

TradeMentor

Chapter 2.2

Company Fundamentals

COMPANY FUNDAMENTALS

Company fundamentals—such as how much money is the company earning and how efficiently is the company utilizing its resources—drive the stock and CFD markets. Stock and CFD traders want to buy companies that they believe are going to continue growing, and they want to sell companies that they believe are going to stop growing. Stock and CFD traders also want to buy companies that appear to be undervalued. Learning a few basic fundamental concepts and what information professional traders are looking at will help you know which way the market is most likely to move in the future.

Company fundamentals are like the ocean tide raising and lowering stocks and CFDs like ships. As the fundamentals for a company get stronger, it is like the tide coming in and raising the value of that company's stock price. As the fundamentals for a company get weaker, it is like the tide going out and lowering the value of that company's stock price.

Traders tend to focus their attention on a few different fundamental numbers when they are evaluating a company. All of this fundamental information, and more, is available to you as a stock and CFD trader. While professionals may get some of the information first, you have access to much of the same information the professionals use to make their buying

and selling decisions. By taking the time to learn about a company's fundamentals, you can better determine which direction a company's stock price should move in the future, which allows you to take advantage of those movements in your trading.

In this section, we will highlight the following categories of fundamental information.

Contents	Earnings
	Operating efficiency
	Cash flow

COMPANY EARNINGS

Stock and CFD traders tend to begin their fundamental evaluations of companies by looking at how much money the company is making for each of its owners. After all, when you buy a share of stock, you become an owner of the company so naturally you would be concerned with how much money the company is making for you.

The fundamental piece of information that tells stock and CFD traders how much money the company earned for each owner is called earnings-per-share, or EPS. To arrive at this number, traders look at the overall earnings for the company and divide that number by the number of stock shares the company has issued. If a company earns \$1 billion and has 1 billion shares outstanding, the company will have an EPS of \$1.

Once stock and CFD traders identify a company's EPS, they then look at how much a stock costs compared to the earnings that are associated with each share of stock. The fundamental ratio that tells traders this information is the price-to-earnings ratio, or P/E ratio.

The P/E ratio gives stock and CFD traders an idea of whether a stock is relatively expensive or inexpensive, which is crucial because traders looking to buy stocks and CFDs are looking for inexpensive stocks. For

example, if a stock has an earnings-per-share, or EPS, of \$1, and the stock is trading for \$20, it has a P/E ratio of 20. By looking back to see what P/E ratios the stock has had previously, traders can see if the current P/E ratio of 20 is comparatively high or low.

Traders are also interested to know if the company is going to increase earnings in the future. Good earnings today are all well and good, but traders want to know if the company can continue growing in the future—past growth is no guarantee of future growth.

Luckily for retail investors, you do not have to do all of the work on your own to determine if a company has good growth prospects. Large financial institutions employ armies of analysts to research companies, the industries they belong to and how they will respond in current and future market conditions, and many of the findings from these analysts are available to the investing public on a delayed basis.

When you are looking for stocks and CFDs to buy, make sure the underlying companies are projected to grow. When you are looking for stocks and CFDs to sell, make sure the underlying companies are projected to experience slow growth or no growth.

OPERATING EFFICIENCY

Once stock and CFD traders have evaluated how much money a company is earning for its owners, they tend to move on to looking at how efficiently the company is utilizing its resources. Stocks in efficient companies tend to perform much better than stocks in inefficient companies because efficiency generally leads to greater profitability and more earnings flowing into stock and CFD owners' pockets. Of course, what is considered efficient in one industry (like transportation) may not be considered efficient in another industry (like healthcare) so it is important you become familiar with the industry norms for any company you are evaluating.

One of the resources traders are most interested in seeing used efficiently is shareholder equity. Shareholder equity is all of a company's cash, hard assets and retained earnings (those company earnings that the company keeps to invest instead of immediately distributing to shareholders). Traders are interested in shareholder equity because if a company can't efficiently use the assets that belong to the stock holders, the stock holders would rather see their assets put to work somewhere else.

To monitor how efficiently their assets are being utilized, stock holders make a comparison to shareholders equity that is similar to the comparison they make with the price of the stock compared to the earnings of the company in the P/E ratio. The comparison they make is called the price-to-book ratio.

Here's how it works, suppose you have two piggy banks both selling for \$100. However, both piggy banks are not the same. Inside the first piggy bank, you will find \$100, while inside the second piggy bank you will only find \$10. Which piggy bank would you rather buy for \$100? You would obviously want to buy the piggy bank with \$100 in it. Looking at a company's price-to-book ratio is a similar concept.

To find a company's price-to-book ratio, you first have to determine the book value of the company. The book value of the company is equal to the shareholders' equity divided by the number of stock shares the company has issued. If a company has \$5 billion in assets and has 1 billion shares outstanding, the company has a book value of \$5 per share. That is how much money is inside the piggy bank per share. Next, stock and CFD traders divide the current stock price by the book value to determine the price-to-book ratio. If the stock was trading at \$20, it would have a price-to-book ratio of 4.

Just like the P/E ratio can, the price-to-book ratio can give you an idea if the current stock price is expensive or not.

CASH FLOW

Cash is a company's life blood. Regardless of how well a company is performing otherwise, if it runs out of money, it will cease to function. A company must have cash to pay its employees, its vendors and its shareholders—whether it is paying the cash out as a dividend or keeping the cash in retained earnings to grow the company and increase the value of the stock.

Some traders look at a company's bottom line, its net income, and assume that number represents the amount of cash the company generated. After all, your net income is what is left after you subtract your expenses from your revenues, right? Well, not exactly.

Net income is the value the government uses to determine how much in taxes a company owes each year. However, governments want companies to grow and expand so they can boost the economy and provide jobs. With this end in mind, governments provide companies with incentives—such as depreciation and interest deductibility—to entice them to grow

and expand. These incentives are accounted for as companies calculate their net income figures.

Traders are interested more in how much cash a company can create than they are in a company's earnings after all of the adjustments are accounted for. Therefore, they like to look at a company's free cash flow. Free cash flow represents a company's true cash flow—how much cash a company has available to invest in new initiatives or to pay to investors via dividends. To find a company's free cash flow, you find the company's net income, add its depreciation and amortization expenses back into that number and then subtract the company's changes in working capital and capital expenditures from the balance.

	Net income
+	Amortization
+	Depreciation
-	Changes in working capital
-	Capital expenditures
=	Free cash flow

Traders also use a company's free-cash-flow data in a discounted-cash-flow analysis to determine if a company's stock is expensive or inexpensive compared to the cash the company is able to generate.



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