PREDICTIONS ARE WORTHLESS

Every year participants in the investment industry (including the financial media) engage in a rather entertaining but ultimately useless game of predicting where the markets are going in the next 12 months. People choose their favourite shares and unit trusts, tell us where the rand is going and what the markets are going to do. Most serious investors treat these predictions as a bit of fun but other people treat these predictions (forecasts) more seriously and use them to make long term investment decisions. As an example, our stock markets are ultimately very reliant on the predictions of economists whose forecasts are used by analysts and fund managers when they develop their financial models. This is where the problems start.

HOW INACCURATE ARE THESE FORECASTS?

According to the Economist Magazine, Robert E Lucas (a Nobel Prize winner) in 2003, said that "macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades." Five years later the worst economic crash since the 1930s occurred, proving him 100% incorrect.

In another example, Baker University in Kansas analysed surveys of U.S. and Australian consumers and their forecasts of inflation. When compared to professional economists' forecasts for the period 1993 to 2005. U.S. consumers were wrong by an average of 0.72%. Over that same period, economists erred by about 0.82%.

I am not criticising the economists who make these forecasts as I believe it is an impossible task due to the number of variables that will influence these predictions. Not only do you need to anticipate what will happen, you also need to anticipate how people will react to these events. As history has proved many times over, people don't always react rationally, which makes it impossible to predict what they will do.

As Peter Lynch, one of the greatest investors in history, said, "If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes."

WHY DO THESE PREDICTIONS MATTER?

Many businesses, especially large ones, rely on budgets when planning for the year ahead. Very large businesses might need to consider the impact of exchange rates, inflation and interest rates on their budgets. These are used to determine if companies will hire or retrench staff and whether or not they will invest capital. The frightening aspect of this budgeting process is that the forecasts (predictions) about exchange rates, inflation and interest rates are almost guaranteed to be wrong. So employees could lose their jobs based on an incorrect economic forecast.

Professional investors rely on research provided by analysts and stock brokers. Most analysts develop financial models to determine whether a company is worth buying, holding or selling. Once again, they use forecasts about interest rates, inflation and exchange rates in their models. These forecasts are usually generated by the internal economist or strategist. As we know, these forecasts are going to be wrong so the analysts' financial model of the company will also be wrong. To make matters worse, the forecasts become increasingly inaccurate as they forecast for longer periods of time. Frankly, any research forecast for a period longer than three years is meaningless.

Unfortunately, investors expect precise forecasts, e.g. the economy will grow 1.7% in the next year. If they're instead told that the economist is 90% sure the economy will grow between 1% and 4%, they won't use the prediction. Analysts certainly will struggle to create financial models based on such a wide discrepancy, so the farce of forecasting will continue.

WHAT DOES THIS MEAN FOR YOU?

While it is human nature to seek certainty in life and therefore to ask “experts” for their predictions about stock markets and exchange rates, you need to understand that this is a futile exercise. Rather plan for a range of different possibilities including scenarios that you think are unlikely to happen. For example, if you want to invest in mining shares because you believe they are undervalued and you think industrial shares are totally overvalued, make sure you won’t lose everything if you are wrong. This means you should take a limited position in mining shares and possibly a smaller position in industrials. Some of the best money managers, make profits on events they did not expect to happen because they positioned their portfolios to benefit from a range of different outcomes. If we relate that to today, the fact that the rand has already dropped so dramatically does not mean that it will continue on this path, it could also recover or stabilise. Viewing investment decisions as a one-way bet is likely to cost you a lot of money over time.