

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

Course Title: Stochastic Calculus for Finance

Course Code: EF 3520

Course Duration: 1 Semester

Credit Units: 3

Level: B3

Arts and Humanities

Proposed Area:
(for GE courses only)

Study of Societies, Social and Business Organisations

Science and Technology

Medium of Instruction:

English

Medium of Assessment:

English

Prerequisites:
(Course Code and Title)

- 1. EF2452 Mathematics for Economics and Finance and EF3450 Principles of Econometrics or MS4504 Statistics for Economic and Financial Modelling**
OR
2. MA1201 Calculus and Basic Linear Algebra II or MA1301 Enhanced Calculus and Linear Algebra II and MA2506 Probability and Statistics

Precursors:
(Course Code and Title)

Nil

Equivalent Courses:
(Course Code and Title)

Nil

Exclusive Courses:
(Course Code and Title)

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 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* (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%			

* If weighting is assigned to CILOs, they should add up to 100%.

Please specify the alignment of CILOs to the Gateway Education Programme Intended Learning outcomes (PILOs) in Section A of Annex.

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 (if applicable)
		1	2	3	4	5	
Lectures	To introduce basic concepts and structure. 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.	√	√	√	√	√	3 hours 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: 50%							
Assignments 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: 50% (duration: 3 hours, if applicable)							
Final examination The final examination which covers topics discussed in lectures will also reveal the students' accomplishments of discovery and innovation.	√	√	√	√	√	50%	
						100%	

* The weightings should add up to 100%.

Students are required to pass both coursework and examination components in order to pass the course.

5. Assessment Rubrics

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

Assessment Task	Criterion	Excellent (A+, A, A-)	Good (B+, B, B-)	Fair (C+, C, C-)	Marginal (D)	Failure (F)
Final Examination (3 hours)	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

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
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2.2 Additional Readings

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

1.	<i>An Introduction to Derivative Pricing</i> by Martin Baxter and Andrew Rennie, Cambridge University Press
2.	<i>Stochastic Calculus and Financial Applications</i> by J. M. Steele, Springer
3.	<i>An Introduction to Measure Theory</i> by T. Tao, American Mathematical Society