

Michael Anderson
Chief Investment Officer

At Hi-Line Capital Management, our intrinsic-value philosophy and decision-making principles drive how we approach investing and provide guard rails for thinking during periods of extreme uncertainty and volatility. Our piece, *Foundational Decision-Making Principles*, details the seven pillars of our decision-making process and its critical function in long-term success and rationality. *Expecting Price Volatility: Bubbles And Manias*, takes a deeper dive into our second principle to provide clarity and opportunity in today's markets.

How to Think About Markets:

1. Confidence in Long-Term Expectations
2. **Expect Pricing Volatility**

Risk Management:

3. Invest with a Margin of Safety
4. Be Business-like
5. Be Conservative
6. Continuously Assess Risk

Lastly

7. Control the Controllable

EXPECTING PRICE VOLATILITY: BUBBLES AND MANIAS

May 2021

EXECUTIVE SUMMARY

- Bubbles—when asset prices are largely inflated relative to their values—and the mania that accompanies are notably events that cause volatile markets.
- Some bubble ingredients such as cheap money and the “no price too high” mentality are observable in the market today.
- We believe maintaining an intrinsic value approach to investing can help navigate such volatility and actively seek opportunities in pockets of the market.

UNDERSTANDING BUBBLES AND MANIA

The terms bubble and mania are often used interchangeably, and while they go hand-in-hand, they can be described as two separate identities, one fueling the other. We can describe bubbles as mechanical and objective when asset prices are largely inflated and exceedingly detached from their fundamental values. Often, bubbles are characterized in hindsight by a drastic incline in asset prices followed by the “burst”, a steep decline in prices. The system is filled with increased leverage stimulated by cheap money with the tendency of being widespread or popular. Mania can be identified as the psychological, behavioral aspects that are generally associated with a bubble. Mania involves irrational euphoria, risk-seeking attitudes, and the “no price too high” mentality. Arguably, an investor can sense mania-like attitudes and behaviors in real-time, possibly comparable to the current sentiment around NFTs and cryptocurrencies. In addition, some argue we are amid a bond market bubble—driven partly by loose monetary policy. Yet do we see bond investor euphoria for low-yielding bonds? Not quite. Whether behaviors coincide with the infamously coined “irrational exuberance”, or detached valuations equate that to a bubble can only be confirmed in hindsight post the qualifying burst.

Bursts are widely accepted as former bubbles. Historic examples include the notable Tulipmania of the 17th century, Dotcom, and most recently identified U.S. housing market. These bubbles did exhibit manic characteristics, and history tends to bring bubbles and mania together into one event (“bubbles”), however, should there be a distinction, and furthermore, could we have one without the other?

In a corner of the financial world, there are discussions regarding existence of bubbles, questioning the irrationality, and empirically investigating whether they are abnormal and manic events or rational price movements. Despite the debate, what we can conclude is there are undoubtedly times of extreme price volatility, and moreover, there are some so called “ingredients” that point to such periods:

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ABOUT HI-LINE CAPITAL
MANAGEMENT

Hi-Line Capital Management, LLC ("HLCM"), based in Watertown, SD, provides investment management and advisory services for institutional and individual clients. The firm was founded in July 2009, became a registered investment advisor (RIA) with the U.S. Securities and Exchange Commission ("SEC") in March 2010.

EXPECTING PRICE VOLATILITY: BUBBLES AND MANIAS

Bubble Ingredients

- There is no price too high...and rejection of valuation norms
- Good early results...and this can't lose money
- More money than ideas...which bids up prices
- Suspension of disbelief or critical thinking...and fear of missing out
- Pursuit of the new and attractive, belief in the virtuous cycle...this time is different
- Increased leverage and cheap money...aided by monetary and fiscal stimulus
- Very widespread...very popular

CURRENT ENVIRONMENT OBSERVATIONS

We detect bubble-like flags in pockets of today's markets. The "ingredients" observed are the following:

- **Money Supply and Protection from the Fed:** Historically, the growth of money supply approximates the growth in nominal GDP. During COVID, the money supply grew 30% more than the change in GDP...and the money flows to somewhere. Furthermore, if or when the money supply contracts, the money will flow from somewhere. Regarding protection, the prevailing attitude appears to believe the Fed will always be available to "bail out" participants from messy economic situations.
- **Pursuit of the new and attractive:** hot sectors such as cryptocurrency, green technology and digital platforms gain much of the headlines and monetary flows, however, many constituents in such sectors have yet to attain profitability.
- **Attitude – Nothing can go wrong:** A similar attitude observed in current markets is comparable to the past belief that home prices nationwide would not decline. The belief that "nothing can go wrong" further aids and perpetuates high prices detached from fundamental values.

GOING FORWARD

Kept in the context of bubbles and manias and its flags in the current observable market, we believe an emphasis on intrinsic value investing is crucial and guides us through volatile times. Value-based investing principles emphasizing proper temperament, critical thinking and analysis, and being patient to find attractive opportunities provide a guard rail from partaking in investments of detached prices. From the intrinsic value standpoint, there are pockets of the market where we see attractive opportunities that fit our investment criteria. Within these areas, we are keen to keep to our investment philosophy and process while being hyper-aware of our current environment.

We end with a couple finishing quotes:

"The trading favorites of 1928 were high-priced, untried, and unseasoned stocks that made one wonder whether the public did not think that the higher the price the better the stock."
- Edwin Lefevre

"The more intense the craze, the higher the type of intellect that succumbs to it"
- Benjamin Anderson