

# 1 Models

In this section we will describe the models that have been implemented throughout the process and highlight the changes and simplifications. To make a framework for model development we created a metaclass, so called BaseModel, where we created all the common functions that all these models share. We manage to implement a strategy to create bounds with existing parameter's transformation. Not only give us a unique opportunity to modeling with various parameter transformations, but in optimizations brought as a more stable results. The optimizer that we use the Python's `scipy.optimize.minimize` function with the setting of the L-BFGS-B method.

## 1.1 MIDAS

The first model was the MIDAS that was first introduced [10], where they compare distributed lag models with MIDAS regression. The MIDAS model can be described with the expressions used in [11]. Suppose  $y_t$  is the low-frequency dependent variable that can be observed once within a time-step  $t$  (say, monthly), then  $x_t^{(m)}$  the high-frequency explanatory variable can be observed  $m$  times during one time-step (say, daily or  $m = 22$ ). We want to describe the relationship between  $y_t$  and  $x_t^{(m)}$ , in the sense of using lagged observations of  $x_t^{(m)}$ . The model is the following:

$$y_t = \beta_0 + \beta_1 B(L^{\frac{1}{m}}, \theta) x_t^{(m)} + \varepsilon_t^{(m)} \quad (1)$$

where  $B(L^{\frac{1}{m}}, \theta) = \sum_{k=0}^K B(k, \theta) L_m^{\frac{k}{m}}$ , where  $L_m^{\frac{k}{m}}$  is a lag operator such that  $L_m^{\frac{1}{m}} x_t^{(m)} = x_{t-\frac{1}{m}}^{(m)}$ . The lag coefficients in  $B(k, \theta)$  of the corresponding lag operator  $L_m^{\frac{k}{m}}$  are parameterized as a function of a small-dimensional vector of parameters  $\Theta$ .  $\beta_1$  is a scale parameter for the lag coefficients

### 1.1.1 Specification of Weighting Function

In the MIDAS literature there is one weighting function that used the most, namely "Beta" Lag. [11, 8, 9]. For completeness, I mention the others, these are the Exponential Weighting and the Exponential Almon Lag. Beta Lag involves two parameters,  $\Theta = (\theta_1, \theta_2)$ , and the parametrization:

$$B(k, \theta_1, \theta_2) = \frac{f(\frac{k}{K}, \theta_1, \theta_2)}{\sum_{k=1}^K f(\frac{k}{K}, \theta_1, \theta_2)} \quad (2)$$

where

$$f(x, a, b) = \frac{x^{a-1} (1-x)^{b-1} \Gamma(a+b)}{\Gamma(a) \Gamma(b)} \quad (3)$$

$$\Gamma(a) = \int_0^\infty e^{-x} x^{a-1} dx \quad (4)$$

The following figure will demonstrate how flexible it is correspond to different parameters:

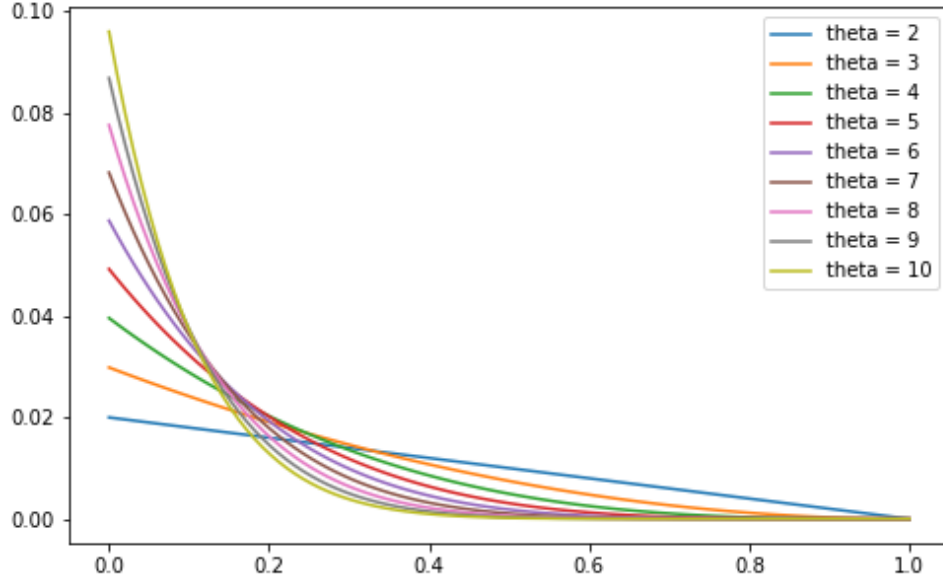


Figure 1: Plot of Beta Lag weighting function in equation 1 with  $K = 100$ ,  $\theta_1 = 1$  and  $\theta_2 = 2, \dots, 10$

We can see that if we choose to fix  $\theta_1 = 1$  and in the case of  $\theta_2 > 1$  cause a monoton decliyin weighting structure. This weight function specification provide us positive coefficients, which is crutual when we want to modeling volatility.

### 1.1.2 Parameter Estimation

This simple model's parameter estimation happens through the sum of squared estimate of error:

$$SSE = \varepsilon^T \varepsilon = \sum_{t=1}^T (y_t - \beta_0 - \beta_1 B(L^{\frac{1}{m}}, \theta) x_t^{(m)})^2 \quad (5)$$

As SSE is a quadratic function, we can find the optimal parameters by minimizing it:

$$\arg \min_{\beta_0, \beta_1, \theta} SSE$$

where  $\beta_0, \beta_1$  and  $theta$  are the desired paremetrs to be estimated.

### 1.1.3 Simulations

The Monte-Carlo simulation was from [[3]]. Suppose we have  $X_t$  is an AR(1) process, that:

$$X_{i,t} = \phi X_{i-1,t} + \varepsilon_t$$

where  $t = 1, \dots, T$  show the low-frequency time-steps,  $i = 1, \dots, I_t$  is the high-frequency. Set the  $I_t$  equals to 22,  $\phi = 0.9$  and  $\varepsilon_t \sim \mathcal{N}(0, 1)$  standard normal variable. The MIDAS equation will be:

$$y_t = \beta_0 + \beta_1 \sum_{k=0}^K \xi_k(1.0, \theta) X_{i-k,t} + z_t$$

with the parameters  $\beta_0 = 0.1, \beta_1 = 0.3, \theta = 4.0$  and  $z_t \sim \mathcal{N}(0, 0.5)$ . We made simulations with  $T = 100, 200, 500$ . A similar approach was described in [9] with the difference of simulating quarterly/monthly data and they found out, as they increase the sample size the more accurate their parameter estimations will be, furthermore the more parsimonious will be the model's computational cost.

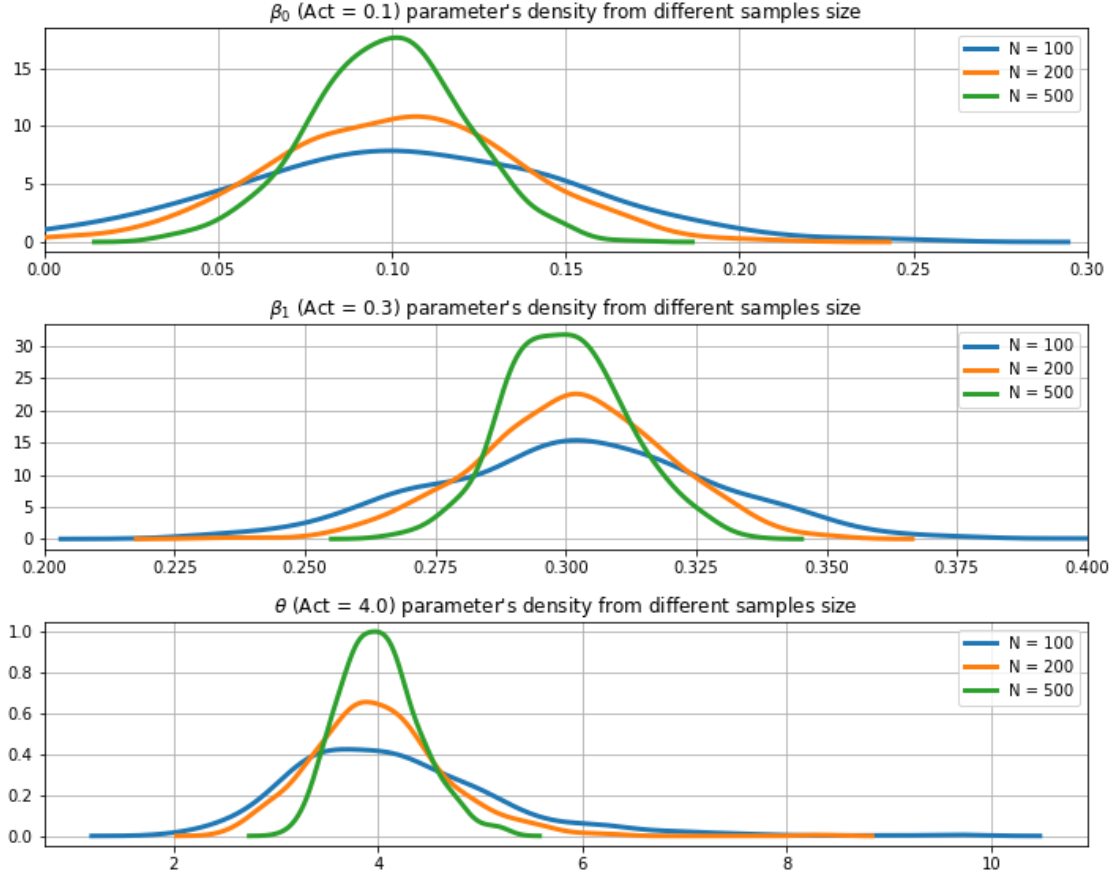


Figure 2: Plot of estimated parameter distributions with sample sizes of 100, 200, 500

## 1.2 GARCH

In this section, I would like to give a brief overview about GARCH model. The underlying concept was first developed in [7], the ARCH model, where we associated  $r_t$  with the daily log return ( $r_t = \log P_t - \log P_{t-1}$ ,  $P_t$  is the stock price at time  $t$ ) for  $t = 1, \dots, T$ , and assume that it can be written as  $r_t = \mu_t \varepsilon_t$ ,  $\varepsilon_t$  are modelled with ARCH model:

$$\varepsilon_t = \sigma_t Z_t$$

$$\sigma_t^2 = \alpha_0 + \sum_{i=1}^p \alpha_i \varepsilon_{t-i}^2$$

where the innovation  $Z_t$  are iid random variables with mean 0 and variance 1. Suppose  $Z_t \sim \mathcal{N}(0, 1)$ . The innovation's distribution can be modelled with various ways, such as Student-t distributed or, the most common, Normally distributed. The parameter constraints are:  $\alpha_0 > 0, \alpha_i \geq 0$ . This model was extended in

[2] to the Generalized ARCH model, where previous values of  $\sigma_t^2$  are added to the volatility process. This extension create phenomenons that can be observed in markets, such as volatility clustering, where high volatility peroids tends to persist. The GARCH(1, 1) process is given by

$$\sigma_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2 + \beta_1 \sigma_{t-1}^2$$

where  $\varepsilon_t$  are real-valued discrete-time stochastic process and  $\mathcal{F}_t$  is the information set of all information up to time t.

$$\varepsilon_t | \mathcal{F}_{t-1} \sim \mathcal{N}(0, \sigma_t^2)$$

where  $\alpha_0 > 0, \alpha_1 \geq 0, \beta_1 \geq 0$  and  $1 > \alpha_1 + \beta_1$  enough wide-sense stacionarity.

$$E(r_t) = 0$$

$$Var(r_t) = E(r_t^2) - E(r_t)^2 = E(\sigma_t^2 Z_t^2) = E(\sigma_t^2)E(Z_t^2)$$

Since  $Z_t \sim N(0, 1)$ , so  $E(Z_t^2) = 1$ . Then,

$$E(\sigma_t^2) = E(\alpha_0 + \alpha_1 r_{t-1}^2 + \beta_1 \sigma_{t-1}^2) = \alpha_0 + \alpha_1 E(r_{t-1}^2) + \beta_1 E(\sigma_{t-1}^2)$$

From  $r_t = \sigma_t Z_t$ , it is known that  $E(r_t^2) = E(\sigma_t^2)$  and for the process to be stationary  $E(\sigma_t^2)$  must be a constant for all t:

$$E(\sigma_t^2) = E(\sigma_{t-1}^2) = E(r_{t-1}^2) = \sigma^2$$

the unconditional mean of the volatility process and the unconditional variance of the returns hence,

$$E(\sigma_t^2) = Var(r_t) = \frac{\alpha_0}{1 - \alpha_1 - \beta_1}$$

To examine the tail behavior we have to examine the excess kurtosis, which implies that the forth moment to exist and be finite. The excess kurtosis of  $r_t$  with normally distributed innovations is then

$$\begin{aligned} \frac{E(r_t^4)}{Var(r_t)^2} - 3 &= \frac{3(1 + \alpha_1 + \beta_1)\alpha_0}{(1 - \alpha_1 - \beta_1)(1 - 2\alpha_1^2 - (\alpha_1 + \beta_1)^2)(\frac{\alpha_0}{1 - \alpha_1 - \beta_1})^2} - 3 \\ &= 3 \frac{1 - (\alpha_1 + \beta_1)^2}{1 - 2\alpha_1^2 - (\alpha_1 + \beta_1)^2} - 3 \\ &= \frac{2\alpha_1^2}{1 - \alpha_1^2 - (\alpha_1 + \beta_1)^2} > 0 \end{aligned}$$

which means that  $r_t$  is fat-tailed, in other words extreme returns can be observed more frequently than they would with normally distributed innovations.

### 1.2.1 Parameter Estimation

We applied the Quasi-Maximum Likelihood Estimation (henceforth QMLE) for parameter estimation. In general, we assume an underlying distribution, which has some kind of probability density function, and we have  $\theta$  the set of parameters to be estimated. In the assumption of normal distribution:

$$f(\varepsilon_t | \theta) = \frac{1}{\sqrt{2\pi \hat{\sigma}_t^2(\theta)}} \exp\left(-\frac{\varepsilon_t^2}{2\hat{\sigma}_t^2(\theta)}\right)$$

where  $\varepsilon_t$  are the innovations in GARCH type models, and  $\hat{\sigma}_t^2(\theta)$  are the volatility estimates with given  $\theta$  parameters. The loglikelihood function will be

$$\mathcal{L}(\theta) = f(\varepsilon_1, \dots, \varepsilon_T | \theta) = \prod_{t=1}^T \frac{1}{\sqrt{2\pi\hat{\sigma}_t^2(\theta)}} \exp\left(-\frac{\varepsilon_t^2}{2\hat{\sigma}_t^2(\theta)}\right)$$

since the logarithm is a monotonically increasing function, the value which maximize the likelihood function will also maximize its logarithm as well. We can write a sum instead of a product in the log-likelihood function:

$$\log \mathcal{L}(\theta) = -\frac{T}{2} \sum_{t=1}^T \left( \log 2\pi + \log \hat{\sigma}_t^2(\theta) + \frac{\varepsilon_t^2}{\hat{\sigma}_t^2(\theta)} \right) \quad (6)$$

The QMLE is then

$$\hat{\theta} = \arg \max_{\theta} \log \mathcal{L}(\theta) = \arg \min_{\theta} -\log \mathcal{L}(\theta) \quad (7)$$

If a function that maximum is a negative number, then we can multiply by minus 1 to minimize it. In practical application there are several algorithms to minimize functions, so we use the negative log-likelihood to estimate the models parameters. Another usefully specification of the probability density function is the Student-t distribution. The log-likelihood of a Student-t distributed specification is the following:

$$\begin{aligned} \log \mathcal{L}(\theta) = & -\sum_{t=1}^T -\log \Gamma\left(\frac{\nu+1}{2}\right) + \log \Gamma\left(\frac{\nu}{2}\right) + \log \sqrt{2\pi(\nu-2)} + \frac{1}{2} \log \hat{\sigma}_t^2(\theta) \\ & + \frac{\nu+1}{2} \log \left(1 + \frac{\varepsilon_t^2}{\hat{\sigma}_t^2(\theta)(\nu-2)}\right) \end{aligned}$$

### 1.2.2 Simulations

To ensure our implementation will truly estimate the desired parameters, we perform a Monte-Carlo simulation for the GARCH(1, 1) model with different sample sizes. In the simulation process we assume that, the log returns follow a normal distribution with the variance from the current state's  $\sigma_t^2$ . The results from the simulations estimated by QMLE as it was described in the previously. Formally we can write as

$$\varepsilon_t \sim \mathcal{N}(0, \sigma_t^2) \quad (8)$$

for  $t = 1, \dots, T$ , where  $T$  is the length of the sample size. The results of the parameter estimations is shown:

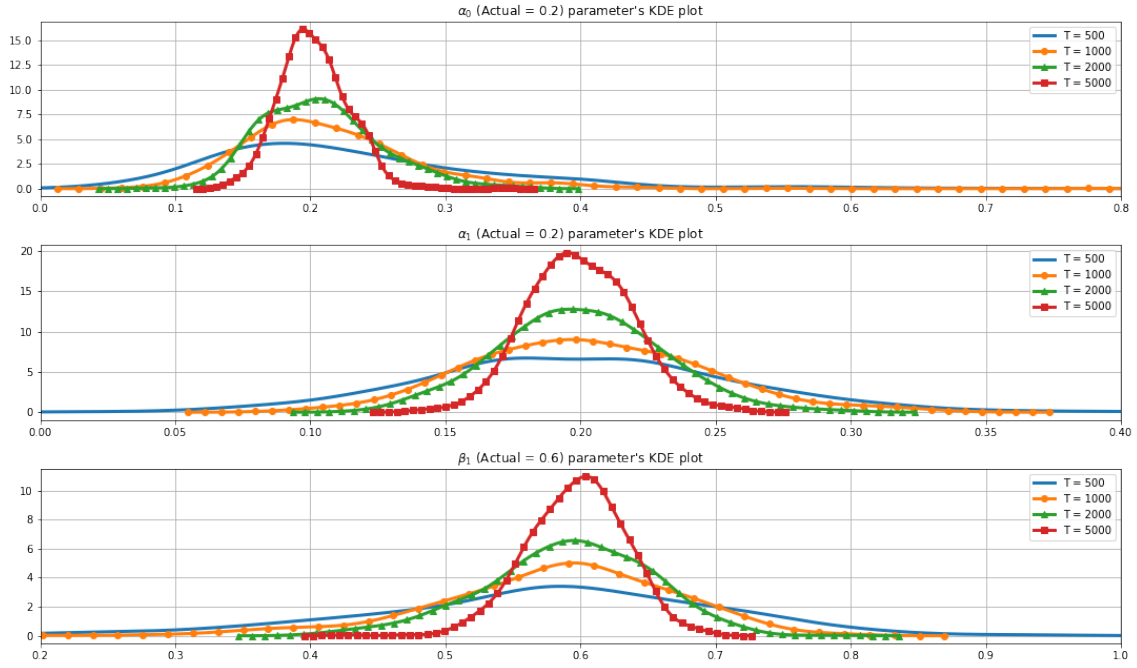


Figure 3: Plot of estimated parameter distributions with sample sizes of 500, 1000, 2000, 5000

The parameter distributions are presented with Kernel Density Estimation (KDE) for the better visualization. The peaks of the distributions are in the theoretical values, moreover, we can see that as we increase the sample size, the more accurate will be the parameter estimations and decrease the variances of the parameters.

### 1.3 GARCH-MIDAS

In this section we present a new class of component GARCH model based on the MIDAS regression. This GARCH-MIDAS framework gives us the possibility to incorporate macroeconomic variables sampled at a different frequency. All macroeconomic variables will be in the specification of the long-term component.

Several papers have been published in the recent years about the topic of GARCH-MIDAS model. [8] was one of the first to discuss about such a model. They rely on long historical time series and examined what was the impact of adding economic variables to the GARCH model. [1] used this framework to predict future volatility, they incorporate with a principal component approach as well to reduce the dimensions of the explanatory variables. To conduct their results they found that GARCH-MIDAS forecast volatility better than a GARCH model. In [4] found that long-term financial volatility behaves counter-cyclically and certain macroeconomic variables help GARCH-MIDAS model to predict better the long-term volatility. [16] showed that GARCH-MIDAS model has fat-tailed marginal distribution.

The GARCH-MIDAS framework gives us the opportunity to incorporate macroeconomic variables sampled at a different frequency. In the recent years many studies showed the effectiveness of this approach, the only pitfall, we found, is the amount of underlying data that we provide for the algorithm. Let  $r_t$  be the

daily log-returns, for  $t = 1, \dots, T$  refers to certain period (say a month) and the index  $i = 1, \dots, I_t$  (say days) within that period. Assume that the daily log-returns follows  $r_{i,t} = \varepsilon_{i,t}$  and

$$\varepsilon_{i,t} = \sqrt{g_{i,t}\tau_t}Z_{i,t} \quad (9)$$

where  $\varepsilon_{i,t} | \mathcal{F}_{i-1,t} \sim \text{mathcal{N}}(0, g_{i,t}, \tau_t)$  with  $\mathcal{F}_{i-1,t}$  is the information set up to day  $i-1$  of period  $t$ .  $g_{i,t}$  denote to the short-term component of conditional variance and follows a unit-variance GARCH(1, 1) process:

$$g_{i,t} = \alpha_0 + \alpha \frac{\varepsilon_{i-1,t}^2}{\tau_t} + \beta g_{i-1,t} \quad (10)$$

where  $\alpha_0 > 0, \alpha \geq 0, \beta \geq 0$  and  $1 > \alpha + \beta$  enough wide-sense stacionarity.  $\tau_t$  is defined as a function of the explanatory variables  $X_t^{(m)}$ , where  $m$  refers to the  $m$ -th explanatory variable. This will serve as the long-term component that varies at lower frequency. We specified with the MIDAS regression as

$$\tau_t = \sum_{m=1}^M \beta_m \sum_{k=0}^K \phi_k(1.0, \theta_m) X_{t-k}^{(m)} \quad (11)$$

where  $K$  is the lag parameter and  $\phi_k$  refers to the weighting scheme, which we can specify. We chose the Beta weighting scheme such as most of the papers suggested. As we fixed the first paramter of the Beta weighting scheme to 1.0, then it will allow us to get monotoneously declining or increasing weights, as it was showed in the MIDAS section. If we want to use explanatory variables that can take positive or negative values, we used the exponential specification of the  $\tau_t$

$$\tau_t = \exp\left(\sum_{m=1}^M \beta_m \sum_{k=0}^K \phi_k(1.0, \theta_m) X_{t-k}^{(m)}\right) \quad (12)$$

We tried to minimize the number of estimated parameters, so we changed the short-term volatility component's equation with a few assumptions.

$$E(r_{i,t}) = 0$$

$$\text{Var}(r_{i,t}) = E(r_{i,t}^2) - E(r_{i,t})^2 = E(r_{i,t}^2) = E(\sigma_{i,t}^2 Z_{i,t}^2) =$$

where they are indepent, since  $Z_{i,t} \sim \mathcal{N}(0, 1)$ , so the expected value of squared  $Z_{i,t}$  is equal to 1. Then,

$$E(\sigma_{i,t}^2) = E(g_{i,t} \tau_t) = E(g_{i,t}) E(\tau_t) =$$

since we assumed that these two factors contibute for the underlying volatility process, namely, for  $\sigma_{i,t}^2$ . The other assumption, that we used, is the expected values of the macroeconomic variables is equal to 0, namely,  $E(X_t^{(m)}) = 0$ . Hence, the logarithm of  $\tau$  has an expected value 0 and  $\tau_t$  is equal to 1.

$$E(g_{i,t}) = E\left(\alpha_0 + \alpha \frac{\varepsilon_{i-1,t}^2}{\tau_t} + \beta g_{i-1,t}\right) = \alpha_0 + \alpha E(g_{i-1,t}) + \beta E(g_{i-1,t})$$

From  $r_{i,t} = \sigma_{i,t} Z_{i,t}$ , it is known that  $E(r_{i,t}^2) = E(\sigma_{i,t}^2)$  and as we see in the GARCH section the unconditional variance of the returns henceforth

$$E(\sigma_{i,t}^2) = \text{Var}(r_{i,t}) = \frac{\alpha_0}{1 - \alpha - \beta}$$

We used the moment matching to eliminate the  $\alpha_0$  parameters in the following way:

$$\hat{\mu} = \frac{1}{T I_t} \sum_{t=1}^T \sum_{i=1}^{I_t} r_{i,t}^2$$

then we can rewrite the short-term volatility equation:

$$g_{i,t} = \hat{\mu}(1 - \alpha - \beta) + \alpha \frac{\varepsilon_{i-1,t}^2}{\tau_t} + \beta g_{i-1,t} \quad (13)$$

### 1.3.1 Parameter Estimation

The GARCH-MIDAS estimation made by maximum likelihood estimation, where the underlying two volatility component's parameters are estimated by a single-step. It was necessary to highlight the single-step estimation, because in the further sections we will introduce the two-step method, which worked better for us in panel models. The loglikelihood function, then

$$\begin{aligned} \log \mathcal{L}(\Theta) &= -\frac{1}{T I_t} \sum_{t=1}^T \sum_{i=1}^{I_t} \left( \frac{1}{2} \log 2\pi + \frac{1}{2} \log (g_{i,t} \tau_t) + \left( \frac{\varepsilon_{i,t}^2}{2g_{i,t} \tau_t} \right) \right) \\ &\quad \arg \min_{\Theta} \log \mathcal{L}(\Theta) \end{aligned} \quad (14)$$

### 1.3.2 Simulations

In the simulations, we assumed that the long-term volatility component is generated from  $X_t$  an AR(1) process:

$$X_t = \psi X_{t-1} + u_t$$

where  $u_t$  is a random process with mean zero and variance  $h^2$  and  $X_0 = 0$ . We set them to  $\psi = 0.8$  and  $h^2 = 0.3$ . Hence,

$$\log(\tau_t) = 0.3 \sum_{k=0}^K \phi_k(1.0, 4.0) X_{t-k}$$

where we chose  $\beta_1 = 0.3$ ,  $\theta = 4.0$  and  $K = 12$ . In the short-term volatility component  $\alpha = 0.1$  and  $\beta = 0.8$ . As we described above, the returns generated in the following way:

$$r_{i,t} \sim \mathcal{N}(0, g_{i,t} \tau_t)$$

The simulations ran in  $T = 60, 120, 180$ , in other words they can be interpreted as 5-year, 10-year or 15-year length of data. The main objective was to about to see the increase the accuracy and the decrease of the variance of the parameter estimation.



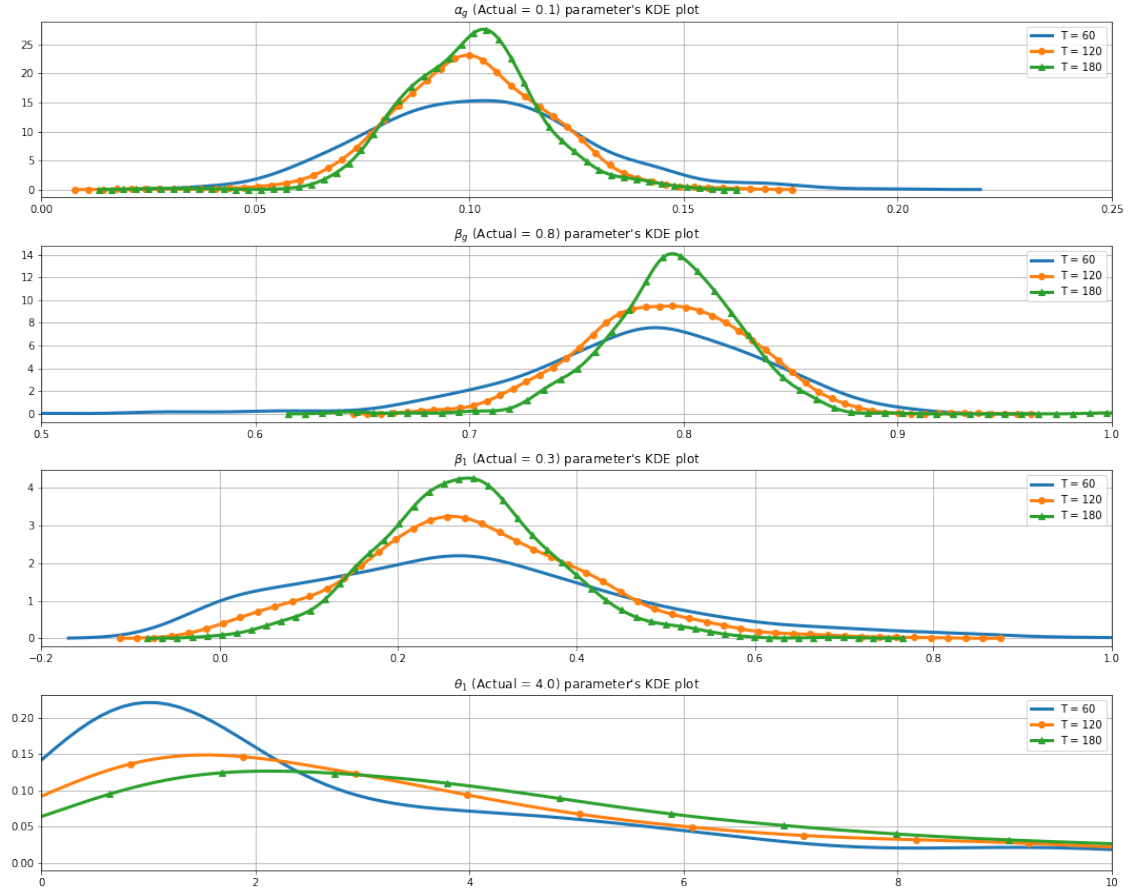


Figure 4: Plot of estimated parameter distributions with sample sizes of  $T = 60, 120, 180$

In the case of the first three parameters, we can see the expected tendency, what we waited for. Not only we can experience huge deviations in parameter's accuracy, but the  $\theta$  estimated parameter's are not accurate at all. We conducted from these simulations, that we need to provide more data for this algorithm to excel in the parameter estimations, so in the following sections we will describe panel models.

## 1.4 Panel MIDAS

In this section I would like to introduce a new application of the MIDAS framework, namely, the panel version of the model. This approach not only provide better understanding about the underlying long term volatility, but it is parsimonious. The main idea was that there are a panel of stock returns and we would like to say something about the common long-term volatility component. In our application, we used the macroeconomic explanatory variables to model the volatility.

Let  $r_{i,t}^{(j)}$  denote the  $j$ -th stock's daily return for  $j = 1, \dots, N$ , at  $i$ -th day for  $i = 1, \dots, I_t$  of  $t$ -th month for  $t = 1, \dots, T$ . The indexes came from the GARCH-MIDAS section and we try to use the same symbols to be consistent. We assumed that these stocks share the same underlying volatility component that will be marked as  $\tau_t$ . The long-term volatility component contains all the explanatory variables, which can describe the volatility. If we choose  $I_t = 1$  means we would like to calculate the monthly returns volatility, so both  $r$

and  $\tau$  will be at the same frequency. Furthermore, we can apply weekly, daily or even intra daily explanatory variables in modeling the volatility. In the lack of intra day data and to keep the modeling parsimonious as possible we used only monthly sampled data.

We describe  $\tau_t$  as we did in GARCH-MIDAS section:

$$\tau_t = \sum_{m=1}^M \beta_m \sum_{k=0}^K \psi_k(1.0, \theta_m) X_{t-k}^{(m)} \quad (15)$$

where  $m$  refers to the  $m$ -th explanatory variable,  $K$  is the lag parameter and  $\phi_k$  refers to the weighting scheme, which we can specify. We used the Beta weighting scheme for modeling as most of the papers suggested. We fixed the first paramter of the Beta weighting scheme to 1.0, then it will allow us to get monotoneously declining or increasing weights, as it was showed in the MIDAS section. We used the exponentail specification of  $\tau_t$  as we used explanatory variables which can take negative values:

$$\tau_t = \exp\left(\sum_{m=1}^M \beta_m \sum_{k=0}^K \phi_k(1.0, \theta_m) X_{t-k}^{(m)}\right) \quad (16)$$

#### 1.4.1 Parameter Estimation

The Panel MIDAS model estimated by QMLE that was described previously. We assumed that the stock's returns mean are equal to zero, then the negative loglikelihood function will be:

$$\log \mathcal{L}(\Theta) = -\frac{T}{2} \sum_{j=1}^N \sum_{t=1}^T \left( \log 2\pi + \log \tau_t + \frac{(r_{i,t}^{(j)})^2}{\tau_t} \right) \quad (17)$$

The log likelihood of each individual stock is summed up to be minimized:

$$\arg \min_{\Theta} \log \mathcal{L}(\Theta) \quad (18)$$

#### 1.4.2 Simulations

The simulation was conducted in the spirit of MIDAS simulation with same changes. Let suppose we have one explanatory variable that define the volatility say  $X_t$  is an AR(1) process:

$$X_t = \psi X_{t-1} + \varepsilon_t \quad (19)$$

where  $t = 1, \dots, T$ ,  $\psi = 0.9$  and  $\varepsilon_t \sim \mathcal{N}(0, 1)$  standard normal variable, than the MIDAS model will be:

$$\log \tau_t = \beta_1 \sum_{k=0}^K \phi_k(1.0, \theta) X_{t-k} \quad (20)$$

where  $\beta_1 = 0.3$  and  $\theta = 4.0$ .  $\tau_t$  remains the same throughout the whole period. The  $\tau_t$  will determine the return's volatility, the returns are generated from normal distribution with zero mean and  $\tau_t$  variance:

$$r_{i,t} \sim \mathcal{N}(0, \tau_t) \quad (21)$$

as  $\tau_t$  is set to be a monthly variable, we generate daily return, so  $i$  mark mean that the  $i$ -th day of  $t$ -th month,  $i = 1, \dots, I_t$ , where  $I_t = 22$ .

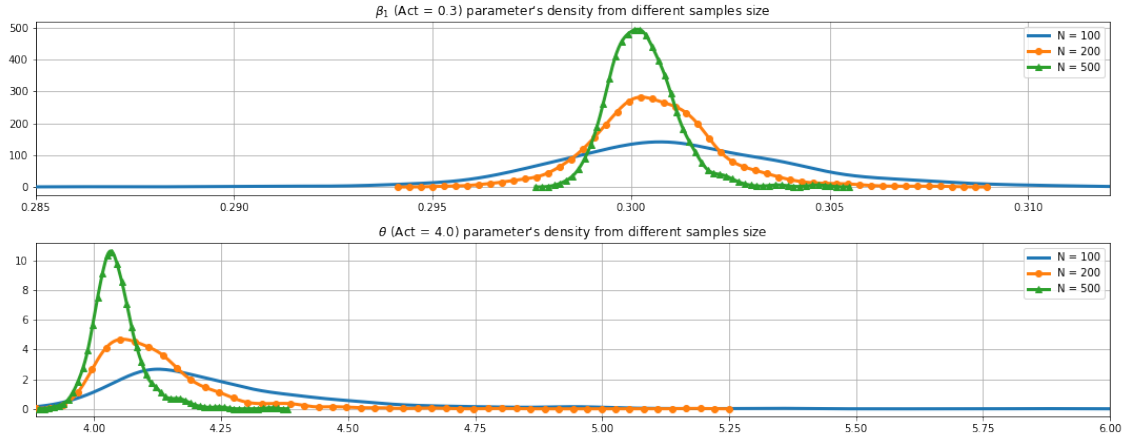


Figure 5: Plot of estimated parameter distributions with sample sizes of  $N = 100, 200, 500$

The distributions show that as we increase the panel size we get better parameter estimation. We simulated 100 month of data, which means around 2200 day's of returns. In the case of  $N = 500$ , we can say the model can estimate the parameters which we used for simulations.

## 1.5 Panel GARCH

In this section we would like to present the panel version of the GARCH model we described above. Our main goal was here to make the model as parsimonious as we could to become the benchmark model for our further analysis.

Let  $r_{i,t}^{(j)}$  denote to the  $j$ -th stock's daily return for  $j = 1, \dots, N$  at  $i$ -th day for  $i = 1, \dots, I_t$  of  $t$ -th month for  $t = 1, \dots, T$ . In order to be consistent with the indexation, we decided to choose the ones that we used in Panel MIDAS section. Not only it will make easier to describe Panel GARCH-MIDAS model, but it also create consistency in indexes. We used the assumption of that the parameters for the dynamics of the volatilities are common to every stocks. In addition, the unconditional means of the volatilities are asset specific. The daily returns follow:

$$r_{i,t}^{(j)} = \varepsilon_{i,t}^{(j)} = \sigma_{i,t}^{(j)} Z_{i,t}^{(j)} \quad (22)$$

where  $Z_{i,t}^{(j)}$  the innovations which identically independent distributed random variables with mean 0 and variance 1. As we described in GARCH section, we specified the distributions for this innovation term, the first one is the Normal distribution and the other is the Student-t distribution to capture more extreme returns. The volatility equation can be written as:

$$\sigma_{i,t}^{(j)2} = \mu^{(j)}(1 - \alpha_1 - \beta_1) + \alpha_1 \varepsilon_{i-1,t}^{(j)2} + \beta_1 \sigma_{i-1,t}^{(j)2} \quad (23)$$

where  $\mu^{(j)}$  refers to the unconditional variance and the parameters of  $\alpha_1$  and  $\beta_1$  satisfies  $\alpha_1 \geq 0, \beta_1 \geq 0$  and  $1 > \alpha_1 + \beta_1$  for wide-sense stationarity. If we would like to estimate  $\alpha$  and  $\beta$  for each individual stock, we have to estimate  $N + 2$  number of parameters. This can be challenging to estimate as the number of the

assets increase, hence we assumed that the parameters in the volatility equations are common as we said earlier.

### 1.5.1 Parameter estimation

First of all we take advantage of the moment matching to calculate  $\mu^{(j)}$ . Not only make it easier the estimation, but it will be more parsimonious. As  $\mu^{(j)}$  is the unconditional variance of the returns, we can estimate by averaging the squared returns:

$$\hat{\mu}^{(j)} = \frac{1}{Tl_t} \sum_{t=1}^T \sum_{i=1}^{l_t} r_{i,t}^{(j)2}$$

In the second step given the unconditional variance estimates, the parameter space will reduce into just two parameter  $\Theta = \alpha_1, \beta_1$ . We used the QMLE to minimize the negative log likelihood function given by:

$$\log \mathcal{L}^{(j)}(\Theta) = -\frac{1}{Tl_t} \sum_{t=1}^T \sum_{i=1}^{l_t} \left( \frac{1}{2} \log 2\pi + \frac{1}{2} \log \sigma_{i,t}^{(j)2} + \frac{1}{2} \frac{\epsilon_{i,t}^{(j)2}}{\sigma_{i,t}^{(j)2}} \right) \quad (24)$$

where  $\sigma_{i,t}^{(j)2}$  is the function of the  $\alpha_1, \beta_1$

$$\arg \min_{\Theta} \sum_{j=1}^N \log \mathcal{L}^{(j)}(\Theta)$$

### 1.5.2 Simulations

We applied the same simulation scheme as we previously did in GARCH section. The only difference is we simulated matrix of returns. Here we sampled returns in arrays these are the rows in the matrix and in the end the columns mean the individual stock returns. As we simulated the returns we matched the individual volatility component which related to the desired "stock" return, so in each row every return has its unique variance.

$$r_{i,t}^{(j)} \sim \mathcal{N}\left(0, \sigma_{i,t}^{(j)}\right)$$

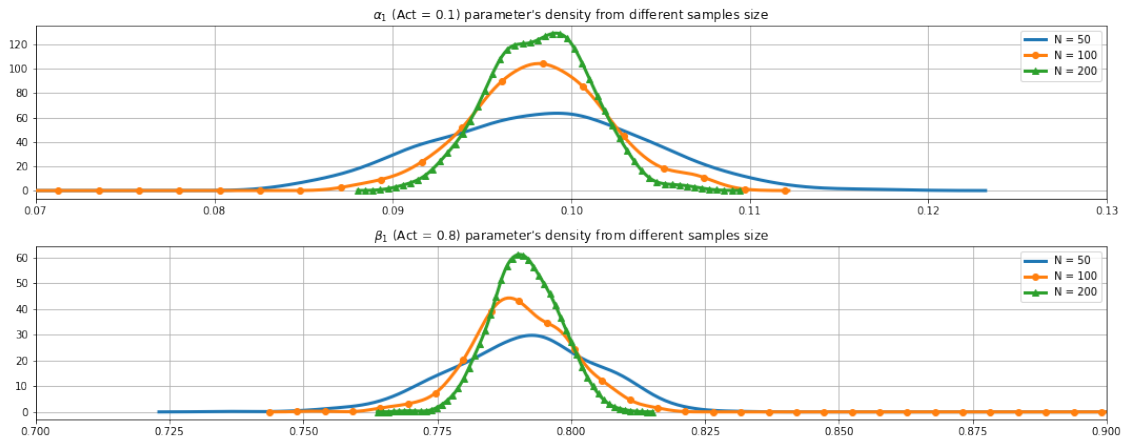


Figure 6: Plot of estimated parameter distributions with sample sizes of 500 and  $N = 50, 100, 200$

In the simulations we simulated panels with 50, 100, 200 number of individual stocks and 500 number of returns for each. In the above figure, we can see, as we increase the number of stocks in the panel the accurate will be the parameter estimations.

## 1.6 Panel GARCH with cross sectional adjustment

In this section, I would like to give you an overview of this unique model. The key concept of the model lays on the cross sectional adjustment part, where we adjust the individual volatilities with the  $c_{i,t}$  component. We used the same notations as we did in the Panel GARCH section, to be consistent and the reader can easily get familiar with the changes we made. Let  $r_{i,t}^{(j)}$  denote to the daily return of the j-th stock  $j = 1, \dots, N$  at i-th day for  $i = 1, \dots, I_t$  of t-th month for  $t = 1, \dots, T$ . The daily returns follow:

$$r_{i,t}^{(j)} = \sigma_{i,t}^{(j)} c_{i,t} \varepsilon_{i,t}^{(j)} \quad (25)$$

where  $\varepsilon_{i,t}^{(j)}$  is the innovation, which identically independent distributed random variables with mean 0 and variance 1. The  $c_{i,t}$  component is the cross sectional adjustment term, which can interpret as the common short-term volatility throughout the panel. If we examine the equation of this component, we can see that as the market or panel, which we investigate, produce more and more abnormal returns, so the  $c_{i,t}$  component's value is increasing. This increment can be used to better forecast volatilities for the panel. On the other hand, if the market conditions generates low volatility period, then  $c_{i,t}$  will decrease.

$$c_{i,t} = (1 - \phi) + \phi \sqrt{\frac{1}{N} \sum_{j=1}^N \left( \frac{r_{i-1,t}^{(j)}}{\sigma_{i-1,t}^{(j)} c_{i-1,t}} - \frac{1}{N} \sum_{j=1}^N \frac{r_{i-1,t}^{(j)}}{\sigma_{i-1,t}^{(j)} c_{i-1,t}} \right)^2} \quad (26)$$

where  $1 \geq \phi \geq 0$  is the parameter of the adjustment. We can see if we observe  $\phi$  equal to zero, then it is identically the same model with the Panel GARCH. In our investigations, we found out that as the higher the  $\phi$  the better the model performance in contrast with the vanilla Panel GARCH model. This whole models lie on the  $c_{i,t}$  last term, which is technically is the standard deviation of the innovations throughout the panel. For illustration purposes, we would like to present the an estimated  $c_{i,t}$  about a panel, which we will use in the modelling section:

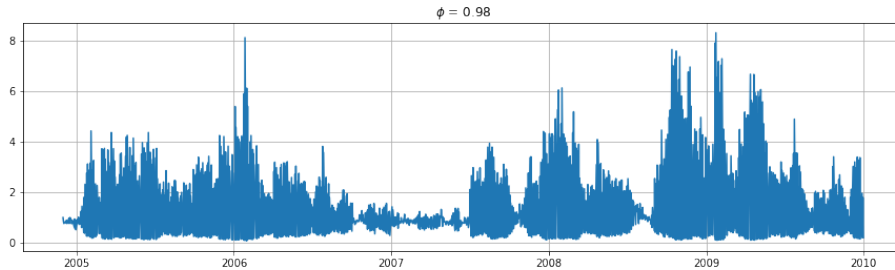


Figure 7: Plot of cross sectional adjustment componet

In the above figure, we used a panel that consist of 492 stocks and the investigated period is between 2004-12-1 and 2009-12-31. You can clearly spot the higher volatility regimes in the plot. The equation for

$\sigma_{i,t}^{(j)^2}$  given by

$$\sigma_{i,t}^{(j)^2} = \mu^{(j)}(1 - \alpha_1 - \beta_1) + \alpha_1 \varepsilon_{i-1,t}^{(j)^2} + \beta_1 \sigma_{i-1,t}^{(j)^2} \quad (27)$$

where we applied the moment matching that we did in Panel GARCH section. The parameters of  $\alpha_1$  and  $\beta_1$  satisfies  $\alpha_1 \geq 0, \beta_1 \geq 0$  and  $1 > \alpha_1 + \beta_1$

### 1.6.1 Parameter estimation

As we mentioned in previously, we approximated the unconditional variance of the returns by averaging the squared returns. Moreover, we applied the same parameter estimation scheme for this model, namely the QMLE where the parameter space is then  $\Theta = \phi, \alpha, \beta$ . We assumed that the innovations are normally distributed, but as we would assume Student-t distribution, the parameter space would be expand with the parameter of the Student-t distribution's degree of freedom. We minimize the negative log likelihood function, which is given by:

$$\begin{aligned} \log \mathcal{L}^{(j)}(\Theta) &= -\frac{1}{Tl_t} \sum_{t=1}^T \sum_{i=1}^{l_t} \left( \frac{1}{2} \log 2\pi + \frac{1}{2} \log \sigma_{i,t}^{(j)^2} + \frac{1}{2} \frac{\varepsilon_{i,t}^{(j)^2}}{\sigma_{i,t}^{(j)^2}} \right) \\ &\arg \min_{\Theta} \sum_{j=1}^N \log \mathcal{L}^{(j)}(\Theta) \end{aligned} \quad (28)$$

### 1.6.2 Simulations

The simulations are made by a fairly simulare way, which we did in Panel GARCH. The returns are generated randomly from normal distribution with variance of  $\sigma_{i,t}^{(j)}$ :

$$r_{i,t}^{(j)} \sim \mathcal{N} \left( 0, \sigma_{i,t}^{(j)} \right) \quad (29)$$

The  $c_{i,t}$  component effect is take place in  $\varepsilon_{i,t}^{(j)}$ . We simulated different size of simulated panels with the same sample size,  $T = 500$ . The parameters which we used for simulation purposes are  $\phi = 0.9$ ,  $\alpha_1 = 0.2$  and  $\beta_1 = 0.6$ . The results are the following:

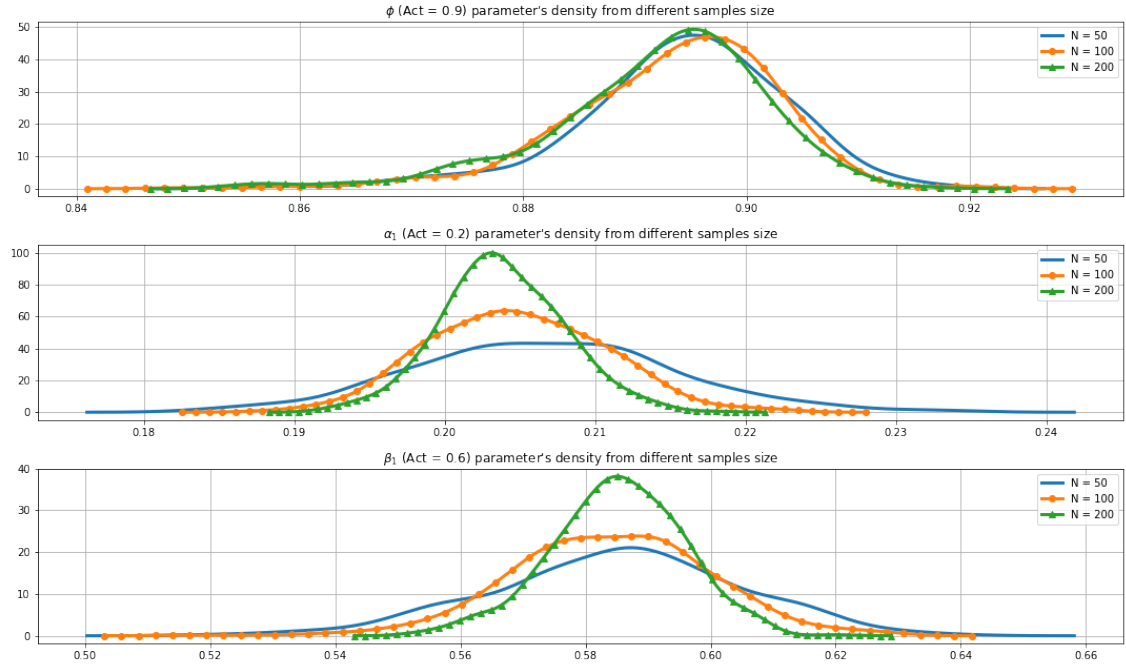


Figure 8: Plot of estimated parameter distributions with  $N = 50, 100, 200$

We can clearly see, as we increase the panel size, the less the variance of the estimated parameters. Unfortunately, in the case of  $\phi$  and  $\beta_1$  the median estimated parameters are less, then what we used for simulations. In the case of  $\alpha_1$  the median estimation is higher. These miss estimation can be easily come from the relatively small sample size, the high  $\alpha_1$  and low  $\beta_1$ . In the modeling section we will point out, this model required quite huge size of samples and the  $\alpha_1 + \beta_1$  tend to be close to 1.0.

## 1.7 Panel GARCH-MIDAS

In this section we specify the Panel version of the GARCH-MIDAS model. Durant the implementation process of this model some issues arised such as identification issues in th estimation of parameters. Finally we decided that we will make a two-step estimation and combine the best of the two world namely Panel MIDAS and Panel GARCH. The implementation is design to handle both multiple asset and single assets, in order to compare the accuracy of parameter estimation with the original single-step GARCH-MIDAS model. The first step is to calculate the long-term volatility component by the Panel MIDAS model. The estimation will provide us the  $\tau_{i,t}$ , the  $i$  index refers to have the same length of the returns, but  $\tau$  is constant between intra periods. With the long-term component we can rescale the returns, by dividing them with the square root of  $\tau_{i,t}$ :

$$\hat{r}_{i,t}^{(j)} = \frac{r_{i,t}^{(j)}}{\sqrt{\tau_{i,t}}}$$

This rescaled return will be modeled by Panel GARCH model to get the short-term volatility component.

The daily rescaled log returns follow:

$$\hat{r}_{i,t}^{(j)} = \varepsilon_{i,t}^{(j)} = \sigma_{i,t}^{(j)} Z_{i,t}^{(j)}$$

where  $Z_{i,t}^{(j)}$  is the innovations, and we can rewrite this equation as the original literatures suggested if we replace the rescaled returns:

$$r_{i,t}^{(j)} = \sqrt{\tau_{i,t} \sigma_{i,t}^{(j)^2}} Z_{i,t}^{(j)}$$

where the returns are driven by the short- and long-term volatility components. Let's take a look at the short term volatility component's equation:

$$\sigma_{i,t}^{(j)^2} = \mu_j(1 - \alpha - \beta) + \alpha \varepsilon_{i,t-1}^{(j)^2} + \beta \sigma_{i,t-1}^{(j)^2} = \mu_j(1 - \alpha - \beta) + \alpha \frac{r_{i,t-1}^{(j)^2}}{\tau_{i,t-1}} + \beta \sigma_{i,t-1}^{(j)^2} \quad (30)$$

where  $\alpha \geq 0, \beta \geq 0$  and  $1 > \alpha + \beta$ .

### 1.7.1 Parameter Estimation

As we discussed, the estimation is a two-step QMLE estimation. In which we first optimize the parameter's of the long-term volatility component where assumed the normal distribution, then the negative log - likelihood function looks like:

$$\log \mathcal{L}(\Theta_1) = -\frac{T * I_t}{2} \sum_{j=1}^N \sum_{t=1}^T \sum_{i=1}^2 \log 2\pi + \log \hat{\tau}_{i,t}(\Theta_1) + \frac{r_{i,t}^{(j)^2}}{\hat{\tau}_{i,t}(\Theta_1)} \quad (31)$$

In order to get the optimal parameters we minimize the argument's of the negative log likelihood

$$\arg \min_{\Theta_1} \log \mathcal{L}(\Theta_1)$$

Then in the case of short-term volatility component, we calculate with the rescaled return, so

$$\log \mathcal{L}(\Theta_2) = -\frac{T * I_t}{2} \sum_{j=1}^N \sum_{t=1}^T \sum_{i=1}^2 \log 2\pi + \log \hat{g}_{i,t}(\Theta_2) + \frac{\hat{r}_{i,t}^{(j)^2}}{\hat{g}_{i,t}(\Theta_2)} \quad (32)$$

This approach is slower in respect of take two optimization instead of one, but we found out that it can estimate the best parameters better in that case.

### 1.7.2 Simulations

To-Write



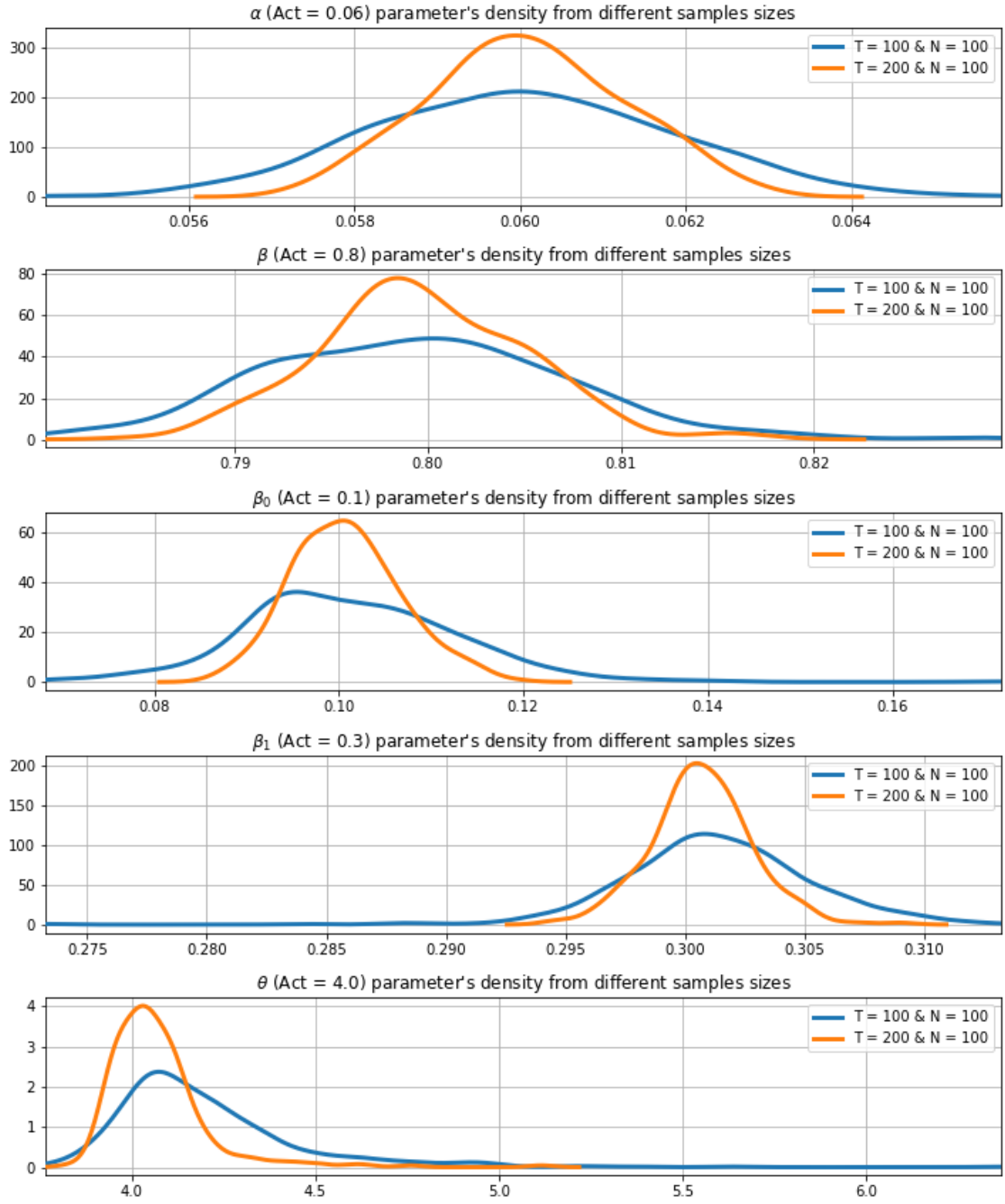


Figure 9: Plot of estimated parameter distributions with  $N = 100$  and the sample size is  $T = 100, 200$

## 1.8 EWMA

In this section we present one of the most commonly used model which is the Exponentially Weighted Moving Average (henceforth EWMA). [13] refers to EWMA ( $\lambda = 0.94$ ) as *RiskMetrics<sup>TM</sup>*. The model for volatility is given by

$$\sigma_t^2 = (1 - \lambda)r_{t-1}^2 + \lambda \sigma_{t-1}^2 \quad (33)$$

where  $\lambda$  is the only parameter to be estimated, which can take  $1 \geq \lambda \geq 0$ . This implies  $\lambda + (1 - \lambda) = 1$ , which can be familiar as we think about the Integrated GARCH (1, 1) model with  $\omega = 0$ . We also implemented the panel version of EWMA, where we can describe the whole market's volatility with only one parameter or we can set to certain number as [13] did. Both cases, namely the EWMA and Panel EWMA are estimated via QMLE as it was previously described.

## 2 Data

In this section, we will go through the macroeconomic variables we used, and what transformation or changes we made. We want to mention, all of our data came from resources that free for everyone. In the selection of macroeconomic variable we mainly rely on those that was previously used in research papers, such as [3] where they used several variables, that will be presented. Both of these time series data start at 1997-01-01 and end at 2020-11-01. We make use of the following time series:

- The AAI Investor Sentiment Survey (AAII) measures the percentage of individual investors who are bullish, bearish, and neutral on the stock market for the next months. The series reported on a weekly basis.  
<https://www.aaii.com/files/surveys/sentiment.xls>
- Moody's Seasoned BAA Corporate Bond Yield Relative to Yield on 10 Year Treasury Constant Maturity (BAA10Y) is a daily series.  
<https://fred.stlouisfed.org/series/BAA10Y>
- The Chicago Fed National Activity Index (CFNAI) is a weighted average of 85 monthly filtered and standardized economic indicators. Whereas positive CFNAI values indicate an expanding US-economy above its historical trend rate, negative values indicate the opposite. [3]  
<https://alfred.stlouisfed.org/series?seid=CFNAI>
- Consumer Price Index for All Urban Consumers: All Items in U.S. City Average (CPIAUCSL) is a measure of the average monthly change in the price for goods and services paid by urban consumers between any two time periods.  
<https://alfred.stlouisfed.org/series?seid=CPIAUCSL>
- Case-Shiller U.S. National Home Price Index (CSUSHPINSA) is a monthly index the leading measures of U.S. residential real estate prices, tracking changes in the value of residential real estate nationally.  
<https://fred.stlouisfed.org/series/CSUSHPINSA>
- 10-Year Treasury Constant Maturity Rate (DGS10) is a daily percent.  
<https://fred.stlouisfed.org/series/DGS10>
- 3-Month Treasury Bill: Secondary Market Rate (DTB3) is a daily percent. [1]  
<https://alfred.stlouisfed.org/series?seid=DTB3>
- Housing Starts Total: New Privately Owned Housing Units Started (HOUST) is a monthly unit. [3]  
<https://fred.stlouisfed.org/series/HOUST>
- Industrial Production: Total Index (INDPRO) is a monthly economic indicator that measures real output for all facilities located in the U.S. [3]

<https://alfred.stlouisfed.org/series?seid=INDPRO>

- M2 Money Stock (M2SL) is a monthly value in units of dollar billions.  
<https://fred.stlouisfed.org/series/M2SL>
- Chicago Fed National Financial Conditions Index (NFCI) provides a weekly update on U.S. financial conditions in money markets. Positive values of the NFCI indicate financial conditions that are tighter than average, negative values indicate financial conditions that are looser than average. [3]  
<https://fred.stlouisfed.org/series/NFCI>
- Producer Price Index by Commodity: All Commodities (PPIACO) is a monthly index.  
<https://alfred.stlouisfed.org/series?seid=PPIACO>
- Unemployment Rate (UNRATE) represents the number of unemployed as a monthly percentage of the labor force. [1]  
<https://fred.stlouisfed.org/series/UNRATE>
- CBOE Volatility Index: VIX (VIXCLS) is a daily close index that measures market expectation of near term volatility conveyed by stock index option prices. [3]  
<https://fred.stlouisfed.org/series/VIXCLS>

The two most commonly used variables for calculating inflation are the differences of Consumer Price Index and Producer Price Index, as we will show in the correlation matrix they have a solid correlation between them. We are going to mark Inflation with the differences of CPIAUCSL and  $\Delta$  PPI is the differences of PPIACO. We make the same transformation for the M2 Money Stock, Case-Shiller U.S. National Home Price Index, Housing Starts Total and Industrial Production. We wanted to measure the slope of the yield curve we subtracted the 10-Year Treasury Constant Maturity Rate with the 3-Month Treasury Bill as [1] they specified. Those variables that are observed weekly or daily we finally take their monthly mean. In order to keep our models as simple as possible, we will only use monthly macroeconomic variables for modeling, but we didn't want to miss them out, so we took those variables monthly average. The time-series of final dataset we will use for modeling:

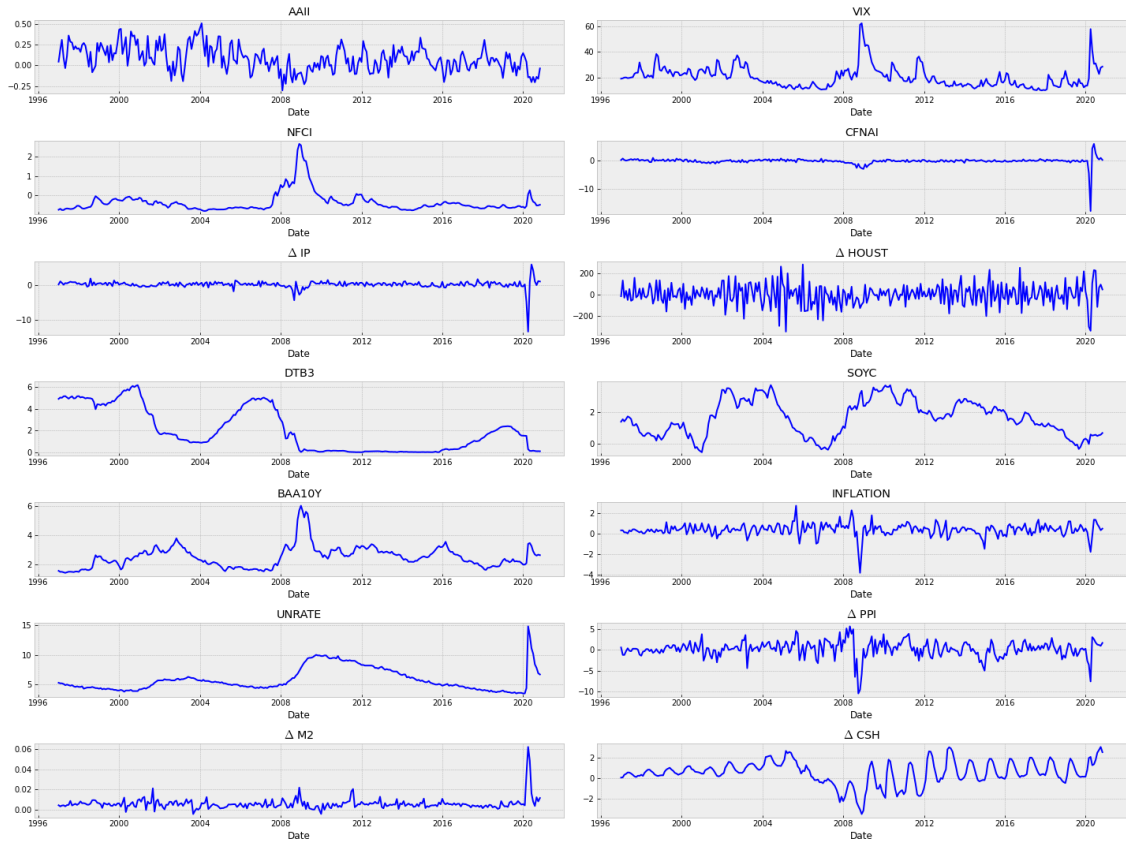


Figure 10: Time-series of macroeconomic variables

The stock prices we used for modeling are the prices of the S&P 500 Index components between 1999-12-01 and 2020-10-31, so due to the recent COVID-19's selloffs in the first quarter of 2020, we can examine two stressed period with our models. These data were downloaded by Python's package called *yfinance*.

	Min.	Max.	Mean	Median	Sd.	Skew.	Kurt
AAII	-0.30	0.51	0.08	0.08	0.15	0.21	-0.30
VIX	10.12	62.25	20.43	19.17	8.27	1.87	5.56
NFCI	-0.80	2.68	-0.36	-0.51	0.51	3.35	13.73
CFNAI	-17.73	5.96	-0.10	-0.01	1.28	-8.89	128.41
$\Delta$ IP	-13.26	5.74	0.09	0.14	1.13	-5.80	72.17
$\Delta$ HOUST	-343.00	279.00	0.73	-3.00	99.74	-0.26	0.79
DTB3	0.01	6.17	2.00	1.41	1.97	0.61	-1.14
Soyc	-0.53	3.69	1.64	1.62	1.11	0.03	-1.04
BAA10Y	1.45	6.01	2.53	2.50	0.75	1.57	4.73
Inflation	-3.84	2.70	0.36	0.39	0.59	-1.48	10.54
UNRATE	3.50	14.80	5.81	5.10	1.92	1.34	1.72
$\Delta$ PPI	-10.50	5.70	0.24	0.30	1.98	-1.28	5.75
$\Delta$ M2	-0.01	0.06	0.01	0.01	0.01	5.64	46.91
$\Delta$ Csh	-3.53	3.04	0.52	0.51	1.14	-0.60	0.92

Table 1: *Notes:* The table presents summary statistics for the variables.

### 3 Implementation strategy

In this section I would like to describe our framework, how we implemented and tested out certain models. I have to highlight the fact that every single model, what you can find in this thesis are implemented by myself, so we didn't used other specific python packages for modeling purposes. One of our main objective was to create a so-called metaclass, where we can declare all the non-model specific function. The metaclass is a class instances are classes in object-oriented programming. This approach provided us the advantage to test and debug our models more easily. We relied on the Python's abc package to create this metaclass. We decided to use the L-BFGS-B method for minimizing the objective function, in our case the negative loglikelihood function. The L-BFGS-B method relies on the approximation to the Hessian matrix of the loss function, so as we take advantage of information matrix equality we can calculate the standard errors easily.

The first issue we faced in the optimization process was the mishandling of bounds and constraint. In order to avoid such failure of optimization, we implemented a technic to transform model parameters.

#### 3.0.1 Parameter Transformation

In this section we will describe an approach to make parameter estimation more consistant and stabil, it is so called parameter transformation. The main idea behind this strategy is that estimators can treat bounds, but in practice it is much more convenient to transform our parameters. With this approach we can create bounds without explicitly programming to the estimator function. First we describe the transform and the back-transform function, then show how they incorporate to the function that will be estimated. Let  $\theta$  denote to the parameter, we want to transform:

$$\tilde{\theta} = \begin{cases} \log(\theta) & \text{,if 'pos' } \\ \log(\theta) - \log(1 - \theta) & \text{,if '01' } \\ \theta & \text{otherwise.} \end{cases}$$
$$\theta = \begin{cases} \exp(\tilde{\theta}) & \text{,if 'pos' } \\ \frac{1}{1 + \exp(-\tilde{\theta})} & \text{,if '01' } \\ \tilde{\theta} & \text{otherwise.} \end{cases}$$

In the log likelihood function instead of calculating with the actual  $\theta$ , the estimation will take place with  $\tilde{\theta}$ . Then the optimization finished, we can easily transform back. The only issue, which we had to handle was that the estimation of standard errors is not correct, so we implemented a function called gradient. In this function, you can see we calculated the first derivatives of the possible transformation.  $\theta^*$  marked as the estimated parameters that were previously transformed.

$$gradient = \begin{cases} \exp(\theta^*) & ,\text{if 'pos' } \\ \frac{\exp(\theta^*)}{(1+\exp(\theta^*))^2} & ,\text{if '01' } \\ 1 & \text{otherwise.} \end{cases}$$

In order to calculate the standard errors of the estimated parameters, now we can calculate their gradients, the inverse Hessian matrix was estimated throughout the optimization process, so we have to take the square root of the diagonal of the inverse Hessian and multiple by the gradients.



## 4 Empirical Results

### 4.1 Predicting Abiliyt Test

In this section we describe the most commonly used to evaluate the volatility predictions. We mainly rely on previous research papers that used this methodology for testing predicting capability. This is the so called Diebold-Mariano Test (henceforth DM Test), which was first developed by [6].

In the research of [3] refers to [14] paper about to compare the most commonly used loss functions for volatility forecast comparison. He found that there are only two robust loss functions, namely the mean squared error (MSE) and the QLIKE. He described the following family of loss functions, indexed by the scalar parameter  $b$ :

$$L(\hat{\sigma}^2, h; b) = \begin{cases} h - \hat{\sigma}^2 + \hat{\sigma}^2 \log \frac{\hat{\sigma}^2}{h} & , b = -1 \\ \frac{\hat{\sigma}^2}{h} - \log \frac{\hat{\sigma}^2}{h} - 1 & , b = -2 \\ \frac{1}{(b+1)(b+2)} (\hat{\sigma}^{2b+4} - h^{b+2}) - \frac{1}{b+1} h^{b+1} (\hat{\sigma}^2 - h) & , \text{otherwise} \end{cases}$$

In order to define different loss functions with only one parameter, namely with  $b$ , we implemented the above family of loss functions in our DM test. The author pointed out, the MSE loss function is obtained when  $b = 0$  and the QLIKE when  $b = -2$ . These two function are the only robust ones, moreover the QLIKE is less sensitive with respect to extreme observation than the MSE loss. DM test relies on assumptions made directly on the forecast error loss differential [5]. In DM test we compare two rival models, by taking there loss differencies in the following way:

$$d_{12t} = L(\hat{\sigma}^2, h^{(1)}; b) - L(\hat{\sigma}^2, h^{(2)}; b) \quad (34)$$

where  $\hat{\sigma}^2$  is the volatility proxy variable. [5] presented that DM assumes:

$$DM = \begin{cases} E(d_{12t}) = \mu & , \forall t \\ cov(d_{12t}, d_{12(t-\tau)}) = \gamma(\tau) & , \forall t \\ 0 < var(d_{12t}) = \sigma^2 < \infty & , \text{otherwise} \end{cases}$$

$$DM = \frac{E(d_{12t})}{\sqrt{var(d_{12t})}} \sim \mathcal{N}(0, 1) \quad (35)$$

where  $E(d_{12t})$  is the sample mean loss differential and  $\sqrt{var(d_{12t})}$  is a consistent estimate of the standard deviaton of  $d_{12t}$ .

The DM-test is a handy when we compare two forecasts for a single asset, what if we would like to compare two forecasts for panels. [15] gave an approach us to do that. They developed new methods for testing forecasting powers in panels Let's start with the calculation of the mean loss throughout the whole panel, where we denote  $\bar{L}_m$  as

$$\bar{L}_h = \frac{1}{NT} \sum_{j=1}^N \sum_{t=1}^T L(\hat{\sigma}_t^{(j)2}, h_t^{(j)}; b) \quad (36)$$

Their first hypothesis was that the panel's mean loss for a pair of forecasts,  $h^{(1)}$  and  $h^{(2)}$  is equal in expectation:

$$H_0^{panel} : E(\bar{L}_{h^{(1)}}) = E(\bar{L}_{h^{(2)}}) \quad (37)$$

In order to test the null hypothesis let's use the above defined  $d_{12t}$ , which is now a matrix and not an array, so the loss differential between forecasts  $h^{(1)}$  and  $h^{(2)}$  as

$$d_{12t} = L(\hat{\sigma}^2, h^{(1)}; b) - L(\hat{\sigma}^2, h^{(2)}; b) \quad (38)$$

We can test the null hypothesis in (37) using the test statistic

$$DM = (NT)^{-\frac{1}{2}} \frac{\sum_{j=1}^N \sum_{t+h=1}^T d_{12t}}{\hat{\sigma}(d_{12t})} \quad (39)$$

where  $\hat{\sigma}(d_{12t})$  is a consistent estimator of standard deviation of  $d_{12t}$ .

Furthermore, we used the Mincer-Zarnowitz Regression [12], which is basically a simple regression to be estimated:

$$\sigma_{t+1}^2 = \beta_0 + \beta_1 \hat{\sigma}_{t+1}^2 + \varepsilon_t \quad (40)$$

where  $\hat{\sigma}_{t+1}^2$  is the predicted value of the volatility for  $t+1$ . If the prediction is unbiased, then the coefficients are  $\beta_0 = 0$  and  $\beta_1 = 1$ . We also investigate the  $R^2$  as well.

Another measure, what we investigated is the RMSE (root mean squared error)

$$RMSE = \sqrt{\frac{1}{NT} \sum_{j=1}^N \sum_{t=1}^T (\sigma_t^{(j)^2} - \hat{\sigma}_t^{(j)^2})^2} \quad (41)$$

where we can compare the RMSE values to each other.

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