Financial Mathematics

MATH 5870/6870¹ Fall 2021

Le Chen

lzc0090@auburn.edu

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Auburn University

Auburn AL

¹Based on Robert L. McDonald's *Derivatives Markets*, 3rd Ed, Pearson, 2013.

Chapter 19. Monte Carlo Valuation

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- $\$ 19.1 Computing the option price as a discounted expected value
- § 19.2 Computing random numbers
- § 19.3 Simulating lognormal stock prices
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- § 19.5 Efficient Monte Carlo valuation
- § 19.6 Valuation of American options
- § 19.7 The Poisson distribution
- 19.8 Simulating jumps with the Poisson distribution
- $\$ 19.9 Simulating correlated stock prices
- § 19.10 Problems

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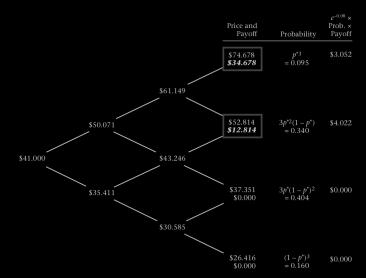
For European call, if one use risk-neutral probability², then

$$\boldsymbol{C} = \boldsymbol{e}^{-rT} \sum_{i=0}^{n} \max(\boldsymbol{S}\boldsymbol{u}^{n-i}\boldsymbol{d}^{i} - \boldsymbol{K}, \boldsymbol{0}) \binom{n}{i} (\boldsymbol{p}^{*})^{n-i} (1 - \boldsymbol{p}^{*})^{i}$$

²One cannot have this simple expression if one uses the true probability.

FIGURE 19.1

Binomial tree (the same as in Figure 10.5) showing stock price paths, along with risk-neutral probabilities of reaching the various terminal prices. Assumes S = \$41.00, K = \$40.00, $\sigma = 0.30$, r = 0.08, t = 1.00 years, $\delta = 0.00$, and h = 0.333. The risk-neutral probability of going up is $p^* = 0.4568$. At the final node the stock price and terminal option payoff (beneath the price) are given.



Instead of using the formula to compute the option price, one can simulate \ldots

Example 19.1-1 Write a piece of code to simulate the binomial tree and compute the corresponding average payoff.

Solution. Check

codes/Section_19-1.py