

TheStreet.com

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Hedging for Small Investors

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Trading is often compared to gambling, but can "water cooler" wagers such as "I bet the **Dow** ends up 100 points today" be considered trading? What if you are long stock -- would taking the other side of your co-worker's proposition be considered a hedge against your existing positions? Can this be considered a derivative?

The founders of HedgeStreet.com certainly would answer a resounding yes to all of the above. The site, which launched in early October, bills itself as "the nation's first mass-market online derivatives exchange" and created a unique way for "individual investors to manage the risks in their everyday lives" according to Russell Anderson, co-founder and vice president of instrument orientation at HedgeStreet.

A Bet Is a Bet Is a Hedge?

Almost all wagers in which there is a win/lose proposition -- that is, in which a set of criteria are either met or not met within a specified period of time -- can be considered binary options and therefore a derivatives contract.

What distinguishes HedgeStreet from sports books, online casinos and even the local bookie? Like these gambling outlets, HedgeStreet, which operates as both an exchange and clearinghouse, is a licensed operator, in this case by the Commodity Futures Trading Commission. But there are two main differences. The first is that HedgeStreet allows for trading of the contract right up to the expiration or completion of the event. (There are not many racetracks that allow for betting after the race begins.) And the second difference is really a matter of focus rather than the pure product difference. Unlike other sites, you won't be able to wager on the expected snowfall in Central Park, "HedgeStreet only offers contracts with economic or financial significance," says Anderson. Currently, HedgeStreet offers contracts on economic data -- such as employment numbers, CPI numbers, the **Fed's** next move, the direction of mortgage rates and energy prices.

HedgeStreet hopes that by concentrating on events with a direct economic or financial impact, it will be the leading player in that sector. This is crucial, because as with any marketplace, its success is dependent on being the market leader, as liquidity breeds liquidity, whether it be an options exchange, an auction market such as **eBay** (EBAY:Nasdaq) or an online dating service.

While Anderson says the site/exchange aspires to be "more about managing the economic risks of your daily life" than short-term trading or speculating, HedgeWorld will need to gather a sufficient amount of the latter to accommodate the former. One unique approach it is taking to achieve this goal is to welcome investors to create new contracts, for which they will be paid a royalty. Because it has no legacy system, it should be able

to create and begin trading new contracts in a very short time period.

HedgeStreet is also accepting applications, which consist of a very short and simple form, for would-be market-makers. For those who think they are adept at managing risk or finding inefficiencies in markets, this might provide a great proving ground for testing one's market-making prowess.

In this sense, HedgeStreet really does represent the trend of democratizing the financial markets. While I doubt it is going to replace the existing exchanges anytime soon, it is the next step in using technology to level the playing field and let anyone who is willing to assume the risk have a fair chance at reaping the benefits offered by an open and competitive price-discovery market.

Anderson points out that residential real estate "has about five times the embedded risk of the equity market on a notional value" and presents a huge opportunity for both owners and lenders and presumably HedgeStreet. But the fact is, with the current contract size of just \$10, which they call "hedgelets," and minimal trading activity, it's hard to see how an individual is going to be "hedging" the interest rate risk on an \$800,000 adjustable-rate mortgage.

Anderson acknowledges that initially most of the activity will be of a strictly speculative nature, but he notes that the site can be used as a predictive tool.

"It does not take many settled prices or completed transactions to begin to get an accurate market price," he says. Anderson estimates that 15 to 20 transactions are all that are needed to begin to draw reasonable conclusions about future price expectations.

Take Trading Lessons Home

I believe other lessons also can be learned and questions raised about how you approach your current trading from looking at this type of site.

Are you speculating or hedging?

Are there other products that would be more appropriate in application toward achieving your goals?

Do you have any informational or competitive advantage in the market?

Does the market provide sufficient liquidity for executing transactions?

The ability to trade contracts on the actual event, such as the result of the next **Federal Open Market Committee** meeting, can make hedgelets a more efficient tool. The product can do this because you are speculating directly on the event or instrument rather than its possible causative impact on the broader market. The minimal contract price of just \$10, and access to nearly anyone with \$500, a credit card and a relatively clean record, opens trading on these markets to a very wide audience.

Steven Smith writes regularly for [TheStreet.com](http://www.thestreet.com). In keeping with TSC's editorial policy, he doesn't own or short individual stocks. He also doesn't invest in hedge funds or other private investment partnerships. He was a seaholding member of the Chicago Board of Trade (CBOT) and the Chicago Board Options Exchange (CBOE) from May 1989 to August 1995. During that six-year period, he traded multiple markets for his own personal account and acted as an executing broker for third-party accounts. He invites you to send your feedback to steve.smith@thestreet.com.
