

# Stochastic Finance (FIN 519)

## Problems and Solutions

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- **BM** stands for Brownian motion. Assume that  $B_t$  is a standard **BM**.
- **RN** and **RV** stand for random number and random variable, respectively.
- $P(\cdot)$  and  $E(\cdot)$  are probability and expectation, respectively.
- The PDF and CDF of the standard normal variable are denoted by  $n(z)$  and  $N(z)$ , respectively. You can use  $n(z)$  and  $N(z)$  in your answers without further evaluation.
- Assume interest rate ( $r$ ) and dividend rate ( $q$ ) are zero in option pricing unless stated otherwise.
- $(x)^+ = \max(x, 0)$
- $\sinh(x) = \frac{1}{2}(e^x - e^{-x})$  and  $\cosh(x) = \frac{1}{2}(e^x + e^{-x})$ .
- **SCFA** stands for the exercise problems of [Stochastic Calculus and Financial Applications](#), **HW** homework, **ME** midterm exam, and **FE** final exam.

## Probability and Statistics Review

1. [2018HW 2-1] In class, we derived the moments of the standard normal distribution:

$$E(Z^{2n}) = (2n-1)(2n-3)\cdots 3\cdot 1 \quad \text{for } Z \sim N(0,1).$$

We can derive the same result using the moment generating function. First, derive the moment generating function,

$$M_X(t) = E(\exp(tX)) = \exp\left(\mu t + \frac{1}{2}\sigma^2 t^2\right) \quad \text{for } X \sim N(\mu, \sigma^2).$$

Then, using the Taylor expansion of  $M_X(t)$ , derive the moment of  $Z$ . (After this problem, you can understand [SCFA 3.4](#) better.)

**Solution:** The PDF of  $X$  is

$$f_X(x) = \frac{1}{\sqrt{2\pi}\sigma} \exp\left(-\frac{(x-\mu)^2}{2\sigma^2}\right).$$

Therefore,

$$\begin{aligned} M_X(t) &= E(\exp(tX)) = \int_{-\infty}^{\infty} e^{tx} f_X(x) dx \\ &= \exp\left(\mu t + \frac{1}{2}\sigma^2 t^2\right) \int_{-\infty}^{\infty} f_X(x - \sigma^2 t) dx = \exp\left(\mu t + \frac{1}{2}\sigma^2 t^2\right). \end{aligned}$$

For  $Z \sim N(0,1)$ , the moment generating function is  $M_Z(t) = \exp(t^2/2)$ . Expanding  $M_Z(t)$ ,

$$M_Z(t) = 1 + \frac{t^2}{2} + \cdots + \frac{1}{2^n \cdot n!} t^{2n} + \cdots$$

The  $2n$ -th moment is given by

$$E(Z^{2n}) = \frac{(2n)!}{2^n \cdot n!} = \frac{(2n)!}{(2n)(2n-2)\cdots 2} = (2n-1)(2n-3)\cdots 3\cdot 1$$

2. [2019HW 1-1] Find the moment generating function (MGF) of uniform distribution on  $[0,1]$ . From the MGF, find the mean and variance of the distribution.

**Solution:** The MGF is

$$M_U(t) = \int_0^1 e^{tu} du = \frac{1}{t} (e^t - 1) = 1 + \frac{1}{2}t + \frac{1}{6}t^2 + \cdots$$

Therefore,

$$\begin{aligned} E(U) &= \frac{1}{2} \\ \text{Var}(U) &= \frac{1}{3} - \left(\frac{1}{2}\right)^2 = \frac{1}{12} \end{aligned}$$

3. [2019HW 1-2] Find the moment generating function (MGF) of the exponential distribution with intensity  $\lambda$ . From the MGF, find the mean and variance of the distribution.

**Solution:** If we let  $X$  be the exponential random variable, the MGF is

$$M_X(t) = \int_0^{\infty} e^{tx} \lambda e^{-\lambda x} dx = \frac{\lambda}{\lambda - t} = 1 + \frac{t}{\lambda} + \frac{t^2}{\lambda^2} + \cdots \quad (t < \lambda)$$

Therefore,

$$E(X) = \frac{1}{\lambda}$$

$$\text{Var}(U) = \frac{2}{\lambda^2} - \frac{1}{\lambda^2} = \frac{1}{\lambda^2}$$

4. [2019HW 1-3] Assume that the random variable  $X$  follows the uniform distributions on  $[0, 1]$ .
- (a) If  $Y$  is another random variable given by  $Y = X^2$ , what is  $\rho(X, Y)$ , the correlation coefficient between  $X$  and  $Y$ ?
  - (b) If  $Y$  is another random variable given by  $Y = 4X(1 - X)$ , what is  $\rho(X, Y)$ , the correlation coefficient between  $X$  and  $Y$ ?
  - (c) Regarding (b), are  $X$  and  $Y$  independent? We know that the independence between  $X$  and  $Y$  implies  $\rho(X, Y) = 0$ . What can you say about the opposite?

**Solution:**

(a)

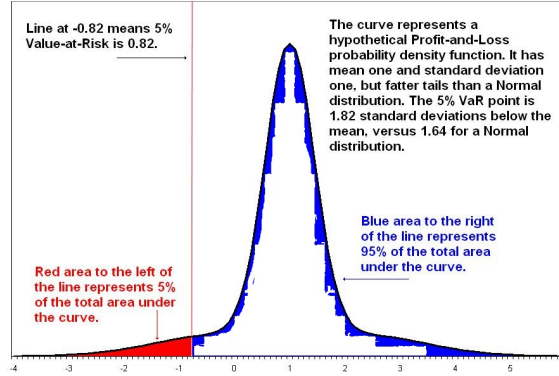
$$E(Y) = \int_0^1 x^2 dx = \frac{1}{3}, \quad E(Y^2) = \int_0^1 x^4 dx = \frac{1}{5}, \quad E(XY) = \int_0^1 x^3 dx = \frac{1}{4},$$

$$\rho = \frac{\text{Cov}(X, Y)}{\sqrt{\text{Var}(X)\text{Var}(Y)}} = \frac{1/4 - 1/6}{\sqrt{1/12}\sqrt{1/5 - 1/9}} = 96.8\%$$

(b) Because  $Y$  is symmetric at  $X = 1/2$ , the correlation should be zero.

(c) The opposite does not hold.  $Y$  is completely dependent on  $X$ .

5. [2018ME, Probability] Value-at-risk (VaR) ([WIKIPEDIA](#)) is a measure of the risk of loss for investments. It estimates how much a set of investments might lose (with a given probability  $p$ ). VaR is typically used by firms and regulators in the financial industry to gauge the amount of assets needed to cover possible losses. For a given portfolio, time horizon, and probability  $p$ , the  $p$ -VaR is defined such that the probability of a loss greater than VaR is (at most)  $p$  while the probability of a loss less than VaR is (at least)  $1 - p$ . In other words,  $p$ -VaR is the loss at the worst  $p$  percentile.



(From Wikipedia. The graph is illustration only. Ignore the numbers in the graph.)

Assume that you invest in one share of stock today and that your profit & loss is distributed as  $S_T - S_0 = X$  for some random variable  $X$  with the CDF,  $F_X(x)$ , and the PDF,  $f_X(x)$ .

- If  $X \sim N(0, 10^2)$  (i.e.,  $\sigma = 10$ ), what is your 5%-VaR,  $\text{VaR}(p = 0.05)$ ? You may use  $N(-1.64) \approx 0.05$ .
- Express the put option price with strike price  $K$ ,  $P(K)$ , in terms of  $f_X(x)$ . (You may use integral in the answer.)
- Conditional VaR (CVaR or expected shortfall) is another risk measure to improve VaR. It is defined as the expected loss conditional on that the loss is within the worst  $p$  percentile. Find the expression for  $\text{CVaR}(p)$ . You can simplify the expression using  $\text{VaR}(p)$  and the put option price,  $P(K)$ . Between  $\text{VaR}(p)$  and  $\text{CVaR}(p)$ , which one assumes bigger loss?

### Solution:

- $X \sim 10Z$  where  $Z \sim N(0, 1)$ .

$$\text{VaR}(0.05) = 10 N^{-1}(0.05) = 10 \cdot (-1.64) = -16.4$$

- 

$$\begin{aligned} P(K) &= \int_{x=-\infty}^{K-S_0} (K - S_0 - x) f_X(x) dx \\ \text{or} &= \int_{x=-\infty}^K (K - x) f_X(x - S_0) dx \end{aligned}$$

- Let  $S_T = K$  be the price which give the  $p$ -percentile loss. Then,  $K - S_0 = \text{VaR}(p)$ . We express  $\text{CVar}(p)$  using  $K$ , and substitute using  $K = S_0 + \text{VaR}(p)$  in the end.

$$\begin{aligned} \text{CVar}(p) &= \frac{1}{p} \int_{x=-\infty}^{K-S_0} x f_X(x) dx \\ &= \frac{K - S_0}{p} \int_{x=-\infty}^{K-S_0} f_X(x) dx + \frac{1}{p} \int_{x=-\infty}^{K-S_0} (x - K + S_0) f_X(x) dx \\ &= \frac{\text{VaR}(p)}{p} p - \frac{P(K)}{p} = \text{VaR}(p) - \frac{P(S_0 + \text{VaR}(p))}{p} \end{aligned}$$

CVaR assumes more severe loss.

# 1 Random Walks and First Step Analysis

## 1. [SCFA 1.1]

**Solution:** Let  $T_{i,j}$  denote the expected time to go from level  $i$  to  $j$ . We are going to compute the answer as

$$T_{25,18} = T_{25,20} + T_{20,19} + T_{19,18}.$$

First,  $T_{25,20} = 15$  from Eq. (1.15):

$$E(\tau | S_0 = 0) = \frac{B}{q-p} - \frac{A+B}{q-p} \frac{1 - (q/p)^B}{1 - (q/p)^{A+B}}$$

with  $p = 1/3$ ,  $q = 2/3$ ,  $A = \infty$ ,  $B = 5$ . We also know  $T_{21,20} = 3$  from  $B = 1$ . Next,  $T_{20,19} = 37$  is calculated from

$$T_{20,19} = \frac{1}{10} \cdot 1 + \frac{9}{10}(1 + T_{21,20} + T_{20,19}).$$

Finally  $T_{19,18} = 77$  is obtained from

$$T_{19,18} = \frac{1}{3} \cdot 1 + \frac{2}{3}(1 + T_{20,19} + T_{19,18}).$$

Therefore,  $T_{25,18} = 15 + 37 + 77 = 129$ .

## 2. [SCFA 1.3]

**Solution:** Let  $N_k$  be the number of visits to the level  $k \neq 0$  before returning to 0 for the first time. First, we prove that  $P(N_k \geq 1) = 1/(2k)$  for  $k \geq 1$ . In order for the event,  $N_k > 0$ , to happen, the first step should be  $+1$ , ( $X_1 = +1$ ). If the first step is  $-1$ , the random walk has to hit 0 before it reaches  $k \geq 1$ . Given that the first step is  $+1$ , the probability to hit  $k$  ( $A = k - 1$  more steps up) before hitting 0 ( $B = 1$  step down) is given by  $1/k$  from Eq. (1.2). Combining the two results together, we have  $P(N_k > 0) = 1/(2k)$  for  $k \geq 1$ .

Next, we prove that

$$P(N_k \geq j + 1 | N_k \geq j) = \frac{1}{2} + \frac{k-1}{2k}.$$

Imagine that the random walk just hit the level  $k$  for the  $j$ -th time before hitting 0. If the next step is up, it is guaranteed that it will hit  $k$  at least one more time before returning to 0. If the next step is down, we know that the probability to hit  $k$  one more time ( $A = 1$ ) before hitting 0 ( $B = k - 1$ ) is  $(k - 1)/k$ . Adding the two probabilities together, we obtain the result.

Therefore, we can say that, for  $j \geq 0$ ,

$$\begin{aligned} P(N_k > j) &= P(N_k > 0)P(N_k > 1 | N_k > 0) \cdots P(N_k > j | N_k > j - 1) \\ &= \frac{1}{2k} \left( \frac{1}{2} + \frac{k-1}{2k} \right)^j = \frac{1}{2k} \left( \frac{2k-1}{2k} \right)^j. \end{aligned}$$

We can prove the final statement:

$$\begin{aligned} E(N_k) &= \sum_{j=1}^{\infty} j \cdot P(N_k = j) = \sum_{j=1}^{\infty} P(N_k \geq j) = \sum_{j=0}^{\infty} P(N_k > j) \\ &= \frac{1}{2k} \sum_{j=0}^{\infty} \left( \frac{2k-1}{2k} \right)^j = 1. \end{aligned}$$

3. [2016HW 1, A popular interview quiz, Recurrence relation]

Imagine that you keep tossing a fair coin (50% for head and 50% for tail) until you get two heads in a row. On average, how many times do you need to toss the coin?

**Solution:** Let  $X$  be the answer (expected number of tosses) and branch on the following three cases based on the outcomes in the beginning. The head is denoted by **H** and tail by **T**.

1. **T** (Prob = 1/2): You start from the scratch with 1 toss wasted. So the expected number of tosses in the branch is  $1+X$ .
2. **HT** (Prob = 1/4): You start from the scratch with 1 toss wasted. So the expected number of tosses in the branch is  $2+X$ .
3. **HH** (Prob = 1/4): You get two heads in a row in 2 tosses.

Therefore, we obtain the following equation on  $X$

$$X = \frac{1}{2}(1 + X) + \frac{1}{4}(2 + X) + \frac{1}{4} \cdot 2$$

and conclude that  $X = 6$ .

4. [2016HW 2-1] Related to the last statement of Chapter 1 of **SCFA**, prove that the expected time for the gambler to become first positive is infinite:  $E(\tau) = \infty$ . [Hint: consider the derivative of  $\phi(z)$  with respect to  $z$ ]

**Solution:**

$$\begin{aligned} E(\tau) &= \sum_{k=1}^{\infty} k P(\tau = k) = \sum_{k=1}^{\infty} k P(\tau = k) z^{k-1} \Big|_{z=1} \\ &= \frac{d}{dz} \phi(z) \Big|_{z=1} = -\frac{1 - \sqrt{1 - z^2}}{z^2} + \frac{1}{\sqrt{1 - z^2}} \Big|_{z=1} = \infty \end{aligned}$$

5. [2019HW 1-4] Let

$$S_n = S_0 + X_1 + X_2 + \cdots + X_n, \quad \text{where} \quad X_k = 1 \ (p = 0.5) \text{ or } -1 \ (q = 1/2)$$

and  $\tau$  be the first time  $n$  when  $S_n$  hits either  $A$  or  $-B$ . From lectures, We know that

$$E(\tau|S_0 = k) = (A - k)(B + k)$$

and that it can be understood as the price of the accumulator derivative which pays  $\$ \tau$  when the underlying stock price  $S_n$  hits either  $A$  or  $-B$  for the first time. Imagine that you are the bank who sold the derivative to a client and you want to hedge the derivative by buying or selling some amount of the underlying stock.

- On the  $n$ -th day with  $S_n = k$  ( $n < \tau$ ), how many shares (positive or negative) of the underlying stock do you need to hold to hedge the derivative? (Hint: consider the derivative with respect to  $k$ .)
- You can verify your answer in (a) under specific scenarios. Assume  $S_0 = 0$ ,  $A = 2$ , and  $B = 1$ , and consider the following two scenarios:
  - $S_1 = -1$  ( $\tau = 1$ ). Therefore, you pay  $\$1$  to your client on the day  $n = 1$ .
  - $S_n = 0, 1, 0, 1, 2$  on  $n = 0, \dots, 4$  ( $\tau = 4$ ). Therefore, you pay  $\$4$  to your client on the day  $n = 4$ .

On each scenario, track your the profit & loss (P&L) from your hedge position and record the accumulated value (of cash and stock) on each day. Do not forget that you received  $\$AB$  from your client as the premium, so your initial value is  $AB$ . On the day  $\tau$ , you have to pay  $\$ \tau$  to your client. What is the accumulated cash you hold (after selling the stocks for the hedge)? Is that cash amount same as  $\tau$ ?

**Solution:**

(a)

$$E(\tau|S_n = k) = n + (A - k)(B + k), \quad \frac{d}{dk} E(\tau|S_n = k) = A - B - 2k$$

Therefore, you have to hold  $A - B - 2k$  shares of the underlying stock.

(b) In both scenarios, the accumulated cash is same as the payout,  $\tau$ .

Scenario 1:	Day ( $n$ )	0	1
	$S_n$	0	-1
	Hedge (Share)	1	x
	P&L from hedge	x	-1
	Accumulated value	2	1

Scenario 2:	Day ( $n$ )	0	1	2	3	4
	$S_n$	0	1	0	1	2
	Hedge (Share)	1	-1	1	-1	x
	P&L from hedge	x	1	1	1	-1
	Accumulated value	2	3	4	5	4

Note: P&L on day  $k$  is the hedge position at  $t = k - 1$  times  $(S_k - S_{k-1})$ . Accumulated value is the sum the cash and the value of the hedge.



6. **[2017ME, Recurrence relation]** A startup company in Shenzhen either fails or succeeds every year with probability of 25% and 75% respectively. If a company is successful, employees spin off a new startup at the end of the year (and it will face with the same fail/success probability afterwards). There is no correlation between companies. Assume that Shenzhen sets off with one startup company when the city was established as a special economic zone in 1980. What is the probability that all startups in Shenzhen eventually fail.

**Solution:** Let  $p$  be the probability and branch on the whether the first company fails or succeeds. If the first company succeeds and there are two companies in Shenzhen next year, the probability that both fail is  $p^2$  due to the independence assumption. Therefore,

$$p = \frac{1}{4} \cdot 1 + \frac{3}{4} \cdot p^2 \quad \Rightarrow \quad 3p^2 - 4p + 1 = (3p - 1)(p - 1) = 0$$

Among the two solutions,  $p = 1/3$  is the right solution.

7. **[2018ME]** In the gambler's ruin problem,

$$S_n = X_1 + \cdots + X_n, \quad X_k = \pm 1 \quad \text{with probability} \quad p : q \quad (p + q = 1),$$

what is the probability that  $S_n$  ever hits a level  $A > 0$ ? How does this probability changes when  $p$  changes? (Hint: consider  $B \rightarrow \infty$  from the results we know from class.)

**Solution:** The probability of hitting  $A$  before hitting  $-B$  is given by

$$P(S_\tau = A) = \frac{(q/p)^B - 1}{(q/p)^{A+B} - 1} \quad (p \neq q) \quad \text{or} \quad \frac{B}{A+B} \quad (p = q = 1/2)$$

If we let  $B \rightarrow \infty$ , the probability of  $S_n$  ever hitting  $A$  is

$$1 \quad \text{if} \quad p \geq 0.5 \quad \text{or} \quad (p/q)^A \quad \text{if} \quad p < 0.5$$

## 2 First Martingale Steps

### 1. [SCFA 2.1]

**Solution:** The roots of the equation qualify for the  $x$

$$E(x_1^X) = \frac{0.52}{x} + 0.45x + 0.03x^2 = 1.$$

Form

$$\frac{0.52}{x} + 0.45x + 0.03x^2 - 1 = \frac{x-1}{x}(0.03x^2 + 0.48x - 0.52)$$

we have the following three values.

$$x = 1, \frac{-0.24 \pm \sqrt{0.24^2 + 0.03 \times 0.24}}{0.03} = 1, 1.01850, -17.0185.$$

We pick  $x = 1.01850$  since the change under high powers are reasonable. If we let  $\tau$  be the first time Gambler's wealth is either 100, 101 or -100, we have the equation from the Martingale property,

$$1 = E(M_\tau) = x^{100}P(S_\tau = 100) + x^{101}P(S_\tau = 101) + x^{-100}P(S_\tau = -100).$$

Letting  $p = P(S_\tau = 100) + P(S_\tau = 101)$  and using the fact that  $x > 1$ ,

$$\begin{aligned} x^{100}p + x^{-100}(1-p) &< 1 < x^{101}p + x^{-100}(1-p) \\ \frac{1-x^{-100}}{x^{101}-x^{-100}} &< p < \frac{1-x^{-100}}{x^{100}-x^{-100}} \Rightarrow 0.13531 < x < 0.13788. \end{aligned}$$

### 2. [SCFA 2.4]

**Solution:** From the hint, let us define

$$A_{n+1} = A_n + E[(M_{n+1} - M_n)^2 | \mathcal{F}_n]$$

and prove the three required properties:

(i)  $N_n$  is a martingale.

$$\begin{aligned} E[N_{n+1} | \mathcal{F}_n] &= E[M_{n+1}^2 - A_{n+1} | \mathcal{F}_n] \\ &= E[2M_{n+1}M_n - M_n^2 - A_n | \mathcal{F}_n] \\ &= 2E[M_{n+1} | \mathcal{F}_n]M_n - M_n^2 - A_n \\ &= M_n^2 - A_n = N_n. \end{aligned}$$

(ii)  $A_{n+1} \geq A_n$  is trivial.

(iii)  $A_n$  is non-anticipating because it is defined via the expectation under  $\mathcal{F}_n$ .

3. [2017HW 1-1] Using martingale property, re-drive that

$$E(\tau) = AB \quad \text{for} \quad \tau = \min\{n : S_n = A \text{ or } S_n = -B\}.$$

**Solution:** You can find the answer in **SCFA** Section 2.3.

4. [2018HW 2-2] Martingale page ([WIKIPEDIA](#)) gives the following example of Martingale. Prove (or disprove) the statement.

Suppose each amoeba either splits into two amoebas, with probability  $p$ , or eventually dies, with probability  $q = 1 - p$ . Let  $X_n$  be the number of amoebas surviving in the  $n$ -th generation (in particular  $X_n = 0$  if the population has become extinct by that time). Let  $r$  be the probability of eventual extinction. (Finding  $r$  as a function of  $p$  is an instructive exercise. Hint: The probability that the descendants of an amoeba eventually die out is equal to the probability that either of its immediate offspring dies out, given that the original amoeba has split.) Then

$$\{r^{X_n} : n = 1, 2, 3, \dots\}$$

is a martingale with respect to  $\{X_n : n = 1, 2, 3, \dots\}$ .

See [2017-ME Recurrence Relation](#) to derive the extinction probability  $r$  as a function of  $p$  (and  $q$ ).

**Solution:** First, we find  $r$  in terms of  $p$  and  $q$ . Since the survival of amoeba's are independent, the probability of  $n$  amoebas' extinction is  $r^n$ . Branching on the 2nd generation (i.e., multiplication vs death of the first amoeba), we get the following recurrence relation,

$$r = p \cdot r^2 + q,$$

and we can solve  $r = q/p$ . In fact, the relation above indicate the first step proof of the Martingale:

$$E(r^{X_2} | X_1 = 1) = E(r^{X_1}) = r.$$

For the rest, we do not need  $r = q/p$ , but just the relation,  $1 = pr + q/r$ .

At each step, each of  $X_n$  amoebas either becomes 2 or 0 with probability of  $p$  and  $q$  respectively. We can write

$$X_{n+1} = X_n + \sum_{k=1}^{X_n} I_k, \quad r^{X_{n+1}} = r^{X_n} \cdot r^{I_1 + \dots + I_{X_n}}$$

where  $I_k$  takes value of +1 or -1 with probability  $p$  and  $q$  respectively and  $\{I_k\}$  are independent events. The probability of  $j$  amoebas multiplying by 2 ( $X_n - j$  amoebas

die) is given by the binomial distribution,  $\binom{n}{j} p^j q^{X_n-j}$ . Therefore,

$$\begin{aligned} E(r^{I_1+\dots+I_{X_n}}) &= \sum_{j=0}^{X_n} \binom{X_n}{j} p^j q^{X_n-j} \cdot \frac{r^j}{r^{X_n-j}} = \sum_{j=0}^{X_n} \binom{X_n}{j} (pr)^j \left(\frac{q}{r}\right)^{X_n-j} \\ &= \left(pr + \frac{q}{r}\right)^{X_n} = 1. \end{aligned}$$

Therefore,

$$E(r^{X_{n+1}}|X_n) = r^{X_n} \cdot E(r^{I_1+\dots+I_{X_n}}) = r^{X_n}.$$

5. **[2016ME(ASP), Martingale, Polya's urn]**

A box has 1 red ball and 9 blue balls. Pick up one ball randomly. If it is red, put it back and add one more red ball into the box. If it is blue, put it back and add one more blue ball into the box. If  $Y_n$  is the proportion of the red balls in the box after the process is repeated  $n$  times ( $Y_0 = 0.1$ ), show that  $\{Y_n\}$  is a martingale. So what is the expected number of the red balls after you repeat the process 100 times?

**Solution:**

$$Y_{n+1} = \begin{cases} \frac{(n+10)Y_n+1}{n+11} & \text{if a red ball is picked with probability } Y_n \\ \frac{(n+10)Y_n}{n+11} & \text{if a blue ball is picked with probability } 1 - Y_n \end{cases}$$

Therefore,

$$E(Y_{n+1}|Y_n) = \frac{(n+10)Y_n+1}{n+11}Y_n + \frac{(n+10)Y_n}{n+11}(1-Y_n) = Y_n,$$

so  $Y_n$  is a martingale. The expected number of the red balls at  $n = 100$  is

$$E((10+100)Y_{100}) = 110 Y_0 = 110 \times 0.1 = 11.$$

6. **[2016ME(ASP), Wald's equation]**

When  $\{X_k\}$  are independent identically distributed random variable and  $N$  is a random variable taking positive integer values, Wald's equation says

$$E(X_1 + X_2 + \dots + X_N) = E(N) E(X_1)$$

if either (i)  $N$  is independent from  $\{X_k\}$  or (ii)  $N$  is a stopping time with respect to  $\{X_k\}$ .

Consider an example where  $X_k = 0$  or  $1$  with 50% and 50% probability and  $N$  is given by

$$N = X_1 + X_2 + 1.$$

Obviously,  $E(X_k) = 1/2$  and  $E(N) = 2/2 + 1 = 2$ . Find  $E(X_1 + X_2 + \dots + X_N)$  and explain why Wald's equation does not hold in this example.

**Solution:** We can branch on the first scenarios (with probability 1/4) depending on the outcome of  $X_1$  and  $X_2$ : 0-0, 0-1, 1-0 and 1-1.

$$\begin{aligned} E(X_1 + X_2 + \cdots + X_N) &= \frac{1}{4}E(0) + \frac{1}{4}E(0+1) + \frac{1}{4}E(1+0) + \frac{1}{4}E(1+1+X_3) \\ &= \frac{1}{4}(0+1+1+2+\frac{1}{2}) = \frac{9}{8} \neq E(X_k)E(N) = 1. \end{aligned}$$

Wald's equation does not hold because  $N = X_1 + X_2 + 1$  is neither

(i) independent from  $\{X_k\}$ :  $N$  is defined via  $X_1$  and  $X_2$

nor (ii) a stopping time w.r.t.  $\{X_k\}$ : it looks into the future, i.e.,  $X_2$  at  $k = 1$ .

7. [2016ME, Wald's equation]

When  $\{X_k\}$  are independent identically distributed random variable and  $N$  is a random variable taking positive integer values, Wald's equation says

$$E(X_1 + X_2 + \cdots + X_N) = E(N) E(X_1)$$

if either (i)  $N$  is independent from  $\{X_k\}$  or (ii)  $N$  is a stopping time with respect to  $\{X_k\}$ .

Consider an example where  $X_k = 0$  or 1 with 50% and 50% probability and  $N$  is given by

$$N = X_2 + 1.$$

Obviously,  $E(X_k) = 1/2$  and  $E(N) = 1/2 + 1 = 3/2$ . Find  $E(X_1 + X_2 + \cdots + X_N)$  and explain why Wald's equation does not hold in this example. If  $N$  is given instead as

$$N = X_1 + 1,$$

does Wald's equation hold? Is  $N$  a stopping time?

**Solution:** Branching on the value of  $X_2$ :

$$N = \begin{cases} 1 & (X_2 = 0, \text{ Prob} = 1/2) \\ 2 & (X_2 = 1, \text{ Prob} = 1/2), \end{cases}.$$

we compute

$$\begin{aligned} E(X_1 + X_2 + \cdots + X_N) &= \frac{1}{2}E(X_1) + \frac{1}{2}E(X_1 + 1) \\ &= \frac{1}{2}(\frac{1}{2} + \frac{1}{2} + 1) = 1 \neq E(X_k)E(N) = \frac{3}{4}. \end{aligned}$$

Wald's equation does not hold because  $N = X_1 + X_2 + 1$  is

(i) not independent from  $\{X_k\}$  as  $N$  is defined via  $X_2$  and (ii) not a stopping time w.r.t.  $\{X_k\}$  because we need future information  $X_2$  in order to determine  $N$  ( $X_1$  is not enough to tell  $N = 1$  or not.)

If  $N = X_1 + 1$ ,  $N$  is a stopping time. Based on  $X_1$  we can tell whether  $N = 1$  or not:  $N = 1$  if  $X_1 = 0$  and  $N \neq 1$  (in fact,  $N = 2$ ) if  $X_1 = 1$ . Therefore Wald's inequality should hold. We can directly verify that

$$E(X_1 + X_2 + \cdots + X_N) = \frac{1}{2}E(X_1) + \frac{1}{2}E(X_1 + X_2) = \frac{1}{2}(\frac{1}{2} + \frac{1}{2} + \frac{1}{2}) = \frac{3}{4}.$$

### 3 Brownian Motion

#### 1. [SCFA 3.1, Brownian Bridge]

**Solution:**

- (a) This problem is based on a series representation of BM ([WIKIPEDIA](#)). See p.286 of **SCFA** also.

$$B_t = tZ_0 + \sum_{k=1}^{\infty} \sqrt{2} Z_k \frac{\sin \pi k t}{\pi k}$$

for independent standard normal random variables,  $\{Z_{k \geq 0}\}$ . (But I think the author somehow dropped this in the current version of **SCFA**.) So,  $\Delta_0(t) = t$  and  $\lambda_0 = 1$ . Because  $B_1 = Z_0$  (from  $\Delta_{k \geq 1}(1) = 0$ ), the first term can be expressed as  $\lambda_0 Z_0 \Delta_0(t) = t B_1$ . Therefore,

$$U_t = B_t - t B_1$$

(b)

$$\begin{aligned} \text{Cov}(U_s, U_t) &= E\left((B_s - sB_1)(B_t - tB_1)\right) = E\left(B_s B_t - sB_1 B_t - tB_s B_1 + stB_1^2\right) \\ &= \min(s, t) - s \min(1, t) - t \min(s, 1) + st = s(1 - t) \end{aligned}$$

- (c) We need to find any set of functions,  $g(\cdot)$  and  $h(\cdot)$ , such that

$$\text{Cov}(X_s, X_t) = g(s)g(t) \min(h(s), h(t)) = s(1 - t) \quad \text{for } s \leq t.$$

If we narrow down the search by assuming  $h(\cdot)$  is monotonically increasing,

$$\text{Cov}(X_s, X_t) = g(s)g(t)h(s) = s(1 - t),$$

so we get

$$g(t) = 1 - t, \quad h(s) = \frac{s}{1 - s},$$

where  $h(s)$  is indeed an increasing function. Therefore we obtained a representation of Brownian bridge,

$$X_t = (1 - t)B_{\frac{t}{1-t}}$$

Since  $U_{1-t}$  is also a Brownian bridge due to the symmetry,

$$X_{1-t} = tB_{\frac{1-t}{t}}, \quad \left(g(t) = t, \quad h(t) = \frac{1-t}{t}\right)$$

is also a valid solution.

- (d) We use the inequality  $s/(1+s) \leq t/(1+t)$  if  $0 \leq s \leq t$ .

$$\begin{aligned} \text{Cov}(Y_s, Y_t) &= \text{Cov}\left((1+s)U_{\frac{s}{1+s}}(1+t)U_{\frac{t}{1+t}}\right) = (1+s)(1+t)\text{Cov}\left(U_{\frac{s}{1+s}}, U_{\frac{t}{1+t}}\right) \\ &= (1+s)(1+t) \frac{s}{1+s} \left(1 - \frac{t}{1+t}\right) = s = \min(s, t). \end{aligned}$$

## 2. [SCFA 3.2, Cautionary Tale]

**Solution:** Suppose  $X$  is a standard normal, consider an independent  $U$  such that  $P(U = 1) = 1/2 = P(U = -1)$ , and set  $Y = UX$ . Then,  $Y$  is also a standard normal as  $X$  and  $-X$  are also standard normal.

In order to show  $X$  and  $Y$  are not independent, we need to show

$$P(I_X \& J_Y) \neq P(I_X)P(J_Y)$$

for some event  $I_X$  and  $I_Y$  regarding  $X$  and  $Y$  respectively.

For any  $h > 0$ ,

$$\begin{aligned} P(X > h \& Y > h) &= \frac{1}{2}P(X > h \& X > h \mid U = 1) \\ &\quad + \frac{1}{2}P(X > h \& -X > h \mid U = -1) \\ &= \frac{1}{2}(1 - N(h)) + 0. \end{aligned}$$

However,

$$P(X > h)P(Y > h) = (1 - N(h))(1 - N(h))$$

is not same as the previous value. Therefore

## 3. [SCFA 3.3, Multivariate Gaussians]

**Solution:**

- (a) Let us work on each components of the vectors and matrices;  $V = (v_i)$ ,  $\mu = (\mu_i)$ ,  $A = (a_{ij})$  and  $\Sigma = (\sigma_{ij})$ .

$$\begin{aligned} E((AV)_i) &= E\left(\sum_j a_{ij}V_j\right) = \sum_j a_{ij}E(V_j) = \sum_j a_{ij}\mu_j = (A\mu)_i \\ E(AV) &= A\mu \end{aligned}$$

$$\begin{aligned} \text{Cov}\left((AV)_i, (AV)_j\right) &= \text{Cov}\left(\sum_l a_{il}V_l, \sum_m a_{jm}V_m\right) = \sum_{l,m} a_{il}\text{Cov}(V_l, V_m)a_{jm} \\ &= \sum_{l,m} a_{il}\sigma_{lm}a_{jm} = (A\Sigma A^T)_{ij} \end{aligned}$$

Therefore,

$$\text{Cov}(AV, AV) = A\Sigma A^T.$$

- (b)

$$\begin{aligned} E(X \pm Y) &= E(X) \pm E(Y) = 0 \pm 0 = 0 \\ \text{Var}(X \pm Y) &= \text{Var}(X) + \text{Var}(Y) \pm 2\text{Cov}(X, Y) = 1 + 1 + 0 = 2 \\ \text{Cov}(X + Y, X - Y) &= \text{Var}(X) - \text{Var}(Y) = 1 - 1 = 0 \end{aligned}$$

(c) When  $\text{Cov}(X, Y) = 0$ , the covariance matrix  $\Sigma$  is given by

$$\Sigma = \begin{pmatrix} \sigma_{11} & 0 \\ 0 & \sigma_{22} \end{pmatrix}, \quad \Sigma^{-1} = \begin{pmatrix} 1/\sigma_{11} & 0 \\ 0 & 1/\sigma_{22} \end{pmatrix}, \quad \det \Sigma = \sigma_{11} \sigma_{22}$$

The joint density function can be factored to the product of the single variable density function,

$$\begin{aligned} f(x, y) &= \frac{1}{2\pi\sqrt{\sigma_{11}\sigma_{22}}} \exp\left(-\frac{(x-\mu_X)^2}{2\sigma_{11}} - \frac{(y-\mu_Y)^2}{2\sigma_{22}}\right) \\ &= \frac{1}{2\pi\sqrt{\sigma_{11}}} \exp\left(-\frac{(x-\mu_X)^2}{2\sigma_{11}}\right) \frac{1}{2\pi\sqrt{\sigma_{22}}} \exp\left(-\frac{(y-\mu_Y)^2}{2\sigma_{22}}\right) = f(x)f(y). \end{aligned}$$

Therefore  $X$  and  $Y$  are independent.

(d) We first find the matrix  $A$  such that, for the independent standard normal variables  $W$  and  $Z$ ,

$$\begin{pmatrix} X - \mu_X \\ Y - \mu_Y \end{pmatrix} = A \begin{pmatrix} W \\ Z \end{pmatrix}$$

has the given covariance matrix

$$\begin{pmatrix} \sigma_{XX} & \sigma_{XY} \\ \sigma_{XY} & \sigma_{YY} \end{pmatrix} = A I A^T = A A^T.$$

One of the solution from Cholesky decomposition is

$$A = \begin{pmatrix} \sqrt{\sigma_{XX}} & 0 \\ \sigma_{XY}/\sqrt{\sigma_{XX}} & \sqrt{\sigma_{YY} - \sigma_{XY}^2/\sigma_{XX}} \end{pmatrix}.$$

Conditional on that  $X = x$ ,

$$Y = \mu_Y + \frac{\sigma_{XY}}{\sqrt{\sigma_{XX}}} \frac{x - \mu_X}{\sqrt{\sigma_{XX}}} + Z \sqrt{\sigma_{YY} - \sigma_{XY}^2/\sigma_{XX}}.$$

Therefore

$$\begin{aligned} E(Y|X = x) &= \frac{\sigma_{XY}}{\sigma_{XX}}(x - \mu_X) = \frac{\text{Cov}(X, Y)}{\text{Var}(X)}(x - \mu_X) \\ \text{Var}(Y|X = x) &= \sigma_{YY} - \frac{\sigma_{XY}^2}{\sigma_{XX}} = \text{Var}(Y) - \frac{\text{Cov}^2(X, Y)}{\text{Var}(X)} \end{aligned}$$

#### 4. [SCFA 3.4, Auxiliary Functions and Moments]

**Solution:**

$$E(e^{tz}) = \int_{-\infty}^{\infty} e^{tz} \frac{1}{\sqrt{2\pi}} e^{-z^2/2} dz = \int_{-\infty}^{\infty} e^{t^2/2} \frac{1}{\sqrt{2\pi}} e^{-(z-t)^2/2} dz = e^{t^2/2}$$



If  $M_n$  is the  $n$ -th moment,

$$E(e^{tz}) = \sum_{k=0}^{\infty} M_k \frac{t^k}{k!} = 1 + \frac{t^2}{2} + \frac{1}{2!} \left(\frac{t^2}{2}\right)^2 + \frac{1}{3!} \left(\frac{t^2}{2}\right)^3 + \dots$$

By matching the coefficients, we get

$$M_0 = 1$$

$$M_1 = M_3 (= M_{2k-1}) = 0$$

$$M_2 = 1$$

$$M_4 = 4!/(2! 2^2) = 3$$

$$M_6 = 6!/(3! 2^3) = 15.$$

For  $t > 0$ ,

$$E(e^{tz^4}) = \int_{-\infty}^{\infty} e^{tz^4} \frac{1}{\sqrt{2\pi}} e^{-z^2/2} dz \rightarrow \infty,$$

so the MGF of  $Z^4$  does not exist.

5. [2019HW 2-1] For a standard BM,  $B_t$ , find the probability that

$$B_1 + B_2 + B_3 \geq 3.$$

**Solution:** Let  $x = B_1$ ,  $y = B_2 - B_1$ , and  $z = B_3 - B_2$ , then  $x$ ,  $y$ , and  $z$  follow  $\mathcal{N}(0, 1)$  and they are independent. Since,

$$B_1 + B_2 + B_3 = x + (x + y) + (x + y + z) = 3x + 2y + z \sim \mathcal{N}(0, 14),$$

the probability that  $B_1 + B_2 + B_3 \geq 3$  is  $1 - N(3/\sqrt{14}) = 0.2113$ .

6. [2016ME, Standard BM]

If  $B_t$  is a standard BM, determine whether each of the followings is a standard BM or not. Provide a brief reason for your answer.

(a)  $4B_{t/2}$

(b)  $tB_{1/t}$  with  $B_0 = 1$ .

(c)  $2(B_{1+t/4} - B_1)$

(d)  $\sqrt{t}Z$  for a standard normal RV  $Z$

**Solution:**

(a) No.  $\text{Var}(4B_{t/2}) = 16 \times t/2 = 8t \neq t$ .

- (b) No.  $B_0$  should be 0.
- (c) Yes.  $B_{1+t/4} - B_1$  is equivalent to  $B_{t/4}$  and  $2B_{t/4}$  is equivalent to  $B_t$ .
- (d) No. For any value of  $Z$ ,  $\sqrt{t}Z$  is not a stochastic process. For example,  $\sqrt{s}Z$  and  $(\sqrt{t} - \sqrt{s})Z$  for  $s < t$  are correlated.

7. [2017ME, Standard BM] If  $B_t$  is a standard BM, determine whether each of the followings is a standard BM or not. Provide a brief reason for your answer.

- (a)  $\frac{1}{2}B_{4t}$
- (b)  $\frac{1}{2}(B_{1+2t} - B_1)$
- (c)  $\frac{3}{5}B_t + \frac{4}{5}W_t$ , where  $W_t$  is another BM independent from  $B_t$ .

**Solution:**

- (a) **Yes.**  $\text{Var}(\frac{1}{2}B_{4t}) = \frac{1}{4} \cdot 4t = t$ .
- (b) **No.** It is equivalent to  $\frac{1}{2}B_{2t}$ , however  $\frac{1}{2}B_{2t}$  is not a standard BM.
- (c) **Yes.**  $aB_t + bW_t$  is a standard BM when  $a^2 + b^2 = 1$ .

8. [2018ME, Standard BM] If  $B_t$  is a standard BM, determine whether each of the followings is a standard BM or not. Explain briefly why it is a standard BM or not.

- (a)  $(1/\sqrt{2})B_{2t}$
- (b)  $\begin{cases} B_t & \text{if } t \leq \tau_a \\ 2a - B_t & \text{if } t > \tau_a \end{cases}$ , where  $\tau_a$  is the first time  $B_t$  hitting the level  $a$ .
- (c)  $\frac{1}{13}(5B_t + 12W_t)$  where  $W_t$  is another standard BM independent from  $B_t$ .
- (d)  $B_{2t} - B_t$

**Solution:**

- (a) Yes. The scaling property.
- (b) Yes. The reflection principle.
- (c) Yes.

$$\frac{5^2 + 12^2}{13^2} = 1$$

- (d) No. Let  $X_t = B_{2t} - B_t$ .

$$\begin{aligned} \text{Cov}(X_s, X_t) &= E((B_{2s} - B_s)(B_{2t} - B_t)) = E(B_{2s}B_{2t} - B_{2s}B_t - B_sB_{2t} + B_sB_t) \\ &= 3 \min(s, t) - \min(2s, t) - \min(s, 2t) \end{aligned}$$

If  $X_t$  is a standard BM,  $\text{Cov}(X_1, X_2) = \min(1, 2) = 1$ . However,  $\text{Cov}(X_1, X_2) = 3 - 2 - 1 = 0$ .

9. [2016ME, Average of a BM path]

If  $B_t$  for  $0 \leq t \leq 1$  is a standard BM, what is the distribution of the average of the BM values observed at three different times,  $T = 1/3, 2/3$  and 1,

$$A = \frac{1}{3} \left( B_{\frac{1}{3}} + B_{\frac{2}{3}} + B_1 \right)?$$

Please make sure to provide the mean and the standard deviation of the distribution.

**Solution:**

$$\begin{aligned} \text{Var} \left( \frac{1}{3} (B_{1/3} + B_{2/3} + B_1) \right) &= \frac{1}{9} E \left( (B_{1/3} + B_{2/3} + B_1)^2 \right) \\ &= \frac{1}{9} E \left( B_{1/3}^2 + B_{2/3}^2 + B_1^2 + 2B_{1/3}(B_{2/3} + B_1) + 2B_{2/3}B_1 \right) \\ &= \frac{1}{9} \left( \frac{1}{3} + \frac{2}{3} + 1 + 2 \cdot \frac{1}{3} \cdot 2 + 2 \cdot \frac{2}{3} \right) = \frac{1}{9} \frac{14}{3} = \frac{14}{27}. \end{aligned}$$

## 4 Martingales: The next steps

### 1. [SCFA 4.6]

**Solution:** The stopped process is a martingale. By the symmetry,  $P(B_\tau = A) = P(B_\tau = -A) = 0.5$ .

$$1 = E(X_\tau) = \frac{1}{2}e^{\alpha A}E(e^{-\alpha^2\tau/2}) + \frac{1}{2}e^{-\alpha A}E(e^{-\alpha^2\tau/2}).$$

Therefore, we have

$$E\left(e^{-\alpha^2\tau/2}\right) = \frac{1}{\cosh(\alpha A)}$$

or

$$\phi(\lambda) = E(e^{-\lambda\tau}) = \frac{1}{\cosh(A\sqrt{2\lambda})}.$$

In order to calculate  $E(\tau^2)$ , we need to obtain the  $x^4$  term in the expansion of  $1/\cosh(x)$  given that  $\sqrt{\lambda}$  appears in the expression. From the expansion,  $\cosh x \sim 1 + x^2/2! + x^4/4! + \dots$ ,

$$\begin{aligned} \frac{1}{\cosh x} &\sim \frac{1}{1 + (x^2/2! + x^4/4! + \dots)} = 1 - \left(\frac{x^2}{2!} + \frac{x^4}{4!} + \dots\right) + \left(\frac{x^2}{2!} + \dots\right)^2 \\ &= 1 - \frac{x^2}{2} + \frac{5}{24}x^4 + \dots \end{aligned}$$

Finally we get

$$E(\tau^2) = 2\frac{5}{24}(A\sqrt{2\lambda})^4|_{\lambda=1} = \frac{5}{3}A^4$$

For the non-symmetric case ( $A \neq B$ ), we can not use  $P(B_\tau = A) = P(B_\tau = -B) = 0.5$  anymore.

### 2. [2016ME, Martingale related to BM]

If  $B_t$  is a standard BM, find the value of the coefficient  $\lambda$  in order for each of the following expressions to be a martingale.

- (a)  $B_{at}^2 - \lambda t$
- (b)  $\exp(-B_{at} + \lambda t)$

**Solution:**

- (a)  $\lambda t = E(B_{at}^2) = at$ . Therefore,  $\lambda = a$ .
- (b)  $\sqrt{a}B_t$  is a BM equivalent to  $-B_{at}$ . Therefore,  $\lambda = -a/2$ .

## Bachelier (Normal) Model

1. **[2016HW 3-1, Digital option]** Derive the (forward) price of the digital(binary) call/put option struck at  $K$  at maturity  $T$ . The digital(binary) call/put option pays \$1 if  $S_T$  is above/below the strike  $K$ , i.e.  $1_{S_T \geq K}/1_{S_T \leq K}$ .

**Solution:** Similarly following the derivation of the call price, the digital call option price is

$$C_D(K) = E(1_{S_T \geq K}) = P(S_T \geq K) = \int_{-d_N}^{\infty} n(z) dz = 1 - N(-d_N) = N(d_N).$$

and the digital put option price is

$$P_D(K) = E(1_{S_T \leq K}) = P(S_T \leq K) = \int_{-\infty}^{-d_N} n(z) dz = N(-d_N) = 1 - N(d_N),$$

where  $d_N$  is given by

$$d_N = \frac{S_0 - K}{\sigma \sqrt{T}}.$$

Notice that  $N(d_N)$  has another meaning as the probability of the stock price ends up in-the-money in addition the delta of the call option.

2. **[2016HW 3-2, Asset-or-nothing option]** The payoff of the call option,  $\max(S_T - K, 0)$  can be decomposed into two parts,

$$S_T \cdot 1_{S_T \geq K} = K \cdot 1_{S_T \geq K} + (S_T - K) \cdot 1_{S_T \geq K}.$$

The first payout is the payout of the **asset-or-nothing** call option and the second payout is the binary call option multiplied with  $-K$ . Under normal model, what is the price of the asset-or-nothing call option?

**Solution:** From the binary call option price above and the (regular) call option price from the class,

$$C(K) = (F - K)N(d_N) + \sigma \sqrt{T} n(d_N),$$

we conclude that

$$C_{A-or-N} = F N(d_N) + \sigma \sqrt{T} n(d_N).$$

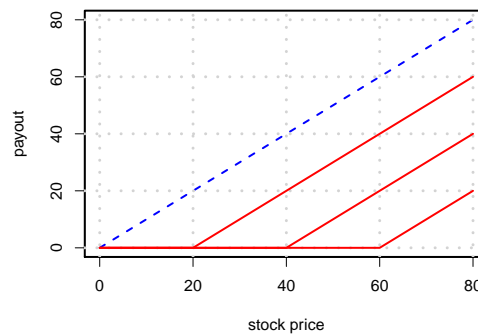
3. **[2016HW 4-4, Maximum call option value]**

- (a) Pleased with the outstanding performance of the Stochastic Finance class, Professor is going to give each student a gift of **EITHER** one share of Tencent stock **OR** one unit of the call option on Tencent stock struck just at 1 yuan (so the call option is deep in-the-money) with maturity at the end of this module. Which gift has more financial value? (Assume that Tencent pays no dividend. No calculation required. Use your common sense.)

- (b) What is the upper limit of the call option value under the normal model? In normal model, under which circumstance the option is more valuable than the underlying stock itself? How does it affect your choice of the gift in the previous question?

**Solution:**

- (a) Given that a stock price can not go below zero, the payoff of a stock is always greater than that of a call option with any strike  $K$ . Therefore, the underlying stock is more valuable. See the plot below for the payoff of a stock (dashed blue) versus that of the options with  $K = 20, 40$  and  $60$ .



- (b) The price of a call option (and put option as well) is unbounded (can go to infinity) under the normal model. This happens when volatility is very high. As  $\sigma \rightarrow \infty$ ,  $d \rightarrow 0$ ,  $N(d) \rightarrow 0$  and  $n(d) \rightarrow 1/\sqrt{2\pi}$ . Therefore  $C \approx 0.4\sigma\sqrt{T} \rightarrow \infty$ . Intuitively, it is because a call option gives you a protection against the negative underlying price (underlying asset becoming liability), which is possible under the normal model. On the other hand, under Black-Scholes-Merton model the call option price is always bounded by the price of the underlying asset as mentioned in the class. Since a stock value can not be negative, you still better off by choosing a stock rather than a call option.

4. [2019HW 2-2] Under the Bachelier (normal) model, the undiscounted price of call option is given by

$$C_N(K) = (S_0 - K)N(d_N) + \sigma\sqrt{T}n(d_N) \quad \text{for} \quad d_N = \frac{S_0 - K}{\sigma_N\sqrt{T}}$$

- (a) Show that the delta, the sensitivity on  $S_0$ , is

$$\frac{\partial C_N}{\partial S_0} = N(d_N)$$

- (b) Show that the vega, the sensitivity on  $\sigma$ , is

$$\frac{\partial C_N}{\partial \sigma_N} = \sqrt{T}n(d_N)$$

In the questions above, make sure to apply the derivative to  $d_N$  since  $d_N$  depends on  $S_0$  and  $\sigma_N$ .

**Solution:**

(a)

$$\begin{aligned}\frac{\partial C_N}{\partial S_0} &= N(d_N) + (S_0 - K)n(d_N)\frac{\partial d_N}{\partial S_0} + \sigma\sqrt{T}(-d_N)n(d_N)\frac{\partial d_N}{\partial S_0} \\ &= N(d_N) + \left((S_0 - K)n(d_N) - \sigma\sqrt{T}d_N n(d_N)\right)\frac{\partial d_N}{\partial S_0} \\ &= N(d_N) + 0 \cdot \frac{\partial d_N}{\partial S_0} = N(d_N)\end{aligned}$$

(b)

$$\begin{aligned}\frac{\partial C_N}{\partial \sigma_N} &= (S_0 - K)n(d_N)\frac{\partial d_N}{\partial \sigma_N} + \sqrt{T}n(d_N) + \sigma_N\sqrt{T}(-d_N)n(d_N)\frac{\partial d_N}{\partial \sigma_N} \\ &= \sqrt{T}n(d_N) + \left((S_0 - K) - \sigma_N\sqrt{T}d_N\right)n(d_N)\frac{\partial d_N}{\partial \sigma_N} \\ &= \sqrt{T}n(d_N) + 0 \cdot n(d_N)\frac{\partial d_N}{\partial \sigma_N} = \sqrt{T}n(d_N)\end{aligned}$$

5. **[2019HW 2-3, A simple credit default swap]** Assume that the stock price of a firm follows an arithmetic BM,

$$S_t = S_0 + \sigma_N B_t \quad \text{where } B_t \text{ is a standard BM}$$

and that the firm is considered default if  $S_t = 0$ . You want to buy a credit default swap (CDS) from an investment bank. You continuously pay at the rate of  $\lambda$  to the bank as premium (i.e., pay  $\lambda dt$  during the time period between  $t$  and  $t + dt$ ). The bank will pay you  $\$M$  if the firm defaults. We want to determine the fair value of  $\lambda$ . Assume that the continuously compounded interest rate is  $r > 0$ .

- (a) What is the expected value of the payout ( $\$M$ ) at the default event.
- (b) What is the expected value of the premium payment.
- (c) Determine the fair rate  $\lambda$  by equating the two values above.

(Hint: use the result from **Hitting time of a level** in SCFA Section 4.5)

**Solution:** The Laplace transform of the first hitting time  $\tau$  is given by

$$E(e^{-r\tau}) = e^{-(S_0/\sigma_N)\sqrt{2r}}.$$

- (a) The expectation of the CDS payout is

$$M \cdot E(e^{-r\tau}) = M e^{-(S_0/\sigma_N)\sqrt{2r}}.$$

- (b) The present value of the premium paid until  $\tau$  is

$$\int_0^\tau e^{-rt} \lambda dt = \frac{\lambda}{r}(1 - e^{-r\tau}).$$

Taking the expectation,

$$E\left(\frac{\lambda}{r}(1 - e^{-r\tau})\right) = \frac{\lambda}{r}(1 - E(e^{-r\tau})) = \frac{\lambda}{r}\left(1 - e^{-(S_0/\sigma_N)\sqrt{2r}}\right)$$

(c) By equating the results of (a) and (b),

$$\frac{\lambda}{r}\left(1 - e^{-(S_0/\sigma_N)\sqrt{2r}}\right) = Me^{-(S_0/\sigma_N)\sqrt{2r}},$$

we obtain  $\lambda$  as

$$\lambda = \frac{rMe^{-(S_0/\sigma_N)\sqrt{2r}}}{1 - e^{-(S_0/\sigma_N)\sqrt{2r}}} = \frac{rM}{e^{(S_0/\sigma_N)\sqrt{2r}} - 1}.$$

6. **[2016ME(ASP), Asian option]** Asian option is an option where the payoff at maturity  $T$  is derived from the average of the underlying prices at a given set of times before and at the maturity,

$$\left(\frac{1}{N} \sum_{k=1}^N S(t_k) - K\right)^+ \quad \text{for } 0 < t_1 < \cdots < t_N = T.$$

When  $N = 4$  and  $t_k = k/4$  ( $T = 1$ ) (a quarterly averaged Asian option), find the price of the Asian option. Assume the underlying stock price follows BM process,  $dS(t) = \sigma dB(t)$ , and the option price is given by  $C = 0.4\sigma\sqrt{T}$  (at-the-money strike, zero interest rate and zero dividend rate). How much the price of this Asian option is cheaper (or more expensive) to that of the European option with the same maturity and the same volatility?

**Solution:**

$$\begin{aligned} \text{Var}\left(\frac{\sigma}{4}(B_{1/4} + B_{2/4} + B_{3/4} + B_{4/4})\right) &= \frac{\sigma^2}{16}\text{Var}(B_{1/4} + B_{2/4} + B_{3/4} + B_{4/4}) \\ &= \frac{\sigma^2}{16}E\left((B_{1/4} + B_{2/4} + B_{3/4} + B_{4/4})^2\right) \\ &= \frac{\sigma^2}{16}E\left(B_{1/4}^2 + B_{2/4}^2 + B_{3/4}^2 + B_{4/4}^2 + 2B_{1/4}(B_{2/4} + B_{3/4} + B_{4/4}) \right. \\ &\quad \left. + 2B_{2/4}(B_{3/4} + B_{4/4}) + 2B_{3/4}B_{4/4}\right) \\ &= \frac{\sigma^2}{16}\left(\frac{1}{4} + \frac{2}{4} + \frac{3}{4} + \frac{4}{4} + 2\frac{1}{4} \cdot 3 + 2\frac{2}{4} \cdot 2 + 2\frac{3}{4} \cdot 1\right) = \frac{\sigma^2}{16} \frac{30}{4} = \frac{15\sigma^2}{32}. \end{aligned}$$

The option price is given by

$$\text{Price of Asian option} = 0.4\sqrt{\frac{15}{32}}\sigma.$$

Asian option is about 31.5% ( $= 1 - \sqrt{15/32}$ ) cheaper than European option with the same expiry,  $0.4\sigma$ .



7. [2017ME(ASP), Asian option]

Asian option is an option where the payoff at maturity  $T$  is derived from the average of the underlying prices at a given set of times before and at the maturity,

$$\left( \frac{1}{N} \sum_{k=1}^N S(t_k) - K \right)^+ \quad \text{for } 0 < t_1 < \cdots < t_N = T.$$

When  $N = 3$  and  $t_k = (k + 3)/3$  ( $T = 2$ ), find the price of the at-the-money Asian option. Assume the underlying stock price follows an arithmetic BM process (normal model),  $dS_t = \sigma dW_t$ , and the option price is given by  $C = 0.4 \sigma \sqrt{T}$  (at-the-money strike, zero interest rate and zero dividend rate). How much the price of this Asian option is cheaper (or more expensive) than that of the European option with the same maturity ( $T = 2$ ) and the same volatility?

**Solution:**

$$\begin{aligned} \text{Var}\left(\frac{1}{3}(B_{4/3} + B_{5/3} + B_2)\right) &= \frac{1}{9} E\left((B_{4/3} + B_{5/3} + B_2)^2\right) \\ &= \frac{1}{9} E\left(B_{4/3}^2 + B_{5/3}^2 + B_2^2 + 2B_{4/3}(B_{5/3} + B_2) + 2B_{5/3}B_2\right) \\ &= \frac{1}{9} \left(\frac{4}{3} + \frac{5}{3} + 2 + 2 \cdot \frac{4}{3} \cdot 2 + 2 \cdot \frac{5}{3}\right) = \frac{1}{9} \cdot \frac{41}{3} = \frac{41}{27}. \end{aligned}$$

The option price is given by

$$\text{Price of Asian option} = 0.4 \sqrt{\frac{41}{27}} \sigma.$$

Asian option is about 12.8% ( $= 1 - \sqrt{41/54}$ ) cheaper than European option with the same expiry,  $0.4\sqrt{2} \sigma$ .

8. [2017ME, Basket/Spread option under normal model] Let  $W_t$  and  $Z_t$  are standard BMs with correlation  $\rho$ , i.e.,  $E(W_t Z_t) = \rho t$ . For (b) and (c), assume that two stock prices follow

$$S_{1t} = 100 + 20W_t, \quad S_{2t} = 80 + 10Z_t.$$

and you may use the simple ATM option price formula,  $C = P = 0.4\sigma\sqrt{T}$ .

- Calculate  $\text{Var}(a W_T + b Z_T)$  for some constants  $a$  and  $b$ .
- Consider a spread option, whose payout is on *the difference of the prices*,  $\max(S_{1T} - S_{2T} - K, 0)$ . What is the price of the ATM option ( $K = 20$ ) as a function of  $\rho$ ? What is the min and max price and when do you get the those values?
- Consider a basket option, whose payout is on *the weighted average of the prices*,  $\max((S_{1T} + S_{2T})/2 - K, 0)$ . What is the price of the ATM option ( $K = 90$ ) as a function of  $\rho$ ? What is the min and max price and when do you get the those values?

**Solution:**

(a)

$$\text{Var}(a W_T + b Z_T) = (a^2 + 2\rho ab + b^2)T$$

(b)  $\text{Var}(S_{1T} - S_{2T}) = \text{Var}(a W_T + b Z_T)$  with  $a = 20$  and  $b = -10$ . Therefore,

$$C = 0.4 \sqrt{(a^2 + 2\rho ab + b^2)T} = 4\sqrt{(5 - 4\rho)T},$$

and

$$4\sqrt{T} \quad (\rho = 1, \text{ i.e., correlated}) \leq C \leq 12\sqrt{T} \quad (\rho = -1, \text{ i.e., anti-correlated}).$$

(c)  $\text{Var}((S_{1T} + S_{2T})/2) = \text{Var}(a W_T + b Z_T)$  with  $a = 10$  and  $b = 5$ . Therefore,

$$C = 0.4 \sqrt{(a^2 + 2\rho ab + b^2)T} = 2\sqrt{(5 + 4\rho)T},$$

and

$$2\sqrt{T} \quad (\rho = -1, \text{ i.e., anti-correlated}) \leq C \leq 6\sqrt{T} \quad (\rho = 1, \text{ i.e., correlated}).$$

9. **[2018ME, Merton's model]** From an accounting standpoint, a firm's equity (stock) value,  $S$ , is equal to  $A - D$ , where  $A$  is total asset value and  $D$  is total debt. When  $A$  goes below  $D$ , the firm defaults with equity value  $S = 0$ . In 1974, Merton proposed a model to price the current equity value  $S_0$  as the expected asset value  $A_T$  above the constant debt value  $D$ , i.e., the call option on the asset  $A_T$  stuck at  $D$ , at some time  $T$  (expiry):

$$S_0 = E(\max(A_T - D, 0)) \quad \text{where} \quad A_0 > D.$$

If  $A_t$  follows a geometric BM, the resulting equity price is same as the call option price formula by Black and Scholes (1973). Thus, the formula is called Black-Scholes-Merton formula (and Merton was awarded Nobel prize with Scholes in 1997).

Instead, in this problem, assume that  $A_t$  follows an arithmetic BM with volatility  $\sigma$ :

$$A_t = A_0 + \sigma B_t \quad (\text{assume } r = 0).$$

- (a) What should be the current equity value  $S_0$ ? You may use the result from class.
- (b) Under this framework, we can also derive the corporate bond (issued by the firm) maturing at  $T$ . At the maturity  $t = T$ , the firm pays \$1 to the bond holder. If the firm defaults before  $T$ , however, the bond value becomes zero. Assume that the risk-free interest rate is zero. (Hint: use the result on the probability of the first hitting time,  $P(\tau_a > T)$ )

**Solution:**

(a) It is same as the call option value under normal model:

$$S_0 = (A_0 - D)N(d_N) + \sigma\sqrt{T} n(d_N) \quad \text{where} \quad d_N = \frac{A_0 - D}{\sigma\sqrt{T}}$$

(b) For a standard BM, the probability for the first time hitting the level  $a$  is given by

$$P(\tau_a > T) = 2N\left(\frac{|a|}{\sqrt{T}}\right) - 1$$

The bond price is same as the probability of  $A_t$  hitting  $D$  happening later than  $T$ .  
Therefore,

$$\text{Corporate bond price} = 2N\left(\frac{A_0 - D}{\sigma\sqrt{T}}\right) - 1$$

10. **[2019ME, Equity Linked Note]** An equity-linked note (ELN) is a debt instrument, usually a bond, that differs from a standard fixed-income security in that the final payout is based on the return of the underlying equity, which can be a single stock, basket of stocks, or an equity index. Equity-linked notes are a type of structured products ([WIKIPEDIA](#)). We (as a security firm) want to design and sell an ELN based on a stock following a BM:

$$S_t = S_0 + \sigma B_t.$$

This note has coupon  $N$  periods,  $t = k\Delta t$  for  $k = 1, 2, \dots, N$ . At  $t = 0$ , investors buy this note at the price of  $P$  for the notional value of \$1. At the end of the  $k$ -th period,  $t = k\Delta t$ , it pays coupon  $\mu$  if the stock price did not fall more than  $\delta$  (i.e., if  $S_{k\Delta t} - S_{(k-1)\Delta t} \geq -\delta$ ) and continues to the next period. At the maturity  $t = N\Delta t$ , it pays  $1 + \mu$  (1 is the redemption of the notional value). If the price falls more than  $\delta$  at  $t = k\Delta t$ , (i.e.,  $S_{k\Delta t} - S_{(k-1)\Delta t} < -\delta$ ), the note terminates immediately by redeeming  $(1 - L)$  (at the loss of  $L$ ).

Assume that the discounting rate for one period,  $\Delta t$ , is  $r$ . So, the present value of \$1 paid after time  $\Delta t$  is  $1/(1 + r)$ . To simplify notation, you can use  $D = 1/(1 + r)$ .

The basic design of this ELN is that investors receive coupon  $\mu$  higher than the risk-free rate  $r$  if stock market does not crash. However, they take a risk of heavy loss  $L$  if market crashes.

- (a) Obtain the price  $P$  by calculating the expected value of the payout of this ELN.  
(b) Assume the following specific parameters:

$$N = 8, \Delta t = 0.25, S_0 = 100, \sigma = 10, \delta = 10, D = 0.97 \text{ } (r \approx 3\%), L = 0.5.$$

That is, this ELN observes the price every 3 months and the maturity is 2 years. Given the parameters, determine the return  $\mu$  to make the price of this ELN par (i.e.,  $P = 1$ ). You may use spreadsheet. How does it compares to the risk-free rate  $r \approx 3\%$ ?

- (c) Right after clients buy this ELN at the price  $P = 1$ , the volatility of the underlying stock suddenly increased to  $\sigma = 20$  due to the spread of the Corvid-19 virus. (Assume that  $S_0 = 100$  is unchanged.) What is client's loss?

**Solution:**

- (a) From the independent increment of BM, the probability  $p$  to pay the coupon  $\mu$  is same at every period. The probability,  $p$ , and  $q = 1 - p$  is given by

$$\begin{aligned} p &= P(S_{k\Delta t} - S_{(k-1)\Delta t} \geq -\delta) = P(\sigma B_{\Delta t} \geq -\delta) \\ &= 1 - N\left(-\frac{\delta}{\sigma\sqrt{\Delta t}}\right) = N\left(\frac{\delta}{\sigma\sqrt{\Delta t}}\right). \end{aligned}$$

The present value of the ELN is decomposed into three components:

- The coupon  $\mu$  paid at the  $k$ -th period ( $k = 1, \dots, n$ ):

$$\text{Present Value} = \mu D^k, \quad \text{Probability} = p^k$$

The expectation is given by

$$\sum_{k=1}^n \mu D^k \cdot p^k = \mu(pD) \frac{1 - (pD)^n}{1 - pD}$$

- The early terminated redemption with loss,  $(1 - L)$ , at the  $k$ -th period ( $k = 1, \dots, n$ ):

$$\text{Present Value} = (1 - L)D^k, \quad \text{Probability} = p^{k-1}q.$$

The expectation is give by

$$\sum_{k=1}^n (1 - L)D^k \cdot p^{k-1}q = (1 - L) \frac{q}{p} \sum_{k=1}^n (pD)^k = (1 - L)(qD) \frac{1 - (pD)^n}{1 - pD}$$

- The redemption of the notional \$1 at the  $n$ -th period (maturity):

$$\text{Present Value} = D^n, \quad \text{Probability} = p^n.$$

The expectation is  $(pD)^n$ .

The price  $P$  is the sum of the three expected values:

$$\begin{aligned} P &= \mu(pD) \frac{1 - (pD)^n}{1 - pD} + (1 - L)(qD) \frac{1 - (pD)^n}{1 - pD} + (pD)^n \\ &= \left(\mu p + (1 - L)q\right) D \frac{1 - (pD)^n}{1 - pD} + (pD)^n. \end{aligned}$$

- (b) The coupon  $\mu$  to satisfy  $P = 1$  is obtained as

$$\begin{aligned} \left(\mu p + (1 - L)q\right) D \frac{1 - (pD)^n}{1 - pD} + (pD)^n &= 1 \\ \mu p + (1 - L)q &= \frac{1 - pD}{D} \\ \mu &= \frac{1}{p} \left( \frac{1 - pD}{D} - (1 - L)q \right) \end{aligned}$$

Using the parameter values, the coupon should be  $\mu = 4.234\%$ . The intermediate values are

$$p = N(2) = 97.725\% \quad \text{and} \quad q = 1 - p = 2.275\%.$$

(c) When  $\sigma$  is suddenly jump to  $\sigma = 20$ , the price drops down to  $P = 0.6867$ . The loss is about 31%. The intermediate values are

$$p = N(1) = 84.134\% \quad \text{and} \quad q = 1 - p = 15.866\%.$$

## 5 Richness of Paths

1. **[An extra problem]** Derive the probability results on the running maximum and the first hitting time to the BM with the volatility  $\sigma$ . Using the scaling,  $\sigma B_t = B_{\sigma^2 t}$ , you are going to replace  $t$  with  $\sigma^2 t$ .

**Solution:** For the CDF (on both time and space) and the PDF on space, the simple replacement works.

$$P(\sigma B_t^* < x) = P(\tau_x > t) = 2N(x/\sigma\sqrt{t}) - 1.$$

$$f_{\sigma B_t^*}(x) = \frac{2}{\sigma\sqrt{t}} n\left(\frac{x}{\sigma\sqrt{t}}\right)$$

For the PDF on time, however, we need to consider the normalization because the time is scaled. The original PDF  $f_{\tau_x}(t)$  satisfies  $\int_0^\infty f_{\tau_x}(t)dt = 1$ . After the scaling,

$$\int_0^\infty f_{\tau_x}(\sigma^2 t)dt = \frac{1}{\sigma^2},$$

so the new PDF should be

$$\sigma^2 f_{\tau_x}(\sigma^2 t) = \frac{x}{\sigma t^{3/2}} n\left(\frac{x}{\sigma\sqrt{t}}\right).$$

2. **[2016ME(ASP). Maximum of a BM with drift]**

**Proposition** The maximum of a BM with drift  $\mu < 0$ ,  $B^* = \max_{0 \leq t \leq \infty} (B_t + \mu t)$ , has exponential distribution

$$P(B^* > x) = e^{2\mu x} \quad (x \geq 0)$$

- (a) Using the above proposition, prove that

$$P(B_t \leq at + b \text{ for all } t > 0) = 1 - e^{-2ab} \quad \text{for } a, b > 0$$

- (b) Using a proper change of variable, scaling of BM and etc, extend the result of (a) for BM with volatility,  $\sigma B_t$ .

**Solution:**

- (a)

$$\begin{aligned} P(B_t \leq at + b \text{ for all } t \geq 0) &= P(B_t - at \leq b \text{ for all } t \geq 0) \\ &= 1 - P(B_t - at > b \text{ for some } t \geq 0) \\ &= 1 - P(B^* > b) = 1 - e^{-2ab} \end{aligned}$$

- (b) Method 1:

$$P(\sigma B_t \leq at + b) = P\left(B_t \leq \frac{a}{\sigma}t + \frac{b}{\sigma}\right) = 1 - e^{-2ab/\sigma^2}$$

Method 2: We use  $\sigma B_t \sim B_{\sigma^2 t}$  ( $t' = \sigma^2 t$ ):

$$P(\sigma B_t \leq at + b) = P(B_{\sigma^2 t} \leq at + b) = P\left(B_{t'} \leq \frac{a}{\sigma^2} t' + b\right) = 1 - e^{-2ab/\sigma^2}$$

3. **[2018ME, Call option on maximum]** Assume that a stock price follows a BM,  $S_t = S_0 + \sigma B_t$ . As in the text book, assume that  $S_t^* = \max_{0 \leq s \leq t} S_s$ . Calculate the call option price whose payout at expiry  $t = T$  is given by the maximum value on the path

$$\max(S_T^* - K, 0) \quad \text{where} \quad K > S_0$$

Intuitively, this option should be more expensive than the regular call option whose payout is given by the final price  $S_T$ . By how much more is it more expensive? (Hint: In class and textbook, we derived the PDF of  $B_T^*$ . Properly adjust  $\sigma$ .)

**Solution:** The PDF for the maximum of BM,  $B_t^*$ , is given by

$$f(x) = \frac{2}{\sqrt{t}} n\left(\frac{x}{\sqrt{t}}\right) \quad \text{for} \quad x \geq 0$$

This is equivalent to the normal distribution,  $N(0, t)$ , defined on the positive side only (that is why factor 2 is multiplied). Therefore,  $S_T^* = S_0 + \sigma\sqrt{T}z$  where the PDF of  $z$  is  $2n(z)$  and  $z \geq 0$ . The option price is twice as expensive as that of the regular call option:

$$C(K) = 2(S_0 - K)N(d_N) + 2\sigma\sqrt{T}n(d_N) \quad \text{where} \quad d_N = \frac{S_0 - K}{\sigma\sqrt{T}}$$

4. **[2019ME, Put option on minimum]** Assume that the stock price follows a BM,  $S_t = S_0 + \sigma B_t$ . Assume that  $S_t^m = \min\{S_s : 0 \leq s \leq t\}$ . Calculate the put option price whose payout at expiry  $t = T$  is given by the minimum value along the path

$$\max(K - S_T^m, 0) \quad \text{where} \quad K < S_0$$

Intuitively, this option should be more expensive than the regular put option whose payout is given by the final price  $S_T$ . By how much is it more expensive?

**Solution:** Let  $W_t = -B_t$ , then  $W_t$  is also a standard BM. The minimum of  $B_t$  is the negative of the maximum of  $W_t$ :

$$B_t^m = \min\{B_s : 0 \leq s \leq t\} = -\max\{W_s : 0 \leq s \leq t\} = -W_t^M$$

Since the PDF for  $W_t^M$ , is given by

$$f(x) = \frac{2}{\sqrt{t}} n\left(\frac{x}{\sqrt{t}}\right) \quad \text{for} \quad x \geq 0,$$

the PDF for  $B_t^m$  is same as

$$f(x) = \frac{2}{\sqrt{t}} n\left(\frac{x}{\sqrt{t}}\right) \quad \text{for } x \leq 0.$$

because  $n(x) = n(-x)$ . This is two times the PDF for  $B_t$  defined on the negative side only. The minimum put option price is twice as expensive as that of the regular put option:

$$P(K) = 2(K - S_0)N(-d_N) + 2\sigma\sqrt{T}n(d_N) \quad \text{where} \quad d_N = \frac{S_0 - K}{\sigma\sqrt{T}}$$

5. [2016ME(ASP), Down-and-out digital option, Joint distribution of  $B_t^m$  and  $B_t$ ]

We are going to derive the price of the binary call option with knock-out (down-and-out) feature under the Bachelier model. Assume that the underlying stock follows the process  $S_t = S_0 + \sigma B_t$ . The option will pay you \$1 at the expiry  $T$  if  $S_T > K$  for a strike price  $K$  **and** the stock price  $S_t$  has never been below  $L$  for  $L < \min(S_0, K)$  anytime before the expiry,  $0 \leq t \leq T$ . In other words, this option knocks out (expires worthless) if  $S_t$  falls below  $L$  any time before the expiry  $T$ . Let the running maximum and minimum of  $B_t$

$$B_T^M = \max_{0 \leq t \leq T} B_t \quad \text{and} \quad B_T^m = \min_{0 \leq t \leq T} B_t.$$

(a) In the class (and in the textbook), we derived the joint CDF for  $B_T$  and  $B_T^M$ ,

$$P(B_T^M < v, B_T < u) = N\left(\frac{u}{\sqrt{T}}\right) - N\left(\frac{u - 2v}{\sqrt{T}}\right) \quad \text{for } v \geq \max(0, u)$$

Using this result, derive the joint CDF for BM with volatility,  $\sigma B_t$ ,

$$P(\sigma B_T^M < v, \sigma B_T < u).$$

(b) Using the symmetry that  $-\sigma B_t$  has the same distribution as  $\sigma B_t$ , drive the probability

$$P(\sigma B_T^m > v, \sigma B_T > u) \quad \text{for } v \leq \min(0, u).$$

(c) Finally find the price of the binary call option with knock-out feature? Assume that interest rate and dividend rate is zero. How much is this derivative cheaper (or more expensive) than the regular binary call option **without** knock-out feature?

**Solution:**

(a)

$$P(\sigma B_T^M < v, \sigma B_T < u) = P(B_T^M < v/\sigma, B_T < u/\sigma) = N\left(\frac{u}{\sigma\sqrt{T}}\right) - N\left(\frac{u - 2v}{\sigma\sqrt{T}}\right)$$

(b) Under the reflection,  $B_t \rightarrow -B_t$ , we get

$$(-B)_T^m = \min_{0 \leq t \leq T} (-B_t) = -\max_{0 \leq t \leq T} B_t = -B_T^M.$$



Applying the reflection to the probability,

$$\begin{aligned}
 P(\sigma B_T^m > v, \sigma B_T > u) &= P(\sigma(-B)_T^m > v, \sigma(-B_T) > u) \\
 &= P(-B_T^M > v/\sigma, -B_T > u/\sigma) \\
 &= P(B_T^M < -v/\sigma, B_T < -u/\sigma) \\
 &= N\left(\frac{-u}{\sigma\sqrt{t}}\right) - N\left(\frac{2v-u}{\sigma\sqrt{t}}\right).
 \end{aligned}$$

(c) Plug in  $K - S_0 \rightarrow u$  and  $L - S_0 \rightarrow v$  to get

$$\text{Price with Knockout} = N\left(\frac{S_0 - K}{\sigma\sqrt{t}}\right) - N\left(\frac{2L - K - S_0}{\sigma\sqrt{t}}\right)$$

The price without knockout is the first term, so the knockout feature is cheapening the price by  $N\left(\frac{2L-K-S_0}{\sigma\sqrt{t}}\right)$ .

6. **[2017HW 2-3, Bachelier knock-out (down-and-out) option]** Derive the price of down-and-out call option with knock-out strike  $L$  and option strike  $K$ . (Obviously,  $L < S_0$  and  $L < K$ ) See the derivation for up-and-out call option ([2016HW 3-3](#)) and down-and-out digital option ([2016ME\(ASP\)](#)).

**Solution:** Assume  $B_T^M = \max_{0 \leq t \leq T} B_t$  and  $B_T^m = \min_{0 \leq t \leq T} B_t$ . From textbook and class, we know

$$P(\sigma B_T^M < v, \sigma B_T < u) = P(B_T^M < v/\sigma, B_T < u/\sigma) = N\left(\frac{u}{\sigma\sqrt{T}}\right) - N\left(\frac{u-2v}{\sigma\sqrt{T}}\right),$$

where  $N(\cdot)$  is the normal distribution CDF. Using the reflection,  $B_t \rightarrow -B_t$ , we get

$$(-B)_T^m = \min_{0 \leq t \leq T} (-B_t) = -\max_{0 \leq t \leq T} B_t = -B_T^M$$

and

$$P(\sigma B_T^m > v, \sigma B_T > u) = N\left(\frac{-u}{\sigma\sqrt{T}}\right) - N\left(\frac{2v-u}{\sigma\sqrt{T}}\right).$$

As the stock price is given by  $S_T = S_0 + \sigma B_T$ ,

$$P(S_T^m > v, S_T > u) = N\left(\frac{S_0 - u}{\sigma\sqrt{T}}\right) - N\left(\frac{2v - u - S_0}{\sigma\sqrt{T}}\right).$$

The probability density function on  $u$  with the joint condition,  $\sigma B_T^m > v$  is obtained from the partial derivative w.r.t.  $u$  (with negative sign),

$$f(u) = \frac{1}{\sigma\sqrt{T}} \left( n\left(\frac{S_0 - u}{\sigma\sqrt{T}}\right) - n\left(\frac{2v - u - S_0}{\sigma\sqrt{T}}\right) \right) \quad \text{for } -\infty < v \leq u.$$

Let  $z = (u - S_0)/\sigma\sqrt{T}$ ,  $d = (S_0 - K)/\sigma\sqrt{T}$  and  $d^* = (S_0 - L)/\sigma\sqrt{T}$ . Then, the down-and-out call option price is given by

$$\begin{aligned} C(K, L) &= \int_{u=K}^{\infty} (u - K) f(u) du = \int_{z=-d}^{\infty} (S_0 - K + \sigma\sqrt{T} z) (n(z) - n(z + 2d^*)) dz \\ &= (S_0 - K)N(d) + \sigma\sqrt{T} n(d) - (S_0 - K - 2d^*\sigma\sqrt{T})N(d - 2d^*) \\ &\quad - \sigma\sqrt{T} n(d - 2d^*). \end{aligned}$$

The first two terms are exactly the regular call option price,  $C(K) = (S_0 - K)N(d) + \sigma\sqrt{T} n(d)$ . Therefore, the down-and-out option is cheaper than the regular option by  $(S_0 - K - 2d^*\sigma\sqrt{T})N(d - 2d^*) + \sigma\sqrt{T} n(d - 2d^*)$ .

We can verify two cases:

1. If  $L \rightarrow -\infty$  ( $d^* \rightarrow \infty$ ),  $C(K, L) = C(K)$  because the probability of being knocked out is zero. It is indeed the case because  $N(d - 2d^*) = n(d - 2d^*) = 0$ .
2. If  $L \rightarrow S_0$  from below ( $d^* \rightarrow 0$ ) on the other hand, the knock-out probability approaches to 100%, so the price should be zero. This is also the case from the formula.

7. [2016HW 3-3, Bachelier knock-out (up-and-out) option]

Using the joint distribution of  $B_t$  and  $B_t^* = \max_{0 \leq s \leq t} B_s$ , derive the price of the call option struck at  $K$  and knock-out at  $H$  ( $> K$ ). First, generalize the joint CDF function  $P(u < B_t, v < B_t^*)$  to  $\sigma B_t$ . Next, derive the pdf on  $u$  by taking derivative on  $u$ . Then, integrate the payoff  $(S_T - K)^+$  from  $K$  to  $H$ . (Assume  $r = q = 0$ . Otherwise the problem is too complicated.)

**Solution:**

$$\begin{aligned} P(S_T^* < v, S_T < u) &= P(\sigma B_T^* < v - S_0, \sigma B_T < u - S_0) \\ &= P(B_T^* < (v - S_0)/\sigma, B_T < (u - S_0)/\sigma) \\ &= N\left(\frac{u - S_0}{\sigma\sqrt{T}}\right) - N\left(\frac{u - 2v + S_0}{\sigma\sqrt{T}}\right) \end{aligned}$$

The probability density function on  $u$  conditional on  $S_T^* < H$  is obtained from the partial derivative w.r.t.  $u$ ,

$$f(u) = \frac{1}{\sigma\sqrt{T}} \left( n\left(\frac{u - S_0}{\sigma\sqrt{T}}\right) - n\left(\frac{u - 2H + S_0}{\sigma\sqrt{T}}\right) \right) \quad \text{for } -\infty < u \leq v$$

With variables,  $z = (u - S_0)/\sigma\sqrt{T}$ ,  $d = (S_0 - K)/\sigma\sqrt{T}$ ,  $d^* = (S_0 - H)/\sigma\sqrt{T}$ , the

knock-out call option price is given by

$$\begin{aligned}
C(K, H) &= \int_K^H (u - K) f(u) du = \int_{-d}^{-d^*} (S_0 - K + \sigma\sqrt{T}z) (n(z) - n(z + 2d^*)) dz \\
&= (S_0 - K) \int_{-d}^{-d^*} (n(z) - n(z + 2d^*)) dz \\
&\quad + \sigma\sqrt{T} \int_{-d}^{-d^*} (zn(z) - (z + 2d^*)n(z + 2d^*) + 2d^*n(z + 2d^*)) dz \\
&= (S_0 - K) (N(-d^*) - N(-d) - N(d^*) + N(-d + 2d^*)) + \sigma\sqrt{T} \left( -n(-d^*) \right. \\
&\quad \left. + n(-d) + n(d^*) - n(-d + 2d^*) + 2d^*N(d^*) - 2d^*N(-d + 2d^*) \right) \\
&= (S_0 - K) (N(d) - 2N(d^*) + N(2d^* - d)) \\
&\quad + \sigma\sqrt{T} (n(d) - n(2d^* - d) + 2d^*N(d^*) - 2d^*N(2d^* - d))
\end{aligned}$$

We can verify two trivial cases:

1. If  $K = H$  ( $d = d^*$ ), the option price should be zero

$$C(K, H = K) = 0.$$

2. If  $H = \infty$  ( $d^* = -\infty$ ), the price is same as the price of the regular call option

$$C(K, H = \infty) = (S_0 - K)N(d) + \sigma\sqrt{T}n(d).$$

We also note that the difference in the prices of the knock-out option and the regular option is given by

$$C(K) - C(K, H) = (S_0 - K)(2N(d^*) - N(2d^* - d)) + \sigma\sqrt{T}(n(2d^* - d) - 2d^*N(d^*) + 2d^*N(2d^* - d)).$$

8. **[2019ME, First hitting time of a BM with drift]** From SCFA Chapter 5, we derived that the probability density of the first-hitting time  $\tau$  to the level  $\delta > 0$  is given by

$$f_\tau(t) = \frac{\delta}{\sqrt{2\pi t^3}} e^{-\delta^2/2t} = \frac{\delta}{\sqrt{t^3}} n\left(\frac{\delta}{\sqrt{t}}\right). \quad (1)$$

We also know from **Hitting time of a level** in Chapter 4.5 that the Laplace transform of  $\tau$  is given by

$$E(e^{-r\tau}) = e^{-\delta\sqrt{2r}}$$

and that the result is interpreted as the present value (discounted with the interest rate  $r$ ) of a derivative paying \$1 at the event. We are going to generalize the result to the first hitting time of a drifted BM,  $B_t + \gamma t$  ( $\gamma > 0$ ). The probability density for  $\tau$ ,

$$\tau = \min\{t : B_t + \gamma t = \delta\} \quad (\delta > 0)$$

is given by

$$f_{\tau}(t) = \frac{\delta}{\sqrt{2\pi t^3}} \exp\left(-\frac{(\gamma t - \delta)^2}{2t}\right) = \frac{\delta}{\sqrt{t^3}} n\left(\frac{\delta - \gamma t}{\sqrt{t}}\right), \quad (2)$$

and you can use this result without proof.

- (a) What is the price of the derivative,  $E(e^{-r\tau})$  ?

**Hint:** Consider the Laplace transform of Eq. (1).

- (b) Obtain the mean and variance of  $\tau$ ,  $E(\tau)$  and  $\text{Var}(\tau)$ .

**Hint:** if  $L(r) = E(e^{-r\tau})$  is the Laplace transform of  $\tau$ ,  $L(-r)$  is the moment generating function because  $L(-r) = E(e^{r\tau})$ .

- (c) We further generalize the results to derivative pricing. Assume that a stock follows the process,  $S_t = S_0 + \mu t + \sigma B_t$  and the derivative pays \$1 when  $S_t$  hits  $K$  ( $> S_0$ ) for the first time, i.e.,  $S_{\tau} = K$ . What is the price of the derivative at  $t = 0$ ? (Modify the result from (a).) Assume that you sold the derivative to clients and that you need to hedge the position using the underlying stock. How many shares of the underlying stock do you need to long or short?

- (d) From class we know that the CDF for Eq. (1) is

$$P(\tau \leq t) = 2 - 2N(\delta/\sqrt{t}),$$

where  $N(\cdot)$  is the normal cumulative distribution function. Can you derive the CDF for the generalized density function, Eq. (2)? (This question might be challenging. Try it only when you have extra time.)

**Solution:** The distribution of  $\tau$ , Eq. (2), is known as the inverse Gaussian distribution ([WIKIPEDIA](#)). The inverse Gaussian distribution is typically parameterized by  $\mu$  and  $\lambda$ :

$$f_{\tau}(t) = \sqrt{\frac{\lambda}{2\pi t^3}} \exp\left(-\frac{\lambda(t - \mu)^2}{2\mu^2 t}\right).$$

The parameters  $(\mu, \lambda)$  are related to our parameters  $(\gamma, \delta)$  by

$$\mu = \delta/\gamma, \quad \lambda = \delta^2.$$

Any established results for the inverse Gaussian distribution can be expressed in terms of  $(\gamma, \delta)$  using the above formula. The distribution is called *inverse* Gaussian because it describes the (first-hitting) time of BM at a fixed location, whereas the Gaussian distribution describes the location at a fixed time. The answers to this problem is well-known properties of the inverse Gaussian distribution. But we can derive the solution from the knowledge obtained in class except (d).

- (a) The density function, Eq. (1) and its Laplace transform are expressed as

$$E(e^{-r\tau}) = \int_{t=0}^{\infty} e^{-rt} f_{\tau}(t) dt = \int_{t=0}^{\infty} \frac{\delta}{\sqrt{2\pi t^3}} \exp\left(-\frac{\delta^2}{2t} - rt\right) dt = e^{-\delta\sqrt{2r}}$$

Based on this, we can derive the Laplace transform of Eq. (2):

$$\begin{aligned}
E(e^{-r\tau}) &= \int_{t=0}^{\infty} \frac{\delta}{\sqrt{2\pi t^3}} \exp\left(-\frac{(\gamma t - \delta)^2}{2t} - rt\right) dt \\
&= \int_{t=0}^{\infty} \frac{\delta e^{\gamma\delta}}{\sqrt{2\pi t^3}} \exp\left(-\frac{\delta^2}{2t} - \left(r + \frac{\gamma^2}{2}\right)t\right) dt \\
&= \int_{t=0}^{\infty} \frac{\delta e^{\gamma\delta}}{\sqrt{2\pi t^3}} \exp\left(-\frac{\delta^2}{2t} - r't\right) dt \quad \left(r' = r + \frac{\gamma^2}{2}\right) \\
&= \exp\left(\gamma\delta - \delta\sqrt{2r'}\right) \\
&= \exp\left(\gamma\delta \left(1 - \sqrt{1 + 2r/\gamma^2}\right)\right).
\end{aligned}$$

(b) From Taylor's expansion,

$$1 - \sqrt{1 + \frac{2r}{\gamma^2}} = 1 - \left(1 + \frac{r}{\gamma^2} - \frac{r^2}{2\gamma^4} + \dots\right) = -\frac{r}{\gamma^2} + \frac{r^2}{2\gamma^4} + \dots,$$

the Laplace transform is expanded into

$$E(e^{-r\tau}) = 1 + \gamma\delta \left(-\frac{r}{\gamma^2} + \frac{r^2}{2\gamma^4} + \dots\right) + \frac{1}{2} \left(\frac{\delta^2}{\gamma^2} r^2 + \dots\right) + \dots.$$

Therefore, the first two moments and the variance are given by

$$M_1 = \frac{\delta}{\gamma}, \quad M_2 = \frac{\delta}{\gamma^3} + \frac{\delta^2}{\gamma^2}, \quad \text{Var} = \frac{\delta}{\gamma^3}.$$

(c) From

$$S_\tau = S_0 + \mu\tau + \sigma B_\tau = K \implies (\mu/\sigma)\tau + B_\tau = (K - S_0)/\sigma,$$

we can use

$$\delta = \frac{K - S_0}{\sigma}, \quad \gamma = \frac{\mu}{\sigma}.$$

From the result of (a),

$$P = E(e^{-r\tau}) = \exp\left(\frac{\mu(K - S_0)}{\sigma^2} \left(1 - \sqrt{1 + \frac{2r\sigma^2}{\mu^2}}\right)\right)$$

The amount of the underlying stock to hold for hedging the position is given by

$$\frac{\partial P}{\partial S_0} = -\frac{\mu}{\sigma^2} \left(1 - \sqrt{1 + \frac{2r\sigma^2}{\mu^2}}\right) \exp\left(\frac{\mu(K - S_0)}{\sigma^2} \left(1 - \sqrt{1 + \frac{2r\sigma^2}{\mu^2}}\right)\right)$$

(d) The CDF of the inverse Gaussian distribution is give by

$$F(t) = N\left(\gamma\sqrt{t} - \frac{\delta}{\sqrt{t}}\right) + e^{2\gamma\delta} N\left(-\gamma\sqrt{t} - \frac{\delta}{\sqrt{t}}\right).$$

This CDF was originally found by

Shuster, J. (1968). On the inverse Gaussian distribution function. *Journal of the American Statistical Association*, 63(324), 1514–1516.  
<https://doi.org/10.1080/01621459.1968.10480942>

It can be also derived using Girsanov theorem in Chapter 13.

When  $\gamma = 0$ , the CDF  $F(t)$  is reduced to the case we learned in class:

$$F(t) = P(\tau \leq t) = N\left(-\frac{\delta}{\sqrt{t}}\right) + N\left(-\frac{\delta}{\sqrt{t}}\right) = 2 - 2N\left(\frac{\delta}{\sqrt{t}}\right)$$

## 6 Itô Integration

### 1. [SCFA 6.1]

**Solution:** The mean of the two expressions are zero.

$$\text{Var} \left( \int_0^t |B_s|^{\frac{1}{2}} dB_s \right) = E \left( \int_0^t |B_s| ds \right) = \int_0^t E(|B_s|) ds = \int_0^t \sqrt{\frac{2s}{\pi}} ds = \frac{2}{3} \sqrt{\frac{2}{\pi}} t^{\frac{3}{2}}$$

$$\begin{aligned} \text{Var} \left( \int_0^t (B_s + s)^2 dB_s \right) &= E \left( \int_0^t (B_s + s)^4 ds \right) \\ &= \int_0^t E(B_s^4 + 4sB_s^3 + 6s^2B_s^2 + 4s^3B_s + s^4) ds \\ &= \int_0^t (3s^2 + 0 + 6s^2 \cdot s + 0 + s^4) ds = \frac{1}{5}t^5 + \frac{3}{2}t^4 + t^3 \end{aligned}$$

### 2. [SCFA 6.2]

**Solution:** For  $I_1$ ,

$$E(I_1) = \int_0^t E(B_s) ds = \int_0^t 0 ds = 0.$$

Using Itô's lemma applied to  $sB_s$ ,  $d(sB_s) = sdB_s + B_s ds$ , we can express  $I_1$  as

$$I_1 = tB_t - \int_0^t s dB_s = t \int_0^t dB_s - \int_0^t s dB_s = \int_0^t (t - s) dB_s,$$

where we used a trick of  $B_t = \int_0^t dB_s$  in order to make the expression suitable for Ito's isometry. We get

$$\text{Var}(I_1) = \int_0^t (t - s)^2 ds = \frac{1}{3}t^3$$

For  $I_2$ ,

$$E(I_2) = \int_0^t E(B_s^2) ds = \int_0^t s ds = \frac{t^2}{2}.$$

Using Itô's lemma applied to  $sB_s^2$ ,  $d(sB_s^2) = B_s^2 ds + 2sB_s dB_s + s ds$ , we can express  $I_2$  as

$$I_2 = tB_t^2 - 2 \int_0^t s B_s dB_s - \frac{t^2}{2}.$$

We apply a similar trick,  $d(B_s^2) = 2B_s dB_s + ds$ , to replace  $B_t^2$  with a more suitable expression for Itô's isometry,

$$I_2 = t \left( 2 \int_0^t B_s dB_s + t \right) - 2 \int_0^t s B_s dB_s - \frac{t^2}{2} = 2 \int_0^t (t - s) B_s dB_s + \frac{t^2}{2},$$

where we can reconfirm that  $E(I_2) = t^2/2$ . Finally,

$$\text{Var}(I_2) = E\left(\left(I_2 - \frac{t^2}{2}\right)^2\right) = 4 \int_0^t E\left((t-s)^2 B_s^2\right) ds = 4 \int_0^t (t-s)^2 s ds = 4 \cdot \frac{t^4}{12} = \frac{t^4}{3}$$

### 3. [SCFA 6.3]

**Solution:** At any time  $s$ ,  $X_s$  and  $B_s$  has the same distribution, normal distribution with mean 0 and variance  $s$ , so  $E(f(B_s)) = E(f(X_s))$  and

$$E(U_t) = \int_0^t E(f(B_s)) ds = \int_0^t E(f(X_s)) ds = E(V_t)$$

For variance, simply let  $f(x) = x$ . Using that  $V_t = \int_0^t \sqrt{s} Z ds = \frac{2}{3} t^{\frac{3}{2}} Z$ ,

$$\text{Var}(V_t) = \frac{4}{9} t^3.$$

According to SCFA 6.2, however,

$$\text{Var}(U_t) = \frac{1}{3} t^3 \neq \text{Var}(V_t).$$

### 4. [2016HW 4-1, Itô's isometry] Find the mean and variance of the following stochastic integral

$$Y_t = \int_0^t e^{B_s} dB_s$$

**Solution:** The mean is zero because an Itô's integral is a martingale. Alternatively, it is because  $dY_t = e^{B_t} dB_t$  has no drift term (i.e.,  $dt$ ). The variance can be calculated using Itô's isometry:

$$\text{Var}(Y_t) = E\left[\left(\int_0^t e^{B_s} dB_s\right)^2\right] = E\left[\int_0^t e^{2B_s} ds\right] = \int_0^t E(e^{2B_s}) ds = \int_0^t e^{2s} ds = \frac{1}{2}(e^{2t} - 1)$$

### 5. [2016ME(ASP), Volatility on holidays]

In the class, we covered the relation between the daily volatility  $\sigma_d$  and the annual volatility  $\sigma_y$  as

$$\sigma_y = \sqrt{256} \sigma_d = 16 \sigma_d,$$

where we assume the stock price is moving only on the 256 trading days in one year.

In this problem, we want to make it slightly more complicated. The stock price is usually more volatile on Mondays because new information, e.g., news related to the stock, economy,



etc, is accumulated over the weekend and make the price move on Monday when the stock market is open. What would be the relation between the daily volatility  $\sigma_d$  and the annual volatility  $\sigma_y$  if we assume Monday's price is 50% more volatile than the other trading days, i.e.,  $1.5\sigma_d$  on Mondays? Assume there are 52 Mondays in one year (so the rest of the trading days are  $256 - 52 = 204$ ).

**Solution:**

$$\sigma_y^2 = (204 \times 1 + 52 \times 1.5^2) \sigma_d^2 = 321 \sigma_d^2$$

Therefore,

$$\sigma_y = \sqrt{321} \sigma_d \approx 17.92 \sigma_d$$

6. **[2017ME, Exponentially decaying volatility]** Assume that a stock follows BM with time-varying volatility:

$$dS_t = \sigma(t)dB_t \quad \text{for} \quad \sigma(t) = a + be^{-\lambda t} \quad (a, b > 0)$$

What is the ATM call option price at expiry  $T$ ? What is the equivalent normal model volatility? In other words, what value of  $\sigma_N$  gives the same option price when the stock price follows  $dS_t = \sigma_N dW_t$  at  $t = T$ .

**Solution:** The variance of  $S_t$  computed as

$$\begin{aligned} \text{Var}(S_T) &= \int_0^T \sigma^2(t)dt = \int_0^T (a^2 + 2abe^{-\lambda t} + b^2 e^{-2\lambda t})dt \\ &= a^2 T + \frac{2ab}{\lambda}(1 - e^{-\lambda T}) + \frac{b^2}{2\lambda}(1 - e^{-2\lambda T}). \end{aligned}$$

The option price is given by

$$C = 0.4 \sqrt{a^2 T + \frac{2ab}{\lambda}(1 - e^{-\lambda T}) + \frac{b^2}{2\lambda}(1 - e^{-2\lambda T})}.$$

From  $\sigma_N^2 T = \text{Var}(S_T)$ ,

$$\sigma_N = \sqrt{a^2 + \frac{2ab}{\lambda T}(1 - e^{-\lambda T}) + \frac{b^2}{2\lambda T}(1 - e^{-2\lambda T})}$$

7. **[2017ME, Stochastic integral]** Assume that you follow a trading strategy based on *momentum*, where you long more stock if the stock price is up and short more if the stock price is down. If  $S_t$  is the process for the stock price, the amount you long/short is  $S_t - S_0$ .
- (a) If  $X_T$  is the profit and loss from this strategy at time  $t = T$ , express  $X_T$  using stochastic integral.
- (b) When the stock follows a BM,  $S_t = S_0 + \sigma B_t$ , what is  $X_T$ ? You may directly use the result from the class.

- (c) Imagine a scenario where the stock price goes up a lot but loses later recovering the original price,  $S_T = S_0$ . How much do you profit or lose at  $t = T$ ? Intuitively explain why you profit or lose? (The opposite is called *mean-reversion* strategy, where you long/short by  $S_0 - S_t$ .)
- (d) Calculate the variance of  $X_T$ . You can either use the result from (b) or use Itô's isometry.

**Solution:**

(a)

$$X_T = \int_0^T (S_t - S_0) dS_t$$

(b)

$$X_T = \sigma^2 \int_0^T B_t dB_t = \frac{\sigma^2}{2} (B_T^2 - T)$$

- (c) Since  $B_T = B_0 = 0$ , the momentum strategy loses by  $\sigma^2 T/2$  (where as the mean-reversion strategy profits the same amount). The strategy profits when the stock price goes up but loses when it goes down. Intuitively, loss is bigger than profit because you start from zero long position when the price is up where as you already have some short position when the price is down.

- (d) From Itô's isometry,

$$\text{Var}(X_T) = \sigma^4 \int_0^T E(B_t^2) dt = \sigma^4 \int_0^T t dt = \frac{\sigma^4}{2} T^2$$

From (b),

$$\begin{aligned} \text{Var}(X_T) &= \frac{\sigma^4}{4} \text{Var}(B_T^2 - T) = \frac{\sigma^4}{4} E(B_T^4 - 2T B_T^2 + T^2) \\ &= \frac{\sigma^4}{4} E(3T^2 - 2T \cdot T + T^2) = \frac{\sigma^4}{2} T^2 \end{aligned}$$

8. **[2018ME, Time-dependent volatility]** The at-the-money options on Meituan Dianping (IPO in September 2018 on Hong Kong stock exchange) with three-month ( $T = 1/4$ ) and one-year ( $T = 1$ ) maturities are currently trading at the prices of 4.0 and 6.4 Hong Kong dollars, respectively. Assume that the stock price follows  $dS_t = f(t) dB_t$  and that the option price can be approximated with  $0.4 \text{stdev}(S_T)$ . Find the piecewise constant instantaneous volatility  $f(t)$  that satisfies the observed option prices.

**Solution:** We need to find

$$f(t) = \begin{cases} a & \text{if } 0 \leq t \leq 0.25 \\ b & \text{if } 0.25 \leq t \end{cases}$$

For the two options,

$$4 = 0.4\sqrt{0.25 a^2}$$

$$6.4 = 0.4\sqrt{0.25 a^2 + 0.75 b^2}$$

We get  $a = 20$  and  $b = \sqrt{208} \approx 14.42$

## 7 Localization and Itô's integral

### 1. [SCFA 7.1]

**Solution:** The function  $\tau_t$  is given by

$$\tau_t = \text{Var}(B_{\tau_t}) = \text{Var}(Y_t) = \text{Var}(X_t) = \int_0^t e^{2s} ds = \frac{1}{2}(e^{2t} - 1).$$

$E(X_t^2) = E(Y_t^2)$  because

$$E(X_t^2) = \int_0^t e^{2s} ds = \frac{1}{2}(e^{2t} - 1), \quad E(Y_t^2) = \tau_t = \frac{1}{2}(e^{2t} - 1).$$

$E(X_t^4)$  and  $P(X_t \geq 1)$  are given by

$$E(X_t^4) = E(Y_t^4 = B_{\tau_t}^4) = 3\tau_t^2 = \frac{3}{4}(e^{2t} - 1)^2$$

$$P(X_t \geq 1) = P(Y_t = B_{\tau_t} \geq 1) = 1 - N(1/\sqrt{\tau_t}) = 1 - N(\sqrt{2/(e^{2t} - 1)}).$$

Note the difference between this problem and **SCFA Corollary 7.1** (time-changed BM). Given  $B_t$  is a standard BM,

$$X_t = \int_0^t f(s) dB_s, \quad \text{and} \quad \tau(t) = v = \text{Var}(X_t) = \int_0^t f^2(s) ds,$$

this exercise problem is effectively stating that  $X_t$  and  $B_{\tau(t)}$  are same processes. Whereas, the Corollary 7.1 states that  $X_{\tau^{-1}(v)}$  and  $B_v$  are same processes where  $\tau^{-1}(\cdot)$  is the inverse function of  $\tau(\cdot)$ , i.e.,  $t = \tau^{-1}(v)$ . Although they look different in forms, the intuitions behind them are same in that the variance of  $X_t$  can be used as a new *time scale* of a standard BM.

## 8 Itô's Formula

### 1. [SCFA 8.2]

**Solution:** (The notation  $h \in C^1(\mathbb{R}^+)$  means that the function  $h(s)$  is differentiable for  $s > 0$ .) From the SDE of  $h(t)B_t$ ,

$$d(h(t)B_t) = h(t)dB_t + h'(t)B_t dt$$

we get

$$\int_0^t h(s)dB_s = h(t)B_t - \int_0^t h'(s)B_s ds.$$

Using that  $B_T = \int_0^T dB_t$ , we also get another useful result:

$$\int_0^T h'(s)B_s ds = h(T)B_T - \int_0^T h(t)dB_t = \int_0^T (h(T) - h(t))dB_t$$

### 2. [SCFA 8.4] (The sub-problem (b) is understood better after [2017HW 3-2](#) is solved.)

**Solution:**

(a) If  $f(t, x) = \phi(t)\psi(x)$ , the condition  $f_t = -\frac{1}{2}f_{xx}$  yields to

$$-2\frac{\phi_t(t)}{\phi(t)} = \frac{\psi_{xx}(x)}{\psi(x)} = \lambda,$$

where  $\lambda$  is a constant. If  $\lambda > 0$  ( $\lambda = \alpha^2$  for some  $\alpha$ ), we get the GBM solution,

$$\phi(t) = \phi(0)e^{-\alpha^2 t/2} \quad \text{and} \quad \psi(x) = Ce^{\alpha x} + De^{-\alpha x} \quad \text{for some constants } C, D$$

$$M_t = (Ce^{\alpha B_t} + De^{-\alpha B_t})e^{-\alpha^2 t/2}$$

If  $\lambda < 0$  ( $\lambda = -\alpha^2$  for some  $\alpha$ ), we get

$$M_t = (C \cos(\alpha B_t) + D \sin(\alpha B_t))e^{\alpha^2 t/2}$$

If  $\lambda = 0$ , we get  $\phi(t) = \phi(0)$  and  $\psi(x) = Cx + D$ , therefore we have

$$M_t = CB_t + D.$$

(b)

$$\begin{aligned} M_t &= 1 + (\alpha B_t - \alpha^2 t/2) + \frac{1}{2}(\alpha B_t - \alpha^2 t/2)^2 + \frac{1}{6}(\alpha B_t - \alpha^2 t/2)^3 \\ &\quad + \frac{1}{24}(\alpha B_t - \alpha^2 t/2)^4 + \dots \\ &= 1 + (B_t)\alpha + \frac{1}{2}(B_t^2 - t)\alpha^2 + \frac{1}{6}(B_t^3 - 3tB_t)\alpha^3 + \frac{1}{24}(B_t^4 - 6tB_t^2 + 3t^2)\alpha^4 + \dots \end{aligned}$$

We get the first five martingales as below:

$$\begin{aligned}H_0(t, B_t) &= 1 \\H_1(t, B_t) &= B_t \\H_2(t, B_t) &= \frac{1}{2}(B_t^2 - t) \\H_3(t, B_t) &= \frac{1}{6}(B_t^3 - 3tB_t) \\H_4(t, B_t) &= \frac{1}{24}(B_t^4 - 6tB_t^2 + 3t^2).\end{aligned}$$

3. **[2016HW 4-3. SDE]** For the following functions  $f(t, x)$ , find the stochastic differential equation (SDE) of the stochastic process  $Y_t = f(t, B_t)$  where  $B_t$  is a standard BM. If  $f(x) = x^2$ , for example, the SDE is

$$dY_t = df(B_t) = d B_t^2 = 2B_t dB_t + dt.$$

- (a)  $f(t, x) = x^3 - 3tx$   
(b)  $f(t, x) = e^{t/2} \sin(x)$

**Solution:** The function  $f(t, x)$  was constructed in such a way that  $dY_t = df(t, B_t)$  becomes a martingale.

(a)

$$df(t, x = B_t) = (3x^2 - 3t)dB_t + \frac{1}{2}(6x)(dB_t)^2 - 3xdt = 3(B_t^2 - t)dB_t$$

(b)

$$\begin{aligned}df(t, x = B_t) &= e^{t/2} \cos(x)dB_t - \frac{1}{2}e^{t/2} \sin(x)(dB_t)^2 + \frac{1}{2}e^{t/2} \cos(x)dt \\&= e^{t/2} \cos(B_t)dB_t\end{aligned}$$

4. **[2017HW 3-2]** For a standard BM  $B_t$ , let

$$N_t = B_t^3 - 3t B_t.$$

- (i) Prove that  $N_t$  is a martingale. (Hint: use **SCFA Proposition 8.1**) (ii) By applying Itô's lemma, express  $N_t$  as a stochastic integration. (iii) Calculate the variance of  $N_t$ .

**Solution:** We set  $N_t = f(t, B_t)$  where  $f(t, x) = x^3 - 3tx$ . Applying Itô's lemma,

$$dN_t = 3(B_t^2 - t)dB_t + 3B_t(dB_t)^2 - 3B_tdt = 3(B_t^2 - t)dB_t$$

As there is no drift term,  $N_t$  is a martingale and is represented as a stochastic integral:

$$N_t = \int_0^t 3(B_s^2 - s)dB_s.$$

The variance is calculated as

$$\begin{aligned}\text{Var}(N_t) &= \int_0^t E[3^2(B_s^2 - s)^2]ds = 9 \int_0^t (E(B_s^4) - 2sE(B_s^2) + s^2)ds \\ &= 9 \int_0^t (3s^2 - 2s^2 + s^2)ds = 6t^2\end{aligned}$$

5. **[2016ME(ASP), Itô's calculus]** Which of the following quantity is same as  $(dB_t)^2$  ?  
 A.  $\sqrt{dt}$  B.  $dt$  C.  $dt/2$  D.  $(dt)^2/2$

**Solution:** B.

6. **[2016FE, Stochastic calculus]** Find **all** surviving terms in stochastic calculus  
 (a)  $dB_t \cdot dt$   
 (b)  $(dB_t)^2$   
 (c)  $dx \cdot dt$   
 (d)  $dB_t^1 \cdot dB_t^2$  for the two independent BMs,  $B_t^1$  and  $B_t^2$

**Solution:** (b)  $(dB_t)^2 = dt$

7. **[2017FE, Stochastic calculus]** Give **True or False**.  
 (a)  $(dB_t)^2 = dt$   
 (b)  $(dB_t)^4 = (dt)^2$   
 (c)  $d(B_t^2) = 2(B_t dB_t + dt)$   
 (d)  $d \sinh(B_t) = \cosh(B_t)dB_t + \frac{1}{2} \sinh(B_t)dt$  where  $\cosh x = \frac{1}{2}(e^x + e^{-x})$  and  $\sinh x = \frac{1}{2}(e^x - e^{-x})$

**Solution:**

- (a) True.  $(dB_t)^2 = dt$ .  
 (b) False.  $(dB_t)^4 = 3(dt)^2$  from  $E(B_t^4) = 3t^2$ .  
 (c) False.  $d(B_t^2) = 2B_t dB_t + dt$   
 (d) True.  $d \sinh(B_t) = \cosh(B_t)dB_t + \frac{1}{2} \sinh(B_t)dt$  since  $\sinh'(x) = \cosh(x)$  and  $\sinh''(x) = \sinh(x)$ .

8. **[2018FE, Stochastic calculus]** Choose **all** surviving terms (i.e., non-zero terms) in stochastic calculus. Assume that  $dX_t = \mu(t, X_t)dt + \sigma(t, X_t)dB_t$  for some functions  $\mu$  and  $\sigma$ .

- (a)  $dX_t \cdot dt$
- (b)  $(dX_t)^2$
- (c)  $dX_t \cdot dB_t$
- (d)  $dB_t^1 \cdot dB_t^2$  for the two independent BMs,  $B_t^1$  and  $B_t^2$

**Solution:** (b)  $(dX_t)^2 = \sigma(t, X_t)^2 dt$  and (c)  $dX_t \cdot dB_t = \sigma(t, X_t) dt$

9. [2018FE, Itô's lemma] The stochastic variance in Heston model is given by

$$dV_t = \alpha(V_\infty - V_t)dt + \sigma\sqrt{V_t}dB_t.$$

This process is also known as Cox-Ingersoll-Ross(CIR) model for stochastic interest rate. Additionally, the stochastic variance under the 3/2 model is also given by

$$dV_t = \lambda V_t(V_\infty - V_t)dt + \xi V_t\sqrt{V_t}dB_t.$$

- (a) Derive  $E(V_t | \mathcal{F}_0)$  under the Heston model. (Hint: The transformation,  $y_t = e^{\alpha t}(V_t - V_\infty)$ , used in the Ornstein-Uhlenbeck process is also useful in this problem. Then, use the martingale property.) What is  $E(V_t | \mathcal{F}_0)$  as  $t \rightarrow \infty$ .
- (b) To solve the 3/2 model, the inverse variance,  $Y_t = 1/V_t$ , is helpful. Find the SDE satisfied by  $Y_t$ .
- (c) What is  $E(1/V_t | \mathcal{F}_0)$  under the 3/2 model? (Hint: You should recognize a similarity between the SDEs for  $V_t$  under Heston model and  $Y_t$  under the 3/2 model.)

**Solution:** See Cox-Ingersoll-Ross model ([WIKIPEDIA](#)).

- (a) The transformation  $y_t$  is a martingale because

$$dy_t = \alpha e^{\alpha t}(V_t - V_\infty) + e^{\alpha t}dV_t = e^{\alpha t}\sigma\sqrt{V_t}dB_t.$$

Therefore,  $y_0 = E(y_t | \mathcal{F}_0)$ :

$$\begin{aligned} V_0 - V_\infty &= E(e^{\alpha t}(V_t - V_\infty) | \mathcal{F}_0) \\ E(V_t | \mathcal{F}_0) &= V_\infty + e^{-\alpha t}(V_0 - V_\infty) = (1 - e^{-\alpha t})V_\infty + e^{-\alpha t}V_0. \end{aligned}$$

$E(V_t | \mathcal{F}_0)$  goes to  $V_\infty$  as  $t \rightarrow \infty$ .

- (b) Applying Itô's lemma:

$$\begin{aligned} dY_t &= -(1/V_t^2)dV_t + (1/V_t^3)(dV_t)^2 \\ &= -Y_t(\lambda(V_\infty - V_t)dt + \xi\sqrt{V_t}dB_t) - Y_t^3\xi^2V_t^3dt \\ &= (\lambda + \xi^2 - \lambda V_\infty Y_t)dt - \xi\sqrt{Y_t}dB_t. \\ &= \lambda V_\infty \left( \frac{\lambda + \xi^2}{\lambda V_\infty} - Y_t \right) dt - \xi\sqrt{Y_t}dB_t. \end{aligned}$$



(c) The process  $Y_t$  follows an CIR model with the parameters,

$$\alpha = \lambda V_\infty, \quad Y_\infty = \frac{\lambda + \xi^2}{\lambda V_\infty}, \quad \sigma = -\xi$$

Therefore,

$$\begin{aligned} E(1/V_t | \mathcal{F}_0) &= E(Y_t | \mathcal{F}_0) = (1 - e^{-\alpha t})Y_\infty + e^{-\alpha t}Y_0 \\ &= \left(1 - e^{-\lambda V_\infty t}\right) \frac{\lambda + \xi^2}{\lambda V_\infty} + e^{-\lambda V_\infty t} \frac{1}{V_0} \end{aligned}$$

10. **[2019FE, Itô's lemma]** Assume that a stochastic process  $X_t$  follows

$$dX_t = \mu(t, X_t)dt + \sigma(t, X_t)dB_t$$

for some functions,  $\mu$  and  $\sigma$ . Find the stochastic differential equation (SDE) for the process  $Y_t = \exp(X_t)$ .

**Solution:** Applying, Itô's lemma,

$$\begin{aligned} dY_t &= \exp(X_t)dX_t + \frac{1}{2}\exp(X_t)(dX_t)^2 \\ &= Y_t(\mu(t, X_t)dt + \sigma(t, X_t)dB_t) + \frac{1}{2}Y_t\sigma^2(t, X_t)(dB_t)^2. \end{aligned}$$

Finally, we obtain the SDE as

$$\frac{dY_t}{Y_t} = \left(\mu(t, X_t) + \frac{1}{2}\sigma^2(t, X_t)\right)dt + \sigma(t, X_t)dB_t.$$

11. **[2016FE, Volatility of a stock denominated in difference currency]** If you invest in a stock listed in a foreign country, you are exposed to the risk of both the stock price (in the foreign currency) and the foreign exchange rate. We are going to see volatility of the value of the stock in the domestic currency. Assume that you invested in Amazon's stock (NASDAQ ticker **AMZN**, which is currently about 900 USD) and the volatility is 20%. Also assume that the volatility of the foreign exchange rate (currency code **USDCNY**,  $X \text{ CNY} = 1 \text{ USD}$ , which is 6.89 recently) and the volatility is 8%. Also assume that the correlation between the stock price change and the FX rate change is given by  $\rho$  (not necessarily independent!). The SDEs for the processes can be written as

$$\text{Stock price: } \frac{dS_t}{S_t} = r_S dt + \sigma_S dB_t^S \quad \text{where } \sigma_S = 20\%$$

$$\text{FX rate: } \frac{dF_t}{F_t} = r_F dt + \sigma_F dB_t^F \quad \text{where } \sigma_F = 8\%$$

$$\text{Correlation: } dB_t^S \cdot dB_t^F = \rho dt.$$

- (a) Derive the SDE for the stock value in CNY. That is, calculate  $d(F_t S_t)$ .

- (b) Re-write the SDE with a single BM, let's say  $B_t^{\text{FS}}$ , and find the volatility of the stock price in CNY. This is the extension of our mid-term exam problem. You need to find  $c$  such that

$$c dB_t^{\text{FS}} = a dB_t^S + b dB_t^F \quad \text{with} \quad dB_t^S \cdot dB_t^F = \rho dt$$

- (c) What is the minimum/maximum value of the combined volatility? Under which scenario?

**Solution:**

(a)

$$\begin{aligned} d(F_t S_t) &= S_t dF_t + F_t dS_t + dF_t \cdot dS_t \\ &= S_t \cdot F_t (r_F dt + \sigma_F dB_t^F) + F_t \cdot S_t (r_S dt + \sigma_S dB_t^S) + F_t dB_t^F \cdot S_t dB_t^S \\ \frac{d(F_t S_t)}{F_t S_t} &= (r_F + r_S + \rho \sigma_F \sigma_S) dt + \sigma_F dB_t^F + \sigma_S dB_t^S \end{aligned}$$

(b) Since,

$$(\sigma_F dB_t^F + \sigma_S dB_t^S)^2 = (\sigma_F^2 + \sigma_S^2 + 2\rho \sigma_F \sigma_S) dt,$$

we can re-write the SDE as

$$\frac{d(F_t S_t)}{F_t S_t} = (r_F + r_S + \rho \sigma_F \sigma_S) dt + \sqrt{\sigma_F^2 + \sigma_S^2 + 2\rho \sigma_F \sigma_S} dB_t^{\text{FS}}.$$

The volatility is

$$\sigma_{\text{FS}} = \sqrt{\sigma_F^2 + \sigma_S^2 + 2\rho \sigma_F \sigma_S}.$$

- (c) The maximum is  $20\%+8\%=28\%$  when  $\rho = 100\%$  and the minimum is  $20\%-8\%=12\%$  when  $\rho = -100\%$ .

## 9 Stochastic Differential Equations

### 1. [SCFA 9.1]

**Solution:** This is slightly modified from the OU process with the extra  $\beta dt$  term. We use the same initial guess,  $e^{\alpha t} X_t$ , for the OU process.

$$\begin{aligned} d(e^{\alpha t} X_t) &= \alpha e^{\alpha t} X_t dt + e^{\alpha t} dX_t + \frac{1}{2} 0 \cdot (dX_t)^2 \\ &= e^{\alpha t} (\alpha X_t dt - \alpha X_t dt + \beta dt) + \sigma e^{\alpha t} dB_t \\ &= \beta e^{\alpha t} dt + \sigma e^{\alpha t} dB_t. \end{aligned}$$

Therefore, we get

$$\begin{aligned} e^{\alpha t} X_t - x_0 &= \frac{\beta}{\alpha} (e^{\alpha t} - 1) + \sigma \int_0^t e^{\alpha s} dB_s \\ X_t &= e^{-\alpha t} x_0 + \frac{\beta}{\alpha} (1 - e^{-\alpha t}) + \sigma e^{-\alpha t} \int_0^t e^{\alpha s} dB_s. \end{aligned}$$

### 2. [SCFA 9.2]

**Solution:** We first guess from the traditional calculus. We let  $x = X_t$  and solve

$$e^{-t^2/2} dx = t x e^{-t^2/2} \Rightarrow \frac{dx}{x} = -t dt$$

Luckily we can solve this to have  $x = C e^{t^2/2}$  or  $e^{-t^2/2} x = C$  for some constant  $C$ , so we stochastically differentiate  $e^{-t^2/2} X_t$  to get

$$d(e^{-t^2/2} X_t) = -t e^{-t^2/2} X_t dt + e^{-t^2/2} (t X_t dt + e^{t^2/2} dB_t) = dB_t.$$

We can solve the SDE as

$$e^{-t^2/2} X_t - X_0 = B_t \Rightarrow X_t = e^{t^2/2} (B_t + X_0).$$

### 3. [SCFA 9.3]

**Solution:** The guess from the traditional calculus is

$$\frac{dx}{x} = \frac{-2}{1-t} dt \Rightarrow x = C(1-t)^2.$$

Therefore we start by differentiating  $(1-t)^{-2} X_t$ :

$$d\left(\frac{X_t}{(1-t)^2}\right) = 2 \frac{X_t}{(1-t)^3} dt + \frac{1}{(1-t)^2} \left(-2 \frac{X_t}{1-t} dt + \sqrt{2t(1-t)} dB_t\right) = \frac{\sqrt{2t}}{(1-t)^{3/2}} dB_t$$

and finally solve the SDE as

$$X_t = (1-t)^2 \int_0^t \frac{\sqrt{2u}}{(1-u)^{3/2}} dB_u.$$

Since the integrand  $\sqrt{2u}(1-u)^{-3/2}$  depends only on the time variable  $u$ ,  $X_t$  is a Gaussian process with the variance

$$\begin{aligned} \text{Var}(X_t) &= (1-t)^4 \int_0^t \frac{2u}{(1-u)^3} du = (1-t)^4 \int_{1-t}^1 \frac{2(1-u')}{u'^3} du' \quad (u' = 1-u) \\ &= (1-t)^4 \left( 1 - \frac{2}{1-t} + \frac{1}{(1-t)^2} \right) = (1-t)^4 \frac{t^2}{(1-t)^2} = t^2(1-t)^2 \end{aligned}$$

The covariance can be obtained similarly. Assuming that  $s < t$ ,

$$\begin{aligned} \text{Cov}(X_s, X_t) &= E(X_s X_t) = (1-s)^2(1-t)^2 E \left[ \int_0^s \frac{\sqrt{2u}}{(1-u)^{3/2}} dB_u \int_0^t \frac{\sqrt{2v}}{(1-v)^{3/2}} dB_v \right] \\ &= (1-s)^2(1-t)^2 E \left[ \left( \int_0^s \frac{\sqrt{2u}}{(1-u)^{3/2}} dB_u \right)^2 \right] \\ &= (1-s)^2(1-t)^2 \cdot \frac{s^2}{(1-s)^2} = s^2(1-t)^2. \end{aligned}$$

The covariance is square of that of the Brownian bridge  $\text{Cov}(X_s, X_t) = s(1-t)$ .

#### 4. [SCFA 9.6]

**Solution:** We first derive the mean and the variance of lognormal distribution,  $Y \sim \exp(\mu + \sigma Z)$ , where  $Z$  is a standard normal (see the same result at ([WIKIPEDIA](#))):

$$E(Y) = e^{\mu + \sigma^2/2}$$

and

$$\begin{aligned} \text{Var}(Y) &= e^{2\mu} E((e^{\sigma Z} - e^{\sigma^2/2})^2) = e^{2\mu} E(e^{2\sigma Z} - 2e^{\sigma Z + \sigma^2/2} + e^{\sigma^2}) \\ &= e^{2\mu} (e^{2\sigma^2} - 2e^{\sigma^2} + e^{\sigma^2}) = e^{2\mu + \sigma^2} (e^{\sigma^2} - 1). \end{aligned}$$

Back to the problem, for  $t = kh$  and  $s = (k-1)h$ ,

$$R_k(h) + 1 = \frac{X_t}{X_s} = \exp \left( \left( \mu - \frac{\sigma^2}{2} \right) h + \sigma(B_t - B_s) \right) = \exp \left( \left( \mu - \frac{\sigma^2}{2} \right) h + \sigma\sqrt{h}Z \right),$$

where  $Z$  is standard normal distribution. Since  $R_k(h) + 1$  is a lognormal distribution with  $\mu := (\mu - \sigma^2/2)h$  and  $\sigma := \sigma\sqrt{h}$ , we obtain the mean and the variance of  $R_k(h) + 1$

as

$$E(R_k(h) + 1) = \exp\left(\left(\mu - \frac{\sigma^2}{2}\right)h + \frac{\sigma^2}{2}h\right) = e^{\mu h}$$

$$\text{Var}(R_k(h) + 1) = e^{2\mu h}(e^{\sigma^2 h} - 1).$$

Therefore,

$$E(R_k(h)) = e^{\mu h} - 1 \quad \text{and} \quad \text{Var}(R_k(h)) = e^{2\mu h}(e^{\sigma^2 h} - 1)$$

and it follows that

$$\text{Var}(R_k(h)) = (1 + E(R_k(h)))^2(e^{\sigma^2 h} - 1)$$

$$\sigma^2 = \frac{1}{h} \log\left(1 + \frac{\text{Var}(R_k(h))}{(1 + E(R_k(h)))^2}\right).$$

From sample data, we can estimate the mean and the variance as

$$E(R_k(h)) = \frac{1}{n} \sum_{k=1}^n R_k(h), \quad \text{Var}(R_k(h)) = \frac{1}{n-1} \sum_{k=1}^n (R_k(h) - E(R_k(h)))^2.$$

Below are the  $s$  and  $\sigma$  values for various values of  $E(R_k(h))$  and  $\text{Stdev}(R_k(h))$ :

(All numbers are in the unit of %.  $h = 1/12$ .)

Stdev( $R_k(h)$ ) $\rightarrow$		5	10	15	20	25
$E(R_k(h))$	$s$	17.3	34.6	52.0	69.3	86.6
-2	$\sigma$	17.7	35.3	52.7	70.0	87.0
0		17.3	34.6	51.7	68.6	85.3
2		17.0	33.9	50.7	67.3	83.7
4		16.6	33.2	49.7	66.0	82.1
6		16.3	32.6	48.8	64.8	80.6

The values of  $s$  and  $\sigma$  are not significantly different unless the average return  $E(R_k(h))$  is high.

5. [2018HW 3-4, Exponential Ornstein-Uhlenbeck process] Solve the following SDE:

$$\frac{dP_t}{P_t} = \alpha(\mu - \log P_t)dt + \sigma dB_t.$$

What are  $E(P_t)$  and  $\text{Var}(P_t)$  as  $t \rightarrow \infty$ ? (Hint: use  $X_t = \log P_t$ .)

**Solution:** The SDE for  $X_t$  satisfies

$$dX_t = \frac{dP_t}{P_t} - \frac{(dP_t)^2}{2P_t^2} = \alpha\left(\mu - \frac{\sigma^2}{2\alpha} - X_t\right)dt + \sigma dB_t.$$

This is the Ornstein-Uhlenbeck with  $X_\infty = \mu - \frac{\sigma^2}{2\alpha}$ . Therefore,

$$X_t = X_\infty + e^{-\alpha t}(X_0 - X_\infty) + \frac{\sigma e^{-\alpha t}}{\sqrt{2\alpha}} B_{e^{2\alpha t}-1}$$

$$\log P_t = \mu - \frac{\sigma^2}{2\alpha} + e^{-\alpha t} \left( \log P_0 - \mu + \frac{\sigma^2}{2\alpha} \right) + \frac{\sigma e^{-\alpha t}}{\sqrt{2\alpha}} B_{e^{2\alpha t}-1}.$$

The mean and variance as  $t \rightarrow \infty$  are given by

$$E(X_t) = X_\infty = \mu - \frac{\sigma^2}{2\alpha}, \quad \text{Var}(X_t) = \frac{\sigma^2}{2\alpha}.$$

For  $P_t$ , we apply the properties of the lognormal distributions:

$$E(P_t) = \exp \left( X_\infty + \frac{1}{2} \text{Var}(X_t) \right) = \exp \left( \mu - \frac{\sigma^2}{4\alpha} \right).$$

$$\text{Var}(P_t) = \left( \exp \left( \frac{\sigma^2}{2\alpha} \right) - 1 \right) \exp \left( 2\mu - \frac{\sigma^2}{2\alpha} \right) = \left( 1 - \exp \left( -\frac{\sigma^2}{2\alpha} \right) \right) e^{2\mu}$$

6. [2016ME(ASP), SDE modified from SCFA 9.2] Solve the SDE for the starting value  $X_0$

$$dX_t = -t X_t dt + \sigma e^{-t^2/2} dB_t.$$

What is the mean and the variance of the process when  $t \rightarrow \infty$ ?

**Solution:** From  $e^{t^2/2}(dx + tdx) = d(e^{t^2/2}x)$ , we apply Itô's lemma to our initial guess of  $e^{t^2/2}X_t$ ;

$$d(e^{t^2/2}X_t) = te^{t^2/2}X_t dt + e^{t^2/2}dX_t = e^{t^2/2}(tX_t dt + dX_t) = \sigma dB_t$$

$$e^{t^2/2}X_t - X_0 = \sigma B_t$$

$$X_t = e^{-t^2/2}(X_0 + \sigma B_t),$$

$$E(X_t) = e^{-t^2/2}X_0 \rightarrow 0 \text{ as } t \rightarrow \infty$$

$$\text{Var}(X_t) = e^{-t^2} \sigma^2 t \rightarrow 0 \text{ as } t \rightarrow \infty$$

7. [2016ME(ASP), SDE between normal and lognormal] Solve the SDE for the starting value  $X_0$  and  $0 < \beta < 1$ ,

$$\frac{dX_t}{X_t^\beta} = \sigma dB_t + \frac{\sigma^2 \beta}{2} X_t^{\beta-1} dt$$

**Solution:** We apply Itô's lemma to  $X_t^{1-\beta}$ ,

$$\begin{aligned} d(X_t^{1-\beta}) &= (1-\beta)X_t^{-\beta}dX_t - \frac{1}{2}(1-\beta)X_t^{-1-\beta}\beta(dX_t)^2 \\ &= (1-\beta)X_t^{-\beta}dX_t - \frac{1}{2}(1-\beta)\beta X_t^{-1-\beta} \cdot X_t^{2\beta}\sigma^2 dt \\ &= (1-\beta)\left(\sigma dB_t + \frac{\sigma^2\beta}{2}X_t^{\beta-1}dt\right) - \frac{1}{2}(1-\beta)\beta X_t^{-1-\beta}(X_t^\beta\sigma)^2 dt \\ &= (1-\beta)\sigma dB_t. \end{aligned}$$

Therefore,

$$\begin{aligned} X_t^{1-\beta} &= X_0^{1-\beta} + (1-\beta)\sigma B_t \\ X_t &= \left(X_0^{1-\beta} + (1-\beta)\sigma B_t\right)^{1/(1-\beta)}. \end{aligned}$$

8. [2016FE, Solving SDE] Solve the modified Cox-Ingersoll-Ross (CIR) model.

$$dX_t = \frac{\sigma^2}{4}dt + \sigma\sqrt{X_t}dB_t.$$

The original CIR model has the drift term  $a(b - X_t)dt$  instead of  $(\sigma^2/4)dt$  and was originally proposed for the movements of interest rates.

**Solution:** First we remove  $\sqrt{X_t}$  from the coefficient of  $dB_t$

$$\frac{dX_t}{\sqrt{X_t}} = \frac{\sigma^2}{4\sqrt{X_t}}dt + \sigma dB_t$$

and we solve either  $dx/\sqrt{x}$  or  $dx/\sqrt{x} = \sigma^2 dt/(4\sqrt{x})$  for our guess. It turns out that the first candidate  $dx/\sqrt{x}$  works. Since  $\int dx/\sqrt{x} = 2\sqrt{x}$ ,

$$\begin{aligned} d\left(2\sqrt{X_t}\right) &= \frac{dX_t}{\sqrt{X_t}} - \frac{(dX_t)^2}{4X_t\sqrt{X_t}} = \frac{\sigma^2}{4\sqrt{X_t}}dt + \sigma dB_t - \frac{\sigma^2 X_t}{4X_t\sqrt{X_t}}dt = \sigma dB_t \\ 2\sqrt{X_t} - 2\sqrt{X_0} &= \sigma B_t \quad \Rightarrow \quad X_t = \left(\sqrt{X_0} + \frac{\sigma B_t}{2}\right)^2 \end{aligned}$$

9. [2017FE, Solving SDE] Solve the modified “3/2” volatility process defined by

$$dV_t = \frac{3\sigma^2}{4}V_t^2 dt + \sigma V_t^{3/2} dB_t.$$

The original “3/2” model has the drift term  $a(b - V_t)V_t dt$  instead of  $(3\sigma^2/4)V_t^2 dt$  and was originally proposed for a stochastic model for volatility.

**Solution:** First we remove  $\sqrt{V_t}$  from the coefficient of  $dB_t$

$$\frac{dV_t}{V_t^{3/2}} = \frac{3\sigma^2}{4}\sqrt{V_t}dt + \sigma dB_t.$$

It turns out that the first candidate  $\frac{dx}{x^{3/2}}$  works. Since  $\int \frac{dx}{x^{3/2}} = -\frac{2}{\sqrt{x}}$ ,

$$-d\left(\frac{2}{\sqrt{V_t}}\right) = \frac{dV_t}{V_t^{3/2}} - \frac{3(dV_t)^2}{4V_t^{5/2}} = \frac{3\sigma^2}{4}\sqrt{V_t}dt + \sigma dB_t - \frac{3\sigma^2}{4}\sqrt{V_t}dt = \sigma dB_t$$

$$\frac{2}{\sqrt{V_0}} - \frac{2}{\sqrt{V_t}} = \sigma B_t \quad \Rightarrow \quad V_t = \left(\frac{1}{\sqrt{V_0}} - \frac{\sigma B_t}{2}\right)^{-2}$$



## 10 Arbitrage and SDEs

1. **[2016FE, Option pricing under the BSM and normal model]** Assume that a stock's daily price change is 1.5% of the current price. What is the annual volatility of the stock under the Black-Scholes-Merton model and the normal model? What is the price of the at-the-money call option maturing in 3 months under the two models? Assume that  $S_0 = 100$ ,  $r = q = 0$  and there are 256 trading days in one year. You may use the following CDF values for the standard normal distribution  $N(z)$ .

$z$	0.02	0.04	0.06	0.08	0.10	0.12	0.14	0.16
$N(z)$	0.508	0.516	0.524	0.532	0.540	0.548	0.556	0.564

**Solution:**

$$\sigma_{BS} = 1.5\% \times \sqrt{256} = 24\%, \quad \sigma_N = 24\% \times S_0 = 24$$

Under the BSM model:

$$d_1 = \frac{\sigma_{BS} \sqrt{1/4}}{2} = 0.06, \quad d_2 = -0.06$$

$$C_0 = S_0 N(d_1) - K N(d_2) = 100 N(0.06) - 100(1 - N(0.06)) = 4.8$$

Under the normal model:

$$C_0 = 0.4 \times \sigma_N \times \sqrt{1/4} = 4.8$$

2. **[2016FE, Option delta under the BSM model]** By directly computing the derivative, show that the delta of a call option (i.e., sensitivity with respect to the underlying stock price  $S_0$ ) is

$$D = \frac{\partial C_0}{\partial S_0} = N(d_1) \quad \text{with} \quad d_1 = \frac{\log(S_0 e^{rT}/K)}{\sigma \sqrt{T}} + \frac{1}{2} \sigma \sqrt{T}.$$

Since the terms  $d_1$  and  $d_2$  are defined through  $S_0$ , you should also differentiate  $d_1$  and  $d_2$  rather than treating them as constants.

**Solution:** Using the properties,

$$\frac{\partial d_1}{\partial S_0} = \frac{\partial d_2}{\partial S_0} = \frac{1}{S_0 \sigma \sqrt{T}}$$

and

$$d_1^2 - d_2^2 = (A + B)^2 - (A - B)^2 = 4AB = 2 \log(S_0 e^{rT}/K)$$

$$\text{for } A = \frac{\log(S_0 e^{rT}/K)}{\sigma \sqrt{T}} \quad \text{and} \quad B = \frac{\sigma \sqrt{T}}{2},$$

we compute the delta as

$$\begin{aligned}
 D &= \frac{\partial}{\partial S_0} (S_0 N(d_1) - e^{-rT} K N(d_2)) \\
 &= N(d_1) + S_0 n(d_1) \frac{\partial d_1}{\partial S_0} - e^{-rT} K n(d_2) \frac{\partial d_2}{\partial S_0} \\
 &= N(d_1) + \frac{n(d_1)}{\sigma \sqrt{T}} \left( 1 - e^{(d_1^2 - d_2^2)/2} \frac{K}{S_0 e^{rT}} \right) \\
 &= N(d_1) + \frac{n(d_1)}{\sigma \sqrt{T}} \left( 1 - \frac{S_0 e^{rT}}{K} \cdot \frac{K}{S_0 e^{rT}} \right) = N(d_1).
 \end{aligned}$$

3. **[2018ME(ASP), 2019FE, Option vega under the BSM model]** Derive that the vega of a call option (i.e., sensitivity with respect to the volatility  $\sigma$ ) is

$$V = \frac{\partial C}{\partial \sigma} = S_0 n(d_1) \sqrt{T} = K e^{-rT} n(d_2) \sqrt{T}.$$

Remind that the call option price under the BSM model is

$$C = S_0 N(d_1) - e^{-rT} K N(d_2) \quad \text{where} \quad d_{1,2} = \frac{\log(S_0 e^{rT}/K)}{\sigma \sqrt{T}} \pm \frac{1}{2} \sigma \sqrt{T}$$

Since the terms  $d_1$  and  $d_2$  are implicit functions of  $\sigma$ , you should also differentiate  $d_1$  and  $d_2$ .

**Solution:** Using the following properties:

(i)

$$\frac{\partial d_{1,2}}{\partial \sigma} = -\frac{\log(S_0 e^{rT}/K)}{\sigma^2 \sqrt{T}} \pm \frac{1}{2} \sqrt{T} = -\frac{d_{2,1}}{\sigma}$$

(ii) if

$$A = \frac{\log(S_0 e^{rT}/K)}{\sigma \sqrt{T}} \quad \text{and} \quad B = \frac{\sigma \sqrt{T}}{2},$$

$$d_1^2 - d_2^2 = (A + B)^2 - (A - B)^2 = 4AB = 2 \log(S_0 e^{rT}/K) \Rightarrow \frac{n(d_2)}{n(d_1)} = \frac{S_0 e^{rT}}{K}.$$

Then, we compute the vega as

$$\begin{aligned}
 V &= \frac{\partial}{\partial \sigma} (S_0 N(d_1) - e^{-rT} K N(d_2)) = S_0 n(d_1) \frac{-d_2}{\sigma} - e^{-rT} K n(d_2) \frac{-d_1}{\sigma} \\
 &= S_0 n(d_1) \left( -\frac{d_2}{\sigma} + \frac{K n(d_2)}{S_0 e^{rT} n(d_1)} \frac{d_1}{\sigma} \right) = S_0 n(d_1) \left( -\frac{d_2}{\sigma} + \frac{d_1}{\sigma} \right) \\
 &= S_0 n(d_1) \sqrt{T} = K e^{-rT} n(d_2) \sqrt{T}.
 \end{aligned}$$

4. **[2018FE, Option price and delta under the BSM model]** You hold a call option with  $K = 100$  maturing in 3 months. Assume that a stock's annual volatility is 32% of the

current price. Also assume that  $r = q = 0$ . You may use the following CDF values for the standard normal distribution  $N(z)$ .

$z$	0.02	0.04	0.06	0.08	0.10	0.12	0.14	0.16
$N(z)$	0.508	0.516	0.524	0.532	0.540	0.548	0.556	0.564

- (a) The stock's current spot price is  $S_0 = 100$ . What is the price of the call option under the BSM model?
- (b) What is the delta (i.e., the sensitivity to  $S_0$ ) of the option?
- (c) If the spot price changed to  $S_0 = 100.5$ , what is the new option price under the BSM model? Approximate the price with Taylor's expansion using the results from (a) and (b).

**Solution:**

- (a) Under the BSM model:

$$d_1 = \frac{\sigma_{BS} \sqrt{1/4}}{2} = 0.08, \quad d_2 = -0.08$$

$$C_0 = S_0 N(d_1) - K N(d_2) = 100 N(0.08) - 100(1 - N(0.08)) = 6.4$$

- (b)

$$\frac{\partial C}{\partial S_0} = N(d_1) = 0.532$$

- (c)

$$C'_0 = C_0 + (S'_0 - S_0) N(d_1) = 6.4 + 0.5 \times 0.532 = 6.666$$

5. **[2019FE, Modified BSM]** Assume that the stock price  $S_t$  follows a BM with the stochastic volatility  $\sigma_t$  following a GBM. The price and volatility are driven by the same standard BM  $B_t$ .

$$dS_t = \sigma_t dB_t \quad \text{and} \quad \frac{d\sigma_t}{\sigma_t} = -\nu dB_t \quad (\nu > 0).$$

- (a) Express the final price  $S_T$  in terms of  $S_0$ ,  $\sigma_0$ ,  $\nu$ ,  $T$ , and  $B_T$  by solving this SDE.
- (b) What is the call option price with strike price  $K$  and time-to-maturity  $T$ ?
- (c) If  $\nu = 0$ , then  $\sigma_t = \sigma_0$  for all  $t$ , that is, the volatility is no longer stochastic. Prove that, in the limit of  $\nu \rightarrow 0$ , the call option price from (b) converges to that of the normal model with normal volatility  $\sigma_0$ . You may need Taylor's expansion:  $\log(1+\varepsilon) \approx \varepsilon - \varepsilon^2/2$  when  $\varepsilon$  is very small.

**Solution:**

- (a)

$$\sigma_T = \sigma_0 \exp \left( -\nu B_T - \frac{1}{2} \nu^2 T \right)$$

$$\sigma_T - \sigma_0 = -\nu \int_0^T \sigma_t dB_t$$

$$S_T - S_0 = \int_0^T \sigma_t dB_t = \frac{1}{\nu} (\sigma_0 - \sigma_T) = \frac{\sigma_0}{\nu} \left( 1 - \exp \left( -\nu B_T - \frac{1}{2} \nu^2 T \right) \right)$$

(b) The final stock price  $S_T$  is expressed by a standard normal variable  $z$ :

$$S_T - S_0 = \frac{\sigma_0}{\nu} \left( 1 - \exp \left( -\nu z \sqrt{T} - \frac{1}{2} \nu^2 T \right) \right).$$

If  $z = -d_1$  is the root of  $S_T = K$ ,  $d_1$  is obtained as

$$\begin{aligned} \log \left( 1 - \frac{\nu}{\sigma_0} (K - S_0) \right) &= \nu d_1 \sqrt{T} - \frac{1}{2} \nu^2 T \\ d_1 &= \frac{\log \left( 1 - \frac{\nu}{\sigma_0} (K - S_0) \right)}{\nu \sqrt{T}} + \frac{1}{2} \nu \sqrt{T}. \end{aligned}$$

The call option price can be obtained as

$$\begin{aligned} C &= E((S_T - K)^+) = \int_{-d_1}^{\infty} \left[ \frac{\sigma_0}{\nu} \left( 1 - \exp \left( -\nu z \sqrt{T} - \frac{1}{2} \nu^2 T \right) \right) + S_0 - K \right] n(z) dz \\ &= \left( S_0 - K + \frac{\sigma_0}{\nu} \right) \int_{-d_1}^{\infty} n(z) dz - \frac{\sigma_0}{\nu} \int_{-d_1}^{\infty} n(z + \nu \sqrt{T}) dz \\ &= \left( S_0 - K + \frac{\sigma_0}{\nu} \right) (1 - N(-d_1)) - \frac{\sigma_0}{\nu} (1 - N(-d_1 + \nu \sqrt{T})) \\ &= \left( S_0 - K + \frac{\sigma_0}{\nu} \right) N(d_1) - \frac{\sigma_0}{\nu} N(d_2) \\ \text{where } d_{1,2} &= \frac{\log \left( 1 - \frac{\nu}{\sigma_0} (K - S_0) \right)}{\nu \sqrt{T}} \pm \frac{1}{2} \nu \sqrt{T} \end{aligned}$$

(c) Let

$$d = \frac{(S_0 - K)}{\sigma_0 \sqrt{T}},$$

then  $d_1$  and  $d_2$  converge to  $d$  as  $\nu \rightarrow 0$ :

$$d_{1,2} = \frac{\log \left( 1 - \frac{\nu}{\sigma_0} (K - S_0) \right)}{\nu \sqrt{T}} \pm \frac{1}{2} \nu \sqrt{T} = \frac{(S_0 - K)}{\sigma_0 \sqrt{T}} + A\nu \pm \frac{1}{2} \nu \sqrt{T} \rightarrow d \quad \text{for some } A.$$

Therefore, the call option price converges to

$$\begin{aligned} C &= (S_0 - K)N(d_1) + \frac{\sigma_0}{\nu} (N(d_1) - N(d_2)) \\ &= (S_0 - K)N(d) + \sigma_0 \sqrt{T} n(d), \end{aligned}$$

where we used the L'Hopital's rule,

$$\lim_{\nu \rightarrow 0} \frac{N(d_1) - N(d_2)}{\nu} = \lim_{\nu \rightarrow 0} \frac{N(d + A\nu + \nu \sqrt{T}/2) - N(d + A\nu - \nu \sqrt{T}/2)}{\nu} = n(d) \sqrt{T}$$

## 11 The Diffusion Equation

There is no question in this chapter.

## 12 Representation Theorems

### 1. [2017HW 3-5, Martingale representation theory]

For a standard BM  $B_t$  ( $0 \leq t \leq T$ ), find the martingale representation of  $X_t = E(B_T^3 | \mathcal{F}_t)$ . (In class, we did the same for  $X_t = E(B_T^2 | \mathcal{F}_t)$ )

**Solution:** Using the short notation  $E_t(\cdot) = E(\cdot | \mathcal{F}_t)$ ,

$$\begin{aligned} X_t &= E_t((B_t + B_T - B_t)^3) = B_t^3 + 3B_t^2 E_t(B_T - B_t) + 3B_t E_t((B_T - B_t)^2) + E_t((B_T - B_t)^3) \\ &= B_t^3 + 0 + 3(T - t)B_t + 0 = B_t^3 + 3(T - t)B_t. \end{aligned}$$

In particular,  $X_0 = 0$ . From the SDE,

$$dX_t = 3B_t^2 dB_t + 3B_t (dB_t)^2 + 3(T - t)dB_t - 3B_t dt = 3(B_t^2 + T - t)dB_t,$$

the martingale representation is

$$X_T = \int_0^T 3(B_t^2 + T - t) dB_t$$

### 2. [2018FE, SDE and martingale representation theorem]

- Apply Itô calculus to find the stochastic differentiation of  $\cosh(B_t)$ . Reminded that  $\cosh x = (e^x + e^{-x})/2$ .
- Find  $\lambda$  such that  $X_t = e^{\lambda t} \cosh(B_t)$  is a martingale (i.e.,  $dX_t$  has no  $dt$  term.)
- Using (b), find the martingale representation of  $\cosh(B_T)$ . In other words, find  $V_0$  and  $\phi_t$  satisfying

$$\cosh(B_T) = V_0 + \int_0^T \phi_t dB_t$$

- Assume a stock price  $S_t$  follows  $dS_t = \sigma dB_t$  and  $r = 0$ . What is the price of a derivative that pays  $\cosh(S_T - S_0)$  at time  $t = T$ ?

**Solution:**

(a)

$$d \cosh(B_t) = \sinh(B_t)dB_t + \frac{1}{2} \cosh(B_t)dt.$$

(b) The SDE for  $X_t$  is

$$dX_t = e^{\lambda t} \sinh(B_t)dB_t + e^{\lambda t} \left( \lambda + \frac{1}{2} \right) \cosh(B_t)dt.$$

Therefore  $X_t$  is a martingale when  $\lambda = -1/2$ .

(c)

$$X_T - X_0 = e^{-T/2} \cosh(B_T) - 1 = \int_0^T e^{-t/2} \sinh(B_t) dB_t$$

$$\cosh(B_T) = e^{T/2} + \int_0^T e^{(T-t)/2} \sinh(B_t) dB_t$$

Therefore, we obtain  $V_0 = e^{T/2}$  and  $\phi_t = e^{(T-t)/2} \sinh(B_t)$ .

(d) With the presence of  $\sigma$ , the results above becomes

$$X_t = e^{-\sigma^2 t/2} \cosh(\sigma B_t)$$

and

$$\cosh(S_T - S_0) = \cosh(\sigma B_T) = e^{\sigma^2 T/2} + \int_0^T e^{\sigma^2(T-t)/2} \sinh(\sigma B_t) dB_t$$

The price is  $V_0 = e^{\sigma^2 T/2}$ . It can also directly computed as

$$V_0 = E(\cosh(\sigma B_T)) = \frac{1}{2} E \left( e^{\sigma \sqrt{T} z} + e^{-\sigma \sqrt{T} z} \right) = \frac{1}{2} \left( e^{\sigma^2 T/2} + e^{\sigma^2 T/2} \right) = e^{\sigma^2 T/2}.$$

3. **[2019FE, Black-Scholes and martingale representation theorem]** For this question, assume that the current time is  $t = t$  (instead of  $t = 0$ ) and the option expiry is  $t = T$ . Therefore, the time-to-maturity is  $T - t$  (instead of  $T$ ). Also assume that  $r = 0$  to make the problem simple. Then, the underlying stock price follows a geometric BM,  $dS_t = \sigma S_t dB_t$ , and the call option price at time  $t$  is given by the Black-Scholes formula,

$$C_t = S_t N(d_1) - K N(d_2), \quad \text{where} \quad d_{1,2} = \frac{\log(S_t/K)}{\sigma \sqrt{T-t}} \pm \frac{1}{2} \sigma \sqrt{T-t}.$$

From the derivation of the BS formula in class, we know

$$dC_t = D_t dS_t,$$

where  $D_t$  is the delta of the option, i.e., the amount of the underlying stock to hold at time  $t$  to hedge the option:

$$D_t = \frac{\partial C_t}{\partial S_t} = N(d_1).$$

The martingale representation also tells us that the option premium,  $C_0$ , and the P&L from the hedge position from  $t = 0$  to  $T$  will exactly add up to the payoff of the option,  $C_T = (S_T - K)^+$ :

$$C_T = (S_T - K)^+ = C_0 + \int_0^T N(d_1) dS_t.$$

In this question, we are going to show  $dC_t = D_t dS_t$  by direct computation.

- (a) Find the gamma, the second derivative with respect to the spot price  $S_t$ , and theta, the derivative with respect to time  $t$ :

$$G_t = \frac{\partial^2 C_t}{\partial S_t^2} \quad \text{and} \quad \Theta_t = \frac{\partial C_t}{\partial t}$$

- (b) Apply Itô's lemma to find the stochastic differential equation (SDE) for  $C_t$ . Use the result of (a).
- (c) Imagine that a situation where the volatility for pricing option is different from that for the underlying stock. You price and risk-manage option using volatility  $\sigma_i$  ( $i$  for *implied* volatility). That is,  $C_t$  and  $D_t$  is evaluated with

$$d_{1,2} = \frac{\log(S_t/K)}{\sigma_i \sqrt{T-t}} \pm \frac{1}{2} \sigma_i \sqrt{T-t}.$$

But the underlying stock has volatility  $\sigma_r$  ( $r$  for *realized* volatility),

$$dS_t = \sigma_r S_t dB_t.$$

Derive the SDE for  $C_t$  again under this new situation. In this situation, does the option premium and hedging P&L amount to the option payout? Compare the cases,  $\sigma_i > \sigma_r$  and  $\sigma_i < \sigma_r$ .

**Solution:**

- (a) Gamma and theta are obtained as

$$G_t = \frac{n(d_1)}{S_t \sigma \sqrt{T-t}} \quad \text{and} \quad \Theta_t = -\frac{\sigma S_t n(d_1)}{2\sqrt{T-t}}.$$

- (b) The SDE for  $C_t$  is computed as

$$\begin{aligned} dC_t &= \frac{\partial C_t}{\partial t} dt + \frac{\partial C_t}{\partial S_t} dS_t + \frac{1}{2} \frac{\partial^2 C_t}{\partial S_t^2} (dS_t)^2 \\ &= \left( \Theta_t + \frac{\sigma^2 S_t^2}{2} G_t \right) dt + D_t dS_t \\ &= \left( -\frac{\sigma S_t n(d_1)}{2\sqrt{T-t}} + \frac{\sigma^2 S_t^2}{2} \frac{n(d_1)}{S_t \sigma \sqrt{T-t}} \right) dt + N(d_1) dS_t \\ &= N(d_1) dS_t. \end{aligned}$$

- (c) Using  $(dS_t)^2 = \sigma_r^2 S_t^2 dt$  instead, we obtain

$$\begin{aligned} dC_t &= \left( -\frac{\sigma_i S_t n(d_1)}{2\sqrt{T-t}} + \frac{\sigma_r^2 S_t^2}{2} \frac{n(d_1)}{S_t \sigma_i \sqrt{T-t}} \right) dt + N(d_1) dS_t \\ &= \frac{\sigma_r^2 - \sigma_i^2}{2} \cdot \frac{S_t n(d_1)}{\sigma_i \sqrt{T-t}} dt + N(d_1) dS_t \\ &= \frac{S_t^2}{2} (\sigma_r^2 - \sigma_i^2) G_t dt + N(d_1) dS_t. \end{aligned}$$

The sum of the premium and hedging P&L is

$$C_0 + \int_0^T N(d_1) dS_t = (S_T - K)^+ + \frac{\sigma_i^2 - \sigma_r^2}{2} \int_0^T S_t^2 G_t dt.$$

Notice that  $S_t^2 G_t$  is always positive. If  $\sigma_i > \sigma_r$ , the value you hold at  $t = T$  is bigger than the option payout  $(S_T - K)^+$ . If  $\sigma_r > \sigma_i$ , the value is less than the option payout  $(S_T - K)^+$ . This is consistent with observation,

$$C_0 > C_0^r \quad \text{if } \sigma_i > \sigma_r \quad \text{and} \quad C_0 < C_0^r \quad \text{if } \sigma_i < \sigma_r,$$

where  $C_0^r$  is the *correct* option price evaluated with the realized volatility  $\sigma_r$ ,

$$d_{1,2}^r = \frac{\log(S_t/K)}{\sigma_r \sqrt{T-t}} \pm \frac{1}{2} \sigma_r \sqrt{T-t}.$$

(Option price is a monotonically increasing function of volatility.)



### 13 Girsanov Theory

1. [2017FE, Black-Scholes and Importance sampling] Assume that  $r = q = 0$  in this problem.

- (a) Suppose that a stock price follows  $dS_t/S_t = \sigma dB_t$  and you want to price a call option with strike price  $K$  and maturity  $T$ . How do you get the option price by Monte-Carlo simulation? In other words, what should be the expression for  $f(Z)$  in the following Monte-Carlo formula:

$$C = \frac{1}{N} \sum_{k=1}^N f(Z_k),$$

where  $Z_k$  is a sequence of i.i.d. standard normal RVs.

- (b) Using Black-Scholes formula, find the call option price for  $S_0 = 100, K = 2000, T = 1, \sigma = 0.5$ . For computation, use approximation  $20 \approx e^3$ . You may also use the following CDF values for the standard normal distribution  $N(z)$ .

$z$	-6.5	-6.25	-6.0	-5.75	-5.5
$N(z)$	$4.0 \times 10^{-11}$	$2.1 \times 10^{-10}$	$9.9 \times 10^{-10}$	$4.5 \times 10^{-9}$	$1.9 \times 10^{-8}$

- (c) As observed in (b), the call option value can be very small if  $K$  is extremely high compared to  $S_0$  ( $K \gg S_0$ ). Therefore, the Monte-Carlo price from (a) would be zero because no  $Z_k$  will make the stock price in-the-money. Apply important sampling and express the option price. (Hint: Select the shift amount to make the stock price at-the-money.)

#### Solution:

- (a) The security price can be simulated as

$$S_T = S_0 \exp(\sigma\sqrt{T}Z - \sigma^2 T/2) \quad \text{for } Z \sim N(0, 1).$$

and the call option price is obtained as

$$C = \frac{1}{N} \sum_{k=1}^N \left( S_0 \exp(\sigma\sqrt{T}Z_k - \sigma^2 T/2) - K \right)^+$$

for i.i.d. samples  $\{Z_k\}$  (assume  $r = 0$ ) and  $(x)^+ = \max(x, 0)$ .

- (b) From  $d_{1,2} = \log(S_0/K)/\sigma\sqrt{T} \pm \sigma\sqrt{T}/2 = -6 \pm 0.25 = -5.75, -6.25$ ,

$$C = 100N(-5.75) - 2000N(-6.25) = 100 \times 4.5 \times 10^{-9} - 2000 \times 2.1 \times 10^{-10} = 3 \times 10^{-8}$$

- (c) Remind that

$$E[f(Z)] = E[f(Z + \mu) e^{-\mu Z - \mu^2/2}].$$

Therefore,

$$C = \frac{1}{N} \sum_{k=1}^N \left( S_0 \exp(\sigma\sqrt{T}(Z_k + \mu) - \sigma^2 T/2) - K \right)^+ e^{-\mu Z_k - \mu^2/2}$$

where  $\mu$  is determined as

$$S_0 \exp(\sigma\sqrt{T}\mu - \sigma^2 T/2) = K \quad \Rightarrow \quad \mu = \frac{\log(K/S_0)}{\sigma\sqrt{T}} + \frac{\sigma\sqrt{T}}{2}.$$

Notice that  $\mu = -d_2$  in the Black-Scholes formula.

## 14 Arbitrage and Martingales

1. **[2017FE, Siegel's paradox]** In foreign exchange market, each currency has a symbol of three characters. For example, USD is for US Dollar, CNY is for Chinese Yuan, and EUR is for Euro. Also, foreign exchange rate is quoted in one fixed direction such that the exchange rate is bigger than one. For example, the exchange between USD and CNY is always quoted in USD/CNY, not in CNY/USD. USD/CNY means the price of 1 USD in terms of CNY, which is around 6.3 as of today.
  - (a) Due to the recent trade war between US and China, suppose that the FX rate USD/CNY is going to be very volatile. Assuming USD/CNY = 6.0 today and it can change to either 4.0 or 8.0 after one year. Under the risk-neutral measure  $Q$ , what are the probabilities for the two scenarios? Assume that risk-free rate is zero in both US and China. (Hint: You can think of USD/CNY as the price of an asset (1 USD) in CNY unit.)
  - (b) Now consider the scenario from the perspective of an investor in US. Suppose a US investor invests in CNY by converting 1 USD to 6 CNY today and holding 6 CNY for one year. What is her expected return in terms of USD after one year? If the expected return is not zero, does it conflict with that the expected return under the risk-neutral measure  $Q$  should be same as the risk-less rate (which is zero in this problem)? (Hint: Consider the numeraire.)
  - (c) We can demonstrate this using stochastic calculus. If  $X_t = \text{USD/CNY}$ ,  $X_t$  is a martingale (no drift), so the SDE is given by

$$\frac{dX_t}{X_t} = \sigma dB_t^Q.$$

By applying Itô's lemma, find the SDE for  $X_0/X_t$ , which is the investment value in USD. Is the drift positive, negative or zero?

- (d) In class, we show that, for a numeraire asset with volatility  $\sigma_N$ , the relation between the two standard BMs between the probability measures,  $Q^N$  and  $Q$  (risk-neutral measure), is given by

$$dB_t^{Q^N} + \sigma_N dt = dB_t^Q.$$

What is the numeraire to make  $X_0/X_t$  a martingale? From the relation above, show that  $X_0/X_t$  is indeed a martingale under the measure associated with the numeraire.

**Solution:** See ([WIKIPEDIA](#)) for **Siegel's paradox**.

(a)

$$4p + 8(1 - p) = 6 \text{ CNY} \quad \Rightarrow \quad p = 0.5$$

(b) After one year, the investor receives in

$$\frac{6}{4} \cdot \frac{1}{2} + \frac{6}{8} \cdot \frac{1}{2} = \frac{9}{8} \text{ USD}$$

Therefore the return is 12.5%. This does not contradict with the zero expected return of the risk-neutral measure because the numeraire of the risk-neutral measure is the CNY cash while the numeraire for the US investor is USD cash.

(c) In general, the SDE for the exchange rate is given by

$$\frac{dX_t}{X_t} = (r_d - r_f) + \sigma dB_t^Q,$$

where  $r_d$  is the risk-free rate of domestic currency (CNY in this case) and  $r_f$  is the foreign currency (USD in this case). We assume  $r_d = r_f = 0$  for this problem, but we derive general result with  $r_d$  and  $r_f$ .

$$\begin{aligned} d \log X_t &= (r_f - r_d - \sigma^2/2)dt + \sigma dB_t^Q \\ d \log(X_0/X_t) &= (r_d - r_f + \sigma^2/2)dt - \sigma dB_t^Q \\ \frac{d(X_0/X_t)}{(X_0/X_t)} &= (r_d - r_f + \sigma^2)dt - \sigma dB_t^Q \end{aligned}$$

Assuming  $r_d = r_f = 0$ ,

$$\frac{d(X_0/X_t)}{(X_0/X_t)} = \sigma^2 dt - \sigma dB_t^Q.$$

(d) The USD cash should be the numeraire and the price of USD in terms of the risk-neutral numeraire CNY is nothing but  $X_t$ ! Therefore the volatility is  $\sigma$  and we get

$$dB_t^{\text{USD}} + \sigma dt = dB_t^{\text{CNY}} (= dB_t^Q).$$

The SDE from (c) becomes

$$\frac{d(X_0/X_t)}{(X_0/X_t)} = \sigma (\sigma dt - dB_t^{\text{CNY}}) = \sigma dB_t^{\text{USD}}$$

and  $X_0/X_t$  is indeed a martingale under the USD numeraire.

## 2. [2017FE, Interest rate and bond price SDE]

(a) Find the mean and variance of the following expression:

$$I = \int_0^T B_t dt.$$

You may find that  $TB_T = \int_0^T T dB_t$  is a helpful trick. Is  $I$  normally distribution?

(b) Suppose now you live in a real world where the risk-free rate,  $r_t$ , is stochastic rather than constant. Therefore the saving account  $\beta_T$  exponentially grows as  $\beta_T = \exp\left(\int_0^T r_t dt\right)$ . Show that, in risk-neutral measure  $Q$ , the zero-coupon bond price  $P(t, T)$  is given by

$$P(0, T) = E^Q \left[ \exp \left( - \int_0^T r_t dt \right) \right]$$

(c) Suppose that the SDE for  $r_t$  is given by

$$r_t = r_0 + \alpha t + \beta B_t,$$

where  $B_t$  is a standard BM under  $Q$  ( $B_t = B_t^Q$ ). Calculate  $P(0, T)$  using the results from (a) and (b).

- (d) Suppose that the SDE for the bond price  $P(t, T)$  in  $Q$  is given by

$$\frac{dP(t, T)}{P(t, T)} = \mu_P dt + \sigma_P dB_t.$$

From the result of (c), find  $P(t, T)$  by replacing  $r_0$  with  $r_t$  and  $T$  with  $T - t$ . Then, apply Itô's lemma to  $\log P(t, T)$ . By matching drift and volatility, find the expressions for  $\mu_P$  and  $\sigma_P$ . (Hint: The answers are quite simple, so check your calculation again if the expressions are complicated. Especially  $\mu_P$  is almost obvious in the risk-neutral measure. Even if you cannot get the derivation right, [you still earn partial credit by correctly guessing  \$\mu\_P\$](#) . When applying Itô's lemma to  $\log P(t, T)$ ,  $t$  is the time variable and  $T$  should be considered as a constant.)

**Solution:**

- (a) Applying Itô's lemma to  $tB_t$  (see [SCFA 6.2](#)),  $d(tB_t) = t dB_t + B_t dt$ , we can express  $I$  as

$$I = TB_T - \int_0^T t dB_t = T \int_0^T dB_t - \int_0^T t dB_t = \int_0^T (T - t) dB_t.$$

We get

$$E(I) = 0 \quad \text{and} \quad \text{Var}(I) = \int_0^T (T - t)^2 dt = \frac{1}{3}T^3.$$

and  $I$  is normally distributed.

- (b) The bond price  $P(0, T)$  is the  $t = 0$  value of \$ 1 at  $t = T$ . Under the risk-neutral measure  $Q$ , any security value measured in the unit of  $\beta_t$  is a martingale,

$$\frac{P(0, T)}{\beta_0 = 1} = E_Q \left[ \frac{P(T, T) = 1}{\beta_T} \right].$$

Therefore,

$$P(0, T) = E_Q \left[ \exp \left( - \int_0^T r_t dt \right) \right]$$

or, more generally,

$$P(t, T) = E_Q \left[ \exp \left( - \int_t^T r_s ds \right) \middle| \mathcal{F}_t \right]$$

- (c) From

$$- \int_0^T r_t dt = -Tr_0 - \frac{1}{2}\alpha T^2 - \beta I,$$

we get

$$\begin{aligned} P(0, T) &= \exp \left( -Tr_0 - \frac{1}{2}\alpha T^2 \right) E_Q(e^{-\beta I}) \\ &= \exp \left( -Tr_0 - \frac{1}{2}\alpha T^2 + \frac{1}{6}\beta^2 T^3 \right) \end{aligned}$$

Note that this is a simplified version of the Ho–Lee model ([WIKIPEDIA](#)). In the original model, the drift  $\alpha$  is time-dependent:

$$dr_t = \alpha_t dt + \sigma dB_t.$$

(d) From

$$\log P(t, T) = -(T-t)r_t - \frac{1}{2}\alpha(T-t)^2 + \frac{1}{6}\beta^2(T-t)^3$$

we get the SDE for  $\log P(t, T)$ :

$$\begin{aligned} d \log P(t, T) &= -(T-t)dr_t + \left( r_t + \alpha(T-t) - \frac{1}{2}\beta^2(T-t)^2 \right) dt \\ &= \left( r_t - \frac{1}{2}\beta^2(T-t)^2 \right) dt - \beta(T-t)dB_t. \end{aligned}$$

and this should be equal to

$$d \log P(t, T) = (\mu_P - \sigma_P^2/2)dt + \sigma_P dB_t.$$

Therefore we get

$$\mu_P = r_t \quad \text{and} \quad \sigma_P = -\beta(T-t).$$

Note that (i)  $\mu_P = r_t$  is obvious in the risk-neutral measure, (ii) the bond volatility  $\sigma_P$  is negative because the bond price moves in an opposite way to the interest rate, and (iii)  $\sigma_P = 0$  at maturity  $t = T$  because the bond price  $P(t, T)$  converges to 1.

3. **[2018FE,  $T$ -forward measure]** In class, we learned that the forward price of buying a bond maturing at  $T + \Delta$  at time  $t = T$ ,

$$F_t = \frac{B(t, T + \Delta)}{B(t, T)},$$

is a martingale under the  $T$ -forward measure. We are going to prove this under an explicit setting. From a 2017 exam problem, we also know that

$$\frac{dB(t, T)}{B(t, T)} = r_t dt - \beta(T-t) dB_t^Q$$

when the risk-free rate changes according to  $dr_t = \alpha dt + \beta dB_t^Q$ . Here,  $B_t^Q$  is the standard BM under the risk-neutral measure.

- Derive the SDE for  $F_t$ . (Hint. First compute  $d \log F_t$  and compute  $dF_t/F_t$ )
- If  $B_t^T$  is the standard BM under the  $T$ -forward measure, what is the relation between  $dB_t^Q$  and  $dB_t^T$ ?
- From (a) and (b), finally derive the SDE for  $F_t$  under the  $T$ -forward measure. Is  $F_t$  a martingale? What is the volatility of  $dF_t/F_t$ ?

**Solution:** Assume  $\sigma = -\beta(T - t)$  and  $\sigma' = -\beta(T + \Delta - t)$  so that

$$\frac{dB(t, T)}{B(t, T)} = r_t dt + \sigma dB_t^Q, \quad \frac{dB(t, T + \Delta)}{B(t, T + \Delta)} = r_t dt + \sigma' dB_t^Q$$

(a) From,

$$d \log B(t, T) = (r_t - \sigma^2/2)dt + \sigma dB_t^Q, \quad d \log B(t, T + \Delta) = (r_t - \sigma'^2/2)dt + \sigma' dB_t^Q,$$

we get

$$\begin{aligned} d \log F_t &= -\frac{1}{2}(\sigma'^2 - \sigma^2)dt + (\sigma' - \sigma)dB_t^Q, \\ \frac{dF_t}{F_t} &= -\frac{1}{2}(\sigma'^2 - \sigma^2)dt + \frac{1}{2}(\sigma' - \sigma)^2dt + (\sigma' - \sigma)dB_t^Q \\ &= -\sigma(\sigma' - \sigma)dt + (\sigma' - \sigma)dB_t^Q \\ &= -\Delta\beta^2(T - t)dt - \Delta\beta dB_t^Q \end{aligned}$$

(b) Because the volatility of the numeraire  $B(t, T)$  is  $\sigma = -\beta(T - t)$ ,

(c)

$$\frac{dF_t}{F_t} = -\Delta\beta dB_t^T.$$

$F_t$  is a martingale indeed and the volatility is  $\sigma' - \sigma = -\Delta\beta$ .