An Introduci

to the

Mathematics of **Financial Derivatives**



Second Edition

Salih N. Neftci

Graduate School, CUNY New York, New York

and

ISMA Centre, University of Reading Reading, United Kingdom



An imprint of Elsevier Science

Amsterdam San Diego

Boston San Francisco

London New York Singapore Sydney

Oxford Paris Tokyo



PREFACE TO THE SECOND EDITION INTRODUCTION xxiii

xxi

CHAPTER • 1 Financial Derivatives A Brief Introduction

1 Introduction	1	
2 Definitions	2	
3 Types of Deri	vatives	2
3.1 Cash-and-Carry	Markets	3
3.2 Price-Discovery	Markets	4
3.3 Expiration Date	4	
4 Forwards and	Futures	5
4.1 Futures 6		
5 Options	7	
5.1 Some Notation	7	
6 Swaps 9	•	
6.1 A Simple Intere	st Rate Swap	10
7 Conclusions	11	
8 References	11	
9 Exercises	11	

CHAPTER · 2 A Primer on the Arbitrage Theorem
1 Introduction 13
2 Notation 14
2.1 Asset Prices 15
2.2 States of the World 15
2.3 Returns and Payoffs 16
2.4 Portfolio 17
3 A Basic Example of Asset Pricing 17
3.1 A First Glance at the Arbitrage Theorem 19
3.2 Relevance of the Arbitrage Theorem 20
3.3 The Use of Synthetic Probabilities 21
3.4 Martingales and Submartingales 24
3.5 Normalization 24
3.6 Equalization of Rates of Return 25
3.7 The No-Arbitrage Condition 26
4 A Numerical Example 27
4.1 Case 1: Arbitrage Possibilities 27
4.2 Case 2: Arbitrage-Free Prices 28
4.3 An Indeterminacy 29
5 An Application: Lattice Models 29
6 Payouts and Foreign Currencies 32
6.1 The Case with Dividends 32
6.2 The Case with Foreign Currencies 34
7 Some Generalizations 36
7.1 Time Index 36
7.2 States of the World 36
7.3 Discounting 37
8 Conclusions: A Methodology for Pricing
Assets 37
9 References 38
10 Appendix: Generalization of the Arbitrage
Theorem 38
11 Exercises 40

CHAPTER \cdot 3 Calculus in Deterministic and Stochastic Environments 1 Introduction 45 1.1 Information Flows 46 1.2 Modeling Random Behavior 46 2 Some Tools of Standard Calculus 47 3 Functions 47 3.1 Random Functions 48 3.2 Examples of Functions 49 4 Convergence and Limit 52 4.1 The Derivative 53 4.2 The Chain Rule 57 59 4.3 The Integral 65 4.4 Integration by Parts 5 Partial Derivatives 66 5.1 Example 67 5.2 Total Differentials 67 5.3 Taylor Series Expansion 68 5.4 Ordinary Differential Equations 72 6 Conclusions 73 7 References 74 8 Exercises 74 CHAPTER • 4 **Pricing Derivatives** Models and Notation

1 Introduction 77 **2** Pricing Functions 78 2.1 Forwards 78 2.2 Options 80 3 Application: Another Pricing Method 84 3.1 Example 85 4 The Problem 86 4.1 A First Look at Ito's Lemma 86 4.2 Conclusions 88 5 References 88 6 Exercises 89

ix

122

CHAPTER • 5 Tools in Probability Theory

	1 Introduction 91
	2 Probability 91
	2.1 Example 92
	2.2 Random Variable 93
	3 Moments 94
	3.1 First Two Moments 94
,	3.2 Higher-Order Moments 95
	4 Conditional Expectations 97
	4.1 Conditional Probability 97
	4.2 Properties of Conditional Expectations 99
	5 Some Important Models 100
	5.1 Binomial Distribution in Financial Markets 100
	5.2 Limiting Properties 101
	5.3 Moments 102
	5.4 The Normal Distribution 103
	5.5 The Poisson Distribution 106
	6 Markov Processes and Their Relevance 108
	6.1 The Relevance 109
	6.2 The Vector Case 110
	7 Convergence of Random Variables 112
	7.1 Types of Convergence and Their Uses 112
	7.2 Weak Convergence 113
	8 Conclusions 116
	9 References 116
1	10 Exercises 117
CHAPTE	R • 6 Martingales and Martingale
	Representations
	1 Introduction 119
	2 Definitions 120
	2.1 Notation 120

2.2 Continuous-Time Martingales 1213 The Use of Martingales in Asset Pricing

4 Relevance of Martingales in Stochastic	
Modeling 124	
4.1 An Example 126	
5 Properties of Martingale Trajectories	127
6 Examples of Martingales 130	
6.1 Example 1: Brownian Motion 130	
6.2 Example 2: A Squared Process 132	
6.3 Example 3: An Exponential Process 133	
6.4 Example 4: Right Continuous Martingales 1.	34
7 The Simplest Martingale 134	
7.1 An Application 135	
7.2 An Example 136	
8 Martingale Representations 137	
8.1 An Example 137	
8.2 Doob-Meyer Decomposition 140	
9 The First Stochastic Integral 143	
9.1 Application to Finance: Trading Gains 144	
10 Martingale Methods and Pricing 14	-5
11 A Pricing Methodology 146	
11.1 A Hedge 147	
11.2 Time Dynamics 147	
11.3 Normalization and Risk-Neutral Probability	150
11.4 A Summary 152	
12 Conclusions 152	
13 References 153	
14 Exercises 154	
CUADTED 17 Differentiation in Stachastic	
Environmenta	
Environments	
1 Introduction 156	
2 Motivation 157	

- 3 A Framework for Discussing Differentiation 161
- 4 The "Size" of Incremental Errors 164
- 5 One Implication 167

xi

6 Putting the F	Results Together	169
6.1 Stochastic Diffe	erentials 170	
7 Conclusions	171	
8 References	171	
9 Exercises	171	

CHAPTER • 8 The Wiener Process and Rare Events in Financial Markets

1 Introduction	173		
1.1 Relevance of the Dia	scussion	174	
2 Two Generic Mo	dels	175	
2.1 The Wiener Process	176		
2.2 The Poisson Process	178		
2.3 Examples 180			
2.4 Back to Rare Events	182		
3 SDE in Discrete	Intervals	, Again	183
4 Characterizing Ra	are and N	Normal Even	nts 184
4.1 Normal Events	187		
4.2 Rare Events 1	89		
5 A Model for Rar	e Events	190	
6 Moments That M	latter	193	
7 Conclusions	195		
8 Rare and Normal	Events	in Practice	196
8.1 The Binomial Mode	l 196	5	
8.2 Normal Events	197		
0 2 D E . 1	00		
6.5 Kare Events I	90		
8.4 The Behavior of Ac	90 cumulated	Changes	199
8.3 Rare Events 18.4 The Behavior of Ac9 References	cumulated 202	Changes	199

CHAPTER • 9 Integration in Stochastic Environments The Ito Integral 1 Introduction 204

1.1 The Ito Integral and SDEs 206	
1.2 The Practical Relevance of the Ito Integral 207	
2 The Ito Integral 208	
2.1 The Riemann–Stieltjes Integral 209	
2.2 Stochastic Integration and Riemann Sums 211	
2.3 Definition: The Ito Integral 213	
2.4 An Expository Example 214	
3 Properties of the Ito Integral 220	
3.1 The Ito Integral Is a Martingale 220	
3.2 Pathwise Integrals 224	
4 Other Properties of the Ito Integral 226	
4.1 Existence 226	
4.2 Correlation Properties 226	
4.3 Addition 227	
5 Integrals with Respect to Jump Processes 2	27
6 Conclusions 228	
7 References 228	
8 Exercises 228	

CHAPTER • 10 Ito's Lemma

1 Introduction 230	
2 Types of Derivatives 231	
2.1 Example 232	
3 Ito's Lemma 232	
3.1 The Notion of "Size" in Stochastic Calculus 235	
3.2 First-Order Terms 237	
3.3 Second-Order Terms 238	
3.4 Terms Involving Cross Products 239	
3.5 Terms in the Remainder 240	
4 The Ito Formula 240	
5 Uses of Ito's Lemma 241	
5.1 Ito's Formula as a Chain Rule 241	
5.2 Ito's Formula as an Integration Tool 242	
6 Integral Form of Ito's Lemma 244	
7 Ito's Formula in More Complex Settings	

245

7.1	l Multivariate Ca	se 245	
7.2	2 Ito's Formula an	id Jumps	248
8	Conclusions	250	
9	References	251	
10	Exercises	251	

CHAPTER • 11 The Dynamics of Derivative Prices Stochastic Differential Equations

	2
.1 Conditions on a_t and σ_t 25	3
2 A Geometric Description of	Paths Ir
SDEs 254	
Solution of SDEs 255	5
.1 What Does a Solution Mean?	255
.2 Types of Solutions 256	
.3 Which Solution Is to Be Preferred	1? 258
.4 A Discussion of Strong Solutions	258
.5 Verification of Solutions to SDEs	261
6 An Important Example 262	
Major Models of SDEs	265
.1 Linear Constant Coefficient SDEs	266
2 Geometric SDEs 267	
3 Square Root Process 760	
A M D C D 27	0
.4 Mean Reverting Process 27	0
.5 Ornstein–Uhlenbeck Process	271
5 Stochastic Volatility 2	271
Conclusions 272	
References 272	

CHAPTER • 12 Pricing Derivative Products Partial Differential Equations

1	Introduction	275		
2	Forming Risk-Free	Portfolios		276
3	Accuracy of the M	ethod	280	

3.1 An Interpretation 282	
4 Partial Differential Equations	282
4.1 Why Is the PDE an "Equation"?	283
4.2 What Is the Boundary Condition?	283
5 Classification of PDEs 28	4
5.1 Example 1: Linear, First-Order PDE	284
5.2 Example 2: Linear, Second-Order PDE	286
6 A Reminder: Bivariate, Second-	Degree
Equations 289	
6.1 Circle 290	
6.2 Ellipse 290	
6.3 Parabola 292	
6.4 Hyperbola 292	
7 Types of PDEs 292	
7.1 Example: Parabolic PDE 293	
8 Conclusions 293	
9 References 294	
10 Exercises 294	

CHAPTER • 13 The Black–Scholes PDE An Application

1 Introduction	296	
2 The Black-Scholes	PDE	296
2.1 A Geometric Look at t	he Black-S	choles Formula
3 PDEs in Asset Pric	ing	299
3.1 Constant Dividends	300	
4 Exotic Options	301	
4.1 Lookback Options	301	
4.2 Ladder Options	301	
4.3 Trigger or Knock-in Op	otions	302
4.4 Knock-out Options	302	
4.5 Other Exotics 30)2	
4.6 The Relevant PDEs	303	
5 Solving PDEs in Pr	ractice	304
5.1 Closed-Form Solutions	304	

298

5.2 Numerical Solutions 306	
6 Conclusions 309	
7 References 310	
8 Exercises 310	
CHAPTER • 14 Pricing Derivative Products	
Equivalent Martingale Measures	
1 Translations of Probabilities 312	
1.1 Probability as "Measure" 312	
2 Changing Means 316	
2.1 Method 1: Operating on Possible Values 317	
2.2 Method 2: Operating on Probabilities 321	
3 The Girsanov Theorem 322	
3.1 A Normally Distributed Random Variable 323	
3.2 A Normally Distributed Vector 325	
3.3 The Radon–Nikodym Derivative 327	
3.4 Equivalent Measures 328	
4 Statement of the Girsanov Theorem 329	
5 A Discussion of the Girsanov Theorem 33	1
5.1 Application to SDEs 332	
6 Which Probabilities? 334	
7 A Method for Generating Equivalent	
Probabilities 337	
7.1 An Example 340	
8 Conclusions 342	
9 References 342	
10 Exercises 343	

CHAPTER • 15 Equivalent Martingale Measures Applications

1 Introduction	345		
2 A Martingale M	leasure	346	
2.1 The Moment-Gen	erating Functi	on 346	
2.2 Conditional Expec	tation of Geor	metric Processes	348
3 Converting Asset Prices into Martingales		349	

3.1 Determining \tilde{P} 350	
3.2 The Implied SDEs 352	
4 Application: The Black–Scholes Formula	353
4.1 Calculation 356	
5 Comparing Martingale and PDE	
Approaches 358	
5.1 Equivalence of the Two Approaches 359	
5.2 Critical Steps of the Derivation 363	
5.3 Integral Form of the Ito Formula 364	
6 Conclusions 365	
7 References 366	
8 Exercises 366	

CHAPTER • 16 New Results and Tools for Interest-Sensitive Securities

1 Introduction	368	
2 A Summary	369	
3 Interest Rate D	erivatives	371
4 Complications	375	
4.1 Drift Adjustment	376	
4.2 Term Structure	377	
5 Conclusions	377	
6 References	378	
7 Exercises	378	

CHAPTER • 17 Arbitrage Theorem in a New Setting

Normalization and Random Interest Rates

1 Introduction 379	
2 A Model for New Instruments	381
2.1 The New Environment 383	
2.2 Normalization 389	
2.3 Some Undesirable Properties 392	
2.4 A New Normalization 395	
2.5 Some Implications 399	

3	Conclusions	404
4	References	404
5	Exercises	404

CHAPTER • 18 Modeling Term Structure and Related Concepts

1 Introduction 407
2 Main Concepts 408
2.1 Three Curves 409
2.2 Movements on the Yield Curve 412
3 A Bond Pricing Equation 414
3.1 Constant Spot Rate 414
3.2 Stochastic Spot Rates 416
3.3 Moving to Continuous Time 417
3.4 Yields and Spot Rates 418
4 Forward Rates and Bond Prices 419
4.1 Discrete Time 419
4.2 Moving to Continuous Time 420
5 Conclusions: Relevance of the
Relationships 423
6 References 424
7 Exercises 424

CHAPTER • 19 Classical and HJM Approaches to Fixed Income

1 Introduction	42	26			
2 The Classical	Approa	ch	427		
2.1 Example 1	428				
2.2 Example 2	429				
2.3 The General Ca	ise	429			
2.4 Using the Spot	Rate Mod	el	432		
2.5 Comparison wit	h the Blac	ck–Scho	les World	434	
3 The HJM Ap	proach (to Terr	n Structure		435
3.1 Which Forward	Rate?	436			
3.2 Arbitrage-Free I	Dynamics	in HJM	437		

Λ

3.3 Interpretation	440				
3.4 The r_t in the HJM	Approac	h	441		
3.5 Another Advanta	ge of the I	-IJM Ap	proach	443	
3.6 Market Practice	· 444				
4 How to Fit r_t to	o Initial	Term	Structure	2	444
4.1 Monte Carlo	445				
4.2 Tree Models	446				
4.3 Closed-Form Solu	tions	447			
5 Conclusions	447				
6 References	447	x			
7 Exercises	448				

CHAPTER • 20 Classical PDE Analysis for Interest Rate Derivatives

1 Introduction 451	
2 The Framework 454	
3 Market Price of Interest Rate Risk	455
4 Derivation of the PDE 457	
4.1 A Comparison 459	
5 Closed-Form Solutions of the PDE	460
5.1 Case 1: A Deterministic r_t 460	
5.2 Case 2: A Mean-Reverting r_t 461	
5.3 Case 3: More Complex Forms 464	
6 Conclusions 465	
7 References 465	
8 Exercises 465	

CHAPTER • 21 Relating Conditional Expectations to PDEs

1 Introduction 40	67		
2 From Conditional Exp	pectations to	PDEs	469
2.1 Case 1: Constant Discour	nt Factors	469	
2.2 Case 2: Bond Pricing	472		
2.3 Case 3: A Generalization	475		
2.4 Some Clarifications	475		
(-			

ν

2.5 Which Drift? 476 2.6 Another Bond Price Formula 477 2.7 Which Formula? · 479 3 From PDEs to Conditional Expectations 479 4 Generators, Feynman-Kac Formula, and Other Tools 482 4.1 Ito Diffusions 482 4.2 Markov Property 483 4.3 Generator of an Ito Diffusion 483 4.4 A Representation for A 484 4.5 Kolmogorov's Backward Equation 485 5 Feynman-Kac Formula 487 6 Conclusions 487 7 References 487 8 Exercises 487

CHAPTER • 22 Stopping Times and American-Type Securities

1 Introduction 489
2 Why Study Stopping Times? 491
2.1 American-Style Securities 492
3 Stopping Times 492
4 Uses of Stopping Times 493
5 A Simplified Setting 494
5.1 The Model 494
6 A Simple Example 499
7 Stopping Times and Martingales 504
7.1 Martingales 504
7.2 Dynkin's Formula 504
8 Conclusions 505
9 References 505
10 Exercises 505

BIBLIOGRAPHY 509 INDEX 513