Stochastic Modelling and Random Processes Problem Sheet 3

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Contents

1 Geometric Brownian Motion

Let $(X_t : t \geq 0)$ be a Brownian motion with constant drift on $\mathbb{R}$ with generator

$$(\mathcal{L}f)(x) = \mu f'(x) + \frac{1}{2}\sigma^2 f''(x), \ \mu \in \mathbb{R}, \ \sigma > 0,$$

and initial condition $X_0 = 0$. **Geometric Brownian motion** is defined as

$$(Y_t : t \geq 0) \quad \text{with} \quad Y_t = e^{X_t}.$$

(a) Show that $(Y_t : t \geq 0)$ is a diffusion process on $[0, \infty)$ and compute its generator. Write down the associated SDE and Fokker-Planck equation.

Sol. Notice that

$$
\begin{aligned}
\mathbb{E}[(\mathcal{L}_Y f)(Y_t)] =& \frac{\mathrm{d}}{\mathrm{d}t}\mathbb{E}[f(Y_t)] \\
=& \frac{\mathrm{d}}{\mathrm{d}t}\mathbb{E}[f(e^{X_t})].
\end{aligned}
\tag{1}
$$

Let $F = f \circ \exp$, then (1) becomes

$$
\begin{aligned}
\mathbb{E}[(\mathcal{L}_Y f)(Y_t)] =& \frac{\mathrm{d}}{\mathrm{d}t}\mathbb{E}[f(e^{X_t})] \\
=& \frac{\mathrm{d}}{\mathrm{d}t}\mathbb{E}[F(X_t)] \\
=& \mathbb{E}[(\mathcal{L}_X F)(X_t)].
\end{aligned}
\tag{2}
$$

Since (2) holds for all $f \in C^1(\mathbb{R})$, we know

$$
\begin{aligned}
(\mathcal{L}_Y f)(Y_t) &= (\mathcal{L}_X F)(X_t) \\
&= \mu \frac{\mathrm{d}}{\mathrm{d}x} f(e^{X_t}) + \frac{1}{2}\sigma^2 \frac{\mathrm{d}^2}{\mathrm{d}x^2} f(e^{X_t}) \\
&= \mu f'(e^{X_t})e^{X_t} + \frac{1}{2}\sigma^2 \frac{\mathrm{d}}{\mathrm{d}x}(f'(e^{X_t})e^{X_t}) \\
&= \mu f'(e^{X_t})e^{X_t} + \frac{1}{2}\sigma^2 (f''(e^{X_t})e^{2X_t} + f'(e^{X_t})e^{X_t}) \\
&= \mu f'(Y_t)Y_t + \frac{1}{2}\sigma^2 (f''(Y_t)Y_t^2 + f'(Y_t)Y_t) \\
&= (\mu + \frac{1}{2}\sigma^2)Y_t f'(Y_t) + \frac{1}{2}(\sigma Y_t)^2 f''(Y_t),
\end{aligned}
\tag{3}
$$

which shows $(Y_t : t \geq 0)$ is a diffusion process with the drift $(\mu + \frac{1}{2}\sigma^2)y$ and the diffusion σy. To derive the Fokker-Planck equation, notice that

$$
\begin{aligned}
&\int_{\mathbb{R}_+} \frac{\partial}{\partial t} p_t(x, y) f(y)\, \mathrm{d}y \\
&= \frac{\partial}{\partial t} \int_{\mathbb{R}_+} p_t(x, y) f(y)\, \mathrm{d}y \\
&= \frac{\partial}{\partial t} \mathbb{E}[f(Y_t)] \\
&= \mathbb{E}[(\mathcal{L}_Y f)(Y_t)] \\
&= \mathbb{E}\left[(\mu + \frac{1}{2}\sigma^2)Y_t f'(Y_t) + \frac{1}{2}(\sigma Y_t)^2 f''(Y_t)\right] \\
&= \int_{\mathbb{R}_+} \left[(\mu + \frac{1}{2}\sigma^2)y f'(y) + \frac{1}{2}(\sigma y)^2 f''(y)\right] p_t(x, y)\, \mathrm{d}y \\
&= (\mu + \frac{1}{2}\sigma^2) \int_{\mathbb{R}_+} y f'(y) p_t(x, y)\, \mathrm{d}y + \frac{1}{2}\sigma^2 \int_{\mathbb{R}_+} y^2 f''(y) p_t(x, y)\, \mathrm{d}y \\
&= (\mu + \frac{1}{2}\sigma^2) \int_{\mathbb{R}_+} y p_t(x, y)\, \mathrm{d}f(y) + \frac{1}{2}\sigma^2 \int_{\mathbb{R}_+} y^2 p_t(x, y)\, \mathrm{d}f'(y) \\
&= (\mu + \frac{1}{2}\sigma^2) \left\{ y p_t(x, y) f(y)\big|_{y=0}^{y=\infty} - \int_{\mathbb{R}_+} f(y)\left[p_t(x, y) + y\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y \right\} \\
&\quad + \frac{1}{2}\sigma^2 \left\{ y^2 p_t(x, y) f'(y)\big|_{y=0}^{y=\infty} - \int_{\mathbb{R}_+} f'(y)\left[2y p_t(x, y) + y^2\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y \right\} \\
&= -(\mu + \frac{1}{2}\sigma^2) \int_{\mathbb{R}_+} f(y)\left[p_t(x, y) + y\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y - \frac{1}{2}\sigma^2 \int_{\mathbb{R}_+} f'(y)\left[2y p_t(x, y) + y^2\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y \\
&= -(\mu + \frac{1}{2}\sigma^2) \int_{\mathbb{R}_+} f(y)\left[p_t(x, y) + y\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y - \frac{1}{2}\sigma^2 \int_{\mathbb{R}_+} 2y p_t(x, y) + y^2\frac{\partial}{\partial y}p_t(x, y)\, \mathrm{d}f(y) \\
&= -(\mu + \frac{1}{2}\sigma^2) \int_{\mathbb{R}_+} f(y)\left[p_t(x, y) + y\frac{\partial}{\partial y}p_t(x, y)\right] \mathrm{d}y - \frac{1}{2}\sigma^2 \left\{ [2y p_t(x, y) + y^2\frac{\partial}{\partial y}p_t(x, y)]f(y)\Big|_{y=0}^{y=\infty} \right. \\
&\quad \left. - \int_{\mathbb{R}_+} f(y)[2 p_t(x, y) + 4y\frac{\partial}{\partial y}p_t(x, y) + y^2\frac{\partial^2}{\partial y^2}p_t(x, y)]\, \mathrm{d}y \right\} \\
&= \int_{\mathbb{R}_+} f(y)\left[(\frac{1}{2}\sigma^2 - \mu)p_t(x, y) + (\frac{3}{2}\sigma^2 - \mu)y\frac{\partial}{\partial y}p_t(x, y) + \frac{1}{2}\sigma^2 y^2\frac{\partial^2}{\partial y^2}p_t(x, y)\right] \mathrm{d}y,
\end{aligned}
$$

2

so the Fokker-Planck equation is

$$\frac{\partial}{\partial t}p_t(x,y) = (\frac{1}{2}\sigma^2 - \mu)p_t(x,y) + (\frac{3}{2}\sigma^2 - \mu)y\frac{\partial}{\partial y}p_t(x,y) + \frac{1}{2}\sigma^2 y^2\frac{\partial^2}{\partial y^2}p_t(x,y).$$

An easier way is to use the conclusion for a diffusion process directly:

$$\begin{aligned}
\frac{\partial}{\partial t}p_t(x,y) &= -\frac{\partial}{\partial y}\left[(\mu + \frac{1}{2}\sigma^2)yp_t\right] + \frac{1}{2}\frac{\partial^2}{\partial y^2}\left(\sigma^2 y^2 p_t\right)\\
&= -(\mu + \frac{1}{2}\sigma^2)(p_t + y\frac{\partial}{\partial y}p_t(x,y)) + \frac{1}{2}\sigma^2\frac{\partial}{\partial y}\left(2yp_t + y^2\frac{\partial}{\partial y}p_t(x,y)\right)\\
&= (\frac{1}{2}\sigma^2 - \mu)p_t(x,y) + (\frac{3}{2}\sigma^2 - \mu)y\frac{\partial}{\partial y}p_t(x,y) + \frac{1}{2}\sigma^2 y^2\frac{\partial^2}{\partial y^2}p_t(x,y).
\end{aligned}$$

The associated SDE is

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

(b) Use the evolution equation of expectation values of test functions $f : \mathbb{R} \to \mathbb{R}$

$$\frac{d}{dt}\mathbb{E}[f(Y_t)] = \mathbb{E}[\mathcal{L}f(Y_t)],$$

to derive ODEs for the meane $m(t) := \mathbb{E}[Y_t]$ and the second moment $m_2(t) := \mathbb{E}[Y_t^2]$. (No need to solve the ODEs.)

Sol. We have calculated the generator of Y_t in (a), which is given by (3). Let f be the identity function, i.e. $f(Y_t) = Y_t$, and plug it and (3) in the evolution to get

$$\begin{aligned}
\frac{d}{dt}\mathbb{E}[Y_t] &= \mathbb{E}[\mathcal{L}f(Y_t)]\\
&= \mathbb{E}[(\mu + \frac{1}{2}\sigma^2)Y_t]\\
&= (\mu + \frac{1}{2}\sigma^2)\mathbb{E}[Y_t].
\end{aligned}$$

Thus, $m(t)$ satisfies

$$\frac{dm(t)}{dt} = (\mu + \frac{1}{2}\sigma^2)m(t). \tag{4}$$

Set $f(Y_t) = Y_t^2$, and use it and (3), to derive the ordinary differential equation for $m_2(t)$:

$$\begin{aligned}
\frac{d}{dt}\mathbb{E}[Y_t^2] &= \mathbb{E}[\mathcal{L}f(Y_t)]\\
&= \mathbb{E}[2(\mu + \frac{1}{2}\sigma^2)Y_t^2 + (\sigma Y_t)^2]\\
&= \mathbb{E}[(2\mu + \sigma^2)Y_t^2 + \sigma^2 Y_t^2]\\
&= 2(\mu + \sigma^2)\mathbb{E}[Y_t^2].
\end{aligned}$$

Therefore, $m_2(t)$ satisfies

$$\frac{dm_2(t)}{dt} = 2(\mu + \sigma^2)m_2(t). \tag{5}$$

(c) Under which conditions on μ and σ^2 is $(Y_t : t \geq 0)$ a martingale?

What is the asymptotic behaviour of the variance $v(t) = m_2(t) - m(t)^2$ in that case?

Sol. To make the process $(Y_t : t \geq 0)$ with respect to the process $(X_t : t \geq 0)$, we need to ensure

- $\forall t \geq 0$,
$$m(t) = \mathbb{E}[Y_t] = \mathbb{E}[|Y_t|] < \infty; \tag{6}$$

- $\forall s \leq t$ and $s \geq 0$,
$$\mathbb{E}\left[Y_t \mid \{X_u : 0 \leq u \leq s\}\right] = Y_s. \tag{7}$$

The general solution to (4) is
$$m(t) = Ce^{(\mu + \frac{1}{2}\sigma^2)t},$$

for some constant $C \in \mathbb{R}$, which can be determined by the initial condition

$$C = m(0) = \mathbb{E}[Y_0] = \mathbb{E}[e^{X_0}] = \mathbb{E}[e^0] = 1.$$

Thus, the solution to (4) is
$$m(t) = e^{(\mu + \frac{1}{2}\sigma^2)t}.$$

To make sure condition (6) fullfilled, μ and σ^2 should satisfy

$$\mu + \frac{1}{2}\sigma^2 \leq 0. \tag{8}$$

Now, let us delve into (7).

$$\begin{aligned}
\mathbb{E}[Y_t|\{X_u : 0 \leq u \leq s\}] &= \mathbb{E}[e^{X_t}|\{X_u : 0 \leq u \leq s\}] \\
&= \mathbb{E}[e^{X_s + X_t - X_s}|\{X_u : 0 \leq u \leq s\}] \\
&= e^{X_s}\mathbb{E}[e^{X_t - X_s}|\{X_u : 0 \leq u \leq s\}] \\
&= Y_s\mathbb{E}[e^{X_t - X_s}|\{X_u : 0 \leq u \leq s\}],
\end{aligned} \tag{9}$$

where $(X_t : t \geq 0)$ is the general Brownian motion with drift μ and noise σ. Since it has stationary and independent increments, we know $X_t - X_s|\{X_u : 0 \leq u \leq s\}$ and $X_{t-s}|X_0$ has the same distribution, which is $\mathcal{N}(\mu(t-s), \sigma^2(t-s))$. Notice that the moment generation function $g_X(t)$ of a normal distribution $\mathcal{N}(\mu, \sigma^2)$ is

$$g_X(t) = e^{\mu t + \frac{1}{2}\sigma^2 t^2},$$

so

$$\mathbb{E}[e^{\mathcal{N}}] = g_X(1) = e^{\mu + \frac{1}{2}\sigma^2}.$$

Thus, in (9),

$$\mathbb{E}[e^{X_t - X_s}|\{X_u : 0 \leq u \leq s\}] = \mathbb{E}[e^{X_{t-s}}|X_0] = e^{\mu(t-s) + \frac{1}{2}\sigma^2(t-s)} = e^{(\mu + \frac{1}{2}\sigma^2)(t-s)},$$

which means to satisfy (7), we need $\mathbb{E}[e^{X_t - X_s}|\{X_u : 0 \leq u \leq s\}] = 1$, and therefore, $\mu + \frac{1}{2}\sigma^2 = 0$. Combined with (8), we konw, when

$$\mu + \frac{1}{2}\sigma^2 = 0,$$

the process $(Y_t : t \geq 0)$ is martingale with respect to the process $(X_t : t \geq 0)$.

Notice that $m_2(t)$ satisfies

$$\begin{cases} \frac{\mathrm{d}m_2(t)}{\mathrm{d}t} = 2(\mu + \sigma^2)m_2(t) \\ m_2(0) = \mathbb{E}[Y_0^2] = \mathbb{E}[(e^{X_0})^2] = \mathbb{E}[1] = 1 \end{cases},$$

so

$$m_2(t) = e^{2(\mu+\sigma^2)t}.$$

In this case,

$$\begin{aligned} v(t) =& m_2(t) - m(t)^2 \\ =& e^{2(\mu+\sigma^2)t} - \left(e^{(\mu+\frac{1}{2}\sigma^2)t} \right)^2 \\ =& e^{2(\mu+\sigma^2)t} - e^{2(\mu+\frac{1}{2}\sigma^2)t} \\ =& e^{\sigma^2 t} - e^0 \\ =& e^{\sigma^2 t} \to \infty, \qquad \text{as } t \to \infty. \end{aligned}$$

(d) Show that δ_0 is the unique stationary distribution of the process on the state space $[0, \infty)$. Under which conditions on μ and σ^2 does the process with $Y_0 = 1$ converge to the stationary distribution?

Under which conditions on μ and σ^2 is the process ergodic? Justify your answer.

Sol.

(e) For $\sigma^2 = 1$ choose $\mu = -1/2$ and two other values $\mu < -1/2$ and $\mu > 1/2$. Simulate and plot a sample path of the process with $Y_0 = 1$ up to time $t = 10$, by numerically integrating the corresponding SDE with time steps $\Delta t = 0.1$ and 0.01.

Sol.