Investment Management

UNIT 3 – FUNDAMENTAL ANALYSIS

Guess the Topic

Stock Analysis

Refers to the evaluation of a particular trading instrument, an investment sector or the market as a whole.

Two types of Stock analysis

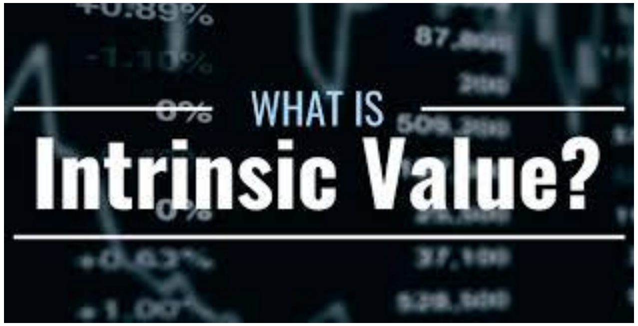
- Fundamental Analysis
- Technical Analysis

INVESTMENT DECISION

- Economic factors play a major role in any investment decision.
- Investment Decision refers to making a investment details regarding the buy and sell orders.
- For making such decisions shareholders depend on more on fundamental analysis
- If investment decision is for short-term and for speculation, technical are more important
- As per the various studies, share prices depend on the fundamental of the company only to the extent of 50% and the rest is decided by the mood of the market.

Intrinsic Value

The intrinsic value is the actual value of a company or an asset based on an underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible factors. This value may or may not be the same as the current market value.



Fundamental Analysis

- Is a logical and systematic approach to estimate future dividends and share price.
- Purpose of fundamental analysis is to evaluate the present and future earning capacity of a share called as intrinsic value or fundamental value.
- Investor can compare the intrinsic value of the share with prevailing market price to arrive at an investment decision.

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- Market price of the share < Intrinsic value – under priced
- Price of that share is expected to move up in the future to match with its intrinsic value
- Market price of the share > Intrinsic value – over priced
- Market price of that share is expected to come down in the future, hence investor would decide to sell such a share.
- Fundamental Analysis thus provides an analytical framework for rational investment decision making

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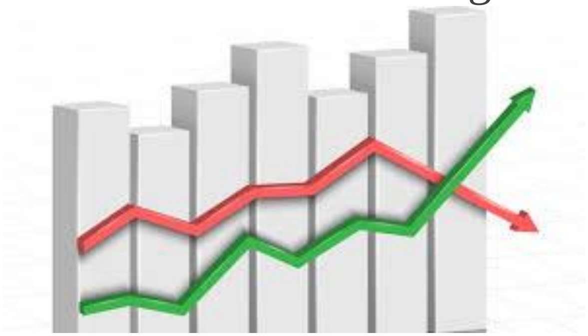
- Fundamental Analysis is carried out in 3 stages
  - Economic Analysis
  - Industry Analysis
  - Company Analysis
- Company belongs to an industry. An industry operates within the economy
- Thus industrial economy factors affect the performance of the company

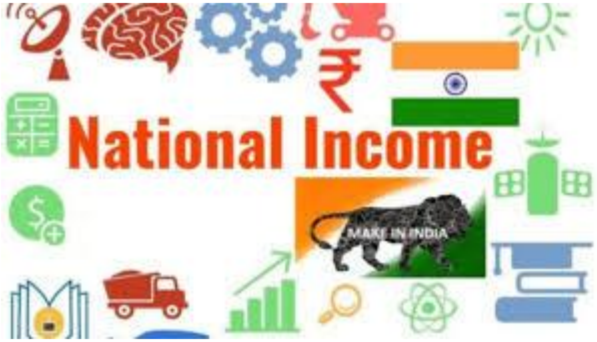
Economic Analysis

- If the economy is booming, incomes rise, demands for goods increases and hence industries and companies tend to be prosperous.
- If the economy is in recession, performance of companies will be bad.
- Investors are concerned with the variables in the economy which affect the performance of the company in which they tend to invest.
- The following are the key economic variables that an investor must monitor to get an idea about future corporate earnings.



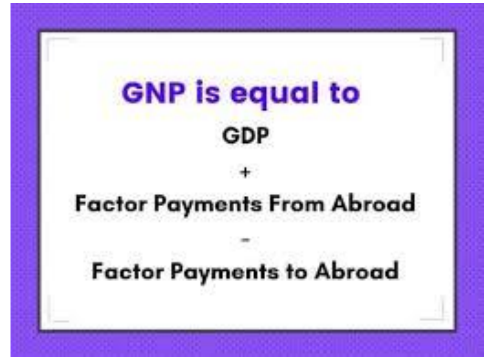
1.Growth Rates of National Income

- GNP (Gross National Product)
- NNP (Net National Product)
- GDP (Gross Domestic Product)



- The growth rates of these measures indicate the growth rate of economy.
- The estimated growth rate of the economy would be a pointer towards the prosperity of the economy.

GNP



Gross national product (GNP) is an estimate of total value of all the final products and services produced in a given period by the means of production owned by a country's residents.

GNP is commonly calculated by taking the sum of personal consumption expenditures, private domestic investment, government expenditure, net exports, and any income earned by residents from overseas investments, minus income earned within the domestic economy by foreign residents.

Net exports represent the difference between what a country exports minus any imports of goods and services.

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GNP is related to another important economic measure called gross domestic product (GDP), which takes into account all output produced within a country's borders regardless of who owns the means of production. GNP starts with GDP, adds residents' investment income from overseas investments, and subtracts foreign residents' investment income earned within a country.

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GNP includes income earned by citizens and companies abroad, but does not include income earned by foreigners within the country.

The figures used to assess GNP include the manufacturing of tangible goods (cars, furniture and agricultural products) and the provision of services (education, healthcare, and business services). GNP does not include the services used to produce manufactured goods because their value is included in the price of the finished product.

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The formula for GNP is:

Consumption + Government Expenditures + Investments + Exports + Foreign Production– Domestic Production by Foreign Companies = Gross National Product

GNP can be adjusted to make valid comparisons year-to-year or among countries. For year-to-year comparisons, GNP needs to be adjusted for inflation. For country-to-country comparisons, GNP needs to be stated on a per capita basis (i.e. GNP divided by the population of the country).

NNP

Net national product (NNP) is the market value of a nation's goods and services minus depreciation (often referred to as capital consumption).

The formula for NNP is:

NNP = Market Value of Finished Goods + Market Value of Finished Services - Depreciation

Alternatively, NNP can be calculated as:

NNP = Gross National Product - Depreciation

Let's assume Country XYZ's companies, citizens and entities produce $1 trillion worth of goods and $3 trillion worth of services this year. The assets used to produce those goods and services depreciated by $500 billion. Using the formula above, Country XYZ's NNP is:

NNP = $1 trillion + $3 trillion - $0.5 trillion = $3.5 trillion

GDP

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. Though GDP is usually calculated on an annual basis, it can be calculated on a quarterly basis as well.

GDP includes all private and public consumption, government outlays, investments and exports minus imports that occur within a defined territory.

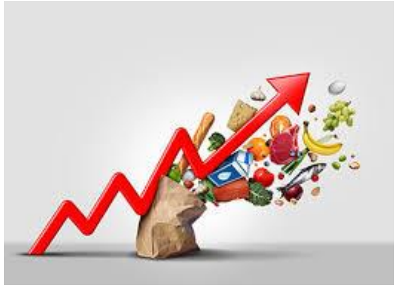
Gross domestic product can be calculated using the following formula:

GDP = C + G + I + NX

C is equal to all private consumption, or consumer spending, in a nation's economy, G is the sum of government spending, I is the sum of all the country's investment, including businesses capital expenditures and NX is the nation's total net exports, calculated as total exports minus total imports (NX = Exports - Imports).

2.Inflation

- Higher rates of inflation upset business plans, lead to cost escalation and result in a squeeze on profit margin.
- Leads to erosion of lower demand for products
- Reduces purchasing power of customers



- Thus Higher rates of inflation affects the performance of companies adversely.
- Measures of Inflation
  - Wholesale Price Index(WPI) (Average changes in the price at wholesale level)
  - Consumer Price Index(CPI) (Average changes in the price at retail level)

3. Interest rates

- Determine the cost and availability of credit for companies operating in an economy.
- Low interest rate – lower cost of finance for companies – higher profitability
- High interest rate – high cost of production – lower demand - lower profitability

4. Government revenue, Expenditure and deficit

- Government Expenditure – stimulates economy by creating jobs and generating demand.
- Government Expenditure > Revenue – Budget deficit – Fuels inflation

5. Exchange Rates

- Depreciation of rupee – improves competitive position of indian products in foreign markets. - stimulates exports – adversely affects companies dependent on imports.

6. Infrastructure facilities

Availability of infrastructural facilities such as power, transportation and communication system affects the performance of companies.

7. Monsoon and Agriculture

Sugar, Cotton, Textile and Food processing industries depend upon agriculture for raw material.

8. Economic and Political Stability

Stable political environment and long-term economic policies are needed for industrial growth.

Knowledge Check

List down the various stages in Fundamental Analysis

Thanks…