



It's Quality That Counts: The Fisher Approach to Stock Investing

By Maria Crawford Scott

Successful investing is often called a mix between science and art. Despite many attempts to find winning combinations of measurable factors that can be used to predict stock market winners, investment decisions often boil down to judgment calls that take qualitative factors into consideration.

One of the first investment “philosophers” to focus almost exclusively on qualitative factors was Philip A. Fisher, who began as a securities analyst in 1928 and three years later founded the investment counseling firm, Fisher & Co.

At a time when many investment professionals attempted to make money in stocks by betting on the business cycle, Fisher instead favored buying and holding the stocks of companies that were well-positioned for long-term growth in sales and profits. And this positioning could best be determined by examining factors that are difficult to measure through ratios and other mathematical formulations—the quality of management, the potential for future long-term sales growth, and the firm’s competitive edge.

Fisher outlined his philosophy for the lay investor in his book “Common Stocks and Uncommon Profits,” which was published in 1958. He later expanded upon his work in “Conservative Investors Sleep Well” and “Developing an Investment Philosophy.” All three works have been republished by John Wiley & Sons in “Common Stocks and Uncommon Profits and Other Writings by Philip A. Fisher,” (\$19.95, John Wiley & Sons Inc., 605 Third Ave., New York, NY 10158). These writings are the primary source for this article.

Growth Stocks: The Overall Philosophy

Fisher first and foremost was a growth stock investor. He felt the greatest investment returns did not come from the purchase of stocks that were undervalued, since even a stock that is undervalued by as much as 50% would only double in price once

it reached fair market value. Instead, he sought much higher returns from those companies that could achieve growth in sales and profits greater than the overall market over a long period of time. On the other hand, once those companies were found, he favored buying them opportunistically, either when the market temporarily undervalues the company due to unexpected bad news, or when the overall markets are depressed.

Fisher did not seek companies that showed promise of short-term growth due to cyclical events or one-time factors, feeling that the timing was too risky and the promised returns too small. Instead, he focused on long-term growth, which he felt could only come from companies that were strong in three “dimensions”:

- The company is producing goods or services with the potential for future long-term sales,
- The company has special characteristics that will allow it to retain a favorable competitive edge over existing competitors and newcomers, and
- The company has excellent management with both a determination to grow the company, and the ability to implement its plans.

True long-term growth companies, he felt, were not necessarily small and relatively young firms, although he did not exclude these companies (as long as they had some operating history upon which he could judge—he did not favor new firms). On the other hand, he noted that the qualities that constitute excellent management vary considerably based on firm size.

Finding Companies Worthy of Consideration

Although Fisher wrote for the average individual investor, his approach is not one that is easy to implement.

To begin with, Fisher did not begin his search through any methodical screening system. Instead, he maintained that most of his original ideas came from “key investment men” (other investment advisers) whom he had come to respect in terms of their knowledge of the kinds of stocks he preferred. Other

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sources included trade and financial periodicals.

The primary type of company he saw as a potential for further investigation was one that was either in or entering into an area with opportunities for unusual sales growth, but in which other newcomers or competitors would have a more difficult time entering. Once a prospective firm is found, Fisher said his next step was to determine whether the company measured up to his 15-point criteria. To determine this, he first examined the financial statements for a thorough understanding of the nature of the business, including: its capitalization and financial position, profit margins, a breakdown of total sales by product lines, the extent of research activity, earning statement figures that throw light on depreciation and abnormal or non-recurring costs in prior years' operations, and the major owners of the stock including the degree of ownership by management. Then, he used what he terms the "scuttlebutt" approach to help answer his 15 points, talking to competitors, analysts, and anyone who may have knowledge of the company. Lastly, he sought information to analyze his 15 points through a discussion with management.

The 15 Points

What are the 15 points?

In his first book, Fisher described a 15-point system he used to rate a prospective company, and he limited his investments to firms that fulfilled most of those 15 points. In later writings, he restated these points in terms of the three dimensions he felt were necessary for strong long-term growth; they are presented here not in the original order, but in reorganized form:

Functional factors:

1) Is the company providing a product or service that has sufficient market potential for a sizable increase in sales for several years? In this instance, Fisher is discussing sales over the long-term, and warns against firms that may show spurts due to one-time factors. On the other hand, he notes that the problems of marketing new products often causes sales increases to come in a series of uneven spurts rather than a smooth progression, and suggests judging sales growth over a series of years rather than single years.

2) Does the company have superiority in production—is it the lowest-cost producer (for manufacturing firms) or have the lowest-cost operations (for service firms or retailers)? Low production costs will allow a company to survive during hard times when higher-cost competitors are weeded out, he notes. In addition, low-cost producers are better able to build funds internally for future growth.

3) Does the company have a strong marketing organization? Fisher's definition of a strong market organization is broad, and includes the ability to recognize changes in public tastes, an effective advertising effort, and an efficient product distribution system.

4) Does the company have outstanding research and development efforts? Fisher was a strong believer in research efforts to produce new and better products in a better way or at lower

cost. Sometimes, he noted, these efforts would even lead to new lines of business. He suggested examining the amount expended on research relative to its size, but warned against simple comparisons among companies because of differences in what is included in reported research and development figures. Fisher was also concerned about the effectiveness of a firm's research effort indicated by its ability to bring research ideas to production and eventually to market—that is, its teamwork with the other parts of the firm. The most important question, he said, is how much in net profits over the past 10 years has been a result of research efforts? Firms that have done well in this regard in the past, he said, will most likely do so in the future.

5) How effective is the company's cost analysis and accounting controls? Good management and the efficient use of resources can only come from good information, according to Fisher. In addition, the finance function should provide an early-warning system for problems that could affect profitability.

6) Does the company have financial strength? Fisher was concerned here with a firm's ability to finance growth without the need to use equity financing, since increasing the number of shares outstanding would dilute an existing shareholder's benefits of investing in the firm.

Excellence in management and labor relations:

7) Does management have the determination, leadership and skills necessary to continue to develop products or services that will further increase sales? Fisher strongly believed that good management was key to long-term growth—by spotting new opportunities, adapting to changing market environments, developing plans, and coordinating the efforts of the organization to carry out those plans.

8) Is there a good working relationship among the management team? Fisher felt that good teamwork was crucial among the major divisions, and that this was best fostered by a strong effort to develop and promote its managers from within the organization.

9) Does the company have enough depth to its management? Even smaller firms, Fisher noted, need enough depth in management to prevent a "corporate disaster" should something happen to the key person.

10) Does the company have good labor relations? Fisher felt that the entrepreneurial atmosphere and teamwork within a firm should permeate through all aspects of a company, including rank and file workers. Mediocre relations, he stated, tends to produce high labor turnover and greater costs in training new workers.

11) Does management have a sufficiently long-range outlook? Fisher noted that long-term growth sometimes comes at the expense of short-term profits, and managements that are unwilling to forego current profits can hurt the future growth of a firm.

12) Does the firm practice good investor relations? To Fisher, good investor relations means a management that is willing to be honest and forthcoming when troubles and disappointments arise. Evasions, he stated, tend to be a sign of weak

Philip Fisher's Approach in Brief

Philosophy and style

Investment in "outstanding" companies that over the years can grow in sales and profits more than industry as a whole. The key features of "outstanding" companies are: strong management that has a disciplined approach designed to achieve dramatic long-term growth in profits, with products or services that have the potential for sizable sales long term, and with other inherent qualities that would make it difficult for competitors and newcomers to share in that potential growth.

Universe of stocks

No restrictions on universe of stocks from which to select. Over-the-counter stocks should not be overlooked, but "outstanding" companies are not necessarily young and small.

Criteria for initial consideration

Prospective companies should pass most of the following 15 points, which can be divided into three main dimensions:

Functional factors:

- Products or services with sufficient market potential for sizable increase in sales for several years. Major sales growth, judged over series of years.
- Superiority in production—lowest-cost production (for manufacturing firms) or lowest-cost operation (for service firms or retailers).
- Strong marketing organization—efficiency of sales, advertising, and distributive organizations.
- Outstanding research and development efforts—amount expended relative to its size, effectiveness of effort as indicated by ability to bring research ideas to production and to market and by how much research contributed to net profits.
- Effectiveness of company's cost analysis and accounting controls, and choice of capital investments that will bring the highest return.
- Financial strength or cash position—sufficient capital to take care of needs to exploit prospects for next several years without the need to raise equity capital.

Excellence in Management

- Attitude of management to continue to develop products or services that will further increase sales.
- Development of good in-house management and teamwork.

- Management depth.
- Good labor and personnel relations: Affiliation with an international union may be an indication of bad relations; labor turnover relative to competitors.
- Long-range outlook by management even at the expense of short-term profits.
- Good investor relations, and willingness to talk freely about problems.
- Management of unquestionable integrity—salaries and perks in line with those of other managers.

Business characteristics

- Above-average profitability: Compare profit margins per dollar of sales—compare within industry and examine for several years, not just single years. Older and larger firms are usually the best in their industry. Younger firms may elect to speed up growth by spending all or a large part of profits on research or sales; for these, make sure a narrow profit margin is due to spending in these areas alone.
- Ability to maintain good profit margins: Good position relative to competition—for instance, skill in a particular line of business, or patent protection for a small business.

Secondary factors

Once an "outstanding" company is found, purchase stock when it is out-of-favor either because the market has temporarily misjudged the true value of the company, or because of general market conditions. "Outstanding" companies can also be purchased at fair value, but investor should expect a lower (but respectable) return.

Stock monitoring and when to sell

- Use a three-year rule for judging results if a stock is underperforming but no fundamental changes have occurred.
- Hold stock until there is a fundamental change in its nature or it has grown to a point where it will no longer be growing faster than the overall economy.
- Don't sell for short-term reasons.
- Sell mistakes quickly, once they are recognized.
- Don't overdiversify—10 or 12 larger companies is sufficient, investing in a variety of industries with different characteristics.

management—either they do not have a plan to deal with an unexpected difficulty, or they do not have a sense of responsibility toward shareholders.

13) Does the management have unquestionable integrity? “The management of a company is always far closer to its assets than is the stockholder,” Fisher states. And managers can benefit themselves at the expense of shareholders in an “infinite” number of ways, including salaries and perks high above the norm. The only protection shareholders have against management abuses of position is to invest in companies whose managers have unquestioned integrity.

Business characteristics

14) Does the firm have above-average profitability? In a rare instance, Fisher actually suggests a mathematical comparison—profit margins per dollar of sales, compared against similar firms in the same industry. Older and larger firms should have among the best figures in their industry, he states. On the other hand, younger firms may elect to speed up growth by spending all or a large part of profits on research or sales; for these firms, Fisher suggested that investors make sure that narrow profit margins are due to spending in these areas alone. Firms operating in areas with high profits will attract competition, but operating at extremely high efficiency levels will reduce the incentive for competitors to enter the market.

15) Is there some aspect to the business that will allow the company to keep its relative competitive edge? Innovations, special skills or services, patent protections and similar advantages give companies a strong ability to fend off competitors or newcomers to the area.

Secondary Factors: When to Buy

Fisher did not necessarily favor the purchase of an “outstanding company” at any price. Instead, he suggested that investors exploit buying opportunities, which can take several forms:

- Short-term troubles: Even companies that are under the guidance of exceptionally able managers are bound to have troubles, plans that fail to unfold or new products with “kinks” that need to be worked out, and once that trouble produces a price decline, investors can purchase the stock.
- Market blindness: Earnings increases that have not yet been reflected in price changes.
- Market declines: When the overall market drops and pulls the stock down with it, investors are faced with a buying opportunity.

Fisher noted that investors can still make money if opportunities don’t arise, but they must have more patience with the chosen stock and recognize that their profits will be smaller.

Although Fisher recognized opportunities in market declines, he suggested that investors in general ignore business and economic trends, investing funds as soon as an “appropriate buying opportunity” arises. For particularly conservative investors, he recommended dollar cost averaging.

Stock Monitoring and When to Sell

Fisher provided a number of helpful rules both for purchasing and selling.

For stock purchases, Fisher warned against agonizing over eighths and quarters when placing a trade. Attempting to shave points off the price, he noted, often results in a trade not going through, and the investor loses out on investing long term in an outstanding firm. And any savings, he pointed out, will be insignificant compared to long-term returns.

Fisher was a strong advocate of long-term investing, advising investors to hold onto their stocks until there is a fundamental change in the firm’s nature, or it has grown to a point where it will no longer be growing faster than the overall economy. He warned, however, that when companies grow, managements need to change and adapt, and investors may need to sell if management doesn’t keep pace. Fisher recommended against selling for short-term reasons—for example, to take profits if a temporary downturn is expected.

Fisher suggested that investors use a three-year rule for judging results if a stock is underperforming the market but nothing else has happened to change the investor’s original view. If after three years it is still underperforming, he recommended that investors sell the stock.

On the other hand, Fisher advised selling “mistakes” quickly, once they are recognized.

Lastly, Fisher warned against overdiversification, which he felt caused investors to lower their standards and to put money in companies in which they do not thoroughly understand. Sufficient diversification, he said, would be an investment in 10 or 12 larger companies in a variety of industries with different characteristics, and any holding of over 20 companies is probably too much.

Fisher in Summary

While Fisher does not provide an easy-to-follow methodical approach for individual investors to implement, his discussion of the qualitative factors within “outstanding companies” serves as a useful outline that adds some color to the strict mathematical approaches. Becoming acquainted with all of a company’s financial statements—the 10-k and annual reports—as well as gaining an understanding of the industry in which a company is operating and knowledge of the firm’s competitors are all necessary components of Fisher’s approach.

Fisher wrote of the complaints he received concerning the amount of time and effort necessary to implement his approach. However, he was unsympathetic:

“Is it either logical or reasonable that anyone could [achieve the kind of reward gained from selecting growth stocks successfully] with an effort no harder than reading a few simply worded brokers’ free circulars in the comfort of an armchair one evening a week? ... So far as I know, no other fields of endeavor offer these huge rewards this easily.”

