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Study of stock bubbles debunks theory of impending crash

ON INVESTING
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Most of us have seen the recent headlines about the stock market hitting new highs. By some measures, stocks now trade at valuation levels only seen twice before: in 1929 and in 1999. If you recall, the aftermath of those periods was not terribly profitable for investors.

That has caused a level of fear, particularly since the stock market's recent run seems counterintuitive to many. How can stocks trade at such high levels and remain sanguine about world affairs? After all, there's potential trouble in North Korea and increasing tension with China. We've experienced a few major natural disasters recently, the Fed is raising short-term interest rates and confidence in our political leaders is at all-time lows.

Is the stock market behaving irrationally, or is there more to the story? There are bright, experienced people arguing both sides. Some see a significant market drop on the horizon, while others see economic strength, low inflation and accommodative interest rates as an environment for further market gains. Unfortunately, market forecasters are notoriously wrong in their predictions, so there is no way to know for sure what lies ahead.

However, academics have studied the past to see what the market has done in analogous periods. A recent study done by Harvard professors looked at stock market behavior after "bubbles" develop. They defined a bubble as any industry sector that appreciated by more than 100 percent in two years. They found 40 periods historically that met this criterion. Interestingly, stocks did not necessarily crater after these periods. Sure, there was the tech bubble that famously imploded in the early 2000s, but the authors also cite examples such as the health care industry in the 1970s. Health care stocks rose over 100 percent between 1976 and 1978 but continued to rise more than 65 percent annually in the next three years. These stocks didn't experience a significant decline until much later, in 1981.

Aside from anecdotal evidence, the Harvard study found that market bubbles have corrected about 50 percent of the time. A correction in the study is defined as a drop of 40 percent or more. However, even in periods when the market does drop after a bubble, the drop usually comes significantly after the bubble is first detected. For example, an industry group may rise more than 100 percent in two years, signaling that it is in a bubble state, but it may not drop for another year or more. Thus, it is very difficult to predict if, when and by how much the market could decline even after a period of very strong performance.

The markets are beyond prediction, even when it seems obvious what the next step will be. I have been hearing for over 10 years that historically low interest rates have to rise, yet they keep making new lows. The stock market has the same tendency to defy the consensus, but that doesn't stop pundits from trying.

Indeed, perhaps no forecast is as audacious, or optimistic, as that proffered recently by Warren Buffett. The Oracle of Omaha believes that the Dow Jones industrial average is going to 1 million.

There's an old adage on Wall Street that when making forecasts, you either predict a number or a date, but not both. That way, you can never be wrong. For example, a market strategist might declare that the market is going up by 1,000 points. The market may go down by several thousand points first, but eventually the forecast will prove correct.

Buffett has bucked the trend by forecasting both a metric and a date. He believes the Dow Jones index will rise to 1 million within 100 years. On the face of it, such a forecast sounds absurd, but the math shows that the forecast is actually quite conservative. To go from today's level of roughly 22,000 to 1 million, the market would need to achieve an annualized return of only 3.9 percent. Historically, stocks have returned over twice that amount on an annualized basis.

The fact that the Dow could reach such a lofty height, even over 100 years, shows the miracle of compounding. When I first started in the investment business, a 100-point swing in any given day was a huge move. Today, 100-point moves happen routinely, and they are insignificant. Similarly, a 10 percent gain on the market when it starts at today's level of 22,000 implies a rise of 2,200 points. However, as the market rises, a 10 percent gain on a base of, say, 100,000 implies a 10,000-point gain. So, as the market goes up in value over time, we will see larger daily, monthly and annual point gains, which could and should eventually get us close to Buffett's target.

What's more, the market tends to go up over time. There are certainly periods when this is not true, but they tend to be short-lived. Short-term drops, as painful as they may seem, really become irrelevant for most of us, if we remain long-term oriented. Buffett is merely reiterating that financial rewards are there for those who remain patient and ride out the market's ups and downs.

The point is that short-term market gyrations, even those that result in significant near-term losses, should not be the main focus of investing. Steep market drops certainly occupy a prominent place in many investors' minds, reinforced by all the media attention they garner. However, market fluctuations cannot be predicted, and working to avoid them by timing the market or hedging usually results in lower long-term performance.

The better approach is to accept that there will be ups and downs in the market. Focus on the proven drivers of investment returns over time: getting the right risk and return profile through asset allocation, committing to a long-term strategy, diversifying to reduce risk, driving down costs and minimizing the bite of taxes. Shifting your focus to these items and away from avoiding short-term losses will go a long way to creating long-term wealth.

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