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Ignore those fallible forecasts

Michael Nairne, Serious Money

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Every New Year brings a bountiful supply of economic and market forecasts by investment pundits. Well-researched, analytic and often insightful, the typical forecast, whether it is bullish, neutral or bearish, is artfully constructed. In search of guidance, many investors (and advisors for that matter) seize upon a specific strategist's prognosis as a rationale for their investment decisions. This raises the question: Just how accurate are the forecasts of experts?

Regrettably, the answer is not very accurate. The Congressional Budget Office (CBO) in the U.S. regularly assesses the accuracy of its forecasting track record and that of the Blue Chip Consensus Forecast, an average of 50 professional economists' forecasts. From 1982 through 2008, CBO found the average error in its annual forecast of real gross domestic product growth was 1.1%. Now that doesn't sound like much until you realize the actual real GDP growth rate was 3% per annum such that CBO's forecasts missed the mark by more than 35%.

Well, that's the government, you might say — certainly, the consensus view of 50 highly regarded economists will be more accurate. As it turns out, the average annual forecast error of the Blue Chip

Consensus was also 1.1%, the same as CBO's. With all of that experience, mountains of data and complex computer models, the professional economists' average forecast of GDP growth also missed by a wide margin.

Making matters worse, the forecasting errors were largest at the key turning points in the economy. For example, in 2008-2009, the annual real GDP growth forecast by CBO and the Blue Chip Consensus was 2.3% and 2.4%, respectively. As the U.S. economy headed into a recession in 2008, the actual growth over this two-year period was negative — the real GDP contracted by 1% annually.

Just when an investor needs accurate guidance the most, the experts didn't deliver.

Of course, every year some economists do get it right. In my experience, investors often gravitate toward the strategist who has made the best call over the past couple of years. Unfortunately, this is not a winning approach either. A comprehensive study by the Federal Reserve Bank of Atlanta found that not one single forecaster in the Blue Chip Consensus consistently performed better than the average of the 50 forecasters. As faulty as the Consensus view often is, it is likely to be more reliable than any single strategist's forecast.

Several studies have found that analysts' forecasts of the earnings per share for the S&P 500 are too optimistic. So if you are relying on some forecaster's frothy market view, think again.

You also shouldn't be waiting for market strategists to call the next bear market correctly. Earnings forecasts for the stock market are most flawed when a recession rears its head. Bianco Research LLC has calculated that market strategists' earnings forecasts were 10% too high in the 1990/91 recession, climbed to a 25% high-side error rate in 2000/01, and missed the mark by a whopping 40% in the 2007/09 recession.

Investors should ignore the annual ritual of myopic fallible forecasts and accept that unpredictable recessions and recoveries are a fact of economic life. Since 1854, the U.S. economy has experienced 33 business cycles that have created a recurring sequence of bear and bull markets. Yet, over this entire span, the U.S. economy has grown on average by 5.5% a year while stocks have earned 8.9% annually.
Hence, serious investors should focus on the long-term and put their effort into what they can control — clarifying their goals, defining their capacity and tolerance for risk, diversifying accordingly and eliminating unnecessary costs and taxes.

John Kenneth Galbraith, the famous economist, quipped, "The only function of economic forecasting is to make astrology look respectable." Investors may find their time better spent reading their horoscopes rather than following fallible forecasts.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.