

# Contents

<b>Preface to the Second Edition</b>	<b>xiii</b>
<b>From the Preface to the First Edition</b>	<b>xix</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 Payoffs	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	22
<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	36
2.6 Arbitrage	38
2.7 No-Arbitrage Pricing	40
2.8 State Prices and the Arbitrage Theorem	41
2.9 State Prices and Asset Returns	44
2.10 Risk-Neutral Probabilities	45
2.11 State Prices and No-Arbitrage Pricing	46
2.12 Asset Pricing Duality	47
2.13 Summary	48
2.14 Notes	49
2.15 Appendix: Least Squares with QR Decomposition	49
2.16 Exercises	52

<b>3</b>	<b>Risk and Return in the One-Period Model</b>	<b>55</b>
3.1	Utility Functions	56
3.2	Expected Utility Maximization	59
3.3	The Existence of Optimal Portfolios	61
3.4	Reporting Expected Utility in Terms of Money	62
3.5	Normalized Utility and Investment Potential	63
3.6	Quadratic Utility	67
3.7	The Sharpe Ratio	69
3.8	Arbitrage-Adjusted Sharpe Ratio	71
3.9	The Importance of Arbitrage Adjustment	75
3.10	Portfolio Choice with Near-Arbitrage Opportunities	77
3.11	Summary	79
3.12	Notes	81
3.13	Exercises	82
<b>4</b>	<b>Numerical Techniques for Optimal Portfolio Selection in Incomplete Markets</b>	<b>84</b>
4.1	Sensitivity Analysis of Portfolio Decisions with the CRRA Utility	84
4.2	Newton's Algorithm for Optimal Investment with CRRA Utility	88
4.3	Optimal CRRA Investment Using Empirical Return Distribution	90
4.4	HARA Portfolio Optimizer	94
4.5	HARA Portfolio Optimization with Several Risky Assets	96
4.6	Quadratic Utility Maximization with Multiple Assets	99
4.7	Summary	102
4.8	Notes	102
4.9	Exercises	102
<b>5</b>	<b>Pricing in Dynamically Complete Markets</b>	<b>104</b>
5.1	Options and Portfolio Insurance	104
5.2	Option Pricing	105
5.3	Dynamic Replicating Trading Strategy	108
5.4	Risk-Neutral Probabilities in a Multi-Period Model	116
5.5	The Law of Iterated Expectations	119
5.6	Summary	121
5.7	Notes	121
5.8	Exercises	121
<b>6</b>	<b>Towards Continuous Time</b>	<b>125</b>
6.1	IID Returns, and the Term Structure of Volatility	125
6.2	Towards Brownian Motion	127
6.3	Towards a Poisson Jump Process	136
6.4	Central Limit Theorem and Infinitely Divisible Distributions	142
6.5	Summary	143
6.6	Notes	145
6.7	Exercises	145
<b>7</b>	<b>Fast Fourier Transform</b>	<b>147</b>
7.1	Introduction to Complex Numbers and the Fourier Transform	147
7.2	Discrete Fourier Transform (DFT)	152
7.3	Fourier Transforms in Finance	153
7.4	Fast Pricing via the Fast Fourier Transform (FFT)	158
7.5	Further Applications of FFTs in Finance	162
7.6	Notes	166
7.7	Appendix	167
7.8	Exercises	169

<b>8</b>	<b>Information Management</b>	<b>170</b>
8.1	Information: Too Much of a Good Thing?	170
8.2	Model-Independent Properties of Conditional Expectation	174
8.3	Summary	178
8.4	Notes	179
8.5	Appendix: Probability Space	179
8.6	Exercises	183
<b>9</b>	<b>Martingales and Change of Measure in Finance</b>	<b>187</b>
9.1	Discounted Asset Prices Are Martingales	187
9.2	Dynamic Arbitrage Theorem	192
9.3	Change of Measure	193
9.4	Dynamic Optimal Portfolio Selection in a Complete Market	198
9.5	Summary	206
9.6	Notes	208
9.7	Exercises	208
<b>10</b>	<b>Brownian Motion and Itô Formulae</b>	<b>213</b>
10.1	Continuous-Time Brownian Motion	213
10.2	Stochastic Integration and Itô Processes	218
10.3	Important Itô Processes	220
10.4	Function of a Stochastic Process: the Itô Formula	222
10.5	Applications of the Itô Formula	223
10.6	Multivariate Itô Formula	225
10.7	Itô Processes as Martingales	228
10.8	Appendix: Proof of the Itô Formula	229
10.9	Summary	229
10.10	Notes	230
10.11	Exercises	231
<b>11</b>	<b>Continuous-Time Finance</b>	<b>233</b>
11.1	Summary of Useful Results	233
11.2	Risk-Neutral Pricing	234
11.3	The Girsanov Theorem	237
11.4	Risk-Neutral Pricing and Absence of Arbitrage	241
11.5	Automatic Generation of PDEs and the Feynman–Kac Formula	246
11.6	Overview of Numerical Methods	250
11.7	Summary	251
11.8	Notes	252
11.9	Appendix: Decomposition of Asset Returns into Uncorrelated Components	252
11.10	Exercises	255
<b>12</b>	<b>Finite-Difference Methods</b>	<b>261</b>
12.1	Interpretation of PDEs	261
12.2	The Explicit Method	263
12.3	Instability	264
12.4	Markov Chains and Local Consistency	266
12.5	Improving Convergence by Richardson’s Extrapolation	268
12.6	Oscillatory Convergence Due to Grid Positioning	269
12.7	Fully Implicit Scheme	270
12.8	Crank–Nicolson Scheme	273
12.9	Summary	274
12.10	Notes	276
12.11	Appendix: Efficient Gaussian Elimination for Tridiagonal Matrices	276

12.12	Appendix: Richardson's Extrapolation	277
12.13	Exercises	277
<b>13</b>	<b>Dynamic Option Hedging and Pricing in Incomplete Markets</b>	<b>280</b>
13.1	The Risk in Option Hedging Strategies	280
13.2	Incomplete Market Option Price Bounds	299
13.3	Towards Continuous Time	304
13.4	Derivation of Optimal Hedging Strategy	309
13.5	Summary	318
13.6	Notes	319
13.7	Appendix: Expected Squared Hedging Error in the Black–Scholes Model	320
13.8	Exercises	322
<b>Appendix A</b>	<b>Calculus</b>	<b>326</b>
A.1	Notation	326
A.2	Differentiation	329
A.3	Real Function of Several Real Variables	332
A.4	Power Series Approximations	334
A.5	Optimization	336
A.6	Integration	338
A.7	Exercises	344
<b>Appendix B</b>	<b>Probability</b>	<b>348</b>
B.1	Probability Space	348
B.2	Conditional Probability	348
B.3	Marginal and Joint Distribution	351
B.4	Stochastic Independence	352
B.5	Expectation Operator	354
B.6	Properties of Expectation	355
B.7	Mean and Variance	356
B.8	Covariance and Correlation	357
B.9	Continuous Random Variables	360
B.10	Normal Distribution	364
B.11	Quantiles	370
B.12	Relationships among Standard Statistical Distributions	371
B.13	Notes	372
B.14	Exercises	372
<b>References</b>		<b>381</b>
<b>Index</b>		<b>385</b>