UNIT IV

Subject Name	Subject Code	Semester	Prepared by
SERVICES MARKETING	18BBA41C	IV	Dr.S.Akilandeswari, Assistant Professor

Security Analysis

Meaning

Investment is commitment of funds in the expectation of some positive rate of return. These funds are to be used by another party, user of fund, for productive activity. It can be giving an advance or loan or contributing to the equity (ownership capital) or debt capital of a corporate or non-corporate business unit. In other words, investment means conversion of cash or money into a monetary asset or a claim on future money for a return. This return is for saving, parting with saving or liquidity and lastly for taking a risk involving the uncertainty about the actual return, time of waiting and cost of getting back funds, safety of funds, and risk of the variability of the return.

Investment in capital market is made in various financial instruments, which are all claims on money. These instruments may be of various categories with different characteristics. These are all called securities in the market parlance.

In a legal sense also, the Securities Contracts Regulation Act, (1956) has defined the security as inclusive of shares, scrips, stocks, bonds, debentures or any other marketable securities of a like nature or of any debentures of a company or body corporate, the Government and semi-Government body etc. It includes all rights and interests in them including warrants, and loyalty coupons etc., issued by any of the bodies, organisations or the Government. The derivatives of securities and Security Index are also included as securities in the above definition in 1998.

In the strict sense of the word, a security is an instrument of promissory note or a method of borrowing or lending or a source of contributing to the funds needed by a corporate body or non-corporate body. Private security for example is also a security as it is a promissory note of an individual or firm and gives rise to a claim on money. But such private securities or even securities of private companies or promissory notes of individuals, partnerships or firms the extent that their marketability is poor or nil, are not part of the capital market and do not constitute part of the security analysis. In nutshell, securities are financial instruments that have been created to represent a legal obligation to pay a sum in future in return for the current receipt of value. Securities thus represent the cash equivalent received from another person.

Definition of security analysis:

For making proper investment involving both risk and return, the investor has to make a study of the alternative avenues of investment– their risk and return characteristics and make proper projection or expectation of the risk and return of the alternative investments under consideration. He has to tune the expectations to his preferences of the risk and return for making a proper

investment choice. The process of analysing the individual securities and the market as a whole and estimating the risk and return expected from each of the investments with a view to identifying undervalued securities for buying and overvalued securities for selling is both an art and a science and this is what is called security analysis.

Security Analysis in both traditional sense and modern sense involves the projection of future dividend, or earnings flows, forecast of the share price in the future and estimating the intrinsic value of a security based on the forecast of earnings or dividends. Thus, security analysis in traditional sense is essentially an analysis of the fundamental value of a share and its forecast for the future through the calculation of its intrinsic worth of the share.

Modern security analysis relies on the fundamental analysis of the security, leading to its intrinsic worth and also risk-return analysis depending on the variability of the returns, covariance, safety of funds and the projections of the future returns. If the security analysis is based on fundamental factors of the company, then the forecast of the share price has to take into account inevitably the trends and the scenario in the economy, in the industry to which the company belongs and finally the strengths and weaknesses of the company itself- its management, promoters' track record, financial results, projections of expansion, diversification, tax planning etc. all these studies are only a part of the total security analysis that the investor should aim at.

Fundamental Analysis

The basic Fundamental Analysis meaning is a method that is used for measuring the intrinsic value of a stock or security. It mainly depends on the economic factors affecting the business and its financials.

This process is not only limited to the company's financial structure but it goes beyond that.

It includes the general economic scenario, the industry's growth, and fall, along with the company's organizational structure, management, and financials.

So, it is a complete study of a business venture to analyze its actual worth and then to measure its share's intrinsic value.

It takes into account both macroeconomic and microeconomics factor at the same time. The notion behind this is to analyze the real price against the prevailing price in the market.

For Fundamental Analysis Strategies, there are few Fundamental Analysis Basics which needs to be considered. These are primary factors which affect the analysis of the stock and they are –

1.Company's revenue and its structure

2.Growth of the revenue over the years

3.Profit made by the company in the past years

4.Debt structure of the company

5.Rate of Turnover

6.Employee management and management's approach towards its employees

These are six basic factors that are looked at while doing fundamental analysis of any security.

Steps in Fundamental Analysis

There are few basic steps to start this analysis and the steps are –

- For preparing the Fundamental Analysis Strategies, you first need to understand the company well
- The second step is to use financial ratios. The ratios are the primary source of information required for this analysis.
- Third step is to study the financial and annual reports of the company.
- The fourth step is also about reading the annual reports but of the rival companies'.
- Next step is to compare the company's debt structure with its peers and rivals
- Finally, you need to analyze the prospects of the company to find out its worth**.**

Economic, Industry and Company Analysis

EIC analysis is the abbreviation of economic, industry and company. The person conducting EIC analysis examines the conditions in the entire economy and then ascertains the most attractive industries in the light of the economic conditions.

1. Economic Analysis

The main objective of economic analysis is to find out whether or not the economic entity is allocating its resources in the most cost-effective manner or not..

The economic analysis involves comparing at least two alternatives in achieving, for example, a certain goal under specific constraints and assumptions.

Economic analyses factor in the opportunity costs that people or companies employ. They measure, in monetary terms, what the benefits of a project are to the economy or community.

Opportunity cost is all about evaluating the option you gave up when you made a choice.

Study of economic systems or a study of a production process or an industry to see if it is operating effectively and how much profit it is making.

Economic analysis is all about analyzing the economic aspects of something. Apart from economists, statisticians and mathematicians may also carry out an economic analysis.

2. Industry Analysis

In 1980, Michael Porter proposed a standard approach to industry analysis which is referred to as competitive analysis frame work. Threats of new entrants evaluate the expected reaction of current competitors to new competitors and obstacles to entry into the industry. In certain industries, it is quite difficult for new companies to compete successfully.

The bargaining power of suppliers has also a substantial influence on the profitability of the company. The supplies for manufacturing products are required by the company and it does not have sufficient control over the costs. It is not possible for the company to increase the price of its finished products in order to cover the increased costs due to the presence of powerful buyer groups in the market of substitute products. So while conducting industry analysis, the presence of powerful suppliers should be considered as negative for the company.

The above considerations of industry structure should be analyzed by the investor in order to make an estimate about the future trends of the industry in the light of the economic conditions. When a potential industry is identified then comes the final step of EIC analysis which is narrower relating to companies only.

3. Company Analysis

In company analysis, different companies are considered and evaluated from the selected industry so that the most attractive company can be identified. Company analysis is also referred to as security analysis in which stock picking activity is done. Different analysts have different approaches to conducting company analysis like

- Value Approach to Investing
- Growth Approach to Investing

Additionally in company analysis, the financial ratios of the companies are analyzed in order to ascertain the category of stock as value stock or growth stock. These ratios include price to book ratio and price-earnings ratio. Other ratios like return on equity etc. can also be analyzed to ascertain the potential company for making an investment.

DOW Theory – Types of Charts- Important Chart Patterns.Analysis:

Dow Theory has been around for almost 100 years, yet even in today's volatile and technology-driven markets, the basic components of Dow Theory still remain valid. Developed by Charles Dow, refined by William Hamilton and articulated by Robert Rhea, Dow Theory addresses not only technical analysis and price action, but also market philosophy. Many of the ideas and comments put forth by Dow and Hamilton became axioms of Wall Street. While there are those who may think that the market is different now, a read through Rhea's book, The Dow Theory, will attest that the stock market behaves the same today as it did almost 100 years ago.

At a high level, Dow Theory describes market trends and how they typically behave. At a more granular level, it provides signals that can be used to identify and subsequently trade with the primary market trend. The theory centers around identifying the trend for the Dow Jones Rail (now Transportation) Average and the Dow Jones Industrial Average, and using volume to confirm those trends. If both Dow Jones averages are trending in the same direction, then the entire market can be said to be trending in that direction as well. Investors can use these signals to identify the primary market trend, and then trade with that trend.

Components of DOW Theory

There are six main components to the Dow theory.

1. The Market Discounts Everything

The Dow theory operates on the efficient markets hypothesis (EMH), which states that asset prices incorporate all available information. In other words, this approach is the antithesis of behavioral economics.

Earnings potential, competitive advantage, management competence—all of these factors and more are priced into the market, even if not every individual knows all or any of these details. In more strict readings of this theory, even future events are discounted in the form of risk.

2. There Are Three Primary Kinds of Market Trends

Markets experience primary trends which last a year or more, such as a bull or bear market. Within these broader trends, they experience secondary trends, often working against the primary trend, such as a pullback within a bull market or a rally within a bear market; these secondary trends last from three weeks to three months. Finally, there are minor trends lasting less than three weeks, which are largely noise.

3. Primary Trends Have Three Phases

A primary trend will pass through three phases, according to the Dow theory. In a bull market, these are the accumulation phase, the public participation (or big move) phase, and the excess phase. In a bear market, they are called the distribution phase, the public participation phase, and the panic (or despair) phase.

4. Indices Must Confirm Each Other

In order for a trend to be established, Dow postulated indices or market averages must confirm each other. This means that the signals that occur on one index must match or correspond with the signals on the other. If one index, such as the Dow Jones Industrial Average, is confirming a new primary uptrend, but another index remains in a primary downward trend, traders should not assume that a new trend has begun.

Dow used the two indices he and his partners invented, the Dow Jones Industrial Average (DJIA) and the Dow Jones Transportation Average (DJTA), on the assumption that if business conditions were, in fact, healthy, as a rise in the DJIA might suggest, the railroads would be profiting from moving the freight this business activity required. If asset prices were rising but the railroads were suffering, the trend would likely not be sustainable. The converse also applies: if railroads are profiting but the market is in a downturn, there is no clear trend.

5. Volume Must Confirm the Trend

Volume should increase if the price is moving in the direction of the primary trend and decrease if it is moving against it. Low volume signals a weakness in the trend. For example, in a bull market, the volume should increase as the price is rising, and fall during secondary pullbacks. If in this example the volume picks up during a pullback, it could be a sign that the trend is reversing as more market participants turn bearish.

6. Trends Persist Until a Clear Reversal Occurs

Reversals in primary trends can be confused with secondary trends. It is difficult to determine whether an upswing in a bear market is a reversal or a short-lived rally to be followed by still lower lows, and the Dow theory advocates caution, insisting that a possible reversal be confirmed.

Patterns in DOW Theory

The Dow Theory is a form of technical analysis and various patterns help the analyst and the trader in identifying the possibilities in trading.

The popular Dow Theory patterns include the Double bottom and Double top formation, the triple bottom and top, trading range, and the flag formation.

Each of these patterns is discussed further in the following sections.

The Reverse Patterns

The double and triple patterns are two types of reverse patterns since the stock price recovers and bounces back to the particular levels within a limited time frame.

Double Bottom

Consider a situation when the stock price is at one of its lowest levels, the price may show some significant recovery for a short period of two weeks or more and then drop down again.

This situation creates a double drop pattern in the chart and is referred to as the double bottom pattern. This pattern indicates a bullish trend and traders can profit from buying shares.

Double Top

It happens in a situation when the stock price trends up to a particular level, comes down, and then again bounces back to the top-level within two weeks or more.

The double top pattern indicates a bearish trend and the traders can look for opportunities to sell.

Triple Bottom and Triple Top

These patterns are in the way the double bottom and double top patterns are formed.

The only difference is that in this case, the price level bounces back twice, that is the price hits a particular point thrice.

Range Formation

The market trends may continue to depict the bouncing pattern more than thrice as a result of which the price seems to show a sideways trend.

The sideways trend in the market creates a range within which the price fluctuates and usually this situation is difficult for trading. However, there are opportunities in this range to generate profits, for which the upper range limit acts as the resistance level and the lower limit the support level. The range pattern may continue for months or a few years and the width of the range comes by the duration of the pattern. Stocks exhibit this range pattern or sideways trending market either due to the lack of some basic factors like new announcements, product launches, etc. or during the waiting period of new changes. However, a change in both these factors can produce a range breakout with high volumes and a higher rate of price change.

Flag Pattern in Dow Theory

A flag pattern happens when the stock price rises sharply follows by a small decline of around 10% (correction). The pattern is what we call a flag formation since it creates a look of the flag on the leg. The largest benefit of the flag formation is that, it provides the trader an additional opportunity to buy the shares that they might have left out.This kind of pattern forms as a result of selling too many shares to gain profit, which further leads to a drop in price.

Reward to Risk Ratio (RRR) in Dow Theory

The Reward to Risk Ratio is a general concept in the trading system. Its general relation to the trading makes it important to mention here.

The fundamental benefit of RRR is that it calculates the possible returns during any particular period. Consider the following hypothetical example for better understanding.

The Contents in this E-Material is taken from the text and reference book as given in the syllabus