
Contents

Preface	vii
Notations	ix
Chapter 1. Overview of the Basics of Stochastic Analysis	1
1.1. Brownian motion	1
1.2. Stochastic integrals	6
1.3. Martingales, Itô processes and general Itô's formula	11
1.4. Stochastic differential equations	17
1.5. Change of probability: the Girsanov theorem	22
Chapter 2. The Black–Scholes Model	29
2.1. Introduction: what is an option?	29
2.2. Self-financing strategies	32
2.2.1. A portfolio and its trading strategy	32
2.2.2. Self-financing strategies	33
2.2.3. Motivation	34
2.2.4. Stock discount	35
2.3. Option pricing problem: the Black–Scholes model	40
2.4. The Black–Scholes formula	43
2.4.1. Option Greeks ⁷	50
2.5. Risk-neutral probabilities: alternative derivation of the Black–Scholes formula	56

2.5.1. Risk-neutral probability	56
2.6. American options in the Black–Scholes model	65
2.7. Exotic options	66
2.7.1. Barrier options	67
2.7.2. Other exotic options	68
2.7.3. Barrier option pricing	69
2.7.4. Lookback option pricing	79
Chapter 3. Models of Interest Rates	83
3.1. Modeling principles	83
3.1.1. Classic models of interest rates	86
3.1.2. Partial differential equation for interest rates	87
3.2. The Vašíček model	89
3.3. The Cox–Ingersoll–Ross model	98
3.3.1. Moments and covariance of the CIR process	102
3.3.2. The value of zero-coupon bond in the CIR model	105
3.4. The Heath–Jarrow–Morton model	111
Bibliography	117
Index	119