# Fundamental or Technical Analysis?

Before we invest any money in the stock market, whether we know it or not, most of us will assess the share in some way. Even if we have no prior knowledge of the stock market, we will intuitively look for some way to assess whether making an investment is a good idea. In broad terms, this is what analysing a share is about, assessing whether it is a good investment.

In the first sentence, I said "whether we know it or not", because some investors might be tempted to admit, if questioned, that they did not analyse a share before they bought it. This will be true in some cases, but mostly, when we dig further, we find their decision was based on a tip from a friend, an article they read somewhere, or advice from a broker or newsletter.

This is when they are acting on analysis, but without always knowing it. What is implied in each of these situations is that the friend who gave the tip, the writer who penned the article or the broker who gave the advice, have all done some research on the share, which our investor is relying on, second hand.

In assessing whether a share is a good investment, we should consider two things.

The first thing we should consider is whether the investment is safe and likely to give a good return over the time we intend to own it. This is the province of what is called "fundamental" analysis.

The second thing we should consider is whether it is a good time to make the investment. This is the province of what is called "technical" analysis.

**Fundamental analysis** is based on some quite simple ideas. The first is that if we determine what a company is worth as a whole, then the value of its shares should theoretically be that value divided by the number of shares that have been issued. This is a very intuitive concept, because most people will accept the idea that if a business is worth $10 million and I am one of 10 equal owners of the business, then my share in the business is worth $1 million. If I wanted to sell it, I should expect to get $1 million for my share. There are, of course two problems with this.

The first problem is that when we buy a share on the stock market, we are not buying the whole business; we are only buying a small part of it. Our small part may be worth less than it should be worth theoretically. There are a variety of reasons why this might be so. For example, If there is a big shareholder, who controls the business, our small share might be worth less per share than the per share value of the controlling interest. Another example is that if the business is seen as an excellent investment, there may be many people wanting to buy shares in it, but few existing shareholders who are willing to sell. To get existing shareholders to sell, some buyers may be prepared to bid the price of the shares above their theoretical value.

The second problem is that value is a very slippery concept. Like beauty, to some extent it is in the mind of the beholder. Just think about buying a house. We go to the auction and find that different potential buyers are placing a range of values on the house. In the same way, when shares are essentially auctioned each day on the share market, there will be a wide range of prices bid for them, depending on how the buyers and sellers see their value. A business is a far more difficult thing to value than a house, so there will always be a wide range of opinions about its value. The way people see the value of a share will also be coloured by factors other than the strict calculation of the worth of the share, that reflects the relative urgency with which each buyer or seller needs to trade.

What these two problems mean is that there will often be a difference between the price at which shares are selling in the stock market and the "true" worth of the shares. This "true" worth is known in the industry as the "intrinsic" value of the shares. Although the textbooks might like to tell us that the intrinsic value of a share can be determined precisely, such that any reasonable person who has all the facts would agree with it, this is not so. Judgements have to be made about all sorts of things that are in the future and essentially unknowable with any certainty. We only have to look at the difference between the values calculated by so-called "independent" experts in a takeover to see this in action.

What this means is that at any time, the price of a share on the stock market may be in line with what a certain analyst thinks is its intrinsic value. However, more commonly, the price will be above or below the intrinsic value. This leads us into the economist's basic pricing mechanism based on supply and demand:

If the price on the market is above the intrinsic value, then the share is expensive and buyers will be less keen to buy that share than some other share. However, sellers will be keen to sell that share and switch into another share that offers better value. So, at an expensive price, the supply will tend to be greater than the demand and the price should fall over time towards the intrinsic value.

If the price on the market is below the intrinsic value, then the share is cheap and buyers will be attracted to buy that share rather than others. However, sellers will not be so keen to offer their holdings to the market because they represent good value. So, at a cheap price, the demand will tend to be greater than the supply and the price should rise over time towards the intrinsic value.

It is more complex than this, because the intrinsic value is not a fixed thing. It will change all the time as the situation changes. If the share is expensive today, then over the next year the price may fall, but the intrinsic value may also rise, so that they move into alignment somewhere in between where they are now. However, in its most basic form, this is how fundamental analysis works. A share is a good buy if its price is lower than the market price. If we buy it and hold it, then over time its price should rise.

There is one other aspect to fundamental analysis. This concerns the safety of the investment. Some businesses are safer than others. There are many reasons why this is so, depending on things like the type of business it is in and how prudently it is financed. As well as putting an intrinsic value on a share, fundamental analysis can assess the relative safety of the investment.

**Technical analysis** approaches the question from a different perspective. The one thing that fundamental analysis does not do very well is to identify when to buy. It will tell us that a share is cheap. However, experience has shown that a share may stay cheap for a long time. If we buy just because a share is cheap, we may find that we have to hold it for a long time before the market moves the price up towards the intrinsic value. While we are waiting for the price to go up, we may be missing other opportunities. This is what economists call "opportunity cost".

Clearly, if we can buy into a share whose price is moving up now, or likely to move up soon, then we will be better off than if we just buy and wait. This is what technical analysis contributes to the assessment process. Fundamental analysis will give us a list of cheap shares. Technical analysis can help us to identify the ones to buy right now.

Technical analysis does this by studying the behaviour of buyers and sellers, as reflected in the movement of prices on the stock market. When buyers are keen, they will bid higher prices to obtain shares. When sellers are keen they will offer their shares for sale at lower prices to get rid of them. Technical analysis studies the keenness of buyers and sellers, or the balance of supply and demand in the economist's terms. We use charts and other statistical techniques to identify changes in the balance of supply and demand. It is possible to spot situations when the probability is that prices will rise and do our buying at that time.

Fundamental and Technical analysis are best used together rather than restricting ourselves to only one type of analysis. Fundamental analysis is used to determine which company is safe to invest in and whether its shares represent good value at current prices. Technical analysis is used to pick a good time to buy those shares.

In industry jargon, technical analysis can "add value" to fundamental analysis. Even if our primary method is fundamental analysis, using technical analysis can give us additional insights into the assessment of a company and its shares.

It works the other way too, in the sense that even if we are active investors using technical analysis, we can add value by using fundamental analysis. One of the most common mistakes I see is people buying shares in a company without even knowing what its business is. It was as though they saw each stock code as being of equal value. However, nothing is clearer than that investing in BHP is a different proposition in terms of safety than XYZ Internet start-up that has never even made any sales, let alone a profit.

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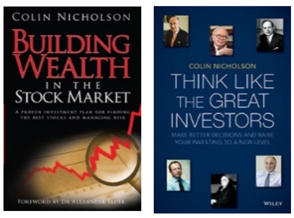


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