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Economy & Business

Wild Bears On the Loose

What should be done to calm Wall Street?

There it was again—the harrowing, sinking feeling that has become all too familiar on Wall Street. Pessimism verging on panic. Stock prices plunging in a free fall. Last Friday the Dow Jones industrial average suffered its third largest drop in history, plummeting 140.58 points to close at 1911.31. Fortunately, the worst of the rout began after 2:30 p.m., and there was not enough time for a full-fledged disaster before the New York Stock Exchange's 4 p.m. closing bell. By the end of the day, however, traders could not help but think back to the 108.36-point fall on Friday, Oct. 16, that set the stage for Black Monday, Oct. 19, when the Dow fell 508 points. The question on everyone's mind: Could it happen again?

Friday's decline more than wiped out the four previous days of healthy stock advances spurred by an unexpected rally of the dollar, which was bolstered by the intervention of central banks in the currency markets (*see following story*). For the week, the Dow was down 27.52 points. As usual, there was a logical, if contorted, economic explanation of why investor sentiment so abruptly turned bearish. The problem started when the Government announced that the U.S. unemployment rate had fallen from 5.9% in November to 5.8% in December, its lowest level since 1979. To most people, that sounds like good news, but nobody has ever accused Wall Streeters of thinking like most people. To a bond trader, lower unemployment means faster growth, more inflation and higher interest rates. So bond prices slumped, and that triggered a drop in stocks. Investors were also concerned because the dollar started dipping again on Friday and because they feared that Government figures on the mammoth U.S. trade deficit due for release this week would show little or no reduction.

But none of this could adequately explain why the Dow dropped 90 points in just 45 minutes late on Friday. Experts quickly pointed out that the slide was accelerated, as other swings have been during the past two years, by computerized program trading of large blocks of stocks and stock-index futures. The debacle raised anew questions that have been hotly debated since October: Is the new high-tech volatility of stock prices out of control? Are investors vulnerable to a crash at any time if reforms are not undertaken to shore up the market's stability?

In the aftermath of Black Monday, more than a dozen investigative bodies have been probing those issues. Last Friday, in a case of remarkably appropriate timing, the most prominent of these groups—the Presidential Commission headed by Investment Banker Nicholas Brady—released its eagerly awaited report just after the market closed. The conclusion of the five-member commission* was clear: sweeping reforms are in fact needed to guard against market meltdowns.

The Brady report says that while the Black Monday crash was triggered by fundamental problems like the trade deficit, it was exacerbated by the complex and poorly controlled interactions between the New York Stock Exchange and the Chicago Mercantile Exchange, which dominates the trading of stock-index futures. If dangerous stock dives are to be avoided, the Brady group contends, Chicago and New York will have to play by similar rules. The commission's central recommendation is that one agency—preferably the Federal Reserve—coordinate the activities of all U.S. financial markets. Currently, the Securities and Exchange Commission regulates the stock exchanges and the Commodity Futures Trading Commission oversees the Chicago Merc and other exchanges that deal in stock-index futures.

The commission's proposal would bring under one master two radically different kinds of markets. An investor who buys stock gets tangible shares of a corporation, which can be held for the long term. The person who buys or sells a stock-index future, in contrast, is making a short-term bet on which direction the overall market is going to go in the near future, usually a month

*The members include Brady, chairman of Dillon Read; James Cotting, chairman of Navistar International; Robert Kirby, chairman of Capital Guardian Trust; Robert Stein, chairman of Dreyfus; and John Opel, former chairman of IBM.

Trading stock-index futures in a pit at the Chicago Merc

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: Stock Exchange: "There is just not enough buying power in times of emergency"

or less. Thus the Chicago Merc is used primarily by brokerage firms and speculators seeking quick profits, and by money managers who want to hedge their portfolios against losses in the stock market. The rules of the two games are wildly disparate. In the stock market, the margin requirement—the percentage of down payment that an investor must make to buy shares on credit—is 50%. In Chicago, investors can buy into the futures market with as little as 12% of the value of the contract purchased.

As different as the two markets are, they have become inextricably linked through the computerized trading strategies carried out by big brokerage houses, pension fund managers and other institutional investors. One variation is called index arbitrage, in which traders try to make swift, sure profits by taking advantage of temporary discrepancies between the prices of stock-index futures and the actual stocks that make up the index. A related gimmick is portfolio insurance, in which money managers sell stock-index futures during a market decline to guard themselves against losses. Heavy use of these strategies can produce violent price swings in the stock market.

The Brady report identified portfolio insurance and index arbitrage as culprits in the Oct. 19 crash. Desperate to cut their losses when the stock market began to fall, money managers sold huge numbers of futures contracts. So many traders were following the same strategy that the downward spiral of prices accelerated in both New York and Chicago, and everyone got burned.

Since portfolio insurance offered no protection to those who tried it on Black Monday, the technique has fallen into disrepute and relative disuse. But profitable index arbitrage is still popular and may have been responsible for a big part of last Friday's plunge. The Brady report suggested that such volatility might be curbed if the 12% margin needed for buying a stock-index future were brought more into line with the 50% required for stocks. That might dampen speculation at the Chicago Merc. Critics of this idea, however, point out that the big institutions that play the index arbitrage game generally pay cash for their contracts.

Far more controversial was the Brady commission's recommendation that financial markets establish "circuit breakers" to stop trading when things get out of control. These safeguards, said the report, might include limits on how much the price of a stock could rise or fall in a day. That idea, leaked to the press before the report was actually released, provoked vehement protests on Wall Street. "It's ridiculous," scoffed Alan Greenberg, chairman of Bear Stearns. "If a stock wants to go down, let it go down."

At a press conference held to announce the commission's recommendations, Brady insisted that the group had brought up price limits only as one of several possibilities. The point the commission wanted to make, said Brady, was that whatever circuit breakers are chosen, they should be coordinated between both financial exchanges. At present Chicago and New York do not agree on the issue. After the crash, the Merc imposed daily limits on price swings. The New York Stock Exchange has long used a different safeguard: trading in a stock is halted only when there is an overwhelming imbalance in buy and sell orders.

Phelan accuses program trading

Too much volatility can destroy credibility.

Getting the Merc and the Big Board to see eye-to-eye will not be an easy task. The two exchanges are archrivals for the investor's dollar, and both have strong-willed leaders who believe in their way of doing things. On one side is N.Y.S.E. Chairman John Phelan, who has warned of the dangers of the rapid growth of speculative trading in Chicago. Two days after the crash he asked for a temporary halt to certain types of program trading, and he has suggested that the practice be permanently restricted. "If we destroy the markets by too much volatility," he has said, "we ruin their credibility."

Two weeks ago, a study done for the N.Y.S.E. by Nicholas Katzenbach, the former U.S. Attorney General, pointed the finger at Chicago. The report called for curbs on program trading and stiffer margin requirements on stock-index futures. Said Katzenbach: "The Chicago market is a made-for-speculation market, but it leads New York around by the nose."

Melamed blames the Big Board

"This business will be somewhere, if not here."

Chicago's leading defender is the feisty Leo Melamed, chairman of the executive committee of the Merc and one of the pioneers of stock-index futures. He argues that increasing margin requirements will chase investors away from Chicago. "This business will be somewhere, if it's not here," he warns. "In London or, more likely, Japan."

Melamed contends, with much justification, that crash investigators should look not at the trading pits of the Merc but at the specialist posts on the floor of the Big Board. The specialists are supposed to moderate price swings by "making a market" in particular stocks—buying, if necessary, when no one else wants to. But on Black Monday the system virtually collapsed. Many of the 450 specialists were unable or unwilling to spend enough money to keep their stocks from going into free fall. Several specialist firms exhausted their capital and went out of business or were absorbed by bigger brokerage houses. The exchange, since then, has been reviewing what happened to the prices of individual stocks in the crash. One such stock, that of the J.P. Morgan banking company, closed at 27.75 on Black Monday, but opened at 47 the next morning, an extraordinary leap in the face of a bear market. Last week, after an investigation into Morgan's erratic movements, Spear, Leeds & Kellogg, the largest specialist firm on the N.Y.S.E., "voluntarily surrendered" its right to make a market in the stock.

The Brady commission did not highlight the role of the specialist, but that may be a major topic of the report expected to be released this month by the Securities and Exchange Commission. SEC Chairman David Ruder contends that a way must be found to provide a much larger pool of capital for the specialists. Says he: "There is just not enough buying power in times of emergency."

Congress is also pondering what action to take. Next month the Senate Banking Committee and the House Telecommunications Subcommittee will conduct hearings on the crash. For one thing, the committees may look into charges that trading in futures contracts based on the Major Market Index, a basket of 20 blue-chip stocks, was manipulated by several major investors on Oct. 20 to trigger an artificial rally in the stock market. The Commodity Futures Trading Commission investigated the accusation and found no evidence of wrongdoing, but the issue will not go away. Says one Senate Banking Committee staffer: "We want to see if the C.F.T.C. report is a whitewash."

A broad consensus is emerging that at least some reforms are needed. But no one seems to agree on just what should be done. The question now is whether New York and Chicago can resolve their differences before they are engulfed by another crash. —*By Philip Elmer-DeWitt.*

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