MASx52: Assignment 4

Solutions and discussion are written in blue. Some common pitfalls are indicated in teal. A sample mark scheme is given in red, with each mark placed after the statement/deduction for which the mark would be given. As usual, mathematically correct solutions that follow a different method would be marked analogously.

Marks are given for [A]*ccuracy*, [J]*ustification, and* [M]*ethod.*

1. Let B_t be a standard Brownian motion.

   (a) Write down the distribution of B_t, and write down $\mathbb{E}[B_t]$ and $\mathbb{E}[B_t^2]$.

   (b) Let $0 \le u \le t$. Show that $\mathbb{E}[(B_t - B_u)^2 \mid \mathcal{F}_u] = t - u$.

   Solution.

   (a) $B_t \sim N(0,t)$, [1A] and $\mathbb{E}[B_t] = 0$, [1A] $\mathbb{E}[B_t^2] = t$. [1A]

   (b) We have

   $$\begin{aligned}\mathbb{E}[(B_t - B_u)^2 \mid \mathcal{F}_u] &= \mathbb{E}[(B_t - B_u)^2] \\ &= t - u.\end{aligned}$$

   [1A] In the first line we use that, by the properties of Brownian motion, $B_t - B_u$ is independent of $\mathcal{F}_u$. [1J] Then, we use that $B_t - B_u \sim N(0, t-u)$, which is the same distribution as B_{t-u} [1J], followed by the third formula in part (a) with $t-u$ in place of t.

2. Write down the following stochastic differential equations in integral form, over the time interval $[0,t]$.

   (a) $dX_t = 2(X_t + 1)\,dt + 2B_t\,dB_t$.

   (b) $dY_t = 3Y_t\,dt$.

   Write down a differential equation satisfied by Y_t, and find its solution with the initial condition $Y_0 = 1$.

   Suppose that $X_0 = 1$. Show that $f(t) = \mathbb{E}[X_t]$ satisfies $f'(t) = 2f(t) + 2$ and hence find $f(t)$.

   Solution.

   (a) We have

   $$X_t = X_0 + \int_0^t 2(X_u + 1)\,du + \int_0^t 2B_u\,dB_u.$$

   [2A]

   (b) We have

   $$Y_t = Y_0 + \int_0^t 3Y_u\,du.$$

   [1A]

Differentiating (b), by the fundamental theorem of calculus we have

$$\frac{dY_t}{dt} = 3Y_t$$

[1M] with solution $Y_t = Ae^{3t}$. Since $Y_0 = 1$ we have $A = 1$. [1A]

In (a), taking expectations we have

$$\begin{aligned}\mathbb{E}[X_t] - \mathbb{E}[X_0] &= \int_0^t 2\mathbb{E}[X_u] + 2\,du + 0 \\ f(t) - f(0) &= \int_0^t 2f(u) + 2\,du\end{aligned}$$

because Ito integrals are zero mean martingales. [1] Differentiating this equation, by the fundamental theorem of calculus we have

$$f'(t) = 2f(t) + 2$$

which has solution $f(t) = Ce^{2t} - 1$. [1A]

Putting in $t = 0$ gives $f(0) = 1 = C - 1$, so we obtain $f(t) = 2e^{2t} - 1$. [1A]

3. Use Ito's formula to calculate the stochastic differential of dZ_t where

   (a) $Z_t = tB_t$

   (b) $Z_t = 1 + t^2 X_t$ where $dX_t = \mu\,dt + \sigma B_t\,dB_t$ and μ, σ are deterministic constants.

   (c) $Z_t = e^{-2t} S_t$ where $dS_t = 2S_t\,dt + 5S_t\,dB_t$.

   In which cases is Z_t is a martingale?

Solution. We have

(a)

$$\begin{aligned}dZ_t &= \left\{(B_t) + (0)(t) + \tfrac{1}{2}(1)^2(1)\right\}\,dt + (t)(1)\,dB_t \\ &= B_t\,dt + t\,dB_t.\end{aligned}$$

[2A]

(b)

$$\begin{aligned}dZ_t &= \left\{2tX_t + (\mu)(t^2) + \tfrac{1}{2}(\sigma B_t)^2(0)\right\}\,dt + (\sigma B_t)(t^2)\,dB_t \\ &= (2tX_t + \mu t^2)\,dt + \sigma t^2 B_t\,dB_t.\end{aligned}$$

[2A]

(c)

$$\begin{aligned}dZ_t &= \left\{(-2e^{-2t}S_t) + (2S_t)(e^{-2t}) + \tfrac{1}{2}(5S_t)^2(0)\right\}\,dt + (5S_t)(e^{-2t})\,dB_t \\ &= 5e^{-2t}S_t\,dB_t.\end{aligned}$$

[2A]

Case (c) is a martingale because here dZ_t has only a $(\dots)\,dB_t$ term, and therefore $Z_t = Z_0 + \int_0^t \dots\,dB_t$ is a martingale because Ito integrals are martingales. [1J]

4. Let S_t be a geometric Brownian motion, with drift $\mu \in \mathbb{R}$, volatility $\sigma > 0$, and (deterministic) initial condition S_0.

   (a) Find $\mathbb{E}[S_t]$ and deduce that S_t is not a Brownian motion when $\mu \neq 0$.

   (b) Is S_t a Brownian motion when $\mu = 0$?

Solution.

(a) The formula for geometric Brownian motion is

$$S_t = S_0 \exp\left((\mu - \tfrac{\sigma^2}{2})t + \sigma B_t\right).$$

So, taking expectations, [1M] using the formula for $\mathbb{E}[e^Z]$ where Z is normally distributed, and using that S_0 is deterministic,

$$\begin{aligned}\mathbb{E}[S_t] &= S_0 e^{(\mu-\frac{\sigma^2}{2})t}\mathbb{E}[e^{\sigma B_t}] \\ &= S_0 e^{(\mu-\frac{\sigma^2}{2})t} e^{\frac{\sigma^2 t}{2}} \\ &= S_0 e^{\mu t}\end{aligned}$$

[1A] A Brownian motion B_t has $\mathbb{E}[B_t] = \mathbb{E}[B_0]$, but for $\mu \neq 0$ we have shown that $\mathbb{E}[S_t]$ is non-constant, which means that S_t cannot be a Brownian motion. [1J]

(b) It remains to consider the case $\mu = 0$. In this case, $S_t = S_0 e^{\sigma B_t - \frac{\sigma^2}{2}t}$. We recall that, for a Brownian motion, $B_t^2 - t$ is a martingale, [1J] and for S_t we have $S_t^2 - t = S_0^2 e^{2\sigma B_t - \sigma^2 t} - t$. This gives us

$$\begin{aligned}\mathbb{E}[S_t^2 - t] &= S_0^2 \mathbb{E}[e^{2\sigma B_t}]e^{-\sigma^2 t} - t \\ &= S_0^2 e^{\frac{4\sigma^2}{2}} e^{-\sigma^2 t} - t \\ &= S_0^2 e^{\sigma^2 t} - t\end{aligned}$$

[1A] which is clearly non-constant. Hence $S_t^2 - t$ is not a martingale, so S_t is not a Brownian motion. [1J]

[Note: There are *lots* of other ways to solve this question!]

Total marks: 27