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INVESTMENT MANAGEMENT

# Market Perspectives

## THE POWER OF CONTRARIAN THINKING

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By Bruce Simon, CFA, CPWA®
Chief Investment Officer, City National Rochdale

As the U.S. stock market was experiencing its worst ever start to the year, the drumbeat from the financial press was decidedly negative. Stock market seers warned of an impending U.S. recession, an economic collapse in China, and a rupture resulting from $20 oil in the thin fabric of geopolitical calm. Polls of investor sentiment registered a level of pessimism last experienced in August 2011 when the U.S. government was threatening to default on its debt, and some respected investors even warned of a 2008-style stock market meltdown.

Fast forward to today. The S&P 500 has rallied 15% from the lows set in mid-February, and is now modestly positive on the year. The broadest global equity index (MSCI All Country World Index), after falling nearly 20% to start the year, is now back in the black (USD). Investor sentiment indicators have moved into the extreme optimism zone.

Were things that bad, and have they gotten so much better since then to explain these wild swings in asset prices? Of course not. While economic conditions have definitely improved since the gloomy days of January, many of the issues that worried investors then are still present today, including weak U.S. economic growth, declining corporate profits, and shaky international economies. The radical swings in stock prices can best be explained by the human tendency to extrapolate recent trends into the future, and to be swayed by the chorus of consensus views.

These tendencies are what create the best opportunities for investors who are willing to go against the herd, take the long view, and exploit the power of contrarian thinking.

Even during the market's early-year swoon, the traditional economic signs preceding a recession were absent. Job growth in the U.S. was still expanding, consumer spending was solid, and interest rates remained at very low levels. While nothing is ever certain when predicting the future, the data seemed to indicate a relatively low probability of a U.S. recession.

Of course, hindsight is 20/20. There was certainly a plausible case for a much more serious market decline, even if the data did not reflect it. However, many investors sell stocks only *because* the market is falling without regard to the reasons *why* it is falling. At the same time, investors clamor to buy when the market is rising, simply for the reason that it is going up. What other purchase decision motivates people to buy more after the price has already gone up, or sell after the price has been cut?

It sounds simple, but being a contrarian is very hard. It requires one to ignore the majority viewpoint and take a stand, which is often in direct opposition to the crowd. Many times the consensus is right and the contrarian looks foolish for ignoring the obvious. But over the long run, we believe that questioning the behavior of the crowd and overcoming the natural tendency to sell low and buy high will separate the investment winners from the losers.

### Index Definitions

The Standard and Poor's 500 Index (S&P 500) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The MSCI All Country World Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The index is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.