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Contrarian Investing:
The Psychology of Going Against the Crowd

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Good morning. In addressing this morning's topic, I'd like to make three points:

- First, I will try to define what contrarian investing *means*; at least I'll try to offer one way to think about it. This part will define one of the hardest parts of investing and one of the most common errors: a failure to distinguish between *fundamentals* and *expectations*.

- Second, I'll spend a few moments on *market efficiency*, a terribly important issue that most active managers don't seem to think about much. This section will propose some ideas on *how* and *why* markets are efficient, which will lead us to a discussion of *how* and *why* markets periodically become inefficient.

- Finally, I'd like to touch on why it's so *hard* to be a contrarian investor. I will argue that there are two types of constraints: institutional and psychological. Clearing either one of these hurdles is difficult for an investor; clearing both is nearly impossible.

What the Game is About

When I consult my dictionary, a contrarian is "one who takes a contrary view" with contrary defined as "being not in conformity with what is usual or expected." Basically, a contrarian runs against the crowd.

Let me start with an obvious statement: the simple act of being a contrarian will make no one rich. In fact, conforming generally makes the most strategic sense. If you're in a movie theatre that catches on fire, you'd be best served to run *out* of the theatre in contrast to the contrarian tack to run *into* the theatre.

This point may seem trivial, but it has very deep-seated psychological roots. Many survival strategies in the animal kingdom rely on cooperation. One simple example is flocking—schools of fish, or flocks of sparrows, act in unison to minimize the threat of a predator.

If being different—not conforming—is *not* the sole goal, what *should* the aspiring contrarian focus on? Here I turn to a common sense distinction that I would argue is the single most common error in the investment business: failure to distinguish between the *fundamentals of the situation* (for example, the fundamentals of a company in the case of stocks) and the *expectations reflected in the asset price*.

Horse racing provides a good metaphor for this distinction. There are two issues: how well the horse will likely run—to figure out the *fundamentals* you'd look at the horse's record, the stable it came from, the jockey, the track conditions, etc.—and the *expectations*, which show up as the odds posted on the board.

Evidence shows that horse racing is a pretty efficient market. To quote a study by Professor Ray Sauer on the topic, "prices set in these markets, to a first approximation, are efficient forecasts of outcomes."[1]

A contrarian investor focuses not only on the general sentiment, but more importantly on *how that sentiment can lead to disconnects between fundamentals and expectations.*

To continue with the horseracing theme, I'd like to read a quotation from Steven Crist, now Chairman of the *Daily Racing Form* and for many years the *New York Times* reporter covering horse racing. Crist contributed a chapter to a book called *Bet with the Best*. Crist's 13-page chapter "Crist on Value" is fabulous reading and stacks right up against Warren Buffett and Ben Graham.

Here's Crist's comment, and please mentally strike out "horse" and insert "stock": [2]

> The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory . . . This may sound elementary, and many players may think that they are following this principle, but few actually do. *Under this mindset, everything but the odds fades from view. There is no such thing as "liking" a horse to win a race, only an attractive discrepancy between his chances and his price.* (Emphasis added.)

The successful hedge fund manager, Michael Steinhardt, shared a very similar view in his 2001 autobiography: [3]

> I defined variant perception as holding a well-founded view that was meaningfully different than the market consensus . . . *Understanding market expectation was at least as important as, and often different from, the fundamental knowledge.* (Emphasis added.)

Now ask yourself, very honestly, how clearly do you distinguish between fundamentals and expectations? If you're like most people, not very clearly. I quote a psychologist Robert Zajonc, who sums it up pretty well: [4]

> We sometimes delude ourselves that we proceed in a rational manner and weigh all of the pros and cons of various alternatives. But this is seldom the actual case. Quite often "I decided in favor of X" is no more than "I liked X". . . We buy the cars we "like," choose the jobs and houses we find "attractive," and then justify these choices by various reasons.

Moreover, what *we* like is heavily influenced by what *other people* like. Successful contrarian investing isn't about going against the grain per se, it's about exploiting expectations gaps. If this assertion is true, it leads to an obvious question: how do these expectations gaps arise? Or, more basically, *how* and *why* are markets inefficient?

The Rules of the Game

In his excellent book, *Inefficient Markets*, Harvard professor Andrei Shleifer summarizes the three arguments that underpin the efficient market hypothesis (EMH): [5]

1. Investors are rational, and value securities rationally. This is the basis for so-called general equilibrium models.
2. Investors are not rational, but their errors are independent, and hence cancel out, leaving us with an "efficient solution." And,
3. The no-arbitrage assumption—even if some investors are irrational, rational arbitrageurs swoop in and eliminate those inefficiencies.

The burgeoning behavioral finance field takes aim at the efficient market hypothesis, focusing its efforts on undermining number one, the rational agent model, and number three, the no-arbitrage assumption. By and large, though, behavioral finance dismisses the second alternative out-of-hand. We'll come back to that in a moment.

No one really believes the rational agent model any more—or at least no one takes it too literally—although it does provide some very elegant solutions. The main focus of the behavioral finance attacks on EMH has been on the limits to arbitrage—that since arbitrage is nowhere close to costless, riskless, and there are no perfect substitutes—many inefficiencies exist—even if they can't be exploited profitably.

Let's revisit the second way to achieve market efficiency—the interaction of heterogeneous investors. Over the past 20 years some important developments occurred in this area, generally put under the larger rubric of "complex adaptive systems." Complex adaptive systems are ubiquitous, and have some common features:

1. The system starts with a group of heterogeneous agents, be they ants, or cells, or investors;
2. The agents interact, leading to a feature called "emergence"
3. A global system results.

Importantly, the features and attributes of the global system are distinct from the underlying agents. The sum is greater than the addition of the parts. Reductionism doesn't work; you can't understand the global system by understanding each individual part.

A classic example of a complex adaptive system is an ant colony—study the system at the colony level and you will observe an adaptive and robust system with a life cycle vastly beyond the lifespan of any ant. But interview the individual ants and they will have no idea what's going on at the global level—they operate with local information and local interaction.

We can easily view the stock market as a good example of a complex adaptive system. You have investor diversity—growth versus value, long-term versus short-term, fundamental versus technical, and tips from Uncle Bob. You have an aggregation mechanism called the stock exchange, and you have a global system, or output, in stock prices.

But not all is perfect in complex adaptive system land. You need certain conditions in place for efficiency to prevail. We believe these conditions are:

1. Agent diversity
2. An aggregation mechanism
3. Incentives

Jim Surowiecki deftly articulated this line of thinking in his delightful book, *The Wisdom of Crowds.* Surowiecki argued that when these conditions are in place, the crowd will outperform a vast majority of individuals, including experts. Perhaps I can put this more bluntly: When these conditions are in place, markets are efficient.

Just to close the loop on behavioral finance, some critics claim investors are not diverse because they make errors in exactly the same way. About investor diversity Shleifer writes,[6] "it is this argument that the Kahneman and Tversky theories dispose of entirely." I don't know if Prof. Shleifer has spent much time with real investors, but to suggest they all act in concert all the time presses the limit of credibility.

If markets are efficient when these conditions prevail, when do they become inefficient? The answer, I believe, is when one of the three conditions is violated. By far the most likely is investor diversity.

We know from studying social psychology that diversity breakdowns occur periodically. As humans, we like to belong to the group, but we're willing to join in with the group to varying degrees: more formally, we all have different adoption thresholds.

The one point I'll add, but won't develop, is that these systems are non-linear. They are subject to critical points. So you can see diversity breakdowns start but without any notable influence on prices. Then, there's the proverbial "straw that broke the camel's back" and the system changes states very quickly.

Returning to the power of being part of the group, psychology professor Solomon Asch performed a series of experiments at Yale in the 1950s. Asch's experimental groups had eight members—seven were in on the experiment and the eighth was the subject. Each member of the group had to identify which line (of three choices) was of the same length as the sample line. The task was very simple, and in trial runs subjects effectively got 100% correct.

Asch then signaled the seven in the know to offer wrong answers. Thirty five percent of the subjects went with the majority, even when the answer was obviously wrong![7]

So the key is to find diversity breakdowns and make sure the "odds" compensate you for the risk you are assuming. Neither of these tasks is easy.

There is no doubt that diversity breakdowns occur. This means stock market risk is *endogenous* and *exogenous*. Still, diversity breakdowns are more the exception than the rule.

Ned Davis's book, *The Triumph of Contrarian Investing*, offers a host of indicators that help identify sentiment extremes, or diversity breakdowns.

One of my favorite examples is called the "Curse of Lyford Cay." For the past 20 years or so, Morgan Stanley has hosted a conference of the smartest investors around to discuss markets and stocks. Barton Biggs, the long-time head of strategy at Morgan Stanley, noted that the Lyford Cay consensus often proved to be a great signal to bet the other way. For example, the overwhelming majority of investors in late 2003 felt that rates were going higher in 2004. When the dust settled in 2004, yields on the 10-year Government note were actually *lower*.

The Constraints

OK. Even if you've accepted my arguments up to this point, you might ask, "why don't more people try to do this?" In this case, two significant types of constraints act on investors.

The first I call organizational constraints, but they basically emanate from agency problems. I think Charley Ellis framed it best when he contrasted the "business" from the "profession" of investing. The business is about generating fees; while there's nothing wrong with having a vibrant business, actions that seek solely to maximize fees (or keep them from dropping) can be detrimental to performance. The profession is about delivering superior long-term results for your shareholders.

The challenge is that the pendulum feels like it has swung from the profession to the business. The number of mutual funds and hedge funds has massively proliferated in recent years, and the new funds are often launched precisely where performance has been best in the recent past! For example, Jack Bogle notes that 44 equity mutual funds advertised in the March 2000 issue of *Money* magazine—mostly hot tech funds—had average one-year results of 85.6%. This is the exact opposite of what contrarian investing is all about, although it is arguably good business—at least for the short-term.

Another example is that fees over the years have been rising, not falling. Many mutual funds companies seek to maintain assets, so they ask their portfolio managers to minimize tracking error. Many portfolio managers complain that too much of their time is dedicated to bringing in assets versus delivering financial performance.

Hedge funds are not immune to these agency issues. The recent popularity of absolute return strategies may cause some managers to make shorter-term bets than what makes ideal economic sense. The recent introduction of long-only funds by some prominent hedge funds raises some interesting questions, as well.

Even if an investor operates in an environment focused on the profession, successful contrarian investing requires a certain psychological makeup.

One of Keynes's many great lines is, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."[8] There is no better lead in for the significant psychological constraints of contrarian investing. Without dwelling on the various sub-points, two major psychological requirements capture the idea:

1. *Independence*. Again, the goal is not to be a contrarian just to be a contrarian, but rather to feel comfortable betting against the crowd when the gap between fundamentals and expectations warrants it. This independence is difficult because the widest gap often coincides with the strongest urge to be part of the group. Independence also incorporates the notion of objectivity—an ability to assess the odds without being swayed by outside factors. After all, prices not only inform investors, they also influence investors.

2. *Long-term orientation*. Investing is inherently a probabilistic exercise, where process should be the focus versus short-term outcomes. Contrarian investors acknowledge that it may take some time for the market to revise expectations. This problem is compounded by myopic loss aversion, the idea that the more frequently you assess your portfolio, the more likely you are to see losses and hence suffer loss aversion.

To conclude, contrarian investing is clearly very difficult. The first step toward successful investing is clarifying the issues and how best to think about them. These comments are my attempt to do just that.

The Greenwich Roundtable is a non-profit research and educational organization for investors who allocate capital to alternative investments.

Endnotes

[1] Raymond D. Sauer, “The Economics of Wagering Markets,” *Journal of Economic Literature,* Vol. 36, 4, December 1998, 2021-64.
[2] Steven Crist, “Crist on Value,” in Beyer, et al., *Bet with the Best* (New York: Daily Racing Form Press, 2001), 64.
[3] Michael Steinhardt, *No Bull: My Life In and Out of Markets* (New York: John Wiley & Sons, 2001), 129.
[4] Robert B. Zajonc, "Feeling and Thinking: Preferences Need No Inferences," *American Psychologist*, 35, 1980, 151-175.
[5] Andrei Shleifer, *Inefficient Markets* (Oxford, UK: Oxford University Press, 2000), 5.
[6] Ibid., 12.
[7] Solomon E. Asch, “Effects of group pressure upon the modification and distortion of judgment,” in H. Guetzkow, ed., *Groups, Leadership and Men* (Pittsburgh, PA: Carnegie Press, 1951).
[8] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt Brace Jovanovich, Inc., 1936), 154-158.

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Other Resources

http://www.vanguard.com/bogle_site/sp20031103_2.html.

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