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MARKETING INTELLIGENCE Report

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From evolving market trends to new legislation, change is a constant in our industry. M Marketing Intelligence Reports are designed to support Member Firms with insightful commentary that addresses these changes, and their impact on the life insurance market, and adds value to client and advisor relationships.

Understanding Asset Bubbles

Introduction

Asset "bubbles" have recently been the subject of much conversation and analysis in the investing community. While the interest in bubbles may be due to the impact of the most recent housing bubble on the economy (and indeed, its bit part in the current global financial crisis), the reality is that speculative bubbles have a long history in the financial marketplace, dating back several centuries. Some of the more notorious bubbles include the "tulip mania" that occurred in Holland during the 17th century, when the price of futures contracts on rare tulip bulbs rose to astonishing levels and then fell abruptly, and the "South Sea" bubble of the 18th century, when the price of shares of the British South Sea Trading Company increased by ten times over the course of a year before collapsing, creating a crisis in public confidence. More recent bubbles include Japan's asset bubble, in which a meteoric rise in the prices of Japanese stocks and real estate from 1986 to 1991 was followed by a decade of deflation, with some assets falling as much as 99% from their highs, and the "dot com" bubble that occurred from 1995 to 2000, as a result of widespread speculation in U.S. Internet and technology stocks.

Although asset bubbles manifest themselves in different ways, they share a number of common characteristics, not the least of which is that they are generally misunderstood. In virtually every case, bubbles bring with them both opportunity as well as the potential for significant wealth destruction. While there may be no way — except with the benefit of hindsight — to definitively identify an asset bubble, financial professionals and advisors should be aware of the key characteristics of bubbles and of the risk management appropriate to avoid excessive losses due to the collapse in the pricing of a particular asset.

Much has been written about bubbles in academic journals and the mainstream press. Some well-known accounts include *Extraordinary Popular Delusions and the Madness of Crowds* by Charles MacKay, first published in 1841, and the most recent book by Michael Lewis, *The Big Short*, published earlier this year. Other works, including Nicholas Taleb's *Fooled by Randomness*, have examined bubbles from an academic perspective, creating colorful descriptors such as "fat tails" and "black swans" to illustrate the statistical probabilities and potential disproportionate impacts of outlier events and catastrophic price movements in the financial markets. This paper does not purport to cover what others have written about in such detail, but simply to illustrate some of the root causes, consequences, and common characteristics of asset bubbles. Given this background, one needn't look far to identify a number of potential bubbles in the current investment landscape.

What are Asset Bubbles?

An asset bubble may be described as a dramatic increase in the market values of a particular asset (e.g., tulip bulbs, gold), asset class (e.g., residential real estate, U.S. treasury bonds), economic sector (e.g., technology companies) or national economy (e.g., Japan, Brazil), that is unsustainable over a medium-to long-term time horizon. While individual asset bubbles have their own unique characteristics, most are caused

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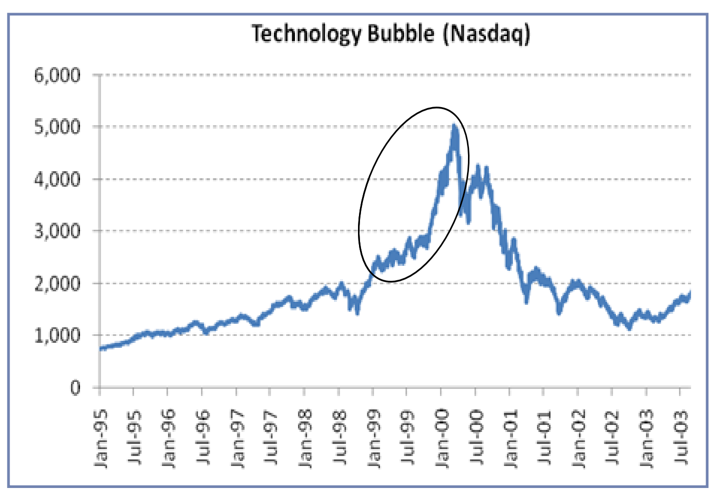
by speculative investing that may initially occur as a result of expectations as to future growth or price appreciation. Such speculation may, in turn, drive trading volumes higher, creating an environment of even more exaggerated expectations in which buyers outnumber sellers to an extent that prices rise beyond what an objective analysis of an asset's value would suggest. In other words speculative bubbles have both fundamental and psychological aspects. While attractive fundamentals may fuel an initial rise in asset values, psychology ultimately takes over. This phase typically involves the participation of a large number of less sophisticated investors, motivated less by sound investment analysis than by a desire to avoid missing out on the high returns realized by others, leading to artificial price inflation. Once the inflated prices begin to fall, short-term investors are quickly shaken out, usually resulting in a steep decline in asset values to normalized levels.

The phenomena of speculative bubbles seems to be rooted in the psychology of fear and greed, with the result that risk management and prudence are moved to the sidelines. During a bubble investors may fail to recognize the amount of risk they are taking at stretched valuation levels and the risk/reward dynamic turns upside down. Often in the late stages of a bubble, investors unwittingly risk as much as 10 to make 1, essentially relying on the probability that marginal, less qualified buyers will enter the market at even more inflated values in order to generate investment gains. In comparison with the historical bubbles of the 17th and 18th centuries, the speed with which information is disseminated in today's marketplace has created an environment in which bubbles can deflate extremely quickly, further increasing the potential for unanticipated wealth destruction.

What are some Common Characteristics of Bubbles?

One of the most common characteristics of asset bubbles is an availability of cheap capital to fuel speculative investing, including leverage and notional capital that may be obtained through the use of products such as futures or otherderivatives. The tulip bubble in Holland involved the use of forward contracts, in the form of agreements to buy bulbs at the end of the season, which were then traded among counterparties. No deliveries were ever made to fulfill the agreements because of the market collapse. During the "South Sea" bubble, the British South Sea Trading Company gave stock options to politicians in order to facilitate favorable debt-for-equity trades with the government, and issued loans to shareholders to finance the purchase of more shares. While the use of leverage in an investment portfolio is not inherently bad, it contributes to price inflation. Nowhere is this more clear than in the case of the U.S. housing bubble, in which "no income verification" loans and easy to obtain, subprime mortgages contributed to the dramatic increase in U.S. housing prices between 2001 and 2008. Leverage is particularly dangerous when the asset being leveraged is of dubious quality.

Another common characteristic of bubbles is the relatively steep nature of the increase in asset prices compared with historical norms. The following charts illustrate the classic, rapid price acceleration, on top of building bull markets, of recent asset bubbles in the Japanese equity market, U.S. technology stocks, U.S. housing market, crude oil, and the Chinese equity market.



Source: Bloomberg

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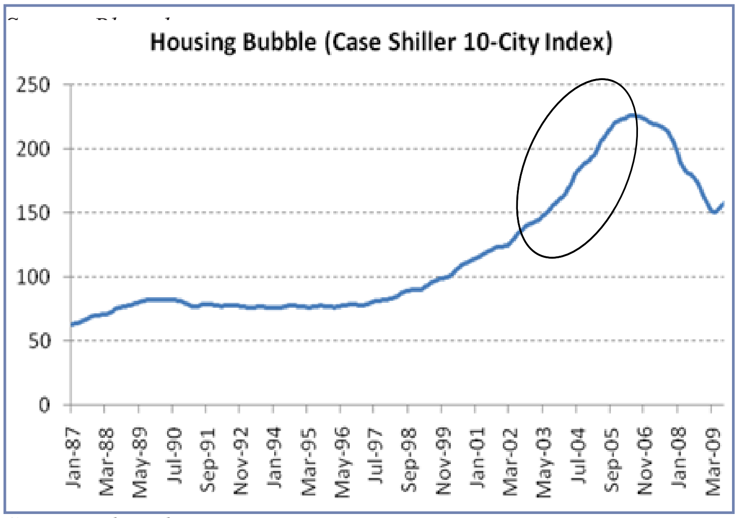
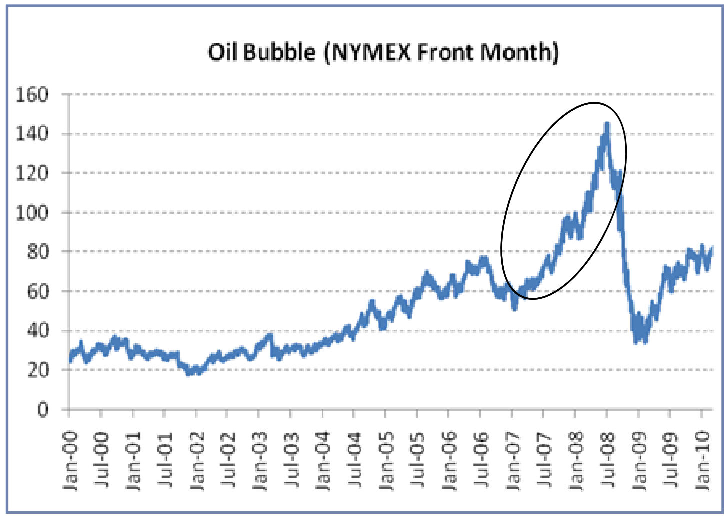


Source: Bloomberg

Source: Bloomberg



Source: Bloomberg

Source: Bloomberg

Given these illustrations, it is interesting to consider whether, as some have suggested, gold prices are currently experiencing a bubble.

Source: Bloomberg

Source: Bloomberg

While gold prices have moved up considerably in the last few years, this price movement does not appear to have reached bubble status yet. Worth noting, gold is difficult to buy on leverage, has not become popular with mainstream

How Does One Deal with Asset Bubbles?

From an investment perspective, addressing a potential asset bubble is a difficult balancing act. Recognizing the potential for dramatic asset appreciation, whether due to fundamentals or to speculative interest, during the early stages of a bubble presents a significant investment opportunity, while an overabundance of caution during this phase will result in underperformance. On the other hand, of course, the failure to retain a level-headed approach to investing in the midst of a bubble, whether through fundamental analysis, appropriate position sizing, limited use of leverage or other risk management techniques, can result in staggering losses within a relatively short period. In addition, recent governmental interventions have led the market to a dangerous belief in the so-called "Greenspan put," the notion that central banks will act to bail out investors. This idea can cause investors to underestimate the risk in the market and become overconfident. At the same time, the central banks may be reluctant to act prudently for fear of pricking the bubble and creating a boom/bust cycle. Thus, in their aim of not being blamed for the next bust, the central bankers may sow the seeds for the next bubble.

Terms like risk management, liquidity, and diversification, while well-understood, are often tossed out the window during a bubble as greed takes over. New behaviors and attitudes are readily accepted, with investors rationalizing to themselves, "it's different this time." An essential aspect of investing is to consider the possibility that one may be wrong, to calculate the potential downside and to maintain a portfolio that, as closely as possible, meets the risk parameters of the investor. Many investors never considered that their technology stocks could decline by 30%, much less by 90%. Others believed that their real estate investments would continue to appreciate indefinitely, never dreaming they could end up under water on mortgage-financed properties. This mindset, coupled with the availability of easy capital, exaggerated real estate losses and, indeed, the economic downturn that followed the housing bubble.

Conclusion

Asset bubbles have been part of the economic landscape for centuries and, absent a change in human nature, will continue to reoccur. While the early stages of an asset bubble present investment opportunity, it is extremely difficult to predict the timing and magnitude of the inevitable decline in asset prices. As liquidity disappears and risk is unwound, assets are quickly revalued, making it costly to try to time one's exit or to stay in a position hoping for a rebound. The famous speculator Jessie Livermore wrote in his memoir, *Reminiscences of a Stock Operator*, that "[t]he first 1/8th and the last 1/8th can end up being very expensive. " And when an asset bubble bursts, as was the case with the infamous "South Sea" bubble, investment gains may be suddenly erased leaving "nothing but air."

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