

# return to average

## Reversion to the mean can still, surprisingly, take investors by... surprise

Sports fans are familiar with what is often referred to as the Sports Illustrated cover jinx.

It is rumoured that teams or athletes who appear on the front cover of S.I. are doomed to underperformance and bad luck.

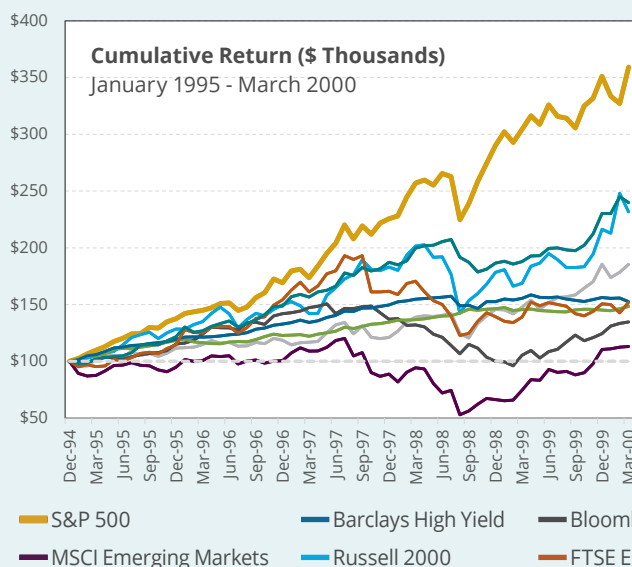
- Pete Rose's impressive 44-game hitting streak came to an end the same week he appeared on the cover.
- In late 2003, the Cubs and the Red Sox appeared on the cover and both teams went on to suffer dramatic collapses in the playoffs.
- In March 2016, Oklahoma guard Buddy Hield, who averaged 29.3 points per game, appeared on the cover hyping Oklahoma in the Men's Final Four. The Sooners were blown out by the Villanova Wildcats 95-51 as Hield was held to just 9 points.

The explanation is what psychologists refer to as **mean reversion**, or the tendency to move toward average over time. Investors would be wise to understand that excesses of all kinds are never permanent.

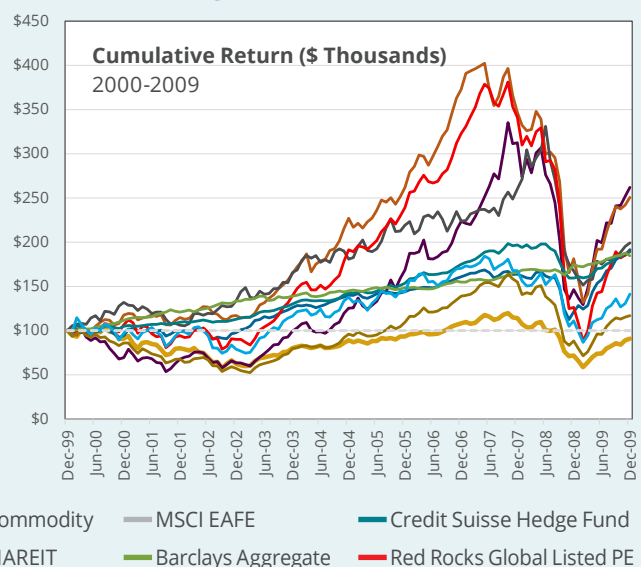
The impact of regression to the mean can be felt at least as dramatically on Wall Street as it can on a sports field, although it is little understood by the average investor.

With investor sentiment as muted as it is today, it can be hard to conceive of this as a time of excess or "irrational exuberance." However, data suggests that broad market equity valuations are in the top historical quartile relative to history.

The S&P 500 was the dominant index in the late 90s...



Leading into the "Lost Decade"



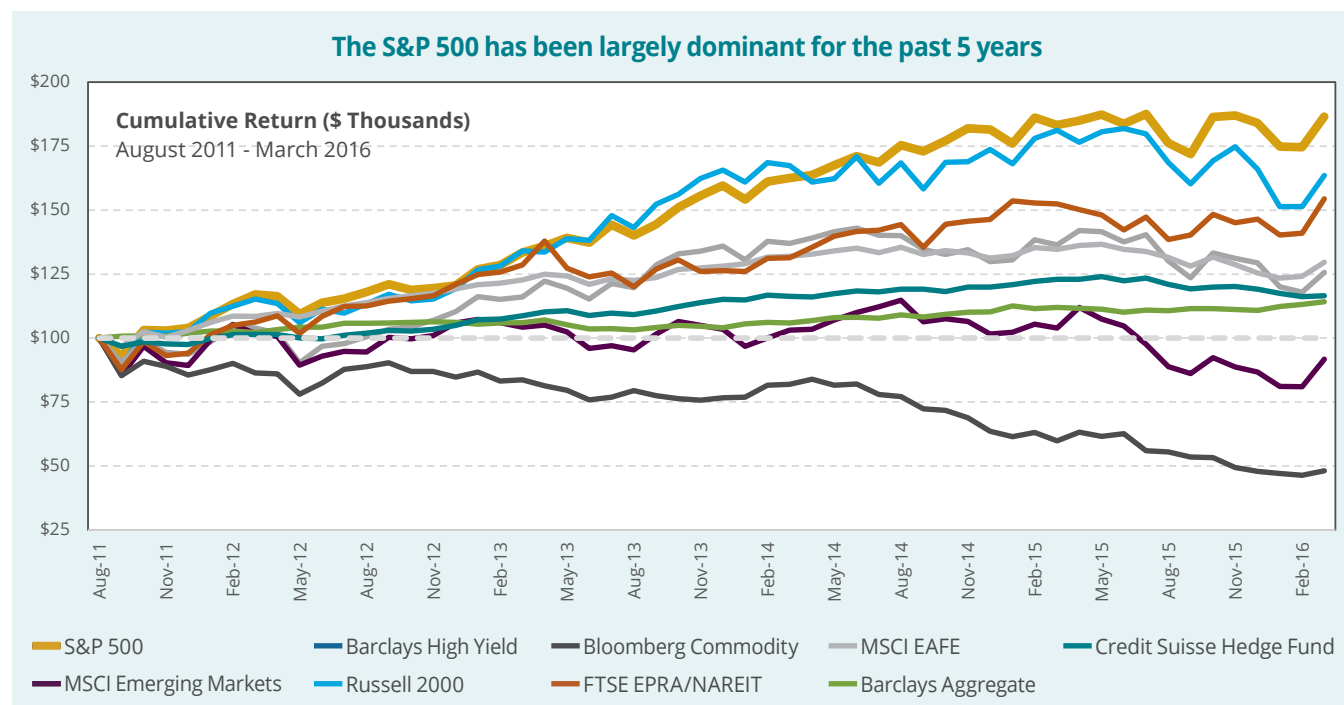
Source: FactSet

The “Lost Decade” was named because investors in large capitalization U.S. stocks (e.g. the S&P 500) would have realized losses of 1% per annum over that 10-year stretch. But the fact is that those who were evenly diversified across five asset classes (U.S. stocks, foreign stocks, commodities, real estate, and bonds) realized a respectable annualized gain of 7.2% per year.

We are now seven years into a market where the S&P 500 has outperformed nearly everything,

much as it did in the 90s. And while the returns of passive, mega-cap U.S. indexes have helped investors recover from the damage of the Great Recession, this sort of success tends to sow the seeds of future underperformance.

Just as the returns of the 90s set the stage for the Lost Decade, it seems reasonable to suppose that U.S. megacaps will underperform based on the idea that “excess is never permanent.”



Source: FactSet

### So what happens next?

If history is to repeat itself after this period of outperformance, what can investors do?

At Brinker Capital, we believe the answer lies within a program of multi-asset class investing. In many ways we find ourselves at a time where, like the 90s, passive equity investing has made anyone holding an index fund look like a genius while those in diversified portfolios have experienced more tepid growth. Investors would be wise to consider the protection offered by broad portfolio diversification when a trend inevitably comes to an end.

Brinker Capital has adhered to a multi-asset class investment philosophy since 1987. To us, diversification is more than a theory, it's the idea behind everything we do.

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