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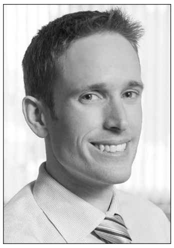

Booms and Bubbles

We're all familiar with the saying: hindsight is 20/20. Nowhere is this more applicable than after you've lost money.

Recently many investment portfolios have probably been harmed by the bursting of the U.S. housing bubble. With the benefit of hindsight, we realise it should have been obvious that U.S. housing prices had reached ridiculous levels. It is clear that it wasn't a boom — but a bubble.

What are Booms and Bubbles?

It turns out that booms and bubbles are one and the same. A market boom refers to a self-perpetuating rise in the price of shares in a certain industry, or sector, or type of asset class (example: U.S real estate). The term bubble can only be used in retrospect to describe what happened in an industry or asset class after prices have crashed. Market bubbles are generally propagated by two things: financial innovation and a speculative demand for some desirable asset fuelled by information. Let's take a look at each of these points.

Anatomy of a Crash

The financial industry, through financial innovation, has contributed in part to almost every bubble in history. In certain cases, government policy played a similar role to financial innovation by contributing to the formation of a bubble. Examples of innovation (and government policies) that preceded market crashes include:

- the introduction of margin accounts in the U.S. just prior to the 1929 stock market crash, which allowed investors to purchase stocks with only 10 percent down.
- the creation of junk bonds in the 1980s made possible leveraged company buyouts.
- the creation and propagation of sub-prime mortgages and low interest rates which allowed previously unqualified borrowers to purchase homes.

A common thread among these three innovations is that they each increased the supply of available (but unsound) capital in the markets.

Assets and Needs

The second ingredient necessary for both a boom and bubble is strong demand fuelled by information. What generally creates demand for an asset? Demand for an asset can be driven by a real need. For example, in the U.S. some people needed to buy a house, despite the high prices. Acquiring the house fulfilled their basic need for shelter. But in boom times greed and fear can also artificially increase speculative demand. People are attracted to any idea that promises a quick and substantial return on their money. And as people start to invest in that idea it will attract others who fear missing out on those same returns.

For example, let's go back to early 2007. You're attracted to the idea of speculating in U.S. housing. Unless you're privy to some form of insider information, you will never have perfect information about whether to buy or sell an asset. The important yet incredibly difficult thing to do here is determine whether or not the decision is being influenced by an information cascade[1], which I'll explain shortly. With the information in hand, you conclude that speculating in real estate is a bad idea. But people around you continue to buy a record number of houses at higher and higher prices. This has two effects:

1. You begin to question whether everyone else has better information. Did they have access to information that said speculating in real estate is a great idea?

2. As people continue to buy and prices continue to rise, this activity is creating new information and adding noise to the market and adding to your existing information. This is the information cascade. A cascade of bad information, hard to discern from good, can strongly influence decision-making.

While you initially concluded that speculating in real estate was a bad idea, this build-up of information, created by other buyers and continually increasing prices, warps your perception. Everyone around apparently is making money and that property you were going to buy has already gone up 20 percent in value! Suddenly your decision pendulum swings, influenced by this information cascade; you decide the logical course of action is to buy real estate. Such action will further contribute to the information cascade.

What stops this phenomenon? Facts. Hard facts will shatter an information cascade. In late August of 2007 we started to learn about the increasing default rates on mortgages in the U.S. This was a hard fact which exposed sub-prime lending, how this practice had inflated demand and thus prices. Incorporate hard facts into the existing information, and the decision pendulum swings again — now you, along with everyone else in the market, want to be a seller, and the bubble bursts. This is usually when hindsight appears.

What This Means to You

Do you believe the following statements because of good information — or because you are facing an information cascade?

- Given our aging demographic, investing in health-care related stocks is a sure thing.
- Commodity prices and the related stocks will keep on skyrocketing due to Chinese and Indian demand.
- Dental practice prices and earnings, and the availability of associates in the GTA will continue to rise steeply; adequately rewarding investor dentists for the concentrated risk they're taking by acquiring multiple practices.

I'm not saying that any one of the above statements is untrue. In fact, all of the above statements may play out to be 100 percent correct, but you'll only know with complete certainty after the fact. For this reason my strategy remains:

- Ensure your portfolio is truly globally diversified.
- Clearly identify the broad-asset classes (stocks, bonds, cash, etc.) and sub-asset classes (large-cap stocks, small-cap stocks, commodities, health-care, etc.) in which you are going to invest, and establish the portfolio's desired weighting in each.
- Have the discipline, over time, to rebalance back to the levels defined above. This may mean selling some of the winners and reinvesting the proceeds into the losers.

Following the above strategy usually means you have some exposure to assets that are experiencing a boom, and will permit you to capture the increased returns being posted in that sector. Should the boom turn into a bubble, this strategy would also ensure that you don't lose a significant portion of your wealth.

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1. "A Theory of Fads, Fashion, Custom and Cultural Change as Informational Cascades," Bikchandani, Hirshleifer and Welch, *The Journal of Political Economy*, October 1992.