TMS165/MSA350GU Stochastic Calculus Part I Fall 2008

Lecture on Applications 10 October

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25th July 2008

1 Introduction

In this lecture we will give two applications to the modelling of real-world financial data by means of tools from stochastic calculus.

The first application is to model a Stockholm Stock Exchange index by the stochastic exponential of Brownian motion (BM), that is, the Black-Scholes model. The second application is to model Nordpool spot market eletricity prices by means of an Ornstein-Uhlenbeck (OU) process, that is, the Langevin stochastic differential equation (SDE).

The issue whether we can establish a good fit of the above models to the data has to be investigated by statistical methodology. The motivation for the modelling is as usual in science that with a theoretical model we can use theory to calculate various properties of the model, which we can hope that they fit with the corresponding properties of the modelled real-world phenomena if the model is good enough.

2 Elements of diffusion theory

A *time homogeneous diffusion process* is the solution $X(t)$ to an SDE of the form

$$dX(t) = \mu(X(t))\,dt + \sigma(X(t))\,dB(t), \tag{1}$$

where the drift $\mu : \mathbb{R} \to \mathbb{R}$ and diffusion coefficient $\sigma : \mathbb{R} \to \mathbb{R}$ are "nice" functions. Of course, as usual $B = \{B(t)\}_{t\geq 0}$ denotes standard BM. By definition, the solution $X = \{X(t)\}_{t\geq 0}$ to (1) satisfies

$$X(t) = X(0) + \int_0^t \mu(X(r))\,dr + \int_0^t \sigma(X(r))\,dB(r) \quad \text{for } t \geq 0. \tag{2}$$

In order to get a unique solution to (1) we have to specify an random or non-random initial value $X(0)$, which is also the case when dealing with ordinary differential equations (ODE). Any random $X(0)$ is required to be independent of B.

The solution X will be adapted to the filtration $\mathcal{F}_t = \sigma\{X(0), \sigma(B(r) : r \leq t)\}$, as we only use $X(0)$ and the process values $\{B(r)\}_{0\leq r\leq t}$ of BM together with the non-random coefficient functions μ and σ to determine the value $X(t)$ of X at time t, see (2).

2.1 Markov property

The solution X to the SDE (1) is a *Markov process*, which is to say that

$$\mathbf{P}\big\{X(t) \in \cdot \,\big|\, \mathcal{F}_s^X\big\} = \mathbf{P}\{X(t) \in \cdot \,|\, X(s)\} \quad \text{for } s \leq t.$$

Here $\mathcal{F}_s^X = \sigma\{X(r) : r \le s\}$, $s \ge 0$, is the filtration generated by the process X.

While a complete rigorous proof of the Markov property is *very* complicated, it is rather less complicated to understand from a more heursitic point of view: Using the representation (2) for both $X(t)$ and $X(s)$ we get

$$\begin{aligned} X(t) &= X(0) + \int_0^t \mu(X(r))\,dr + \int_0^t \sigma(X(r))\,dB(r) - X(s) + X(s) \\ &= \int_s^t \mu(X(r))\,dr + \int_s^t \sigma(X(r))\,dB(r) + X(s) \\ &= \lim \sum_{i=1}^n \mu(X(t_{i-1}))\,(t_i - t_{i-1}) + \lim \sum_{i=1}^n \sigma(X(t_{i-1}))\,(B(t_i) - B(t_{i-1})) + X(s), \end{aligned}$$

where $s = t_0 < t_1 < \ldots < t_n = t$ is a partion of the interval $[s, t]$ that becomes finer and finer in the limit. From this we see the that the only thing from the past $\mathcal{F}_s^X$ that affects the future value $X(t)$ is that value $X(s) = X(t_0)$ of X at time s.

2.2 Markov transition densities

The *transition density function* of a time homogeneous Markov process X is given by

$$p(t, x, y) = \frac{d}{dy}\,\mathbf{P}\{X(t+s) \le y \,|\, X(s) = x\} \quad \text{for } s, t > 0.$$

In the particular case when X is the solution to the SDE (1) the transition density satisfies the Kolmogorov backward partial differential equation (PDE)

$$\frac{\partial}{\partial t}\,p(t, x, y) = \frac{\sigma(x)^2}{2}\,\frac{\partial^2}{\partial x^2}\,p(t, x, y) + \mu(x)\,\frac{\partial}{\partial x}\,p(t, x, y), \quad p(t, x, y) \to \delta(x - y) \text{as } t \downarrow 0. \tag{3}$$

One way to try to find the transition density is thus to try to solve this PDE.

Example 2.1. By Section 3.4 in Klebaner's book BM has transition density

$$p_B(t, x, y) = \frac{1}{\sqrt{2\pi\, t}}\,\exp\left\{-\frac{(x - y)^2}{2\, t}\right\}.$$

Example 2.2. The *Black-Scholes asset price model* from Examples 5.1 and 5.5 in Klebaner's book is the solution X to the SDE

$$dX(t) = r\,X(t)\,dt + \sigma\,X(t)\,dB(t),$$

where $r \in \mathbb{R}$ (the interest rate) and $\sigma > 0$ (the volatility) are parameters. The solution is given by

$$X(t) = X(0)\,\exp\left\{\left(r - \frac{\sigma^2}{2}\right)t + \sigma\,B(t)\right\} \quad \text{for } t > 0.$$

Note that $X(t)$ is a random perturbation of the solution $x(t) = x(0)\,\mathrm{e}^{rt}$ to the ODE $dx(t) = r\,x(t)\,dt$. The size of σ determines whether X looks just like such a peturbation or if (for σ large) X will deviate significanly from the ODE solution.

If we log the Black-Scholes model $Y(t) = \log(X(t))$ we get

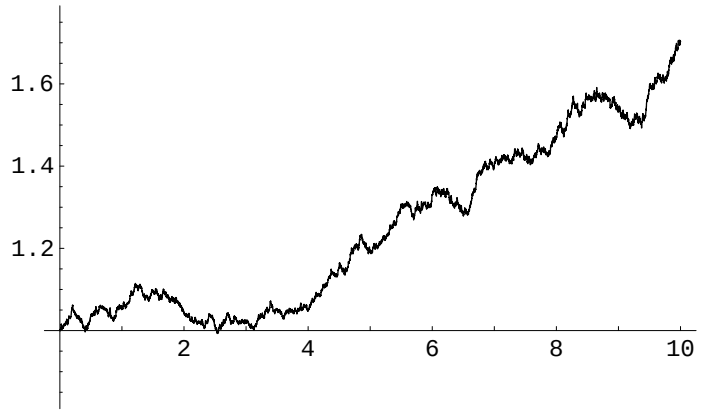
$$Y(t) = Y(0) + \left(r - \frac{\sigma^2}{2}\right)t + \sigma\,B(t) \quad \text{for } t > 0.$$

As $Y(0) = \log(X(0))$ is independent of B it follows that

$$\begin{aligned}
&p_Y(t,x,y)\\
&= \frac{d}{dy}\,\mathbf{P}\{Y(t+s) \le y \,|\, Y(s) = x\}\\
&= \frac{d}{dy}\,\mathbf{P}\left\{Y(0) + \left(r - \frac{\sigma^2}{2}\right)(t+s) + \sigma\,B(t+s) \le y \;\middle|\; Y(0) + \left(r - \frac{\sigma^2}{2}\right)s + \sigma\,B(s) = x\right\}\\
&= \frac{d}{dy}\,\mathbf{P}\left\{\left(r - \frac{\sigma^2}{2}\right)t + \sigma\,B(t+s) - B(s) + x \le y\right\}\\
&= \frac{d}{dy}\,\mathbf{P}\left\{B(t) \le \frac{1}{\sigma}\left(y - x - \left(r - \frac{\sigma^2}{2}\right)t\right)\right\}\\
&= \frac{1}{\sigma}\,f_{B(t)}\left(\frac{1}{\sigma}\left(y - x - \left(r - \frac{\sigma^2}{2}\right)t\right)\right)\\
&= \frac{1}{\sqrt{2\pi\,t}\,\sigma}\,\exp\left\{-\frac{1}{2\,t\,\sigma^2}\left(y - x - \left(r - \frac{\sigma^2}{2}\right)t\right)^2\right\} \quad \text{for } t > 0.
\end{aligned}$$

We may plot a trajectory $\{X(t)\}_{0\le t\le 10}$ of the Black-Scholes model with $X(0) = 1$ and $r = \sigma = 0.05$ with 10000 plotgridpoints using Mathematica as

```
In[1]:= x0=1; r=0.05; sigma=0.05; T=10; n=10000; deltat=N[T/n];
        For[i=1; B={0}, i<=n, i++, AppendTo[B,B[[i]]
                + Random[NormalDistribution[0,Sqrt[deltat]]]]];
            X = Table[x0*Exp[(r-sigma^2/2)*i*deltat+sigma*B[[i]]],
                {i,1,1+n}];

In[2]:= Display["~/user/courses/StokAnal/AppliedLecture/BS1.eps",
            ListPlot[X, PlotJoined->True, PlotRange->{0.81,1.79},
            Ticks->{{{1000,""},{2000,"2"},{3000,""},{4000,"4"},
                {5000,""},{6000,"6"},{7000,""},{8000,"8"},
                {9000,""},{10000,"10"}},Automatic}],"EPS"];
```



Example 2.3. An *OU process* $\{X(t)\}_{t\geq 0}$ is the solution to the Langevin SDE

$$dX(t) = -\mu\, X(t)\, dt + \sigma\, dB(t),$$

where $\mu > 0$ (the rate of mean reversion) and $\sigma > 0$ (the volatility) are parameters. This process is basically a scaled (in size by the factor σ) BM, but with a *mean reversion* component $-\mu\, X(t)\, dt$ that takes down the solution X towards zero as soon as X gets too large, and on the other hand takes up X towards zero as soon as X gets too small (/negative). Thus we will have a "balanced development" of the solution so that it never goes away too far from zero.

The transition density for this process is given by

$$p_X(t,x,y) = \frac{\sqrt{\mu}}{\sqrt{\pi\,(1-\mathrm{e}^{-2\,\mu\,t})}\,\sigma}\,\exp\left\{-\frac{\mu\,(y-x\,\mathrm{e}^{-\mu\,t})^2}{\sigma^2\,(1-\mathrm{e}^{-2\,\mu\,t})}\right\} \quad \text{for } t>0.$$

This can be verified by solving the Kolmogorov backward PDE (3) with $\sigma(x) = \sigma$ and $\mu(x) = -\mu\, x$. Indeed, we may use Mathematica to check that p_X satisfies (3):

```
In[3]:= Clear[x,y,t,mu,sigma,pOU]; pOU[mu_,sigma_,x_,y_,t_]
        := (Sqrt[mu]/(Sqrt[2*Pi*(1-Exp[-2*mu*t])]*sigma)) * Exp[
            -(mu*(y-x*Exp[-mu*t])^2)/(sigma^2*(1-Exp[-2*mu*t]))];
In[4]:= Simplify[D[pOU[mu,sigma,x,y,t],t]
            - sigma^2*D[D[pOU[mu,sigma,x,y,t],x],x]/2
            + mu*x*D[pOU[mu,sigma,x,y,t],x]]
Out[4]= 0
```

In addition it is easy to see that $p_X(t,x,y) \to 0$ as $t \downarrow 0$ for $x \neq y$ and that p_X re-

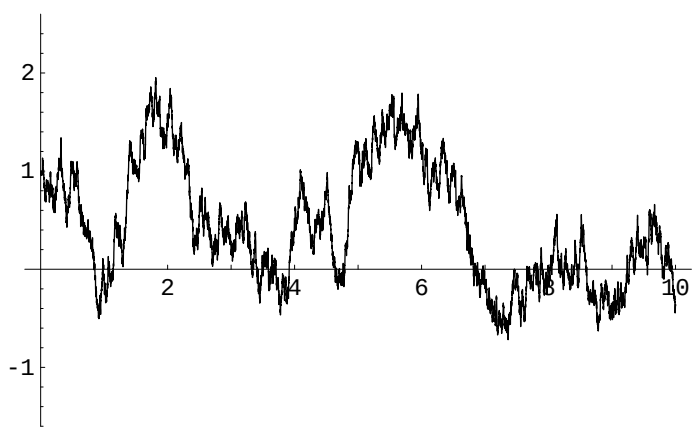
ally is a density function, as

```
In[5]:= Integrate[pOU[mu,sigma,x,y,t],{y,-Infinity,Infinity},
            Assumptions->sigma>0&&t>0&&mu>0]

Out[5]= 1
```

This establishes the second part of (3) that $p_X(t,x,y) \to \delta(x-y)$ as $t \downarrow 0$.

We may plot an approximative trajectory $\{X(t)\}_{0\le t\le 10}$ of an OU process with $X(0)=1$ and $\mu=\sigma=1$ with 10000 plotgridpoints using Mathematica as

```
In[6]:= x0=1; mu=1; sigma=1; T=10; n=10000; deltat=N[T/n];
        deltaB = Table[Random[NormalDistribution[0, Sqrt[deltat]]],
            {i,1,n}];
        For[i=1; X={x0}, i<=n, i++, AppendTo[X,X[[i]]
                - mu*X[[i]]*deltat + sigma*deltaB[[i]]]];

In[7]:= Display["~/user/courses/StokAnal/AppliedLecture/OU1.eps",
        ListPlot[X, PlotJoined->True, PlotRange->{-1.6, 2.6},
            Ticks->{{{1000,""},{2000,"2"},{3000,""},{4000,"4"},
                {5000,""},{6000,"6"},{7000,""},{8000,"8"},
                {9000,""},{10000,"10"}},Automatic}],"EPS"];
```



2.3 Likelihood functions

By the Markov property the joint density function of the values $X(t_0),\ldots,X(t_n)$ of the solution X to the SDE (1) at times $0\le t_0<\ldots<t_n$ for $X(t_0),\ldots,X(t_n)$ is given by

$$f_{X(t_0),\ldots,X(t_n)}(x_0,\ldots,x_n)$$

$$
\begin{aligned}
&= \frac{f_{X(t_0),\ldots,X(t_n)}(x_0,\ldots,x_n)}{f_{X(t_0),\ldots,X(t_{n-1})}(x_0,\ldots,x_{n-1})}\, f_{X(t_0),\ldots,X(t_{n-1})}(x_0,\ldots,x_{n-1}) \\
&= f_{X(t_n)\,|\,X(t_0),\ldots,X(t_{n-1})}(x_n \mid x_0,\ldots,x_{n-1})\, f_{X(t_0),\ldots,X(t_{n-1})}(x_0,\ldots,x_{n-1}) \\
&= f_{X(t_n)\,|\,X(t_{n-1})}(x_n \mid x_{n-1})\, f_{X(t_0),\ldots,X(t_{n-1})}(x_0,\ldots,x_{n-1}) \\
&= p_X(t_n - t_{n-1}, x_{n-1}, x_n)\, f_{X(t_0),\ldots,X(t_{n-1})}(x_0,\ldots,x_{n-1}) \\
&\qquad\qquad \vdots \\
&= p_X(t_n - t_{n-1}, x_{n-1}, x_n)\, p_X(t_{n-1} - t_{n-2}, x_{n-2}, x_{n-1})\, f_{X(t_0),\ldots,X(t_{n-2})}(x_0,\ldots,x_{n-2}) \\
&\qquad\qquad \vdots \\
&= \left(\prod_{i=1}^{n} p_X(t_i - t_{i-1}, x_{i-1}, x_i)\right) f_{X(t_0)}(x_0).
\end{aligned}
$$

If we have a parametric SDE, for examples, of the types considered in Examples 2.2 and 2.3, where the parameters are unknown, then we may estimate the parameter values from real-world observations $x_0, \ldots, x_n$ of the process values $X(t_0), \ldots, X(t_n)$ by means of the so called *maximum likelihood method*. This means that we insert the observed values $x_0, \ldots, x_n$ in the above expression for their joint density which gives us the so called *likelihood function* $f_{X(t_0),\ldots,X(t_n)}(x_0, \ldots, x_n)$ which depends only on the unknown parameters. We estimate these parameter values by means of the parameter values that maximizes the likelihood function.

The likelihood method we have desribed above is the usual likelihood method in statitical science, only that our data are non-independent which makes the likelihood function take a more complicated form than usual. Note that it is often convenient to log the likelihood before the maximization is carried out in order to avoid numerical overflows or underflows in the computer.

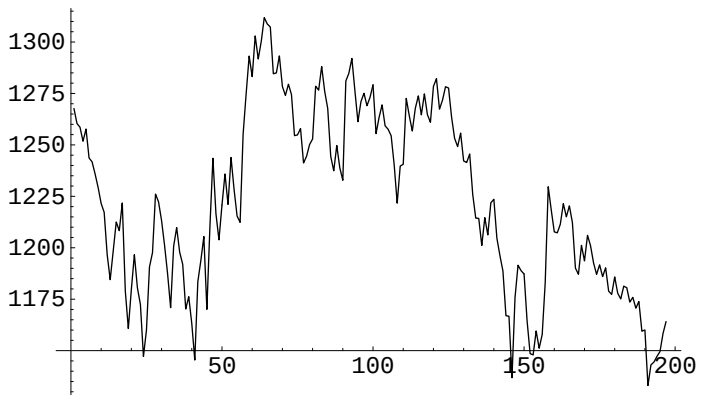
3 Stockholm Stock Exchange index

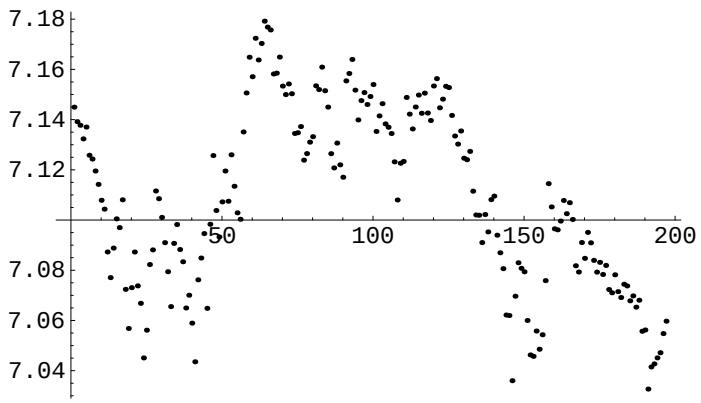
We use the Black-Scholes model to model the index OMXS30 from January 1, 2007 to October 10, 2007 of the 30 most traded in at the Stockholm Stock Exchange.

Our data set is as follows

```
In[6]:= OMXS30=Reverse[Import[
            "~/user/courses/StokAnal/AppliedLecture/OMXS30","Table"]];
        lt=Length[OMXS30]; OMXS30=Table[OMXS30[[i]][[2]], {i,1,lt}];
```

```
    LogOMXS30=Table[Log[OMXS30[[i+1]]]-Log[OMXS30[[i]]],
    {i,1,lt-1}];
lt = Length[LogOMXS30];
Display[" /user/courses/StokAnal/AppliedLecture/OMXS30.eps",
    ListPlot[OMXS30, PlotJoined->True], "EPS"];
Display[" /user/courses/StokAnal/AppliedLecture/LogOMXS30.eps",
    ListPlot[LogOMXS30];, "EPS"];
```





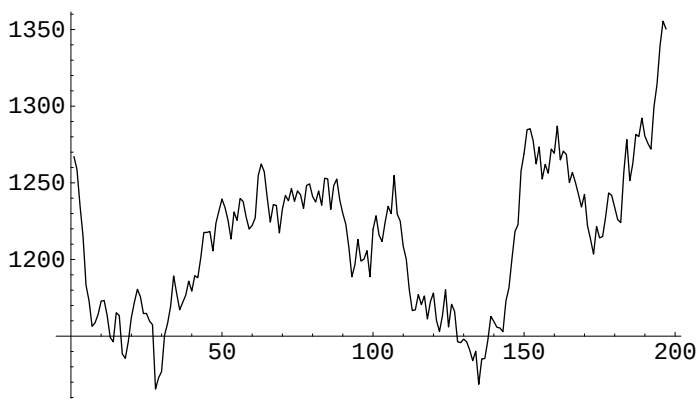
We carry out the maximum likelihood fit by Mathematica (cf. Example 2.2):

```
In[7]:= pY[r_,sigma_,t_,x_,y_] := (1/(Sqrt[2*Pi*t]*sigma))*
            Exp[-(1/(2*t*sigma^2))*(y-x-(r-sigma^2/2)*t)^2];
        Clear[r,sigma];
        NMaximize[{Sum[Log[pY[r,sigma,1,LogOMXS30[[i]],
            LogOMXS30[[i+1]]]]], {i,1,lt-1}], sigma>0}, {r,sigma}]
Out[7]= {581.488, {r->-0.000357341, sigma->0.012454}}
```

In a thorough statistical investigation we should have checked the quality of the fit by means of statistical methodology. However, as this is a course in stochastic calculus rather tha statistics we leave that out for the moment. Instead we just plot the model with the fitted parameters in order to visually check whether it seems to fit with the OMXS30 data.

```
In[8]:= x0=OMSX30[[1]]; r=-0.000357341; sigma=0.012454; n=lt-1; deltat=1;
        For[i=1; B={0}, i<=n, i++, AppendTo[B,B[[i]]
                + Random[NormalDistribution[0,Sqrt[deltat]]]]];
            X = Table[x0*Exp[(r-sigma^2/2)*i*deltat+sigma*B[[i]]],
                {i,1,1+n}];
```

```
In[9]:= Display["~/user/courses/StokAnal/AppliedLecture/BS2.eps",
            ListPlot[X, PlotJoined->True],"EPS"];
```



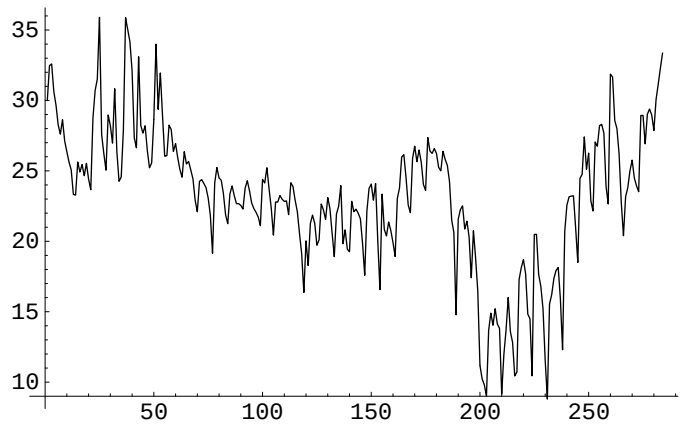
4 Nordpool spot market eletricity prices

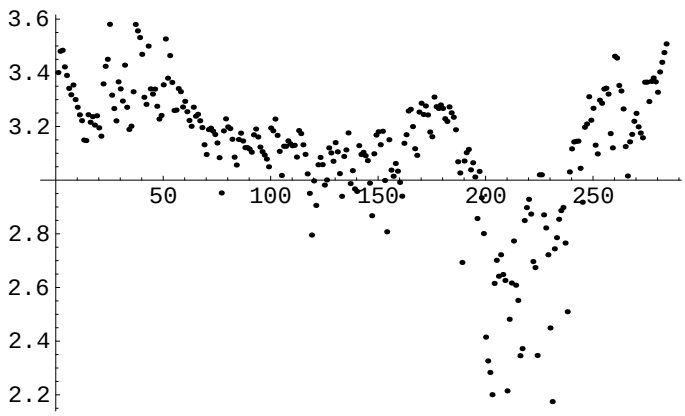
We use an exponential (to obtain positive values) OU process to model daily Nordpool spot market eletricity prices from January 1, 2007 to October 11, 2007.

Our data set is as follows

```
In[10]:= Nordpool=Reverse[Import[
            "~/user/courses/StokAnal/AppliedLecture/Nordpool","Table"]];
        lt=Length[Nordpool]; Nordpool=Table[Nordpool[[i]][[2]], {i,1,lt}];
            LogNordpool=Table[Log[Nordpool[[i+1]]]-Log[Nordpool[[i]]],
            {i,1,lt-1}];
```

```
lt = Length[LogNordpool];
Display[" /user/courses/StokAnal/AppliedLecture/Nordpool.eps",
    ListPlot[Nordpool, PlotJoined->True], "EPS"];
Display[" /user/courses/StokAnal/AppliedLecture/LogNordpool.eps",
    ListPlot[LogNordpool];, "EPS"];
```





We carry out the maximum likelihood fit by Mathematica (cf. Example 2.3):

```
In[11]:= Clear[mu,sigma];
        NMaximize[{Sum[Log[pOU[mu,sigma,LogNordpool[[i]],
            LogNordpool[[i+1]],1]],{i,1,lt-1}], mu>0, sigma>0},
            {mu,sigma}]
Out[11]= {17.5628, {mu->0.00468615, sigma->0.0418831}}
```

Again we check the fit just by plotting the model with the fitted parameters. We leave the details of this to the reader. (see Example 2.3 and Section 3 for hints), as such simulations is the topic of next weeks activities.