

Prediction Markets: The next big disruption in investing?

Nadine Blaney [00:00:20] From sports to politics, prediction markets are blurring the line between trading and betting, and Wall Street is paying attention. Magellan Investment Partners, Emma Williams is here. Emma, really nice to see you. Thanks for coming. Good to see, you too. Let's just start with the basics, because I think a lot of people wouldn't be entirely clear on what prediction markets are and how they differ, I suppose, from traditional hedging.

Emma Williams [00:00:45] Sure, so in simple terms, prediction markets are exchange-shaded markets where you buy contracts that pay out based on whether a specific future event occurs. So, for instance, you can purchase contracts related to whether the Federal Reserve will cut rates at the next meeting. Prediction markets rose in popularity at the most recent U.S. Presidential election. Where trading activity more accurately pointed to Trump being the front runner despite official polling pointing to a much closer race. I think it might be helpful for our listeners to take a step back and talk through how historically market participants would hedge and prepare for event risk and how prediction markets add value here. If you were managing a portfolio historically and you wanted to hedge against a particular macroeconomic or political risk, say a piece of legislation or an election, you'd have to use proxy assets. The issue there is it can be inefficient because you're not just trading based on whether that event happens or not, you're also relying on how the market reacts to that event, which can be more unpredictable.

Nadine Blaney [00:02:05] How do prediction markets solve for that, though?

Emma Williams [00:02:08] So it's a good question. Prediction markets solve for this by isolating the event. So, what that means is that prediction markets offer binary yes or no contracts, which are tied directly to an outcome. So, a trader can place a trade, for example, on whether they believe the Republicans will maintain majority in the Senate at the midterms. Right now, on prediction markets, event contracts cover a huge range of events. So, you've got everything from politics to macroeconomic factors, you've even got pop culture events like who's going to attend the Oscars, however, most contract trading that we're seeing at the moment relates to sports.

Nadine Blaney [00:03:06] Just to get my head around it because if we're talking sports or we're talking pop culture it sounds more like a casino or like betting rather than something that's a real legitimate financial exchange so just flash that out. What's the difference?

Emma Williams [00:03:20] It's a very fair question and it's a common concern. So, the key difference between sports books or casinos and prediction markets is the market structure. So, in a sports book or a casino environment, you're betting against the house, and the house is structured to win, whereas prediction markets are peer-to-peer engines. Where you pay a small transaction fee to the exchange and you're betting against your peer.

Nadine Blaney [00:03:53] Why are the traditional exchanges paying attention to the development and the evolution of these prediction markets and the popularity, I guess?

Emma Williams [00:04:01] So, for context, Intercontinental Exchange or ICE for short, and CME are two leading global derivative exchanges. ICE and CMA have both established strategic partnerships in this space. However, their strategies differ. So, ICE has partnered with Polymarket, which is a decentralised crypto-based prediction market. However, ICE's partnership is not so much about the trading side. It's primarily an exclusive data agreement, which means ICE is taking polymarkets crowdsourced probabilities. They're cleansing that data and then they're selling that onto hedge funds and traders who use it for their risk management strategies. By contrast, CME, they have a partnership with third party prediction markets, including FanDuel Predicts. Their partnership is more about customer acquisition and increase in exposure to retail traders. In that arrangement, CME processes, the event contracts through their regulated exchange, and they click the ticket through an exchange fee. It's worth noting for ICE and CME, prediction markets are an immaterial contributor to overall income at present, but we still view it as an incremental growth lever.

Nadine Blaney [00:05:36] That's fascinating. OK, but it makes me think, what is the likelihood or what is a risk associated with the regulators shutting these prediction markets down altogether, or maybe limiting what they can do? We've seen outrage over some of these prediction markets in particular when it comes to instability in the Middle East, for example.

Emma Williams [00:05:57] So it's fascinating. We are observing a fierce regulatory turf war in the United States, which is evolving by the day. So, on one side, you have the Federal Commodity Regulator, the CFTC, who are aggressively asserting jurisdiction over this market. They argue that event contracts are essential hedging tools, and they should be regulated like any other derivative. On the other side you have the state regulators. Who regulate gambling in the US, and they're pushing back fiercely on this definition. In recent months, we've seen the debate heat up, as you allude to, because of some controversial markets that have popped up relating to the US and Israeli strikes in Iran, and before that, the operations in Venezuela. In our view, despite this pushback, we view it as unlikely that there would be a federal ban on prediction markets. We think it's more likely that we'll see stricter regulation, for instance, to curb or mitigate any insider trading and to reduce regulatory drift. For our clients and for our fund, we are comforted that CME and ICE are more in the background here. We see that they are benefiting from the prediction market boom without being in the direct line of regulatory fire.

Nadine Blaney [00:07:24] With the prediction markets capturing so much headline space, as of late in particular, you do not see them as an existential threat or some sort of significant competition to the traditional exchanges.

Emma Williams [00:07:38] It's a valid concern. We view it as highly unlikely that they're a credible competitive threat for ICE and CME. So derivative exchanges like ICE and CME are very high-quality businesses. They benefit from near monopoly status within their key contracts, which is by virtue of strong network effects built on deep liquidity and benchmark status. This near monopoly position creates very favourable capital efficiencies, and it makes it hard for any competitor to break in. In saying that, we do from time to time see new competitors pop up and try their luck. The most recent example is FMX Futures Exchange, which launched in September 2024 in an effort to take on CME's dominant position in interest rate futures. In about the 18 months or so since it launched, trading volume still remains negligible, which to us reinforces the quality of the incumbents. We like ICE and CME because of these quality attributes. We also like the exchanges because they are a natural hedge in periods of volatility, including what we've seen year to date. If we were to see any share price weakness because of perceived competitive threats from the prediction markets, we view that as an opportunity to lean in further.

Nadine Blaney [00:12:07] Emma Williams, thank you.



Important Information: This material has been delivered to you by Magellan Asset Management Limited ABN 31 120 593 946 AFS Licence No. 304 301 trading as Magellan Investment Partners (**Magellan Investment Partners**) and has been prepared for general information purposes only and must not be construed as investment advice or as an investment recommendation. This material does not take into account your investment objectives, financial situation or particular needs. This material does not constitute an offer or inducement to engage in an investment activity nor does it form part of any offer documentation, offer or invitation to purchase, sell or subscribe for interests in any type of investment product or service. You should obtain and consider the relevant Product Disclosure Statement (**PDS**) and Target Market Determination (**TMD**) and consider obtaining professional investment advice tailored to your specific circumstances before making a decision about whether to acquire, or continue to hold, the relevant financial product. A copy of the relevant PDS and TMD relating to a Magellan Investment Partners financial product may be obtained by calling +61 2 9235 4888 or by visiting www.magellaninvestmentpartners.com

Past performance is not necessarily indicative of future results and no person guarantees the future performance of any financial product or service, the amount or timing of any return from it, that asset allocations will be met, that it will be able to implement its investment strategy or that its investment objectives will be achieved. This material may contain 'forward-looking statements'. Actual events or results or the actual performance of a Magellan Investment Partners financial product or service may differ materially from those reflected or contemplated in such forward-looking statements.

This material may include data, research and other information from third party sources. No guarantee is made that such information is accurate, complete or timely and no warranty is given regarding results obtained from its use. This information is subject to change at any time and no person has any responsibility to update any of the information provided in this material. Statements contained in this material that are not historical facts are based on current expectations, estimates, projections, opinions and beliefs of Magellan Investment Partners or the third party responsible for making those statements (as relevant). Such statements involve known and unknown risks, uncertainties and other factors, and undue reliance should not be placed thereon. No representation or warranty is made with respect to the accuracy or completeness of any of the information contained in this material. Magellan Investment Partners will not be responsible or liable for any losses arising from your use or reliance upon any part of the information contained in this material.

Any third-party trademarks contained herein are the property of their respective owners and Magellan Investment Partners claims no ownership in, nor any affiliation with, such trademarks. Any third-party trademarks contained herein are the property of their respective owners, are used for information purposes and only to identify the company names or brands of their respective owners, and no affiliation, sponsorship or endorsement should be inferred from such use. This material and the information contained within it may not be reproduced, or disclosed, in whole or in part, without the prior written consent of Magellan Investment Partners. (080825-#W17)

