

This is an original article written by Philip Loh.

Why we all love bubbles and how it happened

As we witness today the bursting of asset bubbles on a truly global and universal scale, it is perhaps apt to reflect on how we got into those mega asset bubbles – in particular, stock market bubbles – in the first place.

To begin with, it is a well-known fact that retail fund investors and direct stock investors have underperformed their respective stock indices by an incredibly wide margin.

One simple reason why the average investors have performed so poorly is because more often than not, many are drawn to invest in asset bubbles, which are landmines in the investment world. Stepping on a big one which subsequently deflates may pull down your average considerably and take you years to recover from it.

Why we all love bubbles

The more I think about the amazing rise of the Straits Times Index in 2007, the more I am convinced that human nature has never changed very much since the time Noah found dry land.

Our motivation to invest in asset bubbles is very much linked to our in-built capacity for greed, as well as what we term “common sense”. To be fair, greed that is not excessive actually spurs us to build a better life for ourselves and our loved ones. After all, when we see that something works well for our neighbour, we naturally want some or more of it. Our common sense thus tells us to do more of that which has worked for us in the past. This makes perfect sense when it comes to making a good livelihood since many of the conditions that existed previously are still applicable, thus making it seem a good idea to follow whatever that worked in the recent past.

But the truth is applying this thinking to modern finance can actually lead to our downfall. The efficient market theory tells us that all the available information about a company is supposed to be already built into its current stock price. Even if you had enjoyed big capital gains in the past, there is no reason to think you will continue to do so in the future. If your neighbour made a lot of money in stocks last year while you unfortunately opted to park your funds in cash, that's no reason to get into stocks now. But if the market goes up month after month, we will be tempted to join the party. Numerous researches have shown that the primitive part of our brain which controls our emotions is much stronger than the cognitive part which is in charge of logical thinking. So when our buying decision is made based on our emotions, our cognitive mind reasons that since the stock price went up in the recent past, there is no reason to expect the contrary this time round.

In fact, I have found that almost everyone shows emotional biases, even if they are aware of their inconsistencies in decision-making. Many clients often defend their poor decisions, saying: “Who would have expected that...”

In recent years, studies in neuroeconomics, which studies the brain's role in buying and selling decisions, have put forth the hypothesis that irrational psychology, rather than cool calculation, plays a key role in such decisions. Many neuroeconomists even

go further to suggest that emotions are almost the sole basis for the buying decisions that are made.

Market actions can also be self-reinforcing. Many stock brokers will tell you that one of the main reasons why the market had been rising in the four years leading to August 2007 was because people who were upset over missing out on previous gains were desperate to get a piece of the action. But as the supply of such people runs out, the asset bubble will start to deflate. The fear of losing money will ensure that the bubble will burst as spectacularly as it is formed.

The enduring romance that investors have had with asset bubbles has a long and illustrious history. From the time of the tulip bulb mania in 17th century Holland to the time of the 18th century South Sea Bubble in England, and the more recent Internet bubble of the late 1990s, speculative financial bubbles have always been an integral part of the financial market. Recall the stock market bubble in the 1960s that eventually led to the “going nowhere market” in the 1970s. Then there was the Japan stock market that peaked in 1989 and is now trading at less than a quarter of its peak value.

However, it is also a fact that many great things were accomplished when bubble maniacs were at their absolute worst. It was the out-sized investment in Internet infrastructure that has enabled many to now enjoy cheap broadband access even until today. And while WorldCom has gone bust, what it has left behind has been most instructive. Of course, we cannot say the same for what the investors have accomplished.

How did it happen? That’s another interesting story...

Once upon a time in a village, a man appeared and announced to the villagers that he would buy monkeys for \$10 each. The villagers, seeing that there were many monkeys around, went out to the forest, and started catching them. The man bought hundreds of them at \$10 each and as supply started to diminish, the villagers stopped catching them.

He then announced that he would now buy them at \$30 each. This spurred the villagers to start catching monkeys again. Soon the supply of monkeys diminished even further and it was difficult to even spot a single monkey, let alone catch it, so the people stopped catching them again.

The man then announced that he would now buy the monkeys at \$100 each. However, since he had to go to the city on some business, his assistant would now buy them on his behalf.

In the absence of the man, the assistant told the villagers, “Look at all these monkeys in the big cage that the man has amassed. I will sell them to you at \$60 each and when the man returns from the city, you can sell them to him for \$100 each.”

So the villagers rounded up all their savings and bought all the monkeys as the assistant suggested. Subsequently they never saw the man or his assistant again. The stock market works in exactly the same way.

Author unknown

There are many theories of how bubbles are formed. On the individual level, I believe that human emotions are a key cause. On a macro level, I tend to subscribe to the view that there is a small group of elite or dominant players that facilitates bubble creation simply because there is money to be made, just as in any other business. These are usually professional traders working for large financial institutions like banks and brokers, or ultra-rich individuals with deep pockets.

Now, the bigger the underlying market, the greater the amount of resources needed to create a bubble out of it. Manipulating an entire stock market thus requires the vast resources of large institutions or ultra-rich billionaire speculators.

The elite players know that a bubble feeds on itself, and are always ready to create one when conditions are right. Indeed, the playing field of large institutions has to be enormous, often that of an entire country, for them to be truly profitable. For example, Mr. George Soros was rumoured to have cornered the British pound and Thai baht some years back. In fact, the Thai baht episode is widely recognised as the start of a chain of events that spiralled into the then Asian currency crisis.

The first criterion for making money from bubble creation is that there must be a lot of cash on the sidelines. If there is no ready cash within the system to feed the bubble, it will have to come from external sources which can be more difficult to engineer. The money on the sidelines is mostly the cash savings of retail investors.

The elite group meanwhile provides the seed money to start the bubble by grabbing a big bunch of asset classes at a good price. They can act aggressively from time to time to ensure that the bubble created remains intact. For example, they can ensure that the STI closes at 3,500.1 points rather than 3,499.9 points for the day.

Once individual retail players have depleted their cash reserves, it will then be time for the elite group to cash out. This may be the time when it becomes psychologically difficult to push prices any higher in the near term. For example, the Japanese equity market had a good run in 2005, followed by a period of distribution in the ensuing two years.

But note that understanding the mechanism of a bubble alone may not fully prevent you from stepping into one. Where I myself am concerned, the key to avoid stepping into a bubble lies in managing my own greed, and not allowing it to cloud my investment decisions.

Remember: a bubble never looks like one at the outset until the very moment it bursts. Always do your own research before investing. And if you really believe that any asset class is on a permanently higher plateau, you must first convince yourself why “reversion to mean” no longer applies in this case. I would venture to say that, based on what has happened in financial markets in the past, these instances are few and far between.