

Pricing and Hedging Path-Dependent Options Under the CEV Process

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Published Online: 1 Jul 2001 | <https://doi.org/10.1287/mnsc.47.7.949.9804>

Abstract

Much of the work on path-dependent options assumes that the underlying asset price follows geometric Brownian motion with constant volatility. This paper uses a more general assumption for the asset price process that provides a better fit to the empirical observations. We use the so-called *constant elasticity of variance (CEV) diffusion* model where the volatility is a function of the underlying asset price. We derive analytical formulae for the prices of important types of path-dependent options under this assumption. We demonstrate that the prices of options, which depend on extrema, such as barrier and lookback options, can be much more sensitive to the specification of the underlying price process than standard call and put options and show that a financial institution that uses the standard geometric Brownian motion assumption is exposed to significant pricing and hedging errors when dealing in path-dependent options.

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Volume 47, Issue 7

July 2001

Pages 881-1027

Information

Received: August 01, 2000

Published Online: July 01, 2001

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Cite as

Dmitry Davydov, Vadim Linetsky, (2001) Pricing and Hedging Path-Dependent Options Under the CEV Process. *Management Science* 47(7):949-965.

<https://doi.org/10.1287/mnsc.47.7.949.9804>

Keywords

Path-Dependent Options

Barrier Options

Lookback Options

Diffusion Processes

CEV Model

Generalized Bessel Process

Radial Ornstein-Uhlenbeck Process

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