Paths to Wealth through Common Stocks

Philip A. Fisher

John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Originally Published in 1960 by Prentice-Hall, Inc.

Wiley Bicentennial Logo: Richard J. Pacifico

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Library of Congress Cataloging-in-Publication Data:

Fisher, Philip A.
Paths to wealth through common stocks/Philip A. Fisher, Kenneth L. Fisher.
p. cm. – (Wiley investment classics)
Includes index.
ISBN 978-0-470-13949-3 (pbk.)
1. Stocks. 2. Investments. I. Fisher, Kenneth L. II. Title.
HG4521.F59 2007
332.63′22–dc22

2007014931

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

This book is dedicated
to all investors, large and small,
who do not *adhere to the philosophy:*
"Everyone seems to believe it,
so it must be so."

Contents

Foreword ix

Preface: The Need for Additional Investment Books xix

Part I: Adjusting to Key Influences of the 1960's 1

Stocks and Inflation; Institutional Buying; Foreign Competition; Increased Population; The Economists Go Out—The Psychologists Come In

Part II: How the Greatest Increases in Stock Values Come About 70

Alert Corporate Management; A New Concept; The Role of Institutional Buying; A Reward Usually Overlooked

Part III: You and Where Your Investment Business Must Go 91

Methods of Investment Evaluation; Five Steps for Selecting the Right Investment Counselor

Part IV: Trivia but not Entirely 122

What About Mergers?; Voting Rights and Proxy Fights; Should You Buy or Sell Stocks Because of U.S. Election Prospects?

Part V: Major Growth Industries of the 1960's 149

The Chemical Industry; The Electronics Industry; The Pharmaceutical Industry; Other Interesting Industries; The False Growth Stocks of the Immediate Post-War Years

Index 205

Foreword

Paths to Wealth through Common Stocks was my father's second book, and was written very much as a follow-on to his 1958 classic, *Common Stocks and Uncommon Profits*. That first book became a basic text at the Stanford Graduate School of Business for decades, and changed the way countless readers thought of investing—including Warren Buffett, who said it pulled him away from his straight Ben Graham approach and set him on his own approach ever after. Although this book never had the sales, impact, or longevity of the first book, it's important and useful for any serious market student for two reasons.

First, this embellishes concepts in the first book—adding depth and texture. It's a wide swath of what he later decided should have been included in his first book. Anyone who was a fan of that first book (and there were many) will find more here. Written less than two years after *Common Stocks and Uncommon Profits*, this book was originally published just before my father's time teaching the Investment course at Stanford's Graduate School of Business. Here, he details even more of his concepts of what separates a normal stock from a great one, a normal business from a stellar one.

Second, this may be the best single slice on the state of the investment industry and what serious professionals fretted as they peered

into the 1960s. In some ways, it's a history book. Although it wasn't intended that way when he wrote it, that's what it has become. There are few professionals today old enough to have a serious memory of the 1960s. I don't. My memories of that period are through the hazy eyes of a boy whose father talked at the dinner table—and I'm 56. If you're 10 years older than I am and facing retirement, your eyes would have seen more, but at most you would have been a young beginner without much experience, canvassing the landscape as it blurred by you. The 1960s were a very important era in investing. They built a plateau above which equities would have difficulty climbing for two decades. Understanding how investors saw the opening of the decade, from the eyes of one of its top practitioners, is about as important a history book as you can find.

In 2007 my first new book in 13 years, *The Only Three Questions that Count,* was published and became a *New York Times* business best seller. It's based on the notion that much, maybe more than half, of what we commonly know as investing wisdom is demonstrably false mythology. You can know what others don't by learning to find and measure mythology and bet against it. So, I love the dedication to *Paths to Wealth through Common Stocks*:

> *This book is dedicated to all investors, large and small, who do not adhere to the philosophy: Everyone seems to believe it so it must be so.*

This says essentially the same thing in a simplified way. Don't forget, this was long before modern portfolio theory had been widely adopted (a scant nine years after Markowitz created the basis for modern portfolio theory).

He starts out by asking, "Is there any possible excuse for another book on investments?" Now, 47 years later, with more useless investment books than a normal mind can comprehend, it's always a good question. We rarely create more than a couple of really useful and enduring investment books in any year, and many years create none at all.

In Part 1 , he starts with issue number one of the day: inflation. You'll find his analysis here both deficient and prescient all at the same time. It's deficient because he doesn't have in his arsenal the full array of monetarism that Milton Friedman would soon develop and popularize. After all, he was writing this three years before Friedman would publish

his groundbreaking and world-changing book, *A Monetary History of the United States, 1867–1960*. (Moreover, it was years after that before Freidman's 860-page bomb had fully exploded and was absorbed by the world.)

Still, the discussion is prescient—he takes you through a stunningly correct analysis that Friedman would have loved: Why central bank rate hikes and cuts are not necessarily consistent with a monetary policy that controls inflation. He shows you how, in the right circumstances, the Fed raising rates can actually add to inflationary forces rather than dampen them. He argues the Fed shouldn't use rate hikes and cuts as the basis for fighting inflation. Friedman would have agreed completely. Still today we have a world both my father and Friedman disdained, where the prime mechanism central banks use to grapple with inflation is rate hikes and cuts.

Then, counter to Friedman, he paints an inflation picture that basically has the Fed largely subordinate to larger social trends in our society. I believe he is correct. If you view the Fed as a powerful victim in a huge system defined by our social values slowly shifting over time, it makes sense why in some environments the Fed has an easier time and in others a harder one. He predicted, quite correctly, that inflation was here to stay and even accelerate. The 1960s social trends towards more government, the increased spending of aging baby boomers, and shifting morals leading to the desire for higher prices rather than lower—all of this would create a wave of increased inflation. That of course, is what happened.

But he then points out there is opportunity. Although the average stock may or may not offset inflation, a great one will. By taking advantage of normal stock market volatility—timing done rarely, but done well—a single downturn can provide enough bounce to cover inflation for years. It is the closest he ever came to a justification for market timing.

Repeatedly my father justified science and technology as inflation's foes and the investor's friends. This book may be the first to herald the impact of science and technology on productivity, growth, and inflation. Make no mistake—my father was over-the-top on this point all his life. He saw the social pressures favoring inflation as never ending, whereas the efficiency and cost-dropping forces of science and technology were the antidote.

I will not recount his descriptions on this, but they are as valid today as ever. We live now in a world where inflation bears have been wrong because productivity in the last decade has skyrocketed beyond most seers' ability to fathom. What drove that? The same things my father foresaw in this book almost 50 years ago. He was adamant that new plants reduce costs and help fight inflation, while almost anything the government does—including raising short rates—tending to slow the development of new plants with new, cost-reducing technology is inflationary.

He saw unions and science as almost equally potent archenemies, where unions hurt and science helps. He simply couldn't fathom what actually happened, which is subsequently most unionism has withered (outside of government unions, which have grown immensely). Never would he have envisioned a world where government workers would need, want, or be allowed union protection from the government—any more than, as he points out, he could envision a world where the government's job was to ensure you a happy marriage.

His discussion of how taxes affect the stock market was ahead of his time—pre–supply-side economics. It's interesting to see his focus on foreign competition and foreign investing at a time when we presume no one thought about those things. Of course, they did—but you must read this as a history book to know that.

He has a single line that should be pressed into all aspiring rich people's memories. On page 49, he says, "In the first place it is nearly always the rich member of any family that the others envy and dislike." How true, but note how many of us aspire to become the disliked ones. Quite cute! Of course, he is using this in a different context, but it remains true: The way to have your siblings, nephews, and others envy and dislike you is to become much richer than they. Strange we should, so many, so aspire.

In Part 2, his description of Pioneer Metals Corporation is another perfect example of what we all know but never think about. One person, one idea, and the next thing you know, a boring, profitless company and useless stock is transformed in just a few years into an innovative world beater. My father said this theoretical example isn't any one company but a collage of many. Yet, in rereading Part 2 I was struck with how perfectly this example was illustrated a little more than a dozen years later at Nucor.

At Nucor Corporation (NUE), Ken Iverson flipped a near-bankrupt metals company into the world's low-cost producer of steel and, eventually, America's largest steel maker. I was part of that excitement in a small way, discovering Nucor in 1976 and leading an investor group into it—including my father, who held it until just before he died and had profited more than 100 to 1. Nucor's story and evolution over the decades almost perfectly parallels my father's fictional Pioneer Metals Corporation. If you're unfamiliar with Nucor, you are missing one of the great American stories and should read my friend Richard Preston's biography of the company, *American Steel*.

But there are more stories in this book. Just as fascinating is reading what my father wrote about people who transformed their realms. His description of Bill Hewlett and Dave Packard doing a parallel thing in creating Hewlett-Packard boggles the mind, considering the company's market value as my father wrote was a mere $150 million. Had someone simply bought Hewlett-Packard then and held on for a few decades, they would have been made. Texas Instruments is another such company he writes about—all someone would have had to do was buy this book then, buy these stocks, and they would have beaten almost everyone for decades, which by itself is a pretty great story.

In my mind, Part 3 is not my father's best work. There is little that is prescient in any regard, as near as I can tell. Since its original publication, so much has been written on how to pick a money manager that perhaps the chapter's most important concept is how truly primitive the process was in 1960.

But, then, Part 4 is stunning. Had CEOs of the day heeded his advice on mergers, the mess with 1960s conglomerates might have been avoided altogether. He drove nail after nail into the coffin of stupid mergers. He accurately defines and predicts the kinds of mergers that often work well and those that rarely do. Simply said, my father takes you through how acquirers who integrate forward or back or stay within their field of core competency often do well, while those that acquire for lateral diversity rarely ever succeed. Of course, the conglomerate craze of the 1960s was lateral diversity almost purely, and in retrospect gained nothing in efficiency for society. But his nine rules for mergers should be required reading for anyone contemplating either doing a merger or owning companies or stocks that do mergers.

This is particularly appropriate in 2007 as this edition is being released, because of the all-time record level of cash-based stock takeovers.

The section on voting rights in Part 4 shows how silly our current emphasis on corporate governance and shareholder voting is. He was 50 years ahead of his time on this. We took a wrong turn decades ago as a society on this matter (led by politicians, social scientists, and attorneys) and have never come back——much to our detriment.

He hits the nail on the head once again in a timely fashion for 2007 as he shows that politicians and politics aren't what we typically think they are, and that you have no rational basis for getting out of stocks, or even changing the type of stocks you have, because of a shift in power between our two political parties. His focus here is more on shifts in Congress than presidents, so it's particularly useful for 2007. However, he could as well be writing specifically about this year as about nearly half a century ago.

Part 5 is of interest partly for historical study and partly as a standard tool for business analysis. He focuses on then-contemporary industry analysis. On the surface, much of it won't relate to many readers seeking advice about buying stocks today. Most readers will be surprised at how much time he devotes to the chemical industry and will have difficulty seeing why. But in those days, it was a major growth industry and, as he says, was growing at about three times the growth rate of the national economy. But any material area today growing at three times the nation's growth rate gets lots of attention from everyone, so it isn't really surprising chemicals did then.

Chemicals then were a lot like technology is now—the big field that had grown at rapid rates for decades with huge, entrenched players as well as small upstarts trying to break in. He was clear that if you found the right established chemical firm, because of the safety of the growth, you could rely on it for a long time. He points out two in particular, Dow Chemical and DuPont. Today, they are America's two largest chemical companies, and if you bought either then and held them into the 1970s, 1980s, or even late 1990s, you would have beaten the market over that period. DuPont was then America's biggest chemical company and Dow was number five.

My father never mentions by name Union Carbide, Monsanto, and W.R. Grace, the other big independents of the day, but none of them remain in their original form as independent firms. All were broken up,

split off, and sold to others, including pieces to Dow and DuPont. Other smaller but still big U.S. chemical firms of the day, such as Stauffer and Rohm and Hass, have all been gobbled up and taken private decades ago. So the fact that my father concentrated on Dow and DuPont is testimony to his being able to see the longer-term vision—who had depth and who didn't.

My father personally owned DuPont in the 1950s but sold it in the early 1960s after this book was completed. He held Dow until the late 1970s and finally sold it. By the time he sold Dow, it was number three in an industry that had consolidated greatly—now it's America's largest chemical firm. Today the chemical industry is commodity-like and has low growth rates. It largely is and long has been a straight cyclical play.

That might be true for technology in the not-too-distant future. My father didn't talk about technology in Part 5. He talked about the "electronics industry." Then it was the new and exciting area where little firms were slaying giants and becoming giants themselves at a gigantic pace. He discusses two in particular, Texas Instruments and Ampex. The former today is a long-time giant. The latter has disappeared, except in Silicon Valley history, as one of its early bright lights that flickered out.

He describes these areas as high growth with high risk, maybe a bit more like today's biotech than technology. To my thinking, the explosive technology leaders today aren't really leading because of technology (the way biotech firms do), but because of radical and innovative marketing and product design. Whether Amazon, Apple, Research in Motion (makers of the Blackberry), eBay, or Google, these firms aren't fundamental in technology and aren't growing based on their technological innovations. They are instead using technology to address consumer needs through innovative market research and product design and distribution.

Ironically, my father pointed out that success is best made by firms using multidisciplinary approaches linked to sales, marketing, and market research. The firms we have today that are truly based on advancing technology, like the leading semiconductor firms, are basically growing at much slower rates, more like my father's chemical companies. And that is how I would have you see electronics today, much like chemicals in the 1950s. And you should view biotech much like electronics then. Still, in Part 5 you'll see a multitude of tips on what

to look for and how a firm should be run. My father's emphasis was regularly on management excellence. You can learn lots here about how explosive firms should manage themselves versus ones in more prosaic fields.

After devoting time to the pharmaceutical industry, he offers what may be his most prescient advice in Part 5 in his discussions of "Other Interesting Industries." In 1960, he viewed many emergent companies as being on the fringe of industries where there are more differences than similarities—and it is the differences that make the firms appealing. They may as well not be in any industry. He also sees companies creating their own fields inside the then-brand-new field of "services." Today, the services industry is bigger than manufacturing in America, but in 1960, services was largely new and tiny in the realm of investing.

In 1960, almost all investing was in what today we would see as manufacturing sectors. This book cameos A. C. Nielson and Manpower as very recent IPOs with huge potential. And, he focuses on a still fairly new Dunn & Bradstreet. Although seemingly old and boring names today—far from futuristically exciting—these were very hot stocks in the 1960s.

If someone had simply built a portfolio out of the stocks my father focused on in this book, he or she would have done well in the 1960s, far better than the market. They were, in the 1960s, testament to my father's approach, as laid out in *Common Stocks and Uncommon Profits* and embellished further here, in *Paths to Wealth through Common Stocks*. His fundamental view of finding stocks of outstanding firms with outstanding managements that would stay ahead of the competition for years to come by developing the next new thing—stocks that hadn't yet been fully appreciated or accepted by the institutional investing world, so they could later be bid up beyond their growth rate—that is still a valid approach these 47 years later.

Later, after he had completed this book, he devised a line he asked managers regularly. It's my favorite line he ever wrote: "What are you doing your competitors aren't doing yet?" The emphasis was on the *yet*, implying that by so doing they would be ahead of competitors, gaining an edge—or might simply force their competitors to follow. In my life I've applied that line so many times to good usage that I mightily suggest it to you. It's been a guiding light behind all my business endeavors.

What are you doing your competitors aren't doing yet? It's a pretty good thought to reuse regularly and is pretty well seeded throughout this book, if not said exactly that way.

However, as you read this book, you'll see the inherent risk in my father's approach—you can pick the wrong stocks by not seeing the management correctly. The approach laid out here is sound, but its biggest risk is, in my opinion, not just that you might presume a superior management where it doesn't exist, but also that you might see the management correctly when you buy it, but fail to notice that succession management is not as good. This is a very difficult thing to do. In my career, I've done it wrong many, many times. I use a lot of other risk controls today—ones that didn't exist then—to try to keep myself out of too much trouble when trouble arises. That isn't this book—yet I encourage you to embrace more modern risk-control techniques than were available in 1960.

The approach my father laid out is still one of the most basic and fundamental approaches to looking at stocks. That is why his first book has endured and continued selling so long, and why I'm pleased and proud to write the foreword for this re-introduction of his second book. Enjoy!

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The Need for Additional Investment Books

BOOKS ABOUT INVESTING in securities are getting to be like television commercials and crime comics. Most of us think there are far too many of them already. Therefore, before adding still more to the already bulging volume of material that can bewilder the investor with confusing and quite contradictory advice on how to handle common stocks, I gave considerable thought to whether the material presented herein would diminish or would merely add to that confusion. Two years ago, I added one book to this already overcrowded field. I did so because I believed (and still believe) it presented an investment philosophy that needed to be told. The astounding public response to that book vindicated this conclusion. But would adding a second book now do anything more than make the field still more overcrowded? Would it be like adding one more brand of soap when there might be twenty already on the market?

It was primarily because of my experiences resulting from having written *Common Stocks and Uncommon Profits* that I have come more and more to the conclusion there is a basic need for a book such as this. That book summarizes not only the method by which worthwhile profits have been and will continue to be made through common stock ownership, but the policies which I believe will make

by far the greatest profits at the least risk. That book primarily attempts to do two things. First, it shows how the investor (or his adviser) can determine the occasional company with outstanding management that is likely to provide the vehicle for tremendous increases in market value over a long period of years. Second, it indicates when the shares in such unusual companies may best be bought and the much rarer situation when a stock that has been well selected in the first place should be sold.

Ever since my earlier book was published I have been hearing from investors all over the country. From these inquiries, repeated again and again, I have, I believe, been given an unusual insight into the type of additional information a tremendous number of stockholders and potential stockholders desire.

Their inquiries fall into two broad classifications. One of these is how to apply my philosophy of investment (or any philosophy of investment for that matter) to the specific conditions we will be facing in the period ahead. How significant, for example, is this matter of inflation, and what should we do about it? What about foreign competition and the prospects of investing abroad? Which will be the best industries for investment? The first and last sections of this book are largely devoted to answering such questions and to show how the investor can gain rather than be hurt by the powerful but quite divergent influences that in the years immediately ahead will cause some stocks to rise spectacularly, while others to disappoint the high hopes many now have for them.

In the second classification, a very large segment of investors seem to recognize something I accentuated heavily in my prior book: That highly profitable handling of common stock investments requires both a degree of knowledge and an amount of time that only a minority possess. Most investors, therefore, quite correctly want to go to an expert. From every adult age group and from people varying from the most modest means to some of extreme wealth, I am repeatedly asked this question: "How do I find an investment man in whom I can place real confidence?" I find a tremendous lack of basic understanding of the strengths and weaknesses of the various subdivisions of the investment business. Yet it is this background knowledge that will most help such people find the man they are seeking. To answer this type of inquiry, I have included the section: "You and Where the Investment Business Must Go." To this basic background knowledge, I have added the five

steps which, in my opinion, an investor might take to select a suitable type of investment connection. Finally, I have indicated my views of what lies ahead—and why—and the road investment houses must eventually take to improve what they are now doing in this all-important function of offering sound investment advice.

To these I have added two smaller sections covering certain investment concepts concerning material which an abnormal amount of investor confusion still seems to exist. I believe one of these, in which I describe how the greatest increases in stock values come about, illustrates one of the most important matters in the entire field of common stocks so far as making important profits are concerned. Yet it is something concerning which nine investors out of ten seem completely unaware.

As in my other book, I have used an extremely informal style of presentation. I address you, the reader, in the first person, presenting many of these principles in almost exactly the same language and illustrating them with examples and analogies that I have used to make identical matters crystal clear to the few large investors whose funds it is my sole business to manage.

However, if I have tried to express myself in simple, everyday language, I have not tried to oversimplify the concepts I present. Such oversimplification results in making it seem quite easy to master the art of handling common stocks, but also results in the investor failing to get the benefits he anticipated, because the rules he was given were so simple they only fit some of the facts and not all of them. Before the publication of my first book, I was told I had thrown away all chance of making it a "popular" success, because by describing all the things that are needed to uncover outstanding investments other than by accident, I was describing something anybody and everybody obviously could not do at the drop of a hat. Yet the overwhelming public response to that book convinces me beyond a shadow of doubt that an important part of the investment public is tired of oversimplifications which, when put in practice, do not seem to work out as they should and welcomes a more complex treatment that describes investment matters as they actually are.

Again, as in my prior book, I have not hesitated to express what I believe to be the best financial course simply because some of the things I advocate run either partly or totally contrary to the generally accepted

financial thinking of the moment. In the first edition of *Common Stocks and Uncommon Profits* I stated "There is a considerable degree of twisted thinking and general acceptance of half truths about a number of aspects of common stock investment. However, . . . in regard to dividends this confusion is little short of monumental." Now, only a little over two years after those words were written, there have been a number of rather spectacular stock market examples which confirm the points I made then on this subject. The false views that were so widely accepted only two years ago are already beginning to fade. Similarly, I am well aware that in a number of places in this book I have taken stands quite at variance with much of what I consider the easy and slipshod notions that are almost universally accepted by the financial community at the moment. My comments on the utter folly of the present "tight money" policy of the Federal Reserve Board as a means of fighting inflation, on investment trusts, and on the wisdom of making foreign investments, for example, are but a few instances of this. I can only point out that time and again, in matters of investment, the many beliefs that almost everyone accepted as a matter of course and without further thought have proved wrong, and those who thought the matter through to the right answer have been richly rewarded. Just two years of turbulent stock market history seem to lend strong confirmation to the soundness of the very points at which those who always blindly accept the popular view of the moment most raised their eyebrows when my other book first appeared. In comparable fashion, I leave passing judgment on the soundness of the views I am now presenting to the future and to you.

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December 1959