Every crowd has a golden lining: bet on it

June 23, 2009 - 7:08PM

Want to know what the future looks like? Follow the crowd and the money. It's an idea that might explain the growing interest by economists, business and policy pundits in predictive markets and their forecasts on everything from election results to business ventures, writes Leon Gettler.

These forums - also known as internal, information, opinion or event markets - work by aggregating otherwise decentralised data from a collective. The group gets it right more often than the smartest individual.

At the end of last year, global research and advisory firm Gartner forecast that a combination of predictive markets, wikis - special websites on which anyone can post material - and free open-source software would drive a 10 per cent rise in corporate productivity in the next 10 years.

Gartner's sweeping claim ignores that collaborative work has been around for decades. The Total Quality Movement in the 1960s and '70s in Japan, for example, encouraged assembly line workers to innovate and improve routine production processes. What's different now is that technology makes decentralisation easier. That suggests more organisations will be adopting decentralised processes and market-generated forecast systems.

A working paper released last year by US academics Justin Wolfers and Eric Zitzewitz found these systems consistently outperformed established benchmarks. For example, the Iowa Electronics Futures Market, which predicts votes for election candidates, had a 1.5 per cent error margin; Gallup Poll's was 2.1 per cent. Regulated by the Commodity Futures Trading Commission, the Iowa system works as a real-money winner-takes-all market where people can bet on candidates by buying contracts based on those candidates winning. The market for contracts ultimately picks the price and probability of the result.

Similarly, in the last federal election here, opinion polls were pointing to a close-run thing. The punters knew better. Betting fluctuations, according to Centrebet, suggested they knew well in advance that the Coalition had it in the bag. On the morning of October 9, opinion polls were saying it was neck and neck. The closing prices, however, were telling a different story: $1.10 for the Coalition and $6 for Labor. With odds like that, it's not hard to see why the Coalition not only won but increased its majority.

To predict the result, you needed to follow the money. In one of the election's turning points, the release of Labor's forests policy, the Labor member for the Tasmanian seat of Bass, Michelle O'Byrne, went from $1.33 to $3 while the Liberal who defeated her, Michael Ferguson, came in the other way, from $3.20 to $1.33. Betting exchanges had a similar, eerie accuracy predicting the US election result. While most polls were saying it was too close to call, Tradesports.com, the Dublin-based online trading exchange for politics, economics and sport, was giving George Bush a 58 per cent chance and John Kerry 42 per cent. Betfair was offering 2-1 odds for Kerry.

Predictive markets extend beyond elections. The Hollywood Stock Exchange, an affiliate of online trading firm Cantor Index Ltd, allows people to buy and sell virtual shares in movies, celebrities and music. To pay for pseudo-shares, they use pseudo-money in the form of "Hollywood Dollars". This allows people to bet on such questions as total box office returns and Oscar winners. Because the data outperforms industry forecasts, it is also syndicated as market research.

Three years ago, Goldman Sachs and Deutsche Bank launched a market for economic statistics futures including employment, industrial output, retail sales and inflation. The Chicago Mercantile Exchange now trades in inflation futures contracts. Some companies have also experimented with prediction markets. Hewlett-Packard, for example, set one up that reportedly generated more accurate forecasts of sales than its own internal processes.

Siemens had one that predicted the German conglomerate would fail to deliver on a software project in time, in defiance of its established management systems that insisted the deadline would be met. Management was wrong.

Information markets are, however, never perfect. Just as prices lose all connection to value in sharemarket bubbles, Wolfers and Zitzewitz say punters can put too much weight on long shots and overvalue unlikely events. They can also be swayed by personal biases; for example, backing teams and political candidates that they like.

In The Future of Work (Harvard Business School Press, 2004), MIT professor Thomas Malone says decentralised structures, including markets, work well, but not for all organisations.

Centralisation is the go, he says, when hard decisions need to be made and conflicts resolved. It also is the only alternative when lots of detail needs to go under the umbrella of a single vision. Microsoft, for example, could make its strategic shift to the internet in the 1990s only because Bill Gates wielded centralised power. And, says Malone, you centralise when only a few have the knowledge and expertise to make good decisions.

The onus then falls on managers to determine when they should break down hierarchies and tap into the wisdom of liquid markets. If Gartner is right, many more could be heading in that direction in years to come. But the organisation as we know it is not about to fade away.

lgettler@theage.com.au