

ACTL3182 Module 3 and 4 Extra Questions: Radon-Nikodym Theorem, Martingales and Itô's Lemma

Andrew Wu

October 2020

Unless stated otherwise, all processes should use their natural filtration.

1. Let $X := (X_n)_{n=1,2,\dots}$ be a (discrete-time) martingale with respect to filtration $(\mathcal{F}_n)_{n=1,2,\dots}$. Show that X is a martingale **if and only if**

$$\mathbb{E}[X_n|\mathcal{F}_n] = \mathbb{E}[X_{n+1}|\mathcal{F}_n] = X_n.$$

2. Consider the stochastic process

$$X_n = \sum_{k=1}^n Z_k, \quad X(0) = 0$$

where $Z_k, k = 1, 2, \dots, n$ are iid with distribution

$$Z_k = \begin{cases} +1 & \text{w.p. } \frac{1}{2} \\ -1 & \text{w.p. } \frac{1}{2}. \end{cases}$$

Show that X is a martingale.

3. Consider the stochastic process

$$X_n = \prod_{k=1}^n Z_k, \quad X(0) = 1$$

where $Z_k, k = 1, 2, \dots, n$ are iid with distribution

$$Z_k = \begin{cases} 2 & \text{w.p. } p \\ \frac{1}{2} & \text{w.p. } 1 - p. \end{cases}$$

Find the probability p such that X is a martingale.

4. Consider the stochastic processes X, Y defined by:

$$X_n = \sum_{k=1}^n Z_k, \quad X(0) = 0$$

where $Z_k, k = 1, 2, \dots, n$ are iid with distribution

$$Z_k = \begin{cases} +1 & \text{w.p. } 0.6 \\ -1 & \text{w.p. } 0.4. \end{cases}$$

and

$$Y_n = Y_{n-1} + IY_{n-2}, \quad Y_0 = Y_1 = 0,$$

where I is independent of Y_n for every $n = 0, 1, \dots$ and

$$I = \begin{cases} +1 & \text{w.p. } \frac{1}{2} \\ -1 & \text{w.p. } \frac{1}{2}. \end{cases}$$

- (a) Explain why X is a Markov process but not a martingale.
- (b) Explain why Y is a martingale but not a Markov process.
5. Consider two independent coin flips; that is let the sample space be $\Omega := \{HH, HT, TH, TT\}$. Under the \mathbb{P} measure, the coin is fair. Under the \mathcal{Q} measure, the coin has a probability of $\frac{1}{3}$ of landing on heads on each flip.
- (a) Find the probability of each scenario under \mathbb{P} and \mathcal{Q} .
- (b) Find the Radon-Nikodym Derivative $\frac{d\mathcal{Q}}{d\mathbb{P}}$.
- (c) Show that for the event A , where A represents getting a head on the first flip, that

$$\mathcal{Q}(A) = \mathbb{E}_P \left[\frac{d\mathcal{Q}}{d\mathbb{P}} 1_A \right]$$

6. The following question works with a scaled version of the random walk process in question 2:
- (a) Consider a time interval $[0, T]$ and divide the interval into n equal subintervals of length $\Delta = T/n$. Let $(X_t^n)_{t \in [0, T]}$ be the process

$$X_t^n = \sqrt{\Delta} \sum_{k=1}^{\lfloor t/\Delta \rfloor} Z_k, \quad \text{for } 0 \leq t \leq T,$$

where Z_k , $k = 1, 2, \dots, n$ are iid with distribution

$$Z_k = \begin{cases} +1 & \text{w.p. } \frac{1}{2} \\ -1 & \text{w.p. } \frac{1}{2}. \end{cases}$$

Draw a possible graph of X_t^n for $n = 1, 2$. What happens as $n \rightarrow \infty$?

- (b) Calculate $\mathbb{E}[X_t^n]$ and $\text{Var}[X_t^n]$.
- (c) Using the Central Limit Theorem, determine the limiting distribution of X_t^n .
- (d) What continuous-time process does X_t^n converge to? (no formal justification required)
7. Consider the continuous-time Radon-Nikodym derivative ζ_t :

$$\zeta_t = \exp \left(- \int_0^t \gamma_s dW_s - \frac{1}{2} \int_0^t \gamma_s^2 ds \right)$$

Prove that ζ_t is a martingale.

8. (Challenge) Consider the stochastic differential equation (SDE)

$$dX(t) = \alpha(\mu - X(t)) + \sigma dW(t), \quad X(0) = x_0.$$

The solution to this equation is called the Ornstein-Uhlenbeck process and can be used to model a massive particle moving under Brownian Motion when friction is accounted for.

- (a) Using Itô's Lemma, show that the solution to the SDE above is

$$X(t) = e^{-\alpha t} x_0 + \mu(1 - e^{-\alpha t}) + \sigma \int_0^t e^{-\alpha(t-s)} dW(s).$$

- (b) Explain why

$$\mathbb{E}[X(t)] = e^{-\alpha t} x_0 + \mu(1 - e^{-\alpha t}).$$

Hint: What type of stochastic process is $\int_0^t e^{-\alpha(t-s)} dW(s)$?

- (c) The Itô isometry is a special property that allows the expected value of the product of Itô integrals to be calculated using Riemann integrals instead. That is, for two suitable stochastic processes $X(t)$, $Y(t)$, we have:

$$\mathbb{E} \left[\int_0^t X(s) dW(s) \int_0^t Y(s) dW(s) \right] = \mathbb{E} \left[\int_0^t X(s) Y(s) ds \right]$$

Assuming this property holds for $X(t)$, show that

$$\text{Var}[X(t)] = \frac{\sigma^2}{2\alpha} (1 - e^{-2\alpha t}).$$

- (d) What is the distribution of $X(t)$? Explain this intuitively.
 (e) Show that for any $s, t \geq 0$:

$$\text{Cov}(X(s), X(t)) = \frac{\sigma^2}{2\alpha} (e^{-\alpha|t-s|} - e^{-\alpha(s+t)})$$

9. The price at time t of a put option is given by

$$p(t, S_t) = K e^{-r(T-t)} N(-d_2) - S_t N(-d_1),$$

where

$$d_1 = \frac{\ln(S_t/K) + (r + \frac{1}{2}\sigma^2)(T-t)}{\sigma\sqrt{T-t}}, \quad d_2 = d_1 - \sigma\sqrt{T-t}.$$

Derive the expressions for the replicating portfolio $(\phi(t), \psi(t))$ given that

$$\phi(t) = \frac{\partial p}{\partial S}(t, S_t), \quad \psi(t) = \frac{p(t, S_t) - S_t \phi(t)}{B(t)}.$$

Select Answers:

3. $p = \frac{1}{3}$

5. (b) The Radon-Nikodym derivative is the ratio of the two probabilities;

$$\frac{dQ}{dP} = \begin{cases} 4/9 & \text{if } HH \\ 8/9 & \text{if } HT \\ 8/9 & \text{if } TH \\ 16/9 & \text{if } TT \end{cases}$$

6. (b) $\mathbb{E}[X_t^n] = 0$, $\text{Var}[X_t^n] = \Delta \lfloor t/\Delta \rfloor \approx t$ for n large (c) $\mathcal{N}(0, t)$ (d) Brownian Motion.

8. (d) $\mathcal{N}\left(e^{-\alpha t} x_0 + \mu(1 - e^{-\alpha t}), \frac{\sigma^2}{2\alpha}(1 - e^{-2\alpha t})\right)$