**FE5222 ADP Project One**

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1. **Introduction**

In this project, we would implement the least square Monte Carlo (LSMC) method for American put options pricing, and employ the binomial Black-Scholes model with Richardson extrapolation (BBSR) as a benchmark. Results from both methods are compared and discussed in various scenarios. The effects of numerical parameters such as the number of simulation paths as well as the number of discrete time steps are further investigated and visualized.

As a simulation-based model, LSMC can be extended with factor models. It allows for path-dependent and early exercise features, and permits parallelization. Overall, it’s intuitive to understand, and transparent or flexible to implement. At the same time, the simulation per path and regression per time-step inside are time-consuming, which asks up to balance between MC simulation counts and time step counts.

As a tree-based model, BBS is improved from traditional binomial trees by applying BSM on option values at the m-2 step, which were difficult for traditional binomial trees to consider the time value of OTM options. BBSR further involved the Richardson extrapolation technique to cancel out higher-order error terms while keeping its simplicity and adding limited computational costs. Disadvantages from binomial trees were still inherited inside. Moreover, it’s not flexible enough to cope with incomplete market or extreme scenario tests.

1. **Materials and Methods**
   1. **LSMC**

Cashflow vector

Exercise value and continuation value

Least square regression

Backward induction and discounting

* 1. **BBSR**
* Binomial tree
* Black-Scholes binomial tree method

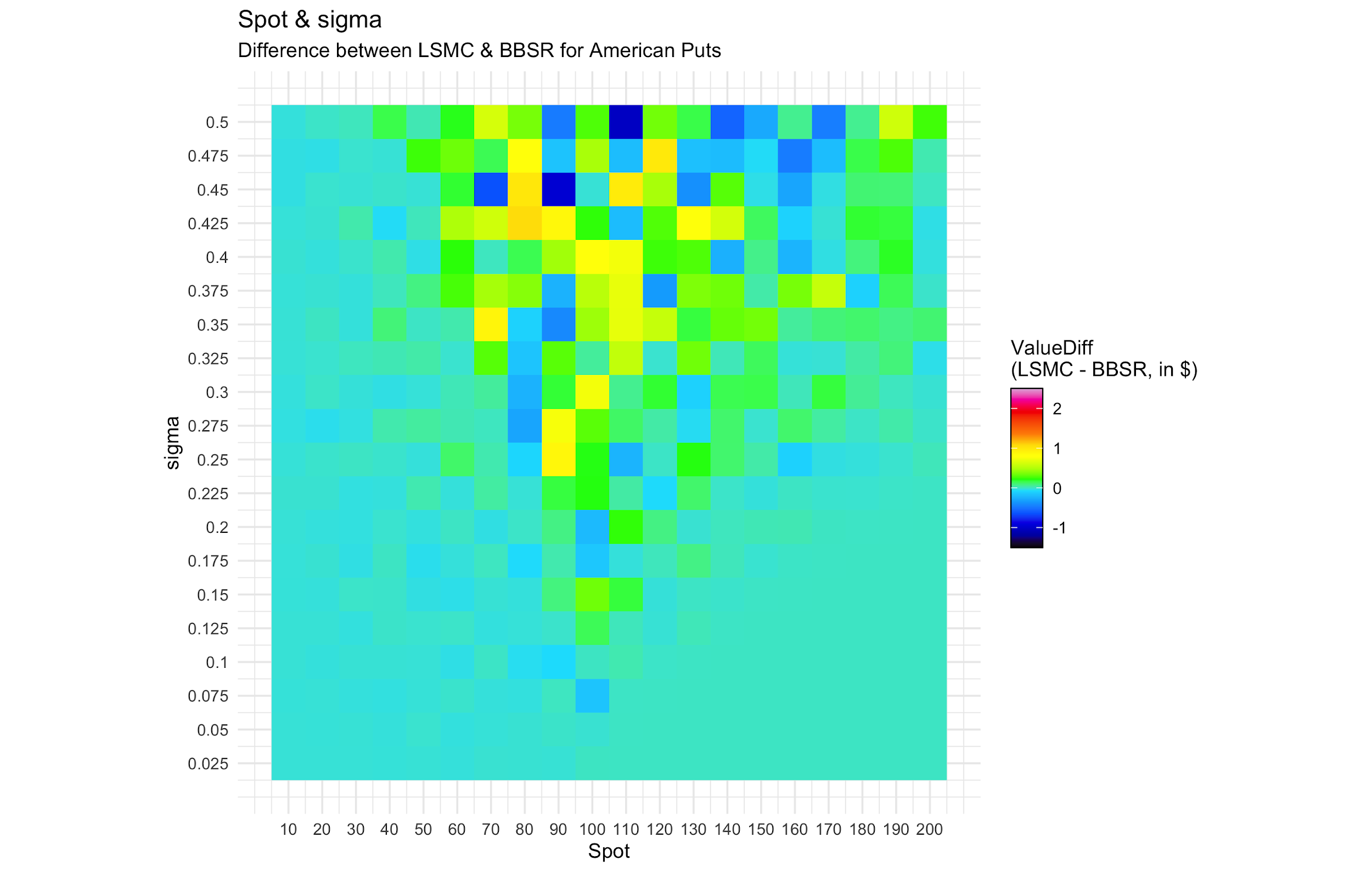
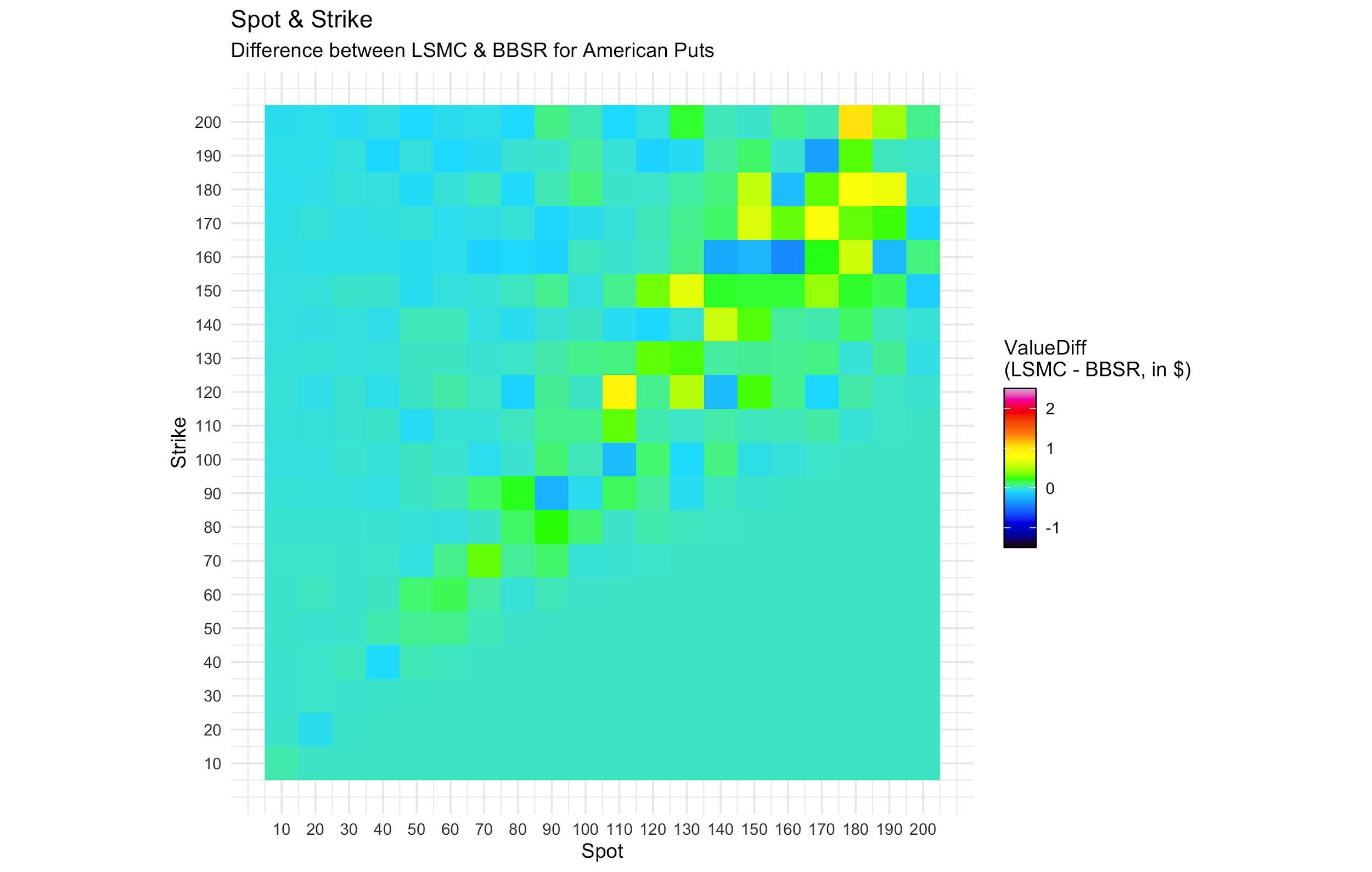
BBS method is a modification to the binomial method where the Black-Scholes formula replaces the usual “continuation value” at the time step just before option maturity. At time t\_(N-1), the continuation value is equivalent to the price of a European put option, replace it with BS formula for put option, that is:

* Richardson extrapolation
  1. **Comparison and visualization**

To compare the two investigated models with respect to the pricing parameters and numerical parameters, we further performed pairwise pricing and visualized their differences (LSMC - BBSR) over two dimensional surfaces with color scales. To improve comparability, we kept the color bar from $-1.5 to $2.5.

Investigated pricing parameters with default values includes: Spot = $100, Strike = $100, volatility () = 0.2, interest rate () = 0.06, time to maturity () = 1. They are explored using equal spaced sequences in corresponding plots but kept constant otherwise. Investigated numerical parameters with default values includes: number of Monte Carlo paths () = 1000, number of time steps () = 252. We calculated the LSMC outputs at different and , then charted the BBSR outputs at different .

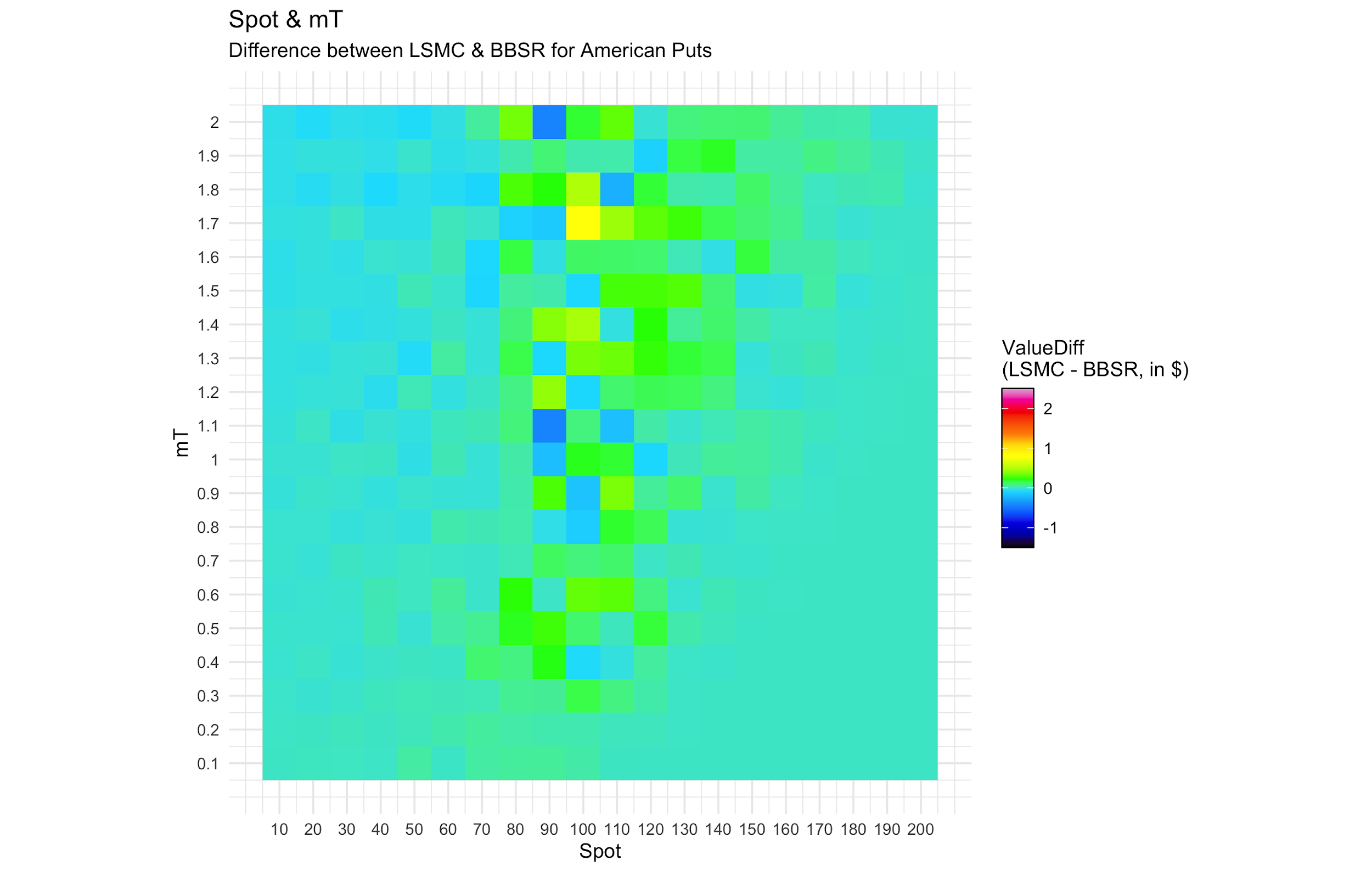
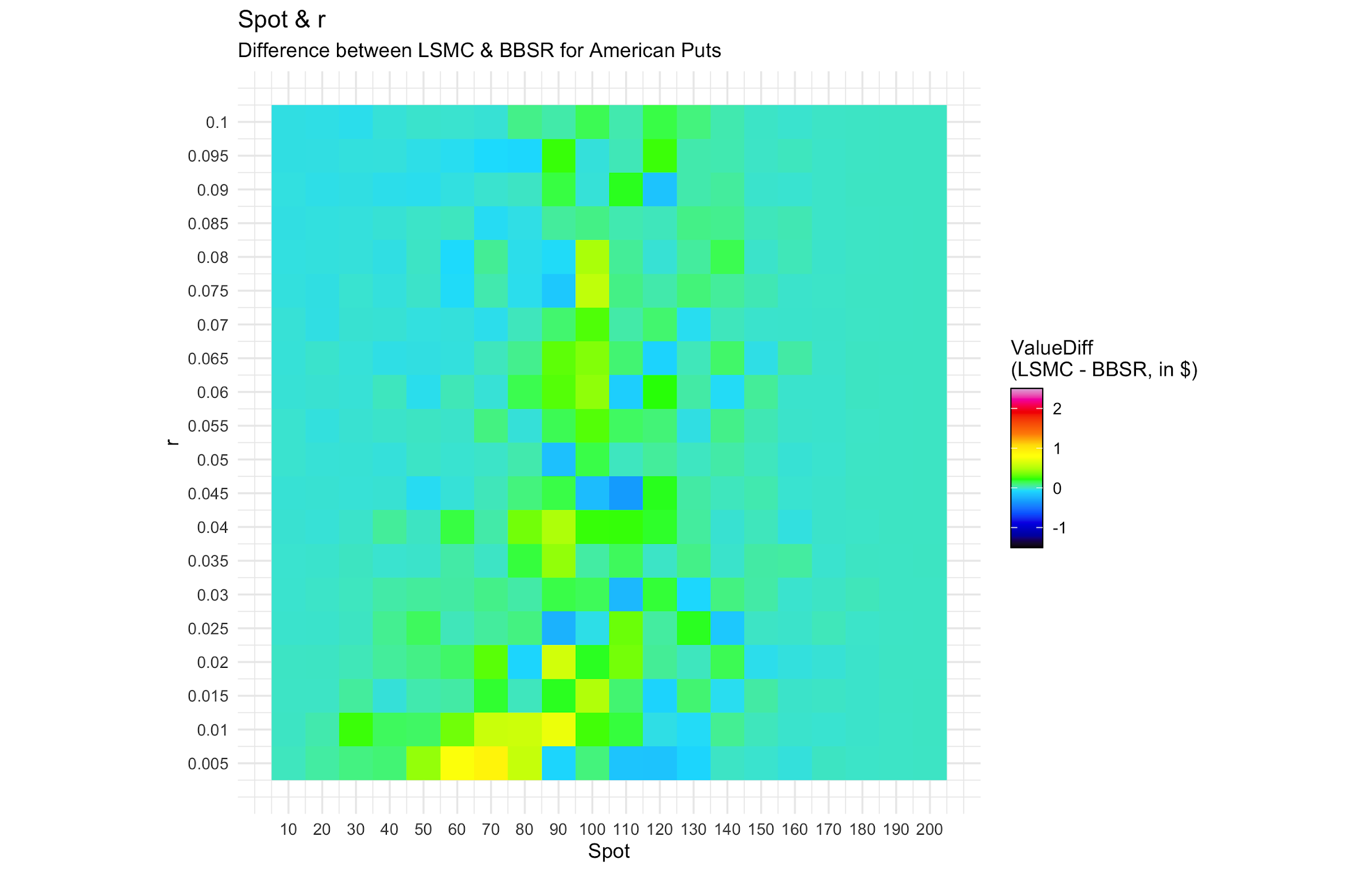
1. **Results and Discussion**
   1. **Grid comparison for pricing parameters**

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(a) (b)

Figure 1. The differences between LSMC and BBSR among various

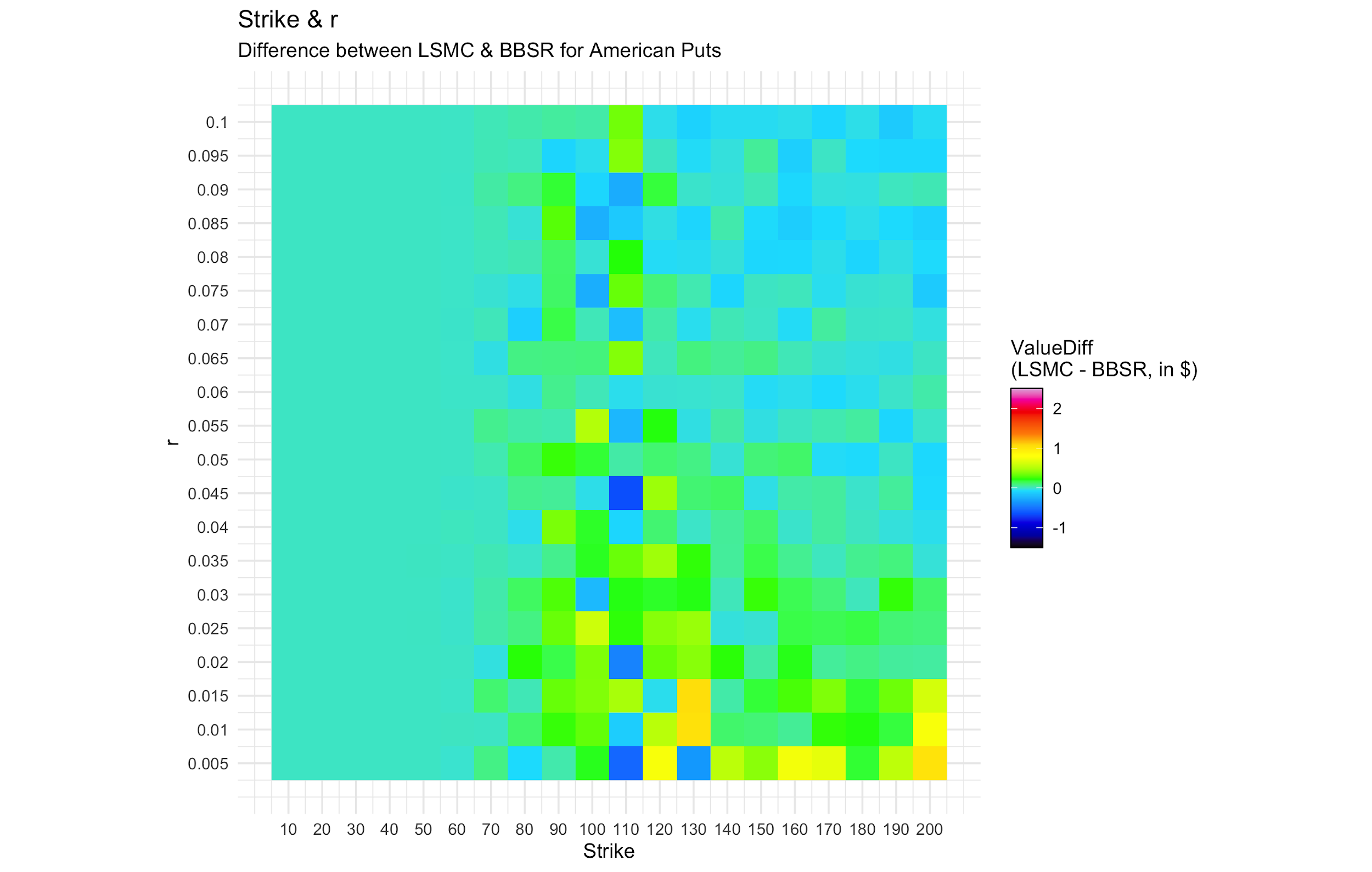
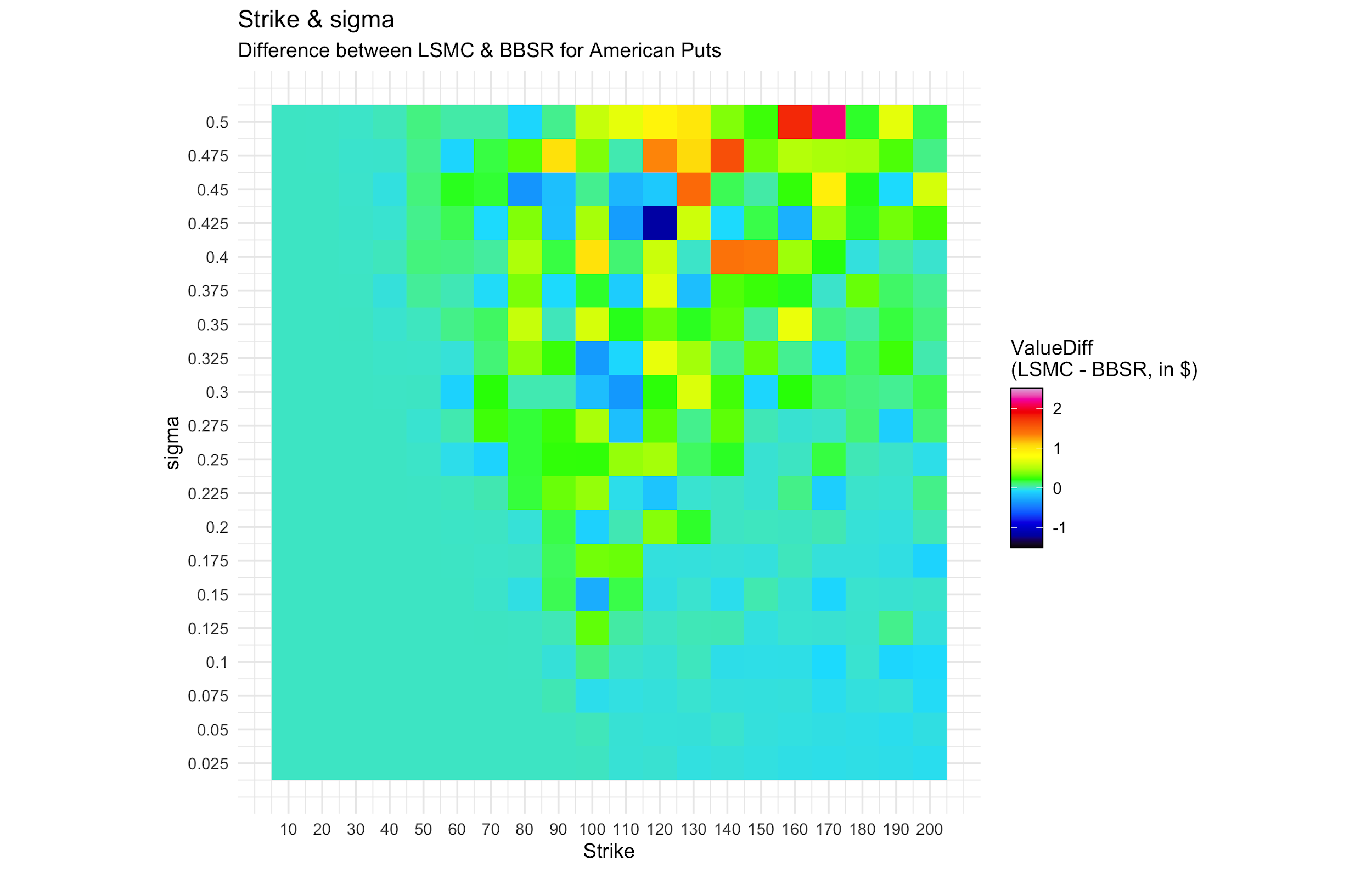
(a) spot and strike, as well as (b) spot and volatility (sigma).

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(a) (b)

Figure 2. The differences between LSMC and BBSR among various

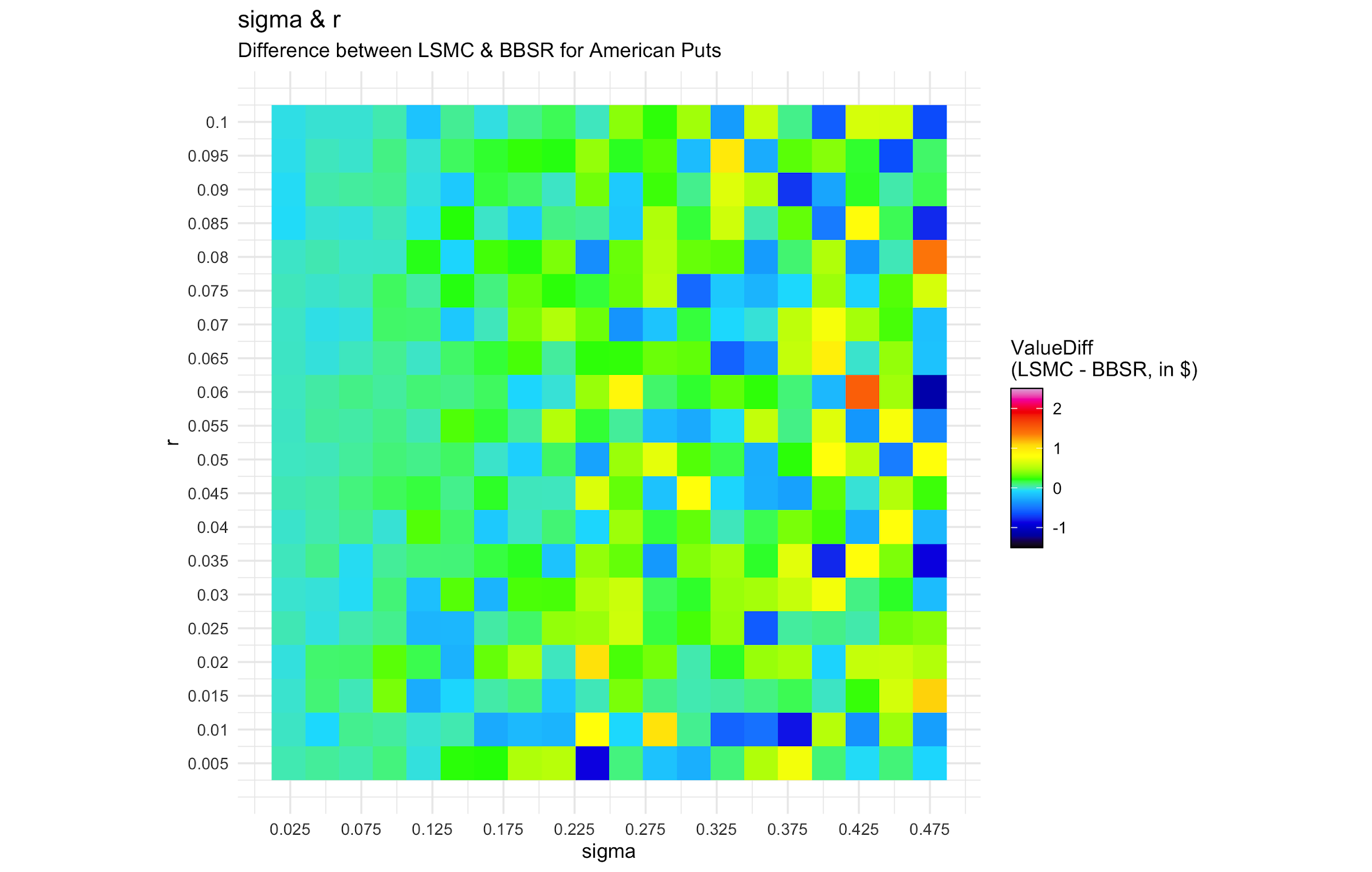
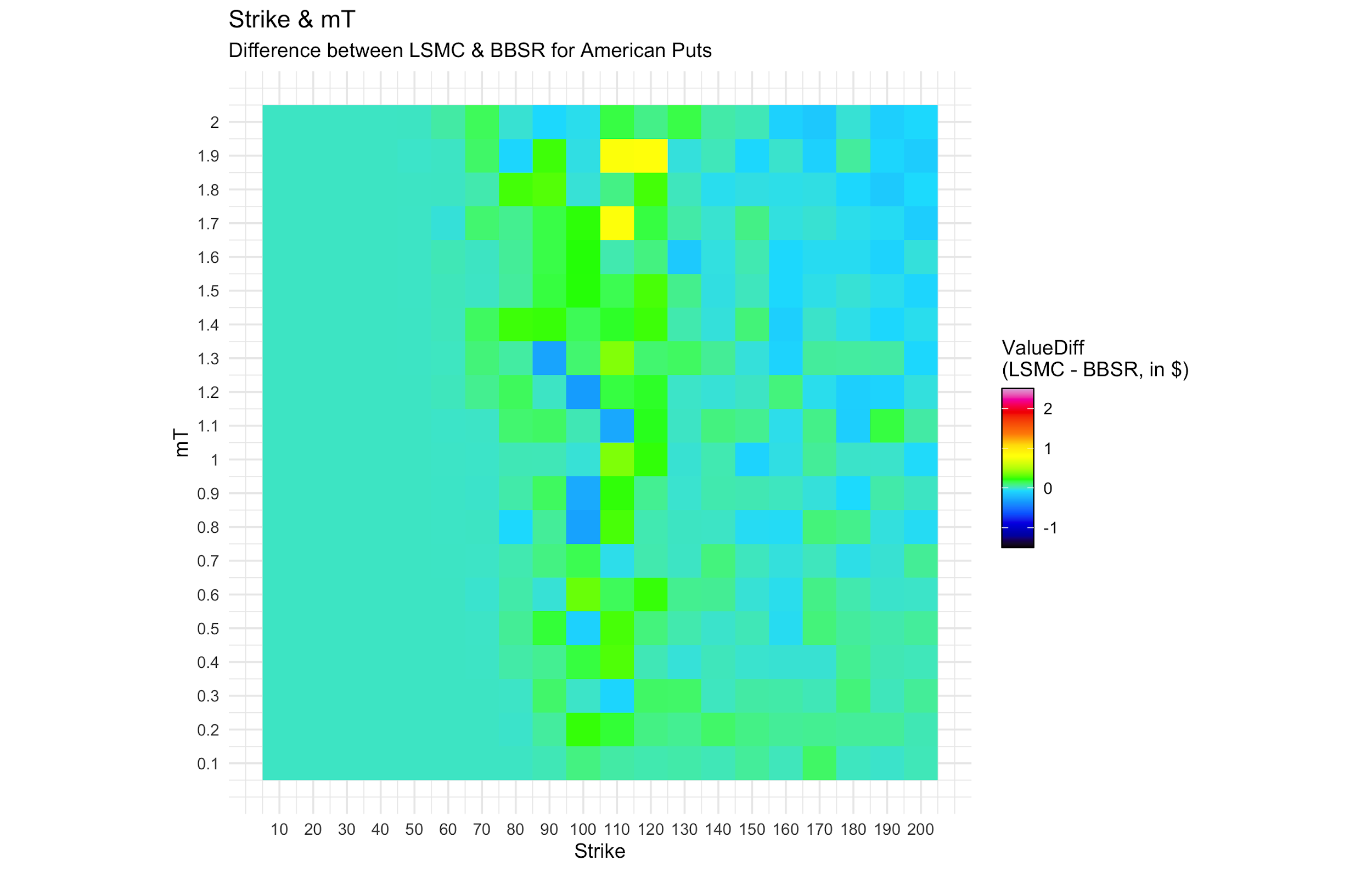
(a) spot and interest rate (r), as well as (b) spot and time to expiry (mT).

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(a) (b)

Figure 3. The differences between LSMC and BBSR among various

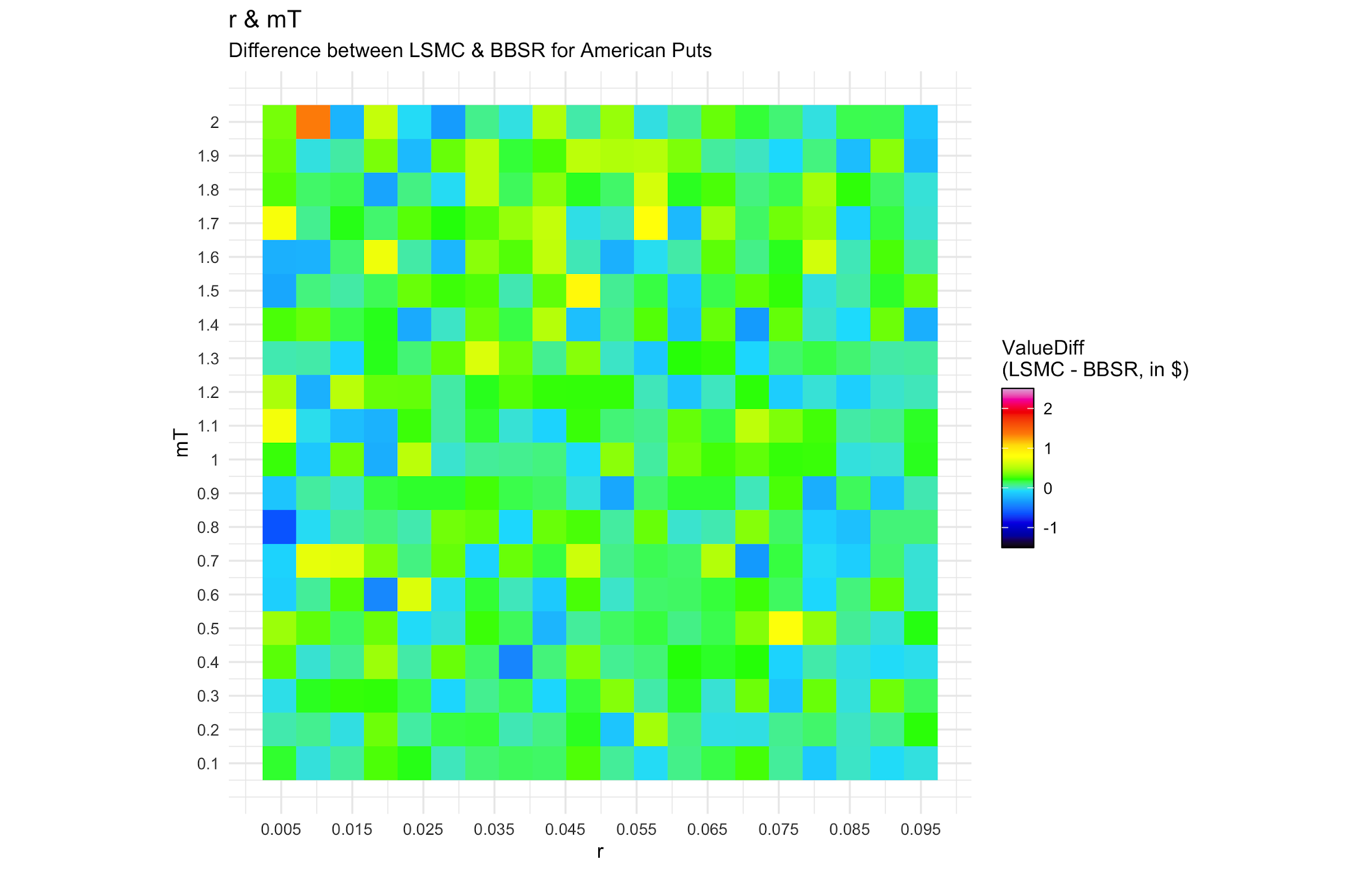
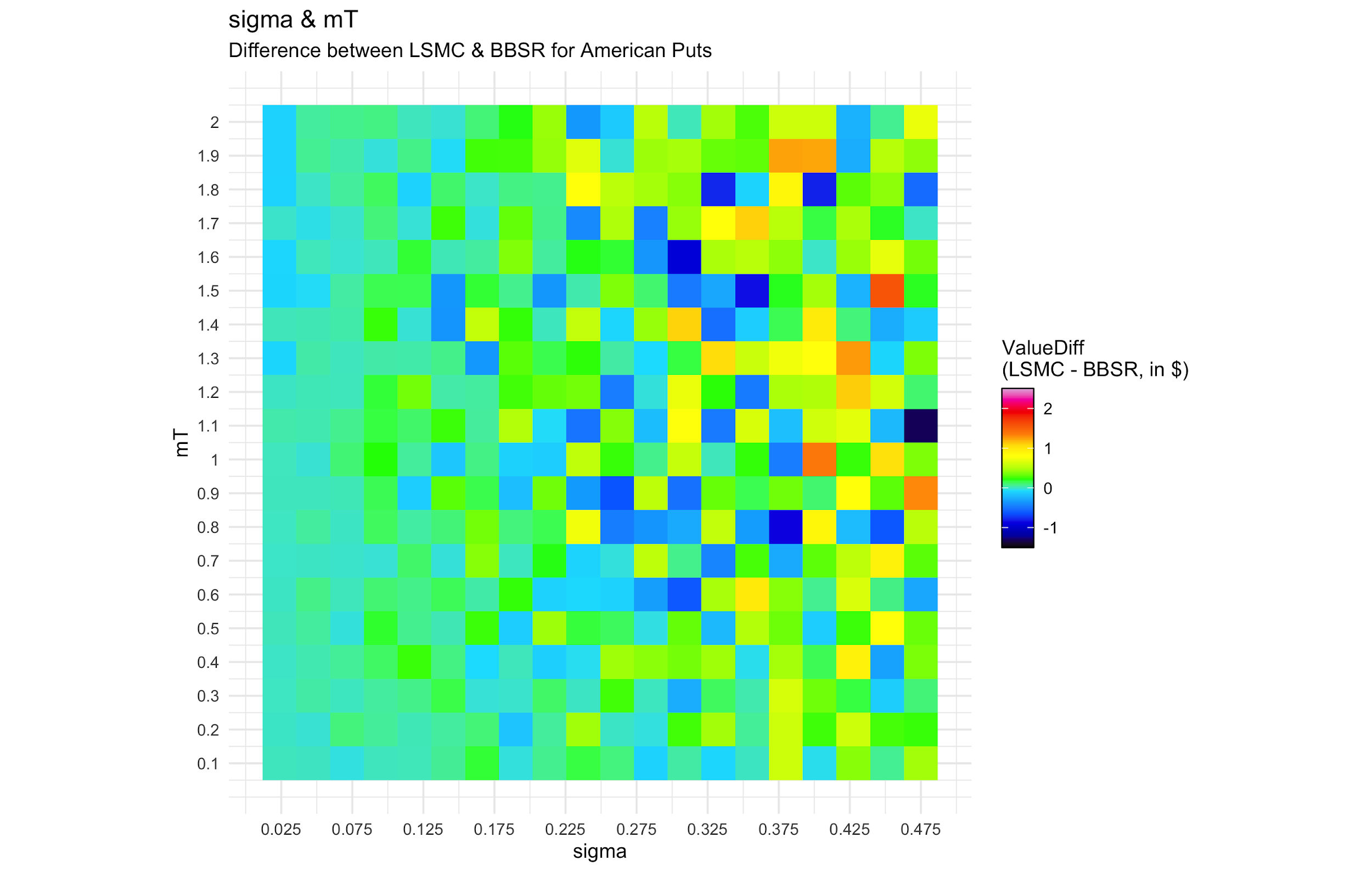
(a) strike and sigma, as well as (b) strike and interest rate.

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(a) (b)

Figure 4. The differences between LSMC and BBSR among various

(a) strike and time to expiry, as well as (b) volatility and interest rate.

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(a) (b)

Figure 5. The differences between LSMC and BBSR among various

(a) volatility and time to expiry, as well as (b) interest rate and time to expiry.

* 1. **Grid comparison for numerical parameters**

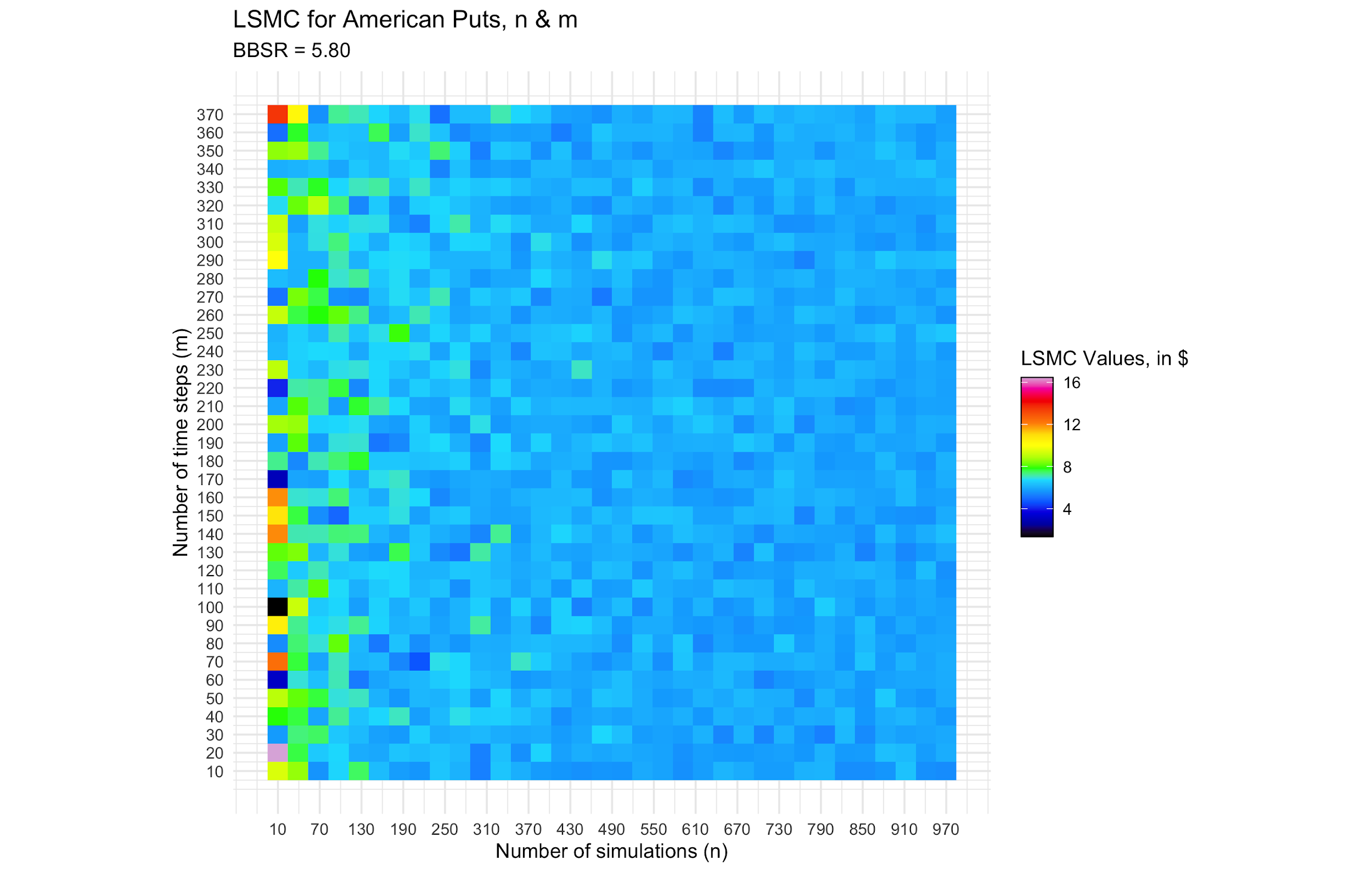


Figure 6. The LSMC results among various numbers of Monte Carlo simulations (n) and numbers of time steps (m). We are assuming Spot = 100, Strike = 100, sigma = 0.2, r = 0.06, mT=1, And the BBSR benchmark value is $ 5.80.

Needs a trade-off between time steps and simulations to price with satisfactory accuracy and acceptable computational complexity.

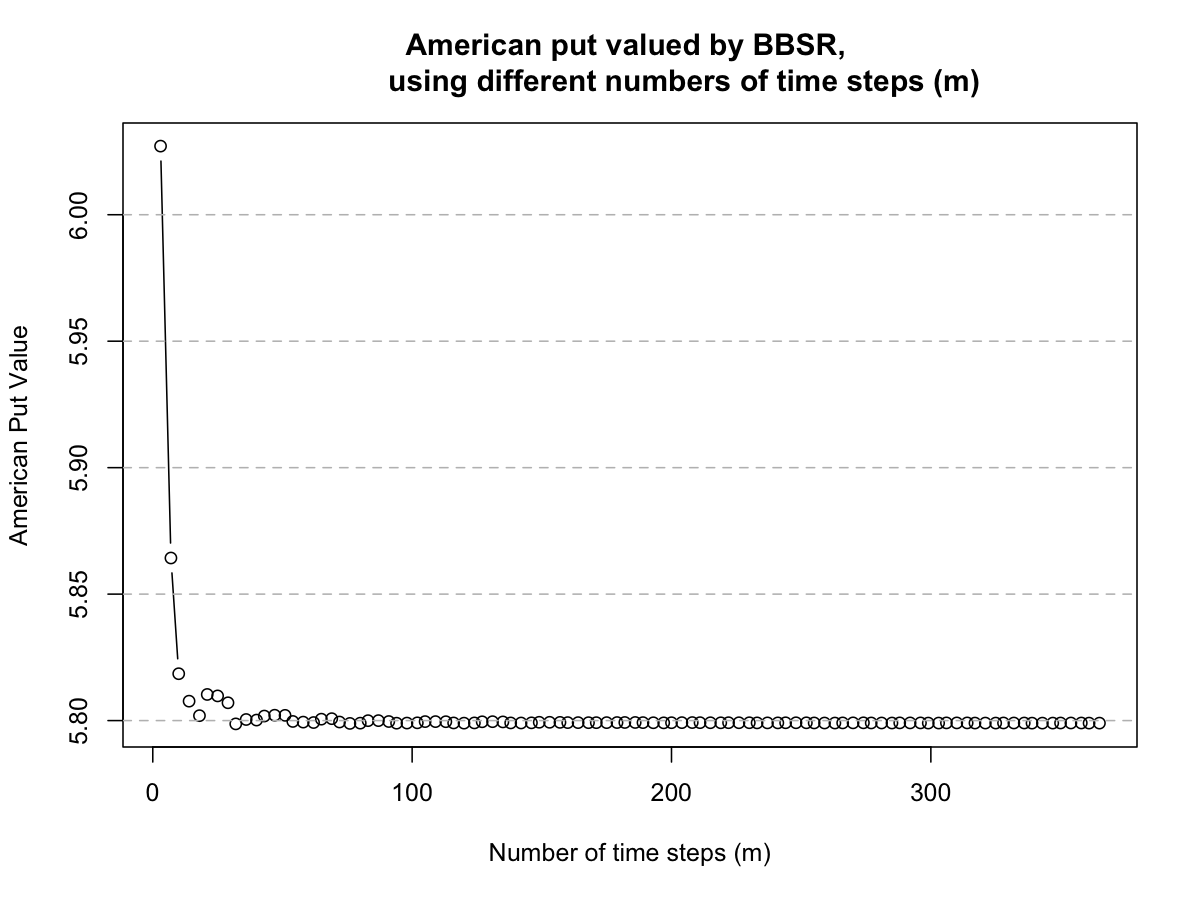


Figure 7. The BBSR results among various numbers of time steps (m). We are assuming Spot = 100, Strike = 100, sigma = 0.2, r = 0.06, mT=1, And the BBSR benchmark value is $ 5.80.

BBSR converges efficiently within a limited number of time steps, and remains stable afterward. It is serving as a good benchmark for vanilla American option pricing.

1. **Conclusion and Future Research**

Different basis functions

LSMC application on more path-dependent options

Comparison among trees

1. **References**

Longstaff, F.A., and Schwartz, E.S., 2001. Valuing American options by simulation: a simple least-squares approach. *The review of financial studies*, *14*(1), pp.113-147.

Haug, E.G., 2007. *The complete guide to option pricing formulas*. McGraw-Hill Companies.

Wilmott, P., 2007. *Paul Wilmott introduces quantitative finance*. John Wiley & Sons.

1. **Appendix:** 
   1. **LSMC in Python Jupyter notebook, by Ho Ngok Chao**
   2. **BBSR in Python Codes, by Gao Jichen**
   3. **Comparison & Visualization in R Codes, by Cheng Tuoyuan**