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THE INTELLIGENT INVESTOR

Why Market Forecasts Keep Missing the Mark



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Fish gotta swim, birds gotta fly and analysts and market strategists gotta try predicting what stocks will do every year. But you don't gotta act on those predictions -- at least not before you ask how likely they are to hit the bullseye.

In December, Barron's asked a dozen experts to forecast the level of the Standard & Poor's 500-stock index at the end of 2009. Not one called for the market to go down; they all predicted gains between 5% and 38%, with a median of 13%.

Given how wide off the mark their predictions usually land, you may already be skeptical of the forecasts of Wall Street's finest Pollyannas. But their inaccuracy doesn't make your own forecasts more likely to hit the target. You should be as skeptical of your predictions as of theirs.

Nearly all of us try forecasting the market as if each of the past returns of every year in history had been written on a separate slip of paper and tossed into a hat. Before we reach into the hat, we imagine which return we are most likely to pluck out. Because the long-term average annual

gain is about 10%, we "anchor" on that number, then adjust it up or down a bit for our own bullishness or bearishness.

But the future isn't a hat full of little shredded pieces of the past. It is, instead, a whirlpool of uncertainty populated by what the trader and philosopher Nassim Nicholas Taleb calls "black swans" -- events that are hugely important, rare and unpredictable, and explicable only after the fact.

History shows that the vast majority of the time, the stock market does next to nothing. Then, when no one expects it, the market delivers a giant gain or loss -- and promptly lapses back into its usual stupor. **Javier Estrada**, a finance professor at IESE Business School in Barcelona, Spain, has studied the daily returns of the Dow Jones Industrial Average back to 1900. I asked him to extend his research through the end of 2008. Prof. Estrada found that if you took away the 10 best days, two-thirds of the cumulative gains produced by the Dow over the past 109 years would disappear. Conversely, had you sidestepped the market's 10 worst days, you would have tripled the actual return of the Dow.

"Although we could make a bundle of money if we could accurately predict those good and bad days," says Prof. Estrada, "the sad truth is that we're very, very unlikely to do that." The moments that made all the difference were just 0.03% of history: 10 days out of 29,694.

We also over-extrapolate the recent past. After the five fat years from 2003 through 2007, when stocks shot up by an annual average of 12.8%, who expected 2008 to be a bloodbath? And now, with stocks down 37% last year and another 8% so far this year, the market feels like a runaway boulder crashing downhill through the woods. But the market's path is no more predictable than it was a couple of years ago; black swans, materializing out of thin air, can make stocks go up as well as down.

So is all prediction pointless? Not quite. In an important new study for the National Bureau of Economic Research, finance professors Miguel Ferreira and Pedro Santa-Clara of Universidade Nova in Lisbon, Portugal, have developed a sophisticated method to predict future results.

You can do a roll-your-own version. Take the dividend yield on stocks (3.4%), then add the annual rate of earnings growth over the past 20 years (3.4%). That's 6.8%, what John C. Bogle, founder of the Vanguard funds, calls the "investment return."

Next, factor in the "speculative return." The price/earnings ratio on the S&P 500 is around 15. If investors pay more than 15 times earnings for stocks down the road, the market will rise more than 6.8% a year; if they set lower P/Es, the overall return will be less.

Earnings are likely to keep falling, and investors are unlikely to set higher valuations anytime soon, so 6.8% is probably high. For 2009, Messrs. Ferreira and Santa-Clara forecast a 4.2% return. But over the longer term -- five years and beyond -- I think stocks could gain at least 7% a year. That would be worth sticking around for.

Along the way, the Dow might slump to 6000, or drop 10% or more in a day. But just as huge losses often come out of a clear blue sky, gains can arrive when the world seems darkest. If you forecast the market with your gut feelings alone, you may never hit the target.

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