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# Pricing Security Derivatives under the Forward Measure

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PRICING SECURITY DERIVATIVES UNDER THE FORWARD  
MEASURE

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Worcester Polytechnic Institute 2007

## Abstract

This project is an investigation and implementation of pricing derivative securities using the forward measure. It will explain the methodology of building a modified discrete Ho-Lee interest rate model to do so, along with the extraction of historical yield and interest rates to calibrate the model.

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# 1 Introduction

The forward measure provides an alternate method of pricing derivative securities. This method relies on using forward measures to build interest rate models instead of the more common risk-neutral measure. Under this method derivatives are often simpler to price, and consequentially much easier to implement.

Illustrated by Geman et al [1] as long as a fair price for a security exists, the price does not depend on the choice of a risk-neutral measure. It is possible to substitute a different measure which is absolutely continuous with respect to the usual risk-neutral measure. This option leaves the possibility that there may be a ‘best’ measure to use for derivative pricing.

Using a zero-coupon bond as the numéraire is a natural starting point. Zero-coupon bonds are the simplest fixed income securities; they give a single cash flow at a defined maturity time  $T$ . After the change of numéraire the forward price of a derivative relative to time  $T$  is equal to the expectation of the value at time  $T$  under the new forward measure.

Discrete models are used to create term structures for zero-coupon bonds. These bonds are priced solely by interest rates, so models estimate the term structure of interest rates using probabilities. The simplest models are binomial and assign a probability of rates performing either well or poorly. From there the expectation of each bond is taken and the price discounted. Once these values are found the more complex securities can be priced.

A binomial tree is a set of nodes with discrete spacing and times. At time 0 there is one root node with the current interest rate. From there it leads to two other nodes. These represent the performance of the market with new interest rates. As time goes on more and more possibilities can occur. In a non-recombining model  $2^t$  nodes are created with each new time  $t$ . Every node leads to two new unique possibilities. Recombining models are simpler because there are only  $t + 1$  nodes at each time  $t$ . This is because two nodes can point towards the same node in the next time step. Moving up then down leads to the same node as moving down then up.

The forward measure is implemented through a Radon-Nikodym derivative process. A set of equations simplifies the problem from involving the joint distribution of two random variables. This is the main advantage to using the forward measure for derivative pricing.

## 2 Background

### 2.1 Bond Pricing Definitions

There are some common definitions used when pricing derivative securities. These include zero-coupon bonds and the discount and interest rates with volatility  $\sigma$ . Spot rates and yield rates are derived from interest rates. The functions  $B(n, T)$ ,  $D(n)$ , and  $V(n)$  are also fundamental. Knowledge of all of these is required to create our term structure.

Zero-coupon bonds are the simplest fixed income securities. Bought by investors at a discount from their face value, they are bonds that have no payoff until the end of their lifetime. The face value is the amount a bond will be worth at some maturity time  $T$ . When a zero-coupon bond matures the investor will receive one lump sum. By convention this value is \$1. Given a complete market any other derivative can be built using a portfolio composed of only zero-coupon bonds of different maturity.

The interest rate  $R(n)$  is the rate at which the value of the zero coupon bond increases over the step of time from  $n$  to  $n + 1$ . The value of future interest rates  $\{R(n) : n > t\}$  where  $t$  is the current time are unknown; with one exception. At the maturity of a bond, time  $T$ , a zero-coupon bond will pay \$1. So the interest rate from time  $T - 1$  to time  $T$  is forced to accommodate that. This special case is called the spot rate. A yield rate  $y_n$  is the average annual rate of return for a bond, while a yield curve is the set



of yield rates.

$$y_n = \prod_0^n \frac{1}{1 + R(n)} \quad (1)$$

Tied to the interest rate is the discount rate  $d(n)$ , which is the inverse of  $1 + R(n)$ ,

$$1 + R(n) = \frac{1}{d(n)} \quad (2)$$

$d(n)$  is used to know what price a bond had times previous to  $n$ . For instance, at time  $T$  a zero coupon bond has a value of 1.  $d(T - 1) = \frac{1}{1+R(T-1)}$  is the price of the bond at  $T - 1$ . It discounts the amount earned by  $R(n)$ .

The value  $\sigma_n$  is the volatility of  $R(n)$  derived from historical data. In an uncertain market this value is used as a parameter for estimation.

$$\sigma_n^2 = E[R_i(n)^2] - E[R_i(n)]^2 \quad \forall i \text{ known} \quad (3)$$

The function  $B(n, T)$  is the price of a zero-coupon bond at time  $n$  with maturity time  $T$ .

$$\frac{B(n, T)}{B(n - 1, T)} = B(n - 1, T)R(n) = B(n, T)d(n) \quad (4)$$

Linked to this is the discount function  $D(n)$  which is the function used to find the price  $B(0, T)$  given  $B(n, T)$ .

$$D(n) = \prod_{i=1}^n d(i) \quad (5)$$

The aptly named discount function defines how much the face value of a future amount should be discounted for a fair price. This is easy when  $R(n) : n \leq T$  are known, but in an uncertain market an expectation of  $D(T)$  must be used.

Lastly  $V(n)$  is the payoff function used to price other derivatives. Caps, floors, and options are all common examples that pay an amount, fixed or variable, when certain conditions occur. For instance, a cap may pay \$0.01 every time  $R(n)$  is greater than some value  $S$ .  $V(n)$  would be the amount earned by the derivative at time  $n$ . Finding the price of a derivative would then require knowing what will occur with both the zero-coupon bonds and the payoff function built on top of it.

## 2.2 Risk Neutral Measure

Arbitrage is a trading strategy that invests \$0 and has a positive expected return. Such practices are not desirable and cannot be found in complete markets. As such, the Fundamental Theorem of Asset Pricing states that there is no arbitrage in a market if and only if there exists a risk-neutral measure equivalent to the real life probability measure. Furthermore, the market is complete if that measure is unique. Unlike the real life measure the risk-neutral measure values all derivatives on their expected payoff regardless of risk. In real life risky ventures assets tend to have greater expected rates of return.

The risk-neutral pricing formula uses the money market account as its numéraire. A money market account is equivalent to a long position in the shortest maturity zero-coupon bond. The interest rate for the money market account is thus the interest rate at time  $t$  for zero-coupon bonds with maturity  $t+1$ . These are the bonds that mature in the upcoming time period at the spot rate. Characterized by the risk-less return such bonds experience, they are useful for finding a zero-coupon bond evolution. Unfortunately, a problem occurs when dealing with derivatives.

Pricing for derivatives depends on taking the conditional expectation of the product of the payoff and random discount functions. The joint distribution of both is required when pricing with the risk neutral measure. Pricing

the payoff function at time  $n$  is defined as:

$$V_n = \frac{1}{D(n)} E_n[D(m)V(m)] \quad (6)$$

given the first outcomes where  $n \leq m \leq N$  and  $E_n$  is the conditional expectation. This conditional expectation relies on the previous  $n$  outcomes. Likewise,  $E^n$  would denote expectation where the expectant value depends on the first  $n$  outcomes. The difference in notation is that in the latter the outcomes do not need to be known. Our payoff and discount functions  $D(m)V(m)$  rely only on  $m$  outcomes, but  $n$  need to be known to find the expectation.

It is possible to avoid needing the joint distribution of  $D$  and  $V$  with a change of measure defined by a Radon-Nikodym derivative. As a result expectations under the new measure no longer rely on future discounts.

### 2.3 Forward Measure

A zero-coupon bond bought at  $t$  with maturity  $T+1$  would earn almost the same rates as a bond bought at  $t$  with maturity  $T$ . They give identical returns until time  $T$ . It is only in the time  $T + 1$  that a difference occurs, which is called the forward rate. The forward rate  $f(n, T)$  is the implicit rate earned by holding a bond an extra time period.

$$f(n, T) = \frac{B(n, T)}{B(n, T + 1)} \quad (7)$$

which gives

$$B(n, T) = \frac{1}{\prod_{i=1}^{T-1} f(n, i)} \quad (8)$$

These rates, built by zero-coupon bonds, are the foundation of the forward measure.

To price under the forward measure it will be necessary to change from the risk neutral measure. To begin with let  $m$  be fixed with  $1 \leq m \leq N$ , with  $N$  the highest year our model is carried out to. Our Radon-Nikodym derivative is:

$$Z_{m,m} = \frac{D(m)}{B(0, m)} \quad (9)$$

With the use of  $Z_{m,m}$  it is possible to define  $\mathbb{P}^{*m}$  to be the  $m$ -forward measure on our probability space  $\Omega$ , where  $\Omega$  is the set of all possible outcomes for market movements. Letting  $\mathbb{P}$  denote the risk neutral-measure on

$\Omega$  that assigns a probability to each event, we define

$$\mathbb{P}^{*m}(w) = Z_{m,m}(w)\mathbb{P}(w) \quad \forall w \in \Omega \quad (10)$$

$\mathbb{P}^{*m}$  is a probability measure absolutely continuous with respect to the risk neutral probability measure  $\mathbb{P}$ . We can verify that  $\mathbb{P}^{*m}(\Omega)$  is assigned a probability of 1 because  $EZ_{m,m} = 1$ .

$$\mathbb{P}^{*m}(\Omega) = \sum_{w \in \Omega} \mathbb{P}^{*m}(w) = \sum_{w \in \Omega} Z_{m,m}(w)\mathbb{P}(w) = EZ_{m,m} = \frac{1}{B(0,m)}ED_m = 1 \quad (11)$$

The relationship between zero-coupon bond prices and the discount function allows that:

$$B(n,m) = E_n\left[\frac{D(m)}{D(n)}\right] \implies D(n)B(n,m) = E_n[D(m)] \quad (12)$$

Which in turn can define

$$Z_{n,m} = E_n[Z_{m,m}] = \frac{D(n)B(n,m)}{B(0,m)} \quad (13)$$

Thus, under our previous definition of  $V$  coupled with the following

$$E^m[V_m] = E[Z_{m,m}V_m] \quad (14)$$

we can use the  $m$ -forward measure  $\mathbb{P}^{*m}$  to get:

$$E_n^m[V_m] = \frac{V_n}{B(n, m)} \quad (15)$$

In summary, this is the expectation of the payoff function at time  $m$  when  $V_m$  relies on the first  $m$  outcomes and the first  $n$  are known. It is defined by zero coupon bond prices maturing at time  $m$ . For all  $n$  this is the forward price of the security.

## 3 The Ho-Lee Model

### 3.1 General Model

To implement the pricing of securities under the forward measure the discrete Ho-Lee model was chosen. It is a simple recombining binomial model derived by market volatility. At each time node the interest rate  $R_n$  may step up or down to a new node. The discount function  $D$  can therefore be found by tracing paths from node to node and finding the interest rates; which are defined as follows:

$$R_n^c = a_n + b_n \cdot c \quad (16)$$

Where  $a_n$  and  $b_n$  are calibration constants derived from data and  $c$  is the number of ‘up’ steps taken in that path. Developed by T.S.Y. Ho and S.B. Lee in 1986 [3], this was the first model to find single period risk-less returns required to match bond prices.

Nodes are the basis of the tree and each represents both a point in time and a link to its parent and children nodes. Figures 1 and 2 are visual representations of the model.



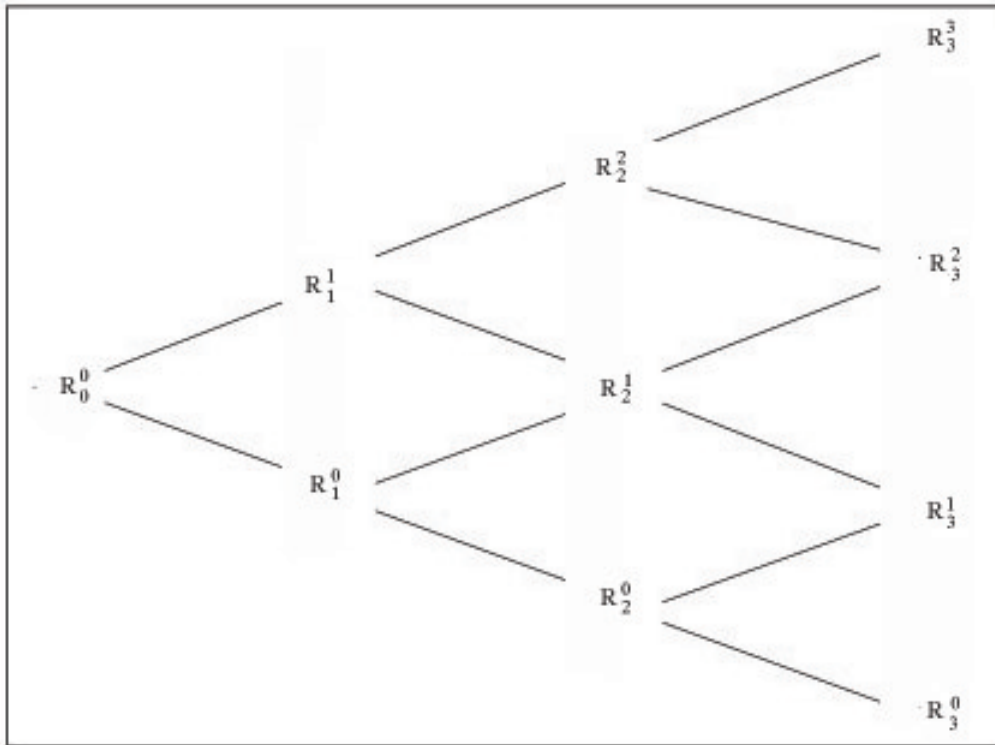


Figure 1: A Recombining Binomial Tree

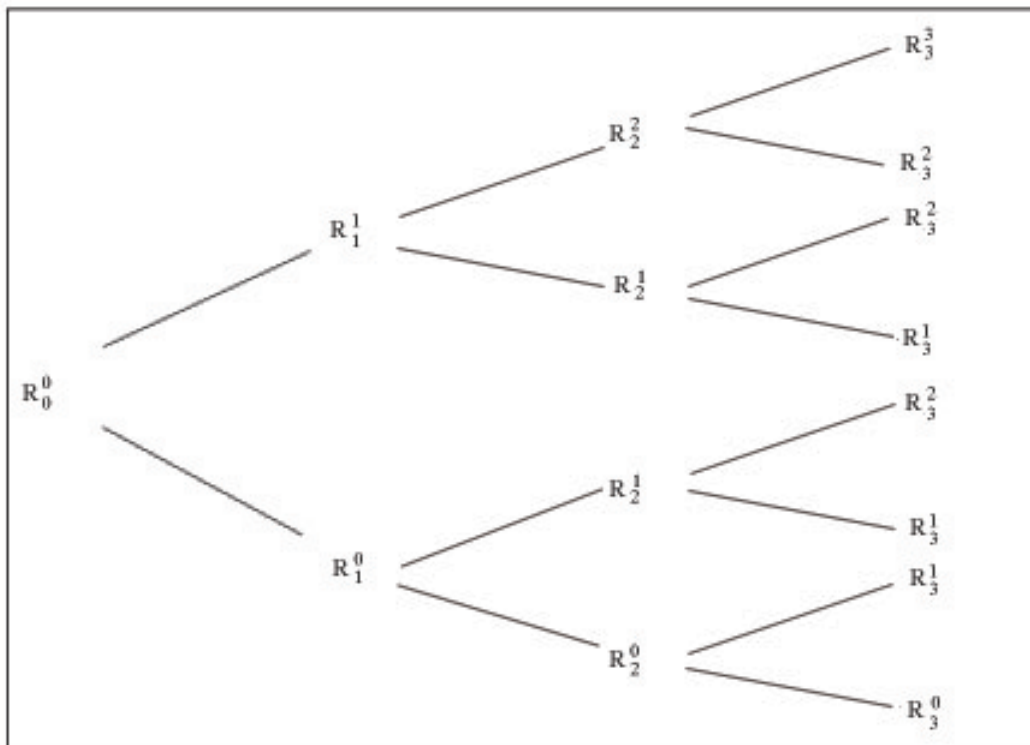


Figure 2: A Non-Recombining Binomial Tree

## 3.2 Drawbacks

There have been many variations and elaborations on the Ho-Lee model. This is because it has a few shortcomings. Most of these stem from being too simple a model without the flexibility to accurately reflect the market.

The model has only one parameter, volatility  $\sigma$ , which is assumed to be constant. The volatility for each period is estimated using historical data, but there is no mechanism for changing the values as the model goes on. Newer models can have both multiple factors and volatility that changes over time.

Static volatility is a problem computationally because that is the basis for  $b_n$ . If the yield curve drifts over time there will be a larger volatility. Coupled with a large  $n$ , the resulting interest rates may very well be negative. This is because the Ho-Lee model builds a symmetric term structure.

### 3.3 Alteration

The basic structure of the Ho-Lee model was used but slight modifications were required. The algorithm described in detail in section 4 is used to derive interest rates from historical data. This required continuously compounded interest rates in the calculations and output. Standard implementation called for a discrete time model. It is possible to transform continuously compounded rates to annual rates by knowing the relationship:

$$e^{R_\infty(n)} = 1 + R(n) \quad (17)$$

Where  $R_\infty(n)$  is the continuously compounded rate, and  $R(n)$  is our standard definition for the interest rate.

Converting from continuously compounded to annual interest rates results in a new problem. The rates are converted to the  $a_n$  and  $b_n$ 's required by the Ho-Lee model in equation 16. The problem lies in the  $b_n \cdot c$ . In continuous time the system is built symmetrically, with the vertical distance between nodes the same (see Figure 1.) This value was equal to  $b_n$ . The transformation into discrete time, however, made each step size slightly greater than the last.

$$(e^{-a_\infty+b_\infty} - 1) - (e^{-a_\infty} - 1) < (e^{-a_\infty+2b_\infty} - 1) - (e^{-a_\infty+b_\infty} - 1) \quad (18)$$

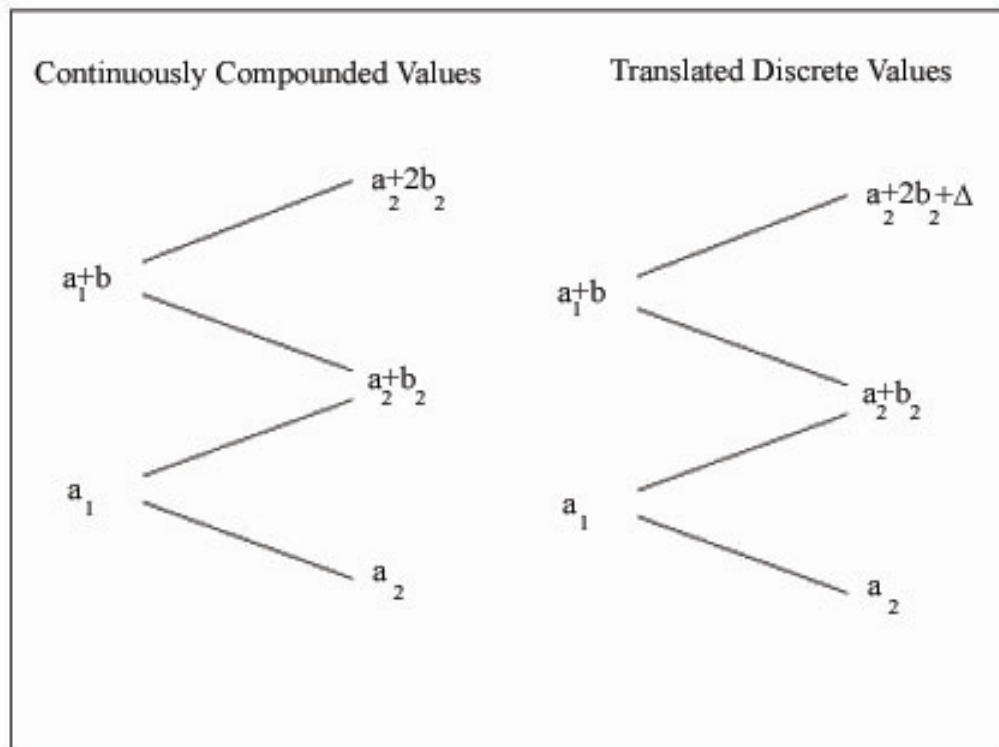


Figure 3: Differences in Translation

Figure 3 illustrates the problem. On the left are the derived  $a_n$  and  $b_n$  values found from continuously compounded rates. On the right are the translated values into their discrete time equivalents.  $\Delta$  represents the difference shown in equation 18. Therefore, the differences between nodes  $R_2^0$ ,  $R_2^1$ , and  $R_2^2$  are no longer constant.

This was the only way to get closed form solutions for the interest rates. So the Ho-Lee model was altered as described. The modular nature of the model also allows for this change to be undone easily.

## 4 Extracting Interest Rates

For the model to be useful in predicting bond prices we require a methodology for choosing sets of  $a_n$  and  $b_n$ . This was started by using Agca and Chance's [6] method for deriving rates for Ho-Lee models. Their approach requires working with continuous compounding. According to the authors, this is the only way to achieve a closed form solution.

This approach requires two inputs to estimate interest rates from historical information. First we need the volatility of spot rates at each  $t \leq N$ . As this is the Ho-Lee model, these values are constant. Second is the time zero zero-coupon bond prices for each  $t \leq N + 1$ . Both these inputs can be found using historical zero-coupon bond yield curves.

The algorithm described revolves on iteratively solving systems of equations. As such, the following values are found:

$$b(n) = 2\sigma_n \quad (19)$$

$$a_n + nB(n) = \ln \frac{Q_n}{2^n B(0, n+1)} \quad (20)$$

$$\implies a_n = \ln \frac{Q_n}{2^n B(0, n+1)} - 2n\sigma_n \quad (21)$$

$$Q_n = e^{-\sum_{j=0}^{n-1} a_j + B_j^n} \prod_{j=1}^n [1 + e^{2\sum_{k=0}^{j-1} \sigma_{n-k}}] \quad (22)$$

It is easily verifiable to see this algorithm is accurate by passing the outputs  $a_n$  and  $b_n$  to the model and retrieving the same time zero-coupon

bond prices as entered.

The programmed implementation starts by reading in a set of  $N$  yields. Since the Ho-Lee model assumes constant volatilities they could be read in once along with the yields. A two-pass function derives its own values for the mean and volatility. Afterwards the yields can give the  $B(0, t)$  prices for all  $t \leq N$ . Similarly  $a_0$  is defined as  $\frac{1}{B(0,1)}$ . From there  $Q_j$  for  $j \leq N$  is found by using nested loops to follow the above algorithm. The relevant output  $a_j$  is stored in a new array. From here our sets of  $a_n$  and  $b_n$  can be output to a file or passed to the Ho-Lee model.



## 5 Calibration

Now that methods for pricing derivatives given interest rates and extracting interest rates from historical data have been established, the next step is to calibrate the data so as to have an accurate model of the real world. This can be approached a few different ways.

First, the Ho-Lee model depends on volatility. It is possible to use one constant volatility  $\sigma$  for each time  $n$  or a variable  $\sigma_n$  can be used. Since these values are derived from data the set,  $\sigma_n$  gives more flexibility to the model. This leads to a more accurate representation.

Volatility is defined in Eq. (3). The practical method to get this value for a large population is as follows:

$$\sigma = \sqrt{\frac{1}{N-1} \sum_{i=1}^N (x_i - \bar{x})^2} \quad (23)$$

$\bar{x}$  is defined as the mean of the  $N$   $x_i$  historical samples. This method is iterated for each time  $n$  until a set of  $\sigma_n$  is found. As mentioned before, the Ho-Lee model is too simple to calibrate on a large data set. There is a limit to what volatility will give non-negative interest rates, which goes down as  $n$  increases. The derived interest rates are weighted to center around the mean of spot rates.  $b_n = 2\sigma_n$  gives the size of the spread between nodes. If the spread is sufficiently large, or mean is sufficiently low, negative interest rates will result.

For instance, take  $a_4 = -.01$ ,  $b_n = 2\sigma = .03$ .

$$R_3^0 = -.01, R_3^1 = .02, R_3^2 = .05, R_3^3 = .08 \quad (24)$$

The expected  $R_3$  has a perfectly valid value between .02 and .05, despite having a negative  $R_3^0$ . The model has no corrections for this type of behavior.

## 6 Passing Information

There have been two distinct processes created to price under the forward measure. The first extracts rates from raw data, and the second extracts prices given rates. These communicate by passing csv (comma separated variable) files.

The calibration program receives a simple  $N + 1$  variable per line file, with  $N$  being the size of the tree. The first variable is the value of  $N$  and the next  $N$  inputs are the continuously compounded yield rates for the zero-coupon bonds. A yield rate is the average annual interest rate for a bond. The input file would look like:

$$4, 0.077971, 0.07771, 0.077916, 0.078194 \quad (25)$$

Shown here are  $N$ , which has a value of 4, and  $y_0, y_1, y_2$ , and  $y_3$ .

The output of the calibration program is identical to the input of the model program. This csv file holds  $2N + 1$  variables. Once again the file is opened by the variable  $N$ , but instead of yield rates we give  $N$  interest rates. These make up the  $a_n$  array used to build the Ho-Lee model. The  $N$   $b_n$  come last, made up of twice the volatility rates ( $2\sigma_n$ ).

$$4, 0.077971, 0.0634728, 0.0528765, 0.0441478, 0, 0.0257994, 0.023709, 0.0220502 \quad (26)$$

Here we see  $N, a_0, a_1, a_2, a_3, b_0, b_1, b_2, b_3$ .

## 7 Implementation

### 7.1 Creation

To find the price of a security derivative the model goes through several distinct steps. First variables, such as length of the tree and the  $a$  and  $b$  values, are read in. A binomial Ho-Lee model is built to find rates using these inputs and the various maturity time zero-coupon bond prices. A second pass goes through to find the  $Z$  and  $\mathbb{P}^*$  values. A payoff function for a derivative is determined to be priced, such as a cap or floor, and a third pass goes through to price the derivative under the forward measure. Lastly these prices are outputted.

The actual building of the model was done using the programming language C++. The design was chosen so as to be modular and easy to modify. Several steps were taken in implementation to allow for this. The most important are the ability to use non-recombining models and the possibility of adjusting interest rate changes to, in effect, use new models.

The driving force of the model is building the binomial tree. The tree is made of nodes which contain all the information needed to price under the forward measure. Using the Ho-Lee model,  $R_n^c$  values are assigned. It does not, however, affect the building of the binomial tree. It is therefore possible to execute an alternate model using the implemented structure by assigning  $R_n^c$  in a different manner.

The  $B(0, T)$  prices must be found by taking expectation of future rates.

Pricing derivatives under the forward measure does not take the origin of the rates into account, just that they exist. Any model may be used to output rates.

## 7.2 Data Variables

The first data item to be stored is the depth of a node, which represents its place in time. The first node at time 0, or the root, has a depth value of zero. Each step along the path, representing an increase in time, increments the depth by a value of one. Tied to that is the number of time steps left until the tree is complete. This is of use when building the tree. This value could also be derived knowing the current node depth and total depth of the tree,  $N$ . Particularly important for the Ho-Lee model is the counter for ‘up’ movements. Each node (barring the last set) has two children, one that represents an up movement in interest rates, and one down. This is what the Ho-Lee model uses to create interest rates.

Variables are created to store data derived from interest rates. Both the discount rate  $d(n)$  and discount function  $D(n)$  are stored for each node. The risk-neutral probabilities are kept as well, to find  $B(0, t)$ .

Last are the values associated with pricing under the forward measure. The probability of reaching that node under the forward measure  $\mathbb{P}^*$  and  $Z$ , its Radon-Nikodym derivative with respect to the risk neutral measure  $\mathbb{P}$ . These are derived as explained above, with  $Z$  a function of the discount function with the relevant node and the time zero zero-coupon bond with maturity  $N$ .  $\mathbb{P}^*$  is the product of  $Z$  and the probability of reaching the node under the risk-neutral measure. The programming structure allows the odds of an up or down movement to be changed, although as in Agca[6] we assume risk-neutral probabilities of  $\frac{1}{2}$ . The real risk-neutral probabilities

may be slightly different to be consistent with the absence of arbitrage. The flexibility provided by the model parameters compensates for this assumption and return proper results.

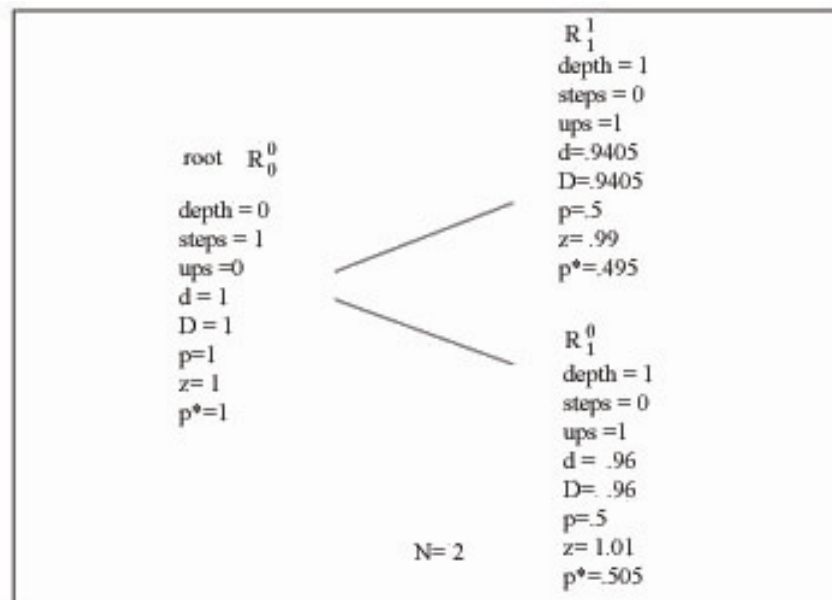


Figure 4: Passed Variables



### 7.3 Functions

Upon creation of a node, a function is called to return the derived interest rate. This is where the program form may be used for different models. A different value function can be substituted in, thus altering the term structure. Once the value is retrieved, whatever it may be, the inverse is taken to find the discount rate  $d(n)$  for that year. The discount function,  $D(n)$  as defined before, is the product of all discount rates in a particular path. That rate is also stored along each node in a path and can be derived by multiplying the parent node's discount function by the current node's discount rate. To this effect, and in the act of building the tree, the pointers to the parent and children nodes are stored. With this the time zero zero-coupon bond price with a maturity of the node depth can be found, which is stored in an array of size  $N$ .

The program reads in the  $N$ ,  $a_n$ , and  $b_n$  values required to build a Ho-Lee tree. If a different model wishes to be used the form of the input file would be different. A new root is created with an interest rate of  $a_0$  and probability of 1. The price of the time zero zero-coupon bond would simply be it's discount rate. Until the the proper depth is reached, the root and all following nodes create children. They pass on their discount function and the new nodes call an interest rate value function. Here the continuous interest rates are transformed to create a discrete tree as explained above. Using that information the tree finds the relevant  $B(0, n)$ . This is done by summing the product of the current nodes discount rate and it's parents discount function

with the risk neutral probabilities that this outcome would occur.

Now that we have both the discount function for each path leading to a node and the time zero zero-coupon bond price  $B(0, n)$  for each maturity date the  $Z$  and  $\mathbb{P}^*$  values can be computed. A recursive passthrough, starting at the root and passing on to its children, begins. Finally, a second set of inputs decides which derivative security should be priced. Although only a few securities are currently created, the comparison process is also modular. By setting new constraints to compare the interest rate at each node to some value any security can be created. The payoff function is given a value according to this, and a recursive pass through can price it using the  $\mathbb{P}^*$  probabilities.

## 8 Results

### 8.1 Estimated Rates

To estimate interest rates from historical data, 100 yield curves were used. The selection started in 1990 and chose every 5th business day, going well into 1992.

$N$	$y_0$	$y_1$	$y_2$	$y_3$
11	0.077971	0.07771	0.077916	0.078194
11	0.077771	0.077765	0.078179	0.078623
11	0.079992	0.080278	0.080764	0.081154
11	0.081011	0.081766	0.082487	0.083016
11	0.081519	0.082646	0.083407	0.083844
11	0.080255	0.081052	0.081723	0.0822
11	0.080889	0.082611	0.083483	0.083952
11	0.081909	0.083448	0.084479	0.085089
11	0.08379	0.085435	0.086192	0.086457

Table 1: Input to Estimate Rates

$N$	$a_0$	$a_1$	$a_2$	$b_0$	$b_1$	$b_2$
11	0.077971	0.0634728	0.0528765	0	0.0257994	0.023709
11	0.077771	0.0637828	0.0535555	0	0.0257994	0.023709
11	0.079992	0.0665878	0.0562845	0	0.0257994	0.023709
11	0.081011	0.0685448	0.0584775	0	0.0257994	0.023709
11	0.081519	0.0697968	0.0594775	0	0.0257994	0.023709
11	0.080255	0.0678728	0.0576135	0	0.0257994	0.023709
11	0.080889	0.0703568	0.0597755	0	0.0257994	0.023709
11	0.081909	0.0710108	0.0610895	0	0.0257994	0.023709
11	0.08379	0.0731038	0.0622545	0	0.0257994	0.023709

Table 2: Estimated Rates

Only a truncated version is shown. A full 12 variable 100 line file was actually input and a 23 variable file was output. So far the results are straightforward and unsurprising.  $a_0$  is the root node, and is therefore the only node at time 0. This correlates to the value of  $b_0$ , which is 0. Also, it is evident that all  $b_n$  are constant, regardless of time. This is one of the drawbacks of the Ho-Lee model. It is caused by assuming a constant volatility across time.

## 8.2 Pricing Derivatives

Given sets of  $a_n$  and  $b_n$ , it is now possible to price fixed income derivatives under both the forward and risk-neutral measures. Let an interest rate cap of .05 be imposed with a maturity of 7. For every year until then, a value function  $V(n)$  will compare  $R(n)$  to .05. The derivative pays  $R(n) - .05$  when  $R(n) > .05$ . Inputting these conditions to our program, along with our estimated rates, will price the derivative.

Risk-Neutral	Forward
0.159576	0.159576
0.162585	0.162585
0.172813	0.172813
0.18251	0.18251
0.185412	0.185412
0.178274	0.178274
0.186014	0.186014
0.191539	0.191539
0.195627	0.195627

Table 3: Cap Prices

Here is another fixed income derivative, an interest rate floor with a maturity of 8 for the same estimated term structure. The value function  $V(n)$  will now compare  $R(n)$  to .07 and pay  $.07 - R(n)$  when  $R(n) < .07$ . The derivative prices are as follows:

Risk-Neutral	Forward
0.0210254	0.0210254
0.0195019	0.0195019
0.0159325	0.0159325
0.0127138	0.0127138
0.0122266	0.0122266
0.0138367	0.0138367
0.011993	0.011993
0.0105975	0.0105975
0.0102725	0.0102725

Table 4: Floor Prices

Pricing under both measures gives the same result, as is expected. The surprising result is that there is no notable change in computational speed between methods. This is because our model is required to calculate the  $B(0, n)$  prices, regardless.

By assigning possible values and probabilities to the discount function  $D(n)$  the binomial implementation of the Ho-Lee model avoids the difficulties involved with a random  $D(n)$ . If  $D(n)$  were treated as a true random variable with some distribution, the joint distribution between  $D$  and  $V$  would be required for risk-neutral valuation.

The forward measure also has the advantage in pricing when  $B(0, n)$  prices are readily available.

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