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OPINION

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A market for votes

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The University of Iowa's electronic futures exchange has already made a name for itself in politics, and could soon do so in financial economics



YOU can buy and sell George W. Bush in a millisecond. Likewise, Al Gore, Hillary Clinton or the entire Congress. On the Iowa Electronic Markets (IEM), investors trade a variety of "futures" whose pay-offs are linked to the outcomes of America's elections next week. These futures are mostly used merely for some light-hearted betting. But speculation plays a crucial role in almost all financial markets, and the Iowa markets provide a useful laboratory for studying how investors behave—and even for exploring the prospects of the growing number of electronic exchanges.

Academics at the University of Iowa set up the IEM in 1988 in order to help teach students about finance. The markets are not for futures in the classical sense—that is, promises to exchange some good or service at a fixed date and price. Rather, they are of the "cash-settled" variety. Consider the IEM's "winner-takes-all" market for the American presidency. Each dollar invested with a central clearing-house, up to \$500 per participant, buys a bundle containing one future for every candidate. When a candidate wins, futures linked to him will pay \$1 each. As only one candidate can win, each bundle of four Bush/Gore/ Nader/Buchanan futures is sure to be worth \$1. Prior to the election, investors can trade individual futures at any price for which they can find a counterparty, presumably reflecting what chance they think a candidate has of winning.

Futures such as these can make investors better off, by allowing them to hedge against unpredictable events. For instance, weather futures, a popular commodity on bigger exchanges, do this: betting on an early frost might reduce the risk faced by a farmer, or by somebody who also sells "real" futures that are linked to farm products. A trader might contract to sell coffee beans at a fixed price after the harvest, only to find that a frost cuts supplies and drives the price up. A bet on frost can then provide insurance against this losing situation.

Weather futures are a convenient method for a hedge that could be done using other securities based on the underlying commodities—eg, options to buy coffee at low prices. Political futures may not have such obvious substitutes. How else could you hedge against the glum feeling that

comes from seeing your favourite presidential candidate lose in a landslide?

Do political futures really serve this purpose? After the 1988 election, the Iowa professors looked into whether investors had used the market to hedge their political desires—playing the market with their heads rather than their hearts. If they had been investing solely to make money, supporters of Michael Dukakis and George Bush senior should have been equally likely to place bets on either man. In fact, an investor's partisan loyalty, identified in a questionnaire, tended to make him more likely to invest in his own candidate's futures—increasing the risk of a glum feeling on election night, not hedging it.

Market microcosm

Nevertheless, the final prices in 1988 and at the two presidential elections since have almost perfectly mimicked the vote tallies. Indeed, they proved better predictors than many opinion polls. How so? A small group of investors took advantage of the irrational behaviour of the majority by selling futures of candidates whose prices had been artificially bid up by their supporters. As the majority were passive investors—the electoral equivalent of stockmarket-index investors—the small elite of informed active traders were able to arbitrage away the price impact of blind party loyalty.

Further proof that the market's investors are not fully rational comes from bid prices. Often the sum of such prices for the bundle of futures on all candidates exceeds \$1. In this situation, selling one future for all candidates yields a guaranteed profit whatever the result of the election—the seller receives more than \$1 for a bundle of futures that will pay out exactly \$1.

Besides assessing market rationality, the IEM also provides a test of the efficient-markets hypothesis, a core piece of financial theory which, in its most widely accepted form, states that no information available to the public can be used to predict future prices of securities. Any news, data or expectations about future events should already have been factored into prices. Applied to the IEM, this assumption implies that predictable post-convention "bounces" in the polls should have no effect on futures prices. And indeed, price changes before, during and after this year's conventions were smooth, compared with the volatile opinion polls.

The IEM may have a more useful role besides providing cute tests of economic theory: examining the strengths and weaknesses of different sorts of electronic exchanges. The Iowan professors have allowed students to bet on such prospects as the Federal Reserve's interest-rate policy and Microsoft's share price, to extend the IEM beyond the electoral cycle, and to let them see what happens when they switch between a market that closes once a day and a market that closes continuously. This may show how investors will react when, as seems inevitable, traditional exchanges give way to 24-hours-a-day computer-trading. Another project will examine how much investors rely on information about trading volumes and price histories.

Despite similarities to established commodity markets, the IEM is unregulated. That might change if serious money started to change hands on the exchange. Potential punters should note that this week the IEM was predicting victories for Mr Bush and Mrs Clinton, as well as Republican majorities in the House and Senate. You disagree? Then place your bets.