

UNIVERSITY OF COPENHAGEN

CONTINUOUS TIME FINANCE (FINKONT)

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# Homework

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# Introduction

## Weeks

### Week 1

#### Table of Contents

- Brownian motion (Chapter 4.1)
- Conditional expectation (Appendix B.5)
- Filtration (Appendix B.3 and Chapter 4.2)
- Martingales (Appendix C.1 and Chapter 4.4)
- Introduction (Chapter 1)
- Discrete time models (Chapter 2 and 3)
- Exercises

#### Theory

This week revolves around the theory of the Brownian motion and martingale processes. Other main topics are the binomial model and an introduction to financial derivatives. Financial derivatives is contingent on the outcome of a stochastic process at some future time  $t = T$  and often is a function  $\Phi$  of some assets price  $S_t$ . As such the derivative will give a stochastic payout, at time  $t = T$  of the size  $X_T = \Phi(S_T)$ . Naturally we want to say something about the *fair* price of the derivative in the form of

$$\Pi_t(X_T) = \mathbb{E}[\Phi(S_T) \mid \mathcal{F}_t],$$

where  $\mathcal{F}_t \subset \mathcal{F}$  is the available information at time  $t$ . We will by default interpret the times  $t = 0$  as *today* and  $t = T$  as *tomorrow*. This indeed require some fundamental understanding of the behaviour of the asset price  $S_t$ . This lead us over to discussing the process in center of the *Black-Scholes* model: the Brownian motion.

**The Brownian motion** **Definition 4.1.** (*Brownian motion*) A stochastic process  $W$  is called a **Brownian motion** or **Wiener process** if the following conditions hold

1.  $W_0 = 0$ .
2. The process  $W$  has independent increments, i.e. if  $r < s \leq t < u$  then  $W_u - W_t$  and  $W_s - W_r$  are independent random variables.
3. For  $s < t$  the random variable  $W_t - W_s$  has the Gaussian distribution  $\mathcal{N}(0, t - s)$ .
4.  $W$  has continuous trajectories i.e.  $s \mapsto W(s; \omega)$  is continuous for all  $\omega \in \Omega$ .

As one can see from the simulated sample path on the right, the Brownian motion is rather erratic. In fact, the process varies infinitely on any interval with length greater than 0. This gives some of the characteristics of the process including that:  $W$  is continuous and  $W$  is non-differentiable everywhere. This erratic behaviour is summed up in the theorem.

**Theorem 4.2.** A Brownian motions trajectory  $t \mapsto W_t$  is with probability one nowhere differentiable, and it has locally infinite total variation.

This may seem not that horrifying since we can observe the process at any time and conclude an increment  $W_{t+\Delta t} - W_t$  for any  $\Delta t > 0$  but any integral constructed with  $W_t$  as integrator becomes nonsensical. We will be studying processes on the form

$$S_{t+\Delta t} - S_t = \mu(t, S_t)\Delta t + \sigma(t, S_t)\Delta W_t, \quad \Delta W_t = W_{t+\Delta t} - W_t.$$

where  $W_t$  is a standard Brownian motion and  $\mu(t, S_t)$  is locally deterministic (velocity), that is  $\mu(t, S_t)$  is deterministic on a small time interval. One could consider the dynamics of the process  $S_t$  by studying the equation below as  $\Delta t \rightarrow 0_+$

$$\frac{S_{t+\Delta t} - S_t}{\Delta t} = \mu(t, S_t) + \sigma(t, S_t) \frac{W_{t+\Delta t} - W_t}{\Delta t}.$$

The limit however is impossible to determine as  $W_t$  is non-differentiable and as such  $dS_t$  is not well-defined. From LivStok we know that the dynamics of  $S_t$  is given by letting  $\Delta t$  tend to 0 without dividing by it, that is

$$dS_t = \mu(t, S_t) dt + \sigma(t, S_t) dW_t.$$

Giving that  $S_0$  is observable we could interpret the dynamics on the integral form

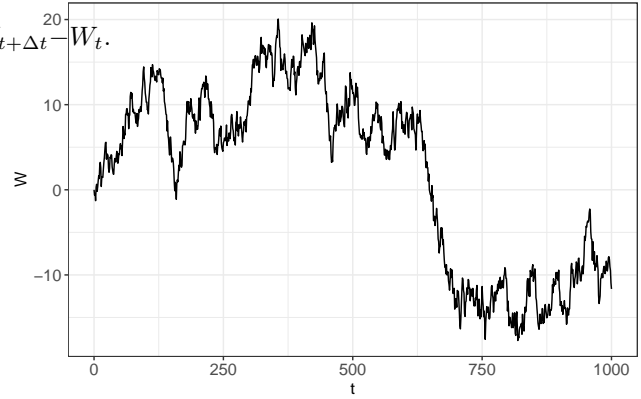
$$S_t = S_0 + \int_0^t \mu(s, S_s) ds + \int_0^t \sigma(s, S_s) dW_s,$$

where the above integrals is Riemann-Stieltjes integral. This is however still at dead-end, since from theorem 4.2 we know that  $W_t$  has unbounded variation on any interval. So **we cannot define  $S_t$  for each  $W$ -trajectory seperately** we will despite this define another integral (the Ito integral) that in some other sense give a global solution to this integral. To this we will be considering a  $L^2$ -definition.

**Conditional expectation** The theory of conditional expectation is well-known from courses on the bachelor. Because of this we will only summarise the most important results.

We consider a background space  $(\Omega, \mathcal{F}, P)$  and a sub-sigma algebra  $\mathcal{G} \subseteq \mathcal{F}$ . We assume that some stochastic variable is  $\mathcal{F}$ -measurable, that is the mapping  $X : (\Omega, \mathcal{F}, P) \rightarrow (\mathbb{R}, \mathbb{B}, m)$  is  $\mathcal{F} - \mathbb{B}$ -measurable i.e.  $\forall B \in \mathbb{B} : \{X \in B\} \in \mathcal{F}$ . For some random variable  $Z$  defined on the subspace  $(\Omega, \mathcal{G}, P)$ , we say that  $Z$  is the conditional expectation of  $X$  given  $\mathcal{G}$  if

Realisation of a Brownian motion



$$\forall G \in \mathcal{G} : \int_G Z(\omega) dP(\omega) = \int_G X(\omega) dP(\omega).$$

This fact is summed up in the definition below.

**Definition B.27.** (*Conditional expectation*) Let  $(\Omega, \mathcal{F}, P)$  be a probability space and  $X$  a random variable in  $L^1(\Omega, \mathcal{F}, P)$  ( $|X|$  is integrable). Let furthermore  $\mathcal{G}$  be a sigma-algebra such that  $\mathcal{G} \subseteq \mathcal{F}$ . If  $Z$  is a random variable with the properties that:

- i.  $Z$  is  $\mathcal{G}$ -measurable.
- ii. For every  $G \in \mathcal{G}$  it holds that

$$\int_G Z(\omega) dP(\omega) = \int_G X(\omega) dP(\omega).$$

Then we say that  $Z$  is the *conditional expectation of  $X$  given the sigma-algebra  $\mathcal{G}$* . In that case we denote  $Z$  by the symbol  $E[X \mid \mathcal{G}]$ .

We see that from the above it always holds that  $X$  satisfies (ii). It does not, however, always hold that  $X$  is  $\mathcal{G}$ -measurable. Given this fact it is not trivial that a random variable  $E[X \mid \mathcal{G}]$  even exists. This nontriviality is fortunatly resolved by the Radon-Nikodym theorem.

**Theorem B.28.** (*Existence and uniqueness of Conditional expectation*) Let  $(\Omega, \mathcal{F}, P)$ ,  $X$  and  $\mathcal{G}$  be given as in the definition above. Then the following holds:

- There will always exist a random variable  $Z$  satisfying conditions (i)-(ii) above.
- The variable  $Z$  is unique, i.e. if both  $Y$  and  $Z$  satisfy (i)-(ii) then  $Y = Z$   $P$ -a.s.

This result ensures that we may condition on any sigma-algebra for instance  $\mathcal{G} = \sigma(Y)$  in that case we (pure notation) write

$$E[X \mid \sigma(Y)] = E[X \mid Y], \quad \sigma(Y) = \sigma(\{Y \in A, A \in \mathbb{B}\}).$$

In the above  $\sigma(Y)$  is simply the smallest sigma-algebra containing all the pre-images of  $Y$ , that is the smallest sigma-algebra making  $Y$  measurable! Giving this foundation there are a few properties conditional expectation have which is rather useful (for instance the tower property).

Below we assume: Let  $(\Omega, \mathcal{F}, P)$  be a probability space and  $X, Y$  be random variables in  $L^1(\Omega, \mathcal{F}, P)$ .

**Proposition B.29.** (*Monotonicity/Linearity of Conditional expectation*) The following holds:

$$X \leq Y \Rightarrow E[X | \mathcal{G}] \leq E[Y | \mathcal{G}], \quad P - \text{a.s.}$$

$$E[\alpha X + \beta Y | \mathcal{G}] = \alpha E[X | \mathcal{G}] + \beta E[Y | \mathcal{G}], \quad \forall \alpha, \beta \in \mathbb{R}.$$

**Proposition B.30.** (*Tower property*) Assume that it holds that  $\mathcal{H} \subseteq \mathcal{G} \subseteq \mathcal{F}$ . Then the following hold:

$$E[E[X|\mathcal{G}]|\mathcal{H}] = E[X|\mathcal{H}],$$

$$E[X] = E[E[X|\mathcal{G}]].$$

**Proposition B.31.** Assume  $X$  is  $\mathcal{G}$  and that both  $X, Y$  and  $XY$  are in  $L^1$  (only assuming  $Y$  is  $\mathcal{F}$ -measurable), then

$$E[X|\mathcal{G}] = X, \quad P - \text{a.s.}$$

$$E[XY|\mathcal{G}] = XE[Y|\mathcal{G}], \quad P - \text{a.s.}$$

**Proposition B.32.** (*Jensen inequality*) Let  $f : \mathbb{R} \rightarrow \mathbb{R}$  be a convex (measurable) function and assume  $f(X)$  is in  $L^1$ . Then

$$f(E[X|\mathcal{G}]) \leq E[f(X)|\mathcal{G}], \quad P - \text{a.s.}$$

**Filtrations** Let  $(\Omega, \mathcal{F}, P)$  be a probability space. We define a filtration as an increasing family of sub-sigma-algebras in the following definition.

**Definition B.16.** (*Filtration*) Let  $\mathbf{F} = (\mathcal{F}_t)_{t \geq 0}$  be an time indexed family of sub-sigma-algebras such that  $\mathcal{F}_s \subseteq \mathcal{F}_t$  for  $s \leq t$  and  $\mathcal{F}_t \subseteq \mathcal{F}$  for all  $t \geq 0$ . We may given this filtration define  $\mathcal{F}_\infty$  as  $\sigma\left(\bigcup_{t \geq 0} \mathcal{F}_t\right)$ .

Filtrations is widely used in stochastic processes, as they allow for the concept of knowledge/information. This is useful when considering mean-values of future states but in an increasing information setting. For this we introduce the term adapted processes.

**Definition B.17.** (*Adapted process*) Let  $(\mathcal{F}_t)_{t \geq 0}$  be a filtration on the probability space  $(\mathcal{F}_t)_{t \geq 0}$ . Furthermore, let  $(X_t)_{t \geq 0}$  be a stochastic process on the same space. We say that  $X_t$  is adapted to the filtration  $\mathbf{F}$  if

$$X_t \text{ is } \mathcal{F}_t - \text{measurable}, \quad \forall t \geq 0.$$

Obviously, we may introduce the **natural filtration**  $\mathcal{F}_t^X$  given by the trajetory of the process  $X_t$ :

$$\mathcal{F}_t^X = \sigma(\{X_s, s \leq t\}).$$

Indeed,  $X_t$  is adapted to this filtration.

**Martingales Definition C.1.** Let  $M_t$  be a stochastic process defined on a background space  $(\Omega, \mathcal{F}, P)$ . Let  $(\mathcal{F}_t)_{t \geq 0}$  be a filtration. If  $M_t$  is adapted to the filtration  $\mathcal{F}_t$ ,  $E|M_t| < \infty$  and

$$E[M_t | \mathcal{F}_s] = M_s, \quad P - \text{a.s.}$$

holds for any  $t > s$  we say that  $M_t$  is a martingale (**F**-martingale). If the above has  $\geq$  or  $\leq$  we say that  $M_t$  is either a **submartingale** or **supermartingale** respectively.

Naturally, this definitions may easily be extended to discrete models and we have the trivial equality:

$$E[M_t - M_s | \mathcal{F}_s] = 0.$$

Martingales is useful, when proofing probabilistic statements as the posses tractable properties. A useful technique often include the construction of the martingale

$$M_t = E[X | \mathcal{F}_t].$$

## Discrete time models

**One-period time models** The study of this course is the **European call** option (and *put* option). This financial derivative is an agreement between two parties where the holder of the option has the right to “*exercise*” the derivative, at a future time  $t = T$ . Exercising means buying an asset at a certain agreed upon price-strike  $K$ . In the case of the put-option: the holder has the right (but not obligation) to sell the asset at the strike price  $K$ . As such the derivative has the payoff

$$\text{Call option: } \Phi(S_T) = (S_T - K)^+, \quad \text{Put option: } \Phi(S_T) = (K - S_T)^+.$$

Our objective is to understand when an arbitrage exist and to find the fair price of these derivative. The strategy in pricing is finding a replicating portfolio with the same payoff as the option (with probability one) and then price the derivative accordingly.



**Model description** In the one-period model we consider the simplest possible market. We have two distinct times  $t = 0$  (today) and  $t = 1$  (tomorrow) and we may buy any portfolio as a mixture of bonds and one stock. We denote the bonds price by  $B_t$  and the stocks price by  $S_t$  and we assume the following:

$$B_0 = 1, B_1 = 1+R, \quad S_0 = s, S_1 = \begin{cases} s \cdot u, & \text{with probability } p_u. \\ s \cdot d, & \text{with probability } p_d. \end{cases}$$

We may introduce  $Z$  as the random variable

$$Z = u \cdot (I) + d \cdot (1 - I),$$

for an bernoulli variable  $I$  with succes probability  $p_u$ . Naturally, we assume  $d \leq (1 + R) \leq u$  (this is imperative to ensure no arbitrage as we will see).

**Portfolios and arbirtage** We study any portfolio on the  $(B, S)$  market as a vector  $h = (x, y)$  where  $x$  is the amount of bonds and  $y$  is the amount of stock held in the portfolio. Notice that we allow for shorting, that is  $x < 0$  or  $y < 0$ . As such, we have that  $h \in \mathbb{R}^2$ . In this we have made some unrealistic, but attractable assumptions included in the assumptions:

- We allow short positions and fractional holding, i.e.  $h \in \mathbb{R}^2$ ,
- We assume no spread between ask and bids,
- No transaction costs and
- A completely liquid market i.e. we may borrow and buy as much stock and bonds as wanted.

Given that we have chosen a portfolio  $h$  we may introduce the value process.

**Definition 2.1.** The **value process** of the porfolio  $h \in \mathbb{R}^2$  is the stochastic process

$$V_t^h = xB_t + yS_t, \quad t = 0, 1.$$

Given this notation we may define what an arbitrage is.

**Definition 2.2.** An **arbitrage** is a portfolio  $h$  with the properties: 1)  $V_0^h = 0$ , 2)  $P(V_1^h \geq 0) = 1$  and 3)  $P(V_1^h > 0) > 0$ .

That is  $h$  is an deterministic money-machine where we at least never loose any money. Granted the bonds give a determinictic non-negative return, but an arbitrage does not require any money out of pocket. With the notion of an arbitrage we will show the first

proposition regarding the choice of  $R, u, d$  as defined above.

**Proposition 2.3.** The one-period binomial model is arbitrage free if and only if the following inequality hold:

$$d \leq (1 + R) \leq u. \quad (2.1)$$

**Proof.**

The statement is proofed by contradiction. Assume that  $d > 1 + R$  holds. Then by definition  $u > d > 1 + R$ . Notice that any portfolio satisfying  $V_0^h = 0$  must satisfy

$$0 = xB_0 + yS_0 = x + ys \iff x = -ys$$

That is for some choice  $y$  the only arbitrage candidate is the portfolio  $h = (-ys, y)$ . Calculating the value at time  $t = 1$  we have

$$V_1^h = -ys \cdot (1 + R) + y \cdot s \cdot Z = ys(Z - 1 - R)$$

However since  $Z \geq d$  we have  $Z - (1 + R) \geq 0$  and therefore an arbitrage (for  $y > 0$ ). The other inequality  $1 + R > u$  follows analog steps. Simply choose some  $y < 0$  and the result follows. ■

From inequality (2.1) we see that since  $1 + R$  is between  $u$  and  $d$  we may find a pair  $q_d, q_u \geq 0$  with  $q_d + q_u = 1$  such that

$$1 + R = q_u \cdot u + q_d \cdot d.$$

This yields the important risk neutral valuation formula as summed up in the following definition

**Definition 2.4.** A probability measure  $Q$  is called a **martingale measure** if the following condition holds:

$$S_0 = \frac{1}{1 + R} E^Q[S_1].$$

The above measure  $Q$  is the measure  $Q(Z = d) = q_d$  and  $Q(Z = u) = q_u$  for the binomial model. This does in fact yield the risk neutral valuation formula:

$$\begin{aligned} S_0 &= \frac{1}{1 + R} E^Q[S_1] = \frac{1}{1 + R} (Q(Z = d) \cdot d \cdot s + Q(Z = u) \cdot u \cdot s) \\ &= s \frac{1}{1 + R} (q_d \cdot d + q_u \cdot u) = s, \end{aligned}$$

where we simply use  $1 + R = q_d \cdot d + q_u \cdot u$ . We call this the risk neutral valuation formula because it in some sense gives an expected discounted value of the future stock price. We end this endeavour with reformulating the arbitrage proposition and determining the values of the  $Q$ -measure.

**Proposition 2.5.** The one-period binomial model is arbitrage free if and only if there exists a martingale measure  $Q$ .

**Proposition 2.6.** The one-period binomial model has martingale probabilities given by:

$$\begin{cases} q_u = \frac{(1+R)-d}{u-d}, \\ q_d = \frac{u-(1+R)}{u-d}. \end{cases}$$

**Contingent Claims** This chapter revolves around the financial derivative and we start by stating the definition of the financial derivative.

**Definition 2.7.** A **contingent claim** (financial derivative) is *any* stochastic variable  $X$  of the form  $\Phi(Z)$ , where  $Z$  is the stochastic variable driving the stock price process.

We may also call the function  $\Phi$  the **contract function** as it states how the contract is resolved once the stochastic variable  $Z$  has been realised. Our objective is now to study, what a buyer of said contract would have to pay at any given time  $t$ . We call the fair price of  $X$  at time  $t$ :  $\Pi_t[X]$ . As such it is easy to see that the fair price at the time of maturity  $T$  is simply the payout  $X$  i.e.  $\Pi_T[X] = X$ . Our strategy is to find a replicating portfolio  $h$  and determine the price of said portfolio.

**Definition 2.8.** A contingent claim  $X$  can be **replicated**, or said to be **reachable** if there exist a portfolio  $h$  such that

$$V_1^h = X,$$

with probability one. In that case, we say that the portfolio  $h$  is a **hedging** portfolio or a **replication** portfolio. If all claims can be replicated we say that the market is **complete**.

Our pricing strategy is then to determine the value process of the replicating portfolio and then by the first pricing principle below we say that the price is simply the value of the replicating portfolio.

**Pricing principle 1.** If a claim  $X$  is reachable with replicating portfolio  $h$ , then the only reasonable price process for  $X$  is given by

$$\Pi_t[X] = V_t^h.$$

Notice, that this assumes that a replicating portfolio exist and even so we have a uniqueness statement to solve. We end this section by writing two important results.

**Proposition 2.9.** Suppose that a claim  $X$  is reachable with replicating portfolio  $h$ . Then any price at time  $t \geq 0$  of the claim  $X$  other than the value process of  $h$  will lead to an arbitrage on the extended market  $(B, S, X)$ .

**Proposition 2.10.** If the one-period binomial model is free of arbitrage, then it is also complete.

The hedging portfolio in the one-period binomial model is given by the portfolio  $(x, y)$  below

$$x = \frac{1}{1+R} \cdot \frac{u\Phi(d) - d\Phi(u)}{u-d}, \quad y = \frac{1}{s} \cdot \frac{\Phi(u) - \Phi(d)}{u-d}.$$

**Risk Neutral Valuation** We see that since the one-period model is complete we can price any contingent claim and we see that

$$\begin{aligned} \Pi_0[X] &= \frac{1}{1+R} \cdot \frac{u\Phi(d) - d\Phi(u)}{u-d} + s \frac{1}{s} \cdot \frac{\Phi(u) - \Phi(d)}{u-d} \\ &= \frac{1}{1+R} \left\{ \frac{u\Phi(d) - d\Phi(u)}{u-d} + (1+R) \frac{\Phi(u) - \Phi(d)}{u-d} \right\} \\ &= \frac{1}{1+R} \left\{ \frac{(1+R) - d}{u-d} \Phi(u) + \frac{u - (1+R)}{u-d} \Phi(d) \right\} \\ &= \frac{1}{1+R} E^Q[X]. \end{aligned}$$

i.e. the price at time  $t = 0$  should simply be the expected discounted payout according to the martingale measure. This leads to the important pricing proposition:

**Proposition 2.11.** If the one-period binomial model is free of arbitrage, then the arbitrage free price of a contingent claim  $X$  is given by

$$\Pi_0[X] = \frac{1}{1+R} E^Q[X]. \quad (2.4)$$

Here the martingale measure  $Q$  is uniquely determined by the relation

$$S_0 = \frac{1}{1+R} E^Q[S_1], \quad (2.5)$$

and the explicit expressions for  $q_u$  and  $q_d$  are given in proposition 2.6. Furthermore the claim  $X$  can be replicated using the portfolio

$$x = \frac{1}{1+R} \cdot \frac{u\Phi(d) - d\Phi(u)}{u-d}, \quad (2.6)$$

$$y = \frac{1}{s} \cdot \frac{\Phi(u) - \Phi(d)}{u-d}. \quad (2.7)$$

**Multi-period model** The one-period binomial model can easily be extended to a multi-period model, by assuming that the bond and stock prices evolve by the processes:

$$t \geq 1 : B_t = (1+R)B_{t-1} \quad \text{and} \quad B_0 = 1,$$

$$t \geq 1 : S_t = Z_{t-1}S_{t-1} \quad \text{and} \quad S_0 = s,$$

where we obviously have that  $B_t = (1+R)^t$  for  $t \geq 0$ . In the above  $Z_t$  is  $u$  with probability  $p_u$  and  $d$  with probability  $p_d$ . In this context, we need to define a portfolio in terms of a strategy.

**Definition 2.13.** A **portfolio strategy** is a stochastic process on  $\{1, \dots, T\}$

$$h = \{h_t = (x_t, y_t); t = 1, \dots, T\}$$

such that  $h_t$  is a function of  $S_0, S_1, \dots, S_{t-1}$ . For a given portfolio strategy  $h$  we set  $h_0 = h_1$  by convention. The associated **value process** corresponding to the portfolio  $h$  is defined by

$$V_t^h = x_t(1+R) + y_tS_t.$$

Given this notation we may define what an arbitrage is, but first we introduce the notion of a self-financing portfolio. A self-financing portfolio in an intuitive sense is a portfolio that is not withdrawn from or deposited into.

**Definition 2.14.** A portfolio strategy  $h$  is said to be **self-financing** if the following condition holds for all  $t = 0, \dots, T-1$ :

$$x_t(1+R) + y_tS_t = x_{t+1} + y_{t+1}S_t.$$

The above equation says that the portfolio purchased at time  $t$  and held until  $t+1$  ( $x_{t+1}, y_{t+1}$ ) can only

be financed by the market value of the portfolio held from  $[t-1, t]$  i.e.  $(x_t, y_t)$ . We now define an arbitrage.

**Definition 2.15.** An **arbitrage** is a self-financing portfolio  $h$  with the properties: 1)  $V_0^h = 0$ , 2)  $P(V_T^h \geq 0) = 1$  and 3)  $P(V_T^h > 0) > 0$ .

The multiperiod binomial model has an just like the oneperiod model a result regarding when an arbitrage exists.

**Lemma 2.16.** If  $d \leq (1 + R) \leq u$  then the multiperiod model is arbitrage-free.

As one can see, the multiperiod model is rather similar to the one period model. We wil in the following summarise equivalent statements for the multiperiod model as the ones in the oneperiod model.

**Definition 2.17.** The martingale probabilities  $q_u$  and  $q_d$  are defined as the probabilities for which the relation below holds.

$$s = \frac{1}{1 + R} E^Q[S_{t+1} | S_t].$$

**Proposition 2.18.** The martingale probabilities  $q_u$  and  $q_d$  are given by

$$\begin{cases} q_u = \frac{(1+R)-d}{u-d}, \\ q_d = \frac{u-(1+R)}{u-d}. \end{cases}$$

**Definition 2.19.** A **contingent claim** is a stochastic variable  $X$  of the form

$$X = \Phi(S_T),$$

where the **contract function**  $\Phi$  is some given real valued function.

**Definition 2.20.** A given contingent claim  $X$  is said to be **reachable** if there exists a self-financing portfolio  $h$  such that

$$V_T^h = X,$$

with probability one. In that case we say that the portfolio  $h$  is a **hedging** portfolio or a **replicating** portfolio. If all claims can be replicated we say that the market is (*dynamically*) **complete**.

**Pricing principle 2.** If a claim  $X$  is reachable with replicating portfolio  $h$ , then the only reasonable price process for  $X$  os given by

$$\Pi_t[X] = V_t^h, \quad t = 0, 1, \dots, T.$$

**Proposition 2.21.** Assume  $X$  is reachable by  $h$ , then any price other than  $V_t^h$  for some  $t \geq 0$  leads to an arbitrage opportunity.

**Proposition 2.22.** The multiperiod model is complete, i.e. every claim can be replicated by a self-financing portfolio.

**Proposition 2.24. (Binomial algorithm)** Consider a  $T$ -claim  $X = \Phi(S_T)$ . Then this claim can be replicated using a self-financing portfolio. If  $V_t(k)$  denotes the value of the portfolio at the node  $(t, k)$  ( $k$  referring to  $k$  amount of up-moves for the stock), then  $V_t(k)$  can be computed recursively by the scheme

$$\begin{cases} V_t(k) = \frac{1}{1+R} \{q_u V_{t+1}(k+1) + q_d V_{t+1}(k)\}, \\ V_T(k) = \Phi(su^k d^{T-k}). \end{cases}$$

where the martingale probabilities  $q_u$  and  $q_d$  are given by

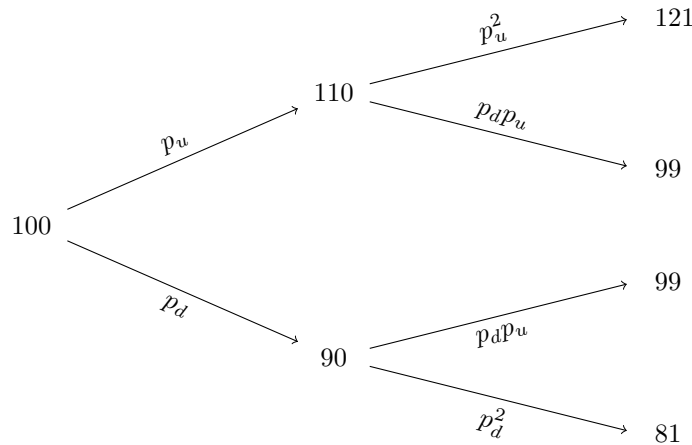
$$\begin{cases} q_u = \frac{(1+R)-d}{u-d}, \\ q_d = \frac{u-(1+R)}{u-d}. \end{cases}$$

With the notation as above, the hedging portfolio is given by

$$\begin{cases} x_t(k) = \frac{1}{1+R} \cdot \frac{uV_t(k)-dV_t(k+1)}{u-d}, \\ y_t(k) = \frac{1}{S_{t-1}} \cdot \frac{V_t(k+1)-V_t(k)}{u-d}. \end{cases}$$

In particular, the arbitrage free price of the claim at  $t = 0$  is given by  $V_0(0)$ .

**Example.**



Consider  $R = 0.04$ ,  $s = 100$ ,  $u = 1.1$ ,  $d = 0.9$ ,  $p_u = 0.6$  and  $p_d = 0.4$ . We consider a model of length  $T = 2$  and we want to evaluate the price of

the european call option with strike  $K = 90$  that is the contingent claim

$$X = (S_T - K)^+, \quad \Phi(s) = (s - K)^+.$$

For each time  $t$  we know the replicating portfolio, if we know the payoff the following period. Therefore we start from the leaves of the tree and work towards the root. Since the strike price is  $K = 90$  the end result will be the following payoffs:

$$\begin{aligned} u^2 : & \quad (121 - 90)^+ = 31 \\ ud : & \quad (99 - 90)^+ = 9 \\ du : & \quad (99 - 90)^+ = 9 \\ d^2 : & \quad (81 - 90)^+ = 0 \end{aligned}$$

Therefore by the risk neutral valuation formula with  $q_u = \frac{(1+R)-d}{u-d} = 0.7$  and  $q_d = \frac{u-(1+R)}{u-d} = 0.3$  we have that the cost of the replicating portfolio at time  $t = 1$  is respectively

$$\begin{aligned} u : & \quad \frac{1}{1+R} \{31 \cdot q_u + 9 \cdot q_d\} \approx 23.46 \\ d : & \quad \frac{1}{1+R} \{9 \cdot q_u + 0 \cdot q_d\} \approx 6.06 \end{aligned}$$

To replicate this payoff at time  $t = 1$  we can use the risk neutral valuation formula once more to find the base cost of the replicating portfolio i.e. the price of  $X$  at time  $t = 0$

$$\frac{1}{1+R} \{23.46 \cdot q_u + 6.06 \cdot q_d\} \approx 17.54.$$

Working from the root to the leaves we can now calculate the hedging portfolio at time  $t = 0, 1$  for each path. For time  $t = 0$  we calculate

$$\begin{aligned} x &= \frac{1}{1+R} \cdot \frac{u \cdot 6.06 - d \cdot 23.46}{u-d} \approx -69.46, \\ y &= \frac{1}{s} \cdot \frac{23.46 - 6.06}{u-d} \approx 0.87 \end{aligned}$$

We see by calculations that this does indeed replicate the payoff at time  $t = 1$ :

$$\begin{aligned} u : & \quad V_1^h = (1+R) \cdot x + 110 \cdot y \approx 23.46, \\ d : & \quad V_1^h = (1+R) \cdot x + 90 \cdot y \approx 6.06. \end{aligned}$$



We also see by calculation that the initial portfolio does cost the expected 17.54 as

$$x \cdot 1 + y \cdot 100 = 87 - 69.46 = 17.54.$$

Following these steps at time  $t = 1$  the portfolios  $(-86.54, 1)$  (for the up-scenario) and  $(-38.94, 0.5)$  (for the down-scenario) would arise. Notice when calculating  $y$  one has to use the current price  $S_1 = S_0 \cdot Z$  not  $S_0$ . One should also check by similar calculations as above, that these portfolios does indeed replicate the payoff of the contingent claim  $X$ .  $\square$

**Proposition 2.25.** The arbitrage free price at  $t = 0$  of a  $T$ -claim  $X$  is given by

$$\Pi_0[X] = \frac{1}{(1+R)^T} E^Q[X]$$

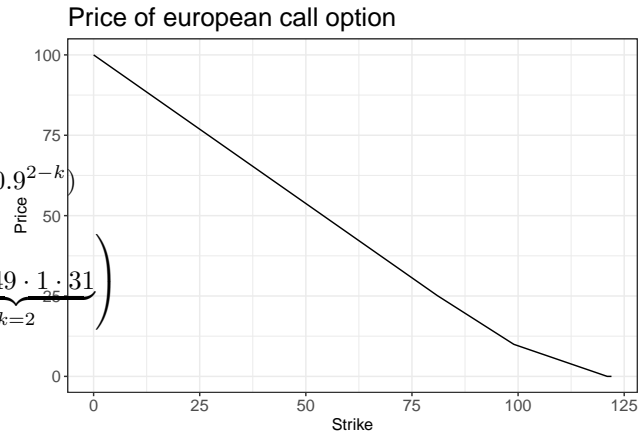
where  $Q$  denotes the martingale measure, or more explicitly

$$\Pi_0[X] = \frac{1}{(1+R)^T} \sum_{k=0}^T \binom{T}{k} q_u^k q_d^{T-k} \Phi(su^k d^{T-k}).$$

**Example.**

We follow an analog example as the one after proposition 2.24. Let  $K = 90$  and we see that

$$\begin{aligned} \Pi_0[X] &= \frac{1}{(1+0.04)^2} \sum_{k=0}^2 \binom{2}{k} \cdot 0.7^k \cdot 0.3^{2-k} \cdot \Phi(100 \cdot 1.1^k \cdot 0.9^{2-k}) \\ &= 0.9245562 \cdot \left( \underbrace{1 \cdot 1 \cdot 0.09 \cdot 0}_{k=0} + \underbrace{2 \cdot 0.7 \cdot 0.3 \cdot 9}_{k=1} + \underbrace{1 \cdot 0.49 \cdot 1 \cdot 31}_{k=2} \right) \\ &= 0.9245562 \cdot (0 + 3.78 + 15.19) \\ &= 17.53883 \end{aligned}$$



Since we know that  $K$  must meaningfully range in  $[0, 121]$  we could try to calculate the price of the contingent claim at time  $t = 0$  for all integers in this interval. We see that the price range between  $S_0$  and 0 as expected. One can also see that the price changes slope at the prices 99 and 121 as the function is linear in  $\Phi$  and some realisations loose any effect on the price when the strike is higher than the outcome.  $\square$

**Proposition 2.26.** The condition  $d < (1+R) < u$  is necessary and sufficient condition for absence of arbitrage.

**Generalised one-period model** In the previous we had the simple model where we only had one stochastic asset  $S$  and only one stochastic variable  $Z$  determining the future stock price. Now we will generalise this model by introducing  $N$  assets and introducing some stochastic behaviour to the system.

**Model specification** We consider the market consisting of a collection of stochastic prices assets  $i = 1, \dots, N$  with  $N$ -dimensional price process.

$$S_t = \begin{bmatrix} S_t^1 \\ \vdots \\ S_t^N \end{bmatrix}$$

We now assume that  $S_t$  is defined on a background space with finite sample space  $\Omega = \{\omega_1, \dots, \omega_M\}$  with associated probabilities  $p_j = P(\omega_j)$ ,  $j = 1, \dots, M$ . We can then for each time  $t = 1, \dots, T$  define the  $N \times M$  matrix  $D_t$  as such

$$D_t = \begin{bmatrix} S_t^1(\omega_1) & \dots & S_t^1(\omega_M) \\ \vdots & \ddots & \vdots \\ S_t^N(\omega_1) & \dots & S_t^N(\omega_M) \end{bmatrix}.$$

We will assume that  $S_0^1 > 0$  and  $S_1^1(\omega_j) > 0$ ,  $j = 1, \dots, M$ .

**Absence of Arbitrage** We now define a **portfolio** as an  $N$ -dimensional row vector

$$h = [h^1, \dots, h^N]$$

representing the amount of assets held at time  $t = 0$  and held until  $t = 1$ . The **value process** is then

$$V_t^h = h \cdot S_t = \sum_{i=1}^N h^i S_t^i, \quad t = 0, 1.$$

For a given  $\omega_j \in \Omega$  we have the realisation

$$V_t^h = h S_t(\omega_j) = h d_j = (h D)_j.$$

**Definition 3.1.** The portfolio  $h$  is an **arbitrage portfolio** if it satisfies the conditions:  $V_0^h = 0$ ,  $P(V_1^h \geq 0) = 1$  and  $P(V_1^h > 0) > 0$ .

**Lemma 3.2. (Farkas' Lemma)** Suppose that  $d_0, d_1, \dots, d_M$  are column vectors in  $\mathbb{R}^N$ . Then exactly one of the following problems possesses a solution.

- **Problem 1:** There exist  $\lambda_1, \dots, \lambda_M \geq 0$  such that  $d_0 = \sum_{j=1}^M \lambda_j d_j$ .
- **Problem 2:** There exist  $h \in \mathbb{R}^N$  such that  $h^\top d_0 < 0$  and  $h^\top d_j \geq 0$  for  $j = 1, \dots, M$ .

We now investigate this system for any possible arbitrage portfolios. However first we acknowledge that there exist a nominal price system  $S_t$  and a normalised price system  $Z_t$ . The latter we define as the nominal price under the numeraire  $S_t^1$  that is

$$Z_t = \begin{bmatrix} S_t^1/S_t^1 \\ S_t^2/S_t^1 \\ \vdots \\ S_t^N/S_t^1 \end{bmatrix} = \begin{bmatrix} 1 \\ S_t^2/S_t^1 \\ \vdots \\ S_t^N/S_t^1 \end{bmatrix}.$$

The reason for introducing the normalized price system is that we can without much effort translate results in this system to the nominal system and the normalised system is easier to analyze. For this, however, we need a few results.

**Lemma 3.3.** With notation as above, the following hold.

1. The  $Z_t$  value process is related to the  $S_t$  value process by

$$V_t^{h,Z} = hZ_t = \frac{1}{S_t^1} V_t^h.$$

2. A portfolio is an arbitrage in the  $S_t$  system if and only if there is an arbitrage in the  $Z_t$  system.
3. In the  $Z_t$  price system, the numeraire asset  $Z^1$  has unit constant prices i.e.  $Z_t^1 = 1$  for all  $t \geq 0$ .

One of the reasons that the normalised system is attractive is that the numeraire asset is constant i.e. risk free in the normalised system. Let us formulate our first main result.

**Proposition 3.4.** The market is arbitrage free if and only if there exists strictly positive real numbers  $q_1, \dots, q_M \geq 0$  with  $q_1 + \dots + q_M = 1$  (probability vector) such that the following vector equality holds

$$\begin{bmatrix} Z_0^1 \\ \vdots \\ Z_N^1 \end{bmatrix} = \begin{bmatrix} Z_1^1(\omega_1) \\ \vdots \\ Z_1^N(\omega_1) \end{bmatrix} q_1 + \dots + \begin{bmatrix} Z_1^1(\omega_M) \\ \vdots \\ Z_1^N(\omega_M) \end{bmatrix} q_M. \quad (3.3)$$

**Proof.**

**Martingale Measures** **Definition 3.5.** Given the objective probability measure  $P$  on  $(\Omega, \mathcal{F}, P)$ , we say that another probability measure  $Q$  defined on  $\Omega$  is **equivalent** to  $P$  if

$$\forall A \in \mathcal{F} : P(A) = 0 \iff Q(A) = 0,$$

or equivalently

$$\forall A \in \mathcal{F} : P(A) = 1 \iff Q(A) = 1.$$

**Definition 3.7.** Consider the market model above and set  $S^1$  as the numeraire asset. We say that a probability measure  $Q$  defined on  $\Omega$  is a **martingale measure** if it satisfies the following conditions:

1.  $Q$  is equivalent to  $P$ , i.e.  $Q \sim P$ .
2. For every  $i = 1, \dots, N$ , the normalized asset price process

$$Z_t^i = \frac{S_t^i}{S_t^1},$$

is a martingale under the measure  $Q$ .

**Theorem 3.8. (First Fundamental Theorem)** Given a fixed numeraire, the market is free of arbitrage possibilities if and only if there exists a martingale measure  $Q$ .

By assuming that the numeraire asset is risk free (i.e. does not depend on  $\omega$ ) then by scaling we can derive the short interest rate as

$$1 + R = \frac{S_1^1}{S_0^1}.$$

With this in mind we can formulate theorem 3.8 in its more widely used form.

**Theorem 3.9. (First Fundamental Theorem)** Assume that there exist a risk free asset, and denote the corresponding risk free interest rate by  $R$ . Then the market is arbitrage free if and only if there exist a measure  $Q \sim P$  such that

$$S_0^i = \frac{1}{1+R} E^Q[S_1^i], \quad \text{for all } i = 1, \dots, N. \quad (3.9)$$

**Martingale Pricing** Moving forward we will assume that there exist a risk free asset and we will denote it by  $B_t$  ( $B_t = S_t^1/S_0^1$ ).

**Definition 3.10.** A **contingent claim** is any random variable  $X$ , defined on the sample space  $\Omega$ .

To ensure no arbitrage in the extended market containing the  $N$  assets and the contingent claim we can apply the first fundamental pricing theorem on the extended market.

**Proposition 3.11.** Consider a given claim  $X$ . In order to avoid arbitrage,  $X$  must then be priced according to the formula

$$\Pi_0[X] = \frac{1}{1+R} E^Q[X], \quad (3.10)$$

where  $Q$  is a martingale measure for the underlying market  $(\Pi, S^1, \dots, S^N)$ .

**Completeness** Given that a market is arbitrage-free we may run into a uniqueness issue when determining the price of a contingent claim. If a martingale measure exist we will very much like it to be unique as this will ensure that the price from the risk neutral valuation formula is unique. To this we need the market to be complete.

**Definition 3.12.** Consider a contingent claim  $X$ . If there exists a portfolio  $h$ , based on the underlying assets, such that

$$V_1^h = X, \text{ with probability } 1 \quad (3.11)$$

i.e.

$$V_1^h(\omega_j) = X(\omega_j), \quad j = 1, \dots, M, \quad (3.12)$$

then we say that  $X$  is **replicated**, or **hedged** by  $h$ . Such a portfolio  $h$  is called a replicating, or hedging portfolio. If every contingent claim can be replicated, we say that the market is **complete**.

We can now formulate a proposition on when the market is complete in terms of the matrix  $D$ .

**Proposition 3.13.** The market is complete if and only if the rows of the matrix  $D$  span  $\mathbb{R}^M$ , i.e. if and only if  $D$  has rank  $M$ .

Now we formulate the second fundamental pricing theorem in terms of the martingale measure  $Q$ .

**Proposition 3.14. (Second Fundamental Theorem)** Assume that the model is arbitrage free i.e.  $Q$  exist. Then the market is unique if and only if the martingale measure is unique.

**Stochastic Discount Factors** **Definition 3.16.** The random variable  $L$  on  $\Omega$  is defined by

$$L(\omega_i) = \frac{q_i}{p_i}, \quad i = 1, \dots, M.$$

**Definition 3.17.** Assume the absence of arbitrage, and fix a martingale measure  $Q$ . With notation as above, the **stochastic discount factor** (or “state price deflator”) is the random variable  $\Lambda$  on  $\Omega$  by

$$\mathbf{M}(\omega) = \frac{1}{1+R} \cdot L(\omega). \quad (3.19)$$

**Proposition 3.18.** The arbitrage free price of any claim  $X$  is given by the formula

$$\Pi_0[X] = E^P[\mathbf{M} \cdot X]$$

where  $\mathbf{M}$  is a stochastic discount factor.

## Exercises Week 1

### Probability exercises

Let  $(W(t))_{t \geq 0}$  be a Brownian motion (Bjork, Definition 4.1).

**Exercise 1.** Show that the following processes also are Brownian motions.

- i.  $(-W(t))_{t \geq 0}$  (symmetry)
- ii. For any  $s \geq 0$ ,  $(W(t+s) - W(s))_{t \geq 0}$  (time-homogeneity).
- iii. For every  $c > 0$ ,  $(cW(t/c^2))_{t \geq 0}$  (scaling).

#### Solution (i).

By assumption  $W$  is a Brownian motion and so it follows that

$$-W_0 = -1 \cdot 0 = 0$$

Furthermore, for  $r < s \leq t < u$  it holds that  $W_u - W_t$  and  $W_s - W_r$  is independent. By separate transformations the independence property is preserved and  $-(W_u - W_t)$  and  $-(W_s - W_r)$  is independent. Next, for a normal distributed random variable  $N \sim \mathcal{N}(\mu, \sigma^2)$  it holds, that for a scalar  $c \in \mathbb{R}$  we have  $cN \sim \mathcal{N}(c\mu, c^2\sigma^2)$ . Then obviously;

$$-(W_t) = (-1)W_t \stackrel{d}{=} \mathcal{N}((-1) \cdot 0, (-1)^2(t-s)) \stackrel{d}{=} \mathcal{N}(0, t-s).$$

Lastly, let  $\omega \in \Omega$  and consider the sample path  $s \mapsto (-W_s)(\omega)$ . Clearly for two continuous functions  $f$  and  $g$  it holds that  $(g \circ f)$  is continuous. Then with  $g(f) = -f$  and  $f(t) = W_t(\omega)$  it follows that  $(-W_t) = (g \circ f)(t)$  is also continuous.

#### Solution (ii).

Much like the previous exercise we define a new process and show the properties hold. Let  $s \geq 0$  be chosen arbitrary. Now define  $X_t = W(t+s) - W(s)$ .

First, we let  $t = 0$  and see

$$X_0 = W(0+s) - W(s) = W(s) - W(s) = 0.$$

Secondly, we have that for  $r < u$ :

$$X_u - X_r = W(u+s) - W(s) - (W(r+s) - W(s)) = W(u+s) - W(r+s) \sim \mathcal{N}(0, u+s-(r+s)) = \mathcal{N}(0, u-r).$$

and since for  $r < u \leq k < l$  the translation  $r+s < u+s \leq k+s < l+s$  still holds and  $X_l - X_k = W(l+s) - W(k+s)$  and  $X_u - X_r = W(u+s) - W(k+s)$  are independent. Finally since  $W_t(\omega)$  is continuous

in  $t$  hence the translation  $W_{t+s}$  is continuous. Adding a constant yields a function that is also continuous, hence  $X_t$  is continuous.

**Solution (iii).**

Let  $c > 0$  be given. We show that

$$X_t = cW\left(\frac{t}{c^2}\right)$$

is a Brownian motion. We simply show the four properties. Let  $t = 0$  and notice

$$X_0 = cW\left(\frac{0}{c^2}\right) = cW(0) = 0.$$

The second property follows from separate transformation and that for  $r < u \leq s < t$  we consider

$$X_u - X_r = c\left(W\left(\frac{u}{c^2}\right) - W\left(\frac{r}{c^2}\right)\right) \quad \text{and} \quad X_t - X_s = c\left(W\left(\frac{t}{c^2}\right) - W\left(\frac{s}{c^2}\right)\right)$$

and since  $c, r, u, t, s > 0$  we have the same order for the scaled version of  $r, u, t, s$  and hence we have two independent RV scaled by  $c$ . Then by separate transformations the variables is still independent. Next for the third property:

$$X_t - X_s = c\left(W\left(\frac{t}{c^2}\right) - W\left(\frac{s}{c^2}\right)\right) \sim \mathcal{N}\left(c \cdot 0, c^2\left(\frac{t}{c^2} - \frac{s}{c^2}\right)\right) = \mathcal{N}(0, t - s).$$

Where we use the properties of scaling a normal distributed random variable i.e. for  $c > 0$  and  $N \sim \mathcal{N}(\mu, \sigma^2)$  it follows that  $cN \sim \mathcal{N}(c\mu, c^2\sigma^2)$ . Finally, the forth property follows since  $g(f) = cf$  is continuous and  $h(t) = t/c^2$  is continuous, then for any continuous function  $f(s)$  it follows that  $(g \circ f \circ h) = g(f(h(t)))$  is continuous.

**Proposition B.37.** Let  $(\Omega, \mathcal{F}, P)$  be a given probability space, let  $\mathcal{G}$  be a sub-sigma-algebra of  $\mathcal{F}$ , and let  $X$  be a square integrable random variable. Consider the problem of minimizing

$$E[(X - Z)^2]$$

where  $Z$  is allowed to vary over the class of all square integrable  $\mathcal{G}$  measurable random variables. The optimal solution  $\hat{Z}$  is then given by.

$$\hat{Z} = E[X|\mathcal{G}].$$

**Exercise 2.** (Bjork, exercise B.11.) Prove proposition B.37 by going along the following lines.

- Prove that the “estimation error”  $X - E[X|\mathcal{G}]$  is orthogonal to  $L^2(\Omega, \mathcal{G}, P)$  in the sense that for any  $Z \in L^2(\Omega, \mathcal{G}, P)$  we have

$$E[Z \cdot (X - E[X|\mathcal{G}])] = 0$$

- Now prove the proposition by writing

$$X - Z = (X - E[X|\mathcal{G}]) + (E[X|\mathcal{G}] - Z)$$

and use the result just proved.

**Solution (a).**

Let  $X \in L^2(\Omega, \mathcal{F}, P)$  be a random variable. Now consider an arbitrary  $Z \in L^2(\Omega, \mathcal{G}, P)$ . Recall that  $\mathcal{G} \subset \mathcal{F}$  and so  $X$  is also in  $Z \in L^2(\Omega, \mathcal{G}, P)$ , as it is both square integrable and  $\mathcal{G}$ -measurable. Then

$$E[Z \cdot (X - E[X|\mathcal{G}])] = E[Z \cdot X] - E[Z \cdot E[X|\mathcal{G}]].$$

Then by using the law of total expectation and secondly that  $Z$  is  $\mathcal{G}$ -measurable we have that

$$E[Z \cdot X] = E[E[Z \cdot X|\mathcal{G}]] = E[Z \cdot E[X|\mathcal{G}]].$$

Combining the two equations gives the desired result.

**Solution (b).**

Obviously, we have that

$$X - Z = X - Z + E[X|\mathcal{G}] - E[X|\mathcal{G}] = (X - E[X|\mathcal{G}]) + (E[X|\mathcal{G}] - Z).$$

Then squaring the terms gives

$$(X - Z)^2 = (X - E[X|\mathcal{G}])^2 + (E[X|\mathcal{G}] - Z)^2 + 2(X - E[X|\mathcal{G}])(E[X|\mathcal{G}] - Z)$$

Taking expectation on each side and using linearity of the expectation we have that

$$E[(X - Z)^2] = E[(X - E[X|\mathcal{G}])^2] + E[(E[X|\mathcal{G}] - Z)^2] + 2E[(X - E[X|\mathcal{G}])(E[X|\mathcal{G}] - Z)].$$

We can now use that  $E[X|\mathcal{G}] - Z$  is  $\mathcal{G}$ -measurable with the above result on the last term.

$$E[(X - Z)^2] = E[(X - E[X|\mathcal{G}])^2] + E[(E[X|\mathcal{G}] - Z)^2].$$

Now since  $X$  is given the term  $E[(X - E[X|\mathcal{G}])^2]$  is simply a constant not depending on the choice of  $Z$ . The optimal choice of  $Z$  is then  $E[X|\mathcal{G}]$  since this minimizes the second term. The statement is then proved.

**Exercise 3.** Discuss the following theory/results of Moment generating functions (Laplace transform).

Let  $X$  be a random variable with distribution function  $F(x) = P(X \leq x)$  and  $Y$  be a random variable with distribution function  $G(y) = P(Y \leq y)$ .

**Definition.** The moment generating function or Laplace transform of  $X$  is

$$\psi_X(\lambda) = E[e^{\lambda X}] = \int_{-\infty}^{\infty} e^{\lambda x} dF(x)$$

provided the expectation is finite for  $|\lambda| < h$  for some  $h > 0$ .

The MGF uniquely determine the distribution of a random variable, due to the following result.

**Theorem 1. (Uniqueness)** If  $\psi_X(\lambda) = \psi_Y(\lambda)$  when  $|\lambda| < h$  for some  $h > 0$ , then  $X$  and  $Y$  has the same distribution, that is,  $F = G$ .

There is also the following result of independence for Moment generating functions.

**Theorem 1. (Independence)** If

$$E[e^{\lambda_1 X + \lambda_2 Y}] = \psi_X(\lambda_1)\psi_Y(\lambda_2)$$

for  $|\lambda_i| < h$  for  $i = 1, 2$  for some  $h > 0$ , then  $X$  and  $Y$  are independent random variables.

**Example.** Recall that the Moment generating function of a normal (Gaussian) distribution is given by

$$\psi_X(\lambda) = E[e^{\lambda X}] = \exp\left(\lambda\mu + \frac{\lambda^2}{2}\sigma^2\right)$$

where  $X$  is normally distributed with mean  $\mu$  and variance  $\sigma^2$  and  $\lambda \in \mathbb{R}$  is a constant. Since a Brownian motion  $W(t)$  is normally distributed with zero mean and variance  $t$ , we have that

$$E[\exp(\lambda W(t))] = \exp\left(\frac{\lambda^2}{2}t\right).$$

**Discussion.**

**Exercise 4.** (Bjork, exercise C.8.(a-c)) Let  $W$  be a Brownian motion. Notice that for the natural filtration  $\mathcal{F}_s = \sigma(W_t | t \leq s)$   $W_t - W_s$  is independent of  $\mathcal{F}_s$

- Show that  $W_t$  is a martingale.
- Show that  $W_t^2 - t$  is a martingale.
- Show that  $\exp(\lambda W_t - \frac{\lambda^2}{2}t)$  is a martingale.

**Solution (a).**

We show that for the natural filtration that  $W_t$  is a martingale. This include showing integrability and the martingale property. For the first we note that for a normal distributed random variable with mean 0 we have

$$E[|N|] = \int_{-\infty}^{\infty} |x| dF_N(x) = 2 \int_0^{\infty} x dF_N(x)$$

since the distribution is symmetric. Substituting the distribution function  $\Phi(x) = P(N \leq x)$  in we see that

$$E[|N|] = 2 \int_0^{\infty} x d\Phi(x) = 2 \int_0^{\infty} x \frac{1}{\sqrt{2\pi\sigma^2}} e^{-x^2/(2\sigma^2)} dx = (*)$$

by substituting  $u = x^2/(2\sigma^2)$  ( $x = \sqrt{2\sigma^2 u}$ ) we have that

$$\frac{dx}{du} = \frac{1}{2} \sqrt{2\sigma^2 u} 2\sigma^2 = (\sigma^2)^{3/2} \sqrt{2} u \iff dx = (\sigma^2)^{3/2} \sqrt{2} u du$$

hence

$$(*) = \frac{2}{\sqrt{2\pi\sigma^2}} \int_0^{\infty} \sqrt{2\sigma^2 u} e^{-u} (\sigma^2)^{3/2} \sqrt{2} u du = \frac{2\sqrt{2\sigma^2} (\sigma^2)^{3/2} \sqrt{2}}{\sqrt{2\pi\sigma^2}} \int_0^{\infty} \sqrt{u} e^{-u} u du.$$

This then simplify to

$$(*) = \frac{(2\sigma^2)^{3/2}}{\sqrt{\pi}} \int_0^{\infty} u^{3/2} e^{-u} du = (2\sigma^2)^{1/2} \sqrt{\frac{2\sigma^2}{\pi}} \int_0^{\infty} u^{3/2} e^{-u} du = \sqrt{\frac{2\sigma^2}{\pi}} < \infty.$$



(Obviously the above is not derived correctly, but the end expression is valid, source: link) However since

$$W_t = W_t - 0 = W_t - W_0 \sim \mathcal{N}(0, t)$$

we have that  $E|W_t| < \infty$  as desired.

Next, we have that

$$E[W_t|\mathcal{F}_s] = E[W_t - W_s|\mathcal{F}_s] + W_s = 0 + W_s = W_s.$$

In the above we used that  $W_t - W_s$  is  $\mathcal{F}_s$ -measurable with mean 0. Then it follows that  $W_t$  is a martingale.

**Solution (b).**

Let  $M_t = W_t^2 - t$ . First, we observe that two measurable functions composed is still a measurable function. Hence we know that  $M_t$  is measurable wrt. the filtration since  $W_t$  is measurable and  $w \mapsto w^2 + t$  is measurable. Secondly, we have that

$$E[|W_t^2 - t|] \leq E|W_t^2| + E|t| = t + t = 2t < \infty$$

where we use the triangle inequality. Thirdly, for the martingale property we have that for  $t > s$ :

$$E[M_t|\mathcal{F}_s] = E[W_t^2 - t|\mathcal{F}_s] = E[W_t^2 + W_s^2 - 2W_tW_s - W_s^2 + 2W_tW_s - t|\mathcal{F}_s]$$

which by linearity and independence of increments to the filtration gives

$$E[M_t|\mathcal{F}_s] = E[(W_t - W_s)^2 - W_s^2 + 2W_tW_s - t|\mathcal{F}_s] = t - s - t + E[2W_tW_s - W_s^2|\mathcal{F}_s]$$

However since  $W_s$  is measurable wrt. the filtration at time  $s$  the above is

$$E[M_t|\mathcal{F}_s] = 2W_sE[W_t|\mathcal{F}_s] - W_s^2 - s = 2W_s^2 - W_s^2 - s = W_s^2 - s = M_s.$$

Since from (a) we know that  $W_t$  is a martingale. Then we arrive at the desired result.

**Solution (c).**

Let  $M_t = \exp\left(\lambda W_t - \frac{\lambda^2}{2}t\right)$ . First, by composition of measurable functions  $M_t$  is  $\mathcal{F}_t$ -measurable. Secondly, we have using the MGF for a normal distributed random variable:

$$E[M_t] = E\left(\exp\left(\lambda W_t - \frac{\lambda^2}{2}t\right)\right) \leq E(\exp(\lambda W_t)) = \exp\left(\frac{\lambda^2}{2}t\right) < \infty.$$

Thirdly, we consider

$$E[M_t|\mathcal{F}_s] = E\left[\left(\exp\left(\lambda W_t - \frac{\lambda^2}{2}t\right)\right)\middle|\mathcal{F}_s\right] = \exp\left(-\frac{\lambda^2}{2}t\right) E[(\exp(\lambda W_t))|\mathcal{F}_s].$$

By adding and subtracting  $W_s$  in the exponent we get

$$\begin{aligned}
E[M_t|\mathcal{F}_s] &= \exp\left(-\frac{\lambda^2}{2}t\right) E[(\exp(\lambda(W_t - W_s) + \lambda W_s))|\mathcal{F}_s] \\
&= \exp\left(-\frac{\lambda^2}{2}t\right) \exp\left(\frac{\lambda^2}{2}(t-s)\right) E[(\exp(\lambda W_s))|\mathcal{F}_s].
\end{aligned}$$

Using that  $E[(\exp(\lambda W_s))|\mathcal{F}_s] = \exp(\lambda W_s)$  and combining the exponents gives the desired:

$$E[M_t|\mathcal{F}_s] = \exp\left(\lambda W_s - \frac{\lambda^2}{2}s\right) = M_s.$$

## Week 2

### Table of Contents

- Stochastic integrals and Ito formula (Chapter 4 and Appendix C.2)
- Stochastic differential equations (Chapter 5.1-4)
- Exercises

### Theory

**Stochastic Integrals** We want to formulate financial markets in continuous time and the most elegant theory is obtained from processes that can be defined in terms of **stochastic differential equations** or in other words by their dynamics. We may call them **diffusion processes**, as they may be approximated by a stochastic difference equation:

$$X_{t+\Delta t} - X_t = \mu(t, X_t)\Delta t + \sigma(t, X_t)Z_t. \quad (4.1)$$

Above  $Z_t$  is a normally distributed random variable (a disturbance). In this formulation we say that  $S_t$  is driven by two forces: on one hand a locally deterministic velocity or drift  $\mu(t, X_t)$  and on the other hand a Gaussian term amplified by the deterministic factor  $\sigma(t, X_t)$ .

**Information** We consider a primary process  $X_t$  and we introduce the notion of information generated by  $X_t$  in terms of the natural filtration. The idea can be summed up in the following definition.

**Definition 4.3.** The symbol  $\mathcal{F}_t^X \subseteq \mathcal{F}$  denotes “the information generated by  $X_t$  on the interval  $[0, t]$ ”, or alternatively “what has happened to  $X_t$  over the interval  $[0, t]$ ”.

1. If, based upon observations of the trajectory  $\{X_s; 0 \leq s \leq t\}$ , it is possible to decide whether a given event  $A$  has occurred or not, then we write this as

$$A \in \mathcal{F}_t^X$$

or say that “ $A$  is  $\mathcal{F}_t^X$ -measurable”.

2. If the value of a given random variable  $Z$  can be completely determined given observations of the trajectory  $\{X_s; 0 \leq s \leq t\}$ , then we also write

$$Z \in \mathcal{F}_t^X. \text{ (} Z \text{ is } \mathcal{F}_t^X\text{-measurable)}$$

3. If  $Y$  is a stochastic process such that we have

$$Y_t \in \mathcal{F}_t^X$$

for all  $t \geq 0$  then we say that  $Y_t$  is **adapted** to the **filtration**  $\{\mathcal{F}_t^X\}_{t \geq 0}$ . For brevity of notation, we will sometimes write the filtration as  $\{\mathcal{F}_t^X\}_{t \geq 0} = \mathbf{F}$ .

**Stochastic Integrals** We will now formulate the theory of stochastic integrals, that is, processes written in terms of stochastic processes with stochastic integrator and/or stochastic integrand. We will consider some given standard Brownian motion  $W_t$  and another stochastic process  $X_t$ . We need some integrability condition on  $X_t$  in order to do the calculations. We therefore determine a selection of suitable stochastic processes  $X$  must be contained in.

**Definition 4.4.** Let  $X_t$  be a stochastic process, then

- i. We say that  $X_t$  belongs to the class  $\mathcal{L}^2[a, b]$  if  $X_t$  is adapted to the filtration  $\mathcal{F}_t^X$  and the following holds

$$\int_a^b E[X_s^2] ds < \infty$$

- ii. We say that  $X_t$  belongs to the class  $\mathcal{L}^2$  if  $X_t \in \mathcal{L}^2[0, t]$  for all  $t > 0$ .

We now want to define what we mean by

$$\int_a^b X_t dW_s$$

for some process  $X_t \in \mathcal{L}^2$ . We see that a way to go about this problem is to start by defining the concept for a simple stochastic process  $X_t$ . By *simple* we mean a process  $X_t$  that is constant on between some deterministic points in time  $a = t_0 < t_1 < \dots < t_n = b$ . In that case we may define the integral as

$$\int_a^b X_s dW_s = \sum_{k=0}^{n-1} X_{t_k} [W_{t_{k+1}} - W_{t_k}].$$

In the more general setting we may follow the following approach:

1. Approximate  $X$  with a sequence  $\{X^n\}_{n \in \mathbb{N}}$  of simple processes such that the following convergence criteria hold

$$\int_a^b E[(X_s^n - X_s)^2] ds \rightarrow 0, \quad n \rightarrow \infty$$

2. For each  $n$  the integral  $\int_a^b X_s^n dW_s := Z^n$  is well defined and it is possible to prove, using DCT, that a variable  $Z$  exists such that  $Z^n \rightarrow Z$  that is in  $L^2$ .
3. We now define the stochastic integral by the limit

$$\int_a^b X_s dW_s = \lim_{n \rightarrow \infty} \int_a^b X_s^n dW_s.$$

Obviously the hardest step is finding the processes  $X^n$ . This stochastic has some properties we will use.

**Proposition 4.5.** Let  $X_t \in \mathcal{L}^2$ , then

$$E \left[ \int_a^b X_s dW_s \right] = 0. \tag{4.11}$$

$$E \left[ \left( \int_a^b X_s dW_s \right)^2 \right] = \int_a^b E[X_s^2] dW_s. \tag{4.13}$$

$$\int_a^b X_s dW_s \text{ is } \mathcal{F}_b^W\text{-measurable.} \tag{4.14}$$

**Martingales** **Definition 4.7.** Let  $M_t$  be a stochastic process defined on a background space  $(\Omega, \mathcal{F}, P)$ . Let  $(\mathcal{F}_t)_{t \geq 0}$  be a filtration. If  $M_t$  is adapted to the filtration  $\mathcal{F}_t$ ,  $E|M_t| < \infty$  and

$$E[M_t | \mathcal{F}_s] = M_s, \quad P - \text{a.s.}$$

holds for any  $t > s$  we say that  $M_t$  is a martingale (**F**-martingale). If the above has  $\geq$  or  $\leq$  we say that  $M_t$  is either a **submartingale** or **supermartingale** respectively.

**Proposition 4.8.** For any process  $X_t \in \mathcal{L}^2[s, t]$  the following hold:

$$E \left[ \int_s^t X_s dW_s \middle| \mathcal{F}_s^W \right] = 0$$

**Corollary 4.9.** For any process  $X_t \in \mathcal{L}^2$  the process

$$M_t = \int_s^t X_s dW_s,$$

is an  $(\mathcal{F}_t^W)$ -martingale. In other words, modulo an integrability condition, *every stochastic integral is a martingale*.

**Lemma 4.10.** Let  $M_t$  be a stochastic process with stochastic differential, then  $M_t$  is a martingale if and only if the stochastic differential has the form  $dM_t = X_t dW_t$  i.e.  $M_t$  as no  $dt$ -term.

**Stochastic Calculus and the Ito Formula** Given this brief introduction to stochastic integrals we may formulate some simple calculus revolving around Ito's formula. We consider the stochastic process  $X_t$  and we suppose that there exist a real number  $X_0$  and adapted processes  $\mu$  and  $\sigma$  wrt.  $\mathcal{F}_t^W$  such that for all  $t \geq 0$  we have

$$X_t = X_0 + \int_0^t \mu_s ds + \int_0^t \sigma_s dW_s, \quad (4.16)$$

where  $W_t$  is a standard Brownian motion. We know from earlier courses that the above may be written in terms of the dynamics (pure notation):

$$\begin{cases} dX_t = \mu_t dt + \sigma_t dW_t, \\ X_0 = X_0. \end{cases}$$

Here we interpret the above as  $X_t$  has boundary condition  $X_0$  and evolves with a drift  $\mu_t dt$  amplified and distorted by the drift  $\sigma_t dW_t$ . We say that  $X_t$  has **stochastic differential**  $dX_t$  and initial condition  $X_0$ .

We want to understand how transformation of such an integral behaves and therefore we introduce some calculus which will tell how for instance  $f(t, X_t)$  (for some  $C^{1,2}$ -function) behaves. This insight is given by the important Ito's formula.

**Theorem 4.11. (Ito's formula, one-dimensional)** Assume that the process  $X$  has a stochastic differential form given by

$$dX_t = \mu_t dt + \sigma_t dW_t, \quad (4.28)$$

where  $\mu$  and  $\sigma$  are adapted processes, and let  $f : \mathbb{R}_+ \times \mathbb{R} \rightarrow \mathbb{R}$  be a  $C^{1,2}$ -function. Define the process  $Z$  by  $Z_t = f(t, X_t)$ . Then  $Z$  has stochastic differential given by

$$df(t, X_t) = \left( \frac{\partial f}{\partial t}(t, X_t) + \mu_t \frac{\partial f}{\partial x}(t, X_t) + \frac{1}{2} \sigma_t^2 \frac{\partial^2 f}{\partial x^2}(t, X_t) \right) dt + \sigma_t \frac{\partial f}{\partial x}(t, X_t) dW_t. \quad (4.29)$$

**Proposition 4.12. (Ito's formula, one-dimensional)** With assumptions as in theorem 4.11,  $df$  is given by

$$df = \frac{\partial f}{\partial t} dt + \frac{\partial f}{\partial x} dX_t + \frac{1}{2} \frac{\partial^2 f}{\partial x^2} (dX_t)^2, \quad (4.31)$$

where we use the following table

$$\begin{cases} (dt)^2 = 0, \\ dt \cdot dW_t = 0, \\ (dW_t)^2 = dt. \end{cases}$$

**Lemma 4.18.** Let  $\sigma(t)$  be deterministic function of time and define the process  $X$  by

$$X_t = \int_0^t \sigma(s) dW_s. \quad (4.37)$$

Then

$$X_t \sim \mathcal{N} \left( 0, \int_0^t \sigma^2(s) ds \right).$$

**The multidimensional Ito Formula** Consider a vector process  $X = (X^1, \dots, X^n)^\top$  where each component  $X^i$  has stochastic differential

$$dX_t^i = \mu_t^i dt + \sum_{j=1}^d \sigma_t^{ij} dW_t^j$$

where  $W^1, \dots, W^d$  is independent Brownian motions. Then we have respectively the drift vector process  $\mu_t$  in  $n$  dimensions, the vector Brownian motion in  $d$  dimensions and a  $n \times d$ -dimensional **diffusion matrix**  $\sigma_t$  given as below

$$\mu_t = \begin{bmatrix} \mu_t^1 \\ \vdots \\ \mu_t^n \end{bmatrix}, \quad W_t = \begin{bmatrix} W_t^1 \\ \vdots \\ W_t^d \end{bmatrix}, \quad \sigma_t = \begin{bmatrix} \sigma_t^{11} & \dots & \sigma_t^{1d} \\ \vdots & \ddots & \vdots \\ \sigma_t^{n1} & \dots & \sigma_t^{nd} \end{bmatrix}.$$

Given this we may write the dynamics of  $X$  as

$$dX_t = \mu_t dt + \sigma_t dW_t \in \mathbb{R}^n.$$

Consider now a function  $f : \mathbb{R}_+ \times \mathbb{R}^n \rightarrow \mathbb{R}$  which is a  $C^{1,2}$ -mapping. We want to study the dynamics of the process

$$Z_t = f(t, X_t).$$

The dynamics is given in the multidimensional version of Ito's formula.

**Theorem 4.19. (Ito's formula, multi-dimensional)** Let  $X$  be given as above. Then the following holds:

- The process  $f(t, X_t)$  has the stochastic differential given by

$$df(t, X_t) = \left( \frac{\partial f}{\partial t}(t, X_t) + \sum_{i=1}^n \mu_t^i \frac{\partial f}{\partial x^i}(t, X_t) + \frac{1}{2} \sum_{i,j=1}^n C_t^{ij} \frac{\partial^2 f}{\partial x^i \partial x^j}(t, X_t) \right) dt + \sum_{i=1}^n \sigma_t^i \frac{\partial f}{\partial x^i}(t, X_t) dW_t.$$

Here the row vector  $\sigma_t^i$  is the  $i$ 'th row of the matrix  $\sigma_t$  and the matrix  $C$  is defined by  $C = \sigma \sigma^\top$ .

- Alternatively, the differential is given by the formula

$$df(t, X_t) = \frac{\partial f}{\partial t}(t, X_t) dt + \sum_{i=1}^n \frac{\partial f}{\partial x^i}(t, X_t) dX_t^i + \frac{1}{2} \sum_{i,j=1}^n \frac{\partial^2 f}{\partial x^i \partial x^j}(t, X_t) dX_t^i dX_t^j,$$

with the formal multiplication table

$$\begin{cases} (dt)^2 = 0, \\ dt \cdot dW_t^i = 0, & i = 1, \dots, d, \\ (dW_t^i)^2 = dt, & i = 1, \dots, d, \\ dW_t^i \cdot dW_t^j = 0, & i \neq j. \end{cases}$$

Obviously, one can write the differential in Ito's formula in many other ways including a matrix-wise version using the Hessian matrix  $H_{ij} = \frac{\partial^2 f}{\partial x^i \partial x^j}$ .

**Correlated Brownian motions** In the previous section the  $d$ -dimensional Brownian was assumed to have independent Brownian motions. However we may instead consider a variation where we have some dependence between the Brownian motions.

This section has not been finished.

**Discrete Stochastic Integrals** This section has not been finished.

**Stochastic Differential Equations** We start the chapter by formalising some used objects. We consider the following objects.

- $M(n, d)$  denotes the class of  $n \times d$ -matrices.
- $W$  is a  $d$ -dimensional Brownian motion
- $\mu$  is a  $\mathbb{R}^n$ -valued function with arguments  $(t, X_t)$  with  $X_t$  being a  $n$ -dimensional stochastic process.
- $\sigma$  a  $M(n, d)$ -valued function with arguments as in  $\mu$ .
- $x_0$  a  $\mathbb{R}^n$ -valued vector.

We want then to understand when the following has a solution

$$dX_t = \mu(t, X_t) dt + \sigma(t, X_t) dW_t, \quad X_0 = x_0.$$

We call such an equation the **stochastic differential equation** or simply SDE. We know that the above is loosely notation for the integral form as

$$X_t = x_0 + \int_0^t \mu(s, X_s) ds + \int_0^t \sigma(s, X_s) dW_s,$$

for all  $t \geq 0$ . The following proposition tells us when an solution exist to the problem above. In the below  $\|\cdot\|$  is usual euclidian norm

$$\|x\| = \sqrt{\sum_{i=1}^n x_i^2}.$$

**Proposition 5.1.** Suppose that there existis a constant  $K$  such that the following conditions are satisfied for all  $x, y$  and  $t$ .

$$\begin{aligned}\|\mu(t, x) - \mu(t, y)\| &\leq K\|x - y\|, \\ \|\sigma(t, x) - \sigma(t, y)\| &\leq K\|x - y\|, \\ \|\mu(t, x)\| + \|\sigma(t, x)\| &\leq K(1 + \|x\|).\end{aligned}$$

Then there exists a unique solution to the SDE above. Furthermore, the solution has the properties

1.  $X$  is  $\mathcal{F}_t^W$ -adapted.
2.  $X$  has continuous trajectories.
3.  $X$  is a Markov process.
4. There exists a constant  $C$  such that

$$E[\|X_t\|^2] \leq Ce^{Ct}(1 + \|x_0\|^2).$$

In genereal the solution to an SDE is so complicated, that it in practical terms is unsolvable and may only be approximated on a finely subdividet grid as jumps. There does however exist som nontrivial cases where we may infer a analytical solution. One is the rather important **Geometric Brownian motion**.

**Proposition 5.2.** Consider the SDE

$$dX_t = \alpha X_t dt + \sigma X_t dW_t,$$

with  $X_0 = x_0$ . Then the solution is given as

$$X_t = x_0 \cdot \exp \left\{ \left( \alpha - \frac{\sigma^2}{2} \right) t + \sigma W_t \right\}.$$

The expected value of  $X$  is given as  $E[X_t] = x_0 e^{\alpha t}$ .

One other generalisation that is analytically solvable is the Linear SDE.

**Proposition 5.3.** Consider the SDE

$$dX_t = (AX_t + b_t) dt + \sigma_t dW_t,$$

with  $X_0 = x_0$  and  $A \in M(n, n)$  and  $b_t$  being a real-valued function. Then the solution is given as

$$X_t = e^{At} x_0 + \int_0^t e^{A(t-s)} b_s ds + \int_0^t e^{A(t-s)} \sigma_s dW_s.$$

Where we define the exponential of a matrix as below

$$e^{At} = \sum_{k=0}^{\infty} A^k \frac{1}{k!} t^k.$$

In general with the SDE we have a partial differential operator  $\mathcal{A}$  called the **infinitesimal operator** of  $X$  which has some interesting analytical properties regarding  $X$ .

**Definition 5.4.** Consider the SDE

$$dX_t = \mu(t, X_t) dt + \sigma(t, X_t) dW_t.$$

The partial differential operator  $\mathcal{A}$  is defined, for any function  $h \in C^2(\mathbb{R}^n)$ , by

$$\mathcal{A}h(t, x) = \sum_{i=1}^n \mu_i(t, x) \frac{\partial h}{\partial x_i}(x) + \frac{1}{2} \sum_{i,j=1}^n (\sigma(t, x) \sigma(t, x)^\top)_{ij} \frac{\partial^2 h}{\partial x_i \partial x_j}(x).$$

We see that in terms of Ito's formula the operator is included as such

$$df(t, X_t) = \left\{ \frac{\partial f}{\partial t}(t, X_t) + \mathcal{A}f(t, x) \right\} dt + [\nabla_x f](t, X_t) \sigma(t, X_t) dW_t,$$

where  $\nabla_x$  is the gradient for function  $h \in C^1(\mathbb{R}^n)$  as

$$\nabla_x h(x) = \left[ \frac{\partial h}{\partial x_1}(x), \dots, \frac{\partial h}{\partial x_n}(x) \right].$$

## Exercises Week 2

**Exercise 1** (*Bjork 4.1*) Compute the stochastic differential  $dZ_t$  when

- $Z_t = e^{\alpha t}$ .
- $Z_t = \int_0^t g_s dW_s$ , where  $g$  is an adapted stochastic process.
- $Z_t = e^{\alpha W_t}$ .
- $Z_t = e^{\alpha X_t}$ , where  $X$  has stochastic differential  $dX_t = \mu dt + \sigma dW_t$  and  $\mu, \sigma$  is constants.
- $Z_t = X_t^2$ , where  $X$  has stochastic differential  $dX_t = \alpha X_t dt + \sigma X_t dW_t$ .

**Solution (a).**

Let  $Z_t = e^{\alpha t}$ , then we see that  $f(t, x) = e^{\alpha t}$  and the the following relevant derivatives is

$$\frac{\partial f}{\partial t}(t, x) = \alpha e^{\alpha t}, \quad \frac{\partial f}{\partial x}(t, x) = 0, \quad \frac{\partial f}{\partial x^2}(t, x) = 0.$$

Since  $Z$  does not depend on any stochastic process, we will content with  $X_t = 0$ , that is  $\mu_t = \sigma_t = 0$ . Then by theorem 4.11 (Ito's formula) we have

$$dZ_t = (\alpha e^{\alpha t} + 0 + 0) dt + 0 = \alpha e^{\alpha t} dt,$$

as expected.  $\square$

**Solution (b).**

Let  $Z_t = \int_0^t g_s dW_s$ , where  $g$  is an adapted stochastic process. We see that if we set  $X_t = \int_0^t g_s dW_s$  then

$$dX_t = 0 dt + g_t dW_t.$$

Then we have the function  $f(t, x) = x$  and the relevant derivatives are:

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = 1, \quad \frac{\partial f}{\partial x^2}(t, x) = 0.$$

This then gives

$$dZ_t = \left( 0 + 0 + \frac{1}{2} g_t \cdot 0 \right) dt + g_t \cdot 1 dW_t = g_t dW_t,$$



as expected.  $\square$

**Solution (c).**

Let  $Z_t = e^{\alpha W_t}$ . Then we may set  $X_t = W_t$  and we then have  $\mu_t = 0$  and  $\sigma_t = 1$ . The function  $f(t, x) = e^{\alpha x}$  and the relevant derivatives are:

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = \alpha e^{\alpha x}, \quad \frac{\partial f}{\partial x^2}(t, x) = \alpha^2 e^{\alpha x}.$$

Then the dynamics of  $Z_t$  is as follows

$$\begin{aligned} dZ_t &= \left( 0 + 0 + \frac{1}{2} 1^2 \alpha^2 e^{\alpha X_t} \right) dt + 1 \alpha e^{\alpha X_t} dW_t \\ &= \frac{\alpha^2}{2} e^{\alpha X_t} dt + \alpha e^{\alpha X_t} dW_t \\ &= \frac{\alpha^2}{2} Z_t dt + \alpha Z_t dW_t. \end{aligned}$$

As desired.  $\square$ .

**Solution (d).**

Let  $Z_t = e^{\alpha X_t}$ , where  $X$  has stochastic differential  $dX_t = \mu dt + \sigma dW_t$  and  $\mu, \sigma$  is constants. Then we have been given the definition of  $X_t$  and we set  $f(t, x) = e^{\alpha x}$ . The relevant derivatives are then:

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = \alpha e^{\alpha x}, \quad \frac{\partial f}{\partial x^2}(t, x) = \alpha^2 e^{\alpha x}.$$

We may now derive the dynamics of  $Z_t$ :

$$\begin{aligned} dZ_t &= \left( 0 + \mu \alpha e^{\alpha X_t} + \frac{1}{2} \sigma^2 \alpha^2 e^{\alpha X_t} \right) dt + \sigma \alpha e^{\alpha X_t} dW_t \\ &= \left( \mu + \frac{1}{2} \sigma^2 \alpha \right) \alpha e^{\alpha X_t} dt + \sigma \alpha e^{\alpha X_t} dW_t \\ &= \left( \mu + \frac{1}{2} \sigma^2 \alpha \right) \alpha Z_t dt + \sigma \alpha Z_t dW_t. \end{aligned}$$

As desired.  $\square$ .

**Solution (e).**

Let  $Z_t = X_t^2$ , where  $X$  has stochastic differential  $dX_t = \alpha X_t dt + \sigma X_t dW_t$ . Then we set  $f(t, x) = x^2$  and the relevant derivatives are:

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = 2x, \quad \frac{\partial f}{\partial x^2}(t, x) = 2.$$

Given this we have the dynamics of  $Z_t$  as follows

$$\begin{aligned} dZ_t &= \left( 0 + \alpha X_t 2X_t + \frac{1}{2} (\sigma X_t)^2 2 \right) dt + \sigma X_t 2X_t dW_t \\ &= (2\alpha + \sigma^2) X_t^2 dt + 2\sigma X_t^2 dW_t \\ &= (2\alpha + \sigma^2) Z_t dt + 2\sigma Z_t dW_t. \end{aligned}$$

As desired.  $\square$ .

**Exercise 2** (*Bjork 4.2*) Compute the stochastic differential for  $Z$  when  $Z_t = (X_t)^{-1}$  and  $X$  has the stochastic differential

$$dX_t = \alpha X_t dt + \sigma X_t dW_t.$$

Furthermore, by using the definition  $Z = X^{-1}$  you can in fact express the right-hand side of  $dZ$  entirely in terms of  $Z$  itself (rather than in terms of  $X$ ). Thus  $Z$  satisfies a stochastic differential equation. Which one?

**Solution.**

We see that  $f(t, x) = 1/x$  and so the relevant derivatives is

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = -\frac{1}{x^2}, \quad \frac{\partial^2 f}{\partial x^2}(t, x) = \frac{2}{x^3}.$$

Then we by Ito's formula we have

$$\begin{aligned} dZ_t &= \left( 0 - \alpha X_t \frac{1}{X_t^2} + \frac{1}{2} \sigma^2 X_t^2 \frac{2}{X_t^3} \right) dt - \sigma X_t \frac{1}{X_t^2} dW_t \\ &= \left( -\alpha \frac{1}{X_t} + \sigma^2 \frac{1}{X_t} \right) dt - \sigma \frac{1}{X_t} dW_t \\ &= (\sigma^2 - \alpha) Z_t dt - \sigma Z_t dW_t. \end{aligned}$$

We also notice that

$$Z_t = \frac{1}{X_t} \Rightarrow dZ_t = d\left(\frac{1}{X_t}\right) = -\left(\frac{1}{X_t}\right)^2 dX_t = -Z_t^2(\alpha X_t dt + \sigma X_t dW_t)$$

Hence we may insert  $X_t = Z_t^{-1}$  and obtain

$$dZ_t = -Z_t^2 \left( \alpha \frac{1}{Z_t} dt + \sigma \frac{1}{Z_t} dW_t \right) = -\alpha Z_t dt - \sigma Z_t dW_t.$$

Which clearly is faulty..  $\square$

**Exercise 3.** (*Bjork 4.3*) Let  $\sigma(t)$  be a given deterministic function of time and define the process  $X$  by

$$X_t = \int_0^t \sigma(s) dW_s.$$

Use the technique discribed in example 4.17 in order to show that the characteristic function of  $X_t$  (for a fixed  $t$ ) is given by

$$E[e^{iuX_t}] = \exp \left\{ -\frac{u^2}{2} \int_0^t \sigma^2(s) ds \right\}, \quad u \in \mathbb{R},$$

thus showing that  $X_t$  is normally distributed with zero mean and a variance given by

$$\text{Var}[X_t] = \int_0^t \sigma^2(s) ds.$$

**Solution.**

We follow along the lines of

1. Determine the dynamics of  $Z_t = e^{iuX_t}$  (for fixed  $u$ ).
2. Write the integral form of  $Z_t$ .
3. Take expectation.
4. Solve ODE.

“1)” Set  $f(t, x) = e^{iuX_t}$  then the relevant derivatives are

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = iue^{iuX_t} = iuZ_t, \quad \frac{\partial^2 f}{\partial x^2}(t, x) = i^2u^2e^{iuX_t} = -u^2Z_t.$$

Recall that  $dX_t = \sigma(t) dW_t$ , then by Ito's formula we have

$$dZ_t = \left( -\sigma(t)^2 \frac{1}{2} u^2 Z_t \right) dt + \sigma(t) iu Z_t dW_t. \quad (*)$$

“2)” We can now write (\*) on integral form as below

$$Z_t = Z_0 - \frac{u^2}{2} \int_0^t \sigma^2(s) Z_s ds + iu \int_0^t \sigma(s) Z_s dW_s,$$

where  $Z_0 = e^{iuX_0} = 1$ .

“3)” Taking expectation now yields

$$E[Z_t] = 1 - \frac{u^2}{2} \int_0^t \sigma^2(s) E[Z_s] ds + iu E \left[ \int_0^t \sigma(s) Z_s dW_s \right] = 1 - \frac{u^2}{2} \int_0^t \sigma^2(s) E[Z_s] ds,$$

since any expectation of an integral wrt. a Brownian motion is 0 (proposition 4.5).

“4)” Now we see that the  $t$ -derivative gives

$$dE[Z_t] = -\frac{u^2}{2} \sigma^2(t) E[Z_t] dt, \quad E[Z_0] = 1.$$

This is a ordinary differential equation with solution  $y(t) = \exp\{-u^2/2 \int_0^t \sigma^2(s) ds\}$  (check by differentiating) hence

$$E[e^{iuX_t}] = E[Z_t] = \exp \left\{ -\frac{u^2}{2} \int_0^t \sigma^2(s) ds \right\}.$$

We recognize this as the characteristic function of a normally distributed random variable with variance  $\int_0^t \sigma^2(s) ds$  as desired. ( $X_t$  follows this distributions since characteristic functions determine the distribution)  
□

**Exercise 4** (*Bjork 4.4*) Suppose that  $X$  has the stochastic differential

$$dX_t = \alpha X_t dt + \sigma_t dW_t,$$

where  $\alpha$  is a real number and  $\sigma_t$  is a integrable adapted stochastic process. Use the technique in example 4.17 in order to determine the function  $m(t) = E[X_t]$ .

**Solution.**

We follow the same steps as the previous exercise. We have been given the dynamics of  $X$  hence we may write it on integral form.

$$X_t = X_0 + \alpha \int_0^t X_s ds + \int_0^t \sigma(s) dW_s.$$

Then taking expectation now gives

$$E[X_t] = X_0 + \alpha \int_0^t E[X_s] ds.$$

Hence  $E[X_t]$  follows from the solution to the ODE below

$$dE[X_t] = \alpha E[X_t] \Rightarrow E[X_t] = C \cdot \exp\{\alpha t\}.$$

Then obviously  $C = X_0$  and we arrive at the solution  $E[X_t] = X_0 e^{\alpha t}$ , where  $X_0$  is some deterministic value.  $\square$

**Exercise 5** (*Bjork 4.5*) Suppose that the process  $X$  has a stochastic differential

$$dX_t = \mu_t dt + \sigma_t dW_t,$$

and that  $\mu_t \geq 0$  with probability one for all  $t \geq 0$ . Show that this implies that  $X$  is a sub-martingale.

**Solution.**

Note that we are (strictly speaking) supposed to show adaptation and integrability, we will however only focus on the submartingale property.

“ $E[X_t | \mathcal{F}_s] \geq X_s$ ” Intuitively speaking, the statement is obvious since we have with probability one a positive upwards drift with Brownian distortion (i.e. martingale). Formally, we will show the statement by first writing  $X_t$  on integral form

$$X_t = x_0 + \int_0^t \mu_s ds + \int_0^t \sigma_s dW_s.$$

And so

$$X_t - X_s = \int_s^t \mu_u du + \int_s^t \sigma_u dW_u.$$

We then have

$$\begin{aligned} E[X_t | \mathcal{F}_s] - X_s &= E[X_t - X_s | \mathcal{F}_s] \\ &= E \left[ \int_s^t \mu_u du + \int_s^t \sigma_u dW_u \mid \mathcal{F}_s \right] \\ &= E \left[ \int_s^t \mu_u du \mid \mathcal{F}_s \right] + E \left[ \int_s^t \sigma_u dW_u \mid \mathcal{F}_s \right] \\ &= E \left[ \int_s^t \mu_u du \mid \mathcal{F}_s \right] \geq 0. \end{aligned}$$

Then adding  $X_s$  to the above inequality yields the result.  $\square$

**Exercise 6** (*Bjork 4.7*) The objective of this exercise is to give an argument for the formal identity

$$dW_1(t) \cdot dW_2(t) = 0,$$

when  $W_1$  and  $W_2$  are independent Brownian motions. Let us therefore fix a time  $t$ , and divide the interval  $[0, t]$  into equidistant points  $0 = t_0 < t_1 < \dots < t_n = t$ , where  $t_i = \frac{i}{n} \cdot t$ . We use the notation

$$\Delta W_i(t_k) = W_i(t_k) - W_i(t_{k-1}), \quad i = 1, 2.$$

Now define  $Q_n$  by

$$Q_n = \sum_{k=1}^n \Delta W_1(t_k) \cdot \Delta W_2(t_k).$$

Show that  $Q_n \rightarrow 0$  in  $L^2$ , i.e. show that

$$E[Q_n] = 0, \text{Var}[Q_n] \rightarrow 0.$$

**Solution.**

We wish to show the statement

$$E[(Q_n - 0)^2] = E[Q_n^2] \rightarrow 0,$$

as  $n \rightarrow \infty$ . Recall that

$$\text{Var}[Q_n] = E[Q_n^2] - E[Q_n]^2,$$

hence if  $Q_n$  has mean 0, then showing convergence in  $L^2$  is equivalent to showing variance going to 0. Let us start by showing the mean is 0.

We have that

$$\begin{aligned} Q_n &= \sum_{k=1}^n \Delta W_1(t_k) \cdot \Delta W_2(t_k) \\ &= \sum_{k=1}^n (W_1(t_k) - W_1(t_{k-1})) \cdot (W_2(t_k) - W_2(t_{k-1})) \\ &\stackrel{\mathcal{D}}{=} \sum_{k=1}^n XY, \end{aligned}$$

where  $X, Y \sim \mathcal{N}(0, t_k - t_{k-1}) = \mathcal{N}(0, 1/n)$  and independent random variable. This is justified since the increments of the Brownian motion has mean 0 and variance equal to the increment size. Now this implies, that we need to show that  $E[XY] = 0$  and that  $\text{Var}[XY]$  is sufficiently small in terms of  $n$  such that it is summable. We see that

$$E[XY] = E[X]E[Y] = 0^2 = 0.$$

Here we use independence. We now know that the mean is

$$E[Q_n] = \sum_{k=1}^n E[XY] = 0.$$

We know from basic properties of variance that

$$\begin{aligned} \text{Var}(Q_n) &= \sum_{k=1}^n \text{Var}(XY) = \sum_{k=1}^n E[(XY)^2] \\ &= \sum_{k=1}^n \frac{1}{n^2} = \frac{1}{n^2} n \\ &= \frac{1}{n} \rightarrow 0, \quad n \rightarrow \infty. \end{aligned}$$

And so the result follows.  $\square$

**Exercise 7** (*Bjork 4.8*) Let  $X$  and  $Y$  be given as the solutions to the following system of stochastic differential equations.

$$\begin{aligned} dX_t &= \alpha X_t dt - Y_t dW_t, & X_0 &= x_0, \\ dY_t &= \alpha Y_t dt + X_t dW_t, & Y_0 &= y_0. \end{aligned}$$

Note that the initial values  $x_0$  and  $y_0$  are deterministic constants.

- Prove that the process  $R$  defined by  $R_t = X_t^2 + Y_t^2$  is deterministic.
- Compute  $E[X_t]$ .

**Solution (a).**

We see that

$$dR_t = d(X_t^2 + Y_t^2) = d(X_t^2) + d(Y_t^2)$$

Hence we may start by considering the dynamics of the processes  $X_t^2$  and  $Y_t^2$ . We see that for the process  $Z_t = X_t^2$  we may set  $f(t, x) = x^2$  and the relevant derivatives are

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = 2x, \quad \frac{\partial^2 f}{\partial x^2}(t, x) = 2.$$

By Ito's formula we have

$$d(X_t^2) = (\alpha X_t 2X_t + Y_t^2 2) dt - Y_t 2X_t dW_t = 2(\alpha X_t^2 + Y_t^2) dt - 2X_t Y_t dW_t.$$

By the same concept we have

$$d(Y_t^2) = (\alpha Y_t 2Y_t + X_t^2 2) dt + X_t 2Y_t dW_t = 2(\alpha Y_t^2 + X_t^2) dt + 2X_t Y_t dW_t.$$

Combining we get the dynamics

$$\begin{aligned}
dR_t &= 2(\alpha X_t^2 + Y_t^2) dt - 2X_t Y_t dW_t \\
&\quad + 2(\alpha Y_t^2 + X_t^2) dt + 2X_t Y_t dW_t \\
&= (2\alpha + 1)(X_t^2 + Y_t^2) dt \\
&= (2\alpha + 1)R_t dt
\end{aligned}$$

Hence  $R_t$  has deterministic derivative and therefore a deterministic process. In fact, the solution to above is

$$R_t = R_0 \exp \{(2\alpha + 1)t\} = (x_0^2 + y_0^2)e^{(2\alpha+1)t},$$

which is clearly deterministic.  $\square$

**Solution (b).**

We start by acknowledging that the differential form of  $X$  may be written on integral form:

$$X_t = x_0 + \alpha \int_0^t X_s ds - \int_0^t Y_s dW_s.$$

Taking expectation we see that

$$E[X_t] = x_0 + \int_0^t E[X_s] ds$$

as the last term has mean 0 according to proposition 4.5. Then the above may be written on the differential form

$$dE[X_t] = E[X_t] dt$$

Hence we have that

$$E[X_t] = x_0 e^t.$$

Hence  $X_t$  has mean not depending on the trajectory of the sister-process  $Y_t$ .  $\square$

## Week 3

### Table of Contents

- Partial differential equations (Chapter 5.5)
- Self-financing portfolios (Chapter 6)
- Black-Scholes PDE (classic approach) and risk neutral valuation (Chapter 7.1-5)
- Exercises

## Theory

**Partial differential equations Proposition 5.5. (Feynmann-Kac)** Assume that  $F$  is a solution to the boundary value problem

$$\frac{\partial F}{\partial t}(t, x) + \mu(t, x) \frac{\partial F}{\partial x}(x, t) + \frac{1}{2} \sigma^2(t, x) \frac{\partial^2 F}{\partial x^2}(t, x) = 0,$$

with boundary condition  $F(T, x) = \Phi(x)$ . Assume furthermore that the process

$$\sigma(s, X_s) \frac{\partial F}{\partial x}(s, X_s) \in \mathcal{L}^2$$

as per definition 4.4, where  $X$  is defined below. Then  $F$  has the representation

$$F(t, x) = E_{t,x}[\Phi(X_T)] = E[\Phi(X_T) \mid X_t = x],$$

where  $X$  satisfies the SDE

$$dX_s = \mu(s, X_s) ds + \sigma(s, X_s) dW_s,$$

with boundary condition  $X_t = x$ .

**Proposition 5.6. (Feynmann-Kac)** Assume that  $F$  is a solution to the boundary value problem

$$\frac{\partial F}{\partial t}(t, x) + \mu(t, x) \frac{\partial F}{\partial x}(x, t) + \frac{1}{2} \sigma^2(t, x) \frac{\partial^2 F}{\partial x^2}(t, x) - rF(t, x) = 0,$$

with boundary condition  $F(T, x) = \Phi(x)$ . Assume furthermore that the process

$$e^{-rs} \sigma(s, X_s) \frac{\partial F}{\partial x}(s, X_s) \in \mathcal{L}^2$$

as per definition 4.4, where  $X$  is defined below. Then  $F$  has the representation

$$F(t, x) = e^{-r(T-t)} E_{t,x}[\Phi(X_T)] = e^{-r(T-t)} E[\Phi(X_T) \mid X_t = x],$$

where  $X$  satisfies the SDE

$$dX_s = \mu(s, X_s) ds + \sigma(s, X_s) dW_s,$$

with boundary condition  $X_t = x$ .

**Proposition 5.8. (Feynmann-Kac)** Assume that  $F$  is a solution to the boundary value problem

$$\frac{\partial F}{\partial t}(t, x) + \sum_{i=1}^n \mu_i(t, x) \frac{\partial F}{\partial x}(x, t) + \frac{1}{2} \sum_{i,j=1}^n C_{ij}(t, x) \frac{\partial^2 F}{\partial x^2}(t, x) - rF(t, x) = 0,$$

with boundary condition  $F(T, x) = \Phi(x)$  and  $C_{ij} = \sigma \sigma^\top$ . Assume furthermore that the process

$$e^{-rs} \sum_{i=1}^n \sigma_i(s, X_s) \frac{\partial F}{\partial x}(s, X_s) \in \mathcal{L}^2$$



as per definition 4.4, where  $X$  is defined below. Then  $F$  has the representation

$$F(t, x) = e^{-r(T-t)} E_{t,x}[\Phi(X_T)],$$

where  $X$  satisfies the SDE

$$dX_s = \mu(s, X_s) ds + \sigma(s, X_s) dW_s,$$

with boundary condition  $X_t = x$ .

**Proposition 5.9.** Consider as given a vector process  $X$  with generator  $\mathcal{A}$ , and a function  $F(t, x)$ . Then, modulo some integrability condition, the following hold:

- The process  $F(t, X_t)$  is a martingale relative to the filtration  $\mathcal{F}^X$  if and only if  $F$  satisfies the PDE

$$\frac{\partial F}{\partial t} + \mathcal{A}F = 0.$$

- The process  $F(t, X_t)$  is a martingale relative to the filtration  $\mathcal{F}^X$  if and only if, for every  $(t, x)$  and  $T \geq t$ , we have

$$F(t, x) = E_{t,x}[F(T, X_T)].$$

**Self-financing portfolios** We move forward in this chapter by first defining a self-financing portfolio in discrete time and then by letting the step length tend to zero obtain the continuous time analogue.

**Discrete time SF portfolio** We consider  $N$  different adapted price processes  $S^1, \dots, S^N$ . We use the following definition.

**Definition 6.1.** We use the following definitions.

- $S_n^i$  is the price of asset  $i$  at time  $n$ ,
- $h_n^i$  is the number of units of asset  $i$  held during  $[n, n+1)$ , that is bought at time  $n$ ,
- $d_n^i$  is the dividends from asset  $i$  in the time-interval  $[n-1, n)$ , that is received at time  $n$ ,
- $h_n$  is the portfolio  $(h_n^1, \dots, h_n^N)$  held during  $[n, n+1)$ ,
- $c_n$  is the consumption i.e. withdrawal at time  $n$  (negative being deposits/saving),
- $V_n$  is the value of the portfolio just before time  $n$  i.e. of the portfolio  $h_{n-1}$  at time  $n$ .

We are now ready to define the self-financing portfolio

**Definition 6.2.** A self-financing portfolio supporting the consumption stream  $\mathbf{c}$  is a portfolio adhering to the **budget constraint** given as

$$h_{n+1}S_{n+1} + c_{n+1} = h_nS_{n+1} + h_nd_{n+1}.$$

The interpretation being, that we may only use funds obtained from selling the old portfolio  $h_n$  and received in dividends to buy the new portfolio  $h_{n+1}$  and consume the amount  $c_{n+1}$ .

Before studying the self-financing portfolio we define the operator  $\Delta$  (in definition 6.3) as the increment  $\Delta x_n = x_{n+1} - x_n$  of a countable sequence  $(x_n)_{n \in \mathbb{N}_0}$ . Notice that we define the increment forward so the increment  $n$  is the increment over the time period  $[n, n+1)$  with the first increment being  $[0, 1)$ . Using this notation we can derive the lemma below.

**Lemma 6.4.** For any pair of sequences of real numbers  $(x_n)_{n \in \mathbb{N}_0}$  and  $(y_n)_{n \in \mathbb{N}_0}$  we have the relations

$$\begin{aligned}
\Delta(xy)_n &= x_n \Delta y_n + y_{n+1} \Delta x_n, \\
\Delta(xy)_n &= y_n \Delta x_n + x_{n+1} \Delta y_n, \\
\Delta(xy)_n &= x_n \Delta y_n + y_n \Delta x_n + \Delta x_n \Delta y_n.
\end{aligned}$$

This is also valid if the sequences are  $N$ -dimensional, where we interpret the products above as scalar products  $(xy^\top)$ .

Using these definitions and the lemma above we see that the dynamics of the self-financing portfolio is given below.

**Proposition 6.6.** The dynamics of any self-financing portfolio supporting the consumption stream  $c$  are given by

$$\Delta V_n = h_n \Delta S_n + h_n d_{n+1} - c_{n+1},$$

or, in more detail

$$\Delta V_n = \sum_{i=1}^N h_n^i (\Delta S_n^i + d_{n+1}^i) - c_{n+1}.$$

We may rewrite the dividends as accumulating dividends  $D_n^i = \sum_{k=1}^n d_k^i$  and see that  $d_{n+1}^i = \Delta D_n^i$  and so the above condition is equivalent with.

**Proposition 6.8.** The dynamics of any self-financing portfolio supporting the consumption stream  $c$  are given by

$$\Delta V_n = h_n \Delta S_n + h_n \Delta D_n - c_{n+1},$$

or, in more detail

$$\Delta V_n = \sum_{i=1}^N h_n^i (\Delta S_n^i + \Delta D_n^i) - c_{n+1}.$$

**Continuous time SF portfolio** Formulating the dynamics of the self-financing portfolio in continuous time is easy work given the discrete setup above. However since we now are in continuous time we will change the  $n$  with a  $t$  and consider the behaviour  $V_{t+dt} - V_t$  as we let  $dt \rightarrow 0$ . First we formulate some basic notation.

**Definition 6.9.** We use the following definitions.

- $S_t^i$  is the price of asset  $i$  at time  $t$ ,
- $h_t^i$  is the number of units of asset  $i$  held at time  $t$ ,
- $D_t^i$  is the cumulative dividend process for asset  $i$ ,
- $h_t$  is the portfolio  $(h_t^1, \dots, h_t^N)$  held at time  $t$ ,
- $c_t$  is the consumption rate at time  $n$  (negative being deposits/saving),
- $V_t$  is the value of the portfolio at time  $t$  i.e. of the portfolio  $h_t$  at time  $t$ .

Given these definitions we may define a portfolio strategy that is self-financing.

**Definition 6.10.** Let  $S$  be an adapted  $N$ -dimensional price process. We define the following

1. A **portfolio strategy** is any adapted  $N$ -dimensional process  $h$ .

2. The **value process**  $V^h$  corresponding to the portfolio  $h$  is given by

$$V_t^h = \sum_{i=1}^N h_t^i S_t^i.$$

3. A **consumption process** is any adapted one-dimensional process  $c$ .

4. A portfolio-consumption pair  $(h, c)$  is called **self-financing** if the value process  $V^h$  satisfies the condition

$$dV_t^h = \sum_{i=1}^N h_t^i (dS_t^i + dD_t^i) - c_t dt,$$

i.e. if

$$dV_t^h = h_t dS_t + h_t dD_t - c_t dt.$$

5. The **gain process**  $G$  is defined by

$$G_t = S_t + D_t$$

so we can write the self-financing condition as

$$dV_t = h_t dG_t - c_t dt.$$

6. The portfolio  $h$  is said to be **Markovian** if it is of the form

$$h_t = h(t, S_t),$$

for some function  $h : \mathbb{R}_+ \times \mathbb{R}^N \rightarrow \mathbb{R}^N$ .

**Portfolio weights** **Definition 6.11.** For a given portfolio  $h$  the corresponding **relative portfolio** or **portfolio weights**  $w$  are defined by

$$w_t^i = \frac{h_t^i S_t^i}{V_t^h}, \quad i = 1, \dots, N,$$

so, in particular, we have  $\sum_{i=1}^N w_i = 1$ .

**Lemma 6.12.** A portfolio-consumption pair  $(h, c)$  is self-financing if and only if

$$dV_t^h = V_t^h \sum_{i=1}^N w_t^i \frac{dS_t^i + dD_t^i}{S_t^i} - c_t dt$$

or equivalently with the absolute weights

$$dV_t^h = \sum_{i=1}^N h_t^i (dS_t^i + dD_t^i) - c_t dt.$$

**Lemma 6.13.** Consider the case with no dividends. Let  $c$  be a consumption process, and assume that there exist a scalar process  $Z$  and a vector process  $q = (q^1, \dots, q^N)$  such that

$$dZ_t = Z_t \sum_{i=1}^N q_t^i \frac{dS_t^i}{S_t^i} - c_t dt,$$

and  $\sum_{i=1}^N q q^i = 1$ . Now define a portfolio  $h$  by

$$h_t^i = \frac{q_t^i Z_t}{S_t^i}.$$

Then the value process  $V^h$  is given by  $V^h = Z$ , the pair  $(h, c)$  is self-financing, and the corresponding relative portfolio  $w$  is given by  $w = q$ .

**Black-Scholes PDE** The Black-Scholes model revolves around SDE's as seen above. In this model we have two assets a risk free asset  $B$  and a stochastic priced asset  $S$ . We therefore start by defining what we mean by a quote-on-quote *risk free* asset.

**Definition 7.1.** The price process  $B$  is the price of a **risk free** asset if it has the dynamics

$$dB_t = r_t B_t dt,$$

where  $r$  is any  $\mathcal{F}_t$  adapted process.

We see from this definition that the meaning of “risk free” is the property, that  $B$  is priced locally deterministic in the sense that  $r$  is adapted and therefore known at time  $t$  and we therefore know the yield on a short term basis. This is also why we may call  $r$  the **short interest rate**. Given the dynamics above, we know that  $B$  in fact is represented by the process

$$B_t = B_0 e^{\int_0^t r_s ds},$$

for some  $B_0$  initial value. We will moving forward assume that  $B_0 = 1$ . The stochastic asset  $S$  has dynamics.

$$dS_t = \mu(t, S_t) dt + \sigma(t, S_t) dW_t,$$

where as usual  $\mu$  and  $\sigma$  are deterministic functions and  $W_t$  is a standard Brownian motion. Note that the risk free asset has a similarly process with  $\sigma = 0$ . We may now include this in the definition of the Black-Scholes model.

**Definition 7.2.** The **Black-Scholes model** consists of two assets with dynamics given by

$$\begin{aligned} dB_t &= r B_t dt, \\ dS_t &= \mu S_t dt + \sigma S_t dW_t, \end{aligned}$$

where  $r, \mu, \sigma$  are deterministic constants.

**Definition 7.3.** A **zero coupon bond** with maturity  $T$  (henceforth “ $T$ -bond”) is an asset which pays the holder the face value 1 dollar at time  $T$ . The price at time  $n$  of a  $T$ -bond is denoted by  $p(n, T)$ .

**Definition 7.4.** The (possible stochastic) discrete **short rate**  $r_n$ , for the period  $[n, n+1]$ , is defined as

$$p(n, n+1) = \frac{1}{1 + r_n}.$$

From this short rate we may derive the dynamics of the bank account receiving zero-coupon rates for each distinct time interval.

**Definition 7.5.** The dynamics of the bank account are given by

$$\Delta B_n = r_n B_n.$$

**Contingent Claims and Arbitrage** **Definition 7.6.** A **European call option** with **exercise price** (or strike price)  $K$  and **time of maturity** (exercise date)  $T$  on the **underlying asset**  $S$  is a contract defined by the following clauses:

- The holder of the option has, at time  $T$ , the right to buy one share of the underlying stock at the price  $K$  dollars from the underwriter of the option.
- The holder of the option is in no way obliged to buy the underlying stock.
- The right to buy the underlying stock at the price  $K$  can only be exercised at the precise time  $T$ .

Obviously, we also have the **European put** option which gives the owner the right to sell an asset at price  $K$  at time  $T$ . Let us formally define a contingent claim.

**Definition 7.7.** Consider a financial market with vector price process  $S$ . A **contingent claim** with **date of maturity**  $T$ , also called a  $T$ -claim, is any random variable  $\mathcal{X} \in \mathcal{F}_T^S$ . A contingent claim  $\mathcal{X}$  is called a **simple claim** if it is of the form  $\mathcal{X} = \Phi(S_T)$ . The function  $\Phi$  is called the **contract function**.

**Definition 7.8.** An **arbitrage** possibility on a financial market is a self-financed portfolio  $h$  such that

$$\begin{aligned} V^h(0) &= 0, \\ P(V_T^h \geq 0) &= 1, \\ P(V_T^h > 0) &> 0. \end{aligned}$$

We say that the market is **arbitrage free** if there are no arbitrage possibilities.

**Definition 7.9.** Suppose that there exists a self-financing portfolio  $h$ , such that the value process  $V^h$  has the dynamics

$$dV_t^h = k_t V_t^h dt,$$

where  $k$  is an adapted process. Then it must hold that  $k_t = r_t$  for all  $t$ , or there exists an arbitrage possibility.

**Theorem 7.10. (Black-Scholes equation)** Assume that the market is specified by the equations

$$\begin{aligned} dB_t &= rB_t dt, \\ dS_t &= \mu(t, S_t)S_t dt + \sigma(t, S_t)S_t dW_t, \end{aligned}$$

and that we want to price a contingent claim of the form  $\mathcal{X} = \Phi(S_T)$ . Then the only pricing function of the form  $\Pi_t[\Phi(S_T)] = F(t, S_t)$  which is consistent with the absence of arbitrage in the market  $[B_t, S_t, \Pi_t]$  is when  $F$  is the solution of the following boundary value problem in the domain  $[0, T] \times \mathbb{R}_+$ :

$$\begin{aligned} F_t(t, s) + r s F_s(t, s) + \frac{1}{2} s^2 \sigma^2(t, s) F_{ss}(t, s) - r F(t, s) &= 0, \\ F(T, s) &= \Phi(s). \end{aligned}$$

**Risk Neutral Valuation** **Theorem 7.11. (Risk Neutral Valuation)** The arbitrage free price of the claim  $\Phi(S_T)$  is given by  $\Pi_t[\Phi] = F(t, S_t)$ , where  $F$  is given by the formula

$$F(t, s) = e^{-r(T-t)} E_{t,s}^Q[\Phi(S_T)],$$

where the  $Q$ -dynamics of  $S$  are those of

$$dS_t = rS_t dt + S_t\sigma(t, S_t) dW_t^Q.$$

**Property 7.12. (The Martingale Property)** In the Black-Scholes model, the price process  $\Pi_t$  for every traded asset, be it the underlying or derivate asset, has the property the the normalized price process

$$Z_t = \frac{\Pi_t}{B_t},$$

(including  $S_t/B_t$ ) is a martingale under the measure  $Q$ .

### Exercises Week 3

**Exercise 1.** (*Bjork 5.1*) Show that the scalar SDE

$$\begin{cases} dX_t = \alpha X_t dt + \sigma dW_t, \\ X_0 = x_0, \end{cases}$$

has the solution

$$X(t) = e^{\alpha t} x_0 + \sigma \int_0^t e^{\alpha(t-s)} dW_s,$$

by differentiating  $X$  as defined by the equation above and showing that  $X$  so defined satisfies the SDE.

**Solution.**

We move forward by rewriting the solution in terms of three processes  $Z$ ,  $Y$  and  $R$  as

$$X_t = \underbrace{x_0 e^{\alpha t}}_{:=Y_t} + \underbrace{\sigma e^{\alpha t}}_{:=Z_t} \underbrace{\int_0^t e^{-\alpha s} dW_s}_{R_t} = Y_t + Z_t \cdot R_t.$$

We furthermore see easily that the dynamics of the processes individually has dynamics

$$\begin{aligned} dY_t &= \alpha x_0 e^{\alpha t} dt = \alpha Y_t dt, & Y_0 &= x_0, \\ dZ_t &= \alpha \sigma e^{\alpha t} dt = \alpha Z_t dt, & Z_0 &= \sigma, \\ dR_t &= e^{-\alpha t} dW_s, & R_0 &= 0. \end{aligned}$$

We then have the following function

$$f(t, y, z, r) = y + zr.$$

With the following multi-dimensional process

$$dM_t = \begin{bmatrix} \alpha Y_t \\ \alpha Z_t \\ 0 \end{bmatrix} dt + \begin{bmatrix} 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & e^{-\alpha t} \end{bmatrix} \begin{bmatrix} dW_t \\ dW_t \\ dW_t \end{bmatrix},$$

with

$$C = \sigma\sigma^\top = \begin{bmatrix} 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & e^{-\alpha t} \end{bmatrix}^2 = \begin{bmatrix} 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & e^{-2\alpha t} \end{bmatrix}.$$

That is  $X_t = f(t, M_t)$ . We can then use the multidimensional version of Ito's formula.

$$\begin{aligned} dX_t &= df(t, M_t) \\ &= \left( \frac{\partial f}{\partial t}(t, M_t) + \sum_{i=1}^3 \mu_i \frac{\partial f}{\partial x^i}(t, M_t) + \frac{1}{2} \sum_{i,j=1}^3 C_t^{ij} \frac{\partial^2 f}{\partial x^i \partial x^j}(t, M_t) \right) dt + \sum_{i=1}^3 \frac{\partial f}{\partial x^i}(t, M_t) \sigma_t^i dW_t \\ &= (0 + \alpha Y_t + \alpha Z_t R_t) dt + Z_t e^{-\alpha t} dW_t \\ &= \left( \alpha x_0 e^{\alpha t} + \alpha \sigma e^{\alpha t} \int_0^t e^{-\alpha s} dW_s \right) dt + \sigma e^{\alpha t} e^{-\alpha t} dW_t \\ &= \left( \alpha x_0 e^{\alpha t} + \alpha \sigma \int_0^t e^{(t-s)\alpha} dW_s \right) dt + \sigma dW_t \\ &= \alpha X_t dt + \sigma dW_t. \end{aligned}$$

Then this solution does in fact satisfies the differential form. We furthermore have that  $X_0 = x_0$  and the desired result follows.  $\square$

**Exercise 2.** (Bjork 5.5) Suppose that  $X$  satisfies the SDE

$$dX_t = \alpha X_t dt + \sigma X_t dW_t.$$

Now define  $Y$  by  $Y_t = X_t^\beta$ , where  $\beta$  is a real number. Then  $Y$  is also a GBM process. Compute  $dY_t$  and find out which SDE  $Y$  satisfies.

**Solution.**

If we set  $f(t, x) = x^\beta$ , we have the relevant derivatives as follows

$$\frac{\partial f}{\partial t}(t, x) = 0, \quad \frac{\partial f}{\partial x}(t, x) = \beta x^{\beta-1}, \quad \frac{\partial^2 f}{\partial x^2}(t, x) = \beta(\beta-1)x^{\beta-2}.$$

Then by applying Ito's formula we have

$$\begin{aligned} dY_t &= df(t, X_t) \\ &= \left( 0 + \beta X_t^{\beta-1} \alpha X_t + \frac{1}{2} \sigma^2 X_t^2 \beta(\beta-1) X_t^{\beta-2} \right) dt + \sigma X_t \beta X_t^{\beta-1} dW_t \\ &= \left( \alpha \beta + \frac{1}{2} \sigma^2 \beta(\beta-1) \right) X_t^\beta dt + \sigma \beta X_t^\beta dW_t \\ &= \left( \alpha \beta + \frac{1}{2} \sigma^2 \beta(\beta-1) \right) Y_t dt + \sigma \beta Y_t dW_t \\ &= \alpha^Y Y_t dt + \sigma^Y Y_t dW_t, \end{aligned}$$

where  $\alpha^Y = (\alpha \beta + \frac{1}{2} \sigma^2 \beta(\beta-1))$  and  $\sigma^Y = \sigma \beta$ . Furthermore  $Y_0 = y_0 = x_0^\beta$ . Then by definition of GBM we have that  $Y_t$  is a GBM as desired.  $\square$

**Exercise 3.** (*Bjork 5.6*) Suppose that  $X$  satisfies the SDE

$$dX_t = \alpha X_t dt + \sigma X_t dW_t,$$

and  $Y$  satisfies

$$dY_t = \gamma Y_t dt + \delta Y_t dV_t,$$

where  $V$  is a Brownian motion which is independent of  $W$ . Define  $Z = X/Y$  and derive an SDE for  $Z$  by computing  $dZ$ . If  $X$  is nominal income and  $Y$  describe inflation then  $Z$  describes real income.

**Solution.**

We have that for the function  $f(t, x, y) = x/y$  and wish to determine the derivative of the stochastic process  $Z_t = f(t, X_t, Y_t)$ . We do this by applying Ito's formula in the multidimensional case. That is

$$\begin{aligned} df(t, X_t, Y_t) &= \frac{\partial f}{\partial t}(t, X_t, Y_t) dt + \frac{\partial f}{\partial x}(t, X_t, Y_t) dX_t + \frac{\partial f}{\partial y}(t, X_t, Y_t) dY_t \\ &+ \frac{1}{2} \frac{\partial^2 f}{\partial x^2}(t, X_t, Y_t) (dX_t)^2 + \frac{1}{2} \frac{\partial^2 f}{\partial y^2}(t, X_t, Y_t) (dY_t)^2 \\ &+ \frac{1}{2} \frac{\partial^2 f}{\partial x \partial y}(t, X_t, Y_t) (dX_t)(dY_t) \\ &= \frac{1}{Y_t} (\alpha X_t dt + \sigma X_t dW_t) - \frac{X_t}{Y_t^2} (\gamma Y_t dt + \delta Y_t dV_t) + \frac{1}{2} 2 \frac{X_t}{Y_t^3} (\gamma Y_t dt + \delta Y_t dV_t)^2 \\ &- \frac{1}{2} \frac{1}{Y_t^2} (\gamma Y_t dt + \delta Y_t dV_t) (\alpha X_t dt + \sigma X_t dW_t) \end{aligned}$$

Calculating further gives

$$\begin{aligned} (dY_t)^2 &= \gamma^2 Y_t^2 (dt)^2 + \delta^2 Y_t^2 (dV_t)^2 + 2\gamma Y_t \delta Y_t dt \cdot dV_t \\ &= 0 + \delta^2 Y_t^2 dt + 0 = \delta^2 Y_t^2 dt \\ (dX_t)(dY_t) &= (\gamma Y_t dt + \delta Y_t dV_t)(\alpha X_t dt + \sigma X_t dW_t) \\ &= \gamma Y_t \alpha X_t (dt)^2 + \gamma Y_t \sigma X_t dt \cdot dW_t \\ &+ \delta Y_t \alpha X_t dt \cdot dV_t + \gamma Y_t \sigma X_t (dW_t)(dV_t) \\ &= 0 + 0 + 0 + 0 = 0 \end{aligned}$$

Hence we conclude that

$$\begin{aligned} df(t, X_t, Y_t) &= \alpha \frac{X_t}{Y_t} dt + \sigma \frac{X_t}{Y_t} dW_t - \gamma \frac{X_t Y_t}{Y_t^2} dt + \delta \frac{X_t Y_t}{Y_t^2} dV_t \\ &+ \frac{1}{2} 2 \frac{X_t}{Y_t^3} \delta^2 Y_t^2 dt \\ &= (\alpha Z_t - \gamma Z_t + Z_t \delta^2) dt + \sigma Z_t dW_t + \delta Z_t dV_t \\ &= (\alpha - \gamma + \delta^2) Z_t dt + \sigma Z_t dW_t + \delta Z_t dV_t. \end{aligned}$$

As desired the above is the SDE for the process  $Z_t$ .  $\square$



**Exercise 4.** (*Bjork 5.9*) Use a stochastic representation result in order to solve the following boundary value problem in the domain  $[0, T] \times \mathbb{R}$ .

$$\frac{\partial F}{\partial t} + \mu x \frac{\partial F}{\partial x} + \frac{1}{2} \sigma^2 x^2 \frac{\partial^2 F}{\partial x^2} = 0,$$

with  $F(T, x) = \log(x^2)$ . Here  $\mu$  and  $\sigma$  are assumed to be known constants.

**Solution.**

We use proposition 5.5 Feymann-Kac with  $\mu(t, x) = \mu x$  and  $\sigma(t, x) = \sigma x$ . We know that, given that the process

$$\sigma X_t \frac{\partial F}{\partial x}(x, X_t) \in \mathcal{L}^2,$$

Then  $F$  has stochastic representation

$$F(t, x) = E[\log(X_T^2) \mid X_t = x],$$

with stochastic process  $X_t$  satisfying the SDE

$$dX_t = \mu X_t dt + \sigma X_t dW_t, \quad X_t = x.$$

Now, since  $X_t$  satisfies the above SDE, we see that  $X_t$  is a GBM. Then by proposition 5.2 we have

$$X_T = x \exp \left\{ \left( \mu - \frac{1}{2} \sigma^2 \right) (T - t) + \sigma (W_T - W_t) \right\}.$$

Inserting this we find that

$$\begin{aligned} F(t, x) &= E \left[ \log(x^2 \exp \{ (2\mu - \sigma^2) (T - t) + 2\sigma (W_T - W_t) \}) \mid X_t = x \right] \\ &= E \left[ \log(x^2) + (2\mu - \sigma^2) (T - t) + 2\sigma (W_T - W_t) \mid X_t = x \right] \\ &= 2 \log(x) + (2\mu - \sigma^2) (T - t) + 2\sigma E [W_T - W_t \mid X_t = x] \\ &= 2 \log(x) + (2\mu - \sigma^2) (T - t). \end{aligned}$$

Using that the Brownian motion has increments with mean 0.  $\square$

**Exercise 5.** (*Bjork 5.13*) Solve the boundary value problem

$$\frac{\partial F}{\partial t}(t, x, y) + \frac{1}{2} \sigma^2 \frac{\partial^2 F}{\partial x^2}(t, x, y) + \frac{1}{2} \delta^2 \frac{\partial^2 F}{\partial y^2}(t, x, y) = 0,$$

with  $F(T, x, y) = xy$ .

**Solution.**

We see if this problem fit into the context of Feymann-Kac's multi-dimensional proposition 5.8. Comparing the above PDE with the propositions we see that

$$\mu_i(t, X_t, Y_t) = 0$$

for  $i = 1, 2$  representing the assets  $X_t$  and  $Y_t$ . We furthermore have the matrix  $C$

$$\begin{aligned} C &= \sigma(t, X_t, Y_t) \sigma(t, X_t, Y_t)^\top \\ &= \begin{bmatrix} \sigma_{1,1} & \sigma_{1,2} \\ \sigma_{2,1} & \sigma_{2,2} \end{bmatrix} \begin{bmatrix} \sigma_{1,1} & \sigma_{2,1} \\ \sigma_{1,2} & \sigma_{2,2} \end{bmatrix} \\ &= \begin{bmatrix} \sigma_{1,1}^2 + \sigma_{1,2}^2 & \sigma_{1,1}\sigma_{2,1} + \sigma_{2,2}\sigma_{1,2} \\ \sigma_{1,1}\sigma_{2,1} + \sigma_{2,2}\sigma_{1,2} & \sigma_{2,2}^2 + \sigma_{2,1}^2 \end{bmatrix} \end{aligned}$$

Where we have that the only non-zero entrances is the diagonal with

$$\begin{aligned} C_{1,1} &= \sigma_{1,1}^2 + \sigma_{1,2}^2 = \sigma^2, \\ C_{2,2} &= \sigma_{2,2}^2 + \sigma_{2,1}^2 = \delta^2. \end{aligned}$$

and obviously  $r = 0$  and  $\Phi(x, y) = xy$ . From proposition 5.8 we then have that  $F$  has stochastic representation:

$$F(t, x, y) = e^{-r(T-t)} E^Q[\Phi(X_T, Y_T) \mid X_t = x, Y_t = y] = E^Q[X_T Y_T \mid X_t = x, Y_t = y]$$

Having given the  $C$  matrix we have the following

$$C = \begin{bmatrix} \sigma^2 & 0 \\ 0 & \delta^2 \end{bmatrix} = \sigma \sigma^\top \iff \sigma = \begin{bmatrix} \sigma & 0 \\ 0 & \delta \end{bmatrix}.$$

Hence in the stochastic representation  $X$  and  $Y$  has dynamics

$$\begin{cases} dX_t = \sigma dW_t \\ dY_t = \delta dV_t. \end{cases}$$

where  $W$  and  $B$  are independent Brownian motions. In particular we have that  $X$  and  $Y$  are martingales and independent i.e.

$$F(t, x, y) = E_{X_t=x}^Q[X_T] \cdot E_{Y_t=y}^Q[Y_T] = xy.$$

And so we arrive at the desired result.  $\square$

**Exercise 6.** (Exam 2017/18, problem 1, question (a)-(b)) Let  $W_t$  denote a Brownian motion and let

$$\mathcal{F}_t = \mathcal{F}_t^W = \sigma(\{W_s \mid 0 \leq s \leq t\}).$$

Let  $T > 0$  be a given and fixed time.

Let  $f(t)$  be a bounded deterministic continuous function. Define the two processes

$$\begin{cases} X_t = \int_0^t f(u) dW_u, \\ M_t^{(\lambda)} = \exp \left\{ \lambda X_t - \frac{\lambda^2}{2} \int_0^t f^2(u) du \right\}, \end{cases}$$

where  $\lambda \in \mathbb{R}$  is a constant.

- a. Show that  $M^{(\lambda)}$  is a martingale with  $E[M_t^{(\lambda)}] = 1$ .

Let  $0 < s < t$  and  $\lambda_1, \lambda_2 \in \mathbb{R}$  be given and fixed.

b. i. Show that

$$\begin{aligned} M_s^{(\lambda_1)} &= E \left[ \frac{M_s^{(\lambda_1)} M_t^{(\lambda_2)}}{M_s^{(\lambda_2)}} \middle| \mathcal{F}_s \right] \\ &= E \left[ \exp \left\{ \lambda_1 X_s + \lambda_2 (X_t - X_s) - \frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du - \frac{1}{2} \lambda_2^2 \int_s^t f^2(u) du \right\} \middle| \mathcal{F}_s \right] \end{aligned}$$

ii. Show that  $X_s$  and  $X_t - X_s$  are normally distributed and independent.

**Solution (a).**

First, we see that since  $X_t$  is on integral form we know that

$$\begin{cases} dX_t = f(t) dW_t \\ X_0 = 0. \end{cases}$$

Hence we may represent  $M$  as  $M_t^{(\lambda)} = g(t, X_t, Y_t)$  given by

$$g(t, x, y) = \exp \left\{ \lambda x - \frac{\lambda^2}{2} y \right\},$$

where  $Y_t = \int_0^t f^2(u) du$  with dynamics

$$\begin{cases} dY_t = f^2(t) dt \\ Y_0 = 0. \end{cases}$$

Hence by the multidimensional Ito's formula we have the dynamics of  $M$  given by

$$\begin{aligned} dM_t^{(\lambda)} &= g_t dt + g_x dX_t + g_y dY_t + \frac{1}{2} g_{yy} (dY_t)^2 + \frac{1}{2} g_{xx} (dX_t)^2 + f_{xy} (dX_t)(dY_t) \\ &= 0 + \lambda g dX_t - \frac{\lambda^2}{2} g dY_t + 0 + \frac{1}{2} \lambda^2 g (dX_t)^2 + 0 \\ &= \lambda M_t^{(\lambda)} f(t) dW_t - \frac{1}{2} \lambda^2 M_t^{(\lambda)} f^2(t) dt + \frac{1}{2} \lambda M_t^{(\lambda)} f^2(t) dt \\ &= \lambda f(t) M_t^{(\lambda)} dW_t, \end{aligned}$$

And so we see that  $M$  is a martingale as it only has dynamics wrt. the Brownian motion  $W$  (assuming  $\lambda f_t M_t^{(\lambda)} \in \mathcal{L}^2$ ). Furthermore we have that

$$M_0^{(\lambda)} = g(0, X_0, Y_0) = \exp \left\{ \lambda X_0 - \frac{1}{2} \lambda^2 Y_0 \right\} = e^0 = 1$$

and so we have  $E[M_t^{(\lambda)}] = M_0^{(\lambda)} = 1$  as desired.  $\square$

**Solution (b).**

“(i)” We have from the previous exercise

$$\begin{aligned}
& \frac{M_s^{(\lambda_1)} M_t^{(\lambda_2)}}{M_s^{(\lambda_2)}} \\
&= \exp \left\{ \lambda_1 X_s - \frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du \right\} \exp \left\{ \lambda_2 X_t - \frac{1}{2} \lambda_2^2 \int_0^t f^2(u) du \right\} \exp \left\{ \frac{1}{2} \lambda_2^2 \int_0^s f^2(u) du - \lambda_2 X_s \right\} \\
&= \exp \left\{ \lambda_1 X_s - \frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du + \lambda_2 X_t - \frac{1}{2} \lambda_2^2 \int_0^t f^2(u) du + \frac{1}{2} \lambda_2^2 \int_0^s f^2(u) du - \lambda_2 X_s \right\} \\
&= \exp \left\{ \lambda_1 X_s + \lambda_2 (X_t - X_s) - \frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du - \frac{1}{2} \lambda_2^2 \int_s^t f^2(u) du \right\}
\end{aligned}$$

and so the conclusion follows.  $\square$

“(ii)” We have that from lemma 4.18 that

$$X_s = \int_0^s f(u) dW_u \sim \mathcal{N} \left( 0, \int_0^s f^2(u) dW_u \right)$$

furthermore we have that

$$X_t - X_s = \int_s^t f(u) dW_u \sim \mathcal{N} \left( 0, \int_s^t f^2(u) dW_u \right).$$

In regard to the independence claim we could check identity below

$$E[e^{t_1 X} e^{t_2 Y}] = E[e^{t_1 X}] E[e^{t_2 Y}]$$

where  $X, Y$  are independent random variables. The above identity holds if and only if  $X$  and  $Y$  are independent. From above we have that

$$M_s^{(\lambda_1)} = E[e^{\lambda_1 X_s} e^{\lambda_2 (X_t - X_s)} \mid \mathcal{F}_s] e^{-\frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du - \frac{1}{2} \lambda_2^2 \int_s^t f^2(u) du}$$

and so taking expectation we have

$$1 = E[e^{\lambda_1 X_s} e^{\lambda_2 (X_t - X_s)}] e^{-\frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du - \frac{1}{2} \lambda_2^2 \int_s^t f^2(u) du}$$

Which then gives

$$E[e^{\lambda_1 X_s} e^{\lambda_2 (X_t - X_s)}] = e^{\frac{1}{2} \lambda_1^2 \int_0^s f^2(u) du + \frac{1}{2} \lambda_2^2 \int_s^t f^2(u) du} = E[e^{\lambda_1 X_s}] E[e^{\lambda_2 (X_t - X_s)}]$$

and so the conclusion is that  $X_s$  and  $X_t - X_s$  are independent.  $\square$

**Exercise 7.** (Exam 2019/20, problem 1, question (a))

**Solution.**

**Exercise 8.** (Exam 2020/21, problem 1, question (a)-(b))

**Solution.**

**Extra-Exercise 1.** (Bjork 5.7)

**Solution.**

**Extra-Exercise 2.** (*Bjork 5.8*)

**Solution.**

**Extra-Exercise 3.** (*Bjork 5.10*)

**Solution.**

**Extra-Exercise 4.** (*Bjork 5.11*)

**Solution.**

**Extra-Exercise 5.** (*Bjork 5.12*)

**Solution.**

## Week 4

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- Black-Scholes formula (Chapter 7.6, see also Remark to Black-Scholes formula)
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### Theory

**Black-Scholes formula** This chapter will center on deriving the famous Black-Scholes formula. We start by laying out the assumptions of the model. We have a market consisting of two assets: a stochastic price asset  $S$  and a risk free asset  $B$ . The price processes have dynamics:

$$\begin{aligned} dS_t &= \mu S_t dt + \sigma S_t dW_t, \\ dB_t &= r B_t dt, \end{aligned}$$

where  $S_0 = s$  and  $B_0 = 1$  (by assumption). Now from Feymann-Kac and the definition of arbitrage we know that a simple claim  $\Phi(S_T)$  has the arbitrage free price given by the risk neutral valuation formula.

$$F(t, s) = e^{-r(T-t)} E_{t,s}^Q[\Phi(S_T)],$$

where  $Q$  is a probability measure, namely a Martingale measure, such that the dynamics of  $S$  under this measure is

$$dS_t = r S_t dt + \sigma S_t dW_t^Q,$$

with  $W_t^Q$  being a Brownian motion wrt. to the probability measure  $Q$  (not  $P$ ). The above still has the initial condition  $S_0 = s$ . Given these assumptions we may formulate the Black-Scholes formula.

**Theorem 7.13. (Black-Scholes formula)** The price of the european call option with strikeprice  $K$  and maturity  $T$  (contract function  $\Phi(S_t) = (S_t - K)^+$ ) takes the form  $\Pi_t = F(t, s)$ , where

$$F(t, s) = sN(d_1(t, s)) - e^{-r(T-t)}KN(d_2(t, s)), \quad (7.52)$$

where  $N$  is the distribution-function for an  $\mathcal{N}(0, 1)$ -distributed random variable and

$$d_1(t, s) = \frac{1}{\sigma\sqrt{T-t}} \left( \log\left(\frac{s}{K}\right) + \left(r + \frac{1}{2}\sigma^2\right)(T-t) \right), \quad (7.53)$$

$$d_2(t, s) = d_1(t, s) - \sigma\sqrt{T-t}. \quad (7.54)$$

**Proof.**

We let the market be given in terms of the price processes  $S$  and  $B$  with dynamics.

$$\begin{aligned} dS_t &= \mu S_t dt + \sigma S_t dW_t, \\ dB_t &= rB_t dt, \end{aligned}$$

with  $B_t = 1$  and  $S_t = s$ . We assume that  $\mu, \sigma, r$  are deterministic real numbers. Consider the contingent claim

$$\Phi(S_t) = (S_t - K)^+,$$

that is the European call option. Let  $Q$  be a martingale measure such that the dynamics of  $S$  may be written as

$$dS_t = rS_t dt + \sigma S_t dW_t^Q,$$

then  $S_t$  is clearly a GBM wrt. the measure  $Q$ . Therefore we know the solution given in terms of the increment of the Brownian motion  $W^Q$  as follows

$$S_u = s \cdot \exp \left\{ \left( r - \frac{1}{2}\sigma^2 \right) (u - t) + \sigma (W_u^Q - W_t^Q) \right\},$$

for some initial condition  $S_t = s$ . From theorem 7.10 we know that the only pricing function which takes the form

$$\Pi_t[\Phi(S_T)] = F(t, S_t),$$

can only be consistent with the absence of arbitrage if  $F$  is the solution the the boundary value problem

$$\begin{aligned} F_t(t, s) + rsF_s(t, s) + \frac{1}{2}s^2\sigma^2F_{ss}(t, s) - rF(t, s) &= 0, \\ F(T, s) &= \Phi(s). \end{aligned}$$

From Feymann-Kac we then know that the stochastic representation of such a solution take the form

$$F(t, s) = e^{-r(T-t)}E_{t,s}^Q[\Phi(S_T)].$$

Here the superscript refers to taking mean value with respect to the measure  $Q$ . This gives the solution to the pricing function

$$F(t, s) = e^{-r(T-t)} \int \Phi(S_T) dQ.$$

Under the measure  $Q$  we have that for  $u \geq t$ :

$$Z_u = \log(S_u/s) \sim \mathcal{N}\left(\left(r - \frac{1}{2}\sigma^2\right)(u-t), \sigma\sqrt{u-t}\right)$$

Hence we may set  $u = T$  and observe that

$$\begin{aligned} F(t, s) &= e^{-r(T-t)} \int_{-\infty}^{\infty} \Phi(se^z) f(z) dz \\ &= e^{-r(T-t)} \int_{-\infty}^{\infty} (se^z - K)^+ f(z) dz \\ &= e^{-r(T-t)} \int_{\log(\frac{K}{s})}^{\infty} (se^z - K) f(z) dz \\ &= e^{-r(T-t)} \left( s \int_{\log(\frac{K}{s})}^{\infty} e^z f(z) dz - K \int_{\log(\frac{K}{s})}^{\infty} f(z) dz \right), \end{aligned}$$

where we used that  $f$  is the distribution function of a normal distributed random variable with mean  $(r - \sigma^2/2)(T-t)$  and variance  $\sigma\sqrt{T-t}$  and that

$$(se^z - K)^+ \geq 0 \iff se^z \geq K \iff z \geq \log\left(\frac{K}{s}\right)$$

Using that the MGF of a  $X \sim \mathcal{N}(\alpha, \beta^2)$  variable is

$$E[e^{tX}] = e^{\alpha t + \frac{1}{2}\beta^2 t^2},$$

and the shorthand  $N(t)$  for the distribution function of the standard normal distribution, we have

$$\begin{aligned} F(t, s) &= e^{-r(T-t)} \left( sE \left[ e^{Z_T} 1_{Z_T \geq \log(\frac{K}{s})} \right] - KP \left( Z_T \geq \log\left(\frac{K}{s}\right) \right) \right) \\ &= e^{-r(T-t)} s \exp \left\{ \left( r - \frac{1}{2}\sigma^2 \right) (T-t) + \frac{1}{2}\sigma^2 (T-t) \right\} E \left[ 1_{Z_T \geq \log(\frac{K}{s})} \right] \\ &\quad - e^{-r(T-t)} KP \left( X \geq \frac{1}{\sigma\sqrt{T-t}} \left( \log\left(\frac{K}{s}\right) - (r - \sigma^2/2)(T-t) \right) \right) \\ &= sE \left[ 1_{Z_T \geq \log(\frac{K}{s})} \right] - e^{-r(T-t)} KP \left( X \leq \frac{1}{\sigma\sqrt{T-t}} \left( \log\left(\frac{s}{K}\right) + (r - \sigma^2/2)(T-t) \right) \right) \\ &= sN(d_1(s, t)) - e^{-r(T-t)} KN(d_2(s, t)), \end{aligned}$$

as desired. ■

**Completeness and Hedging** We derived the pricing function of the european call option above and introduced the theory around boundary value problems and Feymann-Kac solution to the partial differential stochastic equation. Now we want to see if a portfolio exists such that it gives the payout  $\Phi(S_T)$  with probability one.

In order to do this, we return to the concept of hedge and replication.

**Definition 8.1.** We say that a  $T$ -claim  $\mathcal{X}$  can be **replicated**, alternatively the it is **reachable** or **hedgeable**, if there exists a self-financing portfolio  $h$  such that

$$V_T^h = \mathcal{X}, \quad P - \text{a.s.} \quad (8.1)$$

In this case we say that  $h$  is a **hedge** against  $\mathcal{X}$ . Alternatively,  $h$  is called a **replicating** or **hedging** portfolio. If every contingent claim is reachable we say that the market is **complete**.

If we can find a portfolio  $h$  that reaches  $\mathcal{X}$  in value over the time period  $[t, T]$  it must mean, that holding the portfolio is equivalent with holding the contract itself. We therefore have the natural assumption that the price process must satisfy  $\Pi_t[\mathcal{X}] = V_t^h$  for all  $t \geq 0$ . How this relates to the absence of arbitrage is given below.

**Proposition 8.2.** Suppose  $\mathcal{X}$  is hedged using the portfolio  $h$ . Then the only price process  $\Pi_t[\mathcal{X}]$  which is consistent with no arbitrage is given by  $\Pi_t[\mathcal{X}] = V_t^h$ . Furthermore, if  $\mathcal{X}$  can be hedged by both  $h$  and  $g$  then  $V_t^g = V_t^h$  for all  $t$  with probability one.

**Completeness in Black-Scholes** The Black-Scholes model will be investigated in the following. We start by stating the important theorem.

**Theorem 8.3.** Consider the Black-Scholes model given by

$$dS_t = \mu(t, S_t)S_t dt + \sigma(t, S_t)S_t dW_t, \quad (8.2)$$

$$dB_t = rB_t dt, \quad (8.3)$$

The model above is complete.

The following lemma gives us replicability of a **simple** claim (which we will restrict ud to).

**Lemma 8.4.** Suppose that there exist an adapted process  $V$  and an adapted process  $w = [w^B, w^S]$  with  $w_t^B + w_t^S = 1$  for all  $t \geq 0$ , such that

$$\begin{aligned} dV_t &= V_t(w_t^B r + w_t^S \mu(t, S_t)) dt + V_t w_t^S \sigma(t, S_t) dW_t, \\ V_t &= \Phi(S_t). \end{aligned}$$

Then the claim  $\mathcal{X} = \Phi(S_t)$  can be replicated using  $w$  as the relative portfolio. The corresponding value process is given by the process  $V$  and the absolute portfolio  $h$  is given by

$$h_t^B = \frac{w_t^B V_t}{B_t}, \quad h_t^S = \frac{w_t^S V_t}{S_t}.$$

Doing some heuristics we come up with some clever weights, which turns on to adhere to the boundary value problem formulated in the Black-Scholes equation. Given that the weights gives rise to the desired value process, we have succesfully found the portfolio weight (see lemma above).

**Theorem 8.5.** Consider the Black-Scholes model given in (8.3)-(8.4), and a simple contingent claim  $\mathcal{X} = \Phi(S_t)$ . Define  $F$  as the solution to the boundary value problem



$$F_t(t, s) + rsF_s(t, s) + \frac{1}{2}s^2\sigma^2F_{ss}(t, s) - rF(t, s) = 0,$$

$$F(T, s) = \Phi(s).$$

Then  $\mathcal{X}$  can be replicated by the relative portfolio

$$w_t^B = \frac{F(t, S_t) - S_tF_s(t, S_t)}{F(t, S_t)},$$

$$w_t^S = \frac{S_tF_s(t, S_t)}{F(t, S_t)}.$$

The corresponding absolute portfolio is given by

$$h_t^B = \frac{F(t, S_t) - S_tF_s(t, S_t)}{B_t},$$

$$h_t^S = F_s(t, S_t),$$

and the value process  $V^h$  is given by

$$V_t^h = F(t, S_t).$$

**Proposition 8.6.** Consider the Black-Scholes model given in (8.3)-(8.4), and a contingent claim on the form  $\mathcal{X} = \Phi(S_T, Z_T)$ . We define the process  $Z_t$  as

$$Z_t = \int_0^t g(u, S_u) du,$$

for some choice of the deterministic function  $g$ . Then  $\mathcal{X}$  can be replicated using a relative portfolio given by

$$w_t^B = \frac{F(t, S_t, Z_t) - S_tF_s(t, S_t, Z_t)}{F(t, S_t, Z_t)},$$

$$w_t^S = \frac{S_tF_s(t, S_t, Z_t)}{F(t, S_t, Z_t)}.$$

where  $F$  is the solution to the boundary value problem

$$F_t(t, s, z) + rsF_s(t, s, z) + \frac{1}{2}s^2\sigma^2F_{ss}(t, s, z) - rF(t, s, z) = 0,$$

$$F(T, s, z) = \Phi(s, z).$$

The corresponding value process is given by  $V_t = F(t, S_t, Z_t)$ , and  $F$  has the stochastic representation

$$F(t, s, z) = e^{-r(T-t)}E_{t,s,z}^Q[\Phi(S_T, Z_T)],$$

where the  $Q$ -dynamics are given by

$$\begin{aligned}
dS_u &= rS_u du + S_u \sigma(u, S_u) dW_u^Q, \\
S_t &= s, \\
dZ_u &= g(u, S_u) du, \\
Z_t &= z.
\end{aligned}$$

**Absence of Arbitrage** In general we have conflicting forces when evaluating when a certain market is arbitrage free and/or complete. We have in simple terms the non-rigorous theorem below.

**Meta-theorem 8.3.1.** Let  $N$  denote the number of underlying **traded** assets in the model **excluding** the risk free asset, and let  $R$  denote the number of random sources driving the price system. Generically we then have the following statements.

- The model is arbitrage free if and only if  $N \leq R$ .
- The model is complete if and only if  $N \geq R$ .
- The model is arbitrage free and complete if and only if  $N = R$ .

**Put-call Parity** The notion of continuous rebalancing the replicating portfolio require leads to problems in the real world. Trading does cost some money (typical in fractions) and so continuous balancing would make the portfolio go to 0 rather quickly. Why? The Brownian motion has unbounded variation and so we would have to sell and buy the portfolio uncountable many time in any interval and the shift in weight is not negligible. Because of this we would like to see which claims we can replicate by buying and holding a combination of assets and derivatives.

**Proposition 10.1.** Let  $\Phi$  and  $\Psi$  be contract functions for the  $T$ -claims  $\mathcal{X} = \Phi(S_T)$  and  $\mathcal{Y} = \Psi(S_T)$ . Then for any real numbers  $\alpha$  and  $\beta$  we have the following price relation:

$$\Pi_t[\alpha\Phi + \beta\Psi] = \alpha\Pi_t[\Phi] + \beta\Pi_t[\Psi].$$

If we consider the basic contract functions

$$\begin{aligned}
\Phi_S(x) &= x, \Phi_B(x) = 1, \\
\Phi_{C,K}(x) &= (x - K)^+, \Phi_{P,K}(x) = (K - x)^+.
\end{aligned}$$

That is a contract paying (respectively): the price of one stock, 1 dollar, one european call and one european put both with strike  $K$ . It is clear that the following prices are

$$\begin{aligned}
\Pi_t[\Phi_S] &= S_t, \Pi_t[\Phi_B] = e^{-r(T-t)}, \\
\Pi_t[\Phi_{C,K}] &= c(t, S_t; K, T), \Pi_t[\Phi_{P,K}] = p(t, S_t; K, T).
\end{aligned}$$

Where  $c(t, s, K, T, r, \sigma)$  and  $p(t, s, K, T, r, \sigma)$  are the pricing function of the european call and put option. We see that we can replicate these payouts by: buying the stock today and selling at time  $T$ , buying a zero coupon  $T$ -bond with face value 1, buying the call and put option.

Then we can by choosing  $\alpha, \beta, \gamma_1, \dots, \gamma_n$  form a portfolio consisting of  $\alpha$  stocks,  $\beta$   $T$ -bonds and  $\gamma_i$  call options with maturity  $T$  and strike  $K_i$ . The price is then a linear combination given the choice (see proposition 10.1).

The put option is not included in the above portfolio as we have the put-call parity below

**Proposition 10.2. (Put-call parity)** Consider a European call and a European put, both with strike  $K$  and time of maturity  $T$ . Then we have the relation.

$$p(t, s) = Ke^{-r(T-t)} + c(t, s) - s.$$

In particular the put option can be replicated by a constant portfolio consisting of  $K$  zero coupon  $T$ -bonds, a European call option and a single short position in the underlying stock.

We now have the pleasing proposition given the class of claims we can reach with the buy-and-hold portfolio with  $T$ -bonds, stock and call options

**Proposition 10.3.** Fix an arbitrary continuous contract function  $\Phi$  with compact support. Then the corresponding contract can be replicated with arbitrary precision (in sup-norm) using a constant portfolio consisting only of bonds, call options and the underlying stock.

**The Greeks** When holding a portfolio we may denote the pricing function by  $P(t, s)$ . Here we only have one **underlying** asset with price process  $S_t$ . We now have two types of risk:

- Price changes in the underlying asset.
- Misspecifications in the model parameters.

These two risk give rise to “the greeks” as defined below.

**Definition 10.4.** The greeks of a portfolio is given by

$$\Delta = \frac{\partial P}{\partial s}, \quad \Gamma = \frac{\partial^2 P}{\partial s^2}, \quad \rho = \frac{\partial P}{\partial r}, \quad \Theta = \frac{\partial P}{\partial t}, \quad \mathcal{V} = \frac{\partial P}{\partial s}.$$

For the call option in particular we have the following derivatives.

**Proposition 10.5.** The greeks of a portfolio consisting of a single European call option with maturity  $T$  and strike price  $K$  have the following greeks ( $\varphi$  denoting the density function of a  $\mathcal{N}(0, 1)$ -variable):

$$\begin{aligned} \Delta &= N(d_1), \\ \Gamma &= \frac{\varphi(d_1)}{s\sigma\sqrt{T-t}}, \\ \rho &= K(T-t)e^{-r(T-t)}N(d_2), \\ \Theta &= -\frac{s\varphi(d_1)\sigma}{2\sqrt{T-t}} - rKe^{-r(T-t)}N(d_2), \\ \mathcal{V} &= s\varphi(d_1)\sqrt{T-t}. \end{aligned}$$

**Risk Neutral Valuation Formula** We have the setting of a market consisting of the assets  $S^0, \dots, S^N$  of  $N+1$  assets. We consider the numeraire  $S^0$  being a risk free asset. We introduce a price of contingent claim  $X$ , such that the extended market consisting of the price process of  $X$  and the  $N+1$  assets is arbitrage free. Alternatively, we can, equivalently, find a replicating portfolio  $h$  such that  $V_T^h = X$  with probability one.

**Theorem 11.18. (General Pricing Equation)** The arbitrage free price process for the  $T$ -claim  $X$  is given by

$$\Pi_t[X] = S_t^0 E^Q \left[ \frac{X}{S_T^0} \middle| \mathcal{F}_t \right],$$

where  $Q$  is the (not necessarily unique) martingale measure for the a priori given market  $S^0, S^1, \dots, S^N$ , with  $S^0$  as the numeraire.

If if we assume that the bank account takes the form

$$S_t^0 = S_0^0 e^{-\int_0^t r(s) ds},$$

where  $r$  is the short rate, then we have the familiar *risk neutral valuation formula*.

**Theorem 11.19. (Risk Neutral Valuation Formula)** Assuming the existence of a short rate, the pricing formula takes the form

$$\Pi_t[X] = E^Q \left[ e^{-\int_0^T r(s) ds} X \middle| \mathcal{F}_t \right],$$

where  $Q$  is the (not necessarily unique) martingale measure with the bank account as the numeraire.

**Definition 11.20.** A **zero coupon bond** with **maturity date**  $T$ , also called a  $T$ -bond, is a contract which guarantees the holder one dollar to be paid on the date  $T$ . The price at time  $t$  of a bond with maturity date  $T$  is denoted by  $p(t, T)$ .

**Proposition 11.21.** The price of a zero coupon  $T$ -bond is given by

$$p(t, T) = E^Q \left[ e^{-\int_t^T r(s) ds} \middle| \mathcal{F}_t \right],$$

and in particular we have  $p(T, T) = 1$  for all  $T \geq 0$ .

## Equivalent Probability Measures

**The Radon-Nikodym Theorem** **Definition A.50.** Consider a measurable space  $(X, \mathcal{F})$  on which there are defined two separate measures  $\mu$  and  $\nu$ :

- If, for all  $A \in \mathcal{F}$ , it holds that

$$\mu(A) = 0 \Rightarrow \nu(A) = 0,$$

then  $\nu$  is said to be **absolutely continuous** with respect to  $\mu$  on  $\mathcal{F}$  and we write this as  $\nu \ll \mu$ .

- If we have both  $\mu \ll \nu$  and  $\nu \ll \mu$ , then  $\mu$  and  $\nu$  said to be **equivalent** and we write  $\mu \sim \nu$ .
- If there exists two events,  $A$  and  $B$  such that:
  - $A \cup B = X$ ,
  - $A \cap B = \emptyset$ ,
  - $\mu(B) = 0$ , and  $\nu(A) = 0$ ,

then  $\nu$  and  $\mu$  are said to be mutually **singular**, and we write  $\mu \perp \nu$ .

**Theorem A.52. (The Radon-Nikodym Theorem)** Consider the measure space  $(X, \mathcal{F}, \mu)$ , where we assume that  $\mu$  is finite, i.e. that  $\mu(X) < \infty$ . Let  $\nu$  be a measure on  $(X, \mathcal{F})$  such that  $\nu \ll \mu$  on  $\mathcal{F}$ . Then there exists a non-negative function  $f : X \rightarrow \mathbb{R}$  such that:

$$\begin{aligned} &f \text{ is } \mathcal{F}\text{-measurable} \\ &\int_X f(x) d\mu(x) < \infty, \\ &\nu(A) = \int_A f(x) d\mu(x), \text{ for all } A \in \mathcal{F}. \end{aligned}$$

The function  $f$  is called the **Radon-Nikodym derivative** of  $\nu$  w.r.t.  $\mu$ . It is uniquely determined  $\mu$ -a.e. and we write

$$f(x) = \frac{d\nu(x)}{d\mu(x)},$$

or alternatively

$$d\nu(x) = f(x) d\mu(x).$$

**EPM Lemma B.38.** For two probability measures  $P$  and  $Q$ , the relation  $P \sim Q$  on  $\mathcal{F}$  holds if and only if  $P(A) = 1$  if and only if  $Q(A) = 1$  for all  $A \in \mathcal{F}$ .

**Proposition B.39.** Assume that  $Q \ll P$  on  $\mathcal{F}$  and that  $\mathcal{G} \subseteq \mathcal{F}$ . Then the Radon-Nikodym derivatives  $L^{\mathcal{F}}$  and  $L^{\mathcal{G}}$  are related by

$$L^{\mathcal{G}} = E^P[L^{\mathcal{F}} \mid \mathcal{G}].$$

**Proposition B.41. (Bayes' Theorem)** Assume that  $X$  is a random variable on  $(\Omega, \mathcal{F}, P)$ , and let  $Q$  be another probability measure on  $(\Omega, \mathcal{F})$  the Radon-Nikodym derivative

$$L = \frac{dQ}{dP}$$

on  $\mathcal{F}$ . Assume that  $X \in L^1(\Omega, \mathcal{F}, Q)$  and  $\mathcal{G}$  is a sigma-algebra with  $\mathcal{G} \subseteq \mathcal{F}$ . Then

$$E^Q[X \mid \mathcal{G}] = \frac{E^P[L \cdot X \mid \mathcal{G}]}{E^P[L \mid \mathcal{G}]}, \quad Q - a.s.$$

**Likelihood processes Proposition C.12.** Consider a filtered probability space  $(\Omega, \mathcal{F}, P, \mathcal{F}_t)$  on a compact interval  $[0, T]$ . Suppose  $L_T$  is some non-negative integrable random variable in  $\mathcal{F}_T$ . We can then define a new measure  $Q$  on  $\mathcal{F}_T$  by setting

$$dQ = L_T dP$$

on  $\mathcal{F}_T$  and if  $E^P[L_T] = 1$  the measure  $Q$  will also be a probability measure. The likelihood process  $L$ , defined by

$$L_t = \frac{dQ}{dP}, \quad \text{on } \mathcal{F}_t,$$

is a  $(P, \mathcal{F}_t)$ -martingale.

**Proposition C.13.** A process  $M$  is a  $Q$ -martingale if and only if the process  $L \cdot M$  is a  $P$ -martingale.

#### Exercises week 4

**Exercise 1. (Bjork 7.1)** Consider the standard Black-Scholes model and a  $T$ -claim  $\mathcal{X}$  of the form  $\mathcal{X} = \Phi(S_T)$ . Denote the corresponding arbitrage free price processes by  $\Pi_t$ .

- Show that, under the martingale measure  $Q$ ,  $\Pi_t$  has a local rate of return equal to the short rate  $r$ . In other words show that  $\Pi_t$  has a differential of the form

$$d\Pi_t = r\Pi_t dt + g_t dW_t^Q.$$

**Hint:** Use the  $Q$ -dynamics of  $S$  together with the fact that  $F$  satisfies the pricing PDE.

- b. Show that, under the martingale measure  $Q$ , the process  $Z_t = \frac{\Pi_t}{B_t}$  is a **martingale**. More precisely show that the stochastic differential for  $Z$  has zero drift term, i.e. is of the form

$$dZ_t = Z_t \sigma_t^Z dW_t^Q.$$

Determine also the diffusion process  $\Sigma_t^Z$  (in terms of the pricing function  $F$  and its derivatives).

**Solution (a).**

First we have that the dynamics of  $S$  and  $B$  are given by

$$\begin{aligned} dS_t &= \mu S_t dt + \sigma S_t dW_t, \\ dB_t &= r B_t dt. \end{aligned}$$

We know that  $\Pi_t[X] = F(t, S_t)$  for some smooth function  $F$  hence by Ito's formula we have

$$\begin{aligned} d\Pi_t &= \frac{\partial F}{\partial t}(t, S_t) dt + \frac{\partial F}{\partial s}(t, S_t) dS_t + \frac{1}{2} \frac{\partial^2 F}{\partial s^2}(t, S_t) (dS_t)^2 \\ &= F_t dt + F_s(rS_t dt + \sigma S_t dW_t^Q) + \frac{1}{2} F_{ss}(rS_t dt + \sigma S_t dW_t^Q)^2 \\ &= (F_t + rS_t F_s) dt + F_s \sigma S_t dW_t^Q + \frac{1}{2} F_{ss} \sigma^2 S_t^2 dt \\ &= (F_t + rS_t F_s + \frac{1}{2} F_{ss} \sigma^2 S_t^2) dt + F_s \sigma S_t dW_t^Q. \end{aligned}$$

By setting  $g_t = F_s \sigma S_t$  and restating the Black-Scholes equation we have

$$rF = F_t + rS F_s + \frac{1}{2} F_{ss} \sigma^2 S^2$$

hence

$$d\Pi_t = rF dt + g_t dW_t^Q$$

as desired.  $\square$

**Solution (b).**

Consider the stochastic process  $Z_t = F(t, \Pi_t, B_t)$  given by  $F(t, \pi, b) = \frac{\pi}{b}$ . Then by Ito's formula we have the dynamics of  $Z$  as

$$\begin{aligned} dZ_t &= F_t dt + F_\pi d\Pi_t + F_b dB_t + \frac{1}{2} F_{\pi\pi} (d\Pi_t)^2 + \frac{1}{2} F_{bb} (dB_t)^2 + F_{b\pi} (d\Pi_t)(dB_t) \\ &= 0 + \frac{1}{B_t} d\Pi_t - \frac{\Pi_t}{B_t^2} dB_t + \frac{1}{2} 0 g_t dt + \frac{\Pi_t}{B_t^3} 0 - \frac{1}{B_t^2} 0 \\ &= \frac{1}{B_t} (r\Pi_t dt + g_t dW_t^Q) - \frac{\Pi_t}{B_t^2} (rB_t dt) \\ &= \frac{1}{B_t} (r\Pi_t dt - r\Pi_t dt + g_t dW_t^Q) \\ &= \frac{1}{B_t} g_t dW_t^Q. \end{aligned}$$

hence we have that  $Z_t$  is a  $Q$ -martingale since it only has dynamics in terms of the Brownian motion  $W^Q$ . Additionally we may represent the process as

$$Z_t = \Pi_0 + \int_0^t \frac{g_s}{B_s} dW_s^Q.$$

From this it is clear that  $Z_t$  is a  $Q$ -martingale.  $\square$

**Exercise 2.** (*Bjork 7.2*) Consider the standard Black-Scholes model. An innovative company, F&H Inc., has produced the derivative “the Golden Logarithm”, henceforth abbreviated as the  $GL$ . The holder of a  $GL$  with maturity time  $T$ , denoted as  $GL_t$ , will, at time  $T$ , obtain the sum  $\Phi(S_T) = \log S_T$ . Note that if  $S_T < 1$  this means that the holder has to pay a positive amount to F&H Inc. Determine the arbitrage free price process for the  $GL_t$ .

**Solution.**

We know that in the BS model the simple derivative has to have the smooth pricing function  $F(t, s)$  that is the solution to the boundary value problem.

$$\begin{cases} F_t(t, s) + r s F_s(t, s) + \frac{1}{2} \sigma^2 s^2 F_{ss}(t, s) - r F(t, s) = 0 \\ F(T, s) = \Phi(s). \end{cases}$$

Which has the stochastic representation (proposition 7.11) given by the risk neutral valuation formula:

$$F(t, s) = e^{-r(T-t)} E_{t,s}^Q[\Phi(S_T)] = e^{-r(T-t)} E_{t,s}^Q[\log(S_T)],$$

with  $S_t$  having dynamics

$$dS_t = r S_t dt + \sigma S_t dW_t^Q.$$

Then by Ito's formula on the function  $f(t, s) = \log(s)$  we have

$$d(\log(S_t)) = df(t, S_t) = f_t dt + f_s dS_t + \frac{1}{2} f_{ss} (dS_t)^2.$$

Since  $f_t = 0$  and  $f_s = 1/s$  and  $f_{ss} = -1/s^2$  we have

$$\begin{aligned} d(\log(S_t)) &= \frac{1}{S_t} (r S_t dt + \sigma S_t dW_t^Q) - \frac{1}{2} \sigma^2 S_t^2 \frac{1}{S_t^2} dt \\ &= \left( r - \frac{1}{2} \sigma^2 \right) dt + \sigma dW_t^Q. \end{aligned}$$

Then given that  $S_t = s$  we have

$$\begin{aligned} \log(S_u) &= \log s + \int_t^u \left( r - \frac{1}{2} \sigma^2 \right) dv + \sigma \int_t^u dW_v^Q \\ &= \log s + \left( r - \frac{1}{2} \sigma^2 \right) (u - t) + \sigma (W_u^Q - W_t^Q) \end{aligned}$$

Taking expectation we then have

$$E^Q[\log(S_T) \mid S_t = s] = \log s + \left(r - \frac{1}{2}\sigma^2\right)(T - t),$$

given that

$$\Pi_t(\Phi(S_t)) = e^{-r(T-t)} \log s + e^{-r(T-t)} \left(r - \frac{1}{2}\sigma^2\right)(T - t).$$

The arbitrage free price is the the above.  $\square$

**Exercise 3.** (*Bjork 7.4*) Consider the standard Black-Scholes model. Derive the arbitrage free price process for the  $T$ -claim  $X$  where  $X$  is given by  $X = S_T^\beta$ . Here  $\beta$  is a known constant.

**Solution.**

We may solve the pricing problem by evaluating the risk neutral valuation formula 7.11 given by

$$F(t, s) = e^{-r(T-t)} E_{t,s}^Q[\Phi(S_T)] = e^{-r(T-t)} E_{t,s}^Q[S_T^\beta].$$

We know that  $S_t$  is a Geometric Brownian motion with drift  $(r - \sigma^2/2)$  and diffusion  $\sigma$  i.e.

$$S_T = s \cdot \exp \left\{ \left(r - \frac{1}{2}\sigma^2\right)(T - t) + \sigma(W_T^Q - W_t^Q) \right\}$$

wrt. the martingale-measure  $Q$ . Here we assume that  $S_t = s$ . Then we know that  $S_T^\beta$  is likewise a GBM given as

$$S_T^\beta = s^\beta \cdot \exp \left\{ \beta \left(r - \frac{1}{2}\sigma^2\right)(T - t) + \beta\sigma(W_T^Q - W_t^Q) \right\}.$$

Evaluating the price process then becomes

$$\begin{aligned} \Pi_t &= e^{-r(T-t)} E^Q \left[ s^\beta \cdot \exp \left\{ \beta \left(r - \frac{1}{2}\sigma^2\right)(T - t) + \beta\sigma(W_T^Q - W_t^Q) \right\} \right] \\ &= e^{-r(T-t)} s^\beta e^{\beta(r - \frac{1}{2}\sigma^2)(T-t)} E^Q \left[ e^{\beta\sigma(W_T^Q - W_t^Q)} \right]. \end{aligned}$$

Evaluating the expectation may be done by calculating the MGF of a  $\mathcal{N}(0, T - t)$  variable i.e.

$$E^Q \left[ e^{\beta\sigma(W_T^Q - W_t^Q)} \right] = e^{0 \cdot 1 + (T-t)(\beta\sigma)^2/2} = e^{\beta^2\sigma^2 \frac{T-t}{2}}.$$

Combining these two equations yields

$$\log \Pi_t = -r(T-t) + \beta \log s + \beta \left(r - \frac{1}{2}\sigma^2\right)(T-t) + \beta^2\sigma^2 \frac{T-t}{2} = -r(T-t) + \beta \log s + \left(\beta r + \frac{1}{2}\sigma^2\beta(\beta - 1)\right)(T-t).$$

We arrive at the arrived result.  $\square$

**Exercise 4.** (*Bjork 7.5*) A so-called **binary option** is a claim which pays a certain amount if the stock prices at a certain date falls within some pre-specified interval. Otherwise nothing will be paid out. Consider a binary option which pays  $K$  dollars to the holder at date  $T$  if the stock price at time  $T$  is in the interval



$[\mu, \beta]$ . Determine the arbitrage free price. The pricing formula will involve the standard Gaussian cumulative distribution function  $N$ .

**Solution.**

First we see that the claim may be written on the form

$$\Phi(S_T) = 1_{S_T \in [a, b]} K,$$

using the values  $a < b$  for the interval endpoints (instead of  $\mu, \beta$ ). We then by the risk neutral valuation formula must have

$$\Pi_t = e^{-r(T-t)} E_{t,s}^Q[1_{S_T \in [a, b]} K].$$

Under closer inspection we see that we must evaluate the expectation of the indicator under the measure  $Q$ . Then we have

$$E_{t,s}^Q[1_{S_T \in [a, b]}] = Q(S_T \in [a, b] \mid S_t = s) = (*).$$

When assuming  $S_t = s$  we must have that under  $Q$  that

$$S_T = s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T - t) + \sigma (W_T^Q - W_t^Q) \right\}.$$

Then

$$\begin{aligned} (*) &= Q(S_T \leq b \mid S_t = s) - Q(S_T < a \mid S_t = s) \\ &= Q(S_T \leq b \mid S_t = s) - Q(S_T \leq a \mid S_t = s) \\ &= Q \left( s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T - t) + \sigma (W_T^Q - W_t^Q) \right\} \leq b \right) \\ &\quad - Q \left( s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T - t) + \sigma (W_T^Q - W_t^Q) \right\} \leq a \right) \\ &= Q \left( \frac{1}{\sqrt{T-t}} (W_T^Q - W_t^Q) \leq \frac{1}{\sigma \sqrt{T-t}} \left\{ \log b - \log s + \left( \frac{1}{2} \sigma^2 - r \right) (T - t) \right\} \right) \\ &\quad - Q \left( \frac{1}{\sqrt{T-t}} (W_T^Q - W_t^Q) \leq \frac{1}{\sigma \sqrt{T-t}} \left\{ \log a - \log s + \left( \frac{1}{2} \sigma^2 - r \right) (T - t) \right\} \right) \\ &= N \left( \frac{1}{\sigma \sqrt{T-t}} \left\{ \log b - \log s + \left( \frac{1}{2} \sigma^2 - r \right) (T - t) \right\} \right) \\ &\quad - N \left( \frac{1}{\sigma \sqrt{T-t}} \left\{ \log a - \log s + \left( \frac{1}{2} \sigma^2 - r \right) (T - t) \right\} \right) \\ &= N(d_b) - N(d_a), \end{aligned}$$

as  $W_T^Q - W_t^Q$  is  $\mathcal{N}(0, T - t)$  distributed under the  $Q$ -measure. The function  $d_c$  is defined as

$$d_c = \frac{1}{\sigma \sqrt{T-t}} \left\{ \log c - \log s + \left( \frac{1}{2} \sigma^2 - r \right) (T - t) \right\},$$

as expected. We then arrive at the price

$$\Pi_t = e^{-r(T-t)} K(N(d_b) - N(d_a)),$$

as desired.  $\square$

**Exercise 5.** (*Bjork 7.6*) Consider the standard Black-Scholes model. Derive the arbitrage free price process for the  $T$ -claim  $X$  where  $X$  is given by  $X = \frac{S_{T_1}}{S_{T_0}}$ . The times  $T_0$  and  $T_1$  are given and the claim is paid out at time  $T_1$ .

**Solution.**

Firstly, we may use that  $S$  is a GBM. Setting  $S_t = s$  we have that

$$\begin{aligned} X = \frac{S_{T_1}}{S_{T_0}} &= \frac{s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - t) + \sigma \left( W_{T_1}^Q - W_t^Q \right) \right\}}{s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T_0 - t) + \sigma \left( W_{T_0}^Q - W_t^Q \right) \right\}} \\ &= \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - t - T_0 + t) + \sigma \left( W_{T_1}^Q - W_t^Q - W_{T_0}^Q + W_t^Q \right) \right\} \\ &= \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - T_0) + \sigma \left( W_{T_1}^Q - W_{T_0}^Q \right) \right\}. \end{aligned}$$

Then it follows from proposition 7.11 that the price process is given by

$$\begin{aligned} \Pi_t &= e^{-r(T_1-t)} E_{t,s}^Q[X] \\ &= e^{-r(T_1-t)} E^Q \left[ \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - T_0) + \sigma \left( W_{T_1}^Q - W_{T_0}^Q \right) \right\} \right] \\ &= \exp \left\{ -r(T_1 - t) + \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - T_0) \right\} E^Q \left[ \exp \left\{ \sigma \left( W_{T_1}^Q - W_{T_0}^Q \right) \right\} \right] \\ &= \exp \left\{ -r(T_1 - t) + \left( r - \frac{1}{2} \sigma^2 \right) (T_1 - T_0) + \frac{1}{2} \sigma^2 (T_1 - T_0) \right\} \\ &= \exp \left\{ -r(T_1 - t) + r(T_1 - T_0) \right\} \\ &= \exp \left\{ -r(T_1 + T_0 - T_1 - t) \right\} = \exp \left\{ -r(T_0 - t) \right\} \end{aligned}$$

as desired.  $\square$

**Exercise 6.** (*Exam 2017/18, problem 2, question (c)-(d)*) Consider a standard Black-Scholes model, that is, a model consisting of a bank account  $B_t$  with  $P$ -dynamics given by

$$dB_t = rB_t dt, \quad B_0 = 1$$

and a stock  $S_t$  with  $P$ -dynamics given by

$$dS_t = \alpha S_t dt + \sigma S_t d\bar{W}_t, \quad S_0 = s > 0$$

where  $r, \alpha \in \mathbb{R}$  and  $\sigma > 0$  are constants and  $\bar{W}_t$  is a  $P$ -Brownian motion. Let  $T > 0$  be a given and fixed date.

Consider the derivative that at time  $T$  pays

$$X = \max \{ \min \{ S_T, K_2 \}, K_1 \},$$

where  $0 < K_1 < K_2$  are constants.

- a. Determine the arbitrage free price of derivative  $X$  at time  $t < T$ .

Consider a new derivative that at time  $T$  pays

$$Y = (S_T^2 - K^2)^+ - (K^2 - S_T^2)^+.$$

- b. i. Determine the arbitrage free price of derivative  $Y$  at time  $t < T$ .  
ii. Find a hedging portfolio for derivative  $Y$ .

Let  $h(t) = (h_0(t), h_1(t))$  be a portfolio where

$$h_0(t) = -e^{r(T-2t)+\sigma^2(T-t)} S^2(t)$$

is the number of units in the bank account at time  $t$  and

$$h_1(t) = 2e^{(r+\sigma^2)(T-t)} S(t)$$

is the number of shares in the stock at time  $t$ . Let  $V^h(t)$  denote the associated value process.

- c. Determine whether the portfolio  $h$  is self-financing or not.  
d. Compute  $V^h(T)$ .

**Solution (b).**

(i): We start by seeing that the derivative pays out

$$Y = \begin{cases} S_T^2 - K^2 & \text{if } S_T^2 \geq K^2, \\ -(K^2 - S_T^2) & \text{if } S_T^2 < K^2. \end{cases}$$

hence the payout is  $Y = S_T^2 - K^2 = \Phi(S_T)$  where  $\Phi(s) = s^2 - K^2$ . That is  $Y$  is in fact a simple claim. We have from the risk neutral valuation formula 7.11 that

$$\begin{aligned} \Pi_t[Y] &= e^{-r(T-t)} E_{t,s}^Q[S_T^2 - K^2] \\ &= e^{-r(T-t)} E_{t,s}^Q[S_T^2] - e^{-r(T-t)} K^2. \end{aligned}$$

Recall that under the martingale measure  $Q$  we have that  $S_t$  is a GBM hence

$$S_t = s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T - t) + \sigma (W_T^Q - W_t^Q) \right\}$$

then

$$S_T^2 = s^2 \cdot \exp \left\{ 2 \left( r - \frac{1}{2} \sigma^2 \right) (T - t) + 2\sigma (W_T^Q - W_t^Q) \right\}.$$

Inserting this into the risk neutral valuation formula we get

$$\begin{aligned}
\Pi_t[Y] &= e^{-r(T-t)} E_{t,s}^Q[S_T^2] - e^{-r(T-t)} K^2 \\
&= e^{-r(T-t)} s^2 e^{2(r-\frac{1}{2}\sigma^2)(T-t)} E^Q \left[ \exp \left\{ 2\sigma \left( W_T^Q - W_t^Q \right) \right\} \right] - e^{-r(T-t)} K^2 \\
&= e^{-r(T-t)} s^2 e^{2(r-\frac{1}{2}\sigma^2)(T-t)} e^{\frac{1}{2}4\sigma^2(T-t)} - e^{-r(T-t)} K^2 \\
&= e^{-r(T-t)} \left( s^2 e^{(2r-\sigma^2)(T-t)+\frac{1}{2}4\sigma^2(T-t)} - K^2 \right) \\
&= e^{-r(T-t)} \left( s^2 e^{(2r+\sigma^2)(T-t)} - K^2 \right).
\end{aligned}$$

The arbitrage free price of the derivative is then given above.  $\square$

(ii): From theorem 8.5 we can determine a hedging portfolio with weightings

$$\begin{aligned}
w_t^B &= \frac{\Pi_t - S_t \frac{\partial \Pi}{\partial s}}{\Pi_t} \\
&= 1 - \frac{S_t 2S_t e^{-r(T-t)} e^{(2r+\sigma^2)(T-t)}}{e^{-r(T-t)} \left( S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2 \right)} \\
&= 1 - \frac{2S_t^2 e^{(2r+\sigma^2)(T-t)}}{S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2} \\
&= 1 - \frac{2}{1 - K^2 S_t^{-2} e^{(2r+\sigma^2)(t-T)}} \\
w_t^S &= \frac{2}{1 - K^2 S_t^{-2} e^{(2r+\sigma^2)(t-T)}}.
\end{aligned}$$

In absolute terms we will hold the portfolio

$$\begin{aligned}
h_t^S &= 2S_t e^{-r(T-t)} e^{(2r+\sigma^2)(T-t)} \\
h_t^B &= \frac{e^{-r(T-t)} \left( s^2 e^{(2r+\sigma^2)(T-t)} - K^2 \right) - S_t h_t^S}{B_t} \\
&= \frac{e^{-r(T-t)} \left( s^2 e^{(2r+\sigma^2)(T-t)} - K^2 \right) - S_t h_t^S}{e^{rt}} \\
&= e^{-rT} s^2 e^{(2r+\sigma^2)(T-t)} - e^{-rT} K^2 - e^{-rt} S_t h_t^S.
\end{aligned}$$

The portfolio above will hedge  $Y$  with probability one.  $\square$

### Solution (c).

We assume no dividends and no consumption that is  $c_t = 0$  and  $dD_t^i = 0$  for  $i = 0, 1$ . Then the portfolio is self-financing if and only if the value process has dynamics.

$$h_0(t) dB_t + h_1(t) dS_t = 0$$

This is given in lemma 6.12.

**THE BELOW IS IN WORKS AND NOT CORRECT!**

Now we have that the value process is given by

$$V_t^h = h_0(t)B_t + h_1(t)S_t.$$

Using the representation  $V_t^h = f(h_0(t), B_t) + f(h_1(t), S_t)$  given by  $f(x, y) = xy$  we have

$$dV_t^h = df(h_0(t), B_t) + df(h_1(t), S_t).$$

Using Ito's formula on each term we have

$$\begin{aligned} df(h_0(t), B_t) &= B_t dh_0(t) + h_0(t) dB_t + (dB_t)(dh_0(t)), \\ df(h_1(t), S_t) &= S_t dh_1(t) + h_1(t) dS_t + (dS_t)(dh_1(t)), \end{aligned}$$

since of cause  $f_{xx} = f_{yy} = 0$ . We can the determine the dynamics of the portfolio by

$$\begin{aligned} dh_0(t) &= -(-2t - \sigma^2)S_t^2 e^{r(T-2t) + \sigma^2(T-t)} dt \\ &\quad - 2S_t e^{r(T-2t) + \sigma^2(T-t)} dS_t \\ &\quad - \frac{1}{2} 2e^{r(T-2t) + \sigma^2(T-t)} (dS_t)^2 \\ &= (-2t - \sigma^2)h_0(t) dt + \frac{2}{S_t} h_0(t) (\mu S_t dt + \sigma S_t dW_t) + \frac{1}{S_t^2} h_0(t) \sigma^2 S_t^2 dt \\ &= (\mu - 1)2h_0(t) dt + 2\sigma h_0(t) dW_t \end{aligned}$$

and

$$\begin{aligned} dh_1(t) &= (-r - \sigma^2)2e^{(r+\sigma^2)(T-t)} S_t dt \\ &\quad + 2e^{(r+\sigma^2)(T-t)} dS_t + 0 \\ &= (-r - \sigma^2)h_1(t) dt + \frac{1}{S_t} h_1(t) (\mu S_t dt + \sigma S_t dW_t) \\ &= (-r - \sigma^2 + \mu)h_1(t) dt + h_1(t) \sigma dW_t \end{aligned}$$

And so in total

$$\begin{aligned} dV_t^h(t) &= df(h_0(t), B_t) + df(h_1(t), S_t) \\ &= B_t dh_0(t) + h_0(t) dB_t + (dB_t)(dh_0(t)) \\ &\quad + S_t dh_1(t) + h_1(t) dS_t + (dS_t)(dh_1(t)) \\ &= B_t ((\mu - 1)2h_0(t) dt + 2\sigma h_0(t) dW_t) + h_0(t) rB_t dt + 0 \\ &\quad + S_t ((-r - \sigma^2 + \mu)h_1(t) dt + h_1(t) \sigma dW_t) + h_1(t) (\mu S_t dt + \sigma S_t dW_t) + \sigma^2 S_t h_1(t) dt \\ &= [B_t(\mu - 1)2h_0(t) + h_0(t)rB_t + S_t(-r - \sigma^2 + \mu)h_1(t) + h_1(t)\mu S_t + \sigma^2 S_t h_1(t)] dt \\ &\quad + [B_t 2\sigma h_0(t) + S_t h_1 \sigma + h_1 \sigma S_t] dW_t \\ &= [(2\mu - 2 + r)B_t h_0(t) + (-r + 2\mu)S_t h_1(t)] dt \\ &\quad + [B_t h_0(t) + h_1 S_t] 2\sigma dW_t \\ &= V_t^h 2\mu dt + V_t^h dW_t \end{aligned}$$

**Solution (d).**

We compute  $V_T^h$  easily by inserting  $h_0$  and  $h_1$  below

$$\begin{aligned} V_T^h &= B_T h_0(T) + S_T h_1(T) \\ &= B_T \left( -e^{r(T-2T)+\sigma^2(T-T)} S_T^2 \right) + S_T \left( 2e^{(r+\sigma^2)(T-T)} S_T \right) \\ &= -S_T^2 + 2S_T^2 = S_T^2. \end{aligned}$$

and so  $h$  hedge the payout  $\Phi(S_T) = S_T^2$ .  $\square$

**Solution.**

**Exercise 7.** (*Exam 2018/19, problem 1*)

**Solution.**

**Exercise 8.** (*Exam 2018/19, problem 2, question (a)*)

**Solution.**

**Extra-Exercise 1.** (*Bjork 7.7*)

**Solution.****Week 5****Table of Contents**

- Martingale representation theorem (Chapter 12)
- Girsanov theorem (Chapter 12, see also Levy characterization of Brownian motion and proof of Girsanov)
- Exercises

**Theory****Martingale representation theorem Theorem 12.1. (Representation of Brownian Functionals)**

Let  $W$  be a  $d$  dimensional Brownian motions, and let  $X$  be a random variable such that

- $X \in \mathcal{F}_T^W$ ,
- $E[|X|] < \infty$ .

Then there exist uniquely determined  $\mathcal{F}_t^W$ -adapted processes  $h^1, \dots, h^d$ , such that  $X$  has the representation

$$X = E[X] + \sum_{i=1}^d \int_0^T h_s^i dW_s^i.$$

Under the additional assumption

$$E[X^2] < \infty,$$

then  $h^1, \dots, h^d$  are in  $\mathcal{L}^2$ .

**Theorem 12.2. (The Martingale Representation Theorem)** Let  $W$  be a  $d$  dimensional Brownian motions, and assume that the filtration  $\mathbf{F}$  is defined as

$$\mathcal{F}_t = \mathcal{F}_t^W, \quad t \in [0, T].$$

Let  $M$  be any  $\mathcal{F}_t$ -adapted martingale. Then there exist uniquely determined  $\mathcal{F}_t$ -adapted processes  $h^1, \dots, h^d$  such that  $M$  has the representation

$$M_t = M_0 + \sum_{i=1}^d \int_0^t h_s^i dW_s^i, \quad t \in [0, T].$$

If the martingale  $M$  is square integrable, then  $h^1, \dots, h^d$  are in  $\mathcal{L}^2$ .

**Girsanov theorem Theorem 12.3. (The Girsanov Theorem)** Let  $W$  be a  $d$  dimensional  $P$ -Brownian motion on  $(\Omega, \mathcal{F}, P, \mathbf{F})$  and let  $\varphi$  be any  $d$ -dimensional adapted column vector process. Choose a fixed  $T$  and define the process  $L$  on  $[0, T]$  by

$$\begin{aligned} dL_t &= \varphi_t^\top L_t dW_t, \\ L_0 &= 1, \end{aligned}$$

i.e.

$$L_t = \exp \left\{ \int_0^t \varphi_s^\top dW_s - \frac{1}{2} \int_0^t \|\varphi_s\|^2 ds \right\}.$$

Assume that

$$E^P[L_T] = 1,$$

and define the new probability measure  $Q$  on  $\mathcal{F}_T$  by

$$L_T = \frac{dQ}{dP}, \quad \text{on } \mathcal{F}_T.$$

Then

$$dW_t = \varphi dt + dW_t^Q,$$

where  $W^Q$  is a  $d$  dimensional  $Q$ -Brownian motion or equivalently

$$W_t^Q = W_t - \int_0^t \varphi_s ds$$

is a standard  $Q$ -Brownian motion.

We will often refer to  $\varphi$  as the **Girsanov kernel** of the measure transformation. Furthermore, we have written on component form above and the  $L$  dynamics will have the form

$$dL_t = L_t \sum_{i=1}^d \varphi_t^i dW_t^i,$$

and  $L$  will have the explicit form

$$L_t = \exp \left\{ \sum_{i=1}^d \int_0^t \varphi_s^i dW_s^i - \frac{1}{2} \int_0^t \sum_{i=1}^d (\varphi_s^i)^2 ds \right\}.$$

The conclusion of the Girsanov Theorem is thwn that we can write

$$dW_t^i = \varphi_t^i dt + dW_t^{Q,i},$$

for  $i = 1, \dots, d$  where  $W_t^{Q,1}, \dots, W_t^{Q,d}$  are independent standard Brownian motions under  $Q$ .

**Definition 12.4.** For any Brownian motion  $W$  and any kernel process  $\varphi$ , the **Doleans exponential** process  $\mathcal{E}$  is defined by

$$\mathcal{E}(\varphi \bullet W)_t = \exp \left\{ \int_0^t \varphi_s^\top dW_s - \frac{1}{2} \int_0^t \|\varphi_s\|^2 ds \right\}.$$

**Lemma 12.5. (The Novikov Condition)** Assume that the Girsanov kernel  $\varphi$  is such that

$$E^P \left[ e^{\frac{1}{2} \int_0^T \|\varphi_t\|^2 dt} \right] < \infty.$$

Then  $L$  is a martingale and in particular  $E^P[L_T] = 1$ .

**Theorem 12.6. (The Converse of the Girsanov Theorem)** Let  $W$  be a  $d$ -dimensional standard  $P$ -Brownian motion on  $(\Omega, \mathcal{F}, P, \mathbf{F})$  and assume that

$$\mathcal{F}_t = \mathcal{F}_t^W, \quad \forall t.$$

Assume that there exists a probability measure  $Q$  such that  $Q \ll P$  on  $\mathcal{F}_T$ . Then there exists an adapted process  $\varphi$  such that the likelihood process  $L$  has the dynamics

$$\begin{aligned} dL_t &= L_t \varphi_t^\top dW_t, \\ L_0 &= 1. \end{aligned}$$

This gives us a recipe to transform dynamics of Ito processes under the measure  $Q$  as we may rewrite the dynamics of the Brownian motion. We therefore have for an Ito process  $X$  with dynamics

$$dX_t = \mu(t, X_t) dt + \sigma(t, X_t) dW_t,$$

may be transformed under  $Q$  as

$$\begin{aligned} dX_t &= \mu(t, X_t) dt + \sigma(t, X_t) dW_t \\ &= \mu(t, X_t) dt + \sigma(t, X_t) (\varphi_t dt + dW_t^Q) \\ &= (\mu(t, X_t) + \varphi_t) X_t dt + \sigma(t, X_t) X_t dW_t^Q. \end{aligned}$$

This may lead us into deducing that

$$\mu(t, X_t) + \sigma(t, X_t) \varphi_t = r_t \iff \varphi_t = \frac{r_t - \mu(t, X_t)}{\sigma(t, X_t)}.$$



We furthermore have the Levy characterisation of a Brownian motion.

**Theorem. (Levy Characterisation of Brownian motion)** Let  $X_t$  be an Ito process with  $X_0 = 0$ . Then  $X_t$  is a Brownian motion if and only if the two processes  $X_t$  and  $X_t^2 - t$  are continuous martingales.

### Exercises Week 5

**Exercise 1.** (*Bjork 10.1*) Consider the standard Black-Scholes model. Fix the time of maturity  $T$  and consider the following  $T$ -claim  $X$ :

$$X = \begin{cases} K & \text{if } S_T \leq A, \\ K + A - S_T & \text{if } A < S_T < K + A, \\ 0 & \text{if } S_T > K + A. \end{cases}$$

This contract can be replicated using a portfolio consisting solely of bonds, stock, and European call options, which is constant over time. Determine this portfolio as well as the arbitrage free price of the contract.

#### Solution.

We see that the put option with strike  $K + A$  gives the payout

$$P_{K+A}(S_T) = \begin{cases} K + A - S_T & \text{if } S_T \leq A, \\ K + A - S_T & \text{if } A < S_T < K + A, \\ 0 & \text{if } S_T > K + A. \end{cases}$$

Hence this asset will “almost” gives the wanted payout except for the event  $(S_T \leq A)$ . If we find an asset giving the payout  $A - S_T$  if and only if the event  $(S_T \leq A)$  occurs, we may short this asset. It happens that the put with strike  $A$  has the wanted payout that is

$$P_A(S_T) = \begin{cases} A - S_T & \text{if } S_T \leq A, \\ 0 & \text{if } A < S_T < K + A, \\ 0 & \text{if } S_T > K + A. \end{cases}$$

Then making the portfolio of one long position in the put  $P_{K+A}$  and a short position in the put  $P_A$  will replicate  $X$ . We know from the put-call parity that this exact portfolio may be replicated by  $K + A - A = K$  long zero-coupon bonds, long call with strike  $K + A$  and short call with strike  $A$ . Notice no position is taking on the underlying stock since we both go long and short on a put. Let us check if this portfolio give the wanted payout:

$$V_T^h = \begin{cases} K + 0 - 0 = K & \text{if } S_T \leq A, \\ K + 0 - (S_T - A) = K + A - S_T & \text{if } A < S_T < K + A, \\ K + (S_T - K - A) - (S_T - A) = 0 & \text{if } S_T > K + A. \end{cases}$$

Then the portfolio give the desired payout. Given the price process for the call option and the zero-coupon bond we have that the value process is given by

$$\begin{aligned} V_t^h &= Ke^{-r(T-t)} + c(K + A; t, T) - c(A; t, T) \\ &= e^{-r(T-t)} \{K + (K + A)N(d_2(K + A; t, S_t)) - AN(d_2(A; t, S_t))\} \\ &\quad + S_t \{N(d_1(K + A; t, S_t)) - N(d_1(A; t, S_t))\} \end{aligned}$$

with  $d_1$  and  $d_2$  as given in the Black-Scholes formula. The price of the portfolio is given by the above value process.  $\square$

**Exercise 2.** (*Bjork 10.2*) The setup is the same as the previous exercise. Here the contract is a so-called **straddle**, defined by

$$X = \begin{cases} K - S_T & \text{if } 0 < S_T \leq K, \\ S_T - K & \text{if } S_T > K. \end{cases}$$

Determine the constant replicating portfolio as well as the arbitrage free price of the contract.

**Solution.**

We search for portfolio paying the payout above. Recall that a call option with strike  $K$  has payout  $S_T - K$  if  $S_T \geq K$  and a put option with strike  $K$  has payout  $K - S_T$  if  $S_T \leq K$ . Hence by longing one call with strike  $K$  and long one put with strike  $K$  will give the desired payout.

We know that we can replicate this portfolio by buying  $K$  zero-coupon bonds, long two call options with strike  $K$  and shorting the underlying stock. Lets see what this yields

$$V_T^h = \begin{cases} K + 2 \cdot 0 - S_T = K - S_T & \text{if } 0 < S_T \leq K, \\ K + 2 \cdot (S_T - K) - S_T = S_T - K & \text{if } S_T > K. \end{cases}$$

As desired. The price is the then value process with

$$\Pi_t = V_t^h = Ke^{-r(T-t)} + 2c(t, T) - S_t.$$

Giving the desired result.  $\square$

**Exercise 3.** (*Bjork 10.3*) The setup is the same as the previous exercise. We will now study a so-called bull spread (see Fig. 10.7). With this contract we can, to a limited extent, take advantage of an increase in the market price while being protected from a decrease. The contract is defined by

$$X = \begin{cases} B & \text{if } S_T > B, \\ S_T & \text{if } A \leq S_T \leq B, \\ A & \text{if } S_T < A. \end{cases}$$

We have of course the relation  $A < B$ . Determine the constant replicating portfolio as well as the arbitrage free price of the contract.

**Solution.**

Again we search for a replicating portfolio. If we long one stock we get the payout  $S_T$  only and so we want to receive an additional payout on the events  $S_T$  falls outside the interval  $[A, B]$ . We want to have an asset paying  $-(S_T - A)$  on the event  $S_T < A$  and an asset paying  $-(S_T - B)$  on the event  $S_T > B$ . The two assets are: one put with strike  $A$  giving the payout  $A - S_T$  and a short position call option with strike  $B$ . Hence we may replicate the put with  $A$  bonds, one call and a short position. In total we hold  $A$  bonds, one call option with strike  $A$  and a short on a call with strike  $B$ . We will then receive the payout:

$$V_T^h = \begin{cases} A + S_T - A - (S_T - B) = B & \text{if } S_T > B, \\ A + S_T - A - 0 = S_T & \text{if } A \leq S_T \leq B, \\ A + 0 + 0 = A & \text{if } S_T < A. \end{cases}$$

As desired. The value process then give the portfolio price:

$$\Pi_t = V_t^h = Ae^{-r(T-t)} + c(A; t, T) - c(B; t, T)$$

as desired.  $\square$

**Exercise 4.** (*Exam 2017/18, problem 2, question (a)-(b)*) Consider a standard Black-Scholes model, that is, a model consisting of a bank account  $B_t$  with  $P$ -dynamics given by

$$dB_t = rB_t dt, \quad B_0 = 1$$

and a stock  $S_t$  with  $P$ -dynamics given by

$$dS_t = \alpha S_t dt + \sigma S_t d\bar{W}_t, \quad S_0 = s > 0$$

where  $r, \alpha \in \mathbb{R}$  and  $\sigma > 0$  are constants and  $\bar{W}_t$  is a  $P$ -Brownian motion. Let  $T > 0$  be a given and fixed date.

Consider the derivative that at time  $T$  pays

$$X = \max \{ \min \{ S_T, K_2 \}, K_1 \},$$

where  $0 < K_1 < K_2$  are constants.

- a. Determine the arbitrage free price of derivative  $X$  at time  $t < T$ .

Consider a new derivative that at time  $T$  pays

$$Y = (S_T^2 - K^2)^+ - (K^2 - S_T^2)^+.$$

- b.
  - i. Determine the arbitrage free price of derivative  $Y$  at time  $t < T$ .
  - ii. Find a hedging portfolio for derivative  $Y$ .

Let  $h(t) = (h_0(t), h_1(t))$  be a portfolio where

$$h_0(t) = -e^{r(T-2t)+\sigma^2(T-t)} S^2(t)$$

is the number of units in the bank account at time  $t$  and

$$h_1(t) = 2e^{(r+\sigma^2)(T-t)} S(t)$$

is the number of shares in the stock at time  $t$ . Let  $V^h(t)$  denote the associated value process.

- c. Determine whether the portfolio  $h$  is self-financing or not.
- d. Compute  $V^h(T)$ .

**Solution (a).**

We see that the derivative is the bull spread given by the payout function

$$X = \begin{cases} K_2 & \text{if } S_T > K_2, \\ S_T & \text{if } K_1 \leq S_T \leq K_2, \\ K_1 & \text{if } S_T < K_1. \end{cases}$$

We know from exercise 10.3 that this can be replicated by holding  $K_1$  bonds, one call option with strike  $K_1$  and a short on a call with strike  $K_2$ . The arbitrage free price of the derivative is then the value process of the mentioned portfolio i.e.

$$\Pi_t[X] = K_1 e^{-r(T-t)} + c(K_1; t, T) - c(K_2; t, T),$$

where  $c$  denotes the pricing function for a European call option (non-instructive parameters suppressed).  $\square$

**Solution (b).**

(i): We start by seeing that the derivative pays out

$$Y = \begin{cases} S_T^2 - K^2 & \text{if } S_T^2 \geq K^2, \\ -(K^2 - S_T^2) & \text{if } S_T^2 < K^2. \end{cases}$$

hence the payout is  $Y = S_T^2 - K^2 = \Phi(S_T)$  where  $\Phi(s) = s^2 - K^2$ . That is  $Y$  is in fact a simple claim. We have from the risk neutral valuation formula 7.11 that

$$\begin{aligned} \Pi_t[Y] &= e^{-r(T-t)} E_{t,s}^Q[S_T^2 - K^2] \\ &= e^{-r(T-t)} E_{t,s}^Q[S_T^2] - e^{-r(T-t)} K^2. \end{aligned}$$

Recall that under the martingale measure  $Q$  we have that  $S_t$  is a GBM hence

$$S_t = s \cdot \exp \left\{ \left( r - \frac{1}{2} \sigma^2 \right) (T-t) + \sigma (W_T^Q - W_t^Q) \right\}$$

then

$$S_T^2 = s^2 \cdot \exp \left\{ 2 \left( r - \frac{1}{2} \sigma^2 \right) (T-t) + 2\sigma (W_T^Q - W_t^Q) \right\}.$$

Inserting this into the risk neutral valuation formula we get

$$\begin{aligned} \Pi_t[Y] &= e^{-r(T-t)} E_{t,s}^Q[S_T^2] - e^{-r(T-t)} K^2 \\ &= e^{-r(T-t)} s^2 e^{2(r - \frac{1}{2}\sigma^2)(T-t)} E^Q \left[ \exp \left\{ 2\sigma (W_T^Q - W_t^Q) \right\} \right] - e^{-r(T-t)} K^2 \\ &= e^{-r(T-t)} s^2 e^{2(r - \frac{1}{2}\sigma^2)(T-t)} e^{\frac{1}{2}4\sigma^2(T-t)} - e^{-r(T-t)} K^2 \\ &= e^{-r(T-t)} \left( s^2 e^{(2r - \sigma^2)(T-t) + \frac{1}{2}4\sigma^2(T-t)} - K^2 \right) \\ &= e^{-r(T-t)} \left( s^2 e^{(2r + \sigma^2)(T-t)} - K^2 \right). \end{aligned}$$

The arbitrage free price of the derivative is then given above.  $\square$

(ii): From theorem 8.5 we can determine a hedging portfolio with weightings

$$\begin{aligned}
w_t^B &= \frac{\Pi_t - S_t \frac{\partial \Pi}{\partial s}}{\Pi_t} \\
&= 1 - \frac{S_t 2S_t e^{-r(T-t)} e^{(2r+\sigma^2)(T-t)}}{e^{-r(T-t)} (S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2)} \\
&= 1 - \frac{2S_t^2 e^{(2r+\sigma^2)(T-t)}}{S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2} \\
&= 1 - \frac{2}{1 - K^2 S_t^{-2} e^{(2r+\sigma^2)(t-T)}} \\
w_t^S &= \frac{2}{1 - K^2 S_t^{-2} e^{(2r+\sigma^2)(t-T)}}.
\end{aligned}$$

In absolute terms we will hold the portfolio

$$\begin{aligned}
h_t^S &= 2S_t e^{-r(T-t)} e^{(2r+\sigma^2)(T-t)} \\
h_t^B &= \frac{e^{-r(T-t)} (S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2) - S_t h_t^S}{B_t} \\
&= \frac{e^{-r(T-t)} (S_t^2 e^{(2r+\sigma^2)(T-t)} - K^2) - S_t h_t^S}{e^{rt}} \\
&= e^{-rT} S_t^2 e^{(2r+\sigma^2)(T-t)} - e^{-rT} K^2 - e^{-rt} S_t h_t^S.
\end{aligned}$$

The portfolio above will hedge  $Y$  with probability one.  $\square$

**Exercise 5.** (*Exam 2019/20, problem 2*)

**Solution.**

**Exercise 6.** (*Exam 2020/21, problem 2, question (a)-(b)*)

**Solution.**

**Exercise 7.** (*Exam 2020/21, problem 3, question (b)*)

**Solution.**

**Extra-Exercise 1.** (*Bjork 10.4*)

**Solution.**

## Week 6

### Table of Contents

- Black-Scholes model, martingale approach (Chapter 13)
- Multidimensional models (Chapter 14)
- Exercises

### Theory

**Black-Scholes model - martingale approach** We consider the standard Black-Scholes model with a single risk free asset and risky asset with dynamics

$$\begin{aligned} dS_t &= \mu S_t dt + \sigma S_t dW_t, \\ dB_t &= r B_t dt. \end{aligned}$$

We want check whether the model is arbitrage free on any time interval  $[0, T]$ , and find a (perhaps unique) martingale measure such that we may apply the fundamental pricing theorem 1 and 2. From Girsanov this endeavour is equivalent with searching for a (perhaps unique) Girsanov kernel  $\varphi$ . We therefore define as usual the likelihood process

$$dL_t = \varphi_t L_t dW_t,$$

and setting  $dQ = L_T dP$  on  $\mathcal{F}_T$ , we know from Girsanov theorem that

$$dW_t = \varphi_t dt + dW_t^Q.$$

Inserting into the Black-Scholes model we have

$$dS_t = S_t(\mu + \sigma\varphi_t) dt + \sigma S_t dW_t^Q.$$

We know that for  $Q$  to be a martingale measure we know that the local rate of return under  $Q$  of  $S$  must be the short rate  $r$  i.e. we have

$$\mu + \sigma\varphi_t = r \iff \varphi_t = \frac{r - \mu}{\sigma} = -\frac{\mu - r}{\sigma},$$

and so we see the Girsanov kernel is **constant and deterministic**. The process has the economic interpretation that the Girsanov kernel is the risk premium per unit volatility.

**Lemma 13.1.** The Girsanov kernel  $\varphi$  is given by

$$\varphi = -\lambda$$

where the market price of risk  $\lambda$  is defined by

$$\lambda = \frac{r - \mu}{\sigma}.$$

We therefore have determined a *martingale* and so we have the result.

**Theorem 13.2.** The Black-Scholes model above is arbitrage free.

We could in general have that  $\mu, \sigma, r$  are adapted processes. If this is the case we would have to show the Novikov condition.

Pricing then of any  $T$ -claim  $X$  then is given by the risk neutral pricing formula

$$\Pi_t[X] = e^{-r(T-t)} E^Q[X \mid \mathcal{F}_t],$$

where the  $Q$  dynamics of  $S$  has local drift  $r$  and volatility from the  $Q$ -brownian motion  $W^Q$ .

**Theorem 13.3.** The Black-Scholes model above is complete. This also holds for the more general model where  $r, \mu, \sigma$  are adapted processes.

Hedging is the possible by considering a  $T$  claim with

$$E^Q \left[ \frac{X}{B_T} \right] < \infty.$$

Notice the numeraire  $B_t$  as in the normalized  $Z$ -economy. Consider now the  $Q$ -martingale

$$M_t = E^Q \left[ \frac{X}{B_T} \mid \mathcal{F}_t \right],$$

and it now follows from lemma 11.15 the the model is complete if we can find a process  $h_t^1$  such that

$$dM_t = h_t^1 dZ_t^i.$$

In order to prove existence of such a process  $h^1$  we use the Martingale Representation Theorem 12.2, which says that there *exists* a process  $g_t$  such that

$$dM_t = g_t dW_t^Q.$$

We can now combine these two equation by the following  $Q$  dynamics

$$dZ_t^1 = Z_t^1 \sigma dW_t^Q.$$

Hence we have

$$dM_t = h_t^1 Z_t^1 \sigma dW_t^Q = g_t dW_t^Q \Rightarrow h_t^1 = \frac{g_t}{Z_t^1 \sigma}.$$

**Theorem 13.4.** In the Black-Scholes model every  $T$ -claim  $X$  satisfying

$$E^Q \left[ \frac{X}{B_T} \right] < \infty$$

can be replicated. The replicating portfolio is given by

$$\begin{aligned} h_t^1 &= \frac{g_t}{Z_t^1 \sigma}, \\ h_t^0 &= M_t - h_t^1 Z_t^1, \end{aligned}$$

where  $M$  is defined by the above and  $g$  is defined by above.

If the  $T$ -claim is simple that is  $X = \Phi(S_T)$  we may solve a boundary value problem with Feymann-Kac to arrive at the familiar result.

**Theorem 13.5.** In the Black-Scholes model every  $T$ -claim on the form  $X = \Phi(S_T)$ . Then  $X$  can be replicated by the portfolio

$$\begin{aligned} h_t^0 &= \frac{F(t, S_t) - S_t \frac{\partial F}{\partial s}(t, S_t)}{B_t}, \\ h_t^1 &= \frac{\partial F}{\partial s}(t, S_t), \end{aligned}$$

where  $F$  solves the **Black-Scholes equation**

$$\begin{aligned} \frac{\partial F}{\partial t}(t, s) + rs \frac{\partial F}{\partial s}(t, s) + \frac{1}{2} \sigma^2 s^2 \frac{\partial^2 F}{\partial s^2}(t, s) - rF(t, s) &= 0, \\ F(T, s) &= \Phi(s). \end{aligned}$$

Furthermore the value process for the replicating portfolio is given by

$$V_t = F(t, S_t).$$

**Multidimensional models** We specify the general model by the assumptions below.

**Assumption 14.0.1** We assume the following:

- There are  $n$  risky assets  $S^1, \dots, S^n$ .
- Under the objective probability measure  $P$ , the  $S$ -dynamics are given by

$$dS_t^i = \mu_t^i S_t^i dt + S_t^i \sum_{j=1}^N \sigma_t^{ij} dW_t^j,$$

for  $i = 1, \dots, n$ .

- The coefficients processes  $\mu^i$  and  $\sigma^{ij}$  above are assumed to be adapted.
- We have a standard risk free asset with price process  $B$  with dynamics

$$dB_t = r_t B_t dt,$$

where the short rate process  $r$  is assumed to be an adapted stochastic process.

We can use the representation of  $\mu^i$ ,  $\sigma^{ij}$  and  $S^i$  as vectors and matrices on the form.

$$\mu = \begin{bmatrix} \mu^1 \\ \vdots \\ \mu^n \end{bmatrix}, \quad \sigma = \begin{bmatrix} \sigma^{1,1} & \dots & \sigma^{1,N} \\ \vdots & \ddots & \vdots \\ \sigma^{n,1} & \dots & \sigma^{n,N} \end{bmatrix}, \quad D(S) = \begin{bmatrix} S^1 & \dots & 0 \\ \vdots & \ddots & \vdots \\ 0 & \dots & S^n \end{bmatrix}.$$

And so we have the model on compact form.

$$\begin{aligned} dS_t &= D(S_t) \mu_t dt + D(S_t) \sigma_t dW_t, \\ dB_t &= r_t B_t dt. \end{aligned}$$

Now using Girsanov Theorem we can define the prospective likelihood process  $L$  by

$$\begin{aligned} dL_t &= L_t \varphi_t^\top dW_t, \\ L_0 &= 1, \end{aligned}$$

where  $\varphi$  is an adapted  $N$ -dimensional process. Then our candidate martingale measure  $Q$  is given by  $dQ = L_t dP$  on  $\mathcal{F}_t$  and the Girsanov theorem give the dynamics

$$dW_t = \varphi_t dt + dW_t^Q,$$



where  $W^Q$  is a standard  $Q$ -Brownian motion. Inserting into the  $P$ -dynamics we obtain.

$$dS_t = D(S_t)[\mu_t + \sigma_t \varphi_t] dt + D(S_t)\sigma_t dW_t^Q.$$

From (11.54) we know that  $Q$  is a martingale measure if and only if the local rate of return (the  $dt$ -term) is the short interest rate i.e. if and only if

$$\mu_t + \sigma_t \varphi_t = \mathbf{r}_t,$$

where  $\mathbf{r}_t = [r, \dots, r]^\top \in \mathbb{R}^n$ . We then have that

$$\sigma_t \varphi_t = \mathbf{r}_t - \mu_t, \quad (14.11)$$

where we want to solve for  $\varphi$ . Thus we may write a condition for the absence of arbitrage in linear algebra terms.

**Proposition 14.1.** A necessary condition for absence of arbitrage is that

$$\mathbf{r}_t - \mu_t \in \text{Im}[\sigma_t]$$

with probability one for each  $t$ . A sufficient condition for absence of arbitrage is that there exists a process  $\varphi$  which solves (14.11) and such that  $L$  is a martingale.

Note that it is not enough for  $\varphi$  to solve (14.11). We also need that  $L$  is a martingale.

**Definition 14.2.** A Girsanov kernel  $\varphi$  is said to be **admissible** if it generates a martingale measure, i.e. it solves (14.11) and  $L$  is a true martingale.

**Definition 14.3.** The model above is said to be **generically arbitrage free** if it is arbitrage free for every choice of  $\mu$ .

**Proposition 14.4.** Disregarding integrability problems the model is generically arbitrage free if and only if, for each  $t \leq T$  and  $P$ -a.s., the mapping

$$\sigma_t : \mathbb{R}^B \rightarrow \mathbb{R}^n$$

is surjective, i.e. if and only if the volatility matrix  $\sigma_t$  has rank  $n$ .

**Proposition 14.5.** Assume that the model is generically arbitrage free and that the filtration  $\mathbf{F}$  is defined by

$$\mathcal{F}_t = \mathcal{F}_t^W.$$

Then, disregarding integrability problems, the model is complete if and only if  $n = N$  and the volatility matrix  $\sigma_t$  is invertible  $P$ -a.s. for each  $t \leq T$ .

**Assumption 14.3.1.** We assume that the model is generically free of arbitrage, i.e. that

$$\text{Im}[\sigma_t] = \mathbb{R}^n,$$

for all  $t$  and with probability one. We also assume that the model is purely Brownian driven, i.e. that  $\mathcal{F}_t = \mathcal{F}_t^W$ .

**Proposition 14.6.** Under assumption 14.3.1 the model is complete if and only if

$$\text{Im}[\sigma_t^\top] = \mathbb{R}^N.$$

If the model is complete then, using the notation of chapter 11, the replicating portfolio  $[h^0, h^S]$  is given by

$$\begin{aligned} h_t^S &= g_t \sigma_t^{-1} D^{-1}(Z_t), \\ h_t^2 &= M_t - h_t^S Z_t. \end{aligned}$$

With  $M_t$  defined by

$$M_t = E^Q \left[ \frac{\mathcal{X}}{B_T} \mid \mathcal{F}_t \right].$$

**Theorem 14.7. (The Second Fundamental Theorem)** Under assumptions 14.3.1 the model is complete if and only if the martingale measure is unique. This is equivalent with the statements:  $\text{Ker}[\sigma_t] = \{0\}$ ,  $\text{Im}[\sigma_t^\top] = \mathbb{R}^N$  and  $\sigma_t^{-1}$  exists (i.e.  $\sigma_t$  is invertible).

Pricing of any  $T$ -claim  $\mathcal{X}$  is now given by the risk neutral valuation formula

$$\Pi_t[\mathcal{X}] = E^Q \left[ e^{-\int_t^T r_u du} \mathcal{X} \mid \mathcal{F}_t \right],$$

where  $Q$  is some choice of martingale measure. Alternatively we can write the price as

$$\Pi_t[\mathcal{X}] = E^Q \left[ \frac{\mathbf{M}_T}{\mathbf{M}_t} \mathcal{X} \mid \mathcal{F}_t \right],$$

where  $\mathbf{M}$  is the stochastic discount factor, defined by

$$\mathbf{M}_t = \frac{1}{B_t} L_t.$$

If we have a simple claim i.e. of the form  $\mathcal{X} = \Phi(S_t)$  and if  $S$  is Markovian we have

$$e^{-r(T-t)} E^Q[\Phi(S_t) \mid \mathcal{F}_t] = e^{-r(T-t)} E^Q[\Phi(S_t) \mid S_t],$$

and then the pricing process must be of the form  $\Pi_t[\Phi] = F(t, S_t)$ . We then have  $F$  to be the solutions to the PDE

$$\begin{aligned} F_t(t, s) + \sum_{i=1}^n r s_i F_i(t, s) + \frac{1}{2} \text{tr} \{ \sigma^\top D(S) F_{ss} D(S) \sigma \} - r F(t, s) &= 0, \\ F(T, s) &= \Phi(s), \end{aligned}$$

where  $F_i = \frac{\partial F}{\partial s_i}$  and  $F_{ss}$  denotes the Hessian matrix. Furthermore,  $\text{tr}(A)$  denotes the trace of  $A$  i.e. the sum of the diagonal. We have that the hedging portfolio has value process  $V_t^h = F(t, S_t)$  with dynamics

$$dV_t^h = \sum_{i=1}^n F_i(t, S_t) dS_t^i.$$

Then we must have the solution

$$h_t^i = \frac{\partial F}{\partial s_i}(t, S_t), \quad i = 1, \dots, n,$$

$$h_t^0 = \frac{1}{B_t} \left\{ F(t, S_t) - \sum_{i=1}^n \frac{\partial F}{\partial s_i}(t, S_t) S_t^i \right\}.$$

**Proposition 14.8.** With  $L$ -dynamics as in  $dL_t = L_t \varphi_t^\top dW_t$ , the  $\mathbf{M}$ -dynamics are

$$d\mathbf{M}_t = -r_t \mathbf{M}_t dt + \mathbf{M}_t \varphi_t^\top dW_t,$$

or alternatively in terms of the market price of risk  $\lambda_t = -\varphi_t$

$$d\mathbf{M}_t = -r_t \mathbf{M}_t dt - \mathbf{M}_t \lambda_t^\top dW_t.$$

**Proposition 14.9. (The Hansen-Jagannathan Bounds)** Assume generic absence of arbitrage. Then the following holds for all assets, underlying or derivative, and for all admissible Girsanov kernels  $\varphi$ , and market prices of risk  $\lambda$ .

$$\frac{|\mu_t^p - r_t|}{\|\sigma_t^p\|} \leq \|\varphi_t\|, \quad \frac{|\mu_t^p - r_t|}{\|\sigma_t^p\|} \leq \|\lambda_t\|.$$

## Exercises Week 6

**Exercise 1.** (*Exam 2017/18, problem 1, question (c)*) Let  $W_t$  denote a Brownian motion and let

$$\mathcal{F}_t = \mathcal{F}_t^W = \sigma(\{W_s \mid 0 \leq s \leq t\}).$$

Let  $T > 0$  be a given and fixed time.

Let  $f(t)$  be a bounded deterministic continuous function. Define the two processes

$$\begin{cases} X_t = \int_0^t f(u) dW_u, \\ M_t^{(\lambda)} = \exp \left\{ \lambda X_t - \frac{\lambda^2}{2} \int_0^t f^2(u) du \right\}, \end{cases}$$

where  $\lambda \in \mathbb{R}$  is a constant.

c. Compute the mean value of  $M_T^{(\lambda)} \log(M_T^{(\lambda)})$ .

**Solution (c).**

We recall the definition of  $M_t^{(\lambda)}$  and observe that

$$\log M_t^{(\lambda)} = \lambda X_t - \frac{\lambda^2}{2} \int_0^t f^2(u) du.$$

Furthermore we have the dynamics of  $M^{(\lambda)}$  given by the differential form

$$dM_t^{(\lambda)} = \lambda f(t) M_t^{(\lambda)} dW_t.$$

with  $M_0^{(\lambda)} = 1$ . Since we know that  $M_t^{(\lambda)}$  is a martingale we have

$$E^P[M_T^{(\lambda)}] = E^P[M_0^{(\lambda)}] = 1,$$

and so we may define a new probability measure as

$$d\tilde{P} = M_T^{(\lambda)} dP$$

on  $\mathcal{F}_T$ . We then have a new Brownian motion  $\tilde{W}$  such that

$$dW_t = \lambda f(t) dt + d\tilde{W}_t.$$

We can then see

$$\begin{aligned} E^P[M_T^{(\lambda)} \log M_T^{(\lambda)}] &= \int M_T^{(\lambda)} \log M_T^{(\lambda)} dP = \int M_T^{(\lambda)} \log M_T^{(\lambda)} \frac{1}{M_T^{(\lambda)}} d\tilde{P} \\ &= \int \log M_T^{(\lambda)} d\tilde{P} = E^{\tilde{P}}[\log M_T^{(\lambda)}]. \end{aligned}$$

Then we can evaluate the mean value by seeing the  $X$  has representation wrt.  $\tilde{P}$  by

$$X_t = \int_0^t f(u) (\lambda f(u) du + d\tilde{W}_u) = \lambda \int_0^t f^2(u) du + \int_0^t f(u) d\tilde{W}_u.$$

Giving that

$$\begin{aligned} E^P[M_T^{(\lambda)} \log M_T^{(\lambda)}] &= E^{\tilde{P}}[\log M_T^{(\lambda)}] \\ &= E^{\tilde{P}} \left[ \lambda X_T - \frac{1}{2} \lambda^2 \int_0^T f^2(u) du \right] \\ &= E^{\tilde{P}} \left[ \lambda^2 \int_0^T f^2(u) du + \lambda \int_0^T f(u) d\tilde{W}_u - \frac{1}{2} \lambda^2 \int_0^T f^2(u) du \right] \\ &= \lambda E^{\tilde{P}} \left[ \frac{1}{2} \lambda \int_0^T f^2(u) du + \int_0^T f(u) d\tilde{W}_u \right] \\ &= \frac{1}{2} \lambda^2 \int_0^T f^2(u) du + \lambda E^{\tilde{P}} \left[ \int_0^T f(u) d\tilde{W}_u \right] \\ &= \frac{1}{2} \lambda^2 \int_0^T f^2(u) du \end{aligned}$$

Since

$$\tilde{X}_T = \int_0^T f(u) d\tilde{W}_u,$$

is a  $\tilde{P}$ -martingale.  $\square$

**Exercise 2.** (Exam 2018/19, problem 2, question (b)i and (c)-(d))

**Solution.**

**Exercise 3.** (Exam 2019/20, problem 1, question (b)-(c))

**Solution.**

**Exercise 4.** (Exam 2019/20, problem 3, question (b))

**Solution.**

**Exercise 5.** (Exam 2020/21, problem 1, question (c))

**Solution.**

**Exercise 6.** (Exam 2020/21, problem 2, question (c)-(d))

**Solution.**

## Week 7

### Table of Contents

- Pricing and proof of fundamental pricing theorem I and II (Chapter 11)
- Incomplete Markets (Chapter 9)
- Exercises

### Theory

**Fundamental pricing theorem I and II** We start by stating the following theorem.

**Theorem 11.1.** If at least one of the assets  $S^1, \dots, S^N$  has diffusion term which is non-zero at all times, and if naive portfolio strategies are admitted, then the model admits arbitrage.

We will go as follows. Derive the fundamental pricing theorem 1 and 2 in a setting with zero interest rate. Then we will extend the result in general by choosing a simple numeraire. We start by defining some basic notation.

**Definition 11.2.** Define the process  $h$  as

$$h = [h^0, h^S] := [h^0, h^1, \dots, h^N]$$

We define the following.

- For a process  $h$ , its **value process**  $V_t^h$  is defined by

$$V_t^h = h_t^0 \cdot 1 + \sum_{i=1}^N h_t^i S_t^i,$$

or in compact form

$$V_t^h = h_t^0 \cdot 1 + h_t^S S_t$$

- An adapted process  $h^S$  is called **admissible** if there exists a non-negative real number  $\alpha$  (which may depend on the choice of  $h^S$ ) such that

$$\int_0^t h_u^S dS_u \geq -\alpha,$$

for all  $t \in [0, T]$ . A process  $h$ , is called an **admissible portfolio process** if  $h^S$  is admissible.

- An admissible portfolio is said to be **self-financing**, if

$$V_t^h = V_0^h + \int_0^t h_u^S dS_u,$$

i.e. if

$$dV_t^h = h_t^S dS_t.$$

**Lemma 11.3.** For any adapted process  $h^S$  satisfying the admissibility condition above, and for any real number  $x$ , there exists a unique adapted process  $h^0$ , such that:

- The process  $h$  defined by  $h = [h^0, h^S]$  is self-financing.
- The value process is given by

$$V_t^h = x + \int_0^t h_u^S dS_u.$$

In particular, the space  $\mathcal{K}_0$  of portfolio values, reachable at time  $T$  by means of a self-financing portfolio with zero initial cost is given by

$$\mathcal{K}_0 = \left\{ \int_0^T h_t^S dS_t : h^S \text{ is admissible} \right\}.$$

**Definition 11.4.** A probability measure  $Q$  on  $\mathcal{F}_T$  is called **equivalent martingale measure** for the market model, the numeraire  $S^0$ , and the time interval  $[0, T]$ , if it has the following properties:

- $Q \sim P$  on  $\mathcal{F}_T$ , so  $P$  and  $Q$  are equivalent.
- All price processes  $S^0, S^1, \dots, S^N$  are martingales under  $Q$  on the time interval  $[0, T]$ .

An equivalent martingale measure will often be referred to as just “a martingale measure” or as “an EMM”. If  $Q \sim P$  has the property that  $S^0, S^1, \dots, S^N$  are local martingales, then  $Q$  is called a **local martingale measure**.

**Theorem 11.5. (The First Fundamental Theorem)** The model is arbitrage free “essentially” if and only if there exists a (local) martingale measure  $Q$ .

**Definition 11.6.** With the notation above, we say that the model admits

- **No Arbitrage (NA)** if

$$\mathcal{C} \cap L_+^\infty = \{0\},$$

- **No Free Lunch with Vanishing Risk (NFLVR)** if

$$\tilde{\mathcal{C}} \cap L_+^\infty = \{0\},$$

where  $\tilde{\mathcal{C}}$  denotes the closure of  $\mathcal{C}$  in  $L^\infty$ .

**Theorem 11.7. (Kreps-Yan Separation Theorem)** If  $\mathcal{C}$  is weak\* closed, and if

$$\mathcal{C} \cap L_+^\infty = \{0\},$$

then there exists a random variable  $L \in L^1$  such that  $L$  is  $P$  almost surely strictly positive, and

$$E^P[L \cdot X] \leq 0,$$

for all  $X \in \mathcal{C}$ .

**Proposition 11.8.** If the asset price processes are uniformly bounded, then the condition NFLVR implies that  $\mathcal{C}$  is weak\* closed.

**Theorem 11.9. (First Fundamental Theorem)** Assume that the asset price process  $S$  is bounded. Then there exists an equivalent martingale measure if and only if the model satisfies NFLVR.

**Theorem 11.10. (First Fundamental Theorem)** Assume that the asset price process  $S$  is locally bounded. Then there exists an equivalent martingale measure if and only if the model satisfies NFLVR.

**Assumption 11.4.1.** We assume that  $S_t^0 > 0$   $P$ -a.s. for all  $t \geq 0$ .

**Definition 11.11.** The **normalized economy** (also referred to as the “Z-economy”) is defined by the price vector process  $Z$ , where

$$Z_t = \frac{S_t}{S_t^0}.$$

**Definition 11.12.**

- A **portfolio strategy** is any adapted  $(N + 1)$ -dimensional process

$$h_t = [h_t^0, h_t^1, \dots, h_t^N].$$

- The **S-value process**  $V_t^S$  corresponding to the portfolio  $h$  is  $h_t S_t$ .
- The **Z-value process**  $V_t^Z$  corresponding to the portfolio  $h$  is  $h_t Z_t$ .
- A portfolio is said to be **admissible** if it is admissible as an  $Z$  portfolio.
- An admissible portfolio is **S-self-balancing** if

$$dV_t^S = \sum_{i=0}^N h_t^i dS_t^i$$

- An admissible portfolio is **Z-self-balancing** if

$$dV_t^Z = \sum_{i=0}^N h_t^i dZ_t^i.$$

**Lemma 11.13. (Invariance Lemma)** With assumptions as above, the following hold.

- A portfolio  $h$  is S-self-financing if and only if it is Z-self-financing.
- The value processes  $V^S$  and  $V^Z$  are connected by

$$V_t^Z = \frac{1}{S_t^0} \cdot V_t^S.$$

- A claim  $\mathcal{Y}$  is S-replicable if and only if the claim

$$\frac{\mathcal{Y}}{S_T^0}$$

is Z-replicable.

- The model is S arbitrage free if and only if it is Z arbitrage free.

**Theorem 11.14. (The First Fundamental Theorem)** Consider the market model  $S^0, S^1, \dots, S^N$  where we assume that  $S_t^0 > 0$ ,  $P$ -a.s. for all  $t \geq 0$ . Assume furthermore that  $S^0, S^1, \dots, S^N$  are locally bounded. Then the following conditions are equivalent:

- The model satisfies NFLVR.
- There exists a measure  $Q \sim P$  such that the processes

$$Z^0, Z^1, \dots, Z^N,$$

are local martingales under  $Q$ .

**Completeness Lemma 11.15.** Consider a given  $T$ -claim  $X$ . Fix a martingale measure  $Q$  and assume that the normalized claim  $X/S_T^0$  is integrable. If the  $Q$ -martingale  $M$ , defined by

$$M_t = E^Q \left[ \frac{X}{S_T^0} \middle| \mathcal{F}_t \right],$$

admits an integral representation of the form

$$M_t = x + \sum_{i=1}^N \int_0^t h_s^i dZ_s^i,$$

then  $X$  can be hedged in the S-economy. Furthermore, the replicating portfolio  $(h^0, h^1, \dots, h^N)$  is given by the above for  $h^i$ ,  $i = 1, \dots, N$  and  $h_t^0 = M_t - \sum_{i=1}^N h_t^i Z_t^i$ .

**Theorem 11.16. (Jacod)** Let  $\mathcal{M}$  denote the convex set of equivalent martingale measures. Then, for any fixed  $Q \in \mathcal{M}$ , the following statements are equivalent:

- Every  $Q$  local martingale  $M$  has dynamics of the form

$$dM_t = \sum_{i=1}^N h_s^i dZ_s^i.$$

- $Q$  is an extremal point of  $\mathcal{M}$ .

**Theorem 11.17. (The Second Fundamental Theorem)** Assume that the market is arbitrage free and consider a fixed numeraire asset  $S^0$ . Then the market is complete if and only if the martingale measure  $Q$ , corresponding to the numeraire  $S^0$ , is unique.

**Stochastic Discount Factors Definition 11.22.** Assume the existence of a short rate  $r$ . For any fixed martingale measure  $Q$ , let the likelihood process  $L$  be defined by

$$L_t = \frac{dQ}{dP}, \text{ on } \mathcal{F}_t.$$

The **stochastic discount factor** (SDF) process  $\mathbf{M}$ , corresponding to  $Q$ , is defined as

$$\mathbf{M}_t = e^{-\int_0^t r(s) ds} L_t \quad \left( = \frac{1}{B_t} \cdot L_t \right).$$

**Proposition 11.23.** Assume absence of arbitrage. With notation as above, the following hold:

- For any sufficiently integrable  $T$ -claim  $X$ , the arbitrage free price is given by

$$\Pi_t[X] = E^P \left[ \frac{\mathbf{M}_T}{\mathbf{M}_t} X \middle| \mathcal{F}_t \right].$$

- For any arbitrage free asset price process  $S$  (derivative or underlying) the process  $\mathbf{M}_t S_t$  is a (local)  $P$ -martingale.
- The  $P$ -dynamics of  $\mathbf{M}$  are given by

$$d\mathbf{M}_t = -r_t \mathbf{M}_t dt + \frac{1}{B_t} dL_t.$$



**Summary Theorem 11.24.**

**Proposition 11.25.**

**Theorem 11.26.**

**Proposition 11.27.**

**Incomplete Markets** We assume a market with a risk free asset and one risky assets with dynamics

$$dX_t = \mu(t, X_t) dt + \sigma(t, X_t) dW_t.$$

We want to find a unique price of a derivative on a functional form of the risky asset. We assume that we cannot invest in the asset representing the process  $X_t$  and so we can solely write contracts based on the observation  $X_T$ . The problem here is that we can only short or long the risk free asset and so no derivative is replicable.

The way we solve this problem is by having the market set the price of risk and universally price derivatives based on this given price process. We then have the assumptions

**Assumption 9.2.1** We have the market given with the only investable asset  $B$  with dynamics

$$dB_t = rB_t dt.$$

We furthermore, have an empirically observable stochastic process  $X$  which is **not** the price process of any traded asset. The  $P$ -dynamics of  $X$  is given by

$$dX_t = \mu(t, X_t) dt + \sigma(t, X_t) dW_t.$$

**Assumption 9.2.2** There is a liquid market for every contingent claim.

**Assumption 9.2.3** We assume that

- There is a liquid, frictionless market for each of the contingent claims  $\mathcal{Y}$  and  $\mathcal{Z}$ .
- The market prices of the claims are of the form

$$\Pi_t[\mathcal{Y}] = F(t, X_t),$$

$$\Pi_t[\mathcal{Z}] = G(t, X_t),$$

where  $F$  and  $G$  are smooth real valued function.

From Ito's formula we have the dynamics

$$dF = \mu_F F dt + \sigma_F F dW,$$

$$dG = \mu_G G dt + \sigma_G G dW.$$

Where the processes  $\mu_F$  and  $\sigma_F$  are given by

$$\mu_F = \frac{F_t + \mu F_x + \frac{1}{2}\sigma^2 F_{xx}}{F},$$

$$\sigma_F = \frac{\sigma F_x}{F}.$$

By forming a portfolio of the two contracts we lead to the relation.

$$\frac{\mu_F - r}{\sigma_F} = \frac{\mu_G - r}{\sigma_G}.$$

This gives the important insight.

**Proposition 9.1.** Assume that the market for derivatives is free of arbitrage. Then there exists a universal process  $\lambda(t, X_t)$  such that, with probability one, and for all  $t$ , we have

$$\frac{\mu_F(t, X_t) - r}{\sigma_F(t, X_t)} = \mu(t, X_t),$$

regardless of the specific choice of the derivative  $F$ .

**Proposition 9.2.** Assume absence of arbitrage, the pricing function  $F(t, x)$  of the  $T$ -claim  $\Phi(X_T)$  solves the following boundary value problem.

$$\begin{aligned} F_t(t, x) + \mathcal{A}F(t, x) - rF(t, x) &= 0, & (t, x) &\in (0, T) \times \mathbb{R}, \\ F(T, x) &= \Phi(x), & x &\in \mathbb{R}, \end{aligned}$$

where

$$\mathcal{A}F(t, x) = \{\mu(t, x) - \lambda(t, x)\sigma(t, x)\} F_x(t, x) + \frac{1}{2}\sigma^2(t, x)F_{xx}(t, x).$$

**Proposition 9.3. (Risk neutral valuation)** Assuming absence of arbitrage, the pricing function  $F(t, x)$  of the  $T$ -claim  $\Phi(X_T)$  is given by the formula

$$F(t, x) = e^{-r(T-t)} E_{t,x}^Q[\Phi(X_T)].$$

The dynamics of  $X$  under the martingale measure  $Q$  are given by

$$dX_t = \{\mu(t, x) - \lambda(t, x)\sigma(t, x)\} F_x(t, x) + \sigma(t, x) dW_t^Q,$$

where  $W^Q$  is a  $Q$ -Brownian motion.

## Exercises Week 7

**Exercise 1.** (Exam 2018/19, problem 2, question (b).ii)

**Solution.**

**Exercise 2.** (Exam 2017/18, problem 3)

**Solution.**

**Exercise 3.** (Exam 2018/19, problem 3)

**Solution.**

**Exercise 4.** (Exam 2019/20, problem 3, question (a) and (c)-(e))

**Solution.**

**Exercise 5.** (Exam 2020/21, problem 3, question (a) and (c))

**Solution.**