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How to Spot a Market Bubble

Investors can get burned when the air rushes out of a hot market.

By JOE LIGHT CONNECT

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The drop in the tech-heavy Nasdaq Composite Index since early March encourages the vigilance of spotting market bubbles. *Reuters*

Investors have big fears about a small word: pop.

The bursting of two major asset bubbles—in home prices in recent years and Internet stocks at the turn of the century—has trained investors to scan the horizon for signs of where the next one might form.

The drop in the tech-heavy Nasdaq NDAQ +1.34% Composite Index since early March encourages the vigilance. Even with the recent pullback, the Nasdaq has more than tripled since hitting a 6½-year low in 2009, pumped up by highflying social media and biotechnology stocks.

Caution is well-advised for investors tempted to chase hot markets. At the same time, the "bubble" label sometimes gets slapped on assets too quickly, experts say. Investors should try to distinguish between markets that are overinflated and ones that are merely overpriced.

"Prices can be both 'not cheap' and 'not in a bubble,'" says Vikram Mansharamani, a lecturer at Yale University who has written extensively on how to detect a bubble.

It isn't easy to tell the difference. But the distinction matters a lot. When stocks are pricey, Mr. Mansharamani notes, future returns are generally lower. But when stocks—or any asset—are in a bubble, the pop can cause values to plummet, by 50% or more in extreme cases.

Beyond tech stocks, some warning signs point to shares of small companies, real estate in cities such as San Francisco and Honolulu, government bonds of debt-laden European countries and even stocks in utilities that are usually seen as safe havens.

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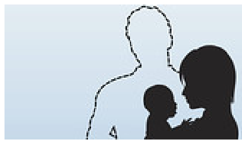

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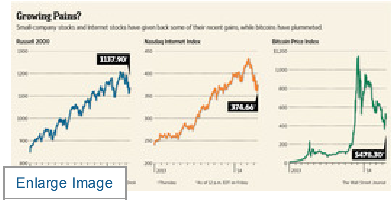

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Here is a guide to spotting bubbles, where they might be inflating now, and what to do when you find one:

Three Red Flags

The first sign of a potential bubble, and the easiest to spot, is a rapid rise in prices. The Nasdaq rose 110% in the 12 months before the dot-com bubble crested on March 10, 2000. Home prices in Las Vegas rose 41% in the two years before their April 2006 peak, according to S&P/Case-Shiller.

When bubbles are forming, the price spikes also tend to be interspersed with bouts of panicky selling, says Didier Sornette, who is director of the Financial Crisis Observatory at the Swiss Federal Institute of Technology Zurich.

To help find those patterns in the prices for hundreds of assets, Mr. Sornette and his colleagues enlist the help of a supercomputer named "Brutus."


Enlarge Image

Tim Foley

Another warning sign is when prices break sharply from an asset's underlying value. With stocks, one popular way to measure value is to divide the market's price by 10-year average earnings after adjusting for inflation.

Using that method, the median price/earnings ratio of large U.S. stocks since the late 1800s is 16, according to Yale economist Robert Shiller, a Nobel Prize winner who tracks the data. By contrast, the Shiller P/E passed 44 during the dot-com bubble.

The third indicator of a bubble is that investors and analysts identify an exciting technology or innovation that serves as an explanation for the rapid climb in prices, such as the rise of the Internet in the late 1990s, says the Bank of Finland's Katja Taipalus, whose model is one of a number of tools that many central banks use to help identify bubbles.

As the bubble matures, individual investors pour into the asset, which is akin to "pouring fuel on a fire," says Mr. Mansharamani, who wrote "Boombustology," a book about detecting bubbles. "When there's no one else left to get in, it's almost over."

What a Bubble Does—and Doesn't—Look Like

Some investors have expressed concern that the broad U.S. stock market looks bubbly. That is reasonable, given the 32% gain that investors in the S&P 500 enjoyed last year, including dividends.

But on closer inspection, it is clear that U.S. stocks can't be called a bubble—at least not yet. To begin with, the Shiller P/E of the S&P 500 is 25. That is higher than the historical average but far below the dot-com era peak. Mr. Sornette's model also isn't detecting alarming patterns in the overall market.

To meet Boston-based asset manager GMO's definition of a bubble, the S&P 500 would have to rise about 25%, says Edward Chancellor, an investment strategist on GMO's asset-allocation team who wrote "Devil Take the Hindmost," a book on financial speculation.

The S&P 500 closed at 1864.85 on Thursday.

Yet Mr. Sornette's model did identify Internet retail stocks and health-care and life-sciences stocks as bubbles before the recent pullback, which has dragged the Nasdaq down 6%, through Thursday, from the index's peak for the year in March. The Nasdaq Biotechnology Index has fallen 19% since hitting a peak for the year in late February.

On the other hand, the digital currency bitcoin has many of the features typical of bubbles.

Last year, the price of bitcoin rose to more than $1,100 in early December from about $13 in January. Mr. Sornette told the Journal in mid-November that bitcoin appeared to be in a bubble.

Bitcoins also have no established fundamentals underlying their price. They exist only online and aren't backed by any government or tangible assets.

Proponents say bitcoin could assume a central role in Internet commerce or the money-transmitting business, which would bolster its value. If it turns out to be a fad, however, bitcoin ultimately will be worth little.

"If you want a good bubble, it's best that the asset inflated has no underlying assets or earnings whatsoever. That frees you from the anchor of valuation," Mr. Chancellor says.

And bitcoin long ago captured the imaginations of investors.

Handle With Care

Even if you think a bubble could be forming, that doesn't necessarily mean you should give up the asset completely, says Stephen Utkus, director of the Vanguard Center for Retirement Research.

For one thing, you could be wrong.

"No one talks about bubbles that never collapsed. Everyone wants to time bubbles, but that's almost impossible to do," he says.

Instead, for core holdings such as large-company stocks, an investor could reasonably cut back on his allocation by 10 to 20 percentage points, as his confidence in identifying the bubble increases, Mr. Utkus says.

Investments that even enthusiasts should only hold a small amount of in their portfolio—such as bitcoin, for example—can be avoided completely when the market looks frothy, he says.

Bubbles are rare, which means it is uncommon to find assets displaying all of the warning signs at once. But investors also should keep an eye on assets that show one or two of the common red flags. Here are some current candidates.

Internet companies. The Nasdaq Internet Index—which includes firms from the broader Nasdaq with Internet-related businesses—has dropped 14% since its March peak, but it is still up 44% over the past 12 months.

Some companies, such as Amazon.com, AMZN +1.83% have achieved that performance without making much money, Mr. Chancellor notes.

The P/E ratio of the PowerShares Nasdaq Internet Portfolio exchange-traded fund stands at 47, based on the past 12 months of earnings, according to FactSet, compared with 17 for the S&P 500.

Small stocks. Based on average earnings over five years, the median small-company stock has a P/E ratio of 29, compared with a median of 22 since 1990, according to investment-research and asset management firm Leuthold Group, based in Minneapolis. That is almost as high as its all-time peak of 30, hit in 1997.

Utilities. The traditionally ho-hum sector has a P/E ratio of 19, using average earnings over the past five years, according to Leuthold. That is significantly higher than the historical median of 16, according to Leuthold, which is striking because stocks in the sector don't often stray so far from the norm.

Companies that work with natural gas, in particular, appear on Mr. Sornette's watch list of sectors whose recent price movements look bubbly.

Hot real-estate markets. It may seem that the housing recovery has just begun, but some urban areas already look pricey, experts say.

Home values in San Francisco, Honolulu, and Santa Cruz, Calif., for example, are at least 20 times as high as estimated average rents as of February, the latest data available, according to Zillow, which estimates home values. Once home prices rise above that level, according to some economists, a market starts to look dangerously expensive.

Bonds of some European countries. Spain and Italy still have significant fiscal problems that could make it difficult for them to pay their debts, but investors have sharply bid up the countries' bonds.

Ten-year Italian government bonds, for example, yield 3.1%, down 1.1 percentage points in the past 12 months, and only 0.4 percentage point above that of comparable U.S. Treasurys. Spanish 10-year bonds also yield 3.1%. Yields and prices move in opposite directions.