The Journal of Portfolio Management

Exercising the Options on Our 25th Birthday

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This issue marks *The Journal of Portfolio Management*'s twenty-fifth birthday. Our maiden issue in the fall of 1974 made its debut at a moment when the Dow Jones Industrial Average was below 600, long Treasury bonds yielded 8.40%, the cost of living was less than one-third of what it is today, and the words "personal computer" would have been considered some kind of oxymoron, even to Steve Jobs.

The changes across the world in the past twenty-five years loom large even against the extraordinary changes of the preceding quarter century from 1949 to 1974. In the field of finance and investments, the most powerful driver for change developed from a scholarly article that had appeared only fifteen months before we made our debut: "The Pricing of Options and Corporate Liabilities," which appeared in the May/June 1973 issue of the *Journal of Political Economy* and was written by two obscure economists named Fischer Black and Myron Scholes.

This issue of *The Journal of Portfolio Management* celebrates our silver anniversary by focusing on the remarkable world of finance that has developed from the roots set in place by Black, Scholes, and their essential colleague, Robert C. Merton. These three men did much more than develop the first workable formula for valuing options. They recognized immediately that the concept of derivatives could open up a vista in finance to extend well beyond the parochial world of puts and calls. The title of their seminal 1973 article itself points the way to these distant horizons by including corporate liabilities among the financial variables for which their approach provides the key to valuation.

The choice of the subject matter of derivatives for this occasion is highly appropriate. Twenty-five years ago, in the introduction to our first issue, I wrote that "the objective of this Journal is to provide a platform where practitioner, academic, regulator, and client can communicate with one another, can clarify the areas of agreement and disagreement, and can provide fresh viewpoints of the perennial problems of risk-adjustment, security selection, and timing." More than any other instrument or concept in finance, derivatives have brought academicians and practitioners into such close collaboration in the analysis of risk, selection, and timing that the lines of demarcation are now blurred beyond recognition. Derivatives also have forced the regulators to bring themselves up to a much higher level of sophistication in approaching the material and the individuals they are called upon to regulate; the literature from the regulators' side today is more thoughtful and more sensitive to the impact of regulation on free markets than at any time in the past.

My introduction of Fall 1974 also commented on the importance of "the one word that the academics persisted in warning us about during the 1960s but that

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too many of us stubbornly ignored: risk." The appetite for risk is much greater today than it was in the dark days of the 1970s, but risk *management* is now a central concern in finance and business, and even in areas like environmental protection and public health; twenty-five years ago it was an essentially alien or primitive concept. Today, derivative instruments have become the choice tool for risk management, displacing diversification in many manifestations.

Derivatives have an additional justification for serving as the focal point of this issue. To many people today, "derivative" is a dirty word. Some wag has observed that a derivative is like a razor — you can shave with it, but you can also slash your throat with it. Some pretty famous organizations have lost some pretty impressive sums by being on the wrong side of a derivatives transaction.

Derivatives are controversy. A good journal eats controversy like ice cream. If we are to accomplish the mission we have set out for ourselves, our obligation to our readers cannot be limited to what is compatible, congenial, or familiar. The more that people are steamed up over some aspect of finance, the greater our responsibility to find authors who will dive right into the rumpus in order to bring reason out of turmoil and discord.

Finally, we welcome to the pages of this anniversary issue a recent Nobel Laureate who has been one of the great innovative thinkers in finance — Merton Miller of the University of Chicago. His presence on this occasion is also appropriate because, in a way, he is the grandfather of options theory. Black and Scholes's original manuscript was rejected in October 1970 by the *Journal of Political Economy* for being excessively specialized and too concentrated on finance instead of economics. The editors of the JPE did not even send the paper out for review. Miller and Eugene Fama, who together had immediately recognized the extraordinary achievement of Black and Scholes, finally prodded the JPE to publish the paper.

Miller is responsible for more than that. He encouraged Fama, a novice on the Chicago faculty, to teach a course on Markowitz when nobody else was even aware of Markowitz's work. He guided Scholes into finance, offered William Sharpe a job at Chicago in 1962, and introduced Jack Treynor to Franco Modigliani. At all points, he has been generous in his help to others and remarkable for his recognition of talented scholars so far ahead of anyone else. We are honored that he participates in our anniversary celebration.