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Pershing Square's Pandemic Trade (B)

On the afternoon of March 12, 2020, Bill Ackman logged into his computer from his home office to check on the positions held by Pershing Square Capital Management, L.P., the investment firm that he founded and ran. Ackman was still adjusting to the new reality of managing the firm remotely, as Pershing Square had closed its offices in late February due to the spread of Covid-19 virus across the globe.

Of particular interest to Ackman that morning were three credit default swap (CDS) positions that he and his team had entered into in February in an effort to hedge against the economic fallout from the Covid-19 pandemic. As it stood, Pershing Square had notional exposures of \$42 billion on the CDX Investment Grade (IG) Index, €21 billion on the iTraxx Europe Index, and \$3 billion on the CDX High-Yield (HY) Index. In all of these CDS positions, Pershing Square had bought protection, meaning that the position would pay off if any of the underlying firms defaulted or if there were an increase in the credit spread associated with each index (**Exhibit 1** summarizes Pershing Square's CDS hedging strategy during the pandemic).

These positions had paid off tremendously over the past several weeks. For instance, when they initiated their CDS positions, **the CDS spread on the CDX IG index was roughly 46 basis points**,¹ In less than a month, it had skyrocketed to as high as 152 basis points. Over the same period, spreads on the iTraxx Europe had gone from 48 to as high as 137 basis points, and the CDX HY had gone from 326 to as high as 703 basis points. In total, Pershing Square's CDS positions were currently worth over \$2.6 billion, accounting for over 30% of its total portfolio value. On March 12 alone, the value of the positions had gone up by \$780 million. Because they had initially purchased protection when credit spreads were near historical lows, the carrying costs of their CDS positions were just under \$20 million dollars. In other words, if Pershing Square liquidated its CDS positions now, it could realize a return over 100 times the capital deployed in the trade.

As he looked at the value of Pershing Square's pandemic hedges, Ackman knew he had a difficult decision to make. On the one hand, the pandemic was likely still in its early stages. As of March 11,

¹ Pershing Square initiated its CDX IG trades when the breakeven CDS spread was 46 basis points, though the spread moved in response to their trading behavior.

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2020, there were over 126,675 confirmed cases globally and 4,611 deaths.² The United States had 1,105 confirmed Covid-19 cases and 33 deaths, but health experts were predicting substantially more. It was also far from clear how policy makers would respond to the pandemic and whether their response could prevent the virus from causing a prolonged contraction in economic activity. On the other hand, financial markets may have already priced in the impact of the pandemic. After all, the MSCI World Index was down almost 25% year-to-date and credit spreads had already widened quite dramatically (see Exhibit 2). In addition, while governments were still in the early stages of crafting their policy responses to Covid-19, many had already indicated they would intervene heavily to mitigate the economic and financial impact of the virus. Was this the right time to liquidate?

² COVID-19 confirmed cases and deaths data retrieved from Johns Hopkins University Coronavirus Resource Center, <https://coronavirus.jhu.edu/map.html>. Accessed September 21, 2020.

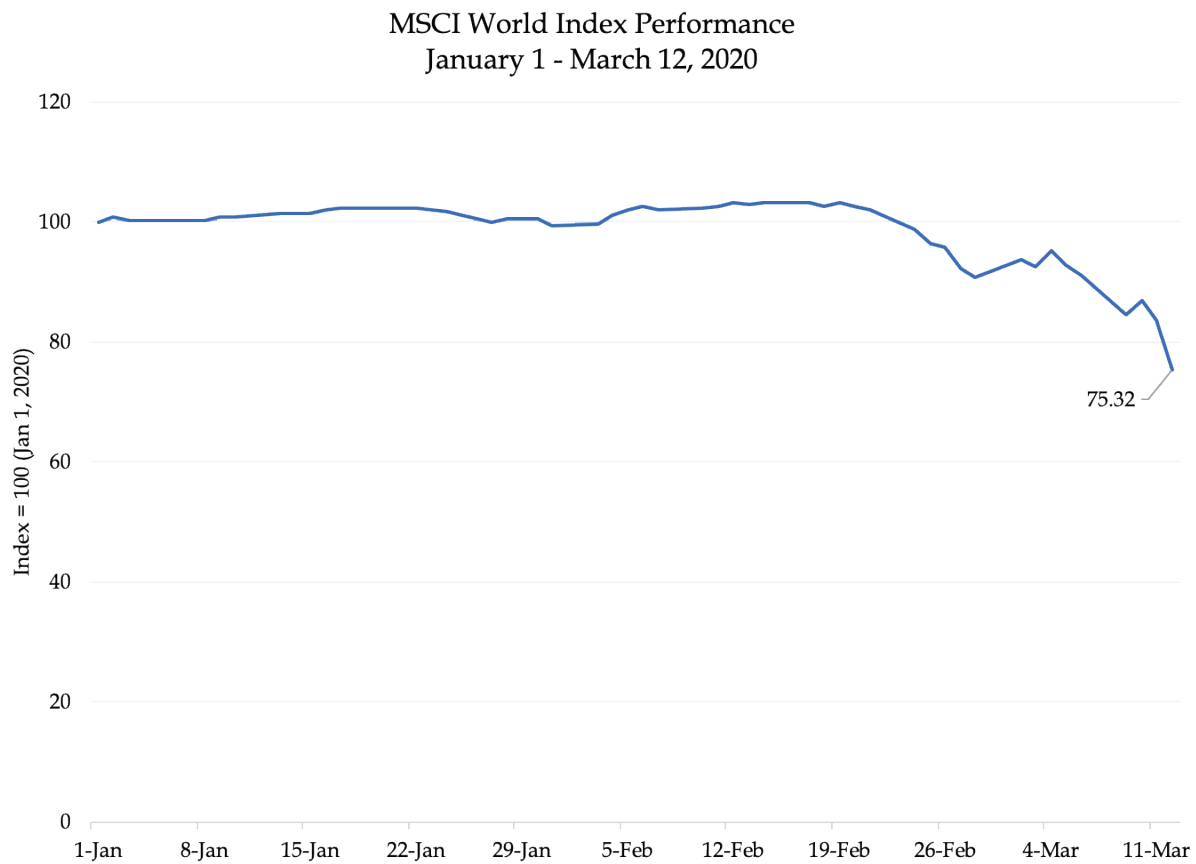
Exhibit 1 Pershing Square Hedging StrategyCDS Trades as of March 12, 2020

Date	Protection Type	Index Name	CDS Spread (bps)	Notional	Cumulative Notional
24-Feb	Buy Protection	CDX IG	53.73	\$17,500,000,000	\$ 17,500,000,000
26-Feb	Buy Protection	CDX IG	57.26	\$ 17,000,000,000	\$ 34,500,000,000
28-Feb	Buy Protection	CDX IG	68.50	\$ 5,000,000,000	\$ 39,500,000,000
2-Mar	Buy Protection	CDX IG	72.88	\$ 5,000,000,000	\$ 44,500,000,000
5-Mar	Sell Protection	CDX IG	71.45	\$ (2,300,000,000)	\$ 42,200,000,000

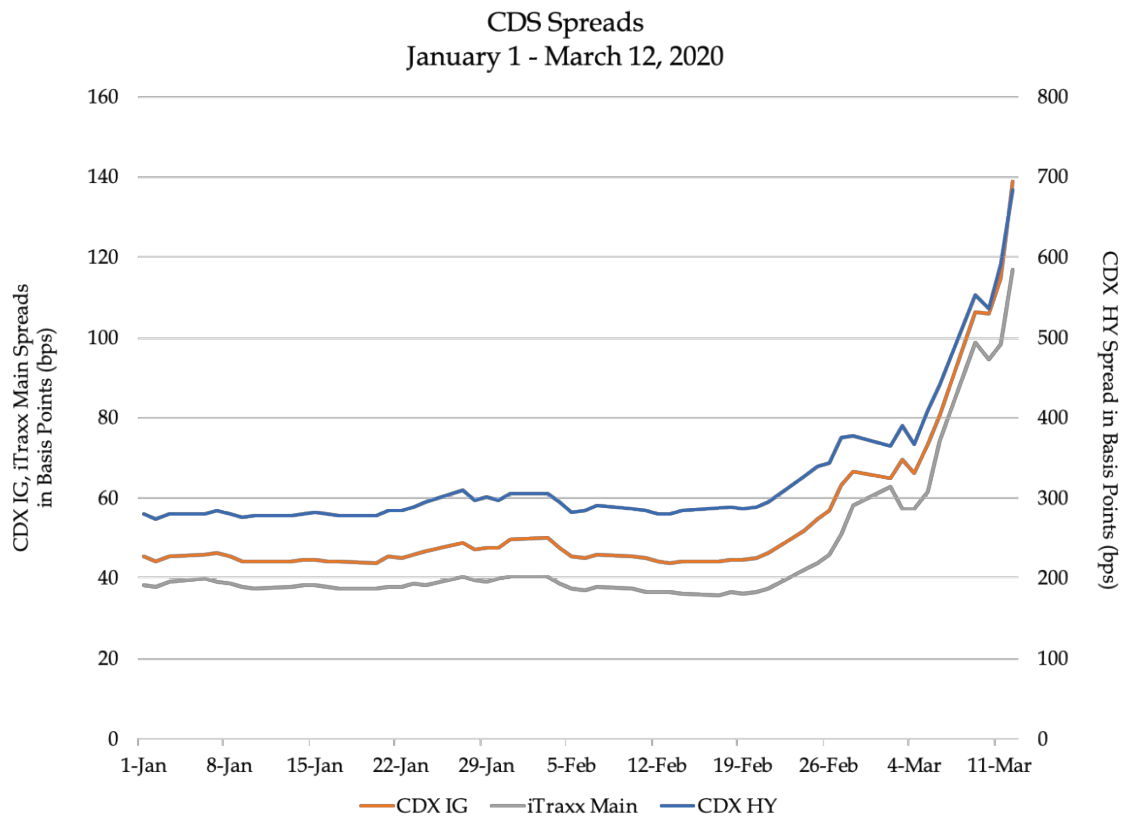
Date	Protection Type	Index Name	CDS Spread (bps)	Notional	Cumulative Notional
24-Feb	Buy Protection	CDX HY	334.25	\$ 2,500,000,000	\$ 2,500,000,000
5-Mar	Buy Protection	CDX HY	396.68	\$ 575,000,000	\$ 3,075,000,000

Date	Protection Type	Index Name	CDS Spread (bps)	Notional	Cumulative Notional
24-Feb	Buy Protection	iTraxx Main	48.06	€ 6,000,000,000	€ 6,000,000,000
26-Feb	Buy Protection	iTraxx Main	52.98	€ 5,000,000,000	€ 11,000,000,000
2-Mar	Buy Protection	iTraxx Main	69.50	€ 5,000,000,000	€ 16,000,000,000
2-Mar	Buy Protection	iTraxx Main	72.50	€ 5,000,000,000	€ 21,000,000,000

Source: Company documents.

Exhibit 2a MSCI World Index Performance YTD

Source: Bloomberg, using ticker MXWO Index. Accessed September 23, 2020.

Exhibit 2b CDS Spreads YTD

Source: Bloomberg, accessed June 16, 2020; Capital IQ, accessed September 14, 2020; author's calculations.