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Steadyhand

No One Can Predict the Future - Not Even Financial Advisers

By Tom Bradley

In Canada, there's been an increased effort by financial and public institutions to educate investors. Out of this have come some exceptional students, but as a whole, Canadians are still lingering in the early grades.

If I were to do a report card, I'd say that investors understand that asset mix is an important driver of returns. They sort of get that higher returns come with greater volatility. And they grudgingly accept that the long-term is what matters.

But despite this knowledge of basic principles, investors can't break the habit of trying to call the market. As a result, near-term forecasts invariably play too big a role in their investment decisions.

In doing my marking, I'm not excluding myself and other portfolio managers from this plight. For us, predicting the market is an occupational hazard. Clients ask all the time and there's only so many times we can say "I don't know." And when we win a new client and are implementing their strategy, we can't help but want their initial experience to be good. A negative return right out of the gate makes for unpleasant phone calls.

But talking about where the market is going is investing's lowest common denominator. It's like talking about the weather, except it has less chance of being right.

The S&P/TSX Composite Index is ultimately driven by the profitability of companies in it, but in the short term, its direction is influenced by a myriad of factors. They range from those in the spotlight (currently oil, currencies and a strong U.S. economy) to ones lurking in the shadows – revenue, profit margins, technological change, price-to-earnings multiples, debt levels, credit spreads, regulatory policy, corporate governance, investor psychology, demographics, wars, weather and thousands of others.

So if predicting the market is so hard, why do we spend so much time doing it? As noted above, the investment industry and media contribute to this misallocation of intellectual resources, but at the core, human nature is the problem. Investment professionals want their clients to believe that they know more than they do; the media want readers to care about the daily news flow; and investors, who naturally want to grow their money, not lose it, are constantly fighting the twin demons of fear and greed.

Investors are particularly vulnerable to hindsight bias, or the tendency to see an event as having been predictable, even though there was no basis for predicting it prior to its occurrence. In this regard, I've lost track of how many people have told me they predicted the tech wreck. In a decade, the list has grown from a handful to almost everyone.

What can you do to break this nasty habit? Well for sure, you need to stop asking your adviser or portfolio manager where she thinks the market is going. If she offers her view unsolicited, politely cut her off.

Remind yourself how difficult it is to predict the market by looking for patterns on a long-term chart of the S&P/TSX or S&P 500. From year to year, or decade to decade, you won't find any consistency or symmetry. The trend up and to the right is irresistible, but the path is anything but predictable.

If you're serious about reform, there's nothing like real money to learn more about investing. You might consider carving off a small part of your retirement portfolio and managing the money at a discount broker. This will allow you to act on your market views and keep track of how you're doing. But a cautionary note – don't allocate more money to the strategy, or talk about it at parties, until you've been through a full cycle. Short-term results are meaningless.

Or you might consider the approach with the highest chance of succeeding – determine an appropriate long-term asset mix and stick to it by using contributions and withdrawals to rebalance your portfolio. The more automatic you make the process, the less influence market noise will have on your investment decisions.

Doug Macdonald of Macdonald Shymko & Co., one of the pioneers of the fee-only financial planning in Canada, had it right when he told me, "It became much easier to do our job once we realized that nobody, including us, knows what is going to happen in the future." We all need to learn that lesson.

Tom Bradley is the President of Steadyhand. This article was published on January 15, 2015, as a Special to the Globe and Mail.