Introduction

In the hope of helping you avoid encasing your life savings in the next bubble or contributing to the next crash, we'll be looking at the crème de la crème of crashes as a cautionary tale. Welcome to our feature dedicated to the biggest market crashes in history.

What are Crashes and Bubbles?

A bubble is a type of investing phenomenon that demonstrates the frailty of some facets of human emotion. A bubble occurs when investors put so much demand on a stock that they drive the price beyond any accurate or rational reflection of its actual worth, which should be determined by the performance of the underlying company. Like the soap bubbles a child likes to blow, investing bubbles often appear as though they will rise forever, but since they are not formed from anything substantial, they eventually pop. And when they do, the money that was invested into them dissipates into the wind.
A crash is a significant drop in the total value of a market, almost undoubtedly attributable to the popping of a bubble, creating a situation wherein the majority of investors are trying to flee the market at the same time and consequently incurring massive losses. Attempting to avoid more losses, investors during a crash are panic selling, hoping to unload their declining stocks onto other investors. This panic selling contributes to the declining market, which eventually crashes and affects everyone. Typically crashes in the stock market have been followed by a depression.

The relationship between bubbles and crashes is similar to the relationship between clouds and rain. Since you can have clouds without rain but you can’t have rain without clouds, bubbles are like clouds and market crashes are like the rain. Historically, a market crash has always precipitated from a bubble (pun intended), and the thicker the clouds or the bigger the bubble, the harder it rains.

It is important to note the distinction between a crash and a correction, which can be a bit sticky at times. A correction is supposedly the market’s way of slapping some sense into overly enthusiastic investors. As a general rule, a correction should not exceed a 20% loss of value in the market. Surprisingly, some crashes have been erroneously labeled as corrections, including the terrifying crash of 1987. But a "correction," however, should not be labeled as such until the steep drop has halted within a reasonable period.

Now that we're familiar with the definitions of crashes and bubbles, we can look at how they occurred throughout history

**The Tulip-Bulb Craze**

**When:** 1634-1637  
**Where:** Holland

**The amount the market declined from peak to bottom:** This number is difficult to calculate, but, we can tell you that at the peak of the market, a person could trade a single tulip for an entire estate, and, at the bottom, one tulip was the price of a common onion.

**Synopsis:** In 1593 tulips were brought from Turkey and introduced to the Dutch. The novelty of the new flower made it widely sought after and therefore fairly pricey. After a time, the tulips contracted a non-fatal virus known as mosaic, which didn't kill the tulip population but altered them causing "flames" of color to appear upon the petals. The color patterns came in a wide variety, increasing the rarity of an already unique flower. Thus, tulips, which were already selling at a
premium, began to rise in price according to how their virus alterations were valued, or desired. Everyone began to deal in bulbs, essentially speculating on the tulip market, which was believed to have no limits.

The true bulb buyers (the garden centers of the past) began to fill up inventories for the growing season, depleting the supply further and increasing scarcity and demand. Soon, prices were rising so fast and high that people were trading their land, life savings, and anything else they could liquidate to get more tulip bulbs. Many Dutch persisted in believing they would sell their hoard to hapless and unenlightened foreigners, thereby reaping enormous profits. Somehow, the originally overpriced tulips enjoyed a twenty-fold increase in value - in one month!

Needless to say, the prices were not an accurate reflection of the value of a tulip bulb. As it happens in many speculative bubbles, some prudent people decided to sell and crystallize their profits. A domino effect of progressively lower and lower prices took place as everyone tried to sell while not many were buying. The price began to dive, causing people to panic and sell regardless of losses.

Dealers refused to honor contracts and people began to realize they traded their homes for a piece of greenery; panic and pandemonium were prevalent throughout the land. The government attempted to step in and halt the crash by offering to honor contracts at 10% of the face value, but then the market plunged even lower, making such restitution impossible. No one emerged unscathed from the crash. Even the people who had locked in their profit by getting out early suffered under the following depression.

The effects of the tulip craze left the Dutch very hesitant about speculative investments for quite some time. Investors now can know that it is better to stop and smell the flowers than to stake your future upon one.

The South Sea Bubble

When: 1711

Where: United Kingdom

The amount the market declined from peak to bottom: Stocks in the South Sea Company were traded for 1,000 British pounds (unadjusted for inflation) and then were reduced to nothing by the later half of 1720. A massive amount of money was lost.

Synopsis: In the 1700s, the British empire was the big dog on the block, and that particular block spanned the entire globe. For the British, the eighteenth century was a time of prosperity and opulence, meaning a large section of the
population had money to invest and were looking for places to put their money. So, the South Sea Company had no problem attracting investors when, with an IOU to the government worth £10,000,000.00, the company purchased the "rights" to all trade in the South Seas.

The few companies offering stock at that time were all solid but difficult investments to buy. For example, the East India Company was paying out considerable tax-free dividends to their mere 499 investors. The SSC was perched on top of what was perceived to be the most lucrative monopoly on earth.

The first issue of stock didn't even satiate the voracious appetite of the hardcore speculators, let alone the average investors who were assured of this company's coming dominance. The popular conception was that Mexicans and South Americans were just waiting for someone to introduce them to the finery of wool and fleece in exchange for mounds of jewels and gold! So nobody questioned the repeated re-issues of stocks by the South Sea Company--people just bought the expensive stocks as fast as they were offered. It didn't matter either to investors that the company wasn't headed by experienced management. Those who lead the company, however, were born public relations directors, who set up offices furnished with affluence in the most extravagant quarters. People, once they saw the wealth the SSC was "generating," couldn't keep their money from gravitating towards the SSC.

Not long after the emergence of the SSC, another British company, the Mississippi Company, established itself in France. The company was the brainchild of an exiled Brit named John Law. His idea wasn't so much based in trade, but in switching the monetary system from gold and silver into a paper currency system. The Mississippi Company caught the attention of all the continental traders and gave them a space to put their hard-earned dollars. Soon the worth of the Mississippi Company's stock was worth 80 times more than all the gold and silver in France. Law also began collecting defunct companies to add to his massive conglomerate.

This success on the continent stirred British pride, and, believing that British companies could not fail, British investors were desperate to invest their money. They were blind to many indications that the SSC was run too poorly to break even (whole shipments of wool were misdirected and left decaying in foreign ports), and people wanted to buy even more stocks. The South Sea Company and others made a point of giving people what they wanted. The demand for investments caused IPOs to sprout out of everything, including companies that promised to reclaim sunshine from vegetables and to build floating mansions to extend Britain's landmass. They all sold like mad.
Eventually the management team of SSC took a step back and realized that the value of their personal shares in no way reflected the actual value of the company or its dismal earnings. So they sold their stocks in the summer of 1720 and hoped no one would leak the failure of the company to the other shareholders. Like all bad news, however, the knowledge of the actions of SSC management spread, and the panic selling of worthless certificates ensued. The huge hole in the south sea bubble also punctured the Mississippi Company’s unrealistic value and both came crashing down.

A complete crash, which would be heralded by the folding of banks, was avoided due to the prominent economic position of the British Empire and the government’s help in stabilizing the banking industry. The British government outlawed the issuing of stock certificates, a law that was not repealed until 1825.

**The Florida Real Estate Craze**

**When:** 1926  
**Where:** Florida

The amount the market declined from peak to bottom: Land that could be bought for $800,000 could, within a year, be resold for $4 million before crashing back down to pre-boom levels. The prices were so inflated that to buy a condo-style property in 1926, you’d’ve had to pay the same as you would now have to pay for a luxury home in the guard-gated communities in Miami ($4,500,000) without adjusting for inflation!

Synopsis: In the 1920s, the United States of America was chugging along like the British Empire of the 1700s, and it was only natural that people were beginning to believe such prosperity was infinite. But it wasn’t the stock market that was the recipient of a bubble. It was the real estate market.

In 1920, Florida became the popular U.S. destination/residence for people who don’t like the cold. The population was growing steadily and housing couldn’t match the demand, causing prices to double and triple in some cases, which was not exactly unjustified at this point. But, news of anything doubling and tripling in price always attracts speculators. So, once people began pumping huge amounts of money into the real estate market it took off. Soon everyone in Florida was either a real estate investor or a real estate agent.

Unfortunately, the rules are the same whether you pay too much for a stock or for a piece of land: you have to make that much more to claim a profit. This did happen for awhile, and land prices quadrupled in less than a year. Eventually, however, there were no “greater fools” to buy the disgustingly overpriced land,
and prices began to adjust ever so subtly. Speculators realized there was a limit to the boom, and began to sell their properties to solidify their profits while they could.

Then everybody simultaneously saw the writing on the wall, and panic selling ensued. With thousands of sellers and very few buyers, prices came down with a sickening thud, twitched a bit, and then crawled down even lower.

The Great Depression (1929) - AKA Black Monday, Thursday, and Tuesday

**When:** October 21, 24 and 29, 1929

**Where:** USA

**The amount the market declined from peak to bottom:** A string of terrible days led to a more than 40% drop in the market from the beginning of September 1929 to the end of October 1929. In fact, the market continued to decline until July 1932 when it bottomed out, down nearly 90% from its 1929 highs.

**Synopsis:** Despite the Florida crash, Americans were as bullish as ever. The stock market was guaranteed to make everyone rich as the first world war had been won, and industrialization was resulting in previously-unimaginable luxuries. It was a good time to be American.

Since the stock market was believed to be a no-risk, no-brain world where everything went up, many people poured all their savings into it without learning about the system or the underlying companies. With the flood of uneducated investors, the market was ripe for some manipulation and swindling. Investment bankers, brokers, traders, and sometimes owners banded together to manipulate stock prices and get out with gains. They did this by subtly acquiring large chunks of stock between them and trading them between each other for slightly more each time. When the public noticed the progression of price on the ticker tape, everyone would buy the stock. So, the market manipulators would then sell off their overpriced shares for a healthy profit. On and on the cycle went as uneducated investors turned a profit by selling the manipulated, over-priced shares to someone who wanted to have a rising stock.

**Behavioral finance** shows that the less an investor knows, the easier it is for him or her to be swept up in popular opinion (herd mentality). This behavior is a double-edged sword because the ignorant investors are also easily spooked into panic. Both actions, joining and fleeing, have very little basis in the quality of the news or the quality of the market. Instead, the herd follows the cow that runs the fastest, trampling the market.
During the craze before the Great Depression a number of academics, including Roger Babson, were predicting a crash if things didn't "calm the hell down." Sadly, for every Roger Babson, there were four bull-blinded academics guaranteeing the eternal rapid growth of the American stock market. Although Babson had been predicting the crash for years, the capricious and ignorant investors finally listened. The twelve-year worldwide depression came and ended only with the declaration of war. This stands as the worst financial blow to the USA ever. The crash itself, though large in its own right, was nothing compared to the ensuing graveyard market and devastating depression.

The Crash of 1987

When: October 19, 1987
Where: USA

The amount the market declined from peak to bottom: 508.32 points, 22.6%, or $500 billion lost in one day. The largest one-day percentage drop in history.

Synopsis: This was the crash that everyone expected but could not justify because of the work of the U.S. Securities and Exchange Commission, which is the governing body President Franklin D. Roosevelt ordered after the depression. The SEC - which was established for the prevention of further crashes and fraudulent practices that had infected the stock market - was doing a fine job after the war and finally coaxed tentative investors back into the market in the sixties.

The SEC, however, could take investors to the proper information but couldn't make them think. In the early '60s and '70s, investors looked not at the value of the company but at the appeal of its public image and the vernacular used to describe it. The following kinds of over-embellished company sketches would attract the public eye:

"Synergy Space-Bovubetribucus forges a new frontier in the introduction of organic entities into the ecosystem of the lunar-scape in order to promote greater synergy. This triumphant new paradigm will be enacted through a leveraged advantaged momentum initiator."

Even though these illustrations were vague, investors were infatuated with these companies, which somehow represented some higher idea. The SEC required companies to state explicitly that they had no assets or even a fighting chance at getting any, but investors continued to believe that the potential for these companies was limitless. This bullish attitude, despite frequent bumps and
insolvencies, continued into the eighties when conglomerates and hostile takeovers were the golden children of a finance-hungry media. Under the math of the "new economy," firms would grow exponentially rather than incrementally simply by picking up other companies.

The SEC was unable to halt the shady IPOs and conglomerations, so the market continued to rise unabated throughout the '80s. Even institutional investors and large mutual funds, increasing their dependency on program trading, began to adhere to the mantra, "if a stock isn't gaining big time, find one that is."

Then, in early 1987, there was a rash of SEC investigations into insider trading. For the most part, people were aware of the tendency of Wall Street to look out for itself, but the barrage of SEC investigations, rattled investors. By October, investors decided to move out of the crooked game and into the more stable environment offered by bonds or, in some cases, junk bonds.

As people began the mass exodus out of the market, the computer programs began to kick in. The programs put a stop loss on stocks and sent a sell order to DOT (designated order turnaround), the NYSE computer system. The instantaneous transmission of so many sell orders overwhelmed the printers for DOT and caused the whole market system to lag, leaving investors on every level (institutional to individual) effectively blind.

Herd-like panic set in and people started dumping stock in the dark without knowing what their losses were or whether their orders would execute fast enough to keep up with plummeting prices. The Dow plummeted 508.32 points (22.6%) and 500 billion dollars vaporized. Fortunately, the newbie chairman of the Fed, Alan Greenspan, was around to help fight off a depression by preventing the insolvency of commercial and investment banks. The market recovered, and some modest refinements were made, including a circuit breaker that cuts out trading programs if the market slides to a set level.

The Asian Crash (or Crises)

When: 1989 - Ongoing
Where: Southeast Asia but primarily Japan
Percentage Lost From Peak to Bottom: 63.5% as of 2003.
Synopsis: The Japanese have an uncanny ability to enhance what they adopt from the Americans (market economy). Sadly, the Japanese have picked up on
crashes as well and made theirs a lot bigger than any one historical American crash. The crash of the Nikkei has morphed into a massive, surly bear that attacks any signs of recovery. It all started with a boom/bull market of the 1980s….

The Japanese economy gained extreme strength after its long recovery from the war and the atomic bombs. By coupling with the other emerging southeast Asian economies to form an unstoppable economic force, Japan seemed to create a flawless realization of Keiretsu. The phrase Japan Inc. was coined to describe how Japanese economy, business, and government were intertwined. Businesses from all over the world were sending representatives to try and find out how Japan was gaining its success. In true business fashion, the Japanese built an industry around visitors with company expense accounts and profited off the corporate spies. Soon, the Asian economy became an alternative for investors who were recently bruised by 1987.

Between 1955 and 1990, land prices in Japan appreciated by 70 times and stocks increased 100 times over. Trading became the national sport, and the Japanese jumped into the market with more blind confidence than that of the Americans of the 1920s. During the eighties, large Tokyo firms were worth more individually than all their American counterparts combined, and Japanese golf courses were worth more than the value of all the stocks on the Australian exchange.

Investors may have realized Japan was becoming a bubble, but it was believed that the high level of collusion between the government and business could sustain the growth forever. But an inverted growth cycle perpetuated itself when landowning firms started using the book value of their land to buy stocks that they in turn used to finance the purchase of American assets (Rockefeller Center is 80% owned by Mitsubishi Estate Company). Like the prosperity of the Roman Empire, the prosperity of Japan proved to be its undoing as corruption began to spread throughout the political and business realms.

The government sought to excise the tumor and put a halt to the inflammatory growth of stocks and real estate by raising interest rates. Regrettably, this didn't have the slow soothing effect on the market that the government hoped. Instead, it plunged the Nikkei index down more than 30,000 points.

The bursting of the Asian bubble nearly took out the American economy as well, but the measures enacted after 1987 sopped the avalanche of program trading. We learned at least one lesson from all of these crashes: humans may overact frequently with small effects, but computers do it only once in a big way.
The Dot-Com Crash

When: March 11, 2000 to October 9, 2002  
Where: Silicon Valley (for the most part)

Percentage Lost From Peak to Bottom: The Nasdaq Composite lost 78% of its value as it fell from 5046.86 to 1114.11.

Synopsis: Decades before the word "dotcom" slipped past our lips as the answer to all of our problems, the internet was created by the U.S. military, who vastly underestimated how much people would want to be online. Commercially the internet started to catch on in 1995 with an estimated 18 million users. The rise in usage meant an untapped market--an international market. Soon, speculators were barely able to control their excitement over the "new economy."

Companies underwent a similar phenomenon to the one that gripped Seventeenth century England and America in the early eighties: investors wanted big ideas more than a solid business plan. Buzzwords like networking, new paradigm, information technologies, internet, consumer-driven navigation, tailored web experience, and many more examples of empty double-speak filled the media and investors with a rabid hunger for more. The IPOs of internet companies emerged with ferocity and frequency, sweeping the nation up in euphoria. Investors were blindly grabbing every new issue without even looking at a business plan to find out, for example, how long the company would take before making a profit, if ever.

Obviously, there was a problem. The first shots through this bubble came from the companies themselves: many reported huge losses and some folded outright within months of their offering. Siliconaires were moving out of $4 million estates and back to the room above their parents' garage. In the year 1999, there were 457 IPOs, most of which were internet and technology related. Of those 457 IPOs, 117 doubled in price on the first day of trading. In 2001 the number of IPOs dwindled to 76, and none of them doubled on the first day of trading.

Many argue that the dotcom boom and bust was a case of too much too fast. Companies that couldn't decide on their corporate creed were given millions of dollars and told to grow to Microsoft size by tomorrow.

The Housing Bubble and Credit Crisis

When: 2007-2009  
Where: Housing centered in the United States and Britain; Credit crisis occurred around the world
The amount the market declined from peak to bottom: The S&P 500 declined 57% from its high in October 2007 of 1576 to its low in March 2009 of 676; many indicators of credit risk such as the "Ted Spread" or the option adjusted spread (OAS) on corporate bonds reached record highs.

Synopsis: Following the bursting of the tech bubble and the recession of the early 2000s, the Federal Reserve kept short-term interest rates low for an extended period of time. This coincided with a global savings glut, as developing countries and commodity producing nations accumulated large financial reserves. As these excess savings were invested, global interest rates declined to record low levels. Frustrated with low returns, investors began to assume more risk by seeking higher returns wherever they could be found. For several years, global financial markets entered a period which came to be called the "Great Moderation" due to the above-average returns and below-average volatility demonstrated by a wide variety of asset classes. (Check out our Federal Reserve Tutorial.)

In the United States, the Great Moderation coincided with a housing boom, as prices soared (particularly on the two coasts and in cities such as Phoenix and Las Vegas.) Rising home prices led to rampant real estate speculation, and also fueled excessive consumer spending as people began to view their homes as a "piggy bank" that they could extract cash from to fuel discretionary purchases. As home prices soared and many homeowners "stretched" to make their mortgage payments, the possibility of a collapse grew. However, the true extent of the danger was hidden because so many mortgages had been securitized and turned into AAA-rated securities.

When the long held belief that home prices do not decline turned out to be inaccurate, prices on mortgage-backed securities plunged, prompting large losses for banks and other financial institutions. These losses soon spread to other asset classes, fueling a crisis of confidence in the health of many of the world’s largest banks. Events reached their climax with the bankruptcy of Lehman Brothers in September 2008, which resulted in a credit freeze that brought the global financial system to the brink of complete collapse. (You might also want to read Case Study: The Collapse of Lehman Brothers.)

Unprecedented central bank actions combined with fiscal stimulus (notably in the US and China) helped ease some of the panic in the market place, but by late winter 2009, widespread rumors surfaced that Citigroup (NYSE:C), Bank of America (NYSE:BAC), and other large banks would have to be nationalized if the global economy was to survive. Fortunately, the aggressive actions by governments around the world eventually helped avoid financial collapse, but the credit freeze forced the global economy into the worst recession since WW2.
The credit crisis and accompanying recession caused unprecedented volatility in financial markets. Stocks fell 50% or more from their highs through March 2009 before rallying more than 50% once the crisis began to ease. In addition to stocks, most fixed income markets also displayed unprecedented volatility, with many corporate bond markets at one point forecasting bankruptcies at a level not seen since the Great Depression. Oil fell 70%, then doubled as the financial system stabilized.

The events of the housing bubble and credit crisis are likely to resonate with consumers and investors for years to come. In many countries (including the U.S.) consumers remain heavily leveraged and many homeowners are "underwater." As consumers deleverage and repair their finances, their purchasing patterns will be permanently altered. Many developed market countries have also seen a substantial deterioration in their fiscal position. While government actions helped prevent worst-case outcomes from the credit crisis, large budget deficits now represent a structural problem that may take decades to solve.

Finally, investors have experienced the most volatile and frightening markets of their life. Positive lessons, such as the importance of diversification and independent analysis can be taken from the crisis, but there are also emotional affects that must be considered. In particular, investors must remember that the events of the crisis were unusual and are unlikely to be repeated; while excessive greed in the financial markets is inappropriate, so too is excessive fear. Investors that can incorporate the lessons of the credit crisis without having their emotions unduly influenced will be best positioned for future investment success.

**Conclusion**

As hindsight is always 20/20, we should take the time to highlight what we can learn from these past tragedies.

First off, we should point out that most market volatility is all our fault. In reality, people create most of the risk in the market place by inflating stock prices beyond the value of the underlying company. When stocks are flying through the stratosphere like rockets, it is usually a sign of a bubble. That's not to say that stocks cannot legitimately enjoy a huge leap in value, but this leap should be justified by the prospects of the underlying companies, not just by a mass of investors following each other. The unreasonable belief in the possibility of getting rich quick is the primary reason people get burned by market crashes. Remember that if you put your money into investments that have a high potential for returns, you must also be willing to bear a high chance of losing it all.
Another observation we should make is that regardless of our measures to correct the problems, the time between crashes has decreased. We had centuries between fiascoes, then decades, then years. We cannot say whether this foretells anything dire for the future, but the best thing you can do is keep yourself educated, informed, and well-practiced in doing research.