OPTIMAL CLOSING OF A PAIR TRADE WITH A MODEL CONTAINING JUMPS

STIG LARSSON\textsuperscript{1}, CARL LINDBERG, AND MARCUS WARFHEIMER\textsuperscript{2}

ABSTRACT. A pair trade is a portfolio consisting of a long position in one asset and a short position in another, and it is a widely applied investment strategy in the financial industry. Recently, Ekström, Lindberg and Tysk studied the problem of optimally closing a pair trading strategy when the difference of the two assets is modelled by an Ornstein-Uhlenbeck process. In this paper we study the same problem, but the model is generalized to also include jumps. More precisely we assume that the above difference is an Ornstein-Uhlenbeck type process, driven by a \L{e}vy process of finite activity. We prove a verification theorem and analyze a numerical method for the associated free boundary problem. We prove rigorous error estimates, which are used to draw some conclusions from numerical simulations.

1. Introduction

A portfolio which consists of a positive position in one asset, and a negative position in another is called a pair trade. Pairs trading was developed at Morgan Stanley in the late 1980’s, and today it is one of the most common investment strategies in the financial industry. The idea behind pairs trading is quite intuitive: the investor finds two assets, for which the prices have moved together historically. When the price spread widens, the investor takes a short position in the outperforming asset, and a long position in the underperforming one with the hope that the spread will converge again, generating a profit. A main advantage of pairs trading is that the short position can, in principle, remove any exposure to market risk. For a historical evaluation of pairs trading we refer to \cite{6}.

To model the pair spread the authors in \cite{3} proposed a mean reverting Gaussian Markov chain which they considered to be observed in Gaussian noise. Recently, in \cite{2} the authors suggested the continuous time analogue, the so called mean reverting Ornstein-Uhlenbeck process. In this paper we generalize the model of the spread to also include possible jumps. Let \((\Omega, \mathcal{F}, \mathcal{P})\) be a complete probability space where the following processes are defined in such a way that they are independent:

- A standard Brownian motion \(W = \{W_t\}_{t \geq 0}\).
- A Possion process \(N^\lambda = \{N^\lambda_t\}_{t \geq 0}\) with intensity \(\lambda > 0\).
A sequence of independent random variables \( \{X^\varphi_k\}_{k=1}^\infty \) with common continuous symmetric density \( \varphi \). Moreover, the support of \( \varphi \) is contained in the interval \((-J, J)\) for some \( J > 0 \).

Define the compound Poisson process \( C^{\lambda, \varphi} = \{C^{\lambda, \varphi}_t\}_{t \geq 0} \) in the usual way as

\[
C^{\lambda, \varphi}_t = \sum_{k=1}^{N^\lambda_t} X^\varphi_k
\]

and denote the filtration generated by \( W \), \( C^{\lambda, \varphi} \) and the null sets of \( F \) by \( F = \{F_t\}_{t \geq 0} \). It is well known that this filtration satisfies the usual hypotheses (see for example [10]). From now on, when we say that a process is a martingale, submartingale or supermartingale we mean that this is with respect to \( F \).

Let the difference \( U = \{U_t\}_{t \geq 0} \) between the assets be the unique solution of the stochastic differential equation

\[
dU_t = -\mu U_t \, dt + \sigma \, dW_t + dC^{\lambda, \varphi}_t, \quad t > 0,
\]

where \( \mu > 0, \sigma > 0 \). (The solution of equation (1.1) is usually called a generalized Ornstein-Uhlenbeck process or an Ornstein-Uhlenbeck type process.) Sometimes we will denote the driving Lévy process in (1.1) by \( Z^{\sigma, \lambda, \varphi} \), i.e.

\[
Z^{\sigma, \lambda, \varphi}_t = \sigma W_t + C^{\lambda, \varphi}_t, \quad t \geq 0.
\]

As discussed in [2], there is a large risk associated with a pair trading strategy. Indeed, if the market spread ceases to be mean reverting, the investor is exposed to substantial risk. Therefore, in practice the investor typically chooses in advance a stop-loss level \( a < 0 \), which corresponds to the level of loss above which the investor will close the pair trade. For a given stop-loss level \( a < 0 \) define

\[
\tau_a = \inf\{t \geq 0 : U_t \leq a\},
\]

the first hitting time of the region \((-\infty, a]\), and the so called value function

\[
V(x) = \sup_{\tau} E_x[U_{\tau \wedge \tau}], \quad x \in \mathbb{R},
\]

where the supremum is taken over all stopping times with respect to \( U \). (Here and in the sequel \( E_x \) means expected value when \( U_0 = x \).) The major interest here is to characterize \( V \), and perhaps more importantly, to describe the stopping time where the supremum is attained. Since the drift has the opposite sign as \( U \), we have no reason to liquidate our position as long as \( U \) is negative. On the other hand, if \( U \) is positive, then the drift is working against the investor and for large values of \( U \) the size of the drift should overcome the possible benefits from random variations. Moreover, since the jumps are assumed to be symmetric, this indicates that there is a stopping barrier \( b > 0 \) with the property that we should keep our position when \( U_t < b \) and liquidate as soon as \( U_t \geq b \). We note that we cannot be sure to close the pair trade at any of the boundaries \( a \) or \( b \), because the spread can exhibit jumps. This was not the case in [2] and it is the major reason for the additional difficulties encountered in the present paper.

General optimal stopping theory (described for example in [2] Ch. 3) leads us to believe that the value function is given by \( V = u \), where \( (u, b) \) is the solution of
the free boundary problem

\[ G_U u(x) = 0, \quad x \in (a, b), \]
\[ u(x) = x, \quad x \notin (a, b), \]
\[ u'(b) = 1. \]

Here \( G_U \) is the infinitesimal generator of \( U \), which is defined on the space of twice continuously differentiable functions \( f : \mathbb{R} \to \mathbb{R} \) with compact support:

\[ G_U f(x) = \frac{\sigma^2}{2} f''(x) - \mu x f'(x) + \lambda \int_{-\infty}^{\infty} (f(x + y) - f(x)) \varphi(y) \, dy, \quad x \in \mathbb{R}. \]

Moreover, the stopping time where the supremum in (1.3) is attained should be

\[ \tau_b = \inf \{ t \geq 0 : U_t \geq b \}. \]

Indeed, our first result is a so called verification theorem.

**Theorem 1.1.** Assume that \((u, b)\) is a classical solution of (1.4) with

a) \( G_U u(x) \leq 0, \) for \( x > b, \)
b) \( u(x) \geq x, \) for \( x \in \mathbb{R}. \)

Then \( u(x) = V(x) = \mathbb{E}_x[U_{\tau_a \wedge \tau_b}], \) for \( x \in \mathbb{R}, \) where \( V \) is given by (1.3).

**Remark:** As seen from the assumptions on \( \varphi, \) we are assuming that the absolute value of the jumps of the process \( \{U_t\}_{t \geq 0} \) are bounded. The reason is that on the financial market, an asset cannot jump to arbitrarily large levels. If nothing else, the jumps are bounded by all the money in the world.

The rest of the paper is organized as follows. In Section 2 we prove Theorem 1.1 and in Section 3 we discuss a numerical solution of the free boundary problem (1.4). We also present strong evidence for the existence and uniqueness of a solution of (1.4).

2. **Proof of Theorem 1.1**

Before we start to prove Theorem 1.1 we need to recall some facts. From the general theory in [5] we get that the boundary value problem

\[ G_U u(x) = 0, \quad x \in (a, b), \]
\[ u(x) = x, \quad x \notin (a, b), \]

has a unique classical solution and that such a solution belongs to the space

\[ C^2(\mathbb{R} \setminus \{a, b\}) \cap C^1(\mathbb{R} \setminus \{a, b\}) \cap C(\mathbb{R}). \]

Moreover, the finite left and right limits of \( u' \) and \( u'' \) exist at \( a \) and \( b. \) Although these facts follow from [5], we present in Theorem 1.1 a self-contained proof for the simpler situation that we consider here. Hence, if \((u, b)\) is a classical solution of (1.4), then necessarily

\[ u \in C^2(\mathbb{R} \setminus \{a, b\}) \cap C^1(\mathbb{R} \setminus \{a\}) \cap C(\mathbb{R}) \]

with finite left and right limits of \( u' \) and \( u'' \) everywhere. Furthermore, recall a generalized version of Itô’s formula for convex functions (see for example [10, Ch. 4]):
Theorem 2.1 (Meyer-Itô formula). Let $X = \{X_t\}_{t \geq 0}$ be a semimartingale and let $f$ be the difference of two convex functions. Then

$$f(X_t) = f(X_0) + \int_{0+}^t D^- f(X_{s-}) \, dX_s + \sum_{0 < s \leq t} (f(X_s) - f(X_{s-}) - D^- f(X_{s-}) \Delta X_s) + \frac{1}{2} \int_{-\infty}^\infty L_t^y(X) \, d\mu(y),$$

where $D^- f$ is the left derivative of $f$, $\mu$ is a signed measure which is the second generalized derivative of $f$ and $\{L_t^a(X)\}_{t \geq 0}$ is the local time process of $X$ at $a$.

Due to the regularity of $u$ it can be written as a difference of two convex functions (see Problem 6.24 in [7, Ch. 3]). Moreover, the second derivative measure $\mu$ of $u$ can be split into two parts $\mu = \mu_c + \mu_d$, where the continuous part $\mu_c$ is given by $d\mu_c = u''(x) \, dx$ and the discrete part $\mu_d = \delta_a$ is a point mass at $a$. Here, $u''(x)$ denotes the second derivative of $u$ at $x$ except at the points $a$ and $b$, where it denotes the right second derivative (which we know is finite). By Corollary 1 of the Meyer-Itô formula in [10], we can now write

$${\frac{1}{2}} \int_{-\infty}^\infty L_t^y(U) \, d\mu(y) = \frac{1}{2} \int_0^t u''(U_{s-}) \, d[U,U]_s + \frac{1}{2} L_t^y(U) (u'(a+) - u'(a-))$$

$$= \frac{\sigma^2}{2} \int_0^t u''(U_{s-}) \, ds + \frac{1}{2} L_t^a(U) (u'(a+) - u'(a-)),$$

where $[U,U]^c$ denotes the continuous part of the quadratic variation $[U,U]$.

Furthermore, by using [10] and the compensated Poisson random measure

$$\tilde{N}_Z(dt, dy) = N_Z(dt, dy) - \lambda dt \varphi(y) dy,$$

where $N_Z$ denotes the jump measure associated with $Z^{\sigma, \lambda, \varphi}$, we get

$$\int_{0+}^t D^- u(U_{s-}) \, dU_s + \sum_{0 < s \leq t} (u(U_s) - u(U_{s-}) - D^- u(U_{s-}) \Delta U_s)$$

$$= -\mu \int_0^t U_s - D^- u(U_{s-}) \, ds + \sigma \int_0^t D^- u(U_{s-}) \, dW_s$$

$$+ \int_{0+}^t \int_\mathbb{R} (u(U_{s-} + y) - u(U_{s-})) \tilde{N}_Z(ds, dy)$$

$$+ \lambda \int_0^t \int_\mathbb{R} (u(U_{s-} + y) - u(U_{s-})) \varphi(y) dy ds.$$

Summing up, we now have for $t \geq 0$

$$u(U_t) = u(U_0) + \int_0^t \left( \frac{\sigma^2}{2} u''(U_{s-}) - \mu U_{s-} D^- u(U_{s-}) \right) ds$$

$$+ \lambda \int_0^t \int_\mathbb{R} (u(U_{s-} + y) - u(U_{s-})) \varphi(y) dy ds$$

$$+ \frac{1}{2} L_t^a(U) (u'(a+) - u'(a-)) + M_t,$$
where
\[ M_t = \sigma \int_0^t D^- u(U_s-) \, dW_s + \int_0^t \int_{\mathbb{R}} (u(U_s + y) - u(U_s-)) \, \tilde{N}_Y(ds, dy). \]

Since \( u \) is Lipschitz, has a bounded left derivative and since the jumps density \( \varphi \) has a finite swe get that \( \{M_t\}_{t \geq 0} \) is a martingale.

**Lemma 2.2.** Assume \( a \in \mathbb{R} \) and \( U_0 > a \). Then a.s. \( L_{\tau_a \wedge t}^a(U) = 0 \) for all \( t \geq 0 \).

**Proof.** Fix \( a \in \mathbb{R} \) and assume \( U_0 > a \). Since the local time process \( \{L_t^a\}_{t \geq 0} \) is continuous in \( t \) it is enough to prove that for fixed \( t \geq 0 \) we have \( L_{\tau_a \wedge t}^a(U) = 0 \) a.s.

From Proposition 2.1, we get that
\[
\frac{1}{2} L_{\tau_a \wedge t}^a(U) = \begin{cases} \int_0^{\tau_a \wedge t} (U_{\tau_a \wedge t} - a)^- - \sum_{0 < s \leq \tau_a \wedge t} 1_{\{U_{s-} > a\}}(U_s - a)^- \\ + \int_{0+}^{\tau_a \wedge t} 1_{\{U_{s-} \leq a\}} dU_s - \sum_{0 < s \leq \tau_a \wedge t} 1_{\{U_{s-} \leq a\}}(U_s - a)^+ \end{cases}.
\]

Furthermore, from the fact that \( U_s > a \) for all \( 0 < s < \tau_a \wedge t \), we get that \( U_{s-} \geq a \) for all \( 0 < s < \tau_a \wedge t \) and from the left continuity of \( U_{s-} \), we can conclude that we also have \( U_{\tau_a \wedge t-} \geq a \). From that and by splitting the integral and the sum, we obtain
\[
\frac{1}{2} L_{\tau_a \wedge t}^a(U) = 1_{\{U_{\tau_a \wedge t} = a\}}(U_{\tau_a \wedge t} - a)^- + \sum_{0 < s < \tau_a \wedge t} 1_{\{U_{s-} = a\}}(U_s - a)
\]
\[
- \sum_{0 < s < \tau_a \wedge t} 1_{\{U_{s-} = a\}}(U_s - a)^+ + \int_{0+}^{\tau_a \wedge t} 1_{\{U_{s-} = a\}} dU_s
\]
\[
- \int_{0+}^{\tau_a \wedge t} 1_{\{U_{s-} = a\}} dU_s - \sum_{0 < s < \tau_a \wedge t} 1_{\{U_{s-} = a\}}(U_s - a)^+.
\]

From the observation that if \( U_{s-} = a \) for some \( 0 < s < \tau_a \wedge t \), then \( s \) is a jump time and the jump must be in the up direction, we conclude that the right hand side of the last expression is zero and so we are done. \( \square \)

**Remark:** In a similar way one can show that, if \( a < U_0 < b \), then
\[ L_{\tau_a \wedge t}^a(U) = 0 \text{ and } L_{\tau_a \wedge t}^b(U) = 0 \text{ for } t \geq 0. \]

**Proof of Theorem 1.1.** Since \( u(x) = V(x) = \mathbb{E}_x[U_{\tau_a \wedge t}] = x \), when \( x \leq a \), we can assume that \( x > a \). Define \( Y_t = u(U_{\tau_a \wedge t}) \), \( t \geq 0 \). By using (2.4), Lemma 2.2, the expression (1.5) for the generator of \( U \), and (1.4), we get
\[
Y_t = u(x) - \int_0^{\tau_a \wedge t} \mu U_{s-} 1_{\{U_{s-} \geq b\}} \, ds
\]
\[
+ \lambda \int_0^{\tau_a \wedge t} \int_{\mathbb{R}} (u(U_{s-} + y) - u(U_{s-})) \varphi(y) 1_{\{U_{s-} \geq b\}} \, dy \, ds + M_{\tau_a \wedge t}.
\]

Property a) and the martingale property of \( \{M_{\tau_a \wedge t}\} \) give that \( \{Y_t\}_{t \geq 0} \) is a super-martingale. Furthermore, from property b) we get that \( Y_t \geq U_{\tau_a \wedge t} \), for \( t \geq 0 \), and since
\[
U_{\tau_a \wedge t} \geq a - J, \quad t \geq 0,
\]
we can apply the optional sampling theorem (see [7]) and obtain
\[ E_x[U_{\tau_n \wedge t}] \leq E_x[Y_{\tau}] \leq E_x[Y_0] = u(x), \]
where \( \tau \) is an arbitrary stopping time with respect to \( U \). Hence, \( V(x) \leq u(x) \) for \( x > a \). In particular, if \( x \geq b \) then \( x \leq V(x) \leq u(x) = x \) and so \( u(x) = V(x) = E_x[U_{\tau_n \wedge t}] \) when \( x \geq b \).

For the case when \( a < x < b \), note that from (2.4) we get for \( t \geq 0 \) that
\[ Y_{\tau_n \wedge t} = M_{\tau_n \wedge t} + u(x) \]
and since
\[ a - J \leq Y_{\tau_n \wedge t} \leq b + J, \quad t \geq 0, \]
the optional sampling theorem applies again and we obtain \( u(x) = E_x[Y_{\tau_n}] \). Finally, the fact that \( Y_{\tau_b} = U_{\tau_n \wedge \tau_b} \) gives us \( u(x) = E_x[U_{\tau_n \wedge \tau_b}] \leq V(x) \) and the proof is complete. \( \Box \)

3. Numerical solution of the free boundary value problem

We have not been able to give a rigorous proof of the existence and uniqueness of the solution \((u, b)\) of the free boundary value problem (1.4). We therefore resort to a numerical solution by means of the finite element method. However, at the end of this section we will show that we have strong computational evidence for both existence and uniqueness for (1.4). In order to achieve this we first show rigorous existence and regularity results for the boundary value problem (2.1) and rigorous convergence estimates with explicit constants for the finite element approximation.

3.1. The boundary value problem. We begin by transforming the free boundary value problem (1.4) to a problem with homogeneous boundary values. Set \( v(x) = u(x) - x \) and use \( \int_{-\infty}^{\infty} y \varphi(y) \, dy = 0 \) to get
\[
-\frac{1}{2} \sigma^2 v''(x) + \mu xv'(x) - \lambda \int_{-\infty}^{\infty} (v(x + y) - v(x)) \varphi(y) \, dy = -\mu x, \quad x \in (a, b),
\]
\[
v(x) = 0, \quad x \notin (a, b),
\]
\[
v'(b) = 0.
\]
Introducing the operators
\[
\mathcal{L} v(x) = -\frac{1}{2} \sigma^2 v''(x) + \mu xv'(x),
\]
\[
\mathcal{I} v(x) = \lambda \int_{-\infty}^{\infty} (v(x + y) - v(x)) \varphi(y) \, dy,
\]
our approach will be to first solve the boundary value problem
\[
\mathcal{L} v - \mathcal{I} v = f, \quad x \in (a, b),
\]
\[
v(x) = 0, \quad x \notin (a, b),
\]
with \( f(x) = -\mu x \), and then for fixed \( a < 0 \) find \( b > a \) such that \( v'(b) = 0 \).

To solve (3.2) we follow a standard approach based on a weak formulation and Fredholm’s alternative. We denote by \((\cdot, \cdot)\) and \( \| \cdot \| \) the standard scalar product and norm in \( L^2(a, b) \), and we denote by \( H^1(a, b) \) and \( H^1_0(a, b) = \{ v \in H^1(a, b) : v(a) = v(b) = 0 \} \) the standard Sobolev spaces. We denote the derivative \( Dv = dv/dx \). We
choose \( v \mapsto \|Dv\| \) to be the norm in \( H^1_0(a,b) \), which is equivalent to the standard \( H^1 \)-norm. We extend functions \( v \in L_2(a,b) \) by zero outside \((a,b)\) so that \( I_v \) is properly defined. We define bilinear forms

\[
A_L(u, v) = \int_a^b \left( \frac{1}{2} \sigma^2 u'(x)v'(x) + \mu xu'(x)v(x) \right) \, dx, \quad u, v \in H^1_0(a,b),
\]

(3.3)

\[
A_T(u, v) = \int_a^b I_v(x)v(x) \, dx, \quad u, v \in L_2(a,b)
\]

\[
A(u, v) = A_L(u, v) - A_T(u, v).
\]

Since \( \int_{-\infty}^\infty \varphi(y) \, dy = 1 \), \( \varphi(-y) = \varphi(y) \), and \( v(x) = 0 \) for \( x \notin (a,b) \), we also have

\[
I_v(x) = \lambda \int_a^b \varphi(x-y)v(y) \, dy - \lambda v(x), \quad v \in L_2(a,b).
\]

(3.4)

The convolution operator \( I_1 v(x) = \int_{-\infty}^\infty \varphi(x-y)v(y) \, dy \) is bounded in \( L_2(a,b) \) with constant \( c = \int_{-\infty}^\infty \varphi(y) \, dy = 1 \) by Young’s inequality. Hence,

\[
\|I_v\| \leq 2\lambda \|v\|, \quad v \in L_2(a,b),
\]

(3.5)

\[
\|D I_v\| \leq 2\lambda \|Dv\|, \quad v \in H^1_0(a,b),
\]

(3.6)

and

\[
-A_T(v, v) \geq \lambda \left( \|v\|^2 - \|I_1 v\| \right) \geq 0, \quad v \in L_2(a,b).
\]

Hence,

\[
|A(u, v)| \leq \frac{1}{2} \sigma^2 \|Du\| \|Dv\| + \mu \max(|a|, |b|) \|Dv\| \|v\| + 2\lambda \|u\| \|v\|
\]

\[
\leq c_1 \|Du\| \|Dv\|, \quad u, v \in H^1_0(a,b),
\]

\[
c_1 = \frac{1}{2} \sigma^2 + c_2 (\mu \max(|a|, |b|) + 2\lambda c_2),
\]

where we also used Poincaré’s inequality

\[
\|v\| \leq c_2 \|Dv\|, \quad v \in H^1_0(a,b), \quad c_2 = (b-a)/\pi.
\]

By integration by parts we obtain

\[
A_L(v, v) = \frac{1}{2} \sigma^2 \|Dv\|^2 - \frac{1}{2} \mu \|v\|^2, \quad v \in H^1_0(a,b),
\]

so that \( A(\cdot, \cdot) \) is bounded and coercive on \( H^1_0(a,b) \):

\[
|A(u, v)| \leq c_1 \|Du\| \|Dv\|, \quad u, v \in H^1_0(a,b),
\]

(3.8)

\[
A(v, v) \geq \frac{1}{2} \sigma^2 \|Dv\|^2 - \frac{1}{2} \mu \|v\|^2, \quad v \in H^1_0(a,b).
\]

(3.9)

We say that \( v \in H^1_0(a,b) \) is a weak solution of \( \mathcal{L} w = g \) if

\[
A(v, \phi) = (f, \phi) \quad \forall \phi \in H^1_0(a,b).
\]

(3.10)

We also use the adjoint problem: find \( w \in H^1_0(a,b) \) such that

\[
A(\phi, w) = (\phi, g) \quad \forall \phi \in H^1_0(a,b).
\]

(3.11)

The strong form is (note that \( I \) is self-adjoint in \( L_2(a,b) \))

\[
\mathcal{L}^* w(x) - I_w(x) = g(x), \quad x \in (a,b),
\]

(3.12)

\[
w(x) = 0, \quad x \notin (a,b),
\]

where

\[
\mathcal{L}^* w(x) = -\frac{1}{2} \sigma^2 w''(x) - \mu x w'(x) - \mu w(x).
\]
We may now prove the existence and uniqueness of a classical solution of (3.2). In principle this follows from the general theory in [5], but we present a self-contained proof, with explicit constants, for the simpler situation that we consider here. The theorem also provides results necessary for the analysis of the finite element method.

**Theorem 3.1.** The boundary value problem (3.2) has a unique weak solution \( v \in H^1_0(a, b) \) for every \( f \in L_2(a, b) \). The solution belongs to \( H^2(a, b) \) and there is a constant \( c_3 \) such that

\[
\|D^2v\| \leq c_3\|f\|.
\]

Moreover, if \( f(x) = -\mu x \), then the solution is classical, \( v \in C^2([a, b]) \). Similarly, the adjoint problem (3.12) has a unique weak solution \( w \in H^1_0(a, b) \) for each \( g \in L_2(a, b) \), which belongs to \( H^2(a, b) \) and

\[
\|D^2w\| \leq c_3\|g\|.
\]

**Proof.** The proof is a standard argument as presented, for example, in [4, Ch. 6] for elliptic PDEs. The only difference is that the lowest order term in (3.12) is defined by means of an integral operator, but the crucial properties (3.8), (3.9) are the same.

We first show that weak solutions are regular. We use a regularity result for elliptic problems (see [3] p. 323)): If \( v \) is a weak solution of

\[
\mathcal{L}v(x) = g(x), \ x \in (a, b); \quad v(a) = v(b) = 0,
\]

and if \( g \in H^k(a, b) \) for some \( k \geq 0 \), then \( v \in H^{k+2}(a, b) \). A weak solution \( v \in H^1_0(a, b) \) of (3.2) satisfies this with \( g = f + I\mu \), where (3.5), (3.6) \( I\mu \in H^1(a, b) \).

For \( f \in L_2(a, b) \) we conclude that \( v \in H^2(a, b) \). If \( f \in H^1(a, b) \), then we have \( v \in H^3(a, b) \) and by Sobolev’s imbedding \( v \in C^2([a, b]) \). In particular, a weak solution is classical when \( f(x) = 0 \) and \( f(x) = -\mu x \). Analogous regularity results hold for the adjoint problem.

Now we can prove existence. Let

\[
A_\mu(u, v) = A(u, v) + \frac{1}{2} \mu(u, v).
\]

By the Lax-Milgram lemma we know that the shifted problem

\[
A_\mu(u, \phi) = (g, \phi) \quad \forall \phi \in H^1_0(a, b),
\]

has a unique solution \( u \in H^1_0(a, b) \) for each \( g \in L_2(a, b) \). This defines the bounded linear operator \( A_\mu^{-1} : L_2(a, b) \to H^1_0(a, b) \) by \( u = A_\mu^{-1}g \). The equation (3.10) is now equivalent to

\[
v = A_\mu^{-1}f + \frac{1}{2} \mu A_\mu^{-1}v,
\]

or \( v - K\mu = h \), where \( h = A_\mu^{-1}f \) and where \( K = \frac{1}{2} \mu A_\mu^{-1} : L_2(a, b) \to L_2(a, b) \) is a compact operator, because \( H^1_0(a, b) \) is compactly imbedded in \( L_2(a, b) \).

By the Fredholm alternative we know that the latter equation is uniquely solvable for every \( h \in L_2(a, b) \) if and only if the corresponding homogeneous equation has no non-trivial solution. But a non-trivial solution of \( v - K\mu = 0 \) would be a weak solution, and hence a classical solution, of (3.2) with \( f = 0 \).

Then we can apply the maximum principle for classical solutions of (3.2), see [5] Theorem 3.1.3. It says that if a classical function satisfies \( (\mathcal{L} - I)u \leq 0 \) in \( (a, b) \), then \( \max_{[a, b]} u = \max_{\partial \Omega \backslash (a, b)} u \). (The maximum principle for the integro-differential equation is proved in the same way as for the differential equation after noting that
\[-\mathcal{I}u(x_0) \geq 0\] if \(u\) has a maximum at \(x_0\). We conclude that the homogeneous equation has no non-trivial solution and therefore \((3.2)\) has a unique weak solution for every \(f \in L_2(a,b)\). By the Fredholm theory the adjoint problem \((3.12)\) is then also uniquely solvable for all \(g \in L_2(a,b)\).

Finally, we prove the bounds \((3.13)\) and \((3.14)\). Let \(v = A^{-1}f\) and \(w = (A^*)^{-1}g\) denote the solution operators of \((3.2)\) and \((3.12)\), respectively.

Let \(f \in H^0_2(a,b)\). Then \(v = A^{-1}f\) is classical and the maximum principle gives

\[\|v\|_{L_\infty(a,b)} \leq c_4\|f\|_{L_\infty(a,b)}.\]

In order to compute the explicit constant we briefly recall the proof. Let

\[\phi(x) = \begin{cases} e^{\gamma(b-a)} - e^{\gamma(x-a)}, & x \leq b, \\ 0, & x \geq b, \end{cases}\]

where \(\gamma > 0\) is chosen so that that \(A\phi \geq 1\) in \((a,b)\). Then \(u(x) = \|f\|_{L_\infty(a,b)}\phi(x)\) satisfies \(Au \geq \|f\|_{L_\infty(a,b)} \geq f = Av\) in \((a,b)\) and \(u \geq 0\) outside \((a,b)\), so that the maximum principle gives \(\max_{(a,b)}(v-u) = \max_{(a,b)}(v-u) = 0\), that is, \(u \geq v\) in \([a,b]\). Hence \(v \leq \|\phi\|_{L_\infty(a,b)}\|f\|_{L_\infty(a,b)}\) in \([a,b]\). The lower bound \(v \geq -\|\phi\|_{L_\infty(a,b)}\|f\|_{L_\infty(a,b)}\) is obtained in a similar way and so we get

\[\|v\|_{L_\infty(a,b)} \leq \|\phi\|_{L_\infty(a,b)}\|f\|_{L_\infty(a,b)} \leq e^{\gamma(b-a)}\|f\|_{L_\infty(a,b)}.\]

To determine \(\gamma\), let \(x \in (a,b)\) and compute

\[-\mathcal{I}\phi(x) = \lambda e^{\gamma(x-a)} \int_{-\infty}^{b-x} (e^{\gamma y} - 1)\varphi(y) \, dy + \lambda (e^{\gamma(b-a)} - e^{\gamma(x-a)}) \int_{b-x}^{\infty} \varphi(y) \, dy \geq -\lambda e^{\gamma(x-a)} \int_{-\infty}^{\infty} \varphi(y) \, dy = -\lambda e^{\gamma(x-a)}.\]

Hence,

\[A\phi(x) \geq (\frac{1}{2}\sigma^2\gamma^2 - \mu b\gamma - \lambda)e^{\gamma(x-a)} \geq 1, \quad x \in (a,b),\]

if \(\frac{1}{2}\sigma^2\gamma^2 - \mu b\gamma - \lambda \geq 1\), that is, if

\[\gamma = \hat{\gamma} = \frac{\mu b}{\sigma^2} + \sqrt{\frac{2(\lambda + 1)}{\sigma^2}}.\]

Then we conclude that \((3.15)\) holds with \(c_4 = e^{\hat{\gamma}(b-a)}\).

Hence, since \(\|v\| \leq (b-a)^{\frac{3}{2}}\|v\|_{L_\infty(a,b)}\) and \(\|f\|_{L_\infty(a,b)} \leq (b-a)^{\frac{3}{2}}\|Df\|\), we obtain the bound

\[\|v\| = \|A^{-1}f\| \leq c_5\|Df\| \quad \forall f \in H^0_2(a,b), \quad c_5 = (b-a)c_4.\]

By duality we conclude

\[\|(A^{-1})^*\|_{B(L_2,H^{-1})} = \|A^{-1}\|_{B(H^0_2,L_2)} \leq c_5.\]

Hence

\[w_{H^{-1}} = (A^*)^{-1}g_{H^{-1}} = \|(A^{-1})^*g\|_{H^{-1}} \leq c_5\|g\| \quad \forall g \in L_2(a,b),\]
where $H^{-1}(a, b) = (H^1_0(a, b))^*$ and

$$\|w\|_{H^{-1}} = \sup_{\phi \in H^1_0} \frac{\langle \phi, w \rangle}{\|D\phi\|}.$$ 

Recall that $v \mapsto \|Dv\|$ is the chosen norm in $H^1_0(a, b)$. By using $\phi = w \in H^1_0(a, b)$ here we obtain

$$\|w\|^2 \leq \|w\|_{H^{-1}}\|Dw\|.$$ 

We take $\phi = w$ in the adjoint equation (3.11) and use coercivity (3.9), the inequality $2ab \leq c_1a^2 + c_2b^2$, and (3.17) to get

$$\frac{1}{2}\sigma^2\|Dw\|^2 \leq A(w, w) + \frac{1}{2}\mu\|w\|^2 \leq \|g\|\|w\| + \frac{1}{2}\mu\|w\|^2$$

$$\leq \frac{1}{2}\mu^{-1}\|g\|^2 + \mu\|w\|^2 \leq \frac{1}{2}\mu^{-1}\|g\|^2 + \mu\|w\|_{H^{-1}}\|Dw\|$$

$$\leq \frac{1}{2}\mu^{-1}\|g\|^2 + \mu^2\sigma^{-2}\|w\|^2_{H^{-1}} + \frac{1}{4}\sigma^2\|Dw\|^2.$$ 

With (3.16) this leads to

$$\|Dw\|^2 \leq 2\sigma^{-2}\mu^{-1}\|g\|^2 + 4\sigma^{-4}\mu^{-2}\|w\|^2_{H^{-1}}$$

and with Poincaré’s inequality (3.7),

$$\|w\| \leq c_2\|Dw\| \leq c_2(2\sigma^{-2}\mu^{-1} + 4\sigma^{-4}\mu^{-2}c_3^2)^\frac{1}{2}\|g\|.$$ 

Hence

$$\|(A^*)^{-1}g\| = \|w\| \leq c_6\|g\| \quad \forall g \in L^2(a, b),$$

$$c_6 = c_2(2\sigma^{-2}\mu^{-1} + 4\sigma^{-4}\mu^{-2}c_3^2)^\frac{1}{2}.$$ 

By duality in $L^2$ we also have

$$\|v\| = \|A^{-1}f\| \leq c_6\|f\| \quad \forall f \in L^2(a, b).$$ 

In order to bound $D^2v$ we recall that $v \in H^2(a, b)$. Hence it satisfies (3.2) strongly, so that with (3.3) we obtain

$$\frac{1}{2}\sigma^2\|D^2v\| \leq \mu\|xv\| + \|Dv\| + \|f\|$$

$$\leq \mu\max(|a|, |b|)\|Dv\| + 2\lambda\|v\| + \|f\|$$

$$\leq \mu\max(|a|, |b|)\|D^2v\|^{\frac{1}{2}}\|v\|^{\frac{1}{2}} + 2\lambda\|v\| + \|f\|$$

$$\leq \frac{1}{2}\sigma^2\|D^2v\| + (2\lambda + \sigma^{-2}\mu^2\max(|a|, |b|)^2)\|v\| + \|f\|.$$ 

Hence,

$$\|D^2v\| \leq c_7\|f\| + c_8\|v\|,$$

$$c_7 = 4\sigma^{-2}, \quad c_8 = 4\sigma^{-2}(2\lambda + \mu + \sigma^{-2}\mu^2\max(|a|, |b|)^2).$$

In the last step we replaced $2\lambda$ by $2\lambda + \mu$ in $c_8$, so that the same result holds also for the adjoint equation (3.12). Using also (3.18) and (3.16) we finally conclude

$$\|D^2v\| \leq c_3\|f\|, \quad \|D^2w\| \leq c_3\|g\|,$$

$$c_3 = c_7 + c_6c_8.$$ 

This completes the proof. □
3.2. The finite element method. The finite element method is based on a family of subdivisions $\mathcal{T}_h$ of the interval $[a, b]$ parametrized by the maximal mesh size $h$. Each mesh is of the form

$$\mathcal{T}_h : a = x_0 < x_1 < \cdots < x_{j-1} < x_j < \cdots < x_N = b, \quad h = \max_{j=1,\ldots,N} (x_j - x_{j-1}).$$

We introduce the space $V_h \subset H^1_0(a, b)$ consisting of all continuous functions that reduce to piecewise polynomials of degree $\leq 1$ with respect to $\mathcal{T}_h$. See [5, Ch. 5] or [11, Ch. 1]. Then there is an interpolator $I_h : C([a, b]) \to V_h$ such that $I_h u(x_j) = u(x_j), \ j = 1, \ldots, N,$ and

$$\text{(3.20) } \|D(u - I_h u)\|_{L^p(a, b)} \leq h^{\frac{2}{p} - \frac{1}{2}} \|D^2 u\|, \quad u \in H^2(a, b) \cap H^1_0(a, b), \ p = 2, \infty.$$

To prove this we use the identity

$$D(u - I_h u)(x) = h_j^{-1} \int_{x_{j-1}}^{x_j} (u'(x) - u'(y)) dy = h_j^{-1} \int_{x_{j-1}}^{x_j} \int_y^x u''(z) dz dy,$$

for $x \in (x_{j-1}, x_j)$ and with $h_j = x_j - x_{j-1}$, which yields

$$|D(u - I_h u)(x)| \leq h_j^2 \|D^2 u\|_{L^2(x_{j-1}, x_j)} \leq h_j^2 \|D^2 u\|, \quad x \in (x_{j-1}, x_j).$$

This proves the case $p = \infty$ and for $p = 2$ we have

$$\|D(u - I_h u)\|^2 \leq \sum_{j=1}^N h_j^2 \|D^2 u\|^2_{L^2(x_{j-1}, x_j)} \leq h^2 \|D^2 u\|^2.$$

The finite element problem is based on the weak formulation in (3.10): find $v_h \in V_h$ such that

$$\text{(3.21) } A(v_h, \phi_h) = (f, \phi_h) \quad \forall \phi_h \in V_h,$$

where $A(\cdot, \cdot)$ is defined in (3.3) with the integral operator computed as in (3.2). In the following theorem we prove convergence estimates with explicit constants.

**Theorem 3.2.** Let $v$ be the solution of (3.2) as in Theorem 3.1. There is $h_0 = \sigma/(2^{1/2} \mu^{1/2} c_1 c_3)$ such that, for $h \leq h_0$, $\text{(3.22) } \|v - v_h\| \leq 4 c_2^2 c_3^2 \sigma^{-2} h^2 \|f\|, \quad \|D(v - v_h)\| \leq 4 c_1 c_3 \sigma^{-2} h \|f\|.$

**Proof.** We adapt an argument from [11]. Let $e = v - v_h$ denote the error. By subtraction of (3.21) and (3.10) with $\phi = \phi_h \in V_h \subset H^1_0(a, b)$ we get

$$\text{(3.23) } A(e, \phi_h) = 0 \quad \forall \phi_h \in V_h.$$  

Consider the adjoint problem (3.11) with $g = e$ and solution $w = (A^*)^{-1} e$. With $\phi = e$ this yields

$$\|e\|^2 = A(e, w) = A(e, w - I_h w) \leq c_1 \|D e\| \|D(w - I_h w)\| \leq c_1 \|D e\| h \|D^2 w\| \leq c_1 c_3 h \|D e\| \|e\|.$$

Here we used (3.23), (3.8), (3.20), and (3.14). We conclude

$$\text{(3.24) } \|e\| \leq c_1 c_3 h \|D e\|.$$
In view of (3.23) we have \( \sigma^2 \| De \|^2 \leq A(e, e) + \frac{1}{2} \| e \|^2 = A(e, v) + \frac{1}{2} \| e \|^2 \)
\begin{equation}
\frac{1}{2} \sigma^2 \| De \|^2 \leq c_1 \| De \| \| Dv \| + \frac{1}{2} \mu c_1^2 h^2 \| De \|^2.
\end{equation}

Hence, for \( h \leq h_0 \) sufficiently small \((h_0^2 = \sigma^2/(2\mu c_1^2))\), we have
\[ \| De \| \leq c_9 \| Dv \|, \quad c_9 = 4c_1 \sigma^{-2}. \]

Now if \( f = 0 \) in (3.10) and (3.21), then \( v = 0 \) by uniqueness, and hence \( e = 0 \), so that \( v_h = 0 \). This means that we have uniqueness for the finite element problem (3.21). But this is an equation in a finite dimensional space so existence also follows. Therefore, (3.21) has a unique solution for all \( f \in L_2(a, b) \) if \( h \leq h_0 \).

In order to prove the error estimate (3.22) we return to (3.25) but use \( A(e, e) = A(e, v - v_h) = A(e, v - I_h v) \) instead:
\[ \frac{1}{2} \sigma^2 \| De \|^2 \leq A(e, e) + \frac{1}{2} \| e \|^2 = A(e, v - I_h v) + \frac{1}{2} \| e \|^2 \]
\begin{equation}
\leq c_1 \| De \| \| D(v - I_h v) \| + \frac{1}{2} \mu c_1^2 h^2 \| De \|^2,
\end{equation}

and conclude, for \( h \leq h_0 \),
\[ \| De \| \leq c_9 \| D(v - I_h v) \|, \quad c_9 = 4c_1 \sigma^{-2}. \]

Hence, by (3.21), (3.23), and (3.24),
\[ \| De \| \leq c_9 h \| D^2 v \| \leq c_9 c_3 h \| f \| = 4c_1 c_3 \sigma^{-2} h \| f \|, \]
\[ \| e \| \leq c_1 c_3 h \| De \| \leq 4c_1^2 c_3^2 \sigma^{-2} h^2 \| f \|, \]

which is (3.22).

We finish by proving the pointwise convergence of the derivative.

**Corollary 3.3.** Assume that each finite element mesh \( T_h \) is uniform, that is, \( x_j - x_{j-1} = h \) for \( j = 1, \ldots, N \). Then, for \( h \leq h_0 \) as in Theorem 3.2 we have
\[ |v'(b) - v_h'(b)| \leq c_{10} h^{\frac{1}{2}} \| f \|, \quad c_{10} = 2 + 4c_1 c_3 \sigma^{-2}. \]

**Proof.** We use the inverse inequality
\[ \| D\phi_h \|_{L_\infty(a,b)} \leq h^{-\frac{1}{2}} \| D\phi_h \|, \quad \phi_h \in V_h. \]

To prove this we note that
\[ D\phi_h(x) = h^{-1} \int_{x_{j-1}}^{x_j} D\phi_h(y) dy, \quad x \in (x_{j-1}, x_j), \quad h = x_j - x_{j-1}, \]

which yields
\[ |D\phi_h(x)| \leq h^{-\frac{1}{2}} \| D\phi_h \|_{L_2(x_{j-1}, x_j)} \leq h^{-\frac{1}{2}} \| D\phi_h \|, \quad x \in (x_{j-1}, x_j). \]

Hence, by (3.20) and (3.22),
\[ \| De \|_{L_\infty(a,b)} \leq \| D(v - I_h v) \|_{L_\infty(a,b)} + \| D(I_h v - v_h) \|_{L_\infty(a,b)} \]
\[ \leq \| D(v - I_h v) \|_{L_\infty(a,b)} + h^{-\frac{1}{2}} \| D(I_h v - v_h) \| \]
\[ \leq \| D(v - I_h v) \|_{L_\infty(a,b)} + h^{-\frac{1}{2}} \| D(I_h v - v) \| + h^{-\frac{1}{2}} \| D(v - v_h) \| \]
\[ \leq 2h^{\frac{1}{2}} \| D^2 v \| + h^{-\frac{1}{2}} \| D(v - v_h) \| \leq (2 + 4c_1 c_3 \sigma^{-2}) h^{\frac{1}{2}} \| f \|. \]
Therefore
\[ |v'(b) - v'_h(b)| \leq (2 + 4c_1c_3\sigma^{-2})h^{1/2}\|f\|. \]

\[ \Box \]

In particular, with \( f(x) = -\mu x \), Corollary 3.3 gives
\[ |v'(b) - v'_h(b)| \leq c_{11}h^{1/2}, \quad c_{11} = c_{10}\mu\sqrt{b^3 - a^3} \]

Given numerical values for the parameters \( a, b, \sigma, \mu, \lambda \) we may now compute numerical values for \( h_0 \) and \( c_{11} \). Alternatively, we may conclude that there are uniform bounds \( h_0 \geq \hat{h}_0, \quad c_{11} \leq \hat{c}_{11} \) for \( b \in [b_1, b_2] \) and with the other parameters fixed.

### 3.3. The free boundary value problem.

We use uniform meshes \( \mathcal{T}_h \) with
\[ x_j - x_{j-1} = h = \frac{b - a}{N}, \quad j = 1, \ldots, N. \]

Since we want to vary \( b \), we parametrize by \( N \) instead of \( h \). Let \( f(x) = -\mu x \), fix \( a < 0 \) and let \( v, v_N \) denote the solutions of (3.10) and (3.21) for \( b > a \). Define the functions
\[ F(b) = v'(b), \quad F_N(b) = v'_N(b). \]

From (3.26), we get for \( a < b_1 < b_2 \)
\[ \|F - F_N\|_{L_\infty(b_1, b_2)} \leq \hat{c}_{12}N^{-1/2}, \quad N \geq \hat{N}_0, \]
\[ \hat{c}_{12} = \hat{c}_{11}(b_2 - a)^{1/2}, \quad \hat{N}_0 = \frac{b_2 - a}{h_0}. \]

By writing down the matrix equation for solving the finite element problem (3.21), it is easy to see that, for fixed \( N \), the function \( b \mapsto F_N(b) \) is continuous on \((a, \infty)\). From (3.27) we conclude that \( b \mapsto F(b) \) is also continuous on \((a, \infty)\). Moreover, by a direct consequence of the strong maximum principle and the Hopf boundary point principle for our equation (see [5, Theorem 3.1.4-3.1.5]), we get the following:

**Lemma 3.4.** If \( a < b \leq 0 \), then \( F(b) < 0 \). In particular, if \((u, b)\) is a solution to the free boundary problem (1.4), then \( b > 0 \).

We believe that there exists a unique \( b > 0 \) such that \( F(b) = 0 \). We are not able to provide a rigorous proof of this, but numerical simulations present strong evidence in the following way. Assign numerical values to the parameters \( a, \sigma, \mu, \lambda \) and fix a jump density \( \varphi \). In all our computations, we took \( \varphi \) to be the truncated normal distribution with mean zero, variance \( \gamma > 0 \) and support \([-J, J] \), i.e.

\[ \varphi(y) = \begin{cases} e^{-\frac{y^2}{2\gamma^2}} & \text{if } -J < y < J, \\ \frac{1}{\gamma\sqrt{2\pi}} \left( 2\Phi(J/\gamma) - 1 \right) & \text{if } y \in \mathbb{R}. \end{cases} \]

where
\[ \Phi(x) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^{x} e^{-\frac{y^2}{2}} \, dy, \quad x \in \mathbb{R}. \]
From computations of the boundary value problem (3.21) (see Figures 3.1 and 3.2), we can find $0 \leq b_1 < b_2$ and $\tilde{N} \geq \hat{N}_0$ such that

$$F_\tilde{N}(b_1) \leq -\frac{1}{2}, \quad F_\tilde{N}(b_2) \geq \frac{1}{2}, \quad \text{and} \quad \tilde{c}_{12} \tilde{N}^{-\frac{1}{2}} < \frac{1}{4}.$$  

(The $1/2$ and $1/4$ may vary if we change the parameters.) From (3.27), we can then conclude that

$$F(b_1) < 0, \quad F(b_2) > 0,$$

$$F_N(b_1) < 0, \quad F_N(b_2) > 0 \quad \text{for all} \quad N \geq \tilde{N}.$$ 

Hence, there exists $b \in (b_1, b_2)$ such that $F(b) = 0$ and for each $N \geq \tilde{N}$ there exists $b_N \in (b_1, b_2)$ such that $F_N(b_N) = 0$. Moreover, (3.27) gives us that

$$\lim_{N \to \infty} F(b_N) = 0.$$ 

Of course, we cannot conclude that $b$ is unique and $b_N \to b$ as $N \to \infty$. However, Figure 3.1 suggests that $b$ is unique and from computations with increasing $N$, it seems like $b_N$ converges, see Table 3.1.

We now discuss whether the properties $a)$ and $b)$ in the statement of Theorem 1.1 hold for a solution $(u, b)$ of (1.4). We have no rigorous proof, but computational evidence. The properties $a)$ and $b)$ boil down to

$$(3.28) \quad \lambda \int_a^b v(y) \varphi(y - x) \, dy \leq \mu x, \quad \text{for} \quad x > b,$$ 

and $v \geq 0$ respectively, where $(v, b)$ solves (3.1). We believe that $v \geq 0$ holds for all values of the parameters, but computations suggests that (3.28) may fail for certain parameter values, typically when $\sigma$ is small and $\lambda$ is three or four times larger than $\mu$. See Figures 3.3 and 3.4 where we check (3.28) for $(v_N, b_N)$ instead of $(v, b)$.

| $N$     | $b_N$      |
|---------|------------|
| 2000    | 0.0572939  |
| 4000    | 0.0572743  |
| 6000    | 0.0572678  |
| 8000    | 0.0572653  |

Table 3.1. $a = -0.1$, $\lambda = 10$, $\sigma = 0.2$, $\mu = \frac{\sigma^2}{0.005}$, $\gamma = 0.02$ and $J = 0.05$.

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Figure 3.1. The function $F_N$ when $a = -0.1$, $\lambda = 10$, $\sigma = 0.2$, $\mu = \frac{5^2}{0.005}$, $\gamma = 0.02$ and $J = 0.05$.

Figure 3.2. The solution $(v_N, b_N)$ when $a = -0.1$, $\lambda = 10$, $\sigma = 0.2$, $\mu = \frac{5^2}{0.005}$, $\gamma = 0.02$ and $J = 0.05$. 
Figure 3.3. A simulation of (3.28) when $a = -0.1$, $\lambda = 30$, $\sigma = 0.2$, $\mu = \frac{\sigma^2}{0.005}$, $\gamma = 0.02$ and $J = 0.05$. The condition fails.
Figure 3.4. A simulation of (3.28) when $a = -0.1$, $\lambda = 10$, $\sigma = 0.2$, $\mu = \frac{\sigma^2}{0.005}$, $\gamma = 0.02$ and $J = 0.05$. The condition holds.