Instructions: This is an open book and notes exam. Calculators should be used but laptop computers and other wireless devices are not allowed. You need to show all the details of your work to receive full credit.

1. In each of the following situations, determine if there is any arbitrage opportunity. If there is, construct such an arbitrage portfolio. If not, explain why.

   (a) The stock is currently traded at $50 per share, and the European call and put with the same strike $55, and expiration in 3 months are quoted at $1 and $6 respectively. The risk-free interest rate is 1%.

   (b) Same as above, except that the risk-free rate is 10%.

2. For each of the following pairs of prices of non-dividend paying stock $S$ and 1-year risk less zero-coupon bond $Z$ with principal $1,

   $S = 100, Z = 1,$
   $S = 90, Z = 1,$
   $S = 110, Z = 0.9,$
   $S = 110, Z = 1,$

find optimal rational bounds on the following 1-year contracts

   • a digital put struck at 100;
   • a portfolio of 0.5 digital call struck at 100 and one call option struck at 110.

3. In our prototype one-period binomial model for a stock price, we assume the time period is one half year, and use $u = 2, d = 1/2$ for the up and down moves respectively, and a money market rate $r = 5\%$ (annualized) for the interest rate over this time period. What are the risk-neutral probabilities $\tilde{p}$ and $\tilde{q}$? What is the annualized volatility (in percentage) implied from this model? Suppose the current stock price is $10, and you wrote a put option with strike $8$, how much is the worth of this put option based on the no-arbitrage principle? How do you hedge this put option using the stock and a money market account?

4. In a two-period binomial model with $\Delta t = 0.5$, the stock prices and risk-neutral probabilities are displayed in the following, and the annualized risk-less interest rate is $r = 5\%$. Price an European call option on the stock with strike $K = 10$ that expires at $T = 1$. 


5. If 

\[ \frac{dS_t}{S_t} = r \, dt + \sigma \, dW_t, \]

(a) Derive the process for \( S_t^2 \).

(b) Does \( S_t^2 \) follow a geometric Brownian motion? If the answer is yes, write down the Black-Scholes model price for a derivative with payoff \( (S_T^2 - K)^+ \).

6. Use the Black-Scholes formula to price the put in Problem 3, using a volatility of 75%. The put price in the formula is given by

\[ P = Ke^{-rT}N(-d_2) - S_0N(-d_1), \]

where

\[ d_1 = \frac{\log(S_0/K) + (r + \sigma^2/2)T}{\sigma \sqrt{T}}, \quad d_2 = d_1 - \sigma \sqrt{T}. \]

What is the implied volatility for the put price from Problem 3? You can use any trial-and-error approach to get an approximation within a price error of 10 cents.

7. A stock \( S_t \) follows a geometric Brownian motion with time-dependent volatility. We have \( S_0 = 100, \ r = 0\% \). Put options struck at 100 with expirations 0.3, 0.6 and 1 have implied volatilities 10%, 15% and 20%. Find a piecewise constant volatility function that is consistent with these implied volatilities. Is this piecewise function the only way to fit the implied volatilities? Explain.

8. Price the American put option with strike \( K = $10 \) in the same model as in Problem 3. For each node in the model, determine whether the option should be exercised or not.
9. An up-and-in call is a barrier option where the call option comes into existence only if the barrier is reached before the expiration. In the following, we have a three-period model with $\Delta t = 1/12$, and the European call option with expiration at $T = 1/4$ and strike $K = $86 is valid only if the stock price reaches level 16 before $T$. In particular, the payoff of the barrier option at $T$ is

$$\max(S_3 - 6, 0) \cdot I\{\tau < 3\}$$

where the stopping time $\tau = \min\{n : S_n = 16\}$. For simplicity, we assume the interest rate is zero and all probabilities of up and down moves are $1/2$. Use our general binomial pricing model to price this barrier option at time zero. Should this option always be priced lower than the corresponding standard European call with the same strike and expiration? Why?
10. If $dX_t = \sigma dW_t$, and $X_0 > L$, give an expression in terms of the cumulative normal, $X_0, \sigma$ and $T$ for

$$P \left( \min_{t \in [0,t]} X_t \geq L \right).$$