

Contents

Preface	vii
1 Introduction to Derivative Instruments	1
1.1 Financial Options and Their Trading Strategies	2
1.1.1 Trading Strategies Involving Options	5
1.2 Rational Boundaries for Option Values	10
1.2.1 Effects of Dividend Payments	16
1.2.2 Put-Call Parity Relations	18
1.2.3 Foreign Currency Options	19
1.3 Forward and Futures Contracts	21
1.3.1 Values and Prices of Forward Contracts	21
1.3.2 Relation between Forward and Futures Prices	24
1.4 Swap Contracts	25
1.4.1 Interest Rate Swaps	26
1.4.2 Currency Swaps	28
1.5 Problems	29
2 Financial Economics and Stochastic Calculus	35
2.1 Single Period Securities Models	36
2.1.1 Dominant Trading Strategies and Linear Pricing Measures ..	37
2.1.2 Arbitrage Opportunities and Risk Neutral Probability	
Measures	43
2.1.3 Valuation of Contingent Claims	48
2.1.4 Principles of Binomial Option Pricing Model	52
2.2 Filtrations, Martingales and Multiperiod Models	55
2.2.1 Information Structures and Filtrations	56
2.2.2 Conditional Expectations and Martingales	58
2.2.3 Stopping Times and Stopped Processes	62
2.2.4 Multiperiod Securities Models	64
2.2.5 Multiperiod Binomial Models	69

2.3	Asset Price Dynamics and Stochastic Processes	72
2.3.1	Random Walk Models	73
2.3.2	Brownian Processes	76
2.4	Stochastic Calculus: Ito's Lemma and Girsanov's Theorem	79
2.4.1	Stochastic Integrals	79
2.4.2	Ito's Lemma and Stochastic Differentials	82
2.4.3	Ito's Processes and Feynman–Kac Representation Formula	85
2.4.4	Change of Measure: Radon–Nikodym Derivative and Girsanov's Theorem	87
2.5	Problems	89
3	Option Pricing Models: Black–Scholes–Merton Formulation	99
3.1	Black–Scholes–Merton Formulation	101
3.1.1	Riskless Hedging Principle	101
3.1.2	Dynamic Replication Strategy	104
3.1.3	Risk Neutrality Argument	106
3.2	Martingale Pricing Theory	108
3.2.1	Equivalent Martingale Measure and Risk Neutral Valuation	109
3.2.2	Black–Scholes Model Revisited	112
3.3	Black–Scholes Pricing Formulas and Their Properties	114
3.3.1	Pricing Formulas for European Options	115
3.3.2	Comparative Statics	121
3.4	Extended Option Pricing Models	127
3.4.1	Options on a Dividend-Paying Asset	127
3.4.2	Futures Options	132
3.4.3	Chooser Options	135
3.4.4	Compound Options	136
3.4.5	Merton's Model of Risky Debts	139
3.4.6	Exchange Options	142
3.4.7	Equity Options with Exchange Rate Risk Exposure	144
3.5	Beyond the Black–Scholes Pricing Framework	147
3.5.1	Transaction Costs Models	149
3.5.2	Jump-Diffusion Models	151
3.5.3	Implied and Local Volatilities	153
3.5.4	Stochastic Volatility Models	159
3.6	Problems	164
4	Path Dependent Options	181
4.1	Barrier Options	182
4.1.1	European Down-and-Out Call Options	183
4.1.2	Transition Density Function and First Passage Time Density	188
4.1.3	Options with Double Barriers	195
4.1.4	Discretely Monitored Barrier Options	201

4.2	Lookback Options	201
4.2.1	European Fixed Strike Lookback Options	203
4.2.2	European Floating Strike Lookback Options	205
4.2.3	More Exotic Forms of European Lookback Options	207
4.2.4	Differential Equation Formulation	209
4.2.5	Discretely Monitored Lookback Options	211
4.3	Asian Options	212
4.3.1	Partial Differential Equation Formulation	213
4.3.2	Continuously Monitored Geometric Averaging Options ...	214
4.3.3	Continuously Monitored Arithmetic Averaging Options ...	217
4.3.4	Put-Call Parity and Fixed-Floating Symmetry Relations ...	219
4.3.5	Fixed Strike Options with Discrete Geometric Averaging ...	222
4.3.6	Fixed Strike Options with Discrete Arithmetic Averaging ...	225
4.4	Problems	230
5	American Options	251
5.1	Characterization of the Optimal Exercise Boundaries	253
5.1.1	American Options on an Asset Paying Dividend Yield ...	253
5.1.2	Smooth Pasting Condition	255
5.1.3	Optimal Exercise Boundary for an American Call	256
5.1.4	Put-Call Symmetry Relations	260
5.1.5	American Call Options on an Asset Paying Single Dividend	263
5.1.6	One-Dividend and Multidividend American Put Options ...	267
5.2	Pricing Formulations of American Option Pricing Models	270
5.2.1	Linear Complementarity Formulation	270
5.2.2	Optimal Stopping Problem	272
5.2.3	Integral Representation of the Early Exercise Premium ...	274
5.2.4	American Barrier Options	278
5.2.5	American Lookback Options	280
5.3	Analytic Approximation Methods	282
5.3.1	Compound Option Approximation Method	283
5.3.2	Numerical Solution of the Integral Equation	284
5.3.3	Quadratic Approximation Method	287
5.4	Options with Voluntary Reset Rights	289
5.4.1	Valuation of the Shout Floor	290
5.4.2	Reset-Strike Put Options	292
5.5	Problems	297
6	Numerical Schemes for Pricing Options	313
6.1	Lattice Tree Methods	315
6.1.1	Binomial Model Revisited	315
6.1.2	Continuous Limits of the Binomial Model	316
6.1.3	Discrete Dividend Models	320
6.1.4	Early Exercise Feature and Callable Feature	322

6.1.5	Trinomial Schemes	323
6.1.6	Forward Shooting Grid Methods	327
6.2	Finite Difference Algorithms	332
6.2.1	Construction of Explicit Schemes	333
6.2.2	Implicit Schemes and Their Implementation Issues	337
6.2.3	Front Fixing Method and Point Relaxation Technique	340
6.2.4	Truncation Errors and Order of Convergence	344
6.2.5	Numerical Stability and Oscillation Phenomena	346
6.2.6	Numerical Approximation of Auxiliary Conditions	349
6.3	Monte Carlo Simulation	352
6.3.1	Variance Reduction Techniques	355
6.3.2	Low Discrepancy Sequences	358
6.3.3	Valuation of American Options	359
6.4	Problems	369
7	Interest Rate Models and Bond Pricing	381
7.1	Bond Prices and Interest Rates	382
7.1.1	Bond Prices and Yield Curves	383
7.1.2	Forward Rate Agreement, Bond Forward and Vanilla Swap	384
7.1.3	Forward Rates and Short Rates	387
7.1.4	Bond Prices under Deterministic Interest Rates	389
7.2	One-Factor Short Rate Models	390
7.2.1	Short Rate Models and Bond Prices	391
7.2.2	Vasicek Mean Reversion Model	396
7.2.3	Cox–Ingersoll–Ross Square Root Diffusion Model	397
7.2.4	Generalized One-Factor Short Rate Models	399
7.2.5	Calibration to Current Term Structures of Bond Prices	400
7.3	Multifactor Interest Rate Models	403
7.3.1	Short Rate/Long Rate Models	404
7.3.2	Stochastic Volatility Models	407
7.3.3	Affine Term Structure Models	408
7.4	Heath–Jarrow–Morton Framework	411
7.4.1	Forward Rate Drift Condition	413
7.4.2	Short Rate Processes and Their Markovian Characterization	414
7.4.3	Forward LIBOR Processes under Gaussian HJM Framework	418
7.5	Problems	420
8	Interest Rate Derivatives: Bond Options, LIBOR and Swap Products	441
8.1	Forward Measure and Dynamics of Forward Prices	443
8.1.1	Forward Measure	443
8.1.2	Pricing of Equity Options under Stochastic Interest Rates ...	446
8.1.3	Futures Process and Futures-Forward Price Spread	448

8.2	Bond Options and Range Notes	450
8.2.1	Options on Discount Bonds and Coupon-Bearing Bonds . . .	450
8.2.2	Range Notes	457
8.3	Caps and LIBOR Market Models	460
8.3.1	Pricing of Caps under Gaussian HJM Framework	461
8.3.2	Black Formulas and LIBOR Market Models	462
8.4	Swap Products and Swaptions	468
8.4.1	Forward Swap Rates and Swap Measure	469
8.4.2	Approximate Pricing of Swaption under Lognormal LIBOR Market Model	473
8.4.3	Cross-Currency Swaps	477
8.5	Problems	485
References		507
Author Index		517
Subject Index		521