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Making Sense of Market Disagreement

By JUSTIN WOLFERS

Who is most likely to win the presidential race? Conventional wisdom did a reversal in the wake of the Sarah Palin phenomenon, shifting John McCain from underdog to new favorite. The pollsters largely agree.

But the prediction markets aren't so sure. In fact, the many markets tracking the battle for the White House show a surprising degree of price variation. The present outlook for the election depends entirely on which market you're following.

The world of polling, like the new conventional wisdom, shows a slight yet persistent lead for Sen. McCain -- even as his lead has narrowed from last week. The [poll-of-polls run by RealClearPolitics.com](#) sees a lead of about one percentage point for the Republican contender across national surveys. Sorting out the true underlying trend from the usual post-convention bounce is a tough task, but the ground has shifted enough for Barack Obama's lead in several key states to have either narrowed or dissipated.

What about political prediction markets?

The [Wall Street Journal's own fantasy prediction market](#) rates the race a virtual dead heat. This market is tightly linked to [Intrade.com](#), whose real-money markets also [see the race as a dead heat](#). Both markets suggested an important shift in the narrative last week, when the Republicans took on the role of presumptive favorite in the presidential race.

Political insiders are known to follow the Intrade market closely, partly because the large sums of money being bet give the opinions of these traders greater credibility. Greater volume also makes it more difficult -- or at least expensive -- for politically-motivated traders to manipulate this market.

But there exists another major political exchange: [Betfair](#). This British alternative also takes large real-money bets, but will not accept trades from U.S. customers. Across the pond the Democrats remain a robust favorite, with a [58% chance of winning](#) the White House compared with the [Republicans' 42% chance](#).

The [Iowa Electronic Markets](#) also rate the Democrats as the favorites by a roughly similar margin. However, the Iowa market is linked to the [winner of the popular vote](#), not the winner of the White House, and so perhaps it is not surprising that the Democrats are performing better on this score.

While Iowa is famous for being the first modern political prediction market, the maximum

trade is capped at \$500 and volume is far smaller than those of Betfair or Intrade. Nonetheless, all three have built useful track records in predicting political outcomes.

Various online bookmakers (and, in England, street-corner betting shops) are offering odds -- and all rate Sen. Obama as a strong favorite.

There are myriad other play-money prediction markets, which also point to an Obama victory. For instance, the market run by NewsFutures.com suggests a [53% chance](#) of the Democrats taking the White House, while a competing market run by Inklings suggests a [61% chance](#) for the Democrats.

The current variation in price is larger than I have ever seen in my years of studying prediction markets. The forces of arbitrage that would typically eliminate these differences have been handicapped by the legal restrictions preventing U.S.-based traders from using overseas markets.

I also suspect that this week's financial strife may be a pretty big distraction for many people who would otherwise might be active traders. Even so, it is surprising that enterprising European- or Australasian-based traders are not exploiting the current arbitrage opportunities.

The different demographics of the traders populating each market may partly explain the variation. Intrade has a large U.S. user base, drawn heavily from the financial markets, whereas Betfair's customers are largely European. [Traders in the Iowa Electronic Markets](#) are more likely to be white, male and have graduated college than typical voters, but surveys suggest that this market draws about as many Democrats as Republicans.

But even if these markets are not demographically balanced, there is no reason to believe that this imparts a bias. An important advantage of markets over polls is the discipline of "putting your money where your mouth is," which should reveal who you think will win the election, rather than who you personally prefer.

Which of these forecasts should we trust: Intrade's assessment of a 50-50 bet or those markets making Sen. Obama the going favorite?

Unfortunately, we are in uncharted waters, so history cannot be much of a guide. The markets at Intrade are certainly the most liquid, which suggests a slight reason to favor their insights. At the same time, [research suggests](#) that the importance of liquidity may be overstated. Even play money markets can yield [very accurate forecasts](#).

This column rarely suggests that political prediction markets are mistaken. But when different markets assessing the same event give such different signals, we can be sure that some of them are wrong.

One assessment remains unanimous: the current election is a nail biter.

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