

Graduate School of Business, University of Chicago
Business 41202, Spring Quarter 2005, Mr. Ruey S. Tsay

Midterm

GSB Honor Code:

I pledge my honor that I have not violated the Honor Code during this examination.

Signature:

Name:

ID:

Notes:

- Open notes and books.
- Write your answer in the blank space provided for each question.
- **Manage** your time carefully and answer as many questions as you can.
- The exam has 7 pages and the computer output has 10 pages. Please **check** to make sure that you have all the pages.
- For simplicity, **ALL** tests use the 5% significance level.

Problem A: (30 pts) Answer briefly the following questions.

1. **For problems 1 to 6**, consider the daily log return, in percentages, of the S&P 500 composite index from January 1996 to December 31, 2004 for 2267 data points. Summary statistics of the percentage log returns from SCA and Splus are attached. See Page 1 of the attached output. Is the mean of percentage log returns significantly different from zero? Why?
2. Suppose one invested \$1 dollar on the S&P 500 index at the very beginning of 1996 and held the investment until the end of 2004. What was the value of the investment at the market closing on December 31, 2004?
3. Test the null hypothesis that the skewness of the log returns is zero. Draw your conclusion.
4. Given that the last percentage log return was -0.134 (i.e. $T = \text{December 31, 2004}$), what is the corresponding simple return?

5. Are the log return serially correlated? You may use $Q(10)$ of the series to answer the question.
6. Is there any ARCH effect in the log return series? You may use $Q(12)$ of the squared series to answer the question.
7. Give two empirical features of daily log returns of a financial asset.
8. What is the purpose of studying kurtosis of an asset return series?
9. Describe two applications of studying sample autocorrelation function (ACF) of an asset return series.
10. Describe two methods that can be used to identify the order of an AR model.
11. Consider the AR(1) model $(1 - 0.9B)r_t = 0.2 + a_t$, where $\{a_t\}$ is an independent and identically distributed random variables with mean zero and variance 1.0. What is the half-life of the series?
12. Suppose that the log return r_t of an asset follows the model below:

$$r_t = 0.02 + a_t, \quad a_t = \sigma_t \epsilon_t, \quad \sigma_t^2 = 0.116 + 0.42a_{t-1}^2.$$

Let p_t be the log price of the asset at time t and $p_T(\ell)$ be the ℓ -step ahead forecast of the log price at the forecast origin T . Then, what is the value of $p_T(\ell)$ as ℓ increases?

13. **For problems 13-14**, consider quarterly series of U.S. unit labor cost from 1947 to 2004. The data were seasonally adjusted and obtained from the Federal Reserve Bank of St Louis. Let $x_t = (1 - B)ULC_t$ be the first-differenced series of the data at time t . The model

$$(1 - 0.371B^2)x_t = 0.265 + (1 + 0.171B^4)a_t, \quad \sigma_a = 0.5998,$$

fits the data reasonably well. Under the fitted model, what is the mean of x_t , i.e. $E(x_t) = ?$

14. Does the model imply that there exist business cycles in the unit labor cost? Why?
15. Give two weaknesses of the GARCH-type of models for modeling asset volatility.

Problem B. (20 pts) This problem is concerned with the analysis of quarterly earnings per share of the Procter & Gamble (PG) Company from 1992 to the first quarter of 2003 for 45 data points. The data were obtained from First Call. Log transformation was taken to stabilize the variability of the earnings. Computer output is attached; p.2-6 of output. Due to strong seasonal pattern, which results in models that are close to being non-invertible, we analyze the seasonally differenced series in Splus. Let x_t be the logarithm of quarterly earnings per share and $w_t = (1 - B^4)x_t$. Thus, SCA uses x_t and Splus uses w_t .

1. (5 points) Because ACF of the log earnings shows strong seasonal pattern, the seasonal difference $(1 - B^4)$ is taken. The ACF of the seasonally differenced data indicates no further differencing is necessary. Write down the fitted model for the x_t series (not the differenced w_t).
2. (4 points) Is the AR coefficient of the fitted model statistically significant? Why?
3. (4 points) Is there any serial correlation in the residuals of the fitted model? Use Q(12) of the ACF of residuals to answer the question. [Hint: for a chi-square distribution with m degrees of freedom, the expected value is m .]
4. (4 points) Let $T = 45$ be the forecast origin. What are the 1-step and 2-step ahead forecasts of the fitted model (after taking anti-log transformation)?
5. (3 points) Give an interpretation of the estimated constant 0.0508 of the fitted model for x_t .

Problem C. (20 pts) Consider the daily log returns, in percentages, of the Wal-Mart stock and the S&P 500 index from January 1999 to December 2004 with sample size $T = 1508$. We employ the *market model*:

$$r_t = \alpha + \beta r_{m,t} + e_t,$$

where r_t and $r_{m,t}$ are Wal-Mart stock return and S&P 500 index return, respectively. Splus output is attached; page 6 of output. Answer the following questions.

1. (4 points) Write down the fitted market model.
2. (4 points) The Ljung-Box statistics of the ACF of residuals show some minor serial correlations, but the ACFs are relatively small so we ignore the serial correlations and perform the ARCH effect test. Is there an ARCH effect in the residuals of the fitted market model?
3. (4 points) We employ a GARCH(1,1) model (called “m2” in the output). Write down the fitted model. Comment on the fitted model.
4. (6 points) Further analysis indicates that an EGARCH(2,1) model fits the data better. There are two leverage effect parameters. Are these two effects statistically significant? Why? You may test the effect individually.
5. (2 points) What are the 1-step ahead forecasts for the return and its volatility of Wal-Mart stock at the forecast origin $T = 1508$ using the EGARCH model.

Problem D. (30 pts) Consider the daily log returns, in percentages, of Home Depot stock from January 1995 to December 2004 with 2519 observations. Splus output is attached; page 8 of output. Answer the following questions. The ACFs of the returns are small so that the mean equation consists of a constant term only.

- (5 points) Consider the fitted GARCH(1,1) model. The volatility equation is

$$\sigma_t^2 = 0.042 + 0.049a_{t-1}^2 + 0.944\sigma_{t-1}^2.$$

Let $\eta_t = a_t^2 - \sigma_t^2$. Rewrite the prior volatility equation in an ARMA form for the $\{a_t^2\}$ series.

- (5 points) Write down the fitted EGARCH(1,1) model with leverage effect (both mean and volatility equations and the parameter of the conditional distribution used).
- (4 points) Test the hypotheses $H_o : v = 5$ vs $H_a : v \neq 5$, where v is the degrees of freedom of the conditional Student t distribution. Draw your conclusion. [Hint: you may use the usual t-ratio test.]
- (5 points) To better understand the leverage effect, use the fitted EGARCH(1,1) model to calculate the ratio $\frac{\sigma_t^2(\epsilon=-3)}{\sigma_t^2(\epsilon=3)}$, where ϵ_t denotes the *iid* sequence of the innovations defined in class.
- (4 points) Used the fitted EGARCH model and $T = 2519$ as the forecast origin. What are the 1-step ahead forecasts of log return and volatility?

6. (4 points) Write down the mean equation of the fitted GARCH-M model for the data.
7. (3 points) Based on the GARCH-M model, is the risk premium statistically significant? Why?