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DARE TO BE DULL

How to lose money when investment bubbles burst

It seems to me that investment bubbles are happening faster than ever. And the impact when these bubbles burst seems to be getting worse and worse.

We are very early into the new century and we've already seen three investment bubbles pop, destroying massive amounts of wealth.

The Tech Bubble: Just as the new century was beginning, we seemed to be worried more about Y2K than about the rationale of the new age economy.

Suddenly, cash flow didn't matter and companies with few sales and millions of dollars of annual losses went public with multi-billion dollar valuations. All they needed was a dot.com in their name.

Anyone who questioned the logic was criticized for being an old-schooled thinking fool. The NASDAQ passed the 5,000 mark and good times would last forever.

The Hedge Fund Bubble: Once the stock market plummeted, we had to find something better to stash our cash in.

Enter the craze of hedge funds, with "guaranteed" market beating returns. We pretended it was OK to pay freshly minted MBAs 2 percent of our investment annually plus 20 percent of any gain. After all, they were smarter than the market.

What we did, of course, was provide incentives for these hedge fund managers to take as much risk as they could with our money. It was the fastest way to make the managers rich.

The Sub-Prime Mortgage Bubble: About two years ago, in order to get a mortgage, all you needed was a pulse. Want to borrow 110 percent of the value of your home? No job, bad FICO score? No problem!

Any financial institution wanting to keep



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up with their competitors just had to keep making those loans. They could then repackage them, call them something like enhanced, insured, collateralized debt obligations and then each financial institution could swap them with each other. It was no big deal that underneath the fancy names were mortgages to people who had no means to make the payments.

Ingredients of a bubble

What do these bubbles have in common? First is the belief that we are smart and the rest of the world is stupid. We understand there is a "new paradigm" that everyone else is too dumb to figure out.

Next comes the "herd mentality." Even though we think we are the only ones who understand the new paradigm, we are actually following the fad and investing in the same things everyone else is. We think we are the contrarian, although we are anything but.

To be a bubble, the investment must be "smokin' hot!" Money must be pouring into these investments and people have to be getting rich quickly. It has to be a full-fledged gold rush.

Finally, there must be no tolerance for questioning the bubble. How dare anyone question my brilliance about buying a company with a \$40 billion value because it only has \$2 million in sales! They just don't get it!

The next investment bubble?

I've asked around to scope out the next bubble. Here are some candidates.

Real Estate: Sure real estate has declined and maybe even plummeted in places like California and Florida. But the decline is partially driven by the sub-prime bubble causing the foreclosure market to mushroom. The thing about real estate is that it's real. There is only so much and we can't manufacture supply, as we did with Internet stocks, hedge funds and mortgages.

Gold: Gold has almost quadrupled in price since the tech bubble collapsed at the turn of the century. A recent investment club talk about gold was sold out weeks in advance.

I don't know if it's me but I would have found the presentation far more useful a few years ago, when I actually would have profited from it. While the supply of gold is limited, it has value only because we say it does. It has little commercial use.

Green energy: Sure, alternatives to petroleum are critical, and I firmly believe we need to invest in these new technologies. I applaud the companies working on this, and I'd like nothing more than to see the value of a barrel of oil fall to less than a barrel of tap water.

But that doesn't mean I think these companies are great investments, themselves. Valuations have skyrocketed faster than the price of oil itself, and the investing herd seems to be buying up anything in sight.

My advice

I'm not sure what the next bubble will be. Bubbles are obvious in hindsight; they're never clear in the moment.

To avoid the agony of seeing your nest egg destroyed by the next bubble is to diversify and own the entire market. And, in the words of Warren Buffett, if the herd seems to be getting greedy, you might want to be a bit fearful.

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