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

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Abstract

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 macro-structure 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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