

Financial Mathematics

MATH 5870/6870¹
Fall 2021

Le Chen

lzc0090@auburn.edu

Last updated on
August 3, 2021

Auburn University
Auburn AL

¹Based on Robert L. McDonald's *Derivatives Markets*, 3rd Ed, Pearson, 2013.

Chapter 1. Introduction to Derivatives

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§ 1.1 What is a derivative?

§ 1.2 An overview of financial markets

§ 1.3 The use of derivatives

§ 1.4 Buying and short-selling financial assets

§ 1.5 Problems

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Common reasons to use derivatives

1. **Risk management.** Derivatives are a tool for companies and other users to reduce risks (\sim hedging). Every form of insurance is a derivative.
2. Speculation. Derivatives can serve as investment vehicles (\sim betting).
3. Reduce transaction costs. Sometimes derivatives provide a lower cost way to undertake a particular financial transaction.
4. Regulatory arbitrage. It is sometimes possible to circumvent regulatory restrictions, taxes, and accounting rules by trading derivatives.

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Three perspectives on derivatives

End users	Intermediaries	Economic Observers
Corporations Investment managers investors	Market-makers Traders	Regulators Researchers
How to use a derivative to meet the goal	Mathematical details of pricing and hedging	Make sense of the market

New securities can be designed by using existing securities

Financial engineering is the construction of
a financial product from other products.

Principles for financial engineering (or security design):

1. Facilitate hedging of existing positions
2. Allow for creation of customized products
3. Enable understanding of complex positions
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