

December 31, 2013

***“Prediction is very difficult, especially if it’s about the future.”
— Niels Bohr***

As we ring in another new year, we enjoy exchanging holiday cards, making resolutions and reading about everyone’s forecasts. In our industry, everyone’s favorite subject is to predict the market: *“Where are stocks going in 2014?”*

Many try to answer the question by using a variety of economic and earnings metrics that should help explain stock market returns. It turns out that most are not very useful. Curiously, the amount of rainfall was a more useful predictor than corporate profit margins.

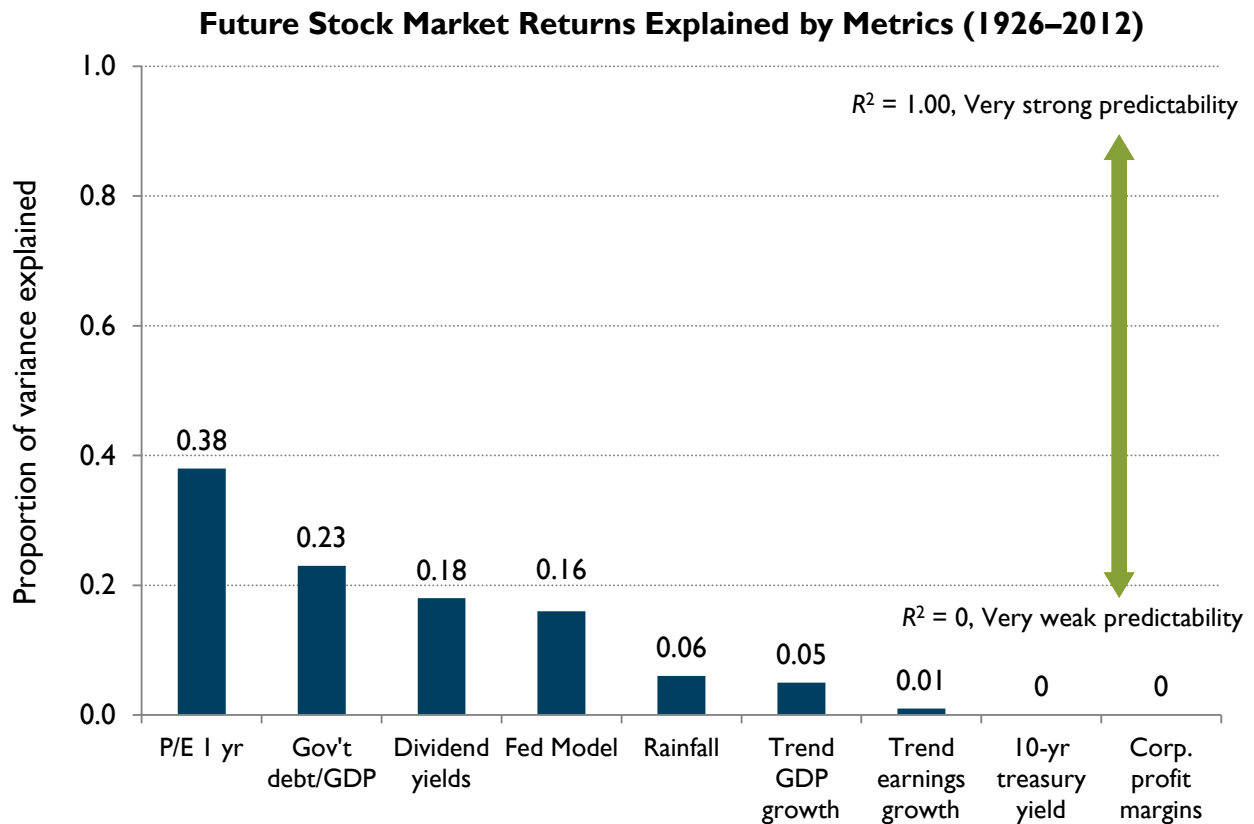


Figure 1: Bar chart displaying the R^2 of a regression model of 10-year real, annualized stock market returns on each metric between January 1926 and June 2012. Figure based on analysis done by Vanguard.¹

¹ <https://personal.vanguard.com/pdf/s338.pdf>

With or without data, predicting the future is hard enough, let alone predicting something as volatile as the stock market. If you could predict the market with 70% accuracy in any given year, you would be considered a market sage. Now how about being able to correctly predict it three years in a row? This would be a significant feat.

The odds of correctly predicting the market three years in a row with 70% accuracy per year would be:

$$70\% (\text{year 1}) \times 70\% (\text{year 2}) \times 70\% (\text{year 3}) = 34\%$$

Even though the probability of being right in any one year is high, to be *consistently* right over time is much less likely. It is *more* likely to be wrong!

Most market predictions are accompanied with colorful stories. The more colorful the story, the more believable it sounds. While stories make the predictions sound credible, the longer and more involved the story, the less likely the probability of success.

Here is a hypothetical example of a prediction for 2014:

“I predict that previous accommodative policy from the Fed will create jobs and the unemployment rate will fall back below 6% (I feel I can predict employment data with 70% accuracy).

I then predict this will cause the Fed to significantly taper its quantitative easing as a result of stronger economic data (I feel I can predict the Fed’s movements due to economic data with 70% accuracy).

I then predict earnings will suffer because interest rates will rise and real estate prices will stagnate causing consumers to tighten their belts again (I feel I can predict the relationship between earnings and consumer confidence with 70% accuracy).

I finally predict this slowdown in earnings will cause the stock market to drop 10% in 2014 (I feel I can predict movements in the stock market due to earnings with 70% accuracy).”

All of these stories are plausible. This prediction may be correct but for all the wrong reasons. For the whole story to play out for all the right “reasons,” the probability is only $0.70^4 = 24\%$.

Is there a different way? While many spend all of their energy predicting the market direction and the variety of nuanced reasons why it will get there, what else can be done to generate profits?

Ultimately, the goal is to *make money* in the market, not to predict the market. The two are often very different things. You can make money in the market without predicting the market.

There are countless businesses that exist solely for the purpose of helping *everyone else* solve a challenging problem. Someone had to provide pick axes, shovels and blue jeans to all the miners during the gold rush. Someone had to provide the servers and rack space to all the tech startups that built websites during the Internet bubble. Someone had to provide the title transfers and appraisals for all the homes purchased leading up to the housing bubble. Someone has to provide liquidity in the financial markets so investors can predict and express their views year in and year out.

These businesses all provide an important service to meet the demands of the public. They are competitive and require infrastructure in order to scale, but, before that, they must have a reason to exist. Why should the business profit? Is there an edge that does not rely on predicting the market?

We do not know if the price of gold will go up or down but we are certain that it is worth something. We are certain gold producers, consumers and investors all require insurance and hedges for their activities.

In the same way, we may not know if the stock market is going up or down, but there may be investors who do. Some will be right and some will be wrong. We are certain, however, that investors need to hedge. They buy and sell options and futures on their holdings.

This year will bring its share of predictions as happens every year. There is no easy playbook to follow with all of the unknowns surrounding the Fed and the consequences for U.S. dollar-denominated assets.

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