An Analysis of the Covered Warrants Market in the UK

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Abstract

The covered warrant market in the UK has gained in popularity over time since first launched in 2002. This has opened up an alternative investment choice which offers derivative securities with a life of typically one to two years. It seems to fulfill many of the functions of a traded options market. Since most research has been focused on options trading, the investigation on covered warrants trading is still very limited. This is also largely due to the lack of readily available data for end-traded covered warrants and the existing covered warrants. A unique set of hand-collected data, supplemented by public and private data from main covered warrants issuer and the financial database are employed, making this thesis possible. The sample periods can be divided into two separate sets.

The UK covered warrants trading during the period July 2004 - December 2006 are used to examine the impact of warrant introduction and expiration on the price, volume and volatility of the underlying securities. For the introduction analyses, both the announcement and listing of covered warrants have negative impacts on the price of underlying securities for both call and put features, though the impact of the announcement is more pronounced than that of the listing. These affects are temporary and do not persist much beyond the introduction of the warrants. Negative price impacts of the expiration event are also reported for both call and put covered warrants. However, this study finds no significant impacts on the volume of underlying securities trading from the announcement, listing and expiration of call and put covered warrants. Further evidence indicates an increase in volatility of the underlying securities during the announcement and listing of covered warrants. The results hold true for both call and put warrants cases. On the other hand, a decreasing stock volatility is found as a consequence of the expiration of both call and put covered warrants.

The second data set involves the call covered warrants traded in the UK market between April 2007 and December 2008; this was analysed for evidence of the best appropriate covered warrants pricing model. This study suggests default risk as a major concern for the warrant price which is called the Vulnerable warrant price. The reasons

behind this arise from concern about the issuer's creditworthiness due to traders' fraudulent action and the recent subprime problem, the difficulties of dynamic hedging by issuers because of market imperfections, as well as the no guarantees on covered warrant trading provided by the London Stock Exchange. The most salient findings of the study are the following. The Vulnerable warrant price is generally lower than both the Black-Scholes price and warrant market price throughout the warrant's lifetime. The evidence suggests an overvalued warrant price in the UK market. Moreover, the in-the-money warrants indicate a higher rate of default in comparison to the out-of-the-money warrants. An additional finding shows that the market becomes aware of the default risk only on a short-term basis. The presentation of negative abnormal returns of both market and the Black-Sholes prices support the assumption that default risk is a relevant factor in pricing the UK covered warrants.

These findings add to the literature dealing with the effect of derivatives trading on the underlying securities as well as providing more empirical evidence on a particular covered warrant market. This could be of interest not only for practitioners to widen their investment opportunities but also for regulators to have this as a guideline for their future related policies planning.

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