What goes up...

Many people defy conventional wisdom when it comes to their investments, often piling in on a rising market. Peter Webb applies some common sense

Price is what you pay, value is what you get. In the standard model of common sense, if the price of something rises it gets less attractive; if it falls more attractive. So why on earth do people treat asset prices differently?

When you look at capital markets, very often when a price rises speculators view it as a good signal and buy, anticipating further rises. When the price falls people sell, expecting it to fall further. If prices are going ballistic, they often buy everything they can. Despite flying in the face of common sense, this is OK because you can offload them 'if the market cracks'.

Somehow, all speculators believe they are a better than average player in this game of musical chairs. At the top, as the market turns, people get out. They exit the market not necessarily because they have a view on the market but simply because they can see the turn and others' exposure and want to save themselves.

During the sell off liquidity dries up and the poor liquidity impacts prices. This puts the whole thing into reverse and the market multiplies on the downside, often over shooting in the opposite direction – especially where excess borrowing is used. Long-term thinking is a luxury not available to the highly leveraged; they might not survive that long.

Always focus on yield

Look at investing in residential property at the moment and you will see that people are using lots of leverage and accepting yields on new purchases that simply don't make sense. A lot of net yields are below that of the risk-free rate. That obviously does not make sense.

This is why I always focus on yield, whether that yield is outright or implicit. When the yield is too poor I simply don't buy. If you adopt this strategy it is very likely you will avoid bubbles. Do not concern yourself about capital growth because if you are truly in for the long-term and have made a good investment then a consistent and growing yield will ensure capital growth by default.

It is important to remember that investors as a whole cannot get anything out of their investment except what the investment earns. Between now and when you or your investment expires you will only get out of it what it throws off in cash. You might outsmart the next person by buying low and selling high, but no money would leave the game when that happened; you would simply take out what they put in. The experience of the group wouldn't have been affected at all, because its fate would still be tied to the underlying returns.

Bubbles are always self-limiting because, as the number of participants increase, they bid up the price of the asset. As the bubble inflates the return will move downwards towards zero, so either the yield on the investment needs to accelerate or the size of the bubble needs to reduce. History tells us the latter is more common.

Soft landings are rare because bubbles generally inflate to levels where a soft landing is not an option. You face either years of stagnation or as people see below-par returns they cash in and set off a down wave.

Should central banks step in to puncture bubbles? Most central bankers avoid attempting to define a bubble in case they ruin the 'efficiency' of the market. Also, the underlying return remains unchanged regardless of how much people are willing to pay for it.

So, why should a central bank define what is and is not the right price to pay for an investment? If people want to pay silly prices for a certain rate of return, then why should it stop that? It is up to the investor to decide what rate of return they are happy with.

In for the long-haul

If you are in for the long-term, there is nothing wrong with focusing on the underlying value of an asset rather than its market price. The market is there to serve you rather than instruct you. You choose when to buy and at what price. Remember that as people buy an asset and increase its price, it destroys value for the potential investor – it doesn't create it.

Asset prices have a tendency to fluctuate greatly over shorter periods but over longer periods they roughly mimic the true underlying value, so always invest with this in mind. If you are a longer-term investor the best way to avoid a bubble and take advantage of undervalued assets is simple but not easy. Be fearful when others are greedy and greedy when others are fearful.■

How bubbles inflate to bursting point

The price people are willing to pay for the asset is rising

And so is the return

But nowhere near enough to maintain the yeild

As the risk free rate rises

Our return above the risk free rate shrinks

Asset price	Capital growth	Return	Yield	Risk free rate	Risk premium
£1.00		£0.1000	10.00%	3.75%	6.25%
£1.50	50%	£0.1050	7.00%	4.00%	3.00%
£2.10	40%	£0.1103	5.25%	4.25%	1.00%
£2.80	33%	£0.1158	4.13%	4.50%	-0.37%
£3.70	32%	£0.1216	3.29%	4.75%	-1.46%
£1.28	-66%	£0.1276	10.00%	4.75%	5.25%

If the market price regresses to the original yield you have the potential for a big collapse in price.

A 1.46% discount to the risk free rate means our money would be better off in a savings account.

Soft or hard landing?

% Overvaluation of asset	60%	50%	40%	30%	20%	10%
Underlying growth in yield per annum	5.00%	5.00%	5.00%	5.00%	5.00%	5.00%
Years to recover to 'fair' valuation	18.78	14.21	10.47	7.31	4.57	2.16