

# How Volatility Dynamics Change Path-Dependent Prices

Arithmetic Asian Call Options

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# Arithmetic Asian Call Options

- ▶ Derivative-based financial asset.
- ▶ Payoff depends on the average price.

$$\text{Payoff} = \max(\bar{S} - K, 0), \quad \bar{S} = \frac{1}{T} \int_0^T S_t dt$$

- ▶ Path-dependent! Averaging reduces sensitivity to volatility spikes.
- ▶ Less volatility → Less expensive.
- ▶ In class: Stock paths follow Geometric Brownian Motion (GBM)
- ▶ Are there other stock path models?
  - ▶ Generalized Autoregressive Conditional Heteroskedasticity (GARCH)

# The GARCH(1,1) Model

Why use this model?

- ▶ Models time-varying volatility.
- ▶ Volatility clustering.
- ▶ Simple recursion procedure!

Model Returns ( $r$ ) Structure:

$$r_t = \mu_{\Delta t} + \epsilon_t, \quad \epsilon_t \sim \mathcal{N}(0, h_t)$$

$$h_t = \omega + \alpha \epsilon_{t-1}^2 + \beta h_{t-1}$$

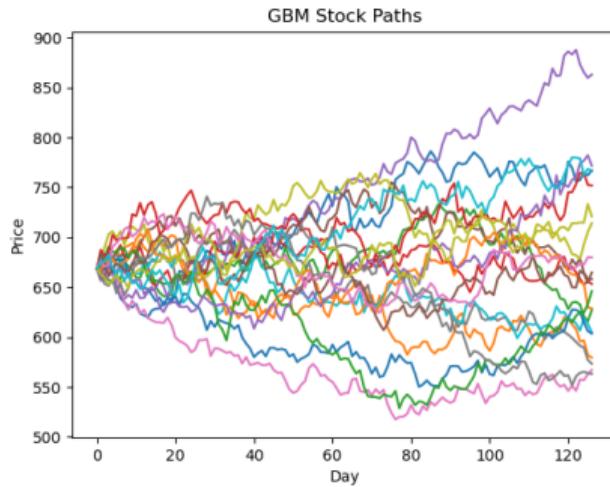
- ▶  $\mu_{\Delta t}$  expected return per day under the chosen measure.
- ▶  $\epsilon_t$  = random innovation (shock).
- ▶  $h_t$  = conditional variance.
- ▶  $\omega, \alpha, \beta$  = free parameters.

# Data and parameters

- Used SPY historical data
- GARCH(1,1) params. by minimizing

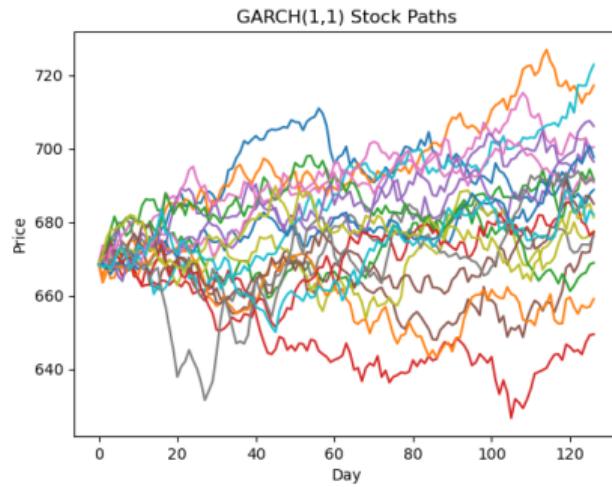
$$\ell = -\frac{1}{2} \sum_{t=1}^T \left[ \log(2\pi) + \log(h_t) + \frac{(r_t - \mu)^2}{h_t} \right]$$

$$S_t = S_{t-1} e^{(r - \frac{1}{2}\sigma^2)dt + \sigma\sqrt{dt}\mathcal{N}(0,1)}$$

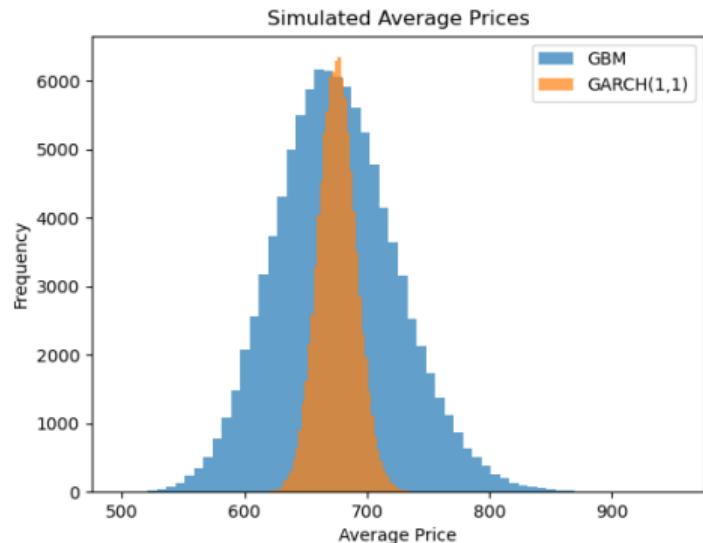
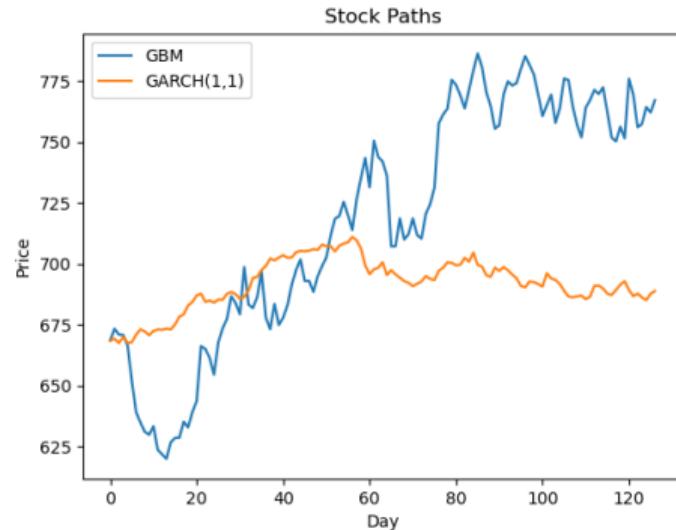


Parameters	
GBM	$\sigma = 0.179$
GARCH(1,1)	$\omega = 1.2 \times 10^{-6}$ $\alpha = 0.05$ $\beta = 0.85$

$$S_t = S_{t-1} e^{(r - \frac{1}{2}\sigma^2)dt + \sqrt{h_t}\mathcal{N}(0,1)}$$



# Market-Maker Perspective GBM vs GARCH(1,1)



- ▶ GBM path has uniform volatility.
- ▶ GARCH(1,1) shows clustered volatility.
- ▶ Averaging smooths out clustered volatility spikes.

# Trading Implications

Arithmetic Asian Call Option Prices		
	Price (USD)	Error (95% CL)
GBM	22.74	0.20
GARCH(1,1)	10.14	0.07

- GBM (Black-Scholes) → Used for quoting and hedging.
- GARCH(1,1) → Realistic and risk assessment.

