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# Growth stocks-fact or fancy

Arthur Grey Staples Jr.

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**GROWTH STOCKS--FACT OR FANTASY?**

by

**Arthur Grey Staples, Jr.**

**Thesis submitted to the Faculty of the Graduate School  
of the University of Richmond in partial fulfillment  
of the requirements for the degree of  
Master of Science in Business Administration  
1962**

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## INTRODUCTION

### HOW DOES ECONOMIC GROWTH CORRELATE WITH STOCK GROWTH?

Often in business articles the following remark may be seen: "If a company is not growing, it is retrogressing; for no business may stand still!" The sagacity of this observation with regard to individual enterprises cannot be stressed too frequently nor too strongly. Yet this truism becomes even more appropriate and apparent when applied to a nation's economy. Although this paper deals primarily with common stocks, seldom can any part of a nation's economy move independently of the total trend. Therefore, a few explanatory remarks regarding the United States economy as a whole are in order.

Even a passing acquaintance with history makes clear the concern man has always had with raising his standard of living.<sup>1</sup> In his eagerness and efforts to increase the quantity (and quality) of the goods and services in circulation, twentieth-century man has developed a veritable maze of distribution channels through which a flood of enticing and labor-saving goods and services flows, propelled by the unrelenting pressure of invested dollars. A very complicated economy has developed, with much at stake for both the consumer and the investor.

Therefore, it is neither surprising nor inconsistent that the measurement and prognostication of the direction, magnitude, and growth of the

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<sup>1</sup>"Standard of Living," Encyclopaedia Britannica, XI (1961), p. 308. The subject of standard of living is interestingly discussed here. It is defined as a convenient way of expressing the kind and quantity of goods and services one individual (group or nation) enjoys relative to those enjoyed by another (group or nation).

United States economy has received the attention and concern of so many.<sup>1</sup> It should be pointed out that this concern is universal due to the stake the whole world has in the success or failure of the United States.

Either to dwell on the formidable array of statistical indicators that are used to measure the progress of the United States economy,<sup>2</sup> or to review extensively the many forecasts made for the future of the economy,<sup>3</sup> would be digression for this thesis. However, the investor must not interpret this statement as a dismissal of these areas as unimportant ones. It is imperative that he be aware of cyclical variations in the economy's past and with the nature of the current trend of business. In addition, he must be cognizant of the areas of activity that are considered significant indicators and with forecasters' predictions for their future.<sup>4</sup> For any general growth comparisons made in this paper, the gross national product alone will be cited since, "it is probably the most widely used

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<sup>1</sup>This question is paramount in the minds of most leaders and captains of industry in the United States. One of the most complete and informative studies in the area was just completed by the Commission on Money and Credit. The report is available in book form under the title, Money and Credit, from McGraw-Hill Book Company, Inc.; "Setting Growth Goals," Business Week (November 18, 1961), p. 34.

<sup>2</sup>To somewhat comprehend the extent to which the economy is measured, one has only to pick up a copy of the monthly publication of the Department of Commerce, entitled, Survey of Current Business.

<sup>3</sup>A compendium of these reviews may be secured from the Federal Reserve Bank, under the title of Business Forecasts (1962).

<sup>4</sup>Frequently, indicators are broken down for forecasting purposes into three groups: "leaders, laggards, and coinciders." An interesting article on this subject appeared in the Management Review (April, 1959), p. 19; The American Institute of Economic Research, Great Barrington, Massachusetts, also has many articles on this subject.

measure of total economic activity (growth) and is the statistic which most business analysts use to express their predictions for the business cycle."<sup>1</sup> There appears to be general agreement among business forecasters that the growth which the United States economy has experienced in the past should continue into the indefinite future. (Some even see an accelerating rate due to the all-significant population explosion.)<sup>2</sup>

Therefore, an investor may well be curious about obtaining a means for imitating this historic growth pattern, especially in light of the forecasts for the future. It is reasonable to expect many United States corporations to share generously in this future economic growth, others only moderately or not at all. It is almost a certainty that investors whose portfolios contain stocks of corporations which will most bountifully participate in this growth, will enjoy proportionate returns on their investments. The real problem for the investor and the crux of this paper lies in discovering how to identify these growth companies' securities and in deciding how much can be reasonably paid for their growth prospects.

At this point, though, the investor is probably questioning his ability to be able to buy these securities in the future. He sees that the economy is rising, but rightly asks whether his income will also rise. The most often quoted statistic for measuring the income of John Q. Public is personal income--constructed and presented from data gathered by the

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<sup>1</sup>Federal Reserve Bank, The Monthly Review (February, 1962), pp. 6-7. An excellent article on the composition and significance of the gross national product from which this sentence is quoted.

<sup>2</sup>Henry Steel Commager, "The Enormous Increase in Population in the United States and in the World," A Report Prepared for the Committee for Economic Development (January, 1958), p. 345.



United States Department of Commerce.<sup>1</sup> Personal income has risen from an annual rate of approximately \$275 billion in 1954 to an annual rate of approximately \$425 billion in 1961. There is no reason to believe that this upward trend will falter in the near future, with the continued pressure of labor unions, coupled with the demands for more highly skilled workers (and consequently more highly paid) from an expanding industrial fabric. Even more significant, for the purposes of this paper, than the amount of money that wage earners receive, is the amount that they do not immediately spend. This amount is represented by the savings element.<sup>2</sup> The rise in savings from approximately \$18 billion in 1954 to approximately \$28 billion in 1961, indicates: (1) that people are able to achieve a satisfying standard of living from their incomes and still have excess funds, and (2) that there is a potential power which may be routed to goods and services or channeled into investments. If the wage earner continues in this savings bend, he should become aware of how best to make these savings work most effectively for him.

A logical question now is whether wage earners currently are selecting common stocks for saved earnings. The New York Stock Exchange conducted the most recent study in this area, using transactions which occurred on that exchange during one day.<sup>3</sup> This study showed that institutional investors (banks, insurance companies, mutual funds, etc.) continued to grow

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<sup>1</sup>Federal Reserve Bank, Federal Reserve Chart Book (1961), p. 52; Survey of Current Business (December, 1961), p. 12; Federal Reserve Bank, Monthly Review (November, 1961), p. 5.

<sup>2</sup>Federal Reserve Bank, Federal Reserve Chart Book (1961), p. 46.

<sup>3</sup>New York Stock Exchange, Eleventh Public Transaction Study (September 13, 1961).

in importance. Their proportion of total sales purchased was 22.6 percent (1,936,000 shares) compared with 24.3 percent (733,745 shares) in September, 1960, and 24.6 percent (329,190 shares) in September, 1952. Public individuals accounted for 51.4 percent (1,557,125 shares) which is substantially the same percentage as in years past: 52.6 percent (1,467,990) in 1960, and 57 percent (649,397 shares) in 1952. The real importance of these statistics lies in the increases in the number of shares traded, and the increased number of individual shareholders represented. The last census of shareholders was made in 1959,<sup>1</sup> at which time 12,490,000 individuals owned shares in publicly held corporations. The Brookings Institute made a similar study in 1956<sup>2</sup> at which time 8,630,000 individuals held shares. The current (January, 1962) estimate is 15,000,000.

Several significant conclusions may be drawn from close study of these statistics. The increased purchases of common stocks by institutional investors attests to the fact that common stocks have gained investment stature. Institutional portfolio managers realize that common stocks have a large part to play in maximizing investment returns, while still maintaining an acceptable level of risks.<sup>3</sup> The above quoted figures also appear to indicate that an increased number of private investors have decided that common stocks offer one of the best routes for achieving their investment goals.

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<sup>1</sup>"Shareownership in America," New York Stock Exchange (1959).

<sup>2</sup>George Leffler, Stock Market, Ronald Press Company (1959).

<sup>3</sup>"Fund Managers Break Rank," Business Week (February 17, 1962), p. 110. Although there is agreement in principle, quite naturally there are differences in the extent.

In light of the foregoing, the incentive, the funds, and the precedent all seem to be facing the discretionary income-holding investor with the question: "What is the nature of growth stocks?" Can he select a security that will equal or better the future growth rate of the United States economy and that will grant him an estimable and adequate return?

This paper will not offer recommendations for particular issues. Growth stocks will be examined only to determine if a form of value analysis can be performed to reduce the stock's future growth prospects to an objective and tangible concept. This will be done for the benefit of the investor who decides that growth stocks are the means which will best achieve his investment goal.

#### WHAT IS THE PLAN OF THIS PAPER?

Certain sound investment principles concerning personal finances and investment portfolio management will be assumed as immutable; for example: (1) all investors must provide adequately for family needs, and segregate funds for the market place as truly discretionary income; (2) the investor should know within rough limits the nature (if not the percentage) of the return he desires from his portfolio; (3) he should desire to practice diversification of holdings in his portfolio; and (4) he must wish to move into the market only after thoroughly investigating the potential and risks surrounding a market opportunity.

This discussion must not be construed to be a disparagement of more conservative approaches to investment. Investors' goals, needs, and attendant financial resources must be matched and will often dictate a

reserved investment policy; e.g., the widow who needs immediate and current income. Usually, limited resources preclude growth stocks from these portfolios, since by their nature growth has to occur before much "harvest" can be reaped. Also, as will be seen, greater risks to principal are generally incurred in dealing in growth stocks. Growth stocks are being recognized merely as a current force, and consideration of their merit is given for investors whose goals are in harmony with the character of such investments.

After further documenting growth stocks and their attractiveness in Chapter One, definition of growth is offered in Chapter Two. Indications of growth are reviewed and examined there also, as they might appear in a corporation's profile. Chapter Three is concerned with discussing methods for ferreting out the risks inherent in the growth corporations and their stock issues. Then, the subjective task of balancing the risks observed against the return potential seen is undertaken. Chapter Four is concerned with reducing this balancing process to a mathematical exercise that will make the process more objective. The final chapter will be a summary of the preceding four and an attempt to stress the dangers inherent when human judgment determines whether or not money will be made.

## CHAPTER ONE

### IS GROWTH REALLY A FACTOR IN STOCKS?

When one thumbs through nearly any business periodical, he is likely to run across an article discussing common stocks or the stock market. Some of these articles discuss technical aspects of the market; some describe market mechanics; currently, some revolve around a phase of the Securities Exchange Commission investigation; and many will probably be concerned with the question of how one decides which stocks offer the best profit potential for investment in the near future. Frequently, an article concerns itself specifically with growth stocks.<sup>1</sup> This interest in stocks, plus their relationship with the growing economy noted in the introduction, justifies a further examination of growth in stocks.

The majority of investors define growth for a particular stock in terms of market price increases. For this reason, many services attempt to chart the growth of the stock market as gauged by market price aggregates. These figures are statistically adjusted aggregates of some 33 to 425 issues,<sup>2</sup> depending upon the particular service observed. Some of these services and

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<sup>1</sup>Lelean E. Drake, "Are Analysts Techniques Adequate for Growth Stocks?" Financial Analysts Journal (November-December, 1960), p. 45; "Those Delicious Growth Stocks," Fortune (April, 1959), p. 32.

<sup>2</sup>This allusion highlights an area which is not central to this paper, but should be noted. Much criticism and praise surrounds these measures. The Dow-Jones Industrial Average is probably the most widely known and frequently cited. Standard and Poors 425 and the New York Times averages are also well known. Two extensive articles concerning one average (pro and con) may be found in The Financial Analysts Journal, (March-April, 1961). They are written by Charles J. Collins, "The Dow-Jones Industrial Average," and Nicholas Molodovosky, "Dow-Jones Industrials: a Reappraisal."

their charts are familiar to even the cursory reader of business articles or of the financial pages of almost any daily newspaper. A glance at any one of these services reveals the general growth of stock market prices since World War II. But, how may an investor see this growth stated in clearer and more familiar categories?

A recent issue of the U. S. News and World Report included a pertinent article entitled, "What Investors Need to Know."<sup>1</sup> In the article was a chart showing the performance of stock prices, by industries, in 1961. This chart directed the investor's attention to the issues which, as measured by market prices, have grown most rapidly. It is an excellent example of a tool which an investor might use in his efforts to delimit stocks through the use of categories into a manageable number of candidates for investment consideration.<sup>2</sup>

Yet, when the stocks of an industry as a whole have enjoyed growth at a certain rate, the growth of market prices for the stocks of selected companies within the industry have not necessarily grown at the same rate. Examples of this condition abound. A familiar one for 1961 is International Business Machines. Business machines as an industry had 47.7 percent rise in market price, but International Business Machines' market price rose only 35.8 percent. (Low of \$447; high of \$607) Consequently,

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<sup>1</sup>U. S. News and World Report (January 3, 1962), p. 53.

<sup>2</sup>Another example of important point-categorizing which facilitates investment opportunity appraisal appears in the U. S. News and World Report (August 21, 1961). This chart shows in percentage, by industrial classes, stocks whose market prices were still below earlier peaks.

although a certain industry may enjoy growth in general, an investor will not necessarily reap a proportional harvest. His investment must have real growth, be attractive to other investors (offering liquidity), and, most important, must be bought at a reasonable price. A real problem lies in selecting such stocks which will grow most rapidly before their growth is over-discounted in their market prices by demands of other investors.

The investor should observe that although growth comes in many sizes--slow, moderate, spectacular, or even no growth<sup>1</sup>--this quality exists, and its inherent profit potential almost magnetically attracts study for better definition of its nature.

#### WHY IS GROWTH ALLURING TODAY?

It is somewhat axiomatic to the field of investments to say that the only two ways in which gain may be realized from an investment are through current income (i.e., rent, dividends, interest, etc.) or through appreciation of the market price, often called capital appreciation. Many good investment opportunities allow the owner to realize his profit from both sources; however, one or the other is generally selected at the outset to furnish the primary source of profit. In the field of securities, current income would be in the form of dividends from stocks or interest from bonds. A rise in the security's market price would give capital appreciation, if sold.

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<sup>1</sup>The sales and/or profits of some companies remain almost static throughout a year, and therefore, qualify as no growth situations. This point is discussed in an article by Burton Crane, entitled, "Value of Growth in Stock Weighted," which appeared in New York Times (April 10, 1960).

In recent years, the yields on common stocks have been very low.<sup>1</sup> For the last quarter of a century, yields in the Dow-Jones industrial grouping have not dipped below 3 percent (except for a very brief period in mid-1959 and again the summer of 1961). Yet it should be noted that yields were 6.48 percent in 1950, and that they have fallen each year since then--to a 1961 low of 3.03 percent. In light of these figures, it appears that investors are not presently looking to current income from their stocks for their investment return to the degree that they had previously. Another fact from the study by the New York Stock Exchange (noted in Introduction) appears pertinent at this point.<sup>2</sup> The September 13, 1960, study showed that 62 percent of the shares bought by the public individuals were for long-term investment. This compares with 60.8 percent in 1961 and 55.6 percent in 1955. In light of common stock's current yields, these holding-period figures lend evidence to the argument that investors are looking more to capital appreciation than to dividends for their return.<sup>3</sup>

From the foregoing observations, the logical question would be: why, as evidenced by the increased stock sales, are many investors

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<sup>1</sup>"Dividend Yields on Stocks Near Low of 30's as Market Rises to Another New High," Wall Street Journal (December 14, 1961), p. 3.

<sup>2</sup>"Eleventh Public Transaction Study," (September 13, 1961), conducted by the New York Stock Exchange.

<sup>3</sup>In truth, this is not the only conclusion that may be drawn from these figures, since investors who are holding stocks solely for income would be included in this group also, but in light of low current yields, the conclusion is sound.



apparently looking eagerly toward future growth and capital appreciation for their investment returns? Several conditions exist today that make investors who do not need current income for living expenses willing to look to the future.

The corporations, especially industrial giants, have come of age and respectability in the eyes of the average investor. With the additional strength of the government's watchful and regulatory eye over business' shoulder, serious fraud is minimized. The increased stature of corporate securities was mentioned in the introduction of this paper, but the fact plays such an important role in this story that it merits this sentence of repetition.

The personal income tax, currently at almost onerous rates, takes such sizable chunks from an individual's current income that the deferring of income to another taxable year will have beneficial results in most instances. This is especially true with the favorable capital-gains treatment provided by the Internal Revenue Code.<sup>1</sup> It is noteworthy that the six-month holding period necessary to qualify income for capital gains treatment ties in reasonably with the holding-period intentions of investors for securities noted by the New York Stock Exchange study.

Inflation, the insidious enemy of the dollar's purchasing power, is still another factor that has made investors find capital appreciation the most enticing form of return on invested funds. No attempt to discuss it fully will be made here; but the catastrophic effect that it has had on the

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<sup>1</sup>Internal Revenue Code, Section 1201.

purchasing power of the dollar is a matter of record. Inflation has motivated many investors to protect the current purchasing power of their saved dollars by investing in securities that promise future capital appreciation. Every investor has this formidable problem of protecting the purchasing power of his earned dollars. He must recognize the dangers of inflation and observe how capital gains might aid in solving his dilemma.

Because of these significant reasons for considering capital appreciation as the bulk of return on any investment, growth stocks are now the real elements in the investment world. There is also evidence that more investors are taking this route to investment return. Because of this, a study of growth stocks to discern true value will be helpful in this quest for capital appreciation on invested funds.

## CHAPTER TWO

### WHAT IS GROWTH?

In the first chapter it was stated that growth, as measured by market price increases, has occurred at various rates throughout the stock market listing in recent years. It was also noted that many investors apparently are buying stocks that offer future growth prospects in the hope of obtaining investment return in the form of future capital appreciation.

To this point, no complete definition has been given for the cause (growth) of these effects. When one speaks of a stock as a growth stock, if he will analyze what he is envisioning (beyond the market price), he will perceive that he has really decided that this stock's market price will appreciate in the future due to growth factors that are intrinsic to the stock. He believes that when these factors come to fruition, other investors will bid up the price for the privilege of owning a share of this stock! For these reasons, before any further discussion of growth stocks can be engaged in, growth must be examined for a definition.

In 1960, Business Week carried an article concerned with growth in a general sense; it likened growth for an economy unto the development of the physical stature of a child into the body of an adult.<sup>1</sup> The thrust of this article was that many unseen processes are working diligently and untiringly to evoke only a gradual outward evidence of growth. This is somewhat like the real growth prospects an investor should seek.

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<sup>1</sup>"The United States Invents a New Way to Grow," Business Week (January 23, 1960), p. 52.

Before examining this matter more closely, it will be beneficial to cite a few growth patterns that must not be confused with real growth. Spurious growth (for this thesis) would be growth of market prices brought about by making a bargain purchase, or through a properly-timed purchase. Examples of these types of purchases abound, but not as often as "tips on the street" would lead prospective investors to believe. For instance, occasionally a company's stock may be selling at a market price below the per-share value of its assets. This bargain-purchase situation may be bought with hopes that other investors will notice this situation and subsequently, through the effects of demand, bid up the market price. Or, possibly, the investor feels that the unglamorous situation that apparently (judged by the market price) besets the company will soon be corrected.<sup>1</sup> He may buy the stock due to these convictions, or he may even buy the stock at this depressed price in expectation of realizing a profit through liquidation. Also included in this category of bargain hunting would be purchasing stock to make a profit on the market impact that the announcement of certain corporate news will have.<sup>2</sup>

This does not mean that all of these and similar market positions are not advantageous, and even desirable, for an investor; but, the point is that these positions ought to be "in addition to's" for stocks that have sound basic growth potentials, or value. This basic value is of

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<sup>1</sup>Some market pundits consider Chrysler Corporation a possible current candidate for this situation since the "shake-up" in top management appears completed.

<sup>2</sup>Revlon, Inc. was an example of a stock that was affected this way; with the announcement of "Eterna" (face cream) the market price went from \$61 to \$85 in a matter of weeks.

primal importance because the investor will have nothing with which to "bail himself out," and he may well suffer a heavy loss if the market price situation that makes a stock a bargain purchase does not materialize and there is no basic growth value in the situation.

Therefore, the growth potential to be sought will come from the adroit applications of labor and materials by skillful, capable, and imaginative management, and be manifested by ever-increasing corporate earnings. Merely increased sales--without the maintenance of profit margins--will not give increased earnings! Quite often, increased sales figures are pointed to as prima-facie proof that a company is growing and is a desirable investment opportunity--this just is not so!<sup>1</sup>

#### HOW CAN GROWTH BE IDENTIFIED?

This question still faces the investor: how can the stock of a company that has these desirable growth qualities be discerned? In answering this question, an investor would be well advised, first, to glance at the gross national product and observe areas that are sharing greatly in this \$555 billion annual spending spree. It will be observed by glancing at a breakdown of the gross national product that non-durables, especially services, are receiving an ever-increasing number of dollars from the public. Consumer expenditures represent the largest part of the gross national product, accounting for approximately two-thirds of the total in recent years. Secondly, the investor should recognize that

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<sup>1</sup>"A fresh Look at the Role of Profits in Company Growth," Business Week (February 27, 1960), p. 94.

stocks themselves can be divided into three helpful categories: (1) ones which relate to money rates, (2) ones of companies with cyclical sales patterns, and (3) growth stocks. These variations must be kept in mind when brooding over risks inherent in stock evaluations. These divisions exist, and an investor must not lose sight of these forms while studying their shadows, the individual companies. The value of having broad ideas regarding industrial stock interests and the rates at which money is being funneled thereto, lies in aiding estimates of what the future may hold for a certain industry or company.

With these general thoughts in mind, an investor must now decide what areas to examine behind the stock in the company which he feels might have growth prospects. In examining the influences that must be considered before drawing conclusions regarding a company's growth prospects, it will be helpful to divide these influences, somewhat arbitrarily, into external and internal ones.

The importance of management is not included in either the external or internal category. At first blush, management might appear to be strictly an internal influence. Upon examination, however, it will be noted that the caliber of management to be sought must make decisions conscious of and within the matrix of both areas, and perceive how each influence will affect the total corporate strategy. The quality of its management is the most important single element in any company. It is also the most difficult to evaluate. Management must skillfully direct the utilization of the company's assets of capital, labor, and tools for profits to be realized. Maximum earnings can accrue only through the optimum utilization

of these assets.<sup>1</sup> Skillful, cost-conscious, and imaginative management can compensate for marginal assets, but seldom can a surplus of fixed assets offset marginal or weak management.

External influences are those elements in and through which a corporation must operate and distribute its product and which, therefore, bear upon the earning potential of the corporation. Only by reasonable and thorough analysis of these, as well as internal influences, will an investor be in a position to decide intelligently how a particular corporation will fare, relative to competitive investment opportunities. External considerations to be observed and weighed will vary widely from industry to industry, from geographic location to geographic location, and from company to company. The most important external influences revolve around the general economic outlook referred to in the introduction. An understanding of economic forecasts and statistical measures is fundamental to any sound stock decisions. Integral with this, and equally as fundamental, is a general grasp of governmental intentions (especially federal) with regard to expenditures and business legislation (tax, import, export, duty, labor, commerce, etc.).

Once familiar with these general influences, the investor should turn his attention to the particular stocks which he wishes to study and then, one by one, study them more closely. State and local governmental influences on the particular industry or company under study will still

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<sup>1</sup>As expenses mount, putting more of a squeeze on profit margins, management is becoming more concerned with more accurately determining this point. An expansion of this point may be found in "Return on Investment Concept and Corporate Policy," National Association of Accountants Bulletin, L. Millard Gelvin, July, 1961.

be in the category of external influences. These will be more significant if the industry is a regulated business; i.e., a utility or a financial institution..

Last, but not least in this external grouping are general industrial influences. Some of these will be listed, but not commented upon extensively:

- A. Is competition aggressive, intense and plentiful?
- B. Does industry live on governmental and/or defense contracts?
- C. Is the industry generally regarded as glamorous (electronics) or sick (railroads)?
- D. Are earnings customarily plowed back into research and development and therefore hidden by accounting entries? This is critical because plowed-back earnings, if well used, tend to maintain growth into perpetuity.
- E. Are consumer-acceptable substitutes, which will drastically affect the industry in the future, entering the market?

Consideration of these questions is essential for grasping the scope of external influences that will buffet the corporation being examined.

The internal influences are numerous and more individualistic for each company and, therefore, require more research for adequate answers than do external influences. The extent of this examination will be limited by the availability of information, the ability of the investigator, and the time available for investigation. The objective here is to discern the major trends and pick out any particularly exciting ones. The extent and depth of analysis applied to each situation is as critical a judgment for the investor as any other since all prospects will be relative to the security's market price, and this probably means daily danger--"Time is money!"



Again, a few important areas to observe will be mentioned, but not extensively commented upon:

- A. What has the history of earnings been? What is their current trend? Does the future appear rosy? Is the gross and net profit margin holding up, increasing, or decreasing?
- B. What appears to be the future sales return? The sales history must be viewed and then projected into the future. If the company (or industry) is plagued by a seasonal pattern, the secular trend must be discerned.<sup>1</sup> (Only the secular trend is concrete enough for prognostications.)
- C. From the sales study, it must be discovered which product (or subsidiary company) is profitable and which is not. If the future of the company hangs on one product, and that product accounts for only a small part of the total sales, the future of the total company, especially its stock, would be doubtful.
- D. Cash flow has been emphasized in recent years as a significant guide to the value of an investment.<sup>2</sup> The investor should compute this amount and observe how many times said amount the market price asks him to pay. The investor here is paying cash for cash!

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<sup>1</sup>Secular trend is a familiar statistical concept which simply means the real trend, either upward or downward, after adjustments are made for seasonal and cyclical factors. It is important to observe this trend because an investor clearly can afford to pay more for sure secular growth than he can for merely transitory, seasonal, or cyclical growth.

<sup>2</sup>"Cash Flow is the New Fad," Business Week (November 4, 1961), p. 135.

- E. What is the future, in general, for the company's major products? The answer to this question must be gauged by consumer whims, social mores, and social trends. The classical economic example of the fate of the horse's collar with the advent of the automobile points up the risks here.
- F. The company's annual profit and loss figures should be studied closely to determine if there are any non-recurring profits or losses included in these figures. Such items might be insurance casualty loss payments or tax assessment. These could badly debase any profit projections.
- G. How do the balance sheet and operating statements stack up against those of the industry?<sup>1</sup>
- H. Does the company have a strong patent position? (Polaroid<sup>2</sup> is an excellent example.) What are the future risks here?
- I. How much research and development has been and is being carried on? How productive has it been?
- J. How difficult is it for new companies to enter the competitive field? (e.g., the steel industry, automobiles)
- K. Does the company appear to be geographically locked in from its markets? Are the markets stable, falling, or increasing?

All of these questions and many more must be thoughtfully answered in order to reach sound judgment decisions regarding the growth possibilities of a particular company.

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<sup>1</sup>Statistical comparisons are available from such services as the Robert Morris Associates (National Association of Bank Loan Officers and Credit Men, Philadelphia, Pennsylvania) in their publication, "1960 Statement Studies."

<sup>2</sup>"The Magic That Made Polaroid," Fortune (April, 1959), p. 125.

At this juncture, the investor should have some firm and maybe even glamorous notions regarding the growth and profit potential of the stocks in several companies. He probably recognizes that the projections he has made for the company's earning power, probable dividend policy, and market price rises for the stock are all human decisions. But, he feels convinced that his analysis has been thorough and that growth will occur.

In order to decide definitely how much he may intelligently pay for these prospects, he must compress all of these factors into an estimate of the future earnings of the company, expressed in dollars per share. In thinking about this task, the investor will undoubtedly begin to think about the fact that, so far, no really negative aspects to this investment opportunity have been mentioned. Where are the risks that frequently are attributed to the practice of investing? These elements are the consideration of Chapter Three.

## CHAPTER THREE

### HOW IS RISK IDENTIFIED AND MEASURED?

In considering the risks encrusting a particular security offering, an investor should utilize rather arbitrarily contrived categories to organize his thoughts. As a suggestion, two broad, but interdependent divisions or risks will be submitted: (1) market and (2) business.

Market risks refer to those in and around the stock market bazaar itself. One area of risk, alluded to earlier, lies in the effects created by the large numbers of shares that are bought and held by institutional investors. Institutional investors, especially mutual funds, have large quantities of money to invest from the funds of their depositors and/or participants. These funds must be promptly and regularly invested in order to comply with the fund's statutory obligations and to earn the money needed to pay dividends and expenses. Therefore, when these institutional investors culminate studies into a market move, a sizable number of shares are either bought or sold, and frequently the impact is great enough to create market price fluctuations in these particular issues. The size of institutional holdings has definitely had an effect on market prices, due to limiting the number of floating shares of certain stocks.

This drying up of supply, especially as demand has increased, has affected stock market prices true to the axiomatic principles of supply and demand. This supply and demand situation has been compounded by corporate reluctance in the introduction of new equity issues,<sup>1</sup> again, while

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<sup>1</sup>This reluctance has been due to the favorable tax treatment of interest payments, as opposed to dividends which have to come from after-tax earnings.

demand has increased. One effect of these situations has been the tendency to create a generally higher level in all stock market prices. This supply shrinkage and attendant general price rise is clearly a risk and could become even more so in the future, as these forces continue virile and volatile.

A second formidable risk of the market place will be called stock fashions. These movements develop centrifugally from a discovery by certain stock market analysts, causing groups of investors to decide that a certain industry's, or company's, stocks are particularly valuable because of their growth potentials relative to their current market prices. This condition may be due to a multiplicity of causes, such as the discovery of a new process (e.g., Technicolor Corporation in 1939 or Polaroid in the late 1940's and early 1950's), defense and corporate spending patterns (e.g., electronics in general; International Business Machines in particular, in the 1950's and 1960's), or merely the rediscovery of plodding, but sure growth (e.g., utility and bank stocks in the 1950's and 1960's).

The risks inherent when a stock becomes glamorous lie in paying too dearly for the envisioned growth. The fickle stockbuying public may become disenchanted with this industry quickly, and if the stock does not have recuperative powers through strong real growth, the holder of the security will suffer loss.

A third market risk of which investors should be cognizant is the limited marketability of certain issues. In all the foregoing discussion regarding growth of market prices for stocks and potential profit possibilities, it has been implicit that the investor would have a ready sale when he decided that his profit was satisfactory or when he needed the

invested funds for other purposes. If the stocks in question are traded on a major exchange (New York Stock Exchange, American, etc.), a ready buyer, providing the desired liquidity, is virtually always available. But, if the shares are in a closely-held corporation,<sup>1</sup> sale problems can be manifold. Investors must consider this with every purchase,

There are many other risks involved in the market place, especially with regard to specific and specialized trading techniques; but, the points mentioned appear to be the major market considerations with which any investor should be thoroughly familiar and for which he should be watchful. Before a particular market move is made, an investor should observe his choice carefully to discern if specialized market risks are peculiar to this investment.

Business risks, as here broadly defined, are the mirror images of any or all of the favorable trends and qualities which first attracted the investor to the particular corporation's stock. These were noted in Chapter Two; therefore, there need be no lengthy itemization of these trends (either external or internal) or reiteration of the obvious fact that the risks lie in these trends reversing their positive patterns. But, a few statements regarding the extremely important quality of management will aid in clearing this point of risk. This will point out that all business risks are inversely proportional to the ability of the company's management. Management should immediately observe all reversals

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<sup>1</sup>See the American Appraisal Corporation's booklet entitled, "Valuation of Closely Held Corporate Stocks," by David Glunt. Frequently, losses are suffered due to "thin-market" situations (where an investor holds a few shares of stock in a closely-held corporation which has a small number of outstanding shares). If a major holder dumps his shares on the market, the few investors who might seek shares will be quickly satisfied. This will cause demand to drop and correspondingly wreck the market prices, creating a loss for the small shareholders.

and new problems. If management is really perceptive and robust enough to make corporate earnings dramatically grow, these changes will be compensated for through immediate and direct action. The answer to the question of why some companies fail and others do not must be laid at the feet of the company's management. When an investor is scrutinizing a corporation behind any security, he must note carefully all phases as indicators of management's foresight, ability and attitude (or lack thereof). For instance, a corporation's dividend policy or its capitalization (leverage) policy will give some insight to the attitude management holds toward stockholders. This attitude is critical because the investor will quickly pass the stock of the company by if he observes historic, unrealistic payouts of earnings by the company as dividends; and/or foresees little corporate expansion, earnings growth, or other factors to induce future growth. (Later reference will be made to this point.) If enough investors assume that management does not have foresight or concern for stockholders, and they do not hold or buy--the stock's market price will fall out of bed--collapse!

Therefore, when an investor examines a corporation in order to decide its future and the future for its stock, he must carefully study characteristics to discern risks. Then he must mentally sum all risks. It may be apparent at this stage that the risk in the situation far outweighs the growth potential; in which case, the investor should abandon any further investigation. This decision frequently can be made easily because the investor knows roughly what return he desires on his portfolio, and the risks may be so formidable that he could not realize his desires. Yet, in many other cases, the risks are not so great and further investigation

is warranted. The investor must not forget his mental appraisal of these risks, though, because they do form the basis for deciding what return he must demand in order to justify the assumption of these risks.

#### HOW ARE GROWTH POTENTIALS AND RISKS BALANCED?

At this point, the investor is bound to be dizzy with value judgments and probably feels less confident than when he started this examination that stock investment is the route for him. This points out the real agony of stock market analysis--personal value judgments; it is also, paradoxically, why the field is intriguing to so many. However, if the investment opportunity appears to warrant further investigation, the next step is the key value judgment. This forces the investor to crystallize objectively and realistically the value of any qualifying growth stock into a somewhat pragmatic form. This step will be called the act of balancing risks and growth potentials.

First, emphasis must be made of an element that has been, and always will be, basic to any investment decision. This key element, inescapable in every judgment that an investor must make and, generally, the critical question, is an estimate of time--"when?" Emphasis of this point was reserved purposefully for this section because, to balance growth and risk value judgments, a decision regarding "when" will have to be made with regard to each. The investor will quickly discover that answering when accurately is equally as difficult a decision to make as which stock. Involved here is deciding how long the growth prospects will take to bear fruit, and, therefore, when to buy the stock, when to hold, and when to sell. It should be obvious how critical these decisions are to successful



investment activities! The question of time does not pose any problem if it is obvious that the risks against real growth are so great that the return prospects do not justify the purchase. Once it is decided that further investigation is justified, time becomes critical. Therefore, the investor must recognize that he is constantly racing the clock in making his decisions. Other investors are not waiting; conditions are constantly changing, as is the market price.

In the balancing of risks against growth potentials for any future illustrations, decisions regarding when will have to be arbitrarily made; but the investor must never lose sight of the fact that these are separate and difficult decisions, and the success or failure of his total investment program hangs in the balance.

In Chapter Two, the investor was directed to establish roughly a dollars and cents estimate for future earnings. As was emphasized in the introductory paragraphs of this section, integral with this estimate, a more or less definite time limit must be established for materialization of these earnings. The results of any risk estimations must be introduced as countervailing forces to make this growth estimate more realistic, both in numbers of dollars to be realized as profit and the amount of time necessary for realization.

Several noteworthy events in history dramatize how extremely deluded and unrealistic investors will allow themselves to become when visions of extraordinarily large and quick pecuniary profits dance in their heads. These dramas, which are slightly aside from the central theme of this paper, are submitted here as facing the investor with the real crux of the value-balancing problem. The nature of the task is pointed out by showing how unbalanced growth and risk can become in the minds of investors.

Two situations from the eighteenth century, "The South Sea Bubble" and "The Mississippi Scheme," clearly show how entire nations can be overcome by the allure of quick profits. The Mississippi Scheme was contrived by an Englishman, John Law, as a cure for the huge national debt with which France was saddled, due to the extravagance of Louis XIV. Law had such success initially with erasing France's deficit (partially through the use of fully backed paper currency) that the king allowed Law's Mississippi Company exclusive rights to trade in the Mississippi area of the New World. The king also allowed the Royal Bank and Law's company to become one because of Law's successes, coupled with the king's apathy towards "routine" problems. Law and the king were, therefore, jointly liable for the final collapse of this venture. Speculation in the stock of the Mississippi Company reached unbelievable proportions due to the fact that "Law's promises had become fact." Collapse came when a few more realistic and discerning men recognized that all relationships had been destroyed between value and market price, making their fiat money virtually worthless, and asked for specie in exchange.

The South Sea Company Bubble was a similar scheme devised by Harley, Earl of Oxford, to aid England in eliminating a national debt and restoring public credit in the early 1700's. Exclusive trading rights to the company were granted in the South Seas. The South Sea Company also superseded the Bank of England as the pilot behind the public credit after a running competition before the House of Commons. The publicity of this battle made the demands for stock of the South Sea Company almost frantic, and the price went out of reason. The fervor caused many spurious stocks

and frauds to be perpetrated on the public. Ensuing public indignation and investigation made market prices collapse, causing long-lasting misery.<sup>1</sup>

However, these debacles are not restricted to other centuries or countries. In the 1920's, the people of America engineered, through avarice, an unprecedented land boom in Florida. "It was a 1920's boom practice for sellers to accept as little as a tenth of the sale price-- or even the buyer's note--as down payment on property. M. A. Hortt, veteran Fort Lauderdale real-estate broker, tells of some scrub-pine land he bought in 1911 for \$3,200. He sold it for \$58,000 in 1924, then bought it back a few days later for \$116,000. In May, 1925, he sold the property again, for \$282,000. Thirteen days later it went for \$640,000. In another three months and five days it brought \$800,000. Finally, a couple of months after that, it sold for \$1,500,000. As all these sales turned out to have been mainly on paper, however, the land eventually reverted to Hortt...."<sup>2</sup>

The Crash of 1929 vividly points out the fact that unrealistic value judgment can reach fever pitch in the stock market. "Since it was important, the question inevitably arises whether a similar cycle of speculation and collapse could again occur. The simple answer is, "Of Course"! Laws have been passed to outlaw some of the more egregious behavior which

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<sup>1</sup>Charles MacKay, Extraordinary Popular Delusions and the Madness of Crowds, L. C. Page and Co., a subsidiary of Farrar, Straus and Cudahy, Inc. (1932). See this reference for detailed reading on the Mississippi Scheme and the South Sea Bubble.

<sup>2</sup>R. Jarman, "New Styles in Florida Land Booms," Saturday Evening Post (February 18, 1956), p. 104.

contributed to the big bull market of the twenties. Nothing has been done about seminal lunacy which possesses people who see a chance of becoming rich. On the assumption that history does not repeat itself precisely, we may never again see the particular lunacy of the late twenties. But if we survive to suffer such things, we can undoubtedly count on some variation. The time to worry will be when important people begin to explain that it cannot happen because conditions are fundamentally sound."<sup>1</sup>

One further debacle is quickly cited because it poignantly shows the ludicrousness of these avaricious delusions. The tulip became a status symbol in the late 1500's and early 1600's in western Europe-- especially Holland and Germany. The prices reached such peaks that entire fortunes passed hands merely for a new variety. A new measure of weight had to be developed (peritie) since roots were so light. Shortly, the number of bulbs increased to the point that demand abated and value was reflected upon and prices fell catastrophically. Hundreds of fortunes were wiped out due to "Tulipmania."<sup>2</sup>

These incidents from the past make the importance of careful value balancing clear. As a part of the history of man, they make it imperative that an investor weigh risks and growth potential carefully to avoid repetition of these debacles. These debacles occur when reason and analysis go out the window and the false idea enters that extraordinary returns do not always require the assumption of proportional risks. For each point

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<sup>1</sup>John Kenneth Galbraith, "The Great Wall Street Crash," Harper's Magazine (October, 1954), pp. 71-80.

<sup>2</sup>MacKay, op. cit.

that the investor sees in the economy and the corporation indicating growth, there will be factors working against this growth prospect. He must weigh carefully to judge how sure growth really is.

To avoid becoming a part of even a microscopic debacle, as growth delusions in one particular issue might be considered, the investor should compare his judgment of the balance of risks and return potentials against another evaluation or standard. Does such a yardstick exist? In competitive bidding for the limited number of securities offered, investors are pitting their evaluations of growth and risk potential against one another. It follows that the market price at any point in time is the embodiment of the various judgments of the investment opportunity at the same time. The relationship of the market price to the earnings at this time is significant.<sup>1</sup> "The price/earnings ratio, or its reciprocal, the earnings/price rate, is one of the fundamental yardsticks utilized by investors in the evaluation of the market prices in general and the price of individual stocks in particular."

Examination of a sample of listed securities will usually reveal a wide range in price/earnings ratios, giving wide earnings/price percentage rates. This is manifestation of the excitement or despair that investors feel over prospects for various companies.

After the investor has examined the current price earnings ratio for the security in which he is interested, he decides whether his

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<sup>1</sup>Sanford L. Margoshes, "Price/Earnings Ratio in Financial Analysis--Its Uses and Abuses," Financial Analysts Journal (November-December, 1960); Benjamin Graham and David Dodd, Security Analysis, McGraw-Hill Book Co., Inc., New York (1951).

estimation coincides with this multiple or not. He should also decide whether or not this multiple is realistic. This must concern him because this multiple reflects the market price, dictating whether the investment will be profitable or not; and this is really the proof of whether or not a value was obtained.

## CHAPTER FOUR

### WHAT RATE OF RETURN?

Involved mathematical calculations and comparisons are usually resorted to for objectivity and precision in measuring the value of the growth prospects for a security. Almost every current article covering this area makes use of involved and frequently obtuse calculations; and voluminous findings are charted and/or tabled to document the text. Some authors even go so far as to develop formidable and often monumental formulas into which the several factors purported as critical can be inserted by an investor; from these, mechanistically, the optimum market price to pay for a certain growth rate can be ejected.<sup>1</sup> But, in each article it is clear that the factors to be inserted and the basic premise come from value judgment on the investor's part. Specifically, he always has to decide the amount of and the rate of growth at which earnings travel and, also, his desired rate of return.

In this chapter the basic principles behind almost any penetrating mathematical experiment for stock analysis will be discussed to point up the desired results. Although it is herein felt that these mathematical approaches attempt to formulize an area that is much too emotional and qualitative to formulize, the discipline of the mathematical approach does more clearly show the investor what factors are critical in deciding whether the market price for a stock is too high to obtain his desired return.

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<sup>1</sup>Robert Ferguson, "A Monograph for Valuing Growth Stocks," Financial Analysts Journal (May-June, 1961), p. 29.

Making the decision with regard to desired return on invested funds, as was noted in the introduction, is elemental to any investment policy. An investor who is considering growth stocks should now see that he must set an aggressively high return goal. The reasoning here is straightforward and will be dealt with quickly, simply as a link in a logical chain.

Axiomatically, it should be restated that an investor only assumes risks because he envisions commensurate returns. If riskless investment existed, it would mean that invested funds would not lose any purchasing power, and they could be retrieved intact at will. It is not likely that such an investment would deliver a handsome return; yet many existing investment opportunities have minimal risks and coincidentally yield a return for invested funds compounded at growth rates equal or greater than that of the gross national product. Many of these situations allow funds to be withdrawn with short periods of notice--or even at demand! Excellent examples of this exist in the form of government bonds, bills, and notes. These examples are significant because United States government obligations are the bulwark of value in the United States. With fiat money and government guarantees so prevalent in this country, nearly the total faith and credit of the American people lies in government guarantees, control, and coinage. Therefore, if the standard of good credit has to pay  $1\frac{1}{2}$ - $3\frac{1}{2}$  percent for money to use for relatively short periods of time, a floor under return appears to form. Further, an investor can receive 3 percent--computed on a daily basis in the savings departments of many commercial banks. For commitments of one year, banks are allowed to pay



up to 4 percent. Nothing needs to be said defending the safety of deposits in these institutions. Many savings and loan associations will pay 4 percent for a committal of one calendar quarter! In both of these situations, funds are guaranteed safe up to certain statutory limits by the United States government and are retrievable virtually upon demand. Therefore, an investor could consider 4 percent a minimal return. Yet, following this bend of thought further, if the stature of the debt instruments of some of the largest United States corporations are dispassionately examined, their credit standing will rank close to that of the United States government. If this statement is accepted as true, the rates paid on the corporation bonds would push the floor of minimum acceptable investment return up to 5 percent, still assuming a very low risk level. It should also be noted that very little investigation or management is required by the investor to maintain his investment and its return safe in these situations.

So far only debt instruments have been mentioned. In a recent issue of an important financial magazine, a list was given of stocks listed on the New York Stock Exchange which still yield 5-6 percent or greater.<sup>1</sup> Even the slightest acquaintance with the qualifications of a corporation before it may be listed on the "big board" will convince an investor that investment stature is represented in most of these stocks. It must be recognized that these stocks are not growth stocks (as defined herein), and, moreover, as has already been pointed out, the average big board stock pays only 2.9 percent. Yet, the investor must now see that if he

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<sup>1</sup>"High Yielding Big Board Stocks," Forbes (September 15, 1961), p. 47.

is going to assume greater risks than the above illustrations represent and is going to look to the future for his return, he must demand a sufficiently high one. How much he should demand is up to the individual because he must decide the degree of risk he is willing to assume, and the return he feels this assumption merits. For illustration purposes in the example to be given, 8 percent will be used, but must not be interpreted as a recommendation or suggestion of what should be expected. The problem that still faces the investor is deciding if the return he may expect from an investment in a particular growth stock is currently over-priced.

The percentage rate referred to in Chapter Three as earnings/price rate will represent the rate of return an investor may expect under limited circumstances only. These would be (1) if there is no change in earnings over the period of time he will hold the investment; (2) if the earnings/price rate will remain constant for the same period; and (3) if declared dividends will equal reported earnings. A stock with these outstanding qualities would closely resemble an interest-bearing bond and consequently lend itself to a yield to maturity calculation.<sup>1</sup> However, the investor knows by this stage in his examinations that the above factors will not remain constant and such a yield calculation will be ephemeral in nature at best.

One tool that any basic finance text will incorporate for aiding bond-yield studies is noted. This aid is known as a chart of present

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<sup>1</sup>Yield to maturity is the rate of return calculated by dividing the total income received from an investment, plus the increments of appreciation minus the loss through amortization, by the original cost of the investment.

value.<sup>1</sup> It shows in tabular form the present value for the repayment of \$1 at various future times and rates of return. For growth stock consideration, though, this is not directly applicable because there are more variable elements in the nature of stocks than there are in bonds. However, it does show the nature of the quantity that should be sought.

In almost any common stock investment, at least part of an investor's return will be in dividends. As stated earlier, a large segment of the investing public puts heavy emphasis on the amount of and the rate of payment for dividends. (This explains why management's attitude toward this policy was stressed in Chapter Three.) Therefore, the payout of dividends must be considered in any calculation for yield on a common stock investment. Two methods for arriving at this factor are offered: (1) a study of the percentage payout of earnings; and (2) a study of percentage payout of cash flow. Basing his judgments on history and future predictions, the investor has been directed to forecast the rates and amounts of growth for both methods; after this, he may elect either one. Both methods are defensible since the relationship of dividends to the one chosen is what is really significant.

The earnings of a company should be looked upon as a stream running continuously from origin into infinity. The investor has already examined the past and present earnings of this company. He has also examined the growth prospects for a definite future period. From these, he has decided the average annual growth rate for the future. He has examined the risks

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<sup>1</sup>"Present Value," Financial Handbook, Ronald Press Co. (1957), p. 1186.

of this stock and of competitive stocks and has decided that 8 percent is the minimum return that he will accept. He has estimated what part of these earnings he will receive as annual dividends. He has observed what the current market price asks him to pay for the privilege of investing--is this acceptable? Assume that the investor feels (for a certain company) that he can safely estimate earnings for five years. He thinks that earnings will compound at 20 percent annually and that the company will continuously be able to grant a 50 percent payout in earnings:

(All amounts shown as amounts per share)

| YEARS     | 1      | 2      | 3      | 4      | 5      |
|-----------|--------|--------|--------|--------|--------|
| EARNINGS  | \$1.00 | \$1.20 | \$1.44 | \$1.73 | \$2.08 |
| DIVIDENDS | \$ .50 | \$ .60 | \$ .72 | \$ .86 | \$1.04 |

If the investor refers to a present value chart and computes the value of the above dividends, the following figures will arise:

| YEAR                       | 1     | 2     | 3     | 4     | 5     |
|----------------------------|-------|-------|-------|-------|-------|
| PRESENT VALUE OF DIVIDENDS | \$.46 | \$.51 | \$.57 | \$.63 | \$.71 |

However, dividends are not the total nature of return, especially for growth stocks. An estimate of the market price for the stock in the terminal year is necessary. Since the investor feels that his funds must obtain an 8 percent return, he will estimate this return for his stock in the terminal year. Consequently, he would estimate his stock as selling at  $12\frac{1}{2}$  times the terminal year's earnings, or \$21.32. This amount returned in the fifth year would have a present value of \$14.52. The total present value of this investment would be the aggregate of the present value of the dividend's and stock's terminal market price--( $$.46 + $.51 + $.57 + $.63 + $.71 + $14.52$ ) or \$17.40. The investor should not pay any more than \$17.40 today for this stock. This calculation may be performed

for any situation by merely changing the elements. If the values are correctly assumed, the result will be realistic.

In summary, an investor should be certain that he is entering a transaction that will give him the return he feels the situation merits in light of foreseen risks and the competitive situation. By using such computations as above, he can determine this; and by inserting various figures, he can determine mathematically the possibility of paying too much for future growth! He can also prove that the current price/earnings ratio is evidence that other investors either know facts that he does not or that they are deluded with regard to growth potential.

## CHAPTER FIVE

### WHAT DOES THIS HAVE TO SAY TO THE GROWTH STOCK INVESTOR?

This paper has attempted to determine whether growth stocks are fact or fantasy. There is no categorical or absolute answer to this inquiry. At this stage, however, there should be little question regarding the character of growth stocks, their existence and attractiveness. The question, "Fact or fantasy?" must be answered individually with regard to the price an investor pays for the privilege of ownership. As a two-pronged offering toward (1) the question posed by the title of the paper and (2) summarizing the preceding chapters, several thoughts on a philosophy for growth stock investors will be submitted.

The investor must become a fact gatherer. The more he knows about the economy, industry, scientific advancements, social trends, new products, and individual companies, the larger becomes his universe from which to pick investment candidates. Consequently, the more he knows about each individual situation, the better his chances are of having a portfolio of some of the best real growth values currently available.

The more facts an investor has, the more incisive and penetrating his analysis must be. This is true because (1) the nature of a real growth situation is complex and transitory; (2) funds are usually limited, but once committed, may be hard to retrieve, and (3) the time to invest in a real growth stock is now! An investor must be able to separate quickly, yet correctly, the chaff from the good kernels in order to buy while the market price makes the investment opportunity a value opportunity.

The object of growth stock investing is to participate in future large earnings; therefore, any delay in making commitment mitigates possible profits. This points up why elaborate mathematical computations can be more costly (due to time needed) than helpful.

Therefore, the investor must not only be a fact-gatherer; he must also be a rapid sifter of facts. Since a discount of these future earnings is built into the current market price of growth issues, the sifting operation of the investor must be accurate and perceptive. He must also remain sensitive to the rumors of the market place, since any indication of doubt in the minds of the investing public regarding the total market, or especially regarding a particular issue is an omen of danger.

The most disastrous elements of risk inherent in growth stocks lie in an abrupt reversal of a glamorous growth rate, or in the failure of a forecasted growth rate to occur. As noted earlier, the fickle investing public quickly becomes disenchanted with an issue when its future growth prospects appear threatened or the current market price appears to over-discount future growth.

Therefore, the investor must remain sensitive to the market, and must constantly re-evaluate the corporate situation and his personal market position. This re-evaluation must be conducted in order to assure that his investment remains at the same value level as when he purchased it. He must also decide whether he agrees, after his studies, with the rumors in the market place and whether or not the complexion of the situation has changed markedly enough to require changing his position in the security.

The investor must constantly consider both the facts and the rumors of the market place. However, he must not allow such knowledge of technical information regarding the market price, the economy, or the company concerned to destroy his self-confidence. There always have been and always will be prophets of doom who say that a crash is coming or that the market as a whole or an issue in particular is over-priced. The investor cannot allow either these rumors or this technical information to deter him from a thorough objective examination of the facts, nor to destroy his confidence in his own ability to decide what the facts really say. This is mandatory because in the final analysis the decisions (key) which determine success or failure of an investment program, especially growth stocks, lie within the investor himself.

In summary, the investor should see that he is compelled to invest<sup>1</sup> by aggressive forces attacking the store of value in his money. He sees that true growth stocks are really FACT and that they offer outstanding opportunities for rewarding investment. At the same time, he sees that he must personally bear the burden of minimizing inherent risks by sound value judgments in order to maximize future profits. If he does not, his growth stocks may become FANTASY and be no more to him than a tulip bulb was to many Dutchmen at the end of the fever known as Tulipmania.

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<sup>1</sup>It must be reiterated that this clearly cannot be interpreted as advocating compulsive investing without the analysis recommended in the paper. It is far better to hold cash than an unsound investment. But, the purchasing power of the dollars must be protected.



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