

CALIFORNIA STATE UNIVERSITY, NORTHRIDGE

METHODS TO SOLVE ASSET BUBBLE IN FINANCE

A thesis submitted in partial fulfillment of the requirements  
For the degree of Master of Science in  
Applied Mathematics

by

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August 2013

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## Dedication

Jas' dedication

## Acknowledgements

I would like to thank my advisor Dr. Jorge Balbas for his tremendous support and commitment towards my thesis research. I would like to special thank all of the faculty members at CSUN and my committee members Dr. Mary Rosen and Dr. Casaba Toth. Thank you so much for helping me to improve my work.

I would personally like to thank my husband, family and friends for supporting me through out my thesis work. With their support and encouragement, I was able to complete my thesis

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## ABSTRACT

### METHODS TO SOLVE ASSET BUBBLE IN FINANCE

By

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Master of Science in Applied Mathematics

Financial Market is very attracting topic in finance and mathematics world. Recently we have heard lot about Gold Prices inflations. It is the the hot topic in today's finance market. So how will be combine mathematics with today's asset changes? How can we determine the tale of asset's volatility for future? These are the questions which we will consider in this thesis. We will study non parametric estimator Floren Zmirou in local real time on compact domain with stochastic differential equation which has unknown drift and diffusion coeificents. Once we will have volatility from floren zmirou then we will able to use RKHS to estimates function which will extrapolate the tale of function.

## 0.0.1 Outline

As for the outline, i think you should have four chapters:

(1) Introduction:

(1.1) What problem are you trying to solve? Why is it important? What is your goal?

(1.2) Challenges

(1.3) Summary of how you've addressed those challenges, what have you found/built?

(1.4) Overview of following chapters

(2) Theoretical Background ~ The Math:

(2.1) Where does your problem come from? (you'll have to talk about stochastic PDEs, volatility, assets price modeling, martingales, etc.)

(2.2) Describe the math problem: parametric estimation, interpolation, extrapolation, minimization

(2.3) What is your solution? Based on all this theory connecting math and finance and assets and asset bubbles, how can you get an answer to your (math) problem as you described in chapter (1).

(3) Algorithm and Implementation ~ The Software Tool:

~ We can discuss later, but you may want to consider different format options: do you want to have a section for each sub problem (acquiring data, fitting data, extrapolation, etc.) or you may want to group some of those and have a separate section talking about software tools that you have downloaded/modified, and tools you have developed

~ Also a section describing the Algorithm step by step.

(4) Numerical Examples ~ Once your code works, run some experiments on real data, some that you know the answer, some that you don't know

You may want to have a final chapter with conclusions. future work, etc

## 0.1 Chapter 2

### 0.1.1 Theoretical Background

First of all we will introduce Stochastic Differential Equations. SDE are being used in various fields for example biology, physics, mathematics and of course finance. In finance, SDE is used to model asset price included with Brownian motion. Here we will use constant parameters drift and diffusion coefficients. With these constants , we will use euler muruyama method to model asset price.

In this chapter, we will focus on numerical solution of stochastic differential equations (SDE). It will give us better understanding toward the theory behind SDE. SDE are used in various areas like biology, chemistry, economics and of course finance. We will also study Brownian motion and compute Brownian paths with different methods. Euler -Maruyama

method, strong and weak convergence, milstein method are being used to show solutions of SDE.

Now let's start with finance knowledge, Suppose the market price of an asset increases significantly. How can one determine if the market price is inflated above the actual price of an asset? This price behavior is known as a bubble.

To model price bubbles, we want to consider the following:

- What is an asset price bubble?
- How does one determine if an asset price is experiencing a bubble?
- Can one detect an asset price bubble in *real-time*?

Let's consider finance definitions :

- Market Price - The current price of an asset.
- Fundamental Price - The actual value of an asset based on an underlying perception of its *true value*.
- Risk - Variance of return on an asset
- Portfolio - Set of Assets.
- Asset Bubble- The difference between the market and fundamental price, if any, is a price bubble.
- Strike price -The strike price or exercise price of an option is the fixed price at which the owner of the option can buy( in the case of call) or sell (in the case of a put) the underlying security or commodity.
- Volatility-Rate at which the price of security moves up and down.

## 0.1.2 Probability Measure

### 0.1.2.1 Probability Space

$(\Omega, \mathcal{F}, P)$  where  $\Omega$  is a set ( sample space),  $\mathcal{F}$  is a sigma algebra of subsets (events) of  $\Omega$ , and  $P$  is a Probability Measure.

### 0.1.2.2 Random Variable

- Measurable functions of real analysis.  $X : \Omega \rightarrow \mathcal{R}$  map  $X : (\Omega, \mathcal{F}) \mapsto (\mathcal{R}, \mathcal{B})$  and  $X$  is random variable if

$$X^{-1}(A) \in \mathcal{F}, \forall A \in \mathcal{B},$$

where  $X^{-1}(A) := \{\omega \in \Omega \mid X(\omega) \in A\}$



### 0.1.3 Stochastic Differential Equations

We treat the asset price as a stochastic process:

#### 0.1.3.1 Stochastic Process

Given a probability space  $(\Omega, \mathcal{F}, P)$ , a stochastic process with state space  $X$  is a collection of  $X$ -valued random variables,  $S_t$ , on  $\Omega$  indexed by a set  $T$  (e.g. time).

$$S = \{S_t : t \in T\} \quad (1)$$

One can think of  $S_t$  as a asset price at time  $t$ .

#### 0.1.3.2 Stochastic Differential Equation

A differential equation with one or more terms is a stochastic process.

### 0.1.4 Brownian Motion

$\{S_t : 0 \leq t \leq T\}$ :

$$\begin{aligned} dS_t &= \sigma(S_t)dW_t + \mu(S_t)dt \\ S_0 &= 0 \end{aligned} \quad (2)$$

- $W_t$  denotes the standard Brownian Motion.
- $\mu(S_t)$  called the drift coefficient.
- $\sigma(S_t)$  called the volatility coefficient.

#### 0.1.4.1 Definition of Brownian motion

A continuous-time stochastic process  $\{S_t : 0 \leq t \leq T\}$  is called a *Standard Brownian Motion* on  $[0, T]$  if it has the following four properties:

- (i)  $S_0 = 0$
- (ii) The increment of  $S_t$  are independent; given

$$0 \leq t_1 < t_2 < t_3 < \cdots < t_n \leq T$$

the random variables  $(S_{t_2} - S_{t_1}), (S_{t_3} - S_{t_2}), \dots, (S_{t_n} - S_{t_{n-1}})$  are independent.

- (iii)  $(S_t - S_s), 0 \leq s \leq t \leq T$  has the Gaussian distribution with mean zero and variance  $(t - s)$

(iv)  $S_t(W)$  is a continuous function of  $t$ , where  $W \in \Omega$ .

### 0.1.5 Martingales

(a)  $E[|S_n|] < +\infty$ , for all  $n$ .

(b)  $S_n$  is said to be *adapted* if and only if  $S_n$  is  $\mathcal{F}_n$ -measurable.

The stochastic process  $S = \{S_n\}_{n=0}^{\infty}$  is a *martingale* with respect to  $(\{\mathcal{F}_n\}, P)$  if  $E[S_{n+1} | \mathcal{F}_n] = S_n$ , for all  $n$ , almost surely and:

- $S$  satisfies (a) and (b).

### 0.1.6 Supermartingale

The stochastic process  $S = \{S_n\}_{n=0}^{\infty}$  is a *supermartingale* with respect to  $(\{\mathcal{F}_n\}, P)$  if  $E[S_{n+1} | \mathcal{F}_n] \leq S_n$ , for all  $n$ , almost surely and:

- $S$  satisfies (a) and (b).

### 0.1.7 Local Martingale

If  $\{S_n\}$  is adapted to the filtration  $\{\mathcal{F}_n\}$ , for all  $0 \leq t \leq \infty$ , then  $\{S_t : 0 \leq t \leq \infty\}$  is called a *local martingale* provided that there is nondecreasing sequence  $\{\tau_k\}$  of stopping times with the property that  $\tau_k \rightarrow \infty$  with probability one as  $k \rightarrow \infty$  and such that for each  $k$ , the process defined by

$$S_t^{(k)} = S_{t \wedge \tau_k} - S_0$$

for  $t \in [0, \infty)$  is a martingale with respect to the filtration

$$\{\mathcal{F}_t : 0 \leq t < \infty\}$$

### 0.1.8 Remark

A strict local martingale is a non-negative local martingale.

### 0.1.9 Theorem

If for any strict local martingale

$$\{S_t : 0 \leq t \leq T\}$$

with  $E[|S_0|] < \infty$  is also a supermartingale and  $E[S_T] = E[S_0]$ , then  $\{S_t : 0 \leq t \leq T\}$  is in fact a martingale.

### 0.1.10 Remark

- $\{S_t : 0 \leq t \leq T\}$  is a supermartingale and a martingale if and only if it has constant expectation.
- For a strict local martingale its expectation decreases with time.

### 0.1.11 Relating Martingales and Bubbles

#### 0.1.12 theorem

$\{S_t : 0 \leq t \leq T\}$  is a strict local martingale if and only if

$$\int_{\alpha}^{\infty} \frac{x}{\sigma^2(x)} dx < \infty \quad (3)$$

for all  $\alpha > 0$ .

- A bubble exists if and only if (3) is finite.
- We shall call (3) the volatility of asset return.
- In this scope, the difference between a martingale and a strict local martingale is whether the volatility of asset return, (3), is finite or not finite.

### 0.1.13 Numerical Methods of SDE

For  $t \in [0, T]$ , (2) can be represented in an integral form in the following way:

$$\begin{aligned} dS_t &= \sigma(t) dW_t + \mu(t) dt \\ \int_0^t dS_t &= \int_0^t \sigma(S_t) dW_t + \int_0^t \underbrace{\mu(S_t)}_{\in \mathcal{R}^+} dt \\ S_t - S_0 &= \int_0^t \sigma(S_t) dW_t + \left( \underbrace{\mu(S_t) \cdot t}_{x_0} - \mu(S_t) \cdot 0 \right) \\ S_t &= x_0 + \int_0^t \sigma(S_t) dW_t \end{aligned}$$

#### 0.1.13.1 What is $S_t = x_0 + \int_0^t \sigma(S_t) dW_t$ ?

The price model is

$$S_t = x_0 + \int_0^t \sigma(S_t) dW_t \quad (4)$$

### 0.1.13.2 What is $S_t = x_0 + \int_0^t \sigma(S_t) dW_t$ ?

$$\begin{aligned} dS_t &= \mu(S_t)dt + \sigma(S_t)dW_t \\ S_0 &\in \mathcal{R} \end{aligned} \quad (5)$$

### 0.1.13.3 The Euler-Maruyama Method

Equation (4) can be written into integral form as:

$$S_t = S_0 + \int_0^t f(S_s) ds + \int_0^t g(S_s) dW(s), t \in [0, T] \quad (6)$$

f, g are scalar function with  $S_0 = x_0$  random variable

$$\begin{cases} dS_t = \mu(S_t)dt + \sigma(S_t)dW_t \\ S(0) = S_0 \end{cases}$$

Using Euler Maruyama method:

$$w_0 = S_0$$

$$w_{i+1} = w_i + a(t_i, w_i) \Delta t_{i+1} + b(t_i, w_i) \Delta W_{i+1}$$

$$w_{i+1} = w_i + \mu w_i \Delta t_i + \sigma w_i \Delta W_i$$

$$\Delta t_{i+1} = t_{i+1} - t_i$$

$$\Delta W_{i+1} = W(t_{i+1}) - W(t_i)$$

Now drift coefficient  $\mu$  and diffusion coefficient  $\sigma$  are constants, the SDE has an exact solution:

$$S(t) = S_0 \cdot \exp\left(\left(\mu - \frac{1}{2}\sigma^2\right)t + \sigma W(t)\right) \quad (7)$$

### 0.1.14 What is $S_t = x_0 + \int_0^t \sigma(S_t) dW_t$ ?

$$S(t) = S_0 \cdot \exp\left(\left(\mu - \frac{1}{2}\sigma^2\right)t + \sigma W(t)\right) \quad (8)$$

For an example, we use the Euler-Maruyama Approximation Method on the SDE where the constants  $\mu = 2$ ,  $\sigma = 1$ , and  $S_0 = 1$  are given.

There are other methods such as Strong and weak convergence of the Euler Maruyama method, Milstein's Higher Order Method, Linear Stability and Stochastic Chain Rule are also used for numerical solutions for SDE.

- From this, we will focus on real time stock data. We will have couple estimators to determine volatility function. For instance,

- We will assume that  $\sigma$  is not constant. We will approximate  $\sigma$  with non parametric estimator method on local time.

### 0.1.15 Methods used to solve the problem

In this classical setting, Jarrow, Protter, and Shimbo [19], [20] show that there are three types of asset price bubbles possible. Two of these price bubbles exist only in infinite horizon economies, the third called type 3 bubbles exist in finite horizon settings. Consequently, type 3 bubbles are those most relevant to actual market experiences. For this type of bubble, saying whether or not a bubble exists amounts to determining whether the price process under a risk neutral measure is a martingale or a strict local martingale: if it is a strict local martingale, there is a bubble.

Stock price is strict local martingale if and only if

$$\int_{\alpha}^{\infty} \frac{x}{\sigma(x)} dx < \infty \text{ for all } \alpha > 0 \quad (9)$$

Floren Zmirou's non parametric estimator is based on the local time of the Diffusion Process.

#### 0.1.15.1 Diffusion Process

In probability theory, a branch of mathematics, a diffusion process is a solution to a stochastic differential equation. It is a continuous-time Markov process with almost surely continuous sample paths.

### 0.1.16 Floren Zmirou

Lets consider following equation:

$$S_t = S_0 + \int_0^t \sigma(S_t) dW_t \quad (10)$$

In Floren Zmirou, the drift coefficient  $\mu(S_t)$  is null which is ignored without loss of generality. It is not involved in our problem.  $\sigma(S_t)$  the volatility coefficient is unknown. We will follow steps for Floren Zmirou method:

- $(S_{t_1} \dots S_{t_n})$  are the stock prices in the interval  $t_1 \dots t_n \in [0, T]$
- Without loss of generality, we assume  $T = 1$ , therefore  $t_i = i/n$

Estimator as follows:

$$\text{Local time} = l_T(x) = \lim_{\epsilon \rightarrow 0} \frac{1}{2\epsilon} \int_0^T 1_{\{|S_s - x| < \epsilon\}} d\langle S, S \rangle_s$$

where  $d\langle S, S \rangle_s = \sigma^2(S_s)$

$$L_T(x) = \lim_{\epsilon \rightarrow 0} \frac{1}{2\epsilon} \int_0^T 1_{\{|S_s - x| < \epsilon\}} dS$$

$$\implies l_T(x) = \sigma^2(S_s) L_T(x)$$

$$\implies l_T(x)_T(x) = \sigma^2(S_s)$$

Now we will define local time of  $S_s$  in  $x$  during  $[0, t]$ .

Let's assume that  $nh_n \rightarrow \infty$  and  $h_n \rightarrow 0$

$$\implies L_T^n(x) = \frac{T}{2nh_n} \sum_{i=1}^n 1_{\{|S_{t_i} - x| < h_n\}}$$

estimator of  $\sigma^2(S_x)$  as follows:

$$S_n(x) = \frac{\sum_{i=1}^n 1_{\{|S_{t_i} - x| < h_n\}} n(S_{t_{i+1}} - S_{t_i})^2}{\sum_{i=1}^n 1_{\{|S_{t_i} - x| < h_n\}}}$$

### 0.1.17 Theorem

If  $Sigma$  is bounded above and below from zero, has three continuous and bounded derivatives, and if  $(h_n)_n$  satisfies  $nh_n \rightarrow \infty$  and  $nh_n^3 \rightarrow 0$ , then  $S_n(x)$  is a consistent estimator of  $\sigma^2(x)$ .

Now we have  $\sigma^2(x)$  and we will use interpolation methods to see function's behaviour.

### 0.1.18 Interpolation

Interpolation is a method of constructing new data points within the range of a discrete set of known data points. There are many methods to do interpolation. For example Linear Interpolation, polynomial interpolation, piecewise constant interpolation, spline interpolation. Here we will interpolate an estimate of  $\sigma^2(x_i)$  where  $i \in [1, M]$  within the bounded finite interval  $D$  where we have observations. We used cubic spline interpolation and Reproducing Kernel Hilbert Spaces to get interpolation function.

#### 0.1.18.1 Cubic Spline

A cubic spline is a spline for which the function is a polynomial of degree 3 on every subinterval, and a function with two continuous derivatives overall.

### 0.1.18.2 Interpolation is seen as inverse problem.

### 0.1.18.3 We will have two types of solutions for inverse problem.

### 0.1.18.4 Normal Solution

It will allow an exact interpolation with minimal squared norm.

### 0.1.18.5 Regularized Solution

It will yield quasi-interpolative results, accompanied by an error bound analysis with Tikhonov Regularization produces an approximate solution  $f_\alpha$  which belongs to  $H(D)$  and that can be obtained via the minimization of the regularization functional. Regularized solution with Kernel function For interpolation, we denote kernel function  $K_{n,\tau}^{a,b}$  for  $n=1$  and  $n=2$ . of  $H^n(a, d)$  where  $D = (a, b)$  Now one we have interpolation function and extended form of the estimated  $\sigma^2(x)$  call this extended function  $\sigma^b(x)$ , we can decide if there is need of extrapolation.

- if the volatility  $\sigma^2(x_i)$  doesn't diverge to  $\infty$  when  $x \rightarrow \infty$  and it remains bounded on  $\mathcal{R}^+$ .
  - No extrapolation is required.
  - $\int_{\epsilon}^{\infty} \frac{x}{\sigma^2(x)}$  is infinite.
  - The process is true martingale.
- If the volatility diverges to  $\infty$  when  $x \rightarrow \infty$  then we will extrapolate.

### 0.1.19 Extrapolation ,Optimization and Minimization

Now since we have extended function  $\sigma^b(x)$ , we will extrapolate this over  $\mathcal{R}^+$ . Let's consider following optimization with minimization problem:

$$m = \operatorname{argmin}_{m \geq 0} \sqrt{\int_{[a, \infty] \cap D} |\sigma_m - \sigma^b|^2 dS}$$

- $\sigma_m$  will interpolate the input data points when  $n=2$ .
- $\sigma_m$  has the asymptotic behavior that best matches our function on the estimation interval. We will  $\frac{1}{\sigma^2 m}$ .
- $a = \max S - \frac{1}{3}(\max S - \min S)$

- $H_{2,m}$  allows the best interpolation of  $M$  which is estimated points such that the extrapolation function remains as close as possible to  $\sigma^b(x)$ .
- We will plot function with different asymptotic weighting parameter  $m$  which is obtained from RKHS extrapolation method.
- The asymptotic weighting function's parameter *obtained by optimization and minimization is the*