A Binomial Tree to Price European and American Options

Brogi, Athos

2016

Online at https://mpra.ub.uni-muenchen.de/74962/
MPRA Paper No. 74962, posted 11 Nov 2016 12:42 UTC
A Binomial Tree to Price European and American Options

Athos Brogi
UniCredit SpA, Piazza Gae Aulenti, 20121 Milano, e-mail: athos.brogi@unicredit.eu

Keywords: Arbitrage, Kurtosis, Martingale, Option, Risk-neutral, Skewness, Volatility

1. Introduction

First of all, the model in this paper is exactly the same as the binomial tree in my earlier paper, Brogi (2014). What differs now is that, while in my previous paper the tree was implemented by Monte Carlo simulation, i.e. simulating price trajectories along the tree, in this paper the whole (recombining) underlying price tree is calculated without resorting to Monte Carlo, just like for example the classic Cox, Ross and Rubinstein (1979) binomial tree (CRR tree). This means that the option price is obtained virtually instantly using for example Matlab on a standard PC. On the other hand, Monte Carlo simulation was rather lengthy and the resulting option price had a standard error. The main features that make the tree appealing are unchanged: excess kurtosis and negative skewness of price distribution of underlying security. For more details please see simulation in Brogi (2014).

The paper proceeds as follows. In Section 2 the binomial tree is described. Section 3 derives a formula for the risk-neutral measure. Section 4 shows how volatility is modeled. Section 5 explains how to implement the tree. Finally Section 6 concludes the paper with some remarks.

2. Binomial Tree

Time-points $t_i, \ i = 0,1,\ldots,n$, are equidistant, and time-periods $\Delta t = t_i - t_{i-1}, \ i = 1,\ldots,n$, and time horizon $T = n\Delta t$, which is fixed length of time of expiration of option in years. $t_0$ is current time-point. We also have an extra historical time-point, $t_{-1}$, which precedes $t_0$, and such that $t_0 - t_{-1} = \Delta t$.

The underlying security price can either rise or fall from one-point to the next, $i = 1,\ldots,n$:

$$
S_i = S_{i-1}u_i \quad \text{with probability } q_i \text{ or }
S_i = S_{i-1}d_i \quad \text{with probability } 1 - q_i,
$$

(1)

where $u_i$ stands for up, $d_i$ stands for down, and $u_i$, $d_i$ are variable. $q_i$ is the risk-neutral probability of underlying security price at $t_{i-1}$, $S_{i-1}$, rising to $S_{i-1}u_i$ at $t_i$.

Further down we derive a formula for $q_i$. 

The definition of continuously compounded return of underlying security from $t_{i-1}$ to $t_i$:

$$R_i = \log S_i - \log S_{i-1}, \quad i = 0, 1, \ldots, n.$$  \hspace{1cm} (2)

We call current return $R_0 = \log S_0 - \log S_{-1}$, where $S_{-1}$ is a known historical price, so current return is known too. Rearranging (1), and taking logarithms, and using (2) we define, $i = 1, \ldots, n$,

$$\log S_i / S_{i-1} | \sigma_i = \log u_i = R_i^+ \text{ with probability } q_i, \text{ or}$$

$$\log S_i / S_{i-1} | \sigma_i = \log d_i = R_i^- \text{ with probability } 1 - q_i,$$  \hspace{1cm} (3)

where

$$R_i^+ = \mu \Delta t + \sigma_i \sqrt{\Delta t},$$  \hspace{1cm} (4)

$$R_i^- = \mu \Delta t - \sigma_i \sqrt{\Delta t},$$  \hspace{1cm} (5)

with $\mu \Delta t < \sigma_i \sqrt{\Delta t}$ for large $n$, or equivalently small $\Delta t$. $\sigma_i \sqrt{\Delta t}$ is part of a volatility process, $\{ \sigma_i \sqrt{\Delta t} \}_{k=0}^n$, which we need to model, where $\sigma_i$ is known current annual volatility.

### 3. Martingale Condition

Under no arbitrage, the discounted price process of the underlying security, $\{ \tilde{S}_i \}_{i=0}^n$, must be a martingale. We now derive a formula for risk-neutral probability $q_i$ in (1), so that $\{ \tilde{S}_i \}_{i=0}^n$ is a martingale.

Let us introduce a sample of independent Bernoulli random variables, which are independent of $\{ \tilde{S}_i \}_{i=0}^n$:

$$Z_i = +1 \text{ with probability } q_i \text{ or}$$

$$Z_i = -1 \text{ with probability } 1 - q_i,$$

where $q_i$ is the risk-neutral probability in (1). Then (4) and (5) can be written as one equation:

$$R_i = \mu \Delta t + \sigma_i \sqrt{\Delta t} Z_i, \quad i = 1, \ldots, n.$$  \hspace{1cm} (6)

The martingale condition is
\[ E(\tilde{S}_t \mid \tilde{S}_{t-1}, \tilde{S}_{t-2}, \ldots) = \tilde{S}_{t-1}, \quad i = 1, \ldots, n, \]
\[ E(e^{-r iT} \tilde{S}_t \mid \tilde{S}_{t-1}, \tilde{S}_{t-2}, \ldots) = e^{-(i-1)r IT} \tilde{S}_{t-1} \]
\[ E(e^{\mu(t) + \sigma_i \sqrt{\Delta t}} \mid \tilde{S}_{t-1}, \tilde{S}_{t-2}, \ldots) = e^{\mu(t) \Delta t}, \]

where \( r \) is the risk-free rate of interest, which is constant during time horizon \( T \), and

\[ e^{\mu(t) + \sigma_i \sqrt{\Delta t}} \mid \sigma_i = e^{\mu(t) + \sigma_i \sqrt{\Delta t}} \text{ with probability } q_i \text{ or} \]
\[ e^{\mu(t) + \sigma_i \sqrt{\Delta t}} \mid \sigma_i = e^{\mu(t) - \sigma_i \sqrt{\Delta t}} \text{ with probability } 1 - q_i, \]

so that

\[ q_i e^{\mu(t) + \sigma_i \sqrt{\Delta t}} + (1 - q_i) e^{\mu(t) - \sigma_i \sqrt{\Delta t}} = e^{\mu(t) \Delta t}. \]

Hence,

\[ q_i = \frac{e^{\mu(t) \Delta t} - e^{\mu(t) - \sigma_i \sqrt{\Delta t}}}{e^{\mu(t) + \sigma_i \sqrt{\Delta t}} - e^{\mu(t) - \sigma_i \sqrt{\Delta t}}}. \]

In risk-neutral pricing we set \( \mu = r \), so that

\[ q_i = \frac{1 - e^{-\sigma_i \sqrt{\Delta t}}}{e^{\sigma_i \sqrt{\Delta t}} - e^{-\sigma_i \sqrt{\Delta t}}}, \quad i = 1, \ldots, n. \quad (6) \]

For large \( n \), or equivalently small \( \Delta t \), substituting the exponentials in (6) by their series expansions ignoring terms of order \( (\Delta t)^{\frac{3}{2}} \) or higher, we get

\[ q_i = \frac{1}{2} - \frac{1}{4} \sigma_i \sqrt{\Delta t}, \quad i = 1, \ldots, n. \quad (7) \]

So, the risk-neutral probability of \( S_{t+1} \) rising is less than for \( S_{t+1} \) falling. This is true for any \( n \), or equivalently any \( \Delta t \).

\[ E(R_i \mid \sigma_i) = \mu \Delta t + (2q_i - 1)\sigma_i \sqrt{\Delta t} \quad (8) \]
\[ \text{var}(R_i \mid \sigma_i) = 4q_i(1 - q_i)\sigma_i^2 \Delta t. \quad (9) \]

Notice that if \( q_i = 1/2 \) (which it is not), then

\[ E(R_i \mid \sigma_i) = \mu \Delta t \]
\[ \text{var}(R_i \mid \sigma_i) = \sigma_i^2 \Delta t. \]
Setting \( q_i \) as in (6) is an artificial device which forces \( \left\{ \delta_t \right\}_{t=0}^T \) to be a martingale.

4. Modeling Volatility

As regards the modeling of \( \sigma_t \sqrt{\Delta t} \), Black (1976) already noticed a negative correlation between returns and volatility, i.e. when returns are high, volatility is low, and when returns are low, volatility is high. Such negative correlation can be captured by the following equation:

\[
\sigma_t \sqrt{\Delta t} = \sigma_{t-1} \sqrt{\Delta t} - \alpha (R_{t-1} - \mu \Delta t), \quad i = 1, \ldots, n ,
\]

(10)

where \( 0 < \alpha < 1 \). When \( R_{t-1} = \mu \Delta t \) volatility is constant. This can be seen as an equilibrium. Whilst the more \( R_{t-1} \) differs from \( \mu \Delta t \), the more we move away from equilibrium, and the more pronounced changes in volatility are. It is clear that according to (10) volatility of returns, \( \sigma_t \sqrt{\Delta t} \), can never be negative, because, recalling (4) and (5), if \( R_{t-1} = R_{t-1}^- \), then

\[
\sigma_t \sqrt{\Delta t} = \sigma_{t-1} \sqrt{\Delta t} - \alpha (\sigma_{t-1} \sqrt{\Delta t}), \quad i = 2, \ldots, n ,
\]

(11)

\( 0 < \alpha < 1 \). Alternatively, if \( R_{t-1} = R_{t-1}^- \), then

\[
\sigma_t \sqrt{\Delta t} = \sigma_{t-1} \sqrt{\Delta t} + \alpha (\sigma_{t-1} \sqrt{\Delta t}), \quad i = 2, \ldots, n ,
\]

(12)

\( 0 < \alpha < 1 \).

\[
E(\sigma_t \sqrt{\Delta t} | \sigma_{t-1}) = \sigma_{t-1} \sqrt{\Delta t} - \alpha (E(R_{t-1} | \sigma_{t-1}) - \mu \Delta t) \\
= \sigma_{t-1} \sqrt{\Delta t} - \alpha (2q_{t-1} - 1)\sigma_{t-1} \sqrt{\Delta t}
\]

where, as in (6),

\[
q_0 = \frac{1 - e^{-\sigma_0 \sqrt{\Delta t}}}{e^{\sigma_0 \sqrt{\Delta t}} - e^{-\sigma_0 \sqrt{\Delta t}}},
\]

which is known.  
From (10) we see that

\[
\sigma_t \sqrt{\Delta t} = \sigma_0 \sqrt{\Delta t} - \alpha \sum_{j=0}^{i-1} (R_j - \mu \Delta t), \quad i = 1, \ldots, n .
\]
Hence,
\[
E(\sigma_t \sqrt{\Delta t} | \sigma_{t-1}, \sigma_{t-2}, \ldots) = \sigma_t \sqrt{\Delta t} - \alpha \sum_{j=0}^{t-1} (2q_j - 1) \sigma_j \sqrt{\Delta t}.
\]

At \( t_n \), dropping \( \sqrt{\Delta t} \),
\[
E(\sigma_t | \sigma_{t-1}, \sigma_{t-2}, \ldots) = \sigma_t - \alpha \sum_{j=0}^{n-1} (2q_j - 1) \sigma_j,
\]
and, using (7) for \( q_j \),
\[
\lim_{n \to \infty} E(\sigma_t | \sigma_{t-1}, \sigma_{t-2}, \ldots) = \sigma_t - \alpha \lim_{n \to \infty} \sum_{j=0}^{n-1} \left( -\frac{1}{2} \sigma_j \sqrt{\Delta t} \right) \sigma_j = \infty,
\]
(13)
because each term in the sum is of order \( \sqrt{\Delta t} \) (order \( 1/\sqrt{n} \)), but extra terms are added to the sum at rate \( n \). So, the expected value of \( \sigma_t \) has no finite limit.
\[
\text{var}(\sigma_t \sqrt{\Delta t} | \sigma_{t-1}) = \alpha^2 \text{var}(R_{t-1} | \sigma_{t-1}) = 4\alpha^2 q_{t-1} (1 - q_{t-1}) \sigma_{t-1}^2 \Delta t.
\]
(14)
Looking at (14), we note that the greater the \( \alpha \), the greater the variance of volatility of returns, and the greater the variance of volatility of returns, the greater the kurtosis of the distribution of returns.

5. Implementing the Tree

Before providing commented Matlab code implementing the tree, let me first make it clear that the tree of underlying security prices is in fact recombining, because
\[
d_{t_i-1} u_{t_i} = e^{2\mu \Delta t + a \sigma_{t_i-1} \sqrt{\Delta t}} = u_{t_i-1} d_{t_i} \quad i = 2, \ldots, n
\]
Furthermore, volatilities are also recombining, because from equations (11) and (12) we have that
\[
\sigma_t \sqrt{\Delta t} = \sigma_{t_i-1} \sqrt{\Delta t} (1 - \alpha) \quad \text{or} \quad \sigma_t \sqrt{\Delta t} = \sigma_{t_i-1} \sqrt{\Delta t} (1 + \alpha) \quad i = 2, \ldots, n
\]
Given the recombining property of prices and volatilities, the full price tree can be obtained. Then the option value at expiry is calculated, and from the expiry nodes work backwards down the tree to obtain option values at earlier nodes in standard fashion, as in the CRR tree, with the possibility of pricing European or American options. The only difference in working backwards down the tree compared to the CRR tree is that, while in the CRR tree the probability of an ‘up’ move is fixed, here we have a different
probability of an ‘up’ move at each node calculated according to equation (6) or (7). It is these different probabilities that need to be used when working backwards down the tree. The option price equals the value obtained at the starting node. See for example Haug (2007) to see how to work backwards in the CRR tree.

Here follows the Matlab code (comments in green).

```matlab
function optionprice=athostree(St0,Shist,k,sigt0,r,T,n,alpha,otype,earlyexercise)
%function to calculate the price of a vanilla European or American
%Put or Call option using the binomial tree presented in paper
%"A Binomial Tree to Price European and American Options" by Athos Brogi.
%Function inputs:
% St0 - current price of underlying
% Shist - historical price of underlying
% k - strike price
% r - risk free interest rate (=mu)
% T - time horizon in years
% n - number of time steps
% otype - must be 'PUT' or 'CALL'
% earlyexercise - true for American, false for European

currentreturn=log(St0)-log(Shist);

%calculate the recombining volatility tree (vtree)
vtree=nan(n,n);
vtree(1,1)=sigt0*sqrt(T/n)-alpha*(currentreturn-r*(T/n));
%(note: check vtree(1,1)>0)
for i=2:n
    vtree(1:i-1,i)=vtree(1:i-1,i-1)*(1-alpha);
    vtree(i,i)=vtree(i-1,i-1)*(1+alpha);
end

%calculate the recombining price of underlying tree (ptree)
ptree=nan(n+1,n+1);
ptree(1,1)=St0;
for i=2:n+1
    ptree(1:i-1,i)=ptree(1:i-1,i-1).*exp(r*(T/n)+vtree(1:i-1,i-1));
    ptree(i,i)=ptree(i-1,i-1).*exp(r*(T/n)-vtree(i-1,i-1));
end

%calculate the probability tree (probtree), where each node shows
%probability %of an 'up' move. The probability of a 'down' move equals 1 minus %probability of an 'up' move
probtree=nan(n,n);
probtree=1/2-1/4*vtree;

%calculate value at expiry
valuetree=nan(size(ptree));
switch otype
    case 'PUT'
        valuetree(:,end)=max(k-ptree(:,end),0);
    case 'CALL'
```

6
valuetree(:,end)=max(ptree(:,end)-k,0);
end

% work backwards down the valuetree to get values at earlier nodes
for i=n:-1:1
    valuetree(1:i,i)=... 
    exp(-r*T/n)*(probtree(1:i,i).*valuetree(1:i,i+1)... 
    + (1-probtree(1:i,i)).*valuetree(2:i+1,i+1));
    if earlyexercise
        switch otype
            case 'PUT'
                valuetree(1:i,i)=... 
                max(k-ptree(1:i,i),valuetree(1:i,i));
            case 'CALL'
                valuetree(1:i,i)=... 
                max(ptree(1:i,i)-k,valuetree(1:i,i));
        end
    end
end

% option price
optionprice=valuetree(1);
end

Here are 4 examples of calculated prices.

>> optionprice=athostree(100,98,100,0.3,0.03,1,100,0.05,'PUT',false)
optionprice = 10.1273

>> optionprice=athostree(100,98,100,0.3,0.03,1,100,0.05,'CALL',false)
optionprice = 13.0822

>> optionprice=athostree(100,98,100,0.3,0.03,1,100,0.05,'PUT',true)
optionprice = 10.3303

>> optionprice=athostree(100,98,100,0.3,0.03,1,100,0.05,'CALL',true)
optionprice = 13.0822

6. Final Remarks

The greatest challenge is not implementing the tree, but to choose appropriate values of \( \alpha \) and \( n \) for pricing. As we have seen above, equation (13), as \( n \) tends to infinity so does volatility, and therefore the tree explodes. We have also seen, equation (14), that the greater \( \alpha \), the greater the kurtosis of the distribution of returns. So, the tree explodes also if \( \alpha \) is too large. Therefore, appropriate values of \( \alpha \) and \( n \) need to be input to avoid the tree calculating meaningless prices.
However, on the positive side, the tree has a relatively small number of parameters, and to me it can also be viewed as a sound application of martingale pricing. It also calculates American and European option prices virtually instantly on a standard PC.

References


