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The art of forecasting

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One reader recently questioned how profit forecasts prepared for a company by three different analysts could be so different from each other given that the basic information left little “wiggle room for the analysts to manipulate”.

A similar question can be asked about the forecasts of economists. We can read a headline about inflation or house sales and one economist will describe it as an improving trend, while another will say that it's an aberration.

Given that numbers are numbers, you'd think that there wouldn't be much room for disagreement. But neither financial analysis nor economic analysis is an exact science. In economies as in companies, any forecaster must take account of the 'x' factor, the unpredictable or unknown factor that could lead your forecast to be completely wrong.

The other factor that introduces variability into forecasts is the philosophy or attitude of the forecaster. On the face of it, analysts should be easily able to forecast a company's profitability - they can look at a company's track record, grill the management team, talk to the company's competitors and customers and get a fairly good idea of how much the company might earn in the year ahead.

But what they can't forecast is the loss or win of a major contract, or a gain in market share as a competitor drops the ball, or the dumping of cheap product on the European market which impacts the company's sales in New Zealand. Similarly economists should be able to review such things as consumer and business confidence, unemployment, and the overall supply and demand of products and services to figure out whether the economy is going to grow, remain flat or shrink.

But they can't forecast unforeseen influences that can derail the most successful forecaster – natural disasters, political upheavals, epidemics, and changes in social patterns and behavior. The influence of an analyst's or economist's own philosophy or attitude is important and must be considered when deciding whether his forecast can be relied on.

Some of us are natural optimists who are prepared to believe that good things are possible in the future. Others are naturally cautious and reluctant to give the benefit of the doubt. These attitudes will affect us when we are forecasting a company's profit growth or predicting the strength of an economy.

There are some commentators who seem to enjoy issuing warnings about the hard times that lie ahead. Whereas others are cheerily optimistic about the future and can find positive aspects in even the most disappointing news. I have known analysts whose forecasts I discounted by 10%, just to give myself a margin in case their optimism proved unfounded. And I know other analysts who are so cautious that if they ever say a stock is worth buying, I will be the first to place my order!

Forecasting is an imperfect science, but knowing the track record of a forecaster's picks and having an idea of their personal disposition can point to whether they will be accurate. Considering the views of both the most optimistic and the most pessimistic forecaster is also a good trick.

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