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Corporate Bond Specialness

February 1, 2007

NBER Working Paper

The U.S. bond market is a well-understood source of corporate financing, but academic research of its cash and lending markets has been limited by their OTC structure and lack of transparency. Using a unique dataset of corporate bond-lending transactions arranged by one of the world's largest custodians, we shed light on the drivers of shorting activity, shorting costs and the economic implications.

We find that 3% of the corporate bonds in our sample are on loan, implying that corporate bond lending and shorting is almost as prevalent as equity shorting. Corporate bond lending fees are substantial and tend to be largest for risky low-rated bonds — especially around the time of downgrade — as well as for small issues, old bonds and bonds where a smaller fraction is held by the largest custodian (i.e., likely harder to locate).

Interestingly, we find that a company's equity specialness — a measure of the cost of borrowing a security in order to short sell it — is positively related to the specialness of the same company's bonds. This may indicate that short-selling investors view the company's stock and bonds both as being overvalued at the same time.

Finally, we present evidence that corporate bonds that have high shorting costs are likely to be overpriced relative to the CDS contract on the issuer. Said differently, bonds with a higher specialness have a more positive bond-CDS basis. Surprisingly, equity specialness is also significantly related to corporate bond over-valuation relative to the CDS, even after controlling for corporate bond specialness.

eliminate the risk of experiencing investment losses.

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