

# Contents

## Part I Revisiting Two Classic Results in Dynamic Portfolio Management

<b>1</b>	<b>Merton's Optimal Dynamic Portfolio Revisited</b> .....	3
1.1	Merton's Optimal Portfolio Problem .....	3
1.1.1	Problem and Notation .....	3
1.1.2	Solution .....	6
1.1.3	Logarithmic Utility Functions .....	8
1.2	A Discrete-Time Model .....	9
1.2.1	Problem and Notation .....	9
1.2.2	Solution .....	11
1.2.3	Market Models .....	15
<b>2</b>	<b>Option Pricing: Classic Results</b> .....	17
2.1	Introduction .....	17
2.2	Problem Formulation .....	18
2.3	Stop-Loss Strategy .....	20
2.4	Black–Scholes Theory .....	21
2.4.1	Black–Scholes Equation .....	21
2.4.2	Proof of Lemma .....	22
2.5	Digital Options .....	25

## Part II Hedging in Interval Models

<b>3</b>	<b>Introduction</b> .....	31
3.1	Why Hedge? .....	31
3.2	A Simplistic Hedging Scheme: The Stop-Loss Strategy .....	33
3.3	Risk-Free Hedging in the Binomial Tree Model .....	34
3.4	Relationship with the Continuous-Time Black–Scholes–Merton Model .....	38

3.5	Risk Assessment Models .....	41
3.5.1	Current Models .....	41
3.5.2	Interval Model .....	42
<b>4</b>	<b>Fair Price Intervals</b> .....	<b>45</b>
4.1	Fair Price Interval of an Option: The General Discrete-Time Case .....	45
4.2	Fair Price Intervals in Interval Models .....	47
4.2.1	Fair Price Interval .....	47
4.2.2	Characterization of the Fair Price Interval in Terms of Strategies .....	48
4.2.3	Example .....	51
4.2.4	Characterization of Fair Price Interval in Terms of Martingale Measures .....	52
4.3	Computation of the Fair Price Interval for Path-Independent Strategies .....	54
4.4	Worst-Case Analysis .....	57
4.4.1	Introduction .....	57
4.4.2	A Nonextremal Path with Worst-Case Cost .....	59
4.4.3	Worst Cases in Interval Models Versus Tree Models .....	60
<b>5</b>	<b>Optimal Hedging Under Robust-Cost Constraints</b> .....	<b>65</b>
5.1	Introduction .....	65
5.2	Effect of Cost Constraints on Admissible Strategies .....	66
5.3	Calculating Maximum Profit Under a Cost Constraint .....	67
5.4	Extensions .....	72
5.4.1	Loss/Profit Ratio .....	73
5.4.2	Maximum Expected Profit Under a Cost Constraint .....	76
5.5	Summary .....	77
<b>6</b>	<b>Appendix: Proofs</b> .....	<b>79</b>
 <b>Part III Robust-Control Approach to Option Pricing</b>		
<b>7</b>	<b>Continuous and Discrete-Time Option Pricing and Interval Market Model</b> .....	<b>91</b>
7.1	Introduction .....	91
7.1.1	A New Theory of Option Pricing? .....	92
7.1.2	Related Contributions .....	93
7.2	Modeling .....	94
7.2.1	Contingent Claims .....	94
7.2.2	Market .....	95
7.2.3	Portfolio .....	97
7.2.4	Hedging .....	99
7.2.5	Conclusion: A Minimax Dynamic Game .....	101

7.3	Extensions .....	103
7.3.1	American Options .....	104
7.3.2	Delayed Information.....	105
<b>8</b>	<b>Vanilla Options</b> .....	<b>107</b>
8.1	Introduction and Main Results.....	107
8.1.1	Vanilla Options .....	107
8.1.2	Terminal Payment .....	108
8.1.3	Main Results .....	110
8.1.4	Joshua Transformation and the DQVI .....	114
8.2	Geometric Approach .....	118
8.2.1	Geometric Formulation.....	119
8.2.2	Primary Field and Dispersal Manifold $\mathcal{D}$ .....	121
8.2.3	Equivocal Manifold $\mathcal{E}$ .....	129
8.2.4	Focal Manifold $\mathcal{F}$ .....	133
8.2.5	Synthesis: Representation Formula .....	140
8.3	Viscosity Solution .....	141
8.3.1	Uniqueness.....	142
8.3.2	Verification of Representation Formula .....	153
8.4	Discrete Trading and Fast Algorithm.....	156
8.4.1	Dynamic Programming and Algorithms.....	156
8.4.2	Convergence .....	161
<b>9</b>	<b>Digital Options</b> .....	<b>167</b>
9.1	Introduction and Main Results.....	167
9.1.1	Digital Options .....	167
9.1.2	Main Results .....	168
9.2	Geometric Approach .....	173
9.2.1	Trivial Regions.....	173
9.2.2	Region of Interest.....	175
9.2.3	Synthesis .....	184
9.3	Viscosity Solution .....	186
9.3.1	The Discontinuity.....	186
9.3.2	Continuous Regions .....	189
9.4	Discrete Trading and Algorithms .....	192
9.4.1	Algorithms .....	192
9.4.2	Convergence .....	194
<b>10</b>	<b>Validation</b> .....	<b>199</b>
10.1	Numerical Results and Comparisons.....	199
10.1.1	Numerical Computations.....	199
10.1.2	Numerical Comparison with Black–Scholes .....	200
10.1.3	Explaining the Volatility Smile .....	202
10.2	Compared Strengths and Weaknesses .....	204
10.2.1	Strict Mathematical Properties.....	204
10.2.2	Robustness .....	205
10.3	Conclusion .....	211

**Part IV Game-Theoretic Analysis of Rainbow Options  
in Incomplete Markets**

<b>11</b>	<b>Introduction</b> .....	217
11.1	Introduction to Game-Theoretic Pricing .....	217
11.2	Related Works .....	218
<b>12</b>	<b>Emergence of Risk-Neutral Probabilities from a Game-Theoretic Origin</b> .....	221
12.1	Geometric Risk-Neutral Probabilities and Their Extreme Points .....	221
12.2	Game-Theoretic Origin of Risk-Neutral Laws: Preliminaries .....	226
12.3	Game-Theoretic Origin of Risk-Neutral Laws: Main Result .....	233
12.4	Nonlinear Extension .....	237
12.5	Infinite-Dimensional Setting and Finite-Dimensional Projections .....	240
12.6	Extension to a Random Geometry .....	243
12.7	Mixed Strategies with Linear Constraints .....	245
<b>13</b>	<b>Rainbow Options in Discrete Time, I</b> .....	249
13.1	Colored European Options as a Game Against Nature .....	249
13.2	Nonexpansion and Homogeneity of Solutions .....	253
13.3	Submodular Payoffs: Two Colors .....	254
13.4	Submodular Payoffs: Three or More Colors .....	256
13.5	Transaction Costs .....	258
<b>14</b>	<b>Rainbow Options in Discrete Time, II</b> .....	261
14.1	Rainbow American Options and Real Options .....	261
14.2	Path Dependence and Other Modifications .....	262
14.3	Upper and Lower Values for Intrinsic Risk .....	264
14.4	Cash-Back Methodology for Dealing with Intrinsic Risk .....	266
14.5	Degenerate or Random Geometry of Nonsimultaneous Jumps .....	267
14.6	Stochastic Interest Rates and Stochastic Volatility .....	269
14.7	Identification of Pre-Markov Chains .....	270
<b>15</b>	<b>Continuous-Time Limits</b> .....	273
15.1	Nonlinear Black–Scholes Equation .....	273
15.2	An Example with Two Colors .....	275
15.3	Transaction Costs in Continuous Time .....	278
15.4	Models with Stochastic Volatility .....	280
15.5	Fractional Dynamics .....	281
<b>16</b>	<b>Credit Derivatives</b> .....	285
16.1	Basic Model with No Simultaneous Jumps .....	285
16.2	Simultaneous Jumps: Completion by Tranching .....	288
16.3	Mean-Field Limit, Fluctuations, and Stochastic Law of Large Numbers .....	288

## Part V Viability Approach to Complex Option Pricing and Portfolio Insurance

### 17 Computational Methods Based on the Guaranteed

<b>Capture Basin Algorithm</b> .....	293
17.1 Guaranteed Capture Basin Method for Evaluating Portfolios .....	293
17.1.1 Classical Option Evaluation .....	293
17.1.2 Limits of Classic Evaluation Methods .....	294
17.2 The Dynamic System Underlying Financial Instruments .....	294
17.2.1 State and Control Variables .....	295
17.2.2 Viability Constraints and Target .....	295
17.2.3 Uncertainty of the Environment .....	297
17.2.4 Differential and Discrete Games Describing Portfolio Evolution .....	297
17.2.5 Guaranteed Capture Basin Algorithm .....	299
17.2.6 Approximation of Valuation Function .....	300
17.2.7 Implementing the Guaranteed Capture Basin Method to Evaluate a European Call .....	301
17.3 Extension of Capture Basin Methods to Evaluate Complex Instruments .....	302
17.3.1 Taking into Account Transaction Costs and Constraints .....	303
17.3.2 Approximation of Valuation Function in the Presence of Transaction Costs .....	305
17.3.3 Bermuda and Capped-Style Options: Two Examples of Constrained and Multitarget Problems .....	307
17.4 Evaluation of Complex Financial Instruments Using Impulse Systems .....	309
17.4.1 Hybrid Dynamic Systems and Viability Concepts .....	310
17.4.2 Guaranteed Hybrid Capture Basin Algorithm .....	311
17.4.3 Evaluation of Barrier Options .....	312
17.4.4 Evaluation of Options Using NGARCH Uncertainty Correction and in the Presence of Transaction Costs .....	314

### 18 Asset and Liability Insurance Management (ALIM) for Risk Eradication .....

18.1 Introduction .....	319
18.2 VPPI in Summer 2011 Crisis .....	324
18.2.1 Inputs .....	324
18.2.2 Outputs .....	326
18.2.3 Flow Chart of VPPI Software .....	329

18.3	Uncertainties.....	330
18.3.1	Stochastic Uncertainty.....	331
18.3.2	Tychastic Uncertainty .....	332
18.3.3	Historic Differential Inclusions .....	333
18.3.4	Nature and Measures of Insurance.....	334
18.4	Comparing VPPI and CPPI .....	335
	<b>References</b> .....	<b>337</b>
	<b>Index</b> .....	<b>345</b>