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Fighting for the futures

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'Bloody Monday' may be a sign of hard times ahead, says the founder of a multi-billion-dollar international financial industry

By Steve Marten

Leo Melamed doesn't scare easily.

When he was 7, he and his parents fled Nazi-occupied Poland across the wastelands of Russian Siberia. He dug his way out of financial ruin three times during his climb to the top of the Chicago financial world.

In 1972, as chairman of the Chicago Mercantile Exchange, he launched the world's first financial futures market, despite overwhelming odds and expert predictions that the venture was destined to fail.

Melamed, who thrives on adversity, is among the most powerful players in the world's financial markets. But last fall, after the worst stock market crash in history, he was frightened.

"I felt like it was a witch hunt and we were what they were after," he said.

"People were looking for someone or something to blame for the crash and because financial futures were the arcane end of the financial world, they pointed the finger at us. I thought it was Salem 1650 all over again."

Melamed ('52 Navy Pier) and Nobel Prize-winning economist Milton Friedman developed the concept of financial futures almost 20 years ago. The 56-year-old executive has been defending it ever since.

Most people don't know what a financial future is, let alone what it does; that includes a surprisingly large segment of the investment community, Melamed said.

On the traditional stock exchanges, both small and large investors provide long-term financing for private business growth. Ideally, stock values increase and the company pays dividends to its investors.

In the futures market, investors speculate on the future price of a given commodity. They try to forecast prices by predicting how well supply will meet demand. If they're right, they earn sizable profits; if they're wrong, they lose enormous sums of money. It's not a business for the weak of heart or bank book.

Futures traders have been buying and selling contracts on precious metals and agricultural products for many years, but it was Melamed's financial and stock index futures that turned the Chicago Mercantile Exchange into a $127 billion-a-day industry.

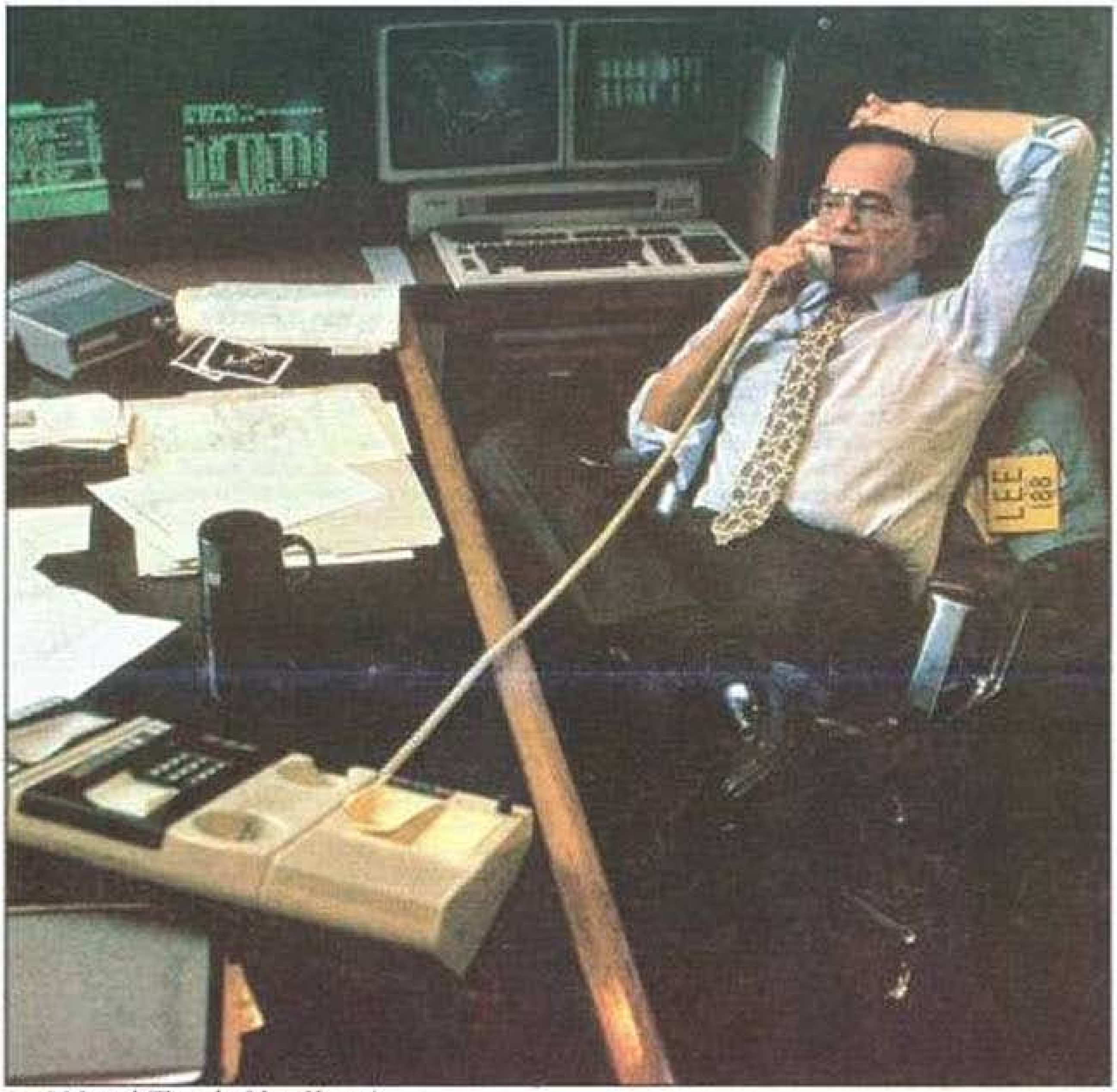
Instead of speculating on the future price of eggs, beef or soybeans, many of today's traders speculate on the future value of U.S. Treasury bills, foreign currency, Eurodollars (U.S. dollars on deposit in foreign banks) and the Standard and Poor's 500 stock index.

The success of financial futures has brought some big, new players to the trading floor.

"Ours is not a retail market. We're talking about accounts of $100 billion and small accounts of $10 billion," Melamed said. "These aren't small potatoes."

Major commercial institutions, such as banks and investment firms that manage billion-dollar mutual funds, use financial futures and sophisticated computer equipment to generate profits and protect investments.

Index arbitrage, one of the most popular computer trading techniques, involves simultaneous trading in the stock market and the stock index futures market. Computers look for stock index futures that are over- or under-valued when compared to the true value of the individual stocks. When the difference becomes large enough, the computer sells the more expensive and buys the cheaper to make a profit for the investor.



Leo Melamed (Photo by Marc Hauser)

In portfolio insurance, another computer trading strategy, a declining stock market triggers the computer to sell stock index futures. The cash raised from the futures sales helps offset losses in the stock market.

"We're a tool for commercial elements to transfer risk to the speculative elements," Melamed said. "We provide a very liquid market that has a consistent flow of bids and offers from a speculative community that, for reasons of its own, is willing to assume that risk for a short period of time."

Critics say those speculators are driven by unbridled greed and a burning desire to make a fast buck.

"That's a total misconception," Melamed said. "My God, if there was a place where you could just bend over and pick up some money without any commensurate risk, we'd all be there. It doesn't work that way.

"There is a great deal of risk in the futures market because the markets are very volatile and we live in very volatile times. Nobody is taking any unnecessary profits, because for someone to make money, someone else has to lose money.

"The consumer benefits in the long run, because the commercial elements are able to lay off their investment risks on the backs of the speculators," he said.

The main difference between the futures speculator and the small-time stock investor, Melamed said, is that the latter is typically in for the long haul, while the former is in and out of the market in days, often hours.

"As a matter of fact, without the so-called speculator you can't have a market, so by definition you'd better love them," Melamed said. "Without them there's no market, and without a market you don't have an economy and if we don't have an economy, we're all broke."

Melamed gets tired of defending the futures market. He places part of the blame for the public's ignorance on higher education.

"Most people know little about finance in general and even less about financial futures," he said. "There is a big vacuum out there in our universities."

There's also a big vacuum of knowledge in the financial media, Melamed said.

"My biggest frustration comes from financial reporters who know nothing about finance. It frightens me that they can know so little and think they can still report and interpret financial information for their audience," he said.

"I had a reporter who came in to do a story on the failure of one of our markets. I explained to her that there was nothing to be ashamed of, because every now and then you have to build an Edsel if you're going to succeed.

"And she said to me, 'Oh, did you try trading that contract too?'"

Melamed and the press have had a roller-coaster relationship this year. After the October crash, reporters flocked to their financial sources for quick

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explanations of the dramatic tailspin; many pointed to Melamed's futures market and the Chicago Mercantile Exchange.

"They listened to some financial guru from New York who told them futures were the problem and they took that as gospel," Melamed said. "It didn't matter that the facts weren't in."

Earlier this year, when Congress pushed for market reform, national and financial publications hinted that a New York vs. Chicago turf battle was stifling the markets. Many reports suggested that New Yorkers saw reform as a chance to pull in the reins on the thriving Chicago markets. It culminated in the *Time* magazine article, "The War of Two Cities."

"I think that was the worst piece of journalism I've ever seen from a responsible magazine like *Time*," Melamed said. "The issue at hand was much larger than a city vs. city dispute. We were talking about whether the United States was going to maintain its leadership role in the world's financial markets, or whether we were going to drive these investors to other parts of the world.

"It's my view that the press was used by some members of the financial community and they needed to ask some critical questions — which they didn't do. I think they've learned a lot this year," he said.

When the finger pointing was done, a detailed study of stock market transactions showed that the futures market may have protected the economy from even greater disaster.

"The market had reached fantasyland in terms of price structure. It was moving willy-nilly as if economic reality somehow didn't count anymore," Melamed said. "Real value and economic rules didn't count — it was nonsense.

"When you have a mania like that, the market is going to exact a punishment in some way, and on Oct. 19 it exacted a very severe punishment in a very heavy way," he said.

"I thought it was going to happen in July or March of that year and it wouldn't have been so painful. But the longer you wait for that price adjustment to get back to reality, the more severe the punishment is going to be."

Mounting economic problems — the falling dollar, an enormous budget deficit, high interest rates and an unrealistic market — triggered a selling spree among financial futures traders, Melamed said.

"Our records showed that the selling was done by the biggest, most powerful institutional managers in the country. They were protecting their investors' money by hedging in our markets," he said. "They held billions of dollars in pension funds and mutual funds from small investors and on Oct. 19 they were relieving some of the risk of an inflated market.

"The knee-jerk reaction was to blame futures because we were the first market to show a blush of evidence of what was going to come. The truth is, things could have been a whole lot worse in the equity market if we hadn't been there as a safety valve for all the hedging that was going on," Melamed said.

The health of the economy has been one of the biggest issues in the presidential campaign. Vice President George Bush says it's fine. Mass. Gov. Michael Dukakis says it's suffering from "voo-doo economics." Leo Melamed says no matter who wins, "they're going to be facing some very tough times."

"The elections and the economy — with all due respect to the two candidates — have little to do with each other, because most of what will happen in the next four years will be a result of the last four to eight years. That's typically how economies work. We're victims of our past," Melamed said. "And there are some problems coming up for the next president that won't be very pleasant to face."

Melamed is particularly concerned about the budget deficit.

"There is a struggle going on for funding for social programs and right now we're already so deep in debt that it's sapping our economic strength. That may cause all kinds of problems and we might be facing some kind of recessionary period in the times ahead — I don't know," he said.

"I do know that if I wanted to be president — and God knows I wouldn't want the job — I would say no thank you this time around and wait and see how this all shakes out."

If anyone knows about financial uncertainty, it's Melamed. His three bankruptcies were the lowest points in his life.

"It was a very frightening period and I don't recommend it to anyone. You've got to be under 30 in order to survive," he said.

He never told his parents, Yiddish schoolteachers.

"I think they knew, but that's not something you like to admit to your parents. My father's greatest dream was that I would become a professional, and when I became a lawyer it made them both very happy," he said. "I don't think he talked to me for an entire year after I left the law profession to go into the markets."

Melamed put himself through John Marshall Law School after attending Navy Pier campus. He drove a cab at night; in the morning, he was a runner for Merrill Lynch at the Chicago Mercantile Exchange.

After law school he practiced for several years, but eventually returned to the trading pits. In 1954, he became a member of the exchange and in 1967, a member of the board of governors.

When he was selected chairman two years later, one of his biggest concerns was the Merc's lack of diversification. A bad year for agricultural or meat products meant a disastrous year for the exchange. Melamed went in search of other markets.

"There were rumblings in the world's financial system and if you put your ear to the ground you could hear them," Melamed said. "Those rumblings spelled the end of the fixed rate era in world currencies. They had existed since 1945 and they weren't going to last much longer.

"I put two and two together and asked myself, 'Is a currency market in futures possible, if and when this financial upheaval results in a new financial system for the world — one that is not based on fixed rates but determined by market forces?'"

University of Chicago economist Milton Friedman said yes. Armed with a Friedman feasibility study, Melamed sold the idea to the federal government and the financial futures market was launched May 17, 1972.

It took several years to establish the market in a reluctant financial world, but eventually the University of Chicago called it "one of the most innovative financial happenings of the last 20 years."

"I told our membership that if we succeed in foreign currency futures, then the sky was the limit because we would have successfully broken the mold," Melamed said. "We used that vehicle to show the world that the day had come for financial futures."

Melamed lives by the edict, "Make no little plans." The success of the foreign currency market helped launch the T-bill and Eurodollar markets, which in turn spawned a market for stock indices.

A member of Congress once asked Melamed, who traded his chairman title for that of "special counsel" in 1981, how much his share of the Chicago Mercantile Exchange would be worth if it was a private corporation.

"I told him it would be mind boggling," Melamed said. "It would probably be in the billions of dollars."

While such figures are nice to ponder, they're not the bottom line for Melamed.

"My parents took me to a philosophy lecture when I was 10 years old, and the lecturer said something to the effect that the only way to achieve immortality is to tie yourself to an ideal," Melamed said.

"That made an impression on me and I don't know to what extent that is tied to my involvement with the markets, but they did become an ideal for me. I had to truly believe in them to overcome the adversity of those first three or four years.

"They kept me going and I hope that can tide me over beyond my own lifetime. I'd like to think I have a footnote somewhere in history."