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Prediction Markets

Prediction markets offer a powerful mechanism for aggregating dispersed information, allowing participants to hedge and speculate based on their beliefs about future events. Because prediction markets incorporate diverse perspectives and involve institutional and retail participants putting their own capital behind their predictions, these markets can produce highly accurate forecasts, often outperforming expert analysis and other traditional sources of news and information. By allowing individuals to buy and sell contracts tied to specific outcomes – known as "event contracts" – prediction markets help reduce uncertainty by providing real-time probabilities that reflect the collective wisdom of participants. In other words, prediction markets can enhance the economic value of information itself, allowing businesses and individuals to make better decisions which, in turn, creates a variety of benefits.[1] Prediction markets can be particularly valuable in fields such as finance, politics, and technology, among others, where decision-makers seek the best possible insights to navigate an unpredictable future.

Another key advantage of prediction markets is their ability to serve as a risk management tool. Businesses and investors can use these markets to hedge against uncertain events and associated risks, such as election outcomes, regulatory changes, or economic shifts. By taking positions in these markets, they can offset potential losses elsewhere in their portfolios. On the other side of the trade are the speculators who provide important liquidity in these markets by attempting to profit from price changes in futures contracts. This is no different than those speculators and retail participants who buy or sell futures contracts in agricultural products such as corn or wheat.

Additionally, prediction markets have educational value, as they encourage critical thinking and data analysis skills. Participants must assess probabilities, interpret trends, and understand how new information affects market prices, fostering a deeper understanding of decision-making under uncertainty.

The combination of risk mitigation, information aggregation, speculation, and learning potential makes prediction markets a valuable economic and informational tool for businesses and individuals alike.

[1] Consider, for example, a manufacturing business that is able to commit substantial capital toward building a new plant and hiring thousands of workers in the U.S. because it has access to more accurate information about expected macro- or micro-economic and political conditions generated by prediction markets.

Background on Event Contracts

"Event contracts" are the most common tool in prediction markets, allowing participants to trade on the likelihood of specific outcomes. These contracts function as simple binary (or "yes-or-no") predictions on events including, but not limited to, elections, economic indicators, commodity price movements, weather, and sports. Prices can fluctuate based on market sentiment and new information, reflecting the collective probability assigned to each outcome. Event contracts are straightforward and adaptable, and therefore, widely used for forecasting, risk management, and speculation across various industries and products. Event contracts are traded directly in orderly, transparent, two-sided markets on federally regulated platforms. Types of event contracts include, among other things:

- Political events, like elections;
- Economic events, such as corporate earnings releases and macroeconomic data releases;
- Commodity price movements;
- Weather events; and
- Sports and entertainment events.

General Benefits of Prediction Markets

Prediction markets can provide many benefits to market participants, including:

- **Hedging:** Prediction markets allow businesses and individuals to hedge risks associated with various events. For example, a small manufacturing business might use political event contracts to hedge risks related to elections. Event contracts can also be used to hedge risks in financial portfolios. Moreover, because they are smaller in size than futures contracts, event contracts can allow for a more accurate hedge to be created. Larger futures contracts can lead to investors being overhedged which can be just as risky and harmful as being underhedged. By providing liquidity to the markets, retail trading generally facilitates the ability of market participants to effectively hedge risk.

- **Customer Protection:** Prediction markets and event contracts are regulated at the federal level by the Commodity Futures Trading Commission under the Commodity Exchange Act. Federal regulation provides a number of customer safeguards and market integrity measures. For example, the exchanges that provide prediction markets via event contracts, as well as the firms that provide customers access to those markets, are required to safeguard customer funds by segregating them from the firms' own proprietary business activities. These firms also are required to prevent manipulative trading activity to help ensure the integrity of predictions markets, instilling greater confidence in the usefulness and predictive value of the event contracts.

- **Information Aggregation:** Prediction markets are a powerful predictive tool that can aggregate diverse opinions and sets of information into accurate forecasts. Prediction markets often exhibit lower statistical errors than professional forecasters and polls, and can be more reliable than other traditional sources of news and information. As a result, prediction markets can enhance the economic value of all types of information.

- **Reduce Uncertainty:** The prediction markets generally reflect the "best estimate" of the probability of an event occurring. Prediction markets can reduce uncertainty about the likelihood of future events and can be an effective tool in predicting the outcome of those events. For example, prediction market event contracts can generate information that is useful for businesses when planning their future operations, as well as information that is useful for an individual's portfolio and how the outcome of events can impact the pricing of financial instruments.

- **Speculation:** Like traditional securities, options, and futures markets (e.g., corn and wheat), prediction markets can be used by market participants, including retail investors, to profit from price movements. In doing so, speculative investors provide important liquidity to prediction markets.

- **Educational Value:** Prediction markets create a financial incentive for market participants to be better informed about the likelihood of future events occurring. By making information publicly available, prediction markets can democratize access to information.

Types of Prediction Markets and Event Contracts

As noted above, there are several types of prediction markets and event contracts including, but not limited to:

- **Politics.** Political prediction markets and event contracts allow businesses to hedge risks associated with political and electoral factors. Companies and individuals can hedge against risks stemming from or speculate on the partisan composition of government, or from the uncertainty of which political party will control Congress, which can impact the probability of legislation impacting a company or individual. Moreover, by providing an unbiased and market-based mechanism for viewing and understanding complex issues, political event contracts can strengthen the democratic process and improve public analysis.

- **Economics.** Economic prediction markets and event contracts enable market participants to hedge risks related to macroeconomic announcements, such as unemployment rates, payroll data, and the federal funds rate. These contracts allow participants to hedge exposure to specific events without sacrificing the upside of their instruments and can

revolutionize the hedging process. For example, event contracts can augment the utility of hedging by allowing participants to directly hedge macroeconomic risks before the data is released.

- **Weather.** Prediction markets and event contracts for weather-related events and patterns allow market participants to hedge risks related to future weather events, associated government policies, and related activities carried out by market participants (for example, insurers). They can protect an investor from risks related to the degree to which weather events impact the economy and particular industries. These contracts can also be created around specific weather-related events such as drought, sea level rise, polar ice volumes, and agricultural yields, providing a more refined hedge. Weather event contracts can also provide information that will be valuable to policymakers. For example, an event contract based on the rise of sea level would provide policymakers with valuable information on the potential future costs of the government programs like the National Flood Insurance Program.

- **Sports.** Sports prediction markets and event contracts are one subset of the broader predication markets that have recently gained popularity. Unlike sports gambling, in which there is a "House" and oddsmakers, sports event contracts are binary products traded directly between buyers and sellers in open, transparent, two-sided markets on federally regulated exchanges (known as "designated contract markets"). Various commercial entities, including team sponsors, media outlets, and vendors, can use sports event contracts to manage risks related to team performance. For example, team sponsors could hedge their risk of a team having a losing season. Consumer-focused businesses near a sports stadium may want to hedge the possibility of cancellation or lower attendance that would impact their revenue for the day. Similarly, the price discovery provided by these prediction markets can result in more accurate and valuable information which would, for example, enable consumer-focused businesses to better predict the labor and material resources they might need to successfully serve customers.

The Path Forward

Policymakers should adopt policies that continue to recognize that the prediction markets, including event contracts related to economic events, commodities, weather events, sporting events, and political events, have economic value and are generally in the public interest, as they can provide legitimate hedging, risk-management, speculative and informational benefits for individuals and businesses of all sizes. Moreover, policymakers should avoid rules that prohibit retail customers from taking advantage of the same opportunities available to institutional investors.

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