Model-based pricing for financial derivatives

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\section*{Abstract}
Assume that $S_t$ is a stock price process and $B_t$ is a bond price process with a constant continuously compounded risk-free interest rate, where both are defined on an appropriate probability space $P$. Let $y_t = \log(S_t/S_{t-1})$. $y_t$ can be generally decomposed into a conditional mean plus a noise with volatility components, but the discounted $S_t$ is not a martingale under $P$. Under a general framework, we obtain a risk-neutralized measure $Q$ under which the discounted $S_t$ is a martingale in this paper. Using this measure, we show how to derive the risk neutralized price for the derivatives. Special examples, such as NGARCH, EGARCH and GJR pricing models, are given. Simulation study reveals that these pricing models can capture the “volatility skew” of implied volatilities in the European option. A small application highlights the importance of our model-based pricing procedure.

\section*{1. Introduction}
After the seminal work of Black and Scholes (1973) and Merton (1973), there has been explosive growth in the trading activities on derivatives in the worldwide financial markets. A fundamental question in finance is how we give a fair price for the derivative, whose payoff is on the evolution of an asset price upon which the derivative is written. Black and Scholes (1973) first fairly valued the option according to the principle of “the absence of arbitrage”. Their valuation method relies on “efficient market hypothesis”, under which there exists a risk-neutralized probability measure such that the discounted asset price is a martingale, and then a fair price of the derivative is the expected discounted value of its future payoff under this measure. Particularly, the risk-neutralized measure is not unique when the market is incomplete. For more discussions on the principle of “the absence of arbitrage”, we refer to Harrison and Kreps (1979) and Harrison and Pliska (1981).

Although Black and Scholes’s (1973) pricing model (hereafter, BS model) has achieved a great success in finance, it exhibits some systematic bias. The well-documented evidence is the so-called “volatility smile” in Rubinstein (1985) and Sheikh (1991), from which one may concern that the homoskedastic assumption on an asset return (that is, the asset return follows a geometric Brownian motion) is not reliable any more. This motivates people to use other heteroskedastic stochastic processes to model the asset return. The related works in this field are Cox (1975), Merton (1976), Hull and White (1987), Stein and Stein (1991), Heston (1993), and Xiu (2014) to name a few; see also Bates (2003) or Broadie and Detemple (2004) for an overview in this framework.

In this paper, we model the asset return by a discrete stochastic process under the physical probability measure $P$, which can be decomposed into the conditional mean part plus a noise with volatility components. In this case, the discounted asset price is not a martingale under $P$. By using the method in Gerber and Shiu (1994), we first construct a risk-neutralized Esscher measure $Q$, under which the discounted asset price is a martingale. Next, we give the structure of our stochastic process of an asset return under $Q$, when the conditional distribution of the innovation is normal, shift negative gamma, and shift negative inverse gaussian, respectively. Particularly, the option pricing models in Duan (1995), Siu et al. (2004), and Christensen et al. (2006) can be easily retrieved from our method. Furthermore, we propose a model-based Monte Carlo pricing procedure and apply it to some special examples, such as NGARCH, EGARCH and GJR pricing models. Simulation study reveals that these pricing models can capture the “volatility skew” of implied volatilities in the European option. A small application highlights the importance of our model-based pricing procedure.

The remainder of the paper is organized as follows. In Section 2, we introduce a risk-neutralized Esscher measure $Q$. In Section 3, we consider the processes for asset return under $Q$. A model-based Monte Carlo procedure with application to some pricing models is given in Section 4. Simulation study is reported in Section 5. A small
application is given in Section 6. Concluding remarks are offered in Section 7.

2. Risk-neutralized Esscher measure

Let \( \{S_t : t = 0, 1, \ldots \} \) be an asset price process and \( B_t \) be a bond price process with a constant continuously compounded risk-free interest rate \( r \), where both are defined on the probability space \( (\Omega, P, \mathcal{F}) \). Assume that the log-return of \( S_t \) follows a discrete stochastic process under the physical probability measure \( P \), i.e.,

\[
y_t = \log \frac{S_t}{S_{t-1}} \quad \text{and} \quad y_t = \mu_t + \eta_t \sqrt{h_t}, \quad \text{under } P,
\]

where \( \eta_t | \mathcal{F}_{t-1} \sim D(0, 1) \), \( D(0, 1) \) denotes some distribution \( F(\cdot) \) with zero mean and unit variance, and \( \mathcal{F}_t \) is the information set up to time \( t \); \( \mu_t \in \mathcal{F}_{t-1} \) and \( h_t \in \mathcal{F}_{t-1} \) are the conditional mean and the conditional variance of \( y_t \), respectively. Process (2.1) gives us enough freedom to model the asset return, and most importantly it includes the ARCH-type models originally introduced by Engle (1982). Nowadays, the ARCH-type models are widely used to analyze economic time series with time-varying volatility; see, e.g., Bollerslev et al. (1992), Berkes et al. (2003), and França and Zakoïan (2010). Since the price of the derivative is sensitive to the volatility of its underlying asset, the ARCH-type model which provides a good prediction on volatility is applicable to value the derivative; see, e.g., Engle and Mustafà (1992), Duan (1995), Ritchken and Trevor (1999), Heston and Nandi (2000), Christoffersen and Jacobs (2004), Garcia et al. (2010), and many others.

Next, we use the method in Gerber and Shiu (1994) to get a risk-neutralized measure, under which the discounted process \( e^{-rt}S_t : t = 0, 1, \ldots \) is a martingale. First, let \( M_t(z) \) be the conditional moment-generating function of \( y_t \), given \( \mathcal{F}_t \), i.e.,

\[
M_t(z) = \mathbb{E}[e^{z y_t} | \mathcal{F}_{t-1}] = \int_{-\infty}^{\infty} e^{zx} \mathbb{P}\left( y_t = x | \mathcal{F}_{t-1} \right) dx.
\]

Second, we define a sequence of the conditional distribution functions as follows:

\[
\mathbb{E}_t(u | \mathcal{F}_{t-1}) \equiv \mathbb{E}_t \left[ \mathbb{I}\{y_t \leq u\} e^{z y_t} | \mathcal{F}_{t-1} \right] = \frac{1}{M_t(\theta_t)} \int_{-\infty}^{u} e^{z x} dF(x | \theta_t),
\]

where \( \mathbb{I}\{\cdot\} \) is the indicator function and \( \theta_t \in \mathcal{F}_{t-1} \) be determined subsequently. Furthermore, we define a sequence of conditional distribution functions \( Q_t : t = 1, 2, \ldots \) on \( (\Omega, \mathcal{F}_t) \):

\[
Q_t(y_t \leq u : i = 1, 2, \ldots, t) = \int_{-\infty}^{u} \int_{-\infty}^{\infty} \cdot \cdots \cdot \int_{-\infty}^{\infty} \prod_{i=1}^{t} \mathbb{E}_i(du_i | \mathcal{F}_{i-1}).
\]

Obviously, \( \{Q_t : t = 1, 2, \ldots \} \) is consistent, i.e.,

\[
Q_t(y_t \leq u : i = 1, 2, \ldots, t) = Q_{t+1}(y_{t+1} \in R, y_t \leq u : i = 1, 2, \ldots, t).
\]

By Kolmogorov extension theorem, there exists a probability \( Q \) on \( (\Omega, \mathcal{F}) \) such that

\[
Q(y_t \leq u : i = 1, 2, \ldots, t) = Q(y_t \leq u : i = 1, 2, \ldots, t)
\]

for all \( t \) and \( u \), where \( \mathcal{F} = \sigma(\bigcup_{i=1}^{\infty} \mathcal{F}_i) \). Thus, we have

\[
Q(y_t \leq u) = Q(y_t \leq u) = \int_{-\infty}^{\infty} \cdots \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} \cdot \cdots \cdot \int_{-\infty}^{\infty} \prod_{i=1}^{t} \mathbb{E}_i(du_i | \mathcal{F}_{i-1}).
\]

Finally, it is worth noting that by (2.2) and (2.4), we have

\[
M_t(z) = \mathbb{E}_t \left[ e^{z y_t} | \mathcal{F}_{t-1} \right] = \int_{-\infty}^{\infty} e^{zx} \mathbb{P}\left( y_t = x | \mathcal{F}_{t-1} \right) dx.
\]

Thus, under \( Q \), \( \{e^{-rt}S_t : t = 0, 1, \ldots \} \) is a martingale if \( e^{-rt}M_t(1) = 1 \), i.e.,

\[
M_t(1 + \theta_t) = e^\theta \quad \text{for all } t = 0, 1, \ldots.
\]

Now, if Eq. (2.4) has a unique solution \( \theta_t \), the martingale measure \( Q \) associated with this \( \theta_t \) is called the risk-neutralized Esscher measure by Proposition 2.6 in Harrison and Pliska (1981), a fair price of any derivative at current time \( t \), denoted by \( V_t \), can be calculated as

\[
V_t = \mathbb{E}_Q \left[ e^{-r(\tau - t)}W(S_j; j \leq T) | \mathcal{F}_{t-1} \right],
\]

where \( W(S_j; j \leq T) \) is the payoff of this derivative at future time \( T \). Note that

\[
S_j = S \exp \left( \sum_{i=t+1}^{j} y_i \right).
\]

So, to calculate (2.5), it is necessary for us to consider \( y_t \) under \( Q \).

Finally, it is worth noting that by (2.2) and (2.4), we have

\[
M_t \left[ e^\theta \cdot Z_{t-1} | \mathcal{F}_{t-1} \right] = 1 \quad \text{and} \quad \mathbb{E}_Q \left[ e^{\theta \cdot Z_{t-1}} | \mathcal{F}_{t-1} \right] = 1,
\]

where \( Z_{t-1} = e^{\theta \cdot y_t} \left( \mathbb{E}_t \left[ e^{\theta \cdot (y_t + \eta_t)} | \mathcal{F}_{t-1} \right] \right)^{-1} \). Thus, our method to construct \( Q \) can be viewed as a special case of stochastic discount factor (SDF) methods with SDF equals \( Z_{t-1} \). Particularly, Chorro et al. (2012) used the SDF method to get the same martingale measure \( Q \) as ours, and they further applied it to get the ARCH-type option pricing model when \( \eta_t \) is conditional generalized hyperbolic distributed. For more discussions on SDF methods, we refer to Jagannathan and Wang (2001), Smith and Wickens (2002), Monfort and Pegoraro (2011), and references therein.

3. Processes for an asset return under \( Q \)

After the empirical studies in Mandelbrot (1963), Fama (1965), Bollerslev (1987), and Bollerslev et al. (1992), the valuation of the derivative with non-normal innovation has drawn more and more attentions. For example, Duan (1999) and Christoffersen et al. (2010) studied the case when the conditional innovation is a generalized error distribution; Siu et al. (2004) explored an option pricing model when the conditional innovation has a gamma distribution; and Christoffersen et al. (2006) gave an analytic pricing form when the conditional innovation has an inverse gaussian distribution; see also Chorro et al. (2012), Xi (2013), and references therein.

In this section, we consider the processes of an asset return under \( Q \) when \( \eta_t \) is conditionally normal, shift negative gamma
(SNG) or shift negative inverse gaussian (SNIG) distributed. When \( \eta_t \) is conditionally normal distributed, we retrieve the result in Duan (1995). When \( \eta_t \) is conditionally SNG or SNIG distributed, the Gamma-GARCH process in Siu et al. (2004) or IG-GARCH process in Christoffersen et al. (2006) can also be easily derived, respectively. Meanwhile, it is worth noting that our method is different from Duan’s (1999) method for dealing with a non-normal innovation \( \eta_t \). The method in Duan (1999) needs to transform the non-normal innovation into another innovation which is standard normal with a shift in mean under the local risk-neutralized measure. However, our method skips that transformation and keeps the distribution of the non-normal innovation unchanged under the risk-neutralized Esscher measure \( \mathcal{Q} \). It not only seems to be more reasonable, but avoids the cumbersome numerical problem arisen from the transformation as shown in Duan (1999) and Christoffersen et al. (2010).

3.1. Normal innovation

Suppose that \( \eta_t | \mathcal{F}_{t-1} \sim N(0, 1) \). Then, we have

\[
M_t(z) = \exp \left( z \mu_t + \frac{z^2 h_t}{2} \right).
\]

By (2.4), it follows that

\[
\theta_t = \frac{1 - \mu_t}{h_t} - \frac{1}{2}.
\]

With this specified \( \theta_t \) and relation (2.3), we have

\[
M_t^{(q)}(z) = \exp \left[ \frac{z \left( \mu_t + \frac{\sqrt{a_t h_t}}{h_t} \right) - z^2 h_t}{2 \left( 1 + z/b_t \right)^{q_t}} \right], \quad \text{for } z > -b_t.
\]

Thus, under \( \mathcal{Q} \),

\[
y_t = \mu_t + \varepsilon_t, \quad (3.3)
\]

where \( \varepsilon_t = \sqrt{a_t h_t} + \varepsilon_t^* \) with \( \varepsilon_t^* | \mathcal{F}_{t-1} \sim -\mathcal{N}(a_t, b_t) \).

Particularly, when \( \mu_t = r + \sqrt{h_t}/h_t/2 \) and \( h_t = \omega + \alpha \varepsilon_t^* + \beta h_{t-1} \), with \( \eta_t = (\varepsilon_t - a_t) / \sqrt{a_t} \) and \( \mathcal{N}(a_t, b_t) \sim G(a, b) \) for some constant \( a > 0 \), by (3.2), we have under \( P \),

\[
y_t = r + \sqrt{h_t}/h_t/2 + \varepsilon_t, \quad (3.4)
\]

and by using the same method as for (3.3), we have under \( \mathcal{Q} \),

\[
y_t = r + \sqrt{h_t}/h_t/2 + \varepsilon_t, \quad (3.5)
\]

where

\[
b_t^* = \left[ 1 - \exp \left( \frac{\sqrt{h_t}/h_t/2 - \sqrt{a_t}}{a} \right) \right]^{-1}.
\]

Models (3.4)–(3.5) are the Gamma-GARCH models in Siu et al. (2004).

3.3. SNIG innovation

Suppose that \( \eta_t = (\varepsilon_t + \delta_t)/\sqrt{a_t} \), where \( \varepsilon_t \in \mathcal{F}_{t-1} \) is positive, \( \xi_t | \mathcal{F}_{t-1} \sim -\mathcal{N}(a_t, 1) \), and \( \mathcal{N}(\delta) \) is a random variable having the density function

\[
g(\delta) = \frac{\delta}{2(2\pi)^{3/2}} \exp \left\{ \frac{-(\delta - \theta)^2}{2x} \right\}, \quad \text{for } x > 0;
\]

see Barndorff-Nielsen (1998). In this case, we call that \( \eta_t \) is conditionally SNIG distributed, and denote it by \( \eta_t | \mathcal{F}_{t-1} \sim \text{SNIG}(a_t) \). As for the SNK case, the conditional skewness and kurtosis of \( \eta_t \) are both time-varying in this case, and they satisfy

\[
skew(\eta_t | \mathcal{F}_{t-1}) = -3 \delta_t^{-1/2} \quad \text{and} \quad kurt(\eta_t | \mathcal{F}_{t-1}) = 9 \delta_t^{-2},
\]

respectively. When \( \eta_t | \mathcal{F}_{t-1} \sim \text{SNIG}(\delta_t) \), model (2.1) reduces to

\[
y_t = \mu_t + \varepsilon_t \quad \text{under } P, \quad (3.6)
\]

where \( \varepsilon_t = \sqrt{b_t} h_t + \sqrt{h_t}/h_t \xi_t \). Furthermore, by (2.2)–(2.4), a direct calculation gives us

\[
M_t^{(q)}(z) = \exp \left\{ \left( \mu_t + \frac{\sqrt{b_t h_t}}{h_t} \right) z \right\}
\]

\[
+ \delta_t \left[ 1 + 2 \left( \frac{h_t}{b_t} \theta_t - 1 + 2 \frac{h_t}{b_t} \left( z + \theta_t \right) \right) \right],
\]

where \( \theta_t \in \mathcal{F}_{t-1} \) satisfies

\[
1 + 2 \frac{h_t}{b_t} \theta_t = \frac{1}{4} \left( r - \mu_t + \frac{\sqrt{b_t h_t}}{h_t} - \frac{2 \sqrt{b_t h_t}}{\sqrt{r - \mu_t - \sqrt{h_t}}} \right)^2 \leq c_t.
\]

Thus, it follows that

\[
y_t = \mu_t + \varepsilon_t \quad \text{under } \mathcal{Q}, \quad (3.7)
\]
where $\varepsilon_t^* = \sqrt{h_t} + \xi_t^{-1}\sqrt{h_t}/\delta_t \xi_{t-1}$ with $\xi_t^* \sim IG(\sqrt{c_t} \delta_t)$.

Particularly, when $\mu_t = r + \lambda h_t$ and $h_t = \omega + \alpha h_{t-1} + \beta \xi_{t-1} + \gamma h_{t-1}^2/\xi_{t-1}$, with $\xi_t^* \sim IG(\delta_t)$ and $\delta_t = h_t/\eta$ for some $\eta > 0$, by (3.6), we have under $P$,

$$y_t = r + v_{t-1} - \eta \xi_t,$$
$$h_t = \omega + \alpha h_{t-1} + \beta \xi_{t-1} + \gamma h_{t-1}^2/\xi_{t-1},$$

where $v = \lambda + 1/\eta$; and by (3.7), we have under $Q$,

$$y_t = r + v^* \xi_t^* - \eta \xi_t^*,$$
$$h_t = \omega^* + \alpha^* h_{t-1} + \beta^* \xi_{t-1} + \gamma^* h_{t-1}^2/\xi_{t-1},$$

where $\xi_{t-1}^* \sim IG(\eta^*/\nu^2)$, $\xi_t^* = c_t \xi_t$, $h_t = h_t/\epsilon^{1/2}$, $\nu^* = \nu^{1/2}$, $\eta^* = \eta/\epsilon$, $o^* = \omega/\epsilon^{1/2}$, $\beta^* = \beta/\epsilon^{1/2}$, $\gamma^* = \gamma/\epsilon^{1/2}$ and $c = \{1/(\nu^2) - (\nu^2)/4\}^{1/2}$. Models (3.8)–(3.9) are the IG-GARCH models in Christoffersen et al. (2006).

4. Model-based pricing procedure

In this section, we give a model-based pricing procedure to calculate $V_t$ in (2.5). Since $V_t$ has no closed form in general, our pricing procedure is fulfilled by Monte Carlo method as follows:

Step 1. Fit the historical data set $\{y_t\}_{t\leq T}$ by a specified model in (2.1) under $P$;

Step 2. Obtain the corresponding fitted model under $Q$;

Step 3. Generate a sequence of data set $\{y_t\}_{t=1}^N$ from the fitted model in Step 2, and then obtain a value of $V_t$ through

$$v_t = e^{-\tau t(t-1)} W(S_t; j \leq T),$$

where $S_t$ is calculated from (2.6);

Step 4. Repeat Step 3 by $N$ times to get a sequence $\{v_t^{(i)}\}_{i=1}^N$, and eventually approximate $V_t$ by

$$\hat{V}_t = \frac{1}{N} \sum_{i=1}^N v_t^{(i)}.$$

Clearly, the value of $\hat{V}_t$ is model-based, because we need to choose a specified pricing model in Step 1. For $\mu_t$ in (2.1), the usual choices are the GARCH–in–mean (GIM) model in Duan (1995) and ARMA model. For the conditional variance $h_t$ in (2.1), we can choose it from the ARCH family or other nonlinear models as long as $h_t > 0$ and $h_t \in \mathbb{R}^N$. Some special choices are the nonlinear NGARCH model in Engle and Ng (1993), EGARCH model in Nelson (1991), and GJR model in Glosten et al. (1993). These three models are to capture the “leverage effect” in volatility (see, e.g., Rubinstein (1994) and Xiu (2014)), and their practical usefulness in asset pricing has been verified in Schmitt (1996), Heston and Nandi (2000), Duan and Zhang (2001), Barone-Adesi et al. (2008), and many others.

4.1. GIM-type pricing models

In this subsection, we give three price models when $\mu_t$ in (2.1) is the GIM model.

Example 4.1 (GIM-NGARCH Pricing Models). Suppose $\mu_t$ in (2.1) follows a GIM model and $h_t$ in (2.1) follows a NGARCH(1, 1) model, i.e., under $P$,

$$y_t = r + v \sqrt{h_t} - h_t/2 + \varepsilon_t,$$
$$\varepsilon_t = \eta \sqrt{h_t},$$
$$h_t = \omega + \alpha (\varepsilon_{t-1} - \theta \sqrt{h_{t-1}})^2 + \beta h_{t-1},$$

where $v$ is the unit risk premium, $\omega, \alpha, \beta > 0$, $\beta \in (0, 1)$, and $\eta, \varepsilon_{t-1} \sim N(0, 1)$, $\text{SNAG}(a)$, or $\text{SNIG}(\delta)$. Based on the historical data set $\{y_t\}_{t\leq T}$, the vector of parameters $(v, \omega, \alpha, \beta, \theta)$ can be estimated by its QMLE $(\hat{v}, \hat{\omega}, \hat{\alpha}, \hat{\beta}, \hat{\theta})$ as in Francq and Zakoian (2004). Denote the realized error and conditional variance by $\hat{\varepsilon}_t$ and $h_{t-1}$. Notice that $E(\eta_t^2 | \mathcal{F}_{t-1}) = -2 / \sqrt{\delta}$ when $\eta_t \sim \text{SNAG}(a)$, and $E(\eta_t^2 | \mathcal{F}_{t-1}) = -3 / \sqrt{\delta}$ when $\eta_t \sim \text{SNIG}(\delta)$. Then, by the method of moments approach, the parameters $a$ and $\delta$ can be estimated by $\hat{a}$ and $\hat{\delta}$, respectively, where

$$\hat{a} = \left( \frac{2 \sum h_{t-1}^2}{\sum \xi_{t-1}^2} \right)^2$$
$$\hat{\delta} = \left( \frac{3 \sum h_{t-1}^2}{\sum \xi_{t-1}^2} \right)^2.$$

Hereafter, we will use the proceeding method to obtain the estimators for all models.

By (3.1), when $\eta_t \sim N(0, 1)$ and under $Q$, model (4.1) reduces to

$$y_t = r - h_t - 1/2 + \varepsilon_t^*,$$
$$\varepsilon_t^* \sim N(0, h_t),$$
$$h_t = \omega + \alpha (\varepsilon_{t-1}^* - \theta \sqrt{h_{t-1}})^2 + \beta h_{t-1},$$

where

$$b_t = \frac{\exp \left( \frac{v \sqrt{h_t} - h_t/2 + \sqrt{h_t}}{a} \right) - 1}{2 \sqrt{h_t} - h_t/2 - \sqrt{h_t} - \sqrt{h_t}}.$$
respectively, when \( \eta_t | F_{t-1} \sim N(0, 1) \), SNG(α) and SNIG(δ). Using a user-chosen initial variance \( h_0 \), then we can generate the data set \( \{y_t\}_{t=1}^{T} \) from model (4.6), (4.7) or (4.8).

### Example 4.3 (GIM-GJR Pricing Models)
Suppose \( \mu_t \) in (2.1) follows a GIM model and \( h_t \) in (2.1) follows a GJR(1, 1) model, i.e., under \( P \),
\[
\begin{align*}
  y_t &= r + v \sqrt{h_t} - h_t/2 + \epsilon_t^* \quad \text{and} \quad \epsilon_t^* = \sqrt{\alpha h_t + \xi_t^*}, \\
  \log h_t &= \omega + \alpha (\epsilon_{t-1}^*/\sqrt{h_{t-1}}) + \theta(|\epsilon_{t-1}^*/\sqrt{h_{t-1}}| - \sqrt{2/\pi}) + \beta \log h_{t-1},
\end{align*}
\]
where \( \omega, \alpha, \beta > 0, \beta \in (0, 1) \), and \( \eta_t | F_{t-1} \sim N(0, 1) \), SNG(α), or SNIG(δ). By (3.1) and (3.7), model (4.9) under \( Q \) reduces to
\[
\begin{align*}
  y_t &= r - h_t/2 + \epsilon_t^* \quad \text{and} \quad \epsilon_t^* = N(0, h_t), \\
  \log h_t &= \omega + \alpha (\epsilon_{t-1}^*/v \sqrt{h_{t-1}}) + \theta (\epsilon_{t-1}^*/\sqrt{h_{t-1}} - \sqrt{2/\pi}) + \beta \log h_{t-1},
\end{align*}
\]
respectively, when \( \eta_t | F_{t-1} \sim N(0, 1) \), SNG(α) and SNIG(δ). Using a user-chosen initial variance \( h_0 \), then we can generate the data set \( \{y_t\}_{t=1}^{T} \) from model (4.10), (4.11) or (4.12).

### 4.2 ARMA-type pricing models

In this subsection, we give three price models when \( \mu_t \) in (2.1) is the ARMA model.

### Example 4.4 (ARMA-NGARCH Pricing Models)
Suppose \( \mu_t \) in (2.1) follows an ARMA(p, q) model and \( h_t \) in (2.1) follows a NGARCH(1, 1) model, i.e., under \( P \),
\[
\begin{align*}
  y_t &= \phi_0 + \sum_{i=1}^{p} \phi_i y_{t-i} + \sum_{i=1}^{q} \psi_i \epsilon_{t-i} + \epsilon_t \quad \text{and} \quad \epsilon_t = \eta_t \sqrt{h_t}, \\
  h_t &= \omega + \alpha (z_{t-1}^*/\sqrt{h_{t-1}})^2 + \beta h_{t-1},
\end{align*}
\]
where \( \omega, \alpha > 0, \beta \in (0, 1) \), and \( \eta_t | F_{t-1} \sim N(0, 1) \), SNG(α), or SNIG(δ). Hereafter, we assume that \( \Phi(z) \neq 0 \) and \( \Psi(z) \neq 0 \) when \( |z| \leq 1 \), and \( \Psi(z) \) and \( \Psi(\bar{z}) \) have no common root with \( \psi_p \neq 0 \) or \( \psi_q \neq 0 \), where \( \Phi(z) = 1 - \sum_{i=1}^{p} \phi_i z^i \) and \( \Psi(z) = 1 + \sum_{i=1}^{q} \psi_i z^i \). Next, by (3.1), (3.3) and (3.7), model (4.13) under \( Q \) reduces to
\[
\begin{align*}
  y_t &= r - h_t/2 + \epsilon_t^* \quad \text{and} \quad \epsilon_t^* = N(0, h_t), \\
  h_t &= \omega + \alpha (z_{t-1}^*/\sqrt{h_{t-1}})^2 + \beta h_{t-1},
\end{align*}
\]
respectively, when \( \eta_t | F_{t-1} \sim N(0, 1) \), SNG(α) and SNIG(δ). Using a user-chosen initial variance \( h_0 \), then we can generate the data set \( \{y_t\}_{t=1}^{T} \) in Step 3 from model (4.14), (4.15) or (4.16).
model, i.e., under $P$,
\begin{align}
  y_t &= \phi_0 + \sum_{i=1}^{p} \phi_i y_{t-i} + \sum_{i=1}^{q} \psi_i \epsilon_{t-i} + \epsilon_t \quad \text{and} \quad \epsilon_t = \eta_t \sqrt{h_t}, \\
  h_t &= \omega + \alpha \epsilon_{t-1}^2 I(\epsilon_{t-1} > 0) + \theta \epsilon_{t-1}^2 I(\epsilon_{t-1} \leq 0) + \beta h_{t-1},
\end{align}
where $\omega, \alpha, \theta > 0$, $\beta \in (0, 1)$, and $\eta_t | F_{t-1} \sim N(0, \sigma^2)$, SNIG($\alpha$), or SNIG($\delta$). By (3.1), (3.3) and (3.7), model (4.21) under $Q$ reduces to
\begin{align}
  y_t &= r - h_t/2 + \epsilon_t^* \quad \text{and} \quad \epsilon_t^* \sim N(0, h_t), \\
  h_t &= \omega + \alpha (\epsilon_{t-1}^* )^2 I(\epsilon_{t-1}^* > 0) + \theta (\epsilon_{t-1}^* )^2 I(\epsilon_{t-1}^* \leq 0) + \beta h_{t-1},
\end{align}
(4.22)
respectively, when $\eta_t | F_{t-1} \sim N(0, 1)$, SNIG($\alpha$) and SNIG($\delta$), and then compare $V_{bs}$ and $\tilde{V}$ in terms of $\sigma_m$ and $\sigma_m$ through a conventional way. Moreover, Figs. 1–3 plot $\sigma_m$ along with different pricing models, distributions of $\eta_t$, TMs, and IVs. Since the results based on SN and SNIG innovations are similar, we only report the results when $\eta_t$ is conditionally SNIG distributed. From Figs. 1–3, our findings are as follows:

(i) In all cases, the choice of IV will determine the position of the $\sigma_m$ curves. Specifically, when IV gets large, the $\sigma_m$ curves will shift up. Thus, how to choose a suitable IV should be very important in practice.

(ii) For the GIM-GARCH pricing model, the price of ITM option based on $\eta_t | F_{t-1} \sim N(0, 1)$ is significantly higher than that based on $\eta_t | F_{t-1} \sim SNIG(\delta)$. However, the price based on GIM-GARCH, GIM-EGARCH and GIM-GJR models is less impacted by the distribution of $\eta_t$.

(iii) For the GIM-GARCH pricing model with $\eta_t | F_{t-1} \sim N(0, 1)$, the relationship between $V_{bs}$ and $\tilde{V}$ is consistent to that in Duan (1995). For other cases, when IV is smaller, $V_{bs}$ is higher than $\tilde{V}$ for the OTM and ATM options, while it is smaller than $\tilde{V}$ for the ITM option; and when IV is larger, $V_{bs}$ is smaller than $\tilde{V}$.

(iv) For the GIM-GARCH pricing model, the U-shaped of the $\sigma_m$ curves (i.e., “volatility smile”) exists when $\eta_t | F_{t-1} \sim N(0, 1)$, while the U-shape of the $\sigma_m$ curves is skew-to-left (i.e., “volatility skew”) when $\eta_t | F_{t-1} \sim SNIG(\delta)$. For other three pricing models, the $\sigma_m$ curves are always skew-to-left. The reason is because except the GIM-GARCH pricing model with $\eta_t | F_{t-1} \sim N(0, 1)$, all of our pricing models can capture the “leverage effect”, meaning that positive returns are associated with decreases of volatility and vice versa. So, the OTM option which needs larger positive returns to end up in the money at maturity, tends to have a smaller $\sigma_m$.

(v) Except the GIM-GARCH pricing model with $\eta_t | F_{t-1} \sim N(0, 1)$, the U-shape of each $\sigma_m$ curve fades away as TM becomes longer. The reason is that when TM is shorter, a big movement in stock price is highly possible, and hence the OTM option is more likely to become the ITM option. If this really happens, the OTM option will produce higher return but with lower capital than ATM or ITM option. Therefore, the speculators in the market will buy OTM options to take advantage of the potential big movement in stock price.

### 5. Simulation study

In this section, we examine the finite sample performance of our GIM-NGARCH, GIM-EGARCH, and GIM-GJR pricing models in Section 4 and the GIM-GARCH pricing model in Duan (1995). For brevity, we only consider European call option written on daily Hang Seng Index (HSI). To choose the values of parameters in GARCH, NGARCH, EGARCH, and GJR models, we fit these four models to the log-return of a historical HSI data set, which has a total of 1001 observations taken from January 13, 2009 to December 31, 2012. The estimated results are reported in Table 1. Since our major interest in this section is to see how the implied volatility of the European call option varies according to different models and distributions of $\eta_t$, we use these estimators for simulations without considering model-checking. In application, model checking should be important, and we will consider it in Section 6.

Next, by using the parameters in Table 1, we calculate the price of the European call option $\tilde{V}$ by the Monte Carlo procedure in Section 4 with a control-variate technique in Boyle et al. (1998).

<table>
<thead>
<tr>
<th>$\nu$</th>
<th>$\omega$</th>
<th>$\delta$</th>
<th>$\beta$</th>
<th>$\alpha$</th>
<th>$\theta$</th>
<th>$\gamma$</th>
<th>$\eta$</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0595</td>
<td>0.4 × 10^{-6}</td>
<td>0.1024</td>
<td>0.8855</td>
<td>2.484 × 10^3</td>
<td>5.590 × 10^3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.0264</td>
<td>0.4 × 10^{-6}</td>
<td>0.0932</td>
<td>0.8654</td>
<td>1.264 × 10^3</td>
<td>2.843 × 10^4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.0387</td>
<td>-0.5290</td>
<td>-0.0874</td>
<td>0.9385</td>
<td>7.702 × 10^3</td>
<td>1.733 × 10^4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.0289</td>
<td>0.3 × 10^{-6}</td>
<td>0.0260</td>
<td>0.9061</td>
<td>1.720 × 10^3</td>
<td>3.870 × 10^4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Fig. 1. Annualized implied volatility for $TM = 30$ under GIM-GARCH model (solid line), GIM-NGARCH model (dashed line), GIM-EGARCH model (dotted line), and GIM-GJR model (dot-dashed line).

stock price, and consequently, this will cause the higher $\sigma_{\text{im}}$ in OTM options. When $TM$ becomes longer, the possibility of extreme stock movement tends to be smaller, and eventually it will cause the vanish of the upwards movement of $\sigma_{\text{im}}$ in OTM options.

Overall, our pricing models can capture the “volatility skew” phenomenon in the market and should be useful in practice.

6. Application

In this section, we assess the performance of six different pricing models (see Table 3) by comparing our model-based prices with the real market prices. For brevity, we only consider the traded European S&P 500 call option data on April 18, 2002. This data set from Schoutens (2003) includes a total number of 53 call options with $TM = 22, 46, 109, 173$ or $234$ days and $K$ ranging from 975 to 1325; see Table 2 for more details. The closing price $S_0$ is 1124.47. The annual risk-free interest rate $r$ is 1.9%, and the dividend yield $d$ is 1.2%. So, the annual effective interest rate $r_0$ is 0.7% in all calculations. The parameters of all pricing models are estimated using the log-return of daily closing price of S&P 500 from January 04, 1988 to April 17, 2002 (a total of 3606 observations), and their results are reported in Table 3. To check the model adequacy, the p-values of the Ljung and Box tests $Q(M)$ and
Li and Mak tests $Q^2(M)$ are also reported in the same table. From Table 3, we find that all of ARMA-type models are adequate to fit this log-return series, while all of GIM-type models are inadequate to fit the conditional mean of this log-return series.

Next, we calculate the model-based prices of those call options in Table 2, and use the average relative error (ARE) criterion to measure the performances of our model-based prices, where

$$\text{ARE} = \frac{1}{N} \sum_{j=1}^{N} \left| \frac{V_{j}^{\text{model}} - V_{j}^{\text{market}}}{V_{j}^{\text{market}}} \right| \times 100,$$

and $N$ is the total number of options considered, $V_{j}^{\text{market}}$ is the market price of $j$th option, and $V_{j}^{\text{model}}$ is the model-based price of $j$th option. For each pricing model, since $V_{j}^{\text{model}}$ depends on the choice of IV $h_1$, we choose $h_1$ to be $(\kappa \sigma^2)$, where $\sigma$ is the estimated volatility of the last day of the log-return series, and $\kappa$ is taken as follows:

$$\kappa = \min_{\kappa_0 \in \{0, 0.1, 0.2, ..., 2.0\}} \hat{\text{ARE}}(\kappa_0),$$

where $\hat{\text{ARE}}(\kappa_0)$ is the ARE of this pricing model with $h_1 = (\kappa_0 \sigma^2)$ and $\eta_t | F_{t-1} \sim N(0, 1)$. Based on this choice of IV, Table 4
reports the detailed results of ARE along with different models, distributions of $\eta_t$, and TMs. From Table 4, we find that (i) except the GIM-GJR model with $\eta_t | \mathcal{F}_{t-1} \sim SNIG(\delta)$, each pricing model with non-normal innovation has a smaller ARE than that with normal innovation, even $\kappa$ is optimally chosen for the normal innovation; (ii) the performance of each pricing model becomes worse when the value of TM increases; (iii) for each pricing model, the performance of two non-normal cases is comparative; (iv) the performance of the GIM-type pricing models and ARMA-type pricing models is also comparative, and although the GIM-EGARCH pricing model is inadequate, the GIM-EGARCH pricing model with $\eta_t | \mathcal{F}_{t-1} \sim SNIG(\delta)$ has the best performance; see Fig. 4 for the plot of difference of model-based prices and market prices in this case. Overall, all of our pricing models have a good performance no matter of model-adequacy and they are much better than the BS pricing formula and Duan’s standard GARCH(1,1) model with $\eta_t | \mathcal{F}_{t-1} \sim N(0, 1)$. Our best ARE is 2.22 less than 2.36, which is the best ARE based on the ESS-TGARCH-M pricing model in Xi (2013).

7. Concluding remarks

In this paper, we construct a risk-neutralized Esscher measure for the asset return which can be decomposed into the conditional mean plus a noise with time-varying volatility components under
a physical probability measure $P$. Using this risk-neutralized measure, six ARCH-type model-based pricing procedures are proposed to value the derivatives. Simulation studies show that our pricing models can capture the "volatility skew" of implied volatilities in the European option. A small application to the S&P

Table 2

| $K$ | IV | $\eta_1|T_{t-1} \sim N(0,1)$ | $\eta_1|T_{t-1} \sim SNIG(\kappa)$ | $\eta_1|T_{t-1} \sim SNIG(\delta)$ |
|-----|----|----------------|----------------|----------------|
| TM = 22 | 161.6 | 173.3 | 173.3 | 173.3 |
| TM = 46 | 144.8 | 157 | 157 | 157 |
| TM = 109 | 120.1 | 133.1 | 133.1 | 133.1 |
| TM = 173 | 100.7 | 114.8 | 114.8 | 114.8 |

500 option highlights the importance of our model-based pricing procedure with non-normal innovations. As the empirical studies suggested, the performance of our pricing procedure varies in terms of IV, TM, and the distribution of innovation. Hence, two promising directions for future study are (i) choosing an "optimal" IV by the range of TM in some sense, and (ii) estimating the distribution of innovation non-parametrically.

Table 3

<table>
<thead>
<tr>
<th>Estimators</th>
<th>$Q(6)$</th>
<th>$Q(12)$</th>
<th>$Q^2(6)$</th>
<th>$Q^2(12)$</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIM-NARCH</td>
<td>0.0065</td>
<td>0.0038</td>
<td>0.2830</td>
<td>0.7527</td>
</tr>
<tr>
<td>GIM-EGARCH</td>
<td>0.0185</td>
<td>0.0073</td>
<td>0.9122</td>
<td>0.9920</td>
</tr>
<tr>
<td>GIM-GJR</td>
<td>0.0300</td>
<td>0.0126</td>
<td>0.9174</td>
<td>0.9959</td>
</tr>
<tr>
<td>AR(3)-NARCH</td>
<td>0.5562</td>
<td>0.1833</td>
<td>0.2998</td>
<td>0.7764</td>
</tr>
<tr>
<td>AR(3)-EGARCH</td>
<td>0.4608</td>
<td>0.1512</td>
<td>0.9328</td>
<td>0.9935</td>
</tr>
<tr>
<td>AR(3)-GJR</td>
<td>0.5398</td>
<td>0.1583</td>
<td>0.6446</td>
<td>0.9538</td>
</tr>
</tbody>
</table>

$p$-values of Ljung–Box test statistics $Q(M)$ and Li–Mak test statistics $Q^2(M)$.

Table 4

| Models | IV | $\eta_1|T_{t-1} \sim N(0,1)$ | $\eta_1|T_{t-1} \sim SNIG(\kappa)$ | $\eta_1|T_{t-1} \sim SNIG(\delta)$ |
|--------|----|----------------|----------------|----------------|
| GIM-NARCH | 0.7 | 1.40 | 0.83 | 2.34 | 4.77 | 6.39 | 3.31 | 1.60 | 1.07 | 1.32 | 2.94 | 4.87 | 2.39 | 1.74 | 0.78 | 2.47 | 3.65 | 5.50 | 2.90 |
| GIM-EGARCH | 0.8 | 0.75 | 1.30 | 2.74 | 5.20 | 7.42 | 3.76 | 0.80 | 1.23 | 3.00 | 4.67 | 6.87 | 3.56 | 2.21 | 1.03 | 1.19 | 2.59 | 4.35 | 2.22 |
| GIM-GJR | 0.7 | 1.76 | 1.54 | 3.56 | 7.71 | 3.98 | 0.72 | 1.69 | 2.71 | 4.51 | 6.61 | 3.50 | 1.56 | 1.36 | 2.11 | 1.50 | 9.83 | 3.76 |
| AR(3)-NARCH | 0.7 | 1.17 | 0.85 | 2.48 | 4.09 | 6.12 | 3.10 | 2.35 | 1.79 | 1.41 | 3.41 | 4.86 | 2.77 | 1.51 | 0.91 | 1.76 | 3.40 | 4.80 | 2.55 |
| AR(3)-EGARCH | 0.9 | 5.93 | 1.84 | 4.03 | 6.75 | 11.24 | 5.70 | 2.08 | 2.04 | 2.51 | 4.62 | 7.00 | 3.77 | 7.15 | 5.73 | 1.94 | 2.75 | 4.51 | 3.92 |
| AR(3)-GJR | 0.7 | 1.77 | 1.78 | 3.82 | 5.90 | 7.23 | 4.36 | 0.62 | 0.98 | 2.86 | 4.59 | 6.03 | 3.28 | 1.19 | 2.04 | 2.60 | 4.12 | 5.92 | 3.37 |

The ARE is based on all options, and the smallest ARE is in bold.

$^a$ The ARE is based on all options, and the smallest ARE is in bold.

$^b$ The ARE of BS pricing model and GIM-GARCH pricing model with $\eta_1|T_{t-1} \sim N(0,1)$ is calculated with $IV = (\kappa \sigma_\theta)^2$ and $(\kappa \sigma_\varphi)^2$, respectively. Here, $\sigma_\theta$ is the annualized volatility of the log-return series.
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