DomainMart

Thoughts on Hedging Domain-Name Price Risk

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Developing means to hedge against domain-name price risk not only protects current owners against losses but also boosts corporate acquisitions and prices.

Many domainers have a lot more money tied up in names than they do in real estate. Moreover, the pain from a $10,000 loss is sharper and deeper than the pleasure of gaining $10,000. Hence, even if the odds of gaining the $10,000 versus losing it appear to be split fifty-fifty, the prospect may still seem uninviting. Should domainers worry about the possibility of price drops? And, if they should, how can they protect value?

On an industry level, the price risk comes from bubbles and economic downturns. Selling a domain name frees you from the risk but also ends any chance you have of price appreciation. Hedging, by contrast, saves your upside while moderating your downside risk. Of course, like any insurance policy, the protection it provides is not free.

Price risk impacts sales and value. Fear of price decline is one of the main reasons corporations are not using domain name acquisitions to bolster their marketing efforts.[1] At the same time, the ability to hedge creates secondary-market liquidity and increases value because it gives financial institutions an incentive to increase lending for domain name acquisitions and development.

As in real estate, borrowing fuels risk, and risk magnifies price appreciations and declines. Of course, a large number of individual domainers have not borrowed to finance acquisitions or development. But some have, for example through Domain Capital. Some corporate portfolioholders, like Name Media, also carry considerable debt.[2]

Let’s consider possible hedging solutions and their cost-effectiveness:

1. **Insure your portfolio**. The insurance company, such as Lloyds of London, would face two unrelated risks: market price risk and development risk. The latter, being driven by the actions of the domain name owner, would be unacceptable to the insurer.

   There are two distinct approaches to mitigating development risk: contractual and market-oriented. The former approach is unappealing to domainers because designing

[1] In the real estate market, the fear of price decline has driven a certain segment of the market into renting instead.
[2] For example, based on their IPO filing with the SEC, Name Media has $105 million in debt payable in less than a year. It is not clear what percent of the debt is used for domain name acquisitions.

and enforcing contracts can be very expensive and also ineffective. One market solution is not to base price changes solely on the price of the domain name but on the average Web site price of the associated class of domain names.[3] Another is to pool a large number of Web sites, with the effects of good and bad management canceling each other out until the risk becomes negligible.

2. **Find an investment bank to securitize your expected cash flows.** Under such a solution, the investment banker also faces the two sources of risk. To viably reduce the total risk, a large pool of domain names is needed.

3. **Lease your domain name.** You lock in cash flows for the period of the lease. The risk is that your lessee might default.

4. **Buy put options.** A put option is a contract the gives the owner the right, but not the obligation, to sell an asset (for instance, a domain name) at a price specified by the contract. This price stays the same no matter how high or low the domain name's price may be on the open market.

   Going by opinions expressed at various message boards, it appears domainers are split as to whether our market is heading up or down. Given this difference, we should be looking into the economic viability of an option market.

5. **Use Google stock prices.** This solution involves selling Google stock short or buying put options on Google. Unfortunately, however, such a solution has a number of limitations:
   a. It is not easy to construct domain-name price data so as to correlate it with Google stock price movements. Thus, the hedge would be imperfect. Moreover, even if data were available, Google might not be a good instrument to hedge with.[4]
   b. Google stock prices might not be a representative of all pay-per-click (PPC) segments. The direction of PPC rates for different product and geographical segments might not move in the same direction.
   c. For a parked domain name, one can establish a relationship between parking revenue and returns on Google stock. However, this strategy is viable only for a subset of domain names.

Though none of the solutions above are ideal, we are within reach of an answer. Hedging techniques, properly developed, will not only protect domain owners against precipitate price drops but also lead to higher market prices and boost domain name sales during good times. ■

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[3] Statistical models can be used for grouping similar domain names. See Alex Tajirian, "94 Percent Annual Domain-Name Price Appreciation." However, analytical domain-name tools are incorrectly considered heresy by a very large segment of domainers.

[4] For example, during the 1987 stock market crash junk bond traders were surprised to find out that hedging their positions with Treasury bonds was ineffective, as junk bonds behaved more like stocks than they did interest rate instruments.