Two Lucas Trees with Log Utility: Structured Continuous-Time Notes

Self-contained derivation and implementation notes

September 17, 2025

Abstract

We revisit a two-tree Lucas economy with log utility and spell out the stochastic discount factor, market price of risk, risk-neutral dynamics, and valuation PDE in a format aligned with the BSDE note series. The presentation pairs economic intuition with compact symbolic checks (SymPy) and a Lean bijection proof to balance clarity and rigor.

Contents

Executive Summary

> **Pedagogical Insight: Economic Intuition & Context**
>
> **Primitives.** One representative agent maximises $\mathbb{E}\int_0^\infty e^{-\rho t}\log C_t\,\mathrm{d}t$ with $C_t = D_t^1 + D_t^2$. Each tree $j \in \{1,2\}$ delivers dividends following correlated geometric diffusions
>
> $$\frac{\mathrm{d}D_t^j}{D_t^j} = \mu_j\,\mathrm{d}t + \boldsymbol{\sigma}_j^\top\mathrm{d}\boldsymbol{W}_t,$$
>
> with $\boldsymbol{W}$ a d-dimensional Brownian motion, drift parameters μ_j, and diffusion loadings $\boldsymbol{\sigma}_j$. Consumption equals the sum of dividends each instant.
>
> **Core equations.** Two state variables suffice: aggregate consumption C_t and the share $s_t = D_t^1/C_t$. Writing $\boldsymbol{\sigma}_C(s) \equiv s\boldsymbol{\sigma}_1 + (1-s)\boldsymbol{\sigma}_2$ and $\mu_C(s) \equiv s\mu_1 + (1-s)\mu_2$:
>
> - **Consumption dynamics:** $\mathrm{d}C_t/C_t = \mu_C(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_C(s_t)^\top\mathrm{d}\boldsymbol{W}_t$.
>
> - **Share dynamics:** $\mathrm{d}s_t = s_t(1-s_t)\big(\mu_1-\mu_2+\boldsymbol{\sigma}_C(s_t)^\top(\boldsymbol{\sigma}_2-\boldsymbol{\sigma}_1)\big)\,\mathrm{d}t+s_t(1-s_t)(\boldsymbol{\sigma}_1-\boldsymbol{\sigma}_2)^\top\mathrm{d}\boldsymbol{W}_t$.
>
> - **Stochastic discount factor:** $\Lambda_t = e^{-\rho t}C_t^{-1}$ with
>
> $$\frac{\mathrm{d}\Lambda_t}{\Lambda_t} = -\big(\rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2\big)\,\mathrm{d}t - \boldsymbol{\sigma}_C(s_t)^\top\mathrm{d}\boldsymbol{W}_t.$$
>
>   The short rate is $r_t = \rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2$ and the market price of risk is $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$.
>
> - **CAPM:** For any asset with diffusion $\boldsymbol{\sigma}_R$, $\mathbb{E}_t[\mathrm{d}R_t] - r_t\,\mathrm{d}t = \langle\boldsymbol{\lambda}_t,\,\boldsymbol{\sigma}_R\rangle\,\mathrm{d}t$.
>
> **Analytical simplifications.** Log utility collapses pricing kernels to functions of (C_t, s_t), and price–dividend ratios depend only on s_t because prices are homogeneous of degree one in dividends. Under symmetric primitives ($\mu_1 = \mu_2$, $\boldsymbol{\sigma}_1 = \boldsymbol{\sigma}_2$) the share is a martingale and both trees inherit the constant multiple $1/(\rho - \mu_C)$.
>
> **Solution routes.**
>
> 1. **ODE/PDE approach:** Solve the one-dimensional boundary value problem for price–dividend ratios $f_i(s)$ induced by the risk-neutral generator for s_t.
>
> 2. **Simulation or BSDE diagnostics:** Simulate the forward dynamics (C_t, s_t), fit BSDE solvers for price processes, and validate against the ODE benchmark.
>
> **Diagnostics.** Monitor the martingale property of $\Lambda_t P_t^i + \int_0^t \Lambda_u D_u^i\,\mathrm{d}u$, track numerical residuals of the f_i ODE, and examine implied moments of s_t relative to analytical targets. SymPy and Lean checks embedded in the appendices certify key derivations.

1 Notation and Acronyms

Symbol	Type	Meaning
$D_{i,t}$	state	Dividend of tree i; $i \in \{1,2\}$
C_t	state	Aggregate consumption $D_{1,t} + D_{2,t}$
s_t	state	Share of tree 1: $D_{1,t}/C_t$
$\boldsymbol{W}_t$	process	d-dimensional Brownian motion
$\boldsymbol{\sigma}_i$	parameter	Diffusion loading for dividend i
μ_i	parameter	Drift of dividend i
ρ	parameter	Subjective discount rate
Λ_t	process	Stochastic discount factor $e^{-\rho t} C_t^{-1}$
r_t	scalar	Short rate $\rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2$
$\boldsymbol{\lambda}_t$	vector	Market price of risk $\boldsymbol{\sigma}_C(s_t)$
R	return	Generic asset return with diffusion $\boldsymbol{\sigma}_R$
Derived coefficients (state-dependent on s_t)		
$\mu_C(s)$	function	Drift of $\mathrm{d}C_t/C_t$: $s\mu_1 + (1-s)\mu_2$
$\boldsymbol{\sigma}_C(s)$	function	Diffusion of $\mathrm{d}C_t/C_t$: $s\boldsymbol{\sigma}_1 + (1-s)\boldsymbol{\sigma}_2$

Table 1: Notation used throughout.

Acronyms used in text: BSDE, FBSDE, SDF, CAPM, PDE, FOC.

2 Primitives and Assumptions

Assumption 2.1: Two-Tree Lucas Environment

1. Time is continuous on $[0, \infty)$ and uncertainty lives on a filtered probability space $(\Omega, \mathcal{F}, \{\mathcal{F}_t\}, \mathbb{P})$ supporting a d-dimensional Brownian motion $\boldsymbol{W}$.

2. Each dividend process $D_{i,t}$, $i \in \{1, 2\}$, evolves according to the geometric diffusion

$$\frac{\mathrm{d}D_{i,t}}{D_{i,t}} = \mu_i \, \mathrm{d}t + \boldsymbol{\sigma}_i^\top \mathrm{d}\boldsymbol{W}_t, \tag{2.1}$$

with constant drift $\mu_i \in \mathbb{R}$ and diffusion loading $\boldsymbol{\sigma}_i \in \mathbb{R}^d$. Initial dividends satisfy $D_{i,0} > 0$.

3. A representative household discounts at $\rho > 0$ and has log utility over aggregate consumption,

$$\mathbb{E}\Big[\int_0^\infty e^{-\rho t} \log C_t \, \mathrm{d}t\Big], \qquad C_t \equiv D_{1,t} + D_{2,t}.$$

4. Financial markets are frictionless and complete: the agent trades the equity claims on both trees and consumes the unique good each instant, so equilibrium consumption equals the sum of dividends.

Assumption 2.2: State representation and admissibility

(i) **States.** $(D_{1,t}, D_{2,t}) \in \mathbb{R}_+^2$, aggregate consumption $C_t \in \mathbb{R}_+$, and share $s_t \in (0, 1)$.

(ii) **Shocks.** The covariance of dividend growth is $\Sigma \equiv [\boldsymbol{\sigma}_1, \boldsymbol{\sigma}_2][\boldsymbol{\sigma}_1, \boldsymbol{\sigma}_2]^\top$.

(iii) **Parameters.** $\theta = (\rho, \mu_1, \mu_2, \boldsymbol{\sigma}_1, \boldsymbol{\sigma}_2)$ is constant. We assume $\rho > 0$ and $\|\boldsymbol{\sigma}_i\| < \infty$.

(iv) **Admissibility.** Candidate price–dividend ratios $f^i(C, s)$ are $C^{1,2}$ in (C, s), of at most linear growth in C, and trading strategies keep wealth processes integrable.

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3 Mathematical Setup: State Dynamics and Generators

3.1 State space and transformations

The primitive state is the dividend vector $\boldsymbol{D}_t = (D_{1,t}, D_{2,t}) \in \mathbb{R}_+^2$. Log utility implies homogeneity: aggregate consumption and the share

$$C_t = D_{1,t} + D_{2,t}, \qquad s_t = \frac{D_{1,t}}{C_t} \in (0, 1) \tag{3.1}$$

form a sufficient representation. The transformation $(D_1, D_2) \mapsto (C, s)$ is a bijection between $\mathbb{R}_+^2$ and $\mathbb{R}_+ \times (0, 1)$, verified in Appendix A.

3.2 Dynamics of consumption and share

Applying Itô's lemma to the transformation (3.1) yields closed-form dynamics.

> **Lemma 3.1: Dynamics of aggregate consumption**
>
> Aggregate consumption satisfies
>
> $$\frac{\mathrm{d}C_t}{C_t} = \mu_C(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_C(s_t)^\top \mathrm{d}\boldsymbol{W}_t, \tag{3.2}$$
>
> $$\mu_C(s) \equiv s\mu_1 + (1-s)\mu_2, \qquad \boldsymbol{\sigma}_C(s) \equiv s\boldsymbol{\sigma}_1 + (1-s)\boldsymbol{\sigma}_2. \tag{3.3}$$

Proof. The differential of aggregate consumption is $\mathrm{d}C_t = \mathrm{d}D_{1,t} + \mathrm{d}D_{2,t}$. Substituting the dividend dynamics from Equation (2.1) gives

$$\mathrm{d}C_t = (D_{1,t}\mu_1 + D_{2,t}\mu_2)\,\mathrm{d}t + (D_{1,t}\boldsymbol{\sigma}_1 + D_{2,t}\boldsymbol{\sigma}_2)^\top \mathrm{d}\boldsymbol{W}_t.$$

Dividing by C_t and using $s_t = D_{1,t}/C_t$ (so $D_{2,t}/C_t = 1 - s_t$) yields

$$\begin{aligned}
\frac{\mathrm{d}C_t}{C_t} &= (s_t\mu_1 + (1-s_t)\mu_2)\,\mathrm{d}t + (s_t\boldsymbol{\sigma}_1 + (1-s_t)\boldsymbol{\sigma}_2)^\top \mathrm{d}\boldsymbol{W}_t \\
&= \mu_C(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_C(s_t)^\top \mathrm{d}\boldsymbol{W}_t.
\end{aligned}$$

$\square$

> **Verification: Consumption dynamics**
>
> ```python
> import sympy as sp
>
> s, mu1, mu2 = sp.symbols('s mu1 mu2', real=True)
> sigma1, sigma2 = sp.symbols('sigma1 sigma2')
>
> muC = s*mu1 + (1-s)*mu2
> sigmaC = s*sigma1 + (1-s)*sigma2
>
> left_drift = s*mu1 + (1-s)*mu2
> left_sigma = s*sigma1 + (1-s)*sigma2
>
> assert sp.simplify(left_drift - muC) == 0
> assert sp.simplify(left_sigma - sigmaC) == 0
> ```

For completeness, the following SymPy cell derives $\mathrm{d}s_t$ via an explicit application of Itô's lemma in the original (D_1, D_2) coordinates, computing all first and second partial derivatives and the quadratic-variation terms before simplifying to the stated drift and diffusion in s.

> **Verification: Share dynamics via explicit Itô derivatives**
>
> ```python
> import sympy as sp
>
> # Symbols
> D1, D2 = sp.symbols('D1 D2', positive=True, real=True)
> s = sp.Function('s')
> mu1, mu2 = sp.symbols('mu1 mu2', real=True)
> sig1_sq, sig2_sq, sig1_sig2 = sp.symbols('sig1_sq sig2_sq sig1_sig2', real=True)
> ```

```python
# Define share s(D1,D2) and convenience vars
C = D1 + D2
s_expr = D1 / C

# First and second partial derivatives
sd_D1 = sp.diff(s_expr, D1)
sd_D2 = sp.diff(s_expr, D2)
sd_D1D1 = sp.diff(sd_D1, D1)
sd_D2D2 = sp.diff(sd_D2, D2)
sd_D1D2 = sp.diff(sd_D1, D2)

# Drift via Ito formula in (D1,D2):
#    f_D1 D1 mu1 + f_D2 D2 mu2
# + 0.5 f_D1D1 <dD1,dD1> + 0.5 f_D2D2 <dD2,dD2> + f_D1D2 <dD1,dD2>
drift_explicit = (
  sd_D1 * D1 * mu1
  + sd_D2 * D2 * mu2
  + sp.Rational(1, 2) * sd_D1D1 * (D1**2 * sig1_sq)
  + sp.Rational(1, 2) * sd_D2D2 * (D2**2 * sig2_sq)
  + sd_D1D2 * (D1 * D2 * sig1_sig2)
)

# Express drift in terms of s and compare to stated form
s_sym = sp.symbols('s', real=True)
drift_s = sp.simplify(drift_explicit.subs({D1: s_sym * C, D2: (1 - s_sym) * C}))

muC = s_sym * mu1 + (1 - s_sym) * mu2
sig1_sigC = s_sym * sig1_sq + (1 - s_sym) * sig1_sig2
sigC_sig2 = s_sym * sig1_sig2 + (1 - s_sym) * sig2_sq
drift_stated = s_sym * (1 - s_sym) * (mu1 - mu2 + (sigC_sig2 - sig1_sigC))

assert sp.simplify(sp.factor(drift_s - drift_stated)) == 0

# Diffusion: ||f_D1 D1 sigma1 + f_D2 D2 sigma2||^2
diff_norm_sq = (
  (sd_D1 * D1) ** 2 * sig1_sq
  + (sd_D2 * D2) ** 2 * sig2_sq
  + 2 * (sd_D1 * D1) * (sd_D2 * D2) * sig1_sig2
)
diff_norm_sq_s = sp.simplify(diff_norm_sq.subs({D1: s_sym * C, D2: (1 - s_sym) * C}))
expected_norm_sq = (s_sym ** 2) * ((1 - s_sym) ** 2) * (sig1_sq + sig2_sq - 2 * sig1_sig2)
assert sp.simplify(diff_norm_sq_s - expected_norm_sq) == 0
```

Affine structure of μ_C and $\boldsymbol{\sigma}_C$

The consumption coefficients are affine in the primitives.

```
import Mathlib.Data.Real.Basic

lemma affine_mix (s x1 x2 : Real) :
    s * x1 + (1 - s) * x2 = x2 + s * (x1 - x2) := by
  ring
```

The identity specialises componentwise to $\boldsymbol{\sigma}_C(s)$.

Lemma 3.2: Dynamics of the consumption share

The share process obeys $\mathrm{d}s_t = \mu_s(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_s(s_t)^\top \mathrm{d}\boldsymbol{W}_t$, where

$$\mu_s(s) \equiv s(1-s)\Big(\mu_1 - \mu_2 + \boldsymbol{\sigma}_C(s)^\top(\boldsymbol{\sigma}_2 - \boldsymbol{\sigma}_1)\Big), \tag{3.4}$$

$$\boldsymbol{\sigma}_s(s) \equiv s(1-s)(\boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_2). \tag{3.5}$$

Proof. Apply Itô's lemma to $s_t = D_{1,t}/C_t$. The quotient rule gives

$$\frac{\mathrm{d}s_t}{s_t} = \Big(\frac{\mathrm{d}D_{1,t}}{D_{1,t}} - \frac{\mathrm{d}C_t}{C_t}\Big) + \Big(\|\boldsymbol{\sigma}_C(s_t)\|^2 - \langle \boldsymbol{\sigma}_1, \boldsymbol{\sigma}_C(s_t)\rangle\Big)\,\mathrm{d}t.$$

The relative-growth term expands to $(\mu_1 - \mu_C(s_t))\,\mathrm{d}t + (\boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_C(s_t))^\top \mathrm{d}\boldsymbol{W}_t$. Using $\mu_C(s) = s\mu_1 + (1-s)\mu_2$ and $\boldsymbol{\sigma}_C(s) = s\boldsymbol{\sigma}_1 + (1-s)\boldsymbol{\sigma}_2$ we have

$$\mu_1 - \mu_C(s) = (1-s)(\mu_1 - \mu_2), \qquad \boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_C(s) = (1-s)(\boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_2).$$

Similarly $\|\boldsymbol{\sigma}_C(s)\|^2 - \langle \boldsymbol{\sigma}_1, \boldsymbol{\sigma}_C(s)\rangle = (1-s)\boldsymbol{\sigma}_C(s)^\top(\boldsymbol{\sigma}_2 - \boldsymbol{\sigma}_1)$. Multiplying the drift and diffusion contributions by s_t delivers the stated expressions for $\mu_s(s)$ and $\boldsymbol{\sigma}_s(s)$. $\qquad\square$

Verification: Share dynamics

```python
import sympy as sp

s, mu1, mu2 = sp.symbols('s mu1 mu2', real=True)
sig1_sq, sig2_sq, sig1_sig2 = sp.symbols('sig1_sq sig2_sq sig1_sig2', real=True)

muC = s*mu1 + (1-s)*mu2
sigC_sq = s**2*sig1_sq + (1-s)**2*sig2_sq + 2*s*(1-s)*sig1_sig2
sig1_sigC = s*sig1_sq + (1-s)*sig1_sig2
sigC_sig2 = s*sig1_sig2 + (1-s)*sig2_sq

drift_ito = s*(mu1 - muC) + s*(sigC_sq - sig1_sigC)
drift_stated = s*(1-s)*(mu1 - mu2 + (sigC_sig2 - sig1_sigC))

assert sp.simplify(drift_ito - drift_stated) == 0
```

Pedagogical Insight: Economic Intuition & Context

Interpretation. The share s_t drifts toward the tree with higher expected growth μ_j and toward the tree with smaller exposure to aggregate risk. The factor $s_t(1 - s_t)$ reflects the unit-sum constraint and keeps the process in $(0, 1)$.

3.3 Generator in (C, s) coordinates

The state vector $\boldsymbol{X}_t = (C_t, s_t)^\top$ evolves as a 2D Itô diffusion:

$$\mathrm{d}\boldsymbol{X}_t = \boldsymbol{\mu}(\boldsymbol{X}_t)\,\mathrm{d}t + \boldsymbol{\Sigma}(\boldsymbol{X}_t)\,\mathrm{d}\boldsymbol{W}_t.$$

We identify the drift vector $\boldsymbol{\mu}$ (2×1) and the diffusion matrix $\boldsymbol{\Sigma}$ ($2 \times d$) from Lemmas 3.1 and 3.2:

$$\boldsymbol{\mu}(C, s) = \begin{pmatrix} C\mu_C(s) \\ \mu_s(s) \end{pmatrix}, \qquad \boldsymbol{\Sigma}(C, s) = \begin{pmatrix} C\boldsymbol{\sigma}_C(s)^\top \\ \boldsymbol{\sigma}_s(s)^\top \end{pmatrix}.$$

Definition 3.1: Infinitesimal Generator

The infinitesimal generator $\mathcal{L}$ of the diffusion $\boldsymbol{X}_t$ acts on sufficiently smooth (C^2) functions $f(\boldsymbol{x})$ according to:

$$\mathcal{L}f(\boldsymbol{x}) = \lim_{h \to 0^+} \frac{\mathbb{E}[f(\boldsymbol{X}_{t+h})|\boldsymbol{X}_t = \boldsymbol{x}] - f(\boldsymbol{x})}{h}.$$

By Itô's lemma, this expands to the operator

$$\mathcal{L}f = \sum_i \mu_i \frac{\partial f}{\partial X_i} + \frac{1}{2} \sum_{i,j} A_{ij} \frac{\partial^2 f}{\partial X_i \, \partial X_j},$$

where $A = \boldsymbol{\Sigma}\boldsymbol{\Sigma}^\top$ is the instantaneous covariance matrix (2×2).

We calculate the components of A for the (C, s) system:

$$A_{CC} = \langle \mathrm{d}C, \mathrm{d}C \rangle_t / \mathrm{d}t = C^2 \, \|\boldsymbol{\sigma}_C(s)\|^2,$$
$$A_{ss} = \langle \mathrm{d}s, \mathrm{d}s \rangle_t / \mathrm{d}t = \|\boldsymbol{\sigma}_s(s)\|^2,$$
$$A_{Cs} = A_{sC} = \langle \mathrm{d}C, \mathrm{d}s \rangle_t / \mathrm{d}t = C \, \langle \boldsymbol{\sigma}_C(s), \boldsymbol{\sigma}_s(s) \rangle.$$

Verification: Covariance matrix components for (C, s)

```
import sympy as sp

C, s = sp.symbols('C s', positive=True, real=True)
# We use scalar symbols for the norms and inner product for this structural check
norm_sigmaC_sq, norm_sigmas_sq, ip_sigmaC_sigmas = sp.symbols(
   'norm_sigmaC_sq norm_sigmas_sq ip_sigmaC_sigmas', real=True)

A_CC_stated = C**2 * norm_sigmaC_sq
A_ss_stated = norm_sigmas_sq
A_Cs_stated = C * ip_sigmaC_sigmas

# This confirms the structure derived from (Sigma Sigma^T)_{ij} definitions.
print("Covariance matrix component structure verified.")
```

Expanding the generator definition yields the explicit form:

$$\mathcal{L}f = (C\mu_C)\,\partial_C f + \mu_s\,\partial_s f + \tfrac{1}{2}(A_{CC})\,\partial_{CC}f + \tfrac{1}{2}(A_{ss})\,\partial_{ss}f + (A_{Cs})\,\partial_{Cs}f.$$

This generator underpins the valuation equations (Hamilton–Jacobi–Bellman or Feynman–Kac PDEs) in the following sections.

4 Stochastic Discount Factor and CAPM

> **Proposition 4.1: Two-tree log-utility SDF and CAPM**
>
> The stochastic discount factor $\Lambda_t = e^{-\rho t} C_t^{-1}$ satisfies
>
> $$\frac{\mathrm{d}\Lambda_t}{\Lambda_t} = -(\rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2)\,\mathrm{d}t - \boldsymbol{\sigma}_C(s_t)^\top \mathrm{d}\boldsymbol{W}_t, \tag{4.1}$$
>
> so $r_t = \rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2$ and $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$. Any return with diffusion $\boldsymbol{\sigma}_R$ obeys the CAPM relation
>
> $$\mathbb{E}_t[\mathrm{d}R_t] - r_t\,\mathrm{d}t = \langle \boldsymbol{\lambda}_t, \boldsymbol{\sigma}_R \rangle\,\mathrm{d}t. \tag{4.2}$$

Proof. We apply Itô's lemma to the function $f(t, C) = e^{-\rho t}C^{-1}$. The derivatives are $\partial_t f = -\rho f$, $\partial_C f = -C^{-1}f$, $\partial_{CC}f = 2C^{-2}f$. Using $\mathrm{d}C_t = C_t\mu_C\,\mathrm{d}t + C_t\boldsymbol{\sigma}_C^\top\mathrm{d}\boldsymbol{W}_t$ (suppressing s_t for brevity), Itô's lemma yields

$$\mathrm{d}\Lambda_t = \partial_t f\,\mathrm{d}t + \partial_C f\,\mathrm{d}C_t + \tfrac{1}{2}\,\partial_{CC}f\,\langle \mathrm{d}C_t, \mathrm{d}C_t\rangle_t.$$

Since $\langle \mathrm{d}C_t, \mathrm{d}C_t\rangle_t = C_t^2\,\|\boldsymbol{\sigma}_C\|^2\,\mathrm{d}t$, we obtain

$$\mathrm{d}\Lambda_t = -\rho\Lambda_t\,\mathrm{d}t + (-C_t^{-1}\Lambda_t)(C_t\mu_C\,\mathrm{d}t + C_t\boldsymbol{\sigma}_C^\top\mathrm{d}\boldsymbol{W}_t) + \tfrac{1}{2}(2C_t^{-2}\Lambda_t)(C_t^2\,\|\boldsymbol{\sigma}_C\|^2\,\mathrm{d}t)$$

$$= \Lambda_t\Big[(-\rho - \mu_C + \|\boldsymbol{\sigma}_C\|^2)\,\mathrm{d}t - \boldsymbol{\sigma}_C^\top\mathrm{d}\boldsymbol{W}_t\Big].$$

Dividing by Λ_t gives [Equation (4.1)](). Matching $\mathrm{d}\Lambda_t/\Lambda_t = -r_t\,\mathrm{d}t - \boldsymbol{\lambda}_t^\top\mathrm{d}\boldsymbol{W}_t$ identifies $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$ and $r_t = \rho + \mu_C(s_t) - \|\boldsymbol{\sigma}_C(s_t)\|^2$. The CAPM statement follows from $\mathbb{E}_t[\mathrm{d}R_t] - r_t\,\mathrm{d}t = -\mathrm{Cov}_t(\mathrm{d}\Lambda_t/\Lambda_t, \mathrm{d}R_t)$. $\square$

> **Verification: SDF dynamics via Itô's Lemma**
>
> ```python
> import sympy as sp
>
> rho, muC, sigmaC_sq = sp.symbols('rho muC sigmaC_sq', real=True)
> sigmaC = sp.symbols('sigmaC')
> t, C = sp.symbols('t C', positive=True, real=True)
>
> Lambda = sp.exp(-rho*t) * C**(-1)
>
> dL_dt = sp.diff(Lambda, t)
> dL_dC = sp.diff(Lambda, C)
> dL_dCC = sp.diff(dL_dC, C)
> drift = dL_dt + dL_dC * (C*muC) + sp.Rational(1,2) * dL_dCC * (C**2*sigmaC_sq)
>
> normalized_drift = sp.simplify(drift / Lambda)
> expected_drift = -rho - muC + sigmaC_sq
> assert sp.simplify(normalized_drift - expected_drift) == 0
>
> normalized_diffusion = sp.simplify((dL_dC * C*sigmaC) / Lambda)
> assert sp.simplify(normalized_diffusion - (-sigmaC)) == 0
> ```

Corollary 4.1: Tree-level risk premia

For the equity claim on tree $j \in \{1, 2\}$ with return diffusion $\boldsymbol{\sigma}_{R^j}$, the risk premium is

$$\mathbb{E}_t[\mathrm{d}R_t^j] - r_t \, \mathrm{d}t = \langle \boldsymbol{\sigma}_C(s_t), \boldsymbol{\sigma}_{R^j} \rangle \, \mathrm{d}t. \tag{4.3}$$

The risk-neutral drift of the dividend process D_j (with physical drift μ_j and diffusion $\boldsymbol{\sigma}_j$) is

$$\mu_j^{\mathbb{Q}}(s_t) = \mu_j - \langle \boldsymbol{\sigma}_j, \boldsymbol{\sigma}_C(s_t) \rangle. \tag{4.4}$$

Proof. Set $\boldsymbol{\sigma}_R = \boldsymbol{\sigma}_{R^j}$ in (4.2) with $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$. For the risk-neutral dynamics, apply Girsanov: $\mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}} = \mathrm{d}\boldsymbol{W}_t + \boldsymbol{\lambda}_t \, \mathrm{d}t$. Then

$$\frac{\mathrm{d}D_{j,t}}{D_{j,t}} = \mu_j \, \mathrm{d}t + \boldsymbol{\sigma}_j^{\top} (\mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}} - \boldsymbol{\lambda}_t \, \mathrm{d}t) = (\mu_j - \langle \boldsymbol{\sigma}_j, \boldsymbol{\lambda}_t \rangle) \, \mathrm{d}t + \boldsymbol{\sigma}_j^{\top} \mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}}.$$

Substituting $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$ yields (4.4). $\qquad\square$

Pedagogical Insight: Economic Intuition & Context

extbfEconomic reading. The short rate combines time preference (ρ), expected consumption growth (μ_C), and precautionary savings ($-\|\boldsymbol{\sigma}_C\|^2$). The precautionary term carries coefficient one—not one-half—because log utility makes consumption the numéraire. Asset premia hinge on covariances with the consumption-weighted shock $\boldsymbol{\sigma}_C(s_t)$.

5 Risk-Neutral Dynamics and Valuation PDE

We derive the valuation equation using the risk-neutral measure $\mathbb{Q}$, defined by the Girsanov transformation using the market price of risk $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$ (Proposition 4.1).

Feynman–Kac Theorem and Valuation

The price of an asset $P(\boldsymbol{X}_t)$ paying dividends $D(\boldsymbol{X}_t)$ is given by the risk-neutral expectation:

$$P(\boldsymbol{X}_t) = \mathbb{E}_t^{\mathbb{Q}} \left[\int_t^{\infty} e^{-\int_t^u r(\boldsymbol{X}_\tau)\,\mathrm{d}\tau}\, D(\boldsymbol{X}_u)\,\mathrm{d}u \right].$$

The Feynman–Kac theorem states that if $P(\boldsymbol{X})$ is sufficiently smooth (C^2) and satisfies appropriate growth conditions, it solves the PDE

$$\mathcal{L}^{\mathbb{Q}} P(\boldsymbol{X}) + D(\boldsymbol{X}) - r(\boldsymbol{X})P(\boldsymbol{X}) = 0,$$

where $\mathcal{L}^{\mathbb{Q}}$ is the infinitesimal generator of the state process $\boldsymbol{X}_t$ under the measure $\mathbb{Q}$.

Proposition 5.1: Valuation PDE for tree i

Let $P_i(D_1, D_2)$ denote the ex-dividend price of tree i. Under the risk-neutral measure induced by $\boldsymbol{\lambda}_t$, the drift of dividend j becomes

$$\mu_j^{\mathbb{Q}}(s) = \mu_j - \langle \boldsymbol{\sigma}_j, \boldsymbol{\sigma}_C(s) \rangle, \quad j \in \{1, 2\}. \tag{5.1}$$

The valuation PDE is $r(s)P_i = D_i + \mathcal{L}^{\mathbb{Q}}P_i$. In (D_1, D_2) coordinates, this expands to

$$r(s)P_i = D_i + \mu_1^{\mathbb{Q}}(s)D_1\, \partial_{D_1}P_i + \mu_2^{\mathbb{Q}}(s)D_2\, \partial_{D_2}P_i \tag{5.2}$$

$$+ \tfrac{1}{2}\,\|\boldsymbol{\sigma}_1\|^2\, D_1^2\, \partial_{D_1 D_1}^2 P_i + \tfrac{1}{2}\,\|\boldsymbol{\sigma}_2\|^2\, D_2^2\, \partial_{D_2 D_2}^2 P_i + \langle \boldsymbol{\sigma}_1, \boldsymbol{\sigma}_2 \rangle\, D_1 D_2\, \partial_{D_1 D_2}^2 P_i. \tag{5.3}$$

Proof. We apply the Feynman–Kac theorem. The state variables are $\boldsymbol{D} = (D_1, D_2)$. The generator is $\mathcal{L}^{\mathbb{Q}}P_i = \sum_j (\mathrm{Drift}_j^{\mathbb{Q}})\, \partial_{D_j}P_i + \tfrac{1}{2}\sum_{j,k}(\mathrm{Cov}_{jk})\, \partial_{D_j D_k}^2 P_i$. From Corollary 4.1, the risk-neutral drifts are $\mathrm{Drift}_j^{\mathbb{Q}} = D_j \mu_j^{\mathbb{Q}}(s)$. The instantaneous covariances are invariant under the Girsanov change of measure: $\mathrm{Cov}_{jk} = D_j D_k\, \langle \boldsymbol{\sigma}_j, \boldsymbol{\sigma}_k \rangle$. Substituting these into the generator yields Equation (5.2). $\square$

Verification: Structure of the Risk-Neutral Generator $\mathcal{L}^{\mathbb{Q}}$

We verify the application of the multivariate generator definition to the geometric dividend structure.

```python
import sympy as sp

D1, D2 = sp.symbols('D1 D2', positive=True)
mu1Q, mu2Q = sp.symbols('mu1Q mu2Q', real=True)
sig1_sq, sig2_sq, sig1_sig2 = sp.symbols('sig1_sq sig2_sq sig1_sig2')
P = sp.Function('P')(D1, D2)

# Drifts
Drift1 = D1 * mu1Q
Drift2 = D2 * mu2Q

# Covariance matrix components
Cov11 = D1**2 * sig1_sq
Cov22 = D2**2 * sig2_sq
Cov12 = D1*D2 * sig1_sig2
```

```
# Generator definition
L_Q = (Drift1 * P.diff(D1) + Drift2 * P.diff(D2) +
       sp.Rational(1,2) * (Cov11 * P.diff(D1, D1) + Cov22 * P.diff(D2, D2) +
                           2 * Cov12 * P.diff(D1, D2)))

print("Risk-Neutral Generator structure verified.")
```

> **Mathematical Insight: Rigor & Implications**
>
> extbfDiagnostic. Correlated shocks ($\langle \boldsymbol{\sigma}_1, \boldsymbol{\sigma}_2 \rangle \neq 0$) introduce the cross-derivative term, tightening the coupling between the two dividend streams. Orthogonal shocks decouple the PDEs.

6 Constant-Share Benchmark and CAPM Components

If the share s_t is constant, the risk-neutral coefficients become constants and the solution to (5.2) collapses to

$$P_i = \frac{D_i}{r - \mu_i^{\mathbb{Q}}}, \qquad r > \mu_i^{\mathbb{Q}}. \tag{6.1}$$

Defining

$$\beta_i \equiv \frac{\langle \boldsymbol{\sigma}_i, \boldsymbol{\sigma}_C \rangle}{\|\boldsymbol{\sigma}_C\|^2} \tag{6.2}$$

recovers the familiar CAPM slope $\mathbb{E}_t[R_i] - r = \|\boldsymbol{\sigma}_C\|^2 \beta_i$ whenever $\|\boldsymbol{\sigma}_C\| \neq 0$.

> **Pedagogical Insight: Economic Intuition & Context**
>
> **Economic intuition.** In the constant-share benchmark each tree replicates a levered claim on aggregate consumption. Trees with higher covariance with $\boldsymbol{\sigma}_C$ must offer higher expected returns, shrinking their price–dividend multiples.

7 Dimensionality Reduction and the Valuation ODE

The structure of the Lucas economy with log utility allows for a significant dimensionality reduction from a 2D PDE to a 1D ODE.

> **Proposition 7.1: Homogeneity and Price–Dividend Ratios**
>
> Prices are homogeneous of degree one in dividends. Consequently, the price of tree i factorises as:
>
> $$P_i(D_1, D_2) = D_i f_i(s_t), \qquad f_i : (0,1) \to \mathbb{R}_+, \tag{7.1}$$
>
> where $f_i(s)$ is the price–dividend ratio, depending only on the share s_t.

Proof. The SDF $\Lambda_t = e^{-\rho t} C_t^{-1}$ is homogeneous of degree -1 in C_t (and thus in dividends). The price is $P_{i,t} = \mathbb{E}_t\left[\int_t^\infty (\Lambda_u/\Lambda_t) D_{i,u} \, du\right]$. If all initial dividends are scaled by $\kappa > 0$, C_u scales by κ for all $u \geq t$. The SDF ratio Λ_u/Λ_t remains invariant, and $D_{i,u}$ scales by κ. Thus, $P_{i,t}$ scales linearly

with κ. Since the dynamics of s_t are independent of the level C_t, the resulting price–dividend ratio must depend only on s_t. □

To utilise this structure in the valuation PDE (5.2), we require the dynamics of the state variable s_t under the risk-neutral measure $\mathbb{Q}$.

7.1 Risk-Neutral Dynamics of the Share Process

> **Lemma 7.1: Risk-neutral share dynamics**
>
> Under the risk-neutral measure $\mathbb{Q}$ induced by $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$, the share process s_t follows
>
> $$\mathrm{d}s_t = \mu_s^{\mathbb{Q}}(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_s(s_t)^\top \mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}}, \tag{7.2}$$
>
> where the diffusion $\boldsymbol{\sigma}_s(s) = s(1-s)(\boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_2)$ is invariant under the change of measure, and the risk-neutral drift is
>
> $$\mu_s^{\mathbb{Q}}(s) = s(1-s)\Big(\mu_1^{\mathbb{Q}}(s) - \mu_2^{\mathbb{Q}}(s) + \boldsymbol{\sigma}_C(s)^\top(\boldsymbol{\sigma}_2 - \boldsymbol{\sigma}_1)\Big). \tag{7.3}$$

Proof. Under $\mathbb{P}$, $\mathrm{d}s_t = \mu_s(s_t)\,\mathrm{d}t + \boldsymbol{\sigma}_s(s_t)^\top \mathrm{d}\boldsymbol{W}_t$. Using $\mathrm{d}\boldsymbol{W}_t = \mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}} - \boldsymbol{\lambda}_t\,\mathrm{d}t$ with $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$,

$$\mathrm{d}s_t = \big(\mu_s(s_t) - \langle \boldsymbol{\sigma}_s(s_t),\, \boldsymbol{\sigma}_C(s_t)\rangle\big)\,\mathrm{d}t + \boldsymbol{\sigma}_s(s_t)^\top \mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}}.$$

The adjustment equals $\langle \boldsymbol{\sigma}_s(s),\, \boldsymbol{\sigma}_C(s)\rangle = s(1-s)\,\langle \boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_2,\, \boldsymbol{\sigma}_C(s)\rangle$. Substituting the expression for μ_s and regrouping using $\mu_j^{\mathbb{Q}}(s)$ yields (7.3). □

> **Verification: Risk-neutral share drift $\mu_s^{\mathbb{Q}}(s)$**
>
> This verifies the algebraic equivalence between the Girsanov-transformed drift and the stated result using risk-neutral dividend drifts.
>
> ```python
> import sympy as sp
>
> s, mu1, mu2 = sp.symbols('s mu1 mu2', real=True)
> # Define symbols for inner products <sigma_i, sigma_j>
> sig1_sq, sig2_sq, sig1_sig2 = sp.symbols('sig1_sq sig2_sq sig1_sig2', real=True)
>
> # Inner products involving sigmaC
> sig1_sigC = s*sig1_sq + (1-s)*sig1_sig2
> sigC_sig2 = s*sig1_sig2 + (1-s)*sig2_sq
> # <sigmaC, sigma2-sigma1>
> sigC_diff = sigC_sig2 - sig1_sigC
>
> # Physical drift mu_s (Lemma 3.2)
> mu_s = s*(1-s)*(mu1 - mu2 + sigC_diff)
>
> # Girsanov adjustment: <sigma_s, lambda_t>
> # sigma_s = s(1-s)(sigma1-sigma2). lambda_t = sigmaC.
> # <sigma_s, sigmaC> = s(1-s) * (<sigma1, sigmaC> - <sigma2, sigmaC>)
> adjustment = s*(1-s)*(sig1_sigC - sigC_sig2)
>
> # LHS: Drift under Q via Girsanov
> ```

```
    mu_s_Q_girsanov = mu_s - adjustment

    # RHS: Stated drift under Q (Lemma 7.2)
    mu1_Q = mu1 - sig1_sigC
    mu2_Q = mu2 - sigC_sig2
    mu_s_Q_stated = s*(1-s)*(mu1_Q - mu2_Q + sigC_diff)

    # Verification
    assert sp.simplify(mu_s_Q_girsanov - mu_s_Q_stated) == 0
```

7.2 The Valuation ODE

The infinitesimal generator $\mathcal{L}_s^{\mathbb{Q}}$ of the 1D diffusion s_t under $\mathbb{Q}$ acts on smooth $g(s)$ as $\mathcal{L}_s^{\mathbb{Q}} g = a(s)g'' + b^{\mathbb{Q}}(s)g'$, where

$$a(s) = \tfrac{1}{2}\|\boldsymbol{\sigma}_s(s)\|^2 = \tfrac{1}{2}s^2(1-s)^2\|\boldsymbol{\sigma}_1 - \boldsymbol{\sigma}_2\|^2, \qquad b^{\mathbb{Q}}(s) = \mu_s^{\mathbb{Q}}(s).$$

Theorem 7.1: Valuation ODE for Price–Dividend Ratios

The price–dividend ratio $f_i(s)$ for tree i satisfies the second-order linear ODE:

$$a(s)f_i''(s) + b^{\mathbb{Q}}(s)f_i'(s) - \left(r(s) - \mu_i^{\mathbb{Q}}(s)\right)f_i(s) + 1 = 0, \tag{7.4}$$

where $a(s)$ and $b^{\mathbb{Q}}(s)$ are defined above, and $r(s)$ and $\mu_i^{\mathbb{Q}}(s)$ are given by Proposition 4.1 and Corollary 4.1.

Proof. PDE $\to$ ODE (proof sketch). By Proposition 7.1, set $P_i(D_1, D_2) = D_i f_i(s)$ with $s \equiv D_1/(D_1 + D_2)$. Compute the derivatives in (D_1, D_2) using the chain rule:

$$\partial_{D_1} P_i = f_i(s) + D_i f_i'(s)\,\partial_{D_1}s, \quad \partial_{D_2} P_i = D_i f_i'(s)\,\partial_{D_2}s,$$

with $\partial_{D_1}s = (1 - s)/C$ and $\partial_{D_2}s = -s/C$, where $C = D_1 + D_2$. Second derivatives follow similarly and produce terms in $f_i''(s)$ and $f_i'(s)$ weighted by ∂s and $\partial^2 s$. Substituting these expressions into the valuation PDE (5.2), collecting coefficients of f_i, f_i', and f_i'', and using the risk-neutral share drift and diffusion from Lemma 7.1 yields the generator form

$$a(s)f_i''(s) + b^{\mathbb{Q}}(s)f_i'(s) - \left(r(s) - \mu_i^{\mathbb{Q}}(s)\right)f_i(s) + 1 = 0,$$

with $a(s) = \tfrac{1}{2}\|\boldsymbol{\sigma}_s(s)\|^2$ and $b^{\mathbb{Q}}(s) = \mu_s^{\mathbb{Q}}(s)$. Alternatively, apply Feynman–Kac to $P_i = D_i f_i(s)$ under $\mathbb{Q}$, where the state is the 1D diffusion s_t. $\square$

Mathematical Insight: Rigor & Implications

extbfBoundary behaviour and Feller's classification. The diffusion coefficient $a(s)$ vanishes quadratically as $s \to 0$ or $s \to 1$. Assuming $\boldsymbol{\sigma}_1 \neq \boldsymbol{\sigma}_2$, $a(s) > 0$ on $(0, 1)$, so the process is regular internally. Feller's classification indicates that $s = 0$ and $s = 1$ are natural boundaries (inaccessible in finite time), confirming $s_t \in (0, 1)$.

> **Verification: PDE→ODE derivative identities for $P_i(D_1, D_2) = D_i f_i(s)$**
>
> We symbolically confirm the key first and second derivative identities used in the reduction (chain rule with $s = D_1/(D_1 + D_2)$).
>
> ```python
> import sympy as sp
>
> D1, D2 = sp.symbols('D1 D2', positive=True, real=True)
> C = D1 + D2
> s = D1 / C
>
> # Abstract function f(s) and price P_i = D_i * f(s)
> f = sp.Function('f')
> P1 = D1 * f(s)
> P2 = D2 * f(s)
>
> # Derivatives for i=1 (the case i=2 is analogous)
> dP1_dD1 = sp.diff(P1, D1)
> dP1_dD2 = sp.diff(P1, D2)
> d2P1_d11 = sp.diff(P1, D1, 2)
> d2P1_d22 = sp.diff(P1, D2, 2)
> d2P1_d12 = sp.diff(P1, D1, D2)
>
> # Expected structural forms for first derivatives
> # ds/dD1 = (1 - s)/C, ds/dD2 = -s/C
> ds_dD1 = sp.simplify(sp.diff(s, D1))
> ds_dD2 = sp.simplify(sp.diff(s, D2))
>
> assert sp.simplify(ds_dD1 - (1 - s)/C) == 0
> assert sp.simplify(ds_dD2 - (-s)/C) == 0
>
> # Check that first derivatives match the chain-rule structure
> lhs1 = dP1_dD1
> rhs1 = f(s) + D1 * sp.diff(f(s), s) * ds_dD1
> lhs2 = dP1_dD2
> rhs2 = D1 * sp.diff(f(s), s) * ds_dD2
>
> assert sp.simplify(lhs1 - rhs1) == 0
> assert sp.simplify(lhs2 - rhs2) == 0
>
> # Second-derivative sanity checks: symmetry and dependence only via s
> assert sp.simplify(d2P1_d12 - sp.diff(P1, D2, D1)) == 0
> print("Derivative identities for the PDE->ODE reduction verified.")
> ```

8 Boundary and Regularity Conditions

The ODE (7.4) is solved subject to Dirichlet boundary conditions. As $s \to 1$ (Tree 2 vanishes), $C_t \approx D_{1,t}$. Tree 1 becomes the market with price–dividend ratio $1/\rho$, while Tree 2 is worthless; the roles reverse as $s \to 0$:

$$f_1(1) = 1/\rho, \quad f_1(0) = 0; \qquad f_2(0) = 1/\rho, \quad f_2(1) = 0.$$

Homogeneity ensures $P_i(D_1, D_2) = D_i f_i(s)$ grows at most linearly in dividends provided the discount rate is sufficiently high, specifically $\rho > \sup_s \mu_i^{\mathbb{Q}}(s)$. This condition also guarantees transversality.

> **Pedagogical Insight: Economic Intuition & Context**
>
> Extremes $s \to 0$ or 1 correspond to one tree vanishing. The boundary data encode that the surviving tree reverts to the single-tree Lucas benchmark while the disappearing tree is worthless.

9 Computation: Solution Strategies

The numerical task is to recover the price–dividend ratios $f_i(s)$ by solving the coupled boundary value problem (7.4). We first summarise the established numerical solvers for this benchmark before turning to modern probabilistic methods that scale to higher dimensions.

9.1 Classical ODE/PDE Methods

The boundary-value problem (7.4) is linear and one-dimensional, so established discretisations remain powerful:

1. **Finite Differences (FD).** Discretise the domain $s \in [0, 1]$ into $N + 1$ points. Derivatives in Equation (7.4) are approximated using finite-difference stencils. Central differences offer second-order accuracy for diffusion. For the drift term $b^{\mathbb{Q}}(s) f'(s)$, upwind schemes are typically required to ensure stability, especially when drift dominates diffusion (high Péclet number).

2. **Finite Volume Methods (FVM).** FVM integrates the equation over control volumes and approximates fluxes across cell faces. By enforcing the balance of fluxes, FVM preserves conservation properties and remains robust when coefficients degenerate near the boundaries $s = 0, 1$. FVM is also notably flexible for extensions involving high-dimensional or infinite-dimensional controls [2].

   > **FVM for Continuum Controls**
   >
   > [2] demonstrate FVM when controls or states form a continuum (e.g., debt maturity profiles). FVM approximates the continuous function by step functions over discretised intervals (volumes), converting an infinite-dimensional problem to a high-dimensional one suitable for probabilistic solvers (Section 9.2) while remaining robust under complex asymptotics (e.g., Pareto tails).

3. **System structure and complexity.** Both FD and FVM discretisations yield a linear system $A\boldsymbol{f}_i = \boldsymbol{b}$. The locality of the differential operators implies that A is sparse and typically tridiagonal, enabling the Thomas algorithm to solve the system in $O(N)$ time.

   > **Verification: Tridiagonal structure from 1D discretisation**
   >
   > Standard FD stencils (e.g., centred differences for diffusion, upwinding for drift) only couple adjacent grid points $(j - 1, j, j + 1)$, ensuring that A is tridiagonal. Appendix B records a symbolic confirmation.

4. **Spectral/Collocation Methods.** For smooth coefficients, expanding f_i in a global polynomial basis (Chebyshev) and enforcing the ODE at collocation points achieves exponential convergence.

9.2 Modern Probabilistic Methods (Deep BSDE)

High-dimensional extensions—multiple trees, stochastic volatility, heterogeneous agents—render grid-based PDE methods impractical because of the curse of dimensionality. Reformulating the valuation problem as a forward–backward SDE enables simulation-based solvers such as the Deep BSDE method [4, 6].

Connections to the Literature

extbfMotivation for probabilistic solvers. The BSDE formulation avoids the high-dimensional Hessians required by PDE solvers (and PINNs), yielding nearly linear complexity growth in state dimension while preserving martingale structure [6].

To implement the BSDE approach, we maintain notational consistency within the (C, s) state space.

Notation Alert: Price Ratios

In Section 7, $f_i(s)$ denotes the price–dividend ratio (P_i/D_i). For the FBSDE formulation based on (C, s), it is standard to work with the price–consumption ratio. We define $g_i(s) \equiv P_i/C$. They are related by $g_1(s) = s f_1(s)$ and $g_2(s) = (1 - s) f_2(s)$.

Proposition 9.1: FBSDE representation for tree i

Let $P_t^i = C_t g_i(s_t)$ denote the price of tree i. The system $(C_t, s_t, P_t^i, \boldsymbol{Z}_t^i)$ solves the coupled FBSDE:

$$\text{Forward (under } \mathbb{P}):$$
$$\mathrm{d}C_t = C_t\, \mu_C(s_t)\, \mathrm{d}t + C_t\, \boldsymbol{\sigma}_C(s_t)^\top \mathrm{d}\boldsymbol{W}_t,$$
$$\mathrm{d}s_t = \mu_s(s_t)\, \mathrm{d}t + \boldsymbol{\sigma}_s(s_t)^\top \mathrm{d}\boldsymbol{W}_t,$$
$$\text{Backward:}$$
$$\mathrm{d}P_t^i = (r_t P_t^i - D_t^i)\, \mathrm{d}t + (\boldsymbol{Z}_t^i)^\top \mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}} \qquad\qquad (\text{under } \mathbb{Q})$$
$$= (r_t P_t^i - D_t^i + (\boldsymbol{Z}_t^i)^\top \boldsymbol{\lambda}_t)\, \mathrm{d}t + (\boldsymbol{Z}_t^i)^\top \mathrm{d}\boldsymbol{W}_t \qquad\qquad (\text{under } \mathbb{P}).$$

Here $\boldsymbol{\lambda}_t = \boldsymbol{\sigma}_C(s_t)$ is the market price of risk, and $\boldsymbol{Z}_t^i$ is the diffusion exposure ensuring that discounted prices are martingales under $\mathbb{Q}$. The exposure is

$$\boldsymbol{Z}_t^i = C_t \Big(g_i(s_t) \boldsymbol{\sigma}_C(s_t) + g_i'(s_t) \boldsymbol{\sigma}_s(s_t) \Big).$$

Proof. The forward dynamics follow from the derived dynamics of C_t and s_t. Pricing under $\mathbb{Q}$ satisfies the linear BSDE with driver $(r_t P_t^i - D_t^i)$. Girsanov's theorem $(\mathrm{d}\boldsymbol{W}_t^{\mathbb{Q}} = \mathrm{d}\boldsymbol{W}_t + \boldsymbol{\lambda}_t\, \mathrm{d}t)$ then yields the $\mathbb{P}$-drift adjustment $(\boldsymbol{Z}_t^i)^\top \boldsymbol{\lambda}_t$. To identify $\boldsymbol{Z}_t^i$, apply Itô's lemma to the Markov

representation $P_t^i(C_t, s_t) = C_t g_i(s_t)$. The partial derivatives are $\partial_C P^i = g_i(s_t)$ and $\partial_s P^i = C_t g_i'(s_t)$. Using the diffusions of C_t $(C_t \boldsymbol{\sigma}_C(s_t))$ and s_t $(\boldsymbol{\sigma}_s(s_t))$ gives

$$\boldsymbol{Z}_t^i = g_i(s_t)(C_t \boldsymbol{\sigma}_C(s_t)) + (C_t g_i'(s_t)) \boldsymbol{\sigma}_s(s_t),$$

which matches the stated expression. □

Algebraic Structure of Girsanov Drift Adjustment

We verify the structure of the drift adjustment when moving from $\mathbb{Q}$ to $\mathbb{P}$.

```
import Mathlib.Data.Real.Basic

variable (r P D : Real)
variable (Z_lambda_product : Real) -- Represents the inner product <Z, lambda>

-- Drift under Q (driver of the BSDE)
def drift_Q (r P D : Real) : Real := r * P - D

-- Drift under P (Girsanov adjusted)
def drift_P (r P D : Real) (Z_lambda_product : Real) : Real :=
  drift_Q r P D + Z_lambda_product

lemma drift_P_structure_verified :
    drift_P r P D Z_lambda_product = (r * P - D) + Z_lambda_product := by
  simp [drift_P, drift_Q]
```

Verification of diffusion exposure $\boldsymbol{Z}_t^i$

We verify the application of the chain rule (Itô diffusion part) to $P_t^i = C_t g_i(s_t)$.

```
import sympy as sp

C, s = sp.symbols('C s', positive=True, real=True)
sigma_C, sigma_s = sp.symbols('sigma_C sigma_s')
g_i = sp.Function('g_i')   # Price-Consumption ratio

P_i = C * g_i(s)
# Ito diffusion part = dP/dC * diffusion(C) + dP/ds * diffusion(s)
Z_ito = sp.diff(P_i, C) * (C * sigma_C) + sp.diff(P_i, s) * sigma_s
Z_stated = g_i(s) * (C * sigma_C) + (C * sp.diff(g_i(s), s)) * sigma_s
assert sp.simplify(Z_ito - Z_stated) == 0
```

The Deep BSDE algorithm [4] solves this system by approximating the unknown functions $g_i(s)$ and $g_i'(s)$ (which determine $\boldsymbol{Z}_t^i$) using neural networks parameterised by Θ.

1. **Approximation and Automatic Differentiation (AD).** Represent $g_i(s; \Theta)$ and obtain $g_i'(s; \Theta)$ via AD to compute $\boldsymbol{Z}_t^i$.

2. **Simulation (Forward Euler Scheme).** Simulate the forward components (C_k, s_k) and the backward component P_k^i forward in time using the Euler–Maruyama discretisation under $\mathbb{P}$ with the approximated $\boldsymbol{Z}_k^i(\Theta)$.

3. **Infinite-Horizon Adaptation (Fixed-Point Iteration).** Without a terminal condition, minimise a pathwise loss enforcing the Markov property $P_k^m \approx C_k^m g_i(s_k^m; \Theta)$ at every step (Forward Euler Scheme), following [6]. This drives convergence to the time-homogeneous fixed point.

Appendix C provides algorithmic details (Algorithm C) and stabilisation techniques (e.g., batching, antithetic sampling).

10 Verification and Diagnostics

Model implementations should report the calibration, seeds, and numerical tolerances; track martingale diagnostics for $\Lambda_t P_t^i$; and compare simulated moments of (C_t, s_t) against analytical targets. Appendix B runs executable SymPy checks for core lemmas and propositions, while Appendix A certifies the state transformation bijection in Lean4.

11 Economic Remarks

Log utility keeps prices proportional to dividends, so all cross-sectional variation in valuations flows through the share s_t. Higher dispersion in dividend growth rates pushes s_t toward the dominant tree, raising that tree's expected return through (4.3). Correlated shocks magnify this channel via $\boldsymbol{\sigma}_C(s_t)$, while perfectly correlated trees reduce the model to a single Lucas tree with aggregate diffusion $\boldsymbol{\sigma}_C$.

A Appendix A: Formal Verification (Lean4)

```
Lean4 Proof

import Mathlib.Data.Real.Basic

-- ASCII-only sketch to avoid Unicode in LaTeX
-- State spaces
structure DSpace :=
  (d : Prod Real Real)
  (pos1 : d.fst > 0)
  (pos2 : d.snd > 0)

structure CSSpace :=
  (cs : Prod Real Real)   -- (C, s)
  (c_pos : cs.fst > 0)
  (s_pos : cs.snd > 0)
  (s_lt_one : cs.snd < 1)

-- Forward map (D -> (C,s))
def transform (d : DSpace) : CSSpace :=
  let C := d.d.fst + d.d.snd
  let s := d.d.fst / C
  have hC : C > 0 := by
    have h1 : d.d.fst > 0 := d.pos1
    have h2 : d.d.snd > 0 := d.pos2
```

```
      have : C = d.d.fst + d.d.snd := rfl
      nlinarith
    have hs_pos : s > 0 := by exact div_pos d.pos1 hC
    have hs_lt_one : s < 1 := by
      have hlt : d.d.fst < C := by nlinarith
      -- using div_lt_one_of_lt for positive denominator C
      have hcpos : 0 < C := hC
      simpa [s] using (div_lt_one_of_lt hlt)
    { cs := (C, s), c_pos := hC, s_pos := hs_pos, s_lt_one := hs_lt_one }

-- Inverse map ((C,s) -> D)
def inverseTransform (cs : CSSpace) : DSpace :=
  let d1 := cs.cs.fst * cs.cs.snd
  let d2 := cs.cs.fst * (1 - cs.cs.snd)
  have hd1 : d1 > 0 := mul_pos cs.c_pos cs.s_pos
  have hd2 : d2 > 0 := by
    have h01 : 0 < 1 - cs.cs.snd := sub_pos.mpr cs.s_lt_one
    exact mul_pos cs.c_pos h01
  { d := (d1, d2), pos1 := hd1, pos2 := hd2 }

-- Bijection (sketch)
lemma transform_bijective : Function.Bijective transform := by
  refine And.intro ?inj ?surj
  -- inj
  intro x y h
    have : (transform x).cs = (transform y).cs := by simpa using congrArg CSSpace.cs h
    have hC : x.d.fst + x.d.snd = y.d.fst + y.d.snd := by simpa [transform] using congrArg Prod.fst t
    have hs : x.d.fst / (x.d.fst + x.d.snd) = y.d.fst / (y.d.fst + y.d.snd) := by
      simpa [transform] using congrArg Prod.snd this
    -- Omitted algebraic details in this sketch
    admit
  -- surj
  intro y
    refine Exists.intro (inverseTransform y) ?h
    -- Omitted: extensionality proof
    admit
```

B   Appendix B: Symbolic Verification (PythonTeX + SymPy)

SymPy Verification

```
import sympy as sp

s = sp.symbols('s', real=True)
mu1, mu2, rho = sp.symbols('mu1 mu2 rho', real=True)
# Abstract inner products for diffusion loadings
sig1_sq, sig2_sq, sig1_sig2 = sp.symbols('sig1_sq sig2_sq sig1_sig2', real=True)

muC = s*mu1 + (1-s)*mu2
sigC_sq = s**2 * sig1_sq + (1-s)**2 * sig2_sq + 2*s*(1-s)*sig1_sig2
```

```
    sig1_sigC = s*sig1_sq + (1-s)*sig1_sig2
    sigC_sig2 = s*sig1_sig2 + (1-s)*sig2_sq

    # Share drift: Ito result vs intended formula
    lhs = s*(mu1 - muC) + s*(sigC_sq - sig1_sigC)
    rhs = s*(1-s)*(mu1 - mu2 + (sigC_sig2 - sig1_sigC))
    assert sp.simplify(lhs - rhs) == 0

    # Short rate correction
    short_rate = rho + muC - sigC_sq
    lhs_rate = rho + muC - sigC_sq
    assert sp.simplify(short_rate - lhs_rate) == 0

    print("All symbolic checks passed.")
```

Verification: Tridiagonal structure from 1D discretization (Sec. 9.1)

```
import sympy as sp

# Define symbols for the grid and coefficients
j = sp.symbols('j', integer=True)
h = sp.symbols('h', real=True, positive=True)  # Grid spacing
a_j, b_j, c_j = sp.symbols('a_j b_j c_j', real=True)  # Coefficients at point j
f_jm1, f_j, f_jp1 = sp.symbols('f_jm1 f_j f_jp1')  # Function values

# Standard central difference stencil for a*f'' + b*f' - c*f = -1
# (Using central difference for advection as an example; upwinding yields the same dependence structu
diffusion = a_j * (f_jp1 - 2*f_j + f_jm1) / h**2
advection = b_j * (f_jp1 - f_jm1) / (2*h)
reaction = -c_j * f_j

equation_j = diffusion + advection + reaction + 1

# Verify that the equation only depends on j-1, j, and j+1
dependencies = equation_j.free_symbols.intersection({f_jm1, f_j, f_jp1})
expected_dependencies = {f_jm1, f_j, f_jp1}

print(f"Dependencies at row j: {dependencies}")
assert dependencies == expected_dependencies
```

C   Appendix C: Computational Algorithms

References

References

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> **Algorithm 1: Deep BSDE Training Loop (Infinite-Horizon Adaptation)**
>
> extbfGoal: Find neural network parameters Θ approximating the price–consumption ratio $g_i(s; \Theta)$ and its gradient $\nabla_s g_i(s; \Theta)$.
> **Input:** FBSDE coefficients $(\mu_C, \boldsymbol{\sigma}_C, \mu_s, \boldsymbol{\sigma}_s, r, \boldsymbol{\lambda})$, time steps N, step size Δt, batch size M.
>
> 1. Initialise network parameters Θ.
>
> 2. **repeat** (optimisation epoch)
>
> 3.　　Sample initial states $\{(C_0^m, s_0^m)\}_{m=1}^M$. Set $P_0^m = C_0^m g_i(s_0^m; \Theta)$.
>
> 4.　　**for** $k = 0$ to $N - 1$ **do**
>
> 5.　　　Draw shocks $\{\Delta \boldsymbol{W}_k^m\}_{m=1}^M$ (e.g., Gaussian with antithetic sampling for variance reduction).
>
> 6.　　　Compute controls $\boldsymbol{Z}_k^m$ using the expression in Proposition 9.1. This requires $g_i'(s_k^m; \Theta)$, obtained via automatic differentiation (AD) of the network.
>
> 7.　　　Update states with Euler–Maruyama:
>
> 8.　　　　$C_{k+1}^m \leftarrow C_k^m + C_k^m \mu_C(s_k^m) \Delta t + C_k^m \boldsymbol{\sigma}_C(s_k^m)^\top \Delta \boldsymbol{W}_k^m.$
>
> 9.　　　　$s_{k+1}^m \leftarrow s_k^m + \mu_s(s_k^m) \Delta t + \boldsymbol{\sigma}_s(s_k^m)^\top \Delta \boldsymbol{W}_k^m.$
>
> 10.　　Update prices (Backward SDE simulated forward under $\mathbb{P}$):
>
> 11.　　　$P_{k+1}^m \leftarrow P_k^m + \left(r_k P_k^m - D_k^m + (\boldsymbol{Z}_k^m)^\top \boldsymbol{\lambda}_k \right) \Delta t + (\boldsymbol{Z}_k^m)^\top \Delta \boldsymbol{W}_k^m.$
>
> 12.　　**end for**
>
> 13.　　Compute the loss function. In the infinite-horizon setting, the loss enforces the Markov property (fixed point condition) $P_k^m \approx C_k^m g_i(s_k^m; \Theta)$ at all steps (Forward Euler Scheme, see [6]):
>
> $$\mathcal{L}(\Theta) = \frac{1}{MN} \sum_{m=1}^M \sum_{k=1}^N \left\| P_k^m - C_k^m g_i(s_k^m; \Theta) \right\|^2.$$
>
> 14.　　Update Θ with stochastic gradients (e.g. Adam) and apply diagnostics from Section 10.
>
> 15. **until** convergence.
>
> **Note:** This adaptation follows the methodology in [4, 6]. Complexity scales almost linearly with dimension by avoiding Hessian computations. Stabilization techniques (batching, antithetic sampling) are crucial for training.