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MACRO AND MARKET

Prediction Markets Explained: How They Work and Risks to Know

Platforms like Kalshi and Polymarket have skyrocketed in popularity, but big questions remain about prediction markets.

By Raj Kartham , By Jonathan Bauman, CFA

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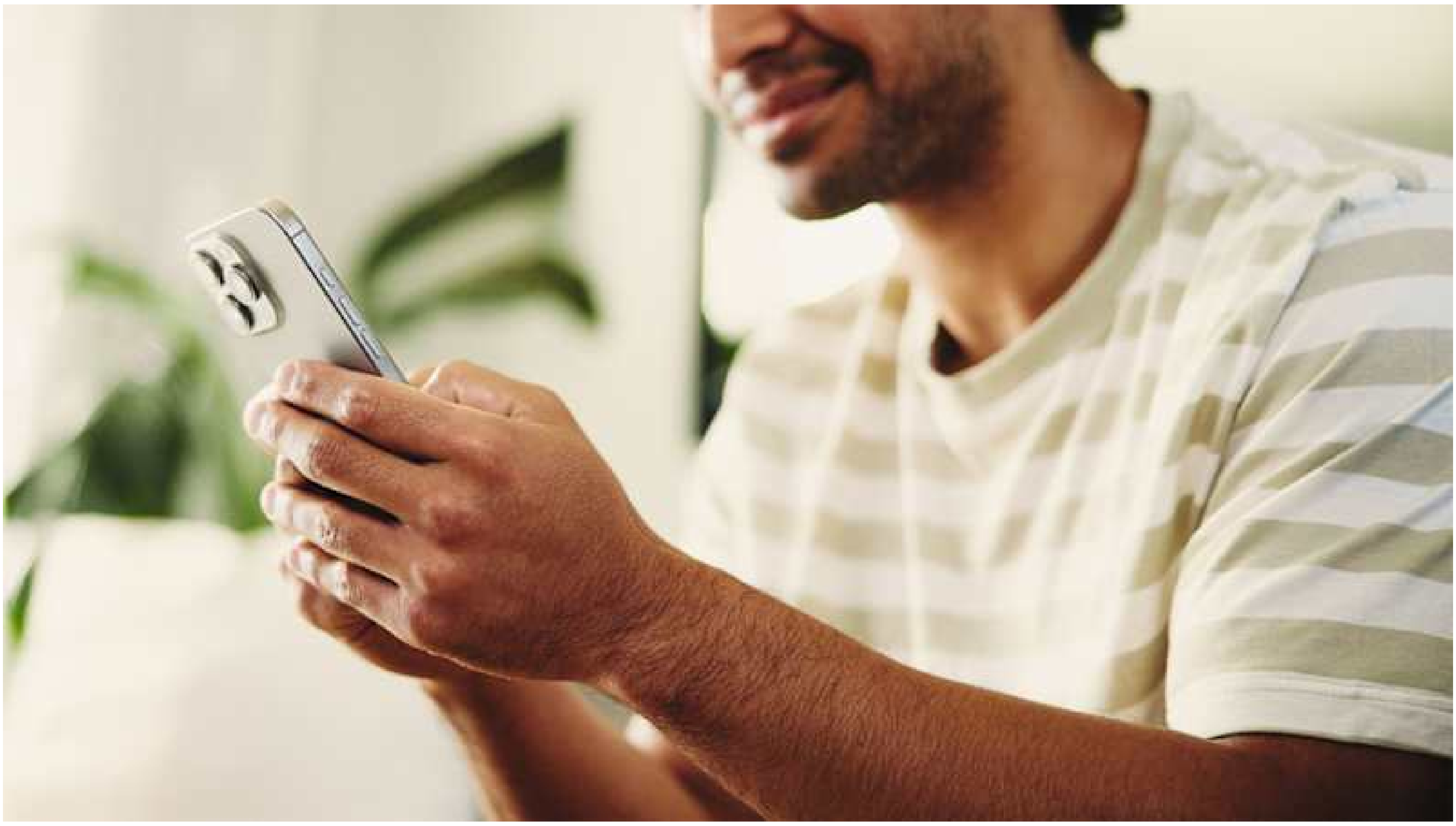


Key Takeaways

Prediction markets give users the chance to profit from their views on real-world questions — and can sometimes be more accurate than traditional polls.	Kalshi and Polymarket, the largest platforms, aren't publicly traded, while other prediction market companies are publicly listed.	Risks facing the prediction market ecosystem include a volatile regulatory landscape and potential insider trading.

If you have an opinion, prediction markets like Kalshi and Polymarket let you put money behind it, even if it's just an opinion about the weather.

For example, a Polymarket user recently turned less than $120 into more than $21,000 with a prediction about the high temperature at Paris Charles de Gaulle Airport.[1] That's the appeal of these platforms. If you're right about the outcomes of elections, corporate earnings or sporting events, you can profit.

Supporters argue that prediction markets reward informed views and can even serve as a forecasting tool. Critics, however, warn that these platforms may be vulnerable to manipulation and insider trading. In the Paris airport example, the winning trade involved an unusual temperature spike, prompting accusations of rigging.[2]

For investors, this tension matters. Prediction markets are expanding rapidly. According to one analysis, the total value of contracts traded in prediction markets could top $1 trillion by 2030, representing a compound annual growth rate of roughly 80%.[3]

However, these platforms also face the possibility of tougher regulation, especially if public sentiment turns against them.

Polymarket has faced criticism for allowing trading on wars and other life-or-death matters.[4] In April, the U.S. Department of Justice charged a U.S. soldier with using confidential information to inform his Polymarket positions. Prosecutors allege he won more than $400,000 on wagers related to the capture of Venezuela's president.[5]

This article explains how prediction markets work, outlines their potential benefits and risks and shows how they already affect some publicly traded companies.

What Are Prediction Markets and How Do They Work?

At first glance, prediction markets look like gambling, but legally, they're not.

Instead of placing a bet, participants buy a contract that pays out based on the outcome of a real-world event such as an election or an interest rate change. In the U.S., the Commodity Futures Trading Commission (CFTC) regulates Kalshi and Polymarket as derivatives markets.

The mechanics of a prediction market are simple. For each event, the platform typically offers a pair of linked binary contracts: "Yes, this is going to happen" and "No, it won't."

A winning contract pays $1; a losing one pays nothing. Want to risk more than that? Buy more contracts.

Prices fluctuate with demand and always total $1, so they read as probabilities. A contract trading at 30 cents implies the market is pricing a 30% chance of that contract's outcome. Because the prices are linked, contracts on the other side of the question would trade at 70 cents.

Contracts trade continuously until the event concludes, allowing participants who expect to lose to sell early and minimize their losses.

The key distinction from a sportsbook: **you're not betting against the house.** Instead, you're taking the opposite side of another trader's position.

Kalshi and Polymarket are neutral venues facilitating the trade, but they don't take the other side of your bet.

Critics argue that, in practical terms, prediction markets are a form of gambling. In fact, some platforms offer sports-related event contracts in areas where they aren't authorized to provide sports betting.

What Are the Pros and Cons of Prediction Markets?

Pro: Aggregated Views and Forecast Accuracy

Because participants risk real money, supporters contend that prediction markets incentivize more accurate forecasting than polls or individual experts.

Kalshi and Polymarket, for example, gave Donald Trump higher odds of winning the 2024 election than most polls did in the final days of the race.[6]

Prediction markets may benefit from the “wisdom of the crowd” by combining diverse insights from multiple participants. Aggregating these views might yield more accurate forecasts than those from a single expert.

Research suggests there is merit to this line of thought.

A recent paper looked at who did a better job of predicting changes in the federal funds rate and the Consumer Price Index. According to the researchers, Kalshi outperformed both professional forecasters and federal funds futures.[7]

Better forecasts could benefit the decision-making of businesses, governments and even individual investors, whether these decisions involve capital spending, public policy or retirement accounts.

Con: Potential for Market Manipulation and Unfair Trading Practices

Critics argue that prediction markets are vulnerable to manipulation and insider trading.

The concern is that someone in a position of power could buy an event contract and then try to shift the outcome to their own benefit. In an election, wealthy individuals or foreign governments might place huge bets on their favored candidates in an effort to mold public opinion.

Or market participants might use sensitive or even classified information to inform their trades. Researchers analyzed Polymarket contracts over two years and found nearly $143 million in winnings that may be linked to “informed trading.”[8]

This includes more than $1 million won by six accounts that bet that Israel and the U.S. would attack Iran on February 28. All those contracts were purchased shortly before the strikes.

The CFTC’s enforcement director recently said he considers insider trading on prediction markets as a top enforcement priority for the agency.[9] For their part, Kalshi and Polymarket say they have implemented systems to identify and address trading violations.

If prediction markets aren’t managed fairly, the accuracy of their predictions could be compromised. It could also damage public perception, adversely affecting the businesses involved and their investors.

Pro: A New Way to Measure Different Types of Risk

Prediction markets might provide new signals about risks that have historically been difficult to measure.

For years, commodity futures have reflected the views of farmers, processors, traders and others with direct exposure to supply and demand. If anybody has an informed opinion about this year’s wheat harvest, it’s probably the people closest to the business.

This has made futures prices an early indicator of inflation risk, supply issues and other factors — useful information for businesses, investors and other parties.

Event contracts do something similar with an even larger set of questions.

Businesses, for example, might turn to prediction markets to gauge the likelihood of Congress passing a critical piece of legislation or to estimate when a strike will end.

Companies could then adjust their operations in response to the odds. They might build up their inventories or delay major capital investments.

Con: An Unclear Regulatory Outlook

The federal government regulates prediction markets in the U.S., but this relationship hasn't always been smooth.

Kalshi and the CFTC went to court over Kalshi's plan to offer event contracts related to elections.[10] A few years ago, Polymarket agreed to block U.S. users from its platform as part of a CFTC settlement.[11] Users could still reportedly skirt the ban by using virtual private networks (VPNs).

Only recently has Polymarket officially resumed serving those customers.[12]

Meanwhile, several state and tribal governments say the prediction markets violate their rules on gambling. This has led to a series of lawsuits, restraining orders and enforcement actions targeting Polymarket and Kalshi.

The CFTC is pushing back against other entities that are trying to regulate the platforms. In April, the agency and the Justice Department filed complaints against Arizona, Connecticut and Illinois. The CFTC claims it has exclusive authority over prediction markets.[13]

Outside the U.S., Polymarket and Kalshi face bans or restrictions in several countries or are unavailable due to regulatory issues.[14]

It's also possible that U.S. rules could grow stricter in the future, limiting the growth of these markets. Members of Congress have introduced several bills targeting prediction markets this year, though their odds of success remain unclear.[15]

How Are Investors Exposed to Prediction Markets?

Polymarket and Kalshi are privately owned, but investors may have exposure to prediction markets through other companies.

This includes firms that weren't created as prediction markets but now provide access to event contracts. Examples include financial services app Robinhood and sports betting app DraftKings.[16] CME Group, a leading derivatives marketplace, and Interactive Brokers Group, a broker/dealer, also offer event contracts.[17]

Others are striking partnerships with prediction markets. Intercontinental Exchange, the owner of the New York Stock Exchange and other properties, has invested $1.6 billion in Polymarket.[18]

Nobody Knows the Odds Yet

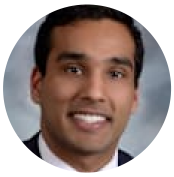
As researchers have noted, platforms like Kalshi and Polymarket may enable more reliable predictions, depending on a number of factors.

At the same time, there are real concerns about these platforms and their potential impacts on society. The possibility of stricter regulation, which could limit growth, deserves to be taken seriously.

For now, our team has a cautious outlook on these platforms. We're also assessing how this trend affects other public companies. Polymarket and Kalshi are privately held firms; however, the evolving landscape is affecting publicly traded companies such as Robinhood, Coinbase, Circle and Intercontinental Exchange.

We're also watching the regulatory environment to see how the battle between the states and the CFTC will be resolved and to gain clarity on insider trading enforcement. Until the odds of increased regulation are clearer, we believe investors would be wise to adopt a wait-and-see approach before increasing their exposure to prediction markets.

Authors


Raj Kartham
Investment Analyst


Jonathan Bauman, CFA
Senior Client Portfolio Manager

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