

## PLAUSIBILITY CHECK OF CONSENSUS: EXPECTATION BUILDING IN FINANCIAL MARKETS

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### ABSTRACT:

*How is the daily practice of expectation formation organized in financial markets? The paper answers this question by investigating a special area of the capital markets, namely active fund management. The inquiry is based on interviews with fund managers, as well as on materials collected during participant observation at a Swiss bank. The paper argues that fund managers structure their expectations as an adjustment of the estimates that already circulate in the market. They do not aim to predict rates of return, but rather the dynamic of market estimates. The procedure takes the form of a plausibility check of the consensus scenario. Those findings contradict the prevalent theoretical idea that investors usually make a point forecast or assign probabilities to possible outcomes.*

### INTRODUCTION

The key feature to every investment is uncertainty: “the investor is trading a *known* dollar amount today for some *expected* future stream of payments” (Reilly/Brown 1997:5). The future stream of payments consists of the yield, like dividends, coupon or interest rate payments, as well as the earnings or losses due to price changes of the security. Those prospective flows of payment and movements of the asset price in the future are uncertain. Thus, uncertainty and expectations are at the core of the decision making process in the financial markets.

This paper deals with one of the oldest puzzles in economics: How do investors build expectations to choose actions whose success depends on unknown future events? Though there has been a prolonged debate in the academic literature, no satisfying theoretical solution to this problem has been provided yet. Standard finance theory suggests that investors are rational actors that possess all of the relevant information, process it quickly and thus build expectations, on average, error-free. This theory is also based on the assumption that actors form homogenous expectations (for example, Capital Asset Pricing Model is based on this assumption, see Sharpe 1964).

Which form do those expectations take? A standard textbook on finance (Reilly/Brown 1997) suggests that investors either provide a point estimate like “a rate of return will be 10 percent” or predict some possible returns and assign probabilities to them to calculate an expected return. In the first case, the most likely value of a variable is determined, and in the second case “[a]n investor determines how certain the expected rate of return on an investment is by analyzing estimates of expected returns. To do this, the investor assigns probability values to all *possible* returns... The probabilities are typically subjective estimates based on the historical performance of the investment or similar investments modified by the investor’s expectations for the future. For example, an investor may know that about 30 percent of the time the rate of return on this particular investment was 10 percent. Using this information, along with future expectations regarding the economy, one can derive an estimate of what might happen in the future.” (Reilly/Brown 1997:11) An investor develops economic scenarios (for example: “strong economy, no inflation”, “weak economy, above average inflation” and “no major change in the economy”) and connects them with probabilities and rates of return. Then, the expected rate of return can

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be easily calculated and thus represented by a particular figure: again, it is either the most probable value or the mathematical expectation based on a construction of possibility space.

However, the idea of the standard financial theory that identical investors calculate and share rational homogenous expectations has been sufficiently criticized. In the modern literature the plausibility of such expectation building is often questioned.

Many studies demonstrate that people do not proceed analytically while building expectations. Especially during the last financial crisis, attention was drawn again to the Knightian distinction between risk and uncertainty (Knight 1971). It is argued that crisis took everybody by surprise because market participants faced genuine uncertainty when no probabilities could be assigned to possible events or those events were simply unknown. This situation could not be transformed into situation of risk where probabilities are measurable and thus the aforementioned calculation is possible. This argumentation is in line with ideas of Keynes (1936): we lack knowledge to be able to determine probabilities, and thus to form mathematical expectations: „The sense I am using the term <uncertainty> is that in which the prospect of a European war is uncertain or the price of copper and the rate of interest... About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.” (Keynes 1973: 113) Thus, writes Keynes, “human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for making such calculations does not exist” (Keynes 1967: 162). Important works by Kahneman and Tversky (1979), Hirshleifer and Riley (1992), Arthur (1994, 1995), Gilboa and Schmeidler (1995) and many others provide a lot of theoretical and empirical support for this statement. But if market participants do not calculate while building expectations how do they form them and thus cope with radical uncertainty in their everyday practice? This is the topic of the paper.

A deeper analysis of the problem, namely that of making “expectations without exact calculations,” could inform current efforts to model Knightian uncertainty in economics and finance. (for example, Epstein and Wang 1994, Liu 1998, Rigotti and Shannon 2005, Epstein and Schneider 2006, Sniedovich 2007). A more precise understanding of the structure of the non-probabilistic expectations could enhance those modeling efforts.

Keynes suggested that because we cannot use mathematics all the time, we are “often falling back for our motive or whim or sentiment or chance” (Keynes 1967: 163), or “animal spirits” (Keynes 1967: 162). The last term became a title of the newest book written by two leading economists of our time – George Akerlof and Robert Shiller. They develop ideas of Keynes and also assert that “decisions that matter for investment are intuitive rather than analytical. That intuition is a social process that follows the laws of psychology – and in particular, since group decisions are being made, social psychology.” (Akerlof and Shiller 2009: 144)

“Animal spirits” and “social psychology” mean first of all that investors orientate towards others’ expectations by forming expectations by themselves. Keynes (1967: 156) suggested that a successful investor in an uncertain situation doesn’t build expectations about particular variables but rather about “what average opinion expects the average opinion to be”. The orientation towards others constitutes an important element of expectation building and decision making in uncertain conditions in financial markets, and in economics in general (Arthur 1995, Soros 2003). Thus, it is important to get a more precise idea of this social process. The paper will describe how the Keynesian “beauty contest” takes place in the practice of financial markets.

Furthermore, critique on the standard theory of expectations stresses that expectations are heterogeneous and that heterogeneity matters for economic analysis (Ito 1990, Benassy-Quere et al. 1999,

Cheung et al. 2004, Rötheli 2007). The paper will demonstrate how heterogeneity emerges in the financial markets.

Obviously, it is difficult, or even impossible, to access those problems – non-calculability, social interdependence, and heterogeneity of expectations - by means of pure theoretical reasoning. It is why the author suggests coping with them by means of a specific form of empirical inquiry: the evaluation of interviews with market participants. Inspired by the book of Truman Bewley “Why Wages Do Not Fall During a Recession” (1999), where the technique of interview surveys was used to solve another theoretically inaccessible economic problem, the author of this article conducted interviews to get insight into decision mechanisms of investors. The paper answers primarily the question of how a specific group of investors, namely fund managers, form their expectations to deal with radical uncertainty and to make decisions.

The paper is structured as follows: In section 2, the method of data collection will be explained. Section 3 demonstrates and discusses steps of expectation building and decision making in the markets. Section 4 contains a conclusion.

## DATA

Argumentation in this paper is based on research that was conducted in several German and Swiss asset management companies and banks during 2007 and the 1<sup>st</sup> half of 2008. The data pool of the analysis encompasses 24 structured interviews with financial market professionals. The respondents work as active fund managers in Frankfurt/Main and in Zurich.

Fund managers invest the money of their clients in different assets, i.e., equities, bonds, structured products, derivatives and other financial instruments. They construct a portfolio of investments to optimize the risk-return trade-off, i.e., to maximize the expected return for the given risk profile. Risk profile is usually defined during the first step of the investment process, when the goals and constraints of an investment are identified. As a result, a benchmark is fixed. The benchmark (for example, a particular market index like DAX30 or STOXX50) serves as a comparison standard for active fund managers: their key goal is to achieve a rate of return that is better than the benchmark. To be able to earn a positive active return, they have to deviate from the benchmark weightings.

“Active management is forecasting” said Grinold and Kahn (1999: 7). This is true because deviation from the benchmark should be based upon forecasting ability that is better than the ability of the market average, and is proven to be sustainable and not random. To compare investment alternatives and to construct a portfolio investment, professionals have to be able to expect rates of return of the securities that are included in the portfolio. It means only investors who are able to build correct expectations have a reason to deviate from the structure of the benchmark. Otherwise, they should practice passive management.

The interviewed fund managers pursue predominantly an active investment strategy. Six of them are responsible for European blue chip portfolios, two for European small and mid-caps, four for emerging markets, two for tactical asset allocation, two for investments in bonds and three for structured products. Three fund managers are responsible for quantitative investments. Two interviews were conducted with a financial advisor and the owner of an independent investment company.

Most of the interviews took place in person, and only one was conducted by telephone. All interviews were recorded and transcribed. The evaluation also included coding and categorizing (see Corbin/Strauss 2008).

Formal interviews were complemented by a 3-month participant observation that was conducted in the portfolio management department of a private Swiss investment bank in Zurich. The author completed some tasks in the department and participated directly in the investment practice. Participation in verbal discussions, such as internal and external investment meetings, morning meetings and informal talks on the floor, as well as in the practice of creating spreadsheets and presentations, provided additional insight into the practice of expectation building of the investors. The author could investigate how fund managers talk about uncertainty and form expectations, and what views they act upon.

Though the sample of collected data cannot be asserted to be entirely representative, the author is convinced that it allows a first approximation to understanding investors' techniques of expectation formation.

### **EXPECTATION BUILDING: SIMPLIFICATION TECHNIQUES**

Let us take an example: It is November 2007, the subprime crisis jeopardizes all investments in the financials. In the morning meeting in an investment bank, the head of the fund management department says "we still have Royal Bank of Scotland in one of our portfolios. Should we keep it?" The question is directed to the responsible fund manager and requires a clear decision: to keep or to sell. The response of the fund manager is "I'll take a closer look at it." According to the standard finance theory, this "closer look" would mean that the fund manager makes a precise forecast, i.e., calculates the expected return of the Royal Bank of Scotland (RBS).

This particular fund manager reported in the interview however, that he has ca. 250 companies in his investment universe. It is unrealistic to expect him to analyze all of the companies in great detail in order to build his own expectations. Other fund managers confirmed that each of them has between 250 and 500 companies in the investment universe. It means that they have to form expectations for up to 500 companies.

Besides that, expectation building in financial markets is a complex task. First of all, there are a large number of factors that influence the future development of securities' returns and prices. In the case of equities, for example, prices depend on future payment streams produced by the company like earnings and dividends. They are affected by the so-called fundamental factors, e.g., profit situation, product range, market position, and management quality. There are also other factors, such as the macroeconomic conditions (interest rates, inflation, currency developments, etc.), political expectations (tax policies, state subsidies, political stability, etc.) as well as the psychology of the market players (their expectations, risk preferences, etc.). It is not only impossible to specify all variables; rather, it must always be anticipated that new factors are added, such as new products, take-over rumors, etc. All those factors influence returns of particular companies and markets in different ways. Many of key factors like the quality of management, market position, and product range are not quantifiable or transparent.

Taking this fact into account, it is unrealistic to expect portfolio managers to analyze all of the companies and to estimate all of the influencing factors in detail. Interestingly, fund managers themselves are aware of the principal handicaps of expectation formation in the markets. Here is the opinion of one quantitative fund manager:

One has to say how earnings and dividends come about... I can continue to drill on it. At the end I come across inputs that I have to forecast in turn. Somehow I do not go ahead.

In terms of theory, it means that portfolio managers cannot make point estimates or assign precise probabilities to particular scenarios in order to calculate expected returns. Interviews show that active portfolio managers appear to be especially skeptical about the significance of such point estimates. They deny the possibility of any reliable point forecasts, i.e., the possibility of determining the return or the price target for a security at a particular point in time. They also consider point predictions as an unrealistic challenge for themselves:

If I make a bet in the market, most people want to know from me, what my time horizon is and what the expected return is. Those are the questions which I don't like at all because I simply do not know. What they expect from me is a point forecast, a point estimator, i.e., a vector as a particular amount at the particular point in time I have to make a statement about. I cannot possibly do this. (quantitative fund manager, department Tactical Asset Allocation, Zurich).

In other words, fund managers find themselves in the situation of Knightian uncertainty, or in the Keynesian situation of "we simply do not know". They lack the scientific basis and capacity to determine all possible outcomes and to assign probabilities.

However, the sentence of the above cited fund manager "what they expect from me is a point forecast" is noteworthy. It means that fund managers are forced to make point estimates, and the only

reason for it is marketing. A quantified forecast has a signaling effect, as one fund manager stated. It indicates respectability, and respectability is what clients expect from financial experts. The bank is obliged to give out numbers that are known to be correct only by chance. A quantitative fund manager stated:

I think it is pseudo-objectivity. Everybody who analyzes data knows that stock price forecasts feature an extremely high error variance. But if one does analysis and has to make a statement, it is a big advantage from the marketing point of view, if he attaches a figure to it... It is a part of show business. That's what I mean.

In other words, published or articulated expectations in form of numbers are considered as a part of the market show but not as a reliable basis for decision making. Fund managers know that a precise forecast is impossible, i.e., that they cannot eliminate uncertainty through calculation. How do they proceed then in practice?

#### *Point of departure: consensus expectations*

The fund manager who promised to “take a closer look at the RBS” does not start to build his expectations from scratch.

His first step in the decision process is a glance at the consensus estimates that are the results of the forecasting efforts of a special group of market participants, namely securities analysts. There is a pool of analysts who cover a particular company. Each analyst comes up with estimated earnings per share for the quarter, the current or the next fiscal year. A consensus estimate number is an aggregated forecast, i.e., an average or median of all individual forecasts made by analysts covering a particular stock. For example, if four analysts estimate next year's earnings per share for the RBS at £0.75, £0.72, £0.71, and £0.62, the consensus estimate is £0.70. This number indicates that the majority of the market expects the earnings per share to be close to £0.70 on average and not much lower as one individual analyst suggests. The consensus estimate represents a mainstream view in the market, or an average opinion of its participants. Those numbers are available on Bloomberg and some other financial websites.

Consensus estimates help fund managers to track what the majority of the market expects on average. This piece of information is important because it allows the orientation of the own expectations towards expectations of others. Of course, fund managers combine information sources to get a complete picture of the market expectations. For example, they also use whisper earnings, i.e., unofficial and unpublished consensus estimates that circulate among professionals in the market. Also important are earnings expectations from the companies, i.e., comments from management on the macroeconomic trends, on industry development and on the earnings prospects of the firm. The major sources of earnings guidance are the company reports and comments on the internet as well as meetings with the company's management. For example, the fund manager who was responsible for the RBS looked not only at the consensus estimates on Bloomberg, but also printed out and analyzed the latest financial statements of the bank. However, the first step of the expectation formation process is gathering information about the current “average opinion” in the market.

#### *Limitations of market forecasts*

Though fund managers constantly observe what the market expects, they usually do not act upon those data. This is so because consensus estimates are point forecasts and market participants are skeptical about them, as described above.

Additionally, consensus estimates are considered by portfolio managers as unreliable because they are outdated:

There are official consensus forecasts on Bloomberg or so... but the analysts gave their forecasts one or two weeks ago... meanwhile all sorts of things happened: one or the other pre-indicator came out

and fears occurred... and the world rotated three times... Nothing is as it was expected and there are strong upside and downside movements (bond manager, Zurich).

Fund managers regard the fact that securities analysts do not actually forecast but react to events and news in the market as a central problem. Analysts constantly adjust their projections to the new information. They are extremely risk averse, and afraid to deviate from the mean forecast significantly. In the majority, they are not forecasters because they do not take the risk of thinking beyond companies' guidance. Interestingly, analysts themselves are obviously aware of the fact that their forecasts are shaky and unreliable; in presentations for clients, they often talk about upside and downside risk for their expectations and even give forecasts for revisions to come. Here is an example of an analyst's statement in an investment meeting with fund managers:

Now we forecast 2.2 for the second quarter. However, we wouldn't be surprised if we will have 1.8 in two months time.

Interviews show that fund managers are aware of the fact that analysts adjust their expectations gradually and with a time lag. According to the independent financial advisor, this time lag becomes quite significant during the crisis or if other big events happen. This typical analysts' behavior makes consensus upgrades and downgrades move in trends. In the interviews fund managers expressed the conviction that recognition and observation of those trends are crucial for the forecasting of future asset prices. We will elaborate on this point later on.

Besides pseudo-exactness of point forecasts and constant revisions, there is one more problem with analysts' expectations, namely self-referentiality. For one fund manager, this is the other reason why the successful forecasting of returns is nearly impossible:

This is the thing which destroys itself... If I as market participant make projections and trade on them, I influence the market price directly. I face the problem that forecasts influence their own realization. (quantitative fund manager, Frankfurt/Main)

Brian Arthur (1995: 3) described this problem as follows: "Where forming expectations means predicting an aggregate outcome that is formed in part from others' expectations, expectation formation can become self-referential." This self-referentiality of investment prices is a huge impediment for successful forecasting in the financial markets. Investors try to build expectations about factors that are created by their own forecasts and the forecasts of everybody else. All such efforts to build expectations for moving targets end up in a logical regress. Expectations in the financial markets are indeterminate and unstable.

Nevertheless, fund managers start their investment process by dealing with the shaky and unreliable consensus expectations. This is the phenomenon that should now be explained.

#### *Why bother with unreliable numbers?*

Why do fund managers care about forecasts that circulate in the market? Those numbers seem to be unreliable but useful. According to finance theory, the usefulness of a forecast depends on the efficiency of the market. The question "what is in the price" is crucial: If all news are immediately reflected in the market price, no published expectations are of any use. What are the views of investors concerning this question?

Though fund managers do not believe in perfect market efficiency, they talk about "tendency to efficiency" (a quantitative fund manager, Frankfurt/Main). This term implies the conviction that the officially known information is reflected in the security price quickly, so that the actual price roughly represents the current information state of the market. Important parts of this information state are consensus estimates. Here is a characteristic statement:

...consensus represents the market... market price corresponds to the consensus very well (fund manager, European Blue Chips, Zurich).

However, “tendency to efficiency” should make all forecasts that circulate in the market uninteresting for fund managers.

I believe that the problem is not the impossibility of forecasting but the fact that the market reflects the forecasts. This is the point. Even if analysts and other market participants make good forecasts, the question occurs: How can I use them? I cannot use them because forecasts in the free markets are directly reflected in the price. (the quantitative fund manager, Frankfurt/Main)

Thus, at first glance, expectations that are reflected in the price are useless to the decision making of fund managers. However, as described above, the overall goal of fund managers is to earn a positive active return, i.e., to deviate from the market to achieve better performance. When the consensus forecast represents the market, it delivers information about the point from which the fund manager has to deviate. By acting upon consensus forecasts, the fund manager would miss his goal.

Every fund manager watches consensus. But he doesn't make money with it. He makes money only when he deviates from consensus. For this purpose he must know what consensus is. (the quantitative fund manager, Frankfurt/Main)

In other words, fund managers have to know what the market expects on average to be able to deviate from those expectations. It is why consensus estimates seem to be at the core of the decision making process of investors even if they are not taken seriously as figures. They deliver information about what is in the price.

Consensus is of no importance as a forecasting figure, but the assumptions and information behind it are. Every analyst publishes data on which he bases his analysis; he discloses his interpretations of those data. An analyst identifies which scenario of the future development of the company (earnings, cash flow, rumors, industry trends etc.) he prices in and what the key points for the future development of the firm are; at the end of the report he explains how he aggregates all past information and forecasts to an earnings figure and to a recommendation.

Thus, to observe consensus doesn't mean to know the number but to understand what analysts identify as earnings drivers for the future. From this viewpoint consensus expectations are useful for portfolio managers. Consensus delivers the information that is already in the price. To capture this information in detail, fund managers read analysts' reports or talk to analysts in person. For example, they scroll the most pessimistic and the most optimistic reports to get an idea about the range of assumptions that is already priced in by the market. Likewise, they follow closely the information disclosed by the company as analysts usually rely on the firm's guidance in their predictions.

After understanding the consensus forecast, portfolio managers have to decide how to deviate from it successfully. For this purpose, they have to build their own expectations about the identified key factors. Their expectations should be better than those of the market.

First of all we look what the market reflects in the price. It is useless for me to say ‘we have a positive development now’: when the market has already priced this development in, I cannot make any added value. One can generate an added value only when he makes a non-consensus call... You have to make a decision which deviates from the majority. (head of the department tactical asset allocation, Frankfurt/Main)

Therefore, the task of a fund manager is not to predict rates of return correctly, but to predict them differently from the majority of forecasters. Consensus expectations serve as an anchoring point to initiate the decision process. Kahneman and Tversky (1974) described anchoring as a heuristic; they showed in their experiments that people often start with a reference point, an "anchor" that is often incorrect or irrelevant. Then they make adjustments to it to form their own expectations. Now, we have to analyze how this adjustment happens.

*Expectation building as a plausibility check*

As mentioned above, fund managers believe that market expectations are usually reflected in the price. That means that a change of market expectations is considered to be the crucial factor that influences asset prices. This opinion was confirmed by another equity fund manager (European blue chips, Zurich):

As I know that the market reacts to the consensus prognoses, it is important for me where the consensus goes: will the forecast be upgraded or downgraded? It's important. It decides about the stock price then. It is not important if earnings estimates are exactly by 5.80 or 5.82, but if they are revised from 5.80 to 6.50 or from 5.80 to 5.10. This is by far more important.

However, as described above, consensus changes gradually and in trends. Some of fund managers build spreadsheets or use other instruments to capture the trends of consensus earnings revisions.

Here I have my investment universe and earnings and dividends... and here you see how earnings revisions change every month. Trends are interesting... For example, in case of Novartis you see a steady trend: earnings forecasts are reduced slightly every month. That is, you see a clear trend of earnings erosion. (an independent financial advisor, Frankfurt/Main)

The goal of fund managers is to forecast if the trend will continue, if yes, how significant upcoming upgrades and downgrades will be or if the trend turns around. In other words, fund managers have to build their own expectations about price movements by guessing about the future dynamics of market expectations. An independent financial advisor concluded in an interview: "Forecast is ... not a particular number but a particular dynamic", meaning the dynamic of the market consensus. This is a reformulation of the Keynesian problem of predicting the average opinion of the market.

Now we will illustrate those considerations by means of the analysis of the RBS in November 2007. The point of reference was the consensus estimate. The question the portfolio manager faced was not if this consensus forecast was correct at this time, but rather how it could change when the market reflects in the price the new world economic situation and the related financial information from the company. Due to the evolving subprime crisis the quality of the bank's assets and the extent of potential depreciations became the key uncertain factor for the future development of all financials. However, there was no reliable information about the bank's exposure to the subprime sector till the RBS published its trading statement. The portfolio manager downloaded and analyzed this document. He reported:

I did not try to estimate earnings for the whole bank. I made a part-estimate for the depreciation requirements. Then I adjusted consensus estimates. That is very simple. According to the new information, the company should earn, I would say, 70 pence per share. The new consensus will be roughly at this level. But are all depreciations priced in given the deterioration of the economic conditions? I look at the financial statement, analyze the structure of the assets and see the possibility for additional depreciation in the amount of 15 pence per share. In this way I arrive at the earnings forecast of 55 pence per share.

The portfolio manager simplified his task significantly: He didn't analyze all divisions of the bank, but identified the depreciation as the key factor for the share price in this phase of the market. He assumed all other variables reflected in the consensus are constant (as *ceteris paribus*). Then, he asked himself "Do I have a different opinion about this key price driver than the market?"

In his calculation the portfolio manager relied on the assumption that analysts will adjust their expectations according to the new available information but won't go beyond it. He expected that consensus will follow the RBS' guidance and oscillate around 70 pence.

“Out of forty analysts included in the consensus two or three might be more aggressive. The other will follow the company’s guidance... They will be afraid to deviate from the mean significantly.” (an independent financial advisor, Frankfurt/Main)

It means that there might be a duplication of adjustments by the portfolio manager and a tiny number of analysts. However, the majority of the analysts will be not aggressive enough. They will rather wait for the next announcement to update again. The portfolio manager’s task is to think and forecast far more aggressively than analysts. By doing so, she or he will deviate from the consensus and forecast the trend.

In our example, the fund manager formed his own forecast while he derived from the published asset structure of the bank how high the depreciation might be. The portfolio manager estimated that future depreciations would be much higher than the bank announced. Then he adjusted the expected consensus estimate for it and arrived at a lower number. This number was of course not exact or true. It actually didn’t matter if the fund manager estimated the future earnings to be exactly 55 or 57 pence. Crucial was the justified expectation that the consensus earnings will be significantly revised to the downside in the future.

We deal here with a special kind of expectation building, which a portfolio manager described as follows:

I downloaded the numbers and build my own expectations for the Royal Bank of Scotland. I considered if the market expectations are plausible. The question is of course: Is it already the formation of my own expectation or not? The plausibility check of the market expectations... What is it – is it my own expectation or is it not?

The fund manager described his forecasting process as a plausibility check. He didn’t try to define a probability space for possible returns, but just asked how probable the market forecast is. It is a serious simplification. Using this approach, investor arrived at his own expectations, though the simplicity of the applied procedure caused him to doubt whether such forecasting can be considered as supplementing his own expectations at all. Instead of delivering a point forecast or defining all possible scenarios, the fund manager checked the plausibility of the one known scenario, i.e., the market scenario.

However, this general approach is implemented by market participants in many different ways. The interviews with the portfolio managers showed that they use quite heterogeneous rules and tools to arrive at their own forecasts that enable them to deviate from the consensus. In fact, the techniques differ substantially from investor to investor and from investment company to investment company. Conversations in person or by phone with analysts and brokers, company meetings and press conferences, reading news papers, and meetings with colleagues are elements of those heterogeneous techniques. Individual investors attach different importance to them, and, in doing so, arrive at diverse forecasts that result in divergent deviations from consensus.

Finally, it should be stressed that the deviation from consensus is one of the most important steps on the way to an investment decision: to keep or to sell the share. To reach at the decision, fund managers eventually translate the revised market forecast for earnings into the valuation of the shares. This step provides insight into the question of whether the shares according to new estimates would be expensive or cheap. This insight was the basis for an investment decision in our example: the responsible fund manager saw that the RBS, with 55 pence earnings per share, would be valued at the PE ratio of 8. He decided that the bank is still cheap and did not sell.

### *Expecting a surprise*

Expectation building structured as a plausibility check is a technique to deal with uncertainty and high complexity of the market. It makes the task of a simultaneous prediction of returns of many companies and markets manageable. It allows the portfolio manager not to arrive at exact predictions of earnings or dividends, but just to predict what the market does not know or sees wrongly yet. If the market discovers this information or interprets the published information correctly, its expectations, and

thus security prices, will adjust. In other words, fund managers try to forecast what could be a surprise for the market. A bond portfolio manager phrased it as follows:

What I estimate or try to estimate is simply ‘Are there any surprises upwards or downwards?’

In other words, fund managers have to expect an outlier, an event that “lies outside the realm of regular expectations” (Taleb 2007: xvii) because only such event can move prices. At the same time, surprises are, by definition, unpredictable; they are uncertain in the Knightian sense: they are unknown. Taleb (2007: 172) paraphrased the related law of iterated expectations as follows: “...to understand the future to the point of being able to predict it, you need to incorporate elements from this future itself.” Hence, at the end of our inquiry, we find fund managers facing an insolvable task of expecting the unexpected.

This article does not claim, however, that the technique of the plausibility check enables fund managers to perform this task successfully in either the short or the long run. This technique just allows the market participants to structure and to simplify the problem of unpredictability in their everyday practice. It doesn’t guarantee accurate forecasting because it comes down to the fundamental analysis with all its well-known handicaps. Plausibility check allows portfolio managers to isolate the most important fundamental factor and to estimate it (depreciation, for example) but it doesn’t help them to do it correctly. There might be fund managers who succeed in their forecasts more regularly but it doesn’t contradict the efficient market hypothesis that claims that market participants on average do not beat the market. According to the plausibility check approach and in line with the efficient market hypothesis, asset prices are moved by a piece of completely new information, or by surprise, but no technique has been developed yet to enable the correct foresight.

Again, the goal of the paper was to demonstrate how market participants structure and simplify the process of expectation building and prediction. Interestingly enough, fund managers themselves do not consider the fact that they have to predict events that are generally unpredictable as a problem. When confronted with questions about such events, active fund managers acknowledge their existence, but are not shaken in their conviction that successful forecasting of returns and market prices is possible:

I think that from the fact that there are things which are unpredictable does not follow that we cannot forecast at all. We simply have to know what we can forecast. (the quantitative fund manager, Frankfurt/Main)

In their practice investors follow the discussed notion of the “quasi-efficiency” and thus are convinced that forecasting is somehow always possible. Though empirical evidence doesn’t support this conviction, market participants act upon it. If fund managers accepted that each forecasting is, in the end, the forecasting of unpredictable events, and by definition impossible, they would lose the grounds of their decision making process. In their practices, they ignore the impossibility and make the impossible possible by simplifying their task of expectation formation. But though forecasting as plausibility check is a significant simplification, it doesn’t allow investors to translate the situation of real uncertainty into the calculable situation of risk.

## CONCLUDING REMARKS

Standard finance theory suggests that expectation building about rates of return is a crucial success factor for investment decisions. Expectation is structured either as a point estimate or an assignment of probabilities to possible rates of return. The more exact the prediction is, the better the decision is. The findings of this paper challenge this view.

Fund managers do not forecast rates of return because this is considered to be a nearly impossible, and basically useless, act. Instead, fund managers adjust consensus estimates that circulate in the market. Consensus estimates represent the average opinion of market participants. They are already reflected in the market price and do not disclose any interesting investment opportunities. Financial market professionals regularly question the mainstream scenarios because they can make money only by deviating from them. Adjustment of consensus estimates is a judgmental plausibility check that is guided by the consideration of usefulness: the usefulness of a forecast seems to be far more important than its

exactness. An exact forecast that is already known in the market is of no value. A useful forecast is actually the prediction of an event that will surprise the market.

Those considerations pose a challenge for further research. Plausibility check has not been categorized as a forecasting methodology until now. This technique is more than just a mental heuristic. It is not only a simplification tool, but a procedure that seems to be at the core of the financial markets. The sustainable efforts of investors to forecast surprises constitute the driving mechanism of the markets. To understand it better one has to investigate further questions: How can this way of forecasting be modeled? Would it help to forecast more reliably? What do the insights of this paper mean for the theory of efficient markets? These are tasks for further research.

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