

- Alpha estimates, 353
- Alternating direction implicit (ADI) method, 241–244
- Alternative Branching Process, 486–487
- American options, 1, 30–33, 102, 137–138, 142, 149, 165, 182, 189–190, 201–202, 232–235, 246, 255–257, 276, 549, 711–712
- American spread call option, 149
- American swaptions, valuation methods, 718–730
- Angular decomposition, 656
- Antithetic variates, 68, 72, 122
- Arbitrage, 2, 15, 31–32
- Arbitrage-free evolution, 596–599, 608, 616–617
- Arbitrage-free market, 34
- Arbitrage-free pricing, 596–599
- Arithmetic Asian options, 63
- Arithmetic average option, 90–92
- Arithmetic averaging, 246, 260–261
- Arithmetic Brownian motion, (ABM), 69
- Arrow-Debreu securities, 178, 180, 470
- Asian options, 69, 85–92, 258, 261–262
- Asymmetric GARCH (A-GARCH), 337–340. *See also* Nonlinear asymmetric GARCH (N-GARCH)
- At-the-money (ATM) Bermudan swaption, 713
- At-the-money (ATM) options, 170, 174, 189–190, 200, 268–273, 277, 281–283, 286–287, 305–307, 309, 441, 685–686
- Autocorrelation, 333
- Autoregressive conditional heteroskedasticity (ARCH) process, 341, 362
- Average forward rate, 397
- Average price option, 258
- Barrier options:
  - characteristics of, 246–255
  - implementation of, 255–257
- Basket call option, 381–388
- Bermudan path-dependent options, 246
- Bermudan swaptions, 466, 710–733
- Berndt-Hall-Hall-Hausmann (BHHH) numerical optimization, 342–344, 346, 353
- Bessel functions, 260, 306
- Beta estimates, 353
- BGM/J model, *see* LIBOR market models (LMMs)
- Binary search tree (BST), construction of, 599
- Binomial distribution, 8
- Binomial average option, 250–251
- Binomial option pricing, 127
- Binomial probability distribution, 126
- Binomial trees, 123–164, 565
- Black-Derman-Toy (BDT) single-factor interest rate model:
  - characteristics of, 395, 438–439
  - tree construction, 467–485, 501–502, 551, 553
- Black-Karasinski short rate model, tree construction, 467, 495–501, 509, 511–515
- Black’s caplet formula, 641–642
- Black-Scholes-Merton:
  - constant volatility, 291
  - implied volatility, 296–297
- Black-Scholes model (BSM), binomial trees, 125–126, 131, 133, 139
- Black-Scholes option pricing model, 1, 4–34, 38–42, 102, 124–125, 171, 247, 259, 261, 275–276, 282–283, 324–325, 399, 448, 789
- Black’s swaption volatility, 672
- Bloomberg, as information resource, 153, 160
- Bond pricing, partial differential equation (PDE), 395, 399–401, 413
- Bonds, *see specific types of bonds*
- Boundary value problem, barrier options, 248–249
- Box-Muller algorithm, 49
- Brownian bridge technique, 92–98
- Brownian motion, impact of, 4–7, 37–38, 40, 46, 53, 70, 93, 145, 151, 243, 314, 319–320, 368, 371–373, 375, 406–407, 421, 436, 469, 556–557, 560, 580, 632, 645, 664, 668, 692, 755–756, 759, 783–787, 790
- Bushy trees, 711–712
- Butterfly spread, 307
- C++ libraries, 804
- Cakici and Topyan (CT) algorithm, GARCH option pricing, 358–359, 361–362
- Calendar spread, 307
- Calibration, 401, 438, 448–449, 457–466, 471–476, 492–495, 522, 556, 641–642, 669–670, 676, 686–687
- Call options, 16, 32–33, 44, 73–76, 127, 140, 178–179, 189–190, 202, 262–263, 286, 381–388, 443, 523–525, 542
- Call provisions, 150–151
- Call spread, 307
- Caplets, 448–450, 561–562, 579, 637–639, 641–642, 648, 670–684
- Caps, 448–455, 561, 579, 641–642, 665, 710, 754, 757

- CD-ROM:  
 applications, 804–805  
 contents of, 803–804  
 customer care, 805  
 system requirements, 803
- Central limit theorem, 48, 67, 126, 129–130
- Central moments, defined, 774
- Change of drift formula, 633, 663, 756, 759
- Charter Communications, 153–155, 159–161
- Chi-squared distribution, 432
- Chicago Board Options Exchange (CBOE), 303
- Chicago Mercantile Exchange, 2
- Cholesky decomposition, 52, 55, 98, 319–320, 375, 377, 557, 656, 667, 685, 694
- Cholesky factorization, 51–52
- CIR, *see* Cox-Ingersoll-Ross (CIR)
- CIR++, 556
- Clean price, 398
- Clustering, volatility, 333, 341
- Complementary binomial distribution, 127–128
- Complete diffusion equations, 374
- Complete financial market, 34
- Compounded returns, 326
- Compounding, 2, 470–471, 502, 587–588, 630
- Conditional probability density, 248–249
- Conditional probability distribution, 776
- Constant elasticity of variance (CEV), 17n, 102, 274, 305–307, 679
- Continuous-time process, 46
- Control variates, Monte Carlo simulation, 67–69
- Convergence rate, trinomial trees, 173
- Conversion ratio, 150, 154–155
- Convertible bonds, valuation of, 150–164
- Corporate bonds, 397
- Correlation/covariance matrix, Monte Carlo simulation, 50–53, 56
- Correlations, LIBOR market models (LMMs), 641–642, 665–669
- Coupon-bearing bonds, 3, 429, 431, 444–445, 524
- Covariance matrix, 50, 53, 56, 372, 557, 656, 764, 770
- Cox-Ingersoll-Ross (CIR) short rate tree construction, 515–521, 541–549
- Cox-Ingersoll-Ross (CIR) single-factor interest rate model: characteristics of, 41, 395, 431–438 extended (time-homogeneous), 436–438 tree construction, *see* Cox-Ingersoll-Ross (CIR) short rate tree construction
- Cox-Ross-Rubinstein (CRR) binomial trees: characteristics of, 131–137, 152, 169 implementation of, 138–140
- Cox-Ross-Rubinstein (CRR) trinomial trees, 165, 168–170
- Crank-Nicolson finite-difference scheme, 212, 235–241
- Credit risk, 164
- Credit spread, 151
- Cubic spline, 308
- Cumulative gamma distribution, 307
- Cumulative normal distribution, 15, 28, 441, 443, 446, 526
- Davidson-Fletcher-Powell (DFP) numerical optimization, 342–343
- Davies, R. B., 56, 346
- Decay factor, GARCH, 366
- Decorrelation, LIBOR market models (LMMs), 669
- Default risk, convertible bonds, 152, 162
- Delayed-barrier options, 254
- Delta, 10, 23–24, 76–78, 142–143, 247, 322, 598, 690–692, 696, 698–704, 780–782
- Delta-based martingale, 77
- Delta-hedged portfolio, 30
- Diffusion coefficient, 4–6, 47, 108–109, 176
- Diffusion process, 189, 232, 252, 368, 388–389, 564
- Dirac's delta function, 780–782
- Dirichlet boundary conditions, 301
- Dirty price, 398
- Discount bonds, 396–397, 442, 448–449, 468, 489, 501–502, 549–551, 555, 562, 579, 585–586
- Discount rate, convertible bonds, 151–153
- Discrete-state tree, GARCH option pricing, 358
- Discrete-time economy, single-factor interest rate models, 587–590, 597
- Discretization, explicit finite-difference, 185–186
- Dividends, 3, 135–137
- Double-barrier options, 254
- Double-barrier step options, 254
- Down-and-in calls/puts, 247, 250
- Down and in (DI) trigger swaps, 752
- Down-and-out calls/puts, 247, 249–250
- Down and out (DO) trigger swaps, 752–753
- Drift calibration, 401
- Drift coefficient, 14, 47, 108, 176, 398–399
- Drift rate, 322–323, 503
- Dupier's equation, 307
- Dynamic replication strategy, 73–74
- Dynamic trading strategy, 11–12, 72, 322
- Early exercise, 32
- Effective barrier, 253–255
- Eigenvectors, Monte Carlo simulation, 53, 56
- Equivalent martingale measure, 4, 15, 17, 33–34, 431, 589
- Estimation process, *see specific types of estimation*
- European market, caplet smiles, 677–679
- European options, 1, 16, 28, 31, 66–67, 79–81, 83, 113–117, 122, 124, 165, 170, 178, 226–228, 231–232, 246, 268–273, 276, 306, 313–314, 354, 420–425, 435, 448–449, 523–525, 541–542, 559, 561, 579, 584–586
- European spread call, 81–83
- European swaptions, 395, 443–448, 562–564, 657–662, 713
- Excel spreadsheets, 415–416, 804

- Excel Viewer, 805
- Exchange-traded contracts, 2
- Exchange-traded options, 178
- Ex-dividend, 135–136
- Exercise dates, exotic options, 246
- Exotic options, 246–259, 260–273, 733–742, 754–770
- Explicit finite-difference methods: characteristics of, 183–186 implementation of, 186–191, 212
- Exponential GARCH (E-GARCH), 338–340
- Exponential weight moving average (EWMA), 331–334, 341
- Fast Fourier transform (FFT), 84, 149
- Fat tails, implications of, 316, 339–340
- Faure sequence, Monte Carlo simulation, 63–66
- Feynman-Kac formula, 323, 400–402, 764–765
- Financial leverage effect, 102
- Financial Times Stock Exchange (FTSE) 100 index, 289, 291, 325, 330–331
- Finite-difference methods, 171–172, 183–202, 212, 232–242
- First conversion date, 150
- First-order approximation, 47, 168, 254, 379
- First-order Taylor series, 254, 275
- Fixed-income derivatives, 549–553, 710
- Fixed leg rate, 642, 753
- Fixed-rate bonds/loans, 443–444, 455–456
- Fixed-strike lookback option, 246, 262
- Fixed-strike volatility, 283
- Floating leg rate, 642–643, 753
- Floating LIBOR rate, 719, 743
- Floating-rate bonds/loans, 443–444, 455–456
- Floating-strike lookback put options, 246
- Floorlets, 441, 443
- Floors, quanto, 710, 757
- Fokker-Planck equation, 311
- Forecasting models, 362–366. *See also* Statistical models
- Foreign currencies (FX) options, 137
- Foreign currency, 3–4
- Foreign exchange market, 316
- Foreign exchange rate, 756, 759
- Forward bond price, 423
- Forward contracts, 1–4
- Forward discount factor, 644
- Forward drift approximation, LIBOR market models (LMMs), 692–695, 697–698
- Forward forward volatilities, 642
- Forward measure, 41–42
- Forward option price, 184–185
- Forward price, 292, 323
- Forward rate, 41, 397, 399, 415–416, 418, 434, 441–442, 522, 555, 558–559, 580–581, 588, 590–594, 596, 598–599, 617, 622–623, 626, 631, 636–640, 642, 644–646, 670, 676, 754
- Forward risk-neutral measure, zero-coupon bonds, 421
- Forward-start swap, 445, 643
- Forward swap rate, 447, 647
- Forward volatilities, 641
- Forward yield curve, 396–397
- Fourier transform, 774
- Fredholm integral equation, 290
- Free boundary, 30–31
- Freeware, 805
- Freezing the drift, 665–666
- Futures contracts, defined, 2
- Galerkin condition, 291
- Gamma, 24, 102, 142, 247, 306, 339, 696, 698, 705–707
- GARCH (generalized autoregressive conditional heteroskedasticity) model: asymmetric (A-GARCH), 337–340 characteristics of, 334–337, 340–353 defined, 324 exponential (E-GARCH), 338–340 forecasting, 362–366 integrated (I-GARCH), 341–342 nonlinear asymmetric (N-GARCH), 355 option pricing model, 354–362 symmetric, 337, 343 vanilla, 337
- Gauss-Hermite quadrature, 763–766, 768–770
- Gauss-Legendre quadrature, 763
- Gauss-Seidel method, iterative finite-difference, 232–234
- Gaussian distribution, 98
- Gaussian kernel, 289–291
- Gaussian quadrature, 84, 149, 760–763, 766–768, 770
- Geman-Yor formulas, 260
- Generalized error distribution, 339
- Geometric Asian options, 63
- Geometric averaging, 246, 258–259
- Geometric Brownian motion (GBM), impact of, 6, 9, 17, 39, 45–46, 69–70, 81, 99, 124, 134, 145, 176, 242, 283, 313, 316, 325, 376–377, 789
- Ghost effects, 325
- Girsanov's theorem, 1, 15, 38–41, 421–422, 589, 665
- Global optimum, 353
- GNU General Public License: copying, distribution, and modification, 808–812 preamble, 807–808
- GNU software, 805
- Greeks: alpha, 353 beta, 353 delta, 10, 23–24, 76–78, 142–143, 247, 322, 598, 690–692, 696, 698–704, 780–782 gamma, 24, 76–78, 102, 247, 306, 339, 696, 698, 705–707 LIBOR market models (LMMs) and, 631, 688–709 rho, 25, 143 theta, 25, 143, 296 vega, 143, 276, 280, 322, 696, 698, 707–709
- Green's function, 248–249, 409, 763–764
- G2++ model: characteristics of, 555–564 tree construction, 564–576
- Heat equation, 248–249
- Heath-Jarrow-Morton (HJM) single-factor interest rate models: characteristics of, 420, 457, 555, 587–592

- Heath-Jarrow-Morton (HJM)  
 single-factor interest rate models (*Continued*)  
 implementation of, 599–607  
 range note valuation, 734–742  
 synthetic swap valuation, 607–615  
 tree construction, 599–607, 734–742
- Heath-Jarrow-Morton (HJM) two-factor model:  
 characteristics of, 555, 580–587, 615–617  
 implementation of, 618–622
- Hedging, 10, 76–84, 140–144, 247, 321–322
- Hessian matrix, 345, 351–352
- High-frequency data, GARCH models, 340–353
- Historic volatility, 329–331
- Hull-White (extended Vasicek) model:  
 characteristics of, 395, 425–429, 449–450  
 tree construction, 467, 485–495, 501, 504–509, 520, 526–541, 584
- Hull-White LIBOR market model, 631, 634, 639–641, 646–648
- Hull-White two-factor model, characteristics of, 576–580
- Implicit finite-difference methods:  
 characteristics of, 191–194  
 implementation of, 196–202, 212, 231–232
- Implied binomial tree, 181–182
- Implied probability distribution, 307
- Implied volatility, 274–303, 410, 638, 676, 681–682
- Incomplete market, 374
- In-the-money (ITM) options, 16–17, 281–282, 723
- In-the-money swaption, 645
- Index-amortizing swaps, valuation of, 742–752
- Infra-correlation, LIBOR market models (LMMs), 671
- Instantaneous correlation, 665–669, 680
- Instrument, options class, 20–22
- Integrated GARCH (I-GARCH), 341–342
- Interest rate floors, 440
- Interest rate(s), implications of, 4, 40–41, 163, 396, 401, 442
- Interest-rate swap (IRS), 443, 642–644
- Intrinsic value, 551, 723
- Inverse Fourier transform, 779
- Iterative finite-difference methods, 232–235, 237
- Ito integral, 787
- Ito's formula, 788–789
- Ito's lemma, 6, 13, 292, 303, 321–322, 368, 388–389, 398–399, 421–422, 495, 581, 626, 647, 789
- Jacobi method, iterative finite-difference, 232–233
- Jamshidian's decomposition, 395, 429–431, 524
- Jarrow-Rudd (JR) trees, 132–137, 166–167
- Jump diffusion, 17, 98–102, 290, 313–315, 681
- Karhunen-Loeve decomposition, 289
- Knockout barrier option, 250, 253
- Laguerre polynomials, 722
- Lambda ( $\lambda$ ), implications of, 169, 189, 339, 344–345, 348–349, 393, 432, 589–590, 597, 626, 640
- Lattice(s), 8, 30, 190, 229–231, 710
- Law of large numbers, 787
- Least-squares Monte Carlo (LSMC) technique, 710, 721, 724–725
- Least-squares regression, 78–79
- Leibnitz's rule, 789–790
- Leptokurtic models, 339
- Leverage effect, 102
- LIBOR market models (LMMs):  
 advantages of, 630–631  
 characteristics of, 631–642, 644–678, 686–709, 732–733  
 defined, 630
- Likelihood density function, 343
- Likelihood ratio methods (LRMs), 688, 694
- Likelihood ratio test statistics, 325
- Linear regression, 78
- Linear sum operator, 345
- Lipschitz continuous function, 690
- Li-Ritchken-Sankarasubramanian (LRS) two-factor model, 556, 626–629
- Local volatility surfaces, 288, 309–313
- Lockout period, 150
- Log-Euler scheme, 656–657
- Log-likelihood function, 343
- Lognormal distribution, 7–8, 37, 46, 93, 125, 130, 260, 314, 412, 447, 496, 759
- Lognormal dynamics, 44
- Lognormal forward model (LFM):  
 calibration, 641  
 correlation structures, 665–666  
 characteristics of, 631  
 forward-swap model, incompatibility with, 631, 663–664  
 swaption pricing with, 642–646  
 swaption volatilities formula, 648–655, 663–664, 673–677
- Lognormal forward-swap model (LSM), 631, 645, 663–664
- Lognormal Hull-White short rate model, *see* Black-Karasinski short rate model
- Lognormal process, stochastic multifactor models, 368, 376–388
- Log-Poisson distribution, 314
- London Interbank Offered Rate (LIBOR), 439–442, 455–456, 562. *See also* LIBOR market models (LMMs)
- Long positions, forward contracts, 2
- Longstaff and Schwartz method (LSM), 721–730
- Lookback options, 262–273
- Low-discrepancy sequence, 98
- LU decomposition, 194–196, 199, 232, 237–238
- Market conditions, 325–326
- Market risk, 3
- Markov chain dynamics, Bermudan swaptions, 712, 719
- Markov diffusion process, single-factor interest rate models, 402
- Markov short rate process, 581–582
- Mark to market, 3
- Martingale, implications of, 33–34, 304, 311, 422–423, 442, 447, 616, 632, 635, 755, 758–759. *See also* Equivalent martingale measure

- Matrix, *see specific types of matrices*
- Maximum likelihood estimates, 325, 341–342, 344, 346, 353
- Mean, defined, 774
- Mean reversion, 316, 403–404, 424, 486–487
- Mean tracking (MT) option price tree, 359–360
- Merton-Ho-Lee model, 424, 449
- Mesh density, 731
- Milstein:
  - approximation, 47
  - dynamics, 666
- Minimand, defined, 295
- Modified barrier, 253–255
- Moment-generating function, 39, 46
- Moments expansion, 774–775
- Money market account (MMA), 3–4, 11–13, 17, 321, 456–457, 608, 634, 712, 734
- Monte Carlo simulation(s), 45–67, 69–122, 246, 320, 323, 362, 365, 367–368, 375–376, 401–402, 585–587, 640, 648, 657, 667, 711–712, 720–721
- Monte Carlo swaption price estimate, 631, 655–663
- Mortgage-backed securities, *see* Index-amortizing swaps, valuation of
- Moving average (MA):
  - characteristics of, 329–330
  - exponential weighted (EWMA), 331–334, 341
  - high-frequency data, 341
- Multidimensional stochastic simulations, 50
- Multinomial tree, 359–360
- Multivariate diffusion processes, 50, 374–376
- Municipal bonds, 398
- Nadaraya-Watson estimator, 288
- Newmat matrix library, 56, 346
- Newton-Cotes formula, 760
- Newton-Raphson equation, 274–276, 278, 297
- Newton-Raphson method, 430, 449, 469, 472–474, 477–478, 480, 489, 497, 670
- No-arbitrage:
  - drift, 579
  - implications of, 10
  - pricing, 1, 13, 34
  - relationships, trinomial trees, 179
- Non-Markovian short rate process, 585–586
- Nonlinear asymmetric GARCH (N-GARCH), 355
- Nonlinear regression, 584
- Nonrecombining trees, Bermudan swaptions, 711
- Normal distribution, 7–8, 15, 68, 101, 130, 178, 339, 406, 773
- Normal random variable, 355
- Nueraire, 1, 4, 35–38, 41–44, 421, 442, 632–634, 645–646
- One-step-ahead forecast, 364
- Optimization methods, 342–343, 458–462, 465, 721
- Options, *see specific types of options*
  - characteristics of, 17–18
  - classes of, 18–30
  - writing, 77
- Ordinary differential equation (ODE), single-factor interest rate models, 405, 437–438
- Ordinary least squares (OLS) estimation, 344–345
- Ornstein-Uhlenbeck process, 18–19, 290, 405–406, 428
- Orthogonality, 290–291
- Out-of-the-money (OTM) options, 127, 281–283, 309, 440
- Out-of-the-money swaption, 645
- Over-the-counter (OTC) market, 2, 276
- Overdetermined diffusion equations, 374
- Parity, 16, 152, 445
- Partial differential equation (PDE), 1, 4–10, 15, 30–31, 163–164, 184, 242–243, 292–293, 311, 322–323, 395, 399–401, 413, 433, 436
- Path-dependent derivatives, 246
- Payer swaption, 443
- Plain-vanilla options, 26–28, 223–224, 679
- Plain-vanilla swaps, 742–743
- Poisson process, 98–102
- Polar rejection method, 49
- Portfolio rebalancing, 11
- Prepayment risk, 742
- Present value (PV), 2–3, 456
- Price caps, *see* Caps
- Pricing, generally:
  - Bermudan swaptions, 710, 713
  - caps, Black's model, 395, 439–443
  - formulas, 33–35
  - range note, 733–734
  - trigger swaps, 752–754
  - types of options, 69, 182, 246–247, 250–252, 258–259, 261–264, 549
- Primary securities, 374
- Principal component analysis (PCA), 289–290, 319, 324, 367, 389–394, 555, 639
- Principal components representation, 391
- Probability, overview of, 771–782
- Probability density function, 764, 773–774, 776, 781, 784
- Probability distribution function, 7
- Probability spaces, characteristics of, 771–773
- Profit/loss (P/L), 12–13, 72–73
- Pseudorandom number generation, 48
- Pseudo-RNGs, Monte Carlo simulations, 56–57
- Put-call parity, 16
- Put options, 16, 141, 143, 182, 197–198, 200–201, 262–263, 265–273, 443
- Put provisions, convertible bonds, 151
- Quadratic variation/covariation, 790–791
- Quadrinomial trees, two-factor models, 565
- Quantitative Pricing Engine Library, 804
- Quantization error, 250
- QuantLibXL, 804
- Quanto (multicurrency) derivatives:
  - caps, 710, 754, 757
  - characteristics of, 710, 754–757
  - floors, 710, 757
  - swaptions, 710, 757–760
- QuantPro, 803
- Quasi-Monte Carlo integrals, 98
- Quasi-random number generators (RNGs), Monte Carlo simulations, 56–57, 63
- Radon-Nikodym derivative, 3, 33, 36, 39–40, 43, 369–370, 422, 432, 559–560

- Random variables, 49–56, 368–371, 773–777  
 Random walk, 93, 165, 367, 371–373, 784  
 Range note, 733–734  
 Rate of return, 6, 9, 128  
 RATS (Regression Analysis of Time Series), 341  
 Rebonato's two-stage approach, LIBOR market models (LMMs), 639–640, 667–668  
 Receiver swaption, 443, 445–446, 564  
 Recombining lattices, LIBOR market models (LMMs), 711  
 Recombining trees, 598, 627–628  
 Recovery rate, 162  
 Recursion, 598  
 Regularizing parameters, 295  
 Replicated option, 30  
 Replicating portfolio, 13, 15, 399  
 Research Seminar in Quantitative Economics (RSQE) database, 364  
 Returns, implications of, *see specific types of returns*  
 Rho, 25, 143  
 Riccati differential equation, 437  
 Riemann sums, 786–787  
 Risk-adjusted martingale, 520  
 Risk-free rate, 2–5, 9–10, 15, 46, 77, 99, 123–124, 152, 162, 399, 590  
 Riskless no-arbitrage portfolio, 292  
 Riskless portfolio, 9, 399  
 Risk-neutral, generally:  
   binomial probability, 124  
   drift, 323, 419, 589–590  
   investors, characteristics of, 3  
   measure, 556, 580, 761  
   numeraire, 43  
   pricing, 1, 4, 10–17, 84–85, 263–264, 423, 549  
   process, 70, 400–401, 434  
   valuation, 734–735  
 Risk-neutral probabilities, 354, 589, 592–594, 616  
 Ritchken and Sankarasubramanian (RS) two-factor model, 555–556, 622–626  
 Ritchken and Trevor (RT) algorithm, 354–355, 357–359, 361–362  
 S&P 500 index, 282, 286–287, 291, 303, 316, 352, 364  
 Scalar random variable, stochastic multifactor models, 369  
 Schwartz inequality, 673  
 Seasoned Asian options, 261–262  
 Self-financing strategy, 35  
 Self-replicating strategy, 34  
 Shareware, 805  
 Shift-extension process, in tree construction, 520–524  
 Short position, forward contracts, 2  
 Short rate process, 395, 398–402  
 Short-rate-tree-building procedures:  
   BDT short-rate model, 467–485, 501–502, 551, 553  
   Black-Karasinski short-rate model, 467, 495–501, 509, 511–515  
   Cox-Ingersoll-Ross (CIR) model, 515–521, 541–549  
   deterministic-shift extension, 520–524  
   fixed income derivatives, 549–553  
   Hull-White short rate process, 467, 485–495, 501, 504–509, 520, 526–541, 584  
   lognormal Hull-White, 467, 495–501  
   Vasicek model, 467, 509–511, 521, 524–541  
 Short sales, 16  
 Sigma field, 33, 557, 561  
 Simpson's rule, 760–761  
 Single-factor interest rate models:  
   arbitrage-free restrictions, 591–594  
   Black-Derman-Toy (BDT) model, 395, 438–439  
   bond pricing partial differential equation, 395, 399–401  
   calibration, 457–466  
   Cox-Ingersoll-Ross (CIR) model, 395, 431–438  
   European swaption pricing, 395, 443–448  
   Heath-Jarrow-Morton model, 599–607  
   Hull-White model, 395, 425–429, 449, 451  
   implementation process, 395  
   Jamshidian's decomposition technique, 395, 429–431  
   overview of, 395–398, 402–404  
   pricing caps, 395, 439–443  
   short rate process, 395, 398–399, 401–402, 448–455  
   swaps, valuation of, 455–457  
   Vasicek model, 395, 404–425, 441  
 Six-step-ahead forecast, 364–365  
 Skew, 276–283, 289, 674, 711  
 Smiles, 277–282, 284, 289, 673–677  
 Smoothing, 288–289  
 Sobol sequences, Monte Carlo simulation, 57–59, 61–63  
 Specification error, 250–251  
 Specified barrier, 253–255  
 Spectral decomposition, 656  
 S-PLUS, 341  
 Spot rate(s), 414–416, 428, 442, 520, 579, 581, 622, 624–626, 631, 743  
 Spread options, 50, 149  
 Spread option stochastic volatility model, 316–317  
 Square-root process, 176, 316  
 Stability condition, 181–182  
 Standard deviation, 47–50, 67, 70, 72, 171, 173, 313, 392, 447, 588–589, 628, 776  
 Standard error, 72  
 State prices, 178, 180  
 Stationary process, 17  
 Statistical models:  
   estimation problems, 353–354  
   GARCH, 334–366  
   moving average (MA), 329–334  
   overview of, 324–329  
 Step-ahead forecast, 363–364  
 Stochastic calculus, review of, 783–791  
 Stochastic differential equation (SDE), 4, 6–7, 11, 38–39, 46–47, 69–70, 92, 374–375, 378, 389, 398, 405–406, 408–410, 422, 439, 521, 582, 657, 675, 755  
 Stochastic discount factor, 34  
 Stochastic integrals, 785–788  
 Stochastic Leibnitz rule, 789–790  
 Stochastic mesh, 730–733  
 Stochastic multifactor models:  
   Brownian motion,  $n$ -dimensional, 368, 371–373, 375  
   correlated random variables, change of measure, 370–371  
   independent random variables, change of measure, 368–370

- lognormal process,
  - $n$ -dimensional, 368, 376–388
- multivariate diffusion processes, 374–376
- overview of, 367–368
- principal component analysis (PCA), 367, 389–394
- random walks,  $n$ -dimensional, 367, 371–373
- vector-valued diffusion processes,
  - Ito's lemma, 368, 388–389
- Wiener process,  $n$ -dimensional, 367, 372–373, 376–377, 388
- Stochastic volatility, 53, 286, 315, 317, 322–323, 411. *See also* Volatility/volatilities
- Successive overrelaxation (SOR)
  - method, iterative finite-difference, 232–234, 237
- Supply and demand, 282
- Swap rate, 444–446, 456, 607–608
- Swaps, types of, 455–457, 710, 742–754
- Swaptions, 395, 443–450, 466, 551–553, 561–564, 579, 631, 644–645, 648–650, 657–662, 670–673, 686–688, 710–733, 757–760
- Symmetric GARCH, 337, 343
- Synthetic forward, 2
- Synthetic swaps, 457, 607–615
- Systematic risk, 3
  
- Taylor series, 775, 788
- Terminal correlation, 665–669, 680
- Term structure, 396–397, 522, 582, 596–599
- $T$ -forward measure, 41–44, 310, 559
- Theta, 25, 143, 296
- Three-factor model, 555
- Tikhonov regularization, 300, 308
- Time-changed Brownian motion, 407, 409
- Time horizon, 341
- Trading strategy, 11–12
- Transcendental equation, 33
- Transitional probabilities, 179–181, 766
- Treasury bills, 277
- Treasury bonds, 391–393, 397–398
- Treasury notes, 455
- Tree-building procedures, single-factor interest rate models, *see* Short-rate-tree-building procedures
- Trigeorgis model, 135
- Trigger swaps, 710, 752–754
- Trinomial diffusion process, 189, 232
- Trinomial tree(s), 8, 165–182, 251–252, 264, 268–269, 273, 356–361, 485–495, 501–509, 626–629
  - lookback options, 264, 268
- Tsiveriotis-Fernandes (TF) model, 164
- Two-factor models:
  - characteristics of, 554–556
  - discount bond pricing, 584–587
  - G2++ model, 555–576
  - Heath-Jarrow-Morton model, 555, 580–592, 615–622
  - Hull-White model, 555, 576–580
  - Li-Ritchken-Sankarasubramanian (LRS) model, 556, 626–629
  - Ritchken and Sankarasubramanian model, 555–556, 622–626
  - synthetic swap valuation, 607–615
- Underdetermined diffusion
  - equations, 375
- Underrelaxation, iterative finite-difference, 234
- Up-and-in calls/puts, 247
- Up and in (UI) trigger swaps, 752
- Up-and-out calls/puts, 247, 257
- Up and out (UO) trigger swaps, 752
  
- Valuation techniques, 79–81, 84–92, 124, 150–164, 455–457, 597, 598, 607–615, 710, 733–754
- Value at risk (VaR), 73, 362, 365–366
- Vanilla GARCH, 337
- Vanilla options, 252, 264, 308. *See also* Plain-vanilla options
- Variance-covariance matrices, 367
- Variance diffusion, 98–102
- Variance reduction, 67–69
- Vasicek single-factor interest rate model:
  - characteristics of, generally, 395, 404–425
  - Hull-White extended process, 425–429, 449, 451
  - tree construction, 467, 509–511, 521, 524–541
  - volatility, 607, 626
- Vega, 143, 276, 280, 322, 696, 698, 707–709
- Volatility/volatilities:
  - hedging and, 321–323
  - impact of, 4, 50, 261, 283, 303–305, 313–315, 343, 418–420, 598–599, 607, 631, 665
  - implied, 274–277, 284–303, 307–309
  - influential factors, 5–6, 14, 37, 94, 102, 274, 276–282, 289, 305–307, 315–321, 398–399, 579–582, 584–586, 622–623, 626–627
  - local surfaces, 309–313
  - term structure of, 277
  - time-varying, 144
- Volterra equation, 438
  
- Wiener process, 5, 17, 93–94, 290, 315, 367, 372–373, 376–377, 388, 409, 412, 426, 470, 576, 785, 789
- Word Viewer, 804
- Writing options, 77
  
- Yield curve(s), 396, 469, 471–495, 501–509, 640
  
- Zero-coupon bonds, 41, 43–44, 400–401, 404, 411–425, 434, 439–440, 457, 521–525, 542, 557–558, 561, 581, 583, 588, 592, 596–599, 608, 617, 632, 734–735, 744
- Zero-coupon curve, 554