

Table of Contents

1	Introduction	1
1.1	An Introduction to Options in Finance	1
1.1.1	Empirical Finance	5
1.1.2	Stochastic Finance	6
1.1.3	Computational Finance	6
1.2	Some Useful Material from Probability Theory	6
2	Statistical Analysis of Data from the Stock Market	11
2.1	The Black & Scholes Model	12
2.2	Logarithmic Returns from Stocks	15
2.3	Scaling Towards Normality	19
2.4	Heavy-Tailed and Skewed Logreturns	20
2.5	Logreturns and the Normal Inverse Gaussian Distribution	23
2.6	An Alternative to the Black & Scholes Model	28
2.7	Logreturns and Autocorrelation	28
2.8	Conclusions Regarding the Choice of Stock Price Model	31
3	An Introduction to Stochastic Analysis	33
3.1	The Itô Integral	33
3.2	The Itô Formula	38
3.3	Geometric Brownian Motion as the Solution of a Stochastic Differential Equation	44
3.4	Conditional Expectation and Martingales	46
4	Pricing and Hedging of Contingent Claims	53
4.1	Motivation from One-Period Markets	54
4.2	The Black & Scholes Market and Arbitrage	58
4.3	Pricing and Hedging of Contingent Claims $X = f(S(T))$	60
4.3.1	Derivation of the Black & Scholes Partial Differential Equation	60
4.3.2	Solution of the Black & Scholes Partial Differential Equation	63
4.3.3	The Black & Scholes Formula for Call Options	65
4.3.4	Hedging of Call Options	67
4.3.5	Hedging of General Options	70

4.3.6	Implied Volatility.....	72
4.4	The Girsanov Theorem and Equivalent Martingale Measures .	73
4.5	Pricing and Hedging of General Contingent Claims	77
4.5.1	An Example: a Chooser Option	79
4.6	The Markov Property and Pricing of General Contingent Claims	81
4.7	Contingent Claims on Many Underlying Stocks.....	83
4.8	Completeness, Arbitrage and Equivalent Martingale Measures	86
4.9	Extensions to Incomplete Markets	88
4.9.1	Energy Markets and Incompleteness	91
5	Numerical Pricing and Hedging of Contingent Claims	99
5.1	Pricing and Hedging with Monte Carlo Methods.....	99
5.1.1	Pricing and Hedging of Contingent Claims with Payoff of the Form $f(S_T)$	100
5.1.2	The Accuracy of Monte Carlo Methods	104
5.1.3	Pricing of Contingent Claims on Many Underlying Stocks	105
5.1.4	Pricing of Path-Dependent Claims.....	107
5.2	Pricing and Hedging with the Finite Difference Method	112
A	Solutions to Selected Exercises	121
	References	157
	Index	161