

## SOLUTIONS 8. 24.3.2014

Q1.

$$M_X(t) = \int_{-\infty}^{\infty} e^{tx} f_X(x) dx = \int_{-\infty}^{\infty} e^{tx} \cdot \frac{1}{\sqrt{2\pi}\sigma} \exp\left\{-\frac{1}{2}(x-\mu)^2/\sigma^2\right\} dx.$$

Make the substitution  $u := (x - \mu)/\sigma$ :  $x = \mu + \sigma u$ ,  $dx = \sigma du$ :

$$M_X(t) = \int_{-\infty}^{\infty} e^{t(\mu+\sigma u)} \cdot \frac{1}{\sqrt{2\pi}} \exp\left\{-\frac{1}{2}u^2\right\} du = e^{\mu t} \cdot \int_{-\infty}^{\infty} e^{\sigma t u} \cdot \frac{1}{\sqrt{2\pi}} \exp\left\{-\frac{1}{2}u^2\right\} du.$$

Completing the square in the exponent on the right,

$$\begin{aligned} M(t) &= e^{\mu t} \cdot \int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi}} \exp\left\{-\frac{1}{2}[u^2 - 2\sigma t u]\right\} du \\ &= e^{\mu t} \cdot \int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi}} \exp\left\{-\frac{1}{2}[(u-\sigma t)^2 - \sigma^2 t^2]\right\} du = e^{\mu t + \frac{1}{2}\sigma^2 t^2} \cdot \int_{-\infty}^{\infty} \frac{1}{\sqrt{2\pi}} \exp\left\{-\frac{1}{2}(u-\sigma t)^2\right\} du. \end{aligned}$$

The integral on the right is 1 (a density integrates to 1 – of  $N(\sigma t, 1)$  as it stands, or of  $N(0, 1)$  after the substitution  $v := u - \sigma t$ ), giving

$$M(t) = \exp\left\{\mu t + \frac{1}{2}\sigma^2 t^2\right\}.$$

Q2. (i) By Q1,  $M_Y(t) = E[e^{tY}] = \exp\{\mu t + \frac{1}{2}\sigma^2 t^2\}$ . Taking  $t = 1$ ,  $M_Y(1) = E[e^Y] = \exp\{\mu + \frac{1}{2}\sigma^2\}$ . As  $X = e^Y$ , this gives

$$E[X] = E[e^Y] = e^{\mu + \frac{1}{2}\sigma^2}.$$

(ii) In the Black-Scholes model, stock prices are geometric Brownian motions, driven by stochastic differential equations

$$dS = S(\mu dt + \sigma dB), \quad (GBM)$$

with  $B$  Brownian motion. This has solution (we quote this – from Itô's lemma – Ch. V W9)

$$S_t = S_0 \exp\left\{\left(\mu - \frac{1}{2}\sigma^2\right)t + \sigma B_t\right\}.$$

So  $\log S_t = \log S_0 + (\mu - \frac{1}{2}\sigma^2)t + \sigma B_t$  is normally distributed, so  $S_t$  is lognormal.

NHB