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JUNE 10, 2010

Kim Inglis, BCom, CIM

Contrarians win when confidence down

React rationally to capitalize on rebounds

According to recent surveys, there has been a significant drop in US investor expectations among both advisors and individual investors. An Investors Intelligence survey found that 29.2% of financial advisors are negative on market outlook, while the American Association of Individual Investors found that nearly 51% of individual investors are pessimistic. That's the highest level since the start of November 2009.

The CBOE Volatility Index (VIX), often called the “investor fear gauge”, has also pointed to increasingly bearish sentiment. Used as the benchmark for implied market volatility, it has been fluctuating extensively over the last few weeks with several excursions into the psychologically significant 40 range. In this snapshot of current attitudes, it is clear that many investors are uneasy.

While some have been fleeing the markets in a panic-stricken haze, others have been looking for opportunities. Many view bearish sentiment as a contrarian indicator and interpret the increasingly pessimistic environment as one laden with hidden gems. They take a contrarian stance and believe that the best time to profit is when fear is at its peak. While the crowd is busy selling and driving stock prices down, the contrarian investor is searching for undervalued companies.

An examination of historical data indicates there is some validity in the contrarian approach. From September 2008 through March 2009, the VIX experienced unprecedented movements, including a period when it neared an all-time high of 90. Measures of bearish sentiment also spiked in March 2009. As markets plunged worldwide, most investors reacted in mass panic and sold their portfolios at huge discounts.

Following the March 2009 market bottom, both indicators slowly retreated to normal range as the markets experienced one of the biggest rebounds in history. Those who were able to react rationally, and digest the available information, capitalized on the rebound. Contrarian investors had a ball; exploiting the extensive mispricing and buying high quality blue chip investments at significantly discounted prices.

The "Dogs of the Dow" is a popular contrarian strategy, which involves annually searching out the ten companies in the Dow Jones Industrial Average with the highest dividend yields, lowest price/earnings ratios, and lowest prices. Contrarians then hold their "Dogs" for a year hoping the share prices will rise.

While the concept of buying low is sound, the "Dogs" theory has flaws. Tweaking and refinements through data mining can enhance otherwise unimportant historical artifacts while overlooking corrosive impacts. As well, the selection criteria aren't fully representative of a company's worth.

Still, as markets continue their rocky ride, thinking outside the box could prove to be wise. The idea of searching for, and holding, the most undervalued blue chip stocks until the investing public rediscovers them and drives their share prices back up is a good approach. However, it must always be accompanied by an examination and analysis of a company's fundamentals.

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Another strategy is to apply simple rules of behavioral finance and avoid hot trends. Investors tend to flock to popular sectors and will overweight them, hoping the upward trend will continue. When sentiment is at its highest and the majority is bullish on a trend, it is usually time to pull the trigger. As Joseph P. Kennedy said, “When even shoeshine boys are giving you stock tips, it’s time to sell."

No matter what strategy you choose, quality matters. Focus on the best-of-class because solid stocks purchased at the right prices will go a long way to building a strong portfolio.

Kim Inglis, BCom, CIM is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca

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