

# Numerical methods for stochastic volatility models: Heston model

---

A Thesis  
Presented to  
The Division of Applied Mathematics  
Getulio Vargas Foundation

---

In Partial Fulfillment  
of the Requirements for the Degree  
M.Sc. of Mathematics

---

Fernando O. Teixeira

julho 31, 2017



Approved for the Division  
(Mathematics)

---

Hugo de la Cruz



# Acknowledgements

I want to thank a few people.



# Table of Contents

<b>Chapter 1: Introduction</b>	<b>1</b>
<b>Chapter 2: Literature Review</b>	<b>3</b>
2.1 Stochastic Calculus	3
2.1.1 Brownian Motion	3
2.1.2 Correlated Brownian Motions	4
2.1.3 Arithmetic Brownian Motion	4
2.1.4 Geometric Brownian Motion	5
2.1.5 Itô's Calculus	5
2.2 Stochastic Differential Equations (SDE's)	7
2.3 Black-Scholes Model	7
2.3.1 The model	7
2.3.2 Limitations	8
2.4 Stochastic Volatility models	8
2.4.1 Other models (PRESENT MODELS PREVIOUSLY USED)	8
2.4.2 Cox-Ingersoll-Ross model	8
2.4.3 Heston Model	9
<b>Chapter 3: The Heston Model Implementation</b>	<b>11</b>
3.1 Characteristic Function	11
3.2 Euler Scheme - Full Truncation	12
3.3 Karl-Jackel	14
3.4 Exact Algorithm	15
<b>Chapter 4: Results</b>	<b>19</b>
<b>Chapter 5: Conclusion</b>	<b>21</b>
<b>Appendix A: The First Appendix</b>	<b>23</b>
<b>Appendix B: The Second Appendix, for Fun</b>	<b>25</b>
<b>References</b>	<b>27</b>





# List of Tables

2.1	Box calculus . . . . .	6
-----	------------------------	---



# List of Figures



# Abstract

The preface pretty much says it all.

Second paragraph of abstract starts here.



# Dedication

You can have a dedication here if you wish.





# Chapter 1

## Introduction

The french mathematician Louis Bachelier was the trail-blazer that brought Brownian motion, previously restricted to the field of botanics where it was firstly observed, to the financial framework. He modeled the stock prices as a brownian motion with drift. Later in time, Black and Scholes [1] improved on Bachelier's work designing a model based on the geometric brownian motion, a more realistic approach.

Options are derivatives that give their bearers the rights to buy or sell a specific asset in a future date and with a predetermined price. They are, by design, affected by small variations in the underlying assets' components, for example, the variance.

The Black-Scholes model, once the standard way of option pricing, was replaced by stochastic process theories in modern financial analysis. These are now prevalent in the academic and real-trading markets.



# Chapter 2

## Literature Review

This chapter presents the concepts of stochastic calculus, from the historic conception of how it first arose through the basic principles and applications in finance. More precisely, we address the classical Black-Scholes model and its limitations and the Heston model. This model is also well known, it introduces the concept of stochastic volatility which brings us closer to reality.

### 2.1 Stochastic Calculus

Stochastic calculus arises from stochastic processes and allows the creation of a theory of integration where both the integrand and integrator terms are stochastic processes. Stochastic calculus, also known as, Itô calculus due to the name of its creator, the Japanese mathematician Kiyosi Itô in the 1940s and 1950s is used for modelling financial options and in another wide variety of fields [2]. In this chapter we present the historical contexts in which the tools and models used arise, but our focus is introducing the concepts and notations that will be further used in our work.

#### 2.1.1 Brownian Motion

The Brownian motion is the name given to the irregular motion observed in the motion of pollen particles suspended in fluid resulting from particle collision with atoms or molecules. It is named after Robert Brown, the first to have observed the movement in 1828. He noted two characteristics in the pollen movement [2]:

- the path of a given particle is very irregular, having a tangent at no point
- the motion of two distinct particles appear to be independent

The first quantitative works in brownian motion come from an interest in stock price fluctuation by Bachelier in 1900. Albert Einstein also leaned over the subject and in 1905 derived the transition density for Brownian motion from molecular-kinetic theory of heat [2,3].

In 1923, the Wiener process was coined in honor of Norbert Wiener mathematical proof of existence of the brownian motion and stating its properties as follows [4]:

- $W_0 = 0$
- The change in  $W$ , given by  $\Delta W = W_{t+1} - W_t$ , is normally distributed with mean zero and standard deviation  $\sqrt{\Delta t}$ , meaning that  $\Delta W = \epsilon\sqrt{\Delta t}$ , where  $\epsilon$  is  $N(0, 1)$ .
- If the increment  $\Delta t_1$  does not overlap with the time increment  $\Delta t_2$ , then  $\Delta W_1$  and  $\Delta W_2$  are independent.
- The process is continuous, meaning that there are no jumps in the process.
- The process is a Markov process. This means that the conditional expectation of  $W_{t+1}$  given its entire history is equal to the conditional expectation of  $W_{t+1}$  given today's information. This can be written as:  $E[W_{t+1}|W_1, \dots, W_t] = E[W_{t+1}|W_t]$ .
- Consider the time interval  $[0, t]$  with  $n$  equally spaced intervals given by  $t_i = \frac{it}{n}$ . Then the paths of the Brownian motion have unbounded variation, this means that they are not differentiable and go towards infinity as  $n$  increases. The quadratic variation is given by  $\sum_{i=1}^n (Z_{t_i} - Z_{t_{i-1}})^2 \rightarrow t$ , meaning that when  $n$  increases it stays constant at  $t$ .

### 2.1.2 Correlated Brownian Motions

Two independent brownian motions that are correlated can describe a new process  $Z_t$ . Let  $W_1$  and  $W_2$  be these two *independent* Brownian motions and let  $-1 \leq \rho \leq 1$  be a given number. For  $0 \leq t \leq T$  define the new process  $Z_t$  as [2]:

$$Z_t = \rho W_{1,t} + \sqrt{1 - \rho^2} W_{2,t} \quad (2.1)$$

This equation is a linear combination of independent normals at each timestep  $t$ , so  $Z_t$  is normally distributed. It is proven that  $Z$  is a Brownian motion and that  $Z$  and  $W_{1,t}$  are correlated [2].

### 2.1.3 Arithmetic Brownian Motion

The arithmetic brownian motion is defined in literature as being a random process (S) defined as follows [2]:

$$dS_t = \mu dt + \sigma dB_t \quad (2.2)$$

or in integral form:

$$\int_{t=0}^T dS_t = \int_{t=0}^T \mu dt + \int_{t=0}^T \sigma dB_t \quad (2.3)$$

Where,  $\mu$  and  $\sigma$  are known and constant with  $\sigma > 0$ . In this process, both the drift  $\mu$  and the diffusion  $\sigma$  coefficient are constant. The expected value of this process is the sum of the initial value and the drift times the elapsed period ( $S_0 + \mu T$ ). The variance is described by  $\sigma^2 T$

### 2.1.4 Geometric Brownian Motion

A stochastic process  $S_t$  is a geometric brownian motion if its solution is described by the solution of the following stochastic differential equation [5,6].

$$dS_t = \mu S_t dt + \sigma S_t dW_t \quad (2.4)$$

for given constants  $\mu \in \mathbb{R}$  and  $\sigma > 0$ . Also, the assumed initial value is positive,  $S_0 > 0$ .

This process is used quite often in finance to model the dynamics of some assets because of its properties. It has independent multiplicative increments and its solution is presented below[7]:

$$S_t = S_0 \times \exp\left(\left(\mu - \frac{\sigma^2}{2}\right)t + \sigma W_t\right), \quad t > 0 \quad (2.5)$$

### 2.1.5 Itô's Calculus

Let  $X_t$  be a real-valued stochastic process that satisfies [5,8,9]:

$$S_t = S_0 + \int_0^t \mu_t dt + \int_0^t \sigma_t dW_t \quad (2.6)$$

for some  $\mu_t$ ,  $\sigma_t$  and  $t \in [0, T]$ . This equation is often rewritten in its differential stochastic form:

$$dS_t = \mu_t dt + \sigma_t dW_t \quad (2.7)$$

for  $0 \leq t \leq T$ .

**Theorem 2.1.1** (Itô's Lemma). *Assume that  $S_t$  has a stochastic differential given by:*

$$dS_t = \mu_t dt + \sigma_t dW_t \quad (2.8)$$

*for  $\mu_t$ ,  $\sigma_t$  and  $t \in [0, T]$ . Assume  $u : \mathbb{R} \times [0, T] \rightarrow \mathbb{R}$  is continuous and that  $\frac{\partial u}{\partial t}$ ,  $\frac{\partial u}{\partial x}$ ,  $\frac{\partial^2 u}{\partial x^2}$  exist and are continuous.*

$$Y_t := u(S_t, t)$$

*Then  $Y$  has the following stochastic differential:*

$$\begin{aligned} dY_t &= \frac{\partial u}{\partial t} dt + \frac{\partial u}{\partial x} dS_t + \frac{1}{2} \frac{\partial^2 u}{\partial x^2} \sigma_t^2 dt \\ &= \left( \frac{\partial u}{\partial t} + \mu_t \frac{\partial u}{\partial x} + \frac{1}{2} \frac{\partial^2 u}{\partial x^2} \sigma_t^2 \right) dt + \sigma_t \frac{\partial u}{\partial x} dW_t \end{aligned} \quad (2.9)$$

*where the argument of  $u$ ,  $\frac{\partial u}{\partial x}$  and  $\frac{\partial^2 u}{\partial x^2}$  above is  $(S_t, t)$ .*

## Getting to the Formula

$$dS_t = \mu S_t dt + \sqrt{V_t} S_t dB_t \quad (2.10)$$

If  $S$  were deterministic,  $dS_t/S_t$  would be the derivative of  $\ln(S_t)$  with respect to  $S$ . This suggests to find an expression for the stochastic differential of  $\ln(S_t)$ , a function of the single random variable  $S_t$ .

$$df(t, S) = \frac{\partial f}{\partial t} dt + \frac{\partial f}{\partial S} dS + \frac{1}{2} \frac{\partial^2 f}{\partial t^2} (dt)^2 + \frac{1}{2} \frac{\partial^2 f}{\partial S^2} (dS)^2 + \frac{\partial^2 f}{\partial t \partial S} dt dS \quad (2.11)$$

$$f(t, S) = \ln(S) \quad (2.12)$$

$$d \ln(S) = \frac{d \ln(S)}{dS} dS + \frac{1}{2} \frac{d^2 \ln(S)}{dS^2} (dS)^2 \quad (2.13)$$

$$d \ln(S) = \frac{1}{S} (\mu S dt + \sqrt{V} S dB) + \frac{1}{2} \frac{-1}{S^2} \sqrt{V}^2 S^2 dt \quad (2.14)$$

$$d \ln(S) = \left( \mu - \frac{1}{2} V \right) dt + \sqrt{V} dB \quad (2.15)$$

$$\int_u^T d \ln(S) = \int_u^T \left( \mu - \frac{1}{2} V_t \right) dt + \int_u^T \sqrt{V_t} dB_t \quad (2.16)$$

$$\ln(S_t) - \ln(S_u) = \int_u^T \left( \mu - \frac{1}{2} V_t \right) dt + \int_u^T \sqrt{V_t} dB_t \quad (2.17)$$

$$\ln \left( \frac{S_t}{S_u} \right) = \mu(t-u) - \frac{1}{2} \int_u^T V_t dt + \int_u^T \sqrt{V_t} dB_t \quad (2.18)$$

$$\ln \left( \frac{S_t}{S_u} \right) = \mu(t-u) - \frac{1}{2} \int_u^T V_t dt + \int_u^T \sqrt{V_t} \left( \rho dB_{1,s} + \sqrt{1-\rho^2} dB_{1,s} \right) \quad (2.19)$$

$$S_t = S_u \times \exp \left( \mu(t-u) - \frac{1}{2} \int_u^T V_t dt + \rho \int_u^T \sqrt{V_t} dB_{1,t} + \sqrt{1-\rho^2} \int_u^T \sqrt{V_t} dB_{2,t} \right) \quad (2.20)$$

Equation (2.9) is the stochastic equivalent to the chain rule, also known as Itô's formula or Itô's chain rule. The proof to this theorem is based on the Taylor expansion of the function  $f(S_t, t)$  [5,8]. For practical uses you should write out a second-order Taylor expansion for the function to be analyzed and apply the 2.1 multiplication table [2].

Table 2.1: Box calculus

	$dt$	$dW_t$
$dt$	0	0
$dW_t$	0	$dt$

## 2.2 Stochastic Differential Equations (SDE's)

### 2.3 Black-Scholes Model

The Black-Scholes (B-S) model arises from the need to price european options in the derivative markets. Derivatives are financial instruments traded in the market, stock exchange or over-the-counter (OTC) market, whose values depend on the values of an underlying asset. [1,10,11]

- A call option is a derivative that gives its bearer the right, but not the obligation, to purchase a specific asset by a fixed price before or on a given date.
- A put option is a derivative that gives its bearer the right, but not the obligation, to sell a specific asset by a fixed price before or on a given date.

The trading price of the option is called the option *premium* and the asset from which the option derives is called the *underlying asset*. This asset may be the interest rate, exchange rates, stock exchanges rates, commodities or stocks. The fixed price in contract in which the underlying asset might to be bought or sold is the *strick price*. The option expiration date is called the *maturity*. [1,11]

There are two major different option types: the European and the American. The difference between these two is that the bearer of the first may exercise it only at the end of its life, at its maturity while the latter can be exercised at any given time until its maturity. [1,12]

#### 2.3.1 The model

The Black-Scholes model that provides analytical solution to the price of a European call at time  $t$  can be described as follows[1,4,10]:

$$C(S_t, t) = N(d_1)S_t - N(d_2)Ke^{-r(T-t)} \quad (2.21)$$

$$d_1 = \frac{1}{\sigma\sqrt{T-t}} \left[ \ln\left(\frac{S_t}{K}\right) + \left(r + \frac{\sigma^2}{2}\right)(T-t) \right] \quad (2.22)$$

$$d_2 = d_1 - \sigma\sqrt{T-t} \quad (2.23)$$

Where:

- $S_t$  is the spot price of the underlying asset at time  $t$
- $r$  is the risk free rate (generally an annual rate)<sup>1</sup>
- $\sigma$  is the volatility of returns of the underlying asset <sup>2</sup>
- $N(\cdot)$  is the cumulative distribution function of the standard Gaussian distribution
- $K$  is the strike price

---

<sup>1</sup>Assumed to be constant.

<sup>2</sup>See footnote 1.

- $T - t$  is the time to maturity

Also, the stock price path is a Geometric Brownian Motion and is under the risk-neutral measure with the following dynamics [4,13]:

$$dS_t = (r - q)S_t dt + \sigma S_t dW_t \quad (2.24)$$

Where  $dW_t$  is a Wiener process [1,13],  $r$  is the risk free rate and  $q$  is the dividend yield<sup>3</sup> and  $t$  denotes the current point in time.

Although the Black-Scholes is very popular and the *de facto* standard in the market there are implications to the B-S model assumptions that affect the results and that are unrealistic. The main assumption that does not hold up is the deterministic (constant) volatility, that can more accurately be described as a stochastic process since we observe that small moves usually are followed by small moves and large moves by large moves. [4,10]

Other assumptions that are critical to the B-S model and are not always observed in practice refer to the asset's continuity through time (no jumps), being allowed to perform continuous hedge without transactions costs and normal (Gaussian) returns.

Most models focus on the volatility problem because transaction costs often translate to rises in volatility and fat-tails (abnormal) returns can be simulated by stochastic volatility and market or volatility jumps.

### 2.3.2 Limitations

## 2.4 Stochastic Volatility models

Introducing stochastic volatility to models brings complexity, but enables modeling some features observed in reality that are crucial like the randomic market volatility effects, skewness (market returns are more realistically modeled) and volatility smile. This kind of model is applied highly succesfully in foreign exchange and credit markets.

### 2.4.1 Other models (PRESENT MODELS PREVIOUSLY USED)

#### 2.4.2 Cox-Ingersoll-Ross model

The Cox-Ingersoll-Ross (CIR) model is a well-known short-rate model that describes the interest rate movements driven by one source of market risk. The dynamics are described as follows[14,15]:

$$dr_t = k(\theta - r_t)dt + \sigma\sqrt{r_t}dB_t \quad (2.25)$$

Where,  $r_t$  is the short rate interest described by parameters  $k$  - the speed of mean reversion,  $\theta$  - the long-run mean variance and  $\sigma$  - the volatility of the variance process.

---

<sup>3</sup> $r$  and  $q$  are assumed to be constant.



This model has been widely used to describe the dynamics of the short rate interest because it has some fundamental features like intuitive parametrization, nonnegativity and pricing formulas. Besides, it takes account of anticipations, risk aversion, investment alternatives and preferences about consumption timing and allows for detailed predictions about how changes in a wide range of underlying variables affect the term structure[14]. Furthermore, this equation constitutes one of the two Heston model equations with the volatility taking the short rate interest place.

### 2.4.3 Heston Model

Heston model solves the deterministic volatility problems introducing the following equations, which represents the dynamics of the stock price and the variance processes under the risk-neutral measure [15,16]:

$$\begin{aligned} dS_t &= \mu S_t dt + \sqrt{V_t} S_t dW_t^* \\ dV_t &= k(\theta - V_t)dt + \sigma \sqrt{V_t} dB_t \end{aligned} \quad (2.26)$$

The second equation, as previously described, is the CIR model equation. The first equation states the asset price process.  $\mu$  is the asset's rate of return,  $dW_{t,1}$  and  $dW_{t,2}$  are two correlated wiener processes with correlation coefficient of  $\rho$ . Because, of the model specifications and what we presentend in section 2.1.2, we can rewrite the first equation as in Broadie and Kaya [17]:

$$\begin{aligned} dS_t &= \mu S_t dt + \rho \sqrt{V_t} dB_t + \sqrt{1 - \rho^2} \sqrt{V_t} S_t dW_t \\ dV_t &= k(\theta - V_t)dt + \sigma \sqrt{V_t} dB_t \end{aligned} \quad (2.27)$$



# Chapter 3

## The Heston Model Implementation

### 3.1 Characteristic Function

The Heston model characteristic function is firstly presented in the 1993 Steven Heston's paper [15] and is described below [18]:

$$f(S_t, V_t, t) = e^{A(T-t)+B(T-t)S_t+C(T-t)V_t+i\phi S_t} \quad (3.1)$$

If we let  $\tau = T - t$ , then the explicit form of the Heston characteristic function is:

$$\begin{aligned} f(i\phi) &= e^{A(\tau)+B(\tau)S_t+C(\tau)V_t+i\phi S_t} \\ A(\tau) &= ri\phi\tau + \frac{k\theta}{\sigma^2} \left[ -(\rho\sigma i\phi - k - M)\tau - 2 \ln \left( \frac{1 - Ne^{M\tau}}{1 - N} \right) \right] \\ B(\tau) &= 0 \\ C(\tau) &= \frac{(e^{M\tau} - 1)(\rho\sigma i\phi - k - M)}{\sigma^2(1 - Ne^{M\tau})} \end{aligned}$$

Where:

$$\begin{aligned} M &= \sqrt{(\rho\sigma i\phi - k)^2 + \sigma^2(i\phi + \phi^2)} \\ N &= \frac{\rho\sigma i\phi - k - M}{\rho\sigma i\phi - k + M} \end{aligned}$$

This function is the driving force behind the following formula, that calculates the fair value of a European call option at time  $t$ , given a strike price  $K$ , that expires at time  $T$  [18]:

$$\begin{aligned} C &= \frac{1}{2}S(t) + \frac{e^{-r(T-t)}}{\pi} \int_0^\infty \Re \left[ \frac{K^{-i\phi} f(i\phi + 1)}{i\phi} \right] d\phi \\ &\quad - Ke^{-r(T-t)} \left( \frac{1}{2} + \frac{1}{\pi} \int_0^\infty \Re \left[ \frac{K^{-i\phi} f(i\phi)}{i\phi} \right] d\phi \right) \end{aligned} \quad (3.2)$$

## 3.2 Euler Scheme - Full Truncation

We present here the Euler Scheme - Full Truncation algorithm [17] along with some insights on how it was implemented in the R programming language [19]. The Euler discretization brings approximation paths to stock prices and variance processes. If we set  $t_0 = 0 < t_1 < \dots < t_M = T$  as partitions of a time interval of  $M$  equal segments of length  $\delta t$ , we have the following discretization for the stock price:

$$S_{t+1} = S_t + rS_t + \sqrt{V_t}S_tZ_s \quad (3.3)$$

And for the variance process:

$$V_{t+1} = V_t + k(\theta - V_t) + \sigma\sqrt{V_t}Z_v \quad (3.4)$$

$Z_s$  being a standard normal random variable, i.e.  $N(0, 1)$ , we set  $Z_t$  and  $Z_v$  as two independent standard normal random variables and  $Z_s$  and  $Z_v$  having correlation  $\rho$ . This means we can write  $Z_s = \rho Z_v + \sqrt{1 - \rho^2}Z_t$

The immediate observable problem in the proposed discretization scheme is that  $V$  can become negative with non-zero probability making the computation of  $\sqrt{V_t}$  impossible [20]. There are several proposed fixes that can be used, we chose the Full-Truncation (FT) and rewrite the equations as follows:

$$S_{t+1} = S_t + rS_t + \sqrt{V_t^+}S_tZ_s \quad (3.5)$$

$$V_{t+1} = V_t + k(\theta - V_t^+) + \sigma\sqrt{V_t^+}Z_v \quad (3.6)$$

Where we use the notation  $V_t^+ = \max(V_t, 0)$ .

```
hestoneuler <- function(S, X, r, v, theta, rho, k, sigma, t = 0,
                        dt = NULL, tau = 1, N, sensibility = 15){

  set.seed(1)

  if(is.null(dt)){ dt <- (tau-t)/1000}

  ST <- NULL
  aux <- NULL
  sqrt_dt <- sqrt(dt)

  for(i in seq(t,tau,dt)){
    # browser()
    Zv <- rnorm(N)
    Zt <- rnorm(N)
    Zs <- rho * Zv + (sqrt(1 - (rho^2)) * Zt)

    # v[v <= 0] = 0
```

```

    aux <- v
    aux[v < 0] <- 0
    sqrt_aux <- sqrt(aux)
    S <- S * (1 + r * dt + sqrt_aux * Zs * sqrt_dt)
    S[S <= 0] = 0

    v <- v + k * dt * (theta - aux) +
        sigma * sqrt_aux * Zv * sqrt_dt

    ST <- rbind(ST,S)
}

rm(aux, v, Zv, Zt, Zs, S)

ST <- as.matrix(ST, ncol=N)
# matplot(graf, type = 'l')
# abline(h=X, lwd=2, col='red')
media <- c()

for (j in (X-sensibility):(X+sensibility)){

    Result <- ST[nrow(ST),] - j
    Result[Result <= 0] <- 0
    media <- c(media, mean(Result))

}

media <- media * exp(-r*tau)
# plot(media, ylab = "Call price", xlab = "Strike price")

Result <- ST[nrow(ST),] - X
Result[Result <= 0] = 0
call = mean(exp(-r*tau)*Result)

lista = list('call' = call, 'Result' = Result,
            'Spot' = ST, 'sensib' = media)
return(lista)
}

```

### 3.3 Karl-Jackel

```
Hestoncallkj <- function(S, X, r, q, v, theta, rho, k, sigma,
                        t = 0, dt = NULL, tau = 1, N,
                        sensibility = 15){

  if(is.null(dt)){ dt <- (T-t)/1000}

  v <- rep(v,N)
  theta<- rep(theta,N)
  graf <- NULL
  S <- log(S)

  for(i in seq(t,tau,dt)){
    # browser()
    Zv <- rnorm(N)
    Zt <- rnorm(N)
    Zs <- rho * Zv + sqrt(1 - rho^2) * Zt

    vt <- (v + k * theta * dt + sigma * sqrt(v) * Zv * sqrt(dt) +
           (1/4) * sigma^2 * dt * ((Zv)^2 - 1))/(1 + k * dt)

    # print(vt)

    # if(!length(vt[vt <= 0]) == 0 & length(vt[vt <= 0]) >= 1){
    #   # browser()
    vt[vt <= 0] <- v[vt <= 0] + k * dt * (theta[vt <= 0] -
                                         pmax(v[vt <= 0],0)) + sigma *
                                         sqrt(pmax(v[vt <= 0],0)) * Zv[vt <= 0] * sqrt(dt)
    v <- vt
    v[v<=0] <- 0

    # }

    S <- S + (r - (v+vt)/4) * dt + rho * sqrt(pmax(v,0)) *
            Zv * sqrt(dt) +
            (1/2) * (sqrt(pmax(v,0)) + sqrt(pmax(vt,0))) *
            (Zs + rho * Zv) *
            sqrt(dt) +
            ((rho * sigma * dt)/2) * ((Zv)^2 - 1)

    S[S <= 0] = 0
    graf <- rbind(graf,S)
  }
}
```

```

}

# browser()

graf <- as.matrix(graf, ncol=N)
ST <- graf
# matplot(graf, type = 'l')
# abline(h=log(X), lwd=2, col='red')

media <- c()

# browser()

for (j in (X-sensibility):(X+sensibility)){

  Result <- exp(ST[nrow(ST),]) - j
  Result[Result <= 0] <- 0
  media <-c(media, mean(Result))

}

media <- media * exp(-r*tau)

# browser()

Result <- exp(ST[nrow(ST),]) - X
Result[Result <= 0] = 0
call = mean(exp(-r*tau)*Result)

lista = list('call' = call, 'Result' = Result,
            'Spot' = graf, 'sensib' = media)
return(lista)

}

```

## 3.4 Exact Algorithm

```

hestonea <- function(S, X, r, v, theta, rho, k, sigma, t = 0,
                    dt = NULL, tau = 1, N, sensibility = 15){

  if(is.null(dt)){ dt <- (tau-t)/1000}

```

```

ST <- NULL

d <- (4 * k * theta)/(sigma)^2
c0 <- (sigma^2 * (1 - exp(-k*dt)))/(4*k)

# browser()

for(i in seq(t,tau,dt)){

  # sampling V
  lambda <- (4*k*exp(-k*dt)*v)/(sigma^2 * (1-exp(-k*dt)))
  vt <- c0 * rchisq(n = N, df = d, ncp = lambda)

  # Sampling int{V}
  int_v <- dt * ((1/2) * v + (1/2) * vt)

  # Sampling int{v}dw
  int_vdw <- (1/sigma) * (vt - v - k * theta * dt + k * int_v)

  # Sampling S
  m <- log(S) + (r * dt - (1/2) * int_v + rho * int_vdw)
  std <- sqrt((1 - rho^2)) * sqrt(int_v)
  S <- exp(m + std * rnorm(N))
  v <- vt
  ST <- rbind(ST,S)
}

ST <- as.matrix(ST, ncol=N)
# matplot(graf, type = 'l')
# abline(h=X, lwd=2, col='red')
media <- c()

for (j in (X-sensibility):(X+sensibility)){

  Result <- ST[nrow(ST),] - j
  Result[Result <= 0] <- 0
  media <-c(media, mean(Result))

}

media <- media * exp(-r*tau)
# plot(media, ylab = "Call price", xlab = "Strike price")

Result <- ST[nrow(ST),] - X

```



```
Result[Result <= 0] = 0
call = mean(exp(-r*tau)*Result)

lista = list('call' = call, 'Result' = Result,
            'Spot' = ST, 'sensib' = media)
return(lista)
}
```

```
require(NMOF)
setwd("../rnmethods")
source("../rnmethods/R/euler_heston.R")
```

# Chapter 4

## Results



# Chapter 5

## Conclusion

If we don't want Conclusion to have a chapter number next to it, we can add the `{-}` attribute.

### **More info**

And here's some other random info: the first paragraph after a chapter title or section head *shouldn't be* indented, because indents are to tell the reader that you're starting a new paragraph. Since that's obvious after a chapter or section title, proper typesetting doesn't add an indent there.



# Appendix A

## The First Appendix

This first appendix includes all of the R chunks of code that were hidden throughout the document (using the `include = FALSE` chunk tag) to help with readability and/or setup.

In the main Rmd file

```
# This chunk ensures that the thesishdown package is  
# installed and loaded. This thesishdown package includes  
# the template files for the thesis.  
if(!require(devtools))  
  install.packages("devtools", repos = "http://cran.rstudio.com")  
if(!require(thesishdown))  
  devtools::install_github("ismayc/thesishdown")  
library(thesishdown)
```

In Chapter ??:

```
# This chunk ensures that the thesishdown package is  
# installed and loaded. This thesishdown package includes  
# the template files for the thesis and also two functions  
# used for labeling and referencing  
if(!require(devtools))  
  install.packages("devtools", repos = "http://cran.rstudio.com")  
if(!require(dplyr))  
  install.packages("dplyr", repos = "http://cran.rstudio.com")  
if(!require(ggplot2))  
  install.packages("ggplot2", repos = "http://cran.rstudio.com")  
if(!require(ggplot2))  
  install.packages("bookdown", repos = "http://cran.rstudio.com")  
if(!require(thesishdown)){  
  library(devtools)  
  devtools::install_github("ismayc/thesishdown")  
}
```

```
library(thesisdown)
flights <- read.csv("data/flights.csv")
```



## Appendix B

The Second Appendix, for Fun



# References

- [1] F. Black, M. Scholes, The pricing of options and corporate liabilities, *Journal of Political Economy*. 81 (1973) 637–654.
- [2] U.F. Wiersema, *Brownian motion calculus*, John Wiley & Sons, 2008.
- [3] I. Karatzas, S. Shreve, *Brownian motion and stochastic calculus*, Springer Science & Business Media, 2012.
- [4] A.D. Helgadóttir, L. Ionescu, Option pricing within the heston model, (2016).
- [5] Z. Tong, Option pricing with long memory stochastic volatility models, PhD thesis, Université d'Ottawa/University of Ottawa, 2012.
- [6] R.S. Tsay, *Analysis of financial time series*, John Wiley & Sons, 2005.
- [7] S.M. Iacus, *Simulation and inference for stochastic differential equations: With r examples*, Springer Science & Business Media, 2009.
- [8] L.C. Evans, *An introduction to stochastic differential equations*, American Mathematical Soc., 2012.
- [9] J.M. Steele, *Stochastic calculus and financial applications*, Springer Science & Business Media, 2012.
- [10] Y. Yang, Valuing a european option with the heston model, (2013).
- [11] M. de F. Salomão, Precificação de opções financeiras: Um estudo sobre os modelos de black scholes e garch, (2011).
- [12] R.C. Merton, Theory of rational option pricing, *The Bell Journal of Economics and Management Science*. (1973) 141–183.
- [13] M. Gilli, D. Maringer, E. Schumann, *Numerical methods and optimization in finance*, Academic Press, Waltham, MA, USA, 2011. <http://nmof.net>.
- [14] J.C. Cox, J.E. Ingersoll Jr, S.A. Ross, A theory of the term structure of interest rates, *Econometrica: Journal of the Econometric Society*. (1985) 385–407.
- [15] S.L. Heston, A closed-form solution for options with stochastic volatility with applications to bond and currency options, *Review of Financial Studies*. 6 (1993)

327–343.

- [16] M. Gilli, D. Maringer, E. Schumann, Numerical methods and optimization in finance, Academic Press, 2011.
- [17] M. Broadie, Ö. Kaya, Exact simulation of stochastic volatility and other affine jump diffusion processes, *Operations Research*. 54 (2006) 217–231.
- [18] R. Dunn, P. Hauser, T. Seibold, H. Gong, Estimating option prices with heston’s stochastic volatility model, (2014).
- [19] R Core Team, R: A language and environment for statistical computing, R Foundation for Statistical Computing, Vienna, Austria, 2017. <https://www.R-project.org/>.
- [20] L.B. Andersen, Efficient simulation of the heston stochastic volatility model, (2007).