

# Beyond the Circle: Deforming Contours in Inverse Z-Transform

Final Year Project Report

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Submission date: March 10, 2024

<sup>1</sup>**Disclaimer:** This report is submitted as part requirement for the MEng degree in Mathematical Computation at UCL. It is substantially the result of my own work except where explicitly indicated in the text. The report may be freely copied and distributed provided the source is explicitly acknowledged.

## Abstract

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# Chapter 1

## Introduction

1.1 Motivation

1.2 Aims and Objectives

1.3 Overview

# Chapter 2

## Background

“By definition, a complex number  $z$  is an ordered pair  $(x, y)$  of real numbers  $x$  and  $y$ , written  $z = (x, y)$ ” [Kreyszig, 2010]. In practice, complex numbers are written in the form  $z = x + iy$ , where  $x$  and  $y$  are real numbers and  $i$  is the imaginary unit. The set of complex numbers is denoted by  $\mathbb{C}$ .

### 2.1 The $\mathcal{Z}$ -Transform

Come up with a more catchy Z-Transform title

The  $z$ -transform is a transformation of a real or complex continuous time function  $x(t)$ , often used for discrete time signals and is commonly described as the discrete time Fourier transform (DTFT). Taking the Fourier transform of a sampled function results in

$$\mathcal{F}\left[x(t) \sum_{n=-\infty}^{\infty} \delta(t - n\Delta t)\right] = \int_{-\infty}^{\infty} x(t) \sum_{n=-\infty}^{\infty} \delta(t - n\Delta t) e^{-i\omega t} dt \quad (2.1)$$

$$= \sum_{n=-\infty}^{\infty} \int_{-\infty}^{\infty} x(t) \delta(t - n\Delta t) e^{-i\omega t} dt \quad (2.2)$$

$$= \sum_{n=-\infty}^{\infty} x(n\Delta t) e^{-i\omega n\Delta t} \quad (2.3)$$

where we make use of the sifting property of the delta function. If we normalise the sampling interval to 1, we get

$$\sum_{n=-\infty}^{\infty} x(n) e^{-in\omega} \quad (2.4)$$

The sequence  $x(n)$  is sampled at discrete time intervals  $t_n = n\Delta t$ , where the sampling interval  $\Delta t$  is the time between consecutive samples and the time index  $n$  numbers the samples. The DTFT is a periodic function of  $\omega$  with period  $2\pi$  and the existence of (2.4) relies on the condition of absolute summability of the sequence  $x(n)$ ; all the terms must converge to a finite value. This requirement is mathematically expressed as

$$\sum_{n=-\infty}^{\infty} |x(n)| < \infty \quad (2.5)$$

We can extend our analysis to the  $Z$ -transform, which generalizes the discrete time Fourier transform to the complex plane, not just the unit circle where  $r = 1$ . The  $Z$ -transform of a sequence  $x(n)$  is formally given by

$$X(z) = \mathcal{Z}_{n \rightarrow z}[x(n)] = \sum_{n=-\infty}^{\infty} x(n)z^{-n} \quad (2.6)$$

For a complete description of  $z$  in the complex plane, we tend to its polar form  $z = re^{i\theta}$ , where  $r$  represents the magnitude of  $z$  and  $\theta$  (often written as  $\omega$  in the context of the unit circle for the DTFT) represents the angle of  $z$  with respect to the positive real axis.

In the analysis of causal systems - systems for which a time origin is defined and is illogical to consider signal values for negative time - the unilateral  $Z$ -transform is used. Unlike the bilateral  $Z$ -transform in (2.6), we sum from zero to positive infinity yielding

$$X(z) = \mathcal{Z}_{n \rightarrow z}[x(n)] = \sum_{n=0}^{\infty} x(n)z^{-n} \quad (2.7)$$

The region within the complex  $z$ -plane where (2.7) converges is known as the Region of Convergence (ROC). The ROC is defined for the set of values of  $z$  for which the  $Z$ -transform is absolutely summable

$$\mathbf{ROC} = \left\{ z : \sum_{n=0}^{\infty} |x(n)z^{-n}| < \infty \right\} \quad (2.8)$$

The ROC for causal sequences is typically the exterior of the outermost pole in the  $Z$ -plane, denoted as  $|z| > a$ . If we say that  $z_1$  converges, then  $z_1$  exists within the ROC. Thus, all  $z$  such that  $|z| \geq |z_1|$  also converge. This region excludes the poles themselves, as the transform does not converge at those points. For the system to be *stable*, it's essential that the ROC includes the unit circle,  $|z| = 1$ . Thus, all poles must lie within the unit circle [Loveless and Germano, 2021].

### 2.1.1 Probability Generating Functions

either keep as subsection or as a paragraph

may be better to discuss within Abate and Whitt's method

## 2.2 The Inverse $\mathcal{Z}$ -Transform

The inverse  $Z$ -transform aims to find the  $n$ -th value of the sequence  $x(n)$  given the  $Z$ -transform  $X(z)$ . This is commonly defined as a Cauchy integral around a contour  $C$  in the complex plane. The contour  $C$  is a counter-clockwise closed path that encloses the region of convergence (ROC). The inverse  $Z$ -transform is formally given by

$$x(n) = \mathcal{Z}_{z \rightarrow n}^{-1}[X(z)] = \frac{1}{2\pi i} \oint_C X(z)z^{n-1}dz \quad (2.9)$$

In real-world applications, we often require numerical approximation due to computational challenges posed by the Cauchy integral formula. Such approximations enable the effective analysis and processing of complex signals within various technological and financial systems.

think about how to make a smooth transition from IZT to NIZT (and how we only discuss contour integration methods given the nature of this project)

### 2.2.1 Abate and Whitt 1992

The numerical approximation formula offered by Abate and Whitt [1992a,b] is based on a Fourier series catering to the inversion of probability generating functions as elucidated in Section 2.1.1. The format is conducive to queuing theory and other probabilistic models where the  $Z$ -transform is defined as  $q = 1/z$ . The authors approximate the inversion using a trapezoidal rule for numerical integration over a complex contour given by

$$x(n) \approx \frac{1}{2nr^n} \left( X(r) + 2 \sum_{k=1}^{n-1} (-1)^k \operatorname{Re} \left( X(re^{\frac{ik\pi}{n}}) \right) + (-1)^n X(-r) \right) \quad (2.10)$$

The parameter  $r$  is used to control the error; setting  $r = 10^{-\lambda/2n}$  yields an accuracy bound of  $10^{-\lambda}$ . The authors leverage the inherent symmetry within the complex plane to enhance computational efficiency by exploiting the complex conjugate symmetry of  $X(z)$ ; each term  $X(re^{\frac{ik\pi}{n}})$  in the upper half has a mirror image in the lower half. The computational load is thus halved by *folding* the problem in this manner.

Given the nature of this project, we may find it easier to use the following definition, where we set  $z = 1/q$ , to approximate (2.9).

$$x(n) \approx \frac{1}{2nr^n} \left( X(r) + 2 \sum_{k=1}^{n-1} (-1)^k \operatorname{Re} \left( X\left(\frac{1}{re^{\frac{ik\pi}{n}}}\right) \right) + (-1)^n X(-r) \right) \quad (2.11)$$

talk about the Nyquist-Shannon sampling theorem? - number of points must be double to avoid aliasing

### 2.2.2 Cavers 1978

### 2.2.3 Series acceleration techniques

## 2.3 Discrete Pricing Options

### 2.3.1 Lookback and Barrier Options

## 2.4 Optimization Techniques

In the context of computational mathematics, optimizations techniques are used to identify the optimal or a sufficiently effective solution to a problem within a given set of constraints. The goal is to minimize or maximize a specific objective function by systematically choosing the values of the variables. The objective function is often referred to as the *cost function* or *loss function* and the variables are referred to as *parameters*. The optimization problem can be formulated as

$$\text{minimize } f(x) \text{ subject to } x \in \Omega \quad (2.12)$$

where  $f(x)$  is the objective function and  $\Omega$  is the feasible region defined by the constraints of the problem.



Gradient descent is one of the most popular algorithms for parameter optimization with success in Deep Learning and Neural Networks employing variants of the algorithm [Lu and Jin, 2017; Zhang, 2019; Zeebaree et al., 2019]. The adaptability to diverse problem domains [Tian et al., 2023] parallels our use case, where gradient descent is applied outside traditional deep learning to optimize parameters of a mathematical function [Persson et al., 2022]. This reinforces the potential of gradient descent algorithms in broader computational mathematics, affirming its efficacy in finding optimal solutions in complex optimization landscapes.

### 2.4.1 Stochastic Gradient Descent

Gradient descent iteratively converges to a local minimum of a function by moving in the direction of the steepest descent, as defined by the negative gradient. This method is expressed mathematically as:

$$x_{k+1} = x_k - \alpha_k \nabla f(x_k) \quad (2.13)$$

where  $x_k$  is the parameter vector at iteration  $k$ ,  $\alpha_k$  is the learning rate, and  $\nabla f(k)$  represents the gradient of the function at  $x_k$ . The selection of  $\alpha_k$  is crucial as it determines the size of the step taken towards the minimum; too large can overshoot the minimum, too small can result in a long convergence time. The process repeats until a predetermined termination criterion is met, typically when the change in the value of  $f$  falls below a threshold, indicating arrival at a minimum. This iterative process is showcased in the pseudocode below:

---

**Algorithm 1** Gradient Descent

---

```

1: Initialize  $x_0$ , set  $k = 0$ 
2: while termination conditions not met do
3:   Compute gradient  $\nabla f(x_k)$ 
4:   Choose a suitable step size  $\alpha_k$ 
5:   Update  $x_{k+1} = x_k - \alpha_k \nabla f(x_k)$ 
6:    $k = k + 1$ 
7: end while

```

---

However, this brings forth limitations such as susceptibility to local minima, overshooting and long convergence time.

## Chapter 3

# Experiment

Finding different parameters to use for the experiment making use of Machine Learning techniques.

## Chapter 4

# Results

## Chapter 5

# Conclusion

### 5.1 Summary

### 5.2 Future Work

### 5.3 Acknowledgements

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# Appendices

## Appendix A

### Initial Project Plan

# Numerical Benchmarking on Inverse Z-Transform and Its Uses in Discrete Pricing Options

Project Plan

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Submission date: 16 November 2023



# Chapter 1

## Aims and Objectives

### 1.1 Aims

We aim to understand a new efficient method for numerical evaluation of the inverse Z-transform, which states to be faster and more accurate than the standard trapezoid rule. A specific area of applying this method would be to the pricing of discretely monitored exotic options, such as lookback and barrier options, and see how it compares to other methods; Abate and Whitt's approach, C. Cavers' method with Euler, Shanks and epsilon accelerations, etc.

### 1.2 Objectives

- Understanding Levendorskii's inverse Z-transform and the common numerical evaluation methods
- Implementing the function as a code
- Numerical benchmarking; average error, maximum error and CPU time
- Exploring its uses in discrete pricing options

### 1.3 Deliverables

- numerical benchmarking results to add to '*Review of numerical inversion techniques of the z-transform*' by Loveless and Germano
- results and implementation in regards to discrete pricing options (*Accurate numerical inverse z-transform and its use in the Fourier-z pricing of discretely monitored path-dependent options* by Loveless, Phelan and Germano)

# Chapter 2

## Work Plan

### 2.1 Project Start $\rightarrow$ 30<sup>th</sup> November '23

- background reading on complex numbers & contour integration based methods, fourier transform,  $z$ -transform and its inverse, numerical approaches to inverse  $z$ -transform and pricing options (barrier and lookback options)
- coding implementation of Levendorskii's inverse  $z$ -transform

### 2.2 1<sup>st</sup> December '23 $\rightarrow$ 24<sup>th</sup> January '24

- preliminary research on Loveless' and Germano's '*Review of numerical inversion techniques of the  $z$ -transform*'
- understanding the other methods; AW, C, CEuler, CShanks and CEpsilon
- going over the different functions; Heaviside Step, Polynomial, Decaying Exp, Sinusoidal
- reviewing the code for numerical benchmarking
- implementing it for Levendorskii's method
- begin work on interim report

### 2.3 24<sup>th</sup> January '24 $\rightarrow$ 15<sup>th</sup> March '24

- preliminary recap on discrete pricing options (barrier and lookback options) and the need for  $z$ -transform
- use-case in discrete pricing options
- start work on project report; however, to be worked on throughout the year/stages

### 2.4 5<sup>th</sup> March '24 $\rightarrow$ 26<sup>th</sup> April '24

- extra time to deal with any unexpected problems or delays
- final touches