ON THE MONEY

Your short guide to getting ahead of forecaster folly for 2012

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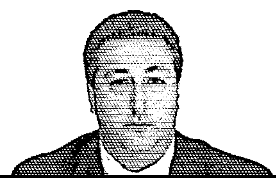

BARRY RITHOLTZ

On Investing

The new year has arrived, and so investors are inundated with all manner of lists: Best and worst stocks for 2012, forecasts of where the economy is going, favorite investments for the year and more.

What's an investor to do? You should start by ignoring those lists. Let's conduct a little experiment to demonstrate why: Do a quick Google search for "where to invest in 2011." I read through the first dozen or so. For the most part, the performance was pretty awful. Before the excuse-making starts — 2011 was an unusual year, the ECB/Fed intervened, etc. — let me clue you in to this fact: Forecasters are pretty awful every year.

Whenever I see one of those "Buy this now for the new year" columns, I diary them in my calendar or use the free Web site *Followupthen.com*. A year later, I look back at these recommendations and forecasts, and, for the most part, they're terrible.

Because of this folly of forecasting, I try not to make many predictions. Whenever I am asked where the economy is going, who is going to win that year's elections or what the markets are going to do, I steal a trick from the weatherman: Always couch your forecasts in probabilities. That way, when I am wrong — and anyone who pretends to know what will happen in the future will frequently be wrong — at least I can declare the outcome was an anticipated probability.

"As we stated last January, there was a 10 percent chance that the Federal Reserve's Hobbensobbers were going to be trounced by the bond market's Rebblesacks — and that's exactly what happened!"

It's a great cheat to avoid saying silly things in public that could come back to haunt you.

These are my 10 forecasts as to what the forecasters will be forecasting for 2012:

1 Stocks will trounce bonds this year: We heard this one a lot in 2010; it turned out to be wildly wrong. Stocks were flat in 2011, while bonds gained about 13 percent. Indeed, turning conventional wisdom on its head, bonds have outperformed stocks the past one, 10 and 30 years.

Hey, maybe stocks will beat bonds next year. If you keep making the same prediction, eventually it will come true.

2 Housing has bottomed: A perennial favorite from the usual suspects, who have been consistently, insistently and persistently wrong about this since residential real estate peaked in mid-2006. As the most recent Case-Shiller data show, home prices fell another 3 to 4 percent in 2011. From prices that remain too high to an excess of inventory to slow household formation, there are many reasons the bottom has not yet occurred.

3 Election forecasts: In politics, six months is a lifetime. Just look at how often the poll leader has shifted in the Republican nomination race over the past six months. Making a forecast 11 months out about politics is sheer folly. But consider: Lots of people will make forecasts about who will win the primary, what the final tickets will look like, who needs to win which states to gain how many electoral votes. The sheer number of forecasts means that someone will, if only by chance, get it right.

4 Buy these 10 stocks: You must buy THESE 10 stocks — not those 10 stocks or even these 10 stocks, but THESE 10 stocks. Looking back at all of these lists, it is surprising more people didn't get something right, if only by accident.

The question investors should be asking themselves is why am I buying stocks at all and not simply indexing? Answer: Makes for too short an article.

5 The economy is better than the data suggest: We see this over-optimistic discussion every year. It is consistently wrong. If anything, data about the economy tend to overstate growth, employment and sales while understating inflation.

There is a period when the economy is better than the data show it to be: At troughs, when a long downturn is reversing itself. Are we at that sort of a juncture? Considering it has been nearly three years since the market lows of March 2009, and 30 months after the recession ended in July 2009, that hardly seems to be the case. The economy was better than the data implied in mid-2009, not today.

6 The Apocalypse is coming! This is the over-pessimistic view. Yes, we know, the end is near. You tell us this year after year, and it is terribly tiresome. After the Apocalypse, you have full license to say "I told you so." Until then, please go away.

7 Banks will come roaring back: My favorite terrible forecast for 2011 was "Buy the Banks" (NYSE: XLF); a variant was "buy Bank of America" (NYSE: BAC). And just how well did that work out? The financial sector was among the worst performers of the S&P in 2011. In a year when markets were flat, financials fell 20 percent. As to Bank of America, it collapsed 60 percent, in percentage returns, the worst forecast of the year.

Every year some value managers come out pounding the table on whatever sector got beat up that year, regardless of the reasons for it. They are always sorry to learn that mean reversion is not tied to a calendar.

8 Hyperinflation: During the 2000s, we hardly heard forecasters say much about inflation. You might recall that during that decade, oil rallied from $20 to $147, foodstuffs skyrocketed, and education and health-care costs had double-digit annual gains.

Post-credit crisis, the economy has been in a deflationary mode. Asset prices are flat-to-negative, labor utilization is way below trend, and demand for goods and services remains soft. No matter how much money central banks print, these are not the factors that lead to Weimar Republic-like hyperinflation.

9 Buy gold: On a related note, the gold bugs got some comeuppance this year. As of mid-August, gold had gained more than 33 percent year to date (according to the gold-tracking ETF: NYSE: GLD). But the enthusiasm for the trade got way ahead of itself, and gold lost more than a quarter of its value, with GLD falling $46.59. After a spectacular decade of gains, the shiny yellow metal failed to achieve gains of even 10 percent in 2011 and was outperformed by bonds.

10 Buy emerging markets: Mulligan! This was another favorite forecast for 2011, and it was wildly wrong. China and Hong Kong were down 20 percent; India and Brazil were off by a third. The decoupling thesis never goes away — that despite the interconnected global economies, some regions will do well even when their biggest trading partners slide into recession.

The key thing you should remember when it comes to investing is that nobody truly knows what tomorrow will bring. Nobody. These predictions are, at best, educated guesses. Yesterday's predictions are undone by tomorrow's news. Circumstances change. New economic data are released. Unanticipated events unfold.

All good reasons to avoid forecasts altogether.

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STEVEN PEARLSTEIN

It's time for the Washington region to start thinking about what's next

PEARLSTEIN FROM G1

to come to an end.

Any reasonable scenario for the future would surely project federal spending on salaries and procurement to grow very little, if at all. Given the region's lopsided reliance on those types of federal spending, it's a pretty good bet that the regional Washington economy will grow slower than the rest of the country for an extended period of time.

The reversal is unlikely to begin this year or even next — there's a lot of built-in momentum to federal contracting and employment. Nor will we really know the extent of the federal pullback until several months after the coming election. Even the anticipation of a slowdown, however, is bound to have a self-fulfilling impact. It's time — indeed, it's past time — for the Washington region to begin thinking about its next act.

Over the next month, I propose we begin together to do just that — I in this and several subsequent columns, you in e-mails to pearlsteins@ washpost.com that will be shared with readers in this space at the end of the month. Please keep them relatively short and to the point. And please, spare us the "green energy" fantasies that have characterized such exercises in the past.

Given its outsize influence, the logical place to begin may be with the federal government and imagining how it is likely to be transformed over the next decade.

There's nobody in the government who does this sort of long-range system planning, if for no other reason than it's impossible to know what future Congresses and presidents will do. However, I'm going to go out on a limb here and predict that when faced with the prospect of big and painful cuts to the government's operating budget, voters and politicians are going to be mighty insistent we start to get more value out of our money. And any discussion about greater productivity and accountability leads directly to an overhaul of how government hires, fires and compensates its employees.

If you look at the tremendous growth in government contracting and outsourcing over the past 20 years, it's been driven by one political imperative — putting a lid on the total number of federal workers — and three economic realities.

The first reality is that lower-level, less-skilled government employees tend to be overcompensated relative to those in the private sector. Their pay is at the high end of the range, and that would be okay if the government aimed to recruit and retain a quality workforce, which it should. What really skews things are the benefits — health insurance and pensions — which are way more generous than in the private sector. A lot of the early outsourcing was about avoiding these higher costs.

At the same time, higher-skilled government employees tend to be significantly under-compensated relative to the private market. For this group, benefits are comparable but salaries are not, particularly given the fact that the government is not allowed to offer bonuses and stock options. Unable to attract skilled workers, the government has had no choice in many instances but to outsource the work to contractors who were free to pay market rates.

The final reality is that because of civil service rules, it is difficult — some would say impossible — for the government to fire low-performing workers or lay off large groups of workers once a project is completed. Outsourcing has been a way to work around this problem. By not having to carry as much deadwood, contractors can do work more cheaply. And while contractors fight hard for new contracts in order to keep a stable workforce, they are often forced to lay off workers who are no longer needed.

By the numbers

50,000
Increase in federal employment in the past decade

166%
Growth of federal procurement spending over the decade, from $30 billion to $80 billion

17%
Percentage of the federal payroll spent in the region, though it has less than 5 percent of the nation's population. And, the region captures …

21%
of procurement dollars.

Moreover, even when good people want to work for the federal government, an arcane hiring system does all it can to stand in the way of hiring them in any timely fashion and promoting them through the ranks. That also gives private contractors a big advantage.

The intense pressure to cut spending without cutting vital services is likely to alter all of these realities and finally force the government to re-engineer the way work is done, rationalize its compensation and reform its civil service rules. And that would present a major challenge for the federal contracting sector, which has driven growth in the Washington economy. With similar hiring and firing rules and a competitive pay structure, some of the major drivers of outsourcing will have been eliminated, and it will make sense for the government to begin bringing more of its work back in-house, forgoing the cost of coordination and contract management, along with contractor profit and marketing expenses.

The only thing standing in the way of these reforms in Washington has been the sway public employee unions have over Democrats in Congress. But with Republicans likely to be in control of the next Congress and Democrats facing the prospect of deep cuts in cherished domestic programs, the political pressure for reform will be unstoppable, as it has been already in a number of traditionally Democratic and pro-union states. If federal union leaders were smart, they'd try to get ahead of the curve by negotiating reasonable reforms in exchange for the opportunity to bring more of the government's work back in-house.

By itself, a shift from outsourcing to insourcing would be bad news for government contractors but not necessarily for the Washington economy. After all, a job insourced from SRA International to the Transportation Department is still a local job.

Unless, of course, it isn't. For at the same time that the government is restructuring how and where work is done, there's a very real possibility that both the government and contractors will decide to shift work away from Washington. The reason: Thanks to all that recent growth, Washington is now a very expensive place for government and businesses to operate.

Even as some of the country's biggest contractors (SAIC, CSC and Northrop) have moved their corporate headquarters to Washington, they have quietly shifted lower-level work out to take advantage of lower living costs and pay scales elsewhere in the country. Some, like CGI, have expanded into southwestern Virginia. Others have moved along with federal clients whose offices were transferred to other regions as part of the Defense Department's base realignment process. As the number of contracts declines and contractors come under even more intense pricing pressure, it's a good guess that even more work will be relocated.

None of this is news to Washington's contracting firms, which are scrambling to come up with new strategies for bolstering revenue and profit in the face of all these budgetary head winds.

As in the past, the first instinct of the big public companies will be to try to pump up their numbers through mergers and acquisitions. To the extent they are successful, that inevitably means fewer jobs overall.

It's also only a matter of time before the Beltway boys start talking of moving into the "commercial space" and competing for private-sector contracts. Over the decades we've seen earlier versions of that movie, and let's say it rarely has a happy ending.

It's time to acknowledge that the Washington economy can't continue to grow and prosper by hitching its wagon to the federal gravy train. That train has reached the end of the line. If we want to make further progress, we'll finally have to hitch our fortunes to other economic engines. Some ideas on that next week.

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