Contrarian Example: Asset Management Stocks

Soros once said that, “The prevailing wisdom is that markets are always right. I take the opposite position. I assume that markets are always wrong. Even if my assumption is occasionally wrong, I use it as a working hypothesis.”

I like this idea and I’ve found it naturally fits my approach to markets, as well.

A lot of my time is spent getting a feel for the market by trying to understand the popular narratives/beliefs/assumptions driving investors’ behavior. I want to know why people are buying and selling.

If I can develop a decent grasp on the above then I can look to where popular narratives are maybe driving market prices to extremes.

This tells me where the market is most wrong.

The narrative-pricing mechanism works something like this.

Fundamentals drive market prices —> Market prices drive narratives —> Narratives drive prices and a trend is developed off a narrative/price feedback loop where trending prices drive narrative adoption and narrative adoption drives trending prices.

This recursive loop develops a momentum of its own.

The momentum eventually drives prices away from underlying fundamentals. And in fact, the driving narrative often becomes so persuasive and widely adopted that those who have bought into it are blinded to new evidence of when the fundamentals begin to change.

A good way to figure out what the popular narratives are is to skim the news and read the headlines. Financial news is mostly noise and filler. But it’s useful from a contrarian perspective for identifying the beliefs and narratives that are driving prices.

And news always lags the fundamentals. It’s when a narrative becomes the topic du jour across the entire financial media that the market is most likely to price the underlying fundamentals wrong.

This is why things like *The Economist* cover contrarian indicator work.

Lately, one of the areas where I think the market may be wrong, is asset management.

I've commented on this some in the *CC* and after doing some digging I think there may be some great trades in the space.

The popular narrative in this case is that "Active is Dead", and this is due to the "Rise of Passive" investing.

The financial media has been full headlines, like those to the right, for the greater part of the last 2-3 years.

Active asset managers have suffered under years of low interest rates and low volatility.

And it's these same things that have driven the popularity of passive indexing.


THE WALL STREET JOURNAL.

MARKETS

'Passive' Investing Frenzy Pushes Vanguard to $4.7 Trillion in Assets

Assets topped $4 trillion for the first time earlier this year and have continued their upward climb since

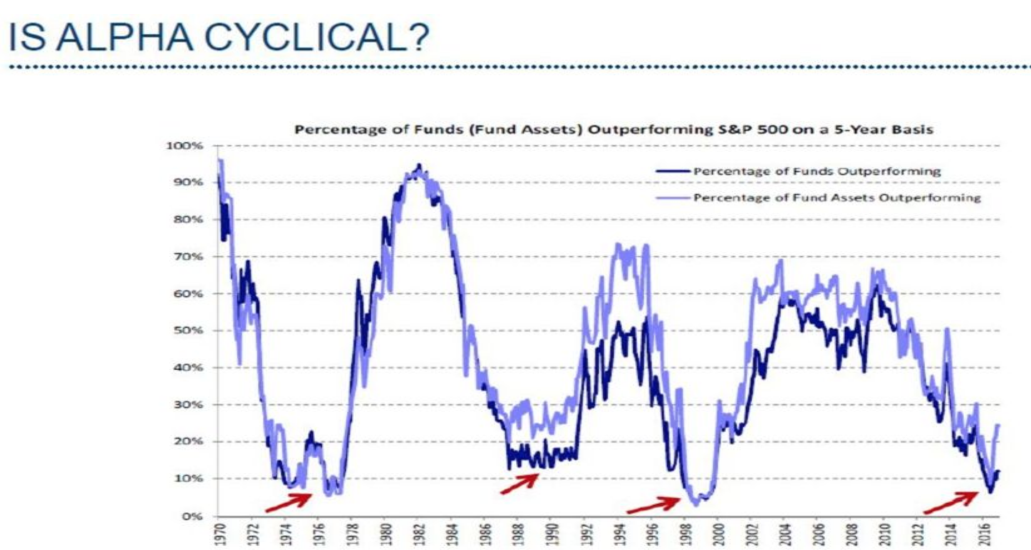

In Hedge Fund 'Killing Field,' Smoldering Fears Catch Fire

By Saijel Kishan and Katherine Burton

April 27, 2016, 7:28 PM EDT *Updated on* April 28, 2016, 1:49 PM EDT

Like all popular narratives this one was once based on true fundamentals. But the narrative has driven prices well past its fundamentals. More importantly, the fundamentals are changing. The period of low interest rates and low volatility is coming to an end as per our Investment Clock/Overheat thematic.

If you remember, "cyclical value" is the best performing equity sector during the overheat phase. And asset management fits this bill. The chart below shows the cyclical nature of the industry on a rolling 5yr performance basis relative to the S&P.



We can see that the chart has clearly bottomed and is turning higher. If this time is anything like the last three cyclical bottoms then asset management stocks should do well in the coming years.

So what I've done is screened for asset management stocks that trade on US exchanges and that meet the following criteria.

- ❖ Significant amount of insider buying.
    - ➢ If the stock of an asset manager is trading at what appears to be a cheap valuation but the insiders aren't buying, then why should we?
- ❖ Market cap above $100 million.
    - ➢ For growth stocks I'll look at lower market caps but on a cyclical play I prefer to stick with larger more established companies.
- ❖ Price to book value below 1.5.
    - ➢ We're looking for mispriced value and the market has a tendency to overlook the value located on the balance sheets of asset management companies (it mostly focuses on earnings ratios).
- ❖ Price to earnings ratio of 12 or below.
    - ➢ I typically don't pay much attention to PE ratios but it's useful in this case because the market pays a lot of attention to it.

This gave me a list of about 20 stocks.

I then went through and looked at the charts of each on a weekly basis and cut out the stocks that look technically weak.

And then I was left with four stocks from which to begin digging into. These four are below.

Ticker	TCRD [NASD]		
Company	THL Credit, Inc.		
Country	USA		
Industry	Asset Management		
Market Cap	304.15M	EPS (ttm)	0.74
P/E	12.60	EPS this Y	-38.40%
Forward P/E	8.37	EPS next Y	-3.23%
PEG	2.52	EPS past 5Y	-15.50%
P/S	4.65	EPS next 5Y	5.00%
P/B	0.81	EPS Q/Q	295.00%
Dividend	11.65%	Sales Q/Q	32.50%
Insider Own	0.60%	Inst Own	46.30%
Insider Trans	5.39%	Inst Trans	-61.58%
Short Float	0.69%	Earnings	Nov 09/a
Analyst Recom	2.70	Target Price	10.93
Avg Volume	101.15K	52W Range	8.75 - 10.60

Ticker	SCM [NYSE]		
Company	Stellus Capital Investment Corporation		
Country	USA		
Industry	Asset Management		
Market Cap	216.75M	EPS (ttm)	2.13
P/E	6.54	EPS this Y	202.40%
Forward P/E	10.29	EPS next Y	4.88%
PEG	-	EPS past 5Y	3.74%
P/S	5.33	EPS next 5Y	-
P/B	0.99	EPS Q/Q	-2.30%
Dividend	9.76%	Sales Q/Q	8.30%
Insider Own	2.20%	Inst Own	26.30%
Insider Trans	18.89%	Inst Trans	9888.33%
Short Float	0.10%	Earnings	Nov 02/a
Analyst Recom	2.00	Target Price	14.43
Avg Volume	69.50K	52W Range	10.22 - 14.82

Ticker	RILY [NASD]		
Company	B. Riley Financial, Inc.		
Country	USA		
Industry	Asset Management		
Market Cap	438.41M	EPS (ttm)	1.97
P/E	8.42	EPS this Y	61.30%
Forward P/E	-	EPS next Y	-
PEG	-	EPS past 5Y	23.40%
P/S	1.63	EPS next 5Y	-
P/B	1.47	EPS Q/Q	-
Dividend	1.93%	Sales Q/Q	228.60%
Insider Own	21.30%	Inst Own	44.40%
Insider Trans	1.09%	Inst Trans	0.28%
Short Float	3.67%	Earnings	-
Analyst Recom	-	Target Price	1.50
Avg Volume	135.91K	52W Range	11.74 - 20.87

Ticker	OXLC [NASD]		
Company	Oxford Lane Capital Corp.		
Country	USA		
Industry	Closed-End Fund - Debt		
Market Cap	261.00M	EPS (ttm)	4.99
P/E	2.17	EPS this Y	201.10%
Forward P/E	-	EPS next Y	-
PEG	-	EPS past 5Y	75.00%
P/S	4.51	EPS next 5Y	-
P/B	1.20	EPS Q/Q	550.10%
Dividend	14.77%	Sales Q/Q	27.00%
Insider Own	3.20%	Inst Own	6.00%
Insider Trans	39.91%	Inst Trans	-7.06%
Short Float	0.35%	Earnings	Nov 10/b
Analyst Recom	1.00	Target Price	11.00
Avg Volume	137.57K	52W Range	9.34 - 11.80

Icahn Enterprises (IEP) which is the fund of legendary investor Carl Icahn, didn't meet my value screen requirements. It trades at a slight premium to the others but nonetheless is another one that I like. Here it is.

Ticker	IEP [NASD]		
Company	Icahn Enterprises L.P.		
Country	USA		
Industry	Conglomerates		
Market Cap	9.04B	EPS (ttm)	7.88
P/E	7.03	EPS this Y	13.10%
Forward P/E	16.54	EPS next Y	-66.20%
PEG	-	EPS past 5Y	-24.50%
P/S	0.49	EPS next 5Y	-
P/B	1.98	EPS Q/Q	-
Dividend	10.83%	Sales Q/Q	18.00%
Insider Own	-	Inst Own	99.60%
Insider Trans	-	Inst Trans	2.66%
Short Float	0.42%	Earnings	Nov 07/b
Analyst Recom	2.50	Target Price	50.00
Avg Volume	71.40K	52W Range	44.81 - 63.94

Since this is a macro/cyclical thematic we'll look to trade a basket of the best 2-3 stocks out of the bunch.

From here, as part of my process, I'll go to each company's site and look at their latest "investor presentation" if they have one. I'll check out their last few earnings reports and skim through the last 2-3 earnings calls. And then I'll google the company and it's head managers to see if any disparaging/troublesome news pops up from the last few years.

I mostly look for reasons to not like the stock; red flags and stuff that doesn't jive.

This can be anything from accounting gimmicks to boastful management (I like conservative leadership) or a history of shareholder abuse (ie, stock dilution and failed promises).

After I do this our list is narrowed even further to just TCRD, SCM, and IEP.

I cut RILY and OXLC because they both have a history of stock dilution and management at both companies didn't impress me. IEP also has a history of serial stock issuance but I'm including it because Uncle Carl just bought a bunch of shares and I like IEP's holdings and I believe they'll do well in the overheat phase.

SCM recently broke out of a tight coiling pattern and looks set to run. IEP and TCRD are both trading in tightening consolidation zones (charts below on a weekly basis).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BATS:TCRD, W 9.27 ▲ +0.02 (+0.22%) O:9.33 H:9.34 L:9.24 C:9.27
THL CR INC, W, BATS
MA (50, close)
TCRD, W
THL CR INC
Vol (10)
Created with TradingView


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BATS:IEP, W 55.40 ▼ −0.17 (−0.31%) O:56.00 H:56.30 L:54.50 C:55.40
ICAHN ENTERPRISES LP, W, BATS
MA (50, close)
IEP, W
ICAHN ENTERPRISES LP
Vol (10)
Created with TradingView

I'm considering putting on a small starter position across this basket of three. Since IEP and TCRD are still trading in consolidation zones we'd have to pick wider stops and maybe only go with 25bps of risk per and then add onto our position once the market confirms our thesis in the form of uptrending prices.

I'm not in a rush though since our book is pretty full already. We'll see where the market is next week and maybe put the trade on.