

Your guide to contrarian investing

Understanding Allan Gray's
contrarian investment approach



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Introduction



At its simplest, taking a contrarian investment approach means going against current market trends.

There are different levels of being a contrarian investor. For some investors being contrarian is merely holding more or less of a particular stock relative to the market or their peer group, or taking one or two different investment positions.

At Allan Gray, being contrarian is much more.

For us, contrarian investing means buying an investment when we believe it's undervalued in a less optimistic environment, with the expectation of selling it when we consider its price reflects our view of its value.

We actively look to buy shares that others are selling and sell when others are buying. Why? Because if you buy and sell the same shares as the majority of investors, at the same time, it is by definition almost impossible to outperform the market.

Our contrarian approach is not about being different just for the sake of it, but driven by performance and a desire to succeed. To seek better-than-average returns, you need independent thinking. You can't just follow the herd.

This guide will give you an understanding of the Allan Gray contrarian investment approach. It also uses empirical research to demonstrate how this strategy provides value by diversifying portfolios and recognising opportunity where it is being overlooked.

You cannot do the same as everybody else and expect a better-than-average result.

The Allan Gray Australia investment approach



Successful contrarian investment requires a strategy that is repeatable and enduring.

At Allan Gray, our investment philosophy is simple – we take a contrarian approach, apply it consistently and invest for the long term. We never try to guess external sentiments, the next share price movement or trends. Instead, we scrutinise opportunities that aren't necessarily obvious.

We do this by searching for value in companies that others overlook or undervalue. Then we determine the things that we believe drive the company's performance and hence its value over the next five or even ten years.

This is how we've been investing in Australia since 2005 and how the broader group has been investing globally since 1973.

Our strategy has three distinct characteristics:

1. Contrarian

To give us a competitive edge in a market where every investor has access to the same information, we thrive on not following the crowd. As contrarians, we resist trends and uncover opportunities in places where no one else is looking. It puts us in a space where we face less competition – where an investor's greatest assets are patience and independent thinking.

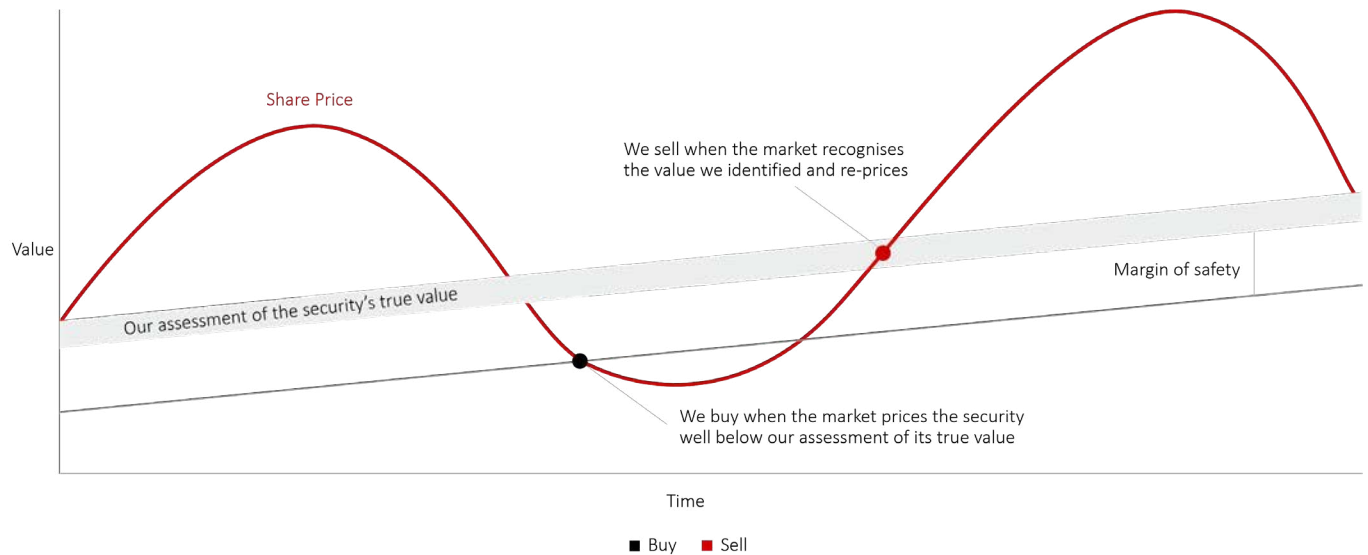
2. Long-term

In an increasingly competitive market, practising patience can give you a distinct advantage. By waiting for the right opportunity to buy and giving an investment time for its value to develop, we may discover potential for an undervalued company.

3. Fundamental

We seek out companies that are out of favour and wait for an opportunity to buy their shares at a price well below their value. We study a company's fundamentals then calculate what we believe to be its true value.

How contrarian investing works



As shown in the chart above, our investment in a security starts with an assessment of the company's true value, with the aim of investing when the price is well below this value.

This increases the likelihood that potential risks are already in the price, to reduce future risk and increase return potential. We then look to sell the security when it reaches our assessment of its true value. When we first start to buy a security, the price can continue to fall. After all, we are buying at a time of negative sentiment and news often gets worse before it gets better. We see this as an opportunity. If the price continues to fall but our thesis remains intact, this is a great chance to buy more of the stock at a lower price, increasing our anticipated gain if and when the price rises.

When the price rises and gathers momentum it may reach or even exceed our assessment of its value. This is the ideal time for us to sell, as there are often plenty of willing buyers in the market making it easier for us to sell the security.



History of Allan Gray Australia

The history of Allan Gray Australia can be traced to the vision of our founder, the late Dr Allan Gray, who started his investment career in 1965 in Boston after graduating from Harvard Business School. When he returned to his native South Africa in 1973, he founded Allan Gray in Cape Town, which today is one of South Africa's largest privately owned investment management firms. He later founded Orbis Investments, which today has offices around the world, including in the UK, Hong Kong and Canada.

In 2005, Allan Gray Australia was established based on the same investment philosophy and values as Allan Gray South Africa and Orbis Investments. The same contrarian approach is applied globally – underpinning our beliefs and our behaviour.

Four benefits of contrarian investing

1. Increasing the chance of upside

Taking a contrarian approach improves your chance of paying a lower price and therefore achieving a better-than-average return. It also helps avoid speculative over-optimism, where stock prices rise too high, thereby increasing the risk of overpaying.

If you are willing to look in areas of the market that are unpopular with investors, you are more likely to find bargains. That is, stocks where excessive investor sentiment has created the opportunity to buy at a good price. The following is some empirical research:

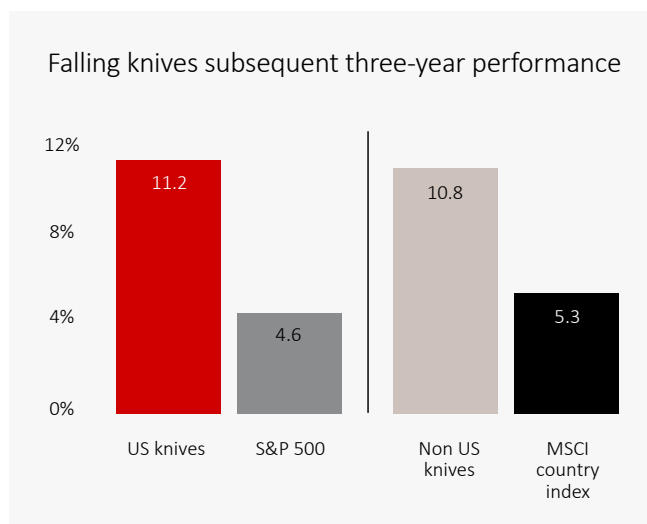
The Falling Knives Analysis

The Brandes Institute examined the performance of falling knives in the US stock market from 1980 to 2003¹.

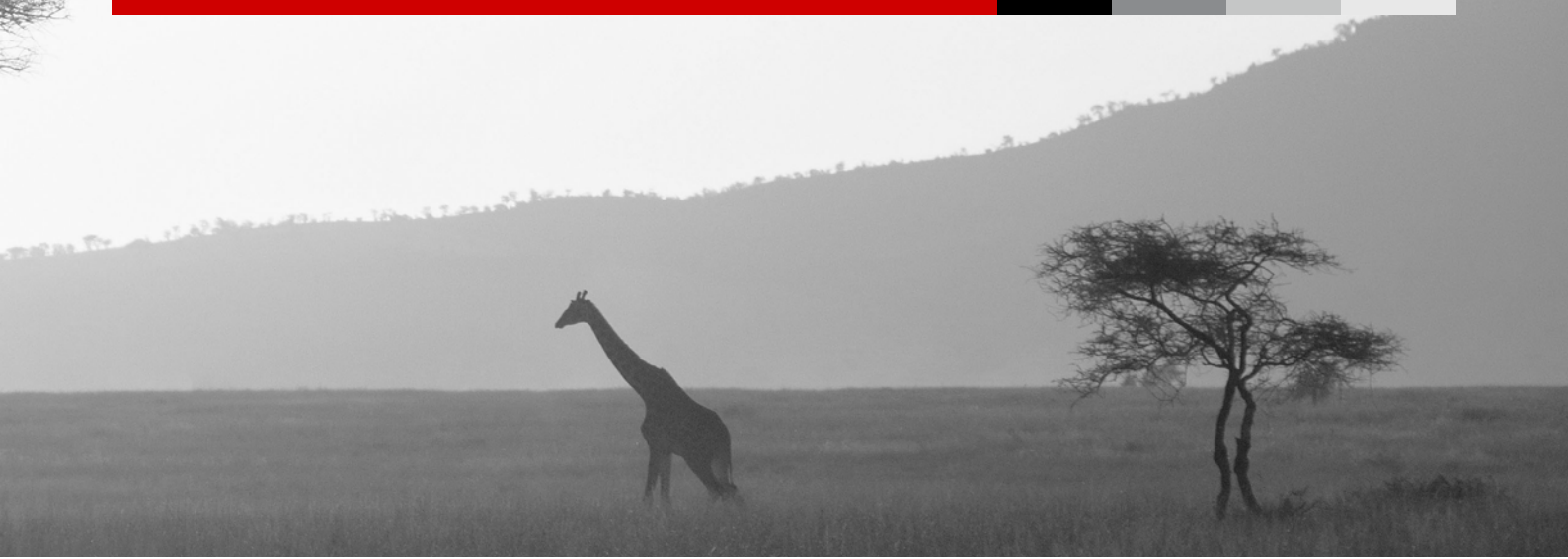
The author of the study defined a falling knife as a stock whose price had fallen 60% or more over a 12-month period, when investors are generally cautioned against jumping into a stock as the share price may fall further. Despite this, the report found that 'investors who never catch a falling knife could be forgoing significant opportunities'. They recognised that the average falling knife went on to outperform the S&P 500 by a wide margin.

In the US, even counting those companies that went bankrupt, the knives returned an average annual performance of 11.2% in the following three years, versus the 4.6% average of the S&P 500. For non-US knives, the average was 10.8% per year, while their MSCI country index advanced at an average annual rate of only 5.3%.

The report however did note that for both US and non-US falling knives, stock selection could be critical to successful falling knife investments. This reinforces our belief that when choosing a contrarian fund manager, you need to ensure they have the right processes and approach in place to identify the most promising stocks.



¹ Falling Knives around the world, August 2004. Prepared by the Brandes Institute, a division of Brandes Investment Partners®.

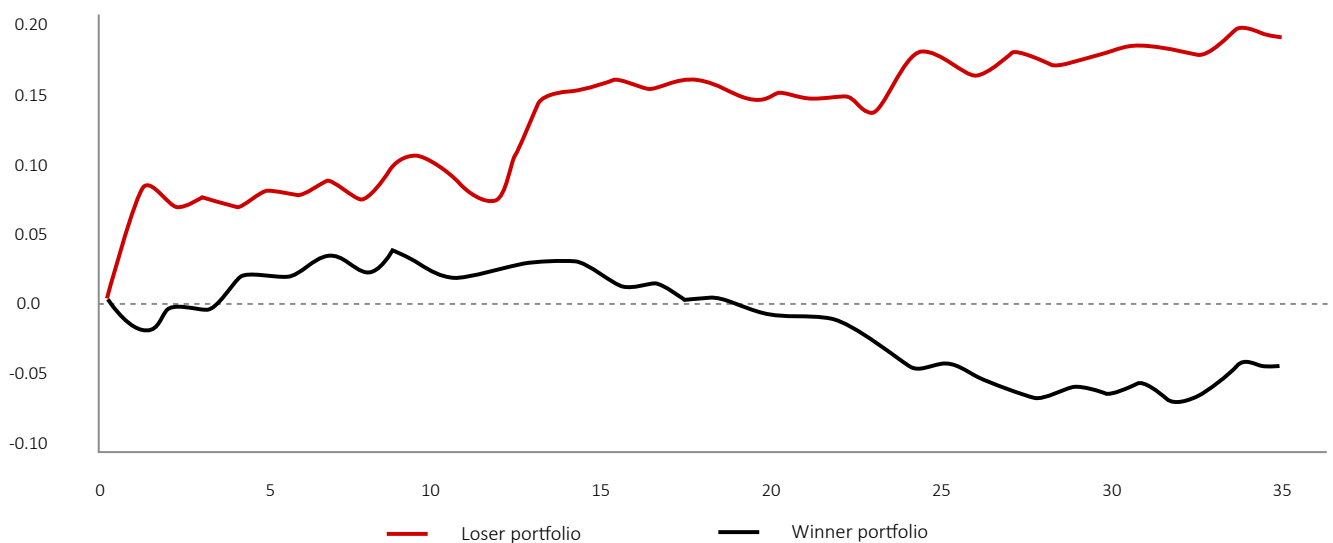


A proven overreaction hypothesis

A famous paper written by Werner FM De Bondt and Richard Thaler in 1984 titled 'Does the stock market overreact?' also comes to the same conclusion.

This compared the subsequent performance of 'loser portfolios' versus 'winner portfolios', with loser (or winner) portfolios consisting of the worst (or best) performing stocks for the prior period. The results showed that over the previous half century, a loser portfolio of 35 stocks outperformed the market on average by a cumulative 19.6% three years after portfolio formation. Winner portfolios on the other hand earned about 5% less than the market.

Cumulative average residuals for winner and loser portfolios of 35 stocks (1-36 months into the test period)



Source: The Journal of Finance²

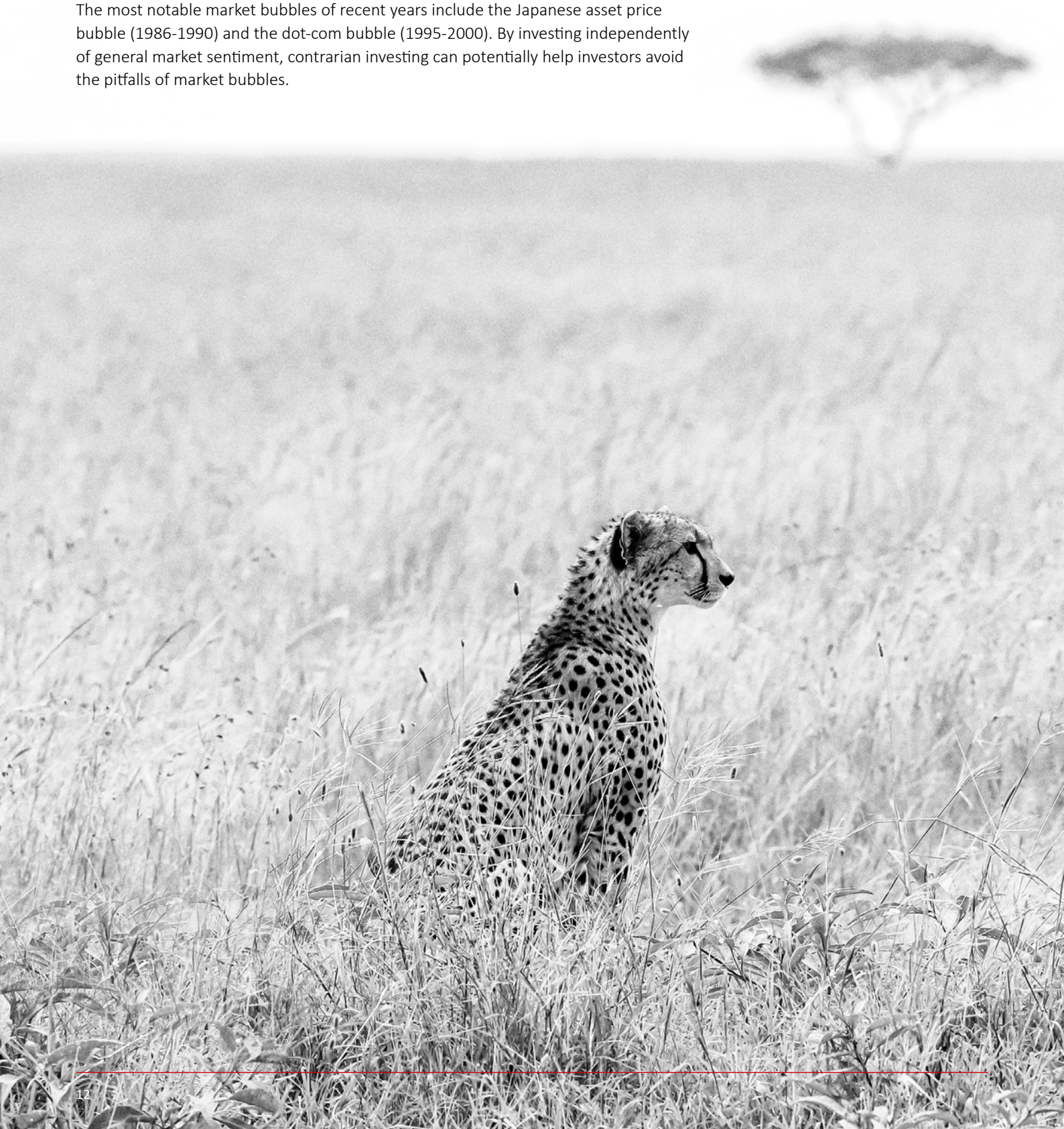
2. Does the Stock Market Overreact? Werner FM De Bondt, Richard Thaler. The Journal of Finance, Vol.40, No3, Papers and Proceedings of the Forty-Third Annual Meeting American Finance Association, Dallas, Texas, December 28-30, 1984 (Jul, 1985), 793-805.

2. Tempering the impact of market bubbles

A stock market bubble is a self-perpetuating rapid rise in the share prices of a group of stocks.

At different times, investor sentiment can drive investment prices far above their rational economic value. Once it becomes apparent that prices have risen far beyond the value of the asset, the bubble bursts and the race is on to sell investments.

The most notable market bubbles of recent years include the Japanese asset price bubble (1986-1990) and the dot-com bubble (1995-2000). By investing independently of general market sentiment, contrarian investing can potentially help investors avoid the pitfalls of market bubbles.



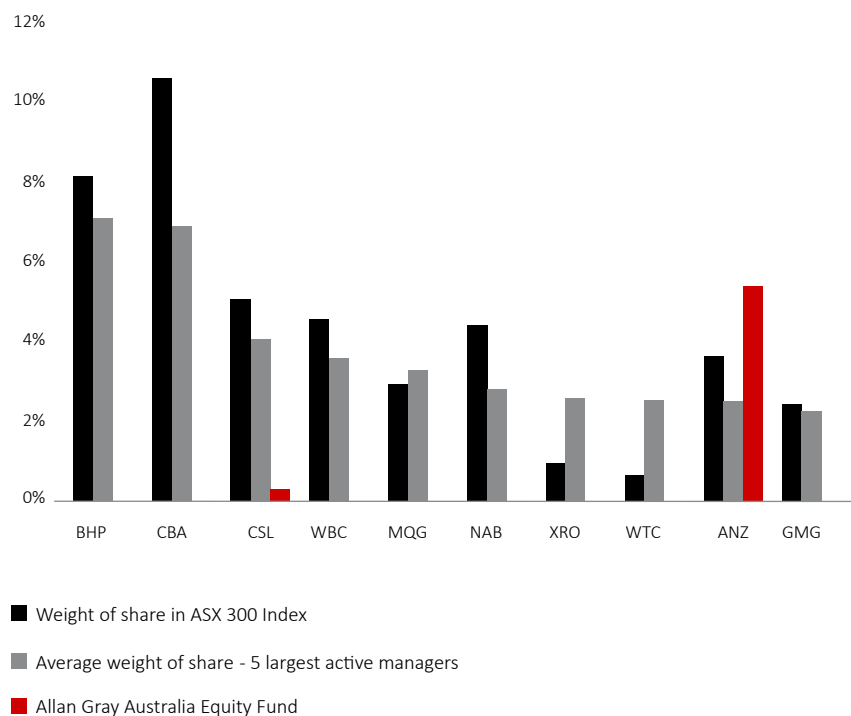
3. Diversification

A genuine contrarian managed fund can provide an attractive alternative to traditional Australian equity funds. The vast difference in approach – and investments – can provide real diversification for investors.

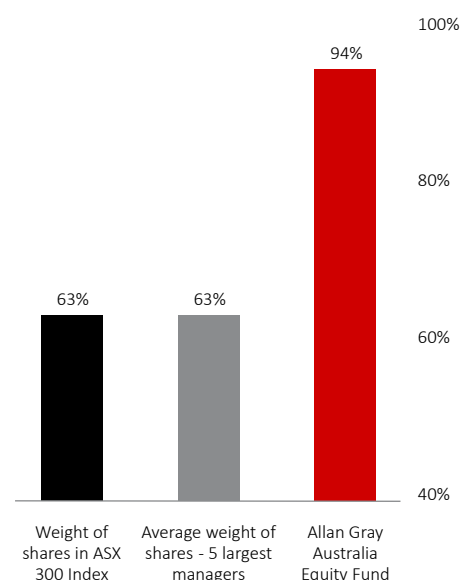
A contrarian fund often holds unpopular stocks that have been written off by the market. This can offer exposure to stocks that the average investor may not hold, providing greater portfolio diversification.

To demonstrate this point, the following chart shows the average top ten holdings of the five largest Australian equity managers that describe themselves as active managers (as opposed to passive, index-tracking managers). It compares these holdings with those in the S&P/ASX 300 Index as well as our Australian Equity portfolio. As you can see, the five largest Australian equity managers' portfolios look similar to the index, whereas our portfolio looks very different.

Average top ten holdings
of the five largest managers



Exposure to stocks outside
top ten holdings



4. Opportunities from behavioural errors

If being a contrarian investor yields so many positive outcomes, why isn't everyone doing it?

The answer is because it's hard.

Behavioural studies show how psychological and emotional factors impact economic decisions, and that by nature, people tend to conform. By understanding how human behaviour can be an investor's worst enemy, the contrarian investor has processes in place to ensure these natural biases do not impede investment decisions. Here we highlight some of the most common investment behaviours that can affect returns and explore how the contrarian investor looks past this.

Human bias creates opportunities for the contrarian investor.



Herding instinct

While popular opinion might be useful when choosing something like a restaurant, it's certainly not good to follow the herd when investing. This is because when stocks become popular with investors, competition to buy increases and stocks can become overbought. This pushes the price higher, leaving you paying more, which detracts from the future return of that investment.

At Allan Gray, we never rely on external research. In fact, we often view what the market is doing as a contrarian indicator (for example, if a sector is running hot and consensus is that it will continue to do well, we are more likely to avoid investing there).



Overconfidence

Research shows that most investors tend to overestimate their abilities. Therefore, being realistic and looking at decisions critically is essential for long-term investing, and that applies to contrarian investing.



Loss aversion

Loss aversion refers to people's tendency to prefer avoiding losses to achieving gains. This means that many investors are more likely to avoid shares that are suffering losses in the short term, even if they have the potential to outperform over the long term.

As contrarian investors, we understand that stock markets are forward looking, meaning future expectations are already priced in. When a stock that is priced for perfection delivers results that are only 'good', the price could fall. But when a stock is priced for disaster and the outcome is only 'quite bad', the price can rise considerably. This is when we as contrarian investors try to benefit from the irrational behaviour of other investors.



Recency bias

This cognitive bias gives undue weight to more recent events when making decisions. This can lead to the assumption that recent trends or market movements will continue, rather than considering the long-term data or potential for reversion to mean. For example, if a stock has recently surged, an investor influenced by recency bias might assume it will continue to perform well, despite factors that could indicate otherwise.

At Allan Gray, we rely on our fundamental research to avoid falling into the recency bias trap.



Anchoring

When investors rely too heavily on preexisting information as a basis for determining value. This information is then used as the reference point for subsequent decisions. For example, if we use the current value of a security as the base for assessing its future value, rather than using fundamental analysis to value the security, this can lead to suboptimal decisions. The better your knowledge of a security, the less likely you are to succumb to anchoring bias.



Overreaction

Some investors overreaction to new information can lead to securities fluctuating in value and becoming overbought or oversold. Whilst contrarian investors prioritise analysing the fundamental value of an asset, we also rely on our experience which has cultivated patience and prioritised long-term views in our investment decision making.

We recognise that we don't get it right all the time, and that there are inherent risks involved in investing. But if we get it right more often than not, we should outperform the market and perform well for our clients over the long term.

Our Australian equity strategy has outperformed the market over the long term, but it requires restraint and patience, and past performance may not be repeated. It can mean periods of short-term underperformance while we wait for the market to recognise the value we've identified in undervalued shares. For this reason, Allan Gray's contrarian investment approach isn't right for everyone.

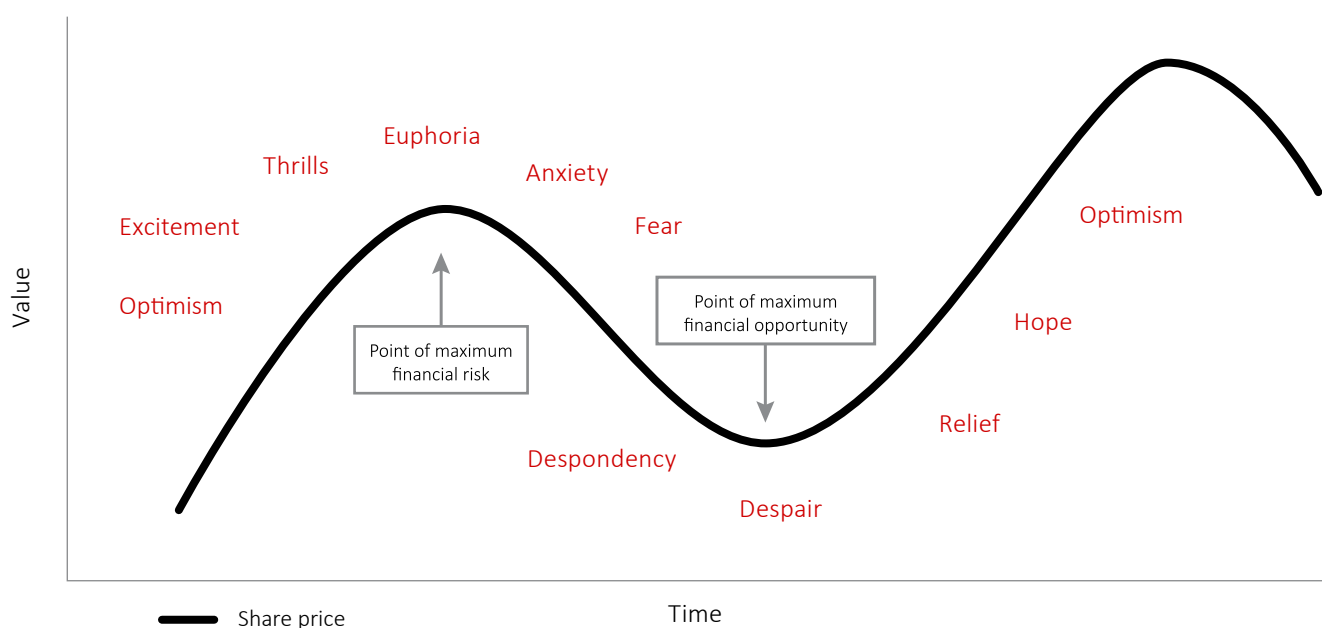
How emotional investing can create opportunities

It's true that emotions can be a threat to investing. As stocks rise, optimism builds into excitement, and even euphoria. Then a wobble happens, the excitement goes away and euphoria gives way to anxiety at first, then fear, and then when the stock really falls, there's a great deal of despair. Then the roller coaster starts again and you feel relief, hope and optimism all over again.

Riding the highs and lows differently

As the following chart suggests, we believe the point of maximum financial risk is actually that feeling of euphoria. That's when the stock is priced for perfection, but it may well be the time to be worried about holding it, as even a small piece of bad news could cause the stock to fall. Conversely, the point of maximum financial opportunity – when the stock is priced to potentially rise the most – is exactly when you may feel most despairing of the stock.

These are the points we are continually looking for when buying stocks – the points of negative sentiment and maximum financial opportunity. Psychologically it is very difficult to invest when market sentiment towards a stock is so negative.



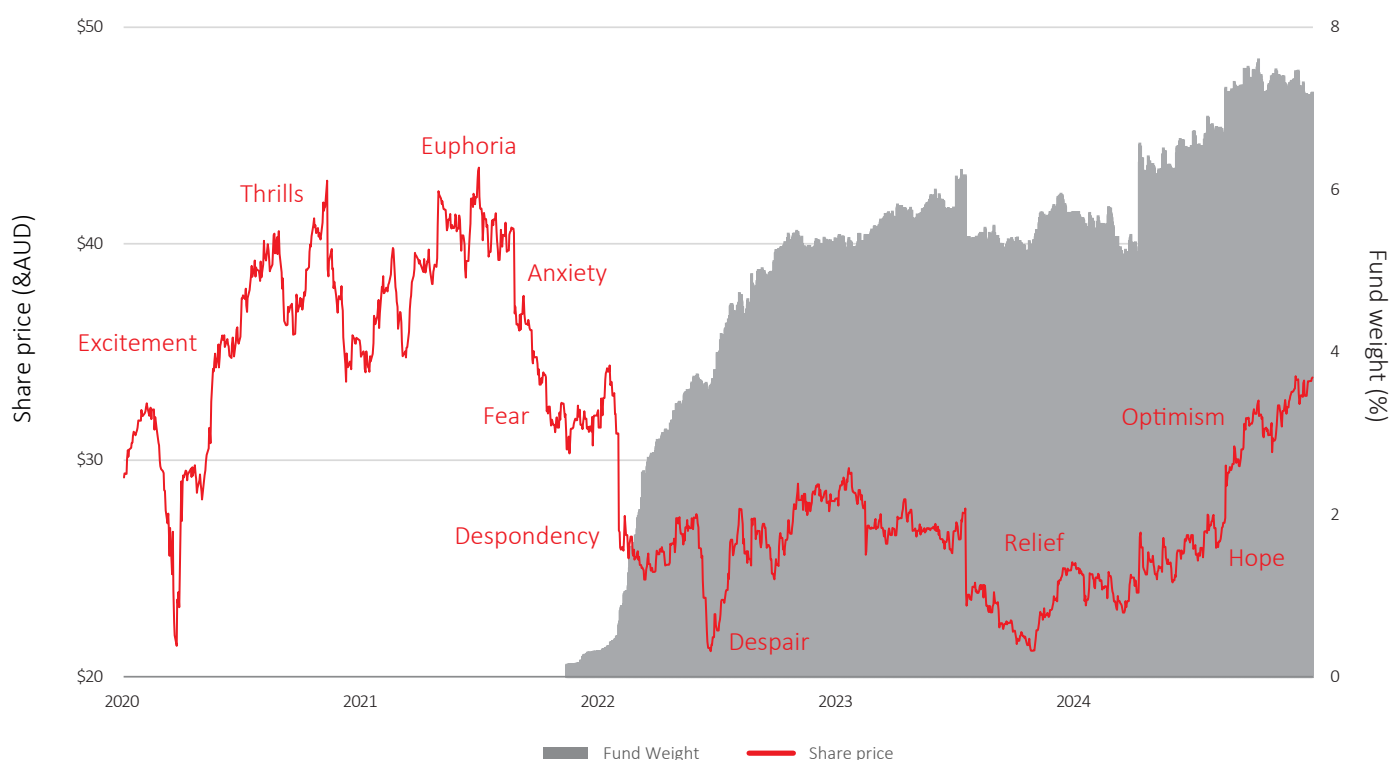
For a long-term sustainable advantage, the contrarian approach makes sense.



The ups and downs of Ansell shares

To demonstrate this cycle, we have overlaid our chart with the performance returns of Ansell. Ansell produces gloves and other protective equipment. The red line shows the share price and the grey shaded area shows how Ansell's weight in the Fund changed over time. The emotions an investor may naturally feel are overlaid.

At the point of euphoria, Ansell was a 'COVID-19 beneficiary' with orders for gloves far exceeding the industry's capacity to supply, resulting in prices surging. Then sentiment shifted to anxiety, fear and eventually despair in the aftermath of the pandemic. Their clients had bought too much supply during the pandemic and Ansell faced into a significant destocking headwind in the years that followed. As contrarian investors, we started seeing value when others saw despair. As the price fell during 2021 and 2022, we increased our position and built a relatively large position in the stock. Then as the outlook improved and the destocking headwind eventually began to dissipate, hope and optimism returned and the price began to rise.





Sometimes it gets worse before it gets better.

Of course when you're a contrarian investor, things don't always work out quite the way you expect.

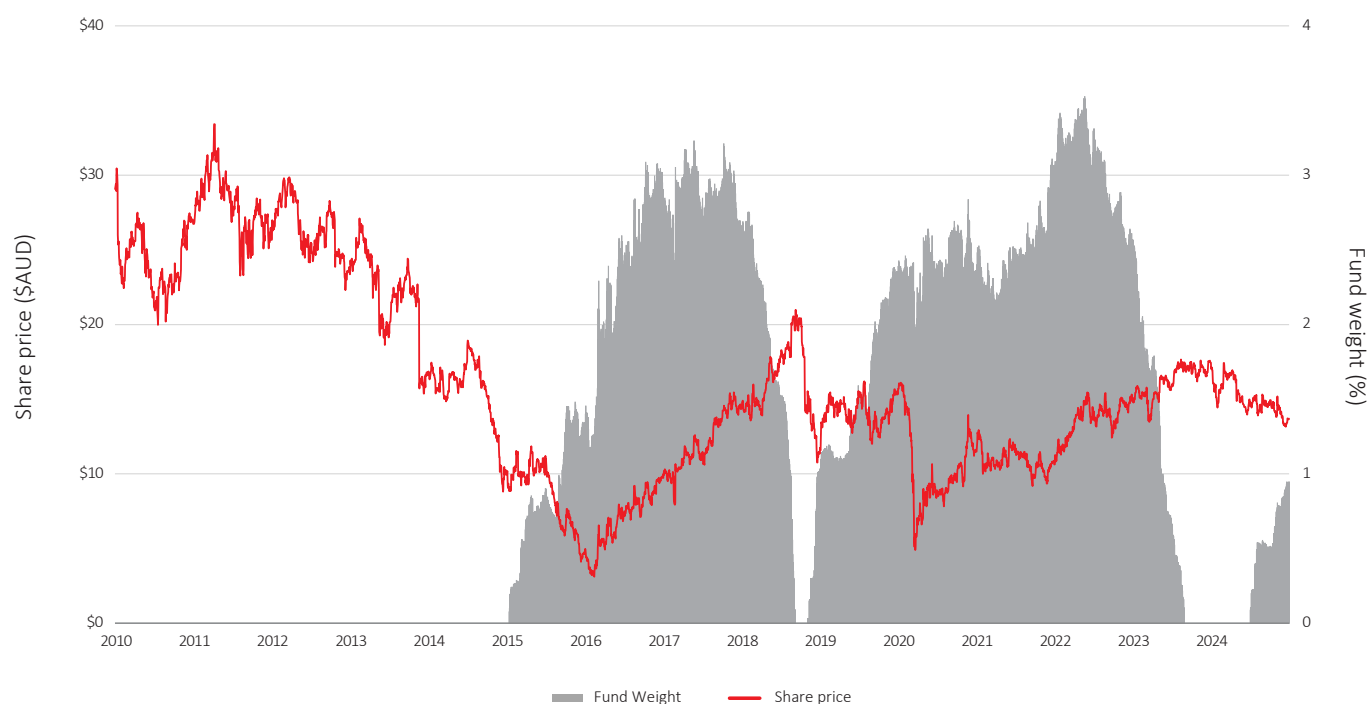
The Worley Parsons experience

Worley Parsons is an example of a company we bought into too early. In 2011 the share price peaked at over \$31. We didn't own the stock then; it was riding high as a result of the commodities boom. Then, over the next few years, the commodities boom gave way and the price continued to decline all the way through 2014. We made our first investment in the company in early 2015.

We thought we were getting a great deal, only to find that for a period of about six or seven months the price fell almost daily. This can cause you to test your thesis again and again. But we did, and added to our position throughout that entire period. It took 13 months, however, from our initial purchase through to the share price trough. Psychologically this can be very hard. You need to fully trust your process and have the discipline to stay true to your convictions.

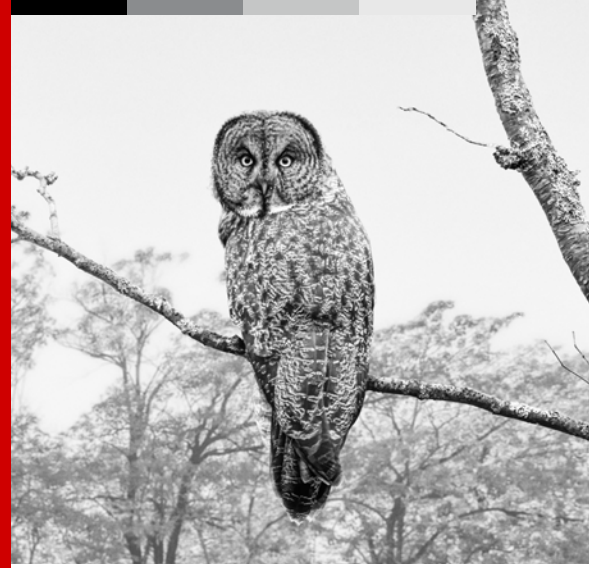
In time, the stock recovered and rewarded our patience. But that is why this investment approach can test our discipline and that of our investors. Sometimes we do find it challenging, but over the long term, we believe contrarian investing adds value.

Some stocks can take much longer to come to fruition. We may invest too early and the stock continues to fall. Sometimes things get a lot worse before they get better and we need to reassess.



Source: Allan Gray Australia and Datastream.

Contrarian investing over the years



While not well-known in Australia, contrarian investing actually has a long history and some notable advocates.

Contrarian investing on the battlefield

The contrarian approach to investing is perhaps as old as investing itself. In 1815, the British economist David Ricardo made a fortune buying British government bonds at deeply depressed prices, just before the Battle of Waterloo. What led Ricardo to recognise this as a great investment opportunity?

As Harvard economist Richard Zeckhauser put it:

‘He was not a military analyst, and even if he were, he had no basis to compute the odds of Napoleon’s defeat or victory, or hard-to-identify ambiguous outcomes. Still, he knew that competition was thin, that the seller was eager, and that his windfall pounds should Napoleon lose would be worth much more than the pounds he’d lose should Napoleon win. Ricardo knew a good bet when he saw it’.

Selling to optimists and buying from pessimists

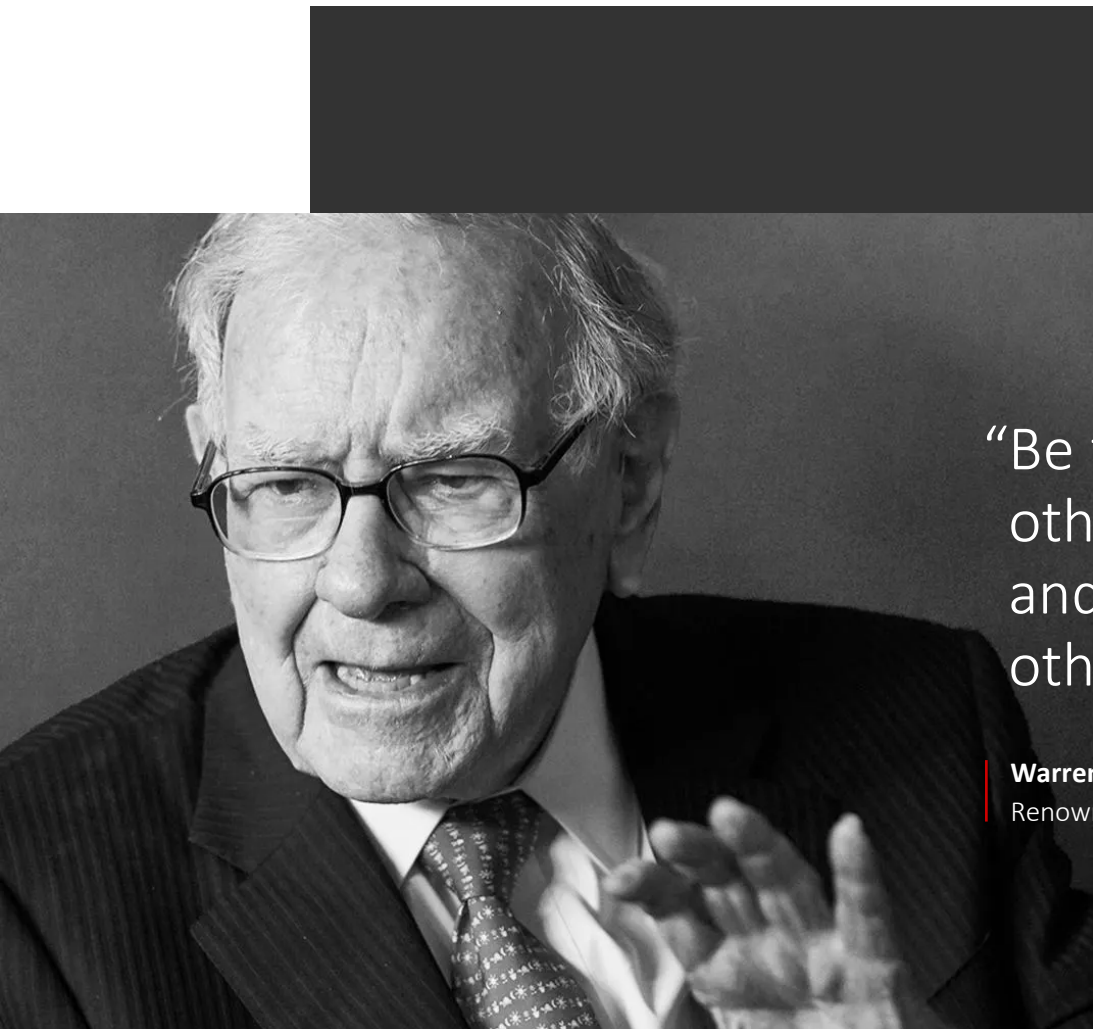
Benjamin Graham was Warren Buffett’s one-time mentor, employer and business partner. Contrarian investment principles were a core component of his long-term success and he wrote extensively about the importance of human behaviour in investing. He famously highlighted that the investment community tends to easily abandon all sense of discipline once it gets a popular idea, and has been extensively quoted as referring to an intelligent investor as ‘a realist who sells to optimists and buys from pessimists’.

He noted that in overpaying for a popular idea, the risk of permanent loss of capital is far higher than investors think. Graham popularised the notion of ‘margin of safety’ – investing at a discount to fair value – to reduce risk and improve return. His investment principles remain just as relevant today as ever.

Warren Buffet – a renowned contrarian investor

“Be fearful when others are greedy, and greedy when others are fearful” is one of Warren Buffett’s most famous quotes and sums up his contrarian approach to investing.

He is widely considered to be one of the most successful investors in the world and is a renowned American business magnate and philanthropist. One of his famous contrarian moves was during the 2008 financial crisis, when the markets were in crisis. Despite investor sentiment being at record lows, he kept counselling Americans to buy. Fast forward to now and his contrarian advice has yielded rewards.



“Be fearful when others are greedy, and greedy when others are fearful.”

Warren Buffett

Renowned contrarian investor



Contrarian investing myths and reality

There are two common myths about contrarian investing that need to be dispelled.

MYTH 1: Contrarian investing is simply value investing

People often think contrarian investors are simply value investors. 'Value' stocks are often considered to be those with a low price to earnings (P/E) ratio, which measures a company's current share price in relation to its earnings per share. It helps investors compare the relative value of different companies. A high P/E ratio could mean a stock is overvalued, or that investors are expecting higher growth rates in the future. Conversely, a low P/E ratio could mean the company is undervalued.

But a contrarian investor doesn't always invest in companies with a low P/E ratio. In fact, we will sometimes invest in companies that appear to have a high P/E ratio, based on current earnings.

If we are value-conscious investors, why would we do this?

The reason is that the company's earnings may have collapsed in the short term. However, long-term, normalised earnings may be much higher than current depressed earnings. Therefore the normalised P/E ratio may actually be much lower. This highlights that simple point-in-time metrics are too often used in place of a detailed study of a company's true earning capacity through the cycle.

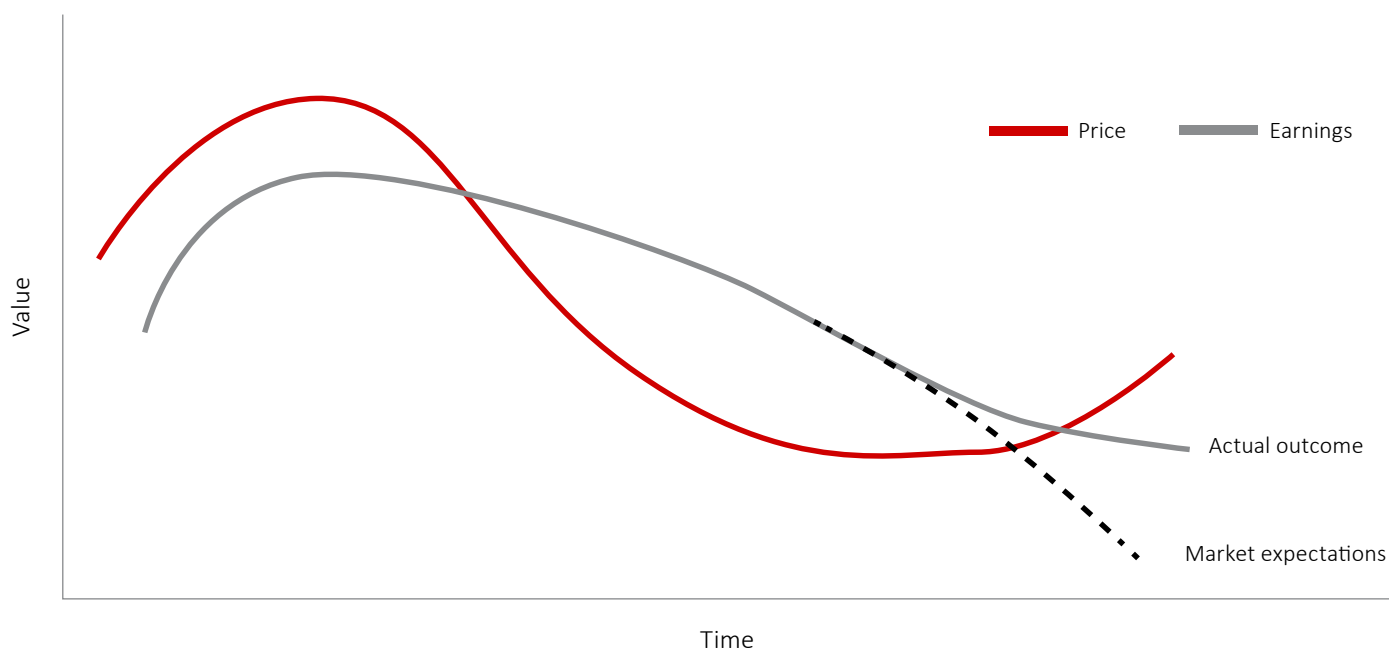
MYTH 2: Contrarian investors need a catalyst

Another myth is that contrarian investors are waiting for a catalyst to trigger an earnings turnaround and a rise in the share price, but this is rarely the case. Much like economic (or even weather!) forecasting, catalysts are exceptionally difficult to predict.

The chart below shows why an earnings turnaround isn't always necessary, rather the outcome only needs to be better (or less bad) than the market predicts.

Here, the market's expectation is for much lower earnings in future, as shown by the black dotted line, which is a terrible outcome for the company. As markets are forward-

looking, the share price has already reacted to the market's expectations and dipped, as shown by the red line. The actual outcome is worse than today, but not as bad as the market expected. Earnings are only 'bad' rather than 'terrible', so the stock beats the market's expectations and the share price rises. As investors in that stock, we don't need a catalyst to trigger an earnings turnaround, the stock just needs to beat market expectations and we can do well.





A different approach
requires a different
type of manager

Every investment management firm claims it is different from its competitors. Many focus on things like a superior investment team and an innovative investment strategy. Despite this, many firms produce results that are anything but different.

At Allan Gray, we strongly believe that to enjoy a sustainable advantage, an investment manager must be very different from the crowd. This is something that we are very comfortable with, and why our investment approach includes a strategy and behaviour that is not easy to replicate.

When choosing a contrarian investment strategy, we believe there are four key characteristics that play an important role in investment outcomes:



Alignment of interests

Alignment of interest between fund managers and clients is important in ensuring that decision-making focuses on investment outcomes, rather than being driven by the self-interest of intermediaries. There has been plenty of discussion around fund manager career risk and job security limiting investment managers' approaches. Employee ownership, co-investment and performance fees can all play powerful roles in aligning the interests of the fund manager with the interests of investors and help to safeguard against closet indexing as a managed fund gathers more assets under management.



Thinking like a long-term business owner

Thinking like a business owner is a simple concept, but one that is often lost to investors who are focused on short-term profit seeking and investor susceptibility to 'noise'. As a result, the practice of rigorous valuation and the risk of overpaying do not receive appropriate attention.



Avoiding overconfidence and accepting uncertainty

Commonly held beliefs and intuitive assumptions often lead to overconfidence and an underestimation of the level of uncertainty in investing. Such behaviour can be difficult to avoid as it 'feels right'. It also leads to opportunity for those investors able to embrace uncertainty.



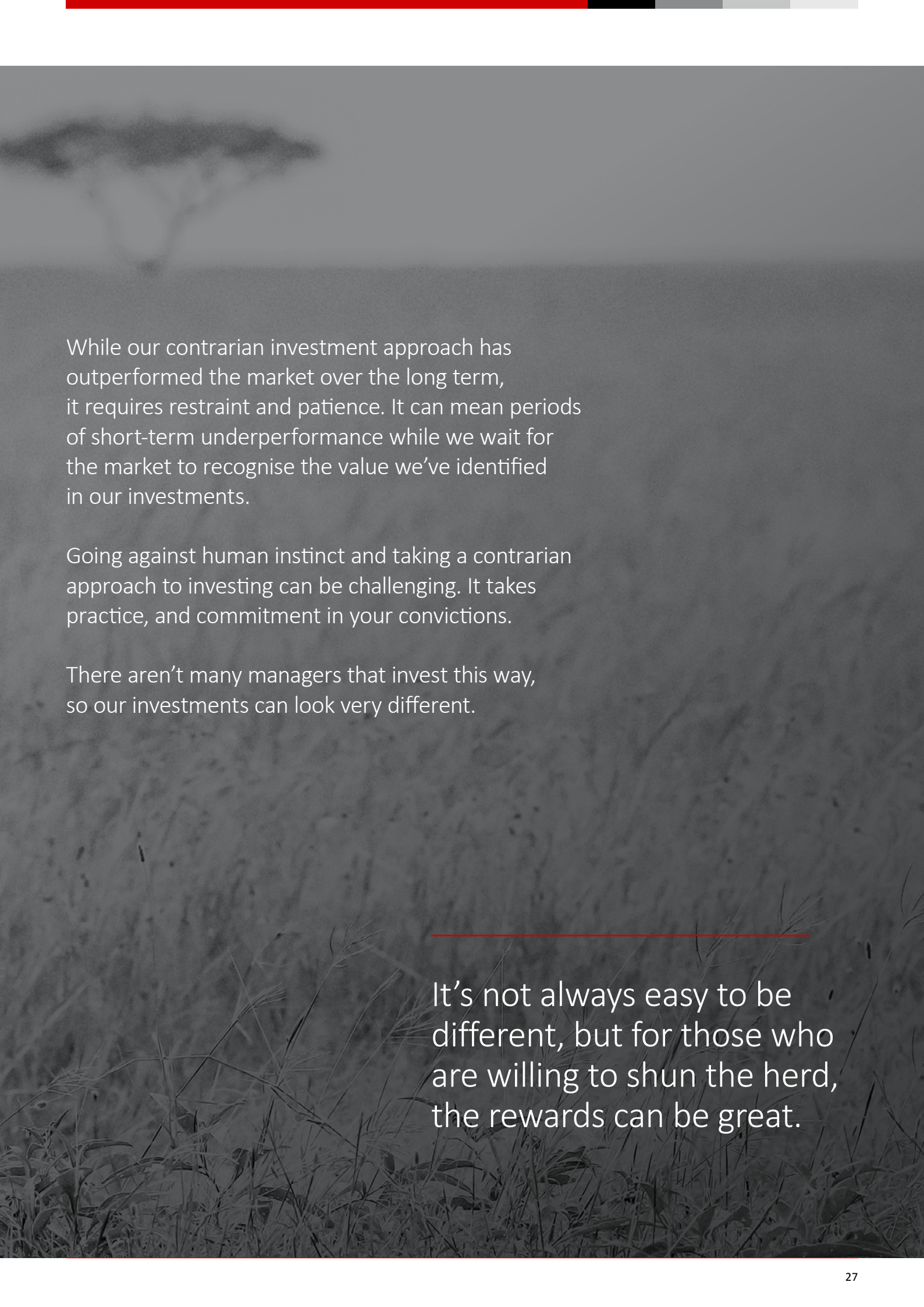
Opposing consensus

Doing the opposite of what everyone else is doing can be psychologically challenging and feel uncomfortable to many investors. The fact that prospective returns can be inversely proportional to the popularity of an investment can be counterintuitive to investor psychology. Ironically, it is doing what is unpopular and uncomfortable that makes contrarian investing such a rewarding and sustainable strategy.



More than an investment philosophy

At Allan Gray, being contrarian is more than just an investment philosophy. It is at the heart of everything we do.



While our contrarian investment approach has outperformed the market over the long term, it requires restraint and patience. It can mean periods of short-term underperformance while we wait for the market to recognise the value we've identified in our investments.

Going against human instinct and taking a contrarian approach to investing can be challenging. It takes practice, and commitment in your convictions.

There aren't many managers that invest this way, so our investments can look very different.

It's not always easy to be different, but for those who are willing to shun the herd, the rewards can be great.

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