2017: Predictions vs. Probabilities

As the holidays come to a close and people turn to the possibilities of what 2017 has to bring, it is tempting to fall into the age old trap of listening to or developing predictions for the next 12 months. Many investment firms will issue targets for the market or stocks like “the S&P 500 will rise 10% in 2017” or “We don’t like utility stocks in 2017”. Others will take a stab at predicting interest rates or what the Federal Reserve may do. Every year we get predictions that promise “great” opportunity or will guide you away from investment “peril,” which crowd the internet and pack the magazine racks. Many of these predictions, some bold in nature, may make great cocktail party fodder, but little else. Steve Forbes, the publisher of Forbes Magazine, was once quoted, “You make more money selling advice than following it. It’s one of the things we count on in the magazine business- along with the short memory of our readers.”

“Consider a simple example where an investor hears a prediction that equities are currently priced “too high,” and now is a better time to hold cash. If we say that the prediction has a 50% chance of being accurate (equities underperform cash over some period of time), does that mean the investor has a 50% chance of being better off? What is crucial to remember is that any market-timing decision is actually two decisions. If the investor decides to change their allocation, selling equities in this case, they have decided to get out of the market, but they also must determine when to get back in. If we assign a 50% probability of the investor getting each decision right, that would give them a one-in-four chance of being better off overall. We can increase the chances of the investor being right to 70% for each decision, and the odds of them being better off are still shy of 50%. Still no better than a coin flip.” The only thing that is certain is the above investor will incur transaction costs.

At LCA we believe in developing a portfolio based on what is proven academically and not based on changing market calls. For example, in measuring overlapping 15 year periods from 1928-2015 the market outperformed T-Bills 96% of the time. See below:

![Overlapping Periods: January 1928–December 2015](image)

The probability of the market beating T-Bills (cash equivalents) is 69% even in a one year time frame.

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1 [https://my-dimensional.com/insight/issue_briefs/199316/](https://my-dimensional.com/insight/issue_briefs/199316/)
2 [https://my-dimensional.com/insight/issue_briefs/199316/](https://my-dimensional.com/insight/issue_briefs/199316/)
3 [DFA Master Slide Library, May 2016, slide #65](https://my-dimensional.com/insight/issue_briefs/199316/)
We also believe in staying disciplined and not letting the predictions of outsized gains or impending doom influence an investment plan. For example, in the chart below, we show the growth of a dollar invested in equities from 1970-2015 coupled with a few of those doomy predictions.

As 2017 begins it is natural to look at the successes and failures of the past year and try to improve on them. When reviewing a well conceived investment plan, unless the objectives or risk tolerance has suddenly changed, you should trust the plan you have in place. Solid plans are based on what is proven to work over time. Focus on what you can control: diversifying broadly, minimizing taxes and reducing costs and turnover. Each will greatly improve your probability of success. Remember, predictions sell magazines. Happy New Year!

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Exhibit 2: Markets Have Rewarded Discipline
Growth of a dollar—MSCI World index (not dividends), 1970–2015

[Graph showing growth of a dollar invested in equities from 1970 to 2015 with notes on doomy predictions from various magazines and services.]

In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. MSCI data © MSCI 2016, all rights reserved.

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