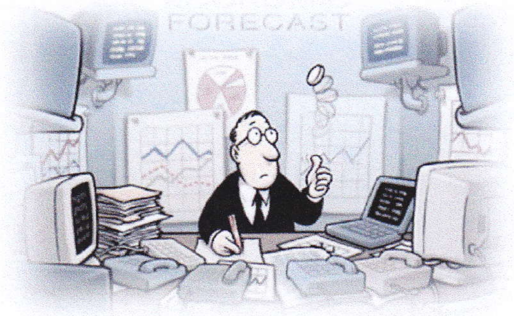

The Forecasting Trap and the Power of the Coin!

by IMCZ Treasurer John Henry Smith

Donald Rumsfeld, the ex-U.S. Defence Secretary is reputed to have said: *"There are known knowns. These are things we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. These are things we don't know we don't know."* [1]

Down through history we've always felt a need to know our future and it explains why especially in dark times people have always sought ways to unlock its secrets. Today the stock market thrives on the fine art of soothsaying, but under the guise of such names as 'forecasting' and 'projections'. This is because the need for certainty is core to investor sentiment, being constantly goaded by the demonic twins of greed and fear.

Alas these analytical techniques, no matter how good they portend to be, are unable to take into account these 'known unknowns' and 'unknown unknowns'. Expressing these observations in a more esoteric way, the widely read non-soothsayer, Nassim Nicholas Taleb,[2] asserts that we are incapable of predicting events that lie outside the realm of regular expectations, even if they have an extreme impact, such as the U.S. sub-prime mortgage crisis.

If so, and expert analysis fails the world of finance, as indeed it has many times, then perhaps the best thing to do is just flip a coin to get an answer to a problem and be done with it. At least there is a 50/50 chance that the answer will be right and that is better than most analysts can do. The following table attempts to prove the point.

CXO Advisory[3] is a website that specializes in tracking the forecasting abilities of 34 self-designated Gurus. I will not list all, but here are five, listing their forecasting skills from the best to the worst (**table 1**).

In total 16 Gurus ranged from 63% to 50% and 18 Gurus ranged from 49% to 21%. By any stretch of the imagination these results are very shocking and support the argument that what they say and recommend is more hype than substance simply because they can no more see into the future than the fattened turkey just before Christmas.

However the buck doesn't stop there, but is a phenomenon that is all pervasive and reaches every corner of the financial advisory sector from forecasting the economy to the forecasting of corporate earnings. In fact, 75% of all SP500 companies beat analyst expectations in the second quarter, and while they are called earnings surprises this very high percentage of error only proves the unbelievable inaccuracy that permeates the stock market!

Even acknowledging that in hindsight forecasting is overwhelmingly difficult, as a known unknown, it begs the question whether this quarterly ritual is deliberately intended to stimulate the market. After all, CEOs and investors alike have a vested interest in boosting their stock prices through the process of beating market expectations. To gain on-going access to corporate developments the analyst must bear this in mind or face ex-communication. And even if diligent attempts are made by analysts to capture the hundreds if not thousands of variables that go

into financial modeling, including dangerous outliers,[4] the majority of reports face at best a short shelf-life or immediate redundancy by the massive information flows that churn the market daily, particularly when the market mood is "Buy on the rumor and sell on the news!"

The purpose of all this analysis is to service clients and to acquire new ones notwithstanding the systemic vagaries of the market place and entrenched practices of market stakeholders. A cornerstone of this activity is to make buy, hold and sell recommendations.

table 2

Stock & Symbol	Analyst	From Date	Recommend -ation	At Price	To Date	Recommend -ation	At Price	%age Price Change
Bucyrus Intl (bucy)	Longbow	13 Aug 08	Upgrade from Neutral to Buy	$65.07	11 May 09	Downgrade from Buy to Neutral	$25.29	-61%
UBS (ubs)	Credit Suisse	28 Nov 07	Upgrade from Neutral to Outperform	$46.67	19 Jun 09	Downgrade from Outperform to Neutral	$23.07	-54%
Potash Corp (pot)	Soleil	15 Sep 08	Upgrade from Hold to Buy	$154.10	30 Mar 09	Downgrade from Buy to Hold	$69.31	-47%
Mosiac Co. (mos)	Canaccord Adams	9 Jul 08	Initiated to Buy	$131.24	3 Oct 08	Downgrade from Buy to Hold	$40.88	-70%

table 1

Position	Guru	Total Measurable Forecasts	Forecasts Essentially Right	Forecasts Essentially Wrong	Accuracy
	Active Reviews				
1.	**Jack Schannep** via Zacks.com	50	31	19	63%
9.	**Marc Faber** (Swiss) via ameinfo.com.et.al.	79	42	37	53%
15.	**David Luskin** via SmartMoney.com	168	84	84	50%
24.	**Jim Cramer** of CNBC via New York Metro	59	27	32	46%
33.	**Bill Fleckenstein** via MSN Money	120	46	74	38%

What is interesting is the incredibly slow reaction time of analyst institutions to renew their recommendations, as **table 2** shows.

Source: http://finance.yahoo.com

Any investor who had placed his trust in these recommendations would have lost serious money, as the end column shows! Considering the persistent dire news about the U.S. economy in 2008 there had to be some point when a normal rational person would have even dispensed with a coin and sold off his loss positions when it became patently clear that the Black Swan had spread his wings and engulfed the market.

In 2008, the turning point had to have been when the so-called Minsky Moment occurred, namely when bullish price patterns radically reversed into the sustained price patterns of a bearish market. Under these circumstances, traditional forecasting models, in the new unknown unknown environment, was like the proverbial chocolate teapot; it only worked when it was not it use.

At the very vanguard were the analysts who were expected to signal changes in the market so that the systemic or specific risks could be managed. In reality, however, the analysts themselves did not know what they claimed to know and only lulled stakeholders and investors alike into a false sense of security.

This is all depressing stuff that is unfortunately supported by the massive losses the market bore last year, even though the daily news brought more and more damaging revelations.

If we use the wrong tools and assumptions we should expect to get the wrong answers. To get the right ones we need nothing short of an entirely new model, one designed to fit true market needs, which would take into account realistic feedback processes and which does not take into account any kind of tacit patronage to corporations. At any rate, it seems that from the evidence of last year, investors are no worse off by deciding on the flip a coin or better still using their own intuition to help them make their choices. Pericles (c.495 – 429), the Greek statesman, seemed to know that no-one knows what tomorrow will bring (a known unknown) when he warned, "The key is not to predict the future, but to be prepared for it."

1 "The Origin of Financial Crises", Chapter 7, Page 141 by George Cooper
2 "The Black Swan", the Prologue, Page 1
3 http://cxoadvisory.com/gurus/
4 Events that lie outside the realm of regular expectations
5 Named after Hyman P. Minsky, author of "The Financial Instability Hypothesis"(1957)

Investment Corner

by IMCZ Treasurer John Henry Smith

As there are several categories of investment styles, each Grail stock will be analyzed in accordance with a stated style or strategy, i.e. Momentum Investor, Value Investor, etc.

Assessments and Analysis based on 21 August 2009 close price: $54.66	
Analysis of:	Ross Stores Inc. (ROST)
Industry:	Specialty Retail
Strategy:	Patient Investor, or the Warren Buffet style
Stock Performance:	+57%
SP 500 YTD:	+14%

COMPANY DESCRIPTION

Ross Stores, Inc. operates two chains of off-price retail apparel and home accessories stores. As of January 31, 2009, the Company operated a total of 956 stores, of which 904 were Ross Dress for Less (Ross) locations in 27 states and Guam and 52 were dd's DISCOUNTS stores in four states. Both chains target value-conscious women and men between the ages of 18 and 54. Ross customers are primarily from middle income households, while the dd's DISCOUNTS customers are lower income households. Ross offers in-season, name brand and designer apparel, accessories, footwear and home fashions for the entire family at everyday savings of 20% to 60% off department and specialty store regular prices. dd's DISCOUNTS features priced assortments of in-season, name brand and fashion apparel, accessories, footwear and home fashions for the entire family at everyday savings of 20% to 70% off moderate department and discount store regular prices.

CATEGORY	CRITERIA OF A LOW P/E INVESTOR	SCORE	REPORT CARD
Earnings Predictability:	Stable earnings that continually expand over 10 years.	From earliest EPS **0.82, 0.92, 0.96, 1.25, 1.47, 1.13, 1.36, 1.70, 1.90, 2.33.** One earnings decline is acceptable.	PASS
Debt service:	Conservatively financed.	ROST has a debt of $150 million and earnings of $345 million, which could be used to pay off the debit in less than two years.	PASS
Return on equity (ROE):	Above average return on equity of above 15%.	ROST's ROE average over the last 10 years is **27.7%.**	PASS
Return on total capital (ROTC):	Over the last 10 years, the ROTC must average 12% or more with the last three years over 12%.	ROST's ROTC over the last 10 years is **25.9%** and the average over the past 3 years is **23.7%.**	PASS
Capital Expenditures expressed as a calculation of free cash flow:	No major upgrades of plant and equipment.	ROST's free cash flow is **+$2.36** per share.	PASS
Use of retained assets:	Over the last 10 years, the gain in the total EPS is divided by the total of retained earnings over the same period.	Retained earnings over 10 years of **$12.02** is compared to the EPS of **$1.15** showing that ROST earned 12.5% return on retained earnings.	PASS
Share repurchase:	Repurchases decrease the number of shares and increases shareholder value.	Outstanding shares fell over the past 5 years from **146,720,000** to **126,000,000.**	PASS
Initial rate of return:	The initial rate of return is compared to the long-term Treasury yield.	Currently, the long-term treasury yield is **4.60%.** ROST's initial yield is **5.91%**, which will expand at an annual rate of 12.5%, based on the 10 year EPS growth rate.	PASS
Expected future return in 10 years:	The average rate of return on equity divided by the retained earnings.	Investors could expect an average return of **17.5%** on ROST for the next 10 years.	PASS

DISCLAIMER: The above financial data is for informational purposes only, and is explicitly not a recommendation made by IMCZ, which cannot be held liable for its accuracy and that any purchase and/or sale of securities in whatever form based on this information is entirely at the reader's own risk.