

The Contrarian Case

ANYONE WHO READS THIS COLUMN regularly knows that I avoid following the investment herd. That's why I recommended getting out of semiconductor stocks at the start of last year, when they were widely favored, but included chip stocks as one of my picks this year, as sentiment turned decidedly gloomy. Although I realize a contrarian methodology sounds peculiar, the rationale is actually very straightforward. History shows that most investors under-perform the stock market, while financial analysts and economists often get more wrong than right. Unfortunately, contrarian investing is about more than simply doing the opposite of everyone. But not following the investment herd off the proverbial cliff is an important first step.

GALLOPING OFF THE CLIFF

A couple years ago, when Wall Street scandals seemed to be front-page news everyday, I came across several sobering studies. Research firm Dalbar found that, over 19 years, the average equity fund investor achieved just a 2.57 percent average annual return versus the inflation rate of 3.14 percent and a return of 12.22 percent from the S&P 500 over the same period. Meanwhile, a study by Morningstar, which tracked the popularity of mutual fund categories going back to 1987, discovered that, over a subsequent three-year period, the least popular outperformed the most popular 90 percent of the time!

And it's not just retail investors who are getting more wrong than right. Professional forecasters frequently lead investors in the wrong direction. A study by Zacks.com looking at the three years from 2000 to 2002 found that each year's 600 most recommended stocks by analysts fell a combined 43 percent, while the 600 least recommended rose 7 percent. Then there are economists – probably the worst forecasters of the bunch. Data from the International Monetary Fund showed that out of 72 recessions worldwide in the 1990s, economists predicted just eight in the year before they occurred. In addition, according to *The Economist* magazine, 95 percent of economists didn't believe the U.S. was entering a recession in 2001, even as the downturn was already being felt. As noted economist, John Kenneth Galbraith, concluded, "The only function of economic forecasting is to make astrology look respectable."

THE PATH LESS TRAVELED

These facts are enough to make many investors simply abandon the idea of trying to outperform the stock

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market and instead to fire their broker, sell their mutual funds and just buy some index funds. Because the market is so efficient at pricing in the consensus opinion by the time most investors become aware of a view, the opportunity to make money on it is long gone. So, even when the consensus is right it often won't make you any money. Furthermore, the consensus is often wrong. Investors with money on the line, along with analysts and economists with jobs and reputations at risk, often allow emotions to intrude on their decision-making processes. As an example, no economist is going to lose face for forecasting economic growth when all of his peers are also predicting growth, so the temptation to follow the crowd is great. As a result, the market is very efficient at pricing in what are often irrational inputs.

But there's another alternative to listening to the experts or buying an index fund. The fact is you can beat the market by taking the path less traveled. If you can summon the emotional courage to fade the consensus and not follow popular opinion, you stand a very good chance of out-performing the stock market. But as I said at the beginning of this column, you need to do more than just the opposite of everyone else. An intelligent contrarian approach requires knowing enough about market history and finance theory to discern when the consensus is too optimistic or not optimistic enough. Right now, for example it is possible investors aren't pessimistic enough on stocks. But my read of history and the fundamentals leads me to believe there's plenty of upside ahead. ☺

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