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Risk Management for Derivatives in Illiquid Markets: A Simulation Study

| Chapter

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Advances in Finance and Stochastics


[Rüdiger Frey](#) & [Pierre Patie](#)

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Summary

In this paper we study the hedging of derivatives in illiquid markets. More specifically we consider a model where the implementation of a hedging strategy affects the price of the underlying security. Following earlier work we characterize perfect hedging strategies by a nonlinear version of the Black-Scholes PDE. The core of the paper consists of a simulation study. We present numerical results on the impact of market illiquidity on hedge cost and Greeks of derivatives. We go on and offer a new explanation of the smile pattern of implied volatility related to the lack of market liquidity. Finally we present simulations on the performance of different hedging strategies in illiquid markets.

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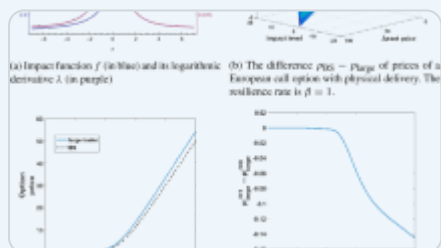
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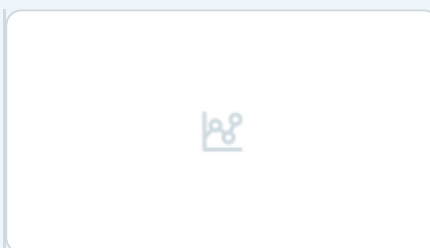
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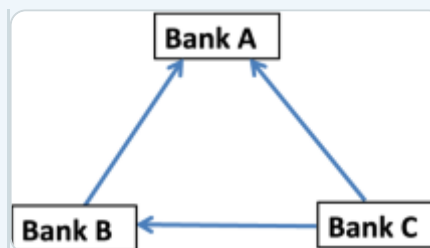
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Author information

Authors and Affiliations

Swiss Banking Institute, University of Zurich, Switzerland

Rüdiger Frey

RiskLab, Department of Mathematics, ETH Zurich, Switzerland

Pierre Patie

Editor information

Editors and Affiliations

**Lehrstuhl für Bankbetriebslehre, Johannes Gutenberg-Universität Mainz,
Jakob Welder-Weg 9, 55128, Mainz, Germany**

Klaus Sandmann

**Inst. f. Gesellschafts- u. Wirtschaftswissenschaften Statistische Abteilung,
Rheinische Friedrich-Wilhelms-Universität Bonn, Adenauerallee 24-42,
53113, Bonn, Germany**

Philipp J. Schönbucher

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