

# BAYESIAN ESTIMATION OF RISK-NEUTRAL PROBABILITY

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New Economic School – 2025-06-20

## IMPLIED RISK-NEUTRAL PROBABILITY DENSITY

$$S = \sum_{s=1}^K \phi(s)q(s)$$

$$\phi^* \stackrel{d}{=} \frac{\phi(s)}{\sum_{s=1}^K \phi(s)} = \frac{\phi(s)}{1/(1+r)} = (1+r)\phi(s)$$

$$S = \frac{1}{1+r} \sum_{s=1}^K \phi^*(s)q(s) = \frac{1}{1+r} \mathbb{E}^*[q(s)].$$

## IMPLIED RISK-NEUTRAL PROBABILITY DENSITY

For TAS utility, the state-prices are

$$\phi(s) = \pi \frac{\beta u'[c(s)]}{u'[c(0)]},$$

→ implied risk-neutral probability is

$$\phi^*(s) = \pi \frac{\beta u'[c(s)]}{u'[c(0)]} (1 + r) = \pi \frac{u'[c(s)]}{u'[c(0)]} \approx \pi,$$

for  $u'$  is constant (risk-neutrality) or  $c(s) \approx c(0)$ .

## BREEDEN-LITZENBERGER (1978) FORMULA

For short-term,  $r \approx 0$ .

$$\begin{aligned} C(S, t) &= \mathbb{E}^* [[S(T) - \mathcal{K}]^+ \mid S(t) = S] \\ &= \int_0^{+\infty} (x - \mathcal{K})^+ dP^*(x) \\ &= \int_{\mathcal{K}}^{+\infty} x dP^*(x) - \mathcal{K} \int_0^{+\infty} dP^*(x) \\ &= \int_{\mathcal{K}}^{+\infty} x dP^*(x) - \mathcal{K}(1 - P^*(\mathcal{K})) \end{aligned}$$

$$\begin{aligned} \frac{\partial C}{\partial \mathcal{K}} &= -\mathcal{K}p^*(\mathcal{K}) - 1 + P^*(\mathcal{K}) + \mathcal{K}p^*(\mathcal{K}) = P^*(\mathcal{K}) - 1 \\ \frac{\partial^2 C}{\partial \mathcal{K}^2} &= p^*(\mathcal{K}). \end{aligned}$$

Ait-Sahalia and Duarte (2003)

## BAYESIAN FORMULATION

Fisher (2016) proposes the following approach.

$$y_i = \lambda \sum_{j=1}^K X_{ij} \beta_j + \varepsilon_i,$$

where  $\beta = (\beta_1, \dots, \beta_K) \in \Delta^{K-1}$ ,  $\Delta^{K-1}$  denotes the simplex of dimension  $(K - 1)$ ;  $X_{ij}$  is a payoff of derivative  $i$  in state  $j$ , and  $\varepsilon_i \sim N(0, \sigma^2)$ .

In vector form,

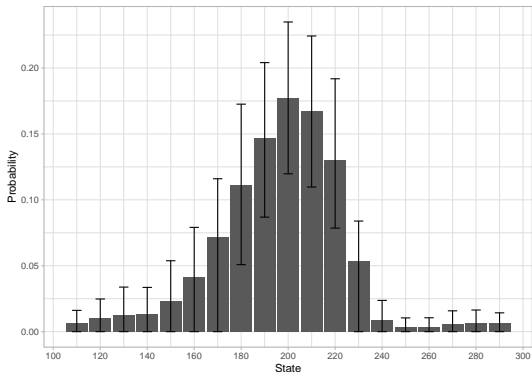
$$y = \lambda X \beta + \varepsilon.$$

In order to insure  $\beta \in \Delta^{K-1}$ , we select the (symmetric) Dirichlet prior:

$$p(\beta \mid \alpha) = \text{Dirichlet}(\beta \mid \alpha) \propto \prod_{i=1}^K x_i^{\alpha-1}.$$

$X$  consists of  $n$  payoffs of  $K$  derivatives, including the payoffs price (you can think of it as call option with strike equal zero).

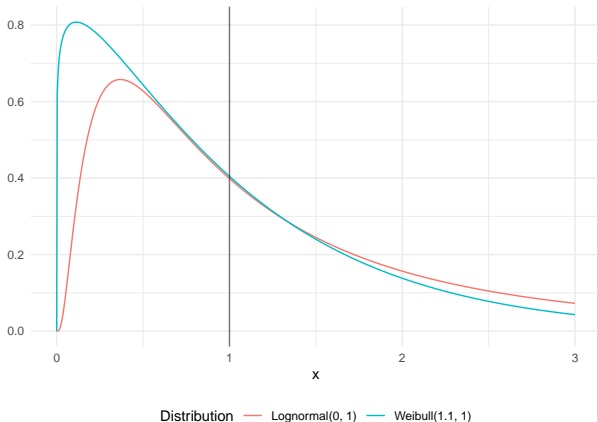
The state space is chosen to ensure that the first and last coefficients are near zero.



## PRIOR FOR CONCENTRATION COEFFICIENT

$\alpha$  is a vector of concentration parameters for Dirichlet distribution.

It is reasonable to select a distribution that is relatively flat on  $[0, 1]$  and assign a large portion of mass to  $[0, 1]$ . Fisher (2016) uses lognormal prior.



## PRIORS AND POSTERIOR

$$p(\beta \mid \alpha) = \text{Dirichlet}(\beta \mid \alpha) \propto \prod_{i=1}^K x_i^{\alpha-1}.$$

$$p(\alpha) = \text{Weibull}(1.1, 1)$$

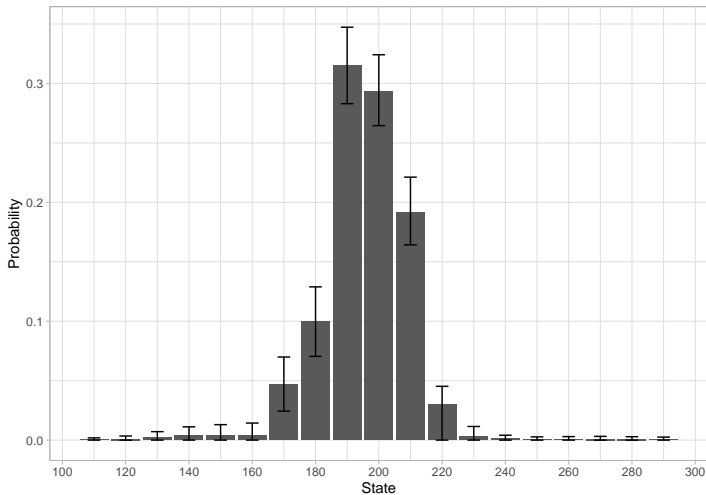
$$p(\sigma^2) \propto \frac{1}{\sigma^2}$$

$$p(\alpha, \lambda, \sigma, \beta \mid y) \propto N(y \mid \lambda X \beta, \sigma) \times \text{Dirichlet}(\beta \mid \alpha) \times \frac{1}{\sigma^2}$$



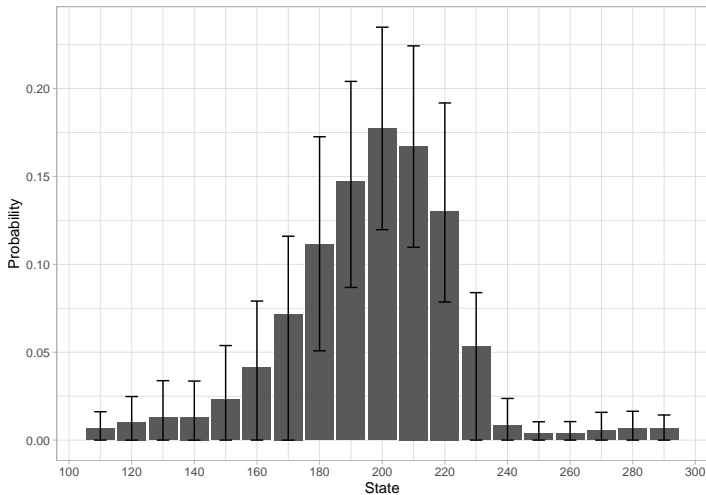
# RISK NEUTRAL DENSITY FOR AAPL I

Calculated in 2025-05-23 with expiration date 2025-06-13

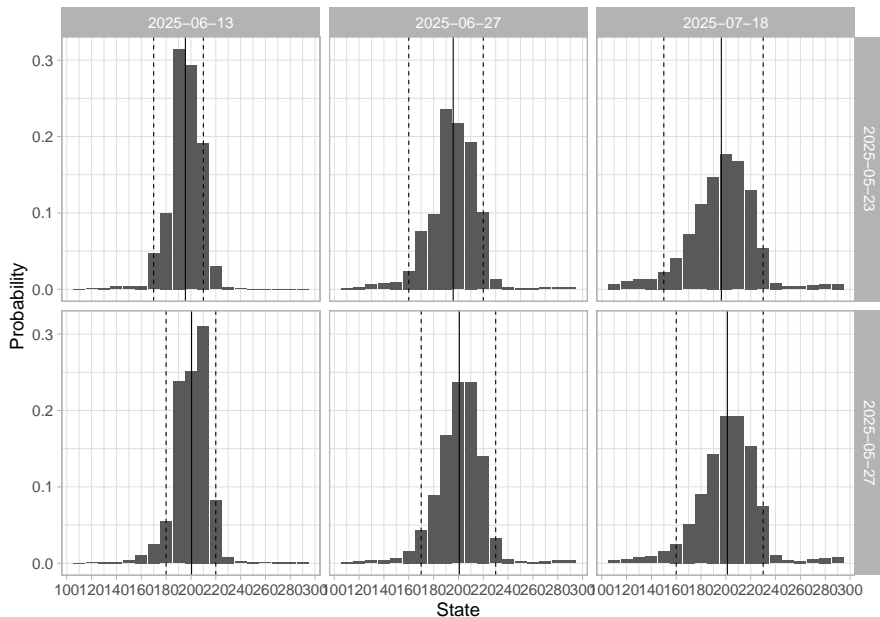


## RISK NEUTRAL DENSITY FOR AAPL II

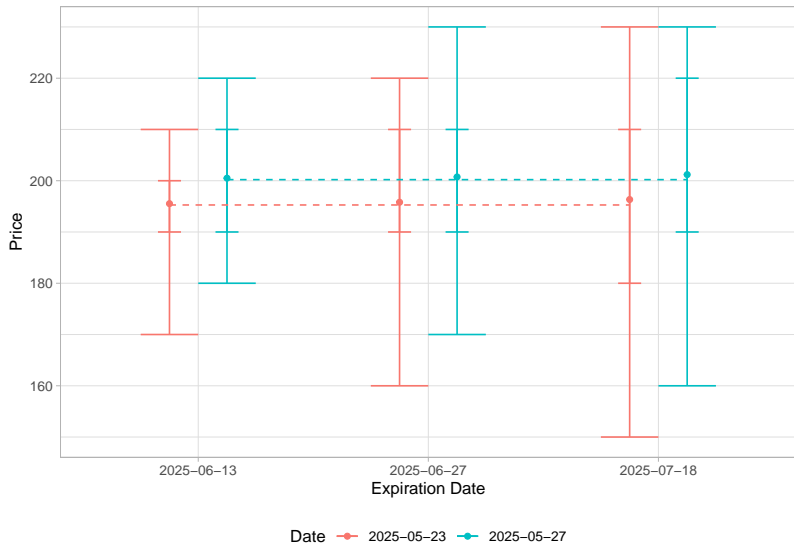
Calculated in 2025-05-23 (same) with expiration date 2025-07-18 (+35 days).



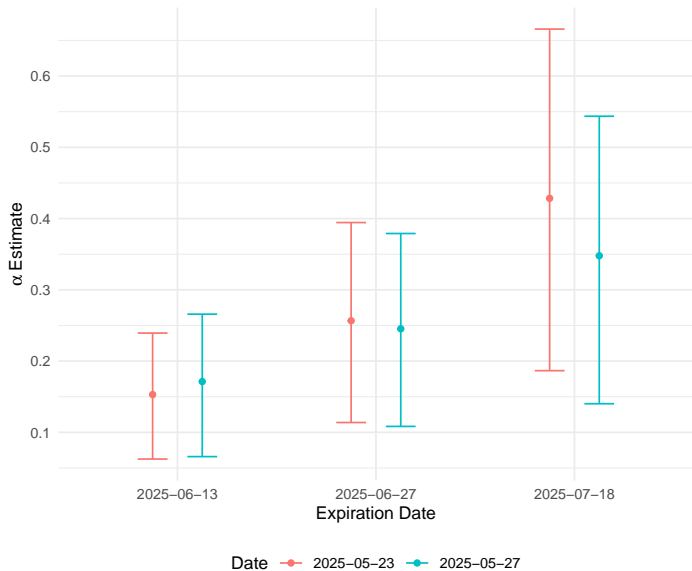
# ESTIMATES OF IMPLIED RISK-NEUTRAL DENSITY



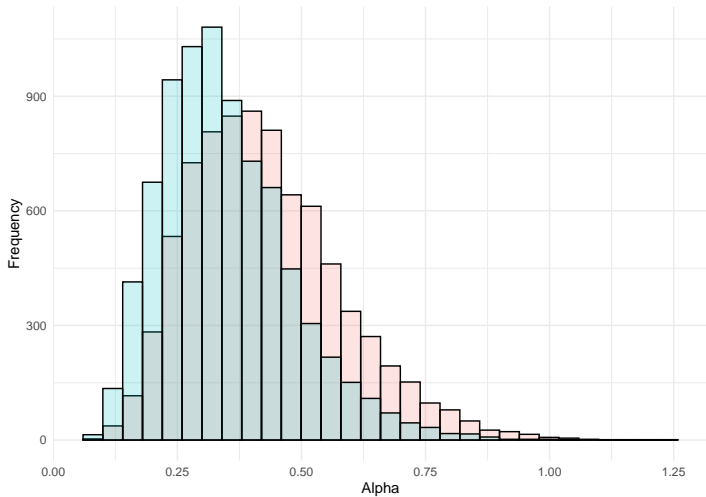
# SUMMARY STATISTICS



# CONCENTRATION PARAMETER ESTIMATES



# ALPHA DISTRIBUTION





# REFERENCES [1]



Ait-Sahalia, Yacine and Jefferson Duarte (Sept. 2003). “Nonparametric Option Pricing under Shape Restrictions”. In: *Journal of Econometrics* 116(1), pp. 9–47. ISSN: 0304-4076. DOI: 10.1016/S0304-4076(03)00102-7. (Visited on 05/31/2025).



Breeden, Douglas T. and Robert H. Litzenberger (1978). “Prices of State-Contingent Claims Implicit in Option Prices”. In: *The Journal of Business* 51(4), pp. 621–651. ISSN: 0021-9398. JSTOR: 2352653. (Visited on 05/31/2025).



Fisher, Mark (May 2016). *Simplex Regression*.