ETC3430

Financial Mathematics under Uncertainty

Assignment 1, Semester 1, 2022

# Question 1

Perform the following simulation exercise in Matlab or R, using your student number as the seed( rng( your student no.)). Consider a three state Markov Chain(“sunny”, “rainy” and “overcast”) to model the daily weather in Melbourne.

1. Without using data, suggest a reasonable estimate of the transition matrix. The later questions should be considered based on your estimates.
2. Given each starting state respectively, what is the most likely state of the weather in the next five days. Present your answer in a table.

print(glue("Most likely states within the next 5 days"))

for (day in 0:5) {

    print(glue("Day: {day}"))

    print(P %^% day)

    cat("\n\n")

}

Table

Description automatically generated

Table

Description automatically generated

1. Label the three states as , i.e., if the weather is sunny, if the weather is rainy and if the weather is overcast. Given each starting state respectively, what is in the next five days. Present your answer in a table.

print(glue("Expected state within the next 5 days"))

for (day in 0:5) {

    print(glue("Day: {day}"))

    print((P %^% day) %\*% matrix(1:3))

    cat("\n\n")

}

Table

Description automatically generated

1. Compare and contrast your answers from (b) and (c)  
   Part b shows the mode given that the previous state at each given day, while part c is showing the expected value given that the previous state at each given day.
2. Generate histograms of with an initial distribution of generated with a seed given by your postcode for sample sizes , compare them with the associated probability density function of , then comment on your findings.

set.seed(3149)

P <- matrix(

    data = c(0.45, 0.35, 0.20, 0.36, 0.34, 0.30, 0.25, 0.65, 0.10),

    nrow = 3, ncol = 3, byrow = TRUE

)

# Cumulative Probability

CP <- t(apply(P, 1, cumsum))

repeater <- function(sim\_size) {

    X <- matrix(0, sim\_size + 1, 1)

    X[1, 1] <- 1

    for (day in 1:3) {

        for (i in 1:sim\_size) {

            u <- runif(1)

            X[i + 1, 1] <- 1 \* (u < CP[X[i, 1], 1]) +

                2 \* (u < CP[X[i, 1], 2]) \* (u > CP[X[i, 1], 1]) +

                3 \* (u > CP[X[i, 1], 2])

        }

        g <- X %>%

            as\_tibble() %>%

            ggplot(aes(x = V1)) +

            geom\_histogram() +

            labs(

                title = paste("Day ", day),

                subtitle = paste("n =  ", sim\_size),

                x = "State"

            )

        print(g)

    }

}

sims <- c(100, 1000, 10000, 100000)

for (index in 1:4) {

    repeater(sims[index])

}

Chart, histogram

Description automatically generated

Chart, histogram

Description automatically generatedChart

Description automatically generated with medium confidence

Chart

Description automatically generated

From the simulation of , the values converge on the pdf value for since the accuracy of the models increases as more datapoints are tested.

1. Use samples with sizes to estimate , comment on the Monte-Carlo estimation with the theoretical answer as increases

set.seed(NULL)

P <- matrix(

    data = c(0.45, 0.35, 0.20, 0.36, 0.34, 0.30, 0.25, 0.65, 0.10), # these are my vals so pls change lol

    nrow = 3, ncol = 3, byrow = TRUE

)

# Cumulative Probability

CP <- t(apply(P, 1, cumsum))

markov\_proc\_del\_start <- function(sim\_size, starting\_day) {

    X <- matrix(1, sim\_size + 1, 1)

    for (day in starting\_day:3) {

        for (i in 1:sim\_size) {

            u <- runif(1)

            X[i, 1] <- 1 \* (u < CP[X[i, 1], 1]) +

                2 \* (u < CP[X[i, 1], 2]) \* (u > CP[X[i, 1], 1]) +

                3 \* (u > CP[X[i, 1], 2])

        }

    }

    pi <- matrix(0, 1, 3)

    pi[1, 1] <- sum(X == 1) / sim\_size

    pi[1, 2] <- sum(X == 2) / sim\_size

    pi[1, 3] <- sum(X == 3) / sim\_size

    return(pi)

}

sims <- c(100, 1000, 10000, 100000)

for (index in 1:4) {

    print(glue("Simulation size: {sims[index]}"))

    print(markov\_proc\_del\_start(sims[index], 2))

    cat("\n\n")

}

theory <- c(1, 0, 0) %\*% (P %^% 2)

print(glue("Theoretical Value:"))

print(theory)

**Simulation size: 100**

[,1] [,2] [,3]

[1,] 0.32 0.43 0.26

**Simulation size: 1000**

[,1] [,2] [,3]

[1,] 0.393 0.383 0.225

**Simulation size: 10000**

[,1] [,2] [,3]

[1,] 0.3718 0.4172 0.2111

**Simulation size: 1e+05**

[,1] [,2] [,3]

[1,] 0.37707 0.40805 0.21489

**Theoretical Value:**

[,1] [,2] [,3]

[1,] 0.3785 0.4065 0.215

Reasoning:

The Monte Carlo estimation is done through random sampling to estimate the true probability. However for this to be done accurately, the sampling size needs to be large, since bias in the sample need to minimised. This can be seen in the different values of n that is used to estimate, . As n grows so does the accuracy, it converges on the theoretical value.

1. Use samples with sizes to estimate , comment on the Monte-Carlo estimation with the theoretical answer as increases.

sims <- c(100, 1000, 10000, 100000)

for (index in 1:4) {

    print(glue("Simulation size: {sims[index]}"))

    print(markov\_proc\_del\_start(sims[index], 3))

    cat("\n\n")

}

theory <- c(1, 0, 0) %\*% (P %^% 1)

print(glue("Theoretical Value:"))

print(theory)

**Simulation size: 100**

[,1] [,2] [,3]

[1,] 0.44 0.33 0.24

**Simulation size: 1000**

[,1] [,2] [,3]

[1,] 0.447 0.36 0.194

**Simulation size: 10000**

[,1] [,2] [,3]

[1,] 0.4444 0.3507 0.205

**Simulation size: 1e+05**

[,1] [,2] [,3]

[1,] 0.44935 0.35178 0.19888

**Theoretical Value:**

[,1] [,2] [,3]

[1,] 0.45 0.35 0.2

Markov processes are memoryless hence, . The Monte Carlo estimation is done through random sampling to estimate the true probability. However for this to be done accurately, the sampling size needs to be large, since bias in the sample need to minimised. This can be seen in the different values of n that is used to estimate, . As n grows so does the accuracy, it converges on the theoretical value.

1. Compare and contrast the results from (f) and (g).

The difference between the two questions is that (f) is checking the probability of day 3 not being sunny given that it was sunny on day 1 which means we should be calculating (or rather simulating) for 2 days. (g) on the other hand, is checking the same idea except it tells us that day 1 & 2 are both sunny. Now since we know that we are working with a Markov process, we just need to know the most recent event as a Markov process can be calculated from only one starting point without any past data. Therefore we should simulating for only 1 day and perform calculations from day .

# Question 2

Perform the following simulation exercise in Matlab or R, using your student number as the seed(rng( your student no.)). In the excel file “Data.Sheet1”, you are given two data sets of Markov Chains. Here, denote the state that occupied by time .

1. Use your chosen appropriate method of estimation, suggest a point estimate of the transition matrix for Dataset 1 given the initial state is 1.
2. Use your chosen appropriate method of estimation, suggest a point estimate of the transition matrix for Dataset 2 given the initial state is 1.
3. Given your estimated transition matrices, project both datasets 10 periods further into the future.
4. Comments on the long term behaviour of both series

# Question 3

Perform the following simulation exercise in Matlab or R, using your student number as the seed( rng( your student no.)). In the excel file “Data.Sheet2”, you are given two data sets of continuous time Markov Process with two states. Here, is the waiting time between the *th* and nth jump of the process

1. Use your chosen appropriate method of estimation, suggest a point estimate of the transition matrix for Dataset 1 given the initial state is 1.
2. Use your chosen appropriate method of estimation, suggest a point estimate of the transition matrix for Dataset 2 given the initial state is 1.
3. Given your estimated transition matrices, project both datasets 10 jumps further into the future.
4. Comments on the long term behaviour of both series.