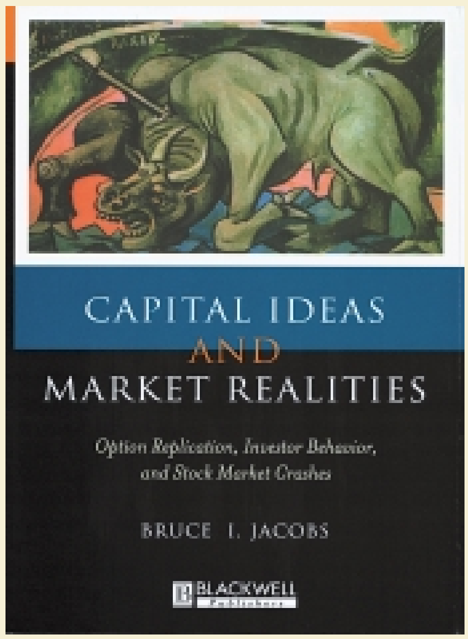
Letter to the editor

From Bruce Jacobs, Jacobs Levy Equity Management

Sir,

In "The Point of a Put" (*Risk* April 2000), professor Michael Brennan reviews my book, *Capital Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes*. Brennan asserts that "this is an interesting book that is marred in places by a journalistic tone". Perhaps he feels that the work (despite its numerous references to the academic literature) places too much emphasis on the aggressive advertising materials used by portfolio insurance vendors. I find that Brennan's review misses the point of the book and is blemished by an ivory tower view that does not acknowledge market realities.

The heating oil analogy he uses to represent the thrust of my book is fatally flawed because it does not incorporate the positive feedback mechanism at the heart of my argument. Portfolio insurance is trend-following trading. Rising prices lead to buying, which raises prices, which causes more buying; falling prices leads to selling, which leads to falling prices and more selling – and, potentially, crashes.



Brennan pays lip service to the idea that unanticipated insurance sales can cause a crash, but downplays its impact on October 19, 1987, hauling out the canard that insurance sales were not of sufficient magnitude. This alibi, long touted by insurance vendors and their academic apologists, is refuted in my book.

In an ideal market, as Brennan notes, "sufficiently high prices for volatility will result in a greater supply of puts and calls". In the real world, however, the public's demand for insurance-like puts and for lottery-like calls means that over-the-counter dealers and options exchange market-makers are typically short options, and must resort to dynamic trading to hedge their risks. The extent of this trading is largely unknown, and may catch markets unaware (as it did in October 1989, November 1991, October 1997 and August 1998).

Brennan further states that "portfolio insurance sales reverse themselves". On the contrary: as prices decline, dynamic hedgers are forced to sell; they won't buy unless markets rise. Other investors are willing to step into the breach of falling prices only at steep discounts.

Brennan finds a silver lining in these mini-crashes: "The occasional price gap serves to remind investors of the dangers of dynamic replication and prevent it getting out of hand." Thus dynamic hedgers are chastised. Of course, getting hurt in the process are a multitude of investors who hadn't realised they were shouldering the risk for dynamic hedgers.

Finally, one of the major prescriptions in my book is that full disclosure would help mitigate the potential damage caused by dynamic hedging. Full disclosure in the review by Brennan would include the fact that he has received research funding from Leland O'Brien Rubinstein Associates (LOR), the primary purveyor of portfolio insurance. Readers of my book and of his review can draw their own conclusions.

Sincerely, Bruce Jacobs, PhD

Bruce Jacobs is author of *Capital Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes*, Blackwell Publishers (1999), and principal of Jacobs Levy Equity Management, Roseland, New Jersey, US