

GUIDE SERIES

13

FINANCIAL STANDARD GUIDE TO

# Contrarian Investing

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**FINANCIAL  
STANDARD.**

**Editor**  
Darren Snyder

**Writer**  
Nigel Bowen

**Production Manager**  
Samantha Sherry

**Graphic Designer**  
Jessica Beaver

**Director of Media  
and Publisher**  
Michelle Baltazar

**Group Managing  
Director**  
Christopher Page

**Financial Standard**  
Level 7, 55 Clarence Street,  
Sydney NSW 2000

**T** + 61 2 8234 7500  
**E** [info@financialstandard.com.au](mailto:info@financialstandard.com.au)

[www.financialstandard.com.au](http://www.financialstandard.com.au)

# Industry snapshot

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## Financial advisers willing to use contrarian funds have an advantage over their mainstream peers.

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**W**hile not prominent in this part of the world, contrarian investing has a long history. Theoreticians ranging from John Maynard Keynes to, more recently, Nassim Taleb have pointed out investors' tendency to behave emotionally rather than rationally, causing market overreactions.

And contrarian investors, most notably Warren Buffett, have amassed vast fortunes by being greedy when others are fearful and fearful when others are greedy.

In contrast to most conventional investment funds, which aim to make average to, ideally, slightly above market average returns, contrarians concentrate on trying not to overpay for popular shares. We will explain what this means later in this guide.

In fact they try to buy cheaply when prevailing sentiment is bearish to mitigate the risk of overpaying and increase the potential for better returns. They take stakes, often large stakes, in unloved companies. They then maintain investment discipline.

Contrarian investing can be seen as an extreme form of value investing; extreme because contrarians will buy shares where prevailing sentiment is so negative that even the bolder value funds won't defy crowd behaviour.

# Industry snapshot

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## Contrarians concentrate on trying not to overpay for popular shares.

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The conventional approach to share investing is neither a foolish nor unprofitable investment strategy. Especially over the longer term, it results in unspectacular but solid returns. But this approach does have two drawbacks. Firstly a market-weighted index will generally contain bigger positions in the most popular shares, shares which are more likely to be overpriced. Second, buying and selling the same equities at around the same time as many other investors makes it, by definition, impossible to outperform this market.

Financial advisers willing to use contrarian funds have an advantage over their mainstream peers as they are able to tap into a segment of the funds management market that is not as crowded with competing fund products.

On the other hand, it does require understanding what contrarian investing means versus the broad meaning of 'contrarian' in everyday investment parlance. For example, a conventional fund manager might say they are contrarian simply because they have one or two unusual investment calls.

This guide seeks to provide financial advisers with a framework to understanding the contrarian approach as a distinct investment discipline. This guide also features real-life case studies and performance data that will shine the light on this little-understood but important subset of wealth management.



# What is contrarian investing?

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**C**ontrarian investing is commonly defined as buying – or not buying – shares in contrast to prevailing sentiment. For example, a contrarian investment fund may refuse to buy tech shares at a time when they are skyrocketing in price or on the other hand, they may purchase REITs when they are trading at 25 per cent of book value.

Of course, it could be argued that all investors seek out mispriced shares and value investors, in particular, seek out shares that are underpriced as a result of prevailing sentiment. Plus, it's a rare investor who doesn't like to think of themselves as a rational actor unswayed by the fickle passions of the herd.

Contrarian investing doesn't involve being oppositional for the sake of it. However, to merit the description, a contrarian investment fund analyst does have to invest in an unorthodox manner. (Be warned, it's not unheard of for traditional, index-hugging fund managers to seek to differentiate their product by falsely claiming their methodology is contrarian.) Contrarian investing may be easier to understand than it is to commit to. The strategy and way of thinking needs to be integrated at every level of the investment manager's business.

Contrarian investors take account of valuation metrics but don't then proceed to simply 'screen, rank and allocate' on the basis of the point-in-time metrics used for indices/style categorisation. Rather, they conduct their own internal analysis of a company and carefully assess a range of outcomes throughout the cycle. Rather than the conventional 'value vs growth' categorisation, the contrarian focuses on 'valuation vs price'. The contrarian crafts their investment strategy while remaining focused on two realities.



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## Rather than the conventional 'value vs growth' categorisation, the contrarian focuses on 'valuation vs price'.

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First, the metrics, notably the E in the PE ratio, aren't necessarily indicative of future performance. Second, all their competitors are using the same screening tools and therefore making much the same buying and selling decisions. This results in a crowded market and in most cases, poor returns.

While many investors usually have a macro focus on sectors and trends, fundamental contrarians focus on identifying individual companies that appear underpriced (see page 14). Plus, a contrarian fund management firm is also likely to deviate from industry norms in the type of staff it recruits and how it incentivises them.

It should be noted that contrarian investment funds' scepticism about the utility of standardised measures of value doesn't mean they object to being subject to conventional performance criteria. The reports issued by contrarian funds typically compare the funds' performance to the benchmark and relevant indices.

# Weighing the benefits

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**B**enjamin Graham famously noted, “In the short run the market is a voting machine but in the long run it is a weighing machine.”

Contrarian investors and analysts aspire to maintain a long-term ‘weighing machine’ perspective. They seek to identify companies that are now being voted against but which are likely to be voted for in the future. Buying cheaply increases the chances of earning a return even if the company merely starts performing adequately.

Put another way, contrarian investing increases the chance of an upside and are more likely to avoid market bubbles and provide the opportunity to diversify your portfolio.

However, a contrarian investor acts on the belief the market has mispriced an equity; that a company with a low valuation will rebound rather than go bankrupt (or continue to disappoint indefinitely).

As is the case with all investors, contrarians get a proportion of their calls wrong. That being the case, if it is to survive, a contrarian investment fund needs staff and systems that regularly allow them to see value where others do not. Recruiting the right staff and creating the systems to do this is no simple matter.

In some cases, after buying low, it will often be years until it’s possible to sell high.

For guidance, a financial adviser can always review the long-term track record of the fund manager to see how their aggregate buys and sells translate to overall performance.

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companies that are  
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# Portfolio implementation

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**A**dvisers typically combine investments in contrarian funds with investments in conventional value and growth equity funds, and often other asset classes such as cash and property. In practice, giving clients some exposure to contrarian investment funds allows advisers to diversify and manage risk.

Given their tendency to perform very differently to the market, investors need to be comfortable with being different. This may result in periods of underperformance when other funds perform well in return for periods of outperformance when other funds perform poorly.

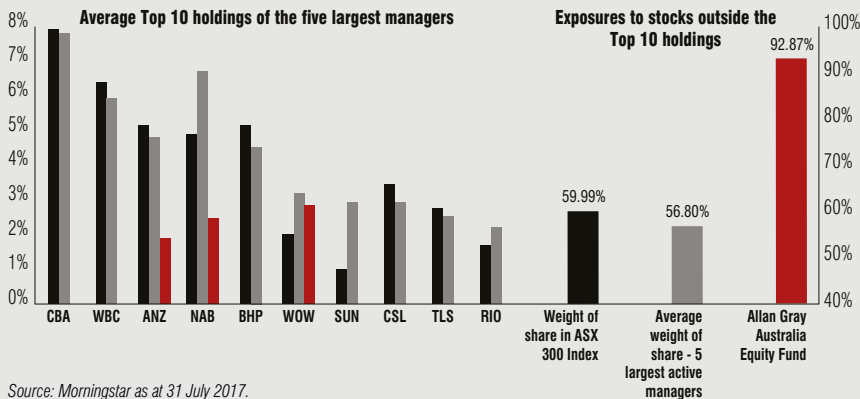
Contrarian investments are not well-suited to those focused on short-term outcomes. But for any client capable of understanding that contrarian investing involves going against the crowd then calmly waiting for that course of action to pay off, contrarian investment funds can produce impressive long-term returns.

The charts on the next page show the average top ten holdings of the five largest Australian Equity managers that describe themselves as active managers. It also compares these holdings with those in the ASX 300 Index, and a contrarian manager – in this case, Allan Gray.

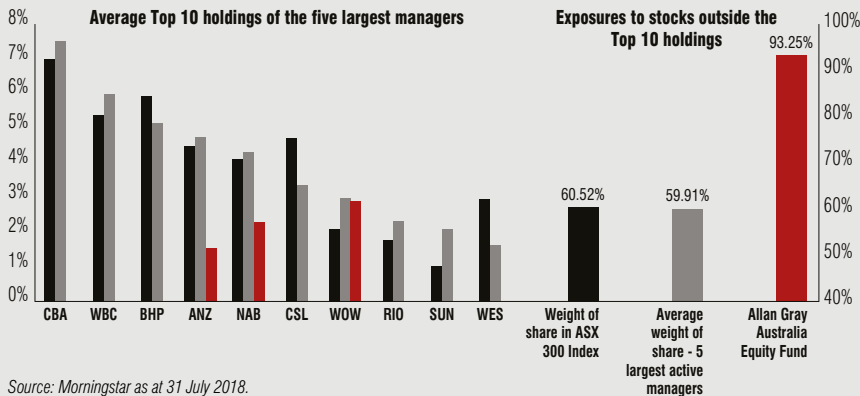
# A comparison of top 10 holdings in a large Australian equity fund versus a Contrarian Australian equity fund

Weight of share in ASX 300 Index
  Average weight of share - 5 largest active managers (Morningstar 'Australian Equity Blend, Growth and Value' category)
  Allan Gray Australia Equity Fund

July 2017



July 2018



# Choosing shares based on a contrarian approach

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**H**ere are two case studies demonstrating how the principles of contrarian investing were applied in real-world situations.

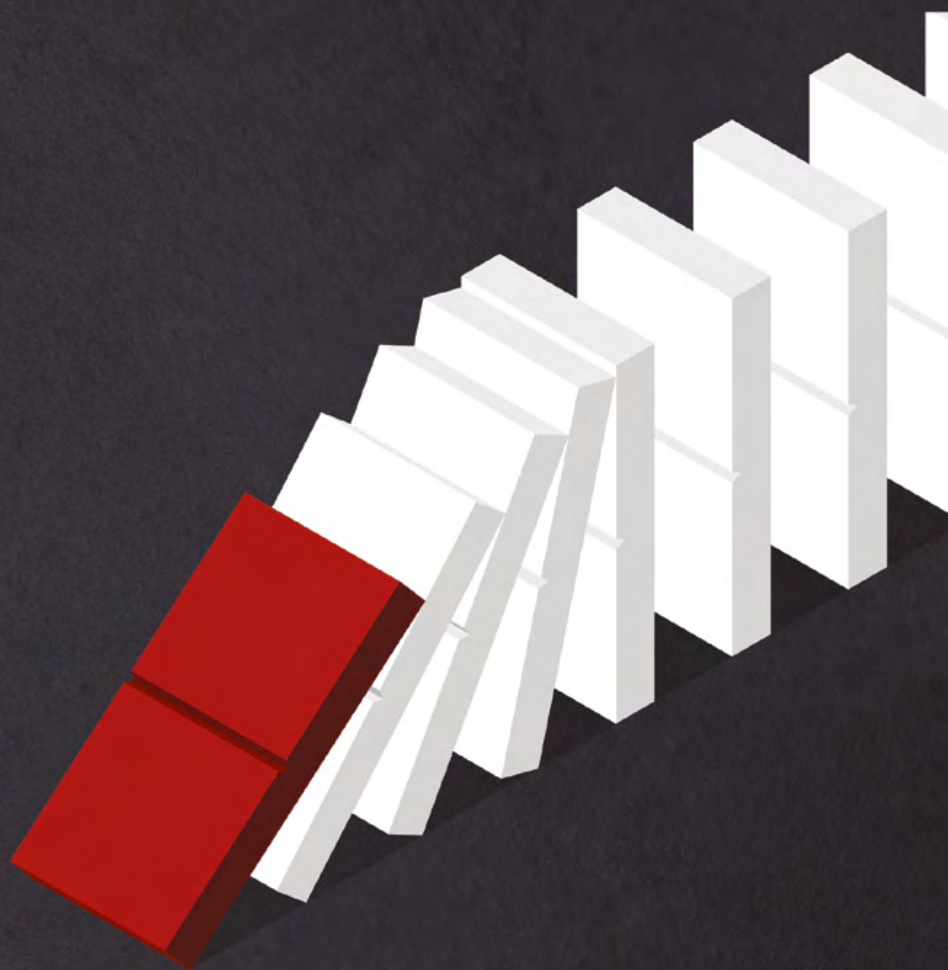
## **Pacific Brands**

Pacific Brands became a listed company in 2004. It initially prospered, manufacturing clothes domestically and selling iconic brands such as Bonds and Berlei in wholesale and department stores. After listing at \$2, shares were trading at over \$3 in early 2007.

Then came the GFC. Consumer confidence took a hit. A rising Australian dollar, combined with elevated labour costs, made manufacturing locally a money pit. An already competitive apparel marketplace was made more so by foreign entrants either setting up bricks and mortar outlets or online shops.

The share price collapsed. Pacific Brand's management moved manufacturing offshore and discontinued less profitable brands. Yet the share price remained stubbornly low for years.

A contrarian fund manager's analysis indicated the company's future wasn't as dire as widely believed. It began buying into the company in May, 2011. It built its position for three years, paying an average of 65c a share. By 2015, the company's bottom line and share price were recovering. In April, 2016, Pacific Brands was bought by Hanes. The acquisition price was effectively \$1.19 a share.



# Choosing shares based on a contrarian approach

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## **Iluka Resources**

Contrarian investors like to buy during cyclical, industry-wide slumps that result in strong companies having weak share prices.

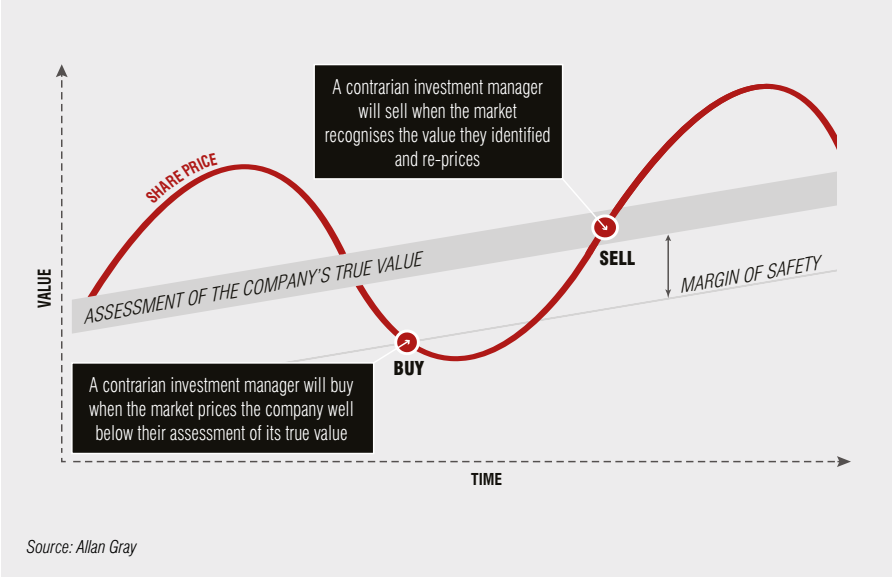
Iluka Resources mines heavy mineral sands to produce zircon and titanium dioxide feedshares, which are used in the production of ceramics and paint. These were in demand in 2005 and the company's shares were trading at just under \$9. But events such as the company's competitors dumping excess capacity on the market saw its share price collapse.

By March, 2008 it had fallen to \$3.50. A contrarian fund manager began buying, ultimately taking a six per cent stake in the company. It was confident that the burgeoning Asian middle class would soon want tiled bathrooms and well-painted walls. It was also excited to buy into "state of the art mining operations and the world's best heavy mineral deposits at cost price". The share price became volatile, with the fund manager buying when shares fell into the \$3-\$3.50 range and selling in 2009 at a little over \$5 and in 2010 at around \$6.

Here is an example of how a contrarian buy-and-sell would look over a period of time.



# An example of a contrarian fund's buy-and-sell approach

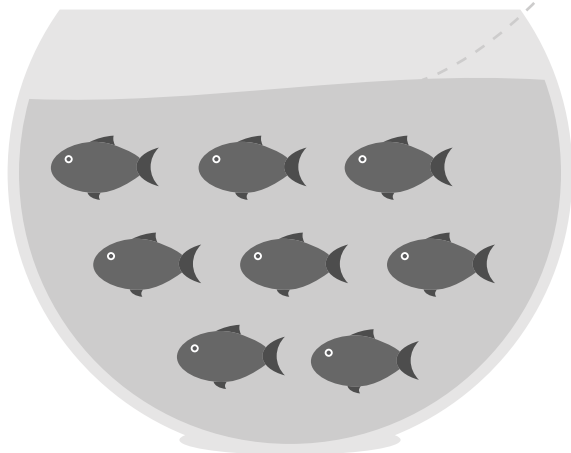


# Fee structure

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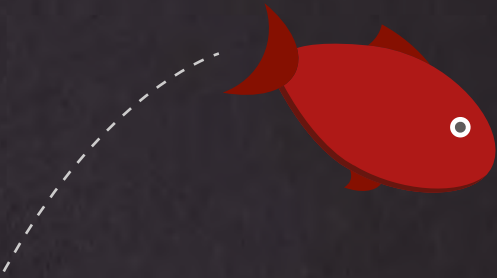
**F**ees vary, although a typical managed fund base management fee falls in the range 0.8 - 1.5% of total funds invested. Some fund managers will charge a base fee and a performance fee. Others charge a performance-only fee. Ask the product provider.

Contrarian investment managers can also be accessed through most leading platforms. Normal administration platform costs will apply. You can also access some contrarian investment managers through mFunds.



Contrarian investment  
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# Case study #1

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## **Down but not out**

**Adam Easter, Certified Financial Planner**

**NorthCorp Wealth Management**

NorthCorp Wealth Management added contrarian fund manager Allan Gray to its portfolio of funds four years ago. "What motivated us to engage with Allan Gray was an increasingly overvalued market," NorthCorp Wealth Management senior adviser Adam Easter says. "That might seem counter-intuitive given value managers typically underperform during momentum-driven markets. But our clients are largely retirees and we prefer to use value-orientated managers, who aim to buy shares that are currently undervalued, and for the longer term."

Easter says contrarian investment funds offer his clients two big benefits.

The first is diversification. "Looking at the top ten holdings of many large Australian share funds, you will see six or seven common names in their portfolios. Investing across several of these types of benchmark-aware funds does not provide diversification," Easter says. "Using a contrarian fund allows our clients to gain access to an investment portfolio that is unlikely to be replicated by many other Australian funds. It's a deep, deep, deep value way of investing our clients' money into corporations."

Easter notes that while plenty of analysts have the skillset to identify companies that are down but probably not out, acting on that analysis is another matter. "It takes a specific type of person to buy into companies where there has been some bad news and the share price has been falling sharply. The teams at contrarian funds have the stomach for that investment strategy when most don't."

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That can cause questions from clients initially, but once they understand the reasoning, they become comfortable with the strategy.

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The second benefit contrarian funds offer is alpha, at least over the longer term. "The track record of funds such as those offered by Allan Gray shows contrarian investing ultimately pays off," Easter says. "The catch is that contrarian investment funds can underperform the benchmark from time to time as their holdings are significantly different to that benchmark. That can cause questions from clients initially, but once they understand the reasoning, they become comfortable with the strategy. We've been fortunate over the last four years in that Allan Gray has consistently outperformed the index by a significant amount."

# AS CONTRARIAN INVESTORS, WE DON'T RUN WITH THE PACK

When you invest with Allan Gray, you're not just buying into a managed fund, you're buying into a distinctive investment philosophy. That philosophy is simple – to take a contrarian approach, apply it consistently and invest for the long term.

This is how we've been investing in Australia for the past 12 years and globally for over 40 years.

Going against human instinct and taking a contrarian approach to investing is not for everyone. It takes practice, and commitment in your convictions. Our long-term results speak for themselves.



## ALLAN GRAY AUSTRALIA EQUITY FUND

An actively managed, contrarian Fund that invests in select Australian shares. Our Fund tends to look very different to others and as a result can be an effective way to diversify portfolios. Choose from two fee structures – base fee plus performance fee or choose to pay only when we outperform.

## ALLAN GRAY AUSTRALIA BALANCED FUND

For those seeking capital growth from a diversified portfolio of shares and fixed income from Australia and overseas. The Fund takes advantage of the best opportunities and our target range is to have anything between 40%-90% of the Fund invested in shares and 10%-50% in fixed income, depending on where the opportunities are.

## ALLAN GRAY AUSTRALIA STABLE FUND

A more conservative investment that aims to outperform cash and boost returns by blending cash with select Australian shares. At least 50% of the portfolio will remain invested in cash and money market instruments and the rest is invested in carefully selected Australian shares.

## DISCOVER THE ALLAN GRAY DIFFERENCE TODAY

To see how our time-tested contrarian approach can help your clients reach more of their potential, visit [allangray.com.au](http://allangray.com.au) to find your local Relationship Manager or call us on **1300 604 604**.

## Case study #2

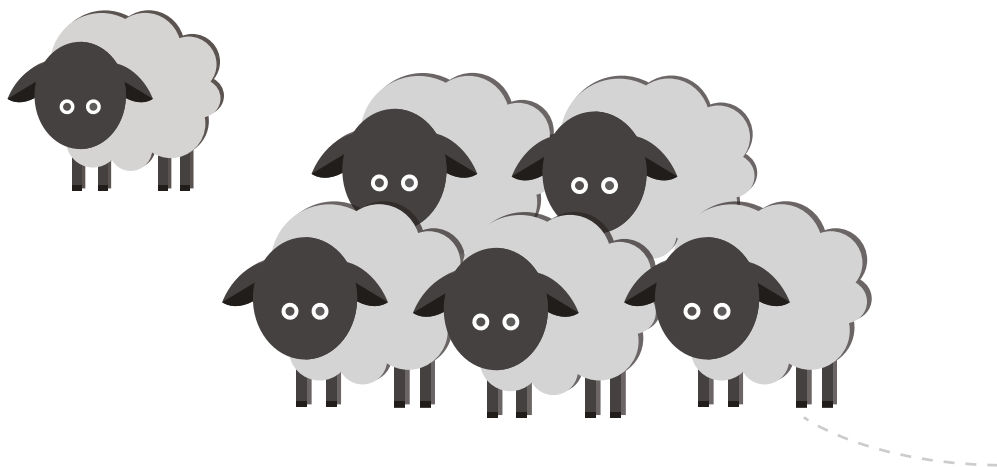
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### Departing from the herd

**Graeme Quinlan, Senior Adviser  
First Financial**

"There are several hundred fund managers offering thousands of registered funds in Australia, so it takes time to understand the ones doing something out of the ordinary," says First Financial senior adviser Graeme Quinlan. "Having been aware of contrarian funds for a while, I had a proper look at Allan Gray around two years ago."

Quinlan was impressed with those funds' long-term records but more so with their philosophy. "That philosophy was: you can't outperform the market by doing the same thing as the market. In other words, to win, the other side of your trade must lose," Quinlan says. "For psychological reasons, it's difficult for investors to depart from the herd. But if they are willing to, they can profit from the herd's mistakes, especially when fear or greed cause market overreactions."





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## Case study #2

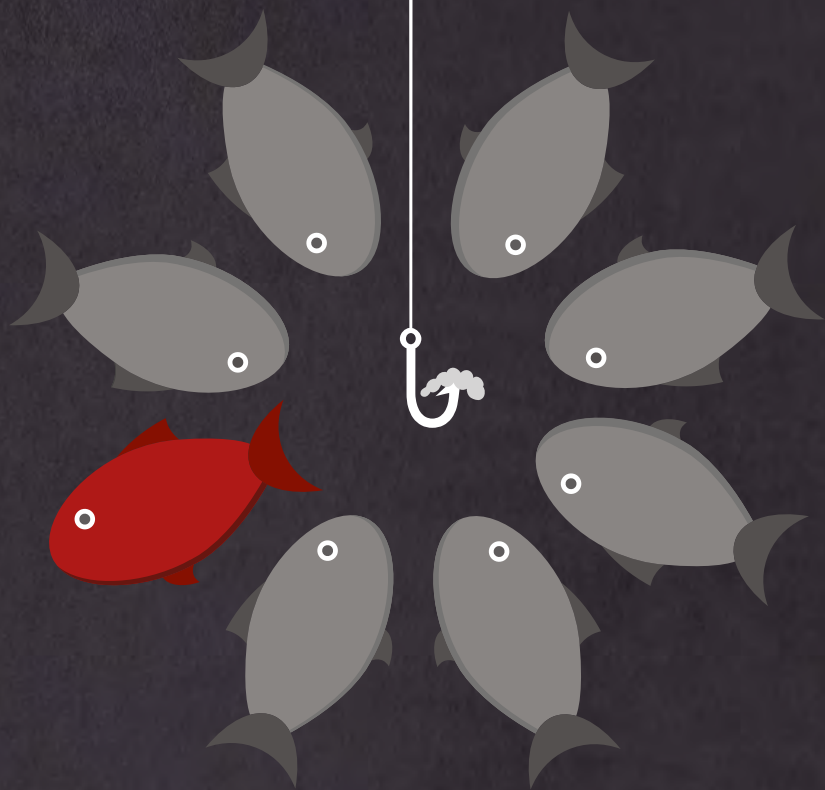
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Quinlan doesn't put new clients with little investment experience into contrarian funds. "The investment philosophy requires some explaining; it's not worth investing if you don't get it," he says. With his other clients, Allan Gray typically makes up 5-10 per cent of their portfolios.

"First Financial directly invests in equities, with a focus more on quality. We use Allan Gray's deep-value contrarian approach to complement that," Quinlan explains. "Of companies that have been heavily sold, Allan Gray is skilled at identifying those companies most likely to rebound."

Quinlan believes the boundary between value and contrarian funds is blurry but notes that it becomes clear in relation to beaten-up shares. "When even, say, a more mainstream manager won't go near a company that is in the media for all the wrong reasons Allan Gray will. Which can be rewarding if they get the call right," he says.

Quinlan hasn't had to have any difficult conversations with clients yet about the putting their money in a contrarian fund, but he knows the day is coming. "For the 18 months we've been using them, Allan Gray has been around the top of the Aussie equity funds pack with returns. But I'm not getting carried away by the current overperformance, just as I won't get too despondent when the fund has periods of underperformance in future. I make it clear to clients that, just like any other type of fund, contrarian funds will fly in certain market conditions and struggle to keep up in others."



# Behavioural investing

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**H**aving reached the end of this guide, you may be wondering why, if the claims made for it are valid, contrarian investing remains contrarian. If it's possible to make a substantial return without more risk than the broad market by buying unloved shares during downturns then selling them when the upswing occurs then, why isn't everyone doing it?

Contrarian investors have long argued what behavioural economics is now scientifically proving: psychological, cultural and emotional factors impact economic decisions. The advantages of being greedy when others are fearful and fearful when others are greedy are easy to intuitively grasp but hard to actually do. That's a result of human frailties, such as the following:

**Herding instinct:** Like political demonstrators, sports fans and cult members, it's easy for investors to get swept up in mobs. Particularly given the emotional greed (during bubbles) and fear (after crashes) pack. People take comfort by confirming their behaviour against what others are doing. But this tends not to be a great strategy for long term investments.

**Loss aversion:** Some studies show that losses are twice as powerful, psychologically, as gains. This means that investors are more likely to avoid shares that are – in the short to medium term – suffering losses even if they are the same shares that have the potential to deliver higher-than-average gains.

**Overconfidence:** Research has shown that it's human nature for investors to overestimate their ability to forecast market performance. Equally, they overestimate their ability to predict market behaviour compared to their peers. This tendency limits an investor's ability to pick the right basket of shares in the long term.

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Contrarian investors have long argued what behavioural economics is now scientifically proving: psychological, cultural and emotional factors impact economic decisions.

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**Recency bias:** Humans more vividly recall recent events. If a share has fallen a lot in the recent past, it's difficult to envisage that it could recover. The same way if a share has risen a lot, it's difficult for investors to envisage it falling.

There are barriers to entry to the contrarian investing industry. Granted, they are chiefly psychological and incentive-related barriers. But those are powerful enough to allow contrarian investment funds to deliver better-than-average returns to the investor willing to understand the mechanics of it and how, in many cases, natural human behaviour can be an investor's worst enemy. **FS**

## Notes

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