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cf_call_merton

Let

- T = maturity date ($T > t$)
- K = strike price
- x = spot price
- t = pricing date
- σ = volatility
- r = interest rate
- δ = dividend yields
- λ = jump intensity
- $\mathbf{E}U$ = the expectation over the random jump variable U
- $\theta = T - t$

We assume [1] that the jump variable U is log-normally distributed with constant mean and variance. Specifically, let $\mathbf{E}[\ln U] = \mu$ and $\mathbf{E}[(\ln U)^2] = \mu^2 + \gamma^2$, such that $\mathbf{E}U = e^{\mu + \frac{\gamma^2}{2}}$.

Set:

$$d_1 = \frac{\log\left(\frac{x}{K}\right) + \left(r_n + \frac{\sigma_n^2}{2}\right)\theta}{\sigma_n\sqrt{\theta}} \quad d_2 = d_1 - \sigma_n\sqrt{\theta},$$

where

$$\sigma_n^2 = \sigma^2 + \frac{n\gamma^2}{\theta} \quad r_n = r - \delta - \lambda\mathbf{E}U + \frac{n}{\theta} \ln(1 + \mathbf{E}U).$$

and N as the cumulative normal distribution function:

$$N(d) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^d e^{-x^2/2} dx.$$

Call Option

PAYOFF	$C_T = (S_T - K)_+$
PRICE	$C(t, x; K) = \sum_{n=0}^{\infty} \frac{(\lambda\theta)^n}{n!} e^{-\lambda\theta} [xN(d_1) - Ke^{-r_n\theta}N(d_2)]$
DELTA	$\frac{\partial C(t, x; K)}{\partial x} = \sum_{n=0}^{\infty} \frac{(\lambda\theta)^n}{n!} e^{-\lambda\theta} N(d_1)$

References

- [1] R.C.MERTON. Option pricing when the underlying stocks returns are discontinuous. *Journ. Financ. Econ.*, 5:125–144, 1976. 1