Contrarian investing obviously comes with risk

Steven Podnos *9:31 a.m. EDT March 23, 2015*

QUESTION: What is a contrary investor?

Podnos: I'm a born contrarian-I love to invest against the crowd. But I've learned some important lessons in doing so.

Contrarian investing usually refers to buying assets that are being aggressively sold and dropping in price. Success in contrarian buying means that the assets that are "cheaper" are in fact less risky at the lower price.

One important lesson is that the crowd is actually usually right. Equity markets go up on average in two out of three days in the long term. A long term investor will usually come out ahead just by staying in the market over the long term. Just pull up a 20-30 year chart of the US markets and you will see what I mean. It would be impossible to nimbly move in and out of the markets in a way that would be just staying put.

A second lesson is that the narrower the investment, the more dangerous a contrarian investment will be. For example, if you follow a particular individual company that is dropping in price (the stock price), there may be some very good reasons for the change. It could be market change, industry change, or just specific company change. You are unlikely to be able to sort that out. If instead a large asset class drops in price, especially compared to other asset classes or to the specific asset class's historical valuation, then your risk in making the contrarian buy goes way down. For example, when the S&P 500 index dropped almost in half in 2008-9, the contrarian interest in buying was a great one. The large liquid American markets were certainly not worth that much less in a short period of time, and buying was of relatively low risk in the long run.

Huge swings in broad markets are unusual, and most contrarian investing that seem reasonable are in sectors and industries. For example, Gold is down at least 30% over the last year or two (and gold mining stocks even more). A contrarian would be attracted. Currently, the energy markets have suffered a sudden large drop in stock prices, which would perk up the ears of a good contrary investor.

But the third lesson I would offer would be to limit the amount of your contrary investment. It is easy to be a true believer and to make a full commitment. But that is usually a mistake. Instead, I'd recommend that you remain broadly invested in a diversified group of markets (unless you have a strong belief that one or two in particular is markedly overvalued), and make the contrary investment with only a small part of your funds (different for everyone, but a ten percent level seems reasonable). This type of investing is sometimes called "core and satellite", and is a reasonable way to be a contrarian.

Steven Podnos MD CFP is a fee-only planner in Brevard County. He can be reached at www.wealthcarellc.com, or Steven@wealthcarellc.com.

Read or Share this story: http://on.flatoday.com/1Ch1eLj