4 Signs of a Bubble

> "An asset allocation is like a wet bar of soap - the more frequently you touch it, the more rapidly it disappears." - William Bernstein

The terms bubble and crash get thrown around far too liberally these days, which makes sense since investors can easily see two large boom-and-bust cycles in the rearview mirror. Many investors now spend 95% of their time worrying about market extremes that only occur 5% or so of the time.

The bubble in bubble predictions makes it tough for investors to figure out the difference between rising prices and a full-fledged euphoric boom. Since there are no formulas or ratios that work in every market environment it really comes down to understanding human emotions when trying to gauge these things.

In a recent conversation with Meb Faber, William Bernstein discussed how his criteria for seeing a bubble has more to do with sociological factors than econometric indicators. Here are his four signs of a financial market bubble:

(1) Everyone around you is talking about stocks (or real estate or whatever the fad asset of the day is). And you should really start worrying when the people talking about getting rich in certain areas of the market don't have a background in finance.

(2) When people begin quitting their jobs to day trade or become a mortgage broker.

(3) When someone exhibits skepticism about the prospects for stocks and people don't just disagree with them, but they do so vehemently and tell them they're an idiot for not understanding things.

(4) When you start to see extreme predictions. The example Bernstein gives is how the best-selling investment book in 1999 was Dow 36,000.

He said he's not worried about a bubble at the moment but seeing 3 out of these 4 conditions being met would be a warning sign.

One of the reasons we've yet to witness euphoria in this bull market is because the crash is still fresh in people's mind.

One of my favorite books on booms and busts is Edward Chancellor's Devil Take the Hindmost: A History of Financial Speculation. Here's his take on how and when new booms begin to take shape:

According to John Stuart Mill, the seeds of each boom are sown during the preceding crisis, when the liquidation of credit causes asset prices to decline so severely that they become genuine bargains. Their subsequent sharp rise from a low level leads to a revival of speculation. After each crisis, the financial markets invariably shrug off past follies and losses to confront the future with bright optimism and fresh credulity. Capital becomes "blind," to use Bagehot's term. Unable to remember the past, investors are condemned to repeat it.

In some ways, it feels as though the Great Financial Crisis has completely changed the way certain investors approach the markets and risk assets. In other ways, it feels like many have already forgotten any of the main lessons from that crisis. It doesn't feel like capital has become blind just yet but you can never rule anything out. Chancellor also talks about how the herd mentality takes shape during history's great financial bubbles:

In financial markets one might say they are prepared to ignore bad news because they still hunger after the immediate profits of speculation. A description of the speculators in William Fowler's circle during the 1860s provides an illustration of this behavior. They were engaged, wrote Fowler, "in bolstering each other up, not for money, for we thought ourselves impregnable in that respect, but by argument in favor of another rise. We knew we were wrong, but tried to convince ourselves that we were right."

Convincing yourself that you're right when you know you're wrong is a time-honored tradition in the markets but today's environment offers a unique challenge for investors who are using history to guide their actions. Prices are up substantially but we're not really seeing the sociological follow-through.

This doesn't necessarily mean we're heading for a melt-up or melt-down but it's always fascinating to see how the prevailing narrative tends to shift with changes in price. New technologies, investments or ideas are seen as useless when prices are falling and revolutionary when they're rising.

Bernstein qualifies his downplaying of a bubble right now by stating that stocks can certainly fall by 50% or so within the next couple of years even without typical bubble behavior. We don't necessarily have to see euphoria before we see a panic.

Market crashes are rare but they are also always a possibility.

Sources:
Devil Take the Hindmost: A History of Financial Speculation
William Bernstein (The Meb Faber Show)

Further Reading:
One of the Best Investment Books I've Read in a While