

# Why Real Estate Index Futures Don't Work

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## **Summary**

Index futures based on private real estate have not been successful due to the nature of futures as financial instruments and the structure of the industry. A futures contract is designed to work most effectively on indexes with underlying assets that are liquid and have volatile pricing. The most successful futures products are based on indexes with underlying assets that trade every day, multiple times, at prices that are difficult to predict with any level of certainty at any time in the future.

Private real estate is very illiquid with a very small proportion of properties changing hands within a given year much less a given day. Hence, futures products based on indexes of private real estate will more likely fail as the first vehicle to improve the liquidity of real estate. When there is some other vehicle in place that will build the bridge between the illiquid real estate market place and the transaction hungry futures world, then futures based on this new real estate product might succeed.

## **Futures Markets: Liquid Underlying Basket of Assets**

Successful futures contracts are generally built around an underlying basket of assets purchased and an arbitrage between that basket of assets and the futures contract. The greater the cost of the arbitrage the more difficult it is to keep the price of the futures in line with the prices of the underlying assets.

Private real estate is an asset class with indexes whereby the underlying basket cannot be purchased. Traditional index arbitrage is not possible. This lack of a basket is a significant operational problem for futures based on private real estate.

A successful, innovative financial product, based on an index of private real estate, must have a structure whereby a basket is not necessary for effective operation.

## **Futures Markets: Once Every 15 Seconds Index Calculation versus Once a Month**

Most successful futures contracts are based on an underlying basket of assets that are priced once every 15 seconds. These baskets of assets are generally very liquid and the prices of the assets are volatile and unpredictable.

Private real estate indexes are calculated once a month or once a quarter. Thus, real estate index levels are always stale. Any successful financial instrument based on a real estate index must thrive even when as index values are stale. The instrument must be valued based on something other than the most recently published stale index value.

## **Futures Markets: Volume Concentrated in Nearby Contract**

Futures contracts generally offer multiple expiration dates; frequently at least quarterly. Frequently, the trading volume in the contracts is concentrated in the contract closest to expiration. These institutional features of futures contracts are appropriate for indexes based on baskets of assets that are very liquid.

Because private real estate is very illiquid, effective hedging tools for real estate need to have a much longer time to reset or expiration than the frequency of the calculation of the index. To be effective, they need the period between reset or expiration to be measured in years. The futures industry culture finds this to be an alien idea.

## **Futures Markets: Business Model**

The futures industry is structured around the liquidity of the underlying assets while its revenue model is based on trading volume. The exchanges realize revenue based on taking a small percentage the cost of every trade. Thus, futures markets measure success in terms of trading volume.

In conclusion, because private real estate is very illiquid, there are trillions of dollars of illiquid assets with no hedging tool. A new financial instrument based on private real estate indexes must be able to survive the ups and downs of trading volume, while improving the liquidity of the asset class in the long run. The business model of a new, successful financial instrument needs to be based on assets under management, not trading volume.