ON SEMIMARTINGALE DECOMPOSITIONS OF CONVEX FUNCTIONS OF SEMIMARTINGALES

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ABSTRACT

Let X be a semimartingale in $\mathbb{R}^d$ and let $f : \mathbb{R}^d \to \mathbb{R}$ be convex. Then $f(X)$ is also a semimartingale. We give here the semimartingale decomposition of $f(X)$ in terms of uniform limits of explicitly identified processes.

On Semimartingale Decompositions of Convex Functions of Semimartingales

by

Eric Carlen[1] and Philip Protter[2]

Let X be a semimartingale with values in $\mathbf{R}^d$, and let $X_t = X_0 + M_t + A_t$ be a decomposition of X into a local martingale M and a càdlàg, adapted, finite variation process A, with $M_0 = A_0 = 0$. Let $f : \mathbf{R}^d \to \mathbf{R}$ be convex. P. A. Meyer showed in 1976 [6] that $f(X)$ is again a semimartingale. We will give a new proof of this result gives the semimartingale decomposition of $f(X)$ in terms of uniform limits of explicitly identified processes.

The case where $d = 1$ is already well understood. Indeed, the Meyer-Tanaka formula allows us to give an explicit decomposition of $f(X)$:

(1)

$$f(X_t) = f(X_0) + \int_0^t f'(X_{s-})dM_s$$
$$+ \{\int_0^t f'(X_{s-})dA_s + \frac{1}{2}\int_{\mathbf{R}} L_t^a \mu(da) + \sum_{0<x\leq t} (f(X_s) - f(X_{s-}) - f'(X_s)\Delta X_s)\},$$

where f' is the left continuous version of the derivative of f, L_t^a is the local time of X at the level a, the measure μ is the second derivative of f in the generalized function sense, and the term in brackets $\{\dots\}$ is the finite variation term in a decomposition of $f(X)$. See [8] for details on this formula. Moreover in the case $d = 1$ if B is a standard Brownian motion and $f(B)$ is a semimartingale, then f must be the difference of two convex functions (see [3]), hence convex functions are the most general functions taking semimartingales into semimartingales.

We now turn to the case $d \geq 2$, where $f : \mathbf{R}^d \to \mathbf{R}$ is convex. Except in very special cases (see [2], [4], [5], [7], [9], [10]) no formula such as (1) is known to exist, except of course when f is $\mathcal{C}^2$, and then the Meyer-Itô formula gives an explicit decomposition of $f(X)$:

(2)

$$f(X_t) = f(X_0) + \sum_{j=1}^d \int_0^t \frac{\partial f}{\partial x_j}(X_{s-})dM_s^j + \left\{ \sum_{j=1}^d \int_0^t \frac{\partial f}{\partial x_j}(X_{s-})dA_s^j \right.$$
$$\left. +\frac{1}{2}\sum_{i,j}\int_0^t \frac{\partial^2 f}{\partial x_i \partial x_j}(X_{s-})d[X^i, X^j]_s^c + \sum_{0<s\leq t} (f(X_s) - f(X_{s-}) - \sum_{j=1}^d \frac{\partial f}{\partial x_j}(X_{s-})\Delta X_s^j) \right\},$$

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where $X_t^j = X_0^j + M_t^j + A_t^j$ denotes the semimartingale decomposition of the jth component of the vector X of d semimartingales.

Let Γ denote the set of convex functions on on $\mathbf{R}^d$, and recall that convex functions are always continuous. We equip Γ with the topology of uniform convergence on compacts. A standard metric ρ for this topology is given by $\rho(f,g) = \sum_{n=1}^{\infty} 2^{-n}\rho_n(f,g)$ where

$$\rho_n(f,g) = \frac{\sup_{|x|\leq n} |f(x) - g(x)|}{1 + \sup_{|x|\leq n} |f(x) - g(x)|} \quad .$$

By an obvious convolution argument, $\mathcal{C}^2$ convex functions are dense in (Γ, ρ).

We show here that if $\{f_n\}$ is a sequence of $\mathcal{C}^2$ convex functions converging to f in (Γ, ρ), and if $f_n(X_t) = f_n(X_0) + N_t^n + S_t^n$ is an appropriately chosen decomposition of $f_n(X_t)$, then the corresponding local martingale terms N^n and finite variation terms S^n converge respectively to N and S, where $f(X_t) = f(X_0) + N_t + S_t$, a decomposition of $f(X)$. This gives a decomposition of $f(X)$ in terms of limits of explicitly identified processes. The proof consists essentially of verifying the hypotheses of a recent theorem of Barlow and Protter [1].

To do this, we require the following lemma:

LEMMA. *Let $\{f_n\}$ be a sequence of $\mathcal{C}^2$ convex functions on $\mathbf{R}^d$, f convex on $\mathbf{R}^d$, and $\lim_{n\to\infty} \rho(f_n, f) = 0$. Then for each $\alpha > 0$,*

$$\sup_n \sup_{|x|\leq\alpha} |\nabla f_n(x)| \leq C(\alpha) < \infty,$$

where $C(\alpha)$ depends only on α and f.

Proof. Since $\rho(f_n, f)$ tends to 0, the variation of f_n on $\{|x| \leq \alpha + 1\}$ is uniformly bounded in n by, say, $V(\alpha)$. Let x_n be some point in $\{|x| \leq \alpha\}$ such that

$$|\nabla f_n(x_n)| = \sup_{|x|\leq\alpha} |\nabla f_n(x)|.$$

Let u_n denote $\nabla f_n(x_n)/|\nabla f_n(x_n)|$. Define φ_n by $\varphi_n(t) = f_n(x_n + tu_n)$. Then φ_n is a $\mathcal{C}^2$ convex function on $\mathbf{R}$. Therefore, for $t \geq 0$, $\varphi_n'(t) \geq \varphi_n'(0) = \nabla f_n(x) \cdot u_n = |\nabla f_n(x_n)|$. Since φ_n is convex, $\varphi_n'(t) \geq |\nabla f_n(x_n)|$ for all positive t. Thus

$$f_n(x_n + u_n) - f_n(x_n) = \int_0^1 \varphi_n'(t)dt \geq |\nabla f_n(x_n)|.$$

Since $|x_n + u_n| \leq \alpha + 1$ we have $|f_n(x_n + u_n) - f_n(x_n)| \leq V(\alpha)$, and therefore $|\nabla f_n(x_n)| \leq V(\alpha)$. □

The next theorem is our principal theorem. Because we wish to use the result of [1], and also because of the simplifications entailed in the existence of canonical decompositions, we consider in Theorem 1 the case where the semimartingale X is in $\mathcal{H}^1$; (that is, X has a decomposition $X_t = X_0 + M_t + A_t$ where X_0, $[M,M]_\infty^{1/2}$ and $\int_0^\infty |dA_s|$ are all in L^1.) In Theorem 2 we consider the general case where X is locally in $\mathcal{H}^1$; that is there exists a sequence $(T^n)_{n\geq 1}$ of stopping times increasing to ∞ a.s. such that $X_{t\wedge T^n} 1_{\{T^n>0\}}$ is in $\mathcal{H}^1$ for each n. Note that if X is a *continuous* semimartingale, then X is automatically at least locally in $\mathcal{H}^1$. We let $\|\cdot\|_{\mathcal{H}^1}$ denote the H^1 norm (see [8]), and $A_t^* = \sup_{s\leq t}|A_s|$.

THEOREM 1. *Let X be an $\mathbf{R}^d$-valued semimartingale which in $\mathcal{H}^1$. Let $X_0 = 0$ and $X_t = N_t + S_t$ be its canonical decomposition. For $\alpha > 0$, let*

$$T_\alpha = \inf\{t > 0 : |X_t| > \alpha\}.$$

Let f be a convex function, and let $\{f_n\}$ be a sequence of $\mathcal{C}^2$ convex functions with $\lim_{n\to\infty} \rho(f_n, f) = 0$. Then $f(X)$ is a semimartingale with canonical decomposition $f(X_t) = f(X_0) + M_t + A_t$, and morover we have for each $\alpha > 0$

$$\lim_{n\to\infty} \|(M^n - M)^{T_\alpha}\|_{\mathcal{H}^1} = 0,$$

$$\lim_{n\to\infty} E\{(A^n - A)^*_{T_\alpha}\} = 0,$$

where

$$M_t^n = \int_0^t \nabla f_n(X_{s-})dN_s$$

and

(3)
$$A_t^n = \int_0^t \nabla f_n(X_{s-})dS_s + \frac{1}{2}\sum_{i,j}\int_0^t \frac{\partial^2 f_n}{\partial x_i \partial x_j}(X_{s-})d[X^i, X^j]_s^c + \sum_{0<s\leq t}\{f_n(X_s) - f_n(X_{s-}) - \sum_i \frac{\partial f}{\partial x_i}(X_{s-})\Delta X_s^i\}.$$

Proof. We need to verify only that the hypotheses of Theorem 1 of Barlow and Protter [1] are satisfied; specifically we must show that for each $\alpha > 0$

(4)
$$\lim_{n\to\infty} E\{\sup_{t\leq T_\alpha} |f_n(X_t) - f(X_t)|\} = 0,$$

and that there is a $K_\alpha < \infty$ such that

(5)
$$\sup_n E\{\int_0^{T_\alpha} |dA_s^n|\} \leq K_\alpha$$

$$(6) \qquad \sup_n E\{\sup_{t\le T_\alpha} |M_t^n|\} \le K_\alpha.$$

First observe that (4) is a trivial consequence of $\lim_{n\to\infty} \rho(f_n, f) = 0$. Also, note that using the lemma together with the Davis inequality,

$$E\{\sup_{t\le T_\alpha} |\int_0^t \nabla f_n(X_{s-})dN_s|\} \le cE\{(\int_0^{T_\alpha} |\nabla f_n(X_{s-})|^2 d[N,N]_s)^{1/2}\}$$
$$\le cC(\alpha)E\{[N,N]_{T_\alpha}^{1/2}\},$$

since $|X_-|$ is bounded by α on $[0,T_\alpha]$. The above holds for each n and since the bound is independent of n, we have (6).

We next turn to (5). We treat separately the three terms in (3). First, again using the lemma,

$$\text{Variation}(\int_0^t \nabla f_n(X_{s-})dS_s) \le C(\alpha)\int_0^{T_\alpha} |dS_s|,$$

which is independent of n. Second, let B^n denote the process

$$B_t^n = \frac{1}{2}\sum_{i,j}\int_0^t \frac{\partial^2 f_n}{\partial x_i \partial x_j}(X_{s-})d[X^i,X^j]_s^c.$$

Since f_n is convex, $\left(\frac{\partial^2 f_n}{\partial x_i \partial x_j}\right)$ is a positive matrix, and also $d[X^i,X^j]^c$ is positive in the sense that for any constants $a_i,\dots,a_d$, $\sum_{i,j=1}^d a_i a_j [X^i,X^j]^c$ is an increasing process. Thus B^n is an increasing process. Next, let D^n denote the third term in (3); that is,

$$D_t^n = \sum_{0<s\le t}\{f_n(X_s) - f_n(X_{s-}) - \nabla f_n(X_{s-})\Delta X_s\}$$
$$= \sum_{0<s\le t}\frac{\partial^2 f}{\partial x_i \partial x_j}(X_{s-}+\Theta_s)\Delta X_s^i \Delta X_s^j$$

where $\Theta_s = \lambda_s \Delta X_s$ for some $\lambda_s \in [0,1]$ by Taylor's theorem. The convexity of f_n yields that D^n is also an increasing process.

Next observe that, letting V_α denote total variation on $[0,T_\alpha]$:

$$(7) \qquad V_\alpha(A_t^n) = V_\alpha(\int_0^t \nabla f_n(X_{s-})dS_s + B_t^n + D_t^n)$$
$$\le C(\alpha)|S|_{T_\alpha} + B_{T_\alpha}^n + D_{T_\alpha}^n.$$

However by the Meyer-Itô formula (2) and since the expectation of the (true) martingale term is zero,

$$(8) \qquad E\{B_{T_\alpha}^n + D_{T_\alpha}^n\} = E\{f_n(X_{T_\alpha}) - f_n(X_0)\} + E\{\int_0^{T_\alpha} \nabla f_n(X_{s-})dS_s\}.$$

Since f_n tends uniformly to f, and since $E\{\int_0^{T_\alpha} \nabla f_n(X_{s-})dS_s\}$ is bounded by $C(\alpha)E\{|S|_{T_\alpha}\}$ independently of n, the right side of (8) is bounded by a K_α for n sufficiently large, and hence for all n. Combining this with (7) and taking expectations yields (5) and completes the proof. □

We next turn to the general case which is handled by "prelocal" stopping: Suppose X is a semimartingale with $X_0 = 0$. Then as is well known (see, eg. [8, p. 192]) there exist stopping times T^k increasing to ∞ a.s. such that X^{T^k-} is in $\mathcal{H}^1$, each k, where $X_t^{T^k-} = X_t 1_{(t<T^k)} + X_{T^k-}1_{(t\geq T^k)}$. Therefore, by taking $T^{k,\alpha}$ to be $T_\alpha \wedge T^k$, we can further assume without loss that $|X^{T^{k,\alpha}}-| \leq \alpha$, for a sequence T_α as given in Theorem 1. We combine the sequences to get T_α increasing to ∞ a.s. such that $|X^{T_\alpha-}| \leq \alpha$ *and* $X^{T_\alpha-} \in \mathcal{H}^1$, each α. We then have:

THEOREM 2. *Let X be an $\mathbf{R}^d$-valued semimartingale with $X_0 = 0$. Let T^α be stopping times increasing to ∞ such that $|X^{T_\alpha-}| \leq \alpha$ and $X^{T_\alpha-} \in \mathcal{H}^1$. Let $X^{T_\alpha-} = N^\alpha + S^\alpha$ be the canonical decomposition, f be a convex function, and f_n a sequence of $\mathcal{C}^2$ convex functions with $\lim_{n\to\infty} \rho(f_n, f) = 0$. Then $f(X)$ is a semimartingale with prelocal canonical decompositions*

$$f(X)^{T_\alpha-} = f(X_0) + M^\alpha + A^\alpha;$$

moreover

$$\lim_{n\to\infty} \|M^{n,\alpha} - M^\alpha\|_{\mathcal{H}^1} = 0$$
$$\lim_{n\to\infty} E\{(A^{n,\alpha} - A^\alpha)^*\} = 0$$

where

$$M_t^{n,\alpha} = \int_0^t \nabla f_n(X_{s-})dN_s^\alpha$$
$$A_t^{n,\alpha} = \int_0^t \nabla f_n(X_{s-})dS_s^\alpha + \frac{1}{2}\sum_{i,j}\int_0^t \frac{\partial^2 f_n}{\partial x_i \partial x_j}(X_{s-})d[X^i, X^j]_s^{c,T_\alpha-}$$
$$\sum_{0<s\leq t}\{f_n(X_s)^{T_\alpha-} - f_n(X_{s-})^{T_\alpha-} - \sum_i \frac{\partial f}{\partial x_i}(X_{s-})(\Delta X_s^i)^{T_\alpha-}\}.$$

Proof. This is merely a localization of Theorem 1; since f is continuous $f(X)^{T-} = f(X^{T-})$. □

Remarks (i) Note that in case X is *continuous* the situation is much simpler: $A_t^n = \int_0^t \nabla f_n(X_s)dS_s$, since there are no jump terms; decompositions are unique, hence there is no need to invoke "canonical" decompositions; there is no need of "pre-local" stopping, since stopping at $T-$ is the same as stopping at T.

(ii)) The general case where X_0 need not be zero is easily handled: take $\hat{f}(X) = f(X) - f(0)$, so that without loss of generality we can assume $f(0) = 0$. Since $X_0 \neq 0$, one cannot assume that $|X^{T_\alpha -}| \leq \alpha$, however one can construct T_α tending to ∞ a.s. such that $|X^{T_\alpha -}1_{\{T_\alpha > 0\}}| \leq \alpha$. Since $f(0) = 0$ and f is continuous, $f(X^{T_\alpha -}1_{\{T_\alpha > 0\}}) = f(X)^{T_\alpha -}1_{\{T_\alpha > 0\}}$, and the proof now proceeds analogously.

(iii)) "Knowing" M^α and A^α in the decomposition $f(X)^{T_\alpha -} = f(X_0) + M^\alpha + A^\alpha$ also means we "know" a decomposition for $f(X)^{T_\alpha}$: namely, we can take

$$f(X_t)^{T_\alpha} = f(X_0) + M_t^\alpha + \{A_t^\alpha + (f(X_{T_\alpha}) - f(X_{T_\alpha -}))1_{\{t \geq T_\alpha\}}\}. \tag{9}$$

Note however that we cannot in general combine these decompositions (9) to obtain only one, because of the lack of a canonical way to choose them. (Of course, in the continuous case this is not a problem.)

(iv) Finally we would like to point out that we have used the convexity of f in two ways in the proofs of Theorems 1 and 2: first through the lemma to control the size of $\int \nabla f_n(X_{s-})dS_s$; second, to establish that $A^n - \int \nabla f_n(X_{s-})dS_s$ is an increasing process: this gave us the estimate (7) which in turn allowed us to take expectations in the Meyer-Itô formula.

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