

# Penny wise...

A Blog from India focusing on Personal Finance, Finance Education, Investing and Retirement Planning...

HOME

50 FINANCE BOOKS

EQUITY

DEBT

REAL ESTATE

Friday, March 20, 2015

## Chapter Summary: Book #22:Common Stocks and Uncommon Profits

### Part 1: Common stocks and uncommon profits

#### Chapter 1: Clues from the past

Traditionally there are two ways to make money in the stock market. One is to play the business cycle. Enter at the trough of the cycle and exit at the boom. However it is difficult for a retail investor to exactly time the troughs or the booms. This results in his receiving suboptimal returns or in worst case incurring losses.

A better approach would be to identify good companies with significant long-term potential and stay invested in them for the long haul. This approach will invariably lead to significant investment profits for a retail investor. This book is about identifying such companies.

What are the main characteristics of good companies? One, they need not be young and small. Even a big company can grow significantly for a long period of time by smart management. Two, the management of such companies balances long range planning with short range execution and three, these companies focus on continuous renewal through Research and Development. The good news for the investor is that many such companies exist today.

One key question that is addressed in this chapter is whether a retail investor should play the bond market or is she better off being invested in stocks. One of the trends in US is of deficit spending where government maintains a budget deficit to propel growth. Deficit spending leads to inflation and creates volatility in bond market. Investment in Bond Market calls for extensive knowledge which the retail investor may not possess. Hence it is better for the retail investor to stay away from the bond market.

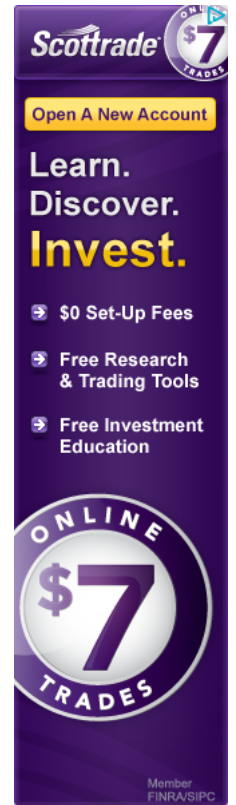
#### Chapter 2: What 'Scuttlebutt' can do

Once an investor identifies a company to research on, the next step is to identify various sources that can provide information on the company. Initially one would start collecting information from various stakeholders outside the company, but we are aware of the company, its industry and its competitors. Author discusses a strategy called 'Scuttlebutt'. As per Scuttlebutt strategy, there are four main sources of external information. They are the Competitors, Suppliers, Customers and Ex-employees of the company. One can make intelligent assumptions about the company from the inputs provided by these sources. Only after the investor has got all the relevant information from the Scuttlebutt, should the investor think of talking to the company management, to fill the gaps in one's understanding.

#### Chapter 3: What to buy: The fifteen points to look for in a common stock.

While researching a company to invest in, an investor should try to get answer to fifteen questions. These are:

1. Does the company have products or services with sufficient market potential to make possible a sizable increase in sales for at least several years? It is possible for a company to make a one time profit by tight control of the costs. It is also possible that a company can make profit for a number of years due to anticipated market changes, for example the sales of Radio Manufacturers increased manifold with the advent of TV, but now the sales have tapered off. Also, one should not expect the company to make profits year on year, rather one should have a block of years in mind while comparing the performance. Investor should look for companies which will have sharply increasing sales for some years ahead.
2. Does the management have a determination to continue to develop products or processes that will still further increase total sales potentials when growth potentials of currently attractive product lines have largely been exploited? New products tend to do well if they are incrementally improved over the existing products rather than developing a new product altogether. Management should have the awareness and the conviction to continually look for new products to augment the organizational portfolio. Points 1 and 2 taken together implies that while the current products are selling well, the smart management is aware of the need to continually develop new products and shelve old ones.
3. How effective are companies R&D efforts in relation to its size? While most of the companies report their R&D expenses separately, the components of what goes into the expense vary significantly, making comparisons difficult. For R&D efforts to be successful, three vital areas of co-ordination has to be considered. First one is the co-ordination within the R&D team. This means that all the different experts in the R&D team must be able to work together as a team. The second is the co-ordination between the research team and the Business and Operation teams. Without this co-ordination, the new products developed will fail to take off. The third and the most important is the co-ordination with the management. R&D effort will take time and focus. If the management continuously shifts the R&D focus based on external factors, the research effort will not be effective. One area where the R&D effort fails is in integrating the research effort with market inputs. Many a times it can happen that esoteric products are developed in house only to find that there is no market demand for those products.
4. Does the company have an above average sales organization? Sales is the lifeblood of any organization. Any smart investor should look for signs of strength in sales organization. One way is to look for the recruitment and training and retraining processes for the sales team. This is area where Scuttlebutt can provide good insight.
5. Does the company have a worthwhile profit margin? An investor should look for good current profit margin with a potential to expand. Sometimes effort in improving sales or research can lower the profit margins. If the investor is convinced of the reasons of low profit margin is as mentioned above (GPM will be high while EBITDA margins will be low, for example), she can invest in that stock even though the current margins are low.
6. What is the company doing to maintain or improve profit margins? The easiest way to maintain / improve profit margins is to pass on the additional costs to the customer. Investor should look out for those companies that can do that (having a 'moat' as per Mr.Warren Buffet). If that is not possible, the organization can improve margins by cutting costs. One aspect of this is to review operations to bring in economies of scale. Another way is to continually bring out new products that can maintain the margins.
7. Does the company have outstanding labor and personnel relations? Absence of Labor unions can provide a clue to the labor relations. Investor should look for amicable relations between management and unions where one exists. Some of the signs of good labor relations are labor turnover, waiting list to join the organization, speed of grievance settlement, rate of wages to profit and attitude of management to employees.
8. Does the company have outstanding executive relations? Investor should look for merit based promotion policy, regular wage increment without employee having to demand the same, wages in line with industry standards, policy of promoting internal talent to key jobs etc.



**Scottrade** ONLINE **\$7 TRADES**

**Open A New Account**

**Learn. Discover. Invest.**

- \$0 Set-Up Fees
- Free Research & Trading Tools
- Free Investment Education

**ONLINE \$7 TRADES**

Member FINRA/SIPC

### Bestowers of Knowledge, Wealth and Success



Godesses Saraswati and Lakshmi with Lord Ganesh

### About Me

**Ramaswamy V Krishnamurti**

**G+ Follow** 15

A passionate writer and blogger, avid reader, an ERP Consultant by profession, broadminded, liberal (follows 'Vasudeva Kudumbakam' to the heart), good sense of humour and likes physical activity. Currently in Bangalore, planning to start a business, all excited

[View my complete profile](#)

9. Does the company have depth to its management? Investor should look for policies enforcing delegation of authority. Also she can look for instances where management was receptive to adverse criticism (demonstrating the management depth) rather than sitting on their pride and ego.
10. How good are the company's cost analysis and accounting controls? Availability of detailed, accurate product cost information is a very important requirement for the company. However it is very difficult for an investor to verify the availability and accuracy of the cost information.
11. 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 competition? Investor should identify industry specific factors and do a performance comparison of the company with its peers. For retailing companies, renting and leasing costs may be significant cost and any company that handles this efficiently can become a winner. For asset rich companies, insurance costs can play a major role in cost escalation.
12. Does the company have a short-range or long-range outlook in regard to profits? How does the company treats the special requirements of the vendors and customers that could impact its profit margins? A company looking at transactional approach will try to squeeze the maximum profits out of the current situation while a company looking at relationship approach will take a temporary hit in current margins but which will pay off spectacularly in the long run.
13. In the foreseeable future will the growth of the company require sufficient equity financing so that the larger number of shares then outstanding will largely cancel the existing stockholder's benefit from this anticipated growth? Investor should look for historic patterns of how the company had financed growth. Any company that can finance its growth through retained earnings and prudent debt should get a better valuation. If the company cannot take anymore debt then it will have to resort to equity dilution by issuing more equity. This will lower the value for the current shareholders.
14. Does the management talk freely to investors about its affairs when things are going well but 'Clam up' when troubles and disappointments occur? Investor should give a lot of importance to management communication and openness. It is quite normal that the business will go through good and bad. Any management that shuts up when things are bad is not to be trusted.
15. Does the company have a management of unquestionable integrity? This is very important. Management should do what it says it will do. To test this Warren Buffet advises the investor to go through management reports of five years ago and see if the management had followed through on the commitments made then.

#### Chapter 4: What to buy: Applying this to your own needs.

The recommendation for the average investor is not to invest on one's own, but to invest through an expert. Secondly an investor should only invest their surplus funds after ensuring the availability of contingency fund. While small sized growth companies have more potential to grow, they are riskier. An Investor should invest about 80-85 percent of his funds in medium sized growth companies. Finally, do not focus on dividend yield. For a growth investor dividend yield is irrelevant. Author also points out that growth investing will always triumph over value investing. This because, while the upside to value investing is more limited, there is no limit to the upside from growth investing. For example, assume that the company A is trading at 100 (close to its intrinsic value) and due to some reason its price falls to 50. At 50 price, it becomes a value buy. However, the potential rise in price is to 100. However if one buys a growth company at 50, there is no limit to the upside.

#### Chapter 5: When to buy

The traditional discussions on timings forecasts the business cycle and if they are positive, a buy is recommended and if negative, a sell. However, Mr.Fisher looks at timing in an innovative way. As per him, the characteristics of stock will tell an investor when to buy it. For example, if the growth company is in the verge of a new product, that is a time to buy. Another time to buy will be when the first plant comes on stream. Another time to buy is when a good growth company falls into temporary difficulties. Yet another time to invest is when a successful growth company makes incremental investments. In each of the above cases, market will provide the investor with very profitable buying opportunities for a few months. In addition, you may find a good stock trading at a high price. In this case it is better to use SIP route to buy into this stock.

#### Chapter 6: When to sell, and when not to

Answer to the question 'When to sell' is almost never. However, there are three reasons why one should sell a stock. First reason is that it becomes clear over a period of time that the original purchase was a mistake. The second reason is that the company no longer meets the requirements of 15 questions discussed earlier. The third reason is to sell is to buy into a better opportunity. The author discourages selling based on reasons like 'Stock had a good advance', 'Stock is overpriced' etc

#### Chapter 7: The Hullabaloo about dividends

The author is not a fan of investing based on Dividend Yield. Remember that value investors give a lot of importance to this ratio. As per him, most of the stock investors are in it for the appreciation in their investments. A good growth company can serve its investors better by investing their funds in growth opportunities rather than returning the same as dividends to the investor. In addition, a good growth company with low current dividend yield could offer significant dividend yield as it enters its growth phase.

#### Chapter 8: Five don'ts for investors

1. Don't buy into promotional companies: Promotional companies mentioned in this book is what we call 'Startups'. Small companies with excellent growth potential but without any operational or profit performance history. This makes it difficult for investors to analyse these companies. Author recommends investing in those companies with at least 2 years of operational history and one year of operating profit.
2. Don't ignore a good stock because it is traded 'Over the counter': The companies in 'Over The Counter' (OTC) segments are those which are not yet listed in the stock market. You could get good bargains in this segment if you are a savvy investor.
3. Don't buy a stock just because you like the 'Tone' of its annual report: An the corollary, don't ignore a stock just because you dislike the tone of the annual report. Most of the annual report send to investors are prepared by professionals whose job is to make it look snazzy. Do not go by the looks, go by the quality of the content of the reports
4. Just because PE is high, do not assume that there is no further growth potential: There is a misconception that high PEs of some companies will ultimately 'revert to mean'. While this may be a general case, there could be many exceptional growth companies whose PE will continue to remain high for significantly long periods.
5. Don't quibble over eighths and quarters: This is a very important lesson to retail investors. If you have decided to buy a stock and if you are planning to buy in small numbers, it is better not to wait for a small fall in stock prices before you start accumulating the shares. It is possible that the stock will not reach your target price at all and you will end up regretting.

#### Chapter 9: Five more don'ts for investors

1. Don't overstress diversification: Diversification is a recommended strategy for investors to mitigate risk. There are two aspects to diversification that one must consider. One is that there will be significant internal diversification within certain companies. For example if you buy CESE, you are getting exposure to Utility as well as a Retail (Spencers) play. Secondly, more stocks do not mean more diversification. For example, out of 10 stocks, if eight are in Financial sector, the investor is not adequately diversified. In addition, if you are investing in a company with shallow management depth, you will need more diversification. Same is the case with investing in cyclical stocks where you will need more diversification to ensure steady returns.

#### My Avatars

**Grow Together...**

**ERP Resources**

#### Blog Archive

- 2016 (5)
- ▼ 2015 (14)
  - December (1)
  - November (1)
  - September (1)
  - August (2)
  - July (4)
  - ▼ March (2)
    - Chapter Summary: Book #22:Common Stocks and Uncomm...
    - Book Review #22: Common stocks and uncommon profit...
  - February (1)
  - January (2)
- 2014 (36)

#### Feed

##### Live Traffic Feed

A visitor from San Diego, California viewed "[Penny wise...: Chapter Summary: Book #22:Common Stocks and Uncommon Profits](#)" 4 days 15 mins ago

A visitor from Los Angeles, California viewed "[Penny wise...: Book Review #28: Think and grow rich: Author: Navision from Mumbai](#)" 4 days 15 mins ago

A visitor from Maharashtra viewed "[Penny wise...: Chapter Summary: Book #22:Common Stocks and Uncommon Profits](#)" 3 days 19 hours ago

A visitor from Central District viewed "[Penny wise...: Chapter Summary: Book #22:Common Stocks and Uncommon Profits](#)" 3 days 19 hours ago

A visitor from New Delhi, Delhi viewed "[Penny wise...](#)" 7 days 6 hours ago

A visitor from San Francisco, California viewed "[Penny wise...](#)" 10 days 5 hours ago

A visitor from Singapore viewed "[Penny wise...: Chapter Summary: Book #22:Common Stocks and Uncommon Profits](#)" 10 days 5 hours ago

A visitor from New Delhi, Delhi viewed "[Penny wise...](#)" 14 days 3 hours ago

A visitor from San Diego, California viewed "[Penny wise...](#)" 14 days 7 hours ago

A visitor from United States viewed "[Penny wise...](#)" 14 days 12 hours ago

[Real-time view](#) · [Get Feedjit](#)

2. Don't be scared of buying into a war scare: War scare provides very good buying opportunities. This is because market excessively sells off at the whiff of a war or tension. A savvy investor will look for such opportunities to build significant wealth.
3. Don't forget your Gilbert and Sullivan (Don't be influenced by stuff that doesn't matter): There are some financial statistics that is given undue importance by investors. One such is the price range at which the stock has traded historically. Considering that one is investing for future, the past price trends do not have any meaning. Another number is the EPS of the last five years. Another heuristic is the belief that the past can be extrapolated to future.
4. Don't forget to consider time and price when buying a true growth stock: Even if you identify a good growth company, it makes sense to wait for the correct time to buy the same. For example, if you are expecting a plant to come onstream in 6 months, it will make sense to buy the stock just before the event takes place.
5. Do not follow the crowd: An investor should look for real reasons for a stock price movement. These could be new product launch, new factory commissioned, price increases etc. All these will impact the stock price positively. However, even when there are no fundamental reasons for the stock prices to fall or rise, the evaluation by the financial community can lead to market price fluctuations. A savvy investor should be careful not to transact based on the assessment of financial community (Mr.Market) about the value of one's portfolio

#### Chapter 10: How I go about finding a growth stock:

This is the question for which probably most of the readers are trying to find answer to. 20 percent of the Author's investment ideas come from friends that he knows. The remaining 80 percent comes from savvy investment experts that he has business relationships with. Once he has an idea, he goes through the 'Scuttlebutt' approach to separate the chaff. If Scuttlebutt shows that the stock is not worth investing, the same is discarded. If the stock overcomes the 'Scuttlebutt Test', he will approach the management to fill the gaps in his knowledge. The focus is on getting answers to the 15 questions that were previously asked. It takes effort, but the returns are commensurate with the efforts.

#### Chapter 11: Summary and conclusion:

While the economic, scientific, political and corporate management environments are changing rapidly over the time and will significantly change in future, the basic principles of successful investments has not changed. One has to identify and stay invested in companies with potential to grow their revenues over the long – term. The part ends with emphasizing the importance of staying invested, of conquering one's nerves, of not being affected by either greed or fear.

## Part 2: Conservative investors sleep well

### Introduction

A 'Conservative Investment' is one that conserves the investor's purchasing power at a minimum risk to the investor. Conservative Investing looks at factors that determine a conservative investment and identify and invest in specific conservative investments. This part of the book discusses the factors that make a Conservative Investments. Many of the points discussed in this section are repetitions of points already mentioned in Part 1 above.

#### Chapter 1: The first dimension of a conservative investment

For a company to become a conservative investment, it must meet the following criteria:

1. It is the lowest cost producer in the industry: There are two aspects to this. One, the cost should be much lower than the Break Even Point giving the company a cushion in difficult economic environment. Second, it should have significant profit margin that can finance the organizational growth.
2. It should have an excellent marketing organization: A good marketing organization will understand the changing needs of the customer as well as anticipated changes in business environment. While they will advertise their products, they will also make customers aware of some needs that customer did not realize and then provide solution.
3. It should have a major focus on researching and developing new products: This was earlier discussed under 15 points in chapter 2. In summary a good R&D strategy will call for internal co-ordination between the R&D team members, co-ordination between the R&D team and the Business team that they are supporting and finally a management focused on R&D. The ideas that this team should focus on must come from good market research.
4. Should have highly efficient finance and accounting control processes: Organization should know its cost elements very thoroughly so that it can focus on products with highest margin, has a good budgeting process that can give early warning to potential problems, an efficient capital allocation process and finally a good receivables and inventory control processes.

#### Chapter 2: The second dimension: The People Factor

Company should promote employee engagement. For this, the management should treat employees with respect and dignity. In addition, there should be delegation of work so that everyone has a chance to learn something new. Also, there should be focus on internal promotions so that employee feels a sense of ownership. There should be training programs to help employees grow. There are three elements of corporate policy that an organization has to understand.

1. The world in which the business is operating is changing rapidly. Company must be nimble and flexible to accept this challenge.
2. Employees must feel that company is a good place to work. This includes, in addition to training, telling employees the what and why of major decisions and quick grievance redressal etc
3. Management should submit itself to the discipline required for sustained growth. Focus on long-term profit is required from management.

#### Chapter 3: The third dimension: Investment characteristics of some businesses

From the perspective of 'Profitability', the investor should consider both ROI and Profit Margin on Sales. A high and sustained value in both of the above is the best situation. From the perspective of 'Safety of Investment' all emphasis must be on Profit Margin. There are four ways in which company can ensure high profit margin. First is the obvious, Pricing Power. Next is by cutting costs using 'Economics of Scale'. The more the company produces, the lower will be the unit cost of the product. Another is to have a combination of technology and associated service (Washing Machine and After Sales Service, for example) and the last one is Brand Equity which ensures repeat business.

#### Chapter 4: The fourth dimension: Price of a conservative investment

The next three chapters talk about how the financial community (Mr.Market) appraises the prospects of the company. This appraisal determines the price which the market is ready to pay for the stock. There could be situations where a company that is identified as a good stock is trading at a low price. From the perspective of the conservative investor, the following criteria are to be followed in the ascending order of potential risk. The lowest risk is investing in a company that does well in the three criteria above and is trading at a very low PE. These are bargains and investor should lap them up. Next up is a company that is doing well in the three criteria but which is trading at the intrinsic PE. These stocks are good and suggestion is for the investor to buy them. Next in risk level is a company that is doing well in the three criteria and which is trading at a high PE. Mr.Fisher advises to buy these stocks since it is difficult to identify companies that are doing well in the three criteria. Companies that do not do well in the three criteria should be avoided irrespective of the PE at which they are trading currently.

#### Chapter 5: More about the fourth dimension

Even when the characteristics of a specific stocks are good, they are traded in the context of the industry in which it is operating. When

the market perception of the industry is negative, all the stocks in the industry are traded at low PE multiples. This is currently happening to the Power and Oil Exploration industries in India. It is better for the investor to evaluate the market view of the industry before investing in a specific company.

#### Chapter 6: Still more about the fourth dimension

Investor return depends on the price performance of the stock. This in turn depend on market perception of the industry of which the stock is a part. Yet another overriding factor is the performance of the Stock Market in general. There are times when markets sell off excessively bringing down the market returns. There are three external factors that impact market returns. One is the interest rates. When they go up, investors will sell off the stocks and move the same into high interest paying debt. Another is the savings rate, which, when it goes up, more money flows into the stock market and market tend to move up. Also, new issues could suck up money from the markets leaving stocks down.

### Part 3: Developing an investment philosophy

Over a period of about 50 year, Philip Fisher straddled the American Investment environment like a Colossus. He had very few highly satisfied long-range customers for whom he made returns in the range of 50 to 100 times.. Mr.Fisher's investment philosophy can be summarized in the following eight points.

1. Buy into companies that have plans of ensuring long-range growth. The factors to be considered as summarized in the 15 points discussed in chapter 2 of this review.
2. Focus on buying these companies when they are out of favour in the market
3. Hold the stock until there is a change in state like a change in management or if the company cannot grow faster than the economy. Do not sell expecting the market to correct.
4. Do not focus on dividends. Instead focus on capital appreciation.
5. Making mistakes is normal in investing. Try to learn from every mistake to become a better investor.
6. There are relatively small number of outstanding companies. Since they are rare, when favourable situation exist (as when L&T traded at 550) full advantage must be taken of the situation. Have about 12-15 stocks in the portfolio if you are an individual investor
7. Do not go with the crowd. If think that your judgement is correct, have the courage to be contrarian
8. Success in common stock investing depends on hard work, intelligence and honesty.

Posted by **Ramaswamy V Krishnamurti** at 8:29 PM



+1 Recommend this on Google

Labels: [50 Finance Books](#), [Chapter Summary](#)

**No comments:**

### Post a Comment

As a policy I publish all the comments except SPAMS. Please be moderate and constructive in your comments

Enter your comment...

Comment as: Unknown (Google) Sign out

Publish Preview ☐ Notify me



Diversify your retirement portfolio.

Get \$200 and 50 free trades with a qualifying deposit.

Restrictions apply. Member FINRA/SIPC



[Newer Post](#)

[Home](#)

[Older Post](#)

Subscribe to: [Post Comments \(Atom\)](#)

