Dreman, David – Contrarian Investment Strategies: The Next Generation

Simon & Shuster, 1998, [Equity Investing] Grade ★★★★

During the summer InvestingByTheBooks will review some older books that we never got around to writing about although we think they are important. Canadian born value investor David Dreman founded New Jersey based Dreman Value Management in 1977 after having served as a senior editor of Value Line Investment Service. Apart from being his firm's president and chairman until 1997 Dreman has written several books on investing. A number of these books, including this one, are continuations, updates and expansions of the author's *Contrarian Investment Strategy* from 1980. Dreman is often considered the dean of contrarian investing

The book contains three main themes: investment psychology, criticism against the efficient market hypothesis (EMH) and value based investment advice. Since the core of being contrarian is that investors overreact, this is to a large extent a book on behavioural finance seen from a practitioner's perspective. Plenty of materials from the likes of later day luminaries such as Daniel Kahneman and Amos Twersky, Richard Thaler, Vernon Smith and Robert Shiller are presented. In this Dreman, who published his first book on investment psychology in 1977, was truly before his time and he not only discusses individual biases among investors but also group dynamics, social validation and herding leading to wider market miss-pricings.

A number of common investment strategies and practices on the financial markets are presented and discarded in a factual but entertaining way. Dreman presents academic evidence that technical analysis doesn't work but has no hope of convincing anyone of its followers. As the price patterns are so complex that chartists often disagree on their meaning there is always lingering hope. Growth investing is dismissed as human ability to forecast long-term growth is close to non-existent. In this Dreman's discussion on the outside view and inside view is reminiscent of Michael Maboussin's 2012 bestseller *The Success Equation*. Further central bankers and analysts are shown to deal with too complex areas for them to be forecasted with any accuracy. Anyone's ability for market timing is thoroughly trashed. Even the absolute rigidity of Benjamin Graham's screening methods receives some criticism.

Compared to what consensus forecasts something unexpected always pops up. The interesting thing is that these surprises affect different types of stocks differently. Positive surprises only lead to minor outperformance for high PE-stocks while low PE-stocks soar. Negative surprises leave low PE-stocks almost unaffected while high PE-stocks get thrashed. Dreman shows that low multiples over time leads to higher returns and that this is not the consequence of higher risks.

The investment strategy that the book presents is the same as Dreman Value Management display on their web site: *"We invest in undervalued companies that exhibit strong fundamentals, above-market dividend yields and historic earnings growth, which our analysis indicates will persist.*" Specifically, investing among the lowest quintile PE-stocks is advocated. Dreman advises to sell stocks when their PE-ratios rise to the average market level or when corporate fundamentals show long term degradation. All strategies are in a great way backed up with academic evidence that they actually do work.

The critique against EMH is justified but perhaps less necessary today than two decades ago. Instead it is the early and deep insights in practical behavioural finance combined with how to use this in real life value investing that deserve the most credit in the text. Paradoxically, the multitude of theoretical information in this 400-page book also obscures Dreman's personal investment experiences as one of the most successful investors of the 1980s and 1990s. The text becomes a bit impersonal.

This book is jam packed with insights and it was far ahead of its time. Most investors still haven't caught up – make sure you have.

Mats Larsson, July 28, 2015