Mark Hulbert

3 reasons to give up your search for stock market predictors

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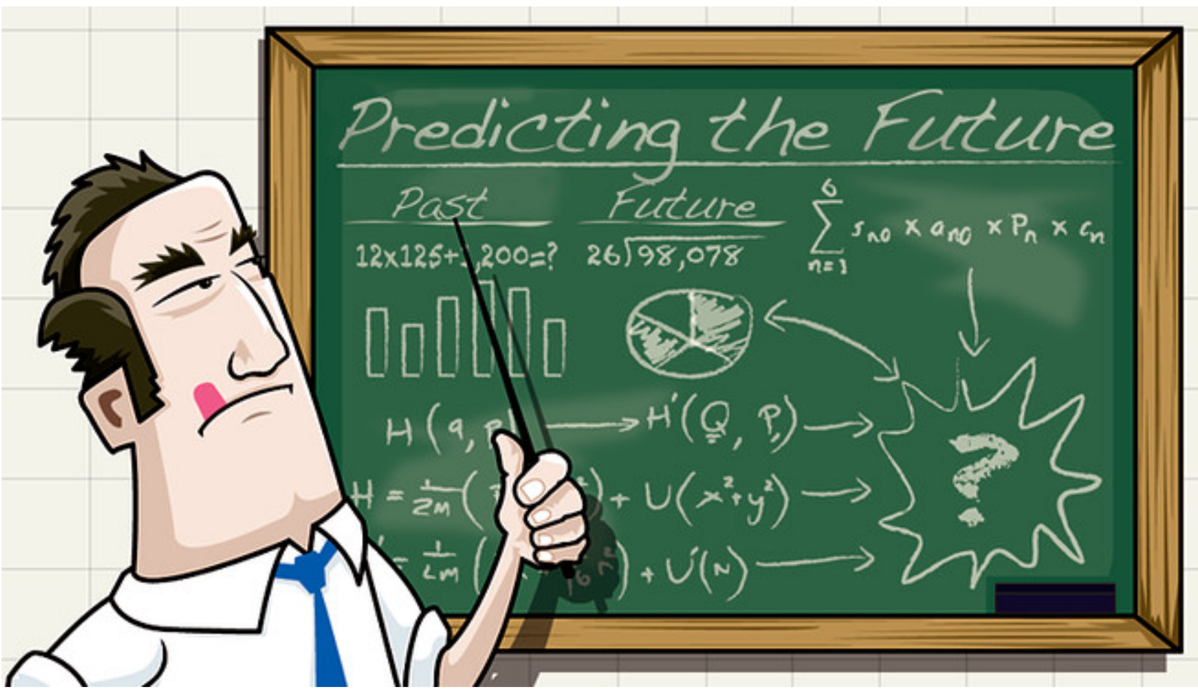
Returns in one year have nothing to do with those of other years



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DJIA 0.38% ▲

CHAPEL HILL, N.C. (MarketWatch) — The best predictor of how the stock market will perform in 2015 is right in your pocket.

Yes, I'm referring to that coin you can flip.

The stock market's returns in any given year are independent of what happened before. Just as a coin doesn't remember whether its previous flip came out heads or tails, the stock market focuses on the future, not the past.

Does this mean you should give up searching for some previously unknown, yet “amazing,” statistical idiosyncrasy that will unlock the stock market’s secret in 2015?

Yes, for several reasons.

First, in almost all cases there is not enough historical data to allow for statistically significant conclusions. So even when you come up with a pattern that appears promising, you still haven’t improved on a coin flip.

Take the pattern that is getting a lot of attention these days: the one that keys off years ending in “5,” which supposedly are especially good for the stock market. Even if you analyze the stock market index that has been around the longest — the Dow Jones Industrial Average **DJIA, 0.38%**, which was created in 1896 — you have a sample of only 11 years. That’s just not big enough to support robust statistical conclusions.

The second reason to give up your search for statistical quirks that will tell you how to invest in 2015: There’s no easy or straightforward way of profiting from any patterns you do discover. That’s because no pattern, even those that do survive tests of statistical significance, can guarantee success in any given instance. The only way to get the odds of success high enough to make it worth your while to bet on a pattern is to bet on it over many years, or even decades.

A gambling analogy is appropriate. Even the best card counter wouldn’t ever bet everything on any one round in blackjack. The only way he can get the overall odds arrayed comfortably in his favor is by applying his card-counting insights across many different rounds.

Take the “years ending in five” pattern mentioned above. To bet on this pattern in a disciplined way, you would need to have a higher-than-normal equity exposure in 2015, 2025, 2035 and so forth for quite a few decades.

If you want to do that, be my guest. Make a note to report back to me later this century.

The third reason to give up your search for statistical idiosyncrasies: Few of the alleged patterns are supported by any plausible underlying theory. And without such an explanation, there remains the distinct possibility that the pattern is a fluke not worth betting on, no matter how good the statistics are in and of themselves.

After all, there are plenty of phenomena that have absolutely nothing to do with the stock market but that are nevertheless highly correlated with it. One of my favorite examples comes from David Leinweber, founder of the Center for Innovative Financial Technology at the Lawrence Berkeley National Laboratory. Several years ago, wanting to illustrate the perils of confusing correlation and causation, he searched through all the data on a United Nations CD-ROM to find the indicator with the most statistically significant correlation with the S&P 500 Index.

His discovery: butter production in Bangladesh.

Once again, take the "years ending in five" pattern. I know of no plausible explanation for why the stock market should perform better in such years than at any other time.

I fully realize that many of you will be disappointed that you can't improve your odds of success by slicing and dicing the historical data in search of some previously unknown statistical quirk. But you should see it as good news.

If the market did take the past into account, it would suffer from "unnecessary and unhealthy turmoil," according to Lawrence Tint, a chairman of Quantal International, a firm that conducts risk modeling for institutional investors. In an interview, he said: "We can be comforted by the fact that reasonably efficient markets always base their level on anticipated future returns, and do not include history in the calculation."

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