A L T E R N A T I V E I N V E S T I N G

Arbitrage Crashes and the Speed of Capital

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Modern finance theory rests on the ability of arbitrageurs to ensure that substantially similar assets trade at substantially similar prices. When prices of related assets diverge, arbitrageurs sell short the expensive asset and simultaneously buy the cheap asset. When the prices of the assets converge, arbitrageurs unwind their trades and generate risk-free profits. As long as arbitrageurs can borrow, they can turn even small pricing discrepancies between substantially similar securities into large profits. Although arbitrageurs may not cause absolute prices to equal fundamental values, they can ensure assets are priced correctly on a relative basis.

If arbitrageurs lose access to debt capital, they may be unable to force prices of similar assets to the same level. When this occurs, substantially similar assets can trade at wildly different prices. In this paper, we measure the relative pricing errors that occurred during the 2008 financial crisis, when arbitrageurs were unable to borrow and were therefore financially constrained.

We focus on arbitrage strategies involving corporate securities, including convertible debenture arbitrage, CDS–corporate debenture arbitrage, closed-end-fund arbitrage, merger arbitrage and Special Purpose Acquisition Company (SPAC) arbitrage. None of these is a true arbitrage strategy because the securities underlying the trades are merely related rather than nearly identical, but we contend the securities are related closely enough to provide an estimate of the relative mispricings arbitrageurs typical eliminate.

In addition to documenting the level of mispricings, we document the time required for capital to flow into the void left by arbitrageurs. Seemingly risk-free arbitrage opportunities offering extraordinary expected returns were available for several months after the 2008 financial crisis.

eliminate the risk of experiencing investment losses.

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