Bubble Bubble, Toil and Trouble

28 January 2010

Like the witches in Macbeth, financial commentators currently claim to be divining all sorts of gloomy market outcomes from their boiling cauldrons. So shouldn't we all be getting rich taking their advice?

Chief among the prognosticators is *The Economist* magazine, which recently ran a cover story entitled 'Bubble Warning: Why Assets are Overvalued'.[1]

The argument of *The Economist* — and other like-minded commentators— is that risk assets currently are overly dependent on extremely lax monetary policies and unsustainable government fiscal stimulus.

The magazine argues that the US equity market is still nearly 50 per cent overvalued. And it says these excessive prices are being maintained essentially via the benefit of free money and the transference of private sector debt to the public sector.

"Investors tempted to take comfort from the fact that asset prices are still below their peaks would do well to remember that they may yet fall back a very long way," the magazine intoned in its editorial.

To be sure, there is a lot of discussion in the media and markets about new "bubbles" forming. Some speculate a messy reckoning is in store when governments and central banks begin withdrawing stimulus.

Indeed, the arguments can seem so convincing at times that you are left wondering why the individual commentators don't put some of their own money at risk and short the market. If it is so evidently a bubble, why not get rich from its inevitable implosion?

The quick answer to that question is that while these people are fairly sure their predictions will eventually be proved correct, they are not sure when.

So in the meantime what are the rest of us supposed to do?

Past Warnings

A first step for the interested is to look at history. A database search of *The Economist* going back to the early 1980s reveals the magazine has made around two thousand mentions of "bubbles" in that time.

This is a magazine which has a long track record of making ex-cathedra pronouncements about the unsustainable nature of market trends.

In April 1998, *The Economist* ran a cover story about "America's bubble economy". It cited the US share market's 65 per cent surge over the prior two years as just one symptom of a "serious asset-price bubble".[2]

Perhaps it was. But that didn't stop the market, as measured by the S&P-500, rising by another almost 40 per cent over the subsequent two years.

The Economist has also for many years complained that people in developed economies like the US, the UK and Australia spend too much on housing. In a leading article in 1989, amid a correction in UK house prices, the magazine speculated that changing demographics, among other factors, were likely to prevent prices bouncing back to the degree seen in the past.

UK house prices did remain stagnant for a few years, but for the decade from 1996 to 2006, prices more than trebled.[3] Reflecting on this, the magazine cited research saying that while this might have been due partly to a combination of rising real incomes, lower real interest rates and keener competition between lenders, up to a half was due to outright speculation.

Defining a 'Bubble'

This notion of a self-generating speculative frenzy in asset markets — taking prices well beyond what their economic fundamentals might suggest — is what is commonly accepted as the definition of a bubble. In these cases, investors are said to buy in anticipation of further increases in price, rather than because of any belief about assets being undervalued.

The most frequently cited modern example is the technology boom of the late 1990s. In that case, there was intense investor appetite for any company with an association with the internet, regardless of the money-making prospects of the particular "dot com" businesses involved.

But the mere act of publicly identifying a run-up in a particular market as a bubble does not mean it will not inflate further. During the tech boom, plenty of people said that the internet was going to revolutionize business and that the productivity enhancements brought on by doing business over the web would lead to a permanent structural improvement in earnings.

So there was a fundamental case for higher prices. The argument was over which individual stocks would be the winners and which would be the losers from what was a technological revolution similar to the invention of rail.

Investors make decisions about these sorts of issues in real time and based on the information available at that time. In this context, there will always be disagreement about individual companies' prospects, simply because there will be differing opinions about what the future holds. The market can only work with the information it has to hand as of now.

Competing Views

And so it is in 2010. For every pessimist who thinks the rally in asset prices in the past 10 months is built on easy money and nothing more, there is an optimist who sees a fundamental under-pinning for the gains.

Australian investment bank Macquarie Group recently issued a bullish forecast for equities this year based on leading indicators for the major industrialised economies and newly emerging economies such as China, India, Russia, Brazil and Indonesia.[4]

A survey of global fund managers, released this month by Bank of America Merrill Lynch, found declining cash balances among money managers and a 13 percentage point rise to 52 per cent in the proportion of those surveyed who were overweight equities.[5]

"This survey is one of the more bullish we have seen and suggests that investors buy into the idea that this recovery has legs," a spokesman for BofA Merrill Lynch Global Research said in a release about the survey.

The point of drawing attention to such research is not to endorse its conclusions, but to point out that the market reflects many differing opinions about what the future holds — from those who think the recovery is justified by fundamentals to those who think it is a speculative bubble.

These opinions can change as stuff happens and as new information becomes available, influencing individual investors' views of future cash flows and the returns they expect to receive from risking their capital.

Managing Uncertainty

So feeling certain that prices are overvalued (or undervalued) is a natural human tendency. But betting against the market and basing one's strategy on identifying mistakes is a dangerous occupation. Even if you are "right", what is to say the market will not go on being "wrong"?

Better instead to start by assuming that prices are a fair representation, based on current information, about future business conditions.

This liberates the individual investor from having to try to time the market and rely on forecasts — even from reputable publications like The Economist.

Instead, the focus can be on elements within one's own control — like building a diverse portfolio of assets matching one's individual appetite for risk, current life circumstances and long-term goals. It also includes being mindful of costs and taxes and occasionally rebalancing the portfolio to manage risk.

There will always be uncertainty in investing. That is the nature of risk - not knowing what will happen next. But this can be managed without having to rely on seers and soothsayers, no matter how credible their reasoning.

[1]The Economist magazine, Jan 9, 2010
[2]'America's Bubble Economy', The Economist, April 18, 1998
[3]Nationwide House price data, UK
[4]'Strong 2010: Macquarie', Australian Financial Review, Jan 20, 2010
[5]'Survey Says Managers Bullish on Equities, Recovery', Pensions & Investments, Jan 19, 2010

Sourced from: **Jim Parker, Regional Director, DFA Australia Limited**