Investment crystal balls: broken or imperfect?

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Investors have long relied on two crystal balls when predicting future returns: equity risk premium and the yield curve. Both have been broken in this decade because of QE.

Whether the unwinding of QE, however, will mean a return to normality is another matter for one simple reason - these crystal balls have always come with a health warning.

Let's start with ERP. It measures the additional rate of return that investors require to compensate them for the risk of holding stocks instead of a 'risk-free' asset, typically the US 10-year Treasury bond.

In theory, it can never be negative. If it is, investors can always switch out of equities into bonds. Yet, over the past 130 years of data, it has been negative 25% of the time.

Its predictive worth has been undermined by the changing structure of markets. In 1958, the average lifespan of a company listed in the S&P 500 was 61 years. Now it is just 18 years, according to Prof. Richard Foster of Yale University.

The rise of high frequency trading and share buy-backs have also weakened the traditional role of markets as efficient allocators of capital.

The predictive worth of the yield curve, too, has been distorted by central banks' super easy money policies. But that's not the only factor. Ageing demographics and ballooning global debt are also bearing down on long-term rates. The data used to back test the yield curve are, of necessity, drawn from a period when these new structural forces were absent.

QE has therefore supercharged the imperfections of ERP and the yield curve – but not necessarily caused them. Every generation of investors conceitedly thinks that it lives in a transformational era where the tried and tested ways of doing things just don't work.

But investment history shows that there is no 'old' normal or 'new' normal. There is only a 'different' normal with each cycle.

As investors seek certainty in an uncertain world, crystal balls have their place, so long as they are combined with an uncommon degree of common sense.

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