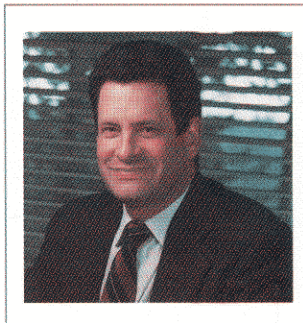


BY KENNETH L. FISHER

The foregoing constitutes the general views of Fisher Investments and should not be regarded as personalized investment advice or a reflection of the performance of Fisher Investments or its clients. Nothing herein is intended to be a recommendation or a forecast of market condition. Rather it is intended to illustrate a point. Current and future markets may differ significantly from those illustrated here. Not all past forecasts were, nor future forecasts may be, as accurate as those predicted herein. Investing in the stock markets involves a risk of loss. Investing in foreign stock markets involves additional risks, such as the risk of currency fluctuations. Past performance is never a guarantee of future returns. This article is from the year 2003 and statements made as of this date may no longer be applicable.



Market Forecasting and

Capitalist Orthodoxy

A TRUE UNDERSTANDING OF CAPITALISM POINTS TO HOW YOU GET THAT EXTRA EDGE NEEDED TO BEAT THE MARKET.

Do you believe in Catholicism, Judaism or Hinduism? Or are you a heretic? Do you disbelieve in Catholicism? If so, you're a Catholic heretic. Pick your ism. Mine is capitalism.

With my ism you must also believe in capital markets, the capital markets pricing mechanism, market history and finance theory. You accept that as finance theory defines the term, markets are at least fairly efficient (the more inefficient you hold markets to be the more distant you are from capitalistic orthodoxy).

Capital markets rapidly discount all known information. That means, among other things, that you can't make excess return in the long run by outguessing everyone else based on

the same information they have. Those who try will sometimes be lucky, more often be unlucky and overall do worse than having simply sought market-like returns. If you think you can outguess the market because you're smarter, you'll come to learn how smart the market is. If you think you're wiser, you are what finance theory defines as a fool (a person who thinks he is wise when he isn't).

To make long-term excess returns you must know something others don't, which is very difficult. How would you? Most folks, even professionals, don't think about it much. But it's the most basic market challenge and, to me, the most stimulating aspect of investing.

Investing operates under what I call the "craftsman's dilemma." It is a world of apprenticeship. Like a 19th centu-

MARKET FORECASTING

The foregoing constitutes the general views of Fisher Investments and should not be regarded as personalized investment advice or a reflection of the performance of Fisher Investments or its clients. Nothing herein is intended to be a recommendation or a forecast of market condition. Rather it is intended to illustrate a point. Current and future markets may differ significantly from those illustrated here. Not all past forecasts were, nor future forecasts may be, as accurate as those predicted herein. Investing in the stock markets involves a risk of loss. Investing in foreign stock markets involves additional risks, such as the risk of currency fluctuations. Past performance is never a guarantee of future returns. This article is from the year 2003 and statements made as of this date may no longer be applicable.

ry craftsman, investing professionals begin in school, enter the work world and apprentice under a mentor in some specific investing style. They tend to stick to it for their career, specializing in growth or value or small-cap or emerging markets or momentum or whatever. They mostly decry innovation, just as craftsmen of all forms dislike radical change in their craft. Craftsmen believe in their craft.

Finance theory holds that market prices discount all known information, not what may become knowable at some future point. History shows investing techniques may become obsolete. How? The investing techniques themselves get priced into the market because too many people fully fathom them. Curriculum becomes obsolete quickly. Yes, styles move in and out of favor. But in the long-term, different investing styles generate almost identical, market-like returns if calculated correctly. Yet craftsmen believe in their craft — more than they believe in capitalism. A value craftsman believes value is simply better than growth. A growth investor believes the reverse. Both fail to realize that what they are saying is they believe in their craft more than in capitalism and capital markets. They disbelieve in capitalism and don't know it. If you really believe in capitalism, you believe these people are heretical.

THE SCIENCE OF INVESTING

I disbelieve in craftsmanship or any equity style's long-term superiority over markets, while recognizing that styles move in and out of favor in the short-term to confuse almost everyone. I believe in markets because I believe in capitalism. In contrast to craftsmanship, the pursuit of unknown and meaningful information is what I

call Capital Markets Technology. It derives from the science of building capital markets, which seeks to explain how markets work in ways no one has previously fathomed.

The goal is to discover data or concepts about how markets operate that others don't know, thereby knowing something others don't, which is the

There is no reason that because people believe something will happen price-wise the reverse must occur.

basis for long-term excess return. This is accomplished through basic research linking history, statistical validity and theory. Think of investing more like a technologically driven science than a craft. Should all old principles be abandoned? No. Many old principles are valid but can't produce long-term excess returns any more than a clean operating room is the key to advances in brain surgery.

Capital Market Technologies can be grouped into two types. Type 1, is the development of unique information proving that "C" causes "Q," when no one had any prior causal conception. With Type 1 technology, when you see "C" happen you bet directly on "Q." Type 2 technology takes known information and re-interprets it based on some new information to show that while everyone believes "X" causes "Y," in fact the two variables are randomly

related. With Type 2, when you see "X" happen and investors bet on "Y," you bet against "Y".

Consider the Price-to-Sales Ratio, an example of Type 1 market technology that I developed over 20 years ago. It was then useful as unique information that wasn't known or understood and offered an edge in stock picking, particularly with profitless firms. But it was and is technology. As it became widely known it became priced into markets and lost its edge. It is still useful but doesn't have the edge it had. What once was cutting edge is now largely an artifact.

Sometimes I'm asked why, if I'm so intent upon building new technologies, do I intently study market history? With market science, like any science, it's helpful to build on the past and avoid mistakes that others have made. History is our best access to the laboratories of the past. It won't foretell the future, but it can help discern where best to develop new technologies. Like any science, what we know about markets today is minute compared to what we'll know 10, 25, or even 100 years hence. We have much to learn and far to go, and there are seemingly countless possibilities in what we can discover.

Another early 1990s Type 1 example I still use is sentiment-based forecasting. If you take a correctly built, scientific survey of all types of professionals' forecasts for each year, expressed in percentages, and plot them along regular, statistical intervals, you create a bell curve-like representation of the aggregate of professional opinion. Do that for almost any year, compare it to where the market actually ended up and you won't see much overlap. Forecasters, in aggregate, represent the body of known information. The market won't end up where they agree it will. That's because of the

market's discounting function. What they know and can agree on has been fully priced into the market and therefore cannot occur.

Others are catching on to this but regularly misapply the technology. They tend to fall into the contrarian's trap, arguing that professionals are bullish (or bearish) and then expecting the reverse to occur. Instead, professionals may be bullish (or bearish), but not nearly enough so. Another misapplication is to look at big-name professionals (usually strategists for big investment banks) and presume that they are a proxy for all professionals. They aren't. Like all polling, the universe must be selected scientifically to represent reality.

GOING OUT ON A LIMB

While this technology has been useful for years, like all technology it will become outmoded someday. Folks will catch on, get it right and then I better have developed the next thing or I will have no chance in the long-term of adding value. It's all about building an edge.

Another Type 2 technology that's worked well over the years has been the reinterpretation of the U.S. presidential election cycle as a mid-term congressional cycle. It's uncanny how often the second half — and especially the third year — of a president's four-year term has been positive for the equity markets. The cause of this phenomenon links three factors together. First, markets hate change and love the status quo. Change causes more pain for losers than pleasure for beneficiaries. Second, the change of wealth redistribution has less market impact than property rights redistribution (such as regulatory change). Wealth can always be created in the future if taken away, but changing property rights determines who has the

History shows investing techniques may become obsolete. How? The investing techniques themselves get priced into the market because too many people fully fathom them.

power to so do, perhaps in perpetuity, and that can terrify markets. Third, when are federal legislative attempts at redistribution made? During the first half of presidents' terms! Effectively all material attempts at redistribution of property rights have occurred by the first half of president's terms (example: 1969 introduction of the Environmental Protection Agency). Presidents expect maximum legislative power in their first two years, understanding that midterm congressional elections almost always drain some power from them. They tend not to push for property rights redistribution in the back half of terms. Hence markets trend better then.

This phenomenon has gone on for decades. So, this must be known information that's priced into the market, right? No. This is Type 2 technology. While most professionals have at least heard of this idea, it's disparagingly referred to as "numerology," or coincidental non-related events that have no meaningful relationship. Political cycles are said to deserve about as

much credence as astrology. But the value of this phenomenon lies not in the cycle itself but the interpretation given the cycle based on the nature of any redistribution efforts attempted by a president.

Because of my search for information that no one else has discovered, some have mislabeled me a contrarian. Being contrary means doing the opposite of collective opinion for the sake of being different. But the notion of contrarian investing is not grounded in finance theory. There is no reason that because people believe something will happen price-wise the reverse must occur. Often, as stated earlier, consensus opinion points the right way but not nearly far enough. For example, throughout the late and mid-1990s professionals were bullish, but not nearly bullish enough. I only take contrary action if I have what I believe to be unique information showing that consensus opinion is backwards.

To be right you must go out on a limb. Finance theory says so. Doing so without knowing something others don't merely increases your potential for risk or reward. When you believe in capitalism, markets and finance theory, the ultimate goal is to push science to build practical technology so you can see things other don't, all to produce excess returns over time. Through three decades in this industry, it's personally the reason I still get up every morning. It's the fun part. Like any science, the more answers I find the more new questions I have. Until I'm too old to play, I'll search for the next technology to get that edge. And there will be more than enough opportunities until long after you and I are long gone. To believe otherwise would make us both heretics. **R**

The foregoing constitutes the general views of Fisher Investments and should not be regarded as personalized investment advice or a reflection of the performance of Fisher Investments or its clients. Nothing herein is intended to be a recommendation or a forecast of market condition. Rather it is intended to illustrate a point. **□** Current and future markets may differ significantly from those illustrated here. Not all past forecasts were, nor future forecasts may be, as accurate as those predicted herein. Investing in the stock markets involves a risk of loss. Investing in foreign stock markets involves additional risks, such as the risk of currency fluctuations. Past performance is never a guarantee of future returns. This article is from the year 2003 and statements made as of this date may no longer be applicable.