

Derivatives: Off to Hollywood!

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As if we needed another buzzword, one appears to be destined to be on everyone's lips before long. It blurs the boundaries between financial derivatives trading and betting still further. Prediction Markets are beginning to emerge as a growing force in the financial markets. The introduction by the Chicago Board of Trade (CBOT) of the Fed Funds Binary Options in July brought to the market a means to trade on the likelihood that the Federal Reserve increases, decreases or leaves unchanged the target Federal Funds Interest Rate.

Why should this be so revolutionary? One can already trade the US interest rate market via the gargantuan swaps, futures and options markets. The difference here is that the actual movement of the interest rate can be traded before the decision rather than a derivative based on prevailing swap and spot rates. Fed Funds Binary Options expire at the regular FOMC meetings at a value of 100 or 0 depending on the target rate decision made at this meeting. Prior to the Fed Funds decision the value of this Binary Option depends on the consensus opinion of the likely outcome of the Fed meeting rather than the underlying Fed Funds rate. Should the consensus be that there is a 50% chance of a rise in the Fed Funds rate at the next meeting, the Binary option for a rise in rates would be priced at 50. Should the consensus that a rise would occur be 20% then the price of the Binary would be 20. Someone betting that the FOMC would increase rates would turn an investment of 20, in this case, into 100 at expiry should indeed raise rates. The CBOT offer a series of Binary options covering different levels for the target federal funds rate to allow varying views to be traded.

The revolutionary change is that it is now possible to make actual transactions based on events that have not yet happened and no underlying market exists. One cannot go and buy \$1m of Fed Funds rate like buying \$1m of gold, oil or shares. This step forward may allow the prediction markets to begin to offer valuable consensus valuation to other economic events such as unemployment and inflation, weather and storm damage. Indeed this data may aid forecasters in their predictions of these events.

On a lighter note, one can see the emergence of Prediction Markets in Hollywood stars ratings, movies and box-office takings on the Hollywood Stock Exchange. The Exchange is a subsidiary of Cantor Index Holdings LLP the spread betting firm. One can clearly see the parallels between trading a share price where future earnings are discounted to derive a share price and the notional value of a Hollywood star such as Tom Cruise, current price \$134, or Clint Eastwood at \$57.40 based upon their perceived future box-office earning power.

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