During the fourth quarter the economy continued to recover but remained well below pre-pandemic activity levels. At the same time, the political environment became even more fraught as challenges to the presidential election confirmed the worst fears of political divisiveness.

Despite these challenges, the fourth quarter continued with strong performance as the Russell 1000 index was up 11.78% in the month of November alone. The frothy sentiment was captured by The Market Ear: "Upside remains the panic trade". The open question for investors is what to make of the increasing dissonance between the market and underlying conditions?

A bubble by any other name ...

Indeed, trying to make sense of that dissonance was an ongoing challenge throughout the latter three quarters of 2020 and into the new year. The phenomenon was covered by earlier market reviews entitled "Calibrating the craziness" and "Should I stay or should I go?" and also traced out by the weekly Observations newsletter.

More recently Jeremy Grantham came out with a note, Waiting for the Last Dance, that expresses his assessment of the dissonance between markets and fundamentals:

"Make no mistake – for the majority of investors today, this could very well be the most important event of your investing lives. Speaking as an old student and historian of markets, it is intellectually exciting and terrifying at the same time … “

The key point here is that the current market environment is like to have an enormous impact on investors. Although it doesn’t matter what you call it, Grantham does refer to it as a bubble.

Criteria

Fortunately, there are ways to identify and manage through bubbles albeit on a more qualitative basis than some investors might prefer. Grantham describes:

"The single most dependable feature of the late stages of the great bubbles of history has been really crazy investor behavior, especially on the part of individuals."

Not surprisingly, there is plenty of evidence of crazy investor behavior. To start with, there has been a strong foundation of just “regular crazy” investor behavior. The phenomenon of capital being raised at a record pace despite economic travails and widespread insider selling was highlighted in a previous blog post. New equity issues garnered special attention as the IPO market re-ignited and special purpose acquisition companies (SPACs) became all the rage.

Incidents of “really crazy” behavior were initially sporadic but became increasingly prominent as the year wore on. Many involved the actions of individual investors. A slew of technological developments combined with the discovery of options vastly reduced friction and increased leverage for individuals eager to capitalize on rising stocks.

First, Nasdaq and bitcoin outperformed other indexes and then in the fourth quarter bitcoin launched into an even higher trajectory. Story stocks, most-shorted stocks, and stocks preferred by individual investors outperformed. Inflows into stock funds were strong. John Authers reported "that behavior is indeed moving to the "barking mad" end of the dial".

Implications

One of the key implications is that the drivers of the market at this point are primarily behavioral ones, not objective, fact-based ones. The line between behavioral motivations and objectively based ones is never a completely clear one but at
times of excess every detail is slathered with subjective narrative.

For example, the purpose of investing in stocks with low valuations is to provide a margin of safety against the downside. As John Authers relates in a recent commentary, however, the effort to protect against downside risk has been completely abandoned in the Russell 2000 index:

“The P/E of the Russell 2000 topped at above 10,000 last month. For the last three weeks, the index hasn’t had a P/E because on aggregate it has had no E; the losses of its constituent companies have more than counterbalanced the profits.”

Even crazier situations have occurred in individual stocks. Tesla was the poster child of bubble behavior in 2020 but there were also several instances of bankrupt stocks being panic bid. Axios reported the stock Signal Advance continued its surge on Monday "as the stock rose by 438%, after previously gaining 1800% during one 24-hour period". The catalyst was a tweet by Elon Musk in regard to the messaging app Signal, not the company Signal Advance. On Tuesday it was down 74%.

Suffice it to say, the condition of “really crazy” investor behavior is met in spades. Once this happens, the proposition of being exposed to stocks changes in subtle but important ways.

One marker of the change is when investment commentary shifts from the realm of the “probable” or “expected” to the realm of the “possible”. The question, “What is to stop stock prices worldwide going on a really crazy run?” by the Economist is a great example.

When the standard transforms from the probable to the possible, the risk profile also transforms. While there may be opportunities for trading, the opportunities for long-term investors saving for retirement diminish.

Herein lies the rub of bubbles. Rapidly expanding markets and individual instances of explosive gains can prove alluring to all kinds of investors. This becomes a very slippery slope for long-term investors. It is all too easy to fall for the prospect of impressive short-term gains without accounting for the implication of considerably lower long-term expected returns.

It is easy for short-term traders to get caught up in bubble excitement as well. When stocks make big moves more often than not, it is tempting to try to get a piece of the action. This is especially true when other options to increase wealth are hard and fraught with their own challenges.

This exposes a common misunderstanding about trading. So much of the thrill is in making short-term gains. What many novice traders don’t realize is making money is the easy part; keeping the money is the hard part. Doing that over an extended period of time requires diligence, discipline, and risk management. Without those, all of the actions that produced gains in a bull market will also produces losses when things change.

Lessons

But this is the problem with bubbles; it is extremely hard to tell when things change. There are no objective criteria. There usually aren't warning signs. Everything is situation-specific, so few rules exist to provide guidance. As Grantham explains, “The great bull markets typically turn down when the market conditions are very favorable, just subtly less favorable than they were yesterday. And that is why they are always missed.”

Further, it is not like the big investment houses will be helpful either. They will be more likely to be egging investors on well after the bubble pops than to provide a useful warning in advance. Grantham describes:

“So, don't wait for the Goldmans and Morgan Stanleys to become bearish: it can never happen. For them it is a horribly non-commercial bet. Perhaps it is for anyone. Profitable and risk-reducing for the clients, yes, but commercially impractical for advisors. Their best policy is clear and simple: always be extremely bullish. It is good for business and intellectually undemanding.”

With so many people on one side of the market, there are opportunities for investors and advisors who can afford to take, and stick to, a contrarian position:

“Fortunes are made and lost in a hurry and investment advisors have a rare chance to really justify their existence. But, as usual, there is no free lunch. These opportunities to be useful come loaded with career risk.”

Finally, investors must contend with their own worst tendencies of being too clever by half. Almost everyone who trades in
bubble conditions believes they can exit just before others do. Obviously, this cannot be the case in aggregate. Worse, because the appropriate time to exit can only be known in hindsight, most traders remain engaged long after the bubble pops.

**A real humdinger**

While bubbles are extreme events that can radically reorder investment outcomes, there are good reasons to believe this time around will be even more disruptive than usual.

For one, technology has significantly enabled bubble-like behavior. Commission free trading eliminates the cost of trading. Smart phone trading apps and gamification make trading both fun and convenient. Fractional share trading further reduces obstacles. Today there is exceptionally little friction to inhibit reckless trading.

In addition, the social mores around gambling have softened considerably. Whereas gambling used to be taboo and was carefully kept out of the limelight, it is now openly embraced and promoted. It is hard to even watch a sporting event without seeing ads for DraftKings or some other gambling service. People who strike it rich are lauded more than people who work to earn their money.

Finally, the structure of the market has changed in ways that amplify bubbles. This was a point Mike Green from Logica funds impressively made on a podcast hosted by Grant Williams and Bill Fleckenstein. Green argued that because passive funds do not care about stock prices, as long as net money flows remain positive, there is nothing to "stand in the way of insanity".

What is worse though, is there is nothing to stand in the way of insanity on the way down either. As Green described, "When the scale [of selling] that hits the market is incapable of being absorbed by the market ... that's where chaos occurs". In other words, there are likely to be instances of massive price disruptions once the selling gets started.

**Conclusion**

Bubbles can be hard to navigate because of their insidious ability to prey on human weaknesses. Long-term investors get lured into making short-term wagers. Risk management discipline gets discarded for a shot at spectacular gains. It is all so tempting and looks so easy. Grantham captured perfectly what it feels like to be left out:

"And when price rises are very rapid, typically toward the end of a bull market, impatience is followed by anxiety and envy. As I like to say, there is nothing more supremely irritating than watching your neighbors get rich."

So, the trouble with bubbles is they prove very tempting opportunities to do the wrong thing. Many investors will take their chances and disregard the warning. They will follow overly optimistic projections to the top and will also follow them back down to the bottom. Some will try, but fail, to resist the temptation. Grantham explains the challenge:

"For positioning a portfolio to avoid the worst pain of a major bubble breaking is likely the most difficult part. Every career incentive in the industry and every fault of individual human psychology will work toward sucking investors in."

Some others, however, will be able to draw on their fortitude, adhere to their long-term plan, and avoid the worst of the pain. As a result, another aspect of bubbles is they represent major transformations. Namely, "These great bubbles are where fortunes are made and lost"