Steps to Formulate Capital Market Expectations

Problems with Producing Capital Market Forecasts

- Limitations to using economic data include time lag between collection and distribution, data are often revised, data definitions and methodologies change, and data indices are rebased over time.
- Data measurement errors and biases include transcription errors, survivorship bias, and appraisal (smoothed) data instead of actual returns. Appraisal data gives correlations and standard deviations that are biased downwards.
- Values from historical data must be adjusted as economic, political, regulatory, and technological environments change. These are regime changes and result in nonstationary data.
- Using ex post data to determine ex ante risk and return can be problematic.
- Using historical data can lead to patterns that are unlikely to occur in the future. Data mining—in which variables appear to have a relationship by change—is an example of this.
- Forecasts may not account for conditioning information. Accounting for current conditions avoids assuming economic relationships will persist over time.
- Misinterpretation of correlations versus causality. An alternative to correlation for uncovering predictive relationships is a multiple regression.
- Falling into psychological traps including anchoring, status quo, confirming evidence, overconfidence, prudence, and recallability traps.
- Model and input uncertainty.

Step 1. Determine expectations needed according to investor's tax status, allowable asset classes, and time horizon. Time horizon is particularly important.

Step 2. Look at drivers of historical performance to establish a range for future performance. The drivers can be used to forecast future performance and compare it to past results.

Step 3. Identify the valuation model used and its requirements.

Step 4. Collect the best data possible as faulty data will lead to faulty conclusions. These issues should considered in data evaluation.
- Calculation methodologies and error rates.
- Data collection techniques and data definitions.
- Investability and correction for free float.
- Turnover in index components.
- Potential biases.

Step 5. Use experience and judgment to interpret investment conditions and decide on values for required inputs.

Step 6. Formulate capital market expectations. Any assumptions and rationales should be required. Determine if what was specified in Step 1 has been provided.

Step 7. Monitor performance and use it to refine the process. If actual performance varies significantly from forecasts, the process and model should be refined.