

Fundamental analysis is the process of looking at a business at the basic or fundamental financial level. This type of analysis examines key ratios of a business to determine its financial health and gives you an idea of the value its stock. Many investors use fundamental analysis alone or in combination with other tools to evaluate stocks for investment purposes. The goal is to determine the current worth and, more importantly, how the market values the stock.

Fundamental analysis focuses 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.

A method of evaluating a security can be attempted by measuring its intrinsic value by examining related economic, financial and other qualitative and quantitative factors. Fundamental analysts attempt to study everything that can affect the security's value, including macroeconomic factors (like the overall economy and industry conditions) and individually specific factors (like the financial condition and management of companies).

The end goal of performing fundamental analysis is to produce a value that an investor can compare with the security's current price in hopes of figuring out what sort of position to take with that security (under priced = buy, overpriced = sell or short).

Fundamental analysis is about using real data to evaluate a security's value. Although most analysts use fundamental analysis to value stocks, this method of valuation can be used for just about any type of security. This method of security analysis is considered to be the opposite of technical analysis.

For example, an investor can perform fundamental analysis on a securities value by looking at revenues, earnings, future growth, return on equity, profit margins and other data to determine a company's underlying value and potential for future growth. In terms of stocks, fundamental analysis focuses on the financial statements of a company being evaluated.

Top-down and Bottom-up

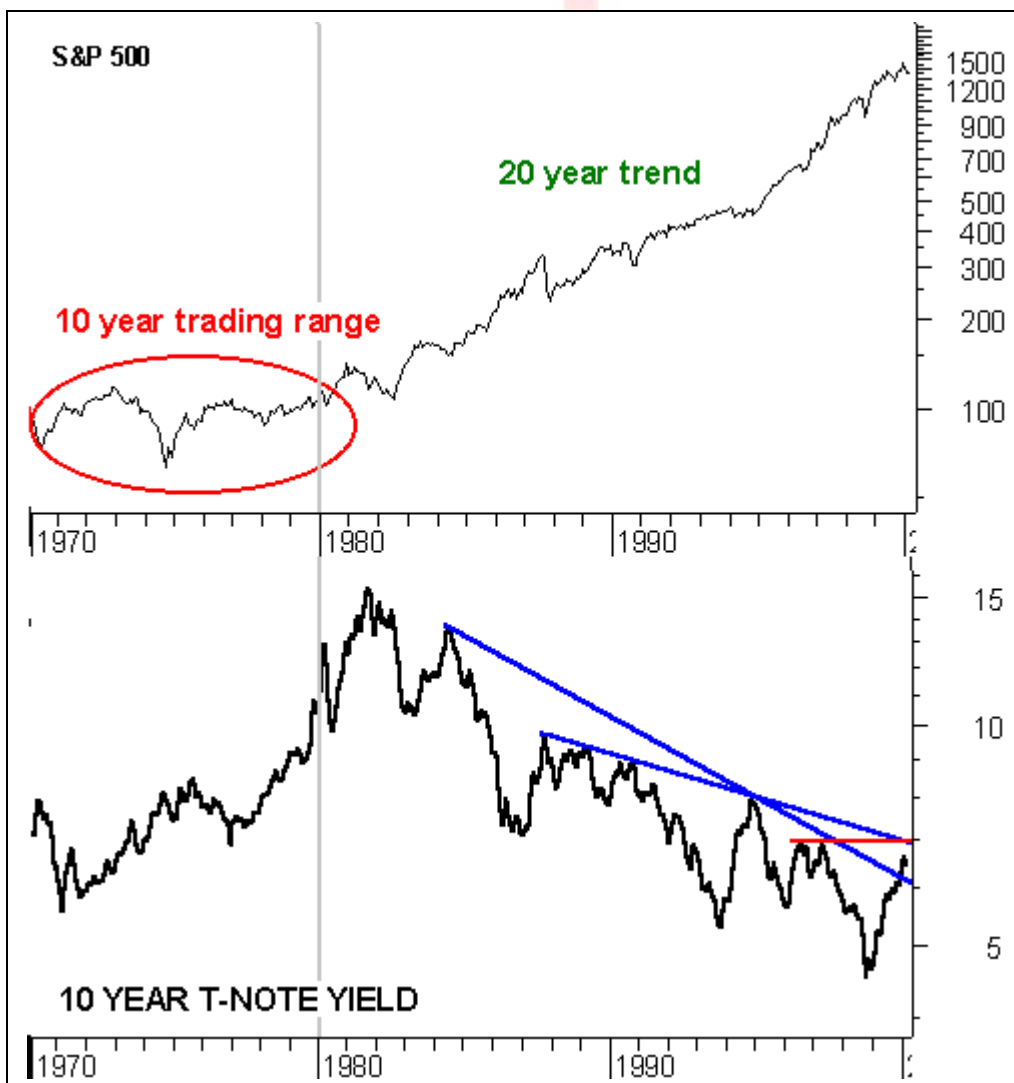
Investors can use either a top-down or bottom-up approach.

The **top-down** investor starts his analysis with global economics, including both international and national economic indicators, such as GDP growth rates, inflation, interest rates, exchange rates, productivity, and energy prices. He narrows his search down to regional/industry analysis of total sales, price levels, the effects of competing products, foreign competition, and entry or exit from the industry. Only then does he narrow his search to the best business in that area. 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 (ChevronTexaco).

The **bottom-up** investor starts with specific businesses, regardless of their industry/region.

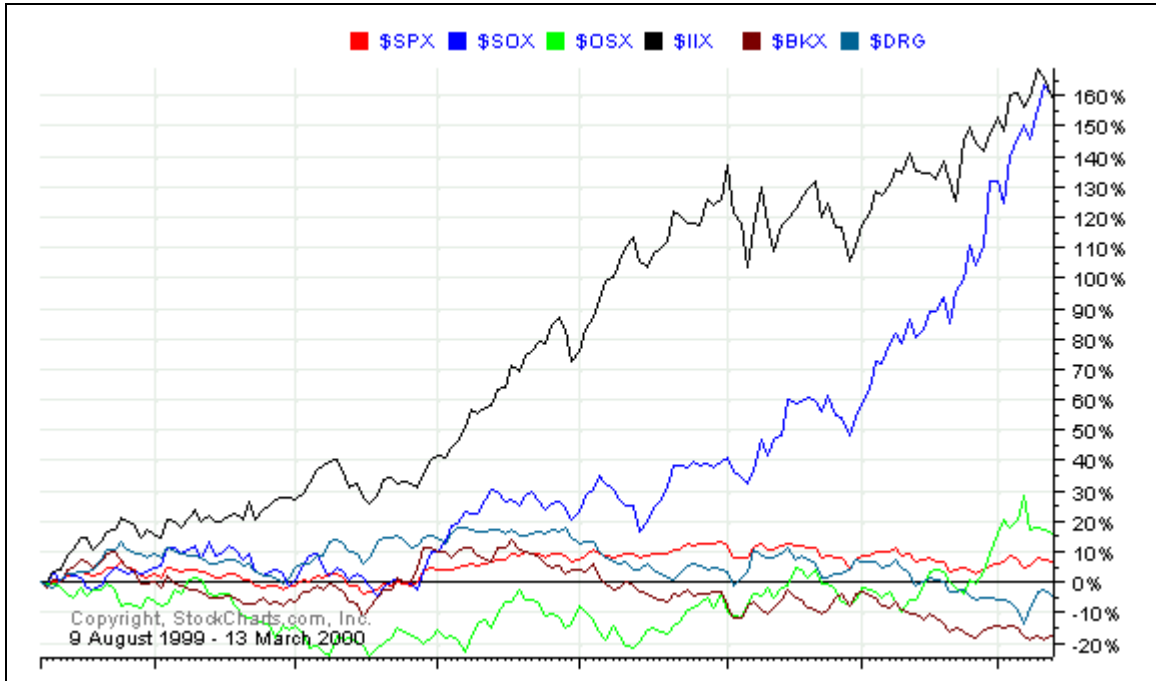
Economic Forecast

First and foremost in a top-down approach would be an overall evaluation of the general economy. 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

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 an industry group's potential, an investor would want 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. It is 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? 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 forms the bedrock upon which all else is built. If the plan, model or concept goes wrong, there is little hope for the business. For a new business, the

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



Its only 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 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 B2B
Price/Sales	ISP or cable company
Price/Subscribers	Telecom
Price/Lines	Web site
Price/Page views	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

Over the course of the analysis process, an understanding will develop of which companies stand out as potential leaders and innovators. The final step of the fundamental analysis process is to synthesize all data, analysis and understanding into actual picks.

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 a good value. Some of the most legendary investors think long-term and value. Fundamental analysis can help uncover companies with valuable assets, a strong balance sheet, stable earnings, and staying power.

Business Acumen

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).

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 prevailing price.

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, which can limit the amount of research that can be performed.

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 valuation, most models are almost always bullish, the only question is how much so. The chart below shows how stubbornly bullish many fundamental analysts can be.



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