

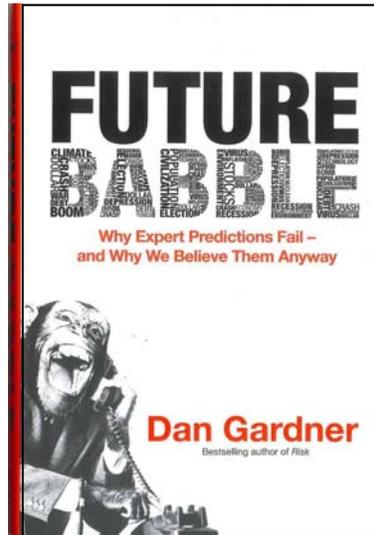
FUTURE BABBLE

January 2011



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The Essence of...



This book explains why expert predictions fail and why we believe them anyway.

The first part of the answer lies in the nature of reality and the human brain. The world is complicated – too complicated to be predicted. As for why we believe expert predictions, the answer lies ultimately in our hard-wired aversion to uncertainty.

My two favourites of the many ‘failed prediction’ examples he gives are:

1. the hardcover edition of economist Ravi Batra’s *The Great Depression of 1990*, which hit the top spot on the New York Times best-seller list and spent a total of ten months on the chart; and
2. another great flop, the 1999 book *Dow 36000* by James Glassman and Kevin Hassett, which was published just prior to the tech bubble bursting.

Gardner uses the research of Philip Tetlock, a psychologist at the University of California’s Haas School of Business. In 1984 Tetlock recruited 284 experts – political scientists, economists and journalists. Over many years, he and his

At Genus we continuously read experts’ predictions for the economy and the markets. As experts ourselves, we also make predictions and position investments to take advantage of those predictions. Therefore, when I received the book “Future Babble” for Christmas, I couldn’t read it fast enough. Here is a summary...

team peppered the experts with questions. Historically, it was by far the biggest exercise of its kind, and the results were startlingly clear: as a group, these experts would have been beaten by “a dart-throwing chimpanzee.”

However, within the group there was a wide range of ability. “Some experts are so out of touch with reality, they’re border-line delusional. Other experts are only slightly out of touch. A few experts are surprisingly nuanced and well-calibrated.”

“What made a big difference is HOW they think.”

Experts who would have improved their results if they had flipped a coin were not comfortable with complexity and uncertainty. They sought to “reduce the problem to some core theoretical theme.” These experts were also more confident than others that their predictions were accurate.

Why wouldn’t they be?

They were sure their One Big Idea was *right*, and so the predictions they stamped out based on that idea must be airtight too. The author called these thinkers “hedgehogs.”

Experts whose predictive success rates were higher than group average – and whose predictions fared better than random guesses – thought differently. Rather than reducing problems to a single theory, as the others had, they instead drew information and ideas from multiple sources and sought to synthesize it. They were self-critical and always questioned whether what they believed to be true was, indeed, really true.

When they were shown that they had made mistakes, they didn't try to minimize, hedge, or evade the fact. Most were comfortable seeing the world as complex and uncertain – so comfortable that they tended to doubt the ability of anyone to predict the future. The author calls these thinkers “foxes.”

And so, interestingly, this all results in a paradox: **the experts who were more accurate than others tended to be less confident.**

The Nature of the Human Brain Makes Predicting Problematic

Most brain functions happen without our having any conscious awareness of activity, which means that this “**unconscious mind**” is far more influential in our decision-making than we realize.

People are particularly disinclined to see randomness as the explanation for an outcome when their own actions are involved. Psychologists call this the “**illusion of control.**”

Blame evolution. **We consistently overlook randomness but we see patterns everywhere, whether they exist or not.** For humans, **inventing stories** that make the world sensible and orderly is as natural as breathing.

Overconfidence is a universal human trait, closely related to an equally widespread phenomenon known as “**optimism bias.**”

Humans also suffer from “**confirmation bias.**” We will eagerly seek out and accept information that supports our ideas, while not bothering to look for information that does not. **Admitting a mistake and moving on does not come easily to homo sapiens.**

People who try to peer into the future – both experts and laypeople – are very likely to start with an **unreasonable bias in favour of the status quo.** Today's trends will continue, and tomorrow will be like today, only more so.



Why Humans Seek Out and Crave Predictions

We want control. We need control. Bad things happen when we don't have it. Control is such a fundamental psychological need that doing without it can even be torture.

“**Hindsight bias**” is a well-documented phenomenon: once we know the outcome of a situation, we tend to think that outcome was *more* likely to happen than we would have had we judged it *without* knowing the outcome.

Hedgehogs give people what they crave. They all but ooze certainty and therefore dominate airwaves, best-seller lists and public discussion. As social animals, **we are exquisitely sensitive to status.** An expert, in the appropriate circumstances, has considerable status.

Research has shown that financial advisers who express considerable confidence in their stock forecasts are more trusted than those who are less confident, even when their objective records are the same.

Statistics be damned. **Tell me a story.**

There's Not Much Risk for Experts Who Make Predictions

An aside - In 1976, my Investments 101 professor at Arizona State University introduced us to the Howard Ruff Newsletter by bringing it to class. My professor's point was that if we chose a career in investments we would always be confronted by confident, pessimistic experts. You can still buy his newsletter, which hasn't changed much in thirty years. www.rufftimes.com



Heads: I win. Tails: You forget we had a bet.

Sunny or bleak, convictions about the future satisfy the hunger for certainty.

We want to believe, so we do.

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problems to a single theory, as the others had, they instead drew information and ideas from multiple sources and sought to synthesize it. They were self-critical and always questioned whether what they believed to be true was, indeed, really true.

Conclusion

Three key elements explain why the foxes' cognitive style improves the accuracy of their forecasts:

- 1 **Aggregation:** they seek out as many sources as possible;
- 2 **Metacognition:** they take time to absorb information, think about it from all angles and as well, give consideration to how they might be wrong;
- 3 **Humility:** they accept new information, they 'know they don't know', and they don't peer too far into the future.

Accurate Predictions are Often Not Needed to Make Good Decisions

What predictions is Genus making as we enter 2011 and therefore *how are Genus portfolios positioned?*

The Federal Reserve is **Reflating** and won't stop until the economy is creating its own self-sustaining growth. (This is normally good for the stock market and has been since July 2010). The longer-term effect of this stimulus is inflation at some point. For the past two years higher risk stocks have out performed the large, safe, high dividend multi-nationals.

The economy is **Recovering**. The U.S. economy will probably grow at 3% in 2011 with Europe slower and the emerging markets higher. Interest rates will have trouble dropping from here. If interest rates go up, the price of bonds goes down.

The world is **Rebalancing** its economic growth engines. The Great Recession is a 'once-in-100-year' event, but the changing of the guard for economic growth is a 'once-in-1000-year' event. In 2011 China is trying to slow down its hot economy. There is going to be volatility in the emerging markets, but over the coming years, this is where the global growth will be. Even if there is a harder landing than anticipated, the future for these markets is strong.

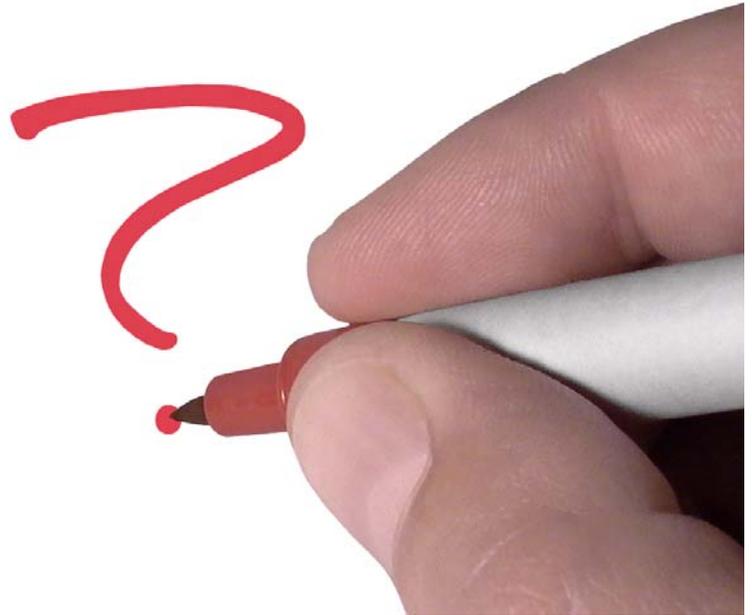


Our exposures include:

- underweight bonds (and the bonds we have are short and corporate);
- overweight defensive stocks;
- emerging markets; and
- an underweight Europe.

How Confident Are We That We Are Right?

And What Happens If We Are Wrong?



We are confident that the reflation efforts by central banks, or Quantitative Easing two (QE2), will continue to stimulate the economic recovery in 2011.

Longer term, there is some risk that after quantitative easing has run its course, deflation rears its head again (Japan scenario). Bonds will do well – and our portfolio would go up, but not as much as longer term bonds. Our high yielding, cash rich, defensive stocks will be the stars in this case. The government and consumers will be sick – these corporations will be the best place to be, and we will be reminding clients to spend their dividends and interest, not their capital.

If China has a hard landing (recession) in 2011, our emerging market exposure will decline, but we do not have a large position – only 6% of the total equity allocation in most portfolios, and only a quarter of that is invested in China. Growth will come there longer term. So, if we are wrong in 2011 we won't sell, but instead we will probably buy more to keep us at 6%.

If China has a severe economic reversal, it would also hurt Canadian commodity stocks but they too will come back later.

If inflation comes back faster than predicted, then our short bonds, versus long bonds, will help, but they will still decline. Our defensive stocks will go up, but not as quickly as commodity stocks. Canadian commodity stocks and our dollar will do very well. In this case we will wish we had more of our core stocks - Suncor, Canadian Natural Resources, Barrick Gold, Goldcorp and Potash.

Genus has a track record of very steady growth. It's our diversification that helps us achieve that result.

Thanks for taking the time to read this.



Please call or email with any questions.

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