

Index

- adapted process, 108, 135, 183
- ADI, *see* alternating direction implicit
- alternating direction implicit, 104, 115
- analytic solution, 30, 45, 85, 86
- antithetic variates, 90
- Apple, 159
- arbitrage, 2, 3, 8, 19–21, 34, 53, 60, 61, 86, 109, 110, 123, 137, 164, 170, 180
- arbitrage-free price, 25, 35
- at-the-money, 28, 51
- barrier
 - continuous, 93, 101, 116, 125, 127
 - discretely monitored, 49, 93, 101, 149
 - knock-in, 45, 59, 101, 107, 130
 - knock-out, 45, 59, 107, 130
 - lower, 49
 - single, 49
 - upper, 49
 - window, 122
- barrier option, *see* option, barrier
- bisection search, 83
- Black-Scholes, 4, 26, 40, 42, 43, 51, 52, 54, 59, 73, 118, 121, 136, 160, 177
- Black-Scholes equation, 29–30, 36, 37, 59, 61
- Black-Scholes formula, 26–29, 31, 34, 44, 51, 53, 61, 86, 112, 113, 129, 142, 148, 150, 170
- Black-Scholes process, 48, 78
- bond, 61
- boundary condition, 30, 36, 37, 59, 68, 69, 74
 - Feller, 71–73
 - zero gamma, 96
 - zero price, 95
- Box-Muller transform, 88
- Breeden-Litzenberger, 56, 116, 137, 170
- broker, 51, 109, 157
- Brownian motion, 9–12, 32, 45, 65, 77, 87, 92, 108, 117, 119, 154, 163, 183
 - correlated, 17, 161
- bump function, 58
- calendar spread, 110, 111
- calibration, 63, 64, 71, 124–125
- call, 3
- call spread, 56, 91
- callable trade, 93, 101, 106
- cash settlement, 2, 157
- cell averaging, 101
- central bank, 5
- central difference, 95, 103, 104
- CEV, *see* constant elasticity of variance
- Chase Manhattan, 131
- Cholesky decomposition, 90
- CIR, *see* Cox-Ingersoll-Ross model
- close out, 2, 147
- CMS, *see* constant maturity swap
- cockroach, 141
- commodities, 2, 8
- constant elasticity of variance, 74
- constant maturity swap, 158
- continuous barrier option, *see* option, barrier
- copula, 154–155, 170
- correlation, 17, 54, 64, 89
 - asset-asset, 153, 154
 - implied, 156, 157, 160–162, 175
 - instantaneous, 153, 166
 - local-stochastic, 166
 - spot-volatility, 65, 66, 73, 84, 113, 116, 117, 122, 127, 130, 142, 165
- correlation matrix, 164
- correlation product, 153
- correlation smile, 155–162, 173–175
- cost of carry, 8
- Cox-Ingersoll-Ross process, 66, 71, 72
- Craig-Sneyd scheme, 105
- Crank-Nicolson scheme, 97, 99, 105
- credit rating, 5
- cross asset, 160

- cross smile, 160, 162–164, 170, 173
- cross volatility surface, *see* cross smile
- cumulative normal function, 28, 46
 - bivariate, 155, 168
 - inverse, 86
- delta, 38, 85, 138, 139, 141
 - Black-Scholes, 52, 112, 137, 161
 - forward, 52, 137
- delta function, *see* Dirac delta function
- delta hedging, *see* hedging, delta
- derivative, 1, 3
- derivatives trading, 40
- digital payout, *see* option, digital
- Dirac delta function, 56, 69, 70, 110, 115, 172
- discount factor, 27, 31, 33, 55, 56, 67, 86
- discounted expectation, 27, 34
- dividend, 8, 19, 20, 61
- domestic currency, 6
- drift, 12, 16, 21, 47, 61, 121, 134, 161, 163, 183, 184
 - terminal, 16
- Dupire local volatility model, *see* local volatility model
- dynamic trading strategy, 36
- efficient market, 2
- eigenvalue, 98
- energy, 2
- equities, 2, 8, 51, 54, 141, 153
- equivalent probability measure, *see* measure, equivalent
- euro-dollar, 51, 53, 153
- European payout, *see* option, European
- exchange, 2
- expectation, 180
- expiry date, 3, 51, 82, 83
- expiry time, *see* expiry date
- explanatory variables, 94
- explicit scheme, 96
- exponential Ornstein-Uhlenbeck model, *see* Ornstein-Uhlenbeck process
- factorisation method, 104
- federal funds rate, 5
- Feller boundary condition, *see* boundary condition, Feller
- filtration, 15, 58, 108, 135, 147, 183
- financial engineer, 183
- financial mathematician, 183
- finite difference method, 86, 94, 104, 106, 115, 116, 145
- first generation exotic option, *see* option, first generation exotic
- fixed income, 6
- floating smile, 112, 113
- Fokker-Plank equation, *see* forward Kolmogorov equation
- foreign exchange, 2, 8, 33, 51, 53, 63, 82, 112, 125, 140, 141, 153, 157, 160
- forward contract, 1, 6–8, 19, 27, 40, 52, 53, 57, 107
- forward induction, 114, 116, 124, 125, 131, 177
- forward Kolmogorov equation, 58–60, 62, 71, 84, 115
- forward level, 1, 8, 27, 28, 33, 35, 43, 44, 121, 140, 146, 147
- forward start, *see* option, forward starting
- forward volatility agreement, 146–151
 - asset, 147
 - cash, 147
- Fourier transform, 69, 70
- FTSE, 54, 63
- fundamental theorem of on-smile pricing, 108–110, 114, 146
- FVA, *see* forward volatility agreement
- FX, *see* foreign exchange
- gamma, 38–40, 85, 139
- Gauss-Hermite integration, 122
- Gaussian, *see* normal variable
- Girsanov's theorem, 22–24, 34, 45, 47, 179–184
- going short, *see* short position
- gold, 8, 19, 107, 158, 160, 165, 172, 173
- government bond, 20
- Greeks, 38–39, 41, 85, 106, 123, 138, 177
- Gyöngy's theorem, *see* fundamental theorem of on-smile pricing
- heat kernel, 75
- hedge fund, 40, 140
- hedging, 1, 85, 123, 141, 178
 - delta, 37–38, 40, 41, 63, 133, 137, 177
 - dynamic, 35–37, 140
- hedging portfolio, 36
- hedging strategy, 38
- Heston model, 65–73, 75, 78, 83, 84, 88, 106
- IBM, 29, 157, 159

- implicit scheme, 97, 103, 106, 115, 131
- implied volatility, *see* volatility, implied
- implied volatility dynamic, 111, 112
- implied volatility smile, *see* smile
- implied volatility surface
 - see* volatility surface, 51
- in-the-money, 29, 35, 51, 141
- inflation, 20
- insurance company, 35
- integral
 - Lebesgue, 181, 182
 - Riemann, 181
- integration by parts, 149
- interest rate, 5–6, 19, 51, 61, 121, 126, 140
 - continuously compounding, 5, 19
 - stochastic, 87
- interfacing, 102, 145
- investment bank, 35, 40, 42, 122, 133, 140, 160, 165
- Ito calculus, 12
- Ito process, 13, 34, 179
- Ito's lemma, 13–14, 16–17, 36, 58, 67, 73, 74, 109, 115, 118, 135, 184
 - product rule, 14, 26, 184
- Jacobian, 88
- joint probability distribution, *see* probability distribution, joint, 93
- JP Morgan, 131
- jumps, 110, 135, 140
- knock-in barrier, *see* barrier, knock-in
- knock-out barrier, *see* barrier, knock-out
- lambda-SABR model, 75, 84, 114, 118, 124, 126, 127, 165
- Laplace transform, 71, 72
- law of large numbers, 87, 88
- Lehman bankruptcy, 63
- Lévy's theorem, 184
- linear congruential generator, 87
- liquid asset, 3
- local correlation model, 162–164, 170, 172
- local stochastic correlation model, 165–166, 172
- local stochastic volatility model, 54, 84, 113–116, 121, 122, 125, 127, 130, 131, 135, 143–145, 149, 165, 177
- local volatility correction, 114–118, 121, 122, 124, 125, 130, 131
- local volatility model, 54, 58–62, 82, 84, 86, 94, 107, 109, 111, 112, 118, 123–127, 130, 149, 172
 - multi-asset, 153, 155
- log contract, 136, 152
- log return, 134, 137, 139
- log-normal, 14–15, 26, 27, 43, 44, 47, 67, 75, 87, 94, 114, 119, 120
- long expiry date, 84, 140
- Longstaff-Schwarz, 94
- low discrepancy random numbers, *see* random numbers, low discrepancy
- LSV, *see* local stochastic volatility model
- LVCC, *see* local volatility, multi-asset
- market data bump, 85
- market maker, 40, 109, 160
- Markov chain, 79
- Markov property, 15
- Martingale, 24–26, 30, 34, 61, 67, 135, 136, 184
 - continuous, 25
- Martingale pricing, 19
- Martingale pricing equation, 25, 27, 32, 86, 105, 169
- matching delta, 173, 174
- mean reversion, 63, 64, 66, 72, 75–77, 84, 117, 118, 121, 123–125, 127, 151, 152
- mean reversion level, 64
- measure, 21, 26, 34, 180
 - equivalent, 22, 181, 183
 - real world, 183
 - risk-neutral, 64, 66, 148, 166
- measure change, 21–24, 119, 161, 166, 169, 179–184
- measure theory, 179
- Mersenne twister algorithm, 87
- method of characteristics, 72
- method of planes, 102, 106, 144, 150
- mixing parameter, 114, 124–131, 144, 145, 152
- mixture model, 77–79, 122, 123, 126, 127, 131, 145, 166
- model uncertainty, 178
- moment matching, 44, 50
- money market account, *see* rolling money market account
- Monte Carlo, 30, 86–94, 105, 106, 144, 154, 164, 167
 - error, 90
 - Greeks, 91

- multiple dimensions, 88
- standard deviation, 88
- variance reduction, 90
- multiple assets, 16, 153
- Newton-Raphson method, 86
- no arbitrage principle, *see* arbitrage
- normal process, 76, 119, 127
- normal variable, 9, 15, 87, 88, 122, 154, 155
- notional, 2, 35
- numeraire, 21, 25, 26, 29, 31, 33, 34, 48, 49, 61, 68, 86, 161, 163, 166, 169, 172
- numeraire symmetry, 172–173
- numerical integration, 65, 86, 92, 122
- numerical stability, 78, 83, 85
- ODE, *see* ordinary differential equation
- off-smile, 126
- oil, 2
- OIS, *see* over night indexed swap
- one-sided differencing, 96
- optimisation problem, 82
- option
 - American, 93
 - Asian, 43–45, 50, 102, 106, 144
 - at-the-money, 28, 40, 54, 63, 129, 142, 147
 - barrier, 45–50, 59, 114, 116, 118, 119, 121, 122, 124, 125, 130, 131, 142, 151
 - basket, 153, 157, 171, 173–175
 - best-of, 34, 158, 167–169, 171
 - call, 19, 26, 31, 38, 48, 54, 60, 63, 68, 109, 153
 - composite, 159, 162, 163, 172, 173, 175
 - digital, 31, 43, 55–57, 68, 91, 116, 128, 129, 149
 - dual asset digital, 171
 - European, 42–43, 50, 55, 57, 61, 86, 109, 122, 131, 154, 167
 - exercise, 3
 - exotic, 2, 4, 59, 64, 107, 114, 123, 124, 126, 130, 131
 - first generation exotic, 116, 122, 131, 143, 144
 - forward starting, 123, 147
 - geometric basket, 159
 - in-the-money, 40, 54
 - no-touch, 130, 149, 165
 - one-touch, 124–128, 130
 - out-of-the-money, 40, 54, 63
 - put, 54, 55, 63
 - quanto, 157
 - short dated, 39, 52
 - spread, 158
 - vanilla, 3, 29, 38, 43, 54–57, 59, 61, 64, 65, 67, 82, 86, 107, 116, 133, 136, 140
 - worst-of, 158, 171
- ordinary differential equation, 69
- Ornstein-Uhlenbeck process, 76–77, 84, 125
- OU process, *see* Ornstein-Uhlenbeck process
- out-of-the-money, 29, 51, 141
- overnight, 39
- overnight indexed swap, 5
- parallel shift, 151
- parameter averaging, 84
- partial differential equation, 29, 30, 34, 58, 59, 61, 64, 67–69, 81, 115, 124, 126, 131, 154
 - multiple dimensions, 103–105
 - numerical solution, 30, 83, 86, 94–106, 144, 166, 177
- parabolic, 95
- stability, 96–100
- payout, 3
- PDE, *see* partial differential equation
- PDE approach, *see* partial differential equation, numerical solution; *see also* finite difference method
- PDE solver, 101–103, 106, 115, 116, 131, 150, 166, 167
- PDF, *see* probability density function
- percentage notional, 29
- physical settlement, 157, 159
- positive definite matrix, 164
- pounds sterling, 20
- precious metals, 2
- predictor-corrector method, 104
- present value, 27, 121
- probability, 181
 - risk-neutral, 68
- probability density function, 55, 58, 59, 71, 72, 167
- probability distribution, 58, 59, 108
 - cumulative, 55
 - implied, 55, 86

- joint, 45, 148, 154, 169–172
- marginal, 148, 154, 155
- probability measure, *see* measure
- probability space, 180, 182, 183
- product rule, *see* Ito's lemma, product rule
- pseudo-random numbers, *see* random numbers, pseudo-random
- put, 3
- put-call parity, 53, 147, 148, 159, 171
- PV, *see* present value

- quant, *see* quantitative analyst
- quantitative analyst, 2, 27, 33, 150, 183
- quasi-random numbers, *see* random numbers, low discrepancy

- Radon-Nikodým derivative, 22, 47, 48, 119, 182, 183
- random numbers
 - low discrepancy, 92
 - pseudo-random, 87, 92
- random variable, 180
- Rannacher stepping, 100
- real world probability measure, *see* measure, real world
- real world process, 19, 21, 22, 26, 35, 37
- realised variance, 133, 136, 141, 145
- reflection principle, 45–48, 50, 119
- regime switching model, 79–81, 145, 166
- regularisation, 164
- replicating portfolio, 7
- replication, 7, 35, 40, 56, 57, 86, 128, 140, 141, 149, 152, 177
 - static, 178
- Reuters, 133
- rho, 38
- risk, 85
- risk free rate, 5, 20
- risk management, 122
- risk manager, 85, 176, 178
- risk reversal, 82
- risk-neutral expectation, 136, 147
- risk-neutral measure, 27, *see* measure, risk-neutral
- risk-neutral probability, 52, 56, 60, 61, 137
- risk-neutral process, 26, 31, 42
- rolling money market account, 20, 25–27, 29, 31, 42, 67

- SABR formula, 74, 75, 82
- SABR model, 73–75, 78, 82–84, 113, 118, 125

- sample space, 179–181
- SDE, *see* stochastic differential equation
- seed, 91
- self-financing portfolio, 36, 37
- short expiry date, 84
- short position, 35
- shorting, *see* short position
- sigma algebra, 179–182
- silver, 165, 172, 173
- skew, 51, 54, 63, 64, 82, 83, 125, 129, 130, 138, 142
- smile, 45, 51–55, 59, 61, 63–65, 74, 77, 78, 83, 84, 107, 111, 112, 124, 126, 129, 130, 133, 137, 138, 142–144, 148, 149, 151, 160, 170, 178
 - convexity, 63–66, 74, 77, 78, 82–84, 118, 124, 125, 138
 - interpolation, 52
- Sobol sequence, 92
- speculation, 2
- spot, 2
- spot dynamic, 54, 59
- spot price, *see* spot
- spread, 40
- standard deviation, 95
- step function, 31, 55
- sterling-dollar, 153, 157
- sticky delta, 112–113, 124, 125, 138
- sticky strike, 111–112, 124, 125, 138
- stochastic differential equation, 12, 58, 62, 65, 73, 74, 118, 163, 173
- stochastic integral, 9, 22
- stochastic process, 9
- stochastic variance, 71
- stochastic volatility model, 54, 63–65, 73, 78, 83, 107, 111, 113, 114, 116, 118, 122–124, 127, 130, 142, 143, 149, 151
 - calibration, 82–84
- straddle, 146, 147
- strangle, 82
- strike, 2, 35, 51, 55, 60, 82, 111
 - at-the-money, 51
- supply and demand, 53–55
- SV model, *see* stochastic volatility model
- swap rate, 5

- Taylor expansion, 29
- term structure, 6, 16, 28, 42, 64, 118, 120–123, 126
- terminal volatility, 118
- theoretical value, 126, 127

- theta, 38, 40
- theta scheme, 97
- Thomas algorithm, 97, 104
- time decay, 39
- time value of money, 111
- tradeable asset, 20, 25, 26, 31
- trader, 27, 37, 42, 85, 91, 124–126, 130, 141, 149, 151, 174, 176
- trading strategy, 35
- triangle rule, 160–163, 165, 166, 173
- TV, *see* theoretical value
- unconditional stability, 100, 105
- United States dollar, 2, 20
- vanilla, *see* option, vanilla
- vanilla market, 59, 107–109, 113, 124
- vanilla payout, *see* option, vanilla
- variance reduction, *see* Monte Carlo, variance reduction
- variance swap, 57, 133–141, 143, 151
- vega, 38–40, 85, 118, 121, 129, 141, 150, 151, 178
- vol-of-vol, *see* volatility of volatility
- volatility, 4, 12, 16, 21, 37, 40, 47, 63, 133
 - at-the-money, 51, 83, 126, 129, 138, 143, 147
 - fair, 134, 141, 143
 - implied, 45, 51, 53, 54, 56, 59, 61, 63, 74, 111, 114, 130, 133, 137, 142, 146, 147, 150, 160
 - instantaneous, 63, 83, 84, 113, 114, 117, 120, 146
 - interpolation, 106, 138
 - local, 58–61, 108, 110, 112, 114, 117, 130, 146, 163
 - realised, 64, 65, 123, 133, 147
 - stochastic, 63, 124
 - terminal, 16, 121, 122, 131
- volatility frown, 55
- volatility of variance, 66, 72
- volatility of volatility, 63, 64, 73, 74, 77, 83, 117, 118, 121–125, 131, 151
- volatility process, 64
- volatility smile, *see* smile
- volatility surface, 51, 52, 54, 85, 108, 110, 116, 126, 130, 148, 165, 178
 - arbitrage, 109
- volatility swap, 141–146, 151
 - instantaneous, 146
- volatility trading, 40
- wavelets, 106
- wheat, 1, 8
- winding number, 70
- wingyness, 140, 143, 144
- yield, 6, 19, 29
- yield curve, 6, 8, 85
- zero coupon bond, 20, 67, 68