Forecasting the "Unforecastable"

In our January 1999 report to our clients, we did something that we seldom do, because we know better. We made a market forecast. Even though most other investment professionals are regularly giving their prognosis for the market, we learned long ago the futility of the exercise. But extremes seemed so extreme at the time that we felt safe with our forecast. And our forecasts were right on the money, just a year too early. The Internet stocks would crash… there would be a significant sell-off in the market… the market would begin to value "value"… the large stocks would start to under perform the rest of the market.

There are two reasons investment professionals are constantly making forecasts. First, it makes good marketing sense. To attract new business, there is a tendency to tell people what they want to hear. Second, and more importantly, these forecasts drive stock prices, but only in the near term, sometimes only in the very near term. Just watch the Nasdaq each day. Dramatic stock swings occur with almost no new information. As professionals, we like to think of these rapid, extreme price changes as reflective of changing forecasts for the fundamentals. In reality, they would be better labeled as investor mood swings.

Since our clients are like most other investors, we assume that they would like to see a reasonable market forecast. Let's avoid the mood swings and look at what we might consider in making a forecast of the future direction of the market. How can we do that in the above context? We should start with some thoughts from two of the most renowned investment professionals.

The Experts Speak

Jeremy #1: Jeremy Siegel is a Wharton professor who wrote the widely acclaimed book, *Stocks for the Long Run*. He has many other credentials, including a Ph.D. from MIT, a close following in the investment community, and frequent appearances on "Wall Street Week," CNN, and CNBC. At a recent conference, Professor Siegel stated that current valuations were reasonable and fully justified because the world has significantly changed, with lower taxes, better liquidity, no threat of depression or hyperinflation, technological innovations, etc. There is no reason not to expect a continuation of above-average market returns for the next decade.

Jeremy #2: Jeremy Grantham has cofounded two investment advisory firms highly regarded by the investment community, Grantham, Mayo, Van Otterloo & Co. and Batterymarch Financial Management. He spoke at the same conference as Professor Siegel, but he projected a very different scenario. Valuations are at their highest level ever, with price/earnings ratios 41% over their long-term trend line. Stocks will need to drop 45% to 55% to move to a proper valuation, and the great bear markets usually go on for years, not months. He forecasts that real returns in the stock market for the next decade will be flat to down.

The above two Jeremys are as knowledgeable and experienced as can be found in this profession. They have used their years of study and practice to make forecasts for stock prices over the next decade—forecasts that are exactly opposite. Which forecasts should you believe and rely upon to make important investment decisions? Probably neither. A good rule with forecasts and with investments in general is to never go with an extreme. Can we come up with something better, and what can we learn in the process?

News You Can Use

As we have stated in the past, one of the most important things to know is what you do not know. The list can be very long, especially when it comes to market forecasting. No reliable forecast of the market can be made for the next year, three years, or even five years. It would have been a purely random event to forecast accurately the explosion/implosion of the technology bubble of 1999/2000 or the bull market of the 1990s. We simply cannot predict future economic conditions, global competitive factors, unexpected events/shocks, etc. However, we do know some things, and we can probably make a reasonably accurate long-term forecast, at least as long as we define long-term as 10 to 20 years out.

We can easily predict that the economy will continue to grow over time. We have relatively accurate forecasts for our work-force growth, and it is reasonable to assume that technology and global competition will result in continued productivity gains. Also, our self-correcting, free market system seems to adjust eventually for severe imbalances, and this will help us keep a handle on inflation. These factors sum to a reasonable forecast for gross domestic product growth in the range of 6% per year. Assuming that competition keeps profit margins stable, this 6% per year growth also serves as a good forecast of corporate sales and profits over time.

If we added to the above a reasonable estimate for inflation, say 3% per year, then our multi-decade equity market forecast would come to 9% per year. This may not be very exciting, but we believe it would be more reasonable than those forecasts by the two Jeremys. Our forecast would be higher if we assumed that price/earnings multiples would continue to expand as they have over the last 19 years. Unfortunately, a more reasonable assumption would be that market multiples will contract, especially for the giant companies that dominate the equity index weightings, such as General Electric.

Portfolio Factors

That is about as far as we are willing to go with our market forecast, around 9% per year for the next 20 years. But we believe that there are things that can be done within a portfolio context to enhance your return. For example, you may have noted our above reference to General Electric (GE). How can we be critical of what is probably the greatest company in the world? We can for the same reason that we singled out Coke in the late 1990s and Cisco in 1999/2000. "Valuation" can be ignored for some time but not forever. GE trades at over twice the average market multiple (price/earnings ratio). Some premium is warranted because of the quality/safety of the company, but, similarly, this $465 billion stock should be discounted because of the inability of anything this huge to grow as fast as other alternative stocks. Competitive forces and government controls will not allow it.

Just as with the economy, it is much easier, when analyzing stocks and sectors, to forecast long-term earning trends than it is to predict current quarter or current year earnings. This is why we use normalized earnings and normalized multiples in our stock buy/sell research process. Fundamentals change slowly over time, but valuations can move rapidly above and below those trend lines. Sometimes good companies stumble, and the market can be punishing. Depending on the qualitative analysis, this may be a buying opportunity. Similarly, studies have shown that stocks with very high growth rates begin to slow before the market expects them to do so. Investors almost always assume that the rosy past will continue forever. This is usually a selling opportunity.

We believe that it is relatively easy to enhance the return of your portfolio. Simply put, you cannot do what everyone else is doing. That will only guarantee failure. We believe that you must always pay attention to price and make sure that you do not waste time forecasting things that cannot be forecasted. If you know what you do not know, then you are more willing to construct a portfolio that recognizes that lack of knowledge, i.e., properly diversify. Portfolio diversification will ensure that you are participating in the upside while easily absorbing the unavoidable shocks on the downside.