

# D THE JOURNAL OF DERIVATIVES

## Editor's Letter

*JOD* 2003, 11 (1) 7-8

doi: <https://doi.org/10.3905/jod.2003.390878>

<http://jod.ijjournals.com/content/11/1/7.citation>

This information is current as of March 18, 2019.

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VOLUME 11, NUMBER 1

FALL 2003

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This is the first issue of Volume 11. A year ago at this time, due to a high rate of time preference, I announced that it was the tenth anniversary of *The Journal of Derivatives*. But calendar purists pointed out that only with the first issue of Volume 11 could we really be said to have completed 10 years of publication. In which case, the current issue calls for another celebration. Let's drink a toast to the *JOD's* True 10th Anniversary, and wish for many more.

This issue has interesting articles covering a wide range of topics. Our lead article, by Ayache, Forsyth, and Vetzal, combines analysis of credit risk, interest rate risk, equity risk, and embedded call and put options all in the same security: convertible bonds. These complex securities have become extremely popular in the difficult financial environment of the last few years, and this article helps put some order to the complexity. The second article explores credit risk, too, but from the perspective of modeling the option-adjusted spreads (OAS) on bond indexes for different credit rating classes. Huang and Kong find that OAS, especially for riskier bonds, is significantly affected by term structure variables, naturally, but also by measures of overall conditions in the macroeconomy (e.g., an index of leading economic indicators) and the equity markets (e.g., the return on the Russell 2000 stock index).

Stochastic volatility and the pricing of equity options is an important area in which much research has still left us with an uneasy feeling that we don't fully understand how the real world works. There is very strong evidence that stock return volatilities are stochastic. But is volatility risk priced in the market? If so, is total volatility priced, or just the part of volatility that is correlated with the market? What is the connection between expected (actual) volatility and implied (risk-neutral) volatility? Our third article, by Bakshi and Kapadia, addresses these interesting issues by examining the returns to delta-hedged positions for options on 25 actively traded stocks. In answer to the third question, the article suggests that the difference between implied volatility and expected volatility provides one measure of the market price of volatility risk.

The fourth article presents some interesting evidence that option-type payoffs are very attractive to European investors, and that they seem willing to pay a premium for structured products that provide those payoffs, even when the same patterns can be (approximately) replicated using actual options and the underlying. The final article describes a contingent security with a rather special payoff: an arithmetic average reset option. The strike price can be reset peri-

odically, meaning that a long maturity option cannot go deep out of the money and become essentially worthless in the short run. Moreover, after reset the strike is based on the average price of the underlying, which reduces problems with regular reset options due to noisy market prices and jumps in delta near the reset dates. The article provides a useful valuation methodology for such securities that handles the technical difficulty that the underlying does not have a tractable distribution, because it is an arithmetic average of lognormal variables.

Well, the plan to enlist derivatives in the nation's service did not pan out. The "Terrorism Futures Market" proposed by the U.S. Department of Defense may have set a new record in speed of failure for a futures contract, after it was found that a lot of people felt very strongly that the idea was (pick one or more:)

- a) weird
- b) an innovative way to use the market to produce information
- c) clever but flawed
- d) doomed to failure
- e) really stupid
- f) all of the above

For my part, I was anticipating a wave of new manuscript submissions. Papers on estimating convenience yields for terrorism futures, hedging strategies with terrorism futures, properties of the risk-neutral density of terrorist attacks, and many others all seemed likely. Oh well. Not all market innovations succeed; perhaps this one was just ahead of its time.

**Stephen Figlewski**  
**Editor**

P.S. My personal answer to the multiple choice question: f) all of the above. But I don't feel strongly.