Standard

| FUNDAMENTALS |

Explaining fundamental analysis

Studying numbers to discover a company's worth

IN ITS SIMPLEST FORM, fundamental analysis is the study of a company's "fundamentals" with the aim of calculating exactly what a listed company is worth. Based on that valuation, investors will either buy or sell its share. That sounds straightforward enough – except for the jargon and the practicalities of how to do it.

So let's first define what those fundamentals are before moving on to a "do-it-yourself" guide over the next three weeks. We've all heard the word "fundamentals" but it's not always clear what it means. Investopedia.com notes that it really means getting down to the basics of what makes a company a good investment.

In its simplest form, fundamental analysis involves looking at any numbers that can show something about what a company's worth. That includes the financial statements and ratios derived from those numbers that can give you more insight into whether the company is performing well, indifferently or badly.

Investopedia.com says: "Fundamental analysis focuses on creating a portrait of a company, identifying the intrinsic or fundamental value of its shares and buying or selling the stock based on that information." That contrasts with technical analysis, which focuses only on the trading history and share price movements of a particular stock.

Leading from that, it's clear that fundamental analysis is the process of looking at a business at the basic or fundamental financial level. Such analysis examines key ratios of a business to determine its financial health and provides you with the tools to calculate its real or "intrinsic value". On page 4 we highlight where you can find some helpful ratios.

Fundamental analysis is that performed by most professional analysts in either stockbroking (sell side) or asset management (buy side) research teams. There are two broad approaches to fundamental analysis, which will be discussed in more depth over the next two weeks. These are called "top-down" and "bottom-up" investing.

Broadly, top-down investing looks at a company's operating environment in addition to its own strategies and likely future performance. (The techniques can be likened to an inverted pyramid.) Taking a top-down approach to a company's earnings' prospects involves first looking at the broad macroeconomic, social and political environment in which it operates.

The focus of the analysis is then funnelled and progressively narrowed to look at industry-specific or regional influences on a company's future economic performance. The major benefit of top-down analysis is that it ensures relevant information is included in a consistent way. It will also highlight specific industries attractive for investment.

So the tricky question is to pick the specific shares into which you – the investor – will put your hard-earned cash. That's where we use bottom-up fundamental analysis, which will filter the different companies in a sector by looking at the individual "investment story" of each, as well as analysing a myriad of different numbers.

We'll look at those more closely in two weeks' time, but for now it's sufficient to say that those numbers include both the financial statements published by each company as well as specific ratios that investors calculate from these in a process that's affectionately known as "number-crunching".

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It also includes an assessment of a company's management: its credibility, experience and strategic insight. From that the analyst draws conclusions concerning the attractiveness of that specific company as an investment and estimates its true, or intrinsic, value.

If the "intrinsic value" is lower than the prevailing share price on the JSE the analyst will rate the stock as a "buy"; if it's lower,


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then the analyst will recommend a "sell". And if intrinsic value is broadly in line with the market price the share will be labelled a "hold". These recommendations usually have a one-year time horizon.

Share price declines can either be a buying opportunity or a trap for the unwary investor, as nearly all corporate collapses are preceded by sustained price falls. (For example, both Enron's and WorldCom's share prices fell for two years before they both finally hit the wall.)

Fundamental analysis can help you ascertain whether a share price fall is a good buying opportunity or a pointer to sell, as it can signpost the warning signs that a company is about to become financially distressed.

First, investors should always keep an eye on cash flow statements, which show the actual cash movements during a year, to ensure that companies generate cash more often than they don't, especially from their operations. Earnings growth that isn't supported by cash flow generation over time will not be sustainable.

The second factor to watch is debt levels.

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Excessive – and growing – debt may highlight a company that's heading for trouble.

But the process of fundamental analysis can be involved and requires commitment, perseverance and attention to detail. As Investopedia.com notes, it can be a lot of hard work. "But that is, arguably, the source of its appeal. By taking the trouble to dig into a company's financial statements and assess its prospects, investors can learn enough to know when the share price is wrong.

"Those investors able to spot the market's mistakes can make themselves money – a lot of it. At the same time, buying companies based on intrinsic long-term value protects investors from the dangers of day-to-day market flux."

However, it's often forgotten that the "intrinsic value" calculation also requires you to forecast future fundamentals, such as earnings per share and dividends per share. Individuals can either use analyst consensus forecasts – available from I-Net on a Standard's Online Share Trading website – or build their own models.

Lastly, it's important to remember that a share price may not immediately shoot up or collapse after you've bought or sold a share based on your fundamental analysis. There could either be an incorrect assumption in your forecast or the market may be pricing some event of which you're unaware into the share price.

Alternatively, it may just take time for the market to recognise your genius and price the share as you believe it should be. ¤

The battle to be right

Fundamental versus technical analysis

THERE'S A BATTLE that rages between fundamental and technical analysts. Many fundamentalists believe that technical analysts might as well consult astrological charts as technical indicators. In return, many technical analysts believe that fundamental analysis is close to numerology. There are two possible ways to settle the dispute.

First, investors may use both as a way of checking their decisions. While the science of analysis is never perfect, believers will find confirmations of strong buy or sell indications from both schools hard to ignore.

Second, pick one analysis horse and back it – but that course risks missing opportunities. As Richard Seddon, head of Online Share Trading at the Standard says, investors should use fundamental analysis to pick their shares and technical analysis to time their trade or use one to validate the other.

Fundamental analysis ensures that an investor knows what they like about a company, how well it's managed and the market in which it operates. By contrast, technical analysis is all about price and doesn't add in that background colour.

Those who favour the technical school point out that fundamental analysis has a number of shortcomings. In particular, it's time-consuming, it can limit the range of possible investments through an analyst's relentless focus on one specialised sector or market and it's not always possible to get the necessary raw material on time, as a company's circumstances may have altered – a situation that will be anticipated by the share price.

In addition, while an individual's interpretation of a set of facts and figures may prove right over the long term it may take some time for the market to truly appreciate your genius.

In many ways, technical analysis addresses those shortcomings by arguing that share prices already contain all the information that the market has about a company, including insider knowledge.

Arguably, the single biggest advantage of technical analysis is that it can be applied to virtually any trading medium and investment time horizon. A technical analyst can analyse shares, bonds, options, mutual funds, commodities and many other forms of investments for buy and sell opportunities and can do so by examining a variety of inputs, including tic-by-tic, intraday, daily, weekly or monthly data – from very short-term to very long-term perspectives.

The technician can follow as many markets as he wants, which is seldom true for the fundamental analyst, who must deal with a lot of data. As a result, most fundamentalists tend to specialise in one market.

Technicians also argue that market prices tend to lead the known fundamentals. While the known fundamentals have already been discounted and are already "in the market" prices are now reacting to the unknown fundamentals. Some of the most dramatic bull and bear markets in history have begun with little or no perceived change in the fundamentals. By the time those changes became known the new trend was well under way.

On the basis of the apparent ease of use of technical analysis it's easy to see why technical analysts are so adamant about the superiority of charts to numbers.

If a trader had to choose only one of the two approaches to use, technical analysis would be the logical choice, as it already encapsulates some fundamental analysis – as the fundamentals are already reflected in market prices.

Charts show what the markets are actually doing and they strip out all the noise and opinions. Charts are like road maps and, more important, with the help of leading indicators and other technical tools they can give us a good idea as to where the markets are likely headed. They don't tell us why, but

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