

Contents

1	The Monte Carlo Method	1
1.1	Monte Carlo method for integration	3
1.2	Connection with stochastic simulation.....	12
1.3	Alternative formulation of the integration problem via f : an example	20
1.4	A primer on uniform random number generation	22
1.5	Using Monte Carlo to approximate a distribution.....	25
1.6	Two more examples.....	27
	Problems	34
2	Sampling from Known Distributions	41
2.1	Common distributions arising in stochastic models.....	42
2.2	Inversion	44
2.3	Acceptance-rejection	46
2.4	Composition	48
2.5	Convolution and other useful identities	50
2.6	Multivariate case	51
	Problems	55
3	Pseudorandom Number Generators	57
3.1	Basic concepts and definitions.....	58
3.2	Generators based on linear recurrences	60
3.2.1	Recurrences over \mathbb{Z}_m for $m \geq 2$	61
3.2.2	Recurrences modulo 2.....	64
3.3	Add-with-carry and subtract-with-borrow generators	66
3.4	Nonlinear generators	67
3.5	Theoretical and statistical testing	68
3.5.1	Theoretical tests for MRGs	70
3.5.2	Theoretical tests for PRNGs based on recurrences modulo 2.....	75
3.5.3	Statistical tests	80

Problems	85
4 Variance Reduction Techniques	87
4.1 Introduction	87
4.2 Efficiency	89
4.3 Antithetic variates	89
4.4 Control variates	101
4.5 Importance sampling	111
4.6 Conditional Monte Carlo	119
4.7 Stratification	125
4.8 Common random numbers	132
4.9 Combinations of techniques	135
Problems	136
5 Quasi-Monte Carlo Constructions	139
5.1 Introduction	139
5.2 Main constructions: basic principles	143
5.3 Lattices	146
5.4 Digital nets and sequences	153
5.4.1 Sobol' sequence	157
5.4.2 Faure sequence	161
5.4.3 Niederreiter sequences	163
5.4.4 Improvements to the original constructions of Halton, Sobol', Niederreiter, and Faure	164
5.4.5 Digital net constructions and extensions	170
5.5 Recurrence-based point sets	174
5.6 Quality measures	179
5.6.1 Discrepancy and related measures	180
5.6.2 Criteria based on Fourier and Walsh decompositions	187
5.6.3 Motivation for going beyond error bounds	197
Problems	197
6 Using Quasi-Monte Carlo in Practice	201
6.1 Introduction	201
6.2 Randomized quasi-Monte Carlo	202
6.2.1 Random shift (or rotation sampling)	204
6.2.2 Digital shift	206
6.2.3 Scrambling and permutations	206
6.2.4 Partitions and Latin supercube sampling	209
6.2.5 Array-RQMC	210
6.2.6 Studying the variance	211
6.3 ANOVA decomposition and effective dimension	214
6.3.1 Effective dimension	216
6.3.2 Brownian bridge and related techniques	222

6.3.3 Methods for estimating σ_I^2 and approximating $f_I(u)$	225
6.3.4 Using the ANOVA insight to find good constructions	228
6.4 Using quasi-Monte Carlo sampling for simulation	229
6.5 Suggestions for practitioners	237
Problems	239
Appendix: Tractability, weighted spaces and component-by-component constructions	241
7 Financial Applications	247
7.1 European option pricing under the lognormal model	247
7.2 More complex models	256
7.2.1 Heston's process	257
7.2.2 Regime switching model	258
7.2.3 Variance gamma model	260
7.3 Randomized quasi-Monte Carlo methods in finance	260
7.4 Commonly used variance reduction techniques	273
7.4.1 Antithetic variates	273
7.4.2 Control variates	273
7.4.3 Importance sampling	275
7.4.4 Conditional Monte Carlo	279
7.4.5 Common random numbers	281
7.4.6 Moment-matching methods	282
7.5 American option pricing	283
7.6 Estimating sensitivities and percentiles	288
Problems	298
8 Beyond Numerical Integration	301
8.1 Markov Chain Monte Carlo (MCMC)	303
8.1.1 Metropolis-Hastings algorithm	305
8.1.2 Exact sampling	310
8.2 Sequential Monte Carlo	312
8.3 Computer experiments	320
Problems	332
A Review of Algebra	335
B Error and Variance Analysis for Halton Sequences	341
References	347
Index	369