Stochastic Processes and Advanced Mathematical Finance

Properties of Geometric Brownian Motion

Rating

Mathematically Mature: may contain mathematics beyond calculus with proofs.
Section Starter Question

What is the relative rate of change of a function?
For the function defined by the ordinary differential equation
\[
\frac{dx}{dt} = rx \quad x(0) = x_0
\]
what is the relative rate of growth? What is the function?

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Key Concepts

1. Geometric Brownian Motion is the continuous time stochastic process
\[z_0 \exp(\mu t + \sigma W(t))\] where \(W(t)\) is standard Brownian Motion.

2. The mean of Geometric Brownian Motion is
\[z_0 \exp(\mu t + (1/2)\sigma^2 t).\]

3. The variance of Geometric Brownian Motion is
\[z_0^2 \exp(2\mu t + \sigma^2 t)(\exp(\sigma^2 t) - 1).\]

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Vocabulary

1. **Geometric Brownian Motion** is the continuous time stochastic process \(z_0 \exp(\mu t + \sigma W(t))\) where \(W(t)\) is standard Brownian Motion.
2. A random variable $X$ is said to have the lognormal distribution (with parameters $\mu$ and $\sigma$) if $\log(X)$ is normally distributed ($\log(X) \sim N(\mu, \sigma^2)$). The p.d.f. for $X$ is

$$f_X(x) = \frac{1}{\sqrt{2\pi}\sigma x} \exp\left((-1/2)[(\ln(x) - \mu)/\sigma]^2\right).$$

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**Mathematical Ideas**

**Geometric Brownian Motion**

Geometric Brownian Motion is the continuous time stochastic process $X(t) = z_0 \exp(\mu t + \sigma W(t))$ where $W(t)$ is standard Brownian Motion. Most economists prefer Geometric Brownian Motion as a model for market prices because it is everywhere positive (with probability 1), in contrast to Brownian Motion, even Brownian Motion with drift. Furthermore, as we have seen from the stochastic differential equation for Geometric Brownian Motion, the relative change is a combination of a deterministic proportional growth term similar to inflation or interest rate growth plus a normally distributed random change

$$\frac{dX}{X} = r \, dt + \sigma \, dW.$$ 

See Itô’s Formula and Stochastic Calculus. On a short time scale this is a sensible economic model.

*Theorem 1.* At fixed time $t$, Geometric Brownian Motion $z_0 \exp(\mu t + \sigma W(t))$ has a lognormal distribution with parameters $(\ln(z_0) + \mu t)$ and $\sigma \sqrt{t}$. 
Proof.

\[ F_X(x) = \mathbb{P}[X \leq x] \]
\[ = \mathbb{P}[z_0 \exp(\mu t + \sigma W(t)) \leq x] \]
\[ = \mathbb{P}[\mu t + \sigma W(t) \leq \ln(x/z_0)] \]
\[ = \mathbb{P}[W(t) \leq \ln(x/z_0) - \mu t / \sigma] \]
\[ = \mathbb{P}\left[W(t)/\sqrt{t} \leq (\ln(x/z_0) - \mu t)/(\sigma \sqrt{t})\right] \]
\[ = \int_{-\infty}^{(\ln(x/z_0) - \mu t)/(\sigma \sqrt{t})} \frac{1}{\sqrt{2\pi}} \exp(-y^2/2) \, dy \]

Now differentiating with respect to \( x \), we obtain that

\[ f_X(x) = \frac{1}{\sqrt{2\pi} \sigma x \sqrt{t}} \exp((-1/2)((\ln(x) - \ln(z_0) - \mu t)/(\sigma \sqrt{t}))^2). \]

Calculation of the Mean

We can calculate the mean of Geometric Brownian Motion by using the m.g.f. for the normal distribution.
Theorem 2. \( \mathbb{E}[z_0 \exp(\mu t + \sigma W(t))] = z_0 \exp(\mu t + (1/2)\sigma^2 t) \)

Proof.

\[
\mathbb{E}[X(t)] = \mathbb{E}[z_0 \exp(\mu t + \sigma W(t))]
= z_0 \exp(\mu t) \mathbb{E}[\exp(\sigma W(t))]
= z_0 \exp(\mu t) \mathbb{E}[\exp(\sigma(t)w)|u=1]
= z_0 \exp(\mu t) \exp(\sigma^2 t u^2/2)|u=1
= z_0 \exp(\mu t + (1/2)\sigma^2 t)
\]

since \( \sigma W(t) \sim \mathcal{N}(0, \sigma^2 t) \) and \( \mathbb{E}[\exp(Yu)] = \exp(\sigma^2 t u^2/2) \) when \( Y \sim \mathcal{N}(0, \sigma^2 t) \).

See [Moment Generating Functions, Theorem 4].

Calculation of the Variance

We can calculate the variance of Geometric Brownian Motion by using the m.g.f. for the normal distribution, together with the common formula:

\[
\text{Var}[X] = \mathbb{E}[(X - \mathbb{E}[X])^2] = \mathbb{E}[X^2] - (\mathbb{E}[X])^2
\]

and the previously obtained formula for \( \mathbb{E}[X] \).

Theorem 3. \( \text{Var}[z_0 \exp(\mu t + \sigma W(t))] = z_0^2 \exp(2\mu t + \sigma^2 t)[\exp(\sigma^2 t) - 1] \)

Proof. First compute:

\[
\mathbb{E}[X(t)^2] = \mathbb{E}[z_0^2 \exp(\mu t + \sigma W(t))^2]
= z_0^2 \mathbb{E}[\exp(2\mu t + 2\sigma W(t))]
= z_0^2 \exp(2\mu t) \mathbb{E}[\exp(2\sigma W(t))]
= z_0^2 \exp(2\mu t) \mathbb{E}[\exp(2\sigma W(t)) u]|u=1
= z_0^2 \exp(2\mu t) \exp(4\sigma^2 tu^2/2)|u=1
= z_0^2 \exp(2\mu t + 2\sigma^2 t)
\]

Therefore,

\[
\text{Var}[z_0 \exp(\mu t + \sigma W(t))] = z_0^2 \exp(2\mu t + 2\sigma^2 t) - z_0^2 \exp(2\mu t + \sigma^2 t)
= z_0^2 \exp(2\mu t + \sigma^2 t)[\exp(\sigma^2 t) - 1].
\]
Note that this has the consequence that the variance starts at 0 and then grows exponentially. The variation of Geometric Brownian Motion starts small, and then increases, so that the motion generally makes larger and larger swings as time increases.

**Stochastic Differential Equation and Parameter Summary**

If a Geometric Brownian Motion is defined by the stochastic differential equation

\[ dX = rX \, dt + \sigma X \, dW \quad X(0) = z_0 \]

then the Geometric Brownian Motion is

\[ X(t) = z_0 \exp((r - (1/2)\sigma^2)t + \sigma W(t)). \]

At each time the Geometric Brownian Motion has lognormal distribution with parameters \((\ln(z_0) + rt - (1/2)\sigma^2t)\) and \(\sigma\sqrt{t}\). The mean of the Geometric Brownian Motion is \(\mathbb{E}[X(t)] = z_0 \exp(rt)\). The variance of the Geometric Brownian Motion is

\[ \text{Var}[X(t)] = z_0^2 \exp(2rt)[\exp(\sigma^2t) - 1] \]

If the primary object is the Geometric Brownian Motion

\[ X(t) = z_0 \exp(\mu t + \sigma W(t)). \]

then by Itô’s formula the SDE satisfied by this stochastic process is

\[ dX = (\mu + (1/2)\sigma^2)X(t) \, dt + \sigma X(t) \, dW \quad X(0) = z_0. \]

At each time the Geometric Brownian Motion has lognormal distribution with parameters \((\ln(z_0) + \mu t)\) and \(\sigma\sqrt{t}\). The mean of the Geometric Brownian Motion is \(\mathbb{E}[X(t)] = z_0 \exp(\mu t + (1/2)\sigma^2t)\). The variance of the Geometric Brownian Motion is

\[ z_0^2 \exp(2\mu t + \sigma^2t)[\exp(\sigma^2t) - 1]. \]
Ruin and Victory Probabilities for Geometric Brownian Motion

Because of the exponential-logarithmic connection between Geometric Brownian Motion and Brownian Motion, many results for Brownian Motion can be immediately translated into results for Geometric Brownian Motion. Here is a result on the probability of victory, now interpreted as the condition of reaching a certain multiple of the initial value. For \( A < 1 < B \) define the “duration to ruin or victory”, or the “hitting time” as

\[
T_{A,B} = \min\{t \geq 0 : \frac{z_0 \exp(\mu t + \sigma W(t))}{z_0} = A, \frac{z_0 \exp(\mu t + \sigma W(t))}{z_0} = B\}
\]

**Theorem 4.** For a Geometric Brownian Motion with parameters \( \mu \) and \( \sigma \), and \( A < 1 < B \),

\[
P\left[ \frac{z_0 \exp(\mu T_{A,B} + \sigma W(T_{A,B}))}{z_0} = B \right] = \frac{1 - A^{1-(2\mu-\sigma^2)/\sigma^2}}{B^{1-(2\mu-\sigma^2)/\sigma^2} - A^{1-(2\mu-\sigma^2)/\sigma^2}}
\]

Quadratic Variation of Geometric Brownian Motion

The quadratic variation of Geometric Brownian Motion may be deduced from Itô’s formula:

\[
dX = (\mu - \sigma^2/2)X \, dt + \sigma X \, dW
\]

so that

\[
(\,dX\,)^2 = (\mu - \sigma^2/2)^2 X^2 \, dt^2 + (\mu - \sigma^2/2) \sigma X^2 \, dt \, dW + \sigma^2 X^2 \, (dW)^2.
\]

Guided by the heuristic principle that terms of order \((dt)^2\) and \(dt \cdot dW \approx (dt)^{3/2}\) are small and may be ignored, and that \((dW)^2 = dt\), we obtain:

\[
(\,dX\,)^2 = \sigma^2 X^2 \, dt.
\]
Continuing heuristically, the expected quadratic variation is

\[
\mathbb{E} \left[ \int_0^T (dX)^2 \right] = \mathbb{E} \left[ \int_0^T \sigma^2 X^2 \, dt \right] = \sigma^2 \mathbb{E} \left[ X^2 \right] \, dt = \sigma^2 \left[ \int_0^T z_0^2 \exp(2\mu t + 2\sigma^2 t) \, dt \right] = \frac{\sigma^2 z_0^2}{2\mu + 2\sigma^2} \left( \exp((2\mu + 2\sigma^2)T) - 1 \right).
\]

Note the assumption that the order of the integration and the expectation can be interchanged.

Sources


Algorithms, Scripts, Simulations

Algorithm

Given values for \( \mu, \sigma \) and an interval \([0, T]\), the script creates \texttt{trials} sample paths of Geometric Brownian Motion, sampled at \( N \) equally-spaced values on \([0, T]\). The scripts do this by creating \texttt{trials} Brownian Motion sample paths sampled at \( N \) equally-spaced values on \([0, T]\) using the definition of Brownian Motion having normally distributed increments. Adding the drift term and then exponentiating the sample paths creates \texttt{trials} Geometric Brownian Motion sample paths sampled at \( N \) equally-spaced values.
on $[0, T]$. Then the scripts use semi-logarithmic least-squares statistical fitting to calculate the relative growth rate of the mean of the sample paths. The scripts also compute the predicted relative growth rate to compare it to the calculated relative growth rate. The problems at the end of the section explore plotting the sample paths, comparing the sample paths to the predicted mean with standard deviation bounds, and comparing the mean quadratic variation of the sample paths to the theoretical quadratic variation of Geometric Brownian Motion.

**Scripts**

**Geogebra** [GeoGebra applet for Geometric Brownian Motion](#)

**R** [R script for Geometric Brownian Motion](#)

```r
mu <- 1
sigma <- 0.5
T <- 1
# length of the interval $[0, T]$ in time units

trials <- 200
N <- 200
# number of end-points of the grid including T
Delta <- T/N
# time increment

t <- t( seq(0, T, length=N+1) * t(matrix(1, trials, N+1)) )
# Note use of the R matrix recycling rules, by columns, so transpose
W <- cbind(0, t( apply(sqrt(Delta) * matrix(rnorm(trials*N), trials), 1, cumsum)))
# Wiener process, Note the transpose after the apply, (side effect
# apply is the result matches the length of individual calls to FUN,
# then the MARGIN dimension/s come next. So it’s not so much
# ”transposed” as that being a consequence of apply in 2D.)
# Note
# use of recycling with cbind to start at 0

GBM <- exp( mu*t + sigma*W)
```

9
meanGBM <- colMeans(GBM)

meanGBM_rate <- lm(log(meanGBM) ~ seq(0,T, length=N+1))
predicted_mean_rate = mu + (1/2)*sigma^2

cat(sprintf("Observed meanGBM relative rate: %f \n", coefficients(meanGBM_rate)[2]))
cat(sprintf("Predicted mean relative rate: %f \n", predicted_mean_rate))

Octave
Octave script for Geometric Brownian Motion

mu = 1;
sigma = 0.5;
T = 1;
# length of the interval [0, T] in time units
trials = 200;
N = 100;
# number of end-points of the grid including T
Delta = T/N;
# time increment

W = zeros(trials, N+1);
# initialization of the vector W approximating
# Wiener process
t = ones(trials, N+1) .* linspace(0, T, N+1);
# Note the use of broadcasting (Octave name for R recycling)
W(:, 2:N+1) = cumsum( sqrt(Delta) * stdnormal_rnd(trials,N), 2);

GBM = exp(mu*t + sigma*W);

meanGBM = mean(GBM);

A = [transpose((0:Delta:T)) ones(N+1, 1)];
meanGBM_rate = A\transpose( log(meanGBM) )
predicted_mean_rate = mu + (1/2)*sigma^2

Perl
Perl PDL script for Geometric Brownian Motion

10
$\mu = 1; 
$\sigma = 0.5; 
$T = 1.; 
# length of the interval \([0, T]\) in time units 

$\text{trials} = 200; 
$N = 100; 
# number of end-points of the grid including T 
$\text{Delta} = \frac{T}{N}; 
# time increment 

$W = \text{zeros}(N + 1, \text{trials}); 
# initialization of the vector \(W\) approximating 
# Wiener process 
$t = \text{ones}(N+1, \text{trials}) \times \text{zeros}(N+1) \rightarrow \text{xlinvals}(0, T); 
# Note the use of PDL dim 1 threading rule (PDL name for R recycling) 
$W(1:N, :) = \text{cumusumover}(\sqrt{\text{Delta}} \times \text{grandom}(N, \text{trials})); 

$\text{GBM} = \exp(\mu \times t + \sigma \times W); 

$\text{meanGBM} = \text{sumover}(\text{GBM} \rightarrow \text{xchg}(0,1)) / \text{trials}; 

\text{use PDL::Fit::Linfit}; 

$\text{fitFuncs} = \text{cat ones}(N + 1), \text{zeros}(N + 1) \rightarrow \text{xlinvals}(0, T); 
(\text{linfitfunc}, \text{coeffs}) = \text{linfit1d log(GBM), fitFuncs}; 
\text{print "Observed Mean GBM Rate: \$coeffs(1) \n"}; 
\text{print "Predicted Mean GBM Rate: \$mu + (1./2.) \times \sigma^2 \n"}; 

\text{SciPy} \quad \text{Scientific Python script for Geometric Brownian Motion} 

\text{import scipy} 

\mu = 1.; 
\sigma = 0.5; 
T = 1. 
# length of the interval \([0, T]\) in time units
trials = 200
N = 100
# number of end-points of the grid including T
Delta = T/N;
# time increment

W = scipy.zeros((trials, N+1), dtype = float)
# initialization of the vector W approximating
# Wiener process
t = scipy.ones((trials, N+1), dtype = float) * scipy.linspace(0, T, N+1)
# Note the use of recycling
W[:, 1:N+1] = scipy.cumsum(scipy.sqrt(Delta) * scipy.random.standard_normal((trials, N)), axis = 1,)

GBM = scipy.exp(mu * t + sigma * W)
meanGBM = scipy.mean(GBM, axis=0)
predicted_mean_OBM_rate = mu + (1./2.)*sigma**2

meanGBM_rate = scipy.polyfit(scipy.linspace(0, T, N+1), scipy.log(meanGBM), 1)

print "Observed Mean_OBM_Relative_Rate: ", meanGBM_rate[0];
print "Predicted Mean_OBM_Relative_Rate: ", predicted_mean_OBM_rate;

Problems to Work for Understanding

1. Differentiate
\[ \int_{-\infty}^{(\ln(x/30)-\mu t)/(\sigma \sqrt{t})} \frac{1}{\sqrt{2\pi}} \exp(-y^2/2) \, dy \]

to obtain the p.d.f. of Geometric Brownian Motion.

2. What is the probability that Geometric Brownian Motion with parameters \(\mu = -\sigma^2/2\) and \(\sigma\) (so that the mean is constant) ever rises to
more than twice its original value? In economic terms, if you buy a stock or index fund whose fluctuations are described by this Geometric Brownian Motion, what are your chances to double your money?

3. What is the probability that Geometric Brownian Motion with parameters $\mu = 0$ and $\sigma$ ever rises to more than twice its original value? In economic terms, if you buy a stock or index fund whose fluctuations are described by this Geometric Brownian Motion, what are your chances to double your money?

4. Derive the probability of ruin (the probability of Geometric Brownian Motion hitting $A < 1$ before hitting $B > 1$).

5. Modify the scripts to plot several sample paths of Geometric Brownian Motion all on the same set of axes.

6. Modify the scripts to plot several sample paths of Geometric Brownian Motion and the mean function of Geometric Brownian Motion and the mean function plus and minus one standard deviation function, all on the same set of axes.

7. Modify the scripts to measure the quadratic variation of each of many sample paths of Geometric Brownian Motion, find the mean quadratic variation and compare to the theoretical quadratic variation of Geometric Brownian Motion.

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**Reading Suggestion:**

**References**


Outside Readings and Links:

1. [Graphical Representations of Brownian Motion and Geometric Brownian Motion](#)
2. [Wikipedia Geometric Brownian Motion](#)

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