

Days Of Housing Futures Past

Economic modelers spend their lives forecasting the past with ever-greater accuracy. No, this is not a typo or a misstatement. You have to describe the past statistically to calibrate any model, and you have to keep reducing the model's historic error band to have any confidence whatsoever you have produced something capable of working in the future.

Past performance may not predict future results, but it certainly captures the assets required to obtain future management fees.

Futures On The Past

This little diversion into the nature of past, present and futures markets was prompted by a review of the Chicago Mercantile Exchange's housing futures. All futures markets are based on the principle of indifference. If interest rates are at 5% and storage costs amount to 1% of the underlying asset's price, then a one-year future should be priced 6% over the current cash market price. You should be indifferent between buying the asset now and storing it yourself or buying it in the futures market for delivery a year from now.

Futures markets also have a large measure of insurance built into them. Producers sell them to lock in a price to be received, and consumers buy them to lock in a price to be paid. Risk management is understood, almost without saying, to involve events that will happen in the future.

This is not the case with housing futures. Each of the contracts is based on the S&P/Case-Shiller (CSI) home price indices. They cover metropolitan areas of Boston, Miami, New York, San Diego, San Francisco, Washington, D.C., Chicago, Las Vegas, Denver and Los Angeles as well as a composite national index. That in itself does not present a problem; we have close to 25 years of experience trading index-based, cash-settled futures on things such as stock indices.

Frequency becomes a problem. Unlike a stock index refreshed several times a minute, the CSI indices are released at 1:15 PM Central Standard Time on the last Tuesday of every calendar month. The release is of necessity for data collected for previous months. For example, the August report will cover the data collected for April, May and June in each reporting region.

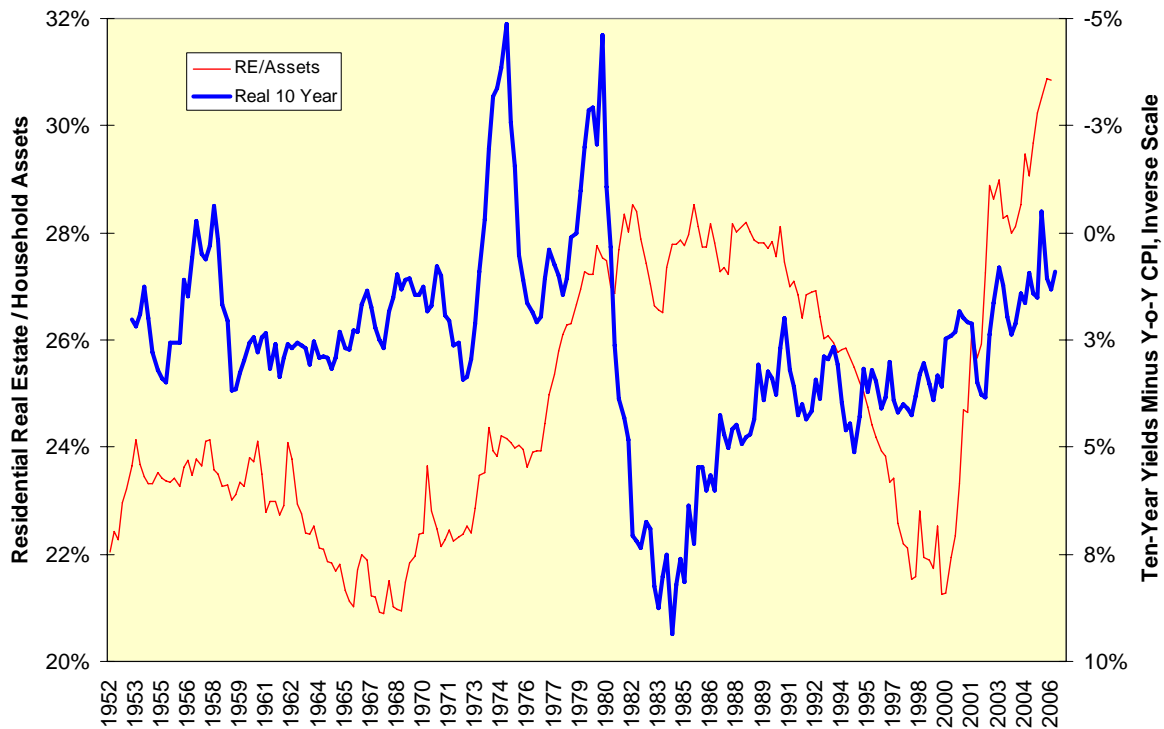
Here's a question for the philosophy majors in the audience: Can you be at risk for something that has happened in the past? Moreover, can you really work up a sweat trading something released just once a month that will not have an immediate impact on other markets? We are perfectly accustomed to trading monthly releases of government data or even quarterly releases as we know they change ours' and others' perceptions of reality. Does anyone remember how a change in the Miami CSI index in March changed their life, or, more important, their business plans?

The Risk Exists

This is not to deny a risk exists in the residential real estate market. The Federal Reserve's Flow of Funds data for the end of the first quarter 2006 household holdings of residential real estate at \$20.364 trillion. For comparison, households and nonprofit organizations own \$5.6845 trillion of corporate equities and \$4.5374 trillion of mutual fund shares.

And whether there is a real estate bubble or not, holdings of residential real estate have surged as a share of household balance sheets in recent years. We have a sideways (at best) stock market to thank for this, perhaps even more than the obvious explanation of low inflation-adjusted long-term interest rates. This latter point is critical: Housing futures are being marketed as an indirect way of playing rising long-term interest rates. The answer is simple: If you think rates are going higher, sell bond futures or something similar. They are a direct play on interest rates.

Real Estate's Response To Real Interest Rates



If you think housing activity is going to decrease, sell homebuilders' stocks. The S&P 500 Homebuilders index' total return for 2006 has been -36.77%. The year to-date return on the Merrill Lynch index of 10-15 year Treasury bonds has been -3.317%. The housing industry is much more than a bond in disguise and should not be traded as such.

Who Is The Buyer?

It is easy to make a list of those who might want to buy insurance against declining home prices. Mortgage lenders, the aforementioned homebuilders and related industries and municipalities whose property tax revenues rise with real estate assessments are obvious candidates. Here we come to a problem faced by so many financial innovators: Size matters, and it matters in a big way.

How so, you ask? The first and most obvious constraint is in the contracts themselves. They have a position limit of 5,000 (total open interest in all housing futures was 759 contracts at last glance). Each index point on the CSI indices is \$250. The most expensive metropolitan index, January 2000 = 100, is the one for Miami at 276.41 at the end of April. A position limit in that contract covers $276.41 * \$250 * 5,000 = \345.5 million. Go to certain high-stepping neighborhoods in South Florida, wave your hand in front of your face, and you will have no problem blocking the view of \$345 million of residential real estate.

The second size issue is related to transaction costs. As anyone who has attended a real estate closing will attest, these things are check-writing extravaganzas. If a market maker sells you a future, that market maker is now short the market. How can he cover his risk? By buying an equivalent package of real estate in the metropolitan area? That would be time-consuming and impractical.

Finally, who is the natural long in this market; who gets hurt when residential real estate prices rise? Someone who has seller's remorse and wishes to replace the house he sold for too little with an index? Hardly. The CME's response, of course, is hedge funds (who else?), but this really does not pass the giggle test. Anyone looking for a diversifying asset in residential real estate can buy and sell the cash flows of mortgage-backed securities or go into apartment REITs or housing-related equities. Why bother with an illiquid and backward-looking futures contract when liquid and forward-looking equity, REIT and fixed-income instruments are available?

The combination of an illiquid market and a one-way view of risk impeded (along with 200% volatility) the growth of the electricity futures market. If you could not deliver electricity into the grid in commercial size, you could not afford to be short an electricity future to any local utility. You would get zapped, to say the least.

Housing futures are but one of the emerging class of so-called macroeconomic markets. Come back in twenty years and we will still be calling them emerging macroeconomic markets. They sound intriguing until you realize they are simply one step over your office football pool: Put your money down, guess the index or report, and you either win or lose. That's it.

And if you are going to do it - and I'm shocked, shocked! to learn betting goes on in corporate offices - at least bet on something that happens in the future.