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The role of sentiment and contrarian investing

Dominic McCormick | Select Investment Partners | 06 February 2014

As we entered 2014, the consensus narrative on the best and worst areas to invest money could be very simply described as follows. Best – shares, especially the US. Worst – gold/gold shares.

Such a consensus was hardly surprising following the recent relative performance of these asset classes. Shares generally had a stellar 2013 with the world's largest market, the US, returning 32.4% (S&P 500 Accumulation US$). Gold and gold shares in particular had a terrible 2013 with gold down 28% and large and mid/small cap gold stocks (as measured by US ETFs GDX and GDXJ, again in US$ terms) down 54% and 60.5%, respectively.

As 2013 closed and 2014 opened, the contrast between the continued rampant enthusiasm for shares – particularly the US – and the passionate distaste for gold-related investments could not have been more pronounced. Momentum investing ruled and contrarian investing was dead, it seemed.

The consensus could be best described by this December 2013 commentary from a major investment bank:

> "(Our) economists and analysts predict that equities are likely to continue to outperform other asset classes in 2014. Cash, commodities (including gold), and bonds are not expected to offer attractive returns in 2014"

Yet, consider some of the sentiment indicators relating to the US sharemarket at end 2013:

- The ratio of bulls to bears in the *Investor Intelligence* survey was at record levels;
- US margin debt was at record levels in absolute terms and as a percentage of GDP;
- Inflows into equity mutual funds were running at near record levels; and,
- Volatility as measured by the VIX was at similar levels as just prior to the GFC.

Gold-related areas were the opposite. Gold ETFs had experienced dramatic outflows, sentiment towards gold equities as a sector was deeply negative and most strategists were projecting further significant falls in the gold price in 2014.

Consider also these representative headlines in some financial media around the turn of the year.

For shares:

> "5 reasons stocks will go up in 2014", *CNNMoney*, 19/12/13
> "2014 Outlook: Market Melt Up", *FT.com*, 2/1/14

And on gold:

> "Gold's prospects in 2014 look tarnished", *WSJ Market Watch*, 31/12/13
> "Why gold bugs should brace for an "awful" 2014, *CNBC.com*, 1/1/14

In the *Weekend Australian*'s "Expert stock picking panel for 2014" (4 January 2014) covering 12 analyst/commentators and a total of 120 stock recommendations, I could see only one gold mining stock on the list and that was Newcrest Mining, recommended by the CEO of the "International Psychic's Association".

Although only a very short time frame, the first month of 2014 has so far provided an abrupt challenge to this mainstream narrative. US shares (as measured by the Dow Jones Industrial Average) have had their worst January in 24 years, down 5.2%. The broader S&P did better, falling 3.5%, but many emerging markets were worse. Meanwhile, gold was up 3.2% and gold mining stocks were amongst the best performing assets over the month (e.g. GDX up 11.1%, GDXJ up 14.0%).

I am not suggesting that these new directions are certain to continue over 2014 or that investors should have dumped all their shares for gold at the end of the year. After all, gold and gold stocks have only recovered a fraction of last year losses and share investors have lost only a portion of last year's strong gains.

But, January's sharp reversal of fortune of two areas with polar opposite levels of investor support does highlight the ease with which investors can become sucked into mature and vulnerable consensus views on asset classes, particularly when that view become so entrenched and one sided.

The important question is: What implications, if any, does this or similar situations have for investors, either in the short or long term?

On the shorter-term perspective, there is some evidence that, as January goes, so goes the year - that is, sometimes, recent "short-term performance" of asset classes cannot be dismissed easily. One commentator pointed out that every down January on the S&P 500 since 1938 has preceded a new or extended bear market, a 10% correction, or at least a flat year.

From that perspective alone, January 2014 is noteworthy and it would certainly not be surprising if calendar 2014 did see a partial or full reversal of many of 2013's trends, given how pronounced they became and how complacent and optimistic investors are.

From the longer-term perspective, the key lesson for investors may be that they should become increasingly wary about an asset class when a consensus view becomes so strongly ingrained in investor sentiment and so widely held and supported. This is precisely the time when a market becomes vulnerable to a rapid reversal, with or without specific catalysts.

Thinking about the dynamics of markets, it seems quite obvious that when a particularly bullish/bearish view is very widely held by investors, it is likely that most have already acted on this view, momentum players are fully long/short and little is required for a sharp reversal to occur. Simply, markets reach a point where the willingness of investors to more aggressively bid up prices or sell down is largely fully satiated, leaving the market vulnerable to a significant move in the other direction. This is why tracking investor sentiment, and being prepared to adopt contrarian position at extremes, is so important to successful investing.

That said, tracking sentiment is more art than science and contrarian investing in practice is inherently difficult. Actual experience of the various market moods through time is one benefit of longevity in the investment industry. There are also a range of professionally-produced surveys that help describe sentiment from a range of perspectives, although tracking more anecdotal evidence through newspaper headlines, investor attitudes and positioning is also important.

Judgement and interpretation of these indicators is necessary to determine when sentiment has gone to an extreme and whether it is appropriate to take or maintain a contrarian bet. However, being prepared to promote publicly or actually implement such contrarian views in a fund or client portfolios brings even greater challenges, with the risk of being too early a frequent problem.

It is no surprise that most of the better known economists, strategists, commentators and even many fund managers cluster around a consensus view, typically with a tilt towards what has worked well recently. They are reluctant to promote or take true contrarian views, even when sentiment becomes extreme. That is the comfortable line to take. As Keynes said "Conventional wisdom teaches that it is better to fail conventionally than to succeed unconventionally."

However, one has to ask whether such consensus views are useless at best and, at worst, ultimately destructive for investors as they are periodically pushed into and out of certain asset classes at precisely the wrong time. Still, investors need to listen to many of these views to gain an appreciation of what the current consensus view is and whether it is becoming extreme. However, there is little value in religiously following any one individual view if it tends to always largely follow the consensus.

Of course, the consensus can and will be right for substantial parts of major trends. The key is to identify periods where the consensus has become extreme and therefore vulnerable to sudden and destructive reversal.

The irony is that when sentiment becomes particularly extreme and widely held, it becomes increasingly hard to even hear contrary views. Contrarians may not give up on their views privately but they often give up trying to convince colleagues or clients. The media also becomes reluctant to report the views of those who have been seen to be wrong recently. Alternatively, some contrarians start to soften their view, at least in the short term, even if they retain long-term conviction. However, this tendency for contrarians to go quiet, soften, or even give up on their views is itself a key warning sign that a trend may have become seriously overextended. We've certainly seen examples of these during 2013 in relation to both the sharemarket and gold - for example, UK-based hedge fund manager Hugh Hendry's recent capitulation on his bearish sharemarket view and Jeremy Grantham's "softened" view that the US sharemarket could rise another 20% to 30% despite being overvalued by as much as 60%.

Partly driving this, of course, is the career risk in being seen to be wrong, particularly for extended periods. But as Robert Arnott said "In investing, what is comfortable is rarely profitable.". Or, as John Hussman recently stated in relation to very extended markets "the problem with bubbles is you have to decide whether you want to be an idiot before the bubble or after the bubble".

In terms of a framework to develop views on asset classes, the main areas investors typically consider are:
- Macro economic
- Valuation
- Momentum/flows
- Sentiment/investor positioning.

Of these, I believe the last is the area most often neglected, or subject to superficial treatment. Even very sophisticated investors often see sentiment as too fickle or a necessary focus for short-term traders only, despite its proven usefulness over medium and longer time frames. It takes sharp reversals like January 2014 to highlight the importance of its role. Active or dynamic asset allocation is very difficult. It makes sense to use a full range of tools and indicators.

However, perhaps the true value in sentiment and contrary thinking for many investors is not actually helping them buy into a deeply out of favour, undervalued asset (given the difficulty of actually pulling the trigger in practice). Rather, it is about helping them to avoid buying into, or adding to, an increasingly fashionable asset that is becoming increasingly vulnerable to losses. Contrarian investing from this perspective is more about risk management (although not about career risk management) than about picking the direction of markets.

Indeed, investors are fortunate that there are many more assets and strategies available then shares and gold and well diversified, multi-asset portfolios go a significant way to reducing the need to make dramatic and/or frequent calls on market direction, in any case. However, even well diversified portfolios tend to become overly skewed to assets and strategies that are popular and have performed well recently. Being prepared to review and rebalance a portfolio with an eye to avoiding vulnerable asset classes and highlighting those with good potential can be greatly aided by a focus on sentiment and a contrarian bent.

January 2014 may or may not turn out to be indicative for the rest of 2014 or beyond. Contrary investing comes with no guarantees. However, it is not just sentiment but a range of the other asset allocation drivers - especially macro and valuation - which currently suggest a more challenging outlook for shares and a more positive one for gold. These are topics for another article. Sometimes, at extremes, sentiment indicators alone are sufficient to encourage caution.

At the beginning of February, there is little sign that the complacency on shares has yet been shaken by one month's negative returns. In the Sydney Morning Herald Economic Survey (1-2 February), not one of the 25 economists and strategists surveyed expected a return to 31 December 2014 from the level of 31 January on the ASX/S&P 200 (plus dividends) of less than 5% and the average return implied for the 11 months was almost 15%. Certainly, 15% is achievable in any one year (as 2013 showed) but most long-term return estimates for the Australian sharemarket are around half this, highlighting the degree of optimism built into current consensus views.

The tendency of asset returns to reverse when sentiment become extreme highlights the flaws in blindly chasing the asset classes that have worked well in recent times. It's when investing seems easiest that it's usually about to become very hard. Last year's strong returns from most growth markets, and increasing investor complacency, have laid the groundwork for higher risks and the potential for quite different outcomes going forward than generally expected. Assessing sentiment is an essential tool for helping to identify such risks and opportunities and supporting contrarian investment decisions.

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