

Stochastic Volatility Models and Simulation

Applied Stochastic Processes (FIN 514)

Instructor: Jaehyuk Choi

Peking University HSBC Business School, Shenzhen, China

2019-20 Module 1 (Fall 2019)

Stochastic Volatility (SV) Models

- The price process (martingale):

$$\frac{dF_t}{F_t^\beta} = \sigma_t dW_t = \sigma_t(\rho dZ_t + \rho_* dX_t), \quad \text{for } \rho_* = \sqrt{1 - \rho^2}.$$

BSM-base: $\beta = 1$, normal-base: $\beta = 0$.

For the models except SABR, $\beta = 1$.

- The (stochastic) volatility process may vary:

$$\sigma_t = a(t, \sigma_t)dt + b(t, \sigma_t)dZ_t,$$

- The correlation between the two Brownian motions:

$$dW_t dZ_t = \rho dt.$$

The correlation explains the *leverage effect*: equity volatility increases as price goes down.

Various SV models

The SDE for volatility is defined for volatility σ_t or variance $v_t = \sigma_t^2$.

- SABR model [[Hagan et al., 2002](#)]:

$$d\sigma_t/\sigma_t = \alpha dZ_t.$$

- [Heston \[1993\]](#) model:

$$dv_t = \kappa(\theta - v_t)dt + \xi\sqrt{v_t}dZ_t.$$

- 3/2 model [[Heston, 1997](#), [Lewis, 2000](#)]:

$$dv_t = \kappa v_t(\theta - v_t)dt + \xi v_t^{3/2} dZ_t.$$

- GARCH diffusion model (relatively new):

$$dv_t = \kappa(\theta - v_t)dt + \xi v_t dZ_t.$$

- OU volatility model [[Li and Wu, 2019](#)]:

$$d\sigma_t = \kappa(\theta - \sigma_t)dt + \xi dZ_t.$$

Simulation scheme for the SV models

- Time discretization (Euler/Milstein):
 - Almost no restriction but computationally expensive.
- Conditional MC:
 - Can skip the simulation of price F_t . (Simulate volatility σ_t only)
 - The final price F_T should be expressed by σ_T and $V_T = \int_0^T \sigma_t^2 dt$.
- Exact Simulation:
 - No need for time-discretization: jump from $t = 0$ to T .
 - The conditional MC condition + should be able to sample σ_T and V_T .
 - σ_T follows a well-known distribution and the (conditional) Laplace transform of $V_T | v_T$ should be analytically available (Heston, 3/2, SABR)

$$E(e^{-sV_T} | v_T = x) = f(s, x)$$

If Laplace transform is known, the CDF of $V_T | v_T$ can be obtained by (numerical) inverse-transform although it may be computationally expensive.

- There are other lucky cases too (e.g. normal SABR).

Conditional and exact MC

Conditional MC:

- 1) Simulate path of σ_t for $(0 \leq t \leq T)$
- 2) Obtain σ_T and V_T (trapezoidal / Simpson's rule)

Exact MC:

- 1) Sample v_T from the (well-known) distribution
- 2) Sample V_T from the (numerical) CDF of $V_T | v_T$.

In Common:

- 3) Obtain $E(F_T | v_T)$ and effective volatility (usually $\rho_* \sqrt{V_T/T}$)
- 4-1) Price sampling: draw normal / log-normal distribution
- 4-2) Call option: BSM formula

Heston model (conditional MC)

$$dv_t = \kappa(\theta - v_t)dt + \xi\sqrt{v_t}dZ_t \quad (v_t = \sigma_t^2)$$

Integrating v_t ,

$$v_T - v_0 = \kappa(\theta T - I_T) + \xi \int_0^T \sqrt{v_t} dZ_t$$
$$\int_0^T \sigma_t dZ_t = \frac{1}{\xi} \left(v_T - v_0 - \kappa(T\theta - V_T) \right).$$

F_T is expressed by v_T and V_T !

$$\log \left(\frac{S_T}{S_0} \right) = \frac{\rho}{\xi} (v_T - v_0 - \kappa(\theta - V_T)) - \frac{1}{2} V_T + \rho_* \sqrt{V_T} X_1$$
$$E(S_T) = S_0 \exp \left(\frac{\rho}{\xi} (v_T - v_0 - \kappa(\theta - V_T)) - \frac{\rho^2}{2} V_T \right)$$

Conditional MC is possible.

Heston model (exact MC)

- It is known that v_T is distributed as a noncentral chi-square distribution, $\text{NCX2}(\delta, \lambda)$:

$$v_T = \frac{\xi^2(1 - e^{-\kappa T})}{4\kappa} \text{NCX2}(\delta, \lambda) = \frac{e^{-\kappa T/2}}{2\phi(\kappa)} \text{NCX2}(\delta, \lambda),$$

where the degrees of freedom δ and the noncentrality λ are

$$\delta = \frac{4\kappa\theta}{\xi^2}, \quad \lambda = \frac{4v_0\kappa e^{-\kappa T}}{\xi^2(1 - e^{-\kappa T})} = 2v_0e^{-\kappa T/2}\phi(\kappa) \text{ for } \phi(\kappa) = \frac{2\kappa/\xi^2}{\sinh(\kappa T/2)}$$

Standard library is available for drawing NCX2 random number.

- The conditional Laplace transform is also known [[Pitman and Yor, 1982](#)].
- Reference: [Broadie and Kaya \[2006\]](#) and [Glasserman and Kim \[2011\]](#) (improvement)

SABR model (conditional MC)

$$\frac{d\sigma_t}{\sigma_t} = \alpha dZ_t \quad \Rightarrow \quad \sigma_T = \sigma_0 \exp \left(-\frac{1}{2} \alpha^2 T + \alpha Z_T \right)$$

Integrating σ_t ,

$$\alpha \int_0^T \sigma_t dZ_t = \sigma_T - \sigma_0 = \sigma_0 \exp \left(-\frac{1}{2} \alpha^2 T + \alpha Z_T \right) - \sigma_0$$

F_T is expressed by σ_T and V_T (Conditional MC is possible) !

$$S_T = S_0 + \frac{\rho}{\alpha} (\sigma_T - \sigma_0) + \rho_* \sqrt{V_T} X_1$$
$$\log \left(\frac{S_T}{S_0} \right) = \frac{\rho}{\alpha} (\sigma_T - \sigma_0) - \frac{1}{2} V_T + \rho_* \sqrt{V_T} X_1$$

SABR Model (exact MC)

- σ_T is distributed by log-normal distribution. Sampling is trivial.
- The conditional Laplace transform of $1/V_T$ is also known:

$$E\left(e^{-s/V_T} | v_T\right) = \exp\left(-\frac{\phi_x(s)^2 - x^2}{2T}\right)$$

where $\phi_x(s) = \text{acosh}(se^{-x} + \cosh(x))$ and $v_T = \exp(\alpha x)$

- From above, we can sample $1/V_T$ and get V_T .
- Reference: [Cai et al. \[2017\]](#)

3/2 model (conditional MC)

$$dv_t = \kappa v_t(\theta - v_t)dt + \xi v_t^{3/2} dZ_t.$$

The change of variable, $x_t = 1/v_t$ yields (good Itô calculus exercise!)

$$dx_t = (\kappa + \xi^2 - \kappa\theta x_t)dt - \xi\sqrt{x_t} dZ_t.$$

This is same as v_t in Heston model with new parameters:

$$\xi' = -\xi, \quad \kappa' = \kappa\theta, \quad \text{and} \quad \theta' = (\kappa + \xi^2)/(\kappa\theta).$$

We can F_T as a function of V_T and v_T (Conditional MC is possible):

$$d\log(x_t) = \left(\frac{\kappa + \xi^2/2}{x_t} - \kappa\theta \right) dt - \frac{\xi}{\sqrt{x_t}} dZ_t$$

$$\int_0^T \frac{1}{\sqrt{x_t}} dZ_t = \frac{1}{\xi} \left(\log \left(\frac{x_0}{x_T} \right) + (\kappa + \xi^2/2)V_T - \kappa\theta T \right),$$

$$\log \left(\frac{F_T}{F_0} \right) = \frac{\rho}{\xi} \left(\log \left(\frac{v_T}{v_0} \right) - \kappa \left(T\theta - \left(1 + \frac{\xi^2}{2\kappa} \right) V_T \right) \right) - \frac{1}{2} V_T + \rho_* \sqrt{V_T} X_1$$

3/2 model (exact MC)

- From Heston model, $1/v_T$ is distributed as a noncentral chi-square distribution, $\text{NCX2}(\delta', \lambda')$ where the degrees of freedom δ' and the noncentrality λ' are

$$\delta' = \frac{4\kappa'\theta'}{\xi^2}, \quad \lambda = \frac{4\kappa' e^{-\kappa'T}}{v_0\xi^2(1 - e^{-\kappa'T})}.$$

Standard library is available for drawing NCX2 random number.

- The conditional Laplace transform V_T is also known.
- Reference: [Baldeaux \[2012\]](#)

Project Suggestion

- General scheme:
 - Implementing existing paper is OK.
 - Try something new (see below):
- Simulation for **GARCH diffusion**:

$$dv_t = \kappa(\theta - v_t)dt + \xi v_t dZ_t.$$

- Currently, there is no easy way to solve the SDE.
 - Conditional MC possible? Option pricing with conditional MC?
 - How to express F_T as a function of v_T and V_T (or something else)?
 - Exact simulation possible?
- *Almost* Exact MC (by Choi)

Project Suggestion: *Almost* Exact MC (by Choi)

Drawback of exact simulation (if existing):

- Inverse Laplace transform of $V_T|v_T$ is complicated.
- Drawing random number from numerical CDF is also slow.

How can we simplify this step with some approximation?

- Approximate $V_T|v_T$ with a well-known distribution with easy sampling with moment matching, $E(V_T|v_T)$, $E(V_T^2|v_T)$, etc.
- Distribution candidates:
 - Log-normal:

$$Y \sim e^X \quad \text{where} \quad X \sim N(\mu, \sigma^2)$$

- Inverse-Gaussian:

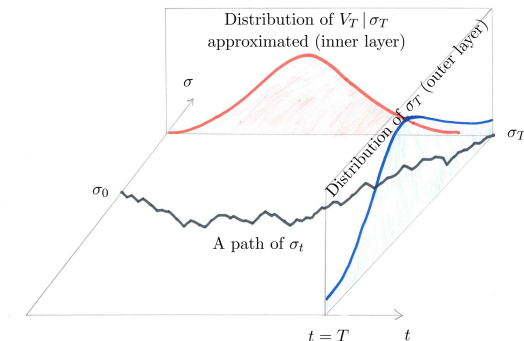
$$f_{\text{IG}}(x | \gamma, \delta) = \frac{\delta}{\sqrt{2\pi x^3}} \exp\left(-\frac{(\gamma x - \delta)^2}{2x}\right) \quad \text{for } \gamma \geq 0, \delta > 0.$$

- First two moments are available. The sampling method for IG is available from [Michael et al. \[1976\]](#).
- A similar idea exists for SABR [Kennedy et al. \[2012\]](#)

Project Suggestion: *Almost* Exact MC (by Choi)

The illustration of the proposed double layer approximation method:

- 1 The outer layer distribution of σ_T (in blue) is typically known
- 2 The inner layer distribution of $V_T|\sigma_T$ (in red) is approximated as well-known distributions such as log-normal or inverse Gaussian.



(Continued) How to obtain the moments of $V_T|\sigma_T$?

Keep in mind for a random variable $X \geq 0$, the MGF and Laplace transform are same:

$$M_X(-s) = E(e^{-sX}) = \int_{x=0}^{\infty} e^{-sX} f_X(x) dx = f(s)$$
$$f(s) = 1 - M_1 s + \frac{1}{2} M_2 s^2 + \dots,$$

where $M_1 = E(V_T|v_T)$ and $M_2 = E(V_T^2|v_T)$.

- Numerical method: [Choudhury and Lucantoni \[1996\]](#)
- Analytic method (obtaining Taylor expansion or else):
 - SABR: well-known [Kennedy et al. \[2012\]](#).
 - GARCH: [Barone-Adesi et al. \[2005\]](#)(?)
 - Heston, 3/2, OU?

References

- Jan Baldeaux. Exact simulation of the 3/2 model. *International Journal of Theoretical and Applied Finance*, 15(05):1250032, 2012. doi:[10.1142/S021902491250032X](https://doi.org/10.1142/S021902491250032X). <http://arxiv.org/abs/1105.3297>.
- Giovanni Barone-Adesi, Henrik Rasmussen, and Claudia Ravanelli. An option pricing formula for the GARCH diffusion model. *Computational Statistics & Data Analysis*, 49(2):287–310, 2005. doi:[10.1016/j.csda.2004.05.014](https://doi.org/10.1016/j.csda.2004.05.014).
- Mark Broadie and Özgür Kaya. Exact Simulation of Stochastic Volatility and Other Affine Jump Diffusion Processes. *Operations Research*, 54(2):217–231, 2006. doi:[10.1287/opre.1050.0247](https://doi.org/10.1287/opre.1050.0247).
- Ning Cai, Yingda Song, and Nan Chen. Exact Simulation of the SABR Model. *Operations Research*, 65(4):931–951, 2017. doi:[10.1287/opre.2017.1617](https://doi.org/10.1287/opre.2017.1617).
- Gagan L. Choudhury and David M. Lucantoni. Numerical Computation of the Moments of a Probability Distribution from its Transform. *Operations Research*, 44(2):368–381, 1996. doi:[10.1287/opre.44.2.368](https://doi.org/10.1287/opre.44.2.368).
- Paul Glasserman and Kyoung-Kuk Kim. Gamma expansion of the Heston stochastic volatility model. *Finance and Stochastics*, 15(2):267–296, 2011. doi:[10.1007/s00780-009-0115-y](https://doi.org/10.1007/s00780-009-0115-y).
- Patrick S Hagan, Deep Kumar, Andrew S Lesniewski, and Diana E Woodward. Managing smile risk. *Wilmott Magazine*, 2002 (9):84–108, 2002.
- Steven L Heston. A closed-form solution for options with stochastic volatility with applications to bond and currency options. *Review of Financial Studies*, 6(2):327–343, 1993. doi:[10.1093/rfs/6.2.327](https://doi.org/10.1093/rfs/6.2.327).
- Steven L. Heston. A Simple New Formula for Options with Stochastic Volatility. SSRN Scholarly Paper ID 86074, Social Science Research Network, Rochester, NY, 1997.
- Joanne E Kennedy, Subhankar Mitra, and Duy Pham. On the approximation of the SABR model: A probabilistic approach. *Applied Mathematical Finance*, 19(6):553–586, 2012. doi:[10.1080/1350486X.2011.646523](https://doi.org/10.1080/1350486X.2011.646523).
- Alan L. Lewis. *Option Valuation under Stochastic Volatility: With Mathematica Code*. Newport Beach, CA, 2000. ISBN 978-0-9676372-0-4.
- Chenxu Li and Linjia Wu. Exact simulation of the Ornstein–Uhlenbeck driven stochastic volatility model. *European Journal of Operational Research*, 275(2):768–779, 2019. doi:[10.1016/j.ejor.2018.11.057](https://doi.org/10.1016/j.ejor.2018.11.057).
- John R Michael, William R Schucany, and Roy W Haas. Generating random variates using transformations with multiple roots. *The American Statistician*, 30(2):88–90, 1976. doi:[10.1080/00031305.1976.10479147](https://doi.org/10.1080/00031305.1976.10479147).
- Jim Pitman and Marc Yor. A decomposition of Bessel Bridges. *Zeitschrift für Wahrscheinlichkeitstheorie und Verwandte Gebiete*, 59(4):425–457, 1982. doi:[10.1007/BF00532802](https://doi.org/10.1007/BF00532802).