

# Contents

<b>Preface</b>	<b>xiii</b>
<b>1 The Simplest Model of Financial Markets</b>	<b>1</b>
1.1 One-Period Finite State Model	1
1.2 Securities and Their Pay-Offs	3
1.3 Securities as Vectors	3
1.4 Operations on Securities	4
1.5 The Matrix as a Collection of Securities	6
1.6 Transposition	6
1.7 Matrix Multiplication and Portfolios	8
1.8 Systems of Equations and Hedging	10
1.9 Linear Independence and Redundant Securities	12
1.10 The Structure of the Marketed Subspace	14
1.11 The Identity Matrix and Arrow–Debreu Securities	16
1.12 Matrix Inverse	17
1.13 Inverse Matrix and Replicating Portfolios	17
1.14 Complete Market Hedging Formula	19
1.15 Summary	20
1.16 Notes	21
1.17 Exercises	21
<b>2 Arbitrage and Pricing in the One-Period Model</b>	<b>25</b>
2.1 Hedging with Redundant Securities and Incomplete Market	25
2.2 Finding the Best Approximate Hedge	29
2.3 Minimizing the Expected Squared Replication Error	32
2.4 Numerical Stability of Least Squares	34
2.5 Asset Prices, Returns and Portfolio Units	37
2.6 Arbitrage	38
2.7 No-Arbitrage Pricing	40
2.8 State Prices and the Arbitrage Theorem	42
2.9 State Prices and Asset Returns	45
2.10 Risk-Neutral Probabilities	45
2.11 State Prices and No-Arbitrage Pricing	46
2.12 Summary	48
2.13 Notes	49
2.14 Appendix: Least Squares with QR Decomposition	49
2.15 Exercises	52

<b>3</b>	<b>Risk and Return in the One-Period Model</b>	<b>55</b>
3.1	Utility Functions	55
3.2	Expected Utility Maximization	59
3.3	Reporting Expected Utility in Terms of Money	60
3.4	Scale-Free Formulation of the Optimal Investment Problem with the HARA Utility	62
3.5	Quadratic Utility	66
3.6	Reporting Investment Potential in Terms of Sharpe Ratios	70
3.7	The Importance of Arbitrage Adjustment	77
3.8	Portfolio Choice with Near-Arbitrage Opportunities	78
3.9	Generalization of the Sharpe Ratio	82
3.10	Summary	83
3.11	Notes	84
3.12	Exercises	85
<b>4</b>	<b>Numerical Techniques for Optimal Portfolio Selection in Incomplete Markets</b>	<b>87</b>
4.1	Sensitivity Analysis of Portfolio Decisions with the CRRA Utility	87
4.2	Newton's Algorithm for Optimal Investment with CRRA Utility	91
4.3	Optimal CRRA Investment Using Empirical Return Distribution	93
4.4	HARA Portfolio Optimizer	99
4.5	HARA Portfolio Optimization with Several Risky Assets	100
4.6	Quadratic Utility Maximization with Multiple Assets	104
4.7	Summary	106
4.8	Notes	107
4.9	Exercises	107
<b>5</b>	<b>Pricing in Dynamically Complete Markets</b>	<b>109</b>
5.1	Options and Portfolio Insurance	109
5.2	Option Pricing	110
5.3	Dynamic Replicating Trading Strategy	113
5.4	Risk-Neutral Probabilities in a Multi-Period Model	121
5.5	The Law of Iterated Expectations	124
5.6	Summary	126
5.7	Notes	126
5.8	Exercises	126
<b>6</b>	<b>Towards Continuous Time</b>	<b>131</b>
6.1	IID Returns, and the Term Structure of Volatility	131
6.2	Towards Brownian Motion	133
6.3	Towards a Poisson Jump Process	142
6.4	Central Limit Theorem and Infinitely Divisible Distributions	148
6.5	Summary	149
6.6	Notes	151
6.7	Exercises	151
<b>7</b>	<b>Fast Fourier Transform</b>	<b>153</b>
7.1	Introduction to Complex Numbers and the Fourier Transform	153
7.2	Discrete Fourier Transform (DFT)	158
7.3	Fourier Transforms in Finance	159
7.4	Fast Pricing via the Fast Fourier Transform (FFT)	164
7.5	Further Applications of FFTs in Finance	167
7.6	Notes	171
7.7	Appendix	172
7.8	Exercises	174

<i>Contents</i>	xi
<b>8 Information Management</b>	<b>175</b>
8.1 Information: Too Much of a Good Thing?	175
8.2 Model-Independent Properties of Conditional Expectation	179
8.3 Summary	183
8.4 Notes	184
8.5 Appendix: Probability Space	184
8.6 Exercises	188
<b>9 Martingales and Change of Measure in Finance</b>	<b>193</b>
9.1 Discounted Asset Prices Are Martingales	193
9.2 Dynamic Arbitrage Theorem	198
9.3 Change of Measure	199
9.4 Dynamic Optimal Portfolio Selection in a Complete Market	204
9.5 Summary	212
9.6 Notes	214
9.7 Exercises	214
<b>10 Brownian Motion and Itô Formulae</b>	<b>219</b>
10.1 Continuous-Time Brownian Motion	219
10.2 Stochastic Integration and Itô Processes	224
10.3 Important Itô Processes	226
10.4 Function of a Stochastic Process: the Itô Formula	228
10.5 Applications of the Itô Formula	229
10.6 Multivariate Itô Formula	231
10.7 Itô Processes as Martingales	234
10.8 Appendix: Proof of the Itô Formula	235
10.9 Summary	235
10.10 Notes	236
10.11 Exercises	237
<b>11 Continuous-Time Finance</b>	<b>239</b>
11.1 Summary of Useful Results	239
11.2 Risk-Neutral Pricing	240
11.3 The Girsanov Theorem	243
11.4 Risk-Neutral Pricing and Absence of Arbitrage	247
11.5 Automatic Generation of PDEs and the Feynman–Kac Formula	252
11.6 Overview of Numerical Methods	256
11.7 Summary	257
11.8 Notes	258
11.9 Appendix: Decomposition of Asset Returns into Uncorrelated Components	258
11.10 Exercises	261
<b>12 Dynamic Option Hedging and Pricing in Incomplete Markets</b>	<b>267</b>
12.1 The Risk in Option Hedging Strategies	267
12.2 Incomplete Market Option Price Bounds	283
12.3 Towards Continuous Time	291
12.4 Derivation of Optimal Hedging Strategy	297
12.5 Summary	306
12.6 Notes	307
12.7 Appendix: Expected Squared Hedging Error in the Black–Scholes Model	307
12.8 Exercises	309
<b>Appendix A Calculus</b>	<b>313</b>
A.1 Notation	313

A.2	Differentiation	316
A.3	Real Function of Several Real Variables	319
A.4	Power Series Approximations	321
A.5	Optimization	324
A.6	Integration	326
A.7	Exercises	332
<b>Appendix B Probability</b>		<b>337</b>
B.1	Probability Space	337
B.2	Conditional Probability	337
B.3	Marginal and Joint Distribution	340
B.4	Stochastic Independence	341
B.5	Expectation Operator	343
B.6	Properties of Expectation	344
B.7	Mean and Variance	345
B.8	Covariance and Correlation	346
B.9	Continuous Random Variables	349
B.10	Normal Distribution	354
B.11	Quantiles	359
B.12	Relationships among Standard Statistical Distributions	360
B.13	Notes	361
B.14	Exercises	361
<b>References</b>		<b>369</b>
<b>Index</b>		<b>373</b>