FT.com
FINANCIAL TIMES

Folly of forecasting and useless data

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Published: January 17 2010 09:58 | Last updated: January 17 2010 09:58

Never invest on the basis of forecasts. So says James Montier, recently anointed the dean of behavioural finance in the UK. Glance at the index of Value Investing, his superb collection of essays on the subject, and you will find that "forecast" appears more often than any other, with the exception only of the holy of holies, Ben Graham himself. References to the former are as consistently negative as those to the latter are positive.

"The evidence on the folly of forecasting is overwhelming," Mr Montier concludes, whether you are talking about economists or stockbroking analysts. "Frankly the three blind mice have more credibility than any macro-forecaster at seeing what is coming," is his verdict on economists. As for analysts, he notes that the average forecasting error in the US analyst community between 2001 and 2006 was 47 per cent over 12 months and 93 per cent over 24 months.

And what does Ben Graham say? "Forecasting security prices is not properly a part of security analysis". Judging by the response to my last column, which described John Templeton's approach to the forecasting business, this is a view that many participants in the securities business share. The only professionally acceptable response to any question on the subject of analyst reports is to say: "Well, I read them – but only for the data, you understand, not for the recommendations."

The only problem with all this is that it does not seem to be true. It would be nice to meet a few professional investors who do not in practice rely quite heavily on forecasts to inform and justify their investment views. This has prompted me over the years to formulate some other rules I have found helpful in distinguishing between useful and useless research.

The first of these is this: "Don't rely on what anyone says they are doing. Look at what they are actually doing." Just as comment is free, but facts are sacred, so too market punditry is cheap, but actual investment decisions are the only thing that really matter. I recall a meeting of IFAs in March 2003 at which, on a show of hands, a clear majority of those present disputed a claim by Anthony Bolton that his then public bullishness on equities was a contrarian call.

A second show of hands revealed that, although being bullish was what the majority professed to be, only a tiny minority had positioned clients' portfolios to reflect that view. While the audience was talking about loading up on equities, Mr Bolton was one of the few who had already done so. A year later many in the audience were struggling to catch up with the renewed bull market they had called, but failed to act on.

A second valuable rule is: “Never waste any time on investors who appear to be telling the markets what to do.” Saying something will happen is a good way to generate a headline, but a poor way to make money. Every investment call can at best be an assessment of probabilities. Those who proclaim that an outcome is a virtual certainty are either deluded, charlatans or professionals who are paid to believe it. Those who are hesitant and make liberal use of phrases such as “my guess”, “the most probable outcome” and so on are the ones talking the true language of the market.

A third useful empirical rule is: “Don’t use Japanese experience as proof of anything.” Many of us have fallen at this hurdle over the years. Just as the great equity bull market of the 1970s and 1980s powered on beyond any possible rationalisation, so too the subsequent 20-year period has been full of commensurate disappointments. The Japanese economic experience of the last 40 years serves only to demonstrate that Japan, for reasons that are open to analysis, marches to different rules from almost every other market, society and economy. It is the exception to almost every rule in the book. Those who claim the US must follow Japan into 20 years of debt deflation are breaking both the second and the third rule.

If forecasts are no use, then what is the basis on which investors can or should make decisions? Value has to be part of it. Momentum is also a useful tool: consistent as long as it works and then periodically catastrophic when it breaks down. Technical analysis, if used as a guide to probabilities, has a place; ditto good fortune. A good deal of the time, however, markets can appear to be neither obviously dear nor cheap. Who is buying government bonds today out of unalloyed conviction?

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