

Stochastic volatility: option pricing using a multinomial recombining tree

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Abstract

We treat the problem of option pricing under the Stochastic Volatility (SV) model: the volatility of the underlying asset is a function of an exogenous stochastic process, typically assumed to be mean-reverting. Assuming that only discrete past stock information is available, we adapt an interacting particle stochastic filtering algorithm due to Del Moral, Jacod and Protter (Del Moral et al., 2001) to estimate the SV, and construct a quadrinomial tree which samples volatilities from the SV filter's empirical measure approximation at time 0. Proofs of convergence of the tree to continuous-time SV models are provided. Classical arbitrage-free option pricing is performed on the tree, and provides answers that are close to market prices of options on the SP500 or on blue-chip stocks. We compare our results to non-random volatility models, and to models which continue to estimate volatility after time 0. We show precisely how to calibrate our incomplete market, choosing a specific martingale measure, by using a benchmark option.

Key words and phrases: incomplete markets, Monte-Carlo method, options market, option pricing, particle method, random tree, stochastic filtering, stochastic volatility.

1 Introduction

1.1 Historical context

Despite significant development in option pricing theory since the publication of the celebrated articles (Black and Scholes, 1973) and (Merton, 1973), the Black-Scholes formula for the European Call Option remains the most widely used application of stochastic analysis in Finance. Nevertheless, this formula has significant biases, see for example (Rubinstein, 1985). The model's failure to describe the structure of reported option prices is thought to arise principally from its constant volatility assumption. Allowing the volatility to change over time means that it should generally be modeled as a stochastic process. However, accounting for such *stochastic volatility* (SV) within an option valuation formula is not an easy task. (Hull and White, 1987), (Chesney and Scott, 1989), (Stein and Stein, 1991), (Heston, 1993) all have constructed various specific stochastic volatility models for option pricing. A notable example of an attempt to find analytic formulas for option prices under stochastic volatility is (Fouque et al., 2000a). Even so, there are no simple formulas for the price of options on stochastic-volatility-driven stocks. When some means of implicit or explicit equations are found, the relations involved are cumbersome and not typically robust. Approximations have been constructed to these and other specific volatility models, e.g. (Hilliard and Schwartz, 1996), and (Ritchken and Trevor, 1999).

The discrete tree-based *Binomial* model (Sharpe, 1978), which proposed a pricing scheme not restricted to seeking explicit formulas, was applied in (Cox et al., 1979) to provide an approximation to the lognormal Black-Scholes model and any associated pricing formulas. Later, (Cox and Rubinstein, 1985) used the same approach to value American style options on dividend paying stock, and they also relaxed some other assumptions of the original Black-Scholes model, solidifying the perceived power and versatility of tree-based pricing.

1.2 Stochastic volatility pricing

We believe that if one hopes to find any concrete results for stochastic volatility option pricing, one will have to resort to numerical approximations. Inspired by the success of the binomial models, we too seek a tree-based approximation. This article shows how to achieve our goal using a *quadrinomial* tree model, one in which, at any time, a stock price's increment may take any one of four values. Moreover our tree has the property of being highly recombining, just like the classical binomial tree, meaning that its number of nodes increases only polynomially, with a low order, as the time horizon increases. In this section, we describe the structure of our results, with comparison to some existing literature.

For our underlying continuous-time stochastic process model, we assume that the price process S_t and

the volatility driving process Y_t solve the equations:

$$\begin{cases} dS_t &= \mu S_t dt + \sigma(Y_t) S_t dW_t \\ dY_t &= \alpha(\nu - Y_t) dt + \psi(Y_t) dZ_t \end{cases} \quad (1.1)$$

This model spans all the stochastic volatility models considered previously for different specifications of the functions $\sigma(x)$ and $\psi(x)$. For simplicity, we assume W_t and Z_t are two *independent* Brownian motions. The case when they are correlated can be treated using ideas similar to those presented herein. We choose a mean-reverting type process to drive the volatility because this seems to be the most lucrative choice from the practical point of view, as noted for example in (Fouque et al., 2000a). Our quadrinomial approximation for this model holds in fact for a much wider class of volatilities than the mean-reverting ones in (1.1); the latter are used here for illustrative purposes.

The SV model (1.1) describes an incomplete market, implying that any derivative price will not be unique, a situation which is resolved by choosing a benchmark option, i.e. fixing the price of a specific derivative a priori. More details are in the leading paragraph of Section 4, and also in Sections 4.4 and 6.

The issue of modeling random volatility is made difficult by the fact that it is not observable. A tree approximation approach has been attempted before, most notably (Leisen, 2000) who uses a binomial tree for the volatility and a so-called 8 successors tree for the price. His idea is similar to the one applied in (Nelson and Ramaswamy, 1990) for the case when the volatility is deterministic. However, that idea falls short of replicating the theoretical model when applied to Leisen's case, since the transformation used to eliminate the volatility does not work with stochastic volatility. Another interesting article is (Aingworth et al., 2003) where a Markov chain is used for the volatility process; unfortunately, the price tree therein is not recombining.

Our method for estimating this volatility distribution uses a genetic-type algorithm based on work by Del Moral, Jacod, and Protter (Del Moral et al., 2001). This algorithm works with a fixed number of interacting particles, and gives a good approximation of the *optimal* estimation (in the sense of least squares) of the volatility given the observed stock prices. Hence it can be best described as an *optimal stochastic volatility particle filter*¹.

1.3 Structure of the article

After some preliminary results on the SV model in Section 2, Section 3 details the stochastic volatility filtering algorithm. Based on this estimated volatility distribution we construct two different models: a

¹We mention that for our later construction of the tree the particle filtering step is not necessary. Any *good* approximation of the distribution of the hidden process Y would serve for the construction of the tree. The reason we choose the specific method described in Section 3 is that it is the best method currently available. In the future if simpler or better algorithms should be developed the adaptation to these new methods is straightforward. We thank one of our anonymous referees for this observation.

Static model in Section 4 (see page 12) and a Dynamic model in Section 5, the distinction being that in the static model, volatility estimation is performed only up to the time at which pricing occurs.

Subsections 4.1 and 4.2 present, for the Static model, the process of constructing a quadrinomial recombining tree which converges in distribution to the price process, and includes the stochastic volatility particle filter. Subsection 4.3 gives the proof of convergence of our quadrinomial tree to the solution of equation (1.1). This proof is based on a general result of convergence of Markov chains to diffusions, which we establish first, in Section 2. We go to the trouble of checking that appropriate classical results can be applied, rather than vaguely quoting Markov chain convergence theorems from referenced books (Stroock and Varadhan, 1979) and (Ethier and Kurtz, 1986), as seems to be the norm in the literature.

It is possible to show – although we leave a full proof out of our article for the sake of conciseness – that a tree with anything less than four basic successors could not possibly converge to the Markov process (1.1) it tries to approximate. This includes any binomial or trinomial tree construction. The basic idea is that the main convergence theorem in Section 2 cannot be verified for smaller trees, because we simply do not have enough parameters in the model to verify all the equations involved. Another fact worth mentioning, which we also leave out in this paper, is that if the correlation between the processes W and Z in (1.1) is nonzero, our quadrinomial tree will not work anymore, but a pentanomial tree should be more than sufficient to handle it.

The Dynamic model presented in Section 5 for the sake of comparison, is what one would expect to have to construct in order to be consistent with the stochastic volatility model and the stochastic volatility particle filter estimation method; to the best of our knowledge, current Wall Street practice uses similar techniques. We present a standard Monte-Carlo method for pricing in this case, based on an Euler-type discretization of the governing system of stochastic differential equations (1.1). Our Static model differentiates itself from the Dynamic one because, once the stochastic volatility has been estimated up to the the time at which the option pricing question is being asked, the random volatility distribution remains unchanged thereafter for the construction of the model. Note however that this volatility is not a constant, but rather a random variable whose law is determined as a function of all passed discrete stock observations.

Section 6 contains numerical results obtained when applying our algorithms to SP500 and IBM option data. Section 7 contains the interpretation of the results, and directions of future study using our model.

1.4 Static versus dynamic models

Although, the Static model may seem to be less consistent with the underlying stochastic processes driving our stock price in the future, we show in this article that it performs significantly better than the more mathematically natural Dynamic model in terms of option pricing, when performance is judged by comparison with prices actually observed on the option market. There are a number of ways of interpreting this mathematically counter-intuitive result. The easiest way is to note that any option pricing is done condi-

tional on the filtration available today (\mathcal{F}_0). Since our constructed process (X_{t_i}, Y_{t_i}) is a Markov chain the option price that we are calculating should only depend on the volatility distribution at time 0. It is a known fact that some traders are able to use past information combined with the constant volatility Black-Scholes model to determine option prices by estimating the fixed volatility every time pricing occurs. This seems to be consistent with the methodology implied by our static model.

1.5 Martingale and Objective probability measures

We finish this introduction with some details as to what model to use when. The SV model as written in (1.1), with μ as the stock's mean rate of return, is the stock price under the so-called *Objective probability measure*, a measure usually denoted by the letter \mathbf{P} . The model under this measure, must be used any time a statistical procedure based on historical data is invoked. In particular, if historical data is used to estimate the coefficients μ, α, ν , the estimation method must refer to (1.1). Similarly, once these coefficients are determined or estimated, if historical data is again used to estimate the probability law of the stochastic volatility, then (1.1) must again be used; this is the case in Section 3, up to the time at which historical data ends, which is typically the time at which option pricing occurs.

As with any arbitrage-free pricing scheme, we also introduce one or more so-called *Martingale* (a.k.a. *risk-neutral*) probability measures, usually denoted by \mathbf{Q} , which is defined as the SV model in (1.1) with μ replaced by r , the risk-free rate. The standard use of Girsanov's theorem is invoked to check that such \mathbf{P} and \mathbf{Q} are equivalent measures. The risk-neutral price of an option is its discounted expected future value under such a martingale measure Q . This means that, given the present state of the stock at the time of pricing, the price must be determined by using the model for the stock under \mathbf{Q} , i.e. with μ replaced by r . This is what occurs in the sections on pricing: Sections 4 and 5. In particular, in Section 5, although the stochastic volatility filtering algorithm is used in a dynamic way in order to simulate future paths of the stock, these paths must obey the martingale measure dynamics, and thus the SV filter must be used with μ replaced by r . The presence of μ can still be felt in this situation because at the time at which pricing is performed (time 0), the initial distribution of the stochastic volatility was estimated via the SV filtering procedure using historical data up to time 0.

The reader will be reminded of these distinctions at the appropriate places in the text. We note at this stage that we are not the first to see the necessity to use both the objective and martingale probability measures, depending on whether one is working with historical data for estimation purposes or performing risk-neutral pricing. For instance, the same switching is described, in the context of models using stochastic volatility and a jump component, by Bates (Bates, 2006).

Our last remark in this introduction is a somewhat ad-hoc one. One might wonder whether there is really any major difference in the results of pricing based on stochastic volatility filtering using μ or r before time 0. For this point, imagine first that the discrete observations are extremely dense (high frequency

data). Then one should expect that the volatility should be estimated with a very high accuracy, since for continuous observations the volatility is known exactly. At the same time, at least in the case where the noise terms W and Z driving the dynamics (1.1) are independent, it is trivial to show that whether under the objective probability measure \mathbf{P} , or the risk-neutral measure \mathbf{Q} , the true volatility process Y has the same law. Indeed, the stochastic differential equation giving Y is autonomous, and the change of measure (Girsanov transformation) that leads from (1.1) with μ to (1.1) with r instead of μ , is a change that effects only the noise W driving S , not the noise Z driving Y . Now if the law of the estimated volatility at time 0 is very close to the true volatility at that time, one should expect that it should not matter much whether one uses r instead of μ in the SV filtering algorithm of Section 3. We have not tried to prove or to quantify this fact theoretically, but we have noticed that the result of the SV filter is highly robust to changes in the value of μ . This empirical fact, which we believe to be true in some generality for fairly high frequency data because of the arguments above, is reassuring to those who know that in theory risk-neutral prices in complete markets should not depend on individual stocks' mean rates of return. In our incomplete market situation, the choice of the market price of risk is equivalent to the choice of a single parameter p which we introduce in Section 4, and explains our dependence of prices on the original μ via this choice of p ; that our prices seem to depend very little on p is indicative of a desirable robustness property.

2 The model and theoretical results

For convenience, we work with the logarithm of the price (the return) $X_t = \log S_t$. We model it under an equivalent martingale measure, because the convergence theorems in this section will be used for pricing; thus equations (1.1) become:

$$\begin{cases} dX_t &= \left(r - \frac{\sigma^2(Y_t)}{2} \right) dt + \sigma(Y_t) dW_t \\ dY_t &= \alpha(\nu - Y_t) dt + \psi(Y_t) dZ_t \end{cases} . \quad (2.1)$$

Here r is the short-term risk-free rate of interest, and W_t and Z_t still denote the corresponding Brownian Motions, under the martingale measure.

We would like to obtain discrete versions of the processes (X_t, Y_t) which would converge in distribution to the continuous processes (2.1). Using the fact that e^x is a continuous function, and that the price of the European Option can be written as a conditional expectation of a continuous function of the price, this is enough to ensure convergence in distribution of the option price found with our discrete approximation to the real price of the option. Our Static model, constructed in Section 4, achieves this goal, as a converging discrete time Markov chain. In this section, we present a general Markov chain convergence theorem which we will apply, in Subsection 4.3, to get the convergence we need. The theorem is based on Section 11.3 in the book (Stroock and Varadhan, 1979) (see also (Ethier and Kurtz, 1986)).

We assume that the historical stock prices $S_{t_1}, S_{t_2}, \dots, S_{t_K}$ are known. We will use this history of prices

to estimate the volatility process in the next Section 3, which results in an approximating process Y_t^n that converges in distribution, for each time $t = t_i, i = 1, 2, \dots, K$, as $n \rightarrow \infty$, to the conditional law of the volatility process Y_t in (2.1) given $S_{t_1}, S_{t_2}, \dots, S_{t_i}$. In this section we only need to assume we have a sequence of random variables $Y_{t_K}^n$ converging in distribution to Y_{t_K} conditional on observations, when $n \rightarrow \infty$. The time t_K is now reinterpreted as being the present time $t = 0$, at which we wish to price our option; thus all times t_i are in the past, which is signified by setting $Y_{t_K}^n = Y_0^n$. For simplicity of notation we will drop the subscript: we use $Y^n = Y_0^n$ for this discrete random variable whose law is an approximation of the conditional distribution of Y_0 given $S_{t_1}, S_{t_2}, \dots, S_{t_K}$, and $Y = Y_0$ for the continuous process at time $t_K = 0$, conditional on all observations. The convergence result we prove in this section will be applied, in the Static case, to provide a quadrinomial-tree approximation to the solution of the following equation:

$$dX_t = \left(r - \frac{\sigma^2(Y)}{2} \right) dt + \sigma(Y) dW_t. \quad (2.2)$$

In modeling terms, we are changing the SV model as follows. The Static model assumes the random variable $Y = Y_0$ is consistent with the past evolution of the volatility process given by the autonomous model for $\{Y_s : s \leq 0\}$ in (2.1), with the uncertainty on Y coming from the fact that it is viewed only via the observations $S_{t_1}, S_{t_2}, \dots, S_{t_K}$, but the value of Y is unchanged from time 0 on. This model (2.2) is in sharp contrast to the Dynamic model, which is none other than the true SV model in (2.1). For the latter, a simple Euler method, rather than a tree, will be used.

Let T be the maturity date of the option we are trying to price and N the number of steps in our tree. Let us denote the time increment by $\Delta t = \frac{T}{N} = h$. We start with a discrete Markov chain $(x(ih), \mathcal{F}_{ih})$ with transition probabilities denoted p_x^z of jumping from the point x to the point z . These transition probabilities also depend on h , but for simplicity of notation we leave that subscript out. For each h let \mathbf{P}_x^h be the probability measure on \mathbf{R} characterized by:

$$\left\{ \begin{array}{l} (i) \quad \mathbf{P}_x^h(x(0) = x) = 1 \\ (ii) \quad \mathbf{P}_x^h \left(x(t) = \frac{(i+1)h-t}{h} x(ih) + \frac{t-ih}{h} x((i+1)h) \quad ; \right. \\ \qquad \qquad \qquad \left. ih \leq t < (i+1)h \right) = 1, \quad \forall i \geq 0 \\ (iii) \quad \mathbf{P}_x^h(x((i+1)h) = z | \mathcal{F}_{ih}) = p_x^z, \quad \forall z \in \mathbf{R} \text{ and } \forall i \geq 0 \end{array} \right. \quad (2.3)$$

Remark 2.1. We can see the following:

1. Properties (i) and (iii) say that $(x(ih), \mathcal{F}_{ih}), i \geq 0$ is a time-homogeneous Markov Chain starting at x with transition probability p_x^z under the probability measure \mathbf{P}_x^h .
2. Condition (ii) ensures that the process $x(t)$ is linear between $x(ih)$ and

$x((i+1)h)$. In turn this will later guarantee that the process $x(t)$ we construct is a tree.

3. We will show in Section 4 precisely how to construct this Markov chain $x(ih)$

Conditional on being at x and on the Y^n variable, we construct the following quantities as functions of $h > 0$:

$$b_h(x, Y^n) = \frac{1}{h} \sum_{z \text{ successor of } x} p_x^z(z-x) = \frac{1}{h} E^Y [\Delta x(ih)]$$

$$a_h(x, Y^n) = \frac{1}{h} \sum_{z \text{ successor of } x} p_x^z(z-x)^2 = \frac{1}{h} E^Y [\Delta^2 x(ih)],$$

where the notation $\Delta x(ih)$ is used for the increment over the interval $[ih, (i+1)h]$, and E^Y denotes conditional expectation with respect to the sigma algebra $\mathcal{F}_{t_K}^Y$ generated by the variable Y . Here the successor z is determined using both the predecessor x and the random variable Y^n . We will see exactly how z is defined in Section 4 when we construct our specific Markov chain. Similarly, we define the following quantities corresponding to the infinitesimal generator of the equation (2.2):

$$b(x, Y) = r - \frac{\sigma^2(Y)}{2},$$

$$a(x, Y) = \sigma^2(Y).$$

We make the following assumptions, which will be justified in section 4:

$$\lim_{h \downarrow 0} b_h(x, Y^n) \xrightarrow{D} b(x, Y), \text{ when } n \rightarrow \infty \quad (2.4)$$

$$\lim_{h \downarrow 0} a_h(x, Y^n) \xrightarrow{D} a(x, Y), \text{ when } n \rightarrow \infty \quad (2.5)$$

$$\lim_{h \downarrow 0} \max_{z \text{ successor of } x} |z - x| = 0, \quad (2.6)$$

where \xrightarrow{D} denotes convergence in distribution

Theorem 2.2. *Assume that the martingale problem associated with the diffusion process X_t in (2.2) has a unique solution \mathbf{P}_x starting from $x = \log S_K$ and that the functions $a(x, y)$ and $b(x, y)$ are continuous and bounded. Then conditions (2.4), (2.5) and (2.6) are sufficient to guarantee that \mathbf{P}_x^h as defined in (2.3) converges to \mathbf{P}_x as $h \downarrow 0$ and $n \rightarrow \infty$. Equivalently, $x(ih)$ converges in distribution to X_t the unique solution of the equation (2.2)*

Proof. This is a straightforward application of Theorem 11.3.4 in (Stroock and Varadhan, 1979). One only needs to check the convergence of the infinitesimal generators formed using the discretized coefficients $b_h(\cdot, \cdot)$ and $a_h(\cdot, \cdot)$ to the infinitesimal generator of the continuous version. It should be noted also that our hypothesis (2.6), implies condition (2.6) in the above cited book, because it is a much stronger assumption.

Since it is available to us, we use it. □

3 Estimating the filtered stochastic volatility distribution

In this section we describe the method used to find the distribution of the volatility process given the discrete stock price observations, also known as the stochastic volatility particle filter. The issue of estimating the coefficients of the volatility process Y_t is itself a very difficult problem, which has not led to many satisfactory answers. We plan to address this problem using a systematic statistical analysis in a subsequent article. For now, the reader is directed to current work in (Fouque et al., 2000b), (Nielsen and Vestergaard, 2000) or (Bollerslev and Zhou, 2002).

We assume that the coefficients μ , ν , α and the functions $\sigma(y)$ and $\psi(y)$ are known or have already been estimated; we assume they are twice differentiable with bounded derivatives of all orders up to 2. We now use an algorithm due to Del Moral, Jacod, and Protter (Del Moral et al., 2001) adapted to our specific case, in order to estimate, in the optimal filtering sense, the actual volatility process given all past stock observations. Specifically, denoting by \mathbf{P} the objective (market) probability measure for all past observations; we use this measure in order to exploit the historical data on which the SV filtering procedure will be used up to the time of pricing. Define the random probability measure for all $i = 1, \dots, K$,

$$p_i(dy) = \mathbf{P}[Y_{t_i} \in dy | X_{t_1}, \dots, X_{t_i}].$$

This is the filtered stochastic volatility process at time t_i given all discrete passed observations of the stock price. Note that if X_{t_1}, \dots, X_{t_i} are assumed to be known (observed), then p_i is non-random and depends explicitly on these observed values. In this case, we change the notation to $x_i := X_{t_i}$. (Del Moral et al., 2001), Section 5, provides an algorithm which constructs n time-varying particles $\{Y_i^j : i = 1, \dots, K; j = 1, \dots, n\}$ together with corresponding probabilities $\{p_i^j : i = 1, \dots, K; j = 1, \dots, n\}$ such that for each i , and for any sequence of observations X_{t_1}, \dots, X_{t_i} , the empirical distribution of these particles converges to the probability measure $p_i(dy)$. This genetic-type algorithm boast a two step iteration: a *mutation* step and a *selection* step. We refer to the cited article (Del Moral et al., 2001, Theorem 5.1) for the proof of convergence. Here we present the algorithm in detail.

For practical purposes, we use, as our initial distribution for the volatility at time t_1 , an arbitrary Dirac point mass $\delta_{\{\nu\}}$, but the empirical distribution of any set of n initial particles $\left\{Y_1^j\right\}_{j=1}^n$ would work as well due to a general so-called “stability property” which we do not discuss here. We assume for simplicity that

$t_{i+1} - t_i = \Delta t = h$. Let ϕ be a function in $L^1(\mathbf{R})$. To fix ideas, we may, and will use, the function:

$$\phi(x) = \begin{cases} 1 - |x| & \text{if } -1 < x < 1 \\ 0 & \text{otherwise} \end{cases}$$

Another function we could use is $\phi(x) = e^{-2|x|}$. For $n > 0$ we define the contraction corresponding to $\phi(x)$ as:

$$\phi_n(x) = \sqrt[3]{n} \phi(x \sqrt[3]{n}) = \begin{cases} \sqrt[3]{n} (1 - |x \sqrt[3]{n}|) & \text{if } -\frac{1}{\sqrt[3]{n}} < x < \frac{1}{\sqrt[3]{n}} \\ 0 & \text{otherwise} \end{cases}. \quad (3.1)$$

Let $M = M_n$ be an integer. It is used to define the number of Euler steps in each time interval. (Del Moral et al., 2001) indicate that $M = n^{1/3}$ is a good choice for theoretical reasons, but we have noted empirically that the filtering algorithm works well even for very small n (say $n = 10$), in which case M will need to be much larger, typically $M = 1000$.

STEP 1: We start with $X_{t_0} = x_0$ and $Y_{t_0} = y_0 = \nu$.

Mutation step: This part calculates a random variable with approximately the same distribution as (X_{t_1}, Y_{t_1}) using the well known Euler scheme for the equation (2.1); here, r should be replaced by μ in (2.1) since the estimation, which is based on historical data, must be relative to the objective probability dynamics given in (1.1). More precisely, with $h = \Delta t = (t_{i+1} - t_i)$ our original time step, which we now divide into M pieces, starting from the initial data $(X'_{t_0,i}, Y'_{t_0,i}) = (x_0, y_0)$ we define recursively: for $i = 0$ to $M - 1$,

$$\begin{aligned} Y'_{t_0,i+1} &= Y'_{t_0,i} + \frac{h}{M} \alpha(\nu - Y'_{t_0,i}) + \sqrt{\frac{h}{M}} \psi(Y'_{t_0,i}) U_i \\ X'_{t_0,i+1} &= X'_{t_0,i} + \frac{h}{M} \left(\mu - \frac{\sigma^2(Y'_{t_0,i})}{2} \right) + \sqrt{\frac{h}{M}} \sigma(Y'_{t_0,i}) U'_i. \end{aligned} \quad (3.2)$$

Here U_i and U'_i are iid Normal random variables with mean 0 and variance 1. At the end of one such mutation (M Euler steps) we obtain Euler approximations of the values X_{t_1} and Y_{t_1} :

$$\begin{aligned} X'_{t_1} &:= X'_{t_0,M}, \\ Y'_{t_1} &:= Y'_{t_0,M}. \end{aligned} \quad (3.3)$$

We repeat the mutation step n times to obtain n independent pairs and we denote them: $\{(X'_{t_1}^j, Y'_{t_1}^j)\}_{j=1, \dots, n}$. The prime notation is used here to make it clear that these are resulting from the intermediate mutation step.

Selection step: Now we introduce a discrete probability measure, constructed using the pairs found at

the end of the mutation step:

$$\Phi_1^n = \begin{cases} \frac{1}{C} \sum_{j=1}^n \phi_n(X_{t_1}^{\prime j} - x_1) \delta_{\{Y_{t_1}^{\prime j}\}} & \text{if } C > 0 \\ \delta_{\{0\}} & \text{otherwise.} \end{cases} \quad (3.4)$$

Here the constant C is chosen to make Φ_1^n a probability measure, i.e., $C = \sum_{j=1}^n \phi_n(X_{t_1}^{\prime j} - x_1)$. The idea is to “select” only the values of $Y_{t_1}^{\prime j}$ which correspond to values of $X_{t_1}^{\prime j}$ not far away from the realization x_1 . Therefore, we sample n “particles” $\{Y_{t_1}^{\prime j}\}_{j=1, \dots, n}$ independently from the distribution Φ_1^n . This is equivalent to saying that each $Y_{t_1}^{\prime j}$ independently jumps to the position of one of the other particles in $\{Y_{t_1}^{\prime j}\}_{j=1, \dots, n}$ with probabilities equal to the “fitnesses” $\{\phi_n(X_{t_1}^{\prime j} - x_1)/C\}_{j=1, \dots, n}$.

At the end of the first Selection step we obtain an estimate of the distribution of the original latent variable Y_{t_1} given by Φ_1^n , which is equivalently given by the unweighted particles $\{Y_{t_1}^{\prime j}\}_{j=1, \dots, n}$.

STEPS 2 TO K : For each step $i = 2, 3, \dots, K$, we apply the mutation step starting with the n values generated from the distribution Φ_{i-1}^n at the end of the previous selection step. Moreover, step i occurs at time t_{i-1} , so that x_{i-1} is observed. Hence, for each $j = 1, 2, \dots, n$, we start with $(x_{i-1}, Y_{t_{i-1}}^j)$, and apply the Euler method (3.2). Thus, we obtain n pairs $\{(X_{t_i}^{\prime j}, Y_{t_i}^{\prime j})\}_{j=1, 2, \dots, n}$. Then we apply the selection step to these pairs i.e., we obtain:

$$\Phi_i^n = \begin{cases} \frac{1}{C} \sum_{j=1}^n \phi_n(X_{t_i}^{\prime j} - x_i) \delta_{\{Y_{t_i}^{\prime j}\}} & \text{if } C > 0 \\ \delta_{\{0\}} & \text{otherwise.} \end{cases} \quad (3.5)$$

and $C = \sum_{j=1}^n \phi_n(X_{t_i}^{\prime j} - x_i)$, with n IID particle positions $\{Y_{t_i}^{\prime j}\}_{j=1, \dots, n}$ sampled from Φ_i^n .

OUTPUT: The output of this algorithm, at each step i , is the discrete distribution Φ_i^n : it is our estimate for $p_i(dy)$, the distribution of the process Y_t at the respective time t_i given all past stock observations x_1, \dots, x_i .

In our construction of the quadrinomial tree, we use only the latest estimated probability distribution, i.e., $\Phi_K^n = \sum_{j=1}^n \bar{p}_j \delta_{\bar{Y}_j}$, where according to (3.5),

$$\begin{aligned} \bar{p}_j &= \frac{1}{C} \phi_n(X_{t_K}^{\prime j} - x_K) \\ \bar{Y}_j &= Y_{t_K}^{\prime j} \end{aligned} \quad (3.6)$$

We will refer to this distribution by saying that it is the set of particles $\{\bar{Y}_1, \bar{Y}_2, \dots, \bar{Y}_n\}$ together with their corresponding probabilities (or weights) $\{\bar{p}_1, \bar{p}_2, \dots, \bar{p}_n\}$. We could, equivalently, define Φ_K^n differently, as the empirical distribution of the last n IID sampled particles $\{Y_{t_K}^{\prime j}\}_{j=1, \dots, n}$. The algorithm’s final output would

have the same properties this way. We prefer the weighted formulation, however.

4 The Static Model

The “Static” model, presented in this section, is our main research contribution in mathematical finance. As we shall see from Section 7 this is the better model when compared with the “Dynamic” model.

The data available is the value of the stock price today S_0 , and a history of earlier stock prices, resulting, from the previous section, in a distribution Φ_K^n as our best estimate for the present volatility given past observations; Φ_K^n is the empirical distribution of the set Y^n of particles $\{\bar{Y}_1, \bar{Y}_2, \dots, \bar{Y}_n\}$ with weights $\{\bar{p}_1, \bar{p}_2, \dots, \bar{p}_n\}$ via formulae (3.6).

Let us divide the interval $[0, T]$ into N subintervals each of length $\Delta t = \frac{T}{N} = h$. At each of the times $i\Delta t = ih$ the tree is branching. The nodes on the tree represent possible return values $X_t = \log S_t$ at times $t = ih, i = 1, \dots, N$.

4.1 Construction of the one period model

In this subsection we construct the basic building block for our tree. See the end of this subsection, and Subsection 4.4 for information about our incomplete market.

Assume we are working in the i th time step, and that we are at a point where the log stock price is x . What are the possible successors of x ?

Since we do not wish to drag the entire set of n particles Y^n along the tree, which would force us to shoot off n additional branches at each node, we propose the following way of reducing this number to one, while allowing the volatility values to change from one time step to the next in a manner consistent with the filtered particle distribution Φ_K^n . We simply sample a volatility value from the distribution Φ_K^n at each time period $ih, i \in \{1, 2, \dots, N\}$. Denote the value drawn at step i corresponding to time ih by Y_i . Corresponding to this volatility value Y_i we construct the successors in the following way.

We consider a grid of points of the form $l\sigma(Y_i)\sqrt{\Delta t}$ with l taking integer values. No matter where the parent x is, it will fall at one such point or between two grid points. In this grid, let j be the integer that corresponds to the point above x . Mathematically, j is the point that attains: $\inf \{l \in \mathbf{N} : l\sigma(Y_i)\sqrt{\Delta t} \geq x\}$. We will have two possible cases: either the point $j\sigma(Y_i)\sqrt{\Delta t}$ on the grid corresponding to j (above) is closer to x , or the point $(j-1)\sigma(Y_i)\sqrt{\Delta t}$ corresponding to $j-1$ (below) is closer. We will use δ to denote the distance from the parent x and the closest successor on the grid. We will use q to denote the standardized value, i.e.

$$q := \delta / \left(\sigma(Y_i)\sqrt{\Delta t} \right). \quad (4.1)$$

We will treat the two cases separately.

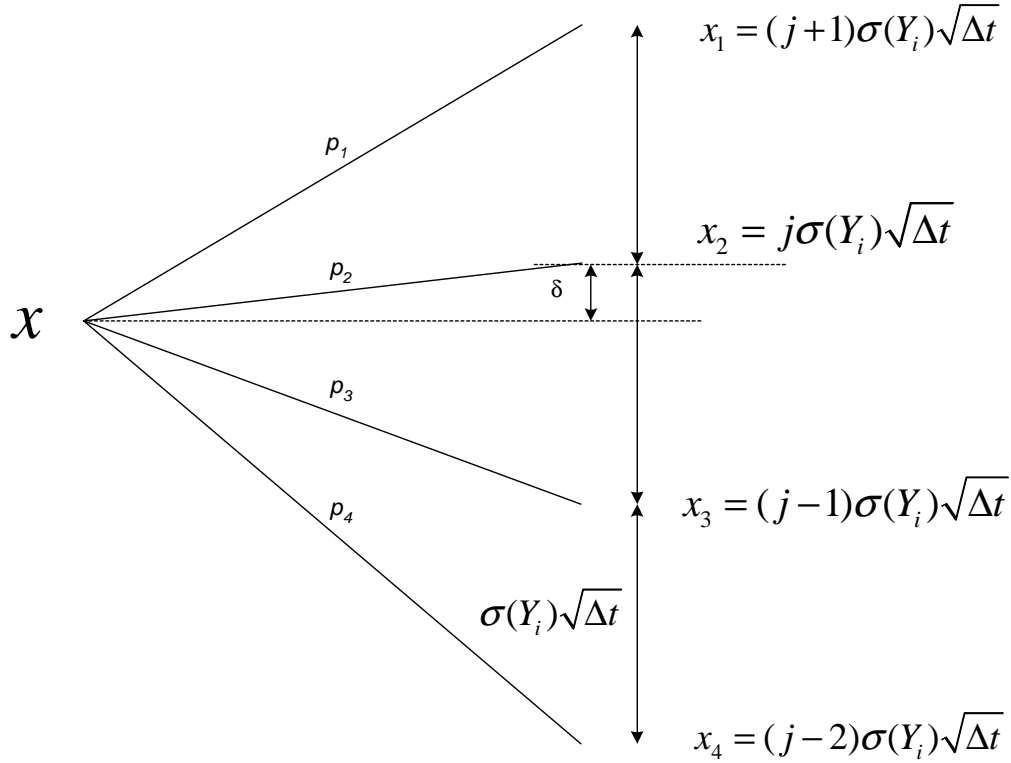


Figure 1: The basic successors for a given volatility value. Case 1.

Case 1. $j \sigma(Y_i) \sqrt{\Delta t}$ is the point on the grid closest to x .

Note that in this case δ is: $\delta = x - j \sigma(Y_i) \sqrt{\Delta t}$.

Remark 4.1. With δ as above and q defined in (4.1) we have $\delta \in \left[-\frac{\sigma(Y_i) \sqrt{\Delta t}}{2}, 0\right]$ and $q \in \left[-\frac{1}{2}, 0\right]$

Figure 1 on page 13 refers to this case.

One of the assumptions we need to verify is (2.4), which asks the mean of the increment to converge to the drift of the process X_t in (2.2). In order to simplify this requirement, we add the drift quantity to each of the successors. This trick will simplify the conditions (2.4) to require the convergence of the mean increment to zero. This idea has been previously used by many authors including Leisen as well as Nelson & Ramaswamy.

Explicitly, we take the 4 successors to be:

$$\begin{cases} x_1 &= (j+1)\sigma(Y_i)\sqrt{\Delta t} + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_2 &= j\sigma(Y_i)\sqrt{\Delta t} + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_3 &= (j-1)\sigma(Y_i)\sqrt{\Delta t} + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_4 &= (j-2)\sigma(Y_i)\sqrt{\Delta t} + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \end{cases} \quad (4.2)$$

First notice that condition (2.6) is trivially satisfied by this choice of successors. We now define a system of equations consisting of the variance condition (2.5), and the mean condition (2.4), and we solve it for the joint probabilities p_1, p_2, p_3 and p_4 . Because the market is incomplete, we cannot expect to have a unique solution to the system. *However, each solution will give us an equivalent martingale measure.*

Algebraically, we may write: $j\sigma(Y_i)\sqrt{\Delta t} = x - \delta$, and using this we infer that the increments over the period Δt are:

$$\begin{cases} x_1 - x &= \sigma(Y_i)\sqrt{\Delta t} - \delta + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_2 - x &= -\delta + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_3 - x &= -\sigma(Y_i)\sqrt{\Delta t} - \delta + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ x_4 - x &= -2\sigma(Y_i)\sqrt{\Delta t} - \delta + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \end{cases} \quad (4.3)$$

Conditions (2.4) and (2.5) translate here as:

$$\mathbf{E}[\Delta x|Y_i] = \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t$$

$$\mathbf{V}[\Delta x|Y_i] = \sigma^2(Y_i)\Delta t$$

where by Δx we denote the increment over the period Δt . Since Δx given Y_i is equal to $x_j - x$ with probability p_j , for $j = 1, 2, 3, 4$, we simply need to solve the following system of equations with respect to p_1, p_2, p_3 and p_4 :

$$\begin{cases} \left(\sigma(Y_i)\sqrt{\Delta t} - \delta\right) p_1 + (-\delta)p_2 + \left(-\sigma(Y_i)\sqrt{\Delta t} - \delta\right) p_3 + \left(-2\sigma(Y_i)\sqrt{\Delta t} - \delta\right) p_4 = 0 \\ \left(\sigma(Y_i)\sqrt{\Delta t} - \delta\right)^2 p_1 + (-\delta)^2 p_2 + \left(-\sigma(Y_i)\sqrt{\Delta t} - \delta\right)^2 p_3 + \left(-2\sigma(Y_i)\sqrt{\Delta t} - \delta\right)^2 p_4 \\ \quad - \mathbf{E}[\Delta x|Y_i]^2 = \sigma^2(Y_i)\Delta t \\ p_1 + p_2 + p_3 + p_4 = 1 \end{cases} \quad (4.4)$$

Eliminating the terms in the first equation of the system we get:

$$\sigma(Y_i)\sqrt{\Delta t} (p_1 - p_3 - 2p_4) - \delta = 0$$

or

$$p_1 - p_3 - 2p_4 = \frac{\delta}{\sigma(Y_i)\sqrt{\Delta t}}. \quad (4.5)$$

Neglecting the terms of the form $\left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t$ when using (4.5) in the second equation in (4.4) we obtain

the following:

$$\begin{aligned} \sigma^2(Y_i)\Delta t &= \sigma^2(Y_i)\Delta t (p_1 + p_3 + 4p_4) + 2\delta\sigma(Y_i)\sqrt{\Delta t} (p_3 - p_1 + 2p_4) + \delta^2 \\ &\quad - \left(\sigma(Y_i)\sqrt{\Delta t} (p_1 - p_3 - 2p_4) - \delta \right)^2. \end{aligned}$$

After simplifications, we obtain the equation:

$$(p_1 + p_3 + 4p_4) - (p_1 - p_3 - 2p_4)^2 = 1.$$

So now the system of equations to be solved is the following:

$$\begin{cases} p_1 + p_3 + 4p_4 = 1 + \frac{\delta^2}{\sigma^2(Y_i)\Delta t} \\ p_1 - p_3 - 2p_4 = \frac{\delta}{\sigma(Y_i)\sqrt{\Delta t}} \\ p_1 + p_2 + p_3 + p_4 = 1 \end{cases} \quad (4.6)$$

This system with 4 unknowns and 3 equations has an infinite number of solutions. Since we are interested in the solutions in the interval $[0, 1]$, we are able to reduce somewhat the range of the solutions. Let us denote by p the probability of the branch furthest away from x . In this case $p := p_4$. Expressing the other probabilities in term of p and the q defined in Remark 4.1, we obtain:

$$\begin{cases} p_1 = \frac{1}{2} (1 + q + q^2) - p \\ p_2 = 3p - q^2 \\ p_3 = \frac{1}{2} (1 - q + q^2) - 3p \end{cases} \quad (4.7)$$

Now using the condition that every probability needs to be between 0 and 1, we solve the following three inequalities:

$$\begin{cases} \frac{1}{2} (-1 + q + q^2) \leq p \leq \frac{1}{2} (1 + q + q^2) \\ \frac{q^2}{3} \leq p \leq \frac{1+q^2}{3} \\ \frac{1}{6} (-1 - q + q^2) \leq p \leq \frac{1}{6} (1 - q + q^2) \end{cases} \quad (4.8)$$

It is not difficult to see that the solution of the inequalities (4.8) is $p \in [\frac{1}{12}, \frac{1}{6}]$. Consequently, we will obtain an equivalent martingale measure for every $p \in [\frac{1}{12}, \frac{1}{6}]$ thanks to the first equation in (4.4).

We postpone the statement of this result until after Case 2.

Case 2. $(j-1)\sigma(Y_i)\sqrt{\Delta t}$ is the point on the grid closest to x .

In this case $\delta = x - (j-1)\sigma(Y_i)\sqrt{\Delta t}$.

Remark 4.2. This case is the mirror image of the first case with respect to x . In this second case we will obtain $\delta \in \left[0, \frac{\sigma(Y_i)\sqrt{\Delta t}}{2}\right]$ and $q \in \left[0, \frac{1}{2}\right]$

The 4 successors are the same as in Case 1; the increments are calculated similarly to (4.3).

Using the Remark 4.2 together with the equations (2.4) and (2.5) gives the following solution:

$$\begin{cases} p_2 = \frac{1}{2}(1 + q + q^2) - 3p \\ p_3 = 3p - q^2 \\ p_4 = \frac{1}{2}(1 - q + q^2) - p \end{cases}, \quad (4.9)$$

where p is the probability of the successor furthest away, in this case p_1 . This is just the solution given in (4.7) with $p_1 \Leftrightarrow p_4$ and $p_2 \Leftrightarrow p_3$ taking into account the interval for δ . Thus, we are able to state the following result.

Lemma 4.3. *If we construct a one step quadrinomial tree with the successors given by (4.2), and we denote by p the probability of the successor furthest away from x , then for every $p \in \left[\frac{1}{12}, \frac{1}{6}\right]$:*

(i) *in Case 1 ($q \in \left[-\frac{1}{2}, 0\right]$) the relations (4.7) define an equivalent martingale measure.*

(ii) *in Case 2 ($q \in \left[0, \frac{1}{2}\right]$) the relations (4.9) define an equivalent martingale measure.*

Because of the indetermination on $p \in \left[\frac{1}{12}, \frac{1}{6}\right]$ in the above two lemmas, as we said, our martingale measure is not unique. Consequently, option prices are determined only after a value of p has been chosen, that is to say, the market defined by the one-period model, and any multiperiod constructions based on it, is incomplete. This is of course no surprise, since volatility is not directly observable in discrete time, and is not a traded asset, and therefore we have a model with two sources of randomness and only one liquid risky asset. In order to complete the market, we make the following.

Assumption 4.4. There is a liquid market for some contingent claim based on S .

The assumption of no arbitrage in itself is not sufficient to determine all option prices, but it *does* imply some consistency relations between various claim prices. With the above assumption 4.4, if we use that contingent claim as a benchmark, saying that its market prices are valid, then we can consider it as a second liquid risky asset, and the price of any other derivative on S would be uniquely determined. In practice, one only needs to find the value p which yields the best fit between any pricing scheme for the benchmark option using our p -based one-period model, and the market price for the benchmark option. A situation where we do just this is given in Sections 4.4 and 6.

Remark 4.5. As we observed above, constructing the Equivalent Martingale Measure involves solving a system with 3 equations and 4 unknowns. It is natural to ask then, why not try a tree with three successors, which will in turn imply solving a system with 3 equations and 3 variables. However, it turns out that such

a system has no solution for any possible choice of successors. This is to be expected, since the existence of such a solution will contradict the incompleteness of the market.

4.2 Construction of the multi-period model. Option valuation.

Suppose now that we have to compute an option value. For illustrative purposes we use an European type option, but the method should work with any kind of path dependent option e.g., American, Asian, Barrier etc.

Assume that the payoff function is $\Phi(X_T)$. The maturity date of the option is T , and the purpose is to compute the value of this option at time $t = 0$ using our model (2.2). We divide the interval $[0, T]$ into N smaller ones of length $h = \Delta t := \frac{T}{N}$. At each of the points $i\Delta t$ with $i \in \{1, 2, \dots, N\}$ we then construct the successors in our tree as in the previous section. This tree converges in distribution to the solution of the stochastic model (2.2). A proof of this fact using Theorem 2.2 is found in the next subsection.

In order to calculate an estimate for the option price we employ a resampling method based on the particles defining the approximate discrete distribution for the initial volatility Y . Suppose that we have the discrete probability distribution of Y , i.e. we know the stochastic volatility particle filter values $\{\bar{Y}_1, \bar{Y}_2, \dots, \bar{Y}_n\}$, each with probability $\{\bar{p}_1, \bar{p}_2, \dots, \bar{p}_n\}$. We sample N values from this distribution, and use them like the realization of volatility process Y along the N levels of the tree, into the future. In other words, call these sampled values Y_1, \dots, Y_N . We start with the initial value x_0 . We then compute the 4 successors of x_0 as in the previous section for the first sampled value, Y_1 . After this, for each one of the 4 successors we compute their respective successors for the second sampled volatility value Y_2 , and so on, resulting in a quadrinomial tree.

This tree allows us to compute one instance of the option price by using the standard pricing technique that is consistent with a no-arbitrage condition: we compute the value of the payoff function Φ at the terminal nodes of the tree; then, working backward in the path tree, we compute the value of the option at time $t = 0$ as the discounted expectation of the final node values using one of the martingale measures found in the previous section. Because the tree is recombining by construction, the level of computation implied is manageable, of a polynomial order in N . We will present empirical evidence of this fact in Section 6. The complexity of the filtering algorithm leading to the original particle values $\bar{Y} := \{\bar{Y}_1, \bar{Y}_2, \dots, \bar{Y}_n\}$ is no greater.

If we are to iterate this procedure by using repeated samples $\{\bar{Y}^1, \dots, \bar{Y}^{n'}\}$, we can take the average of all prices obtained for each tree generated using each separate sample. This Monte Carlo method converges, as the number of particles n and the number of Monte Carlo samples n' increases, to the true option price for the quadrinomial tree in which the original distribution of the volatility is the true filtered law $p_0(dy)$ of Y_0 given past observations of the stock price. We leave a full proof of this convergence out of our article. It uses the following fact proved by Pierre del Moral, known as a *propagation of chaos* result: for fixed number

of samples n' and fixed number of time iterations K , as the number of particles n increases, for n' samples $\{Y_1, \dots, Y_{n'}\}$ from the distribution of particles $\{\bar{Y}_1, \bar{Y}_2, \dots, \bar{Y}_n\}$ with probabilities $\{\bar{p}_1, \bar{p}_2, \dots, \bar{p}_n\}$, the Y_i 's are asymptotically independent and all identically distributed according to the law of Y_0 given all past stock price observations. Chapter 8, and in particular Theorem 8.3.3 in (Del Moral, 2004), can be consulted for this fact. The convergence proof in the next section is also based on del Moral's propagation of chaos.

In fact, a more precise convergence result can be established here. According to del Moral's propagation of chaos Theorem 8.3.3 in (Del Moral, 2004), if the number of samples $n' = n'(n)$ is taken to be a function of the number of particles n , and if the number of time steps $K = K(n)$, used before time 0 to simulate the particle approximation of Y_0 , is also a function of n , then the speed at which the samples $\{Y_1, \dots, Y_{n'}\}$ converge to independent copies of the filtered law of Y_0 given all past continuously observed stock prices is given by

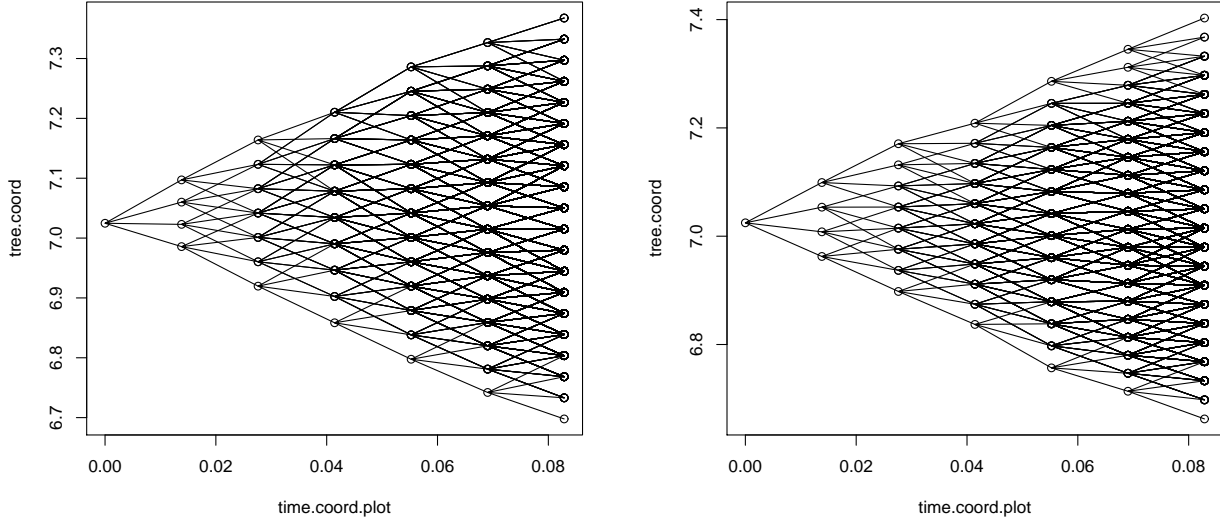
$$\frac{|n'(n)|^2 K(n)}{n}. \quad (4.10)$$

Thus if K and n' are chosen so that the above quantity tends to 0 as n tends to $+\infty$, we indeed have the announced convergence.

Because of the very special nature of stochastic volatility filtering, at any time t , the squared volatility in the original model (2.1) is actually equal to the differential of the quadratic variation of the martingale X , which means that when the number of time observations K tends to infinity in a finite time interval $[0, T]$, $\sigma^2(Y_t)$ does not need to be filtered: it is actually known, given the entire past of the path of X in continuous time. For simplicity, assume that σ^2 is a bijective function on the space where Y lives, or change the dynamics of Y so that $\sigma^2(Y_t)$ is Y_t itself. Alternately, we see that the filtered value of Y_0 tends to the actual objective value of Y_0 when K tends to $+\infty$. Hence in the above situation where we can apply the propagation of chaos, if $K(n)$ also tends to $+\infty$, we can guarantee that our sample $\{Y_1, \dots, Y_K\}$ converges in distribution to independent copies of Y_0 . Then, also invoking the convergence theorem of the next section, we conclude that the option valuation method described in this section converges to the true option price under the Static model (2.2) where the fixed random variable Y is the true objective volatility Y_0 .

The above considerations do not preclude us from using $\lim_{n \rightarrow \infty} n'(n) = \infty$ while the number of discrete stock observations K remains fixed; in this case, expression (4.10) shows that, as soon as $n'(n) \ll n^2$, if $n \rightarrow \infty$, the samples $\{Y_1, \dots, Y_{n'}\}$ converge in law to i.i.d. copies of the the filtered law $p_K(dy)$ of Y_0 given past discrete stock observations, which is sufficient to implement the Monte Carlo pricing method described in this section.

Figure 2, on page 19, contains an example of two simulated trees. We can visualize from the presented images that the trees recombine, and that the level of recombination is closer to that of a classical trinomial or binomial tree (linear growth of number of nodes for each additional time step), and accordingly the level of computation based on such a tree is not very high. Because our tree is constructed using the sampled volatility values at each time step, the number of nodes at each time depends on historical stock



(a) One instance of the generated tree

(b) Another instance of the generated tree

Figure 2: Example of reduced trees

observations. It is therefore not predetermined, and the degree of recombination varies slightly as time increases. We present some empirical studies about the rate of increase of the total number of nodes in the tree in Section 6. The theoretical study of how much recombination actually occurs seems to be a non-trivial problem, as a consequence; we leave such a discussion out of this paper, for the sake of conciseness.

4.3 Convergence result for the quadrinomial tree

As noted in Section 2 we shall prove that our constructed tree converges to the solution of the process

$$dX_t = \left(r - \frac{\sigma^2(Y)}{2} \right) dt + \sigma(Y)dW_t,$$

where Y is a random variable with the same distribution as the actual volatility process at time 0 i.e., Y_0 .

Theorem 4.6. *Consider the quadrinomial tree, with nodes indexed by the log values of a stock, defined by the successors x_1, x_2, x_3, x_4 of a value x as in (4.2), with probabilities p_1, p_2, p_3, p_4 given by the relations (4.7) (resp. (4.9)), with $p = p_1$ (resp. $p = p_4$) when x_1 is furthest from the parent value x (resp. x_4 is furthest). For any fixed $p \in [\frac{1}{12}, \frac{1}{6}]$, these probabilities define a martingale measure on the paths of the tree. Furthermore, the Markov chain defined on the vertices of the tree under any such measure on the tree, defined by the relations (4.7) and (4.9), converges in distribution to the continuous process (2.2) as the time interval $h = \Delta t \rightarrow 0$ and the number of filtering particles $n \rightarrow \infty$.*

Proof. The first equation in the systems we solved above guarantees that the discounted process has expected increments zero, thus assuring us that the resulting measure we find is a martingale measure.

It remains to show the convergence result, and to this end we are using Theorem 2.2. More specifically, we are going to prove that the two critical assumptions (2.4) and (2.5) are satisfied. Assume that at step i the tree is constructed using the volatility value Y_i sampled from the distribution Y^n . The probability of this outcome is denoted with \bar{p}_i . We remind the reader that the formulae for these quantities are given in (3.6).

Let us define the variable \mathcal{X} in **Case 1**:

$$\mathcal{X} = \begin{cases} \sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_1}{\bar{p}_i} \\ -\delta & \text{with probability } \frac{p_2}{\bar{p}_i} \\ -\sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_3}{\bar{p}_i} \\ -2\sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_4}{\bar{p}_i} \end{cases}$$

and in **Case 2** as:

$$\mathcal{X} = \begin{cases} 2\sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_1}{\bar{p}_i} \\ \sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_2}{\bar{p}_i} \\ -\delta & \text{with probability } \frac{p_3}{\bar{p}_i} \\ -\sigma(Y_i)\sqrt{\Delta t} - \delta & \text{with probability } \frac{p_4}{\bar{p}_i} \end{cases}$$

where $\frac{\delta}{\sigma(Y_i)\sqrt{\Delta t}}$ is in the interval $[-\frac{1}{2}, 0]$ in case 1 and in $[0, \frac{1}{2}]$ in the case 2.

Let us note here that using Lemma 4.3 and the equations (4.7) and (4.9) the probabilities defined above are symmetrical with respect to x and that in either of the two cases $\Delta x|Y_i = \mathcal{X} + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t$. Also, note that the system (4.4) gives the mean and variance of \mathcal{X} as 0 and $\sigma^2(Y_i)\Delta t$, respectively. Thus, we have:

$$\begin{aligned} \mathbf{E}[\Delta x|Y_i] &= \mathbf{E}[\mathcal{X}] + \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \\ &= \left(r - \frac{\sigma^2(Y_i)}{2}\right) \Delta t \end{aligned}$$

Now from the definition of $b_h(x)$ we have:

$$b_h(x) = \frac{\mathbf{E}[\Delta x|Y_i]}{\Delta t} = r - \frac{\sigma^2(Y_i)}{2}$$

At this point we need to invoke Theorem 8.3.3 in (Del Moral, 2004). When applied to our particular case it implies that each of the variables Y_1, Y_2, \dots drawn from the discrete distribution Y^n converge in distribution as $n \rightarrow \infty$ to a random variable $Y^{\Delta t}$ whose law is that of the filtered value of Y_0 given the observed stock

prices before time 0. Moreover, using the facts given in the last paragraph of the previous subsection, when $\Delta t \rightarrow 0$, the law of $Y^{\Delta t}$ tends to the law of the actual initial volatility Y_0 . Thus for a n large enough and Δt small enough, using the continuity of $\sigma(y)$, we obtain that Assumption (2.4) is satisfied.

Since $\mathbf{Var}[\Delta x|Y_i] = \mathbf{Var}[\mathcal{X}]$ we have:

$$\mathbf{E}[(\Delta x)^2|Y_i] = \mathbf{Var}[\mathcal{X}] + \mathbf{E}[\Delta x|Y_i]^2 = \sigma^2(Y_i)\Delta t + \left(r - \frac{\sigma^2(Y_i)}{2}\right)^2 \Delta t^2$$

Thus:

$$a_h(x) = \frac{\mathbf{E}[\Delta x^2|Y_i]}{\Delta t} = \sigma^2(Y_i) + \left(r - \frac{\sigma^2(Y_i)}{2}\right)^2 \Delta t$$

Using the fact that r is a constant and that the function σ is locally bounded, the second term in $a_h(x)$ converges to 0 as $\Delta t \rightarrow 0$. Using again the Theorem 8.3.3 in (Del Moral, 2004) and the continuity of the function $\sigma^2(y)$, for a large enough n , we obtain the Assumption (2.5). \square

4.4 Practical issues; choosing p

To construct our tree we need to know the value of the parameter p described in the previous subsections. In order to do that we use the price of a suitably chosen option from the market to calibrate for the parameter p . The option we chose to use in our numerics (see Section 6) is the previous day (April 21, 2004, in the case of the S&P500, and July 18, 2005 for IBM) at-the-money option, but theoretically, it could be any option from any moment in the past. For fixed values of p on a dense grid on the interval $[\frac{1}{12}, \frac{1}{6}]$ we generate trees and compute option prices corresponding to each p in the grid. Then we compare the results obtained with the price of the option from the market and we choose the value p that gave the closest value to the option on the market.

We use this parameter p to compute values for all the options at time 0 (April 22, 2004, and July 19, 2005 respectively). A graphical illustration of this process applied to a specific example is presented in Figure 4. It turns out that these option prices are quite insensitive to the actual choice of p , for p in a wide range within the interval $[\frac{1}{12}, \frac{1}{6}]$. This robustness is a highly desirable property when one is faced with deciding in a rather arbitrary way how to choose a martingale measure.

Using our tree we can also approximate the sensitivities of the option price (the Greeks). If we denote

by C the value of the option obtained using our tree method, we can compute:

$$\begin{aligned} \text{delta} &= \frac{\partial C}{\partial S} = \frac{C(S + \Delta S) - C(S - \Delta S)}{2\Delta S} \\ \text{gamma} &= \frac{\partial^2 C}{\partial S^2} = \frac{C(S + \Delta S) - 2C(S) + C(S - \Delta S)}{\Delta S^2} \\ \text{theta} &= \frac{\partial C}{\partial t} = \frac{C(t + \Delta t) - C(t)}{\Delta t} \\ \text{rho} &= \frac{\partial C}{\partial r} = \frac{C(r + \Delta r) - C(r)}{\Delta r} \end{aligned}$$

Here the value of the option is calculated using various initial conditions. For example, $C(S + \Delta S)$ is estimated using an initial asset price of $S + \Delta S$ with ΔS small. $\Delta S = 0.001S$ would be a good choice here. Every price in a difference or a sum should be computed using the same set of volatility values to eliminate variability due to Monte Carlo randomness.

Notice that we do not compute *vega* which is the derivative with respect to the volatility, because in our case it has no clear interpretation. We could also compute a nonstandard derivative with respect to the above described parameter p .

5 The Dynamic Model: using stochastic volatility filtering in a Monte Carlo method

The idea of this model is to start with the estimated volatility distribution $Y_0^n := \Phi_K^n$ at the present time, represented by its weighted particles $Y^n = \{(\bar{Y}_j, \bar{p}_j) : j = 1, \dots, n\}$ and with the logarithm of the price of the stock today $x_0 = \log S_0$ in equation (2.1), and then to take advantage of the same particle filtering scheme we used in the Section 3 to generate future stock prices and volatility values: that is to say, we wish to use stochastic volatility filtering in a dynamic way for pricing.

More precisely we start with x_0 and the Y_0^n distribution. We sample a volatility value y_0 from the empirical distribution Y_0^n . We divide the time to expiration T into N intervals of length $\Delta t = T/N$ and generate a path (X, Y) recursively:

$$\begin{aligned} Y(y_0)_{i+1} &:= Y_{i+1} = Y_i + \alpha(\nu - Y_i)\Delta t + \psi(Y_i)U_i\sqrt{\Delta t}, \\ X(x_0)_{i+1} &:= X_{i+1} = X_i + \left(r - \frac{\sigma^2(Y_i)}{2}\right)\Delta t + \sigma(Y_i)U'_i\sqrt{\Delta t}. \end{aligned} \tag{5.1}$$

where the variables U_i and U'_i are iid standard normal and $i \in \{0, 1, 2, \dots, N-1\}$. In other words, we use the actual ‘‘Stochastic Volatility’’ dynamics for simulating future values of (X, Y) , but using the risk-free rate for the mean rate of return of the simulated stock in (5.1), and started from a sample from the initial distribution $\delta_{\{x_0\}} \otimes Y_0^n$. The risk-free rate, rather than μ , must be used here because the paths simulated

must be consistent with sampling from a martingale measure, since we are doing pricing via risk-neutral valuation.

Once we find the value at the expiration $X(x_0)_N = X_T$ we can compute the value of the option at the expiration, and then we discount back to the present value using the risk-free rate. This represents one replication of a Monte Carlo method: to compute an estimate of the option price we generate many replications (typically of the order $n'' = 10^6$) then compute the average of the values obtained. This average is our estimate for the price of the option today. The convergence, and the convergence speed, of order $(n'')^{-1/2}$, is of course guaranteed by a standard argument based on the central limit theorem. We omit the details.

Any straight Monte Carlo method is notoriously inefficient, and one may try to improve the convergence of the method by such techniques as reduction of variance, and the like. However, since our dynamic model yields option prices which are not as close to those given in the market as the static model's prices, there seems little reason to improve the efficiency of our Monte Carlo method for the dynamic model.

At this stage it is worth noting that this article's second-named author, in (Viens, 2002), provides a Monte Carlo method that solves a related stochastic portfolio optimization problem using elements of stochastic control, dynamically in time, based on the dynamic evolution of the stochastic volatility particle filter. Because of the non-linear nature of portfolio optimization, as opposed to the linear nature of option pricing, the numerics proposed in (Viens, 2002) are difficult to implement in general (see however the special case of power utility, for which a successful implementation can be found in (Batalova et al., 2006)).

We hope that the successful option-pricing implementation in the present article will be an invitation for researchers to apply the same models and methods to the optimization problem in (Viens, 2002).

6 Using real data: European Call options on S&P500 and IBM

We have chosen to illustrate our method with two sets of data. The first set is S&P500 stock and call option data gathered on April 21-22, 2004. We are using daily data from January 1st, 1999 to April 21, 2004 to compute the discrete volatility distribution according to the method described in Section 3. The second dataset used is IBM stock and call option data gathered on July 18-19, 2005. We present a more detailed explanation about this dataset on page 25.

We are working with the model presented in (2.1) with $\phi(y) = \beta$ and $\sigma(y) = e^{-|y|}$, using the following parameters for the volatility equation: $\alpha = 50$, $m = -4.38$, $\beta = 1$, and $\mu = 0.04$ for the price. The parameters have been estimated from the data, and the short term interest rate $r = 0.01$ used for the tree construction is the value published for April 21, 2004.

We estimate the discrete volatility distribution using the Del Moral, Jacod, Protter method presented in Section 3. We used $m = 300$ time steps between any two observations, and $n = 1000$ mutation particles.

Figure 3 (a) presents a plot of this estimated distribution using the final 1000 particles.

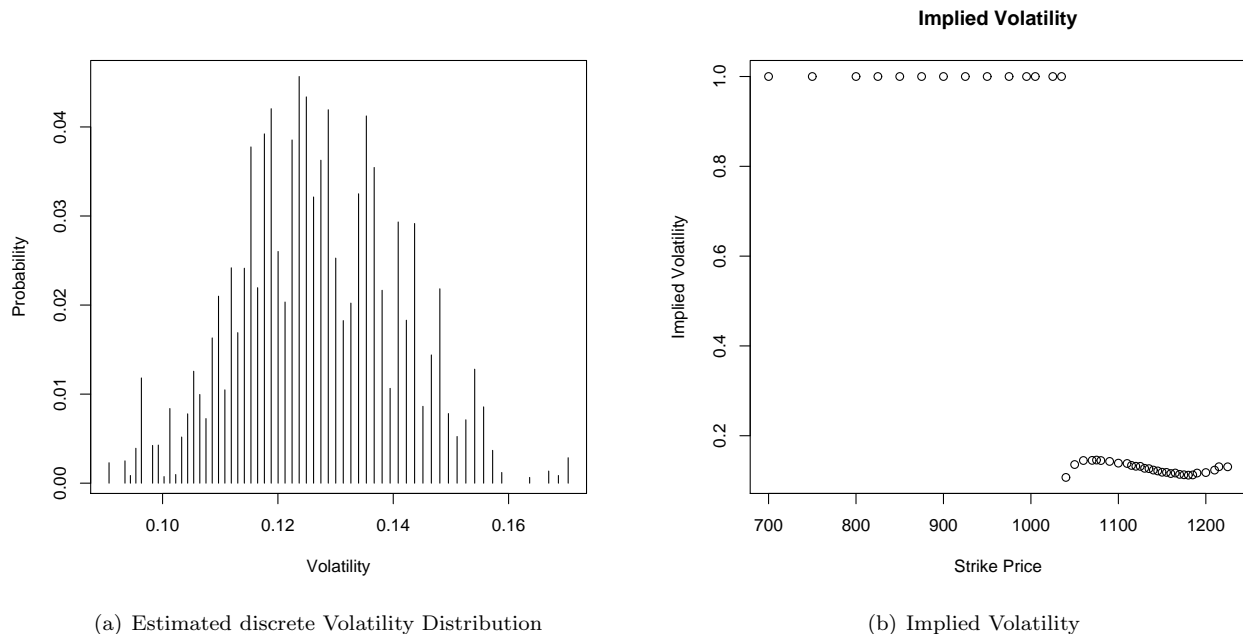


Figure 3: Estimates from historical data

To compare our method, we also estimate the implied volatility on April 21 for a range of strike prices from the option data available that day. To do so, we use a simple bisection method. Figure 3(b) shows the implied volatility’s behavior for various strike prices.

We should note that we used the option and stock (index) data available on April 21st to estimate these two plots. The implied volatility Figure 3(b) corresponds to the 29-day-maturity options but it is representative for the other maturities as well. We notice very high implied volatility values for options deep in the money, and for most others the implied volatility is around $0.12 - 0.135$.

Using the data available a day earlier we estimate option prices for that day for many values of the parameter p in the interval $[\frac{1}{12}, \frac{1}{6}]$. Then, we compare the estimated prices with the price of the “benchmark option” which we chose to be the option at the money. We can see computed values corresponding to a grid for the p parameter in Figure 4.

Beginning with $p = 0.135$ and ending with $p = 0.16$, the option values obtained are close to each other. In fact, this is a feature we have observed for all the option values calculated for the entire range of strike prices. The values of the 29-day-maturity options obtained for $p = 0.135$ are presented in Table 1 in the Appendix.

For better illustration of the performance of the various methods we present in Figures 5 and 6 on pages 34 and 35, the values of the options separated in groups depending on the range of the strike prices (at the money, and out of the money, respectively).

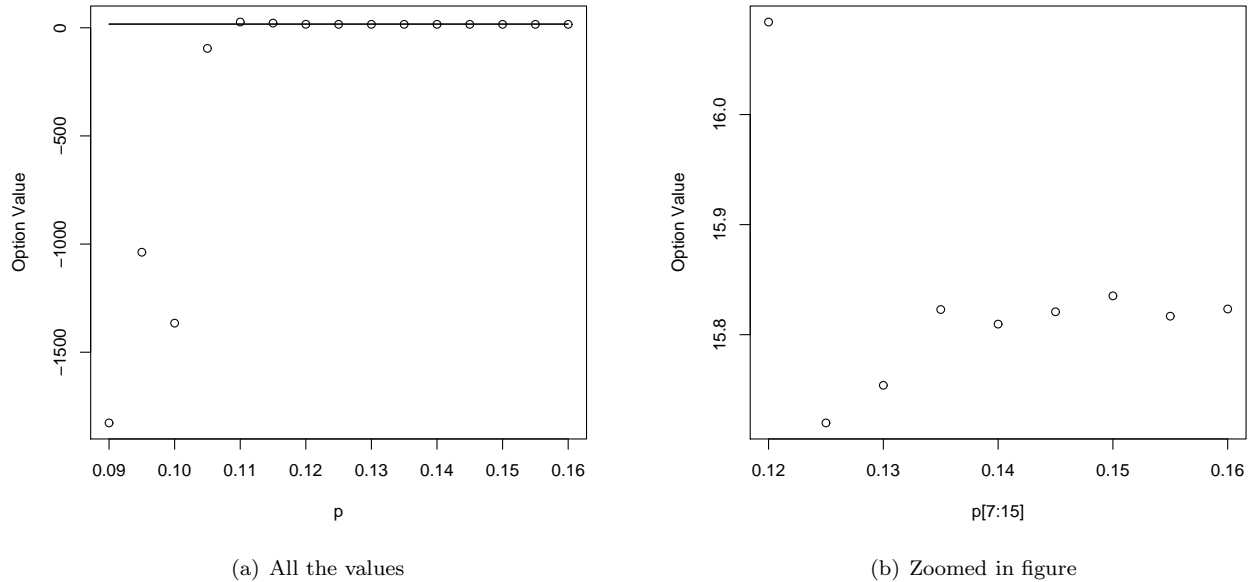


Figure 4: Determining optimal p parameter value

We mention that the plot of the deep-in-the-money options is not shown since the intrinsic value of the options dominate all the valuations methods and no method performs better than the rest. We could also observe the option values at the top of Table 1 for this fact.

All the above option-price graphs include, for comparison, the bid-ask spread of the actual prices seen on the option market, and the price given via the standard Black-Scholes formula with constant (non-random) volatility.

One of the advantages of our method is that it allows the computation of option prices even when there exists no formula for that option type. This idea is even applicable to standard vanilla options, in the following situation. In the third Friday of each month the European option with maturity that month expires. Thus the option with expiration 2 months becomes a one month option and so on. Also, during the following Monday and Tuesday an option with a new, intermediate, maturity date is starting to be traded. Since there is no implied volatility in the previous day for this option we suspected that our method will perform well.

For this simulation we use IBM stock data from July 18-19, 2005. The new options with expiration in September did not appear until Tuesday July 19, 2005 so we are using the Monday July 18 for volatility calibration and finding the optimal p according to the method described above. The coefficients used in this case were: $\alpha = 11.85566$, $\nu = 0.9345938$, $\beta = 4.13415$, $\mu = 0.04588$, and $r = .0343$. We have estimated these coefficients from the historical data, the method we used is to be the subject of another article.

We present the values obtained in Table 2 in the Appendix, we also plot these values in Figure 7 on page

Discussion about the rate of growth in the tree

As pointed out by our anonymous referees a discussion about the recombination level of the constructed trees would be beneficial to justify the utility of the method. We have empirically studied this problem for the trees created to evaluate the IBM at the money option (Strike price =80). We present a plot of the evolution of the total number of nodes in the generated tree in Figure 8 on page 37. On the x -axis we plot the number of steps in the tree. As we see in the plot our tree model contains more nodes than the classical Binomial tree ($n(n+1)/2 \sim O(n^2)$), but it is comparable with a polynomial in n . In fact the curve produced for n^3 is much higher and Figure 8 shows that within 3 standard deviations our node growth rate is clearly below $n^{2.3}$, indicating that a typical tree is quite manageable.

We will note however that the total number of nodes is dependent on the original distribution of the volatility Y . A theoretical result relating these two quantities would be extremely valuable but beyond the scope of the present article.

Discussion about the sensitivity of the estimation with respect to the number of steps in the tree

It is also interesting to see how the precision of our tree estimate changes when increasing the number of steps in the tree and the number of generated trees. Once again we looked at the IBM at-the-money option. We generated the estimate varying first the number of time steps in the tree and second the number of generated trees. More specifically, assume that each estimate comes from a distribution with mean μ and standard deviation σ . We already know from the convergence Theorem 4.6 that μ is the true value of the option. We want to estimate σ and for this purpose denote the number of steps in the tree by n and the number of simulated paths by N . Assume that $X_1 = X_1(n), X_2 = X_2(n), \dots, X_N = X_N(n)$ are the values obtained from each simulated path, we can then estimate σ as:

$$\hat{\sigma}(N)^2 = \frac{1}{N-1} \sum_{i=1}^N (X_i - \bar{X})^2$$

We wanted to study what happens with this estimate when we change n and N . We did just that and we plotted the results in Figure 9 on page 38. Part (a) of the plot keeps $N = 100$ constant and varies n . We can see that $\hat{\sigma}$ decreases as the number of steps in the tree increases, which is to be expected. Part (b) keeps $n = 100$ constant and varies N . We can see that $\hat{\sigma}$ stays approximately constant, this is natural since the value it estimates does not depend on N .

We could have plotted the standard error of the total estimate by taking $\hat{\sigma}/\sqrt{N}$ but we believe our

current plots are more enlightening.

7 Conclusions

This article implements a new way of pricing options under stochastic volatility, by taking advantage of an optimal stochastic particle filtering algorithm yielding the probability distribution of the present-day volatility based on past stock observations. The particles of this filter are used in conjunction with a highly recombining quadrinomial tree for pricing options, based on standard arbitrage-free methodology under a martingale measure which is determined, in this incomplete market, by choosing a benchmark option. The approximation methods presented in this work are computationally intensive, but are based on simple algorithms featuring low, manageable, complexity. The option prices based on our quadrinomial tree implementation are very close to the same prices observed on the option market.

The two numerical cases presented here are fundamentally different. In the first application we used an Index (S&P 500) which is not very sensitive to small movements in the market. For the second application we choose a popular technology stock, IBM; we observed our same basic conclusions for many other stocks (Microsoft, Intel, Yahoo, Ford and GM), not included here for obvious space considerations.

In the case of the S&P 500 we observe that pricing using our Static model (Section 4) is clearly better than the pricing using the Dynamic model of Section 5, since the former typically falls within the option market's bid-ask spread, while the latter does not. This is despite the fact that the Dynamic model approximates pricing under the true Stochastic Volatility model, while in the Static model, volatility is assumed to be constantly distributed in the future according to its best present estimated distribution given all past stock price observations.

In addition to the heuristic explanation given at the end of the introduction (on page 4), by which the static model is closer to what practitioners are actually doing when adjusting the Black-Scholes formula to account for non-constant volatility, there is a numerical reason for its superiority over the dynamical model, which became evident to us after we studied the total number of nodes in the constructed trees. For the static model we have used trees with 100 steps and we replicated the trees 100 times. We suspected that we were using a large number of computations and to make sure that we do not give an unfair advantage to the static model we used 100 time steps in the Dynamic model but with 100,000 simulations of the path. This is apparently not a sufficiently large number for the Monte Carlo computations. After we studied the number of calculations in the tree we discovered that for a 100 steps tree the average total number of nodes is around 22,000. If we do a simple calculation we observe that the number of computations for the Static model is about $44 \cdot 10^5$ (we have to go twice through the trees) versus $\sim 100 \cdot 10^5$ for the Dynamic model. This fact also explains why the run time for the Dynamic model is much larger than the run time for the Static model.

If we look at the three regions depending on how close the strike price is to the stock price in that respective day, we see that the best performance is obtained for the options at-the-money – conveniently so, since those are the majority of options traded. We suspect that we have obtained better results for that region because we used an option at the money to calibrate the parameter p which defines our choice of martingale measure. This fact would suggest to use different optimal values of p for each of the three regions. Recalibrating p for each maturity date should provide even better estimates, although this might go against the idea of arbitrage-free consistency within a single option market.

On the other hand, since we are using European call options, for which there exists a formula that every market participant can readily use at any moment, our results are naturally not far from the values obtained using the Black-Scholes formula. The strength of our method is that it works for any type of option including those that do not have a valuation formula, and may be path dependent.

This fact is illustrated in the second analysis (the IBM case). We see that the Static model once again performs better for at the money options (in the Strike price range 75-85). In this case we also wanted to investigate the reason why the Dynamic method performed worse in the previous simulation so we increased the number of simulations by 100 (thus now using 10^8 runs). We see that there is no detectible difference now between the Static and the Dynamic models, with the exception of the runtime, which naturally is huge now for the Dynamic model when compared with the Static one.

In conclusion, this article’s merit is in showing that in a well-known and mature market, our quadrinomial tree method outperforms others techniques, including the classical Black-Scholes method, or the Monte Carlo method for the Stochastic Volatility model, even when the latter is based on an excellent particle approximation of the best possible stochastic volatility estimation technique.

Lastly, we mention the question of hedging. Since we can estimate the sensitivity of the estimated option price with respect to the various factors in the model (the Greeks: delta, gamma, theta and rho) we can do a heuristic *delta hedging*: starting with the option value at time zero, we can devise a dynamic trading strategy in stock and in a risk-free asset, based on the dynamically observed values of the option’s delta (for example), that approximately replicates the payoff of the option at maturity. We will investigate this topic in separate publication.

8 Appendix

Table 1: Results for 29 day SP500 Call Options on April 22.

Strike Price	Bid-Ask Spread		Implied Volatility	Black-Scholes with const. vol = 0.13	Black-Scholes with vol = prev. day	Static Tree Method	Dynamic Method
700	435.9	437.9	0.99999994	440.4859435	444.7013928	440.8361291	441.6392171
750	386	388	0.99999994	390.5256538	398.3150305	390.8360651	389.4179381
800	336	338	0.99999994	340.565364	353.829711	340.8361125	343.1698244
825	311.1	313.1	0.99999994	315.5852191	332.4452883	315.8360728	317.7046472
850	286.1	288.1	0.99999994	290.6050743	311.7044205	290.8359979	288.6177766
875	261.1	263.1	0.99999994	265.6249294	291.6546932	265.8360605	264.3557368
900	236.2	238.2	0.99999994	240.6447845	272.3377894	240.8361814	242.4258073
925	211.3	213.3	0.99999994	215.6646397	253.7888212	215.8361042	216.070995
950	186.4	188.4	0.99999994	190.6844968	236.035902	190.8361121	191.9580826
975	161.5	163.5	0.99999994	165.7044244	219.0999491	165.8361814	165.3575168
995	141.7	143.7	0.99999994	145.7211165	206.1488679	145.8365447	144.0436024
1005	131.9	133.9	0.99999994	135.7308655	199.8740407	135.8375831	136.3773022
1025	112.2	114.2	0.99999994	115.7639408	187.726882	115.8489649	115.8511543
1035	102.5	104.5	0.99999994	105.8005096	181.8544762	105.1462257	104.9907379
1040	97.6	99.6	0.107155383	100.8298139	100.7659808	100.6728878	101.2075435
1050	88	90	0.135827243	90.92671721	90.98844738	91.05013255	90.85553399
1060	78.5	80.5	0.144771874	81.10857475	81.41030081	81.09046311	79.87881581
1070	69.1	71.1	0.145104229	71.4350287	71.91279678	71.32386	72.79518986
1075	64.5	66.5	0.14579457	66.67796494	67.28775275	66.42264828	64.8763511
1080	59.9	61.9	0.144722283	61.99094358	62.66457473	61.05169626	64.4851441
1090	51	53	0.142792165	52.88699128	53.67984581	52.64029526	54.52657424
1100	42.4	44.4	0.1389274	44.25484143	44.96209243	43.86203883	44.96215623
1110	34.3	36.3	0.138166845	36.23617352	37.02984103	35.8019852	38.1543003
1115	30.4	32.4	0.133875668	32.50000074	32.90619896	32.01309525	33.06596175
1120	26.7	28.7	0.131962717	28.96654938	29.1865849	28.47139516	31.31540725
1125	24	24.7	0.131792247	25.64879123	25.86109624	25.12064397	26.1069527
1130	20.5	22	0.127446949	22.55710072	22.24252051	21.93006175	24.08772635
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Strike Price	Bid-Ask Spread		Implied Volatility	Black-Scholes with constant vol = 0.13	Black-Scholes with vol = prev. day	Static Tree Method	Dynamic Method
1135	17.1	18.6	0.126670897	19.69885882	19.27753338	19.10765002	21.01885359
1140	14.3	15.8	0.123505414	17.07818041	16.24627811	16.43635034	17.63322328
1145	12.2	13.3	0.121538699	14.6957816	13.61508233	14.03991679	15.35886164
1150	9.8	10.8	0.118664801	12.54899328	11.12797184	11.92985116	13.46731373
1155	7.8	8.8	0.118339717	10.63191686	9.218997662	8.807748226	10.92497799
1160	6	7	0.115783632	8.935708498	7.299624754	7.628036313	10.06979747
1165	4.7	5.4	0.116955578	7.448969646	6.04030013	6.944491652	9.177123201
1170	3.5	4	0.113949478	6.158216369	4.568642759	5.63323987	6.099003098
1175	2.7	3	0.113022745	5.048396347	3.526805361	4.606569754	6.228565193
1180	1.9	2.4	0.112161219	4.10342223	2.680084922	3.695063503	4.245166183
1185	1.3	1.8	0.112685382	3.306691969	2.088085291	2.962457681	4.203963659
1190	1	1.35	0.116848767	2.641570893	1.817313699	2.208950922	2.545651178
1200	0.5	0.8	0.117960393	1.641927513	1.086645622	1.417832905	2.068167719
1210	0.4	0.5	0.123467147	0.985039802	0.763164946	0.834163001	1.189949817
1215	0.25	0.4	0.130912602	0.752833946	0.780675446	0.62279235	1.145398155
1225	0.15	0.2	0.130754888	0.428105579	0.443469099	0.339846938	0.642447332

Table 2: Results for IBM Call Options with September Expiration Date on July 19.

Strike Price	Bid-Ask Spread		Black-Scholes with const. vol = 0.234	Static Tree Method	Dynamic Method
60	23.8	24	24.0377906947886	24.1653535881753	24.0399236162121
70	13.9	14.1	14.161570849552	14.1653762415814	14.0904229344650
75	9	9.2	9.51642872827289	9.16997303037814	9.11994784069207
80	4.6	4.8	5.57383978902307	4.37994074833957	4.23440233858245
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Strike Price	Bid-Ask Spread		Black-Scholes with constant vol = 0.234	Static Tree Method	Dynamic Method
85	1.6	1.65	2.76178935046618	1.05711159482768	0.662309959257055
90	0.35	0.4	1.14035152327993	0.112329477448275	0.0454043560956927
95	0.1	0.15	0.391956502635727	0.00401547052393596	0.0050792747562195

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Options at the money

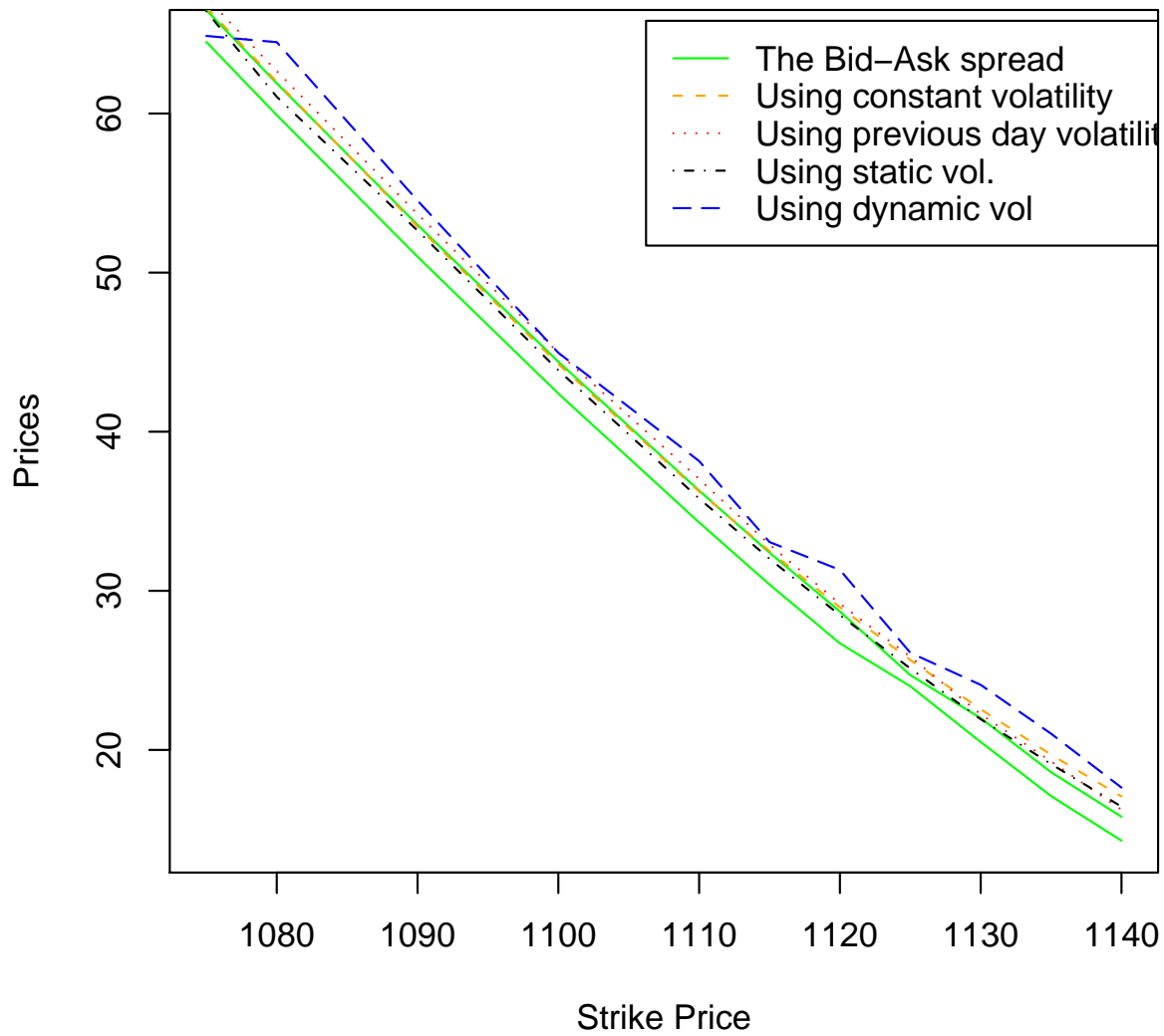


Figure 5: Estimated 29 day option prices: At the money. The S&P500 closing price on April 22 2004 was \$1139.93.

Options out of the money

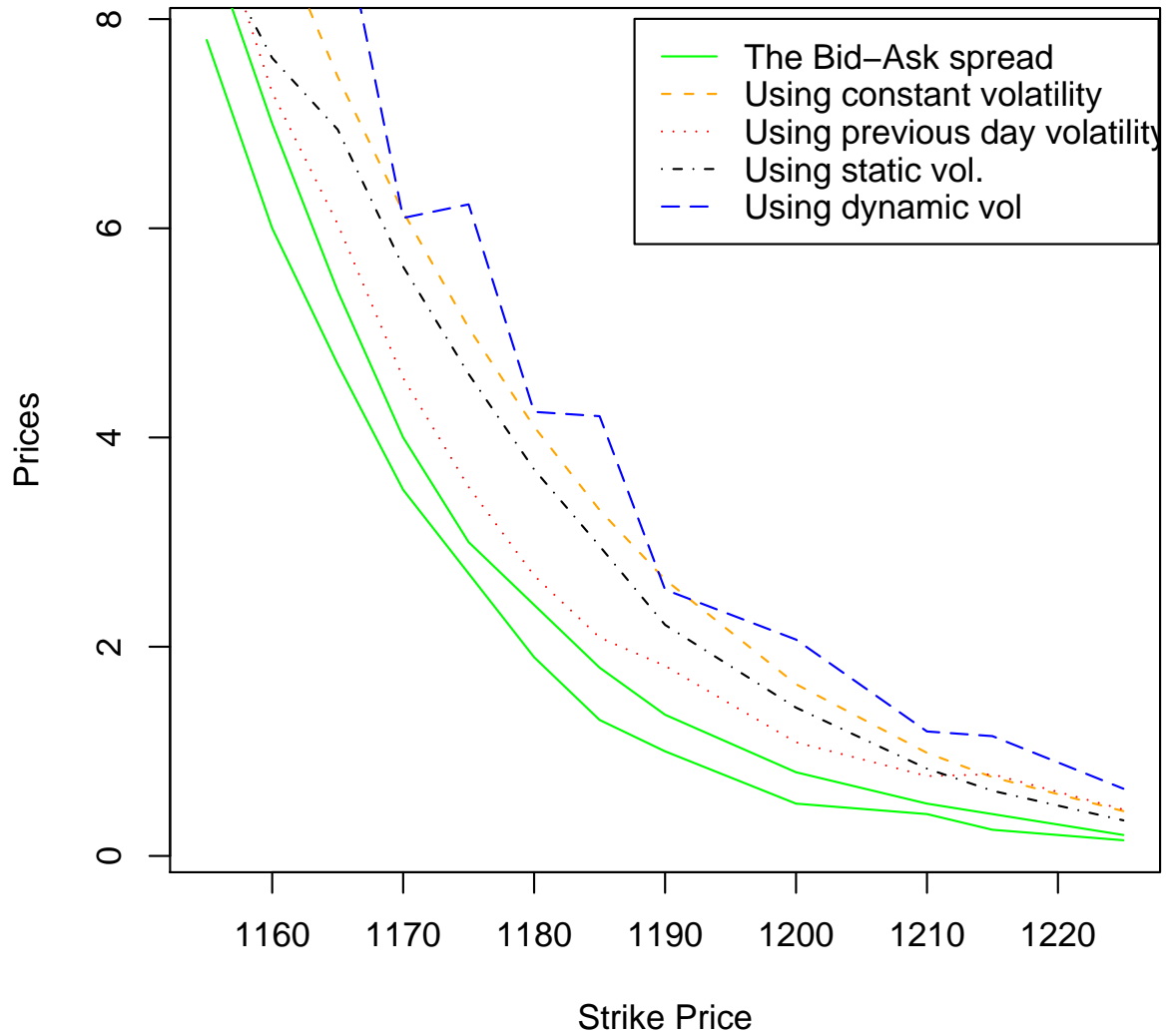


Figure 6: Estimated 29 day option prices: Deep out of the money. The S&P500 closing price on April 22 2004 was \$1139.93.

IBM Options July 19, 2005 Maturity=September

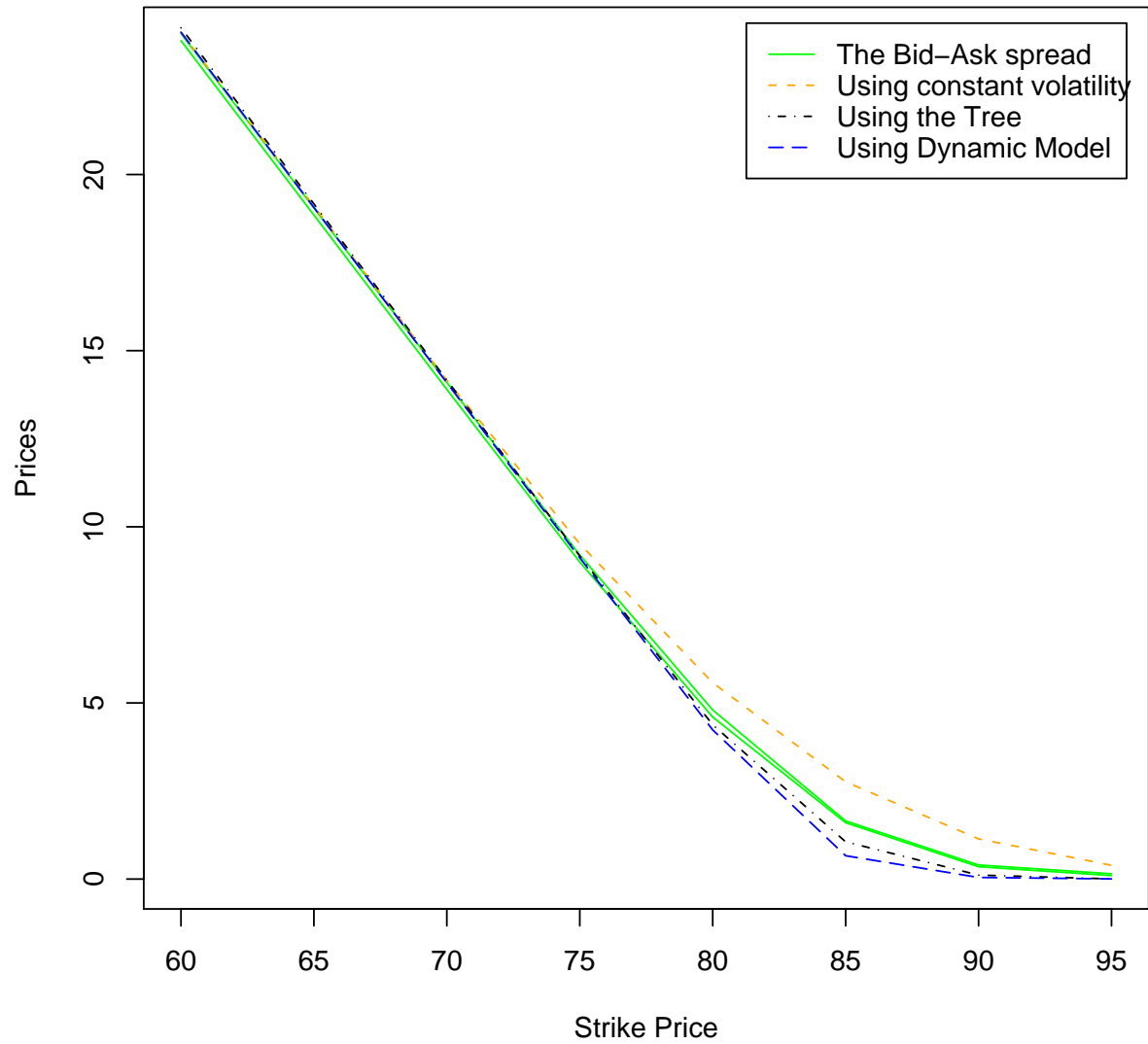


Figure 7: Estimated IBM call option values. The stock price was \$83.70.

Rate of growth in the tree

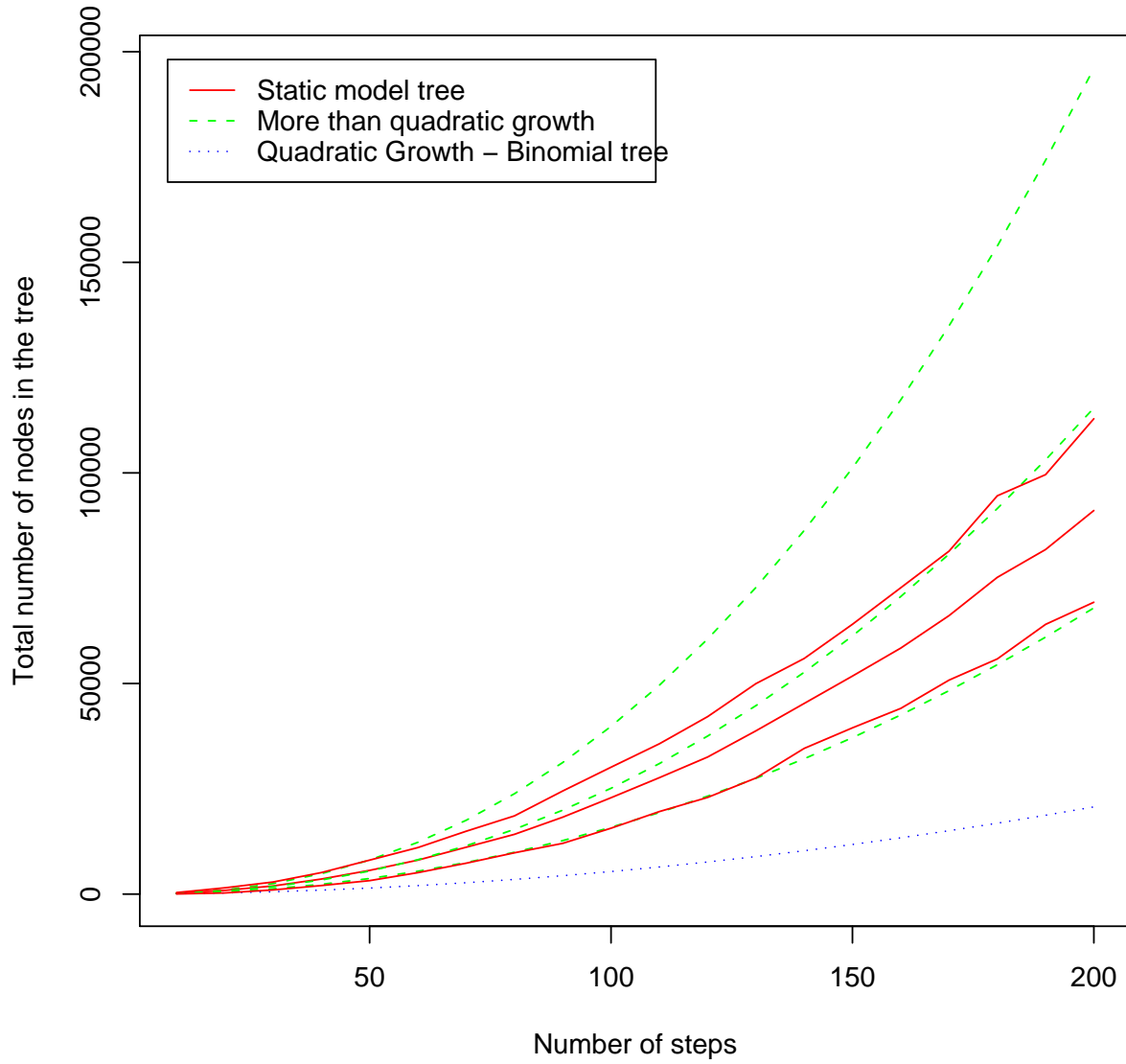
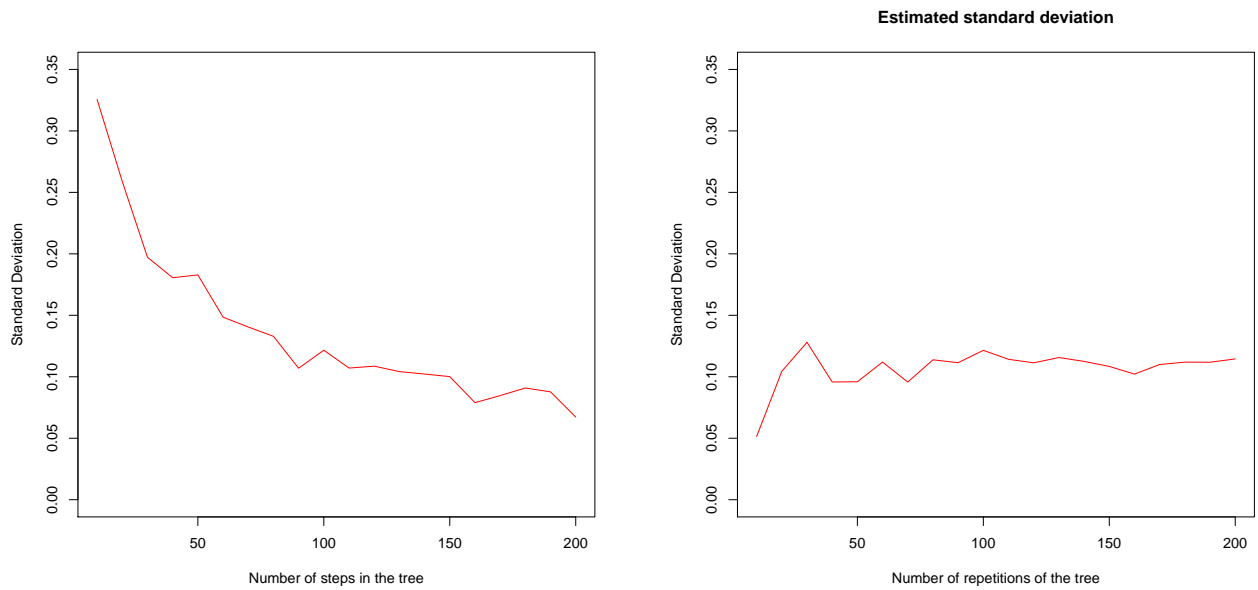


Figure 8: Estimated increase in the total number of nodes in the tree. The red solid lines represent the estimated *total* number of nodes in the tree (center line) and three standard deviations around this value. The blue dotted line represents the total number of nodes in a binomial tree ($O(n^2)$). The green dashed lines are comparable polynomials in n , from bottom up $n^{2.1}$, $n^{2.2}$ and $n^{2.3}$.



(a) Change in the standard deviation of the estimate with number of steps in the tree. We use 100 generated trees in each case.

(b) Change in the standard deviation of the estimate with the number of simulated trees. We use a tree with 100 steps in each case.

Figure 9: The precision of the estimate