Why Forecasting is So Unpredictable

2016 will likely be seen for how forecasters, pollsters, and so called "experts" missed on almost every big event that occurred this past year. From Brexit, to the US Presidential Election, to how the equity markets have reacted to the presidential election, almost the exact opposite has occurred vs. what the predicted outcome was.

With his new book, The Undoing Project, Michael Lewis sets how to find out why it is hard to predict life and financial outcomes. The book's focus is on the unusual relationship forged between two Israeli psychologists Daniel Kahneman and Amos Tversky who wrote a series of original studies undoing our assumptions about the decision-making process. Their papers showed the ways in which the human mind erred, systematically, when forced to make judgments in uncertain situations. Their work created the field of behavioral economics.

One aspect of the field of behavioral economics focuses on human biases. Economics can lay out a brilliant synopsis of what a person should do when faced with making a financial or economic decision, but that doesn't mean the person will choose the best decision. This is where cognitive biases that can affect human decision making come into play. These tendencies to think in certain ways can lead to distortions in how we view the world around us and affect our judgment.

Below are just a few of the most prevalent biases that affect our judgments. A fuller listing go Cognitive biases can be found at The Big Picture and Wikipedia;

1. Bandwagon effect – the tendency to do (or believe) things because many other people do (or believe) the same. Related to groupthink, herd behaviour, and manias. Carl Jung pioneered the idea of the collective unconscious which is considered by Jungian psychologists to be responsible for this cognitive bias.

2. Confirmation bias – the tendency to search for or interpret information in a way that confirms one's preconceptions.

3. Endowment effect – the tendency for people to value something more as soon as they own it.

4. Focusing effect – prediction bias occurring when people place too much importance on one aspect of an event; causes error in accurately predicting the utility of a future outcome.

5. Illusion of control – the tendency for human beings to believe they can control or at least influence outcomes which they clearly cannot.

6. Loss aversion – the tendency for people to strongly prefer avoiding losses over acquiring gains (see also sunk cost effects)

The point to all this which Lewis discusses in his book, is that no matter how great an algorithm or forecasting model you build, the pure fact that you are dealing with irrational humans, you will never be able to predict the outcome of events such as political referendums, elections, and the direction of the stock markets.

Even as great and smart as Kahneman and Tversky are and have been on this subject, they still had to deal with their own biases just like everyone else. This is where having systems and processes in place to help make decisions can overcome some of these natural biases. Simple things, such as checklists and being mindful of your surroundings can have life changing effects.

State of the Portfolio

And as I have just explained, I have no idea what will happen in the markets in 2017. For years now we have been waiting for 1) A significant correction with the equity markets, 2) Interest rates to rise to more normal levels, and 3) Inflation to increase due to all the monetary actions central banks around the world have taken. We have not seen any signs of our current situation changing nor does economic data point to changes on the horizon.

What is different right now is the "so called" uncertainty created by the new administration. I used "so called" because typically the markets do not like uncertainty which would lead to lower stock prices. We have had the exact opposite since the election of Trump as president. Again no one knows with any certainty what changes in policies here within the US will have upon the asset markets not only within the US but around the world as well.

As described in many previous letters and blog posts, I have been a conservative portfolio manager over the past few years. And while this conservative nature has led to being out of balance with the market at times, I believe that it continues to act as a hedge for changes that could happen in the future. Even though one cannot predict the future, you can protect yourself from financial harm by holding back a little more capital than normal.

Even with a conservative approach in 2016, most managed portfolios beat their respective benchmarks. Although most portfolios continue to carry a higher percentage of cash as part of their fixed income asset allocation, portfolios still had above average rates of return for the year. Currently I see no reason to change this asset allocation as most metrics point to a relatively fair value equity market and an overvalued bond market. This has made finding undervalued individual companies to invest in more difficult.

Insider Trading

$45,370...Average cost of tuition, fees, and room and board at private, non-public, four-year institutions for the 2016-2017 school year. (source: The College Board).
$26,100...Average annual net cost at private colleges and universities after grant aid and tax benefits (source: The College Board)
16...Number of payments per year clients should make to pay off student loans a little bit faster. That equates to one extra payment every three months (source: Forbes)

Rather than highlighting individual companies, I wanted to provide you with what a normal asset allocation would be by both sector and asset category. You will see below that a normal aggressive allocation would have an 80/20 split between equities and fixed income. Today that same portfolio would be skewed towards the more moderate portfolio with a 70/30 split. In addition, the portfolio would carry a higher percentage of cash within the fixed income allocation. Markets conditions will dictate when portfolios will return to their normal asset allocation.

Stock Sector	Aggressive	Moderate	Conservative
Consumer Discretionary	12.0%	12.0%	0.0%
Consumer Staples	9.5%	8.5%	0.0%
Energy	11.0%	10.0%	0.0%
Financial Services	4.0%	3.0%	0.0%
Healthcare	5.5%	5.5%	0.0%
Materials & Processing	12.0%	9.0%	0.0%
Producer Durables	10.0%	9.0%	0.0%
REIT	0.0%	0.0%	0.0%
Technology	9.0%	8.0%	0.0%
Utilities	0.0%	0.0%	0.0%
International	7.0%	5.0%	0.0%
Total Equity Allocation	**80%**	**70%**	**0%**

Asset Category	Aggressive	Moderate	Conservative
US Small	35.0%	31.0%	30.0%
US Large	5.5%	5.5%	5.0%
Sm Intl/EM	7.0%	5.0%	5.0%
Lg Global	12.0%	12.0%	10.0%
Energy	9.0%	8.0%	3.0%
Financials	4.0%	3.0%	3.0%
Materials	4.0%	3.0%	2.0%
Consumer Staples	3.5%	2.5%	2.0%
Blended Bonds	7.5%	10.0%	15.0%
International Bonds	2.5%	5.0%	5.0%
TIPS (Bonds)	2.5%	5.0%	5.0%
Cash	7.5%	10.0%	15.0%
Total	**100.0%**	**100.0%**	**100.0%**
Equity	80.0%	70.0%	60.0%
Fixed Income	20.0%	30.0%	40.0%

Personalized Investing; Optimize Your Spending

What if you could increase your level of happiness by what you buy? You may think that is an easy question to answer by saying, "yes, if I could buy anything I wanted I would be happier." However, what if research showed that once you obtained a certain income level, say $75,000, your level of happiness would not change that much because of what you already owned or by what you could buy?

You have likely heard the expression, spend money on experiences and not things. As more research is done on the correlation between what we buy and how happy it makes us, the data points to this statement being very factual.

I see this often as my 6 and 4-year-old children play with their toys. Within the first 30 minutes of playing with something new, they are ready to move onto something else. What is interesting is when we are about ready to donate toys is when at least one kid suddenly takes an interest in it again. I don't think that adults are that much different when it comes to this aspect of ownership.

There is a romance of ownership that is likely higher than owning the item itself. The new house, car, or clothes lose their luster sometimes within 3 to 6 months of ownership. For a new house or car that can be a very expensive feeling.

To take this spending conversation further, what if I told you that you were a millionaire but that you lived around people who had many more millions than you did. How do you believe that would affect your spending patterns and habits? In absolute terms, you would be in the top 1% but in relative terms you may feel like you are in the bottom 1%. This could lead you into the classic "keeping up with the Jones' effect". Thus, driving bad spending habits as you acquire the newest goods but become less happy in the process.

So how can we optimize our spending to help us increase our happiness?

- Don't just spend your money on things or experiences, but instead spend your money on what creates or helps support what you personally value most in your life. This could mean spending it on people, causes or charities, or building something that you want in your life for a long period.
- Money can help you design the life that you want. Setting aside quality time to give real thought to what you want your life to be is a critical step in someone's spending habits. Having life goals whether they are financial or not, can help you resist those spontaneous purchases that can act as a quick adrenaline rush but will likely make you unhappier in the long run.
- Fight the "keeping up with the Jones' effect" by…. you guessed it, maintaining a meaningful life and financial plan that is customized for what you what to achieve. Again, this has a direct correlation between taking the time to really derive what brings purpose and meaning within your life and what you spend your money on.

When we mismanage our money and/or our spending patterns go awry, we can generally feel sick and broke. How you spend your money, the money you have already accumulated, and your actual health all intersect with each other. When you spend money in a way that serves the purposes that you intend it for, that can create happiness which in turn can have lasting positive health impacts not to mention financial stability.

For questions about any wealth and asset management topics, do not hesitate to reach out to us to find out what options may be best for your own personal situation. As TAMMA continues to grow, it helps all clients. Financial relationships are built upon trust and your endorsements help to allow others to share in the same benefits that you have experienced. Your continued support in having conversations and making recommendations to family, friends, and co-workers regarding your relationship with me at TAMMA is always greatly appreciated and welcomed.

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