

Is Forecasting Damaging to Your Wealth?

By Roger L. Gewecke, CFA



"It's tough to make predictions, especially about the future."—Yogi Berra

As the calendar turns to each new year, it is common for the news media to recap important events in the last year and elicit expert predictions about what will happen in the year to come. At this point in a market outlook, the author is expected to predict what will happen in one or more tricky investment areas and suggest a course of action that would logically follow from that prediction to produce outsized investment profits.

It is logical to assume that to do well as an investor it is necessary to make accurate forecasts about the near-term future of the economy, interest rates, the stock market, the industries that should profit most, and the companies within those industries which have the brightest prospects. After all, the experts that appear on television to provide their forecasts have no problem sharing their investment insights. They are well-dressed, experienced, articulate, and speak with an air of authority—but do they really add anything of value to investors?

Studies of economic and stock market forecasts have shown that those forecasts generally assume recent trends will continue indefinitely into the future; as such, they are destined to be

incorrect at the most important point: when a trend reverses course.

In January of each year, *Barron's*, a well-respected weekly financial publication, convenes eleven well-known investors and financial forecasters for their Roundtable, where they give their insights and predictions in a series spanning three issues of the

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magazine. In the January 12, 2009 edition, general skepticism about the economy, the stock market, and the future of the financial system abounded. The S&P 500 had already dropped over 40% from its high in October 2007. As evidence of the fear surrounding the prospects for stocks at that time, none of *Barron's* participants were willing to predict that the stock market would return over 7% either in 2009 or on an annual basis over the next five years. This is despite the fact that the stock

market had a compound annual growth rate of 9.5% for the eighty-four years preceding 2009, a period that included the Great Depression, World War II, the Korean War, the Vietnam War, the Gulf War, the stagflation and record-high interest rates of the 1970s and 1980s, and the bursting of the Internet bubble in the early 2000s. *None* of the forecasters were willing to predict even *average* returns for the market for the foreseeable future. What happened next? Less than two months later the market bottomed and stock market investors enjoyed returns of 26% in 2009 and 17% per year for the next five years, with only 2011 showing a return less than that predicted by the most optimistic of the *Barron's* forecasters.

Maybe the stock market and economy are hard to predict, but surely the knowledgeable Wall Street analysts who follow only a few companies would be able to utilize their deep industry knowledge to make accurate earnings estimates, wouldn't they? In a study by David Dreman, from 1973-2010 (a period that encompassed over 800,000 quarterly earnings estimates) the average analyst estimate missed subsequently reported earnings by an average of 40%. One might think

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analysts would do better over time thanks to the Internet and the recent explosion of information, and they did—over the last 15 years of the study they only missed by an average of 35%. This is not nearly well enough to argue for investing your money in a manner that relies on earnings forecasts.

In defense of professional analysts and investors, much more can happen to render a forecast obsolete than anyone can anticipate, which is precisely the point of this article. Forecasting the future is extremely difficult, if not impossible. Keep that in mind when you watch the news and someone is forecasting the price of oil, the stock market, interest rates, or the economy!

Have we broken the prediction addiction yet? If so, what do we do instead?

First and foremost, it is important for an investor to understand themselves and their own individual financial situation. Only then can one formulate an appropriate individualized asset

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allocation that is more likely to be maintained for the long-term.

We should diversify our investments using historical long-term rates of return, rather than short-term forecasts for stocks and bonds, as a basis for an asset allocation that serves our investment goals and tolerance for investment risk. By being properly diversified, it is emotionally easier for an investor to tolerate a downturn in the stock market.

We realize that over long periods of time there is likely no investment available to the average investor that will have better returns than the U.S. stock market. Market moves are largely unpredictable over the short-term, but over the long-term the stock market will generally appreciate 8-10% per year based on historical data. However, it is important to realize that those returns will not reliably arrive every year in a straight line. We learn to accept market fluctuations as a cost of doing business—the price for earning the superior investment returns that stocks provide. Optimally, we look to add to our stock positions during a general market decline.

We also remind ourselves that stocks represent a share of ownership in a business. We all recognize that some businesses have better characteristics than others. We endeavor to invest only in those businesses that have a consistent operating history and have prospered in both good and bad economic environments. We cannot control the *market risk* of a general market decline, but we can control our *business risk* by owning better businesses, whose stock prices generally hold up better in times of stock market declines. Therein lies another critical advantage—by owning superior businesses, we can hold them for a longer period of time without having to sell them and pay taxes on our capital gains.

We also realize that no investment is very good if the investor overpays for it. After determining that a business has the quality characteristics that we insist upon, we attempt to value the business and purchase it at a discount to what we think it is worth, thus decreasing our *price risk* and increasing our potential return. Even in a normal year, a company's stock price is much more volatile than the value that a share in the business represents. Excellent businesses don't go “on sale” very often,

but they sometimes do during a general market decline or a short-term period in which the company's earnings or sales are not as strong as Wall Street analysts expected. It is then that a true long-term

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investor is at a distinct advantage, as the price decline caused by short-term investors heading for the exits presents a low-risk buying opportunity.

We certainly are not recommending that investors remain ignorant of the economic environment. It is indeed important to evaluate potential investments relative to the current interest rate environment, and it is important for us to understand the economic environment facing each of our companies when determining their intrinsic value, but we do not start with a macroeconomic forecast and then fit our entire portfolio to that forecast.

Returning to our forecasters, theirs is a difficult game to play and there are a lot of ways that forecasts can go wrong. So let's use a different strategy and mindset. Hopefully by now you are convinced that the most reliable factors in successful investing are establishing an asset allocation that you can maintain, correct analysis regarding the companies that you own combined with appropriate judgment about their long-term prospects, and a patient attitude. Forecasting is fun and interesting, but it is not particularly reliable—even by the experts! ♦

A Slippery Slope

By Maxwell R. Pray, CFA



The price of oil continued to fall in January with subdued demand growth and persistently healthy supply. This resulted in oil recently trading below

\$50/barrel for the first time since the credit crisis recession in 2008. While the “normal” price level for a barrel of oil in the twenty years prior to 2005 ranged from \$11 to \$52 per barrel, the price has been above \$50/barrel since 2005, except for a temporary dip during the recession. A question currently on everyone’s minds is, “What happens from here?” Predicting the price of oil is a difficult, if not impossible, exercise and not something we at Clifford Swan seek to do. However, evaluating the dynamics of oil—including the impact of price fluctuations on the investor/consumer, the mechanics of its production, and the economics of oil—affords a deeper understanding of a commodity which has a significant impact on the global economy.

The best place to witness the current “oil shock” is at the pump; the average price for a gallon of regular-grade gasoline was recently down to \$2.44 in California. According to the American Fuel & Petrochemical Manufacturers, the cost breakdown for a gallon of gasoline is 65% for the oil, 13% for refining, 10% for distribution and marketing, and 12% for taxes. There are regional differences as well. Compared to California, the average price in Utah and Idaho was \$1.84, while Hawaii was \$3.11 as of this writing. It is understandable that Hawaii has the highest price because their delivery costs are higher—most of the gas used in Hawaii arrives from Asia via ship. The key reason prices in Utah and Idaho are approximately 25% lower than in California is the proximity of those states to oil sources in the U.S. (e.g. North Dakota). In contrast, California’s

higher prices reflect the state’s need to obtain some of its oil supply from more expensive foreign imports, in addition to a state tax rate on gasoline that is \$0.25-0.30 more than in Utah and Idaho.

According to the U.S. Energy Information Administration (EIA), a barrel of oil (42 U.S. gallons) generates roughly 19 gallons of gasoline, 11 gallons of heating oil and distillates, 4 gallons of jet fuel, and 10 gallons of other products. Crude oil prices are set globally by a confluence of factors which include the supply/demand balance for the product and the interaction of buyers and sellers in both the spot (physical) and futures markets. Geopolitical risks, weather, the Organization of the Petroleum Exporting Countries (OPEC), currency exchange rates (both current and futures), inventories, non-OPEC countries, and other influences also contribute to the price of oil.

A common buzzword linked with the oil supply is “fracking.” Hydraulic fracturing (i.e. fracking) has actually been around for decades; first as an experiment in 1947 and then developed in the 1950’s. The process of fracking involves drilling

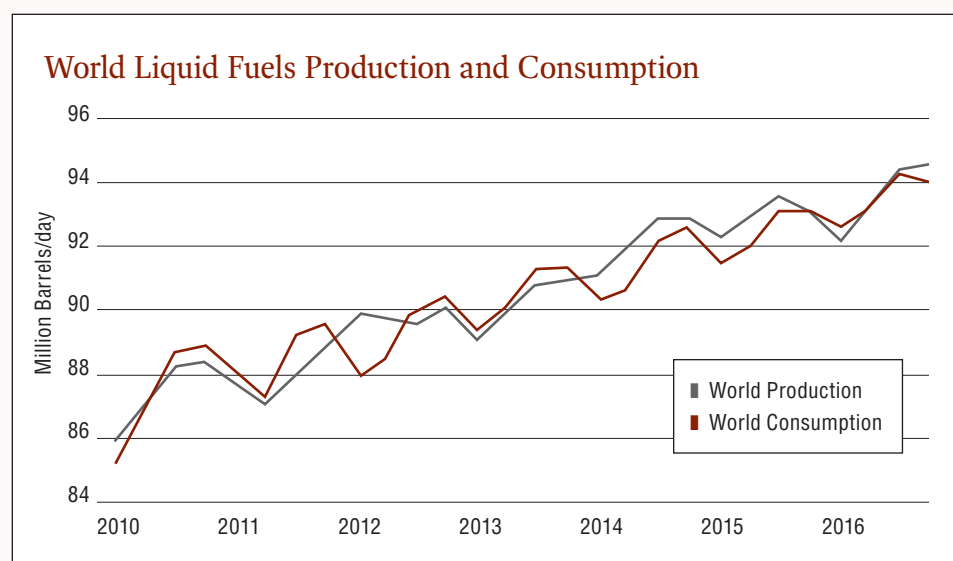
down into the ground 4,000-6,000 feet to the rock and shale areas that have trapped gas and oil (versus drilling to an oil reservoir, the traditional source of oil). A fracturing fluid of water, sand, and chemicals is pumped into the rock, allowing the oil to flow and be extracted. Technological methods that started in the early 2000’s have made extraction methods more profitable, most notably the ability to drill horizontally.

The total worldwide production of oil is approximately 92.2 million barrels per day, of which OPEC contributes 39% and non-OPEC countries supply 61%. The U.S. is the leading non-OPEC supplier of oil, largely attributable to the increased production made possible by fracking. Looking at the chart below, we can see that both worldwide oil production and consumption have increased at a decent clip over the last five years. Production (gray line) has recently surpassed consumption (red line) and created a supply/demand imbalance which has caused the drop in oil prices.

The increased supply from the U.S.

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Source: EIA, Short-Term Energy Outlook, January 2015

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is primarily responsible for production surpassing demand. One of the idiosyncrasies of the current situation is that, in past oil market moves, OPEC used its power to reduce production to steady oil prices. Recently, it did not take this anticipated action, contributing to the rapid descent in falling prices.

The fairly steady growth of supply and demand over the last five years was mostly driven by emerging market economic growth and newer sources of oil. We anticipate that both demand and supply will continue to increase for the foreseeable future. With slow steady growth in developed markets and emerging economies continuing to develop, it makes sense that demand will continue its upward trend. Similarly, with new technologies, the production of oil supply will continue to rise. However, the supply of oil is not infinite, so at some point (20 years from now or 200?) the supply constraint will show itself.

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As supply has caught up with and surpassed demand, we have seen a “correction” in crude oil prices which have fallen from \$105/barrel in June to under \$50/barrel in January 2015. Demand growth has slowed slightly with 2014 consumption increasing at a slower rate than from 2009-2013. The largest demand slowdown has been in China (though still rising, the consumption of oil is increasing at a

slower rate). A very small contribution to the slowing demand may be attributable to increasing sales of hybrid and electric vehicles in the U.S. Hybrids have represented 2-3% of vehicles sold in the U.S. over the last eight years, helping to reduce our oil consumption by 1-2%, at most.

Interestingly, EIA’s 2013 forecast for production growth from North America (primarily the U.S.) predicted about 1.2 million barrels/day for 2014 and 1.0 million barrels/day for 2015; but in the January 2015 Short-Term Energy Outlook, the EIA reported a much higher 1.8 million barrels/day for 2014 and a lowered projection of 0.9 million barrels/day for 2015. Part of the reason for the “dip” in the 2015 forecast is because with oil now at \$50/barrel compared to \$100/barrel a year ago, the incentive to produce oil in the North America has been significantly reduced. When oil is trading around \$100/barrel, the incentive to drill, explore, and find oil makes more expensive technologies profitable to use.

What will happen next? At \$50/barrel, there will be less incentive to extract more oil. Those technologies that cause the cost of producing a barrel of oil to be above \$50-\$75 will be utilized less, ultimately reducing supply. Anyone who tries to predict oil prices and timing will be undertaking a difficult task. A year ago, the experts at the EIA and companies like Chevron and Exxon were expecting and budgeting for a \$90-110/barrel price; today, those prices (and plans) have been adjusted downward significantly.

As investors, we recognize there are many moving parts determining the price of oil and the impact that price has on other factors. With oil below \$50/barrel, how do the economies of Russia (the third largest oil producer behind the U.S. and Saudi Arabia), Saudi Arabia, Iran, Kuwait, etc. react in the short-term and longer-term to the lower price? The EIA reports

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that petroleum/oil represents 36% of the energy sector and supplies 71% of transportation. With such a large percentage of transportation reliant on oil, how do airlines (for which fuel is a key cost) and the consumer benefit? What happens to demand for alternative energy with, effectively, a 50% discount on oil? Where the price will go over the next 12-24 months is unknown. While we expect demand to continue to rise worldwide, we know that supply has two factors: 1) it is limited, and 2) improving technology will allow better access.

Some immediate impacts of the low price may be that consumers who now have more discretionary spending money will use that money to pay down debt, eat out at another casual dining restaurant this month, grab a triple shot skinny macchiato instead of making a cup at home, take the family to a theme park, or upgrade their cell phone—all activities that benefit those companies involved. Lower prices may reduce the demand for hybrid and electric vehicles in the short-term, or reduce the demand for steel as new drilling efforts are stalled. With these few examples, we can see that lower oil prices can have a domino effect on other areas of the economy. We are not looking to play short-term fluctuations in the market based on oil prices, but to seek companies that many benefit over the next 3-5 years due to lower oil prices. ♦

Is Fixed Income Still Relevant in a Low Interest Rate World?

By Lloyd K. Wong, CFA



The short answer to the question is “yes.” Despite global financial turbulence and central bank policies, fixed income will continue to provide steady income streams and serve as a source of stability and balance to mitigate the higher volatility associated with equity-only portfolios.

The short answer, of course, must take into account the grand monetary experiment following the financial crisis of 2008-09, which has included three rounds of quantitative easing (QE) in the U.S. and left in its wake the lowest interest rates in fifty years. As of February 6, 2015, the 10-year U.S. Treasury is yielding 1.93%. The Fed has held its benchmark short-term rate near zero since December 2008 and is now poised to raise rates. While the Fed is expected to make its first move in the latter part of this year, we anticipate the increase to be nominal. Additionally, we expect subsequent increases to be approached gradually at a measured pace, contributing to an extended low interest rate environment for longer than most would expect.

Interest rates are likely to remain low for a variety of reasons, from weak global growth and a divergence in global interest rates to government deficits and demographics.

When considering the global environment, we note that growth in China has slowed and Japan sank into recession late last year. Eurozone economies have also stalled, prompting the European Central Bank to embark on a large scale QE experiment of its own. Currently, non-U.S. credit rates are lower than U.S. Treasuries

of comparable maturities. A sampling of 10-year yields shows bonds in Switzerland at -0.15%, Japan at 0.35%, Germany at 0.36%, and France at 0.58% as of this writing. At these levels, which diverge widely from the 10-year U.S. Treasury at 1.93%, foreign investors will flock to U.S. Treasury bonds for their relatively higher credit quality and more attractive yields. The result of this increase in demand will be to push

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prices up and yields down, as price and yield move in opposite directions.

The U.S. deficit also indirectly exerts downward pressure on interest rates in the following way. Currently, the U.S. has a \$486 billion budget deficit. Of the U.S. total budget of \$3.7 trillion, \$430 billion, or 12%, represents interest on debt. Clearly, it is not in the U.S. government's best interest to raise interest rates rapidly, as the deficit's interest component could rise exponentially and require servicing higher debt on the deficit. This motivation for the government to keep interest rates low contributes to the phenomenon known as “financial repression.”

Additional negative pressure on interest rates can be attributed to demographics. One in five Americans is projected to be over the age of 65 by 2030. Increasing numbers of aging baby

boomers—with diminishing investment time horizons—are retiring and shifting asset allocations from historically riskier equities to fixed income, contributing to higher demand for fixed income securities. This increased demand for fixed income will push up bond prices and put additional downward pressure on already low yields.

As it prepares to hike interest rates, one of the indicators the Fed is watching is inflation. There had been speculation that the large volume of liquidity afforded by three rounds of QE would be difficult to unwind without sparking inflation. However, inflation has been hovering around 1.5% (below the Fed's target of 2%) and will most likely remain at low levels due, in part, to the counter-balancing effects of a strong U.S. dollar. A strong U.S. dollar makes U.S. exports more expensive relative to similar goods in foreign countries, forcing U.S. companies to lower prices to compete. This may negatively impact margins, earnings and profitability for

“As it prepares to hike interest rates, one of the indicators the Fed is watching is inflation.”

U.S. companies, resulting in weaker U.S. economic growth. Recent reports show that U.S. factory activity fell to the lowest level in a year last month as

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slower global growth has hurt demand for American-made goods. Additionally, the strong U.S. dollar will result in imported goods being relatively cheaper than similar domestic goods, contributing to tamer inflation.

Due to projected weaker U.S. economic growth, wage inflation is also unlikely to contribute to inflation. There is still sufficient slack in the labor force as companies such as American Express, eBay, Halliburton, and Schlumberger have announced layoffs in recent weeks. While the unemployment rate has improved, the

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economy has not exhibited sufficient strength to indicate that wage inflation has materialized.

Another factor influencing inflation is the recent dramatic oil price decline (please refer to Max's article in this newsletter). Lower energy costs and cheaper imports will likely keep core inflation low. In fact, a weak global growth environment now makes deflation more of a worry than inflation. If prices are expected to decline and consumers have an incentive to delay purchases and consumption until prices fall further, overall economic activity can be reduced, hampering growth. As this reduces productive capacity, investment also falls, leading to further reductions in overall demand and to a deflationary spiral. This could potentially exacerbate already weak

global economic conditions. While central banks know how to deal with inflation, they have limited tools on dealing with deflation.

Even with all these pressures keeping interest rate levels low, fixed income will continue to play the important roles of providing stability and income to a portfolio. A company can reduce or eliminate a stock dividend, but is obligated to pay the interest promised in a bond covenant. For this reason, fixed income provides a more dependable income stream. Fixed income historically generates lower returns than equity, but it does so with less volatile price movements. This stability helps preserve capital. While one may be inclined to focus on price movements when interest rates begin to increase, it is important to retain a total return perspective; both current income generated and price appreciation/depreciation should be considered rather than focusing on price appreciation or depreciation alone.

When choosing fixed income investments, credit quality and the risk-reward relationship are important considerations as well. For example, credit spreads of bonds in the energy sector have recently widened due to the negative impacts caused by the oil price decline (approximately 18% of the high yield bond market is comprised of oil and gas company issues). While it may be tempting to chase after the typically greater yields that low-credit quality bonds generate, one must determine whether adequate compensation is received for undertaking higher credit default risk.

In the context of a low interest rate environment, fixed income investments are essential to providing stable income with minimum volatility. We at Clifford Swan recognize that selectivity is paramount as we consider all factors when making fixed income investment decisions for our clients. ♦



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