



Navigating Financial Bubbles

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Keith: Welcome to this new episode of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's episode. Marcelo, how are you doing today?

Marcelo: I'm amazing. I'm so excited about this episode.

Keith: It'll be a good one today. We're going to be talking about bubbles—financial bubbles. We're in a time now where you pick up a newspaper, listen to the radio, or watch TV, and there's more and more mention about bubbles. So we're going to dedicate today's discussion around bubbles. What is a financial bubble? Can they be identified in advance? What happens when bubbles are created and when bubbles burst? These are some general talking points that we'll go through in today's episode. Marcelo, start with a small personal story. What happened the other day? I think your mom came to you and asked you a question.

Marcelo: Yeah. So it's funny, man. I was telling you off-mic the other day that my mom, she's a very intelligent woman, but she knows the difference between a stock and a bond. And like every time I talk about finance and get all excited, she always shuts down just like my wife. So the other day she asked me, "What's all this noise with the GameStop? What's going on?" So that was like a click for me. It was like, "Oh boy, we're in a new era of the stock market here."

Keith: That's a good one. On a similar front, that was at home. And then my son goes to me, "Two of my buddies, they've never bought a stock before, but they just bought GameStop." And so clearly there's a lot of buzz going on out there, but this is a broader show today. We're going to talk about. It's all



around this idea of what is a bubble. So Marcelo, do you have a formal definition of a bubble for our listeners today?

Marcelo: Yeah, look, I spent a lot of time going around the web and there are a lot of definitions out there. I think the jury is still out about what the formal definition is, but I think it's safe to say based on what we know and what we've seen through history that when we're in a bubble, you get the type of behavior that people are investing purely with the expectation that they will resell at a higher price with a complete disregard for the fundamentals or what's on the underlying company. It's simply, "I'm buying this stock, I'm riding it in, and I hope to sell it to somebody else at a higher price." Now, I think that's pretty much how I would define a bubble. Do you agree with this?

Keith: I think that makes sense. And the only thing I would add is that usually it's associated with a fast rise in prices of something. We're not necessarily talking about just a general stock market. We could be talking about a stock, a theme, a concept, or a sector, but something that's rising really quickly, like more than 20%. We're talking in the hundreds of percent. Those are typically what I think are bubbles. And Marcelo, there's a lot of discussion in financial circles as to whether one can identify a bubble. What do people think about that? Are they easy to identify in advance? Can you say this is definitely a bubble? What's the thinking around that?

Marcelo: It may sound counterintuitive, but actually there isn't something academically that tells you we have X metric that shows that we're in a bubble because at the end of the day, the stock market is a price-setting mechanism. So prices are being set up every day. Nobody knows whether the price is right. When you're buying, you're thinking it's going up. When you're selling, you're thinking it's going down. So there's not really an academic formula for saying, "This is a bubble," and therefore there's no way of identifying it.

Keith: Yeah. And I guess how do you identify a bubble? There's usually these incredibly strong narratives. And narrative being what are people talking about? Like I remember in the year 2000, to me, that was the last major technology bubble, but everybody back then was saying the world is going to be totally changed and the internet has created this technology that will take over the world and will transform everybody. People were saying back then it's a bubble, but it lasted a whole bunch of years and it was only after the fact that people could look back and say it's a bubble.



Marcelo: And that's the thing. You can sit back now and say the prices are going up like crazy. We're for sure in a bubble, but that can keep going.

Keith: And again, there's different concepts about is the stock market in general elevated or are there certain areas within the stock market that are elevated? And that's what a lot of this discussion is in the media right now around bubbles.

Marcelo: So you're saying the narratives that we hear may not be necessarily incorrect, but they may take a long time to take place. Like we were talking off mic, but this is such a good example with the internet. It came into life in the late eighties and what people said was going to do back in 2000, it only took place 25 years after. We're only starting to see examples of real cases of the internet really changing the world and the way we live and the way companies view productivity.

Keith: Yeah. If you think about it, you're right. Absolutely. The internet was created in the late eighties. There was the internet bubble in the late nineties. So a lot of hardware, a lot of infrastructure, telecommunication, everything related around it. Back then, all you had to do was add the word .com to a stock and it would go up 200%.

Marcelo: Yeah.

Keith: So you had this whole internet craze, stocks went up, then they came down dramatically, but lo and behold, the internet has in fact changed our life. And it's maybe starting 2007, eight, nine, 10. And all the way up till now, we're seeing that the internet's really making things more efficient and companies are becoming more productive. Individuals' lives are being changed because of the internet, but this is not an overnight success story. This has taken time.

Marcelo: No, absolutely. So let's talk about this concept of micro bubbles. What does that mean, Marcel? What do you think that refers to?

Marcelo: It's unfair to say when somebody says, "Oh, the stock market is in a bubble," because that's an overly simplified term. And I get that the media has to refer to it like that to the masses and it helps people understand, but micro bubbles are essentially just pockets of the market that just take off as opposed to other areas of the market. You can think about what's going on with electric vehicles, more specifically Tesla, or batteries for that matter. Then you look at



clean energy, renewables, pandemic stocks. That would be a pocket of the market that's done extremely well, and it's arguably in a bubble. Even though we just said that nobody knows, but when you have Zoom, Peloton, all the stocks that benefited from social distancing, you have Bitcoin in there, who's seen a massive price increase in the last year, small-cap growth stocks with no earnings. So those would be examples of a micro bubble. Can you think of anything else?

Keith: Yeah. I just caught you calling it a bubble. Remember, we're not really supposed to be able to say we can identify a bubble.

Marcelo: You're right. You're right.

Keith: But those are all points that people point to and say that's a bubble. And what I find so fascinating about this bubble concept is there's those that feel strongly that the prices make sense and therefore the investments are rational and that the world is going to change and that these prices are justified. And so therefore they would say it's not a bubble. And then there's others that say, "No, that's not rational. That's not justified." And it makes absolutely no sense.

Marcelo: You sent me this crazy chart about two days ago, which absolutely blew my mind. I have it in front of me now. And do you mind going over that?

Keith: No, let's go for it. Explain what we're looking at right now.

Marcelo: So we're looking at a matrix of different asset classes and how the stock market is broken. So a matrix is essentially a square, and you can see a column for value, for blend, which would be a mix of both growth stocks. And then you have it horizontally broken down in large, mid, and small caps. So for example, if I want to look at the area of small value, what I'm looking at now is the current price-to-earnings compared to the 20-year price-to-earnings average. So that means that essentially I'm trying to look at how overpriced that area of the market is today compared to the 20-year average of the price-to-earnings. So what I'm looking at here is crazy. So when we look at areas of the market like small growth, which have done extremely well in the last year and a half, the price-to-earnings ratio right now is 76.2 compared to the 20-year average of 38.4. So that represents a percentage of about 200%.

Keith: So what you're saying is small growth stocks are trading at twice the levels as they traditionally have over the last 20 years. So when you look



through these different quadrants, and what we're looking at is the U.S. stock market, when you look through it, what are some areas of the U.S. stock market that are extremely expensive relative to their historical levels and others are actually not that much further ahead. So small value stocks would be at 5-7% more than what we've seen in the last 20 years. So here you've just got this great example of some areas of the stock market are starting to look much more expensive than other areas of the stock market.

Marcelo: That's a great example. Ironically, these small growth companies, part of the theme that's going on right now within the stock market is small growth companies that have virtually no earnings, that have no profits, are generating absolutely massive levels of interest. And so this is one area that people are saying just doesn't seem to make any sense and things have to come back down to earth.

Keith: It's reversion to the mean. They're overvalued, and people are loving them. It seems to be a behavioral story, not a fundamental story.

Marcelo: Yeah. We'll get to that in a sec in terms of why people love to pay higher prices for certain things. But in our list of other things that we banter back and forth around micro bubbles, what is more recently some of these stocks that people are infatuated with?

Keith: I think what we lived about a few weeks ago with stocks like GameStop, AMC, and BlackBerry, I can speak for myself, Keith, but in the five years I've been in the finance industry, I have never seen something like that where social media pretty much captured a herd of retail investors and pushed the prices of this company up, identifying something that was happening in the market. So what happened was this company, they had a high number of short positions, which means that big institutional investors are betting that these companies would go down, and the people in social media, Reddit specifically, mobilized, and they started buying these stocks to cause some pain on the short sellers. And the prices went up incredibly. So the stock went from being a \$10 stock to \$500 almost in the span of three-four days, which is, we've never seen something like that. I've never seen something like that.

Marcelo: It's a very tricky story. It's one of these things where it's hard to figure out exactly what's going on. And I know there's a lot in the media right now, even how the SEC is trying to figure out what should we do? Because I'm



not sure. It's just about trying to take short sellers down. It's also about human greed, which is how do you make a quick buck?

Keith: You had a great analogy of the duck. And I love that analogy because it represents the story so well because there's so many things we don't know at this point.

Marcelo: The duck analogy is the sort of the duck going across the pond. It looks all gentle and smooth-minded. This is almost like a spaceship rocket going up in the air, but underneath, the duck's feet are moving at a thousand miles an hour, and here you've got so many actors, so many players, there's so many moving parts, and it's all happening within a two-week period. So one heck of a story here. So Marcel, how do bubbles end?

Keith: That's a good question, but essentially it's hard to know when they will end. What happens is typically there's an event or a trigger event that happens and everything starts going down just in the same way it goes up. And there's like herd mentality when there's a catalyst event or something that happens and people start saying, "You know what? Maybe I won't get the price I want in the future. It's time to sell." And then rumor spreads and everything comes crashing down the same way it went up. That's essentially how bubbles tend to end.

Marcelo: Yeah. I remember 2000. There was all this discussion around, "Are we in a bubble?" Yes. We're in a bubble. No, we're not. Yes, we are. Back and forth. And then the market corrected. And then three years later, everybody said, "Oh, it was absolutely obvious. We were in a bubble." It's the same thing with the U.S. housing crisis in 2007 and 2008 when people were leveraging enormous amounts and flipping homes and paying ridiculous prices for homes. While it was going on, very few people were fascinated with what was going on, but they weren't really identified. After the fact, everybody said, "It's obvious it's a bubble." In hindsight, it always makes sense. Yeah, for sure. Actually, what are some of the ingredients, Marcel, to initiate, to start to create these bubbles?

Keith: If you asked me this probably a month ago, I would have left some of this out, but I think it's clear if you look at history, there's a few that are common denominators. Greed would be one of them. Obviously, it's been part of our history and part of being human that we fall for the quick buck, and greed is part of that. Then a captivating story. We've been talking about weeks



about how captivating the story is about Tesla, and Bitcoin is another captivating story about how it's going to end money as we know it. And you mentioned the 2000s, how the internet was going to change everything, and it took 30 years. So those are a few examples of that. Then you have a fear of missing out, FOMO, which is obviously tied into what we have in social media now, which is, it becomes a feedback loop. You're getting bombarded constantly with what other people are doing. And people making money, you want to jump in. Then the pandemic, that's the one that I would have left out if you asked me a month ago. But after what we saw a few weeks with GameStop and AMC and these stocks, we've spoken about this too regarding Robinhood. People are at home. There were no sporting events. There's massive amounts of cash that people are saving. So the pandemic has definitely had a huge impact on some of the price increases that we've seen.

Marcelo: And recently, I think the thing that hits me is that you can trade for zero commission, so it doesn't cost you anything to trade, but also the fractional shares, being this idea of not necessarily needing to figure out what does a stock trade at, understand the price, and then you've got to take, in the old days, call it even five years ago, you'd have to take how much money do you have, divide it by the stock price, figure out how many units to buy, make a few calculations, and then make an investment. Now with fractional shares, you basically say, "I've got a thousand dollars. I'm going to put 300 down on this company, 200 on this." It almost sounds a little bit like gambling. You don't even need to make the calculation as to what a share costs. How much down on this? How much down on that? It's like how much down on this section of the roulette wheel and how much down on that section of the roulette wheel. And so I don't know if that's all good for investors. I know it improves accessibility and it improves an ability to invest. So there's a positive side to it, but I think there's a bit of a speculative element there, which unfortunately fuels a little bit of bubble investing, if you will.

Marcelo: Yeah. We talked about it in the surprises episode. Robinhood has gamified investing. You don't have to worry about anything like this. You can trade whatever you want whenever you want to. What about social media, Marcelo? Is that having an impact right now?

Keith: Oh yeah. It's a huge factor now. The herding mentality that we're seeing, what happens in the markets and how people trade these days. Retail investors, this wasn't available to us five, six years ago. And what we're seeing now is, I don't know, will it change fundamentally how we view markets and



how markets behave? I think that remains to be seen, but it's definitely something to keep an eye on.

Marcelo: Yeah. I think in the grand picture, institutional money still captures the majority of the weight that's pushed around in the marketplace. So retail investing is still a smaller amount. However, I think the point is when retail investing or this sort of group act together that are glued together with what they feel is a compelling story, either to get rich quick or to mobilize, then I think social media then is actually changing some stories out there, for sure. So Marcelo, let's go through a couple of examples. We've spoken a little bit about what's going on now, but let's go through some examples in history. And I think there's some great ones that we can reflect upon and say, "Wow, that happened 300 years ago." And it's almost the identical kind of narrative. It's the same story. So what examples do you have for us?

Marcelo: I think the first recorded bubble in history was the—I don't think, I'm pretty sure—it's the tulip mania back in Holland in the 17th century. So when this flower was introduced in Holland, it became a novelty, became a luxury item. It became something beautiful. And what happened was people started trading contracts to buy these flowers.

Keith: So hang on. You're talking the tulip bulb?

Marcelo: Yes.

Keith: Okay. All right. I just want to make sure.

Marcelo: I'm glad you stopped me because a lot of people will be going, "What are you talking about?"

Keith: Yeah. Absolutely. Yeah. It's actually a flower. There's the flowers you see when you walk your dog, essentially.

Marcelo: Yeah. And so the Netherlands is known for tulips today, and gardeners around the world use tulips. So you're talking about something that happened 400 years ago.

Keith: Correct.

Marcelo: Okay. So people started trading contracts to buy these tulips, and prices skyrocketed. There was a craze for it. And at one point, the single price



of a tulip flower was worth 10 times a craftsman's salary for the year. Think about that.

Keith: So a laborer or craftsman's income for the year, an entire year multiplied by 10, is what people were paying for a tulip bulb.

Marcelo: Correct.

Keith: And yeah, we've got the chart here. The tulip price went up 2000%. So it went up 22 times in that 1637 era.

Marcelo: And how did it end? One day, the market opened and buyers didn't show up. Craze unfolded.

Keith: How long did it take for the price to come down?

Marcelo: One week.

Keith: Wow. Obviously, a lot of people in the investment field sometimes know about this story, refer to it, but it is an incredible story. The narrative, of course, was everybody looked at the bulb, wanted it, thought it was an amazing thing to start planting in their backyards and really embrace the concept. And prices got out of hand and it's part of this herd mentality. When everybody's doing it, it becomes acceptable. It becomes the norm until people don't want it. Or people don't feel that the prices are justified.

Marcelo: It's like you said, Keith, we were discussing this off mic, but you told me something very interesting regarding this example. When they introduced the flower or the tulip bulb, it was a novelty. It was something people had never seen. And this is something just like when Tesla comes into the market with the electric car. It's this beautiful thing that's going to change the world. And it may well be and do a lot of good for humanity, but when you separate that from the investing side of it, things can become crazy very quickly.

Keith: The pandemic has created it along with a lot of the new initiatives in the world and technology and discussions around disruptive technologies that are going to change the world, clean technologies that change the way we live, technologies that will change the way we operate going back and forth from work and home. There's this massive adoration for these concepts and whether the prices make sense is really what's at stake here. So Marcelo, we're not in any way suggesting that the stock market is in a bubble. We're not



talking about that. We're not even trying to say these issues are bubbles, but when people talk about what is not in a bubble, what prices haven't skyrocketed, what do we hear? What areas of the market are still far from what people consider is highly priced?

Marcelo: There are areas of the market obviously that haven't gone as much as what we just went through. Canadian stocks would be some of them. Canadian stocks didn't do as well as U.S. stocks. Neither did European stocks. So those are two areas of the market that haven't seen appreciation like that. Then if you're breaking down asset classes, value stocks, including large, medium, and small cap in that value category, they're definitely not in a bubble. It's been a tough period for value investors in general. And then the pandemic obviously hit a lot the hospitality and the airline stocks. Those are a few things that are not in a bubble. Definitely.

Keith: Yeah. And when we say bubble, we're just talking prices are lower, more modest if you will. So yeah, I like the summation: Canadian stocks, European stocks, emerging market stocks, value securities, small company, small value. And incidentally, these are lots of the types of positions that we hold in our client portfolios because we hold diversified portfolios that tilt to value and include small company stocks, highly diversified. So we're feeling pretty good about our client portfolios and the way we suggest individuals invest. And it does protect investors from getting trapped into chasing these highly volatile, diversified portfolios. Growth stories that can sometimes lead to bubbles. So what are the implications? Let's wrap it up. Marcelo, takeaways here.

Marcelo: For me, the takeaways is it's hard to go against the herd, especially when you're getting caught in a story. When you have these types of stories that capture the imagination and really like you want to be part of it. It's normal to do this. It's hard to go against the crowd. So for me, the takeaway is this is where an investment philosophy that you can stick with really comes in handy because it adds like a moral compass in this craziness that we're seeing. It acts like a good baseline to have in a good thing to be grounded at when you're looking all these things going past by you.

Keith: Yeah, that's amazing. That's fantastic. I would echo your thoughts. Stick to your investment philosophy, stay focused, stay the course, look long term, and keep on moving forward that way. Those are excellent points, Marcelo. So listen, Marcelo, this is a great show. Our next show we're going to be talking about recovery and where we might be going just in general, how things might



start improving in the next year or two, not just for investors but also for the way we live and hopefully moving out of the pandemic and getting into a brighter zone. So on behalf of both yourself and myself, we want to wish all of our listeners a wonderful week. We'll see you in the next show. Thank you.

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