Dimensional

OUTSIDE THE FLAGS

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Headline Blues

It's a tough gig being a financial media pundit whose job requires making eye-grabbing calls on the outcomes of major world events. But at least the pundits rarely have to deal with the consequences of their bad predictions.

From the Brexit referendum, to the US presidential vote to general elections in Australia, the Netherlands, France and the UK, the record of many media and market pundits, pollsters and self-appointed 'gurus' has not been particularly distinguished.

Time after time, emphatic and confident-sounding headlines about the likely outcome of these events, together with the likely market reaction, have proved incorrect. This wouldn't matter so much, if many investors didn't take these calls seriously.

On April 19, *The Times* of London splashed with 'Theresa May Set for Landslide in Snap Election—Brexit Voters to Desert Labour'. The story said May's Conservative Party was on course to win a majority of more than 100 seats in the June national election.[1]

The Wall Street Journal reported the same day that May's gamble to call an election three years ahead of schedule looked likely to pay off, strengthening her negotiating power in securing a favourable deal for Britain in leaving the European Union.[2]

Echoing this view, *The Economist* magazine reported that one major European bank had responded to May's gamble by changing its call on sterling from bearish to bullish and lifting its outlook for UK economic growth.

"The Conservatives would very likely significantly increase their majority of seats and strengthen their negotiating position for a 'hard' Brexit," the bank was quoted as saying.[3]

As we know now, the Conservatives not only failed to increase their majority, they lost 13 seats and fell short of the majority required to govern in their own right. The opposition Labour Party gained 32 seats despite much pre-poll analysis writing them off.

While the Conservatives did lose ground during the seven-week campaign, few pundits expected a "hung" parliament in which no side held a clear majority. Right up until voting day, the betting markets expected May's party to end up with a majority of around 70 seats.

Around this time, *The Economist* magazine editorialised that in the event of such an inconclusive result, the pound sterling and UK equities would "surely" take a hit.[4] Yet on the day after the poll, the FTSE-100

1. "Theresa May Set for Landslide", *The Times*, 19 April 2017
2. "May's Early Election Gambit Reduces Brexit Risks", *WSJ*, 19 April 2017
3. "Markets Adjust their Brexit Calculations", *The Economist*, 19 April 2017
4. "What will the Markets Do if Labour Wins?", *The Economist*, 6 June 2017

benchmark index ended 1% higher. And while sterling did fall by about 2.5% to an eight-week low against the USD, it remained significantly above the three-decade lows it struck in the wake of the Brexit vote a year before.

Reflecting on the relatively tepid reaction, one analyst said markets appeared to have concluded the result would mean only limited change. In any case, a 'softer' Brexit deal might be more favourable for markets, while the weaker sterling was a boost to an equity market dominated by companies which earn the majority of their income overseas.[5]

It was a familiar story. Polls and circumstances can change. Markets price news as it breaks. And, in any case, there are always so many variables and complications that it's very difficult to form a linear view that because one thing happens, another necessarily follows.

Think back to the US presidential election in 2016. Democratic candidate Hilary Clinton held a clear lead over Republican Donald Trump in most major polls right up to the day before the election. Market analysts quoted by CNBC predicted dramatic falls (of up to 13%) in the US equity market if Trump defied the polls and pundits to win the election.[6]

Of course, not only did Trump defy the polls and win, but equity markets took the news "in their stride" (as one newspaper reported). The S&P-500 quickly moved to a succession of record highs and by June 2017 was about 15% above its pre-election levels.

The difficulty of making a living as a forecaster is laid bare. It's tough to forecast the outcome of an event. But even if you get that right, there's still no guarantee the market will react as you assume given the huge number of inputs that drive prices every minute of every day.

So it's worth asking that if market professionals find it hard to accurately and consistently predict the outcome of major events and the market reaction, why anyone should bother making investment decisions by second-guessing prices.

The fact is markets price news quickly. So if collective expectations of an event change, you would expect prices to reflect that almost instantly. While many people think they can outguess prices, the highly competitive nature of markets makes it extremely hard to do that consistently and without costs eating up any gain they might receive.

And even if you *are* right about the outcome of an event, there is still no guarantee that prices, which reflect a multitude of variables, will move the way you expect. The evidence reflects that, with most money managers struggling to match benchmarks over time.[7]

So what can you do? An alternative approach is to assume prices in highly competitive markets are fair and that they contain information about expected returns. You can use the information in prices to form portfolios that are designed to deliver outperformance.

Through broad diversification and by maintaining a long-term focus on your goal, you can improve the reliability of outcomes so that one-off geopolitical events, economic news and stock-specific factors do not throw your plan off course.

The news will come and go, of course, but using an evidence-based approach that harnesses the power of the markets means you can avoid the headline blues.

5. "Why Did Markets Not Reaction to 'Shock' Election Result?", *Morningstar*, 15 June 2017
6. "If Trump Wins, Here's What the Markets Will Do", *CNBC*, 7 Nov 2016
7. "SPIVA Scorecard, Year-End 2016", *S&P Dow Jones Indices*, 24 April, 2017

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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