

Fear of Crashes and Bubbles is Bad for Health

This post is authored by Christian Kahler, chief equity strategist of DZ BANK and instructor at [European Investing Summit](#). Christian is among a small group of sell-side practitioners who embrace value investing. He publishes [VALUE IDEAS](#) research.

If you ask experienced investors what occurs to them spontaneously regarding the equity market in the eighties they would presumably say “the October crash of 1987.” Bond investors harking back to the nineties often mention the bond market crash of 1994. Is it worth investing in the emerging markets? – A currency crisis like that in 1997 could be looming. Tech stocks around the millennium? Wild dreams about the possibilities of the internet that were followed by a crash. The financial crisis and the Lehman bankruptcy in 2008? Bankers carrying cardboard boxes out of a skyscraper, including a stock market crash, German state-owned banks were also involved.

Even those investors who were not directly involved in these events (e.g. the millennials) are constantly reminded of them. Television images and newspaper reports of anniversaries or interviews with the “crash prophets” have burnt these memories permanently into the brain-synapses of many an investor and non-investor. Who is interested if the crash experts proverbially predicted “15 of the past two” collapses correctly? After all, they need to be mentioned to justify their existence. Such observations are all-pervasive. It is often a case of the newspaper publisher’s motto “a successful aircraft-landing doesn’t sell.” Only crashes make the headlines. Gold is then played as the trump card as an investment vehicle – as though the much-cited baker during the war could with impunity pile up gold ingots in the cellar for the bread rolls he sells. This argument goes down particularly well with German investors, after all the experience of hyperinflation in the twenties has been passed down by word of mouth and in writing from one (investor) generation to the next.

In fact, the DAX and S&P 500 rose three and fourfold in the “awful” eighties. In the nineties things went even better before a few disappointing years came after the millennium. Since the beginning of the seventies German shares have increased by a factor of 26, in the case of the S&P – including dividends – they have even risen 125 times on initial prices. This corresponds to annual returns of 7.2% (DAX) and 10.8% (S&P 500). In the long term, no other asset class can boast such a good performance. The bond markets and the emerging markets, which stumbled at times during the nineties, have since then also generated high returns and in some cases have even outperformed shares. With hindsight, the aforementioned crashes during the past thirty years of the capital market’s history were often no more than mere anecdotes which, with the exception of the 2008/09 crash, had no dramatic consequences for the medium-term performance of the real economy in the highly industrialized countries.

In the global equity markets – similar to the global property markets – there are always temporary exaggerations. At the moment, these are possibly to be found in the USA among the “FANG” stocks. These days such “super firms” play a major role in the equity market. But they differ from those involved in the “dot.com” bubble of a good 17 years ago such as “Pets.com” and similar firms which at that time lived from exorbitant promises but did not earn any money at the operating level or in the worst cases did not even generate any sales revenues. Today, the top-5 companies occupy globally dominant positions which already generate high levels of profitability (e.g. Apple) or which may do so in the future (Amazon).

Looked at from today’s point of view these companies operate in markets in which broad-based growth

can still be achieved in the coming years. Today these companies are already sitting on huge cash cushions. To put things in perspective: at around USD 500 bn the net cash positions of the six-biggest US companies (including Berkshire Hathaway) would be enough to buy at a single stroke the six-biggest German companies in the DAX (SAP, Siemens, Bayer, BASF, Daimler, Allianz) at today's market prices.

Today it is already foreseeable that the next few years will bring many technological breakthroughs in technologies such as blockchain, artificial intelligence, autonomous cars or virtual reality. Combined with more powerful resources (batteries, computing power, data storage, sensors, cameras etc.) and "end consumers" that can be reached by smartphone or in their cars, these technologies are set to create yet more giant sales markets.

At any rate, there is no sign of a broad-based bubble or "naivety-driven bull market" or similar in the equity market. Signs of a bubble include:

- The product is "hip" and it will bring about a "sea change"/ a change of paradigm.
- Stock prices have already risen exponentially within a short period of
- Valuation is not possible using traditional methods (change of paradigm: "this time is different").
- Demand exceeds supply many

At the moment these arguments may possibly hold in the bitcoins market, but certainly not for the broad equity market. On the contrary: German investors still appear to find it hard to shift capital into shares with a current DAX PER of 12.5 points. Widespread market euphoria is something else.

"Shares are the work of the devil?"

If a share is bought "at the wrong place and at the wrong time," i.e. in the form of a bad company at too high a price and with a short investment horizon then the chances of significant price losses are indeed not insignificant. This was the case across a broad front during the dot.com bubble at the end of the nineties. But if shares had been bought from *a large number of* good companies from *different* sectors (key word: diversification) at a fair price (it need not always have been an extremely low price) and if they had been held for a long time, then on average such shares would often have become assets with a high return. *Share-price fluctuations*, which have nothing to do with a company's true performance over the short term, need to be disregarded. Economies grow as long as there is progress and competition without serious military conflicts. The longer the time horizon of an investment in equities, the nearer the returns on equities come to the earnings of the underlying "business." The purchase price is then of secondary importance. More important is that the "compound interest effect" is not interrupted.

Naturally errors also occur with this type of strategy. Many US value investors call these "errors of omission" (e.g. not having had Facebook, Apple and Amazon shares in the portfolio) or "errors of commission" (e.g. holding Nokia or Arcandor shares for too long). This has a negative effect mentally (who likes to miss a "100-bagger") or in terms of hard cash. Scientific studies show that the negative emotional impact of suffering share price losses or missing "homerun" investments activates the same areas of the brain that deal with mortal danger.

But investors that bet on many shares (=an index) at the same time will on average always win in the long term. True to the Dalai Lama's principle "there are many ways to nirvana" no investors should have only Apple or Amazon in their portfolio if they want to increase their wealth – there are enough other good companies. The lower the purchasing price the higher prospects of price gains are. The purchase price is in turn dependent on the degree of uncertainty in the equity market. Good sentiment

and good purchase prices usually rule each other out. Investors who invest rationally do not like (market) optimism as this is tantamount to high prices and thus the prospect of below-average returns. A significant correction is ideal for stock purchases.

Compared to professional investors, private investors have the advantage that they do not need to score investment successes within a twelve-month horizon, but only over the long term, including taxes and inflation. As a rule, they are net savers over several decades and do not need the assets until pensionable age. It is, therefore, a good strategy – especially for private investors – to buy into the equity market patiently and regularly.