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Muddled Markets, The Media, and Our Minds

“Prophesy is a good line of business, but it is full of risks.”

- Mark Twain

Around the beginning of every new year, most major financial publications print articles with interviews of market experts talking about what they expect in the coming year. The people quoted are highly educated, have many years of experience in investing, and can tell intriguing and sometimes even entertaining stories about what they’ve seen.

You may recall that 2017 was a good year for stocks with U.S. stocks up 21% and international stocks up 27%. What had the experts predicted at the beginning of 2017? A survey revealed that, on average, they had expected returns of about 6.3%.

Again, at the beginning of 2018 experts were polled and they predicted more happy returns for the new year. The average expected return was 7.5% for the year. Some expected the S&P 500 to advance to 3000, which would have been a 13% return. One very enthusiastic pundit predicted a 17% gain for the year. If only it were true. You may recall that 2018 started with one of the strongest Januarys in history and then floundered, ending with one of the worst quarters in history. For the year, U.S. stocks were down 5% and international stocks were down 14%.

Where does this leave us? These experienced erudite investors are regarded as some of the best sages in the investment arena. Yet they continually miss the mark when asked the seemingly simple question of what to expect from stock market returns over the next 12 months. And, if they can't do it for 12 months when information is freshest, what makes anyone believe they can do it for longer periods?

Perhaps Some Returns are More Predictable Over the Long-Term?

In 2007, Warren Buffett, Chairman of Berkshire Hathaway, made a bet with a famous hedge fund consultant, Ted Seides. The bet was that $1 million in a low-cost mutual fund would outperform a basket of 5 expertly hand-picked hedge funds over the next 10 years. Buffett chose an S&P 500 index fund and Seides selected the hedge funds. The invested amounts would go to each of their favorite charities at the end of 10 years.

The 10-year period included the financial crisis as well as a few other stock market downturns. We should also note that hedge funds generally may select from a wide range of investments and may also trade frequently (making them generally tax-inefficient and taxes weren't part of this exercise given their charitable endeavor). In the end, Buffett's simple index-fund bet gained 7.1% per year (growing to about $2 million) while Seides's sophisticated and very active bet returned 2.2% per year (growing to about $1.2 million).

While the expertly-chosen hedge funds did better in the down years, especially in the financial crisis, they failed to come close or much less beat the index fund returns in up years. This proves a number of points:

-Experts have a very difficult time choosing managers who will outperform the market.

-Markets tend to be very efficient over long time periods.

-Past performance is not a good predictor of future returns.

-No one’s crystal ball seems to work very well.

And Now, A Word About What Gets Sponsored

Some investors, both expert and amateur, hang on to every word from the experts in the media. They watch Bloomberg TV, MSNBC, and others non-stop hoping to get a few pearls of wisdom they may apply to their investment portfolios. The media knows how to get our attention and draw us into their stories. Should we base our short-term decisions and expectations on them? Probably not. Are experts dumb and should the media be ignored? No. The media serves an important function of keeping us informed and challenged. We just shouldn’t let them direct our investment decisions from the current headlines they sell us.

The media sometimes makes astute observations and helps us set our own expectations. If we acted on what they said everyday, we would be buying and selling constantly to our wealth’s detriment. Instead, we will better understand investing and the world if we use what they say to set our expectations and try to control our emotions. We just can’t bet our futures on investing by headlines.

Efficiency Sufficiency

In an era of 24/7 news feeds and global markets allowing millions (perhaps billions) of investors to trade at virtually any time, current securities prices nearly always reflect what is known. This is what we mean when we say that markets are “efficient”. In other words, current prices reflect all known positive and negative characteristics of a given security. This is why so few investment managers who are picking specific stocks ever beat the market. When they do, it's an anomaly and that is inconsistently achieved.

Humans are naturally wired to react when we hear or see something that may be dangerous or loss-inducing. This is true for all investors, including novices and experts. However, we need to forgo taking action when it comes to investing. We may try to justify action because we think that our era is different, but change is constant and has been since the dawn of civilization. We can certainly say that change is accelerating, but certain principles remain, like expecting and receiving a return from the savings we invest when given enough time.

Humans are very poor at thinking long-term and being patient in a constantly and rapidly changing world. Yet, patience and forbearance are what rewards investors, as proven by long-term investment returns.

We hope that you found this informative and interesting and, as always, we look forward to hearing any comments or questions you may have. Thank you for the trust you've placed in Vista.

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