



Equities

Bubble Logic: Or, How to Learn to Stop Worrying and Love the Bull

August 1, 2000

AQR Working Paper

A bull market, and the incentives of those who make their living from bull markets, can create its own form of logic. That logic, in turn, produces stories that encourage the purchase or retention of stocks or mutual funds. Some stories are honest attempts to explain new phenomenon, others to be unintended falsehoods based on faulty economic reasoning. Some seem less well intended.

The stories, and the analyses behind them, generally originate with Wall Street, sometimes riding academic coattails, and are often readily absorbed by investors engaged in wishful thinking. This has led them to bid up stocks — particularly in the growth/tech sector — so high that even very long-term investors will probably end up disappointed.

Put simply, there are really three possibilities for the broad market (with all three being more extreme for the growth/tech sector):

- 1 Investors understand and are now comfortable with a very low expected return on the stock market going forward.
- 2 We are in for an exceptionally long period of exceptionally high growth in real earnings that justifies today's market prices.
- 3 Most investors are not really thinking about either 1) or 2), but have swallowed the hype and slogans, focused on irrelevant short-term stories, or forced to be in stocks by circumstance (e.g., many mutual fund managers). All this is coming together causing a massive financial bubble. If true, it can only end with a tremendous market crash, or a very long period of stagnation.

The paper argues that 1 and 2 are highly unlikely. Unfortunately, that leaves 3.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC ("AQR") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither

AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.