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

Slow-Moving Capital

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Unlike textbook arbitrageurs who instantaneously trade when prices deviate from fundamental values, real-world arbitrageurs must overcome various frictions. For example, they often invest other people's money, resulting in a principal/agent problem that is exacerbated in market downturns.

For this reason, rather than increasing investment levels when prices dip below fundamental values, arbitrageurs may, in the face of capital constraints, sell cheap securities and cause prices to decline further. As a result, mispricings can be large and can extend for long periods of time.

We document what appear to be major and persistent price deviations from fundamental value, suggesting that while arbitrage is reasonably fast when market participants are not capital constrained, it can be slow following major capital dislocations. Convertible arbitrageurs provide immediate liquidity to firms unable to raise cash efficiently via the equity or straight debt markets. In return, these arbitrageurs receive a premium for holding a security that is highly illiquid.

Likewise, merger arbitrageurs provide immediate liquidity to investors seeking to sell target shares after a merger announcement and, in return, receive a premium for bearing deal failure risk. However, in situations where external capital shocks force liquidity providers to reverse order and become liquidity demanders, it can take months to restore equilibrium to the dislocated market.

actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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