Session 14

Value Investing: The Contrarians

Tests

1. When you are a contrarian investor, which of the following beliefs about investor behavior do you subscribe to,?
    a. Investors make mistakes and correct them over time.
    b. Investors push up (down) prices of good (bad) companies too much, but correct them over time.
    c. Investors push up (down) prices of bad (good) companies too much, but correct them over time.
    d. Investors learn slowly, gradually increasing (decreasing) prices of good (bad) companies
    e. Investors don't make mistakes.
2. Which of the following best summarizes what studies of winner and loser stocks in any given year have found about their subsequent performance?
    a. Winner stocks continue to go up and loser stocks continue to go down in the 5 years after you invest in them.
    b. Winner stocks go down and loser stocks go up in the 5 years after you invest in them.
    c. Winner (loser) stocks continue to go up (down) for the first year after you invest in them but then reverse and end up declining (increasing) by the end of year 5.
    d. Winner (loser) stocks decline (increase) for the first year after you invest in them but then reverse and end up making money (losing money) by the end of year 5.
3. If you decide to invest in loser stocks, which of the following will you need to do to be successful with this strategy?
    a. Avoid low-priced loser stocks, since the transactions costs are high.
    b. Invest at the start of each year rather than in the middle of the year.
    c. Have a long time horizon (many years).
    d. Be willing to take losses on your portfolio in the first few months after your investment.
    e. All of the above
4. There are some investors who subscribe to the theory that all you need to do to make money over time is to find companies that are well managed and in good businesses. Why might this strategy not work?
    a. Good management is subjective. One investor's judgment of what constitutes good management can be different from another.
    b. If the market also perceives these companies to be well managed, they will be priced accordingly.
    c. Well-managed companies will generate lower earnings than badly managed firms.
    d. Well-managed firms will grow more slowly than badly managed firms.

e. Well-managed firms will be in riskier businesses than badly managed firms.

5. If you adopt the contrarian strategy of investing in badly managed firms, which of the following screens would you use to find your investments?
    a. Low current return on capital, high historical return on capital, high industry-average return on capital.
    b. Low current return on capital, low historical return on capital, high industry-average return on capital.
    c. Low current return on capital, low historical return on capital, low industry-average return on capital.
    d. High current return on capital, high historical return on capital, high industry-average return on capital.
    e. High current return on capital, high historical return on capital, low industry-average return on capital.
    f. High current return on capital, low historical return on capital, low industry-average return on capital.

Solution

1. When you are a contrarian investor, which of the following beliefs about investor behavior do you subscribe to?
    a. Investors make mistakes and correct them over time.
    b. Investors push up (down) prices of good (bad) companies too much, but correct them over time.
    c. Investors push up (down) prices of bad (good) companies too much, but correct them over time.
    d. Investors learn slowly, gradually increasing (decreasing) prices of good (bad) companies
    e. Investors don't make mistakes.

Explanation: If you are a contrarian, you must believe that investors push up the prices of good companies and push down the prices of bad companies too much, but that reality eventually catches up, causing prices to reverse themselves.

2. Which of the following best summarizes what studies of winner and loser stocks in any given year have found about their subsequent performance?
    a. Winner stocks continue to go up and loser stocks continue to go down in the 5 years after you invest in them.
    b. Winner stocks go down and loser stocks go up in the 5 years after you invest in them.
    c. Winner (loser) stocks continue to go up (down) for the first year after you invest in them but then reverse and end up losing money (making money) by the end of year 5.
    d. Winner (loser) stocks decline (increase) for the first year after you invest in them but then reverse and end up making money (losing money) by the end of year 5.

Explanation: Studies of winner and loser stocks indicate that while winner (loser) stocks keep winning (losing) for about a year after they were classified, the returns reverse and winner (loser) stocks end up losing (making) money over a longer (five year) period.

3. If you decide to invest in loser stocks, which of the following will you need to do to be successful with this strategy?
    a. Avoid low-priced loser stocks, since the transactions costs are high.
    b. Invest at the start of each year rather than in the middle of the year.
    c. Have a long time horizon (many years).
    d. Be willing to take losses on your portfolio in the first few months after your investment.
    e. All of the above

Explanation: Loser stocks tend to be low priced stocks (with high transactions costs) and the returns are sensitive to whether you find the winners/losers at the end of the

year or mid-year (with the former providing higher returns). You also need a time horizon stretching into years to generate the excess returns found in studies.

4. There are some investors who subscribe to the theory that all you need to do to make money over time is to find companies that are well managed and in good businesses. Why might this strategy not work?
   a. Good management is subjective. One investor's judgment of what constitutes good management can be different from another.
   b. If the market also perceives these companies to be well managed, they will be priced accordingly.
   c. Well-managed companies will generate lower earnings than badly managed firms.
   d. Well-managed firms will grow more slowly than badly managed firms.
   e. Well-managed firms will be in riskier businesses than badly managed firms.

Explanation: The returns to an investment depend on how much you pay up front. If markets push up the prices for well managed companies, there is little payoff (or worse) to investing in these companies, even if they remain well managed.

5. If you adopt the contrarian strategy of investing in badly managed firms, which of the following screens would you use to find your investments?
   a. Low current return on capital, high historical return on capital, high industry-average return on capital.
   b. Low current return on capital, low historical return on capital, high industry-average return on capital.
   c. Low current return on capital, low historical return on capital, low industry-average return on capital.
   d. High current return on capital, high historical return on capital, high industry-average return on capital.
   e. High current return on capital, high historical return on capital, low industry-average return on capital.
   f. High current return on capital, low historical return on capital, low industry-average return on capital.

   Explanation: If you are investing in badly managed companies, you are hoping for a turn around. The chance of that turn around increase if the poor performing company is in a sector which has good performance (there is potential for improvement) and has had a good track record in the past (it has been able to perform well in the past).