



# IMPACT OF FINANCIAL CRISIS ON THE PROFITABILITY OF CAPITAL STRUCTURE ARBITRAGE IN AUSTRALIA

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## Abstract

We evaluate the performance of a convergence style capital structure arbitrage trading strategy using Australian CDS spreads estimated by the Credit Grades model. By comparing a number of volatility inputs, we find that although option-implied volatility inputs produce biased spreads compared to historical measures, their correlation with medium-term changes in market spreads generate significantly more profitable trades during the financial crisis, even after the inclusion of transaction costs. While the strategy is risky at both the individual obligor and the iTraxx Index level, combining positions into an equally-weighted index of arbitrage trades reduces risk.

**Keywords:**

**JEL Classification:**

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## 1. Introduction

Using Credit Default Swap (CDS) spread estimates derived from the CreditGrades model, we develop a convergence-style capital structure arbitrage trading strategy to exploit possible mispricing between each obligor's estimated spreads and market spreads. If the model and market CDS spreads diverge significantly, a position is taken in the CDS market and a corresponding position is taken in the equity market as a hedge. The trade will be profitable if the model and the market spreads subsequently converge. While loosely based on Yu (2006), we make a number of modifications in the implementation of the strategy. Firstly, we analyse a range of volatility inputs. Secondly, while still conducting all estimation out-of-sample, we set aside a longer in-sample period from which to estimate each firm's default boundary level. Thirdly, we include additional stop loss and profit taking trading rules to terminate trades. Finally, in contrast to previous work, we retain financial firms in the sample to test the arbitrage strategy at both the individual obligor's level and the CDS index level.

































































