How to Be a Real Contrarian Investor

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We've all heard that investors move and think like one big crowd, but there are really two crowds. The main herd, and the "anti-herd"—the main herd's near mirror image. The media often call them "contrarians," but the real contrarians are those who see through both herds, think independently and do something different. Not opposite! Just different. This is one key to avoiding common pitfalls and investing successfully over time.

It doesn't take sophisticated models, rigorous training or a finance degree. Often you can cut through the noise with simple logic. The media habitually look for patterns and assume every coincidence of Event A with Outcome B is a concrete causal relationship. You can debunk most of it lickety-split without employing heavy analysis—a basic logic test will do.

Dollar Strength and Weakness

To demonstrate this, let's apply a logic test to most of today's big questions and alleged risks, starting with fears the strong dollar will doom this economic expansion and bull market. The narrative says a strong currency hurts exporters by reducing the value of overseas revenues when converted back to dollars, which sinks earnings and stocks. We could debunk this one with math, showing how multinationals have overseas costs, too, and the dollar's effect on both sides of the balance sheet usually evens out. Or we can ask a simple question: If the strong dollar is so bad, then why did the U.S. economy and big-cap stocks lead in the mid-to-late 1990s, when the dollar was even stronger? On the flipside, if a weak currency is so good, why hasn't Japan been the developed world's best-performing economy since early 2013? Why did foreign stocks and economies dominate the 2003–2007 bull market? These counterpoints show that the fears aren't justified, as many think they are.

A similar test can defang fears of the dollar losing its status as the world's favorite reserve asset. A quick jaunt to the International Monetary Fund's (IMF) database on foreign exchange reserves shows the dollar has steadily lost market share since 2000, and the world didn't end. Society didn't collapse. Some argue that being the world's reserve currency grants America privileges, like low interest rates. Well, if that's true, why aren't U.S. Treasury yields habitually the world's lowest? Japan and Germany frequently have lower yields, and there are far fewer yen and euros in global reserves. This fear, too, evaporates when you test it.

Criticism Over Buybacks

The current bugaboo about stock buybacks evaporates too once tested. Econ 101 tells us that buybacks are bullish: They reduce stock supply, driving stock prices higher. Many believe that buybacks leech money from more productive corporate investment—such as research and development—killing economic growth. Even worse, some argue, buybacks won't even boost earnings or equity per share because euphoric executives are buying back overvalued stocks, teeing up a corporate balance sheet bloodbath. Scary, but wrongheaded. Euphoria is absent today. Price-earnings (P/E) ratios are slightly above average—signaling warming optimism—and they often rise for years as bull markets mature. Nothing now indicates some outlandish blind frenzy.

By thinking differently than the crowd, it becomes easier to see that buybacks also don't kill growth or business investment. Ask yourself: Do companies finance investment with last year's earnings and cash on hand only? Heck no! They borrow, leveraging balance sheets to grow and reward shareholders simultaneously.

If companies financed investment with cash and earnings only, they would never grow—even if they never bought back shares. Say Firm X earns $1 billion annually and has a 10% return on equity. If the company's executives wanted to spend $10 billion on a new plant, they'd have to wait 10 years to build it and another 10 to break even. Twenty years for today's business plan to bear fruit! This won't work. If they borrow, they can break ground now, use cash and earnings to pay the interest and reap rewards much sooner.

Don't Pick Sides, Invest Globally

Logic tests work far and wide. Sometimes, they can be as easy as spotting a false either/or, like the debate over whether now is a better time to invest in the U.S. vs. Europe. You needn't dig into the vagaries of U.S. or European markets to determine which to own. You needn't choose one over the other—this is both/and, not either/or. U.S. and European markets can outperform the world simultaneously. If you're optimistic about America and Europe, you can overweight both relative to their share of the global market, and invest less in Asia or Canada. Exclude either America or Europe, and you lose diversification—bad news.

Same goes for the U.S. vs. foreign stocks debate. Some argue U.S. beats all, citing the S&P 500's superior return since 1970. Well, if American stocks are so permanently superior, why would anyone own a foreign stock ever? And why would many argue foreign stocks are "riskier" and have higher return potential, thus making them superior? Tune out the noise and invest globally. U.S. and foreign stocks swap leadership often, and U.S. stocks' alleged long-term outperformance comes from the last few years.

Simple logic can help you defeat most of today’s fears, such as those about Greece’s debt crisis. Don’t get caught up in thinking of Greece as a country—you’ll overthink political ramifications. Instead, think of Greece as a company—a unit that produces a certain amount of economic activity. Its gross domestic product (GDP) is analogous to corporate revenues—both measure annual output of goods and services. Not a perfect comparison, as the statistics themselves aren’t perfectly precise, but good enough.

Greece’s GDP is roughly $200 billion, comparable to General Motors’ (GM) revenues in 2007, the year before its implosion began. Did GM’s bankruptcy wreck global markets? Nope. GM, like Greece, was too small to cause a market tailspin. Greek GDP is similar today to Chevron’s (CVX) $191.8 billion in revenues and Samsung Electronics’ $195.9 billion. It is smaller than Toyota (TM) and Volkswagen. Would the world end if any of these went under today? In a $77 trillion global economy growing 3% a year with modest inflation, it takes a few trillion dollars in problems to render recession. A $200 billion country going bankrupt won’t cut it.

The counterpoint to this is “yeah, but Greece is in the eurozone, putting other countries at risk.” Fine, then think of Greece as a U.S. city. Greek GDP is smaller than Detroit’s output in 2013, the year it went bankrupt. Did Detroit spark the great U.S. debt crisis of 2013? No, and U.S. stocks rose 32.4% that year. New York City is far, far bigger. When it went bankrupt in 1975, America was fine: The S&P rose an astounding 37.3% that year. Detroit’s and New York City’s bonds were owned primarily by banks and individual investors—both are far less exposed to Greece. Eurozone governments and the European Central Bank own most of Greece’s bonds. The financial system is backstopped.

Price-Earnings Ratios Are Not Predictive

“Stocks are overvalued!” is another easily debunked cry. Pundits point to above-average price-earnings ratios as evidence, arguing stock prices are inflated relative to earnings and must fall. The S&P 500’s current one-year trailing price-earnings ratio is 18.3. So ask: Has a price-earnings ratio of 18.3 historically triggered bear markets? The answer is no. As Figure 1 shows, the S&P 500’s price-earnings ratio crossed above 18.3 in December 1992 and stayed there for two years—while history’s

Price-earnings ratios

blipped lower in 1995 but passed 18.3 again that October and soared for years. The bull partied on until March 2000, when price-earnings ratios neared 30. When the 2002–2007 bull market began, the S&P 500's price-earnings ratio was just over 21.0. It stayed above today's level for most of the next two years. During the current bull, price-earnings ratios topped today's level for big chunks of 2009 and 2010.

Price-earnings ratios have no set relationship with stocks. They predict nothing. Simple logic! Do past returns predict the future? Every investment disclaimer in the universe says no. Do past earnings predict future earnings? Nope. That depends on future business plans, economic growth, industry developments and so much more.

Think differently about price-earnings ratios by using them as sentiment indicators. Rising price-earnings ratios as bull markets mature simply signify stocks' climb up Sir John Templeton's "wall": As investors gain confidence, they pay more for earnings. Confidence can ascend for years before euphoria hits. Or, as happened in 2007, something nasty can wallop the bull before sentiment runs its natural course. Price-earnings ratios' flattish trend before the bear market was more evidence that there was no euphoric peak. The gradual rise we see today is consistent with budding optimism—plenty more "wall of worry" ahead.

Ask Simple Questions

While all the preceding examples vary, the trick to debunking them is the same: Just try poking holes with simple questions. When the financial media warns you of impending doom, look for the yeah-buts. “Yeah, but, if the strong dollar is so terrible, why were the 1990s so great?” “Yeah, but, isn’t Greece too small?” “Yeah, but, haven’t price-earnings ratios matched today’s levels during many bull markets?”

Finding the right answer to a simple question few others ask will keep you thinking differently—and wisely.

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