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Title: **Universal hedging**

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The asset classes that **Risk** covers – the list you see under the magazine’s name on the cover – may soon need to be revamped. For 50 years, since Kenneth Arrow and Gerard Debreu proposed that optimal risk-sharing in an economy could be achieved through complete contingent claims markets, people have tried to develop hedging tools for illiquid assets such as houses and personal income, and for macroeconomic variables such as GDP and inflation. In recent months, these efforts have begun to bear fruit.

A number of high-profile proselytisers for macro or micro derivatives (or variations on those terms) rode the conference circuit – including **Risk’s** – a few years back, but fell far short on specifics. Robert Merton, for example, stepped out of the ruins of Long-Term Capital Management in 1998 and back into academia, where he pushed the idea of ‘life options’, which could be used to hedge risks and expenses such as illness, retirement or college costs. Conference audiences nodded politely, but little came of it.

Robert Shiller, of Irrational Exuberance fame, was also seen on the conference circuit after that book’s incredible success, discussing the benefits of hedging tools for housing prices and GDP, among other things. His consulting firm, Case Shiller Weiss, even batted around a few ideas for macro securities. Schiller has now resurfaced, publishing *The New Financial Order* (reviewed on page 52), in which he again argues in broad strokes for the development of risk-sharing markets for just about everything.

While this is all interesting, it pales in importance to actual product developments. For example, in the past five months, Goldman Sachs and Deutsche Bank have held parimutuel auctions for what they call economic derivatives – options on US employment, retail sales and manufacturing indexes. The firms plan to offer options on eurozone inflation in the coming months (see page 13). But while both firms say the products have been well received, one has to reserve judgement, since the firms are not willing to release figures to buttress the claim.

Several types of housing price hedges are also in the works, spurred by US and UK homeowners’ fear that the housing price appreciation they’ve enjoyed in recent years might prove to be a bubble. Among these are house price insurance to be offered by a firm backed by Stephen Ross called Real Liquidity, and an online futures market for trading real estate risk in New York and California, backed by Ralph Liu (**Risk** December 2002, page 16).

Grand schemes and utopian visions have their place. But unless their proponents make good on them, they may end up looking like cranks – and that’s bad for those involved in actual product development. Only serious work on products and market-building will push the world closer to the Arrow-Debreu ideal.

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