

OUTSIDE THE FLAGS

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Things Change

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It's that time again when harried finance editors ask reporters to call investment professionals and cobble together top predictions for the coming year. These are fun to write. But for readers, they're more entertaining a year later.

Take the late 2010 Barclays Capital Global Macro Survey of more than two thousand institutional investors. The pick for the best performing asset class in 2011 was equities (with 40% support), followed by commodities (34%) and bonds (less than 10%).¹ The consensus prediction was a 15% gain in the S&P 500 for the year to around 1,420.

As we now know, the truth turned out to be rather different. To the beginning of December and using broad indices, diversified fixed income was the best performing asset class of the year, followed by government bonds. Returns from commodities and equities were negative. The year-to-date return for the S&P 500 was close to zero. (And remember, these are the forecasts of big institutional investors.)

Barron's, meanwhile, was telling readers this time last year that smart stock pickers were "looking eastward" in 2011. The year was to be dominated by fast growth and rising inflation, and the smart thing was to reweight toward China and other tigers.²

That didn't really turn out to be such a good idea, as China had another bad year. The Hong Kong Hang Seng index was down nearly 17% to early December. The Shanghai Composite was down by a similar amount.

Conversely, the gloom around fixed income in late 2010 was all pervasive. *Barron's* surveyed 10 strategists and investment managers and found nearly all expected stocks

The Forecast: Asset classes of choice for institutional investors in 2011*



The Outcome (to Nov 30, 2011)**



* Barclays Capital Investor survey, Dec 14, 2010

** Source: Returns Program. Fixed Income represented by BCGA Bond Index; Equities by MSCI World Index (net div); Commodities by Dow Jones-UBS Commodity Index – all in US dollars.

to outperform bonds in 2011. “You’ve got to believe in outright deflation to put new money into bonds right now,” said one investment banker.³

The logic might have been impeccable, but the strategy wasn’t so. As of early December, US debt securities, as measured by a Bank of America Merrill Lynch index, had risen by 8.7% in 2011, their best performance since 2008.⁴

In other words, bond yields might have been seen as unusually low a year ago. But they have fallen even further since, and those who tried to profit by market timing or making concentrated bets elsewhere have paid a heavy price.

So if the experts can’t get the broad asset class movements right, what chance on earth have they of correctly and consistently predicting individual stock or commodity performances? But year after year, that doesn’t stop them from trying.

One prominent investment bank team was quoted by *The Australian Financial Review* last January as saying that platinum was the metal to back in 2011. As of early December, the spot platinum price was down nearly 14% for the year. On the Australian stock exchange, platinum stocks Platinum Australia and Aquarius Platinum—both recommended by the bank—had delivered total returns to the end of November of -83% and -53%, respectively.⁵ Ouch!

Stock picks often go wrong because forecasters base their calls on what turn out to be incorrect assumptions on macro-economic variables like base lending rates and inflation. Take the *AFR Smart Investor* magazine “expert panel,” which in late 2010 suggested to readers moving out of international fixed income and into cash given expectations of rising cash rates in Australia.⁶ As it turned out,

Aussie rates did not move until November, and when they did the direction was *down*, not up.

Currencies are another variable that defy even the most assiduous forecasters. In its 2011 outlook, published in the *London Daily Telegraph* in December 2010, a major British bank forecast sterling would be the best performing currency of the year.⁷ The banks also predicted stock markets would outperform bonds, with the FTSE 100 rising about 18%. A year later, sterling ranked only a distant fourth behind the Japanese yen, Norwegian krone, and Swiss franc, and the FTSE was nearly 6% lower.

It’s a tough business, isn’t it? And remember these are major financial institutions with armies of expert analysts, mountains of data, and sophisticated forecasting tools. So what is an ordinary investor supposed to do?

The first lesson might be that forecasting is hard, particularly about the future! You can do all the analysis you want, but events have a way of messing with your assumptions.

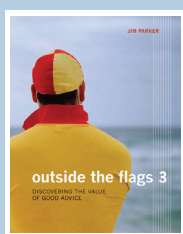
The second lesson is you don’t really need forecasts to succeed as an investor. Yes, equity markets were rocky again this past year. But a properly diversified fixed income portfolio provided excellent returns. Staying diversified both across and within asset classes helps lessen the effects in down times and ensures you are still positioned to reap returns when riskier assets come back into demand.

The third lesson is that the past has gone. The news may be gloomy, but that information is in the price. When risk appetites are low, the price of safety is higher than at other times. But the expected reward for risk is higher. Conversely, when risk appetites are high, the expected rewards are lower.

It's human to feel anxious about bad news because we fear loss more than we like gains. But in this case, the loss isn't real unless you realize it, so it makes sense to stay with the asset allocation your advisor has tailored for you.

The final lesson is that nothing lasts forever. In fact, of all the forecasts ever made, the only one really worth counting on is that things change. What's more, they often change in ways we least expect.

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1. *"For 2011, It'll Be All About Equities," Pensions & Investments, December 27, 2010.*
 2. *"Asian Trader: Stockpickers, Look Eastward," Barron's, December 20, 2010.*
 3. *"Outlook 2011," Barron's, December 20, 2010.*
 4. *"Treasures Rise on Concern Europe Struggling to Resolve Crisis," Bloomberg, December 7, 2011.*
 5. *"Platinum to Become the Price of Metals in 2011," Australian Financial Review, January 7, 2011.*
 6. *"How to Rebalance Your Portfolio in 2011," AFR Smart Investor, December 17, 2010.*
 7. *"Sterling Best Major Currency Next Year, says Barclays," The Daily Telegraph, December 10, 2010.*



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