Accountability Proves the Incompetence of Market Forecasters

by Larry Swedroe, 1/6/20

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Market forecasters know their fallibility, which is why they rarely offer predictions with specific timeframes – it would make it too easy for fact-checkers like me to hold them accountable. When one prominent forecaster – John Mauldin – boldly attached a five-year horizon to his predictions, it gave me an opportunity to look back and hold him accountable.

Let's look at the academic research behind the accuracy of forecasters and then the record of Mauldin's predictions five years ago.

There's a large body of evidence demonstrating that stock market forecasts have no value (though they supply plenty of fodder for my writings) because their accuracy is no better than one would randomly expect. For example, David Bailey, Jonathan Borwein, Amir Salehipour and Marcos López de Prado, authors of the March 2017 study, Evaluation and Ranking of Market Forecasters, covering 6,627 market forecasts (specifically for the S&P 500 Index) made by 68 forecasters who employed technical, fundamental and sentiment indicators, and the period 1998 through 2012, found:

- Across all forecasts, accuracy was 48% – worse than the proverbial flip of a coin.
- Two-thirds of forecasters had accuracy scores below 50%.
- About 40% of forecasters had an accuracy score between 40% and 50%.
- About 3% of forecasters fell in the left tail, with accuracy scores below 20%.
- About 6% of forecasters fell in the far right tail, with accuracy scores between 70% and 79%.
- The highest accuracy score was 78% and the lowest was 17%.

The distribution of forecasting accuracy by the gurus examined in the study looks very much like the common bell curve –what you would expect from random processes. That makes it very difficult to tell if any skill is present.

Evidence such as this led Warren Buffett to state, “We have long felt that the only value of stock forecasters is to make fortune-tellers look good. Even now, Charlie (Munger) and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.” Remarking on the value of forecasts, *Wall Street Journal* columnist Jason Zweig stated “Whenever some analyst seems to know what he’s talking about, remember that pigs will fly before he’ll ever release a full list of his past forecasts, including the bloopers.”

Accountability ruins the game

Zweig’s insight is why you rarely see the financial media hold forecasters accountable by reviewing their prior forecasts – accountability would ruin the game and no one would “tune in.” The lack of accountability by the media motivates me to make it a regular practice to do so.

This article turns its lens on John Mauldin, a well-known author, financial writer and market analyst. His website states, “On behalf of subscribers to Mauldin Economics, John taps into his network either directly or through the reams of high-level research he’s privy to on a regular basis, to assist in identifying the smartest investments for today’s markets. These ideas are then carefully screened and evaluated by a team of ace analysts, with only the best of the best brought to the attention of Mauldin Economics subscribers. This is important to you, because it gives you the equivalent of direct access – just one small step removed – to some of the brightest minds and most successful managers in the world today.”

Mauldin was one of the many forecasters included in the aforementioned study “Evaluation and Ranking of Market Forecasters.” He had one of the worst scores, coming in 36th, just behind CNBC’s Jim Cramer, who was 37th. Today we’ll review Mauldin’s 2015 five-year global financial forecast. (Those forecasts came well after the period covered by the evaluation and ranking study; perhaps his scores would improve.) Mauldin chose to do a five-year forecast, “more useful to long-term investors,” while admitting “an annual forecast … is as much a guessing game as anything else (and I am bad at guessing games).”

Let’s take a look at his five forecasts for the markets and see how they actually turned out. We’ll give him a score of +1 for an accurate forecast, a score of -1 for an incorrect one, and a zero for what we can call a tie:

1. “A major slide in the JPY/USD (Japanese yen to U.S. dollar) exchange rate is almost certain over the next five years.” He gave it a 90% probability. The yen closed 2014 at around 120. It ended 2019 at under 109. In other words, not only did the yen not collapse, but it actually increased about 9 percentage points against the dollar. ***Score -1.***

2. "Europe is headed for a crisis at least as severe as the Grexit (Greece's exit from the eurozone) scare was in 2012, and there will be a resulting run-up in interest rates and a sovereign debt scare in the peripheral countries." He also gave this a 90% probability. There was no deep crisis in Europe, no further sovereign debt scares, the MSCI Europe Index returned about 5% per annum, and interest rates stayed at historically low levels. ***Score: -1.***

3. "The world is simply not prepared for China to experience an outright 'hard landing' or recession, but there is a 70% probability that it will do so within the next five years. And the probability that China will suffer either a hard landing or a long period of Japanese-style stagnation (in the event that the Chinese government is forced to absorb nonperforming loans to prevent a debt crisis) is over 95%." China's GDP growth did slow somewhat, but there was no hard landing and no period of Japanese-style stagnation. ***Score: -1.***

4. "All of the above will be bullish for the dollar, which will make dollar-denominated debt in emerging market countries more difficult to pay back. And given the amount of debt that has been created in the last few years, it is likely that we'll see a series of crises in emerging market countries along with an uncomfortably high level of risk of setting off an LTCM (Long-Term Capital Management)-style global financial shock." He attached an 80-90% probability. There was no emerging market debt crisis. As to the dollar, the dollar index (DXY) began the period at about 95 and ended 2019 at about 96.5, pretty much unchanged. ***Score: -1.***

5. "I do not believe that the secular bear market in the United States that I began to describe in 1999 has ended." He gave the probability that the secular bear market would end in five years a 90% probability. Over the five years ending 2019, Vanguard 500 Index Fund Admiral Shares (VFIAX) provided a compound return of 11.7% and a total return of about 74%. ***Score: -1.***

While Mauldin was 90% confident in each prediction, he got all five wrong. For many wondering how a smart guy like Mauldin could get every forecast he was so confident of so wrong, let's ask, "What happened?" The answer is following the advice of "future-tellers" disguised as experts is the wrong strategy.

David Freedman, in his outstanding book, *Wrong: Why Experts Keep Failing Us*, shows that experts are often the reason we get into big messes, whether the field is medicine, investing, science, psychology, raising children, dieting or business management. With often frightening examples, he exposed the biases and career pressures that often lead to dangerously distorted ways in which experts arrive at their advice.

Freedman explains how biases and corruption play a role in expert recommendations. He explains, “Most of us think of scientists as being devoted to uncovering truths, not pumping their career prospects. Less formal experts don’t enjoy that sort of halo. To win promotion or even simply keep their jobs, law-enforcement officials have to wrestle with the sometimes vicious politics racking the administrations they serve and stockbrokers desperately struggle to corral new customers lest they not survive the next round of pink slips. For such experts, actually being right isn’t always the best path to career success. There have been endless accounts of doctors ginning up unnecessary or overpriced tests for patients carried out at labs in which the doctors are investors, of government officials who receive favors and kickbacks, or brokers churning accounts to raise commissions and so forth.”

As I presented in my book, *The Incredible Shrinking Alpha*, there is an overwhelming body of evidence that clearly demonstrates the vast majority of those attempting to outperform appropriate risk-adjusted benchmarks fail to do so with great persistence, and there is no persistence of outperformance beyond the randomly expected (past performance is not prologue). Yet, despite the evidence, as Freedman noted, “Many of us still put our faith in, not to mention bet our life savings based on, the advice of, say a screaming, bouncing, bell-ringing television personality who claims to have special insight into the movements of stocks, is, I think, a sharp illustration of how some experts can ride straight-out irrationality to great personal success.” Freedman went on to explain why this happens. “We seem to have an insatiable appetite not just for unhealthy foods but for gimmicks that claim to make it easy to live without such foods or to eat without gaining weight. In other words, experts sometimes just give us the implausible advice we want, apparently without much regard for whether it will do much good or not.”

Freedman added, “The simple fact is that most informal experts can spew out conclusions without much fear of being intercepted by wiser or more careful parties. Who’s filtering the recommendations of investment gurus? In the short run, most informal experts can get away with quite a bit, and do all the time.”

Freedman provides a great example of how people react to advice. He presents the case of an individual with back pain. He visits two doctors. Each reviews the MRI. The first states that he’s seen many similar cases and that it’s hard to say exactly what is wrong. It’s hard to predict what will work for any one person. “I suggest we try treatment A first,” he says, “and then go on from there.” The second doctor states that he knows exactly what is wrong and what to do. Which doctor do you choose? Almost always, people will choose the latter. Yet that might very well be the wrong choice. While we want certainty, it rarely exists. And it doesn’t exist in the investment world, where so much of returns are explained by unforecastable events, such as Mideast revolutions, Japanese earthquakes and tsunamis, and the attack on the World Trade Center.

Most of us want certainty, even when we know, logically, that it doesn't exist. With investing, it is a desire to believe that there's someone who can protect us from bear markets and the devastating losses that can result. That leads to what I call the "Wizard of Oz" effect. We come under the spell of wizards, authoritative voices from whom we are "trained" to take words as truths. We want to believe that we can control things because, as Woody Allen put it, otherwise "life is scarier."

The takeaway

The lesson the research provides is that, as much as we would like to believe there are those who can predict the future, prognosticating equity markets is the occupation of charlatans. Index funds have benefited from slowly spreading knowledge of how hard-pressed stock-pickers and market timers are to beat the market.

The financial media focuses much of its attention on stock market forecasts by so-called gurus. They do so because they know it gets the investing public's attention. Investors must believe such forecasts have value or they wouldn't tune in. Nor would they subscribe to various investment newsletters or publications (e.g., *Mauldin Economics*) that, like some, claim to provide you with "news before the markets know."

Of course, some forecasts turn out to be accurate (and the forecaster gets their moment of glory, which almost always turns out to be fleeting). But others lead to significant losses. Unfortunately, it's extremely difficult to determine ahead of time which will prove accurate; there's no way to know.

Here's what Barton Biggs, who at the time was the director of global strategy at Morgan Stanley, had to say: "God made global strategists so that weathermen would look good." Keep this in mind the next time you find yourself paying attention to some guru's latest forecast. You'll be best served by ignoring it. There are just three kinds of market forecasters: those who don't know where the market is going, those who know they don't know, and (the most prevalent kind) those who know they don't know but get paid a lot of money to pretend they do.

Larry Swedroe is the director of research for The BAM Alliance, a community of more than 140 independent registered investment advisors throughout the country.