THE SALMON RUN

“Successful investing is about having people agree with you ... later.”

- James Grant

Salmon is a common name for species of ray-finned fish in the family Salmonidae. They are commonly found in the tributaries of the North Atlantic and Pacific Ocean. Though Salmons are born in the fresh waters of the rivers, they migrate to the sea to develop and grow. And then they travel back hundreds (at times thousands) of miles to return to the fresh water to spawn or reproduce. What is even more fascinating is that the Salmon completes this resolute journey travelling against the river flow. They are anadromous (which is a Greek term for “running upward”) and swim up the river going against the current. This journey, generally timed between September and November every year, is called the Salmon run.

The Salmon run has obvious challenges. However, the fish use their skills, their environment and their perfect timing to accomplish this feat. First, they use the high tides in the ocean to get close to the rivers, then through their sense of smell, they home in on the river entrance. They also time their swim upwards gauging the river flow. The difficult part are the waterfalls and rapids they encounter during the journey. But the fish are ready for that too. Again, it's about skill and timing. The Salmon can flex their body and can leap more than 10 feet in the air. They time their jump and use the strong upward current created when the falling water displaces the water beneath it. The combined force works and the fish are able to clear the obstacles and reach their destination.

AGAINST THE FLOW IN THE MARKETS

Like Salmon, a species of investors who show similar skill and grit in the market are the ‘Contrarian Investors.’ They go against the flow,
taking non-consensus positions and timing their trades when the crowd is overrun by panic or euphoria. Most people define contrarian investing as buying when many others are selling and selling when the crowd is buying. That’s a reflection of the action taken but certainly not the thought behind contrarian investing.

The crowd is not wrong all the time. And the contrarian investor is not the one who expresses a stubborn dissent to market opinions all the time. In the stock market, we often hear that ‘the public is right during the trends but wrong at the ends.’ The crowd is wrong at turning points and that is the precise point where a contrarian investor tries to position himself and take advantage of the possible change in trend. As presented in the quote by James Grant in the beginning of the article, the contrarian investor too wants the crowd to join him ultimately, to enable him to profit from the investment. A contrarian investor understands and identifies the areas in the market where the crowd has overreacted, resists the temptation to go with the flow and sets up an opposite position to the trend to ultimately benefit when market realizes its mistake.

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There is an old French adage about investing (which is also credited to Nathan Rothschild in some sources) – “Buy on the cannons and sell on the trumpets!” It suggests buying when, in a war like situation or crisis, people panic and overreact on the downside, and create good opportunities to invest. On the other hand, when wars end and peace times reign (Trumpets blowing marking the end of the war), people tend to display euphoria and enter a buying frenzy; those tend to be good opportunities to book profits.

**GENESIS OF CONTRARIAN INVESTING**

Proponents of efficient market hypothesis believe that people behave rationally while making investment decisions:

- They incorporate any new information perfectly into the price (using Bayes theorem);
- They make optimum allocation decisions (based on calculated expected value or the efficient frontier).

They also believe in the wisdom of the crowds:

- Even if individuals may suffer some biases in their decision making, the crowd does not.
When different individuals interact in the market, their errors cancel out each other and hence the prices are close to their fundamental values.

In case, there is a net bias which is not negated, there are arbitrageurs who will come in and trade in a way that they make a risk less profit and the prices again revert to the fundamental values.

In reality, people are not so good with handling complexity (know more about it here) and uncertainty (know more about it here). Individuals investors are not perfectly rational in their financial decision making and do get affected by biases. As mentioned, most of the time, the crowd can be right. However, the crowd is influenced by narratives (know more about it here), they extrapolate recent trends into the future (Recency bias) and often ignore regression to mean and base rates. This can lead to imitation within the crowd and results in herding (know more about it here). Herding breaks the diversity in the market and creates a market bias. A feedback loop sets in which pushes the market prices further in the direction of the bias and reinforces the trend (Reflexivity, know more about it here). Behavioral economists have shown that in such conditions, arbitrageurs cannot really influence the prices. The crowd ends up being positioned at one extreme side of the market (overreacting in optimism or pessimism). This is the opportunity for the contrarian investor. An opportunity to buy from the pessimists or sell to the optimists.

THE CHALLENGES IN THE PATH
Life unfolds in cycles, but people project it in straight lines. In the market cycle too, booms are followed by busts, excesses sow the seeds of reversal. The contrarian investor understands & profits hugely from this behavioral cycle. Unfortunately, this path is not without obstacles.

- **Fundamentals and psychology**
  To understand if the market prices are unreasonable in either direction, the contrarian investor must have a good handle on what is the reasonable value. It is important to have grasp of the intrinsic value before claiming a security or asset is mistakenly over or under valued. Along with the fundamental knowledge, the investor must also understand the behavioral cycle of the market. Many investors are trend followers; they may rush in to participate in a bubble.
studying both, the fundamental and the behavioral cycle of the market, the investor can position himself correctly.

➢ **Timing is important and difficult**

‘Markets can remain irrational longer than one can remain solvent’. A contrarian investor disagrees with the crowd but should know when to act on that disagreement. After establishing a position, the investor may have to wait for a long time. Market can continue to move in one direction if it is driven by a seductive narrative. The crowd may take a lot of time to finally change course. Remember, by its very construct, the contrarian investing is about being early.

➢ **Standing alone is difficult**

Being a contrarian investor is contrary to our natural reaction. Resisting temptation to participate or conform to the majority, standing alone against the crowd, betting against what seems obvious etc. is a difficult position to maintain psychologically. It takes courage and perseverance. Recently, scientists have shown that standing against the crowd impacts the same areas of the brain that get affected by physical pain.

**GET THE SET-UP RIGHT**

The strategy is right: a contrarian investor buys when the prices are low and sells when they are high; logically, there is a lot of money to be made. It sounds simple but it has its own challenges. Keeping the right set-up may help implement the contrarian strategy effectively. Some of these ideas may help:

- Have a screener to hunt for contrarian opportunities
- Make a checklist of conditions that help qualify investments
- Build positions slowly - as you can’t predict the exact top or bottom
- There is a need for patience – you, your clients, your management and sponsors
- Be prepared for looking stupid till you look intelligent! You may have to lose the battle to win the war

“The central principle of investment is to go contrary to the general opinion on the grounds that if everyone agreed about its merits, the investment is inevitably too dear and therefore unattractive.”

– John Maynard Keynes
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ABOUT STOIC INVESTOR:
The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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