Fundamental Stock Analysis

Successful investors use fundamental stock analysis in order to determine the [intrinsic value of a stock]. What is intrinsic value? The dictionary definition of intrinsic stock value is its fundamental value. It is obtained by adding up predicted future income of a stock and subtracting current price. It can also be seen as actual value of an equity versus its book value or market value. Using fundamental stock analysis the intrinsic value of a stock is the expected company cash flow discounted to current dollars. Fundamental stock analysis requires the ability to see into the future to see how well a company will manage its assets, products, costs, R&D, and marketing. The point is to decide whether or not to buy, hold or sell a stock.

The Intrinsic Value Formula

Benjamin Graham published a formula for calculating intrinsic stock value in 1962 and modified it in 1974. The 1974 version considers the following:

- Earnings per share, EPS, for the preceding twelve months
- A constant of 8.5 representing an expected price to earnings ratio, P/E ratio, for a company that is not growing
- An estimate of long term growth, five years = g
- A constant of 4.4 which was the average yield of high grade corporate bonds in the early 1960 decade
- The current yield of AAA corporate bonds = Y
- Where V = intrinsic value

The formula is as follows:

$V = (EPS \times (8.5 + 2g) \times 4.4)/Y$

The way the investors were encouraged to use intrinsic value was to derive what is referred to as a Relative Graham Value, RGV. The RGV is the calculated intrinsic value of the stock divided by its current price. If the result, the RGV, is less than one the stock is overvalued and a bad investment and if the ratio is above one it is undervalued and may be a good investment. The point of fundamental stock analysis is clearly to take advantage of good investments and avoid bad ones.

Fundamental Stock Analysis over the Long Term

Fundamental stock analysis helps long term investors see value in underpriced stocks. In our article value investing for 2015 we looked at depressed oil stocks.

> *The price of oil is all about the US fracking boom and OPEC trying to protect its market share. In the Middle East it costs about $17 to produce a barrel of oil. This includes finding the oil and then bringing it to the surface. In the USA this figure is $31 on land and $52 offshore. Thus the Saudis and others better afford a drop in the price of oil than US companies engaged in high tech extraction of oil trapped in shale deposits. Value investing in 2015 will have a lot to do with how long OPEC continues to produce oil at the current rate and how badly they want to protect market share at all costs. So long as high production continues as both Japan and Europe slide into recession prices will remain low.*

The flip side of this argument is that the fracking boom is likely to last a decade or two and not much longer. China, Japan and the EU will recover. The price of oil will go back up. Fundamental stock analysis tells us that oil companies that survive the current market will have excellent intrinsic value over the long run.

A Solid Approach to Investing

We wrote recently that one should not be afraid to invest in stocks. We assume that a smart investor will use fundamental stock analysis to pick winners and avoid losers. A solid approach to stock investing is to analyze stocks, wait for opportunities and let the exponential effects on accumulated gains make you rich.

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