BOOK REVIEWS

Martin S. Fridson, Editor

"Postscript": Author's Comment

***Capital Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes.* By Bruce I. Jacobs. Blackwell Publishers, Inc., 350 Main Street, Malden, MA 02148, 800-216-2522, www.blackwellpub.com. 399 pages, $68.95 hardcover, $32.95 paperback.**

Comment by Bruce I. Jacobs, principal, Jacobs Levy Equity Management, Florham Park, New Jersey.

In Martin Fridson's "Postscript" (January/February 2001) to his review of my book, unnamed "observers," "investment professionals," and "sources" attack the book's presentation of the way in which portfolio insurance was marketed by its primary vendor, Leland O'Brien Rubinstein Associates (LOR) in the 1980s. These anonymous critics do a disservice to the book and to investors generally. *Capital Ideas and Market Realities* (CIMR) does not, as the postscript implies, make a charge of bad faith against LOR's principals. It presents a fair, accurate, and (as Fridson's original, favorable review of July/August 2000 noted) a "meticulously detailed" account of the way portfolio insurance was marketed. This information is vital to understanding the mechanisms by which portfolio insurance and similar strategies affect markets. In brief, the false impression that such strategies offer high returns at low risk allows them to attract investments sufficient in size to threaten market stability.

The postscript charges that CIMR "marshaled selective quotations" to make this case. Nothing could be farther from the truth. CIMR provides extensive quotations from, and references to, hundreds of named sources. In contrast, the postscript builds its case on the basis of anonymous sources and a single citation—Mark Rubinstein's article in the July/August 1985 issue of the *Financial Analysts Journal*. This article (referenced in CIMR) stated that portfolio insurance is not "perfect insurance," but the article was hardly forthcoming about just how imperfect the strategy is. Readers of CIMR can examine this article and numerous other named sources and draw their own conclusions.

The space constraints placed by the *FAJ* on this response prevent me from detailing here the many examples of LOR's claims for portfolio insurance and the firm's failure to adequately disclose the pitfalls. Interested readers will find new evidence from articles, advertisements, and LOR's own Form ADV filings with the U.S. SEC in the complete text of this response at the book's website (www.CIMRbook.com).

Portfolio insurance and the other strategies discussed in CIMR, including dynamic hedging by option traders and arbitrage of the sort carried out by Long-Term Capital Management, have the potential to attract large investments because they seem to offer a free lunch. But these strategies can not only turn out to be much riskier than expected; they can also increase the probability of market crashes. If we are to have any hope of mitigating their pernicious effects, full and candid disclosure and discussion of their real risks is imperative. Continued denials and obfuscation are counterproductive.

———B.I.J.

"Postscript": Reviewer's Response

Response by Martin S. Fridson, CFA

I have only one quibble with Bruce Jacobs' rejoinder: If "attack" is a fair characterization of the postscript, then I am the attacker, not my "unnamed 'observers,' 'investment professionals', and 'sources'." (For the record, I regret that Jacobs apparently considers the postscript hostile; it was certainly not my intention to scold him.)

The professionals whom I consulted were neither purveyors of portfolio insurance nor investors who ultimately decided to buy the product. Accordingly, these "anonymous critics" had no obvious reason either to attack Jacobs or defend Leland O'Brien Rubinstein Associates. I did not ask them to comment on Jacobs' work but merely to indicate whether they believed that LOR's marketers presented the risks and rewards of portfolio insurance fairly. Based on their detailed accounts, I concluded that sophisticated investors who knew the right questions to ask would not have been misled. I presume no bias in Jacobs' contrary conclusion derived from similar LOR presentations. Inevitably, recollections of the emphasis and tone of portfolio insurance presentations made 15 years ago have a "he said/she said" quality. To Jacobs' comment that readers can examine the written sources and draw their own conclusions, I say, "Amen!"

———M.S.F.

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