

Exercise 1:

1. Let (B^1, B^2) be two independent Brownian motions.

- a) (2 points) Find for $\rho \in [-1, 1]$ constants a and b such that

$$W^1 := B^1 \text{ and } W^2 := aB^1 + bB^2$$

satisfy $[W^1]_t = [W^2]_t = t$ and $[W^1, W^2]_t = \rho t$. Compute $\text{corr}(W_t^1, W_t^2)$.

- b) (2 points) Consider adapted and left-continuous bounded processes x_s, y_s, z_s and v_s . Define

$$X_t := \int_0^t x_s dW_s^1, \quad Y_t := \int_0^t y_s dW_s^2,$$

$$Z_t := \int_0^t z_s dX_s, \quad V_t := \int_0^t v_s dY_s.$$

Find $[Z, V]_t, t > 0$.

a)

$$\begin{aligned} \rho t &= [W^1, W^2] \\ &= [B^1, aB^1 + bB^2] \\ &, \text{ since the quadratic covariation is bilinear in its arguments} \\ &= a[B^1, B^1] + b \underbrace{[B^1, B^2]}_{=0, \text{ since } B^1 \text{ and } B^2 \text{ independent}} \\ &= a[B^1] \\ &= at \\ \Rightarrow a &= \rho \end{aligned}$$

Exercise 2:

2. Kunita Watanabe decomposition, hedging with correlated assets.

- a) (2 points) Consider two martingales $N, M \in \mathcal{M}^{2,c}$ and denote by $N_t = N_0 + \int_0^t H_s dM_s + L_t, t \leq T$, the Kunita Watanabe decomposition of N wrt M . Show that the integrand H satisfies the relation

$$[M, N]_t = \int_0^t H_s d[M]_s, \quad t \leq T.$$

Suppose that - as in the case of martingales driven by Brownian motion - $d[M, N]_t = \alpha_t^{[M, N]} dt$ and $d[M]_t = \alpha_t^{[M]} dt$ with $\alpha_t^{[M]} > 0$. Conclude that $H_t = \alpha_t^{[M, N]} / \alpha_t^{[M]}$.

- b) (2 points) Consider a model with two correlated assets with dynamics $dS_t^i = \sigma_i S_t^i dB_t^i$ for two standard Brownian motions B^1, B^2 with $[B^1, B^2]_t = \rho t$ for some $\rho \in [-1, 1]$. Compute the Kunita Watanabe decomposition of S^2 wrt S^1 . (This is one possible approach for hedging the non-tradable asset S^2 with the tradable asset S^1 .)

Exercise 3:

3. Quadratic variation of compensated Poisson process . Consider a Poisson process N_t with parameter λ and recall that $M_t = N_t - \lambda t$ is a square integrable martingale. Use the characterization of quadratic variation to show that $[M_t] = N_t$.

Exercise 4:

4. Generator of the Heston model (3 points) Consider a two-dimensional process X, v with

$$\begin{aligned}dX_t &= \mu X_t dt + \sigma_1 \sqrt{v_t} dB_{t,1} \\ dv_t &= \kappa(\theta - v_t)dt + \sigma_2 \sqrt{v_t} dB_{t,2}\end{aligned}$$

for constants $\mu, \sigma_1, \sigma_2, \kappa, \theta > 0$ and two Brownian motions B_1, B_2 with $[B_1, B_2]_t = \rho t$ for some $-1 \leq \rho \leq 1$. Compute the generator of the process (X, v) .