

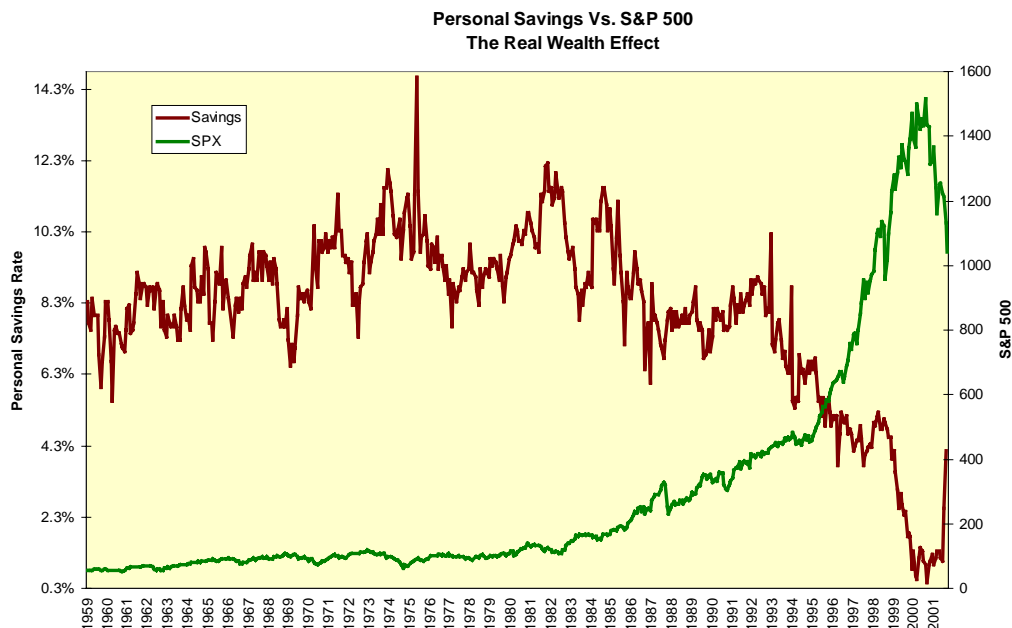
Bending Over Backward To Manage Risk

Liquidity, like a New York taxi on a rainy day, disappears when needed most. Anyone will make you a market when volatility is low and price movements are small, but so what? Great athletes and national leaders are defined by what they do in the clutch, and it is high time we start holding our financial institutions to the same standard.

Economists, with their usual deaf ear for the double entendre, refer to the phenomenon of disappearing when needed as “backward bending.” It shows up on the supply as well as on the demand side. Take the never-ending political lamentations over American’s low rate of personal savings – please. If the government really wants us to save more, they should remove impediments as double taxation of dividends, limitations on contributions to retirement accounts, limited deductibility of losses, and multiple holding periods for capital gains taxes.

Saving, to a large extent, is a fear-driven response. If we are confident of the future and if we are getting a high return on our existing savings, we feel less motivated to save an increasing percentage of our income. It’s no accident that savings rates fell once the Great Bull Market™ took off in 1982, and then plunged rapidly in the 1990s. Note how the savings rate jumped in recent months as the Bear Market (hiss! boo!) left a sizable portion of our portfolios in the woods, as bears are wont to do.

The fear phenomenon helps explain why current exhortations for Americans to get out of the house and spend more will, by themselves, be ineffectual. More important, the present policy of low interest rates, designed to promote consumption, may contribute to an increased demand for saving: Portfolio income will fall with interest rates, so the quantity of savings must increase to maintain investment income. The opposite phenomenon, lower savings in response to higher interest rates, has been observed as well in a classic backward bending response to policy goals.



Answering The Demand

While designation as a hero for stepping up in the clutch is nice, it is far better for all of us to do a little planning in advance to prevent crises. Financial markets exist in large part as risk transference and liquidity provision mechanisms, so they should be designed to accommodate the inevitable wild markets and volatility surges. In the case of the forthcoming futures on single stocks (SSFs), what does this mean for the exchanges’ product offerings?

First, SSFs have a massive advantage over alternative products in their ability to handle specific security risk as opposed to general market, or systemic, risk. After all, if you want to adjust your risk exposure to IBM, then trade IBM futures, not S&P 500 futures. This argues that the availability of SSFs should be a function, in part, of the specific risk for each security.

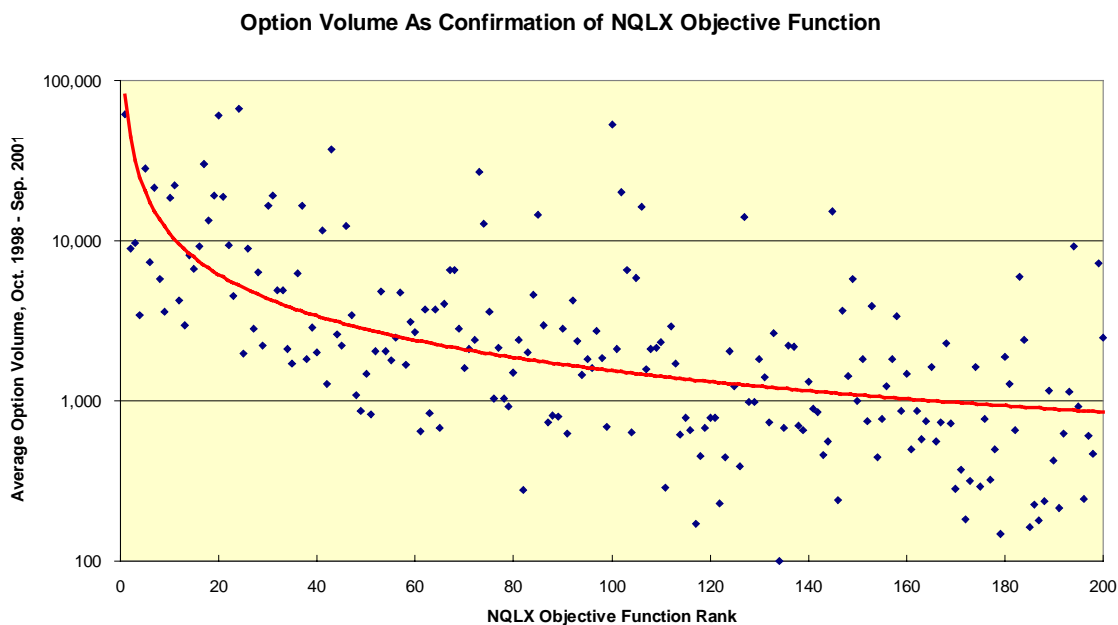
Second, we've all learned the hard way about pre-opening and after-hours stock volatility produced by government reports and earnings announcements, respectively. Liquidity has existed at these times for institutional traders with access to systems such as Instinet, but more often than not individuals have had to wait for the opening bell to ring. The wait isn't always pleasant. Exchanges can serve both themselves and their customers well by meeting the demand to trade during these hours.

Third, the best place to measure volatility is the one market dependent thereon, options. If we view options as a form of insurance – and we should – then volatility represents the price traders are willing to pay for a measure of certainty. High volatility indicates demand for risk protection, and it is the job of exchanges to answer this call.

Finally, exchanges need to remember a truism from the petroleum industry, and that is the best place to look for oil is where you've already found it. Quite simply, there's no better indication of the market's demand for risk management and price discovery than existing trade volume.

The Proof Is In The Pudding

Will exchanges paying attention to their customers' interests as defined above lead to successful SSF products? Empirical evidence suggests combining these factors into a proprietary objective function can be confirmed by trading volume in individual equity options, the products most similar to SSFs. In fact, work done on behalf of the new Nasdaq Liffe Markets exchange (NQLX) shows that combining the variables linked to customer demand is rewarded with exponentially accelerating volume.



The implications of this objective function for SSF acceptance are astonishing. The very phenomena that produce backward bending volume curves elsewhere, such as overnight and early morning gaps, high volatility, and a great deal of stock specific risk should actually increase demand for SSFs.

John Naisbitt, author of *Megatrends*, observed that people use a new technology only as an improvement on existing technology until a new generation realizes the technology's potential. Much of the early usage of personal computers, for example, was simply as a better typewriter and adding machine.

We have an opportunity to short-circuit this process in our adoption of SSFs by envisioning their uses and potential prior to their introduction in the U.S. In the interests of full disclosure, I am not a disinterested party in this topic, but rather am involved intimately in their development. I invite your questions and comments as to how SSFs can help you do what you already do faster, cheaper, and more efficiently.