

Contents

<i>Acknowledgments</i>	<i>page xi</i>
Introduction	1
1 Preliminary Mathematics	5
1.1 Random Walk	5
1.2 Another Take on Volatility and Time	8
1.3 A First Glance at Itô's Lemma	9
1.4 Continuous Time: Brownian Motion; More on Itô's Lemma	11
1.5 Two-Dimensional Brownian Motion	14
1.6 Bivariate Itô's Lemma	15
1.7 Three Paradoxes of Finance	16
1.7.1 Paradox 1: Siegel's Paradox	16
1.7.2 Paradox 2: The Stock, Free-Lunch Paradox	18
1.7.3 Paradox 3: The Skill Versus Luck Paradox	19
2 Principles of Financial Valuation	22
2.1 Uncertainty, Utility Theory, and Risk	22
2.2 Risk and the Equilibrium Pricing of Securities	28
2.3 The Binomial Option-Pricing Model	41
2.4 Limiting Option-Pricing Formula	46
2.5 Continuous-Time Models	47
2.5.1 The Black-Scholes/Merton Model – Pricing Kernel Approach	48
2.5.2 The Black-Scholes/Merton Model – Probabilistic Approach	57
2.5.3 The Black-Scholes/Merton Model – Hedging Approach	61

2.6	Exotic Options	63
2.6.1	Digital Options	64
2.6.2	Power Options	65
2.6.3	Asian Options	67
2.6.4	Barrier Options	71
3	Interest Rate Models	78
3.1	Interest Rate Derivatives: Not So Simple	78
3.2	Bonds and Yields	80
3.2.1	Prices and Yields to Maturity	80
3.2.2	Discount Factors, Zero-Coupon Rates, and Coupon Bias	82
3.2.3	Forward Rates	85
3.3	Naive Models of Interest Rate Risk	88
3.3.1	Duration	88
3.3.2	Convexity	99
3.3.3	The Free Lunch in the Duration Model	104
3.4	An Overview of Interest Rate Derivatives	108
3.4.1	Bonds with Embedded Options	109
3.4.2	Forward Rate Agreements	110
3.4.3	Eurostrip Futures	112
3.4.4	The Convexity Adjustment	113
3.4.5	Swaps	118
3.4.6	Caps and Floors	120
3.4.7	Swaptions	121
3.5	Yield Curve Swaps	122
3.5.1	The CMS Swap	122
3.5.2	The Quanto Swap	127
3.6	Factor Models	131
3.6.1	A General Single-Factor Model	131
3.6.2	The Merton Model	135
3.6.3	The Vasicek Model	139
3.6.4	The Cox-Ingersoll-Ross Model	142
3.6.5	Risk-Neutral Valuation	144
3.7	Term-Structure-Consistent Models	147
3.7.1	“Equilibrium” Versus “Fitting”	147
3.7.2	The Ho-Lee Model	153
3.7.3	The Ho-Lee Model with Time-Varying Volatility	157
3.7.4	The Black-Derman-Toy Model	162
3.8	Risky Bonds and Their Derivatives	166
3.8.1	The Merton Model	167
3.8.2	The Jarrow-Turnbull Model	168

Contents

ix

3.9	The Heath, Jarrow, and Morton Approach	172
3.10	Interest Rates as Options	180
4	Mathematics of Asset Pricing	184
4.1	Random Walks	184
4.1.1	Description	184
4.1.2	Gambling Recreations	186
4.2	Arithmetic Brownian Motion	192
4.2.1	Arithmetic Brownian Motion as a Limit of a Simple Random Walk	192
4.2.2	Moments of an Arithmetic Brownian Motion	196
4.2.3	Why Sample Paths Are Not Differentiable	198
4.2.4	Why Sample Paths Are Continuous	198
4.2.5	Extreme Values and Hitting Times	199
4.2.6	The Arcsine Law Revisited	203
4.3	Geometric Brownian Motion	204
4.3.1	Description	204
4.3.2	Moments of a Geometric Brownian Motion	207
4.4	Itô Calculus	209
4.4.1	Riemann-Stieljes, Stratonovitch, and Itô Integrals	209
4.4.2	Itô's Lemma	214
4.4.3	Multidimensional Itô's Lemma	222
4.5	Mean-Reverting Processes	225
4.5.1	Introduction	225
4.5.2	The Ornstein-Uhlenbeck Process	225
4.5.3	Calculations of Moments with the Dynkin Operator	226
4.5.4	The Square-Root Process	228
4.6	Jump Process	229
4.6.1	Pure Jumps	229
4.6.2	Time Between Two Jumps	231
4.6.3	Jump Diffusions	232
4.6.4	Itô's Lemma for Jump Diffusions	233
4.7	Kolmogorov Equations	234
4.7.1	The Kolmogorov Forward Equation	234
4.7.2	The Dirac Delta Function	236
4.7.3	The Kolmogorov Backward Equation	236
4.8	Martingales	239
4.8.1	Definitions and Examples	239
4.8.2	Some Useful Facts About Martingales	241
4.8.3	Martingales and Brownian Motion	242

4.9	Dynamic Programming	245
4.9.1	The Traveling Salesman	245
4.9.2	Optimal Control of Itô Processes: Finite Horizon	247
4.9.3	Optimal Control of Itô Processes: Infinite Horizon	248
4.10	Partial Differential Equations	253
4.10.1	The Kolmogorov Forward Equation Revisited	253
4.10.2	Risk-Neutral Pricing Equation	256
4.10.3	The Laplace Transform	257
4.10.4	Resolution of the Kolmogorov Forward Equation	262
4.10.5	Resolution of the Risk-Neutral Pricing Equation	265
	<i>Bibliography</i>	269
	<i>Index</i>	327