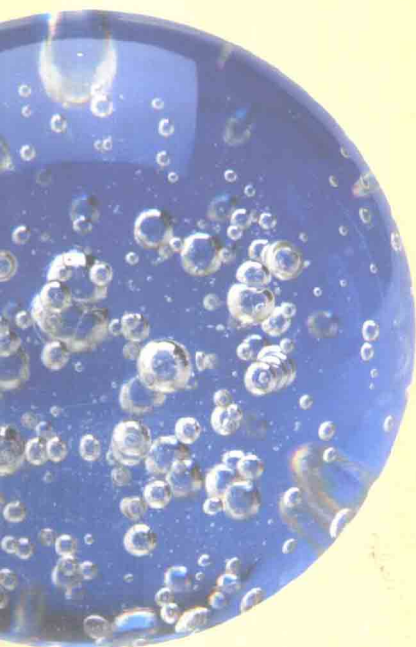


BUBBLOLOGY



THE NEW
SCIENCE
OF
STOCK
MARKET
WINNERS
AND
LOSERS

VIN HASSETT

BUBBLEOLOGY

THE NEW SCIENCE OF STOCK MARKET
WINNERS AND LOSERS

KEVIN HASSETT

A CROWN BUSINESS
BRIEFINGS BOOK



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PRAISE FOR BUBBLEOLOGY

“How stocks are valued is a core question for economists, policymakers, and investors. Kevin Hassett’s highly readable book translates insights from research on asset pricing to bridge the divide between academic and popular discussions of ‘bubbles.’ In addition, the book’s clever and understandable discussion of effects of uncertainty on valuation is well worth the read.”

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“Kevin Hassett has a remarkable capacity for making complicated ideas accessible. His lively writing in *Bubbleology* brings deep insights to bear on important questions of interest to finance professionals and individual investors, and in the most entertaining way imaginable.”

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There are only two types of stocks: those safe from bubbles and those that are not. This is a fact of investing many discovered as they saw their fabulous gains whittled away by the extreme calamity of the Internet sector.

But what about the future? Is there a way for investors to capture the enormous potential for profit that exists at the frontier of the economy, the place where innovation and genius operate, without placing their fortunes in jeopardy? Is there a way to evaluate price increases—and declines—and identify whether they are happening for good or bad reasons?

Bubbleology makes it possible to separate the winners from the losers. It is a brilliant, practical, and original analysis of the stock market that bashes the conventional wisdom about bubbles, showing that such famous examples as Tulipomania were not, in fact, bubbles at all.

Bubbleology shows that the traditional way of evaluating risk—equating it with volatility—is inherently flawed and incomplete. If a stock fluctuates a lot in price it is regarded as risky. If the price is stable, then it is not. What this simplistic way of thinking leaves out is the simple fact that companies trying something completely new that may fundamentally alter the economic landscape are operating at the frontier. The stock of such a company swims in a sea of ambiguity, its circumstances uncertain, since there is little to provide guidance about the future. But when nobody knows for sure what will happen, pundits tell us again about Tulipomania, the South Seas Bubble, and now the debacle of the Internet to scare investors away from potentially enormous profits. To

(continued from front flap)

realize those profits, however, investors have to understand the role that uncertainty and ambiguity—the absence of reliable information about future events—play in the modern stock market. Those who equate ambiguity with bubbles will miss the great opportunities of the future.

Bubbleology provides a new way to observe what is really going on in the market, enabling you to understand whether a stock or a sector is suspicious—whether it is in a bubble and therefore something to be avoided. Finding bubbles requires knowing where to look and what to look for.

Bubbleology will help you avoid both streaming into speculative manias and shying away from perfectly good business opportunities. It tells you why you need to avoid both pontificating pundits and overconfident stock analysts. With this unique and forward-thinking book, you can inspect suspicious stocks, accurately discern risk, and diagnose a blossoming bubble before it vanishes along with your money.



KEVIN HASSETT is a resident scholar at the American Enterprise Institute who formerly served as a senior economist at the Federal Reserve Board. He received his Ph.D. in economics from the University of Pennsylvania. He is the coauthor of *Dow 36,000*.

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**For my family: John, James,
and Kristie Hassett**

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BUBBLEOLOGY

Preface

When stock prices soar, investors are confronted with two competing pieces of conventional wisdom. One comes from a media that always makes bad news out of good. Higher prices signal a “speculative bubble,” and the forward-looking implication is clear: Soon the bubble will pop and only a fool would stay in the market. On the other hand, investment professionals—many of whom have been trained in our top business schools—tell us not to worry. The market always works. Higher prices reflect the wisdom of the omnipotent market gods. Question the market and you are committing blasphemy. Investors are assured that if they repeat the holy mantra “buy and hold,” everything will turn out fine.

Both cannot be right. Deciding whom to believe is one of the most important choices that we make. Yet there is so little to go on if one relies upon the popular debate. Most of all, the motives of these debaters are highly suspicious. Many who claim to see bubbles desperately believe that

the capitalist system itself cannot be trusted, and secretly hope it will fail. Defenders of the market are often those who will profit the most if an investor decides to buy stocks.

Who should be believed? Is there a way for investors to evaluate price increases and price declines and identify whether they are happening for good or bad reasons? Is there a way of thinking about stocks that would have enabled investors to profit successfully from stock market investments without exposing their fortunes to the risk of extreme calamities like the collapse of the Internet sector? These are the questions that motivated the writing of this book.

The questions come up almost every day. In October 2001, for example, the share price for Yahoo!, the Internet search engine, doubled. Did the price rise for good reasons, or was another bubble forming?

Now, more than ever, the answers are within our grasp. A few simple tools can help the prudent investor separate the wheat from the chaff and avoid investing in sectors or shares that are more likely to be affected by a bubble.

The book relies upon a large but recent scientific literature. While the angry partisans have debated bubbles in the popular press, a quiet revolution has been brewing below the surface. Feisty scholars from many different fields have spent the past decade developing new tools for the analysis of stock markets, and the fruits of those efforts are bountiful. This work has mostly stayed out of the public eye, buried in technical papers with more equations than words. Some of the best work has even been done by physicists. Yet the information contained in these