RMSC5102 Simulation Methods for Risk Management Science and Finance

Tutorial Notes

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LEUNG Man Fung, Heman

Contents

I) Probability and statistics

Discrete random variables

Random variables: numeric quantities that take different values with specified probabilities

Discrete random variable: a R.V. that takes value from a discrete set of numbers

Probability mass function: a pmf assigns a probability to each possible value x of the discrete random variable X, denoted by $f(x) = P(X = x)$

$\sum_{i=1}^{n} f(x_i) = 1$ (total probability rule)

Cumulative distribution function: a cdf gives the probability that X is less than or equal to the value x, denoted by $F(x) = P(X \leq x)$

Expected value: $\mu = E(X) = \sum_{i=1}^{n} x_i P(X = x_i)$ (the idea is "probability weighted average")

Variance: $\sigma^2 = Var(X) = \sum_{i=1}^{n} (x_i - \mu)^2 P(X = x_i)$, alternatively $Var(X) = E(X^2) - [E(X)]^2$

Translation/rescale: $E(aX + b) = aE(X) + b$, $Var(aX + b) = a^2 Var(X)$

Linearity of expectation: $E(\sum_{i=1}^{n} X_i) = \sum_{i=1}^{n} E(X_i)$

Binomial distribution

Factorial: $n! = n \times (n-1) \times \ldots \times 1$, note that $0! = 1$

Permutation (order is important): $P_k^n = \frac{n!}{(n-k)!}$

Combination (order is not important): $C_k^n = \frac{n!}{k!(n-k)!}$, also denoted as $\binom{n}{k}$

Binomial distribution: probability distribution on the number of successes X in n independent experiments, each experiment has a probability of success p, then $X \sim B(n, p)$

Pmf: $P(X = x) = \binom{n}{x} p^x (1-p)^{n-x}$ for $x = 0, 1, 2, \ldots, n$

Mean: $E(X) = np$

Variance: $Var(X) = np(1-p)$

Poisson distribution

Poisson distribution: probability distribution on the number of occurrence X (usually of a rare event) over a period of time or space with rate λ, then $X \sim Po(\lambda)$. Useful in modelling jump

Pmf: $P(X = x) = \frac{e^{-\lambda}\mu^x}{x!}$ for $x = 0, 1, 2, \ldots$

Mean: $E(X) = \lambda$

Variance: $Var(X) = \lambda$

Continuous random variables

Continuous random variable: a R.V. that takes value over an interval of numbers

Probability density function: a pdf specifies the probability of the random variable falling within a particular range of values, denoted by $f(x)$

$P(a \le X \le b) = \int_a^b f(x)dx$, which is the area under the curve from a to b

$P(X = a) = \int_a^a f(x)dx = 0$ for all a

$\int_{-\infty}^{\infty} f(x)dx = 1$ (total probability rule)

Cumulative distribution function: a cdf gives the probability that X is less than or equal to the value x, denoted by $F(x) = P(X \le x) = \int_{-\infty}^{x} f(t)dt$

$P(a \le X \le b) = \int_a^b f(x)dx = F(b) - F(a)$ (by the fundamental theorem of calculus)

Expected value: $\mu = E(X) = \int_{-\infty}^{\infty} xf(x)dx$

Variance: $\sigma^2 = Var(X) = \int_{-\infty}^{\infty}(x-\mu)^2 f(x)dx = \int_{-\infty}^{\infty} x^2 f(x)dx - \mu^2$

Uniform distribution

Uniform distribution: if X follows uniform distribution on the interval $[a, b]$, then it has the same probability density at any point in the interval and we denote it by $X \sim U(a, b)$. Basic R.V. in probability integral transform

Pdf: $f(x) = \frac{1}{b-a}$ for $a \le x \le b$, otherwise 0

Cdf: $F(x) = \int_a^x \frac{1}{b-a} dt = \left[\frac{t}{b-a}\right]_a^x = \frac{x-a}{b-a}$ for $a \le x \le b$

Mean: $E(X) = \frac{a+b}{2}$

Variance: $Var(X) = \frac{(b-a)^2}{12}$

Normal distribution

Normal distribution: if X follows normal distribution with mean μ and variance σ^2, then $X \sim N(\mu, \sigma^2)$. Often used to represent continuous random variable with unknown distributions

Pdf: $f(x) = \frac{1}{\sqrt{2\pi}\sigma} e^{-\frac{1}{2\sigma^2}(x-\mu)^2}$ for $-\infty < x < \infty$

Standard normal distribution: $Z \sim N(0,1)$

Cdf of standard normal: denoted as $\Phi(z) = P(Z \leq z)$

$P(a \leq Z \leq b) = P(Z \leq b) - P(Z \leq a) = \Phi(b) - \Phi(a)$

$\Phi(-z) = 1 - \Phi(z)$ by symmetric property

Percentile of standard normal: $\Phi(1.645) = 0.95, \Phi(1.96) = 0.975$

Standardization: if $X \sim N(\mu, \sigma^2)$, then $\frac{X-\mu}{\sigma} \sim N(0,1)$

$P(a < X < b) = P\left(\frac{a-\mu}{\sigma} < Z < \frac{b-\mu}{\sigma}\right) = \Phi\left(\frac{b-\mu}{\sigma}\right) - \Phi\left(\frac{a-\mu}{\sigma}\right)$

Some remarks

Variance of sum: $Var(X+Y) = Var(X) + Var(Y) + 2Cov(X,Y)$

Tower rule of expectation: $E(X) = E[E(X|Y)]$

Law of total variance (EVE): $Var(X) = E[Var(X|Y)] + Var[E(X|Y)]$

Sum of poisson: if $X \sim Po(\lambda_1), Y \sim Po(\lambda_2)$ independently, then $X + Y \sim Po(\lambda_1 + \lambda_2)$

Sum of normal: if $X \sim N(\mu_1, \sigma_1^2), Y \sim N(\mu_2, \sigma_2^2)$ independently, then $X + Y \sim N(\mu_1 + \mu_2, \sigma_1^2 + \sigma_2^2)$

Square of standard normal: if $X \sim N(\mu, \sigma^2)$, the $Z^2 = \left[\frac{X-\mu}{\sigma}\right]^2 \sim \chi_1^2$

Sum of chi square: if $X \sim \chi_n^2, Y \sim \chi_m^2$, then $X + Y \sim \chi_{n+m}^2$

II) Financial derivative

Forward

Payoff: $\mathrm{S_t} - K\ (long), K - S_t\ (short)$

Pricing: $\mathrm{f = S - Ke^{-r(T-t)}, F = Se^{r(T-t)}}$

With known cash income: $\mathrm{f = S - I - Ke^{-r(T-t)}, F = (S - I)e^{r(T-t)}}, I = PV(income)$

With known dividend yield: $\mathrm{f = Se^{-q(T-t)} - Ke^{-r(T-t)}, F = Se^{(r-q)(T-t)}}$

Minimum variance hedge ratio: $\mathrm{h^*} = \rho \times \frac{\sigma_S}{\sigma_F} \Rightarrow N_F^* = h^* \times N_A\ (since\ h = \frac{N_F}{N_S})$

Option

Upper bounds: $\mathrm{C_E} \leq C_A \leq S, P_E \leq Ke^{-r(T-t)}, P_A \leq K$

Lower bounds: $\max\left(\mathrm{S - Ke^{-r(T-t)}}, 0\right) \leq C_E \leq C_A, \max\left(\mathrm{Ke^{-r(T-t)}} - S, 0\right) \leq P_E \leq P_A$

Put-call parity: $\mathrm{C_E} - P_E = S - I - Ke^{-r(T-t)}$ (idea is call – put = forward)

Put call inequality: $\mathrm{S - K \leq C_A} - P_A \leq S - Ke^{-r(T-t)}$

European-American relationship: $\mathrm{P_A} > P_E, C_A = C_E$ (for non-dividend-paying)

Binomial tree

Risk neutral probability: $\mathrm{q} = \frac{\mathrm{e^{r\delta t}} - d}{u - d}, \mathrm{u = e^{\sigma\sqrt{\delta t}}}, d = u^{-1} = \mathrm{e^{-\sigma\sqrt{\delta t}}}$

Pricing: $\mathrm{f = e^{-r\delta t}}[qf_u + (1 - q)f_d]$

Backward induction: start from payoff as terminal prices (American: take max between payoff and f)

III) Stochastic calculus

Brownian motion

Wiener process: W_t is called a Wiener process if the following holds

Stationary increment: $\mathrm{W_t} - W_s \sim N(0, t-s)$

Independent increment: $W_{t_4} - W_{t_3} \perp W_{t_2} - W_{t_1}$

Starts at zero: $P\left(W_{t_0} = 0\right) = 1$

Properties: $\mathrm{Cov}(\mathrm{W_s}, W_t) = \min(s,t)\,, [dW_t]^2 = dt$ (quadratic variation), nowhere differentiable

Itô's process: X_t is an Itô's process if it is solution to the following stochastic differential equation

$$\begin{cases} dX_t = \mu(t, X_t)dt + \sigma(t, X_t)dW_t \\ X_0 = a \end{cases}$$

Where $\mu(t, X_t)$ is known as the drift function and $\sigma(t, X_t)$ is known as the volatility function. **You may think $\boldsymbol{dX_t \approx X_{t+\delta t} - X_t}$ and $\boldsymbol{dt \approx \delta t}$ (useful in simulation)**

This idea implies $X_{t+\delta t} = X_t + \mu(t, X_t)\delta t + \sigma(t, X_t)\sqrt{\delta t}Z$ where $Z \sim N(0,1)$

Stochastic integral

Definition: $\int_0^T f(s, W_s)dW_s = \lim\limits_{\delta(\pi)\to 0} \sum_{j=0}^{N(\pi)-1} f(t_j, W_{t_j})(W_{t_{j+1}} - W_{t_j})$

Itô's lemma: $\mathrm{df(t, X_t)} = \left[\frac{\partial f}{\partial t} + \mu(t, X_t)\frac{\partial f}{\partial x} + \frac{1}{2}\sigma^2(t, X_t)\frac{\partial^2 f}{\partial x^2}\right]\mathrm{dt} + \sigma(t, X_t)\frac{\partial f}{\partial x}dW_t$

Geometric Brownian motion: $\mathrm{dS_t} = rS_t dt + \sigma S_t dW_t \Rightarrow \mathrm{S_t} = S_0 e^{\left(r - \frac{1}{2}\sigma^2\right)t + \sigma W_t}$

Consequently, $S_{t+\delta t} = S_t e^{\left(r - \frac{1}{2}\sigma^2\right)\delta t + \sigma\sqrt{\delta t}Z}$ where $Z \sim N(0,1)$

Solving SDE: "guess" a solution and use Itô's lemma to verify that the solution satisfies the SDE (the following table is borrowed from Prof. Yau Chun Yip's notes on Stochastic Calculus)

Name	SDE	Solution (X_t)
Ornstein-Uhlenbeck(OU) process	$dX_t = -\alpha X_t dt + \sigma dW_t$	$ce^{-\alpha t} + \sigma e^{-\alpha t} \int_0^t e^{\alpha s} dW_s$
Mean reverting OU	$dX_t = (m - \alpha X_t)dt + \sigma dW_t$	$\frac{m}{\alpha} + \left(c - \frac{m}{\alpha}\right) e^{-\alpha t} + \sigma \int_0^t e^{\alpha(s-t)} dW_s$
Geometric Brownian motion	$dX_t = aX_t dt + bX_t dW_t$	$ce^{(a-b^2/2)t+bW_t}$
Brownian bridge	$dX_t = \frac{b-X_t}{1-t} dt + dW_t$	$a(1-t) + bt + (1-t)\int_0^t \frac{dW_s}{1-s}$
	$dX_t = \left(\sqrt{1+X_t^2} + \frac{1}{2}X_t\right) dt + \sqrt{1+X_t^2} dW_t$	$\sinh(c+t+W_t)$
	$dX_t = X_t^3 dt + X_t^2 dW_t$	$\frac{1}{c-W_t}$
	$dX_t = -\frac{1}{2}X_t dt + \sqrt{1-X_t^2} dW_t$	$\sin(c+W_t)$
	$dX_t = -\frac{1}{1+t}X_t dt + \frac{1}{1+t} dW_t$	$(c+W_t)/(1+t)$
	$dX_t = r dt + \alpha X_t dW_t$	$ce^{\alpha W_t - \frac{1}{2}\alpha^2 t} + r\int_0^t e^{\alpha(W_t - W_s) - \frac{1}{2}\alpha^2(t-s)} ds$

Integrating factor: add e^{rt} to both sides of a SDE (target: cancel some terms)

Martingale property: $\mathrm{E}\left[\int_0^T f(t,W_t)dW_t \middle| \mathcal{F}_s\right] = \int_0^s f(t,W_t)dW_t$

In particular, $\mathrm{E}\left(\int_0^T f(t,W_t)dW_t\right) = 0$

Itô isometry: $\mathrm{E}\left[\left(\int_0^T f(t,W_t)dW_t\right)^2\right] = \int_0^T E[f(t,W_t)^2]dt$

Similarly, $\mathrm{E}\left[\left(\int_0^T f(t,W_t)dW_t\right)\left(\int_0^T g(t,W_t)dW_t\right)\right] = \int_0^T E[f(t,W_t)g(t,W_t)]dt$

Product rule: $\mathrm{d}(\mathrm{X}_t Y_t) = X_t dY_t + Y_t dX_t + d[\sigma(t,X_t)W_t, \bar{\sigma}(t,Y_t)\bar{W}_t]$

IV) Simulation methods

Theoretical support

Sample mean: $\bar{X}_n = \sum_{i=1}^{n} X_i$

Sample variance: $S^2 = \frac{1}{n-1}\sum_{i=1}^{n}(X_i - \bar{X}_n)^2$

Law of large numbers (WLLN): Let $X_1, \dots, X_n$ be i.i.d. random variables with mean θ and variance σ^2, then for any given $\epsilon > 0$, $P(|\bar{X}_n - \theta| > \epsilon) \to 0$ as $n \to \infty$

Central limit theorem (CLT, Lindeberg–Lévy): Let $X_1, \dots, X_n$ be i.i.d. random variables with mean θ and finite variance σ^2, then $\bar{X}_n \xrightarrow{d} N\left(\theta, \frac{\sigma^2}{n}\right)$ as $n \to \infty$

Standard Monte Carlo

Idea: take average of independent replications/scenarios of the reality/future

Algorithm:

1) Generate random variable $\mathrm{X_i}$
2) Calculate $\mathrm{h_i} = h(X_i)$, where h is the target function
3) Repeat 1 and 2 for n times
4) $\hat{\theta} = \frac{1}{n}\sum_{j=1}^{n} h_j$ (remember to do discounting if necessary)

Inverse transform

Idea: if we know $X \sim F_X$ (i.e. the cdf), we can generate X out of uniform random numbers

Algorithm (discrete):

1) Generate $\mathrm{U \sim Uniform(0,1)}$
2) $\mathrm{X = x_j}$ if $\sum_{i=0}^{j-1} p_i \le U < \sum_{i=0}^{j} p_i$

Algorithm (continuous):

1) Generate $\mathrm{U \sim Uniform(0,1)}$
2) $\mathrm{X} = \mathrm{F}_X^{-1}(U)$ assuming the inverse exists

Rejection sampling

Idea: if we can simulate $Y \sim G_Y$ easily, we can use the proportional distribution as a basis to simulate X with pdf $f(x)$

Algorithm:

1) Find $\mathrm{c} = \max_{y} \frac{f(y)}{g(y)}$
2) Generate $\mathrm{Y_i}$ from a density g: $\mathrm{U_1} \sim Uniform(0,1) \Rightarrow Y_i = G^{-1}(U_1)$
3) Generate $\mathrm{U_2} \sim Uniform(0,1)$
4) If $\mathrm{U_2} \leq \frac{1}{c} \cdot \frac{f(Y_i)}{g(Y_i)}$, set $\mathrm{X_i} = Y_i$, otherwise return to 2

Number of iterations needed: $N \sim Geo\left(\frac{1}{c}\right) \Rightarrow \mathrm{E(N)} = \mathrm{c}$

V) Variance reduction