

SEVENTH EDITION

OPTIONS, FUTURES, AND OTHER DERIVATIVES

John C. Hull

*Maple Financial Group Professor of Derivatives and Risk Management
Joseph L. Rotman School of Management
University of Toronto*



PEARSON EDUCATION INTERNATIONAL

Course
“Derivatives”
(Academic Year 2015-16)

The chapters from Hull (2009 – Seventh edition) that match with the program of the course are listed below:

- Chapter 1 – (All)
- Chapter 2 – (All)
- Chapter 3 – (All)
- Chapter 4 – (From 4.1 to 4.7 included)
- Chapter 5 – (All)
- Chapter 6 – (All)
- Chapter 7 – (All)
- Chapter 8 – (From 8.1 to 8.8 included)
- Chapter 9 – (All)
- Chapter 10 – (All)
- Chapter 24 – (All the Exotic Options are included, but only definitions of the derivatives and their possible application are requested. The pricing of these instruments is not part of the program)

In some cases slides will be available on the website for students.

CONTENTS IN BRIEF

List of Business Snapshots	xvii
List of Technical Notes	xviii
Preface	xix
1. Introduction	1
2. Mechanics of futures markets	21
3. Hedging strategies using futures	45
4. Interest rates	73
5. Determination of forward and futures prices	99
6. Interest rate futures	129
7. Swaps	147
8. Mechanics of options markets	179
9. Properties of stock options	201
10. Trading strategies involving options	219
11. Binomial trees	237
12. Wiener processes and Itô's lemma	259
13. The Black-Scholes-Merton model	277
14. Derivatives markets in developing countries	311
15. Options on stock indices and currencies	317
16. Futures options	333
17. The Greek letters	349
18. Volatility smiles	381
19. Basic numerical procedures	399
20. Value at risk	443
21. Estimating volatilities and correlations	469
22. Credit risk	489
23. Credit derivatives	517
24. Exotic options	547
25. Weather, energy, and insurance derivatives	573
26. More on models and numerical procedures	583
27. Martingales and measures	615
28. Interest rate derivatives: the standard market models	639
29. Convexity, timing, and quanto adjustments	659
30. Interest rate derivatives: models of the short rate	673
31. Interest rate derivatives: HJM and LMM	703
32. Swaps Revisited	721
33. Real options	737
34. Derivatives mishaps and what we can learn from them	753
Glossary of terms	765
DerivaGem software	785
Major exchanges trading futures and options	791
Tables for $N(x)$	792
Author index	795
Subject index	799

Contents

List of Business Snapshots.....	xvii
List of Technical Notes.....	xviii
Preface	xix
Chapter 1. Introduction.....	1
1.1 Exchange-traded markets	1
1.2 Over-the-counter markets.....	2
1.3 Forward contracts.....	3
1.4 Futures contracts	6
1.5 Options	6
1.6 Types of traders.....	9
1.7 Hedgers.....	10
1.8 Speculators	11
1.9 Arbitrageurs.....	14
1.10 Dangers	15
Summary.....	16
Further reading	16
Questions and problems.....	16
Assignment questions	18
Chapter 2. Mechanics of futures markets.....	21
2.1 Background	21
2.2 Specification of a futures contract.....	23
2.3 Convergence of futures price to spot price	25
2.4 Daily settlement and margins	26
2.5 Newspaper quotes.....	31
2.6 Delivery	33
2.7 Types of traders and types of orders.....	35
2.8 Regulation	36
2.9 Accounting and tax.....	37
2.10 Forward vs. futures contracts.....	39
Summary.....	40
Further reading	41
Questions and problems.....	41
Assignment questions	43
Chapter 3. Hedging strategies using futures.....	45
3.1 Basic principles.....	45
3.2 Arguments for and against hedging	48
3.3 Basis risk.....	51
3.4 Cross hedging	54

3.5	Stock index futures.....	59
3.6	Rolling the hedge forward.....	64
	Summary.....	65
	Further reading.....	67
	Questions and problems.....	67
	Assignment questions.....	69
	Appendix: Proof of the minimum variance hedge ratio formula.....	71
Chapter 4.	Interest rates.....	73
4.1	Types of rates.....	73
4.2	Measuring interest rates.....	75
4.3	Zero rates.....	78
4.4	Bond pricing.....	78
4.5	Determining Treasury zero rates.....	80
4.6	Forward rates.....	82
4.7	Forward rate agreements.....	85
4.8	Duration.....	87
4.9	Convexity.....	90
4.10	Theories of the term structure of interest rates.....	91
	Summary.....	94
	Further reading.....	95
	Questions and problems.....	95
	Assignment questions.....	97
Chapter 5.	Determination of forward and futures prices.....	99
5.1	Investment assets vs. consumption assets.....	99
5.2	Short selling.....	99
5.3	Assumptions and notation.....	101
5.4	Forward price for an investment asset.....	101
5.5	Known income.....	104
5.6	Known yield.....	107
5.7	Valuing forward contracts.....	107
5.8	Are forward prices and futures prices equal?.....	109
5.9	Futures prices of stock indices.....	110
5.10	Forward and futures contracts on currencies.....	112
5.11	Futures on commodities.....	115
5.12	The cost of carry.....	118
5.13	Delivery options.....	118
5.14	Futures prices and the expected future spot price.....	119
	Summary.....	121
	Further reading.....	122
	Questions and problems.....	122
	Assignment questions.....	125
	Appendix: Proof that forward and futures prices are equal when interest rates are constant.....	126
Chapter 6.	Interest rate futures.....	129
6.1	Day count and quotation conventions.....	129
6.2	Treasury bond futures.....	132
6.3	Eurodollar futures.....	136
6.4	Duration-based hedging strategies using futures.....	141
6.5	Hedging portfolios of assets and liabilities.....	142
	Summary.....	143
	Further reading.....	144

Questions and problems.....	144
Assignment questions.....	146
Chapter 7. Swaps.....	147
7.1 Mechanics of interest rate swaps.....	147
7.2 Day count issues.....	153
7.3 Confirmations.....	154
7.4 The comparative-advantage argument.....	155
7.5 The nature of swap rates.....	158
7.6 Determining the LIBOR/swap zero rates.....	158
7.7 Valuation of interest rate swaps.....	159
7.8 Currency swaps.....	163
7.9 Valuation of currency swaps.....	166
7.10 Credit risk.....	169
7.11 Other types of swaps.....	170
Summary.....	173
Further reading.....	173
Questions and problems.....	174
Assignment questions.....	176
Chapter 8. Mechanics of options markets.....	179
8.1 Types of options.....	179
8.2 Option positions.....	181
8.3 Underlying assets.....	183
8.4 Specification of stock options.....	185
8.5 Trading.....	188
8.6 Commissions.....	189
8.7 Margins.....	190
8.8 The options clearing corporation.....	192
8.9 Regulation.....	192
8.10 Taxation.....	193
8.11 Warrants, employee stock options, and convertibles.....	194
8.12 Over-the-counter markets.....	195
Summary.....	195
Further reading.....	196
Questions and problems.....	196
Assignment questions.....	198
Chapter 9. Properties of stock options.....	201
9.1 Factors affecting option prices.....	201
9.2 Assumptions and notation.....	205
9.3 Upper and lower bounds for option prices.....	205
9.4 Put-call parity.....	208
9.5 Early exercise: calls on a non-dividend-paying stock.....	211
9.6 Early exercise: puts on a non-dividend-paying stock.....	212
9.7 Effect of dividends.....	214
Summary.....	215
Further reading.....	216
Questions and problems.....	216
Assignment questions.....	218
Chapter 10. Trading strategies involving options.....	219
10.1 Strategies involving a single option and a stock.....	219
10.2 Spreads.....	221
10.3 Combinations.....	230

10.4	Other payoffs.....	233
	Summary.....	233
	Further reading.....	234
	Questions and problems.....	234
	Assignment questions.....	235
Chapter 11.	Binomial trees	237
11.1	A one-step binomial model and a no-arbitrage argument	237
11.2	Risk-neutral valuation.....	241
11.3	Two-step binomial trees	243
11.4	A put example.....	245
11.5	American options.....	246
11.6	Delta.....	247
11.7	Matching volatility with u and d	248
11.8	Increasing the number of steps.....	251
11.9	Options on other assets.....	252
	Summary.....	256
	Further reading.....	256
	Questions and problems	257
	Assignment questions.....	258
Chapter 12.	Wiener processes and Itô's lemma	259
12.1	The Markov property	259
12.2	Continuous-time stochastic processes.....	260
12.3	The process for a stock price	265
12.4	The parameters.....	268
12.5	Itô's lemma.....	269
12.6	The lognormal property	270
	Summary.....	271
	Further reading.....	272
	Questions and problems	272
	Assignment questions.....	273
	Appendix: Derivation of Itô's lemma	275
Chapter 13.	The Black-Scholes-Merton model.....	277
13.1	Lognormal property of stock prices	277
13.2	The distribution of the rate of return	279
13.3	The expected return.....	280
13.4	Volatility.....	282
13.5	The idea underlying the Black-Scholes-Merton differential equation.....	285
13.6	Derivation of the Black-Scholes-Merton differential equation.....	287
13.7	Risk-neutral valuation.....	289
13.8	Black-Scholes pricing formulas.....	291
13.9	Cumulative normal distribution function	293
13.10	Warrants and employee stock options	294
13.11	Implied volatilities.....	296
13.12	Dividends	298
	Summary.....	301
	Further reading.....	302
	Questions and problems	303
	Assignment questions.....	305
	Appendix: Proof of the Black-Scholes-Merton formula	307

Chapter 14. Derivatives markets in developing countries.....	311
14.1 China's markets.....	311
14.2 India's markets.....	313
14.3 Other developing countries.....	314
Summary.....	314
Further reading	315
Chapter 15. Options on stock indices and currencies.....	317
15.1 Options on stock indices.....	317
15.2 Currency options	319
15.3 Options on stocks paying known dividend yields	322
15.4 Valuation of European stock index options.....	324
15.5 Valuation of European currency options.....	327
15.6 American options	328
Summary.....	329
Further reading	329
Questions and problems.....	330
Assignment questions	332
Chapter 16. Futures options.....	333
16.1 Nature of futures options.....	333
16.2 Reasons for the popularity of futures options	336
16.3 European spot and futures options.....	336
16.4 Put-call parity	337
16.5 Bounds for futures options.....	338
16.6 Valuation of futures options using binomial trees	339
16.7 Drift of a futures prices in a risk neutral world	341
16.8 Black's model for valuing futures options.....	342
16.9 American futures options vs. American spot options.....	344
16.10 Futures-style options	344
Summary.....	345
Further reading	346
Questions and problems.....	346
Assignment questions	348
Chapter 17. The Greek letters.....	349
17.1 Illustration	349
17.2 Naked and covered positions	350
17.3 A stop-loss strategy	350
17.4 Delta hedging.....	352
17.5 Theta	359
17.6 Gamma.....	361
17.7 Relationship between delta, theta, and gamma	365
17.8 Vega	365
17.9 Rho.....	367
17.10 The realities of hedging	368
17.11 Scenario analysis.....	368
17.12 Extension of formulas	370
17.13 Portfolio insurance.....	372
17.14 Stock market volatility.....	374
Summary.....	375
Further reading	376
Questions and problems.....	376

Assignment questions.....	378
Appendix: Taylor series expansions and hedge parameters.....	380
Chapter 18. Volatility smiles.....	381
18.1 Why the volatility smile is the same for calls and puts.....	381
18.2 Foreign currency options.....	382
18.3 Equity options.....	385
18.4 Alternative ways of characterizing the volatility smile.....	387
18.5 The volatility term structure and volatility surfaces.....	388
18.6 Greek letters.....	389
18.7 When a single large jump is anticipated.....	390
Summary.....	392
Further reading.....	392
Questions and problems.....	393
Assignment questions.....	394
Appendix: Determining implied risk-neutral distributions from volatility smiles.....	396
Chapter 19. Basic numerical procedures.....	399
19.1 Binomial trees.....	399
19.2 Using the binomial tree for options on indices, currencies, and futures contracts.....	406
19.3 Binomial model for a dividend-paying stock.....	409
19.4 Alternative procedures for constructing trees.....	414
19.5 Time-dependent parameters.....	417
19.6 Monte Carlo simulation.....	418
19.7 Variance reduction procedures.....	425
19.8 Finite difference methods.....	427
Summary.....	438
Further reading.....	438
Questions and problems.....	439
Assignment questions.....	441
Chapter 20. Value at risk.....	443
20.1 The VaR measure.....	443
20.2 Historical simulation.....	446
20.3 Model-building approach.....	448
20.4 Linear model.....	450
20.5 Quadratic model.....	454
20.6 Monte Carlo simulation.....	456
20.7 Comparison of approaches.....	457
20.8 Stress testing and back testing.....	458
20.9 Principal components analysis.....	458
Summary.....	462
Further reading.....	462
Questions and problems.....	463
Assignment questions.....	464
Appendix: Cash-flow mapping.....	466
Chapter 21. Estimating volatilities and correlations.....	469
21.1 Estimating volatility.....	469
21.2 The exponentially weighted moving average model.....	471
21.3 The GARCH (1,1) model.....	473
21.4 Choosing between the models.....	474
21.5 Maximum likelihood methods.....	475

21.6	Using GARCH (1,1) to forecast future volatility	479
21.7	Correlations	483
	Summary	485
	Further reading	486
	Questions and problems	486
	Assignment questions	488
Chapter 22. Credit risk		489
22.1	Credit ratings	489
22.2	Historical default probabilities	490
22.3	Recovery rates	491
22.4	Estimating default probabilities from bond prices	492
22.5	Comparison of default probability estimates	495
22.6	Using equity prices to estimate default probabilities	498
22.7	Credit risk in derivatives transactions	499
22.8	Credit risk mitigation	502
22.9	Default correlation	504
22.10	Credit VaR	509
	Summary	511
	Further reading	512
	Questions and problems	512
	Assignment questions	515
Chapter 23. Credit derivatives		517
23.1	Credit default swaps	518
23.2	Valuation of credit default swaps	520
23.3	Credit indices	524
23.4	CDS forwards and options	526
23.5	Basket credit default swaps	527
23.6	Total return swaps	527
23.7	Asset-backed securities	528
23.8	Collateralized debt obligations	530
23.9	Role of correlation in a basket CDS and CDO	534
23.10	Valuation of a synthetic CDO	534
23.11	Alternatives to the standard market model	541
	Summary	543
	Further reading	544
	Questions and problems	544
	Assignment questions	546
Chapter 24. Exotic options		547
24.1	Packages	547
24.2	Nonstandard American options	548
24.3	Forward start options	548
24.4	Compound options	549
24.5	Chooser options	550
24.6	Barrier options	550
24.7	Binary options	553
24.8	Lookback options	553
24.9	Shout options	555
24.10	Asian options	556
24.11	Options to exchange one asset for another	558
24.12	Options involving several assets	559
24.13	Volatility and variance swaps	559

24.14	Static options replication	562
	Summary	565
	Further reading	565
	Questions and problems	566
	Assignment questions	568
	Appendix: Calculation of moments for valuation of basket options and Asian options	570
Chapter 25.	Weather, energy, and insurance derivatives	573
25.1	Review of pricing issues	573
25.2	Weather derivatives	574
25.3	Energy derivatives	575
25.4	Insurance derivatives	578
	Summary	579
	Further reading	580
	Questions and problems	580
	Assignment question	581
Chapter 26.	More on models and numerical procedures	583
26.1	Alternatives to Black–Scholes	584
26.2	Stochastic volatility models	587
26.3	The IVF model	590
26.4	Convertible bonds	591
26.4	Path-dependent derivatives	594
26.5	Barrier options	598
26.6	Options on two correlated assets	601
26.7	Monte Carlo simulation and American options	603
	Summary	608
	Further reading	609
	Questions and problems	610
	Assignment questions	612
Chapter 27.	Martingales and measures	615
27.1	The market price of risk	616
27.2	Several state variables	619
27.3	Martingales	620
27.4	Alternative choices for the numeraire	621
27.5	Extension to several factors	625
27.6	Black's model revisited	626
27.7	Option to exchange one asset for another	627
27.8	Change of numeraire	628
27.9	Generalization of traditional valuation methods	629
	Summary	630
	Further reading	630
	Questions and problems	631
	Assignment questions	632
	Appendix: Handling multiple sources of uncertainty	634
Chapter 28.	Interest rate derivatives: the standard market models	639
28.1	Bond options	639
28.2	Interest rate caps and floors	644
28.3	European swap options	650
28.4	Generalizations	654
28.5	Hedging interest rate derivatives	654
	Summary	655

Further reading	656
Questions and problems	656
Assignment questions	657
Chapter 29. Convexity, timing, and quanto adjustments	659
29.1 Convexity adjustments	659
29.2 Timing adjustments	663
29.3 Quantos	665
Summary	668
Further reading	668
Questions and problems	669
Assignment questions	670
Appendix: Proof of the convexity adjustment formula	672
Chapter 30. Interest rate derivatives: models of the short rate	673
30.1 Background	673
30.2 Equilibrium models	674
30.3 No-arbitrage models	678
30.4 Options on bonds	682
30.5 Volatility structures	683
30.6 Interest rate trees	684
30.7 A general tree-building procedure	686
30.8 Calibration	696
30.9 Hedging using a one-factor model	697
Summary	697
Further reading	698
Questions and problems	698
Assignment questions	700
Chapter 31. Interest rate derivatives: HJM and LMM	703
31.1 The Heath, Jarrow, and Morton model	703
31.2 The LIBOR market model	706
31.3 Agency mortgage-backed securities	716
Summary	718
Further reading	719
Questions and problems	720
Assignment questions	720
Chapter 32. Swaps Revisited	721
32.1 Variations on the vanilla deal	721
32.2 Compounding swaps	723
32.3 Currency swaps	724
32.4 More complex swaps	725
32.5 Equity swaps	728
32.6 Swaps with embedded options	729
32.7 Other swaps	732
Summary	733
Further reading	734
Questions and problems	734
Assignment questions	734
Chapter 33. Real options	737
33.1 Capital investment appraisal	737
33.2 Extension of the risk-neutral valuation framework	738
33.3 Estimating the market price of risk	740
33.4 Application to the valuation of a business	741

33.5	Commodity prices	741
33.6	Evaluating options in an investment opportunity	746
	Summary	751
	Further reading	751
	Questions and problems	751
	Assignment questions	752
Chapter 34.	Derivatives mishaps and what we can learn from them	753
34.1	Lessons for all users of derivatives	753
34.2	Lessons for financial institutions	757
34.3	Lessons for nonfinancial corporations	762
	Summary	763
	Further reading	763
	Glossary of terms	765
	DerivaGem software	785
	Major exchanges trading futures and options	791
	Table for $N(x)$ when $x \leq 0$	792
	Table for $N(x)$ when $x \geq 0$	793
	Author index	795
	Subject index	799