The Canadian Property Derivatives Trading Simulation: Guest Feature

By Markus Höchtl - PropPit AG Munich with Martin Legault & Stefan Karg

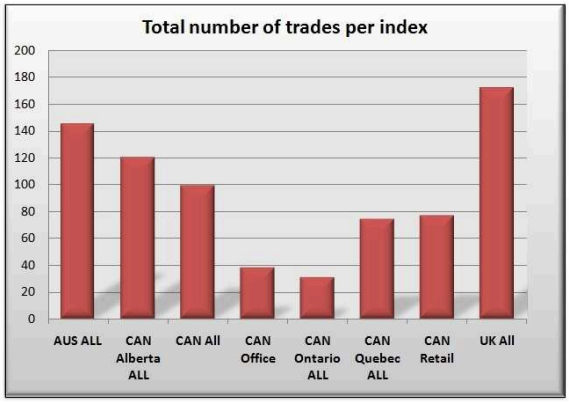
In my experience, there are two important issues why many with real estate risk around the globe do not trade PDs already. The first issue is 'technical know-how'; the second, but perhaps the most important issue, is 'liquidity'. PropPit's trading simulation is a low-cost solution to effectively address both issues.

"We need more information to set up processes…" and "We definitely get involved - once liquidity is adequate…" are statements I hear very often when talking to clients. Most clients fully understand that PDs can help them manage their portfolios and that PDs will be a very important part of their management toolbox in the future. I am sure some of them kick themselves for not having used derivatives to hedge their portfolios in the current property market plunge.

Convincing potential players with words is never easy; actions speak louder than words. Therefore we asked ourselves the following questions: What can we do to break up the diffidence of potential market participants? How can we help with transferring relevant know-how and increasing liquidity?

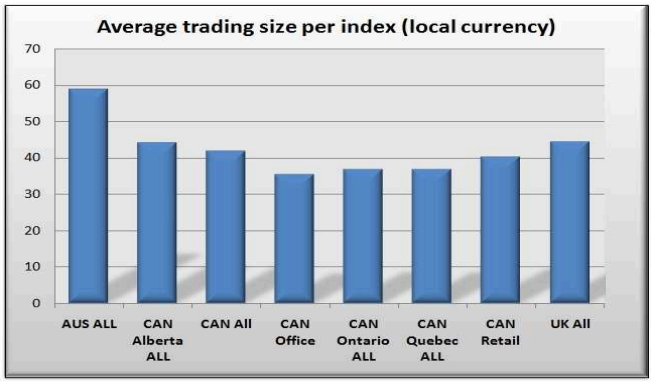
The solution – simply picking up the PDIG trading simulation idea – was obvious, but we thought that it may need some refurbishment. PropPit is a German company, so we love to organize things really well and make any solution work stable, anywhere and anytime. So we immediately got to work, and, from the ground up, implemented a web-based educational trading simulation game for property derivatives. We introduced the first version at the "1st European Forum on Property Derivatives" in November and December 2007.

Since then the trading simulation has been used very successfully at UniCredit Markets & Investment Banking, and since September 2008, in an advanced version, also at National Bank of Canada. Tradition Property helped point the way in Canada by arranging the first Canadian property derivative brokering a deal between NCB and Royal Bank of Scotland. We saw a trading simulation an obvious next step. As such we planned to run the Canadian trading simulation in two phases: the first phase was run in 'time-lapse-mode'. Its goal was to simulate three years of market action (Sept – Nov 2008). It involved 44 clients and the leading real estate consulting company in Canada (Altus Group). Martin Legault at NBC administered the game with realistic scenarios. This provided the opportunity for his clients to practice and gain experience with trading a property derivative portfolio along with a physical portfolio. The second phase, now switching to 'real-time mode', started in December, and was extended through January 2009. Participants could extract pricing information from the real-time trading game. Interestingly, we observed spill-over effects into the real market. Today there are more prices and maturities quoted in the Canadian market and end-users show more real interest.



In my view, a very important aspect why potential players are less reluctant to trade in real market after playing in the trading game, is the tailor-made information they receive from it. It is much easier to explain the business to accounting, controlling, IT and back-office with 'real' simulated cashflow and position reports, payoffs and documentation in hands. Another important aspect is that end-clients learn that trading derivatives is much easier than they thought.

This is what Martin Legault had to say about the trading simulation: ***"I am glad to say that it is all working properly and I am happy with the end result. The feedback I have been getting from the end-users is very positive as well. The simulation is definitely a good tool to learn how property derivatives work and gain insight on how property derivatives can enhance your risk management and performance. As well, with the participation of many end-users, we achieved some level of price discovery through the last two months of the simulation when we traded on real future data. It even generated real life interests from participants to do real trades; only the buyers are still shy to raise their end on the real market….for now."*** All in all a very positive comment and the latter is something even the best German software engineering can't solve…



We are in the midst of talks with several institutions in the US, Europe and in Asia to set up market initiating and liquidity increasing trading simulation games there as well, and to leverage the Canadian experience. Our goal is to melt some more of the big liquidity-ice-blocks to dripping point. And since liquidity attracts liquidity, we may even start a little chain reaction. We will certainly give it a try, and we are looking for partners to help us with our efforts. We are also in the midst of planning a trading game in another small but very innovative market in Europe. In the near future, trading simulations will also be accessible from a famous real estate information platform.

Statistics from the Canadian trading game	
Total Trades	756
Total Volume (Mln.)	$ 30,800
Average Volume (Mln.)	$ 41
Average client logins per day	6
Average trades per day	7
Average trades per client	17

What is the conclusion from all this? First, it seems that the often-cited PDIG trading game idea can still initialize markets. Second, when combined with solid software engineering and some motivated institutions, the trading simulation is a method that can assist new markets to achieve liquidity. At the same time, it distributes relevant know-how and simulated experience directly to clients and market participants.

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