It is tough to make predictions, especially about the future! This humorous quote, credited to Yogi Berra, contains more than a grain of truth. Predictions are as inaccurate as they are numerous. History is littered with failed predictions on matters as diverse as global economy to the fate of civilisations. Each major event results in the growth of the tribe of crow-eaters.

“We see a global market of between 5 and 10 computers,” said Thomas Watson of IBM in 1945. “British rule in India will endure. By 2030, whatever rules of self-rule India has achieved, she will remain a loyal and integral part of the British Empire,” wrote FE Smith, a senior British politician in 1930. He also offered predictions on matters that are non-political. He wrote that, “By 2030, it is probable that the average week of the factory hand will consist of 16 or perhaps 24 hours,” Clearly, he had not seen Blackberry coming!

And all the wrong predictions were not made in the wrong half of the 20th century. Though a change in the global economic order has long been talked about, there has been a sea change in perceptions about the emerging pecking order. As recently as the ‘90s, China was mostly dismissed as inconsequential, even as it was marching relentlessly on the path of economic prosperity. “While China will always be important politically and militarily, it will not have a big impact on the world economy in the first half of the 21st century,” wrote Lester Thurow in his book titled ‘Head to Head’. At that time the focus of all seers was on Japan, which had risen from the ashes of the Second World War like a Phoenix and was conquering one industry after another.

Jacques Attali, a former advisor to French president Francois Mitterand, wrote in his 1990 book titled ‘Millennium’ that in the early 21st century, both the US and the Soviet Union will cease to be super powers, leaving Japan and the European Union contending for economic leadership of the world. Thurow even wrote that Americans should learn to speak German or Japanese! Especially at this time, when Japan has been mired in a slump for more than two decades, and the Eurozone is fighting for survival, the prediction looks quite comic.

Americans may yet need to learn a new language, but it is more likely to be Chinese. And who knows, China itself may get caught in the middle-income trap and America may surge ahead, just like it did in the late 1990s leveraging its innovations in information and communication technologies.

Those who predict things as mundane as the stock market are no less spectacularly wrong, as the titles of two books ‘Dow 30,000 by 2008’ and ‘Dow 36,000’ (written at the height of the dot com bubble, which burst soon thereafter, smashing the reputation of the authors with it) clearly illustrate. A very enlightening and entertaining book titled Future Babble, written by Dan Gardner provides several such examples of failed predictions.

Needless to say, those who bet on such predictions sometimes pay the price. Organisations routinely lose money when they are caught unaware by unexpected swings of currencies, even when they employ expert advisors. A study conducted by Philip Tetlock involving thousands of predictions by experts showed that on average, experts are no better than an ordinary coin at predicting the future!

And it is not just the ivory tower experts, who predict for a living, but also hard-nosed executives who make a hash of predictions. A fascinating study titled ‘Managerial Miscalibration’, conducted by Itzhak Ben-David of Ohio State University and John R Graham and Campbell R Harvey of Duke University, found that Chief Financial Officers (CFOs) are generally miscalibrated, ‘in that their forecast probability distributions are too narrow’. What this means is that they expect the possible outcomes to lie within a very narrow band. For
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instance, they may predict that the stock market index will lie within a 5 per cent range a year later.

They hypothesise that this could be, “…either because people overestimate their ability to predict the future or because they underestimate the volatility of random events”. If someone is certain of the future, he will predict only one outcome for a future event (say Nifty will be at 6200 on August 1, 2013). On the other hand, if one was very uncertain, one would hesitate to predict a single outcome, instead providing a range within which the outcome will lie (Nifty between 5800 and 6500 on August 1, 2013). Thus, greater the uncertainty, the larger the range. Conversely, the lower the uncertainty, the narrower the range.

The study was based on data collected by Duke every quarter between 2001 and 2010 from CFOs and Senior VPs of Finance of firms in the US. Though some questions were unique to each quarterly survey, others were common. Among the latter, CFOs were asked to answer:

Over the next year, I expect the annual S&P 500 return will be:

- There is a 1-in-10 chance the actual return will be less than ___ %
- I expect the return to be: ___ %
- There is a 1-in-10 chance the actual return will be greater than ___ %

This data collected over 10 years allowed researchers to estimate the degree of optimism and miscalibration of CFOs (at least in the US). They found that according to the confidence bounds that CFOs provide, they are severely miscalibrated: Only 33 per cent of the time do realised S&P 500 returns fall within the 80 per cent confidence interval that respondents offer. Even during the least volatile quarters in our sample, only 59 per cent of realised returns fall within the 80 per cent confidence intervals provided.

This was not all. CFOs did not estimate the degree of volatility. The authors say, “CFOs provided an average confidence interval of 14.6 per cent, the difference between the 10th and 90th return percentiles from the historical distribution of the one-year S&P 500 returns is 40.3 per cent. We find that only 3.4 per cent of CFOs provide confidence intervals wider than 40.3 per cent.” This implies that only 1-in-30 CFOs expected the stock market to be as volatile as it turned out to be over the next 12 months. And this is true not just of one particularly volatile year, but on average over 10 years, including a continuous period of relatively less surprises around the mid-2000s.

Not surprisingly, when thinking about the future, people are influenced by recent experiences. However, good and bad news impacts people differently, found the study. When the stock market performed poorly, the lower bound dropped whereas the upper bound remained static. The effect is larger when the S&P dropped by more than 10 per cent. This shows that managers focus more on downside risks.

What is more significant, miscalibration spills into managers’ estimates about the performance of their own firms as well. More miscalibrated CFOs are more certain of their own firms’ IRR than they ought to be going by the real performance. Clearly, this has consequences for corporate planning and forecasting. The study found that the higher the miscalibration and optimism of the CFO, the higher the corporate investment made by the firm! Thus, what appears an idiosyncrasy really has a profound bearing on the future of the firms.

One explanation for the higher optimism bias and miscalibration is that people with these traits are prone to taking higher risks and are more likely to climb the corporate ladder. It is therefore, not surprising that a poll of CFOs (or indeed other senior executives) would find a disproportionate number of miscalibrated forecasters. More research is needed to understand whether the benefits of higher risk-taking outweigh the cost of poor forecasting. Be that as it may, there is a case for being a little more circumspect of the notions - whether one’s own or those of experts - about the future. Clearly, the future is not what it used to be. Perhaps it never was!