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INVESTMENT PERSPECTIVES

Contrarian Investing

Over the past ten to fifteen years we have discussed with our clients and written about our contrarian approach to investing on many occasions because this strategy is a core component of our decision-making process. We have chosen to review our comments on contrarian investing now because of the uncertain investment climate that we currently face.

Contrarian strategies seek to take advantage of investor overreaction in the equity markets by purchasing high-quality companies when their stock prices are low. In many cases investors overvalue the future prospects of popular companies and undervalue those of out-of-favor companies. We determine value by following a very disciplined and consistent research process (see our March 31, 2007 Investment Perspective in the Library section of our Web page: <http://www.hutchinsoncapital.com/research-library.html>). We avoid investments in popular companies that have gained large support because frequently this popularity leads to inflated prices and excessive downside risk. If a popular company disappoints investors with lower than expected earnings, reduced sales, an accounting scandal, or for almost any reason for that matter, the price of the company often drops significantly. In essence, investors realize that the excessive valuation was unrealistic, that overly optimistic expectations will not be met, and – quite simply – they have overpaid for the “privilege” of owning stock in the company!

Contrarian investing requires a combination of patience, discipline, and conviction. For example, the strong stock market performances of the late 1990’s and from 2003 through late 2007, attracted many investors who over-paid for the stocks they purchased and watched them decline significantly during the downturns that followed. Contrarian investing during these times was out-of-favor, but adherence to this strategy helped to produce sound long-term results.

Contrarian investing requires a healthy dose of skepticism toward the mainstream opinion of the so called experts. History is filled with examples of how the experts in various disciplines – the arts, science, military, and medicine – are frequently wrong. In 1899, the commissioner of U.S. Patents recommended to the president to close the patent office because “everything that can be invented has been invented.”¹ A banker told a potential

investor in Ford Motor that, “the horse is here to stay, but the automobile is only a novelty—a fad.”² Thomas Watson, the founder of IBM, said in 1943, “I think that there is a world market for about five computers.”³ The list goes on, but these are just a few examples of how the forecasts of “experts” can be way off the mark.

Unfortunately, the record of forecasters in the field of economics and finance is not much better. In his book, Contrarian Investment Strategies: The Next Generation, David Dreman cites numerous examples of the dismal track record of most economic forecasters. Even consensus estimates are frequently just extrapolations of recent trends and can therefore miss critical turning points. In the words of economist John Kenneth Galbraith, “The function of economic forecasting is to make astrology look respectable.”

Like economists, many security analysts have a poor record of forecasting. Analysts spend much of their time building and maintaining financial models forecasting a company’s sales, earnings, cash flow, and other financial statistics. Dreman conducted several research studies comparing analysts’ forecasted earnings to actual earnings. Over a more than twenty-year period analysts were off the mark on average 42% of the time.⁴ As a result of the dismal forecasting records of economists at the macro level and security analysts at the micro level, we do not spend a lot of time tracking their recommendations. A guiding principle of contrarian investing is to constantly question the assumptions, conclusions and perceived wisdom associated with the consensus view.

Currently there are two particularly good examples of popular investments that are quite overvalued, in our opinion. Many contrarian investors do not believe that these two investments, gold and high-yield bonds, can continue their upward rise for much longer.

- Gold – The current “gold rush” started about ten years ago spurred by the financial crisis and growing concerns about rising sovereign debt levels. Prior to about 2000, central banks had been selling gold as it was considered a drag on profits since it carried no promise of steady yields, and incurred storage and insurance costs.

Gold is unlike traditional investments since it does not produce dividends or earnings (like a common stock), nor interest (like bonds), nor rent (from a real estate investment). You can’t measure its value using the basic tools we have talked about for many years. It is impossible to determine when it is cheap or expensive. It sells strictly, we believe, on the emotions of buyers and sellers.

As you might have guessed by now, we strongly recommend against buying and owning gold. We believe that the gold bubble will burst the same way that tech stocks did in early 2000 and housing did in the mid 2000s. Gold has no fundamental value except what someone else will pay you for it, and right now everybody is on the “gold train”. The optimists will tout how governments are printing money and debasing currencies; a great story, but gold had this same rapid rise in the early 1980s and produced no return for 20 years after that!

We always look for high quality investments that are selling below their intrinsic value; typically that means few people want to buy them. Warren Buffett has a

great quote about this: “Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can’t buy what is popular and do well.”

- Chasing Yield – Another example of where we are contrarians is in the bond area. Many investors are quite disappointed with the performance of their stocks and are incredibly wary after the dramatic downturn in the stock market in 2008. They are looking to bonds for safety of principal but are disgruntled with the current yields offered in the marketplace. The current consensus is that if you look hard enough you can find “special” bonds that pay higher interest, sometimes 6 and 8 percent! Yield is a function of three factors: credit risk (the risk the issuer will default), interest rate risk (the risk interest rates will rise and bonds prices will decline), and liquidity risk (the risk that when you wish to sell your bond, few will be willing to buy them). In order to get higher yields you must be willing to take on one, two, or all three of these risks.

We manage our bonds in an eight year ladder (an approximate equal amount invested in each year of the eight year period) and do not buy lower quality bonds due to their inherent risks. Our bonds primarily act as “shock absorbers” for the portfolio by rising in value when stocks fall. The fact remains that the Federal Reserve has driven interest rates to incredibly low levels to stimulate growth, and there are no “special” bonds available in the marketplace. Because of the three risky factors mentioned above, we will not change our bond process to reach for higher yields while putting your principal at risk.

For most investors, selling a successful stock, bond or commodity when it has been steadily rising in value for several years is very difficult. Generally, the investment has become extremely popular, Wall Street research reports are quite positive about future prospects, and expectations are that the investment’s price will continue to rise, even though valuations are excessive. It is truly amazing to us how many investors make the assumption that because an investment has been going up consistently for a period of time that it will continue to go up – period! It is simply human nature to extrapolate recent trends. In our role as “paid skeptics” we are continually aware of this common behavioral bias.

Being contrarians, we are instinctively suspicious if the price of a stock or any investment is rising too quickly. When doing research on a stock we look very carefully at the following factors:

- reputation as a leader in its industry
- management with a proven track record
- consistency of key operating and financial ratios versus their peers over an economic cycle
- the company’s management of free cash flow and debt
- the potential for sound growth over the next 3-5 years
- barriers to entry in its industry
- sustainable competitive advantages
- pricing power in its product lines

- exposure to international markets.

Typically, if a stock we own has doubled from its initial purchase price, it has become too popular and its valuation is less attractive. Also, the stock position may now be twice as large as the average stock position in a portfolio, which tends to increase risk and limit diversification. At this time, we usually sell at least half of the position as a risk management strategy (assuming the gain is a long term capital gain) in order to maintain the diversification we believe is essential in a balanced portfolio. Interestingly, by being contrarians and asking the right questions, we can often see the seeds of an earnings decline long before it actually occurs. An extra benefit of selling a stock when it is very popular is that it is easy to get a really good price for the stock – this is not the case if everyone else is trying to sell the stock at the same time!

We should point out that there are potential pitfalls in contrarian investing. On the surface, some companies may appear to represent attractive value when in actuality they are “cheap for a reason.” The challenge for us is to distinguish between those companies which are only temporarily out of favor and those whose fundamental position is likely to deteriorate further. Also, we always strive to eliminate from consideration those companies that do not meet our stringent parameters for quality and potential for earnings growth.

We are always searching for leading, well capitalized and soundly managed companies that are selling at attractive valuations. There are not that many companies today that meet our requirements. For this reason we are quite cautious in buying new stocks. We expect, however, that the considerable amount of uncertainty and potential overreaction regarding the future growth of economies in both developed and emerging countries will create some attractive buying opportunities for patient contrarian investors. We will be watching for these opportunities.

¹ Christopher Cerf and Walter Navasky, *The Experts Speak* (New York: Pantheon, 1984), p. 203; ² p.228; ³ p.208

⁴ David Dreman, “The Contrarian,” *Forbes*, June 6, 2000