FUNDAMENTAL ANALYSIS

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In accounting and finance, fundamental analysis is a method of assessing the intrinsic value of a security by analyzing various macroeconomic and microeconomic factors. The ultimate goal of fundamental analysis is to quantify the intrinsic value of a security. Its intrinsic value can then be compared to its current market price to help with investment decisions.

Unlike technical analysis that concentrates on forecasting a security's price movements, fundamental analysis aims to determine the "correct price" (true value) of a security. By knowing the right price, an investor can make an informed investment decision. A security can be overvalued, undervalued, or fairly valued.

Components of Fundamental Analysis

Fundamental analysis consists of three main parts:

- Economic analysis
- Industry analysis
- Company analysis

Fundamental analysis is an extremely comprehensive approach that requires a deep knowledge of accounting, finance, and economics. For instance, fundamental analysis requires the ability to read financial statements, an understanding of macroeconomic factors, and knowledge of valuation techniques.

It primarily relies on public data, such as a company's historical earnings and profit margins, to project future growth.

Top-down vs. Bottom-up Fundamental Analysis

Fundamental analysis can be either top-down or bottom-up. An investor who follows the top-down approach starts the analysis with the consideration of the health of the overall economy. By analyzing various macroeconomic factors such as interest rates, inflation, and GDP levels, an investor tries to determine the overall direction of the economy and identifies the industries and sectors of the economy offering the best investment opportunities.

Afterward, the investor assesses specific prospects and potential opportunities within the identified industries and sectors. Finally, they analyze and select individual stocks within the most promising industries.

Alternatively, there is the bottom-up approach. Instead of starting the analysis from the larger scale, the bottom-up approach immediately dives into the analysis of individual stocks. The rationale of investors who follow the bottom-up approach is that individual stocks may perform much better than the overall industry.

The bottom-up approach is primarily concentrated on various microeconomic factors such as a company's earnings and financial metrics. Analysts who use such an approach develop a thorough assessment of each company to gain a better understanding of its operations.

COMPANY VALUATION RATIOS

Valuation is the financial process of determining what a company is worth. Valuation ratios put that insight into the context of a company's share price, where they serve as useful tools for evaluating investment potential. Financial statements can be used by analysts and investors to compute financial ratios that indicate the health or value of a company and its shares. Financial ratios are powerful tools to help summarize financial statements and the health of a company or enterprise.

Financial ratios are relationships based on a company's financial information and they can serve as useful tools to evaluate a company's investment potential. P/E, P/B, PEG and dividend yields are four commonly used metrics that can help break down a stock's value and outlook.

Any single ratio is too narrowly focused to stand alone, so combining these and other financial ratios give a more complete picture.

Here is a list of principle valuation ratios.

Price-to-earnings

Price-to-earnings ratio (P/E) looks at the relationship between a company's stock price and its earnings.

The P/E ratio gives investors an idea of what the market is willing to pay for the company's earnings. The ratio is determined by dividing a company's current share price by its earnings per share. For example, if a company is currently trading at $25 a share and its earnings over the last 12 months are $1.35 per share, the P/E ratio for the stock would be 18.5 ($25/$1.35). As the P/E goes up, it shows that current investor sentiment is favorable. A dropping P/E is an indication that the company is out of favor with investors.

The price to earnings (P/E) ratio is possibly the most scrutinized of all the ratios. A stock can go up in value without significant earnings increases, but the P/E ratio is what decides if it can stay up. Without earnings to back up the price, a stock will eventually fall back down. An important point to note is that one should only compare P/E ratios among companies in similar industries and markets.

The reason for this is simple: A P/E ratio can be thought of as how long a stock will take to pay back your investment if there is no change in the business. A stock trading at $20 per share with earnings of $2 per share has a P/E ratio of 10, which is sometimes seen as meaning that you'll make your money back in 10 years if nothing changes.

The reason stocks tend to have high P/E ratios is that investors try to predict which stocks will enjoy progressively larger earnings. An investor may buy a stock with a P/E ratio of 30 if he or she thinks it will double its earnings every year (shortening the payoff period significantly). If this fails to happen, the stock will fall back down to a more reasonable P/E ratio. If the stock does manage to double earnings, then it will likely continue to trade at a high P/E ratio.

Price-to-book value

Price-to-book value (P/B) is a measurement that looks at the value the market places on the book value of the company. It is calculated by taking the current price per share and dividing by the book value per share. The book value of a company is the difference between the balance sheet assets and balance sheet liabilities. It is an estimation of the value of the company if it were to be liquidated. For example, a company with a share price of $60 and a book value of $65 per share would have a P/B ratio of 0.9. A ratio over 1 generally implies that the market is willing to pay more than the equity per share, while a ratio under 1 implies that the market is willing to pay less.

With purely financial firms, the book value can fluctuate with the market as these stocks tend to have a portfolio of assets that goes up and down in value. Industrial companies tend to have a book value based more on physical assets, which depreciate year over year according to accounting rules.

Price-to-sales

The price-to-sales ratio (P/S) shows how much the market value every dollar of the company's sales. To calculate it, take the company's market capitalization and divide it by the company's total sales over the past 12 months. A company's market cap is the number of shares issued multiplied by the share price. The

P/S ratio can be used in place of the P/E ratio in situations where the company has a net loss. One of the advantages of using the P/S ratio is that sales are much harder to manipulate than earnings. Since a company's sales are generally more stable than its earnings level, any large changes in the P/S ratio are often more likely to indicate a departure from the intrinsic value of the company (either up or down).

Price-to-cash flow

Price-to-cash flow ratio (P/CF) evaluates the price of a company's stock relative to how much cash flow the company generates. It is calculated by dividing the company's market cap by its operating cash flow in the most recent 12 months. It can also be calculated by dividing the per-share stock price by the per share operating cash flow. P/CF ratio is an alternative method to P/E ratio. Many investors prefer to use a P/CF metric because it is considered harder to manipulate cash tallies than it would be to massage earnings reports under generally accepted accounting principles, which could make the cash-based benchmark a more reliable indicator.

Price/earnings-to-growth (PEG)

Price/earnings-to-growth ratio is the relationship between the P/E ratio and the projected earnings growth of a company. It is calculated by dividing the P/E ratio by the earnings-per-share growth. For example, if a company’s P/E ratio is 16.5 and its earnings-per-share growth over the next 3 years is expected to be 10.8%, its PEG ratio would be 1.5. A PEG of 1 or less is typically taken to indicate that the company is undervalued. A PEG of more than 1 is typically taken to indicate that the company is overvalued. To get a clearer picture of value, the PEG of the company should also be compared with the PEG of the market and with the industry that the company competes in.

Because the P/E ratio isn't enough in and of itself, many investors use the price to earnings growth (PEG) ratio. Instead of merely looking at the price and earnings, the PEG ratio incorporates the historical growth rate of the company's earnings. This ratio also tells you how company A's stock stacks up against company B's stock. The PEG ratio is calculated by taking the P/E ratio of a company and dividing it by the year-over-year growth rate of its earnings. The lower the value of your PEG ratio, the better the deal you're getting for the stock's future estimated earnings.

By comparing two stocks using the PEG, you can see how much you're paying for growth in each case. A PEG of 1 means you're breaking even if growth continues as it has in the past. A PEG of 2 means you're paying twice as much for projected growth when compared to a stock with a PEG of 1. This is speculative because there is no guarantee that growth will continue as it has in the past.

The P/E ratio is a snapshot of where a company is and the PEG ratio is a graph plotting where it has been.

Dividend Yield

It's always nice to have a back-up when a stock's growth falters. This is why dividend-paying stocks are attractive to many investors – even when prices drop, you get a paycheck. The dividend yield shows how much of a payday you're getting for your money. By dividing the stock's annual dividend by the stock's price, you get a percentage. You can think of that percentage as the interest on your money, with the additional chance at growth through the appreciation of the stock.