SCILAB *à l'École nationale des ponts et chaussées*

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Halmstad 2006

Dynamic programing and Markov chains

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15 novembre 2006 (dernière date de mise à jour)

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1 Stopping time problem with the Cox-Ross Model

The Cox–Ross random walk, widely used in Finance, is defined as follows. Let $(U_n, n \geq 0)$ be a sequence of independent random variables with common law $\mathbb{P}(U_n = 1 + b = d) = p$, $\mathbb{P}(U_n = 1 + a = u) = 1 - p$ where $0 < p < 1$, u and d being two fixed real numbers. Let $X_0 = x$ and

$$X_{n+1} = X_n U_{n+1}.$$

Thus, $X_n = x \prod_{i=1}^{n} U_i$. It is easy to check that (X_n) is an homogeneous Markov.

Let $(X_n)_{n\in\mathbb{N}}$ be a finite Markov chain following a Cox-Ross model, we want to recursively compute for $n \in [0, T]$:

$$u_n(x) = \sup_{\tau \ \mathcal{F}_n t.a., n\leq\tau\leq N} \mathbb{E}\left[\frac{1}{(1+r)^{\tau+1-n}} f^{\tau}(X^{\tau})|X^n = x\right].$$

We will use the following numerical values :

```
r=log(1 + 0.05);    // non risky interest rate
mu=0.05;   // unused
sigma=0.2; // volatility of risky asset
S0=40;    // price at time 0 of the risky asset
T=4.0/12.0;   // horizon
K=40;     //  strike value
N = 10;    // number of time steps
Dt = T/N;  // step size
R = r* Dt; // interest rate on time step
down = (1+R) * exp(- sigma * sqrt(Dt)); // state "up"
up = (1+R) * exp(+ sigma * sqrt(Dt)); // state "down"
p = (up-(1+R))/(up-down); // probability to go down !

a=up-1;
b=down-1;
X0=S0;
```

Question 1 *For a given discrete time t compute in a vector the possible states of X_t.*

```
t=3;
I=0:t;
X=....
```

Question 2 *Draw on a figure all the possible states that can be reached from* `X0` *when discrete time evolves from* 0 *to* N

```
t=N;
xbasc();
for i=0:t
  ....
  plot2d(...) // plot the states at time i with a mark
end
```

Question 3 *The number of possible states at time* t *are* $X_0(1+a)^i * (1+b)^(t-i)$ *for* $i \in [0,t]$. *Thus a given state at time* t *can be labeled by its indice* i. *Suppose that we are at time* t *in a state labeled* i *what are the possible labels for the state at time* $t+1$. *What are the probabilities of the possible states.*

Question 4 *We want now to recursively compute the value function* `V(x,n)` *and store all the results in a matrix* `V`. *The number of rows of the matrix is given by the number of possible states at the last discrete time* $t = N$. *At position* `V(i,t)` *we will store the value function at time* `t` *for the state labelled* `i`. *Choosing* $f(x) = (x-K)_+$ *or* $f(x) = (K-x)_+$, *give a function which recursively computes the value function* $u_n(x)$. *During the computation we also want to compute* `U(x,n)` *which for a state labeled* `x` *at time* `n` *return* `1` *or* `2` *(*`2` *if the optimal strategy is to stop).*

Question 5 *Compute also for each discrete time, the values of the state variables and plot the value function according to the state value.*

```
// The cost function at time T
function y=f(x,K) .... endfunction

// at each time we compute in a column of V the function value associated to states
// X_0(1+a)^i*(1+b)^(t-i)

T=10;
I=0:T;
XT=...
n=.. // maximum number of states for t in [0,T]
V=zeros(n,T); // initialize V
X=zeros(n,T); // initialize X


V(:,T)=...
X(:,T)=...

for t=T-1:-1:1
  ...
  X(I+1,t)=... // I is the vector of possible indices at time t
  V(I+1,t) =...
end

// plot the value function at each step

for t=1:T
  xbasc();
  I=0:t;
  plot2d(X(I+1,t),V(I+1,t))
  halt();
end
```

Question 6 *Use the* `U` *matrix to plot the tree of discrete value for the state according to time using a different mark for stopping or non-stopping states.*

Question 7 *Use the previous code to implement a function which computes the value function at time t for a given grid of state values. Draw these functions for time evolving from* 0 *to* N.