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# Market Bubbles - How to Profit When Markets Blow Up

*By Justin Lowes*

Last quarter saw the return of volatility to global stock markets. An 8.8% fall in the Chinese market was the apparent spark for worldwide selling and fleeting hysteria. Yet, given that the Chinese market was widely believed to be in need of a correction; that the falls in Shanghai provided little reflection of the generally rude health of the Chinese economy; and there was little about these falls that should have concerned investors around the world; why should global markets have reacted so strongly? The truth is that investors simply took fright, and whereas the week before they could see only the positives, suddenly they could see only the negatives.

There were plenty of other, much better reasons why markets might fall. These include rising inflationary pressures and the threat of higher interest rates; a collapse in the US housing market that threatens to put a big dent in consumer spending; the twin US budget deficits; the threat of an Avian 'Flu pandemic; geopolitical risk and a potential spike in oil prices due to the instability surrounding Iraq and Iran. But for some time now, markets have sailed serenely on, with only a minor ripple in May and June of last year to disturb the steady upward movement.

Other recent factors were also ignored. India's markets fell more than 6% a few days before the fall in Shanghai, yet this hardly raised an eyebrow. The US economy's worsening housing market has long been known about and its sub-prime

loans collapse made headlines weeks before, though this was only cited as a reason for market falls after China's drop, which itself merely wiped out the gains from the previous ten days, all of which have now been recovered.

The reality it is often virtually impossible to say for definite why markets fall, and that hysteria and market collapses are recurrent themes of investing. Efficient market theory says that investors are rational and that it is impossible to outperform the market as the price of a stock perfectly reflects all available knowledge concerning each company. But history shows us that investors are often anything but rational, and that hysteria and crashes frequently occur, without being predicted by the majority. Examples abound where spectacular market rises lead to devastating market collapses, and one of the few common factors is that prior to each collapse, investors agree that, 'This time it's different'.

Whether it is tulip prices in Holland, the stock price of the South Sea Company (the ensuing collapse of which led Sir Isaac Newton to say that he "could calculate the motions of the heavenly bodies, but not the madness of the people"), the Great Depression, Russian debt default and the collapse of Long Term Capital Management or the technology, media and telecoms boom and bust, markets retain an ability to lull investors into a false sense of security and then strip them of their wealth.

So, given that history shows us that equity markets provide



excellent long-term returns, how can investors minimize the risks of being caught up in the stampede for the exits when the inevitable bust comes along?

All booms and busts rely on prices becoming divorced from reality. Hype and excitement first drives prices way above their historical levels, then panic and hysteria drives them well below these levels. The key to controlling risk whilst investing is to be able to assess what a 'fair' level for a stock is, enabling the investor to buy when the price is below this level and sell when above. The only thing that you can rely upon is that markets will go up, and markets will go down!

Whilst you can never accurately forecast the absolute peak or the absolute trough, adopting an investment strategy that allows you to place a 'value' on a company enables you to determine if its stock is currently cheap or expensive. Value

investing is the practice of assessing the real, net value of a company's assets (land, cash, buildings etc) and only buying when a company is trading substantially below this value, and selling when a company moves above this value. By pursuing this disciplined strategy, not only need the boom and bust cycle be of little concern, but it can actually be turned to the patient investor's advantage as a means to buy great stocks at bargain prices, when a crash depresses prices well below reasonable levels.

In May, we begin a series of seminars in conjunction with the British Chamber of Commerce. The first seminar on 17th May will be a light hearted and entertaining tour of some of the major market collapses throughout history and some of the lessons that can be learned.

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