantial and long-term appreciation of your capital, as it must be if you restrict your portfolio to the most outstanding companies, then you should reduce the emphasis most investors place on the importance of dividends.
- Recognise that mistakes are inevitable. The important thing is that the investor recognises a mistake quickly, accurately diagnoses its cause and does not repeat it.
- A good 'Fisherite' investor is willing to incur a short-term loss that results from a poor investment, and lets the gain from a good investment grow over the years and decades.
- Recognise that the investment universe contains very few truly outstanding companies, and that opportunities to buy them occur very infrequently. Hence concentrate your attention and your funds in the most desirable opportunities.
- 'For individuals [in possible contrast to institutions and certain types of funds], any holding of over 20 different stocks is a sign of financial incompetence. Ten or twelve is usually a better number.'
- Never forget that one of the most basic rules of life also applies to investing: success is highly dependent upon a combination of hard work, intelligence, and honesty.



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