

Contents

I Programming techniques for financial calculus	9
1 An introduction to MATLAB®with applications	11
1.1 MATLAB®basics	11
1.1.1 Preliminary elements	12
1.1.2 Vectors and matrices	15
1.1.3 Basic linear algebra operations	18
1.1.4 Element-by-element multiplication and division	21
1.1.5 Colon (:) operator	22
1.1.6 Predefined and user-defined functions	24
1.2 M-file: Scripts and Functions	26
1.3 Programming fundamentals	29
1.3.1 <code>if</code> , <code>else</code> , and <code>elseif</code> construct	29
1.3.2 <code>for</code> loops	32
1.3.3 <code>while</code> loops	33
1.4 MATLAB®graphics	34
1.5 Preliminary exercises on programming	36
1.6 Exercises on the basics of financial evaluation	49
1.6.1 Interest Rate Swap	55
II Portfolio selection	61
2 Preliminary elements in Probability Theory and Statistics	63
2.1 Basic concepts in probability	63
2.2 Random variables	71
2.3 Probability distributions	74
2.4 Continuous random variables	76
2.5 Higher-order moments and synthetic indices of a distribution . .	80
2.6 Some probability distributions	82

2.6.1	Uniform distribution	83
2.6.2	Normal distribution	86
2.6.3	Log-normal distribution	91
2.6.4	Chi-square distribution	94
2.6.5	Student-t distribution	95
3	Linear and Non-linear Programming	99
3.1	General Framework	99
3.2	Optimization with MATLAB®	100
3.2.1	Linear Programming	101
3.2.2	Quadratic Programming	102
3.2.3	Non-Linear Programming	104
3.3	Multi-objective optimization	106
3.3.1	Efficient solutions and the efficient frontier	108
4	Portfolio Optimization	111
4.1	Portfolio of equities: prices and returns	112
4.2	Risk-return analysis	116
4.2.1	Elements of Expected Utility Theory	116
4.2.2	General Framework	118
4.2.3	Mean-Variance model	119
4.2.4	Effects of diversification for an EW portfolio	139
4.2.5	Mean-Mean Absolute Deviation model	141
4.2.6	Mean-Maximum Loss model	145
4.2.7	Value-at-Risk	149
4.2.8	Mean-Conditional Value-at-Risk model	152
4.2.9	Mean-Gini model	161
4.3	Elements of bond portfolio immunization	166
III	Derivatives pricing	175
5	Further elements on Probability Theory and Statistics	177
5.1	Introduction to Monte Carlo simulation	177
5.2	Stochastic processes	179
5.2.1	Brownian motion	187
5.2.2	Ito's Lemma	192
5.2.3	Geometric Brownian motion	196

6 Pricing of derivatives with an underlying security	199
6.1 Binomial model	200
6.1.1 A replicating portfolio of stocks and bonds	201
6.1.2 Calibration of the binomial model	206
6.1.3 Multi-period case	209
6.2 Black-Scholes model	213
6.2.1 Assumptions of the model	214
6.2.2 Pricing of a European call	218
6.2.3 Pricing equation for a call	220
6.2.4 Implied volatility	223
6.2.5 Black-Scholes formulas via integrals	224
6.3 Option Pricing via the Monte Carlo method	226
6.3.1 Path Dependent Derivatives	228
References	231
Suggested lesson plan	235