

# Contents

<b>Introduction</b>	<b>1</b>
<b>The Trading Process</b>	<b>3</b>
<b>CHAPTER 1 Option Pricing</b>	<b>7</b>
<b>The Black-Scholes-Merton Model</b>	<b>7</b>
<b>Summary</b>	<b>14</b>
<b>CHAPTER 2 Volatility Measurement and Forecasting</b>	<b>15</b>
<b>Defining and Measuring Volatility</b>	<b>15</b>
<b>Definition of Volatility</b>	<b>16</b>
<b>Alternative Volatility Estimators</b>	<b>22</b>
Close-to-Close Estimator	26
Parkinson Estimator	26
Garman-Klass Estimator	27
Rogers-Satchell Estimator	27
Yang-Zhang Estimator	27
<b>Using Higher-Frequency Data</b>	<b>27</b>
<b>Forecasting Volatility</b>	<b>31</b>
Maximum Likelihood Estimation	36
<b>Forecasting the Volatility Distribution</b>	<b>39</b>
<b>Summary</b>	<b>43</b>
<b>CHAPTER 3 Implied Volatility Dynamics</b>	<b>45</b>
<b>Volatility Level Dynamics</b>	<b>48</b>
Informal Definition	50
More Formal Definition	50
A Traders' Definition	50
	<b>vii</b>

<b>viii</b>	CONTENTS
<b>Smile Dynamics</b>	<b>54</b>
<b>Summary</b>	<b>62</b>
<b>CHAPTER 4 Hedging</b>	<b>63</b>
<b>Ad Hoc Hedging Methods</b>	<b>65</b>
Hedging at Regular Intervals	65
Hedging to a Delta Band	65
Hedging Based on Underlying Price Changes	65
<b>Utility-Based Methods</b>	<b>66</b>
The Asymptotic Solution of Whalley and Wilmott	71
The Double Asymptotic Method of Zakamouline	74
<b>Estimation of Transaction Costs</b>	<b>78</b>
<b>Aggregation of Options on Different Underlyings</b>	<b>83</b>
<b>Summary</b>	<b>85</b>
<b>CHAPTER 5 Hedged Option Positions</b>	<b>87</b>
<b>Discrete Hedging and Path Dependency</b>	<b>87</b>
<b>Volatility Dependency</b>	<b>93</b>
<b>Summary</b>	<b>99</b>
<b>CHAPTER 6 Money Management</b>	<b>101</b>
<b>Ad Hoc Schemes</b>	<b>101</b>
<b>The Kelly Criterion</b>	<b>103</b>
<b>Alternatives to the Kelly Criterion</b>	<b>113</b>
<b>Trade Sizing in a Continuously Changing Setting</b>	<b>118</b>
A Simple Approximation	124
<b>Summary</b>	<b>126</b>
<b>CHAPTER 7 Trade Evaluation</b>	<b>127</b>
<b>General Planning Procedures</b>	<b>128</b>
<b>Risk-Adjusted Performance Measures</b>	<b>134</b>
The Sharpe Ratio	135
Alternatives to the Sharpe Ratio	137
<b>Setting Goals</b>	<b>140</b>

<i>Contents</i>	<b>ix</b>
<b>Persistence of Performance</b>	<b>142</b>
Relative Persistence	143
Absolute Persistence	144
<b>Summary</b>	<b>147</b>
<b>CHAPTER 8 Psychology</b>	<b>149</b>
<b>Self-Attribution Bias</b>	<b>151</b>
<b>Overconfidence</b>	<b>152</b>
<b>The Availability Heuristic</b>	<b>155</b>
<b>Short-Term Thinking</b>	<b>156</b>
<b>Loss Aversion</b>	<b>157</b>
<b>Conservatism and Representativeness</b>	<b>158</b>
<b>Confirmation Bias</b>	<b>160</b>
<b>Hindsight Bias</b>	<b>161</b>
<b>Anchoring and Adjustment</b>	<b>162</b>
<b>Summary</b>	<b>162</b>
<b>CHAPTER 9 Life Cycle of a Trade</b>	<b>165</b>
<b>Pretrade Analysis</b>	<b>165</b>
June 25, 2007	165
June 26, 2007	169
June 27, 2007	169
June 28, 2007	170
June 29, 2007	170
July 2, 2007	170
July 3, 2007	170
<b>Post-Trade Analysis</b>	<b>171</b>
<b>Summary</b>	<b>173</b>
<b>CHAPTER 10 Conclusion</b>	<b>175</b>
<b>Execution Ability</b>	<b>176</b>
<b>Concentration</b>	<b>177</b>
<b>Product Selection</b>	<b>177</b>
<b>Appendix A: Model-Free Implied Variance and Volatility</b>	<b>179</b>
<b>The VIX Index</b>	<b>180</b>

<b>Appendix B: Spreadsheet Instructions</b>	<b>183</b>
<b>GARCH</b>	<b>183</b>
<b>Volatility Cones and Skew and Kurtosis Cones</b>	<b>184</b>
<b>Daily Option Hedging Simulation</b>	<b>184</b>
<b>Trade Evaluation</b>	<b>185</b>
<b>Trading Goals</b>	<b>185</b>
<b>Corrado-Su Skew Curve</b>	<b>185</b>
<b>Mean Reversion Simulator</b>	<b>186</b>
<b>Resources</b>	<b>187</b>
<b>Essential Books</b>	<b>187</b>
<b>Thought-Provoking Books</b>	<b>189</b>
<b>Useful Web Sites</b>	<b>190</b>
<b>References</b>	<b>193</b>
<b>About the CD-ROM</b>	<b>201</b>
<b>Index</b>	<b>203</b>