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Top-Down and Bottom-Up Analysis: Why Choose between the Two?

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We recently got asked in a meeting whether our team's macro insights change how we implement our valuation process in stocks country by country. It's an interesting question we had never answered but nevertheless have thought about constantly when executing our top down-bottom up process for the last seven years.
The answer in the vast majority of cases is "no." Cash flow is cash flow, balance sheets are balance sheets. In general, we approach security analysis pretty much the same around the world. There are accounting measures to master and we've also learned over time the countries where we can trust the numbers and the ones where we can't.

As we thought more about answering this question, some important exceptions quickly came to mind, which have been some of our highest value decisions over the years:

1. **If we expect a currency to significantly depreciate in an economy with significant trade activity, price-to-earnings (P/E) ratios aren't going to help much. If that currency forecast turns out to be right, importer earnings are overstated and exporter earnings are understated. In this case, it is very clear where we are looking first—which is exporters—and we are adjusting earnings fairly dramatically in some cases. In the event we choose to buy an export-centric stock, we are doing one more thing and hedging that currency into something else. For us, this was Japan in 2013.**
2. **We have seen situations where interest rates are very high and think they are going to fall a lot. Interest rates are the building block of valuation because they determine the discount rate. In 2015, Brazilian stocks may have very well been fairly valued using the market interest rate like the formula would tell investors to do; however, those who subscribed to this practice missed doubles. Instead, based on macro research, we expected the central bank to start cutting rates and then made that adjustment in our valuations.**
3. **Our dream case is rare, but occasionally the macro insight points us right to the bullseye. In Mexico today, real interest rates are among the highest in the world, and we think the 25 basis point rate cut in August could be the first of several. Real estate investment trusts (REIT) are highly interest-rate sensitive, and in Mexico, REIT shares are depressed. We think this is a case where value investors could buy the best company in a sector with a very strong macro catalyst. An analyst doing security analysis without that macro insight may come to a different valuation conclusion on what is now considered one of our highest conviction positions today.**

So while our macro insights may not supplant the fundamental metrics and tools that a traditional value equity investor uses, this top-down approach certainly enhances our valuation work. We see merit in both top-down and bottom-up strategies, so why choose between the two?

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