THE HARDEST INVESTING QUESTIONS TO ANSWER

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A WEALTH OF COMMON SENSE
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Regression to the mean has to be one of the philosophical underpinnings of any decent investment strategy.

Since nothing works all the time, you have to be willing to bet that the good times won't last forever, but neither will the bad times. Using this framework to guide your actions allows you to lean into the pain when things aren't going well and avoid getting overconfident when things are going gangbusters.

In theory, regression to the mean explains the reasoning behind the oldest investment advice in the world—buy low and sell high. Essentially, regression to the mean is the idea that markets are cyclical.

If market cycles and regression to the mean exist, why is it so difficult to predict what transpires in the markets?

Peter Bernstein tackles this one in his classic *Against the Gods: The Remarkable Story of Risk.*[1]

> *The simplest answer is that the forces at work in nature are not the same as the forces at work in the human psyche. The accuracy of most forecasts depends on decisions being made by people rather than by Mother Nature. Mother Nature, with all her vagaries, is a lot more dependable than a group of human beings trying to make up their minds about something.*

Unfortunately, it's easier in theory than reality.

Bernstein lays out three reasons regression to the mean can be such a frustrating guide to the investment decision-making process:

1. Sometimes it happens at such a slow pace that any shock to the system can disrupt the process.
2. Sometimes the regression happens so swiftly that it overshoots to the upside or downside.
3. Sometimes the mean itself is unstable, meaning yesterday's normal can be replaced by a new normal if something has changed within the system.

In summation—investing is hard.

Because the markets operate in this manner, here are some of the hardest questions to answer as an investor:

Am I being disciplined or stubborn? This is what every fundamental value investor in the world is asking themselves right now as growth stocks continue to pummel them at every turn. It's easy to have conviction in a strategy when looking at a backtest, but living through underperformance in real time sows the seeds of doubt.

What if the world has changed forever? What if the stuff that worked in the past doesn't work in today's world? What if there's a thin line between discipline and delusion when investing?

Cliff Asness once said, *"If you have a three year period where something doesn't work, it ages you a decade. You face an immense pressure to change your models, you have bosses and clients who lose faith, and I cannot explain the amount of discipline you need."*

The problem is we never know the answer to this question until after the fact.

Am I being foolish or staying ahead of the curve? History is littered with bubbles brought about from technological innovation.

There was a railroad bubble in the 1800s. Hundreds of new car companies were created when the automobile first hit the scene, but only a handful of automakers survived. The Roaring 20s that led to the Great Depression were littered with exciting new technologies. The dot-com bubble of the late 1990s will go down in history as one of the greatest manias of all time.

The people who bet on these technologies ahead of time made oodles of money (assuming they had the wherewithal to take some money off the table at some point). Those who showed up to the party late lost their shirts.

The problem is, in the moment, it's nearly impossible to tell the difference between a true paradigm shift and a situation where people are simply looking to get rich in a hurry because prices are going up.

How useful is market history? Investing involves some combination of studying the past, understanding the present, and setting expectations about the future. But, the past can often act as a crutch if you assume history will always repeat itself.

Market history is a much better guide when it comes to predicting risk than returns.

The past can help provide context and perspective, but never a roadmap. We really only have 100 years or so of market data to work with. As much as we would like to believe we've seen it all, 2020 is a good reminder things that never happen tend to happen more often than you think.

What if it really is different this time? In 1933, John Templeton said, *"The investor who says, 'This time is different,' when in fact it's virtually a repeat of an earlier situation, has uttered among the four most costly words in the annals of investing."*

My counter to this argument is that it's different *every* time. Markets and investors incorporate the knowledge we have about the past. Memories help shape the way we view markets.

People thought they had a generational buying opportunity in 1930 after the stock market fell 50% from its highs. It would go on to fall an additional 70% from those levels before bottoming.

By the time the Dow regained its 1929 highs by the mid 1950s, the people who had witnessed the Great Depression assumed another top was imminent. Instead, the market would go on to double over the next decade.

There are countless examples in which people believed they had "seen this movie before and know how it ends," but were instead greeted with an M. Night Shyamalan-style twist they never expected.

Do I have enough? This question is difficult because having enough for today says nothing about having enough for the future.

Financial planning is a process more than an event, because the outcomes are determined by the sequence of returns, spending levels, market performance, economic growth, healthcare costs, tax rates, and the inevitable curveballs life throws at you on a regular basis.

There are no easy answers. The only sound advice when dealing with irreducible uncertainty about the future is to focus on what you can control.

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[1] I'm reading this book for the second time, since it's been well over 15 years since the first time I read it. It holds up. One of the best finance books ever written.