

The Unbearable Lightness of Bubbles

Stockholm (HedgeNordic) – The Swedish House of Finance (SSE) hosted a timely and highly topical seminar entitled *Bubbles in Theory and in Markets* with Jungsuk Han, Associate Professor of Finance, and Torbjörn Iwarson, Commodity Market Specialist at Skandia Investment Management.

Their presentations gave their perspectives of asset price bubbles, in academia on the one hand and the commodity markets on the other hand. They also showed how little has changed since the days in which Charles Mackay's *Memoirs of Extraordinary Popular Delusions and the Madness of Crowds* and Charles Kindleberger's *Manias, Panics, and Crashes* were written.

According to Han, Bubbles are said to occur when asset prices are more than what is justified by fundamentals, although no agreed-upon definition exists. He argued that the real fundamental value of an asset is not known with certainty, agents disagree on forecast cash flows and use different discount rates reflecting individual preferences and wealth, etc. This contributes to making it hard to detect Bubbles with certainty in advance. Han pointed out that bubbles are theoretically not possible with the assumptions of perfectly efficient markets and rational expectations, although most academics don't believe in this and there can be temporary dislocations.

Han distinguished between irrational and rational Bubbles, where in the latter case people know it is a Bubble but still invest because it is caused by sustainable market imperfections and constraints on arbitrageurs. Irrational Bubbles sooner or later burst but rational bubbles may not, depending on changes in the forces behind their creation. Han suggests that investors should avoid irrational Bubbles because market timing is tough, but that it's optimal to invest in rational bubbles because it's profitable offering a premium for risk and increases available investment opportunities.

Bubbles are dangerous when they cause misallocation of capital through overpriced assets, and they create bad aftermaths with illiquidity after bursting. But Han argued Bubbles can be useful when they fill a gap in inefficient markets, offering new investment opportunities where traditional financial instruments can't. He also suggested that Bubbles might help to promote technological innovation with positive spill-over effects on society. Sometimes Bubbles may not be beneficial to individuals when they may be favourable for society as a whole.

Han argued that Bitcoin is a Bubble, with a combination of irrational and rational elements to it. Money is a sustainable, rational Bubble, and shares the characteristic with Bitcoin in that it doesn't have a fundamental fair value, but has a price above zero. Currencies are legal tender backed by central banks, but Bitcoin's sustainability depends only on the confidence of investors. Blockchain technology helps Bitcoin to be useful and adds to investors' trust, but doesn't ultimately guarantee its success. He concluded that it's too early to tell whether Bitcoin will be a success, but argued that we should consider investing in rational Bubbles and that not all Bubbles are bad.

Iwarson provided a discourse on Bubbles from a seasoned veteran commodity investor's perspective. He observed that asset managers must be trend followers as they cannot tolerate underperformance for long and so must follow momentum. It's often difficult to confidently identify what genuine progress and innovation are, and what a Bubble is in advance of any burst. Typically the bursting of a Bubble involves the search for blame (system, instruments, bankers) and increased regulation. Politics and central banks sometimes play a part in creating Bubbles. He concluded by suggesting that Bubbles are social phenomena and we just have to live with them.

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