Value Investing: The Contrarians

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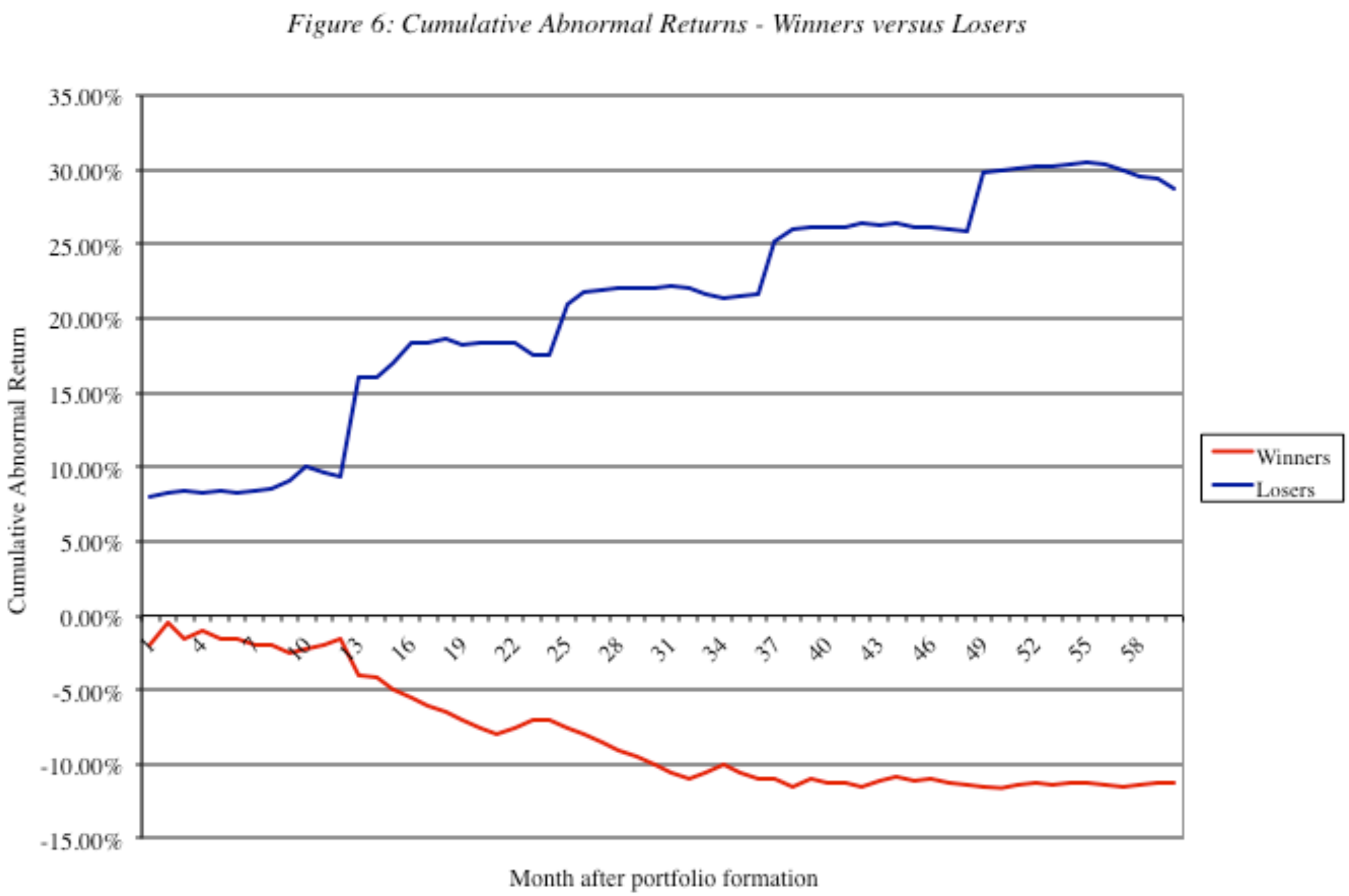
Contrarian Value Investing: Buying the Losers

- In contrarian value investing, you begin with the proposition that markets over react to good and bad news. Consequently, stocks that have had bad news come out about them (earnings declines, deals that have gone bad) are likely to be under valued.
- Evidence that Markets Overreact to News Announcements
  - Studies that look at returns on markets over long time periods chronicle that there is significant negative serial correlation in returns, I.e, good years are more likely to be followed by bad years and vice versal.
  - Studies that focus on individual stocks find the same effect, with stocks that have done well more likely to do badly over the next period, and vice versa.

1. Winner and Loser portfolios

- Since there is evidence that prices reverse themselves in the long term for entire markets, it might be worth examining whether such price reversals occur on classes of stock within a market.
- For instance, are stocks which have gone up the most over the last period more likely to go down over the next period and vice versa?
- To isolate the effect of such price reversals on the extreme portfolios, DeBondt and Thaler constructed a winner portfolio of 35 stocks, which had gone up the most over the prior year, and a loser portfolio of 35 stocks, which had gone down the most over the prior year, each year from 1933 to 1978,

Excess Returns for Winner and Loser Portfolios

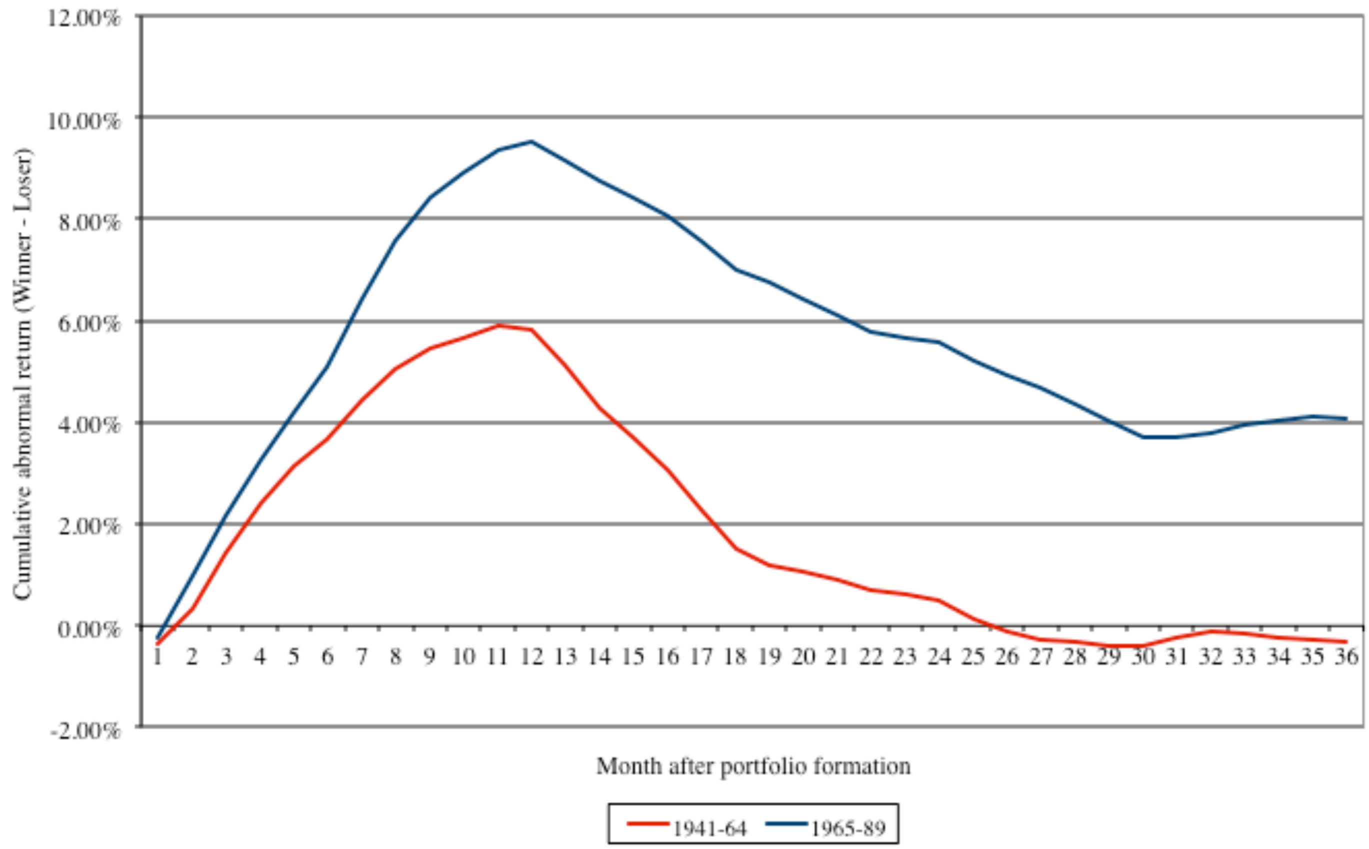


More on Winner and Loser Portfolios

- This analysis suggests that loser portfolio clearly outperform winner portfolios in the sixty months following creation. This evidence is consistent with market overreaction and correction in long return intervals.
- There are many, academics as well as practitioners, who suggest that these findings may be interesting but that they overstate potential returns on 'loser' portfolios.
  - There is evidence that loser portfolios are more likely to contain low priced stocks (selling for less than $5), which generate higher transactions costs and are also more likely to offer heavily skewed returns, i.e., the excess returns come from a few stocks making phenomenal returns rather than from consistent performance.
  - Studies also seem to find loser portfolios created every December earn significantly higher returns than portfolios created every June.
  - Finally, you need a long time horizon for the loser portfolio to win out.

Loser Portfolios and Time Horizon

Figure 7: Differential Returns - Winner versus Loser Portfolios

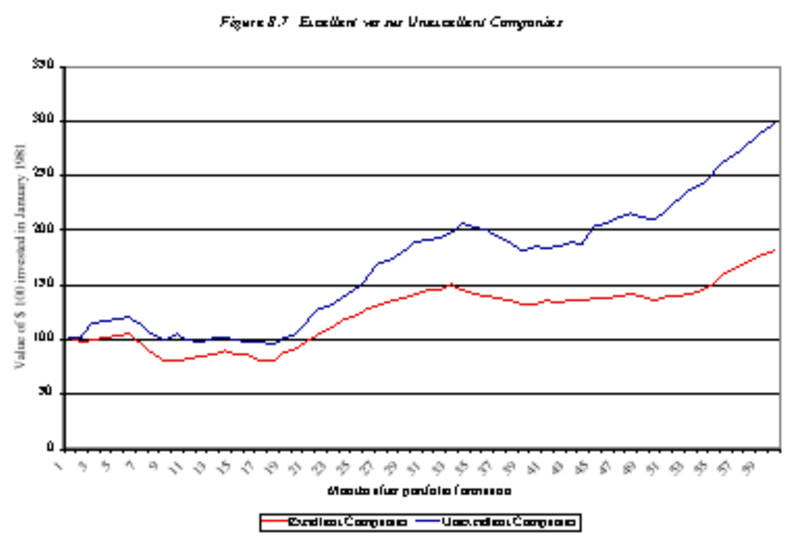


2. Buy "bad" companies

- Any investment strategy that is based upon buying well-run, good companies and expecting the growth in earnings in these companies to carry prices higher is dangerous, since it ignores the reality that the current price of the company may reflect the quality of the management and the firm.
- If the current price is right (and the market is paying a premium for quality), the biggest danger is that the firm loses its lustre over time, and that the premium paid will dissipate.
- If the market is exaggerating the value of the firm, this strategy can lead to poor returns even if the firm delivers its expected growth.
- It is only when markets under estimate the value of firm quality that this strategy stands a chance of making excess returns.

Excellent versus Unexcellent Companies

- There is evidence that well managed companies do not always make great investments. For instance, excellent companies (using the Tom Peters standard) earn poorer returns than “unexcellent companies”.



Determinants of Success at "Contrarian Investing"

1. Self Confidence: Investing in companies that everybody else views as losers requires a self confidence that comes either from past success, a huge ego or both.
2. Clients/Investors who believe in you: You either need clients who think like you do and agree with you, or clients that have made enough money of you in the past that their greed overwhelms any trepidiation you might have in your portfolio.
3. Patience: These strategies require time to work out. For every three steps forward, you will often take two steps back.
4. Stomach for Short-term Volatility: The nature of your investment implies that there will be high short term volatility and high profile failures.
5. Watch out for transactions costs: These strategies often lead to portfolios of low priced stocks held by few institutional investors. The transactions costs can wipe out any perceived excess returns quickly.