# Modeling Stochastic Volatility with Leverage and Jumps: A 'Smooth' Particle Filtering Approach

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**Abstract**

In this paper we provide a unified methodology in order to conduct likelihood-based inference on the unknown parameters of a general class of discrete-time stochastic volatility models, characterized by both a leverage effect and jumps in returns. Given the non-linear/non-Gaussian state-space form, approximating the likelihood for the parameters is conducted with output generated by the particle filter. Methods are employed to ensure that the approximating likelihood is continuous as a function of the unknown parameters thus enabling the use of Newton-Raphson type maximization algorithms. Our approach is robust and efficient relative to alternative Markov Chain Monte Carlo schemes employed in such contexts. The technique is applied to daily returns data for various stock price indices. We find strong evidence in favour of a leverage effect in all cases. Jumps are an important component in two out of the four series we consider.

**Job Market Paper: First Draft**

## 1 Introduction:

The aim of this paper is to conduct likelihood-based inference on a general class of stochastic volatility models using a smooth particle filter. Stochastic volatility (SV) models have gained considerable interest in theoretical options pricing and financial econometrics literature; in the latter as an alternative to the well documented ARCH/GARCH-type models. The SV framework allows variance to evolve according to some latent stochastic process.

In studying the relationship between volatility and asset price/return, a so-called "leverage effect" refers to the increase in future expected volatility following bad news. The reasoning underlying is that, bad news tends to decrease price thus leading to an increase in debt-to-equity ratio (i.e. financial leverage). The firms are hence riskier and this translates into an increase in expected future volatility as captured by a negative relationship between volatility and price/return. In the finance literature empirical evidence supportive of a leverage effect has been provided by Black (1976) and Christie (1982). The state-space form of SV model that is studied in the bulk of the literature assumes that the measurement and state equation disturbances are uncorrelated, thus ruling out leverage.

Another characteristic of financial data are "jumps" in the returns process. Jumps can basically be described as rare events; large, infrequent movement is returns which are an important feature of financial markets (see Merton (1976)). These have been documented to be important in characterizing the non-Gaussian tail-behaviour of conditional distributions of returns.

The case of SV with leverage has recently been considered by Christofferesen, Jacobs and Minouni (2007). They analyse various specifications of the stochastic volatility model with leverage, e.g. the affine SQR model of Heston (1993) and also various non-affine models. They demonstrate the generality and robustness of the smooth particle filter for purposes of parameter estimation (See Pitt (2003)). We add to the literature by providing a very general methodology for carrying out maximum likelihood estimation of the parameters of an SV model which incorporates both leverage and jumps, within a particle filtering framework.

The plan of this paper is as follow. In Section 2 we describe the standard SV model, the SV with leverage model and the SV with leverage with jumps model along with a brief review of the literature. In Section 3 we first describe how parameter estimation can be carried out using particle filters generally, and then specifically in the context of the SV with leverage and jumps model. We also describe the relevant diagnostic tests. Section 4 provides results for simulation experiments testing estimator performance. Section 5 provides empirical examples using daily returns data for S&P500, FTSE 100, Dow Jones and Nasdaq. Section 6 concludes.

## 2 Volatility Models

### 2·1 *Stochastic Volatility*

The standard stochastic volatility (SV) model with uncorrelated measurement and state equation disturbances is given by,

$$
\begin{aligned}
y_t &= \epsilon_t \exp(h_t/2) \\
h_{t+1} &= \mu(1-\phi) + \phi h_t + \sigma_\eta \eta_t, \quad t = 1, ...., T
\end{aligned}
\qquad (2{\cdot}1)
$$

$$
\begin{pmatrix} \epsilon_t \\ \eta_t \end{pmatrix} \backsim N(0, \Sigma) \text{ and } \Sigma = \begin{pmatrix} 1 & 0 \\ 0 & 1 \end{pmatrix}.
$$

Here $y_t$ is the observed return, $\{h_t\}$ are the unobserved log-volatilities, $\mu$ is the drift in the state equation, $\sigma_\eta^2$ is the volatility of log-volatility and $\phi$ is the persistence parameter. Within the econometrics literature, this model is seen as a generalization Black-Scholes option pricing formula that allows for volatility clustering in returns. There have been different methodologies proposed in the context of parameter estimation for such models. Harvey, Ruiz and Shephard (1994), advocates a Quasi Maximum Likelihood procedures, whereas Jacquier, Polson and Rossi (1994) propose an MCMC method in order to construct a Markov chain that can be used to draw directly from the posterior distributions of the model parameters and unobserved volatilities (see also Shephard and Pitt (1997)). Durbin and Koopman (1997) and Shephard and Pitt (1997) consider importance sampling in order to obtain the likelihood.

### 2·2 *Stochastic Volatility with Leverage*

We can take the standard SV model just described and adapt it in order to incorporate a leverage effect. Given that,

$$
\begin{aligned}
y_t &= \epsilon_t \exp(h_t/2) \\
h_{t+1} &= \mu(1-\phi) + \phi h_t + \sigma_\eta \eta_t, \quad t = 1, ...., T
\end{aligned}
\qquad (2{\cdot}2)
$$

$$
\begin{pmatrix} \epsilon_t \\ \eta_t \end{pmatrix} \backsim N(0, \Sigma)
$$

we now allow for the disturbances to be correlated (see e.g. Heston (1993)) [1]which implies that the covariance matrix has the form,

$$
\Sigma = \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix} \qquad (2{\cdot}3)
$$

[1] Primary contributions in modelling leverage within an ARCH/GARCH framework have been made by Nelson(1991), Glosten, Jagannathan and Runkle (1994) and Engle and Ng (1993). Asymmetric models put forth in this regard, such as TARCH and EGARCH make conditional variance a function of the sign in addition to the size of returns.

Furthermore, noting that the disturbances are conditionally Gaussian, we can write $\eta_t = \rho\ \epsilon_t + \sqrt{(1-\rho^2)}\xi_t$, where $\xi_t \backsim N(0,1)$. The state equation can be reformulated as,

$$h_{t+1} = \mu(1-\phi) + \phi h_t + \sigma_\eta \rho \epsilon_t + \sigma_\eta \sqrt{(1-\rho^2)}\xi_t \tag{2·4}$$

By substituting, $\epsilon_t = y_t \exp(-h_t/2)$ into (2.4), the model adopts the following Gaussian nonlinear state-space form where the parameter $\rho$ measures the leverage effect.

$$\begin{aligned} y_t &= \epsilon_t \exp(h_t/2) \\ h_{t+1} &= \mu(1-\phi) + \phi h_t + \sigma_\eta \rho\ y_t \exp(-h_t/2) + \sigma_\eta \sqrt{(1-\rho^2)}\xi_t \end{aligned} \tag{2·5}$$

Alternatively we could have written $\epsilon_t = \rho\ \eta_t + \sqrt{(1-\rho^2)}\zeta_t$, where $\zeta_t$ is again an independent standard Gaussian. In which case, the SV with leverage model is given by, $y_t|\eta_t \sim N(\rho \exp(h_t/2)\eta_t\ ; (1-\rho^2)\exp(h_t))$ where $h_{t+1} = \mu(1-\phi) + \phi h_t + \sigma_\eta \eta_t$.

Amongst the earliest contributions in modelling leverage in the stochastic volatility literature was made by Harvey and Shephard (1996). The authors extend the Quasi Maximum Likelihood (QML) technique used in parameter estimation in standard SV models (see Harvey et al (1994)) to handle correlation between disturbances. Recognizing that information on correlation is lost as result of squaring the observations in the process of linearizing the model; the technique developed by Harvey and Shephard (1996) allows the information to be recovered by carrying out inference conditional on the signs of observations, i.e. by relating these to filtered volatilities. When applied to daily CRSP (Centre for Research in Security Prices) and SP30 (Standard and Poors), the authors find evidence of a leverage effect. A problem with the QML approach is that log $\epsilon_t^2$ is a poor approximated by the normal distribution yielding a quasi-likelihood estimator with poor finite sample properties. .

In order to correct for this Kim, Shephard and Chib (1998) develop an alternative approach for analysis of SV models employing MCMC techniques to provide a likelihood-based framework. The Kim et al. approach revolves around approximating $\log \epsilon_t^2$ by a mixture of seven normal densities which in turn facilitates the state-space representation associated with the Kalman Filter. Omori, Chib, Shephard and Nakajima (2007) extend this approach to handle leverage in SV models. They apply this approach to fit a model to daily returns of TOPIX and find evidence of leverage.

In Jacquier, Polson and Rossi (2004) build upon the MCMC approach put forth in JPR (1994) to conduct inference in an extended SV model, i.e. to allow for both leverage effect but also fat-tails in the measurement equation disturbances, where evidence supportive of the latter has been uncovered by Gallant et al. (1998) and Gweke (1992), amongst others[2]. Application of their model to weekly CRSP, daily S&P 500 data as well as a few daily exchange rate series' yields evidence supportive of the extensions.

Meyer and Yu (2000) also employ a Gibbs sampling approach to perform posterior computations on an asymmetric SV model and find evidence of a leverage effect in daily Pound/Dollar exchange rate series. Yu (2005) documents the two main specifications for modelling leverage in the literature, and notes an important difference between the two which becomes apparent when the two specifications are written in a Gaussian nonlinear state-space form. Whereas, Kim et al. (1998) and Omori et al. (2007) work with the Euler-Maruyuma approximation for the continuous time asymmetric SV model. Yu notes that the timing of the variables makes it difficult to interpret the leverage effect in the Jacquier et al.(2004) specification given we can not obtain the relationship between $E(h_{t+1}|y_t)$ and $y_t$ in analytical form. For further discussion,

[2] Jacquier et al assume $\epsilon_t = \sqrt{\lambda_t} z_t$ where $z_t$ is a standard normal variate and $\lambda_t$ is distributed as i.i.d. inverse gamma, whereby the marginal distribution is student-t.

The fat-tailed extension is also explored in Harvey, Ruiz and Shephard (1994) and Kim et al (1998).

we refer the reader to Yu (2005, pg 6). He concludes that from an empirical stand point having tested both specifications on daily S&P 500 and CRSP data, that the specification of the basic model as used in Shephard et al. (1996, 1998, 2004) is preferred.

### 2·3 *Stochastic Volatility with Leverage and Jumps*

The SV model with leverage which allows for jumps in the returns process can be written as

$$\begin{aligned} y_t &= \epsilon_t \exp(h_t/2) + J_t \varpi_t \\ h_{t+1} &= \mu(1-\phi) + \phi h_t + \sigma_\eta \eta_t, \quad t = 1, ...., T \end{aligned} \tag{2·6}$$

where,

$$\begin{pmatrix} \epsilon_t \\ \eta_t \end{pmatrix} \backsim N(0, \Sigma) \text{ and } \Sigma = \begin{pmatrix} 1 & \rho \\ \rho & 1 \end{pmatrix}$$

$J_t = j$ is the time-$t$ jump arrival where $j = 0, 1$ is a Bernoulli counter with intensity $p$. $\varpi_t \backsim N(0, \sigma_J^2)$ dictates the jump size. The leverage effect is incorporated as before noting $f(\eta_t|\epsilon_t) = N(\rho\epsilon_t; 1-\rho^2)$.

There have been a several recent contributions in estimating SV models with jumps, albeit mostly within a 'Bayesian' framework. Amongst the earliest are Bates(1996) and Bakshi, Cao and Chen (1997), which deal with models involving jumps in returns and parameter estimation carried out via a non-linear generalized least squares/Kalman filtration methodology. This is extended in Bates(2000) which employs a the same estimation methodology for two-factor SV models with jumps in returns. Eraker, Johannes and Polson (2003) provide an MCMC strategy for conducting inference on stochastic volatility models incorporating jumps in returns and also in the volatility process,(initially introduced by Duffie et al.(2000)). They conduct empirical analysis on S&P500 and Nasdaq 100 index returns and find strong evidence of jumps in volatility. Jumps have been documented to be important in characterizing the non-Gaussian tail-behaviour of conditional returns distributions. In order to characterize this feature of returns, the approach of estimating SV models with student-t errors have been employed by, for example, Chib, Nedari and Shephard (2002) and Sandmann and Koopman (1998). For the same purposes, an alternative approach employed by Durham (2008) is to use a mixture of Gaussians for the measurement equation disturbance. Their paper uses simulated maximum likelihood approach to conduct inference.

## 3 Particle Filter Estimation

This paper is concerned with evaluation of state-space models via particle filter. We model time series $\{y_t, t = 1, ....., T\}$ using state space framework with the state $\{h_t\}$ assumed to be Markovian. The problem of state estimation within a filtering 'context' can be formulated as the evaluation of the density, $f(h_t|Y_{t,})$, $t = 1, ..., T$ where $Y_t = (y_1, ....., y_t)$ is contemporaneously available information. In linear Gaussian state space models the density is Gaussian at every iteration of the filter and the Kalman filter relations propagate and update the mean and covariance of the distribution. In nonlinear and/or Non-Gaussian state space models we can not obtain a closed form expression for the required conditional density and particle filters are employed in order to recursively generate (an approximation to) the state density.

There is has been considerable work done on the development of simulation based methods to perform filtering nonlinear Gaussian state space models. Leading contributions to the literature are by Gordon, Salmond and Smith (1993), Kitagawa (1996), Isard and Blake(1996), Muller(1991) and Shephard and Pitt (1997), Pitt and Shephard (1999) and reviewed by Doucet et al. (2000). Most of the literature revolves around on-line filtering of the states with very little work done in the parameter estimation within this framework; see Pitt (2003).

We begin by providing a description of a particle filter, as put forth in the seminal paper by Gordon et al. (1993) and then describe how this framework can be adapted for parameter estimation.

### 3·1 *Preliminaries*

We assume a known 'measurement' density $f(y_t|h_t)$ and the ability to simulate from the 'transition' density $f(h_{t+1}|h_t)$. Particle filters involve using simulation to carry out on-line filtering, i.e. to learn about the state given contemporaneously available information. Suppose we have a set of random samples, 'particles', $h_t^1, ....., h_t^M$ with associated discrete probability masses $\lambda_t^1, ...., \lambda_t^M$, drawn from the density $f(h_t|Y_t)$. The principle of Bayesian updating implies that the density of the state conditional on all available information can be constructed by combining a prior with a likelihood; recursive implementation of which forms the basis for particle filtering. The particle filter is hence an algorithm to propagate and update these particles in order to obtain a sample which is approximately distributed as $f(h_{t+1}|Y_{t+1})$; the true filtering density,

$$f(h_{t+1}|Y_{t+1}) \propto f(y_{t+1}|h_{t+1}) \int f(h_{t+1}|h_t)dF(h_t|Y_t) \tag{3·1}$$

*Prediction step* :Passing these particles, $\left\{h_t^i\right\}, i = 1, ..., M$, through the transition density will yield the prior 'empirical' density of the state i.e. $h_{t+1}^i \backsim f(h_{t+1}|h_t^i)$. The state evolution is initialized by some density $f(h_0)$.

*Updating step* :The prior is combined the likelihood $f(y_{t+1}|h_{t+1})$ in order to update. This step relies on a result by Smith and Gelfand (1992) which states that Bayes theorem can be implemented as a weighted bootstrap, (see also Rubin (1987)).

**Theorem 3.1** *Following Smith and Gelfand (1992), suppose that our required density is proportional to $L(x)G(x)$, for example, and that we have samples $x^i \backsim G(x), i = 1, ...., M$. If $L(x)$ is a known function then, the theorem states that the discrete distribution over $x^i$ with probability mass $L(x^i)/\Sigma L(x^i)$ on $x^i$ tends in distribution to the required density as $M \to \infty$.*

This is the basis for the updating step, in that on receiving the measurement $y_{t+1}$, we evaluate the likelihood at each prior sample $h_{t+1}^i$.We proceed to calculate *normalized* weights,

$$\lambda_{t+1}^i = \frac{f(y_{t+1}|h_{t+1}^i)}{\sum_{i=1}^M f(y_{t+1}|h_{t+1}^i)}$$

and hence we obtain a discrete distribution over $h_{t+1}^i$ with probability mass $\lambda_{t+1}^i, i = 1, ...., M$. The weighted bootstrap (Rubin (1998) refers to this as SIR; Sampling Importance Resampling) involves resampling $h_{t+1}^i$, $N$ times using weights $\lambda_{t+1}^i$ will yield an approximation of the desired posterior density, $f(h_{t+1}|Y_{t+1})$. This prediction-updating procedure is iterated through the data to in order to produce empirical filtering densities,

$$\widehat{f}(h_{t+1}|Y_{t+1}) \propto f(y_{t+1}|h_{t+1}) \sum_{i=1}^M \lambda_t^i f(h_{t+1}|h_{t+1}^i) \tag{3·2}$$

for each time step (see Gordon, Salmond, and Smith (1993)). It is worth noting that we need to know $f(y_{t+1}|h_{t+1})$ only up to a proportionality. Next we look at how this SIR particle filter framework can be exploiting and modified in order to carry out likelihood evaluation for parameter estimation.

### 3·2 *Likelihood Evaluation*

We now assume the model is indexed, possibly in both state and measurement equations, by a vector of fixed parameters, $\theta$. In order to carry out parameter estimation we need to estimate the likelihood function, which in log terms is given by;

$$\log L(\theta) = \log f(y_{1,....,}.y_T|\theta)$$

$$= \sum_{t=1}^{T} \log f(y_{t+1}|\theta; Y_t)$$

via prediction decomposition (e.g. see Harvey(1993)). In order to estimate this function, we exploit the relationship,

$$f(y_{t+1}|\theta; Y_t) = \int f(y_{t+1}|h_{t+1};\theta) f(h_{t+1}|Y_t;\theta) dh_{t+1} \tag{3·3}$$

The particle filter delivers samples from $f(h_t|Y_t;\theta)$, and we can sample from the transition density $f(h_{t+1}|h_t;\theta)$ in order to estimate the integral. The resampling step is crucial. We have weights (discrete probabilities), $f(y_{t+1}|h^i_{t+1})$ associated with proposals $h^i_{t+1}, i = 1, ..., M$. The SIR technique as employed in the Gordon et al. (1993) algorithm works by replicating those particles with large weights and removes those with negligible weights. This allows the resultant particles to be more concentrated in domains of higher posterior probability.

As noted in Pitt (2003), if particles $h^i_t, i = 1, ..., M$ drawn from the filtering density $f(h_t|Y_t;\theta)$ are slightly altered then the proposal samples, $h^i_{t+1}, i = 1, ..., M$ will also alter only slightly, as in the case of a highly persistent transition function, for example. But on the other hand, the discrete probabilities associated with these proposals will change as well, the implication of which is that the even if we generate the same uniforms at each time step, the resampled particles will not be close. Hence, the conventional weighted bootstrap methods are not '*smooth*', in the sense of yielding an estimator of the likelihood which is not *continuous* as a function of the parameters $\theta$. This has huge implications for using gradient based maximization and computation of standard errors using conventional techniques since the likelihood surface will not be smooth. (See also Liu and West (2000) and Polson, Stroud and Muller (2008)).

### 3·3 *Smooth Resampling*

This procedure works by replacing the discrete cumulative distribution function (cdf) given by one that is smooth, thus providing particles from the filter which are smooth as a function of $\theta$. Let us begin by assuming that we have a $1 \times M$ vector of elements $h^i$ sorted in ascending order, with associated discrete probabilities, $\lambda^i$. The time subscript is suppressed for notational convenience. The discrete cdf used in SIR is given by $\widehat{G}(h) = \sum_{i=1}^{M} \lambda^i I(h < h^i)$ approximates the true cdf $G(h)$. In order to obtain a continuous interpolation for, $\widehat{G}(h)$ we proceed as follows.

We construct partitions of the sample space for $h$ by defining region.$i$, $S_i = [h^i, h^{i+1}]$, $i = 1, ..., M-1$. Next we assign $\Pr(i)=\frac{1}{2}(\lambda^i + \lambda^{i+1})$, $\Pr(1)=\frac{1}{2}(2\lambda^1 + \lambda^2)$ and $\Pr(M-1)=\frac{1}{2}(\lambda^{M-1} + 2\lambda^M)$, such that these probabilities sum to unity. Within each region we have conditional densities given by,

$$\begin{aligned} g(h|i) &= \frac{1}{h^i + h^{i+1}},\ h \in S_i,\ i = 2, ...., M-2 \\ g(h|1) &= \left\{ \begin{array}{c} \frac{\lambda^1}{2\lambda^1+\lambda^2},\ \text{when } h = h^1 \\ \frac{\lambda^1+\lambda^2}{2\lambda^1+\lambda^2}\frac{1}{(h^2-h^1)},\ \text{when } h \in S_1 \end{array} \right\} \end{aligned}$$

$$g(h|M-1) \quad = \quad \left\{ \begin{array}{c} \frac{\lambda^M}{\lambda^{M-1}+2\lambda^M}, \text{ when } h = h^M \\ \frac{\lambda^1+\lambda^2}{\lambda^1+2\lambda^2}\frac{1}{(h^M-h^{M-1})}, \text{ when } h \in S_{M-1} \end{array} \right\}$$

By following the above procedure we attain a continuous interpolation for the discrete cdf , and this 'continuous' cdf $\widetilde{G}(h)$ will pass through the mid-point of each step. As $M \rightarrow \infty$, $\widehat{G}(h) \rightarrow \widetilde{G}(h) \rightharpoonup G(h)$. We sample from the continuous density by selecting region $i$ with $\Pr(i)$ and sample from $g(h|i)$. We detail the resampling procedure below.

Once we obtain the continuous empirical cdf we the task is to implement smooth sampling, which will yield an ordered sample of particles, say, $h^{*1}, ....., h^{*M}$ .We use a stratified sampling scheme for purposes of this paper. Stratification reduces *sample impoverishment* and has been suggested by Kitagawa (1996), Carpenter et al. (1999) and Liu and Chen (1998). In an extreme case, after a certain amount of updates, the particle system may collapse to a single point resulting in a poor approximation to the required density[3]. In contrast to SIR which involves generating uniforms $u_1, ...., u_M \backsim UID(0,1)$, stratified sampling will require us to generate a single random variate $u \backsim UID(0,1)$ from which we can propagate sorted uniforms given by $u_j = (j-1)/M + u/M$, $j = 1, ...., M$.

If $\Pr(i) = \widetilde{\lambda}^i = \frac{1}{2}(\lambda^i + \lambda^{i+1})$, then the cumulative probability is given by $\overline{\lambda}^i = \sum_{s=1}^{i} \widetilde{\lambda}^s$, where $i = 1, ..., M-1$. Next we define the interval corresponding to region $i$ as,

$$\left( \sum_{s=1}^{i-1} \widetilde{\lambda}^s \, , \sum_{s=1}^{i} \widetilde{\lambda}^s \right]$$

and the uniform(s) falling within the interval by,

$$u_j^* = \frac{u_j - (\sum_{s=1}^{i-1} \widetilde{\lambda}^s)}{\widetilde{\lambda}^i}$$

We can now sample conditional upon that region, i.e. from $g(h|i)$ using the corresponding uniform(s) $u_j^*$. Since $g(h|i)$ is uniform, the sampled particles can be backed-out as[4],

$$h^{*i} = (h^{i+1} - h^i) \times u_j^* + h^i \tag{3·4}$$

### 3·4 *Implementation of Stochastic Volatility with Leverage and Jumps Model*

Since the returns process can jump with a certain probability, this necessitates simulating $\epsilon_t$ from the mixture density $f(\epsilon_t|h_t, y_t)$ which then feeds into the state equation, $h_{t+1} = \mu(1-\phi) + \phi h_t + \sigma_\eta \rho \epsilon_t + \sigma_\eta \sqrt{(1-\rho^2)}\xi_t$. Here,

$$f(\epsilon_t|h_t, y_t) = \sum_{j=0}^{1} f(\epsilon_t|J_t = j; h_t, y_t) \Pr(J_t = j|h_t, y_t) \tag{3·5}$$

where $\Pr(J_t = 1|h_t, y_t)$ is the conditional probability of a jump. We establish that the functional form is given by,

[3]In the less extreme case, a few particles may survive, but as noted by Carpenter et al (1999), the high degree of internal correlation yields summary statistics reflective of a substantially smaller sample. In order to compensate a very large number of particle will need to be generated.

[4]An algorithm for smooth resampling is provided in Appendix A.

$$f(\epsilon_t|h_t, y_t) = \delta(\frac{y_t}{\exp(h_t/2)}) \Pr(J_t = 0|h_t, y_t) + N(\upsilon_{\epsilon_1}, \sigma^2_{\epsilon_1}). \Pr(J_t = 1|h_t, y_t).$$

The derivation of this density and computation of moments $\upsilon_{\epsilon_1}$ and $\sigma^2_{\epsilon_1}$ is detailed in the Appendix A. It is evident from the description of the components of $f(\epsilon_t|h_t, y_t)$ that this density with be characterized by mass at a unique point, $y_t \exp(-h_t/2)$, but continuous elsewhere, and governed by the moments of $N(\upsilon_{\epsilon_1}, \sigma^2_{\epsilon_1})$. This associated distribution function, $F(\epsilon_t|h_t, y_t)$ can thus be split into three regions with boundaries delineated as follows[5].

- $\Pr(J_t = 1|h_t, y_t). \int_{-\infty}^{\epsilon_t} f(\epsilon_t|J_t = 1, h_t, y_t)d\epsilon_t$ *for* $\epsilon_t < y_t \exp(-h_t/2)$
- $\Pr(J_t = 1|h_t, y_t). \int_{-\infty}^{y_t \exp(-h_t/2)} f(\epsilon_t|J_t = 1, h_t, y_t)d\epsilon_t + (1 - \Pr(J_t = 1|h_t, y_t))$ *for* $\epsilon_t = y_t \exp(-h_t/2)$
- $\Pr(J_t = 1|h_t, y_t). \int_{-\infty}^{y_t \exp(-h_t/2)} f(\epsilon_t|J_t = 1, h_t, y_t)d\epsilon_t + (1 - \Pr(J_t = 1|h_t, y_t))$

  $+ \Pr(J_t = 1|h_t, y_t). \int_{\epsilon_t}^{+\infty} f(\epsilon_t|J_t = 1, h_t, y_t)d\epsilon_t$ *for* $\epsilon_t > y_t \exp(-h_t/2)$

In the context of the particle filter we require samples $\epsilon^i_t \backsim f(\epsilon^i_t|h^i_t, y_t)$, $i = 1, ....., M$. Once these samples are obtained we can evaluate the integral $f(\eta_t|y_t,h_t) = \int f(\eta_t|\epsilon_t)f(\epsilon_t|y_t,h_t)d\epsilon_t$ where $f(\eta_t|\epsilon_t) = \rho\ \epsilon_t + \sqrt{(1-\rho^2)}\xi_t$, and $\xi_t \backsim N(0, 1)$. The method for obtaining these sample is provided in the Appendix B. The states are initialized using the unconditional density $f(h_1) \backsim N(\mu, \frac{\sigma^2_\eta}{1-\phi^2})$. The non-normalized weights for the resampling step are of the form,

$$\begin{aligned} f(y_{t+1}|h^i_{t+1}, \sigma^2_J) &= \left( \frac{1}{\sqrt{2\pi \exp(h^i_{t+1})}} \exp\left( -\frac{1}{2} \frac{y^2_{t+1}}{\exp(h^i_{t+1})} \right) \right) (1-p) \\ &+ \left( \frac{1}{\sqrt{2\pi(\exp(h^i_{t+1}) + \sigma^2_J}} \exp\left( -\frac{1}{2} \frac{y^2_{t+1}}{\exp(h^i_{t+1}) + \sigma^2_J} \right) \right) (p) \end{aligned} \qquad (3{\cdot}6)$$

for $i = 1, ..., M$. Once we are able to resample in a *smooth* manner as described in Section 3.3, the log-likelihood function associated with the particle filtering scheme becomes straight forward to construct[6]. We record at each time step the Monte Carlo estimator of the empirical prediction density, i.e.

$$\widehat{l}_{t+1} = \log \widehat{f}(y_{t+1}|\theta; Y_t) = \frac{1}{M} \sum_{i=1}^{M} \log f(y_{t+1}|h^i_{t+1}, \sigma^2_J) \qquad (3{\cdot}7)$$

After running through time we calculate,

$$\log \widehat{L}(\theta) = \sum_{t=1}^{T} \widehat{l}_{t+1} \qquad (3{\cdot}8)$$

As long as the transition and measurement densities are continuous in $h_{t+1}$ and $\theta$, we can sufficiently ensure $\log \widehat{L}(\theta)$ will be continuous in $\theta$. Within the implementation framework set out for the SV with leverage and jumps model by setting parameters, $\sigma^2_J$ and $p$ to zero we

[5] The continuous component is indicative of fact that identifying whether a jump has actually occured is confounded by the presence of noise.

[6] See Pitt (2002) for a detailed discussion of other possible schemes.

recover the SV with leverage specification. Furthermore, setting $\rho = \sigma_J^2 = p = 0$ we recover the standard SV specification.

Our implementation of the particle filter in the context of the SV with leverage and jumps also allows us to estimate the probability of a jump, i.e. $\Pr(J_t = 1|Y_{t-1}) = \int \Pr(J_t = 1|y_t; h_t) f(h_t|Y_{t-1}) dh_t$ straightforwardly by,

$$\widehat{\Pr}(J_t = 1|Y_{t-1}) = \frac{1}{M}\sum_{i=1}^{M} \Pr(J_t = 1|y_t, h_t^i). \tag{3·9}$$

## 3·5 *Diagnostics*

Standard approaches involved in specification analysis of time-series models is to investigate the properties of residuals in terms of their dynamic structure and unconditional distributions. This is infeasible given the latent dimension of the model under consideration. Alternatively therefore, in order to test the hypothesis that the prior and model are true, we require the distribution function,

$$\mathrm{u}_t = F(y_t|Y_{t-1}) = \int F(y_t|h_t) f(h_t|Y_{t-1}) dh_t \tag{3·10}$$

In the specific case of SV with leverage and jumps, the distribution function can be estimated by,

$$\widehat{\mathrm{u}}_t = \left(\frac{1}{M}\sum_{i=1}^{M} \Phi(\frac{y_t}{\exp(h_t^i/2)})\right)(1-p) + \left(\frac{1}{M}\sum_{i=1}^{M} \Phi(\frac{y_t}{\sqrt{\exp(h_t^i) + \sigma_J^2}})\right)(p) \tag{3·11}$$

where $\Phi(.)$ denotes the standard normal distribution function .If the prior and model were true, then the estimated distribution functions, $\widehat{\mathrm{u}}_t \backsim UID(0,1)$, for $t = 1, ...., T$, as $M \to \infty$ (See Rosenblatt (1952)).

# 4 Simulation Experiments

## 4·1 *Stochastic Volatility with Leverage*

After running the smooth particle filter we maximize the estimated log-likelihood function with respect to $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$. We now investigate the performance of our maximum likelihood estimator for the SV with leverage case. First we simulate two time series of length 1000 and 2000 with parameter values $\theta = (\mu, \phi, \sigma_\eta^2, \rho) = (0.5, 0.975, 0.02, -0.8)$ and run the smooth particle filter 50 times using different random number seeds for the smooth particle filter for each run. The resulting estimated log-likelihoods for each run are then maximized estimates with respect to $\theta$. This is carried out for $M$ =300 and 600. The average of 50 maximum likelihood estimates ($\overline{ML_s}$)and 50 variance estimates ($\overline{Var}$) along with the variance for the sample of maximum likelihood estimates ($Var(ML_s)$),are reported for each case considered. The variance estimates are are obtained by taking the negative of the inverse of the Hessian matrix for $\theta$ at the mode. Results are given in Table 1.

It is informative to consider the ratio of the variance of the maximum likelihood estimates in Table 1 to the variance of each parameter with respect to the data. These are, for $M = 300, T = 1000$ : (0.0281, 0.0124, 0.0095, 0.0497); $M = 600, T = 1000$:(0.0078, 0.0046, 0.0062, 0.0192) and $M = 300, T = 2000$ : ( 0.0171, 0.0142, 0.0094, 0.0223) and $M = 600, T = 2000$ :( 0.00757,

| M=300, T=1000 | | | | M=300, T=2000 | | | |
|---|---|---|---|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ | | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5447 | 0.6491 | 0.01832 | $\mu$ | 0.4087 | 0.3848 | 0.0066 |
| $\phi$ | 0.9770 | 0.0033 | 0.00004 | $\phi$ | 0.9766 | 0.0022 | 0.00003 |
| $\sigma_\eta^2$ | 0.0143 | 0.0015 | 0.00002 | $\sigma_\eta^2$ | 0.0153 | 0.0010 | 0.000009 |
| $\rho$ | -0.7938 | 0.1867 | 0.00931 | $\rho$ | -0.8166 | 0.1106 | 0.00247 |
| M=600, T=1000 | | | | M=600, T=2000 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ | | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5461 | 0.6792 | 0.00534 | $\mu$ | 0.4095 | 0.4181 | 0.00322 |
| $\phi$ | 0.9767 | 0.0034 | 0.000016 | $\phi$ | 0.9765 | 0.0023 | 0.000012 |
| $\sigma_\eta^2$ | 0.0144 | 0.0016 | 0.0000098 | $\sigma_\eta^2$ | 0.0154 | 0.0011 | 0.000004 |
| $\rho$ | -0.7946 | 0.1868 | 0.00392 | $\rho$ | -0.8175 | 0.1178 | 0.00150 |

Table 1: *Fixed dataset. Performance of the smooth particle filter for the stochastic volatility with leverage model for two cases, T=1000 and 2000; considering M=300, 600 for each case.*

| M=200 | | | |
|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5107 | 1.3207 | 2.3506 |
| $\phi$ | 0.9726 | 0.0081 | 0.0073 |
| $\sigma_\eta^2$ | 0.0206 | 0.0043 | 0.0045 |
| $\rho$ | -0.7859 | 0.80467 | 0.6067 |
| M=500 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5154 | 1.3499 | 2.3482 |
| $\phi$ | 0.9728 | 0.0087 | 0.0057 |
| $\sigma_\eta^2$ | 0.0204 | 0.0042 | 0.0044 |
| $\rho$ | -0.7895 | 0.8008 | 0.5722 |
| M=3000 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5164 | 1.3451 | 2.353 |
| $\phi$ | 0.9728 | 0.0066 | 0.0053 |
| $\sigma_\eta^2$ | 0.0205 | 0.0034 | 0.0040 |
| $\rho$ | -0.7911 | 0.7877 | 0.5627 |

Table 2: *50 different datasets. Analysis of the maximum likelihood estimator for stochastic volatility with leverage model for cases, M=200, 500 and 3000. T=1000 in all cases.*

0.00489, 0.00393, 0.01186). There is a substantial reduction in these ratios as $M$ increase which is illustrated by kernel density estimates in Appendix C (Figs. 1 and 2).

Next, we generated 50 different time series each of length $T = 1000$, with fixed values of parameters $\theta = (\mu, \phi, \sigma_\eta^2, \rho) = (0.5, 0.975, 0.02, -0.8)$. Keeping the random number seed fixed we run the smooth particle filter in turn for each of the time series and maximize the estimated log-likelihood with respect to $\theta$ for each run. The average of 50 maximum likelihood estimates ($\overline{ML_s}$)and 50 variance estimates ($\overline{Var}$) along with mean squared errors ($Var(ML_s)$) are reported in Table 2 for each of three cases considered. The histograms in the Appendix C (Figs. 3,4 and 5) indicate that the distribution of the parameters is not too far from normality. In all cases we find that biases are not significantly different from zero[7] and the true values of the parameters lie well within their 95% confidence limits. The procedure does not throw up any outliers and we have no problem with convergence to the mode.

### 4·2 *Stochastic Volatility with Leverage and Jumps*

Now we investigate parameter estimation in the case of SV with leverage and jumps model. We run the smooth particle filter and maximize the estimated log-likelihood with respect to the parameter vector $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$.We again begin by simulating two time series of length 1000 and 2000,setting parameters $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p) = (0.5, 0.975, 0.02, -0.8, 10, 0.10)$.

| M=300, T=1000 | | | | M=300, T=2000 | | | |
|---|---|---|---|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ | | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5595 | 3.0020 | 0.06023 | $\mu$ | 0.4770 | 1.2653 | 0.03098 |
| $\phi$ | 0.9648 | 0.0103 | 0.00021 | $\phi$ | 0.9680 | 0.00522 | 0.00013 |
| $\sigma_\eta^2$ | 0.0458 | 0.0186 | 0.00020 | $\sigma_\eta^2$ | 0.0338 | 0.00661 | 0.000123 |
| $\rho$ | -0.7072 | 1.0326 | 0.01629 | $\rho$ | -0.7419 | 0.7275 | 0.01352 |
| $\sigma_J^2$ | 10.176 | 813.98 | 6.9054 | $\sigma_J^2$ | 7.7568 | 207.71 | 1.1959 |
| $p$ | 0.0769 | 0.0754 | 0.00120 | $p$ | 0.11263 | 0.0659 | 0.00079 |
| M=600, T=1000 | | | | M=600, T=2000 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ | | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.5650 | 2.9623 | 0.03853 | $\mu$ | 0.4830 | 1.2760 | 0.01097 |
| $\phi$ | 0.9648 | 0.0103 | 0.00013 | $\phi$ | 0.9681 | 0.0052 | 0.00005 |
| $\sigma_\eta^2$ | 0.0461 | 0.0192 | 0.00012 | $\sigma_\eta^2$ | 0.0338 | 0.0067 | 0.00008 |
| $\rho$ | -0.7026 | 1.0333 | 0.00665 | $\rho$ | -0.7394 | 0.7425 | 0.00622 |
| $\sigma_J^2$ | 10.174 | 823.13 | 2.5625 | $\sigma_J^2$ | 7.7929 | 216.21 | 0.87021 |
| $p$ | 0.0764 | 0.0771 | 0.00045 | $p$ | 0.1115 | 0.0667 | 0.00047 |

Table 3: *Fixed dataset. Performance of the smooth particle filter for the stochastic volatility model with leverage and jumps for two cases, T=1000 and 2000; considering M=300, 600 for each case.*

The smooth particle filter is run 50 times using a different random number seed but keeping the dataset fixed. The estimated log-likelihood is maximized with respect to $\theta$ for each run. In Table 3, the average of the resulting 50 maximum likelihood estimates ($\overline{ML_s}$)and 50 variance estimates ($\overline{Var}$), along with the variance for the sample of maximum likelihood estimates ($Var(ML_s)$),are reported for different cases considered. The variance covariance matrix is estimated using the variance of the scores, i.e. the outer product of gradients (OPG) estimator.

[7] $E(\widehat{\theta}) - \theta = Bias \backsim N(0, \frac{MSE}{50})$ where the mean squared error ($MSE$) is $E[(\widehat{\theta} - \theta)^2]$ .

We examine the ratio of the variance of the maximum likelihood estimates to the variance of each parameter with respect to the data. These are, for $M = 300, T = 1000$ : (0.0201, 0.0209, 0.0108, 0.01578, 0.0085, 0.0159); $M = 600, T = 1000$:(0.0131, 0.0132, 0.0062, 0.0064, 0.0032, 0.0059); $M = 300, T = 2000$ : (0.0245, 0.0251, 0.0186, 0.0186, 0.0058, 0.0121) and $M = 600, T = 2000$ : (0.0086, 0.0095, 0.0121, 0.0084, 0.0040, 0.0070). These ratios suggest that the variance of the simulated estimates is small in comparison to the variance induced by the data. The reduction in these ratios as $M$ increases is illustrated by kernel density estimates in Appendix C (Figs. 6 and 7).

Next, we generate 50 different time series each of length $T = 1000$, setting values of parameters $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p) = (0.5, 0.975, 0.02, -0.8, 10, 0.10)$. Keeping the random number seed fixed we run the smooth particle filter in turn for each of the time series and maximize the estimated log-likelihood with respect to $\theta$ for each run. The average of 50 maximum likelihood estimates ($\overline{ML_s}$) and 50 variance estimates ($\overline{Var}$) along with mean squared errors ($Var(ML_s)$) are reported in Table 4, for each of three cases considered. Variance estimates are computed using the OPG estimator for the variance covariance matrix.

| M=200 | | | |
|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.49151 | 2.0908 | 1.7937 |
| $\phi$ | 0.97101 | 0.013972 | 0.018073 |
| $\sigma_\eta^2$ | 0.022110 | 0.0086659 | 0.0071614 |
| $\rho$ | -0.84684 | 1.3943 | 1.1835 |
| $\sigma_J^2$ | 9.8470 | 954.42 | 621.81 |
| $p$ | 0.10458 | 0.13002 | 0.069915 |
| M=500 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.50006 | 2.2045 | 1.5714 |
| $\phi$ | 0.97186 | 0.015317 | 0.010667 |
| $\sigma_\eta^2$ | 0.022389 | 0.0097163 | 0.0064737 |
| $\rho$ | 0.83714 | 1.4793 | 1.1215 |
| $\sigma_J^2$ | 9.8013 | 1018.7 | 637.60 |
| $p$ | 0.10358 | 0.13667 | 0.063125 |
| M=900 | | | |
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.49720 | 2.1724 | 1.6280 |
| $\phi$ | 0.97203 | 0.014559 | 0.0099983 |
| $\sigma_\eta^2$ | 0.022474 | 0.0090217 | 0.0075645 |
| $\rho$ | -0.84500 | 1.5008 | 1.1664 |
| $\sigma_J^2$ | 9.8524 | 1007.0 | 648.20 |
| $p$ | 0.10367 | 0.13505 | 0.065325 |

Table 4: *50 different dataset. Analysis of the maximum likelihood estimator for stochastic volatility with leverage model for cases, M=200, 500 and 900. T=1000 in all cases.*

The corresponding histograms in Appendix C (Figs. 8,9 and 10) suggest convergence towards the mode and we are not far from normality. In testing for bias we find very encouraging results. We find that all parameters, except the leverage parameter $\rho$ which is estimated with slight bias, are either within, or on the boundary of their 95% confidence limits. The results are stable across different values of $M$. We note that the settings for this experiment were one of a large jump variance $\sigma_J^2$ with very arrival high intensity, $p$. One would expect the additional noise induced by these setting to render the estimation of the stochastic volatility components less accurate. Our findings suggest that in spite of having large jumps with high intensity, our procedure delivers highly reliable estimates for all the parameters.

| Small Jump - High Intensity | | | |
|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.21240 | 3.4545 | 2.7098 |
| $\phi$ | 0.97290 | 0.0066247 | 0.0072527 |
| $\sigma_\eta^2$ | 0.029170 | 0.013178 | 0.014784 |
| $\rho$ | -0.85636 | 0.70314 | 0.66880 |
| $\sigma_J^2$ | 0.63322 | 9516.9 | 60.103 |
| $p$ | 0.23544 | 43614 | 6.8037 |

Table 5: *50 different dataset. Analysis of the maximum likelihood estimator for stochastic volatility with leverage and jumps model. We set parameter values;* $\mu = 0.25$, $\phi = 0.975$, $\sigma_\eta^2 = 0.025$, $\rho = -0.8$, $\sigma_J^2 = 0.5$ and $p = 0.10$. *M=300 and T=1000* .

| Large Jump - Low Intensity | | | |
|---|---|---|---|
| | $\overline{ML_s}$ | $\overline{Var} \times 100$ | $Var(ML_s) \times 100$ |
| $\mu$ | 0.25359 | 1.9024 | 1.3926 |
| $\phi$ | 0.97293 | 0.0063159 | 0.0074348 |
| $\sigma_\eta^2$ | 0.026733 | 0.0066633 | 0.0070814 |
| $\rho$ | -0.82253 | 0.55547 | 0.42255 |
| $\sigma_J^2$ | 9.6201 | 2162.1 | 3884.2 |
| $p$ | 0.013252 | 0.075626 | 0.020192 |

Table 6: *50 different datasets. Analysis of the maximum likelihood estimator for stochastic volatility with leverage and jumps model. We set parameter values;* $\mu = 0.25$, $\phi = 0.975$, $\sigma_\eta^2 = 0.025$, $\rho = -0.8$, $\sigma_J^2 = 10$ and $p = 0.01$. *M=300 and T=1000* .

We proceed to investigate how the error in estimation is affected by varying the intensity and jump size. The results in Table 5 suggest that having small jumps occurring with high intensity induces a slight amount of bias is estimating of $\sigma_\eta^2$, $\rho$ and $p$. In contrast, if large jumps occur at a very low frequency, i.e. setting $p = 0.01$, the accuracy of our estimates is greatly enhanced (Table 6). All parameters fall well within their 95% confidence limits with only moderate bias in the estimate of leverage. See histograms in Appendix C (Fig. 11 and 12). Using simulated data generated with three different calibrations for $\theta$ considered in this section, we provide diagnostic check (Section 3.5) for the SV with leverage and jumps model in addition to a plot of the data, filtered standard deviation and filtered jump probabilities in Appendix C (Figs. 13,14 and 15)[8].

## 5 Empirical Examples

We now employ our methodology to estimate the three models; (i) stochastic volatility (SV), (ii) stochastic volatility with leverage (SVL) and (iii) stochastic volatility with leverage and jumps

[8]Note that plots in each of these figures illustrate output generated by a single run of the smooth particle filter.

(SVLJ) using daily returns data for four different price indices, namely S&P 500, FTSE100, Dow Jones and Nasdaq. For each of the series, the parameter estimates along with standard errors[9] and log-likelihood values for the three specifications are reported in Tables 7,8,9 and10.

| S&P 500 | | |
|---|---|---|
| | ML estimate | Standard error |
| SV | | |
| $\mu$ | 0.1717 | 0.1872 |
| $\phi$ | 0.9832 | 0.0056 |
| $\sigma_\eta^2$ | 0.0218 | 0.0048 |
| Log-likelihood value $= -3044.1$ | | |
| SVL | | |
| $\mu$ | 0.2432 | 0.0983 |
| $\phi$ | 0.9739 | 0.0040 |
| $\sigma_\eta^2$ | 0.0307 | 0.0044 |
| $\rho$ | -0.7944 | 0.0426 |
| Log-likelihood value $= -2996.4$ | | |
| SVLJ | | |
| $\mu$ | 0.2498 | 0.1010 |
| $\phi$ | 0.9766 | 0.0041 |
| $\sigma_\eta^2$ | 0.0266 | 0.0048 |
| $\rho$ | -0.8303 | 0.0444 |
| $\sigma_J^2$ | 5.2607 | 2.0453 |
| $p$ | 0.0079 | 0.0026 |
| Log-likelihood value $= -2993.7$ | | |

Table 7: *Parameter estimates for S&P 500 daily returns data for period, 16/05/1995 - 24/04/2003. M=500.*

The results reported indicate that the gain in likelihood points moving from the SVL to SVLJ specification is small compared to the gain in points by incorporating only leverage in the SV specification. Table 11 provides likelihood ratio statistics when comparing different specifications.

For the time span of data considered we find that leverage is extremely important component in modelling stochastic volatility whereas including jumps in addition to leverage yield a statistically significant gain in the case Dow Jones and Nasdaq. We illustrate the actual returns data, along with the filtered standard deviation and filtered jump probabilities for S&P 500 and Dow Jones in Appendix C (Figs. 16 and 17). Results of the diagnostic check on the SVLJ specification for all four series are provided in Appendix C (Fig.18).

[9]We use the outer product of gradients estimator for the variance covariance matrix.

| FTSE 100 | | |
|---|---|---|
| | ML estimate | Standard error |
| SV | | |
| $\mu$ | 0.0751 | 0.2093 |
| $\phi$ | 0.9859 | 0.0052 |
| $\sigma_\eta^2$ | 0.0176 | 0.0046 |
| Log-likelihood value $= -3004.4$ | | |
| SVL | | |
| $\mu$ | 0.1135 | 0.1257 |
| $\phi$ | 0.9842 | 0.0037 |
| $\sigma_\eta^2$ | 0.0201 | 0.0040 |
| $\rho$ | -0.7825 | 0.0509 |
| Log-likelihood value $= -2972.8$ | | |
| SVLJ | | |
| $\mu$ | 0.0638 | 0.1262 |
| $\phi$ | 0.9836 | 0.0038 |
| $\sigma_\eta^2$ | 0.0212 | 0.0042 |
| $\rho$ | -0.8029 | 0.0584 |
| $\sigma_J^2$ | 1.4652 | 1.0376 |
| $p$ | 0.0132 | 0.0229 |
| Log-likelihood value $= -2972.2$ | | |

Table 8: *Parameter estimates for FTSE 100 daily returns data for period, 01/07/1996 - 01/03/2004. M=500.*

| Dow Jones | | |
| --- | --- | --- |
| | ML estimate | Standard error |
| SV | | |
| $\mu$ | -0.2379 | 0.1717 |
| $\phi$ | 0.9830 | 0.0061 |
| $\sigma_\eta^2$ | 0.0183 | 0.0043 |
| Log-likelihood value $= -2623.5$ | | |
| SVL | | |
| $\mu$ | -0.1745 | 0.0963 |
| $\phi$ | 0.9805 | 0.0035 |
| $\sigma_\eta^2$ | 0.0213 | 0.0037 |
| $\rho$ | -0.8282 | 0.0410 |
| Log-likelihood value $= -2586.7$ | | |
| SVLJ | | |
| $\mu$ | -0.1557 | 0.0988 |
| $\phi$ | 0.9825 | 0.0034 |
| $\sigma_\eta^2$ | 0.0189 | 0.0036 |
| $\rho$ | -0.8640 | 0.0451 |
| $\sigma_J^2$ | 18.706 | 12.43 |
| $p$ | 0.0018 | 0.0014 |
| Log-likelihood value $= -2579.2$ | | |

Table 9: *Parameter estimates for Dow Jones Composite daily returns data for period, 01/05/2000 - 31/12/2007. M=500.*

| Nasdaq | | |
|---|---|---|
| | ML estimate | Standard error |
| SV | | |
| $\mu$ | 0.7193 | 0.5488 |
| $\phi$ | 0.9973 | 0.0016 |
| $\sigma_\eta^2$ | 0.0054 | 0..0156 |
| Log-likelihood value $= -3457.6$ | | |
| SVL | | |
| $\mu$ | 0.4877 | 0.1834 |
| $\phi$ | 0.9942 | 0.0014 |
| $\sigma_\eta^2$ | 0.0077 | 0.0016 |
| $\rho$ | -0.8291 | 0.0543 |
| Log-likelihood value $= -3429.3$ | | |
| SVLJ | | |
| $\mu$ | 0.2615 | 0.1564 |
| $\phi$ | 0.9930 | 0.2284 |
| $\sigma_\eta^2$ | 0.0131 | 0.0016 |
| $\rho$ | -0.8411 | 0.0034 |
| $\sigma_J^2$ | 0.4781 | 0.0503 |
| $p$ | 0.5599 | 0.0848 |
| Log-likelihood value $= -3423.3$ | | |

Table 10: *Parameter estimates for Nasdaq Composite daily returns data for period, 01/05/2000 - 31/12/2007. M=500.*

| Likelihood Ratio Test Statistic | | |
|---|---|---|
| | SV vs SVL | SVL vs SVLJ |
| S&P 500 | 95.4* | 5.4 |
| FTSE 100 | 63.2* | 1.2 |
| Dow Jones | 73.6* | 15* |
| Nasdaq | 56.6* | 12* |

Table 11: (*) indicates statistical significance at 5% critical level.

## 6 Conclusion

In this paper we have attempted to provide a unified methodology in order to conduct likelihood-based inference on the unknown parameters of discrete-time stochastic volatility models incorporating a leverage effect and jumps in the returns process. In noting that the standard SV and SV with leverage models are restricted forms of the more general SV with leverage and jumps model, we have shown how the proposed methodology can easily facilitate parameter estimation of all three types of models without any alteration in the basic structure of the procedure. Given the non-linear/non-Gaussian nature of the state-space form of this class of model, a particle filtering framework is employed and adapted for parameter estimation. It is demonstrated how smooth resampling can be undertaken in order ensure that the likelihood estimator is continuous as a function of the unknown parameters. This enables the use of gradient-based (Newton-Raphson type) maximization algorithms. The advantage of using particle filters is that we also obtain, as a by-product, the filtered path of the states, jump probabilities (i.e. in the case of SV with leverage and jumps) and output required to perform diagnostics. Our Monte Carlo experiments indicate that the method is both robust and efficient. Especially, when examining bias we find very encouraging results even when considering very high jump intensity. As empirical examples, we model four different daily returns series using our approach. Our results reveal that the inclusion of a leverage effect is extremely important when modeling stochastic volatility, as indicated by the substantial gain in likelihood points over the standard SV model. On the other, we find that inclusion of jumps in returns, after having incorporated leverage leads to a relatively less dramatic gain in likelihood points.

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## 7 Appendix A

**Smooth resampling algorithm:**

The algorithm given below samples the index corresponding to the region which are stored as, $r^1, r^2....., r^M$ and also the uniforms $u_1^*, ....., u_M^*$.

```
set s=0,j=1;
for (i=1 to M-1)
{
s=s+λ̃^i;

while (u_j ≤ s AND j ≤ M)
   {
      r^j = i;
      u*_j = ( u_j − (s − λ̃^i )) / λ̃^i;
            j = j + 1;
    }
}
```

**Deriving the functional form of density $f(\epsilon_t|h_t, y_t)$ :**

The conditional probability of a jump is given by,

$$\Pr(J_t = 1|h_t, y_t) = \frac{\Pr(y_t|J = 1)\Pr(J = 1)}{\Pr(y_t|J = 1)\Pr(J = 1) + \Pr(y_t|J = 0)\Pr(J = 0)}$$

$$= \frac{N(y_t|0;\exp(h_t)+\sigma_J^2)p}{N(y_t|0;\exp(h_t)+\sigma_J^2)p + N(y_t|0;\exp(h_t))(1-p)}. \tag{7·1}$$

Hence, $\Pr(J_t = 0|h_t, y_t) = 1 - \Pr(J_t = 1|h_t, y_t)$. Now since,

$$f(\epsilon_t|J = 1; h_t, y_t) \propto f(y_t|J = 1, h_t, \epsilon_t)f(\epsilon_t) \tag{7·2}$$

we can reformulate the conditional density $f(\epsilon_t|J = 1; h_t, y_t) \propto N(\ y_t|\ \epsilon_t \exp(h_t/2); \sigma_J^2) \times N(\epsilon_t|0; 1)$ in logarithmic form as,

$$\log\ f(\epsilon_t|J = 1; h_t, y_t) = const - \frac{1}{2}\frac{(y_t - \epsilon_t \exp(h_t/2))^2}{\sigma_J^2} - \frac{1}{2}\epsilon_t^2 \tag{7·3}$$

The resultant quardratic form facilitates completing the square to yield,

$$\log\ f(\epsilon_t|J_t = 1; h_t, y_t) = K - \frac{1}{2}\frac{(\epsilon_t - \upsilon_{\epsilon_1})^2}{\sigma_{\epsilon_1}^2} \tag{7·4}$$

**Computing moments $\upsilon_{\epsilon_1}$ and $\sigma_{\epsilon_1}^2$**

Taking the expression $\log\ f(\epsilon_t|J = 1; h_t, y_t) = const - \frac{1}{2}\frac{(y_t - \epsilon_t \exp(h_t/2))^2}{\sigma_J^2} - \frac{1}{2}\epsilon_t^2$

First collect the squared terms corresponding to $-\frac{1}{2}\epsilon_t^2$;

$$\frac{1}{\sigma_{\epsilon_1}^2} = \frac{\exp(h_t)}{\sigma_J^2} + 1 = \frac{\exp(h_t)+\sigma_J^2}{\sigma_J^2}$$
$$\Longrightarrow \sigma_{\epsilon_1}^2 = \frac{\sigma_J^2}{\exp(h_t) + \sigma_J^2}\ .$$

Next those corresponding to $\epsilon_t$;

$$\frac{\upsilon_{\epsilon_1}}{\sigma_{\epsilon_1}^2} = \frac{y_t \exp(h_t/2)}{\sigma_J^2}$$
$$\Longrightarrow \upsilon_{\epsilon_1} = \frac{y_t \exp(h_t/2)}{\exp(h_t) + \sigma_J^2}\ .$$

We hence establish that,

$$f(\epsilon_t|J_t = 1; h_t, y_t) = N(\upsilon_{\epsilon_1}, \sigma_{\epsilon_1}^2)\ \text{ where, } \upsilon_{\epsilon_1} = \frac{y_t \exp(h_t/2)}{\exp(h_t) + \sigma_J^2} \text{ and } \sigma_{\epsilon_1}^2 = \frac{\sigma_J^2}{\exp(h_t) + \sigma_J^2}$$

If the process does not jump, there is a dirac delta mass at the point,

$$f(\epsilon_t|J_t = 0; h_t, y_t) = \frac{y_t}{\exp(h_t/2)} \tag{7·5}$$

## 8 Appendix B

**Sampling from the mixture density $f(\epsilon_t|h_t, y_t)$ :**

In the context of the particle filter, the generation of $h_t^i$, $i = 1, ....., M$ particles each time step, will give rise to densities, $f(\epsilon_t^i|h_t^i, y_t)$, $i = 1, ..., M$. The aim is thus to simulate $\epsilon_t^1, ....., \epsilon_t^M$, from corresponding densities $f(\epsilon_t^1|h_t^1, y_t), ....., f(\epsilon_t^M|h_t^M, y_t)$. We shall illustrate the procedure to simulate $\epsilon_t^1$ from density $f(\epsilon_t^1|h_t^1, y_t) = \sum_{j=0}^{1} f(\epsilon_t^1|J_t = j; h_t^1, y_t)\Pr(J_t = j|h_t^1, y_t)$. Given that the density corresponding to particle $h_t^1$ is of the form,

$$f(\epsilon_t^1|h_t^1, y_t) = \delta(y_t \exp(-h_t^1/2)).\Pr(J_t = 0|h_t^1, y_t) + N(\upsilon_{\epsilon_1}^1, \sigma_{\epsilon_1}^{21}).\Pr(J_t = 1|h_t^1, y_t).$$

For notational simplicity we set $x^* = y_t \exp(-h_t^1/2)$ and the conditional probability of a jump to be $\Pr^J = \Pr(J_t = 1|h_t^1, y_t)$. The associated distribution function $F(\epsilon_t^1|h_t^1, y_t)$ is thus of the form.

$$\begin{aligned}
&F(\epsilon_t^1|h_t^1, y_t) = \Pr^J . \int_{-\infty}^{\epsilon_t^1} f(\epsilon_t^1|J_t = 1, h_t, y_t)d\epsilon_t^1 \quad \text{for } \epsilon_t^1 < x^* \\
&F(\epsilon_t^1|h_t^1, y_t) = \Pr^J . \int_{-\infty}^{x^*} f(\epsilon_t^1|J_t = 1, h_t^1, y_t)d\epsilon_t^1 + (1 - \Pr^J) \quad \text{for } \epsilon_t^1 = x^* \\
&F(\epsilon_t^1|h_t^1, y_t) = \Pr^J . \int_{-\infty}^{x^*} f(\epsilon_t^1|J_t = 1, h_t^1, y_t)d\epsilon_t^1 + (1 - \Pr^J) + \Pr^J . \int_{\epsilon_t^1}^{+\infty} f(\epsilon_t^1|J_t = 1, h_t^1, y_t)d\epsilon_t^1 \text{ for } \epsilon_t^1 > x^*
\end{aligned}$$

As is evident from the form of $F(\epsilon_t^1|h_t^1, y_t)$, the height of this distribution function can be split into three distinct regions. First generate a uniform random variate $u_1 \backsim UID(0, 1)$, then record within which region $u_1$ falls. Conditional on the recorded region we then invert in accordance with the following scheme.

- If $u_1 \leq \Phi(\frac{x^* - \upsilon_{\epsilon_1}^1}{\sigma_{\epsilon_1}^1}).\Pr^J$, we sample $\epsilon_t^1 = \upsilon_{\epsilon_1}^1 + \sigma_{\epsilon_1}^1 \Phi^{-1}(\frac{u_1}{\Pr^J})$
- If $\Phi(\frac{x^* - \upsilon_{\epsilon_1}^1}{\sigma_{\epsilon_1}^1}).\Pr^J < u_1 \leq \Phi(\frac{x^* - \upsilon_{\epsilon_1}^1}{\sigma_{\epsilon_1}^1}).\Pr^J + (1 - \Pr^J)$, we sample $\epsilon_t^1 = y_t \exp(-h_t^1/2)$
- If $u_1 > \Phi(\frac{x^* - \upsilon_{\epsilon_1}^1}{\sigma_{\epsilon_1}^1}).\Pr^J + (1 - \Pr^J)$, we sample $\epsilon_t^1 = \upsilon_{\epsilon_1}^1 + \sigma_{\epsilon_1}^1 \Phi^{-1}(\frac{u_1 - (1 - \Pr^J)}{\Pr^J})$

  $\Phi(.)$ denotes the standard normal distribution function. The above probability integral transform procedure is repeated for each of the generated uniforms $u_{1,}......, u_M \backsim UID(0, 1)$ in order to

  obtain the required sample $\epsilon_t^i \backsim f(\epsilon_t^i|h_t^i, y_t)$, $i = 1, ....., M$.

# 9 Appendix C

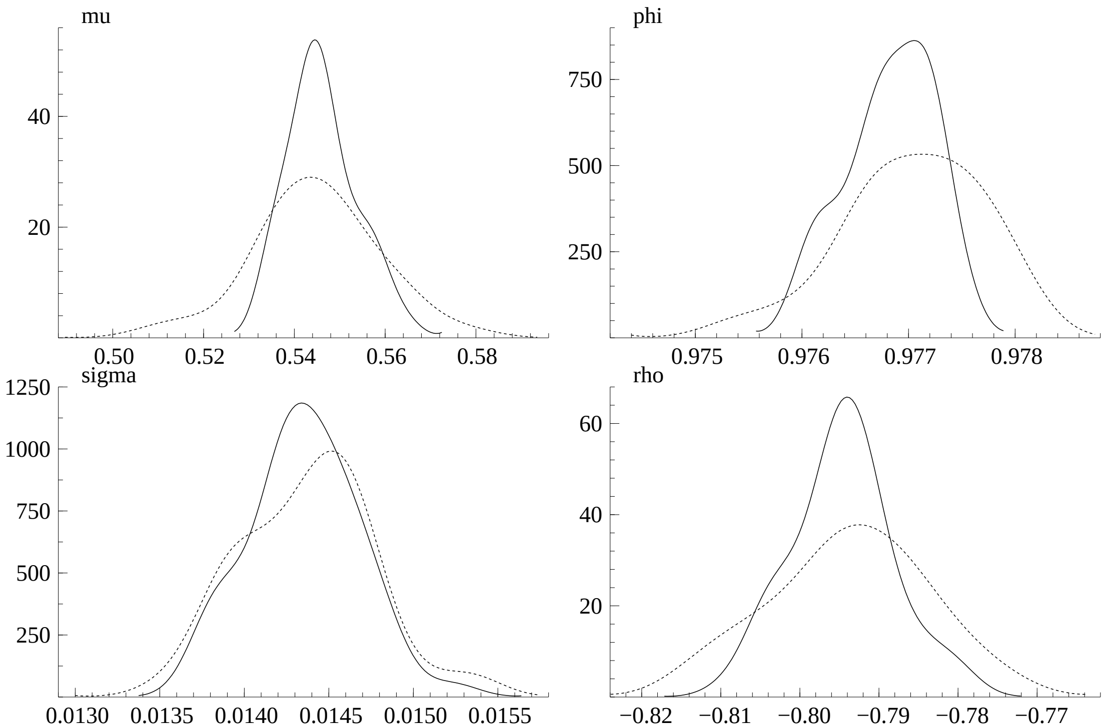


Figure 1: Fixed dataset. Dotted line:Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model; $T = 1000$ and $M = 300$. Solid line: Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model; $T = 1000$ and $M = 600$. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8$.

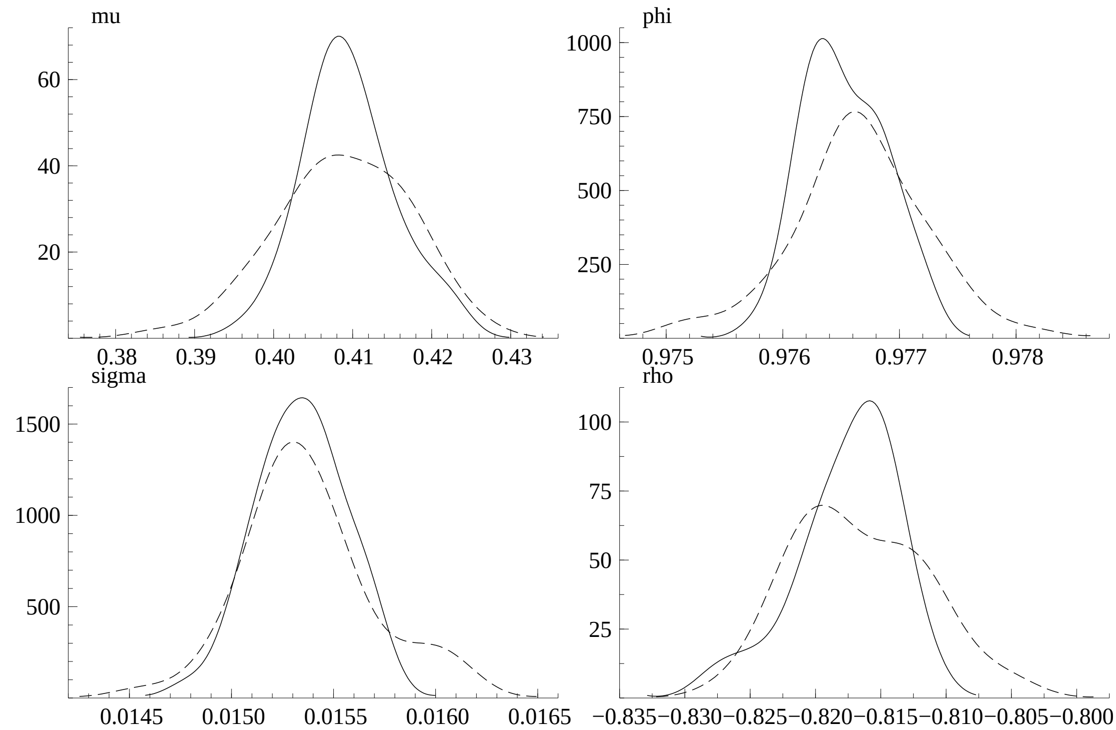


Figure 2: Fixed dataset. Dashed line:Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model; $T = 2000$ and $M = 300$. Solid line: Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model; $T = 2000$ and $M = 600$. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8$.

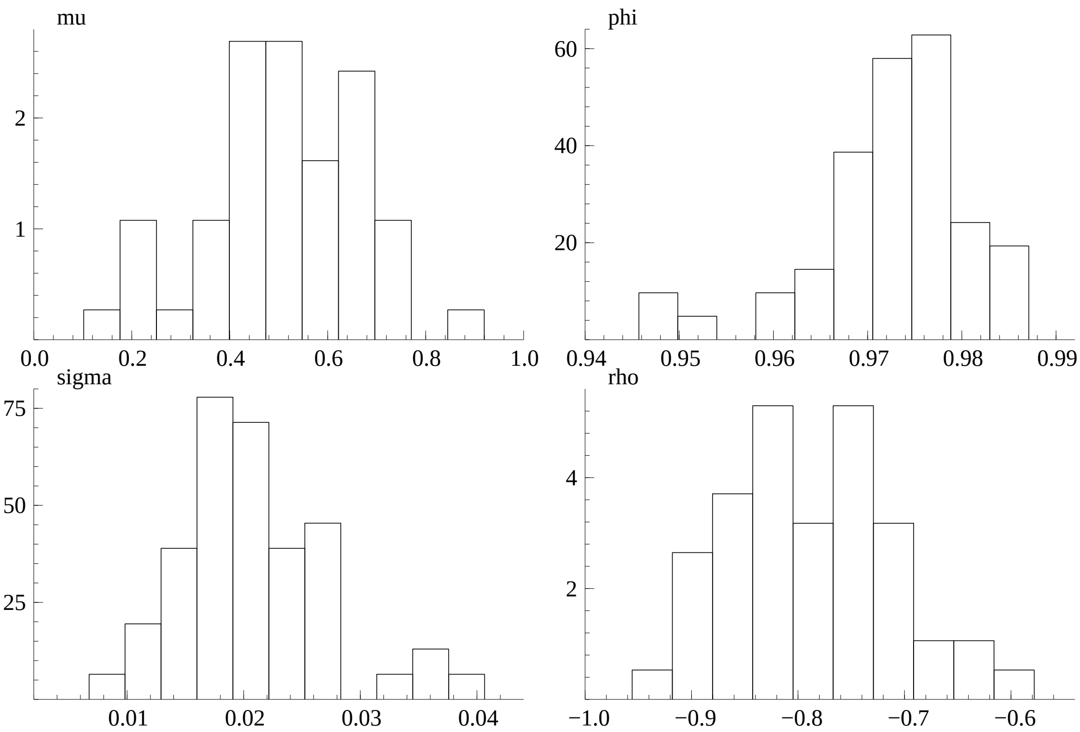


Figure 3: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8$. $M = 200$ and $T = 1000$.

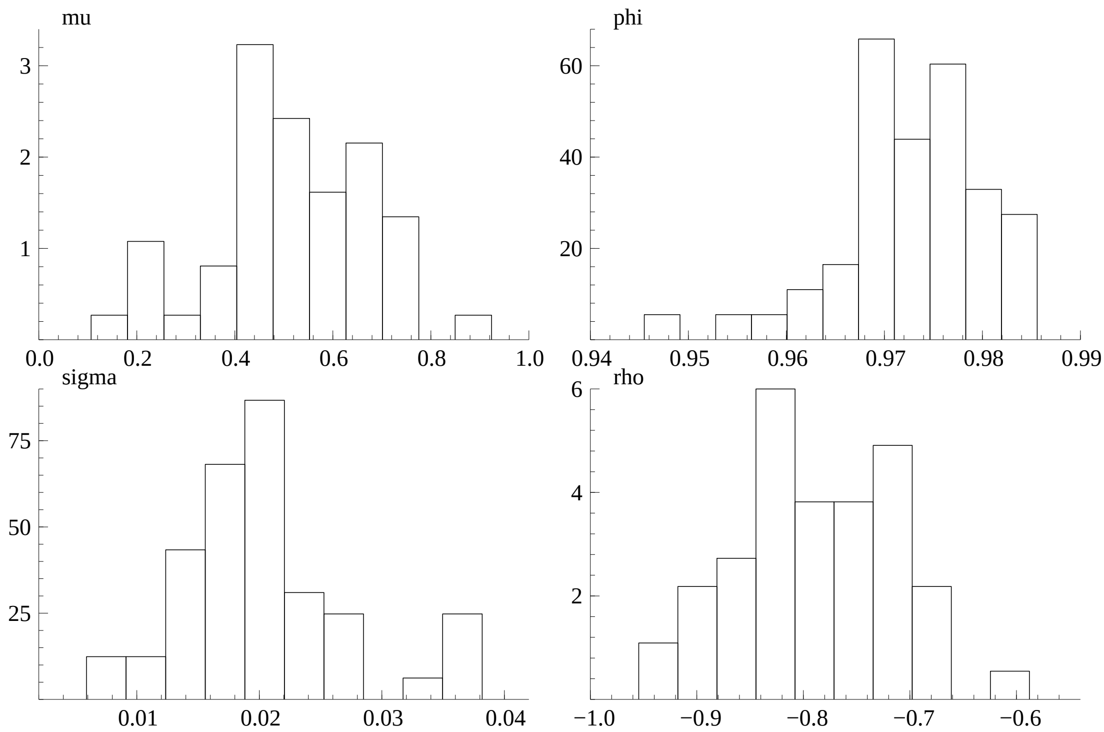


Figure 4: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8$. $M = 500$ and $T = 1000$.

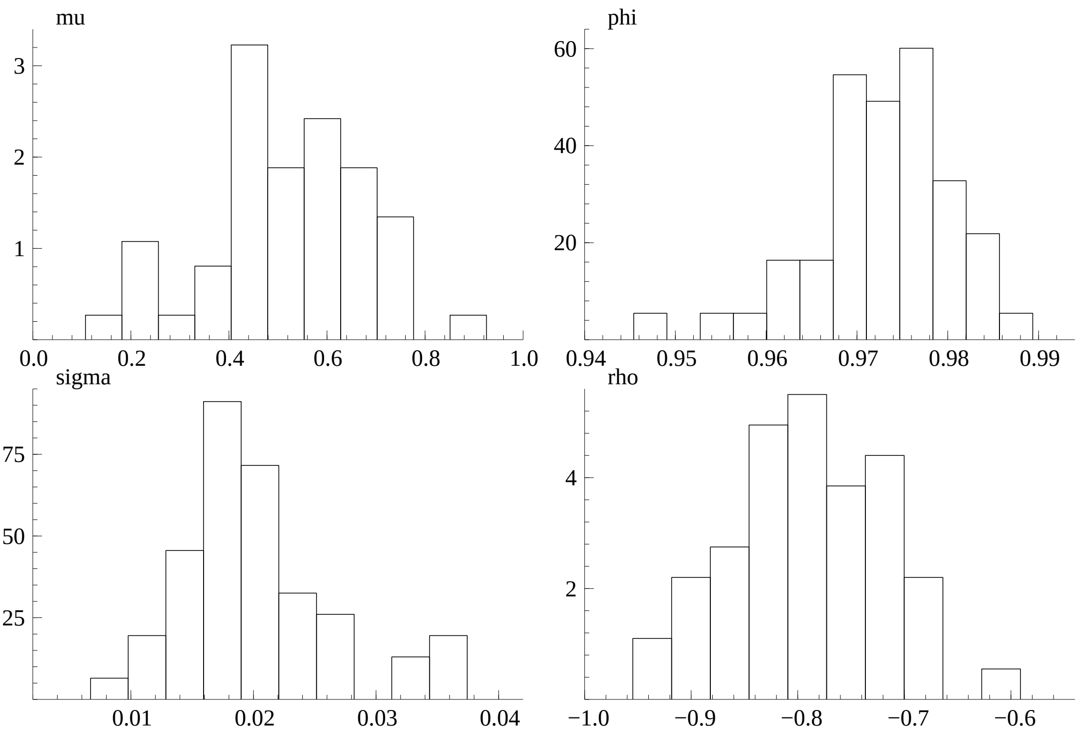


Figure 5: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho)$, for SV with leverage model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8$. $M = 3000$ and $T = 1000$.

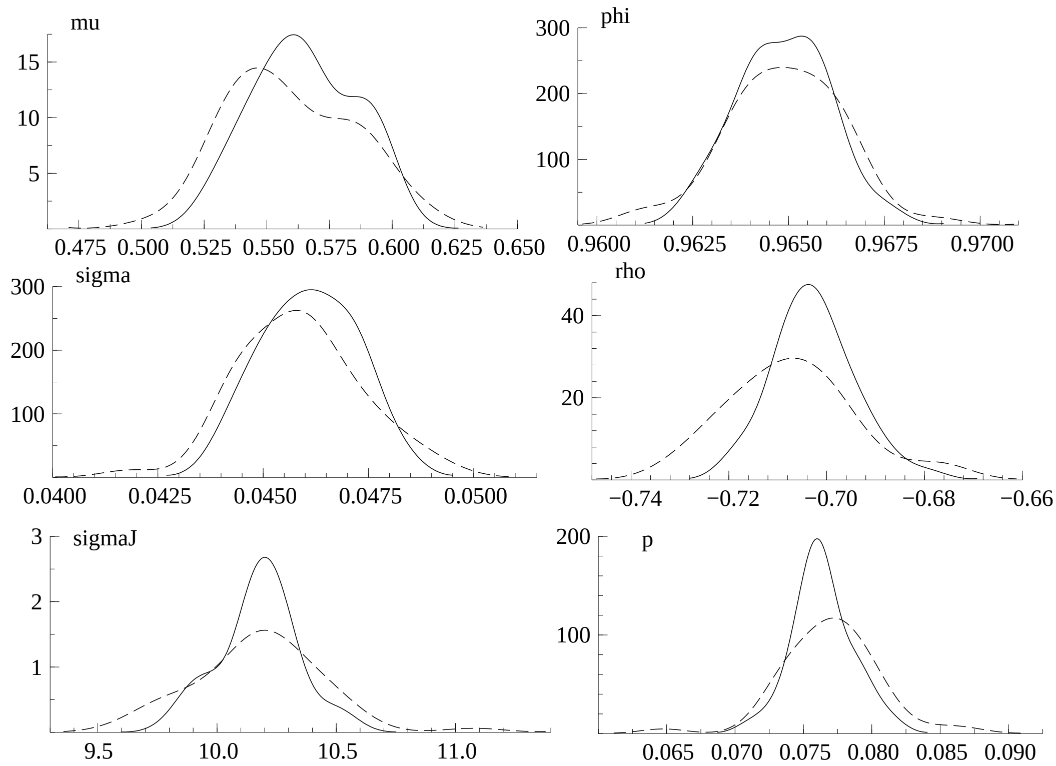


Figure 6: Fixed datasets. Dashed line:Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model; $T = 1000$ and $M = 300$. Solid line: Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model; $T = 1000$ and $M = 600$. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8., \sigma_J^2 = 10$ and $p = 0.10$.

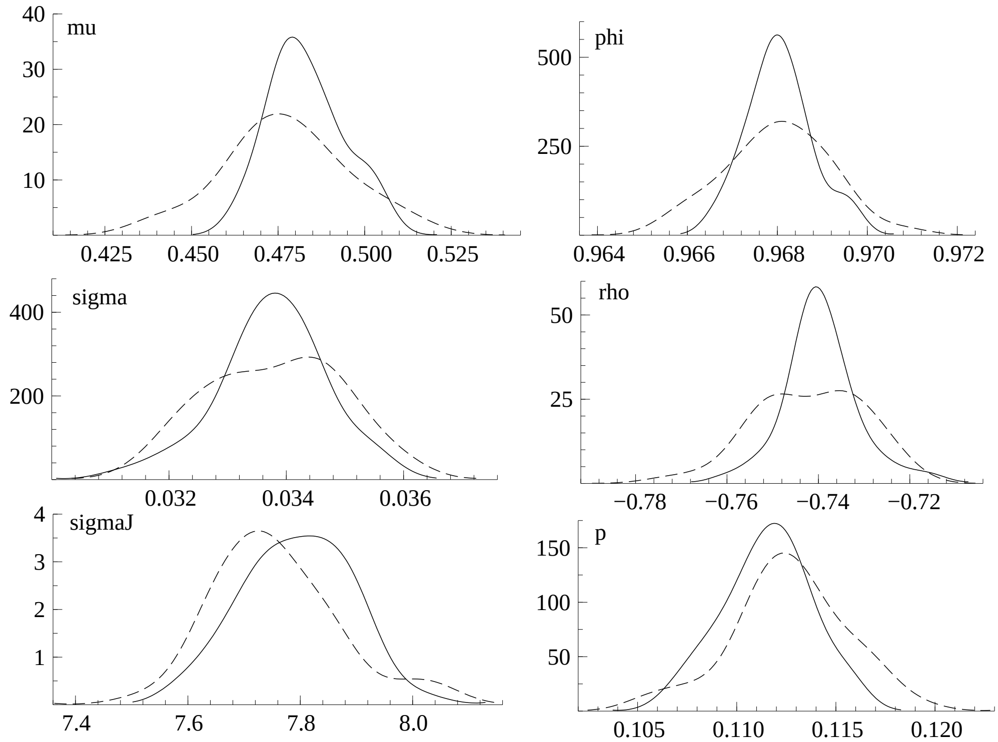


Figure 7: Fixed datasets. Dashed line:Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model; $T = 2000$ and $M = 300$. Solid line: Kernel density estimate of the ML estimator for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model; $T = 2000$ and $M = 600$. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8, \sigma_J^2 = 10$ and $p = 0.10$.

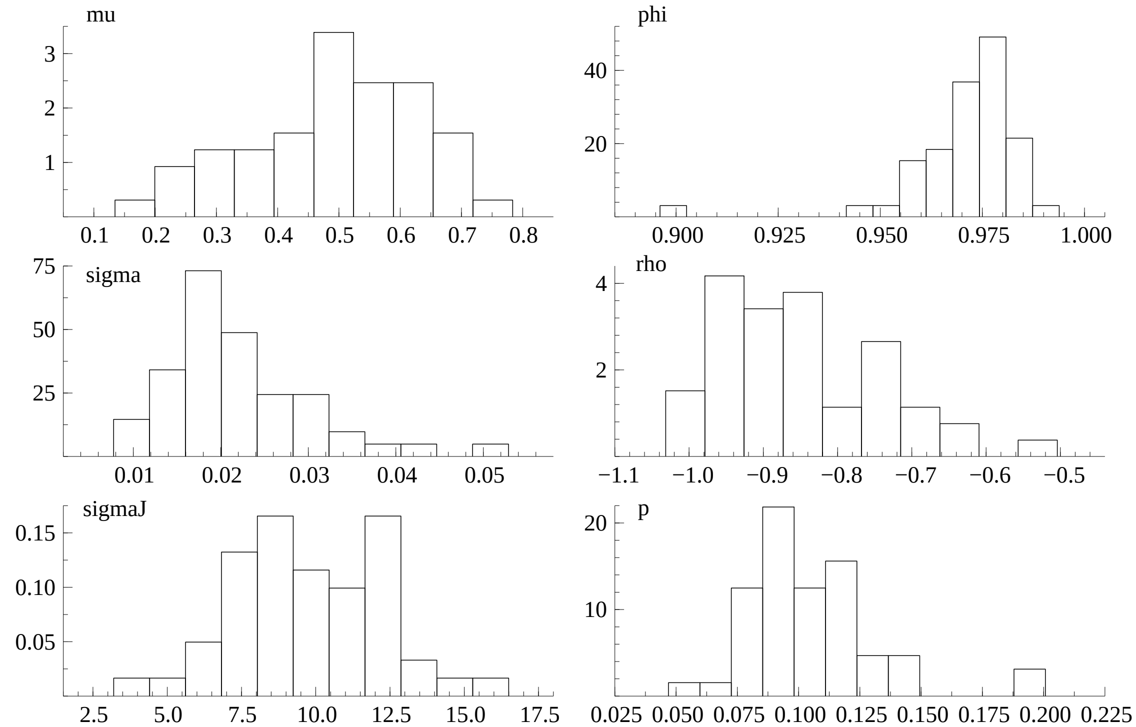


Figure 8: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8, \sigma_J^2 = 10$ and $p = 0.10$. $M = 200$ and $T = 1000$.

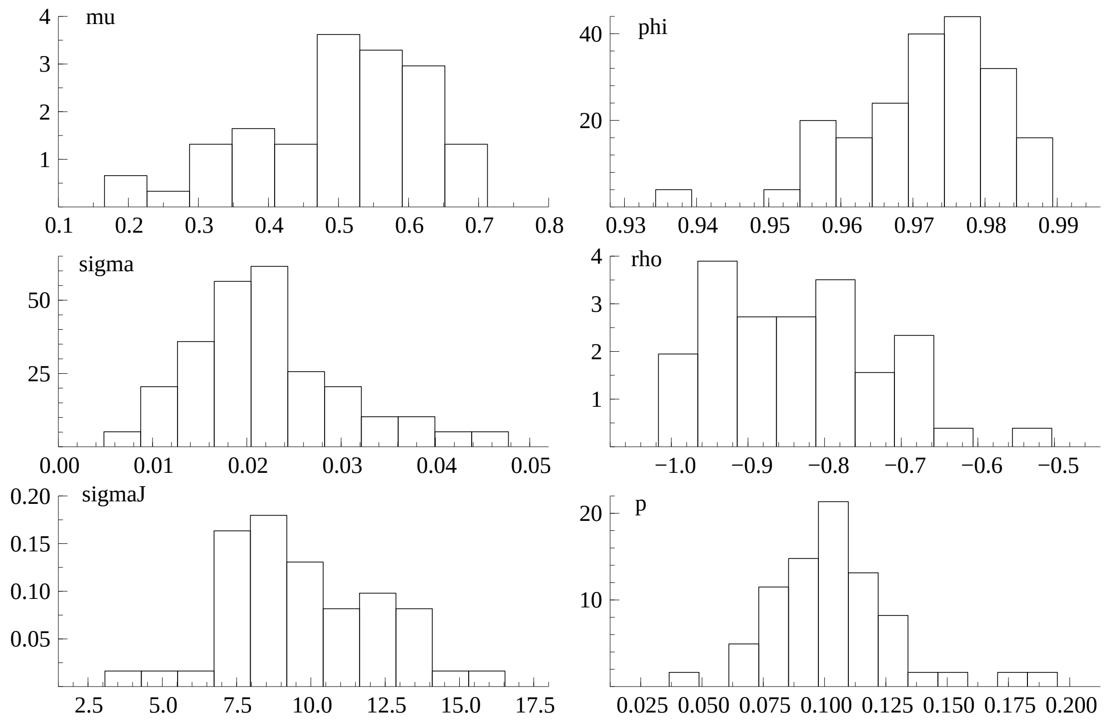


Figure 9: 50 different dataset. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8, \sigma_J^2 = 10$ and $p = 0.10$. $M = 500$ and $T = 1000$.

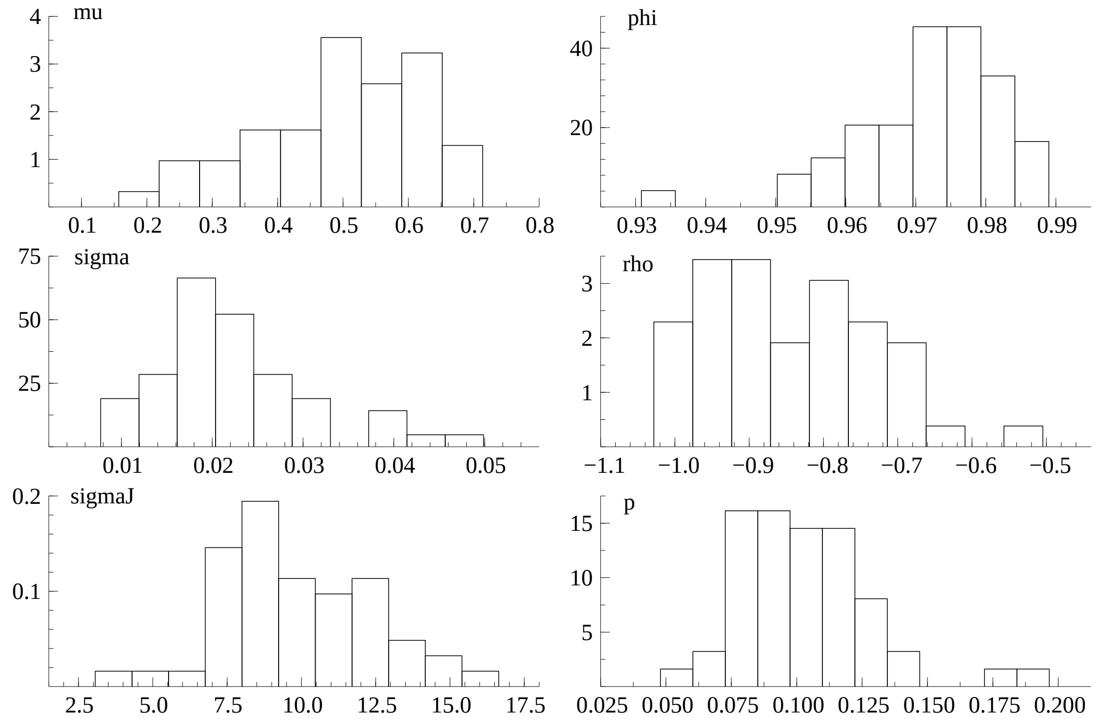


Figure 10: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model. True parameters, $\mu = 0.5, \phi = 0.975, \sigma_\eta^2 = 0.02$ and $\rho = -0.8, \sigma_J^2 = 10$ and $p = 0.10$. $M = 900$ and $T = 1000$.

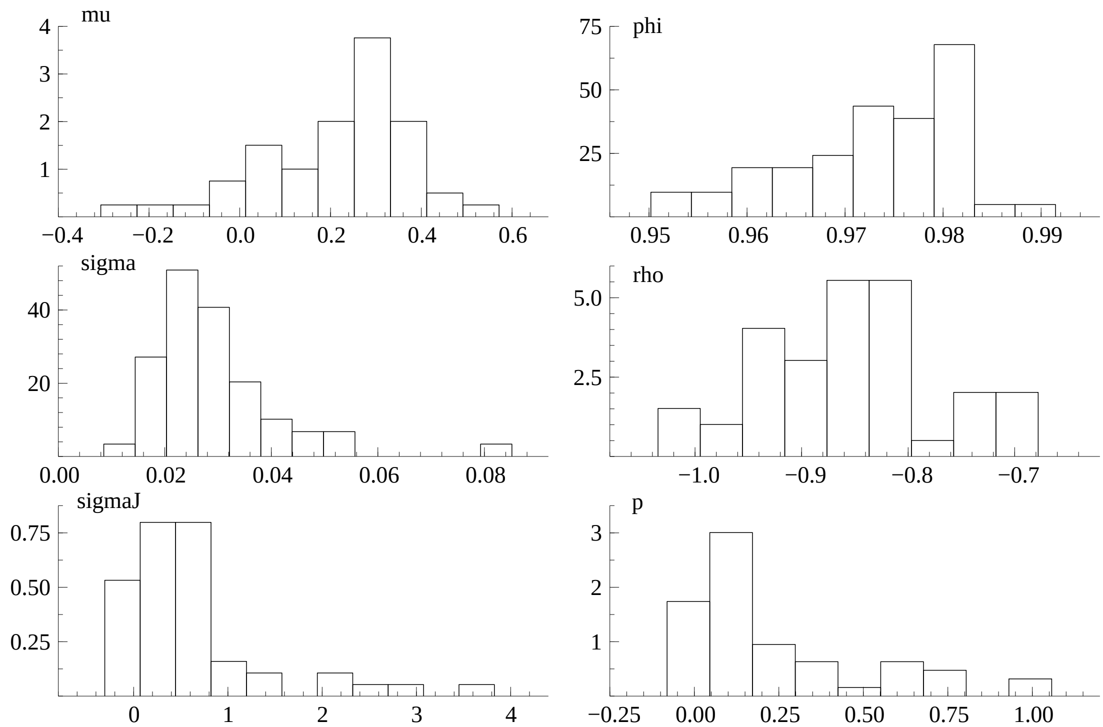


Figure 11: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model. True parameters, $\mu = 0.25, \phi = 0.975, \sigma_\eta^2 = 0.025$ and $\rho = -0.8, \sigma_J^2 = 0.5$ and $p = 0.10$. $M = 300$ and $T = 1000$.

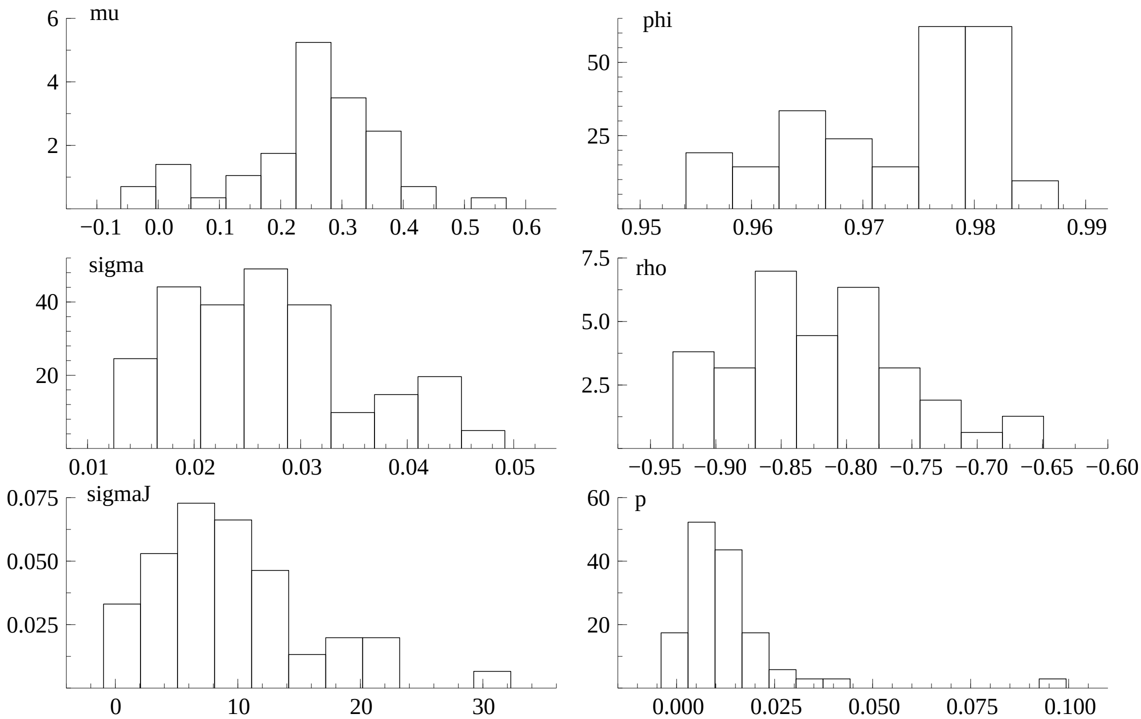


Figure 12: 50 different datasets. Histogram of the Monte Carlo samples of the ML estimates for $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p)$, for SV with leverage and jumps model. True parameters, $\mu = 0.25, \phi = 0.975, \sigma_\eta^2 = 0.025$ and $\rho = -0.8, \sigma_J^2 = 10$ and $p = 0.01$. $M = 300$ and $T = 1000$.

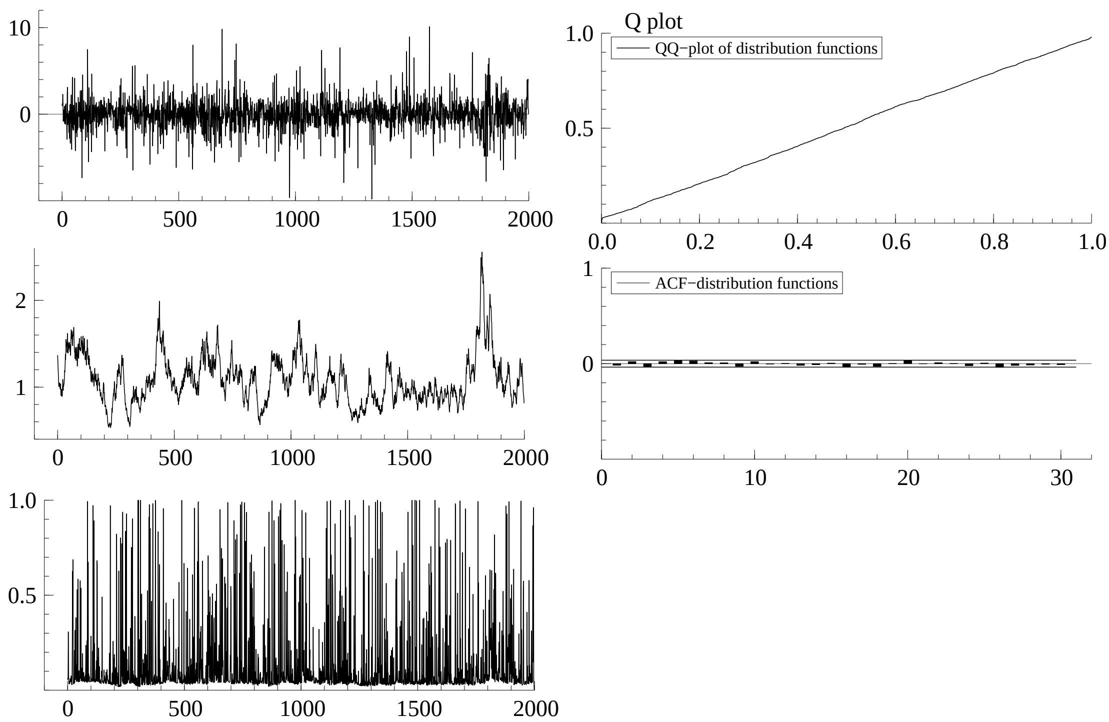


Figure 13: Using simulated data with $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p) = (0.5, 0.975, 0.02, -0.8, 10, 0.10)$ and a single run of the smooth particle filter. LEFT PANEL: (i) Plot of data, (ii) filtered standard deviation, (iii) estimated jump probablities. RIGHT PANEL: (i)QQ-plot of estimated distribution functions, $\widehat{\mathrm{u}}_t^J$ (ii) correlogram of $\widehat{\mathrm{u}}_t^J$. $M = 500, T = 2000$.

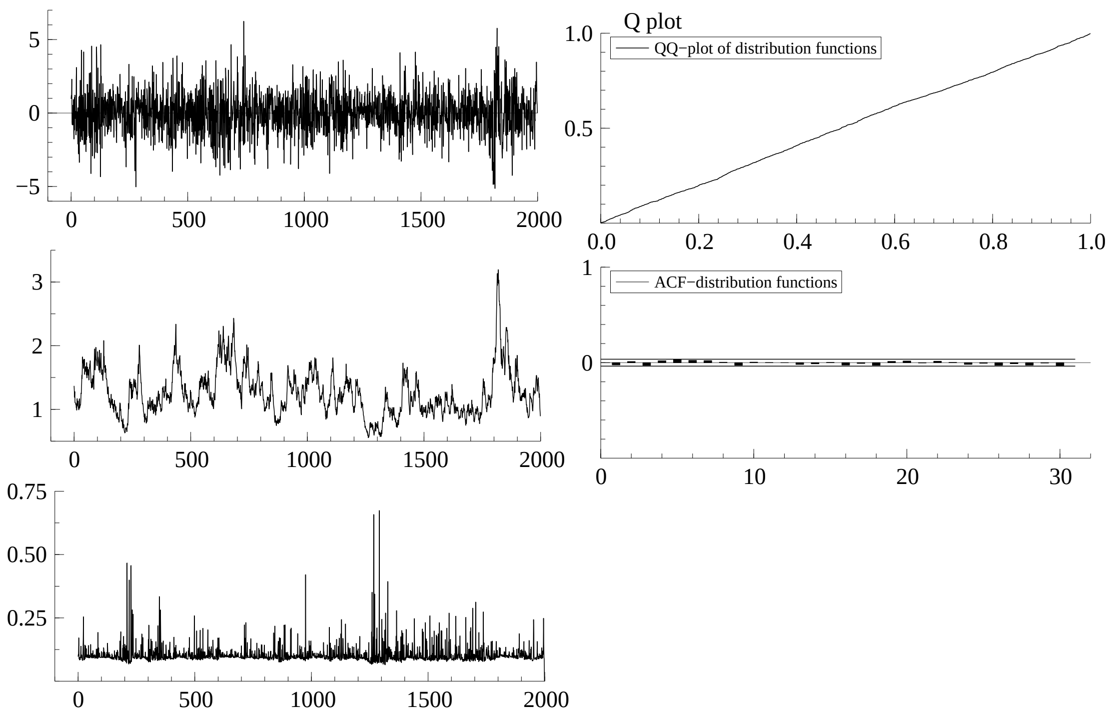


Figure 14: Using simulated data with $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p) = (0.25, 0.975, 0.025, -0.8, 0.5, 0.10)$ and a single run of the smooth particle filter. LEFT PANEL: (i) Plot of data, (ii) filtered standard deviation, (iii) estimated jump probablities. RIGHT PANEL: (i)QQ-plot of estimated distribution functions, $\widehat{\mathrm{u}}_t^J$ (ii) correlogram of $\widehat{\mathrm{u}}_t^J$. $M = 500, T = 2000$.

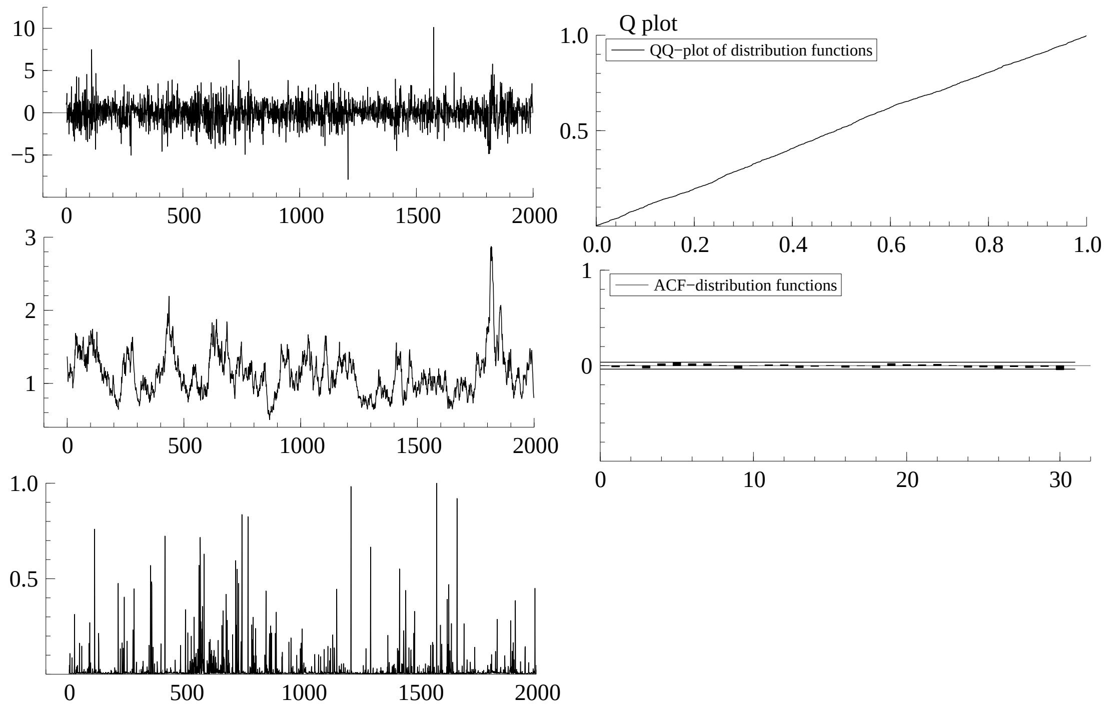


Figure 15: Using simulated data with $\theta = (\mu, \phi, \sigma_\eta^2, \rho, \sigma_J^2, p) = (0.25, 0.975, 0.025, -0.8, 10, 0.01)$ and a single run of the smooth particle filter. LEFT PANEL: (i) Plot of data, (ii) filtered standard deviation, (iii) estimated jump probablities. RIGHT PANEL: (i)QQ-plot of estimated distribution functions, $\widehat{\mathrm{u}}_t^J$ (ii) correlogram of $\widehat{\mathrm{u}}_t^J$. $M = 500, T = 2000$.

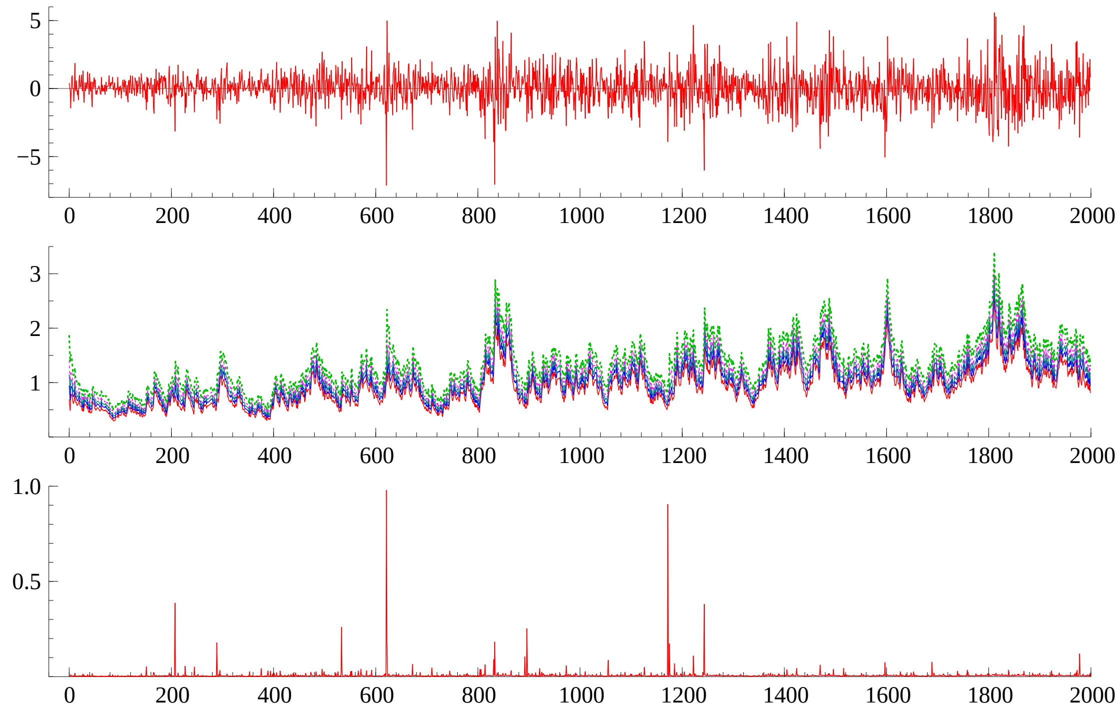


Figure 16: SV with leverage and jumps model. Daily S&P 500 returns over the period 16/05/1995 - 24/04/2003. (i) returns data, (ii) quantiles of filtered standard deviation and (iii) estimated jump probabilities. $M = 500$.

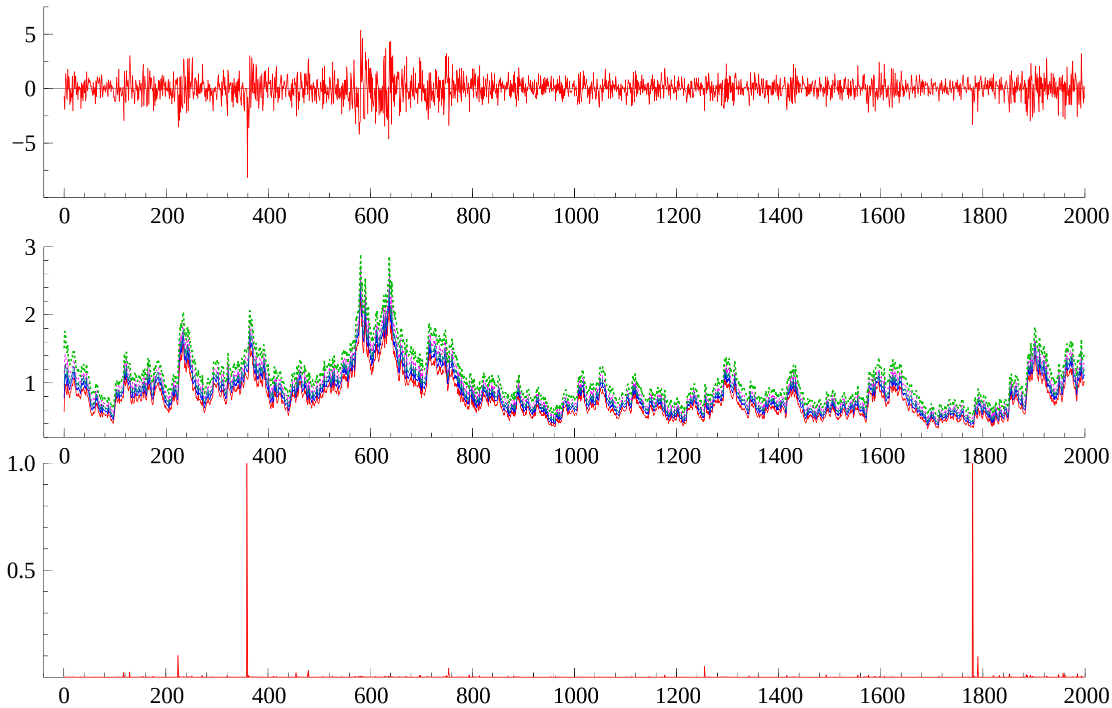


Figure 17: SV with leverage and jumps model. Dow Jones Composite 65 Stock Average returns over the period 01/05/2000 - 31/12/2007.(i) returns data, (ii) quantiles of filtered standard deviation and (iii) estimated jump probabilities. $M = 500$.

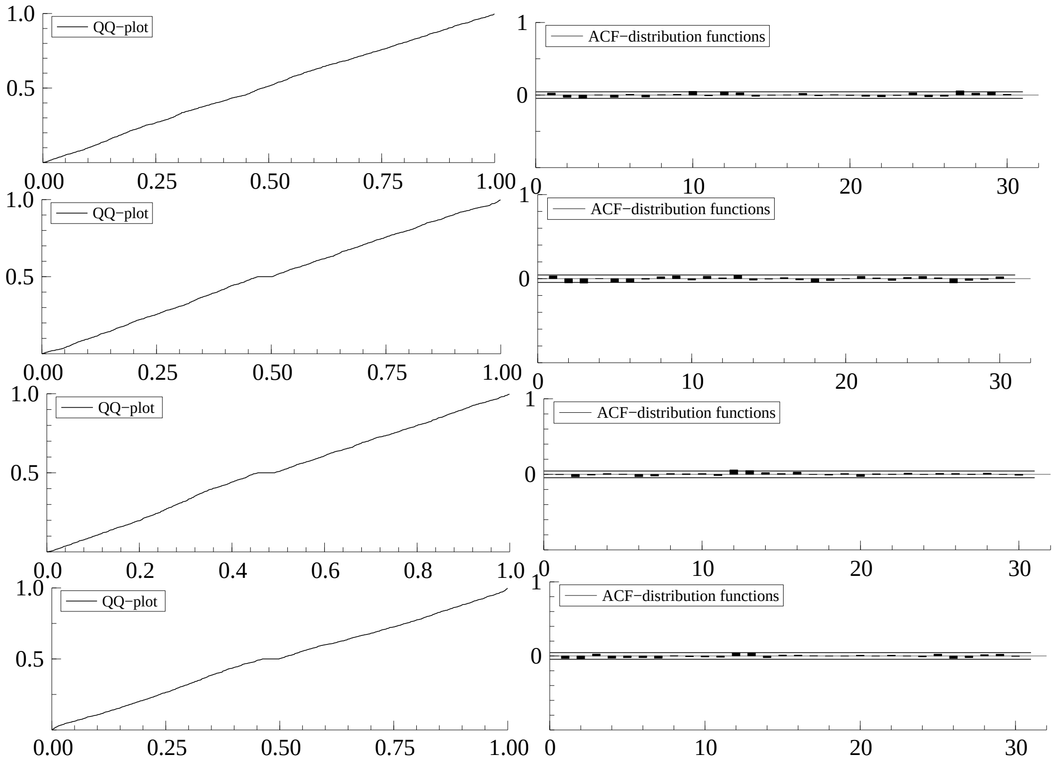


Figure 18: Diagnostic tests in the context of modelling stochastic volatility with leverage and jumps. Left panel: QQ-plot of estimated distribution functions, $\widehat{u}_t^J$. Right panel: Associated correlogram of $\widehat{u}_t^J$. The first row provides diagnostics for the case of S&P 500, the second row FTSE 100, the third row, Dow Jones and fourth row, Nasdaq.