L6: Chapter 1 Fundamental and Technical

Which Is Better for Investing?

One of the most commonly asked questions by beginner investors is, "What's the best way to choose stocks?" Following some of the most successful investors in history, like Warren Buffett and Ralph Seger, shows that taking a fundamental approach has its benefits.

But what about those investors making millions using technical analysis? What about the fact that machines control about 80% of stock buys and sells in today's technology driven society, according to CNBC? The masses can't be wrong, can they?

The truth is that both fundamental and technical analysis have their place. Which is best for you depends on your goals and risk tolerance.

Fundamental vs. Technical Analysis

For the beginner investor, fundamental analysis is far easier to understand. This type of analysis is based on factors like how much money a company has, how much money it's making, and its management team, intellectual property, and products. Essentially, fundamental analysis is based on the health of the company you're considering investing in.

Technical analysis, on the other hand, is built on the idea that movement in the market tends to repeat itself and follow patterns. By looking at signals from stocks 'past performance, investors can predict what will happen in the future — at least, that's the idea. Technical analysts look for patterns in stock charts that provide specific entry and exit points.

Fundamental Analysis

When examining a company from a fundamental standpoint, there are several factors you should look at. Each of them gives you a more detailed understanding of either the current financial well-being of the company or the likelihood it has a strong future.

Balance Sheet

A company's balance sheet gives investors a detailed look at how much cash and cash equivalents the company has on hand in comparison to its debt. It also provides a breakdown of the company's assets outside of cash and cash equivalents.

Here are the key ratios to calculate and line items to consider when looking into a company's balance sheet:

- **Book Value per Share**. Comparing the book value per share to the current share price tells you if you're paying a premium to book value or getting a discount when purchasing shares. To calculate book value per share, find the net worth in the company's balance sheet. Now divide the net worth by the total number of outstanding shares of stock that represents the company. The result is the book value per share.

- **Cash and Cash Equivalents per Share**. The cash and cash equivalents per share ratio gives you a deeper look into the liquidity of the company. To find this figure, divide the total amount of cash and cash equivalents on the balance sheet by the total number of outstanding shares. Companies with high levels of cash and cash equivalents per share in relation to others within their sector are often the most financially sound.

- **Debt-to-Equity Ratio**. This ratio tells you whether or not the company has the financial foundation it needs to continue to meet its debt requirements. To find the debt-to-equity ratio, divide the company's total debt by its net worth. High debt-to-equity ratios tell you a company is struggling financially and not likely a good investment opportunity.

- **Free Cash Flow**. This figure tells you how much money the company has left after paying all of its expenses, giving you a deeper look into its financial stability. Start by adding net income to noncash expenses. These noncash expenses include line items like depreciation and amortization. Now, add in the change in working capital found on the balance sheet. Subtract the capital expenditures for the quarter from your total, and you get the company's free cash flow. A high level of free cash flow tells you the company is financially stable.

- **Current Ratio**. Finally, the current ratio, or the ratio of current assets to current liabilities, gives you a look at the company's liquidity. Simply divide the company's current assets by its current liabilities to find this figure. A low current ratio (a ratio under 1.5) tells you the company may be heading into liquidity problems and a fund raise may be around the corner.

Quarterly Revenue

Quarterly revenue is the amount of money a company brings in through sales or other avenues during the course of a fiscal quarter. Take the time to go through the four most recent quarterly financial reports and compare revenue from quarter to quarter.

In doing so, you'll learn whether the company is experiencing revenue growth, stagnation, revenue declines, or a sporadic revenue pattern. Of course, when making an investment decision, you'll want to see companies that produce consistent revenue growth.

Quarterly Earnings Per Share (EPS)

Quarterly earnings per share (EPS) is the amount of net income a company earns in a given quarter divided by the total number of outstanding shares of that company. This figure is important for multiple reasons:

- **Profit or Loss**. Quarterly EPS tells you if a company is generating a profit or a loss on a quarterly basis. Although some companies that generate losses are worth investing in, it's often better to stick with those that generate profits.
- **Growth**. Quarterly EPS also tells you if a company is experiencing growth. By looking at the four most recent earnings reports and comparing earnings, you'll see either an upward, downward, or flat trend in most cases.
- **Strategy Effectiveness**. Finally, in some cases, you'll see that quarterly EPS is growing even as revenue is declining. This often happens when companies shift gears to focus on

more profitable opportunities. Some other companies with a declining trend in sales focus on reducing costs to increase profits. So, in some cases, even when revenue has fallen, growth in EPS can be a strong buying signal because it shows the company’s strategy to shift focus or reduce expenses is working.

Intellectual Property

Intellectual property, or IP, is a term used to describe the legal ownership of an idea. Documents like trademarks and patents fall into the IP category.

In the world of investing, there are few things more important than IP. When a company holds a strong IP portfolio, it means competitors simply can’t provide the same products that the company can due to patent and other legal protection.

For example, we all know some medications can be found only under brand names, and for other medications, generics are available. The medications that can only be found as brand names are that way because the companies that make them hold patents that give them a predetermined period of exclusivity. While these patents are active, no competitor is legally able to make and sell a generic version.

Management

In sports, we often hear that a team is only as good as its coach. Publicly traded companies are similar.

Instead of a single coach, these companies are led by management teams. Management teams generally consist of a chief executive officer, president, chief financial officer, chief operations officer, chairman, and board of directors.
Investors who take advantage of fundamental analysis dig into the history of each member of the management team leading a company they’re interested in investing in. This research tells the investor if the members of the management team have a strong history of success in their respective positions.

Product

Having a product is only one step. It’s important that the product being sold is one that’s in demand. When taking a fundamental look at a publicly traded company, take time to dive into the products or services they offer. If they offer products you’re interested in using, buying the company’s stock might be a good idea.

If you can’t or don’t want to buy the company’s product, look at reviews online to see if customers are happy with them. Also, think about whether there will be long-term demand for that product. Finally, do a little research to find out what the market size is for products like the one the company is selling. After all, even the best product in a market worth only $1 million per year isn’t going to turn a company into a billion-dollar enterprise.

Market Potential for Products in the Works

Having a popular product now is a great thing, but you're investing for the future. Make sure any company in which you invest is consistently working to develop new, cutting-edge products in their sector.

Consider BlackBerry. At one point, a BlackBerry cellphone was the latest and greatest thing on the market. But due to the company's failure to keep up with technological advances, the BlackBerry became a relic, while new versions of iPhones consistently become the next big craze year after year.

Institutional Interest
Finally, it's a good idea to consider institutional interest. Institutional interest is a gauge of how big-money investors feel about the stock. These investors include some of the world's biggest banks, hedge funds, and other financial institutions.

Of course, institutions like this have several investment professionals on their payroll that do nothing but analyze the market, looking for the next big opportunity.

If a company has little to no institutional shareholders, or the institutional shareholders that have invested have small positions, it's a sign the investment isn't a good one. On the other hand, if there are several institutional investors with sizable positions, it tells you that some of the greatest minds in the market see the stock as a strong investment opportunity.

Technical Analysis
Technical analysis is driven by math and patterns. Those who rely solely on technical analysis couldn't care less about the products sold, revenue generated, or management team that runs a company. All technical analysts care about is the movement of the stock's price and how investors have reacted to the stock in the past.
Some of the most common technical signals used by beginner investors include:

Support
Support is considered to be a stock's floor. It's the price at which a stock that's trending downward is likely to reverse direction and start generating gains. When a stock reaches support, it's generally considered to be a buying signal.
To figure out where support is, open the trading chart for the stock you're interested in and choose a 30-day view. Now, draw a straight line connecting the low points of the chart. This line is called the support trend line.

In some cases, when a stock is on a bullish trend, this trendline will point upward. When a stock is on a bearish trend, the trendline will point downward. Finally, when a stock is trading relatively flat, the line will be flat as well.

Resistance
Resistance is the opposite of support. It's the point at which stocks that are trending up tend to reverse directions and start working their way down. As such, it's a sell signal.

Finding the resistance trend line is just like finding the support trend line. Open your 30-day trading chart and draw a line connecting the high points of the chart.

Breakout
A breakout is an action that takes place when the price of a stock breaks through either the support or resistance lines. In general, when a stock breaks through the support line, it falls dramatically in what's known as a bearish breakout.

When a stock breaks through the resistance line, it often makes a strong run for the top in what's known as a bullish breakout.

Moving Averages
Moving averages are a tool used by investors to filter out the short-term fluctuations in the price of a stock they're considering. Some of the most commonly used moving averages are the 30-day moving average and the 50-day moving average.

These averages add up the closing price of the stock each day over the number of days being averaged. Then, the total is divided by the number of days being averaged.

At the close of each trading session, the oldest day in the average falls out of the equation and the newest day is added, leading to the name "moving" average.

Crossover
A crossover takes place when a short-term moving average crosses a long-term moving average. Most investors use the 50-day moving average as the long-term trend line and the 30-day moving average as the short-term trend line.

When a short-term trend line crosses from below to above a long-term trend line, the move is called a bullish crossover. It's a signal that the price of a stock is heading up. When the short-term trend line crosses from above to below the long-term trend line, the move is called a bearish crossover. A bearish crossover tells investors the price of the stock is on its way down.

Warning

Keep in mind that technical analysis is far from an exact science. The market can be wildly unpredictable. Just because a technical signal says a run is going to happen, there's no guarantee the run will actually take place.

Fundamental or Technical: Which Is Better?
As mentioned above, deciding whether to use technical or fundamental analysis largely depends on your goals and appetite for risk.

Who Should Use Fundamental Analysis?

Fundamental analysis looks at an investment opportunity from a long-term perspective and is best for those with a low appetite for risk. If you're interested in the fundamental approach, you're more interested in buying shares and holding them for a long period of time in an effort to secure sustained growth rather than buying and selling often in hopes of a quick profit.

The fundamental investor is willing to put several hours of research into the analysis of a single investment opportunity because, when they buy shares, they want to feel confident the company will grow and they'll achieve a strong return on their investment.

The fundamental strategy is perfect for the beginner investor as well. There are three reasons beginner investors benefit from a fundamental approach:

1. **Understanding of the Market**. Technical analysis depends on a deep understanding of the stock market that allows the investor to quickly pick up on technical signals and react. Fundamental analysis is more about common sense: Does the company have enough money to survive? Are the company's products popular? Are new products under development? Is the company capable of legally protecting itself? These are all questions that are easy to understand and answer with a little research.

2. **Time**. Before making any investment decision, beginner investors should take time to research the companies being considered to try to ensure that their investments yield gains rather than losses. Buying and selling based on technical analysis, also known as technical trading, is a fast-paced process that offers little time for research and understanding the underlying assets.

3. **Risk**. Finally, due to the heavy amount of research that goes into fundamental analysis, along with the buy-and-hold nature of the fundamental investor, the risk of loss is far lower than the risk associated with technical trading. Beginner investors shouldn't take on much risk until they have a detailed understanding of the market and the monetary risks they're considering accepting.

However, even the most fundamental of investors should consider some technical signals. For example, a stock with strong fundamentals may have been overpurchased by the investing community, leading to high valuations.

When it comes to these types of stocks, it's good to look for the next level of support before buying in to avoid immediate losses upon your purchase. After all, timing is everything in the world of investing, and technical analysis is all about timing.

Who Should Use Technical Analysis?

Technical analysis is best used by the seasoned investor with an uncanny ability to look at a stock chart and quickly identify signals that tell them to buy and sell.

The technical trader should also have a high appetite for risk. The reality is that there's no formula or algorithm that's 100% correct in predicting market activity. If there were, whoever had it would hold the key to unlimited riches. Losses are a common occurrence in the world of technical trading.

There's a compelling reason technical traders are willing to take that risk: Finding crossovers and breakouts can be incredibly lucrative. Following these technical signals, it's not uncommon for a stock to run by double- or even triple-digit percentages. So, with the high risk comes the potential for incredible reward.

Final Word

There's a strong chance that fundamental analysis is the way to go for you. Due to the high risk associated with a technical investing strategy, it should only be used by seasoned professionals who already know which strategy works best for them. Many of you will use both and you absolutely should especially if you find a natural gravitation to both based on the instrument you are investing in at the time.

Nonetheless, just because your strategy is fundamental doesn't mean you can't benefit from technical signals. Before buying any stock, regardless of the strength of its fundamentals, take the time to look at the long-term stock chart to get an understanding of the performance history of the investment opportunity that you're considering. Also, make sure you're not buying in at a resistance level to avoid losses immediately after your purchase.

If you do decide to try your hand at technical trading, there are three things you should do before you get started:

1. **Research**. Take a couple hours each day to learn about technical analysis and how the stock market works. Only try technical analysis once you're confident you have a strong understanding of technical signals and the risks associated with the investment decisions you make.
2. **Limit Yourself**. If you're new to investing, don't throw all of your investing dollars into the technical arena. Instead, only use about 10% of your investing dollars to try out technical trading. Use fundamental analysis to make safer decisions with the other 90% of your money. This way, you're not risking a substantial portion of your investing dollars out of the gate.
3. **Use Virtual Money First**. Instead of risking your hard-earned money to test your strategy, use a virtual account to see if your strategy will work in a real-world setting. One of the most popular of these virtual accounts is paperMoney by TD Ameritrade. It's free to try your hand in the virtual setting.

Do you prefer fundamental or technical analysis? Why?