The fundamental things apply: How to face up to asset market bubbles

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Introduction

Bubbles usually originate due to some new technology or rise in productivity, that in turn drive up asset prices. The term irrational exuberance refers to these waves of excessive optimism when prices reach unrealistic levels. When a bubble bursts, things can get very unpleasant and government intervention often becomes necessary.

Do bubbles exist?

Bubbles result when the growth rate is hyped up and the risk is underestimated. During a bubble, not only are future earnings overestimated but also the equity premium is seen as shrinking. On paper, the irrational behavior of excessively optimistic investors can be countered by short selling. But government regulation often imposes restrictions on short selling. Moreover, short selling may involve waiting patiently for the bubble to burst. The longer the asset boom, the more difficult it is to make short sale bets. The limited ability of short sellers to counter the exuberance of optimistic investors means that bubbles can form. Modern evidence for the existence of bubbles was first provided by Robert Schiller.

Can a bubble be measured?

Identification and measurement of bubbles involves looking for a long positive series of returns, followed by large abrupt negative returns. Identification of the fundamentals driving a rapidly rising market and then causing it to collapse has been quite difficult. A key challenge is the measurement of the new technology and other intangible assets that boost equity prices.

Closed ended mutual funds can be used to measure the size of a bubble. The fundamentals for these funds are known and fixed. It is easy to calculate their net asset value (NAV). Theoretically, there should not be any substantial deviation of the price from the NAV. But it has been reported that during the US stock market boom of the late 1920s, these funds exhibited about 30% premium above the NAV. The premium disappeared after the crash.

A rise in margin requirements, interest rates and implied volatility of stocks all provide empirical evidence for the magnitude of bubbles. However, precise estimates of the size of bubble are not easy.

Should a bubble be popped?

The policy lesson from the Great Depression was that a central bank should not attempt to deflate an asset bubble because it is difficult to get the timing of the intervention right. The failure of the Fed to act appropriately as the lender of last resort during the four banking panics of 1930-33 sent the economy into a downward spiral. The post 1929 US response to the stock market cash illustrates how new regulations are introduced in many post-crash environments. Ultimately, these regulations hinder financial development and economic growth.

How can investors protect themselves from bubble?

Bubbles represent both a danger and an opportunity for investors. The ability to ride a bubble depends on the sustainability of demand. Sustainability of demand depends on whether investors will continue to invest. Sustainability also depends on the supply of the asset. Investors often fail to correctly anticipate how supply will respond when asset prices shoot up.

Conclusion

Currently, a wave of intense regulation is being used to restrain investors, homeowners and financial institutions from pushing up asset prices and taking on excessive risks. But if history is any guide, bubbles will eventually reemerge in markets not anticipated by regulators. Sophisticated investors will seek to ride bubbles. But there is no guarantee that they will get the timing right and succeed.