

Author's telltale signs of a stock market crash

As a student of markets, I believe history is a roadmap for the future. The past may not repeat, but it certainly tends to rhyme. So when I came across "A History of the United States in Five Crashes" by Scott Nation, I was hooked. Beyond a simple recounting of events, the book weaves in regulatory missteps, economic forces, and even investor behaviors that turned boom into bust. The five covered crashes — in 1907, 1929, 1987, 2008 and 2010 — offer insight into how markets unravel and, more importantly, how investors' behavior and discipline can hurt or help.

Nation suggests five principles stemming from these market crashes. Let's examine each.

① The first principle is simple: Beware of shiny new financial innovations; they often hide risks that fuel downturns. Nation's central thesis is that crashes frequently stem from novel financial products that lull investors into false security. In 1907, it was trust companies, which operated like banks but without their oversight. The 1906 San Francisco earthquake led to a run on these trust companies, ultimately causing their collapse.

Fast-forward to Black Monday, 1987. "Portfolio insurance" — a newfangled, computer-driven, derivative strategy designed to hedge against losses — accelerated the sell-off while automated trades piled on. This led to a 22.6% single-day plunge. In 2008, mortgage-backed securities and credit default swaps, touted as ways to spread risk, instead concentrated it, turning subprime loans into a global contagion. And in 2010's Flash Crash, algorithmic trading bots created a feedback loop of erroneous trades, wiping out nearly \$1 trillion in market value in minutes.

The lesson: Scrutinize any "revolutionary" product or strategy, assessing it for any hidden leverage. These "innovations" lower our guard during rallies, only to betray us when the market turns. As an investor, stick to what you know. More than return, consider the value of diversified, transparent assets — liquidity, simplicity and relatability are often undervalued.

② Nation's second principle examines the classic crash pattern: a euphoric rally, a flawed vehicle and an unexpected spark. He argues that every meltdown follows a similar script: Optimism drives markets to irrational heights, investors adopt a financial mechanism that often requires selling at the worst time, and a catalyst sets off the chain reaction.

The 1929 crash is a perfect example. After years of speculative frenzy fueled by easy credit and margin buying (the mechanism that let investors borrow heavily), the catalyst was a fraud scandal in London that exposed market vulnerabilities. This led to Black Tuesday and the Great Depression. Similarly in 2008, the housing boom turned when mortgages went sour, resulting in defaults that triggered cascading losses for many who believed in the "sure thing."

Improving investor behavior means staying vigilant during bull markets. When stocks hit record highs (which often come before crashes), pay attention to valuation, not price. Pre-plan for buffers to weather an inevitable downturn. Remember that leverage, also known as debt, is a double-edged sword. It overcompensates during upturns but becomes a sharp razor when markets fall. Freedom comes from not owing anyone anything.

③ Nation's third principle reminds us not to rely solely on regulation, because it's always playing catch-up. He contends that regulatory frameworks evolve reactively, often too late to prevent disaster. In 1907, virtually nonexistent federal oversight allowed J.P. Morgan to act as a "private savior" stemming panic — ultimately prompting the creation of the Federal Reserve. By 1929, the Fed existed but bungled monetary policy, which further inflated the bubble. The 1987 crash exposed gaps in electronic trading, leading to the creation of circuit breakers ... which didn't prevent the algorithmic issues of 2010. And 2008? Despite post-1990s laws like the Home Ownership and Equity Protection Act, regulators under Alan Greenspan ignored warnings about predatory lending and derivatives.

Innovation outpaces regulation. For investors, this means due diligence is required. Don't assume the SEC, Federal Reserve, or your favorite politician has your back. Instead, read annual reports and prospectuses, and understand company balance sheets. At least seek to diversify across asset classes. Treat regulation as a pseudo-safety net, not a guarantee. *note*

④ Nation's fourth principle focuses on liquidity: available money. During crises, liquidity tends to evaporate, even among "solid" assets. In 1907, banks hoarded cash, freezing credit and forcing fire sales. The 1929 margin calls amplified this, as leveraged

(read indebted) investors dumped stocks to cover their borrowing. Today, you might conclude that instant digital trading makes this a lesser issue, but it's actually the opposite. See the 2020 and 2025 drops as examples for how quickly money can disappear.

A liquidity crunch is challenging as an individual investor. Instead, focus on stabilizing your financial foundation. Reduce high-interest debt to avoid forced sales during job losses — a common occurrence during downturns. Maintain an emergency fund of six-to-12 months' expenses in liquid assets like cash, treasuries or high-yield money-market funds. Personal liquidity lets you capitalize on chaos, investing when others are fearful without jeopardizing your wealth.

⑤ Nation's final principle encourages investors to watch for misaligned incentives that distort markets. Human behavior, driven by greed, is a recurring villain. In 2008, bankers packaged risky mortgages into securities because their bonuses rewarded volume over quality; meanwhile rating agencies rubber-stamped these securities for fees. Homeowners, incentivized by no-down-payment loans, overborrowed.

Incentives shape outcomes, so align your plan with your values. As an investor, favor companies that encourage executives to put skin in the game. Value and foster skepticism. Question why a deal seems too good, and you'll sidestep many traps. Be wary of advertising, media and the internet.

Nation's five principles show that while crashes are seemingly inevitable, their wake need not sink your boat. Studying others' experiences can inform your future. Each crash advances the system, but human nature endures. By applying these lessons, you'll improve both your portfolio and mindset — converting fear into opportunity.

Steve Booren is the founder of Prosperion Financial Advisors in Greenwood Village. He is the author of "Blind Spots: The Mental Mistakes Investors Make" and "Intelligent Investing: Your Guide to a Growing Retirement Income" He was named by Forbes as a 2024 Best-in-State Wealth Advisor, and a Barron's 2024 Top Advisor by State.