FE 620: Pricing and Hedging
Fall 2024: Group Project

Introduction

For your course project, you will work in teams (of 3-4 students) to go through the process of building a pricing and risk managing a simple derivative.

Broadly your projects will consist of three inter-related topics:

1. Expository part: introduction to the financial derivative chosen. Explain the payoff, economic rational and the markets where it is traded

2. Build a valuation algorithm for pricing this derivative, and test the algorithm on appropriate limit and test cases.

3. Data collection and analysis. Download real market data and use it to calibrate the model.

For this project you will implement models and techniques discussed in class or from *Hull* [1] on real data (from, e.g., *Yahoo Finance*).

With this project you will replicate the real life experience of a desk quant, working in a bank to build valuation and risk management models for the derivative chosen. This is a great learning experience.

Important Dates

Milestone	Data	Deliverables
Team Formation	10/11	Submit as text on Canvas. Include the names for the members of the team.
Project Proposal	10/25	Submit **pdf** on Canvas. One per group.
Final Report	12/13	Submit **pdf** on Canvas. One per group.
Project Presentation	12/11 [in class]	Submit **pdf** of slides on Canvas. One per group.

Project Components

Application of Derivatives

Choose a derivative from the following list. More details can be found in *Hull* [1] (Ch. 26).

- American option (highly recommended)

- Asian option

- Barrier option

Think about when your chosen derivative might be used in practice. Research the literature.

Valuation Algorithm

Use a numerical technique to price your derivative on fictitious data. Consider, for instance, Binomial Trees or Monte Carlo simulation of the Black-Scholes model. Compute valuations and sensitivities with respect to market parameters. Consider the errors produced by numerical approximations and simulations in your pricing.

Data Collection and Analysis

In this step your team will download financial data on a liquidly traded asset (equity or commodity future) and option prices from *Yahoo Finance* or other sources. You will need to estimate market parameters from financial data. Consider historical and implied volatilities, find the volatility smile, forward curve of your asset, etc... Use your valuation algorithm to price the derivative under consideration. Think about how to hedge the derivative using the underlying asset and perform a hedging analysis.

Deliverables

Deliverable #1: Team Formation

In this step you submit the team members of your team. Teams should consist of **3-4 students**. If you have trouble forming a group of 3-4 for any reason (whether that means you are a single individual or have a partial group of 2 students), submit the partial group and I will help form a complete team..

Deliverable #2: Project Proposal

In this step each team submits a formal proposal for the chosen project. This should give as much detail as possible about what specifically you will consider the full breadth of your project. It is a good idea to provide a detailed timeline in the form of a Gantt chart[1] detailing the activities necessary to complete your project, timelines for start and end dates of each task, and teammate assignments to each task.

Deliverable #3: Final Report

In this step each team submits the final write-up, which should include all of the information detailed below. The write-up should be about 15 double-spaced pages, Times New Roman 12pt font. This does not include any appendices (for example code) you may wish to include. Any external resources used should have clear citations and a reference page at the end of your work. All group members should contribute to the analysis and write-up as detailed in your Gantt Charts. The report should include an appendix describing the contributions of each team member.

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[1]Named for Henry Gantt, who received a Masters of Engineering degree in mechanical engineering from the Stevens Institute of Technology.

1. **General description** of the derivative: payoff, rationale for trading and possible economic use.

2. Detailed description of the **pricing algorithm** chosen for the derivative considered, and sample results obtained with dummy data. This includes test results, sensitivity to inputs and parameters of the numerical algorithm (e.g. sensitivity to the choice of the time step).

3. **Data analysis**: explain the financial data used, and the details and results of the analysis performed. Mention any data cleaning if required.

4. The results obtained by running the pricing algorithm for the **derivative using real data** as inputs.

5. **Hedging analysis**: principle and test results. What are the main risks of the derivative, and how can they be hedged?

6. **Next steps**: What else could be done with the data collected and pricing algorithm, but time did not permit?

Project Presentation

On the last day of class, your group will give a 15 minute prepared presentation. Every team member should present on their contributions to the work. An additional 2-3 minutes will be used for questions. The order of presentations will be announced prior to the presentation.

References

[1] John C. Hull, Options, Futures and Other Derivatives, Pearson, 11th Edition, 2020