A Meritage commentary on the behavioral side of investing

Bubble Paranoia

We should not be surprised to see investors on high alert for the next bubble. As with most things, all of us have a heightened sensitivity to recent events. This explains why sales of flood insurance spike higher right after that so-called "100-year" flood, not after 99 years of drought. It also reminds us of a client's question around the market bottom last March, asking if this was a good time to buy annuities with a guaranteed return. Our response was "No, but it is a good time to be an annuity salesperson."

In the aftermath of the bust, bubbles are being ascribed to many things now that can go wrong. The popular media is all too willing to play into the fear that potential bubbles are all around us. Today's candidates include emerging markets, US Treasuries, and even recovering financial institutions going right back to the irresponsible behavior that led to near-Depression 2.0. This is not to suggest that these risks won't be problematic to investors, but it is less likely they will become the next bubble.

When bona-fide bubbles do develop (Dot-com, housing, Florida swampland and the epic Tulip mania), they are not typically accompanied by fear, but rather new paradigm thinking that rationalizes why higher prices are justified. At these times, investors increasingly gain comfort when their views are reinforced by others, but the bubble inevitably collapses when the broad consensus is wrong.

Part of this fallacy is normal human behavior and part is definitional. Truth is, most of us are a little fast and loose with the term "bubble". Since a bubble is typically associated with an unsustainable speculative build-up and subsequent bust, it can really only be identified after the fact. If a bubble is successfully deflated without the severe destruction of wealth, can we even know that it was, in fact, a real bubble?

There is a growing belief that it should be the Federal Reserve's job to identify a bubble in advance and move proactively to pierce its momentum and avoid the inevitable bust. On the surface this sounds like a good idea, but we're afraid the judgments required to do this effectively will make their primary responsibility of maintaining price stability and full employment look simple.

In reality, today's risk-averse mentality of looking for bubbles under every rock denies potential bubbles their oxygen – namely complacency and greed. We'd offer that this mindset will be more successful in thwarting potential bubbles than the Fed's best intentions, but this mindset often has a short shelf life.

What's disturbing is that the frequency of bubbles in modern times has well exceeded what was believed to be their statistical probability, with two devastating bubbles in just the past decade. That doesn't make them easier to predict, however. Just ask Fed Chairman Bernanke and his predecessor, Alan Greenspan, who denied the existence of a housing bubble until that was no longer an option.

At its essence, a bubble is a manifestation of human behavior and if history teaches us anything, it should assure us that this behavior will periodically prevail despite the lessons of the past. This is appropriately captured in a quote from legendary investor, Jeremy Grantham, who said "We will learn an enormous amount in the very short term, quite a lot in the medium term, and absolutely nothing in the long-term." That may be a little harsh, but a lesson to take from experience is that the time to worry about prospective bubbles is when there is no obvious reason to do so.

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