
Contents

1	Introduction	1
1.1	No Arbitrage and Its Consequences	1
1.2	Exercises	11
2	The Binomial Model for Stock Options	13
2.1	The Basic Model	13
2.2	Why Is π Called a Risk Neutral Probability?	21
2.3	More on Arbitrage	24
2.4	The Model of Cox-Ross-Rubinstein	25
2.5	Call-Put Parity Formula	27
2.6	Non Arbitrage Inequalities	29
2.7	Exercises	34
3	The Binomial Model for Other Contracts	41
3.1	Forward Contracts	41
3.2	Contingent Premium Options	43
3.3	Exchange Rates	45
3.4	Interest Rate Derivatives	55
3.5	Exercises	61
4	Multiperiod Binomial Models	65
4.1	The Labelling of the Nodes	65
4.2	The Labelling of the Processes	65
4.3	Generalized Quantities	66

4.4	Generalized Backward Induction Pricing Formula	67
4.5	Pricing European Style Contingent Claims	68
4.6	The CRR Multiperiod Model	68
4.7	Jamshidian's Forward Induction Formula	69
4.8	Application to CRR Model	71
4.9	The CRR Option Pricing Formula	73
4.10	Discussion of the CRR Formula	75
4.11	Exercises	78
5	Hedging	81
5.1	Hedging	81
5.2	Exercises	88
6	Forward and Futures Contracts	89
6.1	The Forward Contract	89
6.2	The Futures Contract	90
6.3	Exercises	96
7	American and Exotic Option Pricing	97
7.1	American Style Options	97
7.2	Barrier Options	99
7.3	Examples of the Application of Barrier Options	102
7.4	Exercises	106
8	Path-Dependent Options	109
8.1	Notation for Non-Recombining Trees	109
8.2	Asian Options	110
8.3	Floating Strike Options	112
8.4	Lookback Options	113
8.5	More on Average Rate Options	114
8.6	Exercises	118

9 The Greeks 121

9.1 The Delta (Δ) of an Option 121

9.2 The Gamma (Γ) of an Option 123

9.3 The Theta (Θ) of an Option 124

9.4 The Vega (κ) of an Option 125

9.5 The Rho (ρ) of an Option 125

9.6 Exercises 126

10 Dividends 127

10.1 Some Basic Results about Forwards 128

10.2 Dividends as Percentage of Spot Price 129

10.3 Binomial Trees with Known Dollar Dividends 132

10.4 Exercises 134

11 Implied Volatility Trees 135

11.1 The Recursive Calculation 136

11.2 The Inputs V^{put} and V^{call} 138

11.3 A Simple Smile Example 141

11.4 In General 144

11.5 The Barle and Cakici Approach 145

11.6 Exercises 149

12 Implied Binomial Trees 153

12.1 The Inputs 153

12.2 Time T Risk-Neutral Probabilities 154

12.3 Constructing the Binomial Tree 155

12.4 A Basic Theorem and Applications 158

12.5 Choosing Time T Data 161

12.6 Some Proofs and Discussion 164

12.7 Jackwerth's Extension 168

12.8 Exercises 170

13 Interest Rate Models	171
13.1 $P(0, T)$ from Treasury Data	172
13.2 $P(0, T)$ from Bank Data	174
13.3 The Ho and Lee Model	184
13.4 The Pedersen, Shiu and Thorlacius Model	189
13.5 The Morgan and Neave Model	191
13.6 The Black, Derman and Toy Model	193
13.7 Defaultable Bonds	205
13.8 Exercises	205
14 Real Options	209
14.1 Examples	210
14.2 Options on Non-Tradeable Assets	214
14.3 Correlation with Tradeable Assets	229
14.4 Approximate Methods	233
14.5 Exercises	235
A The Binomial Distribution	237
A.1 Bernoulli Random Variables	237
A.2 Bernoulli Trials	239
A.3 Binomial Distribution	239
A.4 Central Limit Theorem (CLT)	243
A.5 Berry-Esséen Theorem	245
A.6 Complementary Binomials and Normals	246
A.7 CRR and the Black and Scholes Formula	247
B An Application of Linear Programming	249
B.1 Incomplete Markets	250
B.2 Solutions to Incomplete Markets	251
B.3 The Duality Theorem of Linear Programming	253
B.4 The First Fundamental Theorem of Finance	257
B.5 The Duality Theorem	261
B.6 The Second Fundamental Theorem of Finance	264
B.7 Transaction Costs	266

C Volatility Estimation 269

 C.1 Historical Volatility Estimation 270

 C.2 Implied Volatility Estimation 272

 C.3 Exercises 278

D Existence of a Solution 279

 D.1 Farkas' Lemma 279

 D.2 An Application to the Problem 281

E Some Generalizations 285

 E.1 Preliminary Observations 285

 E.2 Solution to System in van der Hoek's Method 287

 E.3 Exercises 288

F Yield Curves and Splines 289

 F.1 An Alternative representation of Function (F.1) 290

 F.2 Imposing Smoothness 291

 F.3 Unknown Coefficients 291

 F.4 Observations 292

 F.5 Determination of Unknown Coefficients 293

 F.6 Forward Interest Rates 295

 F.7 Yield Curve 296

 F.8 Other Issues 296

References 297

Index 301