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More to say about crash

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The market crash of Oct. 19, 1987, is now almost 12 years behind us. Many millions of words have been written about it since then, beginning with the newspapers on Oct. 20 and continuing through the Brady Commission report, which attempted to divine the cause, and many academic articles in scholarly journals.

Yet another book on the topic has just been published. What more needed to be said?

The book, Capital Ideas and Market Realities, by Bruce I. Jacobs (Blackwell Publishers, Malden, Mass.), explains more thoroughly than ever why portfolio insurance failed and how it contributed to the 1987 market crash.

But the analysis of why the 1987 crash occurred and what part portfolio insurance played in it accounts for only half the book. The rest is a warning that hedging strategies based on options replication have multiplied since 1987, often in guises many investors do not recognize. And it identifies those disguises.

Mr. Jacobs shows how the reasoning behind the Black-Scholes options pricing model, which won Myron Scholes and Robert C. Merton the Nobel Prize for Economics, led to the creation of these synthetic options and to portfolio insurance.

In 1983, Mr. Jacobs was one of the first to warn that portfolio insurance probably would not work and probably would be destabilizing. For the next several years he debated the proponents of dynamic hedging, as portfolio insurance also was known, repeating his warning again and again as the product boomed.

After the crash, some defenders of portfolio insurance argued that portfolio insurance couldn t be blamed for the 1987 crash because the 1929 crash occurred when portfolio insurance didn t exist. To which Mr. Jacobs replies in the book: This line of reasoning would suggest that high-powered rifles should not be considered when analyzing President Kennedy s assassination because such weapons were not available when Julius Ceasar was assassinated. Portfolio insurance, the product, died after the 1987 market crash. But dynamic hedging-type vehicles survived and are still in use today.

Mr. Jacobs points out in his book that dynamic hedging products are inevitably trend-following and destabilizing when a problem occurs. They amplify market rises and exacerbate market declines because they require forced selling into declining markets. He shows how these sons of portfolio insurance contributed to the minicrashes of 1989, 1991 and 1997, and even to the collapse last year of Long-Term Capital Management LP.

In fact, many of the financial instruments or devices in use today, including warrants and swaps, might contribute indirectly to market volatility in times of uncertainty, because one side of these transactions usually wants to hedge its position, often by using a dynamic hedging strategy.

In the past 12 years, many pension fund and other investors have entered the market unaware of the role of dynamic hedging in the 1987 market crash. Many of those who were in the business at that time have forgotten the details. Most are unaware of the amount of trend-following hedging that is going on today. Mr. Jacobs book will be an education to the newcomers, a reminder to the veterans, and a warning to all that the dangers of options replication are not behind us. It should be read by all.

And it is to be hoped his warnings this time will be better heeded than his warnings of 1983.