

A Review of Contrarian Strategies in Capital Markets

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Abstract

A contrarian stock selection strategy consists of buying stocks that have been losers and selling short stocks that have been winners. The strategy is formulated on the premise that the stock market overreacts to news, so winners tend to be overvalued and losers undervalued. Many investment strategies, such as those based on the price/earnings ratio, or the book/market ratio, can be regarded as variants of this strategy. The purpose of this paper has been review the empirical evidences of contrarian investment strategies in capital markets in developed and developing economies. The empirical results reviewed in literature indicated that contrarian investment strategies yielded superior performance in stock markets across the world and the success of the strategy can be attributed to either risk or behavioral based explanations. The superior performance of the strategy has been proved on several markets. Evidences for the failure of the contrarian investment strategies were also found and some studies revealed negative results.

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Introduction

Contrarian investment strategies have been used by investment managers and known for decades. Numerous capital market studies have generated enough evidences of significantly superior performance of the contrarian strategies. This superior performance is yielded when investors buy under-priced stocks and sell overpriced stocks. Usually, the under-priced stocks are referred to as the loser or value stocks, while the overpriced stocks are often called winners or growth stocks. Several empirical studies have shown that it is actually possible for one group of stocks to outperform another group. This has caused frustration for the proponents of the rational paradigm, because rational models are unable to explain this tendency. For many years researchers have argued that this strategy can outperform the market in the long run. Contrarian investment strategies work, because investors do not know their limitations as forecasters. As long as market participants believe that they can predict the future of favored and unfavored stocks, it is possible to make good returns on contrarian investment strategies (Dreman, 1998). A contrarian investor attempts to make a profit by investing differently from the conventional manner, when it is believed that the consensus opinion appears to be wrong. Contrarian investment strategies are based on long positions in value assets that will appear undervalued and additionally short positions in growth assets that will appear overvalued to the contrarian (Lakonishok, Shleifer, & Vishny, 1994). Widespread pessimism about a stock will for example lead the stock price down and as a consequence overstate the risk of the company and understate the likelihood of returning to profitability. The contrarian seeks opportunities to buy and sell assets when the herd of the market participants appears to do the opposite, to the point where the investment has become mispriced. One of the most famous contrarians, Warren Buffet believes that the best time to invest in an asset is when short-sightedness of the market has beaten down the price. This may indicate a possibility of long-term profitability. To be able to implement the contrarian investment strategy successfully, it is important to understand, what factors classify the scrips. Lakonishok et al. (1994) make the following identification of growth and value stocks:

- **Glamour stocks** are stocks that 1) have performed well in the past, and 2) are expected by the market to perform well in the future.
- **Value stocks** are stocks that 1) have performed poorly in the past and 2) are expected to continue to perform poorly.

These definitions indicate that the glamour stocks tend to be favored by the market, as the market is in general optimistic about future performance. These stocks are often also sighted as growth stocks, which is defined as stocks that have a significant growth in sales, earning and/or assets. In the following both definitions will be used synonymously. Contrary to this, value stocks tend to be disliked by the market, because the market is generally pessimistic about the future performance of these stocks. The market generally expect stocks with high past growth to continue to deliver, which can be a huge mistake, as it seems unlikely that companies can maintain a very high growth level forever. This behavior will cause the prices to deviate from the fundamental values. Consequently the contrarian investment strategy tries to take advantage of these characteristics and beliefs from the market, to make an abnormal profit. The main objective of this paper is to review the performance of contrarian investment strategies in capital markets in developed and developing economies. The rest of the paper is organized as follows. Section 2 provides the review of literature and section 5 concludes.

Review of Literature

The contrarian strategy has many critics in academic world, for any trading rule based on past prices violates the weakest form of market efficiency hypothesized by finance theorists. Some of the important studies of contrarian strategies across the globe are mentioned below.

Basu (1977) contradicted the predictions of the CAPM Using a sample period that stretched from April 1957 to March 1971; Basu showed that stocks with high earnings/price ratios (or low P/E ratios) earned significantly higher returns than stocks with low earnings/price ratios. His results indicated that differences in beta could not explain these return differences. DeBondt and Thaler (1985), conduct their test on different samples of winning and losing stocks. The main result of DeBondt and Thaler were that losers had much higher average returns than winners over the next three to five years.

Lakonishok, Shleifer and Vishny (1994), supported the extrapolation-based story by showing that a two-way sort on cash flow/price and five-year sales growth produces more dispersion in average returns than other variables (including BM). LSV postulates that value strategies produce superior returns because investors' consistently over estimate future growth rates of glamour stocks relative to value stocks. They found that value portfolios have higher standard deviations in returns than growth portfolios. Davis (1994) showed that the two-way classification using sales growth and cash flow/price produced about the same return dispersion as a simple sort on cash flow/price for the 1940-1963 periods. This out-of-sample evidence does not support the extrapolation hypothesis, which predicts that the two-way classification should produce more dispersion.

Phalippou (2004) showed that the value premium was concentrated in stocks mostly held by individual investors and that, consistent with behavioral explanations, the value premium declined from the lowest to the largest institutional ownership deciles.

Hui et al (2005), examined whether the contrarian strategies could create excess returns, that is, whether overreaction phenomenon exists in stock investors of Taiwan. With average buy and hold month return of holding period, the study exhibited evidence of performance reversal for loser portfolio, while winner portfolio with no evidence. Secondly, they found evidence in favor of long-term overreaction (i.e., significant positive return over a period of 30-36 months to the arbitrage portfolio based on past performance) in Taiwan stock markets. These findings were similar to those obtained by De Bondt and Thaler (1985, 1987) and Jegadeesh and Titman (1993), which showed that contrarian strategies proved to be more profitable over the long-term horizon.

Antonios et al (2006) investigated the existence of contrarian profits for the London Stock Exchange (LSE). The results indicated that contrarian strategies were profitable for UK stocks and more pronounced for extreme market capitalization stocks (smallest – largest); the profits persisted even after the sample was adjusted for market frictions, such as infrequent trading and bid-ask bias, and irrespective of whether raw or risk-adjusted returns were used to calculate them. Ramiah et al (2007), investigated a tactical asset allocation strategy, known as contrarian investment strategies, for equities listed on the Australian Stock Exchange. The empirical results demonstrated that contrarian behavior was a persistent feature of stock returns for strategies examined in Australia. Dapaah and Peiying (2009), used data for REITS stocks traded on the NYSE, AMEX and NASDAQ from 1990 to 2007 to ascertain the relative superiority of the contrarian and momentum REITS investment strategies. The results showed that the strategy provided superior performance, the superior performance of the contrarian strategy increased over time and was found to be statistically significant for holding periods of more than, or equal to, six months. Furthermore, the results showed that the superior performances were not a compensation for risk. This implied that investor psychology could be the driver for the value/growth premium. From the above studies it can be documented that contrarian investment strategies does work well and the success of the strategy can be attributed to either risk or behavioral based explanations. The superior performance of the strategy has been proved on several markets. Evidences for the failure of the contrarian investment strategies were also found and some studies revealed muddy results.

Conclusions

A contrarian stock selection strategy consists of buying stocks that have been losers and selling short stocks that have been winners. The strategy is formulated on the premise that the stock market overreacts to news, so winners tend to be overvalued and losers undervalued. Many investment strategies, such as those based on the price/earnings ratio, or the book/market ratio, can be regarded as variants of this strategy. The purpose of this paper has been review the empirical evidences of contrarian investment strategies in capital markets in developed and developing economies. The empirical results reviewed in literature indicated that contrarian investment strategies yielded superior performance in stock markets across the world and the success of the strategy can be attributed to either risk or behavioral based explanations. The superior performance of the strategy has been proved on several markets. Evidences for the failure of the contrarian investment strategies were also found and some studies revealed negative results.

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