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Investing with the times

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A bubble is a bubble ...

The key feature of a financial bubble is the assumption that today's high prices will continue to rise, even though there is no fundamental value to support the upswing.

Fear and greed are the two major driving forces behind our markets. When greed reigns, we see a bull market, and when fear prevails, a bear market. An imbalance arises when extraordinary high returns are proclaimed and risks are shrugged off. It creates false trust and is the start of a bubble bath where the bubbles can begin to burst.

All investments have inherent risks, but investors should be especially vigilant when super high returns are promised, especially when the higher risk is softened with words like "times are different" and "you have to jump, otherwise you miss the opportunity".

There are many big and small bubbles from the past from which we can learn, such as the:

- Dutch Tulip Mania of the 1630's;
- South-Sea bubble of 1711;
- Japanese real estate and stock market bubble in the early 1990s;
- dot-com bubble of 2002 and
- USA housing bubble of 2006.

The agricultural industry is notorious for its bubbles. A good example is the speculative alpaca investment trend (a small type of llama) barely ten years ago in the USA. It started with their breeders' associations who successfully marketed alpaca farms as an opportunity "one can embrace". Alpacas are cuddly and their wool was said to have the potential of eventually replacing sheep's wool.

Everywhere people started farming with alpacas. However, it soon became clear that there was hardly buyers for alpaca wool because the fine wool is difficult to process. In no time this industry was like a pyramid scheme where it could only work if buyers kept on coming in lower down in the chain.

In 2006, the Davis research report found that the price of alpaca was not realistic, given the price of their wool. The price of these animals plummeted, because there was no longer a market for them and people quietly put their alpacas into their refrigerators.

What we learn from this is that a speculative bubble is preceded by the asset, rather than the product, which is being marketed (e.g. alpaca instead of wool). Investors had unrealistic expectations of alpaca wool becoming more sought after than sheep wool. This, despite it being difficult to process and wool clothing being less popular.

People invest in bubbles, based on past financial performance, without considering the realistic value of the underlying asset. The run is carried out by investors who are willing to buy the assets. But as soon as the investors disappear, the price collapses.

Exotic game

In the case of exotic game it is difficult to determine the fundamental value of the animal. There are two camps in this debate. One argues that prices are artificially high, while the other argues that supply and demand determine the price, which makes it sustainable.

The average price of a king wildebeest cow is about R4 million, while an ordinary cow costs about R10 000. The price of one king wildebeest cow is equal to approximately 400 blue wildebeest or 655 beef cattle or five 74 kW John Deere tractors. Does the value of the king wildebeest cow really make sense?

Bitcoin - digital gold or deceptive euphoria?

Are crypto currencies like bitcoin the biggest investment bubble yet? Since its inception in 2010, bitcoin's value increased by 3 million percent and by 746% in the past year. It surpasses all boundaries of logic. How can we justify this? Where is bitcoin's wool?

Bitcoin (a digital currency created electronically with coding techniques, which is electronically stored) is purely based on trust. The value is determined based on what others are willing to pay for it. But how does one determine the real price if there are no material assets backing it?

Bitcoin meets all the requirements of a bubble. Typically of bubbles, early entrants make a lot of money, while latecomers lose their capital.

Or are we talking about a new network (typically when internet started) and another type of economy in a world without borders? Even an alternative asset class, since hedge funds have already started investing in it?

Only time will tell if this was also just another bubble, which traded far beyond its fundamental value, supported by false confidence, and governed by greed.

Are the exorbitant prices exotic game is attracting just another local bubble and crypto currencies an international bubble, either of which may burst at any moment? Do these excessive valuations have lasting value, or are the soaring prices simply driven by the madness of investors who will lose all their money soon?

Seven sins to avoid

There are certain emotional and psychological factors that can sabotage successful investments.

We already know the seven deadly sins - anger, laziness, envy, gluttony, greed, lust and pride. They put you on a dangerous moral and spiritual path. Investment sins can not only hurt your investments, but may also affect you emotionally.

When you make decisions about investments, you must recognise what is morally correct and avoid any risky opportunities that might tempt you.

The seven investment sins

1 Anger – money lost

You expect your investments to perform well and often get angry with your financial adviser if it does not happen. The best is to admit you made a mistake, correct it and move on. Cut your losses and avoid making the same mistakes in moving forward.

2 Greed – excessive dissertation

Like excessive eating and drinking, an investor can also trade excessively, which often leads to lower yields. There are two risks, namely the decision to buy and to sell. Each trade means new risks and costs. The choice of stable shares held over time involves lower costs with the possibility of better returns over time.

3 Lust – buy in bubbles

It is the constant desire to want more and more. You would typically invest in surplus assets, like the dot-com bubble of the late 90's. It is often argued that the "product and times are different" and that crypto currencies, for example, involve a new technology which will eliminate banks. Buying overvalued "assets" does not lead to future profits. The counter action is to follow a meaningful investment plan and stay away from get-rich-quickly schemes.

4 Gluttony – bow to gold

Here the focus is on profit seeking and the concentration on one investment or share. Money will even be borrowed to invest more in a specific share, because of the promised high return. In the US many home owners took a second mortgage to buy additional houses, only to land with egg on their faces when the market collapsed during the sub-prime crises. The obsession with a single investment type is a recipe for disaster and constant diversification is the best antidote.

5 Sloth – do not learn investment principles

The sin of laziness lies in the absence of hard work and diligence. Sluggishness and the expectation that someone else will do the work for you, leads to failure. Not paying attention to your investments, even if you have an advisor, may lead to poor long-term results. A good choice and recipe for success is always to be well informed. Information is available everywhere. Attend investment seminars, watch television programs like "*Jy Geld*" and be disciplined to read business pages of daily newspapers and business magazines. It will sharpen your skills and give you knowledge to make the right choices.

6 Envy – engaging the herd mentality

It is the obsession to keep up with the Joneses, to have what others have. The financial behaviour concept refers to investors who follow the "herd" and invest where others do just because it is popular. For example, everyone is talking about bitcoin and therefore they must invest in bitcoin. They are jealous of the investors who climbed in early and then invest when the price is at its highest, just before it collapses. This kind of investor ignores his individual circumstances. Avoid this herd mentality by understanding your own personal risk profile and investing with a specific time horizon and goals. That way you follow your own rules and not the herd's.

7 Ego – Your pride determines your choices

It's when you think you know more than others and are over-confident. You'd rather be "right" than objectively making the best decisions for you. Likewise, you will refuse to acknowledge your mistakes and losses. Listen to good advice and note that even your smartest fund managers cannot always beat the market. The best way is to acquire a good understanding of the investment world and to conduct thorough research.

Every investor makes mistakes. Some mistakes or money sins are harmless, while others might be disastrous. Reckless mistakes can lower your standard of living and you may also need to work longer before you can retire.

Avoid the financial sins and feel welcome to contact Ecsponent to help you to prevent or overcome them.

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