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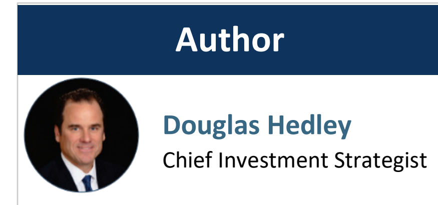
CAPITAL MANAGEMENT

Market Forecasts: Rarely Accurate, Never Reliable



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2017 marks my 33rd year as a student of the financial markets. There has been something new to be learned almost every day. With that in mind, I appreciate how important it is to be open-minded to new ideas and concepts. There has certainly never been a shortage of forward thinking when it comes to managing portfolios and achieving superior results.

However, one thing that has been consistent over the years is that ***markets are unpredictable***. Time and again I've had to remind myself to resist the temptation of believing Wall Street analysts' forecasts for global financial markets. Name any market, and there will be an expert with a uniquely insightful forecast, often times delivered with unwavering confidence and conviction.

In my view, all these attempts to predict the unpredictable are an exercise in futility.

Almost Only Counts in Horseshoes and Hand Grenades

A recent article demonstrated just how difficult it is for forecasters to accurately predict how the market will perform. The table below shows the year-by-year data for what a highly-regarded group of US stock market analysts predicted for the calendar year-end performance of the S&P 500 Index.

Wall Street Strategist's S&P 500 Price Targets **Miss**

	Year-End Forecast	Year-End Actual	Forecasted Return %	Actual Return %	Difference
2000	1,525	1,320	3.8	-10.1	13.9
2001	1,593	1,148	20.7	-13.0	33.7
2002	1,291	880	12.4	-23.4	35.8
2003	1,004	1,112	14.1	26.4	-12.3
2004	1,169	1,212	5.1	9.0	-3.9
2005	1,246	1,248	2.8	3.0	-0.2
2006	1,348	1,418	8.0	13.6	-5.6
2007	1,550	1,468	9.3	3.5	5.8
2008	1,632	903	11.1	-38.5	49.6
2009	1,078	1,115	19.3	23.5	-4.1
2010	1,225	1,258	9.9	12.8	-2.9
2011	1,371	1,258	9.0	0.0	9.0
2012	1,344	1,426	6.9	13.4	-6.5
2013	1,534	1,848	7.6	29.6	-22.0
2014	1,955	2,059	5.8	11.4	-5.6
2015	2,233	2,044	8.5	-0.7	9.2
2016	2,216	2,262	5.5	9.5	-4.0
2017	2,362	?	4.4	?	?
				Average:	13.2

Source: Bespoke Investment Group Data as of: December 31, 2016

The key takeaway: **There was only one calendar year (out of 17) when the experts' average forecast came within 1.00% of the actual return**. Not very close at all.

Here are some additional noteworthy observations:

1. The long-term average miss of the experts was slightly more than 13%;
2. The experts never forecasted a negative yearly return (there have been 5 declines since 2000);
3. The average miss during the five down years was 28.44%.

To summarize, **the predictions were wrong by a large margin** and the biggest failures were during major market declines, which of course are the most important years to be accurate.

Too Many Variables to Get Right

Consider the magnitude of data that needs to be analyzed and breadth of factors that go into making a prediction.

Beyond company-specific earnings, here are just a few of the factors you would have to correctly incorporate into a forecast: interest rates, currencies, and commodity prices. Additionally, you'd have to be sure to correctly predict all changes to monetary policy as well as major geopolitical events.

It's not a question of intelligence or experience, it is simply trying to predict the unpredictable.

Using Forecasts to Allocate Assets: An Accident Waiting to Happen

Traditional asset allocation methods, such as Modern Portfolio Theory, rely on forecasts for each asset class and segment used to construct the portfolio. In the example above, we looked only at the forecasts for the S&P 500 Index, which represents only the large-cap US stock market. The difficultly increases exponentially when there are multiple asset classes and segments.

What is the probability of getting the forecasts right for the return, volatility, and correlation of all the asset segments over the long-term? Sound unlikely? It is.

Incorrectly forecasting by even a small margin can have a dramatic impact on how a portfolio is allocated and can result in significant portfolio underperformance.

Adding fuel to the fire, the biggest failures typically happen during bear markets. When markets change, traditional methods fail to adapt; and when they do, it's typically after the most significant damage is already done. The financial crisis of 2008 is a painful reminder.

Building A Better Balanced Portfolio

After years of intensive research and analysis on portfolio construction, we have concluded there are two core components needed to build a balanced portfolio that has a greater likelihood of performing well over a full market cycle (i.e.; up and down markets):

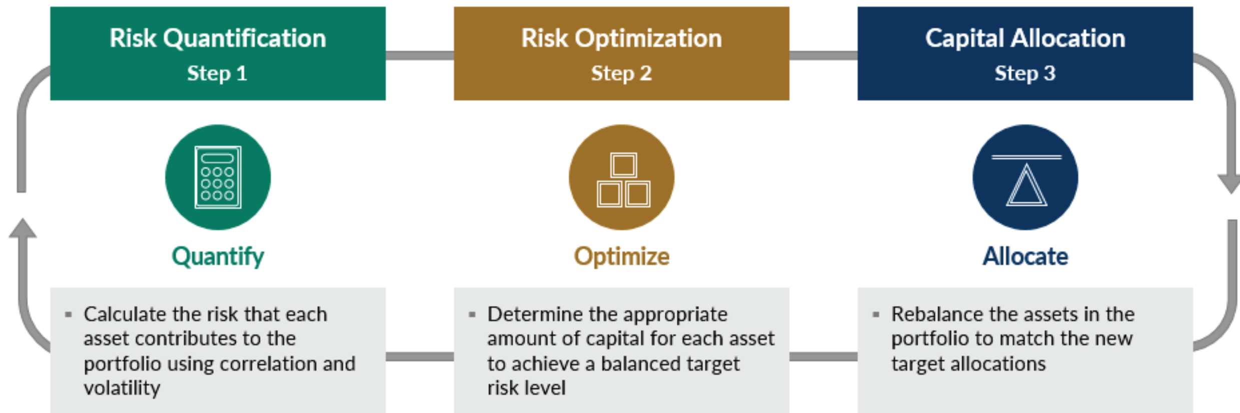
1. A repeatable and sustainable investment process with a rules-based structure and discipline
2. A balanced risk approach to allocate the capital

For any strategy to be successful, it must be straightforward and easy to follow. Common sense and simplicity are key elements of success.

Creating a set of rules that must be adhered to under the most extreme circumstances is very challenging. To stay committed to the process, there must be a heightened degree of confidence that the probability of success will be high *if the rules are followed*. The only way to develop this level of confidence is through rigorous research and testing.

After years of in-depth analysis, we believe that building a portfolio using a balanced risk approach is the optimal way to deliver consistently high risk-adjusted returns over the long term while meaningfully reducing the risks of capital loss. As demonstrated above, forecasts are highly subjective and very unreliable and therefore are not included in our process.

Paritas Capital: A Process to Maximize Risk-Adjusted Returns



A balanced risk portfolio construction process is very different than the traditional 60/40 approach. Rather than simply allocating capital to stocks and bonds, the manager allocates *risk* instead.

A balanced risk portfolio creates equal-sized risk buckets that take into consideration the correlation and volatility attributes of different asset classes to one another. Then, the risk level of each asset is analyzed to quantify its relative attractiveness to the other assets. This process is what determines the capital weights to each bucket.

The consequences of investing without structure combined with using the traditional methodology of allocating capital often leads to losses that are well beyond what investors are prepared to accept. The drawdowns experienced by those invested in traditional balanced portfolios during the tech bubble and financial crisis certainly didn't feel like moderate risk.

Paritas' balanced risk process is supported by years of testing, which gives us the conviction to stay disciplined regardless of the market environment. We don't deviate. We don't second guess. We trust our methodology because it is objective, rules-based, and tested.

The end objective is to deliver consistently high risk-adjusted returns over the long term while reducing the risks of large capital losses.

If It's Broken, Then Fix It

In my previous roles as an advisor to HNW investors, I have found them to be much more concerned about protecting their wealth rather than maximizing returns. In fact, recent research on HNW investor attitudes conducted by The Spectrem Group indicates that 76% have a low-to-moderate risk tolerance level today.

Behavioral finance reminds us that people become overconfident during growth periods and will overstate the amount of loss they are willing to accept. When faced with actual losses, the emotional pain rises to a level that ultimately causes them to capitulate – well after the point that most of the losses

have occurred. What I find fascinating is this cycle continues to repeat itself in every major market correction.

Paritas' primary objective is to break this vicious cycle by providing portfolio solutions that remove forecasting, subjectivity, and emotion from the investment process. We are focused on delivering a strategy that has a higher probability of protecting against these uncomfortable situations that can jeopardize long term client relationships and their portfolios.

Balanced risk portfolios are an intelligent solution to both the behavioral finance issues and the ill-advised tendencies of traditional balanced strategies that rely on forecasts.

At Paritas, we believe our common sense, practical approach works well for all types of investors, regardless of the size of their portfolio. Our research suggests that balancing risk can lead to greater consistency in returns and produce higher risk-adjusted rates of return.

For a core portfolio allocation, this outcome would be very appealing to most risk-averse HNW investors.

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