

The Trouble With Stock Market Predictions

**Portfolios heavy
with
under-
performing
stocks almost
never
outperform the
market.**

Ignat's Law

**“There is nothing so
disastrous as a
rational investment
policy in an
irrational world.”**

*The General Theory
of Employment,
Interest and Money.*
by
**John Maynard
Keynes**

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Many predictions regarding individual stocks do not work out as hoped. One element of my research over the past four years has focused on changes in Wall Street analyst's rating on individual stocks. These reports have covered thousands of analyst's rating changes and they confirm an unexpectedly high error rate for these predictions.

When taken literally, a “buy” recommendation is a prediction that the stock will outperform the market. Conversely a “sell” recommendation is a prediction that the stock will under-perform the market. And a “hold” recommendation is a prediction that the stock will perform as well as the market. These predictions are made by experts who follow the affairs of these companies closely. Why are these predictions so often “off the mark?”

In general, it is understood that predictions usually fail, not because of the analysis of the primary factors that were used to arrive at the prediction, but because of changes that took place in variables that weren't even considered. This is probably true for stock market predictions in general.

There are many, many factors that can affect stock prices. Not only do the independent variables change, but the parameters that tie those variables together can change as well. It seems clear that stock prices are the output of a non-linear system in which the size of the output is not always related to the size of the inputs. Some observers have remarked that economics is not physics and that

seems to be true. If economics is not physics, then investing cannot be physics either. Stock prices are not determined by mathematical formulas and rigid laws that are found in physics.

It must be remembered that Wall Street analysts are human beings after all and they are subject to hopes and fears just like anyone else. Wall Street analysts do not seem to be purely rational in their stock predictions. The “animal spirits” that Keynes wrote about seem to affect analysts just like anybody else.

Stock analysts are also subject to the force of “social proof.” (see the book *Influence* by Dr. Robert Cialdini.) It is a well known behavior pattern when people find themselves in a highly ambiguous and uncertain situation. Almost without thinking, people will look to see how others are behaving in this situation and they will follow suit. Social proof seems to provide an explanation for the crowd following that often takes place on Wall Street. Social proof does not just affect Wall Street analysts, but all investors seem to be subject to its influence.

Investors should not allow themselves to become overly committed to predictions about the future of a stock price. When such a commitment to a prediction takes place, adverse price movements by the stock are often ignored until the loss becomes significant and it is clear that the prediction was wrong. The danger of commitment to stock predictions calls attention to the need for risk control.

The true purpose of risk control is to clearly indicate when expectations about a stock are not working out as hoped. This is often accomplished with a long-term chart of the stock's performance in the market. W. Clay Allen CFA