"BIG HULL"

CH. 12

"THE BLACK-SCHOLES MODEL"

WEEK 5
FOR PHOTOCOPY

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OPTIONS, FUTURES, & OTHER DERIVATIVES

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CHAPTER 12

THE BLACK–SCHOLES MODEL

In the early 1970s, Fischer Black, Myron Scholes, and Robert Merton made a major breakthrough in the pricing of stock options.[1] This involved the development of what has become known as the Black–Scholes model. The model has had a huge influence on the way that traders price and hedge options. It has also been pivotal to the growth and success of financial engineering in the 1980s and 1990s. In 1997, the importance of the model was recognized when Robert Merton and Myron Scholes were awarded the Nobel prize for economics. Sadly, Fischer Black died in 1995; otherwise he also would undoubtedly have been one of the recipients of this prize.

This chapter shows how the Black–Scholes model for valuing European call and put options on a non-dividend-paying stock is derived. We explain how volatility can be either estimated from historical data or implied from option prices using the model. We show how the risk-neutral valuation argument introduced in Chapter 10 can be used. We also show how the Black–Scholes model can be extended to deal with European call and put options on dividend-paying stocks and present some results on the pricing of American call options on dividend-paying stocks.

12.1 LOGNORMAL PROPERTY OF STOCK PRICES

The model of stock price behavior used by Black, Scholes, and Merton is the model we developed in Chapter 11. It assumes that percentage changes in the stock price in a short period of time are normally distributed. Define:

μ: Expected return on stock

σ: Volatility of the stock price

The mean of the percentage change in time δt is $\mu\,\delta t$ and the standard deviation of this percentage change is $\sigma\sqrt{\delta t}$, so that

$$\frac{\delta S}{S} \sim \phi(\mu\,\delta t, \sigma\sqrt{\delta t}) \tag{12.1}$$

where δS is the change in the stock price S in time δt, and $\phi(m, s)$ denotes a normal distribution with mean m and standard deviation s.

[1] See F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy*, 81 (May/June 1973), 637–659; R. C. Merton, "Theory of Rational Option Pricing," *Bell Journal of Economics and Management Science*, 4 (Spring 1973), 141–83.

As shown in Section 11.7, the model implies that

$$\ln S_T - \ln S_0 \sim \phi\left[\left(\mu - \frac{\sigma^2}{2}\right)T,\ \sigma\sqrt{T}\right]$$

From this it follows that

$$\ln\frac{S_T}{S_0} \sim \phi\left[\left(\mu - \frac{\sigma^2}{2}\right)T,\ \sigma\sqrt{T}\right] \tag{12.2}$$

and

$$\ln S_T \sim \phi\left[\ln S_0 + \left(\mu - \frac{\sigma^2}{2}\right)T,\ \sigma\sqrt{T}\right] \tag{12.3}$$

where S_T is the stock price at a future time T and S_0 is the stock price at time zero. Equation (12.3) shows that $\ln S_T$ is normally distributed. This means that S_T has a lognormal distribution.

Example 12.1 Consider a stock with an initial price of \$40, an expected return of 16% per annum, and a volatility of 20% per annum. From equation (12.3), the probability distribution of the stock price, S_T, in six months' time is given by

$$\ln S_T \sim \phi[\ln 40 + (0.16 - 0.2^2/2) \times 0.5,\ 0.2\sqrt{0.5}]$$
$$\ln S_T \sim \phi(3.759, 0.141)$$

There is a 95% probability that a normally distributed variable has a value within 1.96 standard deviations of its mean. Hence, with 95% confidence,

$$3.759 - 1.96 \times 0.141 < \ln S_T < 3.759 + 1.96 \times 0.141$$

This can be written

$$e^{3.759 - 1.96 \times 0.141} < S_T < e^{3.759 + 1.96 \times 0.141}$$

or

$$32.55 < S_T < 56.56$$

Thus, there is a 95% probability that the stock price in six months will lie between 32.55 and 56.56.

A variable that has a lognormal distribution can take any value between zero and infinity. Figure 12.1 illustrates the shape of a lognormal distribution. Unlike the normal distribution, it

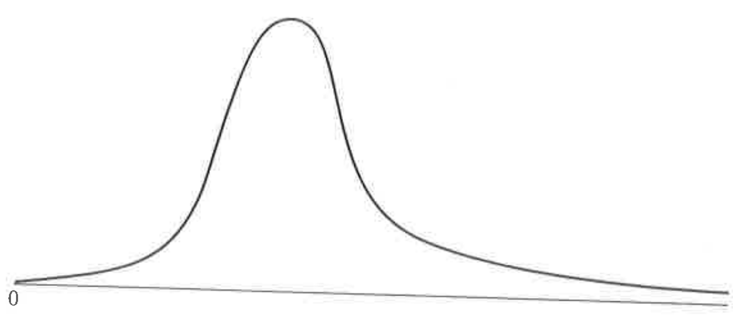

Figure 12.1 Lognormal distribution

is skewed so that the mean, median, and mode are all different. From equation (12.3) and the properties of the lognormal distribution, it can be shown that the expected value, $E(S_T)$, of S_T is given by[2]

$$E(S_T) = S_0 e^{\mu T} \tag{12.4}$$

This fits in with the definition of μ as the expected rate of return. The variance, $\text{var}(S_T)$, of S_T can be shown to be given by

$$\text{var}(S_T) = S_0^2 e^{2\mu T}(e^{\sigma^2 T} - 1) \tag{12.5}$$

Example 12.2 Consider a stock where the current price is \$20, the expected return is 20% per annum, and the volatility is 40% per annum. The expected stock price in one year, $E(S_T)$, and the variance of the stock price in one year, $\text{var}(S_T)$, are given by

$$E(S_T) = 20e^{0.2\times 1} = 24.43$$

$$\text{var}(S_T) = 400e^{2\times 0.2\times 1}(e^{0.4^2\times 1} - 1) = 103.54$$

The standard deviation of the stock price in one year is $\sqrt{103.54}$, or 10.18.

12.2 THE DISTRIBUTION OF THE RATE OF RETURN

The lognormal property of stock prices can be used to provide information on the probability distribution of the continuously compounded rate of return earned on a stock between times zero and T. Define the continuously compounded rate of return per annum realized between times zero and T as η. It follows that

$$S_T = S_0 e^{\eta T}$$

so that

$$\eta = \frac{1}{T}\ln\frac{S_T}{S_0} \tag{12.6}$$

It follows from equation (12.2) that

$$\eta \sim \phi\left(\mu - \frac{\sigma^2}{2}, \frac{\sigma}{\sqrt{T}}\right) \tag{12.7}$$

Thus, the continuously compounded rate of return per annum is normally distributed with mean $\mu - \sigma^2/2$ and standard deviation $\sigma/\sqrt{T}$.[3]

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[2] For a discussion of the properties of the lognormal distribution, see J. Aitchison and J. A. C. Brown, *The Lognormal Distribution*, Cambridge University Press, Cambridge, 1966.

[3] As T increases, the standard deviation of η declines. To understand the reason for this, consider two cases: $T = 1$ and $T = 20$. We are more certain about the average return per year over 20 years than we are about the return in any one year.

Example 12.3 Consider a stock with an expected return of 17% per annum and a volatility of 20% per annum. The probability distribution for the actual rate of return (continuously compounded) realized over three years is normal with mean

$$0.17 - \frac{0.2^2}{2} = 0.15$$

or 15% per annum and standard deviation

$$\frac{0.2}{\sqrt{3}} = 0.1155$$

or 11.55% per annum. Because there is a 95% chance that a normally distributed variable will lie within 1.96 standard deviations of its mean, we can be 95% confident that the actual return realized over three years will be between −7.6% and +37.6% per annum.

12.3 THE EXPECTED RETURN

The expected return, μ, required by investors from a stock depends on the riskiness of the stock. The higher the risk, the higher the expected return. It also depends on the level of interest rates in the economy. The higher the level of interest rates, the higher the expected return required on any given stock. Fortunately, we do not have to concern ourselves with the determinants of μ in any detail. It turns out that the value of a stock option, when expressed in terms of the value of the underlying stock, does not depend on μ at all. Nevertheless, there is one aspect of the expected return from a stock that frequently causes confusion and is worth explaining.

Equation (12.1) shows that $\mu\,\delta t$ is the expected percentage change in the stock price in a very short period of time δt. This means that μ is the expected return in a very short period of time δt. It is natural to assume that μ is also the expected continuously compounded return on the stock over a relatively long period of time. However, this is not the case. The continuously compounded return realized over T years is

$$\frac{1}{T}\ln\frac{S_T}{S_0}$$

and equation (12.7) shows that the expected value of this is $\mu - \sigma^2/2$.

The reason for the distinction between the μ in equation (12.1) and the $\mu - \sigma^2/2$ in equation (12.7) is subtle but important. We start with equation (12.4):

$$E(S_T) = S_0 e^{\mu T}$$

Taking logarithms, we get

$$\ln[E(S_T)] = \ln(S_0) + \mu T$$

It is now tempting to set

$$\ln[E(S_T)] = E[\ln(S_T)]$$

so that $E[\ln(S_T)] - \ln(S_0) = \mu T$, or $E[\ln(S_T/S_0)] = \mu T$. However, we cannot do this because ln is a nonlinear function. In fact $\ln[E(S_T)] > E[\ln(S_T)]$, so that $E[\ln(S_T/S_0)] < \mu T$. This is consistent with equation (12.7).

Suppose we consider a very large number of very short periods of time of length δt. Define S_i as the stock price at the end of the ith interval and δS_i as $S_{i+1} - S_i$. Under the assumptions we are making for stock price behavior, the average of the returns on the stock in each interval is close to μ. In other words, μ is close to the arithmetic mean of the $\delta S_i/S_i$. However, the expected return over the whole period covered by the data, expressed with a compounding period of δt, is close to $\mu - \sigma^2/2$, not μ.[4]

Example 12.4 Suppose that the following is a sequence of returns per annum on a stock, measured using annual compounding:

$$15\%, \quad 20\%, \quad 30\%, \quad -20\%, \quad 25\%$$

The arithmetic mean of the returns, calculated by taking the sum of the returns and dividing by 5, is 14%. However, an investor would actually earn less than 14% per annum by leaving the money invested in the stock for five years. The dollar value of \$100 at the end of the five years would be

$$100 \times 1.15 \times 1.20 \times 1.30 \times 0.80 \times 1.25 = \$179.40$$

By contrast, a 14% return with annual compounding would give

$$100 \times 1.14^5 = \$192.54$$

The actual average return earned by the investor, with annual compounding, is

$$(1.7940)^{1/5} - 1 = 0.124$$

or 12.4% per annum.

The arguments in this section show that the term *expected return* is ambiguous. It can refer either to μ or to $\mu - \sigma^2/2$. Unless otherwise stated, it will be used to refer to μ throughout this book.

12.4 VOLATILITY

The volatility of a stock, σ, is a measure of our uncertainty about the returns provided by the stock. Stocks typically have a volatility between 20% and 50%.

From equation (12.7), the volatility of a stock price can be defined as the standard deviation of the return provided by the stock in one year when the return is expressed using continuous compounding.

When T is small, equation (12.1) shows that $\sigma\sqrt{T}$ is approximately equal to the standard deviation of the percentage change in the stock price in time T. Suppose that $\sigma = 0.3$, or 30% per annum, and the current stock price is \$50. The standard deviation of the percentage change in the stock price in one week is approximately

$$30 \times \sqrt{\frac{1}{52}} = 4.16\%$$

A one-standard-deviation move in the stock price in one week is therefore 50×0.0416, or \$2.08.

Equation (12.1) shows that our uncertainty about a future stock price, as measured by its standard deviation, increases—at least approximately—with the square root of how far ahead we

[4] If we define the *gross return* as one plus the regular return, the gross return over the whole period covered by the data is the geometric average of the gross returns in each time interval of length δt—not the arithmetic average. The geometric average is less than the arithmetic average.

are looking. For example, the standard deviation of the stock price in four weeks is approximately twice the standard deviation in one week.

Estimating Volatility from Historical Data

To estimate the volatility of a stock price empirically, the stock price is usually observed at fixed intervals of time (e.g., every day, week, or month).

Define:

$n+1$: Number of observations

S_i: Stock price at end of ith ($i = 0, 1, \dots, n$) interval

τ: Length of time interval in years

and let

$$u_i = \ln\left(\frac{S_i}{S_{i-1}}\right)$$

for $i = 1, 2, \dots, n$.

The usual estimate, s, of the standard deviation of the u_i's is given by

$$s = \sqrt{\frac{1}{n-1}\sum_{i=1}^{n}(u_i - \bar{u})^2}$$

or

$$s = \sqrt{\frac{1}{n-1}\sum_{i=1}^{n} u_i^2 - \frac{1}{n(n-1)}\left(\sum_{i=1}^{n} u_i\right)^2}$$

where $\bar{u}$ is the mean of the u_i's.

From equation (12.2), the standard deviation of the u_i's is $\sigma\sqrt{\tau}$. The variable s is therefore an estimate of $\sigma\sqrt{\tau}$. It follows that σ itself can be estimated as $\hat{\sigma}$, where

$$\hat{\sigma} = \frac{s}{\sqrt{\tau}}$$

The standard error of this estimate can be shown to be approximately $\hat{\sigma}/\sqrt{2n}$.

Choosing an appropriate value for n is not easy. More data generally lead to more accuracy, but σ does change over time and data that are too old may not be relevant for predicting the future. A compromise that seems to work reasonably well is to use closing prices from daily data over the most recent 90 to 180 days. An often-used rule of thumb is to set n equal to the number of days to which the volatility is to be applied. Thus, if the volatility estimate is to be used to value a two-year option, then daily data for the last two years are used. More sophisticated approaches to estimating volatility involving GARCH models are discussed in Chapter 17.

An important issue is whether time should be measured in calendar days or trading days when volatility parameters are being estimated and used. Later in this chapter, we show that empirical research indicates that trading days should be used. In other words, days when the exchange is closed should be ignored for the purposes of the volatility calculation.

Example 12.5 Table 12.1 shows a possible sequence of stock prices during 21 consecutive trading days. In this case

$$\sum u_i = 0.09531 \quad \text{and} \quad \sum u_i^2 = 0.00326$$

Table 12.1 Computation of volatility

Day	*Closing stock price (\$)*	*Price relative* S_i/S_{i-1}	*Daily return* $u_i = \ln(S_i/S_{i-1})$
0	20.00		
1	20.10	1.00500	0.00499
2	19.90	0.99005	−0.01000
3	20.00	1.00503	0.00501
4	20.50	1.02500	0.02469
5	20.25	0.98780	−0.01227
6	20.90	1.03210	0.03159
7	20.90	1.00000	0.00000
8	20.90	1.00000	0.00000
9	20.75	0.99282	−0.00720
10	20.75	1.00000	0.00000
11	21.00	1.01205	0.01198
12	21.10	1.00476	0.00475
13	20.90	0.99052	−0.00952
14	20.90	1.00000	0.00000
15	21.25	1.01675	0.01661
16	21.40	1.00706	0.00703
17	21.40	1.00000	0.00000
18	21.25	0.99299	−0.00703
19	21.75	1.02353	0.02326
20	22.00	1.01149	0.01143

and the estimate of the standard deviation of the daily return is

$$\sqrt{\frac{0.00326}{19} - \frac{0.09531^2}{380}} = 0.01216$$

or 1.216%. Assuming that there are 252 trading days per year, $\tau = 1/252$ and the data give an estimate for the volatility per annum of $0.01216\sqrt{252} = 0.193$, or 19.3%. The standard error of this estimate is

$$\frac{0.193}{\sqrt{2 \times 20}} = 0.031$$

or 3.1% per annum.

This analysis assumes that the stock pays no dividends, but it can be adapted to accommodate dividend-paying stocks. The return, u_i, during a time interval that includes an ex-dividend day is given by

$$u_i = \ln\frac{S_i + D}{S_{i-1}}$$

where D is the amount of the dividend. The return in other time intervals is still

$$u_i = \ln\frac{S_i}{S_{i-1}}$$

However, as tax factors play a part in determining returns around an ex-dividend date, it is probably best to discard altogether data for intervals that include an ex-dividend date.

12.5 CONCEPTS UNDERLYING THE BLACK–SCHOLES–MERTON DIFFERENTIAL EQUATION

The Black–Scholes–Merton differential equation is an equation that must be satisfied by the price of any derivative dependent on a non-dividend-paying stock. The equation is derived in the next section. Here we consider the nature of the arguments we will use.

The arguments are similar to the no-arbitrage arguments we used to value stock options in Chapter 10 for the situation where stock price movements are binomial. They involve setting up a riskless portfolio consisting of a position in the derivative and a position in the stock. In absence of arbitrage opportunities, the return from the portfolio must be the risk-free interest rate, r. This leads to the Black–Scholes–Merton differential equation.

The reason a riskless portfolio can be set up is that the stock price and the derivative price are both affected by the same underlying source of uncertainty: stock price movements. In any short period of time, the price of the derivative is perfectly correlated with the price of the underlying stock. When an appropriate portfolio of the stock and the derivative is established, the gain or loss from the stock position always offsets the gain or loss from the derivative position so that the overall value of the portfolio at the end of the short period of time is known with certainty.

Suppose, for example, that at a particular point in time the relationship between a small change in the stock price, δS, and the resultant small change in the price of a European call option, δc, is given by

$$\delta c = 0.4\,\delta S$$

This means that the slope of the line representing the relationship between c and S is 0.4, as indicated in Figure 12.2. The riskless portfolio would consist of:

1. A long position in 0.4 share
2. A short position in one call option

There is one important difference between the Black–Scholes–Merton analysis and our analysis

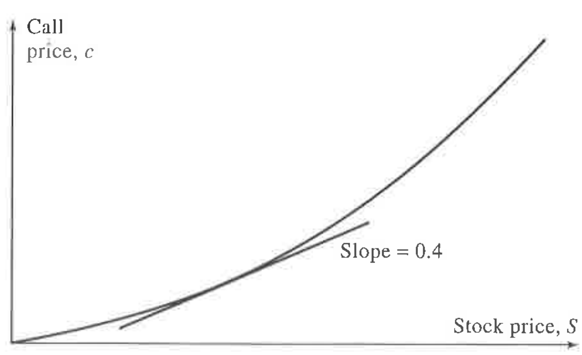

Figure 12.2 Relationship between c and S

using a binomial model in Chapter 10. In the former, the position in the stock and the derivative is riskless for only a very short period of time. (In theory, it remains riskless only for an instantaneously short period of time.) To remain riskless, it must be adjusted, or *rebalanced*, frequently.[5] For example, the relationship between δc and δS in our example might change from $\delta c = 0.4\,\delta S$ today to $\delta c = 0.5\,\delta S$ in two weeks. This would mean that, in order to maintain the riskless position, an extra 0.1 share would have to be purchased for each call option sold. It is nevertheless true that the return from the riskless portfolio in any very short period of time must be the risk-free interest rate. This is the key element in the Black–Scholes analysis and leads to their pricing formulas.

Assumptions

The assumptions we use to derive the Black–Scholes–Merton differential equation are as follows:

1. The stock price follows the process developed in Chapter 11 with μ and σ constant.
2. The short selling of securities with full use of proceeds is permitted.
3. There are no transactions costs or taxes. All securities are perfectly divisible.
4. There are no dividends during the life of the derivative.
5. There are no riskless arbitrage opportunities.
6. Security trading is continuous.
7. The risk-free rate of interest, r, is constant and the same for all maturities.

As we discuss in later chapters, some of these assumptions can be relaxed. For example, σ and r can be a known function of t. We can even allow interest rates to be stochastic providing that the stock price distribution at maturity of the option is still lognormal.

12.6 DERIVATION OF THE BLACK–SCHOLES–MERTON DIFFERENTIAL EQUATION

The stock price process we are assuming is the one we developed in Section 11.3:

$$dS = \mu S\,dt + \sigma S\,dz \tag{12.8}$$

Suppose that f is the price of a call option or other derivative contingent on S. The variable f must be some function of S and t. Hence, from equation (11.14),

$$df = \left(\frac{\partial f}{\partial S}\mu S + \frac{\partial f}{\partial t} + \tfrac{1}{2}\frac{\partial^2 f}{\partial S^2}\sigma^2 S^2\right)dt + \frac{\partial f}{\partial S}\sigma S\,dz \tag{12.9}$$

The discrete versions of equations (12.8) and (12.9) are

$$\delta S = \mu S\,\delta t + \sigma S\,\delta z \tag{12.10}$$

and

$$\delta f = \left(\frac{\partial f}{\partial S}\mu S + \frac{\partial f}{\partial t} + \tfrac{1}{2}\frac{\partial^2 f}{\partial S^2}\sigma^2 S^2\right)\delta t + \frac{\partial f}{\partial S}\sigma S\,\delta z \tag{12.11}$$

[5] We discuss the rebalancing of portfolios in more detail in Chapter 14.

where δS and δf are the changes in f and S in a small time interval δt. Recall from the discussion of Itô's lemma in Section 11.6 that the Wiener processes underlying f and S are the same. In other words, the δz ($= \epsilon\sqrt{\delta t}$) in equations (12.10) and (12.11) are the same. It follows that, by choosing a portfolio of the stock and the derivative, the Wiener process can be eliminated.

The appropriate portfolio is as follows:

$$-1: \quad \text{derivative}$$

$$+\frac{\partial f}{\partial S}: \quad \text{shares}$$

The holder of this portfolio is short one derivative and long an amount $\partial f/\partial S$ of shares. Define Π as the value of the portfolio. By definition,

$$\Pi = -f + \frac{\partial f}{\partial S} S \tag{12.12}$$

The change $\delta\Pi$ in the value of the portfolio in the time interval δt is given by

$$\delta\Pi = -\delta f + \frac{\partial f}{\partial S}\,\delta S \tag{12.13}$$

Substituting equations (12.10) and (12.11) into equation (12.13) yields

$$\delta\Pi = \left(-\frac{\partial f}{\partial t} - \tfrac{1}{2}\frac{\partial^2 f}{\partial S^2}\sigma^2 S^2\right)\delta t \tag{12.14}$$

Because this equation does not involve δz, the portfolio must be riskless during time δt. The assumptions listed in the preceding section imply that the portfolio must instantaneously earn the same rate of return as other short-term risk-free securities. If it earned more than this return, arbitrageurs could make a riskless profit by borrowing money to buy the portfolio; if it earned less, they could make a riskless profit by shorting the portfolio and buying risk-free securities. It follows that

$$\delta\Pi = r\Pi\,\delta t$$

where r is the risk-free interest rate. Substituting from equations (12.12) and (12.14), we obtain

$$\left(\frac{\partial f}{\partial t} + \tfrac{1}{2}\frac{\partial^2 f}{\partial S^2}\sigma^2 S^2\right)\delta t = r\left(f - \frac{\partial f}{\partial S} S\right)\delta t$$

so that

$$\frac{\partial f}{\partial t} + rS\frac{\partial f}{\partial S} + \tfrac{1}{2}\sigma^2 S^2 \frac{\partial^2 f}{\partial S^2} = rf \tag{12.15}$$

Equation (12.15) is the Black–Scholes–Merton differential equation. It has many solutions, corresponding to all the different derivatives that can be defined with S as the underlying variable. The particular derivative that is obtained when the equation is solved depends on the *boundary conditions* that are used. These specify the values of the derivative at the boundaries of possible values of S and t. In the case of a European call option, the key boundary condition is

$$f = \max(S - K,\, 0) \quad \text{when } t = T$$

In the case of a European put option, it is

$$f = \max(K - S,\ 0) \quad \text{when } t = T$$

One point that should be emphasized about the portfolio used in the derivation of equation (12.15) is that it is not permanently riskless. It is riskless only for an infinitesimally short period of time. As S and t change, $\partial f/\partial S$ also changes. To keep the portfolio riskless, it is therefore necessary to frequently change the relative proportions of the derivative and the stock in the portfolio.

Example 12.6 A forward contract on a non-dividend-paying stock is a derivative dependent on the stock. As such, it should satisfy equation (12.15). From equation (3.9), we know that the value of the forward contract, f, at a general time t is given in terms of the stock price S at this time by

$$f = S - Ke^{-r(T-t)}$$

where K is the delivery price. This means that

$$\frac{\partial f}{\partial t} = -rKe^{-r(T-t)}, \qquad \frac{\partial f}{\partial S} = 1, \qquad \frac{\partial^2 f}{\partial S^2} = 0$$

When these are substituted into the left-hand side of equation (12.15), we obtain

$$-rKe^{-r(T-t)} + rS$$

This equals rf, showing that equation (12.15) is indeed satisfied.

The Prices of Tradeable Derivatives

Any function $f(S, t)$ that is a solution of the differential equation (12.15) is the theoretical price of a derivative that could be traded. If a derivative with that price existed, it would not create any arbitrage opportunities. Conversely, if a function $f(S, t)$ does not satisfy the differential equation (12.15), it cannot be the price of a derivative without creating arbitrage opportunities for traders.

To illustrate this point, consider first the function e^S. This does not satisfy the differential equation (12.15). It is, therefore, not a candidate for being the price of a derivative dependent on the stock price. If an instrument whose price was always e^S existed, there would be an arbitrage opportunity. As a second example, consider the function

$$\frac{e^{(\sigma^2 - 2r)(T-t)}}{S}$$

This does satisfy the differential equation, and so is, in theory, the price of a tradeable security. (It is the price of a derivative that pays off $1/S_T$ at time T.) For other examples of tradeable derivatives, see Problems 12.11, 12.12, 12.23, and 12.26.

12.7 RISK-NEUTRAL VALUATION

We introduced risk-neutral valuation in connection with the binomial model in Chapter 10. It is without doubt the single most important tool for the analysis of derivatives. It arises from one key property of the Black–Scholes–Merton differential equation (12.15). This property is that the equation does not involve any variable that is affected by the risk preferences of investors. The variables that do appear in the equation are the current stock price, time, stock price volatility, and the risk-free rate of interest. All are independent of risk preferences.

The Black–Scholes–Merton differential equation would not be independent of risk preferences if it involved the expected return on the stock, μ. This is because the value of μ does depend on risk preferences. The higher the level of risk aversion by investors, the higher μ will be for any given stock. It is fortunate that μ happens to drop out in the derivation of the differential equation.

Because the Black–Scholes–Merton differential equation is independent of risk preferences, an ingenious argument can be used. If risk preferences do not enter the equation, they cannot affect its solution. Any set of risk preferences can, therefore, be used when evaluating f. In particular, the very simple assumption that all investors are risk neutral can be made.

In a world where investors are risk neutral, the expected return on all securities is the risk-free rate of interest, r. The reason is that risk-neutral investors do not require a premium to induce them to take risks. It is also true that the present value of any cash flow in a risk-neutral world can be obtained by discounting its expected value at the risk-free rate. The assumption that the world is risk neutral, therefore, considerably simplifies the analysis of derivatives.

Consider a derivative that provides a payoff at one particular time. It can be valued using risk-neutral valuation by using the following procedure:

1. Assume that the expected return from the underlying asset is the risk-free interest rate, r (i.e., assume $\mu = r$).
2. Calculate the expected payoff from the option at its maturity.
3. Discount the expected payoff at the risk-free interest rate.

It is important to appreciate that risk-neutral valuation (or the assumption that all investors are risk neutral) is merely an artificial device for obtaining solutions to the Black–Scholes differential equation. The solutions that are obtained are valid in all worlds, not just those where investors are risk neutral. When we move from a risk-neutral world to a risk-averse world, two things happen. The expected growth rate in the stock price changes and the discount rate that must be used for any payoffs from the derivative changes. It happens that these two changes always offset each other exactly.

Application to Forward Contracts on a Stock

We valued forward contracts on a non-dividend-paying stock in Section 3.5. In Example 12.6 we verified that the pricing formula satisfies the Black–Scholes differential equation. In this section we derive the pricing formula from risk-neutral valuation. We make the assumption that interest rates are constant and equal to r. This is somewhat more restrictive than the assumption in Chapter 3.

Consider a long forward contract that matures at time T with delivery price K. As explained in Chapter 1, the value of the contract at maturity is

$$S_T - K$$

where S_T is the stock price at time T. From the risk-neutral valuation argument, the value of the forward contract at time zero is its expected value at time T in a risk-neutral world discounted at the risk-free rate of interest. If we denote the value of the forward contract at time zero by f, this means that

$$f = e^{-rT}\hat{E}(S_T - K) \tag{12.16}$$

where $\hat{E}$ denotes the expected value in a risk-neutral world. Because K is a constant, equation (12.16) becomes

$$f = e^{-rT}\hat{E}(S_T) - Ke^{-rT} \tag{12.17}$$

The expected growth rate of the stock price, μ, becomes r in a risk-neutral world. Hence, from equation (12.4),

$$\hat{E}(S_T) = S_0 e^{rT} \tag{12.18}$$

Substituting equation (12.18) into equation (12.17) gives

$$f = S_0 - Ke^{-rT} \tag{12.19}$$

This is in agreement with equation (3.9).

12.8 BLACK–SCHOLES PRICING FORMULAS

The Black–Scholes formulas for the prices at time zero of a European call option on a non-dividend-paying stock and a European put option on a non-dividend paying stock are

$$c = S_0 N(d_1) - Ke^{-rT}N(d_2) \tag{12.20}$$

and

$$p = Ke^{-rT}N(-d_2) - S_0 N(-d_1) \tag{12.21}$$

where

$$d_1 = \frac{\ln(S_0/K) + (r + \sigma^2/2)T}{\sigma\sqrt{T}}$$

$$d_2 = \frac{\ln(S_0/K) + (r - \sigma^2/2)T}{\sigma\sqrt{T}} = d_1 - \sigma\sqrt{T}$$

The function $N(x)$ is the cumulative probability distribution function for a standardized normal distribution. In other words, it is the probability that a variable with a standard normal distribution, $\phi(0, 1)$ will be less than x. It is illustrated in Figure 12.3. The remaining variables should be familiar. The variables c and p are the European call and European put price, S_0 is the stock price at time zero, K is the strike price, r is the continuously compounded risk-free rate, σ is the stock price volatility, and T is the time to maturity of the option.

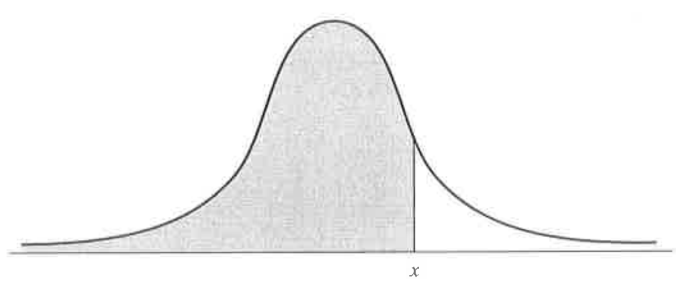

Figure 12.3 Shaded area represents $N(x)$

One way of deriving the Black–Scholes formulas is by solving the differential equation (12.15) subject to the boundary conditions mentioned in Section 12.6.[6] Another approach is to use risk-neutral valuation. Consider a European call option. The expected value of the option at maturity in a risk-neutral world is

$$\hat{E}[\max(S_T - K,\ 0)]$$

where, as before, $\hat{E}$ denotes the expected value in a risk-neutral world. From the risk-neutral valuation argument, the European call option price, c, is this expected value discounted at the risk-free rate of interest, that is,

$$c = e^{-rT}\hat{E}[\max(S_T - K,\ 0)] \tag{12.22}$$

Appendix 12A shows that this equation leads to the result in (12.20).

To provide an interpretation of the terms in equation (12.20), we note that it can be written

$$c = e^{-rT}[S_0 N(d_1)e^{rT} - KN(d_2)] \tag{12.23}$$

The expression $N(d_2)$ is the probability that the option will be exercised in a risk-neutral world, so that $KN(d_2)$ is the strike price times the probability that the strike price will be paid. The expression $S_0N(d_1)e^{rT}$ is the expected value of a variable that equals S_T if $S_T > K$ and is zero otherwise in a risk-neutral world.

Because the European price equals the American price when there are no dividends, equation (12.20) also gives the value of an American call option on a non-dividend-paying stock. Unfortunately, no exact analytic formula for the value of an American put option on a non-dividend-paying stock has been produced. Numerical procedures and analytic approximations for calculating American put values are discussed in Chapter 18.

When the Black–Scholes formula is used in practice, the interest rate r is set equal to the zero-coupon risk-free interest rate for a maturity T. As we show in later chapters, this is theoretically correct when r is a known function of time. It is also theoretically correct when the interest rate is stochastic providing the stock price at time T is lognormal and the volatility parameter is chosen appropriately.

Properties of the Black–Scholes Formulas

We now show that the Black–Scholes formulas have the right general properties by considering what happens when some of the parameters take extreme values.

When the stock price, S_0, becomes very large, a call option is almost certain to be exercised. It then becomes very similar to a forward contract with delivery price K. From equation (3.9), we expect the call price to be

$$S_0 - Ke^{-rT}$$

This is, in fact, the call price given by equation (12.20) because, when S_0 becomes very large, both d_1 and d_2 become very large, and $N(d_1)$ and $N(d_2)$ are both close to 1.0. When the stock price becomes

[6] The differential equation gives the call and put prices at a general time t. For example, the call price that satisfies the differential equation is $c = SN(d_1) - Ke^{-r(T-t)}N(d_2)$, where

$$d_1 = \frac{\ln(S/K) + (r + \sigma^2/2)(T - t)}{\sigma\sqrt{T - t}}$$

and $d_2 = d_1 - \sigma\sqrt{T-t}$. See Problem 12.17 to prove that the differential equation is satisfied.

very large, the price of a European put option, p, approaches zero. This is consistent with equation (12.21) because $N(-d_1)$ and $N(-d_2)$ are both close to zero.

Consider next what happens when the volatility σ approaches zero. Because the stock is virtually riskless, its price will grow at rate r to S_0e^{rT} at time T and the payoff from a call option is

$$\max(S_0e^{rT} - K,\ 0)$$

If we discount at rate r, then the value of the call today is

$$e^{-rT}\max(S_0e^{rT} - K,\ 0) = \max(S_0 - Ke^{-rT},\ 0)$$

To show that this is consistent with equation (12.20), consider first the case where $S_0 > Ke^{-rT}$. This implies that $\ln(S_0/K) + rT > 0$. As σ tends to zero, d_1 and d_2 tend to $+\infty$, so that $N(d_1)$ and $N(d_2)$ tend to 1.0 and equation (12.20) becomes

$$c = S_0 - Ke^{-rT}$$

When $S_0 < Ke^{-rT}$, it follows that $\ln(S_0/K) + rT < 0$. As σ tends to zero, d_1 and d_2 tend to $-\infty$, so that $N(d_1)$ and $N(d_2)$ tend to zero and equation (12.20) gives a call price of zero. The call price is therefore always $\max(S_0 - Ke^{-rT},\ 0)$ as σ tends to zero. Similarly, it can be shown that the put price is always $\max(Ke^{-rT} - S_0,\ 0)$ as σ tends to zero.

12.9 CUMULATIVE NORMAL DISTRIBUTION FUNCTION

The only problem in implementing equations (12.20) and (12.21) is in calculating the cumulative normal distribution function, N. Tables for $N(x)$ are provided at the end of this book. A polynomial approximation that gives six-decimal-place accuracy is[7]

$$N(x) = \begin{cases} 1 - N'(x)(a_1k + a_2k^2 + a_3k^3 + a_4k^4 + a_5k^5) & \text{if } x \geqslant 0 \\ 1 - N(-x) & \text{if } x < 0 \end{cases}$$

where

$$k = \frac{1}{1+\gamma x}, \qquad \gamma = 0.2316419$$

$$a_1 = 0.319381530, \quad a_2 = -0.356563782, \quad a_3 = 1.781477937,$$

$$a_4 = -1.821255978, \quad a_5 = 1.330274429$$

$$N'(x) = \frac{1}{\sqrt{2\pi}}e^{-x^2/2}$$

Example 12.7 The stock price six months from the expiration of an option is \$42, the exercise price of the option is \$40, the risk-free interest rate is 10% per annum, and the volatility is 20% per

[7] See M. Abramowitz and I. Stegun, *Handbook of Mathematical Functions*, Dover Publications, New York, 1972. The function NORMSDIST in Excel can also be used.

annum. This means that $S_0 = 42$, $K = 40$, $r = 0.1$, $\sigma = 0.2$, $T = 0.5$,

$$d_1 = \frac{\ln(42/40) + (0.1 + 0.2^2/2) \times 0.5}{0.2\sqrt{0.5}} = 0.7693$$

$$d_2 = \frac{\ln(42/40) + (0.1 - 0.2^2/2) \times 0.5}{0.2\sqrt{0.5}} = 0.6278$$

and

$$Ke^{-rT} = 40e^{-0.05} = 38.049$$

Hence, if the option is a European call, its value, c, is given by

$$c = 42N(0.7693) - 38.049N(0.6278)$$

If the option is a European put, its value, p, is given by

$$p = 38.049N(-0.6278) - 42N(-0.7693)$$

Using the polynomial approximation, we have

$$N(0.7693) = 0.7791, \quad N(-0.7693) = 0.2209, \quad N(0.6278) = 0.7349, \quad N(-0.6278) = 0.2651$$

so that

$$c = 4.76, \quad p = 0.81$$

Ignoring the time value of money, the stock price has to rise by \$2.76 for the purchaser of the call to break even. Similarly, the stock price has to fall by \$2.81 for the purchaser of the put to break even.

12.10 WARRANTS ISSUED BY A COMPANY ON ITS OWN STOCK

The Black–Scholes formula, with some adjustments for the impact of dilution, can be used to value European warrants issued by a company on its own stock.[8] Consider a company with N outstanding shares and M outstanding European warrants. Suppose that each warrant entitles the holder to purchase γ shares from the company at time T at a price of K per share.

If V_T is the value of the company's equity (including the warrants) at time T and the warrant holders exercise, the company receives a cash inflow from the payment of the exercise price of $M\gamma K$ and the value of the company's equity increases to $V_T + M\gamma K$. This value is distributed among $N + M\gamma$ shares, so that the share price immediately after exercise becomes

$$\frac{V_T + M\gamma K}{N + M\gamma}$$

The payoff to the warrant holder if the warrant is exercised is therefore

$$\gamma\left(\frac{V_T + M\gamma K}{N + M\gamma} - K\right)$$

[8] See F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy*, 81 (May/June 1973), 637–59; D. Galai and M. Schneller, "Pricing Warrants and the Value of the Firm," *Journal of Finance*, 33 (1978), 1339–42; B. Lauterbach and P. Schultz, "Pricing Warrants: An Empirical Study of the Black–Scholes Model and Its Alternatives," *Journal of Finance*, 45 (1990), 1181–1209.

or

$$\frac{N\gamma}{N+M\gamma}\left(\frac{V_T}{N}-K\right)$$

The warrants should be exercised only if this payoff is positive. The payoff to the warrant holder is therefore

$$\frac{N\gamma}{N+M\gamma}\max\left(\frac{V_T}{N}-K,\ 0\right)$$

This shows that the value of the warrant is the value of

$$\frac{N\gamma}{N+M\gamma}$$

regular call options on V/N, where V is the value of the company's equity.

The value of V at time zero is given by

$$V_0 = NS_0 + MW$$

where S_0 is the stock price at time zero and W is the warrant price at that time, so that

$$\frac{V_0}{N} = S_0 + \frac{M}{N}W$$

The Black–Scholes formula in equation (12.20) therefore gives the warrant price W if:

1. The stock price S_0 is replaced by $S_0 + (M/N)W$.
2. The volatility σ is the volatility of the equity of the company (i.e., it is the volatility of the value of the shares plus the warrants, not just the shares).
3. The formula is multiplied by $N\gamma/(N+M\gamma)$.

When these adjustments are made, we end up with a formula for W as a function of W. This can be solved numerically.

12.11 IMPLIED VOLATILITIES

The one parameter in the Black–Scholes pricing formulas that cannot be directly observed is the volatility of the stock price. In Section 12.3, we discussed how this can be estimated from a history of the stock price. In practice, traders usually work with what are known as *implied volatilities*. These are the volatilities implied by option prices observed in the market.

To illustrate how implied volatilities are calculated, suppose that the value of a call option on a non-dividend-paying stock is 1.875 when $S_0 = 21$, $K = 20$, $r = 0.1$, and $T = 0.25$. The implied volatility is the value of σ that, when substituted into equation (12.20), gives $c = 1.875$. Unfortunately, it is not possible to invert equation (12.20) so that σ is expressed as a function of S_0, K, r, T, and c. However, an iterative search procedure can be used to find the implied σ. For example, we can start by trying $\sigma = 0.20$. This gives a value of c equal to 1.76, which is too low. Because c is an increasing function of σ, a higher value of σ is required. We can next try a value of 0.30 for σ. This gives a value of c equal to 2.10, which is too high and means that σ must lie between 0.20 and 0.30.

Next, a value of 0.25 can be tried for σ. This also proves to be too high, showing that σ lies between 0.20 and 0.25. In this way, the range for σ can be halved at each iteration and the correct value of σ can be calculated to any required accuracy.[9] In this example, the implied volatility is 0.235, or 23.5% per annum.

Implied volatilities are used to monitor the market's opinion about the volatility of a particular stock. Traders like to calculate implied volatilities from actively traded options on a certain asset and interpolate between them to calculate the appropriate volatility for pricing a less actively traded option on the same stock. We explain this procedure in Chapter 15. It is important to note that the prices of deep-in-the-money and deep-out-of-the-money options are relatively insensitive to volatility. Implied volatilities calculated from these options tend, therefore, to be unreliable.

12.12 THE CAUSES OF VOLATILITY

Some analysts have claimed that the volatility of a stock price is caused solely by the random arrival of new information about the future returns from the stock. Others have claimed that volatility is caused largely by trading. An interesting question, therefore, is whether the volatility of an exchange-traded instrument is the same when the exchange is open as when it is closed.

Both Fama and K. R. French have tested this question empirically.[10] They collected data on the stock price at the close of each trading day over a long period of time, and then calculated:

1. The variance of stock price returns between the close of trading on one day and the close of trading on the next trading day when there are no intervening nontrading days
2. The variance of the stock price returns between the close of trading on Fridays and the close of trading on Mondays

If trading and nontrading days are equivalent, the variance in the second case should be three times as great as the variance in the first case. Fama found that it was only 22% higher. French's results were similar: he found that it was 19% higher.

These results suggest that volatility is far larger when the exchange is open than when it is closed. Proponents of the view that volatility is caused only by new information might be tempted to argue that most new information on stocks arrives during trading days.[11] However, studies of futures prices on agricultural commodities, which depend largely on the weather, have shown that they exhibit much the same behavior as stock prices; that is, they are much more volatile during trading hours. Presumably, news about the weather is equally likely to arise on any day. The only reasonable conclusion seems to be that volatility is largely caused by trading itself.[12]

[9] This method is presented for illustration. Other more powerful methods, such as the Newton–Raphson method, are often used in practice (see footnote 2 of Chapter 5). DerivaGem can be used to calculate implied volatilities.

[10] See E. E. Fama, "The Behavior of Stock Market Prices," *Journal of Business*, 38 (January 1965), 34–105; K. R. French, "Stock Returns and the Weekend Effect," *Journal of Financial Economics*, 8 (March 1980), 55–69.

[11] In fact, this is questionable. Frequently, important announcements (e.g., those concerned with sales and earnings) are made when exchanges are closed.

[12] For a discussion of this, see K. R. French and R. Roll, "Stock Return Variances: The Arrival of Information and the Reaction of Traders," *Journal of Financial Economics*, 17 (September 1986), 5–26. We consider one way in which trading can generate volatility when we discuss portfolio insurance schemes in Chapter 14.

What are the implications of all of this for the measurement of volatility and the Black–Scholes model? When implied volatilities are calculated, the life of an option should be measured in trading days. Furthermore, if daily data are used to provide a historical volatility estimate, days when the exchange is closed should be ignored and the volatility per annum should be calculated from the volatility per trading day using the formula

$$\text{volatility per annum} = \text{volatility per trading day} \times \sqrt{\text{number of trading days per annum}}$$

This is what we did in Example 12.5. The normal assumption in equity markets is that there are 252 trading days per year.

Although volatility appears to be a phenomenon that is related largely to trading days, interest is paid by the calendar day. This has led D. W. French to suggest that, when options are being valued, two time measures should be calculated:[13]

$$\tau_1: \quad \frac{\text{trading days until maturity}}{\text{trading days per year}}$$

$$\tau_2: \quad \frac{\text{calendar days until maturity}}{\text{calendar days per year}}$$

and that the Black–Scholes formulas should be adjusted to

$$c = S_0 N(d_1) - Ke^{-r\tau_2} N(d_2)$$

and

$$p = Ke^{-r\tau_2} N(-d_2) - S_0 N(-d_1)$$

where

$$d_1 = \frac{\ln(S_0/K) + r\tau_2 + \sigma^2\tau_1/2}{\sigma\sqrt{\tau_1}}$$

$$d_2 = \frac{\ln(S_0/K) + r\tau_2 - \sigma^2\tau_1/2}{\sigma\sqrt{\tau_1}} = d_1 - \sigma\sqrt{\tau_1}$$

In practice, this adjustment makes little difference except for very short life options.

12.13 DIVIDENDS

Up to now, we have assumed that the stock upon which the option is written pays no dividends. In this section, we modify the Black–Scholes model to take account of dividends. We assume that the amount and timing of the dividends during the life of an option can be predicted with certainty. For short-life options, it is usually possible to estimate dividends during the life of the option reasonably accurately. For options lasting several years, there is likely to be uncertainty about dividend growth rates making option pricing much more difficult.

A dividend-paying stock can reasonably be expected to follow the stochastic process developed in Chapter 11 except when the stock goes ex-dividend. At this point, the stock's price goes down by

[13] See D. W. French, "The Weekend Effect on the Distribution of Stock Prices: Implications for Option Pricing," *Journal of Financial Economics*, 13 (September 1984), 547–59.

an amount reflecting the dividend paid per share. For tax reasons, the stock price may go down by somewhat less than the cash amount of the dividend. To take account of this, the word *dividend* in this section should be interpreted as the reduction in the stock price on the ex-dividend date caused by the dividend. Thus, if a dividend of \$1 per share is anticipated and the share price normally goes down by 80% of the dividend on the ex-dividend date, the dividend should be assumed to be \$0.80 for the purposes of the analysis.

European Options

European options can be analyzed by assuming that the stock price is the sum of two components: a riskless component that corresponds to the known dividends during the life of the option and a risky component. The riskless component, at any given time, is the present value of all the dividends during the life of the option discounted from the ex-dividend dates to the present at the risk-free rate. By the time the option matures, the dividends will have been paid and the riskless component will no longer exist. The Black–Scholes formula is therefore correct if S_0 is equal to the risky component of the stock price and σ is the volatility of the process followed by the risky component.[14] Operationally, this means that the Black–Scholes formula can be used provided that the stock price is reduced by the present value of all the dividends during the life of the option, the discounting being done from the ex-dividend dates at the risk-free rate. A dividend is counted as being during the life of the option only if its ex-dividend date occurs during the life of the option.

Example 12.8 Consider a European call option on a stock when there are ex-dividend dates in two months and five months. The dividend on each ex-dividend date is expected to be \$0.50. The current share price is \$40, the exercise price is \$40, the stock price volatility is 30% per annum, the risk-free rate of interest is 9% per annum, and the time to maturity is six months. The present value of the dividends is

$$0.5e^{-0.1667\times 0.09} + 0.5e^{-0.4167\times 0.09} = 0.9741$$

The option price can therefore be calculated from the Black–Scholes formula with $S_0 = 39.0259$, $K = 40$, $r = 0.09$, $\sigma = 0.3$, and $T = 0.5$. We have

$$d_1 = \frac{\ln(39.0259/40) + (0.09 + 0.3^2/2) \times 0.5}{0.3\sqrt{0.5}} = 0.2017$$

$$d_2 = \frac{\ln(39.0259/40) + (0.09 - 0.3^2/2) \times 0.5}{0.3\sqrt{0.5}} = -0.0104$$

Using the polynomial approximation in Section 12.9 gives us

$$N(d_1) = 0.5800, \quad N(d_2) = 0.4959$$

and, from equation (12.20), the call price is

$$39.0259 \times 0.5800 - 40e^{-0.09\times 0.5} \times 0.4959 = 3.67$$

or \$3.67.

[14] In theory this is not quite the same as the volatility of the stochastic process followed by the whole stock price. The volatility of the risky component is approximately equal to the volatility of the whole stock price multiplied by $S_0/(S_0 - D)$, where D is the present value of the dividends. However, an adjustment is only necessary when volatilities are estimated using historical data. An implied volatility is calculated after the present value of dividends have been subtracted from the stock price and is the volatility of the risky component.

American Options

Consider next American call options. In Section 8.5, we showed that in the absence of dividends American options should never be exercised early. An extension to the argument shows that, when there are dividends, it is optimal to exercise only at a time immediately before the stock goes ex-dividend. We assume that n ex-dividend dates are anticipated and that $t_1, t_2, \ldots, t_n$ are moments in time immediately prior to the stock going ex-dividend, with $t_1 < t_2 < t_3 < \cdots < t_n$. The dividends corresponding to these times will be denoted by $D_1, D_2, \ldots, D_n$, respectively.

We start by considering the possibility of early exercise just prior to the final ex-dividend date (i.e., at time t_n). If the option is exercised at time t_n, the investor receives

$$S(t_n) - K$$

If the option is not exercised, the stock price drops to $S(t_n) - D_n$. As shown by equation (8.5), the value of the option is then greater than

$$S(t_n) - D_n - Ke^{-r(T-t_n)}$$

It follows that if

$$S(t_n) - D_n - Ke^{-r(T-t_n)} \geqslant S(t_n) - K$$

that is,

$$D_n \leqslant K(1 - e^{-r(T-t_n)}) \tag{12.24}$$

it cannot be optimal to exercise at time t_n. On the other hand, if

$$D_n > K(1 - e^{-r(T-t_n)}) \tag{12.25}$$

for any reasonable assumption about the stochastic process followed by the stock price, it can be shown that it is always optimal to exercise at time t_n for a sufficiently high value of $S(t_n)$. The inequality in (12.25) will tend to be satisfied when the final ex-dividend date is fairly close to the maturity of the option (i.e., $T - t_n$ is small) and the dividend is large.

Next consider time t_{n-1}, the penultimate ex-dividend date. If the option is exercised at time t_{n-1}, the investor receives

$$S(t_{n-1}) - K$$

If the option is not exercised at time t_{n-1}, the stock price drops to $S(t_{n-1}) - D_{n-1}$ and the earliest subsequent time at which exercise could take place is t_n. Hence, from equation (8.5), a lower bound to the option price if it is not exercised at time t_{n-1} is

$$S(t_{n-1}) - D_{n-1} - Ke^{-r(t_n-t_{n-1})}$$

It follows that if

$$S(t_{n-1}) - D_{n-1} - Ke^{-r(t_n-t_{n-1})} \geqslant S(t_{n-1}) - K$$

or

$$D_{n-1} \leqslant K(1 - e^{-r(t_n-t_{n-1})})$$

it is not optimal to exercise at time t_{n-1}. Similarly, for any $i < n$, if

$$D_i \leqslant K(1 - e^{-r(t_{i+1}-t_i)}) \tag{12.26}$$

it is not optimal to exercise at time t_i.

The inequality in (12.26) is approximately equivalent to

$$D_i \leqslant Kr(t_{i+1} - t_i)$$

Assuming that K is fairly close to the current stock price, the dividend yield on the stock would have to be either close to or above the risk-free rate of interest for this inequality not to be satisfied. This is not often the case.

We can conclude from this analysis that, in most circumstances, the only time that needs to be considered for the early exercise of an American call is the final ex-dividend date, t_n. Furthermore, if inequality (12.26) holds for $i = 1, 2, \ldots, n-1$ and inequality (12.24) holds, then we can be certain that early exercise is never optimal.

Black's Approximation

Black suggests an approximate procedure for taking account of early exercise in call options.[15] This involves calculating, as described earlier in this section, the prices of European options that mature at times T and t_n, and then setting the American price equal to the greater of the two. This approximation seems to work well in most cases. A more exact procedure suggested by Roll (1977), Geske (1979), and Whaley (1981) is given in Appendix 12B.[16]

Example 12.9 Consider the situation in Example 12.8, but suppose that the option is American rather than European. In this case, $D_1 = D_2 = 0.5$, $S_0 = 40$, $K = 40$, $r = 0.09$, $t_1 = 2/12$, and $t_2 = 5/12$. Because

$$K(1 - e^{-r(t_2 - t_1)}) = 40(1 - e^{-0.09 \times 0.25}) = 0.89$$

is greater than 0.5, it follows (see inequality (12.26)) that the option should never be exercised immediately before the first ex-dividend date. In addition, because

$$K(1 - e^{-r(T - t_2)}) = 40(1 - e^{-0.09 \times 0.0833}) = 0.30$$

is less than 0.5, it follows (see inequality (12.25)) that, when it is sufficiently deep in the money, the option should be exercised immediately before the second ex-dividend date.

We now use Black's approximation to value the option. The present value of the first dividend is

$$0.5e^{-0.1667 \times 0.09} = 0.4926$$

so that the value of the option, on the assumption that it expires just before the final ex-dividend date, can be calculated using the Black–Scholes formula with $S_0 = 39.5074$, $K = 40$, $r = 0.09$, $\sigma = 0.30$, and $T = 0.4167$. It is \$3.52. Black's approximation involves taking the greater of this and the value of the option when it can only be exercised at the end of six months. From Example 12.8, we know that the latter is \$3.67. Black's approximation therefore gives the value of the American call as \$3.67.

[15] See F. Black, "Fact and Fantasy in the Use of Options," *Financial Analysts Journal*, 31 (July/August 1975), 36–41, 61–72.

[16] See R. Roll, "An Analytic Formula for Unprotected American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 5 (1977), 251–58; R. Geske, "A Note on an Analytic Valuation Formula for Unprotected American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 7 (1979), 375–80; R. Whaley, "On the Valuation of American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 9 (June 1981), 207–11; R. Geske, "Comments on Whaley's Note," *Journal of Financial Economics*, 9 (June 1981), 213–215.

The value of the option given by the Roll, Geske, and Whaley (RGW) formula is \$3.72. There are two reasons for differences between RGW and Black's approximation (BA). The first concerns the timing of the early exercise decision and tends to make RGW greater than BA. In BA, the assumption is that the holder has to decide today whether the option will be exercised after five months or after six months; RGW allows the decision on early exercise at the five-month point to depend on the stock price. The second concerns the way in which volatility is applied and tends to make BA greater than RGW. In BA, when we assume exercise takes place after five months, the volatility is applied to the stock price less the present value of the first dividend; when we assume exercise takes place after six months, the volatility is applied to the stock price less the present value of both dividends. In RGW, it is always applied to the stock price less the present value of both dividends.

Whaley[17] has empirically tested three models for the pricing of American calls on dividend-paying stocks: (1) the formula in Appendix 12B; (2) Black's model; and (3) the European option pricing model described at the beginning of this section. He used 15,582 Chicago Board options. The models produced pricing errors with means of 1.08%, 1.48%, and 2.15%, respectively. The typical bid–offer spread on a call option is greater than 2.15% of the price. On average, therefore, all three models work well and within the tolerance imposed on the options market by trading imperfections.

Up to now, our discussion has centered on American call options. The results for American put options are less clear-cut. Dividends make it less likely that an American put option will be exercised early. It can be shown that it is never worth exercising an American put for a period immediately prior to an ex-dividend date.[18] Indeed, if

$$D_i \geqslant K(1 - e^{-r(t_{i+1}-t_i)})$$

for all $i < n$ and

$$D_n \geqslant K(1 - e^{-r(T-t_n)})$$

an argument analogous to that just given shows that the put option should never be exercised early. In other cases, numerical procedures must be used to value a put.

SUMMARY

We started this chapter by examining the properties of the process for stock prices introduced in Chapter 11. The process implies that the price of a stock at some future time, given its price today, is lognormal. It also implies that the continuously compounded return from the stock in a period of time is normally distributed. Our uncertainty about future stock prices increases as we look further ahead. The standard deviation of the logarithm of the stock price is proportional to the square root of how far ahead we are looking.

To estimate the volatility, σ, of a stock price empirically, the stock price is observed at fixed intervals of time (e.g., every day, every week, or every month). For each time period, the natural logarithm of the ratio of the stock price at the end of the time period to the stock price at the

[17] See R. E. Whaley, "Valuation of American Call Options on Dividend Paying Stocks: Empirical Tests," *Journal of Financial Economics*, 10 (March 1982), 29–58.

[18] See H. E. Johnson, "Three Topics in Option Pricing," Ph.D. thesis, University of California, Los Angeles, 1981, p. 42.

beginning of the time period is calculated. The volatility is estimated as the standard deviation of these numbers divided by the square root of the length of the time period in years. Usually, days when the exchanges are closed are ignored in measuring time for the purposes of volatility calculations.

The differential equation for the price of any derivative dependent on a stock can be obtained by creating a riskless position in the option and the stock. Because the derivative and the stock price both depend on the same underlying source of uncertainty, this can always be done. The position that is created remains riskless for only a very short period of time. However, the return on a riskless position must always be the risk-free interest rate if there are to be no arbitrage opportunities.

The expected return on the stock does not enter into the Black–Scholes differential equation. This leads to a useful result known as risk-neutral valuation. This result states that when valuing a derivative dependent on a stock price, we can assume that the world is risk neutral. This means that we can assume that the expected return from the stock is the risk-free interest rate, and then discount expected payoffs at the risk-free interest rate. The Black–Scholes equations for European call and put options can be derived by either solving their differential equation or by using risk-neutral valuation.

An implied volatility is the volatility that, when used in conjunction with the Black–Scholes option pricing formula, gives the market price of the option. Traders monitor implied volatilities and commonly use the implied volatilities from actively traded options to estimate the appropriate volatility to use to price a less actively traded option on the same asset. Empirical results show that the volatility of a stock is much higher when the exchange is open than when it is closed. This suggests that, to some extent, trading itself causes stock price volatility.

The Black–Scholes results can be extended to cover European call and put options on dividend-paying stocks. The procedure is to use the Black–Scholes formula with the stock price reduced by the present value of the dividends anticipated during the life of the option, and the volatility equal to the volatility of the stock price net of the present value of these dividends.

In theory, American call options are liable to be exercised early, immediately before any ex-dividend date. In practice, only the final ex-dividend date usually needs to be considered. Fischer Black has suggested an approximation. This involves setting the American call option price equal to the greater of two European call option prices. The first European call option expires at the same time as the American call option; the second expires immediately prior to the final ex-dividend date. A more exact approach involving bivariate normal distributions is explained in Appendix 12B.

SUGGESTIONS FOR FURTHER READING

On the Distribution of Stock Price Changes

Blattberg, R., and N. Gonedes, "A Comparison of the Stable and Student Distributions as Statistical Models for Stock Prices," *Journal of Business*, 47 (April 1974), 244–80.

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Kon, S. J., "Models of Stock Returns—A Comparison," *Journal of Finance*, 39 (March 1984), 147–65.

Richardson, M., and T. Smith, "A Test for Multivariate Normality in Stock Returns," *Journal of Business*, 66 (1993), 295–321.

On the Black–Scholes Analysis

Black, F., and M. Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy*, 81 (May/June 1973), 637–59.

Merton, R. C., "Theory of Rational Option Pricing," *Bell Journal of Economics and Management Science*, 4 (Spring 1973), 141–183.

On Risk-Neutral Valuation

Cox, J. C., and S. A. Ross, "The Valuation of Options for Alternative Stochastic Processes," *Journal of Financial Economics*, 3 (1976), 145–66.

Smith, C. W., "Option Pricing: A Review," *Journal of Financial Economics*, 3 (1976), 3–54.

On Analytic Solutions to the Pricing of American Calls

Geske, R., "Comments on Whaley's Note," *Journal of Financial Economics*, 9 (June 1981), 213–15.

Geske, R., "A Note on an Analytic Valuation Formula for Unprotected American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 7 (1979), 375–80.

Roll, R., "An Analytical Formula for Unprotected American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 5 (1977), 251–58.

Whaley, R., "On the Valuation of American Call Options on Stocks with Known Dividends," *Journal of Financial Economics*, 9 (1981), 207–11.

On the Causes of Volatility

Fama, E. E., "The Behavior of Stock Market Prices," *Journal of Business*, 38 (January 1965), 34–105.

French, K. R., "Stock Returns and the Weekend Effect," *Journal of Financial Economics*, 8 (March 1980), 55–69.

French, K. R., and R. Roll, "Stock Return Variances: The Arrival of Information and the Reaction of Traders," *Journal of Financial Economics*, 17 (September 1986), 5–26.

QUESTIONS AND PROBLEMS (ANSWERS IN SOLUTIONS MANUAL)

12.1. What does the Black–Scholes stock option pricing model assume about the probability distribution of the stock price in one year? What does it assume about the continuously compounded rate of return on the stock during the year?

12.2. The volatility of a stock price is 30% per annum. What is the standard deviation of the percentage price change in one trading day?

12.3. Explain the principle of risk-neutral valuation.

12.4. Calculate the price of a three-month European put option on a non-dividend-paying stock with a strike price of \$50 when the current stock price is \$50, the risk-free interest rate is 10% per annum, and the volatility is 30% per annum.

12.5. What difference does it make to your calculations in Problem 12.4 if a dividend of \$1.50 is expected in two months?

12.6. What is *implied volatility*? How can it be calculated?

12.7. A stock price is currently \$40. Assume that the expected return from the stock is 15% and that its volatility is 25%. What is the probability distribution for the rate of return (with continuous compounding) earned over a two-year period?

12.8. A stock price follows geometric Brownian motion with an expected return of 16% and a volatility of 35%. The current price is \$38.

a. What is the probability that a European call option on the stock with an exercise price of \$40 and a maturity date in six months will be exercised?

b. What is the probability that a European put option on the stock with the same exercise price and maturity will be exercised?

12.9. Prove that, with the notation in the chapter, a 95% confidence interval for S_T is between

$$S_0 e^{(\mu-\sigma^2/2)T-1.96\sigma\sqrt{T}} \quad \text{and} \quad S_0 e^{(\mu-\sigma^2/2)T+1.96\sigma\sqrt{T}}$$

12.10. A portfolio manager announces that the average of the returns realized in each year of the last 10 years is 20% per annum. In what respect is this statement misleading?

12.11. Assume that a non-dividend-paying stock has an expected return of μ and a volatility of σ. An innovative financial institution has just announced that it will trade a security that pays off a dollar amount equal to $\ln S_T$ at time T, where S_T denotes the value of the stock price at time T.

a. Use risk-neutral valuation to calculate the price of the security at time t in terms of the stock price, S, at time t.

b. Confirm that your price satisfies the differential equation (12.15).

12.12. Consider a derivative that pays off S_T^n at time T, where S_T is the stock price at that time. When the stock price follows geometric Brownian motion, it can be shown that its price at time t ($t \leqslant T$) has the form

$$h(t, T)S^n$$

where S is the stock price at time t and h is a function only of t and T.

a. By substituting into the Black–Scholes partial differential equation, derive an ordinary differential equation satisfied by $h(t, T)$.

b. What is the boundary condition for the differential equation for $h(t, T)$?

c. Show that

$$h(t, T) = e^{[0.5\sigma^2 n(n-1)+r(n-1)](T-t)}$$

where r is the risk-free interest rate and σ is the stock price volatility.

12.13. What is the price of a European call option on a non-dividend-paying stock when the stock price is \$52, the strike price is \$50, the risk-free interest rate is 12% per annum, the volatility is 30% per annum, and the time to maturity is three months?

12.14. What is the price of a European put option on a non-dividend-paying stock when the stock price is \$69, the strike price is \$70, the risk-free interest rate is 5% per annum, the volatility is 35% per annum, and the time to maturity is six months?

12.15. Consider an American call option on a stock. The stock price is \$70, the time to maturity is eight months, the risk-free rate of interest is 10% per annum, the exercise price is \$65, and the volatility is 32%. A dividend of \$1 is expected after three months and again after six months. Show that it can never be optimal to exercise the option on either of the two dividend dates. Use DerivaGem to calculate the price of the option.