

Global Equity Strategy

Contrarian or conformist?

Sir John Templeton once observed, *“It is impossible to produce a superior performance unless you do something different from the majority”*. These wise words are often forgotten in a world obsessed with tracking-error, and where comfort is found in the herd. The biggest consensus portfolio bets seem to be small cap and low quality. So large cap, high quality looks like the better bet to us.

- ▶ Keynes opined, *“The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone agreed about its merit, the investment is inevitably too dear and therefore unattractive”*. This has always made excellent sense to us. However, today’s investment market is better characterised by investors desperately trying not to underperform every quarter and fearing to go against the crowd.
- ▶ A recent paper by Dasgupta et al shows that the stocks which institutional fund managers are busy buying are outperformed by the stocks they are busy selling! Over a two-year time horizon Dasgupta et al found that, on average, the stocks that fund managers had bought most over the last five quarters underperformed the stocks they had sold most, by 17%! They found that this strategy worked for large and small caps, and value and growth stocks, so regardless of your universe, being a contrarian seems to make sense.
- ▶ So which are the big consensus trades at the moment? The most obvious is the love of risky assets. Our own fear and greed index is once again in the irrational exuberance territory. In the equity arena there has been a fascination with the lowest quality, junk equity. That has left high quality stocks relatively cheap. This suggests that long high quality may be a good contrarian call.
- ▶ The fact that almost everyone seems bullish makes us nervous. All 12 strategists at the top US investment banks are bullish, the Investors Intelligence survey shows nearly 60% bullish (a good contrarian indicator). Margin debt is back to the levels seen in 1990. Only the insiders seem cautious. They are selling out at near-record pace; in fact, according to a Bloomberg story, their “sales of stocks ... exceeded purchases by the widest margin since 1987”. This suggests that cash might well be the contrarian asset of choice.
- ▶ Baker and Wurgler showed in a classic paper that buying large, old, low risk, highly profitable, dividend payers was generally a good idea when optimism was exceedingly high. This leads to our next contrarian view of long large caps, short small caps. The liquidity premium is negative, so by holding small caps you are paying for the pleasure of illiquidity.
- ▶ Our cheap country screen throws up Belgium, UK, Netherlands, Spain, Norway and France as looking good value in the developed arena. Within the emerging market universe, Thailand, Pakistan, Peru, Hungary, Korea and Turkey all look attractive. Amongst the sells, Japan, Hong Kong, Chile, and China stand out.
- ▶ Of course, as Sir John Templeton noted, “To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest rewards”, but few will find this easy.

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Contrarian or conformist?

For the last couple of years, every January I have written a piece on the importance of being a contrarian – this year will be no exception. As Keynes opined, “*The central principle of investment is to go contrary to the general opinion, on the grounds that if everyone agreed about its merit, the investment is inevitably too dear and therefore unattractive*” or as Sir John Templeton said, “*It is impossible to produce a superior performance unless you do something different from the majority*”.

My view is very simple – an asset price reflects the sum of the market participants’ views; as such, the consensus view is in the price. Now if the consensus is correct (and I don’t think this occurs very often) then the investor gets the return embodied in the price (a ‘fair’ return, if you like). Of course, if markets were efficient then this would be the case for all investors all of the time.

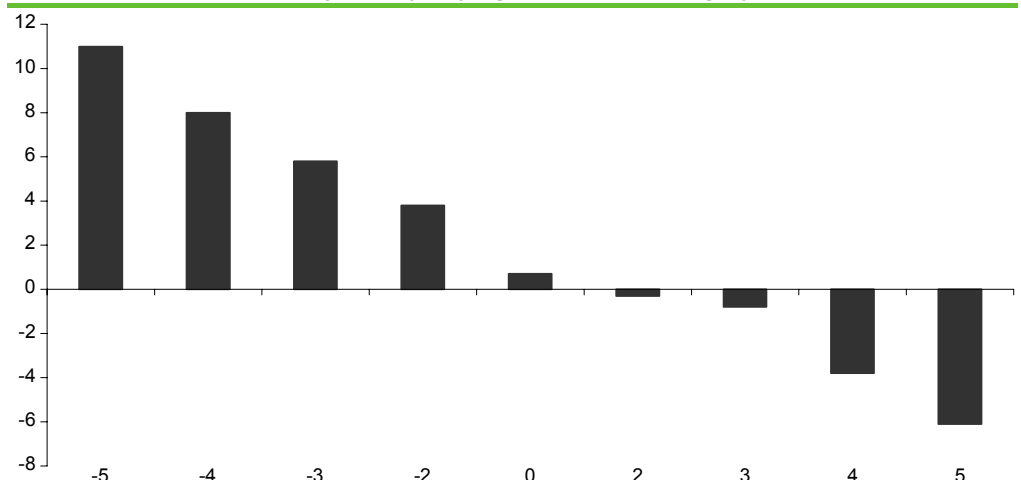
However, if markets aren’t efficient, and investors are driven by fear and greed as much as by mean and variance, other approaches can add value. For instance, if we see a marked tendency to over-react to news, then one could either try to go with the flow (momentum) or bet on an eventual return to normality (contrarian strategies).

Moreover, in a world in which everyone is desperately trying to outperform each other, doing what everyone else is doing is unlikely to generate outperformance. This is brought home in a recent paper by Dasgupta et al¹. **They showed that stocks institutional fund managers are busy buying are outperformed by the stocks they are busy selling!**

They examine US fund managers’ filings from 1983-2004. Each quarter, stocks are assigned to different portfolios, conditional upon the persistence of institutional net trade (that is the number of consecutive quarters for which a net buy or a net sell is recorded). A persistence measure of -5 includes all stocks that have been sold for at least five quarters, and a persistence measure of 0 shows stocks that have been bought or sold in the current period.

The chart below shows the market-adjusted future returns for each persistence portfolio on a two-year time horizon. Even a cursory glance reveals the negative relationship between returns and institutional buying and selling. Over a two-year time horizon there is a 17% return difference - the stock that the institutions sold the most, outperforming the market by around 11%, and the stocks they purchased the most underperforming by 6%!

Abnormal returns over two years by buying persistence category (%)

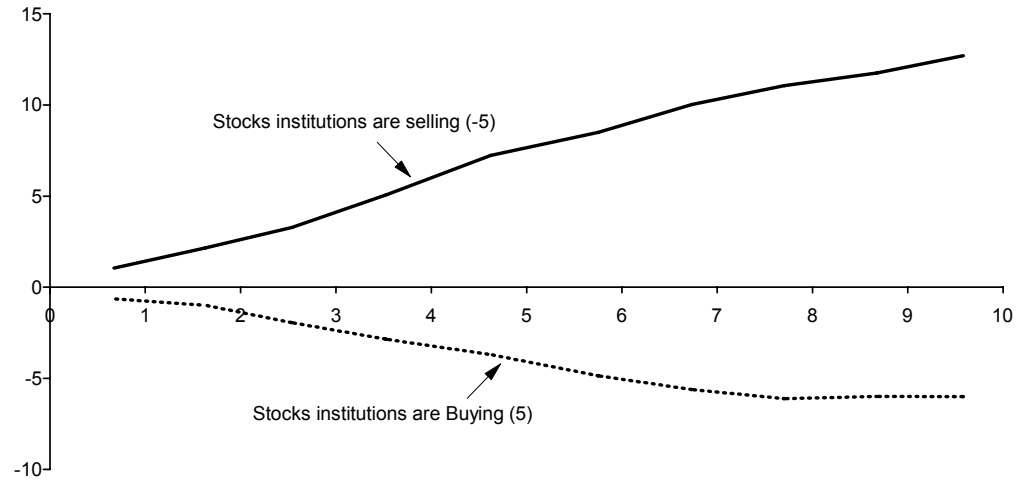


Source: Dasgupta et al (2006), Dresdner Kleinwort Macro research

¹ Dasgupta, Prat and Verardo (2006) The Price of Conformism, available from www.ssrn.com

If two years is too long a horizon then the chart below shows the returns over time for the highest (-5) selling stocks and the highest bought stocks (5). On a one-year horizon the return differential is around 9%.

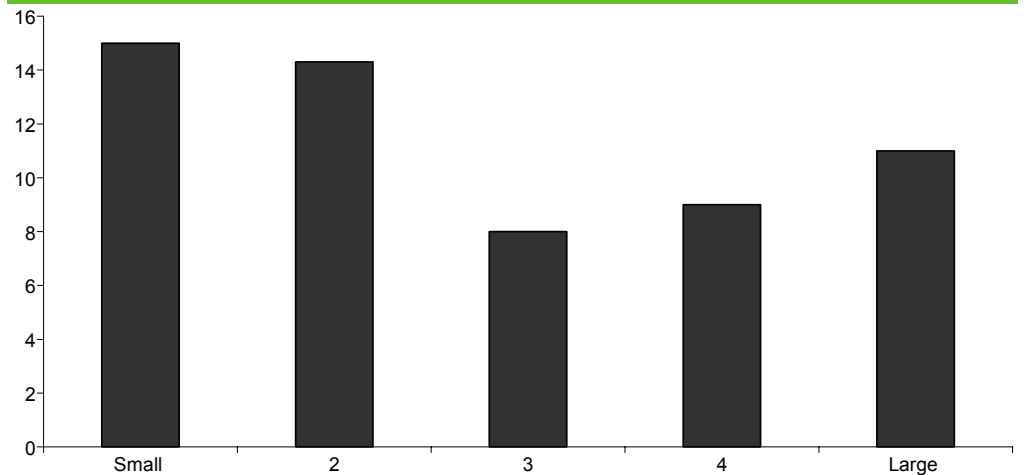
Abnormal returns by buying persistence category over time



Source: Dasgupta et al (2006), Dresdner Kleinwort Macro research

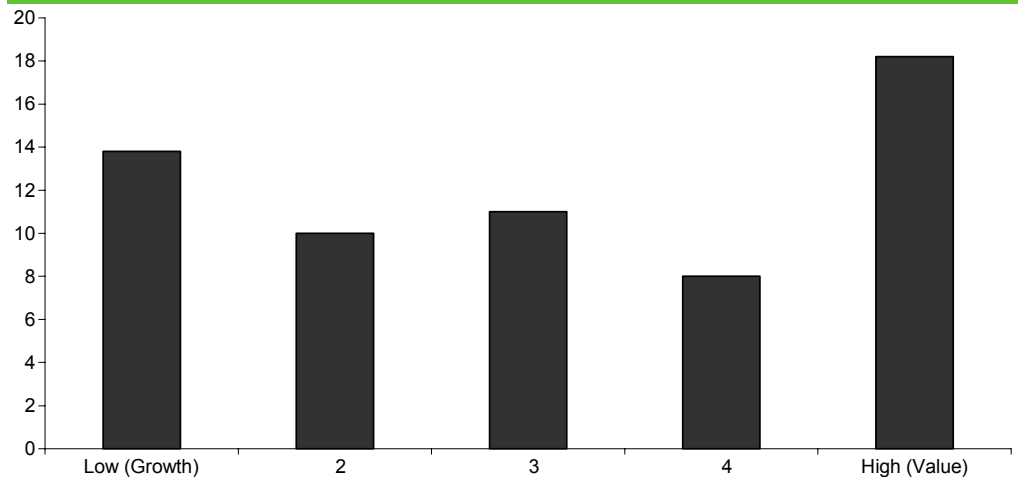
Interestingly, Dasgupta et al found that this strategy works for large and small caps, and value and growth stocks, so regardless of your universe, being a contrarian seems to pay dividends.

Abnormal returns over two years (long -5, short 5) by size category



Source: Dasgupta et al (2006), Dresdner Kleinwort Macro research

Abnormal returns over two years (long -5, short 5) by book to price category



Source: Dasgupta et al (2006), Dresdner Kleinwort Macro research

Dasgupta et al also noted several characteristics of the stocks that fund managers seem to buy with high persistence. Such stocks tend to be liquid, growth (low book to market) stocks with high momentum. Conversely, those that inhabit the selling portfolio are generally less liquid, value stocks with poor past returns.

One final aspect of Dasgupta et al’s work is noteworthy. They estimated a measure of how likely each manager is to herd (or conform, if you prefer). They called this measure the sheep index. They concluded “We find that about three-quarters of institutions display conformist patterns when faced with high-persistence stocks... our measure of conformism is pervasive... with the majority of managers displaying a positive sheep value”.

So it would appear that, as Keynes noted long ago, most fund managers accept that “Worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally”.

At a more anecdotal level, how did our contrarian views from the beginning of last year pan out? As somebody witty once observed, “I’d rather be lucky than good”. Last year was a lucky one from a contrarian perspective. The table below shows the positions we suggested in last year’s contrarian note (See Global Equity Strategy, 12 January 2006).

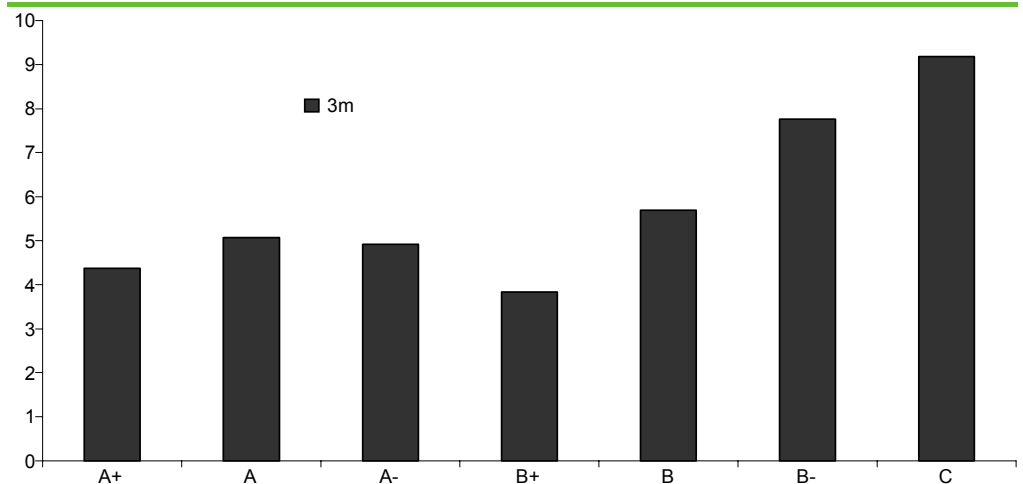
Contrarian profits

Position	Return in 2006 (%)
Long value, Short growth	9
Long large cap, Short small cap	2
Long Europe, Short US	19
Long World, Short Japan	9
Long cheap developed, short expensive developed	7
Long cheap emerging, short expensive emerging	38

Source: Dresdner Kleinwort Macro research

So where are the big consensus trades at the moment? The most obvious is the love of risky assets. In the equity arena there has been a fascination with the lowest quality, junk-like stocks. The chart below shows the performance of the US market, broken down based around the Standard and Poor’s quality rankings (on earnings and dividends) for the last quarter of 2006.

Last quarter 2006 US stock performance by quality ranking



Source: Dresdner Kleinwort Macro research

As we have argued repeatedly, there is a relative value anomaly in the quality space. The highest quality stocks are the cheapest ones relative to their usual range, and the lowest quality stocks are most expensive relative to their historical averages. **This all suggests that being long high quality is a good contrarian call.** Some of our clients and

colleagues have questioned if this is truly a contrarian call, since it is a common theme amongst strategists. However, strategists don't control funds; prices and actions speak louder than words, and the price evidence shown above suggests that those who allocate funds are still enamoured with junk equity.

This is further supported by the overwhelming bullishness that is evident almost everywhere. For instance, the table below shows that all the strategists at top US banks appear to be bullish; on average, they are expecting a 10% rise in the S&P500. Even the perennially bearish Richard Bernstein of Merrill Lynch appears to have turned bullish!

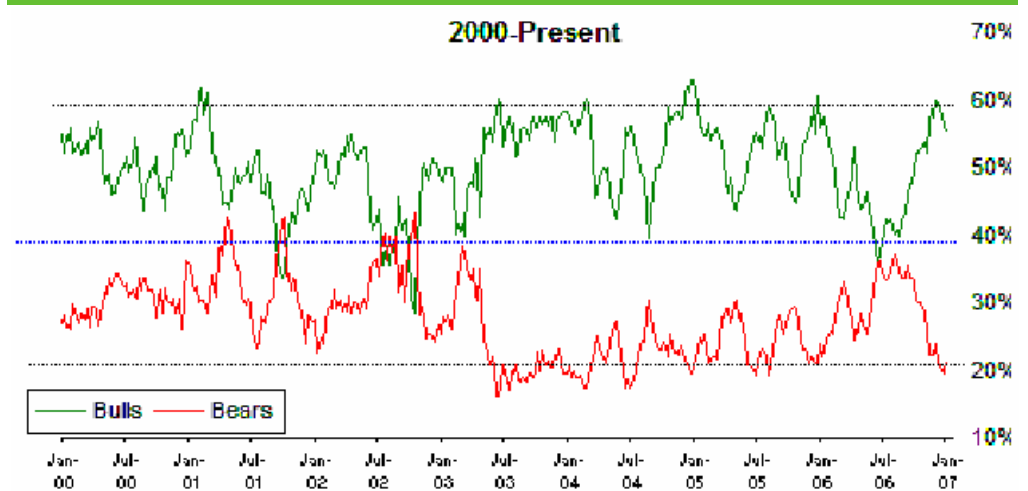
US strategist's forecasts For S&P500 (End Dec 06 = 1418)

Firm	Strategist	Target End 07
Banc of America	Thomas McManus	1465
Bear Stearns	Francois Trahan	1550
Citigroup	Tobias Levkovich	1600
Deutsche Bank	Binky Chadha	1540
Goldman Sachs	Abby Cohen	1550
JPMorgan Chase	A. Chakrabortti	1440
Merrill Lynch	R. Bernstein	1570
Morgan Stanley	Henry McVey	1525
Prudential	Edward Keon	1630
Strategas	Jason Trennert	1600
UBS	David Bianco	1500
Wachovia	Rod Smyth	1500
Average		1539

Source: Dresdner Kleinwort Macro research

The Investors Intelligence measure of sentiment also shows a remarkably high level of bulls relative to bears. The current reading of around 57% bulls and 20% bears is a potential warning sign.

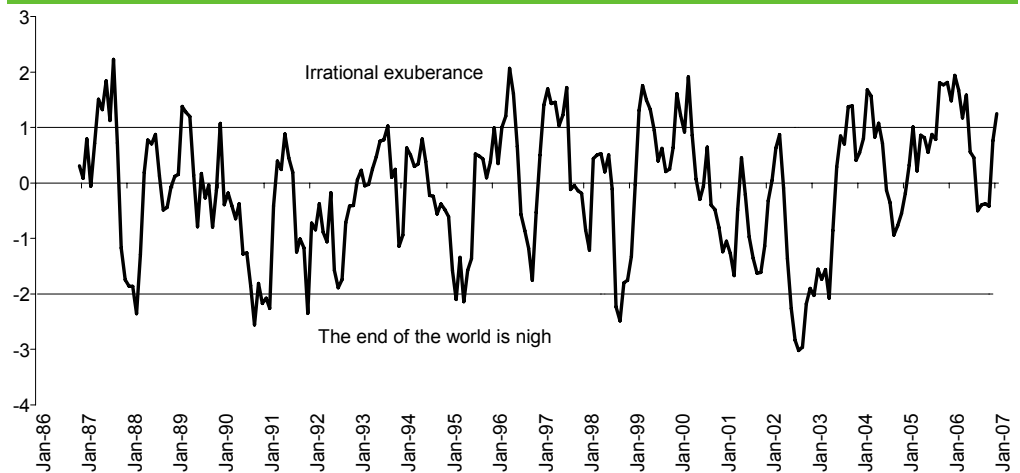
Investors Intelligence bulls and bears



Source: Investors Intelligence, Market Harmonics, Dresdner Kleinwort Macro research

Our own fear and greed index is once again in the irrational exuberance territory, suggesting that investors are pricing assets without any regard to the risk inherent within them (see the chart overleaf).

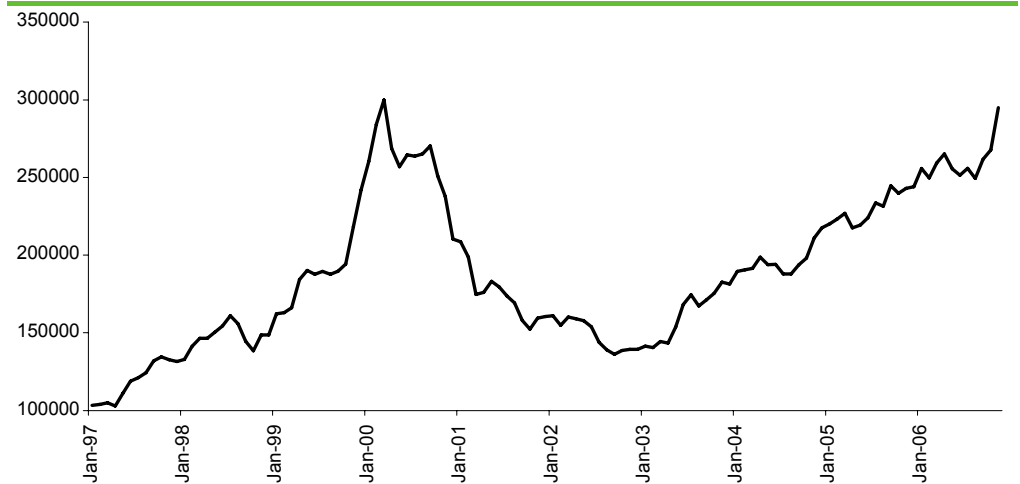
Our fear and greed index



Source: Dresdner Kleinwort Macro research

Margin debt levels are also extraordinarily high. In fact, it has now reached the same level as it did in 2000! (see chart below) However, insiders are selling out at an amazing pace. Through most of last year the ratio of insider sales to purchases was nearly 11-to-1. In November last year this soared to 35-to-1. Indeed according to one Bloomberg story, "Stock sales by America's corporate chieftains exceeded purchases by the widest margin since 1987"!

Net margin debt (\$mn)

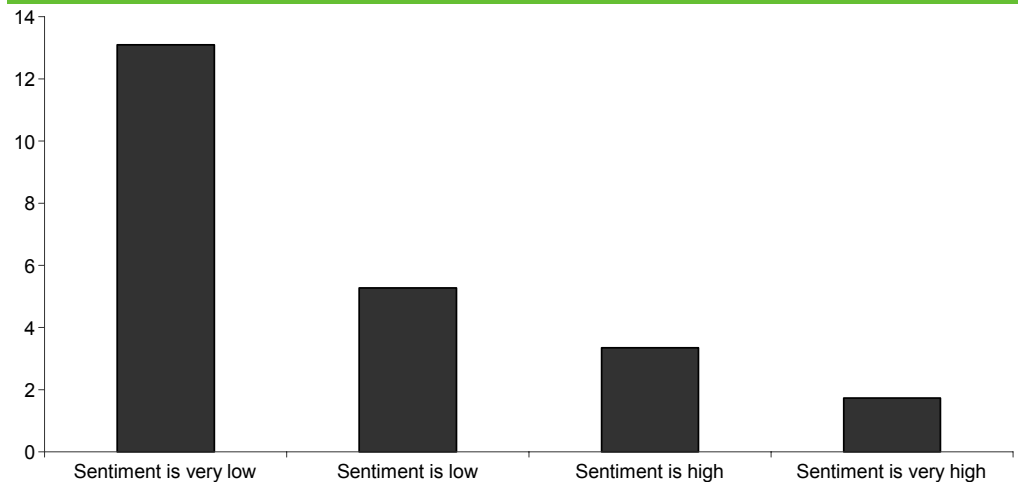


Source: Dresdner Kleinwort Macro research

This all stacks up to a disturbing picture of general enthusiasm for equities, and leads us to our **second contrarian call: overweight cash**. As Sir John Templeton said "The time of maximum pessimism is the best time to buy, and time of maximum optimism is the best time to sell".

The chart below looks at 12 month ahead excess returns over cash by sentiment reading from our fear and greed index. When sentiment is very low (below -2) the excess returns over the next 12 months are around 13%. When sentiment is very high (above 0.9) the excess return is a mere 1.7% - way below any reasonable measure of the equity risk premium. So it would appear that when sentiment is high you are simply not compensated for the risk of holding equities.

Excess returns over next 12 months by sentiment category (%)



Source: Dresdner Kleinwort Macro research

Sentiment is also useful when it comes to stock selection. In the past we have referred to a study by Baker and Wurgler² who investigated stock performance when sentiment was high and low. Their results are summarised in the tables below.

They concluded that when sentiment is high (i.e. optimistic) then investors should concentrate on old, low risk, profitable, dividend paying stocks (i.e. the quality stocks). Whereas when sentiment is low (pessimistic) then investors should buy small cap, youthful, low profitability, non-dividend paying equities (i.e. the junk stocks). Given the above this again suggests that now is the time to be buying high quality stocks.

Sorts based on characteristics and sentiment (% return over the next 12 months)

Characteristic	Sentiment is high			Sentiment is low		
	Decile 10	Decile 1	Difference (10-1)	Decile 10	Decile 1	Difference (10-1)
Size	11.8	8.8	3.0	11.0	28.4	-17.4
Age	13.3	3.0	10.3	14.9	21.2	-6.4
Variance of returns	3.6	17.3	-13.7	28.9	12.1	16.8
Profitability	11.2	4.2	7.0	18.8	31.1	-12.2
Dividend payers	13.8	5.3	8.5	14.2	27.8	-13.7

Source: Baker and Wurgler, Dresdner Kleinwort Macro research

Guide to equity characteristics

	Decile 10	Decile 1
Size	Large	Small
Age	Old	Young
Variance of returns	Risky	Low risk
Profitability	Highly profitable	Unprofitable
Dividend payers	Dividend payers	Non dividend payers

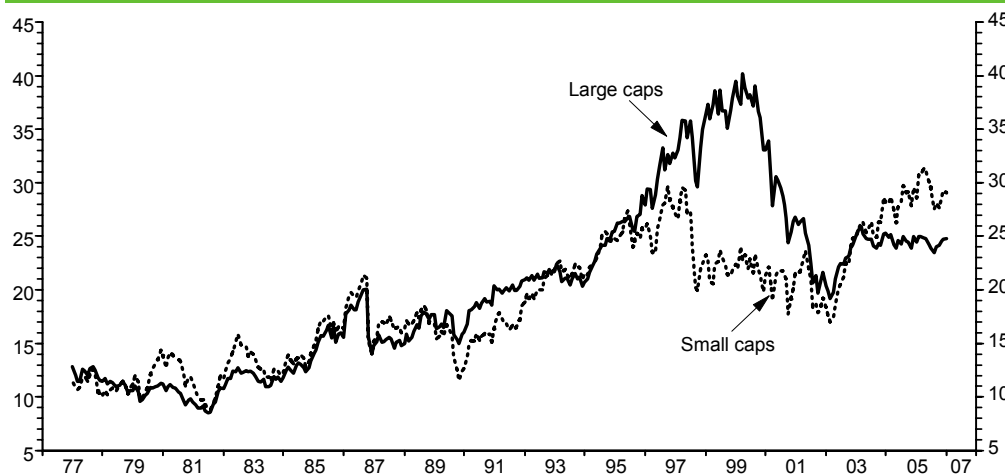
Source: Dresdner Kleinwort Macro research

This work also leads us onto our next contrarian viewpoint (a roll-over from one of our positions last year): **long large caps, short small caps**. The liquidity premium is still negative. That is to say, small caps are still trading at a significant premium to large caps, so effectively investors are paying for the pleasure of holding illiquid stocks. This doesn't seem terribly sensible to us.

² Baker and Wurgler (2006) Investor sentiment and the cross-section of stock returns, Journal of Finance

The chart below shows the Graham and Dodd PE (5 year moving average for earnings) for the US large and small caps. It clearly shows the madness of the current juncture, with the small caps trading at 29x and the large caps trading at 25x.

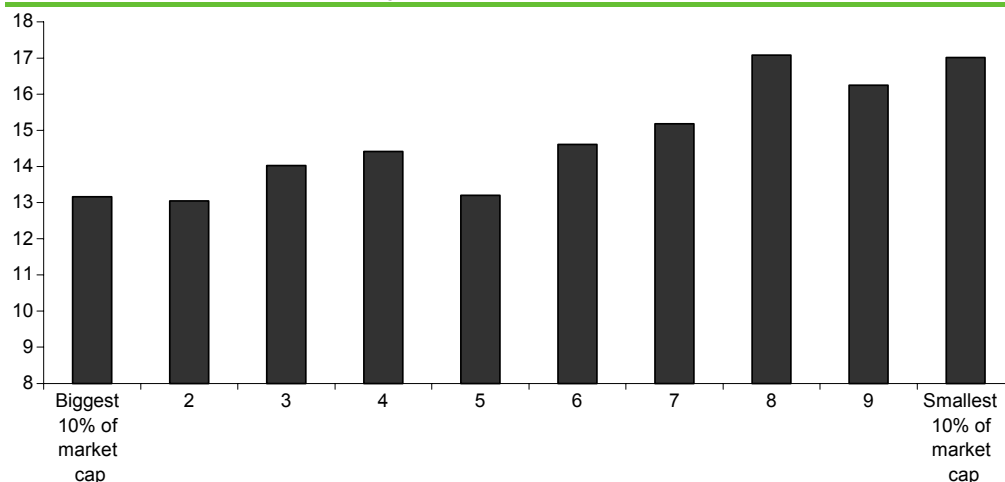
US large and small cap Graham and Dodd PEs



Source: Dresdner Kleinwort Macro research

Andy Lapthorne has recently provided another way of looking at this. He breaks the market down into deciles, each one containing an equal amount of market cap, so the top decile contains the top 10% of the market (around 6 stocks), whilst the bottom decile contains around 295 stocks. The chart below makes it transparently obvious that it is the largest stocks which are on the lowest forward PEs, whilst the smallest stocks are considerably more expensive, so the real value seems to lie in the mega caps.

Global market: 12m forward PE by size decile



Source: Dresdner Kleinwort Macro research

In terms of styles, we continue to favour value. Last year, many were itching to rotate into growth. We suspect that this urge remains unquenched. However, the empirical work we have done shows that style rotation is not often profitable without perfect foresight (sadly lacking amongst all investors). As such **maintaining a value bias** seems better placed to provide a sensible margin of safety.

There is little that stands out in terms of country selection. Often we find a large consensus over country selection. However, there are few obvious areas of agreement at the current juncture. The surveys show that Japan and Europe are the most favoured, with emerging markets and the UK as the least favoured. We ran a long emerging market position last year; however, the valuation gap has been rapidly narrowing. In general, we see no particularly significant country opportunities from a contrarian perspective.

Instead we will rely on value-orientated country screen to aid with global equity market selection (see Global Equity Strategy, 30 April 2003 and 12 January 2005). Based on this simple value screen, **Belgium, UK, Netherlands, Spain, Norway and France all look attractive**, whilst Japan, New Zealand, Switzerland, Hong Kong, Denmark and Austria look relatively expensive.

Amongst the emerging markets, **Thailand, Pakistan, Peru, Hungary, Korea and Turkey look relatively cheap**. On the expensive side we find Chile, India, Morocco, Sri Lanka, China and Czech Republic.

Looking at this list of potential buys I have no doubt that many investors will recoil, arguing that such markets are cheap for a myriad of perfectly sensible reasons. Norway for instance will be dismissed as an oil play – which no doubt it is, but a cheap play nonetheless.

When considering contrarian positions, investors might do well to remember one final piece of advice from Sir John Templeton: “To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest rewards”. But of course as Keynes noted it isn’t easy “For it is the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy.”

Notes

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Add:	5-10% increase in share price	Reduce:	5-10% decrease in share price
Hold:	+5%/-5% variation in share price		

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Source: Dresdner Kleinwort

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