

$$\text{investment value premium} = \frac{\text{market price} - \text{investment value}}{\text{investment value}} \quad [3]$$

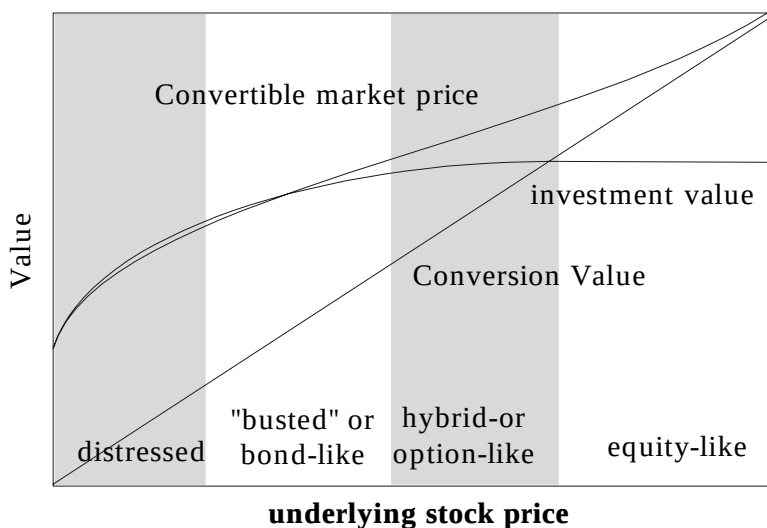
$$\text{conversion value premium} = \frac{\text{market price} - \text{conversion value}}{\text{conversion value}} \quad [4]$$

The net surplus is the gain in the arbitration process.

4.2.10 Obviously, both premiums should be positive.

4.2.11 Exhibit 1 illustrates how a convertible's market price depends upon the underlying stock price. Both the investment value and conversion value are plotted. The investment value is fairly flat at higher stock prices but drops off as the stock price falls. This reflects the fact that the credit quality of the issuer is likely to fall with a marked decline in the stock price. The conversion value is a simple linear function of stock price. The convertible's market price is also plotted.

Price Behavior of a Convertible Security
Exhibit 1



4.2.12 Convertible securities exhibit four different modes of behavior depending on the level of the underlying stock price and the credit quality of the issuer. Practitioners tend to distinguish between four modes of behavior of a convertible bond, depending upon the level of the underlying stock and the issuer's credit quality. Usage is hardly standardized, but we may distinguish between the following modes of behavior. These are also indicated in Exhibit 1:

- distressed
- busted
- hybrid-like, and
- equity-like