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2nd Emerging Scholars in Banking & Finance Conference: Further contemporary issues in financial institutions and markets

Are there benefits to being naked? The returns and diversification impact of capital structure arbitrage

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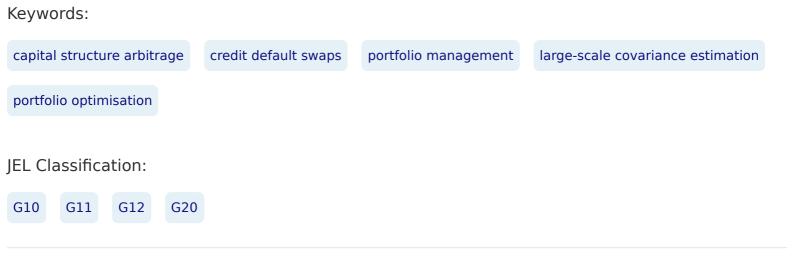
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Abstract

Full Article

In a naked credit default swap (CDS) position, a party pays an income stream to a seller of protection to swap away default risk on an underlying defaultable security without actually holding this reference instrument. Using mark-to-market returns on a large cross section of CDS positions, held independent from their reference entity, we implement a novel test to establish whether their inclusion in an optimised portfolio is replicable by a large set of alternative assets. Overall, we find significant excess returns of over 28% per annum against an optimised benchmark, we speculate that it is these characteristics that could be driving a bubble in the CDS market.



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Notes

- 1 Generally, practitioners refer to capital structure arbitrage as holding, for example, a short naked CDS position and an equivalent sized position in the equity of the same firm. However, we extend this definition to simply holding a large cross section of CDS and alternative instruments. A better description for this paper could be macrostructure arbitrage as we include a very wide variety of money market and other investment instruments across the financial spectrum.
- 2 Source: Bloomberg, news wire 11 March 2010, 'Naked Swaps Crackdown in Europe Rings Hollow Without Washington', by Ben Moshinsky and Aaron Kirchfield, US House of

- Representatives Committee of Financial Services Hearing. 17 July 2009, Serial No. 111-62, 5-17.
- 3 Wall Street Journal, 17 April 2010 'Goldman Sachs Charged With Fraud' by Gregory Zuckerman, Susanne Craig and Serena Ng. By 2008, 99% of the underlying assets and hence the majority of the tranches in this CDO product had been downgraded.
- 4 Source: CMA Vision, 20 April 2010.
- 5 Capital risk is the variation in the value of a portfolio due to market fluctuations in the constituent assets.
- 6 Depository Trust & Clearing Corporation, August 2009 CDS Market Report.
- 7 For the fictional perpetual protection case it is . Recall that the value of a perpetuity with a coupon of at 2.5% is \$40 million.
- 8 We gratefully acknowledge the assistance of Thomson Reuters and CMA in assisting in building the instrument baskets. Thomson Reuters DataStream CMA currently provides sector-level basket data using the cross section of assets available in the CMA database and we use this list to build our CDS sector funds.



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