Contrarian Investment Strategies

By Toh Zhen Zhou, Research Analyst
Introduction

One of the prominent figures in contrarian investing is David Dreman whom has written 5 books regarding contrarian investing. In the 5 books, David Dreman usually collects data of all listed companies in U.S. and proves to readers that by segregating companies into different categories within each financial ratio, there appears to be a group that outperforms the rest. For example, over a period of 20 years, companies with low price to earnings tend to outperform the companies with high price to earnings. But in his books, David Dreman talks of a very broad base investing in which you need to have the ability to invest in all low Price to Earnings Ratio company to achieve such results. So how can we, as retail investors, make use or incorporate this idea into our investment strategies. So this publication will seek to fine tune David Dreman’s idea into a more condensed and succinct one, in order to effectively allocate our funds as retail investors.

But first of all, to understand how contrarian investing works, one must first understand the meaning of a contrarian in the context of finance. Contrarian comes from the word contrary and in the context of finance; a contrarian is one who attempts to go against conventional practices of investing as the individual believes that consensus opinion of stock is wrong. Hence, contrarian investment strategies aim to sieve out mispricing of stocks in the market. Typically, such mispricing arises due to widespread pessimism of a stock; driving its price so low that it overstates the risk of investing in the company. This is very much similar to what Soros calls feedback loop in his theory of reflexivity in The Alchemy of Finance (Soros, 1987), whereby he states that price does in fact influence the fundamentals and with the new fundamentals, it changes expectations and ultimately, influencing price again. Therefore, it is obvious that the crux of this strategy is about seeking out mispriced or distressed stocks and buying them at a low price and selling when they have fully recovered.

Overall Strategy

So then comes the question on how should we go about finding such distressed companies and how can we be sure whether there is truly mispricing in the stock? The following will seek to address these questions with some examples and more often than not, contrarian investing is more of a qualitative than quantitative way of investing. That said, financial ratios are still as important in revealing how a company is doing.

We find the distressed stocks by filtering them through their financial ratios. The following are the quick ratios one can use to filter through the countless listed companies to give us an indication of what are the possible distressed and undervalued companies:

- Price to Earnings Ratio
- Price to Book Ratio
- Price to Cash Flow Ratio
- Net Debt to Equity Ratio
Price to Earnings Ratio

As Dreman stated in his book Contrarian Investment Strategies (Dreman, 2012), the first ratio to look out for is the company’s Price to Earnings (P/E) Ratio. In the book, Dreman dwell upon the psychological reasoning but this publication will not go into that aspect. However he did substantiate with statistics that low P/E companies tend to outperform the market. Generally, we look for company with a low P/E ratio as it usually indicates a company that has seen its price battered down. In essence, a low P/E will only do as much as signal that a particular company may be undervalued but it is not a clear indication. On top of that, a low P/E ratio also signals that market’s sentiment of the company is not too optimistic.

Price to Book Ratio

Price to Book (P/B) ratio is the next most important ratio to look at. Similar to P/E ratio, a low P/B ratio (usually below 1) is an indication that the company is undervalued. It gives a good some idea of how much the company will be worth if it were to go bankrupt immediately. Hence, it is commonly used on companies in distressed financial situation. Furthermore, if a company is actually profitable but is value at a P/B ratio of below 1, it usually indicates that market sentiments of the company is negative, thus the low valuation. It can also suggest that the company is facing increasingly weak business climate in the future.

Price to Cash Flow Ratio & Net Debt to Equity Ratio

The next two points are actually closely related to each other. For Price to Cash Flow (P/CF) Ratio, it works very much the same way as P/B and P/E Ratio in which we try to identify a company with low P/CF. This serves as a ratio to ensure that even if market sentiments of a company is poor, the company still has adequate ability in generating cash flow. Hence, this brings us to the point of Net Debt to Equity Ratio. A distressed company with a low P/CF ratio will usually have a low net debt to equity ratio or even a net cash position. As the saying goes, “Cash is king.” Indeed, a company with strong cash position will have an extra margin of safety because it allows the company to diversify its business by using the cash to acquire other companies. The bottom line is that companies with low net debt to equity ratio or a net cash position will be in a stronger position to maneuver or weather through difficult times.

So, after looking through what is essential in filtering out distressed and undervalued companies, it seems like these criteria can do as much as only to signal or indicate to us that the chances of it being an undervalued is high. Before we go into the part on qualitative analysis and what are the possible situations and pitfalls, we should first explore what exactly is the rationale or the motivation behind filtering out these undervalued companies?

All of the ratios mentioned above have actually got something to do with the psychology of the pricing of stocks. As mentioned above, when we look at low P/E, P/B, P/CF ratios, we are actually looking out for companies with poor market sentiments. These companies are usually the ones that are unloved by investors or institutional funds. Hence, there is a weak demand in their stocks. Therefore, naturally, stock price will eventually head downwards base of the laws of simple demand and supply. Whereas for stocks that are the analysts’ favorites usually have a rosy outlook for the company and hence, many investors will seek to buy into the company. This will result in a company with high price relative to its fundamentals. In David Dreman’s books, he clearly explains that companies with low financial ratios tend to benefit more from earning surprise while the companies with high financial ratios usually get punished from earnings surprise. One can see this in such a way: for companies with low financial ratios, negativity and bleakness of the company has already been
priced in, leaving behind a huge potential for a surge in stock price if earnings were to surprise and exceed estimate. On the other hand, if the earnings remain as poor, the effect it has on the share price would be limited since it would be within ‘expectations’. Conversely, this applies to companies with an optimistic outlook.

The Examples

The above explanation is just a very brief summary of the rationale behind the ratios that are used in filtering out companies. More substantiation can be found from David Dreman’s book as he collected data of companies over a few decades. Now, with the understanding of the rationale, we will now move on to qualitative analysis which is much harder to quantify and is very subjective.

First of all, we look for stocks which have seen their price adversely affected by news and situation of similar companies but are still fundamentally strong. To better illustrate, we can look at China companies that are listed on Singapore Exchange (SGX) which are also often known as S-chips. For the past few years, due to poor corporate governance, there have been many accounting frauds amongst S-chips which led to poor market sentiments and diminishing investors’ confidence of S-chips. This has plagued most S-chips such that any company that has strong and consistent earnings will still be priced below its book value, which gives a P/B ratio of less than 1.

In this case, it may still be as difficult for retail investors to verify the earnings and financials that are reported. Hence, in this scenario, we use substantial shareholders as an indication of the confidence in the due diligence done on the company. For example, China Minzhong (K2N.SI) is one of such companies with strong fundamentals and consistent earnings but was valued at SGD 0.53 a year ago, with a P/E ratio average of 5.3181 and P/B of around 0.5 at its low. But how can we be confident in their financial statements? In the case of China Minzhong, it was straightforward because one of the cornerstone investors during China Minzhong’s Initial Public Offering (IPO) is Government of Singapore Investment Corporation which proves that substantial due diligence should have been done upon the company. Hence, we can be sure that the China Minzhong’s financials can be trusted to a large extent. Thus the poor market sentiment and low price of the company is hence unjustified as risk has been overstated in this case.

We can also look into companies that have seen their profits hurt temporarily and due to the temporary loss or decline in profits, market sentiments becomes poor and investors start to lose confidence in the company’s ability to perform. The key of this qualitative analysis is that such situations should be temporary and that one should be confident in the management’s ability to improve and recover from the loss. Such an example can be seen from a SGX listed company called OSIM. OSIM was a company that has went through a series of unfortunate events. Chronologically, in 2008, investors first started to question its declining profit margins and empty store fronts, and then came the losses which the company incurred in China due to over-expansion.

On top of that, Brookstone, a company in which OSIM acquired large percentage of, was written off as a causing a loss of SGD 57 million to be recognized 2009. This series of events had adversely dampened the outlook of OSIM. However, we take a closer look it seems painfully obvious that the loss incurred is just a very temporary situation. And of course, in hindsight, the situation may seem easy to justify but during the time when the price of OSIM’s stock plunged to SGD0.05, few will be courageous enough to buy into the company. This is the part when contrarian qualitative analysis comes into play. However, one must note that in the case of OSIM, P/E earnings will not be a

---

1 China Minzhong ratios taken from Shareinvestor.com
meaningful ratio to consider since it was making loss. But P/B ratio was a definitely lower than 1 in 2008 allowing a large margin of safety.

**Conclusion**

In conclusion, this publication has briefly gone through how a retail investor can make use contrarian strategies to take advantage of the fluctuations in price and poor market sentiments. The strategy uses financial ratios as leading indicators and qualitative ratios to ultimately make the decision in investing a company. This means that a lot of effort has to be put in to look into how the management runs the company and what are the future strategies that are employed. The bottomline is contrarian investment allows retail investors to achieve good profits in volatile times but much effort has to be put into doing security analysis.

Email us @ research@nusinvest.com if you have any questions!
We will do our best to answer your queries!