Derivatives' Role in Sell-Off

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the stock to the put's seller at the preset price.

But such protection carries a price tag. To buy the option, the investor pays a premium that is based on the market's perception of the likelihood of the stock's falling to the given level. In good times, when stock prices are climbing, those premiums are negligible, except for highly volatile stocks. But amid the kind of turbulence that wiped out the stock market's gains for the year in only six weeks, it is not surprising that the cost to hedge portfolios doubled or trebled during the course of August. Moreover, even at those hefty premiums, many of the large banks and investment dealers that traditionally sell this kind of downside protection effectively retreated from the business.

"We've had a lot more business coming our way from people who typically haven't been our customers," says one London-based market maker in options and other derivative products. "Liquidity seems to be drying up."

Many options trades are highly customized. But trading in options on the Standard & Poor's 500-stock index illustrates the kind of exponential rise in premiums with which investors have been confronted. On July 31, when the index closed at 1120.7, investors could buy the right to sell the index at 1010 in or before the third week of September for only $10. That means they could lock in 10% downside for about 1% of the index's value for a period of seven weeks.

By the time the dust settled late Monday, the S&P 500 had fallen to 957.50, below the 1010 strike price, and the option's premium had soared to $68. Yesterday, as the market rebounded, the premium fell back to only $33. Still, to lock in seven weeks' worth of 10% downside protection from yesterday's S&P 500 close would cost $18, or nearly 18%, almost double levels of a month ago.

There has been no shortage of things for investors to worry about this summer. And all that anxiety has left investors uncertain about the outlook for corporate profits in both the U.S. and Europe. Although the market's swoon began in early August, it wasn't until midway through the month that money managers seriously began to hunt for derivatives products to protect their portfolios from a crash.

In the past, when buying put options became costly, investors have sold call options and used the premiums received from those transactions to finance the cost of the puts. But selling call options, or the right to buy the stock at a specific level in the future, means giving away some of the upside of the underlying stock or index. That is an unpopular strategy among investors who still cling to the hope that rebounds inevitably follow sell-offs.

"No one wants to give away or cap the upside potential, especially after the declines," says Christopher Seery, head of European stock market derivatives distribution at Morgan Stanley Dean Witter. "Whenever we've been driven down, there's been some kind of bounce that takes prices higher."

Hedging problems have been exacerbated by the nature of the sell-off. In the U.S. market, it began with a retreat in smaller and medium-size stocks. That part of the stock market has far fewer derivative products to cut risk and limit downside moves because it is more thinly traded. As the sell-off spread, it trickled gradually into the overall market, leaving investors perplexed about how to hedge. Some analysts suggested customizing portfolios, guarding against steep declines in half of the stocks in the 30-stock Dow Jones benchmark or 100 of the components in the Standard & Poor's 500-stock index. But those strategies also are more complex and costly to execute.

Did the High Cost of Derivatives Spark Monday's Stock Sell-Off?

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By Suzanne McGee
Staff Reporter of The Wall Street Journal

When the August stock-market carnage in the U.S. culminated in Monday's sell-off, people familiar with the trading activity say the final culprit was a flurry of mutual-fund sell orders executed in the final 40 minutes of trading that day.

But market participants say U.S. stock markets have been heading for just such a precipitous drop since last July, when index levels peaked and the cost to investors of protecting their gains began to soar. By the time the markets' slide culminated in Monday's 6.37% plunge in the Dow Jones Industrial Average, leaving the blue-chip benchmark with a loss for the year, it had become practically impossible to use derivatives for their main purpose: to protect a portfolio. That being so, investors resorted to the ultimate "hedge," or protective strategy: selling their holdings.

"Many of our clients have been choosing to sell," says Peter DaPuzzo, president of Cantor Fitzgerald & Co., a New York-based institutional brokerage firm. "We've been hearing from some of them that they've had problems in getting the kind of derivatives protection they wanted, so this is what they could do to protect themselves and what gains they had left."

In past sell-offs, market participants and analysts have worried that derivative products, designed to protect individual portfolios, have in fact exacerbated market declines. During the stock market crash of October 1987, for instance, money managers seeking to protect their holdings aggressively sold stock index futures even as the market slid, sending indexes to new lows that in turn triggered still more selling.

But this sell-off is different. Some market participants believe it was the absence, rather than the presence, of the right kind of derivative products at an affordable price that made a sell-off almost inevitable.

"By the time Monday arrived, volatility had gone up so much that it was far, far too expensive to buy put options," says Scott Fullman, option-market strategist at Swiss American Securities in New York. Put options, a traditional defensive product, give the buyer the right, but not the obligation, to sell a certain stock or portfolio of stocks at a given price, at or before a specified future date. That gives investors a floor, or a form of guarantee that if the price sinks below that "strike" level, they can lock in a profit or minimize their losses by exercising their right to sell

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