Newsletter

Starting with a plan in mind?

"By failing to prepare, you are preparing to fail." Benjamin Franklin

If you don't have a plan when trading, you may be setting yourself up for failure right from the start.

It is important that you have a Game plan. Why? Firstly, it gives you some direction with your trading plus it helps take the emotion out of your trading.

So how do you get a plan happening…here are some basic questions to help you get started:

1. ***First, what is your overall investment strategy going to be?***

   Will you select a certain number of shares and buy and hold for the entire Game?

   Will you consider selling shares if they are not performing? What parameters will you set, for this to be activated e.g. how low are you prepared for them to go?

   Or will you hold no matter what?

   Or is your strategy to buy and sell shares, taking your profit as you go and then investing in something else or the same stock? Keep an eye on how much you are spending on brokerage compared to the profit you are making? Would you be better to buy and hold some shares and look to trade in and out of others?

2. ***Will you diversify your investment?*** This means buying stocks from different sectors rather than all from the same one. This is a great way to help protect your investment.

3. ***Have you decided when to take your profits?*** If your shares rise by a certain percentage above your purchase price, will you continue to hold them, or will you sell and take your profit so that you can invest in something else. If yes, at what point will you take your profit e.g. % increase?

   Tip: *You can set a limit order to sell at a certain profit point.*

4. ***If the stock falls or is not performing as you would like, do you have a plan of when to sell?***

   Have you made any decisions regarding how low you are prepared for a share to go, before getting out? For example, you might set a certain percentage below your purchase price as the lowest you are prepared to let the share price fall before you sell your shares.

   Top: Remember you have a falling sell that you can use so you can set this right from the start.

   Also, if you decide to sell, what factors or indicators will you use to help you make the decision to step back in?

If you haven't chosen your stocks yet, take a look at last fortnight's newsletter, and this week's example of reviewing a stock, by Simply Wall St. Select a few stocks that you know and run them through the Simply Wall Street tool. This will give you an idea as to whether they are a good investment or not.

Also have a goal for this Game, decide what you want to achieve? This will help keep you motivated in your learning.

When investing you must have a plan, if you have started the Game without a plan, take time out now to answer the questions above. By having the answers to these questions, if there is volatility, you will be more prepared and able to make good decisions rather than reacting and making wrong decisions.

SIMPLY WALL ST

Analysing a company - Telstra example

In the last newsletter, we looked at how we can get good ideas for stocks to add to our portfolio.

It's great to have a shortlist of companies that fit your investment criteria, but once you've found them, how do you conduct research to select the ones to invest in?

First, it's important to understand the two common forms of company analysis – Technical and Fundamental.

Technical analysis attempts to use a stock's past price movements to predict future share prices, and is usually used by investors with a short investment time horizon. Conversely, **fundamental analysis** looks at the economics of a company and its financial statements to determine its value, and has a much longer investment horizon. You can find more information here if you want to look into the differences in more detail.

For most investors, it is certainly very difficult to make long term gains looking at charts to determine a company's future share price. Fundamental analysis is a much more principled approach (it's how Warren Buffet values companies) and can be easily understood and learnt by everyday investors like yourself.

Diving into the Fundamentals

Today, we are going to use telecommunications company Telstra to demonstrate how you may go about conducting fundamental analysis on a company.
Simply Wall St specializes in fundamental analysis, and has a very intuitive way for investors to get a strong overview of a company's fundamentals.
When analyzing a company's fundamentals, we divide it into 5 key categories:

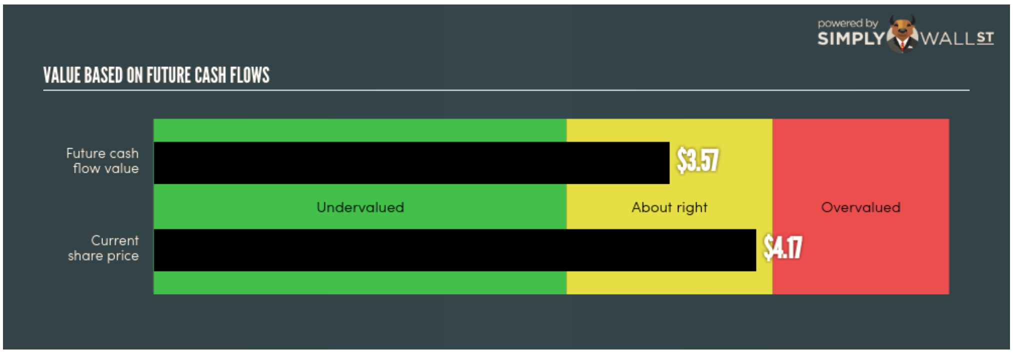
1. Value
2. Future
3. Past
4. Health
5. Income/Dividends

Value

By comparing the current market price to the fair value (true worth) of a company, investors can determine whether a company's shares are potentially under or overvalued.

There are many valuation methods and models which can be used to determine the fair value of a company. A popular and widely regarded method is Discounted Cash Flow (DCF). This approach looks at the total value of a company's free cash flow (FCF), discounted to today's value. More detail on DCF can be found here.

Using the DCF method to examine Telstra's value, we can see that it is currently trading at around its fair value, suggesting that perhaps there is not much more room for capital gains.



Future

When you invest in a company, you're betting on the company to perform well in the future. As a result, you want to make sure that they have good revenue, cash flow and earnings prospects for the coming years.

While no one knows with absolute certainty how a company will perform in the future, there are several ways you could reasonably determine if a company has good future growth prospects. One method is to look at a company's position in the market to see if they have any competitive advantages going forward. You could also look at the news on any new products the company is planning on releasing in the coming months or years. Another reasonable method to assess growth prospects is to look at analyst estimates. Analysts are people whose job is to evaluate and predict a company's future growth and earnings potential.

According to 9 analysts, Telstra's expected earnings per share will grow by approximately 7.5% each year for the next 3 years, a reasonable figure for a company its size.

Past

It is unlikely you will invest in a company that has historically performed poorly and failed to provide returns to shareholders, unless you believe there will be an upcoming event that will trigger a turnaround that most investors don't know about. Therefore, it's important to evaluate a company's past performance over the last 5 years.

Telstra's revenue has remained fairly stable over the last 5 years; however, in that same time they have increased their profit by approximately 56%, demonstrating their operational efficiency and ability to keep costs to a minimum. However, if we look at the trailing 12 months, Telstra's earnings growth did not match the Telco industry average, and in fact had negative earnings growth.

Health

A company can have brilliant past results and great future growth prospects. However, if they have high debt and poor financial management, all that stuff is pretty much irrelevant, as a company needs to be able to sustain operations for the long term.

The debt to equity ratio is one of the most important metrics of a company's financial health. Telstra's debt (17.2B) outweighs its equity (14.57B). On face value, this would suggest that Telstra is in a weak financial position. However, upon further analysis, we can find that Telstra's debt to equity ratio has not only decreased in the last year, but total debt is well covered by its annual operating cash flows and its earnings are 8.9x its debt interest expenses. Whilst the debt is still high, the company is in a sound position to manage it.

Income/Dividends

Dividends are company profits redistributed to shareholders, and are an important consideration for many investors. While dividends may not be the main investment criteria for the share market game, they are certainly important for longer term investors, so it's worth discussing, especially for those who have (or are planning to have) real money invested in the share market.

Telstra currently pays out a dividend of 7.52% as a portion of the current share price. If you look at interest rates on term deposits in Australia of 3.0%, you can see why dividends are so important to Aussie investors! Additionally, it's important to note Telstra's payout ratio (the percentage of its profits that it pays to shareholders, retaining the remainder) is 69%, so it's dividends paid out are being sufficiently covered by its net profit (1.4x).

Conclusion

We hope that by walking you through some fundamental analysis with a real company, you now have a better understanding of how to analyze companies on your own. Remember, that there are plenty of other factors to consider when purchasing a company than just the ones we have discussed. However, using these 5 categories is a great way to understand the most significant performance drivers of a company to decide whether it is right for your investment.
If you'd like to learn more about this approach, you can have a read through Simply Wall St's analysis model.

Now go try with a stock of your own!

Game weekly update

The indices and share price list has been updated for the period 3 - 16 August (CSV 13KB).

Previous newsletters

- Game 1 2017 Winners
- Pre Game
- Game start

Game update

- 9 August
- 17 August
- 24 August

Starting out in shares

The ASX Way