Module 14
Contrarian Theory

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Oscillator
Extremes
Area – Overbought & Oversold

Markets are essentially driven by psychological forces.

Our emotions move from one extreme to another, from greed to fear, from hope to despair.

This is what causes momentum indicators to fluctuate from overbought to oversold levels.

In a sense, momentum reflects crowd psychology and measures the intensity of the emotions of market participants.
Psychology – Investor behavior

- Conviction
- Enthusiasm
- Confidence (Growing recognition)
- Greed
- Hope (Disbelief)
- Caution (Skepticism)
- Contempt
- Apprehension (Shock & fear)
- Fear
- Surrender (Disgust)

Accumulation → Participation → Distribution

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Contrarian Theory

A trading theory that recommends making investments contrary to the apparent direction of the market or commonly accepted wisdom. The theory holds that if everyone is certain something is going to happen, then it won't.

Contrarians also draw their conviction from the viewpoint that if everyone believes the market will rise, they have already bought. Thus, there are few investors remaining to create additional buying, which means it is likely that the market will decline. Some mutual funds have adopted a contrarian trading strategy as their main focus.

So when your grandmother wants to buy...
Area – Overbought & Oversold

All momentum oscillators move from one extreme to another.

Some oscillators, like RSI and IMI are calculated in such a way that they fluctuate between 0% and 100%. In these cases there is an established level for the Overbought and Oversold lines in the above cases 70% and 30%

Other oscillators, Like ROC or Momentum do not have maximum or minimum levels so in this case we must calculate the Overbought and Oversold lines ourselves.
Contrarian Theory
Technical Trading Rules and **Indicators**

- Stock cycles typically go through a *peak and trough*

- For instance, consider the following stock price graph over time, and then consider how a *technical analyst* would interpret the chart
Typical Stock Market Cycle

- Declining Trend Channel
- Peak
- Sell Point
- Rising Trend Channel
- Buy Point
- Trough
- Flat Trend Channel
- Declining Trend Channel
- Trough
- Buy Point
Contrary-Opinion Rules

- Many analysts rely on rules developed from the premise that the majority of investors are wrong as the market approaches peaks and troughs.

- Technicians try to determine whether investors are strongly bullish or bearish and then trade in the opposite direction.

- Neil pointed out that the crowd is actually correct for substantial amounts of time. It is at turning points that the majority get things wrong. It is the last idea that is really central to Neil’s thinking.

- In effect, it’s not as easy as saying:

  “Everyone else is bearish; therefore, I am bullish.”
Contrary Opinion

- Humphrey Neil
- Charles Mackay (Popular Illusions)
- Gustav LeBon (The Crowd)
- Gabriel Tarde

- Put together their ideas and experiences to form the theory of Contrary Opinion
- The crowd is actually correct for substantial amount of time
- It is at turning points that the majority(crowd) get things wrong
Why Crowds Are Irrational

Once an opinion is formed, it is imitated by the majority until virtually everyone agrees that is valid.

«When everyone thinks alike, everyone is likely to be wrong. When masses of people succumb to an idea, they often run off on a tangent because of their emotions. When people stop to think things through, they are very similar in their decisions».

Humphrey Neil
True Contrarian

To be a true contrarian one needs to:

- Study
- Be patient
- Be creative
- Have widespread experience

- A good contrarian should not go contrary for the sake of going contrary, but should learn to think in reverse, to creatively come up with alternative scenarios to those of the crowd. In other words, try to figure out why the crowd bay be wrong.
Contrary Opinion

At the beginning of a new trend(uptrend) a few far seeing individuals anticipate an alternative scenario to that followed by the majority of investors.

Later as prices rise others are persuaded that the scenario is valid. Then as the trend extends more people join in. Eventually the scenario is followed by everyone. Now, price has factored in the new scenario and the security under study is overvalued. All those betting on the old idea then lose money as the price reverses to the downside.
People are **Rational**

During harsh times people will adjust their plans. Businesses will:

- Cut *excessive* inventories
- Lay off workers
- Payoff debts

The result will

- Drop(lower) breakeven points
- **Profits** will increase when economy turns
- Decline demand for credit and subsequently interest rates will fall.
- **Lower interest rates** encourage consumers to go out and buy
- New recovery gets **underway**
Why Crowds Are **Irrational**

Trends occur because investors tend to move as crowds and are subject to *herd instincts*.

*Individuals isolated from their peers tend to act in a far more rational way.*
Why Crowds Are Irrational

Humphrey Neil wrote that there are several, social laws that determine crowd psychology:

1. A crowd is subject to instincts that individuals acting independently would never do.
2. People involuntarily follow the impulses (push) of the crowd.
3. Contagion and imitation of the minority make individuals susceptible to suggestion, commands, customs, and emotional appeals.
4. When gathered as a group or crowd people rarely reason or question, but follow blindly and emotionally to what is suggested or asserted.
Why then is the crowd wrong at turning points?

- The reason is that when everyone holds the same bullish opinion, *there is very little potential buying power left*.

- "By the same token, if the market is mispriced, other investment alternatives are becoming more attractive. Little wonder that money soon flows from the overvalued to the more realistically priced alternative". John Shultz
Contrary Opinion

In a falling market, an economy deep in recession, business activity is declining rapidly and layoffs and high unemployment are getting headlines in the nightly news. Stocks are extending the decline that began over a year ago and the whole situation appears to be out of control in a downward spiral.

While everyone is looking down, it is the prerequisite of the contrarian to look up and ask: What could go right? This is where the alternative scenario comes in.
It is difficult to be Contrarian

There are several reasons why it is difficult to take a position that is opposite to the majority:

- It is very difficult for us to take an opposite view from those around us because of our need to conform.
- If prices are rising sharply and we have already told friends of our reasons for being bearish, we are unlikely to continue in our contrarianism out of a fear of being ridiculed.
- We often meet hostility when we go against the crowd.
- Extrapolation of recent past offers a sense of comfort.
- A certain sense of security may be gained by accepting the opinion of “experts” instead of having confidence of our own opinion. (A lot of experts have vested interest in the opinions they give publicly)
Three Steps in Forming Contrary Opinion

1. Figure Out What the Crowd Thinks

- The first step is to try and get a fix on the consensus opinion of the market or individual security being monitored. If the crowd is not at an extreme, nothing can be done.
- Bear in mind that the crowd is often correct during a trend; it is the turning point that the herd is almost always wrong.
- One method of gauging where the majority of market participants lie in their opinion is to refer to the sentiment indicators or oscillators.
- A study of the media can inform us of what people are thinking. If there is no clear-cut view in the media there is not likely to be an extreme. But when it becomes clear that a general consensus is forming then it is time to begin the process of thinking in reverse.
Three Steps in Forming Contrary Opinion

2. Form Alternative Scenarios

- At this point we know what the crowd thinks, so it is up to us as true contrarians to come up with plausible (reasonable) reasons why it is likely to be wrong.

- In effect, we have to remove ourselves from the crowd and think in reverse.
Three Steps in Forming Contrary Opinion

3. Identify When the Crowd Reaches an Extreme
   ▪ When the crowd reaches an extreme, the question is not usually whether, but when and by how much?
   ▪ In other words, when the crowd truly reaches an extreme, it is a forgone (give up) conclusion that the trend will continue.
   ▪ It is not even questioned; only the timing and amount are in doubt.

The following may help identify when the crowd is at an extreme:
   ▪ Sentiment indicators and oscillators
   ▪ The Media
   ▪ Best-Selling Books
   ▪ Politicians
   ▪ Unrealistic valuations
Sentiment Indicators and Oscillators

- Sentiment indicators or long term oscillators reaching an extreme may gauge whether the crowd is at an extreme.
The Media

- Study the popular and financial media.
- Most of the time they are silent on financial markets and individual stocks.
- Pay attention when significant coverage appears.
- Major peaks and troughs are often signaled by cover stories in the popular and financial press.
- Generally speaking cover stories are fairly reliable indication of turns and usually lead turning points.
- It is not the case that journalists just don’t know what is going on and publish bearish stories at the bottom and bullish stories at the top.
- Actually, quiet markets do not sell newspapers/magazines but panic does!
- Time, Newsweek, BusinessWeek, The Economist, etc.
Best-Selling **Books**

- When financial books appear on the list it is usually a sign that that particular market has attracted the attention of the majority and that the good or bad news has been fully discounted.
- Ravi Batra’s book on the coming depression became a bestseller just after the 1987 crash, a classic sign of a bottom.
- Adam Smith’s *The Money Game* reached the list just as the mutual fund boom was ending in late 1968.
- William Donahue’s book appeared on the list when short-term interest rates were making a secular peak in 1891.
Politicians

- Politicians are an excellent lagging indicator.
- They are the last to take action, and when they do, the next trend has usually started.
- When politicians promote price controls, you can be fairly certain that that specific market/commodity is in the process of peaking.
- In 1981 when the secular peaks of interest rates were occurring, the news was full of stories of congressmen returning to Washington “determined to do something about high interest rates”.
- Gerry Ford, at the end of 1974 introduced the famous W(in) I (n)flation N(ow) buttons while consumer price inflation was already at its peak!
Unrealistic Valuations

- Another hint that the crowd has reached an extreme arises when particular market reaches a historic level of over- or undervaluation.

- In the peak of the Japanese real estate boom, it was reported that the real estate value of the Emperor’s palace in Tokyo was worth as much as all the land in California!

- During the tech boom in the 1990s priceline.com, an online travel service had a capitalization greater than the combined value of several of the airlines it represented. At its peak the stock reached $160 but a year later it had fallen to $1.

- In the 1920s, during the real estate boom in Florida, it was reported that there were 25,000 brokers in Miami, an equivalent of one third of the population.
Technical Analysis and Contrary Opinion

- Since mass psychology can move well beyond the norm, technical analysis should be used as a triggering device for signaling when the crowd is backing off from a bullish or bearish extreme.
- Watch for Oscillators reaching extreme levels, breaking of trendlines, etc
- Contrary opinion analysis should be used as one more indicator.
Sentiment Indicators/Contrary Opinion

Mutual fund cash positions
- This number moves in the opposite direction of the stock market
- The amount of cash held by mutual funds rises as prices fall and vice versa.
- Buy when the mutual fund cash position is high, sell when low
- Assumes that mutual fund managers are poor judges of market turning points

Credit balances in brokerage accounts
- Buy when credit balances increase, sell when credit balances fall

Investment advisory opinions
- Buy when advisory firms become more bearish
Sentiment Indicators/Contrary Opinion

OTC versus NYSE volume
- If OTC volume increases relative to NYSE volume, sell since speculation increases at peaks

Chicago Board Options Exchange (CBOE) put(sell)/call(buy) ratio
- Buy when option purchasers are bearish (when the put/call ratio increases)

Futures traders bullish on stock index futures
- Sell when speculators are bullish
Follow the **Smart Money**

While contrary-opinion rules assume that most investors are not smart, these indicators seek to follow the path of sophisticated, and assumed **smart, investors**

**The Barron’s Confidence Index**

- Measures the yield spread between high-grade bonds and a large cross section of **bonds**
- Declining (increasing) **yield spreads** increase (decrease) this index, and are a bullish (bearish) indicator
Follow the **Smart Money**

**T-Bill - Eurodollar yield spread**
- Decreases in this spread indicates *greater confidence*, and is a bullish indicator

**Debit balances in brokerage accounts**
- Such balances represent *buying on margin*, which is assumed to be done by largely sophisticated investors
- Increases are a *bullish signal*
Other Market Indicators

These indicators are meant to gauge overall market sentiment

Breadth of market
- **Advance-decline** (number of advancing minus the number of declining issues)

Short interest
- Cumulative number of shares sold short in uncovered positions
- Actually a bullish indicator, as it indicates potential demand