TED Lesson: How do investors choose stocks?

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By Richard Coffin
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Every day, billions of stocks are traded on the New York Stock Exchange alone. But with over 43,000 companies listed on stock exchanges around the world, how do investors decide which stocks to buy?

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To answer this question, it’s important to first understand what stocks are, and what individuals and institutions hope to achieve by investing in them.

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Stocks are partial shares of ownership in a company. So by buying a stock, investors buy a share in the company’s success— or failure— as measured by the company’s profits. A stock’s price is determined by the number of buyers and sellers trading it; if there are more buyers than sellers, the price will increase, and vice versa. The market price of a share therefore represents what buyers and sellers believe the stock, and by association the company, is worth. So the price can change dramatically based on whether investors think the company has a high potential for increasing profitability— even if it isn’t profitable yet.

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Investors aim to make money by purchasing stocks whose value will increase over time. Some investors aim simply to grow their money at a faster rate than inflation diminishes its value. Others have a goal of “beating the market,” which means growing their money at a faster rate than the cumulative performance of all companies’ stocks. This idea of “beating the market” is a source of debate among investors— in fact, investors break into two main groups over it. Active investors believe it is possible to beat the market by strategically selecting specific stocks and timing their trades, while passive investors believe it isn’t usually possible to beat the market, and don’t subscribe to stock picking.

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The phrase “beating the market” usually refers to earning a return on an investment that exceeds the Standard & Poor 500 index. The S&P 500 is a measure of the average performance of 500 of the largest companies in the United States, weighted by company valuation, meaning that companies with a higher market value have a larger effect on the S&P— again, market value corresponds to what investors believe a company is worth rather than actual profits. The S&P doesn’t directly represent the market as a whole— many small and mid-range stocks can fluctuate according to different patterns. Still, it’s a pretty good proxy for the overall market. It’s often said that “the stock market behaves like a voting machine in the short term, and a weighing machine in the long term”— meaning short term fluctuations in stock prices reflect public

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opinion, but over the longer term, they do tend to actually reflect companies' profits.

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Active investors aim to exploit the short term, “voting machine” aspect of the market. They believe the market contains inefficiencies: that stock prices at any given point in time may overvalue some companies, undervalue others, or fail to reflect developments that will impact the market. Active investors hope to exploit these inefficiencies by buying stocks they think are priced low. To identify undervalued stocks, they may investigate a company's business operations, analyze its financial statements, observe price trends, or use algorithms.

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Passive investors, by contrast, put their faith in the long term “weighing machine” aspect of the market. They believe that even though markets may exhibit inefficiencies at any given point, over time those inefficiencies balance out— so if they buy a selection of stocks that represents a cross-section of the market, over time it will grow. This is usually accomplished through index funds, collections of stocks that represent the broader market. The S&P 500 index is one of many indexes. The overall goal is the same for all index funds: to hold stocks for the long term and ignore short-term market fluctuations.

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Ultimately, active and passive investing aren't mutually exclusive— many investment strategies have elements of each, for example, choosing stocks actively but holding them for the long term as passive investing advises. Investing is far from an exact science: if there was one foolproof method, everyone would be doing it.

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