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The Power of Contrary Thinking: Economic Boom and Major Disinflation Coming; Buy Basic Industry Stocks

Warren Buffett once said that people should limit the number of investment ideas they try in a lifetime to one a year or even less. In other words, to be successful, you only have to do a few things right, so long as you can avoid making big mistakes.

By contrast, many forecasters today feel that to stay in business they must forecast frequently and on many subjects. Paradoxically, the majority of these subjects are inherently "unpredictable," and hence, the dismal record of the forecasting profession comes as no surprise.

An alternate strategy is to make one or two forecasts a decade (perhaps less) and to make them only when there's a degree of predictability. The only reliable forecast we know of is that a universally accepted view about the business or investment outlook will be wrong. In other words, adopt a different or "contrary" view when opinion is extremely one-sided.

Of course, nearly everyone in the financial community pays lip service to contrary thinking, but few really practice it. It requires an independence of mind and disdain for popular opinion that by its very nature can only be embraced by few persons.

The easiest and simplest measure of employing contrary thinking is a close study of best-selling business and investment books. The fifty-year record of these books as a contrary indicator is as close to infallible as you can find. For example, in 1924, Edgar Lawrence Smith wrote a book entitled: *Common Stocks as Long-Term Investments*, which came to the then revolutionary conclusion that stocks were excellent long-term investments. Ironically, the book only became a best seller in the summer of 1929, just months before the crash.

Between 1932 and 1968, the country had the greatest bull market in stock market history, but it wasn't until 1968 that an investment book made the best seller list. Ironically, *The Money Game* by Adam Smith became the number-one best seller on July 7, 1968, exactly five months before the market topped out. While the drop in stock prices between 1968 and 1974 wasn't as severe as the 1929-32 crash, many stocks lost 70% to 80% of their value.

The next important sell signal in a market came in April 1974, when Harry Browne's *You Can Profit From A Monetary Crisis* became the number-one national best seller. In that book, Browne recommended gold and silver as well as foreign currencies. Gold made a double top that year at just under $200 an ounce in March and again in December, but gold shares hit their peak in April. By mid-1976, gold had fallen to $103 an ounce, and an index of South African gold shares had lost 85% of its value.

The peak of inflation and the forthcoming shakeout in inflation hedges were forecast by a myriad of popular "inflation forever" books in 1979-81. For instance, the popularity of Howard Ruff's *How To Prosper During The Coming Bad Years*, a 1979 best seller, suggested to contrarians that gold and silver prices had peaked in January 1980.

Crisis Investing: Opportunities And Profits In The Coming Great Depression by Douglas Casey was the best-selling book of 1980, attaining the number-one position in the week of September 21, 1980. The book recommended such classic inflation hedges as gold, silver and natural resource stocks. Oil stocks peaked two months later, at the end of November, and gold and silver hit their post-1980 recession peaks of around $725 and $22 an ounce, respectively, in the last week of September.

The Coming Currency Collapse by Jerome Smith, which was about the total destruction of the U.S. dollar, became a best seller in late 1980, just as the dollar began a remarkable three-year bull market. The 1981 peak in interest rates was suggested to contrarians by William E. Donoghue's *Complete Money Market Guide*, which became a best seller in March 1981, only five months before interest rates peaked.

More recently, the demise of high technology stocks was indicated by the popularity of John Nesbitt's *Megatrends*, which became the number-one best seller on March 20, 1983. *Megatrends*, among other things, predicted that the industrial age was dead and that we would now enter a new technology or information age. Since their peak on June 24, many high-technology issues have fallen 50% or more.

Why does contrary thinking work? The easiest answer is that it works because of nature's immutable laws. Biologists tell us that life itself innately seeks individuality. The reason for this is simple: if all the organisms of a particular species were identical, how could it respond to change, resist new diseases, make discoveries, or advance?

Arnold Toynbee, the noted historian, said it well in his book, *Civilization On Trial*: "Creation could hardly make any headway at all if each new form of creature were not represented by numerous eggs in numerous baskets, providing himself with sufficient material for bold and fruitful experiment and with effective means of retrieving inevitable failures?" Thus, nature has decreed that extreme sameness of thinking provides its own self-correcting mechanism.

The bottom line: The wide scale acceptance of a coming depression in 1979-81 suggested we would eventually have a major economic boom. The popular belief in the late 1970s that inflation would last forever implied inflation was ending. (See *Is Inflation Ending? Are You Ready?*, McGraw-Hill 1982, co-authored by economist Gary Shilling and Kiril Sokoloff.) Finally, the current widespread belief that the industrial age is over indicates that some of the best investment opportunities lie in the out-of-favor heavy industrial companies.

If these contrary "forecasts" work out, you won't need to make another prediction until a stock market book reaches the bestseller list, at which time it will be time to sell.

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Coming Takeover Boom, Battle for Corporate Control, The Age of Restructurings

There is a new game in town that offers more opportunities for profit than the takeover spree of the late 1970s and early 1980s. It goes by a variety of names—corporate restructuring, asset redeployment, shareholder democracy assertion of rights by institutional investors, deconglomeratization. Call it what you will, but the common themes are realization of underlying value for shareholders and removal of poor management or forced redirection of corporate strategy.

The trend has been recently exemplified in a number of notable corporate battles: Samuel Heyman/GAF, Odysset Partners/Trans World Corp., Willametta Keck Day/Superior Oil, Delo Caspary/Louisiana Land, and T. Boone Pickens/Gulf Oil.

What is prompting these battles? A growing perception among certain smart investors that large money managers will start to vote their shareholdings in their own financial interests. For years management could count on large institutional investors to back its proposals, but the tide appears to have irrevocably turned.

What are the investment opportunities here? Well-known bargain hunters, such as Odyssey Partners and T. Boone Pickens, will undoubtedly do more of this sort of thing and, in the process, will win a wider and wider following, especially if they are successful. These bargain hunters will probably be able to raise huge sums of money (Pickens' group has already spent close to $1 billion on Gulf shares), and they will go after stodgy, poorly managed, asset-rich companies that have generated poor returns for shareholders.

Other smart bargain-hunting investors are also getting into the act. After all, Rupert Murdoch's purchase of Warner Communications is a classic example of this type of investment. Murdoch can certainly exploit a large amount of shareholder dissatisfaction and disgust with present management if he chooses to.

The opportunities lie not only in following these well-known bargain hunters, but in studying many other lesser-known investors who are doing the same thing. In the last six months we have seen a steep increase in outside investors taking positions in poorly managed companies with a history of operating losses.

Some of these investments are made strictly for investment purposes, but a growing number are made to win control and influence management. While such investments have more risk than the stocks we normally discuss, we plan to increase coverage of this area.

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Big Interest Rate Decline Coming, Henry Kaufman Has Peaked, Avoid Technology, Deregulation And Competition Based on Price, Coming Nuclear Arms Treaty

Will the consensus economic forecast be wrong again in 1984? In 1982, the consensus expected a sharp pickup in the economy in the second half of the year, while in reality economic activity slowed sharply and GNP recorded its largest drop in 36 years. In 1983, the consensus forecast a very slow economic recovery with the Fed pushing down interest rates to keep the economy from stalling. In actuality the economic recovery was very vigorous and interest rates rose rather than fell. Interestingly, the actual inflation rate in 1983 was lower than even the most optimistic predicted.

1984 consensus outlook: Based on surveys in *Time* magazine, *Business Week* magazine and *U.S. News & World Report*, we would describe the consensus forecast as follows: * Interest rates will remain stable in the first half of 1984 and rise modestly in the second half of the year. * Consumer prices will increase gradually from 3.8% in 1983 to 4.9% in 1984. * The economic expansion will slow from about 6.5% in 1983 to 4.5% in 1984, and the first half will be strong, followed by a tapering off of economic activity in the second half of the year.

What's the contrary view to this consensus? Interest rates will decline, particularly in the second half of 1984, the inflation rate will be lower in 1984 than in 1983. (Just as the economists underestimated inflation on the way up, they will underestimate disinflation on the way down.)

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Some contrary thoughts: How should a contrarian view the recent popularity of "The Day After," ABC's movie about nuclear war? Not only did the movie garner an audience of 100 million persons (the largest in years), but a rash of magazine cover stories and newspaper articles on the theme indicates its continued topicality. Is it possible all this publicity suggests that a serious nuclear arms negotiation and/or peace treaty between the two superpowers may be in the offing?... Henry Kaufman's 1984 interest rate forecast has attracted huge media hoopla, including coverage by the foreign media, live TV transmission to Australia, and excerpts on a number of nightly TV broadcasts. It reminds us of all the attention Joe Granville received in 1981...A chart of the relative action of the Hambrecht & Quist Technology Index versus the Dow Jones Industrial Average and the Standard & Poor's 500 Index shows that since early summer the industrial stocks have been outperforming the high technology stocks by a greater margin than any time since 1974. Conclusion: Do your bargain hunting among out-of-favor industrial stocks rather than the recently beaten-down high technology issues (see insert "The Power of Contrary Thinking").

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What's the great unwritten story of the 1980s? In a word, deregulation. More than 50% of GNP is in the throes of deregulation and many industries will experience unbridled competition for the first time in 50 years or more. No one can predict the outcome, but several conclusions seem apparent.

- Price competition (and the need for cost control) will intensify. Investments in debt-heavy companies that are not the low cost producer may prove dangerous.

- Price wars will become a recurring theme of the business landscape. Businesses may sell goods or services below the cost of production to bankrupt weak competitors.

- Inefficient producers or competitors that survived the 1981-82 recession may fail in the next recession, or the one after that, or the one after that. The strong will grow stronger and the weak will become weaker.

- Enormous capital growth opportunities exist as far-sighted, tough, and acquisitive businessmen build empires. Over the next two decades, nineteenth century-type entrepreneurs will accumulate huge sums of capital. Economic power will likely shift away from corporate bureaucracies (notoriously inefficient and lacking in entrepreneurial spirit) to private individuals with vision and money-making talents.

- An intimate knowledge of the tactics, investment and business philosophy, interlocking corporate ownership, and personal interconnections of such free-wheeling individuals will be indispensable. Indeed, James Grant's recent biography of Bernard Baruch points out that Baruch made his fortune not because of market timing ability or a good speculative sense, but because the big boys let him in on their deals.

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Beware the popular theme in investment strategy. Because of the volatility in the past 15 years, many investors have become traders and market timers. Investment advisors managing billions of dollars try to catch intermediate tops in the market and go from fully invested positions to 60% in cash in a matter of weeks. Everyone wants to know where "the market" is going. Individual investors play options and commodity futures, using leverage to bet on the market's next move.

A whole host of new speculative vehicles have appeared, such as interest rate and currency futures, commodity options, stock index futures, etc. Meanwhile, a host of technical analysts have sprung up, most of whom follow the same data, read the same charts, and either reach the same conclusions or move about like a weathercock with every slight change in wind.

What does it all mean? In a nutshell, it means everyone is focusing on the short-term and the greatest opportunities presently lie in long-term investments and long-term commitments of capital.

Perhaps it's another case of the generals fighting the last war. If inflation remains in the 2%-3% range for the foreseeable future, volatility will diminish and market timing won't be so useful. Indeed, the real challenge will be to pick undervalued stocks that can outperform the market over the next few years.

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Smart Money Accumulating Stocks, Strength Of Disinflationary Forces Not Understood

Clients frequently ask why we only write about buying activity. Our answer is that we report about what we see. Generally speaking, since November 1981, we have seen more buying activity by smart investors than at any time since the 1974 bottom. In other words, at the present time, this publication is largely about the accumulation of stocks—because that is what is going on.

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In 1983, producer prices rose only six tenths of one percent, the smallest increase since 1964. In other words, wholesale price inflation, which foreshadows inflation at the consumer level, rose less than 1% for all of 1983. In the late 1970s, spiraling producer prices signaled a surge in consumer price inflation, but most of the big-name economists failed to recognize its significance at the time. They are probably making the same mistake now. An absence of inflation at the wholesale level in 1983 implies the same for consumer prices in 1984. In 1964, long-term AAA corporate bonds yielded under 5%, now they yield over 12 1/2%.