Contrarian theory in investing and trading is based on the idea that markets are driven in large part by crowd behavior. When crowds form around investing themes in the stock market, they push stock prices too high or too low relative to fair value. Contrarians hold that if investment crowds are responsible for the pricing mistakes made by the stock market, it logically follows that you can do better than buy-and-hold if you can detect those situations in which an investment crowd has driven the stock market too high or too low relative to fair value.

The Art of Contrarian Trading shows how to take advantage of the crowd’s periodic bouts of enthusiasm and fear, and make wise investment choices that most others may think are ill-advised. Veteran trader Carl Futia explains the contrarian trader’s principal tool: his media diary. Since major market turning points are almost always foreshadowed by magazine covers and newspaper headlines that turn out to be completely wrong, by monitoring crowd behavior through both quantitative indicators and news media headlines—and with the hindsight of historical examples—a trader or investor will be well equipped to profit from market turning points. Futia shows specifically how the information contained in a media diary can be interpreted and then coordinated with a statistical view of a market’s current and past swings. By looking back at the bull market of 1982–2000, the 2000–2002 bear market, the bull market of 2002–2007, and the crash of 2008, he reveals how his own media diary effectively identified the many valuation mistakes the stock market made during those years. In addition, he explains the development of the theory of contrary opinion, highlights the contributions key individuals made to the theory, briefly discusses several books every contrarian should read, and offers a quick primer on value investing for the contrarian trader.

CARL FUTIA is a trader who runs a highly rated investment/trading blog (carlfutia.blogspot.com). He provides very specific price forecasts for the stock, bond, and various commodity markets. Futia’s main tools are derived from the theory of contrary opinion and box theory. He holds a BA in economics from Yale University, a master’s degree in mathematics from the University of California at Berkeley, and a PhD in mathematical economics from Berkeley as well. Futia has published several papers in theoretical economics in scholarly journals.
The Art of Contrarian Trading
Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers’ professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market’s ever-changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional, or somewhere in-between, these books will provide the advice and strategies needed to prosper today and well into the future.

The Art of Contrarian Trading

How to Profit from Crowd Behavior in the Financial Markets

CARL FUTIA

John Wiley & Sons, Inc.
Contents

Preface xi

CHAPTER 1 Can You Beat the Market? 1
The Speculator's Edge 1
Lending a Helping Hand to Investors 2
Uncovering Market Mistakes 4
Looking at the Evidence 5
Market Timing 6
Catch-22 7

CHAPTER 2 Market Mistakes 9
Efficient Markets 9
Roller Coasters and Stock Markets 10
Do Stock Prices Fluctuate Too Much? 12
A Look at Behavioral Finance 14
Behavioral Finance and Exploitable Market Mistakes 16
No Free Lunch Redux 17

CHAPTER 3 The Edge 19
A Theory of Market Mistakes 19
To Get Along, Go Along 21
Go Along and Create a Mistake 22
The Social Calculus of Crowds 25
The Vision of a Contrarian Trader 27
CONTENTS

CHAPTER 4 The Wisdom and Follies of Crowds 31
Can a Crowd Be Wiser Than Its Members? 31
The Need for Collective Wisdom 32
Independent Decisions in the Financial Markets 34
Forecasting Market Psychology 36
Information Cascades into the Whirlpool of Speculation 38

CHAPTER 5 The Life Cycle and Psychology of an Investment Crowd 43
Prologue 43
The Cycle of Birth and Death 44
The Stock Market Bubble of 1994–2000 46
It’s Different This Time: The New Information Economy 48
Shattered Dreams: The Bear Crowd of 2001–2002 49
Popular Instincts and the Search for Certainty 51
The Pied Pipers of Investment Crowds 54
The Mental Unity of Investment Crowds 55
Suggestibility, Volatility, and Disintegration 59

CHAPTER 6 The Historical Context for Market Mistakes 61
Mature Investment Themes and Market Crowds 61
Mistakes versus Fair Value 62
Market Data Sources 63
The Deadly Mistake 64
When Is the Stock Market (Extremely) Overvalued? 65
When Is the Stock Market Undervalued? 67
The Peak Oil Bubble 70

CHAPTER 7 How Crowds Communicate 71
What Do Information Cascades Tell Investors? 71
The Role of the Mass Media 73
A Word about Personal Flexibility and the Future of Media 76
CONTENTS

CHAPTER 11  The Grand Strategy of Contrarian Trading  123

Contrarian Investment Planning  123
Contrarian Trader’s Investment Portfolio  125
The Investment Goal of the Contrarian Trader  126
A Warning about Capital Gains Taxes  128
Contrarian Trading Strategy #1: Don’t Speculate  128
Contrarian Trading Strategy #2: Don’t Invest with the Crowd  129
Contrarian Trading Strategy #3: Contrarian Rebalancing  129
The Aggressive Contrarian  130
A Long-Only Strategy for the Aggressive Contrarian Trader  131
More Aggressive Contrarian Trading Strategies  134


Prologue  137
The 1987 Crash  138
Interlude: The 1929–1932 Crash and Bear Market  140
The S&L Crisis, the 1987–1990 Bull Market, and the 1990 Bear Market Crowd  141
Rally without Joy, 1991–1994  143
The Stock Market Bubble Inflates, 1995–2000  145
The Aggressive Contrarian Faces the 1987 Crash  147
The 1990 Low  149
Long Term Capital Management Goes Bust  150


End of the Great Bull Market  153
Contrarian Rebalancing during the 2000–2002 Bear Market  154
The Long Way Down Again  154
Contrarian Rebalancing during the Crash  155
The Aggressive Contrarian during the 2000–2002 Bear Market  157
A Wall Street Wreck  158
The Summer Rally  160
Contents ix

The March 2001 Plunge 162
Terrorists Attack on 9/11 164
End of a Bear Market 164
Transition to a New Bull Market 166

CHAPTER 14 The Postbubble Bull Market of 2002–2007 169

Escaping the Bear's Claw 169
What Bull? Looking for Signs of a Bullish Information Cascade 170
The Story of Google's IPO 172
The Housing Bubble 175
Aggressive Contrarian Trading during the 2002–2007 Bull Market 177
April 2005—A Buying Opportunity 181
June 2006—Another Buying Opportunity 182
Aggressive Contrarian Trading in Early 2007 183
July–October 2007 186

CHAPTER 15 The Panic of 2008 189

The Conservative Contrarian during the Panic 189
The Mortgage Mess 191
The Debt-Deflation Spiral Takes Hold 193
Lenders of Last Resort 194
The Credit Crisis and the Contrarian Trader 195
Bull Market Top and the First Step Down 195
The Bear Stearns Failure 198
Fannie and Freddie 199
The Crash: Bankruptcy of Lehman Brothers 201

CHAPTER 16 Vignettes on Contrarian Thought and Practice 205

The Psychology of the Stock Market 206
The Godfather of Contrary Opinion 206
Opinion Polls: What Do You Think 207
CONTENTS

Is the Odd Lotter Always Wrong? 209
A Forecasting Giant of the Past 211
Paul Montgomery, the Magazine Cover Contrarian 212
Irrational Exuberance and Other Bubbles 212
Value Investing—A Back-of-the-Envelope Approach 214

About the Author 218
Index 219
Preface

Why is it so difficult to beat the stock market?
It is easy to see that the market gives us plenty of chances to buy low and sell high. Just look at the history of the past 10 years, 1998 to 2008. During that time the Standard & Poor's (S&P) 500 index has fluctuated between 752 and 1,565. There have been five distinct, substantial swings across this range. The brief panic in 1998 arising from the Russian credit default and the failure of a big hedge fund, Long Term Capital Management, dropped the S&P nearly 20 percent, from 1,187 to 957. Those fears quickly evaporated, and the subsequent climb in prices capped a stock market bubble that was unprecedented in the financial history of the United States. The S&P rose to a high of 1,527 in March 2000, an advance of nearly 1,400 percent from its 1982 low of 102.

The biggest thrills of this stock market roller-coaster ride were yet to come. The S&P dropped nearly 50 percent during the following two years. At the index’s October 2002 low of 777, investors gasped at the shocking collapse of the Internet stocks and feared that corporate accounting statements were meaningless. But the downward rush in stock prices during the preceding two years seemed to generate just the momentum needed to push the market back up to the top of its next hill. During the subsequent five years the S&P more than doubled to a closing high in October 2007 of 1,565.

As the stock market began to edge downward from its 2007 peak, no one could imagine the terrors that lay ahead. Within a year the panic of 2008 had destroyed financial institutions around the world. The rest teetered on the edge of collapse. On November 20, 2008, the S&P closed at 752 after careening downward 52 percent from its high a year earlier. Many people feared that even worse was to come.

In this book I tell you why it is so difficult for the average investor to profit from these roller-coaster swings in stock prices. I explain why it is almost impossible to consistently buy low and sell high and thus do better than the benchmark strategy of the buy-and-hold investor. Along the way
xii

PREFACE

I hope to help you make an informed choice of your personal investment strategy.

You may decide that attempting to beat the market is not really a good choice for you. The emotional strain involved may just not be worth the effort. Self-knowledge like this is invaluable, worth far more than the price of this book.

Or you may choose to learn the art of contrarian trading. If so, I think you have chosen a difficult path, but I also think you have in your hands the only book in print that can help you achieve this goal.

I am a contrarian trader. I have learned my art the hard way, by making plenty of mistakes, by unknowingly becoming part of the crowd at the wrong time. You see, the reason stock prices move up and down so much is that we all like to join crowds, social groups of like-minded people. When such crowds form around investing themes in the stock market, they push stock prices too high or too low relative to fair value. Why? Crowds suppress the dissenting views of nonmembers and amplify the consensus views of their members. Crowd members act together, not independently, and when this happens the market price strays substantially from fair value.

Economic experts believe that stock prices are much more variable than warranted by fluctuations in corporate profits and dividends. I think that the constant formation and disintegration of investment crowds is responsible for this excessive variability and for the wide range over which stock prices tend to fluctuate.

Another way of putting this is to say that investment crowds are responsible for the pricing mistakes made by Mr. Market. Mr. Market is the subject of an investment parable told by the father of value investing, Benjamin Graham. Mr. Market is at your elbow each day telling you what he thinks your investment portfolio is worth. Many days his estimate seems plausible and justified by business conditions. On many other days Mr. Market lets his enthusiasm or fears run away with him, and the value he proposes seems little short of silly. Investment crowds are responsible for Mr. Market’s periodic bouts of enthusiasm or fear.

If investment crowds are responsible for the pricing mistakes made by the stock market, then it logically follows that you can do better than a buy-and-hold investor if you can detect those situations in which an investment crowd has driven a stock or the entire market too high or too low relative to fair value. The method for doing this that I propose in this book rests on a simple observation.

Crowds develop and grow during a communication process called an information cascade. During an information cascade the print and electronic media focus public attention on recent, dramatic movements in markets and the associated profits and losses of investors. This in turn
Preface

encourages people to put aside their natural skepticism and adopt the investment theme the media are highlighting. As the investment crowd thus grows larger, it pushes the market even further away from fair value and toward a substantial valuation mistake.

I think a contrarian trader can learn to take advantage of Mr. Market’s periodic bouts of enthusiasm and fear by tracking information cascades in the media. I will show you how to do this by keeping a media diary. In the final third of this book I’ll illustrate the use of the contrarian trader's media diary during the turbulent years beginning with the 1987 crash and continuing through the panic of 2008.

I warn you that the journey toward becoming a contrarian trader will be a difficult one with an uncertain end. Most people are simply not cut out to be contrarian traders, for they love the companionship and approval of their fellow investors too much. But if you are prepared to step away from the crowd, to make wise investment choices that the crowd will think silly or ill-advised, then this book is for you. You may also want to follow my contrarian trading views in real time. For these you can look to my blog, which currently can be found at www.carlfutia.blogspot.com.

Each of the following 16 chapters begins with a brief outline of its content. Here I want only to give you a general picture of this book’s structure and the way in which it explains the process of contrarian trading.

Chapters 1 to 5 develop the foundation on which our method will rest. We answer the question of why some speculators win but most lose, and in so doing we identify the successful speculator’s characteristic edge. We will see why investment crowds are responsible for market mistakes and discuss the characteristic behavior of such crowds.

Chapters 6 to 11 explain a practical approach to contrarian trading. Here we learn about the contrarian trader’s principal tool, his media diary. We discover how the information contained in a media diary can be interpreted and then coordinated with a statistical view of a market’s current and past swings. We also develop specific contrarian trading strategies, one for a conservative and another for an aggressive contrarian trader.

In Chapters 12 to 15 we apply the techniques explained in the preceding chapters to the stock market. I kept my own media diary in real time during the years 1987 to 2008. I think you will be surprised to see how effectively it identified the many valuation mistakes the stock market made during those years.

Chapter 16 contains a small number of very brief essays and notes I wrote for my own benefit as I learned to be a contrarian trader. It explains the development of the theory of contrary opinion, highlights the contributions key individuals made to the theory, discusses briefly several books every contrarian should read, and offers comments on back-of-the-envelope value investing for the contrarian trader.