Answers to Concepts in Review

1. The three major parts of security analysis are economic analysis, industry analysis, and fundamental analysis. Security analysis is important because it enables the investor to establish the expected return and risk for a stock and to evaluate its desirability in a logical, rational manner.

2. Intrinsic value, the end product of security analysis, is the measure of the underlying worth of a stock and provides a standard for helping investors to judge whether a particular stock is undervalued, fairly priced, or overvalued. If the intrinsic value of a stock is more than the market price, then the stock might be a good buy under the assumption that the stock will rise up to its intrinsic value. The converse would be true if the intrinsic value is less than the stock price. The stock might be a good sell.

3. A satisfactory investment is one that offers an expected return, from the combination of current income and capital gains, that is commensurate with its perceived exposure to risk. The three steps in security analysis should enable investors to identify satisfactory investments. First, economic analysis assesses the general state of the economy and its potential effects on security returns. Industry analysis examines specific industries and the characteristics and outlook of those industries. Finally, fundamental analysis looks at the financial condition and operating results of a particular company in depth. Together, they enable the investor to develop expectations about a stock’s future course of behavior—what kind of return to expect and what kind of risk is likely to be involved. By examining variables such as future earnings, dividends, and so on, the security analysis process allows investors to develop a feel for the stock and what to expect of it in the future.

4. If the stock market is efficient in the strongest form, then securities are never substantially mispriced and hence there would be no need for security analysis. But in reality, the financial markets are not perfectly efficient and pricing errors are inevitable. With thorough security analysis, individuals can profit whenever pricing errors occur. Paradoxically, financial market efficiency is achieved only due to the existence of traders who invest time and money in fundamental analysis to root out pricing errors. Security analysis is also useful in assessing an asset’s liquidity, current income, and risk and in verifying that these match investor criteria.

5. Economic analysis involves studying the underlying nature of the economic environment in which a firm operates. Economic analysis also helps the investor form expectations about the future course of the economy. Such an analysis could be a detailed examination of the economy, sector by sector, or it may be done on a very informal basis. In any event, it deals with such aspects as production and unemployment statistics, inflation, fiscal and monetary policies, and their effects on security returns. This analysis is, indeed, essential to an investor’s decision-making framework. We live in an economy where firms are affected by general economic conditions; therefore, we cannot talk of security analysis without addressing economic analysis. There’s plenty of real-world evidence to demonstrate the high correlation between the performance of stocks and general economic activity—i.e., when the economy starts improving, so do stock returns, all of which indicate the importance of economic analysis to the stock selection process.

6. The behavior and current state of the economy is captured in the business cycle, which measures the change in total economic activity over time. When economic prospects are strong (the business cycle is on an upswing), security returns should do well. If economic prospects are poor (the business cycle is on a downswing), the returns from most stocks will deteriorate as well.
7. a. **Gross domestic product (GDP)**. This is the broadest measure of an economy’s performance. GDP is an estimate of the total value of all goods and services produced in a country over the period of a year.

b. **Leading indicators**. This is an index that combines the behavior of a dozen key measures, each of which tends to be an indication of things to come in the economy. The index of leading indicators is a single number that is supposed to “predict” the direction of the economy.

c. **Money supply**. This is a measure of the amount of money in circulation as reported by the Federal Reserve. Actually, there are three measures of the money supply: M1, M2 (which is the most widely followed and includes currency, demand deposits, NOW accounts, time deposits, money market deposit accounts, and money funds), and M3.

d. **Producer prices**. This is a measure of price behavior at the “wholesale” level. It shows the rate of change in prices at various stages of production and is supposed to be a harbinger of things to come at the consumer price level (i.e., future inflation rates).

8. The effects of high rates of inflation on common stocks can be devastating. In inflationary times, the quality of earnings declines as profit margins are squeezed and the purchasing power of the dollar deteriorates. An increase in inflation results in an increase in interest rates. Hence, firms’ borrowing costs increase, resulting in less investment. Also, as interest rates rise, the return on common stocks becomes less attractive relative to other securities, like bonds and preferred stocks. However, when inflation subsides, common stocks become major beneficiaries, showing substantial price appreciation.

9. **Industry analysis** is the part of the security analysis process involving the study of stocks in terms of their industry groupings. Industry analysis is important because stock prices are influenced, at least in part, by industry effects. Industry analysis can be used to establish the competitive position for a particular industry and to assess the nature of the opportunity the industry offers for the future. It also enables the investor to identify promising firms in an industry.

10. Some important aspects of **industry analysis** include:

    a. The nature of the industry: whether it is monopolistic or competitive.
    b. The extent of regulation: whether regulation is minimal or intense.
    c. The role of big labor: the status of contract talks and general labor regulations.
    d. Technological progress: are any technological breakthroughs likely?
    e. Financial and operating characteristics: considerations involving labor, material, and capital.

Economic forces important to the industry include the demand for the industry’s goods and services and the correlation with key economic variables. To the extent that an industry is influenced by economic forces, we would want to determine the economic variables that are of primary importance to an industry; it might be GDP, or the level of interest rates, or the unemployment rate. Also, the future outlook for these variables would be important since they are likely to set the tone for future industry performance.

11. The four stages of an industry’s growth cycle are:

    a. Initial development—product introduction.
    b. Rapid expansion—everyone wants one.
    c. Mature growth—almost everyone has one.
    d. Stability or decline—there are other things to want.
The rapid expansion phase offers the biggest payoff to investors. At this stage, the industry’s products have gained acceptance, investors can foresee the industry’s future more clearly, and economic variables have little to do with the industry’s overall performance. The mature growth stage is most influenced by the economic cycle.

12. *Fundamental analysis* is the study of the financial affairs of a business. It is essential to the valuation process to the extent that the value of a stock is influenced by the performance of the company that issues the stock. An equivalent statement is that the value of a security depends not only on return, but also on risk—both of which are affected to a large extent by the operating characteristics and financial condition of the firm. Fundamental analysis helps to capture insights to these dimensions from financial statements and other information about a company and incorporates them in the valuation process.

13. *Historical analysis* provides some insight, along with economic and industry figures, for formulating expectations about the future growth prospects and profitability of a company. In particular, historical analysis helps the investor to learn the strengths and weaknesses of a company, identify underlying trends and developments, and evaluate the company’s operating efficiency.

14. *Ratio analysis* is the study of relationships that exist among and between various financial statement accounts. Ratio analysis provides a different perspective on the operating results and financial condition of the firm by expanding the information content of the financial statements. By studying ratios rather than raw numbers, the analyst can better identify trends, whether they are improving or deteriorating, and compare the firm being analyzed to its competitors to determine if it is in a strong or weak position. The most significant contribution of ratio analysis is that it enables the investor to thoroughly assess the firm’s past and present financial condition and operating results.

15. When *historical standards* are used, the company’s ratios are compared and studied from one period to the next. *Industry standards* involve a comparison of a company’s ratios to that of other companies in the same line of business. In the first case, the investor is looking for developing trends; in the second case, the investor wants to see how the company stacks up to its competitors.