

# Contents

<b>1</b>	<b>Approximative Hedging</b>	<b>1</b>
1.1	Black–Scholes Formula Revisited	1
1.1.1	Pricing by Replication	1
1.1.2	Explicit Formulae	3
1.1.3	Discussion	5
1.2	Leland–Lott Theorem	7
1.2.1	Formulation and Comments	7
1.2.2	Proof	9
1.3	Constant Coefficient: Discrepancy	17
1.3.1	Main Result	17
1.3.2	Discussion	19
1.3.3	Pergamenshchikov Theorem	20
1.4	Rate of Convergence of the Replication Error	21
1.4.1	Formulation	21
1.4.2	Preparatory Manipulations	23
1.4.3	Convenient Representations, Explicit Formulae, and Useful Bounds	26
1.4.4	Tools	34
1.4.5	Analysis of the Principal Terms: Proof of Proposition 1.4.5	35
1.4.6	Analysis of the Residual $R^{1n}$	36
1.4.7	Analysis of the Residual $R^{2n}$	39
1.4.8	Asymptotics of Gaussian Integrals	49
1.5	Functional Limit Theorem for $\alpha = 1/2$	51
1.5.1	Formulation	51
1.5.2	Limit Theorem for Semimartingale Scheme	52
1.5.3	Problem Reformulation	53
1.5.4	Tightness	55
1.5.5	Limit Measure	57
1.5.6	Identification of the Limit	58

1.6	Superhedging by Buy-and-Hold . . . . .	59
1.6.1	Levental–Skorokhod Theorem . . . . .	59
1.6.2	Proof . . . . .	61
1.6.3	Extensions for One-Side Transaction Costs . . . . .	64
1.6.4	Hedging of Vector-Valued Contingent Claims . . . . .	68
<b>2</b>	<b>Arbitrage Theory for Frictionless Markets</b> . . . . .	71
2.1	Models without Friction . . . . .	71
2.1.1	DMW Theorem . . . . .	71
2.1.2	Auxiliary Results: Measurable Subsequences and the Kreps–Yan Theorem . . . . .	74
2.1.3	Proof of the DMW Theorem . . . . .	75
2.1.4	Fast Proof of the DMW Theorem . . . . .	77
2.1.5	$NA$ and Conditional Distributions of Price Increments .	78
2.1.6	Comment on Absolute Continuous Martingale Measures	80
2.1.7	Complete Markets and Replicable Contingent Claims ..	80
2.1.8	DMW Theorem with Restricted Information . . . . .	81
2.1.9	Hedging Theorem for European-Type Options . . . . .	82
2.1.10	Stochastic Discounting Factors . . . . .	85
2.1.11	Hedging Theorem for American-Type Options . . . . .	85
2.1.12	Optional Decomposition Theorem . . . . .	86
2.1.13	Martingale Measures with Bounded Densities . . . . .	87
2.1.14	Utility Maximization and Convex Duality . . . . .	90
2.2	Discrete-Time Infinite-Horizon Model . . . . .	93
2.2.1	Martingale Measures in Infinite-Horizon Model . . . . .	93
2.2.2	No Free Lunch for Models with Infinite Time Horizon ..	95
2.2.3	No Free Lunch with Vanishing Risk . . . . .	99
2.2.4	Example: “Retiring” Process . . . . .	101
2.2.5	The Delbaen–Schachemayer Theory in Continuous Time . . . . .	103
<b>3</b>	<b>Arbitrage Theory under Transaction Costs</b> . . . . .	105
3.1	Models with Transaction Costs . . . . .	105
3.1.1	Basic Model . . . . .	105
3.1.2	Variants . . . . .	110
3.1.3	No-arbitrage problem: $NA^w$ for finite $\Omega$ . . . . .	114
3.1.4	No-arbitrage Problem: $NA^s$ for Finite $\Omega$ . . . . .	115
3.2	No-arbitrage Problem: Abstract Approach . . . . .	117
3.2.1	$NA^r$ - and $NA^s$ -Properties: Formulations . . . . .	117
3.2.2	$NA^r$ - and $NA^s$ -Properties: Proofs . . . . .	120
3.2.3	The Grigoriev Theorem . . . . .	124
3.2.4	Counterexamples . . . . .	128
3.2.5	A Complement: The Rásónyi Theorem . . . . .	131
3.2.6	Arbitrage Opportunities of the Second Kind . . . . .	134
3.3	Hedging of European Options . . . . .	137

3.3.1	Hedging Theorem: Finite $\Omega$ . . . . .	137
3.3.2	Hedging Theorem: Discrete Time, Arbitrary $\Omega$ . . . . .	138
3.4	Hedging of American Options . . . . .	139
3.4.1	American Options: Finite $\Omega$ . . . . .	139
3.4.2	American Options: Arbitrary $\Omega$ . . . . .	141
3.4.3	Complementary Results and Comments . . . . .	143
3.5	Ramifications . . . . .	144
3.5.1	Models with Incomplete Information . . . . .	144
3.5.2	No Arbitrage Criteria: Finite $\Omega$ . . . . .	147
3.5.3	No Arbitrage Criteria: Arbitrary $\Omega$ . . . . .	150
3.5.4	Hedging Theorem . . . . .	154
3.6	Hedging Theorems: Continuous Time . . . . .	155
3.6.1	Introductory Comments . . . . .	155
3.6.2	Model Specification . . . . .	156
3.6.3	Hedging Theorem in Abstract Setting . . . . .	158
3.6.4	Hedging Theorem: Proof . . . . .	160
3.6.5	Rásonyi Counterexample . . . . .	162
3.6.6	Campi–Schachermayer Model . . . . .	164
3.6.7	Hedging Theorem for American Options . . . . .	170
3.6.8	When Does a Consistent Price System Exist? . . . . .	174
3.7	Asymptotic Arbitrage Opportunities of the Second Kind . . . . .	176
4	<b>Consumption–Investment Problems</b> . . . . .	183
4.1	Consumption–Investment without Friction . . . . .	183
4.1.1	The Merton Problem . . . . .	183
4.1.2	The HJB Equation and a Verification Theorem . . . . .	186
4.1.3	Proof of the Merton Theorem . . . . .	187
4.1.4	Discussion . . . . .	188
4.1.5	Robustness of the Merton Solution . . . . .	190
4.2	Consumption–Investment under Transaction Costs . . . . .	190
4.2.1	The Model . . . . .	190
4.2.2	Goal Functionals . . . . .	193
4.2.3	The Hamilton–Jacobi–Bellman Equation . . . . .	194
4.2.4	Viscosity Solutions . . . . .	194
4.2.5	Ishii’s Lemma . . . . .	199
4.3	Uniqueness of the Solution and Lyapunov Functions . . . . .	200
4.3.1	Uniqueness Theorem . . . . .	200
4.3.2	Existence of Lyapunov Functions and Classical Supersolutions . . . . .	202
4.4	Supersolutions and Properties of the Bellman Function . . . . .	204
4.4.1	When is $W$ Finite on $K$ ? . . . . .	204
4.4.2	Strict Local Supersolutions . . . . .	206
4.5	Dynamic Programming Principle . . . . .	208
4.6	The Bellman Function and the HJB Equation . . . . .	212
4.7	Properties of the Bellman Function . . . . .	213

4.7.1	The Subdifferential: Generalities . . . . .	213
4.7.2	The Bellman Function of the Two-Asset Model . . . . .	215
4.7.3	Lower Bounds for the Bellman Function . . . . .	216
4.8	The Davis–Norman Solution . . . . .	217
4.8.1	Two-Asset Model: The Result . . . . .	217
4.8.2	Structure of Bellman Function . . . . .	219
4.8.3	Study of the Scalar Problem . . . . .	222
4.8.4	Skorohod Problem . . . . .	228
4.8.5	Optimal Strategy . . . . .	229
4.8.6	Precisions on the No-Transaction Region . . . . .	232
4.9	Liquidity Premium . . . . .	234
4.9.1	Non-Robustness with Respect to Transaction Costs . . . . .	234
4.9.2	First-Order Asymptotic Expansion . . . . .	240
4.9.3	Exceptional Case: $\theta = 1$ . . . . .	245
<b>5</b>	<b>Appendix . . . . .</b>	<b>247</b>
5.1	Facts from Convex Analysis . . . . .	247
5.2	Césaro Convergence . . . . .	250
5.2.1	Komlós Theorem . . . . .	250
5.2.2	Application to Convex Minimization in $L^1$ . . . . .	250
5.2.3	Von Weizsäcker Theorem . . . . .	250
5.2.4	Application to Convex Minimization in $L^0$ . . . . .	253
5.2.5	Delbaen–Schachermayer Lemma . . . . .	253
5.3	Facts from Probability . . . . .	254
5.3.1	Essential Supremum . . . . .	254
5.3.2	Generalized Martingales . . . . .	255
5.3.3	Equivalent Probabilities . . . . .	256
5.3.4	Snell Envelopes of $Q$ -Martingales . . . . .	257
5.4	Measurable Selection . . . . .	258
5.5	Fatou-Convergence and Bipolar Theorem in $L^0$ . . . . .	261
5.6	Skorokhod Problem and SDE with Reflections . . . . .	262
5.6.1	Deterministic Skorokhod Problem . . . . .	263
5.6.2	Skorokhod Mapping . . . . .	264
5.6.3	Stochastic Skorokhod Problem . . . . .	265
	<b>Bibliographical Comments . . . . .</b>	<b>267</b>
	<b>References . . . . .</b>	<b>279</b>
	<b>Index . . . . .</b>	<b>293</b>