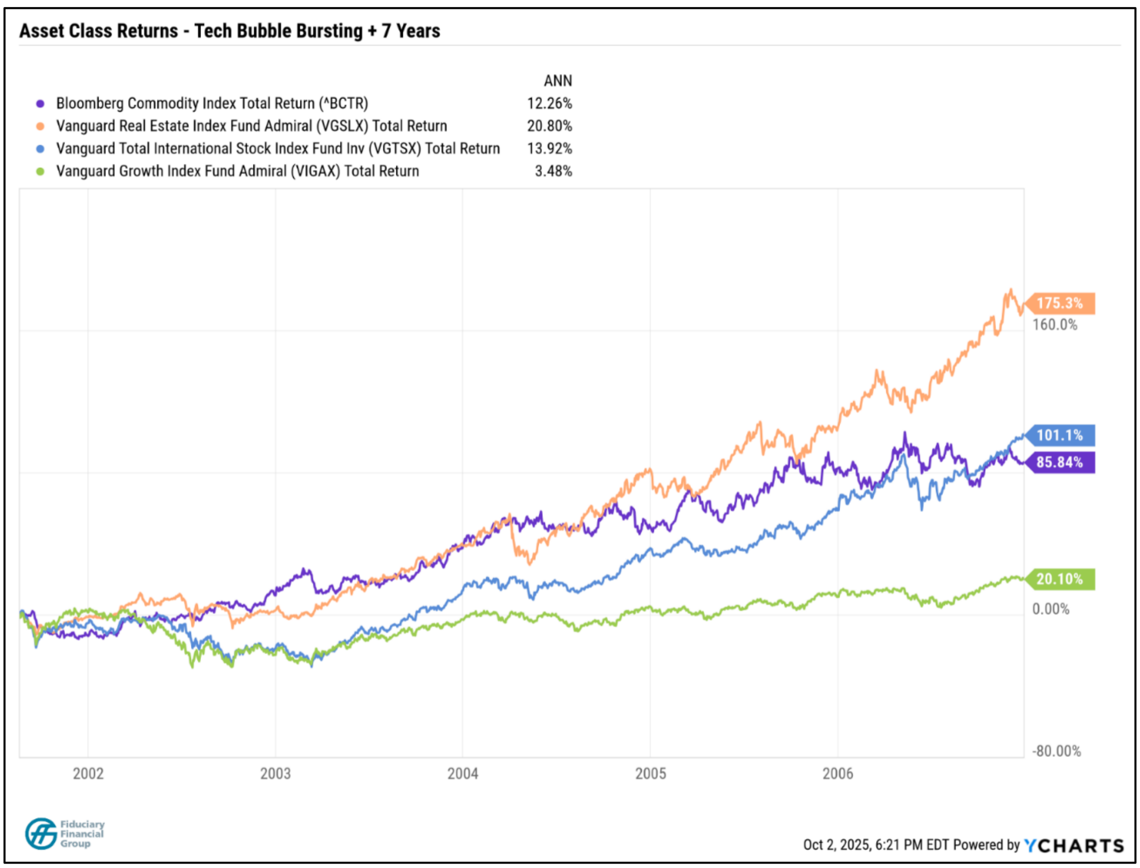
How to Navigate Fears of a Market Bubble

In financial commentary, the word “bubble” is often thrown around loosely. We think it’s more useful to define it clearly: *A bubble is a period of excessive speculative enthusiasm where investor psychology drives prices higher than justified by fundamentals. Herd behavior, fear of missing out (FOMO), and the greater-fool theory (buying only to sell to someone else at a higher price) dominate decision-making.* Importantly, bubbles tend to form in specific areas of the market, and when capital floods into one segment, other assets are often left neglected and become more attractively priced (there’s a beautiful analogy buried somewhere in here related to the tide going out on Earth in one place, only because it was rising somewhere else).

Bubbles often appear obvious in hindsight, but if spotting and, more importantly, timing their collapse were truly easy, active investors would consistently deliver outsized results (yet on average, they don’t). The late 1990s dot-com era was indeed a textbook bubble in growth stocks, but in its aftermath, commodities, real estate, and foreign markets produced compelling returns. Similarly, after the 2008 crisis, when many feared new bubbles were forming, the following decade rewarded disciplined, diversified investors with meaningful returns.

Lessons to be learned: *Bubbles rarely engulf all assets, and stepping out of risk-on markets entirely can be more dangerous than the bubbles themselves.*



At FFG, we are less concerned with the question of whether we are in a bubble, as we are more worried about the risk of not just significant, but also prolonged setback in our investments. For financial planning, the latter issue is far more critical. Short-term declines are a common occurrence in investing. They can happen suddenly, but unless an investor is forced to withdraw funds at the worst possible moment, these pullbacks are usually manageable with robust cash flow modeling. Earlier this year, the S&P 500 dropped 19% and rebounded in less than three months.

Similar sharp, but temporary declines occurred in 2018, 2020, and 2022. Those who tried to time the market often missed significant recoveries.

So, will the next big pullback be more severe, or will it be similar to the last four selloffs above, where recoveries to new highs occurred in under a year? Anyone who answers this question with high conviction is either (A) incredibly arrogant, and/or (B) very foolish. What does seriously concern us about the stock market right now, particularly in light of record high valuations in the S&P 500, is ***recency bias***. Recency bias is a cognitive bias in which people place disproportionate weight or importance on recent events when forecasting future outcomes, essentially assuming that what has just happened is more likely to happen again, while undervaluing longer-term history or older precedents.

In recent years, spectacular recoveries from sharp sell-offs in 2018, 2020, 2022, and 2025, have reinforced a mindset among many investors, particularly those who were not adults holding investments before 2009. That mindset can be summarized by this comment (or similar) that we've all heard from the typical overconfident investor, "if we get a big drop, the market will snap back quickly." But leaning too heavily on those recent rebounds can breed overconfidence. While it has been true in those specific episodes, the broader historical record suggests a more tempered expectation. Over the last 75 years, average bear-market drawdowns have taken an average of approximately 1,100 trading days from bull market peaks through sell-offs and back to eclipse prior highs.[i]

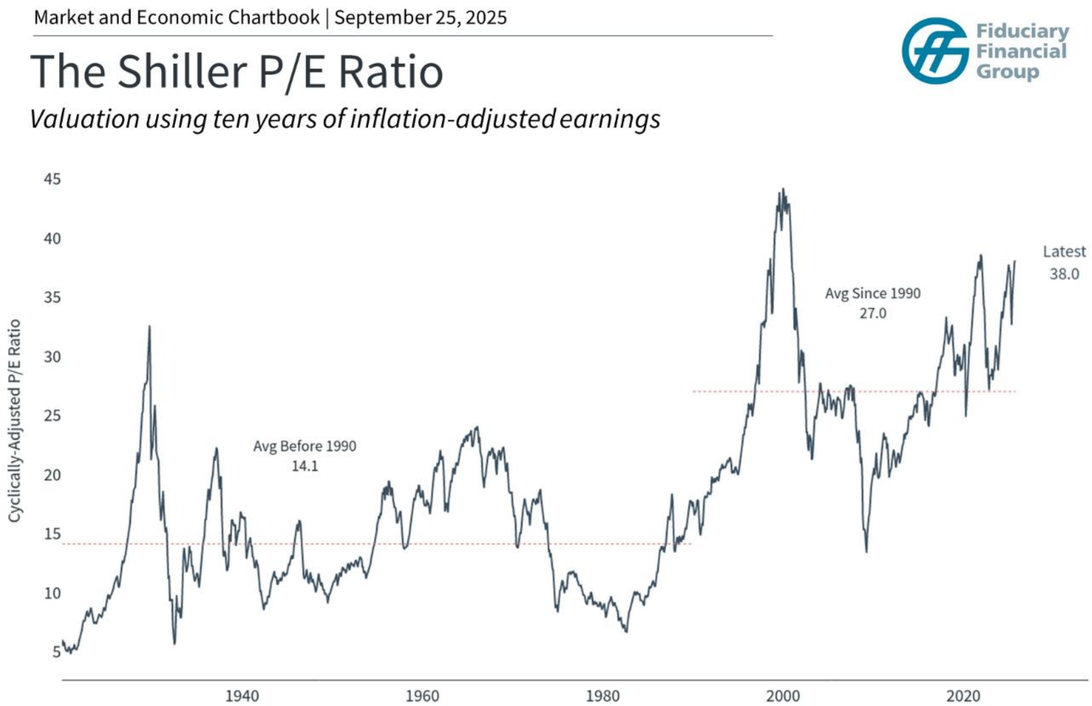
Recognizing that stock market selloffs can, and often do, last longer than the quick rebounds we've seen in recent years sharpens our focus on the timeless principle of diversification. This means not only reducing reliance on asset classes trading well above historical valuations (which we'll get into first) but also rethinking how we structure the more conservative portions of portfolios. For much of the past century, investors could place near-term reserves in USD-denominated investment-grade bonds, particularly US treasury bonds, with full confidence that these instruments would provide complete & total short-term stability. Today, however, with swelling U.S. deficits and rising domestic political dysfunction fueling credible concerns about dollar devaluation, we see merit in extending diversification even into the liquid reserve bucket, strategically allocating across multiple currencies to better protect wealth in an environment where faith in the dollar is no longer taken entirely for granted.

First, let's dig into valuations and diversification in our "risk-on" segment of client portfolios.

The chart on the following page highlights the Shiller price-to-earnings ratio for the S&P 500, which smooths out short-term noise by using inflation-adjusted earnings over the past decade. At today's level of 38x, meaning investors are paying $38 for every dollar of earnings, the index sits well above its long-term average of 27x. That's a troubling sign, and one that dominates many financial headlines, since the S&P 500 has never produced attractive 10-year forward returns from this starting point for the Shiller P/E. But it's worth remembering: this ratio reflects only the S&P 500, an increasingly concentrated index dominated by large U.S. growth and technology companies.

Stopping here risks painting an overly pessimistic picture of future stock market returns.

At FFG, we believe portfolios should include more balanced stock market exposure across company sizes, styles, sectors, and geographies, not just the headline S&P 500 or Nasdaq indexes. This is particularly true when the aforementioned core indexes generate scary charts like the one above! In taking this more granular approach when building stock portfolios, there's some promising news; we see a healthier landscape. Not all areas of the market are overpriced, and some segments are actually trading below historical averages.

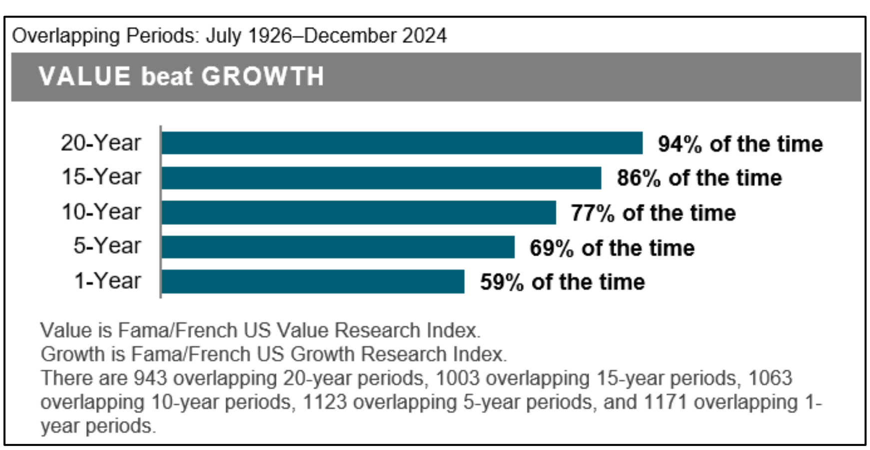


With this in mind, we tilt client portfolios toward styles and sectors that **(A)** have historically outperformed over long horizons, **(B)** trade below their own long-term valuation averages, and **(C)** offer relative value compared to other sectors. These tilts are not about predicting short-term winners but about improving the odds of stronger long-term outcomes, particularly over 10+ years. Could we simply default to the S&P 500 and a bond index, blended to each client's risk tolerance? Yes, and simplicity should always be our starting point. But given today's distortions, we have exceptionally high conviction that applying these three disciplines is warranted. The academic evidence supporting this framework is robust, and in our view, the current market makes it not only relevant but necessary.

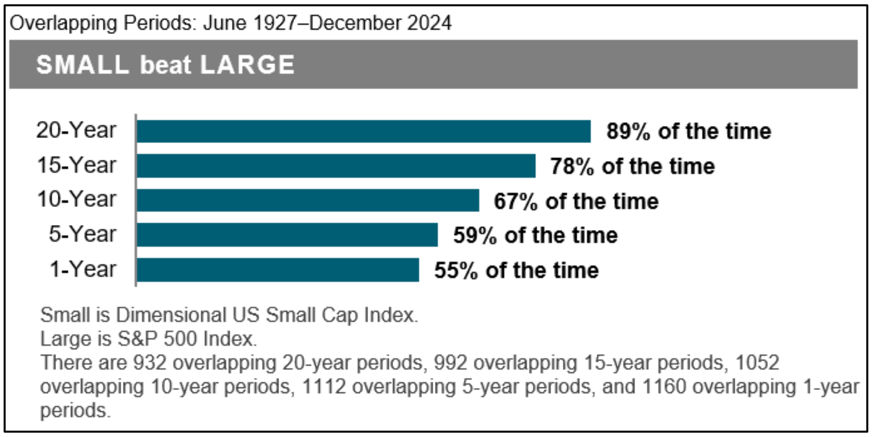
Let's take a closer look at three core FFG stock investing disciplines *** Note: To keep this brief, we have not included similar studies on value, small-cap, and profitability premiums in foreign developed or emerging markets. However, the same patterns appear globally, strengthening our conviction that these strategies add real value across markets, not just within U.S. equities.

A – Emphasize styles that reliably (albeit not perfectly) outperform over longer-term holding periods

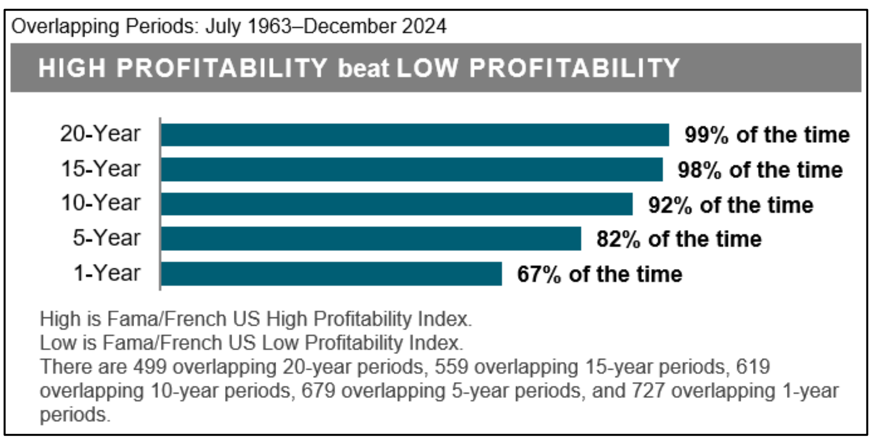
"Winning Style" #1 – Tilt to lower price-to-book ratio stocks (aka "Value" Stocks)



"Winning Style" #2 – Tilt to smaller size (by market capitalization) companies with more room to grow



"Winning Style" #3 – Tilt to companies with a high level of profitability relative to their book equity



B – Emphasize styles / regions / sectors that trade below their own long-term valuation averages

We take this step **after** evaluating discipline (A), and the reason should be clear. If academic research shows that an asset class consistently underperforms the broad market, the fact that it trades below its long-term average valuation carries less weight. Some strategies are simply persistent "losers," and it would take a particularly strong catalyst for us to emphasize them, even if they appear cheap.

The reverse is also true. When research demonstrates that certain asset classes (such as value, small-cap, and high-profitability stocks highlighted in section A) reliably outperform over long holding periods, our conviction to overweight them only strengthens when they are also trading at below-average valuations. So, which areas actually look inexpensive, or at the very least, "normally priced" today? That brings us to our next chart, which reviews current P/E ratios of various stock styles compared to their own multi-decade averages.

Stock valuations by style / region vs. historical averages

US Stock Market Price-to-Earnings Ratios	06/30/1963 - 08/31/2025	Broad US Market	US Large Caps	US Small Caps	US Value Stocks	US Growth Stocks	US Large Value Stocks	US Large Growth Stocks	US Small Value Stocks	US Small Growth Stocks
	Average	17.29	17.52	14.41	11.17	22.57	11.34	22.61	10.69	20.72
	Std Dev	5.42	5.63	3.92	3.30	7.22	3.45	7.33	3.14	5.65
	8/31/2025	28.42	28.97	16.42	13.74	37.98	14.12	38.13	11.99	24.42
	SD Above / (Below) Avg	2.05	2.03	0.51	0.78	2.14	0.80	2.12	0.41	0.65

INTL Developed Market Price-to-Earnings Ratios	06/30/1975 - 08/31/2025	Broad INTL Market	INTL Large Caps	INTL Small Caps	INTL Value Stocks	INTL Growth Stocks	INTL Large Value Stocks	INTL Large Growth Stocks	INTL Small Value Stocks	INTL Small Growth Stocks
	Average	16.32	16.63	13.66	11.75	23.76	12.03	23.92	10.61	21.97
	Std Dev	4.75	5.01	2.43	3.14	8.54	3.46	8.69	2.31	4.92
	8/31/2025	16.84	17.17	13.94	10.41	28.82	10.40	29.05	10.41	24.96
	SD Above / (Below) Avg	0.11	0.11	0.12	(0.43)	0.59	(0.47)	0.59	(0.08)	0.61

Emerging Markets Price-to-Earnings Ratios	06/30/1989 - 08/31/2025	Broad Emrg. Mrkts Market	Emrg. Mrkts Large Caps	Emrg. Mrkts Small Caps	Emrg. Mrkts Value Stocks	Emrg. Mrkts Growth Stocks	Emrg. Mrkts Large Value Stocks	Emrg. Mrkts Large Growth Stocks	Emrg. Mrkts Small Value Stocks	Emrg. Mrkts Small Growth Stocks
	Average	13.09	13.39	10.79	8.91	20.39	9.05	20.57	8.57	17.34
	Std Dev	2.67	2.72	2.86	2.57	5.84	2.66	5.92	2.62	5.37
	8/31/2025	15.23	15.45	13.26	9.47	27.12	9.52	27.10	9.16	27.51
	SD Above / (Below) Avg	0.80	0.76	0.86	0.22	1.15	0.18	1.10	0.23	1.89

* All indexes referenced are from Fama/French indices

The chart highlights how current market valuations compare to long-term averages across different stock styles and regions. What stands out is that **large-cap growth stocks**, which dominate indexes like the S&P 500 and Nasdaq, are priced **well above** their historical norms, in some cases by more than two standard deviations. This suggests that the areas most heavily represented in headline benchmarks trade at unusually high valuations and carry elevated risk. By contrast, **small-cap and value segments** in the U.S., and especially internationally, look far more attractive. In many cases, these areas are trading **at or below** their long-term average valuations. This means investors can tilt toward these styles not only with the support of decades of academic research showing higher long-term expected returns (the size, value, and profitability premiums), but also with the tailwind of more reasonable entry prices today.

In short, this valuation landscape reinforces our decision to **de-emphasize large-cap growth**, where prices are stretched, and **overweight small-cap and value stocks**, where both history and current valuations suggest stronger risk-adjusted outcomes.

C – What sectors offer competitive valuations relative to other sectors?

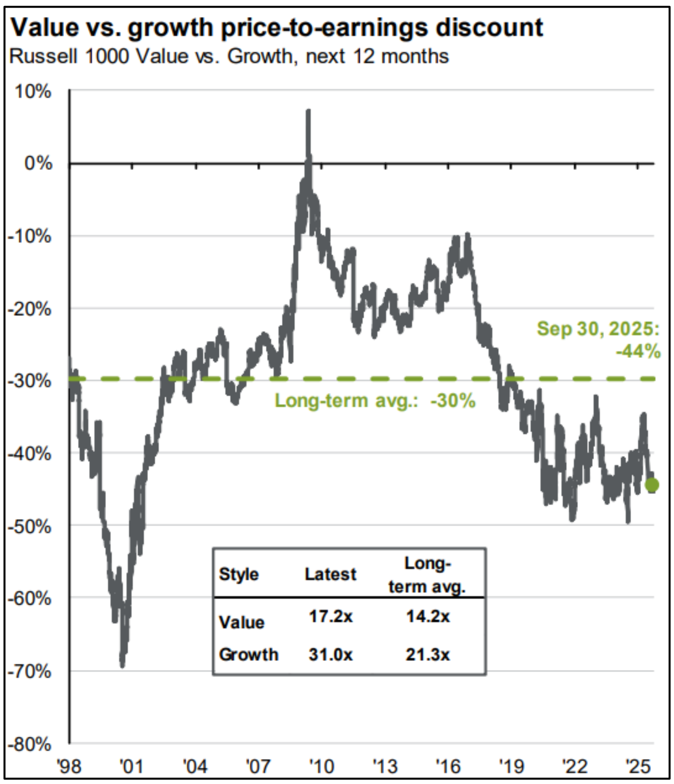
While this won't always be the case, a look at this approach further reinforces what we've already discussed. Small Cap stocks "look cheap" relative to large cap stocks, value stocks "look cheap" relative to growth stocks, and foreign stocks, despite this year's outperformance, continue to "look cheap" vs. US stocks. The following sections contain some visuals to support these comments.

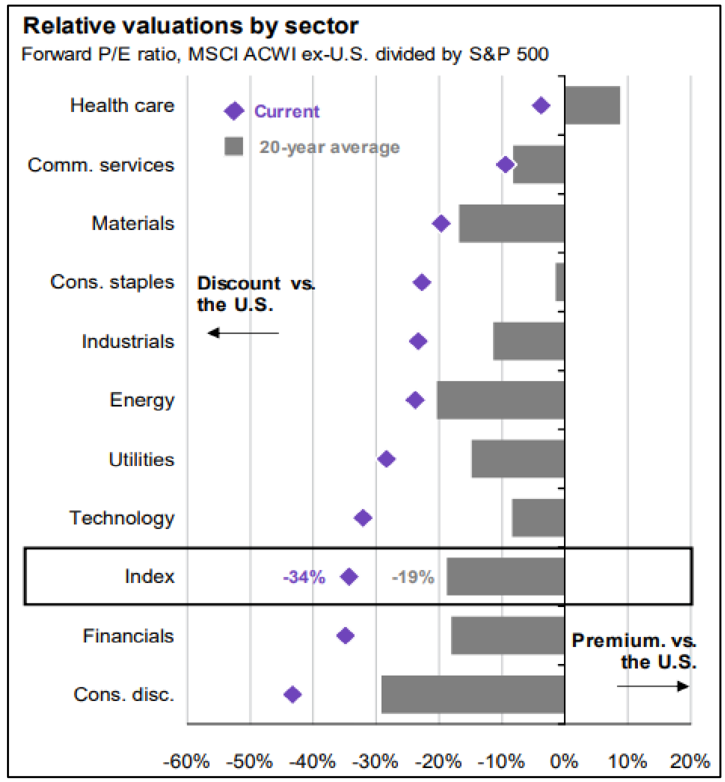
Valuations of different segments as compared to one another

Not only have value stocks outperformed growth stocks reliably with long-term holding periods, AND value stocks trade closer to long-run average valuations as compared to growth stocks, the relative discount using a P/E ratio comparison suggests that value stocks look cheap VS. growth stocks right now.[ii]

Valuations of different regions as compared to one another

While nearly all industry segments of the MSCI ACWI Ex-US index have historically traded at discounts to the same industry segments in the US S&P 500 index (excluding healthcare), the extent of current P/E discounts is significantly greater in all cases, and nearly twice as discounted comparing the two broad market indexes as a whole (a 19% average P/E discount historically, vs. a current discount of 34%). In other words, investors are paying 34% LESS for their share of corporate profits in the INTL index as compared to the S&P 500 index.[iii]



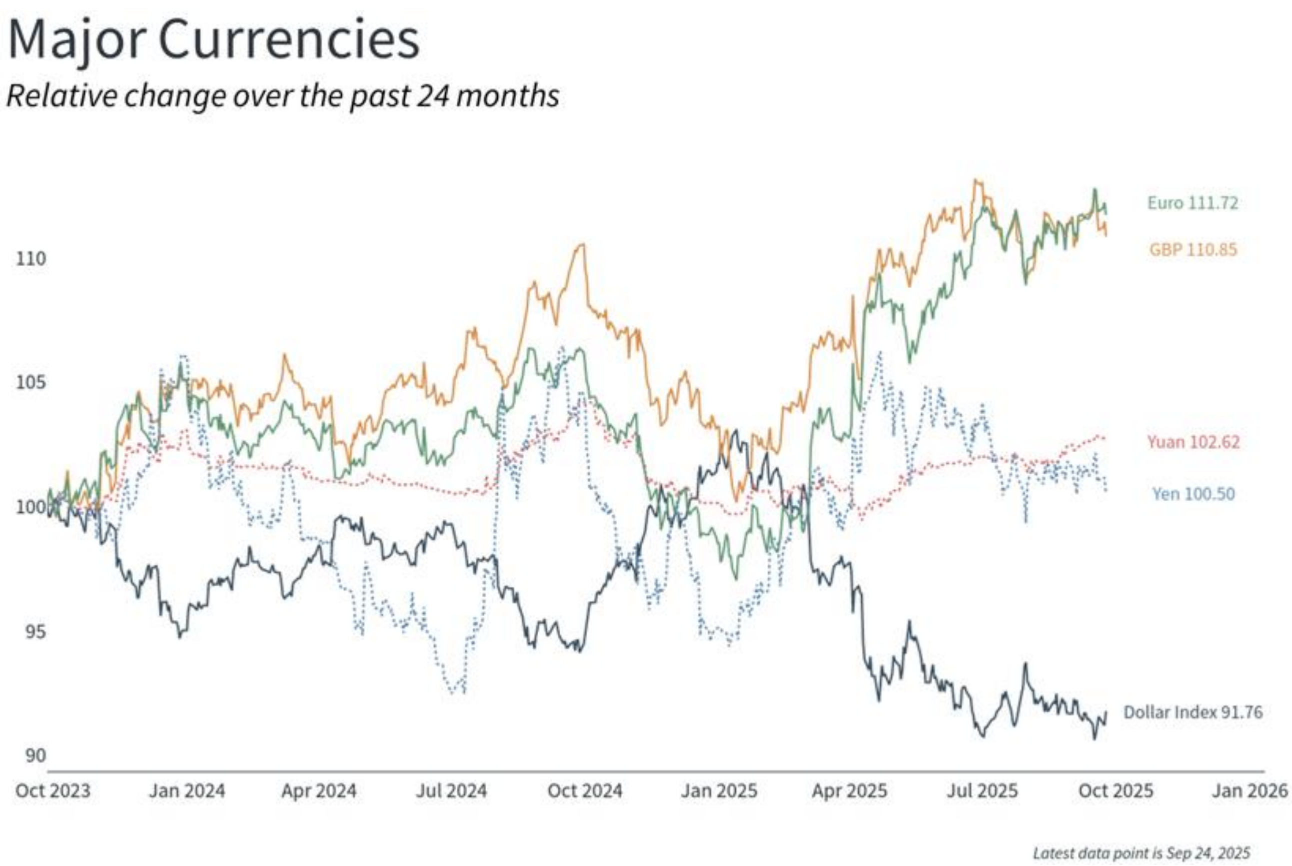


To conclude this first section:

- Bubbles rarely engulf all assets, and stepping out of risk-on markets entirely can be more dangerous than the bubbles themselves.
- Recent quick rebounds in U.S. stocks have bred complacency. Recency bias makes it easy to forget that bear markets can last years, underscoring the need for true diversification and ample liquid reserves.
- With headline indexes trading at stretched valuations, our focus remains on diversifying by sector, style, and region, favoring areas with stronger long-term records that still trade at more reasonable levels.

Dollar Diversification – Shoring up the near-term / liquid portion of our portfolio

For decades, the foundation of modern finance has rested on the assumption that U.S. government bonds, denominated in dollars, provide a "guaranteed" return (if held to maturity) and near-term price stability. Traditionally, diversification has been emphasized in riskier areas like stocks, real estate, and commodities, while US dollars and US bonds were treated as the unquestioned safe haven, with their yields even being referred to as "the risk-free" rate. Today, however, we see growing interest, among clients and across financial media, in extending diversification even to this traditionally "safe" portion of portfolios to non-USD instruments. With the nation's fiscal position worsening, partisan gridlock dominating Congress, and little progress on addressing persistent deficits, we understand and share our clients' concerns about the long-term stability of the U.S. dollar. These concerns are compounded by the risk of escalating tariff wars, which could strain international relationships and push foreign investors to look for alternatives outside of USD-denominated assets.



Many assets tend to move inversely with dollar strength, but few combine that relationship with (A) near-term price stability, (B) meaningful yield or total return potential (outside of exchange rate swings), and (C) insulation from the fiscal risks of paper fiat currency. Gold, industrial commodities, and foreign equities all provide meaningful offsets to dollar weakness with attractive total return potential, but they come with significant short-term volatility. Conversely, short-duration government bonds denominated in foreign currencies may appear to offer stability, yet most of the issuing countries, including those in the EU, Australia, Canada, and Japan, face fiscal challenges of their own, albeit to varying degrees. To boot, these countries' short-term bonds currently yield less than US treasury bills.

So, is worrying about currency diversification a worthwhile concern? Yes. Is finding a great, simple solution for most American investors black & white? No. How seriously you address currency risk should depend on personal circumstances. If you travel internationally, plan to live abroad, or think your kids may end up going to college in a different country, holding some foreign-currency exposure can help offset rising costs overseas. The same applies if you expect to retire outside the U.S., even part-time, where local purchasing power matters more than the dollar's strength.

Income and cash-flow realities also weigh heavily. Retirees relying on USD-denominated Social Security or pensions are fully tied to the dollar and more exposed to its devaluation. Households whose earnings are entirely USD-based have no natural hedge, whereas expats or global businesses may already have some diversification. Fixed, non-discretionary expenses in retirement, including healthcare, housing, insurance, etc. create more vulnerability to currency-driven inflation. Risk tolerance and liquidity needs matter too: investors drawing near-term cash may value USD/Treasury stability, while those with longer horizons can better stomach currency volatility.

Macro views can tilt the decision. Concerns about U.S. fiscal policy, deficits, or waning dollar dominance argue for more proactive diversification. Trade frictions, sanctions, or geopolitical tensions can sap demand for USD assets. And divergences in inflation and central-bank policy (Fed vs. ECB, BOJ, etc.) can materially shift currency values.

To conclude this second section:

- The case for currency diversification is strongest when your spending or income is meaningfully abroad, your time horizon is long, and your macro views are skeptical of the dollar; otherwise, the benefits may be modest relative to the complexity.
- There is no perfect solution for hedging US currency devaluation risk and being too preoccupied with this carries its own risk.
- There are a number of tools available to diversify away from dollars, including commodities, foreign stocks, foreign currency ETFs, foreign currency-denominated bonds, etc. Each have their pros and cons. If you are considering a move in this direction, we recommend consulting with us first.

In summary, today's environment calls for humility, balance, and discipline. While headlines may focus on bubbles or dollar concerns, the real work of investing lies in building resilient portfolios: diversified across styles, sectors, and geographies, and supported by prudent planning for both risk assets and safe reserves. By keeping perspective and avoiding overconcentration, investors can remain positioned to weather uncertainty and participate in the opportunities that inevitably follow.

End Notes

[i] Carlson, B. (2024, January 21). *New all-time highs after a bear market*. A Wealth of Common Sense. https://awealthofcommonsense.com/2024/01/new-all-time-highs-after-a-bear-market/?utm_source=chatgpt.com
[ii] Kelly, Dr. D. (n.d.). J.P. Morgan's guide to the markets. https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf - slides 11. *Be sure to visit the full guide for additional disclosures and other valuable market insights.*
[iii] Kelly, Dr. D. (n.d.). J.P. Morgan's guide to the markets. https://am.jpmorgan.com/content/dam/jpm-am-aem/global/en/insights/market-insights/guide-to-the-markets/mi-guide-to-the-markets-us.pdf - slides 46. *Be sure to visit the full guide for additional disclosures and other valuable market insights.*