Daily Monitoring

- Almost all barrier options monitor the barrier only for the daily closing prices.
- In that case, only nodes at the end of a day need to check for the barrier condition.
- We can even remove intraday nodes to create a multinomial tree.
  - A node is then followed by $d + 1$ nodes if each day is partitioned into $d$ periods.
- This saves time and space?\(^a\)

\(^a\)Contributed by Ms. Chen, Tzu-Chun (R94922003) and others on April 12, 2006.
A Heptanomial Tree (6 Periods Per Day)
Foreign Currencies

- $S$ denotes the spot exchange rate in domestic/foreign terms.
- $\sigma$ denotes the volatility of the exchange rate.
- $r$ denotes the domestic interest rate.
- $\hat{r}$ denotes the foreign interest rate.
- A foreign currency is analogous to a stock paying a known dividend yield.
  - Foreign currencies pay a “continuous dividend yield” equal to $\hat{r}$ in the foreign currency.
Foreign Exchange Options

- Foreign exchange options are settled via delivery of the underlying currency.

- A primary use of foreign exchange (or forex) options is to hedge currency risk.

- Consider a U.S. company expecting to receive 100 million Japanese yen in March 2000.

- Those 100 million Japanese yen will be exchanged for U.S. dollars.
Foreign Exchange Options (continued)

- The contract size for the Japanese yen option is JPY6,250,000.

- The company purchases \( \frac{100,000,000}{6,250,000} = 16 \) puts on the Japanese yen with a strike price of \$.0088 \) and an exercise month in March 2000.

- This gives the company the right to sell 100,000,000 Japanese yen for \( 100,000,000 \times .0088 = 880,000 \) U.S. dollars.
Foreign Exchange Options (concluded)

- The formulas derived for stock index options in Eqs. (24) on p. 261 apply with the dividend yield equal to \( \hat{r} \):

\[
C = Se^{-\hat{r}\tau} N(x) - Xe^{-r\tau} N(x - \sigma\sqrt{\tau}),
\]

\[
P = Xe^{-r\tau} N(-x + \sigma\sqrt{\tau}) - Se^{-\hat{r}\tau} N(-x).
\]

\[ (28') \]

- Above,

\[
x \equiv \frac{\ln(S/X) + (r - \hat{r} + \sigma^2/2) \tau}{\sigma\sqrt{\tau}}.
\]
Bar the roads!
Bar the paths!
Wert thou to flee from here, wert thou
to find all the roads of the world,
the way thou seekst
the path to that thou’dst find not[.]
— Richard Wagner (1813–1883), *Parsifal*
Path-Dependent Derivatives

- Let $S_0, S_1, \ldots, S_n$ denote the prices of the underlying asset over the life of the option.
- $S_0$ is the known price at time zero.
- $S_n$ is the price at expiration.
- The standard European call has a terminal value depending only on the last price, $\max(S_n - X, 0)$.
- Its value thus depends only on the underlying asset’s terminal price regardless of how it gets there.
Path-Dependent Derivatives (continued)

- Some derivatives are path-dependent in that their terminal payoff depends strongly on the path.

- The (arithmetic) average-rate call has a terminal value given by

$$\max \left( \frac{1}{n+1} \sum_{i=0}^{n} S_i - X, 0 \right).$$

- The average-rate put’s terminal value is given by

$$\max \left( X - \frac{1}{n+1} \sum_{i=0}^{n} S_i, 0 \right).$$
Path-Dependent Derivatives (continued)

• Average-rate options are also called Asian options.

• They are very popular.\textsuperscript{a}

• They are useful hedging tools for firms that will make a stream of purchases over a time period because the costs are likely to be linked to the average price.

• They are mostly European.

\textsuperscript{a}As of the late 1990s, the outstanding volume was in the range of 5–10 billion U.S. dollars according to Nielsen and Sandmann (2003).
Path-Dependent Derivatives (concluded)

- A lookback call option on the minimum has a terminal payoff of \( S_n - \min_{0 \leq i \leq n} S_i \).
- A lookback put option on the maximum has a terminal payoff of \( \max_{0 \leq i \leq n} S_i - S_n \).
- The fixed-strike lookback option provides a payoff of \( \max(\max_{0 \leq i \leq n} S_i - X, 0) \) for the call and \( \max(X - \min_{0 \leq i \leq n} S_i, 0) \) for the put.
- Lookback call and put options on the average are called average-strike options.
Average-Rate Options

- Average-rate options are notoriously hard to price.
- The binomial tree for the averages does not combine.
- A straightforward algorithm is to enumerate the $2^n$ price paths for an $n$-period binomial tree and then average the payoffs.
- But the exponential complexity makes this naive algorithm impractical.
- As a result, the Monte Carlo method and approximation algorithms are some of the alternatives left.
\[ C_{u} = \frac{pC_{uu} + (1-p)\ C_{ud}}{e^{r}} \]

\[ C_{ud} = \max \left( \frac{S + Su + Sud}{3} - X, 0 \right) \]

\[ C_{d} = \frac{pC_{du} + (1-p)\ C_{dd}}{e^{r}} \]

\[ C_{dd} = \max \left( \frac{S + Sd + Sdd}{3} - X, 0 \right) \]
States and Their Transitions

- The tuple 

\[(i, S, P)\]

captures the state for the Asian option.a
- \(i\): the time.
- \(S\): the prevailing stock price.
- \(P\): the running sum.

---
aIt is a sufficient statistic.
States and Their Transitions (concluded)

- For the binomial model, the state transition is:

\[(i + 1, Su, P + Su)\] for the up move

\[(i, S, P)\]

\[(i + 1, Sd, P + Sd)\] for the down move
Pricing Some Path-Dependent Options

- Not all path-dependent derivatives are hard to price.
- Barrier options are easy to price.
- When averaging is done geometrically, the option payoffs are

\[
\max \left( (S_0 S_1 \cdots S_n)^{1/(n+1)} - X, 0 \right), \\
\max \left( X - (S_0 S_1 \cdots S_n)^{1/(n+1)}, 0 \right).
\]
Pricing Some Path-Dependent Options (concluded)

• The limiting analytical solutions are the Black-Scholes formulas.
  – With the volatility set to \( \sigma_a \equiv \sigma / \sqrt{3} \).
  – With the dividend yield set to \( q_a \equiv (r + q + \sigma^2/6)/2 \).

• The formula is therefore

\[
C = S e^{-q_a \tau} N(x) - X e^{-r \tau} N(x - \sigma_a \sqrt{\tau}), \quad (29)
\]

\[
P = X e^{-r \tau} N(-x + \sigma_a \sqrt{\tau}) - S e^{-q_a \tau} N(-x), \quad (29')
\]

– where \( x \equiv \frac{\ln(S/X) + (r - q_a + \sigma_a^2/2) \tau}{\sigma_a \sqrt{\tau}} \).
An Approximate Formula for Asian Calls\textsuperscript{a}

\[ C = e^{-r\tau} \left[ \frac{S}{\tau} \int_0^\tau e^{\mu t + \sigma^2 t/2} N \left( \frac{-\gamma + (\sigma t/\tau)(\tau - t/2)}{\sqrt{\tau/3}} \right) dt \right. 
\left. - X N \left( \frac{-\gamma}{\sqrt{\tau/3}} \right) \right], \]

where

\begin{itemize}
  \item $\mu \equiv r - \sigma^2 / 2$.
  \item $\gamma$ is the unique value that satisfies
    \[ \frac{S}{\tau} \int_0^\tau e^{3\gamma \sigma t(\tau-t/2)/\tau^2 + \mu t + \sigma^2 [t-(3t^2/\tau^3)(\tau-t/2)^2]/2} dt = X. \]
\end{itemize}

\textsuperscript{a}Rogers and Shi (1995); Thompson (1999); Chen (2005); Chen and Lyuu (2006).
Approximation Algorithm for Asian Options

- Based on the BOPM.
- Consider a node at time $j$ with the underlying asset price equal to $S_0 u^{j-i} d^i$.
- Name such a node $N(j, i)$.
- The running sum $\sum_{m=0}^{j} S_m$ at this node has a maximum value of

$$S_0 \left( 1 + u + u^2 + \cdots + u^{j-i} + u^{j-i} d + \cdots + u^{j-i} d^i \right)$$

$$= S_0 \frac{1 - u^{j-i+1}}{1 - u} + S_0 u^{j-i} d \frac{1 - d^i}{1 - d}.$$
Approximation Algorithm for Asian Options (continued)

- Divide this value by \( j + 1 \) and call it \( A_{\text{max}}(j, i) \).
- Similarly, the running sum has a minimum value of

\[
S_0 \underbrace{(1 + d + d^2 + \cdots + d^i + d^i u + \cdots + d^i u^{j-i})}_{j}
\]

\[
= S_0 \frac{1 - d^{i+1}}{1 - d} + S_0 d^i u \frac{1 - u^{j-i}}{1 - u}.
\]

- Divide this value by \( j + 1 \) and call it \( A_{\text{min}}(j, i) \).
- \( A_{\text{min}} \) and \( A_{\text{max}} \) are running averages.
Path with maximum running average

Path with minimum running average
Approximation Algorithm for Asian Options
(continued)

• The possible running averages at $N(j, i)$ are far too many: $\binom{j}{i}$.
  - For example, $\binom{j}{j/2} \approx 2^j \sqrt{2/(\pi j)}$.

• But all lie between $A_{\min}(j, i)$ and $A_{\max}(j, i)$.

• Pick $k + 1$ equally spaced values in this range and treat them as the true and only running averages:

$$A_m(j, i) \equiv \left( \frac{k - m}{k} \right) A_{\min}(j, i) + \left( \frac{m}{k} \right) A_{\max}(j, i)$$

for $m = 0, 1, \ldots, k$. 
Approximation Algorithm for Asian Options (continued)

• Such “bucketing” introduces errors, but it works reasonably well in practice.\textsuperscript{a}

• A better alternative is to pick values whose logarithms are equally spaced.

• Still other alternatives are possible.

• Generally, $k$ must scale with at least $n$ to show convergence.\textsuperscript{b}

\textsuperscript{a}Hull and White (1993).
\textsuperscript{b}Dai, Huang, and Lyuu (2002).
Approximation Algorithm for Asian Options (continued)

- Backward induction calculates the option values at each node for the $k + 1$ running averages.
- Suppose the current node is $N(j, i)$ and the running average is $a$.
- Assume the next node is $N(j + 1, i)$, after an up move.
- As the asset price there is $S_0 u^{j+1-i} d^i$, we seek the option value corresponding to the running average

$$A_u \equiv \frac{(j + 1) a + S_0 u^{j+1-i} d^i}{j + 2}.$$
Approximation Algorithm for Asian Options (continued)

• But $A_u$ is not likely to be one of the $k + 1$ running averages at $N(j + 1, i)!$

• Find the running averages that bracket it:

$$A_\ell(j + 1, i) \leq A_u \leq A_{\ell+1}(j + 1, i).$$

• Express $A_u$ as a linearly interpolated value of the two running averages,

$$A_u = xA_\ell(j + 1, i) + (1 - x)A_{\ell+1}(j + 1, i), \quad 0 \leq x \leq 1.$$
Approximation Algorithm for Asian Options (continued)

- Obtain the approximate option value given the running average $A_u$ via

  $$C_u \equiv xC_\ell(j + 1, i) + (1 - x)C_{\ell+1}(j + 1, i).$$

  - $C_\ell(t, s)$ denotes the option value at node $N(t, s)$ with running average $A_\ell(t, s)$.

- This interpolation introduces the second source of error.
Approximation Algorithm for Asian Options (continued)

• The same steps are repeated for the down node $N(j + 1, i + 1)$ to obtain another approximate option value $C_d$.

• Finally obtain the option value as

$$[pC_u + (1 - p) C_d] e^{-r\Delta t}.$$ 

• The running time is $O(kn^2)$.
  - There are $O(n^2)$ nodes.
  - Each node has $O(k)$ buckets.
Approximation Algorithm for Asian Options (concluded)

- Arithmetic average-rate options were assumed to be newly issued: There was no historical average to deal with.
- This problem can be easily dealt with (see text).
- How about the Greeks?\(^a\)

\(^a\)Thanks to a lively class discussion on March 31, 2004.
A Numerical Example

- Consider a European arithmetic average-rate call with strike price 50.
- Assume zero interest rate in order to dispense with discounting.
- The minimum running average at node A in the figure on p. 341 is 48.925.
- The maximum running average at node A in the same figure is 51.149.
A Numerical Example (continued)

- Each node picks $k = 3$ for 4 equally spaced running averages.

- The same calculations are done for node A’s successor nodes B and C.

- Suppose node A is 2 periods from the root node.

- Consider the up move from node A with running average 49.666.
A Numerical Example (continued)

- Because the stock price at node B is 53.447, the new running average will be
  \[
  \frac{3 \times 49.666 + 53.447}{4} \approx 50.612.
  \]

- With 50.612 lying between 50.056 and 51.206 at node B, we solve
  \[
  50.612 = x \times 50.056 + (1 - x) \times 51.206
  \]
  to obtain \( x \approx 0.517 \).
A Numerical Example (continued)

- The option values corresponding to running averages 50.056 and 51.206 at node B are 0.056 and 1.206, respectively.

- Their contribution to the option value corresponding to running average 49.666 at node A is weighted linearly as

\[ x \times 0.056 + (1 - x) \times 1.206 \approx 0.611. \]
A Numerical Example (continued)

- Now consider the down move from node A with running average 49.666.
- Because the stock price at node C is 46.775, the new running average will be
  \[
  \frac{3 \times 49.666 + 46.775}{4} \approx 48.944.
  \]
- With 48.944 lying between 47.903 and 48.979 at node C, we solve
  \[
  48.944 = x \times 47.903 + (1 - x) \times 48.979
  \]
  to obtain \( x \approx 0.033 \).
A Numerical Example (concluded)

• The option values corresponding to running averages 47.903 and 48.979 at node C are both 0.0.

• Their contribution to the option value corresponding to running average 49.666 at node A is 0.0.

• Finally, the option value corresponding to running average 49.666 at node A equals

\[ p \times 0.611 + (1 - p) \times 0.0 \approx 0.2956, \]

where \( p = 0.483. \)

• The remaining three option values at node A can be computed similarly.
Convergence Behavior of the Approximation Algorithm

Asian option value

\[ a_{\text{Dai and Lyuu}} (2002). \]
Remarks on Asian Option Pricing

- Asian option pricing is an active research area.
- The above algorithm overestimates the “true” value.\(^a\)
- To guarantee convergence, \(k\) needs to grow with \(n\).
- There is a convergent approximation algorithm that does away with interpolation with a provable running time of \(2^{O(\sqrt{n})}\).\(^b\)

\(^a\)Dai, Huang, and Lyuu (2002).
Remarks on Asian Option Pricing (continued)

• There is an $O(kn^2)$-time algorithm with an error bound of $O(Xn/k)$ from the naive $O(2^n)$-time binomial tree algorithm in the case of European Asian options.a
  
  – $k$ can be varied for trade-off between time and accuracy.
  
  – If we pick $k = O(n^2)$, then the error is $O(1/n)$, and the running time is $O(n^4)$.

• In practice, log-linear interpolation works better.

---

aAingworth, Motwani, and Oldham (2000).
Remarks on Asian Option Pricing (concluded)

- Another approximation algorithm reduces the error to $O(X \sqrt{n/k})$.
  - It varies the number of buckets per node.
  - If we pick $k$ proportional to $n$, the error is $O(n^{-0.5})$.
  - If we pick $k = O(n^{1.5})$, then the error is $O(1/n)$, and the running time is $O(n^{3.5})$.

- Under “reasonable assumptions,” an $O(n^2)$-time algorithm with an error bound of $O(1/n)$ exists.

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\(^a\) Dai, Huang, and Lyuu (2002).
\(^b\) Hsu and Lyuu (2004).
A Grand Comparison

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<sup>a</sup>Hsu and Lyuu (2004); Zhang (2001,2003); Chen and Lyuu (2006).
## A Grand Comparison (concluded)

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Forwards, Futures, Futures Options, Swaps
Summon the nations to come to the trial. 
Which of their gods can predict the future? 
— Isaiah 43:9

The sure fun of the evening 
outweighed the uncertain treasure[.]
— Mark Twain (1835–1910),
The Adventures of Tom Sawyer
Terms

• $r$ will denote the riskless interest rate.
• The current time is $t$.
• The maturity date is $T$.
• The remaining time to maturity is $\tau \equiv T - t$ (all measured in years).
• The spot price $S$, the spot price at maturity is $S_T$.
• The delivery price is $X$. 
Terms (concluded)

- The forward or futures price is $F$ for a newly written contract.
- The value of the contract is $f$.
- A price with a subscript $t$ usually refers to the price at time $t$.
- Continuous compounding will be assumed.
Forward Contracts

- Forward contracts are for the delivery of the underlying asset for a certain delivery price on a specific time.
  - Foreign currencies, bonds, corn, etc.
- Ideal for hedging purposes.
- A farmer enters into a forward contract with a food processor to deliver 100,000 bushels of corn for $2.5 per bushel on September 27, 1995.
- The farmer is assured of a buyer at an acceptable price.
- The processor knows the cost of corn in advance.
Forward Contracts (concluded)

- A forward agreement limits both risk and rewards.
  - If the spot price of corn rises on the delivery date, the farmer will miss the opportunity of extra profits.
  - If the price declines, the processor will be paying more than it would.

- Either side has an incentive to default.

- Other problems: The food processor may go bankrupt, the farmer can go bust, the farmer might not be able to harvest 100,000 bushels of corn because of bad weather, the cost of growing corn may skyrocket, etc.
Spot and Forward Exchange Rates

- Let $S$ denote the spot exchange rate.
- Let $F$ denote the forward exchange rate one year from now (both in domestic/foreign terms).
- $r_f$ denotes the annual interest rates of the foreign currency.
- $r_\ell$ denotes the annual interest rates of the local currency.
- Arbitrage opportunities will arise unless these four numbers satisfy an equation.
Interest Rate Parity\textsuperscript{a}

\[\frac{F}{S} = e^{r_\ell - r_f}.\]  \hspace{1cm} (30)

- A holder of the local currency can do either of:
  - Lend the money in the domestic market to receive $e^{r_\ell}$ one year from now.
  - Convert local currency for foreign currency, lend for 1 year in foreign market, and convert foreign currency into local currency at the fixed forward exchange rate, $F$, by selling forward foreign currency now.

\textsuperscript{a}Keynes (1923). John Maynard Keynes (1883–1946) was one of the greatest economists in history.
Interest Rate Parity (concluded)

- No money changes hand in entering into a forward contract.

- One unit of local currency will hence become $F/e^r_f/S$ one year from now in the 2nd case.

- If $F/e^r_f/S > e^r_\ell$, an arbitrage profit can result from borrowing money in the domestic market and lending it in the foreign market.

- If $F/e^r_f/S < e^r_\ell$, an arbitrage profit can result from borrowing money in the foreign market and lending it in the domestic market.
Forward Price

- The payoff of a forward contract at maturity is
  \[ S_T - X. \]

- Forward contracts do not involve any initial cash flow.

- The forward price is the delivery price which makes the forward contract zero valued.
  - That is, \( f = 0 \) when \( F = X \).
Forward Price (concluded)

• The delivery price cannot change because it is written in the contract.

• But the forward price may change after the contract comes into existence.
  – The value of a forward contract, \( f \), is 0 at the outset.
  – It will fluctuate with the spot price thereafter.
  – This value is enhanced when the spot price climbs and depressed when the spot price declines.

• The forward price also varies with the maturity of the contract.
Forward Price: Underlying Pays No Income

**Lemma 9** For a forward contract on an underlying asset providing no income,

\[ F = S e^{r\tau}. \]  \hspace{1cm} (31)

- If \( F > S e^{r\tau} \), borrow \( S \) dollars for \( \tau \) years, buy the underlying asset, and short the forward contract with delivery price \( F \).
- At maturity, sell the asset for \( F \) and use \( S e^{r\tau} \) to repay the loan, leaving an arbitrage profit of \( F - S e^{r\tau} > 0 \).
- If \( F < S e^{r\tau} \), do the opposite.
Example

• $r$ is the annualized 3-month riskless interest rate.

• $S$ is the spot price of the 6-month zero-coupon bond.

• A new 3-month forward contract on a 6-month zero-coupon bond should command a delivery price of $S e^{r/4}$.

• So if $r = 6\%$ and $S = 970.87$, then the delivery price is $970.87 \times e^{0.06/4} = 985.54$. 
Contract Value: The Underlying Pays No Income

The value of a forward contract is

\[ f = S - X e^{-r\tau}. \]

- Consider a portfolio of one long forward contract, cash amount \( X e^{-r\tau} \), and one short position in the underlying asset.
- The cash will grow to \( X \) at maturity, which can be used to take delivery of the forward contract.
- The delivered asset will then close out the short position.
- Since the value of the portfolio is zero at maturity, its PV must be zero.
Forward Price: Underlying Pays Predictable Income

Lemma 10 For a forward contract on an underlying asset providing a predictable income with a PV of $I$,

$$F = (S - I) e^{r\tau}.$$ \hspace{1cm} (32)

- If $F > (S - I) e^{r\tau}$, borrow $S$ dollars for $\tau$ years, buy the underlying asset, and short the forward contract with delivery price $F$.

- At maturity, the asset is sold for $F$, and $(S - I) e^{r\tau}$ is used to repay the loan, leaving an arbitrage profit of $F - (S - I) e^{r\tau} > 0$.

- If $F < (S - I) e^{r\tau}$, reverse the above.
Example

- Consider a 10-month forward contract on a $50 stock.
- The stock pays a dividend of $1 every 3 months.
- The forward price is

\[
\left(50 - e^{-r_{3/4}} - e^{-r_{6/2}} - e^{-3\times r_{9/4}}\right) e^{r_{10\times(10/12)}}.
\]

- \(r_i\) is the annualized \(i\)-month interest rate.
Underlying Pays a Continuous Dividend Yield of $q$

The value of a forward contract at any time prior to $T$ is

$$f = S e^{-q \tau} - X e^{-r \tau}. \quad (33)$$

- Consider a portfolio of one long forward contract, cash amount $X e^{-r \tau}$, and a short position in $e^{-q \tau}$ units of the underlying asset.

- All dividends are paid for by shorting additional units of the underlying asset.

- The cash will grow to $X$ at maturity.

- The short position will grow to exactly one unit of the underlying asset.
Underlying Pays a Continuous Dividend Yield (concluded)

• There is sufficient fund to take delivery of the forward contract.
• This offsets the short position.
• Since the value of the portfolio is zero at maturity, its PV must be zero.
• One consequence of Eq. (33) is that the forward price is

\[ F = S e^{(r-q)\tau}. \]  \hfill (34)