FORECASTING

“Experts” Who Beat the Odds Are Probably Just Lucky

by Jerker Denrell

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The finding: People who successfully foresee an unusual event tend to be wrong about the future over the long run.

The research: Working with Christina Fang of the Stern School of Business, Warwick Business School’s Jerker Denrell analyzed years of experts’ quarterly forecasts for interest rates and inflation, which had been reported by the *Wall Street Journal.* People whose predictions were most in line with conventional wisdom proved the most accurate overall. But those who made contrarian predictions that paid off big once or twice were viewed as the real market sages—even though their forecasts were incorrect more often than not. Follow-up lab studies confirmed that people who make wild but successful bets are remembered for those hits—but on average are the worst predictors.

The challenge: Do we give too much credit to people who have one giant win? Is their success just a fluke? **Professor Denrell, defend your research.**

Denrell: It’s obvious once you really think it through, but both real-world and lab results show that while people who hit it big going against the grain are the ones we turn to for wisdom on future events, overall they tend to be bad at making forecasts. People who have decent but not exceptional performance with predictions are the ones with the most to offer us.

HBR: So the great forward thinkers we celebrate are lucky? Not good?

Mostly, yes. We tend to admire these people because we remember that they hit and no one else did—they separated themselves from the pack, and it worked out. But the very traits that lead them to make these out-of-sync predictions—their particular set of knowledge, their worldview, their personality, their tolerance for risk and for being nonconformist—usually also lead to misses. Consider the forecaster whose prediction was closest to the actual outcome in the last period of our data from the *Wall Street Journal,* Sung Won Sohn. He was one of a few who correctly predicted a high inflation rate when the consensus forecast was low. According to the *Journal,* he credited this to an intuition he developed after visiting a California jeans producer. The producer could not keep up with demand for its $250 jeans. Sung Won Sohn figured there had to be money out there if people were willing to pay that much for jeans. But such methods don't always work; in the preceding two periods, he was ranked 43 and 49 out of 55 on predictions.

Missing the Mark

In Denrell's study of interest and inflation rate forecasts, the analyst who successfully predicted the highest number of unusual events (six) had the lowest overall accuracy rate. His forecasts deviated from actual outcomes by 41.5%, while those of the other experts deviated by just 17.4%, on average.

Still, one hit in a place like the stock market can lead to huge gains.

True. But if you rely heavily on the person who had that hit, you probably won't come out ahead. In our study an ability to call many extreme events correctly was an indication of poor judgment. In fact, the analyst with the largest number of accurate extreme forecasts had the worst forecasting record by far.

What leads people to make wild predictions? Personality?

In the lab, that seems to be the case. In the world there are any number of incentives to make bold predictions. TV ratings, for example. Think of sports prognosticators. Being right about the upcoming game is much less important than getting people to tune in to their outrageous predictions. This is why we used *Wall Street Journal* inflation and interest

rate predictions—those forecasters had no incentive to make optimistic predictions.

Why is it important to study this?

The underlying idea is that predicting something unusual is not that informative. We shouldn't rely on people who focus on unusual events, but we do. Think of the CEO who hits it big in one industry and is paid a king's ransom to do the same in another industry. Top performance and outcomes are often produced by things besides skill, so we shouldn't reward them as much as we do.

But couldn't a bold predictor also happen to be a more skilled predictor?

Our results suggest that successful bold predictions don't signal the competence of the predictor at all. Even if someone makes two successful bold predictions, it's more likely a fluke.

Still, two successful predictions against the grain sure seem like an indication that someone's outsmarted everyone else.

The mistake we make is conflating tasks that require well-defined skills, like running a foot race, with ones that don't, like trading stocks. An outlier will not win the 100 meters at the Olympics, because you have to possess certain skills to even qualify. In trading, however, there's much more variability in what drives results. In finance this is well known; that's why financiers try to control variability. We should think of entrepreneurship in these terms as well. We should control for variability; instead we reward big hits because we think business founders are skilled in the way that a sprinter is. They're not. A lot of variability is why you see largely unskilled people strike it rich in ill-defined markets and with start-ups. But in an industry without variability, like retail, you have to be very, very good to succeed, and when you do, you won't be rewarded as greatly as you are with a start-up.

What are some examples of outlier predictions in the real world?

Any example is debatable, and I don't wish to point fingers. But I like to think about

people who judged Elvis or the Beatles to be unlikely to succeed. Those predictions were likely sensible: The data available probably indicated that they would not be popular. Of course, Elvis and the Beatles did succeed, and what had been said about them beforehand was dug up. If someone had said, "They will succeed and be more successful than any other artist," they would have been correct with an unfounded prediction.

Nassim Taleb has made a career of going against the grain. It seems that he has a coherent philosophy and is thoughtful, but the possibility remains that we all have been seduced by a few hits of his.

Does this mean we should dismiss Nate Silver as a predictor, since he hit it so big in the last U.S. presidential election?

In fact, Nate Silver was not going against the crowd in any bold way. He was the focus of more media coverage than others, but really he was saying what many others were saying—but with more precision because he was controlling for variability. In the end he correctly predicted the outcomes in all 50 states. He seems like a good predictor to me. When I talk of bold predictors we celebrate, I'm thinking more of the entrepreneur who enters an industry with a vision and hits it big with one idea. It's human nature to see that as impressive and to seek that person's counsel on another entrepreneurial bet. But that could be his one hit among many failures—and in fact it's likely the case.

Can we change our mind-set to control this overvaluing, or is this human nature?

It's clearly possible to change how we value predictions. First, people need to understand that in many contexts, luck breeds more luck. A firm that got lucky and had a great year starts the next year with an advantage.

I predict this interview will be a big hit.

I think that's a safe bet.

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