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Market Lessons From China

The Peril of Short-Term Investment Predictions

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While investing inherently has a predictive element to it, how can we confidently invest when so many predictions are so completely wrong? Often, while trying to get the details precisely correct, we lose focus on the obvious "big picture" that can serve as an anchor on common sense.

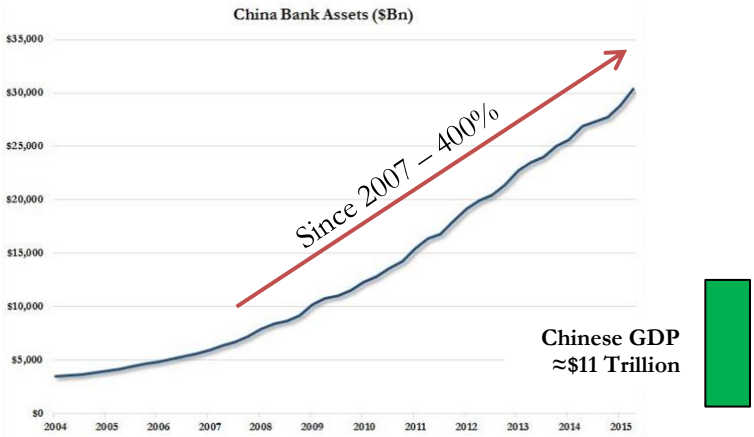
We find an example of this in the current debate over the fate of China's economy. What can be known about such an opaque and complicated economy? Should investors even weigh Chinese growth in their investment decisions given our lack of ability to say anything precise about the Chinese economy?

A few years ago, the consensus was that China had a robust economic model and would continue growing indefinitely at 8-10%. Now the consensus is a little more sober, but most firms still argue that a ~6% rate of growth is sustainable indefinitely.

Yet, short-term and precise predictions about the Chinese economy are impossible. The numbers are notoriously manipulated by the government and are never revised. Even knowing the recent past is a challenge, much less knowing the future.

So what *can* we know? Let's take a look at a few "*big picture*" facts and a little bit of history.

For China, the elephant in the room is its debt growth. Its banking system has grown from roughly $6 trillion in 2007 to more than $30 trillion today, according to hedge fund manager Kyle Bass' estimates.

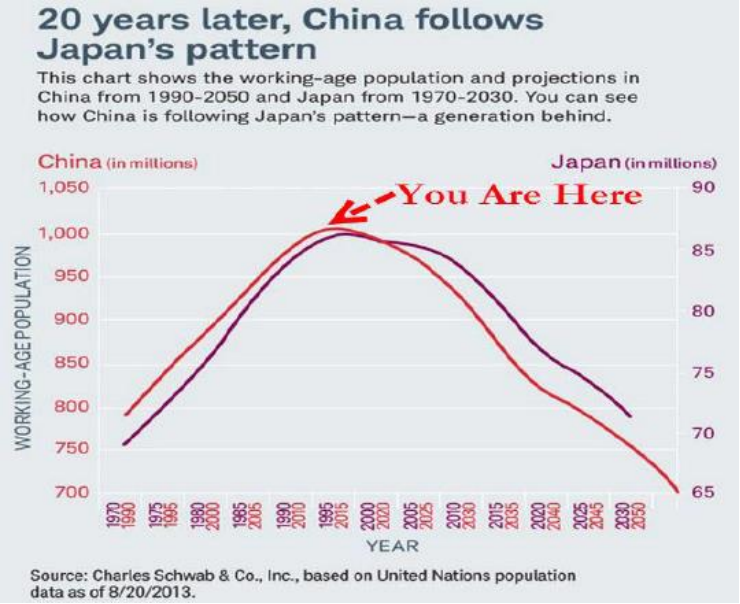


Source: Zerohedge

This is the biggest, fastest credit growth in all of human history. Many economies in history have tried this sort of debt-fueled investment growth. As economist Michael Pettis states, "This is why countries following the investment growth model—like Germany in the 1930s, the Soviet Union in the 1950s and 1960s, Brazil in the 1960s and 1970s, Japan in the 1980s and money other smaller countries—have always overinvested for many years leading in every case, either to a debt crisis or a 'lost decade' of surging debt and low growth."

In short, China, like other economies before it, is addicted to debt.

The second big picture statistic that is worrisome for China is its demographics. An economy is simply the amount of people working in it multiplied by how productive those people are. All else being equal, fewer workers means lower output. China's "one child policy" has created a demographic cliff worse than Japan's 20 years ago.



Can we know what precise path China will take? Not by a long shot. Can we say that any Chinese investment priced as though it's a given that the country's economy keeps growing at 6% indefinitely should be viewed with an extreme skeptical eye? In my opinion, absolutely.

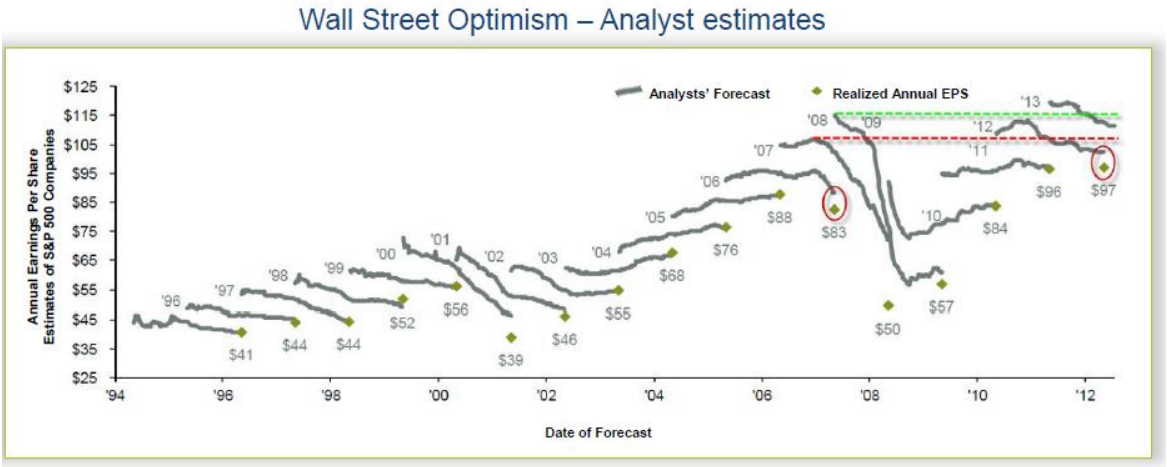
Why are Predictions Often So Wrong?

The example of China reveals the peril of predictions. Most pundits on many investment issues are just wrong. Why is this? Should you listen to anybody? Let's look at some of the biases that affect analysts' and economists' commentary.

Institutional bias

Often, one part of a firm is commenting on an entity that another part of the same firm is trying to court as a client. Although supposed "Chinese walls" have been erected to prevent this, it is still rampant.

Generally, Wall Street makes more money in an optimistic environment. People don't buy high-commission products if they think doom and gloom are around the corner. CEOs don't make acquisitions (the biggest commissions of all) unless they think there will be a handsome payoff. As a result, Wall Street suffers from chronic over-optimism. Looking at the chart below, we can clearly see that earnings estimates usually start out much higher than what is ultimately reported by companies.



Sources: FactSet, J.P. Morgan Asset Management. Data are as of 3-14-13. S&P 500 Annual Earnings Per Share Estimates, operating basis, weekly consensus estimates, annual reported EPS. EPS is earnings per share, or the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability.

Killjoy Bias

When everyone is feeling optimistic and ignoring hard facts that paint a less rosy picture, there can be a hesitancy to speak up. No one wants to be the party pooper. What's more, since we can't time anything in the financial markets with any real precision, people hesitate to stick their neck out to say the party might be over. As a fund manager told *The Economist*, "It makes no sense for me to predict a recession. If I'm right, no one will thank me and if I'm wrong, I will get fired."

In an ideal world, analysts would communicate the good and the bad of what they assess with the same unemotional forthrightness as your math teacher telling you that two plus two equals four. Unfortunately, investing can be highly emotional, and brutal forthrightness should never be expected in the financial markets.

Self-Promotion Bias

Reporters often ask unanswerable questions about the extreme short-term state of the markets. It's how they keep viewers glued to their news feed. They ask questions like, "where will the market be in 6 months" or even more ridiculously, "Where will stocks close today?"

The only real answer to these questions is, "I don't know." Yet, how often will an analyst be queried again if they offer that kind of answer? They won't. It creates an incentive to guess. That's why you get smart people saying some really stupid things.

The great investors don't make such predictions. Warren Buffett usually delivers some version of "I don't know" when he's asked where the market is headed. As he said in his 1992 Chairman's Letter, "I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children."

What Should the Wise Investor Weigh?

Recognizing that bias exists and understanding that there are snake oil predictions a plenty, the smart investor should view markets and opportunities with a healthy amount of skepticism and a view towards the long game.

Look at the Big Picture

A lot of ideas and investment themes sound compelling when you're looking at the trees, especially when things have been going well lately. But when making an investment decision, always take a step back and look at the forest. Many ideas fail the big picture smell test. For example, some say the trees in China are all blossoming, but when you step back and look at what has been the primary engine of growth (debt) and other big picture headwinds (demographics), the forest looks a lot less promising.

Embrace Gradualness

I'm a firm believer that the best regret minimization tool is gradualness. How much wealth has been lost because people didn't want to sell their tech stocks until the absolute high in the 1990s, or wanted to wait until the absolute bottom to buy stocks during the financial crisis? Perfection isn't possible, and striving for it has real consequences. As Jeremy Grantham says, "Perversely, seeking for optimality is a snare and delusion; it will merely serve to increase your paralysis."

A better strategy is to start from the realistic premise that we're human; we don't have a crystal ball, so it's best we do things gradually. When the market is rising, sell along the way, and gradually buy when it is falling. This takes some of the "lottery ticket effect" out of investing, but successful investors win the lottery one day at a time. If you're investing for important goals like your kid's education or retirement, this is the more disciplined way to go.

Stay Grounded

The knowledge of two obvious facts can save investors a lot of money: Trees don't grow to the sky, and the end of the world doesn't happen often.

Over the last decade, many people fretted, "what if it all falls apart," and lately, some have worried, "Will we see another recession?" What if the central banks just keep printing money and the stock market goes up forever?"

While it can certainly *feel* like these extremes are possible, it is important to remember that markets are like a pendulum. The more extreme they trend in one direction, the more likely they are to swing back.

When looking for investment opportunities, be wary of the investment prophecies. No analyst—no matter how insightful they claim to be—has a crystal ball. The more precise and more immediate the prediction, the likelier it is they're just filling up the airwaves. Instead, the more extreme the prices of an asset class have become (high or low), the more important it is to seek out the voices of moderation.

Sources:

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About the Author

Loic LeMener is founder and President of Opus Wealth Management in Dallas, Texas, a boutique wealth management firm that specializes in personalized client solutions. Loic and his team provide their clients with a targeted needs evaluation to answer important questions that provide a better, more personalized experience. The team focuses on integrity and believes in the following "golden rule" – they won't do anything for you that they would not do for themselves or their loved ones.

Loic received his Masters in Business Administration from Southern Methodist University, studying Finance, Accounting and Portfolio Management. He also earned the Certified Financial Planner™ certification and the prestigious Chartered Financial Analyst® designation. In addition, he has been quoted in national publications such as Barron's.

In his free time, Loic is a devout reader, with his favorite topic being "value investing." His favorite investors are Warren Buffett, Ben Graham, Charlie Munger, Seth Klarman, Howard Marks, and Jeremy Grantham.