Investor's Guide to Fundamental Analysis

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This is the first of a two-part article that discusses the relevance of fundamental analysis in stock selection. As commonly argued against the technical analysis, fundamental analysis provides a more in-depth and fundamental measure of stocks from a long-term perspective by studying their fundamental parameters.

Fundamental analysis happens to be the cornerstone of investing. There are innumerable investment strategies that are very different from each other, yet almost all use the fundamentals as a part of their analysis. Fundamental analysis is all about doing qualitative and quantitative analyses about the basic details of the business such as the revenue, expenses, assets, liabilities and all other fundamental aspects of the company. Where pure quantitative analysis tool such as ratio analysis cannot be used, the intangibles in the business have to be broken down into more interpretable process, which is called the qualitative analysis.

Fundamental Analysis Explained

Fundamental analysis tries to value the underlying factors in a business and estimate the intrinsic value of a security. It can be performed on both the industry as well as the economy. It primarily seeks to answer certain questions, such as:

- Is the company's revenue growing?
- Is it actually making a profit?
- Will it be able to repay its debts?
- Is the company's management trying to "manipulate the financial records"?

There may be numerous questions one would like to ask about a company before investing in its stocks. So, they need to be answered, more from the long-term investment point of view.

Fundamentals: Quantitative and Qualitative

Fundamental analysis is all about "researching the fundamentals of the company". These include both the fundamentals of the company such as revenue and expenses, as well as the quality of the management and the market share of the company. The fundamentals of a company can be grouped into two categories; quantitative or which can be measured in numerical terms and qualitative which can be assessed on the basis of certain

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character or process. Thus, for a company, the quantitative factors are those which can be obtained from and the financial statements like those of the revenue, expenses, profit and the deferral of revenue, to mention a few. The qualitative fundamentals involve the nature of governance, the type and quality of the management, the brand name of the company, the market share of the company and expansion plans amongst many others.

Where Quantitative Meets Qualitative

It is difficult to rank both these measures in portfolio analysis. Let us take the example of particular scrip, Pepsi. Any investor would use the financial data, the stock data and the P/E multiplier before investing in this company. This may be very crucial, but one cannot ignore the brand value of Pepsi in the process that adds on to the value of the stock. This is true for all the major brands in their respective industries like Microsoft in the software industry, Bell Labs in communication or Caterpillar in the heavy earth-mover industry. In all these cases, it is tough to assess the values of the companies simply going by the financial data.

The Concept of Intrinsic Value

Let us now address the concept of intrinsic value. Analysts perform fundamental analysis since it is largely believed that the stock price does not reflect the true value of the company. This true value or the 'intrinsic value' can be estimated only through the fundamental analysis.

For example, let us assume that a company's stock was trading at Rs. 20. After doing extensive analysis on the company, the analyst determines that its true worth is Rs. 25. In other words, he determines the intrinsic value of the firm to be Rs. 25. This is clearly relevant because an investor wants to buy stocks that are trading at prices significantly below their estimated intrinsic value. This is commonly termed as an undervalued stock.

It is believed that in the long run, the price of the stock will reflect its intrinsic value. This will precisely lead the investor to go for fundamental analysis; otherwise, no investor would buy a stock if the intrinsic value of the company is never reflected by the business. Thus, fundamental analysis of a company will lead the investor to reach the right opportunity in the market.

Criticisms of Fundamental Analysis

The main criticisms of fundamental analysis come primarily from the proponents of technical analysis and believers of the "Efficient Market Hypothesis" (EMH). According to technical analysis, the news about a company has an impact on a stock and is reflected in the same; hence, the analysis of the volume of the stock, the price momentum and direction can provide more insight than the usage of underlying fundamental factors of the company itself. The rationale put forward by the "EMH" is that, since the market efficiently prices all the stocks on an ongoing basis, any opportunities for excess returns derived from fundamental (or technical) analysis will be almost immediately used away by the market participants.

The Qualitative Factors in the Fundamental Analysis

The Intangibles of the Company

Fundamental analysis takes into consideration the various intangibles of the company such as brand name and the market shares that have a strong influence on the value of the stock of the company.

The Business Model

The business model refers to the process which the company uses. This is obviously the first element investors need to know before investing in any company. Sometimes, it is very easy to understand the business models of companies like Coco-Cola where the products are known, even though the span of the business is large. In many a case such as KFC, the franchisee mode of business makes it difficult to comprehend.

The Competitive Advantage

The companies which can earn competitive advantage and retain it are the real winners in the world of business. It is advisable for the investors to identify companies which have been able to maintain their competitive advantages like, Coco-Cola, Microsoft, etc., which can be an investors' delight in the long run.

The Management of the Company

The management of the company is believed to be the most important aspect of the investment indicators. Getting information about the management of the company is one of the trickiest issues. Management information can be sought in various ways such as conference calls, Management Discussion and Analysis (MD&A), ownership and insider sales and past performance.

Corporate Governance

Corporate governance pertains to the policies within an organization that affect the relationships and responsibilities between management, directors and stakeholders. These policies and procedures help is charting out good functioning by the company.

Companies such as Standard & Poor's attempt to quantitatively assess companies on how well their corporate governance policies serve stakeholders. Most of these reports are publicly available with frank comments on aspects such as the structure of the board of directors, stakeholder rights and financial and information transparency.

Financial and Information Transparency

The timeliness and transparency in the information provided by the company help in deciding the sincerity of the company in establishing a relation with its stakeholders. This enables following of good investment practices by the company as investors feel comfortable with the informations which they can read and comprehend.

Structure of the Board of Directors

The board of directors is composed of representatives from the company and representatives from outside of the company. The combination of the directors from inside and outside the organization creates the balance and assures genuine representation of the stakeholders. The independence of the board of the directors and the management is a key area that has to be looked into while the fundamental analysis is done.

Fundamental Analysis: Qualitative Factors

The Industry

Every industry has particular characters in terms of the investment base, the customers and various other fundamental issues. These are important signals which the investors should take into consideration while doing the fundamental analysis.

The Customers

The nature and the kind of customers the company deals with are very important for the industry analysis. There are companies which deal with only one major customer such as the government. In such a case, a small change in the government policy may change the entire business. Hence, both the nature and the kind of customers should be observed in case of fundamental analysis.

The Market Share

Various companies have various customer bases. A company which has a lion's share in the market will obviously have an economic advantage. However, some companies will have small and niche customer base. This should not be confusing the investors. The merit of the size of the customer base has to be taken into account while the fundamental analysis is done.

Growth of Industry

The growth of an industry depends on many factors. But the main factors which affect it are industry cycle and the demand for its product. Understanding whether the company is in a sunrise sector or in sunset sector makes a lot of difference in terms of fundamental analysis.

Competition

Competitors speak a lot about the business. A company which has less competition has a significant pricing power, which means the ability to pass on the increase in the material price to the customers. Microsoft is a classic example in this case. It is so dominating in the industry that it virtually sets the price of the product in the industry.

Regulation

Some industries such as pharma and food are highly regulated. The regulated industries carry a high degree of risk. Fundamental analysis should reflect the regulatory nature of the industry.

Using Financial Statements for Fundamental Analysis

Financial statements are the eventual outcome of the accounting processes of a company. They are a treasurehouses of information for the investors as long as they can use them. The financial statements can be intimidating at times due to lack of proper knowledge of the usage of these statements. A systematic knowledge about the financial statements can equip the investors with good capability to crack a good investment decision.

Sensex – The Barometer of Indian Capital Markets

The stock exchange of Mumbai which started its journey in 1875, with 318 members and Rs. 318 as corpus (Re. 1 per head) has built up a long cherished history, with both good and bad experiences. Today, the Bombay Stock Exchange (BSE) is rightly the barometer of the Indian economy. The sensitivity index called Sensex of BSE reflects the aspiration of the country as well the corporates as mentioned earlier. A highly scientific index with the base year in 1978-79 and a base value of 100 and a stock size of 30 highly capitalized, traded stocks, it reflects the Indian economic diaspora at the best.

The sensex was originally calculated with a "Full Market Capitalization" methodology. Thereafter, it shifted to the free-float methodology with effect from September 1, 2003. This method is one of the most popularly followed methods in the world in construction of indices and is used by Morgan Stanly Composite Index (MSCI), STOXX, Standard and Poor (S&P) and Dow Jones, to name a few. Being the oldest index in the country, it provides the time series data over a long period of time. Sensex is an international brand in itself as is highly respected in the world of finance. The equity cult in the last two decades has made sensex the most representative of the corporate world and the Indian economic aspiration.

Index Closure Algorithm

A stock which forms a part of the sensex is called a constituent stock. The end or closing sensex is constructed by the weighted average of the traded value of the constituent stock in the last 30 minutes of the market of a day. If the constituent stock is not traded in the last 30 minutes, then the last traded value is taken into consideration. If a constituent stock did not trade in a day, then the last day's closing price is taken for the computation of the index. This process helps prevent the stock from being manipulated.

The maintenance of the indices is one of the most crucial things in index construction. The foremost thing in this regard is base year value replacement. In replacing the base year value, one has to see that the historical credential of the index and its continuity is not lost. It is very crucial that the corporate actions are reflected in the base year revision, without being influenced by it. The day-to-day maintenance of the index within the broad index policy framework set by the index committee is done by the index cell. The index cell maintains the delicate balance of replacement and time series continuity of the index. The index committee is therefore, constituted of the academicians, fund managers of mutual funds, brokers and other market participants, independent governing board members and the members of the exchange administrative board. The traded stocks in a day are automatically used by the index. This called a real time update.

Considering the above factor for an investor, the selection of a scrip in the sensex are:

- Trading Frequency: The scrip should have been traded on each and every trading day in the last three months.
- Listed History: The scrip should have a listing history of at least three months at the BSE.
- Final Rank: Scrips should appear in the top 100 companies listed by final rank, which is arrived at by assigning 75% weightage to the rank on the basis of three-month average full market capitalization and 25% weightage to the liquidity rank based on three-month average daily turnover and three-month average impact cost.
- Industry Representation: The selection of scrips would generally take into account a balanced representation of the listed companies on the BSE.
- Market Capitalization Weightage: The weightage of each scrip in sensex based on three-month average free-float market capitalization should be at least 0.5% of the index created.
- Track Record: The company should have an acceptable track record in the opinion of the committee.

Index Review Frequency

The investor should also remind that the index committee meets every quarter to discuss index-related issues. In case of a revision in the index constituents, the announcement of the incoming and outgoing scrips is made six weeks in advance of the actual implementation of the revision of the index.

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