Selecting Undervalued Stocks – February 28, 2022

Financial analysis is a key to out-performing in investment management. We explain the best ways for individual investors to do investment research.

The ultimate goal of investors should be twofold: to acquire undervalued assets and to dispose of those assets as soon as they become overvalued. A key benefit of purchasing undervalued assets is that there are two different groups that can influence the trading price of your assets.

The first group comprises industry players that wish to grow through acquisition. This is especially so in situations where markets are not performing well. In such circumstances, companies often buy other companies if they are undervalued. That is, if the cost of purchasing the target company is cheaper than building up the parent company in order to expand its operations or enter a new industry, a company will purchase another. A premium is generally paid for the target company, resulting in an increase in its share price.

The second group that can influence the price of assets is the market itself, which includes investment funds, pension funds, other portfolio managers, as well as individual investors. These entities buy and sell stocks based on a number of criteria unrelated to those of the industry players.

As such, an investor can look to two avenues for his or her assets to increase in value, rather than relying solely on the market.

The purchasing of undervalued assets requires one to look at stocks not simply as tradable commodities, but as the foundations on which companies are built. Whether you buy 1,000 shares or one million shares you are buying part of a company. This is an important concept.

The most efficient way for individual investors to know when to sell and when to buy is through thorough financial analysis.

This type of analysis is not the same as technical analysis, which studies the demand and supply of securities and commodities based on trading volumes and price studies. Technical analysts use charts or computer programs to identify and project price trends in the market. It has never been clear, however, whether this type of analysis is useful for investors. It may be of use to traders, but not to investors.

It is important for individual investors to know how to go about conducting their own financial research if they so desire, as well as how professional analysis is carried out and why it is important.

Is financial analysis simply a matter of looking at a company's financial statements? Certainly not. Financial analysis provides information about a company's past and present performance. It also quantifies future expectations. Financial analysis is sub-divided into the following three groups

- Economic analysis is the basis used to determine capital market and industry performance estimates. Furthermore, it provides projections for the total economy in terms of GDP, inflation, profit, monetary and fiscal policy and productivity.
- Capital market analysis provides value and return estimates for the securities markets.

- Security analysis studies industries and the securities of individual companies to develop value and return expectations for those individual securities

The information required for your analysis is available if you know where to look for it. The first place to start is at the original source, such as information prepared and sent by the company itself to its shareholders and to the financial press.

You can simply write to the companies to request quarterly and annual reports. Many companies have web sites that allow you to e-mail your requests. In fact, it is much easier and cheaper to source as much information as you can from the Internet.

Another important original source of information is that which is filed by the company with a regulatory body. For companies that trade in the US, quarterly reports and annual reports comprising complete audited balance sheets, cash flows and income statements can be obtained from the Securities and Exchange Commission web site. For local Hong Kong companies, an investor can request the latest annual report directly from the company.

Subscription services such as Moody's and Standard & Poor's are also available which summarize almost all original company information such as balance sheets, cash flows and income statements. These services provide much more than just sovereign ratings and corporate debt ratings.

Finally, there are many online data providers. Useful features include a comparison of a company's valuation ratios, dividends, historic growth rates, financial strength ratios, profitability ratios, and management effectiveness ratios with the industry ratios and the S&P 500.

Furthermore, companies often provide information to industry and trade organisations, and to supplier and customer groups. This information is then circulated amongst their respective members.

Brokerage reports can also be useful for industry overview and the financial models they often contain.

Given the losses seen in equity markets in the past months, investors may be skeptical of the value of sell-side financial analysis. Sentiments swing to undue market pessimism in periods of crisis and recession, and back to undue market optimism during periods of prolonged prosperity.

However, purchasing undervalued assets will always provide superior investment returns. The most foolish decisions are most often made in purchasing assets rather than in selling them. As such, taking the time to determine which stocks are undervalued will probably make the decision to sell, when the time comes, much easier and more comfortable.

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