Standard

| TOP-DOWN |

Walking the fundamental analysis talk

"Stress test" an investment case

LAST WEEK WE EXAMINED the two types of analysis available to investors: technical and fundamental. Over the next two weeks we'll examine fundamental analysis in more detail and provide some guidelines for how novice investors can walk the fundamental analysis talk.

Fundamental analysis combines an in-depth look at the economic environment, industry and the company itself to forecast future earnings growth and – from that – determine what the company's share price should be.

There are, broadly, two main fundamental analysis schools: top-down and bottom-up. The top-down approach involves beginning with a broad overview and working down to a specific stock pick; bottom-up starts the analysis process by selecting companies that look as though they might be attractive investments from specific ratios and then delving into their intricacies more thoroughly.

It's important to remember that both approaches have the same ultimate goal: to select a share that will be a profitable investment by determining a company's "intrinsic" or real value. This week we pick apart the mechanics of top-down fundamental analysis.

First, let's define exactly what top-down analysis is. The top-down approach to analysing a company involves looking at, first, the broad macroeconomic, social and political environment in which it operates. The investigation is then narrowed to look at the industry-specific factors that affect a company's future performance. Lastly, top-down analysis will then zero in on specific companies and, given this important background information, determine their values.

Top-down analysis has two key benefits. First, it ensures that an investor includes all relevant information in a consistent manner; second, no company operates in a vacuum, and macroeconomic and industry conditions are important inputs into its performance.

A top-down analysis can also incorporate useful alternative assumptions to "stress test" an investment case. For example, a top-down investor may look at how changes in interest rates or exchange rates will affect a company's performance and hence its future profitability and share price.

Richard Seddon, head of Online Share Trading at the Standard, says that researchers do some of that analysis for investors (available on the website www.securities.co.za), but individuals need to understand and agree about it before accepting that view. ¤

The first step

Macroeconomic investigation

THE FIRST STEP in top-down analysis is undertaking a macroeconomic investigation. That's done for two reasons: first, a company's growth prospects are, ultimately, reliant on the economy in which it operates; second, share price performance is generally tied to economic fundamentals, as most companies generally perform well when the economy is doing the same.

The macroeconomic evaluation should first look at the global situation, as South Africa's economy is affected by international developments and a number of JSE-listed companies have international operations. There's a great deal of information available in newspapers, magazines and on the Internet and from the research departments of banks and stockbrokers.

Standard Bank produces a number of economic reports that will fill in some of the details that laymen can't. Its offering includes "Manufacturing Unpacked" (which looks at the health of the manufacturing sector), "Taking Stock" (which examines the retail sector), "Motor Alert", "PPI Alert", "CPI Alert", a monthly "Market Forecast", a "Quarterly Employment Survey", the "Commodity Monitor", "MPC Alert and many others. All are available to Online Share Trading Clients at no cost.

The top-down investor should then move on to a more detailed investigation of SA's economy. There are seven key inter-related

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1 « variables that investors should consider when constructing their economic viewpoint: gross domestic product growth, unemployment, inflation, exchange rates, the balance of payments (BoP), the current account deficit and interest rates.

GDP is, simply, the total income earned by SA. GDP growth statistics published by Statistics SA, the Government arm responsible for compiling the country's statistics, show how fast the economy is growing. Intuitively, investors know that strong economic growth is good for companies and that recessions or full-blown depressions cause share prices to decline, all other things being equal.

Unemployment figures are published by StatsSA and show trends in sectoral employment. For investors those numbers show that SA publishes both consumer (CPI) and producer price inflation (PPI) figures monthly. CPI (or CPI excluding the effect of mortgages (CPIX)) shows what inflation consumers experience, while PPI tracks inflation at the factory gate.

Inflation is important for investors, as excessive inflation undermines consumer-spending power (prices increase) and so can cause economic stagnation. However, deflation (negative inflation) can also hurt the economy, as it encourages consumers to postpone spending (as they wait for cheaper prices).

The exchange rate is the fourth important economic variable and affects the broad economy and companies in a number of ways. First, changes in the exchange rate will alter how much SA companies export or import, because it changes the cost in rand terms. If the exchange rate strengthens (as it did between 2002 and 2005), exporters will find that their product becomes more expensive in international terms, which can result in a

ANNUAL GDP GROWTH

Annualised percentage change in the seasonally adjusted quarterly value, constant 2000 prices

Source: Statistics SA

volume (and profitability) decline.

Investors need to be conscious of the effect that exchange rates have on the companies in which they're invested. Rand hedge shares (such as mining companies, international luxury goods retailer Richemont and Sasol) earn foreign currency revenues, so rand depreciation will increase rand income and cause the rand share price to increase. In addition, even SA companies can have their revenue tied to foreign currencies if they have offshore subsidiaries, such as Steinhoff (furniture manufacturer) or Bidvest (a diversified industrial company).

BoP is simply the scoreboard that reflects a country's international monetary transactions for a specific time period. It includes the trade balance (the difference between imports and exports), foreign investment by local players and inward investment by foreigners.

All trades by both the private and public sectors are recorded to show how much money flows in and out of the country. The BoP affects the exchange rate through supply and demand: the rand appreciates when there's more money coming into than leaving SA.

A current account deficit occurs when a country imports more goods and services than it exports. It affects the exchange rate through demand and supply.

Interest rates have a significant effect on share markets. In very broad terms, share prices improve when interest rates fall and decline when interest rates increase. There are two reasons for that: the "intrinsic value" estimate will increase as interest rates (and the linked discount rate) fall and underlying company profitability will improve if interest payments reduce.

The success of a top-down investment model hinges on the quality of information available and the consistency with which the investor drills down into it. Standard Bank has professionals who do that on a daily basis and produce regular reports that will provide and interpret that information for you. ¤

Picking winners

Industry analysis important

TOP-DOWN FUNDAMENTAL investors believe they increase their chances of picking winning shares by finding winning industries. While the individual company is important, the industry in which it operates is likely to exert a profound influence on its share price, as sector share prices tend to move in tandem. Consequently, investors should look just as carefully at the industry framework in which a company operates as the company itself.

Most industries can either be categorised as defensive or cyclical. Defensive industries are those that sell goods that people consume irrespective of the state of the economy, such as basic foodstuffs or pharmaceuticals. Their performance tends to be relatively steady in bad times, but earnings won't usually increase proportionately with an upswing in the economic cycle. In general, people don't eat more when they have more disposable income – though they may buy more luxury items to complement the basket of basic foodstuffs.

The profitability of cyclical industries is closely tied to a particular economic cycle. For example, the profitability of mining shares is dependent on the commodity cycle (or the change in international commodity prices), while apparel and furniture retailers' prospects are tied to the economic cycle and specifically to consumer spending. That's generally because the demand for goods sold by cyclical industries changes with these underlying cycles: cyclical industries are those whose fortunes change with the rise and fall of the economy.

To start with, investors can ask seven key questions to select industries for further examination:

- Does the industry show a long-term growth trend and is that likely to continue?
- How big is the industry and how important is it to the economy? Smaller industries with higher growth potential are structurally more attractive to investors than large, mature industries with more limited growth prospects.

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