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Benchmarking and Fair Pricing Applied to Two Market Models

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Abstract: This paper considers a market containing both continuous and discrete noise. Modest assumptions ensure the existence of a growth optimal portfolio. Non-negative self-financing trading strategies, when benchmarked by this portfolio, are local martingales under the real-world measure. This justifies the fair pricing approach, which expresses derivative prices in terms of real-world conditional expectations of benchmarked payoffs. Two models for benchmarked primary security accounts are presented, and fair pricing formulas for some common contingent claims are derived.

Keywords: growth optimal portfolio; benchmark approach; fair pricing; Merton jump-diffusion model; minimal market model

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