APR. See annual percentage rate	Black-Scholes formula, 221–227
APT. See arbitrage pricing theory	general, 227
absolute risk aversion, 110	proof of, 265
adapted process, 66, 67, 78	Bond, 3-7, 39-48, 54
admissible portfolio. See portfolio	callable, 19
aggregation, 389	convexity, 341, 351
σ -algebra, σ -field, 65, 474	coupon, 5
generated, 474	duration, 341–347, 350
American option. See options	face, nominal, par, principal value, 3
Amex. See exchanges	floating rate coupon, 312
annual percentage rate, APR, 38	hedging, 341
annual worth, 38	immunization, 347–350
annuities, 37	inflation-indexed, real, 6
antithetic variables, 365	junk, 308
arbitrage, 43, 83–87, 179	long-term, 5
and equivalent martingale measures, 190, 206, 210	price in CIR model, 310
pricing, 179–188, 194	prices of, 4, 289
and replication, 195	pure discount, 5
trades, 85	short-term, 5
arbitrage pricing theory, APT, 436	zero-coupon, 5
ARCH/GARCH, 262–265	bondholder, 6
Arrow-Debreu prices, 133, 192, 198	book of options, 323
Arrow-Debreu securities, 57, 86, 87, 91	book-to-market ratio, 434
Asian options. See options	bottom vertical combination, 321
ask price, 25	boundary conditions, 375
asset, 3	Brownian motion, 63–74
mismatch, 314	and random walk, 476
autoregressive process, 80	geometric, 75
average, 247, 362	<i>n</i> -dimensional, 97
arithmetic, 247	simulated path of, 65
geometric, 247, 366	two-dimensional, 72
sample average, 263, 362, 416, 469	budget constraint, 56, 114, 134, 192, 198, 385, 396
sumple average, 200, 302, 110, 10)	bull spread, 318
backward algorithm, 117	butterfly spread, 319
backward induction, 218, 231, 276	buy and hold, 113
bank account, 54, 62, 74, 114	buying at margin, 23
barrier options. See options	buying price, 111
basis, basis risk, 315	ouying price, 111
Bayes' rule, 144, 200, 211	CBOE. See exchanges
Bayesian approach, 140	CBOT. See exchanges
bear spread, 318	CFTC. See exchanges
Bellman equation, 116	CIR. See Cox-Ingersoll-Ross
beta, 413, 425, 433, 441	CME. See exchanges
consumption, 428	CRR. See Cox-Ross-Rubinstein
bid-ask spread, 25	CRRA, 110
bid price, 25	calibration, 279, 295
binomial formula, 218	call option, 13–15
binomial model. See Cox-Ross-Rubinstein model	arbitrage bounds, 179–188
binomial tree, 61, 218, 231, 355	Black-Scholes formula, 225
for interest rates, 276	covered, 24, 318
Black caplet formula, 301	delta, 327
Black's futures formula, 242	naked, 24
Black-Scholes equation, 223, 331	payoff, 14
for two assets, 249	cap, 305
with stochastic volatility, 255	rate, 305
, 	···· y = ==

capital asset pricing model, CAPM, 409-429	covariance, 155, 372, 472
consumption-based, 405, 427	instantaneous, 372, 427
empirical tests of, 419	covered call. See call option
formula, 412	Cox-Ingersoll-Ross (CIR) model, 81, 287, 449
intertemporal, ICAPM, 423–427	bond price, 310
intertemporal multifactor, 442	equilibrium, 451
pricing formula, 418	Cox-Ross-Rubinstein (CRR) (binomial) model, 61,
capital gains, 236, 240	74, 117, 355
capital market line, 411, 417	and American options, 231
capitalization, 410, 434	and martingale, risk-neutral probabilities, 190
weights, 410	and option pricing, 217
caplet, 300, 305	is complete, 89
cash flow, 35, 36	Crank-Nicholson method, 376
central difference, 371	credit derivatives, 306
central limit theorem (CLT), 170, 222, 474	credit rating, 308
certainty equivalent, 110, 259	credit risk, 306
and pricing in incomplete markets, 259	intensity-based approach, 307
change of measure, xxi, 129	structural models, 306
change of numeraire. See numeraire	value-based models, 306
claim, 87	creditor, 4
closed, 206	cross-hedging, 314
collar, 305	CRRA, 110
collateral, 22	cumulative distribution function, 469
commodity, 187	currency options, 240
complete markets, 87–94, 130, 193, 196, 255	, <u>i</u>
and equivalent martingale measure, 193, 207	DJIA. See index
concave, 108	DPP. See dynamic programming principle
conditional expectation, 65, 475	debtor, 4
properties of, 65, 68, 303, 372, 475	default risk, 306
confidence level, 167	delta, 90, 224, 323, 325, 358
consumption, 103–106	as related to proportion, 155
admissible, 104	hedging, 325
aggregate, 401	in CRR model, 90
CAPM, 405, 427	of calls and puts, 327
choice, 105	delta-neutral, 326
rate, 105	density function, 470
contango, 205	Gaussian, normal, 472
contingent claim, 87	joint, 471
continuation region, 234	marginal, 472
continuous time, 62	derivatives, 9
models, 62	fixed income, interest rates, 275
	principle for pricing, 275
trading, 62	
control variates, 365	diffusion process, 66
convenience yield, 188	discount factor, xxi, 35, 112, 129
convex, 106, 206	discounted, xxi, 35
duality. See duality approach	prices, 56
programming, 336	process, 57
convexity, 341, 351	wealth process, 78
correlation, 72, 156, 472	discretization, 369
instantaneous, 72, 248	distribution, 469
cost of carry, 188	bivariate normal, 473
cost of replication, 191	Gaussian, normal, 472
counterparty, 4	joint, 471
coupon, 5	lognormal, 63, 75

Poisson, 260, 469	estimating means, variances, 77, 143, 262–265
standard normal, 473	Euler scheme, 368
diversification of risk, 156, 413–415	European option. See options
dividends, 7, 185, 235, 448	Excel, xix
and bounds on prices of derivatives, 213	tip, 169, 364, 369
and option prices, 235–240	ex-dividend, 236
net of, 235	exercise, 13, 15
yield, 7	price, 13
drift, 66	region, 234
not affecting option prices, 203, 222	exchange rate, 462–466
dual function, 134, 258	exchanges, 20
dual problem, 258	American Exchange, Amex, 20
duality approach, 134–138, 141, 143, 258	Chicago Board of Options Exchange, CBOE, 21
duration, 341	Chicago Board of Trade, CBOT, 21
Macaulay, 341	Chicago Mercantile Exchange, CME, 21
matching, 347	Commodities and Futures Trading Commission,
of portfolio of bonds, 346	CFTC, 21
dynamic programming, 116, 231	Nasdaq, 21
principle, DPP, 117, 122, 124, 231	New York Stock Exchange, NYSE, 20
proof of, 145	Securities and Exchange Commission, SEC, 21
1	exercise region, 234
e (the base of the natural logarithm), 34	exogenous, 383
early exercise, 13	expectation, expected value, 469, 470
effective annual rate. See interest rate	linearity of, 470
efficient frontier, 157	expectation formula, 218, 275
E-mail addresses, xxii	expectation hypothesis, 48
endogenous, 383	expected excess rate of return, 414
endowment, 385	expiration, 13
aggregate, 385, 400	
equilibrium, 383	face value, 3
and equivalent martingale measure, 393	factor, 433
existence of, 398	model, 433
fully revealing, 454	Fama-Macbeth method, 419
international, 461–466	feasible region, 158
Lucas, 392, 462	feedback form, 123, 124
multiagent, 389	Feynman-Kac theorem, 124, 201
multifactor models, 433–444	filtering theory, 141, 143
partial, 383	filtration, 66, 474
pure exchange, 391–398, 447	financial contracts, 3
single, representative agent, 389	financial instruments, 3
term structure, 447–451	classification of, 3, 4
with heterogeneous agents, 457–461	financial markets, 3
with incomplete information, 451–457	organization of, 20
equities, 3, 306	finite difference, 371
equity premium, 395	boundary condition, 375
puzzle, 395	Crank-Nicholson method, 376
equivalence of probability measures, 190	explicit method, 376
equivalent martingale measure (EMM),	grid, 373
190–193	implicit method, 374
and arbitrage, 193, 206, 210	first-order conditions, FOC, 385
and completeness, 193, 207	first-order scheme, 368
and Cox-Ross-Rubinstein model, 189	fixed-income securities, 3, 275
and equilibrium, 393	fixed rate. See interest rate
and Merton-Black-Scholes model, 200	floating rate. See interest rate

floor, 305	ICAPM. See capital asset pricing model
rate, 305	immunization, 347
forward exchange rate, 241	importance sampling, 366
forward-futures spread, 203	incomplete markets, 193, 256, 259
forward measure, 295	pricing in, 256–259
forward price, 10, 184, 203	independence, 471
and quantos, 253	independent increments, 476
as related to futures price, 186, 203	index, 21
forward rates, 45, 291	Dow Jones Industrial Average, DJIA, 22
continuously compounded, 291	Russell 3000, 22
formulas, 46	Russell 2000, 22
forwards, 10, 184–186, 203	Standard & Poor's 500, S&P 500, 21
pricing by arbitrage of, 184–186, 203	Wilshire 6000, 22
free boundary problem, 234, 235	indicator function, 200
free lunch, 84	inflation rate, 81–83
fully revealing prices, 454	information, 139
futures, 10–13, 186–188, 203	and equilibrium, 451
hedging with, 313	asymmetric, imperfect, incomplete, partial, 139, 451
options, 242	innovation process, 141, 455, 460
pricing by arbitrage, 186, 203	intensity-based approach, 307
futures price, 10, 186–188, 203	interest rate, 4, 31, 55, 59, 60, 74
as related to forward price, 186, 203	annual, annualized, 33
future value, 36	annual percentage rate, APR, 38
	bond's, 31
GARCH. See ARCH/GARCH	compound, 32
GDP. See gross domestic product	continuous, continuously compounded, 34
gains process, 56, 59, 236, 240	derivatives, 275
gamma, 330	effective, 33
negative, 332	fixed, 18
positive, 331	floating, 18
geometric sequence, 37	LIBOR, 299, 305
Greeks, 330	models of, 79–83, 275–295
formulas, 333	nominal, 33
grid, 373	one-factor models, 287
gross domestic product, GDP, 433, 437, 445	real, 81
H ''. I 1' D II (HID) DDE 100 105 100	short, 286
Hamilton-Jacobi-Bellman (HJB) PDE, 122–125, 439	simple, 32
Heath-Jarrow-Morton (HJM) model, 291	internal rate of return, IRR, 39, 342
hedge fund, 24, 171	intrinsic value, 15
hedge ratio, 314	Itô, 67
hedging, 12, 16, 224, 229, 313, 322	integral, 67
by immunization, 347	integral properties, 67
delta hedging, 322–330	multidimensional rule, 97
dynamic, 326, 334	proof of rule, 94
in bond markets, 341 in incomplete markets, 335	rule, 69–73
in Merton-Black-Scholes model, 327–328	Jensen's index, 417
· · · · · · · · · · · · · · · · · · ·	
in multivariable model, 334	Jensen's inequality, 108
options positions, 322 perfect, 313	jumps, 94, 260, 307
with futures, 313	and Merton's pricing formula, 261 intensity, 260
heterogeneous agents. See equilibrium	intensity, 200
	Valman Buoy filter 1/3
HJM drift condition, 293	Kalman-Bucy filter, 143

Lagrangian, 114, 131, 161, 164, 397	mean reversion, 80, 287
law of iterated expectations, 475	speed of, 80
law of large numbers, 362	mean-variance, 110, 153, 409
leverage, 12, 17, 171	analysis, 153–167
liability, 347	and CAPM, 409
LIBOR rate, 299, 305	efficient frontier, 157
linear regression, 316, 414	of a portfolio, 155
liquidity, 20, 171	optimization, 110, 160–167
loss of, 334	measurable, 66, 200, 211, 474
preference, 48	Merton-Black-Scholes (MBS), 62, 74-77, 122, 133
risk, 7	and martingale, risk-neutral probabilities, 197
loan, 37	is complete, 94
amortized, 37	multidimensional, 77
balance, 38	optimal portfolio formula, 121
fees, 38	Merton's generalized option pricing formula, 298
payments calculation, 37	minimum variance point (portfolio), 158
lognormal distribution, 63, 75	model, 53
long delta, 326	affine, 289, 299
long position, 9, 10, 16	binomial, 60, 355
Long-Term Capital Management (LTCM), 171	Black-Derman-Toy, 279, 288
low discrepancy sequences, 366	Brace-Gatarek-Musiela (BGM) market model, 300
1 7 1	continuous-time, 62
margin, 22	Cox-Ingersoll-Ross (CIR), 287
buying at, 23	Cox-Ross-Rubinstein (CRR), 61, 74
call, 22, 171	Heath-Jarrow-Morton (HJM), 291
initial, 22	Ho-Lee, 281, 287
maintenance, 22	Hull-White, 288
requirements, 22	Merton-Black-Scholes (MBS), 62, 74–77
marginal rate of substitution, xxi, 129	Merton's jump-diffusion, 260
market, 3	multiperiod, 58
capitalization value, 21	one-factor, 287
crash, 334	single-period, 54
financial, 3	structural, 306
perfect, 84	trinomial, 89
portfolio, 410	value-based, 306
market maker, 20, 25	Vasicek, 287
market price, 10	moment, 471
market price of risk, 125, 133, 197, 256, 411	moment generating function, 71, 139, 310
implied, 257	money, in, at, out of, 15
market-clearing conditions, 385, 397	Monte Carlo simulation, xix, 362
marking to market, 11	quasi, 366
Markov process, 65	mortgage, 19
martingale, 65, 129, 188, 476	backed securities, 19
approach, 128–138	prepayment, 19
definition, 476	multifactor model, 433
measure, 188	mutual-fund separation, 441
process, 65	myopic, 120
property, 65, 129, 189	mj opie, 120
representation theorem, 92, 136	Nasdaq. See exchanges
matrix notation, 420	NYSE. See exchanges
maturity, 3, 10, 13	naked call. See call option
mismatch, 314	natural hedge, 317
mean, 469	nominal rate, 81
,,	

nominal value, 3	perfect hedge, 313
normal backwardation, 205	performance evaluation, 416
normal random variable, 63, 66, 71, 139, 222,	Poisson distribution, 260, 469
262, 472	Poisson process, 260, 307
cumulative distribution function, 222	portfolio, 56
standard, 473	admissible, 78, 104
notation, xix	benchmark, 434
	dedicated, 347
notional principal, 18	
numeraire, 56, 104, 295, 386	hedging, computation of, 370
change of, 252, 295	hedging, in equilibrium, 441
risk-neutral probability for, 295	insurance, 16, 333
OTTO G	market, 410, 441
OTC. See over the counter	minimum variance, 158
optimal growth problem, 120	process, 55, 56, 78
optimal mutual fund, 163	replicating, 87
options, 13	weight, 115
American, 13, 180, 228–235	positive supply, 389
Asian, 247, 365	posterior distribution, 141
barrier, 245	predictable, 58, 83
Bermudan, 244	locally, 83
binary, 246	preferences, 105, 106
book of, 323	prepayment, 19
chooser, "as you like it," 245	present value, 35, 36
compound, 245	price impact, 25
digital, 246	price-yield curve, 39
down-and-in, down-and-out, 246	pricing, xx, 35
European, 13, 180	bonds, 290
exchange, 249	by expected values, xx, 196, 202
exercise, 13	by Monte Carlo simulation, 362
exotic, 16, 243	formula, 115, 418
forward start, 244	interest-rate derivatives, 278
holder/buyer/owner, 13	kernel, xxi, 129
knock-in, knock-out, 246	with random interest rate, 296
lookback, 246	primitives, 383
on futures, 242, 243	principal, 3
	notional, 18
on two assets, 248	,
path-dependent, 243	prior distribution, 140
path-independent, 92	probability, xxi
payoff, 14	equivalent, 190, 297
plain vanilla, 16, 243	real world, xxii, 48, 179, 188, 260
portfolio of, 317	risk-neutral, xxii, 179, 188, 200, 260
premium, 16	theory, 469
prices, 15	problems, xix
seller/writer, 13, 15	hard, xix
up-and-in, up-and-out, 246	solved in Student's Manual, xix
over the counter (OTC), 20, 243	profit/loss (P&L), 11, 56
	proportion of wealth, 115
par, 3, 39	optimal, 118–132, 142
partial differential equation (PDE), 202, 223	put-call parity, 183, 225
and American options, 234	put option, 13–15
Black-Scholes, 223, 331	arbitrage bounds, 180–184
Feynman-Kac, 124, 201, 224	Black-Scholes formula, 225
numerical solutions of, 373	delta, 327
partially recovered value, 307	payoff, 15
I V	I V 7 -

protective, 318, 333	expected value, 196, 200
synthetic, 334	probability, xxii, 189–193, 203
	world, 190, 276
quadratic error, 335	risk premium, 48, 112, 125, 198
quadratic variation, 71	risk-seeking, 108
quantity uncertainty, 317	rolling the hedge forward, 316
quantos, 252	Russell 2000. See index
	Russell 3000. See index
random numbers, 363	
generators, 363	S&P 500. See index
pseudo, 363	SDE. See stochastic differential equation
quasi, 366	SEC. See exchanges
random variable, 469	sample paths, 368
continuous, 470	scenario analysis, 171
discrete, 469	security, 3
random walk, 64, 476	Arrow-Debreu, 57
hypothesis, 74	derivative, 9
simple, 476	redundant, 91
rate of return, 154	risk-free, 4
real rate, 82	securities market line, 413
rebalancing, 113	segmentation hypothesis, 48
redundant security, 91	self-financing, 56, 59, 78, 104, 114, 396
regulatory agencies, 167, 355	Sharpe's index/ratio, 417
relative risk, 125, 198	short delta, 326
replicating portfolio, 87, 199, 224, 249, 323–335	short position, 9, 10, 16
replication, 87, 88, 199, 224, 328	short calling 0.56
and arbitrage, 195	short-selling, 9, 56
and Black-Scholes equation, 224 and portfolio insurance, 333	sigma-algebra. See σ -algebra, 65, 474 sigma-field. See σ -field, 65, 474
and pricing, 194, 199	simple interest. See interest rate
cost, 194	simple interest. See interest rate simulation, 361
in multivariable models, 334	speculation, 12
with real data, 328	spot price, 10
representative agent, 384, 401	spot rate, 42
and existence of equilibrium, 402	arbitrage, 43
resetting, resettlement dates, 18, 186, 303	standard deviation, 470
retrieval of volatility method, 373	standard error, 362
return, 7, 63, 120	state-price density, xxi, 129
expected rate of, 63, 75, 113, 116, 120	state prices, 192
rate of, 154	state variable, 66
rho, 330	static position, 180, 317
Ricatti ODE, 290	stochastic, 22
risk, 153	calculus, 62
idiosyncratic, nonsystematic, specific, 414	control theory, 124, 336
market, systematic, 414	differential equation, 66, 368
risk-averse, 108	discount factor, xxi, 129
risk aversion, 110	integral, 67
absolute, 110	optimization, optimal control, 336
relative, 110	volatility, 94, 254-257, 332
risk-free, 4	stock, 3, 7, 63, 75
asset/security, 54, 62, 74, 158	price process and martingales, 189, 200
risk management, 167, 355	stockholder, 7
risk-neutral, xxii, 108, 110, 188	stopping time, 229
density, 133, 191, 198, 258	storage costs, 187

straddle, 321 strangle, 321 stress testing, 171 strike price, 13 submartingale, 476 supermartingale, 230, 476 swaps, 17–19, 301 price of, 302 rate, 302 swaption, 304 rate, 304	VaR. See value at risk value at risk, VaR, 167–170 value function, 116, 122, 124, 424, 439 variance, 63, 76, 77, 356, 469 estimation of, 77, 262 in CRR model, 356 of a linear combination, 472 of a portfolio, 155 reduction, 364 sample variance, 77, 263, 416 Vasicek model, 80 vector notation, 420
target price, 316 term structure of interest rates, 41, 42 affine, 289 equilibrium models of, 447 flat, 346 Heath-Jarrow-Morton (HJM) model of, 291 matching, 279–286, 295 parallel shifts, 346 theories, 48	vega, 330 Visual Basic, xix, 369 volatility, 63, 76, 81 implied, 227, 256 matrix, 77 of interest rates, 279 smile, 228 stochastic, 254–257, 332
theorem Black-Scholes formula, 225 CAPM, 412 central limit, 473 Feynman-Kac, 124, 201, 224, 289 fundamental, of asset pricing, 193 Girsanov, 201, 297 martingale representation, 92, 136, 199 one fund, 160, 410, 426 separating hyperplane, Hahn-Banach, 206 theta, 330 transaction costs, 24, 138 tree, 61 binomial, 61, 218, 231, 276, 355 implied, 256 recombining, 61 trinomial, 360	Walras' law, 386 wealth, xxi and martingales, 191, 194, 198, 201 equation, 78, 105, 123–126 initial, 55 optimal, xxi, 114, 135, 143, 259 process, 55–57, 59, 78, 104, 123 web page for this book, xix Wiener process. See Brownian motion Wilshire 6000. See index writing an option, 13, 16 yield, 39, 342 curve, 41 elasticity, 345 to maturity, 39
Treynor's index, 417 underlying, 9, 12 utility, xxi based price, 257 expected, 107, 122 exponential, 109 function, xxi, 107–112 indirect, 116, 424, 439 logarithmic, log, 109, 115–120, 125, 137, 142 marginal, 108 maximization, 113–145, 373 power, 109, 142 pricing, 257 quadratic, 109, 112	zero net supply, 387, 389 zero-sum game, 10, 11, 16, 19