



Search



Home



My Network



Jobs



Messaging



Notifications



Me



Work

Le



## Reminiscences of the 1987 Crash: +100% (and almost had a heart attack)

Published on October 18, 2016

[Edit article](#)

[View stats](#)

William Lawton

Investing for a Better World

15 articles



52



5



Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

“Hello Heidi.”

“Hello Bill, do we have to sell the house?” (Heidi was watching the news of the stock market crash, the single worst day in Wall Street history, with stocks down 22%, and knew we were trading the market.)

“Goodness no, sweetheart, I was calling to ask you out to dinner! For a celebration. We had our best trading day ever. But, I did almost have a heart attack!”

“Oh, thank goodness! So did I! I really was prepared to sell the house! I am so glad to hear you are OK. I want to hear all about it.”

“Yes, we need a dinner out to regroup. Be ready to go at 7.”

When I got home I took Heidi to the Saddle River Inn, an old haunt of Richard Nixon and Wall Street illuminati in Saddle River, NJ.

We ordered extravagantly as soldiers who had barely escaped death; a good bottle of French wine, grilled goose liver foie gras, the double lobster tail special for me and rack of lamb for Heidi, with chocolate soufflé and cognac for desert. We felt a bit guilty as most people in the restaurant were somber, having lost so much money that day. But, we needed a release and were happy to be out.

Over dinner I explained to Heidi how we had endured the most harrowing trading day of my life, but our portfolio was up well over 100% on the close.

Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

In April of 1987 we had moved from Manhattan Beach outside of Los Angeles to Ridgewood, New Jersey, a pleasant suburb 20 miles from downtown Manhattan popular with finance types.

I was setting up a global derivatives trading operation for Nikko Securities, one of Japan's so called "Big Four" securities companies. So I was trading in some size for Nikko, as well as managing my own account in a pretty aggressive fashion.

As a professional investor and trader I was attuned to things going on in financial markets. I got up early, and went to bed late eating and breathing markets.

In 1986 I started to hear about something called "portfolio insurance," a new strategy being touted by consultants and financial advisors as a strategy to protect stock portfolios from losses. While the advocates tried to make it seem like a new and revolutionary magical way to protect your portfolio from losses while enjoying the upside of owning stocks, it was really just another Wall Street version of snake oil.

The idea was that you invested in a portfolio of stocks, enjoying the upside. If prices started to drop, you sold stock index futures which were then coming into vogue against your long portfolio. The more stocks went down, the more index futures you sold. At the time, to some, that seemed new, but in reality it was basically a trend following strategy which forced you to sell as prices moved down. Pretty easy to see in retrospect, but the Wall Street spinmeisters have a way of making anything sound new and alluring, especially when there is a nice commish in it for them.

Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

presentations on how to implement portfolio insurance from major Wall Street houses. The more I watched and listened, the more concerned I became.

When analyzing markets, I often ask myself simple questions. At that time I asked myself, “What would happen if everyone employed portfolio insurance strategies, and the market started to go down?” I did not like the answer.

The market would drop for some reason, such as the Fed raising rates, and portfolio insurance strategies would then kick in and sell to “protect” their portfolio value. This selling would push prices down more, and the new drop in prices would require the PI’ers to sell more, which would push prices down even more, which would require the PI’ers to sell even more, which, uh, you get the idea. While not “everyone” was employing portfolio insurance, many big players that controlled a lot of money were. I concluded this “new” strategy was setting the market up for a nasty fall.

In January of 1987 the economy was picking up. Thirty year bond yields were at around 7 ¼%. The Dow opened the year at 1900. Fed funds were at 5 7/8%.

As 1987 progressed and the economy continued to improve, the Fed decided to slow it down and started to raise rates. I figured that if the Fed was going to raise rates, sooner or later stocks would start to go down, so in April I started to play stocks from the short side by trading put options on the S&P 100 and 500.

Put options on the S&P stock index go up in value when stocks

Messaging







Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

Put options on stock indexes are highly leveraged instruments as each option is 100 times the value of the index, and you only pay a fraction of the index price for the option. Since they are highly leveraged, and it costs money every day to hold them, you better be right on both the direction of the market, and the timing of the move. If you get those two things right, you can make a lot of money, and if you get it wrong, you can lose all of your investment.

Selling options is even more risky because you get paid premium, but if there is a big move in the market you keep the premium but lose 100% of the amount the options are in the money times 100!

As the Fed continued to move rates up in response to the quickening economy, the bond market started to tank. The 30 year bond yield moved from 7 ¼ % to 10 ¼% which created a loss of over 25% on those long bonds. However, stocks did not seem to care. They moved from 1900 at the beginning of the year to a peak of 2747 on August 25, a gain of 45% YTD and a PE multiple of over 20 (expensive).

With Treasury yields over 10%, I reasoned it was just a matter of time before the stock market took notice, and people sold stocks to buy bonds. In September I started buying more puts, and putting on put spreads as the stock market started to roll over. I was watching for the match that would light the fuse for portfolio insurance to kick in and create a sharp drop.

It came October 14 when the US trade deficit was announced to be larger than expected. Treasury Secretary James Baker started rumbling that the Dollar may have to go down. This caused stocks to sell off with the Dow closing Friday October 16th at 2247.

Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

That weekend, Treasury Secretary Baker hit the news talk shows and started saying in earnest that the Dollar needed to devalue versus the Deutsche Mark and other currencies. Currency War! Stocks would not like that.

So, I got into the office early Monday morning and placed what for me at that time was a large order to buy more puts at market. My broker told me the order would be executed on the opening round of options trading once the stock market opened. That is when my nightmare part of this event started.

As news of a potential currency war started to be digested by stock investors, more and more investors decided to lighten up on stocks. However, this was not your old stock market, this was the new and improved stock market where many institutional investors had in place portfolio insurance. So, sell order: started to pile up at brokers even before the market opened. Finally it did open, but at 2047, a drop of 9% from Friday's close!

Usually after a drop of that kind, the market would bounce sharply as buyers were lured in by lower prices. Instead, the drop only brought in more sellers and the market open was very disorderly.

In the stock options pit, it was even more chaotic. They could not open the options market because there seemed to be no put sellers, only buyers. I tried to call my broker to cancel the order but could not get through. The phone lines were jammed. All I got was a busy signal. I was in panic because as the market dropped, I would have to pay more and more for the options I had ordered "at market." This was a bad mistake at that time to give the broker a market order. While you

Messaging



it



Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

Finally, after more than an hour, I saw where the options I had ordered opened, and that is when I almost had a heart attack.

The options price I was filled at was way above what I had expected when I placed the order. Almost my entire account was needed to pay for the options. This was really bad risk management as the stock market could easily have bounced. I sat nervously watching the market on my Bloomberg terminal.

Luckily, there was no bounce now that portfolio insurance was in full sales mode. My pulse began to quiet, and the pain in my chest eased. The markets kept moving down as I watched in relief and my puts became more valuable. As my options continued to move up in value, I tried in vain to call my broker to cover my short positions. Still no answer. The brokerage was swamped.

Near the close of trading I tried again to get through to my broker to close my entire short position, but to no avail. I was still worried the market would bounce.

The Dow finally closed at 1738, down over 22%.

I was emotionally exhausted but deeply in the money on my puts.

I walked over to my neighbor's desk and asked him how he did on the day. He stunned me. He said he had lost \$25 million. I could not believe it. I asked him how? He said he thought that since the stock market was selling off that bonds would sell off too. Instead, Treasuries rallied. I felt sorry for the guy, and all the other people who had lost money.

Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

I had entered my order to buy puts as a market order, a mistake. As the stock market gapped down the implied volatility priced into the options exploded. I had almost 100% of my portfolio in options that easily could have dropped 80% in value had the stock market bounced after the initial drop.

“Heidi, we still have one problem, I could not reach the broker to cover our position. Can you go into the broker’s office personally the first thing in the morning and sell all of our puts just in case they do not answer the phone again?”

“Sure!”

Heidi called me early the next morning and told me she was able to sell our entire position as the market continued to fall further before bouncing. Whew! Later that day, I was able to get through to my broker, and actually went long the market thinking the selloff was overdone due to portfolio insurance.

I learned to be careful about selling naked options, as they simply cannot pay you enough to take the risk of a black swan event. Also, I decided to always use limit orders when placing an order.

I also learned you can outthink the market if you carefully analyze what other players are doing. This served me well in the 1992 bond market crash, the dot com bust and the 2008 collapse. Asking yourself simple questions about the market will help you do this.

What about today? We are in the biggest bond market bubble in the history of the world. This has artificially pushed up stocks and real estate prices. The problem

Messaging







Home



My Network



Jobs



Messaging



Notifications



Me



Work

Le

After Heidi closed the put positions in person, I met her at Tiffany's on Fifth Avenue and bought her a present to remember the crash.

Heidi had the October 20th 1987 New York Times front page blaring the stock market crash framed for me to remind me of the best and worst trading day of our lives.

Report thi

52 Likes

+42

5 Comments



Add a comment...



**Juan C. Acevedo** • 2nd

Associate Director, Hedge Fund Services at SS&C Technologies

2y ...

2007/2008 was worse...

...see more

Like Reply | 1 Reply

Messaging





Home



My Network



Jobs



Messaging



Notifications



Me ▾



Work

Le

William Lawton

Our fund was up 17% in 2008. While worse, 2008 was easier to spot, a slow motion train wreck, despite the spin Greenspan/Bernanke/Yellen et. al. are trying to sell. [...see more](#)

Like Reply

Soh Grace

Charting new ground, balancing efficiency and business controls

2y ...

Thank you for sharing. History will repeat itself... [...see more](#)

Like Reply | 1 Like

Load more comments





William Lawton


Investing for a Better World


More from William Lawton [See all 15 articles](#)


Messaging








  
Home


  
My Network


  
Jobs

  
Messaging

  
Notifications

  
Me ▾

  
Work

  
Le

### High yield return on investment grade government credit risk

William Lawton on LinkedIn

### Investment lessons from 9/11

William Lawton on LinkedIn

### Behind the Scenes on the Return of Hong Kong to China in 1997

William Lawton on LinkedIn

Messaging

