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Eckhard Platen • David Heath

A Benchmark Approach to Quantitative Finance

 Springer

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Authors' Comments on the Corrected Second Printing

The original printing of the book appeared in 2006. Its very positive reception has led to its being sold out in less than three years. Springer's decision to reprint the book gave us the opportunity to correct minor mathematical and typographical errors in the original printing of the monograph. We would appreciate receiving any suggestions for further improvements and thank all those readers who have pointed out misprints and errors to us.

August 2009

Eckhard Platen
David Heath

Preface

In recent years products based on financial derivatives have become an indispensable tool for risk managers and investors. Insurance products have become part of almost every personal and business portfolio. The management of mutual and pension funds has gained in importance for most individuals. Banks, insurance companies and other corporations are increasingly using financial and insurance instruments for the active management of risk. An increasing range of securities allows risks to be hedged in a way that can be closely tailored to the specific needs of particular investors and companies. The ability to handle efficiently and exploit successfully the opportunities arising from modern quantitative methods is now a key factor that differentiates market participants in both the finance and insurance fields. For these reasons it is important that financial institutions, insurance companies and corporations develop expertise in the area of *quantitative finance*, where many of the associated quantitative methods and technologies emerge.

This book aims to provide an *introduction to quantitative finance*. More precisely, it presents an introduction to the mathematical framework typically used in financial modeling, derivative pricing, portfolio selection and risk management. It offers a unified approach to risk and performance management by using the *benchmark approach*, which is different to the prevailing paradigm and will be described in a systematic and rigorous manner.

This approach uses the *growth optimal portfolio* as numeraire and the real world probability measure as pricing measure. The existence of an equivalent risk neutral probability measure is not required, which is one of the aspects distinguishing the approach in this book from other more conventional texts in the area. It is our experience that many practitioners find the use of the *real world* probability measure attractive for *pricing* because it is natural and pricing can still be carried out even under circumstances when a risk neutral probability measure cannot exist.

We have attempted to write a multi-purpose book that provides information and methods for a wide range of professionals, researchers and graduate students. It is designed for three groups of readers. In the first instance it

should provide useful information to financial analysts and practitioners in the investment, banking and insurance industries. Other professionals at financial software companies, hedge funds, consultants, regulatory authorities and government agencies may significantly benefit from using this book. Secondly, the book aims to introduce those with a reasonable basic mathematical background to the area of quantitative finance. Engineers, computer scientists, numerical analysts, physicists, theoretical chemists, biologists, astrophysicists, statisticians, econometricians, actuaries and other readers should be able to gain access to the field through the book. Thirdly, researchers in financial mathematics will find the later parts of the book interesting and possibly challenging. In particular, the monograph aims to stimulate further developments of the benchmark approach.

The material presented is a self-contained introduction that could be part of a coursework masters or PhD program in quantitative finance. The areas of probability and statistics, stochastic calculus, optimization and numerical methods relevant to finance are all introduced. The book has been designed in a modular way with cross references so that it can also be used as a handbook allowing relevant definitions, formulas and results to be easily looked up.

The monograph is divided into fifteen chapters. The first two chapters summarize fundamental results from probability and statistics which are essential for quantitative finance. Some statistical analysis on the log-return distribution of indices is included at the end of Chap. 2.

The Chaps. 3 and 4 introduce stochastic processes. The stochastic calculus needed for financial modeling using stochastic differential equations is presented in Chaps. 5 to 7. Stochastic differential equations with jumps are introduced from a finance perspective. Some of the material goes beyond what can be found in standard textbooks.

In Chap. 8 basic financial derivatives are introduced from a hedging perspective. European call and put options are priced via the corresponding Black-Scholes partial differential equation. The sensitivities of these option prices to movements in parameter values are studied. Hedge simulations are performed, which illustrate derivative pricing and hedging.

Chapter 9 presents various alternative pricing methodologies. First, the concept of *real world pricing* is introduced. Several other pricing methods are shown to be special cases of real world pricing. These include actuarial pricing, risk neutral pricing and pricing under change of numeraire. The existence of an equivalent risk neutral probability measure is *not* required under the benchmark approach. The chapter concludes by introducing the Girsanov theorem, the Bayes rule and the Feynman-Kac formula.

Chapter 10 develops a unified modeling framework for continuous financial markets under the benchmark approach. It presents a range of new concepts and ideas that do not fit under the presently prevailing approaches. A *diversification theorem* is derived, which shows under some regularity condition that diversified portfolios approximate the growth optimal portfolio. This allows

us to interpret a diversified market index as a proxy for the growth optimal portfolio.

Chapter 11 derives results on portfolio optimization via the maximization of Sharpe ratios. The capital asset pricing model (CAPM), the Markowitz efficient frontier, two fund separation and results on expected utility maximization, utility indifference pricing, derivative pricing and hedging are also presented in this chapter.

The modeling of stochastic volatility of stock market indices under the benchmark approach is discussed in Chap. 12. This analysis includes the pricing of index derivatives under models that do not admit an equivalent risk neutral probability measure. More general volatility models than those permitted under the standard risk neutral approach are covered.

In Chap. 13 it is shown that the discounted growth optimal portfolio follows the dynamics of a time transformed squared Bessel process of dimension four. Making the drift of the discounted growth optimal portfolio a function of time, yields the *minimal market model*. Derivative prices which follow under this parsimonious model appear to be rather realistic. Long term derivatives can be realistically priced. These prices deviate significantly from those obtained under risk neutral pricing because the hypothetical risk neutral measure has after several years a total mass that is significantly less than one. Extensions of the minimal market model with random scaling are considered.

In Chap. 14 models are analyzed that permit jumps to model event risk. Most of the results of previous chapters are generalized to jump diffusion markets. Two market models illustrate differences in derivative pricing under the standard risk neutral and the benchmark approach.

Finally, in Chap. 15 a brief introduction is given from a unifying perspective to basic numerical methods for quantitative finance. This introduction covers scenario simulation, Monte Carlo simulation, tree based methods and finite difference methods. A binomial tree method is developed for the benchmark approach and finite difference methods are explained as numerical methods for systems of coupled ordinary differential equations.

Selected *exercises* at the end of each chapter should enable the reader to further develop skills and test the understanding of the subject. *Solutions* to these exercises are included at the end of the book. The material can be taught at different levels. The first sections in most chapters provide a less technical presentation of the subject. At the end of some sections or chapters (*)-subsections or (*)-sections have been included. These are more technical in nature and are usually not necessary for a first reading.

The formulas are numbered according to the chapter and section where they appear. Assumptions, theorems, lemmas, definitions and corollaries are numbered sequentially in each section. The most common notations are listed at the beginning of the book and an *index of keywords* is given at its end. Some readers may find the *author index* at the end of the book useful.

Substantial work is involved in studying the material presented. This should not be underestimated by the reader. Actively solving exercises is

strongly recommended. The reward for this demanding work will be a sound understanding of essential methods in quantitative finance with an emphasis on the benchmark approach.

The authors would like to thank several colleagues and PhD students for many valuable suggestions on the manuscript, including Nicola Bruti-Liberati, Hans Bühlmann, Carl Chiarella, Boris Choy, Morten Christensen, Marc Craddock, Ernst Eberlein, Robert Elliott, Kevin Fergusson, Chris Heyde, John van der Hoek, Hardy Hulley, Monique Jeanblanc, Leah Kelly, Truc Le, Shane Miller, Alex Novikov, Alun Pope, Wolfgang Runggaldier and Marc Yor. The authors would like to express their deep gratitude to Katrin Platen, who organized all technical work on the book, in particular, many figures. She carefully and patiently type set the countless versions of the extensive manuscript. Finally, we like to thank Catriona Byrne from Springer Verlag for her excellent work and for encouraging us to write this book.

It is greatly appreciated if readers could forward any errors, misprints or suggested improvements to: eckhard.platen@uts.edu.au

The interested reader is likely to find updated information about the benchmark approach, as well as, teaching material related to the book on the webpage of the first author under “Benchmark Approach”:

[http://www.business.uts.edu.au/
finance/staff/Eckhard/Benchmark_Approach.html](http://www.business.uts.edu.au/finance/staff/Eckhard/Benchmark_Approach.html)

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*Eckhard Platen
David Heath*

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Basic Notation

μ_X	mean of X ; 21, 22
$\sigma_X^2, \text{Var}(X)$	variance of X ; 23, 24
β_X	skewness of X ; 25
κ_X	kurtosis of X ; 26
$\underline{\kappa}_X$	excess kurtosis; 28
$\text{Cov}(X, Y)$	covariance of X and Y ; 39
$\inf\{\cdot\}$	greatest lower bound; 94, 129
$\sup\{\cdot\}$	smallest upper bound; 61, 79, 94, 128, 129
$\max(a, b) = a \vee b$	maximum of a and b ; 170
$\min(a, b) = a \wedge b$	minimum of a and b ; 170
\mathbf{x}^\top	transpose of a vector or matrix \mathbf{x} ; 40
$\mathbf{x} = (x^1, x^2, \dots, x^d)^\top$	column vector $\mathbf{x} \in \mathbb{R}^d$ with i th component x^i ; 44
$ \mathbf{x} $	absolute value of \mathbf{x} or Euclidean norm; 20, 22, 49
$\mathbf{A} = [a^{i,j}]_{i,j=1}^{k,d}$	$(k \times d)$ -matrix \mathbf{A} with ij th component $a^{i,j}$; 40
$\det(\mathbf{A})$	determinant of a matrix \mathbf{A} ; 40
\mathbf{A}^{-1}	inverse of a matrix \mathbf{A} ; 41, 46
(\mathbf{x}, \mathbf{y})	inner product of vectors \mathbf{x} and \mathbf{y} ; 49
$\mathcal{N} = \{1, 2, \dots\}$	set of natural numbers; 5
∞	infinity; 2

XVIII Basic Notation

(a, b)	open interval $a < x < b$ in \mathfrak{R} ; 8
$[a, b]$	closed interval $a \leq x \leq b$ in \mathfrak{R} ; 12
$\mathfrak{R} = (-\infty, \infty)$	set of real numbers; 8
$\mathfrak{R}^+ = [0, \infty)$	set of nonnegative real numbers; 39
\mathfrak{R}^d	d -dimensional Euclidean space; 38
Ω	sample space; 4
\emptyset	empty set; 4
$A \cup B$	the union of sets A and B ; 4
$A \cap B$	the intersection of sets A and B ; 4
$A \setminus B$	the set A without the elements of B ; 124, 258, 359
$\mathcal{E} = \mathfrak{R} \setminus \{0\}$	\mathfrak{R} without origin; 124, 564
$[X, Y]_t$	covariation of processes X and Y at time t ; 178
$[X]_t$	quadratic variation of process X at time t ; 172
$n! = 1 \cdot 2 \cdot \dots \cdot n$	factorial of n ; 10, 62
$[a]$	largest integer not exceeding $a \in \mathfrak{R}$; 522
i.i.d.	independent identically distributed; 55
a.s.	almost surely; 6, 56
f'	first derivative of $f : \mathfrak{R} \rightarrow \mathfrak{R}$; 14
f''	second derivative of $f : \mathfrak{R} \rightarrow \mathfrak{R}$; 219, 421
$f : Q_1 \rightarrow Q_2$	function f from Q_1 into Q_2 ; 8
$\frac{\partial u}{\partial x^i}$	i th partial derivative of $u : \mathfrak{R}^d \rightarrow \mathfrak{R}$; 39
$(\frac{\partial}{\partial x^i})^k u$	k th order partial derivative of u with respect to x^i ; 39
\exists	there exists; 128
$F_X(\cdot)$	distribution function of X ; 8
$f_X(\cdot)$	density function of X ; 11
$\phi_X(\cdot)$	characteristic function of X ; 35
$\mathbf{1}_A$	indicator function for event A to be true; 9

$N(\cdot)$	Gaussian distribution function; 14
$\Gamma(\cdot)$	gamma function; 15
$\Gamma(\cdot; \cdot)$	incomplete gamma function; 15
$(\text{mod } c)$	modulo c ; 548
\mathcal{A}	collection of events, sigma-algebra; 5
$\underline{\mathcal{A}}$	filtration; 162
$E(X)$	expectation of X ; 21, 22
$E(X \mathcal{A})$	conditional expectation of X under \mathcal{A} ; 32, 33
$P(A)$	probability of A ; 4
$P(A B)$	probability of A conditioned on B ; 6
\in	element of; 1
\notin	not element of; 4
\neq	not equal; 5
\approx	approximately equal; 72, 169
$a \ll b$	a is significantly smaller than b ; 426, 515
$\lim_{N \rightarrow \infty}$	limit as N tends to infinity; 2
$\liminf_{N \rightarrow \infty}$	lower limit as N tends to infinity; 93, 94
$\limsup_{N \rightarrow \infty}$	upper limit as N tends to infinity; 93, 94
i	square root of -1 , imaginary unit; 35, 149
$\delta(\cdot)$	Dirac delta function at zero; 143, 146
\mathbf{I}	unit matrix; 44
$\text{sgn}(x)$	sign of $x \in \Re$; 42
\mathcal{L}_T^2	space of square integrable, progressively measurable functions on $[0, T] \times \Omega$; 191
$\mathcal{B}(U)$	smallest sigma-algebra on U ; 124
$\ln(a)$	natural logarithm of a ; 1
MM	Merton model; 252
MMM	minimal market model; 251

EWI	equi-value weighted index; 397
MSCI	Morgan Stanley capital weighted world stock accumulation index; 332
ODE	ordinary differential equation; 151, 239
SDE	stochastic differential equation; 207, 235, 237
PDE	partial differential equation; 143
PIDE	partial integro differential equation; 358
WSI	world stock index; 399
$I_\nu(\cdot)$	modified Bessel function of the first kind with index ν ; 16
$K_\lambda(\cdot)$	modified Bessel function of the third kind with index λ ; 17, 18
\mathcal{V}	set of nonnegative portfolios; 373
\mathcal{V}^+	set of strictly positive portfolios; 369
$\bar{\mathcal{V}}_{S_0}^+$	set of strictly positive, discounted fair portfolios with initial value S_0 ; 419