ST. LOUIS TRUST
& Family Office

# Black Monday: The Improbable Crash, Its Causes, And Timeless Lessons For Investors

Thirty-six years ago, something so unlikely happened that it was basically impossible: The Dow Jones Industrial Average plunged nearly 23 percent in a single day.

Before Monday, October 19, 1987 (now known as Black Monday), such a massive drop in the market wasnâ€™t considered possible because statistics put such a decline at an impossibly rare twenty-two standard deviation event. How rare is a twenty-two standard deviation event? Writing about the drop in his 2000 book *When Genius Failed*, reporter Roger Lowenstein of the *Wall Street Journal* noted, â€œEconomists later figured that, on the basis of the marketâ€™s historical volatility, had the market been open every day since the creation of the Universe, the odds would still have been against it falling that much in a single day. In fact, had the life of the Universe been repeated one billion times, such a crash would still have been theoretically â€˜unlikely.â€™â€•

Yet it happened.

## Portfolio Insurance and the Perils of Feedback Loops

What caused the drop? While thereâ€™s no one clear answer, and economists and investment strategists still debate the underpinnings of Black Monday, one widely acknowledged cause is the popularity of a derivative strategy known as portfolio insurance. The scheme involved using options to hedge a portfolio to enjoy gains when stocks went up and limit losses when they went down. It was a dynamic trade, meaning that portfolio managers adjusted the hedges as the market gained or lost. In the years leading up to Black Monday, the use of portfolio insurance spread among Wall Street firms that used the strategy on tens of billions of dollars of investments.

On an individual basis, it made sense to implement portfolio insurance. Who wouldnâ€™t like to enjoy oneâ€™s gains while limiting oneâ€™s losses? However, on a system-wide basis, having tens of billions of dollars deployed using the same strategy was disastrous.

As market volatility increased in the days leading up to Black Monday, the portfolio insurance strategy led investment managers to sell holdings to raise money to increase their hedges. This selling generated losses, which caused the portfolio insurance algorithms to require the sale of even more assets to place more hedges. This feedback loop of losses generated still more selling, creating still more losses, leading to more selling, and so on. The next thing you knew, it was Black Monday.

In his book *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation*, Richard Bookstaber, who in 1987 was head of risk management at Morgan Stanley, explained, â€œIf one small portfolio uses this sort of strategy, liquidity will not be an issue. If everyone in the market is trying to do it, it can become a nightmare, a little like everyone on a cruise ship trying to pile into a single lifeboat: it wonâ€™t float.â€•

## What Black Monday Teaches Us

The primary lesson of Black Monday is that highly improbable events can happen, and that they happen all the time. Things like terrorist attacks, wars, earthquakes, tsunamis, pandemics, infestations of murder hornets, boats stuck in shipping canals, and stock market crashes that come out of the blue occur all the time. Each event may be improbable on its own, but these sorts of unlikely things happen enough that we should expect that they are bound to occur. Knowing that, it would be best if you designed your investment portfolio to accommodate improbable occurrences, which is accomplished by diversifying across types of assets (stocks, bonds, real estate, private equity) and building in a margin of safety by having sufficient cash and low-risk assets.

The second lesson is that the market recovers from extreme events. Over the past 40 years, weâ€™ve experienced many extreme events, major ones being Black Monday, 9/11, the Financial Crisis, and the Pandemic. And yet, the stock market is up over 20x since Black Monday. This means that adopting a long-term perspective is essential to successful investing. Try to ignore short-term ups and downs, even if they are extreme.

The third lesson is that the unpredictable nature of extreme events means that relying on predictions of the future to make investment decisions is not a good strategy. Investment experts didnâ€™t predict Black Monday, the 9/11 attacks, or the pandemic. Instead of relying on what we now know to be fanciful predictions of stock market movements and returns, you will be better served if you:

- Embrace the uncertainty inherent in the markets; prepare for gigantic swings that could (and will) be just around the corner.
- Stress test your portfolios by modeling what would happen if we experienced another 1929 crash, another Black Monday, a 2000 dot-com bust, or a 2008â€“ 2009 financial crisis (or an even bigger event). Will your portfolio still meet your cash flow needs?
- Stress test yourself. Can you emotionally handle that much volatility?
- Maintain an adequate margin of safety to ride out extreme downside events.
- Avoid excessive debt.

After designing your portfolio to weather wild storms, sail on. Moving in and out of investments may result in missing the best days in the market, thereby devastating portfolio returns.

This article was an excerpt from my recently publish book *The Uncertainty Solution: How to Invest with Confidence in the Face of the Unknown.*

*St. Louis Trust & Family Office is an independent, multi-family office and trust company that advises clients on more than $10 billion of investment assets and more than $12 billion of total wealth. Founded in 2002, St. Louis Trust & Family Office provides holistic, high-touch client service including customized, independent investment management and a full range of family office and fiduciary services. The firm serves a limited number of clients with substantial wealth in order to* *maintain very low client-to-employee ratios. Visit stlouistrust.com to explore how the firm manages complexity with unmatched expertise and focuses on Family, Always.*