



## ***Contrarian to Popular Belief***

In recent times, we have seen US stock markets tumble from unprecedented highs in 2007 to record lows in March 2009. The Dow Jones Industrial Average closed at an all-time high of 14,164.53 on 9 October 2007 and on 30 May 2007 the Standard & Poor's 500 index closed at an all-time high of 1,530.23. Recent lows for both indices were marked on 5 March 2009 when the Dow closed at 6,594.44 and S&P closed at 682.55. We also witnessed some dramatic and agonizing swings from day to day especially during the months of September and October 2008. Many investors may remember when the Dow dropped 777.68 points on 29 September 2008 (the largest points drop ever) taking their collective hearts right down with it.

Things have settled quite a bit since then as it appears investors have gotten used to a sedated economic environment and are not reacting as frightfully to news. For the most part investors appear to be waiting on the sidelines, including individuals who have been proverbially "once bitten" and are now "twice shy" and those who may have witnessed some carnage and are now hesitant to test the waters themselves. While the majority may have been traumatized by market volatility, investors that subscribe to the contrarian approach would find opportunities.

An extreme view defines a true contrarian as one who does the exact opposite of what the majority of the market is doing: They move counter to the current market trend. So if investors as a whole have a bullish outlook and therefore are buying, a contrarian would sell and if there is an overall bearish outlook so the majority is selling, a contrarian would buy. The belief is that the market is usually wrong at both its extreme highs and lows.

Generally, this view has been tempered somewhat and contrarian investing has often been linked with value investing. Contrarian investors stick to the basic premise of buying when the price is lower/falling and selling when the price is higher/rising to make a profit. Although even novice investors know you should buy low and sell high, for the majority of investors emotions influence investment decisions when they are overcome by waves of market euphoria or gloom and doom. While discounts in other items are much sought after (for example clothes, cars, vacations, real estate), stock investors often confuse a falling price with reduced value so are not interested in stocks that are dropping. Conversely, market "group think" says that if a stock's price is rising then it must be worth buying. The mob runs after the "winners" whose share prices are appreciating while the "losers" with falling prices, are not given much thought. For a contrarian, when the market seems to be at its worst or when a stock price has plummeted, the opportunities for profit seem to be optimal. The focus therefore is on profit versus popular opinion.

The link of contrarians to value investors is frequently made because value investors often go against the market in seeking profitable trades and a contrarian would often use value investing techniques to ascertain whether a pummeled stock is likely to recover. When a stock's price plummets, the contrarian does not automatically put in a buy order (as the extreme view implies) but investigates what has driven the price down and whether it is justified. If it is not justified, the contrarian sees a good buying opportunity. A critical success factor for the contrarian approach is to determine whether a currently troubled stock will make a turnaround or is destined for the dump.

The intrinsic value of a stock using fundamental analysis would be taken into consideration. The output of fundamental analysis is a value (price) which the investor can compare to market prices to determine if a stock is under-valued or over-valued. The aim would be to buy under-valued stocks, that is, stocks that are currently trading at a price lower than their calculated worth. An overreaction by the market to disappointing news may drive prices down to bargain levels creating an opportunity for the contrarian investor. The assumption is that eventually, the market will buy the stock at what it is actually worth as the crowd realizes the invalidity of its mob behaviour and changes gears to move in the other direction.

Discounted cash flow analysis (dividend discount model for example) can be used to determine a stock's value based on estimated future cash flows. Valuation ratios could also be used such as the price-to-earnings (P/E) ratio and the price-to-book (P/B) ratio which compare the market price of the stock to earnings per share and book value per share respectively. Use of these ratios is most effective when a comparison is made to the company's past performance and the performance of industry peers.

External factors that could impact upon a company's performance, and by extension its share price, would be considered as well. The overall health of the economy would be taken into account as well as issues facing the specific industry within which the company operates. In addition to the quantitative analysis of the company (using the valuation methods mentioned above), qualitative factors such as the skill and expertise of the management and whether the company has a special competitive advantage would likely be considered.

Contrarian investors tend to make their best investments in times of turmoil as they are not dissuaded from buying or selling due to prevalent fear and panic or greed. Once a contrarian investor deems that investing is worthwhile, he/she may purchase not only stocks that are not currently in his/her portfolio but also additional stocks of a currently held company in order to reduce the average cost of holdings so when the recovery comes around they would be well positioned to benefit. For example, Google Inc. (Ticker symbol: GOOG) slid from US\$685.33 on 3 January 2008 to US\$257.44 by 24 November 2008 amidst the overall panic in the market. Since then the stock price has recovered (US\$514.18 at 8 October 2009) and therefore a contrarian investor who would have purchased when things looked most dismal could be reaping notable rewards now. On the other hand, greed (fuelled by market euphoria) would not prevent a contrarian from selling once a profit target has been achieved. This is contrary to the majority of investors who tend to hold on to a stock for too long or start buying to get in on the profits that "everyone else is making" when the stock price is being driven upward.

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This investment approach requires discipline in investing; to stay the course that you had planned and avoid getting caught up in market frenzy. For investments made now, this approach can yield healthy returns over the long term as market values are still relatively low and there is significant upside potential. You should assess your individual situation (goals, time horizon, liquidity, risk tolerance) and make investment decisions to suit your unique circumstances. It may be in your best interest to act “contrarian” to popular belief.

*Data Source: Yahoo! Finance*

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