

## LESSON TWO: FUNDAMENTAL ANALYSIS

Fundamental analysis is like peeling back an onion's layers to understand a stock's value.

### What Is Fundamental Analysis?

Imagine you're buying a used car. You'd check its engine, mileage, and history to decide if it's worth the price. Similarly, fundamental analysis examines a stock's intrinsic value by considering economic and financial factors. It's about finding a stock's actual or “fair market” value. This may be what you always thought was how to determine whether to buy a stock. It is the most traditional way for the average person to understand it.

Companies and individuals using this method will spend significant time and resources to get as much information about the company as possible. They may even follow the company for many months or years to gain the most profound understanding of the company. They will also get all publicly available information about the company's finances, including financial statements, balance sheets, and cash flow statements. The government requires these companies to produce this information; a third-party accounting firm usually audits it.

This information is also presented in ratios that allow for quick comparison to similar companies. The popular ratios include the price-to-earnings (P/E) ratio and the price-to-book (P/B) ratio. Using these ratios and other financials allows the researcher to gain insights into the stock company's performance. With that overview, we can examine how they perform the fundamental analysis.

### Outside to Inside

Begin the analysis by looking at the potential investment from the outside. What is the company's big picture? What is the industry it is in? Does the future look bright for this kind of business? How large a player is the company in the industry? Who are its major competitors? Finally, how does this all play into the current state of the whole economy?

Next, let's zoom into the company itself. How well has the company been doing over the past few years? How stable and prosperous is the senior management of the company? Are there any employee issues, such as pending strikes or other worker performance interruptions? Then, zoom into the details of the financial performance. How do the financials stack up against the competitors? How has the stock performed over the past few years?

As the details are further pursued, a detailed dossier is prepared showing the significant findings and some scores in all the major information segments if the company shows promise. A copy of the company's quarterly and annual reports has been added to this information. Then, all the company's official filings, such as the forms 10-Q and 10-K, and any relevant legal documents are produced.

After assembling this information and reviewing the dossier, preliminary conclusions are formed. The proposed actions with the company are set down, and the reasons for supporting the actions are documented. In most instances, fundamental investors will look to place a

significant investment in the company because performing the above research is done at a considerable cost. The final decision to move on or not move with the investment will likely have to be reviewed by one or more committees. Some formal presentations should be prepared along with support handouts. The most important conclusion to be proven in most instances relates to the value of the company's stock. Is it currently overvalued or undervalued? This will be one of the critical factors leading to the decision.

In many ways, the fundamental trader is like a detective preparing a case for trial. It must collect all the relative facts.

Next, we will look at another significant group of traders who examine the metrics of the stock's price actions and charts more closely: the Technical Analysis trader.