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RATIONAL REFLECTIONS

November 2020

The Folly of Predictions

- Coming into 2020 not a single credible Wall Street annual outlook forecast a pandemic. And few, if any, predicted the markets would recover, as they did strongly in the second and third quarter. So why do investors continue to rely on these forecasts for actionable intelligence about future events, even though the strategists have missed some of the most important events?
- As humans, we have an innate desire to make order out of chaos.
- It can be tempting to internalize predictions, especially when the stakes are high, such as the outcome of a presidential election or the growth of our retirement accounts.
- Predictions can be fascinating, terrifying, and even entertaining, just don't let them overly influence the decisions you make with respect to your portfolio.

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In 2016, there were stories that if Donald Trump was elected as the President of the United States, certain individuais would sell everything and move to Canada. A well-educated man that I know deeply internalized the prediction that the U.S. and the economy would fall into a dark abyss if Trump took the White House. After President Trump won, he made good on his word. He sold his house, car, and investment portfolio, and moved to another state (not Canada, but still nice). Taking up freelance work during the day and as a waiter a few nights a week to help get by. Today, he lives very modestly in a small town and is still freelancing.

His belief in a prediction that turned out to be mostly wrong changed his financial life in a dramatic way.

In my June 2020 *Rational Reflections*, I asked a simple question: How valuable are the investment forecasts of proclaimed experts? In constructing a rational answer to this question, I argued:

> *In nearly every decision — whether it be investing, business, health, or relationships — there are some factors and inputs that we can predict and control, and others that we cannot. These decisions, while only completely clear in hindsight, can be difficult in the present as they involve uncertainty, risk, contradictory or incomplete information, and sometimes wilful deception.*

Coming into 2020 not a single credible Wall Street annual outlook forecast a pandemic. Moreover, following the March-April market swoon, few of these well-paid strategists correctly predicted the markets would recover, as they did strongly in the second and third quarter. **So why do investors continue to rely on these forecasts for actionable intelligence about future events, even though the strategists have missed some of the most important events?**

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The folly of predictions is just as relevant on the political front: With weekly polls and predictions showing President-elect Joe Biden commanding a steady lead over President Donald Trump leading up to the November 3rd election, how much value did the polls add, especially now that the president-elect's popular-vote margin appears to have been so narrow?

Sometimes it is easier to accept the illusion of predictions rather than the reality of uncertainty.

As humans, we have an innate desire to make order out of chaos. We think the markets can be measured with precision, like an engineering or physics problem. But investing, although measured by numbers, is not Newtonian physics. Instead, it's more like quantum mechanics, which attempts to explain randomness and disorder — as if quantum mechanics somehow could also reliably predict investor behavior and emotion.

And it can be tempting to internalize predictions, especially when the stakes are high. We have no problem ignoring a weatherman who forecasts cloudy skies or the Las Vegas odds maker who predicts the line on a college football game; except for NASA missions or high-rolling gamblers, the stakes in those predictions are relatively low. **But when it comes to the outcomes of a presidential election or the growth of our retirement accounts, we tend to give more attention to expert predictions because the stakes are relatively high.**

As I noted at the outset, I've seen the consequences of flawed predictions driving bad money decisions firsthand. The doomsday scenario that certain media convinced people would happen never played out. As per the example above his lifestyle, at this moment, is radically different from what it was before. Maybe better, maybe worse. But certainly different.

The problem, from my perspective, was he let a prediction about something over which he had little control drive his money decisions. He believed that if X happens, then Y must necessarily happen. While that "If X, then Y" scenario was certainly possible, he may not have considered the many other possible outcomes. Just as the many elements that pollsters use to construct their models and assumptions led to inaccuracies, as we once again sort through this election cycle, a natural question surfaces:

> *What will happen to the market if the unexpected candidate prevails?*

The answer to this question can range anywhere from euphoric to cataclysmic, with potentially far-ranging impacts on portfolios. For example, in a September 2020 survey of investor attitudes about the election conducted by Edelman Financial Engines, 97% of respondents said they expected their favored candidate to win. (This puts into high relief the intense disappointment of half the nation when the November 3rd results were announced.) Also telling: 50% of respondents said they planned to make changes to their portfolios because of the election outcome.[i] This means that even though nearly all investors thought they could accurately predict the election outcome, fully half were prepared to make significant changes to their investments based on a coin toss on how the market would react based on their inaccurate predictions.

Richard Thaler, a Noble Prize winning economist, sums it up well: **"People aren't dumb. The world is hard."**

It can be scary to accept how much of the world we don't understand and how much of what happens to us – and to our portfolios – is out of our control. Nobody knows the future, and we can fool ourselves into thinking that someone knows anything about what is about to happen next, particularly in complex systems. Predictions are, by their very nature, just that. Sometimes they are right and sometimes they are wrong. **And while predictions can be fascinating, terrifying, and even entertaining, just don't let them overly influence the decisions you make with respect to your portfolio.**

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[i] *Edelman Financial Engines, 2020 Financial Insights Study. Survey of 2,000 U.S. adults ranging from ages 45 to 65 with an annual household income of more than $100,000 was completed online by OnePoll between August 27 and September 1, 2020.*

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