

Property derivatives made simpler

Guest perspective: How to make bets on future home prices

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Until recently, if you thought housing prices were headed for a fall in your market, your only choice was to sell your property or ride it out. With the introduction of property derivatives such as futures contracts traded on the Chicago Mercantile Exchange or OTC-traded options, professional investors can now effectively make bets on the future direction of residential housing prices.

But what about the rest of us who don't work at a hedge fund? San Mateo, Calif.-based HedgeStreet offers an Internet-based market where traders can hedge against or speculate on economic events and price movements for markets like housing. In order to simplify property derivatives, HedgeStreet created financial contracts called "Binaries."

A HedgeStreet Binary is a contract that has a fixed payout of zero or \$100 and is entered into between traders where the buyer takes the position that a certain strike price will be reached, whereas the seller takes the position that it will not. Thus, Binaries are all-or-nothing options with a fixed payout of either zero or \$100, depending on the final value of the underlying index.

For example, Los Angeles Housing Price Binaries allow traders to take a particular position on the National Association of Realtors' reported median sales prices of existing single-family homes for the Los Angeles metropolitan area. At issue is the quarterly median sales prices for the Los Angeles metropolitan area as reported by the NAR on a particular release date. The most recent median price reported by NAR for Los Angeles was \$589,900.

Depending on your belief about Los Angeles housing prices, you could buy or sell one or more Binaries at several different strike prices. If you think that the median home price to be reported by NAR in August will be less than \$615,000, then you would sell a Binary. If you think the median price will be above \$615,000, you would buy a Binary. The price you would pay for that Binary fluctuates just like stocks do throughout the trading day.

If you pay \$75 to sell a Binary for Los Angeles at a strike price of \$615,000, then your potential upside is \$25. That is, if the reported median price is below \$615,000, then you are paid \$100, and so your profit is \$25. On the other hand, if the median price reported is over \$615,000, then you get zero and you've lost your \$75. Obviously depending on your conviction, you would buy or sell more binaries to increase the size of your position: 10 contracts would increase your bet by tenfold.

Binaries currently trade on the HedgeStreet Exchange for just 10 markets: Boston, Chicago, Denver, Los Angeles, Las Vegas, Miami, New York, San Diego, San Francisco and Washington, D.C.

The company plans to double its market coverage by the first quarter of 2008.

There are several things to keep in mind about HedgeStreet trading:

Simpler, not Simple. If investing in your view means buying mutual funds in your 401(k) account, this kind of trading is probably not for you. On the other hand, if you are an active stock trader and have done some trading of futures and options, you should get it pretty quickly.

Limited Liquidity. The biggest limitation is that trading is relatively thin. If you want to buy 100 Binaries to establish a sizable position, it's going to take awhile. For most contracts, the open interest is only a few dozen contracts or less at any one time.

Median Price Basis. CME futures trade based on S&P/Case-Shiller indices. Those indices use the repeat sales pricing

technique to measure housing markets by collecting data on single-family home re-sales, capturing re-sold sale prices to form sale pairs. The result tends to be more directionally consistent and less volatile than median home prices reported by NAR. With median prices, inventory can be rising, the number of home sales can be declining, but if the relatively few homes that sell are mostly on the high end, then the median price will rise. Folks in Beverly Hills probably aren't much affected by the subprime financing meltdown (unless their hedge fund invests in that market).

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