Chapter 12
Binomial Option Pricing  259

12.1 Introduction  259
12.2 The Two-Period Binomial Tree  261
12.3 Pricing Two-Period European Options  262
12.4 European Option Pricing in General $n$-Period Trees  269
12.5 Pricing American Options: Preliminary Comments  269
12.6 American Puts on Non-Dividend-Paying Stocks  270
12.7 Cash Dividends in the Binomial Tree  272
12.8 An Alternative Approach to Cash Dividends  275
12.9 Dividend Yields in Binomial Trees  279
12.10 Exercises  282

Appendix 12A A General Representation of European Option Prices  286

Chapter 13
Implementing the Binomial Model  289

13.1 Introduction  289
13.2 The Lognormal Distribution  289
13.3 Binomial Approximations of the Lognormal  294
13.4 Computer Implementation of the Binomial Model  298
13.5 Exercises  303

Appendix 13A Estimating Historical Volatility  306

Chapter 14
The Black-Scholes Model  308

14.1 Introduction  308
14.2 Option Pricing in the Black-Scholes Setting  310
14.3 Remarks on the Formula  313
14.4 Working with the Formulae I: Plotting Option Prices  314
14.5 Working with the Formulae II: Algebraic Manipulation  315
14.6 Dividends in the Black-Scholes Model  319
14.7 Options on Indices, Currencies, and Futures  324
14.8 Testing the Black-Scholes Model: Implied Volatility  327
14.9 The VIX and Its Derivatives  332

14.10 Exercises  335

Appendix 14A Further Properties of the Black-Scholes Delta  338

Appendix 14B Variance and Volatility Swaps  339

Chapter 15
The Mathematics of Black-Scholes  344

15.1 Introduction  344
15.2 Geometric Brownian Motion Defined  344
15.3 The Black-Scholes Formula via Replication  348
15.4 The Black-Scholes Formula via Risk-Neutral Pricing  351
15.5 The Black-Scholes Formula via CAPM  353
15.6 Exercises  354

Chapter 16
Options Modeling: Beyond Black-Scholes  357

16.1 Introduction  357
16.2 Jump-Diffusion Models  358
16.3 Stochastic Volatility  368
16.4 GARCH Models  374
16.5 Other Approaches  378
16.6 Implied Binomial Trees/Local Volatility Models  379
16.7 Summary  389
16.8 Exercises  389

Appendix 16A Program Code for Jump-Diffusions  393

Appendix 16B Program Code for a Stochastic Volatility Model  394

Appendix 16C Heuristic Comments on Option Pricing under Stochastic Volatility  396

Appendix 16D Program Code for Simulating GARCH Stock Prices Distributions  399

Appendix 16E Local Volatility Models: The Fourth Period of the Example  400

Chapter 17
Sensitivity Analysis: The Option "Greeks"  404

17.1 Introduction  404
17.2 Interpreting the Greeks: A Snapshot View  404
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>17.3</td>
<td>The Option Delta</td>
<td>408</td>
</tr>
<tr>
<td>17.4</td>
<td>The Option Gamma</td>
<td>412</td>
</tr>
<tr>
<td>17.5</td>
<td>The Option Theta</td>
<td>418</td>
</tr>
<tr>
<td>17.6</td>
<td>The Option Vega</td>
<td>423</td>
</tr>
<tr>
<td>17.7</td>
<td>The Option Rho</td>
<td>426</td>
</tr>
<tr>
<td>17.8</td>
<td>Portfolio Greeks</td>
<td>429</td>
</tr>
<tr>
<td>17.9</td>
<td>Exercises</td>
<td>432</td>
</tr>
<tr>
<td>Appendix 17A</td>
<td>Deriving the Black-Scholes Option Greeks</td>
<td>436</td>
</tr>
</tbody>
</table>

**Chapter 18**

### Exotic Options I: Path-Independent Options

18.1 Introduction 440
18.2 Forward Start Options 442
18.3 Binary Options 445
18.4 Chooser Options 450
18.5 Compound Options 453
18.6 Exchange Options 458
18.7 Quanto Options 460
18.8 Variants on the Exchange Option Theme 462
18.9 Exercises 465

**Chapter 19**

### Exotic Options II: Path-Dependent Options

19.1 Path-Dependent Exotic Options 470
19.2 Barrier Options 470
19.3 Asian Options 479
19.4 Lookback Options 485
19.5 Cliquets 488
19.6 Shout Options 490
19.7 Exercises 492
Appendix 19A Barrier Option Pricing Formulae 496

**Chapter 20**

### Value-at-Risk

20.1 Introduction 498
20.2 Value-at-Risk 498
20.3 Risk Decomposition 505
20.4 Coherent Risk Measures 511
20.5 Exercises 515

**Chapter 21**

###Convertible Bonds 519

21.1 Introduction 519
21.2 Convertible Bond Terminology 519
21.3 Main Features of Convertible Bonds 520
21.4 Breakeven Analysis 522
21.5 Pricing Convertibles: A First Pass 523
21.6 Incorporating Credit Risk 530
21.7 Convertible Greeks 534
21.8 Convertible Arbitrage 542
21.9 Summary 542
21.10 Exercises 543
Appendix 21A Octave Code for the Blended Discount Rate Valuation Tree 545
Appendix 21B Octave Code for the Simplified Das-Sundaram Model 546

**Chapter 22**

### Real Options 548

22.1 Introduction 548
22.2 Preliminary Analysis and Examples 550
22.3 A Real Options “Case Study” 554
22.4 Creating the State Space 560
22.5 Applications of Real Options 563
22.6 Summary 564
22.7 Exercises 564
Appendix 22A Derivation of Cash-Flow Value in the “Waiting-to-Invest” Example 568

**PART THREE**

### Swaps 569

**Chapter 23**

### Interest Rate Swaps and Floating-Rate Products 571

23.1 Introduction 571
23.2 Floating-Rate Notes 571
23.3 Interest Rate Swaps 575
23.4 Uses of Swaps 576
23.5 Swap Payoffs 579
23.6 Valuing and Pricing Swaps 582
23.7 Extending the Pricing Arguments 586
23.8 Case Study: The Procter & Gamble–Bankers Trust “5/30” Swap 589
23.9 Case Study: A Long-Term Capital Management “Convergence Trade” 593
23.10 Credit Risk and Credit Exposure 596
23.11 Hedging Swaps 597
23.12 Caps, Floors, and Swaptions 599
23.13 The Black Model for Pricing Caps, Floors, and Swaptions 604
23.14 Summary 609
23.15 Exercises 609

Chapter 24
Equity Swaps 613
24.1 Introduction 613
24.2 Uses of Equity Swaps 614
24.3 Payoffs from Equity Swaps 616
24.4 Valuation and Pricing of Equity Swaps 622
24.5 Summary 628
24.6 Exercises 628

Chapter 25
Currency and Commodity Swaps 631
25.1 Introduction 631
25.2 Currency Swaps 631
25.3 Commodity Swaps 639
25.4 Summary 643
25.5 Exercises 644

PART FOUR
Interest Rate Modeling 647

Chapter 26
The Term Structure of Interest Rates: Concepts 649
26.1 Introduction 649
26.2 The Yield-to-Maturity 649
26.3 The Term Structure of Interest Rates 651
26.4 Discount Functions 652
26.5 Zero-Coupon Rates 653
26.6 Forward Rates 654
26.7 Yield-to-Maturity, Zero-Coupon Rates, and Forward Rates 656
26.8 Constructing the Yield-to-Maturity Curve: An Empirical Illustration 657
26.9 Summary 661
26.10 Exercises 662
Appendix 26A The Raw YTM Data 664

Chapter 27
Estimating the Yield Curve 667
27.1 Introduction 667
27.2 Bootstrapping 667
27.3 Splines 669
27.4 Polynomial Splines 670
27.5 Exponential Splines 673
27.6 Implementation Issues with Splines 674
27.7 The Nelson-Siegel-Svensson Approach 674
27.8 Summary 676
27.9 Exercises 676
Appendix 27A Bootstrapping by Matrix Inversion 680
Appendix 27B Implementation with Exponential Splines 681

Chapter 28
Modeling Term-Structure Movements 684
28.1 Introduction 684
28.2 Interest-Rate Modeling versus Equity Modeling 684
28.3 Arbitrage Violations: A Simple Example 685
28.4 A Gentle Introduction to No-Arbitrage Modeling 687
28.5 “No-Arbitrage” and “Equilibrium” Models 693
28.6 Summary 697
28.7 Exercises 697

Chapter 29
Factor Models of the Term Structure 700
29.1 Overview 700
29.2 The Black-Derman-Toy Model 701
29.3 The Ho-Lee Model 710
29.4 One-Factor Models in Continuous Time 714
29.5 Multifactor Models 720
29.6 Affine Factor Models 722
29.7 Summary 725
29.8 Exercises 726
Appendix 29A Deriving the Fundamental PDE in Factor Models 729

Chapter 30
The Heath-Jarrow-Morton and Libor Market Models 731
30.1 Overview 731
Chapter 33
Reduced-Form Models of Default Risk 829
33.1 Introduction 829
33.2 Modeling Default I: Intensity Processes 830
33.3 Modeling Default II: Recovery Rate Conventions 834
33.4 The Litterman-Iben Model 836
33.5 The Duffie-Singleton Result 841
33.6 Defaultable HJM Models 843
33.7 Ratings-Based Modeling: The JLT Model 845
33.8 An Application of Reduced-Form Models: Pricing CDS 853
33.9 Summary 855
33.10 Exercises 855
Appendix 33A Duffie-Singleton in Discrete Time 859
Appendix 33B Derivation of the Drift-Volatility Relationship 860

Chapter 34
Modeling Correlated Default 863
34.1 Introduction 863
34.2 Examples of Correlated Default Products 863
34.3 Simple Correlated Default Math 865
34.4 Structural Models Based on Asset Values 868
34.5 Reduced-Form Models 874
34.6 Multiperiod Correlated Default 875
34.7 Fast Computation of Credit Portfolio Loss Distributions without Simulation 878
34.8 Copula Functions 881
34.9 Top-Down Modeling of Credit Portfolio Loss 893
34.10 Summary 897
34.11 Exercises 898

Bibliography B-1
Index I-1
The following Web chapters are available at www.mhhe.com/sdle:

PART SIX
Computation  901

Chapter 35
Derivative Pricing with Finite Differencing  903

35.1 Introduction  903
35.2 Solving Differential Equations  904
35.3 A First Approach to Pricing Equity Options  907
35.4 Implicit Finite Differencing  913
35.5 The Crank-Nicholson Scheme  917
35.6 Finite Differencing for Term-Structure Models  919
35.7 Summary  921
35.8 Exercises  922

Chapter 36
Derivative Pricing with Monte Carlo Simulation  923

36.1 Introduction  923
36.2 Simulating Normal Random Variables  924
36.3 Bivariate Random Variables  925
36.4 Cholesky Decomposition  925
36.5 Stochastic Processes for Equity Prices  927
36.6 ARCH Models  929
36.7 Interest-Rate Processes  930
36.8 Estimating Historical Volatility for Equities  932
36.9 Estimating Historical Volatility for Interest Rates  932
36.10 Path-Dependent Options  933
36.11 Variance Reduction  935
36.12 Monte Carlo for American Options  938
36.13 Summary  942
36.14 Exercises  943

Chapter 37
Using Octave  945

37.1 Some Simple Commands  945
37.2 Regression and Integration  948
37.3 Reading in Data, Sorting, and Finding  950
37.4 Equation Solving  955
37.5 Screenshots  955