FundExpert
Smart research. Better investing.

A Short History Of

The Great Crash 1987
Black Monday

30th Anniversary Edition

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WHO ARE WE?

FundExpert is designed to transform your investing success - nothing less.

In particular, our **unique ratings and tools** are built on the experience of our parent, Dennehy Wealth, since before 1987, and our hugely detailed research of what works, and what doesn't.

Most investors are not even close to fulfilling their investing potential, whether through a portfolio of funds, or within their SIPP or ISAs.

It is obviously unhelpful that so many funds are mediocre at best (97% of funds on our calculations).

But the **BIG** problem is that investors don't have a straightforward process to identify funds with outstanding potential. This and a lack of discipline are the two big factors behind the failure of investors to achieve their potential.

FundExpert provides powerful and unique solutions to these twin problems.

This 1987 research is part of our drive to broaden and deepen investor understanding of markets - because history might not repeat precisely, but it does rhyme.

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INTRODUCTION:

The Crash on Black Monday 1987 was a huge event. The falls were greater than the Wall Street Crash in 1929, which is why **we** call the 1987 event “The Great Crash”.

Most importantly, it is vital that we learn from such periods or we are destined to gp through the same pain again - whether as investors or advisers.

This ebook has been written because there is still much that can be learned from 1987.

For example, it was a vital experience for us. We built a tool box that we have applied ever since to help understand markets, particularly markets at extremes – and this has ensured our clients avoided the biggest pitfalls of the last 25 years.

This 30th Anniversary is also a great learning opportunity for someone coming into our industry now or relatively new to investing.

In addition I would also like to consider the relevance in todays markets - what are the similarities and differences? Should we be comforted or concerned?

The answer is more worrying than you might think.

PART 1:
The years before 1987

The 1980s was a time of recovery, for markets in particular and capitalism generally.

In contrast, the 1970s for the UK had been a time of huge turbulence, politically, economically, and socially - there were painful adjustments for many older industries and the communities which relied on them (which continued some way into the 1980s).

That the problems of the UK were more deep-seated than elsewhere in the world was reflected by the markets. For example, the UK stock market fell by 72% from peak to trough in 1972-74, while US prices fell by only 48%.

Then came a turnaround. By the 1980s the stock market was prepared to look beyond the continuing political turbulence, and social pain, and rose very sharply from 1982, celebrating a new era led by Ronald Reagan and Margaret Thatcher (who had been elected Prime Minister in 1979).

The big idea was that Governments were to shrink, and capitalism was to be allowed to flourish. Individualism and greed were good.

“This time next year we’ll be millionaires”

This was more than a Del Boy catch phrase – it was the mantra for a generation. And many of that generation went further, encouraged by laissez-faire Thatcherism, and embraced another Del Boy guide line:

“The government don't give us nothing, so we don't give the government nothing”

This new “can-do” culture was epitomised by the rise of the yuppie, with Filofax (you’ll have to Google that!) in one hand and the new-fangled mobile phone (the size of a house brick) in the other.

Shrinking the Government and popular capitalism combined to create an era of privatisations, selling off publicly-owned assets. In 1984, amidst massive publicity, British Telecom was sold off. Two-fifths went to the general public, mostly novice investors, and on 20th November 1984 there were 2.1 million new budding capitalists enjoying an investment which doubled in value on the first day.

“If you see Sid, tell him”

As well as Del Boy, other populist characters were born. Say “hello” to Sid. By 1986 it was the turn of British Gas to be privatised, the most ambitious to date. To encourage participation the slogan was invented: “If you see Sid, tell him”. Four million “Sids” applied for shares in British Gas, 1.5m received an allocation, and many sold within the first few days for another handsome profit.

In 1985 the new FTSE 100 index was up 14%, and up 19% in 1986.

Such was the background to 1987.

How could capitalism not be popular if you were going to give money away?

A new generation of individual investors were enjoying regular windfalls of apparently free money. Importantly, they were also increasingly confident as consumers. This growing confidence spread through the board ooms of the UK.

There were plenty of corporate predators, from Hanson to Polly Peck. Competition for big fish such as Distillers and Imperial Group ensured opening bids went much higher before these contests were settled.

Animal spirits abounded, a necessary ingredient for any budding mania worthy of the name.

Confidence in the US was also booming. US companies were issuing vast amounts of debt to go on spending sprees. The amount of debt issued in 1986 was twice as much as 1985, and this trend was to continue in 1987. Very early into 1987 the Dow Jones hit new highs, and volume was huge.

PART 2:
1987, a rollercoaster for popular capitalism

The opening of 1987 was full of optimism. In the UK in particular economic growth was accelerating, productivity was continuing to improve, governments revenues were above estimate, and there was political stability as re-election of the Thatcher regime was assured. (This was all a far cry from 2017).

The UK stock market was cheap by international standards, and this was illustrated by the wave of foreign buying.

This confidence was also evident around the globe – the precise reasons varied from country to country, but the confidence was infectious.

The growing worry was the evolution of confidence in stock markets.

“It’s never too late to make a profit, you make money while sleeping.”

A quote from 1987? No. Possibly early 1929? No. It was 1637, Tulip Mania in Holland.

One mania is like another in terms of investor behaviour. This quote was as relevant as we entered 1987 as in 1637. **The constant through the ages is ALWAYS human nature, and, in the case of an investment mania, over-confidence to the point of irrationality** - more on that later.

In 1987 Dennehy Wealth was in its infancy, so we worked hard to fill the gap in our experience through a deeper knowledge of stock market history and, in particular, what could go wrong.

For us, the FT and the Investors Chronicle were constant mainstream sources of feedback. Bob Beckman was a regular purveyor of apocalyptic analysis (though his hair-do distracted us from taking him too seriously!), and Robert Prechter published regular Elliott Wave analysis to make you stop and think. In addition the Traded Options Newsletter was a weekly source of common sense insights on the UK stock market.

Ahead of "The Crash" it was surprising how much reference there was to the possibility of a crash.

As early as January 1987 the legendary student of 1929, John Kenneth Galbraith, said:

"The dynamics of speculation are remorselessly constant...
...those who suffer most will be those who regard current warnings with greatest contempt"

This quote reflected one of the early cracks in the edifice of the mania that was building. Another was the extraordinary corruption and fraud which was being uncovered many months before October.

"Insider trading" and "junk bonds" became household phrases, and prison sentences were being handed out like confetti in the US. In the UK the Guinness Affair was rumbling, though no one had yet rumbled Polly Peck and Asil Nadir.

Yet while all of this was going on, the UK stock market was up 19% at the end of the 1st quarter of 1987.

As we moved into April, criminal rings were uncovered operating midst the US stock market, trading drugs for insider information. Two undercover agents stated that cocaine is either used or accepted by 90% of the people on Wall Street.

Nonetheless the hype was never-ending. In May one flakey US company was promoted by an analyst on the basis that "You are buying a dream". This sort of hype was commonplace, and investors were still buying into it.

Turning back to the UK stock market, after a Spring tumble, Margaret Thatcher was comfortably re-elected, following another "**budget for equities"**, and the UK stock market continued its frothy rise.

In the 2nd quarter of 1987 alone the FTSE 100 index was up another 15%.

As an aside, by July there was growing anxiety over inflation as the oil price hit $22. *(what we wouldn't give for that kind of anxiety now!)* It had been under $10 within the previous year.

The UK stock market peaked for the year on 16th July, up 45% in just 7 months. (The Dow Jones would not hit its high for the year until 25th August, when it would be up 44%).

PART 3:
Summer 1987: Reasons to be cautious

As we moved into August, the UK stock market fell sharply over concerns that it would not be able to cope with a raft of huge rights issues. The FT ran with a "Fear of the Crash" headline on 1st August, albeit on the inside pages.

At a personal level, in August we completed the takeover of a small firm of investment advisers. This made us all the more sensitive to unfolding events. Nonetheless, markets began to recover again as we entered September.

At this manic stage the market is (and was) inherently unstable, and it is inevitable that the mania will be followed by panic – at least history was absolutely clear on this in our view.

The problem is that there is no way to know what might trigger that panic and when.

Myself and Linden Weller certainly recall feeling unsettled and cautious at that time in 1987. The words "instinct" and "gut feeling" come to mind when we reflect on how we felt at that time - there was no single overwhelming fact which was making us nervous. Interestingly a survey conducted by Robert Shiller, at the time of the Crash, also found many large traders and investors expressing the same rather vague sentiment.

Yet there were plenty of raw facts in the Summer of 1987 to engender caution beyond mere gut feeling:

British Gas and earlier privatisations created an atmosphere in which the general public believed investing was "free money".

In May 1987 the stock market offer for Sock Shop was 53 times over-subscribed!

One incident which rang a loud bell of unreality was the takeover approach from an advertising agency (Saatchi and Saatchi) for a huge High Street bank (Midland, now HSBC in the UK).

Wages were going up at a healthy clip, but there was no sense this was eating into company profits (and thereby making shares less attractive).

Consumer spending boom was encouraged by the easy availability of credit, and consumers were not put off by double digit interest rates which would scare us rigid in 2017.

With interest rates at 10% deposit rates were juicy. But the public was more interested in the easy money of the stock market through a raft of privatisations and new issues.

The dividend yield on shares was 3%, but interest on gilts was nearer 10%.The ratio between these two had never been so great, and highlighted a VERY expensive market i.e. surely you would prefer a guaranteed return of 10% in preference to the uncertainty of the stock market?

House prices were booming, despite mortgage rates of 12% at best, and nearer 15% for some. Booming confidence overwhelmed any possible fear of not being able to meet sky-high mortgage repayments.

With only a moment of reflection this was a worrying mix.

Over in the US there were similar but not identical signs.

Paul Volcker was replaced as head of the Federal Reserve in August 1987. A significant part of confidence in the US economy and stock market was based on the key person charged with managing the economy - Volcker. From 1979 he kept rates very high (peaking at 14% in May 1981) to slay the inflation dragon, which fell from a peak of 11.3% in the 1970s to 3.6% by 1987. The latter allowed rates to begin falling, a key element in the growing confidence of the 1980s.

Volcker leaving, and being replaced by the relatively unknown Alan Greenspan, was clearly not helpful. There were also obvious imbalances - budget deficit, trade deficit, and low savings rate. Plus the weak dollar had been a global pre-occupation for much of 1987.

But none of these were sufficient either alone or combined to cause The Crash.

“Tensions were building” according to Manuel Johnson, vice chairman of the Federal Reserve under Volcker and Greenspan - he continued:

> ***“the divergence between the pricing of bond and equity markets had been obvious for quite a while.”***

It was expected that there would be a reaction - it was the magnitude which was “a total shock” he said, as we will see.

In 1986 there were rumblings about the dangers of the use of computers set up to quickly trade large numbers of shares, so-called program trading. This took two forms.

The first was portfolio insurance, where a computer model worked out how much to sell to limit losses when the stock market was falling. Typically the "selling" was done through the futures market rather than by selling individual shareholdings.

The second type of program trading was "index arbitrage". This was designed to make profits by exploiting price discrepancies between the value of shares in a stock market index and the value of the equivalent futures contract.

Despite some concerns, there was no drive to understand these better, beyond a study which was commissioned in July 1987 by John Phelan, chairman of the New York stock exchange. His concerns were largely ignored because a lot of money was being made through these innovations - that feels like 2007/8, on which watch ***The Big Short***.

Manuel Johnson says there were "concerns" over these financial innovations. But the truth is that even if they understood them technically, they did not fully understand the dangers. There was also a laissez-faire attitude, a bias against interference.

In January 1987 Galbraith saw a:

> ***"commitment to seemingly imaginative, currently lucrative, and eventually disastrous innovation in financial structures"***

Just as in 1929. And just as we saw in the years leading up to ***The Great Financial Crisis*** of 2008.

Valuations were not extreme (though John Phelan says they were "reasonably high"). That they were not extreme can be illustrated by a long term chart of a measure widely used today, the cyclically-adjusted price earnings ratio, CAPE (see chart on next page). Looking at this CAPE chart for the US stock market, ***Black Monday*** barely registers - though see how 2017 stands out.

Similarly on a simpler price earnings ratio, based on the current years earnings. This spiked up through 20 in Spring/Summer 1987, but it had been flirting with 20 for more than a decade from the early 1960s - so this was far from an overwhelming worry. This measure was somewhat lower in the UK.

But there was one clear warning, John Phelan again: ***"If you wanted to park your car in New York you got three stock tips from the attendant".***

So no big valuation concern - but a very clear concern about investor behaviour, just as in the UK.

Rich history of bad behaviour

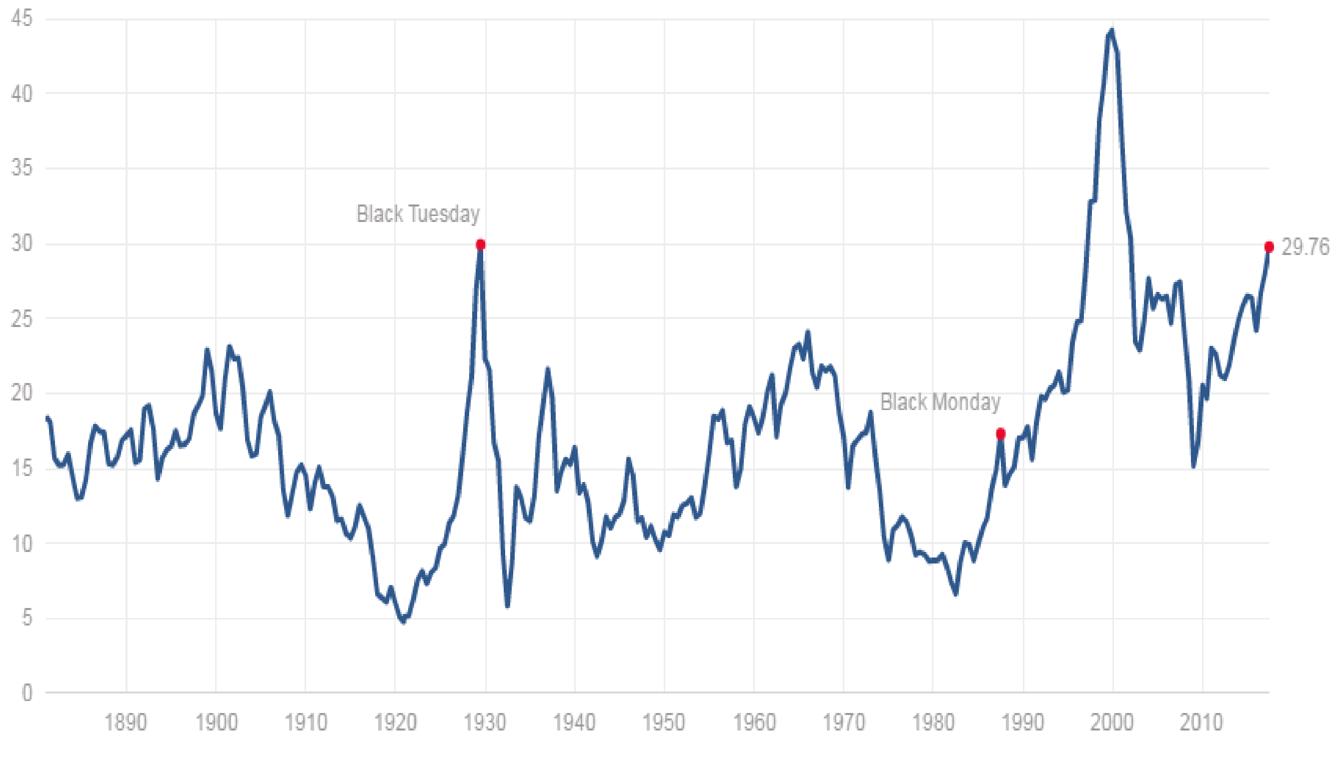
It was the behaviour of investors in particular which concerned us at the time. There was already a rich literature on stock market manias, from the 19th century work of Mackay to the modern classic of Charles Kindleberger, ***"Manias, Panics, and Crashes"***.

What lies at the heart of a mania was captured more recently by Akerlof and Shiller. Extremes are caused by the inter-action of confidence, greed and fear, temptations, envy, resentment and illusions. And, in the case of a mania, they are held together by a good story, widely believed, which binds the crowd of investors more tightly together.

The story was very powerful.

The 1970s had been very tough, and the Thatcher government wanted everyone to believe in a better today and an even better future. It certainly didn't stop with privatisation windfalls.

For example, the FT called the 1986 budget a "***budget for equities***" - income tax was cut, allowances raised, money supply target increased, interest rates cut.



To ensure the widest possible participation in this largesse the Government also introduced a “right to buy” for Council house tenants. Discounts were up to 50%, and 100% mortgages were guaranteed to be made available by the local council. More free money.

The fire was well and truly being stoked.

In the US too. The markets had already been reaching higher all-time highs in 1985 and 1986. Then in October 1986 President Reagan slashed the top rate of tax from 50% to 28%. There were now just two tax rates, and a raft of simplifications. From the day before the Tax Reform Act of 1986 was signed the stock market took off, and rose by over 50% in the next 10 months.

Before the worst crashes of the 20th century (such as 1907,1929,1987, and 2000) the market was already performing well but then had a parabolic rise (something like 50% in a year). This is the transition from a boom to a manic phase - driven by extreme investor behaviour rather than fundamentals.

There was a well established mania by the Summer of 1987.

The stock market is itself a measure of confidence - the problem is knowing when this confidence goes too far, too fast.

What we did (and still do) is measure the gap between the stock market index today and its long term trend (being the 200 day moving average). When the index is 15% above the long term trend it is ringing a loud bell, and the higher it goes the louder the ringing! In simple terms this tells us that the market has gone up too far too fast.

By April 1987 the FTSE 100 index was 15% above its long term trend, and by August it was an extraordinary 30% above. This simple, and effective, measure on its own made us very concerned. We had clearly entered a very dangerous phase.

Interestingly, as we saw earlier, stock markets were not particularly over-valued when judged against company profits. So there was no classic investment bubble with a mix of extreme investor behaviour **and** extreme valuations.

First and foremost this was a behavioural bubble - a bubble in confidence. Not just any old confidence - but that of a crowd, the very powerful investing herd. To most investors there was seemingly unstoppable momentum.

“Madness is rare in individuals, but in groups, parties and nations, it is the rule”

(Nietzsche)

PART 4:
October 1987- crack, Storm, CRASH

The cracks became much more visible as we entered October.

The US central bank (now led by a young-ish Alan Greenspan) had raised interest rates in September to take some steam out of their economy, before inflation became a problem - on that day (9th September) the market fell 62 points, a very big fall for the time.

Bond markets were in a tizzy. At the beginning of 1987 the yield on US government bonds was a little over 7%, but by early October yields were up through 10%. To give this perspective, the long term return from the stock market was just about 10% per annum. After outsize returns in 1985 and 1986 the market was up around 40% in just 9 months - in contrast bonds now offered you a government-guaranteed return of 10%. **Hmmm. What would you do?**

It didn't help that the widely followed analyst Robert Prechter gave a confident "sell" recommendation for the US stock market. The Dow Jones immediately responded with a record daily points drop at the end of the first week of October.

The next week start with a report in the Wall Street Journal citing concerns that the use of portfolio insurance "could snowball into a stunning rout for stocks" if the stock market began to fall. **This was Monday 12th October - the falls were only hours ahead.**

On Wednesday 14th the panic began to unfold as a legislation was introduced to severely limit tax deductions for interest paid on debt to finance takeovers - takeovers had played a key role in this latest manic phase, and were now under threat. Unhelpfully, a worse than expected trade deficit was also announced, and the dollar declined. The latter brought into focus the possibility of another interest rate increase, which again served to highlight the alternative attractions of the risk-free potential in bonds.

That Wednesday the Dow **dropped 95 points (3.8%, a then record)**.

On Thursday 15th the falls continued, another 58 points, and the Dow was now off 12% from the all-time high on 25th August. **It was reported by the Wall Street Journal at the time that institutions were active switching out of the stock market into bonds.** The size of the falls also triggered heavy selling by portfolio insurers, according to a later report (Brady Report, 1988).

In the UK on Thursday the UK stock market was relatively unperturbed by these events in the US. But that night the south east of England was hit by ***"The Great Storm of 1987"***, which caused havoc as well as 13 deaths.

The UK stock market might have been closed on **Friday 16th** (I will explain why in a moment), but it was business as usual in New York, and it was ugly. Another interest rate increase triggered **another record points fall** in the Dow Jones on Friday 16th October.

Over that weekend there was pent-up panic in the UK.

The UK newspapers might as well have been printed with black borders, as the death of the market was being widely predicted for Monday, similarly in the US media.

It is still fascinating looking back at the FT for that weekend (yes, we're very sad people and retain copies that old!). Lots of adverts on how to make a killing investing, how to make a million, "Double your money in weeks", and a flurry of new fund launches. There was no holding back the marketing departments of the fund management groups!

Before looking at what happened on Monday, let's return to Friday, and our offices in Chislehurst.

The storm on Thursday night was punctuated by trees, corrugated iron, and random flotsam and jetsum flying past the bedroom window. It was also a restless night because during the day on Thursday we had decided to start selling client holdings, and put together a plan of action. By Thursday evening this seemed all the more urgent as the US markets closed down sharply again.

By first light on Friday it was clear that driving was impossible (most roads around Chislehurst were closed by felled trees), so we set out to clamber through the debris to reach the office.

Now the fun began...

On reaching the office on Friday morning we had a list of what we wanted to sell, and began ringing the fund management companies to do so – there were no convenient fund platforms at that time, nor online dealing. Mostly our phone calls went unanswered - no one even picked up.

There was no 24 hour news, no Sky, no Bloomberg, no internet. To keep up to date with markets we had a small transistor radio on the corner of the desk.

It quickly became clear that few people made it to work in London. But we persevered with our phone calls, and always remember our relief when Fidelity answered the phone, and took “sell” orders. Most remained closed, and later in the day it was announced that there would be an unofficial Bank Holiday, and the financial markets in the UK would remain closed on Friday 16th October.

At this stage it is worthwhile explaining a small technical matter.

These days you know that if you give an order to sell a fund today, you do not know the sale price until tomorrow; the fund price tomorrow is calculated taking into account the movements in stock markets today. That obviously seems very fair, and is called “forward pricing”.

It was different in 1987, and considerably to the advantage of the investor in volatile markets. If we sold a fund that Friday we would typically receive a known price based on how the stock market moved yesterday, what was called “historic pricing”. Bonkers from today’s perspective, but a huge bonus that Friday.

We managed to reduce client exposures to stock markets, if not to the extent we would have liked.

After lunch on the Friday it became clear there was little more we could do, but the markets were now opening in New York. The news bulletins revealed that, following another interest rate hike in the US, the Dow Jones had fallen sharply again (down

108 points). **It was the first ever one day fall in excess of 100 points - and it was still only Friday**. That day there was more selling by portfolio insurers, retail investors were now selling funds, and some more aggressive institutions understood that this momentum was very likely to continue, so were selling futures to profit.

That weekend the UK (and US) newspapers were full of panic and stock market obituaries.

There was considerable pent-up selling pressure in the UK. Due to The Great Storm the UK stock market had not yet been able to respond to two horrible trading days in the US, let alone their interest rate increase and a painful new tax reform to discourage takeovers.

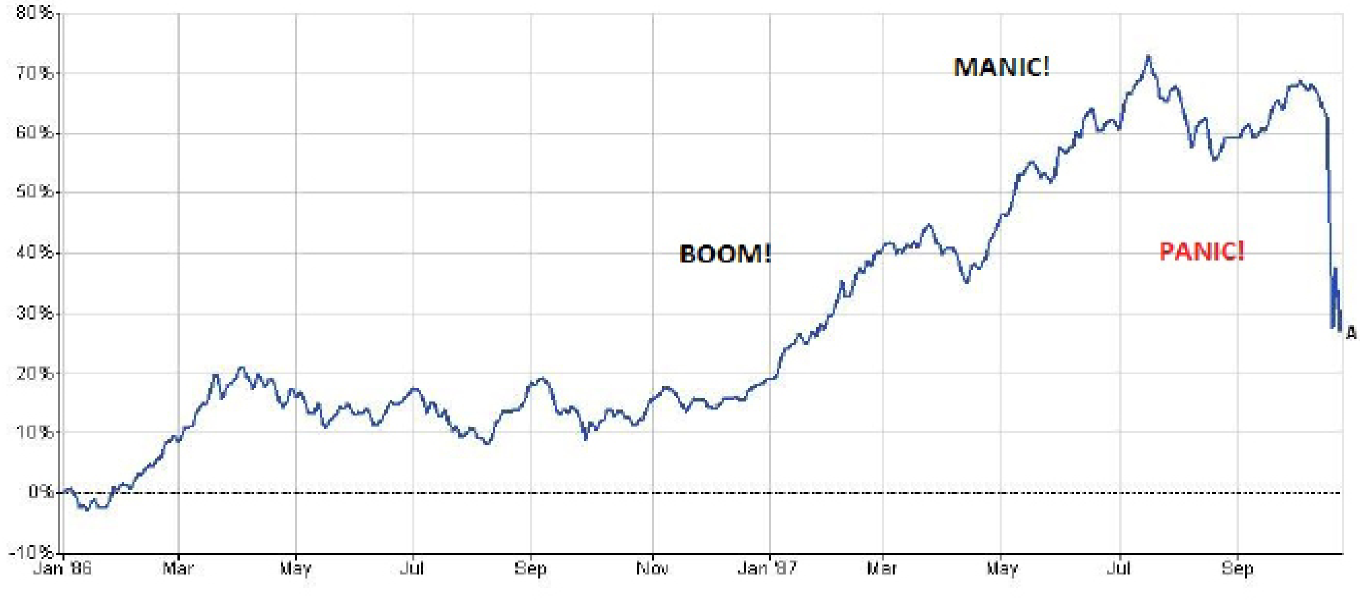
All the elements were in place for a crash worthy of the name on Monday 19th October 1987. But there was still no sense of quite how bad it would be.

Black Monday arrives

Monday 19th October was horrible, and the FTSE 100 index plunged 249.6 points by the close, and was down a further 250.7 on Tuesday. The UK stock market fell by 21.7% in total over the 19th and 20th October.

When the US market opened on Monday it was now following the mood (of panic) in the UK, rather than the other way around. On ***Black Monday*** alone the Dow Jones fell 22.6%, nearly twice as much as the equivalent day in 1929. This mayhem prompted one of our favourite quotes from the period, by M&G's David Tucker, who said this was:

"..the sort of thing you get when you put computers in place of people. Computers can't go out to long lunches - which is what I've just done"



The responses

As the mania had developed in 1986/7, the better informed were drawing parallels with the ***1929 Crash***, beginning with Galbraith early in 1987 (see page 9). They well knew that the appalling ***Great Depression*** followed the 1929 Wall Street Crash, and that the stock market took 25 years to regain the levels of 1929.

As such it was no surprise that many professionals took no chances, and they dominated the selling on ***Black Monday***. In contrast, retail investors were transfixed, in our experience. Plus the fund management industry was, as one, not answering the phone - even if you wanted to sell your funds, there was no way you could do so on ***Black Monday***.

On Monday in the US the market infrastructure was quickly overwhelmed as a sharply lower opening prompted more portfolio insurer selling. Significant selling continued throughout the day, with selling pressure later in the due encouraged by rumours that trading would be halted on Tuesday.

Alan Greenspan, new Federal Reserve boss, needed to be seen to act. Before the market opened on Tuesday he publicly announced that the Fed was ready to pump money into the economy and the markets to stop the Wall Street rout. An extraordinarily turbulent day followed in the US, again full of rumours and a mood of panic. Then something happened after lunch - back to Manuel Johnson:

> **“Luckily, and this is a mystery still today, at some point when the market got low enough some institution which we have never really identified started buying.”**

That day the US market eventually closed up by a record 5.9%.

There was no Great Depression II.

Remarkably, the FTSE 100 index closed the year up 2% (though still off 30% from its July peak).

With the benefit of hindsight it is easy to ask “what was the fuss?”. After all, the US and UK markets had fully recovered within two years - but that is hindsight.

Yet concerns persisted. In the New York Times in December 1987 a survey of 33 eminent economists concluded “the next few years could be the most troubled since the 1930s”. We can call economists perpetual worryguts - perhaps they worry that they have nothing to contribute unless they are worrying about something.

Nonetheless, for many hard-nosed traders this was the most dramatic couple of days of their careers, including the more recent financial crises. I would concur with that from an adviser perspective.

PART 5:
What went wrong?
What were the causes?

Many reasons have been put forward for the ***The Great Crash.***

Some were serious, some a bit more flakey: rising interest rates, soaring bond yields, equity valuations, dollar worries, inflation worries, computer selling, illiquidity, portfolio insurance, derivatives, The Great Storm (UK), fear of war with Iran, it was October, solar storms, it was the full moon after Yom Kippur. Most were either coincidence or of themselves could certainly not have caused a crash.

The answer to "what went wrong?" is in three parts.

- What was the factor (or factors) which created the ***crash-vulnerability***?
- What was the trigger (or triggers) for the precise ***timing*** of ***The Crash***?
- What factor (or factors) exacerbated or ***amplified The Crash?***

To paraphrase Paul Volcker later in 1987, nothing happened in the economy to drive the market up 30% between January and August, and nothing happened in the economy to drive it down 30% in the remainder of the year.

Many blame an overvalued stock market - but there was no extreme over-valuation (see page 15) in contrast to 1929, 1999, 2007/8, and 2017.

The major factor which created the crash-vulnerability was simple - the stock markets (notably in the US and UK) rose too far too fast, as you saw via the simple measure we used at the time (page 15). Confidence had been building through the 1980s, not just in the stock market but more widely, as the Reagan-Thatcher culture took hold, as we saw earlier. There weren't just good stories, but real benefits, including "free money" in the UK.

In 1987 there was first and foremost a confidence bubble, though **not** a typical investment bubble which would also be defined by extreme over-valuation. Stock market valuations were only at an extreme **relative to** bonds - alone that is not sufficient to classify this as a typical investment bubble (like 1929 or 1999), as arguably this was as much a reflection of lack of confidence in bonds.

Nonetheless, the extraordinary action in the bond market (with yields moving sharply from 7% to 10% in 1987) created an extreme tension, and this was the other major factor which created the crash-vulnerability.

Part of that tension is inherent - the stock and bond markets are like Venus and Mars. Not far below the surface the stock market pro's feared another 1929-style event. In contrast, the bond pro's were always more twitchy about a resurgence of the inflation which had destroyed bond values as recently as the prior decade *(until rescued by Paul Volcker*).

The sharply divergent moves in these markets in 1987 created a vulnerability never before seen.

By the Summer of 1987 the elephant in the room was one simple investment question, which can be laid against a very clear back-drop:

> **The average annual return from the stock market is approximately 10%.**
>
> **In 1985 the UK stock market went up 14.7%...**
>
> **...in 1986 it grew by 18.9%...**
>
> **...and in the first 7 months of 1987 it went up by more than 40%.**
>
> **A guaranteed return of 10% was available from government bonds.**
>
> **What should you do?"**

The question was answered on 19th and 20th October. But only after a series of triggers - breaking from the herd is not easy.

Once this bubble of confidence in the stock market was established, it made it extremely vulnerable, just like the avalanche-prone slope. Negative events which might ordinarily cause a shrug of the shoulders can suddenly trigger a hysterical reaction.

There was no single final snow flake to cause the avalanche - there were several. It was an unfortunate sequence of events.

On 9th September the new Chairman of the Federal Reserve, Alan Greenspan, raised interest rates, and markets fell sharply. (p17)

On Wednesday 14th October, tax legislation was introduced to make takeovers much less attractive. Markets fell more sharply. (p18)

On the same day a worse than expected deficit was announced, the dollar fell again, and inflation fears rose (inflation being the bogeyman of the time for many).

On Thursday 15th October, markets fell sharply (again) and it was reported that institutions were now beginning to actively switch out of the stock market and into bonds. Similarly portfolio insurers began selling. (p.18)

In the US, on Friday 16th the selling gathered pace, and interest rates were increased by Greenspan.

Over in the UK, the storm on Thursday night meant that UK markets were closed on Friday, with two days of pent-up selling pressure ready for Monday.

Then on Monday the avalanche quickly gathered pace due to program trading, where huge blocks of shares are traded with the help of computers (p13). In particular, portfolio insurance meant that if prices fell below a certain level the holder would automatically sell some their holdings - pushing the price down to another level at which another portfolio insurer would be required to sell, and so on.

PART 6:
Relevance today?

Many reasons have been put forward for the ***The Great Crash***, as you saw on page 24, from computers to solar storms and the full moon cycle.

If you want to apply the KISS principle (Keep It Simple, Stupid!) the answer isn't so complex, and there was one indespendable ingredient which created the crash-vulnerability. **Stock markets had run too far too fast.**

What about the relevance of 1987 today? *(early October 2017)*

The 30th anniversary of the 1987 Crash is just ahead, and parallels will be drawn in the media in the coming weeks. I was not just there, but selling client holdings in the week before - so I'm reasonably well-qualified to comment.

The essential foundation for a crash was laid by the market running too far too fast – it's that simple. By August the FTSE 100 index was running 30% above the long-term trend (the 200-day moving average). Right now, it is almost exactly at the level of the long term trend.

Yet in 1987 valuations were not extreme, measured by the various versions of the price earnings ratio. *(For the latter reason '87 was not an investment bubble)*.

This vulnerability had an important second leg. Government bond yields had risen to 10% by the summer – therefore bonds offered roughly the same return as the average long run stock market returns, but guaranteed by the government.

In the week before ***Black Monday*** the triggers for The Crash came into view: US tax reforms (which would hit the takeover mania); then rate increases (where the trend of falling rates through the 80's had increasingly buoyed confidence).

Then the stock market closed in London on the prior Friday (following ***The Great Storm*** in SE England on Thursday night), which created considerable pent up selling pressure. On the day of The Crash computer-generated selling exacerbated the downward spiral.

Why no recession like 2008/9? Central banks acted, certainly. But more fundamentally this was a time of growing confidence following the horrible 1970s; demographics were extremely favourable, and there was considerable political cohesion. These positives are not just absent today, but are serious impediments.

There were good fundamental reasons for the depth of confidence in the 1980s, which provided “bounce-ability” after Black Monday. Now such confidence as there is in markets is driven by the hand of the central banks, and their extraordinary intervention since 2009.

The market vulnerability now is quite different to 1987, and is derived from the most expensive US stock market ever. This is accompanied by widespread investor irrationality (evidenced by the scale of ETF buying with a focus on ***price***, and a reckless disregard of ***value***). Together these two elements are the foundation for a classic investment bubble.

Ordinarily, as the market has risen relatively slowly, we might expect the cyclical downturn (whenever it might arrive) to be a long drawn out bear market. Yet when ETF investors take fright this will play a similar role to program trading in 1987, accelerating and deepening falls.

Oh and one final, but vital, point. The most expensive stock market ever has had one single plank - the extraordinary intervention by central banks, through both QE and zero interest rates. It is the clear stated intention of central banks, led by the Federal Reserve, that this plank is removed - at some point the markets will blink.

SUMMARY

While the market has not moved too far too fast in 2017, valuations are much more extreme. Markets now are dependent on central bank action, where in 1987 a strong economic recovery drove the market higher.

Evidence of investor complacency is widespread in 2017, just more subtle.

The role of ETFs and high-frequency trading creates a crash potential just as great as 1987, if not greater.

Favourable demographics and political cohesion created bounce-ability in 1987. These are now totally absent. And this is a classic investment bubble, unlike 1987.

This time when the market goes down, it is much more likely to stay down.

APPENDIX 1:
The best/worst investments since 1987

There aren't a vast number of funds which survive intact from 1987, as many have been closed, or merged since '87. Nonetheless the two tables below are interesting.

That a China fund is at the top, and by a wide margin, might surprise quite a few – but it was very early days for China re-joining the world economy. Those who lived through the technology crash of 1999-2003 might also be surprised to see a technology feature. Again it was a very early stage in the advance of modern technology, and the extraordinary rise of the FAANGS in recent years hs driven the recovery of this once battered sector.

The sprinkling of US, European, and Asian funds are less surprising.

Japan is the big feature in the laggards, 4 out of 10 funds. Their market peaked in 1989, and is still 50% below that peak. Yet it is now one of the most attractive global markets.

There are two bond funds despite a bond bull market lasting more than 30 years. The two equity income funds will also surprise – this is a winning long term strategy, but not if you are in the wrong funds, as we continually highlight.

Three funds with global remits also highlight another truism (with only a few exceptions) – global funds tend to be average performers at best, and more focussed funds should be preferred for most investors. The ethical funds? Again a regular theme of ours – ethical investing typically comes at a very heavy price.

Overall the bottom 10 sends a very strong message that "buy and hold" (which is really "buy and forget") is a convenient mantra for some in the investment industry but is a road to poverty for many investors.

Best Funds	01/11/1987 to 01/10/2017 Overall %
Henderson China Opportunities	6067.78
GAM North American Growth	4381.58
Fidelity European	4117.42
Halifax UK Growth	4045.69
Jupiter European	4037.53
Fidelity American Special Situations	4020.39
Fidelity American	4009.85
Henderson Global Technology	4002.87
Fidelity Asia	3897.5
Aberdeen Asia Pacific Equity	3443.53
FTSE 100	***1202.73***

Worst Funds	01/11/1987 to 01/10/2017 Overall &
Scottish Widows Japan Growth	90.81
Henderson Japan Opportunities	104.57
Fidelity Japan	164.62
Scottish Widows Gilt	261.9
Scottish Widows Ethical	290.16
F&C Global Bond	353.49
Aberdeen World Equity Income	395.62
F&C Global Thematic Opportunities	405.03
Fidelity Japan Smaller Companies	458.66
JPM UK Higher Income	477.28
FTSE 100	***1202.73***

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Brian Dennehy's extensive experience with advisers Dennehy Wealthy stretches back to 1987. He also founded FundExpert, and has been the main contributor to the acclaimed Top-Funds Guide since its launch in 2002.

His long-term commitment to research and uncovering outstanding investment solutions is evidenced by the media coverage he's received week after week for more than 20 years - in The Times, Telegraph, Financial Times, What Investment and Mail on Sunday among others. Brian has also appeared frequently on TV and radio.