

# Bubble, fly away...

"I can calculate the motion of heavenly bodies, but not the madness of people."  
Sir Isaac Newton<sup>1</sup>



Donald Farley, B.Sc.  
Wealth Management Advisor  
Professionals' Financial – Private Management  
dfarley@professionnels.com

What is a bubble? Is it a recent phenomenon, and would it be wise to believe that we will no longer fall victim to bubbles? And what are the consequences when a bubble bursts? Recently, many articles have appeared in specialized publications suggesting that a bubble may be developing in the financial markets. Let's examine the situation.

## Attempted definition

*A phenomenon characterized by the futile pursuit of excessive profits via a tangible vehicle (land, buildings, works of art) or an intangible vehicle, with maximum complacency about the risks involved.*

Without claiming to have the best definition, I believe it must invariably include the elements of risk and complacency. The profit motive, reckless risk taking, and herding behaviour seem to me to be essential ingredients in the formation of bubbles.

Regardless of the form they take, all bubbles have an impact on the economy. The most recent, the real estate bubble in the United States, had a devastating effect, like the technology bubble of 2000 or, worse, the stock market bubble of 1929. But what about older bubbles?

<sup>1</sup> It is interesting and sad to note that Newton apparently lost 20,000 pounds sterling (a substantial sum in 1720!) following the bursting of the South Sea Bubble, which involved a company having a monopoly over trade with South America.

## The origin of bubbles

The first stock exchange was established in Amsterdam in the Netherlands. In 1609, Dutch bankers accepted shares of the VOC company (United Dutch Chartered East India Company) as collateral for loans, thus creating the necessary link between the stock market and credit. Twenty-five years later, the first bubble formed. Introduced to Europe in 1634, tulip bulbs from the Ottoman Empire quickly gave rise to a mania among all the social classes in the Netherlands, to the point where the price of a single bulb reached tens of thousands of dollars in today's money. In 1637, however, prices collapsed in a few days, dragging the economy into a depression that would last for many years.<sup>2</sup>

## European bubbles

From 1716 to 1720, two bubbles formed simultaneously: the South Sea Bubble in England and the Mississippi Company bubble in France. Indebted by its many conflicts overseas, the France of Louis XV requested assistance from the Scottish economist John Law. It couldn't have made a worse choice. After creating the General Bank in May 1716, Law began to issue banknotes, taking gold and silver as security. The goal of this strategy was to reduce the deficit by converting debt into equity. Eventually, he issued more notes than he had security and created inflation that benefitted his Mississippi Company, which had a monopoly over trade with Louisiana.<sup>3</sup> Many French citizens invested in the company and quickly got rich. The country's financial problems seemed a thing of the past, until the bubble burst, plunging France into a deep depression and eventually leading to the French Revolution of 1789.<sup>4</sup>

<sup>2</sup> KINDLEBERGER, Charles, *Manias, Panics and Crashes*, 1995.

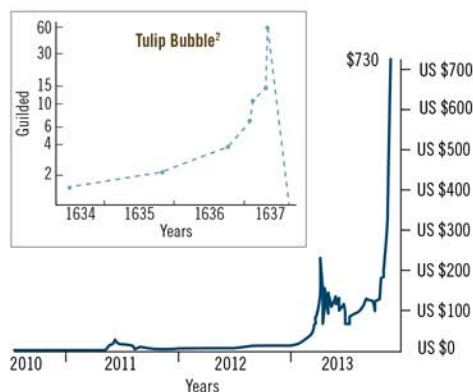
<sup>3</sup> One can see a similarity here with the famous QE of the past few years and its intention to increase the money supply. Readers can refer to my article that appeared in fall 2012.

<sup>4</sup> FERGUSSON, Niall, *The Asset of Money*, 2008.

## Modern times

The story doesn't end there. In 2009, a cryptographer by the name of Satoshi Nakamoto was the first to issue the **Bitcoin**, a virtual currency that is not related to any central bank. Its miners create it by solving increasingly complex mathematical equations. Since early November 2013, the price of the Bitcoin has risen exponentially, reaching a record US\$1,170 on November 28, 2013.

Bitcoin's Evolution<sup>1</sup>



Sources : <sup>1</sup> Coindesk.com, The Wall Street Journal, nov. 2013  
<sup>2</sup> thebubblebubble.com, June 15, 2012

## Some perspective

Bubbles will continue to form, but you can keep control of the management of your assets. Our investment managers are focused on purchasing securities whose intrinsic value is based on the issuer's ability to generate long-term cash flow. Maintain a risk weighting that matches your investor profile and speak regularly with your Advisor or your Advisory Manager. You will thus guard against the possibility of risky investments that are incompatible with your investment objectives. Stick to your action plan and you'll have peace of mind, whatever happens...

After the tulip bubble of 1637, investors at least had a beautiful garden of exotic flowers to contemplate. What will Bitcoin holders have if this currency becomes the next bubble?

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### Montréal

Head office ACDQ - Dentists  
514-350-5050 514-282-1425  
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