UNIT IV

Fundamental and Technical Analysis - Economic Analysis, Industry Analysis, Company Analysis, and Efficient Market Theory:

**Security analysis** is the analysis of tradeable financial instruments called securities. It deals with finding the proper value of individual securities. Security analysis refers to the method of analysing the value of securities like shares and other instruments to assess the total value of business which will be useful for investors to make decisions. There are three methods to analyse the value of securities: fundamental, technical, and quantitative analysis. Security analysts must act with integrity, competence, and diligence while conducting the investment profession.

The securities can broadly be classified into equity instruments (stocks), debt instruments (bonds), derivatives (options), or some hybrid (convertible bond).

Considering the nature of securities, security analysis can broadly be performed using the following three methods:-

1. **Fundamental Analysis**
   This type of security analysis is an evaluation procedure of securities where the major goal is to calculate the intrinsic value of a stock. It studies the fundamental factors that effects stocks intrinsic value like profitability statement & position statements of a company, managerial performance and future outlook, present industrial conditions, and the overall economy.

**Components of Fundamental Analysis**
   Fundamental analysis consists of three main parts:
   1. Economic analysis
   2. Industry analysis
   3. Company analysis
Fundamental analysis is an extremely comprehensive approach that requires a deep knowledge of accounting, finance, and economics. For instance, fundamental analysis requires the ability to read financial statements, an understanding of macroeconomic factors, and knowledge of valuation techniques. It primarily relies on public data, such as a company’s historical earnings and profit margins, to project future growth.

Objectives of Fundamental Analysis:
The objectives of Fundamental Analysis of Stock Market are –
- To predict the future price of the share of the company
- To do the valuation of the asset of the company
- In order to project the performance of the business
- To measure the credit risk
- To evaluate the management’s decisions
- In order to find the intrinsic value of the asset

2. Technical Analysis
This type of security analysis is a price forecasting technique that considers only historical prices, trading volumes, and industry trends to predict the future performance of the security. It studies stock charts by applying various indicators (like MACD, Bollinger Bands, etc.), assuming every fundamental input has been factored into the price.

3. Quantitative Analysis
This type of security analysis is a supporting methodology for both fundamental and technical analysis, which evaluates the historical performance of the stock through calculations of basic financial ratios, e.g., Earnings Per Share (EPS), Return on Investments (ROI), or complex valuations like discounted cash flows (DCF).
**Need for security analysis:**
The basic target of every individual is to increase their Net Worth by investing the earnings into various financial instruments, i.e., the creation of money using the money. Security analysis helps people achieve their ultimate goal, as discussed below:

1. **Returns:** The primary objective of the investment is to earn returns in the form of capital appreciation as well as yield.

2. **Capital Gain:** Capital Gain or appreciation is the difference between the sale price and purchase price.

3. **Yield:** It is the return received in the form of interest or dividend. 

   \[ \text{Return} = \text{Capital Gain} + \text{Yield} \]

4. **Risk:** It is the probability of losing the principal capital invested. Security analysis avoids risks and ensures the safety of capital, also creates opportunities to outperform the market.

5. **Safety of Capital:** The capital invested with proper analysis; avoids chances to lose both interest and capital. Invest in less risky debt instruments like bonds.

6. **Inflation:** Inflation kills ones purchasing power. Inflation over time causes you to buy a smaller percentage of good for every dollar you own. Proper investments provide you hedge against inflation.

7. **Risk-Return relationship:** The higher the potential return of an investment, the higher will be the risk. But the higher risk doesn’t guarantee higher returns.

8. **Diversification:** It means do not invest your whole capital in a single asset or asset class but allocate your capital in a variety of financial instruments and create a pool of assets called a portfolio. The goal is to reduce the risk of volatility in a particular asset.
Efficient market theory:

Efficient market theory holds that markets operate efficiently because at any given time, all publicly known information is incorporated into the price of any given asset. This means that an investor can't get ahead of the market by trading on new information because every other trader is doing the same thing.

Market efficiency refers to the degree to which market prices reflect all available, relevant information. If markets are efficient, then all information is already incorporated into prices, and so there is no way to "beat" the market because there are no undervalued or overvalued securities available.

Market efficiency refers to how well current prices reflect all available, relevant information about the actual value of the underlying assets. A truly efficient market eliminates the possibility of beating the market, because any information available to any trader is already incorporated into the market price. As the quality and amount of information increases, the market becomes more efficient reducing opportunities for arbitrage and above market returns.

Efficient market theory hypothesis proposes that financial markets incorporate and reflect all known relevant information.

Efficient Market Assumptions

Efficient market hypothesis is based on several assumptions.

1. It assumes that all relevant information is reflected in the stock markets.
2. EMH assumes a financial security is always priced correctly.
3. It implies that stocks are never undervalued or overvalued.
4. It also implies that investors can never consistently outperform the market, by employing investment strategies.

**Degrees of Efficient Market Hypothesis**

According to EMH, there are three forms of market efficiency namely

- Weak-form efficiency
- Semi-strong-form efficiency
- Strong-form efficiency

The different forms represent different degrees of adherence to efficient market hypothesis.

1. **Weak Form Market Efficiency:**

According to weak-form market efficiency, the market reflect all historic price data in a stock’s current market price. This implies you cannot use technical analysis to outperform the overall market. However, the investors can discover and exploit through fundamental analysis.

2. **Semi Strong Efficient Market Hypothesis:**

According to semi-strong-form market efficiency, the market reflect all public data (including all historical data and all current financial statement data) in a stock’s current market price. Furthermore, this implies that neither technical analysis nor fundamental analysis can be utilized to outperform the overall market. So investors with access to private information may be able to earn excessive returns.

3. **Strong Form Market Efficiency:**

According to strong-form market efficiency, reflect all data – historic and current, public and private – in a stock's current market price. Furthermore, this form of market efficiency implies that there is no way to achieve excessive returns in financial markets.