MV Capital Management E-Update

Mean Reversion and Market Tectonics
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In finance we often talk about mean reversion, otherwise called central tendency or – less pretentiously – what goes up comes back down and vice versa. It's sort of a comforting thought to think that market excesses or anomalies correct themselves and revert to established long-term trends – maybe not comforting enough for money managers who have big bets on what happens next quarter, but certainly so for investors with long time horizons. Mean reversion is the time-tested antidote to the siren call of "this time it's different" that has plagued gullible types through exuberant manias from the Dutch tulip craze and South Sea Bubble of long ago through the 1960s-70s "Nifty Fifty" and of course the more recent the Internet boom.

In a sense mean reversion is the victory of the practical center. Imbalances in the market self-correct and so, apparently, does our political system. Last week's midterm elections in our opinion were mostly about mean reversion. This was neither a triumph nor a repudiation of any ideology *per se*. Americans are pragmatic, and fortunately we have a robust system of governance through which to exercise our pragmatism, just as we have a robust financial marketplace to shake out the excesses.

Another American trait is dynamism – nothing ever stays the same. Short-term anomalies revert to the mean over time, but that long-term mean itself is subject to an evolving underlying structure – much in the way that geological tectonic plates shift under our land masses and oceans. And just as shifting plates sometimes cause tsunamis or the San Andreas Fault, occasionally our shifting economic and socio-cultural and geopolitical plates produce disruptive changes. We are not talking here about short-term X-factors but rather tendencies that develop and affect market performance over the long term.

For example – the stock-price bubble of the late 1990s was driven by a short-term overreaction to the economic prospects of any company that bore the sexy 'dot-com' appellation. That was an X-factor, an irrationality. But the Internet itself brought about a resounding tectonic collision that continues to exert a profound impact on our lives in ways that are still being assimilated.

It's quite interesting, actually. Back in 1999 there were two camps. The contrarians said that all those wild-eyed predictions of exploding bandwidth usage and "eyeballs" and wireless 24/7 Internet and all the rest would never come to pass, let alone in the five-year time frame so many of the studies were predicting. The exuberant cheerleaders said – not only will these predictions come true, but all these companies like JDS Uniphase and Pets.com will be worth a zillion times what they are now (even though they were already worth a zillion times more than stocks in any "old economy" sector back in those heady days).

As it turned out, both camps were wrong. The contrarians badly underestimated the extent to which Internet usage would explode. If anything, most of those studies back in the late '90s actually underestimated the extent to which the technology would be so pervasively adopted in just about any part of the world where it is available, and through so many different devices using various wireless and fixed-line communications. But the Pollyannas *overestimated* the extent to which this explosive growth would actually benefit the market value of companies that were already trading at astronomical P/E ratios. In other words – both the dynamism of 'market tectonics' and the discipline of mean reversion were at work and on display.

Now, there are minor localized tectonic shifts where a couple plates collide and then there are fundamental rumblings that ripple out across the world – perhaps we could call these supercollisions. In our opinion the big supercollision of the past twenty-odd years has been globalization, and its effects will continue playing out for many years to come. As always, we at MVCM have to figure out how to distill the fallout from these changes into winning strategies for our clients – but to do so in a disciplined way that avoids the overexuberance of the 'this time it's different' syndrome.

International markets are heading towards another strong close in 2006. The MSCI EAFE index is up over 20% for the year as of November 10, some 8% or so above the S&P 500. Emerging markets, after falling precipitously during the mini-correction in equity markets back in May and June, have recovered and also appear set to return a decent premium over US stocks for the year. The largest initial public offering (IPO) in history took place in late October – for the Industrial & Commercial Bank of China, to the tune of $21.9 billion. Incidentally, that figure surpassed the previous IPO record of $18.4 billion – set by Japanese mobile telephone operator DoCoMo.

And yet – international as an asset class continues to represent a modest percentage of most US-based asset allocation strategies. There are many reasons for this but one, in our opinion, involves a mis-pricing of risk. In other words, the structural plates are shifting but the evolving outcomes are not yet reflected efficiently in portfolio strategies. You can expect to hear a lot more about this from us in the coming months. These are interesting times.

With warm regards,

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