The Theory of Contrary Opinion and How To Apply It

The Theory of Contrary Opinion

The theory of contrary opinion is very simple to state: When “too many” investors think stock prices will advance, they usually decline. Likewise, when “too many” think prices will decline, they advance. In other words, prices will move opposite to what investors expect when “too many” investors have that expectation. The key is knowing when there are “too many.”

I want to emphasize this last point: The theory applies only when those expectations have reached an extreme. Notice that the theory does not consider the general economic situation. It simply states that *the necessary and sufficient condition for a major market top or bottom is the existence of an extreme level of bullish or bearish sentiment.*

When applying the theory, one cannot guess when there are “too many”; you must have indicators that measure it. Then you must also have a history that covers numerous bull and bear markets that shows when an indicator has signaled “too many” in the past. An indicator might show two bulls for every bear, but this could be a normal ratio for that indicator and “too many” is a ratio of 4 to 1.

Why the Theory Works

Contrary opinion as a theory was first defined by Humphrey Neill in his 1954 book, *The Art of Contrary Thinking*, but I'm sure it was known before that. For example, in Edwin Lefevre's book, *Reminiscences of a Stock Operator*, written over 100 years ago, there is the statement, "Always buy when complete demoralization has set in."

The usual explanation of why the theory works is this. If everyone is bullish, investors have already purchased so even with more good news there are few buyers left to push prices higher. The advance is “exhausted” so just a little profit taking will reverse things and move prices lower.

On the other hand, if everyone is bearish, they have already sold. So, even with more bad news, there are few sellers left to push prices lower. The market is “washed out.” So just a little buying by bargain hunters will move prices higher.

This is a good explanation, but it doesn't account for everything. For example, I have seen markets that went through a small sideways correction after a big advance, which culminated with almost everyone expecting prices to decline even further. Yet, the number of possible sellers after such a small correction couldn't possibly be exhausted like at the end of a bear market.

Until we get a better explanation, however, this one will suffice.

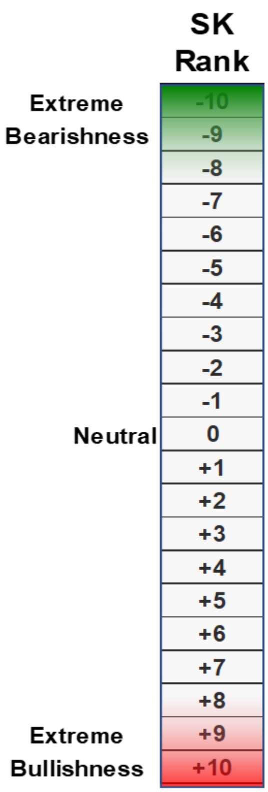
How Investor Expectations are Measured

The methods for measuring investor expectations fall into two categories. The first category attempts to discover what investors expect by measuring their investment activity. The second category measures what investors or advisors expect by polling them to get their outlook on the market.

As we've stated before, indicators of investor expectations only have meaning when they reach extreme values. In between extremes they have little meaning and the technician must let the market move forward until they do. As a rule, always assume the primary trend is intact until sentiment indicators have reached sentiment readings as established by history.

This is a useful guide that will help you stay with the major price trend. The primary error a market technician will make when using contrary opinion indicators is "forming" a market opinion and acting on it when none is there. Have patience. The second is to justify or ignore extreme readings. The Sentiment King's Red and Green Zone ranking scale was designed to help with these issues.

The Red Zone, Green Zone and Neutral Zone Ranking



A moving average of an indicator is calculated - one we believe measures a long-term view for that indicator. Historical values of this moving average are then used to establish where the current moving average ranks against historic norms. A minimum ten-year history is required for this, one that covers multiple bull and bear market. The current value is then positioned on a scale from +10 to -10, each incremental number representing a 5% change in its historical position.

This ranking method makes it possible to put different type indicators – such as the puts to calls ratio and the percent of bullish advisors – on the same scale. It allows us to combine different indicators into one, which we call the Master Sentiment Indicator. All the graphs in the report show this ranking of the indicator, not the indicator itself.

Red zone readings are +8 and above. It means our moving average calculation is in the highest 10% of all readings. Readings of -8 or less are Green Zone readings, meaning it's currently in the lowest 10% of our moving average calculation. There's no sudden demarcation line but a gradual fade in as you can see in the color scheme.

The large area in between, which we call the neutral zone, is just that – the indicator is neutral. The current ranking might indicate more bulls than bears, or vice versa, but it's not enough to have meaning. Only extreme values have meaning.