| FUNDAMENTALS |

Standard

Explaining fundamental analysis

Studying numbers to discover a company's worth

IN ITS SIMPLEST FORM, fundamental analysis is the study of a company's "fundamentals" with the aim of calculating exactly what a listed company is worth. Based on that valuation, investors will either buy or sell its share. That sounds straightforward enough – except for the jargon and the practicalities of how to do it.

So let's first define what those fundamentals are before moving on to a "do-it-yourself" guide over the next three weeks. We've all heard the word "fundamentals" but it's not always clear what it means. Investopedia.com notes that it really means getting down to the basics of what makes a company a good investment.

In its simplest form, fundamental analysis involves looking at any numbers that can show something about what a company's worth. That includes the financial statements and ratios derived from those numbers that can give you more insight into whether the company is performing well, indifferently or badly.

Investopedia.com says: "Fundamental analysis focuses on creating a portrait of a company, identifying the intrinsic or fundamental value of its shares and buying or selling the stock based on that information." That contrasts with technical analysis, which focuses only on the trading history and share price movements of a particular stock.

Leading from that, it's clear that fundamental analysis is the process of looking at a business at the basic or fundamental financial level. Such analysis examines key ratios of a business to determine its financial health and provides you with the tools to calculate its real or "intrinsic value". On page 4 we highlight where you can find some helpful ratios.

Fundamental analysis is that performed by most professional analysts in either stockbroking (sell side) or asset management (buy side) research teams. There are two broad approaches to fundamental analysis, which will be discussed in more depth over the next two weeks. These are called "top-down" and "bottom-up" investing.

Broadly, top-down investing looks at a company's operating environment in addition to its own strategies and likely future performance. (The techniques can be likened to an inverted pyramid.) Taking a top-down approach to a company's earnings' prospects involves first looking at the broad macroeconomic, social and political environment in which it operates.

The focus of the analysis is then funnelled and progressively narrowed to look at industry-specific or regional influences on a company's future economic performance. The major benefit of top-down analysis is that it ensures relevant information is included in a consistent way. It will also highlight specific industries attractive for investment.

So the tricky question is to pick the specific shares into which you – the investor – will put your hard-earned cash. That's where we use bottom-up fundamental analysis, which will filter the different companies in a sector by looking at the individual "investment story" of each, as well as analysing a myriad of different numbers.

We'll look at those more closely in two weeks' time, but for now it's sufficient to say that those numbers include both the financial statements published by each company as well as specific ratios that investors calculate from these in a process that's affectionately known as "number-crunching".

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It also includes an assessment of a company's management: its credibility, experience and strategic insight. From that the analyst draws conclusions concerning the attractiveness of that specific company as an investment and estimates its true, or intrinsic, value.

If the "intrinsic value" is lower than the prevailing share price on the JSE the analyst will rate the stock as a "buy"; if it's lower,

then the analyst will recommend a "sell". And if intrinsic value is broadly in line with the market price the share will be labelled a "hold". These recommendations usually have a one-year time horizon.

Share price declines can either be a buying opportunity or a trap for the unwary investor, as nearly all corporate collapses are preceded by sustained price falls. (For example, both Enron's and WorldCom's share prices fell for two years before they both finally hit the wall.)

Fundamental analysis can help you ascertain whether a share price fall is a good buying opportunity or a pointer to sell, as it can signpost the warning signs that a company is about to become financially distressed.

First, investors should always keep an eye on cash flow statements, which show the actual cash movements during a year, to ensure that companies generate cash more often than they don't, especially from their operations. Earnings growth that isn't supported by cash flow generation over time will not be sustainable.

The second factor to watch is debt levels.

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1 « Excessive – and growing – debt may highlight a company that's heading for trouble.

But the process of fundamental analysis can be involved and requires commitment, perseverance and attention to detail. As Investopedia.com notes, it can be a lot of hard work. "But that is, arguably, the source of its appeal. By taking the trouble to dig into a company's financial statements and assess its prospects, investors can learn enough to know when the share price is wrong.

"Those investors able to spot the market's mistakes can make themselves money – a lot of it. At the same time, buying companies based on intrinsic long-term value protects investors from the dangers of day-to-day market flux."

However, it's often forgotten that the "intrinsic value" calculation also requires you to forecast future fundamentals, such as earnings per share and dividends per share. Individuals can either use analyst consensus forecasts – available from I-Net on Standard's Online Share Trading website – or build their own models.

Lastly, it's important to remember that a share price may not immediately shoot up or collapse after you've bought or sold a share based on your fundamental analysis. There could either be an incorrect assumption in your forecast or the market may be pricing some event of which you're unaware into the share price.

Alternatively, it may just take time for the market to recognise your genius and price the share as you believe it should be. ¤

The battle to be right

Fundamental versus technical analysis

THERE'S A BATTLE that rages between fundamental and technical analysts. Many fundamentalists believe that technical analysts might as well consult astrological charts as technical indicators. In return, many technical analysts believe that fundamental analysis is close to numerology. There are two possible ways to settle the dispute.

First, investors may use both as a way of checking their decisions. While the science of analysis is never perfect, believers will find confirmations of strong buy or sell indications from both schools hard to ignore.

Second, pick one analysis horse and back it – but that course risks missing opportunities. As Richard Seddon, head of Online Share Trading at the Standard says, investors should use fundamental analysis to pick their shares and technical analysis to time their trade or use one to validate the other.

Fundamental analysis ensures that an investor knows what they like about a company, how well it's managed and the market in which it operates. By contrast, technical analysis is all about price and doesn't add in that background colour.

Those who favour the technical school point out that fundamental analysis has a number of shortcomings. In particular, it's time-consuming, it can limit the range of possible investments through an analyst's relentless focus on one specialised sector or market and it's not always possible to get the necessary raw material on time, as a company's circumstances may have altered – a situation that will be anticipated by the share price.

In addition, while an individual's interpretation of a set of facts and figures may prove right over the long term it may take some time for the market to truly appreciate your genius.

In many ways, technical analysis addresses those shortcomings by arguing that share prices already contain all the information that the market has about a company, including insider knowledge.

Arguably, the single biggest advantage of technical analysis is that it can be applied to virtually any trading medium and investment time horizon. A technical analyst can analyse shares, bonds, options, mutual funds, commodities and many other forms of investments for buy and sell opportunities and can do so by examining a variety of inputs, including tic-by-tic, intraday, daily, weekly or monthly data – from very short-term to very long-term perspectives.

The technician can follow as many markets as he wants, which is seldom true for the fundamental analyst, who must deal with a lot of data. As a result, most fundamentalists tend to specialise in one market.

Technicians also argue that market prices tend to lead the known fundamentals. While the known fundamentals have already been discounted and are already "in the market" prices are now reacting to the unknown fundamentals. Some of the most dramatic bull and bear markets in history have begun with little or no perceived change in the fundamentals. By the time those changes became known the new trend was well under way.

On the basis of the apparent ease of use of technical analysis it's easy to see why technical analysts are so adamant about the superiority of charts to numbers.

If a trader had to choose only one of the two approaches to use, technical analysis would be the logical choice, as it already encapsulates some fundamental analysis – as the fundamentals are already reflected in market prices.

Charts show what the markets are actually doing and they strip out all the noise and opinions. Charts are like road maps and, more important, with the help of leading indicators and other technical tools they can give us a good idea as to where the markets are likely headed. They don't tell us why, but 4 »

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ideally the charts and the fundamentals will coincide – and when they do the road map is even clearer.

It's possible to trade commodity futures markets using just the technical approach. It's doubtful that anyone could trade off the fundamentals alone with no consideration of the technical side of the market. You'll find that as you become more skilled in charting and technical analysis that the illusion of randomness in the financial markets will gradually disappear. That will lead to more confidence in making those very crucial trading decisions.

Nonetheless, fundamental analysis can add extra information that a purely technical trader doesn't have access to.

Paradoxically, the two approaches don't invalidate one another but rather complement each other – the key difference being timing. That's simply because the market may move in the opposite direction to a fundamental price projection over the short term – and precise timing information is crucial in successful trading.

Ultimately, investors must make up their own minds. But there can be no doubt that markets don't behave as expected all the time – and analysis provides just one extra advantage in wealth creation. ¤

Where to find the numbers

IT'S CLEAR THAT ANALYSIS – whether fundamental or technical – requires a suite of tools. And though those tools are specialised, the good news is that most are readily available to the novice investor.

Richard Seddon, head of Online Share Trading at the Standard, says that the discount broking website www.securities.co.za provides many of those tools to its broking customers as part of its product offering.

On the fundamental analysis side the website carries top-down insights from Standard Bank's economic research division, plus notes on individual companies from its rated research team.

For bottom-up fundamental analysis the website contains the financial statements for the past 10 years of every single company listed on the JSE. Over and above that raw data it also provides key ratios, such as price:earnings (p:e) multiples, beta, return on equity (ROE) and many others. We'll deal with those more fully in two weeks' time when we work with bottom-up fundamental analysis.

But the website isn't the only place where investors can find some of those key ratios: the share price pages of the daily and weekly press (including *Finweek*) publish information in addition to share prices, including p:e ratios, dividend yields, market capitalisation and share price changes over specific time periods.

The website can also provide more complex bottom-up analysis tools by filtering shares that meet certain criteria. Those could include searching for shares that fall within a prescribed p:e ratio or dividend yield range. In addition, it provides a database of share movements for specified time periods, such as the past month, past three months, past year and past 10 years.

The website also provides forecast data. That's provided by I-Net Bridge, a company that collates analysts' forecasts and recommendations to determine the average (or consensus) projected earnings per share and market view of the share: whether analysts recommend it as a buy, sell or hold.

On the technical analysis side, the Online Share Trading website provides full interactive charting tools with 10 years' worth of data. In addition, customers receive a discount when downloading third-party technical analysis data, paying as little as R90/month.

Over and above all that, the website provides other interesting information, such as directors' dealings, 52-week highs and lows, exchange rates, international indices, news from both Reuters and the JSE, key shareholders of each company, dividends that are payable, as well as the biggest gainers and losers and the most active shares on the JSE in any one trading day.

It's everything that a full-service broker would provide – plus more. ¤

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What type of analysis uses financial information to make an investment decision?
2. What type of analysis uses share price information and trading patterns to make an investment decision?
3. Which website provides a number of fundamental analysis tools? ¤