

Contents

| | |
|---|-------------|
| Preface to the Third Edition | xi |
| Preface to the Second Edition | xiii |
| I Option Pricing | 1 |
| 1 Derivatives | 3 |
| 1.1 Recommended Literature | 10 |
| 1.2 Exercises | 10 |
| 2 Introduction to Option Management | 13 |
| 2.1 Arbitrage Relations | 13 |
| 2.2 Portfolio Insurance | 25 |
| 2.3 Binary One-Period Model | 32 |
| 2.4 Recommended Literature | 37 |
| 2.5 Exercises | 38 |
| 3 Basic Concepts of Probability Theory | 43 |
| 3.1 Real Valued Random Variables | 43 |
| 3.2 Expectation and Variance | 46 |
| 3.3 Skewness and Kurtosis | 47 |
| 3.4 Random Vectors, Dependence, Correlation | 48 |
| 3.5 Conditional Probabilities and Expectations | 49 |
| 3.6 Recommended Literature | 51 |
| 3.7 Exercises | 52 |
| 4 Stochastic Processes in Discrete Time | 55 |
| 4.1 Binomial Processes | 55 |
| 4.2 Trinomial Processes | 59 |
| 4.3 General Random Walks | 61 |
| 4.4 Geometric Random Walks | 62 |
| 4.5 Binomial Models with State Dependent Increments | 63 |
| 4.6 Recommended Literature | 64 |
| 4.7 Exercises | 64 |

| | | |
|----------|--|------------|
| 5 | Stochastic Integrals and Differential Equations | 67 |
| 5.1 | Wiener Process | 67 |
| 5.2 | Stochastic Integration | 71 |
| 5.3 | Stochastic Differential Equations | 73 |
| 5.4 | The Stock Price as a Stochastic Process | 76 |
| 5.5 | Itô's Lemma | 79 |
| 5.6 | Recommended Literature | 82 |
| 5.7 | Exercises | 82 |
| 6 | Black–Scholes Option Pricing Model | 85 |
| 6.1 | Black–Scholes Differential Equation | 85 |
| 6.2 | Black–Scholes Formula for European Options | 92 |
| 6.2.1 | Numerical Approximation | 96 |
| 6.3 | Simulation | 99 |
| 6.3.1 | Linear Congruential Generator | 100 |
| 6.3.2 | Fibonacci Generators | 104 |
| 6.3.3 | Inversion Method | 106 |
| 6.3.4 | Box-Muller Method | 107 |
| 6.3.5 | Marsaglia Method | 109 |
| 6.4 | Risk Management and Hedging | 110 |
| 6.4.1 | Delta Hedging | 113 |
| 6.4.2 | Gamma and Theta | 116 |
| 6.4.3 | Rho and Vega | 118 |
| 6.4.4 | Volga and Vanna | 121 |
| 6.4.5 | Historical and Implied Volatility | 122 |
| 6.4.6 | Realised Volatility | 126 |
| 6.5 | Recommended Literature | 126 |
| 6.6 | Exercises | 127 |
| 7 | Binomial Model for European Options | 133 |
| 7.1 | Cox–Ross–Rubinstein Approach to Option Pricing | 134 |
| 7.2 | Discrete Dividends | 138 |
| 7.2.1 | Dividends as a Percentage of the Stock Price | 139 |
| 7.2.2 | Dividends as a Fixed Amount of Money | 140 |
| 7.3 | Recommended Literature | 143 |
| 7.4 | Exercises | 143 |
| 8 | American Options | 145 |
| 8.1 | Arbitrage Relations for American Options | 145 |
| 8.2 | The Trinomial Model for American Options | 153 |
| 8.3 | Recommended Literature | 157 |
| 8.4 | Exercises | 157 |

| | |
|--|------------|
| 9 Exotic Options | 159 |
| 9.1 Compound Options, Option on Option | 159 |
| 9.2 Chooser Options or “As You Wish” Options | 161 |
| 9.3 Barrier Options | 162 |
| 9.4 Asian Options | 165 |
| 9.5 Lookback Options | 167 |
| 9.6 Cliquet Options | 168 |
| 9.7 Basket Options | 169 |
| 9.8 Recommended Literature | 170 |
| 9.9 Exercises | 171 |
| | |
| 10 Interest Rates and Interest Rate Derivatives | 173 |
| 10.1 Interest Rates and Prices | 173 |
| 10.1.1 Money Market Account | 176 |
| 10.1.2 Forward Rate Agreement | 176 |
| 10.1.3 Interest Rate Swap | 177 |
| 10.2 Risk Neutral Valuation and Numeraire Measures | 179 |
| 10.2.1 Principles of Risk Neutral Valuation | 180 |
| 10.2.2 Change of Numeraire | 181 |
| 10.2.3 Equivalent Martingale Measure | 182 |
| 10.2.4 Traditional Risk Neutral Numeraire | 183 |
| 10.2.5 Other Choices of Numeraire | 184 |
| 10.3 Interest Rate Derivatives | 185 |
| 10.3.1 The Black Model | 186 |
| 10.3.2 Bond Option | 186 |
| 10.3.3 Caps and Floors | 187 |
| 10.3.4 Swaption | 189 |
| 10.4 Short Rate Models | 190 |
| 10.4.1 One-Factor Short-Rate Models | 191 |
| 10.4.2 Two-Factor Short-Rate Models | 193 |
| 10.5 Heath Jarrow Morton Framework | 195 |
| 10.5.1 HJM Approach | 195 |
| 10.5.2 Short Rate Process in the HJM Framework | 197 |
| 10.6 LIBOR Market Model | 197 |
| 10.6.1 Dynamics in the LMM | 198 |
| 10.6.2 The Numeraire Measure | 198 |
| 10.7 Bond Valuation | 199 |
| 10.7.1 The Bond Valuation Equation | 199 |
| 10.7.2 Solving the Zero Bond Valuation | 200 |
| 10.8 Calibrating Short-Rate Models | 201 |
| 10.8.1 CIR Process Densities | 202 |
| 10.8.2 Initial Estimates | 203 |

| | | |
|---|--|------------|
| 10.8.3 | Maximum Likelihood Estimator | 204 |
| 10.8.4 | Implementation Results | 204 |
| 10.9 | Calibrating the LIBOR Market Model | 205 |
| 10.9.1 | Discretization of the Forward Rate | 206 |
| 10.9.2 | Instantaneous Volatility Function | 207 |
| 10.9.3 | Calibration | 209 |
| 10.10 | Recommended Literature | 210 |
| 10.11 | Exercises | 211 |
| II Statistical Models of Financial Time Series | | 213 |
| 11 | Introduction: Definitions and Concepts | 215 |
| 11.1 | Some Definitions | 216 |
| 11.2 | Statistical Analysis of German and British Stock Returns | 223 |
| 11.3 | Expectations and Efficient Markets | 226 |
| 11.4 | Econometric Models: A Brief Summary | 231 |
| 11.4.1 | Stock Prices: the CAPM | 231 |
| 11.4.2 | Exchange Rate: Theory of the Interest Rate Parity | 233 |
| 11.4.3 | Term Structure: The Cox-Ingersoll-Ross Model | 235 |
| 11.4.4 | Options: The Black-Scholes Model | 237 |
| 11.4.5 | The Market Price of Risk | 239 |
| 11.5 | The Random Walk Hypothesis | 242 |
| 11.6 | Unit Root Tests | 244 |
| 11.6.1 | Dickey-Fuller Test | 245 |
| 11.6.2 | The KPSS Test | 248 |
| 11.6.3 | Variance Ratio Tests | 249 |
| 11.7 | Recommended Literature | 252 |
| 11.8 | Exercises | 252 |
| 12 | ARIMA Time Series Models | 255 |
| 12.1 | Moving Average Processes | 256 |
| 12.2 | Autoregressive Process | 257 |
| 12.3 | ARMA Models | 261 |
| 12.4 | Partial Autocorrelation | 263 |
| 12.5 | Estimation of Moments | 267 |
| 12.5.1 | Estimation of the Mean Function | 267 |
| 12.5.2 | Estimation of the Covariance Function | 269 |
| 12.5.3 | Estimation of the ACF | 270 |
| 12.6 | Portmanteau Statistics | 271 |
| 12.7 | Estimation of AR(p) Models | 272 |
| 12.8 | Estimation of MA(q) and ARMA(p, q) Models | 273 |

| | |
|--|------------|
| 12.9 Recommended Literature | 278 |
| 12.10 Exercises | 278 |
| 13 Time Series with Stochastic Volatility | 283 |
| 13.1 ARCH and GARCH Models | 285 |
| 13.1.1 ARCH(1): Definition and Properties | 286 |
| 13.1.2 Estimation of ARCH(1) Models | 295 |
| 13.1.3 ARCH(q): Definition and Properties | 299 |
| 13.1.4 Estimation of an ARCH(q) Model | 301 |
| 13.1.5 Generalised ARCH (GARCH) | 302 |
| 13.1.6 Estimation of GARCH(p, q) Models | 305 |
| 13.2 Extensions of the GARCH Model | 308 |
| 13.2.1 Exponential GARCH | 308 |
| 13.2.2 Threshold ARCH Models | 310 |
| 13.2.3 Risk and Returns | 311 |
| 13.2.4 Estimation Results for DAX and FTSE 100 Returns | 312 |
| 13.3 Shortfalls of GARCH | 314 |
| 13.3.1 Recent Challenges to GARCH Models | 314 |
| 13.3.2 Volatility Forecasting for DAX and FTSE 100 Returns | 321 |
| 13.4 Multivariate GARCH Models | 323 |
| 13.4.1 The Vec Specification | 324 |
| 13.4.2 The BEKK Specification | 326 |
| 13.4.3 The CCC Model | 328 |
| 13.4.4 The DCC Model | 328 |
| 13.4.5 An Empirical Illustration | 329 |
| 13.5 Continuous-Time GARCH Models | 333 |
| 13.5.1 COGARCH(1,1): Definition and Properties | 334 |
| 13.5.2 Relation between GARCH and COGARCH | 335 |
| 13.5.3 Estimation of the COGARCH(1,1) Model | 336 |
| 13.5.4 Extensions of the COGARCH Model | 337 |
| 13.6 Recommended Literature | 339 |
| 13.7 Exercises | 340 |
| 14 Long Memory Time Series | 343 |
| 14.1 Definition of long range dependence | 343 |
| 14.2 Fractional Integration and Long-Memory | 344 |
| 14.3 Long Memory and Self-Similar Processes | 347 |
| 14.4 Detection of the Long Memory | 350 |
| 14.4.1 Rescaled Variance Test | 351 |
| 14.4.2 Semiparametric test | 352 |
| 14.4.3 Tests for Spurious Long Memory | 353 |
| 14.5 Estimation of the Long Memory parameter | 354 |

| | | |
|------------|---|------------|
| 14.5.1 | Exact Maximum Likelihood Estimator | 354 |
| 14.5.2 | Regression on the Periodogram | 355 |
| 14.5.3 | Gaussian Semiparametric Estimator | 355 |
| 14.6 | Long Memory Models | 357 |
| 14.6.1 | ARFIMA Model | 357 |
| 14.6.2 | GARCH Long Memory Models | 358 |
| 14.6.3 | FIAPARCH Model | 360 |
| 14.6.4 | HYGARCH Model | 361 |
| 14.7 | An empirical illustration | 361 |
| 14.8 | Recommended Literature | 364 |
| 15 | Non-Parametric and Flexible Time Series Estimators | 367 |
| 15.1 | Nonparametric Regression | 368 |
| 15.2 | Construction of the Estimator | 370 |
| 15.3 | Empirical illustration | 372 |
| 15.4 | Flexible Volatility Estimators | 373 |
| 15.5 | Pricing Options with ARCH-Models | 374 |
| 15.6 | Application to the Valuation of DAX Calls | 381 |
| 15.7 | Recommended Literature | 384 |
| III | Selected Financial Applications | 387 |
| 16 | Value at Risk and Backtesting | 389 |
| 16.1 | Forecast and VaR Models | 391 |
| 16.2 | Backtesting with Expected Shortfall | 393 |
| 16.3 | Backtesting in Action | 395 |
| 16.4 | Recommended Literature | 400 |
| 16.5 | Exercises | 401 |
| 17 | Copulae and Value at Risk | 405 |
| 17.1 | Copulae | 407 |
| 17.2 | Copula Classes | 409 |
| 17.2.1 | Simplest Copulae | 409 |
| 17.2.2 | Elliptical Copulae | 412 |
| 17.2.3 | Archimedean Copulae | 415 |
| 17.2.4 | Hierarchical Archimedean Copulae | 418 |
| 17.2.5 | Generalisations | 419 |
| 17.3 | Monte Carlo Simulation | 420 |
| 17.3.1 | Conditional Inverse Method | 420 |
| 17.3.2 | Marshal-Olkin Method | 422 |
| 17.4 | Copula Estimation | 425 |

| | | |
|-----------|---|------------|
| 17.4.1 | FML – Full Maximum Likelihood Estimation | 426 |
| 17.4.2 | IFM – Inference for Margins | 426 |
| 17.4.3 | CML – Canonical Maximum Likelihood | 427 |
| 17.4.4 | Gaussian Copula Estimation | 428 |
| 17.4.5 | t -Copula Estimation | 428 |
| 17.5 | Asset Allocation | 429 |
| 17.6 | Value-at-Risk of the Portfolio Returns | 430 |
| 17.6.1 | VaR of the P&L | 433 |
| 17.6.2 | 3-dimensional Portfolio | 437 |
| 17.7 | Recommended Literature | 445 |
| 17.8 | Exercises | 446 |
| 18 | Statistics of Extreme Risks | 447 |
| 18.1 | Risk Measures | 447 |
| 18.2 | Data Description | 449 |
| 18.3 | Estimation Methods | 452 |
| 18.3.1 | The Block Maxima Method | 453 |
| 18.3.2 | The Peaks-Over-Threshold (POT) Method | 463 |
| 18.4 | Backtesting | 477 |
| 18.5 | Extreme Value Theory for Time Series | 478 |
| 18.6 | Recommended Literature | 483 |
| 18.7 | Exercises | 485 |
| 19 | Neural Networks | 489 |
| 19.1 | From Perceptron to Non-linear Neuron | 490 |
| 19.2 | Back Propagation | 499 |
| 19.3 | Neural Networks in Non-parametric Regression Analysis | 501 |
| 19.4 | Forecasts of Financial Time Series with Neural Networks | 508 |
| 19.5 | Quantifying Risk with Neural Networks | 512 |
| 19.6 | Recommended Literature | 516 |
| 20 | Volatility Risk of Option Portfolios | 519 |
| 20.1 | Description of the Data | 520 |
| 20.2 | Principal Component Analysis of the VDAX's Dynamics | 524 |
| 20.3 | Stability Analysis of the VDAX's Dynamics | 527 |
| 20.4 | Measure of the Implied Volatility's Risk | 528 |
| 20.5 | Recommended Literature | 531 |
| 20.6 | Exercises | 531 |
| 21 | Nonparametric Estimators for the Probability of Default | 535 |
| 21.1 | Logistic Regression | 535 |
| 21.2 | Semi-parametric Model for Credit Rating | 537 |
| 21.3 | Credit Ratings with Neural Networks | 541 |

| | |
|---|------------|
| 22 Credit Risk Management | 543 |
| 22.1 Basic Concepts | 543 |
| 22.2 The Bernoulli Model | 545 |
| 22.3 The Poisson Model | 546 |
| 22.4 The Industrial Models | 547 |
| 22.5 One Factor Models | 552 |
| 22.6 Copulae and Loss Distributions | 554 |
| 22.7 Exercises | 558 |
| A Technical Appendix | 561 |
| A.1 Integration Theory | 561 |
| A.2 Portfolio Strategies | 566 |
| Frequently Used Notations | 573 |
| Bibliography | 575 |
| Index | 595 |