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.

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 rate of S&P 500 CEO pay actually slowed last year over the previous year, according to the Corporate Library. In 2006 median annual compensation increased 9.3 percent over 2005. With equity awards thrown in, the median CEO package increased 23.6 percent.

"One reason for smaller gains could be falling stock prices," says Paul Hodgson, a senior research associate with the Corporate Library, "which rendered many stock options underwater."

The slowdown in CEO pay increases is also the result of new Securities and Exchange Commission rules effective last year that require more-detailed reporting about executive compensation, says Stephen Davis, project director for the Millstein Center for Corporate Governance and Performance at the Yale School of Management in New Haven, Conn. Another factor dampening the increases, he adds, is pressure from shareholders demanding CEOs be paid based on their performance.

Last year Aflac's board of directors adopted a resolution giving shareholders approval of executive compensation. In May 2008 Aflac conducted the first stockholder vote on executive pay by a major U.S. company, and 93 percent of shareholders approved CEO Dan Amos' $12 million compensation package. Shareholders have filed similar "say on pay" proposals at more than 90 U.S. companies since last year.

The votes by stockholders on executive pay are nonbinding, but analysts say a steady movement toward majority rule on director elections is giving teeth to shareholder opinion.

"Until recently, most companies had Soviet-style elections, meaning that a director that fell out of favor could stay in place with just one vote cast for him or her," Davis says. "For the first time in the history of corporate America, votes for directors are meaningful.

"So if a board decides to ignore a clear signal from shareholders that they've got executive pay wrong, they may very well see consequences."

For its CEO pay research, the Corporate Library analyzed executive compensation data from 614 companies that filed proxy statements in the first quarter of this year.

Footnotes

How Long Is Long Term?

Time Keeps on Slippin'

by Linda Goin

When tech stocks were going gangbusters a few years back, I picked one that I had watched for all of two weeks and put every cent into that puppy. Imagine my shock the next morning when I discovered I had made $800 overnight.

The same thing happened a few years later. I put all my discretionary cash into a "hot" stock and made $900 while I slept. So you might imagine my difficulty with the concept of long-term investing, especially when my current long-term holdings can't touch my overnight successes.

I'm a failure, in fact, at long-term investing. I always enter the market right before it slides downhill, and I always need to sell some stock holdings to pay for a new toilet or some other necessity before the market has time to head north again. Mainly, though, I fail because I'm not sure exactly how long this long-term investing should last.

A newscaster this past week defined long-term investing as "longer than five years." I read elsewhere it meant more than 10 years. Warren Buffett — the billionaire who lives in the same house he purchased in 1958 for $31,500 — probably believes it lasts longer than his mortgage.

To a student, college represents a long-term investment. Four years is an eon to a teen-ager. Then again, so is that three-month stint at the local burger joint during summer break. New parents look at 18 years as a long-term investment, because that's when their child will most likely leave home. But soon those parents realize that four years of college arrive after those 18 years, and they begin to recognize their mortality: Will they live through the next 22 years?

According to the Death Clock, a quick online survey, I will die on Wednesday, Jan. 25, 2034. This means I might be around for that newborn's college graduation, and it also means I have a quarter-century left to devise yet another long-term investment strategy.

The concept of long-term investing, though, changes for those over 50. Take the time-honored notion of a person's ability to increase her earnings exponentially if she invests early in the stock market. If, say, two people invest $2,000 per year at 8 percent interest, the 25-year-old will make, well, much more money than the person who begins to invest at age 55. The younger person — in theory — has more time to enjoy the value of compound interest.

But time is slippery (as are interest rates). For instance, the average human sleeps six to eight hours per night. If you add it up, that means sleep takes up a full third of a person's lifetime. Sleep makes long-term investments, by any definition, seem short. They are, in the long run, relative — which is why I always keep one eye open for the possibility of another one-night wonder.