Space-Time Analyticity of Solutions to the Heston volatility model in Mathematical Finance

Peter TAKÁČ*
Institut für Mathematik, Universität Rostock,
Ulmenstraße 69, Haus 3, D-18051 Rostock, Germany,
e-mail: peter.takac@uni-rostock.de
Web: http://www.math.uni-rostock.de/forschung/AngAnalysis

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*Joint work with Bénédicte Alziary, CeReMath, Toulouse School of Economics, France.

Abstract

We begin by a brief presentation of a well-known mathematical model for European option pricing in a market with stochastic volatility: the popular *Heston volatility model* (Rev. Financial Studies, 1993). European options are used for *market completion*. We explain the connection between a complete market and the analyticity of the weak solution to a general, strongly parabolic linear Cauchy problem of second order in $\mathbb{R}^N \times (0,T)$ $(N=2)$ with analytic coefficients (in space and time variables). The analytic smoothing property is expressed in terms of holomorphic continuation of global (weak) L^2-type solutions to the system. Given $0 < \xi' < \infty$ and $0 < T' < T < \infty$, we sketch a proof that any L^2-type solution $u : \mathbb{R}^1 \times (0,\infty) \times (0,T) \subset \mathbb{R}^2 \times (0,T) \to \mathbb{R}^1$, $u \equiv u(x,v,t)$, possesses a bounded holomorphic continuation $u(x+\mathrm{i}y, \xi+\mathrm{i}\eta, \sigma+\mathrm{i}\tau)$ into a complex domain in $\mathbb{C}^N \times \mathbb{C}$ $(N=2)$ defined by $(x,\xi,\sigma) \in \mathbb{R}^1 \times (\xi',\infty) \times (T',T)$, $|y| < A_1'$, $|y| < A_2'$, and $|\tau| < B'$, where $A_1', A_2', B' > 0$ are constants depending upon ξ' and T'. The proof uses the extension of a solution to an L^2-type solution in a complex domain in $\mathbb{C}^2 \times \mathbb{C}$, such that this extension satisfies the Cauchy--Riemann equations. The holomorphic extension is thus obtained in a (weighted) Hardy space H^2. A serious difficulty in the Heston model is that the solution is sought only in a half-space $\mathbb{H} = \mathbb{R}^1 \times (0,\infty)$ in $\mathbb{R}^2$ with rather complicated dynamic boundary conditions at the boundary $\partial\mathbb{H} = \mathbb{R}^1 \times \{0\}$; a similarity with the Feller boundary condition (Ann. Math., 1951) will be discussed. We avoid this trouble by a suitable choice of the weight in the weighted L^2 space.

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market completeness, European option

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