Lecture Note of Bus 41202, Spring 2006: Alternative Approaches to Volatility, Mr. Ruey Tsay

Two alternative methods:

- Use of high-frequency financial data
- Use of daily open, high, low and closing prices

Use of High-Frequency Data

Purpose: monthly volatility

Data: Daily returns

Let r_t^m be the t-th month log return.

Let $\{r_{t,i}\}_{i=1}^n$ be the daily log returns within the t-th month.

Using properties of log returns, we have

$$r_t^m = \sum_{i=1}^n r_{t,i}.$$

Assuming that the conditional variance and covariance exist, we have

$$\text{Var}(r_t^m|F_{t-1}) = \sum_{i=1}^n \text{Var}(r_{t,i}|F_{t-1}) + 2\sum_{i<j} \text{Cov}[(r_{t,i}, r_{t,j})|F_{t-1}],$$

where F_{t-1} = the information available at month $t-1$ (inclusive).

Further simplification possible under additional assumptions.

If $\{r_{t,i}\}$ is a white noise series, then

$$\text{Var}(r_t^m|F_{t-1}) = n\text{Var}(r_{t,1}),$$

where $\text{Var}(r_{t,1})$ can be estimated from the daily returns $\{r_{t,i}\}_{i=1}^n$ by

$$\hat{\sigma}^2 = \frac{\sum_{i=1}^n (r_{t,i} - \bar{r}_t)^n}{n-1},$$

where $\bar{r}_t$ is the sample mean of the daily log returns in month t (i.e., $\bar{r}_t = \Sigma_{i=1}^{n} r_{t,i}/n$).

The estimated monthly volatility is then

$$\hat{\sigma}_m^2 = \frac{n}{n-1} \sum_{i=1}^{n} (r_{t,i} - \bar{r}_t)^2.$$

If $\{r_{t,i}\}$ follows an MA(1) model, then

$$\mathrm{Var}(r_t^m | F_{t-1}) = n\mathrm{Var}(r_{t,1}) + 2(n-1)\mathrm{Cov}(r_{t,1}, r_{t,2}),$$

which can be estimated by

$$\hat{\sigma}_m^2 = \frac{n}{n-1} \sum_{i=1}^{n} (r_{t,i} - \bar{r}_t)^2 + 2 \sum_{i=1}^{n-1} (r_{t,i} - \bar{r}_t)(r_{t,i+1} - \bar{r}_t).$$

Advantage: Simple

Weaknesses:

- Model for daily returns $\{r_{t,i}\}$ is unknown.
- Typically, 21 trading days in a month, resulting in a small sample size.

See Figure 1 for an illustration; Ex 3.6 of the text.

Realized integrated volatility

If the sample mean $\bar{r}_t$ is zero, then $\hat{\sigma}_m^2 \approx \Sigma_{i=1}^{n} r_{t,i}^2$.

$\Rightarrow$ Use cumulative sum of squares of daily log returns within a month as an estimate of monthly volatility.

Apply the idea to *intrdaily log returns* and obtain realized integrated volatility.

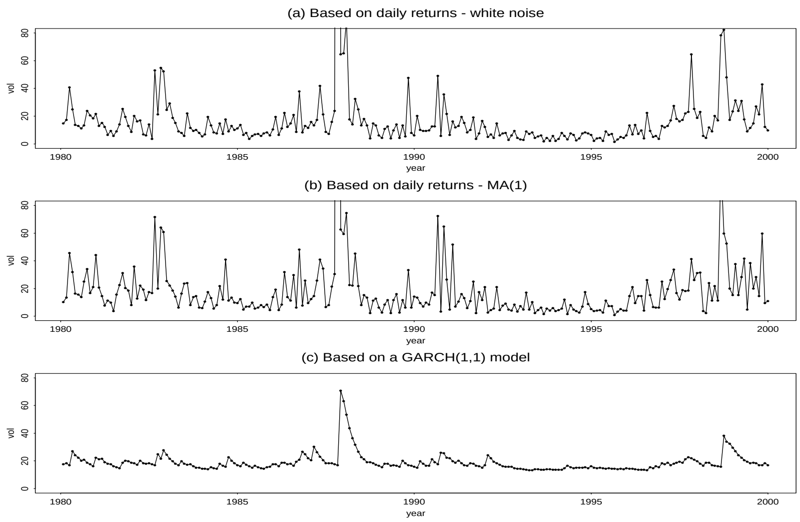

Figure 1: Time plots of estimated monthly volatility for the log returns of S&P 500 index from January 1980 to December 1999: (a) assumes that the daily log returns form a white noise series, (b) assumes that the daily log returns follow an MA(1) model, and (c) uses monthly returns from January 1962 to December 1999 and a GARCH(1,1) model.

Assume daily log return $r_t = \Sigma_{i=1}^{n} r_{t,i}$. The quantity

$$\mathrm{RV}_t = \sum_{i=1}^{n} r_{t,i}^2,$$

is called the *realized* volatility of r_t.

Advantages: simplicity and using intraday information

Weaknesses:

- Effects of market microstructure (noises)
- Overlook overnight return

Use of Daily Open, High, Low and Close Prices

Figure 2 shows a time plot of price versus time for the tth trading day. Define

- C_t = the closing price of the tth trading day;

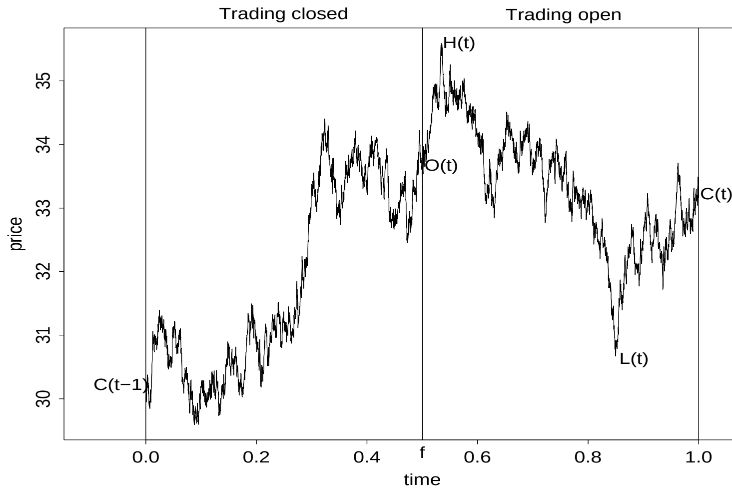

Figure 2: Time plot of price over time: scale for price is arbitrary.

- O_t = the opening price of the tth trading day;
- f = fraction of the day (in interval [0,1]) that trading is closed;
- H_t = the highest price of the tth trading period;
- L_t = the lowest price of the tth trading period;
- F_{t-1} = public information available at time $t-1$.

The conventional variance (or volatility) is $\sigma_t^2 = E[(C_t - C_{t-1})^2 | F_{t-1}]$. Some alternatives:

- $\hat{\sigma}_{0,t}^2 = (C_t - C_{t-1})^2$;
- $\hat{\sigma}_{1,t}^2 = \frac{(O_t - C_{t-1})^2}{2f} + \frac{(C_t - O_t)^2}{2(1-f)}, \quad 0 < f < 1$;
- $\hat{\sigma}_{2,t}^2 = \frac{(H_t - L_t)^2}{4\ln(2)} \approx 0.3607(H_t - L_t)^2$;
- $\hat{\sigma}_{3,t}^2 = 0.17\frac{(O_t - C_{t-1})^2}{f} + 0.83\frac{(H_t - L_t)^2}{(1-f)4\ln(2)}, \quad 0 < f < 1$;

- $\hat{\sigma}^2_{5,t} = 0.5(H_t - L_t)^2 - [2\ln(2) - 1](C_t - O_t)^2$, which is $\approx 0.5(H_t - L_t)^2 - 0.386(C_t - O_t)^2$;
- $\hat{\sigma}^2_{6,t} = 0.12\frac{(O_t - C_{t-1})^2}{f} + 0.88\frac{\hat{\sigma}^2_{5,t}}{1-f}, \quad 0 < f < 1.$

A more precise, but complicated, estimator $\hat{\sigma}^2_{4,t}$ was also considered. But it is close to $\hat{\sigma}^2_{5,t}$.

Defining the efficiency factor of a volatility estimator as

$$\text{Eff}(\hat{\sigma}^2_{i,t}) = \frac{\text{Var}(\hat{\sigma}^2_{0,t})}{\text{Var}(\hat{\sigma}^2_{i,t})},$$

Garman and Klass (1980) found that $\text{Eff}(\hat{\sigma}^2_{i,t})$ is approximately 2, 5.2, 6.2, 7.4 and 8.4 for i = 1,2,3,5 and 6, respectively, for the simple diffusion model entertained.

Define

- $o_t = \ln(O_t) - \ln(C_{t-1})$ be the normalized open;
- $u_t = \ln(H_t) - \ln(O_t)$ be the normalized high;
- $d_t = \ln(L_t) - \ln(O_t)$ be the normalized low;
- $c_t = \ln(C_t) - \ln(O_t)$ be the normalized close.

Suppose that there are n days of data available and the volatility is constant over the period. Yang and Zhang (2000) recommend the estimate

$$\hat{\sigma}^2_{yz} = \hat{\sigma}^2_o + k\hat{\sigma}^2_c + (1-k)\hat{\sigma}^2_{rs}$$

as a robust estimator of the volatility, where

$$\begin{aligned}
\hat{\sigma}_o^2 &= \frac{1}{n-1}\sum_{t=1}^{n}(o_t-\bar{o})^2 \quad \text{with} \quad \bar{o}=\frac{1}{n}\sum_{t=1}^{n}o_t,\\
\hat{\sigma}_c^2 &= \frac{1}{n-1}\sum_{t=1}^{n}(c_t-\bar{c})^2 \quad \text{with} \quad \bar{c}=\frac{1}{n}\sum_{t=1}^{n}c_t,\\
\hat{\sigma}_{rs}^2 &= \frac{1}{n}\sum_{t=1}^{n}[u_t(u_t-c_t)+d_t(d_t-c_t)],\\
k &= \frac{0.34}{1.34+(n+1)/(n-1)}.
\end{aligned}$$

This estimate seems to perform well.

Takeaway

Some alternative approaches to volatility estimation is currently under intensive study. It is rather early to assess the impact of these methods. It is a good idea in general to use more information. However, regulations and institutional effects need to be considered.