Uncertainty and the Dart-Throwing Chimpanzee

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I ran across a wonderful review of Dan Gardner's new book, Future Babble. He discusses why pundits make predictions, why people listen to them, and why you would ultimately be better off with a dart-throwing chimpanzee. The fact is that experts are terrible at predictions:

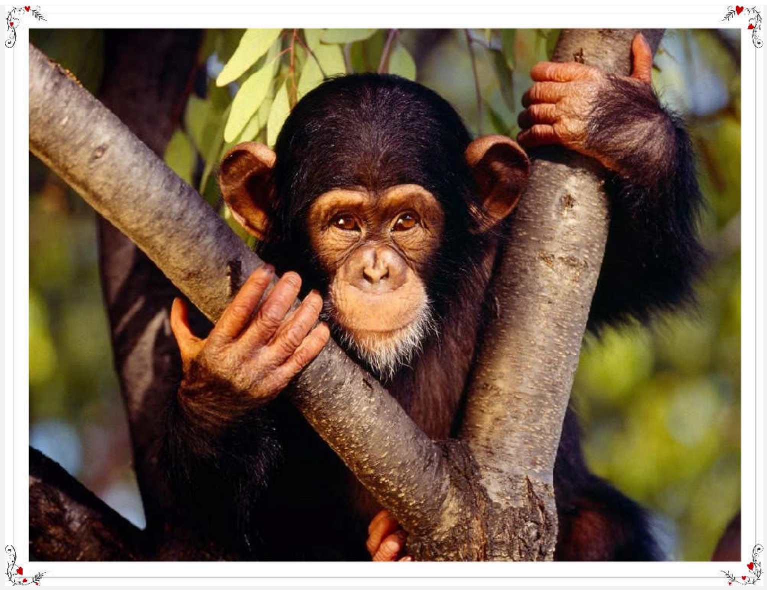
In *Future Babble*, Gardner acknowledges his debt to political scientist Phililp Tetlock, who set up a 25-year experiment in which he enrolled 286 experts who made their living "commenting or offering advice on political and economic trends". He signed a non-discloser statements and framed the questions in a way that the outcome could be measured. By the end of the study. Tetlock had quantified 82,631 different predictions and later checked how well they did. Not so well. Tetlock concluded that most of his experts would have been beaten by "a dart-throwing chimpanzee." Tetlock found that the experts wearing rose-tinted glasses "assigned probabilities of 65 percent to rosy scenarios that materialized only 15 percent of the time." Doomsters did even worse: "They assigned probabilities of 70 percent to bleak scenarios that materialized only 12 percent of the time." After Tetlock tallied up the data, the predictive failures of the pundits became obvious. Although they were paid for their keen insights into world affairs, they tended to perform worse than random chance. Most of Tetlock's questions had three possible answers; the pundits, on average, selected the right answer less than 33 percent of the time. In other words, a dart throwing chimp would have beaten the vast majority of professionals. Tetlock also found that the most famous pundits in his study tended to be the least accurate, consistently churning out overblown and overconfident forecasts. Eminence was a handicap.

In my correspondence with Gardner he wrote me***...."In my original plan for the book, I had a chapter on financial gurus. Most of it was written but we dropped it simply to keep the book short, which was necessary, in a practical sense, but also a shame. Some of the money guys I interviewed -- very big names, at one time or another -- were the finest illustrations of the sort of expert we should flee from. But they were confident. Oh lord, were they confident. Absolutely unshakable. No matter what happened, they were right all along. Truly amazing."***

Why, then, do people even listen?

Besides making fun of the failures of the prognosticating class, Gardner also explains why so many of us keep falling for false prophesy: Humans beings hate uncertainty. Gardner offers myriad insights from research in cognitive psychology and behavioural economics that explains how and why we succumb to our desires for certainty. “Whether sunny or bleak, convictions about the future satisfy the hunger for certainty,” writes Gardner. “We want to believe. And so we do.”

It’s fine, I suppose, if you listen to forecasts for entertainment. But knowing the track record of forecasters, why in the heck would you ever base your investment policy on a forecast? I’m not talking about just extreme forecasts like the rosy scenario or gloom-and-doom. A pie chart that allocates assets based on a forecast of expected returns and expected correlations is no less a forecast—and no more likely to be accurate.



An Expert Pondering His Next Move in the Market

Source: www.blingcheese.com

Just because we hunger for certainty doesn’t mean it is available. The only thing I can forecast with any certainty is that things will continue to change in unpredictable ways. Price represents a market’s best guess about what might happen down the road, rightly or wrongly. Price is an informed guess; people are putting real money on the line. Research shows that predictive markets are often more accurate than experts. Relative strength is just a handy way to measure price and gauge what market participants are doing. There’s no guarantee that they will do the same thing tomorrow, but perceptions generally change gradually over time as new information comes to light, or new thinking about old information emerges. Staying with strong relative strength trends and departing when they weaken is the simplest way to stay in synch with the changing flow of information in the market.

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