Mathematical Finance I

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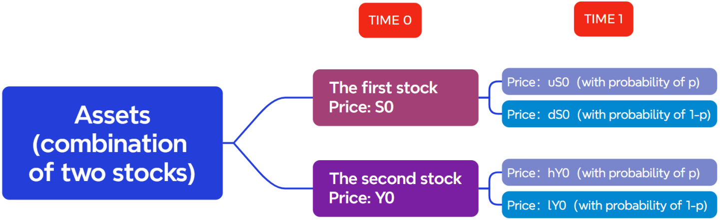
Outline

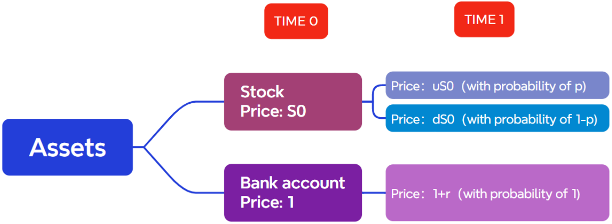
Background

In Section 1 of the lecture on mathematical finance, we studied a model with one stock (risky asset) and one bank account (risk-free asset). Such a risk-free asset may not always be available. In this project, we consider a model with two stocks, but no bank account.The initial values of the stocks are S_0 and Y_0. Their values at time 1 are either uS_0 and hY_0 with probability p, or dS_0 and lY_0 with probability $1 - p$. For the project, we can consider the following different aspects of this model.



Outline

No-arbitrage Condition With Risk-free Asset

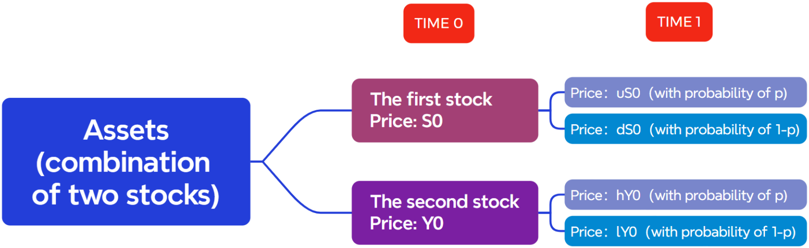


In the previous lecture, we discussed the No-arbitrage condition in two assets, one is stock and the other is a risk-free asset. The No-arbitrage condition means that no investor can lock in a profit without risk and with no initial endowment:

$$d < 1 + r < u.$$

No-arbitrage Condition Without Risk-free Asset

Now, in this project, we consider a model with two stocks without risk-free assets.

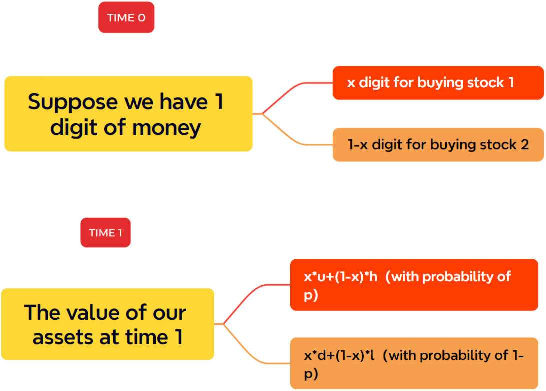


No-arbitrage Condition Without Risk-free Asset

The No-arbitrage condition is that:

$$d < l < h < u \quad or \quad l < d < u < h.$$

Proof.



No-arbitrage Condition Without Risk-free Asset

For situation with probability of p or 1-p(as the picture above shows),the derivative of value can't be positive or negative at the same time,otherwise we can only invest our money into stock1(when the derivatives are all positive)or into the stock2(when the derivatives are all negative),in order to maximize our assets at time 1.Howeverthat kind of financial market is not what we are hoping for.

If we suppose u¡d, h¡l(it's reasonable because the other situations are exactly the sameso we can feel free to make this assumption)therefore when the derivatives mentioned above are neither all postive nor negativewe can infer that:

$$h < u < d < l \quad or \quad u < h < l < d.$$

Outline

For the second question, let us consider there is a bank that sells the options. The bank never wants to lose money, so it will use the option's fee to construct a portfolio in the market. The bank needs to make sure whether the stocks prices go up or down, it will never lose money.

Equation:

$$f_u = \Delta_1 u S_0 + \Delta_2 h Y_0.$$

$$f_d = \Delta_1 d S_0 + \Delta_2 l Y_0.$$

Answer:

$$\Delta_1 = \frac{l f_u - h f_d}{S_0(lu - dh)}.$$

$$\Delta_2 = \frac{d f_u - u f_d}{Y_0(dh - ul)}.$$

Process:

$$\begin{cases} f_u = \Delta_1 u S_0 + \Delta_2 h Y_0 \\ f_d = \Delta_1 d S_0 + \Delta_2 l Y_0 \end{cases}$$

$$\begin{gathered} \mathrm{df}_u = \Delta_1 du S_0 + \Delta_2 dh Y_0 \\ \mathrm{uf}_d = \Delta_1 ud S_0 + \Delta_2 ul Y_0 \\ \mathrm{df}_u - uf_d = (dh - ul) Y_0 \Delta_2 \end{gathered}$$

$$\begin{gathered} \mathrm{lf}_u = \Delta_1 lu S_0 + \Delta_2 lh Y_0 \\ \mathrm{hf}_d = \Delta_1 hd S_0 + \Delta_2 hl Y_0 \\ \mathrm{lf}_u - hf_d = (lu - dh) S_0 \Delta_1 \end{gathered}$$

$$\begin{cases} \Delta_1 = \frac{lf_u - hf_d}{S_0(lu - dh)} \\ \Delta_2 = \frac{df_u - uf_d}{Y_0(dh - ul)} \end{cases}$$

Consider a derivative with payoff $f_u = 2uS_0$ and $f_d = 0$. The parameters of the stocks are given by $S_0 = \$20, Y_0 = \$25, u = 1.4, d = 0.8, h = 1.5$ and with different values for l. Create a plot of the derivative price as a function of l = 0, 0.01, 0.02, . . . , 0.6.

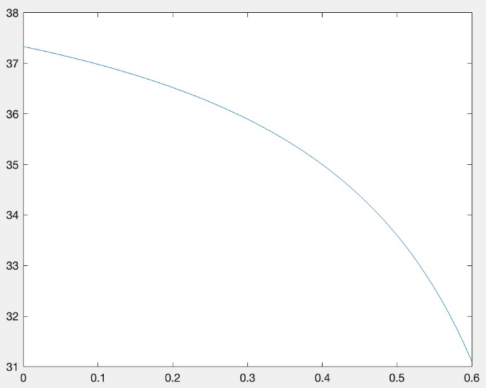


Figure 1: Fair Frice Chart of $f_d = 0$

Fair Frice Chart of $f_d = 2dS_0$

```
% x = delta*S_0 + phi*Y_0;
u = 1.4;
d = 0.8;
h = 1.5;
l = 0:0.01:0.6;
S_0 = 20;
Y_0 = 25;

f_u = 2*u*S_0;
f_d = 2*d*S_0;
I = ones(1,61);
delta = (l.*f_u - I.*h*f_d) ./ (S_0*(l*u - d*h));
phi = (d.*f_u - I*u*f_d) ./(Y_0*(d*h - u*l));

x = delta.*S_0 + phi.*Y_0;

plot(l,x)
```

Consider a derivative with payoff $f_u = 2uS_0$ and $f_d = 2dS_0$. The parameters of the stocks are given by $S_0 = \$20$, $Y_0 = \$25$, $u = 1.4$, $d = 0.8$, $h = 1.5$ and with different values for l. Create a plot of the derivative price as a function of $l = 0, 0.01, 0.02, \ldots, 0.6$.

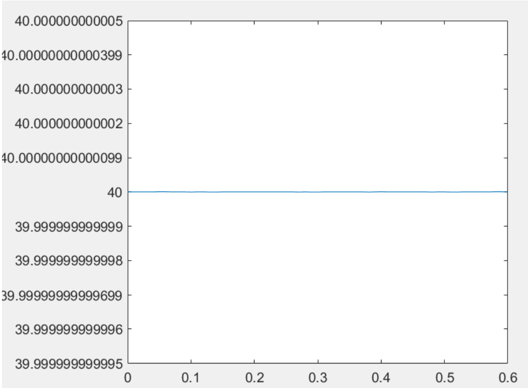


Figure 2: Fair Frice Chart of $f_d = 2dS_0$

- Firstly, when $f_d = 0$, it's really easy to prove the fair price will decline when I increases by the solutions of these equations.
- When $f_d = 2dS_0$, you can easily find that $\Delta_2 \equiv 0$, which means that all the money will be invested in the first stock.
- But for the first figure, it isn't really intuitive(intuitive means: obtained by using your feelings rather than by considering the facts)

We have some idea about why the fair price curve is a monotonic decrease function. If we look more closely, you may find that the Δ_1 is always negative, so it means that the bank needs a margin financing to stock 1 which means going short on the asset. And to balance it, we need to buy stock 2 which shows that the bank going long on this asset. Now if l increases, then the expectation or probability of the Second stock has grown. So we need more security loans on stock 2(Increase Δ_2), which means we can get more money from security loans. So the fair price decreases.

Outline

The First Stock With Strike Price K

Consider a call option on the first stock. The parameters of the stocks are given by $S_0 = \$20$, $Y_0 = \$25$, $u = 1.4$, $d = 0.8$, $h = 1.5$ and $l = 0.5$. Create a plot of the replicating portfolio (Δ_1, Δ_2) as a function of K = 0, 0.1, 0.2, . . . , 40.

For the call options, let us consider S_0 will turn into:

$$\begin{cases} f_u = max\{uS_0 - K, 0\} \\ f_d = min\{dS_0 - K, 0\} \end{cases}$$

at time 1.

The First Stock With Strike Price K

```
% x = delta*S_0 + phi*Y_0;
u = 1.4;
d = 0.8;
h = 1.5;
l = 0.5;
S_0 = 20;
Y_0 = 25;
K = 0:0.1:40;
% x = zeros(401);
delta = zeros(1,401);
phi = zeros(1,401);

for i = 1:401

f_u = max(u*S_0 - K(i),0);
f_d = max(d*S_0 - K(i),0);
```

The First Stock With Strike Price K

```
delta(i) = (l*f_u - h*f_d) / (S_0*(l*u - d*h));
phi(i) = (d*f_u - u*f_d) / (Y_0*(d*h - u*l));

% x(i) = delta.*S_0 + phi.*Y_0;

end
figure
plot(K,delta);
hold on;
plot(K,phi);
hold off;
```

- When K $\geq$ 30. There is no probability that the assets can reach this strike price K. For call options, there is no chance to win money, so the fair price will be zero.
- When K $=$ 0, the f_u and f_d can perfectly match the equations. The bank can buy the first stock directly instead of the second one.

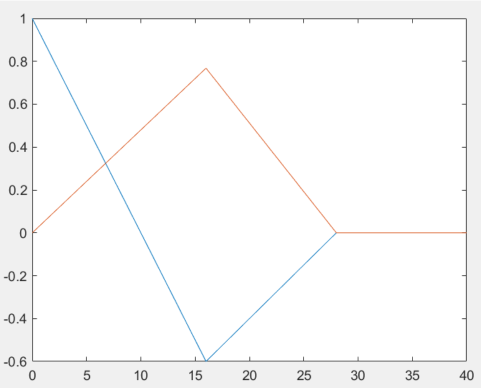


Figure 3: Replicating Strategy

Outline

Form the second question the portfolio is that:

$$\begin{cases} \Delta_1 = \frac{lf_u - hf_d}{S_0(lu-dh)} \\ \Delta_2 = \frac{df_u - uf_d}{Y_0(dh-ul)} \end{cases}$$

Fair price x:

$$\begin{aligned} x &= \frac{lf_u - hf_d}{S_0(lu-dh)} S_0 + \frac{df_n - uf_d}{Y_0(dh-ul)} Y_0 \\ &= \frac{lf_u - hf_d}{lu-dh} + \frac{df_u - uf_d}{dh-ul} \\ &= \frac{l}{lu-dh} f_u - \frac{u-h}{lu-dh} f_d + \frac{d}{dh-ul} f_u - \frac{u}{dh-ul} f_d \\ &= \frac{l-d}{lu-dh} f_u + \frac{u-h}{lu-dh} f_d \end{aligned}$$

$$q_u = \frac{l-d}{lu-dh} \qquad q_d = \frac{u-h}{lu-dh}$$

$$x = E^Q[f]$$

$$Q = (q_u, q_d) \textit{ is not a probability!}$$

$$
\begin{aligned}
x &= q_u f_u + q_d f_d \quad (1 \ period) \\
&= q_u^2 f_{uu} + 2 q_u q_d f_{ud} + q_d^2 f_{dd} \quad (2 \ periods) \\
&= E^{Q_2}[f\ ]
\end{aligned}
$$

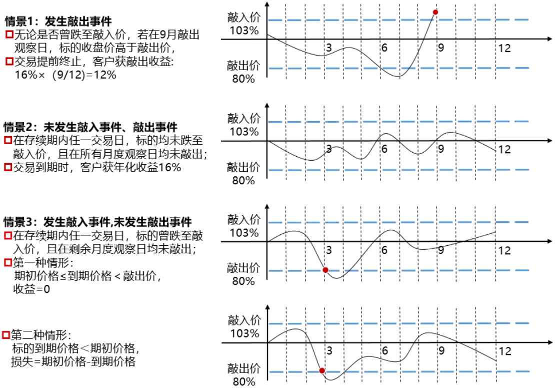
$$
Denote : Q_2 = [q_u^2, 2q_u q_d, q_d^2]
$$

$$
\begin{aligned}
E^{Q_n}[f\ ] = q_u^n u^n S_0 &+ C_n^1 q_n^{n-1} q_d u^{n-1} d S_0 \\
&+ \cdots \\
&+ C_n^{n-1} q_u q_d^{n-1} u d^{n-1} S_0 \\
&+ q_d^n d^n S_0 = S_0
\end{aligned}
$$

The last equation works because if we rearrange the equations you will find that the coefficients of S_0 is the coefficients of binomial expansion.

Outline

'Snowball' Derivative



The money you earn is just like a snowball in the snow. The more time the stock price is in the boundary area, the more money you will make. It's just like a snowball gathers as it goes on.

How does it works?

$$\text{The customers} \xrightarrow{\text{Put options}} \text{The securities company}$$

$$\text{The securities company} \xrightarrow{\text{Make a protfolio}} \text{Markets}$$

$$\text{Markets} \xrightarrow{\text{Throw high and suck low}} \text{The securities company}$$

$$\text{The securities company} \xrightarrow{\text{Throw high and suck low}} \text{The customers}$$

We do the same thing that the securities company does in some aspects. Binary tree options pricing without risk-free assets is an important method if you want to do a financial job in the future, and it has been used in many ways.

Thank you!