

UNIVERSITY OF TEXAS AT AUSTIN

HW Assignment 4

Prerequisite material. Log-normal stock prices. Jensen's inequality.

Provide your **complete solution** to the following problems:

Problem 4.1. (10 points) A continuous-dividend-paying stock is valued at \$75.00 per share. Its dividend yield is 0.03. The time- t realized (rate of) return is modeled as

$$R(0, t) \sim N(\text{mean} = 0.035t, \text{variance} = 0.09t)$$

An investor purchases a single share of stock at time-0 and continuously (and immediately) reinvests any dividends received in the same asset. What are the mean and median values of the investor's position at time-4?

Problem 4.2. (10 points) A continuous-dividend-paying stock is valued at \$75.00 per share. Its dividend yield is 0.03. The time- t realized return is modeled as

$$R(0, t) \sim N(\text{mean} = 0.035t, \text{variance} = 0.09t)$$

Find the probability that the time-4 stock price exceeds today's stock price.

Problem 4.3. (10 points) A non-dividend-paying stock is valued at \$75.00 per share. The annual expected (rate of) return is 16.0% and the standard deviation of annualized returns is given to be 0.30. If the stock price is modeled using the lognormal distribution (as discussed in class), what is the constant $s_{1/2}^U$ such that

$$\mathbb{P}[S(1/2) > s_{1/2}^U] \leq 0.05.$$

Provide your *final answer only* for the following problems:

Problem 4.4. (2 points) A time- T exchange call with underlying \mathbf{S} and strike asset \mathbf{Q} is always worth strictly more than an exchange put option with underlying \mathbf{Q} and strike asset \mathbf{S} . *True or false?*

Problem 4.5. (2 points) A bear spread is a long position with respect to the underlying asset. *True or false?*

Problem 4.6. (2 points) If the random variable X has the distribution function F_X , then the distribution function of the random variable $Y = |X|$ equals

$$F_Y(y) = 2F_X(y).$$

True or false?

Problem 4.7. (2 points) Let X_1, \dots, X_n be random variables with finite expectations and let $\alpha_1, \dots, \alpha_n$ be constants. Then, we always have that

$$\mathbb{E}[\alpha_1 X_1 + \dots + \alpha_n X_n] = \sum_{i=1}^n \alpha_i \mathbb{E}[X_i].$$

True or false?

Problem 4.8. (2 points) Let the stock price be modeled by a lognormal distribution. Then, the expected payoff of a European put option with exercise date T and strike K greater than or equal to $\max(0, K - \mathbb{E}[S(T)])$. *True or false?*

Problem 4.9. (5 points) The random vector (X_1, X_2) is jointly normal. Its marginal distributions are:

$$X_1 \sim N(\text{mean} = 0, \text{variance} = 4), \quad X_2 \sim N(\text{mean} = 1, \text{variance} = 1).$$

The correlation coefficient is given to be

$$\text{corr}[X_1, X_2] = -0.2.$$

What is the variance of the random variable $X = 3X_1 - 2X_2$?

- (a) 32.8
- (b) 47.2
- (c) 54.4
- (d) 58.2
- (e) None of the above.

Problem 4.10. (5 points) Let the stochastic process $S = \{S(t); t \geq 0\}$ denote the stock price. The stock's rate of appreciation is 10% while its volatility is 0.30. Then,

- (a) $\text{Var}[\ln(S(t))] = 0.3t$
- (b) $\text{Var}[\ln(S(t))] = 0.09t^2$
- (c) $\text{Var}[\ln(S(t))] = 0.09t$
- (d) $\text{Var}[\ln(S(t))] = 0.09$
- (e) None of the above.