

FUNDAMENTAL ANALYSIS: THE METHODS OF STUDYING COMPANY'S INVESTMENT APPETITE

E.D. Galyadkina, E.B. Gerasimova

*Finance University under the Government of the Russian
Federation, Moscow*

*Represented by Doctor of Economic Sciences,
Professor V.V. Bykovsky*

Key words and phrases: company equities; fundamental analysis; macroeconomic indicators; making the portfolio investments; potential return on financial investments; traditional approach.

Abstract: Basic indicators of fundamental analysis are considered. Traditional approach of carrying out analysis is studied for the purpose of presenting practical recommendations on making the portfolio investments in securities.

1. Fundamental analysis: historical aspect

The basis of the theory of fundamental analysis was first formed in 1934 in the publication «Security analysis», written by the Americans Benjamin Graham and David Dodd. They determined fundamental analysis as *an instrument for prediction of future prices of equities and bonds* [4]. Moreover, Benjamin Graham is the author of the book, known as «Security analysis. Principles and techniques», in which he evaluates the correlation between internal (true) value of the share and its market price, and formulates the main aspects of the basis of fundamental analysis.

A lot of publications are devoted to security markets fundamental analysis. However, nowadays there is no single opinion about the way of carrying it out, its principles and techniques, with the help of which an analyst can determine the degree of undervaluation or overvaluation of the share with a maximum accuracy. Share undervaluation signals of its potential yield, and an analyst task is to choose the optimal methods of carrying out the fundamental analysis of company equities. The first step one should do in order to determine the value

Галядкина Екатерина Дмитриевна – студентка факультета «Финансы и кредит»; Герасимова Елена Борисовна – доктор экономических наук, профессор кафедры «Экономический анализ», e-mail: gerasim_ova@inbox.com, ФГБОУ ВПО «Финансовый университет при Правительстве Российской Федерации», г. Москва.

of equity is to collect and analyze the information, therefore, the corporate transparency is the necessary factor. Unfortunately, there are few companies which satisfy the principles of transparency and openness in The Russian Federation. That's why it is difficult not only to carry out the analysis, but also to study its methods and principals. Despite the fact that the problem of fundamental analysis methods is more developed abroad, there are some researches devoted to this theme among Russian authors. But, anyway, there is no full list of fundamental factors, which have an influence on a company performance.

In this article we will analyze the factors, which should be taken into account on every step while carrying out the fundamental analysis of a company, and also look at the steps of potential investor, who wants to create an attractive portfolio of stocks.

Scientists usually highlight two basic approaches of the way of carrying out fundamental analysis: traditional "Top-Down Approach to Investing" and alternative "Bottom-Up Approach to Investing" [5]. Traditional approach starts with macroeconomic analysis, continues with the analysis of the branch of the economy and finishes with the analysis of a company performance. Contrary to it, an alternative analysis means starting from the micro level and finishing with the analysis of economic situation in the country.

2. Fundamental analysis: traditional approach

There are five consecutive steps of carrying out fundamental analysis in the traditional way. First, such macroeconomic indicators as the level of inflation or GDP (Gross Domestic Product) should be evaluated since they characterize the level of country development and determine the condition for profit growth of the company. One more thing the investors should pay the attention on is the most perspective branches of the economy. The result of this step is the chosen companies, the shares of which provide maximum liquidity on the market. The next step consists of the exploration of the liquidity of chosen companies. The third step is the comparison of investment qualities of different companies' shares among each other and the choice of the most attractive company. The next step is the most important in evaluation company investment attractiveness and it should be carried in the most accurate way. It is the fourth step in which with the help of different analytical indicators the true value of a company and its under- or overvaluation is determined. The final step is the determination of the price level on which the funds should be invested.

There are specific systems of indicators and factors, which should be analyzed on every step of the fundamental analysis. Moreover, it is important that the information used in the analysis is presented in a comparable way, with corrections on price index, inflation and other factors, which influence the analyzed process.

Macroeconomic fundamental analysis means determination of the level of the country development, which depends on political situation in the

government and also political risks. The ability of the economy to solve the development problems is determined by effectiveness and consistency of economic policy and legal regulation. It should be also taken into account that the mentioned above groups of indicators depend on such factors as the conjuncture of the world financial and commodity markets. Unfortunately, there is no specific system of indicators, which should be evaluated on the first step of fundamental analysis in Russia; therefore we will look at some of the indicators, which are usually analyzed in the process of studying the macroeconomic situation in the United States.

– *Trade balance*. It is counted as the difference between export and import of the goods of a country. Positive difference as well as the decrease of negative difference are stimulating factors for the increase of a share market price;

– *The level of unemployment*. The increase of this indicator is usually the signal of the worsening macroeconomic situation, which has a negative effect on the financial and commodity markets;

– *The Index of producer prices and the Index of consumer prices*. They characterize changes in production costs on different stages of production and the change of value of consumer basket respectively. The increase of these factors influences the financial markets in a bad way;

– *Gross domestic product (GDP)*. It is the sum of the value of all the goods produced and services provided in the country for the specific period. The increase of GDP has the favorable impact on the market and the decrease of it, vice versa, weakens the financial market;

– *The report on retail sales*. As two thirds of GDP usually consist of the goods consumption, the report of retail sales is the important indicator, which helps in evaluation of the consumers' expenditures. The increase of retail sales results in the growth of the GDP and therefore stimulates the increase of financial markets;

– *The report on durables orders*. Since the change in demand for these goods indicates their consumption in future, this report is an outrunning indicator. The increase in demand leads to the increase in the commodity markets;

– *The industrial production report*. It shows the quantity of produced goods. The increase of it leads to the increase in markets;

– *The Index of National association of chief buyers*. The calculation of this Index is based on the report of chief buyers of 300 main companies. This indicator helps to study the development destination in the upcoming future and to determine the growth or recession of the production sector of the economy;

– *The Index of consumers' confidence*. Consumers' optimism or pessimism influences their expenses and therefore this Index is an outrunning indicator which has a direct correlation with the finance market condition;

– *Housing construction*. This indicator is very sensitive to the consumers' confidence because of the high costs of housing construction. Historically, the decrease of construction usually occurred half a year before the recession of economy and therefore this indicator is an outrunning indicator of the stock market [1].

As mentioned above, it is difficult to use these indicators in Russia because of the unavailability of sufficient data. In some other countries, e.g. in the USA, these data is collected and published for the general use, while in Russia investors have to look for and analyze the information themselves, which is a very time-consuming process since there is a huge number of factors, which have to be analyzed during the process of carrying out the fundamental analysis of high quality. However, some of the macroeconomic indicators, such as the deficit of trade and Payment Balance, the dynamic of GDP, inflation indices, unemployment indicators and others can be easily found in the official resources, e.g., on the official website of Federal State Statistic Service [8].

Besides the mentioned above indicators investors can analyze such factors, as refinancing rate, Repo rate, pawnshop rate, used when bailing the real estate in process of crediting. The decrease of percent rates leads to the increase in business activity and strengthens the stock market. The increase of percent rates has a negative effect on the stock market, since in this case the cost of credits rises and therefore the profits of the companies decrease.

It is interesting that all of the macroeconomic indicators are interdependent. The steady decrease of GDP signals of strict monetary policy, because of which the lack of effective demand doesn't let the company sell its production. The effectiveness of the government monetary policy is characterized by the indicators of structure and dynamics of money supply. The change of money supply leads to the misbalance of the effective demand and supply of goods and services, which is usually followed by the increase of inflation level in terms of the increase of price indices, which lead to the decrease of the value of national currency [3].

The macroeconomic analysis is followed by the full analysis of the most interesting for the investor branches of economy. In fact the branch analysis is the transient torque to the analysis of companies, as the most perspective branches for the future analysis are determined on this stage. The influence of macroeconomic indicators on the selected branches of economy is studied in the frame of the branch analysis. For example, the decrease of the conjuncture of the external market usually influences the branches with the traditionally high export portion more than the branches orientated on the internal market. The same can be said about the branches, which, because of their product line react faster on the conjuncture movements, than other branches.

The next step is the analysis of equity liquidity of the selected branches. The most liquid shares are the so-called "blue fishes" – common shares of big companies, famous for the stability of their revenues and the dividends paid.

The third and the fourth step is the calculation of indicators, which characterize the performance of the selected companies and their comparative investment quality. As mentioned above, the evaluation of companies' shares in the process of fundamental analysis is determined by the comparison of the market capitalization of a company with its internal (true) value. If the capitalization is less than the company's true value, than the equities are considered to be unevaluated, otherwise, vice versa.

3. Fundamental analysis: the system of indicators

Let's look at the generalizing indicators, which measure the potential return on financial investments.

– *Earnings per share (EPS)*. This indicator is one of the most important indicators, which influences the company's market capitalization. It shows the net profit per one common share in monetary terms. The growth of EPS indicates the increase of the company and usually leads to the increase of dividends and equities market price. The search of the information will not make any difficulty for the investor, since public corporations are to publish this type of data according to the law. They publish such information in two measures: the basic profit (loss) per share, which indicates profit (loss) of reporting period, which belongs to the shareholders of common shares and the profit (loss) per share which indicates the potential increase of the profit level (the decrease of the loss) per share in the forthcoming reporting period [7].

– *Dividends per share (DPS)* show the sum of dividends on every common share, counted as the quotient of division the sum of money, distributed as dividends among shareholders of common shares, to the quantity distributed common shares. The increase of the sum of dividends paid signals of the increase of the company's profit and therefore the increase of the market price of the equities. However, this type of information is obligatory to publish, so, the search of it may cause some difficulties for the investor. Moreover, because of the usage of different sophisticated schemes for tax evasion by small enterprises, the calculation of DPS for such companies is based on information of bad quality and can lead to false results. Therefore, it is reasonable to rely on this indicator by 100% only in case of investments in big reliable enterprise with good business reputation.

– *The ratio of share price to the profit (P/EPS)*. This is one of the most important indicators, which is very popular among traders and investors. It shows how much money investors are ready to pay for every unit of company's net profit. The less this indicator is the more attractive is the company. The data for evaluating this indicator can be found in the same way as those of EPS and investor can easily calculate it by himself.

– *The coefficient of payments*, counted as the part of company's net profit, distributed among shareholders as dividends. It is considered normal in the worldwide practice if the company use on this aim from 25 to 50 % of gained profit [2]. Unfortunately, it's not easy to find this indicator. Moreover, it's important to take into account which standards the company follows – the calculation of this indicators is different in International Standards of Financial Statement and Russian Standards of Accounting.

Not only evaluation of company's value should be done in the process of fundamental analysis, but also the indicators of correlation between market capitalization and company's revenue, profit, балансовой стоимостью активов, production indicators should be analyzed. If the results are less than average in a certain branch of economy, the company's equities are undervalued.

The last step is the decision on which price level it is reasonable to invest in the chosen company.

4. Fundamental analysis: the basis for making decisions

Thus, for the investor, who is not a professional, the following simplified recommendations can be advised for making the portfolio investments in securities:

- First of all, an investor should identify the current profitability of governmental bonds, the maturity of which is approximately the same as the period of potential investments (the investments in such bonds are riskless, their yield is the base for comparison with any other investments),
- Using the publications, an investor should make a list of companies, in which he may potentially invest, and also look at the statistic characteristics of returns on investments in the shares of these companies,
- Then it's good to figure out P/E indicator for chosen shares,
- And, finally, to distribute the investment capital among the chosen shares in the proportion reciprocal to the P/E indicator, e.g. the more the profit on invested money is, the more attractive the investments are [6].

To resume we'd like to focus your attention on the fact that investments in shares always involve the risk. Riskless investments are impossible and unacceptable. The distribution of invested capital is the investor's own decision and depends on his readiness to take the risk.

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Фундаментальный анализ: методы изучения инвестиционного аппетита компании

Е.Д. Галядкина, Е.Б. Герасимова

*ФГБОУ ВПО «Финансовый университет
при Правительстве Российской Федерации», г. Москва*

Ключевые слова и фразы: акции компании; макроэкономические показатели; потенциальная доходность финансовых вложений; традиционный подход; формирование портфеля инвестиций; фундаментальный анализ.

Аннотация: Рассмотрены основные показатели фундаментального анализа акций компании. Исследован традиционный подход проведения анализа с целью представления практических рекомендаций инвестору по формированию портфеля ценных бумаг.

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