StockCharts.com
Financial charts for the rest of us.

Chart School

Fundamental Analysis - Part 2

Strengths of Fundamental Analysis

Long-term Trends:
Fundamental analysis is good for long-term investments based on long-term trends, very long-term. The ability to identify and predict long-term economic, demographic, technological or consumer trends can benefit patient investors who pick the right industry groups or companies.

Value Spotting:
Sound fundamental analysis will help identify companies that represent good value. Some of the most legendary investors think long-term and value. Graham and Dodd, Warren Buffett and John Neff are seen as the champions of value investing. Fundamental analysis can help uncover companies with valuable assets, a strong balance sheet, stable earnings and staying power.

Business Acumen:
One of the most obvious, but less tangible, rewards of fundamental analysis is the development of a thorough understanding of the business. After such painstaking research and analysis, an investor will be familiar with the key revenue and profit drivers behind a company. Earnings and earnings expectations can be potent drivers of equity prices. Even some technicians will agree to that. A good understanding can help investors avoid companies that are prone to shortfalls and identify those that continue to deliver. In addition to understanding the business, fundamental analysis allows investors to develop an understanding of the key value drivers and companies within an industry. A stock's price is heavily influenced by its industry group. By studying these groups, investors can better position themselves to identify opportunities that are high-risk (tech), low-risk (utilities), growth oriented (computer), value driven (oil), non-cyclical (consumer staples), cyclical (transportation) or income oriented (high yield).

Knowing Who's Who:
Stocks move as a group. Bu understanding a company's business, investors can better position themselves to categorize stocks within their relevant industry group. Business can change rapidly and with it the revenue mix of a company. Some prominent old economy companies are moving into new economy businesses. Enron, a natural gas transmission company, is now making a market to buy and sell bandwidth. Some companies that are part of the new economy are really old economy companies in disguise. This happened to many of the pure internet retailers, which were not really internet companies, but plain retailers. Knowing a company's business and being able to place it in a group can make a huge difference in relative valuations.

Weaknesses of Fundamental Analysis

Time Constraints:
Fundamental analysis may offer excellent insights, but it can be extraordinarily time consuming. Time consuming models often produce valuations that are contradictory to the current price prevailing on Wall Street. When this happens, the analyst basically claims that the whole street has got it wrong. This is not to say that there are not misunderstood companies out there, but it is quite brash to imply that the market price, and hence Wall Street, is wrong.

Industry/Company Specific:
Valuation techniques vary depending on the industry group and specifics of each company. For this reason, a different technique and model is required for different industries and different companies. This can get quite time consuming and limit the amount of research that can be performed. A subscription-based model may work great for an ISP, but is not likely to be the best model to value an oil company.

Subjectivity:
Fair value is based on assumptions. Any changes to growth or multiplier assumptions can greatly alter the ultimate valuation. Fundamental analysts are generally aware of this and use sensitivity analysis to present a base-case valuation, a best-case valuation and a worst-case valuation. However, even on a worst case, most models are almost always bullish, the only question is how much so. The table of new coverage initiatives for March 9, 2000 illustrates the bullish bias in sell-side research. (Source: Yahoo Finance)

Company	Sell-side Analyst	Rating
99 Cents Only Stores	Salomon Smth Brny	at Buy
American Dental Partners Inc	Warburg Dillon Read	at Buy
Ann Taylor Stores Corp	Deutsche Bc Alex. Br	at Mkt Perform
Ashford.com Inc	W.R. Hambrecht	at Mkt Outperform
Baldor Electric Co	George K. Baum	at Strong Buy
bebe stores, inc	Deutsche Bc Alex. Br	at Mkt Perform
Charlotte Russe Holding Inc	Deutsche Bc Alex. Br	at Buy
CompuCredit Corp	JP Morgan	at Buy
Coventry Health Care Inc	Goldman Sachs	at Market Perform
Delta & Pine Land Co	PaineWebber	at Buy
eSpeed Inc	Robertson Stephens	at Buy
FARGO ELECTRNCS	Raymond James	at Strong Buy
Fundtech Ltd	Robinson Humphrey	at Outperform
Globix Corp	Merrill Lynch	at NT Buy/LT Buy
Honeywell Inc	Warburg Dillon Read	at Strong Buy
Men's Wearhouse Inc	Deutsche Bc Alex. Br	at Buy
Packaging Corp of America	Salomon Smth Brny	at Buy
Pactiv Corp	Salomon Smth Brny	at Outperform
PETS.COM INC	Warburg Dillon Read	at Buy
Radio One Inc	Mrgn Stnly Dn Wttr	at Strong Buy
Radiologix Inc	Warburg Dillon Read	at Buy
RealNetworks Inc	Wedbush Morgan	at Strong Buy
Talbots Inc	Deutsche Bc Alex. Br	at Buy
Trigon Healthcare Inc	Goldman Sachs	at Market Outperform
UST Inc	FS Van Kasper	at Buy
WHITEHALL JEWL	CSFB	at Buy
World Access Inc	Mrgn Stnly Dn Wttr	at Strong Buy

Analyst Bias:

The majority of the information that goes into the analysis comes from the company itself. Companies employ investor relations managers specifically to handle the analyst community and release information. As Mark Twain said, "there are lies, damn lies and statistics". When it comes to massaging the data or spinning the announcement, CFOs and investor relations managers are professionals. Only buy-side analysts tend to venture past the company statistics. Buy-side analysts work for mutual funds and money managers. They read the reports written by the sell-side analysts who work for the big brokers (CIBC, Merrill Lynch, Robertson Stephens, CS First Boston, Paine Weber, DLJ to name a few). These brokers are also involved in underwriting and investment banking for the companies. Even though there are Chinese walls in place to prevent a conflict of interest, the brokers have an ongoing relationship with the company under analysis. When reading these reports, it is important to take into consideration any biases a sell-side analyst may have. The buy-side analyst on the other hand is analyzing the company purely from an investment standpoint for a portfolio manager. If there is a relationship with the company, it is usually on different terms. In some cases this may be as a large shareholder.

Definition of Fair Value:
When market valuations extend beyond historical norms, there is pressure to adjust growth and multiplier assumptions to compensate. If Wall Street values a stock at 50 times earnings and the current assumption is 30 times, the analyst would be pressured to revise this assumption higher. There is an old Wall Street adage: the value of any asset (stock) is only what someone is willing to pay for it (current price). Just as stock prices fluctuate, so too will growth and multiplier assumptions. Are we to believe Wall Street and the stock price, or the analyst and the assumptions?

It used to be that free cash flow or earnings were used with a multiplier to arrive at a fair value. In 1999, the S&P 500 typically sold for 28 times free cash flow. However, because so many companies were and are losing money, it has become popular to value a business as a multiple of its revenues. This would seem to be OK, except that the multiple was higher than the PE of many stocks! Some companies were considered bargains at 30 times revenues.

Conclusions

Fundamental analysis can be valuable, but it should be approached with caution. If you are reading research written by a sell-side analyst, it is important to be familiar with the analyst behind the report. We all have personal biases and every analyst has some sort of bias. There is nothing wrong with this and the research can still be of great value. Learn what the ratings mean and the track record of an analyst before jumping off the deep end. Corporate statements and press releases offer good information, but should be read with a healthy degree of scepticism to separate the facts from the spin. Press releases don't happen by accident and are an important PR tool for companies. Investors should become skilled readers to weed out the important information and ignore the hype.

Written by Arthur Hill

Part 1 | Part 2

Send us your Feedback!

©1999-2000 StockCharts.com
All Rights Reserved Terms of Use