Contents

Preface			xii	
		Part I: Finance and Risk Management		
Chapter 1	Potpourri			
•		Introduction	03	
	1.2	Theoretical finance and decision making	05	
	1.3	Insurance and actuarial science	07	
	1.4	Uncertainty and risk in finance	10	
		1.4.1 Foreign exchange risk	10	
		1.4.2 Currency risk	12	
		1.4.3 Credit risk	12	
		1.4.4 Other risks	13	
	1.5	Financial physics	1.5	
	Sele	cted introductory reading	16	
Chapter 2	Mal	Making Economic Decisions under Uncertainty		
	2.1	Decision makers and rationality	19	
		2.1.1 The principles of rationality and bounded rationality	20	
	2.2	Bayes decision making	22	
		2.2.1 Risk management	23	
	2.3	Decision criteria	26	
		2.3.1 The expected value (or Bayes) criterion	26	
		2.3.2 Principle of (Laplace) insufficient reason	27	
		2.3.3 The minimax (maximin) criterion	28	
		2.3.4 The maximax (minimin) criterion	28	
		2.3.5 The minimax regret or Savage's regret criterion	28	
	2.4	Decision tables and scenario analysis	31	
		2.4.1 The opportunity loss table	32	
	2.5	EMV, EOL, EPPI, EVPI	33	
		2.5.1 The deterministic analysis	34	
		2.5.2 The probabilistic analysis	34	
	Sele	cted references and readings	38	

viii CONTENTS

Chapter 3	Exp	Expected Utility			
	3.1	The concept of utility	39		
		3.1.1 Lotteries and utility functions	40		
	3.2	Utility and risk behaviour	42		
		3.2.1 Risk aversion	43		
		3.2.2 Expected utility bounds	45		
		3.2.3 Some utility functions	46		
		3.2.4 Risk sharing	47		
	3.3	, management and expected attrity	48		
		3.3.1 Insurance and premium payments	48		
	3.4	Critiques of expected utility theory	51		
		3.4.1 Bernoulli, Buffon, Cramer and Feller	51		
		3.4.2 Allais Paradox	52		
	3.5	Expected utility and finance	53		
		3.5.1 Traditional valuation	54		
		3.5.2 Individual investment and consumption	57		
		3.5.3 Investment and the CAPM	59		
		3.5.4 Portfolio and utility maximization in practice	61		
		3.5.5 Capital markets and the CAPM again	63		
		3.5.6 Stochastic discount factor, assets pricing			
	2.	and the Euler equation	65		
	3.6	Information asymmetry	67		
		3.6.1 'The lemon phenomenon' or adverse selection	68		
		3.6.2 'The moral hazard problem'	69		
		3.6.3 Examples of moral hazard	70		
		3.6.4 Signalling and screening	72		
	D . C	3.6.5 The principal–agent problem	73		
	References and further reading				
Chapter 4		bability and Finance	79		
		Introduction	79		
	4.2	Uncertainty, games of chance and martingales	81		
	4.3	Uncertainty, random walks and stochastic processes	84		
		4.3.1 The random walk	84		
		4.3.2 Properties of stochastic processes	91		
	4.4		92		
		4.4.1 Ito's Lemma	93		
	4.5	Applications of Ito's Lemma	94		
		4.5.1 Applications	94		
		4.5.2 Time discretization of continuous-time			
		finance models	96		
	n c	4.5.3 The Girsanov Theorem and martingales*	104		
	Kete	rences and further reading	108		
Chapter 5	Deri	vatives Finance	111		
	5.1	Equilibrium valuation and rational expectations	111		

		CONTENTS				
	5.2	Finan	ncial instruments	113		
		5.2.1	Forward and futures contracts	114		
		5.2.2	- F	116		
	5.3		ing and institutions	119		
		5.3.1	mouge runds	120		
			Other hedge funds and investment strategies	123 125		
	5.3.3 Investor protection rules References and additional reading					
	Pa	art II: N	Mathematical and Computational Finance			
Chapter 6	Opt	tions an	nd Derivatives Finance Mathematics	131		
	6.1	Introd	luction to call options valuation	131		
		6.1.1	,	135		
		6.1.2	1 6	137		
		6.1.3	1 1	140		
	6.2		ard and futures contracts	141		
	6.3	6.3.1	neutral probabilities again	145		
	6.4		Rational expectations and optimal forecasts slack—Scholes options formula	146		
	0.4	6.4.1	•	147 151		
		6.4.2		152		
		6.4.3	I Financial part of the property	154		
	Refe	erences	and additional reading	157		
Chapter 7	-		d Practice	161		
	7.1		uction	161		
	7.2		ged options	163		
	7.3		ound options and stock options	165		
			Warrants	168		
	7.4		Other options and practice	169 171		
	7.7	- F	Plain vanilla strategies	171		
			Covered call strategies: selling a call and a	1/2		
			share	176		
		7.4.3	Put and protective put strategies: buying a			
			put and a stock	177		
		7.4.4	Spread strategies	178		
		7.4.5	Straddle and strangle strategies	179		
		7.4.6	Strip and strap strategies	180		
		7.4.7	Butterfly and condor spread strategies	181		
	7 5	7.4.8	Dynamic strategies and the Greeks	181		
	7.5		ng time strategies*	184		
	7.6	7.5.1 Specifi	Stopping time sell and buy strategies ic application areas	184 195		
	, .0	Specifi	ic application areas	173		

x CONTENTS

	77	Ontion minus			
		Option misses	197		
	Λn	ferences and additional reading	204		
	Дþ	pendix: First passage time*	207		
Chapter 8	Fix	Fixed Income, Bonds and Interest Rates			
	8.1	Bonds and yield curve mathematics	211 211		
		8.1.1 The zero-coupon, default-free bond	213		
		8.1.2 Coupon-bearing bonds	215		
		8.1.3 Net present values (NPV)	217		
		8.1.4 Duration and convexity	218		
	8.2	Bonds and forward rates	222		
	8.3	Default bonds and risky debt	224		
	8.4	Rated bonds and default	230		
		8.4.1 A Markov chain and rating	233		
		8.4.2 Bond sensitivity to rates – duration	235		
		8.4.3 Pricing rated bonds and the term structure			
		risk-free rates*	239		
		8.4.4 Valuation of default-prone rated bonds*	244		
	8.5	interest-rate processes, yields and bond valuation*	251		
		8.5.1 The Vasicek interest-rate model	254		
		8.5.2 Stochastic volatility interest-rate models	258		
		8.5.3 Term structure and interest rates	259		
	8.6	F	260		
		8.6.1 Convertible bonds	261		
		8.6.2 Caps, floors, collars and range notes	262		
	.	8.6.3 Swaps	262		
	Refe	References and additional reading			
	Mat	hematical appendix	264 267		
		A.1: Term structure and interest rates	267		
		A.2: Options on bonds	268		
Chapter 9	Inco	omplete Markets and Stochastic Volatility	251		
	9.1	Volatility defined	271		
	9.2	Memory and volatility	271		
	9.3	Volatility, equilibrium and incomplete markets	273		
		9.3.1 Incomplete markets	275		
	9.4	Process variance and volatility	276		
	9.5	Implicit volatility and the volatility smile	278		
	9.6	Stochastic volatility models	281		
		9.6.1 Stochastic volatility binomial models*	282		
		9.6.2 Continuous-time volatility models	282		
	9.7	Equilibrium, SDF and the Euler equations*	00		
	9.8	Selected Topics*	293		
		9.8.1 The Hull and White model and stochastic	295		
		volatility	201		
		9.8.2 Options and jump processes	296		
		S become mire Jamb bioce2262	297		

	CONTENTS			xi	
	9.9 The range process and volatility			299	
	References and additional reading				
	Appendix: Development for the Hull and White model (1987)*				
Chapter 10	Value	e at Risk	and Risk Management	309	
	10.1 Introduction			309	
	10.2	VaR de	finitions and applications	311	
	10.3	VaR sta		315	
		10.3.1	The historical VaR approach	315	
		10.3.2	The analytic variance—covariance approach	315	
			VaR and extreme statistics	316	
		10.3.4	Copulae and portfolio VaR measurement	318	
		10.3.5	Multivariate risk functions and the	316	
			principle of maximum entropy	320	
		10.3.6	Monte Carlo simulation and VaR	324	

10.4.1 VaR and portfolio risk efficiency with

normal returns

10.4.2 VaR and regret

References and additional reading

324

324

326

327

329

333

10.4 VaR efficiency

Author Index

Subject Index