FUNDAMENTAL ANALYSIS

Objective

This part explains the well known theory called EMH (Efficient Market Hypothesis). It also explains certain biases why markets are not completely perfect and why mispricing does occur in share prices.

Fundamental Analysis

- A method of evaluating a security that entails attempting to measure its intrinsic value by examining related
  - economic
  - financial
  - other qualitative and quantitative factors
- End goal of performing fundamental analysis is to produce a value that an investor can compare with the security's current price
- Using real data to evaluate a security's value

Market Hypothesis

Efficient Capital market

- Market in which security prices adjust rapidly to the arrival of new information and therefore current prices of securities reflect all information about the security
- Information efficient market
  - Large number of profit maximizing participants analyze and value securities independently
  - New information about securities come in random fashion
  - Profit maximization investors, adjust security prices rapidly to reflect the effect of new information
  - Security prices should reflect all information provided at any point in the market
  - Expected returns implicit in current prices should reflect its implicit risk

Alternate Efficient Capital Market Hypothesis

- Weak-Form Efficient Market Hypothesis
  - Fully reflect all security market information
- Semi-Strong Efficient Market Hypothesis
  - Fully reflects all Public security market information
  - Rapidly adjusts
- Strong-Form Efficient Market Hypothesis
  - Fully reflects all Public and Private security market information

Biases

Biases explain why Efficient Market Hypothesis (EMH) doesn't work perfectly. Psychology of people impact the stock prices in the following ways

- **Prospect theory :** Winning investment cut short, losing trades held for long
- **Confirmation Bias:** Investor looks for information that supports their previous decision
- **Escalation Bias:** More money in loser than they expected to
- **Fusion Investing:** Fundamental value and investor sentiments, Averaging down

Reasons for Mispricing

- Market efficiency refers to informational efficiency of markets important to Investor, Companies and Government as it helps them in price recovery
- Market prices are not fully efficient because of the following reasons:
  - Cost of Information: All information is not available freely. To gain access to quick information, it increases the cost of trading
  - Cost of Trading: Commissions and brokerages
  - Limits of Arbitrage: unlimited quantity is not available and hence even though arbitrage opportunities exist, they may not be completely exploited

Reasons for Mispricing

- Though EMH says that prices are always efficient, why mispricing occurs is never fully understood. Most analysts attribute this to the psychological behavior of the traders and investors
- Arbitrage costly due to transaction cost
- Profit potential may be insufficient due to these costs
- Trading Restriction (IPOs) for some entities restrict complete price discovery

Credit Ratings

Credit Ratings

- **Credit rating** estimates the credit worthiness
- Evaluation made by credit bureaus of a borrower's overall credit history
- Credit ratings are calculated from financial history and current assets and liabilities. Typically, a credit rating tells a lender or investor the probability of the subject being able to pay back a loan
- In recent years, credit ratings have also been used to adjust insurance premiums, determine employment eligibility, and establish the amount of a utility or leasing deposit

Credit Ratings

- Major Credit rating Agency
  - Standard and Poor (S&P)
  - Fitch
  - Moody’s
- In India
  - CRISIL
  - ICRA
  - CARE Ratings
- Used by Central banks for using marketable securities