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Chapter 1

Basic Probability Concepts

1.1 σ -algebra, Probability space, and Random Variables

From [2]. If Ω is a given set, a σ -**algebra** \mathcal{F} on Ω is a family \mathcal{F} of subsets of Ω with the following properties

1. $\emptyset \in \mathcal{F}$
2. for a set F , if $F \in \mathcal{F}$ then $F^C \in \mathcal{F}$, for $F^C = \Omega \setminus F$
3. for sets $A_1, A_2, A_3, \dots \in \mathcal{F} \Rightarrow \cup_{i=1}^{\infty} A_i \in \mathcal{F}$

Why is it important to have a σ -algebra in a probability space? The σ -algebra represents all events that we can assign probabilities to. Property 1 together with property 2 states that in the space the probability of all events occurring, should be measurable and equal 1, whereas it's complement, no events occurred should be measurable and assigned probability 0. For other events, the probability of an event occurring and its complement should both be measurable. Property 3 assigns some "continuity" in the space of events and allows us to "group" elementary events without risking the creation of an event which is not included in the event space.

The pair (Ω, \mathcal{F}) is called a measurable space. A probability measure P is a function $P : \mathcal{F} \rightarrow [0, 1]$ which assigns each elementary event $A \in \mathcal{F}$ with a number representing its likelihood.

The triplet (Ω, \mathcal{F}, P) is a **probability space**. All probability spaces can be made complete, hence we refer to them as complete from now on.

A function $Y : \Omega \rightarrow \mathbb{R}^n$ is said to be \mathcal{F} -measurable if

$$Y^{-1}(U) := \{\omega \in \Omega; Y(\omega) \in U\}$$

For all open sets $U \in \mathbb{R}^n$. We call ω an elementary event. It is, in fact, a continuous trajectory in the space of continuous functions (but non-differentiable).

A **random variable** X is an \mathcal{F} -measurable function $X : \Omega \rightarrow \mathbb{R}^n$. Every random variable induces a probability measure μ_X on \mathbb{R}^n , defined by

$$\mu_X(B) = P(X^{-1}(B))$$

The function

$$(\omega, t) \rightarrow X(\omega, t)$$

represent a two-dimensional process, where fixing t gives us all the values of the random process X at a particular point in time (assuming t represents time), whereas fixing ω gives us one trajectory over time (one realization of the process). The process X is referred to as a **stochastic process**.

1.2 The Space of Elementary Events

From [3]. The space of elementary events for a Brownian motion is the space of all continuous real functions

$$\Omega = \{\omega(t) : \mathbb{R}_+ \rightarrow \mathbb{R}\}$$

1.3 Noise

[Unfinished] White noise is a process for which there is no correlation between any values at different times. As an idealization of such a process there exist the **Orenstein-Uhlenbeck process** (to be defined) for which produces an almost uncorrelated noise. For this model, the second order correlation function can, up to a constant factor, be described as

$$\langle x(t), x(t') \rangle = \frac{\gamma}{2} \exp(-\gamma|t - t'|)$$

1.4 Cylinder Sets

From [3]. A cylinder set of Brownian trajectories is defined by a sequence of times $0 \leq t_1 < t_2 < \dots < t_n$, and real intervals $I_k = (a_k, b_k)$, $k = 1 \dots n$, as

$$C(t_1, t_2, \dots, t_n; I_1, I_2, \dots, I_n) = \{\omega \in \Omega | x(\omega, t_k) \in I_k\}, \forall 1 \leq k \leq n$$

For a cylinder not to contain a trajectory, it is enough that in one time point the trajectory is not in the interval. The cylinder C contains entire trajectory, which fulfill the inclusion demand.

The joint PDF of $w(t_1, \omega)$, $w(t_2, \omega)$, $w(t_3, \omega)$ is the Wiener measure of the cylinder $C(t_1, t_2, t_3; I^x, I^y, I^z)$. These points belong to the same process ω at three different times.

1.5 Filtration

The σ -algebra \mathcal{F}_t of Brownian event is defined by cylinder sets confined to times $0 \leq t_i < t$, for some fixed t . Obviously, $\mathcal{F}_s \subset \mathcal{F}_t \subset \mathcal{F}$ if $0 \leq s < t < \infty$. The family of σ algebras \mathcal{F}_t for $t \geq 0$ is called the Brownian filtration and is said to be generated by the Brownian events up to time t

In simple words, filtration is an increasing sequence of σ -algebras on a measurable space.

1.6 Adapted Process

The process $x(t, \omega)$ is said to be adapted to the Brownian filtration \mathcal{F}_t if $\{\omega \in \Omega | x(t, \omega) \leq y\} \in \mathcal{F}_t$ for every $t \geq 0$ and $y \in R$. In that case we also say that $x(t, \omega)$ is \mathcal{F}_t -measurable.

Thus an adapted process does not depend on the future behavior of the Brownian trajectory from time t on.

1.7 The Wiener Measure

The probability measure Pr defined on all the Brownian trajectories (events in the set Ω) are defined on cylinder sets and then extended to all events in the space by elementary properties of probability sets.

For a cylinder set $C(t; I)$, where $t > 0$ and $I = (a, b)$, the Wiener measure is

$$Pr\{C(t; I)\} = \frac{1}{\sqrt{2\pi t}} \int_a^b \exp^{-x^2/2t} dx$$

1.8 Martingale

A martingale is a stochastic process $x(t)$ with $\mathbb{E}|x(t)| < \infty, \forall t$, and for $t_1 < t_2 < \dots < t_n$

$$\mathbb{E}[x(t)|x(t_1) = x_1, x(t_2) = x_2, \dots, x(t_n) = x_n] = x_n$$

1.9 Approximation to the stochastic path as $L^2[0, T]$ expansion

From [1]. It $X(t)$ is a random trajectory of the process $X(\omega, t)$ for a given ω , the Wiener process $W(t)$ has trajectories belonging to $L^2[0, T]$ for almost all ω 's, and the **Karhunen-Loeve** expansion for it takes the form

$$W(t) = W(\omega, t) = \sum_{i=1}^{\infty} Z_i(\omega) \phi_i(t),$$

with $0 \leq t \leq T$, and

$$\phi_i(t) = \frac{2\sqrt{2T}}{(2i+1)\pi} \sin\left(\frac{(2i+1)\pi t}{2T}\right)$$

1.10 Stochastic Integration

For an arbitrary function of time $G(t')$ and a Wiener process $W(t)$, the stochastic integral

$$\int_{t_0}^t G(t') dW(t')$$

is defined as a kind of Riemann integral, that is, we divide the interval $[t_0, t]$ into n subintervals $t_0 \leq t_1 \leq \dots \leq t$, and define intermediate points

$t_{i-1} \leq \tau_i \leq t_i$. The integral is then defined as a limit of the partial sums

$$S_n = \sum_{i=1}^n G(\tau_i)[W(t_i) - W(t_{i-1})]$$

Note that the Wiener process in the partial sums is contributing the values at the edges of the interval, whereas the function G contributes the values somewhere in its middle. The choice of τ_i affects the value of the integral. It can be seen that if we choose $\tau_i = \alpha t_{i-1} + (1 - \alpha)t_i$, with $0 \leq \alpha \leq 1$, then the mean value of the integral can take any value between 0 and $(t - t_0)$.

for the **Itô integral**, we choose $\tau_i = t_{i-1}$, which is the left boundary of the subinterval and thus define the stochastic integral as

$$\int_{t_0}^t G(t')dW(t') = ms - \lim_{n \rightarrow \infty} \left\{ \sum_{i=1}^n G(t_{i-1})[W(t_i) - W(t_{i-1})] \right\}$$

by ms-lim, we mean the mean-square limit, which is defined by

$$ms - \lim_{n \rightarrow \infty} \int p(\omega)[X_n(\omega) - X(\omega)]^2 d\omega = \lim_{n \rightarrow \infty} < (X_n - X)^2 >$$

if indeed $\lim_{n \rightarrow \infty} < (X_n - X)^2 > = 0$ we say that $ms - \lim_{n \rightarrow \infty} X_n = X$. One major consequence of the choice $\tau_i = t_{i-1}$ is that

$$\int_{t_0}^t W(t')dW(t') = 0$$

That is, the stochastic integral of the Wiener process over any interval is zero. Because the left point of the subinterval is chosen, the value of the function $G(t'_{i-1})$ is independent of the increments $[W(t_i) - W(t_{i-1})]$, since G is F_t adapted process.

1.11 Properties of Itô integral

We define the class $H_2[0, T]$ of F_t -adapted stochastic processes such that

$$\int_0^T \mathbb{E} f^2(s, \omega) ds < \infty$$

and list the following properties

1. **linearity.** For $f(t), g(t) \in H_2[0, T]$, and α, β real, then $\alpha f(t) + \beta g(t) \in H_2[0, T]$, and

$$\int_0^t \alpha f(s) + \beta g(s) d\omega(s) = \alpha \int_0^t f(s) d\omega(s) + \beta \int_0^t g(s) d\omega(s)$$

2. **additivity.** If $f(t) \in H_2[0, T_1]$ and $f(t) \in H_2[T_1, T]$ for $0 < T_1 < T$, then

$$\int_0^T f(s) d\omega(s) = \int_0^{T_1} f(s) d\omega(s) + \int_{T_1}^T f(s) d\omega(s)$$

3. for a deterministic and integrable $f(t)$

$$\int_0^t f(s) d\omega(s) \sim N\left(0, \int_0^t f^2(s) ds\right)$$

4. for $f(t) \in H_2[0, T]$

$$\mathbb{E} \int_0^t f(s) d\omega(s) = 0$$

5. for $0 < \tau < t < T$

$$\mathbb{E} \left[\int_0^t f(s) d\omega(s) \mid \int_0^\tau f(s) d\omega(s) = x \right] = x$$

6. for $f(t), g(t) \in H_2[0, T]$

$$\mathbb{E} \left[\int_0^T f(s) d\omega(s) \int_0^T g(s) d\omega(s) \right] = \int_0^T \mathbb{E}[f(s)g(s)] ds$$

note that the right-hand-side is integrated with respect to s .

We can see by property 5 that the Itô integral is a martingale (see subsection 1.8).

1.12 Integration with Respect to a Measure

A measure μ_A defines an integral of a nonnegative measurable function $f(\omega)$ by

$$\int_{\Omega} f(\omega) d\mu(\omega) = \lim_{h \rightarrow 0} \lim_{N \rightarrow \infty} \sum_{n=0}^N nh \mu\{\omega : nh \leq f(\omega) \leq (n+1)h\}$$

If the limit exists we say the $f(\omega)$ is a measurable function.

1.13 The Itô Calculus

From [3] p.82. Consider two processes $a(t), b(t)$ of class $H_2[0, T]$ (defined in 1.11) and define the stochastic process

$$x(t) = x_0 + \int_0^t a(s)ds + \int_0^t b(s)d\omega(s)$$

where x_0 is a random variable independent on $\omega(t), \forall t > 0$, then for $0 \leq t_1 \leq t_2 \leq T$

$$x(t_2) - x(t_1) = \int_{t_1}^{t_2} a(s)ds + \int_{t_1}^{t_2} b(s)d\omega(s)$$

We abbreviate the this notation by

$$dx = a(t)dt + b(t)d\omega(t)$$

Example 1: We calculate the differential of $\omega^2(t)$. By the definition of the Ito integral we know that

$$\omega^2(t_2) - \omega^2(t_1) = (t_2 - t_1) + 2 \int_{t_1}^{t_2} \omega(s)d\omega(s) = \int_{t_1}^{t_2} 1dt + 2 \int_{t_1}^{t_2} \omega(s)d\omega(s)$$

. In our abbreviation we can write

$$d\omega^2(t) = 1dt + 2\omega(t)d\omega(t)$$

with $a(t) = 1$ and $b(t) = 2\omega(t)$. So the Ito calculus does not obey the normal chain rule of calculus.

Example 2: We now calculate the differential of $f(t)\omega(t)$. If $f(t)$ is a deterministic smooth function then we can integrate by parts

$$\int_{t_1}^{t_2} f(t)d\omega(t) = f(t_2)d\omega(t_2) - f(t_1)d\omega(t_1) - \int_{t_1}^{t_2} f'(t)\omega(t)dt$$

we now set $x(t) = f(t)\omega(t)$ so

$$dx(t) = f'(t)d\omega(t)dt + f(t)d\omega(t) = \omega(t)df(t) + f(t)d\omega(t)$$

as in the classical calculus.

Example 3: the differential of the product of functions. If $x_1(t)$ and $x_2(t)$ have the Ito differentials

$$dx_1 dt = a_1(t)dt + b_1(t)d\omega(t)$$

$$dx_2(t) = a_2(t)dt + b_2(t)d\omega(t)$$

where $a_1, b_1, a_2, b_2 \in H_2[0, T]$ (see 1.11), then

$$d[x_1(t)x_2(t)] = x_1(t)dx_2(t) + x_2(t)dx_1(t) + b_1(t)b_2(t)dt$$

1.13.1 The Wong-Zakai Correction

From [3]. To see the relationship between the Ito integral and the Stratonovich integral we have the Wong-Zakai correction. If $f(x, t)$ has a second continuous derivative such that $|f_{xx}(x, t)| < A(t)e^{\alpha(t)|x|}$ for some positive continuous function $\alpha(t)$ and $A(t)$ for all $a \leq t \leq b$ then

$$\int_a^b f(\omega(t), t) d_S \omega(t) = \int_a^b f(\omega(t), t) d\omega(t) + \frac{1}{2} \int_a^b \frac{\partial}{\partial x} f(\omega(t), t) dt \quad (1.1)$$

where $\omega_S(t)$ represents the Stratonovich integral.

Example 1: We now use the Wong-Zakai correction to show that the Stratonovich differential satisfies the classical rule

$$d_S x_1(t)x_2(t) = x_1(t)dx_2(t) + x_2(t)dx_1(t)$$

The Stratonovich differential is defined as

$$d_S x(t) = a(t)dt + b(t)d_S \omega(t)$$

1.14 The Langevin Equation

[Unfinished] An equation of the type

$$\frac{dx}{dt} = a(x, t) + b(x, t)\xi(t)$$

1.15 The Itô Equation

Equation of the form

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

is an informal way of expressing the more appropriate integral equation

$$X_{t+s} - X_t = \int_t^{t+s} \mu(X_u, u) du + \int_t^{t+s} \sigma(X_u, u) dB_u$$

where the dynamic of the particle X is given as a sum of two integrals, the first one is a standard Lebesgue integral, and the second is an Itô integral (to be defined). The functions $\mu(X_t, t)$ and $\sigma(X_t, t)$ are well defined continuous functions, and B_t is a Brownian motion (a Weiner process, or white noise). An informal way of interpreting the equation above is to say that at each small time interval of size δ the process X_t is changed by a normally distributed value with expectation $\mu(X_t, t)\delta$ and variance $\sigma(X_t, t)^2\delta$. the function $\mu(X_t, t)$ is referred to as the drift coefficient, and the function $\sigma(X_t, t)$ as the diffusion coefficient.

1.16 Existence and Uniqueness of Itô SDE solutions

For an Ito SDE taking values in n -dimensional Euclidean space, if for $T > 0$

$$\begin{aligned} \mu : \mathbb{R}^n \times [0, T] &\rightarrow \mathbb{R}^n \\ \sigma : \mathbb{R}^n \times [0, T] &\rightarrow \mathbb{R}^{n \times m} \end{aligned}$$

are measurable functions, for which there exist constants C and D such that

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

for all $t \in [0, T]$ and all $x, y \in \mathbb{R}^n$, and $|\sigma|^2 = \sum_{i,j=1}^m |\sigma_{i,j}|^2$. If Z is a random variable, independent of the σ -algebra generated by B_s , $s \geq 0$, and with finite second moment, then the SDE, with initial condition $X_0 = Z$ has an almost surely unique solution in $t \in [0, T]$, $X_t(\omega)$, such that X is adapted to the filtration \mathcal{F}_t generated by Z and B_s , $s \leq t$.

1.17 Non-anticipating Functions

[Unfinished]

1.18 Stochastic Differential Equations

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