Why real estate index futures don't work

Real estate futures endeavors have failed to attain adequate liquidity or establish hedging options for the private real estate market. The nature of futures and the structure of the industry make futures an unrealistic first vehicle for improving the liquidity of the real estate market.

Futures Business Model

The revenue model and the culture of the futures industry is based on trading volume. The exchanges and market makers realize revenue based on taking a small percentage the cost of every trade. Thus, futures markets measure success in terms of trading volume. This is possible in highly liquid asset classes, but since 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.

Liquid Underlying Basket of Assets

Successful futures contracts are generally built around an underlying basket of liquid assets (e.g. S&P500, US Treasuries). If the price of the futures contract moves away from the price of the underlying basket, there is an arbitrage between that basket of assets and the futures contract to keep the two sets of prices in line. 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. In private real estate indexes the underlying basket of assets are extremely illiquid, so illiquid that the basket cannot be purchased. Thus 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.

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 index values are stale. The instrument's value must be based on something other than the most recently published, yet stale, index value.

Volume Concentrated in Nearby Contract

Futures contracts generally offer multiple expiration dates; frequently at least quarterly. Often 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.

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 with indexes whose underlying assets 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 are likely to fail as the first vehicle to improve the liquidity of real estate. When there is some other vehicle to bridge the illiquid real estate market place and the transaction hungry futures world, then futures based on this new real estate product might succeed.

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