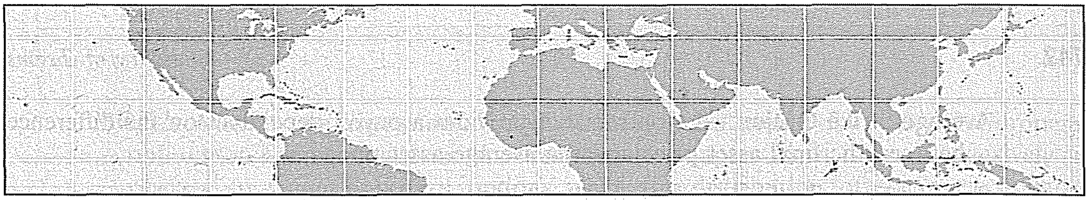

Glossary of Terms

Accrual Swap An interest rate swap where interest on one side accrues only when a certain condition is met.

Accrued Interest The interest earned on a bond since the last coupon payment date.

Adaptive Mesh Model A model developed by Figlewski and Gao that grafts a high-resolution tree on to a low-resolution tree so that there is more detailed modeling of the asset price in critical regions.

American Option An option that can be exercised at any time during its life.

Amortizing Swap A swap where the notional principal decreases in a predetermined way as time passes.

Analytic Result Result where answer is in the form of an equation.

Arbitrage A trading strategy that takes advantage of two or more securities being mispriced relative to each other.

Arbitrageur An individual engaging in arbitrage.

Asian Option An option with a payoff dependent on the average price of the underlying asset during a specified period.

Ask Price The price that a dealer is offering to sell an asset.

Asked Price *See* Ask Price.

Asset-or-Nothing Call Option An option that provides a payoff equal to the asset price if the asset price is above the strike price and zero otherwise.

Asset-or-Nothing Put Option An option that provides a payoff equal to the asset price if the asset price is below the strike price and zero otherwise.

Asset Swap Exchanges the coupon on a bond for LIBOR plus a spread.

As-You-Like-It Option *See* Chooser Option.

At-the-Money Option An option in which the strike price equals the price of the underlying asset.

Average Price Call Option An option giving a payoff equal to the greater of zero and the amount by which the average price of the asset exceeds the strike price.

Average Price Put Option An option giving a payoff equal to the greater of zero and the amount by which the strike price exceeds the average price of the asset.

Average Strike Option An option that provides a payoff dependent on the difference between the final asset price and the average asset price.

Back Testing Testing a value-at-risk or other model using historical data.

Backwards Induction A procedure for working from the end of a tree to its beginning in order to value an option.

Barrier Option An option whose payoff depends on whether the path of the underlying asset has reached a barrier (i.e., a certain predetermined level).

Basel II New international regulations for calculating bank capital expected to come into effect in about 2007.

Basis The difference between the spot price and the futures price of a commodity.

Basis Point When used to describe an interest rate, a basis point is one hundredth of one percent (= 0.01%)

Basis Risk The risk to a hedger arising from uncertainty about the basis at a future time.

Basis Swap A swap where cash flows determined by one floating reference rate are exchanged for cash flows determined by another floating reference rate.

Basket Credit Default Swap Credit default swap where there are several reference entities.

Basket Option An option that provides a payoff dependent on the value of a portfolio of assets.

Bear Spread A short position in a put option with strike price K_1 combined with a long position in a put option with strike price K_2 where $K_2 > K_1$. (A bear spread can also be created with call options.)

Bermudan Option An option that can be exercised on specified dates during its life.

Beta A measure of the systematic risk of an asset.

Bid–Ask Spread The amount by which the ask price exceeds the bid price.

Bid–Offer Spread *See* Bid–Ask Spread.

Bid Price The price that a dealer is prepared to pay for an asset.

Binary Credit Default Swap Instrument where there is a fixed dollar payoff in the event of a default by a particular company.

Binary Option Option with a discontinuous payoff, e.g., a cash-or-nothing option or an asset-or-nothing option.

Binomial Model A model where the price of an asset is monitored over successive short periods of time. In each short period it is assumed that only two price movements are possible.

Binomial Tree A tree that represents how an asset price can evolve under the binomial model.

Bivariate Normal Distribution A distribution for two correlated variables, each of which is normal.

Black's Approximation An approximate procedure developed by Fischer Black for valuing a call option on a dividend-paying stock.

Black's Model An extension of the Black–Scholes model for valuing European options on futures contracts. As described in Chapter 26, it is used extensively in practice to value European options when the distribution of the asset price at maturity is assumed to be lognormal.

Black–Scholes Model A model for pricing European options on stocks, developed by Fischer Black, Myron Scholes, and Robert Merton.

Board Broker The individual who handles limit orders in some exchanges. The board broker makes information on outstanding limit orders available to other traders.

Bond Option An option where a bond is the underlying asset.

Bond Yield Discount rate which, when applied to all the cash flows of a bond, causes the present value of the cash flows to equal the bond's market price.

Bootstrap Method A procedure for calculating the zero-coupon yield curve from market data.

Boston Option *See* Deferred Payment Option.

Box Spread A combination of a bull spread created from calls and a bear spread created from puts.

Break Forward *See* Deferred Payment Option.

Brownian Motion *See* Wiener Process.

Bull Spread A long position in a call with strike price K_1 combined with a short position in a call with strike price K_2, where $K_2 > K_1$. (A bull spread can also be created with put options.)

Butterfly Spread A position that is created by taking a long position in a call with strike price K_1, a long position in a call with strike price K_3, and a short position in two calls with strike price K_2, where $K_3 > K_2 > K_1$ and $K_2 = 0.5(K_1 + K_3)$. (A butterfly spread can also be created with put options.)

Calendar Spread A position that is created by taking a long position in a call option that matures at one time and a short position in a similar call option that matures at a different time. (A calendar spread can also be created using put options.)

Calibration Method for implying a model's parameters from the prices of actively traded options.

Callable Bond A bond containing provisions that allow the issuer to buy it back at a predetermined price at certain times during its life.

Call Option An option to buy an asset at a certain price by a certain date.

Cancelable Swap Swap that can be canceled by one side on prespecified dates.

Cap *See* Interest Rate Cap.

Cap Rate The rate determining payoffs in an interest rate cap.

Capital Asset Pricing Model A model relating the expected return on an asset to its beta.

Caplet One component of an interest rate cap.

Cash Flow Mapping A procedure for representing an instrument as a portfolio of zero-coupon bonds for the purpose of calculating value at risk.

Cash-or-Nothing Call Option An option that provides a fixed predetermined payoff if the final asset price is above the strike price and zero otherwise.

Cash-or-Nothing Put Option An option that provides a fixed predetermined payoff if the final asset price is below the strike price and zero otherwise.

Cash Settlement Procedure for settling a futures contract in cash rather than by delivering the underlying asset.

CAT Bond Bond where the interest and, possibly, the principal paid are reduced if a particular category of "catastrophic" insurance claims exceed a certain amount.

CDD Cooling degree days. The maximum of zero and the amount by which the daily average temperature is greater than 65° Fahrenheit. The average temperature is the average of the highest and lowest temperatures (midnight to midnight).

CDO *See* Collateralized Debt Obligation.

CDO Squared An instrument in which the default risks in a portfolio of CDO tranches are allocated to new securities.

Cheapest-to-Deliver Bond The bond that is cheapest to deliver in the Chicago Board of Trade bond futures contract.

Cholesky Decomposition A method of sampling from a multivariate normal distribution.

Chooser Option An option where the holder has the right to choose whether it is a call or a put at some point during its life.

Class of Options *See* Option Class.

Clean Price of Bond The quoted price of a bond. The cash price paid for the bond (or dirty price) is calculated by adding the accrued interest to the clean price.

Clearinghouse A firm that guarantees the performance of the parties in an exchange-traded derivatives transaction (also referred to as a clearing corporation).

Clearing Margin A margin posted by a member of a clearinghouse.

CMO Collateralized Mortgage Obligation.

Collar *See* Interest Rate Collar.

Collateralization A system for posting collateral by one or both parties in a derivatives transaction.

Collateralized Debt Obligation A way of packaging credit risk. Several classes of securities (known as tranches) are created from a portfolio of bonds and there are rules for determining how the cost of defaults are allocated to classes.

Collateralized Mortgage Obligation (CMO) A mortgage-backed security where investors are divided into classes and there are rules for determining how principal repayments are channeled to the classes.

Combination A position involving both calls and puts on the same underlying asset.

Commission Brokers Individuals who execute trades for other people and charge a commission for doing so.

Commodity Futures Trading Commission A body that regulates trading in futures contracts in the United States.

Commodity Swap A swap where cash flows depend on the price of a commodity.

Compound Option An option on an option.

Compounding Frequency This defines how an interest rate is measured.

Compounding Swap Swap where interest compounds instead of being paid.

Conditional Value at Risk (C-VaR) Expected loss during N days conditional on being in the $(100 - X)\%$ tail of the distribution of profits/losses. The variable N is the time horizon and $X\%$ is the confidence level.

Confirmation Contract confirming verbal agreement between two parties to a trade in the over-the-counter market.

Constant Elasticity of Variance (CEV) Model Model where the variance of the change in a variable in a short period of time is proportional to the value of the variable.

Constant Maturity Swap A swap where a swap rate is exchanged for either a fixed rate or a floating rate on each payment date.

Constant Maturity Treasury Swap A swap where the yield on a Treasury bond is exchanged for either a fixed rate or a floating rate on each payment date.

Consumption Asset An asset held for consumption rather than investment.

Contango A situation where the futures price is above the expected future spot price.

Continuous Compounding A way of quoting interest rates. It is the limit as the assumed compounding interval is made smaller and smaller.

Control Variate Technique A technique that can sometimes be used for improving the accuracy of a numerical procedure.

Convenience Yield A measure of the benefits from ownership of an asset that are not obtained by the holder of a long futures contract on the asset.

Conversion Factor A factor used to determine the number of bonds that must be delivered in the Chicago Board of Trade bond futures contract.

Convertible Bond A corporate bond that can be converted into a predetermined amount of the company's equity at certain times during its life.

Convexity A measure of the curvature in the relationship between bond prices and bond yields.

Convexity Adjustment An overworked term. For example, it can refer to the adjustment necessary to convert a futures interest rate to a forward interest rate. It can also refer to the adjustment to a forward rate that is sometimes necessary when Black's model is used.

Copula A way of defining the correlation between variables with known distributions.

Cornish–Fisher Expansion An approximate relationship between the fractiles of a probability distribution and its moments.

Cost of Carry The storage costs plus the cost of financing an asset minus the income earned on the asset.

Counterparty The opposite side in a financial transaction.

Coupon Interest payment made on a bond.

Covariance Measure of the linear relationship between two variables (equals the correlation between the variables times the product of their standard deviations).

Covered Call A short position in a call option on an asset combined with a long position in the asset.

Credit Default Swap An instrument that gives the holder the right to sell a bond for its face value in the event of a default by the issuer.

Credit Derivative A derivative whose payoff depends on the creditworthiness of one or more companies or countries.

Credit Rating A measure of the creditworthiness of a bond issue.

Credit Ratings Transition Matrix A table showing the probability that a company will move from one credit rating to another during a certain period of time.

Credit Risk The risk that a loss will be experienced because of a default by the counterparty in a derivatives transaction.

Credit Spread Option Option whose payoff depends on the spread between the yields earned on two assets.

Credit Value at Risk The credit loss that will not be exceeded at some specified confidence level.

CreditMetrics A procedure for calculating credit value at risk.

Cross Hedging Hedging an exposure to the price of one asset with a contract on another asset.

Cumulative Distribution Function The probability that a variable will be less than x as a function of x.

Currency Swap A swap where interest and principal in one currency are exchanged for interest and principal in another currency.

Day Count A convention for quoting interest rates.

Day Trade A trade that is entered into and closed out on the same day.

Default Correlation Measures the tendency of two companies to default at about the same time.

Default Intensity *See* Hazard Rate.

Default Probability Density Measures the unconditional probability of default in a future short period of time.

Deferred Payment Option An option where the price paid is deferred until the end of the option's life.

Deferred Swap An agreement to enter into a swap at some time in the future (also called a forward swap).

Delivery Price Price agreed to (possibly some time in the past) in a forward contract.

Delta The rate of change of the price of a derivative with the price of the underlying asset.

Delta Hedging A hedging scheme that is designed to make the price of a portfolio of derivatives insensitive to small changes in the price of the underlying asset.

Delta-Neutral Portfolio A portfolio with a delta of zero so that there is no sensitivity to small changes in the price of the underlying asset.

DerivaGem The software accompanying this book.

Derivative An instrument whose price depends on, or is derived from, the price of another asset.

Deterministic Variable A variable whose future value is known.

Diagonal Spread A position in two calls where both the strike prices and times to maturity are different. (A diagonal spread can also be created with put options.)

Differential Swap A swap where a floating rate in one currency is exchanged for a floating rate in another currency and both rates are applied to the same principal.

Diffusion Process Model where value of asset changes continuously (no jumps).

Dirty Price of Bond Cash price of bond.

Discount Bond *See* Zero-Coupon Bond.

Discount Instrument An instrument, such as a Treasury bill, that provides no coupons.

Discount Rate The annualized dollar return on a Treasury bill or similar instrument expressed as a percentage of the final face value.

Dividend A cash payment made to the owner of a stock.

Dividend Yield The dividend as a percentage of the stock price.

Down-and-In Option An option that comes into existence when the price of the underlying asset declines to a prespecified level.

Down-and-Out Option An option that ceases to exist when the price of the underlying asset declines to a prespecified level.

Downgrade Trigger A clause in a contract that states that the contract will be terminated with a cash settlement if the credit rating of one side falls below a certain level.

Drift Rate The average increase per unit of time in a stochastic variable.

Duration A measure of the average life a bond. It is also an approximation to the ratio of the proportional change in the bond price to the absolute change in its yield.

Duration Matching A procedure for matching the durations of assets and liabilities in a financial institution.

Dynamic Hedging A procedure for hedging an option position by periodically changing the position held in the underlying asset. The objective is usually to maintain a delta-neutral position.

Early Exercise Exercise prior to the maturity date.

Efficient Market Hypothesis A hypothesis that asset prices reflect relevant information.

Electronic Trading System of trading where a computer is used to match buyers and sellers.

Embedded Option An option that is an inseparable part of another instrument.

Empirical Research Research based on historical market data.

Equilibrium Model A model for the behavior of interest rates derived from a model of the economy.

Equity Swap A swap where the return on an equity portfolio is exchanged for either a fixed or a floating rate of interest.

Eurocurrency A currency that is outside the formal control of the issuing country's monetary authorities.

Eurodollar A dollar held in a bank outside the United States.

Eurodollar Futures Contract A futures contract written on a Eurodollar deposit.

Eurodollar Interest Rate The interest rate on a Eurodollar deposit.

European Option An option that can be exercised only at the end of its life.

EWMA Exponentially weighted moving average.

Exchange Option An option to exchange one asset for another.

Ex-dividend Date When a dividend is declared, an ex-dividend date is specified. Investors who own shares of the stock just before the ex-dividend date receive the dividend.

Executive Stock Option A stock option issued by company on its own stock and given to its executives as part of their remuneration.

Exercise Limit Maximum number of option contracts that can be exercised within a five-day period.

Exercise Price The price at which the underlying asset may be bought or sold in an option contract (also called the strike price).

Exotic Option A nonstandard option.

Expectations Theory The theory that forward interest rates equal expected future spot interest rates.

Expected Shortfall *See* Conditional Value at Risk.

Expected Value of a Variable The average value of the variable obtained by weighting the alternative values by their probabilities.

Expiration Date The end of life of a contract.

Explicit Finite Difference Method A method for valuing a derivative by solving the underlying differential equation. The value of the derivative at time t is related to three values at time $t + \Delta t$. It is essentially the same as the trinomial tree method.

Exponentially Weighted Moving Average Model A model where exponential weighting is used to provide forecasts for a variable from historical data. It is sometimes applied to variances and covariances in value at risk calculations.

Exponential Weighting A weighting scheme where the weight given to an observation depends on how recent it is. The weight given to an observation i time periods ago is λ times the weight given to an observation $i - 1$ time periods ago where $\lambda < 1$.

Exposure The maximum loss from default by a counterparty.

Extendable Bond A bond whose life can be extended at the option of the holder.

Extendable Swap A swap whose life can be extended at the option of one side to the contract.

Factor Source of uncertainty.

Factor analysis An analysis aimed at finding a small number of factors that describe most of the variation in a large number of correlated variables (similar to a principal components analysis).

FASB Financial Accounting Standards Board.

Financial Intermediary A bank or other financial institution that facilitates the flow of funds between different entities in the economy.

Finite Difference Method A method for solving a differential equation.

Flat Volatility The name given to volatility used to price a cap when the same volatility is used for each caplet.

Flex Option An option traded on an exchange with terms that are different from the standard options traded by the exchange.

Flexi Cap Interest rate cap where there is a limit on the total number of caplets that can be exercised.

Floor *See* Interest Rate Floor.

Floor–Ceiling Agreement *See* Collar.

Floorlet One component of a floor.

Floor Rate The rate in an interest rate floor agreement.

Foreign Currency Option An option on a foreign exchange rate.

Forward Contract A contract that obligates the holder to buy or sell an asset for a predetermined delivery price at a predetermined future time.

Forward Exchange Rate The forward price of one unit of a foreign currency.

Forward Interest Rate The interest rate for a future period of time implied by the rates prevailing in the market today.

Forward Price The delivery price in a forward contract that causes the contract to be worth zero.

Forward Rate Rate of interest for a period of time in the future implied by today's zero rates.

Forward Rate Agreement (FRA) Agreement that a certain interest rate will apply to a certain principal amount for a certain time period in the future.

Forward Risk-Neutral World A world is forward risk-neutral with respect to a certain asset when the market price of risk equals the volatility of that asset.

Forward Start Option An option designed so that it will be at-the-money at some time in the future.

Forward Swap *See* Deferred Swap.

Futures Contract A contract that obligates the holder to buy or sell an asset at a predetermined delivery price during a specified future time period. The contract is settled daily.

Futures Option An option on a futures contract.

Futures Price The delivery price currently applicable to a futures contract.

Gamma The rate of change of delta with respect to the asset price.

Gamma-Neutral Portfolio A portfolio with a gamma of zero.

GARCH Model A model for forecasting volatility where the variance rate follows a mean-reverting process.

Generalized Wiener Process A stochastic process where the change in a variable in time t has a normal distribution with mean and variance both proportional to t.

Geometric Average The nth root of the product of n numbers.

Geometric Brownian Motion A stochastic process often assumed for asset prices where the logarithm of the underlying variable follows a generalized Wiener process.

Greeks Hedge parameters such as delta, gamma, vega, theta, and rho.

Haircut Discount applied to the value of an asset for collateral purposes.

Hazard Rate Measures probability of default in a short period of time conditional on no earlier default.

HDD Heating degree days. The maximum of zero and the amount by which the daily average temperature is less than 65° Fahrenheit. The average temperature is the average of the highest and lowest temperatures (midnight to midnight).

Hedge A trade designed to reduce risk.

Hedger An individual who enters into hedging trades.

Hedge Ratio The ratio of the size of a position in a hedging instrument to the size of the position being hedged.

Historical Simulation A simulation based on historical data.

Historic Volatility A volatility estimated from historical data.

Holiday Calendar Calendar defining which days are holidays for the purposes of determining payment dates in a swap.

Implicit Finite Difference Method A method for valuing a derivative by solving the underlying differential equation. The value of the derivative at time $t + \Delta t$ is related to three values at time t.

Implied Distribution A distribution for a future asset price implied from option prices.

Implied Tree A tree describing the movements of an asset price that is constructed to be consistent with observed option prices.

Implied Volatility Volatility implied from an option price using the Black–Scholes or a similar model.

Implied Volatility Function (IVF) Model Model designed so that it matches the market prices of all European options.

Inception Profit Profit created by selling a derivative for more than its theoretical value.

Index Amortizing Swap See indexed principal swap.

Index Arbitrage An arbitrage involving a position in the stocks comprising a stock index and a position in a futures contract on the stock index.

Index Futures A futures contract on a stock index or other index.

Index Option An option contract on a stock index or other index.

Indexed Principal Swap A swap where the principal declines over time. The reduction in the principal on a payment date depends on the level of interest rates.

Initial Margin The cash required from a futures trader at the time of the trade.

Instantaneous Forward Rate Forward rate for a very short period of time in the future.

Interest Rate Cap An option that provides a payoff when a specified interest rate is above a certain level. The interest rate is a floating rate that is reset periodically.

Interest Rate Collar A combination of an interest-rate cap and an interest rate floor.

Interest Rate Derivative A derivative whose payoffs are dependent on future interest rates.

Interest Rate Floor An option that provides a payoff when an interest rate is below a certain level. The interest rate is a floating rate that is reset periodically.

Interest Rate Option An option where the payoff is dependent on the level of interest rates.

Interest Rate Swap An exchange of a fixed rate of interest on a certain notional principal for a floating rate of interest on the same notional principal.

In-the-Money Option Either (a) a call option where the asset price is greater than the strike price or (b) a put option where the asset price is less than the strike price.

Intrinsic Value For a call option, this is the greater of the excess of the asset price over the strike price and zero. For a put option, it is the greater of the excess of the strike price over the asset price and zero.

Inverted Market A market where futures prices decrease with maturity.

Investment Asset An asset held by at least some individuals for investment purposes.

IO Interest Only. A mortgage-backed security where the holder receives only interest cash flows on the underlying mortgage pool.

Itô Process A stochastic process where the change in a variable during each short period of time of length Δt has a normal distribution. The mean and variance of the distribution are proportional to Δt and are not necessarily constant.

Itô's Lemma A result that enables the stochastic process for a function of a variable to be calculated from the stochastic process for the variable itself.

Kurtosis A measure of the fatness of the tails of a distribution.

Jump–Diffusion Model Model where asset price has jumps superimposed on to a diffusion process such as geometric Brownian motion.

LEAPS Long-term equity anticipation securities. These are relatively long-term options on individual stocks or stock indices.

LIBID London interbank bid rate. The rate bid by banks on Eurocurrency deposits (i.e., the rate at which a bank is willing to borrow from other banks).

LIBOR London interbank offer rate. The rate offered by banks on Eurocurrency deposits (i.e., the rate at which a bank is willing to lend to other banks).

LIBOR Curve LIBOR zero-coupon interest rates as a function of maturity.

LIBOR-in-Arrears Swap Swap where the interest paid on a date is determined by the interest rate observed on that date (not by the interest rate observed on the previous payment date).

Limit Move The maximum price move permitted by the exchange in a single trading session.

Limit Order An order that can be executed only at a specified price or one more favorable to the investor.

Liquidity Preference Theory A theory leading to the conclusion that forward interest rates are above expected future spot interest rates.

Liquidity Premium The amount that forward interest rates exceed expected future spot interest rates.

Liquidity Risk Risk that it will not be possible to sell a holding of a particular instrument at its theoretical price.

Locals Individuals on the floor of an exchange who trade for their own account rather than for someone else.

Lognormal Distribution A variable has a lognormal distribution when the logarithm of the variable has a normal distribution.

Long Hedge A hedge involving a long futures position.

Long Position A position involving the purchase of an asset.

Lookback Option An option whose payoff is dependent on the maximum or minimum of the asset price achieved during a certain period.

Low Discrepancy Sequence *See* Quasi-random Sequence.

Maintenance Margin When the balance in a trader's margin account falls below the maintenance margin level, the trader receives a margin call requiring the account to be topped up to the initial margin level.

Margin The cash balance (or security deposit) required from a futures or options trader.

Margin Call A request for extra margin when the balance in the margin account falls below the maintenance margin level.

Market Maker A trader who is willing to quote both bid and offer prices for an asset.

Market Model A model most commonly used by traders.

Market Price of Risk A measure of the trade-offs investors make between risk and return.

Market Segmentation Theory A theory that short interest rates are determined independently of long interest rates by the market.

Marking to Market The practice of revaluing an instrument to reflect the current values of the relevant market variables.

Markov Process A stochastic process where the behavior of the variable over a short period of time depends solely on the value of the variable at the beginning of the period, not on its past history.

Martingale A zero drift stochastic process.

Maturity Date The end of the life of a contract.

Maximum Likelihood Method A method for choosing the values of parameters by maximizing the probability of a set of observations occurring.

Mean Reversion The tendency of a market variable (such as an interest rate) to revert back to some long-run average level.

Measure Sometimes also called a probability measure, it defines the market price of risk.

Modified Duration A modification to the standard duration measure so that it more accurately describes the relationship between proportional changes in a bond price and actual changes in its yield. The modification takes account of the compounding frequency with which the yield is quoted.

Money Market Account An investment that is initially equal to $1 and, at time t, increases at the very short-term risk-free interest rate prevailing at that time.

Monte Carlo Simulation A procedure for randomly sampling changes in market variables in order to value a derivative.

Mortgage-Backed Security A security that entitles the owner to a share in the cash flows realized from a pool of mortgages.

Naked Position A short position in a call option that is not combined with a long position in the underlying asset.

Netting The ability to offset contracts with positive and negative values in the event of a default by a counterparty.

Newton–Raphson Method An iterative procedure for solving nonlinear equations.

No-Arbitrage Assumption The assumption that there are no arbitrage opportunities in market prices.

No-Arbitrage Interest Rate Model A model for the behavior of interest rates that is exactly consistent with the initial term structure of interest rates.

Nonstationary Model A model where the volatility parameters are a function of time.

Nonsystematic Risk Risk that can be diversified away.

Normal Backwardation A situation where the futures price is below the expected future spot price.

Normal Distribution The standard bell-shaped distribution of statistics.

Normal Market A market where futures prices increase with maturity.

Notional Principal The principal used to calculate payments in an interest rate swap. The principal is "notional" because it is neither paid nor received.

Numeraire Defines the units in which security prices are measured. For example, if the price of IBM is the numeraire, all security prices are measured relative to IBM. If IBM is $80 and a particular security price is $50, the security price is 0.625 when IBM is the numeraire.

Numerical Procedure A method of valuing an option when no formula is available.

OCC Options Clearing Corporation. *See* Clearinghouse.

Offer Price *See* Ask Price.

Open Interest The total number of long positions outstanding in a futures contract (equals the total number of short positions).

Open Outcry System of trading where traders meet on the floor of the exchange

Option The right to buy or sell an asset.

Option-Adjusted Spread The spread over the Treasury curve that makes the theoretical price of an interest rate derivative equal to the market price.

Option Class All options of the same type (call or put) on a particular stock.

Option Series All options of a certain class with the same strike price and expiration date.

Order Book Official *See* Board Broker.

Out-of-the-Money Option Either (a) a call option where the asset price is less than the strike price or (b) a put option where the asset price is greater than the strike price.

Over-the-Counter Market A market where traders deal by phone. The traders are usually financial institutions, corporations, and fund managers.

Package A derivative that is a portfolio of standard calls and puts, possibly combined with a position in forward contracts and the asset itself.

Par Value The principal amount of a bond.

Par Yield The coupon on a bond that makes its price equal the principal.

Parallel Shift A movement in the yield curve where each point on the curve changes by the same amount.

Path-Dependent Option An option whose payoff depends on the whole path followed by the underlying variable—not just its final value.

Payoff The cash realized by the holder of an option or other derivative at the end of its life.

Plain Vanilla A term used to describe a standard deal.

P-Measure Real-world measure.

PO Principal Only. A mortgage-backed security where the holder receives only principal cash flows on the underlying mortgage pool.

Poisson Process A process describing a situation where events happen at random. The probability of an event in time Δt is $\lambda \Delta t$, where λ is the intensity of the process.

Portfolio Immunization Making a portfolio relatively insensitive to interest rates.

Portfolio Insurance Entering into trades to ensure that the value of a portfolio will not fall below a certain level.

Position Limit The maximum position a trader (or group of traders acting together) is allowed to hold.

Premium The price of an option.

Prepayment function A function estimating the prepayment of principal on a portfolio of mortgages in terms of other variables.

Principal The par or face value of a debt instrument.

Principal Components Analysis An analysis aimed at finding a small number of factors that describe most of the variation in a large number of correlated variables (similar to a factor analysis).

Program Trading A procedure where trades are automatically generated by a computer and transmitted to the trading floor of an exchange.

Protective Put A put option combined with a long position in the underlying asset.

Pull-to-Par The reversion of a bond's price to its par value at maturity.

Put–Call Parity The relationship between the price of a European call option and the price of a European put option when they have the same strike price and maturity date.

Put Option An option to sell an asset for a certain price by a certain date.

Puttable Bond A bond where the holder has the right to sell it back to the issuer at certain predetermined times for a predetermined price.

Puttable Swap A swap where one side has the right to terminate early.

Q-Measure Risk-neutral measure.

Quanto A derivative where the payoff is defined by variables associated with one currency but is paid in another currency.

Quasi-random Sequences A sequences of numbers used in a Monte Carlo simulation that are representative of alternative outcomes rather than random.

Rainbow Option An option whose payoff is dependent on two or more underlying variables.

Range Forward Contract The combination of a long call and short put or the combination of a short call and long put.

Ratchet Cap Interest rate cap where the cap rate applicable to an accrual period equals the rate for the previous accrual period plus a spread.

Real Option Option involving real (as opposed to financial) assets. Real assets include land, plant, and machinery.

Rebalancing The process of adjusting a trading position periodically. Usually the purpose is to maintain delta neutrality.

Recovery Rate Amount recovered in the event of a default as a percent of the face value.

Repo Repurchase agreement. A procedure for borrowing money by selling securities to a counterparty and agreeing to buy them back later at a slightly higher price.

Repo Rate The rate of interest in a repo transaction.

Reset Date The date in a swap or cap or floor when the floating rate for the next period is set.

Reversion Level The level that the value of a market variable (e.g., an interest rate) tends to revert.

Rho Rate of change of the price of a derivative with the interest rate.

Rights Issue An issue to existing shareholders of a security giving them the right to buy new shares at a certain price.

Risk-Free Rate The rate of interest that can be earned without assuming any risks.

Risk-Neutral Valuation The valuation of an option or other derivative assuming the world is risk neutral. Risk-neutral valuation gives the correct price for a derivative in all worlds, not just in a risk-neutral world.

Risk-Neutral World A world where investors are assumed to require no extra return on average for bearing risks.

Roll Back *See* Backwards Induction.

Scalper A trader who holds positions for a very short period of time.

Scenario Analysis An analysis of the effects of possible alternative future movements in market variables on the value of a portfolio.

SEC Securities and Exchange Commission.

Settlement Price The average of the prices that a contract trades for immediately before the bell signaling the close of trading for a day. It is used in mark-to-market calculations.

Short Hedge A hedge where a short futures position is taken.

Short Position A position assumed when traders sell shares they do not own.

Short Rate The interest rate applying for a very short period of time.

Short Selling Selling in the market shares that have been borrowed from another investor.

Short-Term Risk-Free Rate *See* Short Rate.

Shout Option An option where the holder has the right to lock in a minimum value for the payoff at one time during its life.

Simulation *See* Monte Carlo Simulation.

Specialist An individual responsible for managing limit orders on some exchanges. The specialist does not make the information on outstanding limit orders available to other traders.

Speculator An individual who is taking a position in the market. Usually the individual is betting that the price of an asset will go up or that the price of an asset will go down.

Spot Interest Rate *See* Zero-Coupon Interest Rate.

Spot Price The price for immediate delivery.

Spot Volatilities The volatilities used to price a cap when a different volatility is used for each caplet.

Spread Option An option where the payoff is dependent on the difference between two market variables.

Spread Transaction A position in two or more options of the same type.

Static Hedge A hedge that does not have to be changed once it is initiated.

Static Options Replication A procedure for hedging a portfolio that involves finding another portfolio of approximately equal value on some boundary.

Step-up Swap A swap where the principal increases over time in a predetermined way.

Sticky Cap Interest rate cap where the cap rate applicable to an accrual period equals the capped rate for the previous accrual period plus a spread.

Stochastic Process An equation describing the probabilistic behavior of a stochastic variable.

Stochastic Variable A variable whose future value is uncertain.

Stock Dividend A dividend paid in the form of additional shares.

Stock Index An index monitoring the value of a portfolio of stocks.

Stock Index Futures Futures on a stock index.

Stock Index Option An option on a stock index.

Stock Option Option on a stock.

Stock Split The conversion of each existing share into more than one new share.

Storage Costs The costs of storing a commodity.

Straddle A long position in a call and a put with the same strike price.

Strangle A long position in a call and a put with different strike prices.

Strap A long position in two call options and one put option with the same strike price.

Stress Testing Testing of the impact of extreme market moves on the value of a portfolio.

Strike Price The price at which the asset may be bought or sold in an option contract (also called the exercise price).

Strip A long position in one call option and two put options with the same strike price.

Swap An agreement to exchange cash flows in the future according to a prearranged formula.

Swap Rate The fixed rate in an interest rate swap that causes the swap to have a value of zero.

Swaption An option to enter into an interest rate swap where a specified fixed rate is exchanged for floating.

Swing Option Energy option in which the rate of consumption must be between a minimum and maximum level. There is usually a limit on the number of times the option holder can change the rate at which the energy is consumed.

Synthetic CDO A CDO created by selling credit default swaps.

Synthetic Option An option created by trading the underlying asset.

Systematic Risk Risk that cannot be diversified away.

Tail Loss *See* Conditional Value at Risk.

Take-and-Pay Option *See* Swing Option.

Term Structure of Interest Rates The relationship between interest rates and their maturities.

Terminal Value The value at maturity.

Theta The rate of change of the price of an option or other derivative with the passage of time.

Time Decay *See* Theta.

Time Value The value of an option arising from the time left to maturity (equals an option's price minus its intrinsic value).

Timing Adjustment Adjustment made to the forward value of a variable to allow for the timing of a payoff from a derivative.

Total Return Swap A swap where the return on an asset such as a bond is exchanged for LIBOR plus a spread. The return on the asset includes income such as coupons and the change in value of the asset.

Tranche One of several securities that have different risk attributes. Examples are the tranches of a CDO or CMO.

Transaction Costs The cost of carrying out a trade (commissions plus the difference between the price obtained and the midpoint of the bid–offer spread).

Treasury Bill A short-term non-coupon-bearing instrument issued by the government to finance its debt.

Treasury Bond A long-term coupon-bearing instrument issued by the government to finance it debt.

Treasury Bond Futures A futures contract on Treasury bonds.

Treasury Note *See* Treasury Bond. (Treasury notes have maturities of less than 10 years.)

Treasury Note Futures A futures contract on Treasury notes.

Tree Representation of the evolution of the value of a market variable for the purposes of valuing an option or other derivative.

Trinomial Tree A tree where there are three branches emanating from each node. It is used in the same way as a binomial tree for valuing derivatives.

Triple Witching Hour A term given to the time when stock index futures, stock index options, and options on stock index futures all expire together.

Underlying Variable A variable on which the price of an option or other derivative depends.

Unsystematic Risk *See* Nonsystematic Risk.

Up-and-In Option An option that comes into existence when the price of the underlying asset increases to a prespecified level.

Up-and-Out Option An option that ceases to exist when the price of the underlying asset increases to a prespecified level.

Uptick An increase in price.

Value at Risk A loss that will not be exceeded at some specified confidence level.

Variance–Covariance Matrix A matrix showing variances of, and covariances between, a number of different market variables.

Variance-Gamma Model A pure jump model where small jumps occur often and large jumps occur infrequently.

Variance Rate The square of volatility.

Variance Reduction Procedures Procedures for reducing the error in a Monte Carlo simulation.

Variation Margin An extra margin required to bring the balance in a margin account up to the initial margin when there is a margin call.

Vega The rate of change in the price of an option or other derivative with volatility.

Vega-Neutral Portfolio A portfolio with a vega of zero.

Volatility A measure of the uncertainty of the return realized on an asset.

Volatility Skew A term used to describe the volatility smile when it is nonsymmetrical.

Volatility Smile The variation of implied volatility with strike price.

Volatility Surface A table showing the variation of implied volatilities with strike price and time to maturity.

Volatility Swap Swap where the realized volatility during an accrual period is exchanged for a fixed volatility. Both percentage volatilities are applied to a notional principal.

Volatility Term Structure The variation of implied volatility with time to maturity.

Warrant An option issued by a company or a financial institution. Call warrants are frequently issued by companies on their own stock.

Weather Derivative Derivative where the payoff depends on the weather.

Wiener Process A stochastic process where the change in a variable during each short period of time of length Δt has a normal distribution with a mean equal to zero and a variance equal to Δt.

Wild Card Play The right to deliver on a futures contract at the closing price for a period of time after the close of trading.

Writing an Option Selling an option.

Yield A return provided by an instrument.

Yield Curve *See* Term Structure.

Zero-Coupon Bond A bond that provides no coupons.

Zero-Coupon Interest Rate The interest rate that would be earned on a bond that provides no coupons.

Zero-Coupon Yield Curve A plot of the zero-coupon interest rate against time to maturity.

Zero Curve *See* Zero-Coupon Yield Curve.

Zero Rate *See* Zero-Coupon Interest Rate.