Contents

	List o	f Business Snapshots	xvii	
	List of Technical Notes xvii			
	Prefa	ce	xix	
Chapter 1.	1.1 1.2 1.3 1.4 1.5 1.6 1.7 1.8 1.9	luction Exchange-traded markets Over-the-counter markets Forward contracts Futures contracts Options Types of traders. Hedgers. Speculators Arbitrageurs	1 2 6 6 9	
	1.10	Dangers Summary Further reading Questions and problems Assignment questions	. 16 . 16 . 16	
Chapter 2.		anics of futures markets		
	2.1 2.2	Background	. 23	
	2.3	Convergence of futures price to spot price		
	2.4	Daily settlement and margins Newspaper quotes		
	2.6	Delivery		
	2.7	Types of traders and types of orders	. 35	
	2.8	Regulation		
	2.9	Accounting and tax		
	2.10	Forward vs. futures contracts		
		Summary		
		Further reading		
		Questions and problems Assignment questions		
Chapter 3.	Hedgi	ing strategies using futures		
	3.1	Basic principles	. 45	
	3.2	Arguments for and against hedging		
	3.3	Basis risk		
	3.4	Cross hedging	. 54	

	3.5	Stock index futures	. 59
	3.6	Rolling the hedge forward	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
		Appendix: Proof of the minimum variance hedge ratio formula	. 71
Chapter 4.	Intere	est rates	
Chapter 4.	4.1	Types of rates	
	4.2	Measuring interest rates	
	4.3	Zero rates	
	4.4	Bond pricing	
	4.5	Determining Treasury zero rates	
	4.6	Forward rates	
	4.7	Forward rate agreements	
	4.8	Duration	
	4.9	Convexity	
	4.10	Theories of the term structure of interest rates	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
Chapter 5.	Deter	mination of forward and futures prices	. 99
	5.1	Investment assets vs. consumption assets	99
	5.2	Short selling	99
	5.3	Assumptions and notation	101
	5.4	Forward price for an investment asset	101
	5.5	Known income	104
	5.6	Known yield	107
	5.7	Valuing forward contracts	107
	5.8	Are forward prices and futures prices equal?	109
	5.9	Futures prices of stock indices	
	5.10	Forward and futures contracts on currencies	
	5.11	Futures on commodities	115
	5.12	The cost of carry	
	5.13	Delivery options	
	5.14	Futures prices and the expected future spot price	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
		Appendix: Proof that forward and futures prices are equal when interest	
		rates are constant	126
Chapter 6.	Intor		
Chapter 0.	6.1	est rate futures	
	6.2	Treasury bond futures	
	6.3	Eurodollar futures	
	6.4	Duration-based hedging strategies using futures	
	6.5	Hedging portfolios of assets and liabilities	
	0.5		
		Summary Further reading.	
		ruither readiliz	144

		Questions and problems	. 144
		Assignment questions	. 146
Chapter 7.	Swaps	s	. 147
F	7.1	Mechanics of interest rate swaps	
	7.2	Day count issues	
	7.3	Confirmations	
	7.4	The comparative-advantage argument	
	7.5	The nature of swap rates	. 158
	7.6	Determining the LIBOR/swap zero rates	
	7.7	Valuation of interest rate swaps	. 159
	7.8	Currency swaps	. 163
	7.9	Valuation of currency swaps	. 166
	7.10	Credit risk	
	7.11	Other types of swaps	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	. 176
Chapter 8.	Mech	anics of options markets	. 179
	8.1	Types of options	. 179
	8.2	Option positions	
	8.3	Underlying assets	
	8.4	Specification of stock options	
	8.5	Trading	
	8.6	Commissions	
	8.7	Margins	
	8.8	The options clearing corporation	
	8.9	Regulation	
	8.10	Taxation	
	8.11	Warrants, employee stock options, and convertibles	
	8.12	Over-the-counter markets	
		Summary	
		Further reading	
		Questions and problems Assignment questions	
~ 1		•	
Chapter 9.		rties of stock options	
	9.1	Factors affecting option prices	
	9.2	Assumptions and notation	
	9.3	Upper and lower bounds for option prices	
	9.4 9.5	Put-call parity Early exercise: calls on a non-dividend-paying stock	. 208
	9.5 9.6		
	9.7	Early exercise: puts on a non-dividend-paying stock	
	9.7	Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
Charle 10	mc		
Chapter 10.		ng strategies involving options	
	10.1 10.2	Strategies involving a single option and a stock	
	10.2	Spreads	230

	10.4	Other payoffs	233
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
Chapter 11.	Binom	ial trees	
	11.1	A one-step binomial model and a no-arbitrage argument	
	11.2	Risk-neutral valuation.	
	11.3	Two-step binomial trees	
	11.4	A put example	245
	11.5	American options	246
	11.6	Delta	247
	11.7	Matching volatility with u and d	248
	11.8	Increasing the number of steps	251
	11.9	Options on other assets	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
Chapter 12.		r processes and Itô's lemma	
	12.1	The Markov property	
	12.2	Continuous-time stochastic processes	
	12.3	The process for a stock price	
	12.4	The parameters	268
	12.5	Itô's lemma	269
	12.6	The lognormal property	270
		Summary	271
		Further reading	272
		Questions and problems	272
		Assignment questions	273
		Appendix: Derivation of Itô's lemma	275
C1 . 12	Œ B		
Chapter 13.		lack-Scholes-Merton model	
	13.1	Lognormal property of stock prices	277
	13.2	The distribution of the rate of return	
	13.3	The expected return	
	13.4	Volatility	
	13.5	The idea underlying the Black-Scholes-Merton differential equation	
	13.6	Derivation of the Black-Scholes-Merton differential equation	
	13.7	Risk-neutral valuation	
	13.8	Black-Scholes pricing formulas	
	13.9	Cumulative normal distribution function	
		Warrants and employee stock options	
		Implied volatilities	
	13.12	Dividends	298
		Summary	
		Further reading	302
		Questions and problems	
		Assignment questions	
		Appendix: Proof of the Black-Scholes-Merton formula	

14.1 Contractual arrangements. 311 14.2 Do options align the interests of shareholders and managers? 313 14.3 Accounting issues 314 14.4 Valuation 316 14.5 Backdating scandals 320 Summary 321 Further reading 322 Questions and problems 322 Questions and problems 323 Assignment questions 323 Chapter 15. Options on stock indices and currencies 325 15.1 Options on stock indices and currencies 325 15.2 Currency options 327 15.3 Options on stock paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 333 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options 349 16.8 Black's model for valuing futures options 352 16.10 Futures style options 353 16.2 Reasons for the popularity of futures options 349 16.5 Bounds for futures options 340 16.6 Valuation of futures options 352 16.7 Drift of a futures options 352 16.8 Black's model for valuing futures options 353 16.9 American futures options 353 17.1 Future freading 354 18.2 Assignment questions 358 17.3 A stop-loss strategy 358 17.4 Delta hedding 360 17.5 Theta 367 17.6 Gamma 373 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 The realities of hedging 376 17.12 Extension of formulas 378 17.13 Portlohio insurance 378 17.14 Stock market volatility 380	Chapter 14.	Emplo	yee stock options	.311
14.2 Do options align the interests of shareholders and managers? 313 14.3 Accounting issues 314 14.4 Valuation 316 14.5 Backdating scandals 320 Summary 321 Further reading 322 Questions and problems 322 Assignment questions 323 Chapter 15. Options on stock indices and currencies 325 15.1 Options on stock indices 325 15.2 Currency options 327 15.3 Options on stock spaying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options using b	•	_		
14.3 Accounting issues 314 14.4 Valuation 316 14.5 Backdating scandals 320 Summary 321 Further reading 322 Questions and problems 322 Assignment questions 323 Chapter 15. Options on stock indices 325 15.1 Options on stocks and currencies 325 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European stock index options 332 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures option sund problems 344 16.5 Bounds for futures opti		14.2		
14.4 Valuation. 316 14.5 Backdating scandals 320 Summary. 321 Further reading 322 Questions and problems 322 Assignment questions 323 Chapter 15. Options on stock indices and currencies 325 15.1 Options on stock indices 325 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary. 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options using binomial trees 347 16.7 Drift of a futures options using binomial trees 347 16.7 Drift of a fut		14.3		
14.5 Backdating scandals 320 Summary 321 Further reading 322 Questions and problems 322 Assignment questions 323 Chapter 15. Options on stock indices and currencies 325 15.1 Options on stock indices 325 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options 340 16.6 Valuation of futures options 340 16.7 Drift of a futures options using binomial trees 347 16.7 Drift of a futures options 350 16.9 American futures options 350 16.10 Futures-style options 352 16.10 Futures-style options 353 16.10 Futures-style options 353 16.11 The Greek letters 357 17.1 The Greek letters 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.14 Extension of formulas 378 17.15 Theta 378 17.16 The future options 378 17.17 Theta 378 17.18 Tetroloi insurance 380		14.4		
Summary 321 Further reading 322 Questions and problems 322 Assignment questions 323 Chapter 15. Options on stock indices 325 15.1 Options on stocks paying known dividend yields 326 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options using binomial trees 347 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 348 <td></td> <td>14.5</td> <td></td> <td></td>		14.5		
Further reading				
Questions and problems 322				
Assignment questions 323				
15.1 Options on stock indices 325 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 16.11 Futures-style options 352 16.12 Futures and problems 353 16.14 Futures and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 388 17.1 376 17.11 The office 177 17.12 Extension of formulas 378 17.13 Portfolio insurance 388 17.1 376 376 377 378 378 378 379 379 370 370 370 371 371 371 371 371 371 371 371 371 372 373 374 375 375 375 376 376 376 377 377 377 378 377 378 378 379 370 370 370 371 371 371 371 372 373 373				
15.1 Options on stock indices 325 15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 16.11 Futures-style options 352 16.12 Futures and problems 353 16.14 Futures and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 388 17.1 376 17.11 The office 177 17.12 Extension of formulas 378 17.13 Portfolio insurance 388 17.1 376 376 377 378 378 378 379 379 370 370 370 371 371 371 371 371 371 371 371 371 372 373 374 375 375 375 376 376 376 377 377 377 378 377 378 378 379 370 370 370 371 371 371 371 372 373 373	Chapter 15.	Option	ns on stock indices and currencies	.325
15.2 Currency options 327 15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options using binomial trees 344 16.6 Valuation of futures options using binomial trees 344 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352	-	15.1	Options on stock indices	. 325
15.3 Options on stocks paying known dividend yields 330 15.4 Valuation of European stock index options 332 15.5 Valuation of European currency options 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options using binomial trees 347 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 352 16.9 American futures options vs. American spot options 352 Summary 353 Guestions and problems 354 Assignment questions 354 <		15.2		
15.4 Valuation of European currency options. 332 15.5 Valuation of European currency options. 335 15.6 American options 336 Summary. 337 Further reading. 337 Questions and problems. 338 Assignment questions. 340 Chapter 16. Futures options. 341 16.1 Nature of futures options. 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options. 344 16.4 Put—call parity. 345 16.5 Bounds for futures options using binomial trees. 347 16.6 Valuation of futures options using binomial trees. 347 16.7 Drift of a futures prices in a risk neutral world. 349 16.8 Black's model for valuing futures options. 350 16.9 American futures options vs. American spot options. 352 16.10 Futures-style options. 352 Summary. 353 Further reading. 354 Questions and problems. 354 <td< td=""><td></td><td>15.3</td><td></td><td></td></td<>		15.3		
15.5 Valuation of European currency options. 335 15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options using binomial trees 347 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357		15.4		
15.6 American options 336 Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340		15.5		
Summary 337 Further reading 337 Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 344 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures options using binomial trees 347 16.7 Drift of a futures options using binomial trees 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 354 Assignment questions 355 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 Polta		15.6		
Further reading Questions and problems 333 338 Assignment questions 340				
Questions and problems 338 Assignment questions 340 Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 354 Questions and problems 354 Assignment questions 354 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta				
Assignment questions				
Chapter 16. Futures options 341 16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put-call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters. 357 17.1 Illustration 357 17.2 Naked and covered positions 338 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 360 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.10 The realities of hedging 376 17.11 Scenario analy				
16.1 Nature of futures options 341 16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationshi	Ch116	E-4		
16.2 Reasons for the popularity of futures options 344 16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, a	Chapter 16.			
16.3 European spot and futures options 344 16.4 Put—call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.9 Rho 375		_		
16.4 Put-call parity 345 16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis				
16.5 Bounds for futures options 346 16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.9 Rho 375 17.10 The realities of hedging 376 17.12 Extension of formulas 378<				
16.6 Valuation of futures options using binomial trees 347 16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378				
16.7 Drift of a futures prices in a risk neutral world 349 16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
16.8 Black's model for valuing futures options 350 16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
16.9 American futures options vs. American spot options 352 16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		_		
16.10 Futures-style options 352 Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
Summary 353 Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
Further reading 354 Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		16.10		
Questions and problems 354 Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
Assignment questions 356 Chapter 17. The Greek letters 357 17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 378 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
Chapter 17. The Greek letters				
17.1 Illustration 357 17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380			Assignment questions	356
17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380	Chapter 17.	The G	reek letters	357
17.2 Naked and covered positions 358 17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380	-	17.1	Illustration	357
17.3 A stop-loss strategy 358 17.4 Delta hedging 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		17.2		
17.4 Delta hedging. 360 17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		17.3		
17.5 Theta 367 17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		17.4		
17.6 Gamma 369 17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		17.5		
17.7 Relationship between delta, theta, and gamma 373 17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380		17.6		
17.8 Vega 373 17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
17.9 Rho 375 17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
17.10 The realities of hedging 376 17.11 Scenario analysis 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
17.11 Scenario analysis. 376 17.12 Extension of formulas 378 17.13 Portfolio insurance 380				
17.12 Extension of formulas				
17.13 Portfolio insurance				

		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
		Appendix: Taylor series expansions and hedge parameters	388
Chapter 18.	Volatil	lity smiles	389
	18.1	Why the volatility smile is the same for calls and puts	
	18.2	Foreign currency options	
	18.3	Equity options	393
	18.4	Alternative ways of characterizing the volatility smile	
	18.5	The volatility term structure and volatility surfaces	
	18.6	Greek letters	397
	18.7	When a single large jump is anticipated	398
		Summary	400
		Further reading	400
		Questions and problems	401
		Assignment questions	402
		Appendix: Determining implied risk-neutral distributions from volatility smiles	404
Chapter 19.		numerical procedures	
	19.1	Binomial trees.	407
	19.2	Using the binomial tree for options on indices, currencies, and futures contracts	111
	19.3	Binomial model for a dividend-paying stock	
	19.4	Alternative procedures for constructing trees	
	19.5	Time-dependent parameters	
	19.6	Monte Carlo simulation	
	19.7	Variance reduction procedures	
	19.8	Finite difference methods.	
	17.0	Summary	
		Further reading.	
		Questions and problems	
		Assignment questions.	
Chamton 20	Value	at risk	
Chapter 20.	20.1	The VaR measure	
	20.1	Historical simulation	
	20.2	Model-building approach	
	20.3	Linear model	
	20.4	Quadratic model	
	20.6	Monte Carlo simulation	
	20.7	Comparison of approaches	
	20.8	Stress testing and back testing	
	20.9	Principal components analysis.	
		Summary	
		Further reading.	
		Questions and problems	471
		Assignment questions	
		Appendix: Cash-flow mapping	
Chanter 21	Fetim	ating volatilities and correlations	
onapiti 41.	21.1	Estimating volatility	
	21.2	The exponentially weighted moving average model	
		1	.,,

Contents		xii

	21.3	The GARCH (1,1) model	. 481
	21.4	Choosing between the models	
	21.5	Maximum likelihood methods	
	21.6	Using GARCH (1,1) to forecast future volatility	. 487
	21.7	Correlations	
		Summary	
		Further reading	. 494
		Questions and problems	. 494
		Assignment questions	. 496
Chapter 22.	Credit	risk	.497
	22.1	Credit ratings	
	22.2	Historical default probabilities	
	22.3	Recovery rates	
	22.4	Estimating default probabilities from bond prices	
	22.5	Comparison of default probability estimates	
	22.6	Using equity prices to estimate default probabilities	
	22.7	Credit risk in derivatives transactions	
	22.8	Credit risk mitigation	
	22.9	Default correlation	
		Credit VaR	
	22.10	Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
		-	
Chapter 23.		derivatives	
	23.1	Credit default swaps	
	23.2	Valuation of credit default swaps	
	23.3	Credit indices	
	23.4	CDS forwards and options	
	23.5	Basket credit default swaps	
	23.6	Total return swaps	. 535
	23.7	Asset-backed securities	
	23.8	Collateralized debt obligations	. 538
	23.9	Role of correlation in a basket CDS and CDO	
	23.10	Valuation of a synthetic CDO	. 542
	23.11	Alternatives to the standard market model	. 549
		Summary	. 55
		Further reading	. 552
		Questions and problems	. 552
		Assignment questions	. 554
Chanter 24	Exotic	options	
Chapter 24	24.1	Packages	
	24.2	Nonstandard American options	
	24.3	Forward start options	
	24.4	Compound options	
	24.4	Chooser options	
	24.5	Barrier options	
	24.0	Binary options.	
	24.7	Lookback options	
	24.8 24.9		
		Shout options	
	24.IU	Asian options	. 504

	24.11	Options to exchange one asset for another	566
	24.12	Options involving several assets	567
	24.13	Volatility and variance swaps	567
	24.14	Static options replication	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	576
		Appendix: Calculation of moments for valuation of basket options and	570
		Asian options	
Chapter 25.		er, energy, and insurance derivatives	581
	25.1	Review of pricing issues	
	25.2	Weather derivatives	
	25.3	Energy derivatives	
	25.4	Insurance derivatives	
		Summary	200
		Further reading	
		Questions and problems	
		Assignment question	
Chapter 26.	More	on models and numerical procedures	591
	26.1	Alternatives to Black-Scholes	
	26.2	Stochastic volatility models	
	26.3	The IVF model	
	26.4	Convertible bonds	
	26.4	Path-dependent derivatives	
	26.5	Barrier options	
	26.6	Options on two correlated assets	
	26.7	Monte Carlo simulation and American options	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
Chapter 27.	Marti	ngales and measures	623
	27.1	The market price of risk	624
	27.2	Several state variables	
	27.3	Martingales	
	27.4	Alternative choices for the numeraire	
	27.5	Extension to several factors	
	27.6	Black's model revisited	
	27.7	Option to exchange one asset for another	
	27.8	Change of numeraire	
	27.9	Generalization of traditional valuation methods	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	
		Appendix: Handling multiple sources of uncertainty	
Chapter 28.		est rate derivatives: the standard market models	
	28.1	Bond options	
	28.2	Interest rate caps and floors	652

Contents			xv
	28.3 28.4 28.5	European swap options. Generalizations. Hedging interest rate derivatives. Summary. Further reading. Questions and problems. Assignment questions.	662 663 664 664
Chapter 29.	29.1 29.2 29.3	xity, timing, and quanto adjustments Convexity adjustments Timing adjustments Quantos Summary Further reading Questions and problems Assignment questions Appendix: Proof of the convexity adjustment formula	667 671 673 676 676 677
Chapter 30.	30.1 30.2 30.3 30.4 30.5 30.6 30.7 30.8 30.9	Background Equilibrium models No-arbitrage models Options on bonds Volatility structures Interest rate trees A general tree-building procedure Calibration. Hedging using a one-factor model Summary Further reading Questions and problems Assignment questions	681 682 686 690 691 692 704 705 705
Chapter 31.	31.1 31.2 31.3	st rate derivatives: HJM and LMM The Heath, Jarrow, and Morton model The LIBOR market model Agency mortgage-backed securities Summary Further reading Questions and problems Assignment questions	711 714 724 726 727
Chapter 32.	Swaps 32.1 32.2 32.3 32.4 32.5 32.6 32.7	Revisited Variations on the vanilla deal Compounding swaps Currency swaps More complex swaps Equity swaps Swaps with embedded options Other swaps Summary Further reading Questions and problems Assignment questions	729 731 732 736 737 740 741

Chapter 33.	Real	options	745
•	33.1	Capital investment appraisal	
	33.2	Extension of the risk-neutral valuation framework	
	33.3	Estimating the market price of risk	748
	33.4	Application to the valuation of a business	
	33.5	Commodity prices	
	33.6	Evaluating options in an investment opportunity	
		Summary	
		Further reading	
		Questions and problems	
		Assignment questions	760
Chapter 34.	Deri	vatives mishaps and what we can learn from them	761
	34.1	Lessons for all users of derivatives	
	34.2	Lessons for financial institutions	765
	34.3	Lessons for nonfinancial corporations	770
		Summary	771
		Further reading	771
Glossary of	terms	· · · · · · · · · · · · · · · · · · ·	773
DerivaGem	softw	are	793
Major excha	inges	trading futures and options	799
		$hen x \leqslant 0.$	
	. ,	$hen x \geqslant 0.$	
	` '		
Subject inde	X		80 /