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Predictions in the New World

Investment professionals who invest "actively" need to know what will happen in the coming year in the economy and investment markets. However, it may be even more important that they convince potential *investors* that they know. Not a trick question: who earns more, the economist or the head of marketing?

Investment companies' teams of high-priced PhD economists and analysts devote their time and effort to gathering voluminous data, and then to making sense of it in order to direct investment decisions. Teams at different companies may subscribe to diverse schools of approach and come up with varying strategies, but all use their research and analysis to offer predictions for marketing purposes.

Certainly these people believe in the efficacy of their own methods and recommendations. Because they are likely to have some personal money at stake (through direct investment and pay-for-performance), and because their recommendations are so public, they want to be correct. Yet, it's good to remember that the perspective of a PhD economist steeped in one theory or another is more focused on using and testing theory than in practical application. While the average investor's interest in the "success" of a recommendation has to do with increasing his wealth, the economist may be more interested in why his strategy succeeded or failed within the prevailing market climate. An investment loss due to a failed prediction, therefore, is less the fault of the economist and more the fault of the investor who acted on that prediction.

There is a paradox in all of this. First, millions of investors continue to seek the manager who can build strategies that lead to exceptional returns. At the same time, both Wall Street and Main Street have a remarkable level of tolerance for underperformance. You've seen it on "Wall Street Week in Review" in the past, and with all of its successors: investment professionals adamantly share their predictions one week, and later unashamedly admit that those predictions did not prove true. Not a problem for them. Some economists have an extraordinary run of failed forecasts. Byron Wein, since 2009 at Blackrock, but earlier at Morgan Stanley where he began his annual, highly-touted predictions in 1986, has a remarkable legacy of failure. A study of The Economist 1998-2016 found that nearly 70% of the cover page predictions were wrong after one year. **"How many economists does it take to change a lightbulb? Answer: "Seven, plus or minus ten."**

When Assabet Advisors visited the offices of Dimensional Fund Advisors (DFA) in Santa Monica, CA, we saw a hilarious presentation called "Investment Porn." There were no lewd images, just one magazine cover story after another with investment house predictions for the coming year, accompanied by what actually happened in the financial markets. The quantity and depth of miscalculation was astounding, yet the same magazines will be asked for their prognostications in the next year. For good reason, it's the premise of DFA and other "passive" investors that research and theory, however painstaking, is not enough to predict market behavior sufficiently to beat the market itself. Indexing of some form will provide better returns over the long run.

The point is, making correct predictions is tough and happens infrequently, yet hope springs eternal. Despite years of faulty forecasts, professionals continue to research, weigh and analyze a vast amount of data to tell us how to invest successfully. And all experience to the contrary, we listen.

Now, consider the additional confusion caused by the surreal environment of 2016 which ushered in the concepts of "fake news" and "post truth." In a new presidential year, economic and investment predictions tend to hinge largely on the assumed impact of the policies of the incoming POTUS and of his party.

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Predictions in the New World continued

This year, economists and analysts have to offer logical predictions (as always, with a straight face), but they are uniquely challenged. Perusing a myriad of forecasts, we have run across some curious statements amidst the expected references to tax changes, higher interest rates, infrastructure funding, DOL regulations, and the potential for trade wars:

"The truth is, no one has any idea how Trump is going to govern." A. Rothman, investment strategist at Matthews Asia

"Trump talks anti-Wall Street but people are learning that he can exaggerate." J. Waggoner, Investment News 12/1/16

"Stock gurus are no better than pollsters in figuring out Trump," R. Spaulding & D. Burger, Financial Advisor, 11/10/16

Basically, those who have always had trouble creating successful forecasts, now are additionally baffled by an incoming POTUS without the normal analytical things they need to guide their predictions: a political track record, traditional party roots, and a consistent message throughout the campaign.

One analyst sums it up: "This is not normal." (Julie Verhage, Financial Advisor, 12/1/16).

The difficulty in creating true and effective forecasts is not a phenomenon solely attributable to our recent election. It has existed all along. We would take any analyst forecasts with more than a grain of salt, which is why we consistently will say that we don't know what will happen. No one knows what will happen accurately enough to offer a winning investment strategy. That's why we develop asset allocations to manage risk. What is unique in 2016 may be healthy in a perverse way: we may reduce our willingness to believe and be vulnerable to the predictions of "the experts," whether they be pollsters or highly-compensated economists. When we concede that we aren't sure about an outcome, our strategies become more self-protective and more flexible. Asset allocation as a part of a our passive investment strategy doesn't hang on whether or not Trump's infrastructure spending, trade negotiations, repeal of the Affordable Care Act or tax changes come to fruition. We are aiming to balance risk and return for our clients in any environment, no matter how "not normal."

Not My Money

Like many of our readers, we have supported non-profit organizations not only with "treasure," but also with time and talent as Board members. Those experiences can range from tedious to stimulating, depending upon the situation. However, in all cases, we need to remember that as mind-numbing as financial oversight can be, it's vital in order to protect the organization from the "stimulation" of a financial and/or legal crisis.

Pouring over the treasurer's reports and performing prudent reviews may not be your idea of fun, but ask yourself how you approach the same liabilities in your own business. We know how: you're assiduously on top of every detail. Why? Because it's YOUR MONEY! That's never a negligible concern. Because the non-profit is your responsibility as a Board member, make sure that you demand the following safeguards:

-Place a limit on checks that can be written without special monitoring. Greater than 10% above the mean dollar amount of checks in recent years may be a good guideline.

-Have a 3rd party review the financial statements, comparing them to bank statements on a regular and timely basis, not for a formal opinion necessarily but at least to spot any blatant fraud.

-Have someone other than the Treasurer not only have access to the bank account but also will review checks.

-Make sure your Officers & Directors liability insurance is adequate, checking your personal Umbrella Policy while you're at it.

-Establish Board checks-and-balances in the organization's By-Laws and implement them.

It may not be your money, but it's your responsibility, and potentially your headache!

Economic and Financial Overview

In the post-election weeks of 2016, economic concerns and market tensions gave way to optimism, partially due to changing circumstances, but also to a needed respite from campaign fatigue. On the one hand, the threat of a crash in the Chinese economy appeared to have abated, domestic economic indicators remained steady and the Fed signaled economic improvement with a rate hike. On the other, the markets decided that a shift in strategy from a monetary to a fiscal management policy will accelerate positive, but slow growth in the U.S. The early 2017 forecasts anticipated higher interest rates, significant infrastructure spending, reduced corporate taxes and a moderated burden of regulatory constraints. Many caveats might apply to this outlook, but year-end optimism ruled the day and the caveats weren't widely consulted.

The S&P 500 Index of domestic large stocks ended the year +12%. Small stocks were the big winners (+22% on the Russell 2000 index). Value issues surpassed growth. While defensive assets led the market for most of 2016, riskier ones such as cyclical stocks took the lead late in the year. Most analysts believe that if the optimistic view holds, both corporate profits and stock prices will rise. However, market valuations in this 8th year of a bull market are historically high (P/E at 20x last year's earnings), calling into question the potential for continued stock increases. In foreign markets, the emerging sector ended the year +11% (MSCI EM Index) while developed stock markets dragged (+1% on the MSCI EAFE Index)

European economies had fragile growth. The surprising UK Brexit vote in late June caused political unease, not only in Britain, but everywhere globalism was under attack. The European Central Bank's low rate policies persist, in order to spur growth, even as the U.S. has begun to tighten. Result: a widening currency gap which will benefit U.S. consumers, but put pressure on U.S. exporters. International trade may also be affected by growing nationalism and tariff battles.

Anticipating an upward pressure on interest rates as the Fed responds to higher growth and inflation, investors may return to the bond sell-off of 2016.

But You Still Want a Forecast, Right?

OK. We get that. No matter the logic of our lead article warning about the weak success record of economic and investment forecasts (also known as "investment porn,"), you're still interested. Just to be good sports about it, here are some predictions from Fortune's staff for 2017. For the record, the authors say that predictions need to rely on "art and whimsy" as much as science. Do you find that encouraging? For contrast, we've included in parentheses some of the expectations from Barron's survey. and Byron Wein's "10 Surprises for 2017"

Real GDP will break 2%.(Wein: Real GDP will break 3%.)

The IPO market will be coming back.

The climate change agenda will be dismantled. (Wein: Trump will move back from most of his extreme positions.)

A giant infrastructure bill will be proposed. (Barron's: the federal budget deficit may constrain spending.)

Partial tax reform will encourage companies to repatriate their dollars at a low tax rate. This should help the GOP pass deficit-swelling income tax cuts. (Barron's: the additional $ may be spent on stock buybacks and dividends, not capital spending.)

The S&P 500 will finish 2017 at 2,073: 3% less than its close on Election Day 2016. (Barron's: The market will end at 2,380. Wein: The S&P will reach 2,500 and gain 12% for the year.)

The Federal Funds Rate will end 2017 at 1.25%. There will be 3 0.25% hikes before tightening as Trump's plans appear inflationary. (Wein: the 10 year yield will approach 4%.)

China will continue to prop up growth at the cost of high debt.

Putin will increase his cyber offensive, perhaps targeting the Balkans.

Climate Change will drive a refugee crisis.

The Money Exchange: Holiday Giving

What's the best gift you received in the 2016 holiday season? If you answer "a check," you've made my point.

Somehow, over time, gift giving has evolved to a exchange of currency or currency surrogates. The earlier and more obvious shift was in the size of gifts. In mid 19th century America, for example, Christmas wasn't much of a holiday, even to Christians. The gifts tended to be tokens: an embroidered handkerchief, perhaps. (Wahoo!) Hanukkah, never the leading holiday in the Jewish religious calendar, was just beginning to receive greater recognition in that era. As both holidays commercialized over the subsequent decades, gifts became larger.

Traditional gift-giving became an exercise of generosity and creativity. The goal was to select the gift that was adequately costly, and a perfect choice for the recipient. If we focus on the mid 20th century, some of us can recall a time when the choice was easier than it is today. People's lives weren't overwhelmed with "things," and they didn't buy whatever they wanted for themselves. Therefore, it was more apparent what a loved one might want or need, and friends were more appreciative of your thoughtfulness, no matter what you chose. Families who participated in the Santa myth knew what would delight their children because the kids had told him in letter or in person. (Department store Santas first appeared in the first half of the century, but gained traction as a tradition in 1890, thanks to a store owner in Brockton, MA.)

With a rising standard of living, the growing access to cheaper products, and the encouragement of Madison Avenue, Americans bought and spent more for holiday gifts. The circle of those for whom we bought gifts widened accordingly. Gift exchange activities were institutionalized at many workplaces. As the shopping lists became longer, and recipients more finicky, holiday shopping became more of a chore. Some family and friendship groups opted to eliminate gift exchange, abbreviating it to a single gift grab with a cost limit, or enjoying a festive dinner out together.

However, the biggest theme was the monetization of holiday gift giving. The most subtle form was re-gifting. Instead of considering an unappealing gift as just that ("What was she thinking?!"), it became a source of value as it saved you the money of purchasing a gift for someone else.

Some solutions eliminated both aspects of gift-buying: the cost and the selection. Deciding to give to your friend's favorite charity while they give to yours is simply an even cash exchange. No sacrifice of money or thought is required. (So why bother? Do your own charitable giving!)

One of my coworkers years back suggested for the office exchange that we all list the item we wanted to receive, within the cost limit, of course. Basically that amounted to doing someone else's shopping for them. (As I recall, he wanted tennis balls.)

Because people have few apparent needs and have become more picky (wanting not only the product but the precise model and the right color as well) , gift-givers have become terrified of getting the wrong thing. So, we reverted to lists of possible gift items that would be welcome. Making it even easier, we can post our own wish lists in Amazon. The choice becomes a click of the mouse. This is practical and easy, and results in effusive gratitude. When someone says, "Just what I wanted!" they're telling the truth. Men don't have to stand around in the malls in that deer-in-the-headlights stupor.

Gift cards are now the gift most desired by over 60% of Americans. They are not merely a currency substitute. You, the giver, can buy them at a discount, and trade the one you got for one of current design. Some restaurant cards offer the buyer bonuses. The receiver can sell or donate them. Not only has gift giving become a currency exchange, it involves financial sophistication.

Thinking back, my joy was greater when I've picked just the right garment without any guidance, than when I've given right off the list. And my favorite gifts have been those which tell me that the giver has been paying attention.

How about you?