Date: 3rd Nov 2020

VIRTUAL COACHING CLASSES
ORGANISED BY BOS, ICAI

FINAL LEVEL
PAPER 2: STRATEGIC FINANCIAL MANAGEMENT

Faculty: CA SUUSHANT ARORA

Security analysis

Fundamental analysis

Technical analysis

Fundamental analysis

Fundamental analysis is based on the assumption that the share prices depend upon the future dividends expected by the shareholders. The present value of the future dividends can be calculated by discounting the cash flows at an appropriate discount rate and is known as the *'intrinsic value of the share'*. The intrinsic value of a share, according to a fundamental analyst, depicts the true value of a share. A share that is priced below the intrinsic value must be bought, while a share quoting above the intrinsic value must be sold.

Security analysis involves evaluation of a security, to determine its value, so that appropriate decisions(buy/sell) may be made based on such valuation as compared with the market value of security.

Fundamental analysis: Contd.

1.1 Dividend Growth Model and the PE Multiple:

Financial analysts tend to relate price to earnings via the P/E multiples (the ratio between the market price and earnings per share).

For estimating the fundamental or intrinsic price or the fundamental price-earnings multiple of a security, the fundamental analysts use the below model:

$$P(O) = \frac{bE(O)(1+g)}{(k-g)}$$

1.2 Economic Analysis

Macro- economic factors e. g. historical performance of the economy in the past/ present and expectations in future, growth of different sectors of the economy in future with signs of stagnation/degradation at present to be assessed while analyzing the overall economy.

Analysis of entire economy, growth of different sectors, future prospects, trends in income, expenditure and consumption patters.

Fundamental analysis: Contd

1.2.1 Factors Affecting Economic Analysis

Some of the economy wide factors are discussed as under:

(a) Growth Rates of National Income and Related Measures

(b) Growth Rates of Industrial Sector

(c) Inflation

(d) Monsoon

Fundamental analysis: Contd

1.2.2 Techniques Used in Economic Analysis

(a) Anticipatory Surveys

(b) Barometer/Indicator Approach

(c) Economic Model Building Approach

Fundamental analysis: Contd

1.3 Industry Analysis

Assessment to be made regarding all the conditions and factors relating to demand of the particular product, cost structure of the industry and other economic and Government constraints on the same.

1.3.1 Factors Affecting Industry Analysis

(a) Product Life-Cycle*:* An industry usually exhibits high profitability in the initial and growth stages, medium but steady profitability in the maturity stage and a sharp decline in profitability in the last stage of growth.

(b) Demand Supply Gap*:* Excess supply reduces the profitability of the industry because of the decline in the unit price realization, while insufficient supply tends to improve the profitability because of higher unit price realization.

(c) Barriers to Entry*:* Any industry with high profitability would attract fresh investments. The potential entrants to the industry, however, face different types of barriers to entry. Some of these barriers are innate to the product and the technology of production, while other barriers are created by existing firms in the industry.

Fundamental analysis: Contd

(d) Government Attitude*:* The attitude of the government towards an industry is a crucial determinant of its prospects.

(e) State of Competition in the Industry*:* Factors to be noted are- firms with leadership capability and the nature of competition amongst them in foreign and domestic market, type of products manufactured viz. homogeneous or highly differentiated, demand prospects through classification viz customer-wise/area-wise, changes in demand patterns in the long/immediate/ short run, type of industry the firm is placed viz. growth, cyclical, defensive or decline.

(f) Cost Conditions and Profitability*:* The price of a share depends on its return, which in turn depends on profitability of the firm.

(g) Technology and Research

Fundamental analysis: Contd

1.3.2 Techniques Used in Industry Analysis

The techniques used for analyzing the industry wide factors are:

(a) Regression Analysis*:* Investor diagnoses the factors determining the demand for output of the industry through product demand analysis. Factors to be considered are GNP, disposable income, per capita consumption / income, price elasticity of demand. For identifying factors affecting demand, statistical techniques like regression analysis and correlation are used.

(b) Input – Output Analysis*:* It reflects the flow of goods and services through the economy, intermediate steps in production process as goods proceed from raw material stage through final consumption. This is carried out to detect changing patterns/trends indicating growth/decline of industries.

Fundamental analysis: Contd

1.4 Company Analysis

Economic and industry framework provides the investor with proper background against which shares of a particular company are purchased. This requires careful examination of the company's quantitative and qualitative fundamentals.

(a) Net Worth and Book Value*:* Net Worth is sum of equity share capital, preference share capital and free reserves less intangible assets and any carry forward of losses. The total net worth divided by the number of shares is the much talked about book value of a share.

(b) Sources and Uses of Funds*:* The identification of sources and uses of funds is known as Funds Flow Analysis. One of the major uses of funds flow analysis is to find out whether the firm has used short-term sources of funds to finance long-term investments.

Fundamental analysis: Contd

(c) Cross-Sectional and Time Series Analysis*:* One of the main purposes of examining financial statements is to compare two firms, compare a firm against some benchmark figures for its industry and to analyze the performance of a firm over time. The techniques that are used to do such proper comparative analysis are: common-sized statement, and financial ratio analysis.

(d) Size and Ranking*:* The net profits, the return on investment and the sales figures of the company under consideration may be compared with similar data of other companies in the same industry group.

(e) Growth Record: The growth in sales, net income, net capital employed and earnings per share of the company in the past few years should be examined

(f) Financial Analysis*:* An analysis of its financial statements for the past few years would help the investment manager in understanding the financial solvency and liquidity, the efficiency with which the funds are used, the profitability, the operating efficiency and the financial and operating leverages of the company.

Fundamental analysis: Contd

(g) Competitive Advantage: Another business consideration for investors is competitive advantage. A company's long-term success is driven largely by its ability to maintain its competitive advantage.Powerful competitive advantages, such as Apple's brand name and Samsung's domination of the mobilemarket, create a shield around a business that allows it to keep competitors at a distance.

(h) Quality of Management*:* This is an intangible factor and the confidence that investors have in a particular business house, its policy vis-a-vis its relationship with the investors, dividend and financial performance record of other companies in the same group, etc

(i) Corporate Governance: Following factors are to be kept in mind while judging the effectiveness of corporate governance of an organization:

Whether company is complying with all aspects of clause 49.

How well corporate governance policies serve stakeholders?

Quality and timeliness of company financial disclosures. etc

Fundamental analysis: Contd

(j) Regulation: Regulations plays an important role in maintaining the sanctity of the corporate form of organization.

(k) Location and Labour-Management Relations*:* The locations of the company's manufacturing facilities determines its economic viability which depends on the availability of crucial inputs like power, skilled labour and raw-materials, etc. Nearness to markets is also a factor to be considered.

(l) Pattern of Existing Stock Holding*:* An analysis of the pattern of existing stock holdings of the company would also be relevant. This would show the stake of various parties in the company.

(m) Marketability of the Shares: Another important consideration for an investment manager is the marketability of the shares of the company.

Fundamental analysis: Contd

1.4.1 Techniques Used in Company Analysis

Through the use of statistical techniques the company wide factors can be analyzed. Some of the techniques are discussed as under:

(a) Correlation & Regression Analysis*:* Simple regression is used when inter relationship covers two variables.

(b) Trend Analysis*:* The relationship of one variable is tested over time using regression analysis. It gives an insight to the historical behavior of the variable.

(c) Decision Tree Analysis: Information relating to the probability of occurrence of the forecasted value is considered useful. A range of values of the variable with probabilities of occurrence of each value is taken up. The limitations are reduced through decision tree analysis and use of simulation techniques.

Technical analysis: Definition

Technical Analysis is a method of share price movements based on a study of price graphs or charts on the assumption that share price trends are repetitive, that since investor psychology follows a certain pattern, what is seen to have happened before is likely to be repeated.

Technical analysis: Assumptions

i) The market value of stock is actually depending on the supply and demand for a stock.

(ii) The supply and demand is actually governed by several factors.

(iii) Stock prices generally move in trends which continue for a substantial period of time. Therefore, if there is a bull market going on, there is every possibility that there will soon be a substantial correction which will provide an opportunity to the investors to buy shares at that time.

(iv) Technical analysis relies upon chart analysis which shows the past trends in stock prices rather than the information in the financial statements(as covered in company analysis)

Principles of Technical Analysis

The market discounts everything.

Price moves in trends.

History tends to repeat itself

Theories of Technical Analysis-3 theories

The Dow Theory

The Dow Theory's purpose is to determine where the market is and where is it going i.e. if the cyclical swings of the stock market averages are successively higher and the successive lows are higher, then the market trend is up and a bullish market exists. Contrarily, if the successive highs and successive lows are lower, then the direction of the market is down and a bearish market exists.

Elliot Wave Theory

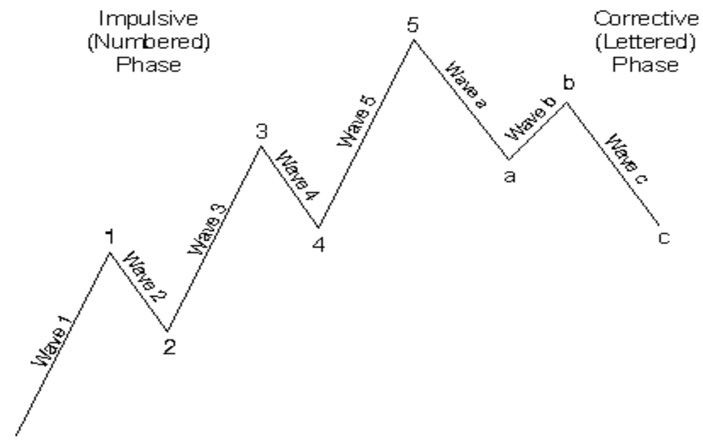
Elliot found that the markets exhibited certain repeated patterns or waves

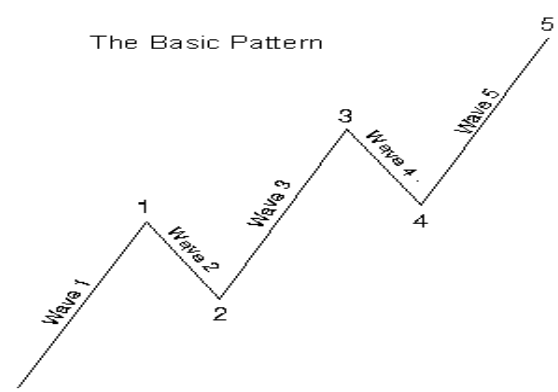
These waves are resulted from buying and selling impulses emerging from the demand and supply pressures on the market. Depending on the demand and supply pressures, waves are generated in the prices.

As per this theory, waves can be classified into two parts:-

Impulsive patterns

Corrective patters





Random Walk theory

Simple meaning: Prices on the stock exchange behave exactly the way a drunk would behave while walking in a blind lane, i.e., up and down, with an unsteady way going in any direction he likes, bending on the side once and on the other side the second time.

The supporters of this theory put out a simple argument. It follows that:

(a) Prices of shares in stock market can never be predicted.

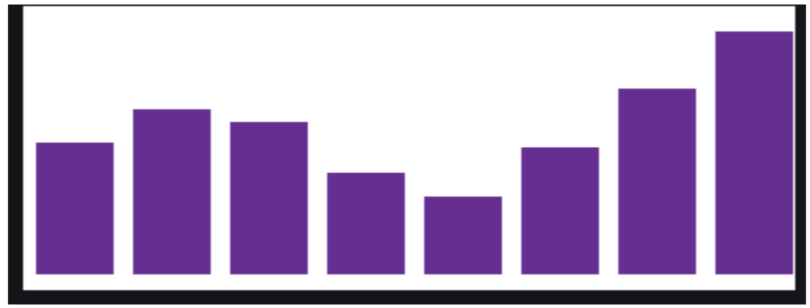
(b) The reason is that the price trends are not the result of any underlying factors, but that they represent a statistical expression of past data.

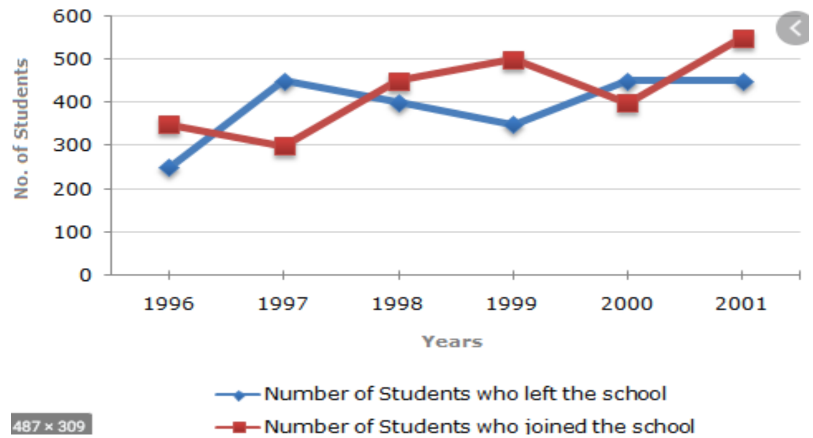
(c) There may be periodical ups or downs in share prices, but no connection can be established between two successive peaks (high price of stocks) and troughs (low price of stocks).

Charting Technique

Bar Chart : In a bar chart, a vertical line (bar) represents the lowest to the highest price, with a short horizontal line protruding from the bar representing the closing price for the period.

Line Chart: In a line chart, lines are used to connect successive day's prices. The closing price for each period is plotted as a point. These points are joined by a line to form the chart. The period may be a day, a week or a month





Other techniques

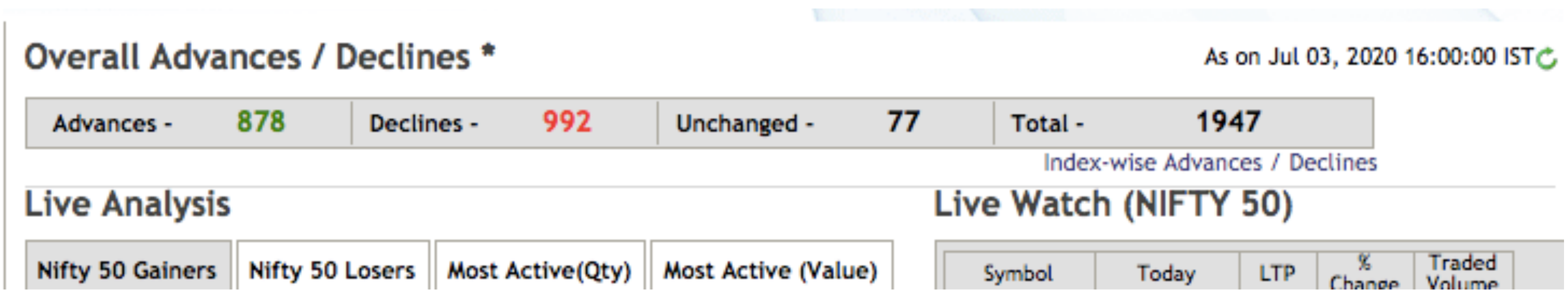
(i) Breadth Index: It is an index that covers all securities traded. It is computed by dividing the net advances or declines in the market by the number of issues traded.

(ii) Volume of Transactions: The volume of shares traded in the market provides useful clues on how the market would behave in the near future.

(iii) Confidence Index: It is supposed to reveal how willing the investors are to take a chance in the market.

(iv) Relative Strength Analysis: The relative strength concept suggests that the prices of some securities rise relatively faster in a bull market or decline more slowly in a bear market than other securities i.e. some securities exhibit relative strength.

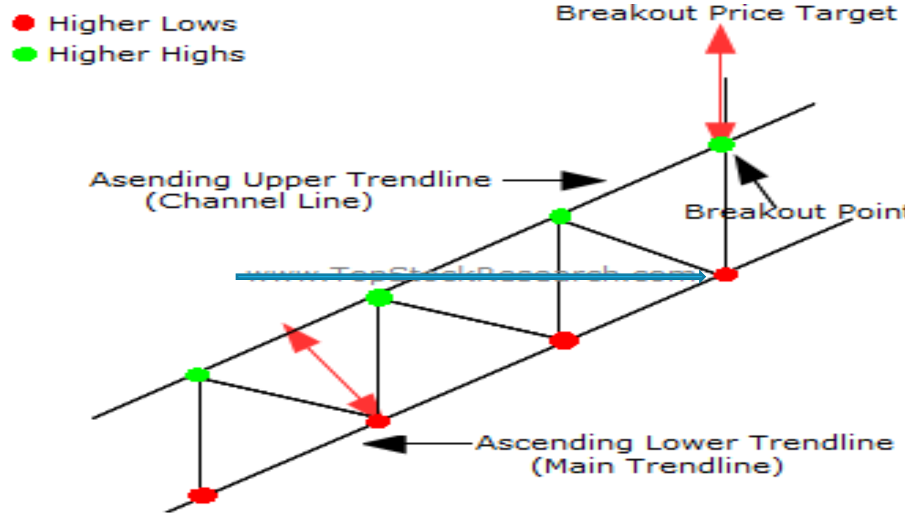
(v) Odd - Lot Theory: The odd-lot theory is used primarily to predict tops in bull markets, but also to predict reversals in individual securities.



Support and Resistance Levels

When the index/price goes down from a peak, the peak becomes the resistance level. When the index/price rebounds after reaching a trough subsequently, the lowest value reached becomes the support level. The price is then expected to move between these two levels. Whenever the price approaches the resistance level, there is a selling pressure because all investors who failed to sell at the high would be keen to liquidate, while whenever the price approaches the support level, there is a buying pressure as all those investors who failed to buy at the lowest price would like to purchase the share.

Interpreting Price Patterns



(a) Channel

(b) Wedge

(c)Head and Shoulders: *Head and Shoulder Top Pattern* **&** Inverse Head and Shoulder Pattern

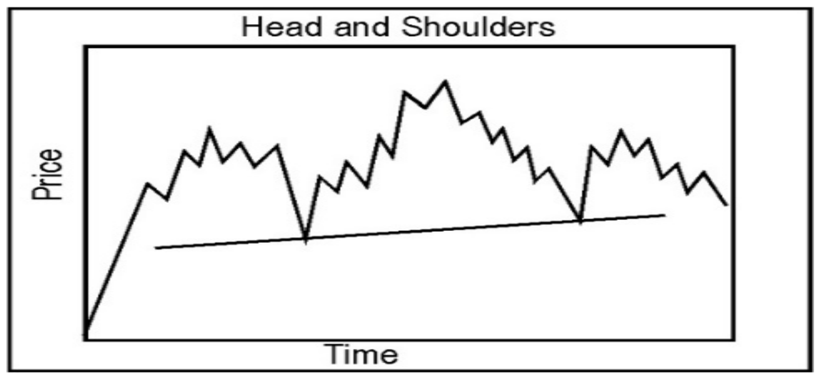
(d) Triangle or Coil Formation

(e) Flags and Pennants Form

(f) Double Top Form

(g) Double Bottom Form

(h) Gap



Decision Using Data Analysis

Technical analysts have developed rules based on simple statistical analysis of price data.

Moving Averages: Moving averages are frequently plotted with prices to make buy and sell decisions. The two types of moving averages used by chartists are the Arithmetic Moving Average (AMA) and the Exponential Moving Average (EMA)

To identify trend, technical analysts use moving average analysis:

(i) A 200 day's moving average of daily prices or a 30 week moving of weekly price for identifying a long term trend.

(ii) A 60 day's moving average of daily price to discern an intermediate term trend.

(iii) A 10 day's moving average of daily price to detect a short term trend

Buy and Sell Signals Provided by Moving Average Analysis

Buy Signal	Sell Signal
(a) Stock price line rise through the moving average line when graph of the moving average line is flattering out.	(a) Stock price line falls through moving average line when graph of the moving average line is flattering out.
(b) Stock price line falls below moving average line which is rising.	(b) Stock price line rises above moving average line which is falling.
(c) Stock price line which is above moving average line falls but begins to rise again before reaching the moving average line	(c) Stock price line which is slow moving average line rises but begins to fall again before reaching the moving average line.

Exponential Moving Average*:* Unlike the AMA, which assigns equal weight of 1/*n* to each of the n prices used for computing the average, the Exponential Moving Average (EMA) assigns decreasing weights, with the highest weight being assigned to the latest price.

EFFICIENT MARKET THEORY (EFFICIENT MARKET HYPOTHESIS)

As per this theory, at any given time, all available price sensitive information is fully reflected in securities' prices. Thus this theory implies that no investor can consistently outperform the market as every stock is appropriately priced based on available information.

They concluded that randomness of stock price was a result of efficient market that led to the following view points:

Information is freely and instantaneously available to all market participants.

Keen competition among the market participants more or less ensures that market will reflect intrinsic values. This means that they will fully impound all available information.

Price change only response to new information that is unrelated to previous information and therefore unpredictable.

Level of Market Efficiency

That price reflects all available information, the highest order of market efficiency & there exist three levels of market efficiency:-

(i) *Weak form efficiency* – Price reflect all information found in the record of past prices and volumes.

(ii) *Semi – Strong efficiency* – Price reflect not only all information found in the record of past prices and volumes but also all other publicly available information.

(iii) *Strong form efficiency* – Price reflect all available information public as well as private.

THANK YOU