Perspectives

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Forecasts: sense and non-sense

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What forecasts are worth – and what not.

Dear investor

At the end of the year, the key Swiss stock market index (SMI) will stand at around 15,000 points, EUR will trade at around CHF 0.80, while oil of the WTI variant will be changing hands for around USD 120 a barrel.

These are precisely the kind of predictions that do the rounds as the investment world approaches the year-end. But quite aside from the very great likelihood of these extreme predictions proving incorrect, these examples also contain two fundamental errors.

Firstly, just as ardent conspiracy theorists refuse to be swayed by hard facts, good predictions should at all costs avoid containing both a figure and a date in the same breath, let alone specifying these precisely. Those who proclaim the likelihood of equity markets falling will always be right at some point, so far better not to mention the extent of the decline, let alone pinning this to a specific future point in time.

Secondly, the above forecasts are not economically consistent in the way they are combined. The Swiss equity market rising by such a remarkable amount does not fit well with such a strong appreciation of the franc, while the excessively strong increase predicted for the price of oil is in turn at odds with a booming stock market. Either the forecaster has failed to understand economic correlations, or the contradictory nature of the combination has been deliberately chosen in order to increase the chances of at least one of their forecasts being right – allowing them to brazenly forget about the erroneous forecasts and present themselves as a forecaster of quality.

Why is it that so many forecasts about the likely development of markets appear at the start of the year? What statements can actually be made with sufficient accuracy, and in what situations might we just as well look to the stars or roll the dice? What methods exist for developing forecasts with utility value, and how should we treat these forecasts? How should these forecasts be incorporated into investment decisions in a meaningful way?

In this publication we explore these and other questions. And of course there's the saying "predictions are difficult, particularly when they..." It is our bold prediction that you can finish off this quotation!

We wish you an enjoyable read.

Christoph Boner
Chief Investment Officer

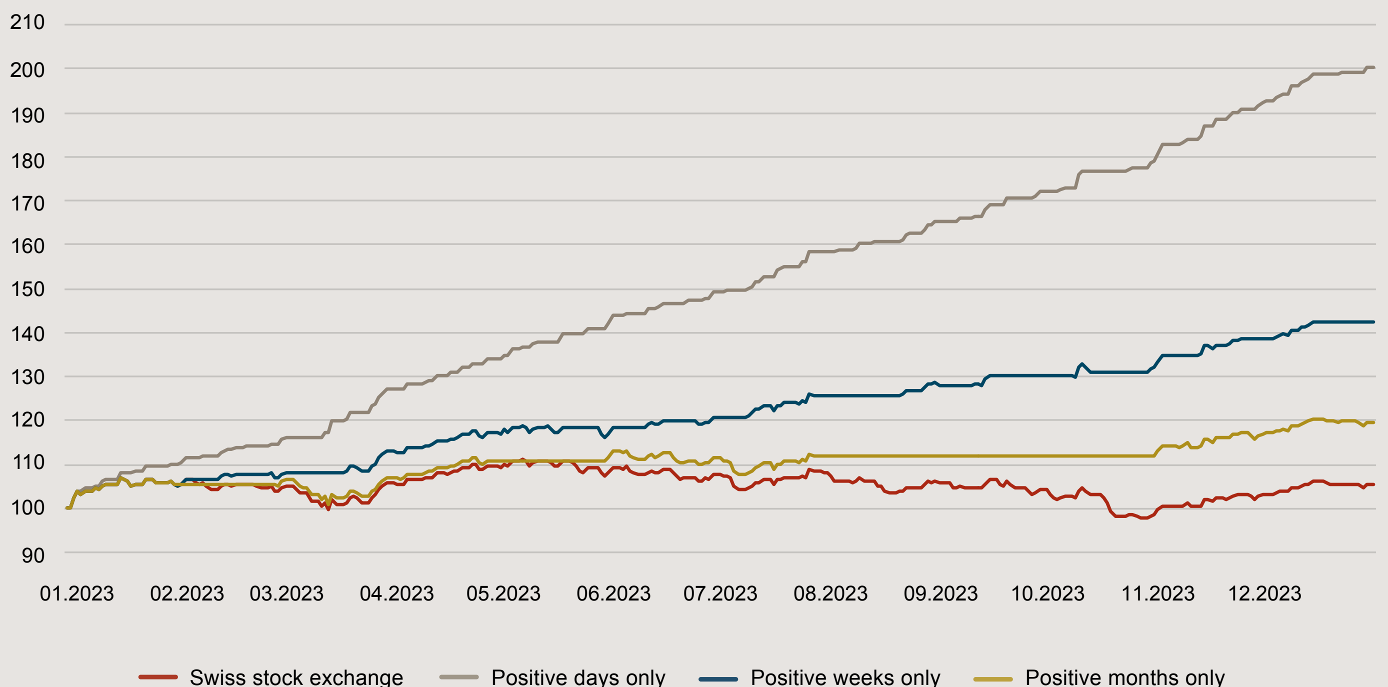
Benefits and potential of forecasts

As long as markets exist and economic values fluctuate over time, there will always be the temptation to come up with forecasts and execute transactions based on them. Forecasts are designed to identify the point at which a purchase or sale makes the most economic sense. But these temptations aside, there is also a key psychological element at work here: as a general rule, uncertainty – at least in important matters – is repugnant to the human psyche. In this respect, forecasts at least help to alleviate stress, as they provide (supposed) support and orientation.

Quite why the attraction of forecasts is so great can be easily illustrated. For example, if an individual had the (binary) ability to accurately predict the direction of the Swiss stock market for the impending timeframe of one day, one week or one month, and if the same individual only invested in timeframes in which positive market performance was generated, the investment result for 2023 alone would be dramatically improved. While the Swiss stock market delivered a positive return of 6.1% in 2023, a portfolio that only invested in months of positive performance would have enjoyed a value increase of 20%, and if that time horizon is switched to a weekly or daily frequency the value increase would have been as much as 40% or 100%. Put simply, the great potential of an accurate forecast has a very seductive aspect.

The problem? There is no such thing as perfect predictability, but despite this self-evident truth mankind seems to have to cling on to at least a bit of just that. The hope that the future can be predicted is strengthened further by the fact that market developments often reveal supposed trends when graphically depicted, even though the empirical evidence suggests that over time no statistically significant dependencies – i.e. predictability – actually exist.

Developments remain random, even if in retrospect they might not (optically) look that way. Trends can be identified even with the experiment of tossing a coin repeatedly – even though the underlying probability of ending up with heads or tails on each flip is precisely 50:50. No one would attach any predictive credibility to such trends. Someone who rolls a 6 three times in succession has exactly the same probability of throwing another 6 on the fourth roll.



The seductive nature of forecasts makes it all the more important for us to critically scrutinise the situations in which financial market forecasts are of any benefit at all and identify what methods for developing forecasts deliver at least some added value.

One initial dimension is the time factor. Generally speaking, it can be shown that the shorter the forecasting window, the more nonsensical the forecasting approach. No reliable performance forecasts can be made on a next-day basis. Weekly and monthly predictions should likewise be viewed with some scepticism, although they can sometimes make sense. For that reason, the tactical positionings involved in asset management processes – despite also being developed on a monthly basis – are often calibrated over a time horizon of several months. Strategic forecasts involving time horizons lasting several years are clearly of greatest value. While these too should be regularly scrutinised to establish their validity, empirical data confirms that they deliver the highest degree of accuracy and therefore benefit.

A second factor is the object of the forecast. As a general rule, the greater the aggregate – such as an entire market, for example – the greater the predictability compared to forecasts for individual securities. However, there is another important thing to bear in mind here: part of the risk inherent in individual securities is not compensated for, as it can be simply diversified away by combining multiple securities so that no risk premium arises. As a direct consequence, this means that forecasts are mostly developed starting with the broader picture and only then narrowing things down – known as the "top-down" approach. But even at the level of broader aggregates, there are significant differences in the degree of predictability. For example, whereas outcomes can clearly be predicted in the case of equities and credit spreads, empirical evidence suggests that interest rate and currency forecasts have a much lower likelihood of hitting the mark.

Even when taking into account the limitations set out above, however, the attraction of forecasts remains – and in addition to the psychological aspect of supposedly providing orientation, forecasts appeal to us not least because they always have a certain entertainment value.

6.1%

The percentage rise in the value of an investment in the Swiss stock market in 2023.

40%

The percentage return generated if no investments had been made in weeks with negative performance. But in this case the decision would have had to be correct in 100% of cases, i.e. 52 times in succession.

Our forecasts

Forecasts are important and have a role to play in any investment decision-making process. However, just as important is the correct assessment and treatment of these very same predictions and expectations. Specifically this means:

Aggregation

Predictions are preferably made at asset category level or on the basis of other meaningful aggregates. In addition to equities and bonds, this may bring in sectors, credit segments, and in some cases also regions. Forecasts at single-instrument level should be treated with great caution and should have no material impact on portfolio construction.

Timeframe

Predictions are made over an investment horizon involving many months. Short-term forecasts are much less valuable, and acting on these can even be said to have a value-destroying effect overall, not least when transaction costs are taken into account.

Object

Whereas forecasts typically relate to value development, there are other relevant parameters of investment activity whose predictability can actually be that much greater. For example, risks and dependencies between asset classes are much easier to predict, which can obviously add value to investment activity.

To sum up: forecasts constitute a key element of any investment activity. They are psychologically important for us as humans, they help to make plausible sense of our environment, they tell a story – but they should also only be used with great care when making investment decisions, as they are wrong more often than not. Any forecaster would do well to possess a certain humility...

Financial market forecasts offer support, provide a yardstick for plausibility, and tell stories – the extent to which predictability actually exists and how correct forecasts are is of secondary importance as long as they are not used indiscriminately to make investment decisions.

What makes a good forecast?

Christoph Boner
Chief Investment Officer

How does the concept of market efficiency fit with the notion of predictability?
If a market can be considered efficient, the degree of predictability should be viewed as low. Market efficiency essentially means that all available, relevant information in the public domain has already been incorporated into prices. Accordingly, no form of analysis based on this information can give rise to "forecastability". This arises in situations where a forecast can be made about the factors that influence the price – or if information is available that has not yet been factored into the price.

Why is there a correlation between risk and return, and what role does this play when drawing up forecasts?
One consequence of mankind's aversion to uncertainty is that an investment involving greater risk must on average deliver a higher return to compensate for the corresponding uncertainty. As shares represent the equity capital of companies, which carries the greatest entrepreneurial risk in the financing structure, the average return on this asset class must surpass that of other instruments such as bonds, for example. As we are dealing here with long-term equilibrium situations, there is a high degree of forecastability – within the framework of the given strategic timeframes. In the short term, the relationship of risk and return can be very skewed. Even the emergence of gross market misappraisals – bubbles, for example – does not conflict with the dependency of risk and return: a higher return always comes at the cost of higher risk.

Why are so many forecasts made if predictability is actually so low?
For one thing it is only human nature – given our aversion to uncertainty – to pounce on forecasts as something useful without really ever considering their worth. This makes it all the more important to ascertain which forecasts can be deemed worthwhile at all, and in what scenarios it makes sense to base investment decisions on such forecasts. Another aspect to bear in mind is that an enormous amount of work often goes into the development of forecasts with dubious benefits, whereas the question of how these should be treated – i.e. the extent to which, and in what form, forecasts should be incorporated into our investment decisions – is an aspect given too little attention.

What is the best way of factoring in the uncertainty of forecasts?
Relying on erroneous forecasts can involve significant losses. The simplest form of risk management is to remove unnecessary, uncompensated risks from a portfolio

through diversification. The risk of forecasting errors can be further reduced through appropriate strategies – from the situation-specific positioning of a portfolio through to portfolio construction, the use of appropriate tactical allocation and the selection of individual securities. The greater the forecast's worth, the more logical it is to make decisions on that basis. However, it should be borne in mind that even high-quality forecasts do not have a probability of accuracy much in excess of 50:50 – so the likelihood of an erroneous forecast remains substantial.

What forecasting methods are there?

From a methodological standpoint, a distinction can be made between fundamental forecasts and technical forecasts. Fundamental forecasts take into account the actual economic situation, deriving from this a value that can be used to predict the subsequent development of the price from its current level. The problem is that a price and its fundamental value are not necessarily aligned with each other, and their development going forward can – at least theoretically – continue to be unrelated. Just because a point of equilibrium exists does not mean that it will also actually come about. Technical analyses focus on price developments, and even if these need not have anything to do with the fundamental value of an investment, such approaches can have predictive power provided that sufficient market participants believe it to be the case. Even if no statistical trend is apparent, if all market participants believe that such a trend nonetheless exists, the price of an investment will develop in this direction as market players execute the corresponding transactions. Here the forecast derives not from the economic situation but from the market participants' behaviour patterns.

To what extent are forecasts dangerous?

The generally low level of predictability in the investment world means that, due to risk considerations, investors should treat forecasts with caution. A positive performance expectation should not prompt the investor to assume excessive risks. The risk of an erroneous decision often outweighs the added value of the forecast. In the world of asset management this problem is addressed by defining a risk profile. The risk/return ratio is then fixed on a strategic and long-term basis with a correspondingly high degree of predictability, while tactical deviations based on short-term forecasts are only undertaken within a clearly defined risk budget (e.g. in the form of bandwidths for individual asset categories). Given the low degree of predictability, the construction of a portfolio through the acquisition of specific instruments ultimately leans heavily on tactical positioning.

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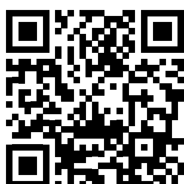

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