Introduction

Most investors would have heard something about ***fundamental analysis***, and many investors would have accepted that it is standard practise to use fundamental analysis in their investment strategies. However, it can be argued that many retail investors over-rely on fundamental analysis.

This Article in Brainy's series on Share Trading and Investing (number ST-2300) provides an introductory discussion to the topic, and an insight into how fundamental analysis can be useful.

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What is fundamental analysis?

As many investors already know, the ***fundamental analysis*** of a company is to do with studying the financial information of the company, and the environment in which it operates, including consideration of it's competitors in the marketplace. This can include analysing its financial position and state of health, including consideration of things like: company profile, news and analyst opinions. The financial position can be determined from the historical information in the company's annual or half-yearly reports. These are normally available from either the ASX web site, or from the company's own web site. *Fundamental analysis* is often considered at the opposite end of analysis methods from ***technical analysis***.

The underlying reason that many investors utilise fundamental analysis is so that they can understand the company's true worth, or it's *intrinsic value*, and form an opinion about whether an investment in the company might be worthwhile and profitable. The study can include any one, or more, of the following:

- Study historic financial performance (based on periodic company financial reports);
- Consider forward estimates of possible future financial performance;
- Evaluate the company's management;
- Study the company's competitors, and the relevant industry and markets in which they all operate.

Some investors use fundamental analysis exclusively, while others use technical analysis exclusively, and others use a mix of both analysis methods.

Fundamental analysis can be quite simple, or it can be very complex. An investor who is keen to arrive at a perfect *stock valuation* (intrinsic price) might incorporate a lot of company-specific fundamental data, plus competitors' data, plus industry data, plus sector-specific information, and perhaps even climate and weather predictions. Some might also include consideration of the political climate — both current and possible future situations. This means that a room full of fundamental analysts could conceivably arrive at a large range in values for a company's *intrinsic value*. In which case, how do we know which one is "correct"? How do we know which one is going to be more accurate than the others? Which one should we pay more attention to?

Let's not forget the purpose behind performing an analysis to arrive at an intrinsic value for a company's stock. Most investors do this so that they know whether today's share price is below or above the derived intrinsic value, and whether they should buy or sell the stock. But let's also not forget that even if we arrive at an intrinsic value which eventually proves to be correct, the market might not trade the stock at the intrinsic value for many weeks, or months. Or something might come out of left field that instantly changes the intrinsic value by a large amount. In which case, what purpose was served by buying (or selling) the stock?

** - The two words *trading* and *investing* are often used somewhat interchangeably.

Fundamental analysis can include consideration of many key measures and ratios including:-

- Revenue,
- ROE (Return on Equity),
- EBIT (earnings before interest and tax),
- EPS (earnings per share),
- NTA (Net Tangible Assets),
- Dividend per share.
- Interest cover,
- Dividend yield, and dividend cover,
- Current ratio,
- Debt/equity ratio,
- Price/Earnings (PE) ratio,
- Price/Earnings Growth (PEG) ratio, and
- Price/dividend ratio.

For a start with more information about *fundamental analysis*, see: Wikipedia[1].

Is fundamental analysis useful?

There is some merit in using fundamental analysis when searching for companies in which to invest, depending on the purpose of the study.

Utilising fundamental analysis can help us to identify and invest only in "quality" companies that should be able to stay around for the long term, and which should be able to produce acceptable returns on an ongoing basis. It might also help us to identify under-valued (or over-sold) companies. There is certainly a lot of scope for a lot of effort with analysing the large amount of available fundamental information.

There are some very useful fundamental parameters that can be utilised to help reduce the risks of the investment activity. Just one key one is the debt to equity ratio. A company with a high debt to equity ratio can be said to be over-geared, and at a greater risk of default in hard times. Some commentators quote a value in the range of 50% to 70% debt to equity as the upper limit which seems to be workable in most situations. Investing in companies with a higher value is more risky in case of hard economic times, or difficulties within the company or the industry.

Another somewhat useful fundamental parameter is the Return on Equity (ROE). A company that has a history of good ROE values (better than, say, 10% per annum, or 20% per annum) is likely to continue to have good returns. By looking at this, it might help to identify quality companies. A company that has a history of good ROE values (better than, say, 10% per annum, or 20% per annum) is likely to continue to have good returns. Some investors will like to look at ROE, while others might like to focus on Total Shareholder Return, or any other similar metric.

Who uses fundamental analysis?

Without doubt, any student of a range of financial subjects will be taught that fundamental analysis is an essential tool. Many finance industry professionals utilise it heavily. Many fund managers (but not all) rely on it heavily to make, and to justify, their stock selections.

The economists who have responsibility for providing forward guidance to large companies and governments need some basis for their economic models, and fundamental analysis is as good as any.

1 Refer to: https://en.wikipedia.org/wiki/Fundamental_analysis, June 2015.

Many fund managers who have large amounts of client money to invest in the markets will utilise fundamental analysis in their stock selection, and also use diversification methods to mitigate the risks of poor selections.

The managers of large funds have two problems. Firstly, they need some seemingly sound basis for their investment selection methods. Secondly, they are not able to quickly change their investment selections, or quickly re-weight their portfolio. They will always rely on fundamental analysis for their decision making.

But what about the average retail investor? Well, many of them use fundamental analysis, but at times some observers wonder why this is the case — especially during long-term market turmoil as was experienced in the few years after the 1987 share market crash, and the years after the Global Financial Crisis period of 2008.

What are the downsides to fundamental analysis?

The pragmatists might identify the following as possible downsides to utilising fundamental analysis.

- Company financial reports are old news. Remembering that (in Australia) a company financial report is filed twice each year, so that the information therein will not be officially updated for another six months. During that time, a lot of things can change.
- It is possible that creative accounting techniques have been used to somewhat massage the fundamental metrics in a financial report. This could make some of the numbers somewhat misleading.
- Company profit ***forecasts*** are basically educated guesswork (no offence intended). That is, whomever prepares forecasts, and earnings guidance, for any company will be using models that attempt to predict the future, based on a range of assumptions. There is no guarantee that things will pan out that way.
- An investor who buys into an under-valued stock, and who is hoping for an increase in the share price, is basically hoping that enough investors eventually share their opinion and create enough demand to cause the price to rise. But if enough investors feel that a higher share price is not justified, then it won't happen.
- An under-valued stock might have a depressed (or falling) share price for a very good reason. It is possible that those in the know are aware of circumstances that are not widely known and that the low share price is justified. Once the real reason for the depressed share price becomes more widely known, it is possible that the price can fall even further (and maybe even further). Over the years there have been good examples of this (especially during the down legs of the economic cycle when credit is tightened and over-leveraged companies fall into a downward and irrecoverable spiral).
- Any change to the environment in which a company operates will not be reflected in the company's fundamentals until the next reporting season. In the meantime, many more investors might have jumped on board, and the company's share price might have tanked.
- Fundamental analysis is somewhat flexible. Depending on which fundamental analysis metrics we study, we could be selective in our study and subtly ignore any that don't support our sub-conscious view of the company (this is actually one of many cognitive biases that tend to affect investors).
- The uses for fundamental analysis are based on the idea that the stock market may price a company incorrectly from time to time, and that profits can be made by finding the under-priced stocks and waiting for the market to adjust the valuation of the company. There are two problems with this approach. Firstly, it is based on forming an opinion about whether the company's share price is correctly rated today or not — and that is a tall order. The second problem is that the active day traders in the markets will react to new company news on the

same day that the news is announced. So any retail investor who reacts to the news some days or weeks later will have already missed out.

Gob smacking?

Consider the following true story. A fund manager once said that he wanted to write a weekly newsletter for his clients, complete with stock recommendations. However, this very successful fund manager with a good track record was a mostly technical analyst, and did not pay much attention to fundamental analysis. But his clients wanted to read about the fundamentals of the stocks, to give them some comfort. So, he was happy to recommend stocks based on technical analysis, and then cherry pick the fundamental data to support the recommendations.

That is, it is generally possible to selectively utilise fundamental analysis metrics to tell you whatever you want to believe about a company.

Summary

You can tell from the above that this author is somewhat sceptical about the usefulness of fundamental analysis. However, fundamental analysis can be used to mitigate some of the risks of investing, by helping to find quality companies, and avoid the poor quality companies. Then it gets down to your own opinion about the criteria that defines a quality company.

Many successful investors use fundamental analysis to identify quality stocks, and then utilise technical analysis to time the entry — this is referred to as Funda-Technical Analysis.

In this article in Brainy's series on Share Trading and Investing (number ST-2300) we have taken an introductory look at fundamental analysis, and considered it from a number of different angles.

For more information, refer to other eBook (PDF) Articles including:

- eBook Article **ST-2350,** ***"Funda-Technical analysis"***;
- eBook Article **TA-2000,** ***"Technical analysis"***.

Your own notes and comments: ....

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