

# SMILE AT THE UNCERTAINTY

D. Brigo, F. Mercurio and F. Rapisarda\*

## Introduction

The success of the Black-Scholes (BS) formula is mainly due to the possibility of synthesizing option prices through a unique parameter, the implied volatility, which is so crucial for traders to be directly quoted in many financial markets. This is because the BS formula allows one to immediately convert a volatility into the price at which the related option can be exchanged.

The BS model, however, can not be used to price simultaneously all options in a given market. In fact, the assumption of a deterministic underlying-asset volatility leads to constant implied volatilities for any fixed maturity, in contrast with the smile/skew effect commonly observed in practice. Moreover, historical analysis shows that volatilities are indeed stochastic.

Stochastic volatility models, therefore, seem to be a more realistic choice when modelling asset price dynamics for valuing derivative securities. However, only few examples, see Hull and White (1987) or Heston (1993), retain enough analytical tractability so as to be relevant in practice. In general, the calibration to market option prices, and the consequent book re-evaluation, can be extremely burdensome and time consuming.

Stochastic volatility models can also be problematic as far as hedging is concerned: hedging volatility changes is less straightforward than in the BS case where we just have one volatility parameter. In general, we can only calculate the sensitivity with respect to the model parameters, which may have an economic meaning but are likely not to have a clear impact on implied volatility surfaces.

The purpose of this paper is to propose a stochastic-volatility model that is analytically tractable as much as BS' and for which Vega hedging can be defined in a natural way. The model is based on an uncertain volatility whose random value is drawn, on an infinitesimal future time, from a finite distribution. The model is similar in spirit to (and developed independently from) that of Alexander et al. (2003).

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\*Product and Business Development, Banca IMI, Corso Matteotti, 6, 20121, Milan, Italy. We are grateful to Aleardo Adotti, head of the Product and Business Development at Banca IMI, for his constant support and encouragement. We are also grateful to Antonio Castagna for disclosing us the secrets of the FX options market and for stimulating discussions. Special thanks go to Lorenzo Bisesti for his fundamental work on the model implementation.

Our uncertain volatility model is equivalent to assuming a number of different possible scenarios for the asset forward volatility, which can therefore be hedged accordingly. Avellaneda *et al.* (1995, 1996) suggested an uncertain volatility model based on the postulate that forward volatility can vary inside a band  $[\sigma_{min}, \sigma_{max}]$ , thus mapping the pricing problem onto the numerical solution of a nonlinear partial differential equation that yields the value of derivatives under the worst-case volatility scenario. However, choosing a finite number of possible forward volatility states, rather than a full band of possible values, enjoys the same degree of analytical tractability as the original BS model. As a direct consequence, prices of exotic claims, even with path-dependent or early-exercise features, are simply mixtures of the corresponding prices in the BS model. This renders our model particularly useful in the FX market, where a trader's book typically contains thousands of barrier (or other exotic) options. In fact, we can calculate P&Ls and sensitivities analytically and consistently with smile effects.<sup>1</sup>

## The model description

We assume that the asset price dynamics under the risk neutral measure is

$$dS(t) = \begin{cases} S(t)[\mu(t) dt + \sigma_0 dW(t)] & t \in [0, \varepsilon] \\ S(t)[\mu(t) dt + \eta(t) dW(t)] & t > \varepsilon \end{cases} \quad (1)$$

with  $S(0) = S_0 > 0$ , and where  $W$  is a standard Brownian motion,  $\eta$  is a random variable that is independent of  $W$ ,  $\sigma_0$  and  $\varepsilon$  are positive constants and the risk-neutral drift rate  $\mu$  is a deterministic function of time. The random variable  $\eta$  takes values in a set of  $N$  (given) deterministic functions  $\sigma_i$  with probability  $\lambda_i$ , and  $\eta(t)$  denotes its generic value. We thus have:

$$(t \mapsto \eta(t)) = \begin{cases} (t \mapsto \sigma_1(t)) & \text{with probability } \lambda_1 \\ (t \mapsto \sigma_2(t)) & \text{with probability } \lambda_2 \\ \vdots & \vdots \\ (t \mapsto \sigma_N(t)) & \text{with probability } \lambda_N \end{cases}$$

where the  $\lambda_i$  are strictly positive and add up to one. The random value of  $\eta$  is assumed to be drawn at time  $t = \varepsilon$ .<sup>2</sup>

We denote by  $\mathcal{F}_t^W$  the  $\sigma$ -field generated by  $W$  up to time  $t$  and by  $\mathcal{F}^\eta$  the  $\sigma$ -field associated with  $\eta$ . Since  $W$  and  $\sigma$  are independent we take as underlying filtration  $\mathbb{F} := \{\mathcal{F}_t = \mathcal{F}_t^W \otimes \mathcal{F}^\eta : t \geq 0\}$ .

As in most stochastic volatility models, our asset price dynamics is directly expressed under a given risk neutral measure. The existence of such a measure, and accordingly the absence of arbitrage, is formally discussed in Appendix A.

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<sup>1</sup>Our model can also be viewed as a particular regime-switching model where its coefficients follow very simple Markov chains. Our approach, however, results in a model that is much more tractable than the existing ones in the related literature.

<sup>2</sup>The reason for drawing at  $t = \varepsilon$  is to have uncertainty at the evaluation time 0. In fact, volatility can be drawn at time  $t = 0^+$ , *i.e.* immediately after  $t = 0$ .

The intuition behind the model is as follows. Our asset price process is nothing but a BS geometric Brownian motion where the asset volatility is unknown and one assumes different scenarios for it. The volatility uncertainty applies to an infinitesimal initial time interval with length  $\varepsilon$ , at the end of which the future volatility value is drawn. Therefore,  $S$  evolves, for an infinitesimal time, as a geometric Brownian motion with constant volatility  $\sigma_0$ , and then as a geometric Brownian motion with the deterministic volatility  $\sigma_i(t)$  drawn at time  $\varepsilon$ .

Setting  $\sigma_i(t) = \sigma_0$  for each  $t \in [0, \varepsilon]$  and each  $i$ , and

$$M(t) := \int_0^t \mu(s) ds, \quad V_i(t) := \sqrt{\int_0^t \sigma_i^2(s) ds}$$

we have that the density of  $S$  at time  $t > \varepsilon$  is the following mixture of lognormal densities:

$$p_t(y) = \sum_{i=1}^N \lambda_i \frac{1}{y V_i(t) \sqrt{2\pi}} \exp \left\{ -\frac{1}{2V_i^2(t)} \left[ \ln \frac{y}{S_0} - M(t) + \frac{1}{2} V_i^2(t) \right]^2 \right\}. \quad (2)$$

In fact, denoting by  $Q$  the risk neutral probability, we have

$$Q\{S(t) \leq y\} = \sum_{i=1}^N Q\{\{S(t) \leq y\} \cap \{\eta(t) = \sigma_i(t)\}\} = \sum_{i=1}^N \lambda_i Q\{S(t) \leq y | \eta(t) = \sigma_i(t)\}.$$

Our model (1) is thus referred to as lognormal-mixture uncertain volatility (LMUV) model.

A direct consequence of (2) is that, under the LMUV model, European option prices are mixtures of BS' prices. For instance the arbitrage-free price of a European call with strike  $K$  and maturity  $T$  is

$$P(0, T) \sum_{i=1}^N \lambda_i \left[ S_0 e^{M(T)} \Phi \left( \frac{\ln \frac{S_0}{K} + M(T) + \frac{1}{2} V_i^2(T)}{V_i(T)} \right) - K \Phi \left( \frac{\ln \frac{S_0}{K} + M(T) - \frac{1}{2} V_i^2(T)}{V_i(T)} \right) \right], \quad (3)$$

where  $P(t, T)$  denotes the discount factor at time  $t$  for maturity  $T$  and  $\Phi$  the standard normal cumulative distribution function.<sup>3</sup>

The LMUV model features the following interesting properties: i) explicit dynamics; ii) explicit marginal densities; iii) explicit formulas for European-style derivatives at the initial time; iv) the analytical tractability at the initial time is extended to all those derivatives which can be explicitly priced under the BS paradigm; v) the analytical tractability is preserved after time 0 in that also future option prices can be obtained in an explicit fashion.

The last two properties follow immediately from the model definition. In fact, similarly to what we did for the option price (3), the expectations of functionals of the process (1)

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<sup>3</sup>Our LMUV model can be viewed as an Hull and White (1987) stochastic volatility model where the volatility is a random variable rather than a stochastic process.

can be calculated by conditioning on the possible values of  $\eta$ , thus taking expectations of functionals of a geometric Brownian motion. In formulas, any  $\mathcal{F}_T$ -measurable (and square integrable) payoff  $V_T$  at time  $T$  has a no-arbitrage price at time  $t = 0$  given by

$$V_0 = P(0, T) \sum_{i=1}^N \lambda_i E\{V_T | \eta = \sigma_i\} = \sum_{i=1}^N \lambda_i V_0^{\text{BS}}(\sigma_i) \quad (4)$$

where  $V_0^{\text{BS}}(\sigma_i)$  denotes the derivative price under the BS model when the asset (time-dependent) volatility is  $\sigma_i$ .

We denote by  $r(t)$  the deterministic instantaneous short rate at time  $t$ , and assume that the asset  $S$  pays a deterministic dividend yield  $y(t)$  at time  $t$ . For instance, in case  $S$  represents an exchange rate,  $y(t) = r_f(t)$ , where  $r_f$  denotes the deterministic instantaneous short rate for the foreign currency. We thus have  $\mu(t) = r(t) - y(t)$ .

## Relationship with the lognormal mixture local volatility model

In terms of marginal densities and prices of European-style derivatives at time 0, our uncertain volatility model is equivalent to the lognormal-mixture local volatility (LMLV) model developed by Brigo and Mercurio (2000, 2001, 2002). More precisely, their LMLV model is the projection of our LMUV counterpart onto the class of local volatility models. We formally prove this in Appendix B. Of the five properties listed above, the LMLV model shares only the first three (i-iii), since in this model only marginal densities are explicitly known.

The substantial difference is that while in the LMLV model randomness in the instantaneous volatility is completely induced instant by instant by randomness in the underlying asset, in the LMUV model randomness acquires a life of its own and, in particular, it is independent of the Brownian motion driving the underlying dynamics. Nevertheless, from the fact that the LMLV model is a sort of projection of the LMUV model follows that the two models share qualitatively several characteristics. For instance, both models decorrelate completely the underlying from its (squared) volatility, see appendix B. Moreover, the future implied volatility curves flatten along the strike dimension both in the LMUV model, after time  $\epsilon$  and conditional on any chosen scenario, and in the LMLV model (even though not completely, see Brigo (2002) for a numerical example). We will also see below that the two models imply quite similar barrier option prices.

Properties iv) and v) above are important since they allow to transfer the BS technology to the LMUV model for all path dependent payoffs, contrary to the LMLV case where numerical methods are needed. If one believed in the LMLV model, hedging would be easier and simply be given by delta hedging, with delta known analytically. This is related to the market completeness of local volatility models and is seemingly in favor of the LMLV formulation. However, this is more a theoretical advantage since financial markets are widely recognized to be incomplete in practice, so that the market incompleteness of the LMUV model, due to the stochastic behavior of the asset volatility, is not such a serious drawback.

	LMLV	LMUV
Marginal densities	Mixture of lognormals	Mixture of lognormals
Transition densities	Unknown	(Mixture of) lognormals
Market completeness	Yes	No
Hedging	Perfect with Delta	Extra assets needed
European options	Mixture of BS prices	Mixture of BS prices
Exotics:	Numerics needed	Mixture of BS-like prices
Corr( $S_t, \sigma_t^2$ )	0	0

Table 1: The LMUV model and its LMLV projection ( $\sigma_t$  denotes the model instantaneous volatility).

Finally, we notice that since the two models have the same marginal distributions at time 0, calibration to European (plain-vanilla) calls or put is identical under both formulations. When one calibrates the LMUV, one is also implicitly calibrating the LMLV. Calibrating to path dependent options, however, would ideally result in two different sets of parameters for the two models. The relationship between the two models is summarized in Table 1.

## Calibration to FX volatility data

Brigo and Mercurio (2001) proved that, for each given maturity  $T$ , the option price (3) leads to implied volatility curves, which have a minimum at the at-the-money forward strike  $K = S_0 \exp(M(T))$ . This renders the LMUV model (1) particularly suitable for calibration to smile-shaped implied volatilities. As a confirmation of this statement, we consider the EUR/USD implied volatilities as of 12 April 2002, which are reported in Table 2. Notice that FX volatilities are typically quoted in terms of deltas rather than strikes.

In our calibration procedure, we parameterize the functions  $\sigma_i$  (actually the corresponding  $V_i$ ) through Nelson and Siegel's (1987) functions by setting

$$\begin{aligned}
 V_i(t) &= f_i^{NS}(t) \sqrt{t} \\
 f_i^{NS}(t) &= a_i + b_i (1 - e^{-t/\tau_i}) \frac{\tau_i}{t} + c_i e^{-t/\tau_i}
 \end{aligned}
 \tag{5}$$

We set  $N = 3$ . By minimizing the mean square error between theoretical and market prices, we obtain the model implied volatilities shown in Table 3.

The absolute differences between model and market volatilities are reported in Table 4. Such differences could be sensibly reduced by choosing a less parsimonious parametrization, like for instance a piece-wise constant one. In this section, however, we just wanted to show the fitting potential of the LMUV model, rather than hinting at possible efficient choices for the ‘‘volatility’’ functions  $\sigma_i$ .

	25 $\Delta$	50 $\Delta$	75 $\Delta$
1W	9.83%	9.45%	9.63%
2W	9.76%	9.40%	9.61%
1M	9.66%	9.25%	9.41%
2M	9.76%	9.40%	9.61%
3M	10.16%	9.85%	10.11%
6M	10.66%	10.40%	10.71%
9M	10.90%	10.65%	11.98%
1Y	10.99%	10.75%	11.09%
2Y	11.12%	10.85%	11.17%

Table 2: EUR/USD implied volatilities as of 12 April 2002.

	25 $\Delta$	50 $\Delta$	75 $\Delta$
1W	9.55%	9.09%	9.55%
2W	9.66%	9.20%	9.67%
1M	9.76%	9.30%	9.76%
2M	10.06%	9.59%	10.07%
3M	10.32%	9.82%	10.35%
6M	10.84%	10.31%	10.89%
9M	11.12%	10.58%	11.19%
1Y	11.27%	10.73%	11.35%
2Y	11.39%	10.90%	11.53%

Table 3: Calibrated volatilities obtained under the parametrization (5).

## The analytical pricing of barrier options

We have seen before that our uncertain volatility model implies closed form prices for all those payoffs which can be analytically priced in the BS framework with time dependent coefficients.<sup>4</sup> Pricing analytically path-dependent derivatives may be fundamental in markets, like the FX one, where a typical trader's book contains thousands of non-vanilla instruments.

The assumption of a geometric Brownian motion with time-dependent coefficients can render the pricing of these derivatives less straightforward than in the constant-parameters case. However, it is usually possible to come up with analytical approximations, like in the case of the barrier option formulas developed by Lo and Lee (2001). Following their approach, and remembering (4), we obtain, for instance, that the price at time  $t = 0$  of an

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<sup>4</sup>Using time-dependent coefficients is essential for retrieving the correct term structures of zero-coupon rates or at-the-money volatilities.

	25 $\Delta$	50 $\Delta$	75 $\Delta$
1W	-0.28%	-0.36%	-0.08%
2W	-0.10%	-0.20%	0.06%
1M	0.10%	0.05%	0.35%
2M	0.30%	0.19%	0.46%
3M	0.16%	-0.03%	0.24%
6M	0.18%	-0.09%	0.18%
9M	0.22%	-0.07%	0.21%
1Y	0.28%	-0.02%	0.26%
2Y	0.27%	0.05%	0.36%

Table 4: Absolute differences between calibrated volatilities and market volatilities.

up-and-out call (UOC) with barrier level  $H > S_0$ , strike  $K$  and maturity  $T$  is approximately

$$\begin{aligned}
\text{UOC}_0 = & 1_{\{K < H\}} \sum_{i=1}^N \lambda_i \left\{ S_0 e^{c_1 + c_2 + c_3} \left[ \Phi \left( \frac{\ln \frac{S_0}{K} + c_1 + 2c_2}{\sqrt{2c_2}} \right) - \Phi \left( \frac{\ln \frac{S_0}{H} + c_1 + 2c_2}{\sqrt{2c_2}} \right) \right] \right. \\
& - K e^{c_3} \left[ \Phi \left( \frac{\ln \frac{S_0}{K} + c_1}{\sqrt{2c_2}} \right) - \Phi \left( \frac{\ln \frac{S_0}{H} + c_1}{\sqrt{2c_2}} \right) \right] - H e^{c_3 + (\beta-1)(\ln \frac{S_0}{H} + c_1) + (\beta-1)^2 c_2} \\
& \cdot \left[ \Phi \left( \frac{\ln \frac{S_0}{H} + c_1 + 2(\beta-1)c_2}{\sqrt{2c_2}} \right) - \Phi \left( \frac{\ln \frac{S_0 K}{H^2} + c_1 + 2(\beta-1)c_2}{\sqrt{2c_2}} \right) \right] \\
& \left. + K e^{c_3 + \beta(\ln \frac{S_0}{H} + c_1) + \beta^2 c_2} \left[ \Phi \left( \frac{\ln \frac{S_0}{H} + c_1 + 2\beta c_2}{\sqrt{2c_2}} \right) - \Phi \left( \frac{\ln \frac{S_0 K}{H^2} + c_1 + 2\beta c_2}{\sqrt{2c_2}} \right) \right] \right\}, \tag{6}
\end{aligned}$$

where  $1_{\{A\}}$  denotes the indicator function of the set  $A$ , and

$$\begin{aligned}
c_1 = c_1^i & := R(0, T) - Y(0, T) - \frac{1}{2} V_i^2(0, T) \\
c_2 = c_2^i & := \frac{1}{2} V_i^2(0, T) \\
c_3 & := -R(0, T) \\
\beta = \beta^i & := -2 \frac{\int_0^T [R(t, T) - Y(t, T) - \frac{1}{2} V_i^2(t, T)] V_i^2(t, T) dt}{\int_0^T V_i^4(t, T) dt} \\
R(t, T) & := \int_t^T r(s) ds \\
Y(t, T) & := \int_t^T y(s) ds \\
V_i^2(t, T) & := \int_t^T \sigma_i^2(s) ds
\end{aligned}$$

A complete list of formulas, including those for windows, digital and double barriers can be found in Rapisarda (2003).

Examples of barrier option prices under the LMUV model, calibrated to the market data of Table 2, are reported in Table 5, where they are compared with those for the LMLV counterpart and those obtained under a BS model with a time-dependent volatility that is stripped from the at-the-money quotes.<sup>5</sup>

As we can infer from this table, the LMUV and LMLV barrier option prices are typically close to each other. This can be motivated by the fact that barrier options are path-dependent derivatives only in a weak sense. However, the purpose of our example is not to suggest a further analogy between the LMUV and LMLV models, but rather to show the possible differences, in terms of option prices, between our model and what is commonly used in the market, at least for books re-evaluations.

Type	LMUV	LMLV	BS
UOC(T=3M,K=1,H=1.05)	28	29	34
UOC(T=6M,K=1,H=1.08)	47	48	57
UOC(T=9M,K=1,H=1.10)	55	57	68
DOC(T=3M,K=1.02,H=0.95)	98	96	99
DOC(T=6M,K=1.07,H=0.98)	67	65	61
DOC(T=9M,K=1.10,H=0.90)	70	68	61

Table 5: Barrier option prices in basis points (we set  $S_0 = 1$ ). DOC denotes the price of a down and out call.

## A simple extension of the LMUV model

The presence in the market of skew-shaped implied volatility curves pushes us to consider an extension of model (1) that accounts for possible asymmetries.

The simplest way to do so is by shifting the geometric Brownian motion followed by  $S$  under each possible scenario. We thus come up with the following asset price dynamics under the risk neutral measure:

$$dS(t) = \begin{cases} S(t)[\mu(t) dt + \sigma_0 dW(t)] & t \in [0, \varepsilon] \\ \mu(t)S(t) dt + \psi(t)[S(t) - \alpha e^{M(t)}] dW(t) & t > \varepsilon \end{cases} \quad (7)$$

where  $(\psi, \alpha)$  is a random pair that is independent of  $W$  and takes values in a set of  $N$

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<sup>5</sup>The LMLV barrier option price is obtained through Monte Carlo simulation of the dynamics (15) based on 50000 paths with simulation timestep roughly equal to one seventh of a day. We checked that the resulting discretization bias is much smaller than the statistical uncertainty achieved on the price estimation; the latter amounts at most to 1 bp.

(given) pairs of deterministic functions and real constants:

$$(t \mapsto \psi(t), \alpha) = \begin{cases} (t \mapsto \sigma_1(t), \alpha_1) & \text{with probability } \lambda_1 \\ (t \mapsto \sigma_2(t), \alpha_2) & \text{with probability } \lambda_2 \\ \vdots & \vdots \\ (t \mapsto \sigma_N(t), \alpha_N) & \text{with probability } \lambda_N \end{cases}$$

The random value of  $(\psi, \alpha)$  is again drawn at time  $t = \varepsilon$ .

Also in this case, we have a clear interpretation for the asset price dynamics: the extended model (7) is a displaced BS model where both the asset volatility and the displacement are unknown. Accordingly, one assumes different (joint) scenarios for them.

This extension has the same advantages as the LMUV model: i) explicit marginal density (mixture of displaced lognormal densities); ii) explicit option prices (mixtures of displaced BS prices); iii) explicit transitions densities; iv) explicit (approximated) prices for barrier options.<sup>6</sup> In addition, the extended model can lead to a nice fitting to skew-shaped implied volatility curves and surfaces, since the displacement parameters induce model implied volatilities whose minimum is shifted with respect to the at-the-money forward price.

In real financial markets, we can easily observe implied volatilities with different skews for different maturities. Our displacement parameters  $\alpha_i$  are, however, associated to the possible scenarios rather than to the quoted maturities. This prevents us from achieving (almost) perfect calibrations to general skew-shaped surfaces. To this end, we must resort to a more a general extension, which we illustrate in the following.

## A general extension of the LMUV model

In order to accommodate general implied volatility skews, we would want the different shifts in the asset price distribution to be associated to the market maturities rather than to the different scenarios one is assuming. A possible way to tackle this issue is by introducing a stochasticity also in the interest rates evolution. In fact, under deterministic rates, the no-arbitrage requirement that the risk neutral expectation of a future asset price be the current forward price somehow limits the possibility of asymmetries in the implied volatility curves. Under stochastic rates, instead, such a constraint applies to expectations under the corresponding forward measure, thus granting us some freedom when modelling the asset price dynamics under the risk neutral measure.

We consider a very simple model for the interest rates (stochastic) evolution, namely an uncertain short-rate model. We assume that at time  $t = \varepsilon$  one also draws a deterministic short-rate process and a deterministic dividend yield. Therefore, the new asset price

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<sup>6</sup>Barrier option prices under a displaced geometric Brownian motion can be derived under similar, but less straightforward, arguments as those used by Lo and Lee (2001).

dynamics under the risk neutral measure is

$$dS(t) = \begin{cases} S(t)[(r(t) - y(t)) dt + \sigma_0 dW(t)] & t \in [0, \varepsilon] \\ S(t)[(\rho(t) - q(t)) dt + \chi(t) dW(t)] & t > \varepsilon \end{cases} \quad (8)$$

where  $(\rho, q, \chi)$  is a random triplet that is independent of  $W$  and takes values in the set of  $N$  (given) triplets of deterministic functions:

$$(t \mapsto (\rho(t), q(t), \chi(t))) = \begin{cases} (t \mapsto (r_1(t), y_1(t), \sigma_1(t))) & \text{with probability } \lambda_1 \\ (t \mapsto (r_2(t), y_2(t), \sigma_2(t))) & \text{with probability } \lambda_2 \\ \vdots & \vdots \\ (t \mapsto (r_N(t), y_N(t), \sigma_N(t))) & \text{with probability } \lambda_N \end{cases}$$

The random value of  $(\rho, q, \chi)$  is again drawn at time  $t = \varepsilon$ .<sup>7</sup>

Also in this more general case, we have a clear interpretation. The extended model is a BS model where the asset volatility, the risk free rate and the dividend yield are unknown, and one assumes different (joint) scenarios for them.

The general LMUV model has the same advantages as the LMUV model: i) explicit marginal density (mixture of lognormals with different means); ii) explicit option prices (mixtures of BS prices); iii) explicit transitions densities, and hence future option prices; iv) explicit (approximated) prices for barrier options and other exotics. In addition, the extended model leads to a potentially perfect fitting to any (smile-shaped or skew-shaped) implied volatility curves and surfaces.

When calculating derivatives prices under (8), we must remember we are now dealing with stochastic rates and that the discount factor  $P(0, T)$  can not be taken out from the risk neutral expectation as we did in (4). In this case, we instead have

$$V_0 = \sum_{i=1}^N \lambda_i e^{-\int_0^T r_i(u) du} E\{V_T | (\rho, q, \chi) = (r_i, y_i, \sigma_i)\} = \sum_{i=1}^N \lambda_i V_0^{\text{BS}}(r_i, y_i, \sigma_i) \quad (9)$$

where  $V_0^{\text{BS}}(r_i, y_i, \sigma_i)$  denotes the derivative price under the BS model when the (time-dependent) risk-free rate is  $r_i$ , the (time-dependent) dividend yield is  $y_i$  and the (time-dependent) asset volatility is  $\sigma_i$ , and where we set  $r_i(t) = r(t)$ ,  $y_i(t) = y(t)$  and  $\sigma_i(t) = \sigma_0$  for  $t \in [0, \varepsilon]$  and each  $i$ .<sup>8</sup>

## The general LMUV model: application to the FX options market

We now consider a second example of calibration to real market FX data. In this case, we remind that the dividend yield coincides with the foreign instantaneous short rate.

<sup>7</sup>One can of course consider the more general random triplet which assigns a non-zero probability to a generic  $t \mapsto (r_i(t), y_j(t), \sigma_k(t))$ , with a further increase in the number of model parameters (more  $\lambda$ 's).

<sup>8</sup>If one wishes to calibrate the uncertain interest-rate model to the market interest rate curve, one has to impose the constraint (10) below.

Since we want to exactly fit both the domestic and foreign zero coupon curves at the initial time, the following no-arbitrage constraints must be imposed:

- Exact fitting to the domestic zero-coupon curve:

$$\sum_{i=1}^N \lambda_i e^{-\int_0^t r_i(u) du} = P(0, t) \quad (10)$$

- Exact fitting to the foreign zero-coupon curve:

$$\sum_{i=1}^N \lambda_i e^{-\int_0^t q_i(u) du} = P^f(0, t) \quad (11)$$

where  $P^f(0, t)$  denotes the discount factor for the maturity  $t$  in the foreign interest rate market.<sup>9</sup>

The market volatility surface we consider is shown in Figure 1, for Deltas ranging from 10% to 90% and for the same maturities as in Table 2.

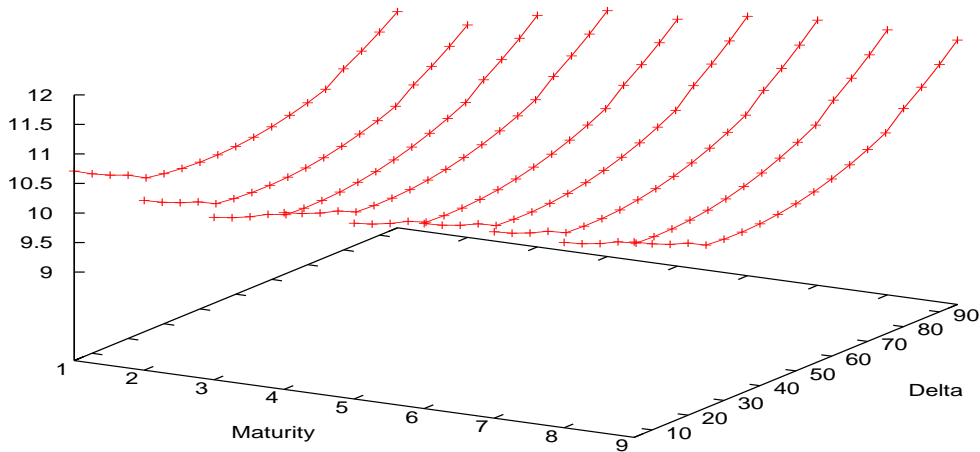


Figure 1: EUR/USD implied volatilities as of 4 February 2003.

For the calibration we decided to resort to a non parametric (cross-section) estimate of functions  $q$  and  $\chi$ , thus considering a deterministic domestic rate  $\rho$ . In fact, it turns out that setting  $N = 2$  and assuming uncertain asset volatility and foreign rates is sufficient

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<sup>9</sup>One may wonder whether it is correct to use the same  $\lambda$ 's both for the domestic and foreign risk-neutral measures. However, we can easily prove that such probabilities do not change when changing measure essentially due to the independence between  $W$  and  $(\rho, q, \chi)$ .

for achieving a perfect calibration to the three main volatility quotes ( $25\Delta$ ,  $50\Delta$ ,  $75\Delta$ ) for all maturities simultaneously.

The relative differences between model and market implied volatilities are shown in Figure 2, where the null difference for the three main Deltas is explicitly highlighted.

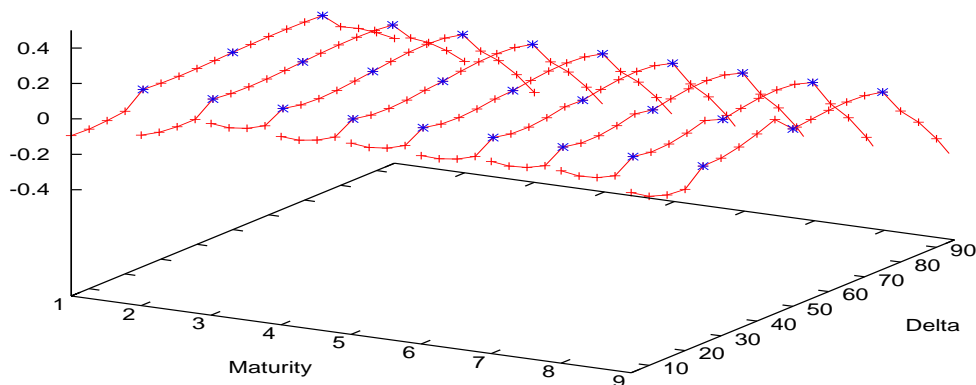


Figure 2: Differences between calibrated volatilities and market volatilities.

One can of course improve the overall fitting of the implied volatility surface by assigning similar weights to all market prices and allowing for a non-zero error in the calibration of the main quotes. However, exactly recovering the market volatilities is essential for producing bucketed sensitivities, namely a Vega breakdown along the strike and maturity dimensions. The calculation of such sensitivities is extremely helpful to traders. It allows them to highlight the areas where their volatility risk is mainly concentrated on, and to implement, accordingly, a proper hedge in terms of plain vanilla instruments. Notice, in fact, that as soon as we depart from the BS world, the concept of Vega loses most of its original meaning, and we actually have as many Vegas as implied volatilities in the market.

## Conclusions

We have proposed a simple stochastic volatility model that possesses the same analytical tractability of BS'. Explicit formulas can in fact be derived both for European-style and path-dependent derivatives, and both at a current or any future times. Even though analytical tractability is not a key requirement by itself, in practice it can be an essential feature for a model to become a true alternative to BS', in terms both of an accurate calibration of market data and of a rapid and consistent valuation of a trader's book.

Our model is based on an uncertain asset-price volatility, which is drawn (and hence known) at an infinitesimal future time. The assumption of deterministic interest rates

leads to implied volatilities with a minimum at the at-the-money forward prices, thus rendering the model suitable for calibration to smile-shaped curves and surfaces. Asymmetric structures or skew-shaped implied volatilities can be calibrated by assuming an uncertainty also in the interest rates evolution. Our experience in the FX market, for instance, is that we can typically obtain an exact fitting to the main volatility quotes, so that a claim sensitivities can be calculated by shifting one pillar at a time and then re-calibrating.

A main criticism to our model is that it makes little sense from a historical point of view, and in fact this is rather unquestionable. However, we believe that a model must be judged not only in terms of its assumptions but especially in terms of its implications. For instance, the existing stochastic volatility models, though based on more realistic dynamics than ours, are typically of little use in the management of a trader's book, either because pricing can be rather cumbersome or because no Vega breakdown is possible.

Another advantage of our model is that it allows for diagnostics on the future implied volatility surfaces. This can be carried out in a twofold manner: i) we can condition on a future realization of the underlying asset price and volatility thus obtaining a flat implied volatility for each maturity, or ii) we can calculate today's price of forward-start options to infer the forward volatility to be plugged into the BS formula (for forward-start options) to match the model price.

The fact that implied volatility smiles flatten as soon as the uncertainty on the asset volatility is resolved can be viewed as a rather disturbing feature. Since smiles are not likely to vanish instantaneously, a new uncertain volatility model will be used tomorrow in contrast with today's assumptions. However, this is exactly what traders do in practice: they recalibrate their favorite model every day, well conscious that their strategies are not self-financing and only provide local hedges.

A further extension of our uncertain volatility model can be considered by assuming subsequent draws of the future asset-price volatility, which will be deterministic between a draw and the next. Such an extension is considered in Mercurio (2002) and is also similar in spirit to that of Alexander et al. (2003). This more general model has the advantage of implying different numbers of density mixtures for different maturities, which typically leads to a better simultaneous calibration to short- and long-dated options when using parsimonious parameterizations. However, exotic option prices are combinations of a number of BS prices which grows exponentially with the number of future draws. This is the reason why, in this article, we decided to stick to a simpler formulation.

We finally mention that an uncertain volatility can also be considered in a Libor market model framework. In this case, we just have to be careful in specifying each forward rate dynamics under the corresponding forward measure and to treat properly measure changes involving discrete random variables. This model has been independently proposed by Gatarek (2003).

## Appendix A: Existence of a risk-neutral measure

The asset price is assumed to evolve under the real-world according to

$$dS(t) = \begin{cases} S(t)[m(t) dt + \sigma_0 dW_P(t)] & t \in [0, \varepsilon] \\ S(t)[m(t) dt + \eta(t) dW_P(t)] & t > \varepsilon \end{cases} \quad (12)$$

where  $m$  is a deterministic function and  $W_P$  is a standard Brownian motion on a probability space  $(\Omega^W, \mathcal{F}^W, P^W)$ . The random variable  $\eta$ , which is assumed to be independent of  $W_P$ , is defined on a probability space  $(\Omega^\eta, \mathcal{F}^\eta, P^\eta)$  as follows

$$(t \mapsto \eta(t)) = \begin{cases} (t \mapsto \sigma_1(t)) & \text{with probability } p_1 \\ (t \mapsto \sigma_2(t)) & \text{with probability } p_2 \\ \vdots & \vdots \\ (t \mapsto \sigma_N(t)) & \text{with probability } p_N \end{cases}$$

where the probabilities  $p_i$  are strictly positive with  $\sum_{i=1}^N p_i = 1$ .

We denote by  $\omega_i^\eta$  the  $i$ -th point in  $\Omega^\eta$ , so that  $\eta(\omega_i^\eta) = \sigma_i$  and  $P^\eta(\{\omega_i^\eta\}) = p_i$ ,  $i = 1, \dots, N$ . We set  $\Omega := \Omega^W \times \Omega^\eta$  and  $P := P^W \otimes P^\eta$ , and remember that we took as underlying filtration  $\{\mathcal{F}_t = \mathcal{F}_t^W \otimes \mathcal{F}^\eta : t \geq 0\}$ , where  $\mathcal{F}_t^W$  is the  $\sigma$ -field generated by  $W$  up to time  $t$ . The asset price (12) is then defined on the (real-world) probability space  $(\Omega, \mathcal{F}_T, P)$ .

The following is proved in Mercurio (2002).

**Proposition.** Let us define a new measure  $Q^\eta$  on  $(\Omega^\eta, \mathcal{F}^\eta)$  by

$$\frac{dQ^\eta}{dP^\eta}(\omega_i^\eta) = \frac{\lambda_i}{p_i}, \quad i = 1, \dots, N \quad (13)$$

where the new probabilities  $\lambda$ 's are strictly positive and  $\sum_{i=1}^N \lambda_i = 1$ . Then, setting  $\sigma_i(t) = \sigma_0$  for each  $t \in [0, \varepsilon]$  and each  $i$ , there exists a (risk-neutral) measure  $Q$  on  $(\Omega, \mathcal{F}_T)$

$$\frac{dQ}{dP} = \frac{dQ^\eta}{dP^\eta} \exp \left\{ -\frac{1}{2} \int_0^T \left( \frac{m(t) - \mu(t)}{\eta(t)} \right)^2 dt - \int_0^T \frac{m(t) - \mu(t)}{\eta(t)} dW_P(t) \right\}, \quad (14)$$

such that the asset price has, under  $Q$ , a drift rate equal to  $\mu(t)$ .

The measure  $Q$  is clearly not unique since the possible choices for the probability vector  $p$  are infinitely many. To state it differently, the market is not complete and the classical Delta-hedging strategy does not guarantee the exact replication of a given derivative's payoff. However, this is something a practitioner is ready to cope with. Markets are incomplete in practice and once the (theoretical) possibility of arbitrage is ruled out by the existence of a risk-neutral world, the pricing measure for the model is selected by the market itself.<sup>10</sup>

<sup>10</sup>As any stochastic volatility model, also our uncertain volatility version could be completed by introducing a suitable number of options with known dynamics that jump at time  $\varepsilon$ .

## Appendix B: the LMLV model as projection of the LMUV model<sup>11</sup>

If the deterministic functions  $\sigma_1, \dots, \sigma_N$ , extended to the interval  $[0, \varepsilon]$  where they take the common value  $\sigma_0$ , are also continuous and bounded from below by positive constants, Brigo and Mercurio (2000) proved that the SDE

$$dS(t) = \mu(t)S(t) dt + \nu(t, S(t))S(t) dW(t) \quad (15)$$

where

$$\nu(t, y) = \sqrt{\frac{\sum_{i=1}^N \lambda_i \sigma_i^2(t) \frac{1}{V_i(t)} \exp \left\{ -\frac{1}{2V_i^2(t)} \left[ \ln \frac{y}{S_0} - M(t) + \frac{1}{2} V_i^2(t) \right]^2 \right\}}{\sum_{i=1}^N \lambda_i \frac{1}{V_i(t)} \exp \left\{ -\frac{1}{2V_i^2(t)} \left[ \ln \frac{y}{S_0} - M(t) + \frac{1}{2} V_i^2(t) \right]^2 \right\}}}$$

for  $(t, y) > (0, 0)$  and  $\nu(0, S_0) = \sigma_0$ , has a unique strong solution whose marginal density is the lognormal mixture in (2).

**Proposition.** Under the previous assumptions on the functions  $\sigma_i$ , the LMLV model is the projection of the LMUV model onto the class of local volatility models, in that (see Derman and Kani, 1998)

$$\nu^2(T, K) = E[\eta^2(T) | S(T) = K]$$

*Proof.* The equality follows from the definitions of  $\eta(t)$  and  $\nu(t, y)$  and a simple application of the Bayes rule. In fact,

$$\begin{aligned} E[\eta^2(T) | S(T) = K] &= \sum_{i=1}^N \sigma_i^2(T) Q\{\eta = \sigma_i | S(T) = K\} \\ &= \sum_{i=1}^N \frac{Q\{S(T) = K | \eta = \sigma_i\} Q\{\eta = \sigma_i\}}{\sum_{j=1}^N Q\{S(T) = K | \eta = \sigma_j\} Q\{\eta = \sigma_j\}} \end{aligned}$$

from which we can conclude by noting that  $Q\{S(T) = K | \eta = \sigma_i\}$  is the lognormal density corresponding to  $V_i(T)$  and calculated in  $K$ .  $\square$

A further analogy between the LMUV and LMLV models concerns the correlation between the asset price and its (instantaneous or average) squared volatility, which is null in both cases:

$$\begin{aligned} \text{Corr}(\nu^2(t, S(t)), S(t)) &= \text{Corr}(\eta^2(t), S(t)) = 0 \\ \text{Corr}\left(S(t), \int_0^t \eta^2(u) du\right) &= \text{Corr}\left(S(t), \int_0^t \nu^2(u, S(u)) du\right) = 0. \end{aligned}$$

<sup>11</sup>We thank Marco Avellaneda for pointing out to us this projection result.

While in the uncertain volatility case this decorrelation property follows almost by construction from independence of  $\eta$  and  $W$ , under the LMLV model it is rather counterintuitive and less straightforward, since in local volatility models volatility is a deterministic function of  $S_t$  itself and is thus much more difficult to decorrelate.<sup>12</sup>

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<sup>12</sup>A formal proof of the related result is in Brigo (2002).

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