Wealth Management

The Crescent Group

RBC Wealth Management
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In 1985, Warren Buffett opened his first ever TV interview with: “The first rule of an investment is don't lose. And the second rule of an investment is don't forget the first rule. And that's all the rules that there are. I mean, if you buy things for far below what they’re worth, and you buy a group of them, you basically don’t lose money.” The most successful investor of the past century focused first on not losing money. Most investors have a tendency to shift between not wanting to lose money when markets decline and then not wanting to miss out on gains during periods of exuberance. These emotional swings are a natural part of human nature. But they can have powerful negative effects on an investor’s financial plan. This is where our Group steps in. We work hard to prevent clients from selling out of fear when markets decline, and conversely to prevent our clients from chasing overvalued or speculative investments in euphoric markets[1].

In March of last year, we spent a lot of time coaching clients to remain invested amidst one of the most treacherous declines in the history of the stock market. Fast forward one year, and we now see pockets of irrational exuberance and bubbles in certain stocks. Many of you have heard the news about the recent mania in stocks such as GameStop and AMC. (As we write, GameStop has already crashed 85% from its high level, sadly leaving many gullible investors in the rubble.) Given this frenzy, we thought it would make sense to provide a brief overview of historical financial bubbles, how they ended, whether you should fear them, and how our Group works to keep our clients out of them[3].

Financial bubbles can develop in any asset class. The first documented financial bubble actually occurred with flowers – the Dutch tulip bulb mania of the 1630s. Scottish Journalist Charles Mackay provided an account which rhymes with bubbles we’ve seen in the U.S. in the past twenty years: “Many individuals suddenly became rich. A golden bait hung temptingly out before the people, and, one after the other, they rushed to the tulip marts, like flies around a honey-pot. Every one imagined that the passion for tulips would last forever, and that the wealthy from every part of the world would send to Holland, and pay whatever prices were asked for them.” People paid higher and higher prices for the tulip bulbs until February 1637, when traders could no longer find buyers at higher prices. Tulip bulb prices crashed more than 90%, and the Dutch economy suffered a severe shock[2].

We need look no further than the U.S. for examples of more recent bubbles. Obviously with stocks, the 1920's bubble resulted in a major crash and the worst recession in U.S. history. The federal government made several changes to regulations and policies as a result of the 1929 crash and Great Depression. Those changes have prevented the U.S. from experiencing similar disastrous consequences in later decades. For example, before the 1929 market crash, investors only had to put down 10% of their money to buy stocks, so they were speculating with as much as 90% borrowed money. All of that borrowed money made the stock market crash much worse than it would have otherwise been. When the recession hit, the Federal Reserve did not act aggressively enough to support the economy, and the U.S. government did not undertake economic aid packages. Fast forward to the 1990's technology bubble and 2008 Financial Crisis, and the situation is dramatically different. An investor must put down 50% when they buy stocks, so they can only invest with 50% borrowed money. And when those recessions and crises hit, the Fed knew to act aggressively to support the economy, and the government knew to spend to stimulate the economy. These policies prevented the technology bust and financial crisis from spiraling downward into depressions, and they also prevented more disastrous consequences during the coronavirus recession.

Bubbles do not always result in widespread economic problems. For example, most people aren't even aware that the U.S. experienced commodity bubbles leading up to the Financial Crisis. Uranium in 2007 and Rhodium in 2008. Rhodium increased from $500 / ounce to $9,000 / ounce in July 2008, then crashed to $1,000 / ounce in January 2009. But those bubbles were small segments of the economy and didn't cause losses beyond the gamblers who threw money at them. As large as the technology bubble of 1990s was, it didn't lead to widespread economic damage. The ensuing recession was short-lived and minor, often referred to as "the recession that wasn't". Most staid and steady companies did well during that time period. However, even traditionally steady assets can lead to bubbles and great crashes if people believe prices can only go up and behave accordingly, as happened with U.S. residential real estate leading up to the financial crisis. Unlike the contemporaneous uranium and rhodium bubbles, the real estate bubble did lead to a crisis because it was such a large part of the U.S. economy, representing trillions of dollars of asset value. Our Group sees some of the current mania in poorly performing businesses such as GameStop and AMC as similar to the uranium / rhodium bubbles. The companies involved represent a nearly unmeasurable fraction of a percent of the total U.S stock market, and we do not expect them to cause problems beyond the losses of the gamblers involved in them[2].

Should you fear bubbles? We think the above paragraph indicates that you should only fear them if you become a part of them. As we mentioned at the beginning of this commentary, a very large part of our Group's work goes into to keeping our clients out of bubbles. Succeeding at this runs counter to human nature – it requires a contrarian personality that doesn't care what everyone else gets excited about, or that has a natural aversion to what excites everyone else. Avoiding bubbles requires an honest and objective understanding of what an investment is worth – if the investment case doesn't add up, you don't invest. It requires recognizing the limits of one's ability to determine the future – if you can't get a sense of the next ten years, you don't invest. It requires sitting out the party if one's independent analysis conflicts with the expectations of the crowd. And it requires patience – specifically, forgoing short-term, illusory gains in exchange for long-term gains. Keep in mind that short-term, illusory gains from bubbles can last for years. The rhodium example above was measured over two years. The real estate bubble of the 2000's lasted several years. This is part of what makes them difficult to spot and resist. Most investors have heard the phrases "don't follow the crowd", "buy low, sell high", and "what the wise man does in the beginning the fool does in the end". But in the heat of the excitement, these investment truisms often get cast aside.

Finally, having a detailed financial plan in place that shows you the investment returns you need to succeed with your financial goals can help you avoid the feeling of needing to participate in bubbles and follow the crowd into the hot investment of the day. If you don't have a comprehensive financial plan in place, we strongly encourage you to get in touch with us to have one set up at no charge to you. Our Group will continue to exercise independent and objective judgment in guiding our clients to steady long-term success with their financial plans. We thank you for the trust you've placed in us as we endeavor to do this.

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Sources:

(1) PBS
(2) Wikipedia
(3) CNBC

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