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Investment Strategies Based on Fundamental Stock Analysis

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Abstract

Fundamental stock analysis is a methodology aimed at researching the financial performance and competitive advantages of a company in order to assess its investment attractiveness. The main focus is on analyzing revenue growth, profitability and sustainability of the company in the market, as well as macroeconomic conditions such as the general state of the economy and market demand. Effective management plays a key role in a company's ability to overcome difficulties and seize opportunities to increase value. Investors use fundamental analysis to evaluate the company's financial statements and determine its fair value, which allows them to identify undervalued and overvalued financial instruments. This method includes analysis at three levels: macroeconomic, industry, and company-specific levels, using various financial ratios and multipliers. Thus, fundamental analysis contributes to making informed investment decisions based on an objective assessment of the value of shares.

Keywords: *Investments, Investment Strategies, Fundamental Stock Analysis, Stock Analysis, Stocks.*

INTRODUCTION

Fundamental analysis of stocks represents one of the key methods for assessing the investment attractiveness of companies, based on the examination of their financial performance and competitive advantages. In today's investment world, where the stock market is characterized by high volatility and uncertainty, this method has become particularly relevant. Fundamental analysis allows investors to make informed decisions based on objective data, which helps reduce risks and increase the profitability of investments.

The primary goal of fundamental analysis is to determine the fair value of a company's stock. This involves an in-depth examination of its financial statements, including the balance sheet, income statement, and cash flow statement. Significant attention is also given to analyzing macroeconomic conditions, industry environment, and the quality of management. Effective use of this data helps identify undervalued or overvalued stocks, which is a crucial factor in forming an investment portfolio.

The relevance of this topic is driven by the need to enhance the financial literacy of investors and their ability to adequately assess the growth prospects of companies. In a globalized economy and a constantly changing economic environment, the ability to analyze and interpret financial indicators has become an essential skill for any investor. Fundamental analysis offers the opportunity to look beyond market sentiment and marketing gimmicks, focusing instead on the long-term potential of a company.

The aim of this paper is to explore various aspects of fundamental stock analysis and their application in developing effective investment strategies.

Core Principles of Fundamental Analysis

Fundamental analysis is a methodology aimed at examining a company's financial performance and competitive advantages. The primary focus is on revenue growth, profitability, and market stability. Additionally, macroeconomic conditions such as the overall state of the economy and market demand for the company's products or services are also analyzed. During fundamental analysis, an investor studies the company's financial statements, assesses its growth prospects, and determines the fair value of its stock. Based on this analysis, the investor concludes whether a financial instrument is undervalued, meaning its fair value is higher than the current market price, or overvalued, when the current price exceeds the fair value. If the current price matches the intrinsic value, further research is required to identify potential future changes.

The primary objective of fundamental analysis is to determine the objective value of securities so that the investor can make an informed decision about buying or selling. The value of a company and its stock is influenced by numerous factors, including the political and economic environment, the company's financial health, and the actions of its competitors.

Fundamental analysis is conducted on three levels. The first level involves analyzing the impact of political and economic factors on the stock market as a whole, which allows for an assessment of the overall investment climate. The second level examines various industries, identifying the most promising ones. The third level involves a detailed analysis of individual companies, including their financial statements over recent years, management efficiency, and growth prospects. At the

level of company-specific analysis, financial statements such as the balance sheet, income statement, cash flow statement, and other documents are used. Depending on the country and accounting standards (IFRS, GAAP, RAS), the data may vary. Analyzing this data allows for the assessment of both absolute and relative growth indicators of the company, such as revenue and net profit, which in turn affects the investment attractiveness of the company [1].

Revenue reflects the amount of money received from the sale of goods and services. Its growth indicates the company's effectiveness and competitiveness in the market. Net profit shows the company's bottom line after deducting all expenses. Growth in net profit increases the company's attractiveness to investors, enhances its profitability, and reduces the risk of bankruptcy.

The earnings per share (EPS) ratio and valuation multiples, such as P/E, are used to assess the investment attractiveness of companies. These indicators help investors understand how profitable investments in a particular company are (see Table 1).

Table 1. Normative Values of the P/E Multiplier [2]

Value	Investment Potential of the Company
P/E < 10	The company's stock is undervalued and has growth potential.
10 < P/E < 20	The company's stock is fairly valued by the market.
P/E > 20	The company's stock is overvalued.
P/E1 < P/E2	Company 1 is more attractive for investment than Company 2.
P/E1 < P/E*	If the company's stock is undervalued by the market, there is a risk of takeover. P/E* – The average industry P/E multiplier.

To determine the P/E multiplier for Apple Inc., we use Formula 2. The average multiplier for the industry is 25.21. Based on the obtained data, it can be concluded that Apple Inc.'s stock is significantly overvalued by the market at the moment.

The P/S (Price to Sales) ratio represents the relationship between the company's market capitalization and its revenue. It can also be calculated as the ratio of the stock price to revenue per share. One of the key advantages of the P/S ratio is its lower susceptibility to fluctuations, providing more accurate valuation results. Normative values of the P/S multiplier are presented in Table 2.

Table 2. Interpretation of the Values of the P/S Multiplier [2]

Value	Investment Potential of the Company
P/S < 1	The company is undervalued and has growth potential.
1 < P/S < 2	The company is fairly valued by the market.
P/S > 2	The company is overvalued by the market.
P/S1 < P/S2	Company 1 is more attractive for investment than Company 2.
P/S1 < P/S*	If the company's P/S is below the market average (*), the company might be a takeover target due to low capitalization.

To assess the financial stability and the company's ability to meet its obligations, various liquidity ratios are used: current liquidity (Current ratio), quick liquidity (Quick ratio), and absolute liquidity (Cash ratio). The main difference between them lies in the timeframes they cover: current liquidity evaluates the company's ability to meet its obligations in the long term, quick liquidity in the medium term, and absolute liquidity in the short term.

The current ratio shows how well a company can cover its obligations with all its assets. The quick ratio reflects the company's ability to pay off debts with assets that can be quickly converted into cash, such as cash, securities, and accounts receivable. The cash ratio demonstrates the company's ability to meet its obligations exclusively with its most liquid assets, i.e., cash. The normative values for these liquidity ratios are presented in Table 3.

Table 3. Regulatory Values for Liquidity Ratios [2]

Value	Indicates
Current Ratio	
Current ratio > 3	High degree of solvency; possible inefficiencies in asset management.
1.5 < Current ratio < 3	Moderate solvency.
Current ratio < 1.5	Low solvency.
Quick Ratio	
Quick ratio > 1	High solvency in the medium term.

Quick ratio < 1	Not all obligations may be covered in the medium term, leading to potential loss of financial reliability.
Cash Ratio	
Cash ratio > 0.5	High solvency, with potential risk of inefficient capital management.
0.2 < Cash ratio < 0.5	Optimal level.
Cash ratio < 0.2	Low company solvency.

The higher the liquidity ratios, the more resources the company has to meet its obligations in the medium and long term. However, the presence of inventories, financial investments, and other assets may negatively impact the company's profitability since these assets do not directly contribute to income generation.

Dividend policy is an important factor influencing stock value. Regular and increasing dividend payments attract investors. The Dividend Payout Ratio (DPR) is used to evaluate the dividend policy, indicating the share of net profit allocated to dividend payments. The formula for calculating DPR is provided below [2].

In conclusion, fundamental analysis helps quantify the value of a company and its stock by using reliable data from financial statements. This provides insight into the company's profitability, liquidity, and overall financial stability. Evaluating the management team, competitive advantages, and industry trends allows investors to determine the fair value of the company and make more informed investment decisions.

Macroeconomic and Industry Factors in Fundamental Analysis

Investment decisions are based on the analysis and interpretation of market data. Various forecasting methods and techniques for assessing future changes in stock prices are used to enable investors to make informed decisions. For example, correlation and regression analysis helps identify trends that are significant both in the short and long term. This allows investors who are aware of macroeconomic or industry changes to timely determine the current phase of the stock market and predict possible future shifts. As a result, a prompt response to market fluctuations enables investors to follow trends and make effective investment decisions, thereby reducing risks and increasing returns.

Numerous studies present various theoretical and methodological approaches to stock market analysis. Each author emphasizes that, among the diverse methods of analyzing the securities market, an investor chooses the most suitable one, allowing them to optimize returns, minimize risks, or strike a balance between these goals. The methods of analysis vary and have their unique characteristics. For instance, technical analysis focuses on historical stock price data and assumes the presence of recurring patterns, often disregarding external factors. This approach uses specific techniques to forecast future trends based on past data.

In contrast to technical analysis, fundamental analysis takes into account the impact of external factors on stock prices and is usually aimed at long-term prospects. Various models are employed in this analysis, including probabilistic, econometric, simulation, and neural network models.

When choosing a method of stock market analysis, it is also necessary to consider intermarket relationships, that is, the connections between different markets, such as commodity and financial markets. Competition between markets for investor capital influences the formation of market trends. Additionally, evaluating the difference between the fair value and the market value of a company plays a significant role in investment decisions [3].

An analyst aiming to determine whether a security is undervalued or overvalued must consider a multitude of factors. These factors include:

- Financial indicators
- Market value of the stock
- Industry classification and characteristics of the industry environment
- Seasonal variations
- Correlation
- Macroeconomic conditions and indicators
- Quality of company management
- Scale of operations and market share
- Unique characteristics of the company

Financial indicators play a key role in evaluating stocks from a fundamental analysis perspective. These include profits, EBITDA, debt levels, assets, and equity. The more efficiently a company operates, the higher its profits, the lower its debt burden, and the greater its capital growth. These indicators directly affect the company's value and its stock price.

To determine whether a stock is undervalued or overvalued, it is necessary to compare the financial results with the current market value of the stock. Stock price is a crucial factor in fundamental analysis.

The financial results of different companies can vary significantly. For example, one company might earn tens of billions of rubles, while another might earn hundreds of millions. However, for shareholders, this does not always translate into higher profits. For a proper comparison, it is essential to consider the ratio of financial indicators to the number of shares. This ratio provides valuation multiples, which help determine whether the stock is undervalued or overvalued.

Seasonal factors play a significant role in various sectors of the economy. Agriculture, energy, trade, transportation, tourism,

and fertilizer production all exhibit significant fluctuations in operational and financial results depending on the season. This must be taken into account in fundamental analysis. For instance, if a company shows good financial results during the off-season, its performance is likely to be even better during the peak season.

In some economic sectors, company performance is highly dependent on fluctuations in the prices of their products. For example, in the metallurgy and oil and gas industries. However, rising oil prices affect the stocks of oil and gas companies differently, depending on their level of correlation. It is important for an investor to consider that some stocks may rise or fall more sharply than others under the same market changes.

The macroeconomic environment has a significant impact on a company's activities. Stocks of companies within the same sector, with identical multiples, may have different investment appeal depending on the inflation rate in the country where they operate. Interest rates also play a crucial role, as companies are forced to pay different interest rates on loans.

It is also important to consider whether a company operates in a country with a rapidly growing GDP or in a recessionary environment.

The quality of a company's management is an important factor in fundamental analysis. A change in leadership can significantly affect the stock price. Therefore, changes in key management positions must be considered when assessing the fundamental attractiveness of a company.

When comparing the stocks of companies within the same sector, an investor should consider the size of the company and its significance within the industry. A large company has more resources and resilience compared to a smaller one. However, a smaller company may have excellent growth prospects, which could lead to a sharp increase in its stock price [4].

Unlike the approach of technical analysis, fundamental analysis considers the impact of both internal and external factors on the market value of stocks. Fundamentally, fundamental analysis is geared toward the long term, whereas technical analysis is typically short-term. Fundamental analysis employs various models, such as probabilistic, econometric, simulation, and neural network models.

When choosing a method for analyzing or forecasting the stock market, it is important to consider intermarket relationships, that is, the connections between different sectors (commodity, financial, and others). This is because different markets compete for investment capital, which moves between them. The movement of capital significantly affects the formation of trends in stock prices. Additionally, assessing the difference between a company's fair value and market value also impacts investment efficiency and capital movement. These patterns determine investor behavior and form the basis for creating models and simulations that help forecast prices [5].

Description of Investment Strategies Based on Fundamental Analysis

One of the key aspects of fundamental analysis is financial analysis, which aims to assess the growth prospects of a particular company. Financial analysis is based on the assumption that each security has its "future value" or "fair value," which differs from its current market price. If the current stock price exceeds its future value, such a security is considered "overvalued," and a price decrease is expected. Conversely, if the current price is below the future value, the stock is considered "undervalued," and its price is expected to rise. Therefore, undervalued stocks are of particular interest when forming an optimal investment portfolio. These often include innovative companies with high revaluation potential [6].

An investment strategy is a carefully developed plan for managing the purchase and sale of financial assets, taking into account the investor's goals, timeframes, and individual characteristics. Without a clearly defined strategy, investment activity can devolve into speculation or blindly following others' actions, leading to significant emotional stress during market downturns.

The choice of investment strategy depends on the investor's personal characteristics and changes with age. Younger investors can afford to take on more risk since they have more time to recover their capital. In contrast, middle-aged and older investors tend to prefer capital preservation and stable income.

There are many different investment strategies available online. While some may be questionable, several classic approaches have gained widespread recognition.

Investing in Growth Stocks: Investors often choose stocks of companies with high growth rates in earnings or revenue. However, focusing solely on this indicator is not always advisable, as high growth rates can be unstable. Companies that grow faster than their industry overall, but with moderate growth rates, may be of interest. Typically, small-cap stocks grow faster than those of large companies.

At certain times, entire growth sectors may emerge, such as vaccine manufacturers or entertainment software developers during the COVID-19 pandemic. Analysts often provide lists of promising sectors depending on the political or environmental situation.

To select growth stocks, it is convenient to use specialized filters. For example, companies can be filtered by industry, growth in earnings per share (EPS), and financial ratios.

Investing for stable income involves purchasing dividend-paying stocks or bonds. This approach was very popular in the past, but interest in it has waned recently, as many technology companies do not pay dividends.

A well-known strategy for selecting dividend stocks in the United States is the "Dogs of the Dow." This strategy involves annually selecting 10 stocks from the Dow Jones Index

with the highest dividend yield and then rebalancing them accordingly.

This strategy can be adapted to the Russian market, taking into account that domestic companies may adjust the size of dividend payments based on their considerations. Therefore, in addition to dividend yield, it is also worth considering profit growth above the industry average.

A hybrid investment style combines growth and income strategies. Investors seek out companies that pay dividends and simultaneously demonstrate growth. These are usually mature companies with high market capitalization.

An example of a hybrid strategy is the CAN SLIM method, developed by William O'Neil. This method involves selecting innovative companies with strong fundamentals and growth in key financial metrics [7].

An active management style involves constantly monitoring the market and responding quickly to changes. Investors actively conduct fundamental and technical analysis, aiming to "outperform" the market. This approach requires significant time and financial investment.

A passive strategy is based on long-term asset holding with minimal changes to the portfolio. The main principle is "buy and hold." This ensures low management costs and a review of assets only when there are significant changes in their returns.

Combining active and passive styles allows investors to allocate assets so that the majority remains unchanged, while a smaller portion is actively managed. This may include maintaining multiple portfolios with different strategies across various brokers.

When choosing a strategy, investors can consider various factors, such as growth in stock value, investments in undervalued companies, stable income, creating an "all-weather" or hybrid portfolio, risk level, momentum investing, or replicating the trades of well-known investors [8].

CONCLUSION

In conclusion, fundamental stock analysis is a crucial tool for developing effective investment strategies, enabling investors to make informed decisions based on a thorough examination of financial indicators and macroeconomic factors. A comprehensive approach to analysis, which includes evaluating revenue, profitability, macroeconomic conditions, and management quality, allows investors to determine the fair value of stocks and assess their investment attractiveness. Regular monitoring and revision of investment portfolios based on changes in fundamental indicators help minimize risks and enhance investment returns. Therefore, fundamental analysis is an indispensable element in the toolkit of any investor aiming for long-term success in the stock market.

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