Public interest in the stock market, stock price levels, and stock market volatility all seem to be at an all-time high. Talk of speculative bubbles and of major “corrections” abounds. Is a stock market crash inevitable? Are there destabilizing forces that exacerbate stock market moves, and if so what are they? And what is a nervous investor to do in this situation? Jacobs, who received his Ph.D. in finance from Wharton and who has worked in the investment management industry for about 20 years, has written a book with the intent of providing some insight into these questions. He provides a detailed analysis of the 1987 stock market crash, as well as some more recent events such as the near collapse of Long Term Capital Management (LTCM). Although 1987 seems far away now, the volume is both fascinating and timely, because understanding this bit of finance history can be important in providing some perspective on today’s markets and on what might come.

While the book includes numerous citations and discussions of academic papers, it is not technical. (Material in an appendix reviews the basic concepts associated with options and option replication techniques, and a detailed glossary explains many of the relevant terms.) The volume is divided into four parts. Part I provides some background on the ideas behind synthetic portfolio insurance and the development of the portfolio insurance market in the early and mid 1980s. It also examines the weaknesses and potential pitfalls of synthetic portfolio insurance. Part II describes possible explanations of the crash of 1987, starting with attempts to explain it as a rational reaction to fundamental information, and continuing with behavior models involving “animal spirits,” bubbles, cascades, and chaos. Part III focuses on the role of dynamic trading in the crash. In this part Jacobs puts synthetic portfolio insurance on trial for being a culprit in the 1987 crash and concludes, after examining some “alibis,” that it did play a major role in the crash. Part IV describes events related to option replication strategies following the crash.
lead to increased volatility in the underlying stock market. (The possible equilibrium impact of portfolio insurance on volatility is discussed, for example, in Sanford J. Grossman and Zhogquan Zhou [Dec. 1996, “Equilibrium Analysis of Portfolio Insurance,” J. Finance, 51:4, pp. 1379-1403], who show in fact that portfolio insurance increases price volatility.)

The success of option replication strategies also depends critically on the liquidity of the stock markets, because the theory justifying these strategies assumes that any desired trades will be executed immediately at prices equal to (or very close to) those that trigger the trades. For this to be the case, there must always be investors ready and willing to take the other side of the transaction that is called for by the replication strategy. As we observed in the 1987 crash as well as on a number of other occasions (including the LTCM crisis), the market does not always possess this degree of liquidity, and so option replication and similar strategies cannot always deliver the promised outcome.

Dr. Jacobs wrote a number of articles in the early and mid-1980s pointing out the potential pitfalls of synthetic portfolio insurance strategies, and he has been an active participant in the debate over the culpability of portfolio insurance in the 1987 crash. He claims, for example, that the aggressive marketing efforts of portfolio insurers played on the instinctive greed and fear of investors, implying that one can enjoy the upside while being protected from the downside at insignificant (or even negative) cost and, in effect, misleading investors. For investors who did not understand fully the nature of the option replication strategies on which portfolio insurance is based, the crash was obviously a rude awakening. While the author quotes some of the defense arguments in the “trial” of portfolio insurers, readers should bear in mind that he represents the prosecution.

In developing his analysis, Jacobs also takes issues with the efficient market paradigm, and discusses many papers on speculative bubbles, cascade models, and behavioral finance. Although these can be relevant in trying to explain stock market crashes, it is not clear whether they are necessary or consistent with the book’s main theme. For example, he refers to option replication strategies as “noise.” However, trading based on pure noise is inherently unpredictable. Option replication strategies, by contrast, are a deterministic function of prices. Models in which portfolio insurance contributes to the crash do not require that investors act on the basis of animal spirits or fads. In Gerard Gnetto and Hayne Leland (Dec. 1990, “Market Liquidity, Hedging and Crashes,” Amer. Econ. Rev. 80:5, pp. 999-1021) and Charles J. Jacklin, Allan W. Kleidon, and Paul Pfleiderer (1992, “Underestimation of Portfolio Insurance and the Crash of October 1987,” Rev. Finan. Stud., 5: 1, pp. 35-63), for example, investors are simply not aware of the extent to which others are using synthetic portfolio insurance. Price run-ups and crash-like events can occur because the actions of portfolio insurers cannot fully be distinguished from those of informed investors.

Synthetic portfolio insurance has fallen out of favor following the 1987 crash. In response to the demand for hedging and portfolio protection, option exchanges expanded the menu of long-term options available on the exchange, and the market in over-the-counter options sold by investment banks has grown dramatically. Jacobs argues, however, that option replication strategies are still being used and act as destabilizing forces, because those who sell over-the-counter options, as well as those making market in options on the exchange, engage in dynamic option replication strategies similar to those used by portfolio insurers of the mid 1980s.

Will there be another major stock market crash? And if so, who will be “blamed” for it? Will it be again professional investors, trading on the basis of fancy mathematical models whose assumptions do not always hold, or are there other forces lurking around these days? (Consider, for example, day traders or investors found in chat rooms around the internet.) These are difficult questions. As for what a nervous investor should do, Jacobs concludes the book by urging investors to go back to basic portfolio theory: diversify and invest for the long run. For many investors, this is probably the best advice around. It is, incidentally, also consistent with market efficiency.

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