StockCharts.com
Financial charts for the rest of us.

Chart School

Fundamental Analysis - Part 1

What is Fundamental Analysis?

Fundamental analysis is the examination of the underlying forces that affect the well being of the economy, industry groups, and companies. As with most analysis, the goal is to derive a forecast and profit from future price movements. At the company level, fundamental analysis may involve examination of financial data, management, business concept and competition. At the industry level, there might be an examination of supply and demand forces for the products offered. For the national economy, fundamental analysis might focus on economic data to assess the present and future growth of the economy. To forecast future stock prices, fundamental analysis combines economic, industry, and company analysis to derive a stock's current fair value and forecast future value. If fair value is not equal to the current stock price, fundamental analysts believe that the stock is either over or under valued and the market price will ultimately gravitate towards fair value. Fundamentalists do not heed the advice of the random walkers and believe that markets are weak-form efficient. By believing that prices do not accurately reflect all available information, fundamental analysts look to capitalize on perceived price discrepancies.

General Steps to Fundamental Evaluation

Even though there is no one clear-cut method, a breakdown is presented below in the order an investor might proceed. This method employs a top-down approach that starts with the overall economy and then works down from industry groups to specific companies. As part of the analysis process, it is important to remember that all information is relative. Industry groups are compared against other industry groups and companies against other companies. Usually, companies are compared with others in the same group. For example, a telecom operator (Verizon) would be compared to another telecom operator (SBC Corp), not to an oil company (Chevron).

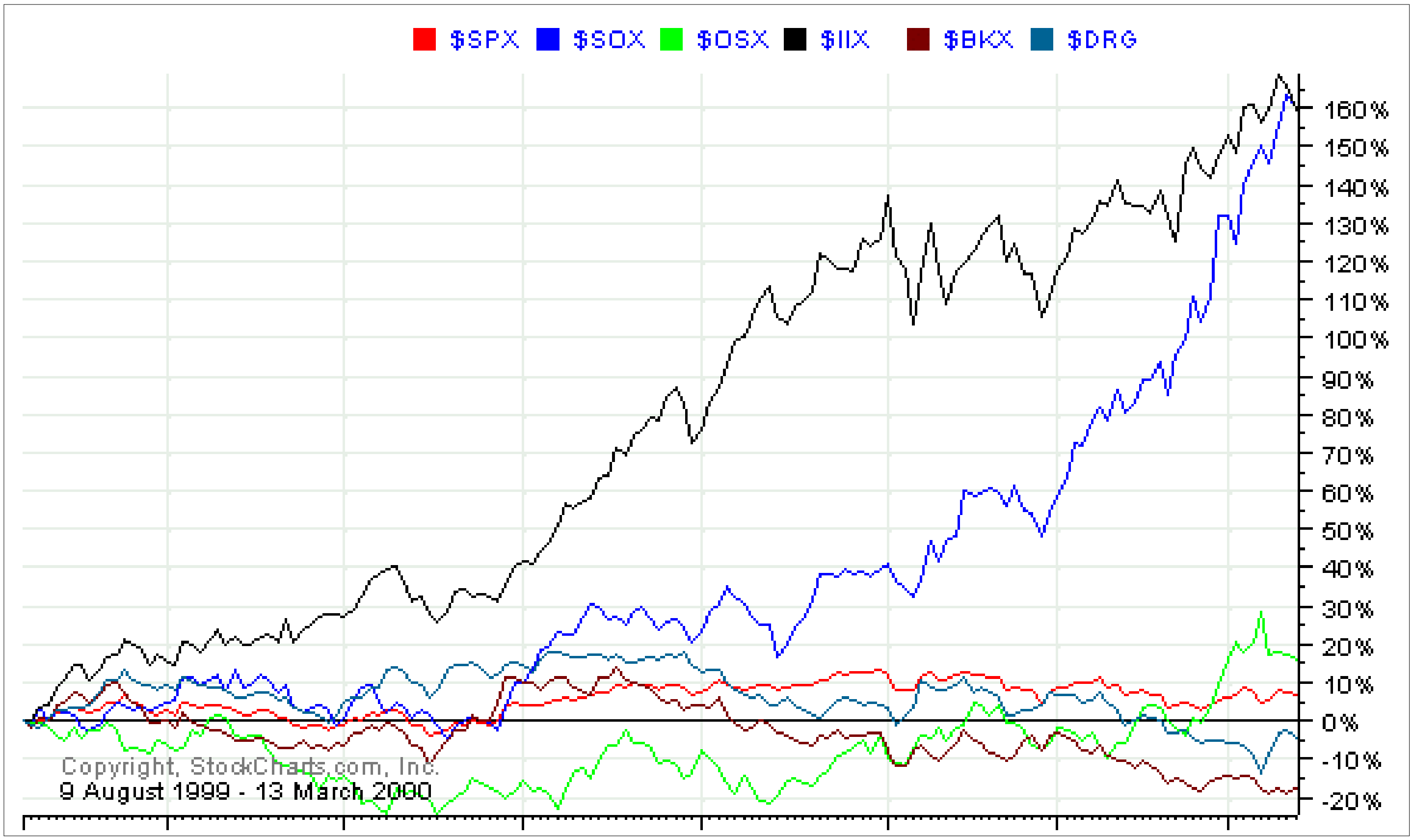
Economic Forcast

First and foremost in a top-down approach would be an overall evaluation of the general economy. The economy is like the tide and the various industry groups and individual companies are like boats. When the economy expands, most industry groups and companies benefit and grow. When the economy declines, most sectors and companies usually suffer. Many economists link economic expansion and contraction to the level of interest rates. Interest rates are seen as a leading indicator for the stock market as well. Below is a chart of the S&P 500 and the yield on the 10-year note over the last 30 years. Although not exact, a correlation between stock prices and interest rates can be seen. Once a scenario for the overall economy has been developed, an investor can break down the economy into its various industry groups.

Group Selection

If the prognosis is for an expanding economy, then certain groups are likely to benefit more than others. An investor can narrow the field to those groups that are best suited to benefit from the current or future economic environment. If most companies are expected to benefit from an expansion, then risk in equities would be relatively low and an aggressive growth-oriented strategy might be advisable. A growth strategy might involve the purchase of technology, biotech, semiconductor and cyclical stocks. If the economy is forecast to contract, an investor may opt for a more conservative strategy and seek out stable income-oriented companies. A defensive strategy might involve the purchase of consumer staples, utilities and energy-related stocks.

To assess a industry group's potential, an investor would what to consider the overall growth rate, market size, and importance to the economy. While the individual company is still important, its industry group is likely to exert just as much, or more, influence on the stock price. When stocks move, they usually move as groups; there are very few lone guns out there. Many times it is more important to be in the right industry than in the right stock! The chart below shows that relative performance of 5 sectors over a 7-month time frame. As the chart illustrates, being in the right sector can make all the difference.



Narrow Within the Group

Once the industry group is chosen, an investor would need to narrow the list of companies before proceeding to a more detailed analysis. Investors are usually interested in finding the leaders and the innovators within a group. The first task is to identify the current business and competitive environment within a group as well as the future trends. How do the companies rank according to market share, product position and competitive advantage? Who is the current leader and how will changes within the sector affect the current balance of power? What are the barriers to entry? Success depends on an edge, be it marketing, technology, market share or innovation. A comparative analysis of the competition within a sector will help identify those companies with an edge, and those most likely to keep it.

Company Analysis

With a shortlist of companies, an investor might analyze the resources and capabilities within each company to identify those companies that are capable of creating and maintaining a competitive advantage. The analysis could focus on selecting companies with a sensible business plan, solid management and sound financials.

Business plan
The business plan, model or concept forms the bedrock upon which all else is built. If the plan, model or concepts stink, there is little hope for the business. For a new business, the questions may be: Does its business make sense? Is it feasible? Is there a market? Can a profit be made? For an established business, the questions may be: Is the company's direction clearly defined? Is the company a leader in the market? Can the company maintain leadership?

Management
In order to execute a business plan, a company requires top-quality management. Investors might look at management to assess their capabilities, strengths and weaknesses. Even the best-laid plans in the most dynamic industries can go to waste with bad management (AMD in semiconductors). Alternatively, even strong management can make for extraordinary success in a mature industry (Alcoa in aluminum). Some of the questions to ask might include: How talented is the management team? Do they have a track record? How long have they worked together? Can management deliver on its promises? If management is a problem, it is

sometimes best to move on.

Financial analysis

The final step to this analysis process would be to take apart the financial statements and come up with a means of valuation. Below is a list of potential inputs into a financial analysis.

- Accounts Payable
- Accounts Receivable
- Acid Ratio
- Amortization
- Assets - Current
- Assets - Fixed
- Book Value
- Brand
- Business Cycle
- Business Idea
- Business Model
- Business Plan
- Capital Expenses
- Cash Flow
- Cash on hand
- Current Ratio
- Customer Relationships
- Days Payable
- Days Receivable
- Debt
- Debt Structure
- Debt:Equity Ratio
- Depreciation
- Derivatives-Hedging
- Discounted Cash Flow
- Dividend
- Dividend Cover
- Earnings
- EBITDA
- Economic Growth
- Equity
- Equity Risk Premium
- Expenses
- Good Will
- Gross Profit Margin
- Growth
- Industry
- Interest Cover
- International
- Investment
- Liabilities - Current
- Liabilities - Long-term
- Management
- Market Growth
- Market Share
- Net Profit Margin
- Pageview Growth
- Pageviews
- Patents
- Price/Book Value
- Price/Earnings
- PEG
- Price/Sales
- Product
- Product Placement
- Regulations
- R & D
- Revenues
- Sector
- Stock Options
- Strategy
- Subscriber Growth
- Subscribers
- Supplier Relationships
- Taxes
- Trademarks
- Weighted Average Cost of Capital

The list can seem quite long and intimidating. However, after a while, an investor will learn what works best and develop a set of preferred analysis techniques. There are many different valuation metrics and much depends on the industry and stage of the economic cycle. A complete financial model can be built to forecast future revenues, expenses and profits. (Click here for an explanation of the discounted cash flow (DCF) model.) Or, an investor can rely on the forecast of other analysts and apply various multiples to arrive at a valuation. Some of the more popular ratios are found by dividing the stock price by a key value driver.

Ratio	Company Type
Price/Book Value	Oil
Price/Earnings	Retail
Price/Earnings/Growth	Networking
Price/Sales	B2B
Price/Subscribers	ISP or cable company
Price/Lines	Telecom
Price/Page views	Web site Biotech
Price/Promises	

This methodology assumes that a company will sell at a specific multiple of its earnings, revenues or growth. An investor may rank companies based on these valuation ratios. Those at the high end may be considered overvalued, while those at the low end may constitute relatively good value.

Putting it All Together

After all is said and done, an investor will be left with a handful of companies that stand out from the pack. Over the course of the analysis process, an understanding will develop of which companies stand out as potential leaders and innovators. In addition, other companies would be considered laggards and unpredictable. The final step of the fundamental analysis process is to synthesize all data, analysis and understanding into actual picks.

Written by Arthur Hill

Part 1 | Part 2