Google: Another Stock Market Bubble?
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The impressive jump in Google’s stock price over the past year has been accompanied by a massive increase in sales and profits. The stock price fell from $430 to $390 on February 1, but the next day it was back over the $400 mark—90 times more than their profit-per-share figures from 2005.

Five years ago, many investors discovered that the Internet is not King Midas. They also learned the need to analyze Internet-related businesses just as meticulously as any other business venture.

Speculation bubbles, however, started some time ago. When the railway companies began building their tracks, for example, investors had tremendous expectations for the growth of these companies, which led to an incredible surge in stock prices. It was later discovered that the shares were overvalued.

The algebraic expression for the concept of speculation bubbles was developed by Olivier Blanchard, a professor at MIT. It is based on the idea that every equation has multiple solutions. One is the basic solution and the other is the basic solution with a speculation bubble added. The latter shows that the stock price may be higher than its basic value—meaning the current value of all future dividends—if a bubble is simultaneously formed. At any moment, the bubble may: a) continue to grow, or b) burst and evaporate.

So as to not bore ourselves with equations, we can imagine a bubble as an overvaluation of share prices. An investor will buy a share for a price greater than its basic value if he or she feels that it will be worth even more tomorrow—in other words, if that investor expects the bubble to keep growing. And this process will continue as long as there are investors who believe in the growth of the speculation bubble.

It is for this reason that bubbles tend to develop in times of euphoria, when it seems like the only possible trend in the market is growth. But the day eventually arrives when investor confidence disappears and the bubble bursts and evaporates. The shares then return to their basic value.

Many have used this theory to explain the dramatic drop in prices at the New York Stock Exchange and other worldwide markets on October 19, 1987. According to the explanation, the drop in prices is attributed to the bursting of a bubble that had developed over the previous months. A study by Professor Shiller at Yale—in which he interviewed 1,000 institutional and individual investors—corroborates this theory.
The investors who sold before Black Monday said they did so because they felt the shares were already overvalued. Surprisingly, more than 90% of the institutional investors who did not sell also believed that the market was overvalued and were hoping to sell before the inevitable crash. Thus, it seems that more than 90% of institutional investors were aware of the development of a speculation bubble, but were confident that they would sell before it burst.

The bursting of a speculation bubble is a relatively common phenomenon. The most recent example is that of the Internet between 1999 and 2000. The share prices for Amazon.com fell from $106.70 on December 10, 1999, to $5.97 on September 28, 2001. The return for America Online shareholders was -68% between May and October 1996; -51% between April and September 1999; and -90% between December 1999 and July 2002. Meanwhile, Microsoft gave its shareholders a return of nearly 60% from March 1986 to December 1999. That month, the share price was $59.56. A year later, shares were trading at $20.75 and the return for shareholders was -65%.

An investor is willing to pay a price for a stock—which is a piece of paper—if that piece of paper yields money—in steady flows—in the future. Therefore, the value of the share is the total expected influx. If this were not the case, we could compare the shares to sardine cans in black-market during the post-war era in Spain. An anecdote shared with the author by Mr. Rafael Termes serves as an example. A black-marketeer sold a can of sardines for one peseta. The buyer, in turn, resold the can for two pesetas to another individual, who in turn sold it for three pesetas. The can went on changing hands and going up in price until a black-marketeer bought the can for 25 pesetas (an exorbitant amount at that time) and decided to open it. He was dumbfounded upon opening the can to find that it was empty and went running to find the merchant who sold it to him to demand his 25 pesetas back. But he was even more dumbfounded when the seller asked him, “What were you thinking opening that can? This can is the kind you sell, not the kind you open.”