

Practical Quant Review

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1 Instrument Basics

1.1 Durations

Assume time interval is τ , yield is y and term is k . We have price

$$P = \sum_{i=1}^k c \frac{1}{(1+y\tau)^i} + \frac{1}{(1+y\tau)^k} \quad (1)$$

If we take the derivative of P versus y

$$dP = -\frac{1}{1+y\tau} \sum_{i=1}^k \frac{c\tau i}{(1+y\tau)^i} + \frac{k\tau}{(1+y\tau)^k} \quad (2)$$

The blue part divided by P is the duration. The red part times the blue part over P is the adjusted duration. Key thing to remember is that adjusted duration have a factor of $\frac{1}{1+y\tau}$

2 Forward Measure

2.1 Intuitive Definition

To start with, recall in the HJM framework we have the discount value of a bond price is a martingale in risk neutral measure. This is true because any tradable assets must be a martingale in risk neutral measure otherwise you have arbitrage opportunity

$$d(D(t)B(t, T)) = -\sigma^* D(t)B(t, T)d\widetilde{W}(t) \quad (3)$$

Then recall the definition of the fundamental theorem that there exists a measure between two tradable assets that those two can form a martingale.

If we further assume the measure is at time T , which is the same expiration time of the zero-coupon bonds, then we have:

$$\frac{V(t)}{B(0, T)} = E^T \frac{V(T)}{B(T, T)} = E^T V(T) \quad (4)$$

$$V(t) = B(0, T)E^T V(T) \quad (5)$$

The idea behind this is that, we cannot find a way using bond to hedge our payoff then get money at any condition. Recall the similar risk neutral pricing formula for any contract. But first, think of risk neutral measure as a measure that you can find a martingale such that it prevents you from being using bank account to make arbitrage

$$V(t) = E^B(V(T)D(T)) \quad (6)$$

Since T, B measures are both defined on same event space. The we can naturally get the transformation of the probability on same event to be

$$\tilde{P}^T(A) = \frac{1}{B(0,T)} \int_A D(T) d\tilde{P}^B(A) \quad (7)$$

2.2 Link To Risk Neutral Measure

2.2.1 Non-Model Based

We often hear someone say *forward price is martingale under T measure* (1 over forward price is martingale under S measure). Firstly, without proof, this statement can be think of as:

- First forward price is the number of bond you hold to hedge the price at time T. Aka the ratio between the expected payoff of contract vs the bond
- Under T measure, this value should equal to $\frac{V(t)}{B(t,T)}$ at time t
- In fact, the ratio value mentioned in first item should equal to $\frac{V(0)}{B(0,T)}$ at time 0
- According to the **Tower Theorem**, this second and third items are chained up to force the evolution of f from time 0 to time t, the f is a martingale

More intuitively, you can see using T measure just include/offset the factor of $B(0,T)$ and $D(T)$ in the risk neutral measure.

$$f(0) = \frac{E^B V(T) D(T)}{E^B D(T)} = B(0,T) E^B V(T) D(T) = E^T f(T) \quad (8)$$

2.2.2 Change of Numeraire

Thinking intuitively, T measure is just some drift transformation of normal distribution. Under risk-neutral measure, assume we have two process $S(t)$ and $N(t)$ (both are tradable assets).

$$D(t)S(t) = D(0)S(0) \exp\left(\int_0^t \sigma(t) d\widetilde{W}(u) - 0.5 \int_0^t \|\sigma(t)^2\| du\right) \quad (9)$$

$$D(t)N(t) = D(0)N(0) \exp\left(\int_0^t \mu(t) d\widetilde{W}(u) - 0.5 \int_0^t \|\mu(t)^2\| du\right) \quad (10)$$

So therefore under this risk neutral pricing measure, we can have

$$\begin{aligned}\frac{S(t)}{N(t)} &= \frac{S(0)}{N(0)} \exp\left(\int_0^t (\sigma(t) - \mu(t))d\widetilde{W}(u) - 0.5 \int_0^t (\|\sigma(t)^2\| - \|\mu(t)^2\|)du\right) \\ &= \frac{S(0)}{N(0)} \exp\left(\int_0^t (\sigma(t) - \mu(t))d\widetilde{W}(u) - 0.5 \int_0^t (\sigma(t) - \mu(t))^2 du\right) - \int_0^t \sum_1^d \mu_i(t)(\sigma_i(t) - \mu_i(t))du\end{aligned}\quad (11)$$

So we can find a measure

$$d\widetilde{W}^N(u) = \begin{bmatrix} d\widetilde{W}_1 - \mu_1(u) \\ d\widetilde{W}_2 - \mu_2(u) \\ \vdots \\ d\widetilde{W}_d - \mu_d(u) \end{bmatrix} \quad (12)$$

This equation is telling you that **under measure N, the normal distribution in risk neutral have positive drift $\mu(u)$**

Example 2.1. Under single stock measure, the log normal stock actually have σ^2 drift

$$d(\log(S)) = (r - \frac{1}{2}\sigma^2)dt + \sigma \cdot \sigma dt + \sigma d\widetilde{W}^S(t) \quad (13)$$

Example 2.2. Quanto Option, suppose XAU-EUR is $S_1(t)$ and USD-EUR $S_2(t)$. Then we have

$$\frac{d(S_1)}{S_1} = r_f dt + \sigma_1 d\widetilde{W}_1^f(t) \quad (14)$$

$$\frac{d(S_2)}{S_2} = (r_f - r_d)dt + \sigma_2 d\widetilde{W}_2^f(t) \quad (15)$$

The inverse of exchange rate process under EUR is

$$d\left(\frac{1}{S_2}\right) = \frac{1}{S_2}((r_d - r_f + \sigma_2^2)dt - \sigma_2 d\widetilde{W}_2^f(t)) \quad (16)$$

Under EUR risk neutral measure, the XAU by USD have (using $dXY = XdY + YdX + dXdY$)

$$\frac{dS_3}{S_3} = (r_d + \sigma_2^2 - \rho\sigma_1\sigma_2)dt + \sigma_1 d\widetilde{W}_1^f(t) - \sigma_2 d\widetilde{W}_2^f(t) \quad (17)$$

when we change measure EUR to measure USD then we have

$$\begin{aligned}\frac{dS_3}{S_3} &= (r_d + \sigma_2^2 - \rho\sigma_1\sigma_2)dt + (\sigma_1 - \rho\sigma_2)(d\widetilde{W}_1^d(t) + \rho\sigma_2 dt) \\ &\quad - \sigma_2 \sqrt{1 - \rho^2}(d\widetilde{W}_2^d(t) + \sqrt{1 - \rho^2}\sigma_2 dt) \\ &= r_d dt + \sqrt{\sigma_1^2 + \sigma_2^2 - 2\rho\sigma_1\sigma_2} \cdot d\widetilde{W}_3^d(t)\end{aligned}\quad (18)$$

The last equation shows that [after exchange rate consideration, the XAU in USD is still a martingale under USD measure.](#)

2.3 Normal Based T Measure

Based on the analysis above. Since discount zero coupon bond is a martingale under risk neutral measure.

$$d(D(t)B(t, T)) = D(t)B(t, T) - \sigma^*(t)d\widetilde{W}(t) \quad (19)$$

Use equation 12 can efficiently get

$$d\widetilde{W}^T(t) - \sigma^*(t) = d\widetilde{W}(t) \quad (20)$$

2.4 Use T Measure To Price Option

Even if interest rate is random, we can still get BS formula in a very general way.

$$\widetilde{E}(D(T)(S(T) - K))^+ = \widetilde{E}(D(T)S(T)\mathbb{1}[S(T) > K]) - K\widetilde{E}(D(T)\mathbb{1}[S(T) > K]) \quad (21)$$

The second part is easy to show. [The \$\sigma\$ here is the vol of forward price, which is comprised of both vol of spot and vol of zero bond\(interest rate\)](#)

$$\begin{aligned} K\widetilde{E}(D(T)\mathbb{1}[S(T) > K]) &= KB(0, T)\widetilde{E}^T(F(T, T) > K) \\ &= KB(0, T)P^T(\exp(-\frac{1}{2}\sigma^2t + \sigma\widetilde{W}^T(T)) > \frac{K}{F(0, T)}) \\ &= KB(0, T)N(d_2) \end{aligned} \quad (22)$$

The first part is quite similar

$$\widetilde{E}(D(T)S(T)\mathbb{1}[S(T) > K]) = S(0)\widetilde{E}^S(F(T, T) > K) \quad (23)$$

The tricky part is in fact, under the definition of S measure, the inverse of F is a martingale with vol $-\sigma$

$$\frac{B(0, T)}{S(0)} = \frac{1}{F(0, T)} = E^S(\frac{B(t, T)}{S(t)}) = E^S(\frac{1}{F(t, T)}) \quad (24)$$

The using the similar technique as for second part proof we can get the expression for first term.

$$S(0)N(d_1) \quad (25)$$

2.5 Application On Financial Instruments

2.5.1 Caplets

As we know that caplets means have an option to enter a borrowing contract at rate K from T to $T + \tau$.

Under the T measure, let F to be forward rate from T to $T + \tau$ we have

$$\frac{V_0}{P(0, T + \tau)} = \tau E^{T+\tau}(F(T) - K)^+ \quad (26)$$

Then we have **F is normal here, not log-normal, similar to swaption**

$$V_0 = P(0, T + \tau) \tau \xi_{call}^N(F(T), K, T, \sigma) \quad (27)$$

2.5.2 Swaptions

As we know that swaptions means have an option to enter a swap contract at rate K from T to $T + \tau$.

Assume par rate is $C(t, T, T + \tau)$. Then forward contract has the price $(K - C)A(t, T, T + \tau)$. A is the risk annuity.

Under this risk annuity measure, C is easy to show it's martingale. For rate, it should be normal distributed. Then we have

$$V_0 = A(0, T, T + \tau) \xi_{put}^N(C(T), K, T, \sigma) \quad (28)$$

3 Short Rate Models

3.1 Overview

HJM framework, Vasicek etc are all short rate. The only assumption we have about the discount is how the instantaneous discount evolve at the time of observation in the future.

3.2 Ho-Lee Model

The formula of Ho-Lee model is

$$dr = \lambda_t dt + \sigma dW_t \quad (29)$$

This gives you:

1. upward trend of discount curve
2. constant volatility (total sum of var over time)

3.3 Vasicek Model

The formula of Vasicek model is

$$dr = \kappa(\theta - r)dt + \sigma dW_t \quad (30)$$

This gives you:

1. upward trend of discount curve (with limit)
2. constant limit **sum** volatility (decreasing volatility over time)

3.4 Hull-White Model

HW steals the idea of Vasicek at the glance

$$dr = (\theta(t) - \alpha(t)r)dt + \sigma(t)dW_t \quad (31)$$

This gives you:

1. more flexible vasicek model

A pretty useful variation of HW model is adding factor to $\theta(t)$. Then We get two-factor Hull-White model.

$$\begin{aligned} dr &= (\theta(t) - \alpha(t)r + u)dt + \sigma_1(t)dW_t^1 \\ du &= -\beta(t)udt + \sigma_2(t)dW_t^1 \\ &\quad < dW^1, dW^2 > = \rho dt \end{aligned} \quad (32)$$

This gives you:

1. An term structure of theta plus with **variance decomposition** (related to PCA of term structure)

4 HJM and LMM

4.1 HJM Framework

4.1.1 No Arbitrage Condition

A key things to remember is that all CIR process, Vasicek process are Markov models, and lies in the HJM framework.

$$f(t, T) - f(0, T) = \int_0^t (\alpha(u, T)du + \sigma(u, T)dW(u)) \quad (33)$$

At time t , since the zero bond $B(t, T)$ is a martingale.

$$\log(B(t, T)) = - \int_t^T f(t, u) \quad (34)$$

$$\begin{aligned} d\log(B(t, T)) &= f(t, t)dt - \left(\int_t^T \alpha(t, u)du \right)dt + \int_t^T \sigma(t, u)dW(t) \\ &= (f(t, t) - \alpha^*(t))dt + \sigma^*(t)dW(t) \end{aligned} \quad (35)$$

Then we have

$$\begin{aligned} d(B(t, T)) &= f(t, t)dt - \left(\int_t^T \alpha(t, u)du \right)dt + \int_t^T \sigma(t, u)dW(t) \\ &= B(t, T)(f(t, t) - \alpha^*(t) + \frac{1}{2}\sigma^{*2}(t))dt - \sigma^*(t)dW(t) \end{aligned} \quad (36)$$

Then we have

$$\begin{aligned} d(D(t)B(t, T)) &= f(t, t)dt - \left(\int_t^T \alpha(t, u)du \right)dt + \int_t^T \sigma(t, u)dW(t) \\ &= D(t)B(t, T)(-\alpha^*(t) + \frac{1}{2}\sigma^{*2}(t))dt - \sigma^*(t)d\widetilde{W}(t) \end{aligned} \quad (37)$$

So we need to have

$$(-\alpha^*(t, T) + \frac{1}{2}\sigma^{*2}(t, T)) = \Theta(t) \text{ for } T \in [0, T] \quad (38)$$

Then take derivative with T , we get

$$\alpha(t, T) = \sigma^*(t)\sigma(t, T) \quad (39)$$

4.1.2 Some Important Feature

Once we get no-arbitrage condition, we can have several important conclusion.

First, the T measure under this is vs risk neutral measure.

$$d\widetilde{W}^T(t) - \sigma^*(t) = d\widetilde{W}(t) \quad (40)$$

Second, The forward rate's drift is. **This means the forward rate can be solely determined by sigma process.**

$$f(t, T) - f(0, T) = \int_0^t (\sigma^*(u)\sigma(u, T)du + \sigma(u, T)dW(u)) \quad (41)$$

4.2 LMM Framework

4.2.1 Forward Payment Replicate

The first things to remember is how to replicate a pay off for a FRA that pays $L(T, T)$ at time $T + \delta$. In fact we can **have portfolio of $\frac{1}{\delta}B(t, T) - \frac{1}{\delta}B(t, T + \delta)$ to exactly replicate the payoff.** (At time T we need to reinvest our earning of first leg to $B(T, T + \delta)$ and have payoff $\frac{1}{\delta B(T, T + \delta)}$)

In fact, the red part is $B(t, T + \delta)L(t, T)$ and we can think of it as a $T + \delta$ bond times forward rate

4.2.2 $B(t, T + \delta)$ Measure Pricing Example (T measure)

Since $B(t, T + \delta)L(t, T)$ is a price of contract (tradable), so under $B(t, T + \delta)$ measure $L(t, T)$ is a martingale. So for example the price of caplet paying $(L(T, T) - K)^+$ at time $T + \delta$ can be valued as

$$C(t, T) = B(t, T + \delta)E^{T+\delta}(L(T, T) - K)^+ \quad (42)$$

Since at $B(t, T + \delta)L(t, T)$ measure the $L(t, T)$ satisfy $d(L(t, T)) = \gamma(t, T)L(t, T)d\widetilde{W}^{T+\delta}(t)$. **Same as HJM, we need to find a vol process for $L(t, T)$ to price the caplet using blacks formula**

In fact, we can get the $\gamma(t, T)$ by using zero bond at risk neutral measure. Since $F(t, T) = (\frac{1}{\delta}B(t, T) - \frac{1}{\delta}B(t, T + \delta))/B(t, T + \delta)$

So we have

$$\begin{aligned}
F(t, T) + \frac{1}{\delta} &= \frac{B(t, T)}{B(t, T + \delta)} \\
&= \frac{B(0, t)}{B(0, T)} \exp\left(\int_0^t (\sigma^*(t, T) - \sigma^*(t, T + \delta)) \cdot d\widetilde{W}(u)\right) \\
&\quad - 0.5 \int_0^t \|\sigma^*(t, T) - \sigma^*(t, T + \delta)\|^2 du \\
&\quad - \int_0^t \sum_1^d \sigma_i^*(t, T + \delta)(\sigma_i^*(t, T) - \sigma_i^*(t, T + \delta)) du
\end{aligned} \tag{43}$$

So

$$\begin{aligned}
d(F(t, T) + \frac{1}{\delta}) &= \left(\sum_1^d \sigma_i^*(t, T + \delta)(\sigma_i^*(t, T) - \sigma_i^*(t, T + \delta)) du + (\sigma^*(t, T) - \sigma^*(t, T + \delta)) \cdot d\widetilde{W}(u)\right) \\
&= (F(t, T) + \frac{1}{\delta})(\sigma^*(t, T) - \sigma^*(t, T + \delta)) \cdot d\widetilde{W}^{T+\delta}(u)
\end{aligned} \tag{44}$$

If we keep HJM notation choose negative σ

$$\gamma(t, T) = \frac{1 + \delta F(t, T)}{F(t, T)} \frac{1}{\delta} (\sigma^*(t, T + \delta) - \sigma^*(t, T)) \tag{45}$$

This is the vol process under $B(t, T + \delta)$ measure

So you can do PCA on historical vol to get component. Then use implied vol of zero coupon bonds or Caplets to get the factored implied vol. Finally you can use monte-carlo engine to price the exotics in forward rate process. The use that to do the pricing of Caplets or Swaptions.

4.2.3 Price A Claim Using Terminal Bond Measure

Assume a payoff at time t_n depend on the forward rate at t_1, t_2, t_3 , and now we are at t . Then we can to use the terminal bond measure (You always have to use a measure to price as base. The example is pay something base on the average past forward rates, which are the use of series of rates for payments)

If we use $B(t, t_n)$ measure to price the forward of the forward contract that pays $F(t_{n-2}, t_{n-1})$ at time t_{n-1} . Then we have

$$E^{B(u, t_n)} \left(\frac{F(u, t_{n-2}, t_{n-1}) - F(t, t_{n-2}, t_{n-1})}{B(u, t_n)} (1 + \delta F(u, t_{n-1}, t_n)) \right) \Big|_{u=t_n} = 0 \tag{46}$$

The equation above can be rewrite as

$$\begin{aligned}
F(t, t_{n-2}, t_{n-1}) &= \frac{E_{u=t_n}^{B(u, t_n)}(F(u, t_{n-2}, t_{n-1})(1 + \delta F(u, t_{n-1}, t_n))}{E_{u=t_n}^{B(u, t_n)}(1 + \delta F(u, t_{n-1}, t_n))} \\
&= \frac{COV_{u=t_n}^{B(u, t_n)}(F(u, t_{n-2}, t_{n-1})(1 + \delta F(u, t_{n-1}, t_n))}{E_{u=t_n}^{B(u, t_n)}(1 + \delta F(u, t_{n-1}, t_n))} + E_{u=t_n}^{B(u, t_n)} F(u, t_{n-2}, t_{n-1}) \\
&= \frac{\delta \rho_{t_{n-2}, t_{n-1}} \sigma_{t_{n-2}} \sigma_{t_{n-1}}}{E_{u=t_n}^{B(u, t_n)}(1 + \delta F(u, t_{n-1}, t_n))} + E_{u=t_n}^{B(u, t_n)} F(u, t_{n-2}, t_{n-1}) \\
&= \frac{\delta \rho_{t_{n-2}, t_{n-1}} \sigma_{t_{n-2}} \sigma_{t_{n-1}}}{1 + \delta F(t, t_{n-1}, t_n)} + E_{u=t_n}^{B(u, t_n)} F(u, t_{n-2}, t_{n-1})
\end{aligned} \tag{47}$$

So the drift is $-\frac{\rho_{t_{n-2}, t_{n-1}} \sigma_{t_{n-2}} \sigma_{t_{n-1}}}{1 + \delta F(t, t_{n-1}, t_n)}$

4.3 Some Important Difference Between LMM and HJM

Here are some bulletin points:

1. HJM model is a model for instantaneous forward rate, it assume instantaneous rate will follow the dynamic of $\mu(t, T)$ and $\sigma(t, T)$
2. LMM model on the other hand, is a model for observable market forward rate.
3. LMM model has multiple random factor while HJM has limited random factor

4.4 SABR Model and LMM

SABR model stands for stochastic α, β, ρ model. It is very similar to Heston.

$$\begin{aligned}
dS &= \sigma S^\beta dW_1 \\
d\sigma &= \sigma \alpha dW_2 \\
corr(dW_1, dW_2) &= \rho
\end{aligned} \tag{48}$$

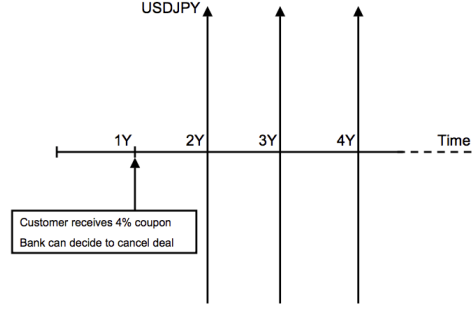
When calibrating models, we can first calibrate the vol parameters for each forward rate from the caps with different strikes. For example when $i > k$:

$$\begin{aligned}
\mu_k(t) &= -\sum_{i=k+1}^i \frac{\tau \rho_{k,j}(t) \gamma_k(t) \gamma_j(t)}{1 + \tau f_t(T_{i-1}, T_i)} \\
\gamma_k(t) &= \sigma f_t(T_{k-1}, T_k)^\beta
\end{aligned} \tag{49}$$

LMM framework has provided stochastic vol forward rate model a good interface to combine.

4.5 PRDC (Power Reversal Dual Callable) Swap

In fact, a product called PRDC can be introduced to be modeled by the rates model above. Investor swap USD for JPY with banks. Therefore, investor can continually get JPY yield and have a USD call, JPY put with bank. Normally this kind of contract occur in second year, and in first year, bank has the option to cancel the contract (In order to compensate the callable, bank will pay investor a big coupon at the beginning).



In fact, the investor of JPY is hopping

1. JPY can go strong (investor get more JPY)
2. r_{jpy} go strong (investor receive more coupon)
3. r_{usd} go weak (investor pay less coupon)

The math formular of this product is ($FX = JPY/USD$)

$$PNL_t = \max(0, \frac{FX_t}{FX_0} r_f - r_d) \quad (50)$$

5 Numerical Method

5.1 Tree Method

5.1.1 Binary Tree

Suppose we have a dynamic

$$dX_t = \mu dt + \sigma dW_t \quad (51)$$

For programming convenient, we choose $\Delta T = T/N$. Then we need to choose X_u , X_d , P (upward probability) to be.

$$\begin{aligned} PX_u - (1 - P)X_d &= \mu \Delta T \\ PX_u^2 + (1 - P)X_d^2 - \mu^2 \Delta T^2 &= \sigma^2 \Delta T \leftarrow \text{Var}(X) = E(X^2) - E(X)^2 \end{aligned} \quad (52)$$

If we want to further write our program to have X_u equals X_d , then P is not flexible enough to match μ and σ

5.1.2 Trinomial Tree

To solve the issue above. We add a P_m in addition to P_u and P_d , where the sum of three is 1. The actual equation is trivial here. If the process exists unique hedges, then the method is ok, however, 3 state model itself does not provide a unique risk neutral measure framework.

5.2 Finite Difference Method

5.3 Explicity Scheme

Directly use future's x derivative:

$$\begin{aligned} \frac{\partial C}{\partial t} &= \frac{C_{n+1}^j - C_n^j}{\Delta t} \\ \frac{\partial C}{\partial x} &= \frac{C_{n+1}^{j+1} - C_{n+1}^{j-1}}{2\Delta x} \\ \frac{\partial^2 C}{\partial^2 x} &= \frac{C_{n+1}^{j+1} - 2C_{n+1}^j + C_{n+1}^{j-1}}{\Delta x^2} \end{aligned} \quad (53)$$

Local truncation error $L(x, t) = O(\Delta t) + O(\Delta x)^2$. The stable condition is $\Delta t \leq \frac{1}{\sigma^2}(\Delta X)^2$

5.4 Implicity Scheme

Directly use past x derivative:

$$\begin{aligned}\frac{\partial C}{\partial t} &= \frac{C_{n+1}^j - C_n^j}{\Delta t} \\ \frac{\partial C}{\partial x} &= \frac{C_n^{j+1} - C_n^{j-1}}{2\Delta x} \\ \frac{\partial^2 C}{\partial^2 x} &= \frac{C_n^{j+1} - 2C_n^j + C_n^{j-1}}{\Delta x^2}\end{aligned}\tag{54}$$

Local truncation error $L(x, t) = O(\Delta t) + O(\Delta x)^2$. The stable condition is for all

5.5 Crank-Nicholson Scheme

Directly use past x derivative:

$$\begin{aligned}\frac{\partial C}{\partial t} &= \frac{C_{n+1}^j - C_n^j}{\Delta t} \\ \frac{\partial C}{\partial x} &= 0.5 \frac{C_n^{j+1} - C_n^{j-1}}{2\Delta x} + 0.5 \frac{C_{n+1}^{j+1} - C_{n+1}^{j-1}}{2\Delta x} \\ \frac{\partial^2 C}{\partial^2 x} &= 0.5 \frac{C_n^{j+1} - 2C_n^j + C_n^{j-1}}{\Delta x^2} + 0.5 \frac{C_{n+1}^{j+1} - 2C_{n+1}^j + C_{n+1}^{j-1}}{\Delta x^2}\end{aligned}\tag{55}$$

Local truncation error $L(x, t) = O(\Delta t)^2 + O(\Delta x)^2$. The stable condition is for all

5.6 Monte-Carlo

5.6.1 Integration

We can use monte-carlo for integration. Just find a density map $p(x)$

$$\begin{aligned}\int_{\Omega} f(x)dx &= E \frac{f(x)}{p(x)} p(x)dx \\ \int_{\Omega} p(x)dx &= 1\end{aligned}\tag{56}$$

5.6.2 Ways to Reduce Variance

1. Antithetic way
2. Control variable $\hat{X}+ = Y - \hat{Y}$
3. Importance Sample $\frac{h(x)f(x)}{g(x)}$ reduce $E(h(x)^2)$

5.6.3 Longstaff-Schwartz

1. generate N path using random (`np.random.randn(N, T)`)
2. backward for loop, each t look at the result of $t+1$, group the payoff by state that you define (S stock price in the simple case).
3. do the regression (Y is payoff X is state) and see if the intrinsic value is better than the expected future payoff of the current state.
4. get the current state decision and payoff

6 Real Data Calibration

6.1 LMM

To calibrate LMM, we need two kinds of data: volatility and correlation of forward rate.

- Caps are for calculating volatility (sum of individual vol)
- Swaptions are for calculating volatility and correlation (average of forward rate)
- Correlation can also be derived from historical analysis

7 Coding Basics

7.1 C++

7.1.1 Useful Function

Some useful C++ function

```
string::append("abc")
string::append(5, 'c')
```

```
//#include<algorithm>
vector<int> a(20, 0);
nth_element(a.begin(), a.begin()+6, a.end()); // partition algo
*min_element(a.begin(), a.end());
*max_element(a.begin(), a.end());

//#include<cmath>
double i=0;
abs(i);
ceil(i);
floor(i);
```

7.1.2 Break String

A very basic thing about c++ is how to break the string using some token. Since C++11 add regex, so there are two common way of breaking strings.

```
#include<iostream>
#include<vector>
#include<string>
#include<sstream>
#include<regex>

using namespace std;

vector<string> break_string1(string& str){
    vector<string> res;
    stringstream ss(str);
    string buff;
    while(getline(ss, buff, ',')){
        res.push_back(buff);
    }
    return res;
}

vector<string> break_string2(string& str){
```

```

    regex r(",");
    vector<string> res;
    for(
        auto x = sregex_token_iterator(str.begin(), str.end(), r, -1);
        x!=sregex_token_iterator();
        x++){
        res.push_back((x->str()));
    }
    return res;
}

int main(int argc, char *argv[])
{
    string a("123,234,345");
    for(auto x: break_string1(a))cout << x << "␣";
    cout <<endl;
    for(auto x: break_string2(a))cout << x << "␣";
    cout <<endl;
    return 0;
}

```

remember when you use *sregex_token_iterator*, the [regex must not be a right value](#).

7.1.3 Template

Key things to know for template:

1. as long as the type is specified clearly, template class will be initiated at compile time
2. you can write a factorial calculation at using template at compiled time. also [const-expr](#) will achieve this function as well
3. we can achieve virtual function by using template
4. the template function can do the type deduction, while template class must specify the typename or leave it blank
5. think of var-dict as Type ...
6. template deduction can be used for compiled time calculation
7. template can also be used to achieve static poly-morphism
8. Java constructor does not have return type and invoke implicitly
9. we cannot overwrite static method in class
10. just like c++ you cannot change return type during overloading

11. It's possible to override the function by return different type (must be sub-type) and it's called **covariant**.

7.1.4 Compiled Time Calculation

This is called template-metaprogramming. You actually store function template during compilation. Trade-off between compile time and run-time. Also, use *ftemplate-depth=200000* to enforce how many recursion you need in compile

```
#include <iostream >
using namespace std;
template<int N> int gauss_sum(){
    return N + gauss_sum <N-1>();
}
template <> int gauss_sum <0>(){
    return 0;
}
int main(int argc, char *argv[]) {
    cout<<gauss_sum <20>() << endl;
    return 0; }
}
```

7.1.5 Variadic Template

Use variable dict template to write print function

```
#include<iostream>
#include<string>
using namespace std;

template<typename T> void print(const T&t){
    cout << t << endl;
}

template<typename T, typename... Y> void print(const T& first, Y... y){
    cout << first << " ";
    print(y...);
}

int main(){
    print(1, 2, 3, "abc");
}
```

7.1.6 Static Polymorphism (CRTP)

Polymorphism can be achieved using inheritance. You first write a base class as template algorithm and customize small function using inheritance to overwrite.

Also you can do it using following template pattern

```
#include < iostream >
#include < string >
using namespace std;
template <typename derived > class base{
public:
    void talk (){
        cout << "my_name_is_" << get_name() << endl;
    }
    string get_name (){
        return static_cast <derived*>(this) -> get_name();
    }
};
// must be public inheritance here otherwise error
class cat: public base <cat >{
    // must add friend here since base class need to // access this method
private:
    friend string base <cat >:: get_name (); string get_name (){
        return "cat"; }
};

int main(int argc, char *argv[]) {
    // direct initialize
    cat d; d.talk();
    // use heap to initialize
    base<cat>* c = new cat(); c->talk();
    return 0;
}
```

7.1.7 Perfect Forwarding

Consider example below, if there is no perfect forwarding, the passed in right value t will become left value if passed to the next function on the stack.

```
#include <utility>
template <typename T, typename U>
std::pair<T, U> make_pair_wrapper(T&&t, U&&u){
    return std::make_pair(std::forward<T>(t), std::forward<U>(u));
}
```

7.1.8 Smart Pointer

Key things to remember:

1. smart pointer will have a internal reference will add 1 when copy, create, go into field and minus 1 when destruct out of field.
2. smart pointer must be copy when returned
3. comment area wont work, no implicit conversion
4. no cycle allowed, use weak pointer.

```
#include<memory>
using namespace std;
/*
int* test(){
    return make_shared<int>(1);
}
*/

shared_ptr<int> test(){
    return make_shared<int>(1);
}
```

7.2 Java

A bit overview here:

1. All the value are reference but all the value are passed by value in argument
2. No operator overloading like C++, but **except for String that is pre-given**
3. ArrayList does not support allocating generic type *eg. ArrayList*
4. Boolean, String is immutable in Java, as well as **Integer, Boolean, etc** wrapper types
5. Java manage memory like convey belt, keep move heap head pointer foward while using GC move what are behind closer to head.
6. **adaptive garbage collection scheme** has two types **Stop And Copy** and **Mark and Sweep**.
7. ArrayList vs Vector/Stack in Java is that the later two are thread safe but slower
8. **default** keyword is for restricting use of class inside package

7.2.1 Pass by Value

Java's references in fact act as a handle (with value in memory) that point to a position of an Object (More like a pointer instead of another name). Therefore, *swap* function like in C++ can not really achieve jobs.

```
class MyObject{
    public MyObject(int x){
        data = x;
    }

    public MyObject(MyObject other){
        data = other.data;
    }
    public int data;
}

class pass_by_reference{
    public static void swap(MyObject a, MyObject b){
        MyObject c = new MyObject(a);
        a = b;
        b = c;
    }

    public static void main(String args[]){
        MyObject a = new MyObject(1);
        MyObject b = new MyObject(2);
        swap(a, b);
        System.out.printf("a: %d, b: %d\n", a.data, b.data);
        // results are: a: 1, b: 2
    }
}
```

7.2.2 Producer And Consumer

Java has good ability of multi-processing. Here is a example using ArraList implementing a locked bounded queue.

In Java, using *new Thread lambda* can bypass the constrain of using *Runnable* where you need to make sure your queue is *static final*

Here are summary of Semaphore/Conditional variable

1. Semaphore must acquire before locked
2. Conditional variable must acquire after locked, and use while to keep release; While in C++ you don't need to


```

package com.company;
import java.util.ArrayList;
import java.util.Random;
import java.util.concurrent.Semaphore;

public class Main {

    static class Buffer {
        private int size;
        private ArrayList<Integer> data;
        private Semaphore full;
        private Semaphore empty;
        public Buffer(int size){
            this.size=size;
            this.data = new ArrayList<Integer>();
            this.full = new Semaphore(this.size);
            this.empty = new Semaphore(0);
        }
        public void add(int value){
            try {
                full.acquire();
            } catch (InterruptedException e) {
                e.printStackTrace();
            }
            synchronized (this) {
                data.add(value);
                empty.release();
            }
        }
        public Integer get(){
            try {
                empty.acquire();
            } catch (InterruptedException e) {
                e.printStackTrace();
            }
            synchronized(this){
                Integer value = data.get(data.size()-1);
                data.remove(data.size()-1);
                full.release();
                return value;
            }
        }
    }

} ;

public static void main(String[] args) throws InterruptedException {

```

```

Buffer b = new Buffer(10);
int producer_num = 2;
int consumer_num = 2;
ArrayList<Thread> a = new ArrayList<Thread>();
for(int i = 0; i< producer_num; i++){
    a.add(new Thread()->{
        for(int j = 0; j<20; j++) {
            int value = new Random().nextInt(100);
            b.add(value);
            System.out.printf("producer_%d_add_%d\n",
                Thread.currentThread().getId(), value);
        }
    });
}
for(int i = 0; i< consumer_num; i++) {
    a.add(new Thread()-> {
        for (int j = 0; j < 20; j++) {
            Integer value = new Integer(b.get());
            System.out.printf("consumer_%d_get_%d\n",
                Thread.currentThread().getId(), value);
        }
    });
}
for(Thread i: a) i.start();
for(Thread i: a) i.join();
}
}

```

7.3 Python

7.3.1 Meta Class

A metaclass is a class whose instances are classes. Like an "ordinary" class defines the behavior of the instances of the class, a metaclass defines the behavior of classes and their instances.

You can think of metaclass as a dispatcher when creating a new class in Python. New class will have customize attributes after metaclass's operation.

type will provide a mapping from text code to real class type that we defined,

In python, default meta class is type.

```

class LittleMeta(type):
    def __new__(cls, clsname, superclasses, attributedict):
        print "LittleMeta.__new__ called"
        # return a instance of LittleMeta, which is A
        return type.__new__(cls, clsname, superclasses, attributedict)

```

```

def __call__(cls, *args, **kwargs):
    # pass class A in here as a argument
    print('MetaFoo: {c},{a},{k}'.format(c=cls, a=args, k=kwargs))

    # invoke normal A initailize process
    return super(LittleMeta, cls).__call__(*args, **kwargs)

```

```

class S(object):
    pass

```

```

class A(S):
    __metaclass__ = LittleMeta

    def __new__(cls):
        print "A.__new__ called"
        return super(A, cls).__new__(cls)
    pass

```

```

a = A()
print a

```

you will get

```

clsname: A
superclasses: (<class '__main__.S'>,)
attributedict: {'__module__': '__main__', '__qualname__': 'A'}

```

The singleton in python can be done by

```

class Singleton(type):
    _instances = {}
    def __call__(cls, *args, **kwargs):
        if cls not in cls._instances:
            cls._instances[cls] = super(Singleton, cls).__call__(*args, **kwargs)
        return cls._instances[cls]

```

7.3.2 __new__ vs __init__

`__new__(cls)` method in python is for creating object, which is called before the `__init__`. `__new__` is supposed to return a obj of current class if you want to let `__init__` get called.

```

class A(object):

    def __new__(cls):
        print "A.__new__ called"

```

```

    def __init__(self):
        print "A.__init__ called" # -> is actually never called

print A()

```

If we change a bit, then both method would get called

```

class A(object):

    def __new__(cls):
        print "A.__new__ called"
        obj = super(A, cls).__new__(cls)
        return obj

    def __init__(self):
        print "A.__init__ called" # -> is actually never called

print A()

```

7.3.3 Abstract Class In Python

Now we understand why when we create abstract base class in Python, we need do the following

```

from ABC import ABCMeta

class abstract(object):
    # ABCMeta here has changed the default behavior of string->class
    # mapping So you cannot create a instance of abstract, since it
    # will raise error at the above step
    __metaclass__ = ABCMeta

    @abstractmethod
    def foo(self)

```

7.3.4 Dataframe Data-structure

1. pandas.DataFrame is a column major data structure, each column is a pd.Series (act as a dictionary plus ndarray).
2. DataFrame frame will group all same type data into a block, int, float, datetime64 ... etc
3. string does not have representation in numpy so in pandas, it is a pointer point to other places, which is very slow

4. use `category` dtype can solve most of string issue properly

7.4 MongoDB

MongoDB has three layers:

1. Database (equivalent to schema)
2. Collection (equivalent to table)
3. Document (equivalent to row, in json format)

Here are some useful command for mongodb

```
db.createCollection("mycol", { capped : true, autoIndexId : true, size :
    6142800, max : 10000 } )

db.tutorialspoint.insert({"name" : "tutorialspoint"})

db.mycol.find({}, {"title":1, _id:0})

db.COLLECTION_NAME.find().sort({KEY:1})

db.COLLECTION_NAME.ensureIndex({KEY:1})

db.mycol.aggregate([{$group : {_id : "$by_user", num_tutorial : {$sum : 1}}}] )
```

MongoDB has easy to config sharding, create backup, map reduce interfaces.

8 Coding Design

8.1 SOLID Principles

Solid principles are the most basic principles in system design

8.1.1 Single Responsible principle

Suppose you are going to design two classes, *rectangle* and *triangle*.

```
class shape{
private:
    int width;
    int height;
};

class rectangle: shape {
};

class triangle: shape{
};
```

Then you want to have a factory function to calculate the size. The function itself should only return the size. But you are not satisfied with it, you want to return an object with other functions.

```
struct summary{
    int size;
    string format;
    string to_string(){
        if(format == ".2d")
            return ....
    }
};

struct getSize(const shape* s, const string& format){
}
```

However, this is not a good design since it violate the single responsibility principle. Since now `getSize` is not only calculate the size, but also in charge of formatting the output. Which add extra interconnection and logic to the code. So we need to refactor the code into following

```
struct summary{
    int size;
    string format;
    string to_string(){
```

```

        if(format == ".2d")
            return ....
    }
};

summary getFormatObject(int size, const string& format){
}

struct getSize(const shape* s){
}

```

The single responsible principle tell us to write a function only for a single purpose. Do not control to many things.

8.1.2 Open/Close principle

Inside the get size function, a short cut. We can write the function with bunch of if-else:

```

struct getSize(const shape* s){

    // dynamic_cast here can check the actual type safely
    // at the run time

    if ( dynamic_cast<rectangle*>( s ) )
        // do something

    else if ( dynamic_cast<triangle*>( s ) )
        // do something else
    }
}

```

The function above is not a good way of code because it violate the open/close principle. If you have another class circle, then you will have to **modify** the function method. **open** in the principle means open for extension (add more method) while **close** here means close for modification of the old method.

```

class circle: shape {

};

int getSize(const shape* s){

    if ( dynamic_cast<rectangle*>( s ) ){
    }
    else if ( dynamic_cast<triangle*>( s ) )
    }
    else if ( dynamic_cast<circle*>( s ) )
    }
}

```

```

        // modify the getSize every time you add new class features
    }
}

```

Correct way of coding is add getSize method as a virtual member function of base and derived class

```

class shape{
private:
    int width;
    int height;
public:
    virtual int getSize() const;
};

class rectangle: shape {
    int getSize() const{
    }
};

class triangle: shape {
    int getSize() const{
    }
};

class circle: shape {
    int getSize() const{
    }
};

int getSize(const shape* s){
    return s->getSize();
}

```

Then every method is closed. If we want to have new class, no existing code subsection will be modified.

8.1.3 Liskov Substitution principle

Liskov substitution principle is about how to design base and child to be inter-changeable. The famous eclipse-circle problem is

```

class eclipse{
private:
    float a;
    float b;
}

```



```

public:
    eclipse(float a, float b): a(a), b(b){}
}

class circle: eclipse{
public:
    circle(float r): eclipse(r, r){}
private:
}

```

Some people would say it is a good design. But, to Liskov principle tell us that the child class must provide everything that parent class method. Think about if our eclipse class have a method **stretch**

```

class eclipse{
private:
    float a;
    float b;
public:
    eclipse(float a, float b): a(a), b(b){}
    stretch(float a, float b){this->a = a; this->b = b;}
}

```

Then our circle must have this method too. However, circle cannot have this method. So here are two possible solutions:

- throw exception or return failure value in circle stretch method
- redefine the data model, add another common base class "shape" to both of it. Now circle vs eclipse is D vs D (Derived vs Derived)

8.1.4 Interface Segregation Principle

In a short word, base interface should not have too much functions, which means the derived class should never be forced to have the method it does not use.

```

class shape{
private:
    int width;
    int height;
public:
    virtual int getSize() const;
    virtual int getVolume
};

class rectangle: shape {
/*
    rectangle here is forced to implement a getVolume.

```

```

    */
        int getSize() const{
        }
};

```

```

class cubic: shape {
    int getVolume const{
    }
};

```

A good solution is bifurcate the original shape interface into two parallel sub interface class. Then we segregate methods that have conflict.

```

class BaseShape{
private:
    int width;
    int height;
};

class FlatShape: BaseShape{
/*
    segregate the getVolume and getSize into two branch
*/
    virtual int getSize const(){
    }
}

class SolidShape: BaseShape{
    virtual int getVolume const(){
    }
}

class rectangle: FlatShape {
    int getSize() const{
    }
};

class cubic: SolidShape {
    int getVolume const{
    }
};

```

8.1.5 Dependency Inversion Principle

This is the easiest of five. The higher level function should only rely on the lower level abstractions but not the detailed implementation. The bridge pattern, abstract factory

pattern are good example. Here the high-level user paint depend on the abstraction of different Painter, no matter how painter is changed. The rectangle can always get the updated result.

Adding abstraction dependency is called dependency injection.

```
class Painter:{
public:
    virtual void paint(){}
};

class FancyPainter: Painter{
public:
    void paint(){
        // fancy painting
    }
};

class rectangle: shape{

    // high level user rectangle only need to know we have a member
    // which is in charge of paint. That's it, no more info that high-level
    // user need to know.

public:
    rectangle(float x, float y, Painter * pt): width(x), width(y), pt(pt){
        // add Painter* here is actually called dependency injection
    }

    void paint(){
        pt.paint();
    }
private:
    Painter pt;
};
```