Option pricing from wavelet-filtered financial series

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ABSTRACT

We perform wavelet decomposition of high frequency financial time series into large and small time scale components. Taking the FTSE100 index as a case study, and working with the Haar basis, it turns out that the small scale component defined by most (≃99.6%) of the wavelet coefficients can be neglected for the purpose of option premium evaluation. The relevance of the hugely compressed information provided by low-pass wavelet-filtering is related to the fact that the non-gaussian statistical structure of the original financial time series is essentially preserved for expiration times which are larger than just one trading day.

1. Introduction

The problem of option pricing [1–3] has been a main topic of investigation in much of the econophysics literature, challenged by the well-known inadequacy of the standard Black–Scholes model for the real world [1–6]. Options are an imperative element in modern markets, since they play a fundamental role, as convincingly shown long ago by Black and Scholes, in reducing portfolio risk. As an alternative to the Black–Scholes model, one of the present authors has implemented an option pricing scheme which is based on the evaluation of statistical averages taken over samples generated from the underlying asset log-return time series [6]. This method, which we will refer to as “Empirical Option Pricing” (EOP), has been successfully validated through a careful study of FTSE100 options.

A deeper understanding of the statistical features of financial time series is in order, since this would eventually allow us to replace real samples by accurate synthetic financial series, improving the statistical ensembles used in EOP. As a closely related issue, our aim in this work is to show that financial series can be hugely compressed (we mean lossy compression, in the information theoretical sense) by wavelet-filtering, without spoiling option premium evaluation by EOP. The low-pass wavelet-filtered signal contains log-return fluctuations defined on time scales larger than a few hours and it is likely to yield, due to its high compression rate, a more suitable basis for modeling and synthetization.

This paper is organized as follows. Sections 2 and 3 provide brief accounts, respectively, of the EOP method and of the low-pass wavelet-filtering procedure that has been applied to our analysis of the FTSE100 index. The wavelet-filtered financial series, which keeps only 0.4% of the total number of wavelet components of the original signal, is seen to encode the essential statistical information needed for a consistent evaluation of FTSE100 option premiums with expiration times larger than a single trading day. In Section 4, we summarize our findings and point out directions for further research.

2. Empirical Option Pricing (EOP)

We rephrase here, without paying much attention to rigorous considerations, the main points of EOP [6]. Let \( S(t) \) be an arbitrary financial index modeled as a continuous stochastic process. More precisely, we write down a Langevin evolution
equation for \( S(t) \), which is a simple generalization of the one underlying the Black–Scholes model [7,8]:
\[
\frac{dS}{dt} = \mu(t)S + \sigma(t)\eta(t)S. \tag{2.1}
\]

Above, \( \mu(t) \) and \( \sigma(t) \) are the time-dependent interest rate and the volatility of the index \( S \). The stochasticity of the financial time series comes from the gaussian white noise process \( \eta(t) \) appearing in Eq. (2.1), which satisfies
\[
\langle \eta(t) \rangle = 0,
\]
\[
\langle \eta(t) \eta(t') \rangle = \delta(t - t'). \tag{2.2}
\]

Observe that both \( \mu(t) \) and \( \sigma(t) \) may be regarded as stochastic processes as well, with fluctuations correlated on time scales which are much larger than the correlation time of \( S(t) \).

Working within the Itô prescription, Eq. (2.1) can be readily rewritten as
\[
\frac{dx}{dt} = \sigma(t)\eta(t), \tag{2.3}
\]
where
\[
S(t) = S \exp \left[ \int_0^t dt' \tilde{\mu}(t') + x(t) - x(0) \right], \tag{2.4}
\]
with
\[
\tilde{\mu}(t) \equiv \mu(t) - \frac{1}{2} \sigma(t)^2. \tag{2.5}
\]

Above, \( S \equiv S(0) \) is just the spot price of the index. We are interested, now, in evaluating the premium of a European option which is negotiated with strike price \( E \) and expiration time \( T \). Similarly to what is done in the Black–Scholes treatment, where \( \mu(t) \) and \( \sigma(t) \) are constant, the option premium \( V \) (for, say, call options) can be obtained by computation of the statistical average
\[
V = \exp[-rT]\langle (S(T) - E)\Theta(S(T) - E) \rangle, \tag{2.6}
\]
where \( \mu(t) \) is replaced by \( r \), the risk-free interest rate, in the definition of \( S(T) \) provided by Eqs. (2.4) and (2.5).

For stochastic processes \( \{x_n\} \) defined in discrete time, with time step \( \epsilon \), like real financial time series, Eq. (2.3) can be replaced by the finite difference equation
\[
\frac{1}{\epsilon}(x_{n+1} - x_n) = \sigma_n \eta_n, \tag{2.7}
\]
where
\[
\eta_n \equiv \frac{\xi_n}{\sqrt{\epsilon}} \tag{2.8}
\]
and \( \xi_n = \pm 1 \) is an arbitrary element of a discrete gaussian stochastic process, defined by \( \langle \eta_n \rangle = 0 \) and \( \langle \eta_n \eta_m \rangle = \delta_{nm} \). From (2.7), we get, immediately,
\[
\sigma_n^2 = \frac{1}{\epsilon}(x_{n+1} - x_n)^2 \equiv \frac{1}{\epsilon} \langle \delta x_n \rangle^2 \tag{2.9}
\]
and, therefore,
\[
\frac{1}{2} \int_0^T dt \sigma(t)^2 \simeq \frac{1}{2} \sum_{n=0}^{N-1} \langle \delta x_n \rangle^2, \tag{2.10}
\]
where the time instants are given by \( t_n = n\epsilon \), with \( T = N\epsilon \).

Substituting, now, (2.4) and (2.5) (with \( \mu(t) \) replaced by \( r \)) in (2.6), we get
\[
S(T) = S \exp \left[ rT + x(T) - x(0) - \frac{1}{2} \sum_{n=0}^{N-1} \langle \delta x_n \rangle^2 \right]
\]
\[
= S \exp \left[ rT + \sum_{n=0}^{N-1} \left( \delta x_n - \frac{1}{2} \langle \delta x_n \rangle^2 \right) \right]. \tag{2.11}
\]
It is important to note that \( \delta x_n \), which appears in the above expressions, is, from Eq. (2.4), nothing more than an element of the detrended log-return series, i.e.,
\[
\delta x_n = \ln[S(t_{n+1})/S(t_n)] - \epsilon \tilde{\mu}(t_n), \tag{2.12}
\]
where \( \langle \delta x \rangle = 0 \), due to Eq. (2.3).
We are now ready to summarize EOP in the following four steps.

(i) A large period (\(> 2\) years) of reasonably statistically stationary high-frequency (minute-by-minute) log-return series of the underlying asset is "purified" by the removal of outlier events (typically, log-return fluctuations which are larger than 10 standard deviations) and of the mean one-week asset interest rate (detrending). The resulting series is a stochastic process \(\delta y_n\).

(ii) Since the historical volatility \(\sigma = \sqrt{\langle (\delta y_n)^2 \rangle}\) is in general different from the volatility of the financial series during the option lifetime \(T\), we introduce a correction factor \(g\) to define the stochastic process \(\delta x_n = g\delta y_n\), which yields a putative volatility \(\sigma^* = g\sigma\) for that period [9]. The \(g\)-factor is the only adjustable parameter in EOP, which accounts for the distinction between the past and future behaviors of the financial index \(S(t)\).

(iii) An ensemble \(\mathcal{E}\) of samples, each of length \(T = N\epsilon\) (\(\epsilon = 1\) min), is defined from one-hour translations of the initial sequence \(\{\delta x_0, \delta x_1, \ldots, \delta x_{N-1}\}\). In other words,

\[
\mathcal{E} = \bigcup_{m, \Delta} \{\delta x_{m\Delta}, \delta x_{1+m\Delta}, \ldots, \delta x_{N-1+m\Delta}\},
\]

where \(m \in \mathbb{N}\) and \(\Delta = 60\).

(iv) Option premiums are computed from (2.6), (2.11) and (2.12), with statistical averages taken over the ensemble \(\mathcal{E}\), defined in (2.13). We note, furthermore, that the optimal value for the \(g\)-factor is found through the least squares method, devised for the comparison between the market and modeled option premiums.

A good agreement has been attained between the market and EOP values in a detailed study of FTSE100 index options [6]. The comparison data are reported in the MKT and OP columns of Table 1.

The performance of EOP would benefit greatly from the use of synthetic financial series which would enlarge the ensemble of samples \(\mathcal{E}\). Thus, one may wonder, having modeling aims in mind, about what the relevant statistical facts hidden in the financial time series are. The essential question we address is, accordingly, whether the financial series should be decomposed into relevant and irrelevant contributions, as far as option pricing is concerned. In the next section, we recall some ideas on wavelet-filtering, which have been crucial in the investigation of this issue.

### 3. Wavelet-Filtering and EOP

Log-return fluctuations are constantly affected by avalanches of market orders which have to do with speculative trends, and are clearly time-localized events. These features render the financial time series suggestively adequate for wavelet analysis.

Since there is no requirement of continuity for the log-return time series, we have chosen, due to ease of handling, to work with Haar wavelets [10]. In the same way as for any other discrete wavelet basis, the Haar wavelets are labelled by

| Strike price | MKT 20dec05 (S = 5528.1) | OP 02dec05 (S = 5538.8) | \(\hat{\text{OP}}\) 02dec05 (S = 5538.8) | MKT 19dec05 (S = 5517.4) | OP 03jan06 (S = 5686.5) | \(\hat{\text{OP}}\) 03jan06 (S = 5686.5) | MKT 12jan06 (S = 5736.1) | \(\hat{\text{OP}}\) 12jan06 (S = 5736.1) |
|--------------|---------------------------|--------------------------|---------------------------------|---------------------------|--------------------------|---------------------------------|---------------------------|---------------------------------|
| 5125         | 329.5                     | 332.38                   | 333.05                          | X                         | X                        | X                               | X                         | X                               |
| 5225         | 323.5                     | 327.49                   | 327.64                          | \(
| 5325         | 148.5                     | 149.46                   | 150.09                          | 271                       | 268.86                   | 269.30                          | 314                       | 315.02                          |
| 5425         | 76                        | 77.75                    | 77.97                           | 177                       | 176.67                   | 174.97                          | 215                       | 215.00                          |
| 5525         | 8                         | 5.18                     | 5.09                            | 34.5                      | 34.40                    | 34.44                          | 40                        | 34.72                           |
| 5625         | 2.5                       | [0.60]                    | 0.60                            | 2                         | 2.66                     | 1.65                            | 0.5                       | 0.35                            |
| 5825         | 0.5                       | X                        | X                               | 0.5                       | X                        | X                               | X                         | X                               |
| 19dec05 (S = 5539.8) | 329.5                     | 332.38                   | 333.05                          | X                         | X                        | X                               | X                         | X                               |
| 03jan06 (S = 5686.5) | 323.5                     | 327.49                   | 327.64                          | \(
| 12jan06 (S = 5736.1) | 148.5                     | 149.46                   | 150.09                          | 271                       | 268.86                   | 269.30                          | 314                       | 315.02                          |
two integer indices $1 \leq j \leq J$ and $0 \leq k \leq 2^j - 1$ and are given by

$$
\psi_{jk}(t) = \psi_{00}(2^j t - k),
$$

(3.1)

where

$$
\psi_{00}(t) = \begin{cases} 
1 & \text{for } 0 \leq t < \frac{1}{2} \\
-1 & \text{for } \frac{1}{2} \leq t < 1
\end{cases}
$$

(3.2)

is the function known as the “mother wavelet”. Observe that the above basis functions are defined in the domain $0 \leq t < 1$.

The detrended log-return series $\{\delta x_0, \delta x_1, \ldots, \delta x_{N-1}\}$ of length $N = 2^{J+1}$ and zero mean [11] can always be expanded in wavelet modes as

$$
\delta x_i = \sum_{j=0}^{J} \sum_{k=0}^{2^j-1} c_{jk} \psi_{jk}(i/N).
$$

(3.3)

Low-pass wavelet-filtering can be straightforwardly implemented from the expansion (3.3) by retaining the modes which have the scale index $j < j^*$, where $j^*$ is an arbitrarily fixed threshold. We have taken (following the prescriptions given in
step (1) of EOP, as discussed in Section 2) a financial time series of 241,664 min (around two years of data) for the the FTSE 100 index, ending on 17 November 2005. The series is partitioned into 59 subseries, each of length 4096 (corresponding to \( J = 11 \) and about two weeks of market activity), which are then wavelet-filtered with threshold parameter \( J^* = 4 \) (compression rate of 99.6%).

Since wavelets with \( j > 0 \) have zero mean, we expect that the histograms of the log-returns \( \sum_{i=0}^{N-1} \delta X_i \) will not be much affected for time horizons \( T = N \epsilon > 4096/2^J = 256 \) min. This is actually verified in Fig. 1. Therefore, on the grounds of Eq. (2.11), it is clear that option prices can be alternatively estimated through the use of the low-pass wavelet filtered series within EOP for time horizons which are larger than one trading day (\( T = 510 \) min).

In Table 1, we report the computed premiums for call options based on the FTSE 100 index with expiration times ranging from a few days to one month, in December 2005 and January 2006. The agreement between the original and wavelet-filtered option premium evaluations is significant. It is important to recall, as already indicated in Ref. [6], that the Black–Scholes framework is unable to yield good estimates of the market option premiums listed in Table 1.

4. Conclusions

We have found, taking the FTSE100 index as a case study, that its high frequency (minute-by-minute) time series can be highly compressed for the purpose of option pricing. The original and low-pass wavelet-filtered series have remarkably similar performances within EOP, even for a compression rate of 99.6%, which means that only 967 out of the original 241,664 wavelet components have been selected through the wavelet-filtering procedure. The retained wavelet coefficients have a scale index \( j \) smaller than the fixed threshold \( J^* = 4 \) and are associated to log-return fluctuations defined on time scales larger than a few hours. It turns out, thus, that one is entitled to use the filtered time series to precify FTSE100 options with expiration times which are larger than just one trading day, where the log-returns are still clearly non-gaussian random variables. A promising approach to option pricing, deserving of further investigation, is to address the problem of series synthetization from the analysis of the statistical properties of the compressed wavelet-filtered financial indices directly in wavelet space, in a spirit similar to what is done in the context of artificial multifractal series [12]. It is likely that EOP would, then, be considerably improved from the use of much larger synthetic statistical ensembles.

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