LEARNING MADE EASY

2nd Edition

Fundamental Analysis

for dummies®
A Wiley Brand

Gauge a company's performance

Minimize risk and improve your overall investment skills

Assess the future value of a business

Matt Krantz

Financial journalist for USA Today

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Fundamental Analysis For Dummies®, 2nd Edition

Published by: **John Wiley & Sons, Inc.,** 111 River Street, Hoboken, NJ 07030-5774, www.wiley.com

Library of Congress Control Number: 2016934821

ISBN 978-1-119-26359-3 (pbk); ISBN 978-1-119-26360-9 (ePub); ISBN 978-1-119-26361-6 (ePDF)

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1

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, 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 whip around, *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.

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. If you just want to know "how well" a company is doing, you might also want to use fundamental analysis. 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.

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. In the course of writing for *USA Today*, including a daily online column about investing called "Ask Matt" at `www.usatoday.com`, I've answered thousands of reader questions that may include the same ones you have.

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*, 9th Edition (Wiley, 2016).

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 probably loaded with investment jargon. 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 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 search for "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

What Fundamental Analysis Is and Why You Should Use It

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 probably 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 take investment money from the public, 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. Just as you'd want to know what's in that Frankenfood you're about to bite into, you want to know what's in an investment you're thinking about adding to your portfolio.

Why Bother with Fundamental Analysis?

You might wonder why you need to hassle with fundamental analysis. After all, at every family picnic there's undoubtedly the loudmouthed relative who's filled with all sorts of can't-go-wrong stock tips. 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 vicious bear market that began in 2007 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 and personal opinion about stocks is often not a great way to invest, as you'll find out in Chapter 20. The financial crisis is now becoming a distant memory for many investors who might again think fundamental analysis doesn't matter. Investors have taken to chasing stories and hype again in the bull market that kicked off in 2011 — and most or certainly many of those "can't-go-wrong" investments will meet a poor fate as the fundamentals catch up to reality.

Some of the real values of fundamental analysis

Ever notice how there's always a new wonder diet promising to make you skinny, and a new pill 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 somewhat 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 bottle full of miracle pills, 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 — right now. 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 recent examples of how fundamental analysis can help you and your portfolio is General Motors. 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% 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 just 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.

Putting fundamental analysis to work

It's easy to get consumed with the fast-money trading aspects of stocks. Exciting 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 for people who get into it.

Fundamental analysis is trying to help you avoid these headaches and 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. Many readers of my Ask Matt column at USATODAY.com are baffled when a stock falls even after the company reports what appears to be good news. 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. Remember that those stock symbols you see flashing red and green aren't dice, horses, or cards. They're more than just the two, three, or four letters of their ticker symbol.

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% to $6.13. Ford also did not accept government funding assistance. By the end of 2014, Ford's shares bounced back to about $15 a share. Meanwhile, shares of GM crashed 79% 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?

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 a 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.