## Contents

Preface xi  

List of Symbols xiii  

1 Fourier Pricing Methods  
  1.1 Introduction 1  
  1.2 A general representation of option prices 1  
  1.3 The dynamics of asset prices 3  
  1.4 A generalized function approach to Fourier pricing 6  
    1.4.1 Digital payoffs and the Dirac delta function 7  
    1.4.2 The Fourier transform of digital payoffs 8  
    1.4.3 The cash-or-nothing option 9  
    1.4.4 The asset-or-nothing option 10  
    1.4.5 European options: the general pricing formula 11  
  1.5 Hilbert transform 12  
  1.6 Pricing via FFT 14  
    1.6.1 The sampling theorem 15  
    1.6.2 The truncated sampling theorem 17  
    1.6.3 Why bother? 21  
    1.6.4 The pricing formula 21  
    1.6.5 Application of the FFT 23  
  1.7 Related literature 26  

2 The Dynamics of Asset Prices 29  
  2.1 Introduction 29  
  2.2 Efficient markets and Lévy processes 30  
    2.2.1 Random walks and Brownian motions 30  
    2.2.2 Geometric Brownian motion 31  
    2.2.3 Stable processes 31  
    2.2.4 Characteristic functions 32  
    2.2.5 Lévy processes 34  
    2.2.6 Infinite divisibility 36  
  2.3 Construction of Lévy markets 39
2.3.1 The compound Poisson process 39
2.3.2 The Poisson point process 41
2.3.3 Sums over Poisson point processes 42
2.3.4 The decomposition theorem 45
2.4 Properties of Lévy processes 49
2.4.1 Pathwise properties of Lévy processes 49
2.4.2 Completely monotone Lévy densities 53
2.4.3 Moments of a Lévy process 54

3 Non-stationary Market Dynamics 57
3.1 Non-stationary processes 57
3.1.1 Self-similar processes 57
3.1.2 Self-decomposable distributions 58
3.1.3 Additive processes 60
3.1.4 Sato processes 63
3.2 Time changes 63
3.2.1 Stochastic clocks 64
3.2.2 Subordinators 64
3.2.3 Stochastic volatility 66
3.2.4 The time-change technique 67
3.3 Simulation of Lévy processes 73
3.3.1 Simulation via embedded random walks 74
3.3.2 Simulation via truncated Poisson point processes 74

4 Arbitrage-Free Pricing 79
4.1 Introduction 79
4.2 Equilibrium and arbitrage 79
4.3 Arbitrage-free pricing 80
4.3.1 Arbitrage pricing theory 80
4.3.2 Martingale pricing theory 81
4.3.3 Radon–Nikodym derivative 82
4.4 Derivatives 83
4.4.1 The replicating portfolio 83
4.4.2 Options and pricing kernels 84
4.4.3 Plain vanilla options and digital options 86
4.4.4 The Black–Scholes model 88
4.5 Lévy martingale processes 89
4.5.1 Construction of martingales through Lévy processes 89
4.5.2 Change of equivalent measures for Lévy processes 90
4.5.3 The Esscher transform 91
4.6 Lévy markets 92

5 Generalized Functions 95
5.1 Introduction 95
5.2 The vector space of test functions 95
5.3 Distributions 97
5.3.1 Dirac delta and other singular distributions 98
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>F</strong></td>
<td></td>
</tr>
<tr>
<td>F The Fractional Fast Fourier Transform</td>
<td>215</td>
</tr>
<tr>
<td>F.1 Circular matrix</td>
<td>216</td>
</tr>
<tr>
<td>F.1.1 Matrix vector multiplication</td>
<td>218</td>
</tr>
<tr>
<td>F.2 Toeplitz matrix</td>
<td>219</td>
</tr>
<tr>
<td>F.2.1 Embedding in a circular matrix</td>
<td>219</td>
</tr>
<tr>
<td>F.2.2 Applications to pricing</td>
<td>220</td>
</tr>
<tr>
<td>F.3 Some numerical results</td>
<td>221</td>
</tr>
<tr>
<td>F.3.1 The Variance Gamma model</td>
<td>221</td>
</tr>
<tr>
<td>F.3.2 The Heston model</td>
<td>223</td>
</tr>
<tr>
<td><strong>G</strong></td>
<td></td>
</tr>
<tr>
<td>G Affine Models: The Path Integral Approach</td>
<td>225</td>
</tr>
<tr>
<td>G.1 The problem</td>
<td>225</td>
</tr>
<tr>
<td>G.2 Solution of the Riccati equations</td>
<td>227</td>
</tr>
<tr>
<td><strong>Bibliography</strong></td>
<td>229</td>
</tr>
<tr>
<td><strong>Index</strong></td>
<td>233</td>
</tr>
</tbody>
</table>