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# Another 'costless' strategy roils market

## *Trading in footsteps of portfolio insurance*

**By Bruce I. Jacobs**

Momentum investors, intoxicated with quintupling tech-stock prices and armed with margin leverage, are wreaking havoc on markets.

As stock prices soar, they buy more, often financing their purchases with borrowing. Further price advances embolden them to pile on more bets. As prices begin to decline, however, these same traders rush for the exit in order to lock in their gains, reduce their risk and meet margin calls. Provided this selling can be done quickly and cheaply, with a click of the mouse, the overall strategy offers the promise of high rewards with little or no risk.

In essence, these momentum traders are trying to create a call option payoff pattern. Call options offer participation in upside price moves with no chance of loss, other than the cost of the option premium. Momentum traders are trying to obtain the benefits of a call option, without any payment of an option premium, by riding the upside of price movements while sidestepping the downside. But absent perfect market-timing skills, this is not possible. Instead, momentum traders can end up incurring huge costs costs that they share with other market participants.

Todays momentum investing is following in the footsteps of other strategies that roiled financial markets. In the 1980s, portfolio insurance promised to create put option payoff patterns also by buying stock as stock prices rose and selling as prices fell. As with the call option replication of momentum investors, portfolio insurance investors paid no premium at the outset of the strategy.

In the 1990s, Long-Term Capital Management tried to exploit arbitrage opportunities across the globe. Its use of near-costless borrowing and highly margined derivatives allowed it to take gargantuan leveraged positions and thereby to magnify minuscule net gains into stellar profits. Of course, LTCMs positions could support such high leverage because they were assumed to be virtually risk-free.

Momentum trading, portfolio insurance and LTCMs arbitrage all seem to promise something for nothing the profits from investing without the costs (or the risks). All three strategies are thus poised at the outset to attract capital.

As more of the markets capital becomes concentrated in these strategies, however, the market becomes increasingly susceptible to damage from their fail-safe mechanism.

That is, a larger and larger percentage of market assets is poised to cut and run when the going gets tough. The concentrated selling by these strategies can end up stampeding other investors and trampling market values.

Not until investors realize the cost of these costless strategies will demand for them lessen. Unfortunately, realization of the cost usually comes only after the fact after the strategies have failed and have caused markets to fail with them, in a big way. At this writing, it appears that even freak-out Friday, April 14, was not big enough.

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