Market Monitor

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Reversion to the Mean is a Powerful Rule that is Proven Over Time

By: Michael Alexenko, CFA

If there are any benefits that come from events like the 2008 financial crisis or the 2020 Covid crash, it's that some of our beliefs about investing can be ratified or we might experience a financial metanoia that helps us reform some of our misconceptions about what are valid investing practices. You might say they are what former President Obama liked to call "teachable moments." On the flip side, it is altogether possible that a post-traumatic stress disorder develops and the mere mention of investing causes panic attacks. This article is meant for those that are still ready, willing, and able to be exposed to the risks of investing.

If you're an even occasional watcher of investing programs or you get some investment newsletters, like the one you're reading now, it's a little annoying that almost no accountability is placed on the prognosticators who appear capable of generating a new investment tip every minute – 24/7. *Market Monitor* is shattering the no accountability habit and is going to look back on one of its own previous issues that will help to persuade readers that often-referred-to investing rules do indeed stand up to historical scrutiny.

Although the specific term "reversion to the mean" was not mentioned directly in the May 2020 issue, the concept was the underlying theme in the article about *Rules of Portfolio Management*. The general concept of mean reversion is investment returns have long-term average rates of return. While they tend to deviate from their averages for periods of time, they eventually find their way back to their averages. This premise can be used to identify some investment categories that may have suffered from severe under-performance or have enjoyed exceptional out-performance which then might signal buy or sell convictions.

Blunders by Warren Buffett from the last thirteen years were cited in the May 2020 *Market Monitor* that highlighted the power of the reversion to the mean rule. It was rightfully questioned why an investor, like Mr. Buffett backed away from airline investments at a time when it seemed that their performance was near bottom. What has occurred since the Oracle sold his airline investments? Take a look at the inset chart for the answer. How about Warren's overall performance as a money manager, has he redeemed himself after thirteen years as the reversion of the mean rule would suggest that he should? Amazingly the 90-year-old investor still has a few tricks up is sleeve and so far, YTD he is easily beating the S&P 500. See the performance of Berkshire Hathaway's stock in the chart.

Market Monitor's article "Rules of Portfolio Management" pointed out that the vacation home real estate market had crashed in the spring of 2020 and that people who were selling their properties were attempting to offload them quickly at deeply discounted prices. For those who may have purchased a vacation home within the past couple of years, they know that they capitalized on an underpriced market and are grinning from ear to ear. For those now looking to

Investment Rotation

Investment Asset Class	Annual 2020	YTD - 2021
Oil Exploration & Production	-32.50	51.27
Airlines	-28.99	16.53
Commodities	-23.72	24.97
Real Estate	-5.00	14.60
U.S. Financial Services Index	1.25	25.63
S&P 500 Value Index	1.36	17.62
Berkshire Hathaway	2.42	25.72
S&P MidCap Value Index	3.73	26.90
Small Cap Value Index	4.63	25.86
Long Term Corporate Bonds	11.30	-4.37
S&P MidCap Growth Index	22.77	10.10
S&P 500 Growth Index	33.47	6.54
Small Growth Index	34.63	1.17
Global Clean Energy Index	141.31	-23.54

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Lending More Strength to the Reversion Rule

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purchase they need to wait for the "reversion to the mean" pendulum to swing back in their favor as they are facing a market with high prices and low inventory. Anyone thinking about purchasing a home in Florida knows this all too well.

The resurgence of the value investment style was noted as a possible investing rotation for which to watch. For ten years or more, growth stocks have out-performed value stocks. We've all heard the stock success stories about Amazon, Apple, Facebook & Google, which are the primary stocks in the growth index. These stocks helped the S&P 500 growth index to outpace the S&P Value index for the past ten years by a margin that would have allowed a $1,000 invested in the growth index to now be worth $4,519 while a $1,000 invested in the value index to finish with a sum of $2,729. But look at what has been happening with growth and value styles for the YTD period and this doesn't fully capture the momentum in value stocks which began in about August/September of last year. Value has a long way to go to catch up, but it has made some good inroads so far. The contrast in performance numbers is more eye popping in the small and mid-cap categories as shown in the *Investment Rotation Chart*.

The *Investment Rotation Chart* displays some other dramatic occurrences that lend more strength to the reversion to the mean rule. You'd think that a new political regime promising to invest gazillions into green energy would be a killer for the fossil fuels industry and a boon for clean energy. That's not what's happening and it seems to have more to do with the reversion rule rather than the promise of a green new deal. Since there were already tectonic shifts taking place in in the energy field (no pun intended) long before November 2020, it is more likely that fossil fuels were due for a bounce and clean energy due for a correction. What reversion to the mean doesn't tell us is whether these are fleeting moves or something more durable? And this is the lynchpin to relying too much on the concept or attempting to employ it to help you know when it's the precise time to jump on or off the bandwagon. We'll have to leave that to the stochastic chart technical analysts who profess to know when inflection points hit, but that's another subject for another time.

Market Snapshot:

Market Snapshot: Market Momentum Runs into Fed and Policy Concerns

BY: MICHAEL ALEXENKO, CFA

We're thankfully emerging from the Covid recession and case and death numbers have come down quickly since the distribution of the vaccine. This prompted the CDC to issue new guidelines that should help people get back to work - which is the last ingredient to get the economy clicking on all cylinders. Stocks are having an excellent year with the S&P 500 up 10.51% which would extrapolate to nearly 23% for the full year. Small and Mid-cap stock are posting better numbers. The Federal Reserve is highly accommodative with printing $125 billion a month, the government is pumping in generous amounts of stimulus and unless we're in risk of a double dip recession it seems like we're pretty much in the clear.

So, let's start making bigger Christmas stockings for all the cash that's going to be stuffed in them for what is sure to be a great Santa Claus rally on Wall Street. If it were that simple, wouldn't it be wonderful? But it's not - and although the market is up for the year, it's having a rough May with an elevated risk measurement (VIX), inflation worries are high which is being exemplified in falling consumer confidence numbers and a Bank of America investor sentiment survey is showing some waning appetite for risk. Looming tax increases and $4 trillion in more spending have investors askew, but letting some steam out of an overbought market might not be a bad thing and sometimes the market has a perverse way of doing the opposite of what the consensus thinks will happen. More clarity is needed on whether the Federal Reserve will be forced to tighten monetary policy sooner than expected and what size and shape the tax and fiscal policies will take. Until then some sideways movement in price performance is possible.

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