

Financial Engineering

Exam

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F20

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
3. The Multi-Step Binomial Model
4. The First Fundamental Theorem of Asset Pricing
5. Pricing in the Binomial Model
6. The Second Fundamental Theorem of Asset Pricing

Table of Contents

1. Bonds and the Value of Money Through Time

1.1 Bonds

1.2 Interest Rate

1.3 Types of Bonds

2. Portfolio Allocation and Risk Measures

3. The Multi-Step Binomial Model

4. The First Fundamental Theorem of Asset Pricing

5. Pricing in the Binomial Model

6. The Second Fundamental Theorem of Asset Pricing

Bonds and the Value of Money Through Time

Bonds

Definition (Bond)

A bond is a financial security that pays the owner a chain of predetermined payments.

Bonds and the Value of Money Through Time

Bonds

Definition (Bond)

A bond is a financial security that pays the owner a chain of predetermined payments.

- ▶ Financial asset with no risk

Bonds and the Value of Money Through Time

Interest Rate

- ▶ Predetermined payments are also known as interest
- ▶ Fraction of an investment paid either ones for several periods
- ▶ Different types of interest
 1. Simple
 2. Compounded
 3. Continuously compounded

Bonds and the Value of Money Through Time

Interest Rate

Definition (Wealth Process)

The evolution of an investment over time is called the wealth process of that investment and is denoted by

$$V = (V_t)_{0 \leq t \leq T}. \quad (1.1)$$

The initial capital is denoted by v_0 , and we assume that V is a real-valued stochastic process on a given probability space $(\Omega, \mathcal{F}, \mathbb{P})$.

Bonds and the Value of Money Through Time

Interest Rate

Definition (Simple Interest)

Let $v_0 \in \mathbb{R}$ be our initial capital. An interest on v_0 is said to be simple if it follows the wealth process

$$V_t = (1 + rt)v_0, \quad 0 \leq t \leq T. \quad (1.2)$$

Bonds and the Value of Money Through Time

Interest Rate

I will now show that the wealth process in (1.2) is indeed a stochastic process in any probability space. Any stochastic process X on the probability space $(\Omega, \mathcal{F}, \mathbb{P})$ satisfies

$$\{\omega \in \Omega : X(\omega) \leq x\} \in \mathcal{F}, \quad \forall x \in \mathbb{R}. \quad (1.3)$$

Suppose $v_0 > 0$ and $x \geq (1 + rt)v_0$ then

$$\{\omega \in \Omega : (1 + rt)v_0 \leq x\} = \{\Omega\} \in \mathcal{F}, \quad (1.4)$$

on the other hand if $x < (1 + rt)v_0$

$$\{\omega \in \Omega : (1 + rt)v_0 \leq x\} = \{\emptyset\} \in \mathcal{F}. \quad (1.5)$$

As both Ω and \emptyset is contained in any σ -algebra we have shown that the wealth process in (1.2) is a stochastic process in any probability space.

Bonds and the Value of Money Through Time

Interest Rate

Definition (Compounded Interest)

Let $v_0 \in \mathbb{R}$ be our initial capital. An interest on v_0 is said to be compounded over $m \in \mathbb{N}$ periods if it follows the wealth process

$$V_t = \left(1 + \frac{r}{m}\right)^{mt} v_0, \quad 0 \leq t \leq T. \quad (1.6)$$

Bonds and the Value of Money Through Time

Interest Rate

Note that we have the following properties $\forall 0 \leq t \leq T$

1. $V_{t+1} = \left(1 + \frac{r}{m}\right)^m V_t$,
2. If $m_1 > m_2, v_0 > 0 \Rightarrow \left(1 + \frac{r}{m_1}\right)^{m_1 t} v_0 > \left(1 + \frac{r}{m_2}\right)^{m_2 t} v_0$,
3. If $m_1 > m_2, v_0 < 0 \Rightarrow \left(1 + \frac{r}{m_1}\right)^{m_1 t} v_0 < \left(1 + \frac{r}{m_2}\right)^{m_2 t} v_0$.

From this it follows that for an *investor* compound interest is more attractive as it pays more, however as a *debtor* it is less attractive as he or she will have to pay more on his or her debt.

Bonds and the Value of Money Through Time

Interest Rate

At last I can turn to continuously compounded interest which I will present as the limit of (1.6) as $m \rightarrow \infty$. Note that by the following definition of e

$$\lim_{x \rightarrow \infty} \left(1 + \frac{1}{x}\right)^x = e, \quad (1.7)$$

by letting $x = r/m$ in the above the limit of the wealth process of compounded interest can be seen as

$$\left[\left(1 + \frac{r}{m}\right)^{\frac{m}{r}} \right]^{rt} v_0 \rightarrow (e)^{rt} v_0, \quad \text{as } m \rightarrow \infty. \quad (1.8)$$

This leads to the definition of continuously compounded interest.

Bonds and the Value of Money Through Time

Interest Rate

Definition (Continuously Compounded Interest)

Let v_0 be our initial capital. An interest on v_0 is said to be continuously compounded at rate $r > 0$ if the wealth process

$$V_t = e^{rt} v_0, \quad 0 \leq t \leq T. \quad (1.9)$$

Bonds and the Value of Money Through Time

Interest Rate

There exists the following relation between the different types of interest

$$(1 + r) \leq \left(1 + \frac{r}{m}\right)^m < e^r. \quad (1.10)$$

To show that the relation indeed holds i will show that the sequence

$$a_m = \left(1 + \frac{r}{m}\right)^m, \quad (1.11)$$

is increasing.

Bonds and the Value of Money Through Time

Interest Rate

Using the binomial theorem

$$(x + y)^n = \sum_{k=0}^n \binom{n}{k} x^k y^{n-k}$$

we have

$$\begin{aligned} \left(1 + \frac{r}{m}\right)^m &= \sum_{k=0}^m \binom{m}{k} 1^{m-k} \left(\frac{r}{m}\right)^k \\ &= \sum_{k=0}^m \binom{m}{k} \left(\frac{r}{m}\right)^k := \clubsuit \end{aligned}$$

Bonds and the Value of Money Through Time

Interest Rate

Each term is of the form

$$\binom{m}{k} \left(\frac{r}{m}\right)^k = \prod_{l=0}^{k-1} \frac{m-l}{k-l} \left(\frac{r}{m}\right)$$

Bonds and the Value of Money Through Time

Interest Rate

Each term is of the form

$$\begin{aligned}\frac{m - l}{k - l} \frac{r}{m} &= \frac{rm - lr}{m(k - l)} \\ &= \frac{m(r - lr/m)}{m(k - l)} \\ &= \frac{r - lr/m}{k - l} := \star\end{aligned}$$

The term \star increases with m and thus the product increases with m and thus the sum \clubsuit increases with m and therefore it is an increasing sequence.

Bonds and the Value of Money Through Time

Types of Bonds

I will discuss the following two types here

1. zero-coupon bonds,
2. coupon bonds.

Bonds and the Value of Money Through Time

Types of Bonds

A **zero-coupon bond** is a bond with a single payment $F > 0$ at time $T > 0$. The pay-off F is called the face value and T the maturity time. The next question i will answer is how much i will be willing to pay for such a financial assest. This depends on the way the time value of money is measured. Consider for example the following setup; let $B_0 \geq 0$ be the value of the zero-coupon bond with face value $F > 0$ and maturity time $T > 0$. Suppose that only annual compound interest at rate $r > 0$ is available.

Bonds and the Value of Money Through Time

Types of Bonds

From a buyers perspective what if

$$B_0 > \frac{F}{(1+r)^T}, \quad (1.12)$$

would i buy the bond?

Bonds and the Value of Money Through Time

Types of Bonds

From a buyers perspective what if

$$B_0 > \frac{F}{(1+r)^T}, \quad (1.12)$$

would i buy the bond?

Suppose now that we flip the inequality and look from a sellers perspective, that is if

$$B_0 < \frac{F}{(1+r)^T}, \quad (1.13)$$

would i sell the bond?

Bonds and the Value of Money Through Time

Types of Bonds

Now i will consider the situatuion where at time $1 \leq t \leq T$ i want to get rid of a bond, but i what to determine what price i should sell it to. At this time the bond can be considered a new zero-coupon bond with face value $F > 0$ and maturity time $T - t$. Thus we have from the previous argumentation that

$$B_t = \frac{F}{(1 + r)^{T-t}}, \quad 0 \leq t \leq T. \quad (1.14)$$

Bonds and the Value of Money Through Time

Types of Bonds

The chain of arguments holds also when the time value of money is different, if a compounded interest over m periods where considered then the fair price of a zero-coupon bond at time t would be

$$B_t = \frac{F}{\left(1 + \frac{r}{m}\right)^{m(T-t)}}. \quad (1.15)$$

If we consider the continuously compounded case the fair price would be

$$B_t = \frac{F}{e^{r(T-t)}}. \quad (1.16)$$

Bonds and the Value of Money Through Time

Types of Bonds

how much money will i have to deposit in my bank account today if i want to

$$1. \quad \text{withdraw } C > 0 \text{ after 1 year} \quad (1.17)$$

$$2. \quad \text{withdraw } C > 0 \text{ after 2 years} \quad (1.18)$$

$$\vdots$$

$$T - 1. \quad \text{withdraw } C > 0 \text{ after } T - 1 \text{ years} \quad (1.19)$$

$$T. \quad \text{withdraw } F + C \text{ after } T \text{ years} \quad (1.20)$$

and have nothing left in the bank account afterwards.

Bonds and the Value of Money Through Time

Types of Bonds

In order to be able to get $C > 0$ after one year i have to put

$$\frac{C}{1+r} \quad (1.21)$$

in the bank.

Bonds and the Value of Money Through Time

Types of Bonds

In order to be able to get $C > 0$ after one year i have to put

$$\frac{C}{1+r} \quad (1.21)$$

in the bank.

In order to be able to get $C > 0$ after two years i have to put

$$\frac{C}{(1+r)^2} \quad (1.22)$$

in the bank.

Bonds and the Value of Money Through Time

Types of Bonds

Generalizing this argument tells me that in order to receive $C > 0$ after t years I have to put

$$\frac{C}{(1+r)^t} \tag{1.23}$$

in the bank.

Bonds and the Value of Money Through Time

Types of Bonds

Generalizing this argument tells me that in order to receive $C > 0$ after t years I have to put

$$\frac{C}{(1+r)^t} \quad (1.23)$$

in the bank.

Lastly in order to get $F + C$ after T years I have to put

$$\frac{F+C}{(1+r)^T} = \frac{F}{(1+r)^T} + \frac{C}{(1+r)^T} \quad (1.24)$$

in the bank.

Bonds and the Value of Money Through Time

Types of Bonds

Adding up all these amounts it is concluded that i have to make a deposit of

$$\sum_{i=1}^T \frac{C}{(1+r)^i} + \frac{F}{(1+r)^T}. \quad (1.25)$$

Bonds and the Value of Money Through Time

Types of Bonds

Adding up all these amounts it is concluded that i have to make a deposit of

$$\sum_{i=1}^T \frac{C}{(1+r)^i} + \frac{F}{(1+r)^T}. \quad (1.25)$$

The agreeable price of a coupon bond is thus given by

$$B_0 = \sum_{i=1}^T \frac{C}{(1+r)^i} + \frac{F}{(1+r)^T} = \frac{\xi_T}{(1+r)^T}. \quad (1.26)$$

Bonds and the Value of Money Through Time

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Where the pay-off ξ_T at time T is given by

$$\xi_T := \sum_{i=1}^T C(1+r)^{T-i} + F, \quad (1.27)$$

Bonds and the Value of Money Through Time

Types of Bonds

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Where the pay-off ξ_T at time T is given by

$$\xi_T := \sum_{i=1}^T C(1+r)^{T-i} + F, \quad (1.27)$$

in other words the fair price of the coupon bond (as well as the zero-coupon bond) can be written as the discounted price of the total pay-off.

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
 - 2.1 Portfolio
 - 2.2 Risk Measures
 - 2.3 Coherent Risk Measures
3. The Multi-Step Binomial Model
4. The First Fundamental Theorem of Asset Pricing
5. Pricing in the Binomial Model
6. The Second Fundamental Theorem of Asset Pricing

Portfolio Allocation and Risk Measures

Portfolio

Let

$$\mathfrak{M} = \left\{ (\Omega, \mathcal{F}, \mathbb{P}), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}, \quad (2.1)$$

be a finite-horizon financial market.

Definition (Portfolio and Strategies)

A portfolio in \mathfrak{M} is a $(d + 1)$ -dimensional vector

$$\Theta_t = \left(\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)} \right), \quad (2.2)$$

in which

$$\Theta_t^j = \text{Number of shares of the } j\text{'th asset held between time } t - 1 \text{ and } t. \quad (2.3)$$

for $j = 1, \dots, d + 1$. The collection $\Theta = (\Theta_t)_{0 \leq t \leq T}$, with the convention that $\Theta_0 = \Theta_1$, is termed a strategy.

Portfolio Allocation and Risk Measures

Portfolio

For every strategy on market there is an associated wealth process.
The wealth process for Θ is defined and denoted by

$$V_t^\Theta = \varphi_t B_t + \sum_{j=1}^d \theta_t^{(j)} S_t^{(j)} = \Theta_t \cdot P_t, \quad 0 \leq t \leq T. \quad (2.4)$$

Portfolio Allocation and Risk Measures

Risk Measures

Any strategy on a given market inherently carries a risk because the return is random, there is in other words no way to predict our profit or losses with certainty. There is no one way to measure the risk associated with a strategy, however in the next two sections i will explore two approaches. Both of these is based on portfolio allocation as an optimization problem.

Portfolio Allocation and Risk Measures

Risk Measures

The problem is given in this way; solve

$$\operatorname{argmin}_{\mathbf{w} \in \mathbb{R}^{d+1}} \mathcal{R}(\mathbf{w} \cdot \mathbf{K}_P), \quad (2.5)$$

subject to:

$$\sum_{j=0}^d w_j = 1, \quad \mathbb{E}[U(\mathbf{w} \cdot \mathbf{K}_P)] = \mu, \quad \mu \in \mathbb{R}, \quad (2.6)$$

where \mathcal{R} is a measure of risk and $U(\mathbf{w} \cdot \mathbf{K}_P)$ is the utility of the strategy.

Portfolio Allocation and Risk Measures

Risk Measures

The mean variance approach assumes the utility function as the identity, that is

$$U(x) = x. \quad (2.7)$$

By letting

$$\mu_K := \mathbb{E}[K_P], \quad (2.8)$$

it follows that

$$\mathbb{E}[U(w \cdot K_P)] = w \cdot \mu_K. \quad (2.9)$$

Thus the optimization problem, in the mean-variance approach becomes

Problem (Optimization Problem Mean-Variance)

$$\operatorname{argmin}_{\mathbf{w} \in \mathbb{R}^{d+1}} \sqrt{\mathbf{w}^\top \mathbf{C} \mathbf{w}} \quad (2.10)$$

Subject to:

$$1.) \sum_{j=0}^d w_j = 1, \quad (2.11)$$

$$2.) \mathbf{w} \cdot \boldsymbol{\mu}_K = \mu, \quad \mu \in \mathbb{R}. \quad (2.12)$$

Portfolio Allocation and Risk Measures

Risk Measures

An illustrative example to demonstrate why one might consider a different risk measure than the standard deviation is the following. Consider two portfolios that generate the following wealth

$$V_1^{(1)} = \begin{cases} 1 & \text{with probability } 1/2 \\ -9 & \text{with probability } 1/2 \end{cases} \quad (2.13)$$

and

$$V_1^{(2)} = \begin{cases} 5 & \text{with probability } 1/2 \\ -5 & \text{with probability } 1/2 \end{cases} \quad (2.14)$$

According to their standard deviation these two portfolios carries the same risk, but one could argue that the first is riskier than the latter. The next risk measure I will consider is concerned with controlling losses rather than the variation of the return.

If i denote the outcome of an investment with V_1 then my potential losses will be given by $-V_1$. Suppose that for some $x \in \mathbb{R}$

$$-V_1 \leq x. \quad (2.15)$$

Then to cover my risk of bankruptcy i must keep at least the amount x in my bank account. In reality the only thing i can quantify is the chance of that happening, which is denoted by

$$\mathbb{P}(-V_1 \leq x). \quad (2.16)$$

This is the motivation behind the risk measure Value at Risk.

Definition (Value at Risk)

Let $0 < \alpha < 1$ and X be a random variable. The Value at Risk (VaR) of X is defined and denoted by

$$\text{VaR}_\alpha(X) := \inf \{x \in \mathbb{R} : \mathbb{P}(X + x \geq 0) \geq 1 - \alpha\}. \quad (2.17)$$

In other words the $\text{VaR}_\alpha(X)$ represents the amount of extra capital i need to hold in order to reduce my risk of bankruptcy to $1 - \alpha$.

An alternative representation of VaR can be formulated using the fact that

$$\mathbb{P}(-X \leq x) \geq 1 - \alpha \iff \mathbb{P}(X + x < 0) \leq \alpha, \quad (2.18)$$

this lets us formulate an equivalent representation given by

$$\text{VaR}_\alpha(X) := \inf \{x \in \mathbb{R} : \mathbb{P}(X < -x) \leq \alpha\}. \quad (2.19)$$

Proposition (Properties of VaR)

Let X, Y be arbitrary random variables. Then, the following holds

- 1. If $X \geq 0$ almost surely, then $\text{VaR}_\alpha(X) \leq 0$.*
- 2. For all $y \in \mathbb{R}$ we have that $\text{VaR}_\alpha(X + y) = \text{VaR}_\alpha(X) - y$. In particular $\text{VaR}_\alpha(X + \text{VaR}_\alpha(X)) = 0$.*
- 3. If $\lambda \geq 0$, then $\text{VaR}_\alpha(\lambda X) = \lambda \text{VaR}_\alpha(X)$.*
- 4. If $X \geq Y$ almost surely, then $\text{VaR}_\alpha(X) \leq \text{VaR}_\alpha(Y)$.*

Portfolio Allocation and Risk Measures

Risk Measures

Proof:

Portfolio Allocation and Risk Measures

Coherent Risk Measures

Note that when using standard deviation as a risk measure we get the following

$$\sigma(X + Y)^2 = \text{Var}(X) + \text{Var}(Y) + 2\rho_{X,Y} \sqrt{\text{Var}(X) \text{Var}(Y)}, \quad (2.20)$$

where $\rho_{X,Y} = \frac{\text{Cov}(X,Y)}{\sqrt{\text{Var}(X) \text{Var}(Y)}} \leq 1$. Then

$$\sigma(X + Y)^2 = \sigma(X)^2 + \sigma(Y)^2 + 2\rho_{X,Y}\sigma(X)\sigma(Y) \quad (2.21)$$

$$\leq \sigma(X)^2 + \sigma(Y)^2 + 2\sigma(Y)\sigma(X) = [\sigma(X) + \sigma(Y)]^2, \quad (2.22)$$

which would imply that

$$\sigma(X + Y) \leq \sigma(X) + \sigma(Y). \quad (2.23)$$

However VaR as a risk measure is not able to reproduce this, that is in general we do not have that

$$\text{VaR}_\alpha(X + Y) \leq \text{VaR}_\alpha(X) + \text{VaR}_\alpha(Y). \quad (2.24)$$

As diversification is a desired i will now introduce the concept of Coherent Risk Measures.

Definition (Coherent Risk Measure)

A function $\rho : L^1 \rightarrow \mathbb{R}$ is said to be a Coherent Risk Measure if

1. If $X \geq 0$ almost surely, then $\rho(X) \leq 0$.
2. For all $y \in \mathbb{R}$ we have that $\rho(X + y) = \rho(X) - y$.
3. If $\lambda \geq 0$, then $\rho(\lambda X) = \lambda \rho(X)$.
4. We have that $\rho(X + Y) \leq \rho(X) + \rho(Y)$.

Portfolio Allocation and Risk Measures

Coherent Risk Measures

The Conditional Value at Risk (CVAR) is a common example of a coherent risk measure.

Given a random variable X , we will write

$$q_{\alpha}(X) := \inf\{x \in \mathbb{R} : \mathbb{P}(X \leq x) \geq \alpha\}. \quad (2.25)$$

With this notation now introduced i can present the definition of CVaR.

Portfolio Allocation and Risk Measures

Coherent Risk Measures

The Conditional Value at Risk (CVAR) is a common example of a coherent risk measure.

Given a random variable X , we will write

$$q_\alpha(X) := \inf\{x \in \mathbb{R} : \mathbb{P}(X \leq x) \geq \alpha\}. \quad (2.25)$$

With this notation now introduced i can present the definition of CVaR.

Definition (Condition Value at Risk)

Let $0 < \alpha < 1$ and $X \in L^1$. The Conditional Value at Risk or Expected Shortfall of X is defined and denoted buy

$$\text{CVaR}_\alpha := -\frac{1}{\alpha} \int_0^\alpha q_r(X) dr. \quad (2.26)$$

The name Expected Shortfall comes from the fact that if X has a continuous distribution, then

$$\text{CVaR}_\alpha(X) = -\mathbb{E}[X \mid X + \text{VaR}_\alpha(X) \leq 0]. \quad (2.27)$$

Thus, CVaR_α measures the expected losses given that $\text{VaR}_\alpha(X)$ was not enough to cover our position on X .

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
3. The Multi-Step Binomial Model
 - 3.1 Model Setup
 - 3.2 Market Information
 - 3.3 Absence of Arbitrage
 - 3.4 Risk-Neutral Measure
4. The First Fundamental Theorem of Asset Pricing
5. Pricing in the Binomial Model
6. The Second Fundamental Theorem of Asset Pricing

The Multi-Step Binomial Model

Model Setup

Consider a model where only two assets are traded: A bond and a risky asset. The bond satisfies that

$$B_t = (1 + r), \quad t = 0, 1, \dots, T. \quad (3.1)$$

The price process $(S_t)_{t=0,1,\dots,T}$ satisfies that $S_0 > 0$ (non-random) and

$$S_t = S_{t-1}(1 + K_s(t)), \quad t = 1, \dots, T. \quad (3.2)$$

The returns are independent and identically distributed with

$$K_s(t) = \begin{cases} R_u & \text{with probability } p; \\ R_d & \text{with probability } 1 - p, \end{cases} \quad (3.3)$$

with the relation

$$R_d < R_u. \quad (3.4)$$

The Multi-Step Binomial Model

Market Information

I am considering the multi-step financial market

$$\mathfrak{M} = \left\{ (\Omega, \mathcal{F}, \mathbb{P}), P = \left(B_t, S_t^{(1)}, S_t^{(2)}, \dots, S_t^{(d)} \right)_{t=0,1,\dots,T} \right\}. \quad (3.5)$$

In order to further explain how information flows in the market i need to be more specific about the definition of the probability space. I will start by letting

$$\Omega = \left\{ \left(\omega^{(1)}, \omega^{(2)}, \dots, \omega^{(T)} \right) : \omega^{(t)} \in \{u, d\}, t = 1, 2, \dots, T \right\}. \quad (3.6)$$

Take for example the two-step binomial model, that is $T = 2$.

The Multi-Step Binomial Model

Market Information

I will consider all possible events, which means that the σ -algebra in this case is

$$\mathcal{F} = 2^{\Omega}. \quad (\text{The power set}) \quad (3.7)$$

Using this set-up the return process can be written as

$$K_s(t)(\omega^{(1)}, \omega^{(2)}, \dots, \omega^{(T)}) = \begin{cases} R_u & \text{if } \omega^{(t)} = u; \\ R_d & \text{if } \omega^{(t)} = d. \end{cases} \quad (3.8)$$

The Multi-Step Binomial Model

Market Information

To ensure that the returns are independent and can go up and down with probability p and $(1 - p)$ respectively, i let

$$\mathbb{P} \left(\left\{ \omega^{(1)}, \omega^{(2)}, \dots, \omega^{(d)} \right\} \right) = p^k (1 - p)^{T-k}, \quad (3.9)$$

where

$$k = \text{number of } u\text{'s in } \left(\omega^{(1)}, \omega^{(2)}, \dots, \omega^{(d)} \right). \quad (3.10)$$

The Multi-Step Binomial Model

Market Information

As an example lets consider the two-step binomial model, that is $T = 2$ and we have that

$$\Omega = \{uu, ud, du, dd\}, \quad (3.11)$$

using the notational convention that

$$\left(\omega^{(1)}, \omega^{(2)}\right) = \omega^{(1)}\omega^{(2)}. \quad (3.12)$$

The Multi-Step Binomial Model

Market Information

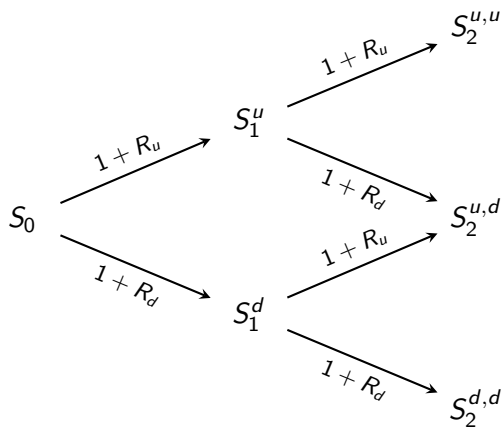


Figure: A graphical representation of the 2-step binomial model.

The Multi-Step Binomial Model

Market Information

At time $t = 0$ no information is available but as time goes by, the price movements reveal information about future outcomes. Say for example that at time $t = 1$ the price went down, the future outcomes are restricted to the set

$$B_d := \{du, dd\}, \quad (3.13)$$

as the the events (uu) and (ud) are no longer possible.

The Multi-Step Binomial Model

Market Information

The aforementioned set is related to the information generated by the return process. Consider the σ -field generated by a random variable, which is given by

$$\sigma(X) = \{X^{-1}(A) : A \in \mathcal{B}(\mathbb{R}).\} \quad (3.14)$$

The Multi-Step Binomial Model

Market Information

This tells me that, in the event that $K_S(1) = R_d$ it follows that

$$\left\{ \left(\omega^{(1)}, \omega^{(2)} \right) : K_S(1) = R_d \right\} = \{du, dd\} = B_d. \quad (3.15)$$

On the other hand if $K_S(1) = R_u$ it follows that

$$\left\{ \left(\omega^{(1)}, \omega^{(2)} \right) : K_S(1) = R_u \right\} = \{uu, ud\} = B_u. \quad (3.16)$$

Therefore

$$B_u, B_d \subseteq \sigma(K_S(1)). \quad (3.17)$$

It is in fact so, that because $K_S(1)$ only takes two values

$$\sigma(K_S(1)) = \{B_u, B_d, \Omega, \emptyset\}. \quad (3.18)$$

The Multi-Step Binomial Model

Market Information

At the end of the trading period, in this case $t = T = 2$, the outcome of the price movements are known and stored in

$$\mathcal{F} = \sigma(K_S(1), K_S(2)). \quad (3.19)$$

Furthermore there has been constructed a family of sub- σ -algebras of \mathcal{F} ;

$$\mathcal{F}_1 = \sigma(K_S(1)) = \{B_u, B_d, \Omega, \emptyset\}. \quad (3.20)$$

$$\mathcal{F}_2 = \sigma(K_S(1), K_S(2)) = \mathcal{F}. \quad (3.21)$$

Note that by construction, \mathcal{F} contains the whole information available on the price movements up until time t .

The Multi-Step Binomial Model

Market Information

Mathematically this means that the price process S_t is adapted to \mathcal{F} ;

$$\sigma(S_t) \subseteq \mathcal{F}_t, \quad t = 0, 1, 2 \text{ where } \mathcal{F}_0 = \{\Omega, \emptyset\}, \quad (3.22)$$

and moreover

$$\mathcal{F}_{t-1} \subseteq \mathcal{F}_t, \quad t = 1, 2. \quad (3.23)$$

The Multi-Step Binomial Model

Market Information

Definition (Filtrations and Adapted Process)

Fix a probability space $(\Omega, \mathcal{F}, \mathbb{P})$. A collection of σ -algebras $\mathbb{F} = (\mathcal{F}_t)_{t=0,1,\dots,T}$ is called a filtration if for all $1 \leq t \leq T$,

$$\mathcal{F}_{t-1} \subseteq \mathcal{F}_t \subseteq \mathcal{F}. \quad (3.24)$$

The quadruplet

$$(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P}), \quad (3.25)$$

is termed a filtered probability space.

Furthermore, a stochastic process $(X_t)_{0 \leq t \leq T}$ is said to be adapted to a filtration \mathbb{F} if

$$\sigma(X_t) \subseteq \mathcal{F}_t, \quad \forall 0 \leq t \leq T. \quad (3.26)$$

The Multi-Step Binomial Model

Market Information

Definition (Financial Markets with Information)

Fix $T, d \in \mathbb{N}$. A finite-horizon financial market with information is the pair

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}, \quad (3.27)$$

consisting of

1. A filtered probability space $\left(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P} \right)$
2. P_t is adapted.
3. $S^{(j)}$ is the price process of the j 'th asset traded in the market
4. B is a numéraire (e.g. a bond), i.e.

$$\mathbb{P}(B_t > 0) = 1, \quad \forall 0 \leq t \leq T. \quad (3.28)$$

The Multi-Step Binomial Model

Absence of Arbitrage

An arbitrage is understood as a way to generate positive wealth with zero investment and zero risk. In the one-step binomial model it is only allowed to allocate wealth ones, namely at time $t = 0$.

Returns are then measured at time $t = T = 1$.

In the multi-step binomial model agents will redesign their strategies based on the available information. In order to create an arbitrage the portfolio need to be updated every time the price changes. Therefore, instead of considering a single portfolio, an arbitrage now consists of a collection of portfolios $(\Theta_t)_{0 \leq t \leq T}$.

The Multi-Step Binomial Model

Absence of Arbitrage

Definition (Portfolio and Strategy)

A portfolio in \mathfrak{M} is a $(d + 1)$ -dimensional vector $\Theta_t = (\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)})$, in which

$$\Theta_t^{(j)} = \text{Number of shares of the } j\text{'th asset held between time } t - 1 \text{ and } t. \quad (3.29)$$

The collection $\Theta = (\Theta_t)_{0 \leq t \leq T}$, with the convention that $\Theta_0 = \Theta_1$ is termed a strategy.

The wealth process associated to $\Theta = (\Theta_t)_{0 \leq t \leq T}$ is defined and denoted by

$$V_t^\Theta := \varphi_t B_t + \sum_{j=1}^d \theta_t^{(j)} S_t^{(j)} = \Theta_t \cdot P_t, \quad 0 \leq t \leq T \quad (3.30)$$

$$\Rightarrow V_0^\Theta = \varphi_0 B_0 + \sum_{j=1}^d \theta_0^{(j)} S_0^{(j)} = \varphi_1 B_0 + \sum_{j=1}^d \theta_1^{(j)} S_0^{(j)} \quad (3.31)$$

The Multi-Step Binomial Model

Absence of Arbitrage

The arbitrage approach from the one-step binomial model can not be used when considering the multi-step binomial model as many strategies that from an intuitive point of view should not be thought of as an arbitrage, will be believed to be an arbitrage. Consider for example the following situation

1. Injection of capital at $t \geq 1$.
2. Privileged information.
3. Unlimited credit.

The Multi-Step Binomial Model

Absence of Arbitrage

Definition (Admissible Strategy)

Let $\Theta = \left(\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)} \right)_{0 \leq t \leq T}$ be strategy on the market

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F})_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}. \quad (3.32)$$

I will say that Θ is admissible if:

The Multi-Step Binomial Model

Absence of Arbitrage

1. **It is self-financed:** It only requires initial capital. I will say that Θ is self financed if

$$V_t^\Theta = \varphi_{t+1} B_t + \sum_{j=1}^d \theta_{t+1}^{(j)} S_t^{(j)}, \quad 0 \leq t \leq T-1. \quad (3.33)$$

2. **Non-anticipative:** It is build up only on current information. I will say that Θ is non-anticipative or predictable if Θ_{t+1} depends only on the information at time t , that is Θ_{t+1} is \mathcal{F}_t -measurable.
3. **It has a limited credit line:** There is a non-random constant $C > 0$, such that

$$V_t^\Theta \geq -C, \quad \forall 0 \leq t \leq T. \quad (3.34)$$

The Multi-Step Binomial Model

Absence of Arbitrage

Definition (Arbitrage)

Consider the market

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F})_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}. \quad (3.35)$$

An admissible strategy $\Theta = \left(\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)} \right)_{0 \leq t \leq T}$ is said to be an arbitrage if:

The Multi-Step Binomial Model

Absence of Arbitrage

1. It has zero initial capital:

$$V_0^\Theta = \varphi_0 B_0 + \sum_{j=1}^d \theta_0^{(j)} \cdot S_0^{(j)} = 0. \quad (3.36)$$

2. At time $t = T$, i am out of debts with 100% certainty:
Almost surely

$$V_T^\Theta = \varphi_T B_T + \sum_{j=1}^d \theta_T^{(j)} \cdot S_T^{(j)} \geq 0. \quad (3.37)$$

3. I have a chance to make a profit:

$$\mathbb{P} \left(\varphi_T B_T + \sum_{j=1}^d \theta_T^{(j)} \cdot S_T^{(j)} > 0 \right) > 0. \quad (3.38)$$

The Multi-Step Binomial Model

Risk-Neutral Measure

To begin this section i will define the notion of a martingale. Fix a filtered probability space

$$\left(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P}\right). \quad (3.39)$$

I am given a discrete time stochastic process

$$X = (X_t)_{0 \leq t \leq T}. \quad (3.40)$$

Under this framework i give the definition of a martingale.

The Multi-Step Binomial Model

Risk-Neutral Measure

Definition (Martingale)

The collection $\{(X_t, \mathcal{F}_t) : t = 0, 1, \dots, T\}$ is said to be a martingale if

1. X is adapted, i.e. $\sigma(X_t) \subseteq \mathcal{F}_t$, $\forall 0 \leq t \leq T$.
2. X_t has finite first moment, that is $\mathbb{E}(|X_t|) < \infty$.
3. For all $0 \leq t \leq T - 1$ we have that almost surely $\mathbb{E}(X_{t+1} | \mathcal{F}_t) = X_t$.

The Multi-Step Binomial Model

Risk-Neutral Measure

Consider the risk neutral multi-step binomial model: $B_0 = 1$, $S_0 > 0$ is a non-random constant and

$$B_t = (1 + r)^t; \quad S_t = S_{t-1}(1 + K_S(t)), \quad t = 1, \dots, T. \quad (3.41)$$

$(K_S(t))_{t=1, \dots, T}$ are i.i.d. with

$$K_S(t) = \begin{cases} R_u & \text{with probability } q^* \\ R_d & \text{with probability } 1 - q^* \end{cases} \quad (3.42)$$

with the relation $R_d < r < R_u$ and

The Multi-Step Binomial Model

Risk-Neutral Measure

The risk neutral measure is the following:

The Multi-Step Binomial Model

Risk-Neutral Measure

I will now show that the discounted price

$$X_t := \frac{S_t}{B_t}, \quad 0 \leq t \leq T, \quad (3.43)$$

is a martingale under the filtration

$$\mathcal{F}_0 = \{\emptyset, \Omega\} \quad (3.44)$$

$$\mathcal{F}_t = \sigma(K_S(1), \dots, K_S(t)), \quad 1 \leq t \leq T. \quad (3.45)$$

In order to show this, i need to verify that the discounted price satisfies all three conditions in definition 16 (Martingale)

The Multi-Step Binomial Model

Risk-Neutral Measure

By definition

$$\mathbb{E}(X_{t+1}|\mathcal{F}_t) = \mathbb{E}\left(\frac{S_{t+1}}{B_{t+1}} \middle| \mathcal{F}_t\right) \quad (3.46)$$

$$= \mathbb{E}\left(\frac{S_t(1 + K_S(t+1))}{B_{t+1}} \middle| \mathcal{F}_t\right) \quad (3.47)$$

$$= \mathbb{E}\left(\frac{S_t(1 + K_S(t+1))}{(1+r)^{t+1}} \middle| \mathcal{F}_t\right) \quad (3.48)$$

$$= \mathbb{E}\left(\frac{S_t}{(1+r)^{t+1}}(1 + K_S(t+1)) \middle| \mathcal{F}_t\right) \quad (3.49)$$

$$\text{(By the Product Rule)} = \frac{S_t}{(1+r)^{t+1}} \mathbb{E}\left((1 + K_S(t+1)) \middle| \mathcal{F}_t\right) \quad (3.50)$$

$$= \frac{S_t}{(1+r)^t} \frac{1}{(1+r)} \mathbb{E}\left((1 + K_S(t+1)) \middle| \mathcal{F}_t\right) \quad (3.51)$$

$$= X_t \frac{1}{(1+r)} \mathbb{E}\left((1 + K_S(t+1)) \middle| \mathcal{F}_t\right). \quad (3.52)$$

The Multi-Step Binomial Model

Risk-Neutral Measure

I am now left to show that

$$\mathbb{E} \left((1 + K_S(t+1)) \middle| \mathcal{F}_t \right) = 1, \quad (3.53)$$

to do this i will use the independence of the returns but let me start by considering $t = 0$.

The Multi-Step Binomial Model

Risk-Neutral Measure

In this case

$$\mathbb{E}((1 + K_S(1)) | \mathcal{F}_0) = \mathbb{E}((1 + K_S(1)) | \{\emptyset, \Omega\}) \quad (3.54)$$

$$(\text{Conditioning on the trivial } \sigma\text{-algebra}) = \mathbb{E}((1 + K_S(1))) \quad (3.55)$$

$$(\text{From Risk-Neutrality}) = (1 + r). \quad (3.56)$$

Let me now consider the case when $t \geq 1$

$$\mathbb{E}((1 + K_S(t+1)) | \mathcal{F}_t) = \mathbb{E}((1 + K_S(t+1)) | K_S(1), \dots, K_S(t)) \quad (3.57)$$

$$(\text{Independence prop. of the cond. expectation}) = \mathbb{E}((1 + K_S(1))) \quad (3.58)$$

$$= (1 + r). \quad (3.59)$$

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
3. The Multi-Step Binomial Model
4. The First Fundamental Theorem of Asset Pricing
 - 4.1 The Theorem
 - 4.2 Explaining the Hypothesis
 - 4.3 Risk-Neutral and Martingale Measures
5. Pricing in the Binomial Model
6. The Second Fundamental Theorem of Asset Pricing

The First Fundamental Theorem of Asset Pricing

The Theorem

The Fundamental theorem of asset pricing gives necessary and sufficient conditions for the absence of arbitrage in the market with information, given by

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}. \quad (4.1)$$

Theorem (FFTAP)

The market given by (4.1) is arbitrage free if and only if there is a martingale measure.

The First Fundamental Theorem of Asset Pricing

Explaining the Hypothesis

To understand the hypothesis presented in the theorem let's first remember the concept of an admissible strategy.

Definition (Admissible Strategy)

Let $\Theta = \left(\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)} \right)_{0 \leq t \leq T}$ be strategy on the market

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F}_t)_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}. \quad (4.2)$$

I will say that Θ is admissible if:

The First Fundamental Theorem of Asset Pricing

Explaining the Hypothesis

1. **It is self-financed:** It only requires initial capital. I will say that Θ is self financed if

$$V_t^\Theta = \varphi_{t+1} B_t + \sum_{j=1}^d \theta_{t+1}^{(j)} S_t^{(j)}, \quad 0 \leq t \leq T-1. \quad (4.3)$$

2. **Non-anticipative:** It is build up only on current information. I will say that Θ is non-anticipative or predictable if Θ_{t+1} depends only on the information at time t , that is Θ_{t+1} is \mathcal{F}_t -measurable.
3. **It has a limited credit line:** There is a non-random constant $C > 0$, such that

$$V_t^\Theta \geq -C, \quad \forall 0 \leq t \leq T. \quad (4.4)$$

The First Fundamental Theorem of Asset Pricing

Explaining the Hypothesis

Next let me recall the notion of arbitrage.

Definition (Arbitrage)

Consider the market

$$\mathfrak{M} = \left\{ \left(\Omega, \mathcal{F}, (\mathcal{F})_{0 \leq t \leq T}, \mathbb{P} \right), P = \left(B_t, S_t^{(1)}, \dots, S_t^{(d)} \right)_{0 \leq t \leq T} \right\}. \quad (4.5)$$

An admissible strategy $\Theta = \left(\varphi_t, \theta_t^{(1)}, \dots, \theta_t^{(d)} \right)_{0 \leq t \leq T}$ is said to be an arbitrage if:

The First Fundamental Theorem of Asset Pricing

Explaining the Hypothesis

1. It has zero initial capital:

$$V_0^\Theta = \varphi_0 B_0 + \sum_{j=1}^d \theta_0^{(j)} \cdot S_0^{(j)} = 0. \quad (4.6)$$

2. At time $t = T$, i am out of debts with 100 % certainty:
Almost surely

$$V_T^\Theta = \varphi_T B_T + \sum_{j=1}^d \theta_T^{(j)} \cdot S_T^{(j)} \geq 0. \quad (4.7)$$

3. I have a chance to make a profit:

$$\mathbb{P} \left(\varphi_T B_T + \sum_{j=1}^d \theta_T^{(j)} \cdot S_T^{(j)} > 0 \right) > 0. \quad (4.8)$$

The First Fundamental Theorem of Asset Pricing

Explaining the Hypothesis

Lastly i will define a martingale measure.

Definition (Martingale Measure)

Let \mathbb{Q} be probability measure on (Ω, \mathcal{F}) , that is there are $0 < q_i^* < 1, i = 1, \dots, N$ such that $\sum_{i=1}^N q_i^* = 1$ and

$$\mathbb{Q}(\{\omega_i\}) = q_i^* \quad \text{for } i = 1, \dots, N. \quad (4.9)$$

We will say that \mathbb{Q} is a martingale measure if under \mathbb{Q} the discounted price $(\tilde{P}_j^{(j)})_{0 \leq t \leq T}$ is a martingale w.r.t $(\mathcal{F}_t)_{0 \leq t \leq T}$, for every $j = 1, 2, \dots, d + 1$.

The First Fundamental Theorem of Asset Pricing

Risk-Neutral and Martingale Measures

In the binomial model q^* plays two roles

1. It transform the real-world probabilities (the one observed in the market) $(p, 1 - p)$ satisfying that

$$K_S(t) = \begin{cases} R_u & \text{with probability } p; \\ R_d & \text{with probability } 1 - p, \end{cases} \quad (4.10)$$

into a risk-neutral world in which the “new” distribution for the returns

$$K_S(t) = \begin{cases} R_u & \text{with probability } q^*; \\ R_d & \text{with probability } 1 - q^*, \end{cases} \quad (4.11)$$

is such that

$$\mathbb{E}_*(K_S(t)) = r, \quad t = 1, 2, \dots, T. \quad (4.12)$$

2. It transforms the discounted prices into a martingale.

The First Fundamental Theorem of Asset Pricing

Risk-Neutral and Martingale Measures

In this model the two are actually equivalent. Consider the martingale property

$$\mathbb{E}_* \left(\frac{S_{t+1}^{(j)}}{B_{t+1}} \middle| \mathcal{F}_t \right) = \frac{S_t^{(j)}}{B_t} \quad (4.13)$$

$$\frac{1}{B_{t+1}} \mathbb{E}_* \left(S_{t+1}^{(j)} \middle| \mathcal{F}_t \right) = \frac{S_t^{(j)}}{B_t} \quad (4.14)$$

$$\frac{1}{S_t^{(j)}} \mathbb{E}_* \left(S_{t+1}^{(j)} \middle| \mathcal{F}_t \right) = \frac{B_{t+1}}{B_t} \quad (4.15)$$

$$\mathbb{E}_* \left(\frac{S_{t+1}^{(j)}}{S_t^{(j)}} \middle| \mathcal{F}_t \right) = \frac{B_{t+1}}{B_t}, \quad (4.16)$$

subtracting 1 from both sides i get:

The First Fundamental Theorem of Asset Pricing

Risk-Neutral and Martingale Measures

$$\mathbb{E}_* \left(\frac{S_{t+1}^{(j)}}{S_t^{(j)}} - 1 \mid \mathcal{F}_t \right) = \frac{B_{t+1}}{B_t} - 1, \quad (4.17)$$

taking expectations gives

$$\mathbb{E}_* \left[\mathbb{E}_* \left(\frac{S_{t+1}^{(j)}}{S_t^{(j)}} - 1 \mid \mathcal{F}_t \right) \right] = \mathbb{E}_* \left[\frac{B_{t+1}}{B_t} - 1 \right] \quad (4.18)$$

$$\mathbb{E}_* \left(\frac{S_{t+1}^{(j)}}{S_t^{(j)}} - 1 \right) = \frac{B_{t+1}}{B_t} - 1 \quad (4.19)$$

$$\mathbb{E}_* (K_S(t+1)) = K_B(t+1). \quad (4.20)$$

This is exactly the definition of risk-neutral probabilities.

The First Fundamental Theorem of Asset Pricing

Risk-Neutral and Martingale Measures

Add application to the pricing of financial derivatives.

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
3. The Multi-Step Binomial Model
4. The First Fundamental Theorem of Asset Pricing

5. Pricing in the Binomial Model

- 5.1 Methodology for Pricing
- 5.2 Define a model for the prices
- 5.3 Indicate a set of information
- 5.4 Check for arbitrage opportunities
- 5.5 Dynamics in the risk-neutral world
- 5.6 Pricing a Call Option
- 5.7 Price function for simple derivatives
- 5.8 General Price of a Call option in the Binomial Model

Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

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Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

Methodology for Pricing

Pricing in the Binomial Model

Methodology for Pricing

Table of Contents

1. Bonds and the Value of Money Through Time
2. Portfolio Allocation and Risk Measures
3. The Multi-Step Binomial Model
4. The First Fundamental Theorem of Asset Pricing
5. Pricing in the Binomial Model
6. The Second Fundamental Theorem of Asset Pricing