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ARTICLE in SIAM JOURNAL ON FINANCIAL MATHEMATICS · OCTOBER 2012
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THE SMALL-TIME SMILE AND TERM STRUCTURE OF IMPLIED VOLATILITY UNDER THE HESTON MODEL

MARTIN FORDE, ANTOINE JACQUIER, AND ROGER LEE

Abstract. We characterise the asymptotic smile and term structure of implied volatility in the Heston model at small maturities and all strikes. Using saddlepoint methods we derive a small-maturity expansion formula for call option prices, which we then transform into a closed-form expansion (including the leading-order and correction terms) for implied volatility. This refined expansion reveals the relationship between the small-expiry smile and all Heston parameters (including the pair in the volatility drift coefficient), sharpening the leading-order result of [9] which found the relationship between the zero-expiry smile and the diffusion coefficients. We solve for in/out-of-the-money and at-the-money cases; in the latter case our proof involves subleading-order saddlepoint approximation along a suitable path of integration.

1. Introduction

Stochastic models are used extensively by traders and quantitative analysts in order to price and hedge financial products. Once a model has been chosen for its realistic features, one has to calibrate it. This calibration must be robust and stable and should not be too computer intensive. This latter constraint often rules out global optimisation algorithms which are very slow despite their accuracy. For this matter closed-form asymptotic approximations have grown rapidly in the past few years. They have proved to be very efficient (i) to provide some information about the behaviour of option prices in some extreme regions such as small or large strikes or maturities (where standard numerical schemes lose their accuracy), (ii) to improve calibration efficiency. Indeed one can first perform an instantaneous calibration on the closed-form first and then use this result as a starting point to calibrate the whole model. In practice calibration is often performed using the implied volatility—i.e. the volatility parameter to be used in the Black-Scholes formula in order to match the observed market price—rather than option prices.

For these reasons, there has recently been an explosion of literature on small-time asymptotics for stochastic volatility models (see [3], [8], [1], [10], [13], [15], [16] and [24]). All these articles characterise the behaviour of the Black-Scholes implied volatility for European options in the small-maturity limit. Varadhan ([27], [28]) and Freidlin & Wentzell [13] initiated the study of large deviations for strong solutions of stochastic differential equations, and showed that on a logarithmic scale the small-time behaviour of such a diffusion process can be characterised in terms of a distance function on a Riemannian manifold, whose metric is equal to the inverse of the diffusion coefficient. Higher-order expansions in powers of the small time parameter have extended these seminal works. Molchanov [22] provided a rigorous probabilistic proof

Date: March 8, 2011.

1991 Mathematics Subject Classification. AMS 91G20, 65C50.

Key words and phrases. Heston model, implied volatility, asymptotics, saddlepoint expansion, calibration.

The work of M. Forde was supported by a SFI grant for the Edgeworth Centre for Financial Mathematics. A. Jacquier acknowledges financial support from MATHEON. A former version of this paper circulated under the title ”Small-time asymptotics for implied volatility under the Heston model: Part 2″.
of this heat kernel expansion at leading order, and Bellaiche \cite{2} improved this expansion for non-compact manifolds under mild technical conditions.

In mathematical finance, Henry-Labordère \cite{16} was the first to introduce heat kernel methods to study asymptotics of the implied volatility, both for local and for stochastic volatility models, and initiated a stream of research in this area. For one-dimensional local volatility models Gatheral et al. \cite{14} provided a rigorous proof of the small-time expansion—up to second-order in the maturity—for the transition density and translated it into an expansion for the implied volatility. On the analytic side, Berestycki et al. \cite{3} showed that for a stochastic volatility model with coefficients satisfying certain growth conditions, the small-maturity implied volatility was given by a distance function obtained as the unique viscosity solution to a non-linear eikonal first-order Hamilton-Jacobi PDE. Paulot \cite{24} derived a small-time expansion for call options under a general local-stochastic volatility model—including the SABR model—by applying the Laplace method to integrate the heat kernel over the range of the volatility variable. It is interesting to note that the small-maturity at-the-money implied volatility has a qualitatively different behaviour than the rest of the smile, and can not be dealt with in the same way.

This heat kernel asymptotic approach however does not apply to the Heston model \cite{2.1} where the variance process follows a square-root diffusion, since the associated Riemannian manifold is not complete (see \cite{16}, Chapter 6) for more details about this phenomenon). Using the affine properties of the Heston model, Forde and Jacquier \cite{9} developed a large deviations approach to obtain the small-time behaviour of the implied volatility (the large-maturity case is treated in \cite{11} by analogous arguments). In this paper we refine this analysis by providing the first-order correction of the small-maturity expansion for the implied volatility in this model. The methodology in use here—similar to the one used in \cite{12} for the large-maturity case—is based on saddlepoint expansions in the complex plane and the properties of holomorphic functions. We first derive an asymptotic expansion for European call options, which we then translate into implied volatility asymptotics. Namely for an European option written on the underlying \((S_t)_{t \geq 0}\) with strike \(S_0 e^x\), we prove that the expansion

\[
\sigma_t^2(x) = \sigma_0^2(x) + a(x) t + o(t)
\]

holds for all real number \(x\) for the implied volatility \(\sigma_t\) as the maturity \(t\) tends to zero (Theorem \ref{4.2}). The correction term \(a(x)\) is important since it takes into account the drift terms in the SDEs \((2.1)\) for the Heston model. The genuine limit \(\sigma_0(x)\) (also derived in \cite{9}) fails to capture these drifts because large deviations theory is only sharp on a logarithmic scale. In \cite{1}, the authors showed that the at-the-money case \(x = 0\) is qualitatively different from the out-of-the-money case since large deviations reduce to a standard central limit argument. This singular behaviour also occurs in the correction term, and a more subtle analysis of the Laplace method for contour integrals is required to take this feature into account.

The paper is organised as follows: we recall the Heston model and the main ingredients that will be needed in Section \ref{2}. Section \ref{3} presents the main results of the paper, namely the small-maturity asymptotic expansion for European call option prices, both for the Heston and for the Black-Scholes model. The lengthy proof of the main theorem is deferred to Section \ref{6}. As mentioned above the at-the-money case behaves differently. In this case the proof of the main theorem does not follow from the general case and needs special treatment, which is the purpose of Section \ref{6.4}. In Section \ref{4} we translate these expansions into implied volatility asymptotics and provide numerical evidence of the accuracy of our formulae. Finally we propose a calibration methodology based on these closed-form approximations in Section \ref{5}. 
2. Model and notations

We work on a model \((\Omega, \mathcal{F}, P)\) with a filtration \((\mathcal{F}_t)_{t \geq 0}\) supporting two Brownian motions and satisfying the usual conditions. Let \((S_t)_{t \geq 0}\) denote a stock price process and we define its logarithm by \(X_t := \log(S_t)\). Without loss of generality we shall assume that interest rates and dividends are null—otherwise we can just model the dynamics of the forward price directly instead of the stock price. In the Heston model the process \((X_t)_{t \geq 0}\) satisfies the following system of SDEs:

\[
\begin{align*}
    \text{d}X_t &= -\frac{1}{2}Y_t \, \text{d}t + \sqrt{Y_t} \, \text{d}W_t, \quad X_0 = x_0 \in \mathbb{R}, \\
    \text{d}Y_t &= \kappa (\theta - Y_t) \, \text{d}t + \sigma \sqrt{Y_t} \, \text{d}Z_t, \quad Y_0 = y_0 > 0, \\
    \text{d}(W, Z)_t &= \rho \, \text{d}t
\end{align*}
\]

where \(\kappa > 0, \theta > 0, \sigma > 0, |\rho| < 1\) and \(W\) and \(Z\) are two standard Brownian motions. We further assume—as in \cite{Heston1993}—that the inequality \(\kappa > \rho \sigma\) holds. The \(Y\) process is a Feller diffusion and the coefficients of the stochastic differential equation satisfy the Yamada-Watanabe condition \cite[Section 5.2.C, Proposition 2.13]{Watanabe1981} so it admits a unique strong solution. The \(X\) process can be expressed as a stochastic integral of the \(Y\) process and thus is well defined. Let us now define the two real numbers \(p_- < 0\) and \(p_+ > 0\) by

\[
\begin{align*}
    p_- &:= \frac{2}{\sigma \rho} \arctan \left( \frac{\bar{\rho}}{\rho} \right) 1_{\{\rho < 0\}} - \frac{\pi}{\sigma} 1_{\{\rho = 0\}} + \frac{2}{\sigma \bar{\rho}} \left( \arctan \left( \frac{\bar{\rho}}{\rho} \right) - \pi \right) 1_{\{\rho > 0\}}, \\
    p_+ &:= \frac{2}{\sigma \bar{\rho}} \left( \arctan \left( \frac{\bar{\rho}}{\rho} \right) + \pi \right) 1_{\{\rho < 0\}} + \frac{\pi}{\sigma} 1_{\{\rho = 0\}} + \frac{2}{\sigma \bar{\rho}} \arctan \left( \frac{\bar{\rho}}{\rho} \right) 1_{\{\rho > 0\}},
\end{align*}
\]

where \(\bar{\rho} := \sqrt{1 - \rho^2}\). We further define the function \(\Lambda : (p_-, p_+) \to \mathbb{R}\) by

\[
\Lambda(p) := \frac{y_0 p}{\sigma \bar{\rho} \cot (\sigma \bar{\rho} / 2) - \rho}, \quad \text{for all } p \in (p_-, p_+).
\]

It can easily be checked that \(\Lambda\) is a real strictly convex function on the interior of its domain, and that \(\Lambda(p) > 0\) for all \(p \in (p_-, p_+) \setminus \{0\}\), and \(\Lambda(0) = 0\).

**Remark 2.1.** In \cite{Dupire1994} the authors proved that the function \(\Lambda\) corresponds to the limiting cumulant generating function of the Heston model, i.e.

\[
\Lambda(p) = \lim_{t \to 0} t \log \mathbb{E} \left( e^{p (X_t - x_0) / t} \right), \quad \text{for all } p \in (p_-, p_+).
\]

Let us finally define the Fenchel-Legendre transform \(\Lambda^* : \mathbb{R} \to \mathbb{R}\) of the function \(\Lambda\) by

\[
\Lambda^*(x) := \sup_{p \in (p_-, p_+)} \{px - \Lambda(p)\}, \quad \text{for all } x \in \mathbb{R}.
\]

In \cite{Dupire1994} the authors proved that the small-maturity limit of the implied volatility is fully characterised by this dual transform. We shall of course recover this result while proving higher-order expansions for the short-maturity implied volatility. The function \(\Lambda^*\) does not admit a closed-form representation, but a straightforward analysis shows that the equality \(\Lambda^*(x) = p^*(x) x - \Lambda(p^*(x))\) holds for all real number \(x\) where \(p^*(x) \in (p_-, p_+)\) is defined as the unique solution to the equation \(\Lambda'(p^*(x)) = x\). By the strict convexity of the function \(\Lambda\), this number is always well defined. As proved in \cite{Dupire1994}, the identities \(p^*(x) > 0\) for \(x > 0\), \(p^*(x) < 0\) for \(x < 0\) and \(p^*(0) = 0\) always hold. We also have \(\Lambda^*(x) > 0\) and \(\Lambda''(p^*(x)) > 0\) for all \(x \neq 0\), and \(\Lambda^*(0) = 0\).
In the Black-Scholes model, the share price process \( (S_t)_{t \geq 0} \) satisfies the SDE \( dS_t = \Sigma S_t dW_t \), with \( S_0 > 0 \) and where the volatility \( \Sigma \) is a strictly positive real number. We shall use the notation \( C_{BS}(x, t, \Sigma) \) to represent the Black-Scholes price of a European call option written on the share price \( S \) with strike \( S_0 e^x \), maturity \( t \) and volatility \( \Sigma \). In the rest of the paper, \( \mathbb{R} \) and \( \Im \) will respectively denote the real and the imaginary parts of a complex number, and \( \nu \) the cumulative distribution function of the standard Gaussian distribution.

3. Small-time behaviour of European call options

In this section we derive small-time expansions for European call option prices in the Heston model (Theorem 2.1) and in the Black-Scholes model (Proposition 2.3). For clarity we postpone the proof of Theorem 2.1 to Section II.

**Theorem 3.1.** In the Heston model (2.1) the asymptotic behaviour for European call options

\[
\frac{\mathbb{E}(e^{X_t} - S_0 e^x)}{S_0} = \begin{cases} 
(1 - e^{-x})_+ + \exp \left( -\frac{\Lambda^* (x)}{t} \right) \frac{A(x)}{\sqrt{2\pi t} \sqrt{t^3/2}} + O\left(t^{5/2}\right), & \text{if } x \neq 0, \\
\sqrt{\frac{yn}{2\pi}} - Bt^{3/2} + O\left(t^{5/2}\right), & \text{if } x = 0,
\end{cases}
\]

holds as the maturity \( t \) tends to zero, where

\[
A(x) := \frac{e^{x} \Upsilon (p^*(x))}{p^*(x)^2 \sqrt{\Lambda''(p^*(x))}},
\]

\[
U (p) := \exp \left( \frac{\kappa \theta}{\sigma^2} \left( i \rho \sigma - d_0 \right) i p - 2 \log \left( \frac{1 - g_0 e^{-i \rho p}}{1 - g_0} \right) \right) \]

\[
\exp \left( \frac{y_0 e^{-i \rho p}}{(1 - g_0 e^{-i \rho p}) \sigma^2} \right) \left( i \rho \sigma - d_0 \right) i p d_1 + (d_1 - \kappa) \left( 1 - e^{i \rho p} \right) - \frac{(i \rho \sigma - d_0) \left( 1 - e^{-i \rho p} \right) \left( g_1 - i d_1 g_0 p \right)}{1 - g_0 e^{-i \rho p}} \right),
\]

\[
B := \frac{1}{48} \sqrt{\frac{2}{y_0 \pi}} \left( \sigma^2 \left( 1 - \rho^2 \right) + y_0 \left( y_0 - 3 \rho \sigma \right) - 6 \kappa (\theta - y_0) \right),
\]

where the functions \( \Lambda \) and \( \Lambda^* \) are defined in (2.3) and in (2.3), and

\[
d_0 := \sigma \bar{\rho}, \quad d_1 := \frac{2 \kappa \rho - \sigma}{2 \rho - 1}, \quad g_0 := \frac{i \rho - \bar{\rho}}{1 \rho + \bar{\rho}}, \quad g_1 := \frac{(2 \kappa - \rho \sigma)}{\sigma \rho (1 \rho + \bar{\rho})^2}.
\]

**Remark 3.2.** Although this is not obvious from its representation, the function \( U \) maps the interval \((p_-, p_+)\) to the real line. The reason for this is explained in Remark II.4. Since \( p^*(x) \) takes values in \((p_-, p_+) \setminus \{0\} \), and \( \Lambda''(p^*(x)) > 0 \) for all \( x \in \mathbb{R}^* \), then \( A(x) \) is a well-defined real number.

Since we shall eventually be interested in deriving small-time asymptotics for the implied volatility, we need an analogous result to Theorem 2.1 for the Black-Scholes model. This is the purpose of the following proposition, the proof of which can be found in Appendix III.
Proposition 3.3. Let $\Sigma > 0$, define $\sigma_t := \sqrt{\Sigma t + ct}$ for $t > 0$ and assume that $t \in (0, \Sigma^2/|c|)$ if $c < 0$. Then the following behaviour holds as the maturity $t$ tends to zero,

$$
\frac{C_{BS}(x, t, \sigma_t)}{S_0} = \begin{cases} 
(1 - e^x)_+ + \exp \left( -\frac{x^2}{2 \Sigma^2 t} + \frac{c}{2} \frac{x^2}{2 \Sigma^2} \right) \left( \frac{\Sigma^3}{x^2 \sqrt{2\pi}} t^{3/2} + O \left( t^{5/2} \right) \right), & \text{if } x \neq 0, \\
\frac{\Sigma t^{1/2}}{\sqrt{2\pi}} + \frac{1}{2 \Sigma \sqrt{2\pi}} \left( \frac{c}{\Sigma} - \frac{\Sigma^4}{12} \right) t^{3/2} + O \left( t^{5/2} \right), & \text{if } x = 0.
\end{cases}
$$

The behaviour of European call options in the standard Black-Scholes follows immediately.

Corollary 3.4. In the standard Black-Scholes model (i.e. $c = 0$) we have $\sigma_t = \Sigma$ for all $t > 0$ and

$$
\frac{C_{BS}(x, t, \Sigma)}{S_0} = \begin{cases} 
(1 - e^x)_+ + \frac{A_{BS}(x, \Sigma)}{x^2} \exp \left( -\frac{x^2}{2 \Sigma^2 t} \right) t^{3/2} + O \left( t^{5/2} \right), & \text{if } x \neq 0, \\
\frac{\Sigma t^{1/2}}{\sqrt{2\pi}} - \frac{\Sigma^3}{24 \sqrt{2\pi}} t^{3/2} + O \left( t^{5/2} \right), & \text{if } x = 0,
\end{cases}
$$

where

$$
A_{BS} (x, \Sigma) := \frac{\Sigma^3}{x^2} \exp \left( \frac{x^2}{2} \right).
$$

4. Small-time behaviour of implied volatility

In this section we translate the call option asymptotics stated above into small-time expansions for the implied volatility. For any $t \geq 0$ and $x \in \mathbb{R}$, $\sigma_t(x)$ shall denote the implied volatility of a European call option with maturity $t$ and strike $S_0 e^x$. We first define the two functions $\sigma_0: \mathbb{R}^* \to \mathbb{R}$ and $a: \mathbb{R}^* \to \mathbb{R}$ by

$$
\sigma_0(x) := \frac{|x|}{\sqrt{2 \Lambda^* (x)}}, \quad \text{and} \quad a(x) := \frac{2 \sigma_0^2(x)}{x^2} \log \left( \frac{A(x)}{A_{BS}(x, \sigma_0(x))} \right), \quad \text{for all } x \neq 0,
$$

where the functions $\Lambda^*$, $A$ and $A_{BS}$ are respectively defined in (3.4), in Theorem 3.3 and in (3.4).

Remark 4.1. In [4], the authors proved that the function $\sigma_0$ is the genuine limit of the implied volatility smile as the maturity tends to zero and that it is continuous at the origin. Although the two functions $A$ and $A_{BS}$ are not continuous at the origin, the function $a$ is, as shown below in Corollary 4.3.

The following theorem is the core of this section and gives the out-of-the-money implied volatility expansion for small maturities. We defer its proof to Section 4.2.

Theorem 4.2. The asymptotic expansion $\sigma_t^2(x) = \sigma_0^2(x) + a(x) t + o(t)$ holds for all $x \neq 0$.

The following corollary—proved in Section 4.2—is a direct consequence of this theorem and provides information on the behaviour of the short-time implied volatility in terms of the model parameters.

Corollary 4.3. The following expansions for the functions $\sigma_0$ and $a$ hold when $x$ is close to zero,

$$
\sigma_0(x) = \sqrt{y_0} \left( 1 + \frac{5 \rho^2}{4 y_0} + \frac{1}{24} \left( 1 - \frac{5 \rho^2}{2} \right) \frac{\sigma^2}{y_0} \right) + O \left( x^3 \right)
$$

$$
a(x) = -\frac{\sigma^2}{12} \left( 1 - \frac{\rho^2}{4} \right) + \frac{y_0 \rho \sigma}{4} + \frac{\kappa}{2} (\theta - y_0) + \frac{\rho \sigma}{24 y_0} (\sigma^2 \rho^2 - 2 \kappa (\theta + y_0) + y_0 \rho \sigma) x + \frac{176 \sigma^2 - 480 \kappa \theta - 712 \rho^2 \sigma^2 + 521 \rho^4 \sigma^2 + 40 y_0 \rho^3 \sigma + 1040 \kappa \rho^2 \sigma^2 - 80 y_0 \kappa \rho^2 \sigma^2 x^2}{7680} + O \left( x^3 \right).
$$
Note that the two functions $\sigma_0$ and $a$ are symmetric when the correlation parameter $\rho$ is null. This is consistent with the fact that uncorrelated stochastic volatility models generate symmetric smiles (see [25]). The following corollary explains why the correction term $a(x)$ is important.

**Corollary 4.4.** The following small-time approximation for call options holds as $t$ tends to zero:

$$E(e^{X_t} - S_0 e^x) + C_{BS} \left( x, t, \sqrt{\sigma_0^2(x) + a(x)t} \right) (1 + O(t)), \text{ for all } x \in \mathbb{R}.$$ 

This corollary is false if we remove the correction term $a(x)$, hence the leading order term alone is not sufficient to estimate call option prices for small maturities. The proof (which we omit for clarity) simply follows by equating option prices in the Heston and in the Black-Scholes models. In the at-the-money case, we can derive an analogous formula to Corollary 4.3, which clarifies the dependence of the implied volatility smile on the parameters of the model. We postpone its proof to Section 7.4.

**Corollary 4.5.** The small-time at-the-money implied volatility has the asymptotic behaviour

$$\sigma_t^2(0) = y_0 + \left( \kappa (\theta - y_0) - \frac{\sigma^2}{6} \left( 1 - \frac{\rho^2}{4} \right) + \frac{\rho \sigma y_0}{2} \right) \frac{t}{2} + o(t), \text{ as } t \text{ tends to zero.}$$

This is consistent with the small-time slope of the implied volatility term structure in [6, Section 3.1.2]. Together with Corollary 4.4, this shows that the expansion $\sigma_0^2(x) + a(x)$ is continuous at the origin.

We now test the accuracy of the small-time expansion for the implied volatility derived in Theorem 4.2.

**Example 4.6.** Let us consider the following set of parameters: $\kappa = 1.15$, $\sigma = 0.2$, $\theta = y_0 = 0.04$ and $\rho = -0.4$. In Figure 1, we plot the smiles computed numerically as well as the zeroth and the first order approximations (i.e. $\sigma_0(x)$ and $\sqrt{\sigma_0^2(x) + a(x)t}$ as given in (4.1)) for the three maturities $t = 0.1$ year, $t = 0.25$ year and $t = 0.5$ year. We observe that our approximation and the generated data are very close for the maturities $t = 0.1$ and $t = 0.25$, and are still close (within 0.18 percentage points uniformly in the displayed strikes) even at $t = 0.5$, an expiry approaching moderate size. The correction term $a(x)$ is essentially the smile-flattening effect which is a stylised feature of implied volatility surfaces observed in the market. It is interesting to note that the error between our refined expansion and the true value of the Heston smile is almost constant over all strikes. We also plot in Figure 2 the correction term $a(x)$ given by the formula in (4.1).

5. **Calibration methodology**

Based on the asymptotic expansion derived in Theorem 4.2 above, we find a calibration formula that generates parameter estimates, which can then serve as starting points to be input into a standard numerical optimiser. For the sake of clarity in this section we introduce the notation $\alpha := \kappa \theta$. Given implied variances for five contracts, our objective is to find explicit formulae to calibrate the five Heston parameters $(v, \sigma, \rho, \alpha, \kappa)$ to the five implied variances. For some configurations of contracts, one cannot expect to solve this problem. For example, a set of contracts with the same expiry would be uninformative in regard to the term structure of implied variance, hence uninformative in regard to the mean-reversion parameter $\kappa$. We

---

1 The implementation is based on a refined quadrature scheme for inverse Fourier transforms using the Zeliade Quant Framework by Zeliade Systems, where the second author was working.
Figure 1. The three graphs on top represent the implied volatilities for different maturities. The three graphs below represent the corresponding errors (difference between our formula and the true implied volatility) for the same maturities. The solid blue line corresponds to the leading-order smile $\sigma_0(x)$, the solid grey one is the refined formula $\sqrt{\sigma_0^2(x) + a(x)t}$, and the blue crosses account for the true Heston implied volatilities. The horizontal axis represents the log-moneyness $x$.

Figure 2. Plot of the correction term $a(x)$ defined in (4.1).
therefore choose configurations which involve multiple expiries. In such a setting our maturity-dependent formula plays a crucial role in capturing the maturity effects needed to calibrate the full set of Heston parameters. Recall that Theorem 4.3 and Corollary 4.3 imply \( \sigma^2_t(x) = H(x, t) + O(x^3) + o(t) \), as \( x \) and \( t \) tend to zero, where

\[
H(x, t) := H(x, t; v, \rho, \sigma, \alpha, \kappa) := y_0 \left( 1 + \frac{\rho \sigma x}{2 y_0} + \left( 1 - \frac{7}{4} \rho^2 \right) \frac{\sigma^2 x^2}{12y_0^2} \right) \\
+ \left( \frac{\rho \sigma y_0}{2} - \frac{\sigma^2}{6} \left( 1 - \frac{1}{4} \rho^2 \right) + \alpha - \kappa y_0 \right) + \frac{\rho \sigma}{12y_0} \left( \sigma^2 \left( 1 - \rho^2 \right) + \rho \sigma y_0 - 2\alpha - 2\kappa y_0 \right) x \frac{t}{2} \\
+ \frac{\sigma^2}{7680y_0^2} \left( 176 - 712\rho^2 + 521\rho^4 \right) \sigma^2 + 40\sigma\rho^3 y_0 + 80 \left( 13\rho^2 - 6 \right) \alpha - 80\kappa \rho^2 y_0 \right) x^2 t.
\]

Let us consider a "skew" \( V : \mathbb{K} \to \mathbb{R} \), where each point in the configuration \( \mathbb{K} \subset \mathbb{R} \times [0, \infty] \) represents a (log moneyness, expiration), and where \( V \) represents the squared implied volatility. We shall say that \((v, \rho, \sigma, \alpha, \kappa)\) calibrates \( H \) to the skew \( V : \mathbb{K} \to \mathbb{R} \) if the equality \( H(x, t; v, \rho, \sigma, \alpha, \kappa) = V(x, t) \) holds for all \((x, t) \in \mathbb{K} \). This definition demands exact fitting of \( H \) to the given volatility skew at all points in \( \mathbb{K} \). Consider now the configuration \( \mathbb{K} = \{(0,0), (x_0, t_1), (-x_0, t_1), (x_0, t_2), (-x_0, t_2)\} \) where \( 0 < t_1 < t_2 \) and \( x_0 > 0 \). Given \( V : \mathbb{K} \to \mathbb{R} \), define

\[
V_0 := V(0, 0), \quad S := \frac{V_+ - V_-}{2x_0}, \quad C := \frac{V_+ - 2V_0 + V_-}{2x_0^2}, \\
V_{\pm} := \frac{t_2 - t_1}{t_2 - t_1} V(\pm x_0, t_1) - \frac{t_1}{t_2 - t_1} V(\pm x_0, t_2).
\]

**Theorem 5.1.** The parameter choices \((\tilde{y}_0, \tilde{\rho}, \tilde{\sigma}, \tilde{\alpha}, \tilde{\kappa})\) calibrate \( H \) to the skew \( V : \mathbb{K} \to \mathbb{R} \), where

\[
\begin{align*}
\begin{pmatrix}
\tilde{y}_0 \\
\tilde{\sigma} \\
\tilde{\rho}
\end{pmatrix} & := \begin{pmatrix}
V_0 \\
\sqrt{7S^2 + 12V_0C} \\
2S/\sqrt{7S^2 + 12V_0C}
\end{pmatrix} \\
\begin{pmatrix}
\tilde{\alpha} \\
\tilde{\kappa}
\end{pmatrix} & := M^{-1}(q - r)
\end{align*}
\]

with

\[
q := \frac{1}{2t_1} \left( \frac{V(x_0, t_1) - V(-x_0, t_1) - V_+ + V_-}{V(x_0, t_1) + V(-x_0, t_1) - V_+ - V_-} \right),
\]

and

\[
r := \begin{pmatrix}
\frac{\tilde{\rho} \tilde{\sigma}^3 \left( 1 - \tilde{\rho}^2 \right) + \tilde{y}_0 \tilde{\rho}^2 \tilde{\sigma}^2}{24\tilde{y}_0} x_0 \\
12\tilde{y}_0 \tilde{\rho} \tilde{\sigma}^3 \left( \tilde{\rho}^2 - 4 \right) \tilde{\sigma}^2 + \left( 176 - 712\tilde{\rho}^2 + 521\tilde{\rho}^4 \right) \tilde{\sigma}^4 + 40\tilde{y}_0 \tilde{\rho}^3 \tilde{\sigma}^3 \tilde{x}_0^2 \\
7680\tilde{y}_0^2
\end{pmatrix},
\]

and

\[
M := \begin{pmatrix}
\frac{-\tilde{\rho} \tilde{\sigma}}{12\tilde{y}_0} x_0 & \frac{-\tilde{\rho} \tilde{\sigma}}{12} x_0 \\
\frac{1}{2} + \frac{(13\tilde{\rho}^2 - 6) \tilde{\sigma}^2}{96\tilde{y}_0^2} x_0^2 & \frac{-\tilde{y}_0}{2} - \frac{\tilde{\rho} \tilde{\sigma}^2 x_0^2}{96\tilde{y}_0^2}
\end{pmatrix},
\]

provided that \( \tilde{y}_0 \neq 0, \tilde{\rho} \neq 0 \) and \( \tilde{\rho}^2 \neq \frac{3}{2} \left( 1 - 16\tilde{y}_0^2 \left( \tilde{x}_0^2 \tilde{\sigma}^2 \right) \right) \).
This theorem follows immediately by substituting (6.2) and (6.3), and each \((x,t) \in \mathbb{K}\), into (6.1). The following provides a simple numerical example based on the implied volatility smiles in Figure 11.

**Example 5.2.** Suppose that the true Heston parameters are the ones that generate Figure 11. Let \(t_1 := 0.1\), \(t_2 := 0.25\), and \(x_0 := 0.1\). Then the squared implied volatilities are

\[
V(0,0) = 0.04, V(x_0,t_1) = 0.03644, V(-x_0,t_1) = 0.04395, V(x_0,t_2) = 0.03610, V(-x_0,t_2) = 0.04325.
\]

Given these data points, the explicit calibration formulae in Theorem 5.1 produce the estimates

\[
\hat{\theta} := \tilde{\alpha}/\tilde{\kappa} = 0.04105, \quad \tilde{\kappa} = 1.104, \quad \tilde{\rho} = -0.4069, \quad \tilde{\sigma} = 0.1907
\]

of the true parameters \((\theta, \kappa, \rho, \sigma) = (0.04, 1.15, -0.4, 0.2)\).

6. Proof of the Call Price Expansion (Theorem 3.1)

In order to prove Theorem 3.1, we split the case \(x \neq 0\) (Sections 5.1 to 5.3) and the at-the-money case \(x = 0\) (Section 5.4). From [20], we know that European call option prices can be written as inverse Fourier transforms (3.1) along some horizontal contour in the complex plane. We then rescale this integral (subsection 5.2) and move the horizontal contour of integration so it passes through the saddlepoint (see Definition 6.1) of the small-time approximation of the integrand (Lemma 6.2). We then prove the desired expansion of the integrand in (3.1), which is performed in Proposition 6.1. Lemma 6.1 is a technical lemma needed to justify the saddlepoint expansion.

6.1. The Fourier inversion formula for call options. For each non negative real number \(t\), define the sets \(A_{t,X} \subset \mathbb{R}\) and \(\Lambda_{t,X} \subset \mathbb{C}\) by

\[
A_{t,X} := \{\nu \in \mathbb{R} : E\left(\exp(\nu(X_t - x_0))\right) < \infty\}, \quad \Lambda_{t,X} := \{z \in \mathbb{C} : -\Im(z) \in A_{t,X}\},
\]

and the characteristic function \(\phi_t : \mathbb{C} \to \mathbb{C}\) of the logarithmic return \((x_t - x_0)_{t \geq 0}\) by

\[
\phi_t(z) := E\left(e^{iz(X_t - x_0)}\right), \quad \text{for all } z \in \Lambda_{t,X}.
\]

By [20, Theorem 5.1], we know that for any \(\alpha \in \mathbb{R}\) such that \(\alpha + 1 \in A_{t,X}\) and \(\alpha \neq 0\), we have the following Fourier inversion formula for the price of a call option

\[
\frac{E\left(e^{X_t} - S_0 e^{x}\right)}{S_0} = \phi_t(-1)\mathbb{1}_{\{\alpha < 0\}} + \left(\phi_t(-1) - e^x \phi_t(0)\right)\mathbb{1}_{\{\alpha < -1\}} + \left(\phi_t(-1) - e^x/2 \phi_t(0)\right)\mathbb{1}_{\{\alpha = -1\}}
\]

\[
+ \frac{1}{\pi} \int_{0^{-1}}^{+\infty} \Re\left(\frac{e^{-iz} \phi_t(z - 1)}{iz - z^2}\right) dz.
\]

The first three terms on the right-hand side are complex residues that arise when we cross the pole of \((iz - z^2)^{-1}\) at \(z = 0\) and at \(z = i\). Setting \(u = i - z\) and using the fact that the process \(e^{X_t}\) is a true martingale (see [19, Theorem 2.5]) we obtain

\[
\frac{E\left(e^{X_t} - S_0 e^{x}\right)}{S_0} = \mathbb{1}_{\{\alpha < 0\}} + (1 - e^x)\mathbb{1}_{\{\alpha < -1\}} + \left(1 - e^x/2\right)\mathbb{1}_{\{\alpha = -1\}}
\]

\[
+ \frac{e^x}{\pi} \int_{0^{-1}}^{+\infty} \Re\left(\frac{e^{iu\phi_t(-u)}}{iu - u^2}\right) du.
\]
6.2. Rescaling the variable of integration. In this subsection, we first rescale the integrand above in order to perform an asymptotic expansion, and we then deform the contour of integration along a line in the complex plane that passes through the point $i p^*(x)$, where $p^*(x)$ is defined on Page 3. The reason for such a choice will be made clear in Lemma 6.1. As proved in [8], since $p^*(x) \in (p_-, p_+)$ for all real number $x$ (see Page 3), then the change of variable $u := k/t$ together with $\alpha + 1 := p^*(x)/t$ in (6.1) is valid, and hence the equality

$$
(6.2) \quad \frac{1}{S_0} \mathbb{E} \left[ e^{X_t} - S_0 e^x \right]_+ = (1 - e^x) 1_{\{x<0\}} + \frac{e^x}{\pi} \Re \left( \int_{0+i p^*(x)}^{\infty+i} \exp \left( \frac{i k x}{t} \right) \frac{\phi_t(-k/t)}{k} \frac{1}{1/(k^2/k^2+t^2)} \frac{dk}{t} \right)
$$

holds for $t$ sufficiently small. The first residue term corresponds to the intrinsic value of the call option. For $k \neq 0$, we have $t^{-1} \left( 1k/t - k^2/t^2 \right)^{-1} = - (t/k^2) (1 + O(t/k)) = - (t/k^2) (1 + O(t))$ uniformly in $k$, therefore we can rewrite (6.2) as

$$
\mathbb{E} \left[ e^{X_t} - S_0 e^x \right]_+ = (1 - e^x) 1_{\{x<0\}} - \frac{e^x}{\pi} \Re \left( \int_{1+i p^*(x)}^{\infty+i} \exp \left( \frac{i k x}{t} \right) \frac{\phi_t(-k/t)}{k^2} \frac{1}{1/(k^2/k^2+t^2)} \frac{dk}{t} \right).
$$

Let us now define, for each $p \in \mathbb{R}$ the explosion time $t^*(p) := \sup \{ t > 0 \mid \mathbb{E} \left[ e^{p(X_t-x_i)} \right] < \infty \}$. In [8], using [19], the authors proved that for any $p \in (p_-, p_+)$ the explosion time $t^*(p/t)$ is strictly larger than $t$ for $t$ sufficiently small, so that $p^*(x)/t \in A_{t,x}$ for $t$ sufficiently small. We also note that

$$
\Re \left( e^{i x \alpha} e^{p(-k)/t} \right) = \Re \left( \exp \left( \frac{i x \alpha}{t} \right) \mathbb{E} \left[ e^{-i x \alpha} \right] \right) = \mathbb{E} \left( \Re \left( \frac{\exp \left( \frac{i x \alpha}{t} \right)}{k^2} \frac{1}{k^2} \right) \right),
$$

and we can easily show that this expression is an even function of $\Re(k)$ and an odd function of $\Im(k)$. We can thus rewrite the normalised call price as

$$
(6.3) \quad \frac{\mathbb{E} \left[ e^{X_t} - S_0 e^x \right]_+}{S_0} = (1 - e^x) 1_{\{x<0\}} - \frac{e^x}{\pi} \Re \left( \int_{\zeta_x} \frac{e^{i x \alpha} \phi_t(-k/t)}{k^2} \frac{1}{1/(k^2/k^2+t^2)} \frac{dk}{t} \right),
$$

where we define the contour $\zeta_x$ for every real number $x \neq 0$ by

$$
\zeta_x : (-\infty, \infty) \to \mathbb{C} \text{ such that } \zeta_x(u) := u + i p^*(x).
$$

Let us also define the set $\mathcal{Z} \subset \mathbb{C}$ by

$$
(6.5) \quad \mathcal{Z} := \{ k \in \mathbb{C} : \Im(k) \in (p_-, p_+) \},
$$

where $p_-$ and $p_+$ are defined in (22).

6.3. Saddlepoint expansion of the integral in (6.3). As mentioned above the proof of Theorem 5.1 relies on an asymptotic expansion of the integral in (6.3), which is stated in Proposition 6.1 below. Before stating and proving this proposition we need to introduce several tools and prove some preliminary results. We start by proving the following lemma which characterises the asymptotic behaviour of the rescaled characteristic function when the maturity $t$ is small.

**Lemma 6.1.** For all $k \in \mathbb{C}$ such that $-\Im(k) \in (p_-, p_+) \setminus \{0\}$ the characteristic function $\phi_t$ satisfies

$$
\phi_t \left( -\frac{k}{t} \right) = U(-i k) \exp \left( \frac{\Lambda(-i k)}{t} \right) (1 + O(t)) \text{, uniformly in } k \text{ as } t \text{ tends to zero,}
$$

where the function $\Lambda$ is defined in (22) and the function $U$ in Theorem 5.1.
Remark 6.2. Let \( p \in (p_-, p_+) \). From [3] we know that for all \( t > 0 \), \( \phi_t(ip/t) \) is a well-defined real number. The proof of Lemma 6.1 can be carried out analogously step by step for such a \( \phi_t(ip/t) \), which implies that the number \( U(p) \) in Theorem 6.1 is real as well.

Proof. Albrecher et al. [1] derived the following closed-form representation for the characteristic function \( \phi_t \) under the Heston model:

\[
\phi_t(k) := \mathbb{E} \left( e^{ik(X_t-x_0)} \right) = \exp \left( C(k, t) + y_0 D(k, t) \right),
\]

where

\[
C(k, t) := \frac{\kappa \theta}{\sigma^2} \left( (\kappa - i \rho \sigma k - d(k)) t - 2 \log \left( \frac{1 - g(k)e^{-d(k)t}}{1 - g(k)} \right) \right),
\]

\[
D(k, t) := \frac{1}{\sigma^2} \frac{(\kappa - i \rho \sigma k - d(k))}{1 - g(k)e^{-d(k)t}},
\]

\[
g(k) := \frac{\kappa - i \rho \sigma k - d(k)}{\kappa - i \rho \sigma k + d(k)} ^{1/2},
\]

and \( d(k) := \left( (\kappa - i \rho \sigma k)^2 + \sigma^2 k (1 + k) \right)^{1/2} \),

and we take the principal branch for the complex logarithm. Lewis [21] proved that the function \( \phi_t \) could be analytically extended in the complex plane inside a strip of regularity. From the above definitions we have the following asymptotic behaviour for \( d(-k/t) \) and \( g(-k/t) \) as the ratio \( t/k \) tends to zero:

\[
d \left( \frac{-k}{t} \right) = t^{-1} \left( \sigma^2 \rho^2 k^2 + (2 \kappa \rho - \sigma) \Im \kappa + \kappa^2 t^2 \right)^{1/2} = \frac{k}{t} d_0 + d_1 + O \left( t \right),
\]

\[
g \left( \frac{-k}{t} \right) = \frac{\kappa t + i \rho \sigma k - (\sigma^2 \rho^2 k^2 + (2 \kappa \rho - \sigma) \Im \kappa + \kappa^2 t^2)^{1/2}}{\kappa t - i \rho \sigma k + (\sigma^2 \rho^2 k^2 + (2 \kappa \rho - \sigma) \Im \kappa + \kappa^2 t^2)^{1/2}} = g_0 + \frac{t}{k} g_1 + O \left( t^2 \right),
\]

where we define the following quantities (similar to (5.11)):

\[
d_0 := \sigma \Im c_k, \quad d_1 := \frac{2 \kappa \rho - \sigma}{2 \rho} \Im c_k, \quad g_0 := \frac{i \rho - \sigma c_k}{\rho (i \rho + \sigma c_k)}, \quad g_1 := \frac{(2 \kappa - \rho \sigma) c_k}{\sigma \rho (i \rho + \sigma c_k)}, \quad c_k := \text{csgn}(k),
\]

and where the sign function \( \text{csgn} \) for complex numbers is defined by \( \text{csgn}(k) = 1 \) if \( \Re(k) > 0 \), or if \( \Re(k) = 0 \) and \( \Im(k) > 0 \), and \(-1\) otherwise. Since \( |k| \geq \Re(k) \geq 0 \) we have

\[
D \left( -\frac{k}{t}, t \right) = \frac{1}{\sigma^2 t} \left( \kappa + i \rho \sigma k - \frac{d_0}{d_1} \right) \frac{1 - \exp \left( -d_0 k - d_1 t + O \left( t^2 \right) \right)}{1 - g(k) \exp \left( -d_0 k - d_1 t + O \left( t^2 \right) \right)} \]

\[
= \frac{(i \rho \sigma - d_0) k}{\sigma^2 t} \left( 1 - \frac{e^{-d_0 k}}{1 - g_0 e^{-d_0 k}} \right) \left( 1 - \frac{1}{\sigma^2} \left( i \rho \sigma - d_0 \right) \left( g_0 - g_0 k d_1 \right) e^{-d_0 k} + O \left( t \right) \right).
\]

Similarly we have

\[
C \left( -\frac{k}{t}, t \right) = \frac{\kappa t}{\sigma^2} \left( \kappa t + i \rho \sigma k - d \left( -\frac{k}{t} \right) t - 2 \log \left( \frac{1 - g \left( -\frac{k}{t} \right) \exp \left( -d \left( -\frac{k}{t} \right) t \right)}{1 - g \left( -\frac{k}{t} \right)} \right) \right) \]

\[
= \frac{\kappa t}{\sigma^2} \left( i \rho \sigma - d_0 \right) k - 2 \log \left( \frac{1 - g_0 \exp \left( -d_0 k \right)}{1 - g_0} \right) + O \left( t \right).
\]

We know that for all \( t > 0 \), the characteristic function in the Heston model is even in the argument \( d \) (see [20, Page 31]). Therefore the limiting behaviour of \( \phi_t(-k/t) \) does not depend on the sign function \( c_k \), and the lemma follows from the definition of the functions \( U \) and \( \Lambda \) in Theorem 6.1 and in (6.6). \( \square \)
Remark 6.3. Note that the assumption \(|\rho| < 1\) on Page 3 implies that \(1 - g_0\) is non null, and therefore the expansion for \(C(-k/t, t)\) is well defined. Concerning the denominator in \(D(-k/t)\), simple calculations show that \(1 - g_0 \exp(-d_0 k) = 0\) if and only if \(k = -\log\left((1+\bar{\rho})/(1-\bar{\rho})\right)/(\sigma \bar{\rho})\), which is a purely imaginary number. Tedious but straightforward computations reveal that this value precisely corresponds—depending on the sign of \(\rho\) to the boundary points \(p_-\) and \(p_+\), which are excluded. Therefore the expansion for \(D(-k/t)\) is well defined as well.

We now state and prove the following lemma which we shall need later in the proof of Proposition 6.4.

**Lemma 6.4.** Let \(k := k_r + i k_i \in \mathbb{Z}\). The map \(k_r \mapsto \Re\left(-ikx - \Lambda (-ik)\right)\) has a unique minimum at zero.

**Proof.** Since \(k_1 \in (p_-, p_+\) is fixed, it is clear that \(\Re\left(-ikx - \Lambda (-ik)\right) = -k_1 x - \Re\left(\Lambda (k_1 - ik_r)\right)\). Hence the lemma is equivalent to proving that the function \(k_r \mapsto \Re\left(\Lambda (k_1 - ik_r)\right)\) has a unique minimum at zero. Using the double angle formulae for trigonometric functions we have

\[
\Re\left(\Lambda (p + iq)\right) = \Re\left(\frac{(p + iq) y_0}{\sigma (\bar{\rho} \cot \left(\frac{1}{2} \sigma (p + iq) \bar{\rho}\right) - \rho)}\right) = \frac{y_0 M(q)}{\sigma N(q)},
\]

where the functions \(M\) and \(N\) are defined by

\[
M(q) := p \left(\rho \cos (p \bar{\rho} \sigma) + \bar{\rho} \sin (p \bar{\rho} \sigma)\right) - pp \cosh (q \bar{\rho} \sigma) - q \bar{\rho} \sinh (q \bar{\rho} \sigma),
\]

\[
N(q) := \cosh (q \bar{\rho} \sigma) + (1 - 2\rho^2) \cos (p \bar{\rho} \sigma) - 2\rho \bar{\rho} \sin (p \bar{\rho} \sigma).
\]

Note that \(N(0) > 0\), and \(N'(q) > 0\) for \(q > 0\). We need to show that \(M(q)/N(q) < M(0)/N(0)\) for \(q \neq 0\). By the symmetry \(q \mapsto -q\), we can take \(q > 0\) and by the symmetry \((p, \rho) \mapsto (-p, -\rho)\), we can take \(p \geq 0\). It hence suffices to show that for \(q > 0\),

\[
(6.7) \quad \frac{M'(q)}{N'(q)} < \frac{M(0)}{N(0)},
\]

since the following inequality will therefore hold for all \(q > 0\):

\[
\frac{M(q)}{N(q)} = \frac{1}{N(q)} \left(M(0) + \int_0^q M'(u)du\right) < \frac{1}{N(q)} \left(M(0) + \frac{M(0)}{N(0)} \int_0^q N'(u)du\right)
\]

\[
= \frac{1}{N(q)} \left(M(0) + \frac{M(0)}{N(0)} (N(q) - N(0))\right) = \frac{M(0)}{N(0)}.
\]

We have \(M'(q)/N'(q) = -1/\sigma - pp - q \bar{\rho} \coth (q \bar{\rho} \sigma) < -pp - 2/\sigma\), so \((6.7)\) will be satisfied as soon as

\[
(6.8) \quad -\frac{2}{\sigma} < pp + \frac{M(0)}{N(0)}.
\]

If \(\rho \geq 0\) then \((6.8)\) holds since \(M(0)/N(0) = \sigma \Lambda(p)/y_0\) and because \(\Lambda(p) \geq 0\) as outlined in Section 2. Otherwise, for \(\rho < 0\), note that the derivative of the right-hand side of \((6.8)\) with respect to \(\rho\) is equal to a positive factor multiplied by

\[
(2 - pp \sigma) \bar{\rho} - 2p^2 \bar{\rho} \cos (p \bar{\rho} \sigma) - \bar{\rho} p^2 \sin (p \bar{\rho} \sigma) \geq \bar{\rho} (2 - pp \sigma - 2p^2 + pp \sigma) > 0,
\]

since \(|-\bar{\rho}^2 \sin \alpha| \leq \alpha\) for all \(\alpha > 0\). So it suffices to verify \((6.8)\) in the limit as \(\rho\) tends to \(-1\). Since

\[
\lim_{\rho \to -1} \left(pp + \frac{M(0)}{N(0)}\right) = -\frac{2p\sigma}{\sigma(2 + p\sigma)} > -\frac{2}{\sigma},
\]

then \((6.8)\) is satisfied and the lemma follows. \(\square\)
Remark 6.5. Using the functions $M$ and $N$ defined in the proof of Lemma 6.4 above, it is easy to see that the ratio $M(q)/N(q)$ tends to $-\infty$ as $|q|$ tends to infinity. This implies that for any $k \in \mathbb{Z}$, $\Re(-ikx - \Lambda(-ik))$ tends to infinity as $|k|$ tends to infinity.

In order to prove an asymptotic expansion of the integral in (6.10), we first need to choose the optimal contour $\zeta_x$ along which to integrate. The optimality of this contour $\zeta_x$ is justified by saddlepoint theory, which we define now.

Definition 6.6. (see [3]) Let $F : \mathbb{Z} \to \mathbb{C}$ be an analytic complex function on an open set $\mathbb{Z}$. A point $x_0 \in \mathbb{Z}$ such that the complex derivative $dF/dz$ vanishes is called a saddlepoint.

Let us now define the function $F : \mathbb{Z} \to \mathbb{C}$ by

$$(6.9) \quad F(k) := -ikx - \Lambda(-ik), \quad \text{for all } k \in \mathbb{Z},$$

where the function $\Lambda$ is defined in (6.3) and the set $\mathbb{Z}$ in (6.3). In the Heston case we are considering, this saddlepoint can be expressed in closed-form as follows.

Lemma 6.7. For all real number $x$ the function $F$ defined in (6.9) has a saddlepoint at $k^*(x) = ip^*(x)$, where $p^*(x)$ is the real number defined on Page 6.

Remark 6.8. By the characterisation of the Fenchel-Legendre transform $\Lambda^*$ of $\Lambda$ in (6.3) and the remarks following this definition, it is clear that the equality $F(k^*(x)) = \Lambda^*(x)$ holds for all real number $x$.

Proof. Let $x \in \mathbb{R}$. By definition of $p^*(x)$ on Page 3 we know that the equation $\Lambda'(p) = x$ has a unique solution $p^*(x) \in (p_-, p_+)$. Therefore $F'(k^*(x)) = -ix + \lambda \Lambda'(p^*(x)) = 0$ and the lemma follows. \qed

We now have all the ingredients to prove the following proposition which, combined with (6.3), finishes the proof of Theorem 6.1 in the general case.

Proposition 6.9. For any real number $x \neq 0$ the following equality holds as $t$ tends to zero,

$$-\frac{e^{xt}}{2\pi} \Re \left( \int_{\zeta_x} e^{ikx/t} \phi_t \left( -\frac{k}{t} \right) \left( \frac{1}{k^2} + \mathcal{O}(t) \right) dk \right) = \exp \left( -\frac{\Lambda^*(x)}{t} \right) A(x) \frac{t^{3/2}}{\sqrt{2\pi}} \left( 1 + \mathcal{O}(t) \right),$$

where the functions $A$ and $\Lambda^*$ are given in Theorem 6.1 and in (6.3), and the contour $\zeta_x$ in (6.2).

Proof. Since $F(k) = -ikx - \Lambda(-ik)$ by (6.3), Lemma 6.4 applied on the contour $\zeta_x$ implies

$$(6.10) \quad \Re \left( \int_{\zeta_x} e^{ikx/t} \phi_t \left( -\frac{k}{t} \right) \left( \frac{1}{k^2} + \mathcal{O}(t) \right) dk \right) = \Re \left( \int_{\zeta_x} U(-ik) \frac{e^{-F(k)/t} \left( 1 + \mathcal{O}(t) \right) \left( 1}{k^2} + \mathcal{O}(t) \right) dk \right).$$

The functions $F$ and $u$ are both analytic along $\zeta_x$. Lemma 6.4 implies the inequality $\Re(F(k)) > \Re(F(ip^*(x)))$ for all $k \in \zeta_x \setminus \{0\}$, and $\Re(F(k))$ tends to infinity as $|k|$ tends to infinity by Remark 6.8 and Definition 6.1. We further know from [1] Proof of Theorem 1.1 that the quantity $F''(ip^*(x))$ is non
null. Therefore the Laplace expansion in [23, Chapter 4, Theorem 7.1] leads the following expression:

\[
\frac{e^x}{2\pi} \mathbb{R} \left( \int F(-ik) \exp \left( \frac{F(k)}{t} \right) \frac{dk}{k^2} \right) = \frac{e^x}{\sqrt{\pi}} \exp \left( - \frac{\Lambda^*(x)}{t} \right) \frac{U(k^*)}{\sqrt{2\pi}} \left( 1 + \mathcal{O}(t) \right)
\]

as \( t \) tends to zero, where the equalities \( F(k^*) = \Lambda^*(x) \) and \( F''(k^*) = \Lambda''(p^*(x)) \) follow from the definition of the function \( F \) in (6.10) and the properties of \( p^*(x) \) on Page 3. The \( \mathcal{O}(t) \) terms in (6.11) constitute higher order terms which we can neglect at the order we are interested in.

This proposition concludes the proof of Theorem 6.1 in the general case. We now move on to the proof of the theorem in the at-the-money case.

6.4. The at-the-money case \( x = 0 \). We now prove Theorem 6.1 for the at-the-money case \( x = 0 \). The methodology for the general case above does not hold here since the horizontal contour of integration now passes through the saddlepoint \( k^*(0) = ip^*(0) = 0 \) of the integrand, and the ratio \( U(-ik)/k^2 \) (appearing in the proof of Proposition 6.9) is not analytic at the origin, so the Laplace expansion [23, Theorem 7.1, chapter 4] does not apply anymore. To circumvent this problem we use Cauchy’s Integral theorem to deform the path of integration for the function \( F \) defined in (6.9), along which it is real, and we deal with the pole at the origin using a limiting contour argument to compute the residue.

The main ingredient (Proposition 6.11) to derive the at-the-money call price expansion is the asymptotic expansion for the probability \( \mathbb{P}(X_t > x_0) \) for small \( t \), where \( x_0 = X_0 \). Let \( \mathbb{P}^* \) denote the Share measure, i.e. the probability measure associated with using the stock price process (which is a true martingale) as the numéraire (see [3] or [12] for more details about the Share measure). We then derive a small-time expansion for the quantity \( \mathbb{P}^*(X_t > x_0) \) using the symmetry of the parameters of the Heston model under both measures (see [23]). The reason why we use both measures comes from the following standard equality for an at-the-money European call option:

\[
e^{-x_0} \mathbb{E} (e^{X_t} - e^{x_0}) = \mathbb{P}^*(X_t > x_0) - \mathbb{P}(X_t > x_0).
\]

Before stating the main result of this subsection (Proposition 6.11), we need to introduce a few tools. Let us first define the descent path (for the function \( F \) defined in (6.9)) \( \gamma : \mathbb{R} \rightarrow \mathbb{C} \) by

\[
\gamma(s) := s + i \left( \frac{\rho \sigma}{4} s^2 + \left( \frac{\rho \sigma}{4} \right)^2 s^4 \right).
\]

Straightforward calculations show that this path has the following fundamental properties:

\[
\Re (F' (\gamma(0))) = 0 \quad \text{and} \quad \Re (F'' (\gamma(0))) > 0.
\]

Remark 6.10. Note that this path \( \gamma \) goes through the saddlepoint \( k^*(0) = 0 \) of the function \( F \), and that it is symmetric around the imaginary axis. Furthermore it lies above the horizontal contour \( s \mapsto s \) if \( \rho > 0 \) and below otherwise. Around the saddlepoint \( k^*(0) \), we have the series expansion \( F(k) = \frac{1}{2} \Lambda''(0) k^2 - \frac{1}{6} \Lambda'''(0) k^3 - \frac{1}{24} \Lambda^{(4)}(0) k^4 + \mathcal{O}(k^5) \). The contour \( \gamma \) in (6.12) was guessed by looking for a path of the form \( \tilde{\gamma}(s) = s + i (a_1 s + a_2 s^2 + \ldots) \) with all coefficients real-valued such that the map \( F \circ \tilde{\gamma} \) is real. Matching the first coefficients of the series expansions around the origin led to the path \( \gamma \).
We now prove Theorem 3.1 for the special case $x = 0$. We shall assume that $\rho < 0$ for clarity, and the arguments in the case $\rho \geq 0$ are analogous. Let us note the following facts:

(i) From Remark 6.10 we know that the contour $\gamma$ lies below the horizontal contour $\gamma_H : \mathbb{R} \to \mathbb{C}$ defined by $\gamma_H(s) = s + 1/p^+(0) = s$, for all $s \in \mathbb{R}$. We wish to deform the contour so that the pole remains outside the new contour, in order to invoke Cauchy’s theorem.

(ii) Let $\epsilon$ be a strictly positive real number and define the contour $\gamma^{-}_\epsilon : (-\pi, \pi] \to \mathbb{C}$ as the clockwise oriented circular contour parameterised by $\gamma^{-}_\epsilon(\theta) = \epsilon e^{i\theta}$ around the pole. To leave the pole outside the contour we follow the path $\gamma(s)$ for $s < -\epsilon$ until it touches $\gamma^{-}_\epsilon$ at the point $s = -\epsilon$. We then follow the contour $\gamma^{-}_\epsilon$ clockwise around the pole, and finally switch back to $\gamma(s)$ for $s > \epsilon$.

(iii) The contour $\gamma$ is below $\gamma_H$ so that $\gamma$ intersects $\gamma^{-}_\epsilon$ on its lower half ($\theta \in (-\pi, 0]$), which can be analytically represented as $\gamma^{-}_{\epsilon} := s \in [-\epsilon, \epsilon] \mapsto s - 1/\sqrt{s^2 - \epsilon^2}$. We can define the path $\gamma^{+}_\epsilon$ similarly, and we therefore clearly see that the two paths $\gamma$ and $\gamma^{-}_\epsilon$ intersect at the points $s^{-}_\epsilon = -\epsilon$ and $s^{+}_\epsilon = \epsilon$ (see also Figure 3).

Choose $0 < \epsilon < \delta < 1 < R$, with $\delta$ inside the radius of convergence of (6.12), and small enough to ensure that the function $k_1$ is strictly decreasing on $[0, \delta]$ and strictly increasing on $[-\delta, 0]$. We now define the following contours (see also Figure 3):

- $\gamma^{-}_{\epsilon, \delta}$ (resp. $\gamma^{+}_{\epsilon, \delta}$) is the restriction of $\gamma$ to $s \in [-\delta, -\epsilon]$ (resp. $s \in [\epsilon, \delta]$), and $\gamma_{\epsilon, \delta} := \gamma^{-}_{\epsilon, \delta} \cup \gamma^{+}_{\epsilon, \delta}$;
- $\gamma^{U}_{\epsilon}$ is the portion of the circular contour $\gamma^{-}_\epsilon$ which lies above $\gamma$;
- $\Gamma^{-}_{R, \epsilon, \delta}$ is the vertical strip which joins $-R + 2i\epsilon$ to $-R - ik_1(-\delta)$;
- $\Gamma^{+}_{R, \epsilon, \delta}$ is the vertical strip which joins $R - ik_1(-\delta)$ to $R + 2i\epsilon$.

As announced above, the following proposition states a small-time expansion for the probability $\mathbb{P}(X_t > x_0)$, which is the main result of this subsection.
Proposition 6.11. As the maturity $t$ tends to zero, the following expansion holds:

$$
\mathbb{P}(X_t > x_0) = \frac{1}{2} - \frac{y_0 + \rho \sigma^2}{2 \sqrt{2 \pi y_0}} t^{1/2} + \sqrt{\frac{2}{\pi}} \left( -8y_0 \kappa \rho + 9 \sigma^3 \rho^3 + 8y_0 + 2 \sigma^2 \rho^2 y_0 + 8 \sigma^2 y_0 + 48 y_0^2 \kappa - 48y_0 \kappa \theta + 40 \kappa \theta \sigma \rho - 12 \nu^2 \sigma \rho - 12 \sigma^3 \rho \right) t^{3/2} + O(t^{5/2}).
$$

The proof of this proposition is an immediate consequence of Lemma 6.14 and Lemma 6.13 below.

Lemma 6.12. The following equality holds:

$$
\mathbb{P}(X_t > x_0) = \frac{1}{2} \pi \int_{\Gamma_{R,0}} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} - \frac{1}{2 \pi} \left( \int_{-\delta + i k_1(-\delta)}^{\delta + i k_1(\delta)} + \int_{\delta + i k_1(\delta)}^{R + i k_1(\delta)} + \int_{R + i k_1(\delta)}^{+ \infty} \int_{-\infty}^{R} \mathbb{R} \left( \phi_t \left( \frac{-k}{t} \right) \right) \frac{dk}{1k} \right.
$$

$$
+ \frac{1}{2} \int_{-\delta}^{\delta} \mathbb{R} \left( \phi_t \left( \frac{-\gamma(s)}{t} \right) \right) \frac{\gamma'(s)}{1 \gamma(s)} ds,
$$

where all the contours of integration are defined on Page 12 and represented in Figure 3.

Proof. Let us consider the closed contour in the complex plane on Figure 3, and note that the function $k \mapsto \phi(-k/t)/(ik)$ is analytic along this contour. Cauchy’s Integral theorem therefore implies the identity

$$
\left( \int_{\Gamma_{R,0}}^{\Gamma_{R,\delta}} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} \right) = 0
$$

We now evaluate some of the integrals in this expression in order to prove the lemma. For $|k|$ small enough and $t > 0$ fixed, we have $(ik)^{-1} \phi_t (-k/t) = (1k)^{-1} + O(1)$, and hence

$$
\int_{\Gamma_{R,\delta}}^{\Gamma_{R,0}} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} = \int_{\Gamma_{R,0}}^{\gamma(s)} \left( e^{-i \theta} + O(\varepsilon) \right) ds.
$$

We further have

$$
\int_{[\varepsilon]} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} = \int_{[\varepsilon]} \phi_t \left( \frac{-\gamma(s)}{t} \right) \frac{\gamma'(s)}{1 \gamma(s)} ds.
$$

As before we can easily verify that the function $s \mapsto \mathbb{R} \left( \phi_t \left( \frac{-\gamma(s)}{t} \right) \right)$ is an even function and that $s \mapsto \mathbb{R} \left( \phi_t \left( \frac{-\gamma(s)}{t} \right) \right)$ is an odd function. Therefore the following equality holds:

$$
\int_{[\varepsilon]} \phi_t \left( \frac{-\gamma(s)}{t} \right) \frac{\gamma'(s)}{1 \gamma(s)} ds = \int_{[\varepsilon]} \mathbb{R} \left( \phi_t \left( \frac{-\gamma(s)}{t} \right) \right) \frac{\gamma'(s)}{1 \gamma(s)} ds.
$$

No that we have $\mathbb{R} \left( (i \gamma(s))^{-1} \right) = -\rho \sigma^2 / 4 + O(1)$, for $|s|$ small enough, i.e. taking the real part removes the singularity at the origin. Combining Equations (6.14) and (6.15) we obtain

$$
\left( \int_{\Gamma_{R,0}}^{\Gamma_{R,\delta}} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} \right) + \int_{[\varepsilon]} \mathbb{R} \left( \phi_t \left( \frac{-\gamma(s)}{t} \right) \right) \frac{\gamma'(s)}{1 \gamma(s)} ds = \pi + o(1) = \int_{[\varepsilon]} \phi_t \left( \frac{-k}{t} \right) \frac{dk}{1k} = - \int_{[\varepsilon]} \phi_t \left( \frac{k}{t} \right) \frac{dk}{1k},
$$

as $\varepsilon$ tends to zero. Now Lee [21, Theorem 5.1] proves that the integral on the right hand side is equal to minus the normalised digital call price $2 \pi \mathbb{P}(X_t > x_0)$, which is clearly independent of $\varepsilon$. The proposition then follows by taking the limit as $\varepsilon$ goes to zero and dividing by $-2 \pi$.

All is now left in order to prove the tail estimate for the probability $\mathbb{P}(X_t > x_0)$ is to approximate each integral in Lemma 6.12. The following lemma contains all these estimates.
Lemma 6.13. All the following estimates hold for the integrals in Lemma 6.12 for $R$ large enough and $t$ small enough.

\begin{align}
(6.17) & \int_{-\delta}^{\delta} \Re \left( \phi_t \left( -\frac{\gamma(s)}{t} \frac{\gamma'(s)}{\gamma(s)} \right) \right) ds = \frac{(2\gamma_0 + \rho\sigma)\pi}{2\sqrt{2\gamma_0}} t^{1/2} + K t^{3/2} + O(t^{5/2}), \\
(6.18) & \left| \int_{-\infty}^{\infty} \Re \left( \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right) \right| = O \left( \exp \left( -\frac{m}{t} \right) \right), \text{ for some } m > 0, \\
(6.19) & \left| \int_{-\infty}^{-R} \Re \left( \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right) \right| = O \left( \exp \left( -\frac{m'}{t} \right) \right), \text{ for some } m' > 0, \\
(6.20) & \left| \int_{\Gamma_k^{R,0,\delta}} \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right| = O \left( \exp \left( -\frac{m''}{t} \right) \right), \text{ for some } m'' > 0, \\
(6.21) & \left| \left( \int_{-R+1k_1(-\delta)}^{-\gamma(\delta)} + \int_{\gamma(\delta)}^{R+1k_1(\delta)} \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right) \right| = O \left( \exp \left( -t^{-1} \min \left\{ \Re (F_{\gamma(\delta)}), \Re (F'_{\gamma(\delta)}) \right\} \right) \right),
\end{align}

where the constant $K$ is defined by

$$K := \frac{2\pi 9^{3/2} + 8y_0^3 + 2\sigma^2 y_0^2 + 8\sigma y_0 (\sigma - \rho)}{384}.$$

Before proving these estimates, we need the following technical lemma.

Lemma 6.14. Let $k = k_r + i k_1 \in \mathbb{Z}$. Then the characteristic function $\phi_t$ has the following tail behaviour:

$$\lim_{|k_r| \to \infty} |k_r|^{-1} \log \left| \phi_t \left( -\frac{k}{t} \right) \right| = -\frac{\bar{\rho}}{\sigma} \left( \kappa \theta + \frac{\gamma(s)}{t} \right), \text{ uniformly in } t \text{ for all } 0 < t < 1.$$

**Proof.** Let $t > 0$, $k = k_r + i k_1 \in \mathbb{Z}$, where $\mathbb{Z}$ is defined in (6.12) and consider the expression for the characteristic function $\phi_t$ given in (6.13). Straightforward calculations show that

$$\lim_{|k_r| \to \infty} |k_r|^{-1} d(-k/t) = \lim_{|k_r| \to \infty} |k_r|^{-1} \sqrt{\frac{(\kappa + \rho\sigma k/t)^2 - \rho^2}{\kappa - k/t}} = \frac{\sigma \bar{\rho}}{t},$$

$$\lim_{|k_r| \to \infty} g(-k/t) = \lim_{|k_r| \to \infty} \left( \frac{\kappa + \rho\sigma k/t - d(-k/t)}{\kappa + \rho\sigma k/t + d(-k/t)} \right) = \frac{\bar{\rho}}{\rho + \bar{\rho}},$$

$$\lim_{|k_r| \to \infty} |k_r|^{-1} \left( \kappa + \rho\sigma k/t - d(-k/t) \right) = -\frac{\sigma}{t} \left( \bar{\rho} + i \rho \text{sgn}(k_r) \right),$$

uniformly in $t$ for all $t < 1$. We have used the fact that $k_1$ is bounded since $k \in \mathbb{Z}$ and hence the ratio $\sqrt{k^2/|k_r|}$ converges to one as $|k_r|$ tends to infinity. Furthermore, the two ratios in the definitions of the functions $C$ and $D$ in (6.14) converge to a constant as $|k_r|$ tends to infinity. Therefore the limit

$$\lim_{|k_r| \to \infty} |k_r|^{-1} \log \phi_t \left( -\frac{k}{t} \right) = -\frac{1}{\sigma} \left( \kappa \theta + \frac{\gamma(s)}{t} \right) \left( \bar{\rho} + i \rho \text{sgn}(k_r) \right)$$

holds as well, uniformly in $t$ for all $t < 1$. \(\square\)

**Proof of Lemma 6.13.** We first consider the integral (6.17). Setting $k = \gamma(s)$ and performing a Taylor series expansion of $\Re \left( \phi_t \left( -\frac{\gamma(s)}{t} \frac{\gamma'(s)}{\gamma(s)} \right) \right)$ around $t = 0$ and $s = 0$, we find that

$$\Re \left[ \phi_t \left( -\frac{\gamma(s)}{t} \frac{\gamma'(s)}{\gamma(s)} \right) \right] = \left( q(s) + \frac{\kappa}{4} (\theta - y_0) t + \varepsilon(s, t) \right) \exp \left( -\frac{F(\gamma(s))}{t} \right),$$

where $q(s)$ is defined in (6.13) and $\varepsilon(s, t)$ is the remainder term.
where the function \( q : \mathbb{R} \to \mathbb{R} \) is defined by
\[
q(s) := q(s; \kappa, \theta, \rho, \sigma) = \frac{2y_0 + \rho \sigma^3}{8} + \frac{1}{4} \left( \rho \sigma + \frac{7}{16} \sigma^3 \rho^3 + \frac{\sigma \rho y_0^2}{8} + \frac{13}{24} \sigma^2 \rho^2 y_0 + \frac{\kappa y_0}{2} (y_0 - \theta) \right) \quad (6.23)
\]

\[
- \frac{y_0^3}{12} + \rho \sigma^3 + \frac{5}{12} \kappa \theta \rho - \frac{\sigma^2 y_0}{3} - \frac{\sigma^2 \rho^2}{16} (2y_0 + \rho \sigma) \bigg) s^2,
\]

and \( \varepsilon(s, t) = O(s^3) + O(st) + O(t^2) \). The function \( q \) is just a quadratic so it has an analytic continuation to the complex plane. Using the Laplace expansion in [23, Chapter 4, Theorem 7.1, Formula 7.0.6] with \( \delta \) is inside the radius of convergence of \( \text{exp}(t^2) \), we obtain
\[
\frac{1}{2\pi} \int_{-\delta}^{\delta} \Re \left( \phi_t \left( -\frac{\gamma(s)}{t} \right) \frac{\gamma'(s)}{2\gamma(s)} \right) ds = \frac{1}{2\pi} \int_{-\delta}^{\delta} \left( q(s) + \frac{\kappa}{4} \left( \theta - y_0 \right) t + \varepsilon(s, t) \right) \exp \left( -\frac{F(\gamma(s))}{t} \right) ds
\]

\[
= \left( \frac{1}{\pi} \sum_{n=0}^{\infty} \Gamma \left( n + \frac{1}{2} \right) a_{2n} t^{n+1/2} + \frac{1}{4\pi} \frac{\kappa (\theta - y_0)}{\sqrt{2}F''(0)} \Gamma \left( \frac{1}{2} \right) t^{3/2} + O \left( t^{5/2} \right) \right) - \int_{-\delta}^{\delta} \varepsilon(s, t) \exp \left( -\frac{F(\gamma(s))}{t} \right) ds
\]

\[
= \frac{q(0) \Gamma(1/2) t^{1/2}}{\pi \sqrt{2} F(\gamma''(0)}} + \frac{\Gamma(3/2)}{\pi} \left( 2q''(0) + \frac{5}{6} \frac{(F \circ \gamma)''(0)^2}{2} - \frac{(F \circ \gamma)''(0)}{2} (F \circ \gamma''(0)) q(0) \right) t^{3/2} + O \left( t^{5/2} \right)
\]

\[
= \frac{2y_0 + \rho \sigma}{4\sqrt{2\pi} y_0} t^{1/2} + K t^{3/2} + O \left( t^{5/2} \right),
\]

where the constant \( K \) is computed explicitly in the lemma and \( \Gamma \) represents the standard Gamma function. We refer the interested reader to [23, Chapter 4, Theorem 7.1, Formula 7.0.6] for the full saddlepoint expansion (up to any order) and a precise characterisation of the coefficients \( a_{2n} \). Since we are only interested in terms of order at most \( t^{3/2} \), we only need to compute the first two coefficients \( a_0 \) and \( a_1 \), which is performed directly in the third line.

Let us now consider the integral (6.18). Lemma 6.11 implies
\[
\left| \int_{R}^{\infty} \Re \left( \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right) \right| \leq \int_{R}^{\infty} \left| \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right| = O \left( \exp \left( -\frac{m''}{t} \right) \right),
\]

for some \( m > 0 \), \( R \) large enough and \( t < 1 \). The same argument holds for the integral (6.14).

Since the contours \( \Gamma_{R,0,\delta}^+ \) and \( \Gamma_{R,0,\delta}^- \) defined on Page 14 are both vertical strips of length \( k_1(\delta) > 0 \), Lemma 6.12 again implies that for any \( m'' > 0 \), the estimate
\[
\left| \int_{R}^{\infty} \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} = O \left( \exp \left( -\frac{m''}{t} \right) \right),
\]

holds for the integral (6.20) for any \( t < 1 \) and \( R \) sufficiently large.

Using Lemmas 6.11 and 6.13 we can bound the remaining integral (6.20) as
\[
\left| \int_{-R+k_1(\delta)}^{\gamma(\delta)} + \int_{R+k_1(\delta)}^{\gamma(\delta)} \phi_t \left( -\frac{k}{t} \right) \frac{dk}{1k} \right| = \left| \int_{-R+k_1(\delta)}^{\gamma(\delta)} + \int_{R+k_1(\delta)}^{\gamma(\delta)} \left| U \left( -\varepsilon(k, t) \right) \exp \left( -\frac{F(k)}{t} \right) (1 + \varepsilon(k, t)) \frac{dk}{1k} \right| \right|
\]

\[
\leq \exp \left( -\frac{1}{t} \min \left\{ \Re \left( F \left( -\varepsilon(k, t) \right) \right), \Re \left( F \left( \varepsilon(k, t) \right) \right) \right\} \right) \left| \int_{-R+k_1(\delta)}^{\gamma(\delta)} + \int_{R+k_1(\delta)}^{\gamma(\delta)} \left| U \left( -\varepsilon(k, t) \right) \exp \left( -\frac{F(k)}{t} \right) \left( 1 + \varepsilon(k, t) \right) \frac{dk}{1k} \right| \right|
\]

\[
= O \left( \exp \left( -\frac{1}{t} \min \left\{ \Re \left( F \left( -\varepsilon(k, t) \right) \right), \Re \left( F \left( \varepsilon(k, t) \right) \right) \right\} \right) \right).
\]

\( \square \)
As explained in the beginning of the proof of the at-the-money case \(x = 0\) (Section 6.2 on Page 13), we need to derive a small-time expansion for the two probabilities \(P(X_t > x_0)\) and \(P^*(X_t > x_0)\). Using the symmetry of the Heston model explained in [29], we can define the function \(q^*\) by \(q^*(s) := q(s, \kappa^*; \theta^*, \sigma^* - \rho^\theta/\kappa^*)\), where the function \(q\) is defined in (6.22). The following expansion under the Share measure \(P^*\) hence follows immediately from Proposition 6.11:

\[
P^*(X_t > x_0) = \frac{1}{2} + \frac{y_0 + \rho \sigma/2}{\sqrt{2 \pi y_0}} t^{1/2} - \sqrt{\frac{2}{2 \pi y_0}} \left( 8 \sigma y_0 \kappa^* \sigma \rho - 9 \sigma^3 \rho^3 + 8 \nu^3 + 2 \sigma^2 y_0 \rho^2 + 8 \sigma^2 \nu + 48 \nu^2 \kappa^* - 48 \nu \kappa^* \theta^* - 40 \nu \kappa^* \theta^* \sigma \rho + 12 \sigma^2 \nu \sigma \rho + 12 \sigma^3 \rho \right) t^{3/2} + O(t^{5/2}).
\]

We can therefore use the equality (6.11) to deduce

\[
e^{-x_0} \mathbb{E}(e^{X_t} - e^{x_0})_+ = P^*(X_t > x_0) - P(X_t > x_0)
\]

\[
= \sqrt{\frac{y_0 t}{2 \pi}} - \sqrt{\frac{2}{2 \pi}} t^{3/2} + O(t^{5/2}),
\]

which proves Theorem 6.13 in the at-the-money case \(x = 0\).

References

7. Appendix

7.1. Proof of Proposition 4.3. Define \( d_{\pm} := \left( -x \pm \frac{\sigma_t^2 t}{2} / \sigma_t \right) \). We first consider the case \( x > 0 \). Note that \( d_{\pm} \) tends to \(-\infty\) as \( t \) tends to 0. Substituting the asymptotic series

\[
1 - \mathcal{N}(z) = (2\pi)^{-1/2} e^{-z^2/2} (z^{-1} - z^{-3} + \mathcal{O}(z^{-5})) ,
\]

as \( z \) tends to infinity, into the Black-Scholes call option formula with implied volatility \( \sigma_t \), we obtain

\[
\mathbb{E} \left( e^{X_t} - S_0 e^{x} \right)_+ = S_0 \mathcal{N}(d_+) - S_0 e^{x} \mathcal{N}(d-) = S_0 \left( 1 - \mathcal{N}(-d_-) - e^{x} + e^{x} \mathcal{N}(-d_-) \right)
\]

\[
= \frac{S_0}{\sqrt{2\pi}} \exp \left( -\frac{d_+^2}{2} \right) \left( -\frac{1}{d_+} + \frac{1}{d_-} + \frac{1}{d_+^3} - \frac{1}{d_-^3} + \mathcal{O}(d_+^{-5}) \right) ,
\]

(7.1)

as \( t \) tends to zero, where we used the fact that \( -d_-^2/2 + x = -d_+^2/2 \). Since the expansion

\[
\exp \left( -\frac{d_+^2}{2} \right) = \exp \left( -\frac{x^2}{2\Sigma_t^2 t} + \frac{x(\Sigma_t^4 + ct)}{2\Sigma_t^4} - \frac{\Sigma_t^8 + 4x^2 c^2 t}{8} + \mathcal{O} \left( t^2 \right) \right)
\]

\[
= \left( 1 - \frac{\Sigma_t^8 + 4x^2 c^2 t}{8} + \mathcal{O} \left( t^2 \right) \right) \exp \left( -\frac{x^2}{2\Sigma_t^2 t} + \frac{x(\Sigma_t^4 + ct)}{2\Sigma_t^4} \right)
\]

holds as well as \( d_-^1 - d_-^3 + d_+^3 - d_+^{-3} = x^{-2}\Sigma_t^4 + \mathcal{O} \left( t^{5/2} \right) \), we can then plug this expression into (7.1) and the desired result follows. The proof of the case \( x < 0 \) is analogous.

When \( x = 0 \), note that \( d_{\pm} \) converges to zero as \( t \) tends to zero, so that we use the asymptotic series \( \mathcal{N}(z) = 1/2 + (2\pi)^{-1/2} (z - \frac{1}{6} z^3 + \mathcal{O}(z^5)) \) and the proposition follows from

\[
\mathbb{E} \left( e^{X_t} - S_0 e^{x} \right)_+ = S_0 \mathcal{N}(d_+) - S_0 \mathcal{N}(d-) = \frac{S_0}{\sqrt{2\pi}} \left( (d_+ - d_-) - \frac{1}{6} (d_+^3 - d_-^3) + \mathcal{O} \left( d_+^5 \right) \right)
\]

\[
= \frac{S_0}{\sqrt{2\pi}} \left( \Sigma t^{1/2} + \frac{12c - \Sigma_t^4}{24\Sigma} t^{3/2} + \mathcal{O} \left( t^{5/2} \right) \right) .
\]

7.2. Proof of Theorem 4.4. Let us first assume \( x > 0 \). If we equate the leading order and correction terms for the Heston and the Black-Scholes models as

\[
\Lambda^*(x) = \Lambda^*_H(x) = \frac{x^2}{2\sigma_0^2(x)}, \quad \text{and} \quad A(x) = A_B(x, \sigma_0(x)) \exp \left( \frac{a(x)x^2}{2\sigma_0^2(x)} \right),
\]

\[
(7.2)
\]
we obtain (\ref{eq:power_series}). We now have to make this argument rigorous, since we do not know a priori that \( \sigma_t \) admits an expansion of the form stated in the theorem. However by Theorem \ref{thm:existence} and \((\ref{eq:expansion}).\) we know that for all \( \varepsilon > 0, \) there exists \( t^*(\varepsilon) \) such that for all \( t < t^*(\varepsilon) \) we have

\[
\mathbb{E} \left( \frac{e^{X_t} - S_0e^x}{S_0} \right)^+ \leq \frac{A(x)}{\sqrt{2\pi}} t^{3/2} \exp \left( -\frac{\Lambda^+(x)}{t} \right) e^{\varepsilon} = \frac{A_{BS}(x, \sigma_0(x))}{\sqrt{2\pi}} \exp \left( \frac{a(x)x^2}{2\sigma^4_0(x)} \right) t^{3/2} \exp \left( -\frac{x^2}{2\sigma^4_0(x) t} \right) e^{\varepsilon}.
\]

The function \( a \) is continuous on \((0, \infty)\). Therefore for any \( \delta > 0 \) sufficiently small we can choose \( \varepsilon' > 0 \) such that the equality

\[
\exp \left( \frac{1}{2} \frac{a(x)x^2}{\sigma^4_0(x)} \right) e^{\varepsilon} = \exp \left( \frac{1}{2} \frac{(a(x) + \delta)x^2}{\sigma^4_0(x)} \right) e^{-\varepsilon'},
\]

holds and hence Theorem \ref{thm:existence} implies the inequalities

\[
\mathbb{E} \left( \frac{e^{X_t} - S_0e^x}{S_0} \right)^+ \leq \frac{A_{BS}(x, \sigma_0(x))}{\sqrt{2\pi}} \exp \left( \frac{(a(x) + \delta)x^2}{2\sigma^4_0(x)} \right) t^{3/2} \exp \left( -\frac{x^2}{2\sigma^4_0(x) t} \right) e^{-\varepsilon'}
\leq C_{BS} \left( x, t, \sqrt{\sigma_0^2(x) + (a(x) + \delta) t} \right)
\]

for \( t \) sufficiently small. Since the Black-Scholes formula is a strictly increasing function of the volatility then the upper bound \( \sigma_1^2(x) \leq \sigma_0^2(x) + (a(x) + \delta) t + \delta t \) holds for all \( x > 0 \). We proceed similarly for the lower bound and for the case \( x < 0, \) and the theorem follows.

7.3. Proof of Corollary \ref{cor:power_series}. We wish to compute a series expansion for \( p^*(x) \) defined on page \ref{pg:power_series} as the unique solution to \( x = \Lambda'(p^*(x)) \) when \( x \) is close to zero (recall that \( p^*(0) = 0 \). We substitute an ansatz power series expansion for \( p^*(x) \) and then recursively we determine the coefficients such that the power series of the composition \( \Lambda'(p^*(x)) \) equals \( x \). We only indicate below the important auxiliary quantities:

\[
\Lambda(p) = \frac{y_0}{2} p^2 + \frac{\rho \sigma y_0}{4} p^3 + \frac{\sigma^2 y_0}{24} \left( 1 + 2 \rho^2 \right) p^4 + \frac{\rho \sigma^3 y_0}{48} \left( 2 + \rho^2 \right) p^5 + \mathcal{O} \left( p^6 \right),
\]

\[
U(p) = 1 - \frac{y_0}{2} p + \left( \kappa (\theta - y_0) - \sigma \rho y_0 + \frac{y_0^2}{2} \right) \frac{p^2}{4} + \left( \frac{\kappa \sigma}{3} (\theta - 2 y_0) - \frac{\sigma^2}{3} (1 + \rho^2) - \frac{y_0}{2} (\kappa (\theta - y_0) - \rho \sigma y_0) \right) \frac{p^3}{4} + \mathcal{O} \left( p^4 \right),
\]

\[
\Lambda^*(x) = x^2 - \frac{\rho \sigma}{2y_0} x^3 + \frac{\sigma^2}{96 y_0^2} (19 \rho^2 - 4) x^4 + \mathcal{O} \left( x^5 \right),
\]

\[
\sigma_0(x) = \sqrt{y_0} + \frac{\rho \sigma x}{4y_0} + \frac{\sigma^2}{24y_0^{3/2}} \left( 1 - \frac{5}{6} \rho^2 \right) \frac{\sigma^2 x^2}{24y_0^{3/2}} + \mathcal{O} \left( x^3 \right),
\]

\[
A(x) = \frac{y_0^{3/2}}{x^2} + \sqrt{\frac{y_0}{4x}} (3 \rho \sigma + 2 y_0) - \frac{1}{96 \sqrt{y_0}} (11 \rho^2 \sigma^2 - 8 \sigma^2 - 48 y_0 \rho \sigma - 24 \kappa \theta + 24 \kappa y_0 \kappa - 12 y_0^2) + \mathcal{O} \left( x \right).
\]

From these formulæ we can deduce the expansion

\[
\frac{A(x)}{A_{BS}(x, \sigma_0(x))} = 1 + \frac{\sigma^2 \left( \rho^2 - 4 \right) + 12 y_0 \rho \sigma + 24 \kappa (\theta - y_0)}{96 y_0^2} x^2 - \frac{\rho \sigma}{96 y_0} \left( 10 y_0 \rho \sigma + 3 \rho^2 \sigma^2 - 6 \sigma^2 - 20 y_0 \kappa + 28 \kappa \theta \right) x^3 + \mathcal{O} \left( x^4 \right),
\]

which implies the expression for \( a(x) = x^{-2} \sigma_0^2(x) \log \left( \frac{A(x)}{A_{BS}(x, \sigma_0(x))} \right) \) in Corollary \ref{cor:power_series}.
7.4. **Proof of Corollary 4.5.** Using Proposition 3.3 and Theorem 3.1 we can equate the normalised at-the-money call option prices under the Heston model and the time-dependent Black-Scholes model. This leads to the following two equalities:

\[(7.3)\]
\[\sigma_0 = \sqrt{y_0}, \quad \text{and} \quad a = -\frac{\sigma^2}{12} \left( 1 - \frac{\rho^2}{4} \right) + \frac{y_0 \rho \sigma}{4} + \frac{\kappa}{2} (\theta - y_0).\]

We now have to make this argument rigorous since we do not know a priori that \(\sigma_t(0)\) admits an expansion of the form in (4.2). However by Theorem 3.1 we know that for all \(\varepsilon > 0\), there exists \(t^*(\varepsilon) > 0\) such that for all \(0 < t < t^*(\varepsilon)\) we have

\[e^{-x_0} E(e^{X_t} - e^{x_0}) \leq \sqrt{\frac{y_0}{2\pi^2}} t^{1/2} - \frac{1}{48} \sqrt{\frac{2}{y_0 \pi}} \sigma^2 \left( 1 - \frac{\rho^2}{4} \right) + y_0^2 - 6\kappa (\theta - y_0) - 3y_0 \rho \sigma t^3/2 + \varepsilon\]

\[= \frac{\sigma_0}{\sqrt{2\pi}} t^{1/2} + \frac{1}{2\sigma_0 \sqrt{2\pi}} \left( \frac{a + \delta(\varepsilon)}{\sigma_0^2} - \frac{\sigma_0^4}{12} \right) t^{3/2} + \varepsilon.\]

We now choose \(\varepsilon > 0\) small and \(\delta(\varepsilon) > 0\) such that the equality

\[\frac{1}{\sigma_0 \sqrt{2\pi}} \left( \frac{a}{2\sigma_0} - \frac{\sigma_0^4}{24} \right) + \varepsilon = \frac{1}{2\sigma_0 \sqrt{2\pi}} \left( \frac{a + \delta(\varepsilon)}{\sigma_0} - \frac{\sigma_0^4}{12} \right) - \varepsilon\]

holds, which directly implies the inequalities

\[e^{-x_0} E(e^{X_t} - e^{x_0}) \leq \frac{\sigma_0^{1/2}}{\sqrt{2\pi}} + \frac{t^{3/2}}{2\sigma_0 \sqrt{2\pi}} \left( \frac{a + \delta(\varepsilon)}{\sigma_0} - \frac{\sigma_0^4}{12} \right) + O \left( \frac{t^5}{2} \right) - \varepsilon \leq C_{BS} \left( 0, t, \sqrt{\sigma_0^2 + (a + \delta(\varepsilon)) t} \right)\]

for \(t\) sufficiently small. The monotonicity of the Black-Scholes call option formula as a function of the volatility implies the upper bound \(\hat{\sigma}_t^2(0) \leq \sigma_0^2(0) + a(0) t + \delta t\). The proof for the lower bound is analogous and we hence omit it for clarity. Since \(\delta(\varepsilon)\) is taken arbitrarily small, the corollary follows.

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