Turbocharging Monte Carlo pricing under rough volatility

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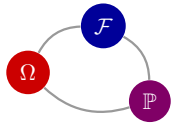
Jim Gatheral's 60th Birthday Conference
Courant Institute, New York, 14 October 2017

Joint work with Ryan McCrickerd

Imperial College London



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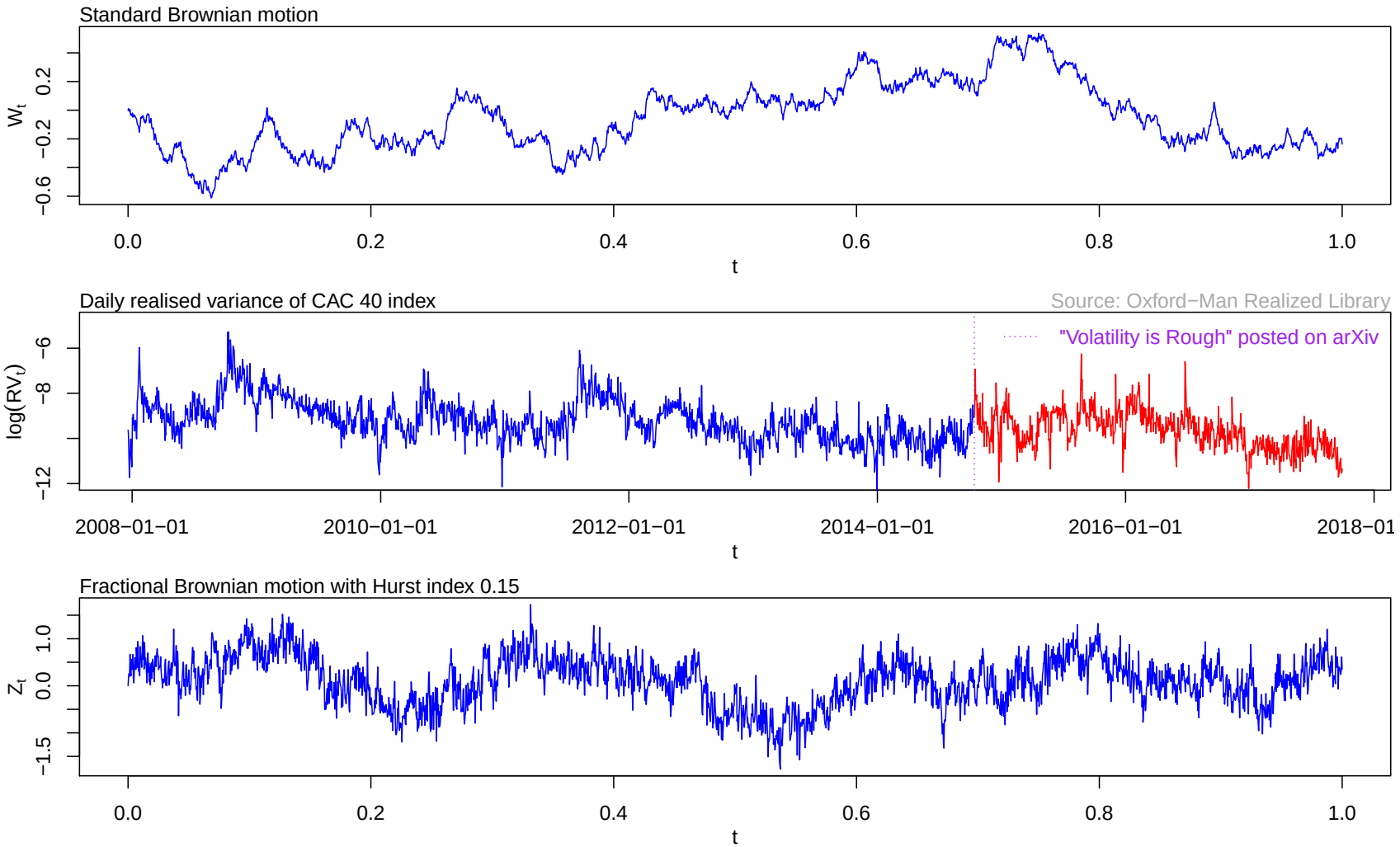
Volatility is (still) rough — 3rd anniversary!



Pricing under rough volatility

Simulating rough volatility

Variance reduction methods

The rough Bergomi model

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where W and $W^{\perp}$ are independent Brownians and $\rho \in [-1, 1]$. The spot variance V_t is a product $V_t = \xi_0(t)\mathcal{E}(\eta W^{\alpha})_t$ of

- the forward variance curve $t \mapsto \xi_0(t)$, known at time 0,
- the Wick exponential $\mathcal{E}(\eta W^{\alpha})_t = \exp\left(\eta W_t^{\alpha} - \frac{1}{2}\mathbf{Var}[\eta W_t^{\alpha}]\right)$ of a parameter $\eta > 0$ times a Gaussian random variable W_t^{α}.

The rough Bergomi model (cont.)

The random variable W_t^α follows the Gaussian Riemann–Liouville process

$$W_t^\alpha = \sqrt{2\alpha + 1} \int_0^t (t-s)^\alpha dW_s, \quad t \geq 0,$$

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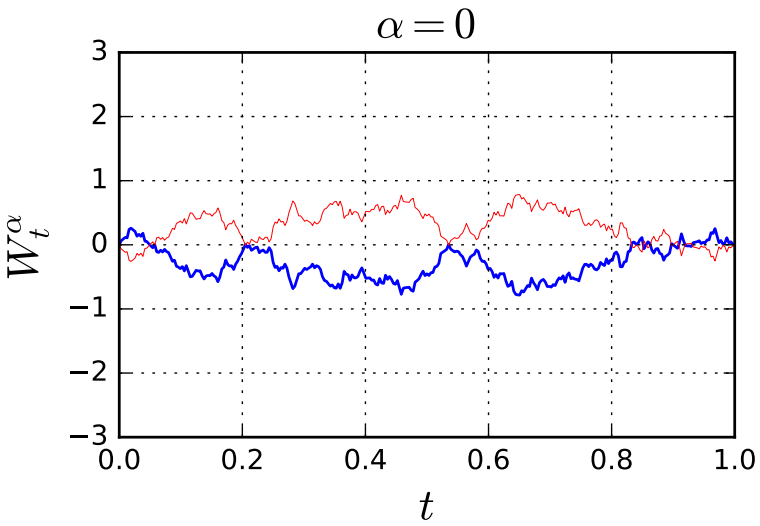
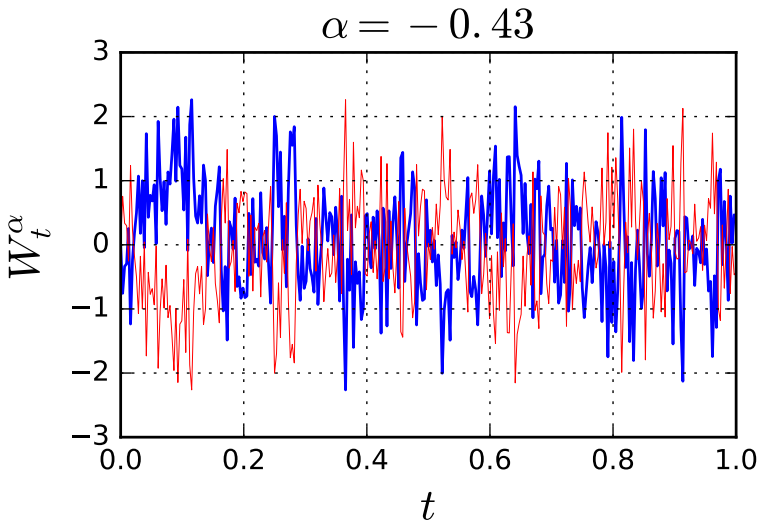
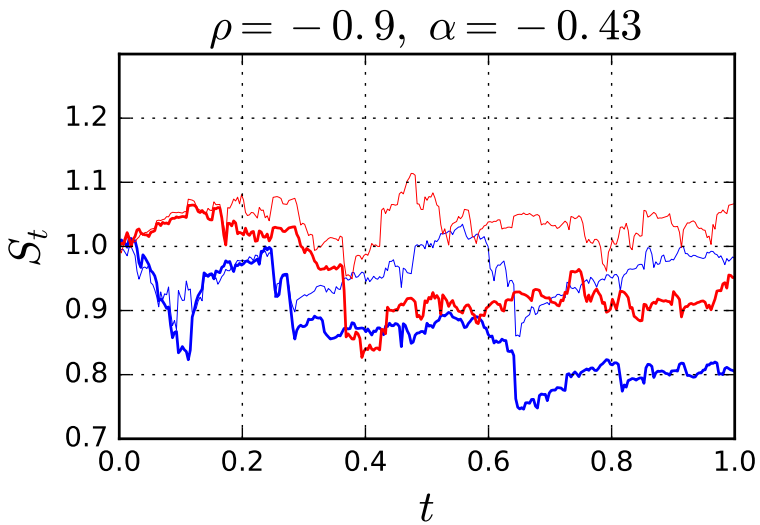
The paths of W^α have Hölder regularity $\alpha + \frac{1}{2}$ and locally look like the paths of a fractional Brownian motion with

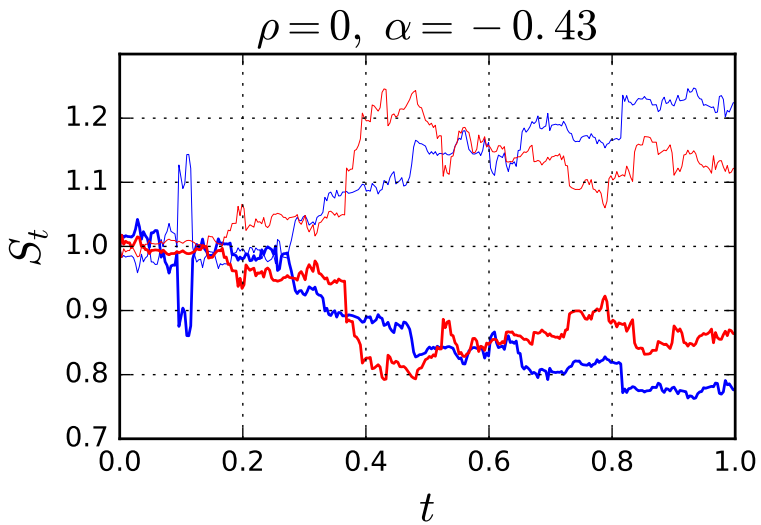
$$H = \alpha + \frac{1}{2}.$$

Example: rough Bergomi paths







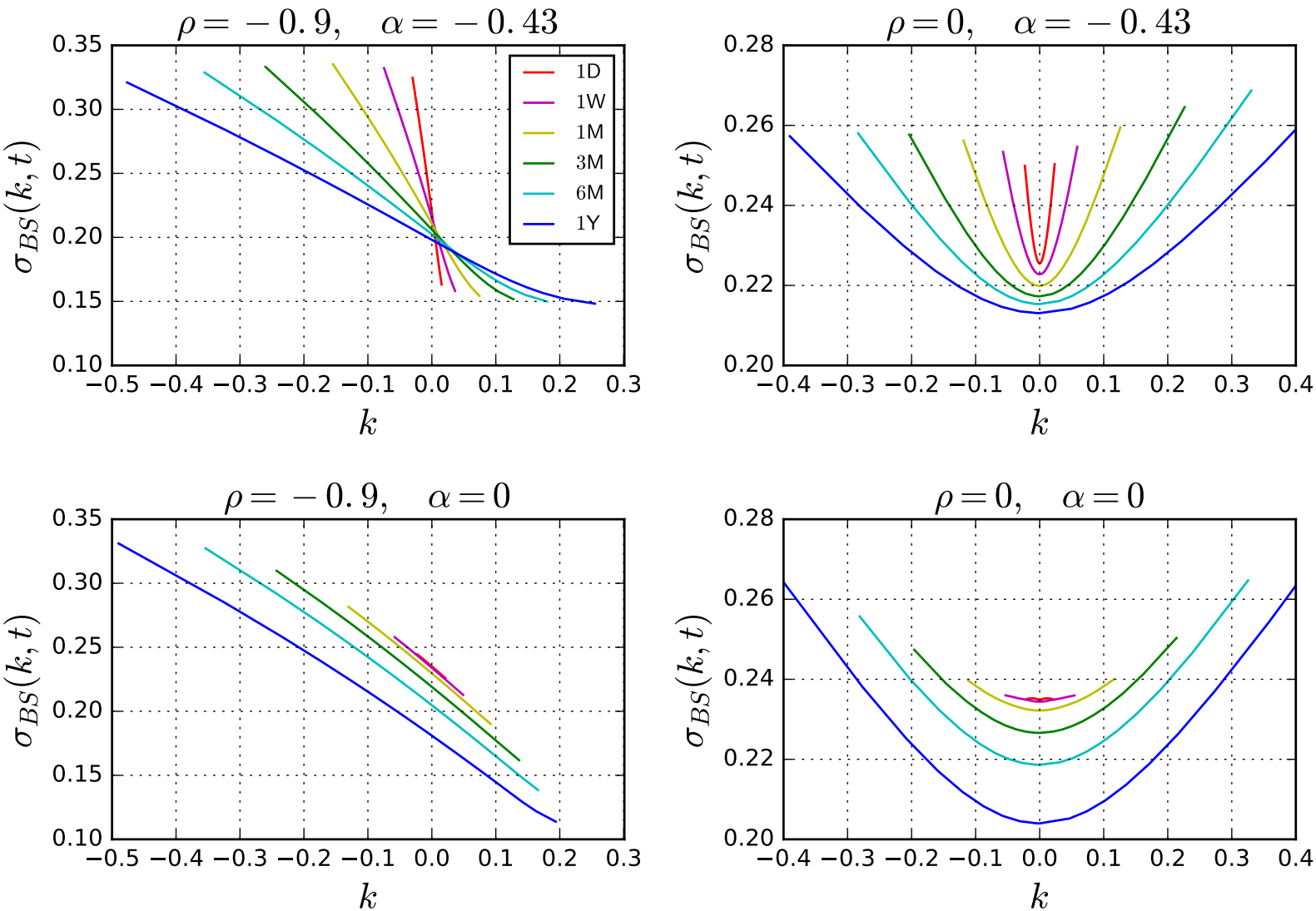


Intuition on the parameters

The rough Bergomi model has three time-homogeneous parameters, α, η, and ρ, with the following interpretations in terms of the implied volatility surface:

- η — smile,
- ρ — skew,
- α — near-maturity explosion (of smile and skew).

Example: rough Bergomi smiles



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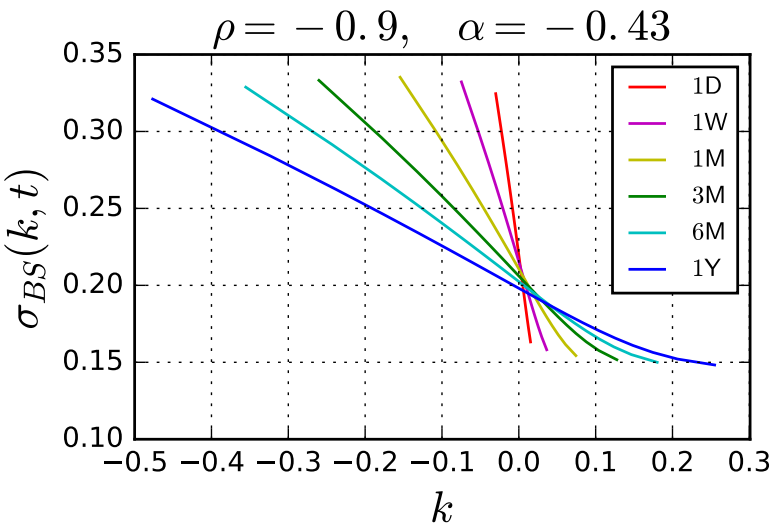

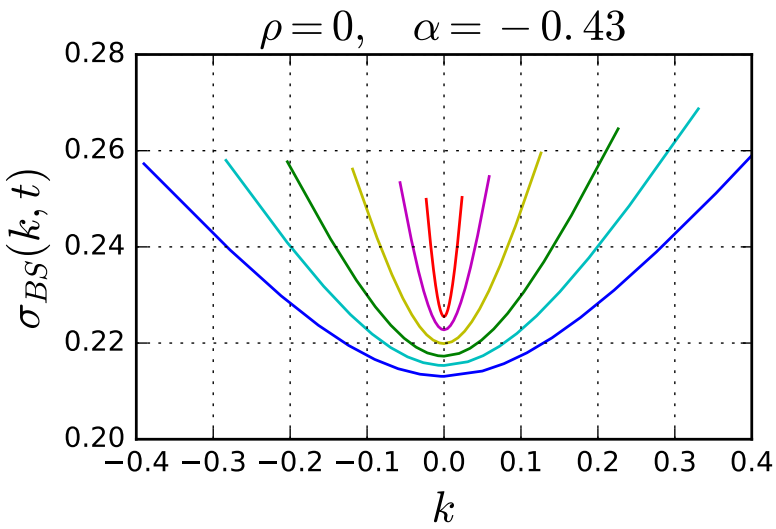

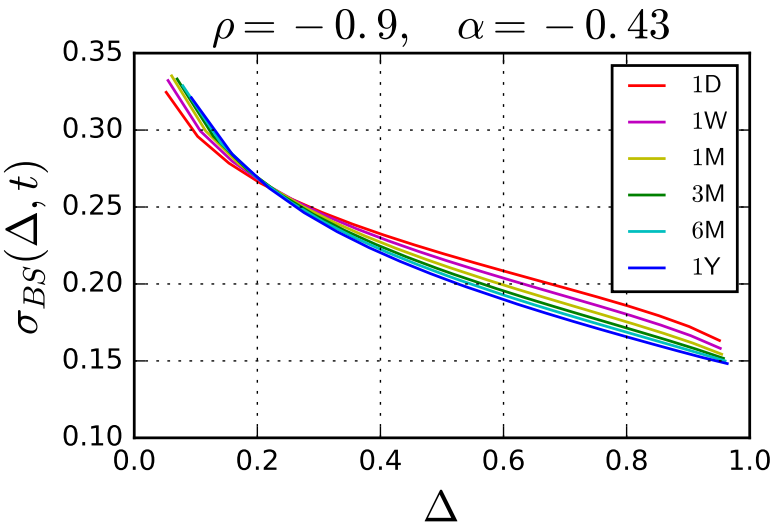

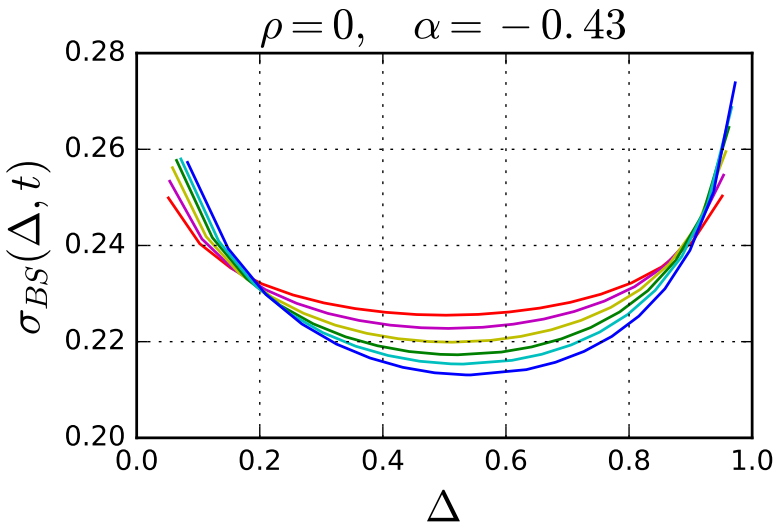

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Thus it is worthwhile to try to optimise, "turbocharge", Monte Carlo pricing as much as possible.

In general, a good Monte Carlo pricer should have:

- low bias, to avoid systematic error,
- low variance, such that good accuracy can be achieved in reasonable runtime.

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The covariance structure of (B, W^α) is not difficult to work out, so we could simulate exactly

$$\boldsymbol{X} := \left((B_0, W^\alpha_0), (B_{1/n}, W^\alpha_{1/n}), (B_{2/n}, W^\alpha_{2/n}), \ldots, (B_{\lfloor nt \rfloor/n}, W^\alpha_{\lfloor nt \rfloor/n})\right)$$

by sampling from a $2\lfloor nt \rfloor$-dimensional Gaussian distribution.

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The Cholesky factor needs to be computed only once, but subsequent realisations of $\boldsymbol{X}$ still take $\mathcal{O}(n^2)$ flops.

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$$W^\alpha_{i/n} = \sum_{k=1}^{i} \int_{\frac{i}{n}-\frac{k}{n}}^{\frac{i}{n}-\frac{k-1}{n}} \left(\tfrac{i}{n}-s\right)^\alpha dW_s \approx \sum_{k=1}^{i} \left(\tfrac{k}{n}\right)^\alpha \left(W_{\frac{i}{n}-\frac{k-1}{n}} - W_{\frac{i}{n}-\frac{k}{n}}\right) =: \widehat{W}^{\alpha,n}_{i/n}.$$

Since $\widehat{W}^{\alpha,n}_{i/n}$ is a discrete convolution, $\widehat{W}^{\alpha,n}_0, \widehat{W}^{\alpha,n}_{1/n}, \ldots, \widehat{W}^{\alpha,n}_{\lfloor nt\rfloor/n}$ can be generated (using FFT) in $\mathcal{O}(n \log n)$ flops.

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However:

- Forward Riemann sums are inaccurate since the integrand $s \mapsto \left(\frac{i}{n} - s\right)^\alpha$ has a singularity.
- This leads to biased estimates of implied volatility.

The hybrid scheme

The hybrid scheme of Bennedsen, Lunde, and Pakkanen (2017) fixes the deficiencies of forward Riemann sums by using:

$$\widetilde{W}^{\alpha,n}_{i/n} := \underbrace{\sum_{k=1}^{\kappa} \int_{\frac{i}{n}-\frac{k}{n}}^{\frac{i}{n}-\frac{k-1}{n}} \left(\tfrac{i}{n}-s\right)^{\alpha} dW_s}_{\text{exact for } \kappa \text{ slices}} + \underbrace{\sum_{k=\kappa+1}^{i} \left(\tfrac{b_k}{n}\right)^{\alpha} \left(W_{\frac{i}{n}-\frac{k-1}{n}} - W_{\frac{i}{n}-\frac{k}{n}}\right)}_{\text{Riemann sum for the rest}},$$

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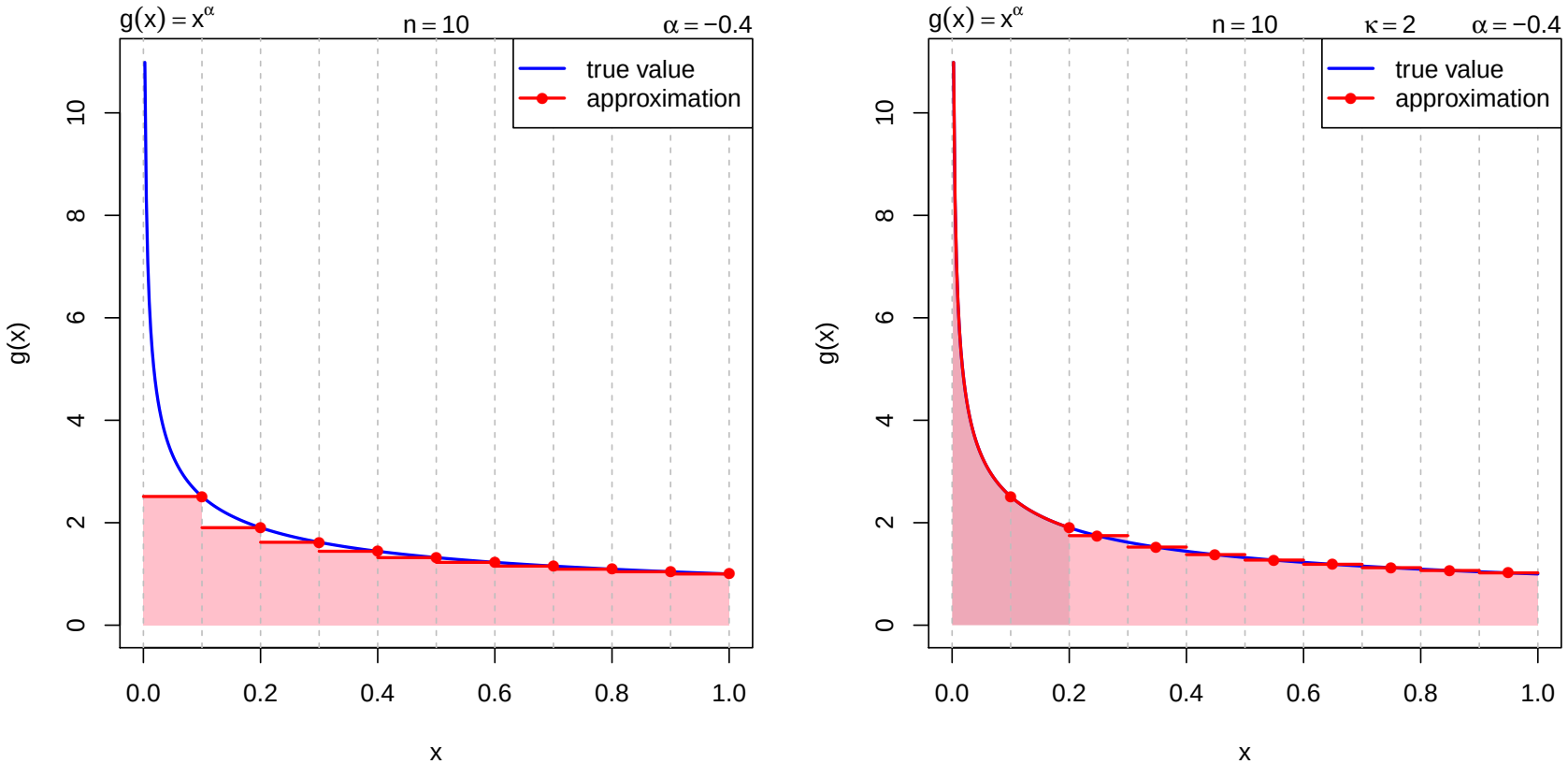
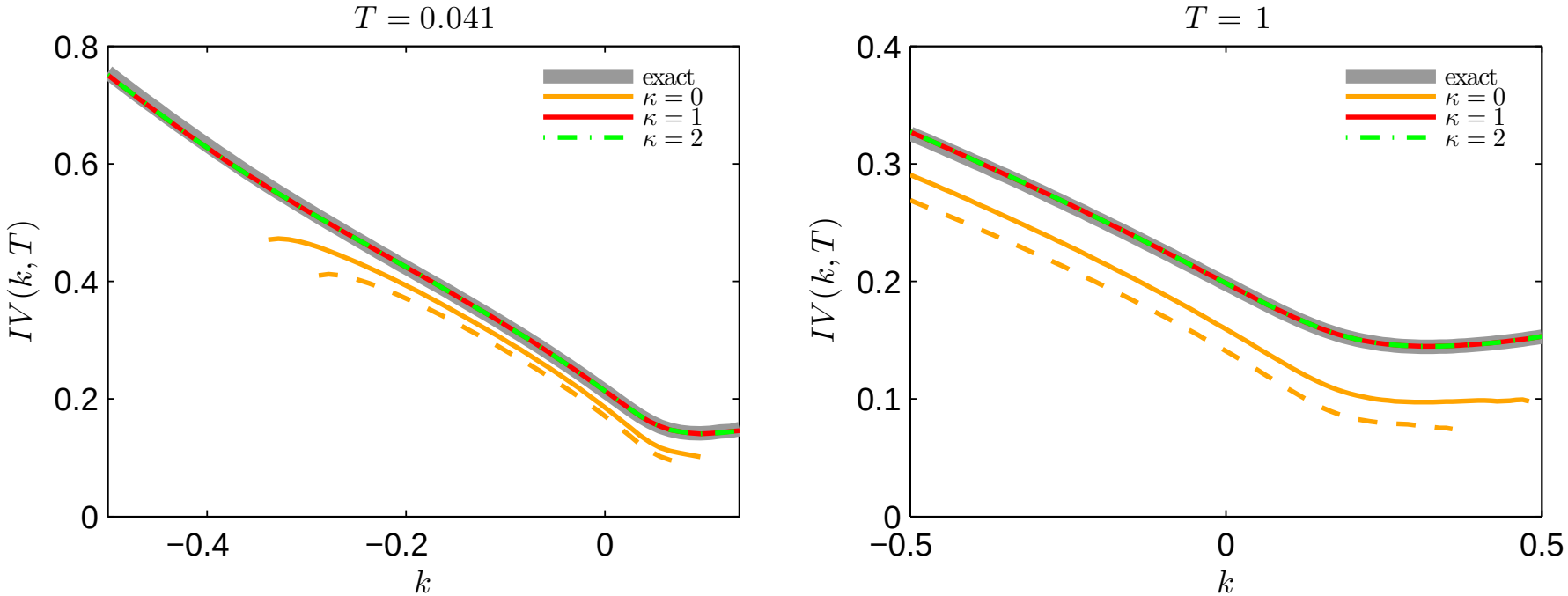
Again, this requires only $\mathcal{O}(n \log n)$ flops.

Approximating $x \mapsto x^{\alpha}$



Forward Riemann sums vs. the hybrid scheme

Numerical results: implied volatility smiles



Solid/patterned line: optimal b_k
Dashed line: $b_k = k$.

S_0	$\xi_0(t)$	η	α	ρ	n	paths
1	0.235^2	1.9	−0.43	−0.9	500	10^6

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Variance reduction methods

Towards variance reduction

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To this end, we work with price estimators of the form

$$\hat{P}_n(k,t) := \frac{1}{n}\sum_{i=1}^{n}(X_i - \hat{\alpha}_n Y_i) - \hat{\alpha}_n \mathbf{E}[Y],$$

where $(X_1, Y_1), \ldots, (X_n, Y_n)$ are identical copies of a random vector (X, Y) and $\hat{\alpha}_n$ is a free parameter, to be defined shortly.

Base estimator

Our reference estimator, which we call the Base estimator, uses

$$X := f(S_t) := \begin{cases} (S_t - S_0 e^k)^+, & k \geq 0, \\ (S_0 e^k - S_t)^+, & k < 0, \end{cases}$$

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Without loss of generality, assume $S_0 = 1$.

Mixing formula

The well-known result of Romano and Touzi (1997) implies that

$$\mathbf{E}[f(S_t)] = \mathbf{E}\left[\mathrm{BS}\left((1-\rho^2)\int_0^t V_s ds, S_t^W, k\right)\right],$$

where BS is the appropriate Black–Scholes function,
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This suggests that we could use

$$X := \mathrm{BS}\left((1-\rho^2)\int_0^t V_s ds, S_t^W, k\right).$$

This method alone is rather effective in reducing variance when $\rho \approx 0$, but its benefits evaporate as $\rho \to -1$.

Control variate

Inspired by the idea of Bergomi (2016) of using a timer option as a control variate, we choose

$$Y := \mathrm{BS}\left(\rho^2\left(\hat{Q}_n - \int_0^t V_s ds\right), S_t^W, k\right),$$

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By a martingale argument,

$$\mathbf{E}[Y] = \mathrm{BS}(\rho^2 \hat{Q}_n, 1, k)$$

Mixed estimator

Our "turbocharged" Mixed estimator (McCrickerd and Pakkanen, 2017) is given by

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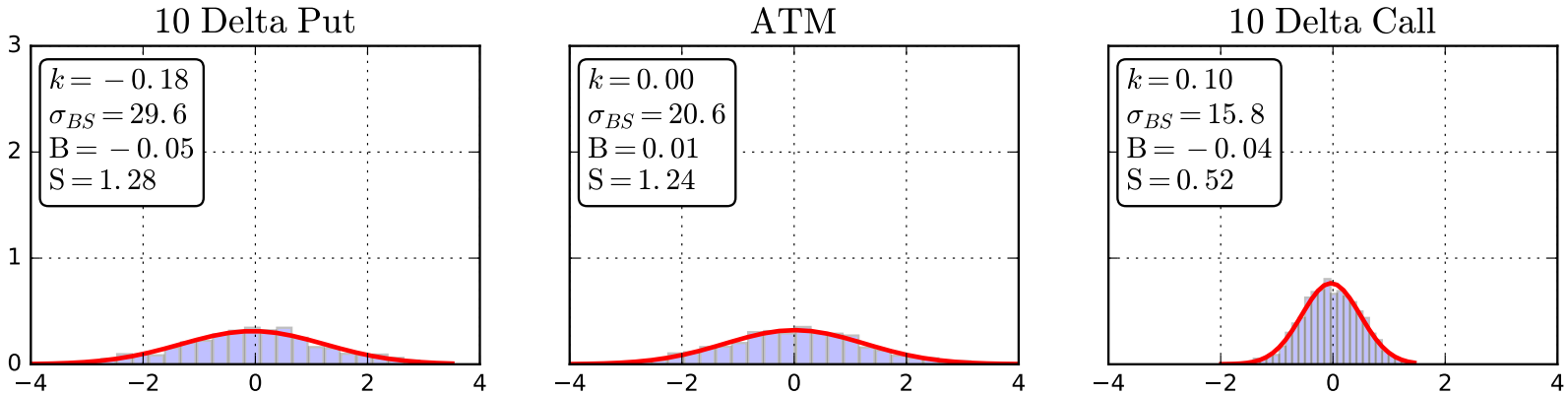
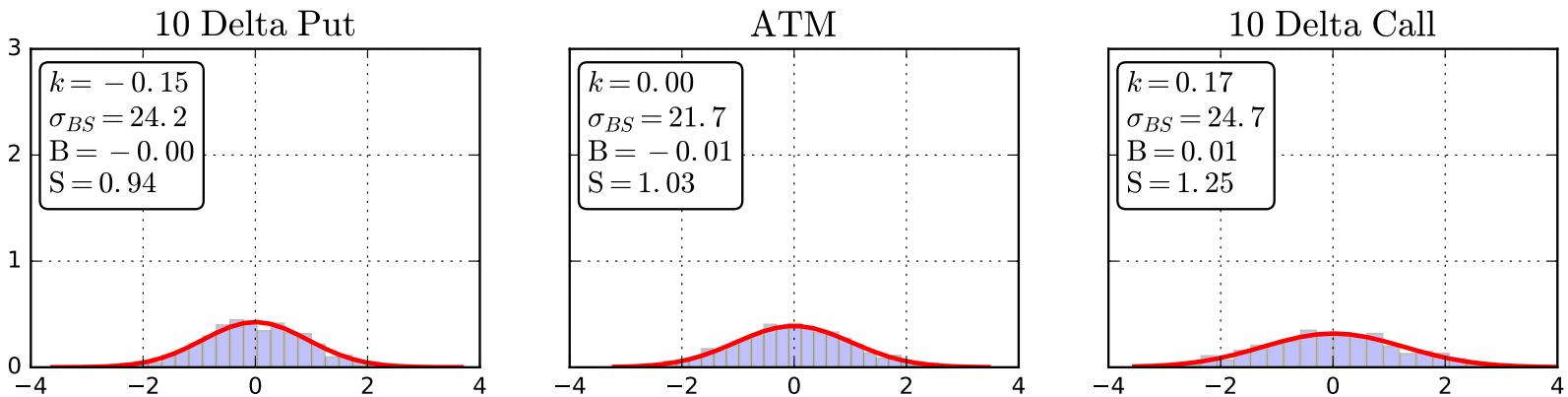
Additionally, we couple (X_{2i-1}, Y_{2i-1}) and (X_{2i}, Y_{2i}) for any $i \geq 1$ by using antithetic pairs (B, W) and $(-B, -W)$ as drivers.

Numerical results: Base estimator



Base error : $100(\hat{\sigma}^n_{BS\,i} - \sigma_{BS})$. $\rho = -0.9$, $n = 1000$, $\tau = 114.4ms$, $N = 1000$, $\psi^2 = 131.4$



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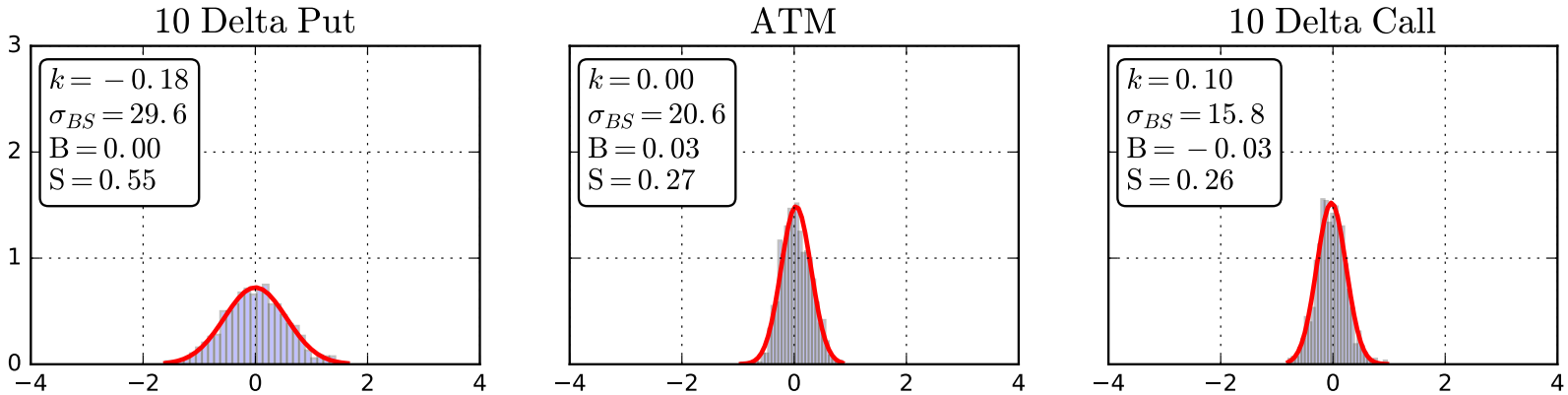
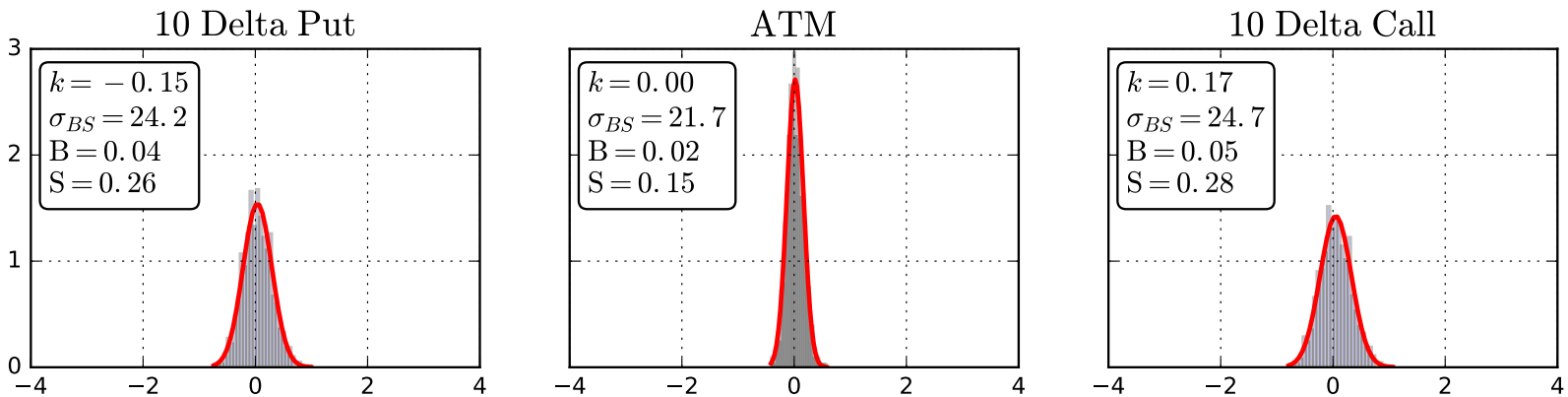


Mixed error : $100(\hat{\sigma}^n_{BS\,i} - \sigma_{BS})$. $\rho = -0.9$, $n = 1000$, $\tau = 70.6ms$, $N = 1000$, $\psi^2 = 10.4$



Mixed error : $100(\hat{\sigma}^n_{BS\,i} - \sigma_{BS})$. $\rho = -0.0$, $n = 1000$, $\tau = 69.8ms$, $N = 1000$, $\psi^2 = 3.9$

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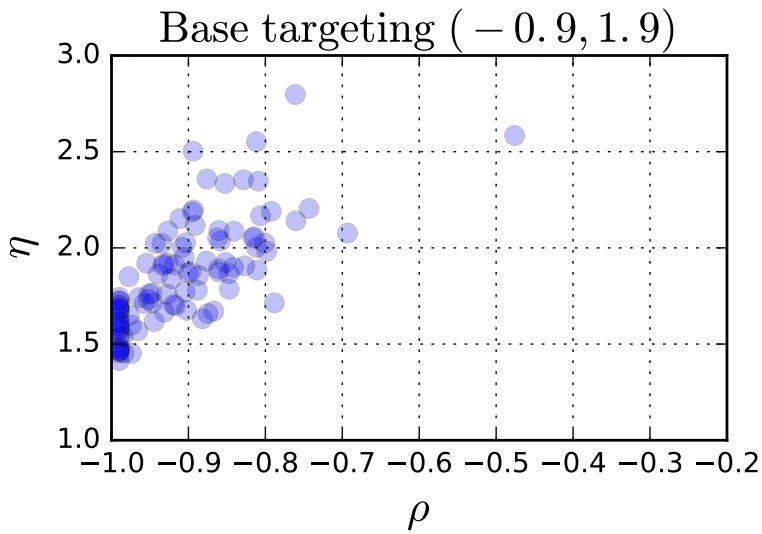
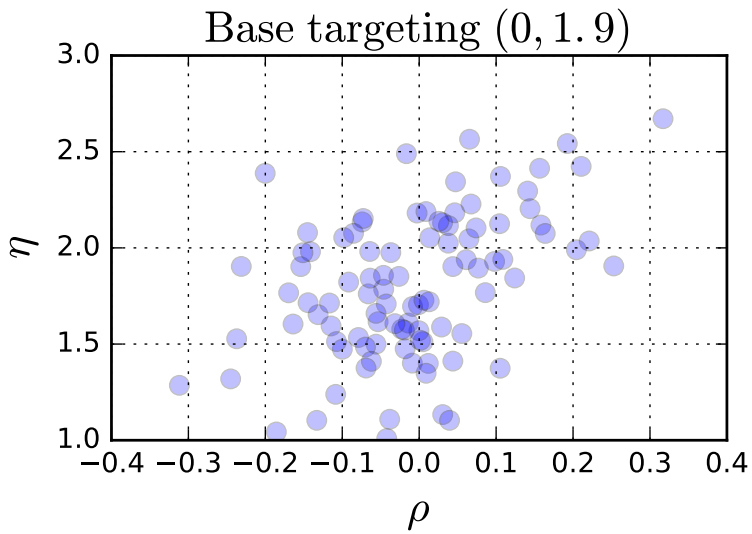
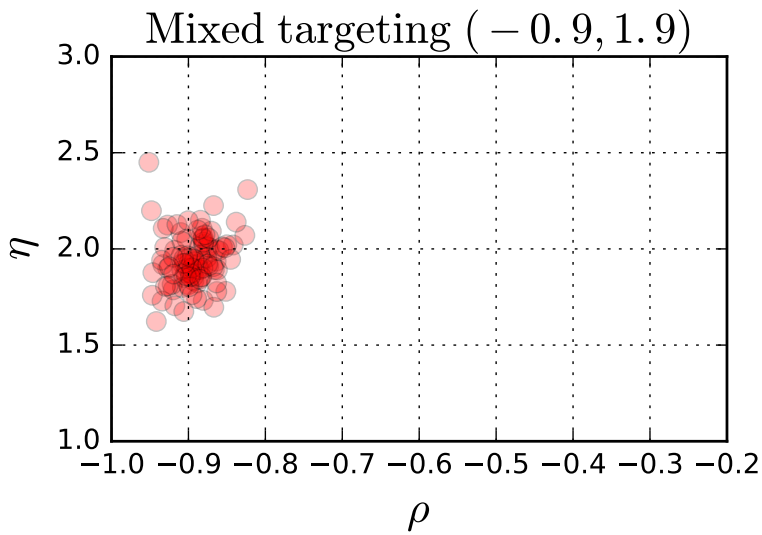
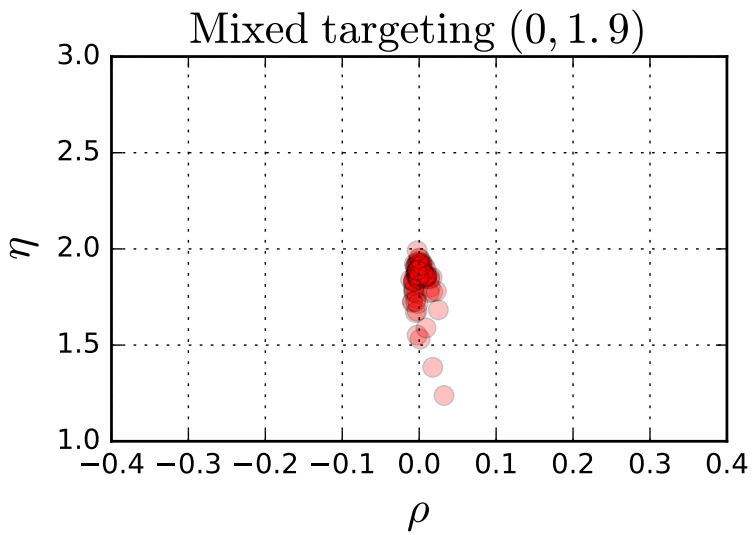
Throughout the experiment, we use $n = 1\,000$.

Numerical results: calibration experiment









Some alternative variance reduction methods

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- Importance sampling — seems unattractive as it would need to be tuned strike by strike.
- Quasi Monte Carlo (Sobol sequences etc) — applicable and useful here, albeit the speed-up appears not to be dramatic.

References


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Implementation

Python implementation of turbocharged pricing along with a Jupyter notebook are available from:

https://github.com/ryanmccrickerd/roughbergomi

Finally...

Happy birthday Jim!