Stock Markets Guides

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Fundamental Analysis of Stocks Quick Guide

Anyone investing in the stock market or even thinking of investing in the stock market knows of Warren Buffet. The billionaire investor amassed his fortunes by investing in the stock market, famously starting when he was barely a teenager. If you asked him right now what the key to stock market investment is, you'd only get two words; fundamental analysis.

In this post, we go through exactly what fundamental analysis of stocks is and how to use it in your own trading.

Fundamental Analysis of Stocks

By definition, fundamental analysis is a form of stock analysis that relies on key business metrics, such as earnings, revenue, and cash flow. The aim is to calculate the "fair value" of a company and its shares. To determine this, investment professionals examine numerous stock indicators as part of the analysis. We will look into these in a later section.

Fundamental analysts are convinced that an objective corporate value is the "true," "intrinsic," or "fair" value that can be derived from the operational activities of the company.

Fundamental analysis is ultimately nothing more than the valuation of a company based on its business data and taking into account the economic environment. A single share of the company represents the smallest denominational share of the company's value.

According to fundamental analysts, stock market prices always tend towards intrinsic value, but fluctuate regularly due to irrational and speculative over-or undervaluation.

Current stock market prices only reflect the true value of a company to a limited extent. Since it usually takes a long time until the fair company value is reached, many analysts use fundamental analysis.

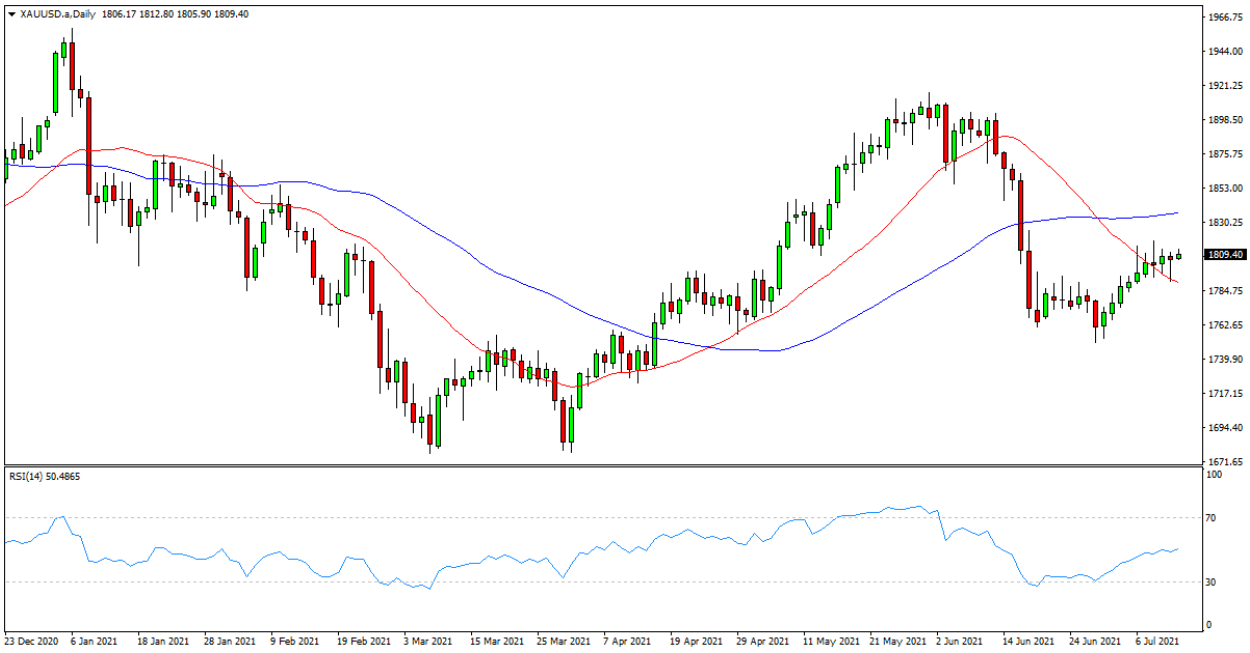
Fundamental Analysis vs Technical Analysis

The philosophy behind fundamental price analysis is that only long-term healthy companies can also offer price increases and high dividends. Although companies may be overvalued in the short term, in the long term, the share price cannot deviate from the "true" value of the company. It tries to determine this "true value."

For this purpose, business and economic data are analyzed. This distinguishes fundamental analysis from technical analysis, in which only stock market data such as

prices are examined. Of course, the prices still play a role because good prospects are worth little if you have to pay a disproportionate amount for the share.

Unlike technical analysts, investors in fundamental analysis look at the price development and closely examine the overall economic environment, the competitive environment, and the company itself.



For short-term investments such as day trading, CFD trading, fundamental analysis is only suitable to a limited extent. Because sometimes, it can take a long time until a high "intrinsic value" of an undervalued stock is also reflected in a high stock market value, which is why many investors prefer to use technical analysis.

In contrast to fundamental stock analysis, technical stock analysis is based on monitoring the price and turnover movements of the shares.

Traditional technical stock analysis has been working primarily with charts for about a century. From the chart formations of the past, the behavior of market participants and the future price development are to be predicted.

Technical analysts do not require balance sheets, annual reports, and company key figures because they make certain assumptions. They believe in the Efficient Market

Hypothesis, which says that all relevant news is always included in the current courses for them.

Fundamental Analysis Tools

Fundamental analysts never rely on just one or a few metrics. You will analyze management and corporate strategy, innovative strength, and competitive position in different markets. A comprehensive analysis of the financial statements provides information about the company's profitability and financial health.

Here are some of the key metrics used in the fundamental analysis of stocks.

The Price-to-Earnings (P/E) Ratio

The P/E ratio is defined by dividing the current share price by earnings per share (P/E = current share price/earnings per share).

Its primary advantage is its simplicity. The current price of the share is divided by the company's profit of the previous year. The sales revenues are compared with expenses when determining the company's profit, i.e., the net income for the year or a net loss. If the company made a loss in the period under consideration, determining a P/E ratio would not be helpful in this case.

A low P/E ratio means that the stock is cheap; you get a lot of profit for the invested money, i.e., the stock market price that you have to pay when buying offers a relatively high profit potential in return.

However, it is important to note that a low P/E ratio should by no means be used as the sole or unconditional purchase criterion for a stock. The P/E ratio is just a relative metric used to compare different companies in terms of their current stock market valuation.

It is common to compare the shares of an industry using the P/E ratio, as these companies operate in the same business areas and have similar structures.

On the other hand, it wouldn't make any sense to compare the P/E ratio of a financial company with that of an automobile company. Therefore, the stock analysts only use the P/E ratio to determine whether a stock is undervalued or overvalued compared to the industry average. Only if the entire industry is expected to outperform the overall market can a buy recommendation be made for the cheapest company in the P/E comparison. What good is it to have the cheapest company in an industry in the depot if the entire industry is on the decline?

Price-to-Sales Ratio (P/S Ratio)

In simple terms, the P/E ratio provides insights into how high a company is valued on the stock exchange. But not every company shows a profit, while others might manipulate their profits through "creative accounting" practices. This is where the P/S ratio comes in.

Price-to-sales ratio = the price per share divided by the revenue per share

Like the P/E ratio, the cap-sales ratio also serves as a key figure for comparing different stocks. However, the name price-to-sales ratio is somewhat misleading because this key figure does not compare a company's share price with its annual turnover but is determined as a quotient of market capitalization and sales.

The Enterprise Value (EV)

The Enterprise Value (EV) focuses on all investors' total value, i.e., for equity and debt investors. The EV is essentially calculated from the total equity market capitalization, i.e., market capitalization and net financial debt (debt capital minus liquid funds). In the EV, the company's overall value is adequately expressed.

Not to be confused is the enterprise value with the company's inner or 'true' value.

Theoretically, the intrinsic value of a share could be determined by discounting all payments resulting from share ownership in the future. Since this would require the perfect knowledge of the future, the intrinsic value is only a fictitious quantity.

On the other hand, Enterprise value is a real, measurable quantity used in acquisitions to determine the purchase price and form the basis for several key stock figures. The enterprise value is related to a figure from the income statement (P&L). As a rule, earnings before interest and taxes (EV/EBIT), earnings before interest, taxes, depreciation, and amortization (EV/EBITDA), or sales (EV/sales) are used for this purpose.

But why do you use EBIT or EBITDA as the earnings figures and not the net profit for the year? The reason is the better comparability of these variables, especially in an international context.

For example, the EV/EBIT ratio eliminates the effects of different tax systems, while the EV/EBITDA ratio no longer uses different depreciation methods. The EV/sales indicator has proven to be relatively unsuitable for valuation comparisons in empirical studies. However, it is still occasionally used when the companies to be compared are in the red.

The Price-to-Book Ratio (P/B)

This metric is used to learn how a company's equity relates to its market capitalization.

P/B = share price/book value of the share

The carrying amount corresponds to the equity divided by the number of shares issued. It thus indicates the ratio of equity to the number of shares.

It measures the net asset value corresponding to the sum of all assets valued at market prices and reduced by the debt. It is the price a potential buyer would be willing to pay if he were to break up the company and sell the assets individually.

The book value is the carrying amount results from the balance sheet from the sum of the assets minus the liabilities – this corresponds roughly to equity, but only "approximately." The book value is not the same as equity; some adjustments need to be made.

Although there is no uniform calculation formula for the carrying amount, the following definition seems to make the most sense: Reported equity minus shares of third-party shareholders minus dividend distribution minus goodwill.

The shares of foreign shareholders and the dividends decided but not yet distributed are deducted because they cannot dispose of these two variables, i.e., they cannot be counted as assets. Finally, goodwill represents an intangible value and cannot usually be "monetized" if the company winds up.

Dividend Yield

The dividend yield allows investors to determine how the share price relates to the dividend paid or announced. Many public companies publish the dividend yield for investors.

This share ratio is calculated as follows:

Dividend yield in percent = (dividend / share price) x 100

If you bought the stock at a lower price than the current one, your dividend yield might also increase.

If the share price is higher, your dividend yield is expected to decrease. It would help if you analyzed the development of the dividend yield over several years. This is the only way to ensure the probability that the share price will continue advancing gradually.

The problem with dividends, however, is that they usually depend on the company's profit.

As soon as this reduces, sooner or later, the dividend will also be cut. High dividends are also typical for companies operating in a mature or stagnating market. Companies in growth industries pay no or only a small dividend because they reinvest the profit.

How to do Fundamental Analysis of Stocks

Fundamental analysis is based on existing data and information generated by the company and its environment. Not only actual and historical data are considered. The analysis also takes into account forecasts. This is because future expectations largely determine the value of a share. The following analysis fields play a role:

Quantitative Business Analysis

The company value is determined based on the published financial and balance sheet data. These come from annual financial statements, interim reports, and other figure-based company information. The determination of key figures enables comparisons with other companies.

Qualitative Business Analysis

Here, an attempt is made to assess prospects and the further development of the company.

Management reports, annual reports, and other published information can serve as sources of information and personal discussions with the management board or employees. The aim is to evaluate the business policy and the corporate strategy concerning their value effects.

The qualitative analysis places special demands on analysts but represents a particular challenge due to its often-subjective evaluation standards.

Industry Analysis

The industry analysis looks at the industry environment of the company. What does the individual industry structure look like? How do competitors present themselves? Which factors determine supply and demand? How dependent is the industry on the economy? What influence do industry-relevant political decisions have? Answers to these questions are analyzed based on their impact on the value of the company.

Global Analysis

The global analysis examines the macro-economic factors relevant to the development of the company.

These are possible effects of monetary or fiscal policy, the effects of interest rate decisions or developments in exchange rates, and international trade. These factors can also have a positive and negative impact on the perspective and value of the company.

Examples of Fundamental Analysis

The P/E ratio is one of the most widely used metrics in stock trading.

A high price-earnings ratio can mean that the respective share is in great demand, and its price is therefore high. This may be an indication of overvaluation and may be an indicator of future price declines. Another possibility, however, is that a high P/E ratio points to strong revenue or earnings growth. Investors may be willing to pay a premium for a fast-growing company.

A low P/E ratio means that the stock has a low stock market valuation relative to the company's earnings generated.

If the company belongs in an industry that is growing very slowly, a low P/E ratio would not be a disadvantage and a possible clue to buy the shares. However, if the P/E ratio is low due to gloomy earnings prospects, a buy is probably not recommended, although the stock seems cheaply valued at the moment.

Now, let's take the example of Apple Inc. (AAPL) and Microsoft (MSFT).

Note that you don't necessarily need to calculate these metrics manually. Several financial websites like Yahoo Finance offer them for free.

AAPL has a P/E of 32.62, while MSFT has a P/E of 37.88

As of this writing, AAPL traded at $145.11 while MSFT at $277.94

That means that shareholders are willing to pay a premium for MSFT's higher P/E.

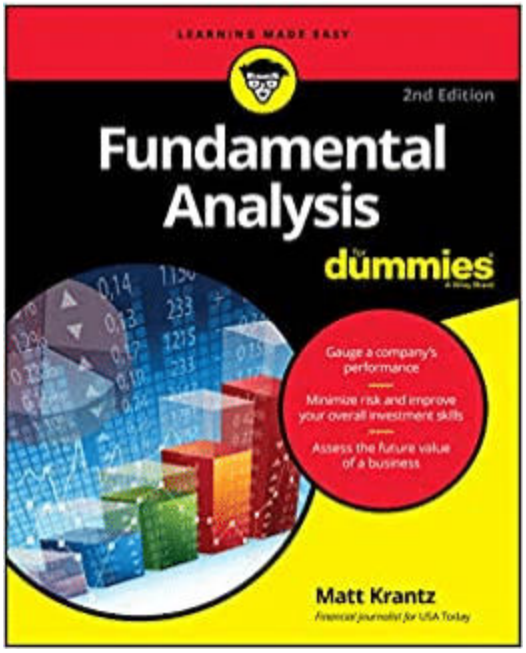
Fundamental Analysis of Stocks Books

Two of the best books on fundamental analysis of stocks are; Fundamental Analysis For Dummies by Matt Krantz and Warren Buffett's Accounting Book: Reading Financial Statements for Value Investing.

Fundamental Analysis For Dummies by Matt Krantz

Although it was first published in 2009, the fundamental analysis teachings of this book still resonate in the market over a decade later. Here are some of the valuable lessons from it:

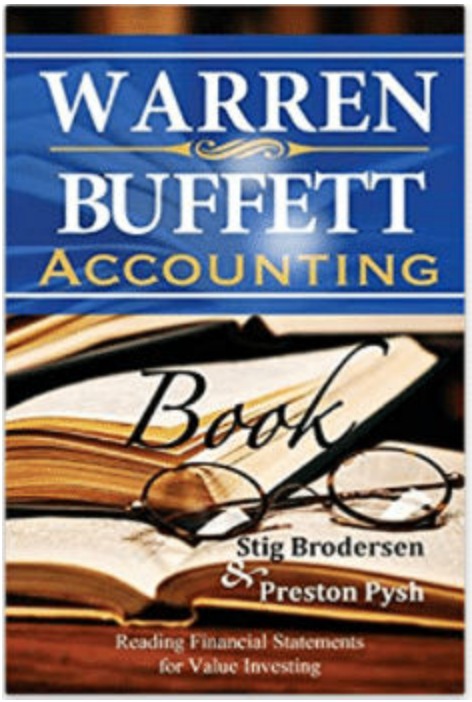
- Tell you what fundamental analysis is and why you should apply it.
- How to get reliable fundamental data for any company.
- How to perform in-depth financial statement analysis and track key financial data across time.
- How to rely on a company's cash flow, not earnings.
- How to pinpoint suitable investments using financial ratios.
- How to avoid blowing up your investment when relying on fundamental analysis.
- How to use the public's comments and statements to analyze a company.



Warren Buffett Accounting Book: Reading Financial Statements for Value Investing

Published in 2014 by Stig Brodersen, this book is a must-read for rookie investors. Here are the valuable lessons we get;

- How to pick winning stocks like Warren Buffet.
- How to calculate a company's intrinsic value.
- How to read and interpret the three key financial statements – Balance sheet, Cash flow statement, and income statement.
- How to calculate and interpret key financial ratios.



Lastly

Which key figures are best used to evaluate shares also depends on the stock market phase. In principle, there are two valuation approaches. If the stock market behaved

rationally, then everything would be quite simple; You would buy the undervalued stocks and sell those that are overvalued.

However, investors as a whole do not behave rationally; greed and fear play a major role. The willingness to take risks depends on confidence in the future, subject to strong fluctuations.

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