The Greater Fool Theory: What Is It?

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Most people are familiar with the term market bubble. In fact, over the past two decades, investors have experienced first-hand two historically significant market bubbles – the real estate market bubble that occurred in the 2000s and the tech-stock bubble that occurred in the late 1990s.

Technically, a market bubble is an economic event in which the prices of specific assets rise dramatically and increase beyond their fundamental value. In general, bubbles are viewed as outbursts of irrationality – self-generating and self-sustaining waves of optimism that drive up asset prices and cause investments to be misallocated. There is no general consensus among finance academics or practitioners as to what causes an asset bubble to form or what sustains the overvalued prices over the life of the bubble. However, one commonly discussed theory related to the continuation of a bubble is “The Greater Fool Theory”.

The Greater Fool Theory is the idea that, during a market bubble, one can make money by buying overvalued assets and selling them for a profit later, because it will always be possible to find someone who is willing to pay a higher price. An investor who subscribes to the Greater Fool Theory will buy potentially overvalued assets without any regard for their fundamental value. This speculative approach is predicated on the belief that you can make money by gambling on future asset prices and that you will always be able to find a “greater fool” who will be willing to pay more than you did. Unfortunately, when the bubble eventually bursts (which it always does), there is a large sell-off that causes a rapid decline in the asset values. During the sell-off, you can lose a great deal of money if you are the one left holding the asset and cannot find a buyer.

Specifically with regard to the stock market, the Greater Fool Theory becomes relevant when the price of a stock goes up so much that it is being driven by the expectation that buyers for the stock can always be found, not by the intrinsic value (cash flows) of the company. Under this assumption, any price (no matter how high) can be justified since another buyer presumably exists who is willing to pay an even higher price.

So as an advisor, should you ever try to implement a greater fool strategy? How do you recognize a client that wants to play the greater fool game? What should you do if your client wants to buy an overpriced stock?

Should you ever try to implement a greater fool strategy?
There is abundant evidence that, with respect to investors, greater fools actually exist. However, this is a very risky strategy that is not recommended for long-term investors. Successfully implementing a greater fool strategy is labor intensive and time intensive. One must pay an excessive amount of attention to markets, because price trends can reverse in minutes. Most clients (and advisors) do not have the time and resources to do that. The greater fool strategy usually is not a feasible or sustainable one for investors that do not have the speculation and market trend expertise of full-time day traders.

Moreover, while speculation based on a belief in The Greater Fool Theory has the potential to make money, there is significant risk that your client(s) could turn out to be the greater fool. When the bubble bursts and the music stops, you do not want your client left standing without a chair.

How do you recognize a client that wants to play the greater fool game?
Greater fools generally are impatient investors that are attracted to stocks that are popular or “hot”. They are not interested in the steady, consistent returns, or value stocks. When markets begin to twitch, these types of clients will want to move on to the next “hot” stock.

What should you do if your client wants to buy an overpriced stock?
It has been well-documented by academics and finance professionals that stock returns are what we call “mean-reverting”. (Which is to say that stock prices move around but they eventually move back to their mean/average price.) When the price of a “hot” stock rises too far above its average, the price will eventually decline. In these situations, it can be useful to remind your client that no one has a crystal ball to predict exactly when a market bubble will burst or when a particular stock’s mean-reversion will happen. Let them know that a greater fool strategy is a form of speculation and that they do not want to be holding the bag when there are no more greater fools left to sell to at a higher price.

Key Take-Aways

- The Greater Fool Theory is a very risky, speculative, strategy that is not recommended for long-term investors.
- While speculation based on a belief in The Greater Fool Theory has the potential to make money, there is a big risk that the greater fool could turn out to be your client.
- Watch out for impatient clients that are only focused on investing in “hot” stocks. Try to educate them on market fundaments, like mean-reversion, and the importance of a long-term focus.

References

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