There's a Futures Contract for Everything (Even Iraq's Fate)

FEW people would disagree with the forecast that stocks would drop if war started tomorrow in Iraq. But two Stanford economics professors, Eric Zitzewitz and Justin Wolfers, go further, predicting that the market would drop 5 percent.

Academics rarely make precise short-term market predictions. The professors arrived at theirs by using standard econometric analysis and an unusual derivative that trades at www.tradesports.com, based in Dublin. At this Web site, you can bet on whether Duke will win the N.C.A.A. basketball title, whether “Chicago” will win the Oscar for best picture or where the Dow Jones industrials will end 2003. According to John Delaney, the site’s chief executive, most of its active users are traders from Wall Street or Chicago futures exchanges.

The derivative on which the professors base their unpublished research is indeed unconventional: a futures contract on Saddam Hussein’s presidency. The contract, which was trading at $7.50 on Friday, will pay $10 if Mr. Hussein is not Iraq’s president on June 30; otherwise it will pay nothing. Because the professors assume that Mr. Hussein won’t step down voluntarily, they argue that the contract reflects traders’ assessment of the probability of a war resulting in his ouster. The contract’s current price suggests that the market assesses this probability as 75 percent between now and midyear.

The professors acknowledge that the contract may seem too bizarre to be the basis of serious research. They further concede that its trading volume is low, just over $140,000 over the last five months. Yet, for a variety of reasons, they say its price accurately gauges the probability of an Iraqi war.

To counter concerns about the contract’s volume, the professors point out that it is still higher than that of the Iowa Electronic Market, a real-money futures exchange administered by the University of Iowa that allows speculating on the American presidential election. Despite trading volume that has averaged just $168,000 an election, these Iowa contracts have had an excellent track record. Their average forecast error for the popular vote in the last four presidential contests has been 1.37 percentage points, about half the average error of nine major polling organizations, according to a study by four professors at the university.

Professors Zitzewitz and Wolfers say they believe that markets in general reflect more wisdom than any single person can possibly have, and thus do a better job of assessing probabilities. That holds true not only for large markets, they say, but also for small and unconventional ones.

The professors concede that Web-based futures, which are largely unregulated, could be skewed by someone willing and able to place sizable buy or sell orders well above or below the current price. But they doubt that this is the case for the contract on Mr. Hussein’s ouster, believing that no one has an obvious motive to do so.

Once the professors were satisfied that this contract was a legitimate basis for research, arriving at their conclusion was straightforward. First, they measured how much the Standard & Poor’s 500 index fell, on average, when the price of the contract increased, and vice versa. These measurements let them estimate how low the S.& P. 500 would drop if the contract approached $10, which they believe would be likely on the day a war breaks out. They also calculated how high it would go if the contract fell to zero, reflecting zero probability. Their study, conducted with the assistance of Andrew Leigh, a Harvard graduate student, is at http://faculty-gsb.stanford.edu/zitzewitz/Research/iraq.pdf.

THEIR analysis projects a 20 percent difference in the S.& P. 500’s level at the contract’s two price extremes. From this, they concluded that on the day a war begins, the cumulative effect of the buildup to war would be a 20 percent drop in the S.& P.

With the $10 contract trading at $7.50, the professors believe that 75 percent of the overall 20 percent drop has already occurred. That implies that when a war begins, the market would drop no more than an additional 5 percent.

If their forecasts prove accurate, the professors will overcome at least some of the concerns about the Saddam Hussein futures contract. In any case, with a proliferation of such unconventional trading instruments, we should anticipate more analyses like theirs in coming years.