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Valuing callable convertible bonds: a reduced approach

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Abstract

This paper analyses the pricing of corporate callable convertible bonds. It reconciles the applicability of the reduced form approach with optimal strategies usually discussed in the structural approach. One demonstrates that some conditions causing rational voluntary conversions may be effectively neglected. The main contribution of the paper is to show that adjusted American Capped Call options well duplicate ‘classical’ optimal strategies. Numerical experiments are then conducted.

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Acknowledgements

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Notes

[1] Neglected in this study.

[2] The conversion premium being defined as the difference between convertible bond price and conversion value.

[3] For a more complete discussion of this point, refer to André and Moraux (2003).

[4] For instance, Ingersoll (1977a,b) has provided evidence that firms wait, on average until the conversion value exceeds the call price by 43.9%. See also Mikkelson (1981), Asquith (1995).

[5] Refer to Rich (1994) and Reiner and Rubinstein (1991) for a complete description of barrier options.

[6] Alternative reduced form models are Jarrow and Turnbull (1995) and Duffie and Singleton (1999). The major advantage of the chosen framework is to take explicitly into account any possible future up/downgrading among the default.

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