Getting Started in Security Analysis

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The principles of successful investing have always been simple: buy low and sell high. The investor who can find the right stocks to buy at the right time will reap the rewards. Unfortunately, the information needed to make these potentially lucrative decisions is often difficult to come by, then hard to decipher, and rely on. Theories abound on the appropriate methodology for establishing valuation. They range from quasi-scientific disciplines to qualitative ones, and are often hard to understand by non-professionals. *Getting Started in Security Analysis* takes the reader through an introductory journey on the topic, from accounting and quantitative analysis to valuation and portfolio management.

The book is divided into three parts and seven chapters. The first part is concerned with "the tools of the trade," that is, the building blocks that the investor will use when constructing his portfolio. Chapter 1 gives a working knowledge of the basics of accounting. It includes topics such as the balance sheet and income statement, the valuation implications of some managerial policies (depreciation, inventory, etc.) as well as merger and acquisitions accounting methods. Of course, the information provided is not sufficient to perform an audit, but will allow a novice investor to read and understand financial statements. Chapter 2 deals with macro-economic information, such as the leading indicators announced periodically by governments, the mechanism of exchange rates and inflation, purchasing power and interest rate parity conditions, as well as the business cycle and investment timing. Chapter 3 explains the mathematics of the time value of money, from compounding (calculating future values) and discounting (calculating present values) to the valuation of annuities. The chapter emphasizes examples and problem sets (with solutions) rather than theories and complicated formulas. Finally, Chapter 4, "Quantitative Analysis," covers basic statistics (averages, measures of dispersion, confidence limits) and regression analysis (covariance, correlations). Although it may appear to be indirectly related to the investment field, the information provided in this chapter is the keystone of portfolio construction and monitoring.

Once armed with the tools learned in the first part of the book, the reader can proceed to the second part, which covers the methodologies underlying the valuation of financial securities. Chapter 5 deals with equity analysis and valuation methods. The framework is based mostly on dividend discount approaches, pulling together the concepts of performance (return on equity), risk (the Capital Asset Pricing Model) and growth. The chapter also includes relevant information on growth prospect estimation, and also on industry and qualitative factor evaluation. A complete case study (Merck & Company) combined with several problem sets and their solutions help reinforce the practical applications of the theory. Chapter 6 covers credit analysis, i.e. the future ability of a company to repay its debt. It describes several ratios (asset utilization and efficiency ratios, as well as performance, leverage and coverage ratios), credit ratings and their methodology, as well as the basic characteristics of bonds.

Finally, the third part of the book reviews the portfolio management process. This includes the investment policy statement (identifying an investor's needs and constraints), the capital market assessment (understanding risks and returns of various asset classes and securities), the asset allocation decisions (portfolio optimization and implementation), and investment monitoring and reporting. A first appendix briefly – and graphically – presents the key ideas of modern portfolio theory, and a second one discusses ethics in the financial industry, with a particular emphasis set on the Association for Investment Management and Research's recommendations. At the end of the book, an Internet index describes briefly some of the best free-access investment sites, according to the author.

There exists a large number of books on security analysis. They are generally full of financial ratios and accounting notions that are hard to understand for the newcomer. On the other hand, Klein's book keeps things simple, but never simplistic. It gives the reader an easy-to-understand, comprehensive, and readable explanation of determining corporate value and the investment management process. Examples and case studies facilitate a better understanding of the techniques. These factors make Klein's book an excellent resource to readers who are unfamiliar with the mechanisms of

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security analysis. It is an effective primer for more advanced works.

On the negative side, the book focuses mostly on stocks and neglects fixed income securities, though there are a few pages on bond valuation and bond ratings. This material should be extended and improved, or totally removed.

Surprisingly, there is also no mention of the distinction between the value of a security and its market price. While value may be assessed using techniques developed in the book, the market price of any stock represents a jumble of contradictory expectations and hypotheses, constantly influenced by investors processing new information and evaluating changing circumstances and forecasts. It is therefore foolish to expect a relentless convergence of market price toward investment value, at least in the short-term. A good illustration of that is the recent Internet bubble, and also the difficulties surrounding new-economy securities analysis. Unfortunately, these two topics are completely ignored in the book.

In conclusion, *Getting Started in Security Analysis* is a dynamic real-world antidote to the abstract approach to securities analysis found in other books on the subject. It is a very valuable book for anyone who wants an introduction to the mechanism of security valuation.

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