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BA Economics Honours | Semester 1 | Calicut University

Security Trading Practices

Course Code: ECO1FM105 • Module 2

Module II: Equity Selection

Successful security investment requires disciplined analytical methodologies to distinguish fundamentally sound, undervalued securities from overvalued or financially distressed enterprises. Equity analysis is traditionally anchored in two complementary intellectual paradigms: **Fundamental Analysis**, which evaluates intrinsic economic value, and **Technical Analysis**, which studies market price action, volume, and behavioral trends.

Unit 6: Fundamental Analysis: The E-I-C Framework

Fundamental analysis evaluates the true intrinsic value of an equity share by analyzing the underlying economic, financial, and managerial realities of the enterprise. It operates through the hierarchical **Economy-Industry-Company (EIC) Framework**:

1. **Economic Analysis:** Assessing macroeconomic indicators: national GDP growth trajectory, monetary policy stance (repo rates), inflation trends, fiscal deficit, foreign exchange stability, and sovereign capital expenditure cycles. A booming macroeconomic environment creates expanding market opportunities for corporate earnings.
2. **Industry Analysis:** Evaluating the competitive structure, regulatory policies, technological disruption, and lifecycle stage of the specific industrial sector (using Michael Porter’s Five Forces Framework: threat of new entrants, bargaining power of suppliers, bargaining power of buyers, threat of substitute products, and competitive rivalry).
3. **Company Analysis:** Conducting qualitative assessments of corporate governance, promoter integrity, management capability, competitive advantage ("economic moats" such as patents, brands, and network effects), and quantitative analysis of corporate financial statements (Balance Sheet, Profit & Loss Statement, and Cash Flow Statement).

Unit 7: Key Valuation and Financial Ratios

Fundamental analysts utilize specialized financial ratios to evaluate corporate valuation, profitability, capital efficiency, and leverage:

- **Price-to-Earnings (P/E) Ratio:**

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  $$P/E = \frac{\text{Market Price per Share}}{\text{Earnings Per Share (EPS)}}$$

  Where: *P/E* compares current market share price to annual Earnings Per Share (EPS). High multiples indicate strong anticipated earnings growth or overvaluation.

  Measures how much capital market investors are willing to pay for every rupee of current corporate profit. A high P/E indicates high future growth expectations or potential market overvaluation.

- **Price-to-Book (P/B) Ratio:**

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$$P/B = \frac{\text{Market Price per Share}}{\text{Book Value per Share}}$$

Where: *P/B* compares market share price to accounting Book Value Per Share (net asset value). Vital valuation metric for capital-intensive firms and financial institutions.

Compares market valuation to the accounting net asset value of the company; widely utilized for asset-heavy banking and manufacturing sectors.

- **Dividend Yield:**

Dividend Yield

$$\text{Dividend Yield} = \frac{\text{Annual Dividend per Share}}{\text{Market Price per Share}} \times 100$$

Where: *Dividend Yield* measures annual dividend cash return relative to current market share price: *(Annual Dividend / Market Price) × 100*.

Measures direct cash income return on share investment.

- **Return on Equity (ROE):**

Return on Equity (ROE)

$$ROE = \frac{\text{Net Income}}{\text{Shareholders' Equity}} \times 100$$

Where: *ROE* measures net income returned as a percentage of shareholders' equity capital, evaluating management's capital allocation efficiency.

Measures how effectively management deploys shareholder capital to generate profits (analyzed via DuPont decomposition into profit margin, asset turnover, and financial leverage).

- **Return on Capital Employed (ROCE):**

Return on Capital Employed (ROCE)

$$ROCE = \frac{\text{EBIT}}{\text{Total Capital Employed (Debt + Equity)}} \times 100$$

Where: *ROCE* measures operating profit (EBIT) generated per unit of total capital employed (debt + equity), independent of financing structure.

Measures operating profitability generated from all capital deployed, independent of capital structure financing choices.

- **Enterprise Value to EBITDA (EV/EBITDA):**

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$$EV = \text{Market Cap} + \text{Total Debt} - \text{Cash}$$

Where: *EV* represents total enterprise value (Market Cap + Total Debt - Cash), and *EBITDA* reflects operational cash profit before capital structure adjustments.

$EV/EBITDA$ normalizes for differences in capital structure, depreciation methods, and taxation across competing firms.

Unit 8 & 9: Technical Analysis: Philosophy and Core Tools

Technical analysis is the study of historical market price action, trading volumes, and chart patterns to forecast future price movements. It rests upon three foundational premises:

1. *The Market Discounts Everything:* All fundamental information, economic data, company news, and market psychology are already priced into the current stock price.
2. *Prices Move in Trends:* Stock prices do not fluctuate randomly; they move in persistent trends (Uptrend: higher highs and higher lows; Downtrend: lower highs and lower lows; Sideways/Consolidation: horizontal trading ranges).
3. *History Repeats Itself:* Human trading psychology (greed and fear) produces recurring geometric chart patterns over time.

Core Technical Charting Techniques

- **Japanese Candlestick Charts:** Each candlestick depicts price action over a specified time interval through four price points: Open, High, Low, and Close (OHLC). A green (bullish) candle forms when Close > Open; a red (bearish) candle forms when Close < Open. Key candlestick patterns include the *Hammer* (bullish reversal at bottoms), *Shooting Star* (bearish reversal at tops), *Bullish Engulfing*, and *Doji* (indecision).
- **Support and Resistance:** *Support* is a horizontal price level where buying interest is strong enough to overcome selling pressure and halt price declines. *Resistance* is a price level where selling pressure overcomes buying interest and halts price advances. When resistance is broken upward, it flips to become future support.
- **Technical Indicators:**
  - *Moving Averages:* Simple Moving Average (SMA) and Exponential Moving Average (EMA). Golden Cross (50-day EMA crossing above 200-day EMA) signals a long-term bull market; Death Cross signals a bear market.
  - *Relative Strength Index (RSI):* A momentum oscillator bounded between 0 and 100. RSI > 70 indicates an **overbought** condition (ripe for pullback); RSI < 30 indicates an **oversold** condition (potential bounce).
  - *MACD (Moving Average Convergence Divergence):* Evaluates trend momentum through the interaction of 12-period and 26-period EMAs against a 9-period signal line.

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Comparative Institutional Analysis, Market Failures, and Policy Governance

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Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
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	distribution is secondary to allocative efficiency.	historical wealth accumulation shape distribution.	human capital investments.
Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

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Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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