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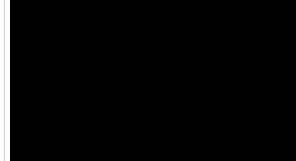
Contrarian investment managers see reward from market's riskiest sectors

By [Sam Mamudi](#), MarketWatch
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NEW YORK (MarketWatch) -- Warren Buffett famously said he tries to be fearful when others are greedy and greedy when others are fearful. For some money managers, that isn't just clever advice -- it's an entire investing strategy.

The idea of embracing out-of-favor stocks, sometimes called contrarian investing, isn't new. But the approach requires a strong stomach in the best markets, let alone during historic downturns.

Video: MarketWatch Hot Stocks: Financials Rally



Many bank stocks rallied on Friday, after results of the government stress tests on banks produced results that were not as bad as expected in some cases. (May 8)

And as investors rushed for the exits last year, these managers kept diving in, frequently engaging the most feared areas of the market.

"It's not uncommon for a new client to call me when I buy a stock, asking me what the hell I'm thinking," said Bernie McGinn, president and chief investment officer of McGinn Investment Management, Inc.

But clients soon get used to his unorthodox approach, McGinn said, often asking why he isn't making certain buys.

"The basic premise of investing is 'buy low and sell high,'" he said. "And low is when nobody else wants it."

But even the professionals don't always get it right. Legendary contrarian-minded managers such as David

Dreman and Marty Whitman had a tough 2008, with Dreman Contrarian Large Cap Value Fund ([DRLVX](#)) and Whitman's Third Avenue Value Fund ([TAVFX](#)) losing 45% and 46%, respectively.

And Bill Miller of Legg Mason Inc. ([LM](#)), another manager with a contrarian bent, saw his Legg Mason Value Trust ([LMVTX](#)) fall 55% in 2008.

As the market has bounced back in recent weeks, these and other contrarian-style funds, with their bargain-minded ways, have been outperforming. Dreman Contrarian Large Cap Value is up about 7% so far this year, while Third Avenue Value has gained around 13% and Miller's fund is up 8% -- well ahead of the Standard & Poor's 500's ([SPX](#)) 2% rise.

Contrarian investing is "a discipline that's hard for an individual investor to follow," said Russ Kinnel, director of mutual-fund research at investment researcher Morningstar Inc. "It's tough to know when to get in and when in fact a stock deserves to be battered."

Head in and hold on

The managers at Evergreen Capital Management take Buffett's advice almost literally. The firm studies the flow of money moving into and out of mutual funds as a starting point for its investment decisions, looking into areas of the markets where net outflows -- selling pressure -- is greatest.

"Most investors are 'wrong cycle investors,'" said David Hay, chief investment officer. They chase performance, focus on short-term results, show impatience and ignore market cycles.

But patience is the key. McGinn said his portfolio turnover rate is about 30% -- about one-third of its holdings are changed each year. The industry average for a U.S. stock fund is 100%, according to Morningstar.

"If you had a one- or two-year view, I don't see how you'd buy anything right now because earnings outlooks are so low," added Ian Lapey, senior member of the investment team at Third Avenue Value.

Lapey said his fund holds a stock for about five years on average, and historically has had a turnover rate of 10%, though partly because of redemption requests last year that figure has climbed to about 20%.

Thyra Zerhusen, manager of Aston/Optimum Mid Cap Fund ([CHTTX](#)), also takes the long view. She owns stocks for about five to seven years, and typically holds about 40 companies.

While she wouldn't call herself a contrarian investor, Zerhusen said that she likes to buy what others are selling.

Evergreen Capital's portfolios -- which use index-linked exchange-traded funds -- also have a turnover of about 30%, Hay noted. The firm's approach marries money flows with valuation. A security with outflows and low valuation is a "buy," while extreme inflows and high valuations flash a "sell" signal.

Picking favorites

Investors ought to have at least one contrarian-style fund in their portfolio, Morningstar's Kinnel said. "It can lead you to profitable investments," he added.

His favorites include Third Avenue Value and FPA Capital Fund ([FPPTX](#)), which is up 18% this year after falling 35% in 2008.

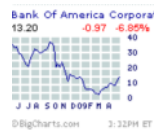
FPA Capital's manager Bob Rodriguez, however, plans a "one-year sabbatical" from the fund beginning in January. Kinnel also suggested FPA Crescent Fund ([FPACX](#)) as a similar fund but one whose manager, Steven Romick, has no plans to leave. FPA Crescent lost 21% in 2008 and is up 7% so far this year.

Some of the stocks picked by the managers live up to a contrarian billing: Bank of America Corp. ([BAC](#)), New York Times Co. ([NYT](#)) and Ford Motor Co. ([F](#)).

McGinn said he likes Bank of America in part because the shares are being valued "in crisis mode" and not according to true worth.

"They have the biggest wealth manager and the biggest originator of mortgages," McGinn said. He added that once he'd decided the bank wouldn't be nationalized, its share price looked cheap.

McGinn also holds Ford, and has for several years. He bought into the company in 2006 when CEO Alan Mulally was hired.



"It was a very speculative position," said McGinn. "But Mulally had a positive influence at Boeing Co. (BA) [where he was senior vice president] after the 9/11 attacks."

McGinn said he thought the fact that William Ford was willing to cede control of Ford to Mulally suggested that the company was being proactive.

Lapey said the biggest holding in Third Avenue Value is a real estate company from Asia -- two areas that took a beating last year as investors saw values fall across the broader sectors.

Lapey said Henderson Land Development Co. Ltd. (HLDVF) , which is 12.5% of the portfolio, has an extremely strong balance sheet, enjoyed a profit last year and saw income from rents increase at double-digit rates.

But, after falling more than 50% in 2008, and even after a 40% rebound this year, shares of the Hong Kong-based property giant still trade at a 30% discount from its reported net asset value, Lapey said.

Zerhusen owns New York Times because, she said, "it is one of the most respected English-language newspapers in the world."

The Times represents good value in the long term, said Zerhusen, because it can gain market share from other, struggling newspapers, and because it has a high-quality and growing core subscriber base. Core subscribers, which she defined as those with subscriptions of two years or longer, have grown to 800,000 from 600,000 in the past few years.

Zerhusen also added to a stake in FMC Technologies Inc. (FTI) as the stock, which provides technology to the energy industry, was falling with the rest of the energy sector.

"A stock price can get so low it gets silly," said Zerhusen, adding that investors often fail to recognize the advantage of a company with "a good product that other companies can't do without."

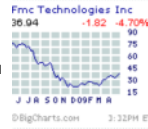
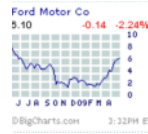
Keep in mind, however, that contrarian investing is no guarantee of success -- as last year's results for some funds prove.

"Each manager is different, but these guys can get it wrong, too," Morningstar's Kinnel said.

Not just wrong, but spectacularly wrong. "They buy stocks thinking things can't get worse," Kinnel said, "but last year was such a bad year that areas such as financials, and other cyclical names, kept getting worse."

McGinn, the independent money manager, would agree. "Being a large-cap contrarian manager in a bear market is like trying to catch a falling knife," he said. "Some things that are going down can keep going down." ■

Sam Mamudi is a reporter for MarketWatch in New York



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