The Investing Herd Data Indicates Potential Opportunity Ahead

Physician's MONEY DIGEST®

Dave Gilreath, CFP May 27, 2020

Did you ever wait until closing time to visit a bakery with hopes of getting still-fresh goods at a discount—or at least a few free cookies thrown in?

This is kind of like the time-honored practice of contrarian investing, where investors seek to benefit by stepping to a different drummer than the herd. Just as most shoppers' habit of going to the bakery on a Saturday morning might create value opportunities later in the day for the patient, the investing herd creates opportunities for contrarians.

These investors think in terms of WWTHD (What Would the Herd Do?), look at what the herd is actually doing, and then often do the opposite.

To identify value stocks, you look for companies that, because of disfavor, have share prices that don't reflect factors that might normally suggest higher values: their historical performance and/or current fundamental characteristics.

That's the "what" of value investing. The "when" can be a lot trickier. How long you end up waiting for a value stock to rise—how long its price ends up languishing—is a critical factor in contrarian investing success. Yet the herd sometimes makes this easier by giving off signals that are historically fairly reliable. Recently, the herd has been making such noises, known as contrarian buy signals, indicating that it may be a good time for contrarians to invest.

These signals include:

- Low numbers on the investor sentiment survey of the American Association of Individual Investors (AAII). The membership of this organization has the dubious distinction of inadvertently identifying good times to invest precisely because of their belief that it's a bad time. AAII members' bullishness/bearishness tends to reflect broad investor individual sentiment—herd sentiment. Recent AAII surveys brought the highest number of bear responses in the last seven years. Respondents' degree of bullishness/bearishness is reflected by their answers to survey questions on how they expect the market to perform over the ensuing six months.

In mid-May, the AAII bullish rating was 23.7%, the lowest level of 2020, landing between one and two standard deviations from the mean--quite a low point historically. Bullishness has been greater than one standard deviation from the mean 265 times since 1987, and the average 12-month forward return from the S&P 500 during that period was 17%.

This greater-than-average return suggests that the association membership usually gets it wrong—that they may be expressing fear that leads to selling, pushing down share prices (particularly those of out-of-favor, non-herd stocks), and thus setting up equities for gains over the next 12 months. Thus, the skittish herd often enables the opportunistic contrarians.

- Recent numbers from Morningstar on overvalued/undervalued stocks. The company's overvalued/undervalued indicator generally characterized large-cap stocks as being undervalued in May, based on its estimations of their fair value.
- In May, extreme spikes in the equal-weighted S&P 500 Index, compared with the capitalization-weighted performance in that index. The cap-weighted index is what everyone talks about. It's dominated by the largest companies in the index, which proportionately have a greater weighting in index performance based on capitalization. The equally weighted stocks in the index got killed in March; the damage was much less for the cap-weighted members of the index.

The fact that these equally weighted companies were still down about 15 percent in early May (while the cap-weighted had bobbed up to about 9 percent off their highs) might indicate an inflection point. When that has happened over the past three decades, out-of-favor value stocks tended to begin shining, bringing gains to investors with the acumen (or professional active management) needed to pick them, as opposed to indexing.

- A through-the-roof spike (to levels above the 99th percentile) in the St. Louis Federal Reserve Bank's Policy Uncertainty Index in late April. This spike was higher than any over the past 35 years. Spikes in this index, which measure public levels of uncertainty regarding economic policy, have long been a strong contrarian buy signal, as they've preceded periods of substantial growth in the S&P 500. The herd doesn't like uncertainty, which suppresses their tendency to invest. This lowers prices, creating room for growth.

Assuming these buy signals rhyme today as they have in the past, this may bode well over the next year or so for sectors currently beaten up by impacts of the coronavirus—but poised to come back when the real economy resumes. The most extreme such contrarian play is energy, which is particularly poised to surge when the global economy chugs back to life, using more and more oil. (There are tankers full of oil lingering offshore, waiting to unload as supplies already on land are used up, for want of real storage in a system designed for continuous high consumption and flow.) Interestingly, since the market lows hit on March 23, the energy sector has registered the best performance of all eleven S&P 500 sectors.

Also in the beaten-up-value-department are credit companies that own their own debt, such as Capital One and Discover, and regional banks, which are most hurt among lenders by low borrowing demand and the current rock-bottom rates that narrow spreads and crimp profitability.

While contrarian buy signals are no panacea (there's no such thing in investing) for projecting the overall market or anticipating comebacks of specific companies, they can be a helpful tool for investors seeking to make informed decisions. Any one signal isn't as significant as a convergence, such as what we have now. The more valid signals you can discern, the better idea you'll have of what the herd is thinking and how you might benefit from it.

David Sheaff Gilreath, a certified financial planner, is a 39-year veteran of the financial service industry. He established Sheaff Brock Investment Advisors LLC, a portfolio management company based in Indianapolis, with partner Ron Brock in 2001. The firm managed over $1 billion in assets nationwide as of 12/31/2019. The author does not own shares of the companies mentioned above.