

Introduction fundamental analysis

[Economics](#), [Financial Markets](#)



Fundamental analysis involves examining the economic, financial and other qualitative and quantitative factors related to a security in order to determine its intrinsic value. It attempts to study everything that can affect the security's value, including macroeconomic factors (like the overall economy and industry conditions) and individually specific factors (like the financial condition and management of companies).

Fundamental analysis, which is also known as quantitative analysis, involves delving into a company's financial statements (such as profit and loss account and balance sheet) in order to study various financial indicators (such as revenues, earnings, liabilities, expenses, and assets). Such analysis is usually carried out by analysts, brokers and savvy investors. Many analysts and investors focus on a single number – net income (or earnings) – to evaluate performance. When investors attempt to forecast the market value of firm, they frequently rely on earnings.

Many institutional investors, analysts and regulators believe earnings are not as relevant as they once were. Due to nonrecurring events, disparities in measuring risk and management ability to disguise fundamental earnings problems, other measures beyond net income can assist in predicting future firm earnings. Two approaches of fundamental analysis: * The top-down investor starts his or her analysis with global economics, including both international and national economic indicators, such as GDP growth rates, inflation, interest rates, exchange rates, productivity, and energy prices.

He or she narrows his or her search down to regional/industry analysis of total sales, price levels, the effects of competing products, foreign

competition, and entry or exit from the industry. Only then does he or she narrow his or her search to the best business in that area. * The bottom-up investor starts with specific businesses, regardless of their industry/region. How does fundamental analysis work? The analysis of a business's health starts with financial statement analysis that includes ratios. It looks at dividends paid, operating cash flow, new equity issues and capital financing.

The earnings estimates and growth rate projections published widely by Thomson Reuters and others can be considered either 'fundamental' (they are facts) or 'technical' (they are investor sentiment) based on your perception of their validity. The determined growth rates (of income and cash) and risk levels (to determine the discount rate) are used in various valuation models. The foremost is the discounted cash flow model, which calculates the present value of the future * Dividends received by the investor, along with the eventual sale price. Gordon model) * earnings of the company, or * Cash flows of the company. The amount of debt is also a major consideration in determining a company's health. It can be quickly assessed using the debt-to-equity ratio and the current ratio (current assets/current liabilities). The simple model commonly used is the Price/Earnings ratio. Implicit in this model of a perpetual annuity (Time value of money) is that the 'flip' of the P/E is the discount rate appropriate to the risk of the business. The multiple accepted is adjusted for expected growth (that is not built into the model).

Growth estimates are incorporated into the PEG ratio, but the math does not hold up to analysis. Its validity depends on the length of time you think the growth will continue. IGAR models can be used to impute expected changes in growth from current P/E and historical growth rates for the stocks relative to a comparison index. Computer modelling of stock prices has now replaced much of the subjective interpretation of fundamental data (along with technical data) in the industry. Since about year 2000, with the power of computers to crunch vast quantities of data, a new career has been invented.

At some funds (called Quant Funds) the manager's decisions have been replaced by proprietary mathematical models. Benefits of fundamental analysis: * Identifying the intrinsic value of a security. * Identifying long term investment opportunities since it involves real time data. Drawbacks of fundamental analysis: * Too many economic indicators and extensive macroeconomic data can confuse novice investors. * The same set of information on, macroeconomic indicators can have varied effects on the same currencies at different times.

It is beneficial only for long term investments. Fundamental Analysis Tools These are the most popular tools of fundamental analysis. They focus on earnings, growth, and value in the market. For convenience, I have broken them into separate articles. Each article discusses related ratios. There are links in each article to the other articles and back to this article. The articles are: * Earnings per Share – EPS * Price to Earnings Ratio – P/E * Projected Earnings Growth – PEG * Price to Sales – P/S * Price to Book – P/B * Dividend Payout Ratio * Dividend Yield Book Value * Return on Equity Ratio Analysis:

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Financial ratios are tools for interpreting financial statements to provide a basis for valuing securities and appraising financial and management performance.

A good financial analyst will build in financial ratio calculations extensively in a financial modelling exercise to enable robust analysis. Financial ratios allow a financial analyst to:

- * Standardize information from financial statements across multiple financial years to allow comparison of a firm's performance over time in a financial model.
- Standardize information from financial statements from different companies to allow an apples to apples comparison between firms of differing size in a financial model.
- * Measure key relationships by relating inputs (costs) with outputs (benefits) and facilities comparison of these relationships over time and across firms in a financial mode.

In general, there are 4 kinds of financial ratios that a financial analyst will use most frequently, these are: 1. Performance ratio 2. Working capital ratio 3. Liquidity ratio 4. Solvency ratio

These 4 financial ratios allow a good financial analyst to quickly and efficiently address the following questions or concerns:

1. Performance ratio:
 - * What return is the company making on its capital investments?
 - * What are its profit margins?
2. Working capital ratios:
 - * How quickly are debts paid?
 - * How many times is inventory turned?
3. Liquidity ratio:
 - * Can company continue to pay its liabilities and debts?
4. Solvency ratios:
 - * What is the level of debt in relation to other assets and debt to equity?
 - * Is the level of interest payable out of profits?

Why conduct fundamental analysis? Fundamental analysis helps you determine if a company is a good or poor investment choice. Imagine you're a venture capitalist or a bank, who must decide if that company is worthy of a loan or equity investment. How can you evaluate whether this particular company deserves your investable capital? Fundamental analysts consider the following in making their decision to invest (or not):

- * Is the company making a profit consistently? (While this is naturally the most important question for investors, it's important to consider the answer in a bigger context.

A single profitable quarter for a new company might be a fluke. In the same regard, a drop in profitability for an established blue-chip company might just be a temporary setback.)

- * Is that profit growing or declining over time?
- * Is the company holding its own relative to the competition? Is it a leader in its sector? Is that sector growing or declining in importance to the overall economy?
- * Can the company pay its bills adequately? If you were to dismantle the company's operations today, what would be the intrinsic value of its assets versus the value of its debts?

What information do we need to perform fundamental analysis? We can think of fundamental analysis as "investing by the numbers," since much of the work involves evaluating financial statements issued by the company. Here are a few key statements you should learn to read and understand. All publicly traded companies in the United States are required to file statements of financial condition on a regular basis. These include the 10-Q,

a quarterly statement, and the 10-K, an annual statement. Each statement follows a prescribed form to include certain basic information.

Publicly traded companies are also subject to audits by government agencies that oversee their given industry. Those audits may be either scheduled or random events. The results of a regulatory audit may also be published-- interesting reading for a would-be investor. The 10-Q and 10-K are good places to start your fundamental research, but you'll likely want to dig deeper into the specifics. For that you'll need to understand three interrelated types of statements: the balance sheet, the income statement and the cash flow statement. Reading a balance sheet: Assets

As the name suggests, a “ balance sheet” presents a picture of how the company's assets – the value a company takes in – are “ balanced out” against its liabilities – what the company must pay out. When Assets equals Liabilities plus Equity, that's when the statement is said to be in balance. You can look up a balance sheet for any publicly traded U. S. stock on the TradeKing website under Quotes + Research > Quotes + News + Research. Just enter the company's ticker symbol and you'll be on your way. In most cases, balance sheets are presented in left and right side format.

You'll find Assets on the left, and on the right side of the page are the Liabilities and Equity. (Sometimes these items are listed from top to bottom instead of left to right.) Assets include resources the company has that are worth something. Many of these are self-explanatory, like Cash & Investments. Others are less familiar, like Current Assets, which refers to the value of assets that are readily converted into cash, such as Inventory or

Receivables. Longer-term assets vary depending on business type, but may include such things as property or equipment values.

Since long-term assets gradually decrease in value over time, Accumulated Depreciation is subtracted from this. Note that depreciated assets may show up as having little or no value on the balance sheet but may have a much greater market value if sold. Reading a balance sheet: Liabilities Liabilities are obligations the company has made to outside parties who have provided resources. In essence, these outside parties may have lent money or other supplies to the company and therefore are owed repayment. It's important to note these outside parties do not have ownership in the company; they are creditors.

Items under Liabilities include Accounts Payable, the amount the company may owe suppliers, and Income Taxes Payable, which is self-explanatory. Note that Current Liabilities, which are short-term, are listed separately just as Current Assets are. This section may also contain long-term debt obligations: for example, if the company has taken out bank loans to finance equipment or real estate, or if the company has issued corporate bonds to investors. A figure called the Quick Ratio helps investors determine if a company's assets and liabilities are in a healthy balance.

The quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets. The higher the quick ratio, the better the financial position of the company. It's calculated as follows: Note that the Quick Ratio is more conservative than some other liquidity measures, like the Current Ratio, because it excludes inventory from current assets. If you

believe the company might have difficulty turning their inventory into cash, then the Quick Ratio might give a more accurate picture of the company's short-term financial strength.

Reading a cash flow statement: The cash flow statement helps investors answer questions like: Is the company generating enough cash needed to fund growth? Is growth outpacing cash generation, requiring additional financing? Is the company generating enough cash to cover its short-term needs? In times of easy credit, companies may be able to patch over cash flow interruptions with interim financing; during tighter credit markets, though, such financing may not be as readily available.

In those situations, steady cash-flow generated by the company's operations becomes especially important. There are three big categories of cash flow to pay attention to here. Word of warning: it's not always crystal-clear from just glancing at a cash flow statement which line items represent cash flowing IN versus cash flowing OUT. Cash generated by and used by the company's operations is summarized in the Net Cash Flow – Operating Activities line. That line includes cash flowing in as well as cash-out.

The company's long-term investing of cash is detailed in the Net Cash Flow – Investing line. That consists of cash flowing out. The third and last part, the “Net Cash Flow – Financing” line, shows the cash a company raised through from financing activities. That's cash that came in. The very bottom line shows the net change in the company's cash position. If you add the line to the cash on the balance sheet from the previous year, you'll get the current cash position on the current year's balance sheet.