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Evidence on the issuer effect in warrant overpricing

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Abstract

Prior literature offers evidence that warrant prices tend to be higher than the prices of matched options. Explanations for warrant overpricing include a liquidity premium, hedging costs, market power and investor perceptions. Each of these explanations suggest that overpricing is likely to be related to the identity of the issuer. Any such issuer effect may also be affected by differences in credit risk. This study reconfirms the existence of a large excess warrant premium and provides evidence that it is significantly related to the identity of the warrant issuer, even after taking into account important liquidity and hedging factors.

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Notes

[1] Institutional details described in this section about warrants and options traded on the ASX are taken from ASX (2000).

[2] Their other two proxies relate to whether trading was floor- or electronic-based and to whether options traders were obliged to make a market. Neither of these distinctions remain relevant in the prices tested in this study.

[3] Results are not sensitive to using the standard deviation over the past 30 days as an alternative measure of volatility. Both volatility measures are similar having a correlation of 0.91. The exponentially-weighted moving average model was chosen as it places higher weight on more recent observations and is therefore likely to be a better measure of current volatility.

[4] $F = (S - d)(1 + r)^{T}$, where S is underlying price, d is present value of cash dividends, r is interest rate and T is time to maturity.

[5] Volumes reported in the market have to be adjusted to be consistent. First the warrant volume is adjusted for the conversion ratio. Second the option volume is adjusted to recognise each contract is for 1000 shares.

[6] These standard errors are heteroscedastic and autocorrelation consistent. Since daily data are being used, excluding weekends, the lag truncation length is set equal to five.