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The pricing of callable preferred stock

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Abstract

In this study, the authors use both the Black/Scholes European option model and the Barone-Adesi/Whaley American option model to estimate call option values implicit in seasoned callable preferred stock issues. Consistent with the finding that call features increase bond yields, a significant relationship is found between estimated option values and discounts of these securities' market prices from their estimated income values. However, the size of the discount is only a fraction of what would be predicted by the American option model. Specifically, the market does not appear to take the "early exercise premium" into account. Furthermore, this discount seems to be isolated to in-the-money call features that have evolved to their final call price. Thus, incorporation of a call feature into a security's indentures, with a deferment period and an initial premium call price, appears to represent a pure gain for the issuing corporation.



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