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*Markovian projection on stochastic volatility models.*

We develop a systematic approach to the reduction of dimensionality of smile-enabled models by projecting them onto a displaced version of the two-dimensional Heston process. The projection is the key for deriving efficient, analytical approximations to European option prices in such models. This is a further development of the method of Markovian projection previously used for projecting on the displaced-diffusion process (with skew but without smile). The method is derived in a generic form and has a wide range of suitable applications. Examples for spread and basket options are given. (Received September 04, 2007)