MB FC 01: Security Analysis & Portfolio Management

Unit – III (Fundamental Analysis: Economic & Industry Analysis)

Techniques Used in Economic Analysis:

(A) Anticipatory Surveys:

(i) Facilitate investors to form an opinion about the future state of the economy.

(ii) Incorporates industry surveys on construction activities, expenditure on plant and machinery, levels of inventory - all having a definite bearing on economic activities.

(iii) Future spending habits of consumers are taken into account.

However, an important limitation is that the survey results do not guarantee that intentions surveyed would materialize. They are not regarded as forecasts per se, as there can be a consensus approach by the investor for exercising his opinion.

(B) Barometer/Indicator Approach: Various indicators are used to find out how the economy shall perform in the future. The indicators have been classified as under:

(i) Leading Indicators: They lead the economic activity in terms of their outcome. They relate to the time series data of the variables that reach high/low points in advance of economic activity.

(ii) Roughly Coincidental Indicators: They reach their peaks and troughs at approximately the same time as the economy.

(iii) Lagging Indicators: They are time series data of variables that lag behind in their consequences vis-à-vis the economy. They reach their turning points after the economy has reached its own already.

(iv) Diffusion/composite index: This index combines several indicators into one index to measure the magnitude of the movement of a particular set of indicators. Computation of diffusion indices are however difficult. Moreover it does not eliminate irregular movements. But this is most useful when the other indicators give conflicting signals and also since they do not measure the magnitude of change.

(C) Economic Model Building Approach: In this approach, a precise and clear relationship between dependent and independent variables is determined. GNP model building or sectoral analysis is used in practice through the use of National Accounting framework. The steps used are as follows:

(i) Hypothesize total economic demand by measuring total income (GNP) based on political stability, rate of inflation, changes in economic levels.

(ii) Forecast the GNP by estimating levels of various components viz. consumption expenditure, gross private domestic investment, government purchases of goods/services, net exports.

(iii) After forecasting individual components of GNP, add them up to obtain the forecasted GNP.

(iv) Comparison is made of total GNP thus arrived at with that from an independent agency for the forecast of GNP and then the overall forecast is tested for consistency.

(D) Gross National Product Analysis: Gross National Product (GNP) as a measure national income reflects the growth rate in economic activities and is regarded as a forecasting tool for analyzing the overall economy along with its various components during a particular period.

Industry or Sector analysis

The second step in the fundamental analysis of securities is Industry analysis. An industry or sector is a group of firms that have similar technological structure of production and produce similar products. These industries are classified according to their reactions to the different phases of the business cycle.

They are classified into growth, cyclical, defensive and cyclical growth industry. A market assessment tool designed to provide a business with an idea of the complexity of a particular industry. Industry analysis involves reviewing the economic, political and market factors that influence the way the industry develops. Major factors can include the power wielded by suppliers and buyers, the condition of competitors and the likelihood of new market entrants.

The industry analysis should take into account the following factors:-

- **Characteristics of the industry:** When the demand for industrial products is seasonal, their problems may spoil the growth prospects. If it is consumer product, the scale of production and width of the market will determine the selling and advertisement cost. The nature of industry is also an important factor for determining the scale of operation and profitability.
- **Demand and market**: If the industry is to have good prospects of profitability, the demand for the product should not be controlled by the government.
- **Government policy:** The government policy is announced in the Industrial policy resolution and subsequent announcements by the government from time to time. The government policy with regard to granting of clearances, installed capacity, price, distribution of the product and reservation of the products for small industry etc are also factors to be considered for industrial analysis.
- **Labor and other industrial problems**: The industry has to use labour of different categories and expertise. The productivity of labour as much as the capital efficiency would determine the progress of the industry. If there is a labour problem that industry should be neglected by the investor. Similarly when the industries have the problems of marketing, investors have to be careful when investing in such companies.
- **Management:** In case of new industries, investors have to carefully assess the project reports and the assessment of financial institutions in this regard. The capabilities of management will depend upon tax planning, innovation of technology, modernisation etc. A good management will also insure that their shares are well distributed and liquidity of shares is assured.
- **Future prospects:** It is essential to have an overall picture of the industry and to study their problems and prospects. After a study of the past, the future prospects of the industry are to be assessed.
- When the economy expands, the performance of the industries will be better. Similarly when the economy contracts reverse will happen in the Industry. Each Industry is different from the other. Cement Industry is entirely different from Software Industry or Textile Industry in its products and process.

Techniques Used in Industry Analysis:

- **(i) Regression Analysis:** Investor diagnoses the factors determining the demand for output of the industry through product demand analysis. The following factors affecting demand are to be considered - GNP, disposable income, per capita consumption / income, price elasticity of demand. These factors are then used to forecast demand using statistical techniques such as regression analysis and correlation.
- **(ii) Input - Output Analysis**: It reflects the flow of goods and services through the economy, intermediate steps in production process as goods proceed from raw material stage through final consumption. This is carried out to detect changing patterns/trends indicating growth/decline of industries.