OPIM 653/353 - Mathematical Modeling in Finance  
Spring 2016

INSTRUCTOR(S)  
Professor Gerry Tsoukalas, gtsouk@wharton.upenn.edu

CLASS HOURS, TEACHING ASSISTANT AND OFFICE HOURS  
There are two sections offered: Section 1: meets MW: 12pm-1:30pm. Section 2: meets MW: 1:30pm-3:00pm, JMMH F65  
Instructor Office Hours: Mondays 3:00-5:30pm. Location: JMMH 567  
TA Office Hours: Joseph Xu, jiaqixu@wharton.upenn.edu, Wednesdays 4:00-6:00pm. Location: JMMH 607

OPTIONAL COURSE SURVEY  
If you are planning on taking this course, the instructor is requesting that you complete a short survey prior to the first day of class, so that your preferences can be taken into account. Survey link: http://goo.gl/axMCC

COURSE OBJECTIVES  
This course focuses on the development of models for the pricing, hedging and management of complex financial instruments and derivative securities. An emphasis is placed on the development of optimization tools and data-driven methods and on their applications to relevant problems faced by financial services firms, in areas such as investment management, quantitative trading and risk management. Extensive cases will be used to illustrate the practical implementation of the modeling tools. Topics include: Pricing and hedging of derivatives (vanilla and exotics), portfolio management/portfolio trading and bond analytics, statistical arbitrage, algorithmic/high-frequency trading and market microstructure. Students will use excel/VBA or Matlab (or other languages if desired) for assigned homeworks.

TEXT AND READINGS  
Most of the reading for the course will be in the form of handouts that will be distributed online. Additional (optional) reading will be posted on the course website through canvas. A list of (optional) references is provided at the end.

ASSIGNMENTS, QUIZZES AND EXAMS  
There will be a series of take-home homeworks/small projects during the course of the semester, corresponding to the topics covered in the lectures.

GRADING  
Grading will be based on take-home assignments (80%), class attendance (10%), and active participation (10%). There is no mid-term or final exam.

LEARNING TEAMS  
Students will be allowed (but not required) to work in teams of 2 towards the homeworks. Each student’s contribution must be clearly stated on each team submission. Late assignments will not be accepted.

CLASSROOM EXPECTATIONS – CONCERT RULES

- Class starts and ends on time  
- Late entry or reentry only under exceptional circumstances  
- Name tents displayed  
- All phones, and other electronic devices turned off unless otherwise stated. Bring your laptops, you will need them.

ETHICS AND USE OF PRIOR MATERIALS  
Students are strictly not allowed to use any material from previous years. Sources must be clearly referenced. Violation of this rule results in severe disciplinary action.
SUMMARY OF CLASS SESSIONS

1. Course Overview & Quantitative Finance in Practice (1 lecture)
We discuss the course syllabus and give an overview of the financial services industry (differentiating between sell-side and buy-side firms) and the different roles encountered in investment banks, hedge funds and quantitative trading firms, including traders, sales, structurers, strategists, risk managers, financial engineers, quants, auditors, compliance etc.

2. Hedging (2-3 lectures)
We lay out the foundations of hedging which will be used throughout the semester. A hedged portfolio is one that is insulated from market forces. We discuss some basic concepts in hedging and distinguish between model-based and data-based hedging.

Topics: Scenario-based hedging; Regression hedging; In-sample versus out-of-sample performance.

3. Option Pricing Part I – Option Pricing Theory (3 lectures)
We introduce option pricing theory and the necessary tools to understand it, including: Taylor expansions, stochastic differentiation and integration, Ito’s lemma, and martingales. We introduce the law of one-price and no-arbitrage pricing principles, before building intuition on the assumed log-normality of stock prices. We then derive and discuss the Black-Scholes-Merton model for European options.

Topics: No-arbitrage pricing; Martingales; Risk-neutral measure; Understanding stochastic differential equations; Ito; Geometric Brownian process and the lognormal distribution of stock prices; The Black-Scholes Model;

4. Option Pricing Part II – The Binomial Method (3 lectures)
After a brief introduction on the history of binomial models, we introduce binomial pricing theory and establish the link with the Black-Scholes model. We then apply binomial pricing on simple European calls and puts, before extending it to American options. We continue with binomial pricing methods for exotic options, including options with path-dependent payoffs and options on multiple underlying assets (three-dimensional binomial trees), and variance swaps. We conclude with a discussion on the limits of binomial pricing in practice. Excel/VBA and Matlab pricing code is developed for all of the examples. Market data is used when appropriate.

Topics: Binomial Model; European and American options; Path independent and path dependent options: caps, barrier and lookback options; Options on multiple assets.

5. Option Pricing Part III – Monte Carlo Simulation (3 lectures)
After a brief introduction on the history of Monte Carlo simulation and a review of basic statistics, we introduce the theory and apply it to pricing exotic options, including pricing path independent and dependent options. We then discuss popular variance reduction techniques which are used in practice. Excel/VBA and Matlab pricing code is developed for all of the examples. Market data is used when appropriate. We conclude by discussing the limits of Monte Carlo simulation and discuss in what practical circumstances each of the three option pricing methods (Parts I, II and III) is the most appropriate.

Topics: Review of statistics and confidence intervals; Pricing path independent and dependent securities by simulation; Variance reduction techniques: antithetic and control variate techniques.

6. Delta Hedging and Gamma Trading in Practice (2 lectures)
Black & Scholes meets the real world: We challenge the model’s assumptions and partially investigate (via simulation) why data from observed market prices differ from theoretical values. We study the implications on delta and gamma trading from the perspective of an options market-maker. We explain how the “Greeks” are used to assess trading risk in practice.

Topics: Static hedging versus dynamic hedging; Implied volatility; Delta and Gamma trading; Naked/Covered positions; Stop-Loss strategies; risk-management and “Greeks”;

7. Portfolio Optimization (6 lectures)
We begin with an overview of classical “single-period” Markowitz portfolio optimization and provide intuition on why asset diversification works in practice. We then introduce the relevant theoretical tools (linear Algebra, linear and non-linear programming) and practical tools (solver, Matlab engines, CVX) required for portfolio optimization. We study the standard mean-variance quadratic programming model, which we solve, both in closed form and numerically, for an arbitrary number of assets. We then study variations of the model based on alternative definitions of risk. We develop several data-driven applications and extensions in Excel/VBA and Matlab, on a variety of topics, including portfolio optimization with transaction costs, ETF indexation and pension fund surplus management.
Topics: Introduction to optimization tools (solver, CVX); ADR and variance measures of risk; Linear and quadratic programming methods for portfolio management and asset allocation; The indexation problem and multiple linear regression; Surplus optimization; Mean-variance analysis with transaction costs; Testing and implementation issues; large-scale portfolio optimization.

8. Multi-period Portfolio Analysis (2 lectures)
We address the multi-period investment problem and the problem of choosing among efficient portfolios.
Topics: Multi-period portfolio models; Kelly’s criterion; log-utility maximization; Portfolio insurance strategies.

9. Bond Analytics (2 lectures)
We give a brief background on bond mathematics. We study the pricing of U.S. Treasury bonds and introduce some of the taxonomy used for fixed-income securities such as yield and duration.
Topics: Review of discounting, present value and yield; Duration and convexity measures; Immunization and hedging applications; The discount factor and the spot yield curve.

10. Interest Rate Derivatives and Credit Models (2 lectures)
We look at pricing of bonds and callable bonds, swaps and swaptions, caps and floors, and mortgage-backed securities. We give an introduction to the pricing of credit-sensitive securities and show how default models can be layered on top of the interest rate models. We do a case study of a convertible bond issue, in which we merge both interest-rate and credit aspects of pricing.
Topics: Interest rate tree and the yield curve; Interest rate models: Ho-Lee, Black-Derman-Toy, Hull-White, and Heath-Jarrow-Morton; Callable bond pricing; Interest rate swaps and swaption pricing; Defaultable bond pricing.

11. High-frequency Trading and Market Microstructure (tentative 1-2 lectures)
We discuss high-frequency trading, price impact and cutting edge algorithmic trading models, that are utilized by electronic trading desks and high-frequency trading firms. We give an overview of the latest academic research on this front. We also investigate the use of statistical arbitrage methods and illustrate how they are used in practice.
Topics: Optimal control of a gains process; order book models; optimization of execution costs; statistical arbitrage; market microstructure.
Optional References

“Industry” Books

The following books are widely read on Wall Street. Some books are edited compilations of research reports from the major investment banks.

Derivatives Trading and Option Pricing, Nicholas Dunbar (Editor), Risk Books, 2005.
My Life as a Quant: Reflections on Physics and Finance, Emanuel Derman, Wiley, 2004
Over the Rainbow, RISK Publications/Fuji, London, 1996,
The Big Short: Inside the Doomsday Machine, Michael Lewis, Norton & Company, 2010
Journals

Finance Textbooks

Statistics Textbooks

Time Series and Multivariate Statistics Textbooks