

## **FADS, BUBBLES AND NORMAL MARKET CYCLES: KNOWING THE DIFFERENCE CAN SAVE YOU A BUNDLE**

As investors we often shake our heads at the irrationality of markets and the many infamous examples of painful lessons learned when greed got the best of us. From the great tulip bulb mania that gripped Holland during the 1630s to the DotCom bubble and its aftermath that is still fresh in our minds, many otherwise intelligent and rational people have lost way too much money following speculative bubbles. While the details of each event vary wildly, behavior follows the same script - almost without fail. Only by understanding how they allowed themselves to embrace the new paradigm of the day – be it the seemingly unlimited demand for rare tulip bulbs or the sky-high upside potential in the internet's 'new economy' - can investors inoculate themselves from such ills in the future.

Every bull market has its own peculiar investment fad, of course. Often such fads start out as a rational response to social, political, or economic forces extant. In the great bull market of the 1960's, for example, the conglomerate was king. Companies like Litton Industries and Textron thrived by swallowing up other companies on the theory that owning different kinds of businesses with different business cycles would protect them from downturns in the economy. Between 1966 and 1969, when the ardor for conglomerates was at its height, investors believed that their share prices could never fall. Prices for such fail-proof businesses were bid up beyond the fundamental value of the underlying companies. Then, in 1970, prices plunged, and with prices went the conventional wisdom.

More recently, the investment fad was to justify exorbitant prices of technology stocks based, in part, on a litany of so-called nonfinancial metrics. For internet stocks these included customer loyalty, Web-site traffic and "engaged shoppers." Never mind that none of these translated into earnings, profits or even, in some cases, revenues. Balance sheets are in fact important and earnings should have some basis in reality. Bubbles start out as fads. The magnitude and duration of the speculative fever that ensues determine whether the fad becomes a bubble that soaks the rest of the economy when it pops. That is not to say that stocks cannot legitimately enjoy a huge leap in value, but this leap should be justified by the prospects of the underlying companies, not just by a mass of investors following each other blindly.

Two current investment phenomena that bear watching are energy stocks and homebuilding companies. Prices for both have enjoyed a terrific run. To date their above average performance can be reasonably attributed to supply and demand imbalances for oil and historically low interest rates fuelling business for homebuilders and building supply companies. Real estate values on the other hand are an entirely different story...

Bob Van Wetter, Principal  
Northstar Investment Advisors, LLC  
303 832 2300  
[bvanwetter@northstarinvest.com](mailto:bvanwetter@northstarinvest.com)