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This book explains in simple settings the fundamental ideas of financial market modelling and derivative pricing, using the No Arbitrage Principle. Relatively elementary mathematics leads to powerful notions and techniques – such as viability, completeness, self-financing and replicating strategies, arbitrage and equivalent martingale measures – which are directly applicable in practice. The general methods are applied in detail to pricing and hedging European and American options within the Cox–Ross–Rubinstein (CRR) binomial tree model. A simple approach to discrete interest rate models is included, which, though elementary, has some novel features. All proofs are written in a user-friendly manner, with each step carefully explained, and following a natural flow of thought. In this way the student learns how to tackle new problems.

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Discrete Models of Financial Markets

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Contents

Preface  ix

1 Introduction  1

2 Single-step asset pricing models  3
  2.1 Single-step binomial tree  4
  2.2 Option pricing  8
  2.3 General derivative securities  11
  2.4 Two underlying securities  18
  2.5 The trinomial model  21
  2.6 A general single-step model  34
  2.7 General properties of derivative prices  42
  2.8 Proofs  45

3 Multi-step binomial model  48
  3.1 Two-step example  48
  3.2 Partitions and information  55
  3.3 Martingale properties  60
  3.4 The Cox–Ross–Rubinstein model  64
  3.5 Delta hedging  70

4 Multi-step general models  72
  4.1 Partitions and conditioning  72
  4.2 Properties of conditional expectation  74
  4.3 Filtrations and martingales  78
  4.4 Trading strategies and arbitrage  81
  4.5 A general multi-step model  86
  4.6 The Fundamental Theorems of Asset Pricing  92
  4.7 Selecting and calibrating a pricing model  98
  4.8 More examples of derivatives  100
  4.9 Proofs  108

5 American options  110
  5.1 Pricing  111
  5.2 Stopping times and optimal exercise  116
  5.3 Hedging  122
Contents

5.4 General properties of option prices 127
5.5 Proofs 133

6 Modelling bonds and interest rates 137
  6.1 Zero-coupon bonds 138
  6.2 Forward rates 141
  6.3 Coupon bonds 146
  6.4 Binary tree term structure models 152
  6.5 Short rates 166
  6.6 The Ho–Lee model of term structure 173

Index 180
Preface

In this first volume of the series ‘Mastering Mathematical Finance’ we present discrete-time mathematical models for the pricing and hedging of derivative securities, as well as an initial analysis of fixed income securities. Throughout, the sample space of possible scenarios is assumed to be finite, and there are finitely many trading dates. This greatly reduces the need for sophisticated mathematical tools, while providing sufficient complexity to highlight the key aspects of arbitrage pricing techniques.

Keeping the mathematical requirements to a minimum makes the text accessible to students from a wide variety of backgrounds, while the large number of exercises, which should be regarded as integral to the text, include routine numerical examples and test understanding of basic techniques as well as providing more challenging problems. Solutions and additional exercises are available on the linked website www.cambridge.org/9781107002630, where, if necessary, a list of errata will be updated regularly.

While most of the material is well known, we have sought to develop ideas gradually through simple examples, leading to careful proofs of the key results for option pricing in finite discrete models. While the setting of the final chapter is standard, the discussion of binomial term structure models, though close to the Ho–Lee model, contains features we believe to be novel.