Winter 2017

360 Insights

Quarterly Investing and Financial Perspectives

Did You Earn 40% in 2016?

by **Matthew Carvalho**, CFA, CFP®, Director of Investment Research, Loring Ward

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That sounds like a crazy question, right? CDs, savings accounts and many bonds are paying next to nothing. Return expectations are down across the industry. Yet, if you held U.S. small companies from their lows in February of 2016 through mid-December you would have seen a more than 40% gain on that position, as measured by the Russell 2000 index. And who saw that coming?

For the last few years, U.S. large cap stocks have lead the way in performance, outperforming small companies, international and emerging markets. Coming into 2016, the common question was why even bother with a diversified portfolio when you could just buy large household names like Apple or Visa and enjoy the gains we've seen since 2009.

Yet, any look back at historical returns will show us that recent performance is not a good predictor of what will happen next. And 2016 was one of those unpredictably predictable years, where following the recent trend might not have been the wise move.

As of 12/14/2016, large value outperformed large growth by 9% and small companies outperformed large companies by 8%.

U.S. Stocks 2016 Year to Date

	Value	Core	Growth
Large	17.7%	12.7%	7.9%
Mid	20.3%	14.4%	8.2%
Small	31.0%	21.1%	11.6%

Keep in mind this was following several years where many of these asset classes underperformed large growth companies. Many investors started to wonder if it was worth the wait.

Looking at the chart below, you can see that large companies outperformed small over the past few years. However, had you sold off your small cap exposure heading into 2016, you could have missed out on an additional 8% of returns for that portion of your portfolio.

	2012	2013	2014	2015	2016*
Large Companies	16.4%	33.1%	13.2%	0.9%	12.7%
Small Companies	16.4%	38.8%	4.9%	-4.4%	21.1%
Small +/-	-0.1%	5.7%	-8.3%	-5.3%	8.4%

*Through December 14, 2016

While we believe U.S. small companies, or value or emerging markets for that matter, are an important piece of a diversified portfolio, no one can predict when performance like we saw in 2016 will occur next. The decision to invest in small or large companies could look good or bad depending on the day you look at your statement. A diversified portfolio will always have some great performers and some less-than-stellar ones, but having gains occur on different asset classes at different times can help to reduce the level of ups and downs the portfolio experiences.

Remember, in order to capture that 40% gain from the lows in February you had to stay invested, even after that asset class dropped by 16% and the potential temptation to sell

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Hindsight

by **Meir Statman**, Glenn Klimek Professor of Finance at Santa Clara University

Predictions on November 7, 2016, the day before voters elected Donald Trump as our next president...

"As the historic 2016 U.S. presidential election approaches, major Wall Street analysts agree that the S&P 500 will likely sell off if Donald Trump wins, and at least hold gains if Hillary Clinton wins." — CNBC

"We believe that if Trump wins, markets are likely to fall further and not bounce back quickly as they did following Brexit, where the United Kingdom voted to leave the EU." — J.P. Morgan

"The S&P 500 could potentially fall 11 to 13 percent if Trump wins the election." — Barclays[1]

These forecasts and their realization, only a day later, teach us once more that hindsight is much clearer than foresight. Psychologist Baruch Fischhoff wrote, "In hindsight, people consistently exaggerate what could have been anticipated in foresight... People believe that others should have been able to anticipate events much better than was actually the case. They even misremember their own predictions so as to exaggerate in hindsight what they knew in foresight."[2]

Good hindsight shortcuts lead us to repeat actions that brought good outcomes and avoid actions that brought bad ones. Hindsight shortcuts can turn into hindsight errors, however, where randomness and luck are prominent, loosening associations between past events and future events and between actions and outcomes.

Fast driving when luck is good gets us faster to our destination, but fast driving when luck is bad gets us a speeding ticket or worse. Hindsight errors can mislead lucky drivers into thinking that fast driving always gets them to their destinations more quickly, and can mislead unlucky drivers into thinking that fast driving always gets them a speeding ticket. Hindsight errors also can mislead lucky traders into thinking that fast trading always gets them to their

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The Future Isn't What It Used To Be

The Great Predictive Failures of 2016

by **J. William G. Chettle**, VP, Loring Ward

The *New York Post* headline the day after the 2016 U.S. elections put it best: "Pundits, Polls, Politicians, the Press: EVERYONE WAS WRONG."

From the U.S. elections to Brexit to economic doom-saying, 2016 saw a series of spectacularly erroneous predictions. Again and again, experts were proven wrong and had to scramble to explain why they had missed the mark so badly.

The year began with calamitous predictions from the economists at the Royal Bank of Scotland who said that 2016 would be a **"cataclysmic year,"** with stock markets falling as much as 20%. The bank told investors: **"Sell everything except high quality bonds..."**

But the Scots were not the only doom and gloom outliers. In January of 2016, market guru Michael Pento predicted similar declines: **"The S&P 500 falls more than 20 percent as it finally succumbs to the incipient global recession."** He also thought the dollar would slide precipitously (it didn't).

Others were even more pessimistic. James Dale Davidson, an investor and economist who correctly predicted the market downturns of 1999 and 2007, warned: **"...a 50-percent correction in the stock market is actually a conservative estimate. If the market drops to its 2009 lows, we'll actually see a 70 percent correction.... Real estate will plummet over 40 percent, savings accounts will lose 30 percent of their value, and unemployment will triple."**

Personal finance author Robert Kiyosaki predicted that the world would see the worst stock market crash in history in 2016: **"We're on the edge of a cliff right now. We have never been here before."**

Back in 2015, Marketwatch columnist Paul Farrell was already seeing disaster ahead: **"It's time to start the countdown to the crash of 2016. No, this is not a prediction of a minor correction. Plan on a 50% crash."**

Even those who should have known better joined in. Lawrence H. Summers, director of the National Economic Council for President Obama, worried in January that volatility in the Chinese market might presage global financial disaster: **"Because of China's scale, its potential volatility and the limited room for conventional monetary maneuvers, the global risk to domestic economic performance in the United States, Europe and many emerging markets is as great as any time I can remember."**

Several actual end-of-the-world predictions also failed to materialize. Some claimed that scholars had incorrectly interpreted the Mayan calendar as showing the world would end in 2012. The "correct date" was actually June 3 – 4, 2016.

And a viral video from the YouTube channel "End Time Prophecies" predicted that the world would end on July 29 with a **"polar flip"** and worldwide **"megaquake."**

But not all the experts were catastrophe mongering. Some were just mildly pessimistic. David Kostin, chief U.S. equity strategist at Goldman Sachs, called for a replay of 2015 this year. **"Flat is the new up,"** with the S&P remaining essentially unchanged for the year. And according to *The New York Times*, the consensus on Wall Street was that the S&P 500 would rise 7% in 2016.[1] As of December 14, the S&P closed up 12.60% year-to-date.

The same *New York Times* article notes that since 2000, the Wall Street consensus, "...has called for an average yearly increase in the S&P 500 of about 9.5 percent. The actual average annual change was less than 4 percent, however, and consensus predictions were inaccurate in every single year, sometimes by preposterous margins. In 2001, for example, the consensus called for a gain of 20.7 percent. But the index fell by 13 percent. In the horrible year of 2008, the consensus was that the market would rise 11.1 percent. As many investors may recall, it fell by 38.5 percent. Not once since 2000 has Wall Street predicted that the market would decline in a calendar year. Yet the market actually fell in five of those years."[2]

As Professor Meir Statman notes in his accompanying article, while experts failed to predict the outcomes of major political events such as Brexit and the U.S. elections, they also missed the mark on the economic impact of these political surprises.

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The Great Predictive Failures of 2016 *continued from page 3*

In both cases, predictions were dire, reality not so much. In fact, British markets have rebounded substantially from their post-Brexit lows and the Dow hit all-time highs in early December.

Why are experts wrong so often? In part, it is the pressure to stand out and get attention. After all, how often do you see a headline proclaiming: "Experts agree that markets will perform normally next year." But the larger challenge is the sheer unknowability of the future. And even if we know something will happen, we can never be sure exactly how markets and economies will react when it occurs. This helps explain one of the largest and most consequential predictive failures: the inability of most active managers to reliably predict how markets and stocks will perform over time.

In fact, over the last 10 years (through June of 2016), 85.36% of large-cap managers, 91.27% of mid-cap managers, and 90.75% of small-cap managers underperformed their respective benchmarks.[3] Identifying those few outperforming managers ahead of time has proven next to impossible, especially since many outperformers are unable to maintain their winning track records over time.

Instead of trying to predict the future and invest accordingly, most investors would be better off buying and holding a globally-diversified portfolio and letting the long-term growth potential of markets help grow their wealth. It isn't exciting or headline-grabbing, but over time this approach has made a real difference for many patient, educated investors.

When it comes to predictions, perhaps we should follow the example of the Leipzig Zoo's "oracle koala" Oobi-Ooob. The zoo had big hopes that Oobi-Ooob could help predict the outcomes of Germany's soccer matches in Euro 2016. But he failed utterly and completely. So the zoo fired him…

"As a fair loser he is now leaving the predictions to others. He sees his strengths in eating eucalyptus," said a zookeeper at the Leipzig Zoo.

[1]Jeff Sommer, "One Market Prediction Is Sure: Wall Street Will Be Wrong," *The New York Times*, Jan. 9, 2016

[2]Ibid.

[3]SPIVA® U.S. Scorecard Mid-Year 2016

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was highest. That's often been true over time — reversal of relative returns can occur quickly in different investments, and in order to take part in those gains you have to be able to stay consistently invested in those areas for the long run.

Source: Morningstar Direct 2016, U.S. markets represented by respective Russell indexes for each category (Large: Russell 1000, Value, and Growth, Mid: Russell Mid Cap, Value and Growth, Small: Russell 2000, Value and Growth). Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Emerging markets involve additional risks, including, but not limited to, currency fluctuation, political instability, foreign taxes, and different methods of accounting and financial reporting. All investments involve risk, including the loss of principal and cannot be guaranteed against loss by a bank, custodian, or any other financial institution.

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profit destinations more quickly, and can mislead unlucky traders into thinking that fast trading always inflicts losses.

We protect ourselves against hindsight errors by the steady holding of diversified portfolios…our way of accepting, wisely, that our investment foresight is not as good as our hindsight, and that we should keep our eyes firmly on our financial and life goals.

[1]Evelyn Cheng, "Wall Street reacts: Here's what the markets will do after the election," CNBC Market Insider, Nov. 7, 2016

[2]Fischhoff, Baruch. "Debiasing," in Judgment Under Uncertainty: Shortcuts and Biases eds. Daniel Kahneman, Paul Slovic, and Amos Tversky (Cambridge University Press, Cambridge U.K. 1982): 422-444

Diversification neither assures a profit nor guarantees against loss in a declining market.

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