Vanguard

The certainty of uncertainty When not to jump

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Vanguard's chief investment officer, Jeff Molitor, reflects on what was forecast for 2011 and how these predictions compared to actual global political and financial events, and suggests how investors can learn from the past year

One year ago, I edited a note that cautioned investors about the then common wisdom that they should be overweight in emerging markets equities. Many investors believed – and continue to believe – that, since emerging markets offered high relative gross domestic product (GDP) growth, it would result in attractive returns. We argued that the correlation between economic growth and equity performance was essentially zero, especially over short time horizons.

While economic growth in emerging markets outpaced developed markets in 2011, emerging market equities were dismal. According to Bloomberg, China and India generated year-on-year real GDP growth of 9.1% and 8.5%, respectively. However, the Shanghai Index fell 20%, while Mumbai fell by more than 24% in local currency. In contrast, the US generated modest GDP growth, while its equity market in 2011 – with a total return of more than 2% – was among the strongest in the world.

This illustrates the critical need to focus on long-term investment truths when building portfolios rather than focusing on the collective noise of experts making economic and investment forecasts. Even if the experts are right about the economics, the ties to short-term investment results are tenuous at best. What is more, exhibiting patience and 'doing nothing' can often be the right strategy, especially in volatile markets.

Most investors want to believe they can foresee the future of market performance despite all evidence to the contrary. One of the most absurd, but consistently repeated, comments on the equity markets in 2011 was that investors were avoiding or selling equities because the outlook was uncertain. Uncertainty and volatility are natural and unavoidable components of the investment landscape; low probability does not mean zero possibility.

Acting on expert predictions can be hazardous to your portfolio's health, whether the crystal-ball gazers say 'now is the time for mid-cap German stocks', 'it's a risk-on, risk-off market and now is the time for…' or 'inflation will come back with a vengeance, making US Treasuries high risk'. Following the lead of high-profile portfolio managers can also lead to dismal results. Any cursory inspection of the investment surprises of 2011 – such as the Arab Spring, events in the eurozone, a slowdown in China, the US government's loss of its AAA rating, and so on – easily demonstrates the futility of trying to predict the future.

A crucial lesson from 2011 is that even the most comprehensive list of conventional forecasts for 2012 will miss key issues. Moreover, even if the forecast of macro issues is on target, markets may respond differently to what one might expect, based on either a flawed assumption – for example, that relative annual GDP growth will determine relative equity market performance – or making assumptions such as bonds with lowered credit ratings will make prices fall, instead of rise.

What should investors do? Vanguard believes the best practice in 2012, as always, is to focus on long-term objectives and let long-term definitions of investment success (for example, meeting a retirement goal over a 20-year horizon) and market history (for example, the equity risk premium will exist but you need to accept the inherent volatility) drive your decisions. Daily assertions about risk on and risk off can be entertaining, but our experience shows they are distractions that rarely help to build wealth over the long term.

Successful investors understand the need for patience and accept that the only certainty in investing is uncertainty. Investors should never feel compelled to do something. In most cases, the better advice is to 'just sit there'. US fund manager Warren Buffett expressed this sentiment in defining the fourth law of motion: "For investors as a whole, returns decrease as motion increases".

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