# Bubbles...

MARCH 24, 2021

Bubble. A bubble is a word used to refer to a good or fortunate situation that is isolated from reality or unlikely to last.

As applied to an investable asset, a bubble is simply a rapid surge in the price of an asset to a level that far exceeds the asset's intrinsic value. What Alan Greenspan once called irrational exuberance.

This rapid increase is irrational because there is no fundamental basis for the rise in the price of the asset. It is as if investors woke up one morning and decided a particular stock was now smart and started acquiring the asset.

The acquisition pressures created by investors' demand for the asset quickly outstrips supply, causing the price of the asset to increase. The price will continue to increase for as long as demand continues to outstrip supply.

The problem with all bubbles of course, is eventually the exuberance associated with owning the asset fades. And, for no particular reason, investors that created demand for the asset decide the asset is no longer the asset of the day and quickly shed their positions, creating a contraction of the asset price, or a bursting of the bubble.

There are five stages of a bubble. The first stage is called displacement. This is the stage when investors become enamored with the new thing, the new widget.

Displacement is followed by the boom stage, which is when prices start to slowly rise, attracting more and more investors, all wanting "in" on the next sure thing and causing the asset price to increase at an ever-faster rate.

The boom stage is followed by the euphoria stage. This is the stage where the word caution has been removed from the collective brains of investors. The stage where investors and non-investors alike start expounding on the virtues of owning the current "favored" asset.

Like so many good things, the euphoria stage is not destined to last and because it is not, it is followed by the profit-taking stage. During this phase, investors awaken from their stupor of stupidity, realize a bubble has formed and start to close their positions in the asset of the day as fast as they can. The lucky ones are able to close their positions, put a few bucks in their pockets and live to invest another day.

The unlucky ones, well they move into the final stage of the bubble, called the panic stage. This is the stage where the price of the asset, contracts as supply now overwhelms demand. Those holding the asset during this phase just want to close their positions. The sale price does not matter, getting out of the asset is what matters.

Bubbles. Maybe the simplest way to think about them is to realize they exist and then to avoid them. Working alongside a reputable investment advisor may seem unexciting. Since it is only your money, your children's education, or your future vacation home, maybe unexciting really isn't such a bad thing.

Perhaps it is worth remembering the words of economist John Maynard Keynes,

*"The stock market can remain irrational longer than you can remain solvent."*