

Fundamental Analysis

What is Fundamental Analysis

Fundamental Analysis is a method of measuring a company's intrinsic value by examining related economic and financial factors. Fundamental analysts' study anything that can affect the security's value, from macroeconomic factors such as the state of the economy and industry conditions to microeconomic factors like the effectiveness of the company's management.

Understanding Fundamental Analysis

All stock analysis tries to determine whether a security is correctly valued within the broader market. Fundamental analysis is usually done from a macro to micro perspective in order to identify securities that are not correctly priced by the market. Analysts typically study, in order, the overall state of the economy and then the strength of the specific industry before concentrating on individual company performance to arrive at a fair market value for the stock.

For stocks, fundamental analysis uses revenues, earnings, future growth, return on equity, profit margins, and other data to determine a company's underlying value and potential for future growth. All of this data is available in a company's financial statements.

Investing and Fundamental Analysis

An analyst works to create a model for determining the estimated value of a company's share price based on publicly available data. This value is only an estimate, the analyst's educated opinion, of what the company's share price should be worth compared to the current market price. Some analysts may refer to their estimated price as the company's intrinsic value.

If an analyst calculates that the stock's value should be significantly higher than the stock's current market price, they may publish a buy or overweight rating for the stock. This acts as a recommendation to investors who follow that analyst. If the analyst calculates a lower intrinsic value than the current market price, the stock is considered overvalued and a sell or underweight recommendation is issued.

Investors who follow these recommendations will expect that they can buy stocks with favourable recommendations because such stocks should have a higher probability of rising over time. Likewise, stocks with unfavourable ratings are expected to have a higher probability of falling in price. Such stocks are candidates for being removed from existing portfolios or added as "short" positions.

Financial Statements

Financial statements are the medium by which a company discloses information concerning its financial performance. Followers of fundamental analysis use quantitative information gleaned from financial statements to make investment decisions. The three most important financial statements are income statements, balance sheets, and cash flow statements.

The Balance Sheet

The balance sheet represents a record of a company's assets, liabilities, and equity at a particular point in time. The balance sheet is named by the fact that a business's financial structure balances in the following manner:

Assets = Liabilities + Shareholders' Equity

Assets represent the resources that the business owns or controls at a given point in time. This includes items such as cash, inventory, machinery, and buildings. The other side of the equation represents the total value of the financing the company has used to acquire those assets. Financing comes as a result of liabilities or equity. Liabilities represent debt (which of course must be paid back), while equity represents the total value of money that the owners have contributed to the business - including retained earnings, which is the profit made in previous years.

The Income Statement

While the balance sheet takes a snapshot approach in examining a business, the income statement measures a company's performance over a specific time frame. Technically, you could have a balance sheet for a month or even a day, but you'll only see public companies report quarterly and annually.

The income statement presents information about revenues, expenses, and profit that was generated as a result of the business' operations for that period.

Statement of Cash Flows

The statement of cash flows represents a record of a business' cash inflows and outflows over a period of time. The cash flow statement is important because it's very difficult for a business to manipulate its cash situation. There is plenty that aggressive accountant can do to manipulate earnings, but it's tough to fake cash in the bank. For this reason, some investors use the cash flow statement as a more conservative measure of a company's performance.

Examples of Fundamental Analysis

Take the Coca-Cola Company, for example. No analysis of Coca-Cola is complete without taking into account its brand recognition. Anybody can start a company that sells sugar and water, but few companies are known to billions of people. It's tough to put a finger on exactly what the Coke brand is worth, but you can be sure that it's an essential ingredient contributing to the company's ongoing success.

A fundamental analysis would begin by assessing the value of Coca-Cola's assets, income streams, debts, and liabilities. CSI Market, a popular source of financial research, begins by comparing objective metrics such as revenue, profits, and growth, especially in the context of the wider beverage industry. Noting that Coca-Cola's revenue grew by 41% in the second quarter of 2021, while the wider beverage industry saw only 25% revenue growth, a fundamental analyst could infer that the Coca-Cola Company is better positioned to make gains in the current market environment than the average company in the same industry.



Question:

1. Why is Fundamental Analysis used?

- To do short term trading
- To do long term Investment
- To identify company's debt record
- None of the above

2. Why is the intrinsic value of a stock?

- The value at which the stock is listed in the market
- The probable future value of the stock
- The true value of the stock
- None of the above