AN INTRODUCTION TO
ANALYSIS OF FINANCIAL
DATA WITH R

Ruey S. Tsay
University of Chicago
2.4.3  Goodness of Fit 67
2.4.4  Forecasting 67

2.5  Simple Moving Average Models 69
2.5.1  Properties of MA Models 72
2.5.2  Identifying MA Order 73
2.5.3  Estimation 74
2.5.4  Forecasting Using MA Models 75

2.6  Simple ARMA Models 78
2.6.1  Properties of ARMA(1,1) Models 79
2.6.2  General ARMA Models 80
2.6.3  Identifying ARMA Models 81
2.6.4  Forecasting Using an ARMA Model 84
2.6.5  Three Model Representations for an ARMA Model 84

2.7  Unit-Root Nonstationarity 86
2.7.1  Random Walk 86
2.7.2  Random Walk with Drift 88
2.7.3  Trend-Stationary Time Series 90
2.7.4  General Unit-Root Nonstationary Models 91
2.7.5  Unit-Root Test 91

2.8  Exponential Smoothing 96

2.9  Seasonal Models 98
2.9.1  Seasonal Differencing 99
2.9.2  Multiplicative Seasonal Models 101
2.9.3  Seasonal Dummy Variable 107

2.10 Regression Models with Time Series Errors 110

2.11 Long-Memory Models 117

2.12 Model Comparison and Averaging 120
2.12.1 In-sample Comparison 120
2.12.2 Out-of-sample Comparison 121
2.12.3 Model Averaging 125

Exercises 125
References 127

3  CASE STUDIES OF LINEAR TIME SERIES 128

3.1 Weekly Regular Gasoline Price 129
3.1.1 Pure Time Series Model 130
3.1.2 Use of Crude Oil Prices 133
3.1.3 Use of Lagged Crude Oil Prices 134
3.1.4 Out-of-Sample Predictions 135
3.2 Global Temperature Anomalies 140
3.2.1 Unit-Root Stationarity 141
3.2.2 Trend-Nonstationarity 145
3.2.3 Model Comparison 148
3.2.4 Long-Term Prediction 150
3.2.5 Discussion 153
3.3 US Monthly Unemployment Rates 157
3.3.1 Univariate Time Series Models 157
3.3.2 An Alternative Model 161
3.3.3 Model Comparison 165
3.3.4 Use of Initial Jobless Claims 165
3.3.5 Comparison 173
Exercises 174
References 175

4 ASSET VOLATILITY AND VOLATILITY MODELS 176
4.1 Characteristics of Volatility 177
4.2 Structure of a Model 178
4.3 Model Building 181
4.4 Testing for ARCH Effect 182
4.5 The ARCH Model 185
4.5.1 Properties of ARCH Models 186
4.5.2 Advantages and Weaknesses of ARCH Models 187
4.5.3 Building an ARCH Model 188
4.5.4 Some Examples 193
4.6 The GARCH Model 199
4.6.1 An Illustrative Example 201
4.6.2 Forecasting Evaluation 210
4.6.3 A Two-Pass Estimation Method 210
4.7 The Integrated GARCH Model 211
4.8 The GARCH-M Model 213
4.9 The Exponential Garch Model 215
4.9.1 An Illustrative Example 217
4.9.2 An Alternative Model Form 218
4.9.3 Second Example 218
4.9.4 Forecasting Using an EGARCH Model 220
4.10 The Threshold Garch Model 222
4.11 Asymmetric Power ARCH Models 224
4.12 Nonsymmetric GARCH Model 226
### CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.13 The Stochastic Volatility Model</td>
<td>228</td>
</tr>
<tr>
<td>4.14 Long-Memory Stochastic Volatility Models</td>
<td>230</td>
</tr>
<tr>
<td>4.15 Alternative Approaches</td>
<td>232</td>
</tr>
<tr>
<td>4.15.1 Use of High Frequency Data</td>
<td>232</td>
</tr>
<tr>
<td>4.15.2 Use of Daily Open, High, Low, and Close Prices</td>
<td>235</td>
</tr>
<tr>
<td>Exercises</td>
<td>239</td>
</tr>
<tr>
<td>References</td>
<td>241</td>
</tr>
</tbody>
</table>

5 APPLICATIONS OF VOLATILITY MODELS | 243

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Garch Volatility Term Structure</td>
<td>244</td>
</tr>
<tr>
<td>5.1.1 Term Structure</td>
<td>246</td>
</tr>
<tr>
<td>5.2 Option Pricing and Hedging</td>
<td>248</td>
</tr>
<tr>
<td>5.3 Time-Varying Correlations and Betas</td>
<td>251</td>
</tr>
<tr>
<td>5.3.1 Time-Varying Betas</td>
<td>256</td>
</tr>
<tr>
<td>5.4 Minimum Variance Portfolios</td>
<td>259</td>
</tr>
<tr>
<td>5.5 Prediction</td>
<td>263</td>
</tr>
<tr>
<td>Exercises</td>
<td>271</td>
</tr>
<tr>
<td>References</td>
<td>272</td>
</tr>
</tbody>
</table>

6 HIGH FREQUENCY FINANCIAL DATA | 274

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 Nonsynchronous Trading</td>
<td>275</td>
</tr>
<tr>
<td>6.2 Bid–Ask Spread of Trading Prices</td>
<td>279</td>
</tr>
<tr>
<td>6.3 Empirical Characteristics of Trading Data</td>
<td>282</td>
</tr>
<tr>
<td>6.4 Models for Price Changes</td>
<td>285</td>
</tr>
<tr>
<td>6.4.1 Ordered Probit Model</td>
<td>288</td>
</tr>
<tr>
<td>6.4.2 A Decomposition Model</td>
<td>293</td>
</tr>
<tr>
<td>6.5 Duration Models</td>
<td>298</td>
</tr>
<tr>
<td>6.5.1 Diurnal Component</td>
<td>299</td>
</tr>
<tr>
<td>6.5.2 The ACD Model</td>
<td>301</td>
</tr>
<tr>
<td>6.5.3 Estimation</td>
<td>303</td>
</tr>
<tr>
<td>6.6 Realized Volatility</td>
<td>308</td>
</tr>
<tr>
<td>6.6.1 Handling Microstructure Noises</td>
<td>313</td>
</tr>
<tr>
<td>6.6.2 Discussion</td>
<td>317</td>
</tr>
<tr>
<td>Appendix A: Some Probability Distributions</td>
<td>320</td>
</tr>
<tr>
<td>Appendix B: Hazard Function</td>
<td>323</td>
</tr>
<tr>
<td>Exercises</td>
<td>324</td>
</tr>
<tr>
<td>References</td>
<td>325</td>
</tr>
</tbody>
</table>

7 VALUE AT RISK | 327

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1 Risk Measure and Coherence</td>
<td>328</td>
</tr>
</tbody>
</table>
CONTENTS

7.1.1 Value at Risk (VaR) 329
7.1.2 Expected Shortfall 334
7.2 Remarks on Calculating Risk Measures 336
7.3 Riskmetrics 337
  7.3.1 Discussion 342
  7.3.2 Multiple Positions 343
7.4 An Econometric Approach 345
  7.4.1 Multiple Periods 348
7.5 Quantile Estimation 352
  7.5.1 Quantile and Order Statistics 353
  7.5.2 Quantile Regression 354
7.6 Extreme Value Theory 358
  7.6.1 Review of Extreme Value Theory 358
  7.6.2 Empirical Estimation 361
  7.6.3 Application to Stock Returns 363
7.7 An Extreme Value Approach to Var 368
  7.7.1 Discussion 370
  7.7.2 Multiperiod VaR 371
  7.7.3 Return Level 371
7.8 Peaks Over Thresholds 372
  7.8.1 Statistical Theory 373
  7.8.2 Mean Excess Function 374
  7.8.3 Estimation 376
  7.8.4 An Alternative Parameterization 378
7.9 The Stationary Loss Processes 381
  Exercises 383
  References 384

Index 387