The Biggest Threat to Your Financial Security

The Current Stock Market Bubble: Fools Following Fools

By Raymond M. Mullaney

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655 Main Street, Suite 211
East Greenwich, RI 02818
Ray@ExceptionalInvesting.com
CT (203) 254-0000
RI (401) 450-4040

EXCEPTIONAL
INVESTING, LLC
institutional investment research

Q – What is a "Financial Bubble"?

A – The term "Financial Bubble" refers to a period in time when the price of most stocks has risen very dramatically and unjustifiably. There are four key indications that the market has reached "Bubble" levels:

1. First and foremost, if most of the stocks in a sector (or the overall stock market) are trading ***at a premium*** of 5 or 6 times the company's ***current net tangible value***, you're looking at a Bubble. In "Bear Markets", the opposite of Bubble markets, stocks of high quality companies can often be purchased ***at a discount*** to their ***current net tangible value***. So why pay Bubble prices? Bubbles always end and Bubbles actually create "Bear Markets", so why not wait until prices fall to buy stocks?
2. If all the stocks in one sector are priced at levels which may, very realistically, fall 50% or more, they're bubble-priced. Speculators, not investors, gamble on stocks. There's nothing wrong with speculation, if you have expertise at it, but speculation is not investing.
3. If the only possible buyers for the stock you own (at current prices) are other speculators in the market, the stock is trading at bubble prices. Stocks that trade at bargain prices may rise in price as they become takeover targets by larger companies. Stocks that trade at bubble prices can only be sold to other speculators.
4. Last, but not least, when most investors sell the stocks of good strong companies at very reasonable valuations to buy popular stocks that everyone loves and that are rising in price, and if those popular stocks meet the above 3 guidelines, you know we're in a Bubble.

The aftermath of the 1998-2000 technology bubbles, and the real estate and banking bubbles in 2004-07, clearly illustrate how much investors can lose when buying Bubble-priced assets.

- From March of 2000 through October of 2002: Most technology stocks fell by 80% or more; the vast majority of investors in these stocks will likely never recover their losses.
- From October of 2007 through March of 2009: The Dow Jones Average fell by 55%. The most widely held and most trusted stocks fell even more: GE by 83%, Citicorp by 98%... and even Apple fell by 57%.

A Financial Bubble occurs when Wall Street representatives convince investors that wealth can be gained without work. The average consumer is the last one in line to buy stocks, and they pay the highest prices, while insiders buy first and sell to those still waiting in line. Where else could the shares come from that average investors are so anxious by buy? The business of Wall Street is to create businesses, businesses that have significant buyer appeal; like every retailer, their goal is to create a brand and a story of what owning these stocks can become and then sell that story.

Resisting the urge to buy stocks in the frenzy of a bull market, especially a Bubble market, requires knowledge of how to put a fair price on a stock. It takes discipline to *not* let your emotions dictate your behavior.

Wall Street representatives provide volumes of detailed explanations of why such-and-such stock will be much higher in the future. But ask any of them, "How much will this stock fall if the company fails to meet Wall Street's earnings projections or if the sales of this company simply level off or slow down?" Now watch as their faces turn white.

Wall Street convinces people to take risks, with the hope of gains, without a providing a full explanation of how much the stocks they recommend might decline, even if there's a small hiccup in their business plans. ***If you do nothing else to protect your savings, promise yourself to never buy another stock without first getting in writing from the advisor exactly how much, by what percentage, the stock can fall. And ask what method he uses to determine how much his favorite stock might fall. Then rely on logic and the numbers.***

When stocks soar, it looks and feels very real, but often such gains are only temporary, because all bubbles burst. When people trade paper, like baseball cards, at ever increasing prices, it provides the illusion that wealth is being created. But creating paper wealth, whether in baseball cards or stock certificates, is not the same as creating real and lasting wealth. Protecting and growing your savings is your duty. Learn more about investing: you will never regret learning too much. You may well regret learning too little.

Q – Are stocks now trading at Bubble Prices?

For our 8 page report on the risks to the US stock market, please see our June 2013 report "Current Threats to your Financial Security".

Q – How does a "Bubble" occur?

A- Bubbles are created when tens of millions of individuals become investors and traders in the same types of assets. How does that happen? Wall Street hires hundreds of thousands of financial salespeople to get more and more investors to buy those products. They hire the most brilliant advertising people to craft enticing and promising messages; they convince investors that buying a certain type of asset is not only safe but also provides near certain profits. They convince people that certain types of assets (the assets they are selling) are safe and are almost certain to rise in price.

Wall Street rewards financial salespeople with greater incomes than any other industry on Earth; it is common for financial salespeople to make $10 to $50 million a year. The most successful Wall Street operators make hundreds of millions each year, not by creating anything tangible of real value, but by selling paper promises of hope. Can an industry create real and lasting wealth by convincing millions of people to buy and sell paper certificates? Can this industry create lasting wealth?

A bubble gets rolling when tens of millions of people all try to buy the same types of asset. Tens of thousands of mutual funds, hedge funds, private equity firms, brokerage firms, banks, and insurance companies all seek out and try to buy and re-sell stocks in the same types of companies.

There are many times more TV programs on how to invest in stocks than on how to start a real business. Pitchmen for Wall Street have become media celebrities (and made fortunes for themselves) by "teaching" excitable college kids (and adults who should know better) how to make millions without ever having to leave the house, just sitting in the living room in front of a computer. There are literally millions of websites and seminars that will teach us how to create wealth with nothing down, and no labor. What a country! This is neither productive nor lasting.

Anyone, we're told, can become a professional investor; you can study at the "best" colleges or find local seminars on how to search for and buy companies with the right attributes, companies that "will go up"! Investors are trained to buy companies with rising sales, rising earnings, and an increasing share of a large and expanding market. Investors are also trained to buy companies with a high return on equity. But most of all, investors are taught to buy companies whose stock price is rising rapidly. All investors are trained to buy the same types of stocks and, in fact, they do all buy the same stocks.

Because everyone buys the same types of stocks, the prices of those types of stocks rise, regardless of their real value. After they've risen, Wall Street salespeople show new prospective clients how well their stock picks have performed. Wall Street, with mutual funds, hedge funds and variable annuities, attracts even more new buyers to these same types of stocks, then these stocks really soar.

When investors make fortunes in stocks they become very confident in the way they select stocks. Understandably so; after all, they're getting rich by doing what they're doing! Wall Street makes billions on fees and commissions. They hire more salespeople, who find even more investors to keep buying those stocks, so those stocks keep rising in price. Everyone is happy: even the small investor on Main Street gets some benefits from Wall Street's rising fortunes. When people and businesses have rising (paper) profits, consumer spending rises, and so the GDP grows. As incomes and spending rise, so do the tax revenues of federal and local governments. As incomes rise, property values rise and property tax revenues rise. As people feel richer they borrow more and spend more. Everyone is happy. Why would anyone do anything differently? If it's not broke don't fix it, right? Bubbles are caused by natural human impulses. In fact, the impulses that give rise to teenage love and infatuation are the same impulses that create stock market bubbles. More than anything else, people want free money and free sex. Wall Street offers both.

Q – How can you protect yourself from buying bubble-priced assets?

A – Here are 13 facts and guidelines to protect your capital. Take heed! And never buy Bubble-Priced assets again.

1) Stock prices rise, mostly for no reason other than that investors are willing to pay more for stocks in the present than in the past.

2) What one thinks something is worth and what that something is really worth are most often very different.

3) The *price of a stock* and the *value of a stock* are almost always two very different numbers.

4) When a stock's price rises, it doesn't become more valuable, it simply becomes more expensive.

5) In a Bull Market nearly every stock rises; everyone is happy. That's the time to avoid most stocks.

6) Every Bull Market ends; after all stocks rise, all stocks fall. After a market crash, stocks offer the best value and lowest risks.

7) When the Bear Market comes nearly every stock falls, often by 50% or more. The whole nation suffers. Smile, you have cash to buy them.

8) The more a stock rises, the lower the profit will be (if any) for future investors.

9) Investors who sell before the market tops may miss an opportunity for greater profits, but by selling early they will be certain to have cash to buy stocks when stock prices fall, as they always do.

10) Investors who hold too long, who hold out for higher prices, may end up losing money as the market declines, which it always does. And they're certain to miss the opportunity to buy when prices fall a great deal, as they always have in the past.

11) If the Federal Reserve Bank buys another $4 trillion of US debt or Wall Street hires another 200,000 salespeople, US stocks will rise in price. But the value of these stocks may not increase at all; they may just be more expensive. The higher they go, the harder they fall.

12) Buying stocks and paying more than they are worth is not investing, it is gambling.

13) Buying stocks with excellent financial strength and buying them at prices which are very close to their current net tangible value is not only safer, but historically this approach has been reliably rewarding.

There are many paths to successful investing. One path, taught by Benjamin Graham in his classic book, The Intelligent Investor, offered a clear and simple approach to safe investing. Graham suggested buying stocks only when you can buy them with a good "margin of safety." He suggested buying stocks when their price is lower than their value; this would lead to a lower chance of a loss than when buying stocks for more than their present value. Graham wrote, "The chief losses to investors come from the purchase of *low-quality* securities at times of favorable business conditions." Graham thought the most prudent investment strategy is to buy stocks with high quality financials, buy them for less than their value, and, above all, avoid the temptation to allow emotions to overrule sound judgment based on those principles. Warren Buffet used this approach to build his wealth.

Oddly enough, this approach can only be used by individuals with modest assets. (You can read about the reasons this is so in a White Paper which will be available online soon.)

Graham also recommends avoiding buying stocks when business conditions are favorable; believes this means avoiding stocks during bull markets and bubble markets, because at these times most believe stocks are over-priced. Avoiding purchasing companies with poor balance sheets is the surest way to protect your capital.

For 30+ years, I’ve studied the relationship between changes in the balance sheets of companies and the subsequent changes in their stock prices. Companies provide a great deal of financial information; investors are unsure what the most important questions are. There are two crucial questions to ask in evaluating every stock: 1) what is the relationship between today’s stock price and its value, and, 2) how much risk is there of the stock falling?

At Mullaney Trust we have developed an exceptional risk indicator for stocks. We believe this indicator will help investors avoid the riskiest stocks and identify stocks with the lowest risks, and excellent prospects for profit. By using our Mullaney Risk Indicator (MRI), we can look at the balance sheet of any company and quantify its relative risk level. We then choose to buy only those stocks with the lowest risk of falling. Our other tool, the Mullaney Market Risk Indicator (MMRI), allows us to look at the risk level of the overall market, and choose to withdraw from the market at times when the market appears most risky.

At this time, stock prices have risen far higher than their current values. Perhaps the market can continue to rise. However, in my judgment, the risks of a very significant stock market decline are extraordinarily great. I base this assessment on my 36 years of practical investment experience, our proprietary stock risk models and macro-economic conditions which I have enumerated in our January 2013 Annual Economic Report, which can be found here.