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9 times out of 10 the consensus will be wrong?

Tim Farrelly | farrelly's | 17 March 2015

Who said that? I think it was me, actually. At the recent PortfolioConstruction Markets Summit, when faced with a huge majority of experts expecting international equities to outperform Australian equities, I blurted out the above. I was wrong, and on a few counts.

Firstly, it came across as being disrespectful, when the thought behind it is quite the opposite. The money management business is hugely competitive. Only the best and smartest operators survive and prosper. They also end up managing most of the money. So, when the best and smartest all agree on a position, you know that most of the smart money – indeed, most of the money – has already moved and that information is already built into prices. And, to be perfectly clear, the panel at Markets Summit did represent some of the very best and brightest investment brains around. The fact that the best and brightest, who manage huge amounts of capital, all line up behind one particular view makes that position ripe for disappointment.

But, being ripe for disappointment is not a guarantee of disappointment.

The second error was that, in reality, the odds of an overwhelming consensus view proving unprofitable is probably more like seven out of 10 rather than nine out of 10. Sometimes, all the experts really do get it right. Typically, that happens when the predicted driver of a position – say that the Fed will raise rates in the next twelve months – happens to a much greater extent than had been imagined. So, if you were bearish on bonds because you thought (along with just about everyone else) that the Fed will raise cash rates to between 0.5% and 0.75% by the end of this year, and if that is exactly what in fact occurs, you will probably only break even. But if the cash rate ended up at 2.5% at the end of the year, then you, and all the bond bears, would make out like bandits. A win for the consensus.

Finally, there is a difference between consensus about markets and consensus about events. When the reigning premiers Hawthorn take on the lowly Saints in June, the overwhelming consensus of the experts will be that the Hawks will win. And, regrettably, that consensus will almost certainly prove to be correct. However, that doesn't mean that you can make money on that view. Backing hot favourites to win all the time will eventually cost you money as upsets do occur. So, while expert consensus actually is quite good when it comes to predicting events, it is much less so when it comes to predicting markets.

So, what do we make of this? Firstly, remain very, very wary when the smartest minds in the business all agree on a position. Secondly, don't lose sight of the difference between a prediction about an event and a market. Finally, and most importantly, never forget that markets are fundamentally difficult to predict in the short and medium term – even for contrarians.

As for a nine out of 10 certainty? It's nuts and you can clearly see it's nuts.

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