An Introduction to Stock Analysis

One of the clichés of Wall Street is that fundamental analysis tells you what to buy, while technical analysis tells you when. While some money managers disagree with that characterization, it points to a deeper difference between the two approaches: fundamental analysis focuses on the performance of the company behind the stock while technical analysis focuses on the behavior of the stock.

Put another way, when you’re analyzing fundamentally, you have to know which company you’re talking about. With technical analysis, you don’t; it might help, but you can do quite well without knowing about the underlying company, what it sells, or even its name. All you have to know is its symbol.

To understand these concepts, let’s review the theoretical assumptions of each school of analysis.

The Fundamental Perspective

Fundamental analysts assume investors will buy the shares of companies that have good potential to make profits and, better yet, grow those profits every year. Based on this assumption, it makes sense to look at every significant aspect of that company’s business, from what its products or services are to how they stack up to the competition, how much money the company spends and owes versus how much revenue it brings in, how good management is, whether the market is growing, and the like.

Fundamental analysts spend most of their time collecting and analyzing this data, comparing them to the same data on competitors, including the stock prices. These analysts also try to assess the

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future growth of each company’s markets and often factor in forecasts of the economy. They estimate the future earnings of each company and use those estimates to predict the price investors are likely to pay for that company’s stock in the future.

Most investors have heard some of the key analytical measures fundamental analysts use. One is a stock’s price-to-earnings ratio, or P/E ratio. To calculate it, analysts divide the current price per share of a stock by its per-share net earnings, or profit. Since it’s possible to calculate the P/E ratio of the entire stock market as well as each industry group, and analysts keep track of the history of those P/E ratios, analysts use P/E ratios to determine whether a stock is relatively expensive (overvalued) or cheap (undervalued).

Another key metric is a company’s estimated five-year earnings growth rate, which is the basis upon which analysts estimate the stock’s future price. The estimated five-year earnings growth rate rests on projections for the company’s competitive market position, its product pipeline, and its financial condition.

A third metric combines the P/E ratio and the earnings growth rate to determine whether the stock is fairly priced or not. It’s called the PEG ratio, for the price-earnings multiple divided by the projected earnings growth rate. To illustrate, let’s take a stock with a P/E ratio of 30 and a projected five-year growth rate of 20% per year. This stock has a PEG ratio of 1.5 (30 divided by 20). Analysts who use the PEG ratio generally avoid recommending stocks with a PEG significantly above 1.0 and generally like stocks with a PEG below that number.

The Technical Perspective

Technical analysis is based on a widely accepted premise: the price of a stock is based on supply and demand. If, at a given price, people want to buy more of a product than the maker can produce, the price will go up, whether it’s a box of cereal, a car, or a stock. Conversely, if there’s more product in the market than people willing to buy at its current price, all things being equal, the price will drop.

So, the theory goes, as long as you know the relative balance of supply and demand for a given stock at a given price, you don’t really need to know what the product is. Technical analysts say all the needed information about supply and demand can be found in the chart of a stock’s historic price movement, particularly if the chart captures the changing levels of volume with the changes in price.

Yet one difference between stocks and commercial goods is the way technical analysts define supply. Companies can increase the production of manufactured goods or delivery of services at will. Not so with stocks — unless a company issues more shares, the number in the market is fairly stable. The supply of shares of stock, from a technical analyst’s point of view, is the number of shares already owned by the public that are being brought to the market for sale by brokers.

To illustrate, technical analysts interpret an upward move in a stock price, combined with higher volume the previous day, as an indication that there is a larger number of buyers (demand) than sellers at the current price, and potential sellers are holding out for a higher price. Conversely, a downward move on higher volume means there are more sellers eager to sell shares than there are buyers willing to pay the current price.

Unlike fundamental analysts, technical analysts generally don’t make predictions of future stock prices. Instead, they try to identify prices that serve either as resistance against any higher movement or support against a further loss in price. The reason these price points exist is because most investors remember what they paid for a stock and base their decision to sell by comparing the current price with what they paid.

For example, it’s human nature to avoid a loss. So, if a stock that has risen in price comes back down to the price an investor paid, he/she may be reluctant to sell, but once it falls below that price, he may be eager to sell right away. By the same token, many investors — particularly professionals — know the price at which a stock peaked. As the stock approaches that price again, investors may begin to sell in order to lock in their profits. This shift toward more sellers than buyers may make that price another resistance point from which the stock declines again.

Technical analysts find many different ways to identify points of resistance and support. They can be found in peaks and valleys in the line that connects a stock’s closing price over time. They can also be found in prices against which the stock has repeatedly bounced from in either direction, or in lines that connect a series of price bottoms or tops, called trend lines.

What Works for You?

Traditionally, more professional investors and advisers have relied on fundamental stock analysis than technical, particularly when the investor is in the market for the long term. But a large and growing number have found both fundamental and technical analysis provide insights that are useful in determining which stocks to buy and when.

Please call if you’d like to discuss this in more detail.
Managing Bond Risks

All investments are subject to risk, although the types of risk can vary. While you can’t totally eliminate risks, you can minimize them. For bonds, consider these strategies:

**Interest rate risk** — Interest rates and bond prices move in opposite directions. A bond’s price will increase when interest rates fall and decrease when interest rates rise. This occurs because the existing bond’s price must change to provide the same return as an equivalent, newly issued bond paying prevailing interest rates. The longer the bond’s maturity, the greater the impact of interest rate changes. Also, the effects of interest rate changes tend to be less significant for bonds with higher-coupon interest rates.

To reduce this risk, consider holding the bond to maturity. This eliminates the impact of interest rate changes, since the total principal value will be paid at maturity. Thus, selecting a maturity date that coincides with your cash needs will help reduce interest rate risk. However, you may still receive an interest income stream lower than current rates. Selecting shorter maturities or using a bond ladder can also help with this risk.

**Reinvestment risk** — You typically know what interest income you will receive from a bond, but you must then take the periodic income and reinvest it, usually at varying interest rates. Your principal may also mature at a time when interest rates are low.

Staggering maturities over a period of time (laddering) can lessen reinvestment risk. Since the bonds in your ladder mature every year or so, you reinvest principal over a period of time instead of in one lump sum. You may also want to consider zero-coupon bonds, which sell at a deep discount from par value. The bond’s interest rate is locked in at purchase, but no interest is paid until maturity. Thus, you don’t have to deal with reinvestment risk for interest payments, since you don’t receive the interest until your principal matures.

**Inflation risk** — Since bonds typically pay a fixed amount of interest and principal, the purchasing power of those payments decreases due to inflation, which is a major risk for intermediate- and long-term bonds.

Investing in short-term bonds reduces inflation’s impact, since you are frequently reinvesting at prevailing interest rates. You can also consider inflation-indexed securities issued by the U.S. government, which pay a real rate of return above inflation.

**Default and credit risk** — Default risk is the possibility the issuer will not be able to pay the interest and/or principal. Credit risk is the risk the issuer’s credit rating will be downgraded, which would probably decrease the bond’s value.

To minimize this risk, consider purchasing U.S. government bonds or bonds with investment-grade ratings. Continue to monitor the credit ratings of any bonds purchased.

**Call risk** — Call provisions allow bond issuers to replace high-coupon bonds with lower-coupon bonds when interest rates decrease. Since call provisions are generally only exercised when interest rates decrease, you are forced to reinvest principal at lower interest rates.

U.S. government securities do not have call provisions, while most corporate and municipal bonds do. Review the call provisions before purchase to select those most favorable to you.

Keep in mind the assumption of risk is generally rewarded with higher return potential. One of the safest bond strategies is to only purchase three-month Treasury bills, but this typically results in the lowest return. To increase your return, decide which risks you are comfortable assuming and implement a corresponding bond strategy. Please call if you’d like help with your bond investing strategy.
Lessons Learned from the Stock Market

If you pay attention to the stock market, you can learn some valuable lessons:

✔ The market tends to revert to the mean. When the stock market has an extended period of above or below average returns, it has a tendency to revert back to the average return.

✔ Don’t chase performance. Investors often move out of sectors that are not performing well, moving money to investments that are currently high performers. But the market is cyclical, and often those high performers are poised to underperform, while the sectors just sold are ready to outperform. A classic example is technology stocks in early 2000.

✔ Avoid strategies designed to get rich quick in the stock market. The stock market is a place for investment, not speculation. When your expectations are too high, you have a tendency to chase after high-risk investments.

✔ Don’t avoid selling a stock because you have a loss. When selling a stock with a loss, an investor has to admit that he/she made a mistake, which is psychologically difficult to do. When evaluating your stock investments, objectively review the prospects of each one, making decisions to hold or sell on that basis.

✔ Make sure an investment will add diversification benefits to your portfolio. It’s common for investors to keep adding investments that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor.

✔ Check your portfolio’s performance periodically. Compare your actual return to your targeted return. Now honestly assess how well your portfolio is performing. Are major changes needed?

✔ No one knows where the market is headed. So don’t pay attention to gloomy or optimistic predictions. Instead, approach investing with a formal plan so you can make informed decisions with confidence.

Your Parents’ Estate Plans

To help ensure your parents’ estate is settled quickly according to their wishes, you should find out:

✔ Where important estate planning documents are located. Don’t ask for specifics, just make sure documents are in place so their wishes will be carried out. Find out if they have a durable power of attorney and a healthcare proxy.

✔ How to contact their advisors. Ask for a list of names, addresses, and phone numbers of lawyers, accountants, and financial advisors.

✔ Their rationale for distributing their estate. If your parents are reluctant to discuss this now, suggest they leave a personal letter with their estate-planning documents explaining their rationale for distributions.

✔ Preferences for the future. Find out where your parents would like to live if they’re not physically able to live in their current home. Do they want to move in with relatives or live in an assisted-living facility? Discuss in detail what procedures they want performed to prolong life. Determine their preferences for funeral arrangements.

Financial Thoughts

In a study of Millennials (born 1979 to 2000), Generation Xers (born 1965 to 1978), and Baby Boomers (born 1946 to 1964), over 70% in each group is saving for retirement using an employer-sponsored 401(k) plan or an alternative individual retirement account. The median age at which workers began saving for retirement was 24 years old for Millennials, 30 years old for Generation Xers, and 35 years old for Baby Boomers. All three generations are afraid they will outlive their savings while in retirement. For that reason, 54% of workers plan to work past age 65 (Source: Transamerica Center for Retirement Studies, April 2019).

Based on data from the U.S. Census Bureau’s Survey of Income and Program Participation, single-earner couples had an average savings rate of 8.6%, two-saver couples had an average contribution rate of 9.3%, and dual-earners with one saver only contributed 4.9% of their household savings to 401(k) accounts (Source: Center for Retirement Research at Boston College, March 2019).

In 2045, it is projected that ethnic minorities will represent more than 50% of the U.S. population (Source: Brookings, 2018).