Postscript

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.**

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In our review of Bruce I. Jacobs' *Capital Ideas and Market Realities* (*Financial Analysts Journal*, July/August 2000), we marveled at the vehemence with which the author attacked portfolio insurance more than a decade after the October 1987 stock market crash rendered it a dead letter. Feedback generated by the review has made clear, however, that intellectual interest remains strong among practitioners who take a more constructive view than Jacobs does. Observers are particularly keen to resolve the question of whether users of the product were, or should have been, surprised by portfolio insurance's performance on Meltdown Monday.

Jacobs marshaled selected quotations to suggest that promotion in the early 1980s by Leland O'Brien Rubinstein Associates (LOR) led investors to believe that its portfolio insurance product placed an absolute floor under their potential returns. In a 1985 article, however, LOR Principal Mark Rubinstein explicitly characterized that theoretical outcome as "perfect portfolio insurance" and added that it was achievable only with instruments not available in listed U.S. markets.[1] In other words, dynamic asset allocation, the technique used by LOR, could only approximate the performance of perfect insurance. Rubinstein also stated clearly that the projected returns of a portfolio insurance strategy incorporated certain key assumptions, including the absence of price discontinuities during large swings in the market. In October 1987, when this assumption was violated, portfolio insurance performed more poorly than many of its users had foreseen. But according to several investment professionals we consulted, LOR's pre-1987 presentations were candid in describing the likely impact of greater-than-expected volatility. As for representations that the cost of the insurance could be negative, another point of Jacobs' criticism, our sources confirmed that LOR mentioned that highly favorable result as a possibility, not a likelihood.

The bottom line is that Jacobs cannot make a charge of bad faith stick against LOR's principals. As our review noted, *Capital Ideas and Market Realities* similarly failed to prove that portfolio insurance caused the 1987 crash. The book's main value, then, is its valid warning that price discontinuities occur more frequently than financial models generally assume. Long-Term Capital Management's 1998 implosion shows that investors need to be frequently reminded of this point.