Trade-off between Fundamental and Technical Analysis

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Abstract

Fundamental analysis and technical analysis are two different approaches to evaluating stocks. Fundamental analysis is a long-term investment strategy that seeks to identify undervalued stocks by examining a company's financial statements, management, industry, and economic environment. Technical analysis is a short-term investment strategy that seeks to identify trends and make trading decisions based on those trends. Both fundamental and technical analysis have their own advantages and disadvantages. Fundamental analysis is more time-consuming and requires a deep understanding of financial statements, but it can be more reliable in the long run. Technical analysis is faster and easier to learn, but it is more prone to false signals. The best approach for an investor depends on their individual goals and risk tolerance. Investors who are looking for long-term growth may prefer fundamental analysis, while investors who are looking for short-term profits may prefer technical analysis. In some cases, it may be beneficial to use both fundamental and technical analysis together.

Keywords: Fundamental analysis, technical analysis, intrinsic value, market trends, investments

Introduction

Mr. Jamshed has decided to invest in stock market to increase his earnings by taking additional risk. While selecting the stocks, he is confused whether to use fundamental approach or technical approach (Abdullah et al., 2022). Although both the approaches serve different purposes, striking a balance ensures a satisfactory return at low risk (Bandara et al., 2022). This article will focus on the overview of both the approaches, pros and cons of each approach, basic differences between the approaches and the circumstances when both the approaches should be used simultaneously (Chowdhury et al., 2021).

Fundamental Analysis

Fundamental Analysis means a comprehensive examination of the basic factors which influence the interest of the economy, industry and company (Chowdhury et al., 2023). It is meant to measure the actual intrinsic value of a share, by measuring the economic, financial and other factors both qualitative and quantitative in nature to identify the opportunities where the value of share varies from its current market price (Chowdhury et al., 2015). It requires a deep knowledge of accounting, finance, and economics. For instance, fundamental analysis requires the ability to read financial statements, an understanding of macroeconomic factors, and knowledge of valuation techniques. It primarily relies on public data, such as a company's historical earnings and profit margins, to project future growth ((Chowdhury & Islam, 2017).

Why is it called fundamental?

The fundamental analysis assesses all the factors that have the capability of influencing the value of the security including macroeconomic factors and organization-specific factors, called as fundamentals, which are nothing but the financial statements, management, competition, business concept, etc. It aims at analyzing the economy as a whole, the industry to which it belongs, business environment and the firm itself (Chowdhury, 2021). It relies on the assumption that there is some sort of delay in influencing the share prices by these fundamentals. So, in the short run, the prices of stocks do not match its value, but in the long run, it adjusts itself.

Steps to Conduct Fundamental Analysis

Although fundamental analysis can be done either top-down or down-top approach, in this section, the top-down approach has been discussed as it is the most followed approach across the world.

1. Economic Analysis or Forecast: In the top-down process, the first step is always the evaluation of the economy in general (Chowdhury, 2012). There are multiple sectors and industries with hundreds of companies in them which builds an economy in general. This needs to be analyzed closely to begin fundamental research (Chowdhury and Chowdhury, 2010). The growth in the economy directly affects the growth of companies and their stocks in general with some exceptions. There is a direct link of the interest rates prevailing in the economy with the stock market and bond markets. So, it is highly important that you take note of the crucial aspects of the economy and then dig deeper into it (Chowdhury, 2023).

2. Industry or Sector Analysis: After economic analysis, you need to get down to a few or one specific industry which seems more promising than the others in your analysis (Chowdhury and Rozario, 2018). It can be done by comparing the growth of certain industries that you prefer or as per your analysis. In a growing economy, certain industries will bring more profits than others (Chowdhury, 2012). To choose the specific industry for your investment purpose, you need to check the industry's overall growth potential in the upcoming years. How the industry is affecting the economy or its importance to the economy (Chowdhury, 2020). Then you need to see the market strength or a number of companies in that industry and similar aspects. Apart from these, you need to check the prospects of the industry as well. Innovations and technologies involved and getting developed in the industry (Chowdhury, 2022).

3. Company Analysis as part of Fundamental Analysis: Finally, you come down to company analysis post industry analysis. Now you have analyzed the economy, chosen an industry (Chowdhury, 2016). Now you have to choose a company and its stock for investment from the industry you have selected (Chowdhury, 2017). For selecting a company out of the industry, the first step is to shortlist a few of them (Chowdhury, 2020). You need to shortlist the companies on the basis of –
    - Its prospects in terms of technology and innovation
    - Its financial strengths and marketing standards
    - Whether it has an edge over other company or not?
    - Market share, Financials, Brand value
    - Check the business plan thoroughly.
    - Whether the business is demanding or not? Is it profitable or not? It is feasible or not?
    - Are company's goals well-defined?
    - Is the company a leader, a follower or a niche?
    - Understand the strength and weaknesses of management.

If the intrinsic value of the stock is above the current market price, it indicates, the stock is undervalued in the market. This is the scope of investment. You may buy the share at this point as the market is going to boost the share's price eventually with time if other factors go in the favorable directions (Chowdhury, 2017).

When to apply fundamental analysis?
Under the following situations, fundamental analysis can help investors to stay gainer in the long- run:

a) Understanding macroeconomics can help in assessing the future business climate.

b) Fundamentals can provide insights into the effect of Fiscal and Monetary Policy on the direction of global markets.

c) Being able to accurately value a business can help understand the gap between actual stock price and actual worth – Value Investing.

d) Fundamentals are the only way to determine the overall health of an economy and how beneficial the climate is for doing business.

e) Understanding Industry & Sub Industry Business climates provide greater insights!

f) Easy access to analyze reports based on fundamental data (Chowdhury, 2019).

When to avoid the use of fundamental analysis?

Under the following situations, fundamental analysis should be avoided:

a) If understanding the theoretical concept and the relevant terminologies are quite tough.

b) When reality does not go with the theoretical framework and mislead the users.

c) There are so many facets to economics even economists cannot agree on solid core theory.

d) To be a value investor means you need to spend a lot of time on company accounts, reports and get close to companies. This means the scope of company coverage is more limited.

e) Just because a company on paper is under-valued does not guarantee that its stock price will increase (Chowdhury, 2019).

f) You could wait years for a stock price to make a significant move, which is ultimately wastage of time.

Technical Analysis

Technical Analysis is used to forecast the price of a share, which says that the price of a share of the company is based on the interaction of demand and supply forces, operating in the marketplace (Araf et al., 2022). It is used to forecast the future market price of the stock, as per the past performance statistics of the share. For this purpose, first of all, the changes in the price of the stock are ascertained, to know how the price will change in future (Chowdhury, 2021).

The price at which the buyer and seller of the share, decides to settle the deal, is one such value which combines, weighs and expresses all the factors, and is the only value which matters (Akhter et al., 2016). In other words, technical analysis gives you a clear and comprehensive view of the reason for changes in prices of a security (Chowdhury, 2018). It is based on the premise that the price of share moves in trends, i.e., upward or downward, relying upon the attitude, psychology and emotion of the traders (Chowdhury, 2022).

Tools used for Technical Analysis

a) Prices: The change in the price of securities is represented in the change in the attitude of the investor and the demand and supply of securities.
b) Time: The degree of price movement is a function of time, i.e. the time taken in the reversal of trend will determine the change in price (Chowdhury and Begum, 2012).
c) Volume: The magnitude of price changes can be seen in the transaction volume that characterizes the change. Suppose there is a change in the price of shares, but there is a small change in the transaction volume, then it can be said that the change is not very powerful (Chowdhury and Chowdhury, 2017).
d) Width: The quality of change in price, is gauged by ascertaining if the change in trend is dispersed across many industries or it is specific to a few securities only. It reflects the degree to which changes in the price of securities have taken place in the market as per the overall trend ((Chowdhury and Chowdhury, 2014).

When to follow technical analysis?

Under the following situations, use of technical analysis may give desired results:

a) If the price includes all the information available in the market, then the investor / speculator needs only price and volume data.
b) Technicians can analyze through their instruments any desired market or product. Thus, technical analysis can be used to track a wide range of instruments across multiple markets.
c) Charts can be used to analyze data for intervals ranging from hours to a century.
d) There are sufficient number of available tools of the technical analysis that are created to respond to the needs of different sectors of the market.

When to avoid the use of technical analysis?

a) When sufficient amount of data is not available.
b) When market is driven by rumors or investors do not act rationally.
c) When there is significant change in the policy formulations, government decisions, or change in the attitude of investors.
d) The technical analysis is based on the probability of an event happening and not on the certainty that it will happen;
e) If the tools are too general and accuracy of data is questionable.

Distinction between Fundamental and Technical Analyses

In the light of above discussion, the basic differences between the approaches are drawn below:

Basis	**Fundamental analysis**	**Technical analysis**
Relevant for	Long term investments	Short term investments
Function	Investing	Trading
Objective	To identify the intrinsic value of the stock.	To identify the right time to enter or exit the market.
Decision based on	Available information.	Market trends and prices of stock.
Focuses on	Both Past and Present data.	Past data only.
Form of data	Economic reports, news events and industry statistics.	Chart Analysis

Future prices	Predicted on the basis of past and present performance and profitability of the company.	Predicted on the basis of charts and indicators.
Type of trader	Long term position trader.	Swing trader and short-term day trader.

The Trade-off

There are several situations where both the technical and fundamental analyses can be used simultaneously (Chowdhury et al., 2022). The following are a few of them:

a) You can build a watchlist of stocks you are ready to own based on fundamental analysis, and then use technical analysis to decide if or when to buy them (Chowdhury et al., 2022).
b) Technical analysis can be used to find favorable entry levels for growth stocks that are in an uptrend. Companies that have high growth rates and trade on high valuations often experience large corrections. In such cases, technical analysis can be used to identify oversold levels. These are often the best opportunities investors will ever get to buy growth stocks (Chowdhury et al, 2022).
c) If a stock is trading close to its fair value, it makes sense for the price to consolidate or trade in its range. While the fundamental picture remains the same, you can use technical methods to trade within the range (Chowdhury et al, 2021).
d) Fundamental research can sometimes be used to determine which parts of a business cycle are most profitable for a company. Technical analysis can then be used to confirm anticipated trends (Chowdhury and Reza, 2013).
e) Simply looking at a price chart can give you an idea of the direction of a trend. This will give you an idea of whether the market agrees with your valuation or not. You should have a stronger conviction when going against the crowd and also be prepared to exit quickly if a stock is widely owned and the fundamentals change (Chowdhury and Nahar, 2017).
f) Quantitative studies have found that a combination of value and momentum can be an effective method of stock picking. Stocks trading on low valuations but with strong momentum tend to outperform (Chowdhury and Chowdhury, 2023).
g) Stocks can continue trading higher long after they become overvalued. Selling a stock just because it is expensive often means missing out on a large percentage of a rally. By using price and volume trends you can continue to hold the stock until the momentum is exhausted.

Conclusion

If you invest in such a company which is not listed on any organized bourse, fundamental analysis is all you have available to work with. When it comes to listed stocks, there is a lot that can be learnt from their trading history. The price of tradeable securities is also affected by a lot more than the underlying fundamentals. For these reasons, technical analysis does have value. However, for long term investors, it's important to have an idea of the value of a company. This is important when picking stocks to hold for the long term, to manage portfolio risk, and to know when to exit extended price moves. Finally, fundamental analysis is used to determine the direction, while technical analysis suggests timing and specific entry and exit points. Of course, nothing can guarantee that every trade is successful, but the use of appropriate tool and blending of both the approaches may bring desired results.

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