How To Spot A Bubble

SYNOPSIS

- William Bernstein's seminal masterpiece The Four Pillars of Investing details four conditions necessary for an investment bubble to appear.
- We have all lived through one of the biggest bubbles of all-time, so use these battle scars as protection when the next bubble begins to form.
- One of the most effective ways to cause irreparable damage to a nest egg is to assume that this time is different.

Blowing Bubbles

The announced Verizon acquisition of Yahoo! for $4.8 billion brought back memories of the late 1990s when dot-com companies sprouted up like weeds to fuel a bubble that will never be forgotten.

The excitement surrounding the early days of the internet was immeasurable, and any idea that tapped into this revolution received immediate attention (a.k.a. "funding"). A company that lacked a viable business plan could sell their stock for billions as long as they had a good story to tell.

Inexperienced management teams would then take this capital and use it to give away products and services to the public for free. Might as well. None of these companies were being valued on profits, so there was no reason to waste time trying to make any money at all.

Price-to-earnings (P/E) multiples had become passé and were being replaced with newer "metrics" like price-per-clicks. This measured the price of a stock to the number of visitors to a website, and the more visitors a company attracted, the higher their stock soared.

Value investors, or those who factor the price of an investment before purchasing it, were baffled. To them, this was akin to investors buying Walmart's stock after management announced a new plan to give away free plasma televisions to anyone who walked through the front door, irrespective of whether a visitor made an actual purchase or not.

Watching how the rise of the internet led to such misery was why I became so interested in behavioral finance. Fortunately, my curiosity eventually led me to William Bernstein's seminal masterpiece *The Four Pillars of Investing*.

This book is a must read for so many reasons that it’s hard to know where to begin, but when it comes to the subject of bubbles, this is my bible. In it, the author highlights four necessary conditions that must exist for a bubble to develop.

The first is either a major technological revolution or a shift in financial practice. Think about the impact of the light bulb, automobile, steam engine, etc. These products changed the world and created a level of excitement that could not be contained.

Next, we need easy access to credit. If money is cheap and accessible, then fewer barriers exist for people to put not just their money behind an idea, but more dangerously, someone else’s in the form of margin debt.

NOTE*: A low interest rate environment does not on its own qualify as easy access to credit. Anyone who has tried to get a mortgage since the financial crisis will tell you that it takes more than a heartbeat to get a loan from a bank.*

The third condition is that people must have already forgotten about the last bubble and/or bear market. Since the bursting of a bubble leaves permanent emotional scars, a new crop of young investors must exist that were not around the last time things got really bad. Typically, this period is a generation, or roughly thirty years, since the last hysteria.

The fourth condition is, as Bernstein puts it, “a complete abandonment from time-honored methods of security valuation.” As bubbles begin to form, inexperienced investors who are less skilled at estimating the value in an investment eventually take control of the market.

These four conditions lead to an environment where investors buy stocks simply because they keep going up. It’s akin to throwing gasoline on a flame, and what makes matters worse is that timing when the fuel goes out is virtually impossible.

Said another way, investors can test for the presence of a bubble, but there’s no way to know when it will actually burst.

Litmus Test In Action

In order to determine the efficacy of Bernstein’s criteria, let’s apply it to the dot-com craze to see if it would have picked up the presence of a bubble.

Condition 1: There is no question that the internet was a major technological revolution that was changing the world. The internet made visionaries re-think how the world would operate now that we all could truly be connected, but few knew how to translate this into profitable ideas.

Condition 2: Access to capital was frictionless. Companies with no earnings, cash flow, or even sales being run by freshly-minted MBAs were commanding huge dollars for selling their shares in initial public offerings (IPOs). Investors who bid up these stocks to meteoric heights on the very first day they traded only incented other start-ups to follow suit.

Condition 3: A generation had certainly passed. Most investors were too young to experience the pain and misery of the 1973/74 bear market, which was one of the worst in U.S. history.

Condition 4: This is by far the most entertaining of them all. In April 2000, right around the time the dot-com bubble burst, here are just a few of the companies that were trading at valuations that look like typos:

- Terra Networks selling at 1,200 times sales
- Akamai Technologies selling at 3,700 times sales
- Telocity selling at 5,200 times sales

For scale, even the most egregiously expensive growth stock in today's market sells for 20x or maybe 30x sales. A more realistic valuation for a growth company is closer to 3x-5x sales, and even this range could be debated amongst conservative investors. Oh, and none of these companies had any earnings.

***NOTE**: Yahoo! was no different, as it reached a peak valuation of $125 billion back then. To put this valuation into context, Verizon just bought them for 96% less than what the company was worth in 2000.*

Simply put, each of the four necessary conditions were most certainly present during the dot-com debacle.

Implications for Investors

Charles Mackay wrote *Extraordinary Popular Delusions and the Madness of Crowds* in the nineteenth century, which chronicled the world's most famous bubbles. It's a fascinating read because of the underlying consistencies portrayed across each example.

Without question, my favorite is the "tulip mania" that almost destroyed the Dutch economy in the 17th Century. Back then, tulips made their way to the Netherlands, and long story short, some species became so popular that by 1693, they sold for more than ten times the annual income of a skilled craftsman. Yes, tulips. Those pretty flowers that last about a week in a vase.

This bubble eventually burst and destroyed the lives of those who traded their land, life savings, and anything else they could liquidate to get more tulip bulbs. Ultimately, the panic forced the government to step in and support the market, which unsurprisingly only made matters worse.

The whole story sounds a bit crazy, but switch tulip bulbs for dot-com companies, and it reads nearly identical. Maybe it's a byproduct of human nature in that until we put our hand on a hot stove, we just can’t learn from the warnings of the past. I’m not sure why these keep happening to us, but at least we now know what to look for.

In any event, try not to fret too much because not all is hopeless. The battle scars from our past are now tools, and the experience we have gained over the last two decades will show its value by protecting us the next time a bubble forms.

The dot-com era was not a complete waste either, and the pioneers that ended up with arrows in their backs paved the way for today’s crop of dot-com companies that are not only healthy but in many cases some of the largest and most profitable enterprises in the world.

Lastly, I look at the some of the euphoric parts of the global economy, and when I apply Bernstein’s criteria to each of them, I just do not see a bubble that is of the scale of what we witnessed at the turn of the millennium. In short, bubbles just don’t come around all that often.

However, one will pop up eventually, and when it does, never forget to heed Sir John Templeton’s famous warning:

The four most expensive words in the English language are, “This time, it’s different.”

Sincerely,

Mike Sorrentino, CFA
Chief Strategist, Aviance Capital Management
mikeonmarkets.com