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Crystal Balls Can Be Misleading

Imagine an investor who could read just the front-page stories of future newspapers today. How would this change things? Even if he or she could not see the stock price tables, surely this fortunate person would be able to ride a bull market and avoid a bear market. Think again. The events of 2003 should put to rest the notion that it is likely that any mortal (with or without access to tomorrow's headline news) could time the market successfully. Let's review the events that have transpired to see if it was likely that we could have benefited from knowing with certainty what would occur ahead of time.

Early in the year the economy was staggering and unemployment rising, despite a dramatic easing of monetary policy and recent tax cuts. There were great concerns about the risk of future deflation (which historically has been very bad for equities). Then we had the Iraqi war amid concerns about weapons of mass destruction. Iraq remained a minefield fraught with great dangers. On top of that, we experienced an escalation of tensions in the rest of the Middle East.

Even as the economy seemed to improve around mid-year, the employment situation continued to deteriorate. Then we had to deal with the SARS epidemic — and its threat to world trade. Add to that the problem of corporate scandals plaguing Wall Street — even encompassing the quasi-government Freddie Mac corporation. This was almost unthinkable prior to 2003. But if that were not enough, there have been a seemingly endless string of headlines on alleged corrupt behavior within the mutual fund industry. Surely all of this could lead to investors losing some confidence in the markets.

And there's more. We are warned about the dangers of the unprecedented federal budget deficit that continues to grow in size. On top of that, we have record trade deficits. We are constantly warned that the combination of these "twin deficits" could lead to foreign investors losing confidence in the US economy, leading to monetary flows out of domestic stock and bond markets. The results could lead to rising interest rates, rising inflation and a falling stock market. In fact, the dollar has fallen dramatically against major foreign currencies. And the conflicts in Iraq continue.

Further, we're facing a renegade nuclear power, North Korea, a rise in oil and natural gas prices, an increase in overall commodity prices, and the threat of rising inflation. Had investors possessed perfectly clear crystal balls, allowing them to predict these events, would they have been likely to run

out to buy stocks (increasing their equity allocation)? Or is it more likely they would have run as quickly as possible to the sell (if not the panic) button?

Despite all this bad news, the S&P 500 was up more than 28 percent in 2003 — and it was about the worst-performing equity asset class in the world.

Using appropriate benchmark indexes for the various domestic asset classes, we can see that 2003 proved to be a great year for US equities.

Benchmark Index	2003 Returns
CRSP 9-10 Index (Micro Cap)	78.4%
CRSP 6-10 Index (Small Cap)	58.5%
Fama/French Large Value Index	35.0%
Fama/French Small Value Index	74.7%
Wilshire All REIT Index	36.2%

The following are the returns of international asset classes during what many perceived to be a tumultuous period. Again, we use the benchmark indexes as indicators of asset class returns.

Benchmark Index	2003 Returns
MSCI EAFE Index	38.6%
MSCI Emerging Markets Free Index	56.3%
MSCI EAFE International Value Index	45.3%
MSCI EAFE International Small Index	57.8%

What, if any, lesson should we take from this seeming paradox of terrible economic and political news amidst strong global equity markets? Since the basis for any stock market forecast is founded in political and economic forecasts, even if investors got the political and economic forecasts 100 percent correct (and in reality, no one has tomorrow's papers), they can still get the market forecast 100 percent wrong.

So why does Wall Street focus so much of its attention on political and economic forecasts? Because, by getting investors to play that game, Wall Street makes money — either via commissions every time a trade is made or by enticing people to invest in expensive actively managed mutual funds that claim they can outperform (even though they rarely do). And why does the media pay so much attention to market-timing efforts? It is simply because they need viewers to tune in. The winning strategy for Wall Street and the financial media is the losing strategy for investors. The successful formula for investors is to build a globally diversified portfolio that meets their unique ability,

willingness and need to take risk. Then, they must ignore the noise of the markets, the media and Wall Street propagandists; and simply rebalance the portfolio along the way.

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