Principles of Financial Computing

Prof. Yuh-Dauh Lyuu

Dept. Computer Science & Information Engineering

and

Department of Finance National Taiwan University

Class Information

- Yuh-Dauh Lyuu. Financial Engineering & Computation: Principles, Mathematics, Algorithms. Cambridge University Press. 2002.
- Official Web page is

www.csie.ntu.edu.tw/~lyuu/finance1.html

• Check

www.csie.ntu.edu.tw/~lyuu/capitals.html

for some of the software.

Class Information (concluded)

- Please ask many questions in class.
 - The best way for me to remember you in a large class.^a
- Teaching assistants have been announced.

^a "[A] science concentrator [...] said that in his eighth semester of [Harvard] college, there was not a single science professor who could identify him by name." (*New York Times*, September 3, 2003.)

Useful Journals

- Applied Mathematical Finance.
- Finance and Stochastics.
- Financial Analysts Journal.
- Journal of Banking & Finance.
- Journal of Computational Finance.
- Journal of Derivatives.
- Journal of Economic Dynamics & Control.
- Journal of Finance.
- Journal of Financial Economics.

Useful Journals (continued)

- Journal of Fixed Income.
- Journal of Futures Markets.
- Journal of Financial and Quantitative Analysis.
- Journal of Portfolio Management.
- Journal of Real Estate Finance and Economics.
- Management Science.
- Mathematical Finance.

Useful Journals (concluded)

- Quantitative Finance.
- Review of Financial Studies.
- Review of Derivatives Research.
- Risk Magazine.
- SIAM Journal on Financial Mathematics
- Stochastics and Stochastics Reports.

Introduction

[An] investment bank could be more collegial than a college.
— Emanuel Derman, My Life as a Quant (2004)

The two most dangerous words in Wall Street vocabulary are "financial engineering." — Wilbur Ross (2007)

What This Course Is About

- Financial theories in pricing.
- Mathematical backgrounds.
- Derivative securities.
- Pricing models.
- Efficient algorithms in pricing financial instruments.
- Research problems.
- Finding your thesis directions.

What This Course Is Not About

- How to program.
- Basic mathematics in calculus, probability, and algebra.
- Details of the financial markets.
- How to be rich.
- How the markets will perform tomorrow.

The Modelers' Hippocratic Oath^a

- I will remember that I didn't make the world, and it doesn't satisfy my equations.
- Though I will use models boldly to estimate value, I will not be overly impressed by mathematics.
- I will never sacrifice reality for elegance without explaining why I have done so.
- Nor will I give the people who use my model false comfort about its accuracy. Instead, I will make explicit its assumptions and oversights.
- I understand that my work may have enormous effects on society and the economy, many of them beyond my comprehension.

^aEmanuel Derman and Paul Wilmott, January 7, 2009.

Analysis of Algorithms

It is unworthy of excellent men to lose hours like slaves in the labor of computation. — Gottfried Wilhelm Leibniz (1646–1716)

Computability and Algorithms

- Algorithms are precise procedures that can be turned into computer programs.
- Uncomputable problems.
 - Does this program have infinite loops?
 - Is this program bug free?
- Computable problems.
 - Intractable problems.
 - Tractable problems.

Complexity

- A set of basic operations are assumed to take one unit of time (+, -, ×, /, log, x^y, e^x,...).
- The total number of these operations is the total work done by an algorithm (its computational complexity).
- The space complexity is the amount of memory space used by an algorithm.
- Concentrate on the abstract complexity of an algorithm instead of its detailed implementation.
- Complexity is a good guide to an algorithm's *actual* running time.

Asymptotics

- Consider the search algorithm on p. 17.
- The worst-case complexity is n comparisons (why?).
- There are operations besides comparison.
- We care only about the asymptotic growth rate not the exact number of operations.
 - So the complexity of maintaining the loop is subsumed by the complexity of the body of the loop.
- The complexity is hence O(n).

Algorithm for Searching an Element

1: for
$$k = 1, 2, 3, \ldots, n$$
 do

2: **if**
$$x = A_k$$
 then

- 3: return k;
- 4: **end if**
- 5: end for
- 6: return not-found;

Common Complexities

- Let n stand for the "size" of the problem.
 - Number of elements, number of cash flows, etc.
- Linear time if the complexity is O(n).
- Quadratic time if the complexity is $O(n^2)$.
- Cubic time if the complexity is $O(n^3)$.
- Exponential time if the complexity is $2^{O(n)}$.
- Superpolynomial if the complexity is less than exponential but higher than polynomials, say $2^{O(\sqrt{n})}$.^a

^aE.g., Dai and Lyuu (2007) and Lyuu and Wang (2010).

Basic Financial Mathematics

In the fifteenth century mathematics was mainly concerned with questions of commercial arithmetic and the problems of the architect. — Joseph Alois Schumpeter (1883–1950)

I'm more concerned about the return of my money than the return on my money. — Will Rogers (1879–1935)



Time Value of Money $^{\rm a}$

$$FV = PV(1+r)^{n},$$

PV = FV × (1+r)⁻ⁿ.

- FV (future value).
- PV (present value).
- r: interest rate.

^aFibonacci (1170–1240) and Irving Fisher (1867–1947).

Periodic Compounding

- Suppose the annual interest rate r is compounded m times per annum.
- Then

$$1 \to \left(1 + \frac{r}{m}\right) \to \left(1 + \frac{r}{m}\right)^2 \to \left(1 + \frac{r}{m}\right)^3 \to \cdots$$

• Hence

$$FV = PV\left(1 + \frac{r}{m}\right)^{nm}.$$
 (1)

Common Compounding Methods

- Annual compounding: m = 1.
- Semiannual compounding: m = 2.
- Quarterly compounding: m = 4.
- Monthly compounding: m = 12.
- Weekly compounding: m = 52.
- Daily compounding: m = 365.

Easy Translations

- An annual interest rate of r compounded m times a year is "equivalent to" an interest rate of r/m per 1/myear.
- If a loan asks for a return of 1% per month, the annual interest rate will be 12% with monthly compounding.

Example

- Annual interest rate is 10% compounded twice per annum.
- Each dollar will grow to be

$$[1 + (0.1/2)]^2 = 1.1025$$

one year from now.

• The rate is equivalent to an interest rate of 10.25% compounded once *per annum*,

$$1 + 0.1025 = 1.1025$$

Continuous Compounding $^{\rm a}$

• Let $m \to \infty$ so that

$$\left(1+\frac{r}{m}\right)^m \to e^r$$

in Eq. (1) on p. 23.

• Then

$$FV = PV \times e^{rn},$$

where e = 2.71828...

^aJacob Bernoulli (1654–1705) in 1685.

Continuous Compounding (concluded)

- Continuous compounding is easier to work with.
- Suppose the annual interest rate is r_1 for n_1 years and r_2 for the following n_2 years.
- Then the FV of one dollar will be

 $e^{r_1n_1+r_2n_2}.$

Efficient Algorithms for PV and FV

• The PV of the cash flow C_1, C_2, \ldots, C_n at times $1, 2, \ldots, n$ is

$$\frac{C_1}{1+y} + \frac{C_2}{(1+y)^2} + \dots + \frac{C_n}{(1+y)^n}$$

• This formula and its variations are the engine behind most of financial calculations.^a

- What is y?

- What are C_i ?

- What is n?

^a "Asset pricing theory all stems from one simple concept [...]: price equals expected discounted payoff" (see Cochrane (2005)).

An Algorithm for Evaluating PV

- 1: x := 0;
- 2: for i = 1, 2, ..., n do
- 3: $x := x + C_i \times (1+y)^i;$
- 4: end for
- 5: return x;
- The algorithm takes time proportional to $\sum_{i=1}^{n} i = O(n^2).$
- Can improve it to O(n) if you apply $a^b = e^{b \ln a}$.

Another Algorithm for Evaluating PV

1:
$$x := 0;$$

2:
$$d := 1 + y;$$

3: for
$$i = n, n - 1, ..., 1$$
 do

$$4: \quad x := (x + C_i)/d;$$

$$5:$$
 end for

6: return x;

Horner's Rule: The Idea Behind p. 31

• This idea is

$$\left(\cdots\left(\left(\frac{C_n}{1+y}+C_{n-1}\right)\frac{1}{1+y}+C_{n-2}\right)\frac{1}{1+y}+\cdots\right)\frac{1}{1+y}$$

– Due to Horner (1786–1837) in 1819.

- The algorithm takes O(n) time.
- It is the most efficient possible in terms of the absolute number of arithmetic operations.^a

^aBorodin and Munro (1975).

Conversion between Compounding Methods

- Suppose r_1 is the annual rate with continuous compounding.
- Suppose r_2 is the equivalent rate compounded m times per annum.
- How are they related?

Conversion between Compounding Methods (concluded)

- Both interest rates must produce the same amount of money after one year.
- That is,

$$\left(1+\frac{r_2}{m}\right)^m = e^{r_1}.$$

• Therefore,

$$r_1 = m \ln \left(1 + \frac{r_2}{m}\right),$$

$$r_2 = m \left(e^{r_1/m} - 1\right).$$

${\sf Annuities}^{\rm a}$

- An annuity pays out the same C dollars at the end of each year for n years.
- With a rate of r, the FV at the end of the nth year is

$$\sum_{i=0}^{n-1} C(1+r)^i = C \, \frac{(1+r)^n - 1}{r}.$$
 (2)

 $^{\rm a}$ Jan de Witt (1625–1672) in 1671 and Nicholas Bernoulli (1687–1759) in 1709.

General Annuities

• If m payments of C dollars each are received per year (the general annuity), then Eq. (2) becomes

$$C \, \frac{\left(1 + \frac{r}{m}\right)^{nm} - 1}{\frac{r}{m}}.$$

• The PV of a general annuity is

$$\sum_{i=1}^{nm} C\left(1+\frac{r}{m}\right)^{-i} = C \,\frac{1-\left(1+\frac{r}{m}\right)^{-nm}}{\frac{r}{m}}.$$
 (3)

Amortization

- It is a method of repaying a loan through regular payments of interest *and* principal.
- The size of the loan (the original balance) is reduced by the principal part of each payment.
- The interest part of each payment pays the interest incurred on the remaining principal balance.
- As the principal gets paid down over the term of the loan, the interest part of the payment diminishes.

Example: Home Mortgage

- By paying down the principal consistently, the risk to the lender is lowered.
- When the borrower sells the house, the remaining principal is due the lender.
- Consider the equal-payment case, i.e., fixed-rate, level-payment, fully amortized mortgages.
 - They are called traditional mortgages in the U.S.

A Numerical Example

- Consider a 15-year, \$250,000 loan at 8.0% interest rate.
- Solving Eq. (3) on p. 36 with PV = 250000, n = 15, m = 12, and r = 0.08 gives a monthly payment of C = 2389.13.
- The amortization schedule is shown on p. 40.

Remaining principal	Principal	Interest	Payment	Month
250,000.000				
$249,\!277.536$	722.464	$1,\!666.667$	$2,\!389.13$	1
$248,\!550.256$	727.280	$1,\!661.850$	$2,\!389.13$	2
247,818.128	732.129	$1,\!657.002$	$2,\!389.13$	3
		• • • •		
4,730.899	$2,\!341.980$	47.153	$2,\!389.13$	178
2,373.308	$2,\!357.591$	31.539	$2,\!389.13$	179
0.000	$2,\!373.308$	15.822	$2,\!389.13$	180
	$250,\!000.000$	$180,\!043.438$	430,043.438	Total

A Numerical Example (concluded)

In every month:

- The principal and interest parts add up to \$2,389.13.
- The remaining principal is reduced by the amount indicated under the Principal heading.
- The interest is computed by multiplying the remaining balance of the previous month by 0.08/12.

Method 1 of Calculating the Remaining Principal

- Go down the amortization schedule until you reach the particular month you are interested in.
 - A month's principal payment equals the monthly payment subtracted by the previous month's remaining principal times the monthly interest rate.
 - A month's remaining principal equals the previous month's remaining principal subtracted by the principal payment calculated above.

Method 1 of Calculating the Remaining Principal (concluded)

- This method is relatively slow but is universal in its applicability.
- It can, for example, accommodate prepayment and variable interest rates.

Method 2 of Calculating the Remaining Principal

• Right after the kth payment, the remaining principal is the PV of the future nm - k cash flows,

$$\sum_{i=1}^{nm-k} C\left(1+\frac{r}{m}\right)^{-i} = C \, \frac{1-\left(1+\frac{r}{m}\right)^{-nm+k}}{\frac{r}{m}}.$$
 (4)

• This method is faster but more limited in applications.

Yields

- The term yield denotes the return of investment.
- Two widely used yields are the bond equivalent yield (BEY) and the mortgage equivalent yield (MEY).
- Recall Eq. (1) on p. 23: $FV = PV \left(1 + \frac{r}{m}\right)^{nm}$.
- BEY corresponds to the r above that equates PV with FV when m = 2.
- MEY corresponds to the r above that equates PV with FV when m = 12.

Internal Rate of Return (IRR)

• It is the interest rate which equates an investment's PV with its price P,

$$P = \frac{C_1}{(1+y)} + \frac{C_2}{(1+y)^2} + \frac{C_3}{(1+y)^3} + \dots + \frac{C_n}{(1+y)^n}.$$

• The above formula is the foundation upon which pricing methodologies are built.

Numerical Methods for Yields

• Define

$$f(y) \equiv \sum_{t=1}^{n} \frac{C_t}{(1+y)^t} - P.$$

-P is the market price.

- Solve f(y) = 0 for $y \ge -1$.
- The function f(y) is monotonic in y if $C_t > 0$ for all t.
- A unique solution exists for a monotonic f(y).

The Bisection Method

- Start with a and b where a < b and f(a) f(b) < 0.
- Then $f(\xi)$ must be zero for some $\xi \in [a, b]$.
- If we evaluate f at the midpoint $c \equiv (a+b)/2$, either (1) f(c) = 0, (2) f(a) f(c) < 0, or (3) f(c) f(b) < 0.
- In the first case we are done, in the second case we continue the process with the new bracket [a, c], and in the third case we continue with [c, b].
- The bracket is halved in the latter two cases.
- After n steps, we will have confined ξ within a bracket of length $(b-a)/2^n$.



The Newton-Raphson Method

- Converges faster than the bisection method.
- Start with a first approximation x_0 to a root of f(x) = 0.
- Then

$$x_{k+1} \equiv x_k - \frac{f(x_k)}{f'(x_k)}.$$

• When computing yields,

$$f'(x) = -\sum_{t=1}^{n} \frac{tC_t}{(1+x)^{t+1}}.$$



The Secant Method

- A variant of the Newton-Raphson method.
- Replace differentiation with difference.
- Start with two approximations x_0 and x_1 .
- Then compute the (k+1)st approximation with

$$x_{k+1} = x_k - \frac{f(x_k)(x_k - x_{k-1})}{f(x_k) - f(x_{k-1})}.$$

The Secant Method (concluded)

- Its convergence rate is 1.618.
- This is slightly worse than the Newton-Raphson method's 2.
- But the secant method does not need to evaluate $f'(x_k)$ needed by the Newton-Raphson method.
- This saves about 50% in computation efforts per iteration.
- The convergence rate of the bisection method is 1.

Solving Systems of Nonlinear Equations

- It is not easy to extend the bisection method to higher dimensions.
- But the Newton-Raphson method can be extended to higher dimensions.
- Let (x_k, y_k) be the *k*th approximation to the solution of the two simultaneous equations,

f(x,y) = 0,g(x,y) = 0.

Solving Systems of Nonlinear Equations (concluded)

• The (k+1)st approximation (x_{k+1}, y_{k+1}) satisfies the following linear equations,

$$\begin{bmatrix} \frac{\partial f(x_k, y_k)}{\partial x} & \frac{\partial f(x_k, y_k)}{\partial y} \\ \frac{\partial g(x_k, y_k)}{\partial x} & \frac{\partial g(x_k, y_k)}{\partial y} \end{bmatrix} \begin{bmatrix} \Delta x_{k+1} \\ \Delta y_{k+1} \end{bmatrix} = -\begin{bmatrix} f(x_k, y_k) \\ g(x_k, y_k) \end{bmatrix},$$

where unknowns $\Delta x_{k+1} \equiv x_{k+1} - x_k$ and $\Delta y_{k+1} \equiv y_{k+1} - y_k$.

• The above has a unique solution for $(\Delta x_{k+1}, \Delta y_{k+1})$ when the 2 × 2 matrix is invertible.

• Set
$$(x_{k+1}, y_{k+1}) = (x_k + \Delta x_{k+1}, y_k + \Delta y_{k+1}).$$

Zero-Coupon Bonds (Pure Discount Bonds)

• The price of a zero-coupon bond that pays F dollars in n periods is

$$F/(1+r)^n,$$

where r is the interest rate per period.

• Can meet future obligations without reinvestment risk.

Example

- The interest rate is 8% compounded semiannually.
- A zero-coupon bond that pays the par value 20 years from now will be priced at 1/(1.04)⁴⁰, or 20.83%, of its par value.
- It will be quoted as 20.83.
- If the bond matures in 10 years instead of 20, its price would be 45.64.

Level-Coupon Bonds

- Coupon rate.
- Par value, paid at maturity.
- F denotes the par value, and C denotes the coupon.
- Cash flow:



• Coupon bonds can be thought of as a matching package of zero-coupon bonds, at least theoretically.^a

^a "You see, Daddy didn't bake the cake, and Daddy isn't the one who gets to eat it. But he gets to slice the cake and hand it out. And when he does, little golden crumbs fall off the cake. And Daddy gets to eat those," wrote Tom Wolfe (1931–) in *Bonfire of the Vanities* (1987).

Pricing Formula

$$P = \sum_{i=1}^{n} \frac{C}{\left(1 + \frac{r}{m}\right)^{i}} + \frac{F}{\left(1 + \frac{r}{m}\right)^{n}}$$
$$= C \frac{1 - \left(1 + \frac{r}{m}\right)^{-n}}{\frac{r}{m}} + \frac{F}{\left(1 + \frac{r}{m}\right)^{n}}.$$
(5)

- *n*: number of cash flows.
- *m*: number of payments per year.
- r: annual rate compounded m times per annum.
- C = Fc/m when c is the annual coupon rate.
- Price P can be computed in O(1) time.

Yields to Maturity

- It is the r that satisfies Eq. (5) on p. 59 with P being the bond price.
- For a 15% BEY, a 10-year bond with a coupon rate of 10% paid semiannually sells for

$$5 \times \frac{1 - [1 + (0.15/2)]^{-2 \times 10}}{0.15/2} + \frac{100}{[1 + (0.15/2)]^{2 \times 10}}$$
74.5138

percent of par.

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Price Behavior (1)

- Bond prices fall when interest rates rise, and vice versa.
- "Only 24 percent answered the question correctly."^a

^aCNN, December 21, 2001.

Price Behavior (2)

- A level-coupon bond sells
 - at a premium (above its par value) when its coupon rate is above the market interest rate;
 - at par (at its par value) when its coupon rate is equal to the market interest rate;
 - at a discount (below its par value) when its coupon rate is below the market interest rate.

Yield (%)	Price (% of par)
7.5	113.37
8.0	108.65
8.5	104.19
9.0	100.00
9.5	96.04
10.0	92.31
10.5	88.79

9% Coupon Bond

Terminology

- Bonds selling at par are called par bonds.
- Bonds selling at a premium are called premium bonds.
- Bonds selling at a discount are called discount bonds.

