

Contents

Preface	ix
to Dorothy and Domenic	xi
Introduction	xiii
1 Density Functions and Borel Measures	1
1.1 Joint Density Functions	1
1.1.1 Joint Distribution Functions	1
1.1.2 A Digression into Integration Theory	4
Riemann-Stieltjes Perspective	5
Lebesgue-Stieltjes Perspective	6
Riemann-Stieltjes vs. Lebesgue-Stieltjes	7
1.1.3 Properties of Density Functions	9
1.1.4 Existence of Density Functions	12
1.2 Marginal Density Functions	15
1.3 Independent Random Variables	18
1.4 Conditional Density Functions	20
2 DFs of Transformed Random Vectors	25
2.1 Product Integrals and Cavalieri's Principle	25
2.2 DFs of Sums and Ratios of RVs	29
2.2.1 Sums of Independent Random Vectors	29
2.2.2 Ratios of Independent Random Variables	35
2.3 Densities of Transformed Random Vectors	39
3 Multivariate Normal Distribution	43
3.1 Derivation and Properties	43
3.2 Interesting Properties	52

3.2.1	Higher Moments	53
3.2.2	Independent vs. Uncorrelated	57
3.2.3	Mean and Variance of a Random Normal Sample	59
3.3	Existence of Multivariate Normal Densities	65
4	Weak Convergence of Measures	69
4.1	Measures on \mathbb{R}	69
4.1.1	Portmanteau Theorem on \mathbb{R}	69
4.1.2	Applications	73
4.2	Measures on \mathbb{R}^j	74
4.2.1	Portmanteau Theorem on \mathbb{R}^j	74
4.2.2	Applications	80
	(Continuous) Mapping Theorem	81
	Cramér-Wold Device - Part 1	85
	Slutsky's Theorem	87
	The Delta Method	89
4.2.3	Scheffé's Theorem	94
4.2.4	Prokhorov's theorem	100
5	Expectations of Random Variables 2	105
5.1	General Definition of $E[g(X)]$	105
5.2	Weak Convergence and Moment Limits	110
5.3	Conditional Expectations	113
5.3.1	Conditional Probability Measures	113
5.3.2	Conditional Expectations	118
	Elementary Conditional Expectations	118
	General Conditional Expectations - An Introduction	121
	General Definition of Conditional Expectation	123
5.3.3	Properties of Conditional Expectations	127
6	The Characteristic Function	133
6.1	The Moment Generating Function	133
6.2	The Characteristic Function	137
6.3	Examples of Characteristic Functions	139
6.3.1	Discrete Distributions	140
6.3.2	Continuous Distributions	141
6.4	Properties of Characteristic Functions on \mathbb{R}	144
6.5	Properties of Characteristic Functions on \mathbb{R}^n	147
6.5.1	The Cramér-Wold Device	160
6.6	Bochner's Theorem	162

6.7	A Uniqueness of Moments Result	172
7	Applications of Characteristic Functions	175
7.1	Central Limit Theorems	176
7.1.1	The Classical Central Limit Theorem	177
7.1.2	Lindeberg's Central Limit Theorem	179
7.1.3	Lyapunov's Central Limit Theorem	186
7.1.4	A Central Limit Theorem on \mathbb{R}^n	188
7.2	Distribution Families Related Under Addition	190
7.2.1	Discrete Distributions	191
7.2.2	Continuous Distributions	193
7.3	Infinitely Divisible Distributions	195
7.4	Distribution Families Related Under Multiplication	209
8	Discrete Time Asset Models in Finance	211
8.1	Spatial Models of Asset Prices	212
8.2	Temporal Models of Asset Prices	214
8.2.1	Additive Temporal Models	215
8.2.2	Multiplicative Temporal Models	217
8.3	Induced Models	219
8.3.1	Spatial and Additive Temporal Models	219
8.3.2	Spatial and Multiplicative Temporal Models	221
8.3.3	Simulating Asset Price Paths	224
8.4	Harmonious Asset Models	225
8.4.1	Identifiability of the Spatial Distribution	226
8.4.2	Scalability of the Temporal Distribution	228
8.4.3	Harmonious Additive Temporal Models	231
8.4.4	Harmonious Multiplicative Temporal Models	236
8.5	Limiting Distributions of Harmonious Asset Models	240
8.5.1	Perfectly Scalable Harmonious Models	241
8.5.2	Approximately Scalable Harmonious Models	242
	Additive Temporal Models	243
	Multiplicative Temporal Models	248
9	Pricing of Financial Derivatives	253
9.1	Discrete Time Pricing on a Binomial Lattice	253
9.1.1	Binomial Lattice Pricing of European Derivatives	254
9.1.2	Binomial Lattice Pricing of American Derivatives	262
9.2	Limiting Asset Distribution: Risk Neutral Measure	264
9.2.1	Analysis of Risk Neutral Binomial Probability q	264

9.2.2	Limiting Asset Distribution Under q	266
9.3	Limiting Price of European Derivatives	268
9.3.1	Black-Scholes-Merton Option Pricing Formulas	275
9.3.2	Properties of Black-Scholes-Merton Formulas	279
	Price Convergence to the Payoff	279
	Put-Call Parity	281
	A Derivative's "Greeks"	283
	A Derivative's "Greeks" - Lattice Approximations	289
9.4	Limiting Price of American Derivatives	292
9.5	Binomial Pricing of Path Dependent European Options	292
9.5.1	Binomial Path-Based Pricing	293
	Standard European Options	293
	Path-Dependent European Options	294
9.5.2	Approximate Path-Based Pricing	298
	Multinomial Distribution	299
	Approximate Path-Based Pricing of European Options	301
	References	305