## Contents

**Author Biographies**  xv  
**Preface**  xvi  
**Acknowledgments**  xxi  

### Chapter 1  
**Introduction**  1  
1.1 **Forward and Futures Contracts**  5  
1.2 Options  9  
1.3 Swaps  10  
1.4 **Using Derivatives: Some Comments**  12  
1.5 The Structure of this Book  16  
1.6 Exercises  17  

### PART ONE  
**Futures and Forwards**  19  

**Chapter 2**  
**Futures Markets**  21  
2.1 Introduction  21  
2.2 The Functioning of Futures Exchanges  23  
2.3 The Standardization of Futures Contracts  32  
2.4 Closing Out Positions  35  
2.5 Margin Requirements and Default Risk  37  
2.6 Case Studies in Futures Markets  40  
2.7 Exercises  55  
**Appendix 2A** Futures Trading and US Regulation:  
A Brief History  59  
**Appendix 2B** Contango, Backwardation, and  
Rollover Cash Flows  62  

**Chapter 3**  
**Pricing Forwards and Futures I: The Basic Theory**  63  
3.1 Introduction  63  
3.2 Pricing Forwards by Replication  64  
3.3 Examples  66  
3.4 Forward Pricing on Currencies and Related Assets  69  
3.5 Forward-Rate Agreements  72  
3.6 Concept Check  72  
3.7 The Marked-to-Market Value of a Forward Contract  73  
3.8 Futures Prices  75  
3.9 Exercises  77  
**Appendix 3A** Compounding Frequency  82  
**Appendix 3B** Forward and Futures Prices with Constant Interest Rates  84  
**Appendix 3C** Rolling Over Futures Contracts  86  

**Chapter 4**  
**Pricing Forwards and Futures II: Building on the Foundations**  88  
4.1 Introduction  88  
4.2 From Theory to Reality  88  
4.3 The Implied Repo Rate  92  
4.4 Transactions Costs  95  
4.5 Forward Prices and Future Spot Prices  96  
4.6 Index Arbitrage  97  
4.7 Exercises  100  
**Appendix 4A** Forward Prices with Convenience Yields  103  

**Chapter 5**  
**Hedging with Futures and Forwards**  104  
5.1 Introduction  104  
5.2 A Guide to the Main Results  106  
5.3 The Cash Flow from a Hedged Position  107  
5.4 The Case of No Basis Risk  108  
5.5 The Minimum-Variance Hedge Ratio  109  
5.6 Examples  112  
5.7 Implementation  114  
5.8 Further Issues in Implementation  115  
5.9 Index Futures and Changing Equity Risk  117  
5.10 Fixed-Income Futures and Duration-Based Hedging  118  
5.11 Exercises  119  
**Appendix 5A** Derivation of the Optimal Tailed Hedge Ratio $h^{**}$  124  

**Chapter 6**  
**Interest-Rate Forwards and Futures**  126  
6.1 Introduction  126  
6.2 Eurodollars and Libor Rates  126  
6.3 Forward-Rate Agreements  127  
6.4 Eurodollar Futures  133  
6.5 Treasury Bond Futures  140
6.6 Treasury Note Futures 144
6.7 Treasury Bill Futures 144
6.8 Duration-Based Hedging 144
6.9 Exercises 147
Appendix 6A PVBP-Based Hedging Using Eurodollar Futures 151
Appendix 6B Calculating the Conversion Factor 152
Appendix 6C Duration as a Sensitivity Measure 153
Appendix 6D The Duration of a Futures Contract 154

PART TWO
Options 155

Chapter 7
Options Markets 157
7.1 Introduction 157
7.2 Definitions and Terminology 157
7.3 Options as Financial Insurance 158
7.4 Naked Option Positions 160
7.5 Options as Views on Market Direction and Volatility 164
7.6 Exercises 167
Appendix 7A Options Markets 169

Chapter 8
Options: Payoffs and Trading Strategies 173
8.1 Introduction 173
8.2 Trading Strategies I: Covered Calls and Protective Puts 173
8.3 Trading Strategies II: Spreads 177
8.4 Trading Strategies III: Combinations 185
8.5 Trading Strategies IV: Other Strategies 188
8.6 Which Strategies Are the Most Widely Used? 191
8.7 The Barings Case 192
8.8 Exercises 195
Appendix 8A Asymmetric Butterfly Spreads 198

Chapter 9
No-Arbitrage Restrictions on Option Prices 199
9.1 Introduction 199
9.2 Motivating Examples 199
9.3 Notation and Other Preliminaries 201
9.4 Maximum and Minimum Prices for Options 202
9.5 The Insurance Value of an Option 207
9.6 Option Prices and Contract Parameters 208
9.7 Numerical Examples 211
9.8 Exercises 213

Chapter 10
Early Exercise and Put-Call Parity 216
10.1 Introduction 216
10.2 A Decomposition of Option Prices 216
10.3 The Optimality of Early Exercise 219
10.4 Put-Call Parity 223
10.5 Exercises 229

Chapter 11
Option Pricing: A First Pass 231
11.1 Overview 231
11.2 The Binomial Model 232
11.3 Pricing by Replication in a One-Period Binomial Model 234
11.4 Comments 238
11.5 Riskless Hedge Portfolios 240
11.6 Pricing Using Risk-Neutral Probabilities 240
11.7 The One-Period Model in General Notation 244
11.8 The Delta of an Option 245
11.9 An Application: Portfolio Insurance 249
11.10 Exercises 251
Appendix 11A Riskless Hedge Portfolios and Option Pricing 255
Appendix 11B Risk-Neutral Probabilities and Arrow Security Prices 256
Appendix 11C The Risk-Neutral Probability, No-Arbitrage, and Market Completeness 257
Appendix 11D Equivalent Martingale Measures 260
Chapter 33
Reduced-Form Models of Default Risk  816
33.1 Introduction  816
33.2 Modeling Default I: Intensity Processes  817
33.3 Modeling Default II: Recovery Rate Conventions  821
33.4 The Litterman-Iben Model  823
33.5 The Duffie-Singleton Result  828
33.6 Defaultable HJM Models  830
33.7 Ratings-Based Modeling: The JLT Model  832
33.8 An Application of Reduced-Form Models: Pricing CDS  840
33.9 Summary  842
33.10 Exercises  842
Appendix 33A Duffie-Singleton in Discrete Time  846
Appendix 33B Derivation of the Drift-Volatility Relationship  847

Chapter 34
Modeling Correlated Default  850
34.1 Introduction  850
34.2 Examples of Correlated Default Products  850
34.3 Simple Correlated Default Math  852
34.4 Structural Models Based on Asset Values  855
34.5 Reduced-Form Models  861
34.6 Multiperiod Correlated Default  862
34.7 Fast Computation of Credit Portfolio Loss Distributions without Simulation  865
34.8 Copula Functions  868
34.9 Top-Down Modeling of Credit Portfolio Loss  880
34.10 Summary  884
34.11 Exercises  885

Bibliography  B-1
Index  I-1
The following Web chapters are available at www.mhhe.com/sd2e:

PART SIX
Computation  

Chapter 35
Derivative Pricing with Finite Differencing  

35.1 Introduction 3
35.2 Solving Differential Equations 4
35.3 A First Approach to Pricing Equity Options 7
35.4 Implicit Finite Differencing 13
35.5 The Crank-Nicholson Scheme 17
35.6 Finite Differencing for Term-Structure Models 19
35.7 Summary 21
35.8 Exercises 22

Chapter 36
Derivative Pricing with Monte Carlo Simulation  

36.1 Introduction 23
36.2 Simulating Normal Random Variables 24
36.3 Bivariate Random Variables 25
36.4 Cholesky Decomposition 25
36.5 Stochastic Processes for Equity Prices 27
36.6 ARCH Models 29
36.7 Interest-Rate Processes 30
36.8 Estimating Historical Volatility for Equities 32
36.9 Estimating Historical Volatility for Interest Rates 32
36.10 Path-Dependent Options 33
36.11 Variance Reduction 35
36.12 Monte Carlo for American Options 38
36.13 Summary 42
36.14 Exercises 43

Chapter 37
Using Octave  

37.1 Some Simple Commands 45
37.2 Regression and Integration 48
37.3 Reading in Data, Sorting, and Finding 50
37.4 Equation Solving 55
37.5 Screenshots 55