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APPLICATION OF THE OPTION  
PRICING MODEL TO ESTIMATE  
EXPECTED STOCK RETURNS

A thesis presented in partial fulfilment  
of the requirements for the degree of

Master of Business Studies  
in  
Finance

at Massey University,  
Palmerston North,  
New Zealand

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2002

## ABSTRACT

### APPLICATION OF THE OPTION PRICING MODEL TO ESTIMATE EXPECTED STOCK RETURNS

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2002

This thesis refines and tests an option-based methodology for estimating the expected rate of return on firms' equity, being an approach proposed by Hsia (1991). Hsia's approach is based on an option-theoretic model of the firm, as proposed by Merton (1974) and others. Tests of the Hsia approach are thus joint tests of the Merton model and of the Hsia approach. The Merton model is successfully fitted in its basic form by solving for firm asset volatility and, consistent with prior studies, the implied volatility for firms' assets is found, on average, to be higher than that expected from examining historical equity volatility. The Hsia-based expected excess returns on equity are then estimated and tested in regressions against realised excess stock returns. The Hsia-based expected excess returns are found to be only weakly, positively associated with realised excess returns, and not of statistical significance. When the sample is split in half on the basis of various option-like characteristics (such as higher gearing), the Hsia approach is found to work better for the more option-like sub-sample. This research thus provides some tentative support for the Hsia approach, but does not provide a clear conclusion about its ability to explain the variation in realised excess stock returns. It also provides some ideas and possible directions for further research into applying the Hsia approach.

## ACKNOWLEDGMENTS

The author wishes to acknowledge the assistance and support of his supervisors, Dr Andy Prevost and Mr Chris Malone. In particular the invaluable assistance provided by Dr Prevost in obtaining the data to enable this study to be undertaken on a meaningful sample size.

I would also like to acknowledge the support of my employer, PricewaterhouseCoopers, in particular Messrs Murray Coppersmith, Roger France, Eric Lucas and Bruce Wattie who have all encouraged my research interest in financial economics.

Finally, I must sincerely thank my wife and children for their support, tolerance and understanding while I have undertaken this research.

Any errors in this thesis are solely the author's responsibility.

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## GLOSSARY

<i>A</i>	aggregate annual debt service charges of the firm
<i>B</i>	value of the firm's debt
<b>CAPM</b>	Capital Asset Pricing Model
<b>CBOE</b>	Chicago Board Options Exchange
<b>CBOT</b>	Chicago Board of Trade Options Exchange
<i>d</i>	Merton "quasi" debt-to-firm ratio
<i>D</i>	debt servicing as a percentage of the value of the firm's assets
<b>FRB</b>	US Federal Reserve Board
<i>i</i>	yield on the firm's debt
<i>k<sub>B</sub></i>	expected rate of return on the firm's debt
<i>k<sub>S</sub></i>	expected rate of return on the firm's equity
<i>k<sub>V</sub></i>	expected rate of return on the firm's assets
<i>m</i>	borrowing margin
<i>μ</i>	instantaneous rate of return on the firm's assets
<b>MLHYM</b>	Merrill Lynch High Yield Master II corporate bond index
<b>MM</b>	Modigliani and Miller
<b>N(.)</b>	cumulative probability of the standard normal distribution
<b>OPM</b>	Option Pricing Model
<i>r</i>	risk-free rate of interest
<i>σ<sub>S</sub></i>	standard deviation of rates of return on the firm's equity
<i>σ<sub>V</sub></i>	standard deviation of rates of return on the firm's assets
<b>S</b>	value of the firm's equity
<b>T</b>	time to maturity
<b>V</b>	value of the firm's assets
<b>X</b>	face value of the firm's debt, at maturity