The Risk and Return of Arbitrage in Dual-Listed Companies

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Some additional information

We are aware of three other DLCs that have been created. Hoesch AG/Hoogovens NV was established in 1972 and ended in 1982. Investec Ltd/Investec PLC came into existence on July 26, 2002, and a DLC of Carnival Corp., and Princess P&O PLC was created on April 17, 2003. Because the existence of these twins only partly overlaps our sample period, we have decided not to analyze these DLCs in this study. We have also excluded the Anglo-French combination Eurotunnel from the sample. Eurotunnel shares are listed in the forms of units (comprising of one share in Eurotunnel PLC stapled to one share of Eurotunnel SA) on the London Stock Exchange and on Euronext Paris. As these shares are convertible into each other, their characteristics differ importantly from those of the other twins in our sample.

Lowenstein (2000) describes arbitrage positions of Long-Term Capital Management (LTCM) in Royal Dutch/Shell. LTCM established an arbitrage position in this twin in the summer of 1997, when Royal Dutch traded at an 8 to 10 percent premium. In total $2.3 billion was invested, half of which long in Shell and the other half short in Royal Dutch (Lowenstein, p. 99). In the autumn of 1998 large defaults on Russian debt created significant losses for the hedge fund and LTCM had to unwind several positions. Lowenstein reports that the premium of Royal Dutch had increased to about 22 percent at the time LTCM had to close the position and they incurred a loss. This loss was amplified by the likely further widening of the spread caused by unwinding the large position held by LTCM. According to Lowenstein (p. 234), LTCM lost $286 million in equity pairs trading and more than half of this loss is accounted for by the Royal Dutch/Shell trade.[1]

[1] Lowenstein (2000) does not provide the precise loss on the Royal Dutch/Shell trade, but a back-of-the-envelope calculation indicates that it is at least half of the total loss in pairs trading. An interesting detail is that Lowenstein (p. 111) describes Shleifer and Vishny (1997) as a warning that an arbitrage firm could be overwhelmed by noise traders pushing prices further away from fundamental value. He mentions that LTCM insiders read the paper prior to publication, but were not convinced by the arguments.