Outside the Flags

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July 2010

Ask the Octopus

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A "psychic" octopus correctly predicted Germany's path through the soccer World Cup and Spain's victory in the final over the Netherlands. If only there were such prescient creatures in the financial markets.

"Paul" the Octopus made his successful picks by choosing between glass boxes containing mussels and carrying the flags of the combatant countries.[1]

So maybe former US President Harry Truman came up with the wrong solution to bad economic forecasts when he said that what he really needed was a one-handed economist. *Eight* arms might have been better.

But, seriously, the attribution of the power of divination to a cephalopod, however ridiculous, is not that different to how many people attribute to economists the power to accurately and consistently forecast the paths of stocks, interest rates and currencies.

The only difference is that our eight-armed soccer-following underwater friend seems to get it right more often than his two-armed land-loving brethren!

Economists can deal with the professional hazard of inaccurate predictions in a number of ways –make forecasts continuously to give themselves the flexibility to change their minds, make forecasts so far into the future that no-one can remember what they said or, more sensibly, point out that their predictions are really just assumptions subject to significant variation.

Fortunately, in this internet age, we can trace back to discover what the various experts were saying about the outlook this time last year. (By the way, it's a good opportunity to make these comparisons in Australia, because our financial year ended on June 30 and media outlets are currently jammed with sage-sounding forecasts for the coming 12 months.)

Take for instance, the economists polled a year ago by *The Australian Financial Review*. They tipped that the Reserve Bank of Australia, having cut benchmark interest rates to historic lows in April, 2009, would most likely sit on its hands for the rest of that year and possibly even cut rates further.[2]

As it turned out, not only did the RBA fail to *cut* interest rates again in the financial year just passed, it began *raising* them from October and did so another five times in the ensuing seven months.

So what about the equity market forecasts? The AFR asked a panel of six strategists their projections for the Australian share market's benchmark S&P/ASX 200 index by the end of June 2010. The consensus was a gain of 21.4 per cent over 12 months. As it turned out, the index rose only 8.8 per cent and all but one of the expert panel was too optimistic.

One could legitimately ask that if analysts are so off in their broad market forecasts, how they can possibly pick individual stocks with any accuracy. But that clearly doesn't stop them from trying.

[1] 'Sucker for Soccer: Octopus Predicts World Cup Finalist', The Guardian, July 8, 2010.

[2] 'Economists Don't See Rises on the Cards', Australian Financial Review, July 3, 2009

Business Review Weekly magazine[3] at the end of the 2008/09 financial year asked "some of Australia's largest and best performing investors" for some "blue chip stock picks" for the coming 12 months.

They came up with a list of 10 stocks – Asciano, Australian Securities Exchange, BHP Billiton, CSL, Harvey Norman, Rio Tinto, Toll Holdings, Westpac, Woodside Petroleum and Woolworths. These, we were told, were "attractively priced shares for the new financial year".

But maybe they weren't priced attractively enough, because only two of those stocks – Rio Tinto and Asciano – beat the wider market on a total return basis. Another two performed broadly in line with the market (BHP, Westpac), four delivered single digit returns (Woolworths, Harvey Norman, CSL and Woodside) and a couple posted negative returns over the year (Toll Holdings and the ASX). The median return of the 10-stock portfolio was 6.7 per cent, just over half the total market return of 13.1 per cent.

One has to feel for economists and bottom-up share analysts. It's a tough business making forecasts. As smart and as well qualified as they are, there are just so many ways their assumptions can go awry.

The great mystery is why, despite their patchy overall record, these end-of-financial-year supplements and features turn up in the media year after year and people go on buying them and reading them.

Maybe go ask the octopus.

[3] 'Smart Investing in Tough Times, BRW magazine, July 1, 2009.