INVESTMENT STRATEGIES

How to spot a fad investment — and help clients avoid one

By Nathan Place April 3, 2024 3:06 PM

Stocks in Trump Media, owner of Truth Social, soared during the company's IPO on March 26, 2024, before crashing a week later. *Bloomberg/Yuki Iwamura*

Sometimes when an opportunity seems too good to be true, it's because it is.

Since the beginning of capitalism, investing has been prone to bubbles and fads. During the "tulip mania" of the 1630s, the price of a tulip bulb in Holland soared past six times the average Dutchman's salary — and then, just as quickly, collapsed. In the United States in the 1990s, the floppy stuffed animals known as Beanie Babies were auctioned off for thousands of dollars apiece — and then, just a few years later, their prices returned to the single digits.

Today there's Trump Media. Last week, the former president's social media company enjoyed an explosive IPO, with its stock reaching $57.99 per share and the company valued at about $8 billion.

Less than a week later, the bubble burst. On Monday, Trump Media revealed that it had lost more than $58 million in 2023, and the news sent its stock tumbling by 21%. By the end of the day, the company had lost $4 billion in value, according to CBS News.

In each case, investors who jumped on the bandwagon were left with badly devalued stocks, seeds or teddy bears. And yet when they bought in, it seemed like too good a chance to pass up.

"Fad investments are hard to resist," said Crystal McKeon, a certified financial planner at TSA Wealth Management in Houston, Texas. "The skyrocketing prices make you feel like you're missing out and you're the only idiot not making a fortune."

How can investors avoid this temptation? One answer is for a financial advisor to steer them away from it. But how can advisors spot a fad investment when they see one? Luckily, wealth managers with plenty of experience talking clients out of boondoggles have pinpointed the red flags. Here's what to look out for:

Everyone's talking about it

The fact that many people recommend something is usually a good indication of its merit. But when it comes to investments, experts say, it's often a warning sign.

"If your hairdresser or cabbie is excitedly talking about an investment, it's a fad that will end in tears," said Kashif Ahmed, president of **American Private Wealth** in Bedford, Massachusetts. "The people who are eager to give you advice or tout an investment are usually the least qualified to give such a recommendation."

In Ahmed's view, financial advice is about quality, not quantity. One trustworthy source — like a professional investment advisor — is worth far more than dozens of random ones. And when legions of those random sources start extolling a stock, it could well be evidence of misguided groupthink — or what one chronicler of the tulip mania called "**the madness of crowds**."

So how does Ahmed deflect fads, even when clients are champing at the bit to put their money in them? He discusses them — but that's it.

"I tell clients that I'm happy to entertain an investment idea they bring up, but only for academic discussion," Ahmed said. "If an investment is truly worth exposing your portfolio to it, it will already be in there."

Earnings aren't rising

Another red flag is when the profits of a company are out of sync with its stock price. One example is Trump Media, whose shares briefly soared even as the company was losing money. Another is the "meme stocks" of 2021: These included AMC and GameStop, both of which saw their earnings dwindle amid the COVID-19 pandemic, but enjoyed a stock bonanza thanks to an online group of amateur investors.

In theory, this shouldn't happen; the price of a stock should closely relate to the company's value. But amid the madness of crowds, investments can temporarily defy this law of finance — until gravity kicks in. In all three of these companies' cases, the stocks eventually crashed.

"The first lesson I was taught was that stock prices follow earnings," said Tom Balcom, founder of **1650 Wealth Management** in Lauderdale-by-the-Sea, Florida. "If there are no earnings, the stock price should not increase."

How can advisors help clients steer clear of these bubbles? The first, best option is to talk them out of the investment. But when that fails, Balcom said, one can at least minimize the damage.

"We advise our clients that these stocks … should only account for a small percentage of their overall portfolio, so that the impact will be modest in either direction," he said. "Folks that are trading these stocks should do so with funds they don't mind losing and then monitor these investments on a daily basis. These are not buy-and-hold investments."

The clock is ticking

One reason investors sometimes get drawn into fads is the time pressure they usually come with: The investment is doing well right now, and any delay induces a fear of missing out. If that FOMO is the main motivation for investing, experts say, that's already a bad sign.

"The biggest red flag for investors is when an investment is generating buzz and FOMO outside of the investment community," said Daniel Masuda Lehrman, owner of **Masuda Lehrman Wealth** in Honolulu, Hawaii. "If the average person who barely knows how their 401(k) works is throwing money into bitcoin because they're afraid of missing the boat, this is a clear warning sign to be careful."

The solution to this time pressure is simple: wait. If the stock doesn't stand the test of time, it's probably not worth investing in anyway.

"The warning signs for a 'fad' investment are that the company is new and unproven in terms of profitability, that the product or service is novel and does not have a long-established demand by consumers," said Robin Hovis, a financial advisor at **LPL Financial** in Millersburg, Ohio.

But FOMO can be a powerful force, even in the face of such rational counsel. If a client insists on following the herd, one thing an advisor can do is take a step back and remind them of the bigger picture.

"When clients come to us with these fad investments, we go back and discuss why we invest," said Austin Marrs, co-founder of **TSA Wealth Management**. "We invest based on long-term financial planning decisions, not to try to make the greatest return in any given period. Once we review this point and discuss the various risks associated with these fads, they usually happily move on."