(Un)Happy Anniversary, "Tulipomania" : Bursting Our Bubbles for 380 Years

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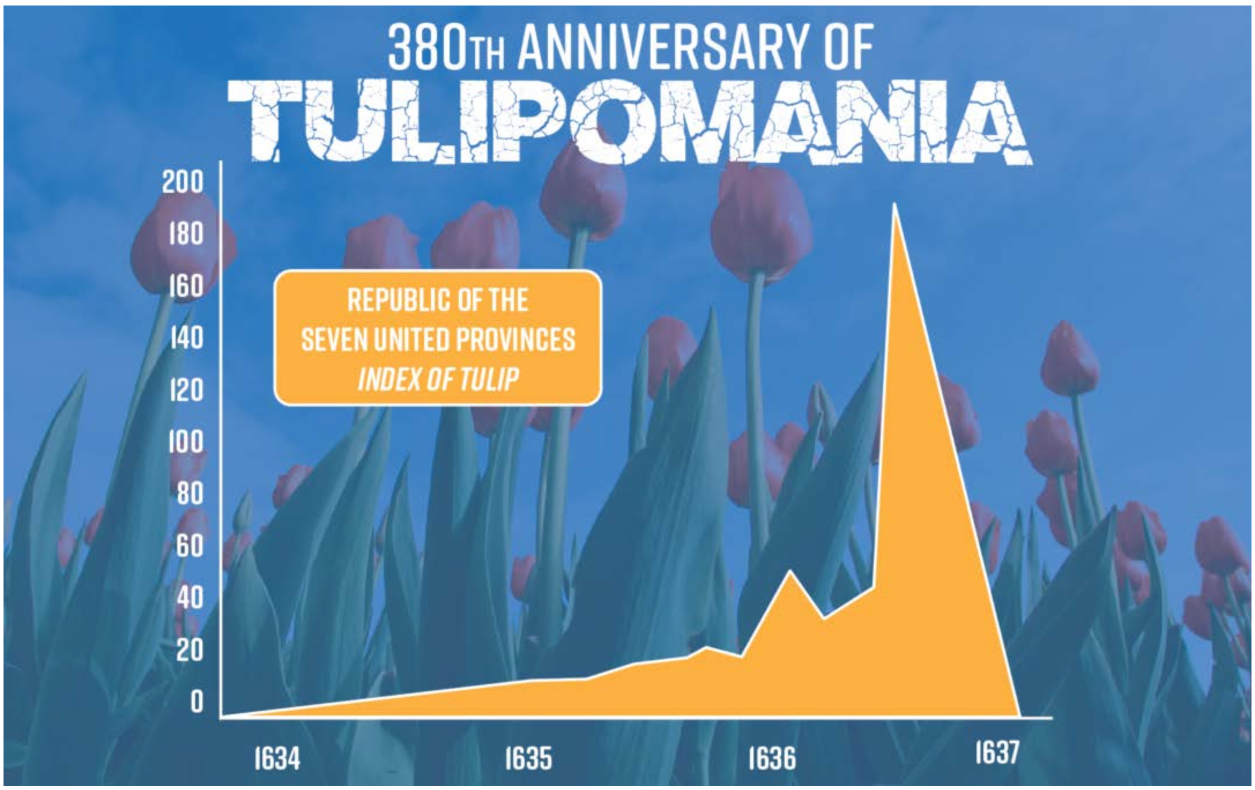
If you were to spend thousands – perhaps even tens of thousands – of dollars on the bulb of a flower that blooms for just one week per year, would your friends think you were crazy?

They wouldn't if you lived in Holland in the early 17th century. At that time, the Dutch were trading tulips for many times more than a craftsman could make in an entire year. Tulip traders could make in a couple years what it previously had taken some of the richest families in Dutch society generations to amass.



All because the tulip market said that's what these flowers were worth. For a while, anyway.

It Couldn't Last Forever

The tulip was already a status symbol in Holland by 1634 when speculators entered the market to buy and sell the plant's bulbs for quick profit, or to "flip" the flowers as people do today in the housing market. The demand was so great that cultivation of the flower, which takes seven to 12 years to grow from seed, couldn't keep up. In 1636, the Dutch created what would today be called a futures market in which contracts to buy bulbs at the end of the season were bought and sold.

There was no longer even a flower changing hands, just a piece of paper.

By the winter of 1636-1637, tulip prices had swelled to 60 times what they had been just three years earlier. Even more remarkable, their value increased twentyfold in just a single month leading up to the bubble's breaking point. On Feb. 5, 1637, a buyer defaulted on a tulip bulb contract at a routine auction in Haarlem, triggering a crisis of confidence in the market that led to its quick demise.

A few days later, tulips were worth a mere hundredth of their former prices.

What We Can Learn from Tulipomania

While historians and economists debate the causes, depth and breadth of the "tulip mania" of 380 years ago, the event remains a vivid illustration of the lure of economic bubbles and the pain they cause when they burst.

1. Sometimes common sense is not so common. On Feb. 6, 1637, some traders woke up to the realization that they had traded their homes for not even a beautiful, blood-red flower, just the option to buy it once it had grown. How had they not realized their folly before this?

In a modern word, FOMO: fear of missing out. When we are surrounded by well-meaning people telling us we ought to get in on something good or we'll miss out, it's easier than we think to dismiss our better judgment. The market says this is extremely valuable, we think, so it must be.

But the market can be an unthinking mob, and a flower is just a flower, however beautiful. We must never forget this when we are thinking of betting our fortunes on a fad.

2. All good things come to an end, some faster than others. That said, it is hard to argue against the value of real money one makes from the purchase and sale of a product rapidly rising in value (be it a security or little brown flower bulb). You could easily argue that it would have been folly for Dutch traders not to participate in the tulip market to some degree.

This is where it gets tricky. It makes sense to participate in growing markets, and it is next to impossible to recognize a bubble except in hindsight. We don't have crystal balls. How can we turn off our FOMO in time to pull ourselves out of the thrill of rapid gain before the tides turn on us?

3. The only defense we have is a strong plan and a determination to stay the course. The best solution we have as flawed human beings is to install circuit breakers into our future investment activity *before* we become overtaken with manias like the Dutch suffered four centuries ago. This is the first, vital function of a financial advisor: to help investors make a plan based on their goals and values that determines in advance how much risk is acceptable and how much gain is reasonably attainable.

A financial advisor's second vital function is to help clients stay the course through feast or famine. A properly diversified portfolio of investments will not be dependent on the rise and fall of fads in isolated markets.

If fiduciary financial advisors dedicated to the promise of true wealth management had been around in Holland in the early 17th century, we'd like to think we would have said the following to our clients: "Of course we'll take a look at the tulip trade. But first, let's take a look at your plan."

About Joe Delaney, Managing Director, Lifeguard Wealth, San Rafael, CA

Joe Delaney founded Lifeguard Wealth to help others realize their goals and dreams. As a fee-only financial advisor, he is dedicated to putting clients first. Joe has more than 30 years of financial-industry experience as a CPA and CFO; he has held senior positions with institutional investment and wealth management firms. Since 2001, he has focused his career on creating and executing wealth management strategies for individuals and families. He is licensed to provide investment advisory services, and he holds a BA in economics from Stanford University and an MBA in finance from UCLA Anderson.