Dispersion-Constrained Martingale Schrödinger Problems
and the Joint S&P 500/VIX Smile Calibration Puzzle

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Motivation

- Volatility indices, such as the VIX index, are not only used as market-implied indicators of volatility.
- Futures and options on these indices are also widely used as risk-management tools to hedge the volatility exposure of options portfolios.
- The very high liquidity of S&P 500 (SPX) and VIX derivatives requires that financial institutions price, hedge, and risk-manage their SPX and VIX options portfolios using models that perfectly fit market prices of both SPX and VIX futures and options, jointly.
- Calibration of stochastic volatility models to liquid hedging instruments: SPX options + VIX futures and options.
- Since VIX options started trading in 2006, many researchers and practitioners have tried to build such a jointly calibrating model, but could only, at best, get approximate fits.
- “Holy Grail of volatility modeling”
- Very challenging problem, especially for short maturities.
Main results

The joint calibration of SPX and VIX smiles is a longstanding issue that had eluded quants since 2006. For the first time:

1. We characterize the absence of joint SPX/VIX arbitrage and build an algorithm to detect joint arbitrages when they exist.
2. In absence of joint arbitrage, we build (theoretically and numerically) a model that jointly and exactly fits the SPX and VIX smiles.
   - The model is cast as the unique solution of what we call a Dispersion-Constrained Martingale Schrödinger Problem.
   - The problem is numerically solved by duality using an extension of the Sinkhorn algorithm.

→ J. Guyon, *The Joint SPX/VIX Smile Calibration Puzzle Solved*, Risk, April 2020
→ J. Guyon, *Dispersion-Constrained Martingale Schrödinger Problems and the Exact Joint SPX/VIX Smile Calibration Puzzle*, preprint, 2021

3. We extend our construction to continuous-time stochastic volatility models, via Dispersion-Constrained Martingale Schrödinger Bridges, inspired by the classical Schrödinger bridge of statistical mechanics.

→ J. Guyon, *VIX-Constrained Martingale Schrödinger Bridges and Exact Joint SPX/VIX Smile Calibration with Stochastic Volatility Models*, in prep
Related topics

For the first time:

1. We uncover a remarkable feature of the SPX and VIX markets that we call Inversion of Convex Ordering, and explain how classical stochastic volatility models can reproduce it.

2. We prove that, due to this inversion of convex ordering, and contrary to what has often been stated, among the continuous SV models calibrated to the market smile, the local volatility model does NOT maximize the price of VIX futures.

3. We derive the optimal model-free bounds on the prices of VIX futures given SPX smiles.
Brief reminder on the VIX index

- VIX = Volatility IndeX.
- Published every 15 seconds by the Chicago Board Options Exchange.
- Indicator of short-term options-implied volatility. Known as “fear factor.”
- **Objective of CBOE:** VIX is meant to reflect the 30-day implied volatility of SPX options.
- Problem: implied vol of SPX call/put options depend on the option strike. VIX should be a strike-free measure of SPX implied vol.
- Natural choice: define VIX as the implied volatility of a 30-day variance swap on SPX.
- Problem: Variance swaps are OTC. Not listed on an exchange.
- ⇒ **VIX is defined as the implied volatility of a 30-day log-contract on SPX:**

\[(VIX_t)^2 := -\frac{2}{\tau} \text{Price}_t \left[ \ln \left( \frac{S_{t+\tau}}{F_{t+\tau}} \right) \right], \quad \tau = 30 \text{ days}\]

- The log-contract is not listed on an exchange but it can be replicated at \(t\) using OTM call and put options on the SPX with maturity \(t + \tau\).
Brief reminder on VIX futures

- The VIX index cannot be traded, but VIX futures can.
- VIX future expiring at $T =$ the instrument that pays $\text{VIX}_T$ at $T$.
- $\text{VIX}_T^2$ can be replicated using vanilla options on SPX:

$$ (\text{VIX}_T)^2 := -\frac{2}{\tau} \text{Price}_T \left[ \ln \left( \frac{S_{T+\tau}}{F_{T+\tau}^T} \right) \right] $$

$\implies$ To replicate exactly $(\text{VIX}_T)^2$ at time 0: buy $-\frac{2}{\tau} \ln S_{T+\tau}$, sell $-\frac{2}{\tau} \ln F_{T+\tau}^T$.

- But its square root $\text{VIX}_T$ cannot.
- Contrary to the price of the future on $\text{VIX}^2$, the price of the VIX future cannot be inferred by arbitrage arguments from the SPX smile.
- $T$ is 30 days before SPX option monthly maturities, i.e., 30 days before the third Friday of each month.
Brief reminder on VIX options

- Pays $(\text{VIX}_T - K)_+$ or $(K - \text{VIX}_T)_+$ at $T$; $T$ is a VIX future maturity.
- The underlying asset of VIX options is the VIX future with the same expiry. Only one option maturity per VIX future: the VIX future expiry.
- VIX options are quoted on the CBOE and are liquidly traded, just like SPX options.
- We can replicate the payoff $\text{VIX}_T^2$ using OTM VIX options: take $y = \text{VIX}_T$, $x = F_{t}^{\text{VIX},T}$, and $f(y) = y^2$ in the Carr-Madan replication formula

\[
 f(y) = f(x) + f'(x)(y - x) + \int_{0}^{x} f''(K)(K - y) + dK \\
 + \int_{x}^{\infty} f''(K)(y - K) + dK \\
\]

\[
\text{Price}_t [\text{VIX}_T^2] = \left( F_{t}^{\text{VIX},T} \right)^2 + 2 \int_{F_{t}^{\text{VIX},T}}^{\infty} \text{Price}_t [(K - \text{VIX}_T)_+] dK \\
+ 2 \int_{F_{t}^{\text{VIX},T}}^{\infty} \text{Price}_t [(\text{VIX}_T - K)_+] dK 
\]
Motivation

Figure: Average daily volume for VIX options and VIX futures. Source: CBOE
Motivation

Figure: SPX smile as of January 22, 2020, $T = 30$ days
Motivation

Figure: VIX smile as of January 22, 2020, $T = 28$ days
Motivation

- ATM skew:

  Definition: \( S_T = \left. \frac{d \sigma_{BS}(K, T)}{dK} \right|_{K=F_T} \)

  \( SPX, \) small \( T: \) \( S_T \approx -1.5 \)

  Classical one-factor SV model: \( S_T \xrightarrow{T \to 0} \frac{1}{2} \times \text{spot-vol correl} \times \text{vol-of-vol} \)

- Calibration to short-term ATM SPX skew \( \implies \)

  \( \text{vol-of-vol} \geq 3 = 300\% \gg \text{short-term ATM VIX implied vol} \)

The very large negative skew of short-term SPX options, which in classical continuous SV models implies a very large volatility of volatility, seems inconsistent with the comparatively low levels of VIX implied volatilities.
Gatheral (2008)

Consistent Modeling of SPX and VIX options

Jim Gatheral

Merrill Lynch

The Fifth World Congress of the Bachelier Finance Society
London, July 18, 2008
Double CEV dynamics

- Buehler’s affine variance curve functional is consistent with double mean reverting dynamics of the form:

\[
\begin{align*}
\frac{dS}{S} &= \sqrt{\nu} \, dW \\
\, d\nu &= -\kappa (\nu - \nu') \, dt + \eta_1 \, \nu^\alpha \, dZ_1 \\
\, d\nu' &= -c (\nu' - z_3) \, dt + \eta_2 \, \nu'^\beta \, dZ_2
\end{align*}
\]

for any choice of \( \alpha, \beta \in [1/2, 1] \).

- We will call the case \( \alpha = \beta = 1/2 \) Double Heston,
- the case \( \alpha = \beta = 1 \) Double Lognormal,
- and the general case Double CEV.

- All such models involve a short term variance level \( \nu \) that reverts to a moving level \( \nu' \) at rate \( \kappa \). \( \nu' \) reverts to the long-term level \( z_3 \) at the slower rate \( c < \kappa \).
Double CEV fit to VIX options as of 03-Apr-2007

Setting the correlation $\rho$ between volatility factors $z_1$ and $z_2$ to its historical average (see later) and iterating on the volatility of volatility parameters $\xi_1$ and $\xi_2$ to minimize the differences between model and market VIX option prices, we obtain the following fits (orange lines):
Double CEV fit to SPX options as of 03-Apr-2007

Minimizing the differences between model and market SPX option prices, we find $\rho_1 = -0.9$, $\rho_2 = -0.7$ and obtain the following fits to SPX option prices (orange lines):
Fit to VIX options

\[ T = 0.12 \]
Fit to VIX options

T = 0.21

-0.4 -0.2 0.0 0.2 0.4 0.6 0.8

-0.4 -0.2 0.0 0.2 0.4 0.6 0.8

0.4 0.6 0.8 1.0 1.2

Implied vol.

Log-Strike

Julien Guyon

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Fit to SPX options

\[ T = 0.24 \]

\[ \text{Implied vol.} \]

\[ \text{Log-Strike} \]
Similar experiments with other models

- Skewed 2-factor Bergomi model (Bergomi 2008)
- Skewed rough Bergomi model (G. 2018, De Marco 2018):

\[
\sigma_t^2 = \xi_0^t \left( (1 - \lambda)\mathcal{E} \left( \nu_0 \int_0^t (t - s)^{H - \frac{1}{2}} dZ_s \right) + \lambda \mathcal{E} \left( \nu_1 \int_0^t (t - s)^{H - 1/2} dZ_s \right) \right)
\]

with \( \lambda \in [0, 1] \).
- Quadratic rough Heston model (Gatheral Jusselin Rosenbaum 2020)
- \textbf{VIX smile well calibrated} \implies \textbf{not enough SPX ATM skew}
Skewed rough Bergomi: Calibration to VIX futures and options (G. 2018)
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Skewed rough Bergomi calibrated to VIX: SPX smile (G. 2018)
Quadratic rough Heston model (Gatheral Jusselin Rosenbaum 2020)
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THE VIX FUTURE IN BERGOMI MODELS:
ANALYTIC EXPANSIONS AND JOINT CALIBRATION WITH S&P 500 SKEW

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ABSTRACT. We derive the expansion of the price of a VIX future in various Bergomi models at order 6 in small volatility-of-volatility. We introduce the notion of volatility of the VIX squared implied by the VIX future, which we call "VIX\(^2\) implied volatility", expand this quantity at order 5, and show that the implied volatility expansion converges much faster than the price expansion. We cover the one-factor, two-factor, and skewed two-factor Bergomi models and allow for maturity-dependent and/or time-dependent parameters. The expansions allow us to precisely pinpoint the roles of all the model parameters (volatility-of-volatility, mean reversion, correlations, mixing fraction) in the formation of the prices of VIX futures in Bergomi models. The derivation of the expansion naturally involves the (classical or dual bivariate) Hermite polynomials and exploits their orthogonality properties. When the initial term-structure of variance swaps is flat, the expansion is a closed-form expression; otherwise, it involves one-dimensional integrals which are extremely fast to compute. The VIX\(^2\) implied volatility expansion is extremely precise for both the one-factor model and the two-factor model with independent factors, even for the very large values of volatility-of-volatility that are usual in equity derivatives markets, and can virtually be considered an exact formula in those cases. We use the new expansion together with the Bergomi-Guyon expansion of the S&P 500 smile to (instantaneously) calibrate the two-factor Bergomi model jointly to the term-structures of S&P 500 at-the-money skew and VIX\(^2\) implied volatility. Our tests and the new expansion shed more light on the inability of traditional stochastic volatility models to jointly fit S&P 500 and VIX market data. The (imperfect but decent) joint fit requires much larger values of volatility-of-volatility and fast mean reversion than the ones previously reported in [10,13].

Keywords. VIX, VIX futures, Bergomi models, VIX\(^2\) implied volatility, analytic expansion, small volatility-of-volatility, at-the-money skew, S&P 500/VIX joint calibration, Hermite polynomials.

1. INTRODUCTION

Closed-form approximations are always very useful in mathematical modeling. They give insights on the structural properties of the models and the precise role of model parameters. They are computed in no time
Joint calibration of 2-factor Bergomi model to term-structure of SPX ATM skew and VIX$^2$ implied vol (G. 2020)

**Figure:** Left: ATM skew of SPX options as a function of maturity. Right: implied volatility of the squared VIX as a function of maturity. Calibration of the Bergomi-Guyon expansion of the SPX ATM skew and a newly derived expansion of the VIX$^2$ implied volatility, either jointly or separately. Calibration as of October 8, 2019.
Related works with continuous models on the SPX

- Fouque-Saporito (2018), Heston with stochastic vol-of-vol. Problem: their approach does not apply to short maturities (below 4 months), for which VIX derivatives are most liquid and the joint calibration is most difficult.

- Goutte-Ismail-Pham (2017), Heston with parameters driven by a Hidden Markov jump process.

  
  “Interestingly, we observe a 20% difference between the [vol-of-vol] parameter obtained through VIX calibration and the one obtained through SPX. This suggests that the volatility of volatility in the SPX market is 20% higher when compared to VIX, revealing potential data inconsistencies (arbitrage?).”

To try to jointly fit the SPX and VIX smiles, many authors have incorporated jumps in the dynamics of the SPX: Sepp, Cont-Kokholm, Papanicolaou-Sircar, Baldeaux-Badran, Pacati-Pompa-Renò, Kokholm-Stisen, Bardgett-Gourier-Leippold...

Jumps offer extra degrees of freedom to partly decouple the ATM SPX skew and the ATM VIX implied volatility.

So far all the attempts at solving the joint SPX/VIX smile calibration problem only produced an approximate fit.
Exact joint SPX/VIX smile calibration: a dispersion-constrained martingale Schrödinger problem approach

(G. 2019)
Exact joint calibration as a dispersion-constrained martingale Schrödinger problem (G. 2019)

- **A completely different approach:** instead of postulating a parametric continuous-time (jump-)diffusion model on the SPX, we build a nonparametric discrete-time model:
  - Help decouple SPX skew and VIX implied vol.
  - Perfectly fits the smiles.
- Given a VIX future maturity $T_1$, we build a joint probability measure on $(S_1, V, S_2)$ which is perfectly calibrated to the SPX smiles at $T_1$ and $T_2 = T_1 + 30$ days, and the VIX future and VIX smile at $T_1$.
- $S_1$: SPX at $T_1$, $V$: VIX at $T_1$, $S_2$: SPX at $T_2$.
- Our model satisfies:
  - **Martingality constraint** on the SPX;
  - **Consistency condition:** the VIX at $T_1$ is the implied volatility of the 30-day log-contract on the SPX.
- Our model is cast as the solution of a dispersion-constrained martingale Schrödinger problem which is solved using the Sinkhorn algorithm, in the spirit of De March and Henry-Labordère (2019).
The joint S&P 500/Vix smile calibration puzzle solved

Since Vix options started trading in 2006, many researchers have tried to build a model that jointly and exactly calibrates to the prices of Standard & Poor’s 500 options, Vix futures and Vix options. In this article, Julien Guyon solves this long-standing puzzle by casting it as a discrete-time dispersion-constrained martingale transport problem, which he solves in a non-parametric way using Sinkhorn’s algorithm.

Volatility indexes, such as the Vix index, do not just serve as market-implied indicators of volatility. Futures and options on these indexes are also widely used as risk management tools to hedge the volatility exposure of options portfolios. The existence of a liquid market for these futures and options has led to the need for models that jointly calibrate to the prices of options on the underlying asset and the prices of volatility derivatives. Without such models, financial institutions could possibly arbitrage each other: even market-making desks within the same institution could do so, e.g., the Vix desk could arbitrage the S&P 500 (SPX) desk. By using models that fail to correctly incorporate the prices of the hedging instruments, such as SPX options, Vix futures and Vix options, exotic desks may misprice options, especially (but not only) those with payoffs that involve both the underlying and its volatility index.

For this reason, since Vix options began trading in 2006, many researchers and practitioners have tried to build a model that jointly and exactly calibrates to the prices of SPX futures, SPX options, Vix futures and Vix options. This is known to be a very challenging problem, especially for short maturities. In particular, the very large negative skew of short-term SPX options, and Vix smiles: that the distribution of the Dupire market local variance be smaller than the distribution of the (instantaneous) Vix squared in the convex order, at all times. He also reported that for short maturities the distribution of the true Vix squared in the market local volatility model is actually larger than the market-implied distribution of the true Vix squared in the convex order. Guyon showed numerically that when the (typically negative) spot-vol correlation is large enough in absolute value, both (a) traditional stochastic volatility models with large mean reversion and (b) rough volatility models with a small Hurst exponent can reproduce this inversion of convex ordering.

Acceia & Guyon (2020) provide a mathematical proof that the inversion of convex ordering can be produced by continuous models. However, the inversion of convex ordering is only a necessary condition for the joint SPX/Vix calibration of continuous models; it is not sufficient.

Since it looks to be very difficult to jointly calibrate the SPX and Vix smiles with continuous models, many authors have incorporated jumps in the dynamics of the SPX: see references in Guyon (2019a). Jumps offer extra degrees of freedom to partly decouple the ATM SPX skew and the ATM/Vix implied volatility. However, the attempt so far have only produced...
Setting and notation

- For simplicity: zero interest rates, repos, and dividends.
- $\mu_1 =$ risk-neutral distribution of $S_1 \leftrightarrow$ market smile of SPX at $T_1$.
- $\mu_V =$ risk-neutral distribution of $V \leftrightarrow$ market smile of VIX at $T_1$.
- $\mu_2 =$ risk-neutral distribution of $S_2 \leftrightarrow$ market smile of SPX at $T_2$.
- $F_V$: value at time 0 of VIX future maturing at $T_1$.
- We denote $E^i := E^{\mu_i}$, $E^V := E^{\mu_V}$ and assume
  
  $E^i[S_i] = S_0$, $E^i[|\ln S_i|] < \infty$, $i \in \{1, 2\}$; $E^V[V] = F_V$, $E^V[V^2] < \infty$.

- No calendar arbitrage $\iff \mu_1 \leq_c \mu_2$ (convex order)
Setting and notation

\[ V^2 := (VIX_{T_1})^2 := -\frac{2}{\tau} \text{Price}_{T_1} \left[ \ln \left( \frac{S_2}{S_1} \right) \right] = \text{Price}_{T_1} \left[ L \left( \frac{S_2}{S_1} \right) \right] \]

- \( \tau := 30 \) days.
- \( L(x) := -\frac{2}{\tau} \ln x \): convex, decreasing.
Superreplication, duality: dispersion-constrained martingale optimal transport problems
The knowledge of $\mu_1$ and $\mu_2$ gives little information on the prices $\mathbb{E}^\mu [g(S_1, S_2)]$, e.g., prices of forward-starting options $\mathbb{E}^\mu [f(S_2/S_1)]$.

Computing upper and lower bounds of these prices:

- **Optimal transport** (Monge, 1781; Kantorovich, 1942)

- Adding the no-arbitrage constraint that $(S_1, S_2)$ is a martingale leads to more precise bounds, as this provides information on the conditional average of $S_2/S_1$ given $S_1$:

  **Martingale optimal transport** (Henry-Labordère, 2017)

- When $S = \text{SPX}$: Adding VIX market data information produces even more precise bounds, as it gives information on the conditional dispersion of $S_2/S_1$, which is controlled by the VIX $V$:

  **Dispersion-constrained martingale optimal transport** (This talk)
Classical optimal transport

Figure: Example of a transport plan. Source: Wikipedia
Superreplication: primal problem

**Fundamental principle:** Upper bound for the price of payoff \( f(S_1, V, S_2) \) = smallest price at time 0 of a superreplicating portfolio.

Following De Marco-Henry-Labordère (2015), G.-Menegaux-Nutz (2017), the available instruments for superreplication are:

- At time 0:
  - \( u_1(S_1) \): SPX vanilla payoff maturity \( T_1 \) (including cash)
  - \( u_2(S_2) \): SPX vanilla payoff maturity \( T_2 \)
  - \( u_V(V) \): VIX vanilla payoff maturity \( T_1 \)

Cost: \( \text{MktPrice}[u_1(S_1)] + \text{MktPrice}[u_2(S_2)] + \text{MktPrice}[u_V(V)] \)

\[
= \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^2[u_2(S_2)] + \mathbb{E}^V[u_V(V)]
\]

- At time \( T_1 \):
  - \( \Delta_S(S_1, V)(S_2 - S_1) \): delta hedge
  - \( \Delta_L(S_1, V)(L(S_2/S_1) - V^2) \): buy \( \Delta_L(S_1, V) \) log-contracts

Cost: 0

**Shorthand notation:**

\[
\Delta^{(S)}(s_1, v, s_2) := \Delta(s_1, v)(s_2 - s_1), \quad \Delta^{(L)}(s_1, v, s_2) := \Delta(s_1, v) \left( L \left( \frac{s_2}{s_1} \right) - v^2 \right)
\]
Superreplication: primal problem

- The model-independent no-arbitrage upper bound for the derivative with payoff $f(S_1, V, S_2)$ is the smallest price at time 0 of a superreplicating portfolio:

$$P_f := \inf_{U_f} \left\{ \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] \right\}.$$

- $U_f$: set of superreplicating portfolios, i.e., the set of all functions $(u_1, u_V, u_2, \Delta_S, \Delta_L)$ that satisfy the superreplication constraint:

$$u_1(s_1) + u_V(v) + u_2(s_2) + \Delta_S(s_1, v, s_2) + \Delta_L(s_1, v, s_2) \geq f(s_1, v, s_2).$$

- Shorthand notation:

$$(u_1 \oplus u_V \oplus u_2)(s_1, v, s_2) := u_1(s_1) + u_V(v) + u_2(s_2)$$

Superreplication constraint:

$$u_1 \oplus u_V \oplus u_2 + \Delta_S^{(S)} + \Delta_L^{(L)} \geq f$$

- Linear program
Superreplication: dual problem

- $\mathcal{P}(\mu_1, \mu_V, \mu_2)$: set of all the probability measures $\mu$ on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$ such that

  $S_1 \sim \mu_1, \ V \sim \mu_V, \ S_2 \sim \mu_2, \ \mathbb{E}^{\mu}[S_2|S_1, V] = S_1, \ \mathbb{E}^{\mu}[L\left(\frac{S_2}{S_1}\right)|S_1, V] = V^2$.

- Dual problem:

  $D_f := \sup_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} \mathbb{E}^{\mu}[f(S_1, V, S_2)]$.

- **Dispersion-constrained martingale optimal transport problem**.

  - $\mathbb{E}^{\mu}[S_2|S_1, V] = S_1$: martingality condition of the SPX index, condition on the average of the distribution of $S_2$ given $S_1$ and $V$.
  
  - $\mathbb{E}^{\mu}[L(S_2/S_1)|S_1, V] = V^2$: consistency condition, condition on dispersion around the average.
Theorem (G. 2020)

Let $f : \mathbb{R}^+ \times \mathbb{R}^+ \times \mathbb{R}^+ \to \mathbb{R}$ be upper semicontinuous and satisfy

$$|f(s_1, v, s_2)| \leq C(1 + s_1 + s_2 + |L(s_1)| + |L(s_2)| + v^2)$$

for some constant $C > 0$. Then

$$P_f := \inf_{U_f} \left\{ \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] \right\}$$

$$= \sup_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} \mathbb{E}^\mu[f(S_1, V, S_2)] =: D_f.$$

Moreover, $D_f \neq -\infty$ if and only if $\mathcal{P}(\mu_1, \mu_V, \mu_2) \neq \emptyset$, and in that case the supremum is attained.
Superreplication of forward-starting options

- The knowledge of $\mu_1$ and $\mu_2$ gives little information on the prices $\mathbb{E}^\mu [g(S_1, S_2)]$, e.g., prices of forward-starting options $\mathbb{E}^\mu [f(S_2/S_1)]$.

- Computing upper and lower bounds of these prices:
  **Optimal transport** (Monge, 1781; Kantorovich, 1942)

- Adding the no-arbitrage constraint that $(S_1, S_2)$ is a martingale leads to more precise bounds, as this provides information on the conditional average of $S_2/S_1$ given $S_1$:
  **Martingale optimal transport** (Henry-Labordère, 2017)

- When $S = \text{SPX}$: Adding VIX market data information produces even more precise bounds, as it information on the conditional dispersion of $S_2/S_1$, which is controlled by the VIX $V$:
  **Dispersion-constrained martingale optimal transport** (This talk)

- Adding VIX market data may possibly reveal a joint SPX/VIX arbitrage. Corresponds to $\mathcal{P}(\mu_1, \mu_V, \mu_2) = \emptyset$ (see next slides).

- In the limiting case where $\mathcal{P}(\mu_1, \mu_V, \mu_2) = \{\mu_0\}$ is a singleton, the joint SPX/VIX market data information completely specifies the joint distribution of $(S_1, S_2)$, hence the price of forward starting options.
Joint SPX/VIX arbitrage: definition, characterization
Joint SPX/VIX arbitrage

- \( U_0 = \) the portfolios \((u_1, u_2, u_V, \Delta^S, \Delta^L)\) superreplicating 0:

\[
u_1(s_1) + u_2(s_2) + u_V(v) + \Delta_S(s_1, v)(s_2 - s_1) + \Delta_L(s_1, v) \left(L \left( \frac{s_2}{s_1} \right) - v^2 \right) \geq 0
\]

- A joint SPX/VIX arbitrage, or \((S_1, S_2, V)\)-arbitrage, is an element of \(U_0\) with negative price:

\[
\text{MktPrice}[u_1(S_1)] + \text{MktPrice}[u_2(S_2)] + \text{MktPrice}[u_V(V)] < 0
\]

- Equivalently, there is an \((S_1, S_2, V)\)-arbitrage if and only if

\[
\inf_{U_0} \{\text{MktPrice}[u_1(S_1)] + \text{MktPrice}[u_2(S_2)] + \text{MktPrice}[u_V(V)]\} = -\infty
\]
If $E^V[V^2] \neq E^2[L(S_2)] - E^1[L(S_1)]$, there is a trivial $(S_1, S_2, V)$-arbitrage. For instance, if $E^V[V^2] < E^2[L(S_2)] - E^1[L(S_1)]$, pick

$$u_1(s_1) = L(s_1), \quad u_2(s_2) = -L(s_2), \quad u_V(v) = v^2, \quad \Delta_S(s_1, v) = 0, \quad \Delta_L(s_1, v) = 1.$$  

We assume that

$$E^V[V^2] = E^2[L(S_2)] - E^1[L(S_1)]. \quad (2.1)$$

Violations of (2.1) in the market have been reported, suggesting arbitrage opportunities, see, e.g., Section 7.7.4 in Bergomi (2016).

However, the quantities in (2.1) do not purely depend on market data. They depend on smile extrapolations.

The reported violations of (2.1) actually rely on some arbitrary smile extrapolations.

G. (2018) explains how to build consistent extrapolations of the VIX and SPX smiles so that (2.1) holds.
Characterization of joint SPX/VIX arbitrage

Theorem (G. 2020)

The following assertions are equivalent:

(i) The market is free of \((S_1, S_2, V)\)-arbitrage,

(ii) \(\mathcal{P}(\mu_1, \mu_V, \mu_2) \neq \emptyset\),

(iii) There exists a coupling \(\nu\) of \(\mu_1\) and \(\mu_V\) such that \(\text{Law}_\nu(S_1, L(S_1) + V^2)\) and \(\text{Law}_{\mu_2}(S_2, L(S_2))\) are in convex order, i.e., for any convex function \(f : \mathbb{R}_{>0} \times \mathbb{R} \to \mathbb{R}\),

\[
\mathbb{E}^\nu[f(S_1, L(S_1) + V^2)] \leq \mathbb{E}^2[f(S_2, L(S_2))].
\]
Solve the joint calibration puzzle:
build a model in $P(\mu_1, \mu_V, \mu_2)$
as the solution of a
dispersion-constrained martingale
Schrödinger problem
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- Recall $\mathcal{P}(\mu_1, \mu_V, \mu_2) := \text{probability measures on } \mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$ s.t.
  
  $S_1 \sim \mu_1, \quad V \sim \mu_V, \quad S_2 \sim \mu_2, \quad \mathbb{E}^\mu [S_2 | S_1, V] = S_1, \quad \mathbb{E}^\mu \left[ L \left( \frac{S_2}{S_1} \right) \big| S_1, V \right] = V^2.$

- Assume absence of joint SPX/VIX arbitrage: $\mathcal{P}(\mu_1, \mu_V, \mu_2) \neq \emptyset$.
- **Build a model** $\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2) = \text{solve the joint calibration puzzle}.$
- To build an element $\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)$, we choose a reference probability measure $\bar{\mu}$ on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$ and look for the measure $\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)$ that minimizes the relative entropy $H(\mu | \bar{\mu})$ of $\mu$ w.r.t. $\bar{\mu}$, also known as the Kullback-Leibler divergence:

  $$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}), \quad H(\mu | \bar{\mu}) := \begin{cases} \mathbb{E}^\mu \left[ \ln \frac{d\mu}{d\bar{\mu}} \right] = \mathbb{E}^{\bar{\mu}} \left[ \frac{d\mu}{d\bar{\mu}} \ln \frac{d\mu}{d\bar{\mu}} \right] & \text{if } \mu \ll \bar{\mu}, \\ +\infty & \text{otherwise.} \end{cases}$$

- This is a strictly convex problem that can be solved after dualization using, e.g., Sinkhorn's fixed point iteration (Sinkhorn, 1967).
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$
Reminder on Lagrange multipliers

\[
\inf_{g(x,y)=c} f(x,y) = \inf_{x,y} \sup_{\lambda \in \mathbb{R}} \{ f(x,y) - \lambda (g(x,y) - c) \} \\
= \sup_{\lambda \in \mathbb{R}} \inf_{x,y} \{ f(x,y) - \lambda (g(x,y) - c) \}
\]

- To compute the inner inf over \(x, y\) unconstrained, simply solve \(\nabla f(x,y) = \lambda \nabla g(x,y)\): easy!
- Then maximize the result over \(\lambda\) unconstrained: easy!
- Constraint \(g(x,y) = c \iff \frac{\partial}{\partial \lambda} \{ f(x,y) - \lambda (g(x,y) - c) \} = 0\).

\[
\inf_{\mu \text{ s.t. } S_1 \sim \mu} H(\mu|\bar{\mu}) = \inf_{\mu} \sup_{u_1(\cdot)} \left\{ H(\mu|\bar{\mu}) + \mathbb{E}^1[u_1(S_1)] - \mathbb{E}^\mu [u_1(S_1)] \right\}
\]

\[
\inf_{\mu \text{ s.t. } \mathbb{E}^\mu[S_2|S_1,V]=S_1} H(\mu|\bar{\mu}) = \inf_{\mu} \sup_{\Delta_S(\cdot,\cdot)} \left\{ H(\mu|\bar{\mu}) - \mathbb{E}^\mu [\Delta_S(S_1, V)(S_2 - S_1)] \right\}
\]

\[
\inf_{\mu \text{ s.t. } \mathbb{E}^\mu[L(S_2/S_1)|S_1,V]=V^2} H(\mu|\bar{\mu}) = \inf_{\mu} \sup_{\Delta_L(\cdot,\cdot)} \left\{ H(\mu|\bar{\mu}) - \mathbb{E}^\mu \left[ \Delta_L(S_1,V) \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \right\}
\]
Reminder on Lagrange multipliers

\[
\inf_{g(x,y) = c} f(x, y) = \inf_{x, y} \sup_{\lambda \in \mathbb{R}} \{ f(x, y) - \lambda (g(x, y) - c) \} = \sup_{\lambda \in \mathbb{R}} \inf_{x, y} \{ f(x, y) - \lambda (g(x, y) - c) \}
\]

- To compute the inner inf over \( x, y \) unconstrained, simply solve
  \( \nabla f(x, y) = \lambda \nabla g(x, y) \): easy!
- Then maximize the result over \( \lambda \) unconstrained: easy!
- Constraint \( g(x, y) = c \iff \frac{\partial}{\partial \lambda} \{ f(x, y) - \lambda (g(x, y) - c) \} = 0 \).

\[
\inf_{\mu \text{ s.t. } S_1 \sim \mu_1} H(\mu | \bar{\mu}) = \inf_{\mu} \sup_{u_1(\cdot)} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] - \mathbb{E}^\mu [u_1(S_1)] \right\}
\]

\[
\inf_{\mu \text{ s.t. } \mathbb{E}^\mu [S_2 | S_1, V] = S_1} H(\mu | \bar{\mu}) = \inf_{\mu} \sup_{\Delta_S(\cdot, \cdot)} \left\{ H(\mu | \bar{\mu}) - \mathbb{E}^\mu [\Delta_S(S_1, V)(S_2 - S_1)] \right\}
\]

\[
\inf_{\mu \text{ s.t. } \mathbb{E}^\mu \left[ L \left( \frac{S_2}{S_1} \right) \right] | S_1, V] = V^2} H(\mu | \bar{\mu}) = \inf_{\mu} \sup_{\Delta_L(\cdot, \cdot)} \left\{ H(\mu | \bar{\mu}) - \mathbb{E}^\mu \left[ \Delta_L(S_1, V) \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \right\}
\]
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: \textbf{unconstrained}
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: \textbf{Lagrange multipliers}

$$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$$

$$= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] ight.$$ 

$$- \mathbb{E}^{\mu} \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_{S}(S_1, V, S_2) + \Delta^{(L)}_{L}(S_1, V, S_2) \right] \right\}$$

$$= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] ight.$$ 

$$- \mathbb{E}^{\mu} \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_{S}(S_1, V, S_2) + \Delta^{(L)}_{L}(S_1, V, S_2) \right] \right\}$$
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: unconstrained
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: Lagrange multipliers

$$D_{\mu} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$$

$$= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta_S^{(S)}(S_1, V, S_2) + \Delta_L^{(L)}(S_1, V, S_2) \right] \right\}$$

$$= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta_S^{(S)}(S_1, V, S_2) + \Delta_L^{(L)}(S_1, V, S_2) \right] \right\}$$
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: unconstrained
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: Lagrange multipliers

$$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$$

$$= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1 [u_1(S_1)] + \mathbb{E}^V [u_V(V)] + \mathbb{E}^2 [u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$

$$= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1 [u_1(S_1)] + \mathbb{E}^V [u_V(V)] + \mathbb{E}^2 [u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: **unconstrained**
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: **Lagrange multipliers**

$$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu|\bar{\mu})$$

$$= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu|\bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$

$$= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu|\bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: **unconstrained**
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: **Lagrange multipliers**

\[
D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})
\]

\[
= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] 
- \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta_S^{(S)}(S_1, V, S_2) + \Delta_L^{(L)}(S_1, V, S_2) \right] \right\}
\]

\[
= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] 
- \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta_S^{(S)}(S_1, V, S_2) + \Delta_L^{(L)}(S_1, V, S_2) \right] \right\}
\]
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0}$: unconstrained
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: Lagrange multipliers

\[
D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})
\]
\[
= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}
\]
\[
= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}
\]
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

- $\mathcal{M}_1$: set of probability measures on $\mathbb{R}_0^+ \times \mathbb{R}_0^+ \times \mathbb{R}_0^+$: unconstrained
- $\mathcal{U}$: set of portfolios $u = (u_1, u_V, u_2, \Delta_S, \Delta_L)$: Lagrange multipliers

$$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$$

$$= \inf_{\mu \in \mathcal{M}_1} \sup_{u \in \mathcal{U}} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] 
- \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$

$$= \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] 
- \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

$$D_{\bar{\mu}} = \sup_{u \in \mathcal{U}} \inf_{\mu \in \mathcal{M}_1} \left\{ H(\mu | \bar{\mu}) + \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \mathbb{E}^\mu \left[ u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^{(S)}_S(S_1, V, S_2) + \Delta^{(L)}_L(S_1, V, S_2) \right] \right\}$$

- **Remarkable fact:** The inner infimum can be exactly computed:

$$\inf_{\mu \in \mathcal{M}_1} \{ H(\mu | \bar{\mu}) - \mathbb{E}^\mu [X] \} = -\ln \mathbb{E}^{\bar{\mu}} \left[ e^X \right]$$

and the infimum is attained at $\mu = \bar{\mu}_X$ defined by (Gibbs type)

$$\frac{d\bar{\mu}_X}{d\bar{\mu}} = \frac{e^X}{\mathbb{E}^{\bar{\mu}}[e^X]}.$$ 

- That is why we like (and chose) the “distance” $H(\mu | \bar{\mu})$!
Build a model in $\mathcal{P}(\mu_1, \mu_V, \mu_2)$

$$D_{\bar{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}) = \sup_{u \in \mathcal{U}} J_{\bar{\mu}}^{\ln}(u) =: P_{\bar{\mu}}$$

$$J_{\bar{\mu}}^{\ln}(u) := \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \ln \mathbb{E}^{\bar{\mu}} \left[ e^{u_1(S_1) + u_V(V) + u_2(S_2) + \Delta^S(S_1, V, S_2) + \Delta^L(L)} \right].$$

- $\inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)}$: **constrained** optimization, **difficult**.
- $\sup_{u \in \mathcal{U}}$: **unconstrained** optimization, **easy**! If sup is attained, to find the optimum $u^* = (u_1^*, u_V^*, u_2^*, \Delta^S, \Delta^L)$, simply cancel the gradient of $J_{\bar{\mu}}^{\ln}$.
- Most important, $\inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$ is reached at

$$\mu^*(ds_1, dv, ds_2) = \bar{\mu}(ds_1, dv, ds_2) \frac{e^{u_1^*(s_1) + u_V^*(v) + u_2^*(s_2) + \Delta^S(S_1, v, s_2) + \Delta^L(L)(s_1, v, s_2)}}{\mathbb{E}^{\bar{\mu}} \left[ e^{u_1^*(S_1) + u_V^*(V) + u_2^*(S_2) + \Delta^S(S_1, V, S_2) + \Delta^L(L)(S_1, V, S_2)} \right]}.$$

**Problem solved**: $\mu^* \in \mathcal{P}(\mu_1, \mu_V, \mu_2)$!
Strong duality for the VIX-constrained martingale Schrödinger problem

\[ D_{\tilde{\mu}} := \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu|\tilde{\mu}) = \sup_{u \in \mathcal{U}} J^{\text{ln}}_{\tilde{\mu}}(u) =: P_{\tilde{\mu}} \]

\[ J^{\text{ln}}_{\tilde{\mu}}(u) := \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - \ln \mathbb{E}^{\tilde{\mu}} \left[ e^{\left( u_1 \oplus u_V \oplus u_2 + \Delta^{(S)} + \Delta^{(L)} \right)}(S_1, V, S_2) \right] \]

**Generalization:**

\[ \mathcal{G} := \{ g : (0, +\infty] \to (-\infty, +\infty] \mid \forall x \in (0, +\infty], \ g(x) \geq \ln x \ \text{and} \ \ g(1) = 0 \} \]

For \( g \in \mathcal{G} \) we define \( J^{g}_{\tilde{\mu}} : \mathcal{U} = L^1B \to [-\infty, +\infty) \) by

\[ J^{g}_{\tilde{\mu}}(u) := \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - g \left( \mathbb{E}^{\tilde{\mu}} \left[ e^{\left( u_1 \oplus u_V \oplus u_2 + \Delta^{(S)} + \Delta^{(L)} \right)}(S_1, V, S_2) \right] \right) \]

\[ Z_{\tilde{\mu}}(u) := \mathbb{E}^{\tilde{\mu}} \left[ e^{\left( u_1 \oplus u_V \oplus u_2 + \Delta^{(S)} + \Delta^{(L)} \right)}(S_1, V, S_2) \right] \]

For \( E \in \{ L^1B, CC_b, C_bC_b \} \), we denote \( E_{\text{exp}} := \{ u \in E \mid Z_{\tilde{\mu}}(u) < +\infty \} \).
Strong duality for the VIX-constrained martingale Schrödinger problem

Theorem (G. 2020)

Let $\bar{\mu} \in \mathcal{M}_1$ and $g \in \mathcal{G}$. The following equality holds in $[0, +\infty]$:

$$\sup_{u \in C C_b} J^g_{\bar{\mu}}(u) = \sup_{u \in L^1 B} J^g_{\bar{\mu}}(u) = \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}).$$

Moreover:

1. The stronger $C_b C_b$-duality $\sup_{u \in C_b C_b} J^g_{\bar{\mu}}(u) = \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$ holds if for all $(\Delta_S, \Delta_L) \in C_b(\mathcal{X}_1 \times \mathcal{X}_V)^2$,
   $$\mathbb{E}^{\bar{\mu}} \left[ e^{\left(\Delta_S^{(S)} + \Delta_L^{(L)}\right)(S_1,V,S_2)} \right] < +\infty.$$

2. If $\mathcal{P}(\mu_1, \mu_V, \mu_2) \neq \emptyset$, then the infimum is attained.

3. If the problem is finite, then $\mathcal{P}(\mu_1, \mu_V, \mu_2) \neq \emptyset$ and the infimum is uniquely attained. We then denote by $\mu^* := \arg \min_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu})$ the minimum entropy jointly calibrating model.
Strong duality for the VIX-constrained martingale Schrödinger problem

Theorem (G. 2020, cont’d)

4 Let $E \in \{L^1 B, CC_b\}$ and $u^* \in E$. The following assertions are equiv.:
   (i) $J_{\mu}^{\ln}(u^*) = \sup_{u \in E} J_{\mu}^{\ln}(u)$.
   (ii) The problem is finite, $u^* \in E_{\exp}$, and
   \[
   \frac{d\mu^*}{d\bar{\mu}} = Z_{\bar{\mu}}(u^*)^{-1} e^{\left(u_1^* u_V^* + u_2^* + \Delta^*_S + \Delta^*_L\right)}(S_1, V, S_2) \quad \bar{\mu}-\text{a.s.}
   \]
   In this case, let $u^\dagger := (u_1^* - \ln Z_{\bar{\mu}}(u^*), u_V^*, u_2^*, \Delta^*_S, \Delta^*_L)$. Then $u^\dagger \in E$ and $u^\dagger$ satisfies the three equivalent assertions below.

5 Let $E \in \{L^1 B, CC_b\}$ and $u^\dagger \in E$. The following assertions are equivalent:
   (i) $J_{\mu}^{id^{-1}}(u^\dagger) = \sup_{u \in E} J_{\mu}^{id^{-1}}(u)$.
   (ii) For all $g \in G$, $J_{\mu}^g(u^\dagger) = \sup_{u \in E} J_{\mu}^g(u)$.
   (iii) The problem is finite and
   \[
   \frac{d\mu^*}{d\bar{\mu}} = e^{\left(u_1^\dagger + u_2^\dagger + \Delta^*_S + \Delta^*_L\right)}(S_1, V, S_2) \quad \bar{\mu}-\text{a.s.}
   \]
   In this case, $Z_{\bar{\mu}}(u^\dagger) = 1$. 
Strong duality for the VIX-constrained martingale Schrödinger problem

\[
\frac{d\mu^*}{d\bar{\mu}} = Z\bar{\mu}(u^*)^{-1} e^{(u_1^* \oplus u_2^* + \Delta_1^*(S) + \Delta_2^*(L))}(S_1,V,S_2) \quad \bar{\mu}-a.s.
\]

We call maximizers \((u_1^*, u_2^*, \Delta^*_S, \Delta^*_L)\) and \((u_1^\dagger, u_2^\dagger, \Delta^\dagger_S, \Delta^\dagger_L)\) **Schrödinger potentials** (if they exist).

We call the corresponding portfolios
\[
\pi_{u^*} := u_1^* \oplus u_V^* \oplus u_2^* + \Delta^*_S + \Delta^*_L \quad \text{and} \\
\pi_{u^\dagger} := u_1^\dagger \oplus u_V^\dagger \oplus u_2^\dagger + \Delta^\dagger_S + \Delta^\dagger_L
\]
**Schrödinger portfolios**.

The Schrödinger portfolio is essentially unique: two Schrödinger portfolios \(\pi_{u^*}\) and \(\pi_{u^\dagger}\) are \(\bar{\mu}\)-a.e. equal up to an additive constant.

We call \(\pi_{u^\dagger}\) the **standard Schrödinger portfolio**.
Strong duality for the VIX-constrained martingale Schrödinger problem

Sketch of the proof of strong duality:

1. Prove strong duality for the classical Schrödinger problem (marginal constraints only, $E = L^1$ or $C$ or $C_b$)

$$\inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} H(\mu|\bar{\mu}) = \sup_{(u_1, u_V, u_2) \in E} J^{S,g}_{\bar{\mu}}(u_1, u_V, u_2)$$

using Fenchel-Rockafellar convex duality theorem. Be careful: in general $\mathcal{M}(\mathcal{X}) \not\subset C_b(\mathcal{X})^*$ when $\mathcal{X}$ is not compact!

2. Extend to the mixed Schrödinger-Monge-Kantorovich problem (or entropy-regularized optimal transport problem, $E = L^1$ or $C$)

$$\inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} \{H(\mu|\bar{\mu}) - \mathbb{E}^\mu[f(S_1, V, S_2)]\} = \sup_{(u_1, u_V, u_2) \in E} J^{SMK,g}_{\bar{\mu}, f}(u_1, u_V, u_2).$$
Strong duality for the VIX-constrained martingale Schrödinger problem

Sketch of the proof:

1. Prove strong duality for the classical Schrödinger problem (marginal constraints only, $E = L^1$ or $C$ or $C_b$)

$$\inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}) = \sup_{(u_1, u_V, u_2) \in E} J^S,g_{\bar{\mu}}(u_1, u_V, u_2)$$

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$$J^S,g_{\bar{\mu}}(u_1, u_V, u_2) := \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - g\left(\mathbb{E}^{\bar{\mu}}\left[e^{(u_1 \oplus u_V \oplus u_2)}(S_1, V, S_2)\right]\right)$$

$$J^{SMK,g}_{\bar{\mu}, f}(u_1, u_V, u_2) := \mathbb{E}^1[u_1(S_1)] + \mathbb{E}^V[u_V(V)] + \mathbb{E}^2[u_2(S_2)] - g\left(\mathbb{E}^{\bar{\mu}}\left[e^{(u_1 \oplus u_V \oplus u_2 + f)}(S_1, V, S_2)\right]\right)$$
Strong duality for the VIX-constrained martingale Schrödinger problem

Sketch of proof:

1. Prove strong duality for the classical Schrödinger problem
\[ \inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}) = \sup_{(u_1, u_V, u_2) \in E} J_{\bar{\mu}}^{g, \mu} (u_1, u_V, u_2) \]

2. Extend to the mixed Schrödinger-Monge-Kantorovich problem
\[ \inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} \left\{ H(\mu | \bar{\mu}) - \mathbb{E}^{\mu} [f(S_1, V, S_2)] \right\} = \sup_{(u_1, u_V, u_2) \in E} J_{\bar{\mu}, f}^{\text{SMK}} (u_1, u_V, u_2). \]

3. Back to the dispersion-constrained martingale Schrödinger problem:
   1. Dualize the martingality and dispersion constraints:
\[ \inf_{\mu \in \mathcal{P}(\mu_1, \mu_V, \mu_2)} H(\mu | \bar{\mu}) = \inf_{\mu \in \Pi(\mu_1, \mu_V, \mu_2)} \sup_{(\Delta_S, \Delta_L) \in C_B} \left\{ H(\mu | \bar{\mu}) - \mathbb{E}^{\mu} \left[ \left( \Delta_S^{(S)} + \Delta_L^{(L)} \right) (S_1, V, S_2) \right] \right\} \]
   2. Use the weak compactness of \( \Pi(\mu_1, \mu_V, \mu_2) \) and Sion’s minimax theorem to swap inf and sup.
   3. Apply the SMK strong duality.
Build a model in \( P(\mu_1, \mu_V, \mu_2) \)

\[
\mu^*(ds_1, dv, ds_2) = \bar{\mu}(ds_1, dv, ds_2) \frac{e^{u_1^*(s_1)+u_V^*(v)+u_2^*(s_2)+\Delta_S^*(s_1,v,s_2)+\Delta_L^*(L)(s_1,v,s_2)}}{E^{\bar{\mu}} \left[ e^{u_1^*(S_1)+u_V^*(V)+u_2^*(S_2)+\Delta_S^*(S_1,V,S_2)+\Delta_L^*(L)(S_1,V,S_2)} \right]}
\]

- \( J_{\bar{\mu}}^{ln} \) is invariant by translation of \( u_1, u_V, \) and \( u_2 \) (\( c = \text{cash position} \)):

\[
J_{\bar{\mu}}^{ln} (u_1 + c_1, u_V + cV, u_2 + c_2, \Delta_S, \Delta_L) = J_{\bar{\mu}}^{ln} (u_1, u_V, u_2, \Delta_S, \Delta_L)
\]

\[\implies\] We always work with a normalized version of \( u^* \in U \) s.t.

\[
E^{\bar{\mu}} \left[ e^{u_1^*(S_1)+u_V^*(V)+u_2^*(S_2)+\Delta_S^*(S_1,V,S_2)+\Delta_L^*(L)(S_1,V,S_2)} \right] = 1 \rightarrow J_{\bar{\mu}}^{id-1}
\]

- By duality, the initial, difficult problem of minimizing over \( \mu \in P(\mu_1, \mu_V, \mu_2) \) (constrained) has been reduced to the simpler problem of maximizing the strictly concave function \( J_{\bar{\mu}}^{ln} \) over \( u \in U \) (unconstrained). If it exists, the optimum \( u^* \) cancels the gradient of \( J_{\bar{\mu}}^{ln} \):

\[
\frac{\partial J_{\bar{\mu}}^{ln}}{\partial u_1(s_1)} = \frac{\partial J_{\bar{\mu}}^{ln}}{\partial u_V(v)} = \frac{\partial J_{\bar{\mu}}^{ln}}{\partial u_2(s_2)} = \frac{\partial J_{\bar{\mu}}^{ln}}{\partial \Delta_S(s_1,v)} = \frac{\partial J_{\bar{\mu}}^{ln}}{\partial \Delta_L(s_1,v)} = 0.
\]
The Schrödinger equations (a.k.a. Schrödinger system)

\[
\begin{align*}
\frac{\partial J_{\ln}}{\partial u_1(s_1)} &= 0 : \quad \forall s_1 > 0, \quad u_1(s_1) = \Phi_1(s_1; u_V, u_2, \Delta_S, \Delta_L) \\
\frac{\partial J_{\ln}}{\partial u_V(v)} &= 0 : \quad \forall v \geq 0, \quad u_V(v) = \Phi_V(v; u_1, u_2, \Delta_S, \Delta_L) \\
\frac{\partial J_{\ln}}{\partial u_2(s_2)} &= 0 : \quad \forall s_2 > 0, \quad u_2(s_2) = \Phi_2(s_2; u_1, u_V, \Delta_S, \Delta_L) \\
\frac{\partial J_{\ln}}{\partial \Delta_S(s_1, v)} &= 0 : \quad \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_S}(s_1, v; u_2, \Delta_S(s_1, v), \Delta_L(s_1, v)) \\
\frac{\partial J_{\ln}}{\partial \Delta_L(s_1, v)} &= 0 : \quad \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_L}(s_1, v; u_2, \Delta_S(s_1, v), \Delta_L(s_1, v))
\end{align*}
\]

- We could have simply postulated a model of the form

\[
\mu(ds_1, dv, ds_2) = \bar{\mu}(ds_1, dv, ds_2) \frac{e^{u_1(s_1)+u_V(v)+u_2(s_2)+\Delta_S(s_1,v,s_2)+\Delta_L(s_1,v,s_2)}}{\mathbb{E}_{\bar{\mu}} \left[ e^{u_1(S_1)+u_V(V)+u_2(S_2)+\Delta_S(S_1,V,S_2)+\Delta_L(S_1,V,S_2)} \right]}. 
\]

- Then the 5 conditions defining $\mathcal{P}(\mu_1, \mu_V, \mu_2)$ translate into the 5 above equations.

- The system of equations is solved using Sinkhorn's algorithm.
Sinkhorn’s algorithm

- Sinkhorn’s algorithm (1967) is a coordinate ascent method which was first used in the context of optimal transport by Cuturi (2013). It performs alternating projections.
- In our context: Fixed point method that alternates maximizations in the different directions (one per Lagrange multiplier) to approximate the maximizer $u^\dagger$.
- Start from initial guess $u^{(0)} = (u_1^{(0)}, u_V^{(0)}, u_2^{(0)}, \Delta_S^{(0)}, \Delta_L^{(0)})$, recursively define $u^{(n+1)}$ knowing $u^{(n)}$ by

\begin{align*}
\forall s_1 > 0, \quad u_1^{(n+1)}(s_1) &= \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall v \geq 0, \quad u_V^{(n+1)}(v) &= \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall s_2 > 0, \quad u_2^{(n+1)}(s_2) &= \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall s_1 > 0, \forall v \geq 0, \quad 0 &= \Phi_{\Delta_S}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n)}(s_1, v)) \\
\forall s_1 > 0, \forall v \geq 0, \quad 0 &= \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v))
\end{align*}

until convergence.
- Each of the above 5 lines corresponds to a Bregman projection in the space of measures.
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\[ \forall s_1 > 0, \quad u_1^{(n+1)}(s_1) = \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \]

\[ \forall v \geq 0, \quad u_V^{(n+1)}(v) = \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \]

\[ \forall s_2 > 0, \quad u_2^{(n+1)}(s_2) = \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \]

\[ \forall s_1 > 0, \quad \forall v \geq 0, \quad 0 = \Phi_{\Delta_S}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n)}(s_1, v)) \]

\[ \forall s_1 > 0, \quad \forall v \geq 0, \quad 0 = \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v)) \]

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- Start from initial guess $u^{(0)} = (u_1^{(0)}, u_V^{(0)}, u_2^{(0)}, \Delta_S^{(0)}, \Delta_L^{(0)})$, recursively define $u^{(n+1)}$ knowing $u^{(n)}$ by
  \[
  \forall s_1 > 0, \quad u_1^{(n+1)}(s_1) = \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)})
  \]
  \[
  \forall v \geq 0, \quad u_V^{(n+1)}(v) = \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)})
  \]
  \[
  \forall s_2 > 0, \quad u_2^{(n+1)}(s_2) = \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)})
  \]
  \[
  \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_S}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n)}(s_1, v))
  \]
  \[
  \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v))
  \]
- until convergence.
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  $\forall s_1 > 0, \quad u_1^{(n+1)}(s_1) = \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)})$

  $\forall v \geq 0, \quad u_V^{(n+1)}(v) = \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)})$

  $\forall s_2 > 0, \quad u_2^{(n+1)}(s_2) = \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)})$

  $\forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_S}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n)}(s_1, v))$

  $\forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v))$

- until convergence.

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\[
\begin{align*}
\forall s_1 > 0, \quad u_1^{(n+1)}(s_1) &= \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall v \geq 0, \quad u_V^{(n+1)}(v) &= \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall s_2 > 0, \quad u_2^{(n+1)}(s_2) &= \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall s_1 > 0, \forall v \geq 0, \quad 0 &= \Phi_{\Delta_S}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n)}(s_1, v)) \\
\forall s_1 > 0, \forall v \geq 0, \quad 0 &= \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v))
\end{align*}
\]

until convergence.
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- Start from initial guess \( u^{(0)} = (u_1^{(0)}, u_V^{(0)}, u_2^{(0)}, \Delta_S^{(0)}, \Delta_L^{(0)}) \), recursively define \( u^{(n+1)} \) knowing \( u^{(n)} \) by

\[
\begin{align*}
\forall s_1 > 0, \\
&u_1^{(n+1)}(s_1) = \Phi_1(s_1; u_V^{(n)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall v \geq 0, \\
&u_V^{(n+1)}(v) = \Phi_V(v; u_1^{(n+1)}, u_2^{(n)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
\forall s_2 > 0, \\
&u_2^{(n+1)}(s_2) = \Phi_2(s_2; u_1^{(n+1)}, u_V^{(n+1)}, \Delta_S^{(n)}, \Delta_L^{(n)}) \\
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\forall s_1 > 0, \forall v \geq 0, \\
&0 = \Phi_{\Delta_L}(s_1, v; u_2^{(n+1)}, \Delta_S^{(n+1)}(s_1, v), \Delta_L^{(n+1)}(s_1, v))
\end{align*}
\]

until convergence.
- Each of the above 5 lines corresponds to a Bregman projection in the space of measures.
Sinkhorn’s algorithm

- **If the algorithm diverges**, then $P_{\bar{\mu}} = +\infty$, so $D_{\bar{\mu}} = +\infty$, i.e.,

$$\mathcal{P}(\mu_1, \mu_V, \mu_2) \cap \{\mu \in \mathcal{M}_1 | H(\mu | \bar{\mu}) < +\infty\} = \emptyset.$$  

- In practice, when $\bar{\mu}$ has full support, this is a sign that **there likely exists a joint SPX/VIX arbitrage**.

- One should directly check if $\mathcal{P}(\mu_1, \mu_V, \mu_2) = \emptyset$ (linear program).

- We have never experienced this situation in our numerical tests, which covered both low and high volatility regimes.
Numerical experiments
Implementation details

- **Choice of $\bar{\mu}$:**
  - $S_1 \sim \mu_1$ and $V \sim \mu_V$ independent;
  - Conditional on $(S_1, V)$, $S_2$ lognormal with mean $S_1$ and variance $V$.
  - Under $\bar{\mu}$, $S_2 \not\sim \mu_2$.

- Instead of abstract payoffs $u_1, u_V, u_2$, we work with market strikes and market prices of vanilla options on $S_1, V$, and $S_2$.

- Canceling the gradient of $J_{\bar{\mu}}^{ln} \rightarrow$ system of equations solved using Sinkhorn’s algorithm.

- Enough accuracy is typically reached after $\approx 100$ iterations.
August 1, 2018, $T_1 = 21$ days

Smile of SPX as of August 1, 2018, $T_1 = 21$ days

Smile of VIX as of August 1, 2018, $T_1 = 21$ days

Smile of SPX as of August 1, 2018, $T_2 = 51$ days

Market

Model
August 1, 2018, $T_1 = 21$ days

Price of $\frac{S_2 - S_1}{S_1}$ given $(S_1, V)$, calib as of Aug 1, 2018, $T_1 = 21$ days

Price of $\left(\frac{S_2}{S_1} - V^2\right)/V^2$, calib as of Aug 1, 2018, $T_1 = 21$ days
Figure: Joint distribution of $(S_1, V)$ and local VIX function $\text{VIX}_{\text{loc}}(S_1)$

$$\text{VIX}_{\text{loc}}^2(S_1) := \mathbb{E}^{\mu^*} \left[ V^2 \right| S_1$$
August 1, 2018, \( T_1 = 21 \) days

Figure: Conditional distribution of \( S_2 \) given \((s_1, v)\) under \( \mu^* \) for different values of \((s_1, v)\): \( s_1 \in \{2571, 2808, 3000\} \), \( v \in \{10.10, 15.30, 23.20, 35.72\}\% \), and distribution of the normalized return \( R := \frac{\ln(S_2/S_1)}{V \sqrt{\tau}} + \frac{1}{2} V \sqrt{\tau} \)
August 1, 2018, $T_1 = 21$ days

Function $u_1(s_1)$ as of Aug 1, 2018, $T_1 = 21$ days

Function $u_2(s_2)$ as of Aug 1, 2018, $T_1 = 21$ days

Function $u_3(v)$ as of Aug 1, 2018, $T_1 = 21$ days
August 1, 2018, $T_1 = 21$ days

Function $\Delta_S(s_1, v)$ as of August 1, 2018, $T_1 = 21$ days

Function $\Delta_L(s_1, v)$ as of August 1, 2018, $T_1 = 21$ days

**Figure:** Optimal functions $\Delta_S^*(s_1, v)$ and $\Delta_L^*(s_1, v)$ for $(s_1, v)$ in the quadrature grid
August 1, 2018, $T_1 = 49$ days

**Smile of SPX as of August 1, 2018, $T_1 = 49$ days**

- Red: Market
- Blue: Model

**Smile of VIX as of August 1, 2018, $T_1 = 49$ days**

- Red: Market
- Blue: Model

**Smile of SPX as of August 1, 2018, $T_2 = 79$ days**

- Red: Market
- Blue: Model
August 1, 2018, $T_1 = 49$ days

Price of $\frac{S_2 - S_1}{S_1}$ given $(S_1, V)$, calib as of Aug 1, 2018, $T_1 = 49$ days

Price of $\left( L^{S_1}_{S_2} - V^2 \right)/V^2$, calib as of Aug 1, 2018, $T_1 = 49$ days
December 24, 2018, $T_1 = 23$ days: large VIX, $F_V \approx 26\%$
December 24, 2018, $T_1 = 23$ days

Model price of $S_2 - S_1$, calibration as of Dec 24, 2018, $T_1 = 23$ days

Model price of $L\left(\frac{S_2}{S_1}\right) - V^2$, calibration as of December 24, 2018, $T_1 = 23$ days
Continuous time:
Exact joint calibration via dispersion-constrained martingale Schrödinger bridges

(G. 2020)
Martingale optimal transport approach in continuous time

- Same point of view as the discrete-time model: Pick a reference measure $P_0 \leftrightarrow$ a particular SV model:
  \[
  \frac{dS_t}{S_t} = a_t \, dW^0_t \\
  da_t = b(a_t) \, dt + \sigma(a_t) \left( \rho \, dW^0_t + \sqrt{1 - \rho^2} \, dW^0_t, \perp \right)
  \]

- We want to prove that $\mathcal{P} \neq \emptyset$ and build $P \in \mathcal{P}$, where
  \[
  \mathcal{P} := \{ P \mid S_1 \sim \mu_1, S_2 \sim \mu_2, \sqrt{\mathbb{E}^P[L(S_2/S_1)|\mathcal{F}_1]} \sim \mu_V, S \text{ is a } P\text{-martingale} \}.
  \]

- No need to introduce a new r.v. for the VIX: $\text{VIX} = \sqrt{\mathbb{E}^P[L(S_2/S_1)|\mathcal{F}_1]}$.

- We look for $P \in \mathcal{P}$ that minimizes the relative entropy w.r.t. $P_0$:
  \[
  D := \inf_{P \in \mathcal{P}} H(P, P_0)
  \]

- Inspired by Henry-Labordère 2019: From (Martingale) Schrödinger Bridges to a New Class of Stochastic Volatility Models (calib to SPX smiles)

- Follows closely the construction of Schrödinger bridges
Simple Schrödinger bridge (à la Follmer, Saint-Flour 1988)

\[ dX_t = dW_t^0, \quad X_0 = x_0 \]

\[ \mathcal{P} := \{ \mathbb{P} \ll \mathbb{P}_0 | X_1 \sim \mu_1 \} \]

\[ D := \inf_{\mathbb{P} \in \mathcal{P}} H(\mathbb{P}, \mathbb{P}_0) \]

\[ = \inf_{\mathbb{P} \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1)} \left\{ H(\mathbb{P}, \mathbb{P}_0) + E^{\mu_1} [u_1(X_1)] - E^\mathbb{P} [u_1(X_1)] \right\} \]

\[ = \sup_{u_1 \in L^1(\mu_1)} \inf_{\mathbb{P} \in \mathcal{M}_1} \left\{ H(\mathbb{P}, \mathbb{P}_0) + E^{\mu_1} [u_1(X_1)] - E^\mathbb{P} [u_1(X_1)] \right\} \]

Recall the remarkable fact about the inner infimum:

\[ \inf_{\mathbb{P} \in \mathcal{M}_1} \left\{ H(\mathbb{P}, \mathbb{P}_0) - E^\mathbb{P} [u_1(X_1)] \right\} = - \ln E^{\mathbb{P}_0} \left[ e^{u_1(X_1)} \right] \]

and the infimum is reached at \( \mathbb{P}^* \) defined by

\[ \frac{d\mathbb{P}^*}{d\mathbb{P}_0} = \frac{e^{u_1(X_1)}}{E^{\mathbb{P}_0} \left[ e^{u_1(X_1)} \right]} \]
Simple Schrödinger bridge (à la Follmer, Saint-Flour 1988)

\[ dX_t = dW_t^0, \quad X_0 = x_0 \]

\[ \mathcal{P} := \{ \mathbb{P} \ll \mathbb{P}_0 \mid X_1 \sim \mu_1 \} \]

\[
D := \inf_{\mathbb{P} \in \mathcal{P}} H(\mathbb{P}, \mathbb{P}_0) \\
= \inf_{\mathbb{P} \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1)} \left\{ H(\mathbb{P}, \mathbb{P}_0) + \mathbb{E}^{\mu_1} [u_1(X_1)] - \mathbb{E}^\mathbb{P} [u_1(X_1)] \right\} \\
= \sup_{u_1 \in L^1(\mu_1)} \inf_{\mathbb{P} \in \mathcal{M}_1} \left\{ H(\mathbb{P}, \mathbb{P}_0) + \mathbb{E}^{\mu_1} [u_1(X_1)] - \mathbb{E}^\mathbb{P} [u_1(X_1)] \right\}
\]

Recall the remarkable fact about the inner infimum:

\[
\inf_{\mathbb{P} \in \mathcal{M}_1} \left\{ H(\mathbb{P}, \mathbb{P}_0) - \mathbb{E}^\mathbb{P} [u_1(X_1)] \right\} = -\ln \mathbb{E}^{\mathbb{P}_0} \left[ e^{u_1(X_1)} \right]
\]

and the infimum is reached at \( \mathbb{P}^* \) defined by

\[
\frac{d\mathbb{P}^*}{d\mathbb{P}_0} = \frac{e^{u_1(X_1)}}{\mathbb{E}^{\mathbb{P}_0} \left[ e^{u_1(X_1)} \right]}.
\]
Simple Schrödinger bridge (à la Follmer, Saint-Flour 1988)

\[ D := \inf_{\mathbb{P} \in \mathcal{P}} H(\mathbb{P}, \mathbb{P}_0) = \sup_{u_1 \in L^1(\mu_1)} \left\{ \mathbb{E}^{\mu_1} [u_1(X_1)] - \ln \mathbb{E}^{\mathbb{P}_0} \left[ e^{u_1(X_1)} \right] \right\} =: P \]

- Assume \( P < +\infty \) and the sup is reached at \( u_1^* \). Then
  \[ M_{T_1} := \frac{d\mathbb{P}^*}{d\mathbb{P}_0} = e^{u_1^*(X_1)} \quad (Z = 1 \text{ by cash adjustment of } u_1^*) \]

- Let \( M_t := \mathbb{E}^{\mathbb{P}_0} [M_{T_1} | \mathcal{F}_t] = \mathbb{E}^{\mathbb{P}_0} [e^{u_1^*(X_1)} | \mathcal{F}_t] \). Then \( M_t = U^*(t, X_t) \) where
  \[ \partial_t U^* + \frac{1}{2} \partial_x^2 U^* = 0, \quad U^*(T_1, x) = e^{u_1^*(x)}. \]

- By Girsanov, \( W_t^* := W_t^0 - \int_0^t \partial_x \ln U^*(s, X_s) \, ds \) is a \( \mathbb{P}^* \)-Brownian motion,
  \[ dX_t = \partial_x \ln U^*(t, X_t) \, dt + dW_t^* = \partial_x \ln \mathbb{E}^{\mathbb{P}_0} [e^{u_1^*(X_1)} | X_t = x] \, dt + dW_t^* \]

- Brownian motion with drift, which is explicitly known.

- In practice, \( u_1(X_1) \) is replaced by \( \sum_{K \in \mathcal{K}} \alpha_K (X_1 - K)^+ \). The gradient of
  \[ \mathbb{E}^{\mu_1} \left[ \sum_{K \in \mathcal{K}} \alpha_K (X_1 - K)^+ \right] - \ln \mathbb{E}^{\mathbb{P}_0} \left[ e^{\sum_{K \in \mathcal{K}} \alpha_K (X_1 - K)^+} \right] \]
  is simply the vector of differences between model and market call prices.
VIX-constrained martingale Schrödinger bridge

\[
\frac{dS_t}{S_t} = a_t \, dW_t^*
\]
\[
da_t = (b(a_t) + (1 - \rho^2)\sigma(a_t)^2 \partial_a u^*(t, S_t, a_t)) \, dt + \sigma(a_t) \left( \rho \, dW_t^* + \sqrt{1 - \rho^2} \, dW_t^* \perp \right)
\]

Let \( P := \sup_{u_1, u_V, u_2} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - u(0, S_0, a_0) \right\} \) where \( u \) is solution to a nonlinear Hamilton-Jacobi-Bellman PDE:

\[
\begin{align*}
\partial_t u + \mathcal{L}^0 u + \frac{1}{2} (1 - \rho^2)\sigma(a)^2 (\partial_a u)^2 &= 0, \quad t \in (T_1, T_2), \\
\Phi(s, a) := \sup_{v \geq 0} \inf_{\delta^L \in \mathbb{R}} \left\{ u_V(v) - \delta^L (L(s) + v^2) + u(T_1, s, a; \delta^L) \right\}, \\
u(T_1, s, a) &= u_1(s) + \Phi(s, a), \\
\partial_t u + \mathcal{L}^0 u + \frac{1}{2} (1 - \rho^2)\sigma(a)^2 (\partial_a u)^2 &= 0, \quad t \in [0, T_1).
\end{align*}
\]

Assume \( P < +\infty \) and \((u_1^*, u_V^*, u_2^*)\) maximizes \( P \rightarrow u^* \)
VIX-constrained martingale Schrödinger bridge

\[
\frac{dS_t}{S_t} = a_t \, dW_t^*
\]

\[
dat = \left( b(a_t) + (1 - \rho^2) \sigma(a_t)^2 \partial_a u^*(t, S_t, a_t) \right) dt + \sigma(a_t) \left( \rho \, dW_t^* + \sqrt{1 - \rho^2} dW_t^* \right)
\]

- Optimal deltas:

\[
\Delta_t^* = -\partial_s u^*(t, S_t, a_t) - \rho \frac{\sigma(a_t)}{a_t S_t} \partial_a u^*(t, S_t, a_t); \quad \Delta^*,L = \delta^*,L(S_1, a_1)
\]

- The drift of \((a_t)\) under \(\mathbb{P}^*\) also reads as

\[
b(a_t) + (1 - \rho^2) \sigma(a_t)^2 \partial_a \ln \mathbb{E}^0 \left[ e^{u_1^*(S_1)} + \int_t^{T_1} \Delta^*(r, S_r, a_r) dS_r + \Phi^*(S_1, a_1) | S_t, a_t \right], \quad t \in [0, T_1],
\]

\[
b(a_t) + (1 - \rho^2) \sigma(a_t)^2 \partial_a \ln \mathbb{E}^0 \left[ e^{u_2^*(S_2)} + \int_t^{T_2} \Delta^*(r, S_r, a_r) dS_r + \Phi^*(S_1, a_1) | S_t, a_t \right], \quad t \in [T_1, T_2]
\]

- It is path-dependent on \([T_1, T_2]\) so as to match the market VIX smile.

- If \(P = +\infty\), then

\[
\mathcal{P} \cap \left\{ \mathbb{P} \ll \mathbb{P}_0 \bigg| \mathbb{E}^\mathbb{P} \left[ \ln \frac{d\mathbb{P}}{d\mathbb{P}_0} \right] < +\infty \right\} = \emptyset.
\]
\[ da_t = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \]

‘Market’: \( \nu = 0.4 \), \( \mathbb{P}_0 : \nu = 0.5 \)

\[ k = 1.5, \quad a_0 = m = 0.2, \quad \rho = 0 \]
\[ da_t = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \] ‘Market’: \( \nu = 0.4, \, \mathbb{P}_0 : \nu = 0.5 \)
\[ da_t = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \] ‘Market’: \( \nu = 0.4 \), \( \mathbb{P}_0 : \nu = 0.5 \).
\[ da_t = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \] ‘Market’: \( \nu = 1.2, \ P_0 : \nu = 1 \)

\[ k = 1.5, \quad a_0 = m = 0.2, \quad \rho = -0.7 \]
\[ \text{Optimal } \delta^t(s, a), T_1 = 0.17 \]

\[ \text{VIX } \nu(s, a) \text{ in calibrated model, } T_1 = 0.17 \]

\[ da_t = -k(a_t - m)\, dt + \nu a_t\, dZ_t. \] ‘Market’: \( \nu = 1.2, \mathbb{P}_0: \nu = 1 \)
\[ da_t = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \] ‘Market’: \( \nu = 1.2, \mathbb{P}_0 : \nu = 1 \)
\[ \text{Dispersion-constrained MOT/Schrödinger problems} \]

\[ \text{Dispersion-constrained martingale Schrödinger bridges} \]

\[ \text{Inversion of convex ordering} \]

\[ \frac{d a_t}{t} = -k(a_t - m) \, dt + \nu a_t \, dZ_t. \]

‘Market’: \( \nu = 0.9, \rho = -0.5, \mathbb{P}_0 : \nu = 1, \rho = -0.3 \)
Other approaches

- **Guo-Loeper-Obłój-Wang (2020):** joint calibration via semimartingale optimal transport
  - More general cost function: volatilities and correlations are allowed to be modified from reference model
  - Model \((S_t, Y_{tT})\) instead of \((S_t, a_t)\) where \(Y_{tT}\) is the price at \(t\) of the forward integrated variance over \([t, T]\)
  - Terminal constraint on the semimartingale \(Y\): \(Y_{tT} = 0\). Dimension issue: one process \(Y\) per VIX future expiry.

- **Cont-Kokholm (2013):** Bergomi-like model with simultaneous jumps on SPX and VIX.
  - Best fit
  - An approximation of the VIX in the model is used

- **Gatheral-Jusselin-Rosenbaum (2020):** quadratic rough Heston volatility model.
  - Best fit
  - VIX smile well calibrated, not enough ATM SPX skew

- **Fouque-Saporito (2018):** Heston Stochastic Vol-of-Vol Model

- **Pacati-Pompa-Renò (2018):** displacement of multi-factor affine models with jumps (Heston++)

- **Papanicolaou-Sircar (2014), Goutte-Amine-Pham (2017):** regime-switching Heston model (with or without jumps)
Inversion of convex ordering in the VIX market
Inversion of convex ordering in the VIX market

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We investigate conditions for the existence of a continuous model on the S&P 500 index (SPX) that jointly calibrates to a full surface of SPX implied volatilities and to the VIX smiles. We present a novel approach based on the SPX smile calibration condition \( \mathbb{E}[\sigma_t^2 | S_t] = \sigma_{lv}^2(t, S_t) \). In the limiting case of instantaneous VIX, a novel application of martingale transport to finance shows that such model exists if and only if, for each time \( t \), the local variance \( \sigma_{loc}^2(t, S_t) \) is smaller than the instantaneous variance \( \sigma_t^2 \) in convex order. The real case of a 30-day VIX is more involved, as averaging over 30 days and projecting onto a filtration can undo convex ordering.

We show that in usual market conditions, and for reasonable smile extrapolations, the distribution of \( VIX_T^2 \) in the market local volatility model is larger than the market-implied distribution of \( VIX_T^2 \) in convex order for short maturities \( T \), and that the two distributions are not rankable in convex order for intermediate maturities. In particular, a necessary condition for continuous models to jointly calibrate to the SPX and VIX markets is the inversion of convex ordering property: the fact that, even though associated local variances are smaller than instantaneous variances in convex order, the VIX
Continuous model on SPX calibrated to SPX options

\[
\frac{dS_t}{S_t} = \sigma_t \, dW_t, \quad S_0 = x. \tag{4.1}
\]

- Corresponding local volatility function \( \sigma_{\text{loc}} \): \( \sigma_{\text{loc}}^2(t, S_t) := \mathbb{E}[\sigma_t^2 | S_t] \).
- Corresponding local volatility model:
  \[
  \frac{dS_{\text{loc}}^t}{S_{\text{loc}}^t} = \sigma_{\text{loc}}(t, S_{\text{loc}}^t) \, dW_t, \quad S_{\text{loc}}^0 = x.
  \]
- From Gyöngy (1986): \( \forall t \geq 0, \quad S_{\text{loc}}^t \overset{(d)}{=} S_t \).
- Using Dupire (1994), we conclude that Model (4.1) is calibrated to the full SPX smile if and only if \( \sigma_{\text{loc}} = \sigma_{\text{lv}} \) (market local volatility computed using Dupire’s formula).
- Market local volatility model:
  \[
  \frac{dS_{\text{lv}}^t}{S_{\text{lv}}^t} = \sigma_{\text{lv}}(t, S_{\text{lv}}^t) \, dW_t, \quad S_{\text{lv}}^0 = x.
  \]
By definition, the (idealized) VIX at time $T \geq 0$ is the implied volatility of a 30 day log-contract on the SPX index starting at $T$. For continuous models (4.1), this translates into

$$VIX^2_T = \mathbb{E} \left[ \frac{1}{\tau} \int_T^{T+\tau} \sigma^2_t \, dt \middle| \mathcal{F}_T \right] = \frac{1}{\tau} \int_T^{T+\tau} \mathbb{E} \left[ \sigma^2_t \middle| \mathcal{F}_T \right] \, dt.$$

Since $\mathbb{E}[\sigma^2_{loc}(t, S_{loc}^t) \middle| \mathcal{F}_T] = \mathbb{E}[\sigma^2_{loc}(t, S_{loc}^t) \middle| S_{loc}^T]$, $VIX_{loc,T}$ satisfies

$$VIX^2_{loc,T} = \frac{1}{\tau} \int_T^{T+\tau} \mathbb{E}[\sigma^2_{loc}(t, S_{loc}^t) \middle| S_{loc}^T] \, dt = \mathbb{E} \left[ \frac{1}{\tau} \int_T^{T+\tau} \sigma^2_{loc}(t, S_{loc}^t) \, dt \middle| S_{loc}^T \right].$$

Similarly,

$$VIX^2_{lv,T} = \frac{1}{\tau} \int_T^{T+\tau} \mathbb{E}[\sigma^2_{lv}(t, S_{lv}^t) \middle| S_{lv}^T] \, dt = \mathbb{E} \left[ \frac{1}{\tau} \int_T^{T+\tau} \sigma^2_{lv}(t, S_{lv}^t) \, dt \middle| S_{lv}^T \right].$$
Reminder on convex order

- (The distributions of) two random variables $X$ and $Y$ are said to be in convex order if and only if, for any convex function $f$, $\mathbb{E}[f(X)] \leq \mathbb{E}[f(Y)]$.
- Denoted by $X \leq_c Y$.
- Both distributions have same mean, but distribution of $Y$ is more “spread” than that of $X$.
- **In financial terms:** $X$ and $Y$ have the same forward value, but calls (puts) on $Y$ are more expensive than calls (puts) on $X$ (dimension 1).
The case of instantaneous VIX: $\tau \to 0$

- Assume SV model is calibrated to the SPX smile: $\mathbb{E}[\sigma_t^2 | S_t] = \sigma_{1v}^2(t, S_t)$.
- As observed by Dupire (2005), by conditional Jensen, $\sigma_{1v}^2(t, S_t) \leq c \sigma_t^2$, i.e.,

  \[
  \text{mkt local var}_t \leq_c \text{instVIX}_t^2.
  \]

- Conversely, if $\text{mkt local var}_t \leq_c \text{instVIX}_t^2$, there exists a jointly calibrating SPX/instVIX model (G., 2017).

  \[\implies \textbf{Convex order condition is necessary and sufficient for instVIX}.
  \]

- Proof uses a \textbf{new type of application of martingale transport to finance}: martingality constraint applies to $(\text{mkt local var}_t, \text{instVIX}_t^2)$ at a single date, instead of $(S_1, S_2)$.
The real VIX: $\tau = 30$ days

- In reality, squared VIX are not instantaneous variances but the **fair strikes** of **30-day** realized variances.

- Let us look at market data (August 1, 2018). We compare the market distributions of

\[
\text{VIX}_{lv,T}^{2} := \mathbb{E}\left[ \frac{1}{\tau} \int_{T}^{T+\tau} \sigma^2_{lv}(t, S^l_{tv}) \, dt \middle| S_T^{lv} \right]
\]

and

\[
\text{VIX}_{mkt,T}^{2} \quad \left( \longleftrightarrow \mathbb{E}\left[ \frac{1}{\tau} \int_{T}^{T+\tau} \sigma^2_{t} \, dt \middle| \mathcal{F}_T \right] \right)
\]
$T = 21$ days

Distribution of $\text{VIX}_T^2$ as of Aug 01, 2018, $T=21$ days

- $\mathbb{E}[\text{VIX}_T^2] = 226.6$
- Red: VIX option market
- Blue: SPX LV model
$T = 21$ days

### VIX$^2$ convex order as of Aug 01, 2018, $T=21$ days

- $\mathbb{E}[\text{VIX}_T^2] = 226.6$
- Red line: VIX option market
- Blue line: SPX LV model
$T = 21$ days

Implied volatilities of $\text{VIX}_T$ as of Aug 01, 2018, $T=21$ days

- VIX option market
- SPX LV model
- VIX future market 14.15%
- VIX future SPX LV model 12.67%
Density of $VIX^2_{T}$ in SPX LV model as of Aug 01, 2018, T=21 days

VIX$^2_{lv,T}(S^l_{T})$
\( T = 77 \text{ days} \)

Distribution of \( \text{VIX}_T^2 \) as of Aug 01, 2018, \( T=77 \text{ days} \)

- \( \mathbb{E} [\text{VIX}_T^2] = 332.1 \)
- Red: VIX option market
- Blue: SPX LV model
$T = 77$ days

VIX$^2$ convex order as of Aug 01, 2018, $T=77$ days

- **Expected Call on VIX$^2_T$**
- Red: VIX option market
- Blue: SPX LV model

$$\mathbb{E}[\text{VIX}_T^2] = 332.1$$
$T = 77$ days

Implied volatilities of VIX$_T$ as of Aug 01, 2018, $T=77$ days

- **VIX option market**
- **SPX LV model**
- **VIX future market 15.75%**
- **VIX future SPX LV model 15.18%**
Inversion of convex ordering

- **Inversion of convex ordering**: the fact that, for small $T$, $VIX_{loc,T}^2 \geq_c VIX_T^2$ despite the fact that for all $t$, $\sigma_{loc}^2(t, S_t) \leq_c \sigma_t^2$.

- A **necessary** condition for continuous models to jointly calibrate to the SPX and VIX markets.

- In the paper, we numerically show that when the spot-vol correlation is large enough in absolute value,
  
  (a) traditional SV models with **large mean reversion**, and
  
  (b) rough volatility models with **small Hurst exponent**

satisfy the inversion of convex ordering property, and more generally can reproduce the market term-structure of convex ordering of the local and stochastic squared VIX.

- Not a sufficient condition though.

- Actually we have proved that **inversion of convex ordering can be produced by a continuous SV model**.

- In such models, for small $T$, $VIX_{loc,T}^2 \geq_c VIX_T^2$ so $(x \mapsto \sqrt{x}$ concave)

\[
\mathbb{E}[VIX_T] > \mathbb{E}[VIX_{loc,T}]:
\]

Local volatility does **NOT** maximize the price of VIX futures.
Short Communication: Inversion of Convex Ordering: Local Volatility Does Not Maximize the Price of VIX Futures

Beatrice Acciaio† and Julien Guyon‡

Abstract. It has often been stated that, within the class of continuous stochastic volatility models calibrated to vanillas, the price of a VIX future is maximized by the Dupire local volatility model. In this article we prove that this statement is incorrect: we build a continuous stochastic volatility model in which a VIX future is strictly more expensive than in its associated local volatility model. More generally, in our model, strictly convex payoffs on a squared VIX are strictly cheaper than in the associated local volatility model. This corresponds to an inversion of convex ordering between local and stochastic variances, when moving from instantaneous variances to squared VIX, as convex payoffs on instantaneous variances are always cheaper in the local volatility model. We thus prove that this inversion of convex ordering, which is observed in the S&P 500 market for short VIX maturities, can be produced by a continuous stochastic volatility model. We also prove that the model can be extended so that, as suggested by market data, the convex ordering is preserved for long maturities.

Key words. VIX, VIX futures, stochastic volatility, local volatility, convex order, inversion of convex ordering

AMS subject classifications. 91G20, 91G80, 60H30

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1. Introduction. For simplicity, let us assume zero interest rates, repos, and dividends. Let $\mathcal{F}_t$ denote the market information available up to time $t$. We consider continuous stochastic volatility models on the S&P 500 index (SPX) of the form
Thanks!
A few selected references


A few selected references


A few selected references


A few selected references


The joint S&P 500/Vix smile calibration puzzle solved

Since Vix options started trading in 2006, many researchers have tried to build a model that jointly and exactly calibrates to the prices of Standard & Poor’s 500 options, Vix futures and Vix options. In this article, Julien Guyon solves this long-standing puzzle by casting it as a discrete-time dispersion-constrained martingale transport problem, which he solves in a non-parametric way using Sinkhorn’s algorithm.

Volatility indexes, such as the Vix index, do not just serve as market-implied indicators of volatility. Futures and options on these indexes are also widely used as risk management tools to hedge the volatility exposure of options portfolios. The existence of a liquid market for these futures and options has led to the need for models that jointly calibrate to the prices of options on the underlying asset and the prices of volatility derivatives. Without such models, financial institutions could possibly arbitrage each other: even market-making desks within the same institution could do so, e.g., the Vix desk could arbitrage the S&P 500 (SPX) desk. By using models that fail to correctly incorporate the prices of the hedging instruments, such as SPX options, Vix futures and Vix options, exotic desks may misprice options, especially (but not only) those with payoffs that involve both the underlying and its volatility index.

For this reason, since Vix options began trading in 2006, many researchers and practitioners have tried to build a model that jointly and exactly calibrates to the prices of SPX futures, SPX options, Vix futures and Vix options. This is known to be a very challenging problem, especially for short maturities. In particular, the very large negative skew of short-term SPX options, and Vix smiles: that the distribution of the Dupire market local variance be smaller than the distribution of the (instantaneous) Vix squared in the convex order, at all times. He also reported that for short maturities the distribution of the true Vix squared in the market local volatility model is actually larger than the market-implied distribution of the true Vix squared in the convex order. Guyon showed numerically that when the (typically negative) spot-vol correlation is large enough in absolute value, both (a) traditional stochastic volatility models with large mean reversion and (b) rough volatility models with a small Hurst exponent can reproduce this inversion of convex ordering. Acciaio & Guyon (2020) provide a mathematical proof that the inversion of convex ordering can be produced by continuous models. However, the inversion of convex ordering is only a necessary condition for the joint SPX/Vix calibration of continuous models; it is not sufficient.

Since it looks to be very difficult to jointly calibrate the SPX and Vix smiles with continuous models, many authors have incorporated jumps in the dynamics of the SPX: see references in Guyon (2019a). Jumps offer extra degrees of freedom to partly decouple the ATM SPX skew and the ATM/Vix implied volatility. However, the attempts so far have only produced...
Equations for $u^* = (u_1^*, u_V^*, u_2^*, \Delta_S^*, \Delta_L^*)$

\[
\frac{\partial J_{\ln}}{\partial u_1(s_1)} = 0: \quad \forall s_1 > 0, \quad u_1(s_1) = \Phi_1(s_1; u_V, u_2, \Delta_S, \Delta_L)
\]

\[
\frac{\partial J_{\ln}}{\partial u_V(v)} = 0: \quad \forall v \geq 0, \quad u_V(v) = \Phi_V(v; u_1, u_2, \Delta_S, \Delta_L)
\]

\[
\frac{\partial J_{\ln}}{\partial u_2(s_2)} = 0: \quad \forall s_2 > 0, \quad u_2(s_2) = \Phi_2(s_2; u_1, u_V, \Delta_S, \Delta_L)
\]

\[
\frac{\partial J_{\ln}}{\partial \Delta_S(s_1,v)} = 0: \quad \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_S}(s_1, v; \Delta_S(s_1, v), \Delta_L(s_1, v))
\]

\[
\frac{\partial J_{\ln}}{\partial \Delta_L(s_1,v)} = 0: \quad \forall s_1 > 0, \forall v \geq 0, \quad 0 = \Phi_{\Delta_L}(s_1, v; \Delta_S(s_1, v), \Delta_L(s_1, v))
\]

\[
\Phi_1(s_1; u_V, \Delta_S, \Delta_L) := \ln \mu_1(s_1) - \ln \left( \int \bar{\mu}(s_1, dv, ds_2) e^{u_V(v) + u_2(s_2) + \Delta_S(s_1, v, s_2) + \Delta_L(s_1, v, s_2)} \right)
\]

\[
\Phi_V(v; u_1, \Delta_S, \Delta_L) := \ln \mu_V(v) - \ln \left( \int \bar{\mu}(ds_1, v, ds_2) e^{u_1(s_1) + u_2(s_2) + \Delta_S(s_1, v, s_2) + \Delta_L(s_1, v, s_2)} \right)
\]

\[
\Phi_2(s_2; u_1, u_V, \Delta_S, \Delta_L) := \ln \mu_2(s_2) - \ln \left( \int \bar{\mu}(ds_1, v, ds_2) e^{u_1(s_1) + u_V(v) + \Delta_S(s_1, v, s_2) + \Delta_L(s_1, v, s_2)} \right)
\]

\[
\Phi_{\Delta_S}(s_1, v; u_2, \delta_S, \delta_L) := \int \bar{\mu}(s_1, v, ds_2) (s_2 - s_1) e^{u_2(s_2) + \delta_S(s_2 - s_1) + \delta_L \left( L \left( \frac{s_2}{s_1} \right) \right) - v^2}
\]

\[
\Phi_{\Delta_L}(s_1, v; u_2, \delta_S, \delta_L) := \int \bar{\mu}(s_1, v, ds_2) \left( L \left( \frac{s_2}{s_1} \right) - v^2 \right) e^{u_2(s_2) + \delta_S(s_2 - s_1) + \delta_L \left( L \left( \frac{s_2}{s_1} \right) \right) - v^2}
\]
Implementation details

Practically, we consider market strikes $\mathcal{K} := (\mathcal{K}_1, \mathcal{K}_V, \mathcal{K}_2)$ and market prices $(C^1_K, C^V_K, C^2_K)$ of vanilla options on $S_1$, $V$, and $S_2$, and we build the model

$$
\mu^*_K(ds_1, dv, ds_2) = \bar{\mu}(ds_1, dv, ds_2)e^{c^* + \Delta^0_S s_1 + \Delta^0_V v + \sum_{K \in \mathcal{K}_1} a^1_K(s_1 - K) + \sum_{K \in \mathcal{K}_V} a^V_K(v - K) + \sum_{K \in \mathcal{K}_2} a^2_K(s_2 - K) + \Delta^*(S)(s_1, v, s_2) + \Delta^*(L)(s_1, v, s_2)}
$$

where $\theta^* := (c^*, \Delta^0_S, \Delta^0_V, a^1, a^V, a^2, \Delta^S, \Delta^L)$ maximizes

$$
J^{-1}_{\bar{\mu}, \mathcal{K}}(\theta) := c + \Delta^0_S S_0 + \Delta^0_V F_V + \sum_{K \in \mathcal{K}_1} a^1_K C^1_K + \sum_{K \in \mathcal{K}_V} a^V_K C^V_K + \sum_{K \in \mathcal{K}_2} a^2_K C^2_K - \mathbb{E}^{\bar{\mu}}\left[e^{c + \Delta^0_S S_1 + \Delta^0_V V + \sum_{K \in \mathcal{K}_1} a^1_K(S_1 - K) + \sum_{K \in \mathcal{K}_V} a^V_K(V - K) + \sum_{K \in \mathcal{K}_2} a^2_K(S_2 - K) + \Delta^*(S)(\ldots) + \Delta^*(L)(\ldots)}\right]
$$

over the set $\Theta$ of portfolios $\theta := (c, \Delta^0_S, \Delta^0_V, a^1, a^V, a^2, \Delta^S, \Delta^L)$ such that $c, \Delta^0_S, \Delta^0_V \in \mathbb{R}$, $a^1 \in \mathbb{R}^{\mathcal{K}_1}$, $a^V \in \mathbb{R}^{\mathcal{K}_V}$, $a^2 \in \mathbb{R}^{\mathcal{K}_2}$, and $\Delta_S, \Delta_L : \mathbb{R}_0^+ \times \mathbb{R}_0^+ \rightarrow \mathbb{R}$ are measurable functions of $(s_1, v)$. 

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Implementation details

- This corresponds to solving the entropy minimization problem

\[ P_{\bar{\mu}, \mathcal{K}} := \inf_{\mu \in \mathcal{P}(\mathcal{K})} H(\mu | \bar{\mu}) = \sup_{\theta \in \Theta} J_{\bar{\mu}, \mathcal{K}}^{id-1}(\theta) =: D_{\bar{\mu}, \mathcal{K}} \]

where \( \mathcal{P}(\mathcal{K}) \) denotes the set of probability measures \( \mu \) on \( \mathbb{R}_{>0} \times \mathbb{R}_{\geq 0} \times \mathbb{R}_{>0} \) such that

\[
\mathbb{E}^\mu [S_1] = S_0, \quad \mathbb{E}^\mu [V] = F_V, \quad \forall K \in \mathcal{K}_1, \quad \mathbb{E}^\mu [(S_1 - K)_+] = C^1_K, \\
\forall K \in \mathcal{K}_V, \quad \mathbb{E}^\mu [(V - K)_+] = C^K_V, \quad \forall K \in \mathcal{K}_2, \quad \mathbb{E}^\mu [(S_2 - K)_+] = C^2_K, \\
\mathbb{E}^\mu [S_2 | S_1, V] = S_1, \quad \mathbb{E}^\mu \left[ L \left( \frac{S_2}{S_1} \right) \bigg| S_1, V \right] = V^2.
\]

- One can directly check that model \( \mu^*_\mathcal{K} \) is an arbitrage-free model that jointly calibrates the prices of SPX futures, options, VIX future, and VIX options. Indeed, if \( J_{\bar{\mu}, \mathcal{K}}^{id-1} \) reaches its maximum at \( \theta^* \), then \( \theta^* \) is solution to

\[
\frac{\partial J_{\bar{\mu}, \mathcal{K}}^{id-1}}{\partial \theta_i}(\theta) = 0:
\]
Implementation details

\[ J_{\bar{\mu},K}^{\text{id}^{-1}}(\theta) := c + \Delta_{S}^{0}S_{0} + \Delta_{V}^{0}F_{V} + \sum_{K \in K_{1}} a_{K}^{1}C_{K}^{1} + \sum_{K \in K_{\mathcal{V}}} a_{K}^{V}C_{K}^{V} + \sum_{K \in K_{2}} a_{K}^{2}C_{K}^{2} \]

\[-\mathbb{E}[e^{c + \Delta_{S}^{0}S_{1} + \Delta_{V}^{0}V + \sum_{K \in K_{1}} a_{K}^{1}(S_{1} - K) + \sum_{K \in K_{\mathcal{V}}} a_{K}^{V}(V - K) + \sum_{K \in K_{2}} a_{K}^{2}(S_{2} - K) + \Delta_{S}^{(S)}(\ldots) + \Delta_{L}^{(L)}(\ldots)}] \]

\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial c} = 0 : \mathbb{E}[d\mu_{K}^{*} / d\bar{\mu}] = 1 \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial \Delta_{0}^{S}} = 0 : \mathbb{E}[S_{1} d\mu_{K}^{*} / d\bar{\mu}] = S_{0} \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial \Delta_{0}^{V}} = 0 : \mathbb{E}[V d\mu_{K}^{*} / d\bar{\mu}] = F_{V} \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial a_{K}^{1}} = 0 : \mathbb{E}[(S_{1} - K) + d\mu_{K}^{*} / d\bar{\mu}] = C_{K}^{1} \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial a_{K}^{V}} = 0 : \mathbb{E}[(V - K) + d\mu_{K}^{*} / d\bar{\mu}] = C_{K}^{V} \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial \Delta_{S}(s_{1}, v)} = 0 : \mathbb{E}[d\mu_{K}^{*} / d\bar{\mu} \bigg| S_{1} = s_{1}, V = v] = 0, \quad \forall s_{1} \geq 0, v > 0 \]
\[ \frac{\partial J_{\bar{\mu},K}^{\text{id}^{-1}}}{\partial \Delta_{L}(s_{1}, v)} = 0 : \mathbb{E}[d\mu_{K}^{*} / d\bar{\mu} \bigg| S_{1} = s_{1}, V = v] = 0, \quad \forall s_{1} \geq 0, v > 0 \]
Martingale optimal transport approach in continuous time

\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]

\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u \in L^1(\mu V), (\Delta_t)\mathcal{F}\text{-adapted}} \left\{ H(P, P_0) + \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\} \]

\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u \in L^1(\mu_1, \mu_2, \mu V), (\Delta_t)\mathcal{F}\text{-adapted}} \left\{ H(P, P_0) + \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\} \]

\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u \left( \sqrt{\mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \big| \mathcal{F}_1 \right]} \right) + \int_0^T \Delta_t dS_t \right] \}

\[ = \sup_{u_1, u_2, u \in L^1(\mu_1, \mu_2, \mu V), (\Delta_t)\mathcal{F}\text{-adapted}} \left\{ \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\} \]

\[ - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u V(V)} + \int_0^T \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \]

\[ = \sup_{u_1, u_2, u \in L^1(\mu_1, \mu_2, \mu V), (\Delta_t)\mathcal{F}\text{-adapted}} \left\{ \cdots \right\} \]
Lagrange multipliers $u_1, u_2, u_V$

\begin{align*}
D &:= \inf_{P \in \mathcal{P}} H(P, P_0) \\
&= \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u_V \in L^1(\mu_V)} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \\
&\quad - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V \left( \sqrt{\mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \big| \mathcal{F}_1 \right]} \right) + \int_0^T \Delta_t dS_t \right] \\
(\text{relax}) &\quad = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V, (\Delta_t)} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \\
&\quad - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^T \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \\
(\text{dual}) &\quad = \sup_{u_1, u_2, u_V, (\Delta_t)} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \\
&\quad - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^T \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)} \right] \\
&\quad = \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0, T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \sup_{(\Delta_t)_{t \in [T_1, T_2]}} \{ \cdots \}
\end{align*}
Lagrange multipliers $\Delta_t$: martingality of $S$

\[
D := \inf_{P \in \mathcal{P}} H(P, P_0)
\]

\[
= \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u_V \in L^1(\mu V), (\Delta_t) \mathcal{F} \text{-adapted}} \left\{ H(P, P_0) + \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\}
\]

\[
- \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V \left( \sqrt{\mathbb{E}^P \left[ \frac{S_2}{S_1} \right] | \mathcal{F}_1} \right) + \int_0^T \Delta_t dS_t \right]
\]

(relax)

\[
= \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V, (\Delta_t) \mathcal{V} \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ H(P, P_0) + \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\}
\]

\[
- \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^T \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right]
\]

(dual)

\[
= \sup_{u_1, u_2, u_V, (\Delta_t) \mathcal{V} \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \left\{ H(P, P_0) + \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\}
\]

\[
- \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^T \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)} \right]
\]

\[
= \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0,T_1]} \mathcal{V} \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \sup_{(\Delta_t)_{t \in [T_1,T_2]} \mathcal{V} \in \mathcal{F}_1} \left\{ \cdots \right\}
\]
Relaxation

\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]

\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u \in L^1(\mu_V)} \sup_{(\Delta_t) \mathcal{F} \text{-adapted}} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \}
\]

\[ -E^P \left[ u_1(S_1) + u_2(S_2) + u \left( \sqrt{E^P \left[ \frac{L \left( \frac{S_2}{S_1} \right)}{\mathcal{F}_1} \right]} \right) + \int_0^{T_2} \Delta_t dS_t \right] \}

(relex)

\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u \in L^1(\mu_V)} \sup_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \}
\]

\[ -E^P \left[ u_1(S_1) + u_2(S_2) + u \left( V \right) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( \frac{S_2}{S_1} \right) - V^2 \right] \}

(dual)

\[ = \sup_{u_1, u_2, u \in L^1(\mu_V)} \sup_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \inf_{P \in \mathcal{M}_1} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \}
\]

\[ -E^P \left[ u_1(S_1) + u_2(S_2) + u \left( V \right) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( \frac{S_2}{S_1} \right) - V^2 \right] \}

\[ = \sup_{u_1, u_2, u} \sup_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \}
\]

\[ - \ln E^0 \left[ e^{u_1(S_1) + u_2(S_2) + u \left( V \right) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( \frac{S_2}{S_1} \right) - V^2} \right] \}

\[ = \sup_{u_1, u_2, u} \sup_{(\Delta t) \in [0, T_1]} \sup_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \{ \cdots \} \]
Relaxation

\[
\mathbb{E}^P \left[ u_V \left( \sqrt{\mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \mid \mathcal{F}_1 \right]} \right) \right] = \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \mathbb{E}^P \left[ u_V (V) + \Delta^L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right]
\]
Relaxation

\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V \left( \mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \right] \right) \mathcal{F}_1 + \int_0^{T_2} \Delta_t dS_t \right] \]

(relax)
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V, (\Delta_t)} \sup_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \]

(dual)
\[ = \sup_{u_1, u_2, u_V, (\Delta_t)} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \inf_{P \in \mathcal{M}_1} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \]
\[ = \sup_{u_1, u_2, u_V, (\Delta_t)} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) } \right] \]
\[ = \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0, T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \sup_{(\Delta_t)_{t \in [T_1, T_2]}} \left\{ \cdots \right\} \]
\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u \in L^1(\mu_V), (\Delta_t) F \text{-adapted}} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \]
\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V \left( \sqrt{\mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \big| F_1 \right]} \right) + \int_0^{T_2} \Delta_t dS_t \right] \}

(relax)
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V, (\Delta_t) V \in F_1} \sup_{\Delta L \in F_1} \inf_{\Delta t \in [0, T_1]} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \]
\[ - \mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) \right] \}

(dual)
\[ = \sup_{u_1, u_2, u_V, (\Delta_t) V \in F_1} \sup_{\Delta L \in F_1} \inf_{\Delta t \in [T_1, T_2]} \{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \]
\[ - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)} \right] \}
\[ = \sup_{u_1, u_2, u_V} \sup_{(\Delta_t) t \in [0, T_1]} \sup_{V \in F_1} \inf_{\Delta L \in F_1} \sup_{(\Delta_t) t \in [T_1, T_2]} \{ \cdots \} \]
Remarkable fact: inner inf is explicit

\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]

\[ = \inf_{P \in \mathcal{M}_1} \inf_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u_V \in L^1(\mu_V)} \sup_{(\Delta_t) \mathcal{F}} \{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \} \]

\[ -\mathbb{E}^P \left[ u_1(S_1) + u_2(S_2) + u_V \left( \sqrt{\mathbb{E}^P \left[ L \left( \frac{S_2}{S_1} \right) \mid \mathcal{F}_1 \right]} \right) + \int_0^{T_2} \Delta_t dS_t \right] \]
Optimizing first over $[T_1, T_2]$, then $T_1$, then $[T_0, T_1]$, then $T_0$.

\[ D := \inf_{P \in \mathcal{P}} H(P, P_0) \]
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1 \in L^1(\mu_1), u_2 \in L^1(\mu_2), u_V \in L^1(\mu_V), (\Delta_t) F\text{-adapted}} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ = \inf_{P \in \mathcal{M}_1} \sup_{u_1, u_2, u_V, (\Delta_t) V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ = \sup_{u_1, u_2, u_V, (\Delta_t) V \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \inf_{P \in \mathcal{M}_1} \left\{ H(P, P_0) + \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ = \sup_{u_1, u_2, u_V, (\Delta_t) V \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \]
\[ = - \ln \mathbb{E}_0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_{t} dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)} \right] \]
\[ = \sup_{u_1, u_2, u_V, (\Delta_t) t \in [0, T_1]} \sup_{V \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \sup_{(\Delta_t) t \in [T_1, T_2]} \left\{ \cdots \right\} \]
Optimize over \([T_1, T_2]\)

- The inner \(\inf_{P \in \mathcal{M}_1}\) is reached at \(P^*\) defined by (renorm. \(Z = 1\) by cash adjustment of vanilla payoffs)

\[
\frac{dP^*}{dP_0} = e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)}
\]

\[
D = \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0,T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \sup_{(\Delta_t)_{t \in [T_1,T_2]}} \left\{ \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\}
\]

\[
= \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0,T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1,2,V\}} (\mu_i, u_i) \right\}
\]

\[
- \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + u_V(V) + \int_0^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right)} \right]
\]
Optimize over $[T_1, T_2]$: stochastic control

\[
D = \sup_{u_1, u_2, uV} \left( \sup_{(\Delta t)_{t \in [0, T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \right.
\]

\[
- \ln \inf_{(\Delta t)_{t \in [T_1, T_2]}} \mathbb{E}^0 \left[ e^{u_1(S_1) + u_2(S_2) + uV(V) + \int_{T_1}^{T_2} \Delta_t dS_t + \Delta L \left( L \left( \frac{S_2}{S_1} \right) - V^2 \right) } \right]
\]

\[
(U) = \sup_{u_1, u_2, uV} \left( \sup_{(\Delta t)_{t \in [0, T_1]}} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \right.
\]

\[
- \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + uV(V) + \int_{T_1}^{T_2} \Delta_t dS_t - \Delta L (L(S_1) + V^2) } U(T_1, S_1, a_1; \Delta L) \right] \}
\]

\[
\textbf{Stochastic control:}
\]

\[
U(t, S_t, a_t; \Delta L) := \inf_{(\Delta r)_{r \in [t, T_2]}} \mathbb{E}^0 \left[ e^{u_2(S_2) + \int_{T_1}^{T_2} \Delta_r dS_r + \Delta L S_2} \right| S_t, a_t, \Delta L \right], \quad t \in [T_1, T_2].
\]
Optimize over $[T_1, T_2]$: stochastic control

- $U$ is solution to the HJB PDE
  \[
  \partial_t U + \mathcal{L}^0 U + \inf_{\Delta} \left\{ \frac{1}{2} \Delta^2 a^2 s^2 U + \Delta a s (a s \partial_s U + \rho \sigma(a) \partial_a U) \right\} = 0,
  \]
  \[
  U(T_2, s, a; \delta^L) = e^{u^2(s) + \delta^L L(s)}.
  \]

- Optimal delta:
  \[
  \Delta^*_t = - \frac{\partial_s U(t, S_t, a_t) + \rho \sigma(a_t) \partial_a U(t, S_t, a_t)}{U(t, S_t, a_t)},
  \]

- $U$ satisfies
  \[
  \partial_t U + \mathcal{L}^0 U - \frac{(a s \partial_s U + \rho \sigma(a) \partial_a U)^2}{2U} = 0,
  \]
  \[
  U(T_2, s, a; \delta^L) = e^{u^2(s) + \delta^L L(s)}.
  \]

- $u := \ln U$ satisfies
  \[
  \partial_t u + \mathcal{L}^0 u + \frac{1}{2} (1 - \rho^2) \sigma(a)^2 (\partial_a u)^2 = 0,
  \]
  \[
  u(T_2, s, a; \delta^L) = u_2(s) + \delta^L L(s).
  \]
Optimize at $T_1$: simply pathwise

\[
D = \sup_{u_1, u_2, u V} \sup_{\Delta t \in [0, T_1]} \inf_{V \in \mathcal{F}_1} \sup_{\Delta L \in \mathcal{F}_1} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) \right\} \\
- \ln \mathbb{E}^0 \left[ e^{u_1(S_1)} + u V(V) + \int_0^{T_1} \Delta_t dS_t - \Delta^L(L(S_1) + V^2) + u(T_1, S_1, a_1; \Delta^L) \right]
\]

Since $S_1$, $a_1$, and $\int_0^{T_1} \Delta_t dS_t$ are $\mathcal{F}_1$-measurable,

\[
= - \ln \sup_{V \in \mathcal{F}_1} \inf_{\Delta L \in \mathcal{F}_1} \left[ e^{u_1(S_1)} + u V(V) + \int_0^{T_1} \Delta_t dS_t - \Delta^L(L(S_1) + V^2) + u(T_1, S_1, a_1; \Delta^L) \right]
\]

\[
= - \ln \mathbb{E}^0 \left[ e^{u_1(S_1)} + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1) \right]
\]

\[
\Phi(s, a) := \sup_{v \geq 0} \inf_{\delta^L \in \mathbb{R}} \left\{ u V(v) - \delta^L(L(s) + v^2) + u(T_1, s, a; \delta^L) \right\}.
\]

The optimal $V$ and $\Delta^L$ are functions of $(S_1, a_1)$: $v^*(S_1, a_1)$, $\delta^L(S_1, a_1)$. 

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Dispersion-Constrained Martingale Schrödinger Problems
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Optimize over \([T_0, T_1]\): same stochastic control

\[
D = \sup_{u_1, u_2, u} \sup_{(\Delta_t)_{t \in [0, T_1]}} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1)} \right] \right\}
\]

\[
= \sup_{u_1, u_2, u} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \inf_{(\Delta_t)_{t \in [0, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1)} \right] \right\}
\]

\[
= \sup_{u_1, u_2, u} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln U(0, S_0, a_0) \right\}
\]

\[
= \sup_{u_1, u_2, u} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - u(0, S_0, a_0) \right\} =: P
\]

where \(U(t, S_t, a_t) := \inf_{(\Delta_r)_{r \in [t, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_t^{T_1} \Delta_r dS_r + \Phi(S_1, a_1)} \bigg| S_t, a_t \right] \)

satisfies

\[
\partial_t U + \mathcal{L}^0 U - \frac{(as\partial_s U + \rho \sigma(a) \partial_a U)^2}{2U} = 0, \quad t \in [0, T_1), \quad U(T_1, s, a) = e^{u_1(s) + \Phi(s, a)}
\]

and \(u := \ln U\) satisfies

\[
\partial_t u + \mathcal{L}^0 u + \frac{1}{2}(1 - \rho^2)\sigma(a)^2(\partial_a u)^2 = 0, \quad t \in [0, T_1), \quad u(T_1, s, a) = u_1(s) + \Phi(s, a).
\]
Optimize over \([T_0, T_1]\): same stochastic control

\[
D = \sup_{u_1, u_2, u_V} \sup_{(\Delta_t)_{t \in [0, T_1]}} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1)} \right] \right\}
\]

\[
= \sup_{u_1, u_2, u_V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \inf_{(\Delta_t)_{t \in [0, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1)} \right] \right\}
\]

\[
= \sup_{u_1, u_2, u_V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln U(0, S_0, a_0) \right\}
\]

\[
= \sup_{u_1, u_2, u_V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - u(0, S_0, a_0) \right\} =: P
\]

where \(U(t, S_t, a_t) := \inf_{(\Delta_r)_{r \in [t, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1) + \int_t^{T_1} \Delta_r dS_r + \Phi(S_1, a_1)} \big| S_t, a_t \right] \) satisfies

\[
\partial_t U + \mathcal{L}^0 U - \frac{(as \partial_s U + \rho \sigma(a) \partial_a U)^2}{2U} = 0, \ t \in [0, T_1), \ U(T_1, s, a) = e^{u_1(s) + \Phi(s, a)}
\]

and \(u := \ln U\) satisfies

\[
\partial_t u + \mathcal{L}^0 u + \frac{1}{2}(1 - \rho^2)\sigma(a)^2(\partial_a u)^2 = 0, \ t \in [0, T_1), \ u(T_1, s, a) = u_1(s) + \Phi(s, a).
\]
**Final dual representation**

\[
D = \sup_{u_1, u_2, u V} \sup_{(\Delta_t)_{t \in [0, T_1]}} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \mathbb{E}^0 \left[ e^{u_1(S_1)} + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1) \right] \right\}
\]

\[
= \sup_{u_1, u_2, u V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln \inf_{(\Delta_t)_{t \in [0, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1)} + \int_0^{T_1} \Delta_t dS_t + \Phi(S_1, a_1) \right] \right\}
\]

\[
= \sup_{u_1, u_2, u V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - \ln U(0, S_0, a_0) \right\}
\]

\[
= \sup_{u_1, u_2, u V} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - u(0, S_0, a_0) \right\} =: P
\]

where \( U(t, S_t, a_t) := \inf_{(\Delta_r)_{r \in [t, T_1]}} \mathbb{E}^0 \left[ e^{u_1(S_1)} + \int_t^{T_1} \Delta_r dS_r + \Phi(S_1, a_1) \right| S_t, a_t \]

satisfies

\[
\partial_t U + \mathcal{L}^0 U - \frac{(a \sigma(a) \partial_a U)^2}{2U} = 0, \quad t \in [0, T_1), \quad U(T_1, s, a) = e^{u_1(s) + \Phi(s, a)}
\]

and \( u := \ln U \) satisfies

\[
\partial_t u + \mathcal{L}^0 u + \frac{1}{2}(1 - \rho^2)\sigma(a)^2(\partial_a u)^2 = 0, \quad t \in [0, T_1), \quad u(T_1, s, a) = u_1(s) + \Phi(s, a).
\]
Motivation Dispersion-constrained MOT/Schrödinger problems Dispersion-constrained martingale Schrödinger bridges Inversion of convex ordering

Calibrated model = reference model with modified drift

- Assume $P < +\infty$ and $(u^*_1, u^*_V, u^*_2)$ maximizes $P$. The probability $\mathbb{P}^*$ that minimizes $H(\mathbb{P}, \mathbb{P}_0)$ satisfies ($Z = 1$)

$$
\frac{d\mathbb{P}^*}{d\mathbb{P}_0} = e^{u^*_1(S_1) + u^*_2(S_2) + u^*_V(V^*) + \int_0^T \Delta^* dS_t + \Delta^*, L \left( L \left( \frac{S_2}{S_1} \right) - (V^*)^2 \right)} =: M_{T_2}.
$$

- Let $M_t := \mathbb{E}^0[M_{T_2} | \mathcal{F}_t]$. It is easy to check that $M_t = \mathcal{E}(L)_t$ with

$$
dL_t = \sqrt{1 - \rho^2} \sigma(a_t) \partial_a u^*(t, S_t, a_t) dW^0, \perp
$$

- Girsanov $\Longrightarrow (W^*, W^*, \perp)$ is a standard $\mathbb{P}^*$-Brownian motion, where

$$
W^*_t = W^0_t, \quad W^*_{t, \perp} = W^0_{t, \perp} - \sqrt{1 - \rho^2} \int_0^t \sigma(a_r) \partial_a u^*(r, S_r, a_r) dr.
$$

- The model dynamics reads

$$
\frac{dS_t}{S_t} = a_t dW^*_t
$$

$$
da_t = (b(a_t) + (1 - \rho^2) \sigma(a_t)^2 \partial_a u^*(t, S_t, a_t)) dt + \sigma(a_t) \left( \rho dW^*_t + \sqrt{1 - \rho^2} dW^*_{t, \perp} \right)
$$

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Dispersion-Constrained Martingale Schrödinger Problems
Recap: VIX-constrained martingale Schrödinger bridge

\[
\begin{align*}
\frac{dS_t}{S_t} &= a_t \, dW_t^* \\
\, da_t &= (b(a_t) + (1 - \rho^2)\sigma(a_t)^2 \partial_a u^*(t, S_t, a_t)) \, dt + \sigma(a_t) \left( \rho \, dW_t^* + \sqrt{1 - \rho^2} \, dW_t^* ' \right)
\end{align*}
\]

- Let \( P := \sup_{u_1, u_V, u_2} \left\{ \sum_{i \in \{1, 2, V\}} (\mu_i, u_i) - u(0, S_0, a_0) \right\} \) where \( u \) is solution to a nonlinear Hamilton-Jacobi-Bellman PDE:

\[
\begin{align*}
\partial_t u + \mathcal{L}^0 u + \frac{1}{2} (1 - \rho^2) \sigma(a)^2 (\partial_a u)^2 &= 0, \quad t \in (T_1, T_2), \\
\Phi(s, a) := \sup_{v \geq 0} \inf_{\delta^L \in \mathbb{R}} \left\{ u_V(v) - \delta^L (L(s) + v^2) + u(T_1, s, a; \delta^L) \right\}, \\
u(T_1, s, a) &= u_1(s) + \Phi(s, a), \\
\partial_t u + \mathcal{L}^0 u + \frac{1}{2} (1 - \rho^2) \sigma(a)^2 (\partial_a u)^2 &= 0, \quad t \in [0, T_1).
\end{align*}
\]

- Assume \( P < +\infty \) and \((u_1^*, u_V^*, u_2^*)\) maximizes \( P \rightarrow u^* \)
Recap: VIX-constrained martingale Schrödinger bridge

\[
\frac{dS_t}{S_t} = a_t \, dW_t^*
\]

\[
da_t = (b(a_t) + (1 - \rho^2)\sigma(a_t)^2 \partial_a u^*(t, S_t, a_t)) \, dt + \sigma(a_t) \left( \rho \, dW_t^* + \sqrt{1 - \rho^2} \, dW_t^*, \perp \right)
\]

- Optimal deltas:

\[
\Delta^*_t = -\partial_s u^*(t, S_t, a_t) - \rho \frac{\sigma(a_t)}{a_t S_t} \partial_a u^*(t, S_t, a_t); \quad \Delta^{*,L} = \delta^{*,L}(S_1, a_1)
\]

- The drift of \((a_t)\) under \(\mathbb{P}^*\) also reads as

\[
b(a_t) + (1 - \rho^2)\sigma(a_t)^2 \partial_a \ln \mathbb{E}^0 \left[ e^{u_1^*(S_1)} \int_{T_1}^T \Delta^*(r, S_r, a_r) \, dS_r + \Phi^*(S_1, a_1) \bigg| S_t, a_t \right], \quad t \in [0, T_1],
\]

\[
b(a_t) + (1 - \rho^2)\sigma(a_t)^2 \partial_a \ln \mathbb{E}^0 \left[ e^{u_2^*(S_2)} \int_{T_1}^{T_2} \Delta^*(r, S_r, a_r) \, dS_r + \delta^{*,L}(S_1, a_1) L(S_2) \bigg| S_t, a_t \right], \quad t \in [T_1, T_2],
\]

- It is path-dependent on \([T_1, T_2]\) so as to match the market VIX smile.

- If \(P = +\infty\), then

\[
\mathcal{P} \cap \left\{ \mathbb{P} \ll \mathbb{P}_0 \bigg| \mathbb{E}^\mathbb{P} \left[ \ln \frac{d\mathbb{P}}{d\mathbb{P}_0} \right] < +\infty \right\} = \emptyset.
\]
SLV calibrated to SPX: VIX smile (Aug 1, 2018)

- All continuous models on SPX that are calibrated to full SPX smile are of the form:
  \[
  \frac{dS_t}{S_t} = \frac{a_t}{\sqrt{\mathbb{E}[a_t^2 | S_t]}} \sigma_{loc}(t, S_t) \, dW_t.
  \]

- They are stochastic local volatility (SLV) models

  \[
  \frac{dS_t}{S_t} = a_t \ell(t, S_t) \, dW_t
  \]

  with stochastic volatility (SV) \((a_t)\) and leverage function

  \[
  \ell(t, S_t) = \frac{\sigma_{loc}(t, S_t)}{\sqrt{\mathbb{E}[a_t^2 | S_t]}}.
  \]

- In those models \((\tau := 30 \text{ days})\)

  \[
  \text{VIX}_T^2 = \frac{1}{\tau} \int_T^{T+\tau} \mathbb{E} \left[ \frac{a_t^2}{\mathbb{E}[a_t^2 | S_t]} \sigma_{loc}^2(t, S_t) \bigg| \mathcal{F}_T \right] \, dt.
  \]

- Optimize SV parameters to fit VIX options.
SLV calibrated to SPX: VIX smile, $T = 21$ days (Aug 1, 2018)

SLV model, SV = skewed 2-factor Bergomi model
SV params optimized to fit VIX smile