LEARNING MADE EASY

3rd Edition

Fundamental Analysis

for dummies®
A Wiley Brand

Gauge a company's performance

Minimize risk and improve your overall investment success

Assess the future value of a business

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Personal finance and management editor at *Investor's Business Daily* and author of *Investing Online For Dummies*

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Contents at a Glance

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Introduction

If someone gave you a dollar for every newfangled stock-picking method invented every year, well, you probably wouldn't need a book on investing. You'd already be rich.

Investors are constantly barraged with new ways to pick stocks and buy stocks. There's no shortage of pundits, professional investors, bloggers, and traders who all claim to know the best ways to invest. The trouble is, most of their advice is conflicting and often confusing.

Maybe it's this constant swirl of investment babble that tempted you to pick up this book. If so, you made a wise decision. This book will help you get back to the basics of investing, understand business, and measure how much that business is really worth. Rather than chasing hot stocks that inevitably crash, *Fundamental Analysis For Dummies* will show you how to study the value of a business. You'll then use that information to make intelligent decisions about how to invest.

While faddish stock-picking systems come and go, fundamental analysis has been around for decades. The ability to pore over a company's most basic data and get a good idea of how a company is doing, how skilled the management team is, and whether or not a company has the resources to stay in business is a valuable skill to have.

History is full of examples where just knowing a little fundamental analysis would've saved you from a massive financial hit. The dot-com boom in 2000 followed by the bust in 2001 was easily sidestepped by investors who knew these young Internet stocks were grossly overvalued and many companies' business models were flawed.

And even the bear market of 2022 wasn't as painful for students of fundamental analysis. If you read companies' financial statements, instead of following the stock tips of complete strangers on Reddit, you likely avoided some of the brunt of the market's pain.

In other words, taking the time to learn about fundamental analysis will actually help you make, and keep, more money. Following the fundamentals of companies keeps you rooted in reality. And that's very valuable when other investors lose their heads and go chasing after stocks they see featured in Internet memes or eye-catching posts on social media.

Fundamental analysis is best known as a tool for investors trying to get a very detailed assessment of what a company is worth. But you might be surprised to learn you don't have to be an investor to use fundamental analysis. If you buy a warranty from a company and want to know if the company will be able to honor it, that calls for fundamental analysis. You should know how solid a company is prior to entering any kind of long-term contract with it.

If you just want to know "how well" a company is doing before you take a job offer, you might also want to use fundamental analysis. Just think of the young people hired by small, underfunded firms in 2022 who had their offers rescinded. Journalists, too, can use fundamental analysis to find stories that will interest readers. Fundamental analysis also helps you figure out whether what you read about companies makes sense. Knowing how companies are truly performing is an important part of being informed about the economy. If you're at a cocktail party and the talk is about a popular company like Tesla, fundamental analysis will help you know what's really the score with the company. It's similar to how you might want to study the performance of teams before talking sports.

The aim of this book is to show you what fundamental analysis is and help you use it as a way to better understand business and investment.

About This Book

Fundamental Analysis For Dummies is one of the most approachable texts to tackle this somewhat complex topic. Rather than bog you down with the nitty-gritty details that academics pull their hair over, I've attempted to lay out all the main topics and techniques you'll need to apply fundamental analysis to a variety of business tasks.

While fundamental analysis is useful for anyone with genuine interest in learning more about business, I appreciate the fact you are likely hoping to make some money from fundamental analysis. For that reason, the book is largely targeted toward investors who are either hoping to use fundamental analysis to manage their portfolios or to enhance their current system of selecting stocks.

As the author, I can share the tricks, tips, and secrets I've learned from a career writing about online investing for readers just like you.

Fundamental Analysis For Dummies gives you all the tools you need to access fundamental data, process it, and make decisions. The book, however, stops short of showing you how to actually buy or sell stocks by choosing a broker and entering orders. If you're interested in the actual process of buying or selling stocks, that topic is covered exhaustively in my other book, *Investing Online For Dummies*, 10th Edition (Wiley).

Icons Used in This Book

When you're flipping through this book, you might notice several icons that catch your attention. That's done on purpose. I use several distinct icons to alert you to sections of the book that stand out. Those icons are as follows:

REMEMBER

These icons highlight info that you should etch on the top of your brain and never forget, even when you're getting caught up in the excitement of fundamental analysis.

TIP

Read these sections to quickly pick up insider secrets that can boost your success with fundamental analysis.

TECHNICAL STUFF

Some of the things covered in the book get a bit hairy and complicated. This icon flags such sections for two reasons. First, you may decide to avoid the headache and skip over them, because the info isn't vital to your understanding of fundamental analysis. Second, the icon is a heads-up that the paragraph is a little complicated. Don't be embarrassed if you need to read the section a second or third time. Hey, you didn't want this book to be too easy, did you?

WARNING

Avoid the land mines scattered throughout Wall Street that can decimate your good intentions at building wealth with these sections.

Beyond the Book

In addition to what you're reading right now, this product also comes with a free access-anywhere Cheat Sheet that clues you in to stuff like knowing the key Securities and Exchange Commission (SEC) filings, goes over financial ratios to know and love, and offers a financial analyst's mini-dictionary. To get this Cheat Sheet, simply go to `www.dummies.com` and type **Financial Analysis For Dummies Cheat Sheet** in the Search box.

Where to Go from Here

If you're a new investor or just curious about fundamental analysis, you might consider starting from the beginning. That way, you'll be ready for some of the more advanced topics I introduce later in the book. If you've already been using fundamental analysis or wondering if fundamental analysis might enhance a strategy you think is working for you, you might skip to Part 2. And if you're dying to know about a specific topic, there's nothing wrong with looking up those terms in the Index and flipping to the appropriate pages.

1 Getting Started with Fundamental Analysis

IN THIS PART . . .

Find out how understanding the way a company makes money can help *you* make money.

See how fundamental analysis compares with other ways of investing.

Check out how some successful investors put fundamental analysis to work.

Understand the accounting procedures companies use to record their fundamentals for all to see.

IN THIS CHAPTER

- Getting a solid overview of why fundamental analysis is worth your time
- Stepping through some of the main concepts that are critical to fundamental analysis
- Understanding the ways that fundamental analysis can fit into many investment strategies
- Grasping how to use this book to further your understanding of fundamental analysis

Chapter 1 Understanding Fundamental Analysis

Before you gulp down that neon-colored energy drink or pour yourself a bowl of super-sweetened cereal that looks like it was made by Willy Wonka himself, you probably do something first. It's usually not a bad idea to take a glance at the nutrition label that spells out what ingredients are in the box.

You might not know what guar gum, guarana, or other ingredients that often show up on the labels of such processed foods are, but you can get a pretty good idea of what's good for you and what's not. If a bottle of apple juice, for instance, has a list of ingredients longer than your arm and is filled with stuff you can't pronounce, you know you're not drinking squeezed apples. Being aware of what's in a food may or may not sway your decision to eat it, but at least you know what you're putting into your body.

Companies and stocks, too, come with similar labels. All companies that are *publicly traded*, or that allow investors to buy and sell their shares on public marketplaces, are required to disclose what they're all about. Just as food processors must list all the ingredients that go into their products, companies must tell investors what they're composed of.

Unfortunately, all the information investors need to know about a company doesn't fit inside a tiny rectangle — like it does on a food label. Instead, the key elements that make up a company are broken down at length in a series of *financial statements* and other sources of fundamental data.

Reading these critical financial statements and gleaning insights from them are the most basic goals of fundamental analysis. Fundamental analysis is the skill of reading through all the information companies provide about themselves to make intelligent decisions.

Why Bother with Fundamental Analysis?

You might wonder why you need to hassle with fundamental analysis. Why bother with technical things like net income or discounted cash flow analysis when you can just turn on the TV, write down a couple of stock symbols, buy the stocks and hope for the best?

You might also figure learning how companies operate is just needless information. After all, you don't need to know about fuel injection systems, suspensions, and car battery technology to drive a car. And you don't need to know what's going on behind the curtain to enjoy a play. Some investors figure they can just pick a couple of hot stocks, buy them, and drive off to riches.

REMEMBER

If the bear market that began in 2022 taught investors anything, it's that blindly buying stocks just because you might "like" a company or its products was hardly a sound way to tune up a portfolio. Chasing hunches, online posts, personal opinion, stories, and "memes" about stocks is often not a great way to invest, as you'll find out in Chapter 20. Many of these "meme investors" who followed their guts lost half, or much more, of their money invested in these stocks. This isn't the first time hype punished investors for not paying attention. The financial crisis of 2008 and 2009 pounded many investors, who assumed financial stocks and real estate would never fall.

Some of the real values of fundamental analysis

Ever notice how there's always a new wonder diet promising to make you healthier? More times than not, though, it seems these things never work. Getting healthy comes back to the basics — a balanced diet and exercise.

The same goes with investing. Believe it or not, investing can be full of fads. There's always a new investment pundit or economist with a novel way to pick winning stocks. And just as an hour on the treadmill will do you more good than a miracle diet, successfully choosing stocks often comes back to fundamental analysis.

Fundamental analysis is the classic way to examine companies and investments for a variety of reasons, including the fact it is:

- **Based on fact, not opinion:** It's easy to get caught up in general enthusiasm about what a company is doing or the products it's selling. Fundamental analysis blinds you to this investment hype and gets you focused on cold-hard business realities. It doesn't matter if all the kids in your neighborhood are buying a company's products if the company isn't making any money at selling them.
- **Good at pinpointing shifts in the business's health:** If a company's success is starting to fade, you'll see it show up in the fundamentals. No, there won't be a giant sign saying "Sell this stock." But there are clues if you know how to look, as you'll discover in Chapter 18. Companies are required to disclose key aspects of their business, so if there's a problem, a fundamental analyst will often be early at spotting some trouble.
- **All about execution:** Companies' CEOs are usually good at getting investors focused on the future and how things are going to get better next quarter. But fundamentals are based in reality. Just think of children who say how hard they're working at school. The report card is still the tangible evidence of how things are actually going. The numbers don't lie — if you know where to look.
- **A way to put price tags on companies:** What's a painting worth? What's a used car worth? The price of an asset with a subjective value is generally what someone else is willing to pay for it. The stock market, an auction of buyers and sellers, does a good job putting price tags on companies. But fundamental analysis gives you another way to see just how much investors, by buying or selling stock, are paying for a stock.

Driving home an example

One of the best examples of how fundamental analysis can help you and your portfolio is General Motors. It's one for the history books of capitalism. For decades, GM represented the might of U.S. industriousness, know-how, and creativity. GM commanded a massive market value of $3.5 billion in 1928, says Standard & Poor's. I'll step you through what market value means in more detail in Chapter 3, but for now, just know that GM was the most valuable company by far in 1928.

For decades, investors figured a dollar invested in GM was money in the bank. The company slugged through upturns and downturns and was a lasting power that helped drive the U.S. economy. The company kept paying fat dividends and kept powering profits higher. There was even an expression: "As GM goes, so goes the nation."

But investors who blindly bet GM would remain a lasting force and ignored the fundamental signs of trouble suffered a brutal blow on June 1, 2009. On that day, which will forever remain one of the lowlights of capitalism, GM became the fourth-largest public company to seek bankruptcy protection, according to BankruptcyData.com. Shares of GM stock collapsed to just 75 cents a share, down 97 percent from their level just three years before.

Fundamental analysis may not have helped you predict just how shocking GM's fate would be. But concrete elements from the company's financial statements could have tipped you off to how challenged GM was well before it became a penny stock and was liquidated. GM was ultimately reborn when a new company was created and bought many of the old company's assets, including the GM name. You can be sure that investors in the new GM paid much closer attention to the fundamentals.

GM VERSUS FORD

Even months before GM filed for bankruptcy protection, fundamental analysis could have served you well.

Back in January 2009, seeing both GM and Ford facing intense financial strain, many investors wondered if either one was worth taking a bet on. Some helpful fundamental analysis tools, including an analysis of the statement of cash flows, could have determined whether you lost a fortune or enjoyed a big gain.

I'll show you how to read the statement of cash flow in detail in Chapter 7. But for now, I'm just giving you a real example of why fundamental analysis matters to whet your appetite. At the beginning of 2009, both Ford and GM were constantly in the news. Both faced a tough business climate and both had depressed stock prices: Ford began 2009 at $2.46 a share and GM $3.65. The market clearly saw big-time troubles at both firms.

But a quick fundamental analysis showed Ford was the much better bet. Ford ended the quarter with $27.5 billion in cash and burnt $600 million in cash. Don't let the numbers scare you at this point. I'm just exposing you to a basic free cash flow analysis, as you'll learn about later. Just for now, know that at the quarterly rate, Ford had enough cash to last nearly 46 quarters.

Over at GM, however, the company ended the quarter with just $15.9 billion in cash. Meanwhile, it burnt through $8.9 billion during the quarter. A fundamental analyst knew right away the company wasn't going to make it through the year at that rate. That's critical information to have known.

Knowing how to do this one type of fundamental analysis made a world of difference for investors. In the following six months, shares of Ford jumped 149 percent to $6.13. Ford also did not accept government funding assistance during the financial crisis. By the end of 2014, Ford's shares bounced back to about $15 a share. Meanwhile, shares of GM crashed roughly 80 percent to 75 cents, the company was renamed Motors Liquidation Company, its assets were sold off, and investors were decimated.

Makes you want to read the rest of the book, doesn't it?

Putting fundamental analysis to work

It's easy to get consumed with the fast-money trading aspects of stocks. TV reports about stocks on the move and companies that have new products practically turn investing into a sporting event. If you listen to some traders talk, they rattle off companies' ticker symbols in rapid-fire delivery just as sports fans talk about teams. Flashing arrows and rapid trading can become an addiction.

Fundamental analysis is trying to help you avoid this insanity. Stocks rise and fall each minute, day, and week based on a random flow of news. That's mostly noise to a fundamental analyst. The constant ups and downs of stocks can sometimes confound logic and reason. Trying to profit from these short-term swings is a game for gamblers and speculators. It's futile on a long-term basis.

But that's not to say investing is gambling. When you buy a stock, you're buying a piece of ownership in companies that make and sell products and services.

You’re buying a claim to the companies’ future profits. Owning a piece of a real business over time isn’t gambling, it’s capitalism.

REMEMBER

Fundamental analysis forces you to focus on investing in businesses, not stocks. You’re not buying a lottery ticket, but a piece of ownership in an actual company. Sometimes this gets lost by investors who pay more attention to stock charts than to financial statements.

If jumping in and out of stocks at the right time isn’t the way to riches, then what is the trick to successful investing? The answer is to stop thinking of stocks as just symbols that gyrate each day. The goal of fundamental analysis is to help you step away from the short-term trading and gambling of stocks. Instead, you approach investing as if you’re buying a business, not rolling the dice.

Fundamental analysis ideally helps you identify businesses that sell goods and services for more than what they paid to produce them. Fundamental analysis is your tool to evaluate how good a company is at turning raw materials into profits. If there’s an investor who best personifies fundamental analysis over speculation, it’s famed investor Warren Buffett of Berkshire Hathaway. Buffett is one of the best-known users of fundamental analysis — in fact, he’s so confident in his analysis of a business he’ll often buy very large stakes and hold on to it for decades. You will read more about how Buffett applies fundamental analysis to investing in Chapter 3.

TIP

No matter how you choose investments currently, you can likely apply fundamental analysis. Even if you’re the kind of investor who likes to buy diversified mutual funds and hold onto them forever, called a *passive investor*, it can be helpful to understand basic financial characteristics of the companies.

Knowing what fundamentals to look for

Knowing what makes a company tick isn’t as convoluted as it may sound. Companies are so regulated and scrutinized, all the things you need to pay attention to are usually listed and published for all to see. Generally, when you hear about a company’s fundamentals, the key elements to be concerned will fall into several categories including:

- **Financial performance:** Here you’re looking at how much a company collects from customers who buy its products or services, and how much it keeps in profit. Terms you probably hear quite a bit about, such as *earnings* and *revenue*, are examples of ways fundamental analysts evaluate a company’s financial performance.

- **Financial resources:** Companies don't succeed long term simply selling goods and services. It's not even enough to turn a profit. Companies must also have the financial firepower to invest in themselves and keep their businesses going and growing. Aspects of a business, such as its assets and liabilities, are ways to measure a company's resources.
- **Management team:** When you invest in a company, you're entrusting your money to the CEO and other managers to put your cash to work. Fundamental analysis helps you separate the good managers from the bad.
- **Valuation:** It's not enough to identify which companies are the best. What's a "good" company anyway? Definitions of "good" can run the gamut. You also need to consider how much you're paying to own a piece of a company. If you overpay for the best company on the planet, it's still likely you'll end up losing money on the investment. You'll read more about valuation in Chapter 10 and Chapter 11.
- **Macro trends:** No company operates in a vacuum. A company's performance is highly influenced by actions of competitors or the condition of the economy. These broad factors need to be incorporated into fundamental analysis, as you'll discover in Chapter 15 and Chapter 16.

Knowing what you need

One of the great things about running as a hobby is all you need is a pair of decent shoes. And basketball? Just grab a ball and find a hoop. No fancy equipment is required. The same goes with fundamental analysis. Much of the data you need is provided free by companies and can be accessed in seconds from any device connected to the Internet.

Fundamental analysis can get pretty involved. But in its most basic form, fundamental analysis has just a few basic ideas behind it, including:

- **Awareness of the benefits:** Because fundamental analysis takes some know-how and time spent learning a bit, you'll want to know ahead of time why you're going to the trouble. Chapter 2 and Chapter 3 highlight the payoff of fundamental analysis. Even if you're a passive investor, or one who simply buys a basket of stocks and holds on, there are reasons why fundamental analysis might be worth your while.
- **Retrieval of financial data:** Getting all the key data you need to apply fundamental analysis is easy, if you know where to look. Chapter 4 gives you quick tips on how to round up all the company financial data you'll need.

- **Basic math:** There it is: The M word. There's no way around the fact there will be some number crunching involved in some aspects of fundamental analysis. Don't worry, I'll guide you to help keep the math as painless as possible.

Knowing the Tools of the Fundamental Analysis Trade

You can read all sorts of books on home repair and even take a trip to your hardware store and buy lots of screws, nails, and glue. But none of that effort will benefit you unless you have a tool belt and the knowledge of how to get started and put your plan into reality.

The same importance of execution is part of fundamental analysis. You may appreciate the importance of fundamental analysis and may even be able to download fundamental data from websites or from a company's annual report. But you need to have the tools to analyze the fundamentals to get any real value from them.

Staying focused on the bottom line

If there's one thing investors may agree is of upmost importance, it's the company's profitability. When it comes down to it, when you invest in a stock you're buying a piece of the company's earnings. Knowing how to read and understand how much profit a company is making is very important when it comes to knowing whether or not to invest.

The income statement, described in full detail in Chapter 5, will be your guide when you're trying to determine how profitable a company is. What might also surprise you is that the income statement can tell you a great deal about a company, in addition to just how much income it brings in.

Sizing up what a company has to its name

During times of intense financial stress, investors often make a very important mental shift. They're not so concerned about making money as they are about just getting their money back. Similarly, when things get tough in the economy, investors are less interested in how profitable a company is and are more mindful of whether a company will survive the economic downturn.