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Mean Reversion May Be Longer Than Your Life

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Title: The Time for Mean Reversion May be Longer Than Your Life

Investing for relative results is a fool's game. Unfortunately, it took a year like 2008 to jar investors into seeing what is wrong with "losing less."

The recent field of behavioral finance is most insightful, and it is gaining attention since Daniel Kahneman was awarded the 2002 Nobel Prize in Economics for his work in Prospect theory. Humans are not economic maximizers. We are herd animals, not rational calculating machines. In part, herd behaviors come from our distant heritage and do not fit the calculations of "economic man." The drive to belong pushes us to make relative comparisons. In investing, we do not want to be different, and so we measure our results against "the herd." Clearly we want to invest better than the herd, but being different from it produces both discomfort and risk. For investors, this is the "relative measurement trap." Even when we lose wealth, we seem to be "happy" if we lose less than the herd. This trap completely misses the point of what it means to invest towards building long term wealth in an absolute sense.

We believe that investors should focus on an absolute return instead of a relative return. We know we are attacking the long held industry foundations of buy and hold, historical asset class returns and relative results. Some may even criticize that switching now from a relative return to an absolute return strategy may look like a case of putting your money where it should have been. Such a switch now would only be a mistake if we were returning to a period of stock market friendly policies that produced immediate high returns on risk capital. On the contrary, the mood of the country and government has turned hostile towards wealth. The focus has shifted to spreading the current wealth around rather than producing more of it. Perhaps the year '08 compared to '80 is not merely the numerical opposite but the policy opposite. If we are in a period of sustained hostility to capital, it is important to break out of our automatic assumptions, biases and prejudices about investing. We must start from the basis of preserving and protecting capital. That means starting with an assumption of being fully invested in risk free assets rather than being fully invested in a risky benchmark, like the S&P500. Markets are not living things. They do not know they are oversold, undervalued or making a triple bottom, reverse head and shoulders pattern. Instead, market prices are footprints of government policy. If we are not satisfied with merely "hoping" that markets bounce back, then we must construct an investing framework to both preserve and grow capital based on policy. This is where investing with an absolute return framework across multiple asset classes, not just equities, can produce superior results. It not only changes the way investors construct portfolios, but it fundamentally changes one's thinking and orientation to the world. It changes the observer you are.

What is wrong with relative results?

Constructing portfolios and measuring portfolio performance in a relative results game is dangerous. It forces managers to "play" to lose less than their benchmark. In a year like 2008, a manager who lost "merely" a third of your money was a hero for beating the S&P benchmark by 400 basis points. In fact, managers who beat relative benchmarks by as little as 200 basis points a year become investment gurus. According to Morningstar figures, any diversified equity mutual fund that lost a "mere" 27% in 2008 ranked in the top 5% of all funds. Even with the benchmark suffering as it did, more than 60% of all funds did worse than the S&P 500. This whole idea of relative performance and playing to "lose less" is a fool's game. In the end, no manager should ever be praised for losing a third of their client's money. So then, how do we think about and measure an investment strategy?

An absolute return strategy

In a relative game, the default way of investing is to be fully invested in the benchmark. Managers depart from that fully invested posture at their own peril, running the risk of being "different" from the market. A relative game measures how well the manager does, but investors really should measure and reward their managers for how well the money does. To do this, investors should change their focus to an absolute return. In an absolute game the default is 100% invested in some positive, risk free rate of return as opposed to being 100% invested in the risky market benchmark. Since anyone can earn the risk free rate, or Treasury bill yield, that becomes the minimum hurdle rate any capital must earn. An investment in Treasuries would have no years of decline, have no default risk, provide instant liquidity, be subject to taxation, and be eroded by inflation.

Taking the T-bill return as the minimum, let's examine how one's money would have done returning the T-bill rate plus 100 and 200 basis points. The results are most surprising. As you see in the data below, except in those rare and wonderful decades when great policy collides with low market valuations (1980's), T-bills plus 100-200 basis points does very well. In the 1980's, a period of "as good as it gets," pro growth policies for stocks, an investment in the S&P 500 returned 404% (17.5% annualized) while an investment in T-bills returned 133% (8.8% annualized). A manager who earned T-bills plus 2, and this is very hard to do, returned 179% (10.8% annualized). So even if you failed to invest in the S&P during one of the best decades ever for stocks, you would have still more than doubled your money with a T-Bill return. Now let's look at a period of bad policy and down markets, opposite the 1980's. From 2000 to 2008 an investment in the S&P lost 31.5% (-4.1% annualized). An investment in T-bills returned 30% (3% annualized), and an investment in T-bills plus 2 returned 54.6% (5% annualized). Combining these two periods into a sample set of a great policy period and a bad policy period, the results are shocking. An investment made in the S&P 500 returned 245% (6.7% annualized) while an investment in T-bills plus 2 returned 331% (8% annualized).

	Total Return			
	S&P 500	T Bill	T Bill + 1%	T Bill + 2%
1980-1989 Good Policy Period	403.91%	132.29%	154.55%	178.72%
2000-2008 Bad Policy Period	(31.56%)	30.06%	41.88%	54.64%
Combine both periods	244.87%	202.11%	261.15%	331.02%

	Annualized Return			
	S&P 500	T Bill	T Bill + 1%	T Bill + 2%
1980-1989 Good Policy Period	17.55%	8.79%	9.79%	10.79%
2000-2008 Bad Policy Period	(4.13%)	2.96%	3.96%	4.96%
Combine both periods	6.73%	5.99%	6.99%	7.99%

How do we construct an absolute portfolio?

An absolute portfolio begins fully invested in Treasury bills as the default, rather than being fully invested in the S&P 500 as the default. From there, our investment process considers five other asset classes for investment: U.S. Equities, Fixed Income, Foreign Markets, Real Estate and Commodities. These asset classes compete to pull investment capital away from risk free Treasuries. Our process implements a top down, macro view focusing on government policy and economics to continually assess where investment capital will be treated best. In normal times these asset classes will be somewhat uncorrelated and provide a high level of diversification. However, in a collapse year like 2008 the correlations will rise as wealth flees all risky asset classes. In those times, our rigid and process driven sell discipline is essential to force capital into T-bills and out of risky asset classes. Rigorously making assessments in each of the five asset classes broadens both our thinking and our sources of future return.

What is the right benchmark for an absolute return strategy?

When constructing a benchmark, there are two important areas of assessment: 1. How has your manager done? 2. How has your money done? These two are always in conflict. Managers are paid to beat the benchmark, which is not the same as doing well with the client's money. Beating a relative benchmark is not good enough when you lose money on an absolute basis. Therefore, investors must change both the strategy and the benchmark. We think investors should use an absolute benchmark of T-bills plus 100-200 basis points. One may think this is an easy benchmark to beat, but history would suggest otherwise. Importantly, it avoids the safe, almost cowardly, posture of hiding behind a relative number. Fundamentally, it means that if we lose money we cannot "blame" the market and smugly report that we "lost less." We believe it is crucial to depart from this industry practice of hiding behind relative results. In doing so, we will achieve lower volatility while still producing strong returns.

Investors with a 50 -100 year time horizon may have long enough to wait for asset class returns to normalize around their historical averages. However, "mere mortals" with retirement looming should only focus on an absolute return for their capital. Although the market has returned 8% per year on average, there are no average years or average decades. Prosperity and equity friendly policies cluster. Returns may be mean reverting, but they are not random. Importantly, the time for mean reversion may be much longer than the rest of your life. The market does not know it is seriously undervalued or that it fell 50% in the last fourteen months. It is not a living thing nor does it know that it "owes" you a double on your investment capital. The market is simply a mechanism that prices future cash flows, and those cash flows are dominated by government policy. Do not fight the effects of government policy. Assess those effects across multiple asset classes instead of just using the S&P 500. Invest capital in those asset classes that are helped by government policies. Concentrate on absolute, not relative, returns. In the end, an absolute return strategy reminds us not to lose money, and that must be the first priority of any wealth building strategy.

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