Does market forecasting have any value?

TIM SHUFELT INVESTMENT REPORTER
PUBLISHED YESTERDAY

Investing culture is awash in guru worship.

Every couple of months, for example, we apparently need to know what Michael Burry "of Big Short fame" thinks about where the market is headed. Just this week, the hedge-fund manager – who anticipated the U.S. subprime mortgage crisis in 2008 – made headlines with his US$1.6-billion bet against U.S. stocks. For the past few years, he has been warning of bubbles and crashes with regularity.

Other exalted investing minds are on the other side of the fence, foreseeing soft landings, controlled inflation and bull markets on the horizon.

Expert market calls are effective at getting investors' attention. In a couple weeks, the pros will be returning from the Hamptons and Muskoka, and getting back to the work of forecasting what the rest of the year might hold for the unwashed masses.

But does market forecasting have any value at all? Plenty of research suggests that it does not.

CXO Advisory Group has been tracking the accuracy of stock market gurus over the years. The project collected roughly 6,500 forecasts made by 68 different recognized experts on the U.S. stock market between 2005 and 2012. The sample included a mix of bulls and bears, who had used a variety of fundamental, technical and sentiment-based methods to make their calls.

According to the study, the aggregate accuracy across all of the forecasts was 47 per cent. The average forecast was wrong more often than it was right. You'd be better off flipping a coin.

A few years later, researchers from California and Australia updated the analysis, this time giving greater weight to longer-term forecasts and those with more specific predictions. This study concluded that total accuracy was 48 per cent.

One last example. A study published in March looked at a different kind of forecast – surveys. Perhaps the crowd possesses a foresight that eludes the average guru.

This study looked at some popular U.S. surveys, such as the quarterly CFO Survey, and the twice-yearly survey of economists conducted by the Federal Reserve Bank of Philadelphia.

How well did the surveyed forecasts perform? Shocker – not well. None of them outperformed a “random walk” forecast, which simply predicts future returns based on their past averages.

You get the picture. We should all probably be giving market forecasts a whole lot less attention.

It’s difficult enough explaining what already happened in the stock market, let alone predicting the future. Consider Black Monday – the worst day for the Dow Jones Industrial Average in history. There was no obvious catalyst that caused the index to drop 22.6 per cent on that day in 1987, setting off a financial crisis on a global scale. There was certainly no clear fundamental shock to the financial system.

There are lots of theories about what inflamed the panic that day. There were some aggravating elements, such as automatic trading systems and options expiries. But more than 35 years after Black Monday, we still don’t know the definitive cause.

So why should we expect the stock market to be remotely forecastable? Even if investors could somehow magically know what the economy will do in the months ahead, most of them would struggle to turn that knowledge into profits.

Meb Faber, the chief investment officer of Cambria Investment Management in Los Angeles, tried to illustrate that point in a post on social media this past week.

As a thought experiment, he wondered what an investor’s reaction would have been if they had known, in early 2022, that the U.S. Federal Reserve was going to hike its

funds rate from zero to 5 per cent over the next year or so.

"Your only question would be: 'how many S&P 500 puts can I buy?!'" he wrote.

A put is an options contract that goes up in value when the underlying security – in this case, the S&P 500 index – declines.

And yet, even though the Fed has hiked rates aggressively, the U.S. stock market is in positive territory. Knowing the future, in this case, probably would have lost you money.

When it comes to the stock market, the news itself doesn't really matter. It's how market participants react to the news that drives markets. And investor behaviour often defies logic. Just look at meme stocks.

Last week, WeWork Inc. said that it has "substantial doubt" it can continue operating. The workspace provider has struggled with layoffs in the tech sector and is facing enormous financial losses. So of course, the company's stock soared, at least briefly. WeWork shares gained as much as 140 per cent, before eventually coming right back down.

It was a similar story with trucking company Yellow Corp., which gained more than 600 per cent earlier this month when the market learned that the company was preparing for bankruptcy. Tupperware Brands Corp., which is also struggling mightily, saw a comparable boost in its shares. This has become a surefire way to revive your stock: Just tell the world your business is doomed. How do you factor that into a forecast?

The stock market is chaotic and random. Most of those who pretend to know otherwise are fooling themselves.

Follow Tim Shufelt on Twitter: @tshufelt

Report an error

Editorial code of conduct