

# Crystal Balls, Tea Leaves, and “Expert” Opinions

By William Hammer, Jr.



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*“We have long felt that the only value of stock forecasters is to make fortune-tellers look good.”*

*-Warren Buffett*

**T**he best financial resolution that we can make this year is to stop giving any weight to economic and market forecasts. By forecasts, we are referring to any prediction about GDP growth, interest rates, hot sectors, stocks, the next investment guru, or anything else that would require a crystal ball.

While these predictions are certainly very interesting to read, history has proven that they are worth about as much as the paper on which they are printed. In the investment world, talk is cheap and predictions are even cheaper. Before you open your favorite publication’s 2011 investment guide, remember the following examples of expert predictions gone wrong.

During Jim Cramer’s show on March 11, 2008, he told viewers, *Bear Stearns is fine. Do not take your money out.* The stock was trading at around \$62. Less than three months later, the company was bought for \$10/share.

Few of us would invest based on Cramer’s advice, but most of us would feel confident in the recommendations of Goldman Sachs’ Senior U.S. Investment Strategist Abby Joseph Cohen, right? In December 2007, she predicted that the S&P 500 would finish 2008 at 1675. It closed 2008 at 903.25.

What if Rich Pzena, a manager guru in charge of \$15 billion, called a company “the cheapest stock I have ever seen” and presented his thesis at a well-known investment conference? That would be a slam dunk, right? He recommended Freddie Mac in December 2007, and the government took control of the company on September 7, 2008.

How about Ken Fisher, a billionaire investment guru who has been a Forbes columnist for over 25 years? He recommended AIG stock in his January 28, 2008 column. AIG stock declined 97% through the end of 2008 and was the worst-performing S&P 500 stock of the year.

If there is anything these predictions can teach us, it’s that the “experts” cannot foresee even the most extreme market movements and global financial meltdowns.

Yes, every rose has its thorn, and every market meltdown has its John Paulson, who made billions in 2008. The bad news is that we could not have identified him as a genius ahead of time. Furthermore, it is highly unlikely that the hero of one

crisis will have a repeat performance during the next one.

The good news is that solid, long-term investment returns are dependent on factors we can control. One crucial factor, which the above examples reinforce, is that we need to diversify our portfolios as broadly as possible. We diversify because we cannot know which stock, sector, or country will perform best or worst in the short run. On top of that, we are not compensated for individual holding risk because it can be diversified away.

Once you lower risk through broad diversification, the three main sources of returns become asset allocation, market timing, and security selection.

A 2002 study by Dimensional Fund Advisors showed that only 4% of the variation in returns of \$452 billion of pension plans was based on stock picking and market timing. The study also showed that 96% of the returns were explained by three factors—their allocation of equities versus fixed income, small-cap versus large-cap stocks, and value versus growth companies.

Those three asset allocation factors explain returns because in fair markets **your cost of capital is your expected return**. The capital markets create enormous competition. Analysts compete to find attractive securities, companies fight to issue stock at high prices and borrow at low interest rates and investors seek to buy stock at low prices and bonds at high interest rates.

Investors buy equity instead of debt because of a higher expected return. Small companies would never get funding unless they provided a higher expected return than larger companies. Returns for distressed, cheap companies have also been historically higher because investors want greater compensation for uncertainty.

We pay attention to forecasts in hopes of finding quick or easy returns, but the truth is that risk and return are always interconnected. Hoping for high returns with low risk is what swindled Madoff investors out of billions of dollars.

While the entire industry is focused on the 4% that cannot be predicted, make 2011 the year that you focus on the two factors that will make almost all of the difference in lifetime investment returns: 1) Your asset allocation and 2) Your commitment to diversification. **FA**

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