Dimensional

OUTSIDE THE FLAGS

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The Forecasting Season

'Tis the season to make forecasts. As we approach the end of the year, newsroom staffing dwindles and editors look for space fillers to keep the readers happy. Yes, here come the investment "outlooks" again.

Each year at this time, the financial pages are filled with "investment outlooks" that tell us what we can expect to occur in the markets in the coming year and where the best bargains are.

Starved of news, reporters usually find there is no shortage of experts willing to share their forecasts with a public primed to believe that sound investing is all about finding a reliable crystal ball.

Of course, these features can be fun to read if you don't take them too seriously. And they become even more entertaining a year later.

During the rocky start for global shares in January 2016, one major investment bank issued a call to investors to "sell everything", warning of a deflationary crisis and a cataclysmic year on markets.[1]

"Sell everything except high quality bonds," the bank advised clients in a research note. "This is about return of capital, not return on capital. In a crowded hall, exit doors are small."

The bank forecast a decline of up to 20% in major stock markets, a fall in world crude oil prices to as low as $16 a barrel with only high-quality government bonds showing a positive result for the year.

At the time of writing, with 2016 almost over, those forecasts look well wide of the mark. As at late November, the major US equity indices were all at record highs. The UK FTSE-100 recently hit record highs and Brent crude was near $50 a barrel.

Yet if you had known in advance the news of the year you might have imagined different outcomes, with the results of the Brexit referendum and US election confounding many media and market pundits.

Another favoured media template around the turn of the year is to come up with a list of "hot stocks" for the coming 12 months.

1. 'RBS Cries 'Sell Everything' as Deflationary Crisis Nears', *The Telegraph*, 11 Jan 2016

For instance, one popular website last December picked "three top Australian shares for 2016"—shopping centre giant Westfield Corp, digital real estate business REA Group and healthcare company CSL.[2]

Each company had "strong management teams, defensive earnings and the kind of profit-growing business models that should be able to survive all but the most severe of economic downturns," the website said.

Now all of that may well be true, but as at late November 2016, Westfield Corp shares were down 4.3%, CSL was 4.7% lower and REA Group was down 9.5% compared with a market return of 1.2%.

Inevitably with these lists, some stocks will do well, while others will do poorly. Without seeking to denigrate the abilities of forecasters, it is a tough job to consistently outguess the market. It's even tougher when your picks come out of a media list that many other people are reading.

In any case, a small portfolio like this is likely to be unnecessarily concentrated and open to what's known as idiosyncratic risk—influences related to individual companies and sectors.

For instance, another news outlet picked a UK-based financial services company as a possible "currency play" for 2016, saying it might benefit from the Australian dollar weakening against the British pound.[3]

Well, that *might* have been a good idea at the time, but the AUD actually rose nearly 20% against the pound year-to-date, the appreciation accelerating after the UK's vote to leave the European Union.

Another stock in that list, James Packer's Crown Resorts, ran into trouble in October when Chinese authorities arrested 18 of the gaming giant's staff as part of a crackdown on illegal gambling in China.

So you can see that investing based on forecasts about individual companies is extremely difficult because you have to take into consideration so many moving parts and future events (that are by definition unexpected).

A better approach is to diversify as broadly as possible across stocks, sectors and countries so as to lessen the influence of any one company, sector or jurisdiction.

Diversification is an antidote to avoidable risks like holding too few securities. It can also save you from missing opportunities. Neither list cited here included Fortescue Metals Group (up more than 200% YTD), Bluescope Steel (up more than 100%) or Worley Parsons (up 85%).

By broadly diversifying, you're taking the guesswork out of investing and saving yourself a whole lot of time scouring the investment pages for stock picks.

Most of all, you're more likely to have many happy returns.

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2 "Three Top Shares for 2016", *Motley Fool*, 25 Dec 2015
3 'Wealth's Top Picks for 2016', *The Australian*, 26 Dec 2015

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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