
Fundamental Analysis

Getting acquainted with fundamental analysis

Fundamental analysis looks at data about an individual company and its operations. The efficient market hypothesis that underlies modern portfolio theory states that stock prices automatically reflect all available information about a stock, including its fundamental data. However, fundamental analysts believe they may be able to gain an edge over other investors by sifting through facts and figures to try to assess the company's prospects for the future based on its past and current performance. Fundamental analysis is especially useful for comparing companies in the same industry.

Analyzing a company's fundamental financial data

A company's income statement and balance sheet contains a wealth of information for investors. To make that data more meaningful, however, it's useful to look not just at the data itself but at the ratios of certain statistics to others. Ratios provide a quick way to measure a company's financial condition. They also are used to compare a firm's performance with others, though what is considered acceptable in one industry may be very different in another. Although an accounting background is certainly useful for understanding financial statements, you can get by if you have a general idea of what the ratios mean, what direction they should be heading, and how to compare different companies. You can compare financial ratios between different firms in the same industry (a cross-sectional analysis). You also can view one company's performance over time (a time-series analysis).

Financial statistics generally fall into four categories related to profitability, liquidity, activity (or turnover), and debt.

Profitability measures

There are many ways to measure a firm's profitability. These ratios generally compare a company's returns (earnings) to its sales, assets, equity, or share value. Without profits, a firm has difficulty attracting capital and holding on to current investors.

Earnings per share (EPS)

This figure represents the number of dollars earned on behalf of each outstanding share of common stock (not the earnings actually distributed to shareholders). It's considered an important indicator of corporate success and is watched closely by investors. EPS is calculated by dividing the total earnings available for common stockholders by the number of shares of common stock outstanding. Companies report EPS in two ways. Basic EPS doesn't include stock options, warrants, and convertible securities. Fully diluted EPS does count them and is considered a more accurate picture of the company's financial situation.

Price earnings (P/E) ratio

The P/E ratio represents the amount investors are willing to pay for each dollar of the firm's earnings. It indicates the degree of confidence investors have in a firm's future performance. It is calculated by dividing the market price per share of common stock by the earnings per share (EPS). Like EPS, the P/E ratio is very important to potential investors because it's considered an indicator of how expensive or cheap a stock is. The stocks of faster-growing companies tend to have higher P/E ratios and are often more volatile. A trailing P/E compares the stock price to the previous 12 months of EPS; a forward or leading P/E compares the price to anticipated earnings for the coming year.

Price/sales ratio

This is a company's stock price divided by its per-share revenues for the past 12 months. It is often used in combination with other statistics to assess companies relative to their peers, especially those that are in a highly cyclical industry or that are relatively new and do not have meaningful profits.

Gross profit margin

Gross profit margin is calculated by subtracting the cost of goods sold from a company's total sales, and then dividing the result by the total sales revenue. The resulting percentage represents the portion of each sales dollar that can be used to pay expenses and provide profit.

Operating profit margin

This figure indicates profits earned on each sales dollar before interest charges and taxes. The operating profit margin equals operating profits (i.e., earnings before interest and taxes) divided by total annual sales. It indicates how well a company is managing its costs.

Net profit margin

This is the percentage of each sales dollar remaining after all expenses, including interest and taxes, have been deducted. The net profit margin equals net profits after taxes divided by total annual sales.

Return on total assets (ROA)

This measures the overall effectiveness of management in generating profits with available resources and assets. It is computed by dividing net profits after taxes by total assets.

Return on investment (ROI)

Also known as return on invested capital, this is another way to measure a company's efficiency or effectiveness. It is calculated by dividing earnings before interest, taxes, and dividends by the company's total common and preferred stock equity plus its long-term debt.

Return on equity (ROE)

The ROE measures the return earned on the owners' investment in the firm. It's calculated by dividing net profits after taxes by stockholders' equity.

Dividend yield per share

This is the stock's annual dividend per share divided by the share price. Assuming the dollar amount of the dividend doesn't change, the yield goes up when the share price goes down, and vice versa. Therefore, a high yield can mean that the stock is a good source of income, or that the share price is down.

Price/book ratio

This compares a stock's price to its book value per share. Because it suggests what the company would be worth based on the value of its assets, it's often used as a measure of whether the company is fairly valued relative to its peers.

Liquidity measures

The liquidity of a business is measured by its ability to satisfy its short-term obligations as they become due. If a company can't pay its bills, it's in trouble.

Creditors and investors typically begin by reviewing a company's net working capital: its current assets minus its current liabilities. Current assets include cash, marketable securities, accounts receivable, inventory, and other miscellaneous items. Current liabilities include accounts payable, dividends payable, income taxes payable, current maturities of long-term debt, and the like. In addition to net working capital, two ratios are used to measure a firm's ability to pay bills in a timely manner: the current ratio and the quick ratio.

Current ratio

This measures a company's ability to pay current liabilities. It equals current assets divided by current liabilities. The current ratio should be neither too low (an indication of financial weakness and potential inability to pay bills) nor too high (an indication that the company is not making the best use of its current funds). A current ratio of 2:1 is often cited as acceptable. This means that there are two dollars of current assets for every dollar of current liabilities. However, acceptability really depends on the industry.

Quick ratio

This ratio is also called the acid-test ratio. It equals current assets minus inventory, divided by current liabilities. Sometimes it can take several months for inventory to be sold and converted into cash. Therefore, this ratio provides a better measure of overall liquidity when a firm's inventory cannot easily be converted into cash. Because inventory is excluded, the quick ratio will always be lower than the current ratio.

Activity or turnover

Activity ratios can be used to assess the speed with which assets (e.g., inventory, accounts receivable) are converted into sales or cash. If two firms have identical current ratios, activity ratios can help you determine which firm is really more liquid. The higher the turnover to cash, the better position the company is in to meet its current liabilities. Several ratios are used, including the following:

- Average collection period--The average age of accounts receivable is useful in evaluating how well a firm's credit and collection policies are followed. It measures the speed with which receivables are collected. The faster a company collects its accounts receivable, the faster it accumulates cash (and the better able it is to pay current expenses). The average collection period is determined by dividing the total accounts receivable by the average sales per day.
- Receivables turnover--Like the average collection period, this ratio measures how quickly a company collects its accounts receivable. The formula is: annual sales divided by total accounts receivable. The larger the receivables turnover ratio, the faster a company turns its sales into cash.
- Fixed asset turnover--This measures productivity, or the efficiency with which a firm has been using its fixed assets to generate sales. Fixed assets consist of long-term assets such as property, plant, and equipment. This ratio is computed by dividing a firm's total annual sales by its net fixed assets, and it tells you the amount of sales generated for every dollar invested in fixed assets.
- Inventory turnover--This measures the liquidity of a firm's inventory (i.e., the speed with which inventory is sold). You must divide the cost of goods sold by the inventory. Compared with industry averages, a low inventory turnover might indicate that a company is carrying too much inventory. This is viewed as a warning sign because the company may then be vulnerable to falling prices.

Debt or leverage

The more debt a firm uses, the greater the potential for both risk and return. If a firm borrows money and uses it to increase sales, shareholders benefit without having put additional capital at risk. However, if a highly leveraged company--one that owes a great deal of debt--has trouble, there is less of a financial cushion to protect both creditors and the value of shareholders' equity.

- Debt ratio--This measures the proportion of total assets financed by the firm's creditors. The debt ratio equals total liabilities divided by total assets.
- Debt-equity ratio--The debt-equity ratio indicates the relationship between the long-term funds provided by creditors and those provided by the firm's owners. It is calculated by dividing long-term debt by stockholders' equity (the sum of common and preferred stock, retained earnings, and other paid-in capital). The stock price of a company with a high debt-to-equity ratio may be more volatile than one with a low ratio.

Analyzing a company's operating environment

In addition to company data, fundamental analysis takes into account environmental factors that may affect a business's profitability.

The economy

Changes in interest rates, employment levels, inflation, and economic growth all can have an impact on stock prices. Economists often use the term "business cycle." The basic economic cycle includes expansion to a peak (usually accompanied by inflation), followed by decline to a trough (recession). Recessions involve rising unemployment and a decline in national production. Although the length of expansionary and recessionary periods may vary, the entire cycle itself repeats over time. Business cycles can affect stock prices. During periods of economic prosperity, the demand for goods and services may result in increased sales and profits, so securities prices tend to rise. Recessionary times have the opposite effect.

As business has become more global, the state of overseas economies has become more important to investors. Many companies do a large percentage of their business overseas, and problems with debt and currencies in other parts of the world also can affect U.S. companies' revenues and profitability.

To a certain extent, monetary and fiscal policy can minimize drastic swings in the economy. Monetary policy refers to the Federal Reserve's changes in the supply of money and credit. When the Fed wants to contract the money supply, for example, it sells government securities. This decreases the price of those securities and increases overall interest rates. Fiscal policy, by comparison, involves taxation, expenditures, and debt management by the federal government in an attempt to influence price stability, employment, and economic growth. Although securities prices can be affected by both monetary and fiscal policy, economists differ as to which approach is more effective.

The industry

Industries also go through life cycles. Technological advances can cause rapid growth in an industry; that growth typically slows at some point as the industry matures. Industries also can decay if they become technologically obsolete. The early stages of an industry's growth can produce companies that eventually dominate the field; it's also important to know when an industry is on its way out. It would have been a mistake, for instance, to keep your money in companies that produced nothing but phonographs when compact-disc technology arrived.

In addition, be aware that some industries are cyclical and are affected more than others by the direction of the economy. Airlines and hotels are good examples; if the economy is suffering, people often travel less. Also, certain industries are subject to extensive government regulation, labor relations rules or labor needs, and financing requirements. These external factors can affect stock prices.

The market

In analyzing a stock, it's useful to have some idea of how it's viewed by the market. For example, you may want to have some idea of how liquid a stock is--how much day-to-day trading goes on in that stock. It is very easy to buy or sell a stock that is actively traded on one of the major exchanges. It may not be so easy to buy or sell a stock that is thinly traded (very few shares change hands regularly). You may also want to consider the recommendations of professional analysts who follow the stock market and individual companies. Many brokerage and investment firms either employ their own stock analysts or make available to their clients research from independent third-party services.

Screening investing ideas

With so much information constantly available, how do you know which stocks might make sense for you? A financial professional has many computerized tools that help him or her screen a database of stock information very quickly based on parameters that match the type of stocks that best suit your portfolio strategy. A stock screen can, for example, search a database for stocks that are growing quickly; to do so, the screen might look for growing earnings and revenue per share, favorable coverage by analysts, and good operating margins.

To build a stock screen, an investor would set minimum or maximum values in the categories most relevant to the

search. For example, to look for a high-yielding stock, an investor might set the screen to look for companies that pay at least a 3 percent dividend. To increase the chance that the dividend will likely continue in the future, the investor might also require the screen to eliminate any companies that don't have at least a 1 percent annual growth rate in earnings per share. And, to try to forecast the company's longer-term stability, the investor might also screen for companies for which analysts have projected a 5-year growth rate greater than, say, 10 percent. The more criteria a stock screen uses, the shorter the list of potential candidates for investment becomes, and the more closely the candidates might match an investor's specific requirements.

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