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# **Against The Top Down Approach To Picking Stocks**

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If you have heard fund managers talk about the way they invest, you know a great many employ a top down approach. First, they decide how much of their portfolio to allocate to stocks and how much to allocate to bonds. At this point, they may also decide upon the relative mix of foreign and domestic securities. Next, they decide upon the industries to invest in. It is not until all these decisions have been made that they actually get down to analyzing any particular securities...

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A stock earnings yield is the inverse of its P/E ratio. So, a stock with a P/E ratio of 25 has an earnings yield of 4%, while a stock with a P/E ratio of 8 has an earnings yield of 12.5%. In this way, a low P/E stock is comparable to a high yield bond.

Now, if these low P/E stocks had very unstable earnings or carried a great deal of debt, the spread between the long bond yield and the earnings yield of these stocks might be justified. However, many low P/E stocks actually have more stable earnings than their high multiple kin. Some do employ a great deal of debt. Still, within recent memory, one could find a stock with an earnings yield of 8-12%, a dividend yield of 3-5%, and literally no debt, despite some of the lowest bond yields in half a century. This situation could only come about if investors shopped for their bonds without also considering stocks. This makes about as much sense as shopping for a van without also considering a car or truck.

All investments are ultimately cash to cash operations. As such, they should be judged by a single measure: the discounted value of their future cash flows. For this reason, a top down approach to investing is nonsensical. Starting your search by first deciding upon the form of security or the industry is like a general manager deciding upon a left handed or right handed pitcher before evaluating each individual player. In both cases, the choice is not merely hasty; it is false. Even if pitching left handed is inherently more effective, the general manager is not comparing apples and oranges; he is comparing pitchers. Whatever inherent advantage or disadvantage exists in a pitcher's handedness can be reduced to an ultimate value (e.g., run value). For this reason, a pitcher's handedness is merely one factor (among many) to be considered, not a binding choice to be made. The same is true of the form of security. It is neither more necessary nor more logical for an investor to prefer all bonds over all stocks (or all retailers over all banks) than it is for a general manager to prefer all lefties over all righties. You needn't determine whether stocks or bonds are attractive; you need only determine whether a particular stock or bond is attractive. Likewise, you needn't determine whether "the market" is undervalued or overvalued; you need only determine that a particular stock is undervalued. If you are convinced it is, buy it - the market be damned!

Clearly, the most prudent approach to investing is to evaluate each individual security in relation to all others, and only to consider the form of security insofar as it affects each individual evaluation. A top down approach to investing is an unnecessary hindrance. Some very smart investors have imposed it upon themselves and overcome it; but, there is no need for you to do the same.

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