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EDUCATION

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Turning losers into winners

JULIAN MORRISON
Allan Gray

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In 1934, just five years after the great crash of 1929, Benjamin Graham and David Dodd published the first edition of "Security Analysis". At 1.2 kilograms and 752 pages, the hardback version of this investment classic is hardly light reading.

But if you had to pick a key concept from the book, and summarise it in a sentence, the below quote from Horace might be a good starting point. Perhaps that is why those words earned their position at the very start of the book, before the extensive list of contents.

"Many shall be restored that now are fallen, and many shall fall that now are in honour."

Put another way, this expresses that past losers may become future winners. And past winners may become future losers.

The concept of mean reversion is a very real feature of financial markets. As we will see, it may contribute to a reliable investment strategy. But why? Because people generally feel far more comfortable backing recent winners than recent losers. Ironically, this behavioural trait creates an opportunity for contrarian investors to outperform by favouring recent losers.

The contrarian approach to investing is perhaps as old as investing itself. In 1815, the British economist David Ricardo made a fortune buying British government bonds at deeply depressed prices, just before the Battle of Waterloo. What did Ricardo recognise that led him to assess this as a great investment opportunity? As Richard Zeckhauser put it: