



Getting to grips with the fundamentals

How do professional investors work out which shares to buy and what price to pay? The answer is something called “fundamental analysis” – and you can do it too. Here’s how to get started.

In Newsletter 1 we talked about some of the things you might want to think about when deciding which shares to buy. This week we’re going to drill a little deeper into one of the main methods professional investors use to decide what to buy and when. It’s called “fundamental analysis”, and it’s easier to do than you might think.

What is fundamental analysis?

Fundamental analysis is all about the numbers – but that doesn’t mean you have to be a maths nerd to do it. It involves looking at key financial data to answer questions about a company’s past performance and future prospects. Questions like:

- How profitable is it?
- Are its profits growing?
- How risky is it, and how much debt does it have?
- How does it compare to other companies I might want to buy?

You can even use fundamental to try and work out how much a share is worth, although that part is trickier.

To answer these questions, investors look at a bunch of different numbers. Here are three of the most important.

Earnings per share (EPS)

A company’s EPS is simply its profit divided by the number of shares it has issued to shareholders. For example, if a company’s profit last year was \$100 million, and it has 100 million shares, then its EPS is \$1.

Why does it matter? Because when you buy a share, you become a part owner of the company – which means you share in its profits. EPS tells you what you’re getting for your money. And by looking at how a company’s EPS has changed over time, you can see if its profits are growing, shrinking or standing still.

Price earnings (P/E)

Now you know what your share of the company’s profits is, you need to work out what price you’re paying for them. That’s where P/E comes in. P/E is simply the company’s current share price divided by its EPS. For example, if our company has a current share price of \$10, and its EPS is \$1, then it has a P/E ratio of 10.



That's a fairly typical number – over the long term, the average P/E ratio on the Australian stock market has moved between 10 and 20, averaging around 15. That said, individual stocks can have much higher P/Es, sometimes in the hundreds.

That's because investors are willing to pay more for companies they think will grow strongly in the future. If a company is earning \$1 per share today, but investors think it will earn \$10 a share next year, then they will happily pay much more than \$10 for it.

So a company with a P/E over 20 might just be expensive, or it might have great growth prospects that investors are willing to pay extra for. In the same way, a company with a P/E under 15 might be cheap, or it may have stagnating or falling profits, keeping investors away.



Dividend yield

We've said that as a share-owner you share in a company's profits – but that doesn't mean the company will simply send you a cheque (although they might). When companies make a profit, they can use the money in two ways. They can re-invest in the company, making it bigger and more valuable, and hopefully driving up the share price. Or they can pay it to you and the other shareholders as a dividend. Often, they might do a little of both.

A company's dividend yield is its last annual dividend divided by its share price. For example, if our company paid 50 cents in dividends last financial year, and its current share price is \$10, then it has a dividend yield of 5% ($0.5 \div 10$). Currently the average dividend yield on the Australian market is between 3% and 4%.

A high dividend yield is useful if you're looking to earn an income from your investments. But, if you're more interested growth stocks, you might prefer a company that re-invests its profits to become bigger and better, rather than paying them out to you now.

Game Tip

To find fundamental data for a company, visit the ASX website at www2.asx.com.au, click the Search icon and search on the company name or ASX code. The company page has trailing 12 month (TTM) data for P/E, EPS, annual dividend yield, and more.

Fundamental data for BHP on the ASX website



SHARE INFORMATION		FUNDAMENTALS		DIVIDENDS
Day range	35.960 - 36.410	P/E TTM	16.1	Type
Previous close	36.110	EPS TTM	2.220	Dividend amount
Average volume	6,195,259	Annual revenue TTM	60.7K	Annual yield
52 week range	24.050 - 41.470	Net income TTM	11.2K	Ex date
Foreign exempt?	No	Cash flow TTM	1,683.88	Record date
ISIN	AU000000BHP4	Price/free cash flow	7.99	Pay date
Share description	Ordinary Fully Paid	Free cash flow yield	0.12%	Franking



Putting it all together

So now you know what numbers to look for, how do you make sense of them? As we pointed out in Newsletter 1, it all depends on your strategy. If you care more about long term growth and less about income, then a company with a higher P/E but a lower dividend yield might be best for you. But if you're a more cautious investor or you rely on your shares for income, you might be more interested in a company with a lower P/E but a higher dividend yield.

Further reading

James Chen, [Earnings Per Share](#), Investopedia
 Adam Hayes, [Price-to-Earnings Ratio](#), Investopedia
 James Chen, [Dividend Yield](#), Investopedia
 Troy Segal, [Fundamental Analysis](#), Investopedia



GAME UPDATE

Top 5 syndicates - 28 October 2020:

#	Syndicate	School	Portfolio value
1	BlaTomi	St Peter's College, SA	\$57,299.85
2	The Treasury	Karalee Homeschool, WA	\$56,519.10
3	James Doran	Whitefriars College, VIC	\$56,436.03
4	H Limmer	Trinity Grammar School, VIC	\$55,369.41
5	OscarL	Geraldton Grammar School, WA	\$54,159.97

Most improved syndicate

Syndicate name: H Limmer

School: Trinity Grammar School, VIC

Weekly change: 6.0%

Portfolio value: \$55,369.41

Previous newsletters

- [Game 2 Five lessons from our most successful players](#)
- [Game 2 Getting to grips with risk](#)
- [Game 2 What moves markets](#)
- [Game 2, Starting out and setting a game plan](#)
- [Game 2, Will you take the challenge?](#)
- [Game 1, 2020 Winner](#)

Game update



Financial links

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- [Ninemsn money](#)
- [The Bull](#)
- [Trading room](#)
- [Yahoo finance](#)

Financial news

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- [The Australian](#)
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