What I Learned When the Tech Bubble Burst

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I was driving home the other day and heard an interesting fact during the business report. The reporter said that this past Friday, 2/23/07, marked the first time that the overall stock market reached the level it was at in March of 2000.

If you recall, March 2000 was when the "tech bubble burst." The birth of the internet led to the birth of a number of tech companies whose stock values went through the roof in a pretty short period of time. If you were lucky enough to buy stocks like AOL when they first went public, and sell them at their peak, you turned a very nice profit. Kudos to you. Many people however didn't fare so well. They saw all these other people making serious money on tech investments and they wanted their piece too. They were doing what is called "chasing returns" which means they were hoping that the future returns of a stock would match the past returns. Unfortunately it doesn't always work this way. There was no way that tech stocks were going to continue going up forever at the rate they were going and they eventually reached a "bubble," and that bubble burst. All of a sudden, people were selling these stocks rather than buying them and as demand decreases so does price. Prices dropped drastically over a short period of time and that's why they say "the bubble burst." The people who "bought high and sold low" got killed.

The effect was felt throughout the entire stock market so the entire market suffered a pretty significant decline. It has taken the market 7 years to recover. Basically, if you had invested $50,000 in the stock market on March 1st, 2000, your $50,000 had turned into around $26,000 by March of 2003 and now, on February 23, 2007, you finally had $50,000 in your account again.

> The chart below represents the growth of a 1997, $10,000 initial investment in the Vanguard Stock Market Index Fund. Notice the nice growth from 1997 until 2000, the precipitous decline from 2000 until 2003 and the subsequent recovery from 2003 until 2007.

So What are the lessons to be learned?

Here are some of the lessons I have learned, but remember different people learn different lessons from the same event. For example, some kids who get hit by a pitch playing baseball learn to get out of the way, some learn to play piano. I readily admit that the lessons I learned may not be what a financial adviser learned, but you subscribed to my e-mails so you are stuck reading this. :) Always consult a professional financial advisor when in doubt

(**One important note before you begin.** Throughout this article I will refer to investing "in the market." What I mean by this is that you have a well diversified asset allocation strategy throughout the stock market, not all your money in one place)

Lesson 1. Dollar Cost Average:

The first thing I learned is to not invest my money in the stock market all at one time. Instead I invest a little bit every paycheck. The guy who put all his money in the Market in March of 2000 and sold 3 years later got slaughtered. I also took a hit because my investment also dropped significantly, but the difference between me and that other guy is that I had been putting my money in the market for 10 years already so I paid less for my $50,000 than the guy who put all his money in on one day, plus I haven't sold yet. That may not make sense so let me explain.

Let's say there is me and that other guy, and we both had $50,000 in the market in March 2000. He had just put $50,000 in and I have been putting money in for 10 years. By March 2003 we both only had $26,000 but it was easier for me to deal with that than him. Why? (You should take a second to try and answer this question before you read on.)

The reason is our initial investments were drastically different. He had just put $50,000 in there so his principal was $50,000. My account was worth $50,000 but my principal was much less. Because I had been investing for 10 years, I maybe only have about $30,000 of my own money in there, the rest of my $50,000 represented compounded growth of my investment over the previous 10 years. When the account dropped to $26,000 I was bummed but not suicidal. I knew I had only contributed about $30,000 of my own money so I hadn't lost $20,000, I really only at a little under break even.

Lesson Conclusion: Dollar Cost Averaging is smart and protects you against giant loss during market swings.

(Two quick points: The $50,000 dropping to $26,000 is an estimate of how the market moved after the bubble burst. I'm not sure exactly how much the market dropped and I used those numbers to tell the story but they are in the ballpark. Second Point. You never lose or make money in the market until you sell a stock. When the price of a stock drops, that just means the value of your investment has gone down, it does not mean you have lost money. When you actually sell a stock for less than you paid, it is then that you can say you have lost money.)

Lesson 2: The Market Will *Probably* Go Up Over Long Periods of Time and Will *Definitely* Go Down Over Short Periods of Time.

When the market crashed in March 2000, many people jumped out of the market to try to reduce their losses. Not me, you know what I did? (pause to try and answer)

I kept on buying shares of the Market. Because the market this past Friday was at the same level as it was in 2000, I know that virtually every single share of the Market I bought during the last 7 years is worth more now than I paid for it! The only shares of the market that haven't gone up in value are the ones I bought in March 2000, those ones I have broke even on, all the rest are worth more than I paid for them. By the way, think about the shares I bought back in 1993 when I started teaching (and investing)!

At my last presentation I mentioned that I hope the market goes down for the next 5 years and I got some curious looks, but think about it. If we believe that the market will go up over time, which we don't really know for sure but most economists think that will happen because it always has, don't you want the market going down now? If the market goes down now and I invest my $100 every two weeks then I get to buy more shares for my $100. When the price goes back up I will have more shares of something that is worth a lot rather than just a few shares.

Let me explain that.

Let's say I am going to invest $100 in the stock market each of the next 5 weeks. Furthermore let's say the market is now at $50 per share. Let's take a look at a few possible scenarios.

Scenario 1. The Market Stays Flat

If the market stays flat, each week I will be able to buy 2 shares so in five weeks I will have 10 shares. If each share is still worth $50 per share then my total investment was $500 and my investment is currently worth $500. I have essentially broken even.

Scenario 2. The Market goes down and then back up.

Let's now assume that the price per share follows the following pattern.

Week 1 $50, Week 2 $45, Week 3 $40, Week 4 $45, Week 5 $50.

The current price after 5 weeks is still $50 per share, just like the previous example. Now however how many shares do I own? (you can test your math skills first on this if you like)

Just look at how many shares I was able to buy each week. Week 1 $100/$50 = 2 shares. Week 2 $100/$45 = 2.22 shares. Week 3 $100/$40 = 2.5 shares. Week 4 $100/45 = 2.22 shares. Week 5 $100/$50 = 2 shares. Adding those up I now have 10.94 shares which at $50 per share is $547. Better than the $500 I had after the market was flat for 5 weeks.

Scenario 3. The Market Goes Up and Up and Up

Lets assume that the price per share follows the following pattern.

Week 1 $50, Week 2 $53, Week 3 $55, Week 4 $57, Week 5 $60.

Look at how many shares I was able to buy each week. Week 1 $100/$50 = 2 shares. Week 2 $100/$53 = 1.88 shares. Week 3 $100/$55 = 1.81 shares. Week 4 $100/57 = 1.75 shares. Week 5 $100/$60 = 1.67 shares. Adding those up I now have 9.11 shares which at $60 per share is $546. Also better than the $500 I had after the market was flat for 5 weeks.

The only problem with this scenario is that **THE MARKET IS NOT GOING TO CONTINUE GOING UP FOREVER!** You don't need a financial degree to state that fact.

You can imagine what would happen if the market went down and never came back up. Not good. But the great thing is that over long periods of time the market has never done that. There has **NEVER** been a drop in the stock market that it hasn't recovered from. It recovered from the depression. It recovered from the recession in the 1970's. It recovered from the aftermath of 9/11 and it has pretty much recovered from the "tech bubble" in 2000.

Mathematically, and trust me I am a math teacher, **every single person who has ever continued to invest in the stock market during down periods of the market is glad that they did because they all came out ahead in the end**. There has never been an investor who continued to dollar cost average during market downswings that is upset that they followed that strategy. One caveat. This assumes you have time to stay in the market until the recovery is over. If you are currently taking money out of your account instead of putting it in then this strategy does not apply to you. If you are taking money out then you want to see the market going up not down. That's why most advisers recommend that you slowly adjust your asset allocation from more in stocks to more in bonds as you get closer to needing the money.

Now expand this principal over a number of years. I have been investing in the market religiously for the past 15 years and almost every single share of The Market that I have purchased during that time is worth more than I paid for it. Periods like these past 7 years have been great for me. I know that no matter what the market does over the next 20 years I am going to continue to religiously purchase my shares every paycheck and since I am confident that in 20 years the market will be higher than it is now, I hope the market goes down first to get there. Put another way, if you assume there is a particular level that the stock market will reach in the future, let's say in the year 2020 the market will be at $120 per share. I will be a heck of a lot better off if the market first goes down and then goes up to $120 than if it just goes straight to $120.

Lesson Conclusion: Downswings in the market can be good for the well diversified dollar cost averaging investor so long as their risk tolerance and time frame allows them to continue to invest during the downswing.

Lesson 3: Don't Chase Returns / Don't Put All Your Eggs in One Basket

I have said this for years, "Smart people learn from their mistakes, really smart people learn from other people's mistakes."

I have a friend whose father saw the rising market in the late 90's and decided to get on the train. He reallocated his assets and put a good portion of his assets into tech specific stocks and mutual funds. Do I need to tell you what happened? I said that "the market" has since virtually recovered from the "bubble," but I never said that every individual stock and mutual funds has recovered. The rise of tech stocks created a mania in the late 90's. People made completely irrational investing decisions during that time. Some people forgot all about diversification and asset allocation. They were buying stocks that were ridiculously over priced. Some of these stocks and mutual funds aren't even close to returning to the level they were at in March 2000 and many of the individual stocks went out of business completely.

Here is how a couple of Mutual Funds have recovered from the "burst."

Good Recovery: The high of the Vanguard S&P 500 in 2000 was $144.30 per share. It went down to $75.26 in 2003 and is currently at $132 per share.

Bad Recovery: I you had $30,300 in the Vanguard Growth Equity Fund in 2000 it was worth $9,800 in 2003 and is still only worth $16,700 now.

The type of stocks in the Vanguard Growth Equity Fund have had a harder time recovering from the "bubble" than the types of stocks in the S&P 500. (If you want to test your stock market savvy, can you explain why the Vanguard Growth Equity Fund would take longer to recover than the S&P 500? This is a tough one if you are still new to this.)

My point is not that one fund is better than the other. Don't just invest in the S&P 500 because it recovered quicker than another fund. The point is that if you had had all your eggs in the Vanguard Growth Equity Fund, or worse yet a tech specific fund, you are still well in the hole; which is why you **SHOULD NOT HAVE ALL YOUR EGGS IN ONE BASKET**!

Lastly, if you think you are going to be able to identify which funds, or which sectors of the market, are going to do well, I wish you good luck. When most people hear the term "the latest trend in the market," they think that means it is the most recent trend to be identified. When I hear the term, "the latest trend in the market." I think it means that it's probably too late to get on the trend. Unless you are the one identifying the trend, by the time you hear about it, it's probably too late. It is widely claimed that by the time a stock tip gets to you, the typical investor, that tip has been worked by every fund manager in the world and if it was in fact a good tip it has already been used up. Many of the people who tried to jump on board the "tech stock freight train" did so after it had already left the station, and they got crucified.

Lesson Conclusion: Do not put all your eggs in one basket and do not try to chase returns. Pick a well thought out investment strategy that has appropriate asset allocation based on your age and risk tolerance and stick to that plan regardless of what the market does in the short term.

Parting Words:

I hope some of this article has made sense but more importantly please don't treat this article as advice. I am in no position to offer advice. I know that what I have done has worked for me, but that doesn't mean it will work for you. Talk to as many people as you can and get as much input as you can from people you trust before making any investment decisions. When in doubt seek a professional financial adviser.