Random Walk

Better to Watch Than Blow It

# The Trouble With Bubbles

by James D. Miller

**Oil, housing, Internet stocks — have their price histories been corrupted by bubbles? Bubbles supposedly occur when an asset's price keeps rising even though it's already well above what the fundamentals justify.**

Imagine there's a stock everyone agrees is worth around $10 a share. The stock's price, however, starts steadily increasing and rises considerably above $10. Investors normally would sell the stock, driving its price back toward $10. But pretend that for whatever reason, investors expect the stock's price to keep rising. Existing stockholders would hesitate to sell, and new investors would buy shares, further pushing up the stock's already artificially high price.

Expectations inflate bubbles, because if everyone expects a stock's price to increase, investors might take actions that indeed cause the stock's price to rise.

In the long run, however, bubbles always burst, as a company's profitability ultimately determines its market capitalization. So the key when playing such stocks is to sell just before the bubble pops. But that happens when many investors sell, so to profit you actually need to get rid of your shares before most other people do. Of course, not everyone can win at this game.

Individuals are at a debilitating disadvantage when playing for bubble riches. Big investors such as hedge funds have far more information about when investors will likely move out of artificially expanded stocks. Retail investors, therefore, probably shouldn't buy an asset just because they think a bubble will raise its value.

The most famous possible bubble of modern times was related to Internet stocks in the late 1990s. Many thought the dot.com stock prices of that period were much higher than anything that could be warranted by expected future profits. But if only one or two of the small Internet companies that were started in the 1990s had turned into another Microsoft, the astronomical values of dot.com stocks would have been justified.

Billionaire currency speculator George Soros believes we're currently experiencing an oil bubble. Under his theory, speculators are buying up lots of oil and storing it with the expectation that prices will keep climbing, and oil prices are rising in large part because of continued hoarding by speculators. But some economists, such as *New York Times* columnist Paul Krugman, think that fundamentals in the market — namely, high demand induced by economic growth in countries such as China and by the failure of oil companies to find large new supplies — are causing high oil prices.

And what of a housing bubble? Some analysts believe the bursting of such a phenomenon caused the current fall in housing prices. But perhaps the initial increase in prices was because of low interest rates, expectations of healthy long-run economic growth and the belief that the subprime-mortgage market operated efficiently. Then when views concerning the last two factors changed, housing prices fell. Under this theory, the fundamentals of the housing market, not a speculative bubble, caused the steep rise and fall of prices.

The biggest problem for investors seeking to profit from any bubble is identifying when an asset is bubble-inflated. It's easy to point to a fast rise and quick fall of an asset's price and shout, "Bubble!" But such a market trajectory might have resulted from investors acting rationally on changing information. So the best advice for ordinary investors is not to play the bubble game. B

Voice of the American Shareholder

More Stockholders Get a Say on Compensation

# The Incredible Shrinking CEO Raise

by Kate Fitzgerald

**Individual investors have long complained that CEO pay is out of whack with corporate results. This year is no different, as research shows chief executive compensation soared while the stock market sagged. But shareholders who fear nothing will be done about outlandish paychecks should cheer up.**

A growing number of U.S. companies are adopting resolutions enabling shareholders to vote on executive compensation packages. And on the presidential campaign trail, Sens. Barack Obama and John McCain both have supported initiatives that would give shareholders a voice on executive pay. The upshot is that when corporate results are dismal, CEOs would be less likely to take home record-busting rewards.

Last year median annual compensation for CEOs of S&P 500 companies rose by 5.6 percent, reports the Corporate Library, an executive-compensation research firm in Portland, Maine. With stock options added to the mix, the median package increased 15.9 percent. Although those raises might seem eye-popping, the growth