Bachelor-Thesis

Has the ability of Merton's option pricing model to predict default risk changed in the 21^{st} century? - Especially what happened after 2007?

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Abstract

The purpose of this study is to investigate whether the relationship between equity returns and default risk modeled through Merton's option pricing model has changed in present times. To examine possible changes the relationship is tested through correlation tests and Fama-French regression. Furthermore equity returns in portfolios sorted on a default risk basis are examined. The results indicate that there has been a small increase in strength of the relationship between equity returns and default risk. On top of that it is shown that very high default risk affects equity returns equally regardless of firm characteristics.

Keywords: Default Risk, Equity Returns, Merton's (1974) Model, Firm Characteristics