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BOOK REVIEW

On David Dreman's *Contrarian Investment Strategies: The Psychological Edge*

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In an exciting new book, David Dreman explains the conflict between the efficient market and the behavioral view of the financial world and provides clear-cut investment strategies for investors. This book should be of interest to academics, money managers, and retail investors. The overriding theme of this well-written book is for investors to recognize the powerful role that psychology plays in our investment decisions. By learning to appreciate investor psychology, one can understand why investors make such poor investment decisions and why our financial markets so often experience severe booms and busts. This knowledge might even make it possible for the reader to profit from subsequent irrational trading behavior by market participants.

If there is an antagonist in Dreman's book, it is the well-meaning but misguided proponents of the efficient-market hypothesis (EMH). Dreman argues that the key underlying assumptions of EMH are highly questionable, or have never been tested, or are outright fallacious. The book explains how three major financial calamities—the October 1987 stock market crash, 1998 Long-term Capital Management meltdown, and 2006–08 housing bubble and market crash—all could have been avoided according to the adherents of the EMH. All three of the meltdowns occurred due to leverage and a lack of liquidity. Obviously, as prices decline, large numbers of buyers do not always suddenly appear to snap up securities (as followers of the EMH mistakenly believe). Clearly, markets are not entirely rational.

Given the enormous swings in equity valuations in the United States since 1996, are there any investment strategies that can help investors avoid stocks such as eToys.com, Corvis, and Pets.com? Dreman spells out five investment strategies that should work. Dreman recommends purchasing solid firms that are currently out of market favor (think low price-to-earnings or low price-to-cash flow firms). Investors are easily distracted by exciting new products or concepts. One reason for the documented success of contrarian trading strategies is that investors and analysts do not know their own limitations as forecasters.

In particular, I like the book's chapter on contrarian strategies within industries. Dreman recommends purchasing the least expensive stocks within a particular industry using a contrarian strategy such as low price-to-earnings, low price-to-book, or high dividend yield, regardless of how expensive the prices of the industry. The key benefit with this strategy is much better diversification across industries than if an investor merely purchased low price-to-earnings companies.

In a timely note, the book correctly points out that inflation and taxes wipe out much of the gains from investing in long-term government bonds. At the time of this book review, 10-year U.S. Government bonds are yielding only 1.66%. I cannot imagine that over the next 10 years equity returns will not dominate the meager returns currently offered to investors by holding Treasuries (especially given the reasonable chance for a spike in inflation in the next few years).

Dreman's book offers readers a new method for investing. Understanding the role that psychology plays in all of our investing decisions is critical to the long-term success of a portfolio. Dreman's advice to avoid newfangled, complex products offered by investment banks and instead to stick with proven contrarian trading strategies is an approach that will tilt the odds of success in an investor's favor.

Dreman, D. *Contrarian Investment Strategies: The Psychological Edge*. New York: Free Press, 2012

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