

Contents

Preface	xiii
Acknowledgments	xix
CHAPTER 1	
Black-Scholes and Pricing Fundamentals	1
1.1 Forward Contracts	1
1.2 Black-Scholes Partial Differential Equation	4
1.3 Risk-Neutral Pricing	10
1.4 Black-Scholes and Diffusion Process Implementation	17
1.5 American Options	30
1.6 Fundamental Pricing Formulas	33
1.7 Change of Numeraire	35
1.8 Girsanov's Theorem	38
1.9 The Forward Measure	41
1.10 The Choice of Numeraire	42
CHAPTER 2	
Monte Carlo Simulation	45
2.1 Monte Carlo	45
2.2 Generating Sample Paths and Normal Deviates	47
2.3 Generating Correlated Normal Random Variables	50
2.4 Quasi-Random Sequences	56
2.5 Variance Reduction and Control Variate Techniques	67
2.6 Monte Carlo Implementation	69
2.7 Hedge Control Variates	76
2.8 Path-Dependent Valuation	84
2.9 Brownian Bridge Technique	92
2.10 Jump-Diffusion Process and Constant Elasticity of Variance Diffusion Model	98
2.11 Object-Oriented Monte Carlo Approach	102
CHAPTER 3	
Binomial Trees	123
3.1 Use of Binomial Trees	123
3.2 Cox-Ross-Rubinstein Binomial Tree	131

3.3	Jarrow-Rudd Binomial Tree	132
3.4	General Tree	133
3.5	Dividend Payments	135
3.6	American Exercise	137
3.7	Binomial Tree Implementation	138
3.8	Computing Hedge Statistics	140
3.9	Binomial Model with Time-Varying Volatility	144
3.10	Two-Variable Binomial Process	145
3.11	Valuation of Convertible Bonds	150
CHAPTER 4		
Trinomial Trees		165
4.1	Use of Trinomial Trees	165
4.2	Jarrow-Rudd Trinomial Tree	166
4.3	Cox-Ross-Rubinstein Trinomial Tree	168
4.4	Optimal Choice of λ	169
4.5	Trinomial Tree Implementations	170
4.6	Approximating Diffusion Processes with Trinomial Trees	174
4.7	Implied Trees	178
CHAPTER 5		
Finite-Difference Methods		183
5.1	Explicit Difference Methods	183
5.2	Explicit Finite-Difference Implementation	186
5.3	Implicit Difference Method	191
5.4	LU Decomposition Method	194
5.5	Implicit Difference Method Implementation	196
5.6	Object-Oriented Finite-Difference Implementation	202
5.7	Iterative Methods	232
5.8	Crank-Nicolson Scheme	235
5.9	Alternating Direction Implicit Method	241
CHAPTER 6		
Exotic Options		246
6.1	Barrier Options	246
6.2	Barrier Option Implementation	255
6.3	Asian Options	258
6.4	Geometric Averaging	258
6.5	Arithmetic Averaging	260
6.6	Seasoned Asian Options	261
6.7	Lookback Options	262
6.8	Implementation of Floating Lookback Option	265
6.9	Implementation of Fixed Lookback Option	268

CHAPTER 7		
Stochastic Volatility		274
7.1	Implied Volatility	274
7.2	Volatility Skews and Smiles	276
7.3	Empirical Explanations	283
7.4	Implied Volatility Surfaces	284
7.5	One-Factor Models	303
7.6	Constant Elasticity of Variance Models	305
7.7	Recovering Implied Volatility Surfaces	307
7.8	Local Volatility Surfaces	309
7.9	Jump-Diffusion Models	313
7.10	Two-Factor Models	315
7.11	Hedging with Stochastic Volatility	321
CHAPTER 8		
Statistical Models		324
8.1	Overview	324
8.2	Moving Average Models	329
8.3	Exponential Moving Average Models	331
8.4	GARCH Models	334
8.5	Asymmetric GARCH	337
8.6	GARCH Models for High-Frequency Data	340
8.7	Estimation Problems	353
8.8	GARCH Option Pricing Model	354
8.9	GARCH Forecasting	362
CHAPTER 9		
Stochastic Multifactor Models		367
9.1	Change of Measure for Independent Random Variables	368
9.2	Change of Measure for Correlated Random Variables	370
9.3	N -Dimensional Random Walks and Brownian Motion	371
9.4	N -Dimensional Generalized Wiener Process	373
9.5	Multivariate Diffusion Processes	374
9.6	Monte Carlo Simulation of Multivariate Diffusion Processes	375
9.7	N -Dimensional Lognormal Process	376
9.8	Ito's Lemma for Functions of Vector-Valued Diffusion Processes	388
9.9	Principal Component Analysis	389
CHAPTER 10		
Single-Factor Interest Rate Models		395
10.1	Short Rate Process	398
10.2	Deriving the Bond Pricing Partial Differential Equation	399
10.3	Risk-Neutral Drift of the Short Rate	401
10.4	Single-Factor Models	402

10.5	Vasicek Model	404
10.6	Pricing Zero-Coupon Bonds in the Vasicek Model	411
10.7	Pricing European Options on Zero-Coupon Bonds with Vasicek	420
10.8	Hull-White Extended Vasicek Model	425
10.9	European Options on Coupon-Bearing Bonds	429
10.10	Cox-Ingersoll-Ross Model	431
10.11	Extended (Time-Homogenous) CIR Model	436
10.12	Black-Derman-Toy Short Rate Model	438
10.13	Black's Model to Price Caps	439
10.14	Black's Model to Price Swaptions	443
10.15	Pricing Caps, Caplets, and Swaptions with Short Rate Models	448
10.16	Valuation of Swaps	455
10.17	Calibration in Practice	457
CHAPTER 11		
	Tree-Building Procedures	467
11.1	Building Binomial Short Rate Trees for Black, Derman, and Toy	468
11.2	Building the BDT Tree Calibrated to the Yield Curve	471
11.3	Building the BDT Tree Calibrated to the Yield and Volatility Curve	476
11.4	Building a Hull-White Tree Consistent with the Yield Curve	485
11.5	Building a Lognormal Hull-White (Black-Karasinski) Tree	495
11.6	Building Trees Fitted to Yield and Volatility Curves	501
11.7	Vasicek and Black-Karasinski Models	509
11.8	Cox-Ingersoll-Ross Implementation	515
11.9	A General Deterministic-Shift Extension	520
11.10	Shift-Extended Vasicek Model	524
11.11	Shift-Extended Cox-Ingersoll-Ross Model	541
11.12	Pricing Fixed Income Derivatives with the Models	549
CHAPTER 12		
	Two-Factor Models and the Heath-Jarrow-Morton Model	554
12.1	The Two-Factor Gaussian G2++ Model	556
12.2	Building a G2++ Tree	563
12.3	Two-Factor Hull-White Model	575
12.4	Heath-Jarrow-Morton Model	579
12.5	Pricing Discount Bond Options with Gaussian HJM	584
12.6	Pricing Discount Bond Options in General HJM	585
12.7	Single-Factor HJM Discrete-State Model	586
12.8	Arbitrage-Free Restrictions in a Single-Factor Model	591
12.9	Computation of Arbitrage-Free Term Structure Evolutions	595
12.10	Single-Factor HJM Implementation	598
12.11	Synthetic Swap Valuation	606

12.12	Two-Factor HJM Model	612
12.13	Two-Factor HJM Model Implementation	616
12.14	The Ritchken and Sankarasubramanian Model	620
12.15	RS Spot Rate Process	623
12.16	Li-Ritchken-Sankarasubramanian Model	624
12.17	Implementing an LRS Trinomial Tree	626
CHAPTER 13		
LIBOR Market Models		630
13.1	LIBOR Market Models	632
13.2	Specifications of the Instantaneous Volatility of Forward Rates	636
13.3	Implementation of Hull-White LIBOR Market Model	640
13.4	Calibration of LIBOR Market Model to Caps	641
13.5	Pricing Swaptions with Lognormal Forward-Swap Model	642
13.6	Approximate Swaption Pricing with Hull-White Approach	646
13.7	LFM Formula for Swaption Volatilities	648
13.8	Monte Carlo Pricing of Swaptions Using LFM	650
13.9	Improved Monte Carlo Pricing of Swaptions with a Predictor-Corrector	655
13.10	Incompatibility between LSM and LSF	663
13.11	Instantaneous and Terminal Correlation Structures	665
13.12	Calibration to Swaption Prices	669
13.13	Connecting Caplet and $S \times 1$ -Swaption Volatilities	670
13.14	Including Caplet Smile in LFM	673
13.15	Stochastic Extension of LIBOR Market Model	677
13.16	Computing Greeks in Forward LIBOR Models	688
CHAPTER 14		
Bermudan and Exotic Interest Rate Derivatives		710
14.1	Bermudan Swaptions	710
14.2	Implementation for Bermudan Swaptions	713
14.3	Andersen's Method	718
14.4	Longstaff and Schwartz Method	721
14.5	Stochastic Mesh Method	730
14.6	Valuation of Range Notes	733
14.7	Valuation of Index-Amortizing Swaps	742
14.8	Valuation of Trigger Swaps	752
14.9	Quanto Derivatives	754
14.10	Gaussian Quadrature	760
APPENDIX A		
Probability Review		771
A.1	Probability Spaces	771
A.2	Continuous Probability Spaces	773

A.3	Single Random Variables	773
A.4	Binomial Random Variables	774
A.5	Normal Random Variables	775
A.6	Conditional Expectations	776
A.7	Probability Limit Theorems	778
A.8	Multidimensional Case	779
A.9	Dirac's Delta Function	780
APPENDIX B		
Stochastic Calculus Review		783
B.1	Brownian Motion	783
B.2	Brownian Motion with Drift and Volatility	784
B.3	Stochastic Integrals	785
B.4	Ito's Formula	788
B.5	Geometric Brownian Motion	789
B.6	Stochastic Leibnitz Rule	789
B.7	Quadratic Variation and Covariation	790
References		793
About the CD-ROM		803
GNU General Public License		807
Index		813