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The Sound Investor Series #45

Hedging Your Real Estate Risk

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April 19, 2006

Most homeowners buy fire insurance to protect themselves from fire losses. In the future, it may also be possible for homeowners to buy “price” insurance to protect themselves from their property falling in market value. We will have to wait to see how these new products develop; or are worth the cost, but change is coming.

A major step in this direction will be taken when the Chicago Mercantile Exchange (CME) introduces CME Housing Futures & Options. In the next few weeks, new financial futures based on residential housing price indexes will start trading and promoters hope they will spur development of other products such as home price insurance.

The Housing Futures are based on the S&P/Case-Shiller Indexes (CSI) of single-family residential properties. As you can imagine, measuring changes in housing prices is not easy and the CSI indexes use a technique they developed called repeat-sales. Essentially, each new sale is connected with the previous sale of that same property to create sales-pairs. These price changes form the raw data for the indexes.

Initially, the CME will offer futures on indexes covering 10 separate metropolitan areas and a weighted index of all 10 cities combined. The metropolitan areas are Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco and Washington, D.C. (Complete details are available at www.cme.com.)

Not surprisingly, these markets are showing different trends. Over the last year, Miami has been the strongest with prices up over 30% and Boston the weakest with prices raising 2.7%. Over the last four years, the cities of Miami, Las Vegas and Los Angeles recorded price increases of over 100% while Denver was up only 13%. For comparison, the 10-city Composite Index was up 13.6% and 75.7% over 1 and 4 years respectively.

Trading futures on these indexes, or anything else, can be very risky. When buying a future, an investor only has to put up a margin payment covering part of the cost. This allows them to make very large investments with small amounts of money. Due to this leverage, investors can lose more money than they deposited and can be quickly wiped out if the market goes against them.

Options on futures are less risky than futures themselves. Options give an investor the right, but not the obligation, to buy or sell something. If the market moves against them,

option holders cannot lose more money than they paid for the option. Futures and options are not suitable for all investors.

I think some homeowners and builders will consider using Housing Futures and Options for hedging property prices while they wait for the new housing insurance products. If the options are fairly priced, they may be useful for some hedging, although the hedge will be far from perfect.

For instance, a homeowner listing their house might be nervous about slowing sales and rising inventories. To protect themselves, at least partially, they could buy a put option on one of the indexes that most closely matches their local market. If the index falls, these options will increase in value and the holder's profit or loss would depend on how much they paid for the option. If the market goes up, the put option expires worthless and the holder loses what they paid for the option. Buyers of options, unlike those of futures, can only lose what they paid.

One problem with this strategy is that your town's prices might be weaker than your region as a whole. This could be a significant issue, especially in a large metropolitan area like New York. The New York Index covers a huge area running from New Haven to Trenton and from Montauk to Pike County, Pennsylvania. How well this index corresponds to the price of a house in Norwalk, CT will fluctuate and change over time.

In summary, stay tuned for more discussion as these products start to trade. People love to talk about real estate and if these products are successful, they will provide us with interesting and possibly useful information about the market.

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