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HULBERT ON MARKETS

Online Exclusive

By MARK HULBERT

Beware of Prognosticators Bearing Gifts

The Year Ahead 2006

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Editor's Note: Our series on The Year Ahead 2006 continues with a special Hulbert on Markets that discusses the folly of predicting what the market will do in any given year.

WARNING: WE ARE TREADING ON dangerous territory when we try to guess what 2006 has in store for the investment markets.

As Warren Buffett once put it, the primary purpose of market forecasters is to make fortunetellers look good.

This caution should apply especially to those who would forecast the market's behavior over the coming year on the basis of what happened in 2005 or on the basis of various alleged historical or numerological patterns.



That's because most of what happens in any given month, quarter or year is independent of what happened in the previous month, quarter or year. The market couldn't care less about clocks or calendars.

That's another way of saying that performances from one period to the next are about as unrelated as coin flips: The probability of your getting heads on your 21st coin flip is exactly 50%, for example, regardless of whether your first 20 flips all came up heads, tails or half-heads and half-tails.

Most of us find this truth counterintuitive, of course. We think either the probability of flipping heads is above

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average after we've gotten several heads in a row (on the theory that the coin flipper is "on a roll," or "playing a hot hand") or below average (in the expectation there will be a regression to the mean).

But our intuition is wrong -- at least when it comes to coin flips.

To be sure, the coin-flip analogy is not perfect. Even though the stock market's gyrations are largely random, they are not completely so. So, there may be statistical support for at least some of the forecasts for 2006 that a number of newsletters I monitor have made.

With this possibility in mind, here's what I found when I examined the statistical basis for some of the most popular forecasts that newsletter writers are making about 2006.

1. The stock market performs particularly well following three years in a row of market gains.

As one newsletter I monitor puts it, the fourth year of bull markets tends to be particularly good for stocks, typically registering double- digit percentage gains.

Unfortunately I could find no support for this in the historical data.

I looked for this pattern in the stock market going all the way back to 1802, using data from Prof. Jeremy Siegel of the Wharton School at the University of Pennsylvania.

In fact, it turns out that over the last 200 years, the stock market on average has produced *lower* returns following three years of market gains than it did the rest of the time.

And although this difference turns out not to be statistically significant, insofar as one uses this historical data to make a forecast, one would have to assume that 2006 would be a *below-average* year for the stock market -- just the opposite of what newsletters are forecasting.

2. The stock market will be a mediocre performer in 2006 because it is the second year of the president's four-year term.

The well-known presidential election year cycle, of course, holds that the stock market will be at its worst in the first year of a president's term and at its best in the last two years.

While this does not mean that 2006 should be as bad as what typically happens in the first year of a President's term, we should not expect it to be as good as what happens in the second half of a term.

I could find little support for this in the historical data. Over the last 200 years, there is essentially no difference between the stock market's average returns in the second years of presidents' terms and at all other times.

To be sure, the pattern appears to be different since the 1930s, a period in which the power of the presidency has been far greater than it was in the 1800s.

Over the last 70 years, the stock market has produced only about half the return on average during the second year of the president's term as it has in all other years.

Unfortunately, given the variability of the data, this difference is not meaningful at standard levels of statistical significance. That's another way of saying that statisticians can't be sure that what we've seen over the last 70 years is not just a fluke.

Note carefully, however, that insofar as one does try to glean a forecast from the historical data, as before, it would be that 2006 will be a *subpar* year for the stock market.

3. The stock market in 2006 will perform poorly, because the Nasdaq market in 2005 lagged the New York Stock Exchange.

This forecast appears in different guises, but the idea is that the stock market historically performs better when the Nasdaq is leading the NYSE.

Since the Nasdaq Composite last year rose by just 1.4%, in contrast to the NYSE Composite's 7.0%, this

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supposedly does not bode well for the stock market in 2006.

As with the previous two patterns, however, I could find little support for this in the historical data.

To be sure, since the Nasdaq Composite index was created relatively recently -- in the early 1970s -- there is relatively little data with which to test this alleged pattern.

Even if the Nasdaq's relative strength were a great market-timing indicator, for example, 30 years of data would probably not be enough for it to emerge as significant in the eyes of skeptical statisticians.

Nevertheless, insofar as any pattern does emerge from the data, it is just the opposite from what newsletters are assuming: Statistically insignificant though the data may be, since 1971 the broad stock market has performed better following years in which the Nasdaq *lagged* the NYSE -- not the other way around.

4. Because small-cap stocks' relative strength tends to persist from year to year, small-caps should lag large-caps in 2006.

This is the only forecast for which I found strong support in the historical data. Since 1927, when reliable data on investment styles begin, the persistence from year to year in small-caps' relative strength is significant at the 95% confidence level.

This means that if small-caps (stocks that are in the bottom third of all stocks ranked by market capitalizations) lag the large-caps (stocks in the top third) in a given year, as they did last year, there is an above-average chance that they will do so in the next year as well.

By the way, I did not find similar support for a related forecast about the relative strength of the growth and value styles. That means we can make no prediction about 2006 based on the outperformance in 2005 of the average value stock over the average growth stock.

The bottom line? There is very little in stock-market forecasting that clears the hurdles skeptical statisticians erect. Of the 2006 forecasts I reviewed in this column, the only one that could meet statisticians' rigorous tests is the prediction that large-caps are likely to outperform small-caps in 2006.

But since so many gurus seem to be expecting that, maybe we should be skeptical of that, too.

Mark Hulbert is founder of The Hulbert Financial Digest in Annandale, Va., which recently celebrated its 25th anniversary. He is a senior columnist for MarketWatch.

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