

# Economics and Business

## Bubbles, and how to guard against them

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*Stock market bubbles and how to avoid them*

**Posted:** February 2005

After posting an impressive gain of 93 per cent last year, on top of 2003's stellar performance, many people have begun to wonder whether Romania's stock market will be the next bubble to burst. The fantastic surge in the real estate sector is adding to the feeling that, in Romania, everything just goes up! But what really constitutes a bubble? How can we spot one? And most importantly, what are we to do when confronted with one?

Bubbles have been around ever since man discovered commerce, created supply and demand and prices came into being. While the constant search for equilibrium between supply and demand stands at the basis of prices, it is fear and greed which give rise to bubbles. The greed for profits, the fear of missing out, of leaving profits on the table: these, together with human gullibility and pride can create a powerful, often irresistible, combination of emotions.

But first, what constitutes an investment? Essentially, its definition can be reduced to define buying something, in the hope of selling it for a profit at a later point in time. The fundamental assumption in this calculation is that someone else will buy from us, what we once bought ourselves. Everything ends in tears when that someone else fails to show up to relieve us of our investment in return for a profit. Many people refer to this as the "greater fool theory." Investors nearly always buy on the assumption (or hope!) that others will come after them and do the same.

Bubbles feed on themselves, much as do the ensuing panics. The human herd instinct is powerful, ever more so when it becomes irrational. Tracking and understanding this herd instinct is particularly important, as is paying special attention to the makeup of the herd. As the bubble expands, the herd will transform itself from what might initially be savvy, experienced investors, oftentimes insiders, to desperate individuals, borrowing money so as to invest in assets which they hardly understand, let alone are capable of valuating.

Identifying a bubble is far easier than identifying its bursting point. The Dow Jones Stock Index, as you know, nearly doubled in the three years that followed before the stock market bubble finally burst, sending prices skidding. Calling the market a bubble in early 1999 would have been technically correct, but would have meant missing out on substantial profits.

Here are a few tips to help identify a bubble, as well as an approaching market peak. Pay special attention to the market and begin considering selling when people (such as taxi drivers, your maid, or family friends) begin to talk about a particular investment theme; or when everyone becomes an expert in a given investment sector, get out! Similarly, when new

valuation 'techniques' appear, justifying ever increasing prices - the more expensive a market, the more creative brokers and commentators will become. And when a particular asset class no longer goes up in price, even on top of good news - this means that every possible buyer has already bought in, and the end is near.

In essence, a careful investor should try to gauge the degree to which the greater fool theory is applicable, which to me is the only way to read a market. One should understand that there is a food chain component to this, and understanding where one fits into this chain, vis-à-vis the market is critical. The smart money gets in first, followed by increasingly dumber money until there are no more fools to sucker into further buying.

You DO NOT want to be the last person holding the given asset! Generally speaking, for most people it really all turns into more psychology than economics or valuations. In fact, I believe there is a fine line between pyramid schemes and stock markets - intent being a clear differentiator, somewhat similar to the difference between manslaughter and murder.

One way to avoid becoming the victim of a burst bubble is to rigorously apply strict valuation criteria for assets one invests in. Few people have the required skills with which to properly value an asset, and few still manage to overcome human greed and actually apply those skills.

Where do we stand in Romania? In terms of stocks, Romanian equities have, as of this writing, been red hot. Growing by over thirty per cent thus far, it would mean that by the same time next year it should nearly quadruple, which is clearly impossible. This means that it will soon either correct downwards, or at the very least stay flat for some time.

Having said this, I believe we are still a way off from bursting point. Plenty of dumb local and foreign money still needs to get in before the market collapses. So while in the short run we will most likely face a correction, the more adventurous amongst you might choose to see it as a buying opportunity. But beware the bubble!

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