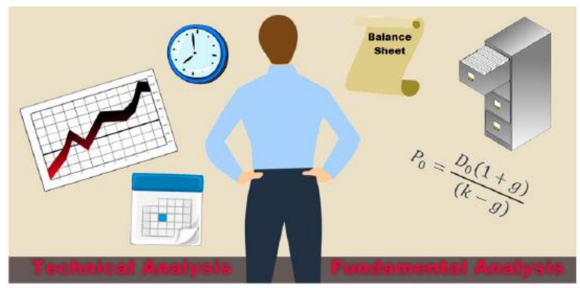
5.5: Stock Valuation in a Non-Textbook World

There are more ideas, books, magazine/internet articles on stock valuation than you could read in a year if that was all you did. The two primary camps are fundamental analysis and technical analysis (although we have even seen stories about people making investment decisions based on planetary alignments – seriously!). Fundamental analysis deals with things like we are focusing on here and in other parts of this class. Looking at the company, industry, and economy to evaluate the company's ability to generate cash flows and its risk levels to determine what a fair price would be to pay to buy a piece of that company. If the current market price is below that fair price, the stock is a "buy". If the current market price is above that fair price, the stock is a "sell". Many investors will use financial statement analysis, evaluate industry competitiveness, regulations faced by the company/industry, economic analysis, Price-Earnings ratios, and valuation models like illustrated in this class (although using a concept called free cash flows instead of dividends) to determine the fair value. This will include reading annual reports, listening to conference calls, evaluating how the firm is doing with new/existing products, looking at supply-chain cost issues, etc. to evaluate the company.

Technical analysis, on the other hand, attempts to evaluate supply/demand issues by looking at the stock price "action". Specifically, technical analysts look at things like stock charts (graphs of the recent stock price) to look for trends, lines of support or resistance, patterns that might predict future movement, etc. They will also incorporate trading volume and other factors that try to gauge whether "smart" investors are accumulating or selling shares. If you get into technical analysis you will encounter things like candlestick charts, Fibonacci numbers, moving averages, and other terms.



Which is the correct approach – fundamental or technical analysis? The answer depends on who you ask. However, we much prefer fundamental analysis as it has a better theoretical foundation for determining what a stock should be worth. However, it is important to remember the concept of market efficiency. Regardless of which approach you use, you should not expect easy riches to suddenly materialize. There are a lot of smart people constantly looking for undervalued stocks to buy and overvalued stocks to sell. In order to beat these other investors, you need (a) the ability to process information better than them, (b) the ability to process information faster than them, (c) access to information that they do not have – and remember it is illegal to trade on information that is not publicly available, or (d) to be lucky. The purpose of this chapter is NOT to make you a multi-millionaire stock trader (if it were that easy we would all be retired on our private islands). Instead it is to make you aware of the basic ideas behind stock valuation so that (a) you have a foundation to understand business news with respect to stock prices, (b) you understand what makes stock prices go up/down, (c) you can talk to a financial advisor and have an understanding of what he/she is talking about, and (d) if you are interested in investment analysis, you have a starting point to investigate further. Remember, any book, TV ad, Internet posting, etc. that offers you the secret to easy wealth from the stock market has a 99.999% chance of being a lie/scam.