

Preface to the Third Edition

The purposes, level, and style of this new edition conform to the tenets set forth in the original preface. We continue with our objective of introducing some theory and applications of stochastic processes to students having a solid foundation in calculus and in calculus-level probability, but who are not conversant with the “epsilon–delta” definitions of mathematical analysis. We hope to entice students toward the deeper study of mathematics that is prerequisite to further work in stochastic processes by showing the myriad and interesting ways in which stochastic models can help us understand the real world.

We have removed some topics and added others. We added a small section on martingales that includes an example suggesting the martingale concept as appropriate for modeling the prices of assets traded in a perfect market. A new chapter introduces the Brownian motion process and includes several applications of it and its variants in financial modeling. In this chapter the Black–Scholes formula for option pricing is evaluated and compared with some reported prices of options. A Poisson process whose intensity is itself a stochastic process is described in another new section.

Some treatments have been updated. The law of rare events is presented via an inequality that measures the accuracy of a Poisson approximation for the distribution of the sum of independent, not necessarily identically distributed, Bernoulli random variables. We have added the shot noise model and related it to a random sum.

The text contains more than 250 exercises and 350 problems. Exercises are elementary drills intended to promote active learning and to develop familiarity with concepts through use. They often simply involve the substitution of numbers into given formulas or reasoning one or two steps away from a definition. They are the kinds of simple questions that we, as instructors, hope that students would pose and answer for themselves as they read a text. Answers to the exercises are given at the end of the book so that students may gauge their understanding as they go along.

Problems are more difficult. Some involve extensive algebraic or calculus manipulation. Many are “word problems” wherein the student is asked, in effect, to model some described scenario. As in formulating a model, the first step in the solution of a word problem is often a sentence of the form “Let $x = \dots$.” A manual containing the solutions to the problems is available from the publisher.

A reasonable strategy on the part of the teacher might be to hold students responsible for all of the exercises, but to require submitted solutions only to selected problems. Every student should attempt a representative selection of the problems in order to develop his or her ability to carry out stochastic modeling in his or her area of interest.

A small number of problems are labeled “Computer Challenges.” These call for more than pencil and paper for their analyses, and either simulation, numerical exploration, or symbol manipulation may prove helpful. Computer Challenges are meant to be open-ended, intended to explore what constitutes an answer in today’s world of computing power. They might be appropriate as part of an honors requirement.

Because our focus is on stochastic modeling, in some instances, we have omitted a proof and contented ourselves with a precise statement of a result and examples of its application. All such omitted proofs may be found in *A First Course in Stochastic Processes*, by the present authors. In this more advanced text, the ambitious student will also find additional material on martingales, Brownian motion, and renewal processes, and presentations of several other classes of stochastic processes.