

# Analysis of the Quantum Advantages for Deep Hedging

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## Abstract

Parameterised Quantum Circuits (PQCs) have opened many doors, one such being the use in financial markets. In this paper, I look at the problem of developing an accurate market generator through the use of quantum computing for the purposes of hedging. Given a Quantum Circuit Born Machine (QCBM), we are able to exploit the high expressibility to generate synthetic data that mimics the statistical distribution of the original dataset. The market generator is then used to simulate an underlying asset to maturity with the intent of learning an optimal hedging strategy  $\pi^*$ , a showcase of a data-driven approach to hedging exposure. I show that the synthetic data produced by this method has shown to capture the fat tails of the market better than classical methods, as well as demonstrating superiority in out-of-sample testing with COVID data. Different generator architectures have been compared to maximise the quality of the synthetic data and avoid issues with barren plateaus. The findings of this research will contribute to the growing literature on risk management in quantitative finance, with applications of the market generator extending beyond deep hedging.

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# 1 Problem Statement

The problem of hedging a portfolio of derivatives is an important part of risk management used widely in financial institutions. This involves understanding the exposure to the market, and taking strategic positions to negate some of this risk. In an ideal world we can picture a perfect, frictionless market where transaction costs are negligible and every asset in the space has a price; here we can price and hedge perfectly. Unfortunately in practice, we experience incomplete markets due to frictions, costs that interfere with trades such as transaction costs or imperfect information. In addition, recent years have presented markets with periods of heightened volatility, much that disobey traditional frameworks. This generates the need for complex, realistic market models that can account for these.

Traditional methods of hedging options has shown to be ineffective for equity markets, new information resulting in rapid changes. Much of the available literature models the market as a smooth, continuous stochastic process within a Gaussian space. Such models are sufficient for common market activity but fail when presented with discontinuous moves in price. These can be reactions to geopolitical events or natural disasters; traditional models are incapable of capturing the effects. The introduction of Jump-diffusion models aimed to solve this issue though face similar issues. In reaction, we have recently observed non-parametric models that harness neural networks and machine learning which aim to demonstrate high accuracy on out-of-sample forecasts.

An alternative approach that has recently emerged utilises the power of quantum computing. The introduction of parameterised quantum circuits(PQCs) have opened up new pathways for navigating complex, large scale time series datasets. Through rotation gates and quantum entanglement, we are able to learn complex distributions and relationships.

In this research, I aim to tackle the problem of generating synthetic financial data, addressing issues that come about from using a classical method particularly the estimation of tail risk and skewness. Through comparisons between traditional approaches, I aim to demonstrate an advantage in the expressibility of Quantum Circuit Born Machines (QCBMs); these will be described quantitatively using measures such as Value at Risk (VaR) and Conditional Value at Risk (CVaR). By performing out-of-sample tests on COVID and Oil data, I aim to highlight the weaknesses of traditional models and showcase a quantum superiority. There will also be an exploration into the variety of architectures available for the QCBM, evaluating different ansatz designs. Where unusual behaviours due to quantum physics occur, such as barren plateau, I will explore in greater detail as well as any circuit optimisation techniques that may present themselves as possible solutions.

This paper will aim to add to the existing literature on risk management for financial firms as well as providing a framework for generating synthetic data. In addition to that, I aim to extend to the QCBM research that exists currently, noting down any behaviours that may be of interest to the curious and potential experts in the field.

## 1.1 Aims & Goals

This section aims to provide a high-level insight into the goals of the project with more detailed explanations being left for their respective sections.

Market data, though appearing entirely stochastic at first glance, contains many hidden patterns and relationships. Classical methods such as Black-Scholes [**blackscholes**] have been proposed to capture some of this behaviour, though built on unrealistic assumptions, these govern our fundamental understanding of quantitative finance. With the move to the new era of electronic trading, the need for more complex markets models became more present. Being able to trade within nanoseconds presented traders with a new, human-free method of trading, moving to a purely mathematical approach. In this approach we strive for optimal strategies to make money, taking calculated positions and limiting exposure to large market movements. It is here where traditional methods started to be insufficient; particua

## 2 Related Literature

To place this research within the context of existing literature, we can split the project into 2 components: the market generator, and parameterised quantum circuits.

The work around deep hedging has evolved, moving away from Greek-based hedging towards a sturdier framework using machine learning. Here a lot of work is being done, with many papers emphasising on using neural networks for optimising delta and gamma exposure [1, 33]. Buehler introduced an approach, modelling trading decisions as neural networks instead of relying on parameterised models [8]. Subsequent advancements focussed on developing realistic market simulators. Wissel proposed a market model for path generation of options but this still employed risk-neutral diffusion[38]. Wiese then introduced a new dimension by using GANs to convert options into local volatility models with simpler no-arbitrage constraints. This focussed on the local stochastic nature of options [10, 45, 46]. Some approaches suggest using actor-critic reinforcement learning algorithms to solve for an optimal value function, a move towards searching for a global maximum over local risk management [7, 27].

Recent research explores using quantum computing to hedge portfolios, here the authors presented a quantum reinforcement learning method based on policy-search and distributional actor-critic algorithms. They proposed using a Quantum Neural Network to approximate the value of a given value function by predicting the expected utility of returns using compound and orthogonal layers which were built using Hamming-weight unitaries [23].

TO CHANGE: This helped overcome the barren plateau by ensuring the gradient variance does not vanish exponentially with qubit count.

Another method models the entire return distribution, leveraging parameterised circuits to learn categorical distributions and capture variability and tail risk [9, 12].

There is an immense amount of research being done on exploiting the benefits of quantum computing, recent advancements being in quantum algorithms. These claim to provide exponential speed-up over classical methods, though in reality, we see great complexity in state preparation, requiring  $\Theta(2^n/n)$  circuit depth with  $n$  qubits or  $\Theta(n)$  circuit depth with  $\Theta(2^n)$  ancillary qubits[48]. Here we see hybrid models such as Born machines and Quantum generative adversarial networks boasting high generalisation ability [18, 20, 22].

There has also been research in harnessing back action from quantum weak measurements to enhance the ability of quantum machine learning algorithms. In quantum reservoir computing, the ability to retain information from past inputs plays a key role in processing temporal series and producing future predictions [16, 17, 19, 28].

This research aims to combine the needs of financial firms in hedging portfolios using realistic market models by utilising QCBMs as a tool for simulating paths in combination with deep hedging engines for learning optimal policies. A comparison will be made

against hedging under Merton-Jump diffusion.

### 3 Markets and Derivatives

The market, though inherently can be thought of as a completely random process, where bids and asks are fulfilled, can be modelled as a stochastic process. The aim of this chapter is to serve as a brief introduction and set up notation for later chapters.

#### 3.1 Market

Consider a market with a finite time horizon  $T$  defined on the probability space  $(\Omega, \mathcal{F}, P)$  along with a filtration  $\mathbf{F} = \{\mathcal{F}|0 \leq t \leq T\}$ . This can be thought of as an adapted  $(n+1)$  dimensional Itô process  $X(t) = (X_0(t), X_1(t), \dots, X_n(t))$  which has the form

$$dX_0(t) = \rho(t, \omega)X_0(t)dt; \quad X_0(0) = 1 \quad (3.1)$$

and

$$dX_i = \mu_i(t, \omega)dt + \sigma_i(t, \omega)dB(t); \quad X_i(0) = x_i \quad (3.2)$$

where  $X_i(t)$  as the price of asset  $i$  at a given time  $t$ .

We can define a portfolio in the market as

$$\theta(t, \omega) = (\theta_0(t, \omega), \theta_1(t, \omega), \dots, \theta_n(t, \omega)) \quad (3.3)$$

where the components  $\theta_n(t, \omega)$  represents the number of units of a given asset held at time  $t$ .

Following from that, we can define the value of a given portfolio to be

$$V(t, \omega) = V^\theta(t, \omega) = \sum_{i=0}^n \theta_i(t)X_i(t) \quad (3.4)$$

Lastly, it is important to state that the portfolio is self-financing, any trading strategy  $\alpha$  requires no extra cost beyond the initial capital

$$V(t) = V(0) + \int_0^t \theta(s) \cdot dX(s) \quad (3.5)$$

We can also make the following assumptions about the market:

- The market is liquid, allowing the trade to execute instantaneously
- There is no bid-ask spread, the price to buy and sell is the same
- Trading actions taken have no impact on the price of the asset traded

#### 3.2 Derivatives

A derivative refers to any financial instrument whose value is derived from an underlying security, the most fundamental being futures and options. It is common practice to refer to the given underlying security as just 'underlying'.



### 3.2.1 Futures

A futures contract is a contract that gives the right and obligation to buy a given asset  $i$  at a specified time  $T$  at price  $K$ .

### 3.2.2 Options

The two types of options going to be explored are Puts and Calls; a Call option gives the owner the right but not the obligation to buy a given asset  $i$  at a specified price  $K$  at time  $T$ . Similar to the Call, a Put option gives the owner the right but not the obligation to sell a given asset  $i$  at a price  $K$  at time  $T$ . If the owner can exercise the option any time up to  $T$ , we call this an American option. For the purposes of this research, I will only be dealing with vanilla European options.

It is important to define the payoffs for both options:

$$C_T = \max(0, S_T - K) \quad (3.6)$$

$$P_T = \max(0, K - S_T) \quad (3.7)$$

## 3.3 Market Data

In this research I will be focussing on hedging a portfolio consisting of a single asset, hence requiring a simulation of a single underlying.

### 3.3.1 Euro Stoxx 50

The Euro Stoxx 50 Index (SX5E) and relevant derivatives. This is a stock index of 50 stocks in the Eurozone. This index captures around 60% of the free-float market capitalisation of the Euro Stoxx Total Market Index which covers about 95% of the free-float market in the Eurozone[14]. Rationale behind choosing this index is the availability of data, options traded with SX5E as the underlying and the liquidity of the index.

Derivatives that are held in the portfolio to be hedged will include those that have SX5E as the underlying, examples are weekly, monthly, and quarterly expiration options. These are European-style so can only be exercised upon maturity. Data can be found on Bloomberg[5] and Refinitiv [26].

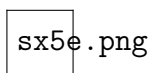


Figure 1: Euro Stoxx 50 price chart

### 3.3.2 Brent Crude Oil

It was appropriate to try and learn a volatile commodity. Sensitive to price movements.

## 4 Merton-Jump Diffusion Model

My model of choice for comparison is the Merton-Jump Diffusion model, this an elementary model that goes beyond Black-Scholes by trying to capture the negative skewness and excess kurtosis of log price returns. This is done through the addition of a compound Poisson jump process. This aims to represent the jumps we observe in the market in a more realistic fashion rather than assuming constant volatility assumption made by Black-Scholes. As a simplification, I will be referring to Black-Scholes by BS and Merton-Jump Diffusion with MJD.

### 4.1 Model

A standard derivation of the model will allow us to explore its assumptions and limitations. This model consists of two components, jump and diffusion. The diffusion will be modelled using a Wiener process and log-normal jumps driven by a Poisson process. This gives us the following SDE.

$$dS_t = (\alpha - \lambda k)S_t dt + \sigma S_t dW_t + (y_t - 1)S_t dN_t \quad (4.1)$$

where  $W_t$  and  $N_t$  are Wiener and Poisson processes respectively.  $\lambda$  represents the intensity of the jumps,  $\alpha$  is the drift rate (expected return), and  $k$  is the expected jump size. Solving the equation gives us an exponential Lévy model described by

$$S_t = S_0 e^{\mathcal{L}_t} \quad (4.2)$$

where  $S_t$  is the stock price at time  $t$ ,  $S_0$  is the initial stock price. We can also define  $\mathcal{L}_t$  to be

$$\mathcal{L}_t = \left(\alpha - \frac{\sigma^2}{2} - \lambda k\right)t + \sigma W_t + \sum_{i=1}^{N_t} Y_i \quad (4.3)$$

### 4.2 Assumptions & Limitations

Through inspection of the equations, we can observe the following assumptions:

1. The asset price experiences continuous, random fluctuations over time, governed by Brownian motion (GBM)
2. The asset price experiences sudden, discontinuous jumps modelled by a Poisson process, occurring at a constant rate  $\lambda$
3. Jumps sizes are assumed to be log-normal  $\ln(y_t) \sim \mathcal{N}(\mu, \sigma^2)$

Starting with the first assumption, we can see that assuming GBM may produce unrealistic behaviour, most important being a lack of excess kurtosis. Markets often exhibit fat tails, especially within commodities. One such event may be the release of news from OPEC+, the organisation of petroleum-exporting countries. A restriction in oil production may cause the price of oil to jump rapidly. In recent times, wars and conflict has also

become ever present, causing large movements in asset prices; therefore it is not unrealistic to expect extreme price movements to be more frequent than can be modelled by a Gaussian.

The MJD requires calibration of parameters before use, typically done using historical data or implied volatility surfaces. Once calibrated these become assumptions of the data and so do not change even if the market observations move away from it. This would lead us to expect higher overfitting to the historical data, possibly failing in unseen conditions such as the market's reaction to COVID.

We also may expect poor volatility clustering with the MJD; constant volatility is not experienced by the market, instead periods of high volatility followed by periods of low volatility is observed. Though this paper won't be focussing on this phenomenon, it is important to consider.

### 4.3 Calibration

In this research, I have chosen to use maximum likelihood estimation to estimate the parameters for the MJD model. In the analytical solution we require five parameters:  $\alpha$ ,  $\sigma$ ,  $\mu_j$ ,  $\delta$ , and  $\lambda$ . These are the expected return, volatility of the given asset, expectation of the jump size, standard deviation of the jump size and lastly the jump intensity. We can then use MLE on the probability density of log returns  $S_t = \ln(\frac{S_t}{S_0})$

$$P(S_t) = \sum_{i=0}^{\infty} \frac{e^{-\lambda t} (\lambda t)^i}{i!} N(S_t; (\alpha - \frac{\sigma^2}{2} - \lambda k)t + i\mu_j, \sigma^2 t + i\delta^2) \quad (4.4)$$

The likelihood function hence becomes

$$L(\theta; S) = \prod_{t=1}^T P(S_t) \quad (4.5)$$

We can minimise the negative log-likelihood to obtain

$$-\ln L(\theta; S) = -\sum_{t=1}^T \ln P(S_t) \quad (4.6)$$

Another popular option to calibrate the MJD model is by considering the implied volatility surface of existing options. This technique can lead to a calibration but suffers with issues surrounding the sensitivity of the tails of the asset prices. It is also well documented that given a function that measures the calibration error, we can observe a largely flat landscape surrounding the optimal solution, implying obtaining accurate parameters can become very computationally expensive, often requiring hundreds of iterations [jump05]. These difficulties can translate into a poor hedge, leaving a buyer overexposed to market fluctuations.

## 5 Quantum Computing

This section aims to serve as a brief introduction to quantum computing, this may prove to be pedestrian to the experienced but is included to maintain the accessibility of this research report.

### 5.1 Quantum Systems

Unlike classical computing, quantum computing acts in a non-deterministic manner, the computer remains in multiple states with given probabilities rather than a fixed resultant state as expected from classical computers. Formally we can define a qubit to be a quantum system where the states of 0 and 1 are represented by a pair of normalised and mutually orthogonal quantum states  $|0\rangle$  and  $|1\rangle$ . Intuitively however, let's start with a two-state machine; we can describe such system to be in the state  $|0\rangle$  with some amplitude  $\alpha$  and in  $|1\rangle$  with amplitude  $\beta$ . This can be represented as

$$|\psi\rangle = \alpha|0\rangle + \beta|1\rangle \quad (5.1)$$

for some  $\alpha$  and  $\beta$  such that  $|\alpha|^2 + |\beta|^2 = 1$ ; we can refer to this as a superposition. If measured in the standard basis, we would expect the outcome to be  $|k\rangle$  with a certain probability, this outcome resulting in the output state of the measurement gate to also be  $|k\rangle$ . This would mean our state  $|\psi\rangle$  is irreversibly lost; we refer to this as a collapse of state. Each qubit can be thought of as a vector,  $\mathbf{v}$ , on a Bloch's sphere which can be represented in two basis:  $\theta$  and  $\psi$ .  $\theta$  is the angle between  $\mathbf{v}$  and the z-axis.  $\psi$  becomes the angle between  $\mathbf{v}$  and the x-axis. Considering a more general parameterisation of 5.1 gives us

$$|\psi\rangle = \cos(\frac{\theta}{2})e^{i\psi_0}|0\rangle + \sin(\frac{\theta}{2})e^{i\psi_1}|1\rangle \quad (5.2)$$

TALK MORE HERE

When extending to a n-qubit system

Before forming quantum circuits, we must first understand how quantum gates operate. Quantum gates can be thought of as fixed unitary operations on selected qubits, often represented with a  $U$ . There are many gates but the ones we are concerned with for this project are the  $T$ ,  $R_x$ ,  $R_y$ ,  $R_z$  and  $CNOT$  gates. Given an angle  $\theta$  we can form the universal gates:

$$R_x(\theta) = \begin{bmatrix} \cos(\theta/2) & -i \sin(\theta/2) \\ -i \sin(\theta/2) & \cos(\theta/2) \end{bmatrix}$$

$$R_y(\theta) = \begin{bmatrix} \cos(\theta/2) & -\sin(\theta/2) \\ \sin(\theta/2) & \cos(\theta/2) \end{bmatrix}$$

$$R_z(\theta) = \begin{bmatrix} e^{-i\theta/2} & 0 \\ 0 & e^{i\theta/2} \end{bmatrix}$$

$$T = \begin{bmatrix} 1 & 0 \\ 0 & e^{-i\pi/4} \end{bmatrix}$$

$$CNOT = \begin{pmatrix} 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \\ 0 & 0 & 0 & 1 \\ 0 & 0 & 1 & 0 \end{pmatrix}$$

Universal gates, Clifford Gates and non-Clifford gates

## 5.2 Born Rule

An essential part of quantum computing involves the existence of the Born Rule. Born's measurement rule states that:

$$p(x) = |\langle x | \psi(\theta) \rangle|^2 \quad (5.3)$$

where

$$|\psi(\theta)\rangle = U(\theta)|0\rangle^{\otimes n} \quad (5.4)$$

The state  $|\psi(\theta)\rangle$  is generated by evolving state  $|0\rangle$  according to a Hamiltonian  $H$  that is constructed from gates. Once combined, the gates form a parameterised quantum circuit which is parameterised by using the variables governing each gate,  $\theta$ . By tuning the values of  $\theta_i$  one can allow for an evolution to any state that will serve as a solution to a given problem.

By taking the distribution associated to the state,  $|\psi(\theta)\rangle$  we can treat the PQC as a generative model, upon measurement will generate samples of a target distribution  $\chi$ . This model is parameterised by  $\theta$ , which defines a quantum circuit  $U(\theta)$  made up of a set of quantum gates. By measuring the circuit, we can obtain samples. Producing samples that emulate the target distribution involves minimising the parameters of the circuit  $U(\theta)$ , a process once convergence is reached, will generate accurate samples [25].

## 5.3 State Preparation

We require state preparation to transfer the classical data onto the Hilbert space. This involves a function  $\phi$  that maps the input vector to an output label. There are many encoding schemes, each of which aim to offer high information density and low error rates; main methods include: basis, amplitude, angle encoding, and QRAM.

Without the use of ancillary qubits, we can expect an exponential circuit depth to prepare an arbitrary quantum state. Using them we can reduce the depth to be sub-exponential scaling, with recent advancements reaching  $\Theta(n)$  given  $O(n^2)$  ancillary qubits [39, 48].

## 5.4 Parameterised Quantum Circuits

Parameterised quantum circuits.

## 6 Quantum Circuit Born Machine

Given a dataset  $D = \{x_1, x_2 \dots x_n\}$  consisting of  $n$  samples and obeys a given distribution  $\chi_d$ , we would like the QCBM to learn the distribution and generate synthetic data points that are of the distribution  $\chi_s$  such that  $\chi_s$  approximates  $\chi_d$ . The QCBM is a subclass of parameterised quantum circuits, here the quantum circuit contains parameters which are updated during a training process. The QCBM takes the product state  $|0\rangle$  as an input, and through an evolution, transforms into a final state  $|\phi_0\rangle$  by a sequence of unitary gates. This can then be measured to obtain a sample of bits  $x \sim p_\theta(x_s) = |\langle x | \phi_\theta \rangle|^2$ . By training the model we are aiming to let  $p_\theta$  approach  $\chi_d$ .

The ansatz for this quantum circuit consists of 7 layers of 1-qubit gates with entangling layers in between them. These are entangled using the CNOT gates as found in the appendix. The number of wires needed depends on the precision required for the generated data. The estimated precision is 12-bit, so the samples are able to take  $2^{12}$  different values in the range of  $(v_{min} - \epsilon, v_{max} + \epsilon)$ , where  $\epsilon > 0$  allows data to be generated that lie outside the range  $(v_{min}, v_{max})$  of the original data.

The QCBM takes a  $n \times m$  matrix of parameters in the range  $(-\pi, \pi)$  as input, in the form of a dictionary. Each angle takes one of  $2^k$  discrete values, where  $k$  is a model parameter. The resulting space therefore spans to:  $(2^m)^{n \cdot m}$ .

### 6.1 Architectures

#### 6.1.1 Brick

#### 6.1.2 Pyramid

#### 6.1.3 Butterfly

### 6.2 Barren Plateau

A point of concern when searching for the optimal set of  $\theta$ s is the large search space, here we may observe issues such as barren plateau(BP). BP insists that the gradient of the parameters of a given PQC will vanish exponentially w.r.t the search space.

Introduce proof of  $\frac{\partial C}{\partial \theta} \rightarrow 0$

### 6.3 ZX Calculus

ZX Calculus as a method to optimise/minimise t gate count. introduce what a non clifford gate is.

## 7 Results

### 7.1 Path Generation

#### 7.1.1 VaR & CVaR

### 7.2 Hedging

### 7.3 Barren Plateau

#### 7.3.1 ZX Calculus

## 8 Outlook and Conclusions



## 9 Appendix

### 9.1 QCBM Architectures

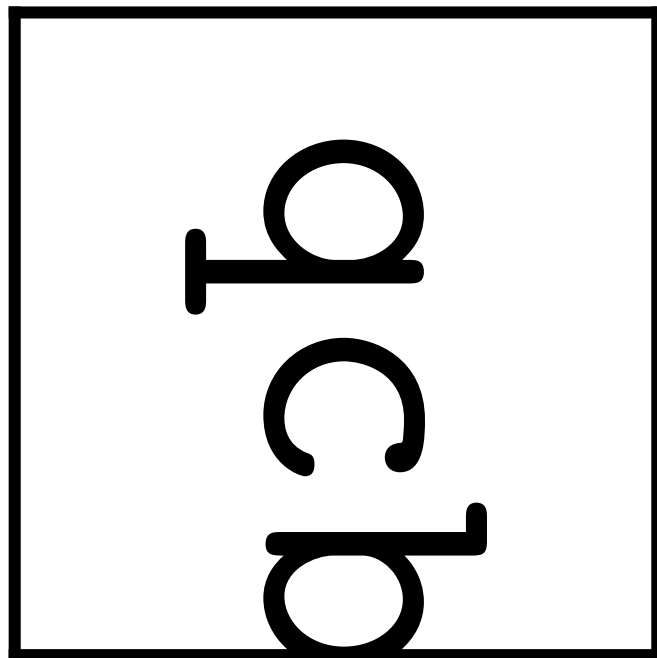


Figure 2: QCBM architecture

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