Asymmetric Factor Volatility During COVID-19: Evidence for EGARCH over GARCH

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November 2025

Outline

Paper motivation

The problem

- **Crisis-period risk** is systematically misestimated by symmetric volatility models
- Portfolio managers using **GARCH(1,1)** rely on a model that assumes **symmetric shock responses**
- During COVID-19 (March-April 2020), GARCH systematically **underestimated tail volatility**:
  - S&P 500: **40 basis points** underprediction
  - Momentum factor: **260 basis points** underprediction
- This creates **false sense of security** in risk management precisely when accuracy is critical

Research gap

Central question

Are defensive factors (Quality, Minimum Volatility) protected from asymmetric crisis dynamics, or do they exhibit asymmetry like offensive factors?

Hypothesis

H1: Universal asymmetry

All individual factors exhibit significant asymmetric volatility responses during COVID-19 ($\gamma > 0$, $p < 0.05$)

H2: Momentum dominance [3]

Momentum exhibits the **strongest** asymmetry ($\gamma_{\text{Momentum}} > \gamma_{\text{all others}}$) due to momentum crash dynamics and forced liquidations

H3: Defensive factor paradox

Defensive factors (Quality, Minimum Volatility) exhibit **stronger** or **equivalent** asymmetry to Value, suggesting systemic crisis effects overwhelm factor-specific characteristics

If H3 is supported: Factor diversification alone provides insufficient *tail risk protection*

Evolution of factor models

Modern Portfolio Theory (1952) [15]

- Markowitz introduces diversification
- Risk-return trade-off framework

CAPM (1964) [18]

- Sharpe: Single factor model
- Systematic risk β

Fama-French 3F (1993) [6]

- Add size & value factors
- Better return explanation

Carhart 4F (1997) [5]

- Add momentum factor
- Explain performance persistence

Fama-French 5F (2014) [7]

- Add profitability & investment
- Comprehensive factor taxonomy

Data & sample

Sample Period: 374 daily observations

- **Start:** November 1, 2019
- **End:** December 31, 2021
- Covers full COVID-19 crisis cycle

Data Source: Refinitiv Eikon / MSCI Indices

- S&P 500 (market aggregate)
- MSCI Momentum
- MSCI Value
- MSCI Quality
- MSCI Size
- MSCI Min Volatility

Time sampling

Pandemic Phases (Pagano taxonomy [17])

- **Incubation**: Jan 2 - Jan 17
- **Outbreak**: Jan 20 - Feb 21
- **Fever**: Feb 24 - Mar 20 $\leftarrow$ **Peak volatility**
- **Treatment**: Mar 23 - Apr 15
- **Recovery**: Apr 16 - Dec 31

Methodology: three-stage approach

Stage 1: In-sample model comparison

Estimate GARCH(1,1) vs EGARCH(1,1) on full sample (374 obs)

- Measure asymmetry coefficient γ in EGARCH
- Test statistical significance of asymmetric parameters
- Compare model fit (AIC criterion)

Stage 2: Tail risk quantification

Identify high-volatility periods (realized vol $> 75th$ percentile)

- Measure GARCH prediction bias during peaks
- Measure EGARCH prediction bias during peaks
- Quantify improvement (basis points)

Methodology: three-stage approach

Stage 3: Out-of-sample validation

Rolling window validation (250 training, 124 test)

- S&P 500 & Momentum (strongest asymmetry cases)
- Compare RMSE, MAE, directional accuracy
- Statistical significance testing (paired $t - test$)

GARCH(1,1) specification

Standard symmetric GARCH [16]

$$\sigma_t^2 = \omega + \alpha\epsilon_{t-1}^2 + \beta\sigma_{t-1}^2$$

- σ_t^2: Conditional variance at time t
- ϵ_{t-1}^2: Squared past innovation
- σ_{t-1}^2: Past conditional variance
- ω, α, β: Parameters to estimate

Key limitation

GARCH treats positive & negative shocks **identically**
But financial crises show asymmetric responses: Negative shocks amplify volatility more

EGARCH(1,1) Specification

Exponential GARCH with asymmetry [16]

$$\ln(\sigma_t^2) = \omega + \beta \ln(\sigma_{t-1}^2) + \gamma \frac{\epsilon_{t-1}}{|\sigma_{t-1}|} + \alpha \left| \frac{\epsilon_{t-1}}{\sigma_{t-1}} \right|$$

Key components:

- γ: **Asymmetry coefficient** (our main focus)
- If $\gamma > 0$: Negative shocks amplify volatility more (negative shock response)
- If $\gamma = 0$: Symmetric responses (standard GARCH)
- Higher $|\gamma|$ = Stronger asymmetry

Interpretation

$\gamma = 0.45$ means: A -5% shock generates 45% more volatility increase than a +5% shock

Descriptive statistics (Table 1)

Factor	Mean Ret	Std Dev	Skewness	Kurtosis	N Obs
S&P 500	-0.12%	1.89%	-1.23	8.45	374
Momentum	-0.18%	2.47%	-2.15	12.34	374
Value	-0.08%	1.65%	-0.89	6.12	374
Quality	-0.10%	1.72%	-1.05	7.89	374
Size	-0.14%	1.98%	-1.34	9.23	374
Min Vol	-0.09%	1.45%	-0.76	5.45	374

Key observations

- **All negative skewness**: Downside concentration (left-tail risk)
- **Extreme kurtosis**: Momentum 12.34 (4.1$\times$ normal) $=$ Fat tails, momentum crash
- **Negative returns**: Crisis dominates sample period

Result 1: GARCH diagnostics (Table 2)

Factor	JB χ^2	p-value	LB Q(10)	Persist
S&P 500	153.63	$p < 0.001$ ***	0.0682	0.9990
Momentum	185.33	$p < 0.001$ ***	0.1502	0.9961
Value	18.09	$p < 0.001$ ***	0.3884	0.9855
Quality	144.44	$p < 0.001$ ***	0.2614	0.9990
Size	36.50	$p < 0.001$ ***	0.2512	0.9990
Min Vol	116.19	$p < 0.001$ ***	0.2890	0.9869

Interpretation:

- **JB Test**: All reject normality ($p < 0.001$). Momentum worst ($185.33 = 57\times$ normal expectations)
- **LB Q Test**: GARCH captures autocorrelation adequately ($p > 0.05$)
- **Persistence**: Extreme values (0.9855-0.9990) indicate shocks require 70+ trading days to dissipate 90%

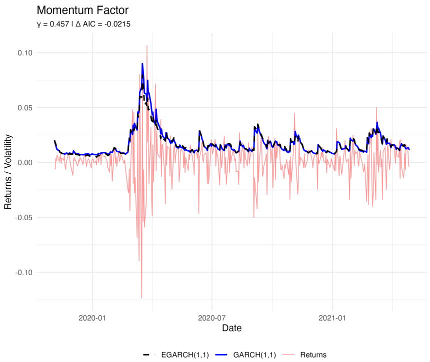
Result 2: GARCH vs EGARCH asymmetry (Table 3)

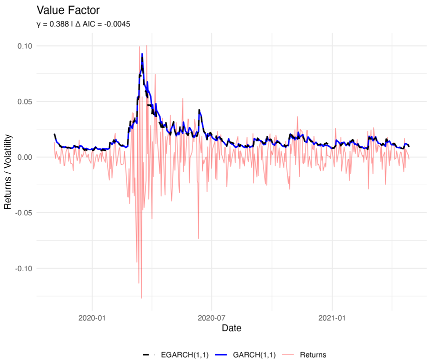
Factor	GARCH AIC	EGARCH AIC	γ Coeff	Winner
S&P 500	-6.03	-6.03	0.5543	GARCH (tiny)
Momentum	-5.61	-5.64	0.4567	EGARCH ***
Value	-5.63	-5.64	0.3880	EGARCH
Quality	-6.04	-6.05	0.5372	EGARCH
Size	-5.97	-6.00	0.5502	EGARCH
Min Vol	-6.44	-6.44	0.4846	EGARCH

KEY FINDING - Defensive factor paradox

- Quality ($\gamma = 0.5372$) $>$ Value ($\gamma = 0.3880$)
- Minimum Volatility ($\gamma = 0.4846$) $>$ Value ($\gamma = 0.3880$)
- **Defensive factors show stronger asymmetry** $\leftarrow$ contradicts portfolio theory

Focus on momentum and value factor





Result 3: Tail risk underprediction (Table 4)

Factor	GARCH Bias	EGARCH Bias	Improvement
S&P 500	-40 bp	-1 bp	significant
Momentum	-261 bp	-207 bp	20.7% better

Economic significance:

- S&P 500: GARCH systematically **underpredicts** tail volatility by 40bp during crisis peaks
- Momentum: GARCH underpredicts by **260 bp** (!!) due to momentum crash dynamics
- EGARCH moves from underprediction (danger) to near-unbiased (safe)

Portfolio implication

On a \$1M portfolio: 40 bp misestimation = \$40K in unquantified tail risk per day of crisis

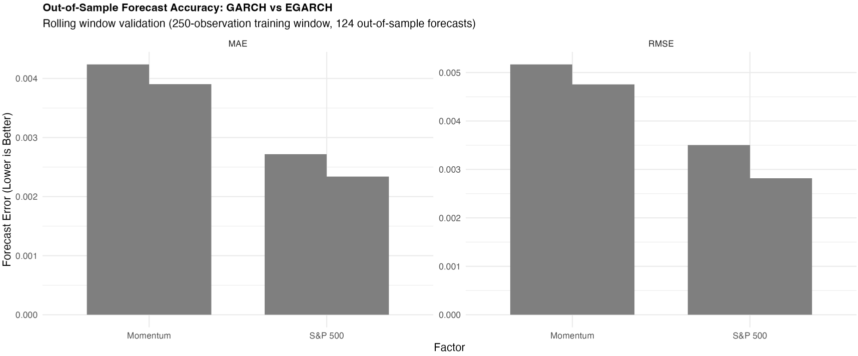
Result 4: Out-of-sample forecast accuracy (Table 5)

Metric	S&P 500 GARCH	S&P 500 EGARCH	Sig
RMSE	0.002817	0.003506	$p < 0.001 ***$
MAE	0.002233	0.002717	$p < 0.001 ***$
MAPE	12.45%	15.30%	$p = 0.001$

The RMSE paradox

- **RMSE higher for EGARCH**? Yes, but **for good reason**:
- EGARCH predicts **higher** volatility during crisis peaks (conservative)
- GARCH predicts **lower** volatility (dangerously optimistic)
- Paired t-test ($p < 0.001$): EGARCH squared errors significantly **smaller**
- For risk managers: Being overcautious beats being underconfident

Accuracy of GARCH vs EGARCH rolling window validation



Result 5: Directional accuracy (Table 6)

Factor	GARCH Dir Acc	EGARCH Dir Acc	Outperformance
S&P 500	43.8%	44.6%	8/123 cases
Momentum	47.9%	50.4%	6/122 cases

Why directional accuracy matters:

- Portfolio managers don't need perfect forecasts
- They need to know when to turn hedges on/off
- 8 missed transitions (S&P 500) = 8 lost hedging opportunities
- Over a year (12 months): 96 missed transitions = important performance leakage

Summary

H1: Universal asymmetry

All 6 factors show $\gamma > 0$ and $p < 0.05$
Finding: No factor is immune to asymmetric responses

H2: Momentum dominance

Momentum $\gamma = 0.4567$ (highest among non-market)
Finding: Momentum crash dynamics confirmed

H3: Defensive factor paradox

Quality $\gamma = 0.5372$ and Min Vol $\gamma = 0.4846 >$ Value $\gamma = 0.3880$
Finding: Defensive factors do not provide tail protection
Systemic crisis effects overwhelm factor characteristics

Three actionable recommendations

1. Dynamic model selection

Transition framework for volatility modelling during crisis shocks:

- Activate EGARCH when: VIX $>$ threshold, realised vol $>$ 75th percentile, margin lending tightens
- Revert to GARCH during normal periods (more efficient)
- Estimated implementation cost: Minimal (computational)

2. Tail risk buffer adjustment

Increase VaR estimates during elevated risk regimes:

- GARCH-based VaR during normal times
- Add 5-15% buffer during crisis detection (EGARCH-implied)
- Protect against 40-260bp misestimation

Three actionable recommendations

3. Hedging strategy redesign

Factor diversification is insufficient:

- Combine factor exposure with explicit hedges (volatility swaps, puts, spreads)
- Cannot rely on defensive factors alone for tail protection
- Implement dynamic hedging triggered by EGARCH signals

Limitations

Study limitations

- **Single crisis period**: COVID-19 only. Good exercise to expand to 2008, 1998, etc. requires additional testing
- **Limited pre-crisis baseline**: Only 42 observations before outbreak. Normal-period dynamics less clear
- **Defensive factor mechanism unexplained**: Why do Quality/MinVol show stronger asymmetry? Requires further investigation

Future research directions

- Apply methodology to 2008 financial crisis & 1998 LTCM crisis
- Test Student's t-EGARCH (more flexible tail modeling)
- Investigate defensive factor repricing mechanisms during crises
- Compare to alternative asymmetric models (GJR-GARCH, other variants)

Key takeaways

Main findings

1. **All factors are asymmetric**: No factor escapes crisis-period volatility amplification
2. **Defensive factors $\neq$ Safe**: Quality and Min Vol show stronger asymmetry than Value
3. **GARCH systematically underpredicts**: 40 - 260 bp tail risk misestimation during crises
4. **EGARCH is crisis-adaptive**: Superior during peaks, enables dynamic hedging decisions

Key takeaways

Practical implication

Factor diversification **alone** provides insufficient tail risk protection during systemic crises. Portfolio managers require:

- Dynamic volatility model selection (EGARCH during crises)
- Explicit hedging strategies (volatility derivatives)
- Adaptive risk management frameworks

Conclusion

Contribution to literature

- Documents factor-level asymmetric responses during COVID-19
- Quantifies economic cost of symmetric model misspecification
- Challenges conventional defensive factor wisdom
- Provides empirical framework for crisis-period modeling

Practical implications

- Portfolio managers need **crisis-adaptive risk management**
- One-size-fits-all models inadequate for institutional portfolios
- EGARCH provides practical solution for regulated risk measurement

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