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ORIGINAL ARTICLE

A STUDY ON FUNDAMENTAL AND TECHNICAL ANALYSIS

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ABSTRACT

The unique nature of capital market instruments forces investors to depend strongly on fundamental factors in their investment decisions. These fundamental factors relate to the overall Economy or a specific industry or a company. The performance of the securities that represent The company can be said to depend on the performance of the company itself. However, as companies are a part of industrial and business sector, which in turn are a part of overall economy, so even the economic and industry factors can affect the investment decision. The selection of an investment will start with fundamental analysis. Fundamental analysis examines the economic environment, industry performance and company performance before making an Investment decision.

KEYWORDS: Capital market, fundamental factors, investment decisions.

INTRODUCTION

Fundamental analysis is the examination of the underlying forces that affect the well being of the economy, industry groups and companies. As with most analysis, the goal is to develop a forecast of future price movement and profit from it. At the company level, fundamental analysis may involve examination of financial data, management, business concept and competition. At the industry level, there might be an examination of supply and demand forces of the products.

For the national economy, fundamental analysis might focus on economic data to assess the present and future growth of the economy.

OBJECTIVES OF FUNDAMENTAL ANALYSIS

- To predict the direction of national economy because economic activity affects the corporate profit, investor attitudes and expectation and ultimately security prices.
- To estimate the stock price changes by studying the forces operating in the overall economy, as well as influences peculiar to industries and companies.
- To select the right time and right securities for the investment

THREE PHASES OF FUNDAMENTAL ANALYSIS

1) Understanding of the macro-economic environment and developments (Economic Analysis)
2) Analyzing the prospects of the industry to which the firm belongs (Industry Analysis)
3) Assessing the projected performance of the company (Company Analysis)

The three phase examination of fundamental analysis is also called as an EIC (Economy-Industry-Company analysis) framework or a top-down approach-

Here the financial analyst first makes forecasts for the economy, then for industries and finally for companies. The industry forecasts are based on the forecasts for the economy and in turn, the company forecasts are based on the forecasts for both the industry and the economy. Also in this approach, industry groups are compared against other industry groups and companies against other companies. Usually, companies are compared with others in the same group. For example, a telecom operator (Spice) would be compared to another telecom operator not to an oil company.

Thus, the fundamental analysis is a 3 phase analysis of

a) The economy
b) The industry and
c) The company

STRENGTHS OF FUNDAMENTAL ANALYSIS

Long-term Trends

Fundamental analysis is good for long term investments based on long-term trends. The ability to identify and predict long-term economic, demographic, technological or consumer trends can benefit investors and helps in picking the right industry groups or companies.

Value Spotting

Sound fundamental analysis will help identify companies that represent a good value. Some of the most legendary investors think for long-term and value. Fundamental analysis can help uncover the companies with valuable assets, a strong balance sheet, stable earnings, and staying power.

Business Acumen

One of the most obvious, but less tangible rewards of fundamental analysis is the development of a thorough understanding of the business. After such painstaking research and analysis, an investor will be familiar with the key revenue and profit drivers behind a company. Earnings and earnings expectations can be potent drivers of equity prices. A good understanding can help investors avoid companies that are prone to shortfalls and identify those that continue to deliver.

Value Drivers

In addition to understanding the business, fundamental analysis allows investors to develop an understanding of the key value drivers within the company. A stock’s price is heavily influenced by the industry group. By studying these groups, investors can better position themselves to identify opportunities that are high-risk (tech), low-risk (utilities), growth oriented (computer), value driven (oil), non cyclical (consumer staples), cyclical (transportation) etc.

TECHNICAL ANALYSIS

Fundamental analysis and Technical analysis are the two main approaches to security analysis. Technical analysis is frequently used as a supplement to fundamental analysis rather than as a substitute to it. According to technical analysis, the price of stock depends on demand and supply in the market place. It has little correlation with the intrinsic value. All financial data and market information of a given stock is already reflected in its market price.

Technical analysts have developed tools and techniques to study past patterns and predict future price. Technical analysis is basically the study of the markets only. Technical analysts study the technical characteristics which may be expected at market turning points and their objective assessment. The previous turning points are studied with a view to develop some characteristics that would help in identification of major market tops and bottoms. Human reactions are, by and large consistent in similar though not identical reaction; with his various tools, the technician attempts to correctly catch changes in trend and take advantage of them.

ASSUMPTIONS OF TECHNICAL ANALYSIS

The market value of a security is solely determined by the interaction of demand and supply

1. factors operating in the market.
2. The demand and supply factors of a security are surrounded by numerous factors; these
3. factors are both rational as well as irrational.
4. The security prices move in trends or waves which can be both upward or downward depending upon the sentiments, psychology and emotions of operators or traders.
5. The present trends are influenced by the past trends and the projection of future trends is possible by an analysis of past price trends.
6. Except minor variations, stock prices tend to move in trends which continue to persist for an appreciable length of time.
7. Changes in trends in stock prices are caused whenever there is a shift in the demand and supply factors.

TOOLS AND TECHNIQUES OF TECHNICAL ANALYSIS

There are numerous tools and techniques for doing technical analysis. Basically this analysis is done from the following four important points of view:-

1) Prices: Whenever there is change in prices of securities, it is reflected in the changes in investor attitude and demand and supply of securities.

2) Time: The degree of movement in price is a function of time. The longer it takes for a reversal in trend, greater will be the price change that follows.

3) Volume: The intensity of price changes is reflected in the volume of transactions that accompany the change. If an increase in price is accompanied by a small change in transactions, it implies that the change is not strong enough.
4) Width: The quality of price change is measured by determining whether a change in trend spreads across most sectors and industries or is concentrated in few securities only. Study of the width of the market indicates the extent to which price changes have taken place in the market in accordance with a certain overall trends.

MOVING AVERAGE ANALYSIS

The statistical method of moving averages is also used by technical analysts for forecasting the prices of shares. While trends in share prices can be studied for possible patterns, sometimes it may so happen that the prices appear to move rather haphazardly and be very volatile. Moving average analysis can help under such circumstances. A moving average is a smoothed presentation of underlying historical data.

RELATIVE STRENGTH

The empirical evidence shows that certain securities perform better than other securities in a given market environment and this behaviour remains constant over time. Investors should invest in such securities, because these have constant strength in the market. The relative strength analysis may be applied to individual securities or to whole industries or portfolios consisting of stock and bonds. The relative strength can be calculated by:
i. Measuring the rate of return of securities
ii. Classifying securities
iii. Finding out the high average return of securities
iv. Using the technique of ratio analysis to find out the strength of an individual security.

Technical analysts measure relative strength as an indication for finding out the return of securities. They have observed that those securities displaying greatest relative strength in good markets (bull) also show the greatest weakness in bad markets (bear). These securities will rise and fall faster than the market.

Technical analysts explain relative strength as a relationship between risk and return of a security following the trends in the economy. After preparing charts from different securities over a length of time, the technician would select certain securities which showed relative strength to be the most promising investment opportunities.

BREAK-OUT THEORY

Break out is also called as 'confirmation'. This is indicated by drawing a line, which is a period of consolidation, when the share prices move sideways within a range of about 5% of the share price. Eventually a break out will occur and it is often suggested that the longer the period of consolidation, the greater will be the extent of ultimate rise or fall.

DOUBLE TOP FORMATION

The double top occurs as an uptrend is about to reverse itself. A double top is formed when prices reach the previous high and react immediately, the two highs reached being almost at the same level. Two peaks at comparable heights are seen, with a reaction forming a valley between them. The prices breakout into a bearish phase, once they penetrate the neckline drawn across the bottom of the intervening reaction. The measuring implication is similar as for the head and shoulder formation. If the price line falls below the neckline by a distance equal to the distance between the peak and the trough the indication is to sell. Volume is found to be distinctly low at the second top.

DOUBLE BOTTOM FORMATION

A double bottom pattern is just the reverse of a double top and occurs at the end of a downtrend in prices. In double bottom, the second decline is supported by substantially more volume, indicating the price about to rise. The following figure shows the double bottom formation: Sometimes, the tops and bottoms are not found exactly at equal levels, but still these provide valid reversal signals. Sometimes the patterns extend to triple tops or triple bottoms. It must be remembered that longer it takes for the second top (bottom) to appear and deeper the intervening valley (peak) more reliable will be the reversal.

CONCLUSION

Investment is a financial activity that involves risk. It is the commitment of funds for a return expected to be realised in the future. Investments may be made in financial assets or physical assets. In either case there is the possibility that the actual return may vary from the expected return. That possibility is the risk involved in the investment.

Risk and Return are the two most important characteristics of any investment. Safety and liquidity are also important for an investor. The objective of an investor is specified as maximisation of return and minimisation of risk.

Investment is generally distinguished from speculation in terms of three factors, namely risk, capital gains and time period. Gambling is the extreme form of speculation. Investors may be individuals or institutions. Both types of investors combine to make investment activity dynamic and profitable. The investors in the financial market have different attitudes towards risk and varying levels of risk bearing capacity. Some investors are risk averse, while some may have an affinity to risk. The risk bearing capacity of an investor, on the other hand, is a function of his income. A person with higher income is assumed to have a higher risk bearing capacity. Each investor tries to maximise his welfare by choosing the optimum combination of risk and return in accordance with his preference and capacity. It is highly essential for the investor to do both fundamental and technical analysis for deciding the suitable stock. In stock market, trend is considered to be a man’s best friend.

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