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As humans, we are bad at predicting the future

Lessons from 2016

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Predicting an event is extremely difficult. With the benefit of hindsight, anyone can be a fortune teller. Especially when you look back at 2016. Most of us believe that we are pretty good at predicting the future.

That's probably because we tend to remember our rationalisations post an event, not our predictions. For pension funds, interest rate predictions have been made explicitly and implicitly. Over the years, we have often heard statements like 'from this point on, interest rates can only go up', but the harsh reality of continuously low interest rates crushed the hopes of many pension fund investors.

To illustrate the difficulties in predicting global events and the subsequent reactions of the financial markets, let's take a closer look at the Brexit vote in 2016. Once the referendum was announced, countless predictions were made on what Brexit would mean for markets, but few of those predictions came true.

Predicting the European Union referendum

If you think about it, a referendum is an unusually well-defined event. The day of the referendum, 23rd June 2016, was set 2 months in advance and the referendum had two possible outcomes: remain in or leave the European Union. We are interested in the predictions that the political experts and opinion polls made regarding the outcome of the referendum. More importantly, we are interested in the predictions that investors made regarding how the markets would react, in the case that the leave vote won the referendum.

Opinion polls and bookmakers provided us with their 'expert view' on the referendum. The Financial Times and The Telegraph used advanced opinion polls, constructed by a renowned political scientist. Both opinion polls indicated that the remain vote would win with a margin of around 5%. On the evening of the vote, the odds offered by the bookmakers were pointing towards a probability of 90% for a remain vote. When the leave side won, many were caught by surprise. Predicting a 'simple' referendum, for which several opinion polls were conducted, turned out to be extremely difficult.

Was the investment community better positioned to predict the impact of Brexit on the market? Before the referendum, banks and experts predicted that Brexit would result in a decrease in sterling with respect to other world currencies, as the Bank of England would resume a quantitative easing program. Deutsche Bank believed that in the event of a leave vote, European equities would go down by 10%[1]. Citigroup was even more pessimistic, seeing a drop of 20%. Morgan Stanley thought that UK stocks would fall by up to 20%[2]. The large players in the financial markets

[1] https://www.ft.com/content/cc1c1d9c-3c10-32ad-afac-a77a1971b246

[2] http://www.cbsnews.com/news/could-brexit-vote-cause-a-stock-market-crash/

believed that the stock indices in the UK, and across the continent, would suffer in the event of a leave vote.

How did the market react to the leave vote?

Given the 'forecasts' of the referendum and the pro-remain sentiment in the financial sector, it is fair to assume that financial markets had priced in that Britain would remain in the EU. When the leave side 'unexpectedly' won the referendum, one would have expected a correction as the market adapted to the new information. How did the markets actually react on the morning of June 24th, when it was clear that the leave side had won the referendum with 52% of the votes?

As expected, investors initially 'overreacted'. The Stoxx 600 fell by 12% within 4 days. The FTSE 100 fell by only 6%. The rush to safe havens resulted in gold experiencing the largest price increase in 7 years. After the initial sell-off, some equity indices rebounded and by the end of June, the FTSE 100 Index increased by nearly 20% from the lowest level that year, which was in mid-February. The immediate rally in UK stocks was explained by a falling pound. European stocks on the other hand remained down by 4% at the end of June. The actual return on the stock market, for the next 7 months, was far different from the predictions provided by major banks as most equity indices had substantial increases. This does not exclude that Brexit blues are still to come. However, the point here is that even if we had known the outcome of the referendum, the impact that such an event would have on the financial market would still have been near impossible to predict.

A dream scenario for DB funds

In the aftermath of the EU referendum and the subsequent quantitative easing, the long-awaited 'dream scenario' for Defined Benefit schemes materialised in the second half of the year – especially in the last quarter. From mid-August to the end of the year, equities increased between 6 - 7% and the yield on 10-year gilts went up by a full percent. This was fuelled by the 'unexpected' market rally that followed the 'unexpected' election of Trump as President of the USA.

This meant that the 'old fashioned' pension fund type of investing had a good run and most DB pension schemes improved their solvency. This led some trustees to believe that markets had finally returned to 'normal' and that they had woken up from a bad dream that had lasted 15 years. Other trustees have viewed the past months as a pleasant power nap, from which they might soon be waking up and returning to reality.

Keep calm and carry on

There are still many outstanding questions on what Brexit and, more importantly, Trump's presidency will mean for investors in 2017. The complexity of the economic jigsaw puzzle has grown significantly because geopolitics and economics are becoming increasingly intertwined. The cocktail of political uncertainty, a growing debt mountain and chronically low economic growth leaves a bitter aftertaste of uncertainty. How this will affect interest rates and inflation is difficult to say. However, we do know that interest rates are determined by monetary policy, economic growth, investor sentiment, and the level of public debt. Considering this, it is plausible that interest rates can start rising in 2017, but also plausible that they could fall even further or stay at the current level for a long period. Experience shows us, time after time, that investors are typically poor at predicting how markets will react. We simply do not know!

Sticking to the traditional asset mix implies two big bets: increasing interest rates and positive equity return. Such a concentrated investment strategy could end amazingly well or in disaster for pension scheme members. Acknowledging that we cannot predict the future, it seems better to build a portfolio with the goal of being diverse. In other words, a portfolio that is robust across different economic developments. At least one thing is certain for 2017 – it will be a very exciting year for pension funds holding a concentrated 'old fashioned' portfolio.

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