AN EXECUTIVE SUMMARY OF

COMMON STOCKS AND UNCOMMON PROFITS

by Philip Fisher

Who is Phil Fisher?

Before writing this book, Fisher handled considerable funds for a number of significant investors. Many people, from small investors to managers of smaller funds, asked him how they could get started on the right path to prosperous investing. This was the trigger for Fisher to start writing, Common Stocks and Uncommon Profits.

Preston and Stig's General Thoughts on the Book

When I started learning about value investing and Warren Buffett, the initial books I studied were *The Intelligent Investor* and *Security Analysis* by Benjamin Graham.

Although Graham's writing provided invaluable advice on how to mitigate risk and find hidden value on corporate balance sheets, other great thinkers assisted Buffett's overall approach. Phil Fisher was one those influencers. His book really provides amazing guidance for investors to assess the potential value of successful and profitable business. He teaches the reader how to find growth opportunities in areas that many overlook. The book is organized in a fun manner and it's fairly straight forward for anyone with a good grasp of financial terminology. This isn't one of my personal favorites, but it's a good book and well worth you time to read.

Chapter 1: Clues From the Past

In this chapter, Fisher indicates that the predominant reason people enter the stock market can be boiled down to one thing: stocks are bought to make money. There are in general two approaches to accumulating wealth in the stock market. One is to time the market, buying buy stocks when they are cheap, and selling when they are expensive. The other is to find outstanding companies and hold them. Fisher prefers the latter.

In this regard, however, Fisher advises caution by the bondholder. If the economy is good, the outstanding stock would outperform bonds, and even in the event the economy goes south, this could still work in the favor of the bondholder, and is only a temporary effect in any case. Adding the complex decision of when to sell bonds and the concept of inflation, the long-term solution of staying with stocks prevails. The biggest opportunities for reward lie with finding companies that are performing better than the industry in terms of sales and profit. Size is of less importance; the thing to look for is growth potential and the ability to execute.

Chapter 2: What "Scuttlebutt" Can Do

In this rather short chapter (originally only three pages), Fisher introduces for the first time the "Scuttlebutt Method." This method follows the premise that the way to gather information about a company is simply to speak to those with the knowledge. This could be competitors, vendors, customers, trade organizations and even former employees. Once this information has been obtained, the truly outstanding companies should stand out clearly, even for the moderately experienced investor.

Chapter 3: What to Buy – The Fifteen Points to Look for in a Common Stock

In this chapter, Fisher provides fifteen points that he encourages the investor to look for before purchasing stocks. Although the investor can't always expect to find stocks that meet all fifteen points, and many stocks will still prove profitable even if they do not score a high rating for some of the points, there is one point that the investor should always ensure is fulfilled: if a company's management does not demonstrate unquestionable integrity, the stock investor should never consider buying into this company.

Fisher outlines that the premise of this book is not to establish a list of quantitative criteria, as is the case with many other books on common stock. He wants to avoid this, as he is keen to ensure that the decision to buy a specific stock is not based predominantly on price, but rather on the potential gain from buying and holding that stock. For this reason, the stock investor may sometimes lack quantitative criteria to measure the fifteen points against.

The most practical approach for the stock investor is to use the "Scuttlebutt Method," simply because the most valuable information about businesses can't always be quantified. Actually, in many situations, the stock investor will need to find, calculate and compare the key ratios that his research has indicated are most relevant.

Some of the general guidelines contained in Fisher's fifteen points include investing in companies in which:

- A long-term rather than a short-term horizon is favored
- Management is qualified and demonstrate unquestionable integrity
- The company is performing better than its industry in terms of sales, research and production

Chapter 4: What to Buy: Applying This to Your Own Needs

In this chapter, Fisher argues that many investors do not devote the time and effort necessary to ensure that they make good investments. The result is misunderstandings and half-truths about investing. What the investor should focus on is finding stocks that have the highest profit compared to risk. The public often misinterpret this as meaning stocks that are the most undervalued, rather than those with prospects for the highest growth. High growth over just a few years quickly outweighs the advantages of an undervalued stock with no growth potential due to compounded returns.

If the investor does not have the time, inclination or skill to manage his own investment portfolio, he can opt to enlist the services of an investment advisor to guide him. In this case, the investor must take care to appoint an expert with a proven track record based on good investment picks, and not an "expert" who has taken higher or lower risks in the stock market and has simply been lucky with timing. He must also ensure that the advisor has a reputation for being honest and truthful at all times, and has the same fundamental approach to picking stocks as himself.

Fisher maintains that growth stocks can vary widely in size and that, provided they are selected wisely, larger and more conservative growth stocks result in temporary losses for the investor but will reward him handsomely over time. Typically, these companies also have decent dividend yields. Smaller-growth companies can be even more profitable, but typically also represent a higher risk in terms of potential severe losses. These companies characteristically reinvest all their capital into the business, hence paying out no or minimal dividend payments.

The small investor is faced with a critical choice when deciding between these two types of growth stock. Fisher personally prefers companies that pay little or no dividend dues, as opposed to the higher returns somewhere down the line—but he also acknowledges that the small investor may have a need for current dividend income.

Chapter 5: When to Buy

In this chapter, Fisher looks at how to time the market. It is one thing to find the very best stocks, but if an investor wants to optimize his profits, he must also pay close attention to the timing of buying stocks, even in outstanding companies. The conventional approach to timing is to base your decision on anticipated interest rates and business activities. Fisher has no objection to the idea behind this approach, but believes that it is not really possible.

What Fisher suggests instead is that the investor should look for outstanding companies with temporary problems. A common example would be a plant that is lagging behind schedule rather than producing at full capacity. According to Fisher, many investors fail to see that high expenses that are eating away at profits in the short run are an inevitable occurrence, even for outstanding companies producing high-quality, profitable products. Timing the purchase so that you buy at a time when many expenses are already paid for and the company is just about to start growing a profit has proven very profitable for many stock investors. Fisher encourages the investor to investigate thoroughly to ensure that the problems are indeed temporary, however, since permanent problems will not reward the investor in the stock market.

Not all good buying opportunities materialize from problems, however. Fisher demonstrates this with the example of an efficiency upgrade for capital-intensive industries such as the chemical industry. Since the majority of expenses have already been incurred, upgrading equipment can lead to a dramatic improvement in profitability. Buying stocks in these companies before the increased profitability is reflected in the financial statements is another opportunity for optimizing the timing.

Fisher addresses the question of whether the stock investor should pay attention to the overall level of the stock market, or focus solely on his individual stock pick. Unless a very rare event such as the Great Depression is imminent, he should focus on the latter, for two reasons: First, it is better to invest based on your knowledge about an outstanding company than a guess about the overall stock market level; and, second, because even in the event of a severe decline, if a stock pick has been identified wisely, the decline in that stock price will typically be less severe.

Fisher acknowledges that an investor might be vulnerable to the overall level of the stock market if he chooses to invest all of his funds, even in outstanding companies. This is especially true if he or his advisors do not yet have a proven track record in making a decent return in the stock market. Instead, Fisher recommends exercising caution and encourages the investor to establish a plan under which funds are invested gradually over a period of several years. In this way, the investor will not lose everything in the event of a severe decline or his advisors turning out to be less than capable.

The uncertainty of the myriad complex factors that can influence the overall stock price level prompts Fisher to make a concluding recommendation about when to buy stock: "Base your investment decision on solid knowledge about the individual company. Disregard fears and hope about conjectures, or conclusions based on assumptions."

Chapter 6: When to Sell—And When Not To

In this chapter, Fisher discusses his belief that there are only three reasons a stock investor should sell his stocks. The first is that the stock purchase has turned out to be significantly less attractive than originally anticipated. As a stock investor, you may simply have made a mistake. The faster you correct that mistake—i.e., your stocks investment in that company—the better.

The second reason for the investor to sell his stock is if that particular stock no longer meets the investment objectives outlined in Chapters Two and Three; in other words, your stocks are no longer attractive. There are many reasons this could occur, but often it is either because the management starts to deteriorate, or simply because the company's future prospects are no longer interesting.

The third reason for selling is if the investor finds a better investment. Taking into consideration how difficult it is to find truly attractive companies, and the potential capital gains tax, the investor needs to be very certain before making any such shift in his portfolio.

Fisher goes on to say that he frequently hears three arguments for investors selling their stocks—all of which he addresses and rejects. The first is that the stock market is soon going to decline. Just as it is difficult to time your purchase based solely on the general stock level, it should be equally as hard, and therefore invalid, to base your selling decision on the same argument.

The second frequently used argument is that the single stock is overvalued—typically based on a higher price to earnings. Fisher does not accept this argument, stating that superior businesses should be valuated at a higher multiple due to the higher expected growth. Rapid growth would make the valuation of the current earnings less important.

Finally, he does not buy into the argument that a stock should be sold off based solely on a huge surge in price. A stock should be based on its current value, not whether or not the current pricing is much higher than the initial investment.

Chapter 7: The Hullabaloo About Dividends

In this chapter, Fisher starts off by arguing that high dividend payments are not always preferential, as many people believe. At the end of the day, the important factor is where the capital can be employed in order to provide the highest value to the shareholder. Earnings that are retained could be used for new plants, major cost savings initiatives over the long run, or product development. Whether or not the highest value for the shareholder would be achieved through dividends or through the management retaining earnings is therefore an issue that must be examined from time to time.

The decision about dividends is further complicated by the investor's individual circumstances. He might have a personal need for capital, for living expenses, or for additional investment in other assets. Simply based on optimizing each dollar for investment, Fisher emphasizes that it is not an easy task to find truly outstanding companies. A received dividend that is invested in companies other than the investor's chosen outstanding company runs the risk of making a lower return—and if the investor then wished to reinvest in the current company, he would have less funds with which to do so, since he will have been taxed when he initially received the dividend.

Fisher further argues that the investor must consider the regularity and dependability of dividends. Well-run companies have official dividend policies, and the investor must scrutinize those. One suggestion is to look at the payout ratio (a measure of how much of the net income is paid out in dividends); however, this would leave the investor vulnerable to fluctuations in the company's new income. Instead, the stock investor should pay attention to the dividend rate (the absolute value of the dividend). He should prefer a steady dividend that is paid out regularly. The management of the company should only decrease the payment in the case of a crisis, and only increase the rate if it can be maintained and does not sacrifice a profitable growth option.

Chapter 8: Five Don'ts for Investors

In this chapter, Fisher warns the investor of what not to do, in five powerful points. The first of these is that the investor should not buy into a promotional company. A promotional company is a new company that has little or no turnover. A company suitable for investment is one that has had a few years during which to prove itself, as it will have more data available—enabling you, the investor, to carry out a solid analysis of the company.

The investor should also not disregard a stock that is traded "over the counter." This means that if he finds the right stock, he should not be discouraged by the fact that it is not publicly listed. Finding an ethical broker will ensure both the desired liquidity and the marketability of the unlisted stock. Another don't for the investor is to purchase stock based on the positive tone of an annual report. He must bear in mind that the annual report is geared towards creating a good image in the eyes of the shareholder, and a positive tone is no guarantee that the management is competent and can execute an ambitious strategy.

One mistake is so commonly made by investors that Fisher draws specific attention to it. He gives the example of a generic outstanding company that is trading at a high price-to-earnings ratio—typically double the Dow Jones Average. If that company has a positive outlook for the future—say double the earnings in five years—many investors then make the mistake of looking at the current valuation and deeming it overvalued. Common-stock investors should acknowledge that an outstanding company will likely be valued at a high price-to-earnings ratio now as well as in the future.

The final don't for the investor is that he should not quibble about quarters or eighths; in other words, when he finds the right stock pick and it is priced reasonably, he should go ahead and buy it at the current price, and not wait in the hope that the stock will drop. In this way, the investor avoids the expensive downside in the event that the stock never reaches a low price again—which is likely to happen for truly outstanding companies.

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Chapter 9: Five More Don'ts for Investors

In this chapter, Fisher outlines yet another five don'ts for the common-stock investor. The first is that he should not go over the top with diversification. Often, the stock investor buys too many different stocks rather than too few, driven by the fear of losing his principal. What typically happens when you, as a stock investor, put your eggs in too many baskets is that you end up investing in companies you have very little knowledge about. This is even more dangerous than inadequate diversification, and is bad for your return. Fisher provides general guidelines for diversification, which basically state that the bigger and more stable the company, the less stocks you need to hold in order to be diversified.

As an investor, you should not be afraid to buy on a war scare. In these situations, the stock price declines and inflation increases. Both are good arguments to buy stocks. Another important thing to avoid, as an investor, is focusing on financial information that is irrelevant. The two most typical examples are looking at the stock prices and earnings per share for stocks for the previous years, and assuming that a similar development will occur. As an investor, you are buying the future cash flow of the business, not the past, so this type of financial information should only be seen as a guide, and should never be a deciding factor when considering a stock purchase. It would be more useful, for example, to evaluate data on the sensitivity of cyclicality for the stock.

Remember, too, to consider time as well as price when buying a true growth stock. A typical example arises when a true outstanding company with reliable growth projections is located, but is trading at a higher price than the current value. Most investors would hope for the stock to increase in value, but Fisher suggests also considering whether the stock would ever trade as low as hoped. It can be better to consider the timing of when to buy the stock, as the majority of the gain from the stock is made by holding it when growth occurs.

Finally, Fisher advises the investor not to follow the crowd when it comes to determining the value of the stock market. This is a very important but also hard concept to quantify, since it is a completely psychological and natural human behavior. Sometimes the financial community decides to take an overly positive or negative view of a particular stock, even though no facts have changed. Looking back in history, these cycles occur for the general stock market, separate industries, as well as individual stocks. The challenge for the investor is to distinguish between the current fundamental trends that will persist because something vital is changing, and the fads of the moment. The skill required in order to make this distinction is not easily acquired.

Chapter 10: How I Go About Finding a Growth Stock

In this chapter, Fisher goes into more detail about how he identifies the best growth stocks in practice. He initiates this discussion by addressing the inevitable question about the amount of time and effort required. According to Fisher, there is no other choice, when it comes to finding the best investments, than to put in the work.

The first of two steps he practices is to sort out the immensely high number of potential companies to invest in by speaking to competent investors with a proven track record. The advantage of doing this is that, through their daily work, these experts already have a valid opinion on the fifteen points that need to be met before purchasing the stock. In these discussions, Fisher likes to investigate whether the company is already in or is steered in the direction of unusually high sales, and whether the market the company is operating in is hard to enter for competitors. Discussions like these can take a few hours.

The second step comes into play once a company has been found is a potentially interesting investment opportunity. The investor should look into the financial statements himself, in particular breaking down and analyzing the sales in the income statements, and the debt in the balance sheet. Next, the "Scuttlebutt Method" should be applied, and as many people connected to the company as possible should be contacted. This provides another great insight regarding the fulfillment of the fifteen points.

Only once at least 50% of the desired data is collected should the final step—contacting the management and visiting the company—be carried out. Finally, Fisher concludes that the investor should not see the extensive research as an unreasonable amount of work and effort. He asks, "In which other line of work could you put up $10,000 one year, and 10 years later grow your assets to $40,000, to $150,000 without any extra work?"

Chapter 11: Summary and Conclusion

In this very short chapter of just over one page, Fisher summarizes the book. The aim has been to underline the fundamental principles of stock investing, including what to buy, when to buy, and when to sell. These principles have remained unchanged over time, and the same can be said of stock investing general. In stock investing, a good nervous system is even more important than a good head.