



Technical Analysis - Volume 2

What is Fundamental Analysis?

Fundamental Analysis

Fundamental analysis examines the underlying economic, industry, and company-specific factors that influence a security's value. Its primary objective is to estimate a company's intrinsic, or fair, value and determine whether its stock is currently undervalued, fairly valued, or overvalued.

At the company level, analysts evaluate financial performance, balance-sheet strength, cash flow, quality management, business strategy, competitive position, and growth prospects. At the industry level, they consider market conditions, competition, regulation, technological change, and supply-and-demand trends. At the broader economic level, they assess factors such as economic growth, inflation, interest rates, employment, and consumer spending.

By combining these layers of analysis, investors can compare a stock's estimated fair value with its current market price. When the market price is below fair value, the stock may represent an investment opportunity; when it is above fair value, it may carry increased downside risk.

Fundamental analysis is based on the belief that market prices do not always reflect all relevant information immediately. Although short-term prices may be influenced by sentiment, momentum, or temporary market conditions, fundamental analysts expect prices to move toward intrinsic value over time. Their goal is to identify and capitalize on these pricing discrepancies before the broader market recognizes them.

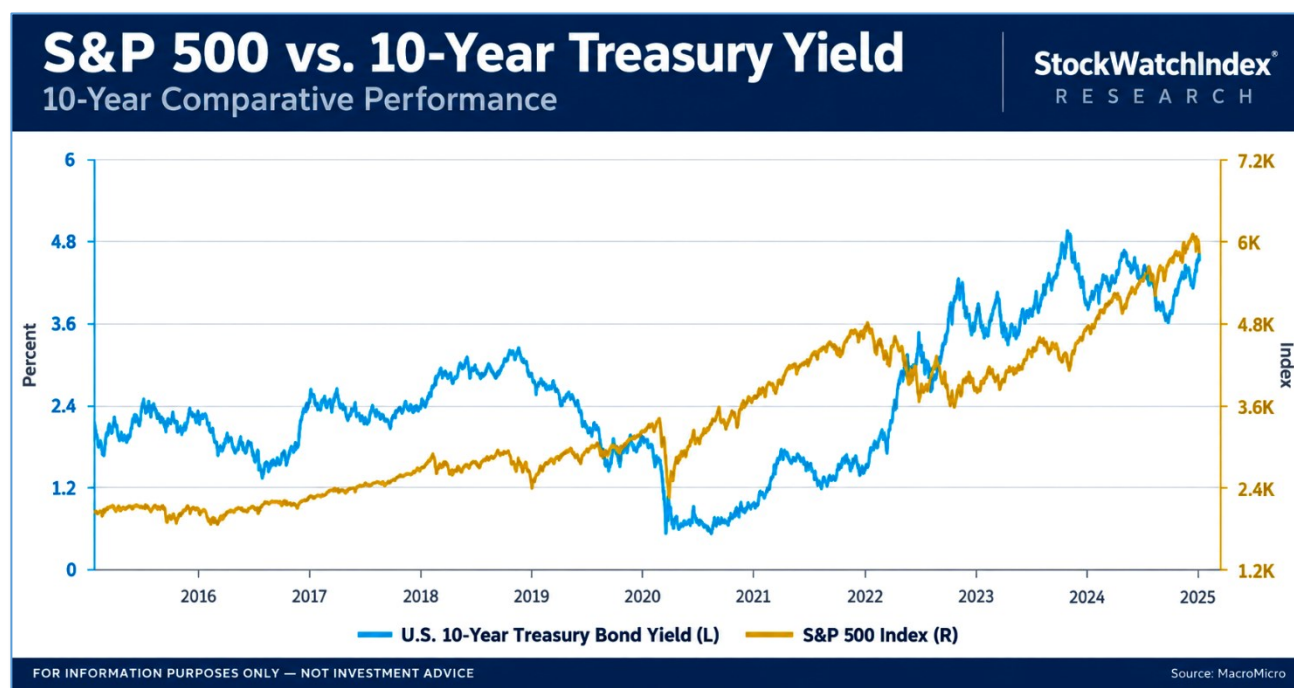
"Fundamental analysis examines the underlying forces. that affect the well-being of the economy and industry"

General Steps to Fundamental Evaluation

Although no clear-cut method exists, the breakdown below follows the order in which 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 essential to remember that all information is relative. Analysts compare industry groups with other industry groups, and companies with 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 (ChevronTexaco).

Economic Forecast

First, a top-down approach evaluates the overall 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 interest rates. Interest rates are also seen as a leading indicator of the stock market. Below is a chart of the S&P 500 and the yield on the 10-year note over the last 10 years. Although not exact, the correlation between stock prices and interest rates is evident. Once an investor develops an overall economic scenario, they can break the economy down into industry groups.

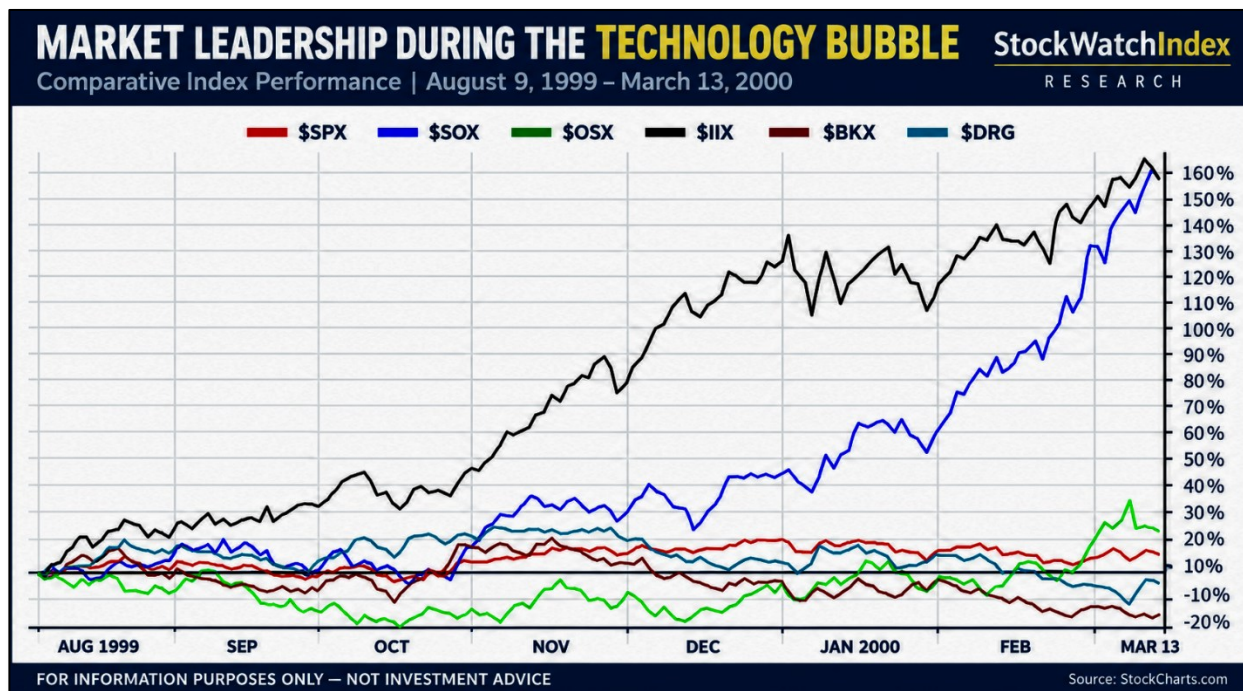


Group Selection

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 groups best suited to benefit from the current or future economic environment. If most companies are expected to benefit from an expansion, equity risk would be relatively low, and an aggressive, growth-oriented strategy might be advisable. A growth strategy might involve purchasing technology, biotech, semiconductor, AI, and cyclical stocks. If the economy is

forecast to contract, an investor may opt for a more conservative strategy and seek stable income-oriented companies. A defensive strategy might involve buying consumer staples, utilities, and energy-related stocks.

An investor should consider the overall growth rate, market size, and economic importance to assess an industry group's potential. 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; few lone guns exist. It is often more important to be in the right industry than in the right stock! The chart below shows the relative performance of five sectors over 7 months. As the chart illustrates, the right sector can make all the difference.



*Not current data; sample data only

Narrow Within the Group

Once an investor chooses an industry group, they need to narrow the list of companies before moving to a more detailed analysis. Investors usually want to identify a group's leaders and innovators. The first task is identifying the group's current business, competitive environment, and future trends. How do companies rank in terms of 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, whether marketing, technology, market share, or innovation. A thorough comparative analysis of the competition within a sector will help identify those companies with an edge and those most likely to keep it.

“The first task is to identify the current business and competitive environment. Within a group, as well as the future trends”

Company Analysis

With a shortlist of companies, an investor might analyze each company's resources and capabilities to identify those that can create and maintain 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 is the cornerstone of a company's strategy. A business is unlikely to succeed if it is flawed. For a new business, the question 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 market leader? Can the company maintain leadership?

Management

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). Questions to ask might include: How talented is the management team? Do they have a record of accomplishment? How long have they worked together? Can management deliver on its promises? If management is a problem, it is sometimes best to move on.

“Strong management can make for extraordinary success in a mature industry”

The final step in this analysis process would be to disassemble the financial statements and devise a valuation method. Below is a list of potential inputs into a financial analysis.

Financial Analysis

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KEY FUNDAMENTAL ANALYSIS FACTORS

A practical checklist for evaluating a company and its market position

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FINANCIAL & OPERATING FACTORS

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-to-Equity Ratio
Depreciation
Derivatives—Hedging
Discounted Cash Flow
Dividend
Dividend Coverage
Earnings
EBITDA
Economic Growth
Equity
Equity Risk Premium
Expenses

MARKET & STRATEGIC FACTORS

Goodwill
Gross Profit Margin
Growth
Industry
Interest Coverage
International
Investment
Liabilities—Current
Liabilities—Long-Term
Management
Market Growth
Market Share
Net Profit Margin
Page-View Growth
Page Views
Patents
Price-to-Book Value
Price-to-Earnings
PEG
Price-to-Sales
Product
Product Placement
Regulations
R&D
Revenues
Sector
Stock Options
Strategy
Subscriber Growth
Subscribers
Supplier Relationships
Taxes
Trademarks

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The list can seem quite long and intimidating. However, an investor will learn what works best over time and develop a set of preferred analysis techniques. Many valuation metrics exist, and what works best depends on the industry and the stage of the economic cycle. An investor can build a complete financial model to forecast future revenues, expenses, and profits, or rely on other analysts' forecasts and apply various multiples to arrive at a valuation. Some more popular ratios are found by dividing the stock price by a key value driver.

VALUATION RATIOS BY COMPANY TYPE

Matching operating models with relevant market-comparison measures

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RESEARCH

RATIO	COMPANY TYPE
Price-to-Book Value	Oil
Price-to-Earnings	Retail
Price/Earnings-to-Growth (PEG)	Networking
Price-to-Sales	Business-to-Business (B2B)
Price-to-Subscribers	ISP or Cable Company
Price-to-Lines	Telecommunications
Price-to-Page Views	Website / Biotechnology
Price-to-Promises	Artificial Intelligence (AI)

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This method assumes 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 substantial 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. Understanding which companies stand out as potential leaders and innovators will develop throughout the analysis process. In addition, other companies would be considered laggards and unpredictable. The final step of the fundamental analysis process is to synthesize all data, analyze it, and turn it into actual picks.

“Synthesize all data, analysis, and understanding into actual picks”

Strengths of Fundamental Analysis

Long-term Trends

Fundamental analysis suits long-term investments based on long-term trends. Identifying and predicting 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 helps identify companies that represent excellent value. Some of the most legendary investors focus on long-term 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 fundamental analysis's most obvious but less tangible rewards is developing a thorough understanding of business. After such painstaking research and analysis, an investor will know a company's key revenue and profit drivers. Earnings and earnings expectations can be potent drivers of equity prices - even some technicians will agree with that. A good understanding can help investors avoid companies prone to shortfalls and find those that keep delivering.

In addition to understanding the business, fundamental analysis helps investors understand the key value drivers and companies within an industry.

“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 high-risk opportunities (tech), low-risk opportunities (utilities), growth-oriented opportunities (computer), value-driven opportunities (oil), non-cyclical opportunities (consumer staples), cyclical opportunities (transportation), or income-oriented opportunities (high yield).

Knowing Who's Who

Stocks move as a group. By understanding a company's business, investors can better position themselves to categorize stocks within their relevant industry group. Businesses can change rapidly, and so can a company's revenue mix. This happened to too many pure Internet retailers, not Internet companies but plain retailers. Knowing a company's business and being able to place it in a group can make a dramatic 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 contradict the current price prevailing on Wall Street. When this happens, the analyst claims that the whole street is wrong. This is not to say that there are misunderstood companies out there, but it is quite brash to imply that the market price, and hence Wall Street, is wrong.

"It is quite brash to imply that the market price, and hence Wall Street, is wrong"

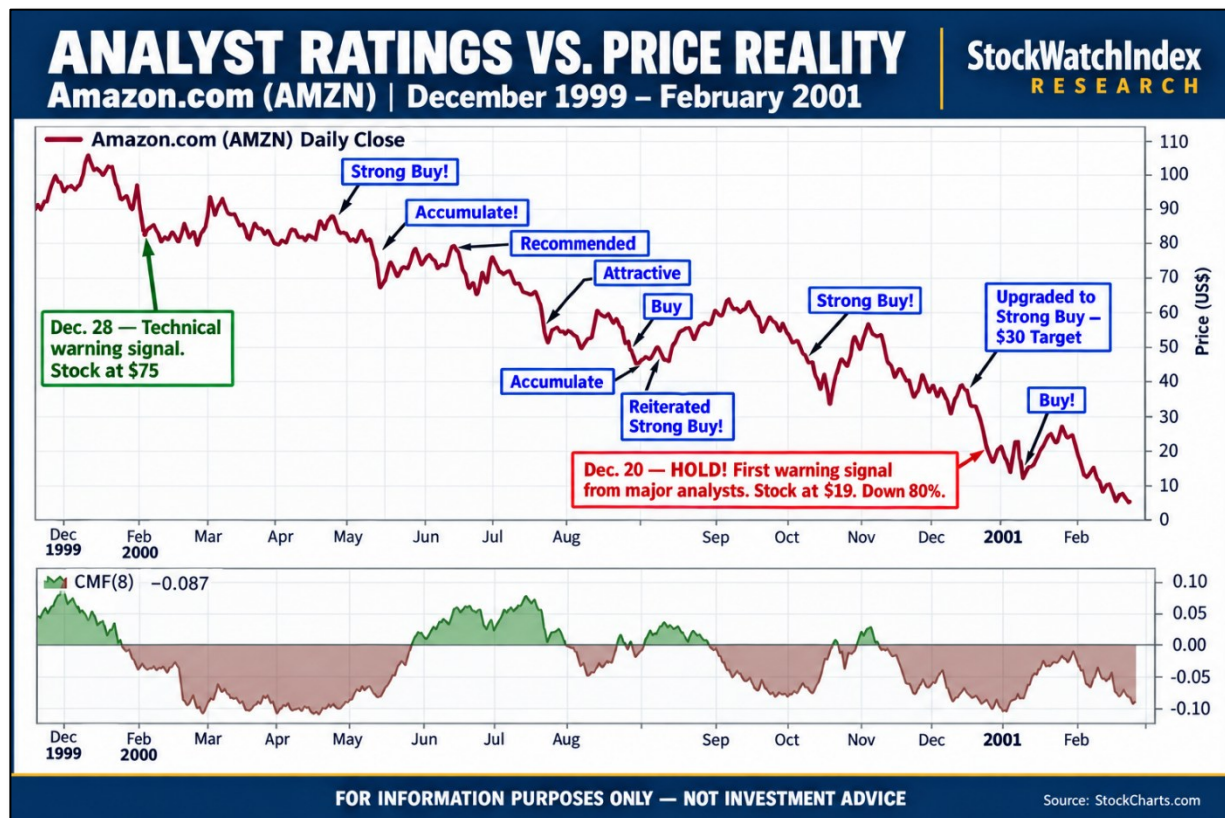
Industry/Company Specific

Valuation techniques vary by industry group and by each company's specifics. For this reason, different industries and companies need different techniques and models. This can be time-consuming, limiting how much research you can do. A subscription-based model may work well for an Internet Service Provider (ISP) but is unlikely to be the best model for valuing an oil company.

Subjectivity

Fair value is based on assumptions. Changes to growth or multiplier assumptions can significantly alter the final valuation. Fundamental analysts know this and use sensitivity analysis to present a base-case valuation, an average-case valuation, and a worst-case valuation. However, even in a worst-case valuation, most models are usually bullish; the only question is how much. The chart below shows how stubbornly bullish many fundamental analysts can be.

"Many fundamental analysts can be stubbornly bullish"



Analyst Bias

Most of the information in 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 reports written by sell-side analysts who work for big brokers (CIBC, Merrill Lynch, Robertson Stephens, CS First Boston, Paine Weber, and DLJ). These brokers also handle underwriting and investment banking for the companies. Even with restrictions to prevent conflicts of interest, brokers maintain an ongoing relationship with the company under analysis. When reading these reports, it is essential to consider any biases.

A sell-side analyst may have.

On the other hand, the buy-side analyst analyzes the company purely from an investment standpoint for a portfolio manager. If a relationship exists with the company, it is usually on different terms. In some cases, this may be as a large shareholder.

"Take into consideration any biases a sell-side analyst may have"

Definition of Fair Value

When market valuations extend beyond historical norms, pressure mounts 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, analysts may be pressured to raise that assumption. An old Wall Street adage says the value of any asset (stock) is only what someone is willing to pay for it (current price). Just as stock prices fluctuate, so do growth and multiplier assumptions. Should we believe Wall Street and the stock price, or the analyst and market assumptions?

Free cash flow or earnings used to be multiplied to arrive at fair value. In recent years, the S&P 500 typically sold for 28 times free cash flow. However, because so many companies were and are losing money, valuing a business as a multiple of its revenues has become popular. This would seem 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 you should approach it with caution. You must be familiar with the analyst behind the report if you read research written by a sell-side analyst. We all have personal biases, and every analyst has some bias. That's not wrong, and the research can still be highly valuable. Learn what the ratings mean and an analyst's accomplishment record before jumping off the deep end. Corporate statements and press releases offer valuable information, but read them skeptically to separate fact from spin. Press releases do not happen accidentally; they are an essential PR tool for companies.

“Investors should become skilled readers to weed out necessary information and ignore the hype”

This will be continued in Technical Analysis Part 3, “Intermarket Analysis.”

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