Jacobs University October 21, 2019
Fall 2019

Stochastic Methods + Lab

Assignment Sheet 6

Due on October 28, 2019

Problem 1 [**10 points**]

(a) Compute an ensemble of geometric Brownian paths (at least $M = 1000$)

$$S(t) = \exp\left(\left(\mu - \frac{1}{2}\sigma^2\right) t + \sigma W(t)\right)$$

as a function of time on the interval $[0, 1]$ partitioned into $N = 500$ time steps. Then plot the empirical mean and standard deviation and 10 sample paths. Make two plots, one using $\mu = 0.2$ and $\sigma = 0.6$, and the other one using $\mu = 0.6$ and $\sigma = 0.2$, respectively.

(b) Plot the mean and standard deviation of the stock price paths which underlie the binomial tree model (using the risk-neutral probabilities) with $N = 500$ time steps calibrated with the same set of parameters $r = \mu$ and annualized volatility σ as in part (a), together with 10 sample paths (two plots for the different parameters are required here). Use the calibration that we discussed in class and in Assignment Sheet 4.

(c) Now, for each of the two parameter choices, plot the results of part (a) and (b) in the same figure and describe what you see.

Problem 2 [**5 points**]

Use geometric Brownian motion (with $\mu = 0.05$, $\sigma = 0.3$) in a Monte-Carlo valuation of a European call option with strike price $X = 0.9$, time to maturity $T = 1$ and risk free rate $r = \mu$. Compare your result against the price obtained from using the Black-Scholes formula by plotting the deviation from the Black-Scholes price against the number of samples in a doubly logarithmic plot.

What is the convergence rate of the Monte-Carlo method as a function of the number of samples?

Problem 3 [**5 points**]

For some large N, approximate the Itô integral

$$I(T) = \int_0^T X(t)\, dW(t) = \lim_{N\to\infty} \sum_{i=0}^{N-1} X(t_i)\left(W(t_{i+1}) - W(t_i)\right)$$

and the Stratonovich integral

$$S(T) = \int_0^T X(t) \circ dW(t) = \lim_{N\to\infty} \sum_{i=0}^{N-1} X\left(\frac{t_{i+1}+t_i}{2}\right)\Big(W(t_{i+1}) - W(t_i)\Big),$$

where $W(t)$ denotes standard Brownian motion, and $t_i = i\,\Delta t$ with $\Delta t = T/N$. As example, choose $X(t) = W(t)$.

(a) Plot one realization of Brownian motion, and the corresponding Itô and Stratonovich integrals.

(b) For some large N, look at the difference between the Itô and Stratonovich integrals and describe what you see.