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Blue chip stocks – have they lived up to their name?

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The term “blue chip” is traditionally used to describe a company that is thought to be safe, in excellent financial shape and the leader in its field. The phrase can be traced to the game of poker in which there are three colours of chips: blue having the highest value, red next in rank, followed by white with the lowest value.

Blue chips generally have stable earnings so they can pay regular dividends, which makes them appealing to investors. Some well-known blue chips are Coca-Cola, Gillette, McDonalds and IBM. A quick glance at the top fifty companies listed on the NZ Stock Exchange confirms that nearly half of them could be described as blue chip. But, if you were asked how many blue chip stocks were listed on the NZ Stock Exchange, you’d probably only name one or two off the top of your head.

Size in itself does not make a company blue chip. For example, Google is enormous, but it can’t be described as blue chip because its earnings and valuation can be extremely volatile (as with most technology companies). We only need to look at the US share market of recent times to see examples of very large companies, household names like Citigroup and General Motors that were once regarded as safe and defensive, but have proven quite the opposite.

Over the past eighteen months, blue chips have not really lived up to their reputation. As share markets have fallen, so has the value of blue chip stocks. The shares of good companies have been sold just as actively as those of poor companies during the share market downturn, illustrating just how panicky investors became.

This does not mean the death of blue chips, it just means that there are opportunities for investors as they troll through the fire sale looking for winners. If the whole share market is available at knocked down prices, I would certainly prefer to buy stocks of quality companies which, because of their quality, are ordinarily more expensive.

So what makes a company blue chip? It may be just a label but I prefer to replace the term *blue chip* with the term *quality*. That’s mainly because I think blue chip suggests safety and certainty, and as we’ve been reminded over the last couple of years, there is always risk associated with share market investing.

To my mind, a quality company should generally have the following characteristics:

- Sell high-quality, widely accepted products and services
- Have a strong balance sheet that allows it to weather economic downturns
- Can operate profitably under adverse economic conditions
- Have a long record of stable and reliable profit growth
- Have a solid and consistent dividend history

Blue chip is an old-fashioned term, but there is nothing old-fashioned about buying quality stocks, particularly when they are selling for similar prices as lesser quality stocks. The market downturn has left the prices of many stocks black and blue (rather than just blue) resulting in good buying opportunities for the savvy investor.

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