

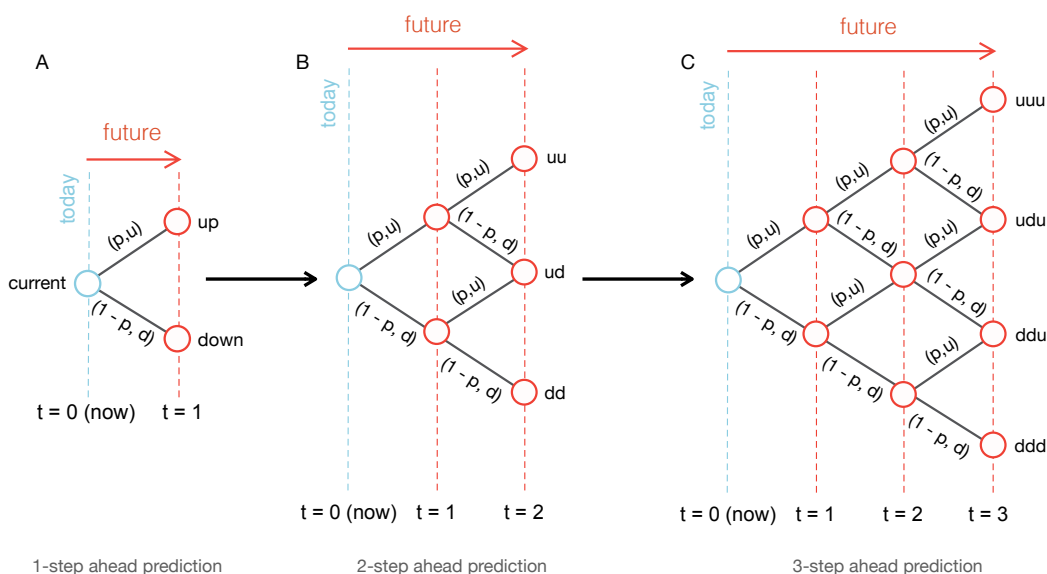
# CHEME 132 Module 1: Lattice Models of Equity Share Price

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## Introduction

A lattice model discretizes the potential future states of the world into a finite number of options. For instance, a binomial lattice model has two future states: `up` and `down`, while a ternary lattice model has three: `up`, `down`, and `flat`. To make predictions, we must assign values and probabilities to each of these future states and then calculate the expected value and variance of future values. Thus, we do not precisely know quantities such as share price because we are projecting into the future. Instead, we have only a probabilistic model of the possible future values. We'll begin with the simplest possible lattice model, a binomial lattice (Fig. 1).



**Fig. 1:** Binomial lattice model schematic. At each node, the share price can either go up by  $u$  or down by  $d$ . The probability of going up is  $p$ , and the probability of going down is  $1 - p$ . **A:** Single time-step lookahead. **B:** Two time-step lookahead. **C:** Three time-step lookahead. At level of the tree  $l$ , the potential share price can take on  $l + 1$  values.

Let's start with a single time-step lookahead, with two possible future states (Fig. 1A). Let the initial share price at time 0 be  $S_0$  and the share price at future time 1 be  $S_1$ . During the transition from time  $0 \rightarrow 1$ , the world transitions from the current state to one of two possible future states: `up` or `down`. We move to the `up` state with probability  $p$  or the `down` state with probability  $1 - p$ . Thus, at the time 1, the share price  $S_1$  can take on one of two possible values:  $S^u = u \cdot S_0$  if the world moves to the `up` state, or  $S^d = d \cdot S_0$  if the world moves to the `down` state. As we move to the future, we can continue to build out the lattice model by adding additional time steps; for example, consider a two-step ahead prediction (Fig. 1B). At time 2, the share price can take on one of three

possible values:  $S^{uu} = u^2 \cdot S_0$  if the world moves to the up-up state,  $S^{ud} = ud \cdot S_0$  if the world moves to the up-down state, or  $S^{dd} = d^2 \cdot S_0$  if the world moves to the down-down state. We can continue to build out the lattice model by adding additional time steps; for example, consider a three-step ahead prediction (Fig. 1C).

## Analytical solution

Let's consider a binomial lattice model with  $n$  time-steps. At each time step, the share price can either go up by a factor of  $u$  or down by a factor of  $d$ . Then, at time  $n$ , the share price can take on  $n + 1$  possible values:

$$S_n = S_0 \times D_1 \times D_2 \times D_3 \times \cdots \times D_n \quad (1)$$

where  $D_i$  is a random variable that can take on one of two values:  $u$  or  $d$ , with probabilities  $p$  and  $(1 - p)$  respectively. Thus, at each time-step, the world flips a coin and lands in either the up state with probability  $p$  or the down state with probability  $(1 - p)$ . For a single time step, we model this random process as a Bernoulli trial, where the probability of success is  $p$  and the probability of failure is  $(1 - p)$ . As the number of time steps increases, we have a series of Bernoulli trials, which is a binomial distribution (Defn: 1):

### Definition 1: Binomial Share Price and Probability

Let  $S_0$  denote the current share price at  $t = 0$ ,  $u$  and  $d$  denote the up and down factors, and  $p$  denote the probability of going up. At time  $t$ , the binomial lattice model predicts the share price  $S_t$  is given by:

$$S_t = S_0 \cdot u^{t-k} \cdot d^k \quad \text{for } k = 0, 1, \dots, t$$

The probability that the share price takes on a particular value at time  $t$  is given by:

$$P(S_t = S_0 \cdot u^{t-k} \cdot d^k) = \binom{t}{k} \cdot (1-p)^k \cdot p^{t-k} \quad \text{for } k = 0, 1, \dots, t$$

where  $\binom{t}{k}$  denotes the binomial coefficient.

## Models of $u$ , $d$ and $p$

The up and down factors  $u$  and  $d$ , and the probability  $p$  can be defined in various ways. For example, we can estimate them from historical data or propose models for their values.

### Historical data

Suppose we have a historical share price dataset from time  $1, \dots, T$  for some ticker  $j$  denoted as  $\mathcal{D}_j = \{S_1^{(j)}, S_2^{(j)}, \dots, S_T^{(j)}\}$ , where  $S_i^{(j)}$  denotes the share price of ticker  $j$  at time  $i$ . We can use different values for the share price, e.g., the opening price, closing price, high price, low price, etc. In our case, when dealing with historical data, we will typically use the volume-weighted average price (VWAP) for the period, e.g., the VWAP for the day, week, month, etc. Over the time range of

the dataset  $\mathcal{D}_j$ , we can calculate the number of `up` and `down` moves occurring between time  $i - 1$  and  $i$ , and the magnitude of these moves. Then, the fraction of `up` moves is an estimate of the probability  $p$ , while some measure of the magnitude of the `up` and `down` moves, e.g., the average value are estimates of  $u$  and  $d$  respectively.

**Estimating  $u$ ,  $d$  and  $p$  from historical data.** Suppose we assume the share price of ticker  $j$  is continuously compounded with an instantaneous discount (interest) rate of  $r_{i,i-1}^{(j)} \equiv \mu_{i,i-1}^{(j)} \cdot \Delta t$ , i.e., we split the return into a growth rate  $\mu_{i,i-1}^{(j)}$  and a time step size  $\Delta t$ . Then, the share price at time  $i$  is an expression of the form governs  $i$ :

$$S_i^{(j)} = \exp(\mu_{i,i-1} \cdot \Delta t) \cdot S_{i-1}^{(j)} \quad (2)$$

where  $\mu_{i,i-1}^{(j)}$  denotes the *growth rate* (units: 1/time) for ticker  $j$ , and  $\Delta t$  (units: time) is the time step size during the time period  $(i - 1) \rightarrow i$ . Solving for the growth rate (and dropping the ticker  $j$  superscript for simplicity) gives:

$$\mu_{i,i-1} = \left( \frac{1}{\Delta t} \right) \cdot \ln \left( \frac{S_i}{S_{i-1}} \right) \quad (3)$$

We'll often use daily price data; thus, a single trading day is a natural time frame between  $S_{i-1}$  and  $S_i$ . However, subsequently, it will be easier to use an annualized value for the  $\mu$  parameter; thus, we let  $\Delta t = 1/252$ , i.e., the fraction of an average trading year that occurs in a single trading day; thus, our base time will be years. We compute the growth rate for each trading day  $i$  in a collection of datasets  $\mathcal{D}$  using Algorithm 1. Then we can estimate the `up` and `down` factors  $u$  and

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#### Algorithm 1 Logarithmic excess growth rate

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**Require:** Collection of price datasets  $\mathcal{D}$ , where  $\mathcal{D}_j \in \mathcal{D}$ . All datasets have the same length  $N$ .

**Require:** list of stocks  $\mathcal{L}$ , where  $\dim \mathcal{L} = M$ .

**Require:** time step size  $\Delta t$  between  $t$  and  $t - 1$  (units: years),

**Require:** risk-free rate  $r_f$  (units: inverse years).

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1:  $M \leftarrow \text{length}(\mathcal{D}_1)$                                 ▷ Number of trading days in the dataset  $\mathcal{D}_j$ 
2:  $N \leftarrow \text{length}(\mathcal{L})$                                 ▷ Number of stocks in the dataset  $\mathcal{D}$ 
3:  $\mu \leftarrow \text{Array}(M - 1, N)$                           ▷ Initialize empty array of growth rates

4: for  $i \in \mathcal{L}$  do
5:    $\mathcal{D}_i \leftarrow \mathcal{D}[i]$                                 ▷ Get dataset for stock  $i$ 
6:   for  $t = 2 \rightarrow N$  do
7:      $S_1 \leftarrow \text{VWAP}(\mathcal{D}_i[t - 1])$     ▷ Get volume weighted average price for stock  $i$  at time  $t - 1$ 
8:      $S_2 \leftarrow \text{VWAP}(\mathcal{D}_i[t])$         ▷ Get volume weighted average price for stock  $i$  at time  $t$ 
9:      $\mu[t - 1, i] \leftarrow \left( \frac{1}{\Delta t} \right) \cdot \ln \left( \frac{S_2}{S_1} \right) - r_f$     ▷ Set  $r_f = 0$  for regular growth rate
10:  end for
11: end for
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$d$  from the growth rate array generated using something like Algorithm 2. While this strategy is simple, it may not be robust. For example, if the dataset  $\mathcal{D}_j$  is short, i.e., only a few trading days, then the number of `up` and `down` moves will be small, and the estimates of  $u$ ,  $d$  and  $p$  will be poor.

**Algorithm 2** Estimating  $u$ ,  $d$  and  $p$  from the  $\mu$ -array**Require:**  $\mu$ -array from Algorithm 1.

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1:  $\mu \leftarrow \text{sort}(\mu_{i,i-1})$ 
2:  $N \leftarrow \text{length}(\mu)$  ▷ Number of growth rates

3:  $i_+ \leftarrow \text{findall}(\mu > 0)$  ▷ Find the indices of all positive growth rates
4: for  $i \in i_+$  do
5:    $\mu[i] \rightarrow (\mu \rightarrow \text{push}!(\text{up}, \exp(\mu \cdot \Delta t)))$  ▷ Push the positive return  $\mu \cdot \Delta t$  onto up-array
6: end for
7:  $u \leftarrow \text{mean}(\text{up})$  ▷ mean is our estimate of the up factor  $u$ 

8:  $i_- \leftarrow \text{findall}(\mu < 0)$  ▷ Find the indices of all negative growth rates
9: for  $i \in i_-$  do
10:   $\mu[i] \rightarrow (\mu \rightarrow \text{push}!(\text{down}, \exp(\mu \cdot \Delta t)))$  ▷ Push the negative return  $\mu \cdot \Delta t$  onto down-array
11: end for
12:  $d \leftarrow \text{mean}(\text{down})$  ▷ mean is our estimate of the down factor  $d$ 

13:  $N_+ \leftarrow \text{length}(i_+)$  ▷ Number of positive growth rates
14:  $p \leftarrow N_+/N$  ▷ Estimate of the probability  $p$ 
return  $u$ ,  $d$  and  $p$ 

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If a precise estimate of  $u$ ,  $d$  and  $p$  is required, the number of trading days in the dataset  $\mathcal{D}_j$  should be large. Furthermore, the estimates of  $u$ ,  $d$  and  $p$  are not robust to outliers in the dataset  $\mathcal{D}_j$ . Thus, we may want to consider other models for computing  $u$ ,  $d$  and  $p$ .

**Risk-neutral probability  $q$** 

Another approach to computing the parameters in the lattice is to use the risk-neutral probability  $q$ . Let's consider a single-step binomial lattice model (Fig. 1A). The expected value of the share price at time 1 for a single step is given by:

$$\mathbb{E}_{\mathbb{Q}}(S_1|S_0) = q \cdot S^u + (1 - q) \cdot S^d$$

where  $\mathbb{E}_{\mathbb{Q}}(\dots)$  denotes the expectation operator written with respect to the risk-neutral probability measure  $\mathbb{Q}$ , the term  $q$  denotes the risk-neutral probability of the up state, and  $S^u$  and  $S^d$  are the share prices in the up and down states respectively. The hypothetical probability  $q$  is used to price derivatives (as we shall see later), however, we could also think of it as a tool to compute a *fair* price for a share of stock. Suppose we rewrite Eqn. (2) as:

$$\mathcal{D}_{1,0}(\bar{r}) \cdot S_0 = \mathbb{E}_{\mathbb{Q}}(S_1|S_0) \tag{4}$$

where  $\mathcal{D}_{1,0}(\bar{r})$  is the continuous discount factor between period  $0 \rightarrow 1$ , and  $\bar{r}$  is the effective (constant) risk-free rate. Thus, unlike the previous case, where the share price  $S_i$  was discounted by the return  $\mu_{i,i-1} \cdot \Delta t$  (which could vary in time), here we discount the share price  $S_i$  by an effective (constant) risk-free rate  $\bar{r}$ . The expectation operator  $\mathbb{E}_{\mathbb{Q}}(\dots)$  can be matched with the

expansion:

$$\mathcal{D}_{1,0}(\bar{r}) \cdot S_o = q \cdot S^u + (1 - q) \cdot S^d \quad (5)$$

The share prices in the up and down states are the product of the up factor  $u$  (or a down factor  $d$ ) and the initial share price, i.e.,  $S^u = u \cdot S_o$  and  $S^d = d \cdot S_o$ . Substituting these price values into Eqn. (5) and solving for  $q$  gives:

$$q = \frac{\mathcal{D}_{1,0}(\bar{r}) - d}{u - d} \quad (6)$$

Thus, we can compute the risk-neutral probability  $q$  from the up and down factors  $u$  and  $d$  and the effective risk-free rate  $\bar{r}$ .

## Binomial lattice trade strategy

Suppose we purchase  $n_o$  share of ticker XYZ at time  $t = 0$  for  $S_o$  USD/share. Then, at some later date  $t = T$ , we sell all  $n_o$  shares for  $S_T$  USD/share. The net present value (NPV) of this trade has two cashflow events, the initial purchase of  $n_o$  shares for  $S_o$  USD/share, and the sale of  $n_o$  shares for  $S_T$  USD/share at some later date  $t = T$ :

$$\text{NPV}(\bar{r}, T) = -n_o \cdot S_o + n_o \cdot S_T \cdot \mathcal{D}_{T,0}^{-1}(\bar{r})$$

where  $\mathcal{D}_{T,0}^{-1}(\bar{r})$  is the inverse of the continuous discount factor for period  $0 \rightarrow T$ , assuming an effective discount rate  $\bar{r}$ . Factoring the initial number of shares  $n_o$  from the NPV expression gives:

$$\text{NPV}(\bar{r}, T) = n_o \cdot \left( S_T \cdot \mathcal{D}_{T,0}^{-1}(\bar{r}) - S_o \right)$$

The term in the parenthesis is the net change in the share price, i.e., the change in the share price  $S_T$  discounted by the effective discount rate  $\bar{r}$ . However, if we hold the shares for only a short period, e.g., on order days or months, then  $\mathcal{D}_{T,0}^{-1}(\bar{r}) \approx 1$ , which simplifies the NPV expression to:

$$\text{NPV}(\bar{r}, T) \simeq n_o \cdot (S_T - S_o)$$

Dividing by the initial investment  $n_o \cdot S_o$  gives the fraction return on investment, or just the fractional return:

$$\frac{\text{NPV}(\bar{r}, T)}{n_o \cdot S_o} \simeq \frac{S_T - S_o}{S_o} = \frac{S_T}{S_o} - 1 \quad (7)$$

In a binomial world, the share price  $S_T$  is a random variable which takes on  $T + 1$  possible values:

$$S_T \in \left\{ S_o \cdot u^{T-k} \cdot d^k \right\}_{k=0}^T \quad (8)$$

where  $S_o$  is the initial share price,  $u$  and  $d$  are the up and down factors, and  $p$  is the probability of going up. Substituting the  $S_T$  expression into Eqn. (7) gives:

$$\frac{\text{NPV}(\bar{r}, T)}{n_o \cdot S_o} \in \left\{ u^{T-k} \cdot d^k - 1 \right\}_{k=0}^T \quad (9)$$

## Summary

Fill me in.