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# The risk-shifting effect and the value of a warrant

Emanuele Bajo & Massimiliano Barbi

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## Notes

§Similarly, the non-stationary nature of stock volatility due to the presence of debt or warrants was also studied by Geske ([1979](#)) and Bensoussan et al. ([1994](#), [1995](#)).

†By ‘leverage effect’ the financial literature refers to a negative correlation between stock prices and volatilities caused by the presence of debt financing (Black [1976](#)).

‡For instance, setting arbitrarily the elasticity parameter to 0.5 would lead to a closed formula for the call price (Beckers [1980](#)).

†The absolute value of the correlation between the asset and the debt is

‡ $N(\cdot)$  denotes the cumulative distribution function of the standard normal distribution.

†To denote the standard deviation of the asset return, we write  $\sigma_s$ .

‡This is true only if the debt is not too large, i.e. if the debt is not greater than the asset value.

§Shown in the Appendix.

¶ $N'(\cdot)$  denotes the probability density function of the standard normal distribution.



⊥ Intuitively, the net effect on  $\epsilon_{\sigma_s, s}^*$  of this substitution is negligible once we recall equation (5). Both of these substitutions ( $s_t$  for  $a_t$  and  $\sigma_s$  for  $\sigma$ ) produce a downward approximation of the variables, which lowers the product  $\sigma a_t$  but also increases the expression in brackets. As a matter of fact, the above-mentioned approximation determines a drop in  $N(d_1)$  (the warrant's delta) due to the decrease in both moneyness and volatility. Hence, the suggested replacement causes two opposite outcomes, whose net effect tends to be insignificant. The analytical expression of the difference between the two elasticities is provided in [appendix A](#).

† This value is also computable through the numerical algorithm proposed by Ukhov (2004). Nevertheless, in our simulation this method is not necessary since we assume that the asset value and its volatility are both known.

‡ We obtain  $a_t$  applying the Newton-Raphson algorithm to the process defined in equation (4).

§ We consider a log-normal distribution of asset values. The moneyness bounds are computed according to the following probability intervals: DOTM [0.01, 0.20), OTM [0.20, 0.45), ATM [0.45, 0.55), ITM [0.55, 0.80), and DITM [0.80, 0.99]. First and last percentiles are excluded to avoid an infinite support.

† Simulations based on different values of  $\sigma$  do not produce significant changes in terms of pricing

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