

# BUY THE DIPS: THE DRAW AND DANGERS OF CONTRARIAN INVESTING

What goes down always goes up, right?



# THE LEAD IN...

- When markets are in free fall, there is a great deal of advice that is meted out to investors, and **one is to just buy the dip**, i.e., buy the stocks that have been beaten down the most, in the hope that they will recover, or the entire market, if it is down.
- "Buying the dip" falls into a **broad group of investment strategies that can be classified as "contrarian"**, where investors act in contrast to what the rest of the market is doing at the time, buying (selling) when the vast majority are selling (buying) , and it has been around through all of market history.
- Contrarian investing **can take different forms**, each based on different assumptions about market behavior, and present the evidence that we have on the success and failure of each one.
- Even if you are swayed intellectually by the arguments for going against the crowd, **it may not work for you, if you are not psychologically attuned to the stresses that contrarian strategies bring with them.**

# CONTRARIAN INVESTING: BASIS AND STRANDS

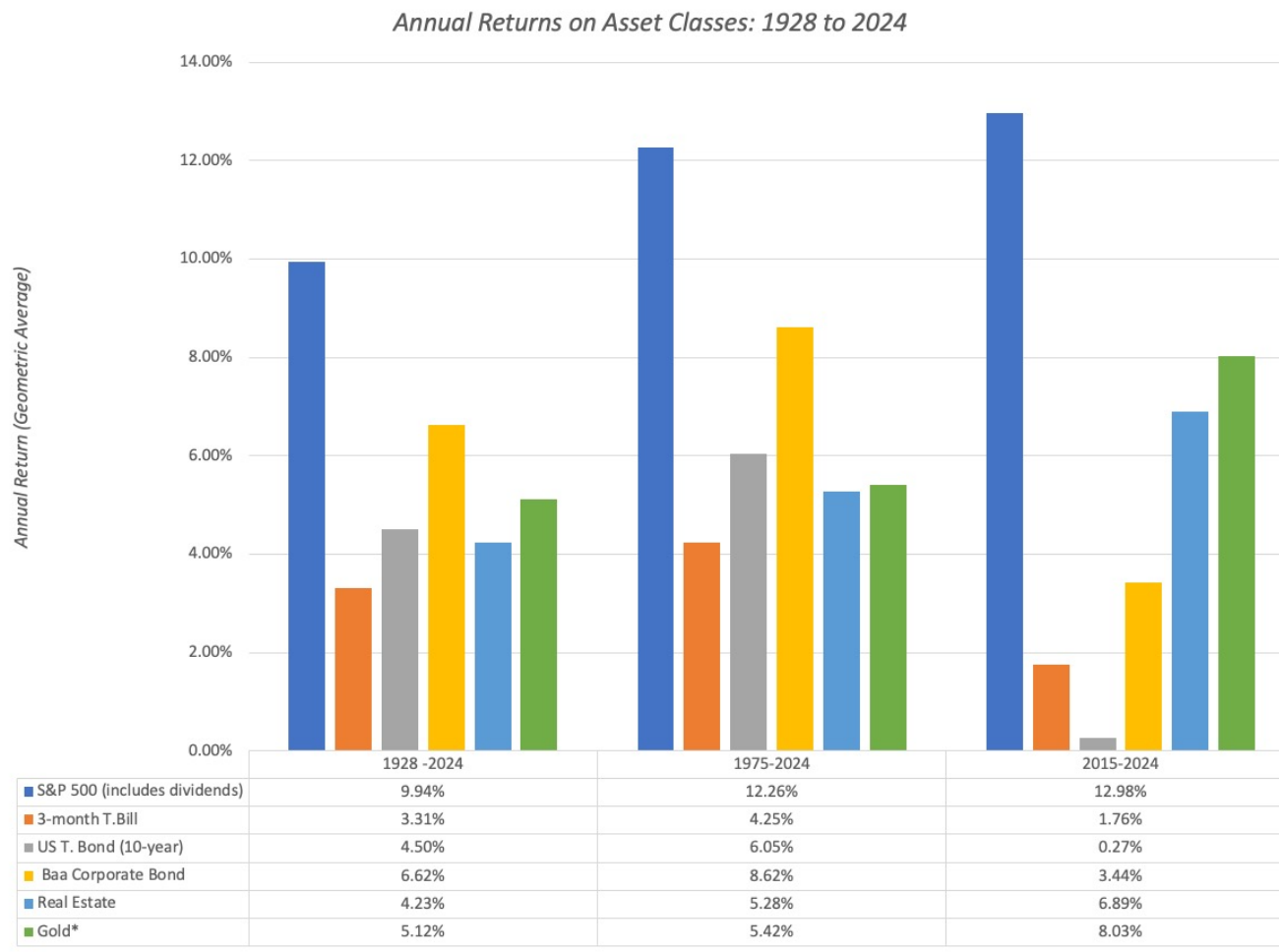
- All contrarian investing is built around a common theme of buying an investment, when its price goes down significantly, but there are wide variations in how it is practiced.
  - In the first, **knee-jerk contrarianism**, you use a bludgeon, buying either individual companies or the entire market when they are down, on the expectation that you will benefit from an inevitable recovery in prices.
  - In the second, **technical contrarianism**, you buy beaten-up stocks or the entire market, but only if charting or technical indicator support the decision.
  - In the third, **constrained contrarianism**, you buy the stocks that are down, but only if they pass your screens for quality and safety.
  - In the fourth, **opportunistic contrarianism**, you use a price markdown as an opportunity to buy companies that you have always wanted to hold, but had not been able to buy because they were priced too high.



# 1. KNEE-JERK CONTRARIANISM

- The simplest and most direct version of contrarian investing is to **buy any traded asset where the price is down substantially from its highs**, with the asset sometimes being an individual company, sometimes a sector and sometimes the entire market.
- Implicit in this strategy is the belief that **what goes down will almost always go back up**, and that buying at the beaten down price and being willing to wait will therefore pay off.
- The evidence to back up this strategy comes from studies of overall market returns, much of it based upon historical data in the US going back a long time, as well as studies of returns to buying "loser" stocks.

# STOCKS ALWAYS WIN! (OR DO THEY?)



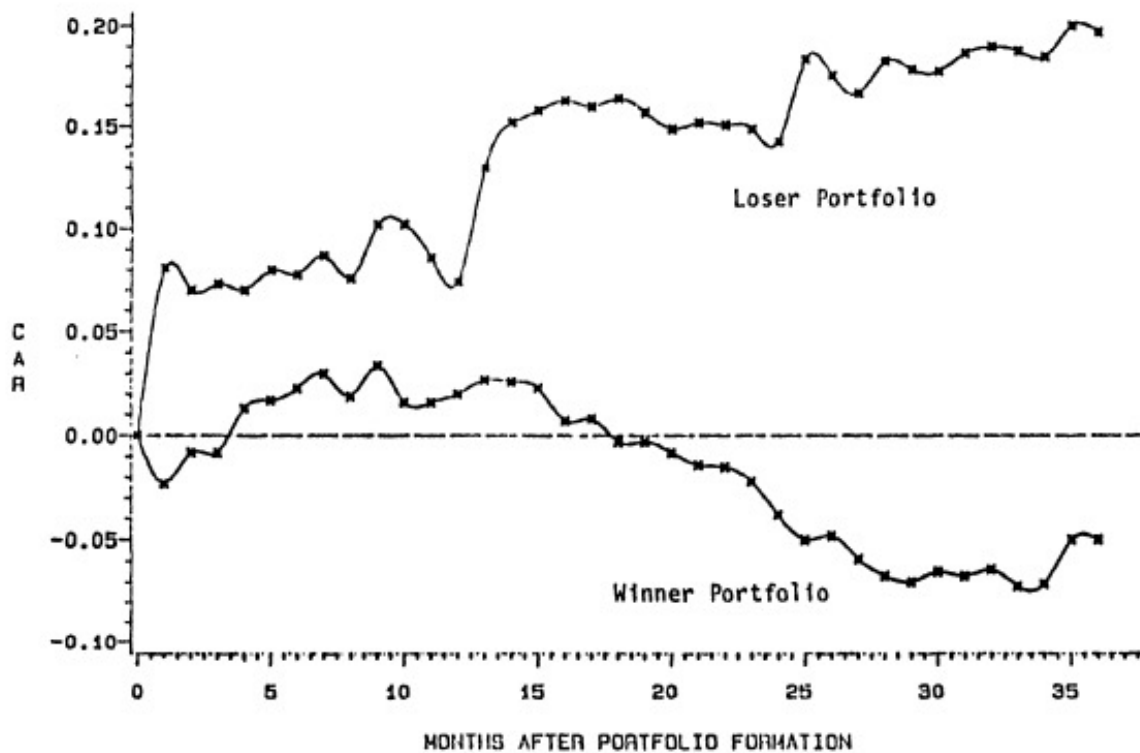
# AND THE SMALL PRINT...

- The first is that there is **selection bias**, where using historical data from the United States, one of the most successful equity markets of the last century, to draw general conclusions about the risk and returns of investing in equities will lead you to under estimate risk and overestimate returns.
- The second is that, even with US equities, an investor who bought stocks just before a major downturn **would have to wait a long time before being made whole again**. Thus, investors who put their money in stocks in 1929, just ahead of the Great Depression, would not have recovered until 1954.



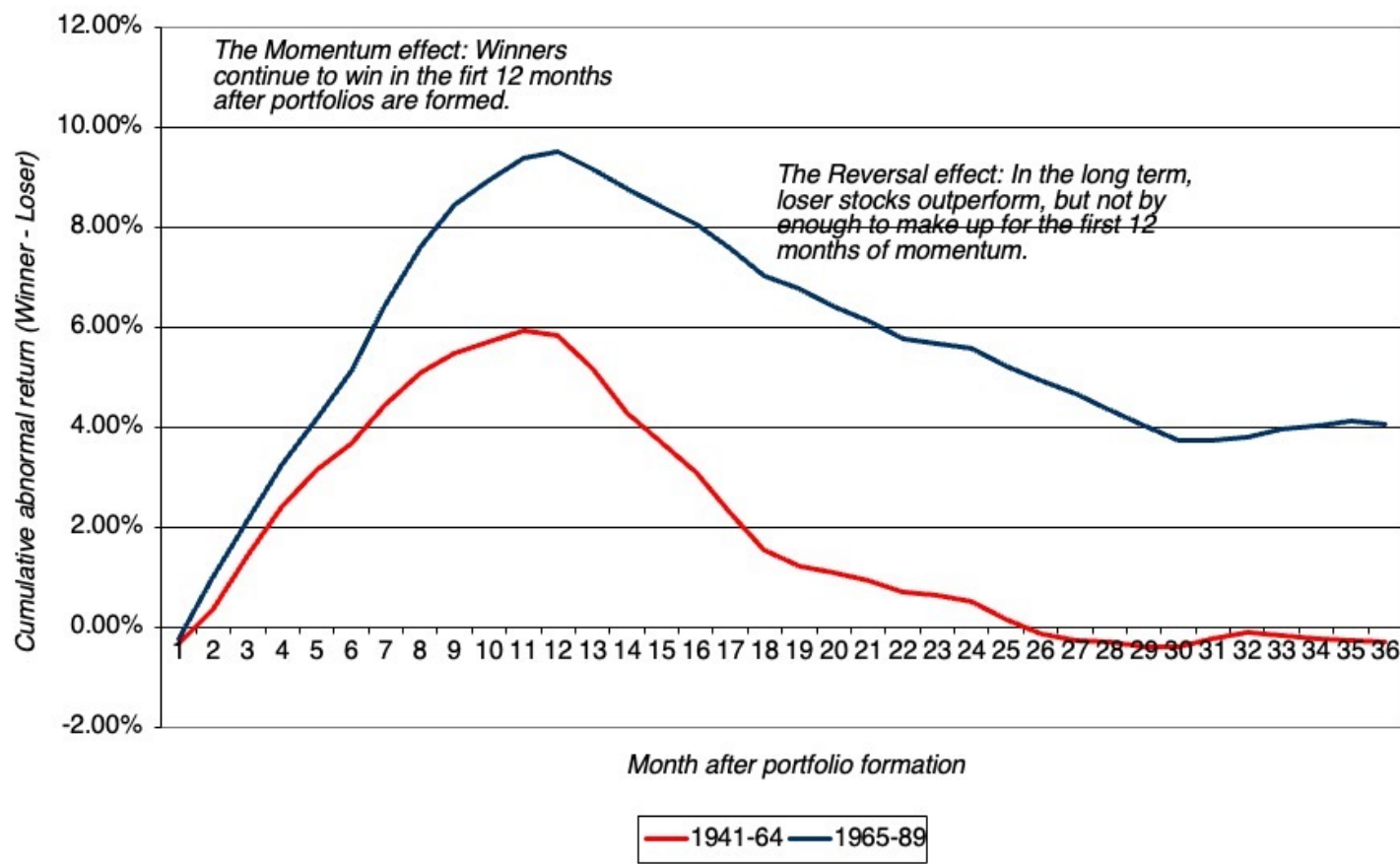
# WINNER VS LOSER STOCKS

Average of 16 Three-Year Test Periods  
Between January 1933 and December 1980  
Length of Formation Period: Three Years



# WITH THE CAVEATS...

Differential Returns - Winner versus Loser Portfolios



# KNEE-JERK CONTRARIANISM: A SUMMING UP

- Setting aside the mixed evidence for the moment, the biggest danger in knee-jerk contrarian investing at the market level is that buying the dip in the market is **akin to catching a falling knife**, since that initial market drop can be a prelude to a much larger sell off, and to the extent that there was an economic or fundamental reason for the sell off (a banking crisis, a severe recession), there will be no quick or even long term recovery.
- With individual stocks, that danger gets multiplied, with **investors buying stocks that are being sold off to for legitimate reasons** (a broken business model, dysfunctional management, financial distress) and waiting for a market correction that never comes.

# THE BIGGEST LOSERS: US STOCKS BETWEEN 3/28/25 – 4/18/25

<i>Company Name</i>	<i>Market Cap (4/18)</i>	<i>Market Cap (3/28)</i>	<i>% Change</i>
Vishay Intertechnology, Inc. (NYSE:VSH)	\$1,523.40	\$2,193.50	-30.55%
Applied Digital Corporation (NasdaqGS:APLD)	\$887.60	\$1,275.00	-30.38%
ManpowerGroup Inc. (NYSE:MAN)	\$1,872.90	\$2,741.80	-31.69%
RH (NYSE:RH)	\$3,017.70	\$4,395.50	-31.35%
Charles River Laboratories International, Inc. (NYSE:CRL)	\$5,208.70	\$7,955.10	-34.52%
Plug Power Inc. (NasdaqCM:PLUG)	\$874.80	\$1,302.00	-32.81%
Alpha and Omega Semiconductor Limited (NasdaqGS:AOSL)	\$510.10	\$765.70	-33.38%
V.F. Corporation (NYSE:VFC)	\$4,071.00	\$6,112.40	-33.40%
Sabre Corporation (NasdaqGS:SABR)	\$783.70	\$1,181.40	-33.66%
Frontier Group Holdings, Inc. (NasdaqGS:ULCC)	\$721.70	\$1,090.80	-33.84%
Fortrea Holdings Inc. (NasdaqGS:FTRE)	\$477.20	\$724.30	-34.12%
Applied Optoelectronics, Inc. (NasdaqGM:AAOI)	\$535.70	\$823.10	-34.92%
New Fortress Energy Inc. (NasdaqGS:NFE)	\$1,597.30	\$2,422.90	-34.07%
ProFrac Holding Corp. (NasdaqGS:ACDC)	\$784.90	\$1,235.00	-36.45%
Neumora Therapeutics, Inc. (NasdaqGS:NMRA)	\$104.80	\$166.80	-37.17%
Helen of Troy Limited (NasdaqGS:HELE)	\$770.00	\$1,234.70	-37.64%
CommScope Holding Company, Inc. (NasdaqGS:COMM)	\$721.10	\$1,162.90	-37.99%
Edgewise Therapeutics, Inc. (NasdaqGS:EWTX)	\$1,280.50	\$2,215.40	-42.20%
TechTarget, Inc. (NasdaqGS:TTGT)	\$583.10	\$1,021.80	-42.93%
RxSight, Inc. (NasdaqGM:RXST)	\$584.30	\$1,075.40	-45.67%
Neogen Corporation (NasdaqGS:NEOG)	\$952.80	\$1,874.40	-49.17%
Vaxcyte, Inc. (NasdaqGS:PCVX)	\$3,946.50	\$8,943.80	-55.87%



## 2. TECHNICAL CONTRARIANISM

- In technical contrarianism, you start with the same basis as knee-jerk contrarianism, by looking at stocks and markets that have dropped significantly, but with **an added requirement that the price has to meet a charting or technical indicator constraint** before becoming a buy.
- While there are many who consign technical analysis to voodoo investing, I believe that charting patterns and technical indicators can provide **signals of shifts in mood and momentum** that drive price movements, at least in the near term.
- Thus, you can view technical contrarianism as buying stocks or markets when they are down, but **only if the charts and technical indicators point to a shift in market mood.**

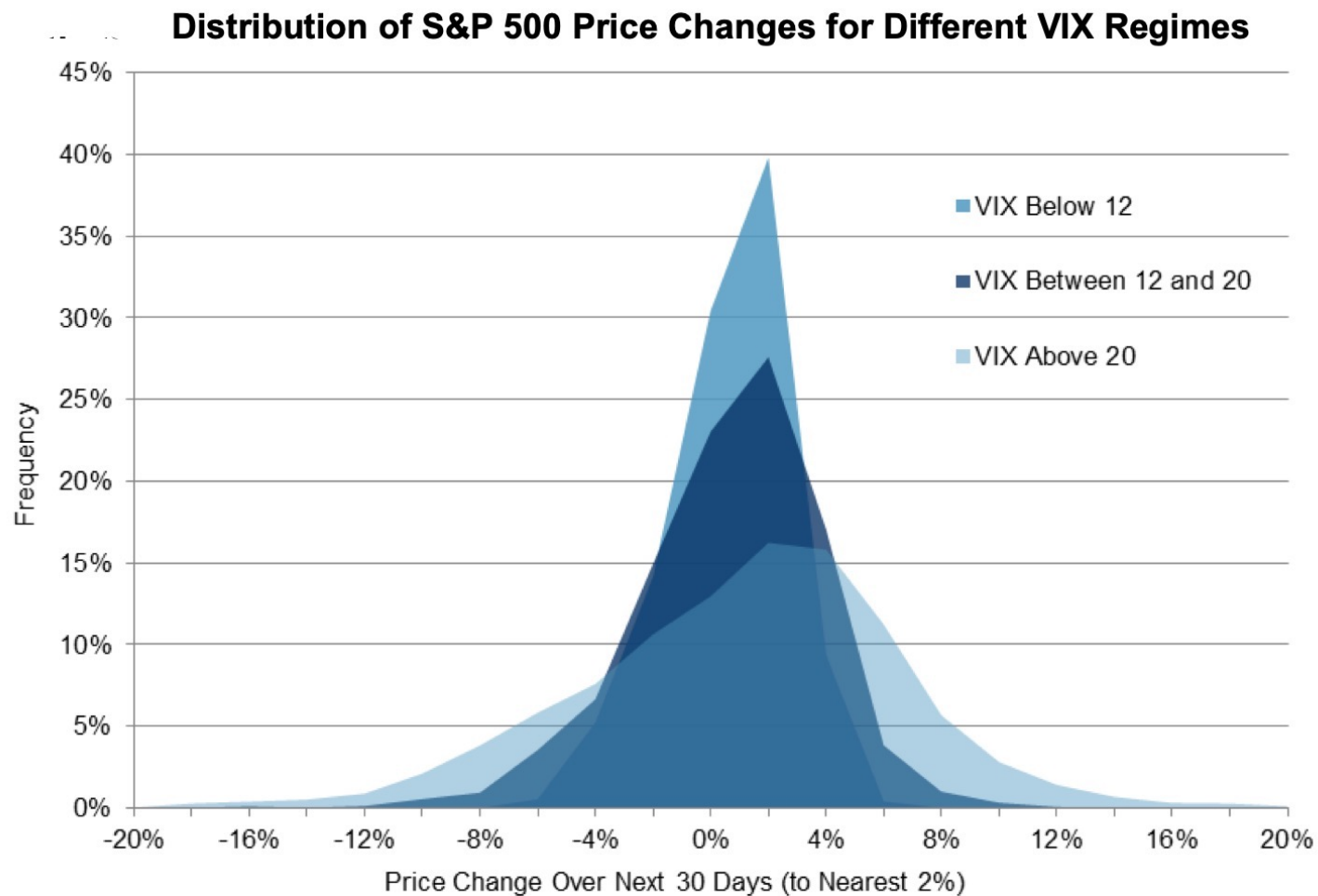


# TESTING TECHNICAL INDICATORS

- One of the problems with testing technical contrarianism, to see if it works, is that even among technical analysts, there seems to be **no consensus as to the best indicator to us**, but broadly speaking, these indicators can be based on either price and/or volume movements.
- They **range in sophistication** from simple measures like relative strength (where you look at percentage price changes over a period) and moving averages to complex ones that combine price and volume.
- In recent decades, investors have added **pricing in newer markets to the mix**, with the VIX (a traded volatility index) as well as the relative pricing of puts and calls in the options market also being used in market timing.
- In sum, all of these indicators are directed at measuring fear in the market, with a "market capitulation" viewed as a sign that the market has bottomed out.



# TECHNICAL MARKET TIMING



# TECHNICAL STOCK TRADING

- It is quite ironic that some of the best defenses of technical analysis have been offered by academics. [Lo, Wang, and Mamaysky](#) present a fairly convincing defense of technical analysis from the perspective of financial economists
  - They use daily returns of stocks on the New York Stock Exchange and NASDAQ from 1962 and 1996 and employ the **most sophisticated computational techniques** (rather than human visualization) to look for pricing patterns.
  - They find that the most common patterns in stocks are double tops and bottoms, followed by the widely used head and shoulders pattern. In other words, they **find evidence that some of the most common patterns used by technical analysts exist in prices.**
- Lest this be cause for too much celebration among chartists, they also point out that these patterns **offer only marginal incremental returns** (an academic code word for really small) and offer the caveat that these returns may not survive transaction costs.



# 3. CONSTRAINED CONTRARIANISM

- If you are in the old-time value investing camp, your approach to contrarian investing will reflect that worldview, where you will buy stocks that have dropped in value, but **only if they meet the other criteria that you have for good companies.**
- In short, you will start with a list of beaten-up stocks, and then **screen them for high profitability, strong moats and low risk**, hoping to separate companies that are cheap from those that deserve to be cheap.
- As a constrained contrarian, you are **hoping to avoid value traps**, every value investor's nightmare , where a company looks cheap on a pricing basis (low PE, low price to book) and proceeds to become even cheaper as you hold it.



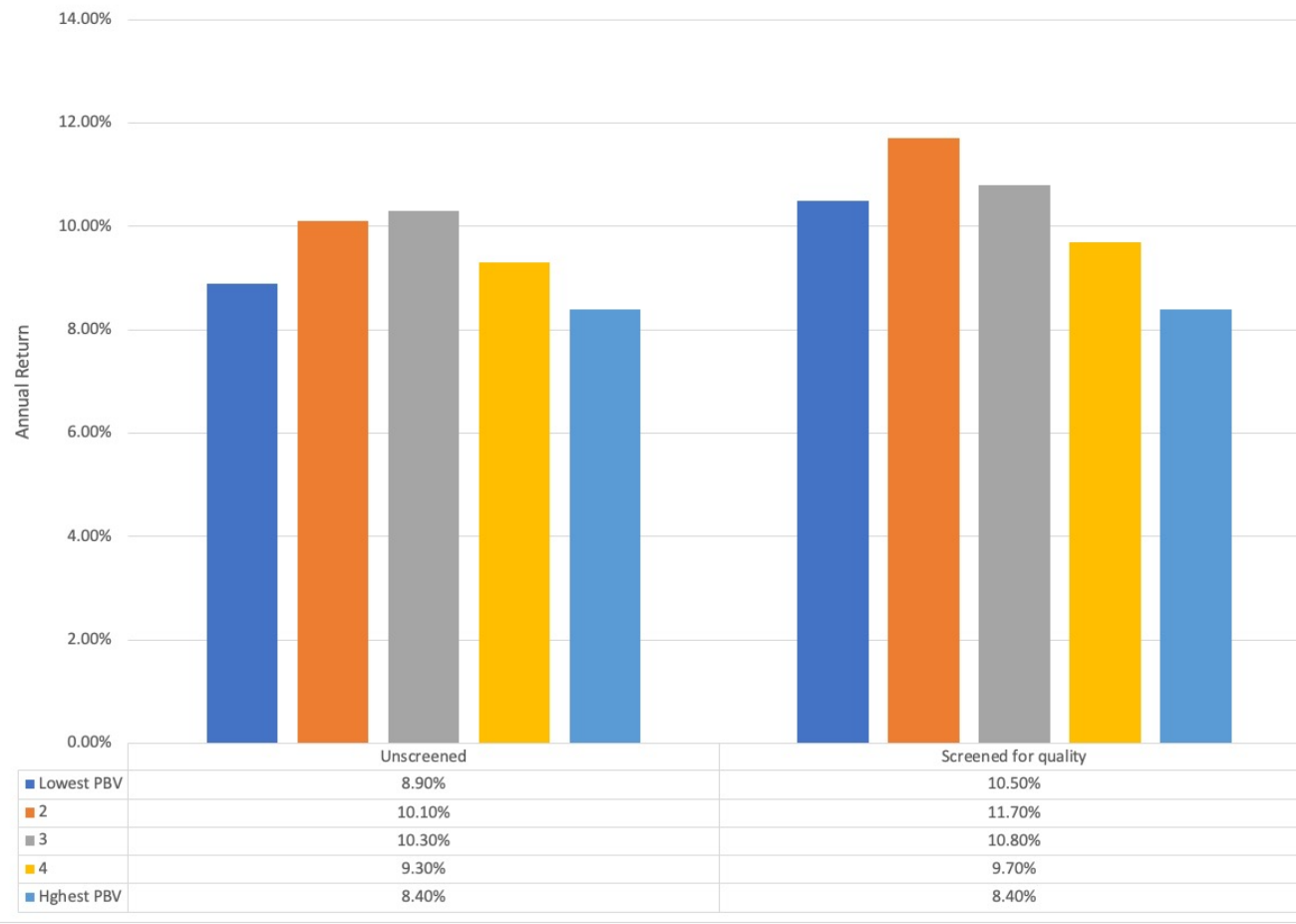
# DOES SCREENING KEEP OUT VALUE TRAPS?

- The evidence on whether screening helps avoid value traps comes largely from studies of the **interplay between proxies of value (such as low price to book ratios) and proxies for quality**, including measures for both operating/capital efficiency (margins and returns on capital) and low risk (low debt ratios and volatility).
- Proponents of quality screens note that while value proxies alone no longer seem to deliver excess returns, **incorporating quality screens seems to preserve these excess returns.**
- While much of the research on quality has been built around value and small cap investing, the findings can be extrapolated to contrarian investing, with the lesson being that rather than buy the biggest losers, you should be **buying the losers that pass screening tests for high profitability (high returns on equity or capital) and low risk (low debt ratios and volatility)**



# ONE STUDY ...

Returns to PBV Classes from 1990 to 2022



# CONSTRAINED CONTRARIANISM IN APRIL 2025

- I again returned to the universe of about 6000 publicly traded US stocks on April 18, 2025, and after removing any firms with market capitalizations less than \$100 million (with the rationale that these companies will have more liquidity risk and transactions costs), I screened first for stocks that have lost more than 20% of their market capitalization between March 28 and April 18, and then added three value screens:
  - a) **a PE ratio less than 15**, putting the stock in the bottom quintile of US stocks as of December 31, 2024
  - b) **a dividend yield that exceeded 1%**, a paltry number by historical norms, but ensuring that the company was dividend-paying in 2024, a year in which 60% of US stocks paid no dividends
  - c) **a net debt/EBITDA ratio of less than two**, dropping it into the bottom quintile of US companies in terms of debt load



# THE RESULTS

<i>Company Name</i>	<i>Market Cap (3/28)</i>	<i>Market Cap (4/18)</i>	<i>% Change: 3/28 to 4/18</i>	<i>PE</i>	<i>Dividend yield</i>	<i>Net Debt/EBITD A</i>
Murphy Oil Corporation (NYSE:MUR)	\$3,050	\$4,049	-24.68%	7.49	5.90%	1.02
Liberty Energy Inc. (NYSE:LBRT)	\$1,956	\$2,565	-23.72%	7.70	2.55%	0.63
Alcoa Corporation (NYSE:AA)	\$6,037	\$7,937	-23.94%	7.02	1.59%	0.75
Matson, Inc. (NYSE:MATX)	\$3,231	\$4,176	-22.62%	6.78	1.39%	0.68
Cricut, Inc. (NasdaqGS:CRCT)	\$873	\$1,097	-20.42%	13.90	2.86%	-3.82
Cirrus Aircraft Limited (SEHK:2507)	\$1,355	\$1,781	-23.89%	11.23	0.00%	-2.33
Steven Madden, Ltd. (NasdaqGS:SHOO)	\$1,440	\$1,929	-25.33%	8.50	4.23%	-0.19
JAKKS Pacific, Inc. (NasdaqGS:JAKK)	\$210	\$274	-23.27%	6.20	0.00%	-0.27



# 4. OPPORTUNISTIC CONTRARIANISM

- In a fourth variant of contrarian investing, you use a market meltdown as an opportunity to **buy companies that you have always wanted to own but could not because they were overpriced before the price drop but look under priced after.**
- The best place to start an assessment of opportunistic investing is with my post on **why good companies are not always good investments**, with the first being determined by all of the considerations that go into separating great businesses from bad businesses, including growth and profitability, and the second by the price you have to pay to buy them.



# GOOD COMPANIES VS GOOD INVESTMENTS

**Cheap or Buy (Green)**  
 When your assessment of a company's quality is better than other investors' perception of its quality, with greater divergence match up to better buys.

**Fairly priced or Hold (Grey)**  
 When your assessment of a company's quality is in sync with other investors' perception of its quality, you have fair pricing, where you earn your required return.

		Investor/Market Perception of Company Quality						
		Abysmal	Very Bad	Bad	Average	Good	Very Good	Awesome
Your perception of Company Quality	Awesome	Green	Dark Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Very Good	Dark Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Good	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Average	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Bad	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Very Bad	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green
	Abysmal	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green	Light Green

**Expensive or Sell (Red)**  
 When your assessment of a company's quality is worse than other investors' perception of its quality, with greater divergence match up to better sells.

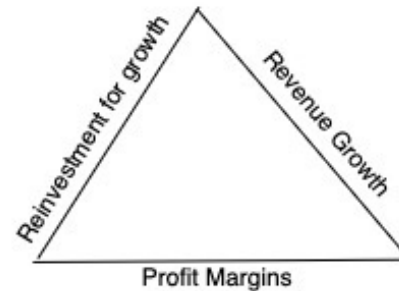


# MY MAG SEVEN VALUATIONS: AUGUST 2024

	<i>Alphabet</i>	<i>Amazon</i>	<i>Apple</i>	<i>Microsoft</i>	<i>Meta</i>	<i>Nvidia</i>	<i>Tesla</i>
Expected CAGR Revenue (next 5 years)	8.00%	12.00%	7.50%	15.00%	12.00%	32.20%	31.10%
Target Operating Margin	30.00%	14.00%	36.00%	45.00%	40.00%	40.00%	13.07%
Cost of Capital	8.84%	8.60%	8.64%	9.23%	8.83%	8.84%	9.17%
Price per share	\$145.00	\$169.15	\$188.00	\$405.49	\$456.08	\$680.00	\$185.07
<b>Value per share</b>	<b>\$138.14</b>	<b>\$155.72</b>	<b>\$176.79</b>	<b>\$355.88</b>	<b>\$445.10</b>	<b>\$436.34</b>	<b>\$183.75</b>
% Under or Over Valued	4.97%	8.62%	6.34%	13.94%	2.47%	55.84%	0.72%
Internal Rate of Return	8.41%	7.85%	7.89%	8.06%	8.53%	7.18%	9.16%
Full Valuation (Excel)	<a href="#">Link</a>	<a href="#">Link</a>	<a href="#">Link</a>	<a href="#">Link</a>	<a href="#">Link</a>	<a href="#">Link</a>	<a href="#">Link</a>



# OPPORTUNISTIC CONTRARIANISM: START WITH GREAT COMPANIES

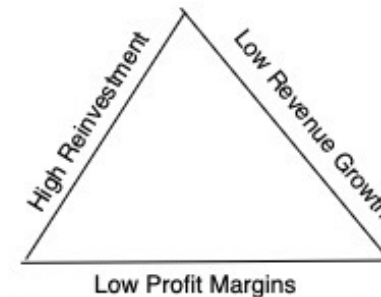


**Generic firm**  
Growth determines scaling, margins drive profitability and reinvestment determines cash flows



**Great firms**  
High growth, high profits and high cash flows

**The Muddled Middle**  
Firms that don't fall at either extreme have to make trade offs accepting "worse" outcomes on one value driver to get "better" outcomes on others:  
- Higher growth, with lower margins  
- Higher margins, with lower growth  
- Higher reinvestment, for more enduring margins.



**Terrible firms**  
Low growth, low profits and low/negative cash flows



# AND WAIT FOR YOUR MOMENT . . .

- At the time that you first value them, **you are likely to find them to be over valued**, which will undoubtedly be frustration. You may be tempted to play with the numbers to make these companies look undervalued, but a better path is to put them on your list of companies you would like to own, and leave them there.
- During a market crisis, and especially when investors are marking down the prices of everything, without discriminating between good and bad companies, you should revisit that list, with a caveat that **you cannot compare the post-correction price to your original valuation of your company**.
- Instead, you will have to **revalue the company, with adjustments to expected cash flows and risk premiums, given the crisis**, and if that value exceeds the price, you should buy the stock.



# CONTRARIAN INVESTING: THE PSYCHOLOGICAL TEST

- **The Mindset:** Investing against the market will not come easily to those who are easily swayed by peer pressure, since they will have to buy, just as other investors (the peer group) will be selling, and often in companies that the market has turned against.
- **The Time Horizon:** To be a contrarian, you don't always need a long time horizon, since correlations can sometimes happen quickly, but you have to be willing to wait for a long period, if that is what is necessary for the correction.
- **The Stomach:** Even if your buy decision is based on the best thought-through contrarian investing strategies, it is likely that in the aftermath of that decision, momentum will continue to push prices down, testing your faith. Without a strong stomach, you will capitulate, and while your decision may have been right in the long term, your investment will not reflect that success.



# WHERE I STAND..

- I have the **luxury of a long time horizon and the luck of a strong stomach**, for market surprises.
- I am **not easily swayed by peer pressure**, but I am not immune from it either. I know that buying stocks in the face of market selling will not come easily to me, and that is the reason that I initiated limit buys on three companies that I have wanted to have in my portfolio, **BYD**, the Chinese electric car maker, **Mercado Libre**, the Latin American online retail/fintech firm, and **Palantir**, a company that I believe is closest to delivering on the promise of AI products and services.
- The **limit buy kicked in on BYD** on April 7, when it briefly dipped below \$80, my limit price, and while Palantir and Mercado Libre have a way to go before they hit my price limits, the crisis is young and the order is good until canceled.

