Financial Services Advisory
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Reflections on the Market Crash of 1987

November 10, 2017

Last month marked the 30-year anniversary of the October 1987 stock market plunge in which the major indices fell over 20% in a single day. It still remains the largest one-day percentage drop in the history of the U.S. stock market. If we were to have a repeat of that event today, it would equate to a loss of nearly 5,000 points on the Dow Jones Industrial Average. Just as we find it hard to fathom such a scenario, investors struggled to fully comprehend what was happening on that fateful day 30 years ago. Without the benefit of the internet or cable news with 24/7 coverage, they couldn't follow the developments minute by minute, as we can today.

Immediately following the 1987 crash, many experts expected the U.S. economy to slip into a recession, as it did after the one-day market crash in October 1929 that set the stage for the Great Depression. Unlike the aftermath to the 1929 crash, however, with the help of intervention from our Federal Reserve, stocks rebounded after the 1987 plunge and recouped the losses within two years. Still, the incident shook investors' confidence in the markets.

After the 1987 crash, the New York Stock Exchange (NYSE) instituted new trading rules (called circuit breakers) that would shut down the stock market temporarily if prices fell more than 7% in a single day. It might take several days of panic selling to achieve a drop of more than 20%. And the hope is that by shutting down the exchange, cooler heads will prevail during the trading halt, as participants get a chance to collect their thoughts.

The causes of the 1987 crash are still debated to this day, but most observers point to several main contributors:

- Rising interest rates
- Strong bullish sentiment by investors
- Reliance on so-called portfolio insurance to protect from market volatility
- Tax bill discussion in Congress

You may notice some similarities between conditions in 1987 and the environment today. In fact, the similarities have led some analysts to predict another crash. Yet, there are some important differences between the conditions in 1987 and in 2017.

- In 1987, the Federal Reserve pushed up the federal funds rate from 6.1% to 7.3% (a rise of 1.2%), while in 2017 the rates have gone from 0.6% to 1.2% (a rise of only 0.6%). Related to this, the yield on a 10-year Treasury note was 10% back then, while the yield today is closer to 2%. So, we are not as concerned about the rise in interest rates in 2017, since the Fed is working just to get interest rates back in line with more normal levels. Rising interest rates could cause a problem in 2018 or beyond, but not in 2017.

- While it is true of both periods that stocks sustained multi-year bull markets, there was a decidedly more excited tone to the market 30 years ago. You may remember the movie "Wall Street," which came out in 1987. It was best known for the line "Greed is good," which summed up the attitude on Wall Street at the time. In addition, from a technical standpoint, the Advance/Decline Line—an indicator of underlying market strength—was trending downward in 1987, while in 2017 it is in an uptrend.

- Back in 1987, a financial innovation was sweeping the institutional world with the promise of fail-safe protection against severe market losses. Known as "portfolio insurance" it helped create a mindset among big investors that they could invest heavily in stocks and still protect their portfolios cheaply. In essence, investors could "have their cake and eat it too." As you might have guessed, portfolio insurance did not live up to its promises during the crash. Today, there is nothing similar to give investors a sense that they can take risks without fear of losing money. To be sure, the low volatility in stock returns this year is creating a fair degree of complacency, but not the giddiness we saw in 1987.

Given these differences, it is hard to make a case that the market is likely to drop severely again, based on comparable market conditions back in 1987. That's not to imply that there is no risk of a market shock, but in the event it happened it would probably be triggered by other causes.

What have we learned?

1) Stock markets will behave irrationally at times. It's important to remember that crazy things can and do happen in the market, and this is something risk managers like FSA keep in mind.

2) It's also important to have an exit strategy to help manage market risks. Our FSA Safety Nets® were designed to help protect our clients' assets by reducing losses during sustained market declines, like those we saw in 2001- 2002 and 2008. While these measures don't guard against the effects of a steep and rapid market crash, we remain alert to stresses in the market that may make it prudent to think about reducing the equity exposure within our various strategies.

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Ronald J. Rough, CFA
Director of Portfolio Management

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