

Post-Earnings Announcement Drift in the Credit Default Swap Market

Bachelor Thesis in Banking and Finance



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Date: 2014/08/21

ABSTRACT

This paper examines the informational efficiency in the CDS market by investigating the relationship between subsequent CDS returns and their responses to earnings announcements between 2004 and 2013. To account for sensitivity towards different earnings surprise specifications this study uses both analyst and time-series forecasts. With the start of the credit crisis in 2007 I find that the CDS market exhibits a systematic post-earnings announcement drift with a stronger concentration during the crisis revealing a mispricing of earnings in the CDS market similar to that observed in the stock market. These results call the CDS market's efficiency into question.

Keywords: Credit Default Swap, Market Efficiency, Mispricing, Post-Earnings Announcement Drift, Earnings Surprise

Executive Summary

Problem Statement

The semi-strong form of market efficiency states that prices adjust immediately to new public information such that no excess return can be earned by trading on this information (Malkiel (2003)). Nonetheless, since the discovery of the post-earnings announcement drift in the stock market by Ball and Brown (1968) there has been numerous research work confirming and attempting to explain this puzzling market phenomenon (see, e.g., Rendleman, Jones, and Latané (1982); Foster, Olsen, and Shevlin (1984); Bernard and Thomas (1990) and Bhushan (1994)).

In contrast, despite the strong link between equity and debt the number of research about the mispricing of earnings in the CDS market is modest. In this context, this study examines the informational market efficiency in the credit default swap market by testing the CDS market's response to earnings announcements. There is a related study of Jenkins, Kimbrough, and Wang (2011) that investigates the earnings-based and accrual anomaly in the CDS market. However, this paper differs from theirs by using a more recent sample and different earnings surprise measures to capture the drift.

Methods

The combination of CDS quotes provided by CMA Datavision CDS series and Thomson Reuters CDS series both offered through Datastream results in a unique CDS time-series ranging from 2004 to 2013. This database is then used to test whether the mispricing of earnings observed in the stock market extends to the CDS market. To examine this market anomaly this paper analyzes the CDS market's response to earnings announcements: cumulative index-adjusted returns are regressed on earnings surprise decile ranks. Applying this methodology allows to interpret the corresponding slope coefficient as a hedge portfolio return which consists of a long position in the top-earnings decile and a short position in the bottom-earnings decile. To account for correlations across firms and times, OLS regression is estimated using robust standard errors adjusted for firm clustering as well as time dummies. To compare the results with previous research the analysis is additionally conducted with subsamples.

Results and Assessment

This study finds evidence supporting the informational efficiency in the CDS market prior to the credit crisis of 2007 and 2008. However, with the start of the crisis the CDS market becomes inefficient exhibiting a delayed price response to information contained in earnings announcement when using analyst forecasts errors as the underlying earnings surprise measure. Moreover, although the effect weakens after the crisis this systematic pattern does not dissipate as documented by Jenkins, Kimbrough, and Wang (2011). In conclusion, this paper confirms that using earnings surprises calculated from analyst forecasts maximizes the drift in both the stock and the CDS market. Furthermore, it extends the findings of previous research examining the efficiency in the CDS market by providing more current insights.