

Contents

Preface	xi
Acknowledgments	xiii
About the Authors	xv
CHAPTER 1 Overview	1
CHAPTER 2 The Principle of Replication	13
CHAPTER 3 Static and Dynamic Replication	37
CHAPTER 4 Variance Swaps: A Lesson in Replication	57
CHAPTER 5 The P&L of Hedged Option Strategies in a Black-Scholes-Merton World	85
CHAPTER 6 The Effect of Discrete Hedging on P&L	105
CHAPTER 7 The Effect of Transaction Costs on P&L	117
CHAPTER 8 The Smile: Stylized Facts and Their Interpretation	131
CHAPTER 9 No-Arbitrage Bounds on the Smile	153

CHAPTER 10		
A Survey of Smile Models		163
CHAPTER 11		
Implied Distributions and Static Replication		175
CHAPTER 12		
Weak Static Replication		203
CHAPTER 13		
The Binomial Model and Its Extensions		227
CHAPTER 14		
Local Volatility Models		249
CHAPTER 15		
Consequences of Local Volatility Models		265
CHAPTER 16		
Local Volatility Models: Hedge Ratios and Exotic Option Values		289
CHAPTER 17		
Some Final Remarks on Local Volatility Models		303
CHAPTER 18		
Patterns of Volatility Change		309
CHAPTER 19		
Introducing Stochastic Volatility Models		319
CHAPTER 20		
Approximate Solutions to Some Stochastic Volatility Models		337
CHAPTER 21		
Stochastic Volatility Models: The Smile for Zero Correlation		353
CHAPTER 22		
Stochastic Volatility Models: The Smile with Mean Reversion and Correlation		369
CHAPTER 23		
Jump-Diffusion Models of the Smile: Introduction		383

CHAPTER 24	
The Full Jump-Diffusion Model	395
Epilogue	417
APPENDIX A	
Some Useful Derivatives of the Black-Scholes-Merton Model	419
APPENDIX B	
Backward Itô Integrals	421
APPENDIX C	
Variance Swap Piecewise-Linear Replication	431
Answers to End-of-Chapter Problems	433
References	497
Index	501