The philosophy and investment style of David Dreman was examined by Maria Crawford Scott in the July 1997 issue of the *AAII Journal*. David Dreman has long studied the psychological underpinnings of the overall stock market and its impact upon valuation levels. Unlike the rational market assumed by traditional academic studies, Dreman sees stocks and markets driven by emotions that often push prices from their intrinsic value. Dreman feels the best approach to beating the market is to follow the principles of contrarian investing.

Contrarian investing is a disciplined investment approach using value measures that helps to avoid the emotional traps of the market. The contrarian strategy seeks to profit from other investors’ misjudgments by seeking stocks that are out-of-favor with the market and avoiding the high-flying fashionable stocks that have been swept up by market euphoria. Eventually the market rediscovers out-of-favor stocks and lets the high-flyers fall back to earth.

David Dreman is one of those most associated with contrarian investing through his books and long-running Forbes column. He began writing about stock market psychology in the early 1970s through his first book, “Psychology and the Stock Market.” Dreman followed up this work in 1979 with “Contrarian Investment Strategy—The Psychology of Stock Market Success” (revised in 1982 under the title “The New Contrarian Investment Strategy”), which examined the range of possible contrarian investment strategies in greater detail. These books served as the primary source for this article.

In this article we will examine the Dreman contrarian investment strategy and its implementation using a computerized screening program.

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Investor program to perform the screen. The Stock Investor Professional version of the program includes percentile ranks, so we were able to simply specify a criterion that looked for price-earnings ratio percentile ranks of 40% or lower. If your screening program does not provide percentile rankings, then first start with the complete universe of available stocks, and start specifying progressively lower price-earnings ratios until only approximately 40% of the starting universe pass the filter. Our first screen left us with 2,049 companies, from a starting base of 7,661 companies. The price-earnings ratios for this group ranged from just above zero to 17.5. In contrast, the price-earnings ratio for the S&P 500 is 22.9, well above our cut-off. Dreman cautions that investment decisions are not clear cut, so it is best to provide for a margin of safety.

Table 1 presents the data for the companies passing all of the Dreman criteria. The median price-earnings ratio for this group is 14.8, below the 19.6 median for all the companies in the Stock Investor database. Russ Berrie, a maker of gift products, has a price-earnings ratio of 6.6, nearly a quarter of the S&P 500 ratio.

### Company Size

Dreman favors large- and medium-sized companies in his...
approach for three primary reasons—greater chance for a rebound if there is a company misstep, greater market visibility with the rebound, and a reduced chance of “accounting gimmickry.”

In his observations, Dreman has found that fewer large firms have gone completely out of business. Large companies have greater managerial and financial resources to weather a company or industry slowdown or problem. However, many of these once-troubled firms have experienced substantial turnarounds coupled with significant price appreciation. Dreman feels that with our dynamic economy, these turnarounds can occur very quickly.

Stocks of rebounding large companies tend to be in the public eye and get noticed more quickly when things go better for the company. This should result in a higher valuation for a given level of earnings. An increase in earnings coupled with an increase in the multiple investors are willing to pay for a given level of earnings translates to significant price increases.

Dreman feels that accounting is a “devilishly tricky subject.” Even when firms follow generally accepted accounting principles (GAAP), a great deal of discretion in the treatment of accounting items leads to various quality levels of earnings. Both novice and sophisticated investors have misinterpreted crucial elements of accounting statements, but larger firms with long records are watched more closely by a wider range of investors and regulators. Dreman reminds investors that it is important to carefully scrutinize the footnotes and even suggests staying clear of a company if it has too many footnotes for a company of its size and industry.

Dreman does not provide any specific cut-off for determining company size—leaving it to the investor to determine his own level of risk tolerance. Dreman believes that the less experienced the investor, the larger the company he should invest in.

To determine the cut-off for our screen we examined market-capitalization levels (share price times number of shares outstanding). If you limit yourself to the top 10% of companies, then you would be examining companies with a market capitalization of at least $2.3 billion. This is a reasonable limit for screening large companies, but for our screen we also wanted to capture a greater number of medium-sized firms. A cut-off of the top 20% results in a market capitalization minimum of approximately $800 million, while a 30% cut-off provides a $400 million floor. To help provide a wider cross-section of passing companies, we made our screen aggressive and used the 30% cut-off. As an independent criterion, 2,400 companies passed the filter, and when combined with the price-earnings criterion, a total of 675 companies passed both filters.

The median market capitalization for the passing companies is $820.1 million, well above the $123.8 million for all the companies in Stock Investor. With a market capitalization of $13.8 billion, Gannett is the largest company to pass all the Dreman filters. Jefferson-Pilot is the other large-cap firm passing the filters. Both of these companies are included in the S&P 500 index.

Financial Strength

Dreman feels that it is important to consider the financial strength of a company when pursuing a contrarian investment strategy. A strong financial position enables a company to work through a period of operating difficulty often experienced by out-of-favor stocks. Financial strength also helps to provide a measure of safety for the dividend payout.

One must consider both the short-term obligations of the company along with long-term liabilities when testing for financial strength. Common measures of the longer-term obligations of the company include the debt-to-equity ratio (which compares the level of long-term debt to owner’s equity), debt as a percent of capital structure (long-term debt divided by capital, which includes long-term sources of financing such as bonds, capitalized leases, and equity), and total liabilities to total assets. We used the ratio of total liabilities to total assets.

Definitions of Screens and Terms

Price-Earnings Ratio: Market price per share divided by most recent 12 months’ earnings per share. A measure of the market’s expectation regarding the firm’s earnings growth potential and risk. Firms with higher price-earnings ratios are being valued by the market on the basis of high-expected growth potential. Low ratios may indicate a neglected firm that is undervalued.

Market Capitalization: Number of shares outstanding times the current market price. An indication of the size of the company.

Total Liabilities to Assets: Long-term and short-term debt divided by total assets of the firm at the end of the most recent fiscal quarter. A measure of financial risk that indicates how much of the assets of the firm have been financed by debt.

Dividend Yield: Indicated dividend divided by current price. Provides a relative valuation measure when compared against other firms. Higher yields provide price support and contribute to total return.

Payout Ratio: Dividend per share for the last 12 months divided by earnings per share for the last 12 months. Provides an indication of the safety of the dividend. Figures between 0% and 50% are considered safe for industrials. Figures ranging between 50% and 100% are considered earning warning flags. Negative values and figures above 100% are considered red flags for a dividend cut if the level persists. Beyond examining a single point, it is important to look at trends.

Dividend Growth Rate: Annual growth rate in dividends per share over the last three years. An indication of past company strength and dividend policy.

Earnings Per Share Estimate: The consensus of analysts’ estimates of earnings per share from continuing operations for the current fiscal year and the next fiscal year as reported by I/B/E/S.

Earnings Per Share Last Fiscal Year: Earnings from continuing operations for the most recent complete fiscal year divided by average number of shares outstanding during the period.
liabilities to assets for our screen because it considers both short-term and long-term liabilities. Alternatively, we could have used both a measure of short-term financial strength, such as the current ratio (current assets divided by current liabilities), and a measure that examines the long-term obligations of the firm, such as the debt-to-equity ratio.

Acceptable levels of debt vary from industry to industry, so we screened for companies with total liabilities to assets below the norms for their sector. The financials and utilities passing have much higher values than the stocks in the consumer sectors. This filter cut the number of passing companies down to 304.

### Dividend Yield

Dreman seeks companies with a high dividend yield that the company can sustain and possibly raise. The yield helps to provide protection against a significant price drop, and also contributes to the total return of the investment. There are many ways to screen for dividend yield: You can simply establish a minimum level, or perform a relative screen that compares the current yield to the market level or to the company’s historical norm. Yield screens typically exclude small, high-growth companies because they need all cash generated through operations to expand.

If an absolute level of yield is specified in a screen, it cannot be too high or only companies from industries that traditionally pay a high dividend will pass. Now that utilities are relatively stable and mature with limited potential for capital appreciation, they trade at yields two to three times the average for the S&P 500. The current S&P 500 dividend yield is approximately 1.7%. For our screen we specified a minimum yield of 1.5%—high enough to be significant, yet low enough not to exclude too many industries. This filter cut the number of passing companies down to 169 from 304.

Yields in danger of being reduced by the company are no bargain, so Table 1 also presents the payout ratios for these firms. The payout ratio is computed by dividing the dividend by earnings and indicates what portion of the earnings are being paid out to shareholders. Companies cannot sustain too high of a payout without harming the long-term growth potential of the firm. Positive payout ratios of 50% or less for industrials and 80% or less for utilities are rule-of-thumb benchmarks for dividend safety. The firms passing the Dreman screen meet these minimums. The dividend growth rate over the last three years is also provided to help gauge the recent dividend policy of the firms. With the strong economic environment recently, many firms have been increasing their payouts, so it is not surprising to see relatively strong dividend growth rates from these firms.

### Earnings Growth

Being a contrarian does not imply that an investor should purchase a company just because it has a low price-earnings ratio or a high dividend yield. A successful contrarian uses these valuation techniques to help identify stocks that may are misspriced. The companies are only attractive if they are expected to grow and prosper in the future.

Dreman seeks companies with a higher rate of earnings growth than the S&P 500 both in the immediate past and the immediate future. We screened for companies with short-term growth in earnings greater than the overall database median and expected increases in earnings estimates for each of the next two years. Collectively these screens reduced our list to the 19 stocks presented in Table 1.

Dreman does not require precise levels of earnings estimates and instead is more concerned with the overall direction of the company. He points out that earning estimates are terribly unreliable and best used as general guides for the company’s prospects. The table presents the earnings from the last fiscal year, along with the consensus earnings estimates from I/B/E/S for the current year and the next year, to help provide a sense of the market expectations embedded in the stock price.

Interestingly, a study of earnings surprises by David Dreman revealed that low price-earnings ratio stocks typically had more positive earnings surprises than high price-earnings ratio stocks and the reaction was typically more significant. Furthermore, when a low price-earnings ratio stock had a negative earnings surprise, its price drop was not as severe as that for high price-earnings ratio stocks.

### A Diversified Portfolio

When selecting stocks and building a portfolio, Dreman recommends equal investment among 15 to 20 stocks, diversified among 10 to 12 industries. The companies passing the Dreman screen in Table 1 are divided by major market segments. Dreman feels that diversification is essential with the low price-earnings ratio screen because the rates of return among the various stocks will vary greatly. It is too dangerous just to rely on a couple of stocks or industries. Dreman is using the contrarian strategy to increase the odds of outperforming the market for a given level of risk consistently over time. While a concentrated portfolio may prove to be a big winner, there is also the chance that it will suffer a great loss.

### Conclusion

It is ironic that the “best” companies often seem to make the worst investments, while the “worst” companies can be the best investments. Too many investors trying to find the next hot stock overbid for the best prospects. Dreman puts forth that to succeed, you should avoid high price-earnings ratio stocks and be careful about new issues with little substance that often sell only in rising markets when the speculative fever is rising.

Like any approach, it must be applied rigorously and patiently for a good chance of success. While following a low price-earnings ratio approach may not stir the blood or provide for good cocktail chatter, it helps to enrich the pocketbook.