

# Stochastic processes and SDEs

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# Stochastic Processes

## Definition

A *stochastic process* is a collection of random variables  $X_t \triangleq X(\omega, t)$  indexed by an index set  $T$  such that  $|T| \geq |\mathbb{N}|$ . For fixed  $\omega$ ,  $X_t(\omega)$  is a *sample path* or *realization*.

- A finite collection of random variables is just a random vector
- $T$  is typically called time but stochastic processes are not necessarily time series
- $\text{im}(X_t)$  and  $T$  can both be either continuous or discrete

$\text{im}(X_t) \setminus T$	cont.	disc.
cont.	Brownian motion (particle motion), Cox process (neuron spike trains)	Rust models
disc.	Contact process (epidemiology), Telegraph process (phase transitions)	Markov chain (noisy logic), Bernoulli process (gambling), Poisson process (queuing)

- Other: Dirichlet process, Pitman-Yor process, Random field

## Definition

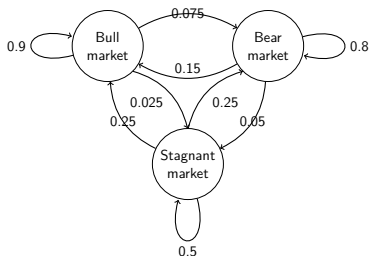
A stochastic process is *Markov* if  $P(X_t \in A | \mathcal{F}_s) = P(X_t \in A | X_s)$ .

- In particular, for a Markov chain

$$P\left(X_n = x_n \mid X_{n-1} = x_{n-1}, X_{n-2} = x_{n-2}, \dots, X_0 = x_0\right) = P\left(X_n = x_n \mid X_{n-1} = x_{n-1}\right)$$

i.e. only short term memory

- Intuitively a DFA with probabilistic transition function (not NFA)



	Bull	Bear	Stag.
Bull	0.9	0.075	0.025
Bear	0.15	0.8	0.05
Stag.	0.25	0.25	0.5

- Hidden Markov models (hierarchical model) great for speech recognition

## Definition

A random variable  $N$  is distributed  $\text{Poisson}(\lambda)$  on some unit interval  $u$  if at

$$P(N = n \text{ events in interval}) = \frac{\lambda^n e^{-\lambda}}{n!}$$

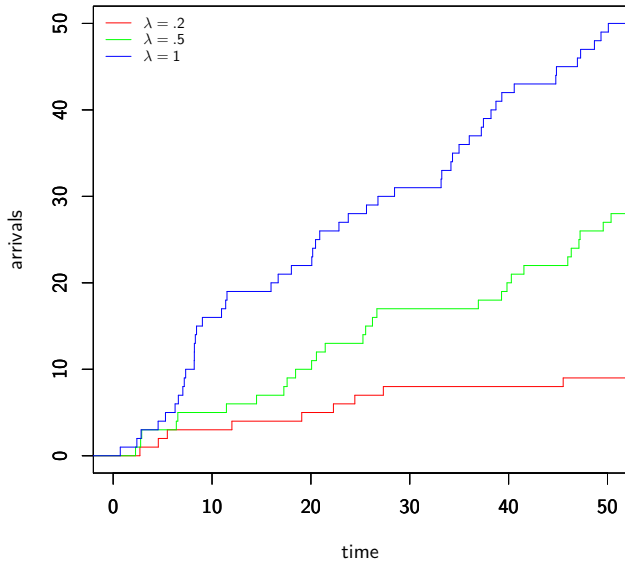
$\lambda$  is called the rate parameter.

- Intuitively “time” between events is exponentially distributed but independent
- Phone calls at an exchange, arrivals bank queue, train arrivals (on a bad day!)

## Example

A *Poisson process*  $N_t$  on  $[0, \infty)$  with rate  $\lambda$  is a stochastic process where the number of events in any interval of length  $t$  is distributed  $\text{Poisson}(\lambda t)$ .

```
lambda <- 1  
x1 <- cumsum(rexp(50),rate=lambda)  
y1 <- cumsum(c(0,rep(1,50)))  
plot(stepfun(x1,y1),xlim = c(0,50),do.points = F)
```



## Example

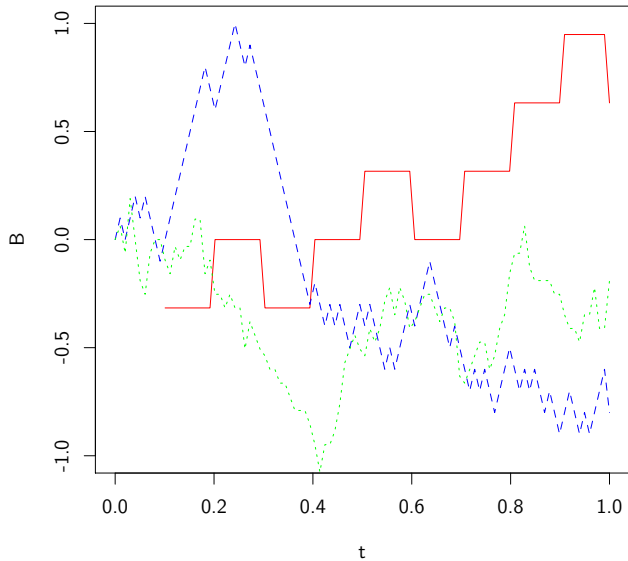
A *random walk* on  $\mathbb{Z}$  is a stochastic process  $S_0, S_1, \dots$  such that

$$S_n = \sum_{j=0}^n X_j$$

and  $X_i$  are iid Bernoulli( $\frac{1}{2}$ ) on  $\{1, -1\}$ .

- Flip a coin and go forward or backward one unit distance in dimension
- Extensions to higher dimensions (random walk on a lattice) involve discrete uniform distribution on directions
- Precursor to Brownian motion
- Drunk man, Drunk bird





# Brownian Motion

## “Rigorous” Brownian motion

Modify  $S_n$  such that  $X_i \in \{0, 1\}$  and suppose spatial increments are  $\Delta x$  and time increments  $\Delta t$ . Note that  $E(S_n) = \frac{n}{2}$  and  $\text{Var}(X_i) = \frac{1}{4}$ . Then

$$X(t) := X(n\Delta t) := \underbrace{S_n \Delta x}_{\text{positive dist}} - \underbrace{(n - S_n)(-\Delta x)}_{\text{negative dist}} = (2S_n - n) \Delta x$$

is the position of the particle at time  $n\Delta t$ . To use Laplace - De Moivre<sup>1</sup> we need

$$\text{Var}(X(n\Delta t)) = (\Delta x)^2 n = \frac{(\Delta x)^2}{\Delta t} t = Dt$$

with,  $D \triangleq \frac{(\Delta x)^2}{\Delta t}$ . Then

$$X(n\Delta t) = \sqrt{Dt} \left[ \left( \frac{S_n - \frac{n}{2}}{\sqrt{n/4}} \right) \right]$$

---

<sup>1</sup> $X_i \sim \text{Bernoulli}(p) \Rightarrow \lim_{n \rightarrow \infty} P(a \leq \sum X_i - np / \sqrt{np(1-p)} \leq b) = (2\pi)^{-1/2} \int_a^b e^{-\frac{x^2}{2}} dx$

and finally

$$\begin{aligned}\lim_{\substack{n \rightarrow \infty \\ t=n\Delta t, \Delta t D = (\Delta x)^2}} P\left(a \leq \sqrt{Dt} X(t) \leq b\right) &= \lim_{n \rightarrow \infty} P\left(a \leq \sqrt{Dt} X(t) \leq b\right) \\ &= \frac{1}{\sqrt{2\pi}} \int_{\frac{a}{\sqrt{Dt}}}^{\frac{b}{\sqrt{Dt}}} e^{-\frac{x^2}{2}} dx \\ &= \frac{1}{\sqrt{2\pi Dt}} \int_a^b e^{-\frac{x^2}{2Dt}} dx\end{aligned}$$

So  $X(t) \sim N(0, Dt)$

## Rigorous Brownian motion

Due to Hida<sup>2</sup>. For  $s \in \mathcal{S}_{\mathbb{R}}$  the Schwartz space of rapidly decreasing functions and its topological dual<sup>3</sup>  $\mathcal{S}'_{\mathbb{R}}$  let

$$e^{-\frac{1}{2}\|s\|_{L_2(\mathbb{R})}^2} = \int_{\mathcal{S}'_{\mathbb{R}}} e^{\langle s', s \rangle} dP(s')$$

Defining  $\Omega := \mathcal{S}'_{\mathbb{R}}$  we have  $(\Omega, \mathcal{B}(\mathcal{S}'_{\mathbb{R}}), P)$  the white noise space and  $L_2(\Omega) \triangleq L_2(\Omega, \mathcal{B}(\mathcal{S}'_{\mathbb{R}}), P)$ . The measure  $P$  is the *white noise* measure. By taking power series of the integrand above we get a definition of  $\langle \omega, f \rangle$ . Then

$$B(t) \triangleq B(\omega, t) \triangleq \langle \omega, \mathbf{1}_{[0,t]} \rangle$$

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<sup>2</sup>T. Hida. *Analysis of Brownian functionals*. Carleton Univ., Ottawa, Ont., 1975. Carleton Mathematical Lecture Notes, No. 13.

<sup>3</sup>Space of tempered distributions (all distributions whose Fourier transforms exist).

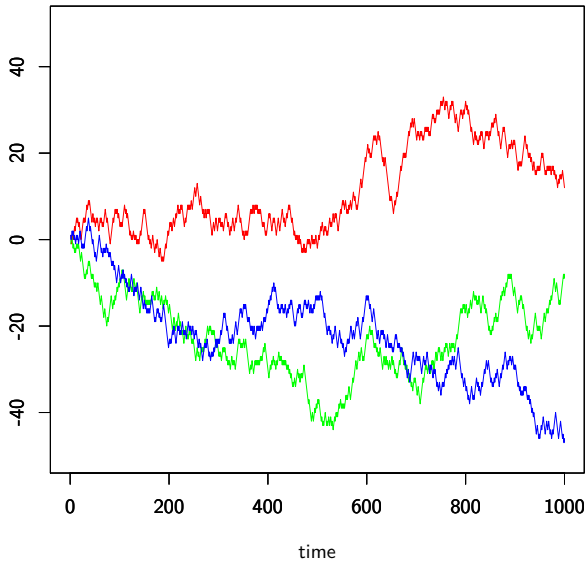
## Definition

A stochastic process  $B(t)$  is a Brownian motion if

- 1  $B(0) = 0$  almost surely, i.e.  $P(B(0) = 0) = 1$
- 2  $B(t) - B(s) \sim N(0, t - s)$  for  $t \geq s \geq 0$
- 3 For all  $0 < t_1 < t_2 < \dots < t_n$  it's the case that  $B(t_1) \perp B(t_2) - B(t_1) \perp \dots \perp B(t_n) - B(t_{n-1})$

## Interesting facts

- $X_t(\omega)$  as a sample path is a continuous function from  $\mathbb{R}^+ \rightarrow \mathbb{R}$
- Brownian motion “induces” a measure on functions  $\mathbb{R}^+ \rightarrow \mathbb{R}$
- Concentrated on continuous but nowhere differentiable functions (i.e. probability of “drawing” a differentiable function is 0)



# Stochastic Differential Equations



## Motivation

Consider the problem of finding an interpretation of

$$\frac{dx}{dt} = b(t, x) + \sigma(t, x) \cdot \text{"noise"}$$

It turns out it's reasonable to model "noise" as some stochastic process  $W_t$  and so

$$\frac{dX_t}{dt} = b(t, X_t) + \sigma(t, X_t) \cdot W_t \quad (1)$$

$x \rightarrow X$  a random variable because noise is stochastic. Empirical fact (experience) suggests  $W_t$  should have three properties

- 1  $t_1 \neq t_2 \Rightarrow W_{t_1} \perp W_{t_2}$
- 2  $\{W_t\}$  is stationary, i.e. the joint distribution of  $\{W_{t_1+\tau}, \dots, W_{t_k+\tau}\}$  does not depend on  $\tau$ .
- 3  $E[W_t] = 0$  for all  $t$ .

Unfortunately property 1 not possible for continuous processes<sup>4</sup>. What to do? Discretize, require independent increments, take averages, redefine, and voila

$$X_k = X_0 + \int_0^t b(s, X_s) ds + \int_0^t \sigma(s, X_s) dB_s \quad (2)$$

But this begs the question; we still haven't defined " $\int_0^t \sigma(s, X_s) dB_s$ ". Let  $0 \leq Q < T$  and start by defining  $\int_Q^T \{\cdot\} dB_s(\omega)$  for simple processes  $S_n(t, \omega) = \sum_{j=0}^{\infty} a_j(\omega) 1_{[j \cdot 2^{-n}, (j+1) \cdot 2^{-n})}(t)$

$$\int_Q^T S_n(s, \omega) dB_s \triangleq \sum_{j=0}^{\infty} a_j(\omega) \left[ B_{s_{j+1}^{(n)}}(\omega) - B_{s_j^{(n)}}(\omega) \right]$$

Then extend by taking limits (which exist because Cauchy) under  $\mathbf{L}_2(P)$  norm

$$\mathcal{I}[f](\omega) \triangleq \int_Q^T f(s, \omega) dB_s \triangleq \lim_{n \rightarrow \infty} \int_Q^T S_n(s, \omega) dB_s$$

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<sup>4</sup>It is possible to represent  $W_t$  as a *generalized* process, meaning it can be constructed as a measure on the space of tempered distributions

## Theorem

Some properties of the Ito integral: let  $f, g \in \mathcal{V}(0, T)$  and  $0 \leq Q < U < T$ . Then

- ①  $P\left(\int_Q^T f dB = \int_Q^U f dB + \int_U^T f dB\right) = 1$
- ② For  $c \in \mathbb{R}$ :  $P\left(\int_Q^T (cf + g) dB = \int_Q^T cf dB + \int_Q^T g dB\right) = 1$
- ③  $E\left[\int_Q^T f dB\right] = 0$

Property 3 says that Ito integrals are martingales.

## Definition

A stochastic process  $X_t$  is a *martingale* if for  $s \leq t$

$$E(X_t | X_s) = X_s$$

i.e. “fair”;  $E(X_t - X_s | X_s) = 0$ , so  $E(X_t) = E(X_0)$  for all  $t$ .

## Theorem (Ito formula)

Let  $X_t$  be an Ito process and  $g(t, x) \in C^2([0, \infty) \times \mathbb{R})$  then

$$Y_t = g(t, X_t)$$

is again an Ito process and

$$dY_t = \frac{\partial g}{\partial t} dt + \frac{\partial g}{\partial x} dX_t + \frac{1}{2} \frac{\partial^2 g}{\partial x^2} \cdot (dX_t)^2 \quad (3)$$

where  $(dX_t)^2 = (dX_t) \cdot (dX_t)$  is computed according to

$$dt \cdot dt = dt \cdot dB_t = dB_t \cdot dt = 0 \quad dB_t \cdot dB_t = dt$$

Kind of like change of variables from single variable calculus.

## Four problems

- Charge  $Q(t)$  in a capacitor an LRC circuit

$$LQ''(t) + RQ'(t) + \frac{1}{C}Q(t) = F(t), \quad Q(0) = Q_0, \quad Q'(0) = I_0 \quad (4)$$

If  $F(t) = G(t) + \text{"noise"}$ . How to solve for  $Q(t)$ ?

- Noisy measurements

$$Z(s) = Q(s) + \text{"noise"}$$

What is the best estimate of  $Q(t)$  satisfying eqn 4 based on  $Z(s)$ ?  
Kalman Filter.

- Equity price  $X_t$  obeys SDE with known  $r$  drift,  $\alpha$  volatility (and discount rate  $\rho$ )

$$\frac{dX_t}{dt} = rX_t + \alpha X_t \cdot \text{"noise"}$$

Know  $X_s$  up to present  $t$  - when to sell? Since noisy *optimal stopping strategy* maximizes expected returns. Can be solved by solving a corresponding semi-elliptic second order PDE with Dirichlet boundary conditions.

- Suppose at some time  $t$  the person in problem 3 is offered the right (without obligation) to buy one unit of the risky asset at a specified price  $K$  at a specified future date  $t = T$ . Such a right/asset is called a *European call option*. How much should they be willing to pay for the option? Problem solved by Fischer Black and Myron Scholes - called the Black-Scholes equation for option pricing

$$\frac{\partial V}{\partial t} + \frac{1}{2}\sigma^2 S^2 \frac{\partial^2 V}{\partial S^2} + rS \frac{\partial V}{\partial S} - rV = 0$$

where  $V$  is the price of the option as a function of the price of the asset,  $r$  is the risk-free interest rate (free money - tbills for example), and  $\sigma$  is the volatility of the stock.

- Probability/Measure theory
  - Schilling *Measures, Integrals, and Martingales*
  - Resnick *A Probability Path*
  - Pollard *A User's Guide to Measure Theoretic Probability*
  - Billingsley *Probability and Measure*
- Stochastic processes
  - Ross *Introduction to Probability Models*
  - Lawler *Introduction to Stochastic Processes*
- Stochastic Differential Equations
  - Klebaner *Introduction to Stochastic Calculus with Applications*
  - Shreve *Stochastic Calculus for Finance II: Continuous-Time Models*
  - Oksendal *Stochastic Differential Equations*
- SDE Numerics
  - Iacus *Simulation and Inference for Stochastic Differential Equations*

# Appendix



## Laplace - De Moivre

$$\begin{aligned}\text{Var}(X(n\Delta t)) &= \text{Var}((2S_n - n)\Delta x) = (\Delta x)^2 \text{Var}((2S_n - n)) \\ &= 4(\Delta x)^2 \text{Var}(S_n) = 4(\Delta x)^2 \text{Var}\left(\sum_{i=1}^n X_i\right) \\ &= 4(\Delta x)^2 n \text{Var}(X_i) = (\Delta x)^2 n = \frac{(\Delta x)^2}{\Delta t} t = Dt\end{aligned}$$

$$\begin{aligned}
X(n\Delta t) &= (2S_n - n) \Delta x = \sqrt{n} \Delta x \left( \frac{S_n - \frac{n}{2}}{\sqrt{n/4}} \right) \\
&= \sqrt{Dt} \left( \frac{(\sum_{i=1}^n X_i) - \frac{n}{2}}{\sqrt{n/4}} \right) = \sqrt{Dt} n \left( \frac{\frac{1}{n} (\sum_{i=1}^n X_i) - \frac{1}{2}}{\sqrt{n/4}} \right) \\
&= \sqrt{Dt} \left[ \left( \frac{\frac{1}{n} (\sum_{i=1}^n X_i) - \frac{1}{2}}{\sqrt{1/4}/\sqrt{n}} \right) \right]
\end{aligned}$$

## Differentiable nowhere

$B_t(\omega)$  has infinite total variation;

$$TV(f) := \lim_{n \rightarrow \infty} \sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|$$

over some  $[Q, T]$ <sup>5</sup>. Here's a short proof of this: first define quadratic variation

$$QV(f) := \lim_{n \rightarrow \infty} \sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|^2$$

and notice that if  $f$  is continuous then

$$\sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|^2 \leq \left( \max_{1 \leq j \leq m} \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right| \right) \sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|$$

and so

$$\frac{\sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|^2}{\max_{1 \leq j \leq m} \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|} \leq \sum_{j=1}^m \left| f\left(t_j^{(n)}\right) - f\left(t_{j-1}^{(n)}\right) \right|$$

---

<sup>5</sup>Recall that  $T - Q = m \cdot 2^{-n}$ .

and hence any continuous  $f$  that has non-zero quadratic variation has infinite total variation<sup>6</sup>. So all we need to prove is that  $B_s$  has non-zero quadratic variation. First some lemmas.

## Fact

If

$$\lim_{n \rightarrow \infty} \text{Var} \left[ \sum_{j=1}^m \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] = 0$$

then  $\lim_{n \rightarrow \infty} QV(f) = T - Q$  in  $L^2$ .

Proof: Let  $\Delta B_j^2 = \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2$ . Then if the variance goes to 0<sup>7</sup>

$$\begin{aligned} \lim_{n \rightarrow \infty} E \left[ \left( \sum_{j=1}^m \Delta B_j^2 \right)^2 \right] &= \lim_{n \rightarrow \infty} \left( E \left[ \sum_{j=1}^m \Delta B_j^2 \right] \right)^2 = \lim_{n \rightarrow \infty} \left( \sum_{j=1}^m E \left[ \Delta B_j^2 \right] \right)^2 \\ &= \lim_{n \rightarrow \infty} \left( \sum_{j=1}^m \left( t_j^{(n)} - t_{j-1}^{(n)} \right) \right)^2 = \lim_{n \rightarrow \infty} (T - Q)^2 \end{aligned}$$

<sup>6</sup>Since  $\max_{1 \leq j \leq m} \left| f(t_j^{(n)}) - f(t_{j-1}^{(n)}) \right| \rightarrow 0$  as  $|\Pi| \rightarrow \infty$  for any continuous  $f$  and your only hope for the left side of the inequality not blowing up is if the numerator,  $QV(f)$ , is 0.

<sup>7</sup>Since  $\text{Var}(X) = EX^2 - (EX)^2$ .

and so

$$\begin{aligned} 0 &= \lim_{n \rightarrow \infty} \left( E \left[ \left( \sum_{j=1}^m \Delta B_j^2 \right)^2 \right] - (T - Q)^2 \right) \\ &= \lim_{n \rightarrow \infty} \left( E \left[ \left( \sum_{j=1}^m \Delta B_j^2 \right)^2 \right] - 2(T - Q)^2 + (T - Q)^2 \right) \\ &= \lim_{n \rightarrow \infty} \left( E \left[ \left( \sum_{j=1}^m \Delta B_j^2 \right)^2 \right] - 2(T - Q) E \left[ \left( \sum_{j=1}^m \Delta B_j^2 \right) \right] + (T - Q)^2 \right) \\ &= \lim_{n \rightarrow \infty} \left( E \left[ \left( \sum_{j=1}^m \Delta B_j^2 - (T - Q) \right)^2 \right] \right) \end{aligned}$$

which is the definition of convergence in  $L^2$ .

## Fact

*On refinement of the mesh*

$$\lim_{n \rightarrow \infty} \text{Var} \left[ \sum_{j=1}^m \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] = 0$$

Proof:

$$\begin{aligned}\text{Var} \left[ \sum_{j=1}^m \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] &= \sum_{j=1}^m \text{Var} \left[ \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] \\&= \sum_{j=1}^m \left( E \left[ \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] - \left( E \left[ \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] \right)^2 \right) \\&= \sum_{j=1}^m \left( E \left[ \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] - \left( t_j^{(n)} - t_{j-1}^{(n)} \right)^2 \right) \\&\quad \text{by Kolmogorov continuity thm.} \\&= \sum_{j=1}^m \left( 1(1+2) \left( t_j^{(n)} - t_{j-1}^{(n)} \right)^2 - \left( t_j^{(n)} - t_{j-1}^{(n)} \right)^2 \right) \\&= 2 \sum_{j=1}^m \left( t_j^{(n)} - t_{j-1}^{(n)} \right)^2\end{aligned}$$

which goes to 0 as the mesh is refined.

# Theorem

For  $f = B_t$  it's the case that  $\lim_{n \rightarrow \infty} QV(f) = T - Q$  almost surely.

Proof: Let

$$X_i^{(n)} = \Delta B_j^2 - \left( t_j^{(n)} - t_{j-1}^{(n)} \right)$$

and

$$Y_n := \sum_{j=1}^m X_i^{(n)} = \sum_{j=1}^m \left( \Delta B_j^2 - \left( t_j^{(n)} - t_{j-1}^{(n)} \right) \right) = \sum_{j=1}^m \Delta B_j^2 - (T - Q)$$

Then

$$\begin{aligned} EY_n &= E \left[ \sum_{j=1}^m \left( B_{t_j^{(n)}} - B_{t_{j-1}^{(n)}} \right)^2 \right] - E(T - Q) \\ &= 0 \end{aligned}$$

and

$$EY_n^2 = E \left( \sum_{j=1}^m \left( X_i^{(n)} \right)^2 + \sum_{i < j} X_i^{(n)} X_j^{(n)} \right) = \sum_{j=1}^m E \left[ \left( X_i^{(n)} \right)^2 \right] + \sum_{i < j} E \left[ X_i^{(n)} X_j^{(n)} \right]$$

but  $E \left[ X_i^{(n)} X_j^{(n)} \right] = 0$  so

$$EY_n^2 = \sum_{j=1}^m E \left[ \left( X_i^{(n)} \right)^2 \right]$$

and so by Chebyshev's inequality<sup>8</sup>

$$\begin{aligned} P(|Y_n| \geq \epsilon) &\leq \frac{E[(Y_n)^2]}{\epsilon^2} \\ &= \frac{1}{\epsilon^2} \sum_{j=1}^m E \left[ \left( X_i^{(n)} \right)^2 \right] \\ &= \frac{1}{\epsilon^2} \sum_{j=1}^m \left( t_j^{(n)} - t_{j-1}^{(n)} \right)^2 \\ &\leq \frac{1}{\epsilon^2} \frac{1}{2^n} \sum_{j=1}^m \left( t_j^{(n)} - t_{j-1}^{(n)} \right) \\ &= \frac{T - Q}{2^n \epsilon^2} \end{aligned}$$

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<sup>8</sup> $P(|X - \mu| \geq \epsilon) \leq \frac{E[(X - \mu)^2]}{\epsilon^2}$



and finally using Borel-Cantelli<sup>9</sup> with

$$\sum_{n=1}^{\infty} P(|Y_n| \geq \epsilon) \leq \sum_{n=1}^{\infty} \frac{T - Q}{2^n \epsilon^2} = \frac{T - Q}{\epsilon^2}$$

which implies almost sure convergence<sup>10</sup> of  $Y_n \rightarrow 0$ .

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<sup>9</sup>If  $\sum_{n=1}^{\infty} P(E_n) < \infty$  for some sequence of events  $E_n$  then  $P(\limsup_{n \rightarrow \infty} E_n) = 0$ .

<sup>10</sup> $P(\liminf_{n \rightarrow \infty} |X_n - X| < \epsilon) = 1$  for all  $\epsilon$ . Naturally this is to equivalent  $P(\liminf_{n \rightarrow \infty} |X_n - X| > \epsilon) = 0$  for all  $\epsilon$ . Why?  $\liminf$  is the set of points  $\omega$  that is ultimately in all of the sets and  $\limsup$  is the set of points  $\omega$  appear infinitely often. So if the set of  $\omega$  for which  $|Y_n| \geq \epsilon$  occur infinitely often has measure 0 then set of  $\omega$  for which  $|Y_n| \leq \epsilon$  eventually always is almost all of them (otherwise  $|Y_n| \geq \epsilon$  would keep happening once in a while).

## Motivation

$$\frac{dx}{dt} = b(t, x) + \sigma(t, x) \cdot \text{"noise"}$$

becomes

$$X_{k+1} - X_k = b(t_k, X_k) \Delta t_k + \sigma(t_k, X_k) W_k \Delta t_k$$

where  $X_k := X_{t_k}$ . Restated the question is: does there exist some  $V_t$  such that for  $\Delta V_k := V_{k+1} - V_k := V_{t_{k+1}} - V_{t_k}$

$$\begin{aligned} X_{k+1} - X_k &= b(t_k, X_k) \Delta t_k + \sigma(t_k, X_k) (V_{k+1} - V_k) \\ &= b(t_k, X_k) \Delta t_k + \sigma(t_k, X_k) \Delta V_k \end{aligned}$$

Assumptions 1,2,3 above suggest that stationary, independent, and mean 0 **increments**. Why? Because what appears in the discretized model are the increments. Turns out the only such process with continuous paths is Brownian motion  $B_t$ . Thus putting  $V_t = B_t$  and taking sums we get

$$\sum_{i=0}^{k-1} (X_{k+1} - X_k) = X_k - X_0 = \sum_{i=0}^{k-1} (b(t_j, X_j) \Delta t_j + \sigma(t_j, X_j) \Delta B_j)$$