

Who benefits from stock market bubbles?

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Stock market bubbles have risen and fallen repeatedly in the past, culminating in painful exchange rate crashes, often with severe economic consequences.

As a result, studying stock bubbles is a critical issue for economic mechanisms. What enables bubbles to form? Is there any indication of bubbles, or are markets efficient, and are these extreme movements a result of rational pricing?

Are the bubbles completely random, or do they form part of a predictable process that can even be attached to considerable advantage? Brunnermeier and Nagel (2004) address these issues in the context of the 2000s technology bubble.

The article is based on three basic statements:

- **By the end of the 1990s, technology stocks were most likely overpriced.**
- **The big investors did not correct the mispricing, but instead bought from the inflated stocks.**
- **They exited the overpriced stocks just in time, implying that they consciously bought from it and were aware that the market was overpriced.**

Many technology stocks had prices that were too high in relation to their fundamental value (price/sales) by the end of 1999, as noted by Nobel Prize-winning economist Robert Shiller in his analysis of bubbles (1981). Furthermore, the price of the same shares plummeted dramatically in 2000.

As shown, there has indeed been spectacular overvaluation, as Shiller (2000) has articulated, resulting in unrealistic

expectations for certain stocks due to media and technological novelty.

How could such substantial mispricing occur? Researchers who support the efficient market theory argue that since it is very expensive to go against a market bubble, rational investors can wait and gullible, less experienced traders over-appear in the market, leading to a bubble.

In contrast, Brunnermeier and Nagel (2004) discovered that hedge funds, which are by far the most informed and powerful investors, did not go against the bubble, stabilizing the market, but instead purchased from these overvalued stocks, driving the market even higher.

This is even possible because the excessively positive sentiment led even hedge funds to overestimate the future of equities and were thus caught off guard by the subsequent crash.

In contrast, Brunnermeier and Nagel (2004) discovered that hedge funds sold their shares before the bubble burst on those stocks, allowing them to sell at a high profit while avoiding the downfalls of the crisis.

All of this suggests that they were well aware that they had been purchasing an overpriced stock. This pattern is well understood in action, as the prices of various stocks peaked at distinct intervals.

Each stock reached its peak at a different time, and as a result, they were able to exit the stock just in time. These conclusions support the theory that rational large investors did not stabilize the market when the exchange rate deviated from its fundamental value, but rather reinforced it.

Furthermore, it all resulted in increased profits for them. As a result, it is expected that they will follow a similar pattern in other situations. This also contradicts the fundamental assumptions of the theory of efficient markets.

No one can deny that the market contains both rational and irrational investors. However, rational investors, according to the theory of efficient markets, always correct the inaccuracies of irrational investors because they can gain a market advantage from it.

Brunnermeier and Nagel (2004), on the other hand, discovered that rational large investors do not correct mispricing and may even reinforce what they do financially well, so they have no incentive to stabilize markets in similar situations.

Brunnermeier, M.K. & Nagel, S. (2004). Hedge funds and the technology bubble. Journal of Finance, 59(5), 2013-2040.

Shiller, R.J. (1981) Do stock prices move too much to be justified by subsequent changes in dividends? American Economic Review, 71, pp. 421-436

Shiller, R. C. (2000). Irrational exuberance. Philosophy & Public Policy Quarterly, 20(1), 18-23.