STOCK ANALYSIS WORKSHOP

Going Against the Crowd: A Look at The Contrarian Investment Strategy

By Maria Crawford Scott

Men are from Mars; women are from Venus.

And stock investors are from . . ?

According to efficient market academics, stock investors are from Vulcan, home planet of Star Trek's totally rational and unemotional Mr. Spock.

The theorists, of course, are referring to the market as a whole. But anyone who has put their own money into the market knows that investment judgments can be affected by emotions.

One approach that seeks to understand and profit from such investor misjudgments is the contrarian strategy—going against the crowd by seeking stocks that are out-of-favor with the market, and avoiding the high-flying fashionable stocks that have been swept up in market euphoria. Eventually, of course, the market rediscovers out-of-favor stocks and lets the high-fliers fall back to earth; contrarian investors have a chance to profit from the rediscoveries.

The person most associated with the term "contrarian" is David Dreman, chairman of Dreman Value Advisors and also a regular columnist in Forbes magazine. Mr. Dreman began writing about stock market psychology in the 1970s and detailed his approach in a highly popular book, "Contrarian Investment Strategy—The Psychology of Stock Market Success" (published in 1979 by Random House and updated in 1982 under the title "The New Contrarian Investment Strategy." The book is very readable, but out-of-print, so check your library for copies). The book is the primary source for this article.

Mr. Dreman feels that institutional investors and research analysts are particularly prone to psychological biases and "running with the crowd" and his contrarian approach is therefore well-suited for individual investors.

Why Contrarian Stocks: The Philosophy

Dreman contends that psychological biases tend to interfere with sound investment decisions. Investors who understand these biases can prevent them from overwhelming their own decisions, and they can profit from the biases in others.

Many of the psychological biases occur because of information-processing short-cuts that everyone uses in daily life. For example, when driving a car, attention is focused on information that directly affects driving, while other distracting information is screened out. Individuals also use probabilities to judge everyday events—they are "intuitive statisticians."

But these mental short-cuts can lead to bad investment decisions when they are carried over to stock market decisions. For instance:

- Investors tend to base decisions on information that is insufficient, drawn from a sample that is too small. The best example Dreman points to is investors who flock to mutual funds with the hottest record over the past year—the record upon which they are judging the fund is too brief.
- Investors tend to immerse themselves in the unique details of a particular situation, and at the same time, they ignore the probabilities based on prior situations that are similar. And the more "certain" an individual is of the particular, the less weight that is given to the prior probabilities. An example is the popularity of hot new issues, which investors tend to view as unique opportunities without examining the high probability of loss that frequently exists in the area.
- Investors tend to be drawn to situations that are currently performing above the average and assume that the high level of performance will continue, even though most stocks do not deviate from the long-term averages for very long.
- Investors' inclinations are reinforced when others interpret information in the same way, so market confirmations and agreement can lock in an individual's position. Similarly, investors tend to demand immediate feedback—if they view a stock as promising, they want this to be immediately confirmed by a quick price rise.
- Investors tend to misread probabilities, putting great em-

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phasis on recent or emotional events, whether positive or negative.

- Investors tend to have hindsight blindness—they look at their past errors and feel that the mistake made would have been "obvious" if they hadn't been blinded by an overly optimistic or overly pessimistic view. The problem with hindsight blindness, Mr. Dreman points out, is that it interferes with a proper assessment of past errors, and prevents the investor from learning from his mistakes.

Investment fads and market overreactions tend to occur when many of these factors are combined: A fashionable investment is "proven" by recent statistics that are easy to recall and is further confirmed by the market in the form of rising prices. All of these biases are used to project the current short-term trend far into the future, even though such a performance would not be representative of most stocks over long time periods. And once the mistake is discovered, the investor in hindsight sees the errors as obvious and can't figure out why he went along with the fad.

The trick for investors, according to Mr. Dreman, is to get the biases working for you, rather than against you.

How?

First, observe the four rules laid out to help avoid falling prey to the biases yourself:

- Rule 1: Don't be influenced by a hot performance record.
- Rule 2: Don't rely solely on the specific situation, but take into account prior probabilities of similar situations. The greater the uncertainty, the less emphasis you should place on your own unique appraisal.
- Rule 3: Don't be seduced by recent rates of investment return for individual stocks when they deviate sharply from past norms. For investors, longer-term characteristics of stocks are far more likely to be established again.
- Rule 4: Don't expect the strategy you adopt to prove a quick success.

Second, follow Mr. Dreman's fifth rule, which is to favor stocks that are out-of-favor with the market as indicated by low price-earnings ratios.

His rule essentially attempts to profit from the biases in others. These biases are particularly strong in security analysis, according to Mr. Dreman, because so much emphasis is placed on earnings projections. Earnings, of course, drive stock prices, so if you can correctly forecast earnings, you can predict future stock prices.

However, to be valuable, earnings forecasts must be very accurate and projected far into the future, a task that Mr. Dreman says is beyond the capabilities of most analysts, who fall prey to the same psychological biases.

He points to considerable research that shows forecasters are often wide of the mark even when forecasting out for less than one year, much less the much longer-term period required for successful price prediction. One study even found that forecasters' long-term forecasts tended to be simple linear extensions of current trends, rather than estimates that take into consideration other factors such as a company's management skills or market condition. Another study found that forecasters tend to be farthest off during periods of changing economic conditions.

If there is so much evidence that accurate predictions aren't possible, why do people still attempt it? Because most people intuitively feel that it must be possible, according to Mr. Dreman.

On the other hand, there is one variable that Mr. Dreman finds to be very predictable: the continuous overreaction of a person whose assessment of a firm's earnings is wrong. And it is upon that predictable variable that Mr. Dreman bases his investment approach: Avoid the stocks the crowd is pursuing, and pursue the ones they are avoiding.

High price-earnings ratio stocks have earnings growing much higher than average and are favored by the crowd. Market prices tend to move even faster than the earnings, and this provides investors with "confirmation" that the projections were correct. But most companies do not perform at above-average levels for long time periods and when earnings growth starts heading toward the "norm," the negative reaction from holders is strong.

Conversely, stocks whose earnings are doing poorly are disfavored, have low price-earnings ratios and their prices remain mired down, offering "confirmation" that the stock is not a good choice, while chances are the company will eventually move back up.

While that doesn't mean there aren't good stocks with justifiably high price-earnings ratios, and others with justifiably low ratios, the odds—and psychological biases—are working in your favor with the lower price-earnings ratio companies.

The Dreman Approach

Mr. Dreman recommends a low price-earnings strategy that is relatively simple and eliminates the need for complicated security analysis. His primary approach has three simple rules:

- Choose from a universe of medium- to large-sized companies, since these firms are more in the public eye and thus there is less chance of accounting gimmickry, and since these firms have more staying power and are less likely to go out of business than smaller companies or start-ups.
- Buy low price-earnings ratio stocks—those that are among the bottom 40% of stocks ranked by price-earnings ratio and have ratios below that of the S&P 500.
- Hold equal amounts of 15 to 20 stocks that are in 10 to 12 different industries for diversification, so that you are not dependent on only one stock or industry to do well.

Choosing among the bottom 40% of stocks ranked by price-earnings ratio provides a fairly large but manageable universe from which to choose. How do you further cull down the list of stocks?

Mr. Dreman does not totally discount the use of fundamental analysis, but only the heavy emphasis on complicated forecasting techniques with the high potential for error. His "eclectic approach" adds several conditioning screens that require judgment, but are based on easy-to-find (or calculate) financial ratios:

- The stock should provide a high dividend yield that can be maintained or, preferably, raised. A high dividend yield

The David Dreman "Eclectic" Approach in Brief

Philosophy and style

Psychological biases tend to interfere with sound investment decisions, but investors who understand these biases can prevent them from affecting their own judgment and can profit from the biases in others.

To prevent the biases from affecting your own decisions:

- Don't be influenced by a hot performance record.
- Don't rely solely on the specific situation, but take into account prior probabilities of similar situations.
- Don't be seduced by recent rates of investment return for individual stocks when they deviate sharply from past norms; use long-term stock characteristics.
- Don't expect the strategy you adopt to prove a quick success

To profit from the biases of others:

- Favor stocks that are out-of-favor with the market as indicated by low price-earnings ratios.

Universe of stocks

Large and medium-sized companies, which offer a level of stability and staying power.

Criteria for initial consideration

- Buy low price-earnings ratio stocks: those that are among the bottom 40% of stocks ranked by price-earnings ratio and have ratios below that of the S&P 500.
- Hold equal amounts of 15 to 20 stocks that are in 10 to 12 different industries for diversification.

Secondary factors

- The stock should provide a high dividend yield that can be maintained or, preferably, raised.
- The company should have a strong financial position: high ratios of current assets relative to current liabilities; low debt as a percentage of equity; and low payout ratios (dividends per share divided by earnings per share).
- The company should have favorable operating conditions, such as high returns on equity and high pretax profit margins relative to others in the industry.
- The company should have a higher rate of earnings growth than the S&P 500 both in the recent past and projected one year down the road. In assessing earnings growth, make sure to understand a company's main line of business, its components, and which components add the most.
- When making an assessment of the general direction of earnings, use conservative earnings estimates.
- For "high-rollers": Buy stocks that show a loss, but be sure of a company's financial strength, and that the company's assessment of the reason for the loss is sound, and it is taking steps to fix the problem. In addition, use only a small portion of your portfolio for this strategy.

Stock monitoring and when to sell

- Portfolios should contain at least 12 to 15 stocks for adequate diversification, but portfolios should be kept to a manageable size.
- Stocks should be sold when their price-earnings ratios approach that of the overall market, regardless of how favorable prospects look. However, stocks that reach high ratios solely because of an earnings decline should not be sold, since the price drop is likely an overreaction to the earnings decline. When stocks are sold, they should be replaced with low price-earnings ratio stocks.
- You can substitute better stocks for ones you already own, but do so selectively and avoid overtrading.
- Use a two-year holding period as a test to weed out stocks that aren't going anywhere: If a stock has not done as well as the overall market over the two-year time period, sell it and replace it.
- Sell a stock if you see management behaving badly or acting only in its own self-interest.

provides a measure of protection when prices drop and also helps add to an investor's overall total return. Mr. Dreman considers this to be a crucial indicator that is dependent on all the other indicators being positive.

- Make sure the company has a strong financial position that will allow it to weather unfavorable economic conditions, a particular problem for companies with low price-earnings ratios. It is also a factor in ensuring that a company can maintain or increase its dividend payments. Investors should use the standard measures for financial strength: high ratios of current assets relative to current liabilities; low debt as a percentage of equity; and low payout ratios (dividends per share divided by earnings per share), which indicate the company is in a good position to raise dividends, assuming it does not need earnings for extraordinary expenditures.
- Look for as many favorable operating conditions as possible, in particular high returns on equity and pretax profit margins, to ensure there are no structural flaws in the company.
- The company should have a higher rate of earnings growth than the S&P 500 both in the recent past and projected one year down the road. Mr. Dreman says he is not recommending an exact estimate of future earnings, but a general sense of direction of the firm's earnings growth. The path that earnings are going to take can be judged based on the condition of the company and the industry in general. In addition, in assessing earnings growth prospects, it is important to understand a company, its main line of business and future prospects, its components, and which components add the most to earnings. The companies being considered already have very low growth expectations that are reflected in a discounted price, so if you are wrong in your assessment, you haven't paid for your error. If you are right and earnings grow faster than the market, the stock will do very well. The risk-reward level, in Mr. Dreman's view, is highly favorable—not much downside, but a good deal of upside if you are right.
- When making an assessment of the general direction of earnings, use conservative earnings estimates, to provide

a margin of safety.

For "high-rollers," Mr. Dreman suggests buying stocks that show a loss. The strategy takes advantage of market overreactions to bad news. Investors always shun stocks reporting losses, and Mr. Dreman points to several studies indicating excess returns over one-year and five-year periods from stocks purchased one year after reporting losses. Mr. Dreman says investors using this approach should be very sure of a company's financial strength. They should also make sure the company's assessment of the reason for the loss is sound and that it is taking steps to fix the problem. The investor should be seeking companies that have stumbled temporarily; the risk, of course, is that it won't be temporary, but this risk is lower for larger corporations. However, Mr. Dreman cautions that investors should devote only a small portion of their portfolio to this strategy.

Mr. Dreman presents a number of examples. While the examples are dated (some recommendations go back to the 1970s), they provide an illustration of his approach. All of the companies had primarily strong fundamental criteria at the time he made the recommendation, but had fallen out of favor for various reasons. These include:

- General Cinema, which suffered badly from the 1974 credit crunch and investors became alarmed at the firm's debt as a percentage of equity. At the time, however, the firm was reducing debt absolutely and as a percentage of equity because of the pace of earnings.
- Honeywell, which had been an institutional favorite, but fell out of favor when profits started to slip in the computer business relative to competitors. At the time, however, other components of the company were adding a greater amount to its bottom-line earnings.
- Bache and Aetna Life and Casualty, both of which were in industries that were highly disfavored at the time of the recommendations. Both, however, were dealing with the problems of their industry better than competitors.

More Mechanical

Mr. Dreman also believes that more mechanical approaches are feasible using his basic low price-earnings ratio approach. Such portfolios would consist of 15 to 20 medium- to large-sized companies diversified among 10 to 12 industries. Three primarily mechanical approaches are outlined:

- Buy-and-hold for a long period of time (three to nine years) the lowest 20% of price-earnings ratio stocks. Alternatively, an investor could pick a large company paying good dividends that is priced at a 20% discount or more from the S&P 500.
- Buy low price-earnings stocks and weed the holdings periodically as the ratios improve or if a stock fails to perform as well as the market over a given time period. He suggests, however, that investors keep the number of trades per year low.
- Purchase the lowest 20% of price-earnings ratio stocks, and re-apply the screen annually. Mr. Dreman says the approach may appear to be high turnover at first glance, but notes that usually less than half of low price-earnings ratio stocks move up in less than a year.

When to Sell

A positive side benefit from the approach, according to Mr. Dreman, is a low portfolio turnover. He notes that low price-earnings ratio stocks can move much higher in price and still be good holdings if earnings are moving up rapidly enough so that the ratio remains low.

Mr. Dreman recommends a portfolio size of roughly 12 to 15 stocks for adequate diversification. But he also suggests that investors keep their portfolios to a manageable size.

Stocks should be sold when their price-earnings ratios approach that of the overall market, regardless of how favorable prospects look. The stock should then be replaced with another low price-earnings ratio stock. On the other hand, a stock that attains a high price-earnings ratio solely because of an earnings decline should not be sold, since the price drop is likely an overreaction to the earnings decline.

While he warns against overtrading, he also suggests a strategy of substituting a better stock for one you already own.

What about stocks that simply don't seem to be going anywhere? He suggests a two-year holding period as a test. If a stock has not done as well as the overall market over the two-year time period, sell it and replace it.

Lastly, Mr. Dreman says you should part with a stock if you see management behaving badly or acting only in its own self-interest.

Dreman in Summary

Mr. Dreman's contrarian investment strategy provides a disciplined approach that seeks to take emotions out of the decision-making process. It is also a classical value approach that offers a somewhat different slant on the underlying philosophy. The reasoning, though, provides investors with useful insights on how underlying behavioral traits can lead to investment mistakes.

The important point is that investors can only profit when making intelligent decisions that are contrary to the consensus thinking that is reflected in the market prices of many companies. And that is difficult to do, unless you understand where the common mistakes are made. On the other hand, it is an approach that is easier for individuals to implement.

Writing in 1982, Mr. Dreman summed up:

"When I was a student reading the newspapers of the 1930s, 1940s and 1950s, I was amazed by the value so abundant in the stock markets of those days and felt a little cheated because I thought the great days of investment coups all lay in the past.

Today, nothing seems further from the truth. Institutional concentration, conformity pressures on professionals, and overreactions to the current economic problems seem to me to present the investor with some of the greatest stock market opportunities in decades."