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Investor Education Centre

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More than a feeling – predictions just best guesses

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I have just enjoyed reading my bumper horoscope for 2011. Of course I focused on the good bits, like the fact that 2011 will be a very good year for me (and all Scorpions), financially. I skimmed over the bits about drinking less and exercising more to maintain good health.

The start of a new year always brings forecasts and predictions about the year ahead, and while we enjoy reading them, particularly if they are optimistic, it is important to take them with a fairly large dose of salt.

It would be nice to accept at face value the current consensus forecasts for world share markets, because the consensus for 2011 is quite heartening. On average, strategists are picking further gains this year after two positive years, on the basis that the stars are aligned economically. Consumer spending and sentiment is improving, corporate earnings are good, inflation is unlikely to rear its ugly head, and central banks (particularly the Federal Reserve) are still in Father Christmas mode, happily doling out cash to ensure that economies remain buoyant.

The typical forecast has share markets (with a few exceptions like Japan – lower – and Germany and China – higher) returning between 8% and 10% for the year, plus dividends.

But forecasts are just best guesses, and few people get them right consistently.

Rather than taking the numbers literally, we should focus on the themes and thoughts behind the forecasts as they are more likely to give us a steer on the future. If we know what makes strategists optimistic enough to call for an 8-10% increase in share prices, we can monitor those factors and position ourselves if the themes don't play out as expected.

For example, most strategists suggest that interest rates will remain low during 2011, which is positive for share prices. If it looks like interest rates are heading up faster than predicted – perhaps due to unexpectedly strong inflationary pressures – we can assume that shares might not perform quite as well as hoped.

Market predictions require some assumptions about the future, but the future is unknowable. In January 2008, the consensus of Wall Street strategists in a Bloomberg survey was that a steady stream of corporate profits would see the S&P 500 Index lift 12% by year end, plus dividends. Not one analyst had the slightest inkling of the dire events that were about to transpire (a fall of 38% for the year).

Some forecasts have more credence than others. For example, I am happy to predict that investor behaviour will continue to be much the same as it always has been. If stocks go up, investors will buy. If they decline, investors will sell. If something's popular, investors will chase it, and if something's not, they will avoid it. Share markets are not predictable, but human behaviour is.

Humans love predictions because they give us a sense of control – “knowing” that markets are going to rise feels better than not having a clue what markets will do. But we shouldn't take predictions too seriously – unless we are Scorpions about to have a great year!

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