1 Foundations of Modern Finance I

Present value of annuities and perpetuities

Perpetuity: $\frac{CF}{r}$.

Growing perpetuity: $\frac{CF}{r-g}$.

Annuity: $\frac{CF}{r}\cdot\left(1-\frac{1}{(1+r)^n}\right)$.

Annuity with growth:
$\frac{CF}{r-g}\cdot\left(1-\frac{(1+g)^n}{(1+r)^n}\right)$,
where r rate of return, g growth rate, n compounding periods

Arrow-Debrew securities. State-space model

$\phi_1\dots\phi_n$ state prices
$p_1\dots p_n$ state probabilities,
where $\sum p_i = 1$
$X_1\dots X_n$ state payouts
$P=\sum\phi_i\cdot X_i=\frac{E(P)}{(1+\bar{r})}$,
$\bar{r}=\frac{E(P)-P}{P}=\frac{\sum p_i\cdot X_i}{P}-1$,
$E(P)=\sum p_i\cdot X_i=P\cdot(1+\bar{r})$,
where P is price, $E(P)$ is expected payout, $\bar{r}$ is expected return.

Discounted cash flow and rate of return

r is rate of return, r_f is risk-free rate of return, $r-r_f$ is excess return
$r=\frac{D_1+P_1-P_0}{P_0}=\frac{D_1+P_1}{P_0}-1$,
$P_0=\frac{D_1+P_1}{1+r}$
With g as growth rate,
$P=\frac{D}{r-g}, g=\frac{D_1}{D_0}-1$
$\bar{r}=E(r)$, expected return, $\pi=\bar{r}-r_f$ is risk premium

Relation between real and nominal cash flows

$r_{real}=\frac{1+r_{nominal}}{1+inflation}-1$
For nominal flow,
$CF\cdot(1+r_{real})\cdot(1+inflation)$
For real flow,
$CF\cdot(1+r_{real})$

Accounting

$I_t=EPS_t\times b$, where b - plowback rate
$EPS_{t+1}=EPS_t+I_t\times ROI_t$
$BVPS_{t+1}=BVPS_t+I_{t+1}$
$D_t=EPS_t\times(1-b_t)$

Growth rate $g=\frac{EPS_{t+1}}{EPS_t}-1$

With growth $P_0=\frac{D}{r-g}$

Without growth $P_0^{nogrowth}=\frac{D}{r}$, where $g=0$ and $b=0$

Growth opportunity $PVGO=P_0-P_0^{nogrowth}$
Horizon value estimation:
$PV(Freecashflow)+$ P/E ratio or P/B ratio or DCF

Risk

Expected utility
$E[u(x)]=\sum p_i\cdot u(P_i)$,
where p_i is probability, P_i is payout
Expected payoff
$E(P)=\sum p_i\cdot P_i$
Relative risk aversion
$RRA(W)=-\frac{W\cdot u''(W)}{u'(W)}$

Certainty equivalent $CE=u^{-1}(E(u(x)))$
π - sure loss, risk premium, W is investment amount, so
$E(u(W\cdot(1+x)))=u(W\cdot(1-\pi))$
or
$CE=W\cdot(1-\pi), \pi=1-\frac{CE}{W}$

$$\begin{cases}+x\%, p_1\\ -x\%, p_2\end{cases}$$

$E(u(W\cdot(1+x)))=\sum p_i\cdot u(W\cdot(1+x))$

Interest rate conversion EAR/APR

T - compounding interval, fraction
yearly: $T=1$
monthly: $T=\frac{1}{12}$
daily: $T=\frac{1}{365}$
P - principal n - number of payment periods, so period payment M is
$M=P\cdot\frac{APR\cdot(1+APR\cdot T)^n}{(1+APR\cdot T)^n-1}$
$\lim_{T\to 0}1+EAR=e^{APR}$, so
$APR=\ln(1+EAR)$
$APR=\frac{(1+EAR)^T-1}{T}$
$1+EAR=(1+T\cdot APR)^{\frac{1}{T}}$

Duration

Discount bond price $B_t=(1+y)^{-t}$, discounted bond duration is t, so modified duration is $MD=\frac{t}{1+y}$

Macaulay duration is
$D=\frac{1}{B}\cdot\sum_t\frac{CF_t}{(1+y)^t}\cdot t$

Modified duration is $MD=\frac{D}{1+y}$

Modified duration for perpetuity is $MD=\frac{1}{y}$, so

Macaulay duration is $D=MD\cdot(1+y)=\frac{1+y}{y}$

Duration based approximations

Δy is the change in the interest rate, P is the asset price.
$\Delta P=-P\times MD\times\Delta y$

Convexity CX is
$CX=\frac{1}{2}\cdot\frac{1}{P}\cdot\frac{1}{(1+y)^2}\cdot\sum_t PV(CF_t)\cdot t\cdot(t+1)$, convexity based approximation is
$\Delta P=P\times(-MD\cdot\Delta y+CX\cdot\Delta y^2)$

Statistic

Excel functions:
Sample mean $AVG()$
Standard deviation $STDEV.S()$
Covariance:
$cov=\frac{1}{T-1}\cdot\sum(r_A-\bar{r}_A)\cdot(r_B-\bar{r}_B)$
Corellation: $corr=\frac{cov}{SD(A)\cdot SD(B)}$

Portfolio variance:
$Var[P_{AB}]=\sum w_i^2\cdot SD_i^2+\sum_{i\neq j}2w_iw_j\cdot SD_iSD_j\cdot corr_{ij}$,
$Var[P]=\frac{1}{n}\cdot SD^2+\left(1-\frac{1}{n}\right)\cdot corr\cdot SD\cdot SD$,
where SD is an average standard deviation

APT

For well diversified portfolios:
$\bar{r}_P=\bar{r}_P+\sum b_i\cdot f_i$, where $\bar{r}_P$ is expected return
$\bar{r}_P-r_f=\lambda\cdot\beta_P$, where r_f is risk free rate, λ is risk price and β_P is factor loading for single factor portfolio. Same $\bar{r}_P-r_f=\sum_i\lambda_i\cdot\beta_i$ for i factors portfolio
Return variance:
$Var(r)=\sum_i\beta_i^2\cdot Var(f_i)+Var(\epsilon)$
Covariance:
$cov(A,B)=\sum_i\beta_{i,A}\beta_{i,B}\cdot Var(f_i)$

APT in Excel

$r_i-r_f=\alpha+\beta_1(r_1-r_f)+\beta_2(r_2-r_f)+\epsilon_i$ To estimate β_1, β_2 and α (in this order):
$=LINEST(\alpha,\beta_2,\beta_1)$ (reverse order)

Capital investment

$CF=OpRev-OpEx-Tax-CapEx$
$OpProfit=OpRev-OpEx$
$Tax=\tau\cdot OpProfit-\tau\cdot Depreciation$
$CF=(1-\tau)\cdot OpProfit-CapEx+\tau\cdot Depreciation$
Work capital:
$WC=Inventory+A/R-A/P$, where A/R accounts receivable, A/P accounts payable
$CF=(1-\tau)\cdot OpProfit+\tau\cdot Depreciation-CapEx-\Delta WC$

Alternatives to NPV

Payback period

Choose S so $PB=S$, $\sum_{i=1}^S CF_i\geq -CF_0$ Discounted payback period:

$DPB=S$, $\sum_{i=1}^S\frac{CF_i}{(1+r)^i}\geq -CF_0$ Internal rate of return (IRR) must satisfy:

$0=CF_0+\sum_i\frac{CF_i}{(1+IRR)^i}$

Payback Interval:
$PI=\frac{PV}{-CF_0}$

2 Foundations of Modern Finance II

Forward rates

Forward interest rate between time $t-1$ and t:
$f_t=\frac{B_{t-1}}{B_t}-1=\frac{(1+r_t)^t}{(1+r_{t-1})^{t-1}}-1$
Expectation hypotesis (forward rates at time 0 are predictors of future spot rates, which is not true):
$E_0[\tilde{r}_1(t)]=\frac{(1+r_{t+1}(0))^{t+1}}{(1+r_t(0))^t}-1=f_{t+1}$

Forward pricing

Current spot price: S_0
Spot price at maturity (random): $\tilde{S}_T$
Forward price (fixed at time 0): F_T
Forward payoff is $\tilde{S}_T-F_T$
$PV_0(\tilde{S}_T)=e^{-yT}S_0$,
where y is dividend yield
$F_T=e^{(r-y)T}S_0$, so dividend yield
$y=r-T\cdot ln\left(\frac{F_T}{S_0}\right)$
Currency forward price is:
$F_T=X_0\cdot e^{(r_{USD}-r_{CHF})\cdot T}$

Futures pricing

Storage cost $Cost_t=c\cdot S_t$.
Net convenience yield $\hat{y}=y-c$, so
$H_T\approx F_T=e^{(r-\hat{y})T}S_0$
Backwardation in terms of convenience yield vs interest rate: $\hat{y}-r=y-c-r>0$
Contango: $H_T>S_0e^{rT}$
Backwardation: $H_T<S_0e^{rT}$

Interest rate swaps

Fixed leg is paid at fixed rate r_S.
Floating leg at the end of each period t is paid as spot risk-free rate $\tilde{r}_1(t-1)$
Forward rate to future spot rate:
$PV_0[\tilde{r}_1(T)\ at\ T+1]=PV_0[f_{T+1}\ at\ T+1]$
Present value of the fixed leg: $r_S\times\sum_{u=1}^T B_u$
Present value of the floating leg of the swap: $\sum_{t=1}^T PV_0[\tilde{r}_1(t-1)\ at\ t]$

Swap rate: $r_S=\frac{\sum_{t=1}^T B_t\cdot f_t}{\sum_{u=1}^T B_u}=\sum_{t=1}^T w_t\times f_t$, where weights w_t are: $w_t=\frac{B_t}{\sum_{u=1}^T B_u}$

Alternative formula: $r_s=\frac{1-B_T}{\sum_{u=1}^T B_U}$

Options

S underlying asset price (at time 0).
S_T underlying asset price (at time T).
B price of discount bond of par \$1 and maturity T ($B\leq 1$)
K strike (excercise) price.
T maturity (expriration) date.
C price of call with strike K and maturity T.
P price of put with strike K and maturity T.
European call option payoff: $CF_T=max[0,S_T-K]$

The net payoff is: $max[S_T - K, 0] - C(1+r)^T$
Excercise value of a call is $S - K$.
Excercise value of a put is $K - S$.
Price bounds are: $max[S - KB, 0] \leq C \leq S$
Put-Call parity: $C + BK = P + S$, where B is e^{-rT} if continious compounding is used.

Corporate securities as options

Equity (E): A call option on firm's assets (A) with K equal to its bond's redemption value.
Debt (D): A portfolio of firm's assets (A) and a short position in the call with K equial to bond's face value F.
Warrant: Call option on firm's stock, with stock dilution as a result of excercise.
Convertible bond: A portfolio of straight bonds and a call on the firm's stock with K related to the conversion ratio.
Callable bond: A portfolio combining straight bonds and a short position in a call on these bonds.
$A = D + E => D = A - E$
$E \equiv max[0, A - F]$
$D = A - E = A - max[0, A - F]$

Binomial pricing: single period

r is the interest rate
Stock price change:

$$\begin{tikzcd}[row sep=small] & S_u = uS_0 \\ S_0 \arrow[ur] \arrow[dr] & \\ & S_d = dS_0 \end{tikzcd}$$

Riskless bond price change:

$$\begin{tikzcd}[row sep=small] & B_0(1+r) \\ B_0 \arrow[ur] \arrow[dr] & \\ & B_0(1+r) \end{tikzcd}$$

Need to solve system of qquations:
$S_u \cdot a + (1+r) \cdot b = C_u$
$S_d \cdot a + (1+r) \cdot b = C_d$,
where a amount of stock shares (option's delta), b dollars invested into riskless bond B, C_u is payoff in up state, C_d is payoff in down state, so current market value of the call option is: $C_0 = S_0 \cdot a + b$.
Alternative notation:
$\delta u S_0 + b(1+r) = C_u$
$\delta d S_0 + b(1+r) = C_d$
where unique solutions is:

$$\delta = \frac{C_u - C_d}{(u-d)S_0}, \; b = \frac{1}{1+r} \cdot \frac{uC_d - dC_u}{(u-d)}, \text{ so}$$

$$C_0 = \delta S_0 + b = \frac{C_u - C_d}{u-d} + \frac{1}{1+r} \cdot \frac{uC_d - dC_u}{(u-d)}$$

Risk-neutral probability

$$q_u = \frac{(1+r) - d}{u-d}, \; q_d = \frac{u - (1+r)}{u-d}$$

$$C_0 = \frac{q_u C_u + q_d C_d}{1+r} = \frac{E^Q[C_T]}{1+r},$$

where $E^Q[\cdot]$ is expectation under risk-neutral probability $Q = (q, 1-q)$.

State prices

$$\phi_u = \frac{q}{1+r}, \; \phi_d = \frac{1-q}{1+r}$$

Black-Scholes-Merton formula

$$C_0 = C(S_0, K, T, r, \sigma) = S_0 N(x) - Ke^{-rT} N(x - \sigma\sqrt{T}),$$

where x is: $x = \dfrac{ln\left(\dfrac{S_0}{Ke^{-rT}}\right)}{\sigma\sqrt{T}} + \dfrac{1}{2}\sigma\sqrt{T}$

So option delta (δ) becomes $N(x) = \dfrac{\partial C}{\partial S}$.
$S_0 \cdot N(x)$ is the dollar mount invested into stock.
$Ke^{-rT} N(x - \sigma\sqrt{T})$ is the dollar amount borrowed.

Put-Call parity with BSM formula

$C + BK = P + S => P = C + e^{-rT}K - S$
$P = S \cdot N(x) - Ke^{-rT} N(x - \sigma\sqrt{T}) + e^{-rT}K - S$
$P = -S(1 - N(x)) + Ke^{-rT}(1 - N(x - \sigma\sqrt{T}))$

Option Greeks

Delta: $\delta = \dfrac{\partial C}{\partial S}$

Omega: $\Omega = \dfrac{\partial C}{\partial S} \dfrac{S}{C}$

Gamma: $\Gamma = \dfrac{\partial \delta}{\partial S} = \dfrac{\partial^2 C}{\partial S^2}$

Theta: $\Theta = \dfrac{\partial C}{\partial T}$

Vega: $v = \dfrac{\partial C}{\partial \sigma}$