
Bubbles or Just Expensive Assets?

The B word is splashed around all over the place these days. Too often, in my view. Bonds are a bubble. Stocks are a bubble. Sydney property is a bubble, too, haven't you heard?

There are, of course, plenty of historical financial bubbles that everyone now agrees on. Think sub-prime lending, tech stocks and tulips. But that agreement only arises ex-post. How do we define and identify a bubble before it bursts?

Cliff Asness has the most coherent explanation I've read. I was watching a video with the US hedge fund manager on [Conversations with Tyler](#) (value investing heretic alert, Asness is a student of Eugene Fama, the author of the original efficient market theory, and a successful momentum trader) when he was asked to identify a bubble in the world today. His response was refreshing - "There's nothing I feel is very, very likely to be a bubble" - but, more interestingly, he went on to explain how he defines a financial bubble.

Many in our field, have I think, dumbed the word bubble down to mean something we think is kind of expensive. That's not a bubble.

A bubble to me is something still subjective, because your answer may not be the same as mine, but is something [where] I've tried my best to come up with future assumptions of growth, be it for a stock, inflation if it's a bond, and current price, and I can't come up with assumptions that would lead any rational investor, subjective again, to want to own this.

When we did that for stocks, anywhere late '99 to 2000, we assumed very aggressive future returns. We took Wall Street's long-term forecasts, which were nuts, they had never been achieved before, current prices, and we came up with, if that happens, we make less than bonds. We were willing to use the word bubble now.

I like that definition. Assume the most optimistic assumptions you can and, if you still can't make a case for investing, it's only then that you can call something a bubble. Plenty of assets are currently expensive, but you couldn't call them bubbles by that definition (my wife and I do pay a sub-2% rental yield on the Sydney apartment we live in, but you could still assume enough rental growth to - just - give you something mildly sensible). Asness explains further with reference to current bond prices:

COWEN: A lot of people from the hedge fund world, they speak to me. They say, "Tyler, interest rates, or rather bond prices are a bubble," because of course right now the low

rate is at zero. It's not going to go down much below that. It could go slightly negative. There's a fear right now we're living the world's biggest bond bubble.

Now, personally, I don't think this at all. But what's your opinion?

ASNESS: I'm going to be real careful, again. I do not think the word bubble is justified. That's not careful. That's overly bold, actually. Having said that, I've got to be clear. When I say I don't think it's a bubble, I'm not saying I think this thing is great.

When I talked about bonds, I said they were more expensive than 90 percent of recorded history. Actually, the low 90s, now. That is not a commercial for forward-looking bond returns. That is saying I reserve the word bubble for something that cannot work out.

I sit down and I go, how would it work out for a bond investor? It's very hard to work out for a cash investor. You've got me there. But cash is largely — it's a government set rate. It's not a market rate.

COWEN: It has other services, right?

ASNESS: Yes. But bonds, how would it work out for a bond investor from here? We look at these ridiculous [2 percent?ish kind of nominal yields](#).

For me, to come up with a scenario, not a prediction, not something I think is a good bet, but a reasonable scenario that could happen in the next 20 years, for instance, for a workout, I need one word. Japan. It wasn't that hard.

COWEN: Sure.

ASNESS: If your standard, like mine, is a bubble is something where you can't really come up with a plausible scenario where this investment might work out, it's proof by contradiction. We just ended it.

Asness's definition of a bubble also got me thinking about the other end of the spectrum. When can we call something an absolute screaming bargain? Flipping his definition on its head, I'd say only when you assume the worst possible scenarios you can imagine and you still can't up with a way of losing money. Now that we can call a lay-down misere.