CONTENTS

Preface	vi
Acknowledgments	viii
The second se	~
Part I Fundamentals	
I.1 Money, Capital, and Securities	1
1.1 Money and Capital	1
1.2 Investment	1
1.3 Interest	1
1.4 Cash Flows	2
1.5 Financial and Real Investment	2
1.6 Securities	3
1.7 Financial Market	12
1.8 Financial Institutions	12
1.9 Financial System	12
I.2 Interest Rate	13
2.1 Simple and Compound Interest	13
2.2 Calendar Conventions	14
2.3 Determinants of the Interest Rate	15
2.4 Decomposition of the Interest Rate	16
2.5 Term Structure of Interest Rates	18
2.6 Continuous Compounding	19
I.3 Measures of Cash Flows	21
3.1 Present Value	21
3.2 Annuities	23
3.3 Future Value	24
3.4 Internal Rate of Return	26
3.5 Duration	29
3.6 Convexity	30
3.7 Comparison of Investment Projects	31
3.8 Yield Curves	36
I.4 Return, Expected Return, and Risk	39
4.1 Return	39
4.2 Risk Measurement	43
I.5 Valuation of Securities	48
5.1 Coupon Bonds	48
5.2 Options	52
5.3 Forwards and Futures	63
I.6 Matching of Assets and Liabilities	64
6.1 Matching and Immunization	64
6.2 Dedicated Bond Portfolio	65
6.3 A Stochastic Model of Matching	67
I.7 Index Numbers and Inflation	68
7.1 Construction of Index Numbers	68
7.2 Stock Exchange Indicators	70
7.3 Inflation	71

•

I & Basice of Ilitility Theory	72
8.1 The Concept of Utility	72
8.2 Utility Function	72
8.3 Characteristics of Utility Functions	74
8.4 Some Particular Utility Functions	75
8.5 Rick Considerations	76
8.6 Containty Equivalent	70
10 Monkowitz Moor Verinnes Destelie	70
0.1 Dentfolio	79
	80
9.2 Construction of Optimal Portiolios and Separation Theorems	81
1.10 Capital Asset Pricing Model	92
10.1 Sharpe-Linther Model	92
10.2 Security Market Line	93
10.3 Capital Market Line	95
1.11 Arbitrage Pricing Theory	96
11.1 Regression Model	96
11.2 Factor Model	97
I.12 Bibliographical Notes	101
Part II Discrete Time Stochastic Decision Models	
II.1 Introduction and Preliminaries	103
1.1 Problem of a Private Investor	104
1.2 Stochastic Dedicated Bond Portfolio	105
1.3 Mathematical Programs	106
II.2 Multistage Stochastic Programs	108
2.1 Basic Formulations	108
2.2 Scenario-Based Stochastic Linear Programs	112
2.3 Horizon and Stages	116
2.4 The Flower-Girl Problem	117
2.5 Comparison with Stochastic Dynamic Programming	119
II.3 Multiple Criteria	123
3.1 Theory	123
3.2 Selected Applications to Portfolio Optimization	127
3.3 Multi-Objective Optimization and Stochastic Programming Models	131
II.4 Selected Applications in Finance and Economics	137
4.1 Portfolio Revision	137
4.2 The BONDS Model	139
4.3 Bank Asset and Liability Management – Model ALM	141
4.4 General Features of Multiperiod Stochastic Programs in Finance	144
4.5 Production Planning	148
4.6 Canacity Expansion of Electric Power Generation Systems - CEP	150
4.7 Unit Commitment and Economic Power Dispatch Problem	153
4.8 Melt Control: Charge Optimization	154
II 5 Approximation Via Scenarios	159
5.1 Introduction	159
5.2 Scenarios and their Concration	150
5.3 How to Draw Inference about the True Problem	164
Sto Mon to Bran Interence Boody the True I tooleni	104

5.4 Scenario Trees for Multistage Stochastic Programs	169
IL6 Case Study: Bond Portfolio Management Problem	180
6.1 The Problem and the Input Data	180
6.2 The Model and the Structure of the Program	182
6.3 Generation of Scenarios	187
6.4 Selected Numerical Results	190
6.5 "What if" Analysis	192
6.6 Discussion	197
II.7 Incomplete Input Information	199
7.1 Sensitivity for the Black-Scholes Formula	199
7.2 Markowitz Mean-Variance Model	200
7.3 Incomplete Information about Liabilities	204
II.8 Numerical Techniques and Available Software (by Pavel Popela)	206
8.1 Motivation	206
8.2 Common Optimization Techniques	208
8.3 Solution Techniques for Two-Stage Stochastic Programs	214
8.4 Solution Techniques for Multistage Stochastic Programs	218
8.5 Approximation Techniques	224
8.6 Model Management	226
II.9 Bibliographical Notes	228
Part III Stochastic Analysis and Diffusion Finance	
III 1 Martingales	231
1.1 Stochastic Processes	231
1.2 Brownian Motion and Martingales	238
1.3 Markov Times and Stopping Theorem	244
1.4 Local Martingales and Complete Filtrations	252
1.5 Lo-Martingales and Density Theorem	257
1.6 Doob-Meyer Decomposition	263
1.7 Quadratic Variation of Local Martingales	269
1.8 Helps to Some Exercises	275
III.2 Stochastic Integration	277
2.1 Stochastic Integral	277
2.2 Stochastic Per Partes and Itô Formula	286
2.3 Exponential Martingales and Lévy Theorem	295
2.4 Girsanov Theorem	300
2.5 Integral and Brownian Representations	308
2.6 Helps to Some Exercises	316
III.3 Diffusion Financial Mathematics	319
3.1 Black-Scholes Calculus	319
3.2 Girsanov Calculus	333
3.3 Market Regulations and Option Pricing	350
3.4 Helps to Some Exercises	363
III. 4 Bibliographical Notes	366
References	369
Index	377

ix