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Forecasting Folly

In March 2009, the S&P 500 Index reached its bear market low point of 667. Just in case you forgot how you were feeling during those demoralizing days, here's the cover of *Time* magazine's March 9, 2009 issue that was on newsstands during the week that investors' fear, panic and dread were at their maximum. Long-term optimism was nowhere to be found and according to *Time*, there was just one thin thread of twine between you and the Jaws of Hell.

Then, for no apparent reason, the stock market reversed direction and began the best rally that any of us has seen or is likely to see again. On September 15, 2017 the S&P 500 Index reached 2500 for the first time. Since that demoralizing *Time* cover made its appearance, the S&P 500 has yielded an average annualized return of 17.5%. In order to receive the long-term returns of the stock market, investors must learn to withstand uncomfortable drawdowns that might take years to recover. Investors who ignored the pessimists (who gained their 15 minutes of fame during the financial crisis) and invested in a diversified portfolio of stocks have reaped the rewards of their optimism.

The achievement of 2500 in the S&P 500 isn't the only good news of late. The index has risen in each of the last eight quarters, is up 12.5% year to date through the end of September and set new all-time highs in each of the first four trading days of October. This exceptional performance can be attributed to several factors. The economy has been expanding slowly but steadily since 2009, unemployment and inflation are low and interest rates have barely budged above minuscule levels. Corporate earnings and dividends, which are driven primarily by economic growth, have been boosted by the tailwind of global economic growth. According to the International Monetary Fund, global economic growth this year has been the broadest since 2010 and it raised its forecast for growth for 2017 (better late than never I suppose) and 2018. Just to put icing on the cake, US household net worth in the second quarter of this year reached an all-time high. One would assume that this happy news would be cause for rejoicing among the investor class. But alas, no. It has been accompanied by almost universal skepticism, doubt, fear and hand wringing.

Despite what you may be led to believe by the financial media or financial pundits, new all-time highs in the stock market are not precursors of an imminent decline. Let's look at monthly return data for the S&P 500 Index from January 1926 through December 2015 (1,081 months). If we randomly select any month in these 90 years, the index produced a positive return over the next 12 months 75% of the time. In the 319 months in which the index ended the month at a new all-time high, it produced a positive return over the next 12 months 81% of the time. As the holding period increases, the probability of realizing positive returns in a broadly diversified stock portfolio increases – regardless of current levels. That's why it's important to have a portfolio allocation that you can stay committed to over the long term.

A repeating theme in the financial media this year, one that has increased investor anxiety, is the assertion that we are living at a time when uncertainty is on the rise. But this clever phrasing fools us. The uncertainty of life is a totality, it cannot be modified by the words "more" or "less". We want to believe that there is someone who can predict the future and protect us from the uncertainty and randomness of geopolitical and economic events. Deep down inside we know that no one can do this but like moths to a flame, we are attracted to "experts" who claim to know what lies ahead. "Expert" forecasters who spout predictions about the economy, the stock market and the direction of interest rates work in every level of government and in many corporations. They infest the financial media; pontificating confidently as they peer into the unknowable future. Newsletters containing market forecasts are sold to gullible subscribers. The forecasting charade has become so ludicrous that there are people who publish consensus forecasts of the forecasters. The sheer number of forecasters is proof that no one forecaster possesses the insight that investors are seeking.

There are innumerable bad forecasts and most are quickly forgotten. Given the large number of forecasters, a few will make accurate calls through luck alone, achieving notoriety and keeping the forecasting sham alive. The media eagerly provides a microphone for anyone whose last forecast happened to be reasonably accurate – whether lucky or prescient, it matters not. But random chance is a heartless taskmaster. Few will repeat their success and their 15 minutes of fame will soon end. Uttered without Divine inspiration, these predictions reveal more about the forecasters than the future.

The inability of forecasters to exceed coin flipping accuracy is an old story. The article: Can Stock Market Forecasters Forecast?, by Alfred Cowles was published in the July 1933 issue of the economic journal, *Econometrica*. Cowles presented the results of his analysis of the forecasting efforts of 20 insurance companies, 16 financial services firms and 25 financial publications which attempted either to select stocks which would outperform the market or predict the future movements of the stock market. He analyzed data from January 1, 1928 through July 1, 1932. In Cowles' summary he stated – *"the most successful records are little, if any, better than what might be expected to result from pure chance. There is some evidence, on the other hand, to indicate that the least successful records are worse than what could be reasonably attributed to chance…this would seem to indicate that, in general, these stock market forecasters failed to accomplish their objectives."*

Fast forward 84 years and we discover that Cowles' conclusions are no different than studies done today using a much larger database. A new contribution to the evidence of the inability of forecasters to see the future is the academic paper: Evaluation and Ranking of Market Forecasters published this past May. The study focused on more than 6,600 forecasts for the S&P 500 Index made by 68 forecasters from 1998-2012. The forecasters employed various technical, fundamental and sentiment indicators to generate their forecasts. The forecasts were graded by comparing them to the performance of the S&P 500 Index one month, three months, six months, and 12 months after the prediction.

The authors found that the average forecaster's accuracy was 48% – less than a coin flip. Two thirds of forecasters had accuracy scores less than 50%. The highest score was 78% and the lowest was 17%. The authors of the study noted: *"the distribution of forecasting accuracy is very similar to the proverbial bell curve, implying that the outcomes are due to randomness."* When outcomes are randomly distributed, it's difficult to tell if any of the forecasters demonstrate real skill. Some of the better-known forecasters whose accuracy trailed coin flipping were media darlings Bob Brinker, Jeremy Grantham, Marc Faber, Jim Cramer, Gary Schilling and Robert Prechter.

For reasons I have never understood, people like to hear that the world is going to hell and investors seem to be attracted to "the market is about to crash" predictions. An unspoken assumption in all such prophecies is that only the prognosticator can see what's about to happen; all other investors being blind to the truth. Pessimistic forecasts attract more attention than optimistic scenarios because we have such an aversion to losses. Pessimism screams, "You Must Do Something Now!" while optimism whispers "this too shall pass." Folks in the media don't care a whit about you. They'll do whatever is necessary to keep you tuning in and nothing attracts eyeballs, ears and clicks like predictions of financial Armageddon. The financial media is the mortal enemy of every financial advisor who is trying to help clients reach their financial goals. We must keep assuring our clients that things aren't as bad as they fear. Each new all-time high in the stock market is an exclamation that, once again, the pessimists were wrong. I believe that investors who maintain a positive investment outlook will be rewarded for maintaining an optimistic view of the future.

I remain bewildered that so many people in the investment advisory business wallow in the shallow and brackish pool of market forecasting. Forecasters serve no purpose beyond self-promotion, provide no value and lead gullible investors astray. The future holds an infinite number of possibilities and the years ahead are sure to be challenging. The poor track record of forecasters is of no consequence to long-term investors -- who can safely ignore them. There would be fewer forecasters if we held them accountable for their erroneous predictions and the financial damage done to their disciples. Unfortunately, bad forecasts are soon forgotten and forecasting remains a staple of financial journalism. This sad state of affairs is unlikely to change any time soon.

It Was 30 Years Ago Today

October 19th marks the 30th anniversary of the largest one-day stock market percentage decline in history - 22%. At the close, the Dow Jones Industrial Average stood at 1,738. Surprisingly, I remember it only vaguely. Many people who give financial advice for a living today don't remember it at all – they were watching Sesame Street. I'm sure the talking heads were predicting the imminent end of the world. But the world didn't end and Thanksgiving wasn't canceled. Soon thereafter, the Soviet Union collapsed and the Berlin Wall came down. And the free enterprise system has been expanding around the world ever since.

The Apocalypse du jour will always be with us – North Korea, hurricanes, tsunamis, financial crisis, high oil prices, low oil prices, wars, rumors of war, trade deficits, inflation...etc. There's no way to create a rational investment strategy out of an Armageddon scenario. Problems come and then, somehow, they go and the world does not end. And this is how it will always be, as long as we have problem solvers who turn imminent disaster into events barely remembered.

As I write this, in the middle of October 2017, the Dow Jones Industrial Average stands at just above 22,700 - a compounded rate of return, excluding dividends, of 8.9% since that demoralizing day. It's impossible to be a successful investor if you are afraid of the future. Facing the future with optimism and courage. It's as important today as it was 30 years ago.

If It Sounds Too Good to Be True…

HBO's *Wizard of Lies* is a fascinating look at Bernie Madoff's Ponzi scheme, featuring Robert DeNiro in the title role. A Ponzi scheme is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by investors. With little or no legitimate earnings, Ponzi schemes are sustained by the flow of money from new investors. They tend to collapse when it becomes difficult to recruit new investors or when a large number of investors seek to cash out of the investment. Madoff stole more than $17 billion from amateur investors, professional investors and financial advisors who should have known better. Madoff asserts that banks and hedge funds were complicit in his Ponzi scheme: "They had to know. But the attitude was, 'If you're doing something wrong, we don't want to know.'" Some investment firms abandoned their fiduciary responsibility to clients by failing to do due diligence on Madoff's operation. They must have been suspicious that all was not on the up and up. But when you promise clients market beating returns, perhaps you don't want to look too closely at how the sausage is being made.

Here are some noteworthy red flags that were flapping in the breeze throughout Bernie Madoff's scandal that went unnoticed and that serve as warning signs to anyone who is being pitched an investment that seems too good to be true.

- **There is no independent custodian.** There is no reason for any investor to allow funds to be held by the person or firm investing their money. Invested funds should be held in accounts at independent financial firms, brokers or banks that allow the client to have access to, and management over, their funds. Custody holders such as Charles Schwab, Fidelity, Vanguard and TD Ameritrade provide independent, secondary verification of the status of invested funds through monthly or quarterly statements.
- **There is no independent auditor.** Public companies are required to undergo periodic audits and investment advisers who maintain custody of client funds or securities are required to undergo an annual surprise exam by an independent public accountant. Ideally, the audit should be conducted by a well-known firm in the accounting industry. If the firm conducting the audit is related to, or owned by, the firm it is auditing, this would be a major conflict of interest.
- **Unregistered investments.** Financial frauds typically involve investments that have not been registered with the SEC or with state regulators.
- **Unlicensed sellers.** Federal and state securities laws require investment professionals and their firms to be licensed or registered. Many financial frauds involve unlicensed individuals or unregistered firms.
- **The investment strategy isn't clear.** Investors should understand where their money is invested and the general strategy behind the investment. When answers are not provided for basic questions about investment strategies, something is usually wrong.
- **Returns are not volatile.** Let's face it, no one invested with Madoff to receive the return of Treasury bills. Risk and expected return are always correlated and if you're expecting returns greater than what the market freely offers, you must take more risk and must expect higher volatility. High risk investments never go up in a straight line because no investment manager or strategy is perfect and mistakes will be made. Be wary of any investment that continues to generate regular, positive returns regardless of market conditions.
- **Promised returns are too high.** You should be wary of any promised return that exceeds the expected return of similar liquid investments because market returns are all that are available and must be shared by all investors. Consistent returns greater than what similar, liquid investments are yielding is a red flag. Investors aren't innocent in all of this. They're the ones clamoring for unrealistic gains. Shady advisors and fund firms are more than happy to fill that demand. Hey, who needs diversification when you've found a goose that lays golden eggs?
- **Many financial scams rely on personal relationships.** The promoter of the fraud generally interacts directly with investors. Trusting someone who would "never cheat you" can cause you to ignore the red flags flapping in front of your nose.

Too many people invest their hard-earned retirement dollars in investments they don't understand on the advice of people they barely know, all the while hoping that they won't be cheated. Regardless of past performance or reputation, no money manager or investment strategy can consistently provide market beating returns. Wealth accumulation is a long-term activity, a byproduct of deferred gratification, proper asset allocation and attention to costs. It's slow-but-steady wins the race venture that rewards investors who fund and rebalance their retirement accounts every year, regardless of the headlines.