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2016 shows folly of pundit predictions

ON INVESTING
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Last year was a year of surprises. Sure, the Chicago Cubs won the World Series for the first time in 108 years, and Brad Pitt and Angelina Jolie announced that they are dissolving their marriage, but I'm talking about more interesting topics, like those that impacted the capital markets.

Last June, the United Kingdom held a referendum on continued membership in the European Union. In November, Donald Trump won the election to become the next president of the United States. Then, in December, the Federal Reserve raised its target for short-term interest rates.

There was much advance speculation surrounding all of these events. However, the odds of most of them actually transpiring were quite low. Indeed, many commentators predicted fairly dire consequences if Britain did in fact leave the EU or if Donald Trump were to win the election. The media was rife with talk of economic decline, a nasty bear market in stocks and chaos in the currency markets. Yet the pundits assured us that the odds of Brexit or a Trump White House were very low.

Rising interest rates were more widely anticipated, but any uptick in rates is usually associated with hand-wringing over the potential negative impact on the stock market. There was certainly no shortage of stories in the media and from Wall Street gurus warning of a pending stock market downturn.

Generally, the stock market favors the status quo. Surprises are quite often met with market declines. However, despite the fact that actual events in 2016 turned out differently than the seers foretold, the stock market shrugged off the "bad" news.

Rather than a precipitous decline, the S&P 500 rose almost 12 percent last year. Data on fourth quarter GDP hasn't been released yet, but the economy almost certainly grew at a decent rate for the full year.

This made the forecasters wrong on two accounts: The events they said wouldn't happen actually did occur, and the market's reaction was the opposite of what was predicted.

What happened? Why didn't the sky fall? Why did those calling for a recession suddenly change their tune, and why are they now predicting robust growth for 2017? The short answer is that the "pros" are frequently wrong.

I used to work in the equity strategy group of a large Wall Street firm. I saw firsthand that even the smartest, most experienced professionals who work a lot of hours, have the best technology, and seemingly unlimited resources are not able to consistently make accurate market calls.

My observation is not unique. There are numerous studies from the academic field showing the failure of market prognosticators. In fact, one study estimated that market, economic and political forecasters are correct only about 47 percent of the time. That is worse than flipping a coin. Real-world empirical data also shows a multi-decade track record of underperformance by the vast majority of investment professionals who attempt to beat the market.

That leaves us in a position where we really can't trust most of the "noise" that comes out of the financial world. Whether it is talking heads on CNBC or more formal looking reports out of the major investment banks, you should question the validity of their conclusions.

Rather, a more successful strategy is to focus on what you can control. No one can predict what the market will do next, but there are approaches you can take in any market environment to help ensure you have a positive, long-term investing experience.

The most obvious is to actually take a long-term approach. Most individual investors have a need to save for retirement, which may be several years in the future, and which may last for many years. Accordingly, a long-term need should be met with a long-term investment strategy.

Pick an asset allocation plan you can live with over many years, regardless of market cycles. The "experts" may warn about impending market downturns, but clearly this past year showed that they know no more about the future than you. Tune them out and stick to your plan.

Also, keep trading to a minimum. It can be fun to pick stocks, but moving in and out of stocks frequently can impair your returns. There are trading costs, such as commissions and bid/ask spreads that erode your earnings. They may not seem like much, but even small costs can add up and compound over many years.

In fact, there are many costs involved with investing, and they should all be aggressively minimized. Trading costs, mutual fund expense ratios, and investment advisory fees are a necessary part of the process. After all, brokers, fund managers, and investment advisers should get paid for the work they do, but the costs should be reasonable. It is not unusual for these costs to be much higher than necessary, which ultimately takes money out of your pocket.

The largest cost most of us incur is taxes. High-income or high-turnover strategies may subject your investment returns to ordinary income tax and could erase a third or more of your return. Holding more tax-efficient investments may result in lower long-term capital gains tax treatment. However, the best approach is to trade very little, so you defer your taxes for many years and your earnings continue to compound. In fact, if you defer capital gains until after you die, it is possible your heirs can avoid paying taxes on your investment earnings altogether.

Trading to rebalance back to your long-term asset allocation targets may be necessary to keep your risk profile in check, but even this should be kept to a minimum in taxable accounts.

This coming year may bring additional market surprises. Other nations may leave the EU. We may have new, untested economic and foreign relations policies. Certainly geopolitical events, terrorism and natural disasters represent continual risks. However, while there will always be market surprises, a disciplined, long-term investment approach is timeless.

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