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What Is Fundamental Analysis?

The fundamental analysis measures a security's intrinsic value by examining related economic and financial factors. Intrinsic value is the value of an investment based on the issuing company's financial situation and current market and economic conditions.

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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.

The end goal is to determine a number that an investor can compare with a security's current price to see whether the security is undervalued or overvalued by other investors.

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Fundamental analysis is usually done from a macro-to-micro perspective to identify securities that are not correctly priced by the market.

Analysts typically study, in order:

- The overall state of the economy
- The strength of the specific industry
- The financial performance of the company issuing the stock

This ensures they arrive at a fair market value for the stock.

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Sources for Fundamental Analysis

Fundamental analysis uses publicly available financial data to evaluate the value of an investment. The data is recorded on financial statements such as quarterly and annual reports.

For example, you might perform a fundamental analysis of a bond's value by looking at economic factors such as interest rates and the overall state of the economy. Then, you'd evaluate the bond market and use financial data from similar bond issuers.

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Finally, you'd analyze the financial data from the issuing company, including external factors such as potential changes in its credit rating. You could also read through the issuer's annual reports to find out what they are doing, their goals, or other issues.

Fundamental analysis uses a company's revenues, earnings, future growth, return on equity, profit margins, and other data to determine a company's underlying value and potential for future growth.

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Intrinsic Value

One of the primary assumptions behind fundamental analysis is that a stock's current price often does not fully reflect the value of the company when compared to publicly available financial data.

A second assumption is that the value reflected in the company's fundamental data is more likely to be closer to the true value of the stock.

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For example, say that a company's stock was trading at $20. After extensive research on the company, an analyst determines that it should be worth $24. Another analyst does equal research but decides it should be worth $26.

Many investors will consider the average of these estimates and assume that the stock's intrinsic value may be near $25. Often investors consider these estimates highly relevant because they want to buy stocks trading at prices significantly below these intrinsic values.

This leads to a third major assumption of fundamental analysis: In the long run, the stock market will reflect the fundamentals. The problem is, no one knows how long "the long run" really is. It could be days or years.

This is what fundamental analysis is all about. By focusing on a particular business, an investor can estimate the intrinsic value of a firm and find opportunities to buy at a discount or sell at a premium. The investment will pay off when the market catches up to the fundamentals.

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Fundamental Analysis vs. Technical Analysis

This method of analysis contrasts with technical analysis, which attempts to forecast price direction by analyzing historical market data such as price and volume.

Technical analysis uses price trends and price action to create indicators. Some of the indicators create patterns that have names resembling their shapes, such as the head and shoulders pattern.

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Others use trend, support, and resistance lines to demonstrate how traders view investments and indicate what will happen. Some examples are the symmetrical triangle or the wedge.

Fundamental analysis relies on financial information reported by the company whose stock is being analyzed. Ratios and metrics are created using the data which indicate how a company is performing compared to similar companies.

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Quantitative and Qualitative Fundamental Analysis

The problem with defining the word fundamentals is that it can cover anything related to the economic well-being of a company. They include numbers like revenue and profit, but they can also include anything from a company's market share to the quality of its management.

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The various fundamental factors can be grouped into two categories: quantitative and qualitative. The financial meaning of these terms isn't much different from well-known definitions:

- **Quantitative**: information that can be shown using numbers, figures, ratios, or formulas.
- **Qualitative**: rather than a quantity of something, it is its quality, standard, or nature

In this context, quantitative fundamentals are hard numbers. They are the measurable characteristics of a business.

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That's why the biggest source of quantitative data is financial statements. Revenue, profit, assets, and more can be accurately measured.

The qualitative fundamentals are less tangible. They might include the quality of a company's key executives, brand-name recognition, patents, and proprietary technology.

Neither qualitative nor quantitative analysis is inherently better. Many analysts consider them together.

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Qualitative Fundamentals to Consider

There are four key fundamentals that analysts always consider when regarding a company. All are qualitative rather than quantitative. They include:

The Business Model

What exactly does the company do? This isn't as straightforward as it seems. If a company's business model is based on selling fast-food chicken, is it making its money that way? Or is it just coasting on royalty and franchise fees?

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Competitive Advantage

A company's long-term success is primarily driven by its ability to maintain a competitive advantage—and keep it. Powerful competitive advantages, such as Coca-Cola's brand name and Microsoft's domination of the personal computer operating system, create a moat around a business allowing it to keep competitors at bay and enjoy growth and profits. When a company can achieve a competitive advantage, its shareholders can be well rewarded for decades.

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Management

Some believe management is the most important criterion for investing in a company. It makes sense: Even the best business model fails if the company's leaders fail to execute the plan properly. While it's hard for retail investors to meet and truly evaluate managers, you can look at the corporate website and check the resumes of the top management and the board members. How well did they perform in previous jobs? Have they been unloading a lot of their stock shares lately?

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Corporate Governance

Corporate governance describes the policies in place within an organization denoting the relationships and responsibilities between management, directors, and stakeholders. These policies are defined and determined in the company charter, its bylaws, and corporate laws and regulations. You want to do business with a company that is run ethically, fairly, transparently, and efficiently.

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Particularly note whether management respects shareholder rights and shareholder interests. Make sure their communications to shareholders are transparent, clear, and understandable. If you don't get it, it's probably because they don't want you to.

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Industry

It's also important to consider a company's industry: its customer base, market share among firms, industry-wide growth, competition, regulation, and business cycles. Learning how the industry works will give an investor a deeper understanding of a company's financial health.

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Quantitative Fundamentals to Consider: Financial Statements

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

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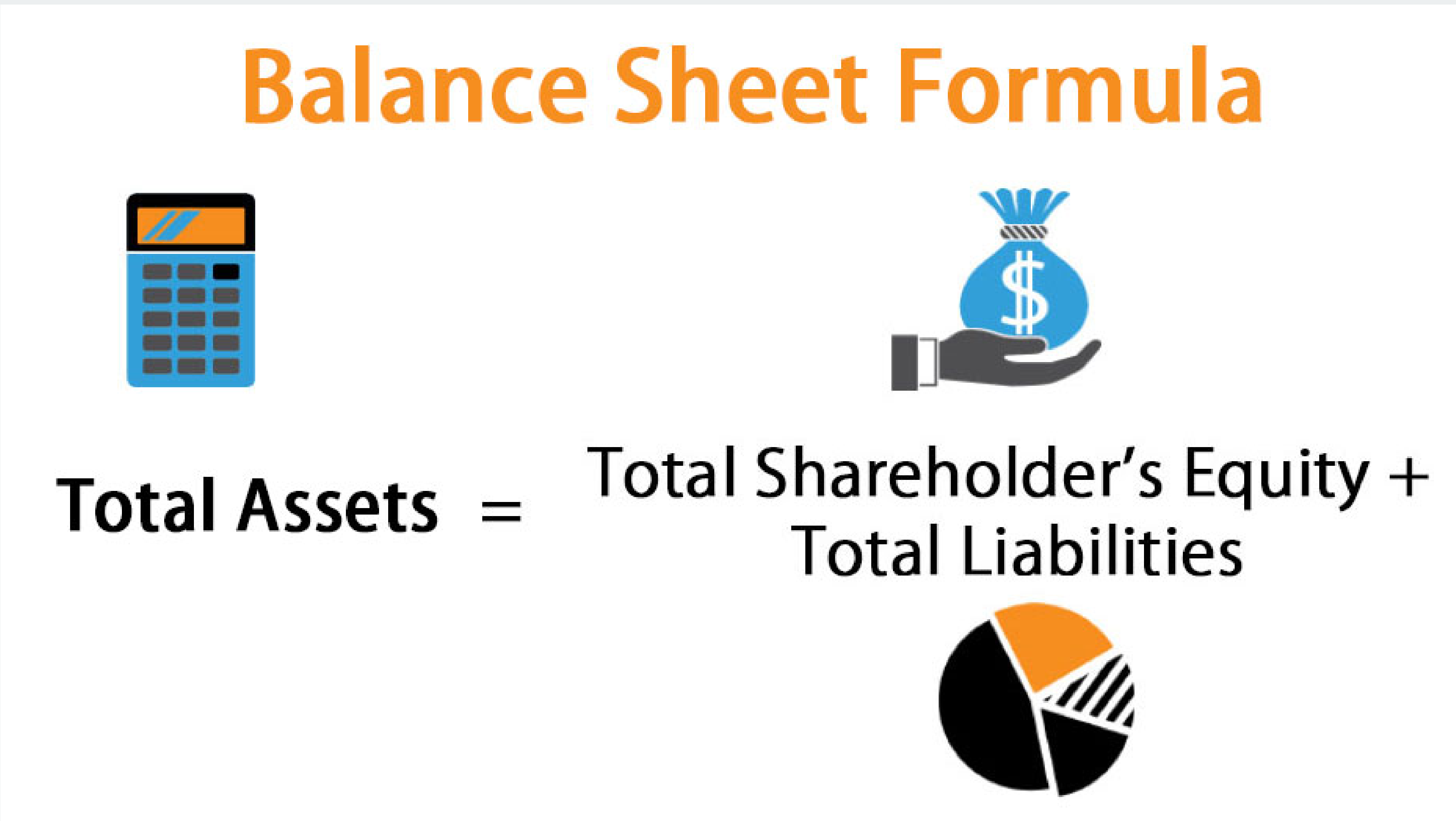
The Balance Sheet

The balance sheet represents a record of a company's assets, liabilities, and equity at a particular point in time.



Balance Sheet Formula

$$\text{Total Assets} = \text{Total Shareholder's Equity} + \text{Total Liabilities}$$

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Assets represent the resources the business owns or controls at a given time. This includes items such as cash, inventory, machinery, and buildings.

Financing comes as a result of liabilities or equity. Liabilities represent debts or obligations that must be paid. In contrast, equity represents the total value of money that the owners have contributed to the business—including retained earnings, which is the profit left after paying all current obligations, dividends, and taxes.

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The Income Statement

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 revenues, expenses, and profit generated from the business' operations for that period.

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Statement of Cash Flows

The statement of cash flows represents a record of a business' cash inflows and outflows over a period of time. Typically, a statement of cash flows focuses on the following cash-related activities:

- Cash from operations (CFO)
- Cash from investing (CFI)
- Cash from financing (CFF)

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The cash flow statement is important because it's challenging for a business to manipulate its cash situation. Earnings can be manipulated, 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.

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Example of Fundamental Analysis

The Coca-Cola Company is a prime example that can be used in fundamental analysis. To begin, an analyst would examine the economy using some published metrics:

- Consumer price index (inflation measure)
- Gross domestic product growth
- Exports/imports
- Interest rates

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Then, the sector and industry would be examined using statistics and metrics from various reports and competitor companies.

Lastly, the analysts would gather the reports from Coca-Cola or The Security and Exchange Commission's filings database.

Analysts might also use data gathered by another firm, such as CSIMarket.

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CSIMarket provides fundamental analysis data for investors, so you could begin by assessing the value of Coca-Cola's assets, income streams, debts, and liabilities. You might find comparisons of objective metrics such as revenue, profits, and growth, especially in the context of the broader beverage industry.

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Using CSIMarket's analysis, the analyst could compare growth rates to the industry and sector Coca-Cola operates in, along with the other information provided, to see if the company is valued correctly. For example, as of August 2022, for the trailing twelve months (TTM), Coca-Cola had (using only a few of the possible ratios and metrics).

Table on the next slide.

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	Coca-Cola	Industry	Sector
Y/Y Revenue Growth	13.48%	10.86%	16.18%
P/E Ratio	29.12	25.16	18.68
Price to Free Cash Flow	24	7.45	4.23
Debt to Equity (TTM)	1.57	0.14	0.11
Quick Ratio (TTM)	0.16	0.24	0.2
Return on Equity (TTM)	13.14%	30.21%	23.16%
Return on Assets (TTM)	11.5%	8.69%	7.91%
Return on Investment (TTM)	13.14%	19.76%	15.84%
Revenue per Employee (TTM)	$111,578	$55,015	$66,896

One factor not shown in an analysis of ratios and numbers is how long a company has been around and the conditions they have weathered. Coca-Cola was founded in 1892 in Atlanta, Georgia.

It has stayed in business through several wars, depressions, recessions, epidemics, pandemics, stock market crashes, and a global financial crisis. Not many companies can claim a history like that.

So, an analyst can combine brand, longevity, growth above that of the beverages manufacturing industry, an above-average price-to-earnings ratio, and a good return on investment.

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Coca-Cola has more debt than equity, but it also generates more returns using its assets than the rest of the industry. The company doesn't have as much liquidity as other companies, but it seems the industry hovers on pretty low quick ratios. More than 1.0 means a company can pay its short-term obligations quickly—so in general, most of the industry is low, but Coca-Cola has more than $1 billion in net cash flows.

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An interesting measurement is how much revenue one employee generates. Coca-Cola employees generate about twice as much revenue as employees for comparative companies. This might warrant a deeper investigation into what Coca-Cola is doing differently. They may have invested in new technology or have much more efficient systems.

Looking over press releases and reading company reports can provide insights into what the company is doing. It might also be that Coca-Cola simply sells more products than its competitors, so it's important to review any reports and releases and conduct a fundamental analysis carefully.

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THANK YOU FOR READING

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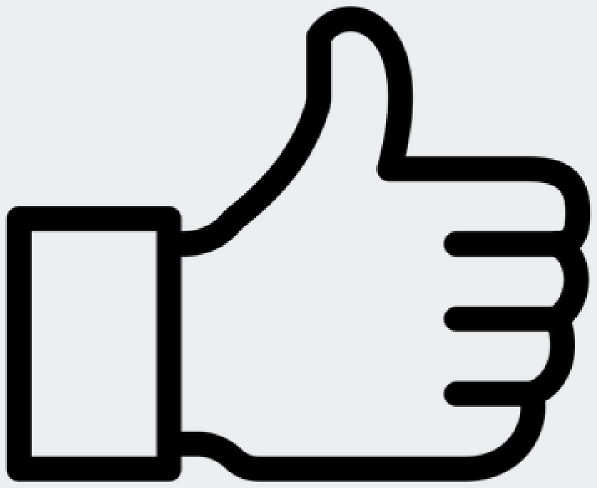

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