

**City University of Hong Kong  
Course Syllabus**

**offered by Department of Economics and Finance  
with effect from Semester A 2018 /19**

---

---

**Part I Course Overview**

|  |                                 |
|--|---------------------------------|
| <b>Course Title:</b>   | Stochastic Calculus for Finance |
| <b>Course Code:</b>  | EF5250                          |
| <b>Course Duration:</b>                                      | 1 Semester                      |
| <b>Credit Units:</b>   | 3                               |
| <b>Level:</b>  | P5                              |
| <b>Medium of Instruction:</b>                                | English                         |
| <b>Medium of Assessment:</b>                                 | English                         |
| <b>Prerequisites:</b><br><i>(Course Code and Title)</i>      | Nil                             |
| <b>Precursors:</b><br><i>(Course Code and Title)</i>         | Nil                             |
| <b>Equivalent Courses:</b><br><i>(Course Code and Title)</i> | Nil                             |
| <b>Exclusive Courses:</b><br><i>(Course Code and Title)</i>  | Nil                             |

## Part II Course Details

### 1. Abstract

This course is designed to enhance students' mathematical ability, and equip them with the basic knowledge and skills of stochastic calculus for financial applications. Students will be introduced to stochastic processes, Brownian motion, and Ito calculus. Student will learn how to use quantitative analysis to derive the Black-Scholes formula for various types of options (European options, etc). At the end of this course, students will be able to price various types of options and construct hedging strategies.

The course also aims to develop students' creative and innovative abilities through various assessment tasks that involve the discovery and innovative process. Classes will encourage students to develop their discovery abilities through problem solving and class discussions. Stress will also be placed on common pricing and hedging problems in global financial markets to help students to discover the basic knowledge in the finance industry.

Assignments will require students to discover and innovate through the use of mathematical concepts. Students will get to know how to use these theories to come up with their own analyses on different financial products.

The final exam which covers topics discussed in the lectures and tutorials will reveal the students' accomplishments in discovery and innovation.

### 2. Course Intended Learning Outcomes (CILOs)

*(CILOs state what the student is expected to be able to do at the end of the course according to a given standard of performance.)*

| No. | CILOs   | Weighting<br>(if applicable) | Discovery-enriched curriculum related learning outcomes (please tick where appropriate) |    |    |
|-----|---|------------------------------|---|----|----|
|     |   |                              | A1  | A2 | A3 |
| 1.  | Analyze the theory and modelling of stochastic processes. Students should discover the rationale behind the quantitative analysis.  | 25%                          | √   | √  | √  |
| 2.  | Create and discover discrete time models and Brownian motion equations to address financial problems and construct innovative solutions.  | 20%                          | √   | √  | √  |
| 3.  | Discover and apply Ito's calculus. Students should also be able to derive Ito's formula to solve stochastic differential equations with innovative insights.                              | 20%                          | √   | √  |    |
| 4   | Derive the Black-Scholes Formula by using partial differential equations (PDEs). This will enable students to discover the logic behind the Black-Scholes Formula, a widely used formula. | 25%                          | √   |    |    |
| 5   | Construct delta and gamma hedging strategies. Students will then be able to generate innovative solutions towards risk management problems.   | 10%                          | √   |    |    |
|     |   | 100%                         |   |    |    |

- A1: *Attitude*  
 Develop an attitude of discovery/innovation/creativity, as demonstrated by students possessing a strong sense of curiosity, asking questions actively, challenging assumptions or engaging in inquiry together with teachers.
- A2: *Ability*  
 Develop the ability/skill needed to discover/innovate/create, as demonstrated by students possessing critical thinking skills to assess ideas, acquiring research skills, synthesizing knowledge across disciplines or applying academic knowledge to self-life problems.
- A3: *Accomplishments*  
 Demonstrate accomplishment of discovery/innovation/creativity through producing /constructing creative works/new artefacts, effective solutions to real-life problems or new processes.

### 3. Teaching and Learning Activities (TLAs)

(TLAs designed to facilitate students' achievement of the CILOs.)

| TLA                              | Brief Description  | CILO No. |   |   |   |   | Hours/week<br>(if applicable) |
|----------------------------------|--|----------|---|---|---|---|-------------------------------|
|                                  |  | 1        | 2 | 3 | 4 | 5 |                               |
| Lectures                         | To introduce basic concepts and structure.<br>Students are expected to discover the theory on stochastic calculus and understand the modelling on asset valuation, followed by the hedging functions of various financial products.  | √        | √ | √ | √ | √ | 2 hours per week              |
| Tutorial and in-class discussion | To apply knowledge and theory.<br>Students will be encouraged to think critically and logically by responding to questions and solving the problems by themselves. Even though the suggested solutions may be given, this process motivates students to be innovative. Through active in-class discussion, the communication skills of students will also be enhanced. | √        | √ | √ | √ | √ | 1 hour per week               |

#### 4. Assessment Tasks/Activities (ATs)

(ATs are designed to assess how well the students achieve the CILOs.)

| Assessment Tasks/Activities  | CILO No. |   |   |   |   | Weighting | Remarks |
|--|----------|---|---|---|---|-----------|---------|
|  | 1        | 2 | 3 | 4 | 5 |           |         |
| Continuous Assessment: <u>50</u> %   |          |   |   |   |   |           |         |
| Assignments<br>Students will perform analyses on various modelling problems. They will be required to apply mathematical theories to generate innovative solutions for certain problems facing the finance industry. | √        | √ | √ | √ | √ | 50%       |         |
| Examination: <u>50</u> % (duration: 3 hours , if applicable)   |          |   |   |   |   |           |         |
| Final examination<br>The final examination which covers topics discussed in lectures and tutorials will also reveal the students' accomplishments of discovery and innovation.                                       | √        | √ | √ | √ | √ | 50%       |         |
|  |          |   |   |   |   | 100%      |         |

## 5. Assessment Rubrics

(Grading of student achievements is based on student performance in assessment tasks/activities with the following rubrics.)

| Assessment Task   | Criterion  | Excellent<br>(A+, A, A-) | Good<br>(B+, B, B-) | Fair<br>(C+, C, C-) | Marginal<br>(D) | Failure<br>(F)                    |
|-------------------|--|--------------------------|---------------------|---------------------|-----------------|-----------------------------------|
| Final Examination | Ability to apply the theory of stochastic calculus and explain its concepts  | High                     | Significant         | Moderate            | Basic           | Not even reaching marginal levels |
| Assignments       | Capacity for discovering/ deriving results complementing the theory of stochastic calculus covered by the lectures and for applying the theory | High                     | Significant         | Moderate            | Basic           | Not even reaching marginal levels |

**Part III Other Information** (more details can be provided separately in the teaching plan)

**1. Keyword Syllabus**

*(An indication of the key topics of the course.)*

1. Partial Differential Equations
2. Two-instants model
3. N-instants model
4. Self-financing portfolio
5. Risk neutral measure
6. Arbitrage opportunity
7. Market completeness
8. Filtration
9. Brownian motion
10. Stochastic processes
11. Itô formula
12. Black-Scholes Formula
13. Delta hedging
14. Gamma hedging

**2. Reading List**

**2.1 Compulsory Readings**

*(Compulsory readings can include books, book chapters, or journal/magazine articles. There are also collections of e-books, e-journals available from the CityU Library.)*

|    |   |
|----|---|
| 1. | <i>Stochastic Calculus for Finance II: Continuous-Time Models</i> by Steven E. Shreve, Springer Finance |
|----|---|

**2.2 Additional Readings**

*(Additional references for students to learn to expand their knowledge about the subject.)*

|    |   |
|----|---|
| 1. | <i>Stochastic Calculus and Financial Applications</i> by J. Michael Steele        |
| 2. | <i>An Introduction to Measure Theory</i> by T. Tao, American Mathematical Society |