Summa Global Advisors

CELEBRATING 10 YEARS

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Will This Bull Ever Tire?
Part 4—Mean Reversion and the Case for Diversification

According to Investopedia, mean reversion is a *financial theory suggesting that asset prices and returns eventually return back to the long-run mean or average of the entire dataset.* Recently, the concern has been that the market is trading above historical norms and may find itself reverting to the mean (Chart 1).

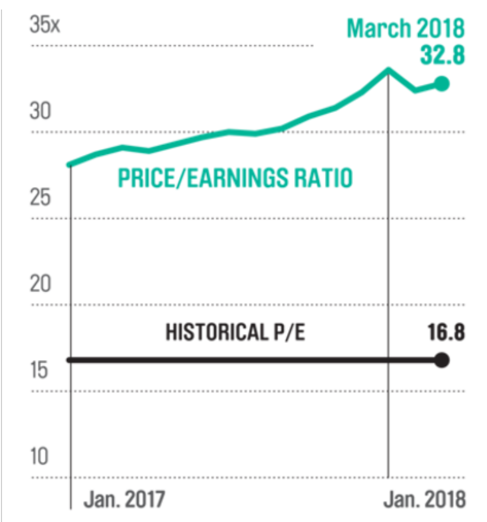

Chart 1. Price/Earnings Ratio. Source: Robert Shiller.

Paying attention to mean reversion while investing endeavors to capture market or asset mispricing. Any asset class, company stock, or sector could conceivably become mispriced according to the mean reversion theory. The most difficult task of investing with this philosophy is determining whether the asset class or investment will revert to its previous state.

Most recently, in the U.S. market, growth stocks have been outperforming value stocks. Growth and value are classifications of stocks by style. You may recall the old adage, "to make a pile, be in style." Growth stocks are companies that are anticipated to grow at a rate that is significantly above the market average. Generally, these companies have a competitive advantage that allows them to grab market share. Also, they often have high Price-to-Earnings (P/E) ratios because of the anticipated growth. Often, these story stocks are found in the technology, biotech, or consumer discretionary sectors. Giant growth companies include Apple, Microsoft and Amazon.

In contrast, other companies are labeled as value stocks. These are mature companies who generally pay dividends and exist in industries that are capital intensive or regulated. They are generally expanding at the same pace as the other companies in their respective sector. Examples of large value stocks include Johnson & Johnson, Exxon Mobil, and Bank of America.

Chart 2 shows the growth style outperforming over the last market cycle. Although it could be argued that all stocks are expensive, if you need to choose where to "place some chips," many of the predictable, dividend-paying companies have lagged behind during the recent market advance. This happens when value is out of favor, as it has been for the past cycle. Awareness of this cycle of possible mean reversion reminds us to hold on to those boring value stocks, realizing that they will likely be the outperformers during the next cycle.

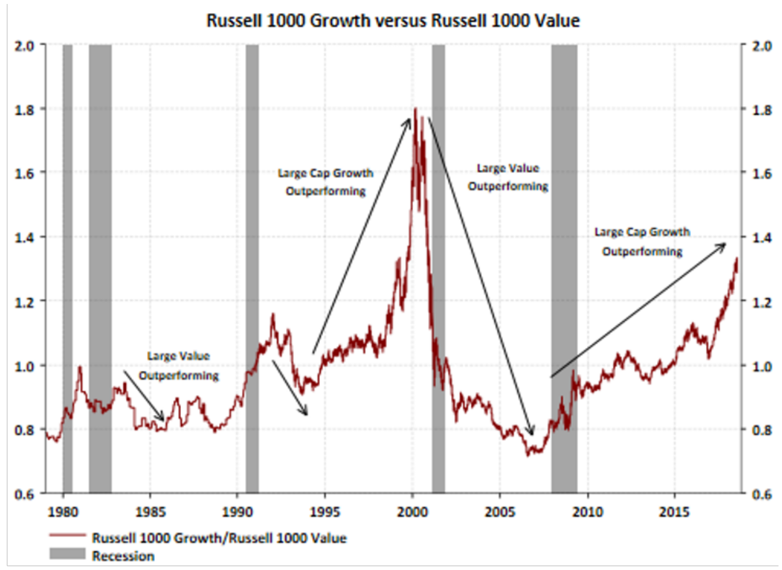

Chart 2. Growth vs Value.
Source: Thomson Reuters Datastream.

...the tendency of asset classes to revert to mean performance is one of the strongest observed trends in the market.

An example of mean reversion can currently be observed in the international markets. Charts illustrate the story best. Asset class outperformance (equities, fixed income/bonds, hard assets) generally runs in cycles, anywhere from ten to thirty years. Back ten years ago, investors had lost faith in the U.S. stock market, labeling it "The Lost Decade."

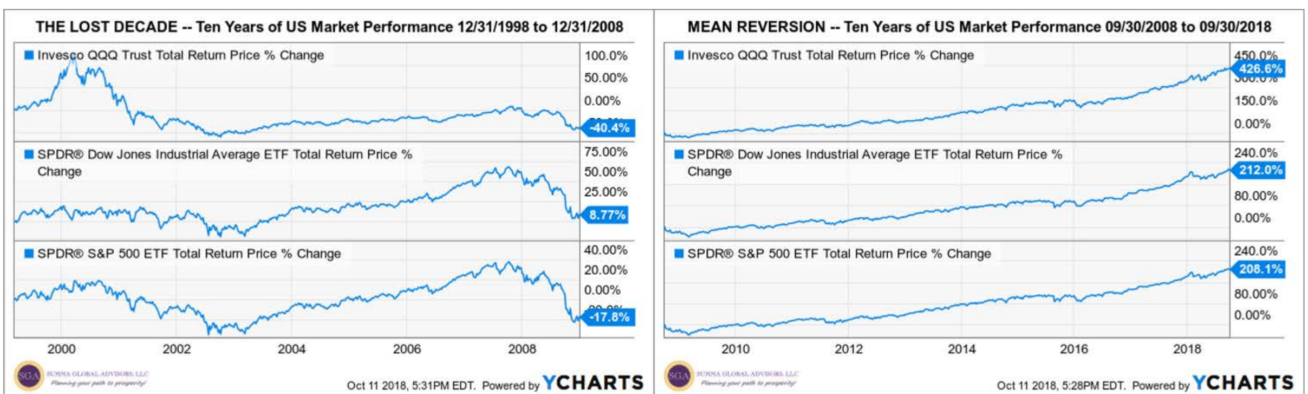

Chart 3. The "Lost Decade" of U.S. stocks and the subsequent decade of performance.
Source: YCharts.

While the U.S. market was in the tank, the international markets enjoyed nine years of comparative outperformance (Chart 4). Much was heard about a potential "decoupling" of the U.S. from the emerging markets. It was suggested that emerging markets would lead the world out of the great recession. As it happened, the U.S. market came roaring back as the emerging markets fell from grace.

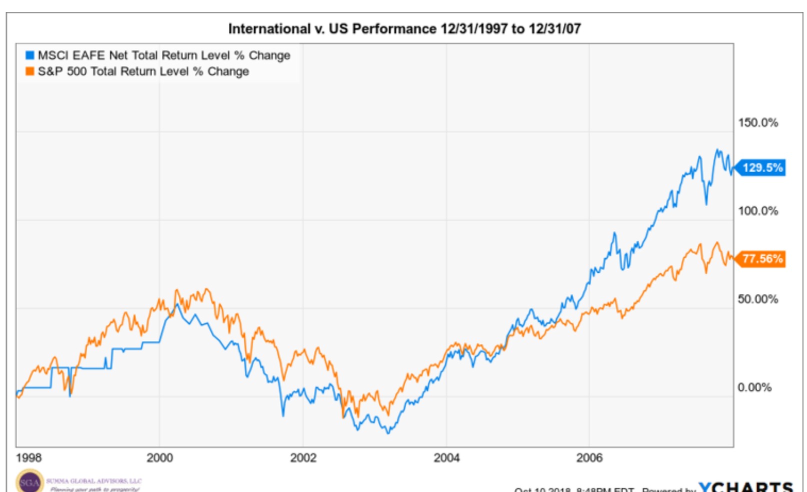

Chart 4. International Stocks vs. U.S. Stocks (1998-2007).
Source: YCharts.

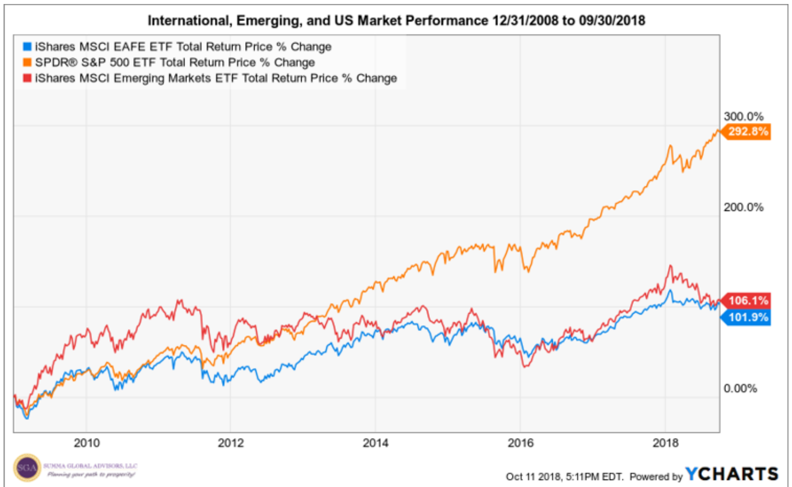

Chart 5. U.S. vs. International vs. Emerging Markets (2009-2018Q3).
Source: YCharts.

It was a process of decoupling indeed, but it was the U.S. that led rather than the emerging markets.

In hindsight, following these ten years of underperformance, one should have stepped up and purchased U.S. equities without abandon. It would have resulted in the following performance (Chart 5).

All of this data serves to remind us that the tendency of asset classes to revert to mean performance is one of the strongest observed trends in the market. Before you contemplate "throwing in the towel" on any specific investment, it is smart to closely review the long-term history of that asset class and determine two things: the average number of years the asset underperforms and whether future expectations will live up to past performance. It takes a brave investor to diversify into underperforming asset classes when our default is to stay with the winners rather than buying into the losers. Market leadership changes as economic cycles run their course. To stay with old winners is to miss out on the fantastic experience of riding former losers as they enjoy the mean reversion performance wave (Chart 6).

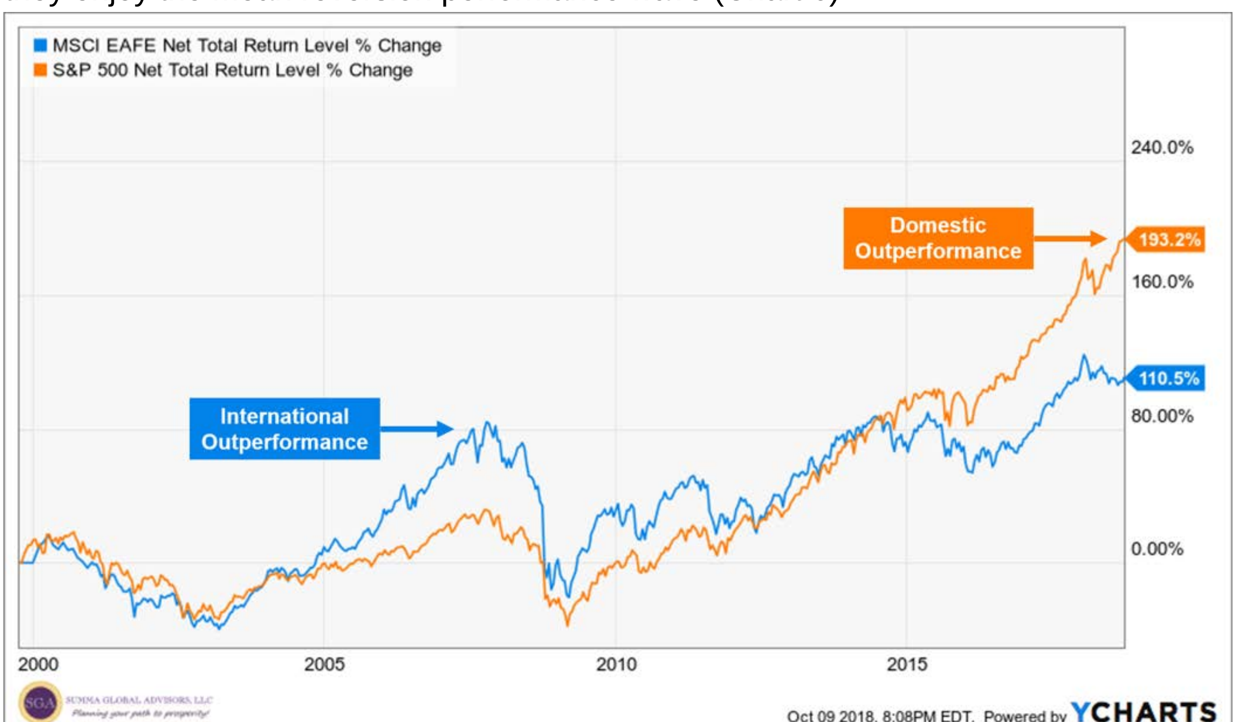

Chart 6. U.S. Stocks vs. International Stocks (1999-2018Q3).
Source: YCharts.

In a market full of noise – interest rates, currencies, tariffs, political unrest, global and domestic angst – one thing is certain. Although the international markets are down, they are certainly not out! With increased U.S. market volatility, value stocks have shown more resilience than growth stocks. Now is a great time to make sure your investments are adequately diversified in order to capture the upside as unloved asset classes revert to the mean.