Oliver's INSIGHTS

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Why investors need to treat forecasts with caution

Key points

- The increasing noise around investing – associated with a messier economic and geopolitical backdrop along with an explosion in information flow and the rise of social media – is arguably accentuating a desire for investment experts, or influencers, to show us the way with forecasts.
- But while forecasts are often seen as central to investing, they should be treated with caution and are no substitute for having a disciplined approach to investing.
- The real value in investment experts – at least the good ones – is to provide an understanding of the issues and to put things in context to help avoid making silly mistakes

Introduction

One criticism of the latest Reserve Bank of Australia decision, its use of forecasts and an assertion that "they're no better at it than the private sector astrologists at major banks masquerading as so-called 'market economists'" got me thinking. What exactly has this person (who is also an economist) got against astrologers? Ever since I heard about the dawning of the age of Aquarius I knew there was something in it.

What's more though, it reminded me of the importance of investors having an awareness of the pitfalls of relying on forecasts. There is nothing new in this and I have written about it several times over the years. But its particularly relevant given the increasing frequency of economic shocks, rising political polarization, climate worries and geopolitical stress globally at a time of increasing access to information and prognostication via social media. So, this note is an update.

Economic and investment forecasts are useful to communicate a view, for the construction of budgets and as a base case against which to assess risks and formulate economic policy. But relying too much on precise forecasts can be dangerous. It was amply demonstrated with forecasts for the oil price on the back of the US/Iran War this year, but its not new.

If forecasting was easy, we might have retired to the south of France to sip champagne…

…well actually other things too! But we would be very rich and I wouldn't be writing about this. The difficulty in economic forecasting is evident in the long list of jokes about economists. Like these:

- Economists exist to make weather forecasters look good.
- An economist is a professional paid to guess wrong about the economy.
- An economist will know tomorrow why the things she or he predicted yesterday didn't happen today.
- Three economists went target shooting. The first missed by a metre to the right, the second missed by a metre to the left and the third exclaimed "we got it!".
- A mathematician, academic economist and a market economist are asked to find a black cat (that doesn't really exist) in closed room with no lights. After an hour in the room, the mathematician goes crazy and is taken to hospital. The academic economist exits the room and says he is unable to catch it but has modelled its moves precisely. The market economist screams out after 30 minutes he has it by the neck.
- Economic forecasting is like driving blindfolded with instruction from a person looking out the rear window.
- Economics is the only field in which two people can share a Nobel Prize for saying the complete opposite.
- For every economist there exists an equal and opposite economist.
- Economists have predicted six of the last two recessions.
- There are two classes of forecasters: those who don't know and those who don't know they don't know (J.K. Galbraith).
- Forecasts create the mirage the future is knowable (Peter Bernstein).
- An economist and an astrologer are arguing about their subjects. The astrologer says, "Astrology is more scientific. My predictions are right about half the time. Yours can't even reach that." The economist replies, "That's because of external shocks. Stars don't have those."
- It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so (Mark Twain).

As my first manager kept telling me, "forecasting is difficult because it concerns the future".

The psychology of forecasting

Economic and investment forecasts need to be treated with care:

- Forecasters, like everyone, suffer from psychological biases: the tendency to extrapolate the current state of the world; the tendency to look for confirming evidence; the tendency to only slowly adjust to new information; and excessive confidence in their ability to forecast.
- Even when forecasters break from the pack and predict some sort of mean reversion resulting in great boom or bust getting the timing right can be hard because structural breaks from trend don't occur that often and can be impossible to predict in advance. What's more a free and liquid asset market incorporates the judgement of many so why should an individual forecaster be better than the market. And in any case rules of logic often don't apply. Sometimes the market sets sensible share prices based on economic and business developments. At other times it is unstable, swinging from years of euphoria to years of pessimism. Trying to get a handle on all that and presenting it as a precise forecast or a grand market call is not easy.
- Point forecasts – eg, that the S&P500 will be 8000 by December 31 - convey no information about risks. They are conditional upon information available when the forecast is made. As new information appears, the forecast should change. Setting an investment strategy for the year based on forecasts at the start of the year and not adjusting for new information is a great way to lose money. This is particularly a problem if you only access forecasts periodically.

- In investment management, what counts is the relative direction of one investment alternative versus others – precisely where they end up is of less consequence in the short term a.

In the quest to be right, the danger is that clinging to a forecast will end up losing money. As Ned Davis has pointed out, for investors the key is to make money, not to be right with some forecast.

Forecasts don't have a great track record

Forecasts are regularly surveyed from economists, compiled and published – often at the start of a new year. It is well known that when the consensus (or average) is compared to the actual outcome, it is often wide of the mark. This is particularly so when there has been a major change in direction (or dislocation) for the variable being forecast – such as around events like the tech wreck, the GFC, the pandemic or President Trump's tariffs last year and war with Iran this year and what it might mean for oil prices. So just when you rely most on forecasts can be when they are most wrong. This applies not only to economists' forecasts for economic variables, but also to share analysts' forecasts for company profits and to most forecasts across most disciplines.

Where precise linear relationships apply where A = B, like in predicting the date and time of the next eclipse, forecasting is easy. But where relationships can be non-linear and complex as in economics, investing and in most things people like to forecast - where a slight shift in the balance can result in A = B or C or ? - forecasting is far more difficult.

And of course, the bigger the call, invariably the bigger the miss. There are numerous examples of gurus using grand economic, demographic or financial theories – usually resulting in forecasts of "new eras" or "great depressions" or with assessments like "too much debt will cause an implosion", "house or share prices are going to crash" or "the oil price is going to $US200" – who may get their time in the sun but who usually spend years before, or after, losing money. Many of those who did get the tech wreck or GFC "right" were bearish for years before and would have lost their fortune if they had shorted shares when they first got bearish.

Future Babble by Dan Gardner (Plume, 2011) is an excellent and entertaining read on the issues around forecasting. Grand prognostications of doom can be particularly alluring. But they are regularly wrong. Calls that the world is about to bump into some physical limit, causing a "great disruption" (famine, global cooling or warming, economic catastrophe!), have been made with amusing regularity over the last two hundred years: Thomas Malthus argued in 1798 that the growth of a population will always exceed the resources required to feed it; this was updated in Paul Ehrlich's *The Population Bomb* of 1968; and again more broadly in the Club of Rome report on *The Limits to Growth* in 1972; and the "peak oil" fanatics have been telling us for decades that global oil production will soon peak and when it does the world will be plunged into chaos (they mustn't have thought of EVs!). Such Malthusian analyses underestimate resources, the role of price increases in driving change and human ingenuity in facilitating it.

And when you're reading books like those from Harry S Dent about *The Great Depression Ahead (2008)*, *The Demographic Cliff (2014)*, etc, all of which had disaster happening well before now, just recall there has been a long list of prognostications for a great depression, often linked to a debt-related implosion, the bulk of which turned out to be wrong.

So why are forecasts treated with reverence?

There are a bunch of reasons.

- Many see the world through the rear-view mirror where its clear and obvious and so assume that the future must be easy to forecast too.
- People hate uncertainty and try to remove it. So, precise quantified forecasts seem to provide a degree of certainty in an uncertain world.
- And, prognostications of doom can be alluring as investors suffer from a behavioural trait known as "loss aversion" in that a loss in wealth is felt more keenly than the beneficial impact of the same sized gain. This leaves us risk averse and predisposed to bad news stories. So, prognosticators of gloom are often revered as "deep thinkers".

Three things investors need to do

If we simply relied on point forecasts for key investment market variables to set our investment strategy, I know the outcome would not be that good for our clients. By the same token, it's impossible to avoid some sort of forecasting: investors who rely on charting are assuming that patterns in past asset price moves are a guide to the future; value investors are relying on implicit assumptions that things will mean revert; and long-term investors in growth assets are assuming that economic progress will favour growth assets over the long term as they have historically. So, what should one do? There are three things investors need to do.

1. **Minimise the reliance on expert forecasts** - particularly point forecasts and grand prognostications. While point forecasts can help communicate a view, the real value in investment experts – the good ones at least – is to provide a better understanding of the issues around investing and what's going on now and to put things in context so as to help avoid silly investment mistakes. While financial history does not repeat, it does rhyme and so in many cases we have seen a variant of what may be currently concerning the market before. This is particularly important in being able to turn down the noise and focus on a long-term investment strategy.
2. **Invest for the long term**. In the 1970s, Charles Ellis, a US investment professional, observed that for most of us investing is a loser's game. A loser's game is where bad play by the loser determines the victor, eg, amateur tennis. The trick is to avoid stupid mistakes and win by not losing. The best way for most investors to avoid losing at investments is to invest for the long term. Get a long-term plan that suits your level of wealth, age, tolerance of volatility, etc, & stick to it.
3. **Finally, if you are going to actively manage your investments, make sure you have a disciplined process**. Ideally, this should rely on a wide range of indicators, such as: valuation measures (ie, whether markets are expensive or cheap); indicators that relate to where we are in the economic and profit cycle; measures of liquidity (or some guide to the flow of funds available to invest); measures of market sentiment (the crowd is often wrong); and technical readings based on historic price patterns. The key to having a disciplined process is to stick to it and let the "weight of indicators" filter the information that swirls around markets, so you are not distracted by the day-to-day soap opera engulfing them. Forecasting should not be central to your process.

Concluding comment

It is tempting to believe that you or someone else can perfectly forecast the economy or the market. But getting economies and markets right is hard and even then, there are plenty of investors who have been "right" on some big call but lost a bundle by executing too early or hanging on for too long. Or got it all wrong on the next big call. The key is to know where expert views can be of use, be humble and stick to a long-term investment strategy designed to attain your goals and, if you are going to actively manage your investments, have a process.

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