

Written by Paul Merriman

Sometimes the way to get ahead is to do what other people don't do. Though that is easier said than done, it's a key to successful investing, as Paul Merriman describes in this article.

I spend a good amount of my time teaching investors not to behave like other investors, not to follow the crowd. You might call this being a contrarian.

There are two primary reasons for this. First, so many investors make so many fundamental mistakes that contrarian behavior can't be entirely bad. Second and perhaps more important, the nature of investing itself calls for doing what others don't do.

I don't recommend investing in individual stocks, but stock-picking makes it easy to show what I mean. Imagine you have somehow discovered a promising company before most other investors. You invest when the price is low, and other investors gradually catch up with your wisdom. The price goes up. More investors catch on, driving the price up farther.

Since this is fantasy, imagine that soon this is the most popular stock on the planet, attracting billions of dollars every day from new investors. What should you do? If you follow the crowd, you take out a third mortgage on the house, borrow on your credit cards and hit up your parents and friends for money to buy more of it, even though the price might be 500 times as high as when you discovered it.

It doesn't take a rocket scientist to figure out that this price appreciation can't last forever. So is it really smart to keep pouring money into it? If you're a contrarian, you sell.

Your friends might be aghast that you would pass up this fabulous opportunity, and indeed you might miss out on some further appreciation. But the only way to make money on this stock at this point is to do the opposite of most others: sell. It's the nature of the beast.

Some years back, one of my colleagues was taking a tour of the Western Washington State Fair with the fair manager. The fairgrounds were packed with people trying to get from place to place.

As my colleague followed, the fair manager purposely walked straight through the middle of the crowd, in the opposite direction of traffic flow. You shouldn't ever try this on the highway, but this technique got the manager where he was going more quickly than if he had followed along behind.

It felt uncomfortable, but nobody got hurt, and it worked. That's being a smart contrarian.

The wrong way to be a contrarian

Some people think being a contrarian investor means buying-out-of-favor stocks like Warren Buffet. However, I have a contrarian view about this famous contrarian. His methods appear easy, especially in hindsight. But in fact, successfully picking individual great companies that are temporarily out of favor is extremely hard to do. Investing in them is highly risky.

Here are four reasons I don't think investors should try to follow Warren Buffet's example.

First, while Buffet is an expert analyst, most investors are not. When the average individual investor buys an out-of-favor company, he or she is often just guessing at a company's future prospects. Warren Buffet not only reads but also understands the financial statements of the firms he considers investing in. He also has the requisite time and training to closely monitor their progress. Most investors have neither.

Second, Buffet has the patience to hold the stocks he buys for five or 10 years, sometimes longer. Even then, a company may not accomplish the results Buffet anticipates.

Third, investing in out-of-favor companies requires a great deal of emotional fortitude. While owners of popular stocks hear good news in the media, owners of out-of-favor stocks may either receive bad news or no news at all. Good news is scarce about these companies.

Finally, taking on the huge risk associated with owning any individual stock could either make you rich or poor. Even a portfolio of 10 or 20 companies carries high risk, no matter how carefully those companies have been chosen.

The right way to be a contrarian

If you want to be a successful contrarian, you have to think for yourself and do what feels wrong. You have to do what the majority tells you is wrong. This is where we will start.

Going against the crowd is not easy. Most investors think following the crowd is safer. Our survival instincts tell us to protect ourselves with the "safety in numbers" and that bad things can happen when the "weak get separated from the herd."

These survival instincts may work well for animals. But they aren't useful for investors.

The checklist

I have made a checklist of common actions that I believe are wrong. Too many investors base their behavior on sales pitches, on comfort and on what they perceive as the conventional wisdom.

You will probably recognize yourself at least somewhere in this list, but don't be alarmed. It's never too late to make a change for the better.

1. If you want to follow the crowd, invest most of your equity holdings in large, well-known companies.

The largest and most widely held funds own mostly large companies. Investors generally believe that large companies are more profitable and safer long term investments than small companies. Yet, over the long run, the returns of small companies have been higher than those of large companies. From 1926 to 2004, micro-cap stocks returned 13.1 percent versus 10.4 percent for large-cap stocks.

If you want to be a contrarian: Diversify your holdings to include small cap funds. This can increase your return with a minimal increase in risk.

2. If you want to follow the crowd, invest heavily in growth stocks.

The majority of investors believe in the promise of glamorous growth stocks that are popular in the press and among other investors. Yet over the long run, stocks that are out of favor – known as value stocks – have had significantly higher returns than growth stocks. From 1927 through 2005, small-cap value stocks returned 14.4 percent vs. only 9.3 percent for small-cap growth stocks. In the same period, large-cap value stocks returned 11.4 percent vs. only 9.4 percent for large-cap growth stocks.

If you want to be a contrarian: Diversify your holdings to include value funds. This can increase your return and reduce your risk at the same time.

3. If you want to follow the crowd, hold relatively few stocks in your portfolio, either directly (which we don't recommend) or indirectly through mutual funds.

Many investors believe that owning too many stocks will reduce their returns. But on the contrary, returns are much more likely to suffer from having too few stocks than from having too many.

Academics have shown that the expected rate of return for one stock in an asset class is no greater than the expected rate of return for 1,000 stocks in that asset class. But there is much more risk in owning only a few stocks. Diversification can virtually eliminate the risk of any one individual security having a large impact on a portfolio.

If you want to be a contrarian: Buy thousands of stocks at a time using mutual funds and ETFs and

get the return of an asset class at vastly reduced risk. When you compare funds, be sure to compare the number of stocks in their portfolios. More is better.

4. If you want to follow the crowd, don't worry about sales commissions and marketing costs when you choose funds.

Clearly, most investors think these costs are either insignificant or that they'll benefit from paying them. Right now, seven of the largest 10 U.S. equity funds are load funds.

To see how important a load can be, imagine you are a 25 year old investor making a \$4,000 Roth IRA investment in a fund with a front-end load of 5.75 percent, or \$230. Do you know the real cost of that \$230?

When it gets your money, the fund skims \$230 off the top and only invests \$3,770. If the fund's portfolio earned 10 percent over the next 40 years, the investment would grow to \$170,627.

If you bought a no-load fund instead, the entire \$4,000 would go into the fund's portfolio for your benefit. If that portfolio earned the same 10% over the next 40 years, the investment would grow to \$181,037.

That difference, all because of the one-time sales commission, would be \$10,410 – more than 2.5 times the entire original investment of \$4,000. That is the true cost of the \$230 sales commission.

If you want to be a contrarian: Refuse to buy load funds.

5. If you want to follow the crowd, buy mutual funds that have high operating expenses.

Many investors believe high expenses are needed to pay higher salaries that attract brighter managers. Investors believe these brighter managers can produce above-average performance.

Currently, about 80 percent of the dollars flowing into mutual funds go into actively managed funds; only about 20 cents of every dollar goes into low-cost index funds.

However, there is absolutely no evidence that paying higher expenses will get you higher returns. In fact, the opposite is true. Higher expenses usually result in lower long-term performance. The academics who have studied investing have concluded that after asset allocation, the most reliable predictor of relative investment success is expenses. The higher the expenses, they say, the lower the expected return.

This makes sense. Every dollar you pay in commissions and marketing costs is a dollar that will never be yours again, a dollar that will never produce retirement income for you. Instead, that dollar will be working for somebody else.

The Securities and Exchange Commission is onto this as well. It has warned that: "A 1 percent increase in a mutual fund's annual expenses can reduce an investor's ending account balance in that fund by 18 percent after 20 years."

The average US equity fund has an annual expense ratio of 1.45 percent. Investors can invest in substantially the same assets at one third of that cost. That's a 66 percent savings!

If you want to be a contrarian: Refuse to pay unnecessarily high expenses.

6. If you want to follow the crowd, own actively managed funds instead of index funds.

Many investors think actively managed portfolios will do better than passively managed ones. They think a high portfolio turnover rate is a sign of a hardworking portfolio manager who will achieve higher returns.

Our culture values brains and hard work. But when it comes to picking stocks (one of the main things

great managers are supposed to do) hundreds of academic studies have found no evidence that active management outperforms passive management over long periods of time.

In reality, the only certain consequences of high portfolio turnover are higher trading costs and higher tax bills (in taxable accounts). Uncle Sam and Wall Street each want a slice of your retirement savings. Trading costs are not usually explicitly disclosed nor subject to much control by the fund shareholders who pay them. But they diminish the return from any portfolio. And they enrich Wall Street.

Taxes are another often-overlooked result of active management. According to a recent report, mutual fund investors could owe nearly \$20 billion in taxes on the capital gains and ordinary dividends they will receive during 2006.

You can get a look at the impact of taxes and portfolio turnover in real life by comparing the before-tax and after-tax returns of two big funds, Fidelity Magellan and Vanguard 500 Index. The portfolios of these two funds are very similar. The biggest difference is that one fund buys and holds while the other moves in and out of lots of stocks.

According to Morningstar, Magellan has a turnover rate of 74 percent, vs. 7 percent for Vanguard 500 Index. Through the end of October 2006, 500 Index's 10-year annualized return was 8.56 percent, vs. 7.23 percent for Magellan. In the same period, 500 Index's after-tax return was 8.01 percent, vs. 5.99 percent for Magellan.

Most investors who saw those numbers probably would neglect to take the next step and do the math. And they would miss the point. I'll do the math for you: Over this period, investors in the highest tax brackets who owned Fidelity Magellan gave up 17 percent of their return to the tax man. Investors in 500 Index gave up only 6.4 percent of their return.

It would be nice if there were a Tiger Woods of investing who could make us all wealthier. But relatively few active managers beat the market in any given year. Fewer yet do so year after year. The odds of identifying such a manager in advance are similar to the odds of picking the right number on a roulette wheel: theoretically possible, but realistically impossible.

Buried in all this bad news is a bit of good news: Most investors don't need above-market returns. They can get what they need from index funds. Investors who seek higher returns from active managers increase their risks and their costs. In the majority of cases, they do not increase their returns.

Here's a simple truth that's inconvenient for Wall Street to admit: High returns don't come from talented managers. They come from asset classes.

If you want to be a contrarian: Buy funds with low portfolio turnover and high tax efficiency.

7. If you want to follow the crowd, base your portfolio on what you think is going to happen next in the market.

Many investors believe they can hire someone who knows where the market is going and profit from their advice. If things don't work out the way they expect, they move on to the next "expert."

Many other investors believe they can find the information they need by watching CNBC or by reading/watching/listening to other trustworthy sources of financial news. They adapt their investments in response to what read and hear. They constantly worry about missing what they think might be potentially vital information.

Few of these media junkies stop to think about the fact that most professional investors learn this news and digest these "insights" – and act on them – long before the information ever gets out to the public.

If you want to be a contrarian: Ignore short-term market forecasts.

8. If you want to follow the crowd, let your emotions dictate your buying and selling. Sell investments that make you blue and hold onto those that make you feel good.

If it weren't so costly it might be comical to watch investors become emotionally attached to the stocks and funds they buy and own. But the result of this behavior is that investors cheat themselves out of substantial returns and increase their risks at the same time – all for emotional reasons.

Investing isn't dating. Emotional investment decisions usually don't work out well. There's no getting around this fundamental law of investing: The way to make money is to buy low and sell high. Yet our emotions want us to do the opposite.

In 1999, technology stocks were extremely popular because they were performing well. Millions of people thought this was a permanent phenomenon. But tech stocks became the Pied Piper of the new millennium, and very few investors sold their technology stocks before the bubble burst.

If you want to be a contrarian: Invest with your brains, not your heart.

9. If you want to follow the crowd, look in the wrong places for advice.

Most investors believe that good financial insight and advice are available from financial publications and the media. The common view is that the financial media have done your homework for you and are on your side. Unfortunately, it just isn't so.

The goal of the media is not to help investors. The goal of the media is to get readers, listeners and viewers to keep coming back. This lets the media sell more advertising.

If you want to be a contrarian: Treat the editorial content in the popular press as entertainment that's disguised to look like insight and advice.

10. If you want to follow the crowd, make your decisions based on how much money you hope to make, not on how much you might lose. Ignore the whole topic of risks. Be an optimist.

We all want to believe that our investments will make money, not lose money. Wall Street emphasizes almost anything on the upside that is plausible in order to sell us products and services. Brokers rarely bring up the possibility that we might face substantial losses.

One of the few things I can guarantee is that if you invest in the equity market, sooner or later you will lose money. Markets rise and fall in random patterns. It's shocking but true: The stock market has no pity on those of us who have invested our life savings.

Investors who understand potential losses are much more likely to find the right balance of asset classes for their risk tolerance. If you have your risks under control, you are much more likely to stick with your strategy. And if you stick with your strategy, you are much more likely to succeed. If you panic, you are likely to make decisions that are counterproductive to your long-term financial interests.

If you want to be a contrarian: Focus on controlling your losses instead of daydreaming about the gains you hope to make.

11. If you want to follow the crowd, load up on asset classes that are currently in vogue.

People tend to think that whatever is happening now will just keep happening. This is a trap. In the late 1990s, many investors loaded up on technology. Unless they abandoned this in a hurry after the market started downward, they lost a lot of money. Most "technology hounds" did no such thing because they had become totally convinced that technology was "the answer." (See item #8 above.)

If you want to be a contrarian: Ignore what is currently popular. If you have made big gains in high-

performing assets, sell some of your holdings and rebalance to reduce your risks.

12. If you want to follow the crowd, buy high and sell low. That's right: Overpay for what you buy and sell when prices are low.

Many investors use what I call the "I can't stand it anymore" timing strategy. They have it all backward. When they are losing money, they can't stand the losses and they bail out. When they are out of the market and others are making money, they can't stand to miss out, and they jump in. These emotion-based responses often get investors out of markets closer to bottoms than tops and back in closer to tops than bottoms. (See Tom Cock's column on Page 7 for more on this.)

If you want to be a contrarian: Diversify widely and be ruthless about rebalancing regularly. If you are determined to time your purchases and sales, adopt a sensible timing system and follow it as a discipline, whether or not you feel like it – and whether or not you think it's right or wrong at the time.

Becoming a contrarian investor

If you are still reading, you can tell I believe that to be successful, investors need to do just the opposite of what most others are doing. Some people find that easy, others find it very difficult. But if you are willing to change, it doesn't have to be hard.

In my book "Live It Up without Outliving Your Money," I devote a whole chapter to the subject of change and how to go about it. If you're feeling stuck, here are a few things you can do to get started:

- Figure out what's important and spend your time on that.
- Disregard what most investors are doing.
- Review your investments with an advisor who doesn't sell products.
- Review your asset allocation to see how much risk you're taking.
- Review the expense ratios, loads, turnover, and tax efficiency of the funds you own to see if you're letting too much of your investment returns leak out to other people and institutions.
- Educate yourself beyond this list. Start with the article archives at www.FundAdvice.com. For some key insights produced from academic research, I recommend Larry Swedroe's book "The Successful Investor Today: 14 Simple Truths You Must Know When You Invest." It is available in paperback.
- To learn more about mutual funds, I recommend "Mutual Funds for Dummies" by Eric Tyson and James Collins and "Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor" by John Bogle.

With some time and effort, you can make contrarian investing work for you. Once you do that, don't be surprised if you wind up ahead of the crowd.