HedgeStreet™: *The Futures of Risk*

A Market Overview

Every day of the week, every week of the year, people spend billions of dollars on insurance. Auto, home, medical, life — insurance is one way, whether consumers realize it or not, of managing risk in their lives. By paying small insurance premiums today, one can avoid the risk of paying large sums in the future.

What if such insurance-like vehicles were widely available for a whole range of other risks — the value of real estate, the risk of inflation, even the soaring cost of a gallon of gas? And what if there were opportunities outside the traditional stock, bond, and futures markets that let investors not only trade such insurance-like vehicles but add them to their portfolios as further forms of investments far beyond the mutual funds and shares of IBM, Cisco, or Proctor & Gamble they've owned for years? These questions are not only being asked; they're being answered by an entirely new concept taking shape within the financial industry. A retail market in "derivatives" (financial instruments "derived" from future events, economic measurements, etc.) is emerging in which average investors, not just Wall Street professionals, can trade and potentially profit from events in their everyday lives — at prices that are well within the means of most any investor's portfolio.

> *A retail market in derivatives is emerging in which average investors, not just Wall Street professionals, can trade and profit from events in their everyday lives.*

A Trillion Dollar Market

Most investors don't really know about trading derivatives. They're often seen as some complicated and very expensive niche within the financial markets, where PhDs in mathematics figure out complex quantitative models taking advantage of market imbalances the average investor could never even understand.

But what if there were a simple and affordable way to trade derivatives, to buy and sell easy-to-understand investments in everyday things we know: real estate, mortgage rates, gasoline prices, anything that makes sense to investors more familiar with Main Street than Wall Street? Not only would that be a welcome opportunity for all retail investors, offering them greater choice in the investment decisions they make and the types of investments available to their portfolios; it would also transform the derivatives markets from the gilded domain of the well-heeled few to an investment opportunity for the masses.

Despite its relative obscurity and inaccessibility to the small retail investor, the worldwide derivatives market represents one of the largest segments of the financial industry traded today. According to the semi-annual survey by the International Swaps and Derivatives Association (ISDA) of their 100 to 120 member firms, the global volume in over-the-counter (OTC) derivatives in interest rates, currencies, equities, and credit derivatives totaled $149.34 trillion for 2003. The worldwide trading volume in futures and options on all derivatives exchanges rose sharply in 2003 to $874 trillion, according to the Bank for International Settlements (BIS). In comparison, the U.S. gross domestic product was $11 trillion for 2003.

Yet, unbelievably large as these markets are, close to 60 percent of over-the-counter derivatives

trading volume remains controlled by a handful of the largest and richest banking institutions, a near market monopoly. That such opportunities still only benefit large institutional investors and wealthy individuals seems at odds with the current intentions of capital market regulators to create increasingly level playing fields of fairness and transparency.

> *"These ... financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago."*
> *Alan Greenspan, Federal Reserve Chairman*

"Major futures markets have always played to the role of the large customer — the hedger, the producer, the institutions, the huge consumer," agrees Philip McBride Johnson, former head of the Commodities Futures Trading Commission (CFTC) in the Reagan administration and current head of the exchange traded derivatives law practice for *Skadden, Arps, Slate, Meagher & Flom, LLP*, a Washington, D.C.-based law firm. "They've never really wanted to, or even tried to, get the little guy involved."

The rationale for opening up such markets to a broader audience, however, is widely recognized, if not self-evident. "When [trading volume] concentration reaches these kinds of levels, market participants need to consider the implications of exit by one or more leading dealers," warned Alan Greenspan, Chairman of the Federal Reserve Bank, in 2003, citing the dangers of having too much derivatives trading in the hands of too few large firms. But Greenspan also cited the clear virtues of derivatives markets, and the benefits of expanding their reach and accessibility. "These increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago," said the Fed Chairman.

> *"Hedging such uncertainties is not really a matter of having a deep knowledge of probability theory; it's about having an awareness of what's happening in life!"*
> *Professor Ronald Howard, Stanford University*

It's for these reasons, among others, that the CFTC — the regulating body of the derivatives industry — designated HedgeStreet™, a venture-backed startup based in San Mateo, California, as a contract market and registered derivatives clearing organization as of February 2004. This is the first time the CFTC has granted such a designation to a firm offering non-intermediated retail derivative contracts outside the traditional structure of existing futures and options markets. Or more simply put, the CFTC has recognized what many academics, financial experts, and HedgeStreet CEO John Nafeh have long argued: that investors should have an available trading platform to "hedge" or manage the risks and uncertainties they face in everyday life.

Trade What You Know

"There are many things in the world that are uncertain, namely everything," says Stanford University Professor of Management Science, Dr. Ronald Howard. "And hedging such uncertainties is not really a matter of having a deep knowledge of probability theory; it's about having an awareness of what's happening in life!"

HedgeStreet aims to create the first true retail market for derivatives, where investors can finally use that awareness to their advantage. Though most investors might be unfamiliar with the term *derivatives*, familiarity is not necessarily an impediment to understanding these new markets and investment opportunities proposed by HedgeStreet. From John Nafeh's perspective, the simpler the derivatives process and the simpler the trading instruments, the better. That the Internet allows an even greater level of

accessibility to HedgeStreet's new markets makes its proposition even better still.

"John sees this from two sides," explains Philip McBride Johnson. "First, he looks at what you and I worry about — mortgage rates, the value of our home, the true costs of inflation — and then looks at how to put together products that can help people moderate those risks. Second, and perhaps from a longer term perspective, he sees that there are other big risks out there that the public may want to play a role in — building a community project in a local neighborhood, participating in producing a Hollywood movie, whatever it may be — and then creating products offering that opportunity to marry big business with the little guy. The interesting thing is, no one really knows how big this can get; it just might surprise us."

> ***The worldwide trading volume in futures and options on all derivatives exchanges in 2003 was $874 trillion; the U.S. GDP was just $11 trillion.***
> *Bank for International Settlements (BIS)*

Keeping It Simple

Thirty years ago, when Charles Schwab bucked Wall Street and founded the first ever discount brokerage, people were skeptical. It couldn't be done, they claimed. Wall Street was governed by the large financial giants which charged enormous fees, catered to the very rich or the institutional investors of the world, and largely paid lip service to the small investor. Despite being blackballed by Wall Street, Schwab changed all that, bringing the financial markets to the masses, reducing commissions to affordable levels such that the nation's significant middle class could invest for their own futures in the same way institutions had done for years. It was a watershed moment.

> ***"The interesting thing is, no one really knows how big this can get; it just might surprise us."***
> *Philip McBride Johnson, Former CFTC Chairman*

Take that change, that paradigm shift, and drill down into this one specific area of the financial industry — derivatives — and that is the marketplace HedgeStreet hopes to equally redefine. Admittedly, even to Nafeh, *derivatives* as a term, let alone a trading vehicle, remains foreign to most retail investors. Futures and options, puts and calls, spreads, straddles, strangles — so technical are the terms, the strategies, and the myriad derivative instruments, that most investors see the derivatives markets as the epitome of risk.

What few in traditional derivatives markets have realized, or perhaps bothered to pursue, is that to open up the world of derivatives to the small investor is either to educate that retail audience in the arcane language of the market, or to make the market simpler to understand. HedgeStreet has chosen both: to focus on making the market easier to understand and directly accessible to every investor. Simply, *hedging* is about alleviating risk, not creating it; and *derivatives* are those instruments, based upon well-defined outcomes, which can help accomplish the task. Or as Professor Howard states, "It's not like regular people even commonly use the word 'hedging'; if we begin to see this as insurance, as a way of insuring things in our lives, it might be far easier for people to understand."

Expanding Investment Choices

In fact, rather than even using the terms *derivatives* or *insurance*, if investors see HedgeStreet's new markets as expanding their portfolio of investment choices — allowing them to trade on the outcomes that occur within more than 90 percent of the economy not covered by public equity markets — they can begin to fathom just how limited their investment choices have been until now.

HedgeStreet aims to bring this new, far broader financial world to the masses by creating *retail derivatives* that average investors will use to alleviate risks related to their own financial uncertainties. "The futures markets have essentially been nothing more than [famed insurance company]

Lloyd's of London," says Johnson. "But the thing that has managed to keep people away from what should essentially be seen as insurance is the leverage that came along with it — the fear that I can give my derivatives broker $5,000 and he can call me two weeks later and say that I owe him $50,000!" Such highly leveraged trading, combined with fast and furious markets filled with cowboys and quantitative modeling jockeys, have understandably kept average retail investors at bay. But that was the old world of derivatives.

> *"HedgeStreet aims to create the first true retail market for derivatives."*
> *John Nafeh, HedgeStreet Founder*

To counter the average investor's fear and confusion regarding derivatives, HedgeStreet had to create a system that took the complexity and margin accounts out of retail derivatives trading, while creating a trading platform and pricing structure that could be affordable to even capital constrained mid-market investors — something available to everyone, confusing to no one. As Robert Shiller, Yale University economist and author of the books *Irrational Exuberance* and *New Financial Order*, says, "HedgeStreet's products are the next generation of instruments that address economic risks faced by people every day."

HedgeStreet's retail derivatives products had to be as easy to trade as they were easy to understand. They had to be completely Internet friendly to allow for full accessibility, while being inexpensive enough to allow for the creation of a critical mass of market liquidity. And they had to be flexible enough to offer investors upside profits while limiting downside risks. Here's roughly how it works.

> *"HedgeStreet's products are the next generation of instruments that address economic risks faced by people every day."*
> *Professor Robert Shiller, Yale University*

The Inner Workings

If hedging is the act of sheltering or protecting oneself from uncertainty, at HedgeStreet, it is the act of buying a financial instrument that will pay out in the event of a specified outcome. These instruments are binary, meaning there are just two possible outcomes. For example, will an inflation index reach a certain number (one outcome)? Or won't it (a second outcome)? Will a benchmark measurement for real estate prices appreciate to a specific level (one outcome, *Yes*)? Or won't it (a second outcome, *No*)? For that matter, could the price of gasoline at the pump reach $3 per gallon (*Yes*) or fall short of $3, not reaching that level, by a certain date (*No*)? The outcome in all cases is simply *Yes* or *No*.

HedgeStreet's contracts, dubbed Hedgelets™, allow investors to take a *Yes* or *No* position on a particular outcome at a market-defined cost of between 0 and $10 per Hedgelet, an inexpensive trade. If the outcome you've invested in occurs, you collect $10 per Hedgelet; if it doesn't, your Hedgelets expire worthless. Unlike in current derivatives markets, you cannot lose more than your initial investment. It's that simple.

HedgeStreet will list on its site financial instruments accessible to all of its member traders, who can then trade such retail derivatives as a means of hedging or speculating on a range of future outcomes. These new financial instruments will include pure finance instruments, such as currencies and the Fed funds interest rate; economic instruments, such as the consumer price index or consumer confidence numbers; real estate instruments, such as residential property price indices for select cities, or mortgage rates; goods and services instruments, such as those tied to prices of prescription drugs or gasoline; and various other instruments related to business, industry, and employment, such as non-farm payrolls or jobless claims.

What makes HedgeStreet's instruments unique is that they do not exist within any other financial exchanges today. And if they did, chances are that the only investors who would have access to them

would be those select large investors who reside within the large institutional Wall Street firms. Because HedgeStreet is specifically a retail derivatives exchange, its contract sizes reflect the modest financial requirements expected of its trading members. In other words, it's an eminently affordable way to trade derivatives.

For example, the minimum contract size to trade crude oil on the New York Mercantile Exchange is 1,000 U.S. barrels, or 42,000 gallons, requiring investors to be highly leveraged before they trade even one contract of crude. Clearly, such trading is cost-prohibitive to the average consumer. By comparison, HedgeStreet's financial products — its *Hedgelets* — limit counterparty and settlement risk by essentially limiting the amount of gains and losses that members can incur. Not only are the contracts less expensive, they're far less risky than what currently exists among other derivatives exchanges.

Hedgelets are HedgeStreet's version of futures and options contracts — without the headache. HedgeStreet members who have sufficient funds in their accounts can simply purchase Hedgelets through the Internet, with the understanding that a Hedgelet pays $10 if a specific outcome occurs. That's it. All Hedgelets expire, all trades clear, and the most that investors can lose is the value of their initial investments.

The minimum contract size to trade crude oil on the New York Mercantile Exchange is 42,000 gallons. A HedgeStreet Hedgelet derived from the crude oil price costs less than $10.

Silencing the Skeptics

Some might argue that what HedgeStreet calls hedging is actually more akin to speculating. Speculation, a cornerstone of all financial markets because it facilitates price-discovery and liquidity, is allowed on HedgeStreet in the same way it is allowed on all other exchanges. Moreover, all of HedgeStreet's Hedgelets are associated with common markets and industries familiar to many online investors (and easily researchable by all). That familiarity, by its very nature, helps reduce the risks associated with trading many of HedgeStreet's new investment products.

Because HedgeStreet's derivatives can actually hedge against everyday unwanted risks, such investments can become a far stronger part of an investor's overall risk-management strategy — even part of their own personal financial planning — than could be achieved were investors to buy a traditional basket of mutual funds or a collection of stocks or bonds, neither of which may have any relationship to a particular investor's risk profile.

If people remain skeptical that such new and differentiated markets will face an investor audience unwilling to give them a try — or even that investors might not be able to grasp the simplified and more accessible process driving HedgeStreet's new markets — there are other recent examples that would prove them wrong. A new class of derivatives recently introduced by Deutsche Bank and Goldman Sachs allows institutional investors, traders, and others to hedge against unforeseen surprises in economic statistics. The two investment banks launched the first auctions in these derivatives in late 2002, essentially trading the outcome of U.S. Non-Farm Payroll statistics, and have since added options auctions based on the monthly Institute of Supply Management manufacturing and U.S. Retail Sales (excluding autos) reports.

These contracts were so successful in helping traders hedge against key economic indicators in the U.S. that the two investment firms launched financial instruments featuring a non-U.S. economic measure: the Eurozone Harmonized Index of Consumer Prices (excluding tobacco). The success of these contracts set the stage to introduce auctions based on the U.S. Consumer Price Index in the middle of last year, and following that, the U.K.-based Retail Price Index. If one considers the success of such new markets as progress along a continuum leading to further expansion and accessibility of derivative instruments, the next logical step is for exchanges

like HedgeStreet to open up these new markets to the average, everyday investor.

In fact, if there were a further example of just how popular and widespread such retail derivatives markets could become, it might be Korea's Kospi 200 Index, which trades more than any other index in the world. This small retail-oriented index now has 15 times the trading volume of the Nikkei 225 Futures and Options, and is three times larger than the S&P 500. With more than 60 percent of traders in the index representing retail traders, the Kospi 200 Index offers an example of the potential size a retail-oriented derivatives exchange could achieve. As Leo Melamed, former Chairman of the Chicago Mercantile Exchange (CME), says, "Retail trade holds huge, huge potential [for derivatives]. Even if we only captured 10 or 20 percent of retail, it would be very meaningful for the growth of our [derivatives] marketplace…In Korea, [the Kospi 200 Index] created a very small index and it now trades more than any other product in the world."

> ***"People will start using risk management not just for trading stocks but to protect themselves from the risks of living."***
> *Professor Robert Shiller, Yale University*

HedgeStreet's markets could conceivably be as large as the Kospi 200, creating limitless opportunities for hedgers, speculators, and investors of all kinds to insure themselves against the risks and uncertainties of everyday life. As Professor Shiller states when describing what we might expect within the *New Financial Order*, "People will start using risk management not just for trading stocks but to protect themselves from the risks of living." With HedgeStreet's next generation of financial instruments, investors will have these opportunities, directly over the Internet, to invest in the outcomes of those risks they know all too well from personal experience.

CONTACT:

The Blueshirt Group
Alex Wellins, Greg Jones
415.217.7722

HedgeStreet, Inc.
Ursula G. Burger
VP Corporate Communications
uburger@hedgestreet.com
650.638.3503