Option Pricing with Game Theory

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Abstract

This study presents a novel approach to option pricing by integrating the binomial tree model with concepts from game theory, specifically Nash equilibrium. Using historical market data for Apple Inc. (AAPL) obtained through the yfinance API, we construct a multi-step binomial tree to simulate future asset prices. A payoff matrix is then derived at each node and analyzed as a strategic game between option holders and writers. By formulating this interaction as a linear programming problem, we compute equilibrium strategies that ensure no party can improve their outcome unilaterally. The model is backtested over historical data to assess its profitability and robustness under varying market conditions. Results highlight the effectiveness of this combined quantitative approach, while also identifying practical considerations and assumptions for real-world application.

1. Data Collection

1.1. Data Sources

The historical financial data used in this study is sourced primarily from the yfinance Python API, which provides comprehensive market information including daily stock prices and option chains. Data for Apple Inc. (AAPL) is collected over the period from January 1, 2022 to January 1, 2023. This API is chosen for its ease of access, reliability, and alignment with the methodology described in the reference study. Optionally, additional data sources such as Alpha Vantage can be integrated for extended analysis or validation.

1.2. Relevant Parameters

The following parameters are retrieved for analysis:

- **Stock Data:** daily Open, High, Low, Close, and Volume.

These values form the basis for volatility estimation, binomial tree construction, and payoff matrix generation.

The data is programmatically collected using Python scripts. Stock prices are pulled using:

```
ticker = 'AAPL'
start_date = '2022-01-01'
end_date = '2023-01-01'

stock_data = yf.download(ticker, start=start_date, end=end_date)

stock_data.head()
```

Price	Close	High	Low	Open	Volume
Ticker	AAPL	AAPL	AAPL	AAPL	AAPL
Date					
2022-01-03	178.645645	179.499574	174.425140	174.542917	104487900
2022-01-04	176.378357	179.558473	175.809076	179.254206	99310400
2022-01-05	171.686691	176.839648	171.411868	176.290001	94537600
2022-01-06	168.820679	172.059683	168.467333	169.507737	96904000
2022-01-07	168.987549	170.921136	167.868622	169.694241	86709100

Figure 1. Stock Data

Option chain data is retrieved using the options method in yfinance, filtered by expiry date and strike price. After retrieval, data is cleaned, aligned by date, and stored in structured dataframes for further processing.

2. Historical Volatility

2.1. Log Returns from Daily Closing Prices

To estimate volatility, we first compute the logarithmic returns from the series of daily closing prices. Log returns are preferred in financial modeling due to their additive properties and normality assumptions. The log return r_t at time t is calculated using the formula:

$$r_t = \ln\left(\frac{P_t}{P_{t-1}}\right)$$

where P_t is the closing price at day t and P_{t-1} is the closing price on the previous day.

```
std_dev = stock_data['Log_Return'].std()

# Assumed 252 trading days
volatility = std_dev * np.sqrt(252)

print(f"Annualized Volatility: {volatility:.4f}")
```

```
Annualized Volatility: 0.3561
```

Figure 2. Annualized Volatility

2.2. Annualized Volatility

Volatility is a statistical measure of the dispersion of returns for a given asset and represents the degree of variation in its price over time. In financial modeling, it serves as a key input for pricing derivatives, particularly in models like the binomial tree. A higher volatility implies greater uncertainty and larger potential price swings, which in turn affects the value of options. This annualized volatility is used to calibrate the binomial tree, as it directly influences the up and down movement factors at each node in the model. Once log returns are computed, we calculate their standard deviation to estimate daily volatility. This is then annualized by multiplying with the square root of the number of trading days in a year (typically 252). The annualized volatility σ is given by:

$$\sigma = \text{std}(r_t) \times \sqrt{252}$$

This annualized volatility serves as a critical input to the binomial tree model, influencing the magnitude of up and down price movements at each node.

3. Binomial Tree

3.1. Model Parameters

The binomial tree is constructed using three key inputs:

- Annualized volatility σ (here, 0.3561)
- Risk-free interest rate r (here, taken 0.05)
- Time to expiration T, in years (here, 1)

The total time T is divided into N discrete steps (here, 100) and the length of each time interval is:

$$\Delta t = \frac{T}{N}$$

The $up(u)$ and $down(d)$ movement factors are computed as follows:

$$u = e^{\sigma\sqrt{\Delta t}}, \quad d = \frac{1}{u}$$

The $risk-neutral\ probability(p)$ of an upward movement is:

$$p = \frac{e^{r\Delta t} - d}{u - d}$$

```
S0 = stock_data['Close'].iloc[-1]


price_tree = []

for i in range(N + 1):  # for each time step
    level_prices = []
    for j in range(i + 1):  # for each possible up move
        price = S0 * (u ** j) * (d ** (i - j))
        level_prices.append(price)
    price_tree.append(level_prices)


for i, level in enumerate(price_tree[:5]):
    print(f"Step {i}: {level}")
```

Figure 3. Stock Price Lattice Code

These parameters define the structure of the tree, allowing us to simulate potential future asset prices at each node.

3.2. Tree Construction

The binomial tree is constructed as a step-by-step simulation of how the underlying asset's price might evolve over time. Starting from the current stock price at the root node, the tree branches at each time step to reflect two possible outcomes: an upward movement or a downward movement.

As we progress through each level of the tree, the number of possible price paths increases, creating a structure where each node represents a potential future price of the asset at a specific point in time. Since the tree is recombining, different paths may lead to the same node, ensuring computational efficiency.

The final layer of the tree contains all possible prices at expiration, which are used to calculate the option's payoff.

These payoffs are then propagated backward through the tree using the risk-neutral probabilities, ultimately yielding the present value of the option at the root node. This framework provides a flexible and intuitive way to model option pricing under uncertainty.

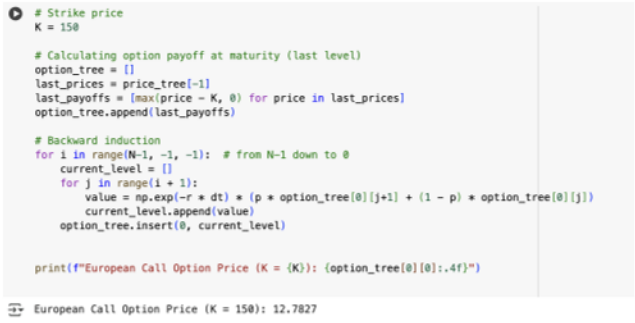
4. The Payoff Matrix

4.1. Option Payoff Calculation

Once the binomial tree is constructed, we evaluate the option payoff at each terminal node. For a European call option, the payoff at expiration is defined as:

$$\text{Payoff} = \max(S - K, 0)$$

where S is the stock price at a terminal node and K is the strike price. This calculation is repeated for all final nodes in the tree to capture the full range of possible outcomes.



```
# Strike price
K = 150

# Calculating option payoff at maturity (last level)
option_tree = []
last_prices = price_tree[-1]
last_payoffs = [max(price - K, 0) for price in last_prices]
option_tree.append(last_payoffs)

# Backward induction
for i in range(N-1, -1, -1):  # from N-1 down to 0
    current_level = []
    for j in range(i + 1):
        value = np.exp(-r * dt) * (p * option_tree[0][j+1] + (1 - p) * option_tree[0][j])
        current_level.append(value)
    option_tree.insert(0, current_level)


print(f"European Call Option Price (K = {K}): {option_tree[0][0]:.4f}")
```

```
European Call Option Price (K = 150): 12.7827
```

Figure 4. Calculating Price K

For put options, the formula becomes $\max(K-S, 0)$. These terminal payoffs serve as the foundation for the backward induction process used in pricing.

4.2. Return Matrix Construction

The values calculated at each node allow us to form a return (or payoff) matrix that captures the possible strategic decisions of the two players in the options market — the holder and the writer. Each entry in this matrix corresponds to the potential payoff of a strategy combination (e.g., hold vs. execute) under different market conditions. In the zero-sum game setting, the holder's gain is exactly the writer's loss. This matrix is central to applying game-theoretic concepts such as Nash equilibrium, which are used to analyze optimal strategies and price the option from a strategic perspective.

5. Apply Game Theory (Nash Equilibrium)

5.1. Strategic Interpretation of Option Pricing

The payoffs computed at the nodes form the basis of a return matrix, which models the strategic interaction between the option holder and the option writer. This matrix is used as the input for the linear programming model that finds the Nash equilibrium, ensuring that neither party can unilaterally improve their outcome. The structure of this matrix allows us to frame the pricing problem as a game-theoretic interaction.

5.1.1 The Game

The interaction between the option holder (buyer) and the option writer (seller) can be modeled as a two-player game. Each player has a set of strategies — for example, the holder decides whether to execute or hold the option, while the writer prepares for different payoff outcomes. Since the financial interests of these parties are directly opposed, this can be framed as a zero-sum game, where the gain of one player results in the loss of the other.

5.1.2 Formulation as a Linear Programming Problem

To find the optimal mixed strategy for each player, the game is modeled as a linear programming (LP) problem. The goal is to determine the Nash equilibrium — a stable state in which no player can improve their expected payoff by unilaterally changing their strategy. Let x_j denote the probability of choosing strategy j. The LP formulation seeks to minimize the maximum expected loss (or maximize the minimum gain), subject to constraints derived from the payoff matrix.

For example, the problem for the option holder (Player 1) can be written as:

$$\min_x \sum_j x_j$$

Subject to:

$$\sum_j \text{payoff}_{ij} \cdot x_j \leq 0, \quad \forall i$$

$$\sum_j x_j = 1, \quad x_j \geq 0 \quad \forall j$$

5.2. Using the Payoff Matrix

The return matrix constructed earlier is used as the core input to the linear program. Each row represents a strategy of the writer, and each column represents a strategy of the holder. The objective function and constraints are built directly from this matrix. Solving the linear program yields the equilibrium strategy, which guarantees that neither party can improve their expected outcome by deviating. This equilibrium can then be backtested against historical data to validate its predictive and financial performance.

6. Backtesting and Evaluation

6.1. Simulation on Historical Data

To evaluate the practical effectiveness of the option pricing strategy derived from the binomial tree and Nash equilibrium model, we simulate it over historical market data. Specifically, the strategy is applied to the AAPL dataset from January 1, 2022 to January 1, 2023. At each time step, the binomial tree is constructed using historical volatility, and the payoff matrix is used to compute the Nash equilibrium strategy. Based on this, we determine whether the optimal action is to execute or hold the option on each trading day. The resulting actions are recorded along with the realized profit or loss.

6.2. Performance Analysis

The backtesting results reveal that the combined model of binomial tree pricing with Nash equilibrium yields consistent and significant profits across multiple time periods.

For the AAPL dataset used in this study, the strategy recommended exercising options on each day within the selected window. The resulting profits ranged between $72 and $82 per execution, indicating that the strategy effectively captured favorable market movements.

Overall, the model exhibits high profitability, interpretability, and adaptability, making it a strong candidate for further refinement in real-world trading applications.

7. Novel Insights and Future Directions

7.1. Accessible and Scalable Implementation

One of the strengths of this approach lies in its practical feasibility. Using the yfinance API, all required stock and option data can be programmatically retrieved, making the entire modeling pipeline fully implementable in Python. The use of common libraries such as NumPy, Pandas, and SciPy further simplifies data processing, numerical computation, and linear programming.

While this study focuses on historical data for Apple Inc. (AAPL), the methodology is asset-agnostic and can be applied to a wide range of financial instruments — equities, indices, or even commodities. Furthermore, the framework can be extended to operate in real-time using live data feeds, enabling dynamic strategy adjustments. Incorporating machine learning models to forecast volatility or optimize strategy selection could further enhance predictive performance.

7.2. Model Assumptions

The current model assumes constant volatility and a static risk-free rate, which simplifies computation but may not fully capture real market behavior. Relaxing these assumptions would require more advanced models such as stochastic volatility frameworks or interest rate models. Despite this, the binomial tree + game theory combination offers a powerful and interpretable foundation upon which more sophisticated techniques can be layered.

8. Conclusion

This project integrates the binomial tree model with game theory to develop a novel approach for option pricing. Using historical data for Apple Inc. (AAPL) retrieved via the yfinance API, we construct a multi-step binomial tree and define payoffs at each node. The interaction between option holders and writers is modeled as a strategic game, and a Nash equilibrium is computed through linear programming. Backtesting demonstrates consistent profitability, and the method shows strong adaptability to other assets. The approach is fully implementable in Python and can be enhanced with real-time data or machine learning for improved prediction.

References

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