Black Monday: The Improbable Crash, Its Causes, And Timeless Lessons For Investors

Portfolio Insurance and the Perils of Feedback Loops

What caused the drop? A number of factors contributed to the crash:

- Economic growth slowed in the first three quarters of 1987 and inflation was rising. Given the recent stagflation experience from the 1970s, investors were jittery.
- The stock market had declined nearly 10% the week prior to Black Monday which added to investors' fears.
- Program trading using computers was relatively new and not sophisticated. The losses in the week prior to Black Monday and the losses at the open triggered computer program trading with little or no human intervention.

And then there's the ill-fated "portfolio insurance" strategy. Portfolio insurance involved using puts and calls to hedge a portfolio against losses while allowing it enjoy gains. Maintaining portfolio insurance required portfolio managers to adust the hedges as the market went up and down. The use of portfolio insurance gained in popularity in the years leadin up to Black Monday and by October 1987, tens of billions of dollars were managed within the portfolio insurance scheme.

For each individual investor, using portfolio insurance to hedge against losses was completely rational — benefitting from gains while limiting losses sounds great. But on a system-wide basis, having that much capital deployed using an indentical strategy was catastrophic.

As market volatility spiked in the weeks leading up to Black Monday, the portfolio insurance strategy caused investment managers to sell holdings to raise money to increase their hedges. Losses generated by selling into a declining market triggered the portfolio insurance algorithms to sell even more assets to place more hedges. This feedback loop of losses generated still more selling, creating still more losses, leading to more selling, and so on. The next thing you knew, the market had plunged 23%.

Quelle: [Black Monday: Its Causes, And Timeless Lessons For Investors (forbes.com)]