A Reprint from *Tierra Grande*

BACK TO THE FUTURES

By Mark G. Dotzour

Commodity traders and other risk-seeking investors have long used the futures market to speculate in gold, silver, platinum, corn, wheat, cattle and a variety of other metals and agricultural products. If they think pork bellies are going to increase in value, they buy a pork bellies futures contract.

The beauty of a futures contract is that you can invest in certain assets for a specified period of time without taking delivery of the assets. Gold investors like futures because they don't have to store the bullion in expensive vaults. Grain traders like them because homeowner associations don't allow corn investors to store 5,000 bushels in their driveways. And have you ever smelled 40,000 pounds of live hogs?

Buying a futures contract allows you to invest in these products without ever seeing them. All you take possession of is a piece of paper. Futures also allow investors to control a large amount of the asset with only a small investment. Futures contracts are traded at markets such as the Chicago Mercantile Exchange (the Merc) and the Chicago Board of Trade.

Wall Street is always coming up with new novelties for investors to buy. Pork bellies are now passé.

Here is how it works. A futures contract is a standard contract to buy or sell a certain underlying asset at a certain date in the future, at a specified preset price. For example, suppose in October 2006 you buy a September 2007 futures contract in gold at the current price of $620 per ounce. The standard gold contract is for 100 troy ounces. The total value of the gold contract on the day of purchase is $62,000. However, the use of margin allows a gold speculator to purchase the $62,000 worth of gold for as little as $2,000. The investor borrows the other $60,000 from a securities broker at the "margin" rate of interest.

If the price of gold increases to $700 an ounce before the contract expiration date, the investor can sell the contract for $70,000. This would be an $8,000 profit (less margin interest paid to the broker on the $60,000 loan) on a $2000 investment.

Conversely, if the price of gold falls to $500 per ounce, the investor would sell the contract for $50,000 and lose a total of $12,000 plus margin interest.

Needless to say, futures contracts are not for the faint of heart. There is substantial risk and volatility. In fact, a *Wall Street Journal* publication noted in 1987 that between 75 percent and 95 percent of all commodity investors lose money. That means that a few savvy traders make good money from the vast majority of less sophisticated players.

Before September 2005, the futures market held no interest or opportunity for real estate investors. But then the Merc announced it would create the world's first futures contract for residential real estate.

The Merc officially launched trading on housing futures contracts on May 22, 2006. Residential futures contracts allow individuals and financial enterprises to invest in the residential real estate market without taking deed to a single property. There is no lengthy search for good deals, no mortgage process, no worries about unexpected maintenance and repairs and no tenants to screen. Investors can just sit back and watch the market unfold.

The Merc currently offers futures contracts for Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco and Washington, D.C.

How do you know if the price of housing in these cities went up or down? The Merc uses the S&P/Case-Shiller Home Price Index for each city in the futures market. These indices were originally formulated by Carl Case and Robert Shiller in the late 1980s. The price index is calculated using a repeat-sales technique similar to that used by the Office of Federal Housing Enterprise Oversight (OFHEO), the regulatory body for Fannie Mae and Freddie Mac.

Every three months, the index is calculated based on the sales prices of homes sold during the period. If the overall price of homes has increased by 4 percent in Boston, the Boston index will also be increased by 4 percent. All Boston futures holders will experience a 4 percent gain in the value of their contracts.

Suppose you want to buy a May 2007 futures contract on residential prices in San Diego. The contract size is $250 times the Case-Shiller Index value on the date of purchase. The current index value for this contract is 248.00, so the total cost of the contract would be $62,000. If the margin rate is 2.5 percent, you could purchase this contract for $1,550. If home prices go up 10 percent in the next year, the index will also rise 10 percent to 272.80. The contract then would be

worth $250 times the index, or $68,200, resulting in a profit of $6,200. This means you quadrupled your investment of $1,550. Of course the interest on your margin loan comes out of your profit.

Texas' real estate market has attracted speculators and out-of-state investors in recent years. This trend is increasing significantly as appreciation rates slow in the high-profile markets in California, Nevada, Arizona and Florida. However, no Texas cities are included in the Merc residential real estate futures offerings. This means that investors who want to benefit from home appreciation in Texas are going to have to resort to the traditional approach of searching for good deals, buying homes, managing them and selling them in the future.

Of course, Wall Street is always coming up with new novelties for investors to buy. Pork bellies are now passé. If residential real estate is too tame for you, try investing in weather futures. You might make money if its too hot, or too cold, or if there is an abnormal amount of snowfall.

Dr. Dotzour (dotzour@tamu.edu) is chief economist with the Real Estate Center at Texas A&M University.

THE TAKEAWAY

Real estate investors can now invest in residential real estate without actually buying houses. Will Texas residential markets be affected?

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031

Director, Gary W. Maler; **Chief Economist,** Dr. Mark G. Dotzour; **Communications Director,** David S. Jones; **Associate Editor,** Nancy McQuistion; **Assistant Editor,** Kammy Baumann; **Art Director,** Robert P. Beals II; **Graphic Designer,** JP Beato III; **Circulation Manager,** Mark Baumann; **Typography,** Real Estate Center.

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Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: E. Joseph Deering, pp. 1, 2, 5.