Research.

the basics of fundamental analysis

"Draw a circle around the businesses you understand and then eliminate those that fail to qualify on the basis of good value, good management and limited exposure to hard times". Warren Buffett, Investment Guru

One way to determine a company's true market value is to simply look at its underlying 'fundamentals'; an approach Warren Buffett has used with great success.

Fundamental analysis

Fundamental analysis involves assessing a company's financials, such as its assets and earnings, as well as the less tangible factors related to the company's actual business, such as its competitive advantage and its management capability. It differs from technical analysis, which uses market data, such as momentum and price charts, to help determine (usually short-term) market trends.

One of the big assumptions of fundamental analysis is that a company's share price doesn't always reflect its true, or 'intrinsic', market value. Another assumption is that, in the long-term, the market will come to realise this intrinsic value and push the company's share price higher, in-line with its underlying fundamentals.

Quantitative versus qualitative

The factors involved in fundamental analysis normally fall into one of two categories: quantitative or qualitative. Quantitative factors are numeric and tend to come from a company's financials, whereas qualitative factors refer to those less tangible aspects of the business. Many would say that neither quantitative nor qualitative analysis is inherently better than the other, and, in fact, most fundamental analysts will use a combination of the two when determining a company's intrinsic value.

Quantitative factors

The quantitative data found in a company's financials, such as its balance sheet and its profit and loss statement, can be used to determine a number of different value measures and ratios. Below are a few of the more common ones used by fundamental analysts:

1. Earnings Per Share (EPS)

Earnings are important because they give an indication of a company's expected dividends and its growth potential. EPS is calculated by taking a company's net earnings and dividing by the number of outstanding shares the company has. For example,

if a company reports $10 million in net earnings for the previous year and has 5 million shares outstanding, then that company has an EPS of $2 per share. A company's EPS is a good way of comparing earnings across companies.

2. Price to Earnings Ratio (P/E ratio)

Analysts use a company's P/E ratio to determine how much the market is prepared to pay for its earnings. It's calculated by taking a company's share price and dividing by its EPS. For example, if a company's share price is $50 and it has an EPS of $5, then it has a P/E ratio of 10. If the P/E ratio is low, then the company is usually considered cheap. If the P/E ratio is high, then the company is usually considered expensive.

3. Book value

The book value of a company is its net worth, as measured by its total assets less its total liabilities. This is how much a company would have left over in assets if it liquidated its assets today (assuming assets realised their book value). In order to compare book values across companies, a simple way is to calculate the book value per share, which is simply a company's latest book value divided by the number of outstanding shares the company has.

4. Price to Book Ratio (P/B ratio)

The P/B ratio is calculated by taking a company's share price and dividing by its book value per share. For example, if a company currently trades at $100 and has a book value per share of $5, then that company has a P/B ratio of 20. The higher the ratio, the more the market is prepared to pay for the company above its hard assets. Quarterly and annual financial reports – where the information needed to make the above calculations is located – can normally be found in the investor section of a company's website.

Qualitative factors

Because qualitative factors focus on the less tangible aspects of a company's actual business, they can be a little harder to assess than quantitative factors. Nonetheless, it's important to try to get a handle on these factors because they can play a big part in determining a company's value.

Qualitative factors can be split into two categories: company and industry.

1. Company factors – these are factors that are specific to a company and how it runs its business, including:

- The business model – what does the company actually do, and how does it make money?
- Competitive advantage – a company's long-term success is driven largely by its ability to maintain a competitive advantage.
- Management – the quality of a company's management team is fundamental to executing its business model.
- Corporate governance – how well does the company protect its investors from unethical or illegal business activities?

2. Industry factors – these are factors that affect the market environment in which a company operates, including:

- Customers – a company's success relies heavily on its ability to attract and retain customers, so understanding them is important.
- Market share – the size of a company's market share usually indicates its strength in the industry within which it operates.
- Industry growth – the growth potential of the industry within which a company operates is important to the growth potential of the company itself.
- Competition – how competitive is the company?
- Regulation – is the industry heavily regulated? If it is, it could limit a company's growth potential.

Information relating to these sorts of qualitative factors can usually be found in trade or industry publications, the investor section of a company's website and in market research publications, as well as on the Internet.

How to measure the information

Once investors have carried out their research, the information they've gathered needs to be measured in order to determine whether a company can be considered good value or not.

One of the most common ways for investors to measure their research is to compare it with a peer group of companies. This enables investors to see how the companies they've chosen stack up against others in the same industry or sector, and therefore provides a good indication of their relative value.

As a client of Westpac Online Investing, you can access this information and more via the Company Research tab from the Quotes page. Most of the calculations and comparison work has already been done for you, so all you need to do now is pick the companies to go in your portfolio!

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