A DISCRETE TIME COUNTERPART OF THE BLACK-SCHOLES BOND REPLICATION PORTFOLIO

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Received October 13, 2005; revised received April 22, 2006; accepted April 27, 2006

Abstract

We construct a discrete time self-financing portfolio comprised of call options short and stock shares long which is riskless and grows at a fixed rate of return. It is also shown that when shorting periods tend to zero then so devised portfolio turns into the Black-Scholes bond replication. Unlike in standard approach the analysis presented here requires neither Ito Calculus nor solving the Heat Equation for option pricing.

Key Words: Binomial Model, Call Replication, Discrete Time Black-Scholes Hedging

AMS CLASS: 62P05, 62P20, 91B28

1. Introduction

Black and Scholes (1973) discovered that a portfolio of one call option short and stock shares long, where $C(t, S)$ and $S$ is the option and stock price at time $t$ respectively, has no risk and consequently it replicates a bond portfolio earning a fixed rate of return, provided $C(t, S)$ satisfies certain partial differential equation. Since then a great deal of studies circled around discrete time option pricing originated by Cox -Ross-Rubinstein (1979), Rubinstein and Leland (1981), which focused entirely on no-arbitrage option replication portfolio determined from a martingale measure corresponding to the discounted stock price on binomial tree. Meanwhile no attention has been given to the fact that the bond portion of such hedging portfolio, in contrast to its continuous time counterpart, is never riskless! In fact, the bond portion is a unique random process whose distribution at each time step is determined by terminal stock prices under the martingale measure. The above raises a question of whether it is possible to construct riskless portfolio in discrete time analogous to continuous time Black-Scholes bond replication portfolio.

The aim of this article is to answer the question in the positive and explain how the findings bridge the long-standing differences between the two models. Namely, we first construct a self-financing bond replication portfolio by augmenting a combination of suitably chosen number of stock shares long and one call option short with a third position in carry-on cash flow (excess or shortage of funds resulting from creating the stock-option position) and then we convert the cash.
flow position into the risk free combination of stocks and options. The key feature of this
discrete time portfolio lies in the fact that it does not suffer from the well-known shortcomings
present in the continuous model: an impossible to implement continuous time trading coupled
with prohibitive(infinite) transaction costs associated with it. The model presented here applies
to both small and large time period situations and works particularly well in the latter case. For
example, when the time intervals are days, months or years and the underlying security can be
modeled by assuming only two different outcomes at the end of each time period (e.g., success
or failure with a price tag) then over the multi-step period the model provides a hedging strategy
that has no risk and for which the transaction costs may in fact be assumed negligible, whereas in
the continuous Black-Scholes model the costs cannot be ignored unless the realities of the actual
security trading are being rejected!

2. Notation, assumptions and binomial model facts

Let \((\Omega, \mathcal{F}, P)\) be a probability space \(\Omega = \{(\omega_1, \ldots, \omega_N) \mid \omega_i \in \{U, D\}, 1 \leq i \leq N\}, \mathcal{F} = 2^\Omega,\)

\[ P((\omega_1, \ldots, \omega_N)) = p^{\alpha U} (1-p)^{\alpha D}, \] with \(0 < p = \frac{1+r-d}{u-d} < 1\) subject to \(0 < d < 1, 1+r < u\) where

\(r\) is a fixed risk-free rate of return per one time period, \(\mathcal{F}_n = \sigma(\omega_1, \ldots, \omega_n)\) and

\(\mathcal{F}_0 = \{\emptyset, \Omega\}, n = 1, \ldots, N.\) Then the risk-neutral stock process \(S_n \in \mathcal{F}_n\) is defined by \(P(\text{stock goes up}) = P(S_{n-1} \uparrow S_n = S_{n-1} U) = P(\omega_n = U) = p\) and \(P(\text{stock goes down}) = P(S_{n-1} \Downarrow S_n = S_{n-1} D) = P(\omega_n = D) = 1-p.\) Here \(S_{n-1} = (\omega_1, \ldots, \omega_{n-1})\) and \(S_n = S_n(\omega_1, \ldots, \omega_{n-1}, U), \) or \(S_n = S_n(\omega_1, \ldots, \omega_{n-1}, D),\) respectively, and \(S_n\) is binomial with

\[ P(S_n = S_0 u^k d^{n-k}) = \binom{n}{k} p^k (1-p)^{n-k}. \] We emphasize that the probability distribution of the actual stock process is irrelevant as it does not play any role in determining no-arbitrage option pricing, aside from the fact that it is rarely known! The only thing the two stock processes have in common is the identical sample space \(\{S_0, S_1, \ldots, S_N\}\) which constitutes the binomial binary tree.

We make the following assumptions about discrete time portfolio modeling:

-\(p1\) prices of stocks, options and bonds change at \(n = 0, \ldots, N\) and stay constant throughout
  \([n-1,n), \ n = 1, \ldots, N;\)
-\(p2\) portfolio values are declared at \(n = 0, \ldots, N\) and stay constant during \([n-1,n), \ n = 1, \ldots, N;\)
-\(p3\) positions (rebalanced holdings) are decided based on time \(n-1\) prices, take effect
  instantaneously after time \(n-1\) and are held unchanged throughout \([n-1,n], \ n = 1, \ldots, N;\)
-\(p4\) portfolio is self-financing in the sense that its value at time \(n-1\) and after rebalancing are
  equal, \(n = 1, \ldots, N;\) and
-\(p5\) portfolio transaction costs are zero, borrowing along with short and fractional sales are
  allowed, option pricing assumes no-arbitrage.

The significance of \(p3\) stems from the fact that different portfolio positions must necessarily be
held over non-overlapping time intervals until the securities undergo price change in order to
unambiguously define portfolio holdings and value when rebalancing. Moreover, (p3) incorporates the fact that security prices must be known first before the portfolio adjustments can be made and consequently one way to implement this is to consider the discrete time sequence as a subset of the continuous time with a proviso that rebalancing takes effect instantaneously after the prices have changed.

Allowing the portfolio to undergo content and value changes periodically at discrete time instances only, while keeping the portfolio intact at all other times, considerably simplifies the analysis of the portfolio dynamics. In addition, it offers a practical alternative to a continuous time model while retaining its validity for both large and small scales of portfolio inactivity period.

A basic fact from binomial asset pricing model Karatzas & Shreve (1998) or Williams (2001) states that a European call option can be replicated through a hedging strategy by holding a portfolio of uniquely determined combination of stocks and bonds. Since the option replication serves as basis for our bond replication construction we first recall all necessary facts needed for further analysis.

Given a strike price \( K > 0 \) the value of the call option at time \( N \) is defined by

\[
C_N = \max(S_N - K, 0) = (S_N - K)^+
\]

and we use the following notation:

- \( S_n \) is the stock price at time \( n \)
- \( C_n \) is the call option price at time \( n \)
- \( B_n = B_0(1 + r)^n \) is the bond price at time \( n \)
- \( a_n \) is the number of stock shares held during \((n-1, n]\)
- \( b_n \) is the number of bonds shares held during \((n-1, n]\)
- \( r \) is a fixed risk-free return rate per period

Then by (p3)-(p4) portfolio values \( \{X_n, 0 \leq n \leq N\} \) satisfy

\[
X_0 = a_0S_0 + b_0B_0 = a_1S_0 + b_1B_0
\]

\[
X_{n-1} = a_{n-1}S_{n-1} + b_{n-1}B_{n-1} = a_nS_{n-1} + b_nB_{n-1} \quad \text{and} \quad X_n = a_nS_n + b_nB_n, \quad n = 1, \ldots, N
\]

Remark Since the initial assets allocation \((a_0, b_0)\) for \( X_0 \) is limited to time \( n = 0 \) and then instantaneously replaced by \((a_1, b_1)\) we may assume without loss of generality that \( a_0 = a_1 \) and \( b_0 = b_1 \) because by \( X_0 = a_0S_0 + b_0B_0 = a_1S_0 + b_1B_0 \) this has no bearing on the initial portfolio value. Therefore \((a_1, b_1)\) is taken as the initial allocation throughout \([0, 1]\) (not just \((0, 1]\)) which renders the choice of \((a_0, b_0)\) as a technical assumption and allows identifying \( X_n \) allocations with a sequence \((a_n, b_n), n = 1, \ldots, N\).

A call option replication portfolio \( \Pi_c = \{X_n, (a_n, b_n), 0 \leq n \leq N\} \) is determined by

\[
X_n = a_nS_n + b_nB_n = C_n = (1 + r)^{-(N-n)} E[(S_N - K)^+ | \mathcal{F}_n], \quad n = 0, \ldots, N
\]
\[ a_n = \frac{C_n(S_{n-1}u) - C_n(S_{n-1}d)}{S_{n-1}u - S_{n-1}d} \in \mathcal{F}_{n-1}, \quad n = 1, \ldots, N \] (3)

\[ b_n = \frac{C_n - a_nS_n}{B_n} = \frac{C_{n-1} - a_{n-1}S_{n-1}}{B_{n-1}} \in \mathcal{F}_{n-1}, \quad n = 1, \ldots, N \] (4)

One checks that \( X_n, a_n \geq 0 \) but \( b_n \) can be negative in which case an investor owes \(-b_nB_n\) or equivalently the investor sold \( b_n \) shares of bond short. \( C_n \) is determined by backward recursion that starts at the terminal time \( N \) of the binomial tree according to

\[ C_{n-1}(S_{n-1}) = \frac{1}{1 + r}[pC_n(S_{n-1}u) + (1 - p)C_n(S_{n-1}d)], \quad n = N, N - 1, \ldots, 2, 1 \] (5)

3. Construction of bond replication portfolio

The first step is to build the option replication portfolio \( \Pi_c = \{X_n, (a_n, b_n), \ 0 \leq n \leq N\} \) satisfying (1)-(5). The second step amounts to recursive construction of a portfolio with values \( \{Y_n, 0 \leq n \leq N\} \) subject to (p1)-(p5) which is based on \( \Pi_c \) and grows risk free.

The interval \([0,1]\). Set \( Y_0 = a_0S_0 - C_0 \equiv a_0S_0 - C_0 \) as the initial capital. Define

\[ Y_0 = a_1S_0 - C_0 = a_1S_0 - C_0 + (Y_0 + C_0 - a_1S_0) \equiv a_1S_0 - C_0 + g_1 \quad \text{during } (0,1). \]

Then

\[ Y_1 = a_1S_1 - C_1 = Y_0(1 + r), \]

since \( a_1S_0 - C_0 \) becomes \( a_1S_1 - C_1 = -b_1B_1 = -b_1B_1(1 + r) = (a_1S_0 - C_0)(1 + r) = Y_0(1 + r) \) due to \( C_0 = X_0 = a_0S_0 + b_0B_0 = a_1S_0 + b_1B_0 \) and \( C_1 = X_1 = a_1S_1 + b_1B_1 \) while \( g_1 \equiv 0 \).

The interval \((1,2]\). Use the first step and define

\[ Y_1 = a_1S_1 - C_1 = (Y_1 + C_1 - a_2S_1) \equiv a_2S_1 - C_1 + g_2 \quad \text{during } (1,2). \]

Then

\[ Y_2 = a_2S_2 - C_2 + g_2(1 + r) = Y_0(1 + r)^2, \]

since \( a_2S_1 - C_1 \) becomes \( a_2S_2 - C_2 = -b_2B_2 \) and \( g_2 \) earns interest \( r \) during \((1,2)\) yielding

\[ g_2(1 + r) = Y_1(1 + r) + (C_1 - a_2S_1)(1 + r) = Y_1(1 + r) + b_2B_1(1 + r) = Y_0(1 + r)^2 + b_2B_2 \]

due to \( C_1 = X_1 = a_1S_1 + b_1B_1 = a_2S_1 + b_2B_1. \)

The interval \((n-1,n], n = 3, \ldots, N \). Use the \( n - 1 \) step and define

\[ Y_{n-1} = Y_0(1 + r)^{n-1} = a_nS_{n-1} - C_{n-1} + (Y_{n-1} + C_{n-1} - a_nS_{n-1}) \equiv a_nS_{n-1} - C_{n-1} + g_n \quad \text{on } (n-1,n) \]

Then

\[ Y_n = a_nS_n - C_n + g_n(1 + r) = Y_0(1 + r)^n, \quad g_n \in \mathcal{F}_{n-1} \]

by an argument similar to the case \( n = 1,2 \).
Summing up, given \( \{S_{n-1}, a_n, C_{n-1}, Y_{n-1}\} \in \mathcal{F}_{n-1} \) create portfolio positions for \( n = 1, \ldots, N \) as follows:

Open a position taking effect instantaneously after time \( n - 1 \) according to

- sell the entire holdings to receive \( Y_{n-1} \)
- sell one option short to receive \( C_{n-1} \)
- buy \( a_n \) shares of stock to spend \( a_n S_{n-1} \)
- hold the cash flow \( g_n = Y_{n-1} + C_{n-1} - a_n S_{n-1} \) earning interest \( r \) over \( (n-1, n) \)

Close the position at time \( n \)

- declare the portfolio value \( Y_n \)

**Theorem 1:**
Let \( \Pi_c = \{X_n, (a_n, b_n), 0 \leq n \leq N\} \) be the option replication portfolio. Then there exists a bond replication portfolio \( \Pi = \{Y_n, (a_n, g_n), 0 \leq n \leq N\} \) of \( a_n \) shares of stock long, one call option short and a carry-on cash flow \( g_n \) such that

(i) \( Y_{n-1} = a_n S_{n-1} - C_{n-1} + g_n \) during the time period \((n-1, n)\)
(ii) \( Y_n = a_n S_n - C_n + g_n (1+r) = Y_0 (1+r)^n \) at time \( n \), \( n = 1, \ldots, N \) \( (6) \)

**Proof:** By construction, it is a consequence of unique \( Y_0 \equiv a_0 S_0 - (1+r)^{-N} E[(S_N - K)^+] \), \( a_0 \equiv a_1, a_n, C_n \) found from (3) - (5) and \( g_n = Y_{n-1} + C_{n-1} - a_n S_{n-1} = (b_n - b_1)B_{n-1} \), because \( a_n S_n - C_n = -b_n B_n \) and \( Y_{n-1} = Y_0 (1+r)^{-n-1} = -b_1 B_0 (1+r)^{-n-1} = -b_1 B_{n-1} \) thanks to \( C_{n-1} = X_{n-1} = a_{n-1} S_{n-1} + b_{n-1} B_{n-1} \).

Below we provide concrete calculations in the case \( N = 3 \).

**Example 1.** Let \( S_0 = K = 40, u = \frac{5}{4}, d = \frac{4}{5}, r = \frac{1}{40} \) which gives \( p = \frac{1+r-d}{u-d} = \frac{1}{2} \). A special choice of \( ud = 1 \) and consequently \( p = \frac{1}{2} \) is only for keeping calculations simple but there are no such restrictions in general, other than as specified in section 2. Solving (5) backward for \( C_n \) and using (3) we obtain \( C_0 = 7.90, a_1 = 0.636 \) and \( Y_0 = a_0 S_0 - C_0 = 17.54 \).

Then \( \{a_2(U) = 0.826, a_2(D) = 0.338\}, \{a_3(U, U) = 1, a_3(U, D) = a_3(D, U) = 0.555, a_3(D, D) = 0\}, \{C_1(U) = 13.83, C_1(D) = 2.38\}, \{C_2(U, U) = 23.47, C_2(U, D) = C_2(D, U) = 4.88, C_2(D, D) = 0\}, \{C_3(U, U, U) = 38\frac{1}{2}, C_3(U, U, D) = C_3(U, D, U) = C_3(D, U, U) = 10, C_3(U, D, D) = C_3(D, D, D) = C_3(D, D, U) = C_3(D, D, D) = 0\} \). For the stock process \( \{S_1(U) = 50, S_1(D) = 32\}, \{S_2(U, U) = 62\frac{1}{2}, S_2(U, D) = S_2(D, U) = S_2(D, D) = 40\}, \{S_3(U, U, U) = 78\frac{1}{2}, S_3(U, U, D) = S_3(U, D, U) = S_3(D, D, U) = 50\} \).
Calculations were carried out in several decimal places but only two or three digits are displayed here as needed. We remark that the bond position \( b_3 \) in the call option replication portfolio \( \Pi_c = \{ X_n, (a_n, b_n), \ 0 \leq n \leq N \} \) is a random variable with a distribution corresponding to binomial probabilities and thus not riskless! Indeed, by \( a_i(U,U) = 1 \) it follows that

\[
P(b_3 = C^3(U,U,U) - S^3(U,U,U)) = P(S_2 = S_0u^2) = p^2, \quad P(b_3 = C^3(U,D,U) - S^3(U,D,U)) = \]

\[
P(S_2 = S_0ud \cup S_2 = S_0du) = 2p(1-p), \quad P(b_3 = 0) = P(S_2 = S_0d^2) = (1-p)^2.
\]

We illustrate the actual portfolio trading and rebalancing on a single stock path which first goes up then down then up again, i.e., \( S_0 = 40, \ S_1(U) = S_0u, \ S_2(U,D) = S_0ud, \ S_3(U,D,U) = S_0udu = 50. \) Open a position on \((0,1] \) by selling one option short and receive \( C_0 = 7.90 \), which combined with initial \( Y_0 = 17.54 \) buys \( a_i = .636 \) shares of stock at the price \( S_0 = 40 \) and leaves the cash flow \( g_1 = 0 \). Close the position at time 1 with holdings valued \( Y_1 = a_iS_1(U) - C_1(U) = 17.98 = Y_0(1+r). \) Open a position on \( (1,2] \) by selling one call option short to receive \( C_1(U) = 13.83 \), which combined with initial \( Y_1 = 17.98 \) requires to borrow \( g_2(U) = Y_1 + C_1(U) - a_2(U)S_1(U) = -9.49 \) to buy \( a_2(U) = .826 \) shares of stock at the price \( S_1(U) = 50 \) and arrive at \( Y_1 = a_2(U)S_1(U) - C_1(U) + g_2(U). \) Close the position at time 2 with holdings valued \( Y_2 = a_2(U)S_2(U,D) - C_2(U,D) + g_2(U)(1+r) = 18.43 = Y_0(1+r)^2. \) Open a position on \( (2,3] \) by selling one call option short to receive \( C_2(U,D) = 4.88 \), which combined with initial \( Y_2 = 18.43 \) buys \( a_3(U,D) = .555 \) shares of stock at the price \( S_2(U,D) = 40 \) and leaves \( g_3(U,D) = Y_2 + C_2(U,D) - a_3(U,D)S_2(U,D) = 1.11 \) to invest at rate \( r \). Close the position at time 3 with holdings valued \( Y_3 = a_3(U,D)S_3(U,D,U) - C_3(U,D,U) + g_3(U,D)(1+r) = 18.89 \) which again matches the desired \( Y_0(1+r)^3. \) The analysis of the other seven cases is similar and shows that in each time step the portfolio so devised matches the fixed rate of return given the initial investment \( Y_0. \)

**Theorem 2:** There exists a bond replication portfolio \( \Pi_b = \{ Y^*_n, (a^*_n, d^*_n), \ 0 \leq n \leq N \} \) of \( a^*_n \) shares of stock long and \( d^*_n \) call options short which replicates the bond exactly in each time interval according to

(i) \( Y^*_{n-1} = a^*_nS_{n-1} - d^*_nC_{n-1} \) during the time period \((n-1,n)\)

(ii) \( Y^*_n = a^*_nS_n - d^*_nC_n = Y_0(1+r)^n \) at time \( n \), \( n = 1, ... , N \)

where \( a^*_n = \frac{b_n}{b_n}a_n \), \( d^*_n = \frac{b_n}{b_n} \) with \((a_n, b_n)\) determined by \( \Pi_c = \{ X_n, (a_n, b_n) \} \).
Proof: It follows from Theorem 1 because by $C_n = X_n = a_n S_n + b_n B_n$ we have

$$-b_n B_n - a_n S_n - C_n$$

which multiplied by $\frac{b_n - h}{bh_n}$ gives $g_n = a_n (\frac{h}{h_n} - 1) S_n - (\frac{h}{h_n} - 1) C_n$.

and consequently

$$Y_n = a_n S_n - C_n + g_n = a_n \frac{h}{h_n} S_n - \frac{h}{h_n} C_n = Y_n'$$

as claimed.

To avoid the phrase *instantaneously after time n* the working assumption below is to use the term *at time n* whenever referring to buy or sell in reference to opening or closing any given position.

Example 2. As before we illustrate the hedging for the up-down-up case. Solving for $b_1$, $b_2 = b_2(U)$, $b_3 = b_3(U, D)$ gives $\frac{h}{h_2} = .654$ and $\frac{h}{h_3} = 1.0627$, whence $(a_1^*, d_1^*) = (a_1, 1)$, $(a_2^*, d_2^*) = (.5405, .654)$, $(a_3^*, d_3^*) = (.5903, 1.0627)$. The first step is the same as in Example 1 because $g_1 = 0$. That is, start at time 0 with $Y_0 = 17.54$, short one call at $C_0 = 7.90$ and buy $a_1^* = a_1 = .636$ shares of stock at $S_0 = 40$, then at time 1 sell the stock at $S_1(U) = 50$ and buy back call at $C_1(U) = 13.83$ to arrive at $Y_1 = 17.98 = Y_0 (1 + r)$. At time 1, with $Y_1 = 17.98$, short $d_2^*(U) = .654$ calls at $C_1(U) = 13.83$ and buy $a_2^*(U) = .5405$ shares of stock at $S_1(U) = 50$, then at time 2 sell the stock at $S_2(U, D) = 40$ and buy back calls at $C_2(U, D) = 4.88$ to arrive at $Y_2 = 18.43 = Y_0 (1 + r)^2$. At time 2, with $Y_2 = 18.43$, short $d_3^*(U, D) = 1.0627$ calls at $C_2(U, D) = 4.88$ and buy $a_3^*(U, D) = .5903$ shares of stock at $S_2(U, D) = 40$, then at time 3 sell the stock at $S_3(U, D, U) = 50$ and buy back calls at $C_3(U, D, U) = 10$ to arrive at $Y_3 = 18.89 = Y_0 (1 + r)^3$.

4. Convergence to Black-Scholes bond replication portfolio

Continuous time modeling assumes the actual stock price to follow exponential Brownian motion process $S_t = S_0 e^{(\mu - \frac{1}{2} \sigma^2) t + \sigma W_t}$ with $ES_t = S_0 e^{\mu t}$. In the special case of $\mu = r$ it turns into the risk-neutral process $S_t = S_0 e^{rt}$ which corresponds to the discrete time risk-neutral process $S_n$ discussed earlier. Here $\{W_t, 0 \leq t \leq T\}$ is the standard Brownian motion, $\mu$ is the average return rate on stock, $r$ is the bond return rate and $\sigma$ is the stock volatility. Notice that the expected return on the risk-neutral process $ES_t = S_0 e^{rt}$ and when volatility is set to zero then the risk-neutral process turns into the bond process itself. The Black-Scholes no-arbitrage option price $C_t = e^{-r(T-t)} E[(S_T - K)^+ | S_t]$, where the conditional expected value is taken with respect to the martingale measure corresponding to the discounted risk-neutral process, says that given the actual stock price $S_t = S_0 e^{(\mu - \frac{1}{2} \sigma^2) t + \sigma W_t}$ the option price at time $t$ is calculated as follows:

$$C_t = e^{-r(T-t)} E[(S_T - K)^+ | S_t] = e^{-r(T-t)} E[(S_t e^{Z} - K) 1_{[\text{hit}_b, \infty)}(Z)]$$

where

$$S_T = S_t e^{(r - \frac{1}{2} \sigma^2)(T-t) + \sigma(W_T - W_t)} \equiv S_t e^Z, \ Z \text{ is normal } \sim N((r - \frac{1}{2} \sigma^2)(T-t), \sigma^2(T-t))$$
Furthermore, the Black-Scholes bond replication portfolio \( \Pi_{B-S} = \{ Y_t, (a_t, 1), \ 0 \leq t \leq T \} \) of \( a_t \) shares of stock long and 1 call option short satisfies the following

\[
Y_t = a_t S_t - C_t = Y_0 e^{rT} \quad \text{with} \quad Y_0 = a_0 S_0 - e^{-rT} E[(S_T - K)^+] \tag{11}
\]

with \( a_t \) is determined by

\[
a_t = \frac{\partial C}{\partial S} \bigg|_{S=S_0} = e^{-r(T-t)} \frac{d}{S} \int_{\ln(e^T)}^{\ln(e^T)} (Se^z - K) dF(z) \bigg|_{S=S_0} = e^{-r(T-t)} E[e^{rZ} 1_{[\ln(e^T), \infty)}(Z)] \tag{12}
\]

Evaluating the above expectations gives \( C_t = S_t \Phi(\alpha) - e^{-r(T-t)} K \Phi(\beta) \) and \( a_t = \Phi(\alpha) \)

where \( \alpha = \frac{\ln(S_0/K + (r+0.5\sigma^2)(T-t))}{\sigma\sqrt{T-t}} \), \( \beta = \alpha - \sigma\sqrt{T-t} \) and \( \Phi(x) \) is the standard normal cumulative distribution.

To see how our previously constructed riskless portfolio \( \Pi_b \) on binomial tree becomes the celebrated Black-Scholes portfolio \( \Pi_{B-S} \) in the limit, additional notation with certain particular choices for underlying variables are in order. Let in the discrete time model \( N = n \), the time period \( \Delta t = \frac{T}{n} \), \( n = m \), \( r \Delta t \) be the return rate per period, \( u = e^{r \Delta t} \), \( d = \frac{1}{u} \), \( p = \frac{e^{r \Delta t} - d}{u - d} \). Furthermore, let for any \( n = 1, 2, ..., \ U_{n1}, ..., U_{nn} \) be a sequence of independent identically distributed random variables with \( P(U_{ni} = u) = p, \ P(U_{ni} = d) = 1 - p \). Then for \( 1 \leq m \leq n \), we have \( S_m = S_0 U_{n1} \cdots U_{nm} = S_0 e^{\sigma \Delta t (\epsilon_{1} + \cdots + \epsilon_{nm})} \) and \( \epsilon_{ni} \)'s are i.i.d. \( P(\epsilon_{ni} = 1) = p \), \( P(\epsilon_{ni} = -1) = 1 - p \). In the sequel, whenever invoking basic facts about convergence in distribution, Billingsley (1999) is a standard reference without further mention. Denoting by \( [x] \) the integer part of \( x \) we have the following convergence in distribution

\[
Z_{m1}^{m} = \sigma \Delta t (\epsilon_{m1} + \cdots + \epsilon_{nn}) \xrightarrow{d} \mathcal{Z}_1 \sim N((r-0.5\sigma^2)\Delta t, \sigma^2(T-t)), \ m = [n \frac{T}{\Delta t}] \to \infty \tag{13}
\]

and

\[
Z_{m1+m}^{m} = \sigma \Delta t (\epsilon_{m1+m} + \cdots + \epsilon_{nn}) \xrightarrow{d} \mathcal{Z}_{m2} \sim N((r-0.5\sigma^2)\Delta t + o(\Delta t)), \ \mathcal{V}ar(W_{i}) = \sigma^2 \Delta t + o(\Delta t), \ E|W_{i}|^3 \leq \sigma^3 \Delta t^3, m \Delta t \to \infty \tag{14}
\]

This follows because \( Z_{m1}^{m} = W_{1} + \cdots + W_{m} + m E \sigma \Delta t \epsilon_{ni} \), \( W_{i} = \sigma \Delta t \epsilon_{ni} - E \sigma \Delta t \epsilon_{ni}, \ EW_{i} = 0 \), \( E \sigma \Delta t \epsilon_{ni} = (r-0.5\sigma^2)\Delta t + o(\Delta t) \), \( \mathcal{V}ar(W_{i}) = \sigma^2 \Delta t + o(\Delta t), \ E |W_{i}|^3 \leq \sigma^3 \Delta t^3 \). Therefore from Lindeberg’s Central Limit Theorem \( W_{1} + \cdots + W_{m} \xrightarrow{d} \mathcal{N}(0,1) \), thanks to Lyapunov’s \( \frac{E|W_{i}|^3 + \cdots + E|W_{m}|^3}{(\sqrt{\mathcal{V}ar(W_{1} + \cdots + W_{m})})^3} \leq \frac{2 \sigma^2 \sqrt{T}}{n^2} \to 0 \)

condition, as \( n \geq m \to \infty \) concludes the proof of (13). The proof of (14) is similar.

**Lemma:**

Let \( X_{n}(\omega), Y_{n}(\omega'), n = 1, 2, ..., \) be independent defined on \( (\Omega \times \Omega', \mathcal{F} \times \mathcal{F}', P \times P') \)
such that $\sup_s E e^{2Y} < M < \infty$. If $X_n \xrightarrow{d} X = X(\omega), Y_n \xrightarrow{d} Y$ and $F(y) = P(Y \leq y)$ is continuous then

$$P(\omega \mid \lim_{n \to \infty} E e^{Y} 1_{[X_n(\omega),\omega)}(Y_n) = E e^{Y} 1_{[X(\omega),\omega)}(Y)) = 1$$

(15)

**Proof:** Due to Skorokhod’s representation theorem one can assume without loss of generality that $X_n, X$ are chosen in such a way that $P(\omega \mid \lim_{n \to \infty} X_n(\omega) = X(\omega)) = 1$.

By assumption $F_n(y) = P(Y_n \leq y) \to F(y)$ for every real number $y$. Then denoting by $X_n \wedge X = \min(X_n, X), X_n \vee X = \max(X_n, X)$ we have

$$E e^{Y} 1_{[X_n(\omega),\omega)}(Y_n) = \int e^y 1_{[X_n(\omega),\omega)}(y)dF_n(y) + \int e^y 1_{[X_n,\omega)}(y)dF_n(y) \to \int e^y 1_{[X,\omega)}(y)dF(y)$$

because by Cauchy-Schwarz inequality the first integral above is dominated by

$$\int e^{2y} dF_n(y)\int 1_{[X_n(\omega),\omega)}(y)dF_n(y) \leq M(F_n(X_n \wedge X) - F_n(X_n \wedge X - \frac{1}{n})) \to 0$$

whence $X_n \wedge X \to X, X_n \vee X - \frac{1}{n} \to X$ and continuity of $F$ implies $F_n(y_n) \to F(y)$, whereas the second integral $E e^{Y} 1_{[X,\omega)}(Y_n)$ converges to $E e^{Y} 1_{[X,\omega)}(Y)$ for $X = X(\omega)$ fixed because $e^{Y} 1_{[X,\omega)}(Y_n)$ are uniformly integrable by assumption $\sup_s E e^{2Y} < M < \infty$, and $h(y) = e^{y} 1_{[X,\omega)}(y)$ is continuous except when $y = X$ which has probability zero due to continuity of $F(y)$.

**Theorem 3:**

The discrete time bond replication portfolio $\Pi_b = \{Y_n, (a_n, d_n^*)\}, 0 \leq n \leq N\}$ with $Y^*_m = a_n^* S_m - d_n^* C_m = Y^*_0 (1 + r\Delta t)^m$, converges to the Black-Scholes bond replication portfolio $\Pi_{BS} = \{Y_t, (a_t, 1), 0 \leq t \leq T\}$ with $Y_t = a_t S_t - C_t = Y_0 e^{r_t}, 0 \leq t < T$. The convergence $\Pi_b \to \Pi_{BS}$ means

(i) $S_m \to S_t, \quad C_m \to C_t, \quad a_n^* \to a_t, \quad d_n^* \to 1, \quad Y^*_m \to Y^*_0 e^{r_t} \qquad \text{as } m = [n \Delta t] \to \infty$

(ii) $S_n \xrightarrow{d} S = \{S_0 e^{(r - \frac{1}{2} \sigma^2) t + \sigma W_t}, 0 \leq t \leq T\}$ in $C[0,T]$ as $n \to \infty$

**Proof:** Since part (ii) is standard, e.g., it follows from Prohorov’s generalization of Donsker’s Invariance Principle for Brownian motion in Billingsley (1999), it suffices to show (i). As before, since by (13) $S_m = S_0 e^{Z_{m+1}^n} \xrightarrow{d} S_0 e^{Z_t} = S_t$, we may assume without loss of generality that $S_m \to S_t$ with probability one. By (2) with the following substitutions, $N = n, \quad n = m, \quad r := r\Delta t$ and $m = [n \Delta t], (9)-(10), \text{Lemma applied to}$

$$Y_n = Z_{m+1}^n \xrightarrow{d} Z, \quad X_n = \ln \frac{x}{S_m} \to \ln \frac{x}{S_t} \quad \text{and (15) we obtain with probability one}$$

$$C_m = (1 + r\Delta t)^{-(r-m)} E[(S_n - K)^+ \mid S_m] = (1 + r\Delta t)^{-(r-m)} E[(S_m e^{Z_{m+1}} - K) 1_{\{S_n(e^{Z_{m+1}} - K) \geq \inf \{Z_{m+1}, \omega\}\}}] \xrightarrow{d} e^{-r(T-t)} E[(S_0 e^{Z} - K) 1_{\{S_0(e^{Z} - K) \geq \inf \{Z, \omega\}\}}] = C_t$$

thanks to continuity of $Z$ and the fact that $\sup_s E e^{2Y} < \infty$ which follows from
$$Ee^{Z^{n+1}_m} = [Ee^{2\sigma^2 \Delta t}]^{n-m} = [e^{2\sigma^2 \Delta t} p + e^{-2\sigma^2 \Delta t}(1-p)]^{n-m} = [1 + (2r + \sigma^2)\Delta t + o(\Delta t)]^{n-m} = e^{2r(\Delta t + o(\Delta t))}$$

To see that $a_m^* \rightarrow a_t$, $d_m^* \rightarrow 1$ it suffices to check that $g_m = (b_m - b_t)B_{m-1} \rightarrow 0$ and $a_m \rightarrow a_t$ because then $\frac{b_m}{b_t} = d_m^* \rightarrow 1$. Namely, convergence of portfolio values $Y_m$ of Theorem 1 to $Y_t$ implies convergence $Y_m^*$ of Theorem 2 to $Y_t$ provided $g_m \rightarrow 0$. To show that $g_m \rightarrow 0$ it suffices to verify $C_m \rightarrow C_t$, $a_m \rightarrow a_t$, and

$$Y_m = Y_0(1 + r\Delta t)^m = (a_0(Y_0)S_0 - (1 + r\Delta t)^n E[(S_n - K)^+])(1 + r\Delta t)^m \rightarrow Y_t = Y_0e^{rt} = (a_0(Y_t)S_0 - e^{-rt} E[(S_T - K)^+])e^{rt}.$$  

The latter convergence follows from $a_m \rightarrow a_t$ (i.e., $a_0(Y_0) \rightarrow a_0(Y_T)$ for $t = 0$), $S_n = S_0e^{Z_t+Z_{n+1}} \rightarrow S_0e^{Z_t+Z}$ by (13)-(14) and the fact that $S_n$ are uniformly integrable. Consequently, by (16), the proof will be concluded if we show that $a_m \rightarrow a_t$. Given $S_{m-1}$, by (2)-(3) applied to $S = S_{m-1}u$ and $S = S_{m-1}d$ we have

$$a_m = \frac{C_m(S_{m-1}u) - C_m(S_{m-1}d)}{S_{m-1}u - S_{m-1}d} = \frac{(1 + r\Delta t)^{-(n-m)}[E[(S_{m-1}ue^{Z_{n+1}} - K)1_{[\ln\frac{K}{S_{m-1}u}], \infty)}(Z_{m+1}^n)] - E[(S_{m-1}de^{Z_{n+1}} - K)1_{[\ln\frac{K}{S_{m-1}d}], \infty)}(Z_{m+1}^n)]]}{S_{m-1}u - S_{m-1}d}$$

$$= \frac{(1 + r\Delta t)^{-(n-m)}[E[e^{Z_{m+1}^n}1_{[\ln\frac{K}{S_{m-1}u}], \infty)}(Z_{m+1}^n)] + [E[(S_{m-1}de^{Z_{n+1}} - K)1_{[\ln\frac{K}{S_{m-1}d}], \ln\frac{K}{S_{m-1}})}(Z_{m+1}^n)]]}{S_{m-1}u - S_{m-1}d}$$

$$\rightarrow e^{-(r(T+t))}E[e^{Z_{m+1}^n}1_{[\ln\frac{K}{S_{m-1}u}], \infty)}(Z)] = a_t, \text{ by Lemma and (12), as } m = [n\frac{T}{t}] \rightarrow \infty$$

since $|S_{m-1}ue^{Z_{m+1}^n} - K| = \frac{K}{S_{m-1}u}(S_{m-1}u - S_{m-1}d)$ on the interval $[\ln\frac{K}{S_{m-1}u}, \ln\frac{K}{S_{m-1}d})$ while

$$E[1_{[\ln\frac{K}{S_{m-1}u}], \ln\frac{K}{S_{m-1}d)}(Z_{m+1})] \leq F_m(\ln\frac{K}{S_{m-1}u}) - F_m(\ln\frac{K}{S_{m-1}d}) - \frac{1}{m} \rightarrow 0, \text{ } u = u(m) \rightarrow 1, F_m \rightarrow F$$

where $F_m$ and $F$ is the distribution function of $Z_{m+1}$ and $Z$ respectively.

Acknowledgements. The author thanks David Diltz of the UTA Finance Department for helpful discussions and comments and the referees for suggestions that enhanced the original exposition.
References


