RPg asset management
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RPg ClearView: Complexity of Predicting the Future

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"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today." – Laurence J. Peter

As a quantitative, rules-based investment manager, we were interested in the accuracy of last year's economic forecasters' projections. A recent article cited that 45 of 46 economists interviewed by The Wall Street Journal in December of 2013 forecasted that interest rates would be higher in 2014 – and the 46th predicted that interest rates would be flat. Overall, they projected an average increase of 0.61 percentage points in the 10-year US Treasury bond.

Chart 1: Prediction: Yields to move up to 3.639% from 3.029% (12/2013 – 11/2014)
Reality: Yields fell to 2.165% from 3.029% (12/2013 – 11/2014)

Source: Bloomberg Finance LP

After multiple decades in this industry, our team has come to the conclusion that predicting the future is a very tough business. Jason Zweig, who writes the Intelligent Investor column for The Wall Street Journal, says two things must be true in order for economic analysis to be useful in investing. First, economists must be able to forecast the economy with reliable accuracy. Second, if that occurs, the forecast must not yet be priced into the market.

As well, predictive modeling is only possible when the data being used is similar to the data you have experienced in the past. Just because you have a data set from the past, that doesn't mean it will present itself the same way going forward. In addition to the missed call on 10-year US Treasury yields, there were many that concluded that if interest rates were to go up, equity sectors like Utilities would suffer. Since 12/31/2013 the 10 year US Treasury yield has gone from 3.029% to 2.165%, and Utilities are up over 24% YTD as of 11/30/2014.

Chart 2: 2014 YTD 10 yr U.S. Treasury Yield vs Utilities Select Sector SPDR (XLU) as of 11/30/2014

Source: Bloomberg Finance LP

There is a high level of complexity employing a predictive aspect to any model that requires statistical significance as economists who are asked for predictions can attest to. When data is presented in a different way, the dimensionality grows exponentially, the volume of the space increases rapidly, and the relevant available data becomes sparse making the outcome extremely complex to predict.

At RPg Asset Management, we focus on what is known in the market at any given time: Price, Volume and Trend. From these three items there is a tremendously rich set of data that we use to help us make decisions. As quantitative tactical managers, we believe that by focusing on data that is known to be true, we can better deliver on our priorities of avoiding bear markets, and materially participating in upwardly trending bull markets. We will continue to leave the forecasting and predictions to the experts.

David M. Gatti, Chief Investment Officer