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Autore	Rebonato Riccardo
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'What is Vega Hedging For?'); 1.2 The Efficient Market Hypothesis and Why It Matters for Option Pricing; 1.2.1 The Three Forms of the EMH; 1.2.2 Pseudo-Arbitrageurs in Crisis; 1.2.3 Model Risk for Traders and Risk Managers; 1.2.4 The Parable of the Two Volatility Traders; 1.3 Market Practice; 1.3.1 Different Users of Derivatives Models; 1.3.2 In-Model and Out-of-Model Hedging; 1.4 The Calibration Debate; 1.4.1 Historical vs Implied Calibration; 1.4.2 The Logical Underpinning of the Implied Approach; 1.4.3 Are Derivatives Markets Informationally Efficient?; 1.4.4 Back to Calibration; 1.4.5 A Practical Recommendation; 1.5 Across-Markets Comparison of Pricing and Modelling Practices; 1.6 Using Models; 2 Option Replication; 2.1 The Bedrock of Option Pricing; 2.2 The Analytic (PDE) Approach; 2.2.1 The Assumptions; 2.2.2 The Portfolio-Replication Argument (Deterministic Volatility); 2.2.3 The Market Price of Risk with Deterministic Volatility; 2.2.4 Link with Expectations - the Feynman-Kac Theorem; 2.3 Binomial Replication; 2.3.1 First Approach - Replication Strategy; 2.3.2 Second Approach - 'Naive Expectation'; 2.3.3 Third Approach - 'Market Price of Risk'; 2.3.4 A Worked-Out Example; 2.3.5 Fourth Approach - Risk-Neutral Valuation; 2.3.6 Pseudo-Probabilities; 2.3.7 Are the Quantities (1) and (2) Really Probabilities?; 2.3.8 Introducing Relative Prices; 2.3.9 Moving to a Multi-Period Setting; 2.3.10 Fair Prices as Expectations; 2.3.11 Switching Numeraires and Relating Expectations Under Different Measures; 2.3.12 Another Worked-Out Example; 2.3.13 Relevance of the Results; 2.4 Justifying the Two-State Branching Procedure; 2.4.1 How To Recognize a Jump When You See One; 2.5 The Nature of the Transformation between Measures: Girsanov's Theorem; 2.5.1 An Intuitive Argument; 2.5.2 A Worked-Out Example; 2.6 Switching Between the PDE, the Expectation and the Binomial Replication Approaches; 3 The Building Blocks; 3.1 Introduction and Plan of the Chapter; 3.2 Definition of Market Terms; 3.3 Hedging Forward Contracts Using Spot Quantities; 3.3.1 Hedging Equity Forward Contracts; 3.3.2 Hedging Interest-Rate Forward Contracts; 3.4 Hedging Options: Volatility of Spot and Forward Processes; 3.5 The Link Between Root-Mean-Squared Volatilities and the Time-Dependence of Volatility; 3.6 Admissibility of a Series of Root-Mean-Squared Volatilities; 3.6.1 The Equity/FX Case; 3.6.2 The Interest-Rate Case; 3.7 Summary of the Definitions So Far; 3.8 Hedging an Option with a Forward-Setting Strike; 3.8.1 Why Is This Option Important? (And Why Is it Difficult to Hedge?)

Sommario/riassunto

In Volatility and Correlation 2nd edition: The Perfect Hedger and the Fox, Rebonato looks at derivatives pricing from the angle of volatility and correlation. With both practical and theoretical applications, this is a thorough update of the highly successful Volatility & Correlation - with over 80% new or fully reworked material and is a must have both for practitioners and for students. The new and updated material includes a critical examination of the 'perfect-replication' approach to derivatives pricing, with special attention given to exotic options; a t