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Behavioral Finance and Investing: Why It Pays to Ignore the "Experts"

"The only function of economic forecasting is to make astrology look respectable."

– John Kenneth Galbraith

By Ted Neild

We recently published the first in a series of insights on behavioral finance, examining how humans are prone to rely on irrational thinking, mental shortcuts, and emotions when it comes to decision-making. Here, we explore how behavioral finance affects one specific aspect of investing — misguided attempts to forecast the stock market.

The overwhelming evidence from decades of academic research is that nobody can reliably and accurately predict what the stock market will do. Short-term forecasts — including predictions of where the market will be one year from now — are a fool's game.

Jeff Sommer, writing in *The New York Times,* recently noted that "the median Wall Street forecast from 2000 through 2020 missed its target by an average 12.9 percentage points — which was more than double the actual average annual performance of the stock market." Even worse, during those 20 years, the median Wall Street prediction was never negative, yet the market was down six of those years, or nearly a third of the time. Another study found that the accuracy of capital market experts' predictions of U.S. equity returns was actually less than 50-50. Sometimes these experts do get it right by random chance and have a moment in the spotlight, but the noise of their predictions eventually catches up.

Why do these so-called experts keep spouting this nonsense when they know their forecasts are essentially worthless? Beyond the fact that few are keeping track of their terrible track record, these analysts are not paid to make accurate forecasts. At Wall Street investment banks, they are paid to support stocks that their firm might be representing in a public offering or other transaction, or they are paid to create the appearance of certainty so that their private banking clients will continue to buy the products they are selling. Their forecasts do not need to be correct, they just need to get a deal done or create the illusion of calming certainty.

Biases and Misbehaviors

The bigger question is why are we such suckers for these predictions? First, these prognosticators are smart people who have interesting things to say about what has already occurred, despite the flaws in their forecast. More importantly, our need for this type of information is normal human behavior that has been ingrained into us over centuries of evolutionary influence. Humans hate uncertainty, or at least the appearance of it. It creates stress, activating our sympathetic nervous system, which is responsible for our fight-or-flight response.

Our brains have evolved to become pattern-recognizing machines as shortcuts. They are constantly trying to find patterns and associate them with previous recognizable patterns so the stress and anxiety of uncertainty melt away. On the other hand, our brains are surprisingly weak at processing logic, remembering facts, and making calculations. As a result, we are highly susceptible to so-called “confirmation bias.” Our natural tendency is to notice, focus on, and give greater credence to evidence that fits with our existing beliefs. These Wall Street forecasts are the tonic our brains seek and impart a subtle halo of credibility even though we intellectually know they are flawed.

How to Fight These Tendencies?

The first step is to recognize the biggest misconception about investing is that great investors have some sort of crystal ball. An honest recognition that no one can predict the future direction of markets should form the strong foundation for long-term investment success.

Don’t Attempt to Time Markets

Attempting to enter and exit markets based on flawed forecasts is a loser’s game. For long-term investors, equity markets generally tend to increase, driven by the ingenuity and hard work of profit-maximizing company leaders and their teams. This is eventually reflected in the increasing value of both public and private companies. Equity markets have risen in roughly two-thirds of calendar years. It does not matter if it’s an even year or an odd year, if it’s a Republican president or a Democratic president, or any other random external condition.

Sit There!

There is wisdom in John Bogle’s famous advice that when faced with uncertainty, “the best rule you can possibly follow is not ‘Don’t stand there, do something,’ but ‘Don’t do something,

stand there!'" All kidding aside, this is incredibly difficult when your brain is racing, and the experts are spewing nonsense. Take a deep breath and recognize that your innate tendency to create an illusion of certainty and assert control is likely going to do more harm than good. Just breathe and remember your long-term plan.

Know Where You Are

While forecasts may be worthless, investors can gain some confidence by understanding where we are. The U.S. equity markets trading at 20 times forward earnings is a riskier proposition than when they are trading at eight times. Valuations are rarely a good indicator of near-term market corrections — in either direction — but they do have some correlation with longer-term expected returns. We do not need a crystal ball to know it's wrong to chase hot markets trading at high prices.

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