

What is Fundamental Analysis

Fundamentals are associated with the economic health of a company, measured in terms of revenues, earnings, assets, liabilities, Return on Equity (ROE), Return on Assets (ROA), Return on Investments (ROI), growth prospects and cash flows, etc. The fundamentals tell you about a company. You can say a company is having robust fundamentals if it is growing at a nice pace, generating a profit, has limited debts and abundant cash.

The analysis of a company's fundamentals involves getting deep into its financials, rather than day-to-day movement in its share price. Equity researchers normally do fundamental analysis in order to calculate the intrinsic value of a company's stock. If a company's stock is trading above the intrinsic value or fair value, then the stock is overvalued. If a company's stock is trading below the intrinsic value, then the stock is undervalued. However, if you watch the stock markets very closely, the share price of most companies never matches the fair value. Often, day traders and investors who would prefer short term investment options invest in those stocks, regardless of the companies' long term growth prospects. However, long term investors generally prefer to invest in companies with robust fundamentals and ignore near-term share price movements.

The following are various components that constitute a company's fundamentals:

Revenues: Revenues (sales) are the total amount of money received by a company through the sales of its goods and services during a specific period of time. Revenues are one of the most important barometers of the growth of a company as it indicates whether there is demand for their products and services.

Cash flows: Cash flows are calculated by deducting a company's cash payments from cash receipts over a particular period of time. Cash flows indicate the liquidity position of a company. However, one must pay particular attention to the operating cash flows, since the health of the business can be most clearly seen there.

Net income: Net income, which is also called the "bottom line", is calculated by subtracting from revenue, all of the company's costs, such as operating costs, interest expenses, depreciation, taxes and other expenses associated with running the business.

Balance Sheet: Balance sheet is the company's financial statement, which reflects its assets and liabilities. A company's fundamentals are said to be robust if its assets are significantly higher than the liabilities. However, one must carefully analyze companies who are reporting large intangible assets as they may have questionable liquidation value to offset any real liabilities.

Return on Assets (ROA): ROA is an Indicator of a company's profitability, which is calculated by dividing the net income for the past 12 months by total average assets of the company. This is one of the important indicators, which long-term investors consider before investing into a particular stock.

Although long-term investors and institutional investors consider a company's fundamentals before investing, the share price of a company often does not correspond to the fundamentals which can present enormous investment opportunities. A company's long-term growth is driven primarily by fundamentals, while a company's share price can be driven by short-term news and investor sentiment, which can be extremely volatile. Every investor must consider a company's fundamentals before investing into its stock if you want to gain stable returns over the long term.

About the Author

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