

INVESTING IN STOCK MARKETS

STOCK VALUATION PART - II

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Important Questions

1. What do you mean by 'valuation of stock'? Discuss the techniques of technical analysis used for valuation of stock.
2. What do you mean by charting? Briefly discuss some commonly used charts to predict the price behaviour of securities?
3. What is trend analysis? How resistance and support level are useful for investors?
4. Short Notes:
 1. Candle-Stick Chart
 2. Shareholding Pattern
 3. Hype-free investing

Valuation of Stock - Meaning

- Valuation of stock means to calculate the **fair market value or intrinsic value of stock** by using some technique or model.
- This fair value or intrinsic value of the share is **compared with its market price or traded price**.
- If Intrinsic value $<$ market price, it means share is **overpriced**.
- If Intrinsic value $>$ market price, it means share is **underpriced**.
- Investments should not be made in overpriced shares.
- An investor should **buy underpriced shares and sell overpriced shares**.

Approaches to Valuation of Stock

- There are basically **two main approaches/school of thoughts** to valuation of stock or to calculate the intrinsic value of shares:
 - 1. Fundamental Analysis Approach** (has already been covered in previous lecture)
 - 2. Technical Analysis Approach**

Technical Analysis Approach

- Under this approach, valuation of stock is done **on the basis of the study of past market data**. Past trends in stock prices are used to predict the future stock prices.
- **It is believed that all financial data like return and risk is already reflected in the stock prices.**
- Stock prices are determined by supply and demand.
- By studying the past behaviour of prices, future prices are predicted as technical analysis believes that **history repeats itself**.
- Such analysis is done to help the investor in taking investment decision.

Techniques/ Tools of Technical Analysis

Charting/ Graphical Representation

- Line Chart
- Bar Chart
- Japanese Chart
- Point & Figure Chart

Market Indicators

- Trend Analysis
- Moving Average Analysis
- Confidence Index
- Breadth of the Market
- Relative Strength

Charts

- Charts are **visual representation** of data that can help spot patterns and trends
- Security analysis requires charts to analyze earnings and sales growth
- Technical analysis requires charts to analyze price behavior
- Some commonly used charts are:
 - **Line Chart**
 - **Bar Chart**
 - **Japanese Chart**
 - **Point & Figure Chart**

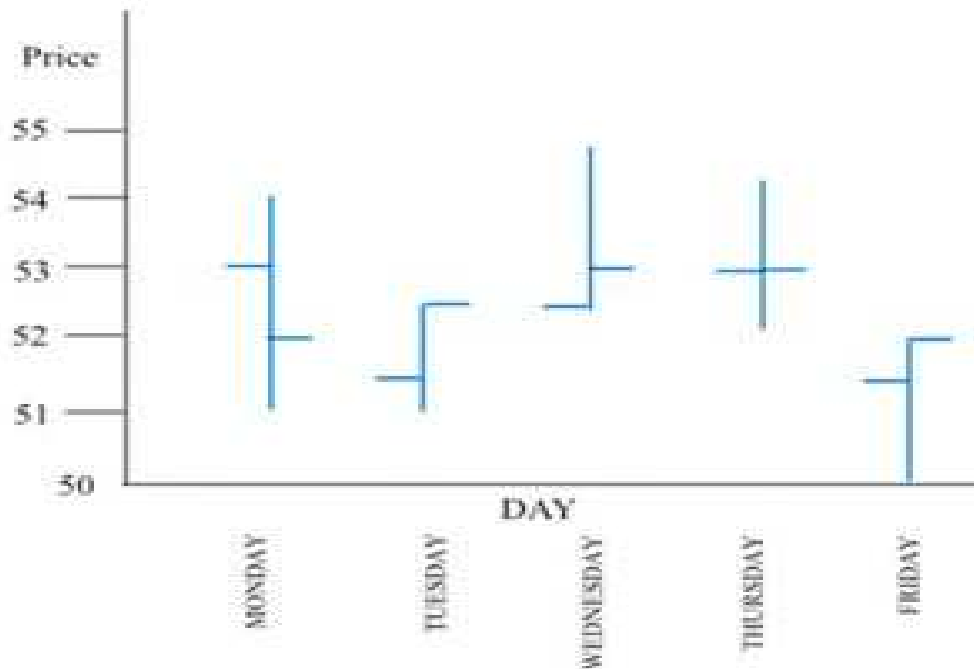
Line Chart

- **Simplest way** to present the movements in stock prices over time.
- Line charts generally **show the closing prices** of securities.



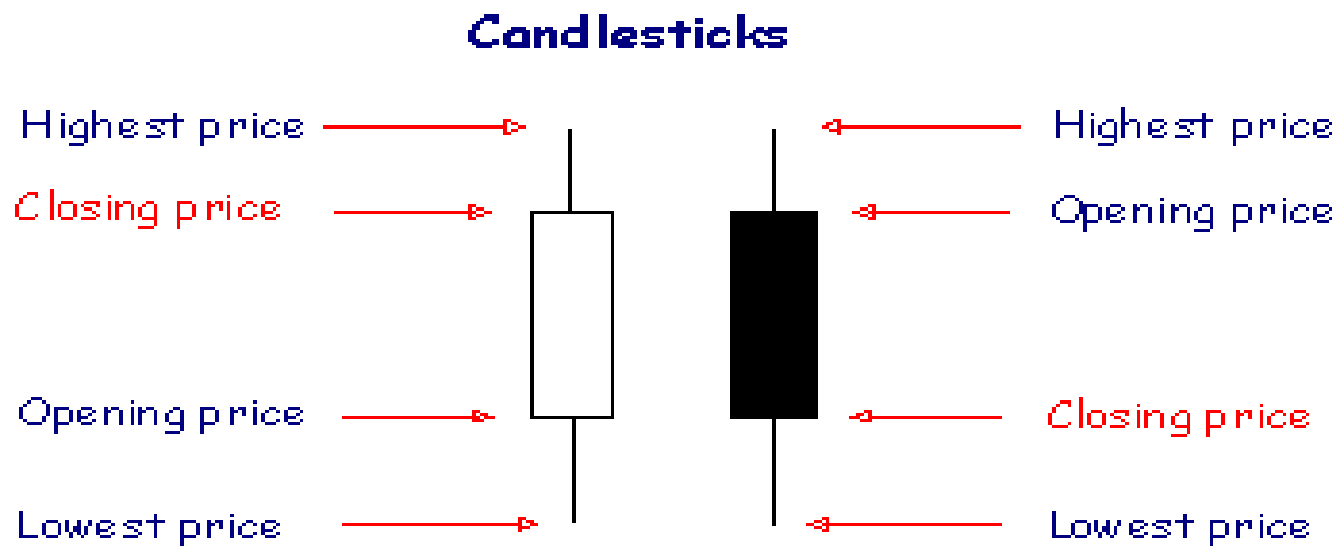
Bar Chart

- Shows **Open, High, Low, Close** prices of the day.
- Easy way to show volatility from day-to-day.



Japanese Chart / Candle-Stick Chart

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- Easy way to show volatility from day-to-day.



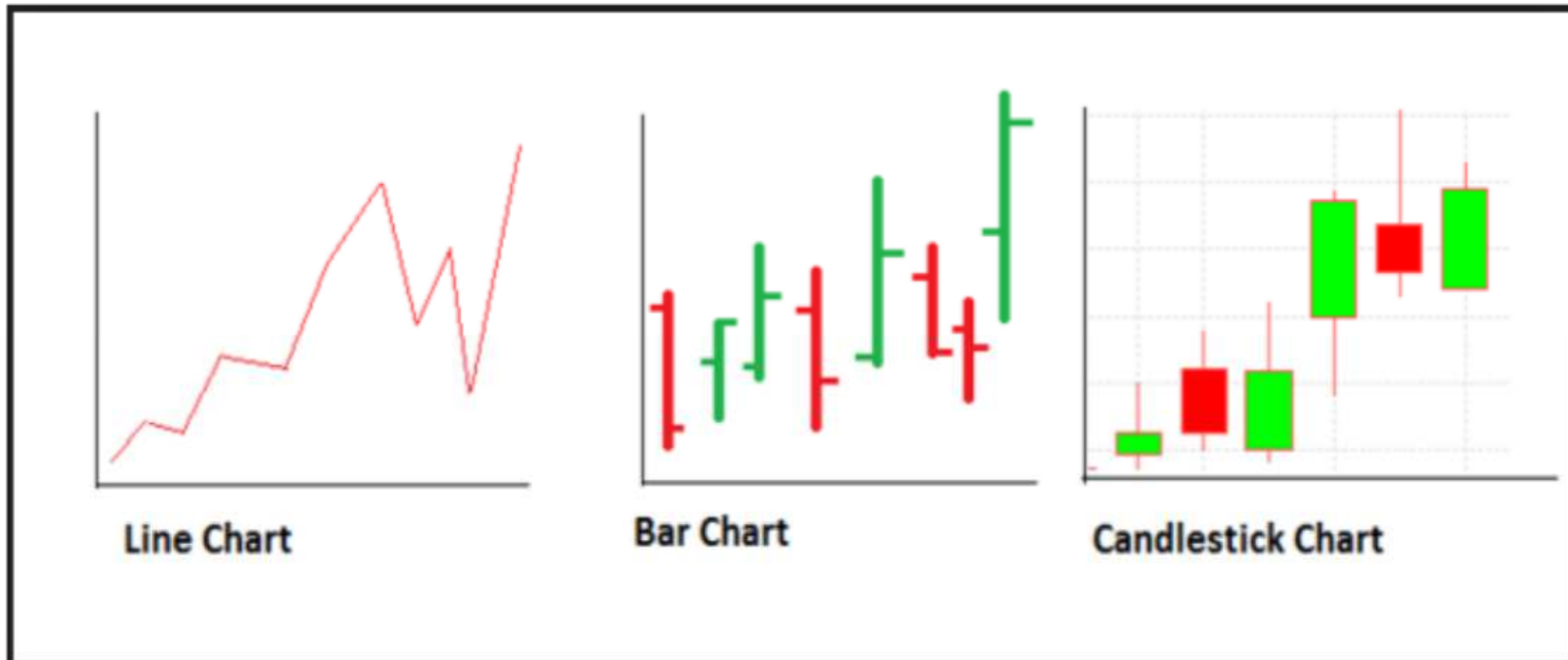
The body is filled if the open is higher than the close.

Point & Figure Chart

- Represents the price moving up by 'X' and price moving down by 'O'.
- Little difficult way to understand the information through this chart. So, normally not used to forecast prices.



TYPES OF CHARTS IN



TECHNICAL ANALYSIS

Market Indicators

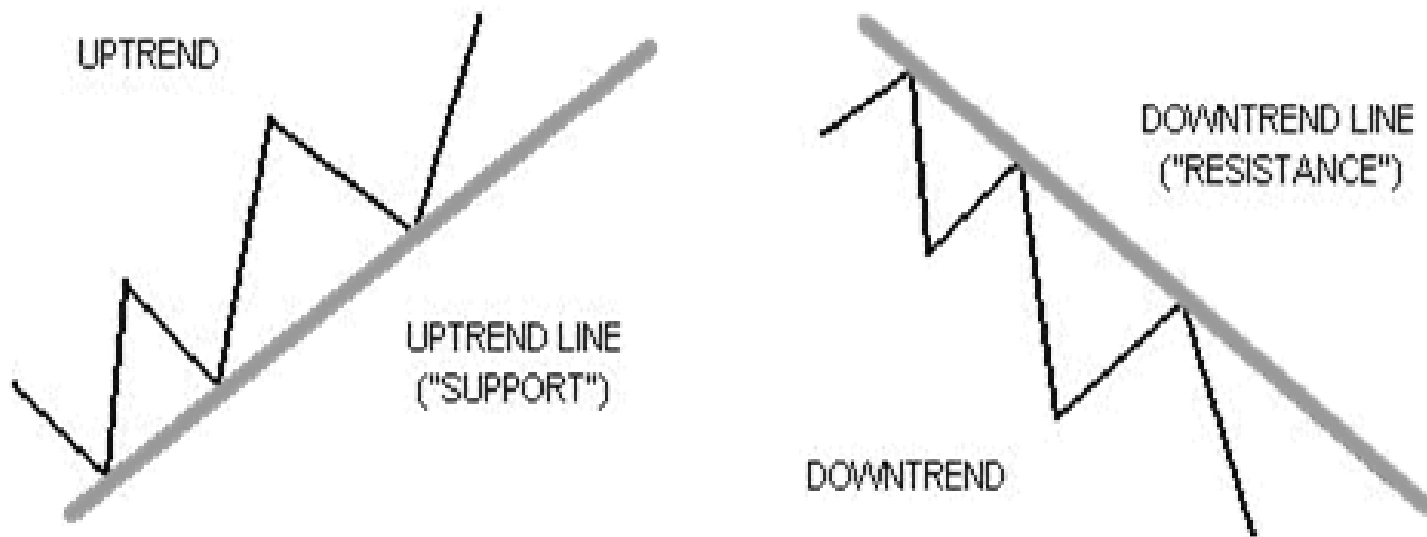
- **Trend Analysis**
- **Moving Average Analysis**
- **Confidence Index**
- **Breadth of the Market**
- **Relative Strength**

Trend Analysis

- Technical analysis is based on one major principle
 - trend. Based on historic prices, trend line is drawn.
- Trend identification is the **primary tool in price forecasting analysis.**
- Trend's direction may show:
 - Upward trend (successively higher peaks and higher troughs)
 - Downward trend (successively lower peaks and lower troughs)
 - Sideways trend (consolidation period where there is no clear direction in prices)

Trend Analysis

Trend line indicates the direction of movement in prices over a period of time.



Trend Reversals

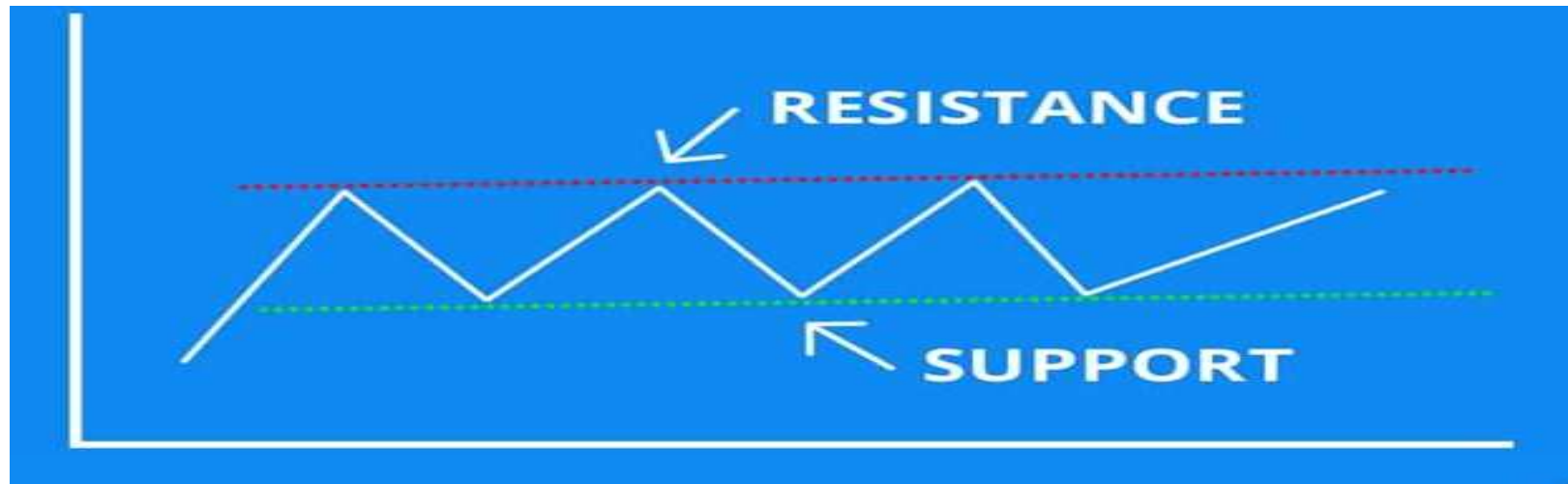
- A **trend reversal** occurs when the direction of a stock price changes and moves back in the opposite direction.
- Up **trends** that reverse into downtrends and downtrends that reverse into up **trends** are examples of **trend reversals**.



Support and Resistance Level

- Support and Resistance levels are the **identifiable turning points of the stock price trend**.
- Support and resistance levels are used to identify the price points on a chart **where the reversal of a prevailing trend happens**.
- **Support level indicates the lowest price below which the price doesn't tend to move down**. So, a downtrend is expected to pause/stop due to a concentration of demand.
- **Resistance level indicates the highest price above which share cannot go**. It occurs where an uptrend is expected to pause temporarily, due to a concentration of supply.

Support and Resistance Level



Moving Average Analysis

- The moving average is a simple tool of technical analysis that smoothens out the price data by creating a constantly updated average price.
- The average is taken over a specific period of time, like 10 days, 20 minutes, 5 weeks or any time period the trader chooses.
- So, moving average is a smoothed presentation of historical data of a stock.

Moving Average Analysis



- **Confidence Index:** A measure of investors' faith in the economy and the securities market. A low/deteriorating confidence level is considered as a bearish sign.
- **Breadth of the Market:** Market breadth is used in technical analysis to gauge the general direction of the stock market based on all traded stocks. It is calculated by dividing the number of stocks that have experienced gains by the number of stocks that have experienced losses.
- **Relative Strength:** Relative strength is a ratio of a stock price performance to a market average (index) performance.

References

- Investing in stock markets by Dr. R.S. Bhardwaj and Bhamini Garg
- Investing in stock markets by Prof. (Dr.) Vanita Tripathi and Neeti Panwar