Convergence to Black-Scholes for Ergodic Volatility Models

JOSEPH G. CONLON\textsuperscript{1} and MICHAEL G. SULLIVAN\textsuperscript{2}

\textsuperscript{1} Department of Mathematics, University of Michigan, Ann Arbor, MI 48109-1109
e-mail: conlon@umich.edu

\textsuperscript{2} Department of Mathematics, University of Massachusetts, Amherst, MA, 01003-9305
e-mail: sullivan@math.umass.edu

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We study the effect of stochastic volatility on option prices. In the fast mean-reversion model for stochastic volatility of [5], we show that there is a full asymptotic expansion for the option price, centered at the Black-Scholes price. We show how to calibrate the first two terms in the expansion with the implied volatility surface. We show, however, that this price does not converge in a strong sense to Black-Scholes as the mean-reversion rate increases.

1 Introduction

Much of the current research in continuous-time financial math traces back to the seminal work of Black and Scholes [1]. They assume the risky asset price $S_t$ to follow a log-normal
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SDE,

\[ dS_t = \mu S_t dt + \sigma S_t dB^P_t. \]  (1.1)

where \( B^P_t \) is Brownian motion for some filtered probability space \((\Omega, \mathcal{F}, P)\). According to this model, the market is complete; thus, the put option pay-off \( \max\{K - S(T), 0\} \) can be replicated with a risk-free self-financing strategy. Hence, if \( Q \) is the (unique) risk-free measure, then the price of a European put option satisfies

\[ P_{BS}(t, S) = e^{-r(T-t)} E^Q[\max\{K - S(T), 0\} \mid S_t = S], \]  (1.2)

which by Feyman-Kac, solves a specific parabolic PDE. We denote by \( E^Q \) and \( E^P \) the expectations with respect to \( Q \) and \( P \), respectively.

One of the more questionable assumptions in [1], which much empirical evidence demonstrates to be faulty, is that the asset price has constant volatility. The volatility is roughly the standard deviation of the relative change in asset price over one unit of time. Formally, it is the coefficient \( \sigma \) in (1.1). To cite but a few studies challenging the notion of constant volatility, Canina and Figlewski [2] show that implied volatility is not consistent with historical volatility. Cont and Fonseca [3] study the dynamics of the implied volatility surface of option prices. They show that the surface changes over time with little relation to the underlying.

There has been some success pricing options when the volatility is an Itô process. Heston [7] was first to use Fourier transforms to derive a semi-explicit formula for the option price. His result was improved by Duffie, Pan, and Singleton [4] who considered the additional complication of Poisson jumps in both the stock price and volatility processes.
1.1 The Fouque-Papanicolaou-Sircar Model

Fouque, Papanicolaou, and Sircar [5] relax the constant volatility assumption by making volatility be a function of an Ornstein-Uhlenbeck process, $\sigma = f(Y_t)$, where

$$M_1 \leq f(y) \leq M_2 \quad a.e. \quad (1.3)$$

for some positive bounds $M_1, M_2$. (Since $P$ and $Q$ have the same sets of measure zero, we shall not distinguish $P-a.e.$ from $Q-a.e.$) The model becomes, in the risk-neutral probability measure,

$$dS_t = rS_t dt + f(Y_t)S_t dB_t^Q$$

$$dY_t = (\alpha(m - Y_t) - \beta \Lambda(Y_t)) dt + \beta dW_t^Q. \quad (1.5)$$

Here $B_t^Q$ and $W_t^Q$ are Brownian motions with respect to $Q$, $\alpha, m, \beta$ are constant, $\rho = \mathbb{E}^Q[dB_t^Q, dW_t^Q]$ and

$$\Lambda(y) = \frac{\rho(\mu - r)}{f(y)} + \gamma(y) \sqrt{1 - \rho^2}$$

is a combined market price of risk. The risk-free interest rate $r$ is assumed to be constant.

Because the market is incomplete, the risk-neutral measure is not uniquely specified by the stock price alone. The unspecified functional form of $\gamma$ reflects this ambiguity.

If we write the dynamics of $Y_t$ in the objective measure $P$, (1.5) becomes

$$dY_t = \alpha(m - Y_t) dt + \beta dW_t^P. \quad (1.6)$$

For this reason, $Y_t$ (and hence the volatility $\sigma$) is said to be fast mean reverting if $\alpha \gg 1$.

Such behavior has been detected for S&P 500 index data [5]. In [5], Fouque et al examine the asymptotic behavior of the option price as they increase $\alpha$ to $\infty$. More specifically, let $\varepsilon = \alpha^{-1}$ and consider the log-price process $X_t = \ln(S_t)$. They consider the stochastic
volatility model $(X^e_t, Y^e_t)$ given by, in the risk-neutral measure,

\[dX^e_t = \left( r - \frac{1}{2} f^2(Y^e_t) \right) dt + f(Y^e_t) dB^Q_t, \quad (1.7)\]

\[dY^e_t = \frac{1}{\varepsilon} (m - Y_t) - \frac{\nu \sqrt{2}}{\sqrt{\varepsilon}} \Lambda(Y^e_t) \, dt + \frac{\nu \sqrt{2}}{\sqrt{\varepsilon}} dW^Q_t. \quad (1.8)\]

Note that (1.7) is simply Itô’s Lemma applied to (1.4).

Let $P_e(t,x,y)$ be the European put option price in a complete market modeled by equations (1.7) and (1.8):

\[P_e(t,x,y) = e^{-r(T-t)} E^Q[h(X^e_T) \mid Y^e_T = y, X^e_T = x] \quad (1.9)\]

where $h(x) = \max\{K - e^x, 0\}$ is the pay-off function. In [5] the authors obtain the first two terms in the asymptotic expansion of $P_e(t,x,y)$ in powers of $\sqrt{\varepsilon}$,

\[P_e(t,x,y) = P_{BS}(t,x) + \sqrt{\varepsilon} P_1(t,x) + O(\varepsilon). \quad (1.10)\]

Note that the two terms on the RHS of (1.10) are independent of the variable $y$ and hence independent of the instantaneous volatility at time $t$. The correction term $P_1(t,x)$ has been used to derive partial hedging techniques [10] and to price certain barrier options [9].

The Black-Scholes price $P_{BS}(t,x)$ is with respect to a volatility $\sigma$ which is the root mean squared average of the stochastic volatility (see (2.5) and (2.12) for a precise definition). The volatility $\sigma$ can be calibrated from the implied volatility surface $\Sigma$, which is the graph of the volatility (implied by setting equal the Black-Scholes and market prices of the option) as a function of the “moneyness” $K - S_t$ and the time to maturity $T-t$ of the option. The first order correction $P_1(t,x)$ can also be calibrated from the implied
volatility surface by fitting the surface to the family of functions

$$a + b \frac{\ln(K/S_t)}{T - t},$$  \hspace{1cm} (1.11)

with the two free parameters $a, b$. Thus if one calibrates implied volatility by a function of the form (1.11), the corresponding Black-Scholes price gives the price of the option correct to order $\sqrt{\varepsilon}$. The parameters $a$ and $b$ therefore depend on $\varepsilon$. The point of course is that $a, b$ can be estimated from data whereas $\varepsilon$ may not be. The authors of [5] refer to the variable occurring in (1.11) as the log-moneyness-to-maturity ratio, $\kappa$ defined by

$$\kappa = \frac{\ln(K/S_t)}{T - t}. \hspace{1cm} (1.12)$$

The expansion (1.10) was rigorously established by the authors of [5] together with Solna [6]. They prove that for any fixed $x, t$ with $t < T$, there is the limit

$$\lim_{\varepsilon \to 0} \left| P_\varepsilon(t, x, y) - (P_{BS}(t, x) + \sqrt{\varepsilon} P_1(t, x)) \right| \varepsilon^{p-1} = 0, \hspace{1cm} (1.13)$$

provided $p > 0$.

1.2 Main results

Using Fourier transforms and perturbation techniques, we improve (1.13) to show the following:

**Theorem 1** Consider the model from Section 1.1 defined by equations (1.3), (1.7), (1.8) and (1.9). There exist functions $P_2(t, x, y), P_3(t, x, y), \ldots$ such that for any positive $n \in \mathbb{Z}$, and fixed $x, t$ with $t < T$

$$\lim_{\varepsilon \to 0} \left| P_\varepsilon(t, x, y) - P_{BS}(t, x) - \sum_{j=1}^{n} \varepsilon^{j/2} P_j(t, x, y) \right| \varepsilon^{n/p} = 0, \hspace{1cm} (1.14)$$
provided $p > 0$.

The higher order correction terms $P_n(t, x, y), \ n \geq 2$ depend on $y$.

In Section 3, we compute the asymptotic expansion of the price induced by an expansion of the volatility. Comparing the $O(\varepsilon^5)$ terms to those from the expansion of Theorem 1, for $i = 0, 1, 2$, we derive a functional form for the implied volatility surface, correct to $O(\varepsilon^5)$, which is a generalization of (1.11):

$$
\Sigma(\kappa, T - t, y) = \frac{c(y)}{T - t} + \sum_{k=0}^{2} (a_k + b_k(T - t))\kappa^i + \sum_{k=3}^{4} b_k(T - t)\kappa^k, \quad (1.15)
$$

where the $a_k, \ 0 \leq k \leq 2$, and $b_k, \ 0 \leq k \leq 4$, are constants. The only dependence in $y$ in (1.15) is in the function $c(y)$. In particular, if we fix a strike $K_0$ and expiration $T_0$ and let $\kappa = \kappa(x, K, T - t), \kappa_0 = \kappa(x, K_0, T_0 - t)$, we can fit determine $a_k, b_k$ from the observed data of

$$
\Sigma(\kappa, T - t, y)(T - t) - \Sigma(\kappa_0, T_0 - t, y)(T_0 - t).
$$

Let $P^{K,T}$ denote the price of a European put with strike $K$ and expiration $T$. To forecast $P^{K,T}$ over some other time period, we need only observe $P^{K_0, T_0}$, which gives us $\Sigma(\kappa_0, T_0 - t, y)$ and hence $c(y)$, via (1.15). Knowing $c(y), a_k, b_k$, we model $\Sigma(\kappa, T - t, y)$ with (1.15), and hence $P^{K,T}$ from Black-Scholes.

Next we consider the representation of $P_\varepsilon(t, x, y)$ in [5] which generalizes the Hull-White formula. Thus let $\Omega$ be the space of volatility paths $Y^\varepsilon_s, \ t \leq s \leq T$. Then if we define $P_\varepsilon(t, x, Y^\varepsilon)$ by

$$
P_\varepsilon(t, x, Y^\varepsilon) = e^{-r(T-t)}\mathbb{E}^Q[h(X^\varepsilon_T) \mid X^\varepsilon_t = x, Y^\varepsilon], \quad (1.16)
$$
it follows from (1.9) that

\[ P_\varepsilon(t, x, y) = E^Q[P_\varepsilon(t, x, Y^\varepsilon) \mid Y^\varepsilon_t = y]. \]  

(1.17)

The function \( P_\varepsilon(t, x, Y^\varepsilon) \) is explicitly given by equation (2.31) of [5]. It is a Black-Scholes price with volatility determined by a path average over \( Y^\varepsilon \), but also with an initial stock price which depends on \( Y^\varepsilon \). Only when the correlation \( \rho = 0 \) is the initial stock price deterministic as in the Hull-White formula. We prove the following:

**Theorem 2** For the Section 1.1 model there is mean-squared convergence under the \( Q \) measure if and only if \( \rho = 0 \). Thus for \( \rho \neq 0 \) one has

\[ \lim_{\varepsilon \to 0} \|P_\varepsilon(t, x, Y^\varepsilon) - P_{BS}(t, x)\|_{L^2(\Omega, Q)} \neq 0. \]

(1.18)

Theorem 2 for \( \rho = 0 \) was proved by Papanicolaou and Sircar [12]. In section 4 we prove the \( \rho \neq 0 \) case.

We end with the obvious remark that because of put-call parity, all our convergence results hold for European calls as well.
2 Convergence to an Asymptotic Expansion

We now prove Theorem 1. From [5] the value \( P_\varepsilon(t, x, y) \) of the option satisfies the initial value problem

\[
\frac{\partial P_\varepsilon}{\partial t} + \frac{1}{2} f(y)^2 \frac{\partial^2 P_\varepsilon}{\partial x^2} + \left[ r - \frac{1}{2} f(y)^2 \right] \frac{\partial P_\varepsilon}{\partial x} - rP_\varepsilon
+ \frac{1}{\varepsilon} \left\{ \sqrt{2\nu f(y)} \frac{\partial P_\varepsilon}{\partial x \partial y} - \sqrt{2\nu \Lambda}(y) \frac{\partial P_\varepsilon}{\partial y} \right\}
+ \frac{1}{\varepsilon} \left\{ \nu \frac{\partial^2 P_\varepsilon}{\partial y^2} + (m - y) \frac{\partial P_\varepsilon}{\partial y} \right\} = 0, \quad t < T,
\]

\( P_\varepsilon(T, x, y) = h(x) \).

To begin the asymptotic analysis of (2.1) we Fourier transform the equation in the \( x \) variable. Thus putting

\[
\hat{P}_\varepsilon(t, \xi, y) = \int_{-\infty}^{\infty} P_\varepsilon(t, x, y) e^{ix\xi} dx,
\]

we see that \( \hat{P}_\varepsilon(t, \xi, y) \) satisfies the initial value problem,

\[
\frac{\partial \hat{P}_\varepsilon}{\partial t} - \frac{1}{2} f(y)^2 \xi^2 \hat{P}_\varepsilon - i\xi \left[ r - \frac{1}{2} f(y)^2 \right] \hat{P}_\varepsilon - r\hat{P}_\varepsilon
- \frac{1}{\varepsilon} \left\{ \sqrt{2\nu f(y)} i\xi \frac{\partial \hat{P}_\varepsilon}{\partial y} + \sqrt{2\nu \Lambda}(y) \frac{\partial \hat{P}_\varepsilon}{\partial y} \right\}
+ \frac{1}{\varepsilon} \left\{ \nu \frac{\partial^2 \hat{P}_\varepsilon}{\partial y^2} + (m - y) \frac{\partial \hat{P}_\varepsilon}{\partial y} \right\} = 0, \quad t < T,
\]

\( \hat{P}_\varepsilon(T, \xi, y) = \hat{h}(\xi) \).

If we denote the solution of (2.3) when \( \hat{h}(\xi) = 1 \) by \( \hat{G}_\varepsilon(t, \xi, y) \) then it is clear that

\[
\hat{P}_\varepsilon(t, \xi, y) = \hat{G}_\varepsilon(t, \xi, y)\hat{h}(\xi), \quad t < T.
\]

We define a function \( u_\varepsilon(s, \xi, z), \ s \geq 0, \ \xi, z \in \mathbb{R} \) by

\[
\hat{G}_\varepsilon(t, \xi, y) = u_\varepsilon \left( \frac{T - t}{\varepsilon}, \xi, \frac{y - m}{\sqrt{2\nu}} \right),
\]
whence the variable $s$ corresponds to $(T - t)/\varepsilon$ and $z$ corresponds to $(y - m)/\sqrt{2} \nu$. Note however that, although $T - t$ has a fixed positive value in the statement of Theorem 1, we shall in the following be defining variables $s_0, s_1, \ldots$ analogous to $s$ which vary in the entire interval $0 < s < (T - t)/\varepsilon$. This is because we generate the function $u_z$ by means of a perturbation series expansion. From (2.3) we see that $u_z$ satisfies the initial value problem

\[
\frac{\partial u_z}{\partial s} = \frac{1}{2} \frac{\partial^2 u_z}{\partial z^2} - \frac{z}{2} \frac{\partial u_z}{\partial z} - \varepsilon \left\{ \Gamma(z) + i\xi \rho g(z) \right\} \frac{\partial u_z}{\partial z} - \varepsilon \left\{ \frac{1}{2} g(z)^2 \xi^2 + i\xi \left[ r - \frac{1}{2} g(z)^2 \right] + r \right\} u_z, \quad s > 0,
\]

\[
u_z(0, \xi, z) = 1,
\]

where the functions $g, \Gamma$ are defined by

\[ g \left( \frac{y - m}{\sqrt{2} \nu} \right) = f(y), \quad \Gamma \left( \frac{y - m}{\sqrt{2} \nu} \right) = \Lambda(y). \]

Next define a function $v_z(s, \xi, z)$ by

\[
v_z(s, \xi, z) = u_z(s, \xi, z) \exp \left\{ \varepsilon s \left\{ \frac{1}{2} \left( g^2 \right) \xi^2 + i\xi \left[ r - \frac{1}{2} \left( g^2 \right) \right] + r \right\} \right\} - 1, \quad (2.5)
\]

where $\bar{\sigma}^2 = \left( g^2 \right)$ is the average of $g^2$ with respect to a probability measure to be determined later. Then it follows from (2.4) that $v_z$ satisfies the initial value problem

\[
\frac{\partial v_z}{\partial s} = \frac{1}{2} \frac{\partial^2 v_z}{\partial z^2} - \frac{z}{2} \frac{\partial v_z}{\partial z} - \varepsilon \left\{ \Gamma(z) + i\xi \rho g(z) \right\} \frac{\partial v_z}{\partial z} - \varepsilon \left\{ \frac{1}{2} \left( g^2 \right)^2 - \left( g^2 \right) \xi^2 \right\} (\xi^2 - i\xi)[v_z + 1], \quad s > 0,
\]

\[ v_z(0, \xi, z) = 0. \]
We wish to obtain the solution of (2.6) as a convergent perturbation series expansion from which we can obtain the terms in the expansion of Theorem 1. To do this we introduce a parameter \( \lambda \in \mathbb{R} \) and let \( v_{\varepsilon, \lambda}(s, \xi, z) \) be the solution to the initial value problem

\[
\frac{\partial v_{\varepsilon, \lambda}}{\partial s} = \frac{1}{2} \frac{\partial^2 v_{\varepsilon, \lambda}}{\partial z^2} - z \frac{\partial v_{\varepsilon, \lambda}}{\partial z} - \lambda \sqrt{\varepsilon} \left\{ \Gamma(z) + i \xi \rho g(z) \right\} \frac{\partial v_{\varepsilon, \lambda}}{\partial z} - \frac{\varepsilon}{2} \left[ g(z)^2 - \left\langle g^2 \right\rangle \right] \left( \xi^2 - i \xi \right) \left[ \lambda v_{\varepsilon, \lambda} + 1 \right], \quad s > 0,
\]

\( v_{\varepsilon, \lambda}(0, \xi, z) = 0. \)

The solutions of (2.6) and (2.7) are related by the identity \( v_{\varepsilon}(s, \xi, z) = v_{\varepsilon, 1}(s, \xi, z) \). We write the solution of (2.7) in a perturbation series expansion in \( \lambda \),

\[
v_{\varepsilon, \lambda} = \sum_{n=0}^{\infty} v_{\varepsilon, n} \lambda^n.
\] (2.8)

Substituting (2.8) into (2.7) and equating the coefficients of powers of \( \lambda \) on both sides of (2.7), we see that the \( v_{\varepsilon, n} \) can be solved for inductively by the equations

\[
\frac{\partial v_{\varepsilon, 0}}{\partial s} = \frac{1}{2} \frac{\partial^2 v_{\varepsilon, 0}}{\partial z^2} - z \frac{\partial v_{\varepsilon, 0}}{\partial z} - \frac{\varepsilon}{2} \left[ g(z)^2 - \left\langle g^2 \right\rangle \right] \left( \xi^2 - i \xi \right), \quad s > 0,
\]

\( v_{\varepsilon, 0}(0, \xi, z) = 0, \)

\[
\frac{\partial v_{\varepsilon, n+1}}{\partial s} = \frac{1}{2} \frac{\partial^2 v_{\varepsilon, n+1}}{\partial z^2} - z \frac{\partial v_{\varepsilon, n+1}}{\partial z} - \sqrt{\varepsilon} \left\{ \Gamma(z) + i \xi \rho g(z) \right\} \frac{\partial v_{\varepsilon, n}}{\partial z} - \frac{\varepsilon}{2} \left[ g(z)^2 - \left\langle g^2 \right\rangle \right] \left( \xi^2 - i \xi \right) v_{\varepsilon, n}, \quad s > 0, n \geq 0,
\]

\( v_{\varepsilon, n+1}(0, \xi, z) = 0. \)

Observe now that the solution of the initial value problem

\[
\frac{\partial v}{\partial s} = \frac{1}{2} \frac{\partial^2 v}{\partial z^2} - z \frac{\partial v}{\partial z} + f(s, z), \quad s > 0
\]

\( v(0, z) = 0, \)
has the representation

\[ v(s, z) = \int_0^s \int_{-\infty}^{\infty} G(s - s', z, z') f(s', z') dz' ds', \quad (2.9) \]

where \( G(s, z, z') \) is given by Mehler’s formula

\[ G(s, z, z') = \frac{1}{a(s) \sqrt{2\pi}} \exp \left[ -\frac{(z' - ze^{-s})^2}{2a(s)^2} \right], \quad (2.10) \]

and \( a(s) \) is defined by

\[ a(s)^2 = \frac{1}{2} \left[ 1 - e^{-2s} \right], \quad s > 0. \]

There are many derivations of Mehler’s formula. See [13] for a derivation using stochastic processes. Note that

\[ \lim_{s \to \infty} G(s, z, z') = p(z'), \quad (2.11) \]

where the function \( p(z'), \ z' \in \mathbb{R}, \) on the RHS of the identity (2.11) is the probability density function for the normal variable with mean 0 and variance 1/2. We define now \( \langle g^2 \rangle \) by

\[ \langle g^2 \rangle = \int_{-\infty}^{\infty} g^2(z) p(z) dz. \quad (2.12) \]

**Lemma 1** For \( z \in \mathbb{R}, \ n = 0, 1, 2, \ldots \) there exists a polynomial \( P_{n,z} \) in \( \xi \) and \( \sqrt{\varepsilon} \) with the property that

\[ \left| v_{\varepsilon,n} \left( \frac{T - t}{\varepsilon}, \xi, z \right) - (\xi^2 - i\xi) P_{n,z}(\xi, \sqrt{\varepsilon}) \right| \leq \]

\[ C_n \left[ 1 + |z|^{n+1} \right] (|\xi|^2 + |\xi|) ||g||^2_{\infty} \left[ ||g||^2_{\infty}(\xi^2 + |\xi|) + ||g||_{\infty} |\xi| + ||\Gamma||_{\infty} \right]^n \exp[-(T - t)/2\varepsilon], \quad \varepsilon < \min[T - t, 1]. \]

The polynomial \( P_{n,z} \) has the properties:
(a) $P_n(z)$ has degree at most $2n$ in $\xi$ and $2n + 2$ in $\sqrt{\varepsilon}$.

(b) If $n$ is odd the lowest power of $\sqrt{\varepsilon}$ which occurs in $P_n(z)$ is $(n + 1)/2$. If $n = 0$ the lowest power of $\sqrt{\varepsilon}$ which occurs is 2. If $n \geq 2$ is even the lowest power of $\sqrt{\varepsilon}$ which occurs is $n/2 + 1$.

(c) There exists a constant $C_n$ depending only on $n$ such that all the coefficients of $P_n(z)$ are bounded by

$$C_n \left[ 1 + |z|^{n+1} \right] ||g||^3 \left[ ||g||^2 + ||g'||_{\infty} + ||g''||_{\infty} \right]^n.$$

(2.14)

Proof We first consider the case $n = 0$. In view of (2.11) we have that

$$G(s, z, z') - p(z') = -\int_{s}^{\infty} \frac{\partial G}{\partial s'}(s', z, z') ds'.$$  

(2.15)

One can see from (2.10) that

$$\frac{\partial G}{\partial s}(s, z, z') = e^{-s}H(s, z, z') + ze^{-s}K(s, z, z'),$$

(2.16)

where for $s \geq 1$ there is a universal constant $C$ such that

$$|H(s, z, z')| + |K(s, z, z')| \leq C \exp \left[- (z' - ze^{-s})^2/2 \right].$$

(2.17)

From (2.9), (2.12) we see that

$$v_{\varepsilon, 0}(s, \xi, z) = -\frac{\varepsilon}{2} (\xi^2 - i\xi) \int_{s}^{\infty} \int_{-\infty}^{\infty} \{G(s', z, z') - p(z')\} [g(z')^2 - \langle g^2 \rangle] dz' ds'.$$

We define the polynomial $P_0(z)$ by

$$P_0(z, \sqrt{\varepsilon}) = -\frac{\varepsilon}{2} \int_{-\infty}^{\infty} \int_{-\infty}^{\infty} \{G(s', z, z') - p(z')\} [g(z')^2 - \langle g^2 \rangle] dz' ds'.$$

(2.18)

It follows from (2.15), (2.16), (2.17) that there is a universal constant $C$ such that $|a(z)| \leq$
\[ C[1 + |z|] \|g\|_\infty^2. \] We can also see that
\[ v_{x,0} \left( \frac{T - t}{\varepsilon}, \xi, z \right) - (\xi^2 - i\xi)P_{0,z}(\xi, \sqrt{\varepsilon}) \]
\[ \leq C\varepsilon[1 + |z|] (|\xi|^2 + |\xi|) \|g\|_\infty^2 \exp[-(T - t)/\varepsilon], \]
for some universal constant \( C \). We have proved the lemma when \( n = 0 \).

To deal with general \( n \geq 1 \) we introduce various integral operators. For \( n \geq 1 \) we define the integral operator \( A(s) \) on functions \( f : \mathbb{R} \to \mathbb{C} \) by
\[ A(s)f(z) = \int_{-\infty}^{\infty} [G(s, z, z') - p(z')] f(z')dz'. \quad (2.19) \]
We define the operator \( B \) by
\[ Bf(z) = \int_{-\infty}^{\infty} p(z')f(z')dz', \]
whence \( B \) projects to the constant function. The operators \( T_1(s), T_2(s) \) are given in terms of \( A(s), B \) by the formulas
\[ T_1(s)f(z) = \frac{1}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] A(s)f(z), \]
\[ T_2(s)f(z) = \frac{1}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] Bf(z). \]
Note that \( T_2(s) = T_2 \) is independent of \( s \) and \( T_2 = 0 \). We define \( T_3(s) \) by
\[ T_3(s)f(z) = \Gamma(z) \int_{-\infty}^{\infty} \frac{\partial G}{\partial z}(s, z, z') f(z')dz'. \]
It is evident from (2.10) that
\[ \frac{\partial G}{\partial z}(s, z, z') = \frac{e^{-s}}{\sigma(s)} K(s, z, z'), \quad (2.20) \]
where
\[ |K(s, z, z')| \leq C G(s, z/2, z'/2), \quad (2.21) \]
for some universal constant $C$. We similarly define an operator $T_4(s)$ by

$$T_4(s)f(z) = \rho g(z) \int_{-\infty}^{\infty} \frac{\partial G}{\partial z}(s, z, z') f(z') dz'. $$

The function $v_{\varepsilon, n}$, $n \geq 1$, can be expressed in terms of the operators $T_j(s)$, $1 \leq j \leq 4$.

In fact $v_{\varepsilon, n}(s, \xi, z)$ is a sum of terms,

$$(-1)^{n+1}(\sqrt{\varepsilon})^p(i\xi)^q \left[ \varepsilon(\xi^2 - i\xi) \right]^r \int \text{d}s_0 \ldots \text{d}s_n$$

\begin{equation}
\{s_0 + \ldots + s_n < s, \ s_k > 0, k = 0, \ldots, n \}
\end{equation}

$$T(s_0)T_{j_1}(s_1) \ldots T_{j_n}(s_n)T_2[1](z),$$

where $1 \leq j_k \leq 4$, $k = 1, \ldots, n$ and $T(s_0)$ can be either the operator $A(s_0)$ or $B$. The integers $p, q, r$ are given by the formulas

$$p = \sum_{k=1}^{n} \delta(j_k - 3) + \delta(j_k - 4),$$

$$q = \sum_{k=1}^{n} \delta(j_k - 4),$$

$$r = 1 + \sum_{k=1}^{n} [\delta(j_k - 1) + \delta(j_k - 2)],$$

where $\delta(x)$, $x \in \mathbb{Z}$, is the Kronecker $\delta$, $\delta(0) = 1$, $\delta(x) = 0$, $x \neq 0$.

We consider first the situation in (222) where $j_k \neq 2$, $1 \leq k \leq n$, and $T(s_0) = A(s_0)$.

In that case one has, on putting

$$K_n(z) = \int_{0}^{\infty} \ldots \int_{0}^{\infty} \text{d}s_0 \ldots \text{d}s_n T(s_0)T_{j_1}(s_1) \ldots T_{j_n}(s_n)T_2[1](z),$$

that there is a constant $C_n$ depending only on $n$ such that

$$|K_n(z)| \leq C_n [1 + |z|^r] ||\Gamma||_{\infty}^{b-\nu} ||g||_{\infty}^{2r+q}. \quad (223)$$

The contribution to the polynomial $P_{n, \varepsilon}(\xi, \sqrt{\varepsilon})$ from (222) is given by

$$(-1)^{n+1}(\sqrt{\varepsilon})^p(i\xi)^q \varepsilon^n(\xi^2 - i\xi)^{r-1} K_n(z). \quad (224)$$
Note that the estimate (2.23) is consistent with the estimate (2.14) on the coefficients of \( P_{n,z} \). Using the fact that
\[
\int ds_0 \ldots ds_n \exp\left[-(s_0 + \ldots + s_n)\right] = \sum_{k=0}^{n} \frac{s^k}{k!} e^{-s},
\]
\( \{s_0 + \ldots + s_n > s, \ s_k > 0, \ k=0, \ldots, n\} \)
we see that the difference between \( K_n(z) \) and the integral in (2.22) is bounded by
\[
C_n \left[ 1 + |z|^r \right] \frac{||\Gamma||^{\infty}}{\infty} \frac{||g||^{2r+\eta}}{\infty} \exp\left(-(T-t)/2\varepsilon\right),
\]
for a constant \( C_n \) depending only on \( n \), when \( s = (T-t)/\varepsilon \). We have therefore proved the estimate (2.13) corresponding to the term (2.22).

We consider now the general case of (2.22). We may write
\[
T(j_1)(s_1) \ldots T(j_n)(s_n)T_2 = \prod_{i=1}^{n_1} T(j_i)(s_i)T_2 \prod_{i=n_1+2}^{n_2} T(j_i)(s_i)T_2 \ldots \prod_{i=n_k+2}^{n} T(j_i)(s_i)T_2,
\]
where \( j_i = 2 \) if and only if \( i = n_1 + 1, \ldots, n_k + 1 \), with \( 0 \leq n_1, n_k + 2 \leq n \). Assuming now that \( T(s_0) = A(s_0) \) we have that the integral in (2.22) is the same as
\[
\int_{\{s_0 + s_1 + \ldots + s_{n_1} + s_{n_1+2} + \ldots + s_{n_k+2} + \ldots + s_n < s\}} ds_0 \ ds_1 \ldots ds_n \frac{1}{k!} \left[ s - (s_0 + s_1 + \ldots + s_{n_1} + s_{n_1+2} + \ldots + s_{n_k+2} + \ldots + s_n) \right]^k \ (2.25)
\]
\[
T(s_0) \prod_{i=1}^{n_1} T(j_i)(s_i)T_2 \prod_{i=n_1+2}^{n_2} T(j_i)(s_i)T_2 \ldots \prod_{i=n_k+2}^{n} T(j_i)(s_i)T_2 \exp[1(z)].
\]
If we expand out the monomial of degree \( k \) in the last expression we can write it as
\[
\sum_{m=0}^{k} s^m K_{n,m}(z, s).
\]
Arguing as in the previous paragraph we see that the infinite integral \( K_n(z, \infty) \) exists
and

\[ |K_{n,m}(z, (T - t)/\varepsilon) - K_{n,m}(z, \infty)| \leq \]

\[ C_n[1 + |z|^r] \|\Gamma\|_{\infty} \|g\|_{\infty}^{2r+q} \exp[-(T - t)/2\varepsilon], \]

for some constant \( C_n \) depending only on \( n \). The contribution to the polynomial \( P_{n,z}(\xi, \sqrt{\varepsilon}) \) from (2.22) is given by

\[ (-1)^{n+1}(\sqrt{\varepsilon})^p (i\xi)^q \varepsilon^r \xi^2 - i\xi^{r-1} \sum_{m=0}^{k} \left( \frac{T-t}{\varepsilon} \right)^m K_{n,m}(z, \infty). \]  

(2.27)

Evidently (2.26) implies the bound (2.13) corresponding to the term (2.22). Similarly one also obtains the bound on the coefficients corresponding to (2.14).

We are left then to establish the bounds (a) and (b) on the degree of the polynomial \( P_{n,z} \). The bound (a) follows from the fact that \( p + r = n + 1, \; q + r \leq n + 1 \). To prove (b) we need an upper bound on \( k \) in (2.27). Since \( T^2 = 0 \) one sees that among \( T(s_0), T_j(s_1) \ldots T_{j_n}(s_n) \) there can be at most \( (n+1)/2 \) equal to \( T_2 \) or \( B \) if \( n \) is odd and \( n/2 \) if \( n \) is even. Now the lowest degree of \( \sqrt{\varepsilon} \) in the polynomial (2.27) is \( p + 2(r - k) = n + 1 - r + 2(r - k) = n + 1 - k + (r - k) \). Since \( k \leq r \) we obtain the estimate \((n+1)/2\) for the lowest degree of \( \sqrt{\varepsilon} \). Similarly for \( n \) even the lowest degree of \( \sqrt{\varepsilon} \) is \( n/2 + 1 \) since \( k \leq n/2 \) and \( r - k \geq 0 \). \( \square \)

We consider next the Green’s function corresponding to the evolution equation (2.7).

Thus let \( G_{\varepsilon,\lambda,\xi}(s, z, z') \) have the property that the function

\[ v(s, z) = \int_{-\infty}^{\infty} G_{\varepsilon,\lambda,\xi}(s, z, z') f(z') dz' \]
is the solution to the initial value problem,

\[
\frac{\partial v}{\partial s} = \frac{1}{2} \frac{\partial^2 v}{\partial z^2} - z \frac{\partial v}{\partial z} - \frac{\lambda}{2} \sqrt{\varepsilon} \left( \Gamma(z) + i \xi \rho g(z) \right) \frac{\partial v}{\partial z}
\]

\[\left( \frac{\partial v}{\partial z} \right) = \frac{\varepsilon}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] (\xi^2 + i \xi) \lambda, \quad s > 0,
\]

\[v(0, z) = f(z).\]

Evidently if \( \varepsilon = 0 \) or \( \lambda = 0 \) then \( G_{\varepsilon, \lambda, \xi} \) coincides with the Green’s function \( G \) of (2.10).

**Lemma 2** Suppose the function \( g \) of (2.28) satisfies the inequality \( g(z)^2 \geq m^2 > 0, \ z \in \mathbb{R} \). Then there is the inequality

\[
\int_{-\infty}^{\infty} |G_{\varepsilon, \lambda, \xi}(s, z, z')| \, dz' \leq \exp \left[ \frac{-\varepsilon s}{2} \left( (1 - \lambda \rho^2) m^2 - \langle g^2 \rangle \right) \xi^2 \lambda \right].
\]

**Proof** We make the transform \( v = \exp[w] \). Then if \( v \) satisfies (2.28) \( w \) satisfies

\[
\frac{\partial w}{\partial s} = \frac{1}{2} \left[ \frac{\partial^2 w}{\partial z^2} + \left( \frac{\partial w}{\partial z} \right)^2 \right] - z \frac{\partial w}{\partial z} - \frac{\lambda}{2} \sqrt{\varepsilon} \left( \Gamma(z) + i \xi \rho g(z) \right) \frac{\partial w}{\partial z}
\]

\[\left( \frac{\partial w}{\partial z} \right) = \frac{\varepsilon}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] (\xi^2 - i \xi) \lambda, \quad s > 0
\]

\[w(0, z) = \log f(z).\]

Writing \( w = w_1 + iw_2 \) with \( w_1, w_2 \) real we have that

\[
\frac{\partial w_1}{\partial s} = \frac{1}{2} \left[ \frac{\partial^2 w_1}{\partial z^2} + \left( \frac{\partial w_1}{\partial z} \right)^2 - \left( \frac{\partial w_2}{\partial z} \right)^2 \right] - z \frac{\partial w_1}{\partial z}
\]

\[-\lambda \sqrt{\varepsilon} \Gamma(z) \frac{\partial w_1}{\partial z} + \lambda \sqrt{\varepsilon} \xi \rho g(z) \frac{\partial w_2}{\partial z} - \frac{\varepsilon}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] \xi^2 \lambda
\]
Using the Schwarz inequality in the last expression we obtain a differential inequality,
\[
\frac{\partial w_1}{\partial s} \leq \frac{1}{2} \left[ \frac{\partial^2 w_1}{\partial z^2} + \left( \frac{\partial w_1}{\partial z} \right)^2 \right] - z \frac{\partial w_1}{\partial z} - \lambda \sqrt{\pi} \Gamma(z) \frac{\partial w_1}{\partial z} - \frac{\varepsilon}{2} \left[ (1 - \lambda \rho^2)g(z) - \langle g' \rangle \right] \xi^2 \lambda,
\]
\[
w_1(0,z) = \text{Re } \log f(z).
\]
Making the inverse transformation \( v_1 = \exp[w_1] \) therefore yields the differential inequality
\[
\frac{\partial v_1}{\partial s} \leq \frac{1}{2} \frac{\partial^2 v_1}{\partial z^2} - \left[ z + \lambda \sqrt{\pi} \Gamma(z) \right] \frac{\partial v_1}{\partial z} - \frac{\varepsilon}{2} \left[ (1 - \lambda \rho^2)m^2 - \langle g'^2 \rangle \right] \xi^2 \lambda v_1 \]
\[
0 \leq v_1(0,z) \leq |f(z)|. \tag{2.29}
\]
Let \( H(s, z, z') \) be the Green’s function for the equation
\[
\frac{\partial v}{\partial s} = \frac{1}{2} \frac{\partial^2 v}{\partial z^2} - \left[ z + \lambda \sqrt{\pi} \Gamma(z) \right] \frac{\partial v}{\partial z}.
\]
Then by the maximum principle \( H(s, z, z') \geq 0 \) and the solution \( v_1 \) of (2.29) satisfies the inequality
\[
0 \leq v_1(s, z) \leq \exp \left[ -\frac{\varepsilon s}{2} \left[ (1 - \lambda \rho^2)m^2 - \langle g'^2 \rangle \right] \xi^2 \lambda \right] \int_{-\infty}^{\infty} H(s, z, z') |f(z')| dz'.
\]
The result follows now by choosing a suitable \( f \) with \( |f(z')| = 1, \ z' \in \mathbb{R} \) and using the identity
\[
\int_{-\infty}^{\infty} H(s, z, z') dz' = 1.
\]
\[
\square
\]

**Lemma 3** Let \( u_\epsilon(s, \xi, z) \) be the solution of (2.4). Then there is the inequality
\[
|u_\epsilon(s, \xi, z) - \exp \left[ -\varepsilon s \left\{ \frac{1}{2} \langle g'^2 \rangle \xi^2 + i \xi \left[ r - \frac{1}{2} \langle g' \rangle \right] + r \right\} \right] | \tag{2.30}
\]
\[ \leq \varepsilon s \xi^2 - i\varepsilon \|g\|^2 \exp \left[ -\varepsilon s \left\{ \frac{1}{4}(1 - \rho^2)m^2 \xi^2 + r \right\} \right]. \]

**Proof** We have from (2.5), (2.6) that the LHS of (2.30) is bounded by

\[ \varepsilon |\xi^2 - i\varepsilon \|g\|^2 \exp \left[ -\varepsilon s \left\{ \frac{1}{2} \langle g^2 \rangle \xi^2 + r \right\} \right] \quad (2.31) \]

\[
\int_0^s \int_{-\infty}^{\infty} |G_{\varepsilon,1,\xi}(s', z, z')| dz'ds'.
\]

If we now use the estimate from Lemma 2,

\[
\int_{-\infty}^{\infty} |G_{\varepsilon,1,\xi}(s', z, z')| dz' \leq \exp \left[ \frac{\varepsilon s}{4} \langle g^2 \rangle \xi^2 \right], \quad 0 < s' < s/2,
\]

\[
\int_{-\infty}^{\infty} |G_{\varepsilon,1,\xi}(s', z, z')| dz' \leq \exp \left[ \frac{-\varepsilon s}{4}(1 - \rho^2)m^2 \xi^2 + \frac{\varepsilon s}{2} \langle g^2 \rangle \xi^2 \right], \quad s/2 < s' < s,
\]

the result follows from (2.31). \[\square\]

**Lemma 4** There is a universal constant \( C > 0 \) such that

\[ |v_{\varepsilon,n} \left( \frac{T - t}{\varepsilon}, \xi, z \right) | \leq C^n \exp[|z|/(e - 1)] \quad (2.32) \]

\[ \varepsilon^{n/4} \max \left[ 1, (T - t)^{n/2} \right] \left( |\xi|^2 + |\xi| \|g\|_\infty^2 \right)^n \left( \|g\|_\infty^2 (\xi^2 + |\xi|) + \|g\|_\infty |\xi| + \|\Gamma\|_\infty \right)^n. \]

**Proof** Let \( G \) be the Green's function (2.10). Then it is easy to see that for any \( \gamma > 0 \) there is the inequality,

\[
\int_{-\infty}^{\infty} dz_1 \ldots \int_{-\infty}^{\infty} dz_k G(s_0, z_0, z_1)G(s_1, z_1, z_2) \ldots \quad (2.33)
\]

\[ G(s_k, z_k, z_k)e^{\gamma|z_k|} \leq C(\gamma)^k e^{\gamma|z_0|}, \]

where \( C(\gamma) \) is a constant depending only on \( \gamma \). We also have that if \( s_0, \ldots, s_k \geq 1, \)

\[
\int_{-\infty}^{\infty} dz_1 \ldots \int_{-\infty}^{\infty} dz_k G(s_0, z_0, z_1)G(s_1, z_1, z_2) \ldots \quad (2.34)
\]
\[ G(s_{k-1}, z_{k-1}, z_k) \exp \left[ \sum_{i=0}^{k-1} |z_i| + \gamma |z_k| \right] \leq C(\gamma)^k \exp \left[ \left( \sum_{j=0}^{k-1} e^{-j} + e^{-k\gamma} \right) |z_k| \right], \]

where \( C(\gamma) \) depends only on \( \gamma \). We have already observed that \( v_{\varepsilon,n}(s, \xi, z) \) is a sum of terms of the form (2.22). The number of such terms is at most \( 4^{n+1} \). Hence if we bound (2.22) by the RHS of (2.32) we shall be done. The inequalities (2.33), (2.34) enable us to do this.

We consider first the situation in (2.22) where \( j_k \neq 2, 1 \leq k \leq n \), and \( T(s_0) = A(s_0) \).

We can write the integral in (2.22) as a sum of \( 2^{n+1} \) integrals,

\[
\int_{E_0 \cap E_i} ds_0 \int_{E_1 \cap E_i} ds_1 \cdots \int_{E_n \cap E_i} ds_n ,
\]

where

\[ E_k = \{ s_0 + \ldots + s_n < s, \ s_k > 0, \ k = 0, \ldots, n \} , \]

and the sets \( E_j \), \( 0 \leq j \leq n \), are either the interval \((0,1)\) or \((1,\infty)\). It follows now from (2.16), (2.17), (2.20), (2.21) and the inequalities (2.33), (2.34) that the integral (2.35) is bounded by

\[
C^n \exp \left[ \frac{e |\phi|}{e - 1} \right] \| \Phi\|_{\infty}^{\nu} \| g \|_{\infty}^{2^{r+q}} \int_{E_0} a(s_0)ds_0 \int_{E_1} a(s_1)ds_1 \cdots \int_{E_n} a(s_n)ds_n ,
\]

where \( C \) is a universal constant and the function \( a : (0, \infty) \to \mathbb{R} \) is defined by

\[ a(s) = 1/\sqrt{s}, \ 0 < s < 1, \ a(s) = e^{-s}, \ s > 1. \]

It is clear now that the bound (2.36) implies that (2.22) is bounded by the RHS of (2.32).

One can generalize the previous argument to deal with the situation where \( j_k = 2 \) for some \( k \). In that case we use the fact that the integral in (2.22) is the same as (2.25). \( \square \)
Proof of Theorem 1 For the put option \( h(x) = \max\{K - e^x, 0\} \) one has

\[
\hat{h}(\xi) = K^{1+i\xi}/i\xi(1+i\xi).
\] (2.37)

Observe that the Fourier integral of the function \( h \) exists only if \( \Im(\xi) < 0 \) but one can justify setting \( \Im(\xi) = 0 \) in the following. The function \( \hat{h}(\xi) \), \( \xi \in \mathbb{R} \), is bounded as \( |\xi| \to \infty \) and \( \xi\hat{h}(\xi) \) is bounded as \( \xi \to 0 \). We have by the Fourier inversion theorem that

\[
P_{\varepsilon}(t, x, y) - P_{BS}(t, x) = \frac{1}{2\pi} \int_{-\infty}^{\infty} e^{-i\varepsilon \xi} \hat{h}(\xi) d\xi,
\] (2.38)

where \( z = (y - m)/\sqrt{2\varepsilon} \). Let \( \alpha > 0 \) be arbitrary. Then it follows from Lemma 3 that for the integral on the RHS of (2.38) we have the estimate,

\[
\left| \int_{|\xi| > 1/\varepsilon^\alpha} d\xi \right| \leq C(\rho, m, T - t) K||g||_{\infty}^2 \exp[-(T - t)(1 - \rho^2)m^2/8\varepsilon^{2\alpha}],
\]

where \( C(\rho, m, T - t) \) is a constant depending only on \( \rho, m, T - t \). From (2.5) we may write

\[
\int_{|\xi| < 1/\varepsilon^\alpha} d\xi = \frac{1}{2\pi} \int_{-1/\varepsilon^\alpha}^{1/\varepsilon^\alpha} e^{-i\varepsilon \xi} \hat{h}(\xi) \exp[-(T - t) \left\{ \frac{1}{2}(g^2)^2 + i\xi \left[ r - \frac{1}{2}(g^2) \right] + r \right\}] v_{\varepsilon} \left( \frac{T - t}{\varepsilon}, \xi, z \right) d\xi.
\]

From (2.8) we have that

\[
v_{\varepsilon} \left( \frac{T - t}{\varepsilon}, \xi, z \right) = \sum_{n=0}^{\infty} v_{\varepsilon, n} \left( \frac{T - t}{\varepsilon}, \xi, z \right).
\] (2.39)

Lemma 4 implies that the series in (2.39) converges for \( |\xi| < 1/\varepsilon^\alpha \) provided \( \alpha < 1/8 \) and \( \varepsilon \) is sufficiently small. In particular we see that

\[
\left| \frac{1}{2\pi} \int_{-1/\varepsilon^\alpha}^{1/\varepsilon^\alpha} e^{-i\varepsilon \xi} \hat{h}(\xi) \exp[-(T - t) \left\{ \frac{1}{2}(g^2)^2 + i\xi \left[ r - \frac{1}{2}(g^2) \right] + r \right\}] \right|
\]
\[ \left \{ v_{\varepsilon} \left( \frac{T-t}{\varepsilon}, \xi, z \right) - \sum_{n=0}^{N} v_{\varepsilon,n} \left( \frac{T-t}{\varepsilon}, \xi, z \right) \right \} d\xi \leq C \exp \left[ \frac{\varepsilon |z|}{\varepsilon - 1} \right] \varepsilon^{N(2\alpha - 2)}, \]

where \( C \) is independent of \( z \) and \( \varepsilon \). The result now follows from Lemma 1. \( \square \)

3 Evaluation of Coefficients

In this section we evaluate the coefficients in the asymptotic expansion correct to \( O(\varepsilon) \).

This has also been carried out in [8] by a different methodology, simultaneously and independently of the present work. We shall further compute the corresponding functional form of the implied volatility. Our starting point is the identity

\[ P_{\varepsilon}(t, x, y) - P_{BS}(t, x) = \frac{1}{2\pi} \int_{-\infty}^{\infty} e^{-i\xi x} \hat{h}(\xi) \exp \left[ -(T-t) \left( \frac{1}{2} (y^2) \xi^2 + i\xi[r - (y^2)] + r \right) \right] \sum_{n=0}^{\infty} v_{\varepsilon,n} \left( \frac{T-t}{\varepsilon}, \xi, z \right) d\xi, \]  

where \( z = (y - m)/\sqrt{2\nu} \). The identity (3.1) follows from (2.5), (2.38), (2.39). The coefficients in the asymptotic expansion can be obtained then by computing the polynomials \( P_{n,\varepsilon}(\xi, \sqrt{\varepsilon}) \) defined by Lemma 1. It follows in particular that all the terms in the expansion depend on the observables, the stock price \( S = e^x \) and the strike price \( K \), only through the derivatives of \( P_{BS}(t, x) \) with respect to \( x \). This is consistent with equation (5.43) of [5].

We can derive (5.43) of [5] by identifying the terms in \( \sqrt{\varepsilon} \) in (3.1). The only polynomial which contributes a term in \( \sqrt{\varepsilon} \) is \( P_{1,\varepsilon} \). From (2.22) the contribution is obtained from
the expression,
\[
\sqrt{\varepsilon} \left[ \varepsilon (\xi^2 - i\xi) \right] \int_{s_0 + s_1 < s} d{s_0}d{s_1} B T_3(s_1)T_2[1](z) \\
+ \sqrt{\varepsilon} i\xi \left[ \varepsilon (\xi^2 - i\xi) \right] \int_{s_0 + s_1 < s} d{s_0}d{s_1} B T_4(s_1)T_2[1](z),
\]
where \( s = (T - t)/\varepsilon \). Doing the integration with respect to \( s_0 \) and then letting \( \varepsilon \to 0 \) we see that the coefficient of \( \sqrt{\varepsilon} \) term in \( P_{1,\varepsilon} \) is given by
\[
(T - t)\sqrt{\varepsilon}(\xi^2 - i\xi) \int_0^\infty d{s_1} B T_3(s_1)T_2[1](z)
\]
\[
+ (T - t)\sqrt{\varepsilon}i\xi(\xi^2 - i\xi) \int_0^\infty d{s_1} B T_4(s_1)T_2[1](z)
\]
\[
= (T - t)(\xi^2 - i\xi)[V_2 - 2V_3 - i\xi V_5],
\]
where \( V_2/\sqrt{\varepsilon}, V_3/\sqrt{\varepsilon} \) are constants depending only on \( \rho, g, \Gamma \). Observing now that we have the correspondence of operators given by
\[
\xi^2 - i\xi \leftrightarrow -\frac{\partial^2}{\partial x^2} + \frac{\partial}{\partial x} = -S^2 \frac{\partial^2}{\partial S^2},
\]
\[
(\xi^2 - i\xi)i\xi \leftrightarrow \frac{\partial}{\partial x} \left[ \frac{\partial}{\partial x - \frac{\partial}{\partial x}} \right] = 2S^2 \frac{\partial^2}{\partial S^2} + S^3 \frac{\partial^3}{\partial S^3}.
\]
it follows from (3.1), (3.2) that
\[
P_{\varepsilon}(t, x, y) = P_{BS}(t, x) - (T - t) \left[ V_2 S^2 \frac{\partial^2 P_{BS}}{\partial S^2} + V_3 S^3 \frac{\partial^3 P_{BS}}{\partial S^3} \right] + O(\varepsilon), \tag{3.3}
\]
which is (5.43) of [5].

The asymptotic expansion (3.3) yields an implied volatility curve (5.55) of [5] which is not flat. We give a derivation of this which we will then generalize to the expansion correct to \( O(\varepsilon^{3/2}) \). Let \( P_{BS}(t, S, \Sigma) \) be the Black-Scholes price of the put option with strike price \( K \), \( S \) the stock price at time \( t \), and \( \Sigma \) the volatility. Then the Black-Scholes
formula yields,
\[
P_{BS}(t, S, \Sigma) = -S \frac{1}{\sqrt{2\pi}} \int_{d_1}^{\infty} e^{-z^2/2} dz + Ke^{-r(T-t)} \frac{1}{\sqrt{2\pi}} \int_{d_2}^{\infty} e^{-z^2/2} dz,
\]
where
\[
d_{1,2} = \frac{\ln(S/K) + (r \pm \frac{1}{2} \Sigma^2)(T-t)}{\Sigma \sqrt{T-t}}.
\]
We now write \( \Sigma \) as an expansion in powers of \( \sqrt{\varepsilon} \),
\[
\Sigma = \sigma + a_1 \sqrt{\varepsilon} + O(\varepsilon),
\]
which in turn yields an expansion
\[
P_{BS}(t, S, \Sigma) = P_{BS}(t, S, \sigma) + b_1 \sqrt{\varepsilon} + O(\varepsilon).
\]
We need to obtain \( b_1 \) as a function of \( a_1 \). To do this we write \( d_1, d_2 \) as a function of \( \Sigma \) and note that
\[
d_1 \left( \sigma + a_1 \sqrt{\varepsilon} + O(\varepsilon) \right) - d_1(\sigma) = a_1 \sqrt{\varepsilon} \left[ \sqrt{T-t} - \frac{d_1(\bar{\sigma})}{\bar{\sigma}} \right] + O(\varepsilon),
\]
\[
d_2 \left( \sigma + a_1 \sqrt{\varepsilon} + O(\varepsilon) \right) - d_2(\sigma) = -a_1 \sqrt{\varepsilon} \left[ \sqrt{T-t} + \frac{d_2(\bar{\sigma})}{\bar{\sigma}} \right] + O(\varepsilon).
\]
Now from (3.4, (3.7) one has
\[
P_{BS} \left( t, S, \bar{\sigma} + a_1 \sqrt{\varepsilon} + O(\varepsilon) \right) - P_{BS}(t, S, \bar{\sigma})
= \frac{S}{\sqrt{2\pi}} \exp \left[ -d_1^2(\bar{\sigma})/2 \right] a_1 \sqrt{\varepsilon} \left[ \sqrt{T-t} - \frac{d_1(\bar{\sigma})}{\bar{\sigma}} \right]
+ \frac{Ke^{-r(T-t)}}{\sqrt{2\pi}} \exp \left[ -d_2^2(\bar{\sigma})/2 \right] a_1 \sqrt{\varepsilon} \left[ \sqrt{T-t} + \frac{d_2(\bar{\sigma})}{\bar{\sigma}} \right] + O(\varepsilon)
= \frac{S}{\sqrt{2\pi}} \exp \left[ -d_1^2(\bar{\sigma})/2 \right] a_1 \sqrt{\varepsilon} \sqrt{T-t} + O(\varepsilon).
\]
We conclude that \( a_1, b_1 \) are related by
\[
b_1 = \frac{S}{\sqrt{2\pi}} \exp \left[ -d_1^2(\bar{\sigma})/2 \right] \sqrt{T-t} a_1.
\]
The implied volatility curve correct to order \( \sqrt{\varepsilon} \) is now obtained by setting \( b_1 \sqrt{\varepsilon} \) equal to the \( \sqrt{\varepsilon} \) term on the RHS of (3.3) and then using (3.8) to solve for \( a_1 \). We have now that

\[
\frac{\partial^2 P_{HS}}{\partial S^2} = \exp\left[ -\frac{d_1^2(\hat{\sigma})/2}{\sqrt{2\pi} \hat{S} \hat{\sigma} \sqrt{T - t}} \right],
\]

\[
\frac{\partial^3 P_{HS}}{\partial S^3} = -\exp\left[ -\frac{d_1^2(\hat{\sigma})/2}{\sqrt{2\pi} \hat{S}^2 \hat{\sigma} \sqrt{T - t}} \right] \left\{ 1 + \frac{d_1(\hat{\sigma})}{\hat{\sigma} \sqrt{T - t}} \right\}.
\]

Hence from (3.3), (3.8) we conclude that

\[
a_1 \sqrt{\varepsilon} = -\frac{V_2}{\hat{\sigma}} + \frac{V_3}{\hat{\sigma}} \left\{ 1 + \frac{d_1(\hat{\sigma})}{\hat{\sigma} \sqrt{T - t}} \right\} = a \frac{\ln(K/S_1)}{T - t} + b = aK + b,
\]

where \( a, b \) are constants of order \( \sqrt{\varepsilon} \). We have derived equation (5.55) of [5].

Next we compute the terms in \( \varepsilon \) in (3.1). By Lemma 1 the polynomials \( P_{n,z} \) which contribute terms in \( \varepsilon \) are \( n = 0, 1, 2, 3 \). The \( n = 0 \) contribution is given by (2.18), and depends on \( z \). The other contributions are independent of \( z \). From (2.22) the contribution from \( P_{1,z} \) is the term

\[
\left[ \varepsilon(\xi^2 - i\xi) \right]^2 \int_{s_0+s_1<s} ds_0 \, ds_1 \, B \, T_i(s_1)T_2[1](z).
\]

Arguing as before this yields an \( \varepsilon \) term given by

\[
(T - t)\varepsilon(\xi^2 - i\xi)^2 \int_0^\infty ds_1 \, B \, T_i(s_1)T_2[1](z).
\]

The contribution from \( P_{2,z} \) is the sum of the terms,

\[
(-1)^j(\xi^j)(\xi^2 - i\xi) \int_{s_0+s_1+s_2<s} ds_0 \, ds_1 \, ds_2 \, B \, T_j(s_1)T_{j'}(s_2)T_2[1](z),
\]

where \( j, j' \) can be either 3 or 4 and \( q \) is the number of them that are 4. The \( \varepsilon \) term corresponding to these is given by

\[
-(T - t)\varepsilon(\xi^j)(\xi^2 - i\xi) \int_0^\infty \int_0^\infty ds_1 ds_2 \, B \, T_j(s_1)T_{j'}(s_2)T_2[1](z).
\]
The contribution from \( P_{3,\pm} \) is the sum of the terms,
\[
\varepsilon (i\xi)^d \left[ \varepsilon (\xi^2 - i\xi)^2 \right] \int_{s_0 + s_1 + s_2 + s_3 < s} ds_0 ds_1 ds_2 ds_3 \ B T_j(s_1) T_\ell(s_2) T_j'(s_3) T_\ell'[1](z),
\]
where again \( j, j' \) can be either 3 or 4 and \( q \) is the number of them that are 4. The \( \varepsilon \) term corresponding to these is given by
\[
\frac{(T-t)^2}{2} \varepsilon (i\xi)^d (\xi^2 - i\xi)^2 \int_0^\infty ds_1 ds_2 ds_3 \ B T_j(s_1) T_\ell(s_2) T_j'(s_3) T_\ell'[1](z). \tag{3.13}
\]
It follows then that the \( O(\varepsilon) \) contribution to the RHS of (3.3) is given from (2.18), (3.11), (3.12), (3.13) as,
\[
\varepsilon \left\{ \alpha_1(z) S^2 \frac{\partial^2 P_{BS}}{\partial S^2} + (T-t) \left\{ \alpha_2 S^2 \frac{\partial^2 P_{BS}}{\partial S^2} + \alpha_3 S^2 \frac{\partial^2 P_{BS}}{\partial S^2} + \alpha_4 S^2 \frac{\partial^4 P_{BS}}{\partial S^4} \right\} \right\} \tag{3.14}
\]
\[
+(T-t)^2 \left\{ \alpha_5 \left( S^2 \frac{\partial^2 P_{BS}}{\partial S^2} \right)^2 + \alpha_6 \left( S \frac{\partial^4 P_{BS}}{\partial S^4} \right)^2 \right\},
\]
where only the coefficient \( \alpha_1(z) \) depends on \( z = (y-m)/\sqrt{2\nu} \). Note that \( \alpha_1(z) \) does not depend option-specific data, like \( K \) and \( T-t \).

We wish now to determine the relation between the \( O(\varepsilon) \) contributions in (3.5), (3.6) analogous to (3.8). We write therefore,
\[
\Sigma = \dot{\sigma} + a_1 \sqrt{\varepsilon} + a_2 \varepsilon + O(\varepsilon^{3/2}), \tag{3.15}
\]
\[
P_{BS}(t, S, \Sigma) = P_{BS}(t, S, \dot{\sigma}) + b_1 \sqrt{\varepsilon} + b_2 \varepsilon + O(\varepsilon^{3/2}).
\]

In analogy to (3.7) we have that
\[
d_1 \left( \dot{\sigma} + a_1 \sqrt{\varepsilon} + a_2 \varepsilon + O(\varepsilon^{3/2}) \right) - d_1(\dot{\sigma}) = [a_1 \sqrt{\varepsilon} + a_2 \varepsilon] \left[ \sqrt{T-t} - \frac{d_1(\dot{\sigma})}{\dot{\sigma}} \right]
\]
\[
+ \frac{d_1^2(\dot{\sigma})}{\dot{\sigma}} \left[ \frac{d_1(\dot{\sigma})}{\dot{\sigma}} - \frac{1}{2} \sqrt{T-t} \right] + O(\varepsilon^{3/2}), \tag{3.16}
\]
\[
d_2 \left( \dot{\sigma} + a_1 \sqrt{\varepsilon} + a_2 \varepsilon + O(\varepsilon^{3/2}) \right) - d_2(\dot{\sigma}) = -[a_1 \sqrt{\varepsilon} + a_2 \varepsilon] \left[ \sqrt{T-t} + \frac{d_2(\dot{\sigma})}{\dot{\sigma}} \right]
\]
\[
+ \frac{d_2^2(\dot{\sigma})}{\dot{\sigma}} \left[ \frac{d_2(\dot{\sigma})}{\dot{\sigma}} + \frac{1}{2} \sqrt{T-t} \right] + O(\varepsilon^{3/2}).
If we write the LHS of (3.16) as \(d_1' - d_1, d_2' - d_2\) with \(d_1 = d_1(\bar{\sigma}), d_2 = d_2(\bar{\sigma})\), then we have from (3.4) that

\[
P_{BS}\left(t, S, \bar{\sigma} + a_1 \sqrt{\tau} + a_2 \varepsilon + O(\varepsilon^3/2)\right) - P_{BS}(t, S, \bar{\sigma}) = \left(\frac{S}{\sqrt{2\pi}}\right)^2 \exp\left[-\frac{d_1^2(\bar{\sigma})/2}{\sqrt{2\pi}\bar{\sigma}^2(T-t)}\right] \left\{ \left(d_1' - d_1\right) - \frac{d_1(d_1' - d_1)^2}{2} + \frac{d_2(d_2' - d_2)^2}{2} + O(\varepsilon^3/2) \right\}.\]

(3.17)

It follows from (3.16), (3.17) that \(b_2\) is given by the formula

\[
b_2 = \left(\frac{S}{\sqrt{2\pi}}\right)^2 \exp\left[-\frac{d_1^2(\bar{\sigma})/2}{\sqrt{2\pi}\bar{\sigma}^2(T-t)}\right] \left\{ a_2 + a_1^2 d_1(\bar{\sigma}) d_2(\bar{\sigma})/2\bar{\sigma} \right\}.
\]

(3.18)

We can derive now from (3.10), (3.14), (3.18) the functional form of \(a_2\) analogous to (3.10). In order to do this we need to obtain derivatives of \(P_{BS}\) higher than those given in (3.9). We first note that

\[
\left(S \frac{\partial}{\partial S}\right)^1 \left(S \frac{\partial^2}{\partial S^2}\right) = -\exp[-d_1^2(\bar{\sigma})/2] d_1(\bar{\sigma}) / \sqrt{2\pi}\bar{\sigma}^2(T-t),
\]

\[
\left(S \frac{\partial}{\partial S}\right)^2 \left(S \frac{\partial^2}{\partial S^2}\right) = \exp[-d_1^2(\bar{\sigma})/2] / \sqrt{2\pi}\bar{\sigma}^2(T-t)^3/2 \left[-1 + d_1(\bar{\sigma})^2\right],
\]

\[
\left(S \frac{\partial}{\partial S}\right)^3 \left(S \frac{\partial^2}{\partial S^2}\right) = \exp[-d_1^2(\bar{\sigma})/2] / \sqrt{2\pi}\bar{\sigma}^2(T-t)^5/2 \left\{3d_1(\bar{\sigma}) - d_1(\bar{\sigma})^3\right\},
\]

\[
\left(S \frac{\partial}{\partial S}\right)^4 \left(S \frac{\partial^2}{\partial S^2}\right) = \exp[-d_1^2(\bar{\sigma})/2] / \sqrt{2\pi}\bar{\sigma}^2(T-t)^7/2 \left\{3 - 6d_1(\bar{\sigma})^2 + d_1(\bar{\sigma})^4\right\}.
\]

It is clear now that \(a_2\) is a polynomial of degree 4 in \(\kappa = \ln(K/S)/(T-t)\) with coefficients...
which depend on $T - t$. More precisely we have from (3.14) the identity,

$$
a_2 + a_1^2 d_1(\bar{\sigma}) d_2(\bar{\sigma})/2\bar{\sigma} = \frac{a_1(z)}{\bar{\sigma}(T-t)} + \frac{a_2}{\bar{\sigma}}$$

$$- \frac{a_3}{\bar{\sigma}} \left[ 1 + \frac{d_1(\bar{\sigma})}{\bar{\sigma}\sqrt{T-t}} \right] + \frac{a_4}{\bar{\sigma}} \left[ 2 + \frac{3d_1(\bar{\sigma})}{\bar{\sigma}\sqrt{T-t}} + \frac{d_1(\bar{\sigma})^2 - 1}{\bar{\sigma}^2(T-t)} \right]$$

$$+ \frac{a_5}{\bar{\sigma}^3} \left[ -\bar{\sigma}\sqrt{T-t} d_1(\bar{\sigma}) - 1 + d_1(\bar{\sigma})^2 \right]$$

$$+ \frac{a_6}{\bar{\sigma}^3} \left[ -1 + d_1(\bar{\sigma})^2 + \frac{3d_1(\bar{\sigma}) - d_1(\bar{\sigma})^3}{\bar{\sigma}\sqrt{T-t}} \right]$$

$$+ \frac{a_7}{\bar{\sigma}^3} \left[ \frac{3d_1(\bar{\sigma}) - d_1(\bar{\sigma})^3}{\bar{\sigma}\sqrt{T-t}} + \frac{3 - 6d_1(\bar{\sigma})^2 + d_1(\bar{\sigma})^4}{\bar{\sigma}^2(T-t)} \right].$$

We can rewrite this as

$$a_2 + a_1^2 d_1(\bar{\sigma}) d_2(\bar{\sigma})/2\bar{\sigma} = Q_{0,z}(T-t) + \sum_{i=1}^{4} Q_i(T-t)\kappa^i$$

where

$$Q_{0,z}(T-t) = \frac{1}{T-t} \left[ p_{0}^0(z) + p_{1}^0(T-t) + p_{2}^0(T-t)^2 \right],$$

$$Q_1(T-t) = p_{0}^1 + p_{1}^1(T-t),$$

$$Q_2(T-t) = p_{0}^2 + p_{1}^2(T-t),$$

$$Q_3(T-t) = p_{0}^3(T-t),$$

$$Q_4(T-t) = p_{0}^4(T-t),$$

and the $p_j^i$ are constants except for $p_{0}^0(z)$ which depends explicitly on $z$. The above equations, (3.10) and (3.15) give (1.15).

### 4 Proof of Theorem 2

We now prove Theorem 2 in the case $\rho \neq 0$. First we obtain a formula for the Fourier transform of the function $P_{\varepsilon}(t, x, \omega)$ of (1.16). One can easily derive from this by Fourier inversion the formula for $P_{\varepsilon}(t, x, \omega)$ given in [5].
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To derive the formula we first note that at least formally the function

\[ P_t(t, x, Y^x) = e^{-r(T-t)}E[h(X^x_T)|X^x_t = x], \]

defined for a given volatility path \( Y^x_t, \ t \leq s \leq T \), solves the initial value problem

\[
\frac{\partial P_t}{\partial t} + \left[ r - \frac{1}{2} f(Y^x_t)^2 + f(Y^x_t) \rho \dot{W}^Q_t \right] \frac{\partial P_t}{\partial x} - r P_t + \frac{1}{2}(1 - \rho^2)f(Y^x_t)^2 \frac{\partial^2 P_t}{\partial x^2} = 0, \quad t < T, \quad P_t(T, x, Y^x) = h(x). \tag{4.1}
\]

In (4.1) the process \( \dot{W}^Q_t \) is the white noise process which is the derivative of the Brownian motion \( W^Q_t \) of (1.8). On taking the Fourier transform of (4.1) we obtain an initial value problem for the transform \( \hat{P}_t(t, \xi, Y^x) \) of \( P_t(t, x, Y^x) \),

\[
\frac{\partial \hat{P}_t}{\partial t} - i\xi \left[ r - \frac{1}{2} f(Y^x_t)^2 + f(Y^x_t) \rho \dot{W}^Q_t \right] \hat{P}_t - r \hat{P}_t - \frac{1}{2}\xi^2(1 - \rho^2)f(Y^x_t)^2 \hat{P}_t = 0, \quad t < T, \quad \hat{P}_t(T, \xi, Y^x) = \hat{h}(\xi). \tag{4.2}
\]

We may solve (4.2) to obtain an explicit formula for \( \hat{P}_t \),

\[
\hat{P}_t(t, \xi, Y^x) = \hat{h}(\xi) \exp \left[ -\int_t^T \left\{ i\xi \left[ r - \frac{1}{2} f(Y^x_s)^2 + f(Y^x_s) \rho \dot{W}^Q_s \right] \right. \right. \left. + r + \frac{1}{2}\xi^2(1 - \rho^2)f(Y^x_s)^2 \right] \right] ds \right]. \tag{4.3}
\]

To see why one might expect Theorem 2 to hold, consider

\[
|\hat{P}_t(t, \xi, Y^x)|^2 = |\hat{h}(\xi)|^2 \exp \left[ -2 \int_t^T ds \left\{ r + \frac{1}{2}\xi^2(1 - \rho^2)f(Y^x_s)^2 \right\} \right] = |\hat{P}_{BS}(t, \xi)|^2 \exp \left[ \xi^2 \int_t^T ds \left\{ \langle \tilde{g}^2 \rangle - (1 - \rho^2)f(Y^x_s)^2 \right\} \right],
\]
where $g$ is as in (2.5) and $\langle g^2 \rangle$ is given by (2.12). If we now take the expectation in the last equation conditioned on $Y_t^\varepsilon = y$ we have, by Jensen’s inequality,

$$E \left[ |\delta P_{\varepsilon}(t, \xi, Y_t^\varepsilon)|^2 \bigg| Y_t^\varepsilon = y \right] \geq |\delta P_{\varepsilon}(t, \xi)|^2 \exp \left[ \xi^2 \int_t^T ds \left\{ \langle g^2 \rangle - (1 - \rho^2)E \left[ f(Y_s^\varepsilon)^2 \bigg| Y_t^\varepsilon = y \right] \right\} \right].$$

It is clear that

$$\lim_{\varepsilon \to 0} \int_t^T ds \left\{ \langle g^2 \rangle - (1 - \rho^2)E \left[ f(Y_s^\varepsilon)^2 \bigg| Y_t^\varepsilon = y \right] \right\} = \rho^2 (T - t) \langle g^2 \rangle.$$

We conclude therefore that

$$\lim_{\varepsilon \to 0} E \left[ |\delta P_{\varepsilon}(t, \xi, Y_t^\varepsilon)|^2 \bigg| Y_t^\varepsilon = y \right] > |\delta P_{\varepsilon}(t, \xi)|^2,$$

if $\rho \neq 0$ and $\xi \neq 0$.

We proceed now to the proof of Theorem 2. First note that the function

$$\hat{P}_{\varepsilon}(t, \xi, y) = E \left[ \hat{P}_{\varepsilon}(t, \xi, Y_t^\varepsilon) \bigg| Y_t^\varepsilon = y \right]$$

is the solution of (2.3). For $\xi, \xi' \in \mathbb{R}$ define the function $\hat{P}_{\varepsilon}(t, \xi, \xi', y)$ by

$$\hat{P}_{\varepsilon}(t, \xi, \xi', y) = E \left[ \hat{P}_{\varepsilon}(t, \xi, Y_t^\varepsilon) \overline{\hat{P}_{\varepsilon}(t, \xi', Y_t^\varepsilon)} \bigg| Y_t^\varepsilon = y \right]. \quad (4.4)$$

It is easy to see that $\hat{P}_{\varepsilon}(t, \xi, \xi', y)$ is the solution to an initial value problem similar to (2.3). In fact if we note that

$$\hat{P}_{\varepsilon}(t, \xi, Y_t^\varepsilon) \overline{\hat{P}_{\varepsilon}(t, \xi', Y_t^\varepsilon)} = \delta(h(\xi)) \overline{\delta(h(\xi'))} \exp \left[ - \int_t^T ds \left( i(\xi - \xi') \right) \right.$$

$$\left[ r - \frac{1}{2} f(Y_s^\varepsilon)^2 + f(Y_s^\varepsilon) \rho W_s^Q \right] + 2 \rho f(Y_s^\varepsilon)^2 (1 - \rho^2) f(Y_s^\varepsilon)^2 \right], \quad (4.5)$$
and compare (4.5) with (4.3) we see from (2.3) that $\hat{P}_t(t, \xi, \xi', y)$ satisfies

$$
\frac{\partial \hat{P}_t}{\partial t} = -\frac{1}{2} f(y)^2 \left[(\xi - \xi')^2 \rho^2 + (\xi^2 + \xi'^2)(1 - \rho^2)\right] \hat{P}_t - \frac{1}{2} f(y)^2 \left[(\xi - \xi') \left(r - \frac{1}{2} f(y)^2\right)\right] \hat{P}_t - 2r \hat{P}_t
$$

$$
- \frac{1}{\sqrt{\varepsilon}} \left\{ \sqrt{2}\nu \hat{P}_t(y) \frac{\partial \hat{P}_t}{\partial y} + \sqrt{2} \nu \Lambda(y) \frac{\partial \hat{P}_t}{\partial y} \right\}
$$

$$
+ \frac{1}{\varepsilon} \left\{ \nu^2 \frac{\partial^2 \hat{P}_t}{\partial y^2} + (m - y) \frac{\partial \hat{P}_t}{\partial y} \right\} = 0, \ t < T,
$$

$$
\hat{P}_t(T, \xi, \xi', y) = \hat{h}(\xi)\hat{h}(\xi').
$$

Let us define $\hat{P}_0(t, \xi, \xi')$ by

$$
\hat{P}_0(t, \xi, \xi') = \hat{h}(\xi)\hat{h}(-\xi') \exp \left[-(T - t) \left\{ \frac{1}{2} \langle g^2 \rangle \left[ \xi^2 + \xi'^2 - 2\xi'\rho^2 \right] \right\}
$$

$$
+ \frac{1}{\varepsilon} \left\{ \frac{\partial \hat{P}_0}{\partial y} \right\} \right\} \frac{1}{\sqrt{2}\nu}, \ t < T.
$$

We shall show that $\lim_{\varepsilon \to 0} \hat{P}_t(t, \xi, \xi', y) = \hat{P}_0(t, \xi, \xi')$. To do this we proceed in a similar way to how we obtained the asymptotic expansion for the solution to (2.3). Thus we define $u_c(s, \xi, \xi', z)$ by

$$
\hat{P}_t(t, \xi, \xi', y) = u_c \left( \frac{T - t}{\varepsilon}, \xi, \xi', \frac{y - m}{\sqrt{2}\nu} \right) \hat{h}(\xi)\hat{h}(\xi').
$$

If we define $v_c(s, \xi, \xi', z)$ by

$$
v_c(s, \xi, \xi', z) = u_c(s, \xi, \xi', z) \exp \left[ \varepsilon \left\{ \frac{1}{2} \langle g^2 \rangle \left[ \xi^2 + \xi'^2 - 2\xi'\rho^2 \right] \right\}
$$

$$
+ \frac{1}{\varepsilon} \left\{ \frac{\partial v_c}{\partial y} \right\} \right\} - 1.
$$

then it follows from (4.6) that $v_c$ is the solution to the initial value problem

$$
\frac{\partial v_c}{\partial s} = \frac{1}{2} \frac{\partial^2 v_c}{\partial z^2} - \frac{\partial v_c}{\partial z} - \sqrt{\varepsilon} \left\{ (z) + i(\xi - \xi') \rho g(z) \right\} \frac{\partial v_c}{\partial z}
$$

$$
- \frac{\varepsilon}{2} \left\{ \langle g(z)^2 \rangle \right\} \left\{ \xi^2 + \xi'^2 - 2\xi'\rho^2 - i(\xi - \xi') \right\} [v_c + 1], \ s > 0,
$$

\text{Ergodic Volatility Models}
Let \( G_{\varepsilon, \xi, \xi'}(s, z, z') \) be the Green's function for the initial value problem

\[
\frac{\partial v}{\partial s} - \frac{1}{2} \frac{\partial^2 v}{\partial z^2} - z \frac{\partial v}{\partial z} - \sqrt{\varepsilon} \{ \Gamma(z) + i(\xi - \xi') \rho g(z) \} \frac{\partial v}{\partial z} \\
- \frac{\varepsilon}{2} \left[ g(z)^2 - \langle g^2 \rangle \right] \left\{ \xi^2 + \xi'^2 - 2 \xi \xi' \rho^2 - i(\xi - \xi') \right\} v, \quad s > 0,
\]

\( v(0, z) = f(z) \).

Thus the solution of (4.8) is given by

\[
v(s, z) = \int_{-\infty}^{\infty} G_{\varepsilon, \xi, \xi'}(s, z, z') f(z') dz'.
\]

Note that \( G_{\varepsilon, \xi, \xi'} \) is an analytic function of \( \xi, \xi' \in \mathbb{C} \). We have in analogy to Lemma 2 the following:

**Lemma 5** Suppose the function \( g \) of (2.28) satisfies the inequality, \( g(z)^2 \geq m^2 > 0, z \in \mathbb{R} \). Then there is the inequality

\[
\int_{-\infty}^{\infty} \left| G_{\varepsilon, \xi, \xi'}(s, z, z') \right| dz' \leq \\
\exp \left[ \frac{\varepsilon s}{2} \left\{ 10 \max |g| \left[ (\Re \xi)^2 + (\Re \xi')^2 - 2(\Re \xi)(\Re \xi')\rho^2 \right] \\
- m^2 \left[ (\Re \xi)^2 + (\Re \xi')^2 \right] (1 - \rho^2) \right\} \right],
\]

provided \( |\Im \xi|, |\Im \xi'| \leq 1 \)

**Proof** Same as for Lemma 2. \( \square \)
Next we define $v_{e,0}(s, \xi, \xi', z)$ by

$$v_{e,0}(s, \xi, \xi', z) = \frac{-\varepsilon}{2} \left\{ \xi^2 + \xi' \xi^2 - 2 \xi \xi' \rho^2 - i(\xi - \xi') \right\} \int_0^s ds' A(s') \left[ g^2 - \langle g^2 \rangle \right](z),$$

where $A(s)$ is the operator (2.19). It follows now from (4.7), (4.8) that $v_e(s, \xi, \xi', z)$ has the representation

$$v_e(s, \xi, \xi', z) = v_{e,0}(s, \xi, \xi', z) - \sqrt{2} \int_0^s \int_0^\infty G_{e,\xi,\xi'}(s - s', z, z'; \xi, \xi', z') \sqrt{dz'ds'}$$

$$\frac{\varepsilon}{2} \left\{ \xi^2 + \xi' \xi^2 - 2 \xi \xi' \rho^2 - i(\xi - \xi') \right\} \int_0^\infty \int_{-\infty}^\infty G_{e,\xi,\xi'}(s - s', z, z')$$

$$[g(z')^2 - \langle g^2 \rangle] v_{e,0}(s', \xi, \xi', z') dz'ds'.$$

It is clear that $v_e(s, \xi, \xi', z)$ is analytic for $\xi, \xi' \in \mathbb{C}$.

**Lemma 6** There is a universal constant $C$ such that if $|\text{Im } \xi|, |\text{Im } \xi'| \leq 1$, then

$$\left| v_e(s, \xi, \xi', z) \right| \leq C \varepsilon \|g\|_\infty^2 |\xi^2 + \xi' \xi^2 - 2 \xi \xi' \rho^2 - i(\xi - \xi')|$$

$$+ \exp \left\{ \frac{\varepsilon}{2} \left\{ 10 \|g\|_\infty^2 + \langle g^2 \rangle \left[ (\text{Re } \xi)^2 + (\text{Re } \xi')^2 - 2(\text{Re } \xi)(\text{Re } \xi') \rho^2 \right] \right\} \right\} C \varepsilon^{3/2} s \left[ \|g\|_\infty^2 \right]$$

$$- m^2 \left[ (\text{Re } \xi)^2 + (\text{Re } \xi')^2 \right] (1 - \rho^2) \left[ \text{Im } \xi - \text{Im } \xi' \right] \|g\|_\infty^2$$

$$+ C \varepsilon^2 s [\xi^2 + \xi' \xi^2 - 2 \xi \xi' \rho^2 - i(\xi - \xi')^2] \left[ \|g\|_\infty^4 \right].$$

**Proof** Use Lemma 5 and the fact that there is a universal constant $C$ such that

$$\left| \int_0^s ds' A(s') [g^2 - \langle g^2 \rangle](z) \right| + \left| \frac{\partial}{\partial z} \int_0^s ds' A(s') [g^2 - \langle g^2 \rangle](z) \right| \leq C \|g\|_\infty^2.$$
Let us put

$$P_\varepsilon(t, x, x', y) = \frac{1}{4\pi^2} \int_{-\infty}^\infty \int_{-\infty}^\infty d\xi d\xi' e^{-i\varepsilon \xi \xi'} e^{i\varepsilon \xi' \xi'} P_\varepsilon(t, \xi, \xi', y),$$

$$P_0(t, x, x') = \frac{1}{4\pi^2} \int_{-\infty}^\infty \int_{-\infty}^\infty d\xi d\xi' e^{-i\xi \xi'} e^{i\xi' \xi'} P_0(t, \xi, \xi').$$

It is clear from (4.4) that

$$P_\varepsilon(t, x, x, y) = E\[\|P_\varepsilon(t, x, Y^*)\|^2 \mid Y^*_T = y\].$$

**Lemma 7** For any \(x, x', y \in \mathbb{R}\), \(t < T\), there is the limit

$$\lim_{\varepsilon \to 0} P_\varepsilon(t, x, x', y) = P_0(t, x, x').$$

**Proof** We have that

$$\hat{P}_\varepsilon(t, \xi, \xi', y) - \hat{P}_0(t, \xi, \xi') = \hat{h}(\xi) \hat{h}(\xi')$$

(4.10)

$$\exp\left[-(T - t) \left\{ \frac{1}{2} \langle y^2 \rangle \left[ \xi^2 + \xi'^2 - 2\xi \xi' p^2 \right] + i(\xi - \xi') \left[ r - \frac{1}{2} \langle y^2 \rangle \right] + 2r \right\}\right]$$

$$v_\varepsilon \left( \frac{T - t}{\varepsilon}, \xi, \xi', \frac{y - m}{\sqrt{2} \nu} \right), \quad \xi, \xi' \in \mathbb{R}.$$

We can represent the function \(P_\varepsilon(t, x, x', y)\) and \(P_0(t, x, x')\) as integrals along the lines

\(Im(\xi) = -1, Im(\xi') = 1\). In that way we avoid the singularity of \(\hat{h}(\xi), \hat{h}(-\xi')\) at \(\xi = 0, \xi' = 0\). The result follows from (4.10) and Lemma 6. In fact we have

$$\|P_\varepsilon(t, x, x', y) - P_0(t, x, x')\| \leq C \varepsilon,$$

for some constant \(C\).
Proof of Theorem 2 In view of Lemma 7 it will be sufficient to show that

\[ P_0(t, x, x) \neq P_{BS}(t, x)^2, \quad \rho \neq 0, \quad t < T. \]  \hspace{1cm} (4.11)

To see this we observe that

\[ \hat{P}_0(t, \xi, \xi') - \hat{P}_{BS}(t, \xi)\hat{P}_{BS}(t, -\xi') = \hat{P}_{BS}(t, \xi)\hat{P}_{BS}(t, -\xi')(T - t)(g^2)\xi\xi'\rho^2 \]

\[ \int_0^1 d\alpha \exp \left[ \alpha (T - t)(g^2)\xi\xi'\rho^2 \right]. \]

Let \( \mu \) be the probability measure for the standard normal variable. Then

\[ \exp[a\xi\xi'] = \exp \left[ -\frac{a^2\xi^2}{2} - \frac{a^2\xi'^2}{2} - \int_0^\infty d\mu(\beta) \exp \left( \sqrt{a\beta}(\xi + \xi') \right) \right], \]

for any \( a > 0 \). Hence we have that

\[ P_0(t, x, x) - P_{BS}(t, x)^2 = \int_0^1 d\alpha \int_{-\infty}^{\infty} d\mu(\beta) |F(\alpha, \beta)|^2, \]  \hspace{1cm} (4.12)

where \( F(\alpha, \beta) \) is given by the formula

\[ F(\alpha, \beta) = \frac{1}{2\pi} \int_{-\infty}^{\infty} d\xi e^{-i\xi\xi'} \hat{P}_{BS}(t, \xi)\xi\rho\sqrt{T - t} \]

\[ \langle g^2 \rangle^{1/2} \exp \left[ -\alpha(T - t)(g^2)\rho^2 \xi^2 + \sqrt{\alpha(T - t)(g^2)\rho} \beta \xi \right]. \]

Observe that \( F(0, \beta) = i\rho\sqrt{T - t}\langle g^2 \rangle^{1/2} \partial P_{BS}(t, x)/\partial x \neq 0 \). Hence (4.11) follows from (4.12).

5 Conclusion

In this paper we have studied a model of Fouque, Papanicolaou and Sircar for the pricing of options on a stock which has stochastic volatility. These authors showed that under the assumption of fast mean reverting volatility, measured by a small parameter \( \varepsilon \), the price of the option can be written in an expansion in powers of \( \sqrt{\varepsilon} \). They gave a formula for
the terms in the expansion correct to order $\sqrt{\varepsilon}$ and also a formula for the corresponding functional form of the implied volatility surface. This paper continues from their work by obtaining an expansion to all orders in $\sqrt{\varepsilon}$, and proving rigorously that it is asymptotic. The paper also contains a formula for the functional form of the implied volatility correct to order $\varepsilon$. Finally, the paper proves a result showing that a homogenization theorem of Fouque et al, which holds in the case of zero correlation between stock price and volatility, does not extend to the case of non-zero correlation.

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References


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