

Contents

Preface to the third edition	v
Preface to the second edition	vi
Preface to the first edition	vii
I Mathematical finance in one period	1
1 Arbitrage theory	3
1.1 Assets, portfolios, and arbitrage opportunities	3
1.2 Absence of arbitrage and martingale measures	7
1.3 Derivative securities	16
1.4 Complete market models	27
1.5 Geometric characterization of arbitrage-free models	33
1.6 Contingent initial data	37
2 Preferences	50
2.1 Preference relations and their numerical representation	51
2.2 Von Neumann–Morgenstern representation	57
2.3 Expected utility	67
2.4 Uniform preferences	83
2.5 Robust preferences on asset profiles	94
2.6 Probability measures with given marginals	113
3 Optimality and equilibrium	121
3.1 Portfolio optimization and the absence of arbitrage	121
3.2 Exponential utility and relative entropy	130
3.3 Optimal contingent claims	139
3.4 Optimal payoff profiles for uniform preferences	148
3.5 Robust utility maximization	151
3.6 Microeconomic equilibrium	159
4 Monetary measures of risk	175
4.1 Risk measures and their acceptance sets	176
4.2 Robust representation of convex risk measures	186
4.3 Convex risk measures on L^∞	199

4.4	Value at Risk	207
4.5	Law-invariant risk measures	213
4.6	Concave distortions	219
4.7	Comonotonic risk measures	228
4.8	Measures of risk in a financial market	236
4.9	Utility-based shortfall risk and divergence risk measures	246
II Dynamic hedging		259
5	Dynamic arbitrage theory	261
5.1	The multi-period market model	261
5.2	Arbitrage opportunities and martingale measures	266
5.3	European contingent claims	274
5.4	Complete markets	287
5.5	The binomial model	290
5.6	Exotic derivatives	296
5.7	Convergence to the Black–Scholes price	302
6	American contingent claims	321
6.1	Hedging strategies for the seller	321
6.2	Stopping strategies for the buyer	327
6.3	Arbitrage-free prices	337
6.4	Stability under pasting	342
6.5	Lower and upper Snell envelopes	347
7	Superhedging	354
7.1	\mathcal{P} -supermartingales	354
7.2	Uniform Doob decomposition	356
7.3	Superhedging of American and European claims	359
7.4	Superhedging with liquid options	368
8	Efficient hedging	380
8.1	Quantile hedging	380
8.2	Hedging with minimal shortfall risk	387
8.3	Efficient hedging with convex risk measures	396
9	Hedging under constraints	404
9.1	Absence of arbitrage opportunities	404
9.2	Uniform Doob decomposition	412
9.3	Upper Snell envelopes	417
9.4	Superhedging and risk measures	424

10 Minimizing the hedging error	428
10.1 Local quadratic risk	428
10.2 Minimal martingale measures	438
10.3 Variance-optimal hedging	449
11 Dynamic risk measures	456
11.1 Conditional risk measures and their robust representation	456
11.2 Time consistency	465
Appendix	476
A.1 Convexity	476
A.2 Absolutely continuous probability measures	480
A.3 Quantile functions	484
A.4 The Neyman–Pearson lemma	493
A.5 The essential supremum of a family of random variables	496
A.6 Spaces of measures	497
A.7 Some functional analysis	507
Notes	512
Bibliography	517
List of symbols	533
Index	535