The DAILY RECKONING *presents...*

21ST CENTURY BUBBLES:

LESSONS FROM THE 3 BIG BLOW-UPS SINCE THE YEAR 2000

AGORA FINANCIAL

BEN TRAYNOR
Managing editor,
The Daily Reckoning U.K.

An economist by training, Ben takes an analytical, evidence-based approach to the markets. His views have been published by respected national and international publications, including *Bloomberg, The Telegraph, MarketWatch, Business Insiderand International Business Times.* Ben previously edited investment newsletter the *Fleet Street Letter*, and has also worked at online gold and silver exchange BullionVault, where he created their Gold Investor Index, a gauge of private investor sentiment that has been cited by Reuters, Bloomberg, the *Economist* and CNBC among others. Ben studied economics at the University of Cambridge and also holds a master's degree in financial economics from the University of London.

21st Century Bubbles: Lessons from the 3 Big Blow-Ups Since the Year 2000

Dear *Daily Reckoning* Reader,

All bubbles pop eventually.

It's one of the most reliable rules in investing.

Paradoxically, though, it's one that exists because people keep forgetting it.

Why? Because it can be hard to judge when a market's in bubble territory.

Sure, it's easy to look at a price chart afterwards and say "Gee, what a bubble that was!"

In real time things are trickier.

As the bubble inflates, the chart only shows Act 1 of the drama. Prices march relentlessly higher, making those already in the market richer.

Act 2 seems a distant prospect. Who's to say those prices won't go much higher first?

That's not to say there aren't naysayers. There are usually a lot of them when a bubble starts to form.

As it gets bigger, though, those naysayers look ever more foolish. Eventually everyone stops listening to them.

Markets are a reflection of different people's opinions. When markets function well they're one of the purest reflections of those opinions because they involve people putting their own actual money at risk.

Bubbles form when opinions get very heavily skewed. Broadly speaking, this happens in two ways.

First, individual investors become less levelheaded.

Second, the more sober players in the market are overwhelmed by a stampede of exuberance.

1. Rationality Goes Out of the Window

One common definition says that prices are in a bubble once they've risen above any rational valuation of the asset.

Of course, valuations are subjective. One man's 'overpriced' might be another man's 'fair value'.

A bubble however involves something beyond just a greater proportion of more favorable valuations. It involves a suspension of logic, the abandonment of principles, which before the bubble most people would have routinely applied.

In the case of a stock market bubble this might take the form of new valuation metrics. These tend to be justified by arguing that the industry in question is new and different so the old rules don't make sense.

Sometimes these arguments hold water. Too often they don't.

Either way, when you see them, take them as warning sign and become extra-rigorous in your due diligence.

There's always a story to go with every bubble:

> *"The internet will make us all rich, so buy dot-com shares."*
>
> *"China is hovering up resources, so buy commodities hand over fist."*

I call them "new paradigm stories". The common thread is the idea that things have changed so fundamentally that the old, boring rules don't apply anymore.

These stories are often fine as far as they go, but they give nothing like the full picture. More fundamentally, new paradigm stories ignore the things that don't change, in particular human nature.

For example, as humans we're not great at judging scale. Can you visualize what a million teapots looks like?

Now visualize a trillion teapots.

If you're human like me you probably just had a mental picture of "lots of teapots" both times.

Even if you think an investment story justifies prices being higher, ask yourself whether it justifies them being *this* high.

It's not always easy to do.

Another human quirk you often see in bubbles is what psychologists call "confirmation bias". Every piece of news that supports the bulls' arguments is seized on and amplified.

Less weight is given to negative news that doesn't fit the narrative.

continue…

A sure sign that you should be worried is when new stories emerge faster than they can be challenged, like some weird game of whack-a-mole.

That's usually when the market price rests almost entirely on emotion. And emotions are fickle.

That leads me on to the second way in which market opinion gets skewed in a bubble…

2. The Ears Get Shouted Down in the Market

Prices rise when the bulls are the dominant voice in the market. Sure, there will be traders who 'go short', trying to profit from a downward correction.

But as the price continues higher, one by one the shorts are gored by the bull market's horns. Eventually it just seems far too risky to bet against higher prices.

So the bears move to the sidelines. They still mutter that the market is crazy, but they stop trying to profit from their views and retire to lick their wounds.

At this point the bulls are not just the dominant voice in the market. They're the only voice.

This is when the market makes what's called a "parabolic move". The price rises exponentially, making anyone who's just joined the party look like an instant genius.

Sadly for them, this is often the beginning of the end.

At some point, there's no one left to enter the market and push the price higher. Momentum wanes. Even some committed bulls think it might be time to take at least some profit.

Selling begins. The price shifts lower. Those who borrowed heavily to juice their returns start to suffer big losses. They close out, adding to the selling.

Then the bears come back.

As an aside, I once saw an interesting talk by the economist Robert Shiller in which he argued that the fact that it's hard to 'go short' housing is one reason that market is so prone to bubbly overvaluations. The bears have no voice.

Keeping Your Head

In a bubble you get a double whammy effect. You get individual investors whose opinions are skewed too far towards the positive.

And, as the bears beat a retreat, you get a market that's skewed too far towards those positive investors.

In this report, I look at three bubbles that have burst since the 21st century began: gold, oil and the dot-com bust.

We can learn a lot from these bubbles. The core lessons, though, are very simple:

1. Know what you're investing in
2. Know why you're investing in it
3. Invest for the long run

There's never a bad time to adopt good practices. But there are times when it's especially important to do so.

This is one of those times. We're in a bubble environment.

With interest rates so low investors have for several years been forced to seek returns in riskier assets.

Often this takes the form of simply speculating on higher prices. Whether it's the property market or biotech shares, investors have been buying into assets with what sometimes appears to be scant regard for the fundamentals.

This approach involves little more than riding a trend higher and hoping to find someone who'll buy the asset from you for more than you paid.

This is known, rather uncharitably, as The Greater Fool approach to investing. The risk of course is that you find out there was no greater fool in the market than you — a dent to your pride as well as your wallet.

Let's try and avoid that, shall we.

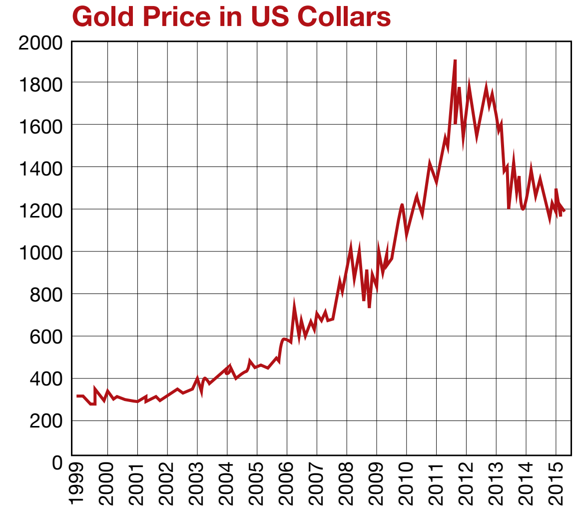
I've put together this report to help you spot the pitfalls. I hope you find it both interesting and useful.

21st Century Bubble #1: Gold 2011

Gold began the 21st century trading at around $300 an ounce. By the end of 2010 it had soared to over $1,300, a gain of more than 300%.

Then, in 2011, it really took off.

Gold Price in US Collars



Source: St Louis Fed

continue…

In April gold hit $1,500 an ounce. By the start of August it was above $1,600.

I remember that month well.

I was working in the gold investment industry at the time. We watched as the gold price continued to tick higher. Less than two weeks into August it passed $1,700.

Then it was like someone lit a rocket. I remember standing behind one of our traders as we watched the gold price smash through $1,800 on his screen.

It was all happening so fast. On the one hand it was hard to explain why something that had been worth less than $1,600 a month ago was now hurtling up towards the $2,000 mark. This certainly felt a bit 'bubbly'.

On the other hand, who was to say it wouldn't go a lot further? It's easy with hindsight to point at a chart and say: "Clearly things went a bit crazy here."

We all like to think we would have been wise.

In real time, though, emotions can take over. Fear of missing out (or FOMO, as it's now been dubbed) can be a powerful thing.

Those who stayed out of the market as gold passed $1,300…then $1,500…then $1,600… then $1,700… they looked (and some felt) like they were missing a trick.

A moment arrives when resistance crumbles. People buy in for no other reason that the price is going up. And so it goes up even more.

Of course, this is no basis for a sustainable uptrend. And so it was that on September 6th, 2011 gold recorded its highest price so far in history. The highest spot price I saw quoted that day was around $1,921 an ounce.

After that the fall was relatively swift, certainly compared to the decade and more it took gold to scale its peak. By the end of 2011 gold was back below $1,600.

It bounced around for the next year and a bit, before a price crash in April 2013 and a slow drift down to around $1,200.

And that was that. A bubble had formed, a bubble had popped.

Naturally, all gold investors took a hit. But some were hurt more badly than others.

There's a different way to think about gold. It can be a volatile asset, but approach it in the right way and you should be spared its most egregious excesses.

Let's take a look at what specific lessons you can learn from the gold bubble that peaked in 2011…

KEY LESSONS FROM THE GOLD BUBBLE

1. What are you buying?

Recognize that gold has no fundamentals. A gold bar is literally just a lump of metal. It has no magic properties. It pays you nothing. In fact it costs you to store it.

2. Why are you buying it?

Think of those costs like an insurance premium. Gold, if you own it outright, won't default on you, so you have some protection against credit risk (though of course you're still exposed to price risk).

Gold's supply is limited by nature. There's a reason gold was used as money for thousands of years. Its supply is tightly limited, not by any government, not by anonymous computer programmers (as with Bitcoin), but by nature.

This means it fulfills one of the three requirements to be money, namely it's a store of value. Gold's fungibility (one ounce of gold is just as good as another) helped it fulfill the other two requirements — medium of exchange and unit of account — for many thousands of years.

Gold's recent bull market occurred in a context of negative real interest rates, with the final run-up coming in the aftermath of the global financial crisis and right in the teeth of a possible Eurozone collapse.

Gold, in short, is financial crisis insurance. That may not be why most people buy it. But it's how we think of it here at *The Daily Reckoning*. Gold is there just in case, like an insurance policy. You buy it and hope it won't be needed. But if our monetary system fails — or starts to look like it might fail — it could be the best thing you ever invested in.

3. Invest For The Long Run

Rather than look at price, some people prefer to have a target allocation to gold and dollar cost average. That is, they buy at regular intervals and end up paying an average price for their gold.

The mistake some people made in 2011 was having no other reason to buy gold other than the assumption the price would go even higher. Short-termists who months earlier would have shown no interest in the metal suddenly piled in looking for a quick buck — and ended up getting hurt.

The One Big Thing You Need To Know About Gold

Gold has no obvious fundamentals.

Gold is often lumped together with the set of assets collectively called 'Commodities'.

From watching the gold price on a daily basis, however, I can tell you that this is a mistake.

Gold behaves a lot more like a currency than a commodity. This is hardly surprising given gold's thousands of years of history as a monetary metal.

It does however make gold tricky to value.

It's not like a stock, where you can look at company earnings, sales, dividends; assets on its balance sheet and whole lot more besides and base your valuation on those hard numbers.

It's not like oil or other commodities were you try

continue…

to judge what price will balance supply and demand based on how much can physically be supplied and how much the world's economies need.

It's not like fiat currencies that have a central bank behind them, changing the interest rate.

Gold itself is just a piece of metal that does absolutely nothing. It doesn't rust. Industrial demand is very limited. It just sits there.

Its price is driven by everything else going on around it. That can make it very tricky to decide what gold's 'fair value' ought to be.

That's why I take a different approach to gold…

Gold as Crisis Insurance

A few weeks back I got a really interesting message:

> *"Hi Ben, Just read your report today about the tech valuation bubble. If, knowing that most bubbles pop eventually, do you think it would be wise to invest in gold while the price is low, because the price goes up when other markets crash?"*

The first thing to say is that gold does not respond in a mechanistic way whenever other markets plunge. It does not go up just because stocks go down.

In the autumn of 2008, for example, gold fell along with stocks before bottoming out in November.

True, it did go on to resume its uptrend that would go on for another three years. But was this a lagged reaction to stock market woes or a response to the super loose monetary policies with which central bankers responded to the crisis?

Or a bit of both? Or neither? Point is, we can't know for sure.

I'm laboring this point a little as it's important to understand that gold doesn't work that well as an out-and-out trading hedge. If you think it's going to magically pop higher at the very moment your other investments fall you're liable to be disappointed.

There is however a broader sense in which gold can be viewed as 'crisis insurance'. This is the way I think of it.

By crisis I don't just mean a common-or-garden stock market drop. I mean the kind of environment where it feels that the financial world as we know it might be coming to an end.

Moments like August 1971, when Nixon's move confirmed the slow death of the fixed exchange rate system known as Bretton Woods. The inflation that followed during the rest of that decade was also accompanied by a massive run-up in gold.

Or the gold price in euros, which didn't peak until summer 2012. That's a year after the dollar price peak, and right when the euro crisis was it its height (not that the euro crisis has gone away, of course, but that's a story for another day…)

When the financial system looks to be facing an existential threat is when gold has historically responded with vigor.

This makes physical gold a traditional fallback in systemic crisis.

21st Century Bubble #2: Oil 2008

By the summer of 2008 it had become painfully obvious that stocks had hit their peak and were on the way down.

The most pessimistic investors thought much worse was to come — and they were right!

The optimists meanwhile found something else to take a punt on.

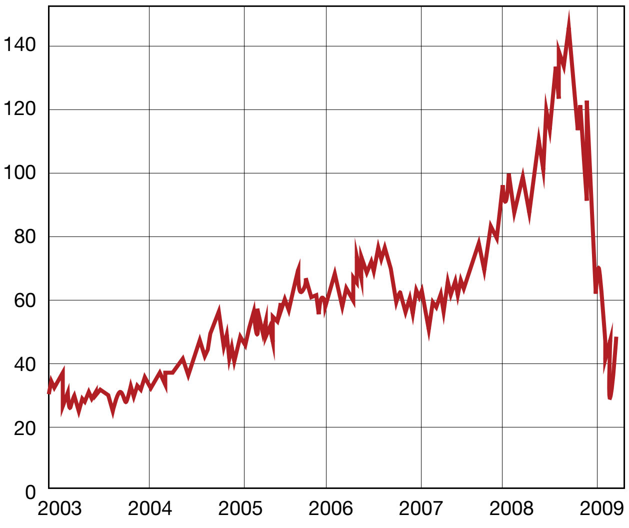
Oil.

There are similarities between the run up in oil in 2008 and the one in gold three years later.

Both gathered speed once the price passed round numbers — $1,500 an ounce in the case of gold, $100 a barrel in the case of oil. Similarly both ran out of steam just short of key milestones — $2,000 for gold, $150 for oil.

One difference though is that oil's demise was much shorter and more brutal.

WTI Crude Oil, Collars Per Barrel



Source: St Louis Fed

After hitting a peak of $147 a barrel on July 11 2008, oil began a precipitous drop. By Christmas it was barely above $30.

Ouch.

The main reason, of course, was the fact that the United States was falling into a deep recession, along with most of the developed world.

continue…

In truth, this had been a clear possibility in the heady days of July. But at that time the market didn't care. It liked another story better.

Oil was scarce, emerging markets would keep on growing, they'd need a lot more oil, buy, buy, buy. All good points, but with hindsight you can see it took some powerful, bubble-grade blinkers to ignore looming recession in the world's biggest oil consuming economies.

One characteristic of bubbles is that the market suddenly gets very selective about which evidence it listens to. The bulls get more than a fair hearing, the bears get drowned out.

KEY LESSONS FROM 2008'S OIL BUBBLE

1. What are you buying?

If you're playing oil through an oil producer, do the due diligence on the company. Be aware that company-specific factors could hurt you even if the underlying commodity does well (think of BP and the Gulf of Mexico oil spill).

If it's an oil services play, check out what else the company is involved in and how strong the fundamentals are.

If, however, you're taking a punt on the price itself, for example by buying options, be aware that this is not really investing, but trading.

Nothing wrong with that, but it comes with a different set of rules and tactics, so make sure it's a game you're comfortable playing.

2. Why are you buying it?

Many people thought oil was "a sure thing" in summer 2008. The story was that insatiable demand from emerging economies, especially China, meant that oil was a one-way bet. This thinking persisted until a speculative frenzy was underway.

Was this a sound enough reason to bet on higher oil prices? We now know that it wasn't.

As the financial crisis bit harder and advanced economies lurched towards recession, oil demand slumped, led by the world's biggest market, the United States.

The lesson?

Fundamentals (or the market's perception of them) change. The market for any commodity has two sides — the supply side and the demand side. Sometimes both can turn against you very quickly. In 2008 the demand side turned bearish for oil. More recently the supply side has looked more bearish as shale output has risen (see below).

3. Invest For The Long Run

Despite the impact of shale, we believe the long run fundamentals for oil are bullish. There's always the threat of a new, cheaper fuel emerging on a mass scale, but oil is such a vital part of everyday life that we don't see it going away any time soon.

It won't be one-way traffic — the precarious state of the global economy (yes, still, even seven years after the financial crisis) will weigh on demand. But the world needs oil. So a quality producer or oil services company could well turn out to be a good long-term performer for your portfolio. And the 2014 oil price slump makes this a good time to look for one at a reasonable price.

The One Thing You Must Do Before Investing In Oil

Look at both sides of the market.

I remember analysts in 2008 dusting off their books on peak oil theory to justify the price spike. Rather than come up with a new paradigm they reached for an old one.

In so doing, not only did they not foresee the rise of shale, they gave insufficient attention to the demand side of the equation. Yes, China was a large and rapidly-growing economy.

But the US is a much larger end user of oil. And it was about to enter recession.

Now, while I say you should look at both sides of the market, I obviously don't expect you to become an oil analyst and start reading up on crude inventories and refinery capacities.

The experts do this and even they often get it very wrong. They're human too, and are prone to confirmation bias.

So what can you do instead?

A common way to play oil is through an oil producer or an oil services company. These guys are exposed to the oil price, naturally, but if you buy one with a solid business, good management and all the other good stuff you want to see in any company then this will let you take a long-term view.

As I argue throughout this report, investing for the long run is one of the core lessons to learn from bubbles.

Investing with this mindset means you can happily pass on an investment when things are looking frothy, reducing your chances of being hurt in a bust.

It also means that you can buy in when an asset looks undervalued knowing that it may take a while for things to turn round but you're patient enough to wait.

The outlook for oil looks volatile right now. Below I look at one of the reasons behind this: Shale.

How Shale Has Changed The Economics Of Oil

Crude oil prices began falling in summer 2014, dropping by more than half by the end of the year.

US production meanwhile continued its upward trend that began in late 2011, when monthly average crude production broke 6,000 barrels a day for the first time this century.

continue…

By October 2014 US crude production had climbed above 9,000 barrels a day, a jump of over 50% in three years.

The reason for the upsurge, of course, is increased use of fracking – the hydraulic fracturing process that enables the extraction of oil and gas deposits from shale rock.

However, there's more to this story than a simple boost in supply followed by a drop in price.

Shale production has undermined Saudi Arabia's ability to set the world's oil price.

The logic is as follows: shale supply comes from a relatively large number of small producers, each of which is too small to influence the oil price by raising or lowering production (unlike Saudi Arabia and its fellow OPEC cartel members).

In economic jargon, shale producers are price takers. Each individual producer's supply decision won't move the price, so each maximizes profits by maximizing its economically feasible production. So if the price goes up, more deposits are deemed economically feasible to extract, leading to a ramp up of supply.

A shale oil well can be drilled in less than a week at a cost of around $1.5 million, according to one estimate I've read.

This is a massive new element in the supply side economics of the oil industry, which had got used to thinking that significant new supplies take years and billions of dollars to bring on stream.

The upshot is that shale supply can respond flexibly to changes in the oil price. This, combined with the fact that shale producers have no incentive to hold back supply when the price rises, may well explain OPEC's decision at the end of November 2014 not to cut production in the face of falling prices.

OPEC's largest producer, Saudi Arabia, has since reiterated that it will maintain production levels - in fact it increased them.

The 'Fracking as Manufacturing' Thesis

One long-time oil watcher, Philip Verleger, even published an essay arguing that fracking should be viewed as a manufacturing rather than an extraction process.

He draws an analogy with computing, which for decades has been characterized by falling costs and rising productivity.

"Fracking, a disruptive technology, makes low-cost manufacturing of oil and gas possible," writes Verleger. He goes on:

> *"The relatively modest investment required to build a crude oil manufacturing plant (otherwise known as a fracking rig) guarantees that fracking will be a permanent and ubiquitous feature of the oil and gas business just as the PC is in the computing world."*

The essay draws a number of implications from the thesis. One is that fracking could end up being off-shored to countries with lower labor costs just like earlier manufacturing processes.

Another is that big oil players that have invested billions in developing hard-to-reach deposits could be severely disrupted by this new more flexible source of supply.

Verleger's argument raises some questions for me. For instance, how much of the fall in fracking costs is down to the technology only recently being exploited at scale?

Will costs really keep falling the way they have in computing?

How long until fracking reserves become lower-yielding/less productive (this is still, after all, an extractive process)?

Oil has not been an ordinary market for decades. It's been deliberately manipulated by a cartel, to everyone's full knowledge. If it had been a free market then we'd all have been swimming in (very) cheap Saudi oil all the way along until it ran out. So drawing comparisons with the computer industry or any other is potentially dangerous.

Verleger himself also notes that efforts to combat climate change may impose constraints on the use of hydrocarbons, unlike computing that faced no such constraints to its exponential growth.

Despite these questions, it's an interesting argument, the idea that fracking offers the potential to simply 'make' some extra crude if and when the market needs it.

There can be little doubt that shale is a major disruptive force in today's oil market

The old incumbent suppliers are still there and they're still huge. But their influence over prices has been diminished, and looks likely to be further diminished in the years ahead.

21St Century Bubble #3: The Dot Com Crash of 2000

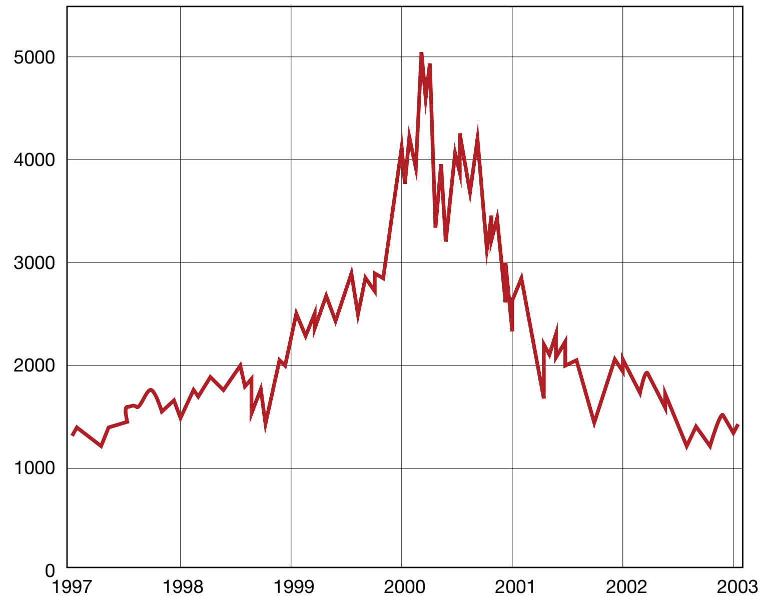
The late 1990s was a heady time for many of the world's stock markets.

But the Nasdaq, the epicenter of the tech stock boom, was on another planet.

continue…

At the start of 1997 the Nasdaq Composite, a US-based stock market index heavily weighted towards technology stocks, was at 1,291. By the eve of the new millennium it had more than tripled.

The Nasdaq — Epicentre of the Dot Com Bubble



Source: Yahoo Finance

The Nasdaq topped out at 5,132 in March 2000. The rest of that year was a story of precipitous decline. By the start of 2001 the index was trading below 2,500.

By October 2002 it had sunk to 1,108, below its pre-bubble level.

What had happened?

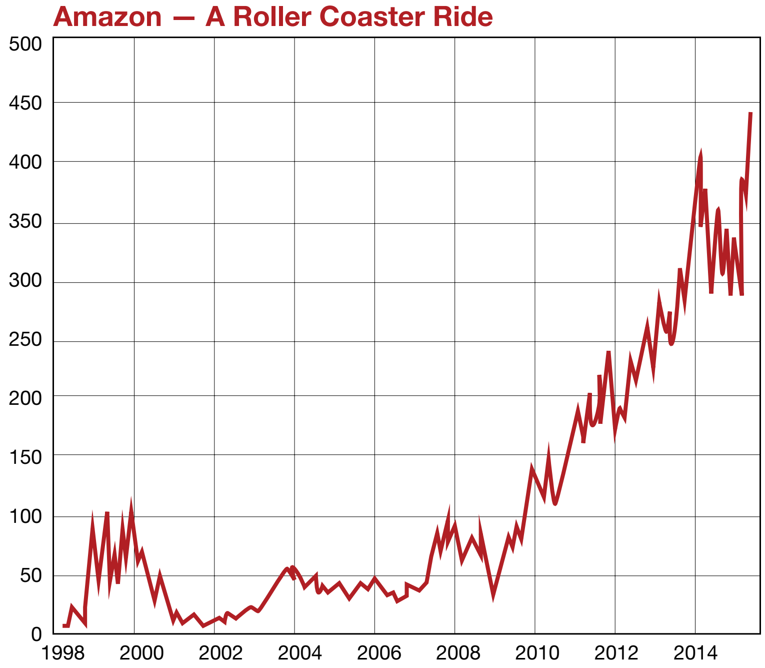
The dot com bubble was accompanied by a classic new paradigm story. The internet was going to change the world.

Geography had ceased to be a meaningful barrier. Companies could use the new technology to serve millions of customers while employing just a handful of people.

The profits were going to be enormous.

That was the story. There was actually a lot of truth in it. The world we live in today delivers many of the benefits tech optimists touted at the end of the last century.

Amazon — A Roller Coaster Ride



Source: Yahoo Finance

But investors got way ahead of themselves. Rationality was tossed aside. Although some of those exciting new companies, such as Amazon, did indeed go on to deliver fantastic returns for those who stayed the course, it was a rollercoaster ride:

You would still have made money over the long run had you bought Amazon for more than $100 a share at its dot-com era peak. It's since risen to trade at more than four times that.

But would you have held your nerve as the share price crashed to less than $7 in 2001?

KEY LESSONS FROM THE DOT-COM BUBBLE

1. What are you buying?

A few questions to ask if you're buying into an 'up-and-comer':

- Is the company making money yet?
- If not, is it reasonable to think it will any time soon?
- Is the market established or brand new?
- If the latter, why will it catch on?
- Why will these guys take market share?

Some questions to ask if you're buying an established player:

- What will drive future growth?
- How much of that growth is already priced in?
- Is the company heavily reliant on developing a string of new and exciting products (e.g. Apple)?
- If so, do you believe that it will continue to turn out the hits?

Research each business so you know as much as possible about where it makes its money.

If you're buying a tech giant because it's involved with some cool new technology (driverless cars with Google, say, or virtual reality player Oculus Rift, now owned by Facebook), be aware that in many cases such baubles are currently adding nothing to the company's bottom line.

If you're happy with the existing business then by all means get involved. If you're not that keen on the core business but you're purely taking a punt on a new technology, be honest with yourself about that.

2. Why are you buying it?

There's usually only one reason people buy tech stocks — to get into an exciting new area before it hits the big time. To buy tomorrow's behemoth while it's only a tadpole.

There are two main reasons why this can go wrong. Number one is that the company doesn't grow. It stumbles along, or even worse goes out of business.

Number two is that the company grows but that doesn't seem to filter back to shareholders.

Many people bought into the dot-com boom without really thinking what they were buying or why.

Or they kidded themselves that huge valuations on loss-making companies that showed no sign of making a penny soon were justified by the growth story.

3. Invest For The Long Run

As with everything in investing, be prepared to be patient. If the company's not making money yet, does it have enough cash on hand to see it through until it is?

continue…

Bear in mind that for every Amazon, there were many more companies that never got close to being a viable business, and whose shares ended up worth exactly zero.

These are relevant questions now that tech has become hot again and the Nasdaq has surpassed its 1999 record.

Are we close to the top? Is a 2000-style crash just around the corner?

We don't know. All we can do is ask the kind of questions we should be asking anyway, whatever market environment we're in.

How to Avoid Getting Burned By Overpriced Tech Stocks

The easiest way to avoid getting burned by tech stocks is not to buy any.

I'm not recommending that approach, nor am I saying eliminating risk should ever be your objective (because you simply can't).

If you avoid risk you avoid the potential for reward.

What I am saying is this: have a good idea how much risk you're willing and able to take on before you consider any specific investments.

Every investor's risk appetite is different. Where people get hurt is when they somehow forget their own risk tolerance.

They allow themselves to be lulled by the potential upside into thinking the risks are smaller than they are. Often there's a handy story to help them convince themselves, complete with selective 'facts' for a bit of DIY confirmation bias.

Their rationality sedated, the once risk-averse investor may even speculate with money they can't really afford to lose, a big no-no.

Let's avoid that.

The points I've been hammering in this report should help you do that, as will asking the basic questions peppered throughout.

To supplement these, here are three questions you should ask if you're worried about succumbing to a story that often attaches itself to tech investments — the growth story…

3 Questions To Ask Before Buying That Growth Stock

You know the drill.

This new, exciting company in a hot new market is going to grow exponentially and make early investors a fortune.

And this is your chance to "get in on the ground floor".

We hear these stories a lot. They often don't work out as advertised.

So, when faced with a mouth-watering investment story, it's worth going back to basics and asking the following questions.

1. Are you overpaying?

Disruptive ideas are exciting. That's why people want to invest in them.

But if the investment story grabs you, it's probably grabbed others too.

One of the pitfalls of growth investing is that if a company's story is compelling, chances are it's already reflected in the share price.

Word gets around. As the buzz grows and the share price climbs, the valuation starts to reflect a very rose-tinted view of the future.

The shares can quickly get to a level where everything will need to go right. Even a minor setback could induce severe disappointment (and the inevitable selloff that follows).

The dot com boom was typified by exciting stories of untrammelled, tech-driven growth. But even shares in those companies who did eventually deliver on their promises weren't spared when the bubble burst.

2. How much will growth cost?

There are hard core value investors who regard growth as worthless. This may seem counterintuitive — surely investing in a company that grows to be much bigger is a sure-fire route to riches, right?

Not necessarily.

Turning an idea into reality and growing the market for it requires investment. Sometimes a lot of it.

In their book 'Value Investing: From Graham to Buffett and Beyond', Bruce Greenwald and Judd Kahn write that "under many commonly encountered strategic situations, growth in sales and even growth in earnings add nothing to a firm's intrinsic value".

In a nutshell, the argument goes like this: more growth usually needs more assets, which need to be funded by extra investment.

This in turn means either taking on more debt, selling additional shares or holding back more profits rather than paying them to shareholders as dividends.

All of these activities can weigh on the value of

continue…

the company's shares. Servicing debt or retaining profits reduces the cash available for shareholders, while issuing new shares dilutes them.

My view: this is an aspect of growth that doesn't get the attention it deserves. How much of any growth will you, the shareholder, get to benefit from?

"The only growth that creates value," say Greenwald and Kahn, "is growth in markets where the firm enjoys a competitive advantage."

So think about what competition this hot new prospect will face. Who might eat its lunch? Or how much of what they make will they need to spend to keep competitors at bay?

3. Can you (and the company) afford to wait?

OK, so you've answered questions one and two and you still want to buy that growth stock.

You're confident you're getting in before the crowd so you're not worried about overpaying. You also think there's a good enough chance the company will capture more value from growth than it will cost to create.

Excellent. Now how long will it take?

For you as an investor, it's about patience. That's not just a question of temperament. It's also about your ability to tie up capital for an indeterminate period of time. Be honest with yourself.

As with any investment, make sure you go in eyes open. If you really are early to the party, you may have to wait a while (maybe years) before things get going.

As for the company, are you confident it can stay the course?

I'm thinking about debt here – if a company is carrying a lot of debt it increases the chances it might get into difficulties before it can launch its amazing disruptive money-spinner.

Fundamentals are important.

None of this is to deny that disruptive companies can offer great investment potential. It's just that for each one that does, there are several that flatter to deceive. Asking the basic questions will help you avoid at least some of the duds.

Conclusion — It's Good To Be Boring

We live in a bubble environment. A low interest rate world awash with cheap capital looking for the next thing to try and make a few bucks on.

Chase the bubble and you may get lucky — provided you're not the Greatest Fool and you sell out before it's too late.

There is another way…

Take a measured approach. Be analytical. In fact, be downright boring.

Be the one who asks the awkward questions. And asks them again if the answer makes no sense.

Be happy saying no to an opportunity, even when it turns out to do well.

If your analysis and your process were sound, don't beat yourself up because an irrational market made a few gamblers a few bucks. Take a means-justifies-the-end approach (because we can never know the end, otherwise this would be easy!)

Know what you're buying and why. Prepare to be patient — if your thesis is right and you are ahead of the crowd, it may take time for the crowd to catch up.

Above all, invest with an eye on the long term, with money you can afford to tie up.

Before I go, here's a piece of technical advice you might find useful, if you're not already using it yourself.

Think about what you want your portfolio to look like.

What assets classes are in there?

How much do you want to put into shares, into bonds, into commodities, into gold etc?

In other words, think about asset allocation.

Everyone's different, so I'm not going to tell you what your asset allocation should be. It's your money.

Once you've decided on your target allocation to each asset, review your portfolio at regular intervals, say every quarter. If something looks suddenly underweight, because the value of those holdings has dropped, take a good hard look at it.

It may be a sign of further trouble ahead. However, if you're happy with the long-term outlook, this may be a good buying opportunity, so you can top up your holdings on the cheap to maintain your target allocation.

Conversely, say you have a given percentage in gold and we start to see a 2011-style upward move. Maintaining a target allocation will mean you automatically start selling as the price climbs, reducing your risk of being caught out by a sudden reversal.

Some people find finance and investing deathly boring. That may because those who are best at it, while often fascinating people, are cold and logical when it comes to where they put their money.

Regards,

Ben Traynor
For *The Daily Reckoning*