KPP FINANCIAL

InvestTalk Insider

Special Info Sheet Series

The Contrarian View

The stock market swings between two poles like a pendulum. Those poles are called Extreme Bullishness and Extreme Bearishness. There can be very long term bullish swings generally lasting between one and two decades and the bearish swing lasting around ten to twenty years. These are broad based movements of the market. We call these secular bull and bear markets.

In the years between those massive movements you have smaller cycles. There are a number of bull and bear market phases inside the longer trend. Some of these movements can be dramatic of 100% or more from one extreme to another and can last several years.

Then we have short-term corrections generally described as movements of 10 to 20% over a number of months.

The contrarian is an investor that tries to take advantage of these market swings looking for signals that tell them the swing has gone too far and is ready to go the other way. Investor buying and selling usually is driven by emotions which can be taken advantage of, especially in cases of overreaction. The difficult part is trying to determine the extent of the emotional reaction.

There are a few signals that most pundits agree with that demonstrate an overreaction such as; extremely negative investor sentiment, extreme media bearishness and strong insider buying. But again how do you measure, extreme or strong?

For investor sentiment you can use the VIX. This is the CBOE Volatility Index. Some call it the fear gauge. As it rises, it shows that traders are fearful with 'put' buying of options much stronger then 'call' buying. As the VIX goes above 30, fear is high in the stock market thus a contrarian would start to buy the market thinking it is at an extreme. Also, a weekly survey of the American Association of Individual Investors (AAII) reveals the percentage investors are bullish and bearish. Recently, a reading of 18% bullish sentiment was the lowest in 10 years meaning that a contrarian would be thinking of buying stocks as fear is very high.

Extreme media bearishness is more difficult to gauge. In this case, look for scare stories and doom and gloom headlines. A few years ago, when oil prices spiked to $140 per barrel the scare story was that it was going to $200 per barrel. It will always be difficult to judge the strength of the media negativism.

Insiders buying or selling is easier, but finding the data may be more difficult. Also, insiders always sell as a means to reap the rewards of working for a big company that pays them in stock options. Buying therefore is more meaningful. When an insider is buying, the thinking is he or she knows the company well and has faith in the future of the company. There is also a Vickers Weekly Insider newsletter that tracks and assigns a ratio. It currently sits at 1.19 and anything below two is bullish. So insiders today remain bullish.

Being a contrarian is not easy. Judging extremes in a market place is very difficult as they can stretch a lot further and longer than expected. But if you can control your emotions and think objectively you will be able to pinpoint attractive investment opportunities that most others are not seeing. With that ability you will begin to outperform even most professionals.