

THE CONTRARIAN MINDSET

Key to Investment Success



By David L. Smith, Editor and Publisher

Cyclical Investing and *The Cassandra Chronicles*

“Contrarian investing is the purchase and sale of investment assets at times, in amounts *and for reasons* opposite to the prevailing wisdom.”

David L. Smith

Contrarians have a soft spot in their hearts for George Armstrong Custer. We know how it feels to be surrounded, outnumbered and attacked from all sides by a determined foe. And yet, unlike the 7th Cavalry, contrarians do not perish at Little Big Horn, but instead march away unscathed. How, you ask? The answer is in the contrarian mindset.

Embracing discomfort

The contrarian mindset begins with the willingness to embrace discomfort. The biggest discomfort contrarians must learn to accept is the inevitable period of time when the contrarian perspective seems to be out of touch with reality. The contrarian approach – buying out-of-favor investments cheaply, then selling them at higher prices when they become popular – is necessarily based on the assumption of change. So for a while, until the tide of investment favor turns, contrarians are, in effect, asserting that “what is not will be.” The conventional wisdom tends to view such an assertion as an article of faith, rather than a scientific basis for investment decision-making.

Avoid “Demon Extrapolation”

The consensus perspective, on the other hand, provides a reassuring veneer of reasonableness, based, as it is, on its link to the tangible realities of the *immediate past*. The main problem with the consensus perception, however, is the implied assumption that the realities of the immediate past will extend indefinitely into the future. It is an all-too-common mindset known as “demon extrapolation.” While the demon extrapolator, in theory, admits to the possibility of eventually change, in practice such change is always somewhere out there in the indefinite future; the next expected event always resembles the immediate past. Consequently, demon extrapolators inevitably



behave as if events advance in a straight line – the future resembling the past – with an equally inevitable result: demon extrapolators *always* miss the turns in a changeable world.

Demon extrapolation is tantamount to driving while looking in the rear-view mirror. Unfortunately, there is nothing in the road immediately behind warning of a curve ahead.

Like the rear-view-mirror driver, the demon extrapolator will seem to be vindicated (and dissenting contrarians discredited) as long as the road remains straight and the future resembles the past. And for a time, it often does, which is what produces the demon extrapolator mindset in the first place. However, when the turn comes, rearward-looking demon extrapolators do not see it coming, and inevitably, they miss the turn, crash and burn.

Welcoming the disdain of the consensus

Contrarians, for their part, must learn to deal with that dissonant period before the turn, when they must accept the disdain of the consensus. Like a man carrying an umbrella on a sunny day, the successful contrarian must confront and ultimately accept the discomfort of being out of step with the majority, for a while anyway. It comes with the territory. However,



for the contrarian the discomfort ends and vindication comes when the future stops resembling the immediate past and the contrarian's out-of-favor investments become popular and appreciate. Laughing all the way to the bank, the contrarian eventually enjoys acceptance, approval, even admiration, not to mention profit. So after successfully navigating a few such turns, contrarians find the consensus' disdain loses its sting. Indeed, the seasoned contrarian feels uneasy without it. Meanwhile, demon extrapolators who miss turns, crash and burn, remain oddly unaffected, since while often wrong, they are never in doubt, nor do they seem to learn from their experience.

Having recognized the systemic fallibility of the consensus, the contrarian develops a healthy skepticism of the conventional wisdom, ceases to be intimidated by its seemingly authoritative pronouncements and cheerfully accepts its disdain in the certain knowledge that vindication will come when the road eventually turns. The disdain of the conventional wisdom tells contrarians they are on the right track. In effect, the contrarian accepts the burden of discomfort in exchange for the rewards of a more accurate vision of reality than the conventional wisdom: where the conventional wisdom sees straight-line continuity the contrarian sees change as inevitable in a curvilinear world. The contrarian must find strength in the conviction that ultimately the conventional wisdom will be revealed as being out of touch with long-term reality,

having succumbed to the fallacy of demon extrapolation and expectation of constancy in a world we know to be changeable.

Knowing when to go along with the consensus



However, let me add, it is just as unproductive to be a knee-jerk contrarian, blindly disagreeing with the consensus just for the sake of being contrary. There are times when, indeed, the road is straight and the consensus is right not to expect change, at least not immediately. At such times, contrarians will go along with the consensus, the main differences being in their expectations and emotional state (about which more later).

The trick is to objectively analyze the situation with sufficient insight, good data, common sense and independence of mind to recognize when the road is, indeed straight, and not get too far ahead of the curve. Not getting too far ahead of the curve accomplishes two things: 1) It reduces the time during which the contrarian must suffer slings and arrows or be seen as “the boy who cried wolf.” (remember, though, in the story the wolf eventually showed up) 2) It also lets the contrarian ride a profitable trend favored by the consensus. Consequently, the contrarian must know when to go along with the consensus during extended periods of relatively little change so as to profit from a stable situation. Therefore, while contrarians may find themselves temporarily in agreement with the consensus, the difference in expectations between the consensus and the contrarian on the straightaways is this: as time passes without change, demon extrapolators in the consensus become increasingly comfortable and reinforced in their conviction that things will continue as they are, while the contrarian becomes increasingly *uncomfortable* with that notion and looks ever more diligently for the signs of change.

Never lose sight of a problem

One of the fallacies nurturing complacency in the conventional wisdom during long periods of stability is the perception that a problem which persists for a long time without serious consequences stops being a problem. Just the opposite perception is true for the contrarian: each day that passes without serious consequences brings the day of reckoning one day closer. Moreover, to the contrarian, the longer the consequences are delayed, the more serious they are likely to be. Contrarians view the consensus' complacency as akin to thinking there is no danger when walking toward a cliff because you haven't fallen off yet. Consequently, while the prevailing wisdom may *see* a problem -- like overvaluation of stocks in the late



1990's, for example -- they are lulled into a false sense of security by the very length of time during which nothing bad happens (but the problems covertly gets worse). The conventional wisdom goes to great lengths to dismiss or explain away the problem, usually beginning with "this time it's different." Once the consensus concludes that the problem is not a problem after all, the bad news suddenly catches them by surprise and unprepared, with disastrous consequences.

Conversely, contrarians stick to their guns, continuing to actively regard a problem as such, despite an extended period of tranquility, while refining their techniques for identifying the onset of trouble and preparing for it. In the case of overvalued stocks in the 1990's, for example, while uneasily recommending stock ownership during the mania on the theory that "the trend is your friend," I provided my subscribers with continual updates on the "top ten signs of a bull market peak," so they could see it coming and prepare to exit the stock market. Then I pulled the plug on stocks on January 4, 2000, ten days before the Dow's all-time peak close at 11,722 and three months before the NASDAQ peak close at 5,048. My subscribers avoided the entire subsequent stock market meltdown during which the Dow fell 38% to a low of 7,206 and the NASDAQ plunged 78% from its March 2000 peak to a bottom of 1,114 in October 2002.

The consensus is the contrarian's reverse barometer

The contrarian analysis needs to be soundly executed in order to accurately gauge the direction and magnitude of change. Extreme conditions are the easiest to analyze. When the consensus enthusiastically proclaims "things couldn't be better," then the logical contrarian conclusion is "they are bound to get worse," as I warned my subscribers in 1999, before the NASDAQ crash in 2000 and the recession in 2001. The very preponderance of consensus agreement serves as a useful reverse barometer as to both the timing and direction of change. In the stock market, for example, when there is nearly universal agreement that stocks will continue to rise, it is likely that virtually all available funds from the bullish consensus will have been committed to the market, leaving little, if any, additional buying reserve to drive stocks higher; consequently stocks will fall. Just the opposite is true at market bottoms when the conventional wisdom overwhelmingly expects stocks will continue to fall. When things are terrible and most pundits on television sagely predict further stock losses and Lou Dobbs somberly nods in agreement, it's time to buy.

The true contrarian versus "mavericks" within the consensus

The middle ground between extremes poses a greater challenge for contrarian analysis. The stock market meltdown in October 1987 provides a good case in point. Over-exuberance in the market had been developing throughout the year following the collapse of oil prices in 1986, events I had foreseen in mid-1984. At a price-earnings ratio of about 20-22, the Dow was quite overvalued by mid-1987. The two-year surge had propelled stocks well above their long-term uptrend, building enthusiasm within the consensus, thereby raising my contrarian anxiety. In July 1987, I had set 2300 on the Dow as my technical stop-loss level, below which I recommended getting out of the

market. The stop-loss was triggered on Friday, October 16, prompting my recommendation to exit the market three days before the crash. On October 19th the Dow plunged 504 points, (22%) the largest single-day decline in the history of the stock market. Nevertheless, stocks closed at just about the level where the long-term technical support could reasonably be inferred and price-earnings multiples were reduced to reasonable levels. With stocks essentially back in the middle of the road, where did the contrarian position lie? Would the downdraft gather momentum, consistent with my earlier bearish contrarian anxieties? Or had October 19th corrected the imbalances of overvaluation and excessive optimism in the market, setting the stage for a rebound? The consensus provided a clue.

Predictably following the principle of demon extrapolation, the conventional wisdom projected the immediate past into the indefinite future and proclaimed the crash as a signal of the beginning of a new bear market and recession. Some pundits, Pierre Renfret prominent among them, styled themselves as “contrarians,” predicting a repeat of the crash of 1929 and the Great Depression of the 1930’s. But was this truly a contrarian position, or merely an exaggerated consensus position?

My contrarian analysis led me to conclude that the October 19th crash would have no perceptible effect on the economy, and that stocks would recover promptly, so I recommended aggressive re-entry into the stock market on October 31, 1987, eleven days after the crash. I based my analysis on the fact that only 12 percent of households in those days owned stocks (compared to more than 50% today) and most investors, being wealthy, would not significantly alter their consumption patterns based on a stock market decline; so the “loss-of-wealth-effect” would be minimal. Moreover, chairman Greenspan famously rescued the day with his one liner announcing the Fed’s commitment to make available the necessary liquidity to stabilize the market. When I added up the economic and monetary analysis and factored in the reverse barometer of a pessimistic consensus, my contrarian instincts led me to conclude a strong rebound was in store. So on October 31, eleven days after the crash, I recommended aggressive re-entry into the stock market. My analysis indeed, proved to be correct as stocks skyrocketed and the economy forged ahead for the next three years.

The point of the story is to illustrate the value of independent analysis and the difference between a true contrarian position and a false one, represented by mavericks within the consensus, in situations occupying the middle ground between extremes. While these mavericks do differ from the consensus, they differ in magnitude, not direction. Consequently, such mavericks do not represent a true opposing contrarian position, but rather an extreme version of the consensus.

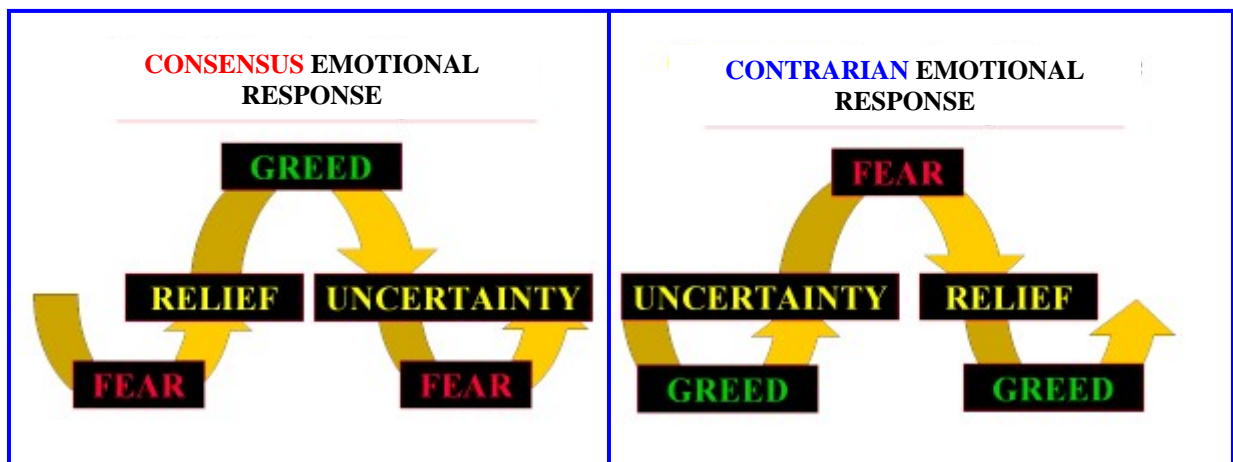
Dealing with emotions



In the epigraph, I stated: “Contrarian investing is the purchase and sale of investment assets at times, in amounts and *for reasons* opposite to the prevailing wisdom.” One of the major reasons motivating investment decisions is *emotion*. Over the course of a

market cycle, the prevailing emotions motivating the consensus, range between fear at the bottom and greed at the top, with intermediate episodes of relief on the way up and uncertainty on the way down. Basing investment decisions on their emotions, the consensus will invariably “buy high and sell low,” consequently prevailing emotions within the consensus provide contrarians with highly reliable *reverse* barometers to guide profitable contrarian investment decisions.

Here’s why: Having been driven by fear to sell assets and raise cash at the bottom of a bear market, the consensus will experience relief in the early stages of a market rebound, and responding to that emotion, will continue to hold cash, reinforcing that sense of relief even as the market recovers. Gradually, as the market improves and the memory of fear recedes, greed begins to emerge, prompting consensus investors to begin buying the appreciating assets. As the market climbs toward a peak, fear is forgotten, and relief within the consensus gives way to greed, driving consensus investors to commit the balance of their cash at the top of the market. Once all of their cash has been committed, there is no further buying power to propel the market higher, so it peaks and begins to fall (dragged down by selling by nervous contrarians and the lack of new money from consensus buyers). As the market begins to fall, greed within the consensus devolves into uncertainty. Wavering between greed and fear, consensus investors are frozen into inaction by uncertainty, so they hang on to their positions, hoping for a prompt end to the decline and a resumption of the bull market, which does not come. When eventually the persistent market declines raise fear once more as the prevailing emotion, consensus investors will again be driven to sell at the bottom. Accordingly, investors who invest by responding to the prevailing emotion of the day will invariably succumb to a well-known and little-loved investment formula: buy high, sell low.



The contrarian investor, on the other hand, uses the prevailing emotion as a reverse barometer, and develops an emotional response that is exactly the opposite to that of the consensus. It is, I might add, an acquired skill, requiring a transcendent perspective, discipline, practice, and a willingness to learn from one’s mistakes. It is also the source of consistent profits for the contrarian. When in the early stages of bull market the consensus is experiencing relief and holding cash, the contrarian investor is fully invested, experiencing uncertainty, wondering when to take profits as the market trends

higher. As the market approaches a top, the contrarian investor's uncertainty resolves into fear inspired by uneasiness about the prevailing greed in the marketplace and a desire to avoid loss, the opposite of the consensus' focus on reaping gains. The contrarian's fear, therefore, prompts a profitable sale of assets at the top of the market. Then, as the market heads down, and the consensus holds assets in a state of uncertainty, the contrarian experiences relief at having sold at the top and avoided the subsequent decline. Finally, as fear of further loss grips the consensus, prompting wholesale liquidation, the contrarian, laden with cash, experiences greed at the sight of the bargains offered by panicked consensus sellers, and enters the market once again at the bottom. *It is important to recognize that only those with the foresight to have raised cash at the top can experience greed at the bottom.* A bargain is no bargain unless you have the cash on hand to buy it. Using the prevailing emotions as a reverse barometer is essential to the contrarian investor buying low and selling high.

Some investment gurus advise taking the emotion out of investing by adhering to mechanistic rules or, perhaps some form of mental discipline, like transcendental meditation. I question the feasibility of such attempts, since investing involves risk and reward and these engage the emotions. Rather than denying their emotions, investors should engage their emotions profitably, using the contrarian techniques described above. Let the prevailing emotions of the consensus serve as a reverse barometer, triggering profitable contrarian investment decisions, which then enable the contrarian to experience the productive contrary emotional states described above.

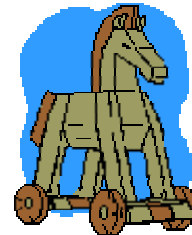
The emotional component to investment decision-making represents the great divide between consensus and contrarian investors. Emotions lead the consensus to buy assets because they are dear (just the opposite of what they do when they buy groceries) and contrarians to buy assets because they are cheap, and just the opposite when it comes to selling.

Avoiding the “Cassandra Syndrome”

I began this article by discussing the discomfort that is the contrarian's lot. In addition to the temporary discomfort associated with appearing to be out of touch with reality or being temporarily in agreement with the consensus during periods of stability, the contrarian suffers another discomfort: the burden of foreknowledge of impending crisis. If the contrarian's creed is “anticipate change,” there will be occasions during good times when contrarians must necessarily anticipate bad times. And since when you know what to look for, it is easiest to find it, the contrarian spends a fair amount of time in good times uncomfortably contemplating the gathering clouds of crisis, while the consensus contentedly basks in the sunshine of the recent past, oblivious to the coming storm.

The preference in good times to look backward at a pleasant past rather than forward to an unpleasant future is another major systemic flaw in the mindset of the conventional wisdom. It is what I call “the Cassandra Syndrome”: the unwillingness to contemplate warnings of impending calamity. The term comes from Greek mythology, which, as we know, is fond of illustrating fatal flaws in human nature. The danger

associated with the unwillingness to contemplate warnings of impending calamity is revealed by the story of Cassandra, the daughter of King Priam of Troy at the time of the Trojan wars. As the favorite of the god Apollo Cassandra received the gift of clairvoyance. However when she rejected him, Apollo cursed her with disbelief. So while Cassandra could accurately foretell the future, nobody would believe her prophecies. Accordingly, her warnings of impending calamity were ignored by her father, the Trojans, and eventually, the Greek king, Agamemnon, who were all destroyed when her prophecies were fulfilled. Consequently, though he intended to curse Cassandra, Apollo also cursed those who heard and ignored her prophecies. The point of the Cassandra story is to reveal the misfortune that befalls those who ignore sound warnings of impending calamity. Since it is impossible to consciously take steps to avoid the dangers one does not see coming, successful contrarians must be willing to bear the discomfort of contemplating an unpleasant future so as to recognize and respond to the signs of approaching danger.

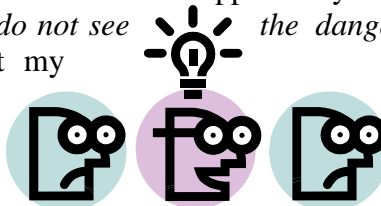


Moreover, the truly successful contrarians not only willingly contemplate the anticipated dangers of impending crises, but they also welcome crises, strange as that



may sound, because of the profit opportunities they present. An anticipated crisis is exceptionally good news for informed, alert investors who understand the meaning of the Chinese symbol for crisis. Notice that it is a combination of two symbols: the first is danger and the second is opportunity. Once you grasp this essential

duality, you lose your fear of crisis, avoid the danger and look for the opportunity. But there's a catch: *You cannot seize the opportunity if you do not see the danger.* My job as a newsletter writer, therefore, is to alert my subscribers to the dangers and show them the opportunities – in short, to provide them with the most valuable information they can use and the most expensive advice to ignore.



The wisdom of this approach is readily apparent in the investment world, offering, as it does, the opportunity for profit at all times as long as one is on the right side of the market. In rising markets, the long position will yield profit. In declining markets, the short position (or cash, awaiting future bargains) will also be profitable. Obviously, a successful investor must know the appropriate investment response to each situation, particularly in relationship to developments in the economic cycle, which is a whole other subject addressed in the companion report: “Cyclical Investing – Mining the Economic Cycle For Consistent Profits” available to *Cyclical Investing* subscribers.

Timing is everything

Finally, a profitable contrarian investing strategy requires not only an appropriate but also a timely investment response, which brings to mind a fundamental investing dictum: “timing is everything.”

As previously stated, there are times when it is profitable to ride a



swelling consensus wave, and there are times to kick out, just before it crashes. It does no good in a bull market to correctly foresee a coming crash but exit the market years before it happens, thereby missing out on considerable appreciation. The same is true of finding a buying opportunity at the trough of a bear market. As in car racing, the money is made skillfully navigating the turns. Contrarian indicators of an approaching market reversal – such as the prevalence of rampant greed and “irrational exuberance” or fear and panic within the consensus; fundamental overvaluation or undervaluation; signals from leading economic indicators – are “atmospherics” that often appear long before a market turns, and consequently provide imprecise cues for investment action. Consequently, in order to fine-tune buy and sell decisions, I find it helpful to keep a few basic technical tools in my back pocket, such as trendlines, moving averages, stochastics, relative strength index (RSI), commodity channel index (CCI), momentum indicators, candlestick patterns and more. (For further information, visit the dean of technical analysis, John Murphy’s excellent web site www.stockcharts.com) Therefore, while the atmospherics provide the early warning of impending change and give some idea of its magnitude, technical reversals trigger the precise timing of a profitable investment response.

Relying on trendlines and moving averages necessarily means reacting just after the event, like a counter-puncher in boxing. No significant reversal can occur without a trendline or moving average being crossed. Therefore, you will never sell precisely at a top or buy precisely at the bottom, nor should you try. It is enough to get out just after a top, or in just after a bottom, thereby capturing the bulk of the profits while avoiding the bulk of the losses. This approach is a variant of another tried-and-true market dictum: “Cut your losses and let your profits run.” The trick is to adjust the technical trigger so as to avoid over-reacting to trivial changes while reacting appropriately to major market reversals foreshadowed by the contrarian indicators.

Other technical indicators strive to provide entry and exit signals coinciding with or anticipating market bottoms or tops by revealing “oversold” or “overbought” conditions or patterns of market behavior common at such turning points. Using these technical tools incorporates a measure of art and intuition besides science and requires a fair amount of experience gained in the school of hard knocks. Consequently, I advise an apprenticeship using “paper” or “virtual” trading before venturing into this arcane world, and even that won’t be sufficient, since you won’t learn how to deal with the emotional side of such trading until you “have some skin in the game.” Therefore, get in to the game with real money slowly and cautiously, learning your lessons along the way.

Bottom line: take your cues from the market. The market behaves irrationally at times, and often confounds. But the market is the 800-pound gorilla. So pay attention to those old Wall Street adages: “Cut your losses and let your profits run.” “Don’t fight the tape.” “The trend is your friend (until it ain’t).” These sayings are the lessons learned the hard way by a long line of investors.

However, the consistently successful investors through the years learned even more fundamental lessons than these, namely to develop a contrarian mindset, the essence of which I have shared with you on these pages.

Summing up

The contrarian mindset is the means by which investors consistently capture profits and avoid losses. It is a skill most contrarians acquire by painful experience, but which can also be acquired by taking to heart and practicing the following principles:

- Embrace the discomfort that accompanies the contrarian mindset
- Avoid “demon extrapolation” by constantly anticipating change
- Welcome the disdain of the consensus
- Know when to go along with the consensus
- Never lose sight of a latent problem
- Analyze the situation objectively and accurately
- Develop contrarian emotions using prevailing emotions as a reverse barometer
- Avoid the “Cassandra Syndrome” by willingly contemplating impending crises
- Identify the dangers and find the opportunities in crises
- Respond appropriately and profitably to change in a timely fashion

Just think. If George Armstrong Custer had been a contrarian and followed this little checklist, he would have avoided Little Big Horn, happily marching away unscathed to live and fight another day.



David L. Smith is a Dartmouth- and Stanford-trained economist, futurist and market strategist based in Houston, TX. During his 40-year career in the investment arena, he has served as a securities analyst with Wells Fargo Bank and Shuman Agnew (acquired by Morgan Stanley); a mergers and acquisitions specialist with Bangor Punta Corporation (acquired by Lone Star Cement); an equity coordinator and financial planner with NASD-member firm, Capital Analysts; private placement underwriter, president and CEO of Alma Securities, a national NASD-member firm. For the past 21 years he has lectured nationally and authored *Cyclical Investing*, an internationally distributed newsletter offering investment professionals “contrarian insight and cyclical market and economic forecasts.” More recently, he has added *The Cassandra Chronicles*, a quarterly “invitation to think outside the box” which “studies the present in light of the past for purposes of the future.” His articles and quotes have appeared in *The Wall Street Journal Online*, CNBC, PBS, *Money Magazine* and *The Banker* published by *The Financial of London* and *Financial Planning Magazine*. DavidLSmith@iname.com (713) 532-6090. 5161 San Felipe St., Suite 320, Houston, TX 77056.