Stocks, Housing, Gold: Why You Should Ignore All the “Bubble” Talk

Description

***Take Stock** is the Motley Fool Canada’s **free** investing newsletter. To have future editions delivered directly to you, simply **click here now**.*

Dear Fellow Fools,

With the holidays upon us, we have a bit of a gift for you, as we’re bringing you the work of Fool.com’s award-winning columnist Morgan Housel in this week’s Take Stock. Enjoy Morgan’s take on the history of bubbles — and why no one has any idea what’s going on.

Bubbles: No One Has Any Idea What’s Going On
By Morgan Housel

By my count, we now have a stock bubble, a bond bubble, a gold bubble, a (new) housing bubble, a Bitcoin bubble, a debt bubble, a profit bubble, a margin bubble, a Fed bubble, a dividend bubble, a social media bubble, a health care bubble, and an [insert thing you don’t like] bubble.

The word “bubble” didn’t exist in economic textbooks 20 years ago, according to Yale economist Robert Shiller. How can something we didn’t talk about before the mid-1990s suddenly infect every inch of the global economy?

The fact that no one talked about bubbles just two decades ago is part of the problem. The concept of bubbles is so new that basic things like definitions aren’t agreed upon. Since there’s no objective definition of what a bubble is, anyone can personally anoint anything they want as a bubble and make a convincing argument that they’re right.

Shiller, who recently won the Nobel Prize for his research on bubbles, took this problem into his own hands. “It wasn’t carefully defined, so I wrote my own definition in the second edition of my book, *Irrational Exuberance*,” he recently told NPR.

A bubble is “like a mental illness,” Shiller said. “The American Psychiatric Association’s diagnostic and statistical manual, which defines mental illness, consists of a checklist of symptoms.” For Shiller, the checklist symptoms of a financial bubble are:

- A time of rapidly increasing prices.
- People tell each other stories that purport to justify the reasons for the bubble.
- People tell each other stories about how much money they're making.
- People feel envy and regret that they didn't participate.
- The news media are involved.

Seems simple enough.

But just as people complain that mental illness is often overdiagnosed, many financial markets could fit this checklist without being a bubble.

Take **Microsoft** stock in the early 1990s, when shares traded at a split-adjusted $0.89 per share.

A time of rapidly increasing prices? Check. Shares increased eightfold from 1985 to 1990.

Stories to justify the reason for the bubble? Check. "Superchips Herald a Revolution," *The New York Times* wrote in 1984.

Stories about how much they're making? Check. *Fortune* magazine ran a story in 1986 with the headline, "THE DEAL THAT MADE BILL GATES $350,000,000."

Envy for not participating? Check. One in five Microsoft employees was a millionaire in 1992, "many under the age of 30," one news article pointed out. You can imagine how that made new employees feel.

The media involved? Check. The personal computer was *TIME* magazine's Person of the Year in 1982.

It fit all of Shiller's bubble criteria. But Microsoft stock in the early 1990s wasn't a bubble. It was, in hindsight, still an amazing bargain. Anyone who bought Microsoft stock in 1990 has since earned a 4,900% return, versus the S&P 500's 730% gain. What looked like a textbook bubble was *literally the opposite of a bubble*.

Think about **Amazon** in 1998, **Google** in 2004, **Netflix** in 2005, **Apple** in 2007, hybrid cars a decade ago, or the automobile 100 years ago. The list of things we once erroneously thought were bubbles dwarfs the list of actual bubbles. By tenfold, at least.

Everyone knows bubbles exist. We know tech stocks in 2000 and housing in 2006 were utter swamps of irrationality.

But that's hindsight. And hindsight can be a jerk. We dupe ourselves with stories about how everything was obvious. I promise you, nine out of 10 people who say the housing bubble was obvious would have given you a different answer in 2006. I'm one of them. The bubble seems so obvious to me today. But I remember telling a friend in 2006 that prices would probably just flatline for a few years, not crash.

Eugene Fama, a University of Chicago economist who shared the Nobel Prize with Shiller, says he knows why this is. He doesn't think bubbles can be predicted at all. And since they can't be predicted, he doesn't think we can say they exist.

"The word 'bubble' drives me nuts, frankly," Fama told NPR last week. He thinks markets are efficient at pricing in all available information, even if in hindsight we know that information was wrong. Markets crash when people receive new information, like, say, housing sales coming in far below expectations.

"If I can predict that housing prices will go down, if the market is working properly, then they should go down *now*," Fama said. "Because what you're saying is, 'I have information that prices will go down,' and that information is not in the prices. But if the market is working properly, the information should be in prices."

Sure. But do markets work properly? On a chalkboard, yes. In reality, of course not. In textbooks, the average consumer spends her day calmly calculating ways to maximize her odds of success. In reality we're tricked by marketing, terrible at math, fooled by randomness, plagued by bad policy, blind to history, and drunk on courage.

Asked, "How many millions are in a trillion?" 79% of Americans either answered wrong or didn't know. Yet the majority of them will calmly tell you a $14 trillion national debt is a major threat to the economy. How can they possibly know if they don't know what a trillion *is*? Even when they're logical, a lot of our economic decisions are driven by emotions rather than facts. And since emotions eat facts for breakfast, we have bubbles.

NPR asked Fama, in a "come *onnn*" tone, if he really believed bubbles can't exist.

"You just used the keyword: *believe*," he said. "I don't believe. I'm an empiricist."

"I don't think there's anything in the statistical evidence that says anyone can reliably predict when prices go down," Fama said. "So if you interpret the world 'bubble' to mean, 'I can predict when prices are going to go down,' you can't do it."

Shiller rebuts that calling something a bubble doesn't mean you know when it's going to burst, just that it will eventually. "You can have a fairly high degree of confidence," he said. "That's what I felt in the stock market in the late 1990s. And then again I felt that in the 2000s, with the housing bubble." Anyone familiar with Shiller's work knows he doesn't call timing. He'll be the first to admit predicting what markets will do next is impossible.

Fama is still skeptical. "What happens each time [a bubble bursts] is the media goes in and finds someone who predicted it, and that person gets anointed," he said. "You don't go back and look at past predictions and see if it's just luck."

But doesn't Shiller calling the last two bubbles prove they can be predicted? "Statistical reliability means more than two, really," Fama said, with a hint of sarcasm. "Predicting the next 10 would be really convincing. Then I'd be convinced."

Shiller laughed. "Yeah, but I don't live that long."

That's exactly the problem. Economics isn't like chemistry, where we can conduct controlled experiments all day in a lab, thousands of times if we need to, in order to prove something exists. So few actual bubbles have occurred that we don't have enough data to be 100% sure of much of anything. By the time we have enough data to prove a concept, the economist who came up with the original idea is often dead, misquoted, or forgotten. We're left dealing with theories, often shaped by political and philosophical beliefs.

I see two problems with the bubble debate.

One is that even if a bubble is spotted, it's hard to know what to do about it. It's sort of like a dog chasing a deer, who then finally catches up to the deer and has no idea how to respond. Bite? Run? Bark? He didn't think he'd ever get this far. Most bubble spotters aren't content just avoiding them, and they try to bet against them. But that can be more dangerous than falling for them. A lot of smart people lost fortunes shorting tech stocks in the 1990s. Even if someone is smart enough to spot an actual bubble, their advice on what to do about it can be disastrous.

Two, real-time economic data is often substantially revised. Data might tell you something looks bubbly (or not) one day, but give you a completely different picture the next, once numbers are revised. This is also true for company financial reports and academic studies. Anyone following the economy has to have an open and flexible mind. But those who are sure something is (or isn't) a bubble tend to have the opposite. They make up their mind, dig in their heels, and treat arguments against their original diagnosis as a my-side-versus-yours battle. As Andy Rooney put it, "People will generally accept facts as truth only if the facts agree with what they already believe."

If the history of bubbles teaches us anything, it's to be humble. Many gasped at Shiller and Fama sharing the Noble Prize, since the two hold what look like opposite beliefs. But the two economists have a common denominator: They both advocate humility. Fama doesn't think we can predict bubbles. Shiller thinks we can, but doesn't think we can ever know when they'll collapse. What we need, but I know we'll never get, is more of this type of thinking. I'm holding out for a humility bubble.

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Many thanks to Morgan for lending a hand! Fool on!

Sincerely,

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