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Bursting bubbles

by Gabby Byron, Investment Services Executive

Investment bubbles have occurred throughout history when the prices of certain assets rise to extremely high and unsustainable levels driven by a variety of reasons, including raw speculation. Eventually, these bubbles "pop" causing prices to plummet, and investors are left with significant losses. Echo bubbles (often referred to as a dead cat bounce) are post-bubble rallies which can occur for a similar variety of reasons, including investors' failure to learn from past mistakes or a view that the market has corrected itself and is now undervalued.

Investment bubbles are often driven by speculation; when investors are confident that an asset is going to increase in value, they start piling in, pushing prices higher and ultimately to further and further beyond the intrinsic value. This pattern can continue until something causes the bubble to burst. The cryptocurrency market is a recent example and has experienced several bubbles, with prices rising and falling dramatically. In late 2021, the price of Bitcoin surpassed $60,000 per token, driven by speculation and hype. However, the bubble eventually burst falling over 70% from its peak in November 2021 to end 2022 at around $16,500.

Additionally, investor psychology also plays a huge role in the forming of investment bubbles. When people see others benefitting from a rapid increase in an asset's price, they can get 'FOMO' (fear of missing out), creating a herd mentality or self-perpetuating cycle, where one invests in an asset simply because others are doing it, which then pushes prices even higher.

Some bubbles have a recognisable 'pin' that bursts the bubble, forcing investors to reconsider the value of the asset. For example, many technology and consumer discretionary stocks benefitted enormously during the pandemic following the stay-at-home trend and valuations of these stocks reached extreme highs. As economies returned to normality, and central banks began addressing more persistent inflation by raising interest rates, investors became spooked by the much more aggressive monetary and fiscal tightening paths (growth stocks are more sensitive to interest rate rises as investors expect higher earnings further out in the future, so the higher the interest rates used to discount their future earnings are, the more the present value of those earnings then decreases). We saw a sharp sell-off in this cohort of stocks in 2022 with the NYSE FANG+ index falling -40% and MSCI World Growth down -29% in US dollar terms.

There was a sharp rebound across most riskier assets in January 2023 with investors seemingly taking a more bullish view, particularly on the path of interest rates. Markets were boosted by growing confidence that we were past peak inflation in the US and Europe, leading investors to moderate their rate hike expectations. Growth stocks outperformed value stocks and the technology sector started bouncing back with the NYSE FANG+ index up more than 20% over the three months to the end of January. However, recent data released in the US has shown that economic activity remains robust, with ongoing tightness in the labour market meaning that inflation is proving more resilient than expected. This raises the probability of higher-for-longer policy rates which potentially forced investors to reappraise their positioning and as a result investors have experienced a bumpier ride throughout February.

So, how can investors avoid getting caught up in the effects of an investment bubble? As the saying goes, "You never know you're in a bubble until it bursts", so it is best to remain prudent and having a strong valuation-based approach will alleviate some of that risk. At Momentum, we take a disciplined valuation approach when it comes to appraising investments – with decisions underpinned by estimates of the intrinsic/fair value of any given investment opportunity in order to focus on those with underappreciated return potential and avoid those where their current market price suggests expectations are too ambitious. This helps us make informed, disciplined decisions about whether to buy, hold or sell an investment based on its future expected return potential. It also helps us avoid making emotional and impulsive investment decisions based on short-term market fluctuations and trends.

We continue to see a lot of opportunities in value stocks and the current environment of high inflation and higher rates should be supportive for many of the constituents. Diversification is critical to help manage risk – by investing in a variety of asset classes and investment styles at attractive valuations, investors can spread their risk and reduce volatility whilst minimising drawdowns. Building in additional diversification levers to further smooth the investment journey is an approach that we have always adhered to and have implemented successfully over the decades.

Sources:
Momentum Global Investment Management
Bloomberg Finance L.P.

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