Property derivatives

Homes with hedges
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Applying modern finance to America's biggest asset class

THERE are many ways to manage risk in America's markets, but the country's sophisticated web of financial products has a $21.6 trillion hole in it. That is how much wealth is tied up in residential property—far more than even the $15 trillion value of America's publicly traded equities. And unlike investors in shares, bonds and many other assets, those with a stake in housing do not have an easy way to hedge the risks. However, the Chicago Mercantile Exchange (CME) is planning to fill that gap.

In the next few weeks, the CME is likely to open trading in financial futures and options linked to American house prices. Investors who want to hedge the risks of residential property—or merely to speculate on the market's direction—will be able to bet on a rise or drop in a house-price index, without having to buy or sell bricks and mortar. With interest rates on the rise, prompting worries that the recent housing boom is about to give way to a downturn, the potential appeal of these new hedging products is easy to see.

Punters will be able to bet on price changes in ten cities from Boston to San Diego, as well on a national index that aggregates all ten. The indices will be part of the CME's Alternative Investment Products group, which fosters derivatives linked to economically important trends and events not directly related to underlying securities or commodities. The group already has products based on the weather and on economic data such as non-farm payrolls.

Creating a useful and reliable index of house prices is tricky, since no two homes are identical and the market is full of messy transactions. But a pair of economists, Karl Case and Robert Shiller, have spent more than a decade sorting out many of the problems, and for several years have published proprietary indices that highlight trends in the market. (Mr Shiller, a tauricidal academic who has spent much of his career slaying bulls and their foaming theories, has a special interest in tracking American house prices, which he has claimed are ripe for a fall.) The Case-Shiller indices have now been tweaked a bit to create a version suitable for trading.

Because the new derivatives will allow bets up to only a year ahead, homeowners will not be able to use them to hedge long-term risks. That limits their usefulness for ordinary folk. For many companies in the property industry, however, they should be helpful. A property developer or contractor, for example, can start a housing project without worrying whether prices will fall sharply by the time it is completed. Monika Piazessi, an economist at the University of Chicago's Graduate School of Business, says that half the volatility in the price of individual homes is linked to city-wide changes in prices. So the CME's new city indices could go a long way towards lowering the risks.

Financial firms such as mortgage lenders will also no doubt find uses for the new derivatives. And so will investors with a view about America's residential property market—whether they expect a continued boom, or a bust.