

Contents

1. Derivative Background	1
1.1 Financial Markets and Instruments	2
1.1.1 Derivative Instruments	2
1.1.2 Underlying securities	4
1.1.3 Markets	5
1.1.4 Types of Traders	6
1.1.5 Modelling Assumptions	7
1.2 Arbitrage	8
1.3 Arbitrage Relationships	11
1.3.1 Fundamental Determinants of Option Values	11
1.3.2 The Put-Call Parity	13
1.3.3 Arbitrage Bounds	16
1.4 Single-Period Market Models	20
Exercises	30
2. Probability Background	33
2.1 Measure	34
2.2 Integral	38
2.3 Probability	41
2.4 Equivalent Measures and Radon-Nikodým Derivatives	47
2.5 Conditional Expectations	48
2.6 Properties of Conditional Expectation	51
2.7 Modes of Convergence	53
2.8 Convolution and Characteristic Functions	56
2.9 The Central Limit Theorem	60
Exercises	63
3. Stochastic Processes in Discrete Time	67
3.1 Information and Filtrations	67
3.2 Discrete-Parameter Stochastic Processes	68
3.3 Discrete-Parameter Martingales	70
3.3.1 Definition and Simple Properties	70
3.3.2 Martingale Convergence	72
3.3.3 Doob Decomposition	73

3.4	Martingale Transforms	73
3.5	Stopping Times and Optional Stopping	75
3.6	The Snell Envelope	78
	Exercises	80
4.	Mathematical Finance in Discrete Time	83
4.1	The Model	83
4.2	Existence of Equivalent Martingale Measures	87
4.2.1	The No-Arbitrage Condition	87
4.2.2	Risk-Neutral Pricing	93
4.3	Complete Markets	96
4.4	Risk-Neutral Valuation	100
4.5	The Cox-Ross-Rubinstein Model	103
4.5.1	Model Structure	103
4.5.2	Risk-Neutral Pricing	105
4.5.3	Hedging	108
4.5.4	Comparison With the General Arbitrage Bounds	110
4.6	Binomial Approximations	111
4.6.1	Model Structure	112
4.6.2	The Black-Scholes Option Pricing Formula	113
4.6.3	Further Limiting Models	118
4.7	Multifactor Models	121
4.7.1	Extended Binomial Model	121
4.7.2	Multinomial Models	122
4.8	Further Contingent Claim Valuation in Discrete Time	123
4.8.1	American Options	123
4.8.2	Barrier Options	126
4.8.3	Lookback Options	127
4.8.4	A Three-Period Example	128
	Exercises	130
5.	Stochastic Processes in Continuous Time	133
5.1	Filtrations; Finite-Dimensional Distributions	133
5.2	Classes of Processes	134
5.3	Brownian Motion	138
5.4	Quadratic Variation of Brownian Motion	141
5.5	Stochastic Integrals; Itô Calculus	144
5.6	Itô's Lemma	149
5.6.1	Geometric Brownian Motion	152
5.7	Stochastic Differential Equations	154
5.8	Stochastic Calculus for Black-Scholes Models	157
5.9	Weak Convergence of Stochastic Processes	161
5.9.1	The Spaces C^d and D^d	161
5.9.2	Definition and Motivation	162
5.9.3	Basic Theorems of Weak Convergence	164

5.9.4 Weak Convergence Results for Stochastic Integrals	165
Exercises	167
6. Mathematical Finance in Continuous Time	171
6.1 Continuous-time Financial Market Models	171
6.1.1 The Financial Market Model	171
6.1.2 Equivalent Martingale Measures	174
6.1.3 Risk-neutral Pricing	177
6.1.4 Changes of Numéraire	180
6.2 The Generalised Black-Scholes Model	184
6.2.1 The Model	184
6.2.2 Pricing and Hedging Contingent Claims	192
6.2.3 The Greeks	195
6.2.4 Volatility	197
6.3 Further contingent claim valuation	199
6.3.1 American Options	199
6.3.2 Asian Options	202
6.3.3 Barrier Options	204
6.3.4 Lookback Options	207
6.3.5 Binary Options	210
6.4 Discrete- vs. Continuous-Time Models	211
6.4.1 Convergence Reconsidered	211
6.4.2 Finite Market Approximations	212
6.4.3 Examples of Finite Market Approximations	214
6.5 Further Applications	221
6.5.1 Futures Markets	221
6.5.2 Currency Markets	224
Exercises	226
7. Incomplete Markets	229
7.1 Pricing in Incomplete Markets	229
7.1.1 A General Option Pricing Formula	229
7.1.2 The Esscher Measure	232
7.2 Hedging in Incomplete Markets	235
7.2.1 Variance Minimising Hedging	235
7.2.2 Risk-Minimising Hedging	239
7.3 Stochastic Volatility Models	241
8. Interest Rate Theory	245
8.1 The Bond Market	246
8.1.1 The Term Structure of Interest Rates	246
8.1.2 Mathematical Modelling	247
8.1.3 Bond Pricing,	252
8.2 Short Rate Models	254
8.2.1 The Term Structure Equation	255

8.2.2 Martingale Modelling	256
8.2.3 Parameter Estimation.....	260
8.3 Heath-Jarrow-Morton Methodology	262
8.3.1 The Heath-Jarrow-Morton Model Class	262
8.3.2 Forward Risk-Neutral Martingale Measures	265
8.3.3 Completeness	267
8.4 Pricing and Hedging Contingent Claims	268
8.4.1 Short Rate Models	268
8.4.2 Gaussian HJM Framework	269
8.4.3 Swaps	271
8.4.4 Caps.....	272
Exercises	274
A. Hilbert Space	277
B. Projections and Conditional Expectations	279
C. The Separating Hyperplane Theorem	281
Bibliography	283
Index	293