By David Keator, Keator Group

During the last 30 years, we have seen investment “bubbles” of different varieties that are nothing more than extreme investment swings based on a myriad of factors. Internet, commodity and real estate bubbles, to name just a few, have all caused many investors anxiety. The primary drivers of these inflated values are based upon momentum and greed. It comes from a feeling that everyone else is making money and the investor is missing out. It’s OK to be an optimist, but it’s a good idea to be watchful when everyone is an optimist. Beware of crowds at the extreme. When we see the type of exuberance that typically leads to inflated values, we believe it’s a good time to take a breath and put up a safety net.

Last year, many economists and market analysts warned bond prices would decline and the result would be higher interest rates. As a result, the conventional wisdom was to shorten the duration of a fixed income portfolio in an attempt to create a bunker. Because we have enjoyed unprecedented and historically low yields (high bond prices), many heeded this call. Some saw a bond “bubble,” and it was time to take profits.

Last spring, the five-year treasury yield was 2.23 percent. Four months later, the five-year yield was 1.48 percent. When prices on bonds rise, their yields typically fall. That means the short-term investment call was premature, giving credence to market calls being more art than science. So, what is being done with all of the cash that is being held?

Investors are searching for a place to invest it. Short treasury yields (one year) fell from .30 basis points (one-third of 1 percent) to .16 basis points (one-sixth of 1 percent) between March 2010 and July 2011. This has caused investors to hunt for yield and seek higher income potential from more aggressive investments.

Theoretically, the higher the potential yield, the greater the risk, but the appetite for higher yield has been strong and that has the potential to cause a bubble in the high yield market just as high demand for Internet stocks caused unrealistic valuations in the late 1990s.

Buyer beware: A fixed-income investment paying a 5 percent yield might not seem risky on face value, but if it is compared to the relative security of treasuries, then you can easily see a potential for a disconnect.

So, back to our title: “What happens next?” The next step for each investor is to evaluate where your safety net is. Do you have an investment plan? Have you figured out your risk profile and adjusted your investments accordingly? Do you have a bunker?

If the market drops by 10 to 20 percent, do you have enough cash and liquid investments as a reserve so that you can avoid selling under-valued assets to meet emergency or even day-to-day needs? Are you properly diversified?

It is painful to see CDs and short-term treasuries paying less than 1 percent. If it is part of your bunker, you have to stay disciplined. If your investment time frame is short, you must be very careful of volatility. With a longer time frame, you could possibly take advantage of high-quality stocks with dividend potential or short-term corporate bonds.

Remember, we are in a global economy, so do not overlook investment opportunities throughout the world.

We believe one of the safest ways to invest is with a long-term horizon.

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About the author

David Keator is a partner at Keator Group. Contact him at (877) 532-8671.