

Applied Quantitative Finance for Equity Derivatives

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Contents

Preface	vii
1 The Forward	1
1.1 The borrow cost	1
1.2 The dividends	2
1.3 Blending dividends	4
1.4 The forward contract	5
1.5 Trading repo via a total return swap	5
1.6 Further reading	6
2 Vanilla Options	7
2.1 Black	7
2.2 Greeks	8
2.2.1 Delta	8
2.2.2 Gamma	9
2.2.3 Vega	9
2.2.4 Vanna	10
2.2.5 Volga	10
2.2.6 Theta	10
2.2.7 Rho	11
2.2.8 Dividend sensitivity	11
2.2.9 Numerical greeks	11
2.2.10 Example values	12
2.3 Put-Call Parity	12
2.4 Implying the volatility from the option price	13
2.5 Options on Index Futures	16
2.6 Fixed notional	16
2.7 Forward model vs. spot model	17
2.7.1 Forward model	17
2.7.2 Spot model	17
2.7.3 The option price continuity relationship	17
2.7.4 The quadrature method	18
2.7.5 Forward vs. spot model greeks	20
2.8 Hybrid models for cash dividends	21
2.8.1 Lehman's model	21
2.8.2 Bühler's model	23
2.9 Approximations for European option prices under the Spot model	24
2.9.1 Etoe and Gobet approximation	24

	2.9.2	Zhang approximation	27
	2.9.3	Comparison	28
2.10		Conclusion	32
2.11		Further reading	32
3		American options	35
3.1		Ju-Zhong approximation	35
3.2		Finite difference methods	38
3.3		TR-BDF2	41
3.4		Richardson extrapolation on implicit Euler	44
3.5		American option specifics	44
3.6		Choice of grid	46
3.7		Exact calibration to discount bonds and forward prices	48
	3.7.1	Exact Bond Price	48
	3.7.2	Exact Forward Price	50
	3.7.3	Put-Call Parity	51
3.8		Exponential fitting	52
3.9		Issues with varying yield and cash dividends	53
3.10		Finite difference method for the spot model	54
	3.10.1	Proportional dividends	54
	3.10.2	Cash dividends	56
	3.10.3	Numerical integration of American Calls under the Spot model	58
3.11		Hybrid models for cash dividends	59
3.12		Exercise boundary	61
3.13		Cash vs. Proportional	62
3.14		Conclusion	63
3.15		Further reading	63
4		Monte-Carlo and basket options	65
4.1		Monte-Carlo simulation	65
	4.1.1	Single asset	66
	4.1.2	Incorporating discrete dividends	69
	4.1.3	Measuring convergence	69
	4.1.4	Random numbers	70
	4.1.5	Multiple assets	81
	4.1.6	Computing sensitivities with algorithmic differenti- ation	84
	4.1.7	Variance reduction of ordinary Monte-Carlo estimates with the Brownian bridge path construction	88
	4.1.8	Control variate	94
	4.1.9	American options	97
4.2		A good approximation for Vanilla basket options under the Black model	102
	4.2.1	Two assets	103
	4.2.2	General case	104
	4.2.3	Beyond Black	108
4.3		Conclusion	108
4.4		Further reading	108

5	Volatility models	109
5.1	Implying volatilities	109
5.2	No-arbitrage conditions	113
5.3	Models for interpolation	114
5.3.1	Spline	114
5.3.2	Sticky strike or sticky Delta	119
5.3.3	A simple trader's model	120
5.3.4	Least-squares natural quintic	122
5.3.5	Least squares spline	123
5.3.6	Controlling the extrapolation	124
5.3.7	SVI	129
5.3.8	SABR	136
5.3.9	Summary of parameterizations on AAPL	141
5.3.10	When SVI breaks down	142
5.4	Dupire Local volatility	145
5.4.1	Taking dividends into account	145
5.4.2	Calibration effects on the local volatility	150
5.4.3	Repairing a broken local volatility	151
5.4.4	Dupire local volatility in Finite Difference Methods	157
5.4.5	Dupire local volatility in Monte-Carlo	160
5.4.6	Extrapolation effects	165
5.5	Local volatility parameterizations	169
5.5.1	Quadratic	169
5.5.2	Andeasen-Huge single-step local volatility	181
5.6	Black-Scholes with a term-structure of volatilities	191
5.7	Stochastic volatility	192
5.7.1	Models and characteristic functions	192
5.7.2	Overview of pricing formulae	194
5.7.3	Black-Scholes control variate	196
5.7.4	A robust algorithm to find the optimal α for Heston	197
5.7.5	Truncation	199
5.7.6	Accuracy of the pricing formulae with control variate	202
5.7.7	Adaptive Filon integration	202
5.7.8	Generic calibration via differential evolution	210
5.7.9	Calibration via Simulated Annealing	212
5.7.10	Calibration via Particle Swarm Optimization	213
5.7.11	Heston calibration	215
5.7.12	Schobel-Zhu calibration	225
5.7.13	Bates calibration	227
5.7.14	Double-Heston calibration	228
5.7.15	Heston simulation	229
5.7.16	Schobel-Zhu simulation	242
5.7.17	SVJ simulation	244
5.7.18	Double-Heston simulation	245
5.8	Stochastic-local volatility	245
5.8.1	QE scheme for the Heston-local volatility model	246
5.8.2	EAE scheme for the Schobel-Zhu-local volatility model	246
5.8.3	Bins	246
5.8.4	Non-conform linear regression	247
5.8.5	The particle method	250

	5.8.6	Vectorization	252
	5.8.7	Particle Quasi Monte-Carlo	252
5.9		Further reading	255
6		Almost Vanilla Options	257
6.1		Forward start	257
	6.1.1	Fixed quantity	257
	6.1.2	Fixed notional	258
	6.1.3	Which volatility?	259
	6.1.4	Local volatility	259
6.2		Asian	260
	6.2.1	Fixed strike	261
	6.2.2	Floating strike	263
	6.2.3	Local volatility	264
6.3		Digital	265
	6.3.1	Cash-or-nothing under the Black model	265
	6.3.2	Local volatility	267
	6.3.3	Stochastic volatility	268
6.4		Barrier	269
	6.4.1	Continuous barriers under the Black model	269
	6.4.2	Partial barriers under the Black model	276
	6.4.3	Double barrier	277
	6.4.4	Discrete observations adjustment	279
	6.4.5	TR-BDF2 with barriers	280
	6.4.6	Monte-Carlo with barriers	288
6.5		Further reading	289
7		Options on a Foreign Stock	291
7.1		Local currency	291
7.2		Quanto	291
	7.2.1	The quanto process under local volatility	291
	7.2.2	The quanto process under the Schobel-Zhu stochastic volatility model	292
	7.2.3	Vanilla quanto under the Black model	293
	7.2.4	Quanto in Monte-Carlo	296
7.3		Compo	296
7.4		A remark on the models	297
7.5		Further reading	297
8		Volatility derivatives	299
8.1		Variance Swap	299
	8.1.1	Definition	299
	8.1.2	Continuous replication in practice	300
	8.1.3	Discrete replication	300
	8.1.4	Replication examples	302
	8.1.5	Model-free replication	305
	8.1.6	Seasoned swap	308
	8.1.7	Initial value of a discretely sampled variance swap	308
	8.1.8	Forward Starting Variance Swap	308
	8.1.9	Variance swap greeks	308

8.1.10	Quanto variance swap	309
8.1.11	Variance Swap and Discrete Dividends	311
8.2	Volatility Swap	313
8.2.1	Payoff	314
8.2.2	Replication	314
8.2.3	A Fast Fourier Transformation	315
8.2.4	Adaptive Filon	316
8.2.5	Integration Boundaries	319
8.3	Options, Caps and Floors	320
8.3.1	Option on Variance	320
8.3.2	Option on Volatility	321
8.3.3	Variance Cap	321
8.3.4	Volatility Cap	321
8.4	Validation	322
8.5	Finite difference method for volatility derivatives under local volatility	323
8.5.1	Variance Swap	323
8.5.2	Quanto variance swap	324
8.6	Further reading	324
9	VIX derivatives	325
9.1	The VIX index	325
9.2	VIX Futures	326
9.3	VIX options	327
10	Dividend derivatives	331
10.1	Dividend swap	331
10.1.1	Price from discrete dividends	332
10.1.2	Price from a dividend yield term-structure	332
10.2	Dividend future	333
10.3	Dividend future option	334
11	Exotics	335
11.1	Autocall	335
11.1.1	Forward evaluation	335
11.1.2	Backward evaluation	337
11.1.3	Stochastic interest rates and the equity-interest rate correlation	338
11.2	Accumulator	340
11.2.1	Forward evaluation	341
11.2.2	Backward evaluation	341
11.3	Altiplano	343
A	A list of useful numerical algorithms	347
A.1	Minimizers	347
A.2	Solvers	348
A.3	Special functions	348
A.4	Quadratures	349
A.5	Random Numbers	349
A.6	Linear algebra	350

A.7	Miscellaneous	350
B	Tools of the trade	353
C	About the cover: implied volatility fractals	355
	Index	379

Preface

This book presents the most significant equity derivatives models used these days. It is not a book around esoteric or cutting-edge models, but rather a book on relatively simple and standard models, viewed from the angle of a practitioner. Most books present models in an abstract manner, often disconnected from how to apply them in the real world. This book intends to fill that gap, with the ambitious goal of transforming a reader unfamiliar with equity derivatives models into a specialist of such models.

There is no introductory mathematical chapter. If the reader is interested in stochastic calculus, the very concise book of Mikosch [Mik98] is highly recommended. Shreve's book [Shr04] is a nice complement with a more detailed, and very accessible mathematical presentation of theorems relevant to finance. John Hull offers a good even if slightly austere introduction to financial derivatives and various rate conventions in his book [Hul99].

The first chapter of this book introduces the specificities of the equity derivatives market in terms of modeling, with a close look at the dividend curves and the forward price. We then move on to the vanilla options, with the famous Black-Scholes model, paying attention to the various adjustments used in practice. After giving the most standard practices for European vanilla options, we follow with the issues raised by discrete cash dividends on the option price and study recent analytical approximations. Regarding American vanilla options, we detail fast and stable finite difference schemes, and proceed to analyze the inclusion of cash or proportional dividends, paying particular attention to the effect of the dividend model on the exercise boundary.

Chapter four introduces the Monte-Carlo method to price financial derivatives on a basket of equities. The parallelization of random numbers generation, the randomization of quasi-random numbers and the various ways of generating of correlated normal variates as well as the use of control variates and their caveats are carefully explained. We then present adjoint algorithmic differentiation techniques to compute sensitivities and finish the chapter with various techniques to include the American or more precisely, Bermudan exercise, in particular non-parametric regressions.

In chapter five, we look at how to imply volatilities in practice, and common volatility representations, be it parametric, Dupire local volatility, or stochastic volatility. We describe precisely how to accurately simulate the different models with the Monte-Carlo method or through finite difference methods. In doing so, we expose the many issues that arise with the classical approach to the Dupire local volatility along with solutions and explain how to handle discrete cash dividends in the Dupire framework. We conclude the chapter with an analysis of the particle method and its close relatives for Heston and Schobel-Zhu stochastic-local volatility models, detailing the use of quasi-random sequences with the method.

Progressively we consider other commonly traded options: forward start, digital,

barrier, Asian, quanto, compo, etc. We will however not present the rarely traded options such as compound or chooser, even when they have apparently nice analytical formulas. On each subject, pricing techniques are presented in great detail, be it through the simplest analytical formula, a Monte-Carlo simulation, or the finite difference method.

In chapter eight, we have a look at common volatility derivatives, that is, variance swaps, volatility swaps and options. Discrete, continuous or model-free replication of variance swaps is analyzed. Newer listed derivatives such as VIX options and dividend derivatives are subsequently covered.

We finally present common exotics and how to evaluate those in a forward Monte-Carlo manner or in a backward PDE manner. Even if those tend to be less traded nowadays, they are still in many traders books, and remain popular in Asia, especially the autocallables.