Barrantagh
Investment Management

The Forecasting Illusion

fore·cast *–verb - to predict (a future condition or occurrence); calculate in advance.*

There are many different ways to view stock markets, many different ways to analyze them and many different ways to buy and sell stocks. Yet there seems to be no bigger quest than to come up with the perfect forecasting method. People spend countless days, months and even years analyzing data in an attempt to find patterns or trends and develop forecasts. Whether it be economic indicators such as industrial production or CPI, stock market measures such as earnings revisions or moving averages, or highly sophisticated algorithms studying complexity and chaos theories, people are on a never-ending search for the illusive holy grail of investing; the one model that will accurately predict when the market will go up or down.

Historically, most of these models are built around the view that markets are rational and efficient. Differences in individual client objectives, risk tolerances, trading patterns and investment time-frames are ignored. They are thrown out as statistically insignificant, yet this is where many models break down.

Human behaviour adds additional complexities to forecasting. People often behave emotionally, rather than rationally. The study of behavioural science reveals emotion can lead people to invest irrationally and make hasty decisions or errors in their forecasting.

One of the major emotions regularly cited in studies is overconfidence. With the abundance of information available to individual investors, overconfidence has become a large, unknown variable in the market. Witness the bubble of 1999. Investors overestimated their knowledge and underestimated risk. This was a repeat of 70 years earlier. Recall that Joe Kennedy pulled out of the market in 1928, shortly before the crash of 1929. As the story goes, he moved all his money into cash after being alarmed by the fact that a shoeshine boy was giving him stock advice.

In an article entitled, “The New Science”, published by Olsen and Associates, Dean LeBaron, founder and chairman of Boston-based Batterymarch Investment Management is quoted as saying, “The results of the forecasting effort have been consistently disappointing. Those of us who are practitioners have developed a very fine art of covering up for this.”

At Barrantagh, we do not rely on market forecasting models. Like Mr. LeBaron, we believe that forecasting does not live up to its promise. Forecasting simply looks for that magical combination of variables that ‘tells you what to do’ and employs hindsight to justify how accurate the econometric model can forecast. This is a top-down focus. We believe that investing should be driven by bottom-up fundamental analysis. Investing should be an iterative process that allows you to accumulate investment knowledge and skill along the way.

For those reasons, we continue to expound the virtues of our tried and true fundamental, bottom-up, value based investment philosophy and process. Simply put, this means we like to purchase stocks that are cheaper than their fair market value.

We start and end our analysis with facts. We analyze each company's current and historic financial health, their management team and establish a price based on these facts. Analyzing a company's financial statements is quantifiable. Factors such as cash flow and price to book can be measured. Confirming whether a management team has been successful versus their business plan is easily determined.

When we conclude what a company is worth, we include a 'margin of safety', which Benjamin Graham described as the three most important words in investing. We use a long time horizon to cancel out short term market noise and unforeseen events. After all, our job as investment managers is not only to make our clients money but also not to lose what they have worked so hard to obtain.

Our consistent, value-added performance comes from knowing companies not forecasting economies or markets. Can we forecast if the market is going to go up or down and by how much? No. Can anyone? No, although many preach in a convincing manner. Remember, you can easily flip a coin with the same mathematical probability. Can we tell you if a company is a good investment? Absolutely!

One final thought. As philosopher Ludwig Wittgenstein said, "The world is all that is the case. The world is the totality of facts, not of things." At Barrantagh, facts talk, theories walk.

fun da men tal –*adjective – being or involving basic facts or principles; the*

fundamental laws of the universe.

Barrantagh Investment Management Inc. provides disciplined portfolio management to institutional and individual investors. The firm is committed to a high level of client service provided directly by its experienced partners. We are dedicated to preserving our clients' capital while generating growth through consistent application of our value-based fundamental investment philosophy. We manage portfolios on a segregated basis to meet our clients' investment objectives. Because the firm is owned by our professional staff we maintain a completely independent and objective perspective.

For more information contact:
Barrantagh Investment Management Inc.
(416) 868-6295
info@barrantagh.com