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Prediction Addiction

You would think that 2016, above all other years, would have cured people of seeking predictions of the future, even leaving aside the Chicago Cubs. The United Kingdom voted to leave the European Union and Donald Trump won the presidency, neither predicted by Las Vegas betting lines, political polls or prediction futures markets. Despite having failed in every possible way they could fail during the political season, pundits now confidently predict the aftermath. New Year's predictions abound.

Assume we could go back to June 1, 2016, when the Dow Jones Industrial Average was about 17,800, and convince you that Brexit passes and Trump gets elected. What would your guess have been then of the year-end Dow price? Would it have been within 5,000 Dow points of 19,762, the actual year-end price?

If you think so, you may be guilty of hindsight bias, rationalizing what happened no matter how farfetched it was previously. The initial reaction to the Brexit vote was that worldwide markets declined sharply. The initial reaction to the U.S. election was that the Dow futures were down about 900 points during the evening of the election. We do not recall seeing any favorable market predictions based on these outcomes.

Now Brexit *might* be good for the world economy and the Trump administration successful, but futilely trying to predict future events is wrong on five counts. First, predicting the future is hard, and this year just about everybody got just about everything wrong. The long run record of those predicting the financial markets is also dismal. Wall Street analysts as a group are too optimistic about future earnings, so we not only know they will be wrong, we also know in which direction they will be wrong. So why bother obsessing about their estimates?

The financial media has an interest in keeping you tuning in or reading, so they have no interest in accountability for the analysts they use as news sources.

Second, even if you predict reality, you do not know how the markets will process it. "Everyone" knew that a Clinton victory would be a positive for the markets (reducing uncertainty!) while Trump would be negative (nothing but uncertainty!). They also knew Brexit would be a disaster, but

nothing much happened.

Hindsight bias allows us to ignore and forget what we thought would happen.

Third, once the markets have reacted to the event, that initial reaction is often incorrect. Consider the 1980 election of another outsider, Ronald Reagan. There was disdain for the president-elect and pre-election predictions of a market decline with that outcome.

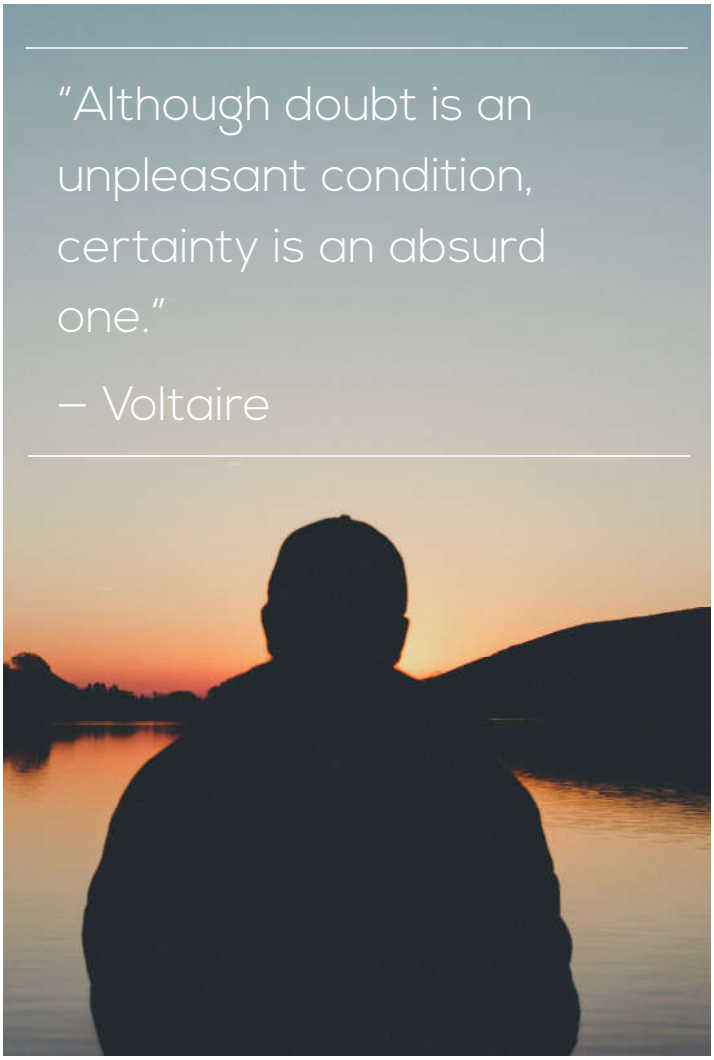
The market rallied ten percent by the end of November, faster than in the current rally. Most observers of all political stripes will now agree that Reagan's economic program was good for the economy and the financial markets, starting a boom and bull market that lasted almost two decades. The market did not exceed that November 1980 market high, though, for almost two years, with the S&P 500 declining 27 percent in between.

Fourth, all prediction rests on the notion of causation – if A occurs, B will happen so therefore we should do C. This is appealing psychologically to most people, a predictable, clockwork universe with few surprises. Unfortunately, this is not the world we live in.

We cannot even agree on causation *of things that happened in the past*, let alone the future. Both the deregulation and capital gains tax cuts attributed to the Reagan revolution started in the Carter administration, but accelerated in 1981.

Both sides still argue that they started the boom, demonstrating another behavioral flaw (confirmation bias) that affects most political commentary. We easily detect evidence that our political side does good, while somehow managing to ignore any contrary evidence.

Finally, as a result of all these difficulties predicting events, evaluating reactions and assigning



causation , insisting on trying to predict events is destabilizing psychologically.

In late 1980 you might reasonably have thought the market cheap, about a third of today's valuation, but frustrated by your inability to predict the election and the market response.

Losing confidence, you could sell everything on the cusp of a two-decade bull market for stocks and bonds.

The enemy of good investing is not our inability to predict the future but our inability to reconcile ourselves to a probabilistic world in which very little is certain. Be smart in the present and the future takes care of itself.