
BOOK REVIEWS

Martin S. Fridson, Editor

***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.**

Reviewed by Martin S. Fridson, CFA.

In 1982, Bruce I. Jacobs, who later co-founded the institutional investment counseling firm Jacobs Levy Equity Management, attended a presentation on portfolio insurance by its leading proponent, Leland O'Brien Rubinstein Associates (LOR). This new product purportedly protected a stock portfolio against market downturns through shifts between stocks and cash equivalents in a manner that mimicked the effect of an equity put option. Contrary to LOR's hopes, Jacobs concluded that portfolio insurance would reduce returns over the long run and, if used by large numbers of investors, would increase market volatility. He began writing and speaking against the innovation with such vigor that LOR principal John O'Brien labeled him "the Darth Vader of portfolio insurance."

The October 19, 1987, stock market crash more or less killed portfolio insurance, which was widely blamed for the debacle, but it did not diminish Jacobs' zeal for denouncing the product. Writing in his spare time during the past decade, he produced *Capital*

Ideas and Market Realities: Option Replication, Investor Behavior, and Stock Market Crashes. Jacobs' rationale for publishing a detailed account of portfolio insurance's rise and fall at this late date is that the historical case study can serve to warn investors about newer kinds of market-destabilizing option strategies. In particular, he attributes the August–September 1998 liquidity crisis at Long-Term Capital Management to the same sorts of fallacies that undid portfolio insurers in 1987.

Jacobs' meticulously documented book presents compelling evidence to support its first charge, namely, that portfolio insurance failed to deliver on its lofty promises. After the crash, LOR's O'Brien acknowledged that between January 1 and October 19, 1987, the firm's average account dropped 3–4 percentage points below the floor supposedly provided by the insurance. Moreover, LOR's Mark Rubinstein conceded that some users of insurance were forced into cash by provisions of their contracts and, consequently, missed the market's subsequent rebound. Investor experience plainly contradicted the 1984 claim by one LOR licensee that portfolio insurance guaranteed a specified minimum return even under "the worst of all worst case scenarios."

Indeed, Jacobs finds LOR's claims for portfolio insurance's benefits dangerously misleading. LOR went so far as to assert, in a 1984 advertisement for one variant of its product, that investors might increase their returns while simultaneously reducing their risk:

There is a cost, or premium, for the minimum return assurance that the Fiduciary Hedge Program provides. However, with the FHP in effect more of the fund's assets

can be placed in higher expected return albeit riskier asset classes. The net effect can be to increase the total fund's expected return by 1 to 2 percent per annum.

Such representations, notes Jacobs, violate the fundamental principle that the risk of holding equity cannot be eliminated but only transferred from one market participant to another. Purveyors of portfolio insurance fostered the illusion that high returns could be achieved with low risk by downplaying the insurance's implicit assumptions of deep, liquid markets and continuous prices. Implementation of the (theoretically foolproof) dynamic hedging strategy foundered when stock indexes skipped downward without trading at each tick along the way.

Similarly illusory were marketers' backtests that showed investors earning a net profit on portfolio insurance in the 10-year interval ending 1982. Uncharacteristically, equities underperformed U.S. T-bills during that long period. Jacobs' simulations over a longer span in which the equity return premium was positive produced the logically expected result: The use of portfolio insurance to reduce risk produced a drag on returns.

Jacobs' second charge, that portfolio insurance on October 19, 1987, "turned a market correction into a major crash" is impossible to prove definitively. His game attempt relies on the process of elimination—that is, rejection of every alternative explanation of the record 22.6 percent one-day decline in the DJIA. Establishing a cause-and-effect relationship between portfolio insurance and the market free fall would depend, however, on refuting a number of nonfrivolous objections. For example, the plunge in the U.S. market

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coincided with dramatic declines in countries where no portfolio insurance existed. So, in the end, Jacobs can conclude only that

the preponderance of evidence examined suggests that the U.S. market crash precipitated the worldwide crash and that synthetic portfolio insurance *played a major role* in the U.S. crash [italics added].

This claim waters down considerably the dust jacket's flat assertion

that dynamic hedging associated with option-replication strategies *caused* a U.S. stock market crash in 1987 that wiped out almost a quarter of U.S. equity value and ignited market crashes around the world [italics added].

Despite the lack of conclusive proof for his charge, Jacobs' comprehensive review of research on the causes of the 1987 crash is an invaluable resource for students

of the market. Moreover, even if Jacobs cannot convict portfolio insurance of full culpability for the October 1987 meltdown, *Capital Ideas and Market Realities* astutely sizes up the continuing search for what he labels "the Northwest Passage of no-risk reward."