Phil Fisher and the Art of Scuttlebutt

For those of you who haven't read it. And for those of you (like me) that read it more than a decade ago. Forager's junior analyst Alvise Peggion has put together a great little summary of *Common Stocks and Uncommon Profits*, legendary investor Phil Fisher's indispensable guide to scuttlebutt investing.

About the author

Phil Fisher practiced 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. He specialised in innovative companies driven by research and development. He practiced long-term investing, and strove to buy great companies at reasonable prices.

Point 1 - Clues from the past

An analysis of how money was made in the past shows that finding the really outstanding companies and staying with them through all the fluctuations of the market proved far more profitable to far more people than did the far more colourful practice of trying to buy them cheap and sell them high.

What was required was the ability to distinguish these relatively few companies with outstanding investment possibilities from the more numerous whose future would vary from moderately successful to the complete failure.

The opportunities of today are as good as those of the past.

Implications:

- There is a place for active management

- Costs involved in researching and understanding a businesses are justified

- The next big opportunity is just around the corner

Point 2 - What 'Scuttlebutt' can do

"It is amazing what an accurate picture of the relevant points of strength and weakness of each company in an industry can be obtained from a representative cross-section of the opinion of those who in one way or another are concerned with any particular company."

Implications:

- Asking intelligent questions to people involved in the business/industry of interest is a great

way to gain useful investment information. You do not be to be a top manager to grasp the potential an industry/business has within it.

Point 3 - What to Buy - The 15 points to look for in a common stock

i) **Does the company have products or services with sufficient market potential to make possible a sizable increase in sales for at least several years?** Fisher doesn't extrapolate from past revenue patterns but he is interested in understanding how growth can continue into the future.

ii) **Does the management have a determination to continue to develop products or processes that will still further increase total sales potentials when the growth potentials of currently attractive product lines have largely been exploited?** This point is more about management attitude, it is not a repetition of point one.

iii) **How effective are the company's research and development efforts in relation to its size**

iv) **Does the company have an above average sales organisation?** For steady long term growth a strong sales force is vital.

v) **Does the company have a worthwhile profit margin?** He argues that investing in marginal companies (those with a small profit margin compared to competitors) is not the recipe for good long term investments as even if these companies grow profit by a larger percentage than a non-marginal company in a given up year, they only represent an opportunity for a one off gain. In fact, these businesses' profits will also decline correspondingly faster when the tide shifts. He argues that the only reason to consider a long term investment in a company with an abnormally low profit margin is that there might be strong indications that a fundamental change is taking place within the company. This would be such that the increase in profit margins would be occurring for reasons other than a temporarily expanded volume of business.

vi) **What is the company doing to maintain or improve profit margins?** Companies can either raise prices or reduce costs. Fisher favours firms that focus on both simultaneously.

vii) **Does the company have outstanding personnel relations?** Hard to gauge for the outsider. As a start, Fisher suggests that companies without unionised workforces are likely to have good internal relationships. Labour turnover is a useful ratio when compared to a competitor. The relative size of the waiting list of job applicants can also be useful… I guess nowadays you can see how many people follow the Linked in company page etc. The company that makes above average profits while paying above average wages is likely to have good labour relations.

viii) **Does the company have outstanding executive relations?** Executives should have confidence in the board and that they will be rewarded for results. This should extend to the whole organisation as per above point.

ix) **Does the company have depth to its management?** Humans are finite too and so key man risk needs to be managed. Internal talent will not develop unless policies are in place. Delegation of authority, welcoming suggestions from the bottom are key positives.

x) **How good are the company's cost analysis and accounting controls?** Need to be able to monitor the business's pulse to allocate resources efficiently.

xi) **Are there other aspects of the business somewhat peculiar to the industry involved which will give the investor important clues as to how outstanding the company may be in relation to its competitors?** I.e. for a retailer it is desirable to excel at managing store openings and lease arrangements. Scuttlebutt is a great way to gain an insight.

xii) **Does the company have a short-range or long-range outlook in regards to profit?** Most times it is better to build goodwill first and make (larger) profits over a longer period of time rather than maximise short term profitability. Scuttlebutt works here too.

xiii) **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 prefers companies that can grow through retained earnings.

xiv) **Does the management talk freely to investors about its affairs when things are going well but become mute when troubles occur?** If yes, avoid these companies.

xv) **Does the company have a management of unquestionable integrity?** Agency costs of equity are lower when management developed a sense of moral responsibility to their stockholders. Scuttlebutt is very useful here.

Point 4: What to Buy – Applying this to your needs

In this section Fisher points how the stereotype of the successful investment analysts is far removed from reality. For Fisher "the successful investor is usually an individual who is inherently interested in business problems. This results in him discussing such matters in a way that will arouse the interest of those from whom he is seeking data. Naturally he must have reasonably good judgement or all the data he gets will avail him nothing". If you are not this kind of person (or have not the time), it makes perfect sense to outsource the job to a professional.

Point 5: When to Buy

Virtually any time can be a good time to buy. If you find an outstanding company there is no need to try forecasting the general macroeconomic conditions to infer how they will influence the business. The prospective company should be able to ride the business cycle almost regardless of general economic conditions. If the business is also selling at a depressed price, because others do not consider general economic conditions to be favourable, then you should just buy, without needing to time the purchase.

Point 6: When to Sell

Fisher gives three situations where you should sell a stock:

i) A Mistake – The company did not actually meet the 15 points as initially anticipated

ii) A Fundamental change in circumstances

iii) A cheaper investment opportunity needs financing

Point 7: Ten don’ts of investing

i) Don’t buy into promotional companies.

ii) Don’t ignore a good stock just because it is traded “over the counter”.

iii) Don’t buy a stock just because you like the “tone” of its annual report.

iv) 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 discounted in the price.

v) Don’t quibble over eighths and quarters (one of Fisher’s most famous quotes, imploring investors not to risk missing out on a stock by holding out for a fractionally better price).

vi) Don’t over-stress diversification.

vii) Don’t be afraid of buying on a war scare.

viii) Don’t forget your Gilbert and Sullivan (There are certain superficial financial statistics which are frequently given an undeserved degree of attention by many investors).

ix) Don’t fail to consider time as well as price in buying a true growth stock.

x) Don’t follow the crowd.