

# Global Equity Strategy

## The folly of forecasting: Ignore all economists, strategists, & analysts

Both an enormous amount of evidence and anecdotal experience suggests that people are very bad at forecasting. This is often because we all tend to be massively overconfident. This begs two questions, firstly why do we persist in forecasting despite the appalling track record? And, more importantly, why do investors put forecasts at the heart of the investment process?

- ▶ Lao Tzu, a 6<sup>th</sup> century BC poet observed, “Those who have knowledge don’t predict. Those who predict don’t have knowledge”. Despite these age-old words of wisdom our industry seems to persist in producing and using forecasts. This is all the more puzzling given the easily available data on the appalling nature of track records in forecasting. Economists, strategists and analysts are all guilty. In general, forecasts seem to be a lagged function of actual outcomes - adaptive expectations dominate forecasts.
- ▶ The two most common biases are over-optimism and overconfidence. Overconfidence refers to a situation whereby people are surprised more often than they expect to be. Effectively people are generally much too sure about their ability to predict. This tendency is particularly pronounced amongst experts. That is to say, experts are more overconfident than lay people. This is consistent with the illusion of knowledge driving overconfidence.
- ▶ Several studies confirm professional investors to be particularly overconfident. For instance, one recent study found that 68% of analysts thought they were above average at forecasting earnings! I’ve found that 75% of fund managers think they are above average at their jobs.
- ▶ Why do we persist in forecasting given such appalling track records? There are two avenues to explore – simply put, ignorance and arrogance. *Dunning and colleagues* have documented that the worst performers are generally the most overconfident. They argue that such individuals suffer a double curse of being unskilled and unaware of it. Dunning et al argue that the skills needed to produce correct responses are virtually identical to those needed to self-evaluate the potential accuracy of responses. Hence the problem.
- ▶ *Tetlock* argues that experts regularly deploy five ego defence mechanisms. Experts use various combinations of these defences to enable them to continue to forecast, despite their poor performance.
- ▶ Why do we persist in using forecasts in the investment process? The answer probably lies in behaviour known as anchoring. That is in the face of uncertainty we will cling to any irrelevant number as support. So it is little wonder that investors cling to forecasts, despite their uselessness.
- ▶ So what can be done to avoid these problems? Most obviously we need to stop relying on pointless forecasts. There are plenty of investment strategies that don’t need forecasts as inputs such as value strategies based on trailing earnings, or momentum strategies based on past prices. Secondly, we need to redeploy the armies of analysts. They should return to doing as their name suggests: analysing, rather than trying to guess the unknowable!

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# The folly of forecasting

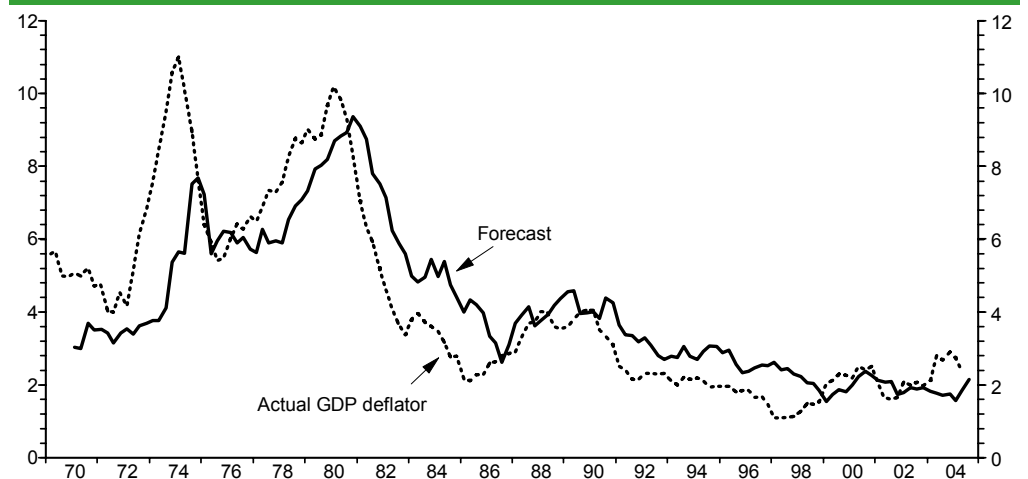
For those who have endured one of my behavioural finance presentations will have heard me rant and rave over the pointlessness of forecasting. I have finally got around to putting pen to paper on this subject<sup>1</sup>.

The 6<sup>th</sup> century BC poet Lao Tzu observed “Those who have knowledge, don’t predict. Those who predict don’t have knowledge.” Despite these age-old words of wisdom, our industry seems to eternally persist in basing the investment process around forecasts.

Before exploring the reasons for our dependency upon the irrelevant guess of unknowable future, I had better buttress my case by showing just how bad the track record of forecasting actually is. The charts below set out the forecasting performance of so-called professionals. For the ease of data accessibility, all series below are taken from the Federal Reserve Bank of Philadelphia Livingston survey or the Survey of professional forecasters. However, the findings are not the result of a strange data set, I have used different data and found similar patterns exist across them all.

The first chart shows economists attempts to forecast the rate of inflation as measured by the GDP deflator. Sadly it reveals a pattern that will become all too common in the next few charts. Economists are really very good at telling you what has just happened! They constantly seem to lag reality. Inflation forecasts appear to be largely a function of past inflation rates.

## US GDP deflator and forecasts

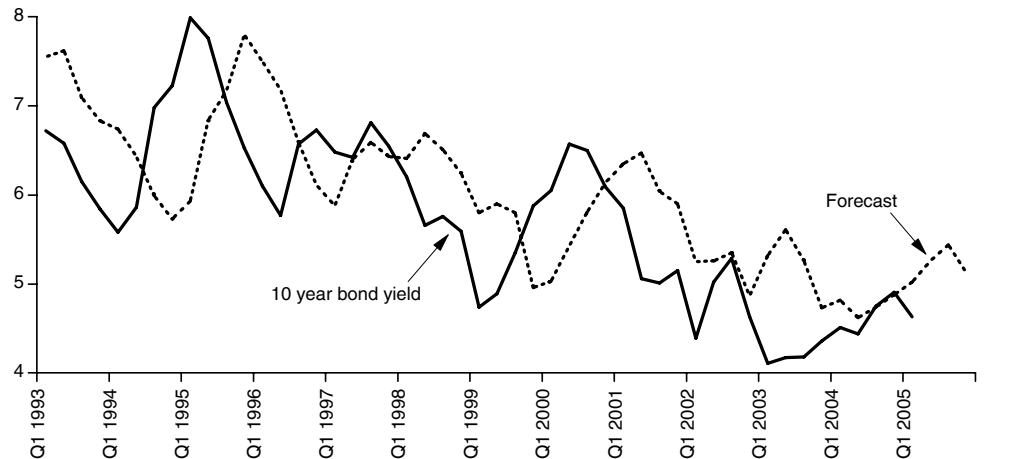


Source: DrKW Macro research

Our second category are the bond forecasters. Previously, we have analysed their behaviour in depth (see *Global Equity Strategy*, 22 February 2005). Much like the economists above, their performance is found to be severely lacking. Not only are bond forecasters bad at guessing the *level* of the yield, they can’t get the *direction* of yield changes right either. The table below shows that when yields were forecast to rise, they actually fell 55% of the time!

<sup>1</sup> I was much inspired to write this after reading Nassim Taleb’s recent paper *The Scandal of Prediction* (2005). He renewed my vigour for this subject.

**Consensus one year ahead bond yield forecasts and reality (%)**



Source: DrKW Macro research

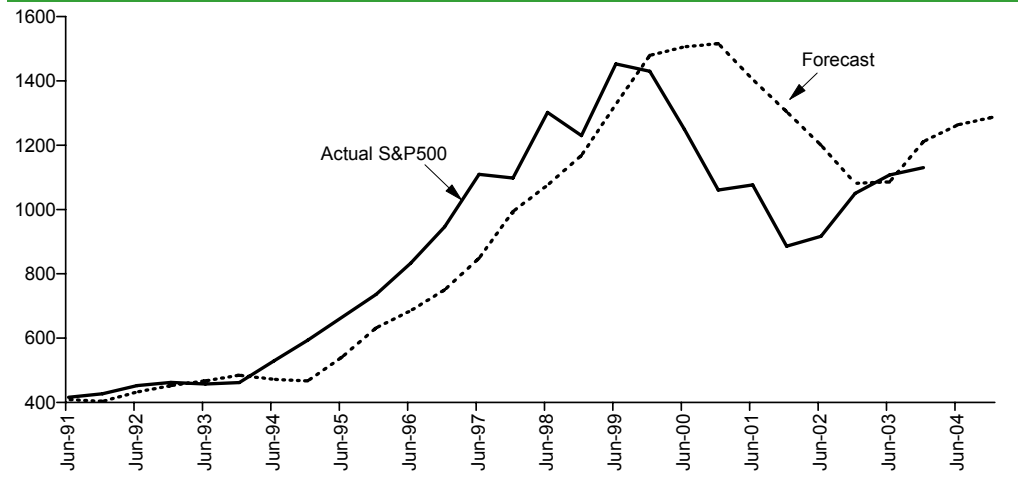
**Predicted vs. actual yield movement (four quarters ahead , 1992-2004)**

		% of occurrences		Actual
Predicted	Up	45	55	Down
	Down	22	78	

Source: DrKW Macro research

Just in case you think this is just a case of an equity man picking on debt, the chart below shows the feeble forecasting abilities of equity strategists. They too seem to think that the recent past is best extrapolated into the future, and hence end up lagging reality. Acknowledgement of our own limitations is one of the reasons why we don't even attempt to produce index forecasts.

**S&P500 and forecasts**

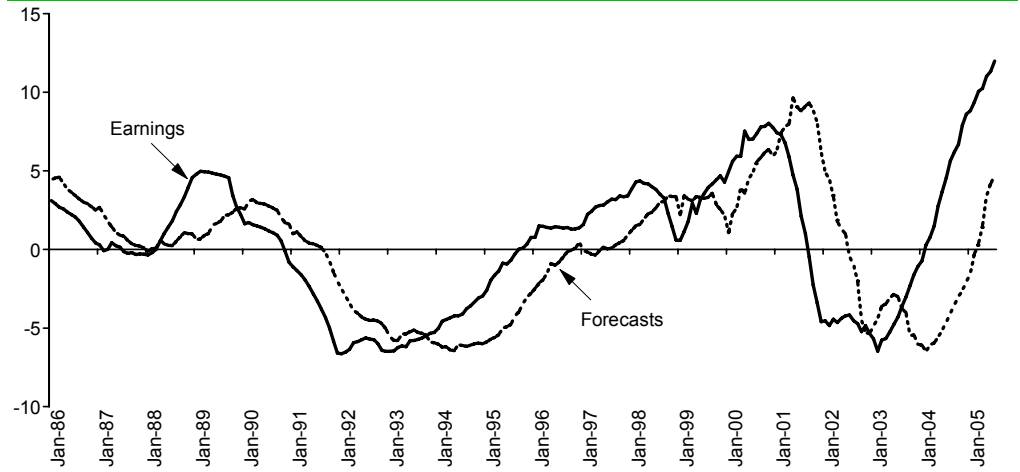


Source: DrKW Macro research

Our last category of truly inept seers are the analysts. Their inability is perhaps the most worrying, as their forecasts are possibly taken far more seriously than the average macro forecast.

The chart overleaf is constructed by removing the linear time trend from both the operating earnings series for the S&P500 and the analyst forecasts of those same earnings. I have simply plotted the deviations from trend in the chart overleaf. It clearly shows that just like the other forecasters examined here, analysts are terribly good at telling us what has just happened but of little use in telling us what is going to happen in the future.

**Analysts lag reality (Operating earnings and forecasts, deviations from trend, \$/Sh)**



Source: DrKW Macro research

**Overconfidence as a driver of poor forecasting**

The two most common biases that psychologists have documented are over-optimism and over-confidence. Technically speaking overconfidence refers to a situation where people are surprised more often than they expect to be. Statistically we describe such individuals as 'not well calibrated'. What we really mean by that is if we ask people for a forecast and then ask them for the 98% confidence intervals, so that the true answer should lie outside of the bounds just 2% of the time, it tends to lie outside of the bounds 30-40% of the time! People are simply far too sure about their ability to predict.

Russo and Schoemaker<sup>2</sup> have devised a simple test. Before you go any further try and answer the questions below and see how you do.

**Self-test of overconfidence**

	90% confidence range	
	Low	High
Martin Luther King's age at death		
Length of the Nile River		
Number of countries that are members of OPEC		
Number of books in the Old Testament		
Diameter of the moon in miles		
Weight of an empty Boeing 747 in pounds		
Year in which Wolfgang Amadeus Mozart was born		
Gestation period (in days) of an Asian elephant		
Air distance from London to Tokyo		
Deepest (know) point in the ocean (in feet)		

Source: Russo and Schoemaker

The answers can be found at the bottom of the page<sup>3</sup>. If you are properly calibrated only one of the answers to the above questions should lie outside of the limits you wrote down. When I took the test two of my answers were outside of the bounds so I, like everyone else, am overconfident. However, compared to Russo and Schoemaker's sample of over 1000 participants I didn't do too badly. Less than 1% got nine or more answer correct, with most respondents missing four to seven items!

One key finding in the literature on overconfidence is that experts are even more overconfident than lay people. Experts do know more than lay people, but sadly this extra knowledge seems to trigger even higher levels of overconfidence.

<sup>2</sup> Russo and Schoemaker (1989) Decision traps: Ten barriers to brilliant decision making and how to overcome them, Simon&Schuster

<sup>3</sup> 39 years, 4187 miles, 13 countries, 39 books, 2160 miles, 390,000 pounds, 1756, 645 days, 5959 miles, 36,198 feet

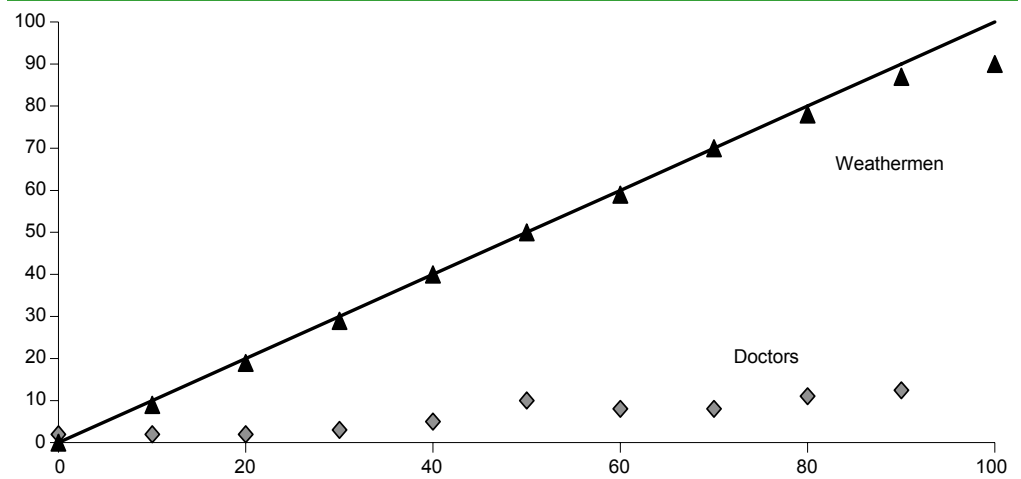
## Overconfidence and experts

The chart below shows the calibration curves for two groups of experts – weathermen and doctors. Each group is given information relative to their own discipline, so weather men are given weather patterns and asked to predict the weather, doctors are given case notes and asked to diagnose the patient.

We are measuring predicted probability (confidence) against actual probability. So the 45° line is perfect statistical calibration. Weather forecasters actually do remarkably well. In contrast, doctors are a terrifying bunch of people. When they were 90% sure they were correct, they were actually right less than 15% of the time!

So why the difference in the performance between these two groups? It largely appears to relate to the illusion of knowledge (defined as a situation where we think we know more than everyone else). Weather men get rapid undeniable evidence on their abilities as forecasters, after all you have to do is look out of the window to see if they managed to get it right or not. Doctors, in contrast, often lack feedback so find it far harder to know when they have been right or wrong.

### Calibration of weathermen and doctors



Source: Plous (1991) The psychology of judgement and decision-making

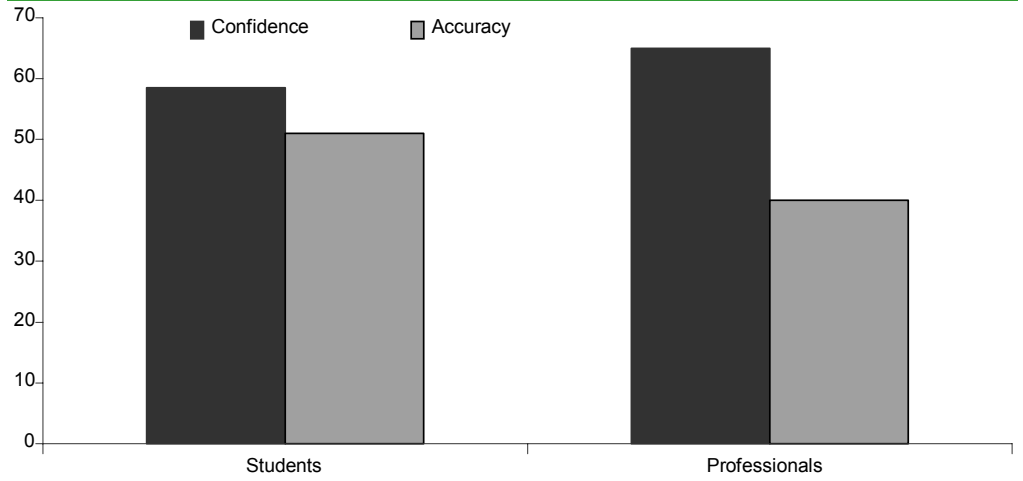
It might be tempting to think of our industry as akin to weather men, if we make decisions or forecasts we should be able to see in the fairly near term if they were correct or not. However, recent evidence suggests that most investors are more akin to doctors than weathermen, at least in terms of the scale of their overconfidence.

The chart below is based on a recent study by *Torngren and Montgomery*<sup>4</sup>. Participants were asked to select the stock they thought would outperform each month from a pair of stocks. All the stocks were well known blue chip names, and players were given the name, industry and prior 12 months' performance for each stock. Both laypeople (undergrads in psychology) and professional investors (portfolio managers, analysts and brokers) took part in the study.

Overall, the students were around 59% confident in their stock picking abilities. However, the professionals averaged 65% confidence. The bad news is that both groups were worse than sheer luck. That is to say you should have been able to beat both groups just by tossing a coin!

<sup>4</sup> Torngren and Montgomery (2004) Worse than chance? Performance and confidence among professionals and laypeople in the stock market, *Journal of Behavioural Finance*, 5

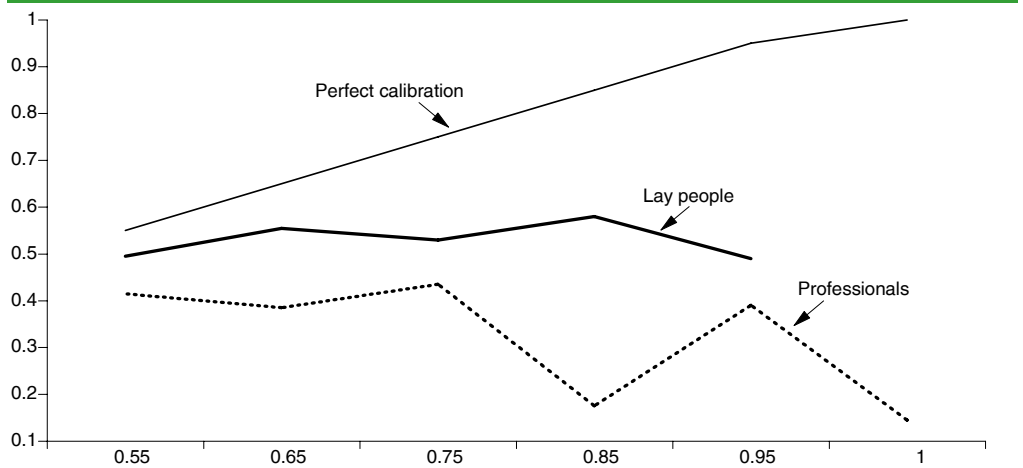
**Average Accuracy and confidence on stock selection (%)**



Source: Torngren and Montgomery (2004)

In addition to the overall statistics, at each selection, players were asked to state how confident they were in the outcome predicted. The even worse news was that professionals were really dreadful, underperforming laypeople by a large margin. For instance, when the professionals were 100% sure they were correct they were actually right less than 15% of the time!

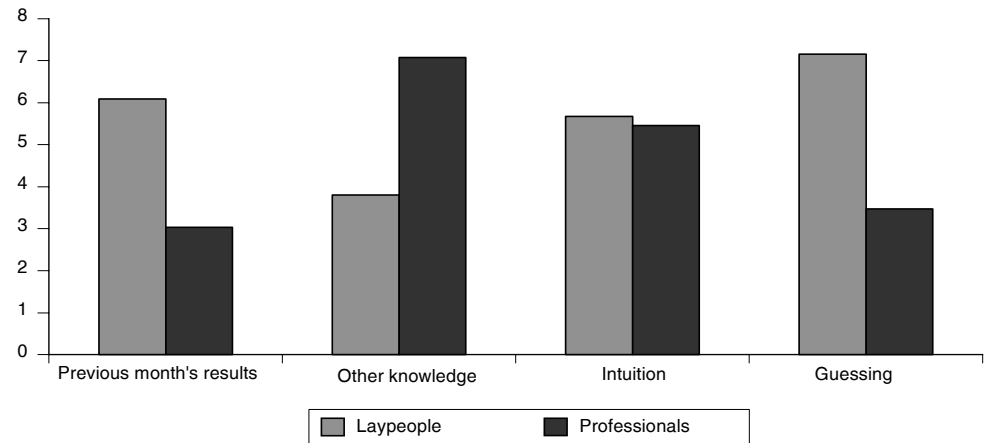
**Accuracy and confidence on stock selection**



Source: Torngren and Montgomery (2004)

Players were also asked to rank the inputs they used in reaching their decisions. The second chart below shows the average scores for the inputs. Laypeople were essentially just guessing, but were also influenced by prior price performance. In contrast, the professionals thought they were using their knowledge to pick the winners. It is hard to imagine a better example of the illusion of knowledge driving confidence.

**Average rating of input importance**

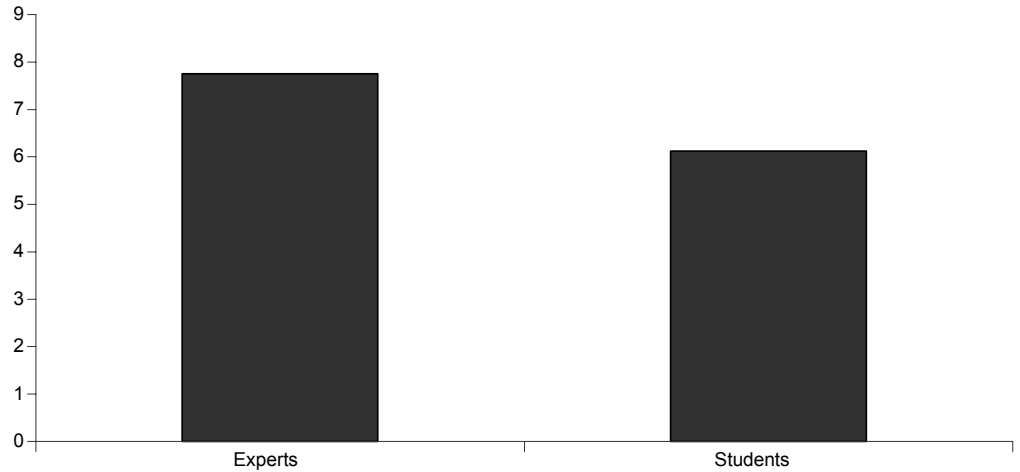


Source: Tomngren and Montgomery (2004)

Glaser, Langer and Weber<sup>5</sup> investigate overconfidence in professional investors and lay people by asking both groups to answer 10 general knowledge questions and 10 finance questions, much like the self-test set out on page 4. If people are well calibrated, the number of correct answers that fall outside the limits should be about one in ten. The chart below shows the actual number of answers that exceeded the confidence limits (the general knowledge and finance questions have been averaged together to give a score out of ten).

The professional investors had a median of nearly 8 questions outside of their confidence intervals; the laypeople (students) had a median 6 questions outside of their confidence ranges. Once again confirming that experts are more over-confident than the rest of us.

**Average number of questions outside of the confidence interval**



Source: Glaser, Langer and Weber (2005)

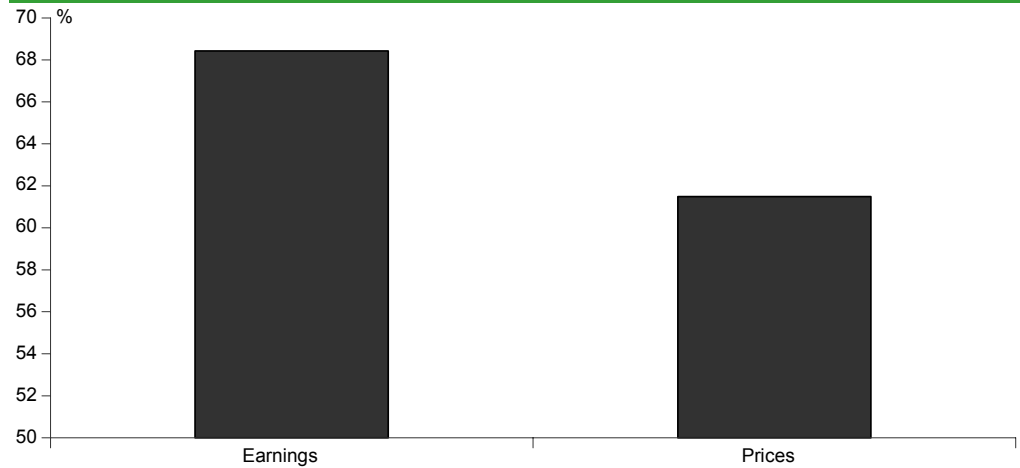
A new paper by Stotz and Nitzsch<sup>6</sup> surveyed analysts at major investment banks. They were asked to say how many of their rivals were more accurate and less accurate than they themselves were with respect to both earnings forecasts and target prices. Unsurprisingly, the analysts thought that they were all above average. Indeed the average analyst's overconfidence with regard to earnings was 68.44%, and 61.49% with respect to target prices.

<sup>5</sup> Glaser, Langer and Weber (2005) Overconfidence of professionals and lay men: Individual difference within and between tasks, University of Mannheim Working Paper

<sup>6</sup> Stotz and Nitzsch (2005) The perception of control and the level of overconfidence: Evidence from analysts earnings estimates and price targets, The Journal of Behavioural Finance, Vol 6

Stotz and Nitzsch also asked the analysts to give reasons for their assessment of their ability. They found that when it came to target prices (where analysts were less overconfident) analysts often argued that “prices sometimes happen by chance”, or that they were the result of “irrational investors”, or that successful price forecasts had a large element of luck. In contrast, when it came to explain their earnings forecasts analysts said “detailed knowledge of the company or sector” helped to make good forecasts, as did “experience” and “hard work”. This would seem to be further evidence of the illusion of control and the illusion of knowledge driving overconfidence.

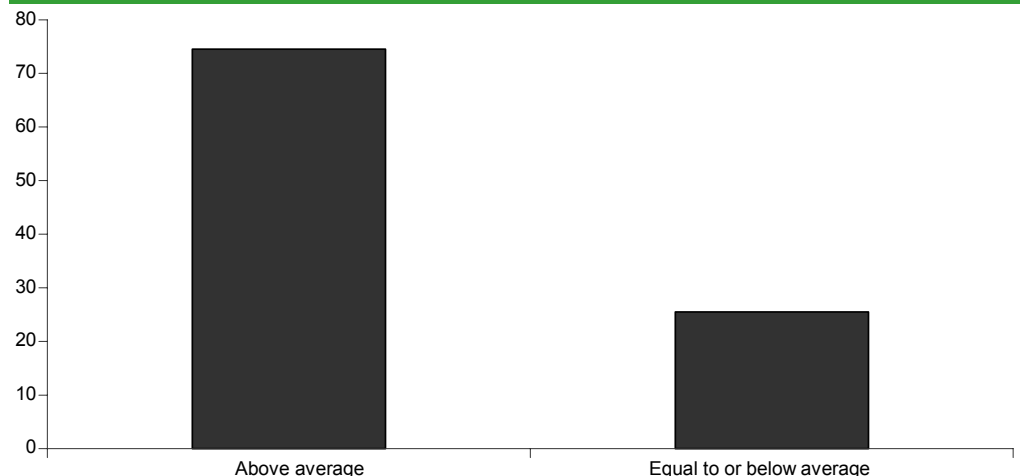
#### Average analysts confidence in their ability to forecast earnings and prices



Source: Stotz and Nitzsch (2005)

I have recently been subjecting participants at my behavioural finance seminars to a questionnaire designed to measure their behavioural biases. I've been collating these results and will soon publish a note on the findings. However, as a sneak preview, one of the questions is: Are you above average at your job? I have around 200 respondents; all of them are professional fund managers<sup>7</sup>. A stunning 75% of those who I have asked think themselves above average at their jobs. Many have written things like, “I know everyone thinks they are above average, but I am”!

#### % of fund managers who rate themselves as above average at their jobs



Source: DrKW Macro research

All of this begs at least two questions. Firstly, why do professionals manage to keep forecasting given that the evidence suggests they can't? Secondly, why do we keep using these useless forecasts? So let's examine each of these in turn.

<sup>7</sup> If anyone is interested in taking the test, please email me, and I will be able to send you the questionnaire and add your response to the sample. [James.Montier@drkw.com](mailto:James.Montier@drkw.com)

## Why forecast when the evidence shows you can't?

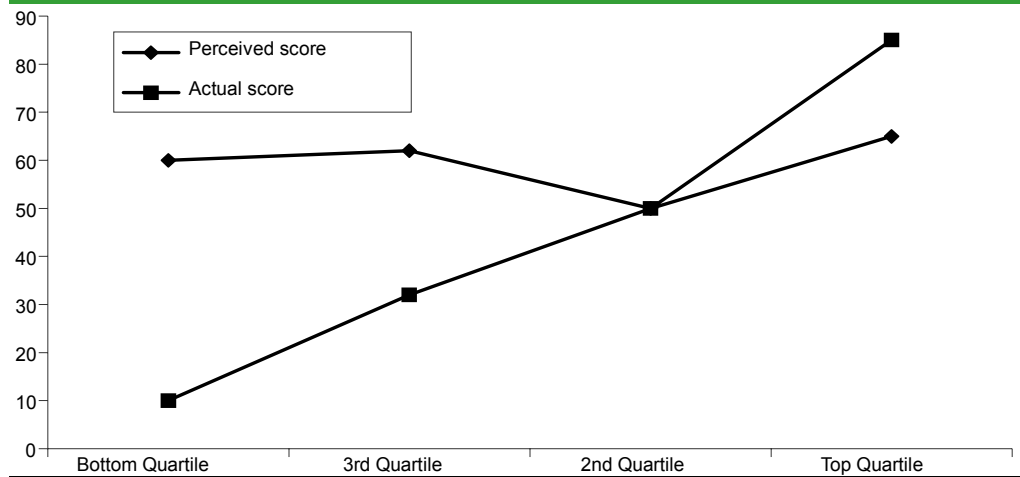
Two areas of psychology help to explain how forecasters keep forecasting in the face of pretty overwhelming evidence that they aren't any good at it. They can perhaps be explained as ignorance (not knowing the overconfidence exists) and arrogance (ego defence mechanism).

### Unskilled and unaware

David Dunning and a variety of co-authors over the years have documented a disturbing pattern of behaviour. **Those who are amongst the worst performers actually are the most over-confident.**

For instance, *Kruger and Dunning*<sup>8</sup> ask people to rate how they have performed on a logic-reasoning test. The chart below shows the perceived score and the actual score. Those in the bottom two quartiles by actual score thought they would be in the 60 percentile (i.e. well above average). However, their actual scores put those in the bottom quartile in the tenth percentile. A massive case of overconfidence.

#### Perceived and actual scores: Unskilled and unaware



Source: Kruger and Dunning (1999)

In a follow-up paper, Dunning et al<sup>9</sup> explore some of the mechanisms that prevent people from realizing just how unskilled they actually are. They note “People fail to recognize their own incompetences because that incompetence carries with it a double curse... the skills needed to produce correct responses are virtually identical to those needed to evaluate the accuracy of one's responses... Thus, if people lack the skills to produce correct answers, they are also cursed with an inability to know when their own answers, or anyone else's are right or wrong.”

Dunning et al also point out that very often people's estimates of their ability arise from a 'top-down' approach. That is to say people start with a preconceived belief about their skills or abilities (along the lines of 'I'm good at my job' or 'I'm good at forecasting') and use those beliefs to estimate how well they will do at a specific task.

Unfortunately, all the evidence suggests that people's impressions of their skills and abilities are at best moderately correlated and frequently uncorrelated with their actual performance. Indeed this is nicely evidenced by the example above where all groups had a perceived score of between 50 and 60% - bearing no relation to the actual outcome!

<sup>8</sup> Kruger and Dunning (1999) Unskilled and unaware of it: How difficulties in recognizing one's own incompetence lead to inflated self-assessments, *Journal of Personality and Social Psychology*, Vol. 77

<sup>9</sup> Dunning, Johnson, Ehrlinger and Kruger (2003) Why people fail to recognize their own incompetence, *Current Directions in Psychological Science*

### Ego defence mechanism

A second group of techniques deployed by forecasters could be best described as ego defence mechanisms. *Philip Tetlock*<sup>10</sup> has investigated the use of ‘excuses’ for forecast failures amongst experts on world politics. Tetlock has been monitoring expert’s views on world politics in real time for more than a decade. He notes “Almost as many experts as not thought that the Soviet Communist Party would remain firmly in the saddle of power in 1993, that Canada was doomed by 1997, that neo-fascism would prevail in Pretoria by 1994, that EMU would collapse by 1997... that the Persian Gulf Crisis would be resolved peacefully.”

He found that across the vast array of predictions with respect to a wide range of political events experts who reported they were 80% or higher confident in their predictions were actually correct only around 45% of the time. Across all predictions, the experts were little better than coin tossers. As Tetlock notes, “Expertise thus may not translate into predictive accuracy but it does translate into the ability to generate explanations for predictions that experts themselves find so compelling that the result is massive over-confidence.”

After each of the events passed the forecasts were shown to be either right or wrong, Tetlock returned to the experts and asked them to reassess how well they thought they understood the underlying process and forces at work. The table below shows the experts belief in their own abilities both before the events and after the events. Look at the judged probabilities both pre and post events for those whose forecasts were incorrect. They are virtually identical. So despite the incontrovertible evidence that they were wrong, the experts showed no sign of cutting their faith in their own understanding of the situation. A true Bayesian would have slashed their assigned probability (last column in the table below). This is prime evidence of the conservatism bias – a tendency to hang on to your views for too long, and only slowly adjust from them.

#### Subjective probabilities experts assigned to their understanding of the underlying forces at the beginning and end of the forecast periods

Predicting the future of	Status of forecast	Judged prior probability (Before the outcome is know)	Judged posterior probability (after the outcome is know)	Bayesian predicted posterior probability
Soviet Union	Inaccurate	0.74	0.7	0.49
	Accurate	0.69	0.83	0.8
South Africa	Inaccurate	0.72	0.69	0.42
	Accurate	0.7	0.77	0.82
EMU	Inaccurate	0.66	0.68	0.45
	Accurate	0.71	0.78	0.85
Canada	Inaccurate	0.65	0.67	0.39
	Accurate	0.68	0.81	0.79

Source: Tetlock (2002)

Tetlock identified five common strategies/defences used to explain the forecast error whilst preserving the faith in the view:

1. The ‘if only’ defence – if only the Federal Reserve had raised rates, then the US stock price bubble would have been avoided. Effectively, the experts claim they would have been correct ‘if only’ their original advice or analysis had been followed. This makes their forecast an historical counterfactual, which is impossible to prove.

<sup>10</sup> Tetlock (2002) Theory-driven reasoning about plausible pasts and probable futures in world politics, in Gilovich, Griffin and Kahneman (2002) Heuristics and Biases: The psychology of intuitive judgement, CUP

2. The 'ceteris paribus' defence - Although the experts' advice or analysis was correct, something else occurred, which was covered in the ubiquitous ceteris paribus, that resulted in the forecast being blown off course. So the stock market would have crashed but for the presence of government led manipulation.
3. The 'I was almost right' defence - Although the predicted outcome did not occur, it 'almost' did. Tetlock gives the examples of so-called close call counterfactuals such as "the hardliners almost overthrew Gorbachev" or "The EU almost disintegrated during the currency crisis of 1992".
4. The 'It just hasn't happened yet' defence – although the predicted outcome has not yet occurred, it will eventually come to pass. This is one of my favourites! I know that I regularly use this defence to assert that high valuations will inevitably and eventually lead to low returns for investors, thus maintaining my faith in my view of markets.
5. The 'single prediction' defence – Although the conditions of the forecast were met, and the outcome never came close to occurring and now never will, this failure shouldn't be held against the framework/view that inspired it. The "everyone knows (or should know) that forecasting is pointless" thus the analysis is valid, but the act of forecasting was flawed.

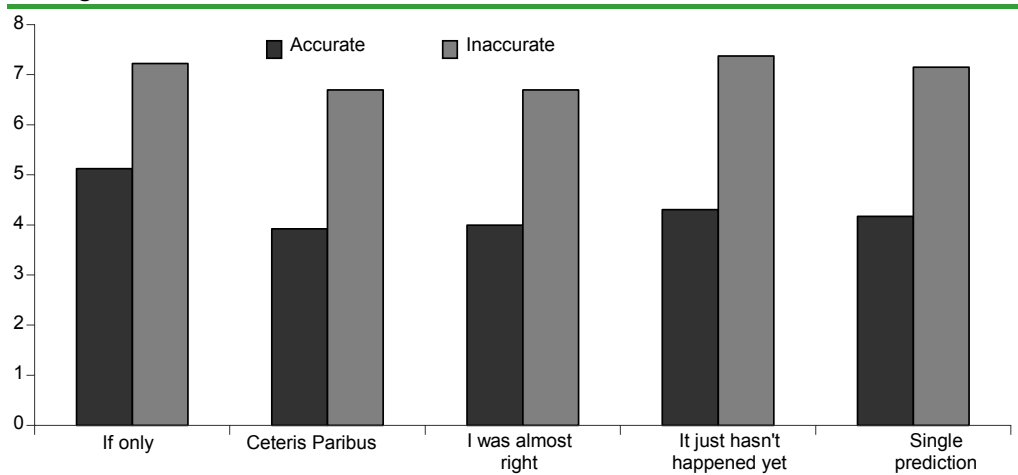
These five defence mechanisms are regularly deployed by experts to excuse the dismal failure of their forecasts. The table below shows scores (on a nine point scale) of how important these defences are. Unsurprisingly those who gave inaccurate forecasts rely much more heavily upon the mechanisms than those who gave accurate forecasts. In fact, across the four cases used here, those who gave inaccurate forecasts were 1.6x more likely to reply on one of these defence mechanisms than the accurate forecasters.

**Average reactions of experts to confirmation and disconfirmation of their conditional forecasts**

Predicting the future of	Status of forecast	If only	Ceteris Paribus	I was almost right	It just hasn't happened yet	Single prediction
Soviet Union	Inaccurate	7	7.1	6.8	6.4	7.3
	Accurate	4.1	3.9	3.6	5	3.1
South Africa	Inaccurate	7.1	7	7.3	7.3	7.1
	Accurate	4.5	3.5	3.3	4	4.8
EMU	Inaccurate	7.2	5.9	6.2	7.8	7
	Accurate	5.1	4.6	4.9	3.8	4.3
Canada	Inaccurate	7.6	6.8	6.5	8	7.2
	Accurate	6.8	3.7	4.2	4.4	4.5

Source: Adapted from Tetlock (2002)

**Average use of defence mechanism across four cases**



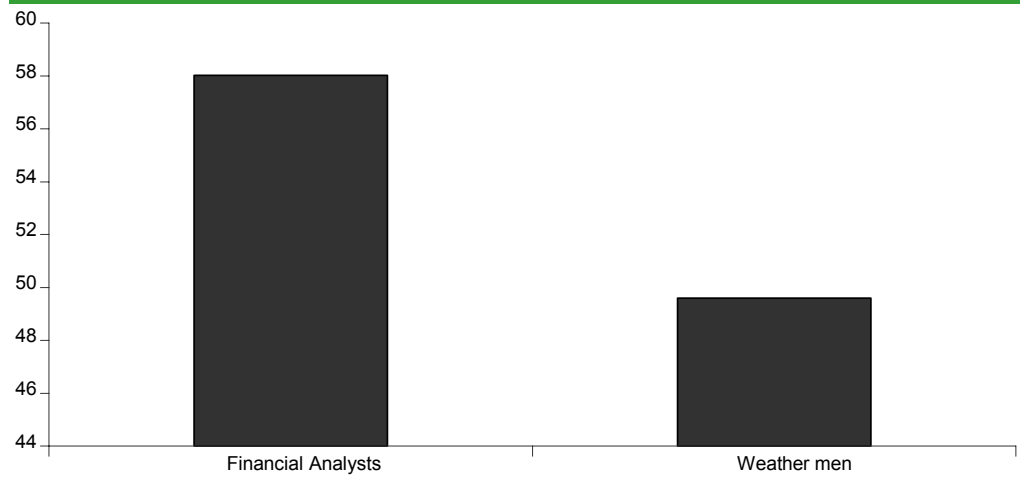
Source: Adapted from Tetlock (2002)

Tyska and Zielonka<sup>11</sup> applied Tetlock's approach to analysts and weathermen. As we have already noted weathermen are one of those rare groups that are actually well calibrated. Financial analysts, in contrast, have been found to be very overconfident as documented above.

Tyska and Zielonka asked financial analysts to predict a stock market level in about a month and half's time. Weathermen were asked to predict the average temperature in April (again around one and half months into the future). In both cases, three mutually exclusive and exhaustive outcomes were specified in such a way that each outcome was roughly equally likely (i.e. had a 0.33 chance of happening). For example, the analysts were asked would the index be below  $y$ , between  $x$  and  $y$ , or above  $x$ . They were also asked how confident they were in their predictions.

The chart below shows the average scale of overconfidence that was reported. Remember that the three choices were constructed so that each option was roughly equally likely, so a well-calibrated individual would have reported 33% confidence. However, the analysts had an average confidence of just over 58%, the weatherman had an average confidence of just over 50%. So both groups were, as usual, overconfident, but the analysts were more overconfident.

#### Average confidence probability



Source: Tyszka and Zielonka (2002)

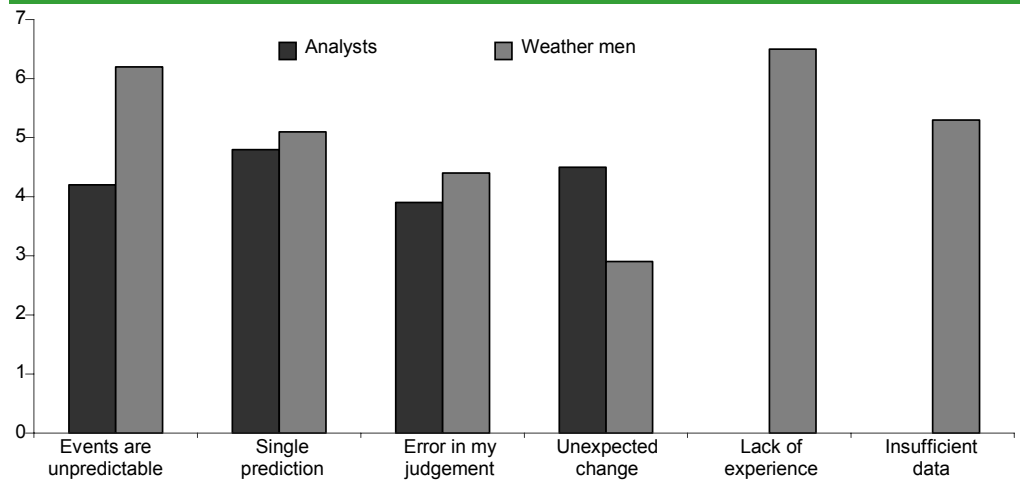
In fact only around one third of the analysts were actually correct, and around two thirds of the weathermen were correct. Those who gave incorrect forecasts were once again contacted and asked to assign importance ratings on a eight point scale to various reasons for their forecast failure.

It is interesting to note that the less confident weathermen's single biggest justification for their forecast failure was a lack of personal experience, followed by an acknowledgment that the weather is inherently unforecastable. Analysts, on the other hand, argued that they shouldn't be judged on the basis of a single prediction (the single prediction defence), and that something else happened that altered the outcome that would have otherwise been achieved (the 'ceteris paribus' defence from above).

So just like Tetlock's political experts, financial analysts seem to be using mental defence mechanisms to protect themselves from the reality of their appalling bad track record at forecasting.

<sup>11</sup> Tyska and Zielonka (2002) Expert judgements: Financial analysts versus weather forecasters, *The Journal of Psychology and Financial Markets*, Vol. 3

### Justifications of the forecast failure



Source: Tyszka and Zielonka (2002)

### So why use forecasts?

Given all the evidence that people are generally dreadful at forecasting<sup>12</sup> why do so many investors use forecasts at the very centre of their investment processes? In part the obsession with forecasts probably stems from the ingrained love of efficient markets. It might seem odd to talk of efficient markets and active managers in the same sentence, but the behaviour of many market participants is actually consistent with market efficiency (EMH). That is, many investors believe they need to know more than everyone else to outperform. This is consistent with EMH because the only way to beat an efficient market is to know something that isn't in the price (i.e. non public information). One way of knowing more is to be able to forecast the future better than everyone else.

However, one psychological trait above all others helps explain the continued use of forecasts – anchoring. We have discussed anchoring in the context of valuations in a previous note (see *Global Equity Strategy*, 27 August 2004). Anchoring refers to our tendency to grab onto the irrelevant when faced with uncertainty.

The classic example of anchoring comes from *Tversky and Kahneman's* landmark paper<sup>13</sup>. They asked people to answer general knowledge questions such as what percentage of the UN is made up of African nations? A wheel of fortune with the numbers 1 to 100 was spun in front of the participants before they answered. Being psychologists, Tversky and Kahneman had rigged the wheel so it gave either 10 or 65 as the result of a spin. The subjects were then asked if the answer was higher or lower than the number on the wheel, and also asked their actual answer. The median response from the group that saw the wheel spot at 10 was 25%, and the median response from the group that saw 65 was 45%! Effectively, people were grabbing at irrelevant anchors when forming their opinions. (For the record the correct answer was 20%).

Another well-known example concerns solving 8 factorial (8!). Except that it is presented in two different ways either (i)  $1*2*3*4*5*6*7*8$  or (ii)  $8*7*6*5*4*3*2*1$ . The median answer under case i was 512, the median answer under case ii was 2250. So people appear to anchor on the early numbers in forming their expectations. By the way, the actual answer is 40,320.

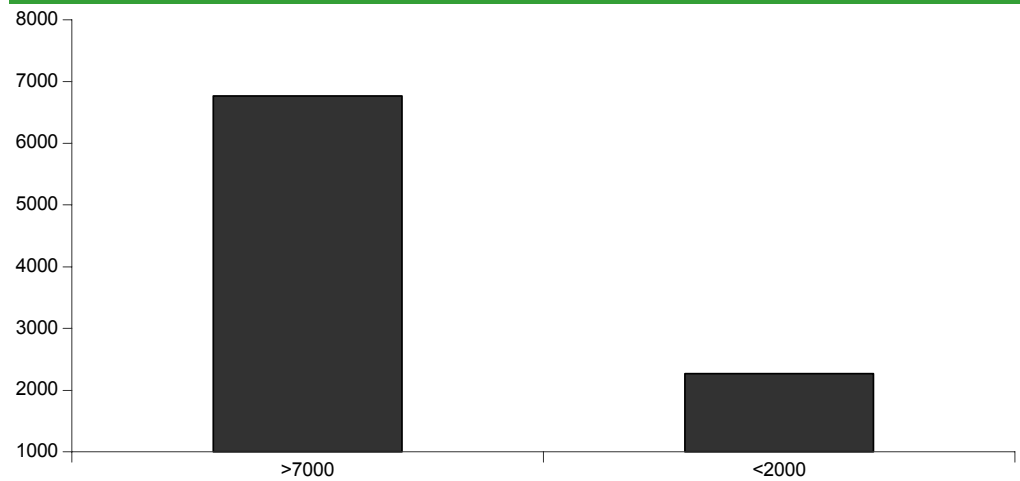
<sup>12</sup> Dawes, Faust and Meehl note that there is an important difference between clinical and actuarial forecasts. Clinical forecasts describe those whereby the decision-maker combines or processed information in his head. Actuarial forecasts rely on well-specified models that have been tested. A vast amount of data shows that actuarial forecasts massively outperform clinical forecasts. We will leave a discussion of what this means for investors until another note, but for the time being recognise that our industry is one in which clinical method often hides behind an actuarial façade. See Dawes, Faust and Meehl (1991) *Clinical versus Actuarial Judgement*, Science, 243

<sup>13</sup> Tversky and Kahneman (1974) *Judgement under uncertainty, heuristics and biases*, Science, 185

Anchoring is not just a cheap parlour trick. *Englich and Mussweiler*<sup>14</sup> take criminal trial judges with an average of more than 15 years of experience as subjects. The judges hear the cases at the end of which the prosecutor asks for either a 36-month sentence, or a 12-month sentence for exactly the same case. Those prosecutors who asked for a 36-month sentence extracted a jail time that was 8 months longer than those who sought a 12-month sentence. Intriguingly, these findings were independent of whether a true prosecutor or a student played the role of the prosecutor!

One of the questions I have asked on my behavioural finance questionnaire has been for people to write down the last four digits of their telephone numbers. Then say whether the number of doctors in their capital city is higher or lower than the last four digits of their telephone number, and finally asked people for their best guess as to the number of doctors in their capital city. The results are shown below. Those with the last four digits greater than 7000 on average report 6762 doctors, whilst those with telephone numbers below 2000 arrived at an average 2270 doctors! So professional fund managers seem to be as liable as everyone else to suffer from anchoring.

#### Anchoring amongst fund managers



Source: DrKW Macro research

When faced with the unknown, people will grasp onto almost anything. So it is little wonder that investors cling to forecasts, despite their uselessness.

#### Debasing

So what can be done to avoid these problems? The most obvious solution is to stop relying upon pointless forecasts. This comes as anathema to most investors. But there are plenty of strategies that one can implement without the use of forecasts. Many examples of such strategies have appeared on these pages such as value-based strategies based on trailing earnings or Graham and Dodd PEs (see *Global Equity Strategy*, 16 March 2005, 28 June 2005 for example).

Secondly, we should redirect our efforts away from forecasting. Having armies of analysts and economists all forecasting is a complete waste of time. There is a good reason we call analysts analysts not forecasters:- they are meant to analyse not guess the unknowable future. They would be better utilised in analysing the present and understanding what that means for the future rather than coming up with spurious anchors for investors to cling to. However, this requires a radical re-think of the investment process and hence is exceptionally unlikely to occur.

<sup>14</sup> Englich and Mussweiler (2001) Sentencing under uncertainty: Anchoring effects in the courtroom, *Journal of Applied Social Psychology*, Vol 31

# Disclosure appendix

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