HB Dobbin
FINANCIAL PLANNING

Contrarian investing

The concept of riskier investment strategies.

Following the latest market trends when it comes to your investment strategy usually pays off, but while most stick with the safety of the shoal there are always a few sharks swimming against the tide.

Contrarian investors are the sharks in this story, inverting conventional wisdom by selling when others buy, and purchasing when mainstream investors are selling.

This approach assumes that people are mindlessly following each other rather than really thinking objectively about the value of a given investment, leaving opportunities open to rigorously logical, unemotional lone wolves.

Investment guru David Dreman published a highly influential book called *Contrarian Investment Strategy: The Psychology of Stock Market Success* back in 1979, revised several times since.

He warns against "aspects of psychology" that "continually trick us into buying securities that are red-hot just before they collapse", and counsels against getting sucked into this kind of hype.

For example, some opportunists with an appetite for risk may have only opted to start buying ultra-hyped unregulated cryptocurrencies in 2017/18 when the bubble seemed to have burst.

In this context, the contrarians were going against the crowd, betting on the long-term future of cryptocurrency, and refusing to join the panic over tumbling values.

It's a strategy that comes with a significant amount of risk – sometimes the herd is right – but it can also provide substantial profits if you have the knack for spotting opportunities.

Attitude to risk

If contrarian investing piques your interest, the first thing to consider is your attitude to risk – this approach is not for the faint hearted.

Contrarian investing is mightily challenging for investors and financial advisers as the volatility of the market can be as lucrative as it is destructive.

There is no guarantee that the value of your investments will grow, and you could lose them altogether in the worst-case scenario.

As greater returns usually come with a higher level of risk, you'll need to weigh up your priorities and figure out how much risk you are willing to take.

Ask yourself whether you would be able to stomach dramatic fluctuations in the market, or whether it might cause too much stress.

Could you handle waking up and seeing that the value of your investment has hit the floor, and hold your nerve on the assumption that it will come up again given time?

What is the level of risk you are happy to take on without disrupting your other financial goals, such as your retirement savings?

Your goal-setting will also play a part in determining your capacity for risk, as you'll need to consider how soon you want to achieve your desired return on your investments.

Given the risk involved, contrarian investing is usually more suitable for those who have the time or resources to properly research their investments.

When it pays off

"Be fearful when others are greedy, and greedy when others are fearful," said the world's third richest person at the time of writing – American billionaire investor Warren Buffett.

Profits are usually generated when investors swoop for distressed stocks and then sell them once the share prices have bounced back and started to attract the attention of other investors.

Buffet amassed an estimated fortune of USD $84.4 billion (£64.1bn), according to *Forbes*, in a career spanning six decades. He built an empire buying profitable firms on the cheap in turbulent times.

Following the collapse of Lehman Brothers, which prompted the economic downturn of 2008, Buffet invested in stricken investment banks on terms that were hugely advantageous to him.

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Investors like Buffet look for undervalued securities based on their interpretation of the market sentiment, which is defined as the overall attitude of investors towards a particular security.

If you go down the contrarian route, you can also avoid any potential losses by getting out of a particular holding once the market peaks – but that requires knowledge and experience.

However, you run the risk of making substantial losses if the market proves you wrong which makes it vitally important to seek professional advice before you invest.

Value investing vs contrarianism

Contrarianism and value investing look broadly similar, as both strategies involve looking for stocks with share prices that are lower than what they judge to be the true value of a company.

What sets contrarian investors apart asides from their significant appetite for risk is that they also focus on the stock price movement.

However, blindly buying stock that is falling in the market with the misguided expectation of it quickly recovering is playing with fire and you can expect to get burnt.

Be aware that the value of such a stock is probably falling for a reason and it may be that the company that issued these stocks, or the sector it operates in, may be failing too.

For this reason, there is no substitute for experience when it comes to contrarian investments as it is often investors with their fingers on the pulse that succeed.

Is it right for you?

Solely focusing your investment portfolio on contrarian investments requires an in-depth understanding of the market and knowledge of what other traders are doing and saying.

This form of investment is also a far cry from the relative safety of owning assets such as cash or government bonds, even if returns are far more modest.

Contrarian investors see an opportunity during times of extreme market volatility, when most investors are seeking a safe haven to protect their investments.

Essentially, this is what contrarian investing is all about: seeing opportunities in what most other investors and financial advisers are inclined to view as threats.

You need to thoroughly understand why a stock is out of favour, grasp that market sentiment is often fickle, and hold the conviction to go against these market trends.

Being comfortable with the possibility that the market could prove you wrong is also important – that particular stock could really be just as bad a bet as the price suggests.

For the likes of Buffet, who saved Goldman Sachs from going under in 2008 by investing $5bn in the ailing firm before walking away with a $3.1bn profit, it presents an opportunity to make big gains.

The chances are, though, that most of us won't be so fortunate, and even if you do decide to experiment with contrarian investing, it would be wise to build an investment portfolio around your own appetite for risk and tailored for your goals. Speak to our advisers for assistance.

Contrarian elements

The concept of contrarianism can be partially applied to represent a small part of your broader holdings depending on your circumstances and appetite for risk.

For the purpose of example, you could allocate 15% of your portfolio for contrarian investments that carry high risk and leave the remaining 85% in safer options.

This would enable the majority of your investment portfolio to be invested in less volatile and risky assets which should generate returns over the longer term.

All of the investments we advise on are either listed, like stocks and shares, or regulated funds, and do not include unregulated options such as cryptocurrencies.

Seek expert advice before you start investing.

Important information

The way in which tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to change in the future.

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