How can you protect your portfolio from the next financial 'bubble'?

So far this year we've seen bitcoin's value reach record highs and then plummet, while thousands of first-time investors have lost money on GameStop shares. We explore the dangers of investing in speculative assets and what you can do to protect yourself from a bubble.

This year has been a rollercoaster for bitcoin, with the cryptocurrency reaching a record high and then almost halving in value all in the space of six weeks. This came after a series of price peaks that saw its value rise from below $5,000 in March 2020 to over $64,000 in April this year. However, its value plunged after Elon Musk tweeted that he would no longer accept bitcoin as payment for Tesla's cars on environmental grounds and Chinese regulators signalled a crackdown on the use of digital currencies.

From the Dutch tulip craze to the dotcom bubble, history is littered with examples of speculative asset classes crashing and private investors losing their savings. If you don't know what you are doing when investing in high-risk speculative assets, it is not much different to gambling and can hit you in the pocket just as hard. While investing in speculative assets can seem tempting because of the potential higher returns on offer, the nature of their volatility can leave investors vulnerable to losses and sharp price swings.

The biggest economic bubbles in history

The Dutch tulip bubble (1636–37)

Tulips were so highly prized that when demand increased prices soared. Some tulips were sold for the price of a house, but the market eventually collapsed.

The South Sea bubble (1720)

The South Sea Company had a monopoly on trade with central and South America. British investors sent shares surging more than eight-fold before collapsing.

Japanese asset bubble (1986–91)

After the yen's surge led to a recession, Japan's government countered it by using monetary and fiscal stimulus. This resulted in Japanese stocks and land values tripling, but then the bubble burst.

Black Monday (1987)

US stock prices rose during the year by more than 40%, stoking fears of a bubble. New computerised trading systems contributed to investor panic and markets from all around the world crashed by more than 20%.

The dotcom bubble (1990s)

The increasing popularity of the internet triggered a wave of speculation in online businesses and the price of shares soaring. Many of the stocks were overvalued which led to a crash.

US housing bubble (2000s)

Housing prices soared due to low interest rates and loose lending conditions, reaching a peak in 2006. The market crashed in 2008, with prices falling by nearly 20%.

What causes financial bubbles?

Financial bubbles occur when price of a financial asset rises well in excess of its real value. Bubbles are often the result of irrational-exuberance from investors who think they can make a quick killing by investing in the latest fad. They arise out of the belief that the value of the asset will continue to rise. People are prepared to pay more as they think they can beat the market, which fuels prices even further. Eventually the price rises hit a wall and the price collapses dramatically as the bubble pops, which is followed by further price falls as panicked investors liquidate their positions. While speculative investing might not always lead to a bubble, it still involves similar risks. It is also important to remember that rising asset prices do not necessarily mean a speculative bubble is forming. For example, stocks might be rising in expectation of strong economic growth as a result of fiscal stimulus.

The first well-documented speculative bubble was tulip-mania in the Netherlands in the seventeenth century. Soon after tulips were introduced from Turkey they became a status symbol. As their popularity grew speculation exploded, helping to drive the price of bulbs to spectacular heights. However, tulip prices were unsustainable and the market eventually collapsed, leaving traders with serious debts.

In the 1990s, euphoria of the new internet age caused rapid growth in the share value of internet companies which were increasingly going public. Excessive speculation of internet-companies such as Pets.com led to an over-valuation of firms relative to their natural value, but it didn't last. On 10 March 2000, the Nasdaq index of technology shares closed at a record 5048.62, up 24% from the beginning of the year. But then the bubble burst, triggering a massive sell off of stock. The Nasdaq lost half its value in 2001 and by October 2002 it had reached an all-time low of 1,108.49. Bubbles are often driven by strong emotions which blur people's ability to make rational investing decisions.

While the more the recent case of GameStop isn't quite a bubble, it does have many similarities to one. Its price was artificially inflated by investors in online communities looking to take on Wall Street. Once word got out, more and more people started piling on the stock, even though the business had been struggling for years (click here to find out more on our podcast). After a few wild weeks its share price reached an eye watering peak of $483 but then plummeted, The share price has crept up again since, but there are still fundamental questions about the underlying value of the business and whether the shares are significantly overvalued. The quick and dramatic drop in price since the peak highlights just how quickly losses can hit investors if they don't know what they are doing.

Ways of protecting from bubbles

Stock markets can be volatile, so it's important to be prepared for any market corrections. When the stock market takes a downturn it can be a worrying time for investors. However, while stock market bubbles can wreak havoc on your investments there are ways of protecting yourself.

1. Look out for warning signs

A big sign that there is a stock market bubble is that the market is flooded with speculators, many of whom are new to the market. They typically have zero knowledge about the asset class they are investing in and are only looking for short-term profit.

Another indicator of a bubble is rapidly rising prices as a result of speculators moving from one asset class to another very quickly to maximise their profits from trading. Long-term assets become less attractive to them, pushing prices up even higher.

Excessive media coverage and hype of a boom in an asset class should also set alarms bells ringing. Media coverage brings in more short-term inexperienced investors who get caught up in the wave of euphoria. By the time the media usually starts reporting on massive gains that have been made it usually means it's already too late to make any significant returns and the professionals who have made a profit are already looking to get out.

2. Invest in high-quality assets

A sensible strategy is to invest in high-quality companies which are well-established businesses. These are usually companies with strong management teams, serviceable levels of debt and predictable cash flows.

Investing in high-quality companies that deliver slow and steady growth can help you ride out any market turbulence. If you invest in individual shares this can be a risk as you are relying on the performance of one or just a few companies. It can also be costly as you have to pay every time you buy and sell shares. One solution is to invest in a mutual fund that pools investors' money together and is invested in a wide range of companies, which can help spread risk.

Fund managers spend their time and expertise in understanding the companies that they invest in, particularly looking at the underlying value of a business and the current share price. This, together with expertise from their investment teams, allows fund managers to look out for signs of an investment bubble.

3. Don't go chasing returns

It is important to carefully consider your reasons for investing before you take the plunge with something new. The fear of missing out (FOMO) can play a big part in making investment decisions and can lead investors to make irrational decisions. It's easy to get caught up in the hype especially if the price is rising substantially and everybody else is piling in, but the best thing you can do is to avoid following the crowds.

Make sure you stop to think. Ask yourself: are your expectations for returns being driven more by speculation rather than the asset's fundamental value? If an investment looks too good to be true it probably is, so you want to be careful about jumping on the bandwagon.

If you want to minimise the impact of a bubble use self-discipline. Don't let your emotions dictate your investment decisions.

4. Diversify

One of the best ways to avoid being hit by market volatility is to make sure your portfolio is invested in a wide range of assets. If your portfolio is weighted to one particular asset it potentially leaves you open to market shocks. By diversifying your assets you can help minimise the impact of a stock market bubble bursting.

It's important to maintain a balance of asset classes (often referred to as 'asset allocation') that are aligned with your investment goals and tolerance for risk. Your financial adviser should ensure your portfolio contains a range of assets, including equities, government and corporate bonds, alternatives and cash, depending on your risk and investment objectives.

5. Rebalance your portfolio

As the value of stocks rise this can result in your asset allocation being off target. This could leave you overexposed to a particular asset classes, increasing your investment risk.

Rebalancing your portfolio involves selling investments and replacing them with new ones so you restore your portfolio to its original mix of asset classes. It also helps ensure your portfolio remains in line with your attitude towards risk and keep your portfolio on track to achieve your goals.

By doing this, a bubble won't overinflate an investment to the point where it has significant impact on your portfolio.

6. Invest for the long term

In 2020, stock markets around the world plummeted as coronavirus panic spread, with many indices seeing their largest declines since the 2008 financial crisis. However, after the turmoil stock markets rebounded, with many indices reaching record highs. This highlights the importance of keeping your nerve when markets are plummeting and not selling. If you had sold when the stock market was falling last year, as many investors did, you would have ended up losing money.

The market downturn caused by the Covid-19 pandemic was one of the worst in history, but it also proved to be one of the fastest recoveries. While a stock market crash can be unnerving it is not a sign of imminent financial collapse and doesn't mean all of a sudden that stocks are not worth investing in. When the markets are spooked investors should make sure they avoid panic-selling and focus on the long term. Staying invested when there is downturn can help you get through any turbulent times and put you in a good position to benefit from any ensuing recovery.

7. Seek financial advice

If you are worried about stock market bubbles, a financial adviser from The Openwork Partnership can help you with your investment decisions and navigate any market turmoil.

They can put together a financial and investment plan that is in line with your financial goals and attitude towards risk.

If the markets take a downturn they can reassure you and help make sure you get the best returns for the level of risk you are comfortable with and make sure your portfolio remains in line with your attitude to risk.

About Omnis

Omnis is a specialist investment company providing **high-quality** investment solutions that are **available exclusively through financial advisers** that are part of The Openwork Partnership and 2plan wealth management. We focus heavily on delivering **steady returns** for our investors, with a clear focus on risk management.

Our funds are available as part of **well-diversified portfolios**, and all have a **long-term investment horizon**, which we identify as at least five years. When you invest in our funds through a diversified portfolio, these will always rebalance and your adviser can provide further details of how this works for your investments.

You can find out our **latest investment thinking** here.

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