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HOW CHICAGO ZAPS WALL STREET

THE FUTURES MARKET IS POWERING THOSE WILD STOCK SWINGS

Financier J. P. Morgan was right. Stocks will fluctuate. And powered by such modern-day inventions as stock index futures and options, they fluctuate with speed and amplitude the visionary investor could never have imagined. In Morgan's day, Chicago traders bought and sold contracts on wheat, eggs, and butter while he traded railroads and steel companies. What would surprise old J. P. today is that it's the trading crowd in Chicago—the world's capital of futures and options—that's driving Wall Street.

There may not be much butter-trading anymore, but futures trading at the Chicago Mercantile Exchange and the Chicago Board of Trade certainly greases the pavement on Wall Street. On Sept. 11, falling prices for futures contracts on the Standard & Poor's 500-stock index touched off the wholesale dumping of stocks. The frenzied selling knocked a harrowing 87 points off the Dow Jones industrial average and an additional 34 the next day, both on record-breaking share volume.

IRONIC VOLATILITY. It was not the first time Chicago zapped New York. It was the Chicago connection that cost the Dow 46 points on June 9 and 62 points on July 6. The pros believe that the next big day will see a 100-point slide—or, just as easily, a 100-point rise. Chicago trading also sparked some huge rises in the bull market's wild ride: 43 points on Mar. 11 and 39 on Mar. 14. As recently as Sept. 4, a kick from the futures market pushed the Dow up 38 points to its highest point ever, 1919.

Chicago has turned the classic financial markets, stocks and bonds, into the kind of commodity markets that are famed for their volatility. It is an ironic volatility. The Midwest created its futures and options markets to allow a wide spectrum of commodity producers and users to achieve some semblance of price stability by hedging.

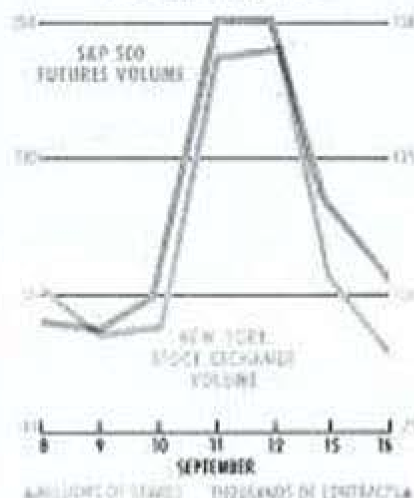
But by enabling real-world market players to lay off the risk of price fluctuations on others, the commodity markets have created contracts for future delivery that are among the most speculative ever seen. The leverage is huge. With a margin deposit of $6,000, a speculator can control a contract worth $120,000 in underlying stock. Even in the 1920s, traders had to put 10% down on their stock purchase.

Creating a market in financial futures and options was not easy. Chicago had to overcome tremendous resistance from Washington's regulators—and extreme skepticism from the Wall Street Establishment. The Chicago exchanges started commodity-style trading for bonds in 1977 and for stocks in 1982.

AWESOME POWER. These contracts proved a bonanza to a financial community that was just getting hooked on computer-assisted trading. A small group of sophisticated traders, centered mainly in the blue-chip investment houses, learned how to make high risk-free returns by arbitraging the differences between the cash value of stocks and bonds and the prices that contracts for future delivery of these instruments will carry on the day they expire. The most famous play is program trading. But the use of portfolio insurance and index funds is zooming, creating still more business for Chicago's futures and options.

The events of September made the investment world fear the awesome power of Chicago's futures and options markets. The people who make these markets go are not the pin-striped potentates of Wall Street, but feisty daredevils who scream their lungs out on the floor of the exchanges.

But there is a lot more to Chicago than screaming and pushing. From these trading pits came the ideas for the new trading instruments. Leo Melamed, chairman of the executive committee of the Chicago Mercantile Exchange, preached the virtues of creating financial futures when most of Wall Street said they would never fly. Few of the instruments were overnight successes. And in the early days, Melamed had to drag other traders into the pits to create enough liquidity to attract big money hedgers.



The action in Chicago started to attract talent from New York. Walter E. Auch, the outgoing chairman of the Chicago Board Options Exchange, recalls that when he left his Wall Street job for the CBOE, "everyone thought I was crazy. What did Chicago's grain traders know about finance?"

Plenty, as it turned out. Once Chicago took off, New York tried to intercept by introducing its own financial futures and options—but it had little success. With all its resources, Wall Street lacked Chicago's pool of commodity-trading talent. "Chicago epitomizes what this country is about more than New York," says S. Richard Szezepanik, a partner in Harvard Management Co., which manages the university's funds. "New York is not a risk-taking town. New Yorkers are merchandisers who work for transaction revenues. Chicago succeeds because it understands how to take risks."

Trading in index futures and options has gained juggernaut force. On Sept. 11 and 12, more than 151,000 S&P 500 contracts traded each day, representing an underlying value of $18 billion worth of stocks—nearly twice the value of the stocks traded on the New York Stock Exchange that day. The number of contracts traded daily now closely tracks the underlying market (chart, page 43). Volume for the S&P 500 futures from January through August ran 33% ahead of last year, and trading in the popular S&P 100 stock index option is 41% ahead.

The recent rout in the stock market almost certainly will add momentum to Chicago's trading, says Richard L. Sandor, senior vice-president of Drexel Burnham Lambert Inc. While stock prices climbed, managers could be content to watch the profits mount. Now, there will be even more pressure on institutions to use futures and options to protect their portfolios. "The ship's just easing out of port," says Sandor. Adds Melamed: "Clearly, futures are a tool a money manager can't afford to do without."

Still, many institutional investors are seething over what they perceive to be an unnecessary and damaging volatility in the market. "It's hypocritical to pontificate about the American economy and then disrupt the marketplace with this kind of trading," says Michael D. Hirsch, chief investment officer for Republic National Bank of New York.

But the big zap wasn't a conspiracy by a bunch of Chicago's savvy, entrepreneurial traders to gang up on the likes of Salomon Brothers, Morgan Stanley & Co., and the nation's private pension funds. Prices for stock index futures collapsed—and dragged stocks down—because of a wave of sell orders from the big brokerage firms and institutional investors. The sell orders were triggered by the very strategies that Salomon, Morgan, and other New York heavyweights had developed to take advantage of the Chicago contracts.

A stock index future is a contract to buy or sell a "basket" of stocks, such as the S&P 500. It gives weight to each company's capitalization but ignores the differences in their business prospects. What Chicago has done is to "commoditize" financial instruments—that is, to consider all stocks as though they are as interchangeable as bushels of wheat or corn. When a slew of orders to sell index futures lands on the floor of the Chicago Mercantile Exchange, stocks in the index are hit indiscriminately.

Index stocks are among the largest and most important in the market. When they fall, the second and third tier of equities follow suit. During the two-day sell-off, the American Stock Exchange index dropped 4.8% and the over-the-counter stock index 5.5%.

After the sell-off, the market began to stabilize. By Sept. 17, the Dow had recovered some 10 points. Whatever direction the market moves, one thing is for sure: The wild ride will continue.

RIFE WITH FEAR. The Sept. 11 rout started while most Americans were still asleep. Prices for U.S. Treasury bonds dropped in Tokyo and again in London

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BUSINESS WEEK/HARRIS POLL: THE PUBLIC IS STILL BULLISH

If you believe the old adage that bullish individual investors are a strong bearish signal, then now's the time to sell your portfolio. Americans, whether they own stocks or not, think the market is headed up, or at worst will stay about where it is. Nevertheless, their favorite investment remains real estate—and gold is coming back into fashion. The public also strongly opposes stricter government controls on the market. There is some bad news for Wall Street pros: A majority of the public thinks individual investors aren't treated fairly in the market, and it doesn't have much faith in the professionals' advice.

Q	A	
Have you owned common stock or shares in a mutual fund at any time in the past two years?	Have owned	20%
	Have not owned	79%
	Not sure	1%
As you probably know, Wall Street took a bath last week, with the Dow Jones industrial average dropping 140 points. Do you think the stock market between now and the end of the year will go up, stay about the same, or go down?	Will go up	46%
	Stay about the same	26%
	Will go down	16%
	Not sure	12%
If you had to choose the one investment that you think would be the best to make right now, which would it be?	Common stocks	4%
	Mutual funds	9%
	Corporate bonds	4%
	Government bonds	12%
	Money market funds	10%
	Bank or savings and loan deposits	9%
	Real estate	37%
	Gold or other precious metals	10%
	Not sure	5%
Some people believe that if the market is going up, the economy is getting better, and if the market is falling, the economy is getting worse. Do you think the stock market is a good indicator of the health of the economy or not?	Is a good indicator	56%
	Is not a good indicator	35%
	Not sure	9%
Do you think that an individual investor gets treated fairly on Wall Street, or do you think that an individual doesn't stand a chance against big institutional traders and market professionals?	Gets treated fairly	31%
	Doesn't stand a chance	52%
	Not sure	17%
Brokerage firms and many individual market professionals are constantly predicting whether the market will rise or fall and are offering advice on which individual stocks to buy or sell. How would you rate the quality of the professionals' advice?	Excellent	3%
	Pretty good	40%
	Fair	39%
	Poor	8%
	Not sure	10%
Some people say the government should regulate more tightly trading on the stock market to prevent wild swings like those that occurred last week. Do you think government regulation of the stock market should be stricter, less strict, or is it adequate right now?	Should be stricter	21%
	Should be less strict	17%
	Adequate right now	53%
	Not sure	9%
How likely do you think it is that the stock market will crash in the next year or two?	Highly likely	5%
	Somewhat likely	15%
	Not very likely	36%
	Not likely at all	38%
	Not sure	6%
If there were a crash, do you think that would mean the country was headed toward a depression?	Headed toward a depression	56%
	Not headed toward a depression	38%
	Not sure	6%

Edited by Stuart Jackson

Survey of 1,255 adults conducted Sept. 15-16 by Louis Harris & Associates Inc. for BUSINESS WEEK. Overall results should be accurate to within three percentage points.

on fears that the Japanese and West German central banks might not lower interest rates as had been generally expected. By the time the trading in Treasury bond futures started in Chicago, prices collapsed, but trading stopped because contract prices had fallen the permissible daily limit.

The sell-off in bonds triggered heavy selling in stocks when trading opened on the New York Stock Exchange. The market was vulnerable, and the Street was rife with fears of rising interest rates and inflation. Such fears have spooked the market for decades. The difference now is Chicago. Speculators, shut out of the dormant bond futures pits, moved to the stock futures pit and started gambling on a tumble in stocks.

At the opening bell, the S&P pit sprang into "fast market"—when the trading moves so quickly that the exchange recorders can only approximate price quotes. Unlike bonds and most other commodities, there's no limit to price moves in the stock index futures market. The more stock futures fell, the more stock prices fell.

When the S&P 500 futures sank below the price of the underlying stocks, it unleashed a torrent of selling by the program traders. In program trading, an elite group of big brokerage firms, investment boutiques, and institutional investors typically sell stock index futures when their prices rise substantially above the current value of the index. The futures price must equal the value of the stock index when the futures contract expires. So at the same time, they buy a like amount of the underlying stocks, usually in "baskets" of $5 million to $10 million. These transactions allow the program traders to capture the "premium"—and earn what amounts to a risk-free rate of return far beyond what is available on Treasury bills. Once a trade is in place, program traders are indifferent to which way stock prices go. They are perfectly hedged.

BASKETLOADS DUMPED. When they "unwind" their programs, however, investors are swept into the maelstrom. The unwinding usually takes place on the last trading hour of days the futures expire. At that time—the so-called triple witching hour—the premium drops to zero. In September, the witching hour occurs on the 19th. But on Sept. 11, the futures premium went to zero. The traders did not have to wait. They dumped basketloads of stock on a market that was already falling.

The selling wave in stocks drove the stock index futures prices down even lower—in fact, below the value of the underlying stocks. When that happens,

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stock index funds—portfolios of stocks designed to track the action of a market index—start unloading, too.

Why? Managers of the index funds have discovered that by selling stocks and buying those underpriced futures, they can pocket some extra dollars and still track the market. Not all the index funds—with $100 billion in assets—play this swapping game with futures, but as more do, they will make the market swing even more wildly.

The markets get the same jolting effect from the portfolio insurers. These investment managers, responsible for about $40 billion in institutional accounts, try to guarantee that their portfolios won't fall below predetermined levels. The strategy: Sell futures when the market is falling, and buy them when stock prices climb. This also accentuates the market moves. "It's the conundrum of the market that investors use portfolio insurance to protect themselves against the kind of market swings caused in part by portfolio insurance," says Sandy E. Lincoln, director of investment services for A. S. Hansen Inc.

If nothing else, the September mauling will drum up business for the portfolios hedgers. Money managers who suffered big losses "are going to be very embarrassed when their clients ask, 'Why didn't you protect me?'" says Peter W. Thayer, vice-president of the Gateway Option Income Fund. Indeed, the message is already coming in from clients, says John S. Osterweis, president of Osterweis Capital Management in San Francisco: "For God's sake, don't let it [profits] all evaporate."

MELAMED: "FUTURES ARE A TOOL A MONEY MANAGER CAN'T AFFORD TO DO WITHOUT"

For the most part, investors have come to expect downdrafts, and some have even prepared for them by raising cash or hedging their portfolios. Many are now looking for bargain-priced stocks (page 44). Some companies are doing the same. Owens-Illinois Inc. rushed into action on Sept. 15 with an already authorized stock repurchase program. The market fall knocked about 6% off Owens' price, and the company viewed it as a buying opportunity.

Individual investors seemed to be taking the fall in stride. According to a BUSINESS WEEK/Harris Poll, only a small minority of the public think the stock market will go down by yearend (page 46). Indeed, 46% think it will go up. "We got a lot of calls," admits William F. Clay, managing director of Morgan Keegan & Co. in Memphis. "But we didn't have any panic. Now, a 30- to 40-point swing is a ho-hum event." Clients called in more for reassurance than to dump stocks, he said. Indeed, the trading statistics for Sept. 12 show about the same level of odd-lot selling—the Street's proxy for the individual investor—as has been seen for the last couple of years, according to Laszlo Birinyi Jr., director of equity market analysis at Salomon Brothers.

'FABULOUS' PROFITS. In the days following the Sept. 11 market rout, clusters around the stock-price quotation machines in the nation's brokerage firms were rippling with talk of who won and who stumbled along with the market. At an office of Charles Schwab & Co. in Dallas, investor Jim Allen gloated over the $1,500 profit he made in trading put options on the S&P 100. Put options gain in value when prices decline.

In San Francisco, the crowd of regulars at one brokerage office wondered why a young man known as Eric, who had boasted of "fabulous" profits, had stopped coming to check on his stocks' prices. "We were all envying him—until Friday," says Victor A. Kamat, an actuarial consultant. For Kamat himself, the sell-off was confirmation of his own instincts that the market was just too high. He had taken profits starting in late spring, after turning $30,000 into $65,000 in two years. Now, Kamat is on the prowl for bargains again.

Individuals who invest in stocks through mutual funds weathered the market fairly well. The average equity fund lost 4.5% in net asset value from Sept. 11 to Sept. 15, compared with a 5.95% fall in the Dow in the same period, and a 6.1% drop in the S&P 500.

Many individual funds, of course, did worse (table, page 47), and among the losers were those that specialized in small, aggressive growth stocks. Only 3% of the 570 equity mutual funds tracked by *Mutual Fund Sourcebook* increased in value. Most of those that did were gold or precious-metals funds. During the same period, gold—a safe haven in an uncertain investment climate—climbed $11 an oz., to $417.

Mutual-fund owners haven't been in any rush to sell. At Baltimore-based T. Rowe Price Associates Inc., the volume of phone calls doubled after the market toppled. Fund owners sold about $40 million in equity mutual funds, roughly 1% of the assets in the T. Rowe Price stock funds.

With state-of-the-art telecommunications systems, the impact of a tumble in stocks reverberates around the world. In Japan, the largest stock market outside of the U. S., news of the New York debacle sent the Nikkei stock average down 6.6% in three trading sessions. Hong Kong's Hang Seng Index tumbled by 3.9% in the days following the U. S. market drop.

Markets in Europe also sold off, but recovered more quickly than in Asia. Watching the U. S. market slide from abroad was a turnoff for many foreign investors. "Confidence [in Wall Street] is gone for the time being," says Klaus Kirstein, managing director of Union Investment in Frankfurt, West Germany's fourth-largest fund group.

While the bull market has hardly been tamed, a backlash has emerged in some quarters against those who play futures and options against the stock market. "I don't think it does anything to instill confidence on the part of the individual investor," says John Everets, executive vice-president of Advest Inc.

> 'We got a lot of calls, but we didn't have any panic. Now, a 30- to 40-point swing is a ho-hum event'

CONGRESSIONAL CRITICS. The wide swings in stock prices have also attracted the regulators, who are trying to piece together what happened on those wild days. The Securities & Exchange Commission had already taken a small step toward control by asking the Big Board to make changes in the market close on triple-witching-hour days. The hope is to soften the impact of program trading. Not far behind are such congressional critics as Representatives John D. Dingell (D-Mich.) and Timothy E. Wirth (D-Colo.). Both have threatened legislative action if regulation fails.

No one has suggested that futures and options can alter the underlying trends of the market. In the end, the stock market is likely to reach the level it would have reached anyway. The difference is that Chicago has made getting there a far wilder journey.

By Jeffrey M. Laderman in New York and John N. Frank in Chicago, with bureau reports