

Take a Bumpy Ride Through the Mean Streets

By Whitney Tilson

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When it comes to investing, following the crowd is a recipe for mediocrity, or far worse. As the hedge fund manager Michael Steinhardt put it, the key is having a “variant perception”, an opinion about a company’s prospects that differs – rightly, of course – from the conventional wisdom.

The market’s tendency to swing between over-optimism and excessive pessimism about the prospects of a particular sector or company is one of the fundamental inefficiencies superior investors can exploit. In other words, betting that things are not as bad – or as good – as they appear at the moment is not only sensible but profitable.

It is also not easy. “The most common comment I get from investors about some of the stocks I buy is ‘Don’t you read the newspaper? Because if you did, there’s no way you’d buy these stocks’,” says Richard Pzena, whose successful Pzena Investment Management manages more than \$20bn for institutional and mutual fund clients. Yet Pzena has made his investors billions by betting on what researchers have termed “reversion to the mean” – the well-documented tendency for extreme observations to regress over time toward long-term averages.

Alliance Capital’s Bernstein Investment Research and Management studied companies in the S&P 500 from 1990-2003 to identify how many had sustained 25 per cent annual earnings growth. By the fifth year, 12 made the cut and by year nine, zero. Even increasing earnings by 10 per cent a year was difficult: only 22 companies grew at that rate after five years and only one, Walgreens, made it the entire 13 years.

The evidence for mean reversion is equally compelling with respect to stock prices. One study by professors Werner DeBondt and Richard Thaler formed theoretical portfolios of stocks in two-year intervals based on company stock prices in relation to book value. In the four years prior to each portfolio being formed, the lowest price/book stocks underperformed the market by a whopping 26 per cent. Yet in the four years after the portfolios were formed, the low price/book stocks trounced the market by 41 per cent. The highest price/book stocks, which beat the market by 76 per cent in the prior four years, returned 1 per cent less than the market over the next four.

There is considerable logic behind mean reversion. Successful companies attract enthusiastic investors as well as aggressive competitors. As competition hits growth and margins, investor enthusiasm wanes and share prices come under pressure. Conversely, troubled companies do not stand still. “If there is overcapacity in the industry, they take

out capacity. If the sales effort isn't working, they try to change things. Most of them succeed in making things better," Pzena says.

The challenge for investors is that the gravitational pull on stock prices and company performance does not happen in a straight line or with a "typical" pace. Turnarounds of troubled companies can be painfully slow to develop, often testing the conviction of even the most resolute contrarian.

A perfect example from my portfolio is Lear, one of the largest manufacturers of automotive seats and interior components in the US. The stock was the worst performer on the New York Stock Exchange last year and, after closing at \$16.67 on Monday, is down another 41 per cent this year.

Lear's entire sector is highly distressed and many fear General Motors, Lear's largest customer, will soon file for bankruptcy.

So why on earth would anyone want to own Lear's stock? Very simply, I think Lear is a good company – in a terrible industry, to be sure – and the stock's sell-off is way overdone. Over the past 10 years, Lear has consistently generated returns on tangible capital of more than 25 per cent and earned more than \$5 a share in both 2003 and 2004. The stock is trading at three times that level of earnings today.

Of course, earnings have been dismal over the past year and many question whether they will revert to anything close to the prior mean. But even if earnings only rebound to half their historical levels, the stock is likely to double from here.

I believe that most, if not all, of the factors that have caused Lear's profits to tumble will go away over time. Rising commodity prices have squeezed margins but Lear should eventually be able to pass such cost increases on to customers. The unusual number of customer platform starts, which crimp Lear's margins during the first 12-18 months, will decline. New suppliers coming on line will allow Lear to cut back on capital expenditures. The company is also being disciplined about renegotiating unfavorable legacy contracts with its customers.

In short, Lear will revert to the mean and my patience will be rewarded. It may not be a smooth ride but no one said uncovering hidden value was easy.

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