

Every Excess is Self-Correcting

In his book *The New Contrarian Investment Strategy* David Dreman discusses the importance to investors of understanding the principle of "regression to the mean." He illustrates this concept in a discussion about a baseball player's batting average:

Although a player may be a .300 hitter over some seasons, his record is anything but even. The player will not get three hits in every ten times at bat. There are times when he will be batting .500 or more, well above his average (or mean), and others when he will be lucky to hit .125.

However, as Mr. Dreman goes on to explain, and baseball fans know, by the end of the season it is likely that his average will have regressed to the mean or his long-term average.

The principle applies to investing and the bond market serves as an excellent example. Long-term interest rates tend to move in extraordinarily long cycles. While the path was never smooth, long-term interest rates declined from the end of the Civil War to about 1900, then rose until approximately 1918, declined until about 1947 and then rose until 1981 only to decline erratically ever since. These are 30- and 40-year cycles with wide fluctuations around a more than 200-year mean of approximately 5.5%.

Most investors tend to place too much emphasis on their own immediate past experience and tend to forget the long-term average. Bond investors of the late 1970's and early 1980's thought that the then double digit rates had become a permanent fixture in our economy, although they deviated far from the past mean. In contrast, the bond investor of the mid 1940's expected to see the then existing 2-3% rates prevail into the future even though those rates were well below the historic norm.

The same case can be made for stocks in general where returns fluctuate widely around a 66-year average of 10.4%. High returns tend to generate expectation of continued high returns while low or negative returns are expected following a period of dismal results. The contrary seems to be true as there is always a tendency to regress to the mean.

Awareness of the regression to the mean principle can be helpful when analyzing the merits of individual securities. A highly profitable company begets expectation of continued high profitability. Yet, over time both internal and external developments chip away at the advantages of the company with abnormally high profitability. The opposite is usually true for companies in a profit slump. The low profit company gets new management, changes its focus, develops new products, or in some other way acts to raise its profitability. In both cases there tends to be a regression to the mean.

The principle of regression to the mean is an important aspect of our approach to investing. When making judgments about the bond or stock markets or individual securities we attempt to take advantage of what appear to be extreme deviations from the norm. Often that means going against conventional wisdom and purchasing that which is out-of-favor and selling when popularity seems extreme.

On the night that George Brett attained his 3000th career hit he went 4 for 5, batting .800 for the night. It is unreasonable to expect his performance to continue at that level. His average for the season will, in fact, come closer to his career average of .307. This principle is all too often ignored in the world of investments.

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