Why Not to Speculate During Bull Markets: Lessons from Newton and Druckenmiller

It was sometime during late 1999 through early 2000, near the peak of the dot com bubble, the legendary George Soros and his hedge-fund team was working on how to prepare for the inevitable sell-off in technology stocks.

The man in charge of Soros' high profile technology funds was Stanley Druckenmiller – one of the best performing hedge fund managers of all time, till date – and he was busy warning his team that the sell-off could be near and could be brutal.

As the markets soared further in March 2000, Druckenmiller was quoted as saying, "I don't like this market. I think we should probably lighten up." Soros himself would regularly warn his team that tech stocks were a bubble set to burst.

Despite this, when the sell-off finally did begin in mid-March 2000, Soros Fund Management wasn't ready for it. His funds were still loaded with high-tech and biotech stocks. Just in five days, starting 15th March, Soros's flagship Quantum Fund saw what had been a 2% year-to-date gain turn into an 11% loss. By the end of April, the Quantum Fund was down 22% since the start of the year, and the smalle Quota Fund was down 32%.

Post that, in April 2000, Soros said at a conference, "Maybe I don't understand the market. Maybe the music has stopped, but people are still dancing."

Same month, at another conference, Druckenmiller confessed, "It would have been nice to go out on top, like Michael Jordan. But I overplayed my hand."

Here is how Druckenmiller summarized his experience of 2000 in an interview late last year (Nov. 2013) –

> *I bought the top of the tech market in March of 2000 [after quickly making money in the same space in mid-late 1999] in an emotional fit I had because I couldn't stand the fact that it was going up so much and it violated every rule I learned in 25 years.*
>
> *I bought the tech market very well in mid-1999 and sold everything out in January and was sitting pretty; and I had two internal managers who were making about 5% a day and I just couldn't stand it. And I put billions of dollars in within hours of the top. And, boy, did I get killed the next couple months.*

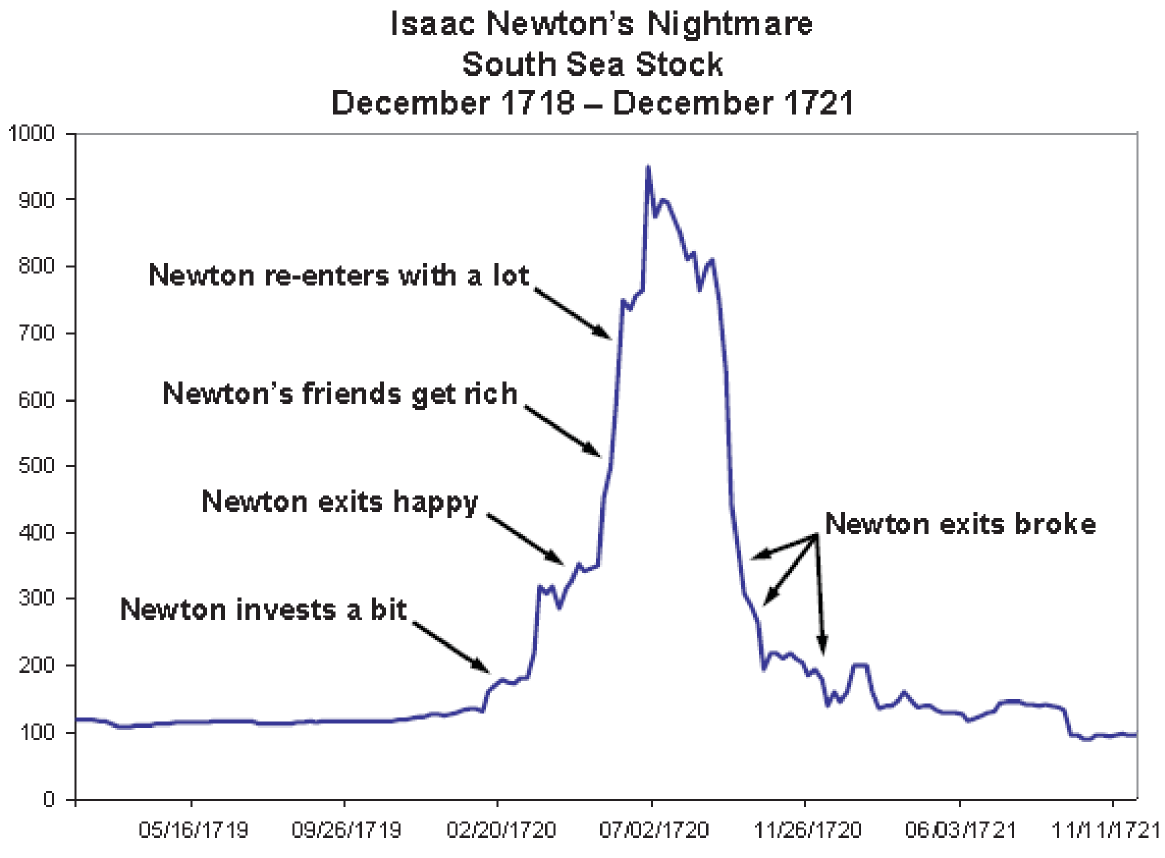
How to Get Killed at the Top, the Newton Way
Let's cut across to the middle of 1720 in Great Britain. Sir Isaac Newton – the inventor of calculus (the branch of mathematics that describes change over time), and the man who framed the laws of motion and set physics on its modern trajectory, put a sizable chunk of his personal fortune into shares of the South Sea Company.

The company had then pursued a new and increasingly risky banking deal – and as insiders began to talk up the trading profits (that turned out fictitious) the company expected from another venture, the stock began to leap, starting January 1720.

The bubble burst that September. Newton lost 90% of his stake, which was a large portion of his total net worth.

Here is how MIT professor Thomas Levinson described Newton's and South Sea's antics in a 2009 article…

> *Newton…made his first investment in the South Sea issue early, in 1713, and held it for several years, marking a modest paper profit. He held on through early 1720…That got the desired result, a sudden leap in stock prices. Starting at £128 in January, the price for South Sea securities rose to £175 in February and then £330 in March.*
>
> *…Newton sold in April, content with his (quite spectacular) gains to date. But then, between April and June, share prices tripled, reaching over £1,000…which is precisely when he could stand it no longer.*
>
> *Having "lost" two thirds of his potential gain, Newton bought again at the very top, and bought more after a slight decline in July.*
>
> *The South Sea stock price held up through August 1720, and then the bubble led by over-expectations of huge returns was pricked in September.*
>
> *…South Sea share prices collapsed to roughly their pre-bubble level. Newton's losses totalled as much as £20,000, between $4 million and $5 million in 21st century terms…It was a terrific blow for Newton.*



What Brought Druckenmiller and Newton Down?
You know the answer, I believe.

During bull markets, or when bubbles are building up, most people come to the stock market because they desire to earn money fast, because they are envious of seeing others doing so.

"If he could make money fast in stocks," one would normally ask during such times, "So why couldn't I?"

If geniuses like Druckenmiller and Newton couldn't stand to watch as others made money, and they carried on with full knowledge that they were purely speculating (re-read Druckenmiller's confession mentioned above), what chance do we non-geniuses have to survive a bubble and its subsequent and certain burst?

The Real Tragedy of Our Life
Charlie Munger says…

> *If you are comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, so what? Someone will always be getting richer faster than you. This is not a tragedy.*

You see, the real tragedy of our life is not that someone else is getting richer or healthier than us, but that he is getting there faster than us.

Another tragedy is that when we fall into this comparison trap, it's hard to stop.

Look at fund managers. Most of them have similar stocks in their portfolios, and each of them still claim to have the skills to outperform others.

Read stock forums. Most of them are filled with noise of people comparing their portfolios with others'.

Why do you think any mention of "5 stocks to buy" or "best stocks to buy now" raises your brain's antennae? This is because you want to compare those best stocks to your exiting portfolio, and buy whatever you don't have already.

This habit of unintelligently buying things because someone else is making fast money on them comes to the fore when the markets have been rising for some time.

Here is what Citigroup's boss Chuck Prince said to a newspaper in July 2007, shortly before the subprime bubble burst…

> *When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.*

So, even as people know that things are not right around them, they keep dancing to the bubble's music because everyone else is dancing and making merry.

After all, not dancing to the rising market's tune is same as underperforming.

After all, isn't it terrible to sit quietly, doing nothing, when some people are predicting the Sensex to touch six-figures soon, and others are dancing to their tunes? Of course, it's terrible!

But if you can't ignore and avoid the temptation that comes from watching other people get rich due to a sharp rise in stock prices, it's best to know sooner than later that that's often a path to destruction.

You can "get killed", like Druckenmiller in 2000 and Newton 280 years prior to that.

Of course, like Druckenmiller did so perfectly, no one can predict when the sell-off is near and how bad it could get, but it's very important to learn from what Druckenmiller didn't do – listen to his gut instead of following the herd.

That's I believe one of the best lessons you can learn on how and why not to speculate, especially when all others are speculating.

After the South Sea disaster, Newton could not bear to hear the phrase “South Sea” mentioned in his presence. But just once he admitted that while he knew how to predict the motions of the cosmos, he could not calculate the madness of the people.

We still can’t…so please be very careful.

Also Read:

1. Speculating In Bubbles With Stan Druckenmiller And Sir Isaac Newton
2. Even a Genius Can Get Suckered