

Formula sheet

Note: any characteristic function for a Lévy process will be given to you in a class test/exam question

- Let $X_t = \mu t + \sigma W_t$, where W is Brownian motion. Then

$$F(b|x) = \mathbb{P}(\bar{X}_t \leq b | X_t = x) = 1 - e^{-\frac{2b(b-x)}{\sigma^2 t}} \quad (1)$$

for $b \geq \max(x, 0)$, where $\bar{X}_t = \max_{0 \leq s \leq t} X_s$. This allows us to sample \bar{X}_t given X_t as $F^{-1}(U|X_t)$, where

$$F^{-1}(u|x) = \frac{1}{2}(x + \sqrt{x^2 - 2t\sigma^2 \log(1-u)})$$

with $U \sim U[0, 1]$ and $F^{-1}(\cdot|x) : (0, 1) \rightarrow [\max(x, 0), \infty]$ is the inverse of the function on the right in (1) (viewed as a function of b), which is very useful for Monte Carlo pricing of **barrier options**.

- Let (Y_i) be a sequence of i.i.d. random variables with density $\mu(x)$ and $(N_t)_{t \geq 0}$ be a **Poisson process** for which $\mathbb{E}(e^{pN_t}) = e^{\lambda t(e^p - 1)}$ (and recall that $N_t \in \mathbb{N}$), and assume N_t is independent of (Y_i) , and let $X_t = \sum_{i=1}^{N_t} Y_i$. X is known as a **compound Poisson process**, and

$$\mathbb{E}(e^{iuX_t - q[X, X]_t}) = e^{\lambda t \int_{-\infty}^{\infty} (e^{iux} - 1) \mu(x) dx} \quad (2)$$

for $u \in \mathbb{R}$, $q \geq 0$.

- Let X be a random variable with $\int_{-\infty}^{\infty} |\mathbb{E}(e^{iuX})| du < \infty$. Then X has a density $f_X(x)$, which can be computed using the **inverse Fourier transform**:

$$f_X(x) = \frac{1}{2\pi} \int_{-\infty}^{\infty} e^{-iux} \mathbb{E}(e^{iuX}) du$$

Similarly, for the joint density $f_{X,Y}(x, y)$ of two random variables X, Y is given by the double IFT:

$$f_{X,Y}(x, y) = \frac{1}{4\pi^2} \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} e^{-iux - ivy} \mathbb{E}(e^{iuX + ivY}) du dv$$

so e.g. we can apply this to (2) with $[X, X]_t = Y$ and $q = iu$.

- General definition of a Lévy process is here: https://en.wikipedia.org/wiki/L%C3%A9vy_process
- A **symmetric α -stable process** X with parameters $\alpha \in (0, 2]$, $\sigma > 0$ is a generalization of Brownian motion, which has **independent stationary increments** like Brownian motion but $\mathbb{E}(e^{iuX_t}) = e^{-t\sigma^\alpha |u|^\alpha}$ for $u \in \mathbb{R}$, and $\mathbb{E}(X_t^2) = \infty$ if $\alpha < 2$. For the special case $\alpha = 2$, $X_t = \sqrt{2}\sigma W_t$ where W is a standard Brownian motion.
- A general Lévy process with no Brownian component has the **Lévy-Khintchine representation**

$$\mathbb{E}(e^{iuX_t}) = \exp(t(i\gamma u + \int_{-\infty}^{\infty} (e^{iux} - 1 - iux 1_{|x| \leq 1}) \nu(x) dx)) \quad (3)$$

where the Lévy density ν must satisfy $\int_{-\infty}^{\infty} \nu(x) \min(1, x^2) dx < \infty$. If the iux integral here is finite, it can be absorbed into the γ term to get

$$\mathbb{E}(e^{iuX_t}) = \exp(t(i\tilde{\gamma} u + \int_{-\infty}^{\infty} (e^{iux} - 1) \nu(x) dx))$$

which also agrees with the form for the compound Poisson case when $\int_{-\infty}^{\infty} \nu(x) dx < \infty$. A compound Poisson process is a Lévy process with $\nu(x) = \lambda \mu(x)$ where $\mu(x)$ is the jump density as above.

- A general **KoBoL/CGMY**-type Lévy process has $\nu(x) = \frac{c_+ e^{-Mx}}{x^{1+Y_+}} 1_{x>0} + \frac{c_- e^{-G|x|}}{|x|^{1+Y_-}} 1_{x<0}$ for $Y_+, Y_- \in (0, 2)$, for which

$$\mathbb{E}(e^{iuX_t}) = \exp(t(i\gamma u + c_+ \Gamma(-Y_+) ((M - iu)^{Y_+} - M^{Y_+}) + c_- \Gamma(-Y_-) ((G + iu)^{Y_-} - G^{Y_-}))) \quad (4)$$

for $Y_{\pm} \neq 1$ and $u \in \mathbb{R}$ and we take the principal branch for the power functions (or if we set $u = -ip$ so $iu = p$ with $p \in \mathbb{R}$, then the right hand side is valid for $p \in [-G, M]$ and $\mathbb{E}(e^{pX_t}) < \infty$ in this range). An α -stable process has $G = M = 0$ and $\alpha = Y_+ = Y_-$; a symmetric α -stable process has $c_+ = c_-$ and $\gamma = 0$, and an α -stable process with positive-only jumps has $c_- = 0$, so in this case $\mathbb{E}(e^{iuX_t}) = e^{iu\gamma t + c_+ \Gamma(-Y_+) (-iu)^{Y_+ t}}$, and this process is non-decreasing if $Y_+ \in (0, 1)$ and $\gamma \geq 0$ (note we usually set $\gamma = 0$ for this case).

- Let X be a Lévy process and e_q an $\text{Exp}(q)$ random variable independent of X . Then \bar{X}_{e_q} and $\bar{X}_{e_q} - X_{e_q}$ are independent, and $\bar{X}_{e_q} - X_{e_q} \sim -\underline{X}_{e_q}$, and if X has a density $\rho_t(x)$, then

$$\Phi_q^+(z) := \mathbb{E}(e^{iz\bar{X}_{e_q}}) = \exp\left(\int_0^\infty t^{-1}e^{-qt} \int_0^\infty (e^{izx} - 1)\rho_t(x)dxdt\right) \quad (z \in \mathbb{R}).$$

- From this we find in Hwk 2 that

$$\mathbb{E}(\bar{X}_t) = \int_0^t \frac{\mathbb{E}(X_s^+)}{s} ds.$$

- A zero-mean Gaussian process B_t^H is called standard **fractional Brownian motion** (fBM) with **Hurst exponent** $H \in (0, 1)$ if

$$R_H(s, t) = \mathbb{E}(B_t^H B_s^H) - \mathbb{E}(B_t^H)\mathbb{E}(B_s^H) = \mathbb{E}(B_t^H B_s^H) = \frac{1}{2}(t^{2H} + s^{2H} - (t-s)^{2H})$$

for $0 \leq s \leq t$. When $H \in (0, \frac{1}{2})$, B^H is **rougher** than standard BM, and when $H \in (\frac{1}{2}, 1)$, B^H is **smoother** than standard BM; more specifically B^H is $H - \varepsilon$ **Hölder continuous** which means that $|B_t^H - B_s^H| \leq c_1(\omega)|t-s|^{H-\varepsilon}$ a.s. for any $\varepsilon \in (0, H)$ where $c_1(\omega)$ is a (in general random) constant.