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Innovation in Futures Markets: Event Contracts, Speculation, and Hedging

The CME Group has recently launched a new type of contract whose payoffs are based on specific events. These contracts are called event contracts but are also known as prediction contracts or information contracts. They are short-term contracts that expire at the end of each trading day. Traders can take positions in these contracts as they predict whether the price of a given asset will finish the trading day above or below a set value.

How are they traded?

The size of event contracts is $20, which means that we receive $20 at the end of the day if we are correct about our price prediction. On the other hand, if we are wrong about our price prediction, we lose whatever amount we paid for the contract, which would range from $0.25 to $19.75 (event contracts are traded in increments of $0.25).

Let's use the event contract on gold to illustrate how they work. On 10/21/2022 the event was "Will gold close above 1640?" At some point during the day, the 'yes' side of this contract was trading at $3.75 while the 'no' side was trading at $17.75. If we believed that the gold price was going to finish the day above 1640, we could buy the 'yes' side of the contract and pay $3.75 for it. If our price prediction is correct (i.e. gold price is above 1640 at the end of the day), we receive $20 and go home with a profit of $16.25 (we paid $3.75 to buy the contract and received $20 for it). However, if our price prediction is wrong (i.e. gold price turns out to be below 1640 at the end of the day), we don't receive anything and go home with a loss of $3.75 (we paid $3.75 to buy the contract and received nothing for it).

Main characteristics of event contracts

One of the main characteristics of event contracts that the CME Group hopes to help attract more traders is the straightforward risk-return structure. If our prediction is wrong, we just lose the money that we paid to buy the contract in the beginning. Thus, we know right from the start the maximum loss per contract with the trade. If our prediction is correct, we receive $20 and our profit will be the difference between $20 and the amount we paid to buy the contract. Therefore, we also know from the start the maximum gain per contract with the trade.

The trading horizon may also attract some traders. Since event contracts are based on daily events, they expire at the end of each day. They are short-term contracts and traders can get in and out of the market within the same day. Traders don't need to carry positions over time and not even overnight.

Finally, event contracts are offered for several types of popular assets, such as equity indices, gold, and crude oil (see the full list below). Therefore, they represent another opportunity for traders to trade these assets in a short trading horizon, relatively low cost, and known potential gains and losses.

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Event contracts offered by CME Group and event examples on 10/21/2022

Equity indices (all mini contracts)	
S&P 500	Will E-mini S&P 500 close above 3675.00?
Nasdaq-100	Will E-mini Nasdaq-100 close above 11100.00?
Russell 2000	Will E-mini Russell 2000 close above 1710.00?
Dow Jones	Will E-mini Dow Jones close above 30250?
Metals	
Gold	Will gold close above 1640?
Silver	Will silver close above 18.500?
Copper	Will copper close above 3.4000?
Energy	
WTI crude oil	Will light sweet crude oil close above 85.00?
Natural gas	Will Henry Hub natural gas close above 5.400?
Foreign currencies	
Euro/U.S. Dollar	Will Euro/U.S. Dollar close above 0.98250?

Why were these contracts created?

As stated in its own website, "CME Group is bringing event contracts to the growing number of retail market participants who want a less complex way to trade some of the world's most recognized markets – ones they know and interact with every day." Essentially, the CME Group is trying to attract more people to trade. They specifically refer to "retail market participants", which are generally considered "small investors" who don't typically have the funds, time and resources to trade large positions in futures and options contracts and be exposed to large amounts of risk. As discussed above, event contracts can be traded with relatively small investments, expire every day, and potential gains and losses can be easily assessed before trades are placed. The CME Group expects that these characteristics will attract traders who would normally be reluctant to trade their futures and options contracts.

Further, event contracts can be easier to understand compared to futures and options contracts. When we think about futures and options contracts, some concepts and terminology may not be straightforward to understand. Buying and selling something for future delivery, different prices for different delivery dates, buying something now that we will only own in the future, selling something that we don't own, initial margins, margin calls, puts, calls, exercising a contract that will give us another contract are examples of ideas and lingo in futures and options markets that may require some time to understand before one starts trading those contracts. On the other hand, event contracts rely on only one basic idea: will the price at the end of day be higher or lower than a set value? This is basically everything one needs to understand to trade event contracts.

Why does the CME Group want to have more people trading in its markets?

The CME Group is a large, publicly-traded corporation that provides a service, namely a marketplace for hedgers, speculators, and investors to trade commodities and other types of assets using futures and options contracts. The company charges fees for traders to use its marketplace, thus more trading activity means more fees and hence more revenues. Further, these fees represent the core revenue of the CME Group. According to its financial statements from the last 3

years, clearing and transaction fees account for approximately 80% of the company's total revenues. Event contracts can bring more traders to the marketplace and generate more trading activity as the 'new' traders keep trading event contracts or even decide to start trading futures and options contracts too.

Can event contracts be used for hedging?

Futures and options contracts have traditionally been used for hedging purposes. They are also used for speculative purposes, but there are many hedgers who use them to manage price risk in their businesses. Besides, futures exchanges (such as the CME Group) and futures contracts were originally created a long time ago with the main purpose to trade physical commodities and manage price risk.

How about event contracts? Can they also be used by hedgers to manage price risk? They are certainly different from futures and options contracts when we think of a typical hedger and the hedging potential of event contracts is not as clear as it is for futures and options contracts. Event contracts have a short trading horizon (one day) and are not tied to a specific risk in the cash market (such as the impact of a price change of a certain magnitude on a particular quantity of a physical commodity), hence it would be challenging to use them for hedging purposes. Therefore, event contracts will likely be used mostly for short-term speculation on prices. And this is perfectly fine. There is room and need for both hedgers and speculators in the marketplace. The marketplace can work well and be beneficial for all traders as long as they all understand what contracts are useful for them and how to use them properly.

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