

Box Office Bingo

Why trends in movie revenues look like the stock market.

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In early 2005, movie box office revenues set a record with 19 straight weeks of revenue decline from the previous year. In 2004, however, movie blockbusters set new revenue records almost every weekend! After 2004's record-breaking revenue, many were tempted to predict a continuation of that trend. But 2005 has provided an important lesson in the Principle of Mean Reversion, a statistical theory proving a very basic concept: extremes won't last.

You can see mean reversion at work in weather trends, driving speeds, or even moods. But many investors ignore this principal and assume a positive trend line is indicative of a "new era." Remember the dot-com bust a few years ago? Hindsight showed us rather than ushering in a new era, the dot-com industry's whirlwind returns were followed by corrections resulting in long term returns closer to the mean. Investors who don't believe in mean reversion often try to time the market, thinking they can move in and out of positions at just the right time and improve upon the returns of those investors who simply buy and hold their positions. However, history supports statistical principles, and illustrates the real winners are those who buy and hold.

But what about all those financial professionals who claim they can beat the market? Someone has to be able to do it, right? Well, historical data shows an investor would have to be right 71% of the time if they try to time the market to get the same return as a buy and hold strategy (Investment Management Council, 1993). When investors believe -- like those in the movie industry -- upward growth will always occur and ignore the inevitable reversion to the mean, losing money on an investment becomes a likely outcome.

Knowledge of the normal curve tells us 67% of all values lay within one standard deviation of the mean and 33% are outside one standard deviation. Since half of that 33% is below the mean, "record breaking" returns can only be expected 16% of the time. Many investors, however, ignore this simple statistical truth, and expect nothing but the best 16%. To come out ahead, an investor needs to understand the nature of the market. A wise investor will commit to buying and holding investments as the market fluctuates rather than attempt to predict which way the market will go and time transactions accordingly.

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