

David Dreman's Contrarian Approach to Stock Selection

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Article Highlights

- Dreman seeks to take advantage of investor irrationality by targeting stocks with low expectations and avoiding stocks with high expectations.
- Positive surprises have a bigger impact on undervalued stocks than highly valued growth stocks, because investors expect good news from the growth stocks, but not from the undervalued stocks.
- The Dreman strategy calls for focusing on fundamentally sound stocks trading at least at a 20% discount to the market and at an attractive yield.

David Dreman is a famous investor whose name is linked with the definition of “contrarian.”

Contrarians think independently, as opposed to going along with the crowd. Dreman feels that irrational behavior in the markets tends to push a stock's value away from its true value. The savvy contrarian investor executes a value investing approach with a strong defense and a powerful offense. Defensively, a systematic approach should preserve capital. Offensively, it takes advantage of consistent mistakes made in the markets. Removing emotion from investing and being aware of investing pitfalls are the contrarian methods that Dreman has successfully followed.

David Dreman founded the investment company Dreman Value Management. For over 30 years, he has written a regularly published *Forbes* column entitled “The Contrarian.” He also authored several books, including “Contrarian Investing Strategy: The Psychology of Stock Market Success” (Random House, 1979), which was revised in 1982 under the title “The New Contrarian Investment Strategy.” These two books examined the range of possible contrarian investment strategies in greater detail and served as the primary source for both this article and an AAI stock screen based on the Dreman approach.

David Dreman's Philosophy

Dreman asserts that psychological biases tend to interfere with sound investment decisions.

His findings, based on academic research, show that our



emotions, either consciously or unconsciously, affect our decision-making processes. Dreman asserts that irrational investor behavior creates market bubbles and excessive security overvaluation. Investors are sensitive to the possibility of a major gain, and less attuned to the actual probability of that gain.

His methodology seeks to profit from investors' irrationality. Contrarians often go against the crowd by seeking stocks that are out of favor with the market and avoiding stocks that are in the spotlight and carry high expectations. Eventually, the prices of these undervalued out-of-favor stocks are pushed upward, giving contrarian investors the opportunity to profit from the re-evaluation.

Among the cognitive biases that Dreman references are:

1. Representativeness

It is a natural human tendency to draw analogies and see identical situations where none exist. An example is labeling two companies or two market environments as the same when the actual resemblance is superficial.

Dreman found that there are two key ways that representativeness bias leads to miscalculations. The first is to put too much emphasis on the similarities between events and not take into account the actual probability that an event will occur. Second, representativeness reduces the importance given to variables that are actually critical in determining an event's probability.

2. The law of small numbers

Researchers systematically overstate the importance of

findings taken from small samples.

Dreman gives the example of investors flocking to a mutual fund simply because of outperformance in one or two years, even though research has proven that the “hot” funds during one time period are often the poorest performers in another.

This concept carries over to brokerage analysts. Investors consider an analyst “hot” based solely on a recent prediction instead of the analyst’s performance over time.

3. The disregard of prior probabilities

Investors tend to see similarities between situations while failing to appreciate the lessons of the past.

4. Regression to the mean

Investors often forget or ignore the long-term rate of return on common stocks.

They believe that recent trends represent a lasting change from the previous historical norms, even though the data shows a tendency for valuations and returns to revert back toward their long-term average (and often swing back beyond it).

5. Information overload

Studies have shown that humans cannot process large amounts of information, and sometimes “information overload” can lead to poor decisions. When people are bombarded with information, they tend to see only the part they are interested in and screen out the rest.

6. Heuristic math

Investors believe that consistent data points supply greater predictability than inconsistent data points do.

Dreman found that investors have more confidence in a company that has 10% earnings growth and rises consistently year after year than they do in one that has 15% growth over the same period but is more volatile. Investors associate a “good” stock with a rising price, and a “bad” stock with a falling price.

7. Anchoring

Investors choose a natural starting point, typically close to the current stock price, where they think a stock is a good buy or a good sell and make adjustments from there. Many investors assume the market is always efficient, when in reality, contrarian investors profit from market inefficiencies.

Defeating Cognitive Biases

Heuristics, or mental shortcuts, are highly efficient in day-to-day situations, but work against us in the market. Although we are intuitive statisticians, under conditions of uncertainty, we do not follow the probability theory. The results of these cognitive biases lead to errors in all areas of decision making, including in economics, management and investments.

How do investors protect themselves from these cognitive biases? Dreman highlights several rules:

1. Look beyond the obvious similarities between a current investment situation and one that appears equivalent in the past. Consider other important factors that may result in a markedly different outcome.
2. Don’t be influenced by the short-term record of a money manager, broker, analyst or adviser, no matter how impressive; don’t accept cursory economic or investment news without significant substantiation.
3. Don’t be seduced by recent rates of return for individual stocks or the market when they deviate sharply from past norms (the “case rate”). Long-term returns of stocks (the “base rate”) are far more likely to be established again. If returns are particularly high or low, they are likely to be abnormal.
4. Don’t expect the strategy you adopt to prove a quick success in the market; give it a reasonable time to work out.

Why Contrarian Investing Works

Contrarian investing attempts to profit from the biases in others. Dre-

man feels that these biases are particularly influenced by the over-optimistic earnings estimates issued by analysts. One study, performed by Dreman and spanning the period of 1988 through 2006, founds that analysts projected an average annualized earnings growth of 21%, while economists forecast 18% growth on average. The actual annualized earnings increase for the S&P 500 index over the studied time span was 12%. In other words, the data showed analysts’ forecasts to have been 81% too high on an annualized basis.

Despite the inaccuracy, investors tend to focus on earnings estimates and whether companies exceed, meet or miss consensus expectations. Dreman emphasizes that it is impossible, in a dynamic economy with continually changing political, economic, industrial and competitive conditions, to use the past to estimate the future.

Dreman says that investors believe they can forecast the prospects for both exciting and unexciting stocks well into the future. Companies with the best prospects, fastest growth rates, and most exciting concepts normally trade at high price-earnings (P/E) ratios, high price-to-cash-flow (P/CF) ratios, high price-to-book-value (P/B) ratios and/or have low or no dividend yields. Conversely, stocks with poor outlooks trade at low levels of earnings, cash flow, or book value and usually have higher dividend yields.

Yet, the undervalued, low-prospect stocks tend to outperform the market following an earnings surprise, while overvalued high-growth stocks tend to underperform the market after an earnings surprise.

Why? Since analysts and investors believe they can effectively judge which stocks will be the real market winners, a positive surprise does little more than confirm their expectations about those stocks. The top companies should have rapidly growing revenues and earnings. However, when these companies fail to beat expectations, it causes a significant change in perception and sends the stock’s price down—along with investors’ confidence. Even when the bad

Dreman Philosophy and Style

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 ratio.

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 index.
- 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 posi-

tion: 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.

Stock monitoring and when to sell

- 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.
- Buy during a market panic, don't sell.

news proves to be not nearly as severe as originally anticipated, the memory of the unpleasant experience lingers.

Additionally, investors have low expectations for what they consider lackluster stocks (the low-valuation group), so when these stocks miss earnings estimates, it hardly turns heads. When such companies beat earnings expectations, people begin a process of perceptual change. These stocks are re-evaluated in a positive manner, leading to their outperformance of the market, particularly because of their original

undervaluation.

The key to how a stock reacts to earnings lies in the market's perception. When this perception adjusts positively, history has shown that undervalued stocks reap the most benefits. When the perception adjusts negatively, highly valued growth stocks underperform. Earnings surprises consistently result in above-average performance for out-of-favor stocks and below-average performance for favored stocks.

Not only are analysts over-optimistic and inaccurate when it comes to

estimating earnings, Dreman discovered that investors react predictably when it comes to earnings surprises, uncovering the perfect opportunity for a contrarian investor. He feels that earnings surprises have an enormous, predictable and systematic influence on stock prices. Dreman asserts that contrarian strategies prosper because investors do not know their limitations as forecasters; as long as investors believe they can pinpoint the future of favored and out-of-favor stocks, contrarian approaches will succeed.

Dreman's Primary Approach

Dreman's primary contrarian approach mentioned in "Contrarian Investment Strategy" contains three simple rules.

1. The investor should buy only low price-earnings ratio stocks because of their superior performance characteristics. Contrarian stocks are stocks that are undervalued in the market based on their current share price relative to their earnings. In his own application of the contrarian approach, Dreman chooses stocks from the bottom 40% of stocks ranked by price-earnings ratio. He feels that using the low price-earnings approach eliminates those aspects of traditional analysis, such as forecasting, that have been shown to be consistently error-prone.

2. Buy medium- or large-sized stocks listed on the New York Stock Exchange, or only larger companies on NASDAQ or the American Stock Exchange. These firms are more in the public eye and thus, Dreman believes, there is theoretically less chance that management has manipulated the financial statements. These firms also have more staying power and are less likely to go bankrupt in a market downturn compared to smaller or startup companies.

3. Ideally, a portfolio should be invested equally in 15 to 20 stocks, diversified among 10 to 12 industries. This is important for diversification. It allows you to spread out the risk and prevents you from depending on only one stock or industry to do well.

Secondary Criteria

While Dreman's studies show that buying stocks based on their contrarian characteristics and placing no reliance on individual stock analysis has given a better-than-average return over long periods of time, he doesn't necessarily recommend abandoning stock analysis entirely. By recognizing the limitations of analysis, investors can apply it to achieve even better returns.

He lists five secondary, or conditioning, criteria he requires.

1. Strong financial position. A

strong financial position will allow a company to survive through periods of operating difficulties, which contrarian companies sometime endure. Financial position is important when deciding if a company can support its dividend payments and, it is hoped, increase them. Dreman feels that investors should seek a high current ratio, low debt-to-equity and a low payout ratio.

2. As many favorable operating and financial ratios as possible. This helps to ensure that companies don't have "structural flaws." Obviously not every company can have a perfect track record and still be underpriced, but an examination of financial ratios should alert an investor to potential glaring flaws or issues.

3. A higher rate of earnings growth than the S&P 500 in the immediate past, and the likelihood that the rate will not decline significantly in the near future. Dreman makes it clear that this contrarian indicator is not an attempt to predict future earnings (which he believes are close to unpredictable) but merely to estimate their general direction. Dreman said, "If, for example, the Street estimates that a company's earnings are likely to be down for some time, I would not rush in to buy, no matter how positive my indicators appeared to be." He doesn't require a precise earnings growth estimate, but merely notes the direction of earnings over about a year or so.

4. Earnings estimates should always lean to the conservative side. This indicator ties into Benjamin Graham and David Dodd's "margin of safety" principle. By relying on general directional forecasts and keeping them conservative, investors further reduce the chance of error.

5. An above-average dividend yield, which the company can sustain and increase. Dividends can go up over time, whereas interest payments on a traditional bonds do not. Dreman feels that investing in higher-yielding companies is also less risky for the investor. Higher dividend returns help to support prices of cheap stocks in bear markets. Dividend-oriented investors

also receive better protection of their principal on the downside and receive rising dividend income as well as capital appreciation on the upside.

When to Sell

Dreman says that investors should sell a stock when its price-earnings ratio (or other valuation indicator) approaches that of the overall market, regardless of how favorable prospects may appear. He explains that this does not require selling a stock simply because its price has risen. Rather, pay attention to the new valuation since, in many cases, the price-earnings ratio is remaining low thanks to earnings growth.

Investors should also not sell a stock that attains a high price-earnings ratio solely because of a decline in earnings, if the reduced profitability is due to a large one-time charge or temporary business conditions.

Dreman advises not waiting too long for a stock to increase in price. A reasonable waiting period is two and a half years to three years. If it's a cyclical company with a drop in earnings, two and a half years to three and a half years is reasonable. After that time period, if the stock continues to disappoint, sell it and find a replacement.

Dreman also mentions that John Templeton, "one of the masters of value investing," used a six-year time span, emphasizing that the specific waiting period it is entirely up to the investor. However, he or she must be disciplined when it comes to selling a stock once it's reached the tail end of its waiting period.

Another sell rule requires an investor to sell a stock immediately if the long-term fundamentals deteriorate significantly. Dreman is not talking about a bad quarter or temporary surprise that a stock can typically bounce back from, but major changes that weaken a company's prospects.

When the market declines and all seems lost, Dreman feels that the contrarian investor should buy. His advice: Buy during a panic, don't sell. His research showed that holding stocks

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over the period July 1, 1926, to June 30, 2015, according to the Center for Research in Security Prices data), which appears to endorse a tilt to value. In addition, the small-cap growth “style box” has historically been a weak performer, but our research demonstrates that, by stripping out the “growthiest” stocks in this category, an investor will be much happier with returns (see “Returns on Small Cap Growth Stocks, or Lack Thereof: What Risk Factor Exposures Can Tell Us” in the Knowledge Center on our website). Insights such as these are ones that we employ in building port-

folios and, indeed, in constructing our own factor-based investment strategies.

To this point, I should add that small cap’s dry spell (recall the 10-year cycle of Figure 3) is a good example of why we at Gerstein Fisher embrace multi-factor investing rather than single-factor investing (for a quick tutorial on our investing style, see “What Is a Multi-Factor Investment Approach?” also in our Knowledge Center). Different factors move in different cycles of different duration, which provides diversification. And importantly, several factor premiums (including momentum,

asset growth and profitability) tend to be stronger among small-cap stocks, which is yet another reason why we continue to like investing in smaller companies despite the eroding premium.

Conclusion

The size premium, while weaker than in the past, is generally still positive. Even with a modest small-cap premium, we still believe there is a benefit in holding small-cap stocks as a distinct tilt in an equity strategy and as an important component of a multi-factor investment strategy. ▲

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AAIL Stock Screens

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for two years after a crisis resulted in spectacular returns. A buyer would have made money in all 11 crises (mentioned in his book), with an average two-year gain of almost 38%.

Overall, Dreman proclaims that investors should not be stubborn, too greedy, or too afraid to take small losses. Above all, when buying a stock, make a mental decision as to the level you will sell it at and stick to that decision.

Conclusion

Dreman says that favored stocks

underperform the market, while out-of-favor companies outperform the market; however, the re-evaluation process often happens slowly, even glacially. Dreman’s research proved that over a 40-year period (1970 to 2010), contrarian strategies outperformed the long-term rate of return on common stocks, 54% to 37%.

Contrarian investing is a behavioral finance approach to investing. A contrarian avoids high-flying growth stocks and instead purchases out-of-favor stocks at a reasonable valuation and benefits from the market’s re-evaluation in the long term. While it can be dif-

ficult to perceive the market as being somewhat irrational, Dreman’s books provide sound, research-based demonstrations of how investors behave in a predictable, emotional manner when investing.

See this issue’s First Cut column on page 21 for a list of stocks currently meeting Dreman’s criteria. More about David Dreman’s strategy will be discussed in the November 2015 issue of *Computerized Investing* (www.computerizedinvesting.com), including guidance for creating quantifiable criteria for implementing the contrarian approach in a stock screen. ▲

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