Three Ingredients of Market Bubbles

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Innovation, speculation and delusion have come together in bubble after bubble, says Financial Analysts Journal editor Rodney Sullivan

Christine Benz: Hi. I'm Christine Benz for Morningstar.com. I'm here at the Morningstar Ibbotson Conference. And today I sat down with Rodney Sullivan. He is the editor of the *Financial Analysts Journal*. And he talked today about financial bubbles, what the commonalities are, and what investors can do to protect themselves against them.

So, Rodney you believe there are some commonalities that exist in every bubble environment. What are some of those features of a bubble?

Rodney Sullivan: Well, bubbles have been around since capital markets first evolved some 400 years ago. And I found that the same three ingredients persist through all of these bubbles throughout the time.

Now, of course, when bubbles are viewed from on high, these three factors exist, but when viewed from on low, they are a bit different. But I think it's important to look at the common features that persist throughout history.

And they are that following three things: some new innovation that sometimes leads people to believe that they can put risk in a cage. That is, we've contained risks, we know how to manage it now.

Benz: So, thinking back to the most recent bubble, what's an example of how people were thinking they had risk under control?

Sullivan: The so-call three letter monsters that ate the economy, right, the CDOs and the like, were some of the new innovations that led people to believe that they could contain risk, when in fact, we were *increasing* risk. So, that's a great example of new innovations and how those innovations can be misconstrued or misperceived or not well understood.

The second is speculative leverage. And speculative leverage is what I call herding on steroids. And by the way, sometime these new instruments allow us to undertake speculative leverage. And credit default swaps and the like, are examples of instruments that allow us to take speculative leverage.

But speculative leverage is a Hyman Minsky idea, and it's the idea that people invest in a particular asset only to sell it at a later date at a higher price, not to receive the dividend stream from that asset. And when you are doing that, that's speculative...

Benz: ...The greater fool theory...

Sullivan: The greater fool theory, and then when you are doing that with leverage it really becomes problematic.

And then the last element is what's called collective delusion, it comes from Kindleberger. So it's the idea that something new has come about, or some new idea has come about, that we all are excited about. The Internet bubble is the perfect example of that. And Dutch Holland in the early 1600s, it was all about tulips, and tulips were actually very new to Dutch Holland in the early 1600s and were all the rage. And if you read Kindleberger, you'll make some connections, I think, between Dutch Holland and the 1600s, and the U.S. in the late 1990s.

Benz: So, how about during the most recent bubble--what was the example of the new idea that got everyone engaged and led to the bubble?

Sullivan: The new idea was that housing prices would go up, always and forever. That there was no downside to owning residential real estate. Then, when combined with some of the speculative leverage opportunities that existed at the time, leveraging up mortgages, and combining that with some of the other elements that allowed us to believe that we can put that risk in a cage, all combined.

So, it’s a confluence of these three factors, it's not any one that matters, and I think that’s the important thing for understanding these three factors is that, they are not independent, they are all intertwined in a way that leads to bubbles.

And I would also argue that these three ingredients are here with us today. They’ve been with us, of course, for the last 400 years, but they are not going away. And so, if they are not going away, what do we do about it? And what we do, I believe, is, we evolve our tools, framework for understanding and managing risk.

And we financial economists haven’t really been very good at this. And part of my thesis is that we need to get better at it and begin to build what I call a risk management dash board--that is, in the same way that when you drive a car or an airplane, you have a dash board that gives you some guidance, some gauges, that help you understand what’s going on around you. In the same way, we need such tools to help us better manage our portfolio.

Benz: So, another thing you’ve talked about is, we need to better manage our own emotions and our own behavioral biases. Let’s talk about some of the key behavioral traps that can lead to some of these bubbles forming and lead to investors being especially susceptible to them?

Sullivan: Well, there are a host of behavioral biases that can trip us up and lead us to make mistakes in our thinking and judgments and decision making. And a great

example, comes from the game of golf. There was an article recently published, where the author of the article surveyed amateur male golfers, and he asked them, how far do you hit your golf ball off the tee? And we all know where this is going, amateur male golfers suggested they hit their golf balls much, much further than they actually do. And it's a great example of overconfidence bias.

And in golf, at least for amateur male golfers, it's not such a big deal to be overconfident in how far you're going to hit your golf ball. But in financial markets, it leads to overconfidence and risk-taking behavior that we wouldn't ordinarily take. And it dovetails back into this speculative leverage and collective delusion that I was mentioning earlier.

When we believe that we have things under control, when we believe that we understand outcomes when we truly don't--because in financial markets, as we know, anything can happen, but when we believe that we have it under control, that we have risk managed and contained, then it leads us to excessive risk-taking, which, of course, can lead to bad outcomes.

Benz: So, in terms of checking yourself against that overconfidence and your investing, what are some ways to do that?

Sullivan: Well, I think the first step is, simply to recognize that we humans have these biases. It doesn't just apply to financial markets. It applies, as I mentioned, to game of golf, and it applies to other areas as well.

So, I think the first thing is to recognize that we have these biases baked into our DNA, if you will. And once we recognize it, then we need to be on the lookout for how these biases are maybe leading us to make mistakes.

And another example might be, look for things that falsify your beliefs, rather than confirm your beliefs. So one thing you can do actively is, we humans tend to look for things that confirm our beliefs. So, if we believe stocks are going to rise, then we look for other arguments, other folks that are arguing that same side of the debate, if you will, and then we say to ourselves, "wow--I must be right."

What we should be doing is, we should be looking for things that falsify our beliefs. And in that way we can check ourselves and challenge ourselves to thinking a different way and bring some of those thoughts into our decision-making process.

Benz: Okay. Well, thank you, Rodney. Thanks for sharing those insights.

Sullivan: Thank you so much for having me.