

Contents

Contents	iii
List of Figures	vii
Preface	ix
1 The mysterious movement of Mr. Brown	1
1.1 A bit of history	1
1.2 Stochastic processes	6
1.3 Brownian motion	10
1.4 Properties of Brownian motion	12
1.5 Bibliography of the chapter	23
2 Are markets efficient?	25
2.1 Bachelier	25
2.2 Samuelson	28
2.3 Fama	33
2.4 Mandelbrot	36
2.5 Bibliography of the chapter	42
3 Free lunches	45
3.1 Arbitrage	45
3.2 Options	52
3.3 Uses of options	57
3.4 The binomial model	60

3.5	The equivalent martingale probability measure	63
3.6	Properties of the measure Q	64
3.7	The first fundamental theorem of asset pricing	67
3.8	The second fundamental theorem of asset pricing	69
3.9	Bibliography of the chapter	72
4	Noisy dynamics	73
4.1	Stochastic differential equations	73
4.2	Linear stochastic differential equations	75
4.3	Geometric Brownian motion	76
4.4	The stochastic exponential	77
4.5	Itô's rule	78
4.6	The Girsanov theorem	79
4.7	The martingale representation theorem	80
4.8	Bibliography of the chapter	81
5	Black and Scholes (and Merton)	83
5.1	Geometric Brownian motion	83
5.2	Properties of geometric Brownian motion	87
5.3	Geometric Brownian motion under Q	90
5.4	The Black-Scholes formula	92
5.5	The Nobel prize	96
5.6	Bibliography of the chapter	98
6	To Black-Scholes and beyond	101
6.1	Put-call parity	101
6.2	The greeks	103
6.3	Delta hedging	107
6.4	The implied volatility	109
6.5	Completeness	115
6.6	Bibliography of the chapter	116

7	He who promises runs in debt	119
7.1	Bonds and interest rates	120
7.2	The duration of a bond portfolio	126
7.3	Duration and price risk	127
7.4	Duration and immunization	129
7.5	Bibliography of the chapter	130
8	Interesting rates	133
8.1	Interest rate derivatives	133
8.2	Affine models	135
8.2.1	Vasicek	136
8.2.2	Cox, Ingersoll and Ross (CIR)	137
8.2.3	Ho and Lee	139
8.2.4	Hull and White	141
8.3	Heath, Jarrow and Morton	142
8.4	Infinite-dimensional models	145
8.5	Forward measures	146
8.6	Derivative valuation	150
8.7	Completeness	154
8.8	Bibliography of the chapter	156
	Bibliography	159
	Index	172