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Jacobs blames portfolio insurance

By Barry B. Burr

Portfolio insurance promoted by Leland O Brien Rubinstein Associates Inc. and other vendors not only caused the 1987 stock market crash, but also helped fuel the then-record climb in equities preceding the plunge, according to a forthcoming book.

It suggests that 10 years later, the market faces another potential crisis because of the great unknown consequences of what the newly completed book calls the sons of portfolio insurance, including options-writing strategies.

Bruce I. Jacobs, principal and co-chief investment officer with Jacobs Levy Equity Management Inc., Roseland, N.J., wrote a more than 400-page manuscript with the working title of Capital Ideas and Market Realities: The True Story of the Crash of 1987 and the Lessons We Have (and Haven t) Learned.

Harry Markowitz, who won a Nobel prize in economics for his work pioneering modern portfolio theory, has written a foreword to the book. Mr. Jacobs hopes to contract with a publisher soon.

In the book, he argues when marketing portfolio insurance, LOR and other vendors played on institutional investors basic feelings of fear and greed, and concern over job security.

The manuscript draws on behavioral finance to examine aspects of portfolio insurance demand and the ensuing crash.

Portfolio insurance appealed to investors having myopic loss aversion, he said in an interview describing the book s contents.

His work examines why portfolio insurance - also called dynamic asset allocation - caused the breakdown in the market on Oct. 19, 1987.

The strategy was inherently destabilizing to the market system, Mr. Jacobs writes. The strategy called for investing into equities as the stock market rose and selling as the stock market fell.

It is a positive feedback system because it serves to amplify price movements, he said. It will cause more volatility and a magnification of . . . uptrends and downtrends.

Value investing s antithesis

Portfolio insurance follows an approach that is the antithesis of value investing, Mr. Jacobs says. Even traditional modern portfolio theory tends to be a negative feedback system, because it tends to call for a scaling back on equities as prices rise.

Portfolio insurance, however, encouraged investors to commit more to equities than they would otherwise.

Portfolio insurance was a fad that helped to fuel the rising market, he added.

In a section dealing with pre-crash advertisements for portfolio insurance, LOR and vendors of LOR-licensed portfolio insurance, including Aetna Life Insurance Co., advertised the product as foolproof.

Aetna, for example, called its product guaranteed equity management.

In a promotional quote illustrated by Mr. Jacobs in his manuscript, Aetna states:

GEM gives plan sponsors an alternative approach to the problem of controlling portfolio risk by allowing them to participate in equity returns while placing absolute limits on downside exposure.

The key word is absolute , said Tate, who was Ralph S. Tate, vice president and director of portfolio management for Aetna s common stock department. If a sponsor chooses a 0 percent return, he s never going to have to go to his pension committee and explain losses. Even the most conservative balanced or bond manager can t offer that. *

Aetna had an estimated $17 billion of the outstanding portfolio insurance. Sources in the book cite the total market at between $60 billion to $100 billion at the time of the crash.

Failing to protect

But when the crash occurred, Mr. Jacobs said, Liquidity wasn t there. Portfolio insurance universally failed to protect its floors, or target levels of protection. Then portfolio insurers were unable to take advantage of the market recovery. They lost out on rising market opportunity over the next two years.

LOR began marketing portfolio insurance in 1982 when the market was coming off of 10 poorly performing years and investors were leery of stocks, Mr. Jacobs said. It turned out that year was the start of the bull market.

In another advertisement, cited by Mr. Jacobs, Aetna brags about 10 years of GEM s simulated returns, ending in 1982.

What else makes our GEM strategy so remarkable? the Aetna ad reads. The investment technology credentials of Leland O Brien Rubinstein Associates are impeccable.

In the interview, Mr. Jacobs said, Portfolio insurance had great appeal because it was very aggressively and egregiously marketed as being a universal panacea. It was marketed as a way to protect assets, but at the same time it claimed it could enhance returns and unleash the aggressive investor, who because of a (portfolio insurance) safety net, could put even more money into stocks.

Among other reasons, portfolio insurance was sold as a benefit to pension funds especially with FAS 87 - the Financial Accounting Standards Board s then new pension disclosure rule - to minimize volatility on (corporate) income statements and raise returns on actuarial rates to lessen (pension) contributions.

Portfolio insurance had substantial credibility because it came from the academic community and academic journals, Mr. Jacobs said. Two LOR principals - Hayne Leland and Mark Rubinstein were - and still arec- scholars at the University of California at Berkeley.

Academic bias claimed

Mr. Jacobs, however, assails the bias of academic journals where he tried several times to have his criticism of portfolio insurance published before the 1987 crash.

He said publication of his work was rejected by reviewers tied to the portfolio insurance market.

Looking at it 10 years later, we can see no discernible fundamentals at the time responsible for the crash, Mr. Jacobs said. The economy continued to grow and the market rebounded, unlike in all previous crashes that were associated with financial panics and economic depressions.

Mr. Jacobs is leery of sons of portfolio insurance now in the market. These include privately negotiated put options with investment banks, he said.

The great unknown is the magnitude of the put option deals, because they are private deals not disclosed, he said. The risk is the issuers may not have adequate resources to cover potential losses.

Such strategies can trigger information-less trading, he said, that is trades based on mechanistic triggers, not fundamentals, as did portfolio insurance in 1987.

Mr. Jacobs is concerned whether market interventions put in place since 1987 to try to prevent another crash will work.

For example, he expressed doubts on the effectiveness of circuit breakers, which halt trading temporarily when the market falls 350 points, giving investors a sort of timeout to deliberate about the cause of a decline.

He noted that after the market fell precipitously the Wednesday, Thursday and Friday before the crash, investors had an entire weekend to sort out the falling market, yet returned Monday to participate in the greatest one-day crash.

Also, he noted there is a gravitational pull of investors wanting to get out before trading halts when they see a decline approaching the circuit-breaker trigger. In addition, he said, savvy front-running investors will start selling ahead when they see portfolio insurance investors following their mechanistic dictates to sell in the face of a declining market.

The timeouts don t cause any harm, though, he added. The real problem is when information is not fully revealed, such as mechanistic portfolio strategies.

He said the new proposed FASB rule on derivative disclosure would help investors know more about the extent of these strategies.