

Lecture Notes in Financial Econometrics (MSc course)

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These lecture notes are for a second M.A. course in econometrics. The goal is to present econometrics in a way so that it can readily be applied, but also understood. The approach is therefore to motivate the key results, but leaving out some details. This means that many “proofs” lack the proper restrictions on the data generating process, and rather says something like “assuming the limit is well defined and finite.” Instead, text includes many Monte Carlo simulations to highlight the properties of the estimators, including cases where things “go wrong.” The text also has very many empirical examples, often illustrated in plots. Optional (often more advanced) material is denoted by a star (*).

In implementing numerical computations based on these notes, my students have typically used Julia, Matlab, Python or R. Julia notebooks with numerical examples for each chapter are found at Paul Söderlind’s Github page: <https://github.com/PaulSoderlind/FinancialEconometrics>

When I first set up this course many years ago, I was inspired by the texts of Verbeek and Greene. More recently, I have enjoyed Hansen’s text. Most likely that shows.

My students at the MBF program at the University of St. Gallen have asked many good questions and pointed out mistakes. Also my teaching assistants did the same. I thank them for their input.

Data Sources

The data used in these lecture notes are from the following sources:

1. The website of Kenneth French,
http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
2. Bloomberg
3. Datastream
4. Federal Reserve Bank of St. Louis (FRED), <http://research.stlouisfed.org/fred2/>
5. The website of Robert Shiller, <http://www.econ.yale.edu/~shiller/data.htm>
6. yahoo! finance, <http://finance.yahoo.com/>
7. OlsenData, <http://www.olsendata.com>

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Chapter 1

Review of Statistics

Reference: Verbeek (2012) Appendix B

1.1 Random Variables and Distributions

1.1.1 The Distribution of a Random Variable

A univariate distribution of a random variable x describes the probability of different values. If $f(x)$ is the probability density function (pdf), then the probability that x is between A and B is calculated as the area under the density function from A to B

$$\Pr(A < x \leq B) = \int_A^B f(x)dx. \quad (1.1)$$

See Figure 1.1 for illustrations of normal (gaussian) distributions.

Remark 1.1 If $x \sim N(\mu, \sigma^2)$, then the probability density function is

$$f(x) = \frac{1}{\sqrt{2\pi\sigma^2}} e^{-\frac{1}{2}(\frac{x-\mu}{\sigma})^2}.$$

This is a bell-shaped curve centred on the mean μ and where the standard deviation σ determines the “width” of the curve.

The probability that $x \leq B$ (that is, $-\infty < x \leq B$) is measured by the *cumulative distribution function*, $\text{cdf}(B)$. For instance, if x has a $N(0, 1)$ distribution, then $\Pr(x \leq -1.645) = 0.05$ and $\Pr(x \leq 0) = 0.5$. Once you have the cdf, you can calculate the probability of $B < x$ as $1 - \text{cdf}(B)$. See Figure 1.2 for an illustration.

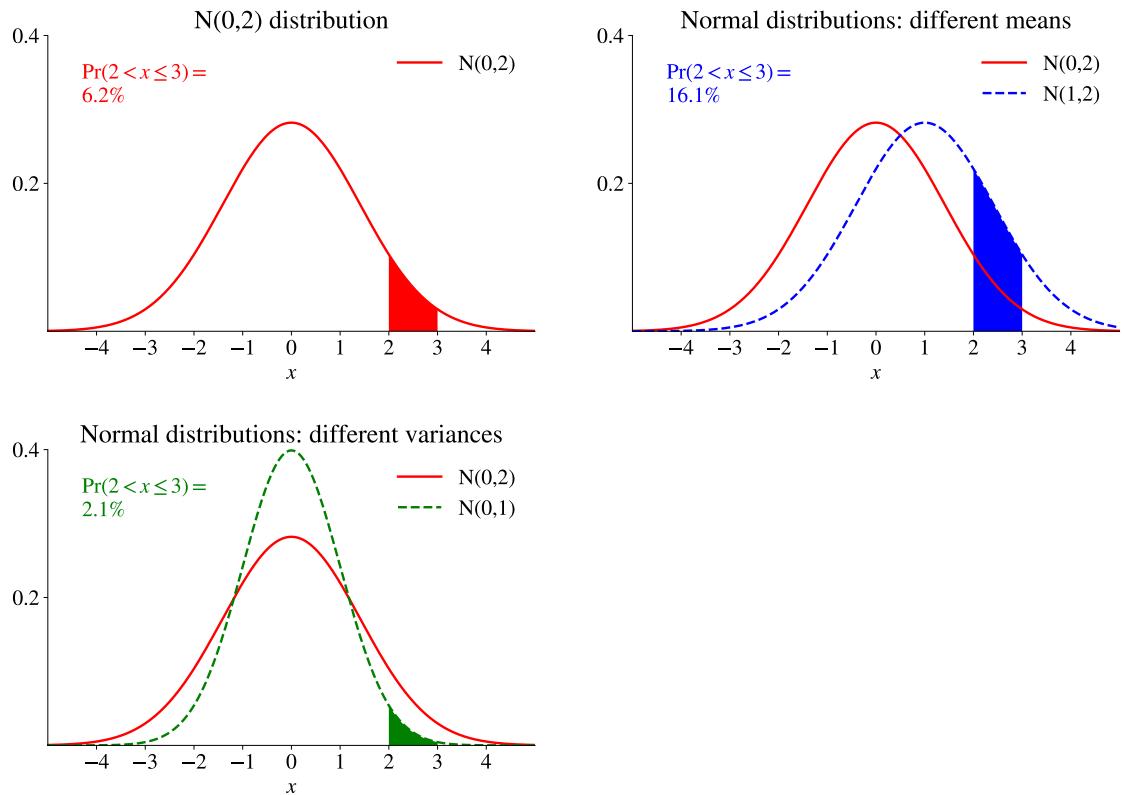


Figure 1.1: A few different normal distributions

If we invert the cdf, then we get the *quantiles* of the random variable. For instance, the 0.05th quantile of a $N(0, 1)$ variable is -1.645 , while the 0.5th quantile (also called the median) is 0.

1.1.2 The Joint Distribution of Several Random Variables

A bivariate distribution of the random variables x and y contains the same information as the two respective univariate distributions, but also information on how x and y are related. Let $h(x, y)$ be the joint density function, then the probability that x is between A and B and y is between C and D is calculated as the volume under the surface of the density function

$$\Pr(A < x \leq B \text{ and } C < y \leq D) = \int_A^B \int_C^D h(x, y) dy dx. \quad (1.2)$$

See Figure 1.3 for an example.

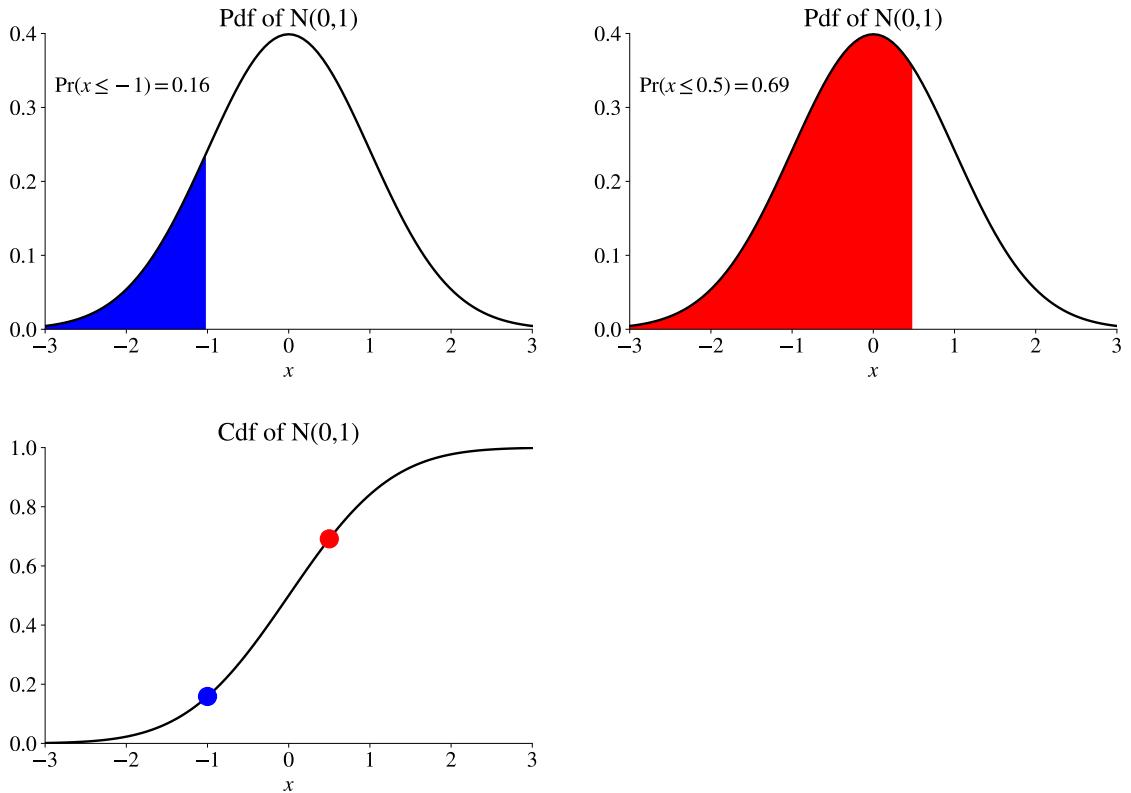


Figure 1.2: Pdf and cdf of $N(0,1)$

A joint normal distributions is completely described by the means and the covariance matrix

$$\begin{bmatrix} x \\ y \end{bmatrix} \sim N \left(\begin{bmatrix} \mu_x \\ \mu_y \end{bmatrix}, \begin{bmatrix} \sigma_x^2 & \sigma_{xy} \\ \sigma_{xy} & \sigma_y^2 \end{bmatrix} \right), \quad (1.3)$$

where μ_x and μ_y denote means of x and y , σ_x^2 and σ_y^2 denote the variances of x and y and σ_{xy} denotes their covariance. Sometimes alternative notations are used: $E x$ for the mean, $Std(x)$ for the standard deviation, $Var(x)$ for the variance and $Cov(x, y)$ for the covariance. See Figure 1.4 for an example.

Clearly, if the covariance σ_{xy} is zero, then the variables are (linearly) unrelated to each other. Otherwise, information about x can help us to make a better guess of y . The correlation of x and y is defined as

$$\rho_{xy} = \frac{\sigma_{xy}}{\sigma_x \sigma_y}. \quad (1.4)$$

See Figure 1.4 for an example.

If two random variables happen to be independent of each other, then the joint density function is just the product of the two univariate densities (here denoted $f(x)$ and $k(y)$)

$$h(x, y) = f(x)k(y) \text{ if } x \text{ and } y \text{ are independent.} \quad (1.5)$$

This is useful in many cases, for instance, when we construct likelihood functions for maximum likelihood estimation.

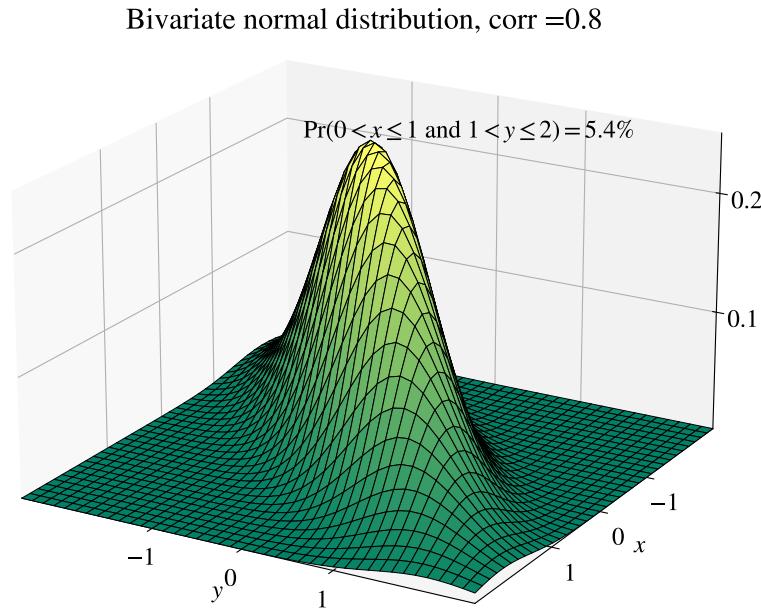


Figure 1.3: Density function bivariate normal distribution

1.1.3 Conditional Distributions*

If $h(x, y)$ is the joint density function and $f(x)$ the (marginal) density function of x , then the conditional density function is

$$g(y|x) = h(x, y)/f(x). \quad (1.6)$$

Notice that the conditional mean can be interpreted as the best guess of y given that we know x . Similarly, the conditional variance can be interpreted as the variance of the

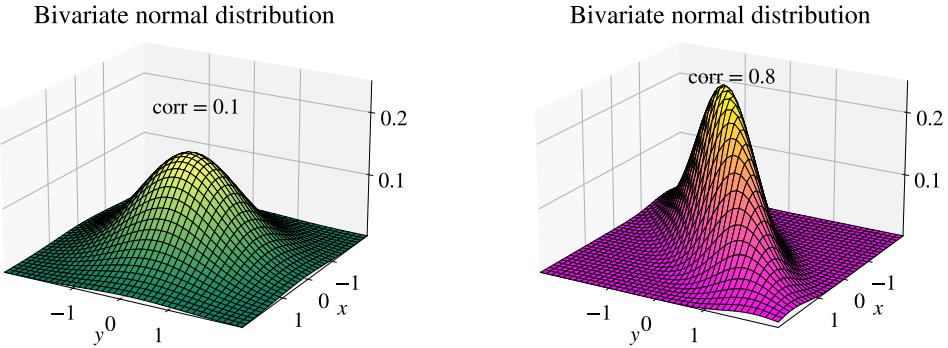


Figure 1.4: Density function bivariate normal distributions

forecast error (using the conditional mean as the forecast). The conditional and marginal distribution coincide if x and y are independent. (This follows directly from combining (1.5) and (1.6).)

For the bivariate normal distribution (1.3) we have the distribution of y conditional on a given value of x as

$$y|x \sim N\left(\mu_y + \frac{\sigma_{xy}}{\sigma_x^2}(x - \mu_x), \sigma_y^2 - \frac{\sigma_{xy}\sigma_{xy}}{\sigma_x^2}\right). \quad (1.7)$$

In this case, the mean depends on x , while the variance does not. Also notice that the variance is lower than in the unconditional distribution (we have more information). Independence of x and y would here mean a zero covariance: set $\sigma_{xy} = 0$ in (1.7) to see that the conditional and unconditional distributions coincide. See Figure 1.5 for an illustration: notice how the location and the width of the conditional distribution of y changes as a function of the correlation and the value of x .

Remark 1.2 (*Relation of (1.7) to a linear regression**) Suppose you regress $y = a + bx + u$. The mean in (1.7) is the same as $a + bx$ and the variance is the same as $\text{Var}(u)$.

1.1.4 Illustrating a Distribution

If we know the type of distribution (uniform, normal, etc) a variable has, then the best way of illustrating the distribution is to estimate its parameters (mean, variance and whatever more—see below) and then draw the density function.

In case we are not sure about which distribution to use, the first step is typically to draw

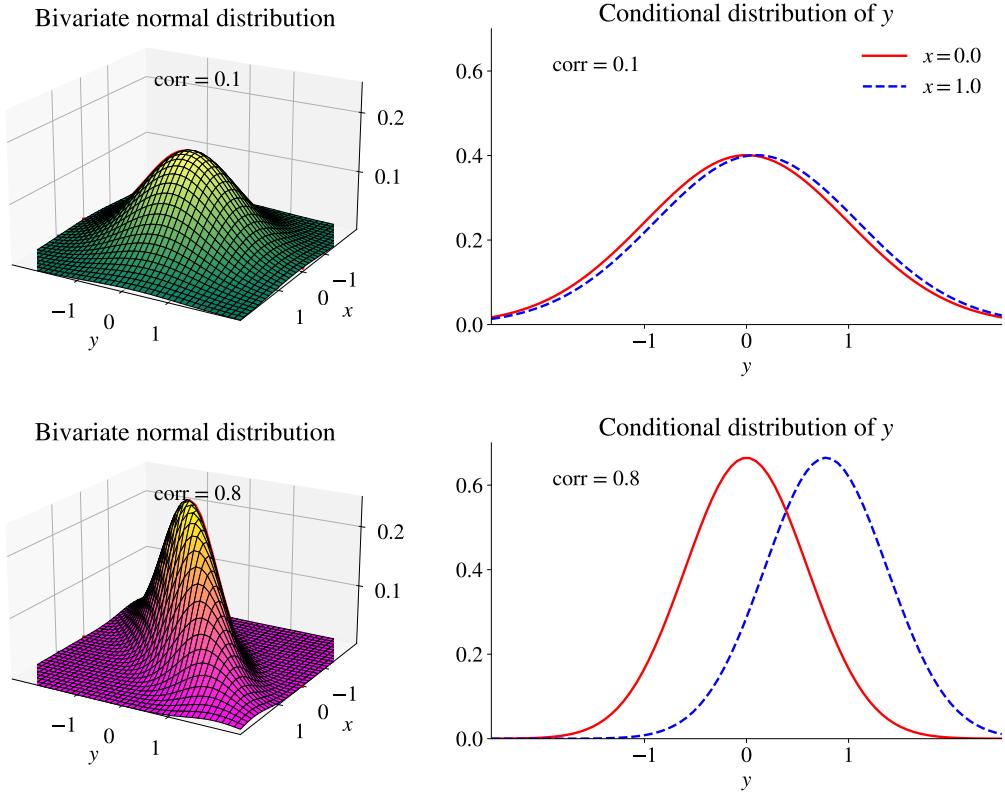


Figure 1.5: Density functions of normal distributions

a histogram: it shows the relative frequencies for different bins (intervals). For instance, it could show the relative frequencies of a variable x_t being in each of the follow intervals: -0.5 to 0, 0 to 0.5 and 0.5 to 1.0. Clearly, the relative frequencies should sum to unity (or 100%), but they are sometimes normalized so the area under the histogram has an area of unity (as a probability density function).

Empirical Example 1.3 (*Histogram of equity returns*) See Figure 1.6.

1.1.5 Confidence Bands and t-tests

For a symmetric distribution, a 90% (two-sided) confidence band is constructed by finding a critical value c such that

$$\Pr(\mu - c < x \leq \mu + c) = 0.9. \quad (1.8)$$

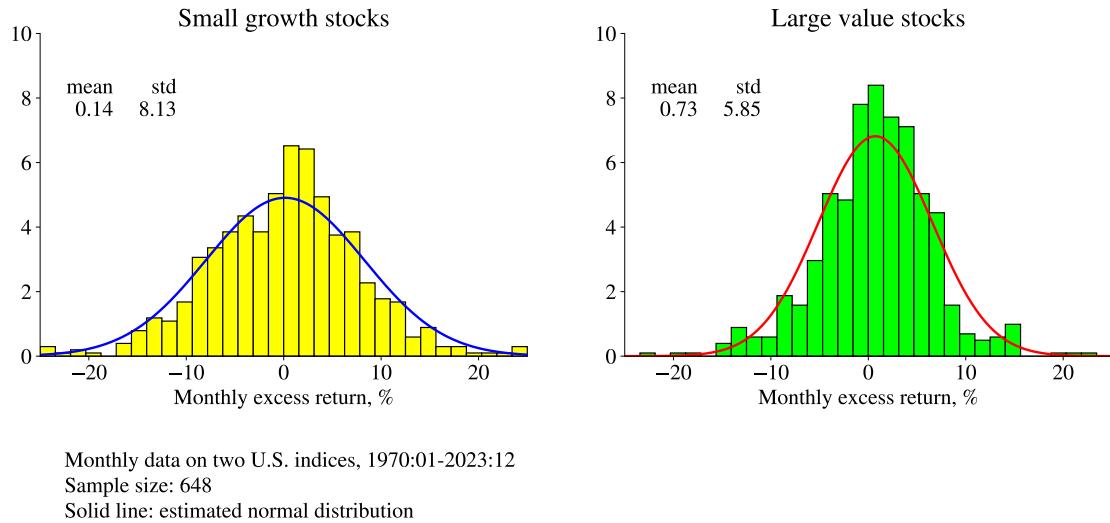


Figure 1.6: Histogram of returns, the curve is a normal distribution with the same mean and standard deviation as the return series

Replace 0.9 by 0.95 to get a 95% confidence band—and similarly for other confidence levels. In particular, if $x \sim N(\mu, \sigma^2)$, then

$$\begin{aligned} \Pr(\mu - 1.64\sigma < x \leq \mu + 1.64\sigma) &= 0.9 \text{ and} \\ \Pr(\mu - 1.96\sigma < x \leq \mu + 1.96\sigma) &= 0.95. \end{aligned} \quad (1.9)$$

As an example, suppose x is not a data series but a regression coefficient (denoted $\hat{\beta}$)—and we know that the standard error equals some number σ . We could then construct a 90% confidence band around the point estimate ($\hat{\beta}$) as

$$[\hat{\beta} - 1.64\sigma, \hat{\beta} + 1.64\sigma]. \quad (1.10)$$

In case this band does not include your null hypothesis $\beta = q$ ($q = 0$ is a commonly used special case), then we would be 90% that the (true) regression coefficient is different from q .

Alternatively, suppose we instead construct the 90% confidence band around q as

$$[q - 1.64\sigma, q + 1.64\sigma]. \quad (1.11)$$

If this band does not include the point estimate ($\hat{\beta}$), then we are also 90% sure that the (true) regression coefficient is different from q .

A third way to create a confidence band is to first create a standardized variable

$$t = \frac{\hat{\beta} - q}{\sigma}, \quad (1.12)$$

and then notice that we are 90% sure that t is in the interval

$$[-1.64, 1.64]. \quad (1.13)$$

(Provided the null hypothesis is true, that is, $\beta = q$.) This is a t -test. Testing the null hypothesis by using (1.10), (1.11) or (1.13) should give the same answer to the question: is there sufficient statistical evidence against the null hypothesis.

1.1.6 The Idea behind Confidence Bands and t-tests

Suppose we have estimated a parameter ($\hat{\beta}$) from a particular sample of data (observations 1 to T , say). The parameter could, for instance, be the mean or a regression coefficient. This estimate is actually a random variable so it makes sense to construct a confidence band as in (1.10). The reason for why it is a random variable is that another sample is most likely to produce a different estimate—and that if we could try all possible samples then the different estimates would have some sort of distribution. *If* we are willing to assume that data for those other samples would be similar (scattered around the same mean, showing the same degree of dispersion, etc) to the sample we actually study (observations 1 to T), then we can use our sample to guess how much other samples would differ. For instance, we can estimate the variance of the data (σ^2) and draw the conclusions about how different the sample averages would be in different samples (it would have a variance of σ^2/T as discussed in (1.16)).

1.1.7 Hypothesis Testing

We are here interested in testing the null hypothesis that $\beta = q$, where q is a number of interest (0.27, say). A null hypothesis is often denoted H_0 . (Econometric programs often automatically report results for $H_0: \beta = 0$.) We here consider the alternative hypothesis (denoted H_1 or perhaps H_A) that $\beta \neq q$. This leads to a two-sided (or two-tailed) test.

Typically, we assume that the estimates are normally distributed. To be able to easily compare with printed tables of probabilities, transform to a $N(0, 1)$ variable. In particular, if the true coefficient is really q , then $\hat{\beta} - q$ should have a zero mean (recall that $E \hat{\beta}$ equals

the true value). Dividing by the standard error (deviation) of $\hat{\beta}$, we should have

$$t = \frac{\hat{\beta} - q}{\text{Std}(\hat{\beta})} \sim N(0, 1) \quad (1.14)$$

In case $|t|$ is very large (say, 1.64 or larger), then our estimate $\hat{\beta}$ is a very unlikely outcome if $E \hat{\beta}$ (which equals the true coefficient value, β) is indeed q . We therefore draw the conclusion that the true coefficient is not q , that is, we *reject the null hypothesis*.

1.2 Moments

1.2.1 Mean and Standard Deviation

The mean and variance of a series are estimated as

$$\bar{x} = \sum_{t=1}^T x_t / T \text{ and } \hat{\sigma}^2 = \sum_{t=1}^T (x_t - \bar{x})^2 / T. \quad (1.15)$$

The standard deviation (the square root of the variance) is the most common measure of volatility. (Sometimes we use $T - 1$ in the denominator of the sample variance instead of T .) See Figure 1.6 for an illustration.

A sample mean is normally distributed if x_t is normally distributed, $x_t \sim N(\mu, \sigma^2)$. The reason is that a linear combination of normally distributed variables is (typically) also normally distributed. However, a sample average is often approximately normally distributed even if the variable is not (discussed below). If x_t is iid (independently and identically distributed), then the variance of a sample mean is

$$\text{Var}(\bar{x}) = \sigma^2 / T, \text{ if } x_t \text{ is iid.} \quad (1.16)$$

Sometimes, we instead report the variance of $\sqrt{T}\bar{x}$, which is

$$\text{Var}(\sqrt{T}\bar{x}) = \sigma^2, \text{ if } x_t \text{ is iid.} \quad (1.17)$$

(To see the link, factor out T from the left hand side of (1.17) to get $T \text{Var}(\bar{x})$. Then divide by sides by T to get (1.16).)

A sample average is (typically) *unbiased*, that is, the expected value of the sample average equals the population mean, that is,

$$E \bar{x} = E x_t = \mu. \quad (1.18)$$

Since sample averages are typically normally distributed in large samples, we thus have

$$\bar{x} \sim N(\mu, \sigma^2/T), \quad (1.19)$$

so we can construct a *t-stat* as

$$t = \frac{\bar{x} - \mu}{\sigma/\sqrt{T}}, \quad (1.20)$$

which has an $N(0, 1)$ distribution. An alternative way of expressing (1.19) is

$$\sqrt{T}(\bar{x} - \mu) \sim N(0, \sigma^2). \quad (1.21)$$

This is often used in the context of the central limit theorem.

Proof (of (1.16)–(1.18)) To prove (1.16), notice that

$$\begin{aligned} \text{Var}(\bar{x}) &= \text{Var}\left(\sum_{t=1}^T x_t / T\right) \\ &= \sum_{t=1}^T \text{Var}(x_t / T) \\ &= T \text{Var}(x_t) / T^2 \\ &= \sigma^2 / T. \end{aligned}$$

The first equality is just a definition and the second equality follows from the assumption that x_t and x_s are independently distributed. This means, for instance, that $\text{Var}(x_2 + x_3) = \text{Var}(x_2) + \text{Var}(x_3)$ since the covariance is zero. The third equality follows from the assumption that x_t and x_s are identically distributed (so their variances are the same). The fourth equality is a trivial simplification.

To prove (1.18)

$$\begin{aligned} E\bar{x} &= E\sum_{t=1}^T x_t / T \\ &= \sum_{t=1}^T E x_t / T \\ &= E x_t. \end{aligned}$$

The first equality is just a definition and the second equality is always true (the expectation of a sum is the sum of expectations), and the third equality follows from the assumption of identical distributions which implies identical expectations. \square

1.2.2 Skewness and Kurtosis

The skewness, kurtosis and Jarque-Bera test for normality are useful diagnostic tools. They are

$$\begin{array}{ll}
 & \text{Test statistic} \\
 \text{skewness} & = \frac{1}{T} \sum_{t=1}^T \left(\frac{x_t - \mu}{\sigma} \right)^3 & N(0, 6/T) \\
 \text{kurtosis} & = \frac{1}{T} \sum_{t=1}^T \left(\frac{x_t - \mu}{\sigma} \right)^4 & N(3, 24/T) \\
 \text{Jarque-Bera} & = \frac{T}{6} \text{skewness}^2 + \frac{T}{24} (\text{kurtosis} - 3)^2 & \chi_2^2.
 \end{array} \tag{1.22}$$

This is implemented by using the estimated mean and standard deviation. See Figure 1.6 for an illustration.

The distributions stated on the right hand side of (1.22) are under the null hypothesis that x_t is iid $N(\mu, \sigma^2)$. The “excess kurtosis” is defined as the kurtosis minus 3. The test statistic for the normality test (Jarque-Bera) can be compared with 4.6 or 6.0, which are the 10% and 5% critical values of a χ_2^2 distribution.

Clearly, we can test the skewness and kurtosis by traditional t-stats as in

$$t = \frac{\text{skewness}}{\sqrt{6/T}} \text{ and } t = \frac{\text{kurtosis} - 3}{\sqrt{24/T}}, \tag{1.23}$$

which both have $N(0, 1)$ distribution under the null hypothesis of a normal distribution.

1.2.3 Covariance and Correlation

A covariance of two variables (here x and y) is defined as

$$\begin{aligned}
 \text{Cov}(x, y) &= E[(x - E x)(y - E y)] \\
 &= E xy - E x E y.
 \end{aligned} \tag{1.24}$$

If $E x = 0$ or $E y = 0$, then $\text{Cov}(x, y) = E xy$. When $x = y$, then we get $\text{Var}(x) = E x^2 - (E x)^2$. These results hold for sample moments too.

It is typically estimated as

$$\hat{\sigma}_{xy} = \sum_{t=1}^T (x_t - \bar{x})(y_t - \bar{y}) / T. \tag{1.25}$$

(Sometimes we use $T - 1$ in the denominator of the sample covariance instead of T .)

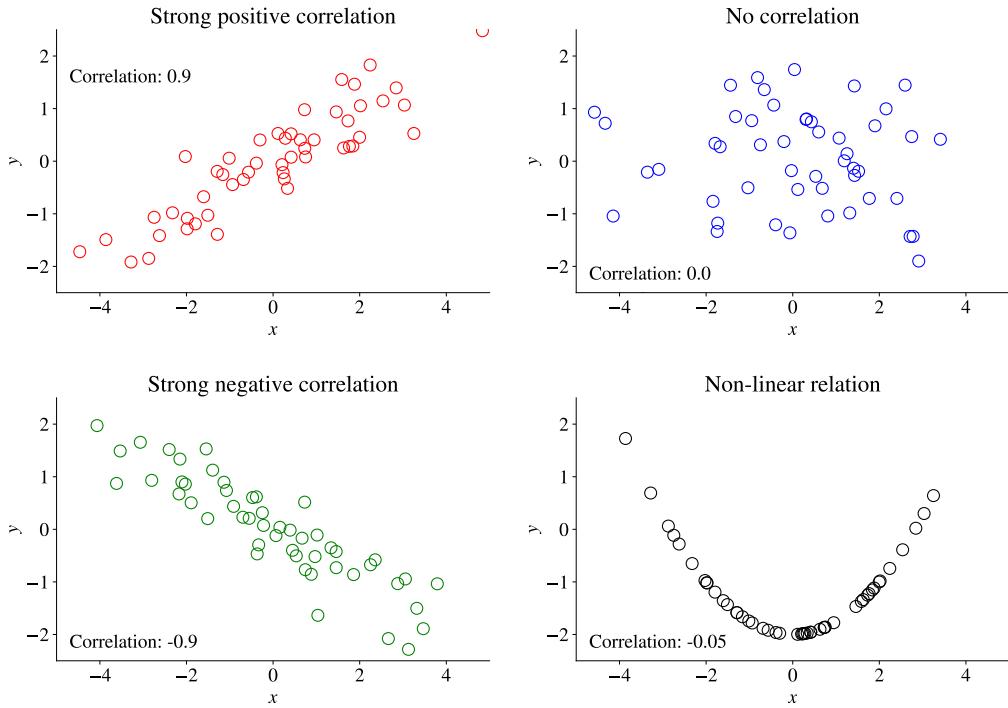


Figure 1.7: Example of correlations.

The correlation of two variables is then estimated as

$$\hat{\rho}_{xy} = \frac{\hat{\sigma}_{xy}}{\hat{\sigma}_x \hat{\sigma}_y}, \quad (1.26)$$

where $\hat{\sigma}_x$ and $\hat{\sigma}_y$ are the estimated standard deviations. A correlation must be between -1 and 1 . Note that covariance and correlation measure the degree of *linear* relation only. This is illustrated in Figure 1.7.

Empirical Example 1.4 (*Scatter plot of equity returns*) See Figure 1.8.

Under the null hypothesis of no correlation—and if the data is approximately normally distributed, then E

$$\frac{\hat{\rho}}{\sqrt{1 - \hat{\rho}^2}} \sim N(0, 1/T), \quad (1.27)$$

so we can form a t-stat as

$$t = \sqrt{T} \frac{\hat{\rho}}{\sqrt{1 - \hat{\rho}^2}}, \quad (1.28)$$

which has an $N(0, 1)$ distribution.

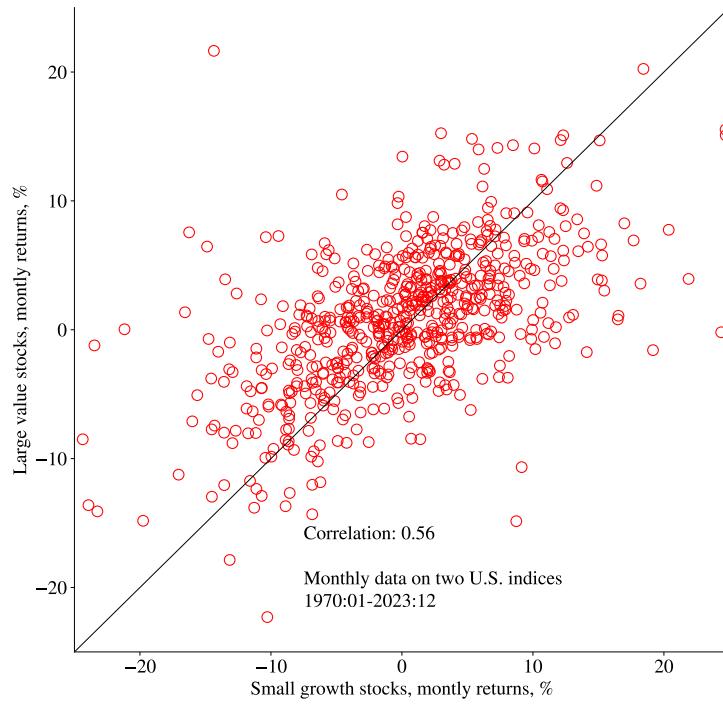


Figure 1.8: Scatter plot of two different portfolio returns

1.2.4 Moments of Vectors

Moments of vectors are straightforward extensions of the previous discussion. For instance, if $x = [x_1, x_2]$ is a vector of the two random variables x_1 and x_2 (the subscripts here indicate different variables, not time periods or anything like that), then the mean of x is just a vector (with 2 elements) of the means of the two variables

$$\mathbb{E}x = \begin{bmatrix} \mathbb{E}x_1 \\ \mathbb{E}x_2 \end{bmatrix}. \quad (1.29)$$

Also, the (2×2) variance-covariance matrix of x is

$$\text{Var}(x) = \begin{bmatrix} \text{Var}(x_1) & \text{Cov}(x_1, x_2) \\ \text{Cov}(x_2, x_1) & \text{Var}(x_2) \end{bmatrix}. \quad (1.30)$$

Clearly, the matrix is symmetric (since two covariances are the same).

Also, if $y = [y_1, y_2, y_3]$ is a vector of the three random variables y_1 , y_2 and y_3 , then

the (2×3) covariance matrix of the x and y vectors is

$$\text{Cov}(x, y) = \begin{bmatrix} \text{Cov}(x_1, y_1) & \text{Cov}(x_1, y_2) & \text{Cov}(x_1, y_3) \\ \text{Cov}(x_2, y_1) & \text{Cov}(x_2, y_2) & \text{Cov}(x_2, y_3) \end{bmatrix}. \quad (1.31)$$

This is not a symmetric matrix, and not even the first two columns define a symmetric matrix (since $\text{Cov}(x_1, y_2)$ need not be the same as $\text{Cov}(x_2, y_1)$).

1.2.5 Correlations vs. Causality

Notice that a correlation between x and y does not say anything about causality. There are several possibilities, including

$$\begin{aligned} (x, \varepsilon) &\Rightarrow y \\ (y, u) &\Rightarrow x \\ (z, u) &\Rightarrow x \text{ and } (z, \varepsilon) \Rightarrow y \end{aligned} \quad (1.32)$$

In the first case, x and some other variables (here labelled ε) are indeed causing y , so changes in x are likely to be accompanied by changes in y . The second case shows the opposite: y is causing x . The third case is when some other variable z is driving the correlation between x and y . However, an independent move in x (due to u) will not lead to moves in y . This reasoning carries over to regression analysis too. In many regressions we would like to capture the causality, although forecasting models are more focused on the correlation as such.

1.2.6 Correlations and the Variance of a Sample Average

The result in (1.16) that $\text{Var}(\bar{x}) = \sigma^2/T$ does not hold if x_t and x_{t-s} are correlated. To see that, consider the case when the sample has just two observations

$$\begin{aligned} \bar{x} &= (x_1 + x_2)/2 \text{ and} \\ \text{Var}(\bar{x}) &= (\sigma^2 + \sigma^2 + \sigma_{12} + \sigma_{21})/4. \end{aligned} \quad (1.33)$$

In the iid case we *assume* that $\sigma_{12} = \sigma_{21} = 0$, so $\text{Var}(\bar{x}) = \sigma^2/2$. In the other extreme case of perfect correlations, $\sigma_{12} = \sigma^2$ so the variance of the sample average is the same as for the data (no precision is gained by averaging), $\text{Var}(\bar{x}) = \sigma^2$.

More generally, with T observations, we have

$$\text{Var}(\bar{x}) = \sum_{i=1}^T \sum_{j=1}^T \sigma_{ij} / T^2, \quad (1.34)$$

which is sum of all the elements of the covariance matrix, divided by T^2 . This can be written as

$$\text{Var}(\bar{x}) = \frac{\bar{\sigma}^2 - \bar{\sigma}_{ij}}{T} + \bar{\sigma}_{ij}, \quad (1.35)$$

where $\bar{\sigma}^2$ is the average variance and $\bar{\sigma}_{ij}$ the average covariance of any two observations (x_t and x_{t-s} , say). This carries over to the variance of regression coefficients—when the residuals are correlated (over time or over cross sectional units).

Example 1.5 (Covariance matrix with $T = 2$) The covariance matrix of x_1 and x_2 is

$$\begin{bmatrix} \sigma^2 & \sigma_{12} \\ \sigma_{21} & \sigma^2 \end{bmatrix},$$

if we assume that x_1 and x_2 have the same variance (σ^2). Also, notice that $\sigma_{12} = \sigma_{21}$.

Example 1.6 ($\text{Var}(\bar{x})$) Assume $\bar{\sigma}^2 = 1$, then $\text{Var}(\bar{x})$ is

$$\begin{array}{ll} \bar{\sigma}_{ij} = 0 & \bar{\sigma}_{ij} = 0.10 \\ T = 10 : & \begin{array}{ll} 0.1 & 0.19 \end{array} \\ T = 100 : & \begin{array}{ll} 0.01 & 0.109 \end{array} \end{array}$$

1.3 Distributions Commonly Used in Tests

1.3.1 Standard Normal Distribution, $N(0, 1)$

Suppose the random variable x has a $N(\mu, \sigma^2)$ distribution. Then, the the *standardized variable* $(x - \mu)/\sigma$ has a standard normal distribution

$$t = \frac{x - \mu}{\sigma} \sim N(0, 1). \quad (1.36)$$

To see this, notice that $x - \mu$ has a mean of zero and that x/σ has a standard deviation of unity. (This result is the motivation for why the confidence band (1.13) gives the same result as (1.11).)

1.3.2 t -distribution

If we instead need to estimate σ to use in (1.36), then the test statistic has t_n -distribution

$$t = \frac{x - \mu}{\hat{\sigma}} \sim t_n, \quad (1.37)$$

where n denotes the “degrees of freedom,” that is the number of observations minus the number of estimated parameters. For instance, if we have a sample with T data points and only estimate the mean, then $n = T - 1$.

The t -distribution has more probability mass in the tails than an $N(0, 1)$ distribution. It therefore gives a more “conservative” test (harder to reject the null hypothesis), but the difference vanishes as the degrees of freedom (sample size) increases. See Figure 1.9 for a comparison and Table 1.1 for critical values.

Example 1.7 (t -distribution) If $t = 2.0$ and $n = 50$, then this is larger than the 10% critical value (but not the 5% critical value) for a 2-sided test in Table 1.1.

1.3.3 Chi-square Distribution

If $z \sim N(0, 1)$, then $z^2 \sim \chi_1^2$, that is, z^2 has a chi-square distribution with one degree of freedom. This can be generalized in several ways. For instance, if $x \sim N(\mu_x, \sigma_{xx})$ and $y \sim N(\mu_y, \sigma_{yy})$ and they are uncorrelated, then $[(x - \mu_x)/\sigma_x]^2 + [(y - \mu_y)/\sigma_y]^2 \sim \chi_2^2$.

More generally, we have

$$v' \Sigma^{-1} v \sim \chi_n^2, \text{ if the } n \times 1 \text{ vector } v \sim N(0, \Sigma). \quad (1.38)$$

See Figure 1.9 for an illustration and Table 1.2 for critical values.

Example 1.8 (χ_2^2 distribution) Suppose x is a 2×1 vector

$$\begin{bmatrix} x_1 \\ x_2 \end{bmatrix} \sim N \left(\begin{bmatrix} 4 \\ 2 \end{bmatrix}, \begin{bmatrix} 5 & 3 \\ 3 & 4 \end{bmatrix} \right).$$

If $x_1 = 3$ and $x_2 = 5$, then

$$\begin{bmatrix} 3 - 4 \\ 5 - 2 \end{bmatrix}' \begin{bmatrix} 5 & 3 \\ 3 & 4 \end{bmatrix}^{-1} \begin{bmatrix} 3 - 4 \\ 5 - 2 \end{bmatrix} \approx 6.1$$

has a χ_2^2 distribution. Notice that 6.1 is higher than the 5% critical value (but not the 1% critical value) in Table 1.2.

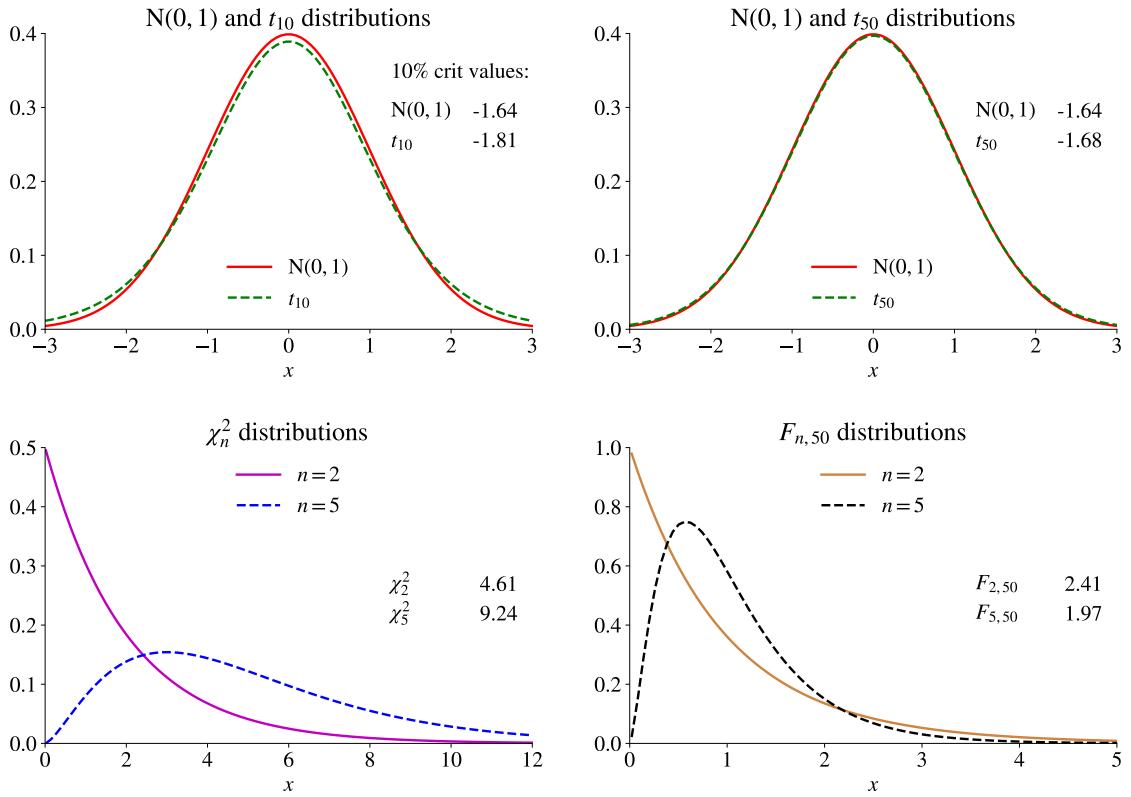


Figure 1.9: Probability density functions

1.3.4 F -distribution

If $x \sim \chi^2_{n_1}$ and $y \sim \chi^2_{n_2}$, then $(x/n_1)/(y/n_2)$ has an F_{n_1, n_2} distribution with (n_1, n_2) degrees of freedom. See Figure 1.9 for an illustration and Tables 1.3–1.4 for critical values.

1.4 Normal Distribution of the Sample Mean

In many cases, it is unreasonable to assume that a random variable x_t is normally distributed. The nice thing with a sample mean (or sample average), here denoted \bar{x} , is that it has very useful properties (in a reasonably large sample). This section gives a short summary of what happens to sample means as the sample size increases (often called “asymptotic theory”).

The *law of large numbers* (LLN) says that the sample mean converges to the true population mean as the sample size goes to infinity. This holds for a very large class

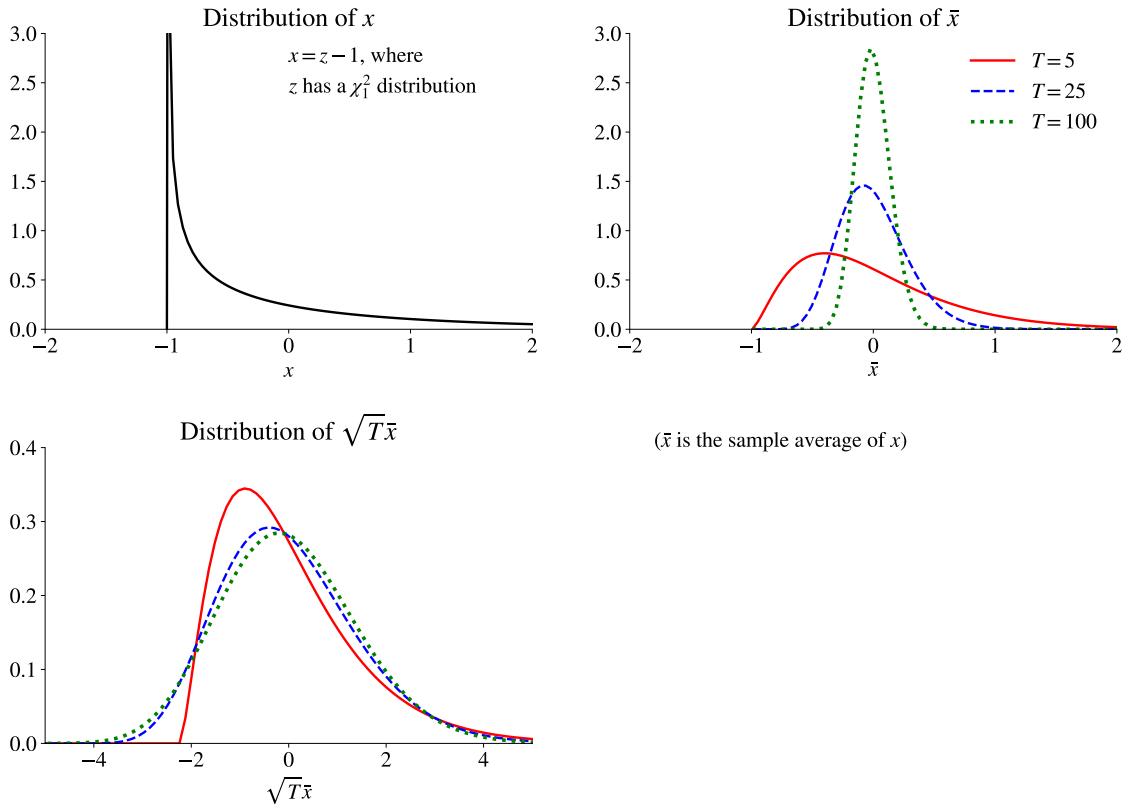


Figure 1.10: Sampling distributions

of random variables, but there are exceptions. A sufficient (but not necessary) condition for this convergence is that the sample average is unbiased (as in (1.18)) and that the variance goes to zero as the sample size goes to infinity (as in (1.16)). (This is also called convergence in mean square.) To see the LLN in action, see Figure 1.10.

The *central limit theorem* (CLT) says that $\sqrt{T}\bar{x}$ converges in distribution to a normal distribution as the sample size increases. See Figure 1.10 for an illustration. This also holds for a large class of random variables—and it is a very useful result since it allows us to test hypotheses by assuming that $\sqrt{T}\bar{x}$ is normally distributed. Most estimators (including least squares and other methods) are effectively some kind of sample average, so the CLT can be applied. If the population mean is μ , then this is often written

$$\sqrt{T}(\bar{x} - \mu) \xrightarrow{d} N(0, \sigma^2), \quad (1.39)$$

where \xrightarrow{d} denotes that the distribution converges to a normal as T goes to infinity. If x is

iid, then σ^2 is the same as the variance of x . This is often expressed as

$$\bar{x} \xrightarrow{a} N(\mu, \sigma^2/T),$$

where \xrightarrow{a} means “is asymptotically distributed as”. (This follows from: (a) if the variance of $\sqrt{T}\bar{x}$ is σ^2 , then the variance of \bar{x} is σ^2/T ; (b) adding μ to $\bar{x} - \mu$ increases the mean by μ .)

1.5 Appendix – Notation*

Here is an incomplete list of the notation used in these notes.

- $\sum_{t=1}^T x_t$ denotes the sum $x_1 + \dots + x_T$. In the running text, this is sometimes written as just $\Sigma_t x_t$. It also happens that Σ is used to denote a variance-covariance matrix. The distinction should be clear from the context.
- $\text{Var}(x)$ denotes either the variance of a single random variable, or the $n \times n$ variance-covariance matrix of a n -vector x .
- $\text{Cov}(x, z)$ denotes either the covariance of single random variables x and z , or the $n_x \times n_z$ matrix of covariances when x is an n_x -vector and z is an n_z -vector.
- $E x$ denotes the expectation (population mean) of x (which could be a single random variable, or a vector/matrix). When x is a vector/matrix, then $E x$ is the vector/matrix of expectation of each element of x . Sample means are typically denoted by \bar{x} .

1.6 Appendix – Statistical Tables*

<u>n</u>	Significance level		
	10%	5%	1%
10	1.81	2.23	3.17
20	1.72	2.09	2.85
30	1.70	2.04	2.75
40	1.68	2.02	2.70
50	1.68	2.01	2.68
60	1.67	2.00	2.66
70	1.67	1.99	2.65
80	1.66	1.99	2.64
90	1.66	1.99	2.63
100	1.66	1.98	2.63
Normal	1.64	1.96	2.58

Table 1.1: Critical values (two-sided test) of t distribution (different degrees of freedom) and normal distribution.

<u>n</u>	Significance level		
	10%	5%	1%
1	2.71	3.84	6.63
2	4.61	5.99	9.21
3	6.25	7.81	11.34
4	7.78	9.49	13.28
5	9.24	11.07	15.09
6	10.64	12.59	16.81
7	12.02	14.07	18.48
8	13.36	15.51	20.09
9	14.68	16.92	21.67
10	15.99	18.31	23.21

Table 1.2: Critical values of chisquare distribution (different degrees of freedom, n).

<u>n_1</u>	<u>n_2</u>					$\chi^2_{n_1}/n_1$
	10	30	50	100	300	
1	4.96	4.17	4.03	3.94	3.87	3.84
2	4.10	3.32	3.18	3.09	3.03	3.00
3	3.71	2.92	2.79	2.70	2.63	2.60
4	3.48	2.69	2.56	2.46	2.40	2.37
5	3.33	2.53	2.40	2.31	2.24	2.21
6	3.22	2.42	2.29	2.19	2.13	2.10
7	3.14	2.33	2.20	2.10	2.04	2.01
8	3.07	2.27	2.13	2.03	1.97	1.94
9	3.02	2.21	2.07	1.97	1.91	1.88
10	2.98	2.16	2.03	1.93	1.86	1.83

Table 1.3: 5% Critical values of F_{n_1, n_2} distribution (different degrees of freedom).

<u>n_1</u>	<u>n_2</u>					<u>$\chi^2_{n_1}/n_1$</u>
	10	30	50	100	300	
1	3.29	2.88	2.81	2.76	2.72	2.71
2	2.92	2.49	2.41	2.36	2.32	2.30
3	2.73	2.28	2.20	2.14	2.10	2.08
4	2.61	2.14	2.06	2.00	1.96	1.94
5	2.52	2.05	1.97	1.91	1.87	1.85
6	2.46	1.98	1.90	1.83	1.79	1.77
7	2.41	1.93	1.84	1.78	1.74	1.72
8	2.38	1.88	1.80	1.73	1.69	1.67
9	2.35	1.85	1.76	1.69	1.65	1.63
10	2.32	1.82	1.73	1.66	1.62	1.60

Table 1.4: 10% Critical values of F_{n_1,n_2} distribution (different degrees of freedom).

	0.0	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
-3.0	0.0013	0.0014	0.0014	0.0015	0.0015	0.0016	0.0016	0.0017	0.0018	0.0018
-2.9	0.0019	0.0019	0.0020	0.0021	0.0021	0.0022	0.0023	0.0023	0.0024	0.0025
-2.8	0.0026	0.0026	0.0027	0.0028	0.0029	0.0030	0.0031	0.0032	0.0033	0.0034
-2.7	0.0035	0.0036	0.0037	0.0038	0.0039	0.0040	0.0041	0.0043	0.0044	0.0045
-2.6	0.0047	0.0048	0.0049	0.0051	0.0052	0.0054	0.0055	0.0057	0.0059	0.0060
-2.5	0.0062	0.0064	0.0066	0.0068	0.0069	0.0071	0.0073	0.0075	0.0078	0.0080
-2.4	0.0082	0.0084	0.0087	0.0089	0.0091	0.0094	0.0096	0.0099	0.0102	0.0104
-2.3	0.0107	0.0110	0.0113	0.0116	0.0119	0.0122	0.0125	0.0129	0.0132	0.0136
-2.2	0.0139	0.0143	0.0146	0.0150	0.0154	0.0158	0.0162	0.0166	0.0170	0.0174
-2.1	0.0179	0.0183	0.0188	0.0192	0.0197	0.0202	0.0207	0.0212	0.0217	0.0222
-2.0	0.0228	0.0233	0.0239	0.0244	0.0250	0.0256	0.0262	0.0268	0.0274	0.0281
-1.9	0.0287	0.0294	0.0301	0.0307	0.0314	0.0322	0.0329	0.0336	0.0344	0.0351
-1.8	0.0359	0.0367	0.0375	0.0384	0.0392	0.0401	0.0409	0.0418	0.0427	0.0436
-1.7	0.0446	0.0455	0.0465	0.0475	0.0485	0.0495	0.0505	0.0516	0.0526	0.0537
-1.6	0.0548	0.0559	0.0571	0.0582	0.0594	0.0606	0.0618	0.0630	0.0643	0.0655
-1.5	0.0668	0.0681	0.0694	0.0708	0.0721	0.0735	0.0749	0.0764	0.0778	0.0793
-1.4	0.0808	0.0823	0.0838	0.0853	0.0869	0.0885	0.0901	0.0918	0.0934	0.0951
-1.3	0.0968	0.0985	0.1003	0.1020	0.1038	0.1056	0.1075	0.1093	0.1112	0.1131
-1.2	0.1151	0.1170	0.1190	0.1210	0.1230	0.1251	0.1271	0.1292	0.1314	0.1335
-1.1	0.1357	0.1379	0.1401	0.1423	0.1446	0.1469	0.1492	0.1515	0.1539	0.1562
-1.0	0.1587	0.1611	0.1635	0.1660	0.1685	0.1711	0.1736	0.1762	0.1788	0.1814
-0.9	0.1841	0.1867	0.1894	0.1922	0.1949	0.1977	0.2005	0.2033	0.2061	0.2090
-0.8	0.2119	0.2148	0.2177	0.2206	0.2236	0.2266	0.2296	0.2327	0.2358	0.2389
-0.7	0.2420	0.2451	0.2483	0.2514	0.2546	0.2578	0.2611	0.2643	0.2676	0.2709
-0.6	0.2743	0.2776	0.2810	0.2843	0.2877	0.2912	0.2946	0.2981	0.3015	0.3050
-0.5	0.3085	0.3121	0.3156	0.3192	0.3228	0.3264	0.3300	0.3336	0.3372	0.3409
-0.4	0.3446	0.3483	0.3520	0.3557	0.3594	0.3632	0.3669	0.3707	0.3745	0.3783
-0.3	0.3821	0.3859	0.3897	0.3936	0.3974	0.4013	0.4052	0.4090	0.4129	0.4168
-0.2	0.4207	0.4247	0.4286	0.4325	0.4364	0.4404	0.4443	0.4483	0.4522	0.4562
-0.1	0.4602	0.4641	0.4681	0.4721	0.4761	0.4801	0.4840	0.4880	0.4920	0.4960

Table 1.5: Values of the standard normal distribution function at x where x is the sum of the values in the first column and the first row.

	0.0	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09
0.0	0.5000	0.5040	0.5080	0.5120	0.5160	0.5199	0.5239	0.5279	0.5319	0.5359
0.1	0.5398	0.5438	0.5478	0.5517	0.5557	0.5596	0.5636	0.5675	0.5714	0.5753
0.2	0.5793	0.5832	0.5871	0.5910	0.5948	0.5987	0.6026	0.6064	0.6103	0.6141
0.3	0.6179	0.6217	0.6255	0.6293	0.6331	0.6368	0.6406	0.6443	0.6480	0.6517
0.4	0.6554	0.6591	0.6628	0.6664	0.6700	0.6736	0.6772	0.6808	0.6844	0.6879
0.5	0.6915	0.6950	0.6985	0.7019	0.7054	0.7088	0.7123	0.7157	0.7190	0.7224
0.6	0.7257	0.7291	0.7324	0.7357	0.7389	0.7422	0.7454	0.7486	0.7517	0.7549
0.7	0.7580	0.7611	0.7642	0.7673	0.7704	0.7734	0.7764	0.7794	0.7823	0.7852
0.8	0.7881	0.7910	0.7939	0.7967	0.7995	0.8023	0.8051	0.8078	0.8106	0.8133
0.9	0.8159	0.8186	0.8212	0.8238	0.8264	0.8289	0.8315	0.8340	0.8365	0.8389
1.0	0.8413	0.8438	0.8461	0.8485	0.8508	0.8531	0.8554	0.8577	0.8599	0.8621
1.1	0.8643	0.8665	0.8686	0.8708	0.8729	0.8749	0.8770	0.8790	0.8810	0.8830
1.2	0.8849	0.8869	0.8888	0.8907	0.8925	0.8944	0.8962	0.8980	0.8997	0.9015
1.3	0.9032	0.9049	0.9066	0.9082	0.9099	0.9115	0.9131	0.9147	0.9162	0.9177
1.4	0.9192	0.9207	0.9222	0.9236	0.9251	0.9265	0.9279	0.9292	0.9306	0.9319
1.5	0.9332	0.9345	0.9357	0.9370	0.9382	0.9394	0.9406	0.9418	0.9429	0.9441
1.6	0.9452	0.9463	0.9474	0.9484	0.9495	0.9505	0.9515	0.9525	0.9535	0.9545
1.7	0.9554	0.9564	0.9573	0.9582	0.9591	0.9599	0.9608	0.9616	0.9625	0.9633
1.8	0.9641	0.9649	0.9656	0.9664	0.9671	0.9678	0.9686	0.9693	0.9699	0.9706
1.9	0.9713	0.9719	0.9726	0.9732	0.9738	0.9744	0.9750	0.9756	0.9761	0.9767
2.0	0.9772	0.9778	0.9783	0.9788	0.9793	0.9798	0.9803	0.9808	0.9812	0.9817
2.1	0.9821	0.9826	0.9830	0.9834	0.9838	0.9842	0.9846	0.9850	0.9854	0.9857
2.2	0.9861	0.9864	0.9868	0.9871	0.9875	0.9878	0.9881	0.9884	0.9887	0.9890
2.3	0.9893	0.9896	0.9898	0.9901	0.9904	0.9906	0.9909	0.9911	0.9913	0.9916
2.4	0.9918	0.9920	0.9922	0.9925	0.9927	0.9929	0.9931	0.9932	0.9934	0.9936
2.5	0.9938	0.9940	0.9941	0.9943	0.9945	0.9946	0.9948	0.9949	0.9951	0.9952
2.6	0.9953	0.9955	0.9956	0.9957	0.9959	0.9960	0.9961	0.9962	0.9963	0.9964
2.7	0.9965	0.9966	0.9967	0.9968	0.9969	0.9970	0.9971	0.9972	0.9973	0.9974
2.8	0.9974	0.9975	0.9976	0.9977	0.9977	0.9978	0.9979	0.9979	0.9980	0.9981
2.9	0.9981	0.9982	0.9982	0.9983	0.9984	0.9984	0.9985	0.9985	0.9986	0.9986

Table 1.6: Values of the standard normal distribution function at x where x is the sum of the values in the first column and the first row.

Chapter 2

Least Squares Estimation

Reference: Verbeek (2012) 2 and 4; Greene (2018) 2-4.

2.1 Least Squares: The Optimization Problem and Its Solution

2.1.1 Simple Regression

The simplest regression model is

$$y_t = \beta_0 + \beta_1 x_t + u_t, \text{ where } E u_t = 0 \text{ and } \text{Cov}(x_t, u_t) = 0, \quad (2.1)$$

where we can observe (have data on) the dependent variable y_t and the regressor x_t but not the residual u_t . In principle, the residual should account for all the movements in y_t that we cannot explain by x_t . The subscript t refers to observation t , which could represent period t (when data is a time series) or investor t (when data is a cross-section). In the latter case, it is common to instead use i as subscript.

Remark 2.1 (*On notation*) These notes sometimes use alternative notations for the regression equation, for instance, $y_t = \alpha + \beta x_t + u_t$ (as is typical in CAPM regressions) or $y_i = a + b x_i + u_i$.

Notice the two very important assumptions: (i) the mean of the residual is zero; and (ii) the residual is not correlated with the regressor, x_t . This basically says that the residual is pure noise. In contrast, if the average of u_t was non-zero, then $\beta_0 + \beta_1 x_t$ would get the general level of y_t wrong. Also, if x_t and u_t were correlated, then the best guess of y_t based on x_t would not be $\beta_0 + \beta_1 x_t$.

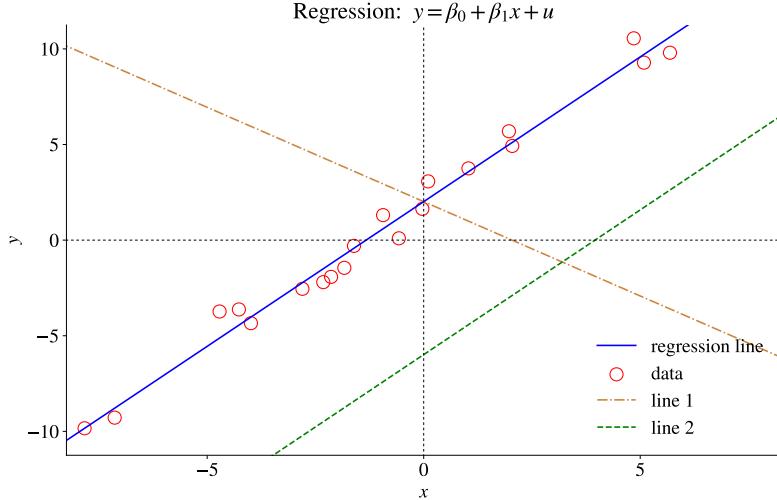


Figure 2.1: Example of OLS

Suppose you do not know β_0 or β_1 , and that you have a sample of data: y_t and x_t for $t = 1, \dots, T$. The LS estimator of β_0 and β_1 minimizes the loss function

$$\sum_{t=1}^T (y_t - b_0 - b_1 x_t)^2 = (y_1 - b_0 - b_1 x_1)^2 + (y_2 - b_0 - b_1 x_2)^2 + \dots \quad (2.2)$$

by choosing b_0 and b_1 to make the loss function value as small as possible. The objective is thus to pick values of b_0 and b_1 in order to make the model fit the data as closely as possible—where close is taken to be a small variance of the unexplained part (the residual). See Figures 2.1–2.2 for illustrations. (Least squares is only one of many possible ways to estimate regression coefficients. We will discuss other methods later on.)

Remark 2.2 (On notation) These notes use $\sum_{t=1}^T x_t$ to denote the sum $x_1 + \dots + x_T$. In the running text, this could sometimes be written as just Σx_t , although we try to avoid that. It also happens that Σ is used to denote a variance-covariance matrix. The distinction should be clear from the context.

Remark 2.3 Note that β_i is the true (unobservable) value which we estimate to be $\hat{\beta}_i$. Whereas β_i is an unknown (deterministic) number, $\hat{\beta}_i$ is a random variable since it is calculated as a function of the random sample of y_t and x_t . We use b_i as an argument in the loss function (so we contemplate different values of b_i)—and the optimal value is clearly $\hat{\beta}_i$.

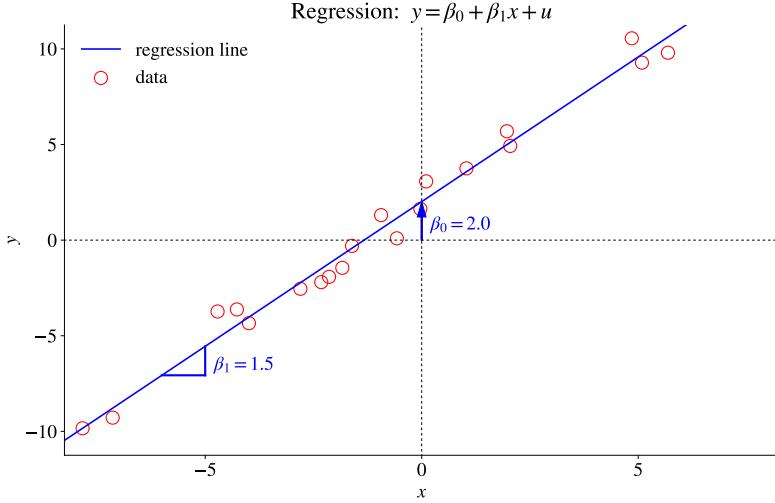


Figure 2.2: Example of OLS

Remark 2.4 (*First order condition for minimizing a differentiable function*). We want to find the value of b in the interval $b_{low} \leq b \leq b_{high}$, which makes the value of the differentiable function $f(b)$ as small as possible. The answer is b_{low} , b_{high} , or a value of b where $df(b)/db = 0$. See Figure 2.3.

The first order conditions for a minimum are that the derivatives of this loss function with respect to b_0 and b_1 should be zero. Notice that

$$\frac{\partial}{\partial b_0} (y_t - b_0 - b_1 x_t)^2 = -2(y_t - b_0 - b_1 x_t)1 \quad (2.3)$$

$$\frac{\partial}{\partial b_1} (y_t - b_0 - b_1 x_t)^2 = -2(y_t - b_0 - b_1 x_t)x_t. \quad (2.4)$$

Let (\hat{b}_0, \hat{b}_1) be the values of (b_0, b_1) where the derivatives are zero (that is, (\hat{b}_0, \hat{b}_1) are the optimal values)

$$\frac{\partial}{\partial \hat{b}_0} \sum_{t=1}^T (y_t - \hat{b}_0 - \hat{b}_1 x_t)^2 = -2 \sum_{t=1}^T 1(y_t - \hat{b}_0 - \hat{b}_1 x_t) = 0 \quad (2.5)$$

$$\frac{\partial}{\partial \hat{b}_1} \sum_{t=1}^T (y_t - \hat{b}_0 - \hat{b}_1 x_t)^2 = -2 \sum_{t=1}^T x_t(y_t - \hat{b}_0 - \hat{b}_1 x_t) = 0, \quad (2.6)$$

which are two equations in two unknowns $(\hat{b}_0$ and $\hat{b}_1)$, which must be solved simultaneously. These equations show that both the constant and x_t should be *orthogonal* to the fitted residuals, $\hat{u}_t = y_t - \hat{b}_0 - \hat{b}_1 x_t$. This is indeed a defining feature of LS and can be seen

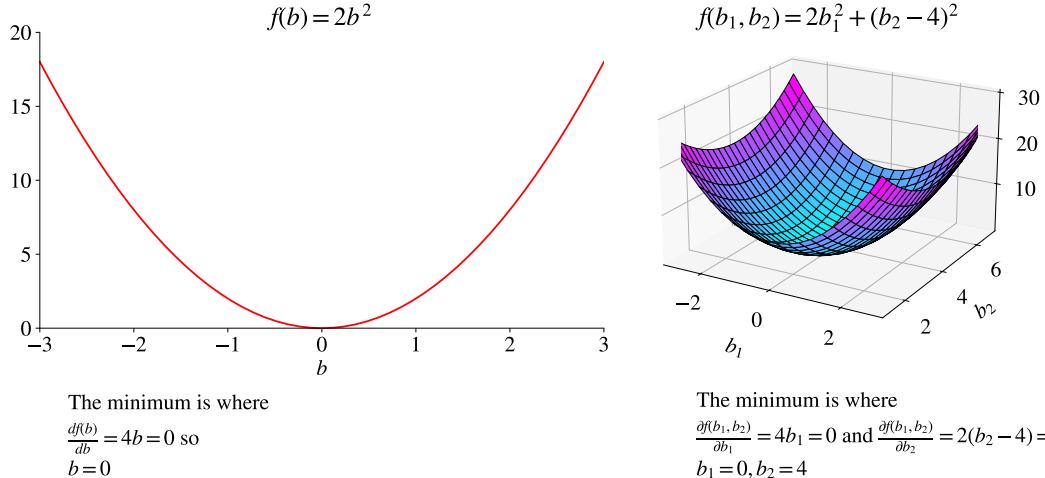


Figure 2.3: Quadratic loss function. Subfigure a: 1 coefficient; Subfigure b: 2 coefficients

as the sample analogues of the assumptions in (2.1) that $E u_t = 0$ and $Cov(x_t, u_t) = 0$. To see this, note that (2.5) says that the sample average of \hat{u}_t should be zero. Similarly, (2.6) says that the sample cross moment of \hat{u}_t and x_t (that is, $\sum_{t=1}^T \hat{u}_t x_t / T$) should also be zero, which implies that the sample covariance is zero as well since \hat{u}_t has a zero sample mean (recall that $Cov(x, u) = Exu - Ex Eu$).

When the means of y and x are zero, then we know that intercept is zero ($\beta_0 = 0$). In this case, (2.6) with $\hat{\beta}_0 = 0$ immediately gives

$$\begin{aligned} \sum_{t=1}^T x_t y_t &= \hat{\beta}_1 \sum_{t=1}^T x_t x_t \text{ or} \\ \hat{\beta}_1 &= \frac{\sum_{t=1}^T x_t y_t / T}{\sum_{t=1}^T x_t x_t / T}. \end{aligned} \quad (2.7)$$

In this case, the coefficient estimator is the sample covariance (recall: means are zero) of y_t and x_t , divided by the sample variance of the regressor x_t (this statement is actually true even if the means are not zero and a constant is included on the right hand side—just more tedious to show it).

Empirical Example 2.5 (CAPM regressions) See Table 2.1 and Figure 2.5 for CAPM regressions for two industry portfolios. The betas clearly differ.

Example 2.6 (Simple regression) Consider the simple regression model (PSLS1). Sup-

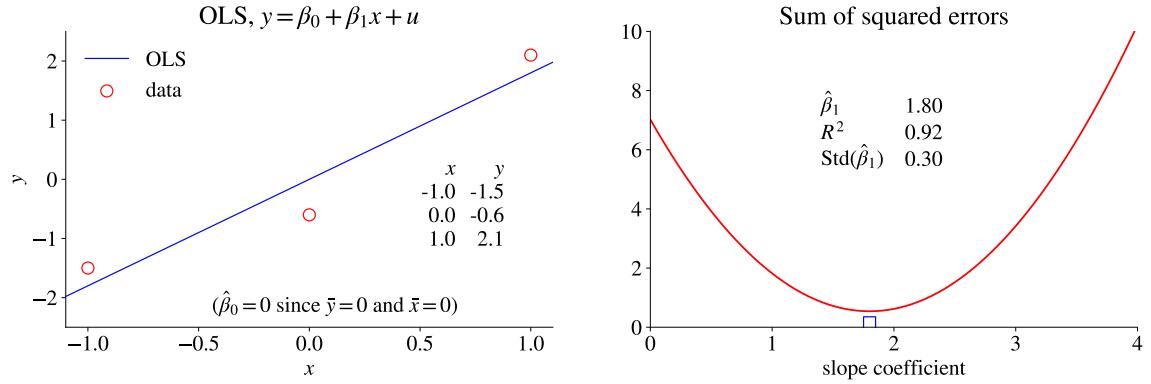


Figure 2.4: Example of OLS estimation

	HiTec	Utils
constant	-0.06 (-0.49)	0.22 (1.60)
market return	1.24 (38.82)	0.52 (14.41)
R^2	0.76	0.33
obs	648	648

Table 2.1: CAPM regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

pose we have the following data

<u>t</u>	<u>x</u>	<u>y</u>
1	-1	-1.5
2	0	-0.6
3	1	2.1

To calculate the LS estimate according to (2.7) we note that

$$\sum_{t=1}^T x_t x_t = (-1)^2 + 0^2 + 1^1 = 2 \text{ and}$$

$$\sum_{t=1}^T x_t y_t = (-1)(-1.5) + 0(-0.6) + 1 \times 2.1 = 3.6$$

This gives

$$\hat{\beta}_1 = \frac{3.6}{2} = 1.8.$$

The fitted residuals are

$$\begin{bmatrix} \hat{u}_1 \\ \hat{u}_2 \\ \hat{u}_3 \end{bmatrix} = \begin{bmatrix} -1.5 \\ -0.6 \\ 2.1 \end{bmatrix} - 1.8 \begin{bmatrix} -1 \\ 0 \\ 1 \end{bmatrix} = \begin{bmatrix} 0.3 \\ -0.6 \\ 0.3 \end{bmatrix}.$$

The fitted residuals indeed obey the first order condition (2.6) since

$$\sum_{t=1}^T x_t \hat{u}_t = (-1) \times 0.3 + 0(-0.6) + 1 \times 0.3 = 0.$$

See Figure 2.4 for an illustration.

Example 2.7 Using the same data as in Example 2.6 we can also calculate the sums of squared residuals for different values of the slope coefficient. With $\beta_1 = 1.6$ we get

t	\underline{u}_t	\underline{u}_1^2
1	$-1.5 - \mathbf{1.6} \times (-1) = 0.1$	0.01
2	$-0.6 - \mathbf{1.6} \times 0 = -0.6$	0.36
3	$2.1 - \mathbf{1.6} \times 1 = 0.5$	0.25
sum	0	0.62

With $\beta = 1.8$ and $\beta = 2.0$ we instead get

t	\underline{u}_t	\underline{u}_1^2
1	$-1.5 - \mathbf{1.8} \times (-1) = 0.3$	0.09
2	$-0.6 - \mathbf{1.8} \times 0 = -0.6$	0.36
3	$2.1 - \mathbf{1.8} \times 1 = 0.3$	0.09
sum	0	0.54

t	\underline{u}_t	\underline{u}_1^2
1	$-1.5 - \mathbf{2.0} \times (-1) = 0.5$	0.25
2	$-0.6 - \mathbf{2.0} \times 0 = -0.6$	0.36
3	$2.1 - \mathbf{2.0} \times 1 = 0.1$	0.01
sum	0	0.62

Among these alternatives, $\beta = 1.8$ has the lowest sum of squared residuals (it is actually the optimum). See Figure 2.4.

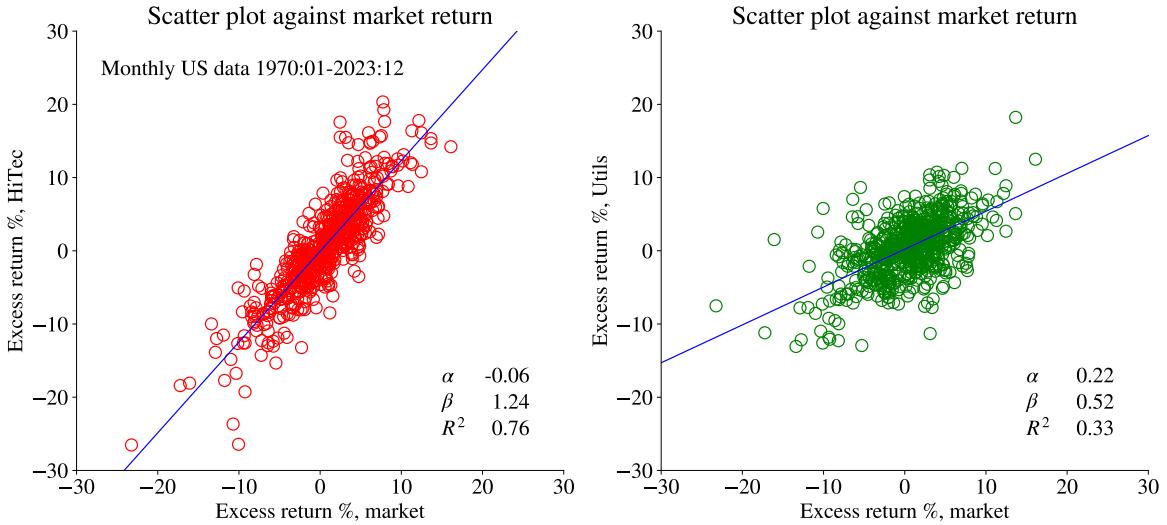


Figure 2.5: Scatter plot against market return

2.1.2 Multiple Regression

All the previous results still hold in a multiple regression—with suitable reinterpretations of the notation.

Consider the linear model

$$\begin{aligned} y_t &= x_{1t}\beta_1 + x_{2t}\beta_2 + \cdots + x_{kt}\beta_k + u_t \\ &= x'_t\beta + u_t, \end{aligned} \tag{2.8}$$

where y_t and u_t are scalars, x_t a $k \times 1$ vector, and β is a $k \times 1$ vector of the true coefficients. In this expression, one of the elements of x_t is typically a constant equal to one (and the intercept is its coefficient).

Example 2.8 (*of $x'_t\beta$*)

$$x_t = \begin{bmatrix} 1 \\ -1 \end{bmatrix}, \beta = \begin{bmatrix} 0 \\ 1.8 \end{bmatrix} \rightarrow x'_t\beta = 1 \times 0 + (-1) \times 1.8 = -1.8$$

Remark 2.9 (*On notation*) These notes typically denote a vector of regression coefficients by β . The distinction from the $y_t = \alpha + \beta x_t + u_t$ notation (sometimes used for simple regressions) should be clear from the context.

Least squares minimizes the sum of the squared fitted residuals

$$\sum_{t=1}^T (y_t - x_t' b)^2, \quad (2.9)$$

by choosing the vector b . The first order conditions (zero derivatives) hold at the (optimal) values $\hat{\beta}$, and can then be written

$$\mathbf{0}_k = \sum_{t=1}^T x_t (y_t - x_t' \hat{\beta}) \text{ or } \sum_{t=1}^T x_t y_t = \sum_{t=1}^T x_t x_t' \hat{\beta}, \quad (2.10)$$

where $\mathbf{0}_k$ denotes a k -vector of zeros. Solve this as

$$\hat{\beta} = \left(\sum_{t=1}^T x_t x_t' \right)^{-1} \sum_{t=1}^T x_t y_t. \quad (2.11)$$

If the regressors are orthogonal (for instance, $\sum_{t=1}^T x_{1t} x_{2t} = 0$) then the results from the multiple regression (2.31) are the same as those from a series of simple regressions: y_t regressed on x_{1t} , y_t regressed on x_{2t} , etc. (This is easy to see since in this case $\sum_{t=1}^T x_t x_t'$ is a diagonal matrix which carries over to the inverse.) This is an unlikely case, unless the regressors have been pre-processed to indeed be orthogonal.

Example 2.10 ($x_t = 1$) With a constant as the only regressor, $x_t y_t = y_t$ and $x_t x_t' = 1$. We then get $\hat{\beta} = \sum_{t=1}^T y_t / T$, that is, the sample average of y_t .

Empirical Example 2.11 (Factor model) Table 2.2 shows results from estimating a multi-factor model for the returns of two sector indices.

	HiTec	Utils
constant	0.13 (1.23)	0.10 (0.80)
market return	1.13 (38.01)	0.60 (17.62)
SMB	0.19 (3.92)	-0.21 (-4.31)
HML	-0.50 (-10.90)	0.30 (5.50)
R^2	0.82	0.41
obs	648	648

Table 2.2: Fama-French regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

Remark 2.12 (*Matrix notation**) Let X be a $T \times k$ matrix where row t is filled with the elements of x_t and let Y be a $T \times 1$ where element t is y_t . Then, $X'X = \sum_{t=1}^T x_t x_t'$ and $X'Y = \sum_{t=1}^T x_t y_t$, so (2.11) can also be written $\hat{\beta} = (X'X)^{-1} X'Y$.

Example 2.13 (*OLS with 2 regressors*) With 2 regressors ($k = 2$) denoted x_{1t} and x_{2t} ,

$$x_t y_t = \begin{bmatrix} x_{1t} y_t \\ x_{2t} y_t \end{bmatrix} \text{ and } x_t x_t' = \begin{bmatrix} x_{1t} \\ x_{2t} \end{bmatrix} \begin{bmatrix} x_{1t} & x_{2t} \end{bmatrix} = \begin{bmatrix} x_{1t} x_{1t} & x_{1t} x_{2t} \\ x_{2t} x_{1t} & x_{2t} x_{2t} \end{bmatrix}.$$

This means that (2.10) is

$$\begin{bmatrix} 0 \\ 0 \end{bmatrix} = \sum_{t=1}^T \begin{bmatrix} x_{1t}(y_t - x_{1t}\hat{\beta}_1 - x_{2t}\hat{\beta}_2) \\ x_{2t}(y_t - x_{1t}\hat{\beta}_1 - x_{2t}\hat{\beta}_2) \end{bmatrix}$$

and (2.11) is

$$\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} = \left(\sum_{t=1}^T \begin{bmatrix} x_{1t} x_{1t} & x_{1t} x_{2t} \\ x_{2t} x_{1t} & x_{2t} x_{2t} \end{bmatrix} \right)^{-1} \sum_{t=1}^T \begin{bmatrix} x_{1t} y_t \\ x_{2t} y_t \end{bmatrix}.$$

Example 2.14 (*OLS in terms of covariance matrices**) Consider the multiple regression $y_t = \alpha + z'_t \gamma + u_t$, where z_t is a vector with $k - 1$ elements. In terms of the first order conditions (2.10), we have $x_t = [1, z_t]$, that is (after dividing by T)

$$\begin{bmatrix} 0 \\ \mathbf{0}_{k-1} \end{bmatrix} = \frac{1}{T} \sum_{t=1}^T \begin{bmatrix} y_t - \hat{\alpha} - z'_t \hat{\gamma} \\ z_t(y_t - \hat{\alpha} - z'_t \hat{\gamma}) \end{bmatrix}.$$

The first line implies that $\hat{\alpha} = \bar{y}_t - \bar{z}'_t \hat{\gamma}$. Use this in the second line to replace $\hat{\alpha}$ and notice that it does not matter if the term outside the parenthesis is z_t or $z_t - \bar{z}_t$ (since the term in parenthesis is zero on average) to get

$$\begin{aligned} \mathbf{0}_{k-1} &= \frac{1}{T} \sum_{t=1}^T (z_t - \bar{z}_t)[(y_t - \bar{y}_t) - (z_t - \bar{z}_t)' \hat{\gamma}], \text{ or} \\ &= \widehat{\text{Cov}}(z_t, y_t) - \widehat{\text{Var}}(z_t) \hat{\gamma}, \end{aligned}$$

where $\widehat{\text{Var}}(z_t)$ denotes the sample variance-covariance matrix of z_t and $\widehat{\text{Cov}}(z_t, y_t)$ the vector of sample covariances of z_t and y_t . We can thus solve as $\hat{\gamma} = \widehat{\text{Var}}(z_t)^{-1} \widehat{\text{Cov}}(z_t, y_t)$ and $\hat{\alpha} = \bar{y}_t - \bar{z}'_t \hat{\gamma}$.

Example 2.15 (*Regression with an intercept and slope*) Suppose we have the following data:

$$\begin{bmatrix} y_1 \\ y_2 \\ y_3 \end{bmatrix} = \begin{bmatrix} -1.5 \\ -0.6 \\ 2.1 \end{bmatrix}, x_1 = \begin{bmatrix} 1 \\ -1 \end{bmatrix}, x_2 = \begin{bmatrix} 1 \\ 0 \end{bmatrix}, \text{ and } x_3 = \begin{bmatrix} 1 \\ 1 \end{bmatrix}.$$

This is clearly the same as in Example 2.6, except that we allow for an intercept (which turns out to be zero in this particular example). The notation we need to solve this problem is the same as for a general multiple regression. Therefore, calculate the following:

$$\begin{aligned} \sum_{t=1}^T x_t x_t' &= \begin{bmatrix} 1 \\ -1 \end{bmatrix} \begin{bmatrix} 1 & -1 \end{bmatrix} + \begin{bmatrix} 1 \\ 0 \end{bmatrix} \begin{bmatrix} 1 & 0 \end{bmatrix} + \begin{bmatrix} 1 \\ 1 \end{bmatrix} \begin{bmatrix} 1 & 1 \end{bmatrix} \\ &= \begin{bmatrix} 1 & -1 \\ -1 & 1 \end{bmatrix} + \begin{bmatrix} 1 & 0 \\ 0 & 0 \end{bmatrix} + \begin{bmatrix} 1 & 1 \\ 1 & 1 \end{bmatrix} \\ &= \begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix} \end{aligned}$$

$$\begin{aligned}
\sum_{t=1}^T x_t y_t &= \begin{bmatrix} 1 \\ -1 \end{bmatrix} (-1.5) + \begin{bmatrix} 1 \\ 0 \end{bmatrix} (-0.6) + \begin{bmatrix} 1 \\ 1 \end{bmatrix} 2.1 \\
&= \begin{bmatrix} -1.5 \\ 1.5 \end{bmatrix} + \begin{bmatrix} -0.6 \\ 0 \end{bmatrix} + \begin{bmatrix} 2.1 \\ 2.1 \end{bmatrix} \\
&= \begin{bmatrix} 0 \\ 3.6 \end{bmatrix}
\end{aligned}$$

To calculate the LS estimate, notice that the inverse of the $\sum_{t=1}^T x_t x'_t$ is

$$\begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix}^{-1} = \begin{bmatrix} 1/3 & 0 \\ 0 & 1/2 \end{bmatrix},$$

which can be verified by

$$\begin{bmatrix} 1/3 & 0 \\ 0 & 1/2 \end{bmatrix} \begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix} = \begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix}.$$

The LS estimate is therefore

$$\begin{aligned}
\hat{\beta} &= \left(\sum_{t=1}^T x_t x'_t \right)^{-1} \sum_{t=1}^T x_t y_t \\
&= \begin{bmatrix} 1/3 & 0 \\ 0 & 1/2 \end{bmatrix} \begin{bmatrix} 0 \\ 3.6 \end{bmatrix} \\
&= \begin{bmatrix} 0 \\ 1.8 \end{bmatrix}.
\end{aligned}$$

The Frisch-Waugh-Lovell theorem*

Split up x_t into the vectors x_{1t} and x_{2t} and write (2.8) as

$$y_t = x'_{1t} \beta_1 + x'_{2t} \beta_2 + u_t. \quad (2.12)$$

First, regress y_t on x_{1t} and get the residuals \tilde{e}_{yt} . Second, regress x_{2t} on x_{1t} and get the residuals \tilde{e}_{2t} . (If x_{2t} is a vector, then this is one regression per element in x_{2t} and \tilde{e}_{2t} is the corresponding vector of residuals.) Third, regress \tilde{e}_{yt} on \tilde{e}_{2t} . This gives the same estimates as β_2 from the multiple regression of y_t on both x_{1t} and x_{2t} . (The proof is a straightforward reshuffling of the first order conditions, see, for instance, Greene (2018) 3.)

	HiTec	Utils
SMB residual	0.19 (3.92)	-0.21 (-4.31)
HML residual	-0.50 (-10.90)	0.30 (5.50)
R^2	0.27	0.12
obs	648	648

Table 2.3: 3rd step in Frisch-Waugh regressions, monthly returns, %, US data 1970:01-2023:12. 1st step: regress the sector returns on (c,market return) and extract the residuals. 2nd step: regress SMB and HML returns on (c,market return) and extract the residuals. 3rd step: regress step 1 residuals on step 2 residuals. Numbers in parentheses are t-stats.

Empirical Example 2.16 (Factor model regression) Table 2.3. Shows the results from the third step for the same data as used in Table 2.2. Both the point estimates and the standard errors should be the same.

The perhaps most common application of this is when x_{1t} contains various dummy variables (for instance, for different cross-sectional units) and x_{2t} are the variables of key interest. It can then be convenient to apply this 3-step approach. This is used in the fixed effects estimator for panel data.

2.1.3 Least Squares: Goodness of Fit

The quality of a regression model is often measured in terms of its ability to explain the movements of the dependent variable.

Let \hat{y}_t be the fitted (predicted) value of y_t . For instance, with (2.1) it would be $\hat{y}_t = \hat{\beta}_0 + \hat{\beta}_1 x_t$. If a constant is included in the regression (or the means of y and x are zero), then a check of the *goodness of fit* of the model is given by the fraction of the variation in y_t that is explained by the model

$$R^2 = \frac{\widehat{\text{Var}}(\hat{y}_t)}{\widehat{\text{Var}}(y_t)} = 1 - \frac{\widehat{\text{Var}}(\hat{u}_t)}{\widehat{\text{Var}}(y_t)}, \quad (2.13)$$

where $\widehat{\text{Var}}()$ denotes a sample variance.

This can also be rewritten as the squared (sample) correlation of the actual and fitted values

$$R^2 = \widehat{\text{Corr}}(y_t, \hat{y}_t)^2. \quad (2.14)$$

Notice that we must have constant in regression (unless both y_t and x_t have zero means) for R^2 to make sense.

A low variance of the residuals will be important for getting low standard errors of the estimates ($\hat{\beta}_0, \hat{\beta}_1, \dots$), since signal only little “noise” in the model. (The details are discussed in later sections.) Equation (2.13) shows that the variance of the residuals and R^2 are negatively related, so it follows that a high R^2 will be associated with low standard errors of the estimates.

Example 2.17 (R^2) From Example 2.6 we have $\widehat{\text{Var}}(\hat{u}_t) = 0.18$ and $\widehat{\text{Var}}(y_t) = 2.34$, so

$$R^2 = 1 - 0.18/2.34 \approx 0.92.$$

See Figure 2.4.

Proof (of (2.13)–(2.14)) Write the regression equation as

$$y_t = \hat{y}_t + \hat{u}_t,$$

where hats denote fitted values. Since \hat{y}_t and \hat{u}_t are uncorrelated (always true in OLS—provided the regression includes a constant), we have

$$\hat{v}(y_t) = \hat{v}(\hat{y}_t) + \hat{v}(\hat{u}_t),$$

where $\hat{v}()$ is compact notation for a sample variance. R^2 is defined as the fraction of $\hat{v}(y_t)$ that is explained by the model

$$R^2 = \frac{\hat{v}(\hat{y}_t)}{\hat{v}(y_t)} = \frac{\hat{v}(y_t) - \hat{v}(\hat{u}_t)}{\hat{v}(y_t)} = 1 - \frac{\hat{v}(\hat{u}_t)}{\hat{v}(y_t)}.$$

Equivalently, we can rewrite R^2 by noting that

$$\hat{c}(y_t, \hat{y}_t) = \hat{c}(\hat{y}_t + \hat{u}_t, \hat{y}_t) = \hat{v}(\hat{y}_t),$$

where $\hat{c}()$ is compact notation for a sample covariance. Use this in the numerator of R^2 and multiply by $\hat{c}(y_t, \hat{y}_t)/\hat{v}(\hat{y}_t) = 1$

$$R^2 = \frac{\hat{c}(y_t, \hat{y}_t)^2}{\hat{v}(y_t)\hat{v}(\hat{y}_t)} = \widehat{\text{Corr}}(y_t, \hat{y}_t)^2.$$

□

To understand this result, suppose that x_t has no explanatory power, so R^2 should be zero. How does that happen? Well, if x_t is uncorrelated with y_t , then slope coefficients are zero. As a consequence \hat{y}_t equals the intercept (a constant). This means that R^2 in (2.13) is zero, since the fitted residual has the same variance as the dependent variable (\hat{y}_t captures nothing of the movements in y_t). Similarly, R^2 in (2.14) is also zero, since a constant is always uncorrelated with anything else (as correlations measure comovements around the means).

Remark 2.18 (R^2 from simple regression*) Suppose $\hat{y}_t = \beta_0 + \beta_1 x_t$, so (2.14) becomes

$$R^2 = \widehat{\text{Corr}}(y_t, x_t)^2.$$

The R^2 can never decrease as we add more regressors, which might make it attractive to add more and more regressors. To avoid that, some researchers advocate using an ad hoc punishment for many regressors, the *adjusted R*²: $\bar{R}^2 = 1 - (1 - R^2)(T - 1)/(T - k)$, where k is the number of regressors (including the constant). This measure can be negative.

Empirical Example 2.19 (CAPM regressions) See Table 2.1 for CAPM regressions for two industry portfolios where the R^2 values clearly differ. This is seen also from the dispersion around the regression line in Figure 2.5.

2.2 Missing Data

It is often the case that some data is missing. For instance, we may not have data on regressor 3 for observation $t = 7$. If data is *missing in a random way*, then we can simply exclude (y_t, x_t) for the t with some missing data. In contrast, if data is missing in a non-random way (for instance, depending on the value of y_{it}), then we have to apply more sophisticated sample-selection models (not discussed in this chapter).

Remark 2.20 (Replacing missing values with 0*) Instead of excluding (y_t, x_t) for the t with some missing data, we could set $(y_t, x_t) = (0, \mathbf{0}_k)$. Notice that also the constant should be set to 0. This would not change the estimates. However, we must then be careful with how to estimate the variance of the residuals (σ^2): the estimation would divide by the effective number of observations (non-zero y_t values).

2.3 The Distribution of $\hat{\beta}$

Note that the estimated coefficients are random variables since they depend on which particular sample that has been “drawn.” For instance, if our sample gives $\hat{\beta} = 0.85$ and we know that the standard deviation across samples is 0.1 then we are pretty sure that the true value β is not 0. In contrast, if the standard deviation across samples is 2.1, then our result is not an unlikely outcome even if the true value β is 0.

It is important to remember that we always assume that there are some true (but unknown) parameter values that would be the same across samples. The only reason why

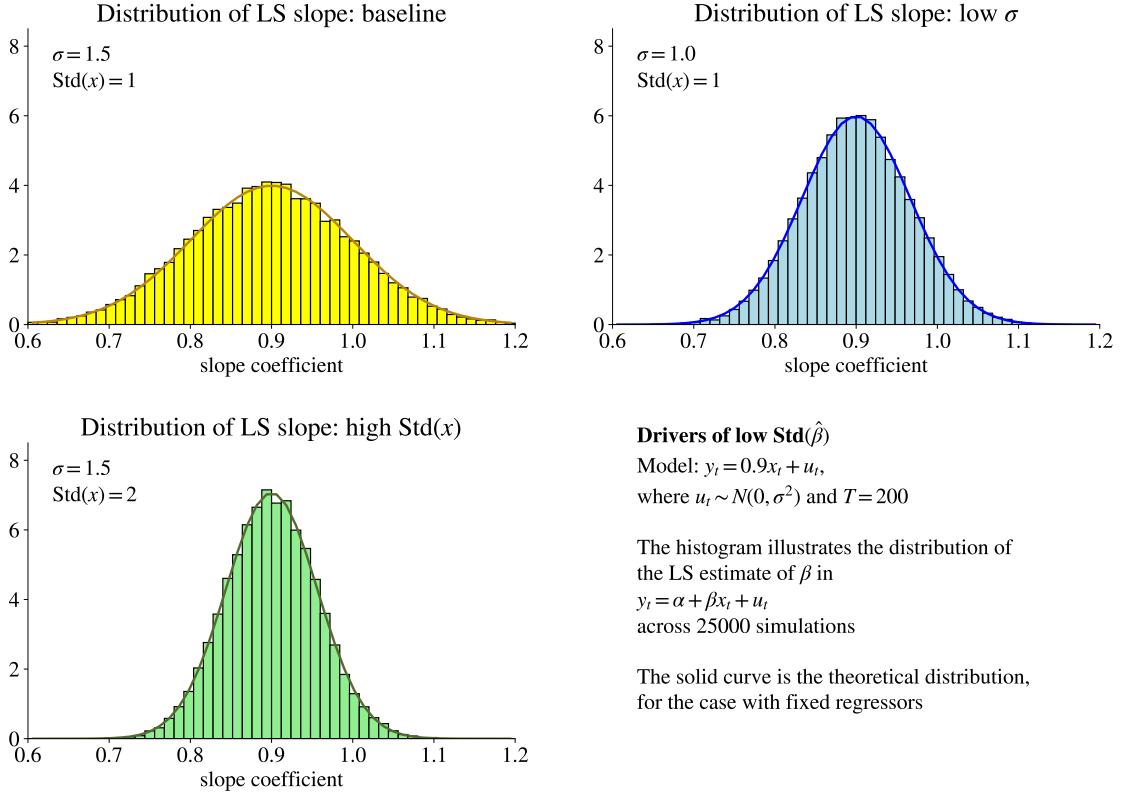


Figure 2.6: Distribution of OLS estimate, from simulation and theory

the estimates differ across samples is that the model is not perfect: there are residuals and they differ (randomly) across observations and thus also across different samples. See Figure 2.6 for an illustration from a computer simulation (Monte Carlo simulation).

We usually do not have several samples, so the variation across samples is not directly observable. However, we can (under some assumptions) use the *variation within our sample to figure out how the variation across samples ought to be*. This can help us testing hypotheses about the coefficients, for instance, that $\beta_1 = 0$.

Use (2.1) in (2.11) to substitute for y_t and simplify

$$\hat{\beta} = \beta + \left(\sum_{t=1}^T x_t x_t' \right)^{-1} \sum_{t=1}^T x_t u_t \text{ or} \quad (2.15)$$

$$= \beta + \left(\frac{1}{T} \sum_{t=1}^T x_t x_t' \right)^{-1} \sum_{t=1}^T x_t u_t / T \quad (2.16)$$

where $\sum_{t=1}^T x_t x_t'$ is a $k \times k$ matrix and $\sum_{t=1}^T x_t u_t$ is a $k \times 1$ vector. This shows that so the OLS estimates, the $\hat{\beta}$ vector, equals the true value, β , plus a term that involves the

residuals, u_t . Since u_t is a random variable, $\hat{\beta}$ is too. Clearly, we do not know the true value β , so this decomposition is just conceptual.

One of the basic assumptions in (2.1) is that the covariance of the regressor and the residual is zero. This should hold in a very large sample (or else OLS cannot be used to estimate β), but in a small sample it may be different from zero. Only as the sample gets very large can we be (almost) sure that the second term in (2.15) vanishes.

Equation (2.15) will give different values of $\hat{\beta}$ when we use different samples, that is different draws of the random variable y_t (and thus u_t), and perhaps also different values of x_t (if the regressors are also random). The distribution of these estimates across samples would describe the uncertainty we should have about the true value after having obtained a specific estimated value. However, we cannot observe this distribution directly (we do not have a lot of different samples...). However, we can use the idea of this distribution to discuss the general properties of OLS—and we can (with some added assumptions) provide a good estimate of how that distribution could look like.

The first conclusion from (2.16) is that, with $u_t = 0$ the estimate would always be perfect. In contrast, with large movements in u_t we will see large movements in $\hat{\beta}$ (across samples). The second conclusion is that a small sample (small T) will also lead to large random movements in $\hat{\beta}$ —in contrast to a large sample where the randomness in $\sum_{t=1}^T x_t u_t / T$ is averaged out more effectively (should be zero in a large sample).

There are three main routes to learn more about the distribution of $\hat{\beta}$: (i) set up a small “experiment” in the computer and simulate the distribution (Monte Carlo or bootstrap simulations); (ii) pretend that the regressors can be treated as fixed numbers (or treat all results as being conditional on the particular sample of regressor values that we have observed) and then assume something about the distribution of the residuals; or (iii) use the asymptotic (large sample) distribution as an approximation. The asymptotic distribution can often be derived, in contrast to the exact distribution in a sample of a given size. If the actual sample is large, then the asymptotic distribution may be a good approximation.

The simulation approach has the advantage of giving a precise answer—but the disadvantage of requiring a very precise question (must write computer code that is tailor made for the particular model we are looking at, including the specific parameter values). See Figures 2.6, 2.9 and 2.7 for examples.

In contrast, asymptotic theory give more general results—but arriving there is hard. Treating the regressors as fixed is easier—and is often good enough for illustrating the main properties of the estimation method.

The typical outcome of all three approaches will (under strong assumptions, to be

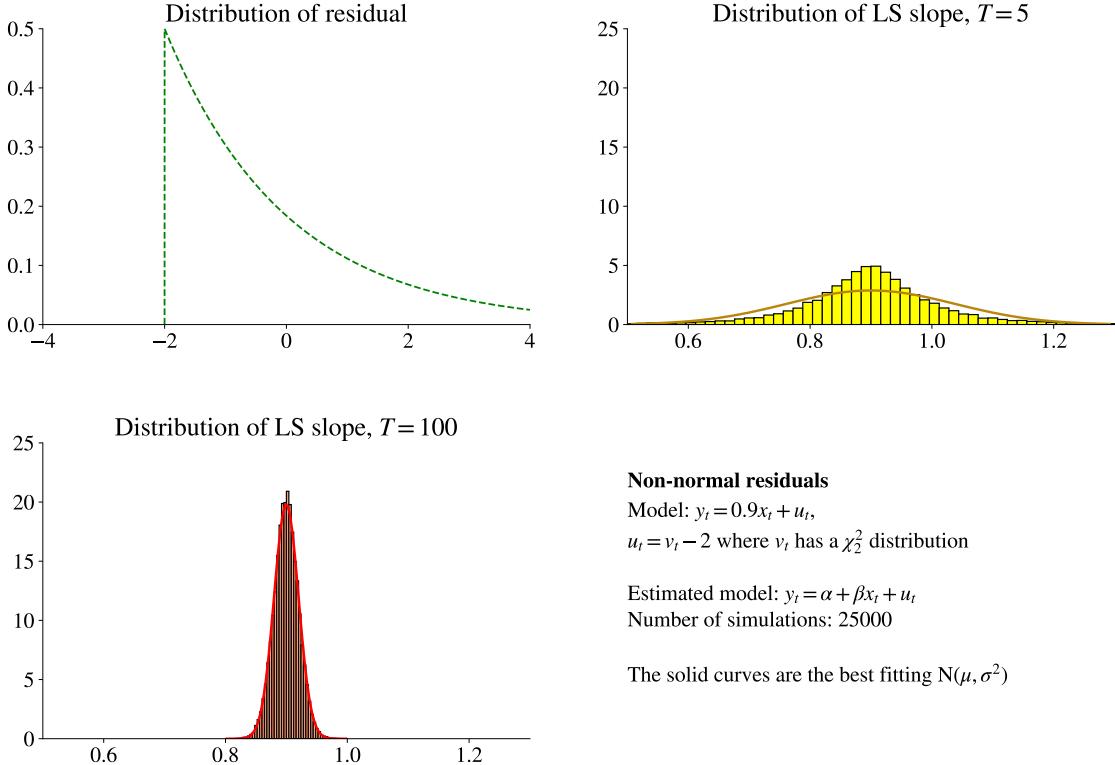


Figure 2.7: Distribution of OLS estimate, from simulations

discussed below) be that

$$\hat{\beta} \sim N(\beta, S_{xx}^{-1}\sigma^2), \text{ where } S_{xx} = \sum_{t=1}^T x_t x_t' \quad (2.17)$$

and where $\sigma^2 = \text{Var}(u_t)$ denotes the variance of the residuals. This expression allows for x_t to be a vector with k elements. In practice, we calculate/estimate both $\Sigma_{t=1}^T x_t x_t'$ and σ^2 from the available data (the latter as the variance of the fitted residuals). See Table 2.1 for an empirical example and Figure 2.6 for an illustration of how the results depend on σ and the standard deviation of x_t .

Notice that the variance-covariance matrix in (2.17) is $k \times k$ and will be denoted $\text{Var}(\hat{\beta})$. The standard errors (or standard deviations), denoted $\text{Std}(\hat{\beta})$, are the square root of the diagonal elements.

Example 2.21 (*The variance-covariance matrix in (2.17)) with two regressors.) With two*

regressors we have

$$\text{Var}(\hat{\beta}) = \text{Var}\left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix}\right) = \begin{bmatrix} \text{Var}(\hat{\beta}_1) & \text{Cov}(\hat{\beta}_1, \hat{\beta}_2) \\ \text{Cov}(\hat{\beta}_1, \hat{\beta}_2) & \text{Var}(\hat{\beta}_2) \end{bmatrix}.$$

Remark 2.22 (*Matrix notation**) Let X be a $T \times k$ matrix where row t is filled with the elements of x_t . Then, the variance-covariance matrix in (2.17) can also be written $(X'X)^{-1}\sigma^2$.

Example 2.23 (*Applying (2.17)*) When the regressor is just a constant (equal to one) $x_t = 1$, then we have

$$\sum_{t=1}^T x_t x'_t = \sum_{t=1}^T 1 \times 1' = T \text{ so } \text{Var}(\hat{\beta}) = \sigma^2 / T.$$

This is clearly the classical expression for the variance of a sample mean.

Example 2.24 (*Applying (2.17)*) When the regressor is a zero mean variable, then we have

$$\sum_{t=1}^T x_t x'_t = \widehat{\text{Var}}(x_t)T \text{ so } \text{Var}(\hat{\beta}) = \sigma^2 / [\widehat{\text{Var}}(x_t)T],$$

where $\widehat{\text{Var}}(x_t)$ is the sample variance. Clearly, $\text{Var}(\hat{\beta})$ is increasing in σ^2 , but decreasing in both T and $\widehat{\text{Var}}(x_t)$.

Example 2.25 (**Applying (2.17)*) When the regressor is just a constant (equal to one) and one variable regressor with zero mean, z_t , so $x_t = [1, z_t]$, then we have

$$\begin{aligned} \sum_{t=1}^T x_t x'_t &= \sum_{t=1}^T \begin{bmatrix} 1 & z_t \\ z_t & z_t^2 \end{bmatrix} = T \begin{bmatrix} 1 & 0 \\ 0 & \text{Var}(z_t) \end{bmatrix}, \text{ so} \\ \text{Var}\left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix}\right) &= \sigma^2 \left(\sum_{t=1}^T x_t x'_t\right)^{-1} = \begin{bmatrix} \sigma^2 / T & 0 \\ 0 & \sigma^2 / [\widehat{\text{Var}}(z_t)T] \end{bmatrix}, \end{aligned}$$

where $\widehat{\text{Var}}(z_t)$ is the sample variance. This is combination of the two previous examples.

Example 2.26 (*Distribution of slope coefficient*) From Example 2.6 we have $\text{Var}(\hat{u}_t) = \sigma^2 = 0.18$ and $\sum_{t=1}^T x_t x_t = 2$, so $\text{Var}(\hat{\beta}_1) = 0.18/2 = 0.09$, which gives $\text{Std}(\hat{\beta}_1) = 0.3$.

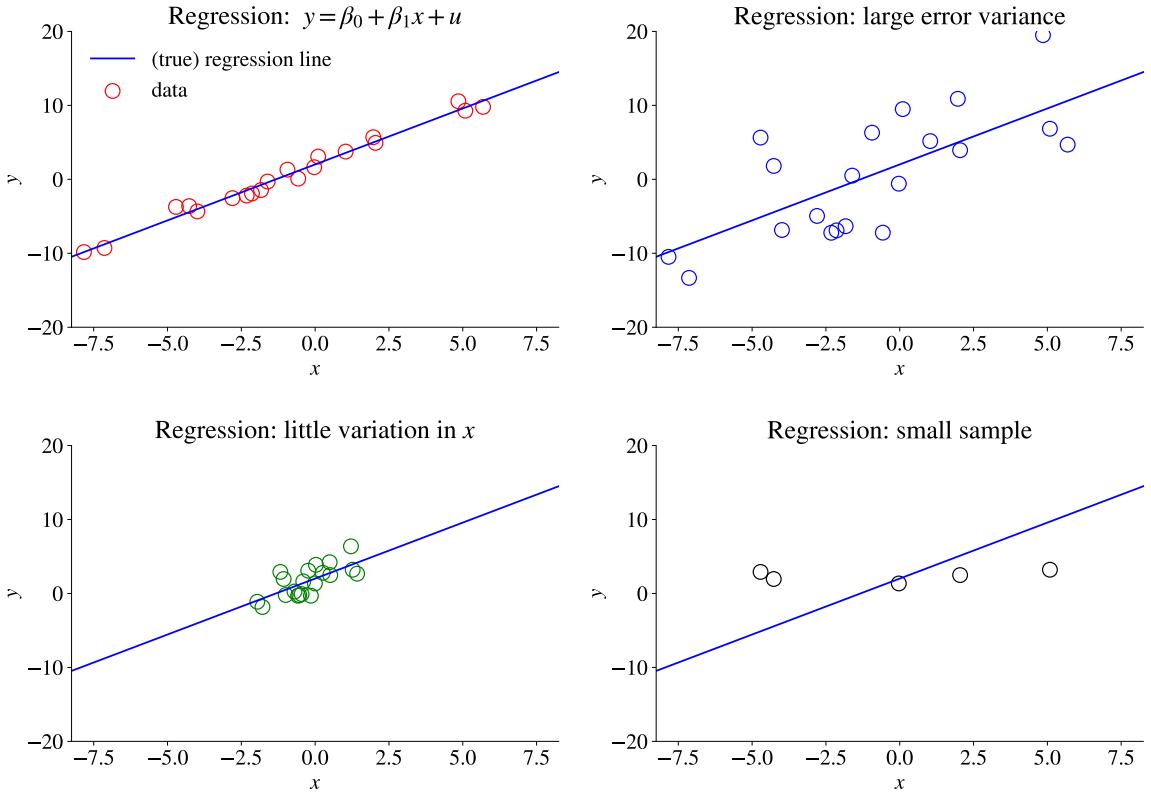


Figure 2.8: Regressions: importance of error variance and variation of regressor

Example 2.27 (*Covariance matrix of $\hat{\beta}_1$ and $\hat{\beta}_2$*) From Example 2.15

$$\sum_{t=1}^T x_t x_t' = \begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix} \text{ and } \sigma^2 = 0.18, \text{ then}$$

$$\text{Var} \left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} \right) = \begin{bmatrix} 1/3 & 0 \\ 0 & 1/2 \end{bmatrix} 0.18 = \begin{bmatrix} 0.06 & 0 \\ 0 & 0.09 \end{bmatrix}.$$

The standard deviations (also called standard errors) are therefore

$$\begin{bmatrix} \text{Std}(\hat{\beta}_1) \\ \text{Std}(\hat{\beta}_2) \end{bmatrix} = \begin{bmatrix} 0.24 \\ 0.3 \end{bmatrix}.$$

2.3.1 The Distribution of $\hat{\beta}$ with Fixed Regressors

Assuming fixed regressors is mostly a simplifying (teaching) device, since econometrics is typically not applied to controlled experiments. However, it is easy to derive results for

this case—and those results are often similar to what asymptotic theory gives.

A version of the “fixed regressors” assumption is to treat all results as *conditional* on the regressor values that we have in the sample. This does not rule out the possibility that samples of x_t differ, but we only bother with those that look like the one we have. This is effectively treating x_t as fixed.

The results we derive below are based on the *Gauss-Markov assumptions* : (a) the residuals have zero means, (b) have constant variances and (c) are not correlated across observations. In other words, the *residuals are zero mean iid variables*. We will also assume that the residuals are normally distributed (not part of the typical Gauss-Markov assumptions).

For notational convenience, write (2.16) as

$$\hat{\beta} = \beta + S_{xx}^{-1} (x_1 u_1 + x_2 u_2 + \dots + x_T u_T), \text{ where } S_{xx} = \sum_{t=1}^T x_t x_t' \quad (2.18)$$

Since x_t is assumed to be fixed, the expected value of this expression is

$$E \hat{\beta} = \beta + S_{xx}^{-1} (x_1 E u_1 + x_2 E u_2 + \dots + x_T E u_T) = \beta \quad (2.19)$$

since we always assume that the residuals have zero means (see (2.1)). This says that OLS is *unbiased* when the regressors are fixed (which does not always carry over to the case of stochastic regressors). The interpretation is that we can expect OLS to give (on average) a correct answer. That is, if we could draw many different samples and estimate the slope coefficient in each of them, then the average of those estimates would be the correct number (β). Clearly, this is something we want from an estimation method (a method that was systematically wrong would not be very attractive).

Remark 2.28 (*Linear combination of normally distributed variables.*) *If the random variables z_t and v_t are normally distributed and independent of each other, then $a + bz_t + cv_t$ is normally distributed with a mean of $a + b\mu_z + c\mu_v$ and a variance of $b^2\sigma_z^2 + c^2\sigma_v^2$.*

Suppose $u_t \sim N(0, \sigma^2)$ and that the residuals are independent of each other, then (2.18) shows that $\hat{\beta}$ is *normally distributed*. The reason is that $\hat{\beta}$ is just a constant (β) plus a linear combination of independent normally distributed residuals (with fixed regressors, x_t and thus S_{xx}^{-1} can be treated as constants). It is clear that the mean of this normal distribution is β (the true value), since $\hat{\beta}$ is unbiased.

Finding the variance-covariance matrix of $\hat{\beta}$ is slightly more complicated. Remember that we treat x_t as fixed numbers (non-random) and assume that the residuals are iid: they are uncorrelated with each other (follows from independently distributed) and have the same variances (follows from identically distributed). We also notice that the variance-covariance matrix of $x_t u_t$ equals

$$\text{Var}(x_t u_t) = x_t x_t' \sigma_t^2. \quad (2.20)$$

where $\sigma_t^2 = \text{Var}(u_t)$ and where we use the fact that the vector x_t is non-random.

Example 2.29 (of (2.20)) With

$$x_t = \begin{bmatrix} 1 \\ 2 \end{bmatrix} \text{ and } \sigma_t^2 = 0.18, \text{ we get}$$

$$\text{Var}(x_t u_t) = \begin{bmatrix} 1 \\ 2 \end{bmatrix} \begin{bmatrix} 1 & 2 \end{bmatrix} \times 0.18 = \begin{bmatrix} 1 & 2 \\ 2 & 4 \end{bmatrix} \times 0.18.$$

The variance of (2.18) can then be written

$$\begin{aligned} \text{Var}(\hat{\beta}) &= S_{xx}^{-1} \text{Var}(x_1 u_1 + x_2 u_2 + \dots + x_T u_T) S_{xx}^{-1} \\ &= S_{xx}^{-1} (x_1 x_1' \sigma_1^2 + x_2 x_2' \sigma_2^2 + \dots + x_T x_T' \sigma_T^2) S_{xx}^{-1} \\ &= S_{xx}^{-1} (x_1 x_1' \sigma^2 + x_2 x_2' \sigma^2 + \dots + x_T x_T' \sigma^2) S_{xx}^{-1} \\ &= S_{xx}^{-1} \left(\sum_{t=1}^T x_t x_t' \right) \sigma^2 S_{xx}^{-1} \\ &= S_{xx}^{-1} \sigma^2. \end{aligned} \quad (2.21)$$

The first line follows directly from (2.18), since β is a constant. The second line follows from assuming that the residuals are uncorrelated with each other ($\text{Cov}(u_i, u_j) = 0$ if $i \neq j$), so all cross terms ($x_i x_j \text{Cov}(u_i, u_j)$) are zero. The third line follows from assuming that the variances are the same across observations ($\sigma_i^2 = \sigma_j^2 = \sigma^2$). The fourth and fifth lines are just algebraic simplifications which use the definition of S_{xx} .

There are three main ways of getting a low uncertainty (low $\text{Var}(\hat{\beta})$). First, a large sample (T is large), decreases the S_{xx}^{-1} factor (since $S_{xx} = \sum_{t=1}^T x_t x_t'$ increases with T) while σ^2 stays constant: a larger sample gives a smaller uncertainty about the estimate. Second, large movements in the regressors (large value of S_{xx}) should help us estimate the link between x and y since the movements in y driven by x should then dominate over the movements in y driven by the residual. Third, a lower volatility of the residuals (lower σ^2) also gives a lower uncertainty about the estimate. See Figures 2.6 and 2.8.

Remark 2.30 (*Notation for conditional on X) Some texts emphasize the “conditional on X ” interpretation instead of the fixed regressor interpretation. The notation is then often $E(\hat{\beta}|X)$ and $\text{Var}(\hat{\beta}|X)$ where the “ $|X$ ” denotes that the expectation/variance is conditional on the sample of x_1, \dots, x_T at hand.

A key assumption in regression analysis is that our sample is “representative” of the population. In practice, this means that we can estimate σ^2 (and S_{xx} if the regressors are stochastic) in (2.21) from the data in the sample. This is the main “trick” behind using our (one and only) sample to inform us about how the distribution of $\hat{\beta}$ (across samples) looks like. This is a plausible assumption when our sample is a random draw from the population (say, 700 out of a total of 10,000 firms). It is perhaps a stronger assumption when the sample is a time series of data points. Then we basically assume that the past (before the sample) and the future (after the sample) will have the same structure. In case you are not willing to accept those assumptions, the t -stats are useless.

2.3.2 Multicollinearity

When the regressors in a multiple regression are highly correlated, then we have a practical problem: the standard errors of individual coefficients tend to be large, even if the R^2 suggests that the regression does fairly well.

As a simple example, consider the regression

$$y_t = \beta_1 x_{1t} + \beta_2 x_{2t} + u_t, \quad (2.22)$$

where (for simplicity) the dependent variable and the regressors have zero means. In this case, the variance (assuming iid errors) is

$$\text{Var}(\hat{\beta}_2) = \frac{\sigma^2}{T \widehat{\text{Var}}(x_{2t})} \frac{1}{1 - \gamma^2}, \quad (2.23)$$

where γ is the sample correlation of x_{1t} and x_{2t} . If the regressors are highly correlated, then the uncertainty about the slope coefficient is high. The basic reason is that we see that the regressors have an effect on y_t , but it is hard to tell if that effect is from regressor one or two (since they are so similar). This can well lead to a situation where the R^2 is high and a joint test easily rejects the null hypothesis that all slopes are zero—but each individual slope coefficient is insignificant.

Remark 2.31 ($\text{Cov}(\hat{\beta}_1, \hat{\beta}_2)$) To simplify the notation, let the sample variances of x_{1t} and x_{2t} be equal to one. It can then be shown (see proof below) that

$$\text{Cov}(\hat{\beta}_1, \hat{\beta}_2) = -\frac{\sigma^2}{T} \frac{\gamma}{1 - \gamma^2}.$$

This says that when the regressors are positively correlated ($\gamma > 0$), then the coefficients tend to be negatively correlated (notice the leading minus sign).

More generally, in the multiple regression

$$y_t = x'_t \beta + u_t, \quad (2.24)$$

it is straightforward to show that for all slope coefficients (not the intercept)

$$\text{Var}(\hat{\beta}_i) = \frac{\sigma^2}{T \widehat{\text{Var}}(x_{it})} \frac{1}{1 - R_i^2}, \quad (2.25)$$

where R_i^2 is the R^2 value obtained from regressing x_{it} on the *other* regressors (including a constant). The last term ($1/(1 - R_i^2)$) is often called the *variance inflation factor* and some regression packages report the maximum across the regressors, and a value of 10 or larger ($R_i^2 \geq 0.9$) is considered highly problematic. (The name variance inflation factor is meant to indicate how much the variance increases compared to a simple regression, assuming σ^2 is unchanged. In practice, the estimated σ^2 often change considerably.)

Proof (of (2.23) and Remark 2.31*). Recall that for a 2×2 matrix we have

$$\begin{bmatrix} a & b \\ c & d \end{bmatrix}^{-1} = \frac{1}{ad - bc} \begin{bmatrix} d & -b \\ -c & a \end{bmatrix}.$$

For the regression (2.22) we get

$$\begin{aligned} \sum_{t=1}^T x_t x'_t &= \begin{bmatrix} T \hat{v}(x_{1t}) & T \hat{c}(x_{1t}, x_{2t}) \\ T \hat{c}(x_{1t}, x_{2t}) & T \hat{v}(x_{2t}) \end{bmatrix}^{-1} \\ &= \frac{1}{T^2 \hat{v}(x_{1t}) \hat{v}(x_{2t}) - T^2 \hat{c}(x_{1t}, x_{2t})^2} \begin{bmatrix} T \hat{v}(x_{2t}) & -T \hat{c}(x_{1t}, x_{2t}) \\ -T \hat{c}(x_{1t}, x_{2t}) & T \hat{v}(x_{1t}) \end{bmatrix}, \end{aligned}$$

where $\hat{v}()$ and $\hat{c}()$ are short hand notation for sample variances and covariances. The variance of the second slope coefficient is σ^2 time the lower right element of this matrix

$$\text{Var}(\hat{\beta}_2) = \frac{\sigma^2}{T} \frac{\hat{v}(x_{1t})}{\hat{v}(x_{1t}) \hat{v}(x_{2t}) - \hat{c}(x_{1t}, x_{2t})^2},$$

Divide both numerator and denominator by $\hat{v}(x_{1t}) \hat{v}(x_{2t})$ to get

$$\text{Var}(\hat{\beta}_2) = \frac{\sigma^2}{T} \frac{1/\hat{v}(x_{2t})}{1 - \widehat{\text{Corr}}(x_{1t}, x_{2t})^2},$$

which is the same as (2.23). Similarly, we get

$$\text{Cov}(\hat{\beta}_1, \hat{\beta}_2) = -\frac{\sigma^2}{T} \frac{\hat{c}(x_{1t}, x_{2t})}{\hat{v}(x_{1t})\hat{v}(x_{2t}) - \hat{c}(x_{1t}, x_{2t})^2},$$

which gives the result in Remark 2.31. \square

2.4 The Distribution of $\hat{\beta}$: More General Results

2.4.1 Problems with the Gauss-Markov (iid) and Normality Assumptions

The previous results on the distribution of $\hat{\beta}$ have several weak points—which will be briefly discussed here.

First, the Gauss-Markov assumptions of iid residuals (constant volatility and no correlation across observations) are likely to be false in many cases.

Second, the idea of fixed regressor is clearly just a simplifying assumption—and unlikely to be relevant for economics and financial data. If the regressors are random variables then we typically not rule out that u_t and x_{t+s} are correlated, for instance, when the regressors include the lagged dependent variable. This can make OLS biased.

Third, there are no particularly strong reasons for why the residuals should be normally distributed. If not, the estimates are unlikely to be normally distributed in small samples, but may well be in large samples (due to the central limit theorem).

The next few sections introduce these issues, but later chapters will discuss them in more detail.

2.4.2 Failure of the Gauss-Markov Assumptions

If the residuals are not iid, then we have to stop at the first line of (2.21), so

$$\text{Var}(\hat{\beta}) = S_{xx}^{-1} S S_{xx}^{-1}, \text{ where } S = \text{Var}(\Sigma_{t=1}^T x_t u_t). \quad (2.26)$$

The S matrix is estimated in different ways (for instance, using White's or Newey-West's methods, to be discussed later) depending on the properties of the residuals (heteroskedasticity or autocorrelation).

2.4.3 Bias

If an estimation method is *biased*, then it produces systematically wrong (say, too low) coefficients. Sometimes, this bias disappears in large samples, so it's only a small sample bias.

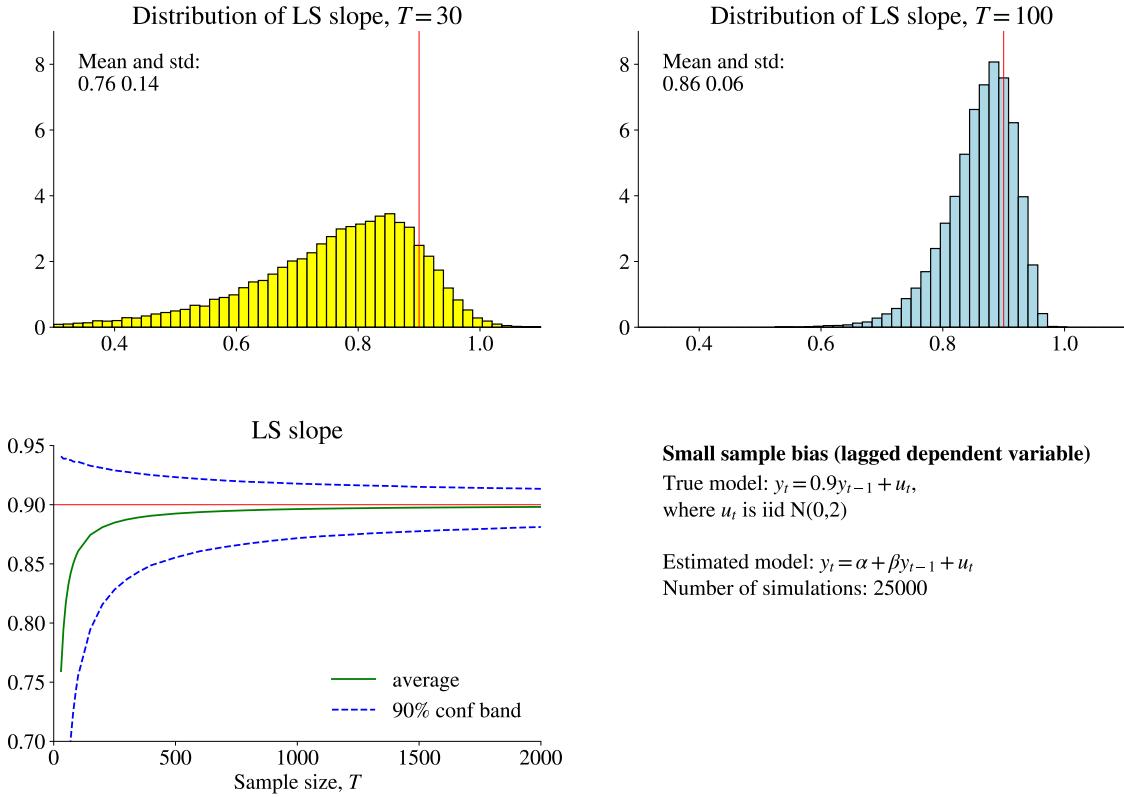


Figure 2.9: Results from a Monte Carlo experiment of LS estimation of the AR coefficient.

Figure 2.9 illustrates some simulation results from estimating an AR(1)

$$y_t = \beta_0 + \beta_1 y_{t-1} + u_t \quad (2.27)$$

on artificial samples where “data” is generated from

$$y_t = 0.9y_{t-1} + u_t, \text{ where } u_t \text{ is iid.} \quad (2.28)$$

In this case, the regressor is a (stochastic) random variable (not fixed). Figure 2.9 suggests that the estimates are biased (not centered on the true value) in small samples, but the bias appears to decrease as the sample size increases.

To understand these results, recall that (2.16) says that

$$\hat{\beta} = \beta + \left(\frac{1}{T} \sum_{t=1}^T x_t x_t' \right)^{-1} \sum_{t=1}^T x_t u_t / T \quad (2.29)$$

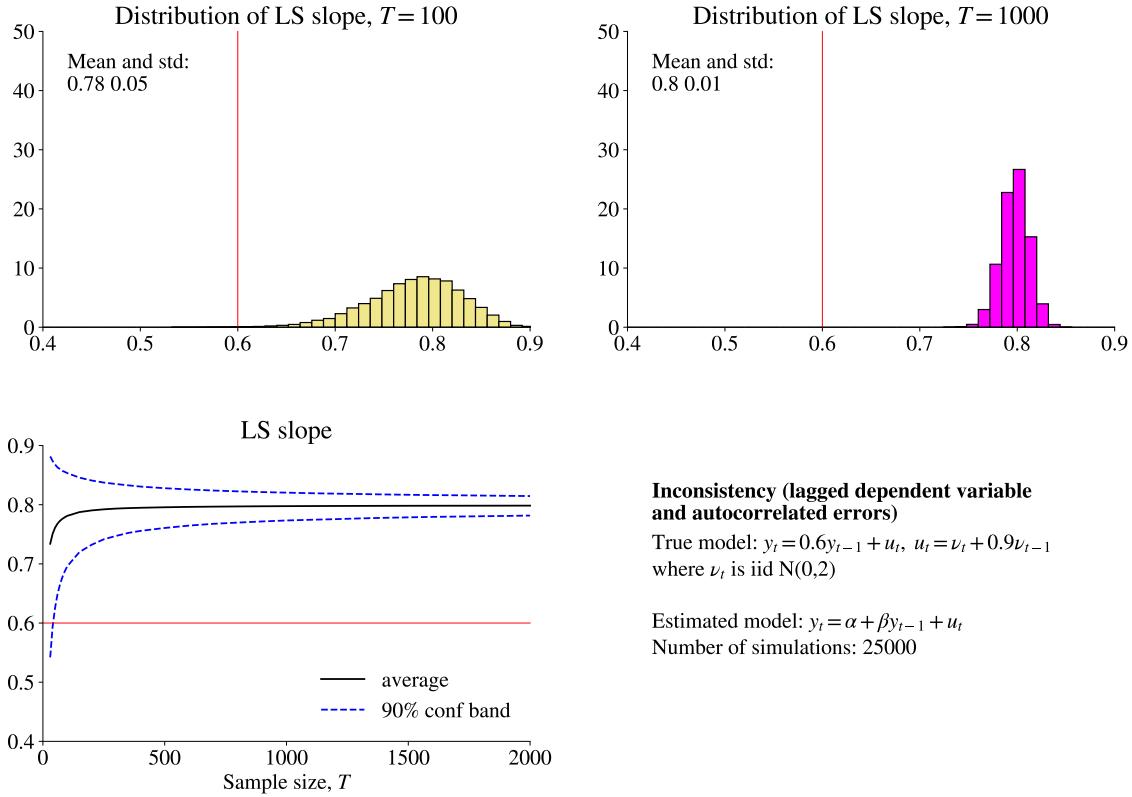


Figure 2.10: Results from a Monte Carlo experiment of LS estimation of the AR coefficient when data is from an ARMA process.

where u_t are the true residuals. (We will never observe the true residuals, so (2.29) can only be used for a conceptual discussion.)

To get *unbiased estimates* ($E \hat{\beta} = \beta$), the second term of the right hand side of (2.29) should have an expectation of zero. This would happen when u_t and x_{t+s} (for all s) are independent. This is hard to guarantee when the regressors are random variables. For instance, in the AR(1) example, then u_t affects x_{t+1} so there is an interaction between the numerator and denominator. This is probably most easily investigated by simulations.

Remark 2.32 (*Bias of AR(1)) It can be shown (see, for instance, Pesaran (2015) 14) that a bias corrected estimate of the AR(1) coefficient can be calculated as $(1 + T \hat{\beta}_1)/(T - 3)$.

Remark 2.33 (Unbiasedness with stochastic regressors*) $\hat{\beta}_1$ in (2.29) is unbiased if x_τ (all τ in the sample) does not help predict u_t . We can use the law of iterated expectations

$(E_x(Eu|x) = Eu)$ to write

$$E\hat{\beta} = \beta + E_x \left(\sum_{t=1}^T x_t x_t' \right)^{-1} \sum_{t=1}^T x_t E(u_t|x),$$

where x here denotes the full sample of x_t . If $E(u_t|x) = 0$ then $E\hat{\beta} = \beta$. Clearly, for an AR(1) this does not hold since u_t affects y_t which is the regressor in $t+1$ (x_{t+1}).

2.4.4 Consistency

If an estimation method is *inconsistent*, then it produces systematically wrong (say, too low) coefficients also in very large samples (actually, in the limit as $T \rightarrow \infty$).

Figure 2.9 suggests that the problem with the AR(1) estimation vanishes as the sample size increases. This shows the importance of doing simulations (to understand the properties of the estimation method)—and perhaps also of using large data sets.

To get *consistent estimates* (which is defined as the bias and the variance of $\hat{\beta}_1$ go to zero as $T \rightarrow \infty$), then it is enough if x_t and u_t (in the same period) are uncorrelated. This is indeed the case in the AR(1) simulations discussed before. To see this from (2.29), notice that a “law of large numbers” makes the numerator $(\sum_{t=1}^T x_t u_t / T)$ converge to the population covariance of u_t and x_t . (Also, the denominator converges to a fixed number, so we can focus on the numerator.)

This means that *if* we knew that $\text{Cov}(x_t, u_t) = 0$ (in the population), then we would also know that OLS is consistent. However, since the true errors are never observed, this cannot be shown by empirical methods. (Recall OLS always construct fitted errors so they are uncorrelated with the regressors.) Instead, we have to rely on theoretical arguments that make it plausible to *believe or not* in consistency.

To make matters worse, it is often the case that $\hat{\beta}_1$ converges (as T increases), but perhaps not to what you hoped for. As an illustration of how tricky this can be, consider the case in Figure 2.10. It estimates the same AR(1) as in (2.27) but where the simulated “data” now follows

$$y_t = \rho y_{t-1} + \varepsilon_t, \text{ where } \varepsilon_t = v_t + \theta v_{t-1} \text{ where } v_t \text{ is iid.} \quad (2.30)$$

In this case, the residuals (here called ε_t) are themselves autocorrelated. The figure clearly shows that the OLS estimate of the slope β_1 in (2.27) does *not* converge to the true value ρ as the sample sizes increases: OLS is inconsistent. The reason in this case is that ε_t and y_{t-1} (the regressor) both depend on v_{t-1} so they are correlated.

An a priori argument for why OLS should be able to estimate a model consistently thus require a careful discussion of the model properties: how can we explain that the residuals are uncorrelated with the regressors? (Alternatively, we use an instrumental variables technique, which is discussed later on.) This typically involves a discussion of the following.

1. Have we excluded (omitted) some relevant regressors? If so, their effect is captured by the residual. If these excluded regressors are correlated to some of the included regressors, then we have a problem.
2. Do we use a lagged dependent variable as regressor at the same time as the residual is autocorrelated? (This is the previous example.)
3. Does y_t affect x_t ? If so a shock to the equation that explains y_t also drives x_t and we get a correlation between the regressor (x_t) and the residual. A classical case is when we try to estimate how the demand for a product depends on its price. In fact, such an equation actually estimates a mix between the demand and supply elasticities.
4. Is the regressor measured without (important) errors? If not, we again have a correlation between (the used) regressor and the residual.

2.4.5 Normality

If the regressors x_t are fixed numbers and u_t is normally distributed, then the second term in (2.29) shows that the normality carries over to $\hat{\beta}$ also in small samples. We can test the assumption of normally distributed residuals by using a Jarque-Bera test

$$BJ = \frac{T}{6} \text{skewness}^2 + \frac{T}{24} (\text{kurtosis} - 3)^2, \quad (2.31)$$

which has χ^2_2 distribution under the null hypothesis that both the skewness and excess kurtosis (that is, kurtosis–3) are zero.

2.4.6 Asymptotic Normality

Even if the normality test fails or if the regressors are stochastic, we can often still hope for a (close to) normal distribution of $\hat{\beta}_1$ if the sample is large—due to the central limit theorem. This is illustrated in Figure 2.7. It is based on simulations where the residual is

drawn from a very non-normal distribution. For a small sample, this carries over to $\hat{\beta}$ and the t -stat for the hypothesis that $\beta_i = 0$. However, in these simulations, already samples of moderate size tend to give an almost normal distribution.

To understand the theory of this, rewrite (2.29) by subtracting β from both sides and then multiply both sides by \sqrt{T}

$$\sqrt{T}(\hat{\beta} - \beta) = \left(\frac{1}{T} \sum_{t=1}^T x_t x_t' \right)^{-1} \sqrt{T} \frac{1}{T} \sum_{t=1}^T x_t u_t. \quad (2.32)$$

The inverted term is the sample average of $x_t x_t'$ which will converge to a matrix of fixed numbers (the population mean of $x_t x_t'$) as $T \rightarrow \infty$. We can therefore focus on what happens to the numerator. It is \sqrt{T} times the sample average of $x_t u_t$ (a vector). Under weak conditions a central limit theorem applies to $\sqrt{T} \times$ a sample average: it typically converges to a normal distribution.

This shows that $\sqrt{T}(\hat{\beta} - \beta)$ has an *asymptotic normal distribution*

$$\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} N(0, W), \quad (2.33)$$

where \xrightarrow{d} indicates that the random variable $\sqrt{T}(\hat{\beta} - \beta)$ has a normal distribution as T increases. This often holds as a reasonable approximation also in moderately sized samples. See Figure 2.11 for an illustration. Actually, it turns out that this is a property of many estimators (not just OLS), basically because most estimators are some kind of sample average.

The variance-covariance matrix W in (2.33) can be understood from (2.32). It has the form

$$W = \left(\frac{S_{xx}^*}{T} \right)^{-1} \frac{S}{T} \left(\frac{S_{xx}^*}{T} \right)^{-1}, \quad (2.34)$$

where S_{xx}^*/T is the limit of $\sum_{t=1}^T x_t x_t'/T$ as $T \rightarrow \infty$ and S/T is the variance-covariance matrix of $\sum_{t=1}^T x_t u_t/\sqrt{T}$, that is the last term in (2.32).

Except for that this expression involves limits and the T terms, it is reminiscent of the expression based on the assumption of fixed regressors (2.26). In fact, cancelling T terms and adding β in (2.33)–(2.34) give

$$\hat{\beta} \xrightarrow{a} N(\beta, S_{xx}^{*-1} S S_{xx}^{*-1}), \quad (2.35)$$

where \xrightarrow{a} means “is asymptotically distributed as”.

We cannot observe the limit S_{xx}^* , so in practice we estimate this by using the infor-

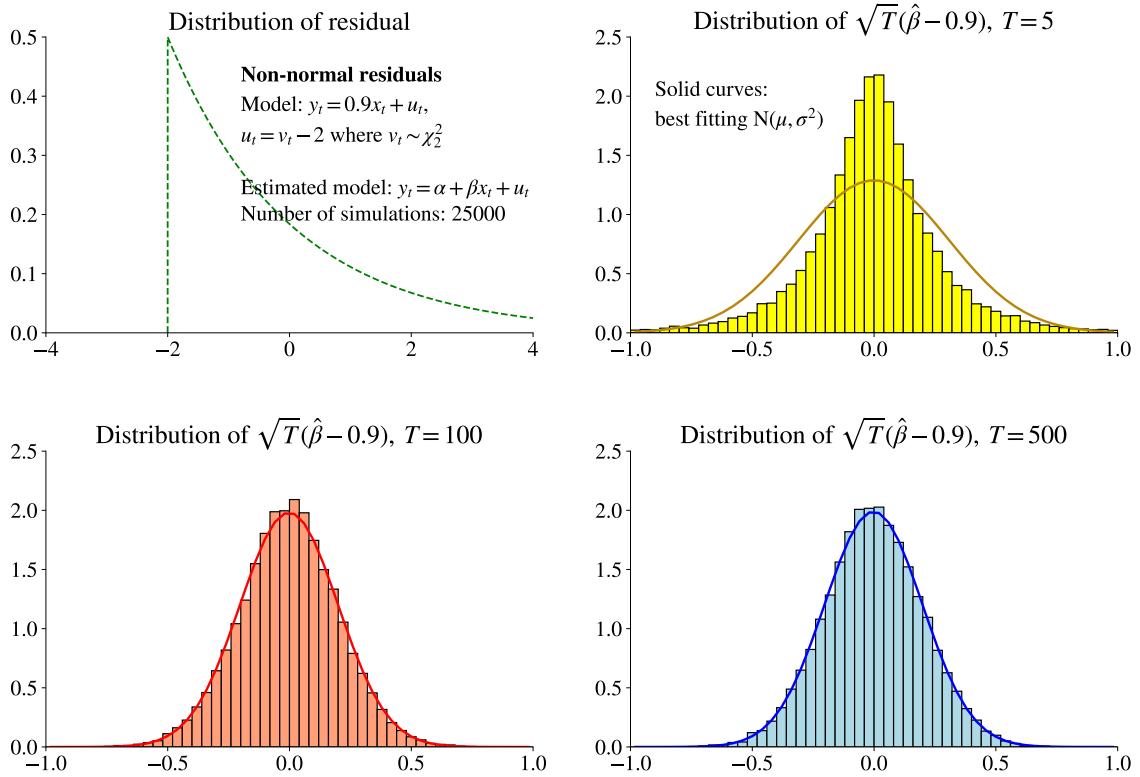


Figure 2.11: Distribution of OLS estimate, from simulations

mation from the available sample: S_{xx}^* is estimated as $S_{xx} = \sum_{t=1}^T x_t x_t'$ and S by some other way (depending on the degree of autocorrelation and heteroskedasticity). A more precise statement is thus that $S_{xx}^{-1} \hat{S} S_{xx}^{-1}$ is an *estimate* of the variance-covariance matrix. In practice, we then have the same estimate of the variance-covariance matrix as in (2.26) which was derived under the assumption of fixed regressors.

Proof (of (2.35)*) Notice that $W = \text{Var}(\sqrt{T}\hat{\beta}) = T \text{Var}(\hat{\beta})$. Therefore, divide both sides of (2.34) by T to get

$$\text{Var}(\hat{\beta}) = \frac{1}{T} \left(\frac{S_{xx}^*}{T} \right)^{-1} \frac{S}{T} \left(\frac{S_{xx}^*}{T} \right)^{-1}.$$

Cancel the T terms. Finally, add β to shift the distribution from being centered on 0 to β . This is (2.35). \square

2.5 Appendix – A Primer in Matrix Algebra*

This appendix introduces fundamental concepts of matrix algebra.

2.5.1 Matrix and Scalar Addition and Multiplication

Let c be a scalar and define the matrices

$$x = \begin{bmatrix} x_1 \\ x_2 \end{bmatrix}, z = \begin{bmatrix} z_1 \\ z_2 \end{bmatrix}, A = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix}, \text{ and } B = \begin{bmatrix} B_{11} & B_{12} \\ B_{21} & B_{22} \end{bmatrix}.$$

Multiplying a matrix by a scalar means multiplying each element by the scalar

$$\begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} c = \begin{bmatrix} A_{11}c & A_{12}c \\ A_{21}c & A_{22}c \end{bmatrix}.$$

Example 2.34 (*Matrix \times scalar*)

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} 10 = \begin{bmatrix} 10 & 30 \\ 30 & 40 \end{bmatrix}.$$

Adding/subtracting a scalar to each element of a matrix is done by

$$\begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} + c J = \begin{bmatrix} A_{11} + c & A_{12} + c \\ A_{21} + c & A_{22} + c \end{bmatrix},$$

where J is a matrix (of the same size as A) filled with ones. This is sometimes written $A + c$, although that notation is not universally liked. In some applications, $\mathbf{1}_n$ (or just $\mathbf{1}$) is used to represent a vector of n ones.

Example 2.35 (*Matrix \pm scalar*)

$$\begin{aligned} \begin{bmatrix} 10 \\ 11 \end{bmatrix} - 10 \begin{bmatrix} 1 \\ 1 \end{bmatrix} &= \begin{bmatrix} 0 \\ 1 \end{bmatrix} \\ \begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} + 10 \begin{bmatrix} 1 & 1 \\ 1 & 1 \end{bmatrix} &= \begin{bmatrix} 11 & 13 \\ 13 & 14 \end{bmatrix}. \end{aligned}$$

2.5.2 Adding and Multiplying: Two Matrices

Matrix *addition* (or subtraction) of matrices of the same size is element by element

$$A + B = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} + \begin{bmatrix} B_{11} & B_{12} \\ B_{21} & B_{22} \end{bmatrix} = \begin{bmatrix} A_{11} + B_{11} & A_{12} + B_{12} \\ A_{21} + B_{21} & A_{22} + B_{22} \end{bmatrix}.$$

Example 2.36 (*Matrix addition and subtraction*)

$$\begin{bmatrix} 10 \\ 11 \end{bmatrix} - \begin{bmatrix} 2 \\ 5 \end{bmatrix} = \begin{bmatrix} 8 \\ 6 \end{bmatrix}$$

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} + \begin{bmatrix} 1 & 2 \\ 3 & -2 \end{bmatrix} = \begin{bmatrix} 2 & 5 \\ 6 & 2 \end{bmatrix}$$

Matrix *multiplication* requires the two matrices to be conformable: the first matrix has as many columns as the second matrix has rows. Element ij of the result is the multiplication of the i th row of the first matrix with the j th column of the second matrix

$$AB = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} \begin{bmatrix} B_{11} & B_{12} \\ B_{21} & B_{22} \end{bmatrix} = \begin{bmatrix} A_{11}B_{11} + A_{12}B_{21} & A_{11}B_{12} + A_{12}B_{22} \\ A_{21}B_{11} + A_{22}B_{21} & A_{21}B_{12} + A_{22}B_{22} \end{bmatrix}.$$

Multiplying a square matrix A with a column vector z gives a column vector

$$Az = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} \begin{bmatrix} z_1 \\ z_2 \end{bmatrix} = \begin{bmatrix} A_{11}z_1 + A_{12}z_2 \\ A_{21}z_1 + A_{22}z_2 \end{bmatrix}.$$

Example 2.37 (*Matrix multiplication*)

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} \begin{bmatrix} 1 & 2 \\ 3 & -2 \end{bmatrix} = \begin{bmatrix} 10 & -4 \\ 15 & -2 \end{bmatrix}$$

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} \begin{bmatrix} 2 \\ 5 \end{bmatrix} = \begin{bmatrix} 17 \\ 26 \end{bmatrix}$$

2.5.3 Transpose

Transposing a column vector gives a row vector. Similarly, transposing a matrix is like flipping it around the main diagonal

$$A' = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix}' = \begin{bmatrix} A_{11} & A_{21} \\ A_{12} & A_{22} \end{bmatrix}.$$

Example 2.38 (*Matrix transpose*)

$$\begin{bmatrix} 10 \\ 11 \end{bmatrix}' = \begin{bmatrix} 10 & 11 \end{bmatrix}$$

$$\begin{bmatrix} 1 & 2 & 3 \\ 4 & 5 & 6 \end{bmatrix}' = \begin{bmatrix} 1 & 4 \\ 2 & 5 \\ 3 & 6 \end{bmatrix}$$

2.5.4 Inner and Outer Products, Quadratic Forms

For two column vectors x and z , the product $x'z$ is called the *inner product* (a scalar)

$$x'z = \begin{bmatrix} x_1 & x_2 \end{bmatrix} \begin{bmatrix} z_1 \\ z_2 \end{bmatrix} = x_1 z_1 + x_2 z_2,$$

and xz' the *outer product* (a matrix)

$$xz' = \begin{bmatrix} x_1 \\ x_2 \end{bmatrix} \begin{bmatrix} z_1 & z_2 \end{bmatrix} = \begin{bmatrix} x_1 z_1 & x_1 z_2 \\ x_2 z_1 & x_2 z_2 \end{bmatrix}.$$

(Notice that xz does not work for two vectors.)

Example 2.39 (*Inner and outer products*)

$$\begin{bmatrix} 10 \\ 11 \end{bmatrix}' \begin{bmatrix} 2 \\ 5 \end{bmatrix} = \begin{bmatrix} 10 & 11 \end{bmatrix} \begin{bmatrix} 2 \\ 5 \end{bmatrix} = 75$$

$$\begin{bmatrix} 10 \\ 11 \end{bmatrix} \begin{bmatrix} 2 \\ 5 \end{bmatrix}' = \begin{bmatrix} 10 \\ 11 \end{bmatrix} \begin{bmatrix} 2 & 5 \end{bmatrix} = \begin{bmatrix} 20 & 50 \\ 22 & 55 \end{bmatrix}$$

If x is a column vector and A a square matrix, then the product $x'Ax$ is a quadratic form (a scalar).

Example 2.40 (*Quadratic form*)

$$\begin{bmatrix} 10 \\ 11 \end{bmatrix}' \begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} \begin{bmatrix} 10 \\ 11 \end{bmatrix} = 1244$$

2.5.5 Kronecker Product

Let \otimes represent the Kronecker product, that is, if A and B are matrices, then

$$A \otimes B = \begin{bmatrix} a_{11}B & \cdots & a_{1n}B \\ \vdots & & \vdots \\ a_{m1}B & \cdots & a_{mn}B \end{bmatrix}.$$

Example 2.41 (*Kronecker product*)

$$A = \begin{bmatrix} 1 & 3 \\ 2 & 4 \end{bmatrix} \text{ and } B = \begin{bmatrix} 10 & 11 \end{bmatrix}, \text{ we get } A \otimes B = \begin{bmatrix} 10 & 11 & 30 & 33 \\ 20 & 22 & 40 & 44 \end{bmatrix}.$$

2.5.6 Matrix Inverse

A matrix *inverse* is the closest we get to “dividing” by a square matrix. The inverse of a matrix A , denoted A^{-1} , is such that

$$AA^{-1} = I \text{ and } A^{-1}A = I,$$

where I is the *identity matrix* (ones along the diagonal, and zeros elsewhere). The matrix inverse is useful for solving systems of linear equations, $y = Ax$ as $x = A^{-1}y$.

For a 2×2 matrix we have

$$\begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix}^{-1} = \frac{1}{A_{11}A_{22} - A_{12}A_{21}} \begin{bmatrix} A_{22} & -A_{12} \\ -A_{21} & A_{11} \end{bmatrix}.$$

Example 2.42 (*Matrix inverse*) We have

$$\begin{bmatrix} -4/5 & 3/5 \\ 3/5 & -1/5 \end{bmatrix} \begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} = \begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix}, \text{ so}$$

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix}^{-1} = \begin{bmatrix} -4/5 & 3/5 \\ 3/5 & -1/5 \end{bmatrix}.$$

2.5.7 Solving Systems of Linear Equations

If A is $n \times n$ and invertible and b and y are $n \times 1$ vectors, then we can solve

$$Ab = y \text{ as } b = A^{-1}y.$$

This solution is unique.

$$\begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix} \begin{bmatrix} b_1 \\ b_2 \end{bmatrix} = \begin{bmatrix} 10 \\ 11 \end{bmatrix}, \text{ gives}$$

$$\begin{bmatrix} b_1 \\ b_2 \end{bmatrix} = \begin{bmatrix} 1 & 3 \\ 3 & 4 \end{bmatrix}^{-1} \begin{bmatrix} 10 \\ 11 \end{bmatrix} = \begin{bmatrix} -1.4 \\ 3.8 \end{bmatrix}.$$

2.5.8 OLS Notation: $X'X$ or $\sum_{t=1}^T x_t x'_t$?

Let x_t be a $K \times 1$ vector of (of data in period t). We can calculate the outer product ($K \times K$) as $x_t x'_t$ and summing each element across T observations gives the $K \times K$ matrix $S_{xx} = \sum_{t=1}^T x_t x'_t$.

Alternatively, let X be a $T \times K$ matrix with x'_t in row t . Then we can also calculate S_{xx} as $X'X$.

Example 2.43 (Sum of outer product, $\sum_{t=1}^T x_t x'_t$)

$$x_1 = \begin{bmatrix} 1 \\ -1 \end{bmatrix}, x_2 = \begin{bmatrix} 1 \\ 0 \end{bmatrix}, \text{ and } x_3 = \begin{bmatrix} 1 \\ 1 \end{bmatrix}.$$

We then have

$$\begin{aligned} \sum_{t=1}^T x_t x'_t &= \begin{bmatrix} 1 \\ -1 \end{bmatrix} \begin{bmatrix} 1 & -1 \end{bmatrix} + \begin{bmatrix} 1 \\ 0 \end{bmatrix} \begin{bmatrix} 1 & 0 \end{bmatrix} + \begin{bmatrix} 1 \\ 1 \end{bmatrix} \begin{bmatrix} 1 & 1 \end{bmatrix} \\ &= \begin{bmatrix} 1 & -1 \\ -1 & 1 \end{bmatrix} + \begin{bmatrix} 1 & 0 \\ 0 & 0 \end{bmatrix} + \begin{bmatrix} 1 & 1 \\ 1 & 1 \end{bmatrix} \\ &= \begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix}. \end{aligned}$$

In this example, the matrix happens to be diagonal, but that is not a general result. However, it will always be symmetric.

Example 2.44 (Sum of outer product, $X'X$) Define

$$X = \begin{bmatrix} 1 & -1 \\ 1 & 0 \\ 1 & 1 \end{bmatrix}.$$

It is straightforward to calculate that $X'X = \begin{bmatrix} 3 & 0 \\ 0 & 2 \end{bmatrix}$.

Also, if y_t is a scalar, then $S_{xy} = \sum_{t=1}^T x_t y_t$ is a $K \times 1$ vector which is calculated as $X'Y$ where Y is a $T \times 1$ vector.

Example 2.45 With $(y_1, y_2, y_3) = (-1.5, -0.6, 2.1)$

$$\sum_{t=1}^T x_t y_t = \begin{bmatrix} 1 \\ -1 \end{bmatrix} (-1.5) + \begin{bmatrix} 1 \\ 0 \end{bmatrix} (-0.6) + \begin{bmatrix} 1 \\ 1 \end{bmatrix} 2.1 = \begin{bmatrix} 0 \\ 3.6 \end{bmatrix}$$

2.5.9 Derivatives of Matrix Expressions

Let z and x be $n \times 1$ vectors. The *derivative of the inner product* is $\partial(x'z)/\partial x = z$.

Example 2.46 (*Derivative of an inner product*) With $n = 2$

$$x'z = x_1 z_1 + x_2 z_2, \text{ so } \partial(x'z)/\partial x = \frac{\partial(z_1 x_1 + z_2 x_2)}{\begin{bmatrix} \partial x_1 \\ \partial x_2 \end{bmatrix}} = \begin{bmatrix} z_1 \\ z_2 \end{bmatrix}.$$

Let x be $n \times 1$ and A a symmetric $n \times n$ matrix. The *derivative of the quadratic form* is $\partial(x'Ax)/\partial x = 2Ax$.

Example 2.47 (*Derivative of a quadratic form*) With $n = 2$, the quadratic form is

$$x'Ax = \begin{bmatrix} x_1 & x_2 \end{bmatrix} \begin{bmatrix} A_{11} & A_{12} \\ A_{12} & A_{22} \end{bmatrix} \begin{bmatrix} x_1 \\ x_2 \end{bmatrix} = x_1^2 A_{11} + x_2^2 A_{22} + 2x_1 x_2 A_{12}.$$

The derivatives with respect to x_1 and x_2 are

$$\partial(x'Ax)/\partial x_1 = 2x_1 A_{11} + 2x_2 A_{12} \text{ and } \partial(x'Ax)/\partial x_2 = 2x_2 A_{22} + 2x_1 A_{12}, \text{ or}$$

$$\partial(x'Ax)/\partial x = \begin{bmatrix} \partial(x'Ax)/\partial x_1 \\ \partial(x'Ax)/\partial x_2 \end{bmatrix} = 2 \begin{bmatrix} A_{11} & A_{12} \\ A_{12} & A_{22} \end{bmatrix} \begin{bmatrix} x_1 \\ x_2 \end{bmatrix}.$$

2.4 Appendix – A Primer in Calculus*

The following derivatives (with respect to x) are often used in these chapters

$$\begin{aligned}\frac{d}{dx}(ax^k + bx) &= akx^{k-1} + b \\ \frac{d}{dx} \ln x &= 1/x \\ \frac{d}{dx} e^x &= e^x.\end{aligned}$$

Derivatives typically depend on at which x value we evaluate them at ($x = 1$ or $x = 2$, say), so the derivatives are themselves functions. The first expression embeds the *sum rule* (the derivative of a sum is the sum of the derivatives).

Example 2.48 (*Derivative of power function*) $3x^2 + 7x$ has the derivative $6x + 7$ which is -5 at $x = -2$ and 13 at $x = 1$.

The *chain rule* says that if $g()$ and $f()$ are two functions, then the derivative of the composite function $g(f(x))$ is

$$\frac{d}{dx} g(f(x)) = g'(u)f'(x), \text{ where } u = f(x),$$

and where $g'(u)$ is short hand (Lagrange's) notation for $\frac{d}{du}g(u)$, and similarly for $f'(x)$. The derivative $g'(u)$ is often referred to as the outer derivative and $f'(x)$ as the inner derivative.

Example 2.49 (*Chain rule*) Let $g(u) = u^2$ and $u = f(x) = 2 - 3x$, so we are considering the composite function $(2 - 3x)^2$. We then get

$$\frac{d}{dx}(2 - 3x)^2 = \underbrace{2(2 - 3x)}_{g'(u)} \underbrace{(-3)}_{f'(x)} = 18x - 12.$$

This derivative is -12 at $x = 0$ and 6 at $x = 1$.

Consider a function of two variables, $f(x, z)$. The *partial derivative* with respect to x is just a standard derivative, treating z as fixed. For instance,

$$\begin{aligned}\frac{\partial}{\partial x} ax^k bz &= akx^{k-1}bz \\ \frac{\partial}{\partial z} ax^k bz &= ax^k b.\end{aligned}$$

Suppose the function $f(x)$ gives a scalar output, but x is a n -vector of inputs (with elements x_1, x_2, \dots, x_n). The *gradient* is then

$$\partial f(x)/\partial x = \begin{bmatrix} \partial f(x)/\partial x_1 \\ \vdots \\ \partial f(x)/\partial x_n. \end{bmatrix}$$

Example 2.50 (Gradient) For the function $f(x) = (x_1 - 2)^2 + (4x_2 + 3)^2$, the gradient is

$$\partial f(x)/\partial x = \begin{bmatrix} 2(x_1 - 2) \\ 8(4x_2 + 3) \end{bmatrix}.$$

The *Hessian* is the $n \times n$ matrix of second derivatives

$$\partial^2 f(x)/\partial x \partial x' = \begin{bmatrix} \partial^2 f(x)/\partial x_1^2 & \cdots & \partial^2 f(x)/\partial x_1 \partial x_n \\ & \ddots & \\ \partial^2 f(x)/\partial x_n \partial x_1 & & \partial^2 f(x)/\partial x_n^2 \end{bmatrix}.$$

(In case the derivatives are continuous, then this matrix is symmetric.)

Example 2.51 (Hessian) Using the same function as in Example 2.50, we get

$$\partial^2 f(x)/\partial x \partial x' = \begin{bmatrix} 2 & 0 \\ 0 & 32 \end{bmatrix}.$$

2.5 Appendix – A Primer in Optimization*

Remark 2.52 (First order condition for optimising a differentiable function). We want to find the value of b in the interval $b_{low} \leq b \leq b_{high}$, which makes the value of the differentiable function $f(b)$ as small as possible (a minimization problem). The answer is b_{low} , b_{high} , or a value of b where $df(b)/db = 0$. The latter is a necessary and sufficient condition for an unconstrained problem where $f(b)$ is convex. (If the function is twice differentiable, then convexity means that $f''(b) \geq 0$.) A maximization problem, except that we rather want $f(b)$ to be concave ($f''(b) \leq 0$).

When the goal is to determine x and y that minimize

$$L = (x - 2)^2 + (4y + 3)^2,$$

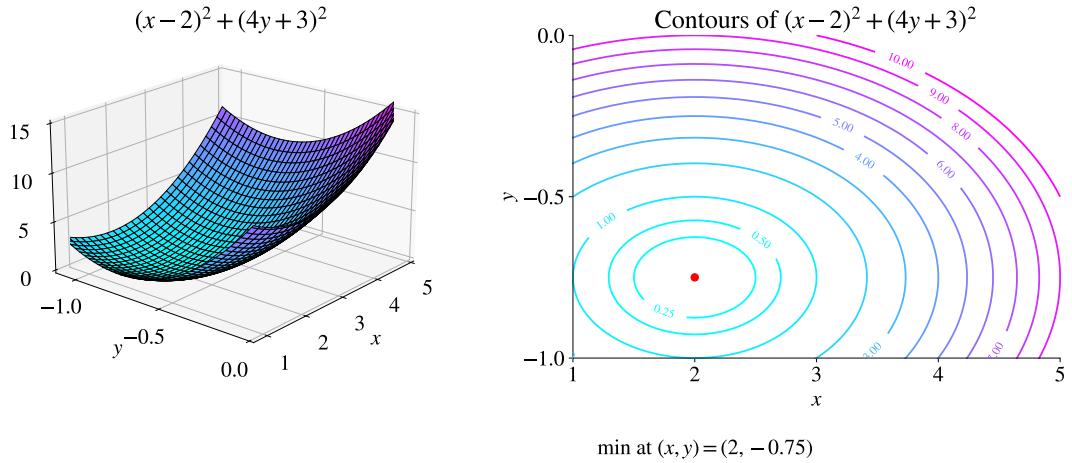


Figure 2.12: Minimization problem

then we have to find the values of x and y that satisfy the *first order conditions* $\partial L/\partial x = 0, \partial L/\partial y = 0$. For L function above, these are

$$\begin{aligned} 0 &= \partial L/\partial x = 2(x - 2) \\ 0 &= \partial L/\partial y = 8(4y + 3), \end{aligned}$$

which clearly requires $x = 2$ and $y = -3/4$. In this particular case, the first order condition with respect to x does not depend on y , but that is not a general property. See Figure 2.12 for the surface of the loss function and the contours.

Also, in this case, there is a unique solution—but in more complicated problems, the first order conditions could be satisfied at different values of x and y .

A *maximization problem* has the same type of first order conditions.

If you want to add a *restriction* to the minimization problem, say

$$x + 2y = 3,$$

then we can proceed in two ways. The first is to simply substitute for $x = 3 - 2y$ in L to get

$$L = (1 - 2y)^2 + (4y + 3)^2,$$

with first order condition

$$0 = \partial L/\partial y = -4(1 - 2y) + 8(4y + 3) = 40y + 20,$$

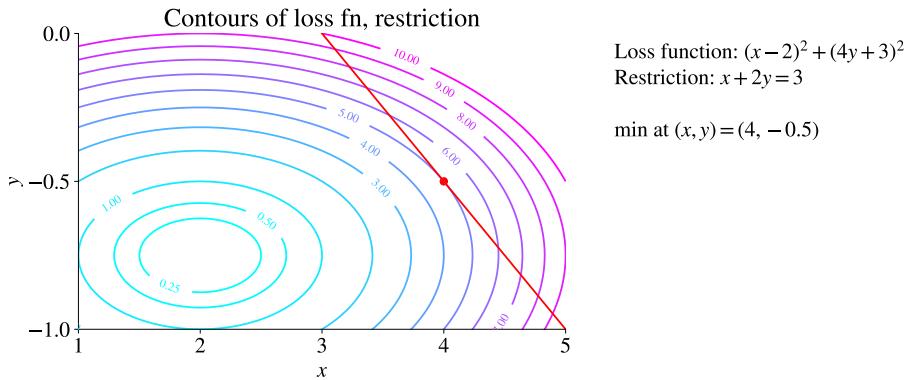


Figure 2.13: Minimization problem with restriction

which requires $y = -1/2$, which by implies $x = 4$. (We could equally well have substituted for y). This is also the unique solution. See Figure 2.13. This is an easy way to eliminate an equality restriction.

The second method is to use a *Lagrangian*. The problem is then to choose x , y , and λ to minimize

$$L = (x-2)^2 + (4y+3)^2 + \lambda(x+2y-3).$$

(If you instead use $-\lambda()$ or write the restriction as $-x - 2y + 3$, you should get the same result. The interpretation of λ differs, though.)

The term multiplying λ is the restriction. The first order conditions are now

$$\begin{aligned} 0 &= \partial L / \partial x = 2(x-2) + \lambda \\ 0 &= \partial L / \partial y = 8(4y+3) + 2\lambda \\ 0 &= \partial L / \partial \lambda = x + 2y - 3. \end{aligned}$$

These are 3 equations in 3 unknowns (x, y, λ) which we have to solve. One way is as follows. The first two conditions say

$$\begin{aligned} x &= 2 - \lambda/2 \\ y &= -3/4 - \lambda/16, \end{aligned}$$

so we need to find λ . To do that, use these latest expressions for x and y in the third first

order condition (to substitute for x and y)

$$3 = 2 - \lambda/2 - 3/2 - \lambda/8 = 1/2 - \lambda 5/8, \text{ so}$$
$$\lambda = -4.$$

Finally, use this to calculate x and y as

$$x = 4 \text{ and } y = -1/2.$$

Notice that this is the same solution as before ($y = -1/2$) and that the restriction holds ($4 + 2(-1/2) = 3$). This second method is clearly a lot clumsier in my example, but it pays off when there are several restrictions and/or when the restriction(s) become complicated.

Chapter 3

Betas and Index Models

Reference: Elton, Gruber, Brown, and Goetzmann (2010) 7–8, 11

3.1 Single-Index Models

The *market model* is a single-index model where the time series of returns of an asset (R_{it}) is regressed on the the series of the “market” return (R_{mt})

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}, \text{ where} \quad (3.1)$$

$$\mathbb{E} \varepsilon_{it} = 0, \text{ Cov}(\varepsilon_{it}, R_{mt}) = 0.$$

This regression may use the net returns (as indicated above), or the returns in excess of a riskfree rate. The results for the β (which is the focus here) are typically very similar.

The two assumptions are the standard assumptions for using ordinary least squares: the residual has a zero mean and is uncorrelated with the non-constant regressor. (Together they imply that the residuals are orthogonal to both regressors.) See Figure 3.1 for an illustration.

Remark 3.1 (A warning about the notation) When discussing OLS we typically write the regression equation as $y_t = x_t' \beta + u_t$. Comparing with (3.1), we notice that $y_t = R_{it}$. Also, x_t equals the column vector $[1, R_{mt}]'$ and $u_t = \varepsilon_{it}$. Finally, notice that we recycle the β symbol: in OLS it is a vector of all coefficients, corresponding to $[\alpha_i, \beta_i]'$ in the index model.

Empirical Example 3.2 (Betas of industry portfolios) See Figure 3.2 and Tables 3.1–3.2 for results on U.S. industry portfolios.

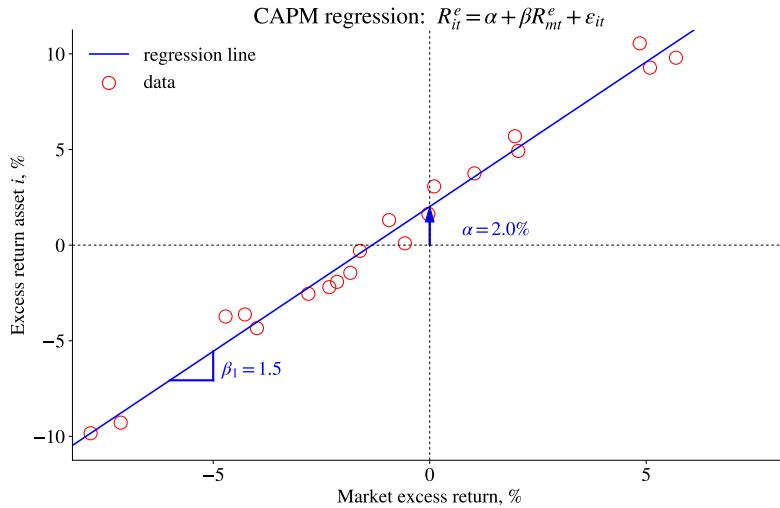


Figure 3.1: CAPM regression

	NoDur	Durbl	Manuf	Enrgy	HiTec
c	0.23 (2.26)	-0.05 (-0.26)	0.01 (0.17)	0.21 (1.07)	-0.06 (-0.49)
R_m^e	0.76 (27.53)	1.25 (21.64)	1.03 (51.44)	0.86 (15.98)	1.24 (38.82)
R^2	0.66	0.59	0.87	0.40	0.76
obs	648	648	648	648	648

Table 3.1: CAPM regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

3.2 Estimating Beta

3.2.1 Estimating Historical Beta: OLS and Other Approaches

It is sometimes argued that the OLS estimate of beta on a historical sample may not be the best forecast of the beta for a future time periods (see, for instance, Blume (1971)). As a potential solution, we could apply a shrinkage towards the average beta (which is 1)

$$\beta = \eta \hat{\beta}_{OLS} + (1 - \eta)1. \quad (3.2)$$

This could be motivated by empirical findings or by a Bayesian principle (see Greene (2018) 16). (In the latter case, η would be higher if the same is long and when the fit is good.)

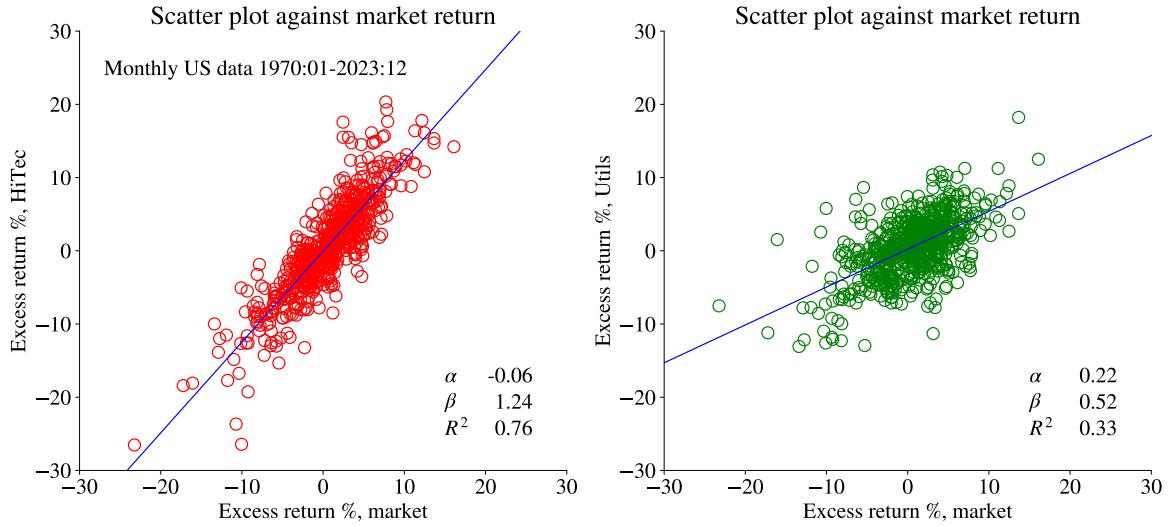


Figure 3.2: Scatter plot against market return

	Telcm	Shops	Hlth	Utils	Other
c	0.05 (0.43)	0.11 (1.09)	0.17 (1.40)	0.22 (1.60)	-0.06 (-0.80)
R_m^e	0.79 (24.64)	1.00 (33.37)	0.81 (21.80)	0.52 (14.41)	1.09 (52.66)
R^2	0.57	0.76	0.58	0.33	0.86
obs	648	648	648	648	648

Table 3.2: CAPM regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

Empirical Example 3.3 *Table 3.3 for an evaluation of several methods: most are of the form (3.2), but we also consider a method where the OLS estimated is replaced by an exponentially weighted moving average estimate (EWMA), which is just a weighted OLS where an observation s periods ago gets the weight λ^s where λ is close to one (for instance, 0.95).*

3.2.2 Fundamental Betas

Another way to improve the forecasts of the beta over a future period is to bring in information about fundamental firm variables. This is particularly useful when there is little historical data on returns (for instance, because the asset was not traded before).

OLS adj	OLS adj	OLS adj	1	EWMA
$0.67\hat{b} + 0.33$	$0.5\hat{b} + 0.5$	$0.33\hat{b} + 0.67$	1	$0.5\hat{b} + 0.5$
-6.9	-6.4	-3.0	10.0	-11.0

Table 3.3: Absolute forecast errors of future betas, as a that is, the average $|\text{next 2 year } \beta - \text{predicted } \beta|$ compared to the results from OLS. A negative number is better performance than OLS. The models are estimated on moving 10-year windows and EWMA uses $\lambda = 0.95$. 49 industry portfolios, monthly data for 1970:01-2023:12.

It is often found that betas are related to fundamental variables as follows (with signs in parentheses indicating the effect on the beta): Dividend payout (-), Asset growth (+), Leverage (+), Liquidity (-), Asset size (-), Earning variability (+), Earnings Beta (slope in earnings regressed on economy wide earnings) (+). Such relations can be used to make an educated guess about the beta of an asset without historical data on the returns—but with data on (at least some of) these fundamental variables.

3.3 Multi-Index Models

3.3.1 Overview

The multi-index model is just a multivariate extension of the single-index model

$$R_{it} = a_i + b_i' f_t + \varepsilon_{it}, \text{ where} \quad (3.3)$$

$$\mathbb{E} \varepsilon_{it} = 0, \text{ Cov}(\varepsilon_{it}, f_t) = \mathbf{0}.$$

As an example, there could be two indices: the stock market return and an interest rate. An ad-hoc approach is to first try a single-index model and then test if the residuals are approximately uncorrelated. If not, then adding a second index might improve the model.

It is often found that it takes several indices to get a reasonable approximation—but that a single-index model is equally good (or better) at “forecasting” the covariance over a future period. This is much like the classical trade-off between in-sample fit (requires a large model) and forecasting (often better with a small model).

The types of indices vary, but one common set captures the “business cycle” and includes things like the market return, interest rate (or some measure of the yield curve slope), GDP growth, inflation, and so forth. Another common set of indices are industry indices.

It turns out (see below) that the calculations of the covariance matrix are simpler if the

indices are transformed to be uncorrelated.

Remark 3.4 (*Fama-French factors*) *Fama and French (1993)* use three factors: the market excess return, the return on a portfolio of small stocks minus the return on a portfolio of big stocks (*SMB*), and the return on a portfolio with a high ratio of book value to market value minus the return on a portfolio with a low ratio (*HML*). All three are excess returns (although only the first is in excess of a riskfree return), since they are long-short portfolios.

Empirical Example 3.5 (*3-factor model for the 10 industry portfolios*) See Tables 3.4–3.5 for regressions of 10 industry portfolios on the three Fama-French factors.

	NoDur	Durbl	Manuf	Enrgy	HiTec
c	0.17 (1.81)	-0.18 (-1.01)	-0.06 (-0.84)	0.02 (0.09)	0.13 (1.23)
R_m^e	0.81 (30.39)	1.26 (22.23)	1.06 (57.18)	0.95 (17.49)	1.13 (38.01)
R_{SMB}	-0.13 (-3.09)	0.21 (2.47)	0.01 (0.21)	-0.10 (-1.42)	0.19 (3.92)
R_{HML}	0.14 (3.22)	0.33 (4.00)	0.18 (6.24)	0.49 (5.14)	-0.50 (-10.90)
R^2	0.68	0.61	0.88	0.46	0.82
obs	648	648	648	648	648

Table 3.4: Fama-French regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

3.3.2 Multi-Index Model as a Method for Portfolio Choice

The factor loadings (betas) can be used for more than just constructing the covariance matrix. In fact, the factor loadings are often used directly in portfolio choice. The reason is simple: the betas summarize how different assets are exposed to the big risk factors/return drivers. The betas therefore provide a way to understand the broad features of even complicated portfolios. Combined this with the fact that many analysts and investors have fairly little direct information about individual assets, but are often willing to form opinions about the future relative performance of different asset classes (small vs large firms, equity vs bonds, etc)—and the role for factor loadings becomes clear.

	Telcm	Shops	Hlth	Utils	Other
c	0.00 (0.02)	0.12 (1.17)	0.28 (2.36)	0.10 (0.80)	-0.22 (-3.29)
R_m^e	0.84 (26.88)	0.98 (31.23)	0.81 (24.61)	0.60 (17.62)	1.14 (60.71)
R_{SMB}	-0.17 (-3.75)	0.08 (1.37)	-0.22 (-4.02)	-0.21 (-4.31)	0.01 (0.24)
R_{HML}	0.13 (2.78)	-0.02 (-0.42)	-0.27 (-4.73)	0.30 (5.50)	0.40 (13.08)
R^2	0.59	0.76	0.62	0.41	0.91
obs	648	648	648	648	648

Table 3.5: Fama-French regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats.

3.4 Principal Component Analysis*

Principal component analysis (PCA) can help us determine how many factors that are needed to explain a cross-section of asset returns.

Let $z_t = R_t - \bar{R}_t$ be an $n \times 1$ vector of demeaned returns with covariance matrix Σ . The first principal component (pc_{1t}) is the (normalized) linear combinations of z_t that account for as much of the variability as possible—and its variance is denoted λ_1 . The j th ($j \geq 2$) principal component (pc_{jt}) is similar (and its variance is denoted λ_j), except that it must be uncorrelated with all lower principal components. Remark 3.6 gives a formal definition.

Remark 3.6 (Principal component analysis) Consider the zero mean $N \times 1$ vector z_t with covariance matrix Σ . The first (sample) principal component is $pc_{1t} = w'_1 z_t$, where w_1 is the eigenvector associated with the largest eigenvalue (λ_1) of Σ . This value of w_1 solves the problem $\max_w w' \Sigma w$ subject to the normalization $w'w = 1$. The eigenvalue λ_1 equals $\text{Var}(pc_{1t}) = w'_1 \Sigma w_1$. The j th principal component solves the same problem, but under the additional restriction that $w'_i w_j = 0$ for all $i < j$. The solution is the eigenvector associated with the j th largest eigenvalue λ_j (which equals $\text{Var}(pc_{jt}) = w'_j \Sigma w_j$).

Let the i th eigenvector be the i th column of the $n \times n$ matrix

$$W = [w_1 \ \cdots \ w_n]. \quad (3.4)$$

We can then calculate the $n \times 1$ vector of principal components as

$$pc_t = W' z_t. \quad (3.5)$$

Since the eigenvectors are orthogonal it can be shown that $W' = W^{-1}$, so the expression can be inverted as

$$z_t = W pc_t. \quad (3.6)$$

This shows that the i th eigenvector (the i th column of W) can be interpreted as the effect of the i th principal component on each of the elements in z_t . However, the sign of column j of W can be changed without any effects (except that the pc_{jt} also changes sign), so we can always reinterpret a negative coefficient as a positive exposure (to $-pc_{jt}$).

Empirical Example 3.7 (PCA for the 25 FF portfolios) See Figure 3.3 for the three most important eigenvectors for the 25 FF portfolios. The first pc seems to capture the average (market), while the other are related to size and growth/value.

Example 3.8 (PCA with 2 series) Let $w_i^{(j)}$ be the t th element in the i th eigenvector. With two series we have

$$\begin{aligned} pc_{1t} &= \begin{bmatrix} w_1^{(1)} \\ w_1^{(2)} \end{bmatrix}' \begin{bmatrix} z_{1t} \\ z_{2t} \end{bmatrix} \text{ and } pc_{2t} = \begin{bmatrix} w_2^{(1)} \\ w_2^{(2)} \end{bmatrix}' \begin{bmatrix} z_{1t} \\ z_{2t} \end{bmatrix} \text{ or} \\ \begin{bmatrix} pc_{1t} \\ pc_{2t} \end{bmatrix} &= \begin{bmatrix} w_1^{(1)} & w_2^{(1)} \\ w_1^{(2)} & w_2^{(2)} \end{bmatrix}' \begin{bmatrix} z_{1t} \\ z_{2t} \end{bmatrix} \text{ and} \\ \begin{bmatrix} z_{1t} \\ z_{2t} \end{bmatrix} &= \begin{bmatrix} w_1^{(1)} & w_2^{(1)} \\ w_1^{(2)} & w_2^{(2)} \end{bmatrix} \begin{bmatrix} pc_{1t} \\ pc_{2t} \end{bmatrix} \end{aligned}$$

For instance, for the two elements in the second eigenvector, $w_2^{(1)}$ shows how pc_{2t} affects z_{1t} , while $w_2^{(2)}$ shows how the same pc_{2t} affects z_{2t} .

Remark 3.9 (Data in matrices*) Transpose (3.5) to get $pc'_t = z'_t W$, where the dimensions are $1 \times n$, $1 \times n$ and $n \times n$ respectively. If we form a $T \times n$ matrix of data Z by putting z_t in row t , then the $T \times N$ matrix of principal components can be calculated as $PC = ZW$.

Notice that (3.6) shows that all n data series in z_t can be written in terms of the n principal components. Since the principal components are uncorrelated ($\text{Cov}(pc_{it}, pc_{jt}) = 0$), and it can be shown that $\sum_{i=1}^n \lambda_i = \sum_{i=1}^n \text{Var}(z_{it})$, we can think of the sum of their

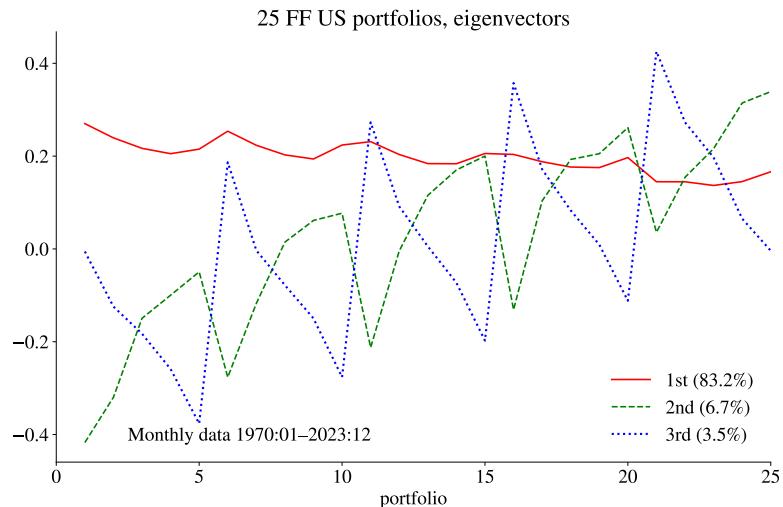


Figure 3.3: Eigenvectors for US portfolio returns

variances ($\sum_{i=1}^n \lambda_i$) as the “total variation” of the series in z_t . In practice, it is common to report the relative importance of principal component j as

$$\text{relative importance of } pc_j = \lambda_j / \sum_{i=1}^n \lambda_i. \quad (3.7)$$

For instance, if it is found that the first two principal components account for 75% for the total variation among many asset returns, then a two-factor model is likely to be a good approximation.

Chapter 4

Least Squares: Testing

Reference: Verbeek (2012) 2 and 4; Greene (2018) 4-5 and parts of 9 and 20.

4.1 Testing a Single Coefficient: A t -test

We are interested in testing the null hypothesis (H_0) that a single coefficient $\beta = q$, where q is a number of interest. (Econometric programs typically report results for $H_0: \beta = 0$.) Here, the alternative hypothesis is that $\beta \neq q$, so this is a two-sided (also called “two-tailed”) test.

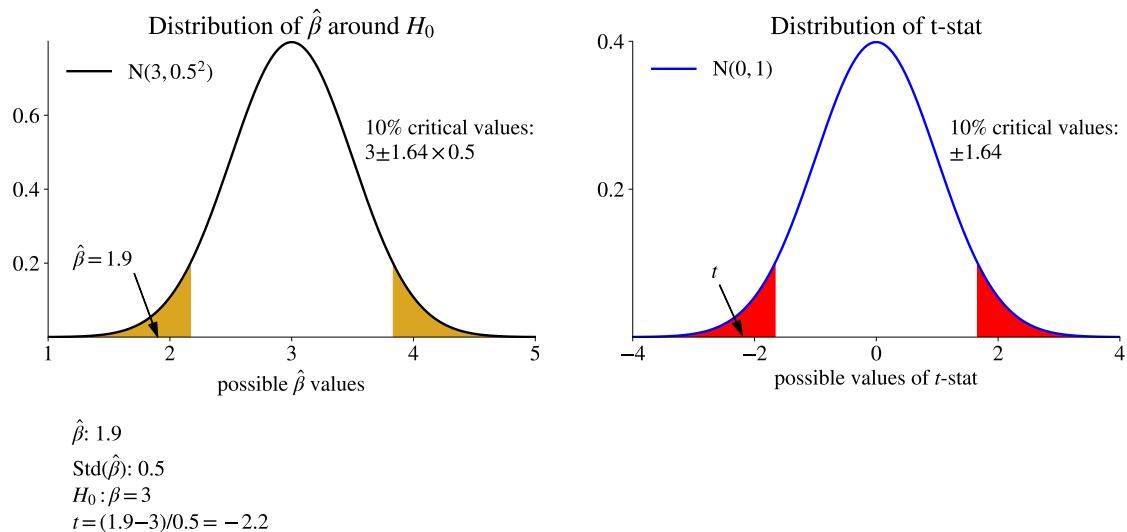


Figure 4.1: Distribution of $\hat{\beta}$ and t-stat

We assume that the estimates are normally distributed, which may be a good approximation when the sample is large (because of the central limit theorem). If the null

hypothesis is true, then

$$\hat{\beta} \sim N(q, \text{Var}(\hat{\beta})). \quad (4.1)$$

The estimate $\hat{\beta}$ could be from a OLS , or from some other method. The variance $\text{Var}(\hat{\beta})$ depends on the properties of data (heteroskedasticity/autocorrelation? and on the estimation method.

To be able to easily compare with printed tables of probabilities, we transform to a $N(0, 1)$ variable. In particular, if the true coefficient is really q , then $\hat{\beta} - q$ should have a zero mean. Dividing by the standard error (deviation) of $\hat{\beta}$, we should have

$$t = \frac{\hat{\beta} - q}{\text{Std}(\hat{\beta})} \sim N(0, 1) \quad (4.2)$$

We reject the null hypothesis when $|t|$ is very large, for instance, if $|t| > 1.64$.

This decision is driven by (a) how far $\hat{\beta}$ is from q ; (b) how uncertain $\hat{\beta}$ is (as measured by $\text{Std}(\hat{\beta})$); (c) and how we define the cut off (here 1.64). The latter is typically done by first choosing a *significance level* (for instance, 10%) which defines a *critical value* (1.64 for the 10% significance level): reject the null hypothesis if $|t|$ is larger than the critical value (1.64 on the 10% level, 1.96 on the 5% level). The significance level represents the probability, in a random sample, of falsely rejecting a null hypothesis that is actually true. See Figure 4.1 for an illustration. A lower significance level (5%, giving a critical value of 1.96) is therefore a more conservative test (we require stronger evidence to reject the null hypothesis), and thus run a lower risk of a false rejection. The significance level is thus a trade-off between actually being able of rejecting the null hypothesis and sometimes doing it wrongly. See Figure 4.2 for an illustration of the probabilities according to an $N(0,1)$ distribution.

Otherwise, when $|t|$ is not very large (for instance, $|t|$), then evidence is not sufficient to reject the null hypothesis. (You may compare with a court of law where the null hypothesis is that the accused is not guilty.)

Example 4.1 (*t-test*) Let $\hat{\beta} = 1.9$, $\text{Std}(\hat{\beta}) = 0.5$ and $q = 3$. Then, $t = (1.9 - 3)/0.5 = -2.2$ so $|t| > 1.64$ and also $|t| > 1.96$. The null hypothesis is thus rejected at both the 10% and the 5% significance levels.

Empirical Example 4.2 (*CAPM regressions for industry portfolios*) See Table 4.1.

Empirical Example 4.3 (*Multi-factor regressions for industry portfolios*) See Table 4.2.

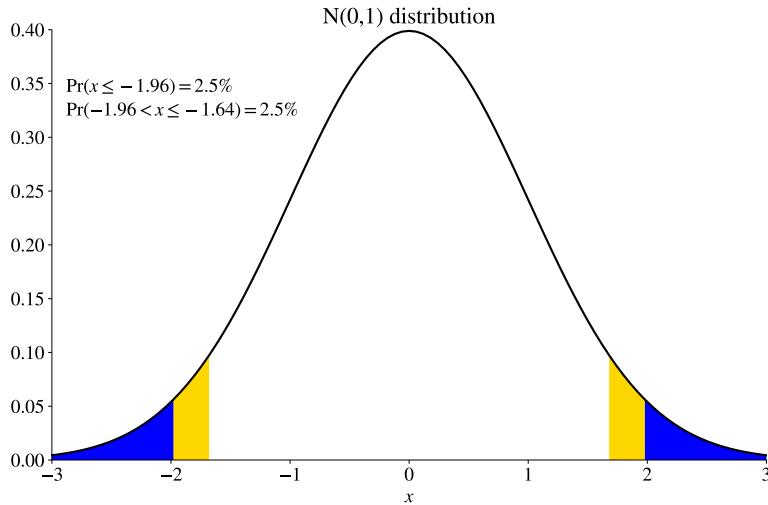


Figure 4.2: Density function of a standard normal distribution

The *p-value* is a related concept. It is the lowest significance level at which we can reject the null hypothesis: a lower number is a stronger rejection. See Figure 4.3 for an illustration.

Example 4.4 (*p-value*) Continuing Example 4.1, notice that according to a $N(0,1)$ distribution, the probability of -2.2 or lower is 1.4% , so the *p-value* is 2.8% . We thus reject the null hypothesis at the 10% significance level and also at the 5% significance level.

We sometimes compare with a *t*-distribution instead of a $N(0,1)$, especially when the sample is short. For instance, with 22 data points and two estimated coefficients (so there are 20 degrees of freedom), the 10% critical value of a *t*-distribution is 1.72 (while it is 1.64 for the standard normal distribution). However, for samples of more than 30–40 data points, the difference is trivial.

Remark 4.5 (*One-sided test**) As an examples of a one-sided test let $H_0 : \beta \leq q$ and $H_1 : \beta > q$. Sometimes the null hypothesis is written $\beta = q$, but that makes little practical difference. We then reject the null hypothesis at the 10% significance level if $t > 1.28$ which is the 0.90 quantile of a $N(0,1)$ distribution. Conversely, when $H_0 : \beta \geq q$ and $H_1 : \beta < q$, then we reject the null hypothesis if $t < -1.28$. Since 1.28 is the 20% critical value in a two-sided test, we can actually use a two sided test (for instance, from a regression package) to also do a one-sided test: (a) if we reject the null hypothesis on the 20% level in a double sided test; (b) and the sign is right; then (c) this is a rejection on the 10% level in a one-sided test.

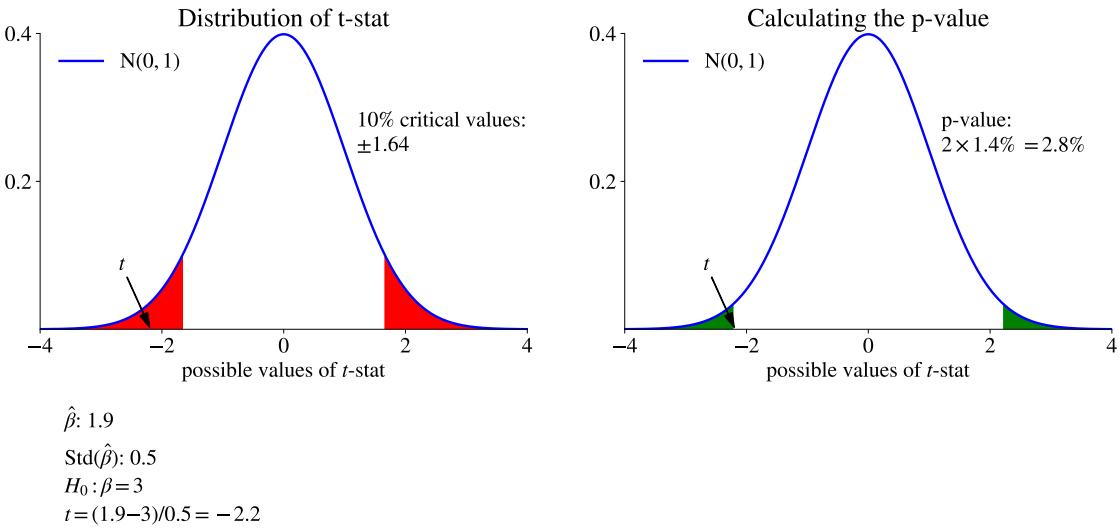


Figure 4.3: Calculating the p-value

4.2 Confidence Bands

A significance level of 10% means that there is (if the null hypothesis is true) a 90% probability that the t value in (4.2) (from a random sample) is within the interval (band) $(-1.64, 1.64)$, that is,

$$\Pr(-1.64 \leq t \leq 1.64) = 90\%. \quad (4.3)$$

The t -test discussed above rejects the null hypothesis ($\beta = q$) when t is outside this confidence band. Notice that

$$t \text{ is outside } [-1.64, 1.64] \iff \quad (4.4)$$

$$\hat{\beta} \text{ is outside } [q - 1.64 \text{ Std}(\hat{\beta}), q + 1.64 \text{ Std}(\hat{\beta})] \text{ and} \quad (4.5)$$

$$q \text{ is outside } [\hat{\beta} - 1.64 \text{ Std}(\hat{\beta}), \hat{\beta} + 1.64 \text{ Std}(\hat{\beta})]. \quad (4.6)$$

The interval in (4.5) is a 90% confidence band of β *centered on the null hypothesis*, while the confidence band in (4.6) is *centered on the point estimate*. These are alternative ways of doing a hypothesis test—and are often used to provide more information than just a reject/no reject decision. For instance, we are 90% sure that the true β value is within the band centered around the point estimate. See Figures 4.1 and 4.4.

Proof (that t and $\hat{\beta}$ are outside their confidence bands at the same time) For $\hat{\beta}$ to be

	HiTec	Utils
constant	-0.06 (-0.49)	0.22 (1.60)
market return	1.24 (38.82)	0.52 (14.41)
R^2	0.76	0.33
Autocorr	0.37	0.91
White	0.05	0.00
All slopes	0.00	0.00
obs	648	648

Table 4.1: CAPM regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats. Autocorr is the p-value for no autocorrelation; White is the p-value for homoskedasticity; All slopes is the p-value for all slope coefficients being zero.

outside the band we must have

$$\hat{\beta} < q - 1.64 \text{Std}(\hat{\beta}) \text{ or } \hat{\beta} > q + 1.64 \text{Std}(\hat{\beta}).$$

Rearrange this by subtracting q from both sides of the inequalities and then divide both sides by $\text{Std}(\hat{\beta})$

$$\frac{\hat{\beta} - q}{\text{Std}(\hat{\beta})} < -1.64 \text{ or } \frac{\hat{\beta} - q}{\text{Std}(\hat{\beta})} > 1.64.$$

□

Example 4.6 (*t-test and confidence band around q*) With $\text{Std}(\hat{\beta}) = 0.5$ and $q = 3$, the 90% confidence band is $3 \pm 1.64 \times 0.5$, that is, $[2.18, 3.82]$. Notice that $\hat{\beta} = 1.90$ is outside this band, so we reject the null hypothesis. Equivalently, $t = (1.9 - 3)/0.5 = -2.2$ is outside the band $[-1.64, 1.64]$.

Example 4.7 (*t-test and confidence band around $\hat{\beta}$*) With $\text{Std}(\hat{\beta}) = 0.5$ and $\hat{\beta} = 1.9$, the 90% confidence band is $1.9 \pm 1.64 \times 0.5$, that is, $[1.08, 2.72]$. Notice that $q = 3$ is outside this band, so we reject the null hypothesis.

4.3 Power and Size*

The *size* is the probability of rejecting a true H_0 . That is, the probability of a wrong rejection. It should be low. Provided you use a valid test (correct standard error, etc),

	HiTec	Utils
constant	0.13 (1.23)	0.10 (0.80)
market return	1.13 (38.01)	0.60 (17.62)
SMB	0.19 (3.92)	-0.21 (-4.31)
HML	-0.50 (-10.90)	0.30 (5.50)
R^2	0.82	0.41
Autocorr	0.59	0.60
White	0.00	0.00
All slopes	0.00	0.00
obs	648	648

Table 4.2: Fama-French regressions, monthly returns, %, US data 1970:01-2023:12. Numbers in parentheses are t-stats. Autocorr the p-value for no autocorrelation; White is the p-value for homoskedasticity; All slopes is the p-value for all slope coefficients being zero.

the size is the significance level you have chosen (which defines the critical values). For instance, with a t -test with critical values $(-1.64, 1.64)$, the size is 10%. (The size is sometime called the type I error.) This means that we run a 10% chance of wrongly rejecting a true null hypothesis. See Table 4.3.

	H_0 not rejected	H_0 rejected
H_0 is true	1 - size	size
H_0 is false	1 - power	power

Table 4.3: Size and power

The *power is the probability of rejecting a false H_0* . That is, the probability of a correct rejection. It should be high. Typically, it cannot be controlled (but some tests are better than others.). This power depends on how false H_0 is, which we will never know. All we can do is to create (artificial) examples to get an idea of what the power would be for different tests and for different values of the true parameter β . For instance, with a t -test using the critical values -1.64 and 1.64 , the power would be

$$\text{power} = \Pr(t \leq -1.64) + \Pr(t \geq 1.64). \quad (4.7)$$

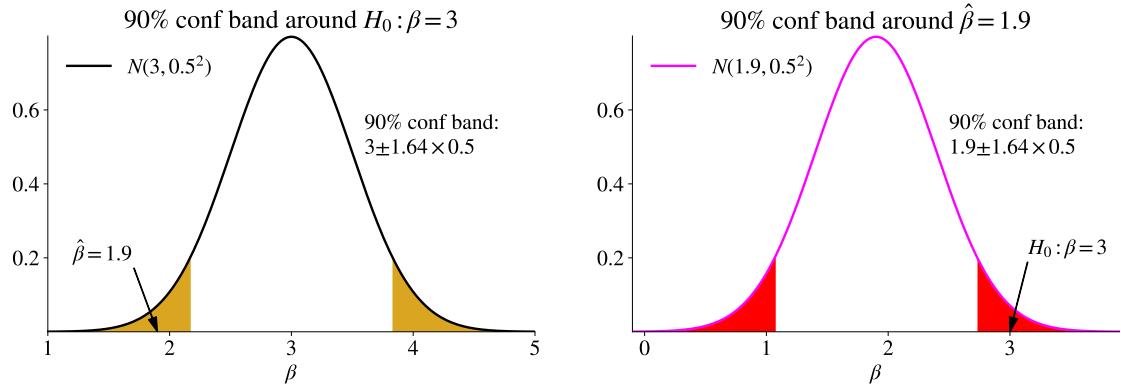


Figure 4.4: Confidence band around the null hypothesis or around the point estimate

($1 - \text{power}$ is sometimes called the type II error. This is the probability of not rejecting a false H_0 .) Again, see Table 4.3.

To make this more concrete, suppose we test the null hypothesis that the coefficient is equal to q , but the true value happens to be β . Since the OLS estimate, $\hat{\beta}$ is distributed as $N[\beta, \text{Std}(\hat{\beta})]$, it must be the case that the t -stat is distributed as

$$t = \frac{\hat{\beta} - q}{\text{Std}(\hat{\beta})} \sim N\left(\frac{\beta - q}{\text{Std}(\hat{\beta})}, 1\right). \quad (4.8)$$

We can then calculate the power as the probability that $t \leq -1.64$ or $t \geq 1.64$, when t has the distribution on the RHS in (4.8). Clearly, the results depend on what the true value β really is. See Figure 4.5.

Example 4.8 If $\beta = 3.6$, $q = 3$ and $\text{Std}(\hat{\beta}) = 0.5$, then the power is 0.33.

4.4 Testing A Linear Combination

We can form linear combinations of the regressions coefficients and apply a t-test.

Let R be a $1 \times k$ (row) vector that defines our linear combination and suppose we want to test $R\beta = q$, where β is k -vector of coefficients. The estimate $\hat{\beta}$ could be from a linear regression, but could equally well be from some other method. We can test the hypothesis by noting that

$$\text{Var}(R\hat{\beta}) = R \text{Var}(\hat{\beta}) R', \quad (4.9)$$

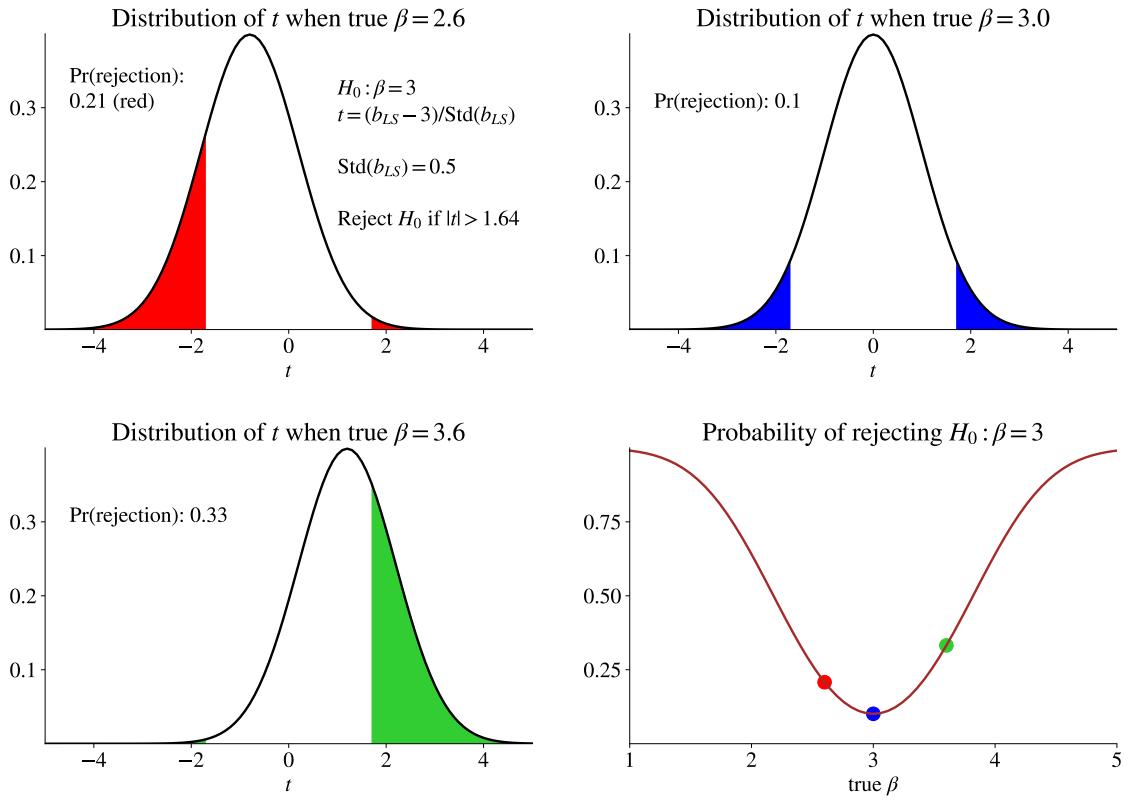


Figure 4.5: Power of t-test, assuming different true parameter values

is a scalar, even if $\text{Var}(\hat{\beta})$ is a $k \times k$ matrix. Therefore, the t-test becomes

$$t = \frac{R\hat{\beta} - q}{\sqrt{R \text{Var}(\hat{\beta}) R'}} \sim N(0, 1). \quad (4.10)$$

Example 4.9 (*Testing a difference*) For simplicity, suppose we have only two coefficients and want to test the difference. Then, $R = [1 \ -1]$. Suppose (again for simplicity) that $\text{Var}(\hat{\beta}) = [\begin{smallmatrix} 1 & \rho \\ \rho & 1 \end{smallmatrix}]$, where $\rho = \text{Cov}(\hat{\beta}_1, \hat{\beta}_2)$. Clearly, $R \text{Var}(\hat{\beta}) R'$ equals $\text{Var}(\hat{\beta}_1) + \text{Var}(\hat{\beta}_2) - 2 \text{Cov}(\hat{\beta}_1, \hat{\beta}_2)$ which here is $2(1 - \rho)$. A higher covariance means that $\hat{\beta}_1$ and $\hat{\beta}_2$ tend to move in the same direction so the difference has a small uncertainty. It is then easy to test the difference. The opposite is true when testing a sum (then $R = [1 \ 1]$).

4.5 Joint Test of Several Coefficients: A Wald Test

A joint test of several coefficients is different from testing the coefficients one at a time. For instance, suppose your economic hypothesis is that $\beta_1 = 1$ and $\beta_3 = 0$. You could

clearly test each coefficient individually (by a t-test), but that may give conflicting results. In addition, it does not use the information in the sample as effectively as possible. It might well be the case that we cannot reject any of the hypotheses (that $\beta_1 = 1$ and $\beta_3 = 0$), but that a joint test might be able to reject it. Intuitively, a joint test is like exploiting the power of repeated sampling.

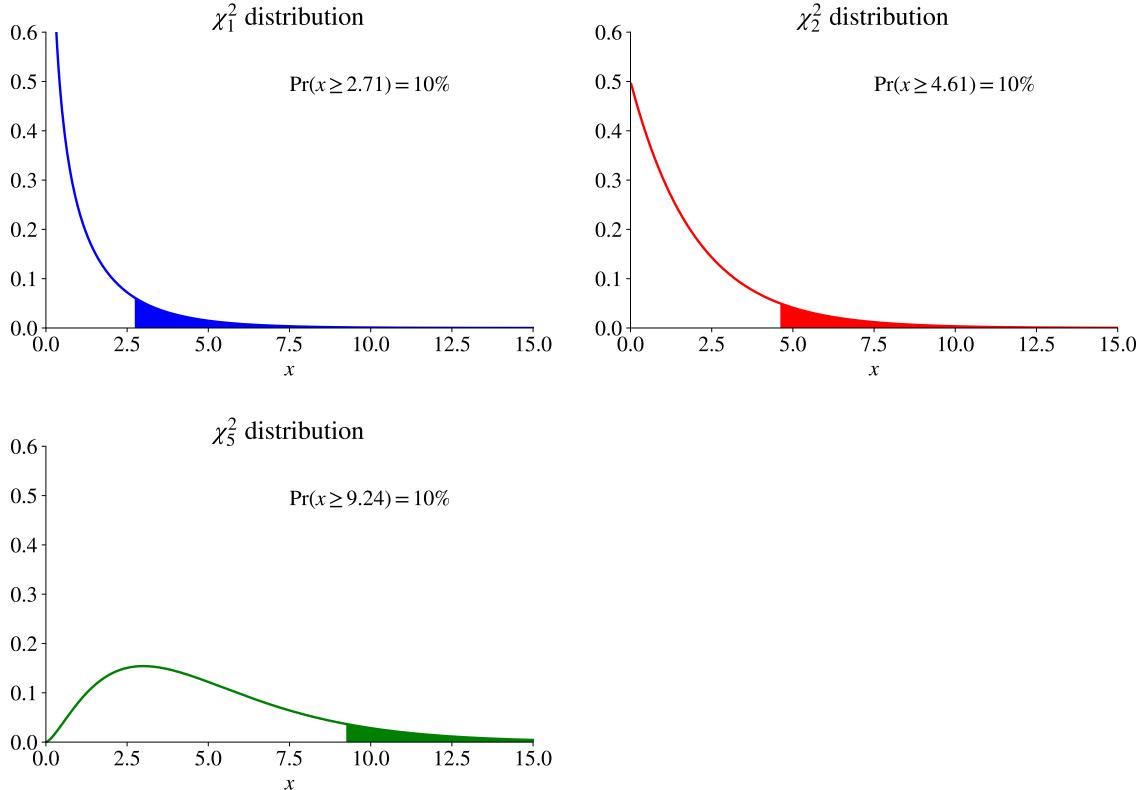


Figure 4.6: Density functions of χ^2 distributions with different degrees of freedom

A joint test makes use of the following remark.

Remark 4.10 (Chi-square distribution) If v is a zero mean vector with n elements which are jointly normally distributed ($v \sim N(0, \Sigma)$), then

$$v' \Sigma^{-1} v \sim \chi_n^2.$$

As a special case, suppose the vector has just one element. In this case, the quadratic form can be written $[v / \text{Std}(v)]^2$, which is the square of a t-statistic (it has a χ_1^2 distribution).

Example 4.11 (Quadratic form with a chi-square distribution) If the 2×1 vector v has

the following normal distribution

$$\begin{bmatrix} v_1 \\ v_2 \end{bmatrix} \sim N \left(\begin{bmatrix} 0 \\ 0 \end{bmatrix}, \begin{bmatrix} 1 & 0 \\ 0 & 2 \end{bmatrix} \right),$$

then the quadratic form

$$\begin{bmatrix} v_1 \\ v_2 \end{bmatrix}' \begin{bmatrix} 1 & 0 \\ 0 & 1/2 \end{bmatrix} \begin{bmatrix} v_1 \\ v_2 \end{bmatrix} = v_1^2 + v_2^2/2$$

has a χ_2^2 distribution. (In a more general example, the variables could be correlated.)

The null hypothesis can be written on matrix form as

$$R\beta = q, \quad (4.11)$$

where R is a $J \times k$ matrix, β a k -vector and q is a J -vector.

Example 4.12 ((4.11) with $J = 2$) Suppose the model has three coefficients and the null hypothesis is

$$H_0 : \beta_1 = 1 \text{ and } \beta_3 = 0.$$

This can be written on the form of (4.11) as

$$\begin{bmatrix} 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} \beta_1 \\ \beta_2 \\ \beta_3 \end{bmatrix} = \begin{bmatrix} 1 \\ 0 \end{bmatrix}.$$

Notice that the variance-covariance matrix of these linear combinations is

$$\text{Var}(R\hat{\beta}) = R \text{Var}(\hat{\beta}) R', \quad (4.12)$$

where $\text{Var}(\hat{\beta})$ denotes the covariance matrix of the coefficients. It is a $J \times J$ matrix. As before, the estimate $\hat{\beta}$ could be from a linear regression, but could equally well be from some other method. Putting together these results we have the test statistic (a scalar)

$$(R\hat{\beta} - q)'[R \text{Var}(\hat{\beta}) R']^{-1}(R\hat{\beta} - q) \sim \chi_J^2. \quad (4.13)$$

This test statistic is compared to the critical values of a χ_J^2 distribution. This is called a *Wald test*. (Alternatively, this test can be put in the form of an F statistic, which is a small sample refinement.)

Remark 4.13 ($J = 1$) When R has just one row, then the test statistic from (4.13) equals t^2 where t is from (4.10) and it follows a χ_1^2 distribution.

A particularly important case is the test of the joint hypothesis that all $k - 1$ slope coefficients in the regression (that is, excluding the intercept) are zero. It can be shown that the test statistic for this hypothesis is (assuming your regression also contains an intercept)

$$TR^2/(1 - R^2) \sim \chi_{k-1}^2. \quad (4.14)$$

Empirical Example 4.14 (Test of all slopes) See Tables 4.1 and 4.2.

Example 4.15 (Joint test) Suppose $H_0: \beta_1 = 0$ and $\beta_3 = 0$; $(\hat{\beta}_1, \hat{\beta}_2, \hat{\beta}_3) = (2, 777, 3)$ and

$$R = \begin{bmatrix} 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix} \text{ and } \text{Var}(\hat{\beta}) = \begin{bmatrix} 4 & 0 & 0 \\ 0 & 33 & 0 \\ 0 & 0 & 1 \end{bmatrix}, \text{ so}$$

$$R \text{Var}(\hat{\beta})R' = \begin{bmatrix} 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} 4 & 0 & 0 \\ 0 & 33 & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} 1 & 0 \\ 0 & 0 \\ 0 & 1 \end{bmatrix} = \begin{bmatrix} 4 & 0 \\ 0 & 1 \end{bmatrix}.$$

(We assume $\text{Var}(\hat{\beta})$ is diagonal just because it makes it easier to invert.) Then, (4.13) is

$$\left(\begin{bmatrix} 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} 2 \\ 777 \\ 3 \end{bmatrix} - \begin{bmatrix} 0 \\ 0 \end{bmatrix} \right)' \begin{bmatrix} 4 & 0 \\ 0 & 1 \end{bmatrix}^{-1} \left(\begin{bmatrix} 1 & 0 & 0 \\ 0 & 0 & 1 \end{bmatrix} \begin{bmatrix} 2 \\ 777 \\ 3 \end{bmatrix} - \begin{bmatrix} 0 \\ 0 \end{bmatrix} \right)$$

$$\begin{bmatrix} 2 & 3 \end{bmatrix} \begin{bmatrix} 0.25 & 0 \\ 0 & 1 \end{bmatrix} \begin{bmatrix} 2 \\ 3 \end{bmatrix} = 10,$$

which is higher than the 10% critical value of the χ_2^2 distribution (which is 4.61).

Remark 4.16 (*An alternative form of (4.13)) Define the standardised values $z = (R\hat{\beta} - q)/\text{Std}(R\hat{\beta} - q)$. Then, (4.13) can be also be written $z' \text{Corr}(z)^{-1} z$.

Remark 4.17 (Power and size of a joint test*) Suppose $v \sim N(v_0, \Sigma)$, where v_0 might be non-zero. Then $v' \Sigma^{-1} v \sim \chi_n^2(\lambda)$ with $\lambda = v_0' \Sigma^{-1} v_0$ and where $\chi_n^2(\lambda)$ is a non-central chi-square distribution with non-centrality parameter λ . (This distribution coincides with the traditional chi-square when $\lambda = 0$.) In particular, if $R\beta - q = q_0$

(instead of zero), then the test static in (4.13) would have a $\chi_J^2(\lambda)$ distribution with $\lambda = q_0' [R \text{Var}(\hat{\beta}) R']^{-1} q_0$. We could then calculate the power of the test in (4.13) for different values of q_0 .

Proof (of (4.14)) Recall that $R^2 = \hat{v}(\hat{y}_t)/\hat{v}(y_t) = 1 - \hat{v}(\hat{u}_t)/\hat{v}(y_t)$, where $\hat{y}_t = x_t' \hat{\beta}$ and \hat{u}_t are the fitted value and residual respectively and $\hat{v}()$ is short hand notation for a sample variance. We therefore get $TR^2/(1-R^2) = T\hat{v}(\hat{y}_t)/\hat{v}(\hat{u}_t)$. To simplify the algebra, assume that both y_t and x_t are demeaned and that no intercept is used. (We get the same results, but after more work, if we relax this assumption.) In this case we can rewrite as $TR^2/(1-R^2) = T\hat{\beta}'\hat{v}(x_t)\hat{\beta}/\hat{\sigma}^2$, where $\hat{\sigma}^2 = \hat{v}(\hat{u}_t)$. If the iid assumptions are correct, then the variance-covariance matrix of $\hat{\beta}$ is estimated as $\text{Var}(\hat{\beta}) = [T\hat{v}(x_t)]^{-1}\hat{\sigma}^2$, so we get

$$\begin{aligned} TR^2/(1-R^2) &= \hat{\beta}' T \hat{v}(x_t) / \sigma^2 \hat{\beta} \\ &= \hat{\beta}' \text{Var}(\hat{\beta})^{-1} \hat{\beta}. \end{aligned}$$

This has the same form as (4.13) with $R = I$ and $q = \mathbf{0}$ and J equal to the number of slope coefficients. \square

4.5.1 A Joint Test of Several Coefficients: F-test*

The joint test can also be cast in *terms of the F distribution* (which may have better small sample properties).

Divide (4.13) by J and replace $\text{Var}(\hat{\beta})$ by the estimated covariance matrix, for instance, $\hat{V} = \hat{\sigma}^2 (\sum_{t=1}^T x_t x_t')^{-1}$ where we use \hat{V} to denote the estimate, but where we (as in reality) have to estimate the variance of the residuals by the sample variance of the fitted residuals, $\hat{\sigma}^2$. This gives

$$\frac{(R\hat{\beta} - q)' (R\hat{V} R')^{-1} (R\hat{\beta} - q)}{J} \sim F_{J, T-k}, \text{ where} \quad (4.15)$$

$$\hat{V} = \hat{\sigma}^2 \left(\sum_{t=1}^T x_t x_t' \right)^{-1}.$$

The test of the joint hypothesis that all $k-1$ slope coefficients in the regression (that is, excluding the intercept) are zero can be written (assuming your regression also contains an intercept)

$$\frac{R^2/(k-1)}{(1-R^2)/(T-k)} \sim F_{k-1, T-k}. \quad (4.16)$$

Proof (of (4.15)) Equation (4.15) can also be written

$$\frac{(R\hat{\beta} - q)' \left[R\sigma^2 \left(\sum_{t=1}^T x_t x_t' \right)^{-1} R' \right]^{-1} (R\hat{\beta} - q)/J}{\hat{\sigma}^2/\sigma^2}.$$

The numerator is a χ_J^2 variable divided by J . The denominator can be written $\Sigma_{t=1}^T (\hat{u}_t/\sigma)^2/(T-k)$. If the residuals are normally distributed (and independent across time), then this is a χ_{T-k}^2 variable (not χ_T^2 since we have estimated k parameters which influence \hat{u}_t) divided by $T-k$. In addition, if the numerator and denominator are independent (which requires that the residuals are independent of the regressors), then the ratio has an $F_{J,T-k}$ distribution. \square

Example 4.18 (*Joint F test*) Continuing Example 4.15, and assuming that $\hat{V} = \text{Var}(\hat{\beta})$, we have a test statistic of $10/2 = 5$. Assume $T-k = 50$, then the 10% critical value (from an $F_{2,50}$ distribution) is 2.4, so the null hypothesis is rejected at the 10% level.

4.6 Confidence Bands around a Forecast and a Forecast Error*

Suppose we have estimated the linear model

$$y_t = x_t' \beta + u_t. \quad (4.17)$$

For a given (known) vector x_s , our *forecast* of y_s is

$$\text{E}(y_s | x_s) = x_s' \hat{\beta}.$$

For a given x_s , this is just a linear combination of the estimated coefficients, so the result in (4.12) holds, but with x_s' replacing R

$$\text{Var}[\text{E}(y_s | x_s)] = x_s' \text{Var}(\hat{\beta}) x_s. \quad (4.18)$$

Instead, if we want the uncertainty about the *forecast error*

$$y_s - \text{E}(y_s | x_s) = x_s' (\beta - \hat{\beta}) + u_s, \quad (4.19)$$

then we have to add the uncertainty of u_s

$$\text{Var}[y_s - \text{E}(y_s | x_s)] = x_s' \text{Var}(\hat{\beta}) x_s + \sigma^2. \quad (4.20)$$

(To show this last result, notice that x_s is not random and that u_s is not correlated with $\hat{\beta}$ if the latter is estimated from a sample that does not contain period s .)

4.7 Testing Nonlinear Hypotheses: The Delta Method

Consider an estimator $\hat{\beta}_{k \times 1}$ which satisfies

$$\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} N(0, W). \quad (4.21)$$

As before, the estimate $\hat{\beta}$ could be from a linear regression, but could equally well be from some other method.

Suppose we want the asymptotic distribution of a function of β

$$\gamma = f(\beta), \quad (4.22)$$

where $f(.)$ has continuous first derivatives. The output from this function could be a vector. We can construct a test by noticing that a first-order Taylor approximation is

$$f(\hat{\beta}) - f(\beta) \approx P(\hat{\beta} - \beta), \quad (4.23)$$

where P is the matrix of partial derivatives (the Jacobian)

$$P = \begin{bmatrix} \frac{\partial f_1(\beta)}{\partial \beta_1} & \dots & \frac{\partial f_1(\beta)}{\partial \beta_k} \\ \vdots & \ddots & \vdots \\ \frac{\partial f_q(\beta)}{\partial \beta_1} & \dots & \frac{\partial f_q(\beta)}{\partial \beta_k} \end{bmatrix}, \quad (4.24)$$

where $\partial f_i(\beta) / \partial \beta_j$ is the derivative of output i from the function $f()$ with respect to parameter j . (Notice that this means that row i is the transpose of the traditional gradient of output/function i .) The derivatives can sometimes be found analytically, otherwise numerical differentiation can be used. In principle, the derivatives should be calculated at the true parameter values and using population moments of the data, but in practice we use the point estimates $\hat{\beta}$ and using the existing sample.

It follows that, as a first order approximation, the variance-covariance matrix of $f(\hat{\beta}) - f(\beta)$ is PWP' . In fact, asymptotically all higher-order terms can be disregarded. This means that, under that null hypothesis (that the true value is γ)

$$\sqrt{T}(f(\hat{\beta}) - \gamma) \xrightarrow{d} N(0, PWP'), \text{ where} \quad (4.25)$$

Now, a test can be done by using (4.25), similarly to the linear case. See below for some more details on the proof.

This result could also be expressed in terms of the variance-covariance matrix of $\hat{\beta}$ (rather than of $\sqrt{T}\hat{\beta}$) as

$$\text{if } \hat{\beta} \xrightarrow{a} N(\beta, V), \text{ then } f(\hat{\beta}) \xrightarrow{a} N(\gamma, PVP'), \quad (4.26)$$

where \xrightarrow{a} means “is asymptotically distributed as”.

Example 4.19 (*Testing a Sharpe ratio*) Stack the mean and variance as $\beta = (\mu, \sigma^2)$. The Sharpe ratio is calculated as a function of β

$$f(\beta) = \frac{\mu}{(\sigma^2)^{1/2}}, \text{ so } P = \begin{bmatrix} \frac{1}{\sigma} & \frac{-\mu}{2\sigma^3} \end{bmatrix}.$$

If $\hat{\beta}$ is distributed as in (4.21), then (4.25) is straightforward to apply. Also, with the Sharpe ratios for two assets (i, j) as outputs of $f(\beta)$ and $\beta = (\mu_i, \sigma_i^2, \mu_j, \sigma_j^2)$ we get

$$P = \begin{bmatrix} \frac{1}{\sigma_i} & \frac{-\mu_i}{2\sigma_i^3} & 0 & 0 \\ 0 & 0 & \frac{1}{\sigma_j} & \frac{-\mu_j}{2\sigma_j^3} \end{bmatrix}.$$

Empirical Example 4.20 (*Test of Sharpe ratio*) See Table 4.4 for a test of the Sharpe ratio of the US equity market.

SR	0.12
SR (ann.)	0.43
t-stat	2.91

Table 4.4: SR for the US equity market and its t-stat. Monthly US data 1970:01-2022:12. The annualised SR is $SR\sqrt{12}$

Example 4.21 (*Linear function*) When $f(\beta) = R\beta$, then the Jacobian is $P = R$, just like in (4.12).

Example 4.22 (*Testing a correlation of x_t and y_t*) Suppose you have estimated the variances of (x_t, y_t) and also their covariance. Stack the parameters in the vector $\beta = [\sigma_{xx}, \sigma_{yy}, \sigma_{xy}]'$. The correlation and the Jacobian is then

$$\rho(x, y) = f(\beta) = \frac{\sigma_{xy}}{\sigma_{xx}^{1/2} \sigma_{yy}^{1/2}}, \text{ so } P = \begin{bmatrix} -\frac{1}{2} \frac{\sigma_{xy}}{\sigma_{xx}^{3/2} \sigma_{yy}^{1/2}} & -\frac{1}{2} \frac{\sigma_{xy}}{\sigma_{xx}^{1/2} \sigma_{yy}^{3/2}} & \frac{1}{\sigma_{xx}^{1/2} \sigma_{yy}^{1/2}} \end{bmatrix}.$$

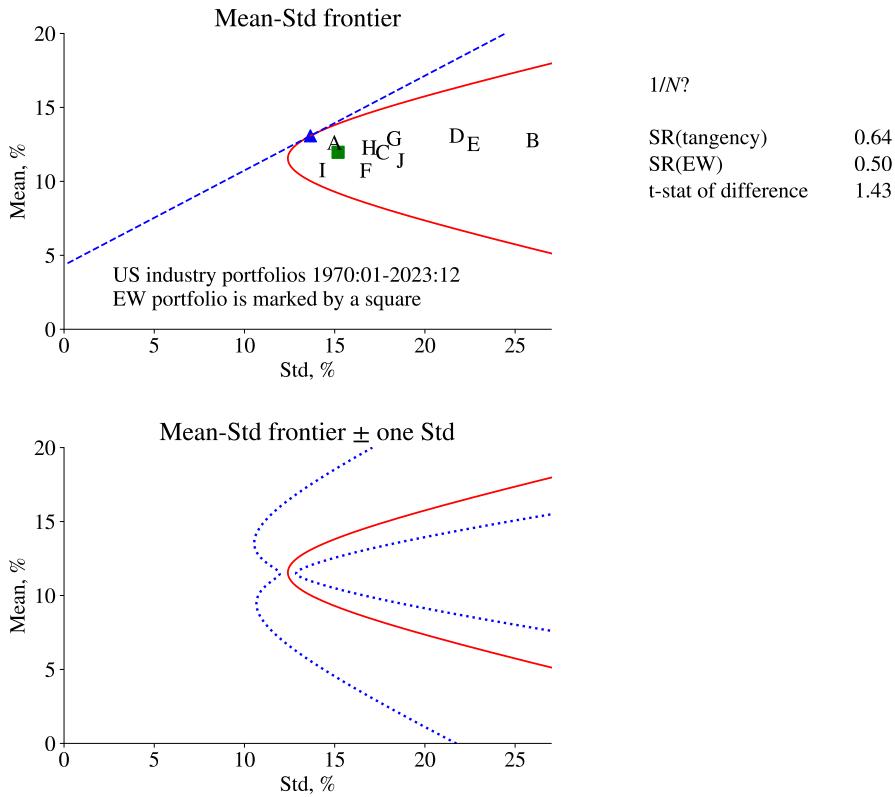


Figure 4.7: Mean-Variance frontier of US industry portfolios. Monthly returns are used in the calculations, but $100\sqrt{12}\text{Variance}$ is plotted against $100 * 12*\text{mean}$.

Delta Method Example: Confidence Bands around a Mean-Variance Frontier

A point on the mean-variance frontier at a given expected return is a non-linear function of the means and the second moment matrix. It is therefore straightforward to apply the delta method to calculate a confidence band around the estimate.

Empirical Example 4.23 (*MVF from industry portfolios*) *Figure 4.7 (lower panel)* shows GMM results. The uncertainty is lowest for the minimum variance portfolio. (This is related to the result that in a normal distribution, the uncertainty about an estimated variance is increasing in the true variance, $\text{Var}(\sqrt{T}\hat{\sigma}^2) = 2\sigma^4$.)

Delta Method Example: Testing the $1/N$ vs the Tangency Portfolio

It has been argued that the (naive) $1/N$ diversification gives a portfolio performance which is not worse than an “optimal” portfolio (see, for instance, DeMiguel, Garlappi, and Uppal (2009)). One way of testing this is to compare the the Sharpe ratios of the tangency and equally weighted portfolios. Both are functions of the first and second moments of

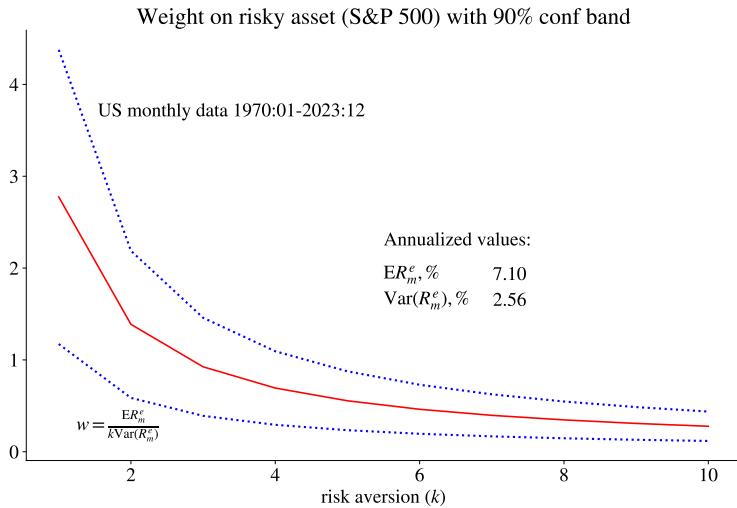


Figure 4.8: Portfolio choice for different risk aversions, with confidence band

the basic assets, so a delta method approach similar to the one for the MV frontier (see above) can be applied. Notice that this approach should incorporate the way (and hence the associated uncertainty) the first and second moments affect the portfolio weights of the tangency portfolio.

Empirical Example 4.24 ($1/N$ vs. the tangency portfolio) See Figure 4.7.

Delta Method Example: Testing the Optimal Portfolio Weight

A mean-variance investor combines the riskfree asset with a mix (the tangency portfolio) of risky assets. The optimal portfolio weight on the latter is $w = E R_m^e / [k \text{Var}(R_m^e)]$, where R_m^e denotes the excess return of the tangency portfolio. If we have estimates and their covariance matrix of $E R_m^e$ and $\text{Var}(R_m^e)$, then it is straightforward to construct a confidence band around w .

Empirical Example 4.25 (Choosing between the riskfree and a single risky asset (S&P 500)) See Figure 4.8.

Proof (Sketch of a proof of (4.25), requiring some asymptotics*) By the mean value theorem we have

$$f(\hat{\beta}) = f(\beta) + \frac{\partial f(\beta^*)}{\partial \beta'} (\hat{\beta} - \beta),$$

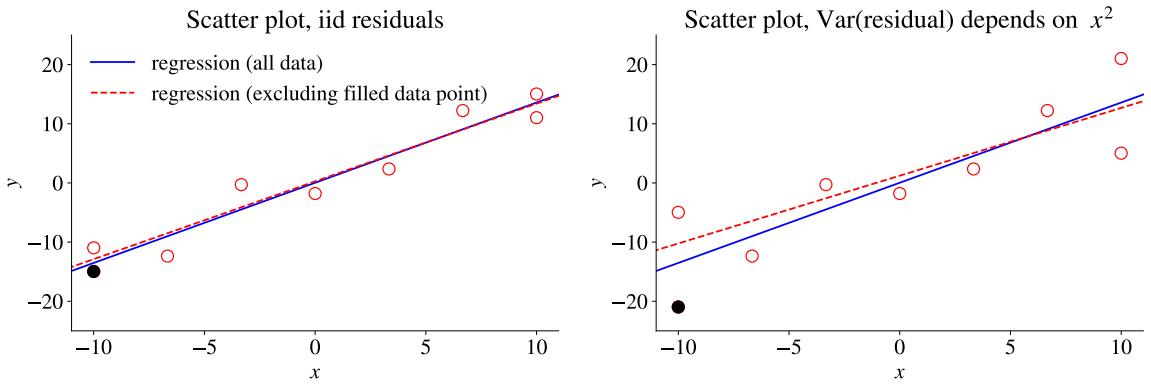


Figure 4.9: Effect of heteroskedasticity on uncertainty about regression line

where the derivatives are evaluated at β^* which is (weakly) between $\hat{\beta}$ and β . Premultiply by \sqrt{T} and rearrange as

$$\sqrt{T}[f(\hat{\beta}) - f(\beta)] = \frac{\partial f(\beta^*)}{\partial \beta'} \sqrt{T}(\hat{\beta} - \beta_0).$$

If $\hat{\beta}$ is consistent ($\text{plim } \hat{\beta} = \beta$) and $\partial f(\beta^*) / \partial \beta'$ is continuous, then (by Slutsky's theorem) the probability limit of the derivatives is $\partial g(\beta) / \partial \beta'$ (that is, evaluated at the true β —and thus a constant). If $\sqrt{T}(\hat{\beta} - \beta_0)$ is asymptotically normally distributed, then (by the continuous mapping theorem) this carries over to the left hand side. \square

4.8 Heteroskedasticity

Suppose we have a regression model

$$y_t = x'_t b + u_t, \text{ where } E u_t = 0 \text{ and } \text{Cov}(x_{it}, u_t) = 0. \quad (4.27)$$

In the standard case we assume that u_t is iid (independently and identically distributed), which rules out variation in the volatility of the residual (heteroskedasticity).

In case the residuals actually are heteroskedastic, least squares (LS) is nevertheless a useful estimator: its consistency is not affected by the heteroskedasticity. However, the standard expression for the standard errors of the coefficients is often not correct. This is illustrated in Table 4.5–4.6, which shows results from simulations. Notice, however, that the simulations suggest that heteroskedasticity that is unrelated to the regressors do not cause any problems with the standard errors, which carries over to the intercept (discussed more in detail below).

To test for heteroskedasticity, we can use *White's test of heteroskedasticity*. The test assumes that the fitted residuals are from consistent estimates (there is little point in testing residuals from false models...) and that the regressors may be stochastic variables.

The null hypothesis is homoskedasticity, and the alternative hypothesis is the kind of heteroskedasticity which can be explained by the levels, squares, and cross products of the regressors—clearly a special form of heteroskedasticity. The reason for this specification is that if the squared residuals are uncorrelated with the squared regressors, then the usual LS covariance matrix applies—even if the residuals have some other sort of heteroskedasticity (see below for a discussion).

To implement White's test, let w_t be a vector of the squares and cross products of the regressors (be sure to have a constant among the regressors). The test is then to run a regression of squared fitted residuals on w_t

$$\hat{u}_t^2 = w_t' \gamma + v_t, \quad (4.28)$$

and to test if all the slope coefficients (not the intercept) in γ are zero. This can be done be using the fact that $TR^2/(1 - R^2) \sim \chi_p^2$, $p = \dim(w_t) - 1$. (Some authors prefer to use TR^2 instead, but the difference is likely to be small.)

There are several versions of White's test: (a) using only the linear terms (also called the Breusch-Pagan test); (b) using only the linear and quadratic terms (not the cross products); (c) using only a subset of the regressors.

Example 4.26 (*White's test*) If the regressors include $(1, x_{1t}, x_{2t})$ then w_t in (4.28) is the vector $(1, x_{1t}, x_{2t}, x_{1t}^2, x_{1t}x_{2t}, x_{2t}^2)$.

Remark 4.27 (**Duplicate variables in w_t . If x_t contains a dummy variable, then its square will be the same. You can still use the same test statistic, but p should be the number of linearly independent variables in w_t minus 1.*)

Empirical Example 4.28 (*Test of heteroskedasticity*) See Tables 4.1 and 4.2.

There are two ways to handle heteroskedasticity in the residuals. First, we could use some other estimation method than LS that incorporates the structure of the heteroskedasticity. For instance, combining the regression model (4.27) with an ARCH structure of the residuals—and estimating the whole thing with maximum likelihood (MLE). As a by-product we get the correct standard errors—provided the assumed distribution (in the

$\alpha :$	$\underline{\gamma = 0}$		$\underline{\gamma = 1}$	
	0	1	0	1
Simulated	7.1	13.4	13.5	19.4
OLS formula	7.0	13.3	13.3	19.2
White's	7.0	13.3	13.3	19.2
Bootstrap	7.1	13.3	13.4	19.2
Bootstrap 2	7.0	13.3	13.3	19.1
Jackknife	7.1	13.4	13.4	19.4
FGLS	7.2	11.6	13.7	18.2

Table 4.5: Standard error of OLS intercept (%) under heteroskedasticity (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t \sim N(0, \sigma_t^2)$, with $\sigma_t^2 = (1 + \gamma|z_t| + \alpha|x_t|)^2$, where z_t is iid $N(0, 1)$ and independent of x_t . Sample length: 200. Number of simulations: 25000. The bootstrap draws pairs (y_s, x_s) with replacement while bootstrap 2 is a wild bootstrap.

likelihood function) is correct. Second, we could stick to OLS, but use another expression for the variance of the coefficients: a heteroskedasticity consistent covariance matrix, among which “White’s covariance matrix” is the most common. (There is also a third possible solution: using GLS, but that is often a non-robust approach.)

To understand the construction of White’s covariance matrix, recall that the variance of $\hat{\beta}$ is found from

$$\hat{\beta} = \beta + S_{xx}^{-1} (x_1 u_1 + x_2 u_2 + \dots x_T u_T), \quad (4.29)$$

where $S_{xx} = \sum_{t=1}^T x_t x_t'$. If we assume that the residuals are uncorrelated with each other, then (with fixed regressors)

$$\begin{aligned} \text{Var}(\hat{\beta}) &= S_{xx}^{-1} (x_1 x_1' \sigma_1^2 + x_2 x_2' \sigma_2^2 + \dots x_T x_T' \sigma_T^2) S_{xx}^{-1} \\ &= S_{xx}^{-1} \underbrace{\sum_{t=1}^T x_t x_t' \sigma_t^2}_S S_{xx}^{-1}. \end{aligned} \quad (4.30)$$

(Notice that S_{xx} and S denote very different things.)

Expression (4.30) cannot be simplified further since σ_t is not constant—and it is related to x_t^2 . The idea of White’s estimator is to estimate S by

$$\hat{S} = \sum_{t=1}^T x_t x_t' \hat{u}_t^2. \quad (4.31)$$

As discussed in earlier chapters, the estimate of the variance-covariance matrix in

$\alpha :$	$\underline{\gamma = 0}$		$\underline{\gamma = 1}$	
	0	1	0	1
Simulated	7.1	19.0	13.5	24.8
OLS formula	7.1	13.3	13.4	19.2
White's	7.0	18.5	13.3	24.3
Bootstrap	7.1	18.5	13.4	24.3
Bootstrap 2	7.0	18.5	13.3	24.3
Jackknife	7.1	18.9	13.5	24.8
FGLS	7.5	17.3	14.0	24.1

Table 4.6: Standard error of OLS slope (%) under heteroskedasticity (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t \sim N(0, \sigma_t^2)$, with $\sigma_t^2 = (1 + \gamma|z_t| + \alpha|x_t|)^2$, where z_t is iid $N(0, 1)$ and independent of x_t . Sample length: 200. Number of simulations: 25000. The bootstrap draws pairs (y_s, x_s) with replacement while bootstrap 2 is a wild bootstrap.

(4.31) can be motivated by either assuming (a) that x_t are fixed regressors or (b) stochastic regressors but applying asymptotic results.

Remark 4.29 (*Matrix form of (4.31)) With x'_t in row t of the $T \times k$ matrix X , $\hat{S} = X' \text{diag}(\hat{u}_t^2)X$, where $\text{diag}(\hat{u}_t^2)$ is a $T \times T$ matrix with \hat{u}_t^2 along the principal diagonal and zeros elsewhere. (This is not an efficient way of calculating the matrix.)

It is straightforward to show that the standard expression for the variance underestimates the true variance when there is a positive relation between x_t^2 and σ_t^2 (and vice versa). The intuition is that much of the precision (low variance of the estimates) of OLS comes from data points with extreme values of the regressors: think of a scatter plot and notice that the slope depends a lot on fitting the data points with very low and very high values of the regressor. This nice property is destroyed if the data points with extreme values of the regressor also have lots of noise (high variance of the residual). See Figure 4.9 and Table 4.6, but see from Table 4.5 that this does not apply to the uncertainty about the intercept.

Remark 4.30 (An interpretation of (4.31)) Irrespective of whether x_t are fixed or stochastic, $x_t \hat{u}_t$ is a k -vector of zero mean variables (OLS is defined by setting $\sum_{t=1}^T x_t \hat{u}_t = 0$). \hat{S} is therefore $T \widehat{\text{Var}}(x_t \hat{u}_t)$, that is, T times the (sample) variance-covariance matrix of the vector $x_t \hat{u}_t$. For instance, with a constant and one more regressor so $x_t = [1, z_t]$, we

get

$$\widehat{\text{Var}}(x_t u_t) = \widehat{\text{Var}} \left(\begin{bmatrix} u_t \\ z_t u_t \end{bmatrix} \right) = \begin{bmatrix} \widehat{\text{Var}}(u_t) & \widehat{\text{Cov}}(u_t, z_t u_t) \\ \widehat{\text{Cov}}(z_t u_t, u_t) & \widehat{\text{Var}}(z_t u_t) \end{bmatrix}.$$

White's covariance matrix should be applied when White's test (4.28) indicates problems, otherwise perhaps not. While White's covariance estimator provides safety against heteroskedasticity, it also comes at a cost: estimating the S matrix as in (4.31) risks introducing more noise.

Remark 4.31 (*Jackknife covariance matrix*) *The jackknife covariance matrix is: (a) reestimate the model T times, each time with one observation excluded (first exclude observation 1, then put it back and instead exclude observation 2,...), to get a $T \times k$ matrix of estimates; (b) calculate the covariance matrix of the k series; (c) multiply the result by $T - 1$. This typically leads to results that are very similar to those from (4.30)–(4.31).*

Remark 4.32 (*Standard OLS vs White's variance**) *For simplicity, consider the case of only one regressor, and consider asymptotic expressions. Recall that $\text{Cov}(x_t^2, \sigma_t^2) = E x_t^2 \sigma_t^2 - E x_t^2 E \sigma_t^2$. It follows that if x_t^2 is not correlated with σ_t^2 , then the S term in (4.30), divided by T , can be thought of as $E \sigma_t^2 E x_t^2$, that is, it involves the average variance, typically estimated as $\sum_{t=1}^T u_t^2 / T$. This is the same as for standard OLS, which applies automatically when the regressor is a constant. See Table 4.5–4.6 for a simulation. In addition, notice that if σ_t^2 and x_t^2 are positively correlated, then $E x_t^2 \sigma_t^2 > E x_t^2 E \sigma_t^2$, which means that the standard OLS expression underestimates S .*

Remark 4.33 (*GLS**) *With heteroskedasticity and/or autocorrelation, OLS is still consistent and we can adjust the covariance matrix of the coefficients. However, OLS is less efficient (higher uncertainty of the coefficients) than GLS (Generalized Least Squares) is. The basic idea of GLS is transform regression equation so*

$$y_t^* = x_t^{*\prime} \beta + \varepsilon_t^*,$$

have iid residuals. Estimating β with LS on this transformation is efficient (called GLS) and the traditional expressions of the covariance matrix of the coefficients can be used. For instance, with heteroskedasticity, the transformation is

$$\frac{y_t}{\sigma_t} = \frac{x_t'}{\sigma_t} \beta + \frac{\varepsilon_t}{\sigma_t}.$$

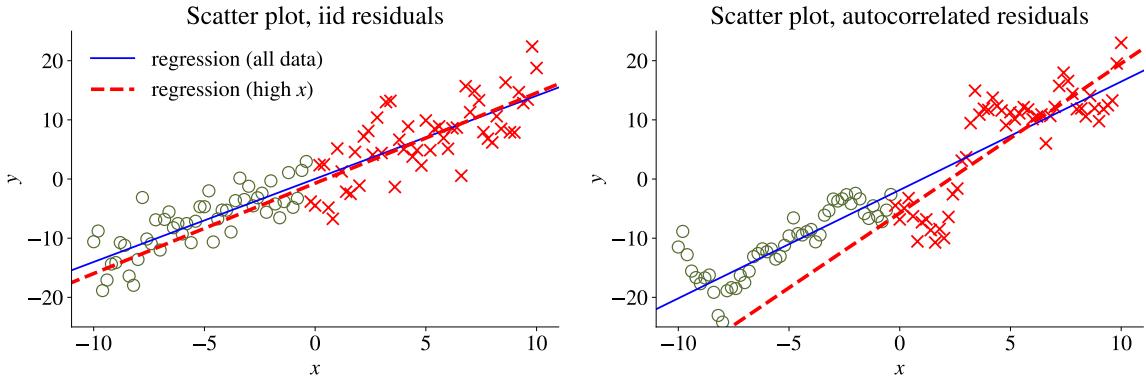


Figure 4.10: Effect of autocorrelation on uncertainty about regression line

(Yes, also the constant is divided by σ_t .) Notice that ε_t/σ_t has a constant variance (equal to one). In practice we don't know σ_t , so we first estimate it (the method is then called "feasible" GLS, FGLS.) FGLS may improve the efficiency, but can be unstable if we model the heteroskedasticity wrongly. A commonly applied approach is the following (a) let $\hat{\varepsilon}_t$ be the residual from the OLS regression; (b) regress $\ln(\hat{\varepsilon}_t^2)$ on the regressors and all the squares (and cross-products of them); (c) let z_t be the fitted values from the regression in (b) and set $\sigma_t = \sqrt{\exp(z_t)}$.

4.9 Autocorrelation

Autocorrelation of the residuals ($\text{Cov}(u_t u_{t-s}) \neq 0$) is also a violation of the iid assumptions underlying the standard expressions for the variance of $\hat{\beta}$. In this case, LS is typically still consistent (exceptions: when the lagged dependent variable is a regressor), but the variances are again wrong.

The typical effect of positively autocorrelated residuals is to increase the uncertainty about the OLS estimates—above what is indicated by the traditional standard errors based on the iid assumption. This is perhaps easiest to understand in the case of estimating the mean of a data series, that is, when regressing a data series on a constant only. If the residual is positively autocorrelated (have long swings), then the sample mean can deviate from the true mean for an extended period of time—perhaps for most of a sample: the estimate is imprecise. See Figure 4.10 for an illustration.

There are several straightforward tests of autocorrelation—all based on using the fitted residuals. The tests all assume that the fitted residuals are from consistent estimates. The

null hypothesis is no autocorrelation. First, estimate the autocorrelations of the fitted residuals as

$$\rho_s = \text{Corr}(\hat{u}_t, \hat{u}_{t-s}), s = 1, \dots, L. \quad (4.32)$$

Second, test autocorrelation s by using the fact that $\sqrt{T}\hat{\rho}_s$ has a standard normal distribution (in large samples)

$$\sqrt{T}\hat{\rho}_s \sim N(0, 1). \quad (4.33)$$

To extend (4.33) to higher-order autocorrelation, use the Box-Pierce test

$$Q_L = T \sum_{s=1}^L \hat{\rho}_s^2 \xrightarrow{d} \chi_L^2. \quad (4.34)$$

Empirical Example 4.34 (Test of autocorrelation) See Tables 4.1 and 4.2.

An alternative for testing the first autocorrelation coefficient is the Durbin-Watson. The test statistic is (approximately)

$$DW \approx 2 - 2\hat{\rho}_1, \quad (4.35)$$

and the null hypothesis is rejected in favour of positive autocorrelation if $DW < 1.5$ or so (depending on sample size and the number of regressors).

These tests can also be applied to *each of the elements in $x_t u_t$* (instead of just u_t), since it is actually autocorrelations of these cross terms that matter most (see the discussion below).

$\rho :$	0.0	0.75
Simulated	5.9	23.1
OLS formula	5.8	8.6
Newey-West	5.7	18.5
VARHAC	5.7	22.2
Bootstrapped	5.5	19.6
FGLS	5.9	23.2

Table 4.7: Standard error of OLS intercept (%) under autocorrelation (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t = \rho\epsilon_{t-1} + \xi_t$, ξ_t is iid $N(0, 1)$. NW uses 10 lags. VARHAC uses 10 lags and a VAR(1). The bootstrap uses blocks of size 20. Sample length: 300. Number of simulations: 25000.

If there is autocorrelation, then we can choose to estimate a fully specified model (including how the autocorrelation is generated) by MLE or we can stick to OLS but apply an

$\rho :$	$\kappa = 0.0$		$\kappa = 0.75$	
	0.0	0.75	0.0	0.75
Simulated	5.8	8.7	3.9	10.8
OLS formula	5.8	8.6	3.9	5.8
Newey-West	5.6	8.3	3.7	9.4
VARHAC	5.6	8.4	3.7	10.3
Bootstrapped	5.8	8.5	3.8	10.1
FGLS	5.8	4.7	3.9	5.8

Table 4.8: Standard error of OLS slope (%) under autocorrelation (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t = \rho\epsilon_{t-1} + \xi_t$, ξ_t is iid $N()$. $x_t = \kappa x_{t-1} + \eta_t$, η_t is iid $N()$. NW uses 10 lags. VARHAC uses 10 lags and a VAR(1). The bootstrap uses blocks of size 20. Sample length: 300. Number of simulations: 25000.

autocorrelation consistent covariance matrix—for instance, the “*Newey-West covariance matrix*”

To understand the Newey-West covariance matrix, notice that the variance of $\text{Var}(\hat{\beta})$ is

$$\text{Var}(\hat{\beta}) = S_{xx}^{-1} \underbrace{\text{Var}(x_1 u_1 + x_2 u_2 + \dots + x_T u_T)}_S S_{xx}^{-1}. \quad (4.36)$$

However, there might be correlation across time periods, so the S matrix ($k \times k$) in the middle needs to account for this.

To understand the Newey-West approach, consider the next example.

Example 4.35 (S with $T = 3$) For simplicity, let $T = 3$, assume fixed regressors and that covariances beyond 1 lag are zero ($\sigma_{13} = \sigma_{31} = 0$) to get

$$S = x_1 x'_1 \sigma_1^2 + x_2 x'_2 \sigma_2^2 + x_3 x'_3 \sigma_3^2 \\ (x_2 x'_1 + x_1 x'_2) \sigma_{1,2} + (x_3 x'_2 + x_2 x'_3) \sigma_{2,3}$$

where each term is a $k \times k$ matrix and $\sigma_{t,t-s} = \text{Cov}(u_t, u_{t-s})$. Replace $\sigma_{t,t-s}$ by $\hat{u}_t \hat{u}_{t-s}$.

The example suggests that, under the assumption of fixed regressors and that all covariances beyond lag are zero, S could be estimated by

$$\hat{S} = \Lambda_0 + (\Lambda_1 + \Lambda'_1), \text{ where } \Lambda_s = \sum_{t=s+1}^T x_t x'_{t-s} \hat{u}_t \hat{u}_{t-s} \quad (4.37)$$

The Newey-West approach extends this to m (instead of 1) lag and also introduces weights on Λ_s that are declining in the lag s . This ensures that the \hat{S} matrix remains

invertible (to show this is somewhat involved). Their approach is

$$\hat{S} = \Lambda_0 + \sum_{s=1}^m \left(1 - \frac{s}{m+1}\right) (\Lambda_s + \Lambda'_s), \text{ where} \quad (4.38)$$

$$\Lambda_s = \sum_{t=s+1}^T x_t x'_{t-s} \hat{u}_t \hat{u}'_{t-s}. \quad (4.39)$$

As for White's variance-covariance matrix, the estimate (4.38)–(4.39) can be motivated by either assuming (a) that x_t are fixed regressors or (b) stochastic regressors but applying asymptotic results.

Example 4.36 (\hat{S} with $m = 2$) The calculations in (4.38)–(4.39) are like

$$\hat{S} = \Lambda_0 + \frac{2}{3}(\Lambda_1 + \Lambda'_1) + \frac{1}{3}(\Lambda_2 + \Lambda'_2), \text{ where}$$

$$\Lambda_0 = x_1 x'_1 u_1 u_1 + x_2 x'_2 u_2 u_2 + \dots$$

$$\Lambda_1 = x_2 x'_1 u_2 u_1 + x_3 x'_2 u_3 u_2 + \dots$$

$$\Lambda_2 = x_3 x'_1 u_3 u_1 + x_4 x'_2 u_4 u_2 + \dots$$

The weights $1 - s/(m+1)$ are close to 1 for small lags (s values), but decline linearly (tent shaped weights) to zero. This suggests that m should be somewhat larger than last lag with significant autocorrelation. However, a common rule of thumb is to use round $m = \text{floor}(0.75T^{1/3})$, where $\text{floor}()$ means rounding down to nearest integer (and alternative rule is $m = \text{floor}(4(T/100)^{2/9})$). Notice that by setting $m = 0$, the result is the same as in White's approach. Hence, Newey-West estimator handles also heteroskedasticity.

The Newey-West approach should be applied when the tests of the residuals indicate autocorrelation, otherwise probably not. The method involves estimating lots of parameters in the S matrix—and this can in itself introduce noise and uncertainty.

It is clear from (4.38)–(4.39) that what really counts is not so much the autocorrelation in u_t in itself, but the autocorrelation of $x_t u_t$. If this is positive, then the standard expression underestimates the true variance of the estimated coefficients (and vice versa). For instance, the autocorrelation of $x_t u_t$ is likely to be positive when both the residual and the regressor are positively autocorrelated. (Notice that a constant, $x_t = 1$ is extremely positively autocorrelated, so autocorrelation of the residual along is enough to cause problems with the intercept.) In contrast, when the regressor has no autocorrelation, then the product does not either. This is illustrated in Tables 4.7–4.8.

Remark 4.37 (An interpretation of (4.39)) Notice that $x_t \hat{u}_t$ is a k -vector of zero mean variables. Therefore, $\Lambda_0 = T \widehat{\text{Var}}(x_t \hat{u}_t)$, where the last term is the (sample) variance-

covariance matrix of the vector $x_t \hat{u}_t$. Similarly, $\Lambda_s = T \widehat{\text{Cov}}(x_t \hat{u}_t, x_{t-s} \hat{u}_{t-s})$, where the last term is the (sample) covariance matrix of the vectors $x_t \hat{u}_t$ and $x_{t-s} \hat{u}_{t-s}$.

Remark 4.38 (*Scaling of S) Equation (4.36) says that $S = \text{Var}(\sum_{t=1}^T g_t)$, where $g_t = x_t u_t$. Therefore, $S/T = \text{Var}(\sqrt{T} \bar{g})$ (which equals $\text{Var}(g_t)$ in case g_t is iid) and $S/T^2 = \text{Var}(\bar{g})$, where \bar{g} is the time average ($\sum_{t=1}^T g_t / T$).

Remark 4.39 (Hansen-Hodrick) The Hansen-Hodrick approach instead uses flat weights, that is, disregards the $s/(m+1)$ term in 4.38. This is appropriate when we know that the autocorrelation structure is of MA style, for instance, with overlapping returns (daily data on weekly returns, say).

Remark 4.40 (VARHAC*) The VARHAC estimator of the covariance matrix (see Andrews and Monahan (1992)) is to first fit a VAR(p) to $z_t = x_t \hat{u}_t$

$$z_t = A_0 + \sum_{i=1}^p A_i z_{t-i} + \varepsilon_t$$

and then calculate $D = I - \sum_{i=1}^p A_i$. Then, $\hat{S} = D^{-1} \hat{S}^\varepsilon D^{-1}$, where \hat{S}^ε is Newey-West estimate applied to $\hat{\varepsilon}_t$ only (use $\hat{\varepsilon}_t$ instead of $x_t \hat{u}_t$ in (4.38)).

Empirical Example 4.41 (Autocorrelation from overlapping return periods) Figures 4.11 – 4.12 are empirical examples of the importance of using the Newey-West method rather than relying of the iid assumptions. In both cases, the residuals have strong positive autocorrelation.

Remark 4.42 (GLS*) With first-order autocorrelation, ($\varepsilon_t = \rho \varepsilon_{t-1} + v_t$, where v_t is iid), we can implement FGLS by doing a “quasi-difference” of the regression equation

$$y_t - \rho y_{t-1} = (x_t - \rho x_{t-1})' \beta + (\varepsilon_t - \rho \varepsilon_{t-1}).$$

This new residual, $\varepsilon_t - \rho \varepsilon_{t-1}$, is iid. In practice we don't know ρ , so we first estimate it.

4.10 Cross-Sectional Correlations (“Clustering”)

In cross-sectional regressions, it is often found that there are clusters of observations that have correlated residuals (for instance, firms within a sector). This has an effect that is similar to the autocorrelation discussed before, except that we now have to be

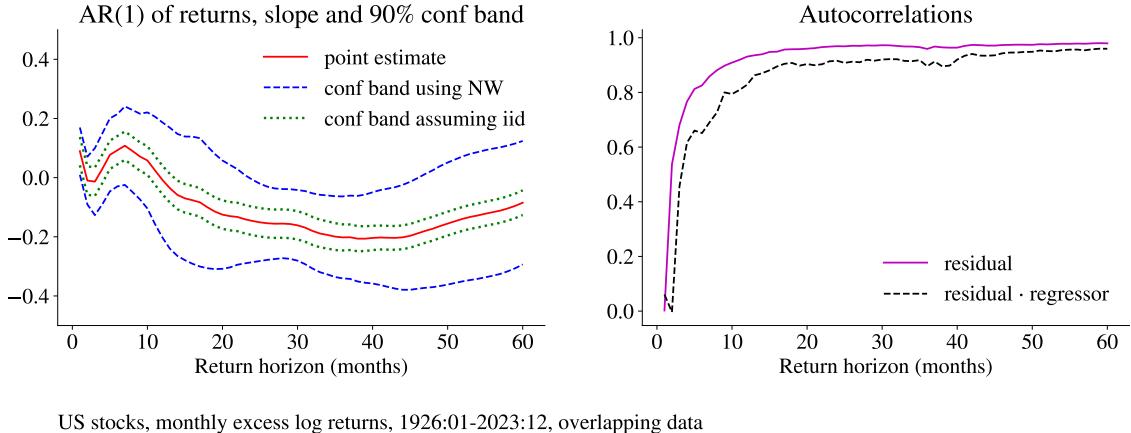


Figure 4.11: Slope coefficient, LS vs Newey-West standard errors

more explicit with indicating which observations that might be correlated and which not. (In a cross-sectional regression, the ordering of observations typically has no particular meaning.)

We again have to estimate the S matrix in (4.36), but this time by defining C different “clusters” within which data can be correlated (we have to know which cross-sectional units i that belong to which cluster). We thus assume that there is no correlation across clusters.

Following the usual convention, we use i (instead of t) to indicate an observation and let there be N (not T) observations. We will also introduce the notation g^c for the sum of $x_i u_i$ inside cluster c . We can then write ,

$$\sum_{i=1}^N x_i u_i = \sum_{c=1}^C g^c, \text{ where } g^c = \sum_{i \in \text{cluster } c} x_i u_i. \quad (4.40)$$

Since there is no correlation across clusters, the S matrix in (4.36) can be written

$$S = \text{Var}(\sum_{i=1}^N x_i u_i) = \sum_{c=1}^C \text{Var}(g^c). \quad (4.41)$$

Example 4.43 (*Cluster method on $N = 4$*) To save space, let $g_i = x_i u_i$ be a scalar and let $v()$ denote a variance and $\gamma(,)$ a covariance. Assume that individuals 1 and 2 form cluster 1 and that individuals 3 and 4 form cluster 2—and disregard correlations across

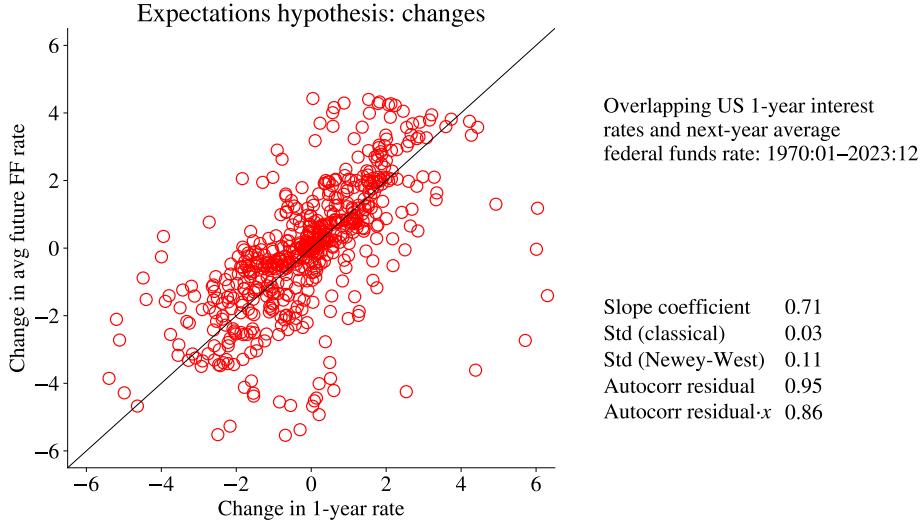


Figure 4.12: US 12-month interest and average federal funds rate (next 12 months)

clusters. This means setting the covariances across clusters to zero

$$\begin{aligned} \text{Var}(\sum_{i=1}^N g_i) &= v(g_1) + v(g_2) + v(g_3) + v(g_4) \\ &\quad + 2\gamma(g_1, g_2) + \underbrace{2\gamma(g_1, g_3)}_0 + \underbrace{2\gamma(g_1, g_4)}_0 + \underbrace{2\gamma(g_2, g_3)}_0 + \underbrace{2\gamma(g_2, g_4)}_0 + 2\gamma(g_3, g_4). \end{aligned}$$

(In case g_i is a vector, $2\gamma(g_1, g_2)$ should be replaced by $\gamma(g_1, g_2) + \gamma(g_2, g_1)$.) Rewrite to get S

$$S = \text{Var}(g_1 + g_2) + \text{Var}(g_3 + g_4).$$

Notice that $\text{Var}(g_1 + g_2)$ can be estimated by $(g_1 + g_2)^2$ since the latter equals $g_1^2 + g_2^2 + 2g_1g_2$ which provides a (rough) estimate of $v(g_1) + v(g_2) + 2\gamma(g_1, g_2)$.

We can estimate S in (4.36) as

$$\hat{S} = \sum_{c=1}^C g^c (g^c)' . \quad (4.42)$$

In this approach, $g^c (g^c)'$ can be thought of as a (crude) estimate of $\text{Var}(g^c)$ since g_i are zero mean variables (see Example 4.43). Summing across clusters creates an estimate of S . It is often argued that scaling \hat{S} by $C/(C - 1)$ improves the small properties.

The iid case is when each i is her/his own cluster. In contrast, we cannot allow everyone to be in the same cluster, since this would give $g^c = 0$.

Example 4.44 (*Importance of correlations*) For simplicity, let g_i be a scalar, assume an equal number of members in each cluster (N/C) and that the correlation within a cluster is ρ . It is then straightforward to show that $\text{Var}(\bar{g}) = [1 + \rho(N/C - 1)]\sigma^2/N$. This is the same as with iid data but with an effective sample size of $N^* = N/[1 + \rho(N/C - 1)]$ instead of N . For instance, with $(N, C, \sigma^2) = (500, 10, 100)$

ρ	$\text{Var}(\bar{g})$	<i>Effective sample size</i>
0	0.2	500
0.1	1.2	85
0.25	2.6	38

Remark 4.45 (*Jackknife covariance matrix with clustering*) The jackknife covariance matrix is similar to that in Remark 4.31, except that we now (1) exclude one cluster (not observation) each time to get a $G \times k$, matrix of estimates; (b) calculate the covariance matrix of the K series; (c) multiply the result by $G - 1$.

Chapter 5

A System of OLS Regressions

Reference: Wooldridge (2010) 7.3; Greene (2018) 10

5.1 A System of Two OLS Regressions

Consider regressions for two different dependent variables (y_{1t} and y_{2t} , for instance, the returns on two different assets) on the same set of regressors (x_t)

$$y_{1t} = x_t' \beta_1 + u_{1t} \quad (5.1)$$

$$y_{2t} = x_t' \beta_2 + u_{2t}, \quad (5.2)$$

where β_1 is the vector of regression coefficients for y_{1t} and β_2 for y_{2t} . (When the regressors are the same, this is often called SURE, Seemingly Unrelated Regression Equations.)

It is straightforward to show (see below) that if the *residuals are iid and independent of all regressors* but we allow for $\text{Cov}(u_{1t}, u_{2t}) \neq 0$, then

$$\text{Var} \left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} \right) = \begin{bmatrix} \sigma_{11} S_{xx}^{-1} & \sigma_{12} S_{xx}^{-1} \\ \sigma_{21} S_{xx}^{-1} & \sigma_{22} S_{xx}^{-1} \end{bmatrix}, \quad (5.3)$$

where $\sigma_{ij} = \text{Cov}(u_{it}, u_{jt})$ and where $S_{xx} = \sum_{t=1}^T x_t x_t'$.

Remark 5.1 (Background to (5.3)) As discussed in earlier chapters, the variance-covariance matrix (5.3) can be motivated by either (a) assuming that x_t are fixed regressors or (b) as an estimate of the variance-covariance matrix motivated by asymptotic results.

More generally, when the residuals are heteroskedastic or autocorrelated,

$$\text{Var} \left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} \right) = \begin{bmatrix} S_{xx}^{-1} & \mathbf{0} \\ \mathbf{0} & S_{xx}^{-1} \end{bmatrix} \Omega \begin{bmatrix} S_{xx}^{-1} & \mathbf{0} \\ \mathbf{0} & S_{xx}^{-1} \end{bmatrix}, \text{ where} \quad (5.4)$$

$$\Omega = \text{Var} \left(\sum_{t=1}^T \begin{bmatrix} x_t u_{1t} \\ x_t u_{2t} \end{bmatrix} \right). \quad (5.5)$$

The Ω matrix (which is $2k \times 2k$ if there are k regressors in x_t) could be estimated with the methods of White or Newey-West.

Remark 5.2 (*Estimating Ω*) To estimate Ω in (5.5), create an $T \times 2k$ matrix. Let first k columns of row t be $u_{1t}x'_t$ and the next k columns be $u_{2t}x'_t$. Then apply, for instance, the methods of White or Newey-West to these $2k$ time series.

Once we have the variance-covariance matrix in (5.4), it is straightforward to test across equations, for instance, that the slope coefficients on a regressor are the same in all regressions or that all intercepts are zero.

Example 5.3 (*Testing the intercepts*) Suppose there are only two regressors and that the first one is the constant. Then, the intercepts (here called α) are picked out by

$$\hat{\alpha} = R \begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} \text{ where } R = \begin{bmatrix} 1 & 0 & 0 & 0 \\ 0 & 0 & 1 & 0 \end{bmatrix}$$

and their variance-covariance matrix is

$$\text{Var}(\hat{\alpha}) = R \text{Var} \left(\begin{bmatrix} \hat{\beta}_1 \\ \hat{\beta}_2 \end{bmatrix} \right) R'.$$

We can then test all the intercepts by a Wald test, $\hat{\alpha} \text{Var}(\hat{\alpha})^{-1} \hat{\alpha}$ which has a χ^2_2 distribution.

Extensions to more than two regression equations are straightforward (and discussed below).

Proof (of (5.3)–(5.5)) Similarly to the single-equation OLS, we can write

$$\begin{aligned} \hat{\beta}_1 &= \beta_1 + S_{xx}^{-1} \sum_{t=1}^T x_t u_{1t} \\ \hat{\beta}_2 &= \beta_2 + S_{xx}^{-1} \sum_{t=1}^T x_t u_{2t} \end{aligned}$$

The variance (matrix) of $\hat{\beta}_1$ or of $\hat{\beta}_2$ follows the same pattern as for single-equation OLS. In contrast, the covariance (matrix) is

$$\text{Cov}(\hat{\beta}_1, \hat{\beta}_2) = S_{xx}^{-1} \text{Cov}(\sum_{t=1}^T x_t u_{1t}, \sum_{t=1}^T x_t u_{2t}) S_{xx}^{-1}.$$

Together, this gives (5.4)–(5.5). If the residuals are iid and independent of the regressors, then $\text{Cov}(\hat{\beta}_1, \hat{\beta}_2)$ simplifies to $\sigma_{12} S_{xx}^{-1}$ which gives (5.3). \square

5.2 A System of n OLS Regressions

Remark 5.4 (*Kronecker product*) Let \otimes denote the Kronecker product, that is, if A and B are matrices, then

$$A \otimes B = \begin{bmatrix} a_{11}B & \cdots & a_{1n}B \\ \vdots & & \vdots \\ a_{m1}B & \cdots & a_{mn}B \end{bmatrix}.$$

For instance, with

$$A = \begin{bmatrix} 1 & 3 \\ 2 & 4 \end{bmatrix} \text{ and } B = \begin{bmatrix} 10 & 11 \end{bmatrix}, \text{ we get } A \otimes B = \begin{bmatrix} 10 & 11 & 30 & 33 \\ 20 & 22 & 40 & 44 \end{bmatrix}.$$

Let $\hat{\beta}$ be the vector with $\hat{\beta}_1, \hat{\beta}_2, \dots, \hat{\beta}_n$ stacked (equation 1 first, then equation 2, etc).

With iid residuals the variance-covariance matrix (instead of (5.3)) is

$$\text{Var}(\hat{\beta}) = \Sigma \otimes S_{xx}^{-1}, \quad (5.6)$$

where $\Sigma = \text{Var}(u_t)$ is the $n \times n$ variance-covariance matrix of the n residuals.

Similarly, with non-iid residuals we get (instead of (5.4))

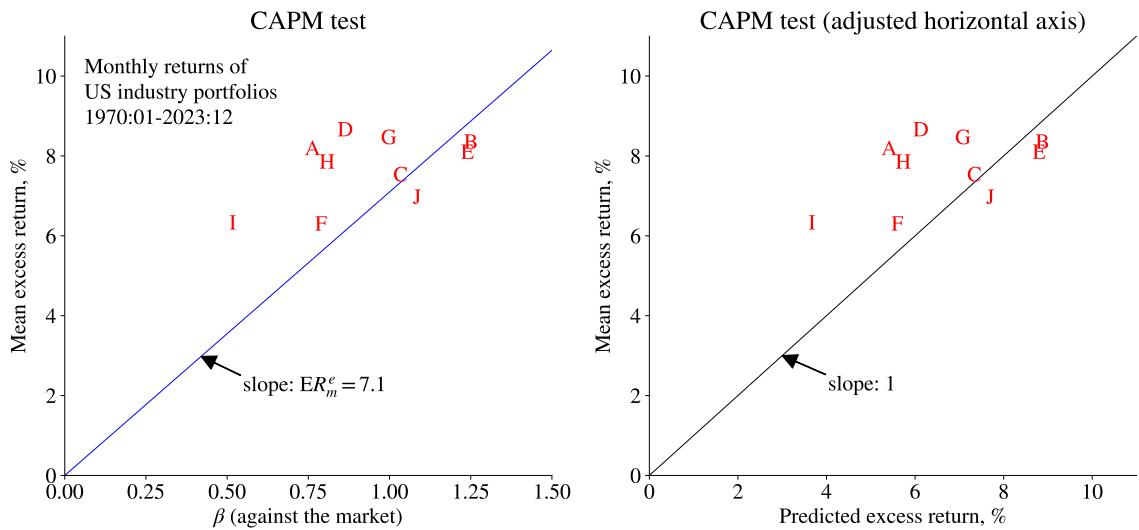
$$\text{Var}(\hat{\beta}) = (I_n \otimes S_{xx}^{-1}) \Omega (I_n \otimes S_{xx}^{-1}), \quad (5.7)$$

where I_n is the $n \times n$ identity matrix. Let u_t be the vector of the n residuals in period t ($u_{1t}, u_{2t}, \dots, u_{nt}$). Then, Ω is (instead of (5.5))

$$\Omega = \text{Var}\left(\sum_{t=1}^T u_t \otimes x_t\right), \quad (5.8)$$

which is an $nk \times nk$ matrix which can be estimated by the methods of White or Newey-West. In practice (with stochastic regressors), we estimate (5.7) by plugging in $S_{xx} = \sum_{t=1}^T x_t x_t'$ and an estimate of Ω .

Remark 5.5 (*Estimating Ω and calculating $I_n \otimes S_{xx}^{-1}$*) To estimate Ω in (5.8), create an $T \times nk$ matrix. Let first k columns of row t be $u_{1t} x_t'$, the second k columns be $u_{2t} x_t'$. Then apply, for instance, Newey-West to these nk time series. Also notice that $I_n \otimes S_{xx}^{-1}$ in (5.7) gives a block-diagonal matrix of the same structure as in (5.4). A Kronecker product is convenient for this, but there are also other methods of creating the block-diagonal matrix.



	α (ann.)	t -stat	σ (ann.)
A (NoDur)	2.73	2.29	8.71
B (Durbl)	-0.57	-0.25	16.72
C (Manuf)	0.15	0.17	6.38
D (Enrgy)	2.49	1.07	16.87
E (HiTec)	-0.75	-0.49	11.19
F (Telcm)	0.66	0.44	10.95
G (Shops)	1.34	1.08	9.03
H (Hlth)	2.08	1.38	10.95
I (Utils)	2.61	1.63	11.69
J (Other)	-0.77	-0.81	6.97

$$\text{CAPM: } R_i^e = \alpha_i + \beta_i R_m^e + e_i$$

$$\text{Predicted excess return: } \beta_i E R_m^e$$

10% crit. value (Bonferroni): 2.58

Test if all $\alpha_i = 0$:

Wald stat 11.20

5% crit val 18.31

p-value 0.34

Figure 5.1: CAPM regressions on US industry indices

Empirical Example 5.6 (CAPM on industry portfolios) Figure 5.1 shows results for the intercepts from regressing US industry portfolios on the market. The joint test is for whether all intercepts are zero.

Chapter 6

Testing CAPM and Multifactor Models

Reference: Elton, Gruber, Brown, and Goetzmann (2010) 15

6.1 Market Model

Let $R_{it}^e = R_{it} - R_{ft}$ be the excess return on asset i in excess over the riskfree asset, and let R_{mt}^e be the excess return on the market portfolio. The basic implication of CAPM is that the expected excess return of an asset ($E R_{it}^e$) is linearly related to the expected excess return on the market portfolio ($E R_{mt}^e$) according to

$$E R_{it}^e = \beta_i E R_{mt}^e, \text{ where } \beta_i = \frac{\text{Cov}(R_i, R_m)}{\text{Var}(R_m)}. \quad (6.1)$$

To test this, consider the regression

$$\begin{aligned} R_{it}^e &= \alpha_i + b_i R_{mt}^e + \varepsilon_{it}, \text{ where} \\ E \varepsilon_{it} &= 0 \text{ and } \text{Cov}(R_{mt}^e, \varepsilon_{it}) = 0. \end{aligned} \quad (6.2)$$

The two last conditions are automatically imposed by LS. Take expectations of the regression (assuming we know the coefficients) to get

$$E R_{it}^e = \alpha_i + b_i E R_{mt}^e. \quad (6.3)$$

Notice that the LS estimate of b_i is the sample analogue to β_i in (6.1). It is then clear that CAPM implies that the intercept (α_i) of the regression should be zero, which is also what empirical tests of CAPM focus on.

This test of CAPM can be given two interpretations. If we assume that R_{mt} is the correct benchmark (the tangency portfolio for which (6.1) is true by definition), then it

is a test of whether asset R_{it} is correctly priced. This is typically the perspective in performance analysis of mutual funds. Alternatively, if we assume that R_{it} is correctly priced, then it is a test of the mean-variance efficiency of R_{mt} . That is, we test if the market portfolio is the correct “pricing factor” of all the test assets. This is the perspective of CAPM tests.

The test of the null hypothesis that $\alpha_i = 0$ uses the fact that, under fairly mild conditions, the t-statistic has an asymptotically normal distribution, that is

$$\frac{\hat{\alpha}_i}{\text{Std}(\hat{\alpha}_i)} \xrightarrow{d} N(0, 1) \text{ under } H_0 : \alpha_i = 0. \quad (6.4)$$

We get $\text{Std}(\hat{\alpha}_i)$ from the OLS regression (possibly with an adjustment due to autocorrelation and/or heteroskedasticity). Note that this is the distribution under the null hypothesis that the true value of the intercept is zero, that is, that CAPM is correct.

The test assets are typically portfolios of firms with similar characteristics, for instance, small size or having their main operations in the retail industry. There are two main reasons for testing the model on such portfolios: individual stocks are extremely volatile and firms can change substantially over time (so the beta changes), whereas the portfolios can be constructed to represent fairly constant characteristics. For instance, a portfolio of small firms could include the firms in the lowest size decile over the previous year (and thus being rebalanced annually). Moreover, it is of interest to see how the deviations from CAPM are related to firm characteristics (size, industry, etc), since that can possibly suggest how the model needs to be changed.

The empirical results from such tests vary with the test assets used. For US portfolios, CAPM seems to work reasonably well for some types of portfolios (for instance, portfolios based on firm size or industry), but much worse for other types of portfolios (for instance, portfolios based on firm dividend yield or book value/market value ratio).

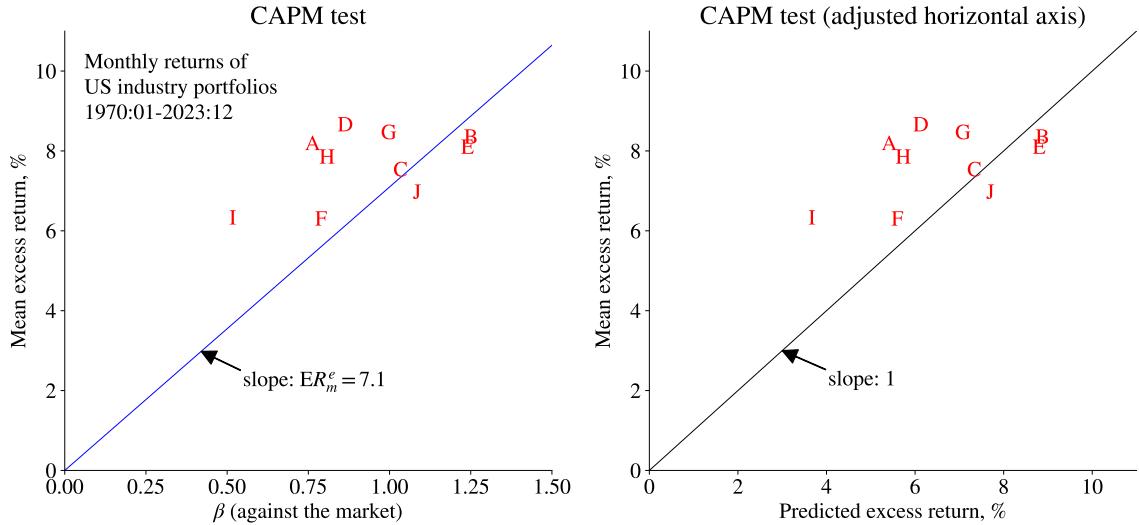
Empirical Example 6.1 (CAPM on industry portfolios) *Figure 6.1 shows results for US industry portfolios.*

In Figure 6.1, the results are presented in two different ways:

	<u>horizontal axis</u>	<u>vertical axis</u>
1 : β_i	\bar{R}_{it}^e	
2 : $\beta_i \bar{R}_{mt}^e$	\bar{R}_{it}^e	

(6.5)

where \bar{R}_{it}^e is the (time series) average excess return of asset i . In the first approach,



	α (ann.)	t-stat	σ (ann.)
A (NoDur)	2.73	2.29	8.71
B (Durbl)	-0.57	-0.25	16.72
C (Manuf)	0.15	0.17	6.38
D (Enrgy)	2.49	1.07	16.87
E (HiTec)	-0.75	-0.49	11.19
F (Telcm)	0.66	0.44	10.95
G (Shops)	1.34	1.08	9.03
H (Hlth)	2.08	1.38	10.95
I (Utils)	2.61	1.63	11.69
J (Other)	-0.77	-0.81	6.97

$$\text{CAPM: } R_i^e = \alpha_i + \beta_i R_m^e + e_i$$

$$\text{Predicted excess return: } \beta_i R_m^e$$

10% crit. value (Bonferroni): 2.58

Test if all $\alpha_i = 0$:

Wald stat 11.20

5% crit val 18.31

p-value 0.34

Figure 6.1: CAPM regressions on US industry indices

CAPM says that all data points (different assets, i) should cluster around a straight line with a slope equal to the average market excess return, \bar{R}_{mt}^e . In the second approach, CAPM says that all data points should cluster around a line with a slope of one. In either case, the vertical distance to the line is α_i (which should be zero according to CAPM).

6.1.1 Econometric Properties of the CAPM Test

A common finding from Monte Carlo simulations is that these tests tend to reject a true null hypothesis too often when the critical values from the asymptotic distribution are used. The practical consequence is that we should either use adjusted critical values (from Monte Carlo or bootstrap simulations)—or more pragmatically, that we should only believe in strong rejections of the null hypothesis.

It is typically found that these tests require a substantial deviation from CAPM and/or

a long sample to get good power. The basic reason for this is that asset returns are very volatile. For instance, suppose that the standard OLS assumptions (iid residuals that are independent of the market return) are correct. Then, it is straightforward to show that the variance of Jensen's alpha is

$$\text{Var}(\hat{\alpha}_i) = [1 + (SR_m)^2]\sigma^2/T, \quad (6.6)$$

where σ^2 is the variance of the residual in (6.2) and SR_m is the Sharpe ratio of the market portfolio. We see that the uncertainty about the alpha is high when the residual is volatile and when the sample is short, but also when the Sharpe ratio of the market is high. Note that a large market Sharpe ratio means that the market asks for a high compensation for taking on risk. A lot of uncertainty about how risky asset i is then translates in a large uncertainty about what the risk-adjusted return should be.

Example 6.2 Suppose we have monthly data with $\hat{\alpha}_i = 0.2\%$ (that is, $0.2\% \times 12 = 2.4\%$ per year), $\sigma = 3\%$ (that is, $3\% \times \sqrt{12} \approx 10\%$ per year) and a market Sharpe ratio of 0.15 (that is, $0.15 \times \sqrt{12} \approx 0.5$ per year). (This corresponds well to US CAPM regressions for industry portfolios, see Figure 6.1.) A significance level of 10% requires a t -statistic (6.4) of at least 1.64, so

$$\frac{0.2}{\sqrt{1 + 0.15^2}3/\sqrt{T}} \geq 1.64 \text{ or } T \geq 626.$$

We need a sample of at least 626 months (52 years)! With a sample of only 26 years (312 months), the alpha needs to be almost 0.3% per month (3.6% per year) or the standard deviation of the residual just 2% (7% per year). Notice that accumulating a 0.3% return over 25 years means almost 2.5 times the initial value.

Proof (*Proof of (6.6)) Consider the regression equation $y_t = x'_t b + \varepsilon_t$. With iid errors that are independent of all regressors (also across observations), the LS estimator, \hat{b}_{LS} , is asymptotically distributed as

$$\sqrt{T}(\hat{b}_{LS} - b) \xrightarrow{d} N(\mathbf{0}, \sigma^2 \Sigma_{xx}^{-1}), \text{ where } \sigma^2 = \text{Var}(\varepsilon_t) \text{ and } \Sigma_{xx} = \text{plim} \sum_{t=1}^T x_t x'_t / T.$$

When the regressors are just a constant (equal to one) and one variable regressor, f_t , so $x_t = [1, f_t]'$, then we have

$$\begin{aligned} \Sigma_{xx} &= E \sum_{t=1}^T x_t x'_t / T = E \frac{1}{T} \sum_{t=1}^T \begin{bmatrix} 1 & f_t \\ f_t & f_t^2 \end{bmatrix} = \begin{bmatrix} 1 & E f_t \\ E f_t & E f_t^2 \end{bmatrix}, \text{ so} \\ \sigma^2 \Sigma_{xx}^{-1} &= \frac{\sigma^2}{E f_t^2 - (E f_t)^2} \begin{bmatrix} E f_t^2 & -E f_t \\ -E f_t & 1 \end{bmatrix} = \frac{\sigma^2}{\text{Var}(f_t)} \begin{bmatrix} \text{Var}(f_t) + (E f_t)^2 & -E f_t \\ -E f_t & 1 \end{bmatrix}. \end{aligned}$$

(In the last line we use $\text{Var}(f_t) = E f_t^2 - (E f_t)^2$.) The upper left element says $\text{Var}(\sqrt{T}\hat{\alpha}) = \{1 + [E f_t / \text{Std}(f)]^2\}\sigma^2$, which is (6.6). \square

6.1.2 Interpretation of the CAPM Test

Instead of a t-test, we can use the equivalent chi-square test

$$(t\text{-stat})^2 = \frac{\hat{\alpha}_i^2}{\text{Var}(\hat{\alpha}_i)} \xrightarrow{d} \chi_1^2 \text{ under } H_0: \alpha_i = 0. \quad (6.7)$$

It is quite straightforward to use the properties of minimum-variance frontiers (see Gibbons, Ross, and Shanken (1989), and also MacKinlay (1995)) to show that the test statistic in (6.7) can be written

$$\frac{\hat{\alpha}_i^2}{\text{Var}(\hat{\alpha}_i)} = \frac{(SR_c)^2 - (SR_m)^2}{[1 + (SR_m)^2]/T}, \quad (6.8)$$

where SR_m is the Sharpe ratio of the market portfolio and SR_c is the Sharpe ratio of the tangency portfolio when investment in both the market return and asset i is possible. (Recall that the tangency portfolio is the portfolio with the highest possible Sharpe ratio.) If the market portfolio has the same (squared) Sharpe ratio as the tangency portfolio of the mean-variance frontier of R_{it} and R_{mt} (so the market portfolio is mean-variance efficient also when we take R_{it} into account) then the test statistic, $\hat{\alpha}_i^2 / \text{Var}(\hat{\alpha}_i)$, is zero—and CAPM is not rejected.

Proof (*Proof of (6.8)) From the CAPM regression (6.2) we have

$$\text{Var} \begin{pmatrix} R_{it}^e \\ R_{mt}^e \end{pmatrix} = \begin{bmatrix} \beta_i^2 \sigma_m^2 + \text{Var}(\varepsilon_{it}) & \beta_i \sigma_m^2 \\ \beta_i \sigma_m^2 & \sigma_m^2 \end{bmatrix}, \text{ and } \begin{bmatrix} \mu_i^e \\ \mu_m^e \end{bmatrix} = \begin{bmatrix} \alpha_i + \beta_i \mu_m^e \\ \mu_m^e \end{bmatrix}.$$

Suppose we use this information to construct a mean-variance frontier for both R_{it} and R_{mt} , and we find the tangency portfolio, with excess return R_{ct}^e . It is straightforward to show that the square of the Sharpe ratio of the tangency portfolio is $\mu^e' \Sigma^{-1} \mu^e$, where μ^e is the vector of expected excess returns and Σ is the covariance matrix. By using the covariance matrix and mean vector above, we get that the squared Sharpe ratio for the tangency portfolio, $\mu^e' \Sigma^{-1} \mu^e$, (using both R_{it} and R_{mt}) is

$$\left(\frac{\mu_c^e}{\sigma_c} \right)^2 = \frac{\alpha_i^2}{\text{Var}(\varepsilon_{it})} + \left(\frac{\mu_m^e}{\sigma_m} \right)^2,$$

which we can write as

$$(SR_c)^2 = \frac{\alpha_i^2}{\text{Var}(\varepsilon_{it})} + (SR_m)^2.$$

Combine this with (6.6) which shows that $\text{Var}(\hat{\alpha}_i) = [1 + (SR_m)^2] \text{Var}(\varepsilon_{it})/T$. \square

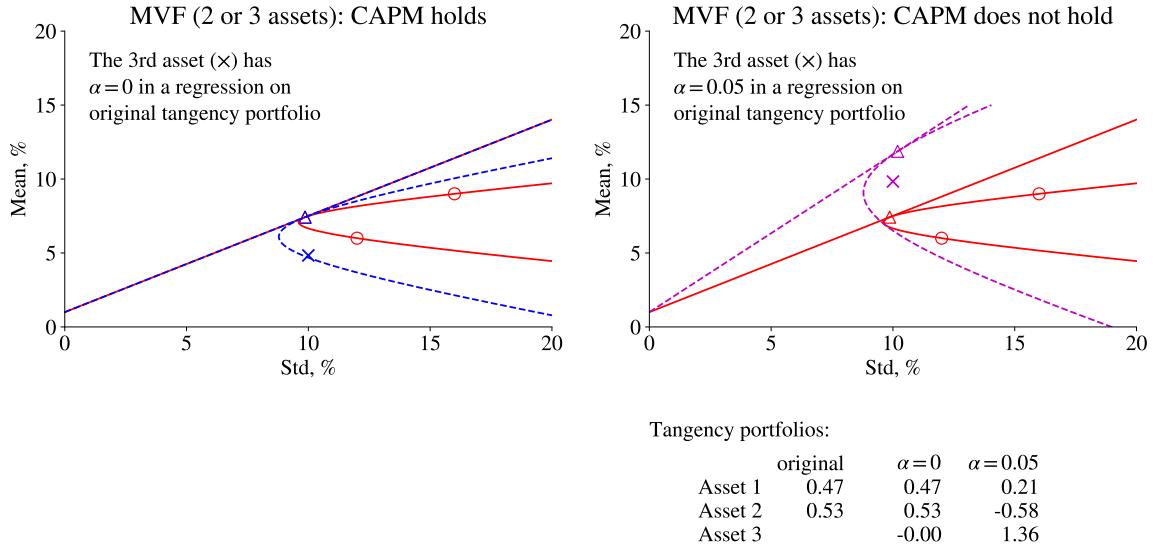


Figure 6.2: Effect on MV frontier of adding assets

This is illustrated in Figure 6.2 which shows the effect of adding an asset to the investment opportunity set. The basic point is that testing the alphas is the same as testing if the new assets move the location of the tangency portfolio. In general, we would expect that adding an asset to the investment opportunity set would expand the mean-variance frontier (and it does) and that the tangency portfolio changes accordingly. However, the tangency portfolio is not changed by adding an asset with a zero alpha (intercept). The intuition is that such an asset has neutral performance compared to the market portfolio (obeys the beta representation), so investors should stick to the market portfolio.

6.1.3 Several Assets

In most cases, there are several (n) test assets, and we actually want to test if all the α_i (for $i = 1, 2, \dots, n$) are zero (otherwise CAPM is not correct). Ideally we then want to take into account the correlation of the different alphas. Such a system based approach is discussed in an other chapter.

Alternatively, we can apply a Bonferroni correction of the individual t-stats: reject CAPM at the 10% significance level only if the largest t-stat (in absolute terms) exceeds the critical value at the $0.10/n$ significance level. For instance, with $n = 25$, the critical value from a standard normal distribution would be 2.88 instead of 1.64.

Alternatively, we estimate all CAPM regressions as a system (“SURE”) and test the

	1	2	3	4	5
1	-3.39	0.07	0.57	2.34	2.60
2	-2.24	0.72	1.70	2.50	2.02
3	-2.00	1.58	1.36	2.47	2.40
4	-0.65	0.56	1.47	2.08	1.64
5	0.13	1.22	1.34	0.09	0.96

Table 6.1: t-stats for α in CAPM, 25 FF portfolios 1970:01-2023:12. NW uses 1 lag. The Bonferroni adjusted 10% and 5% critical values are 2.88 and 3.09.

joint hypothesis that all alphas are zero. (See the chapter on system estimation for more details.)

A quite different approach to study a cross-section of assets is to first estimate CAPM regressions (6.2) for each of the assets ($i = 1, 2, \dots, n$) and then the following cross-sectional regression

$$\bar{R}_i^e = \gamma + \lambda \hat{\beta}_i + u_i, \quad (6.9)$$

where \bar{R}_i^e is the (sample) average excess return on asset i . Notice that the estimated betas are used as regressors and that there are as many data points as there are assets (n).

There are severe econometric problems with this regression equation since the regressor ($\hat{\beta}_i$) contains measurement errors (it is only an uncertain estimate), which typically tends to bias the slope coefficient (λ) towards zero. To get the intuition for this bias, consider an extremely noisy measurement of the regressor: it would be virtually uncorrelated with the dependent variable (noise isn't correlated with anything), so the estimated slope coefficient would be close to zero.

If we could overcome this bias (and we can by being careful), then the testable implications of CAPM is that $\gamma = 0$ and that λ equals the average market excess return. We also want (6.9) to have a high R^2 —since it should be unity in a very large sample (if CAPM holds).

Empirical Example 6.3 (*Joint test of CAPM on industry portfolios*) Figure 6.1 reports also a joint test of the hypothesis that the alphas for all industry portfolios are zero.

6.1.4 Representative Results of the CAPM Test

One of the more interesting empirical studies is Fama and French (1993) (see also Fama and French (1996)). They construct 25 stock portfolios according to two characteristics of the firm: the size (by market capitalization) and the book-value-to-market-value ratio

(BE/ME). In June each year, they sort the stocks according to size and BE/ME. They then form a 5×5 matrix of portfolios, where portfolio ij belongs to the i th size quintile (quintiles divide sorted data into fifths of the sample) *and* the j th BE/ME quintile (so this is a *double-sort*)

$$\begin{bmatrix} \text{small size, low B/M} & \dots & \dots & \dots & \text{small size, high B/M} \\ \vdots & & \ddots & & \vdots \\ \vdots & & & \ddots & \vdots \\ \vdots & & & & \ddots \\ \text{large size, low B/M} & & & & \text{large size, high B/M} \end{bmatrix}$$

They run a traditional CAPM regression on each of the 25 portfolios (monthly data 1963–1991)—and then study if the expected excess returns are related to the betas as they should according to CAPM (recall that CAPM implies $E R_{it}^e = \beta_i \lambda$ where λ is the risk premium (excess return) on the market portfolio).

However, it is found that there is almost no relation between $E R_{it}^e$ and β_i (there is a cloud in the $\beta_i \times E R_{it}^e$ space). This is due to the combination of two features of the data. First, *within a BE/ME quintile*, there is a positive relation (across size quantiles) between $E R_{it}^e$ and β_i —as predicted by CAPM. Second, *within a size quintile* there is a negative relation (across BE/ME quantiles) between $E R_{it}^e$ and β_i —in stark contrast to CAPM.

Empirical Example 6.4 (Testing CAPM on FF portfolios) Figures 6.3–6.4 illustrates the CAPM pricing errors (*alphas*) for the 25 FF (US size/book-to-market) portfolios.

6.1.5 Representative Results on Mutual Fund Performance

Mutual fund evaluations (estimated α_i) typically find (i) on average neutral performance (or less: trading costs&fees); (ii) large funds might be worse; (iii) perhaps better performance on less liquid (less efficient?) markets; and (iv) there is very little persistence in performance: α_i for one sample does not predict α_i for subsequent samples (except for bad funds).

6.2 Calendar Time Regressions

To investigate how the performance (alpha) or exposure (betas) of different investors/funds are related to investor/fund characteristics, we often use the *calendar time* (CalTime) ap-

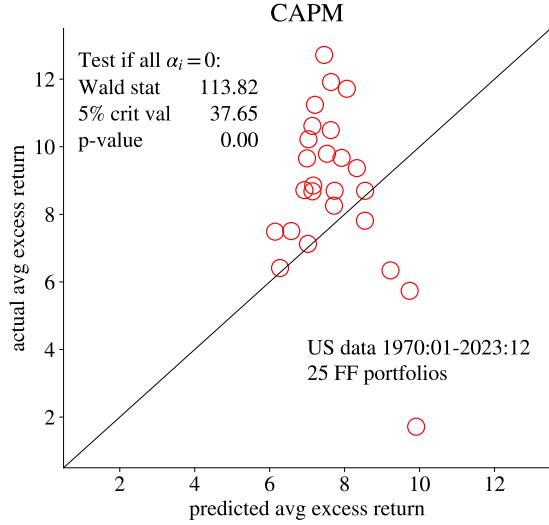


Figure 6.3: CAPM, FF portfolios

proach. First define M discrete investor groups (for instance, age 18–30, 31–40, etc) and calculate their respective average excess returns (\bar{R}_{jt}^e for group j)

$$\bar{R}_{jt}^e = \frac{1}{N_j} \sum_{i \in \text{Group } j} R_{it}^e, \quad (6.10)$$

where N_j is the number of individuals in group j .

Then, we run a factor model

$$\bar{R}_{jt}^e = x_t' \beta_j + v_{jt}, \text{ for } j = 1, 2, \dots, M \quad (6.11)$$

where x_t typically includes a constant and various return factors (for instance, excess returns on equity and bonds). By estimating these M equations as a SURE system with White's (or Newey-West's) covariance estimator, it is straightforward to test various hypotheses, for instance, that the intercept (the “alpha”) is higher for the M th group than for the first group.

Example 6.5 (*CalTime with two investor groups*) *With two investor groups, estimate the following SURE system*

$$\begin{aligned} \bar{R}_{1t}^e &= x_t' \beta_1 + v_{1t}, \\ \bar{R}_{2t}^e &= x_t' \beta_2 + v_{2t}. \end{aligned}$$

The CalTime approach is straightforward and the cross-sectional correlations are fairly

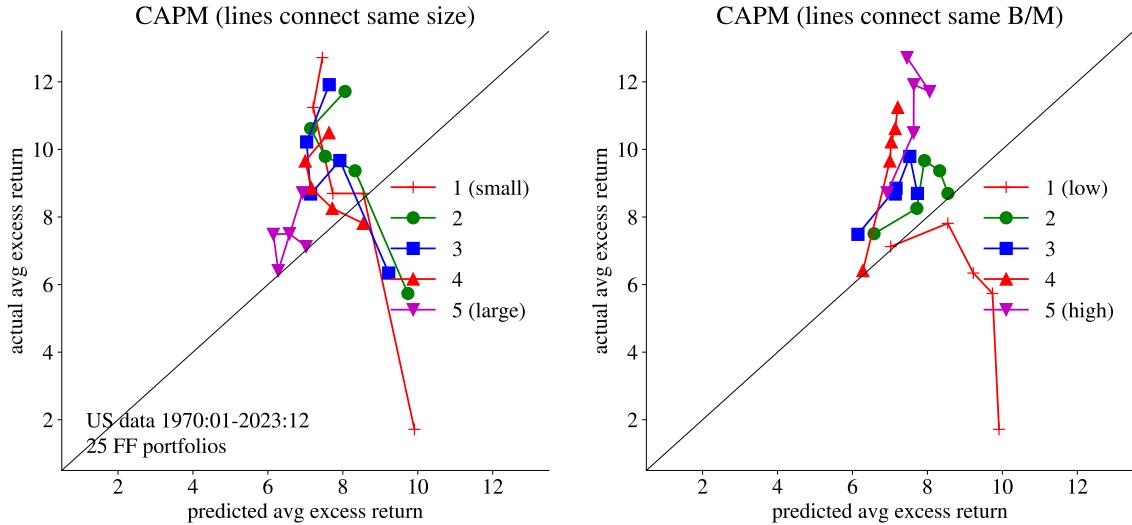


Figure 6.4: CAPM, FF portfolios

easy to handle (in the SURE approach). However, it forces us to define discrete investor groups—which makes it hard to handle several different types of investor characteristics (for instance, age, trading activity and income) at the same time.

6.3 Several Factors

In multifactor models, (6.2) is still valid—provided we reinterpret b_i and R_{mt}^e as vectors, so $b_i R_{mt}^e$ stands for $b_{io} R_{ot}^e + b_{ip} R_{pt}^e + \dots$

$$R_{it}^e = \alpha + b_{io} R_{ot}^e + b_{ip} R_{pt}^e + \dots + \varepsilon_{it}. \quad (6.12)$$

In this case, (6.2) is a multiple regression, but the test (6.4) still has the same form (the standard deviation of the intercept will be different, though).

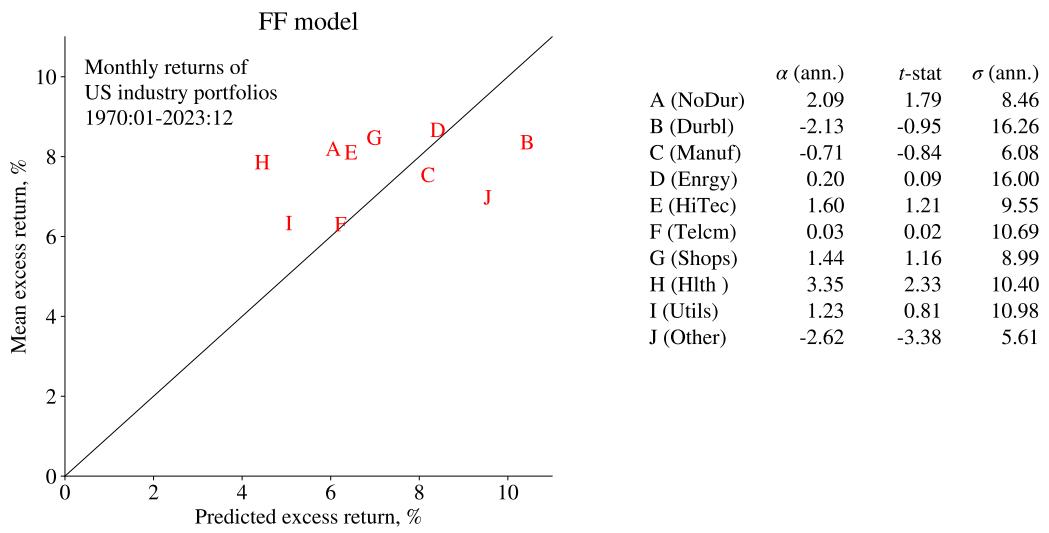
Fama and French (1993) also try a multi-factor model. They find that a three-factor model fits the 25 stock portfolios fairly well (two more factors are needed to also fit the seven bond portfolios that they use). The three factors are: the market return, the return on a portfolio of small stocks minus the return on a portfolio of big stocks (SMB), and the return on a portfolio with high BE/ME minus the return on portfolio with low BE/ME (HML). This three-factor model is rejected at traditional significance levels, but it can still capture a fair amount of the variation of expected returns.

Remark 6.6 (*Returns on long-short portfolios**) Suppose you invest x USD into asset i ,

but finance that by short-selling asset j . (You sell enough of asset j to raise x USD.) The net investment is then zero, so there is no point in trying to calculate an overall return like “value today/investment yesterday - 1.” Instead, the convention is to calculate an excess return of your portfolio as $R_i - R_j$ (or equivalently, $R_i^e - R_j^e$). This excess return essentially says: if your exposure (how much you invested) is x , then you have earned $x(R_i - R_j)$. To make this excess return comparable with net returns, you add the riskfree rate: $R_i - R_j + R_f$, implicitly assuming that your portfolio includes a riskfree investment of the same size as your long-short exposure (x).

Chen, Roll, and Ross (1986) use a number of macro variables as factors—along with traditional market indices. They find that industrial production and inflation surprises are priced factors, while the market index might not be.

Empirical Example 6.7 (*Testing a 3-factor model*) Figure 6.5 shows results for the Fama-French 3-factor model on US industry portfolios and Figures 6.6–6.7 on the 25 Fama-French portfolios.



Fama-French model
 Factors: US market, SMB (size), and HML (book-to-market)
 Predicted excess return: $\beta_m R_m^e + \beta_{SMB} R_{SMB} + \beta_{HML} R_{HML}$

10% crit. value (Bonferroni): 2.58

Test if all $\alpha_i = 0$:

Wald stat	24.03
5% crit val	18.31
p-value	0.01

Figure 6.5: Fama-French regressions on US industry indices

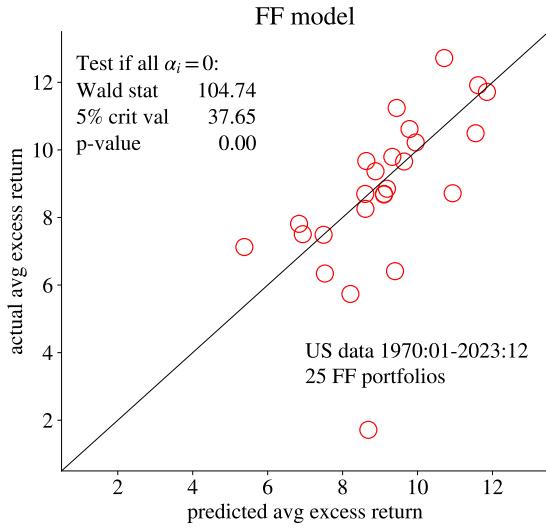


Figure 6.6: FF, FF portfolios

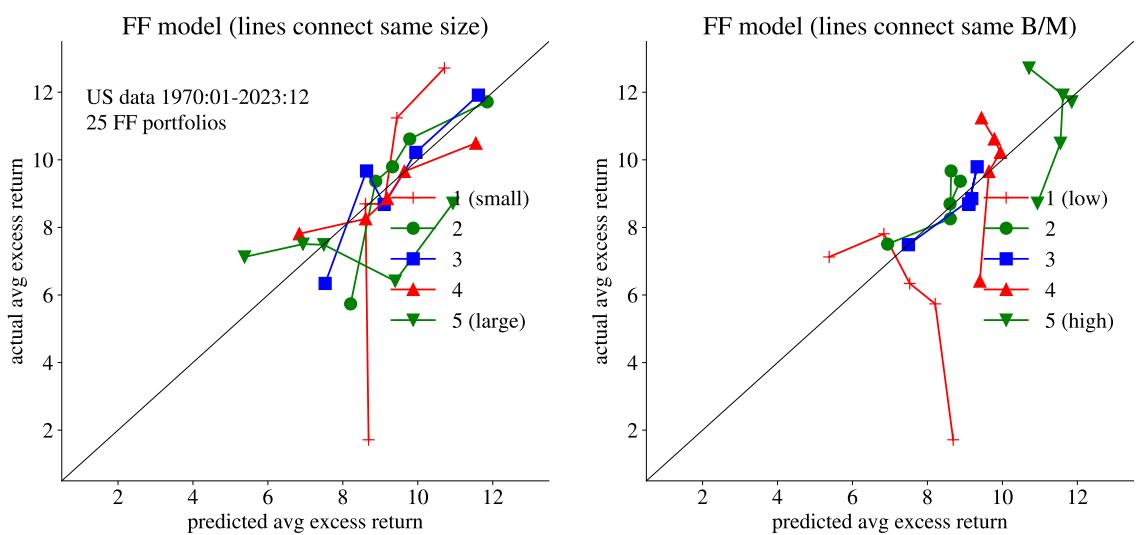


Figure 6.7: FF, FF portfolios

Chapter 7

Model Selection and Other Topics

Greene (2018) 4-5; Hansen (2022) 3

7.1 Model Selection I

Excluding a relevant regressor will cause a bias of all coefficients (unless those regressors are uncorrelated with the excluded regressor). In contrast, *including an irrelevant regressor* is not really dangerous, but is likely to decrease the precision.

To select the regressors, consider the following rules. Rule 1: use *economic theory*; rule 2: *avoid data mining* and mechanical searches for the right regressors; rule 3: maybe use a *general-to-specific approach*—start with a general regression and test restrictions,..., keep making it simpler until restrictions are rejected; rule 4: always *include a constant*; rule 5: avoid overfitting by “punishing” models with many parameters.

Remember that R^2 can never decrease by adding more regressors—not really a good guide. To avoid overfitting, we could consider \bar{R}^2 instead

$$\bar{R}^2 = 1 - (1 - R^2) \frac{T - 1}{T - k}, \quad (7.1)$$

where T is the sample size and k is the number of regressors (including the constant). This measure includes trade-off between fit and the number of regressors (per data point). Notice that \bar{R}^2 can be negative (while $0 \leq R^2 \leq 1$). Clearly, the model must include a constant for R^2 (and therefore \bar{R}^2) to make sense. Alternatively, apply Akaike’s Informa-

tion Criterion (AIC) and the Bayesian information criterion (BIC). They are

$$AIC = \ln \sigma^2 + 2 \frac{k}{T} \quad (7.2)$$

$$BIC = \ln \sigma^2 + \frac{k}{T} \ln T, \quad (7.3)$$

where σ^2 is the variance of the fitted residuals.

These measures also involve trade-offs between fit (low σ^2) and number of parameters (k , including the intercept). Choose the model with the *highest* \bar{R}^2 or *lowest* AIC or BIC. It can be shown (by using $R^2 = 1 - \sigma^2 / \text{Var}(y_t)$ so $\sigma^2 = \text{Var}(y_t)(1 - R^2)$) that AIC and BIC can be rewritten as

$$AIC = \ln \text{Var}(y_t) + \ln(1 - R^2) + 2 \frac{k}{T} \quad (7.4)$$

$$BIC = \ln \text{Var}(y_t) + \ln(1 - R^2) + \frac{k}{T} \ln T. \quad (7.5)$$

This shows that both are decreasing in R^2 (which is good), but increasing in the number of regressors per data point (k/T). It therefore leads to a similar trade-off as in \bar{R}^2 . Recall that the model should always include a constant.

Empirical Example 7.1 (*Empirical application of model selection*) See Table 7.1 for an empirical example showing a number of possible model specifications. The dependent variable is the monthly realized variance of S&P 500 returns (calculated from daily returns). The possible regressors are lags of the dependent variable, the VIX index and the the S&P 500 returns. Similarly, Table 7.2 for the the best specification according to AIC. Notice that AIC tend to favour fairly large models with many regressors.

7.2 Model Selection II

Reference: Hastie, Tibshirani, and Friedman (2001) 3

In some cases, even good economic theory leaves us with too many potential regressors. This is often the case when developing forecasting models—where it also often noticed models with many predictors tend to fail out of sample. It then becomes crucial to apply some model selection technique, that is, a method that sets some regression coefficients to zero.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
RV _{t-1}	0.66 (8.88)						0.17 (2.06)
RV _{t-2}		0.45 (5.63)					-0.03 (-0.37)
VIX _{t-1}			0.93 (10.31)				0.97 (3.58)
VIX _{t-2}				0.66 (8.88)			-0.26 (-1.20)
R _{t-1}					-0.82 (-3.54)		-0.00 (-0.01)
R _{t-2}						-0.45 (-2.29)	-0.08 (-0.93)
constant	5.15 (4.90)	8.34 (6.51)	-2.79 (-1.87)	2.43 (1.86)	15.83 (18.59)	15.55 (17.85)	-0.54 (-0.46)
R ²	0.44	0.20	0.53	0.27	0.14	0.04	0.55
\bar{R}^2	0.44	0.20	0.53	0.26	0.14	0.04	0.55
obs	385	385	385	385	385	385	385

Table 7.1: Regression of monthly realized S&P 500 return volatility 1990:02-2023:12. Numbers in parentheses are t-stats, based on Newey-West with 4 lags.

If there are k potential regressors, then there are 2^k different models. If the list of models is not too long, then the AIC and BIC in (7.2)–(7.3) can be used, see Table 7.2. Otherwise, we need some sort of sequential approach.

Example 7.2 (3 potential regressors) If the three potential regressors are 1, x_1 and x_2 , then the list of models has $2^3 - 1 = 7$ possibilities: (1); (x_1); (x_2); (1, x_1); (1, x_2); (x_1 , x_2); (1, x_1 , x_2).

A forward stepwise selection is as follows

- (1) start with an intercept
- (2) add the variable that improves the fit the most
- (3) repeat (2) until the fit does not improve much

To specify a stopping rule, first define the residual sum of squares (for a given vector of coefficients, β) as

$$RSS(\beta) = \sum_{t=1}^T (y_t - x_t' \beta)^2. \quad (7.7)$$

In step (2) we would then add the variable that gives the lowest RSS (when added to the

	(1)	(2)	(3)	(4)
RV _{t-1}	0.18 (2.12)			
RV _{t-2}				
VIX _{t-1}	0.95 (5.44)	1.12 (6.19)	1.13 (6.25)	0.88 (11.81)
VIX _{t-2}	-0.27 (-1.99)	-0.24 (-1.73)	-0.28 (-1.90)	
R _{t-1}			-0.22 (-2.29)	
R _{t-2}			-0.14 (-1.48)	
constant	-0.68 (-0.74)	-1.86 (-1.57)	-1.18 (-1.25)	-1.61 (-1.36)
R ²	0.55	0.54	0.55	0.54
BIC	3.77	3.77	3.78	3.78
obs	385	385	385	385

Table 7.2: Regression of monthly realized S&P 500 return volatility 1990:02-2023:12. Ordered from best (1) according to BIC to fourth best (4). Numbers in parentheses are t-stats, based on Newey-West with 4 lags.

previous selection). In step (3), it is often recommended that we stop adding regressors when

$$\frac{RSS(\hat{\beta}_{\text{old}}) - RSS(\hat{\beta}_{\text{new}})}{RSS(\hat{\beta}_{\text{new}})/(T - k - 1)} < c_{1,T-k-1}, \quad (7.8)$$

where k is the number of coefficients in $\hat{\beta}_{\text{old}}$ (including the intercept) so there are $k + 1$ coefficients in $\hat{\beta}_{\text{new}}$ and $c_{1,T-k-1}$ is the 90% or 95% critical value of an $F_{1,T-k-1}$ distribution. For instance, the 90% critical value of $F_{1,100}$ equals 2.76.

As an alternative to the RSS based rule in (7.7)–(7.8), we could instead use t-stats: in step (2) add the variable with the highest $|t\text{-stat}|$ and in step (3) stop adding variables when that $|t\text{-stat}|$ is lower than 1.64 (or 1.96).

Empirical Example 7.3 (Forward stepwise selection) Applying the forward step selection approach (based on t-stats) to the regression discussed in Example 7.1 gives a sequence of larger and larger models shown in Table 7.3.

	(1)	(2)	(3)
RV _{t-1}		0.18 (2.12)	
RV _{t-2}			
VIX _{t-1}	0.93 (10.31)	1.12 (6.19)	0.95 (5.44)
VIX _{t-2}		-0.24 (-1.73)	-0.27 (-1.99)
R _{t-1}			
R _{t-2}			
constant	-2.79 (-1.87)	-1.86 (-1.57)	-0.68 (-0.74)
R ²	0.53	0.54	0.55
obs	385	385	385

Table 7.3: Best four regressions of monthly realized S&P 500 return volatility according to a forward step selection (based on t-stats), 1990:02-2023:12. Ordered from smallest model (1) to fourth smallest model (4). Numbers in parentheses are t-stats, based on Newey-West with 4 lags.

7.2.1 The Lasso Method*

An alternative approach to model selection is the *Lasso method*, which minimizes the sum of squared residuals (just like OLS), but with a penalty on $\sum_{i=1}^k |b_i|$. In short, it solves the following optimization problem

$$\min_b \sum_{t=1}^T (y_t - \alpha - x'_t b)^2 + \gamma \sum_{i=1}^k |b_i|, \quad (7.9)$$

where the value of γ is chosen a priori, but where we typically consider different values of γ . Having the same penalty on all $|b_i|$ makes perhaps most sense when the regressors have the same scale (for instance, zero mean and unit standard deviation). The *adaptive Lasso* instead uses weighted penalties, $\gamma \sum_{i=1}^k w_i |b_i|$, often with $w_i = 1/|b_i^{OLS}|$. This will clearly give a larger effective penalty on variables whose OLS coefficients are small (in absolute terms). It is sometimes an advantage to divide the first term in (7.9) by T , to make the interpretation of γ independent of the sample size (and sometimes also for numerical reasons).

	(1)	(2)	(3)	(4)
RV _{t-1}		0.15 (2.11)	0.14 (1.82)	0.18 (2.21)
RV _{t-2}				
VIX _{t-1}	0.93 (10.31)	0.77 (7.63)	0.72 (7.10)	0.94 (3.58)
VIX _{t-2}				-0.27 (-1.17)
R _{t-1}			-0.21 (-2.12)	-0.00 (-0.02)
R _{t-2}				
constant	-2.79 (-1.87)	-1.93 (-1.47)	-0.82 (-0.76)	-0.67 (-0.66)
R ²	0.53	0.54	0.54	0.55
$\sum b_i $	0.73	0.75	0.81	1.13
obs	385	385	385	385

Table 7.4: Best four regressions of monthly realized S&P 500 return volatility where the model are selected by lasso, but then estimated with OLS, 1990:02-2023:12. Ordered from smallest model (1) to fourth smallest model (4). Numbers in parentheses are t-stats, based on Newey-West with 4 lags. The $\sum |b_i|$ is for regression using standardized variables.

Remark 7.4 (*Alternative formulation*) *The same problem can also be written as a constrained optimisation problem*

$$\min_b \sum_{t=1}^T (y_t - \alpha - x_t' b)^2 \text{ subject to } \sum_{i=1}^k |b_i| \leq t,$$

where a small t corresponds to a high γ .

Clearly, when $\gamma = 0$, then the lasso approach reproduces the OLS estimates. For larger values of γ , the lasso will give smaller coefficients: some b_i will be zero and others tend to be closer to zero than OLS would suggest (similar to other “shrinkage” methods like a ridge estimation).

The lasso method can be used as a model selection technique by estimating a sequence of models with increasingly lower γ values. With a sufficiently high γ , only one coefficient is non-zero—for a somewhat lower γ value, two coefficients are non-zero and so on. See Figure 7.1. Once the L (five, say) smallest specifications are found, we could re-

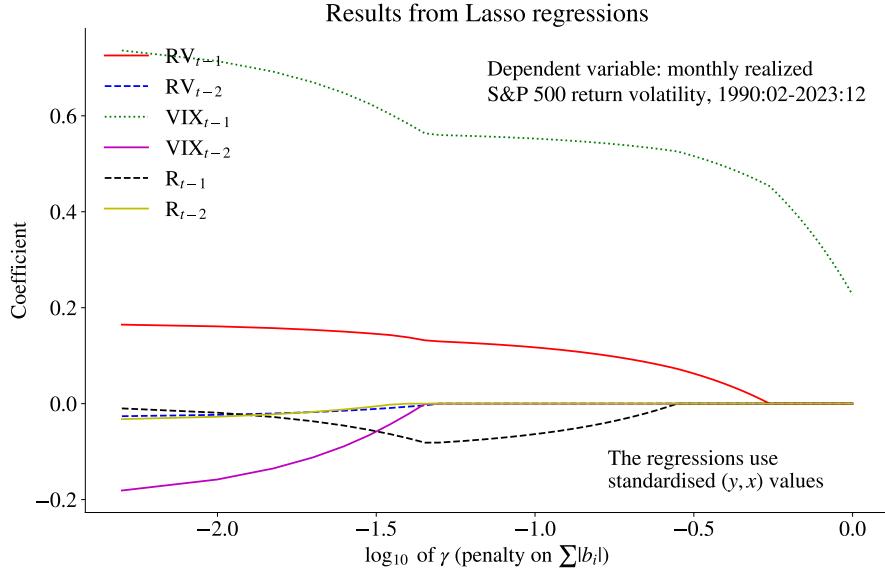


Figure 7.1: Lasso regressions

estimate each of them with OLS. (This is the lars-OLS hybrid discussed in Efron, Hastie, Johnstone, and Tibshirani (2004).)

Empirical Example 7.5 (Lasso regression) Applying the Lasso approach to the regression discussed in Example 7.1 gives a sequence of smaller and smaller models. Figure 7.1 shows how the coefficients of the normalised variables change as penalty parameter is increased. Re-estimating the four smallest of those models with OLS gives the results in Table 7.4.

Remark 7.6 (Application of the lasso/lars algorithms) These algorithms often standardize x_t to have zero means and unit standard deviations, and y_t to have zero means (and perhaps unit standard deviation).

7.2.2 Ridge Regressions*

This section summarises some facts about ridge regressions.

Remark 7.7 (Ridge regression) The ridge regression solves $\min_b \sum_{t=1}^T (y_t - \alpha - x_t' b)^2 + \lambda \sum_{i=1}^k b_i^2$, where $\lambda > 0$, so it forms a compromise between OLS and zero coefficients. This is easiest to see if y_t and x_t are demeaned so $\alpha = 0$. Then, the first order conditions for minimization are $\sum_{t=1}^T x_t (y_t - x_t' \hat{b}) - \lambda \hat{b} = \mathbf{0}$, so $\hat{b} = (\sum_{t=1}^T x_t x_t' + \lambda I)^{-1} \sum_{t=1}^T x_t y_t$. Notice that $\lambda = 0$ gives OLS, while $\lambda = \infty$ gives $\hat{b} = \mathbf{0}$.

Remark 7.8 (*Ridge regression with a target vector*) Let (y_t, x_t) be demeaned (so no intercept is needed) and let the target slope coefficients be the vector β_0 .

$$\hat{b} = (\sum_{t=1}^T x_t x_t' + \lambda I)^{-1} (\sum_{t=1}^T x_t y_t + \lambda \beta_0).$$

This \hat{b} solves the problem $\min_b \sum_{t=1}^T (y_t - x_t' b)^2 + \lambda \sum_{i=1}^k (b_i - \beta_{i0})^2$. The first order conditions for minimization are $\sum_{t=1}^T x_t (y_t - x_t' \hat{b}) - \lambda(\hat{b} - \beta_0) = 0$, which has the solution above.

Remark 7.9 (*Elastic net regression**) An elastic net regression is a mix of a Lasso regression and a ridge regression. It solves $\min_b \sum_{t=1}^T (y_t - \alpha - x_t' b)^2 + \gamma \sum_{i=1}^k |b_i| + \lambda \sum_{i=1}^k b_i^2$.

7.3 Weighted Least Squares*

Suppose we want to put the weight w_t on observation (x_t, y_t) in a regression, $y_t = x_t' \beta + u_t$. That is, we want to minimize

$$\sum_{t=1}^T w_t (y_t - x_t' b)^2. \quad (7.10)$$

The first order conditions are

$$\mathbf{0}_{k \times 1} = \sum_{t=1}^T w_t x_t (y_t - x_t' \hat{\beta}), \quad (7.11)$$

so the solution is

$$\hat{\beta} = S_{wxx}^{-1} \sum_{t=1}^T w_t x_t y_t, \text{ where } S_{wxx} = \sum_{t=1}^T w_t x_t x_t' \quad (7.12)$$

It is straightforward to show that the variance-covariance matrix of $\hat{\beta}$ is

$$\text{Var}(\hat{\beta}) = S_{wxx}^{-1} S S_{wxx}^{-1}, \text{ where } S = \text{Var}(\sum_{t=1}^T w_t x_t u_t). \quad (7.13)$$

We can estimate this by replacing u_t by the fitted residuals $\hat{u}_t = y_t - x_t' \hat{\beta}$ and apply the usual methods on the $T \times k$ matrix of “data” $w_t x_t \hat{u}_t$. For instance, we get a heteroskedasticity consistent (like White’s) estimate by simply estimating a traditional $k \times k$ covariance matrix of $w_t x_t \hat{u}_t$.

Proof (of (7.13)*) Substitute for $y_t = x_t' \beta + u_t$ in (7.12) to get (after simplification)

$$\hat{\beta} = \beta + S_{wxx}^{-1} \sum_{t=1}^T w_t x_t u_t.$$

The result in (7.13) follows directly. \square

Remark 7.10 (*Alternative computation*) Let $\tilde{x}_t = \sqrt{w_t}x_t$ and $\tilde{y}_t = \sqrt{w_t}y_t$. Then, regressing \tilde{y}_t on \tilde{x}_t gives the same result as in (7.12). Notice also that (a) $\Sigma_{t=1}^T \tilde{x}_t \tilde{x}'_t$ is the same as S_{wxx} ; and (b) $\Sigma_{t=1}^T \tilde{x}_t \tilde{u}_t$ (where $\tilde{u}_t = \tilde{y}_t - \tilde{x}'_t \beta$) is the same as $\Sigma_{t=1}^T w_t x_t u_t$. This means that robust standard errors (for instance, White's) from the regression of \tilde{y}_t on \tilde{x}_t gives the same variance-covariance matrix as in (7.13). WLS can thus be implemented as OLS on $(\tilde{y}_t, \tilde{x}_t)$, and this applies to both point estimates and the variance-covariance matrix.

7.4 Comparing Non-Nested Models

Consider two competing models

$$\text{Model A: } y_t = x'_t \beta + \varepsilon_t \quad (7.14)$$

$$\text{Model B: } y_t = z'_t \gamma + v_t. \quad (7.15)$$

For instance, these models could represent alternative economic theories of the same phenomenon. They are *non-nested* if z is not a subset of x at the same time as x is not a subset of z . Comparing the fit of these models starts with the usual criteria: R^2 , \bar{R}^2 , AIC, and BIC.

An alternative approach to compare the fit is to study *encompassing*. Model *B* is said to encompass model *A* if it can explain all that model *A* can (and more). This is clearly a good feature. To test this, run the regression

$$y_t = z'_t \gamma + x'_{2t} \delta_A + v_t, \quad (7.16)$$

where x_{2t} are those variables in x_t that are not also in z_t . Model *B* encompasses model *A* if $\delta_A = 0$ (test this restriction). Clearly, we can repeat this to see if *A* encompasses *B*.

7.5 Non-Linear Models

Regression analysis typically starts with a linear model—which may or may not be a good approximation.

Notice that models that are *non-linear in variables*

$$y_t = \alpha + \delta x_t^{3.4} + \varepsilon_t, \quad (7.17)$$

can be handled by OLS: just run OLS using $x_t^{3.4}$ as a regressor.

In contrast, models that are *non-linear in parameters*

$$y_t = \beta_1 + \beta_2 x_t^{\beta_3} + u_t \quad (7.18)$$

cannot be estimated by OLS. Do nonlinear LS (NLS) instead. This requires the use of a numerical minimization routine to minimize the sum of squared residuals, $\sum_{t=1}^T u_t^2$.

To *test the functional form* (...is a linear specification really correct?), estimate non-linear extension and test if they are significant. Alternatively, do a RESET test

$$y_t = x_t' \beta + \alpha_2 \hat{y}_t^2 + v_t, \quad (7.19)$$

where $\hat{y}_t = x_t' \hat{\gamma}$ (from a linear model, $y_t = x_t' \gamma + \varepsilon_t$). If the null hypothesis $\alpha_2 = 0$ cannot be rejected, then a linear model is good enough. Otherwise, we may need a non-linear specification.

A *binscatter* can be very informative about the functional form. Suppose y_t depends on a vector of variables x_{1t} (which is possibly empty) and also a single variable x_{2t} . We want to investigate if y_t is linearly related to x_2 . To do that, create N non-overlapping bins for x_{2t} and let d_t be an $N \times 1$ dummy vector indicating whether x_{2t} belongs to each of the bins. (Clearly, only one element in d_t is 1 and the rest are zero.) A common choice is to use the (minimum, 10th percentile, 20th percentile,..., maximum) as bin boundaries. Then, we run the regression

$$y_t = x_{1t}' \gamma + d_t' \beta + u_t \quad (7.20)$$

and report the estimates of β and their standard errors (or confidence bands). If the estimates follow a linear pattern across the bins, then a linear model ($y_t = x_{1t}' \theta_1 + \theta_2 x_{2t} + u_t$) is well motivated. See Figure 7.2 for an example.

7.6 Outliers

OLS is sensitive to extreme data points. The starting point (as always in empirical work) in detecting problems is to plot the data: time series plots and histograms—to see if there are extreme data points.

Since the loss function defining OLS is quadratic, a few outliers can easily have a very large influence on the estimated coefficients. For instance, suppose the true model is $y_t = 0.75x_t + u_t$, and that the residual is very large for some time period s .

Consider the loss function at a slope of 0.75 (the true value, actually): it would be large due to the u_t^2 term. The loss function value will probably be lower if the coefficient

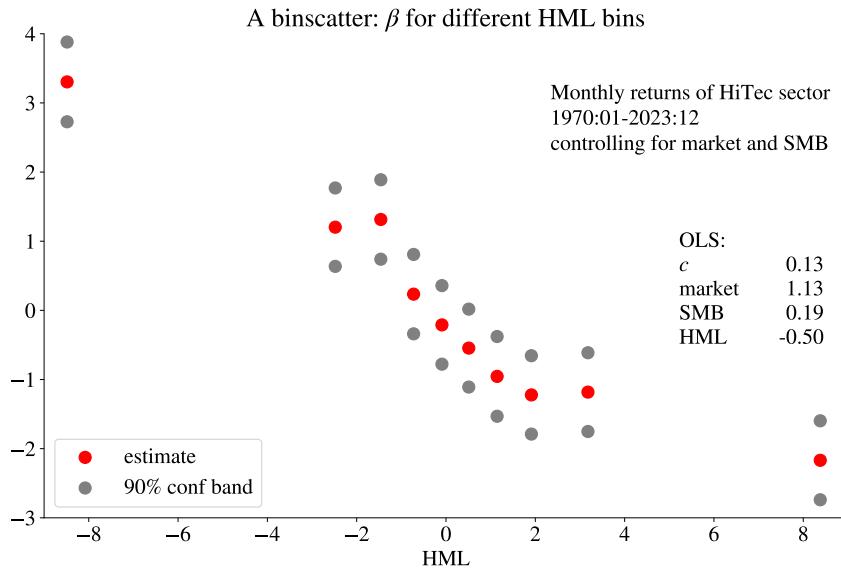


Figure 7.2: Binscatter

is changed to pick up the y_s observation—even if this means that the errors for the other observations become larger (the sum of the square of many small errors can very well be less than the square of a single large error). See Figure 7.4.

There is of course nothing sacred about the quadratic loss function. Instead the sum of squared errors (as in OLS), one could, for instance, use a loss function in terms of the absolute value of the error $\sum_{t=1}^T |y_t - b_0 - b_1 x_t|$. This would produce the Least Absolute Deviation (LAD) estimator. It is typically less sensitive to outliers. This is illustrated in Figure 7.4.

However, LS is by far the most popular choice. There are two main reasons: LS is very easy to compute and it is fairly straightforward to construct standard errors and confidence intervals for the estimator. (From an econometric point of view you may want to add that LS coincides with maximum likelihood when the errors are normally distributed.) |

As complement, it is a good idea to try to identify outliers from the regression results. First, estimate on the whole sample to get the estimates of the coefficients $\hat{\beta}$ and the fitted values \hat{y}_t . Second, estimate on the whole sample, except observation s , and record the estimate $\hat{\beta}^{(s)}$ and the fitted value for period s (the one that was not used in the estimation) $\hat{y}_s^{(s)} = x_s' \hat{\beta}^{(s)}$. Repeat this for all data points (s). Third, plot $\hat{\beta}^{(s)} - \hat{\beta}$, $\hat{y}_s^{(s)} - \hat{y}_s$ or $\hat{u}_s^{(s)} / \hat{\sigma}$. If these series make sudden jumps, then that data point is driving the results for the full sample. It then remains to determine whether this is good (a very informative data

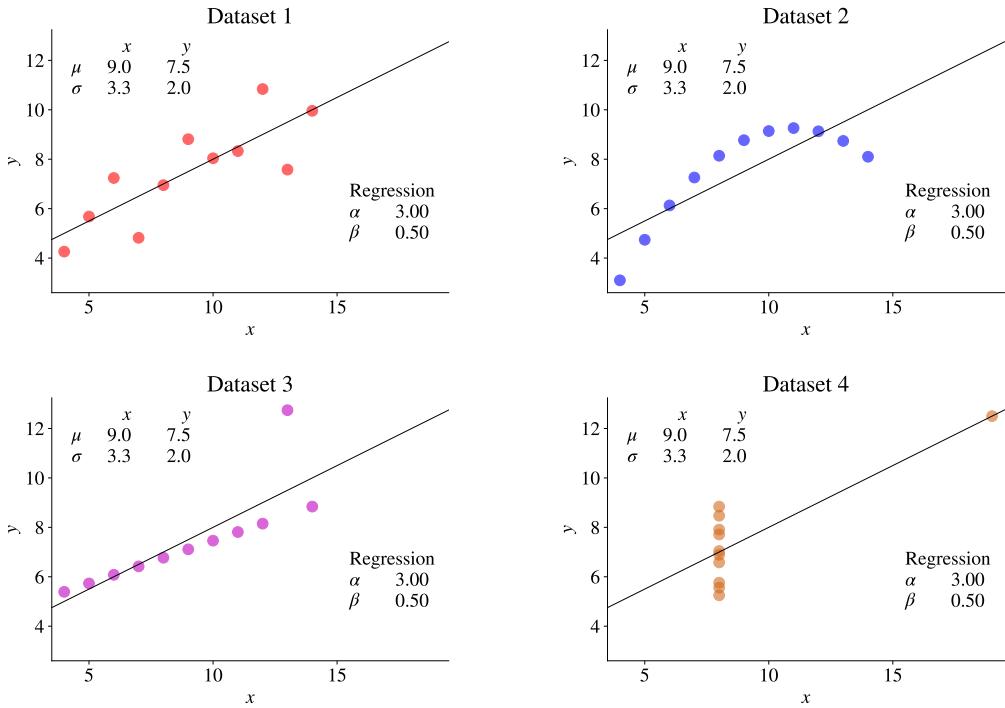


Figure 7.3: Model specification and descriptive statistics (Anscombe's quartet)

point) or bad (unrepresentative or even wrong data point). In particular, the *influence* of observation s (measured as $|\hat{y}_s^{(s)} - \hat{y}_s|$) is often plotted and analysed. See Figure 7.5 for an illustration.

Remark 7.11 (*An alternative way to calculate $\hat{\beta}^{(s)} - \hat{\beta}$ and $\hat{y}_s^{(s)} - \hat{y}_s$*) Let $\hat{u}_t = y_t - x'_t \hat{\beta}$, that is, the residuals from the regression using the whole sample. It is then straightforward to show (see, for instance, Hansen (2022) 3) that

$$\begin{aligned}\hat{\beta}^{(s)} - \hat{\beta} &= -S_{xx}^{-1} x_s \frac{\hat{u}_s}{1 - h_s}, \text{ where } S_{xx} = \sum_{t=1}^T x_t x'_t \text{ and} \\ h_s &= x'_s S_{xx}^{-1} x_s.\end{aligned}$$

The h_s term is called the “leverage” since it will be a gauge of how important observation s is. This is perhaps best seen by rewriting the difference in the fitted values as

$$\begin{aligned}\hat{y}_s^{(s)} - \hat{y}_s &= x'_s (\hat{\beta}^{(s)} - \hat{\beta}) \\ &= -x'_s S_{xx}^{-1} x_s \frac{\hat{u}_s}{1 - h_s} = -\frac{h_s}{1 - h_s} \hat{u}_s.\end{aligned}$$

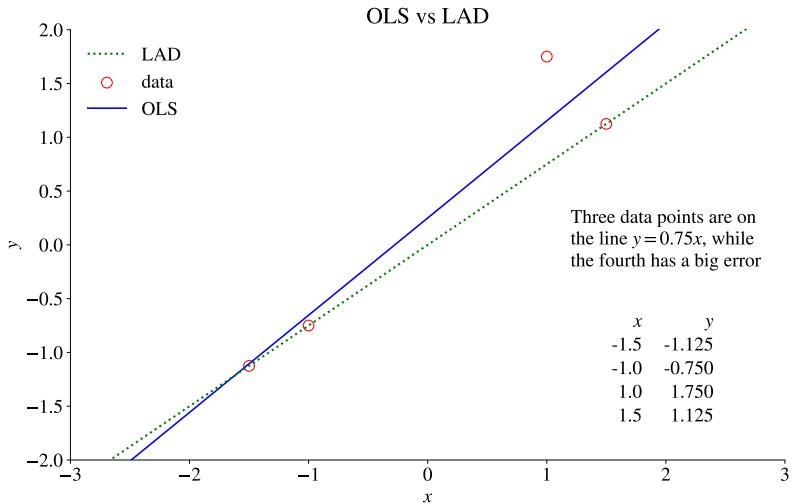


Figure 7.4: Data and regression line from OLS and LAD

7.7 Estimation on Subsamples

To test for a structural break of (one or more) coefficients, add a dummy for a subsample and interact it with the those regressors that we suspect have structural breaks (denoted z_t , which is a subset of x_t)

$$y_t = x'_t \beta + g_t z'_t \delta + \varepsilon_t, \text{ where} \quad (7.21)$$

$$g_t = \begin{cases} 1 & \text{for some subsample} \\ 0 & \text{else} \end{cases} \quad (7.22)$$

and test $\delta = \mathbf{0}$ (a “Chow test”). Notice that δ measures the change of the coefficients from one sub sample to another (since the elements in z_t are also included in x_t).

To capture time-variation in the regression coefficients, it is fairly common to run the regression

$$y_t = x'_t \beta + \varepsilon_t \quad (7.23)$$

on a longer and longer data set (“recursive estimation”). In the standard recursive estimation, the first estimation is done on the sample $t = 1, 2, \dots, \tau$; while the second estimation is done on $t = 1, 2, \dots, \tau, \tau + 1$; and so forth until we use the entire sample $t = 1, \dots, T$. In the “backwards recursive estimate” we instead keep the end-point fixed and use more and more of old data. That is, the first sample could be $T - \tau, \dots, T$; the second $T - \tau - 1, \dots, T$; and so forth.

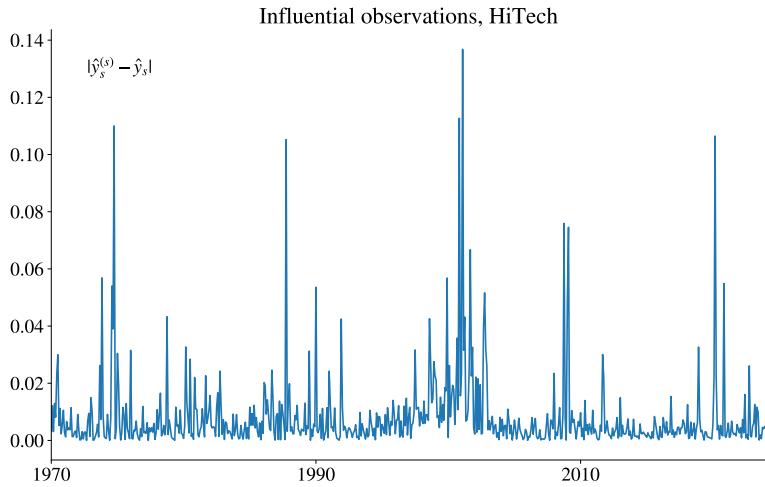


Figure 7.5: Influence of different observations

We could also apply an exponentially weighted moving average (EMA) estimator, which uses all data points since the beginning of the sample—but where recent observations carry larger weights. The weight for data in period t is λ^{T-t} where T is the latest observation and $0 < \lambda < 1$, where a smaller value of λ means that old data carries low weights. In practice, this means that we define

$$\tilde{x}_t = x_t \lambda^{T-t} \text{ and } \tilde{y}_t = y_t \lambda^{T-t} \quad (7.24)$$

and then estimate

$$\tilde{y}_t = \tilde{x}'_t \beta + \varepsilon_t. \quad (7.25)$$

Notice that also the constant (in x_t) should be scaled in the same way. Again, see Figure 7.6 for an illustration.

Alternatively, a moving data window (“rolling samples”) could be used. In this case, the first sample is $t = 1, 2, \dots, \tau$; but the second is on $t = 2, \dots, \tau, \tau + 1$. This means that we drop one observation at the start of the sample and add one at the end. This approach could also be reversed: use all the data except that in the window (this is similar to the approach for detecting outliers, except that we exclude a window, not a single data point).

Empirical Example 7.12 (*Time-varying betas of the HiTech sector*) See Figure 7.6.

Estimation on subsamples is not only a way of getting a more recent/modern estimate,

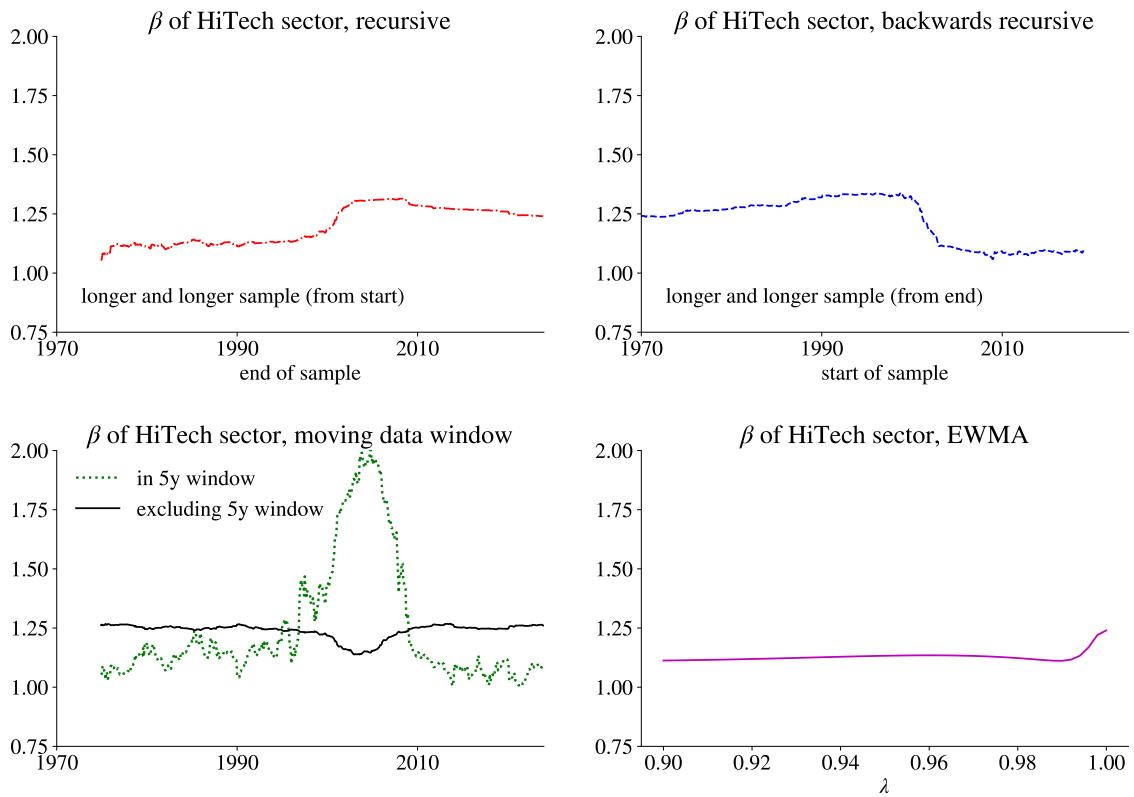


Figure 7.6: Betas of US industry portfolios

but also a way to gauge the historical range and volatility in the betas—which may be important for putting some discipline on judgemental forecasts.

Empirical Example 7.13 (*Range of historical betas (different subsamples)*) See [7.7](#) for an illustration.

From the estimations on subsamples (irrespective of method), it might be informative to study plots of (a) residuals with confidence band (0 ± 2 standard errors) or standardized residuals with confidence band (0 ± 2) and (b) coefficients with confidence band (± 2 standard errors). In these plots, the standard errors are typically from the subsamples.

The recursive estimates can be used to construct another formal test of structural breaks, the recursive *CUSUM test* (see, for instance, Enders (2004)). First, consider a regression on the sample of observation 1 to $s - 1$ and use the estimated coefficients

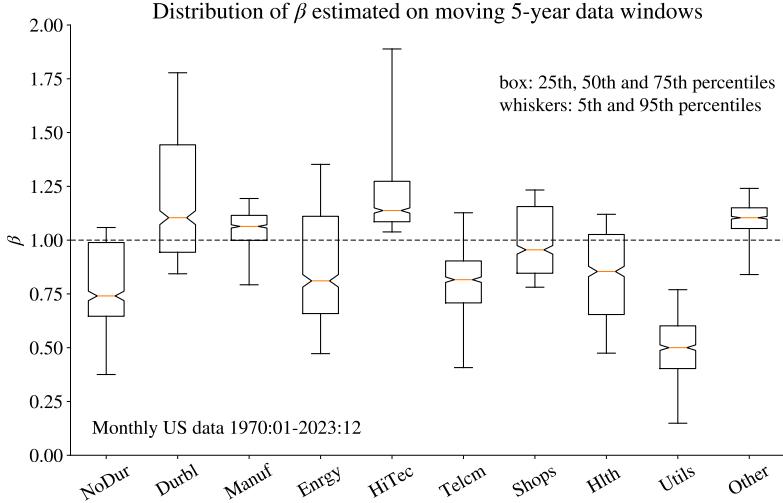


Figure 7.7: Distribution of betas of US industry portfolios (estimated on 5-year data windows)

(denoted $\hat{\beta}_{s-1}$) to calculate a forecast and an adjusted “forecast error” for s as

$$\hat{y}_s = x_s' \hat{\beta}_{s-1} \text{ and } v_s = \frac{y_s - \hat{y}_s}{\sqrt{1 + x_s' S_{xx,s-1}^{-1} x_s'}}, \quad (7.26)$$

where $S_{xx,s-1} = \sum_{t=1}^{s-1} x_t x_t'$ (that is, the sum of outer products which is used in calculating $\hat{\beta}_{s-1}$). Do this calculation for $s = k + 1$ (where k is the number of regressors), then for $s = k + 2$ etc. This means that the first estimation (that is, of $\hat{\beta}_k$) uses the first k observations and so on. Second, estimate the standard deviation (denoted σ_v below) of the vector of v_s values. Third, calculate the sequence of accumulated errors

$$W_t = \sum_{s=k+1}^t \frac{v_s}{\sigma_v}, \text{ for } t = k + 1, \dots, T. \quad (7.27)$$

For instance, $W_{k+1} = v_{k+1}/\sigma_v$ and $W_{k+2} = (v_{k+1} + v_{k+2})/\sigma_v$. Third, plot W_t (as a function of t) along with confidence interval: $\pm \lambda [\sqrt{T-k} + 2(t-k)/\sqrt{T-k}]$, with $\lambda = 0.948$ for a 95% confidence band and 0.85 for a 90% confidence interval. Reject stability if any observation W_t is outside. See Figure 7.8 for an example.

Empirical Example 7.14 (*CUSUM test of a CAPM regression*) See Figure 7.9.

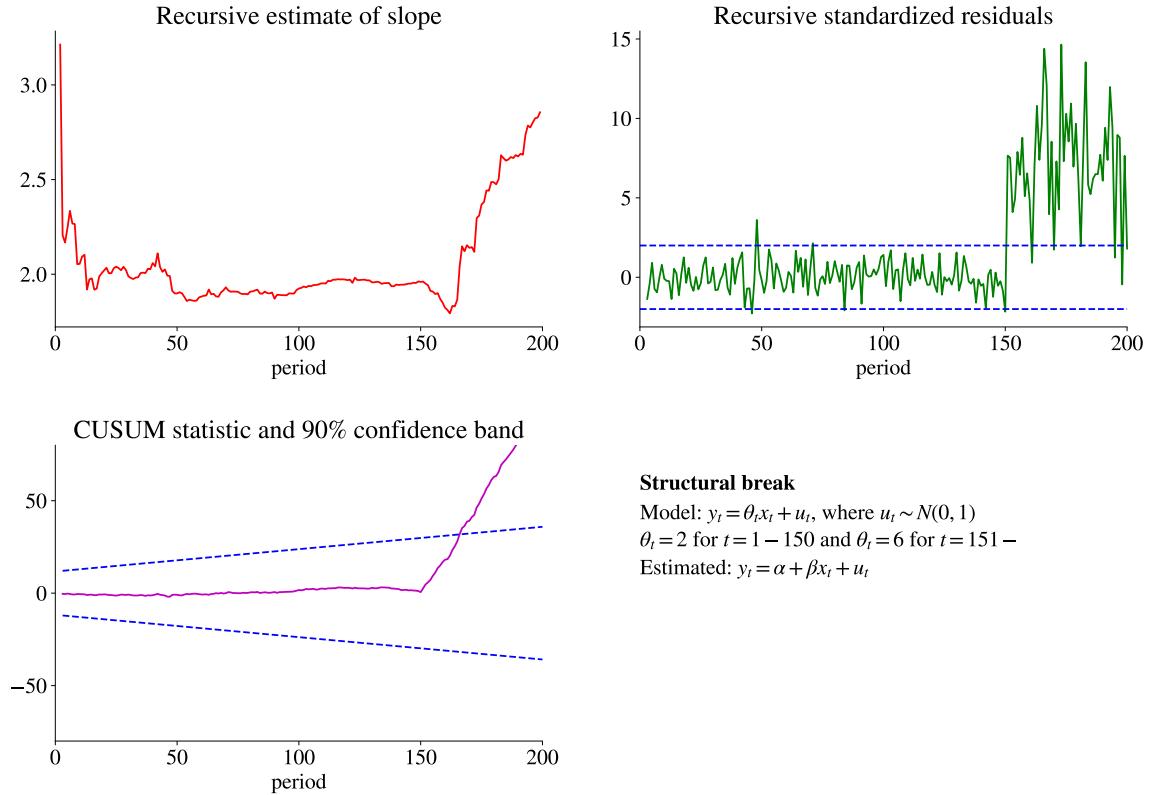


Figure 7.8: Example of a structural break

7.8 Robust Estimation*

7.8.1 Robust Means, Variances and Correlations

Outliers and other extreme observations can have very decisive influence on the estimates of the key statistics needed for financial analysis, including mean returns, variances, covariances and also regression coefficients.

The perhaps best way to solve these problems is to carefully analyse the data—and then decide which data points to exclude. Alternatively, robust estimators can be applied instead of the traditional ones.

To estimate the mean, the sample average can be replaced by the *median* or a *trimmed mean* (where the $x\%$ lowest and highest observations are excluded).

Similarly, to estimate the variance, the sample standard deviation can be replaced by the *interquartile range* (the difference between the 75th and the 25th percentiles), divided

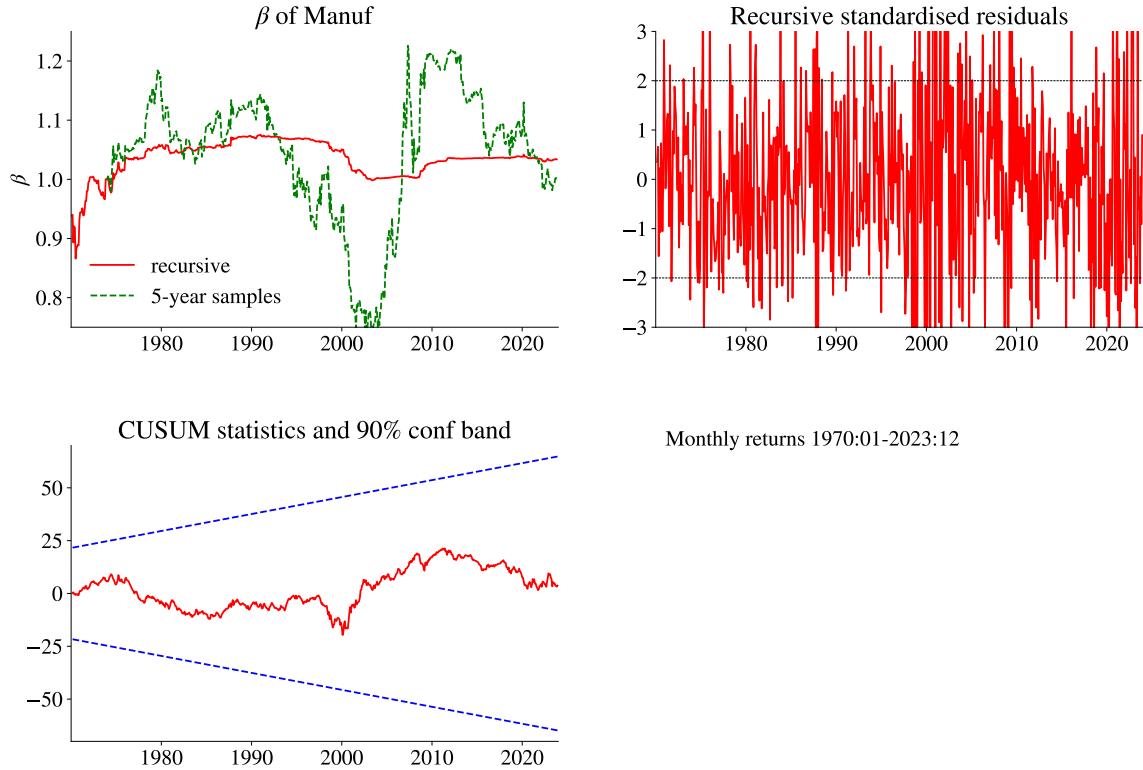


Figure 7.9: Stability test of a CAPM regression

by 1.35

$$\text{StdRobust} = [\text{quantile}(0.75) - \text{quantile}(0.25)]/1.35, \quad (7.28)$$

or by the *median absolute deviation*

$$\text{StdRobust} = \text{median}(|x_t - \mu|)/0.675. \quad (7.29)$$

Both these would coincide with the standard deviation if data was indeed drawn from a normal distribution without outliers.

Remark 7.15 (*Using other quantiles in (7.28)) To use another quantile, for instance, 0.9 and 0.1, change to

$$\text{StdRobust} = [\text{quantile}(0.9) - \text{quantile}(0.1)]/\gamma,$$

where γ is the difference between $\text{quantile}(0.9)$ and $\text{quantile}(0.1)$ according to a $N(0, 1)$ distribution.

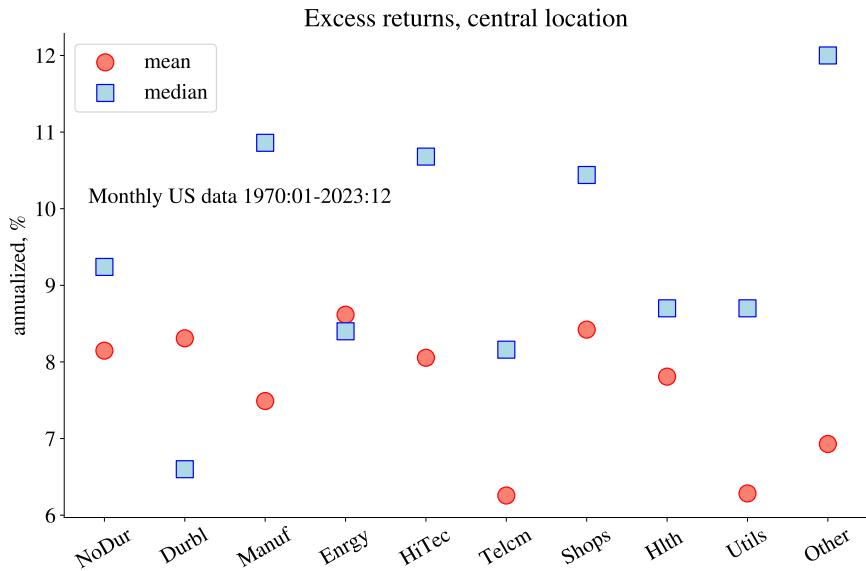


Figure 7.10: Mean excess returns of US industry portfolios

A robust covariance can be calculated by using the identity

$$\text{Cov}(x, y) = [\text{Var}(x + y) - \text{Var}(x - y)]/4 \quad (7.30)$$

and using a robust estimator of the variances—like the square of (7.28). A robust correlation is then created by dividing the robust covariance with the two robust standard deviations.

Empirical Example 7.16 (*Robust estimates of means and standard deviations, U.S. industry portfolios*) See Figures 7.10–7.11 for empirical examples.

7.8.2 Robust Regression Coefficients

Reference: Amemiya (1985) 4.6

The least absolute deviations (LAD) estimator minimizes the sum of absolute residuals (rather than the squared residuals)

$$\hat{\beta}_{LAD} = \arg \min_b \sum_{t=1}^T |y_t - x'_t b| \quad (7.31)$$

This estimator involves non-linearities, but a simple iteration works nicely. It is typically

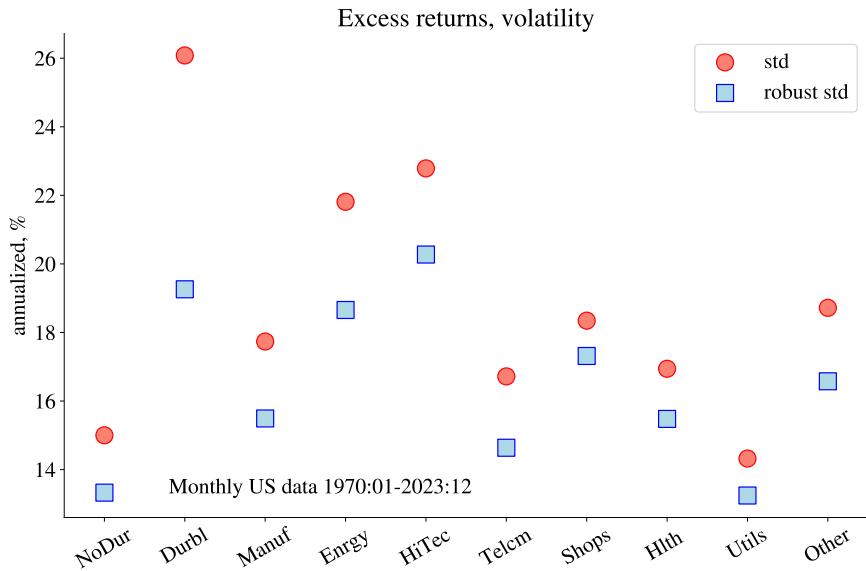


Figure 7.11: Volatility of US industry portfolios

less sensitive to outliers than OLS. (There are also other ways to estimate robust regression coefficients.) This is illustrated in Figure 7.4.

Empirical Example 7.17 (*Robust betas, U.S. industry portfolios*) See Figure 7.12.

If we assume that the median of the true residual, u_t , is zero, then we (typically) have

$$\sqrt{T}(\hat{\beta}_{LAD} - \beta_0) \xrightarrow{d} N[0, f(0)^{-2} \Sigma_{xx}^{-1}/4] \quad (7.32)$$

where Σ_{xx} is (the probability limit of) $\sum_{t=1}^T x_t x_t' / T$ and where $f(0)$ is the value of the pdf of the residual at zero. In practice, Σ_{xx} is estimated by data (as $\sum_{t=1}^T x_t x_t' / T$). Unless we know density function $f()$, we need to estimate it—for instance with a kernel density method.

Example 7.18 ($N(0, \sigma^2)$) When $u_t \sim N(0, \sigma^2)$, then $f(0) = 1/\sqrt{2\pi\sigma^2}$, so the covariance matrix in (7.32) becomes $\pi\sigma^2 \Sigma_{xx}^{-1}/2$. This is $\pi/2$ times larger than when using LS.

Remark 7.19 (*Algorithm for LAD*) The LAD estimator can be written

$$\hat{\beta}_{LAD} = \arg \min_{\beta} \sum_{t=1}^T w_t \hat{u}_t(b)^2, \quad w_t = 1/|\hat{u}_t(b)|, \text{ with } \hat{u}_t(b) = y_t - x_t' \hat{b}$$

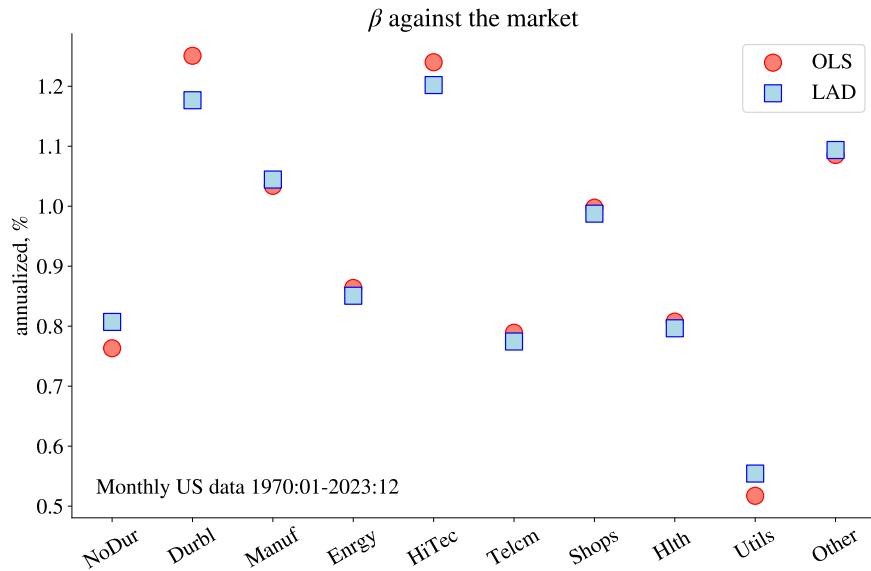


Figure 7.12: Betas of US industry portfolios

so it is a weighted least squares where both y_t and x_t are multiplied by $1/|\hat{u}_t(b)|$. It can be shown that iterating on LS with the weights given by $1/|\hat{u}_t(b)|$, where the residuals are from the previous iteration, converges very quickly to the LAD estimator.

Some alternatives to LAD: least median squares (LMS), and least trimmed squares (LTS) estimators which solve

$$\hat{\beta}_{LMS} = \arg \min_{\beta} [\text{median}(\hat{u}_t^2)], \text{ with } \hat{u}_t = y_t - x_t' \hat{\beta} \quad (7.33)$$

$$\hat{\beta}_{LTS} = \arg \min_{\beta} \sum_{i=1}^h \hat{u}_i^2, \hat{u}_1^2 \leq \hat{u}_2^2 \leq \dots \text{ and } h \leq T. \quad (7.34)$$

Note that the LTS estimator in (7.34) minimizes the sum of the h smallest squared residuals.

Chapter 8

Asymptotic Results on OLS

Reference: Verbeek (2012) 2 and 5

8.1 Motivation of Asymptotics

There are several problems when the standard assumptions about linear regressions are wrong. First, the result that $E \hat{\beta} = \beta$ (unbiased) relies on the assumption that the regressors are fixed (or that we take expectations conditional on $\{x_1, \dots, x_T\}$). Otherwise, it is probably not true (in a finite sample)—see Figure 8.1. Second, the result that $\hat{\beta}$ is normally distributed relies on the assumption that residuals are normally distributed. Otherwise it is not true (in a finite sample). See Figure 8.2.

What *is* true when the standard assumptions are not satisfied? How should we test hypotheses? Two ways to find answers: (a) do computer (Monte Carlo or bootstrap) simulations; (b) find results for $T \rightarrow \infty$ (“asymptotic properties”) and use them as approximations for large samples.

The results from asymptotic theory are more general (and perhaps prettier) than simulations—and can be used as approximations if the sample is large. The basic reason for why this works is that most estimators are sample averages and sample averages often have nice properties as $T \rightarrow \infty$. In particular, we can make use of the law of large numbers (LLN) and the central limit theorem (CLT). See Figure 8.9.

However, the asymptotic results are unlikely to be good approximations in small samples. In those cases we need simulations.

8.2 Asymptotics: Consistency

Reference: Greene (2018) 4.4; Hamilton (1994) 8.2; Davidson (2000) 3

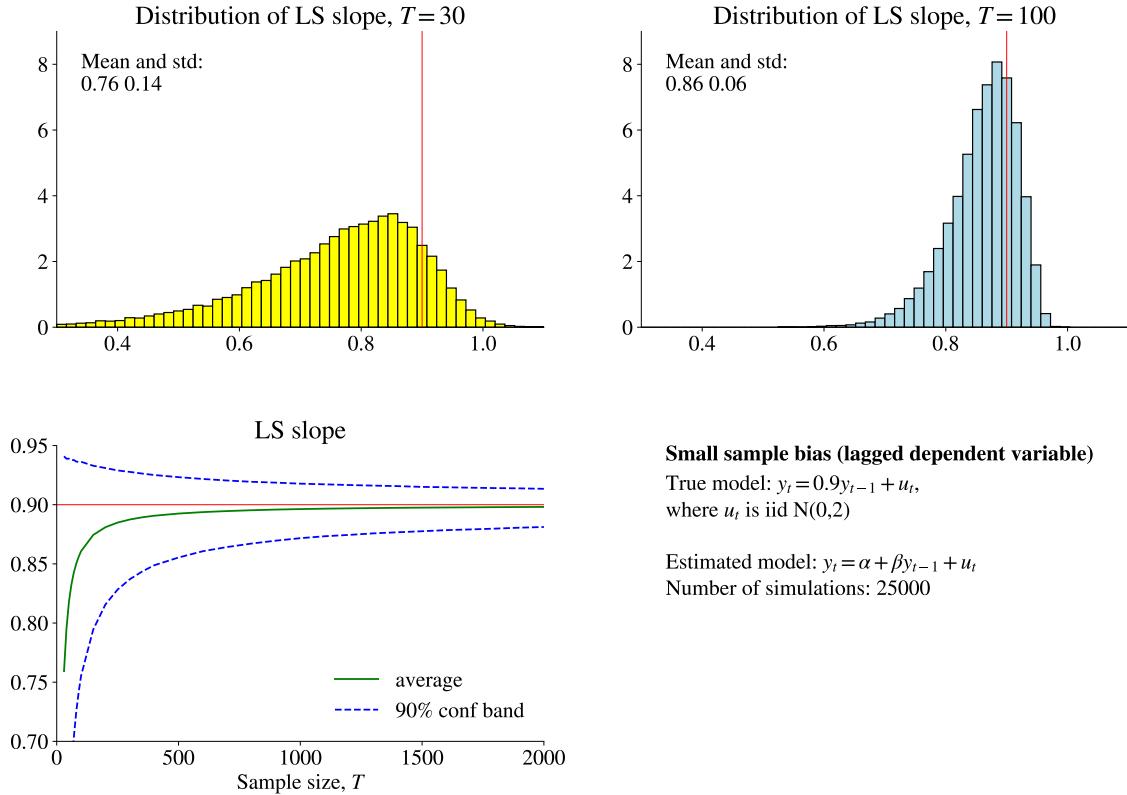


Figure 8.1: Distribution of LS estimator of autoregressive parameter

Issue: will our estimator come closer to the truth as the sample size increases? If not, use another estimator (method).

8.2.1 Probability Limits and the Law of Large Numbers

We need some basic facts about statistics (probability limits) for the discussion of consistency. These are summarized in the following remarks.

Remark 8.1 (*Convergence in probability*) $\hat{\beta}$ converges in probability to b if (loosely speaking)

$$\hat{\beta} \rightarrow b \text{ as } T \rightarrow \infty.$$

Notation: $\text{plim } \hat{\beta} = b$ where plim stands for the probability limit. (Sometimes, $\hat{\beta} \rightarrow^p b$ is used.) In the expression, $\hat{\beta} \rightarrow b$ should be understood as that the probability that $|\hat{\beta} - b| < \text{any number}$ goes to 1.

Remark 8.2 (*Probability limits of a product and of a function*) If $\text{plim } \hat{\alpha} = a$ and $\text{plim } \hat{\beta} =$

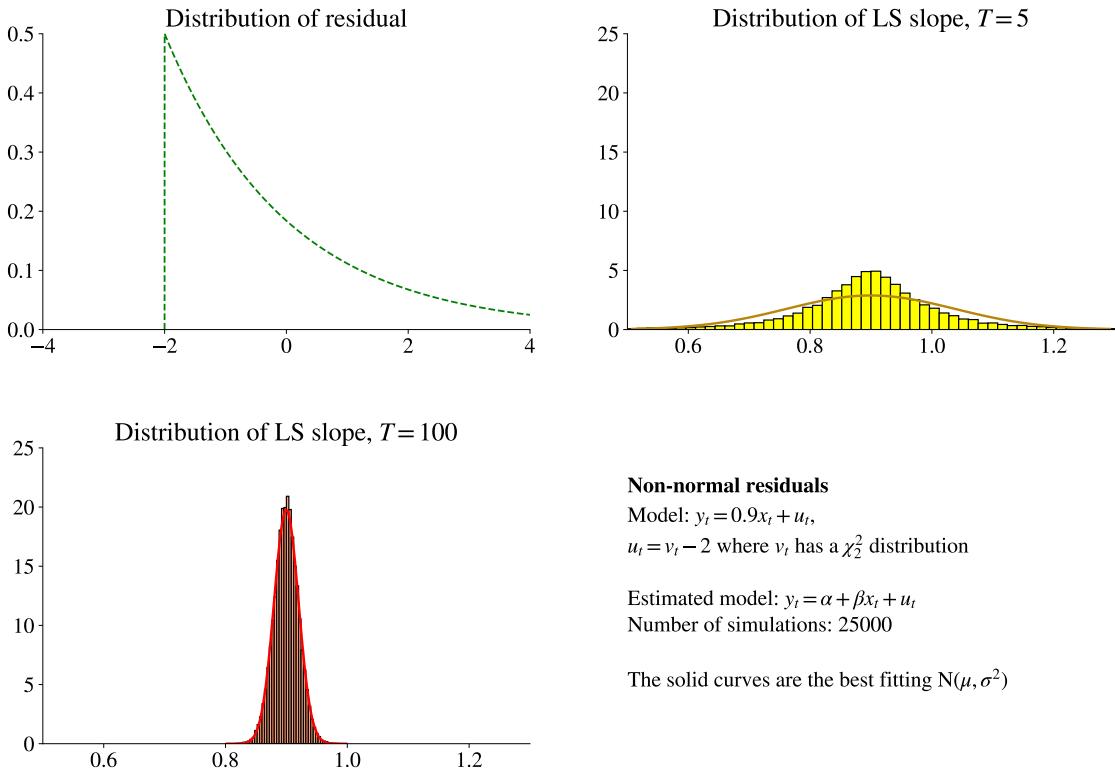


Figure 8.2: Results from a Monte Carlo experiment with thick-tailed errors.

b , then $\text{plim } \hat{\alpha}\hat{\beta} = ab$. (In contrast, this does not hold for expectations: $E\hat{\alpha}\hat{\beta} \neq E\hat{\alpha}E\hat{\beta}$ unless $\hat{\alpha}$ and $\hat{\beta}$ are uncorrelated.) More generally, Slutsky's theorem says that if $g()$ is a continuous function, then $\text{plim } g(\hat{\alpha}) = g(\text{plim } \hat{\alpha})$. For instance, $\text{plim } 1/\bar{x} = 1/\text{plim } \bar{x}$.

Remark 8.3 (Law of large numbers, simple version) A LLN says that the sample average converges to the population mean as the sample size increases (to infinity). Clearly, this means that the sample average is a consistent estimator of the population mean. Notation: $\text{plim}(\bar{x}) = E(x)$.

8.2.2 Consistency of OLS

Remark 8.4 (Consistency) Consistency means that the estimate $\hat{\beta}$ converges in probability to the true value as the sample size increases (to infinity).

The OLS estimate of a slope coefficient is (after dividing and multiplying by T)

$$\hat{\beta} = \beta + \underbrace{\left(\frac{1}{T} \sum_{t=1}^T x_t x_t' \right)^{-1}}_{\rightarrow \Sigma_{xx}^{-1}} \underbrace{\frac{1}{T} \sum_{t=1}^T x_t u_t}_{\rightarrow E(xu)} \quad (8.1)$$

where u_t are the residuals we could calculate if we knew the true slope coefficient (denoted β), that is, the true residuals. The symbols below the equation indicate what the different terms converge to (according to a LLN) as the sample size increases. In particular, the inverse is a continuous function so the first term converges to the inverse of the second moment matrix of x_t ($E x_t x_t'$) which is denoted Σ_{xx} . (This clearly assumes that x_t is such that the expectation is well defined, which we assume.) Also, the two terms form a product so we can apply the rule that the probability limit is the product of the two (individual) probability limits.

In short, the probability limit is

$$\text{plim } \hat{\beta} = \beta + \Sigma_{xx}^{-1} E(x_t u_t), \quad (8.2)$$

where Σ_{xx}^{-1} is (asymptotically) a matrix of constants: there is nothing random about it. Clearly, for the estimate $\hat{\beta}$ to converge to the true values (β), $E(x_t u_t) = 0$ is needed. If $E u_t = 0$ (which is a basic assumption in most regression analysis), then $E(x_t u_t) = \text{Cov}(x_t, u_t)$, so consistency of $\hat{\beta}$ requires the regressors and the (true) residuals to be uncorrelated.

Some observations:

1. We can not (easily) test this, since OLS creates $\hat{\beta}$ and the fitted residuals \hat{u}_t such that $\sum_{t=1}^T x_t \hat{u}_t / T = 0$.
2. The standard regression assumption that u_t and x_t are independent implies that $E(x_t u_t) = 0$. This means that the standard regression assumptions take it for granted that OLS is consistent. However, this might be a false assumption.
3. OLS can be biased (in a small sample), but still be consistent. This means that OLS is systematically wrong in any small sample, but the problem vanishes in large samples. See Figure 8.1. In these figures, $\text{Cov}(u_{t-1}, x_t) \neq 0$ so OLS is biased since x_t is not independent of all residuals, but $\text{Cov}(u_t, x_t) = 0$ so it is consistent since x_t is not correlated with the *contemporaneous* residual.

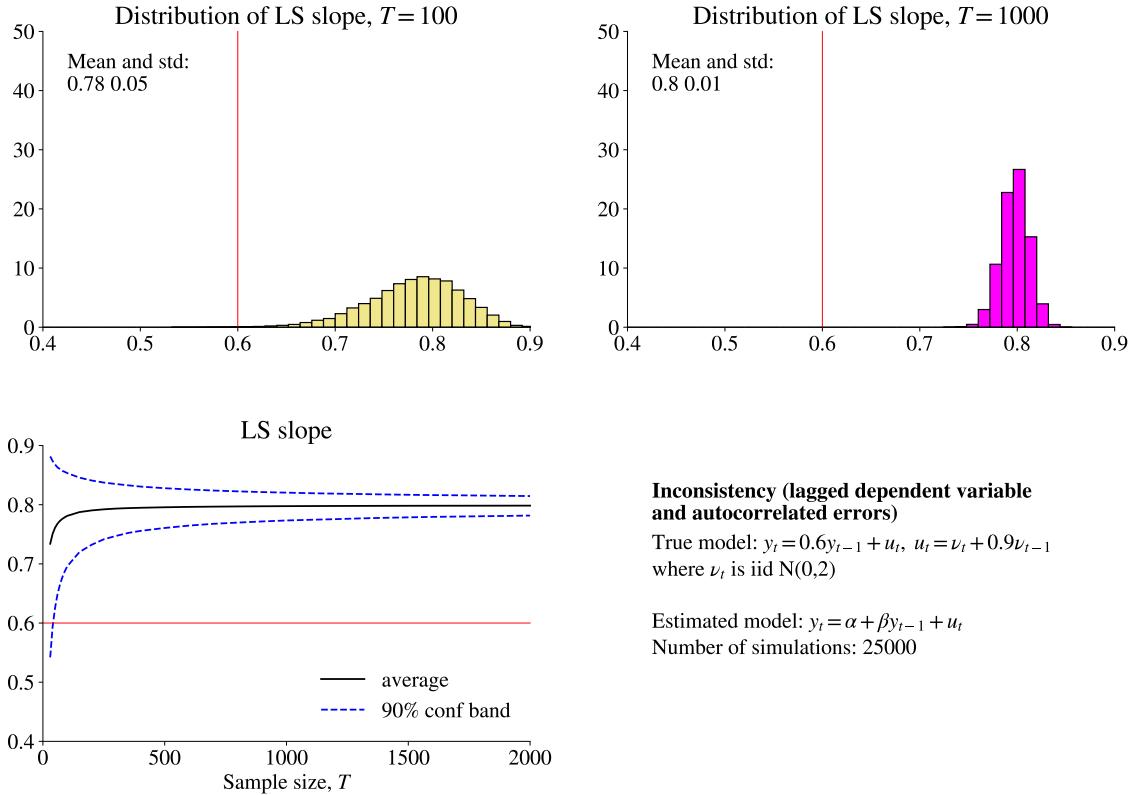


Figure 8.3: Results from a Monte Carlo experiment of LS estimation of the AR coefficient when data is from an ARMA process.

4. There are cases when $E(x_t u_t) = 0$ doesn't make sense. Then OLS is inconsistent, which will be later in this chapter. See Figure 8.1 for an example of where OLS is consistent, and Figure 8.3 when it is not.
5. We have assumed that the limits of $\sum_{t=1}^T x_t x_t'$ and $\sum_{t=1}^T x_t u_t$ are well defined and finite. This is not always the case—and something we discuss later in this chapter, in the section on “spurious regressions.”

What have we learned? Well,...under what conditions ($E(x_t u_t) = 0$) OLS comes closer to the correct value as T increases.

8.3 When OLS Is Inconsistent

This section discusses some typical cases where OLS is inconsistent, that is, $E(x_t, u_t) \neq 0$. These cases include (i) omitted variables; (ii) autocorrelated errors combined with

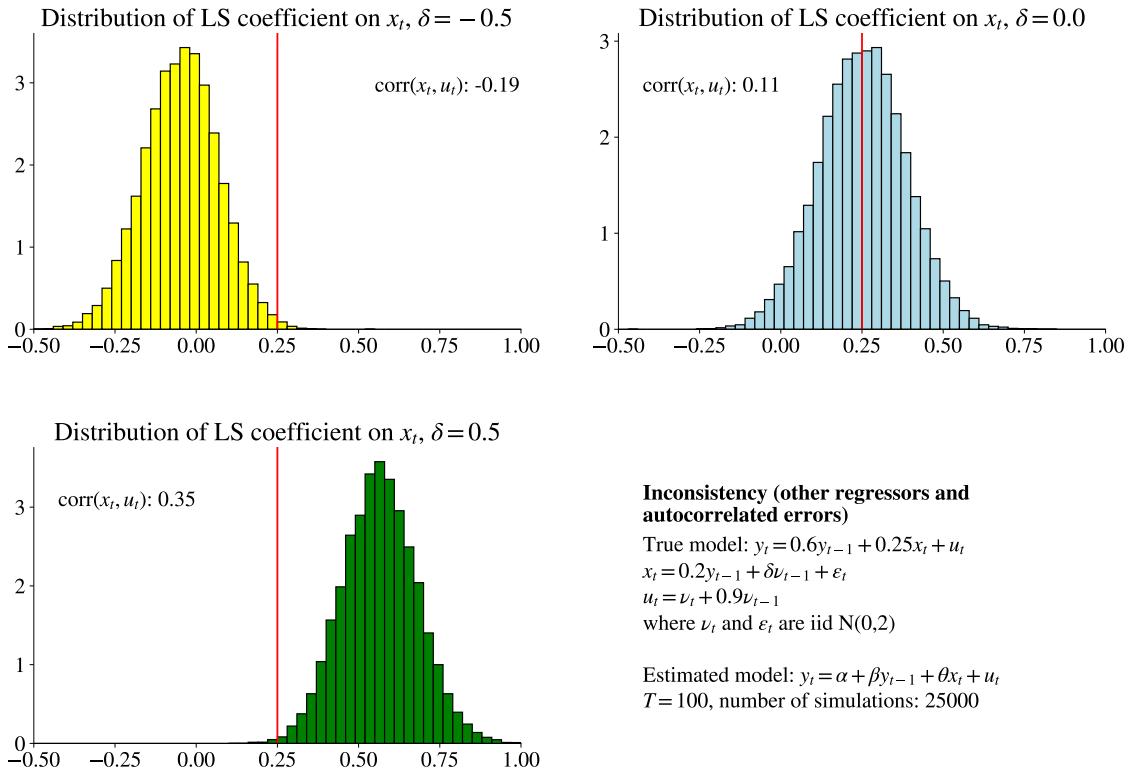


Figure 8.4: Results from a Monte Carlo experiment of LS estimation of the coefficient on x_t when the errors are autocorrelated.

lagged dependent variable; (iii) measurement errors in regressors; and (iv) endogenous regressors.

8.3.1 Omitted Variables

Reference: Greene (2018) 4.3

Consider the regression

$$y_t = x_t' \beta + h_t' \gamma + \varepsilon_t, \quad (8.3)$$

where $E(x_t \varepsilon_{tt}) = 0$.

Suppose we omit (exclude) the h_t variables and instead estimate

$$y_t = x_t' \beta + u_t. \quad (8.4)$$

This means that the residual from in the regression (8.4) is $u_t = h_t' \gamma + \varepsilon_t$, that is, it incorporates the effect of both the omitted variables and the “true” residual. Therefore,

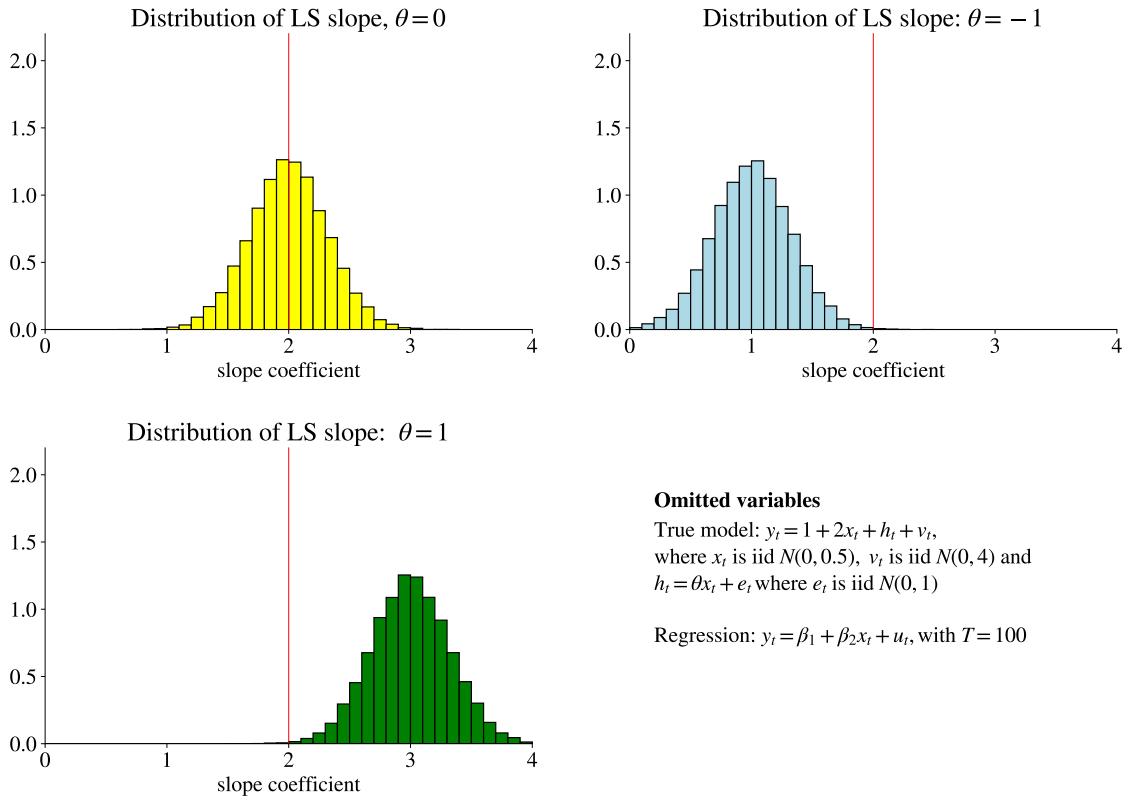


Figure 8.5: Effect of omitted variables

if the omitted variables are correlated with the included variables ($\text{cor}(h_t, x_t) \neq \mathbf{0}$), then $\text{plim } \hat{\beta}_2$ from (8.4) will differ from the true β_2 (in (8.3)).

In fact, the probability limit of $\hat{\beta}$ is

$$\text{plim } \hat{\beta} = \beta + [\theta_1 \dots \theta_L] \gamma, \quad (8.5)$$

where θ_i is the probability limit of vector of coefficients obtained by regressing h_{it} on x_t . (See below for a proof.) This analysis shows that $\hat{\beta}$ incorporates how x_t comoves with the h_t . In case they are uncorrelated ($\theta_i = \mathbf{0}$), then omitting the h_t variables does not affect $\hat{\beta}$. However, if they are correlated, then $\hat{\beta}$ are inconsistent (and biased) in the sense of being systematically different from the true β values in (8.3). See Figure 8.5.

Actually, (8.5) holds in each sample, not just as a probability limit, if all coefficients estimated from that sample (a proof is found below).

Notice the following:

- $\hat{\beta}$ from (8.4) is actually the right number to use if we want to predict: “given x_t ,

what is the best guess of y_t ?" The reason is that $\hat{\beta}$ factors in also how x_t predicts h_t (which affects y_t).

- $\hat{\beta}$ from (8.4) is not right number to use if we want to understand an economic mechanism: "if we increase x_{it} , by one unit (but holding all other variables constant), what is the likely effect on y_t ?" The reason is that we here need a consistent estimate of β . Even in this case, (8.5) and an economic theory might be useful in assessing (guessing) the sign of the bias.

Proof (of (8.5)*) Recall that the OLS estimates are

$$\hat{\beta} = \beta + S_{xx}^{-1} \Sigma_{t=1}^T x_t u_t,$$

where $S_{xx} = \Sigma_{t=1}^T x_t x_t'$. Since $u_t = h_t' \gamma + \varepsilon_t$, we can write this as

$$\hat{\beta} = \beta + S_{xx}^{-1} \sum_{t=1}^T x_t h_t' \gamma + S_{xx}^{-1} \sum_{t=1}^T x_t \varepsilon_t.$$

The probability of the last term is zero (the residual in (8.3) should not be correlated with any of the regressors), while the middle term can be written

$$[\hat{\theta}_1 \dots \hat{\theta}_L] \gamma$$

where $\hat{\theta}_i$ is the (column) vector of coefficients obtained by regressing h_{it} on x_t

$$\hat{\theta}_i = S_{xx}^{-1} \sum_{t=1}^T x_t h_{it}.$$

Take the probability limit and combine to get (8.5). \square

Proof (of that (8.5) hold in every sample, based on sample moments*) For notational convenience, let x_t and h_t be scalars and assume all variables have zero means so we can disregard intercepts.

(1) Regress y_t on x_t (as in (8.4) but where we use b to denote the slope) to get $\hat{b} = S_{xx}^{-1} S_{xy}$, where $S_{zw} = \Sigma_{t=1}^T z_t w_t$.

(2) Regress h_{it} on x_t to get $\hat{\theta} = S_{xx}^{-1} S_{xh}$.

(3) Regress y_t on (x_t, h_t) (as in (8.3)) to get

$$\begin{bmatrix} \hat{\beta} \\ \hat{\gamma} \end{bmatrix} = \frac{1}{S_{xx} S_{hh} - S_{xh}^2} \begin{bmatrix} S_{hh} & -S_{xh} \\ -S_{xh} & S_{xx} \end{bmatrix} \begin{bmatrix} S_{xy} \\ S_{hy} \end{bmatrix},$$

where we use the standard expression for the inverse of a 2×2 matrix.

Combine to calculate $\hat{\beta} + \hat{\theta} \hat{\gamma}$ and note that it equals \hat{b} . \square

8.3.2 Autocorrelated Errors Combined with Lagged Dependent Variable

As an example of how autocorrelated errors combined with a lagged dependent variable as regressor leads to inconsistent OLS estimates, consider

$$y_t = \beta_1 + \beta_2 x_t + \beta_3 y_{t-1} + u_t, \text{ where} \quad (8.6)$$

$$u_t = v_t + \theta v_{t-1}, v_t \text{ iid.} \quad (8.7)$$

As a special case, $\beta_2 = 0$ gives an ARMA(1,1) model, which is a well known case which cannot be estimated by OLS. See Figure 8.3.

The issue is that y_{t-1} is correlated with the lagged shock (v_{t-1}) and hence with the OLS residuals u_t : $\text{Cov}(y_{t-1}, u_t) \neq 0$. This is a common problem in dynamic models.

Remark 8.5 (*Autocorrelated errors and other regressors**) *Autocorrelated errors may affect the coefficient estimates also on other regressors (x_t), but only if x_t is directly related to the residual. It (probably) is not enough that they are correlated with y_{t-1} . This might seem puzzling, since a correlation of a regressor with y_{t-1} will lead to a correlation with the residual, so $E(x_t u_t) \neq 0$. However, the bias in the coefficient on y_{t-1} will effectively create another residual that will be uncorrelated with x_t . (This could probably be proved by using the Frisch-Waugh theorem.) See Figure 8.4.*

Proof (of inconsistency of OLS estimate of an ARMA model*) Consider the case in (8.6)–(8.7) but where $\beta_2 = 0$ so the regression is an AR(1) but the errors follow an MA(1) process. In the limit, the OLS estimate is $\hat{\beta}_3 = \text{Cov}(y_t, y_{t-1}) / \text{Var}(y_{t-1})$. Using (8.6) to replace y_t gives $\hat{\beta}_3 = \beta_3 + \text{Cov}(v_t + \theta v_{t-1}, y_{t-1}) / \text{Var}(y_{t-1})$. The 2nd term is non-zero if $\theta \neq 0$. \square

8.3.3 Measurement Errors in a Regressor

As an example of how measurement errors in a regressor gives inconsistent OLS estimates, consider a simple (true) model like

$$y_t = \beta_1 + \beta_2 w_t + v_t. \quad (8.8)$$

However, we estimate with a proxy x_t for the regressor w_t

$$y_t = \beta_1 + \beta_2 x_t + u_t, \text{ with} \quad (8.9)$$

$$x_t = w_t + e_t, \quad (8.10)$$

where e_t is a measurement error. This is a common problem in micro data, including corporate finance. This leads to $\text{Cov}(x_t, u_t) \neq 0$ since x_t depends on the measurement error e_t directly, while u_t will capture both the original residual v_t and the “noise” induced by $\beta_2 e_t$. (Actually, $u_t = -\beta_2 e_t + v_t$ to see this, use $w_t = x_t - e_t$ in correct model (8.8).) Therefore, OLS is inconsistent for estimating β_2 . See Figure 8.6.

To see the precise source of the inconsistency, solve for $w_t = x_t - e_t$, use in correct model (8.8) to get

$$\begin{aligned} y_t &= \beta_1 + \beta_2(x_t - e_t) + v_t \\ &= \beta_1 + \beta_2 x_t - \underbrace{\beta_2 e_t + v_t}_{u_t}. \end{aligned} \quad (8.11)$$

From (8.10) we know that x_t is correlated with the measurement error (e_t), which gives $\text{Cov}(x_t, u_t) \neq 0$.

In fact, it can be shown that

$$\text{plim } \hat{\beta}_2 = \beta_2 \left(1 - \frac{\sigma_e^2}{\sigma_w^2 + \sigma_e^2} \right). \quad (8.12)$$

Notice that $\hat{\beta}_2 \rightarrow 0$ if the measurement error dominates ($\sigma_e^2 \rightarrow \infty$), since y_t is not related to the measurement error. In contrast, $\hat{\beta}_2 \rightarrow \beta_2$ as measurement vanishes ($\sigma_e^2 \rightarrow 0$): no measurement error. Measurement errors will thus bias the coefficient towards zero. Any significant coefficient can therefore be seen as a conservative estimate.

Proof (of (8.12)) To simplify, assume that x_t has a zero mean. From (8.2), we then have $\text{plim } \hat{\beta}_2 = \beta_2 + \Sigma_{xx}^{-1} \text{E}(x_t u_t)$. Here, $\Sigma_{xx}^{-1} = 1 / \text{Var}(x_t)$, but notice from (8.10) that $\text{Var}(x_t) = \sigma_w^2 + \sigma_e^2$ if w_t and e_t are uncorrelated. We also have $\text{E}(x_t u_t) = \text{Cov}(x_t, u_t)$, which from the definition of x_t in (8.10) and of $u_t = -\beta_2 e_t + v_t$ gives

$$\text{Cov}(x_t, u_t) = \text{Cov}(w_t + e_t, -\beta_2 e_t + v_t) = -\beta_2 \sigma_e^2.$$

Together we get

$$\text{plim } \hat{\beta}_2 = \beta_2 + \Sigma_{xx}^{-1} \text{E}(x_t u_t) = \beta_2 - \beta_2 \frac{\sigma_e^2}{\sigma_w^2 + \sigma_e^2},$$

which is (8.12). \square

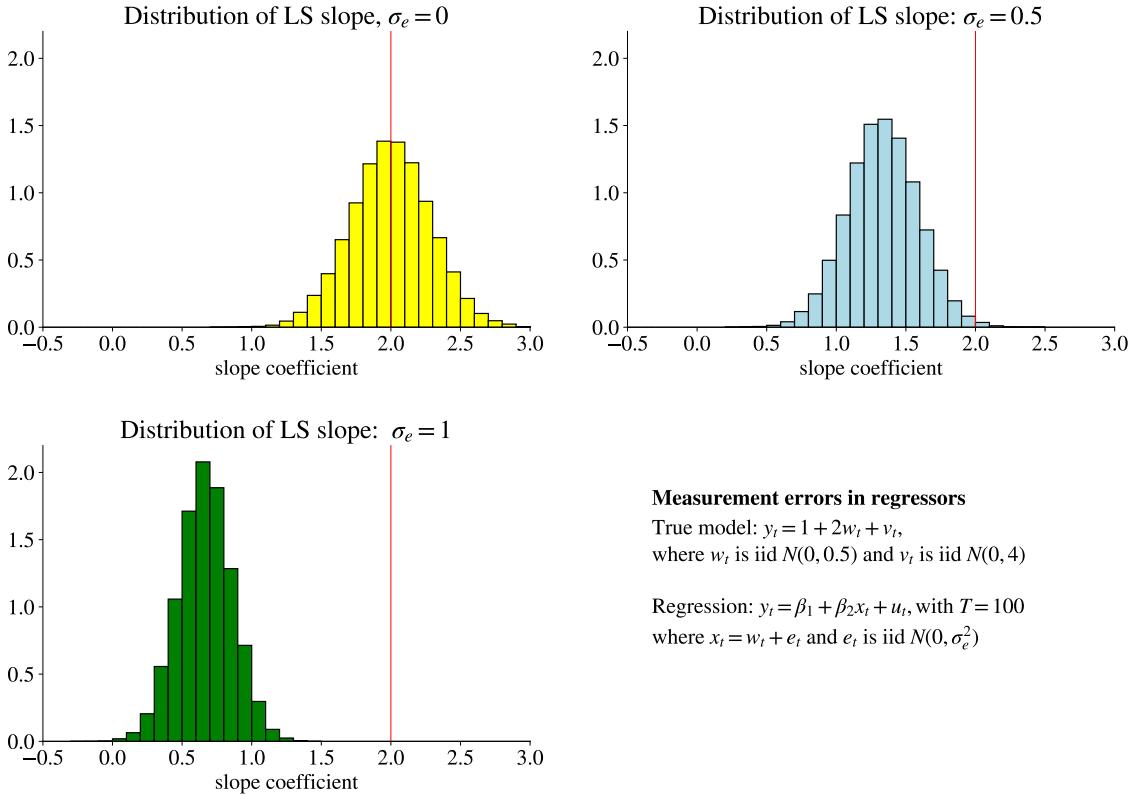


Figure 8.6: Effect of measurement error in regressor

8.3.4 Endogenous Regressors (System of Simultaneous Equations)

Consider the simplest simultaneous equations model for supply and demand on a market. Supply is

$$q_t = \gamma p_t + u_t^s, \quad \gamma > 0, \quad (8.13)$$

and demand is

$$q_t = \beta p_t + \alpha A_t + u_t^d, \quad \beta < 0, \quad (8.14)$$

where A_t is an observable demand shock (perhaps income).

Suppose we try to estimate the supply equation (8.13) by LS. However, p_t is correlated with u_t^s (since $u_t^s \rightarrow q_t \rightarrow p_t$), so we cannot hope that LS will be consistent. See Figure 8.7 for an illustration (disregard the IV/2SLS subfigure for now). It is clear that the OLS estimate $\hat{\gamma}_{OLS}$ will be a mixture of the true γ and β values (and other things). Figure 8.8 illustrates this by a Monte Carlo simulation. Economic theory can sometimes help assessing the sign of the bias and perhaps even motivate why the empirical result might

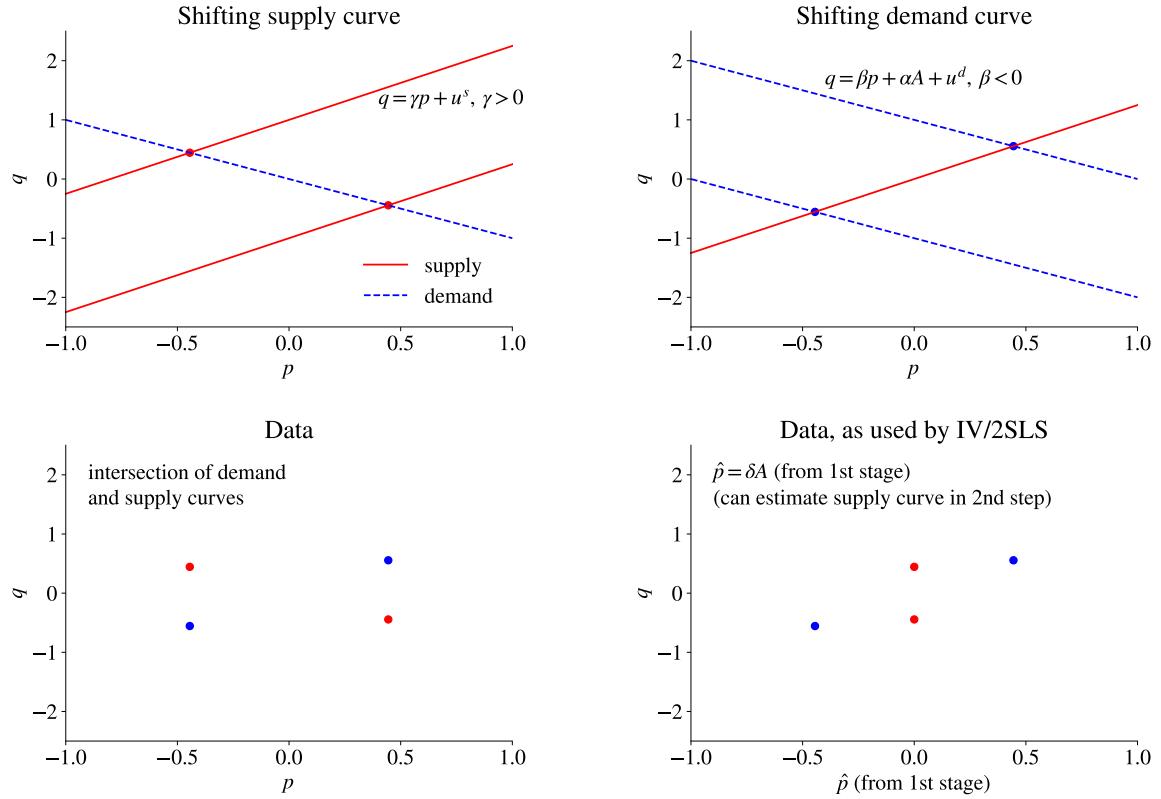


Figure 8.7: Illustration of demand and supply curves

be interpreted as a bound on the true parameter. (The appendix provides extra details.)

8.3.5 What to Do When OLS is Inconsistent?

If possible change model/data. Otherwise consider another estimations method (for instance, IV/2SLS, MLE, or GMM). Later chapter will discuss such methods.

8.4 Asymptotic Normality

Reference: Greene (2018) 4.4; Hamilton (1994) 8.2; Davidson (2000) 3

Issue: what is the distribution of your estimator in large samples?

8.4.1 Central Limit Theorems

We need some basic facts about statistics (central limit theorems) for the discussion of asymptotic normality, summarized in the remarks below.

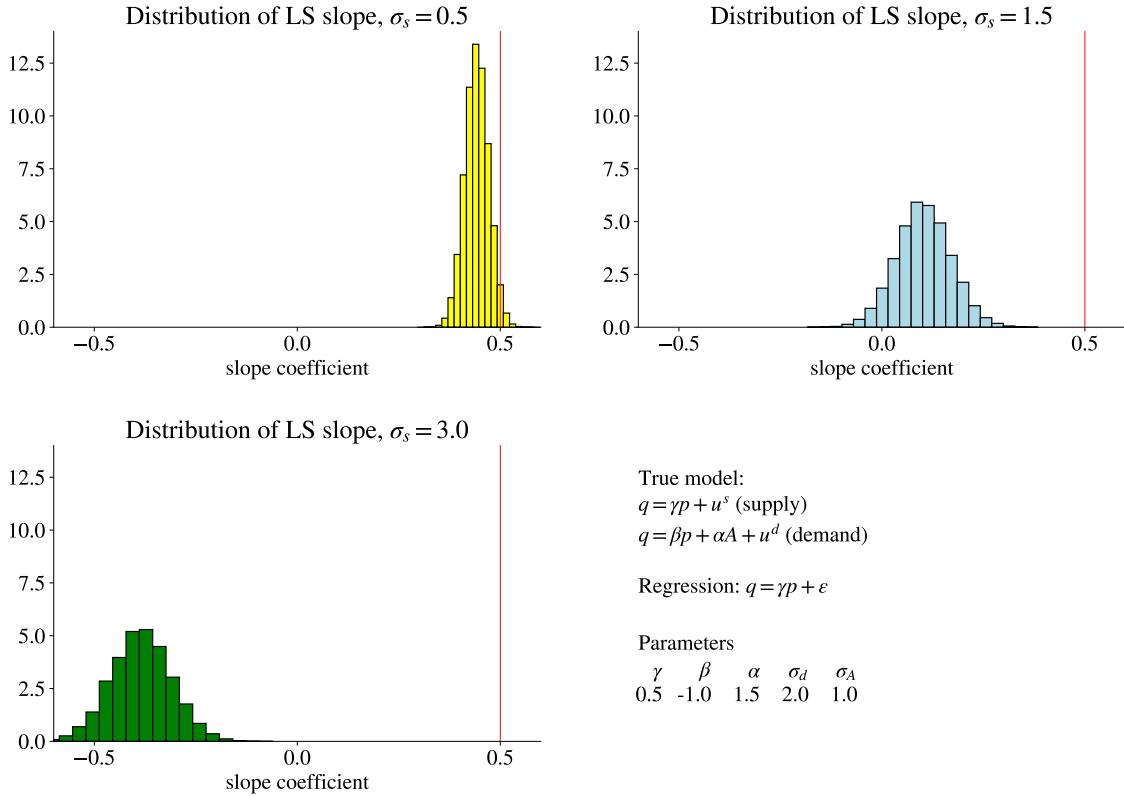


Figure 8.8: Distribution of LS estimator of supply elasticity

Remark 8.6 (*Convergence in distribution*) Let \hat{z} be a random variable (which depends on the sample size T) and let Z be another random variable that does not. If the cdf of \hat{z} is the same as the cdf of z as $T \rightarrow \infty$, then \hat{z} converges in distribution to the random variable Z . Notation $\hat{z} \xrightarrow{d} Z$.

Remark 8.7 (*Central limit theorem, simple version*) A CLT says that $\sqrt{T}\bar{x} \xrightarrow{d} N()$, that is, becomes normally distributed when T becomes really large. This holds for many random variables (although exceptions exist). Notice that the distribution of \bar{x} converges to a spike as T increases (LLN), but the distribution of $\sqrt{T}\bar{x}$ converges to a normal distribution. See Figure 8.9.

Remark 8.8 (*Continuous mapping theorem.*) Let the random variables \hat{z} and \hat{q} and the non-random a_T be such that $\hat{z} \xrightarrow{d} Z$, $\text{plim } \hat{q} = Q$ (a finite and positive definite matrix) and $a_T \rightarrow a$ (a traditional limit). Also, let $g(z, y, a)$ be a continuous function. Then $g(\hat{z}, \hat{q}, a_T) \xrightarrow{d} g(Z, Q, a)$.

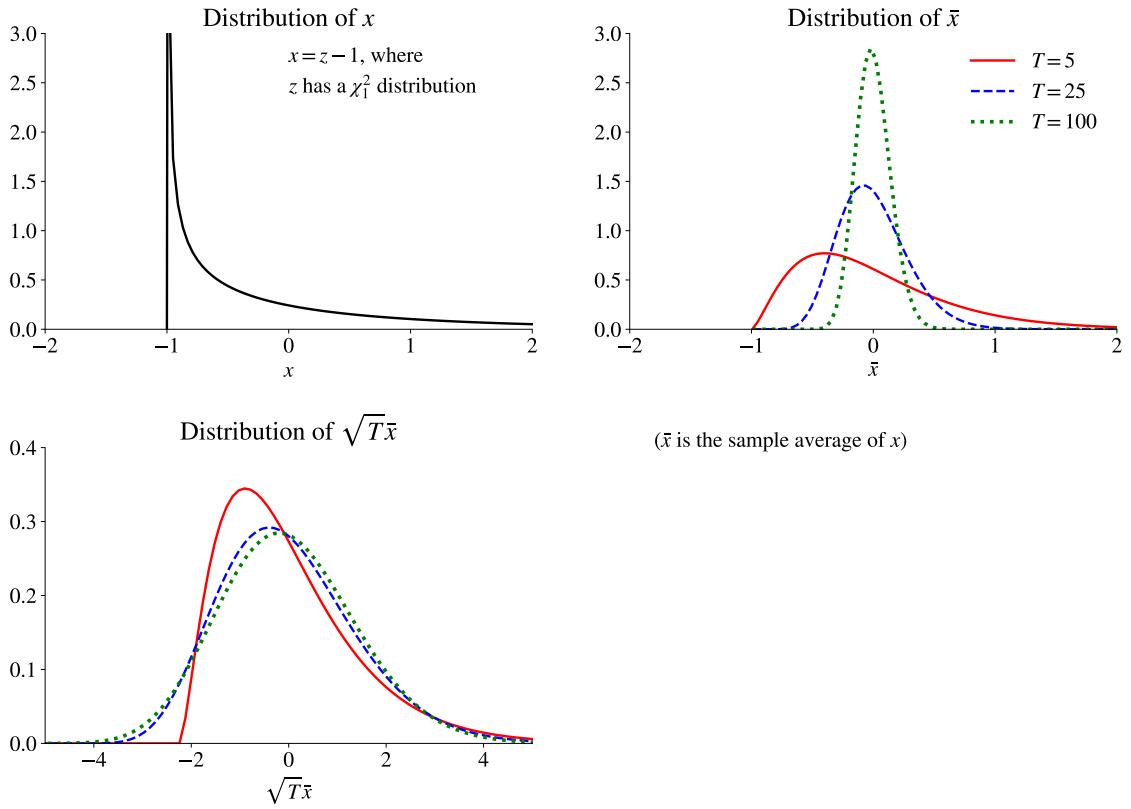


Figure 8.9: Distribution of sample averages

Example 8.9 For instance, the sequences in Remark 8.8 could be $\hat{z} = \sqrt{T} \sum_{t=1}^T w_t / T$ (the scaled sample average of a zero mean random variable w_t) which is likely to obey a CLT; $\hat{q} = \sqrt{\sum_{t=1}^T w_t^2 / T}$ (the sample standard deviation) which would be σ ; and $a = \sum_{t=1}^T 0.7^t$ (which converges to $2\frac{1}{3}$). Then, $a_T \hat{z} / \hat{q}$ would converge to a $N(0, 5\frac{4}{9})$ variable.

8.4.2 Asymptotic Normality of OLS

Subtract β from both sides of (8.1), and multiply both sides by \sqrt{T} to get

$$\sqrt{T}(\hat{\beta} - \beta) = \underbrace{\left(\frac{1}{T} \sum_{t=1}^T x_t x_t' \right)^{-1}}_{\rightarrow \Sigma_{xx}^{-1}} \underbrace{\sqrt{T} \frac{1}{T} \sum_{t=1}^T x_t u_t}_{\sqrt{T} \times \text{sample average}} \quad (8.15)$$

The first term converges (by a LLN) in probability limit to Σ_{xx}^{-1} , assuming the x_t is such that the limit is well defined. (This is like the $\text{plim } \hat{q} = Q$ variables in Remark 8.8.) The second term is $\sqrt{T} \times \text{sample average}$ (of $x_t u_t$), which (by a CLT) will (typically)

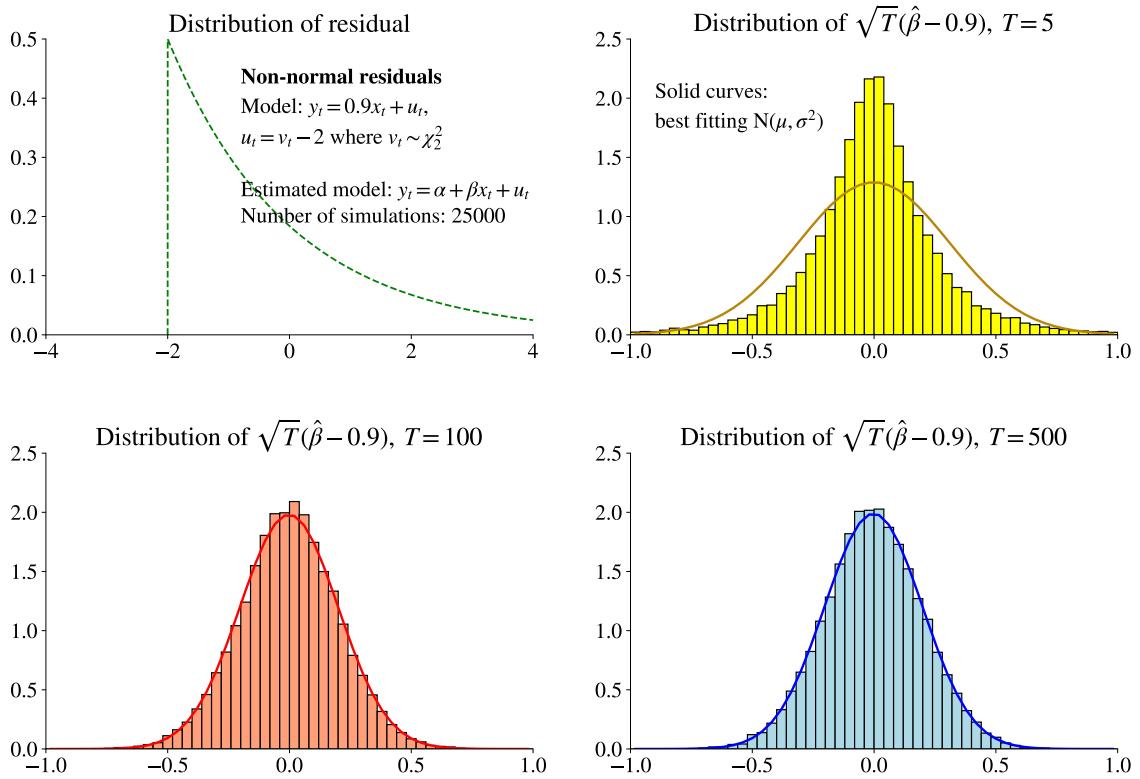


Figure 8.10: Results from a Monte Carlo experiment with thick-tailed errors.

converge in distribution to a normally distributed variable. According to Remark 8.8, we should therefore expect $\sqrt{T}\hat{\beta}$ to be normally distributed in *large* samples—even if the residual doesn’t have a normal distribution. See Figure 8.10 for an example.

According to Remark 8.8 and (8.15) $\sqrt{T}(\hat{\beta} - \beta)$ converges in distribution to Σ_{xx}^{-1} times a normally distributed variable (vector). If OLS is consistent, then the normal distribution has a zero mean ($E x_t u_t = 0$). Let Σ denote the variance-covariance matrix of the last term in (8.15)

$$\Sigma = \text{Var} \left(\sqrt{T} \frac{1}{T} \sum_{t=1}^T x_t u_t \right). \quad (8.16)$$

Together, we then have

$$\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} N(0, \Sigma_{xx}^{-1} \Sigma \Sigma_{xx}^{-1}) \quad (8.17)$$

We sometimes rewrite this as

$$\hat{\beta} \xrightarrow{a} N(\beta, \Sigma_{xx}^{-1} \Sigma \Sigma_{xx}^{-1} / T), \quad (8.18)$$

where $\stackrel{a}{\sim}$ means “is asymptotically distributed as”. (The transformation to get this is (a) divide the LHS of (8.17) by \sqrt{T} and thus the covariance matrix by T ; (b) add β to the LHS and thus shift the mean from 0 to β .)

If we estimate by $\hat{\Sigma}_{xx} = S_{xx}/T$ (where $S_{xx} = \sum_{t=1}^T x_t x'_t$ as in previous chapter) and $\hat{\Sigma} = \hat{S}/T$ (where \hat{S} is an estimate of the variance-covariance matrix of $\sum_{t=1}^T x_t u_t$ as in previous chapters), then after cancelling T terms, an estimate of the variance-covariance term in (8.18) is

$$\widehat{\text{Var}}(\hat{\beta}) = \left(\frac{S_{xx}}{T} \right)^{-1} \frac{\hat{S}}{T} \left(\frac{S_{xx}}{T} \right)^{-1} \frac{1}{T} = S_{xx}^{-1} \hat{S} S_{xx}^{-1}. \quad (8.19)$$

Notice that this has the same form as (an estimate of) the variance-covariance matrix derived under the assumption of fixed regressors.

8.5 Spurious Regressions

This section contains an informal discussion of what happens when the data has trends and/or unit root behaviour. This means, for instance, that the limits of $\sum_{t=1}^T x_t x'_t$ and $\sum_{t=1}^T x_t u_t$, previously used in (8.1)–(8.2) may not be well defined and finite. This can lead to very strange properties of OLS estimators. A precise formal discussion of this is rather involved and beyond the scope of these notes, so the focus in this section is on providing some intuition.

Strong trends often causes problems in econometric models where y_t and x_t both have trending behaviour, but where an explicit trend is missing from the set of regressors: this may then make a regressor look significant just because it is a proxy for the missing trend (a missing variable bias). The same holds for non-stationary processes, even if they have no deterministic trends. The reason is that the innovations accumulate and the series therefore tend to be trending in small samples. Asymptotic results are typically of *little use* here, since the non-stationarity means that the asymptotic results are degenerate (for instance, infinite variance). A warning sign of a spurious regression is when $R^2 > DW$ statistic.

Empirical Example 8.10 (*Regressing the price level on GDP*) See Figure 8.11 for results from regressing the U.S. price level (GDP deflator) on output (GDP level). The results indicate a very significant regression slope, but extreme autocorrelation. This is likely to be a spurious regression. Also, economics would suggest that nominal (price level) and real variables (output) variables are driven by completely different factors.

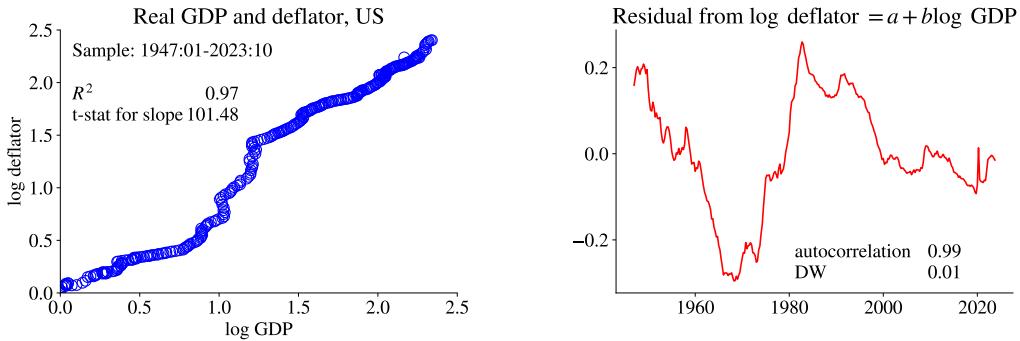


Figure 8.11: Example of a spurious regression

See Figures 8.12 –8.15 for a Monte Carlo simulation. Figure 8.12 shows how the uncertainty about a slope coefficient becomes very large (for a fixed sample size) in a unit root case. That, in itself, is perhaps no big surprise. Figure 8.13 is more worrying since it suggests that (with a unit root) a larger sample size might not help. Figure 8.14 shows how the distribution of the t-stat (of a true null hypothesis) has a very wide distribution—far from being $N(0,1)$. This holds also when Newey-West standard errors are used. Finally, Figure 8.15 show that the R^2 gets a strange distribution and that the autocorrelation of the residuals is typically very high.

For trend-stationary data, this problem is easily solved by detrending with a linear trend (before estimating or just adding a trend variable to the set of regressors).

However, this is usually a poor method for a unit root processes. What is needed is a first difference. For instance, a first difference of the random walk with drift is

$$\begin{aligned}\Delta y_t &= y_t - y_{t-1} \\ &= \mu + \varepsilon_t,\end{aligned}\tag{8.20}$$

which is white noise (any finite difference, like $y_t - y_{t-s}$, will give a stationary series), so we could proceed by applying standard econometric tools to Δy_t .

8.6 Appendix – Some Extra Details on Demand and Supply*

This appendix includes some details that are left out from the main text.

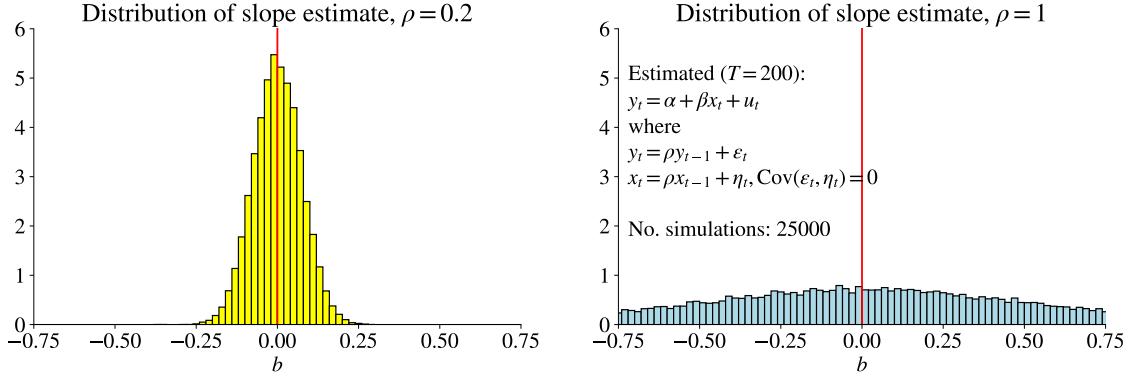


Figure 8.12: Distribution of slope coefficient when y_t and x_t are independent AR(1) processes

8.6.1 Demand and Supply

Example 8.11 (*Supply and Demand**) The system (the “structural form”) is therefore

$$\begin{bmatrix} 1 & -\gamma \\ 1 & -\beta \end{bmatrix} \begin{bmatrix} q_t \\ p_t \end{bmatrix} + \begin{bmatrix} 0 \\ -\alpha \end{bmatrix} A_t = \begin{bmatrix} u_t^s \\ u_t^d \end{bmatrix}.$$

This can be solved in terms of the exogenous variables (the “reduced form”) as

$$\begin{bmatrix} q_t \\ p_t \end{bmatrix} = \begin{bmatrix} -\frac{\gamma}{\beta-\gamma}\alpha \\ -\frac{1}{\beta-\gamma}\alpha \end{bmatrix} A_t + \begin{bmatrix} \frac{\beta}{\beta-\gamma} & -\frac{\gamma}{\beta-\gamma} \\ \frac{1}{\beta-\gamma} & -\frac{1}{\beta-\gamma} \end{bmatrix} \begin{bmatrix} u_t^s \\ u_t^d \end{bmatrix}.$$

Example 8.12 (*Supply equation with LS**) Using the reduced form from Example 8.11, it is straightforward to show that the probability limit of the OLS estimate of γ is (assuming that the supply and demand shocks are uncorrelated)

$$\begin{aligned} \text{plim } \hat{\gamma}_{OLS} &= \frac{\text{Cov}(q_t, p_t)}{\text{Var}(p_t)} \\ &= \frac{\gamma\alpha^2 \text{Var}(A_t) + \gamma \text{Var}(u_t^d) + \beta \text{Var}(u_t^s)}{\alpha^2 \text{Var}(A_t) + \text{Var}(u_t^d) + \text{Var}(u_t^s)}. \end{aligned}$$

First, suppose the supply shocks are zero, $\text{Var}(u_t^s) = 0$, then $\text{plim } \hat{\gamma} = \gamma$, so we indeed estimate the supply elasticity, as we wanted. Think of a fixed supply curve, and a demand curve which moves around. These point of p_t and q_t should trace out the supply curve. It is clearly u_t^s that causes a simultaneous equations problem in estimating the supply curve: u_t^s affects both q_t and p_t and the latter is the regressor in the supply equation. With no

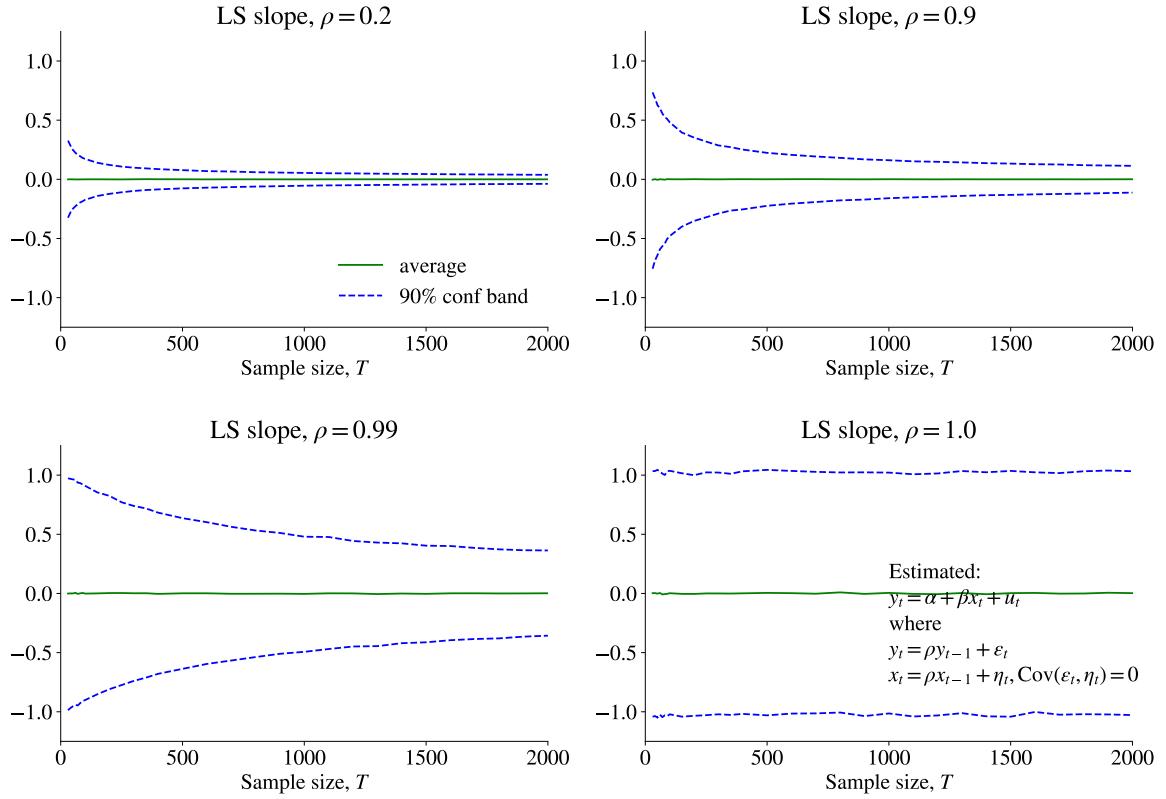


Figure 8.13: Distribution of slope coefficient when y_t and x_t are independent AR(1) processes

movements in u_t^s there is no correlation between the shock and the regressor. Second, now suppose instead that the both demand shocks are zero (both $A_t = 0$ and $\text{Var}(u_t^d) = 0$). Then $\text{plim } \hat{\gamma} = \beta$, so the estimated value is not the supply, but the demand elasticity. Not good. This time, think of a fixed demand curve, and a supply curve which moves around.

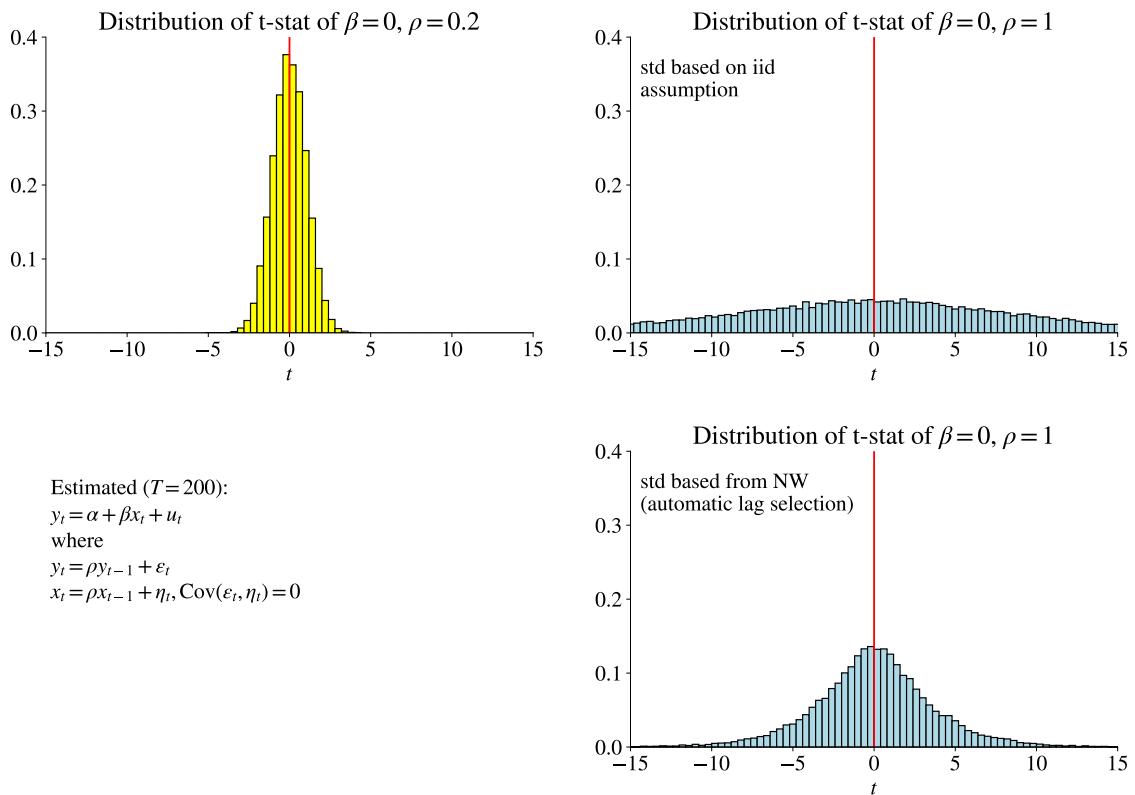


Figure 8.14: Distribution of the t-statistic when y_t and x_t are independent AR(1) processes. See Figure 8.12.

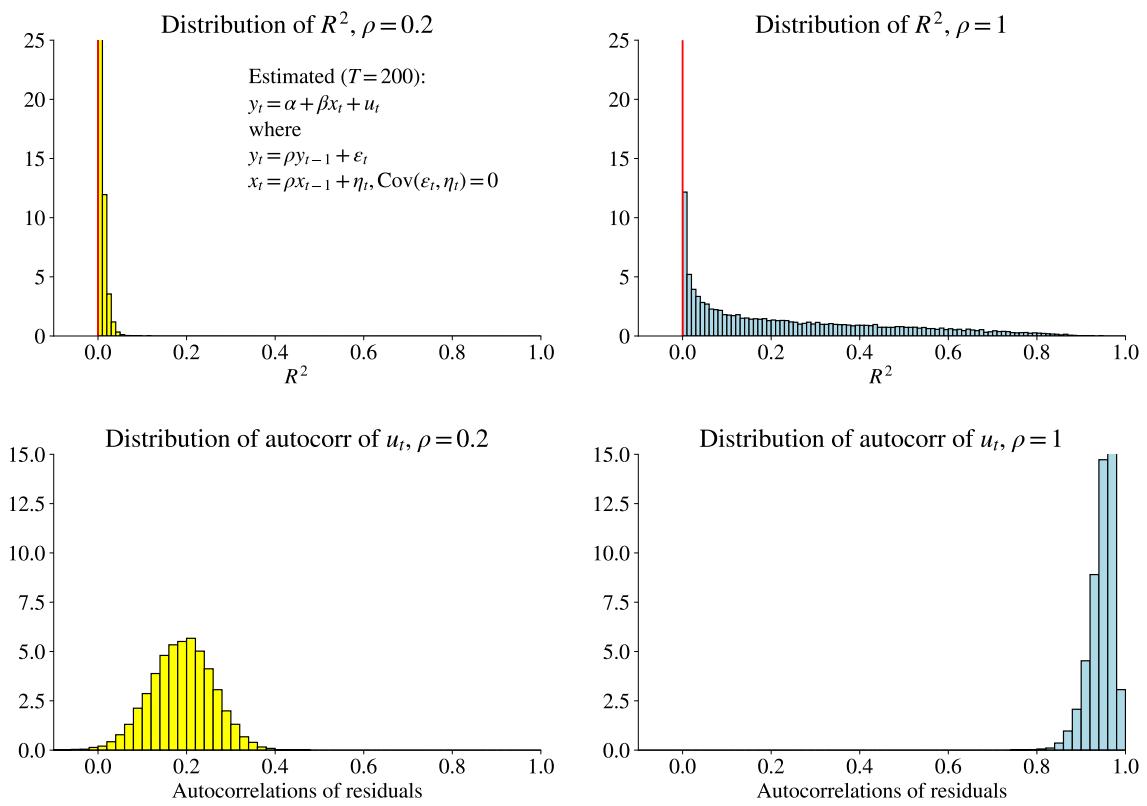


Figure 8.15: Distribution of R^2 and autocorrelation of residuals. See Figure 8.12.

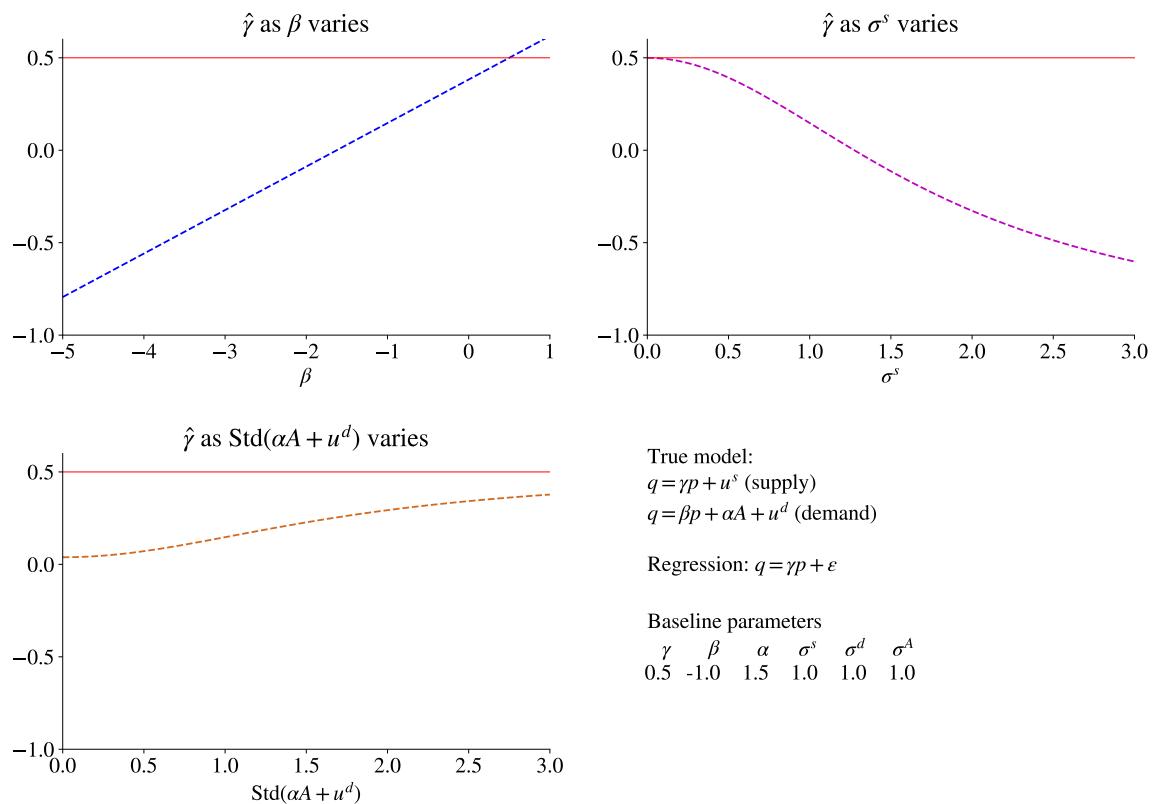


Figure 8.16: OLS estimate of γ in supply equation

Chapter 9

Simulating the Finite Sample Properties

Reference: Greene (2018) 15, Horowitz (2001), Hansen (2022) 10

Additional references: Cochrane (2001) 15.2; Davidson and MacKinnon (1993) 21; Davidson and Hinkley (1997); Efron and Tibshirani (1993) (bootstrapping, chap 9 in particular); and Berkowitz and Kilian (2000) (bootstrapping in time series models)

9.1 Introduction

We know the small sample properties of regression coefficients in linear models with fixed regressors and iid normal error terms. When these conditions are not satisfied, then we may either rely on asymptotic (large sample) results or use Monte Carlo simulations and bootstrapping to understand the small sample properties.

How such simulations should be implemented depends crucially on the properties of the model and data: if the residuals are autocorrelated, heteroskedastic, or perhaps correlated across regressions equations. These notes summarize a few typical cases.

Empirical Example 9.1 (*The empirical importance of simulated standard errors*) *The need for using Monte Carlos or bootstraps varies across applications and data sets. For a case where it does not matter much, see Table 9.1, and for a case where it matters, compare the traditional and bootstrapped t-stats in Tables 9.2–9.3.*

9.2 Monte Carlo Simulations

9.2.1 Monte Carlo Simulations in the Simplest Case

A Monte Carlo simulation is a way to generate many artificial (small) samples from a parameterised model and then estimate the statistic (for instance, a slope coefficient) on

	α	t (LS)	t (NW)	t (boot)
A (NoDur)	2.73	2.29	2.14	1.87
B (Durbl)	-0.57	-0.25	-0.26	-0.26
C (Manuf)	0.15	0.17	0.17	0.16
D (Enrgy)	2.49	1.07	1.04	0.96
E (HiTec)	-0.75	-0.49	-0.49	-0.44
F (Telcm)	0.66	0.44	0.43	0.38
G (Shops)	1.34	1.08	1.03	1.01
H (Hlth)	2.08	1.38	1.41	1.37
I (Utils)	2.61	1.63	1.59	1.68
J (Other)	-0.77	-0.81	-0.77	-0.68

Table 9.1: Estimates of CAPM on US industry portfolios 1970:01-2023:12. NW uses 1 lag. The bootstrap samples (y_t, x_t) pairs, in blocks of 10 observations and has 3000 simulations.

	2y	3y	4y	5y
factor	1.00 (6.95)	1.82 (6.82)	2.55 (6.82)	3.25 (6.88)
constant	0.00 (0.00)	-0.00 (-0.12)	-0.00 (-0.28)	-0.00 (-0.47)
R^2	0.14	0.14	0.14	0.14
obs	708	708	708	708

Table 9.2: Regression of different excess (1-year) holding period returns (in columns, indicating the maturity of the respective bond) on a single forecasting factor and a constant. Numbers in parentheses are t-stats. U.S. data for 1964:01-2023:12.

each of those samples. The distribution of the statistic is then used as the small sample distribution of the estimator.

The following is an example of how Monte Carlo simulations could be done in the special case of a linear model

$$y_t = x_t' \beta + u_t, \quad (9.1)$$

where u_t is iid $N(0, \sigma^2)$ and x_t is stochastic but independent of $u_{t \pm s}$ for all s . This means that x_t cannot include lags of y_t .

Suppose we want to find the small sample distribution of a function of the estimate, $g(\hat{\beta})$. To do a Monte Carlo experiment, we need information on (i) the coefficients β ; (ii) the variance of u_t , σ^2 ; (iii) and a process for x_t .

The process for x_t is typically estimated from the data on x_t (for instance, a VAR

	2y	3y	4y	5y
factor	1.00 (4.10)	1.82 (4.10)	2.55 (4.15)	3.25 (4.23)
constant	0.00 (0.00)	-0.00 (-0.06)	-0.00 (-0.13)	-0.00 (-0.21)
R^2	0.14	0.14	0.14	0.14
obs	708	708	708	708

Table 9.3: Regression of different excess (1-year) holding period returns (in columns, indicating the maturity of the respective bond) on a single forecasting factor and a constant. U.S. data for 1964:01-2023:12. Numbers in parentheses are t-stats. Bootstrapped standard errors, with blocks of 10 observations.

system $x_t = A_1x_{t-1} + A_2x_{t-2} + \varepsilon_t$). Alternatively, we could simply use the actual sample of x_t and repeat it.

Example 9.2 (*Simulating VAR models*) For instance, a VAR(2) $x_t = A_1x_{t-1} + A_2x_{t-2} + \varepsilon_t$, where x_t could be a vector of variables. The simulation procedure is straightforward. First, estimate the model on data and record the estimates $(A_1, A_2, \text{Var}(\varepsilon_t))$. Second, draw a new time series of residuals, $\tilde{\varepsilon}_t$ for $t = 1, \dots, T$ and construct an artificial sample recursively (first $t = 1$, then $t = 2$ and so forth) as

$$\tilde{x}_t = A_1\tilde{x}_{t-1} + A_2\tilde{x}_{t-2} + \tilde{\varepsilon}_t.$$

(This requires some starting values for \tilde{x}_{-1} and \tilde{x}_0 .)

The values of β and σ^2 are often a mix of estimation results and theory. In some case, we simply take the point estimates. In other cases, we adjust the point estimates so that $g(\beta) = 0$ holds, that is, so you *simulate the model under the null hypothesis* in order to study the size of tests and to find valid critical values for small samples. Alternatively, you may *simulate the model under an alternative hypothesis* in order to study the power of the test using either critical values from either the asymptotic distribution or from a (perhaps simulated) small sample distribution.

To make it a bit concrete, suppose you want to use these simulations to get a 5% critical value for testing the null hypothesis $g(\beta) = 0$. The Monte Carlo experiment takes the following steps:

1. Construct an artificial sample of the regressors (see above), \tilde{x}_t for $t = 1, \dots, T$. To do that, draw random numbers \tilde{u}_t for $t = 1, \dots, T$ from a prespecified distribution

(for instance, normal) and use those together with the artificial sample of \tilde{x}_t to calculate an artificial sample \tilde{y}_t for $t = 1, \dots, T$ from

$$\tilde{y}_t = \tilde{x}'_t \beta + \tilde{u}_t, \quad (9.2)$$

by using the prespecified values of the coefficients β (perhaps your point estimates or a tweaked version of the point estimates so $g(\beta) = 0$ holds).

2. Calculate an estimate $\tilde{\beta}$ and record it along with the value of $g(\tilde{\beta})$ and perhaps also the test statistic of the hypothesis that $g(\beta) = 0$.
3. Repeat the previous steps N (3000, say) times. The more times you repeat, the better is the approximation of the small sample distribution.
4. Sort your simulated $\tilde{\beta}$, $g(\tilde{\beta})$, and the test statistic in ascending order. For a one-sided test (for instance, a chi-square test), take the $(0.95N)$ th observations in these sorted vector as your 5% critical values. For a two-sided test (for instance, a t-test), take the $(0.025N)$ th and $(0.975N)$ th observations as the 5% critical values. You may also record how many times the 5% critical values from the asymptotic distribution would reject a true null hypothesis.
5. You may also want to plot a histogram of $\tilde{\beta}$, $g(\tilde{\beta})$, and the test statistic to see if there is a small sample bias, and how the distribution looks like. Is it close to normal? How wide is it? You could also estimate the variance-covariance matrix of $\tilde{\beta}$ by treating each estimate (from each simulation) as an observation—and then estimate the covariance matrix across these observations.

We have the same basic procedure when y_t is a vector, except that we might have to consider correlations across the elements of the vector of residuals u_t . For instance, we might want to generate the vector \tilde{u}_t from a $N(\mathbf{0}, \Sigma)$ distribution—where Σ is the variance-covariance matrix of u_t .

It is straightforward to sample the residuals from other distributions than the normal, for instance, a student- t distribution. See *Figure 9.1* for an example.

9.2.2 *Monte Carlo Simulations when x_t Includes Lags of y_t

If x_t contains lags of y_t , then we must set up the simulations so that the temporal link is preserved in every artificial sample which we create. For instance, suppose x_t includes

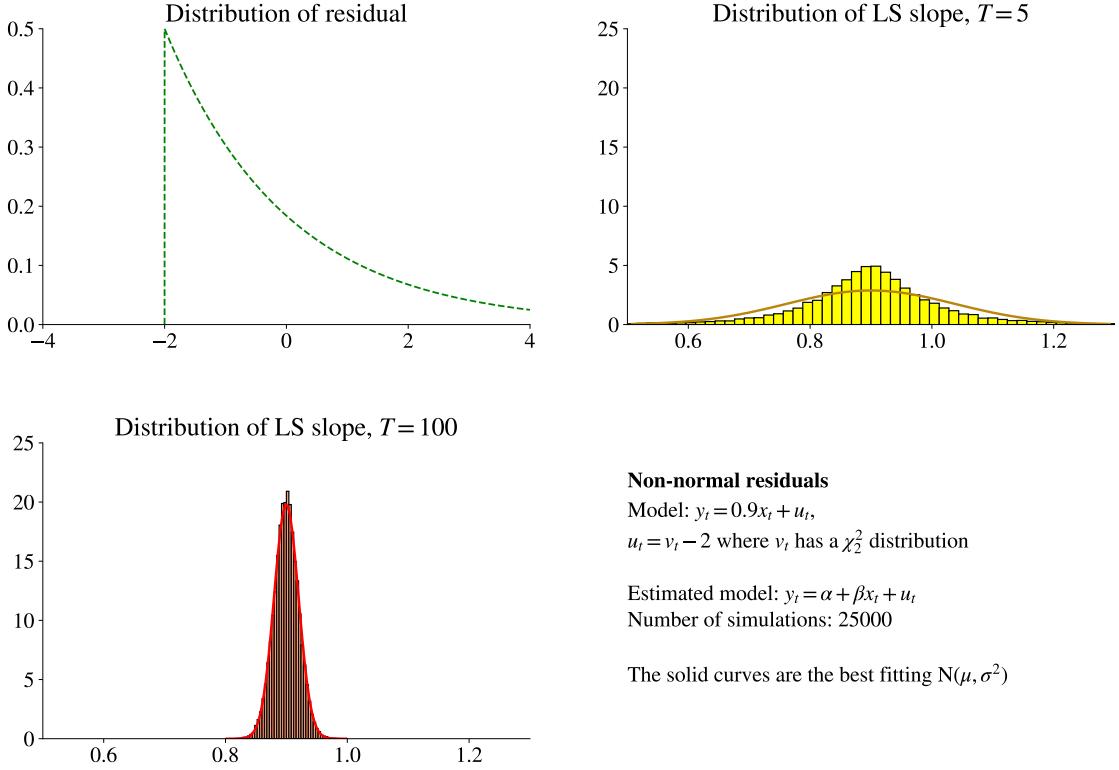


Figure 9.1: Results from a Monte Carlo experiment with thick-tailed errors.

y_{t-1} and another vector z_t of variables which are independent of $u_{t\pm s}$ for all s

$$\begin{aligned} y_t &= x_t' \beta + u_t \\ &= \gamma y_{t-1} + z_t' \phi + u_t \end{aligned} \tag{9.3}$$

We can then generate an artificial sample as follows. First, create a sample \tilde{z}_t for $t = 1, \dots, T$ by some time series model (for instance, a VAR) or by taking the observed sample itself. Second, observation t of is generated recursively as

$$\tilde{y}_t = \gamma \tilde{y}_{t-1} + z_t' \phi + \tilde{u}_t \text{ for } t = 1, \dots, T \tag{9.4}$$

We clearly need the initial value \tilde{y}_0 to start up the artificial sample—and then the rest of the sample ($t = 1, 2, \dots$) is calculated recursively. See Figures 9.2–9.2 for an example.

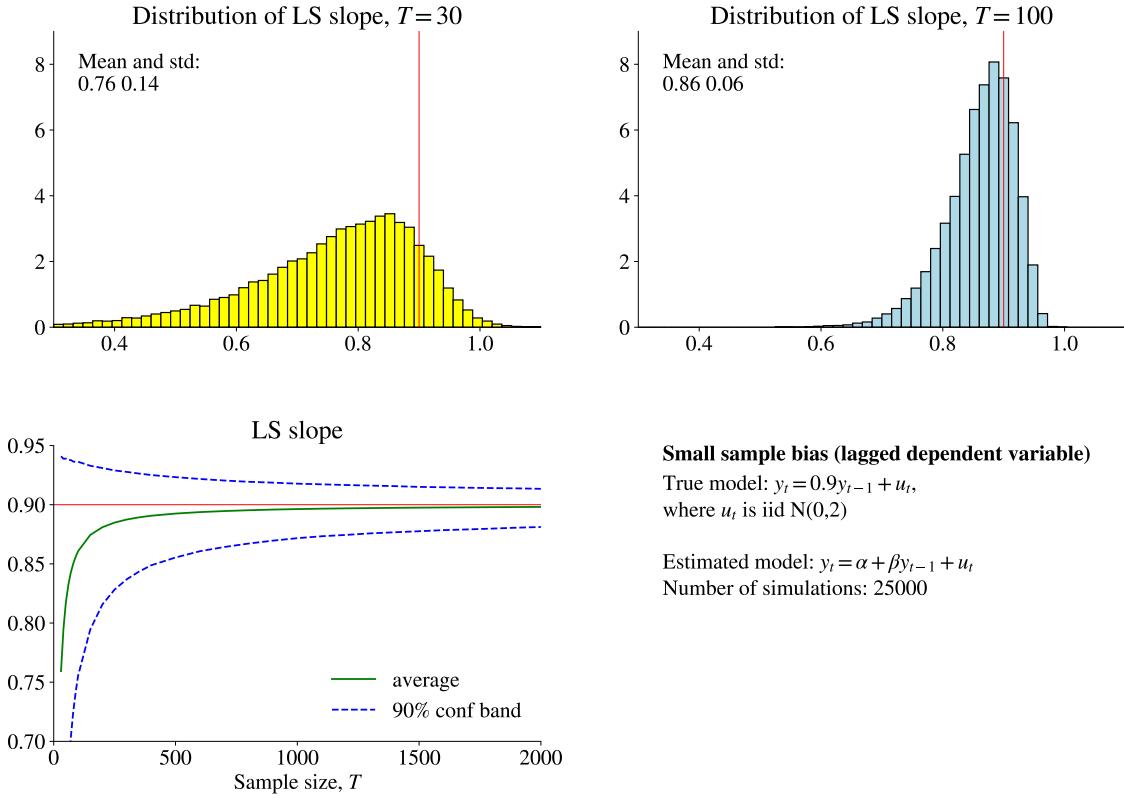


Figure 9.2: Results from a Monte Carlo experiment of LS estimation of the AR coefficient.

9.2.3 Monte Carlo Simulations with non-iid Residuals

With non-iid residuals (for instance, autocorrelation and heteroskedasticity) we need to model the process of residuals.

If the residuals are *autocorrelated*, then we could estimate a time series process from the fitted residuals and then generate artificial samples of residuals. For instance, with an AR(2) we get

$$\tilde{u}_t = a_1 \tilde{u}_{t-1} + a_2 \tilde{u}_{t-2} + \tilde{\varepsilon}_t. \quad (9.5)$$

See Figure 9.3 for an illustration.

Alternatively, *heteroskedastic residuals* can be generated by $N(0, \sigma_t^2)$ process, but where σ_t^2 is approximated by the absolute values of fitted values ($\sigma_t^2 = |\hat{u}_t^2|$) from

$$\hat{u}_t^2 = c' w_t + \eta_t, \quad (9.6)$$

where w_t include the squares and cross product of all the regressors.

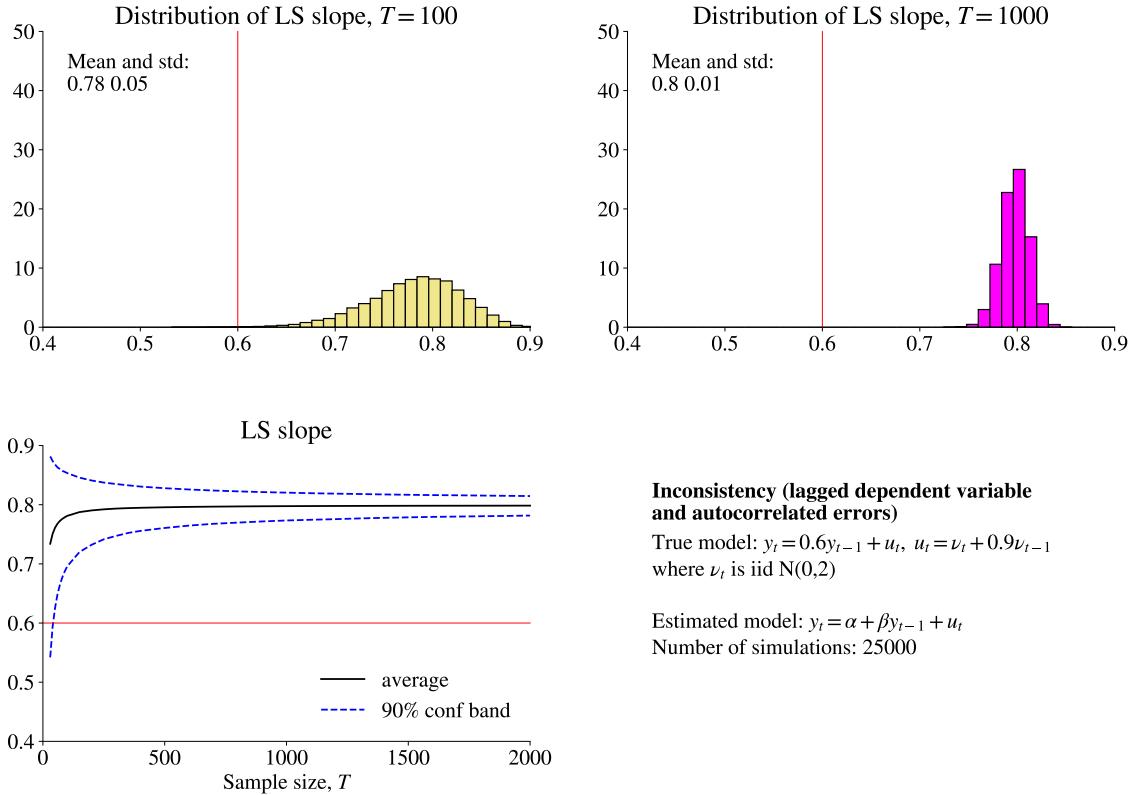


Figure 9.3: Results from a Monte Carlo experiment of LS estimation of the AR coefficient when data is from an ARMA process.

9.3 Bootstrapping

9.3.1 Bootstrapping in the Simplest Case

Bootstrapping is another way to do simulations, where we construct artificial samples by sampling from the actual data. The advantage of the bootstrap is then that we do not have to try to estimate the process of the residuals and regressors (as we do in a Monte Carlo experiment). The real benefit of this is that we do not have to make any strong assumption about the distribution of the residuals.

The bootstrap approach works particularly well when the residuals are iid and independent of x_{t-s} for all s . (This means that x_t cannot include lags of y_t .) We here consider bootstrapping the linear model (9.1), for which we have point estimates (perhaps from LS) and fitted residuals. The procedure is similar to the Monte Carlo approach, except that the artificial sample is generated differently. In particular, Step 1 in the Monte Carlo

$\alpha :$	$\underline{\gamma = 0}$		$\underline{\gamma = 1}$	
	0	1	0	1
Simulated	7.1	19.0	13.5	24.8
OLS formula	7.1	13.3	13.4	19.2
White's	7.0	18.5	13.3	24.3
Bootstrap	7.1	18.5	13.4	24.3
Bootstrap 2	7.0	18.5	13.3	24.3
Jackknife	7.1	18.9	13.5	24.8
FGLS	7.5	17.3	14.0	24.1

Table 9.4: Standard error of OLS slope (%) under heteroskedasticity (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t \sim N(0, \sigma_t^2)$, with $\sigma_t^2 = (1 + \gamma|z_t| + \alpha|x_t|)^2$, where z_t is iid $N(0, 1)$ and independent of x_t . Sample length: 200. Number of simulations: 25000. The bootstrap draws pairs (y_s, x_s) with replacement while bootstrap 2 is a wild bootstrap.

simulation is replaced by the following:

1. Construct an artificial sample \tilde{y}_t for $t = 1, \dots, T$ by

$$\tilde{y}_t = x_t' \beta + \tilde{u}_t, \quad (9.7)$$

where \tilde{u}_t is drawn (with replacement) from the *fitted residual* (“residual resampling”) and where β is the point estimate from the original sample.

Example 9.3 With $T = 3$, the artificial sample could be

$$\begin{bmatrix} (\tilde{y}_1, \tilde{x}_1) \\ (\tilde{y}_2, \tilde{x}_2) \\ (\tilde{y}_3, \tilde{x}_3) \end{bmatrix} = \begin{bmatrix} (x_1' \beta + \hat{u}_2, x_1) \\ (x_2' \beta + \hat{u}_1, x_2) \\ (x_3' \beta + \hat{u}_2, x_3) \end{bmatrix}.$$

The approach in (9.7) works also when y_t is a vector of dependent variables—and will then help retain the cross-sectional correlation of the residuals.

One issue with the bootstrap is that it does not directly create observations that obey the null hypothesis, or even a given alternative hypothesis. For instance, it is not straightforward to create samples where a particular coefficient is zero ($\beta_2 = 0$, say). Actually, (9.7) creates a *distribution around the point estimate*, that is, of $\tilde{\beta} - \hat{\beta}$, where $\hat{\beta}$ is the point estimate from the original sample. This is not important if we just want to understand the standard error of a coefficient (since the standard deviation across the bootstrap

simulations is already defined in terms of squared deviations around the average value in the bootstraps.). However, it is crucial when we want to understand percentiles of coefficients, t -stats, or χ^2 -stats.

An additional complication is that the average (across bootstrap simulations) estimate $\tilde{\beta}$ may not always equal the point estimate $\hat{\beta}$. If we still want to use the bootstraps to find critical values, then we have to center the test statistic on the the average estimate in the bootstraps, $\tilde{\beta}$. For instance, for a t -test we calculate

$$t = \frac{\tilde{\beta} - \text{average } \tilde{\beta}}{\text{Std}(\beta^*)} \quad (9.8)$$

for each simulation and then take the $(0.025N)$ th and $(0.975N)$ th observations as the 5% critical values (instead of the ± 1.96 from a standard normal distribution). In this expression, $\text{Std}(\hat{\beta})$ should be a consistent estimate of the standard error, which could be either from (a) the original sample ($\text{Std}(\hat{\beta})$ from White, Newey-West, etc), (b) the simulation itself ($\text{Std}(\tilde{\beta})$, again from a consistent estimate for the simulated sample), (c) the standard deviation of $\tilde{\beta}$ across the N simulations. In the latter case, the $\tilde{\beta}$ values are often winsorized (at quantiles 0.01 and 0.99, say) to mitigate the risk that a few very strange simulated samples dominate.

These critical values can then be used for t -tests based on the original sample, for instance, that $\beta_2 = q$. In most cases, there is little difference between centering on the average $\tilde{\beta}$ and the point estimate $\hat{\beta}$.

A similar reasoning applies to joint tests of coefficients. Consider a linear combination of the coefficients, $R\tilde{\beta}$. If V^* is the variance-covariance matrix (as before, a consistent estimate based on the original sample or each simulation), then for each sample we would calculate the quadratic form

$$\Xi = [R(\tilde{\beta} - \text{average } \tilde{\beta})]'(RV^*R')^{-1}[R(\tilde{\beta} - \text{average } \tilde{\beta})]. \quad (9.9)$$

Once again, we could take the $(0.95N)$ th simulated τ as the 5% critical value (instead of the 95th percentiles for a χ_q^2 distribution, for instance, 5.99 for $q = 2$). This critical value can be used to hypotheses like $R\beta = q$ based on the original sample.

The bootstraps of test statistics like the t and Ξ are often more precise than the bootstraps of the regression coefficients themselves—provided that we use consistent estimates of the standard error/covariance matrix. (In the limit, these statistics do not depend on model parameters—they asymptotically “pivotal”—which often improves the convergence rate.)

Remark 9.4 (*Bootstrapped confidence bands**) Using the simulated 0.025th and 0.975th quantiles of the bootstrapped $\tilde{\beta}$ values is a way of creating a 95% confidence band, sometimes called Efron’s “bootstrap percentile method”. The “bootstrap percentile t-method” (also suggested by Efron) is often considered to be an improvement. To implement it, first define $\tilde{t} = (\tilde{\beta} - \hat{\beta}) / \text{Std}(\tilde{\beta})$, where $\text{Std}(\tilde{\beta})$ is the standard deviation across the bootstrap estimates. (Sometimes the centering is done by subtracting the average of $\tilde{\beta}$ values instead of the point estimate $\hat{\beta}$). Let $Q(\tilde{t}, p)$ be the p th quantile of \tilde{t} . Then, we could define a 95% confidence band as $[\hat{\beta} - Q(\tilde{t}, 0.975) \text{Std}(\hat{\beta}), \hat{\beta} - Q(\tilde{t}, 0.025) \text{Std}(\hat{\beta})]$, where $\text{Std}(\hat{\beta})$ is a consistent estimate of the standard deviation of $\hat{\beta}$ (for instance, from White’s or Newey-West methods). Notice that the quantiles are reversed, compared to what would perhaps be expected and that both are subtracted.

9.3.2 *Bootstrapping when x_t Includes Lags of y_t

When x_t contains lagged values of y_t , then we have to modify the approach in (9.7) since \tilde{u}_t can become correlated with x_t . The easiest way to handle this is as in the Monte Carlo simulations in (9.4), but where \tilde{u}_t are drawn (with replacement) from the sample of fitted residuals.

9.3.3 Bootstrapping when Errors Are Heteroskedastic

Suppose now that the residuals are heteroskedastic, but serially uncorrelated. If the heteroskedasticity is unrelated to the regressors, then we can still use (9.7).

In contrast, if the heteroskedasticity is related to the regressors, then it would then be wrong to pair x_t with just any $\tilde{u}_t = \hat{u}_s$ since that destroys the relation between x_t and the variance of the residual.

An alternative way of bootstrapping can then be used: generate the artificial sample by drawing (with replacement) pairs (y_s, x_s) , that is, we let the artificial pair in t be $(\tilde{y}_t, \tilde{x}_t) = (y_s, x_s) = (x'_s \beta + \hat{u}_s, x_s)$ for some random draw of s so we are always pairing the residual, \hat{u}_s , with the contemporaneous regressors, x_s . This approach is also called “case resampling.” Note that we are always sampling with replacement—otherwise the approach of drawing pairs would be to just re-create the original data set.

This approach works also when y_t is a vector of dependent variables.

See Table 9.4 for results from a simulation.

Example 9.5 With $T = 3$, the artificial sample could be

$$\begin{bmatrix} (\tilde{y}_1, \tilde{x}_1) \\ (\tilde{y}_2, \tilde{x}_2) \\ (\tilde{y}_3, \tilde{x}_3) \end{bmatrix} = \begin{bmatrix} (y_2, x_2) \\ (y_3, x_3) \\ (y_3, x_3) \end{bmatrix} = \begin{bmatrix} (x'_2 \beta + \hat{u}_2, x_2) \\ (x'_3 \beta + \hat{u}_3, x_3) \\ (x'_3 \beta + \hat{u}_3, x_3) \end{bmatrix}$$

It could be argued (see, for instance, Davidson and MacKinnon (1993)) that bootstrapping the pairs (y_s, x_s) makes little sense when x_s contains lags of y_s , since the random sampling of the pair (y_s, x_s) destroys the autocorrelation pattern on the regressors.

Remark 9.6 (*The wild Bootstrap*) The wild bootstrap is also aimed at solving the heteroskedasticity problem. In this case, the artificial sample is generated as in (9.7), but we use $\tilde{u}_t = \hat{u}_t \tilde{\varepsilon}_t$ where \hat{u}_t is the fitted (OLS) residual for observation t and $\tilde{\varepsilon}_t$ is drawn from an iid random variable with mean 0 and variance 1. For instance, $\tilde{\varepsilon}_t$ could have a two-point distribution where it is either -1 or 1 with equal probabilities.

9.3.4 Bootstrapping when Errors Are Autocorrelated

It is quite hard to handle the case when the residuals are serially dependent, since we must then sample in such a way that we do not destroy the autocorrelation structure of the data. A common approach is to fit a time series model for the residuals, for instance, an AR(1), and then bootstrap the (hopefully iid) innovations to that process.

Another approach amounts to *resampling blocks* of residuals. For instance, suppose the sample has 10 observations, and we decide to create blocks of 3 observations. The first block is $(\hat{u}_1, \hat{u}_2, \hat{u}_3)$, the second block is $(\hat{u}_2, \hat{u}_3, \hat{u}_4)$, and so forth until the last block, $(\hat{u}_8, \hat{u}_9, \hat{u}_{10})$. If we need a sample of length 3τ , say, then we simply draw τ of those block randomly (with replacement) and stack them to form a longer series. To handle end point effects (so that all data points have the same probability to be drawn), we also create blocks by “wrapping” the data around a circle. In practice, this means that we use the following blocks: $(\hat{u}_{10}, \hat{u}_1, \hat{u}_2)$ and $(\hat{u}_9, \hat{u}_{10}, \hat{u}_1)$. The length of the blocks should clearly depend on the degree of autocorrelation, but $T^{1/3}$ is sometimes recommended as a rough guide. An alternative approach is to have non-overlapping blocks. See Berkowitz and Kilian (2000) for some other approaches.

Example 9.7 With $T = 9$ and a block size of 3, the artificial sample could be

$$\underbrace{\hat{u}_2, \hat{u}_3, \hat{u}_4}_{block\ 2}, \underbrace{\hat{u}_7, \hat{u}_8, \hat{u}_9}_{block\ 7}, \underbrace{\hat{u}_4, \hat{u}_5, \hat{u}_6}_{block\ 4}.$$

See Table 9.5 for results from a simulation.

$\rho :$	0.0	0.75
Simulated	5.9	23.1
OLS formula	5.8	8.6
Newey-West	5.7	18.5
VARHAC	5.7	22.2
Bootstrapped	5.5	19.6
FGLS	5.9	23.2

Table 9.5: Standard error of OLS intercept (%) under autocorrelation (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t = \rho\epsilon_{t-1} + \xi_t$, ξ_t is iid $N()$. NW uses 10 lags. VARHAC uses 10 lags and a VAR(1). The bootstrap uses blocks of size 20. Sample length: 300. Number of simulations: 25000.

Chapter 10

Portfolio Sorts

10.1 Overview

Reference: Bali, Engle, and Murray (2016)

Portfolio sorts are used to construct portfolios (groups) based on some characteristic, for instance, firm size. Once the portfolios have been defined (to which group/portfolio does i belong?) we often compute the (possible weighted) average with each (group or) portfolio

$$R_{gt} = \sum_{i \in \text{Group}_g} w_{it} R_{it}, \quad (10.1)$$

where w_{it} is the relative portfolio weight of asset i in the portfolio ($\sum w_{it} = 1$). We often use an unweighted average where $w_{it} = 1/(\text{number of members of the group})$.

A common way (since Jensen, updated in Huberman and Kandel (1987)) is to study the performance of a portfolio by running the following regression

$$\begin{aligned} R_{gt}^e &= \alpha + \beta R_{mt}^e + \varepsilon_t, \text{ with} \\ \mathbb{E} \varepsilon_t &= 0 \text{ and } \text{Cov}(R_{mt}^e, \varepsilon_t) = 0, \end{aligned} \quad (10.2)$$

where R_{gt}^e is the excess return on the portfolio being studied and R_{mt}^e the excess returns of a vector of benchmark portfolios (for instance, only the market portfolio if we want to rely on CAPM). Neutral performance requires $\alpha = 0$, which can be tested with a t test. With several groups, the regressions can be estimated as a system to allow for testing across equations, for instance, if $\alpha_1 = \alpha_2$.

10.2 Univariate Sorts

A simple and commonly applied method for studying how an asset characteristic (x_i) is related to returns (or some other performance measure) is to do a *univariate sort*. For instance, we could sort the assets $i = 1, \dots, n$ according to x_i and then construct three portfolios: (1) for those i whose x_i belong to the lowest 1/3; (2) those in the mid 1/3 and (3) those in the highest 1/3. Then, we measure the return on equally weighted portfolios—and perhaps analyse the return of portfolio 3 minus the return on portfolio 1. The sorting and portfolio construction is typically repeated at regular intervals. For instance, the Fama-French size portfolios are based on the market capitalization and are rebalanced every June. For a daily momentum strategy, we would rather redo the sort every day based on recent performance.

Empirical Example 10.1 (*Sorting on recent returns*) See Table 10.1 for an empirical example where the 25 FF portfolios are sorted into low/low recent 22-day returns, with 5 portfolios in each. The results indicate strong momentum.

Low 22-day return	3.85
	(0.19)
High 22-day return	14.08
	(0.76)
Difference	10.23
	(0.91)

Table 10.1: Average excess returns and (Sharpe ratios) for 3 portfolios from a univariate sort on recent (22-day) returns (5/5 assets). Daily data on 25 FF portfolios 1979:01-2023:12

Example 10.2 (*Simplified version of “Betting against beta” by Frazzini and Pedersen**) First, find those assets with $\beta_{i,t-1} < \text{median}(\beta_{i,t-1})$ where $\beta_{i,t-1}$ is the CAPM beta estimated on data up to and including $t - 1$. (The median is across the assets.) This is the low beta group. Second, calculate the equally weighted portfolio return in t . Third, repeat for all periods. Fourth, do points 1–3 also for the high beta assets, $\beta_{i,t-1} \geq \text{median}(\beta_{i,t-1})$. Fifth, form the excess return as the difference between the two portfolios.

10.3 Bivariate Sorts

Bivariate sorts (also called double sorts) are used when there are two important characteristics (here called x and z) and you want to study how z affects returns—controlling for x (that is, holding x “constant”). This may well be important if x and z are correlated.

Bivariate sorts can be done in several ways. An *independent bivariate sort* first does a univariate sort of x_i (say, forming 3 categories: growth, neutral or value), then it makes another univariate sort according to another sorting variable z_i (say, forming two categories: small or big). Then we find the intersections of the two sorts—think of a matrix

	Low x_i	Medium x_i	High x_i	
Low z_i :	(x_L, z_L)	(x_M, z_L)	(x_H, z_L)	(10.3)
High z_i :	(x_L, z_H)	(x_M, z_H)	(x_H, z_H)	

where, for instance, (x_M, z_H) denote the set of assets that belong to the medium x category and high z category. Notice that this matrix has a different structure than a traditional scatter plot with x on the horizontal axis and z on the vertical axis: in this (and all other tables) we put low z_i on the first line and high z_i on the second.

In an independent bivariate sort we cannot directly control how many assets there will be in each group—and some groups might be empty (see Example 10.3 and Figure 10.1).

Once the portfolio sort is done, we typically calculate the average return (or some other variable of interest) of each portfolio. In the independent sort, you can either compare across rows or across columns.

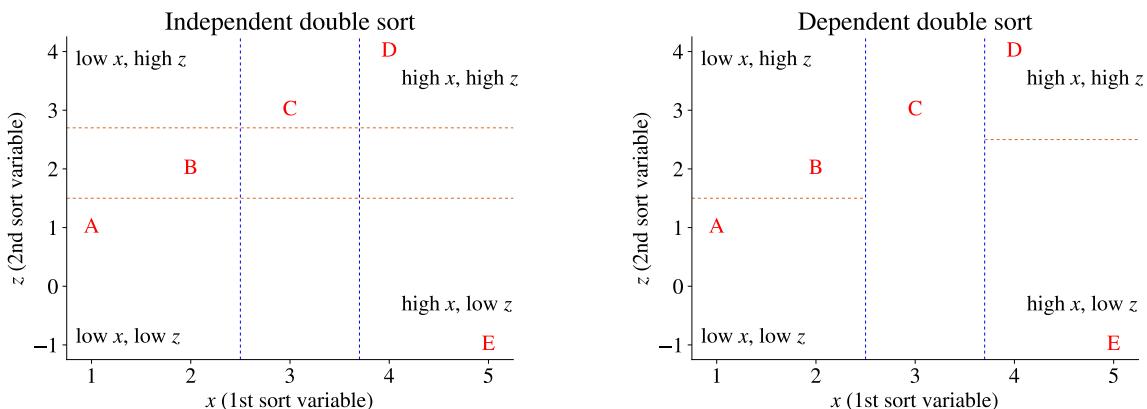


Figure 10.1: Example of bivariate sorts. The data is indicated by letters.

Example 10.3 (*Independent double sort*) Suppose there are 5 assets (labelled A, B,...) and that the values of x and z are

	$\underline{x_i}$	$\underline{z_i}$
Asset A	1	1
Asset B	2	2
Asset C	3	3
Asset D	4	4
Asset E	5	-1

We form low/high groups with 2 elements in each

	<u>Assets</u>
Low x :	A, B
High x :	D, E
Low z :	E, A
High z :	C, D

The independent double sort then gives

	<u>Low x</u>	<u>High x</u>
Low z :	A	E
High z :		D

Notice that there are no assets in the (low x , high z) group. See also Figure 10.1 for an illustration, but notice that the scatter plot has a different structure: low z values are plotted below high z values.

Empirical Example 10.4 (*Independent sorting on recent volatility and returns*) We first sort the 25 FF portfolios according to recent volatility, putting 10 into the low group and 10 into the high group. Then we sort on recent returns, also putting 10 into a low group and 10 into a high group. Finally, we form intersections. Figure 10.2 illustrates (for a short subsample) how the number of portfolios in the “low vol, low return” group varies over time. Typically, there are 4–5 portfolios in the group, but it varies considerably over time. The subsequent analysis is therefore focused on the dependent sort (see below).

In *dependent bivariate sort* we first sort according to x_i as before. Then, within an x category we sort according to z_i . This allows us to control the number of assets in each group. Notice that the ordering matters in the dependent sort: letting x represent

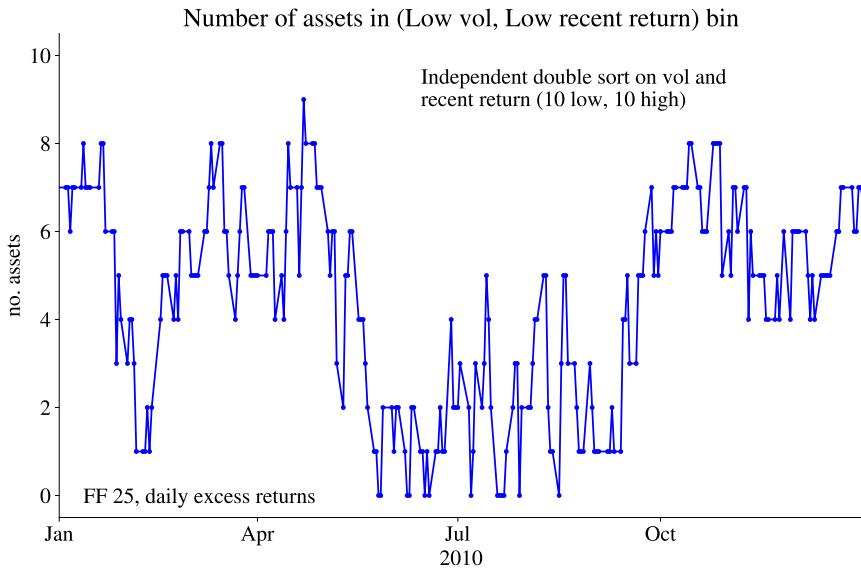


Figure 10.2: Independent bivariate portfolio sort, 25 FF portfolios

growth/neutral/value and z small/big will not give the same results as switching the labels. In the dependent sort, we compare across the z categories, that is, *across rows* in (10.3), for instance, the return of (x_L, z_H) minus the return of (x_L, z_L) and so forth. In (10.3) this gives three numbers—which are sometimes averaged: the interpretation is that you are studying the effect of z (here: small/large), but controlling for x (here: one of growth/neutral/value). See Figure 10.1 for an example.

Example 10.5 (Dependent double sort) Continuing the previous example, the dependent double sort (with one asset in each portfolio) gives

	<u>Low x</u>	<u>High x</u>
<i>Low z:</i>	A	E
<i>High z:</i>	B	D

For instance, among the “high x ” assets D and E , asset E has a lower z value so it is allocated to the (high x , low z) portfolio, while asset D has a higher z value so it is allocated to the (high x , high z) portfolio. Notice that all portfolios are populated. See also Figure 10.1 for an illustration.

Empirical Example 10.6 (Dependent sorting on recent volatility and returns) We first sort the 25 FF portfolios according to recent volatility, putting 10 into the low group and

10 into the high group. Within the “low vol” group, we then sort according to recent returns, putting 5 into to the “low vol, low return” group and 5 into the “low vol, high return” group. We do the same within the “high volatility” group. This means that there are always 5 FF portfolios in each of the 4 groups. See Figure 10.3 for some (unconditional) background information about the 25 FF portfolios and Figure 10.4 for how often the different FF portfolios are in each of the four groups. Table 10.2 reports the average excess returns and the Sharpe ratios for the four groups.

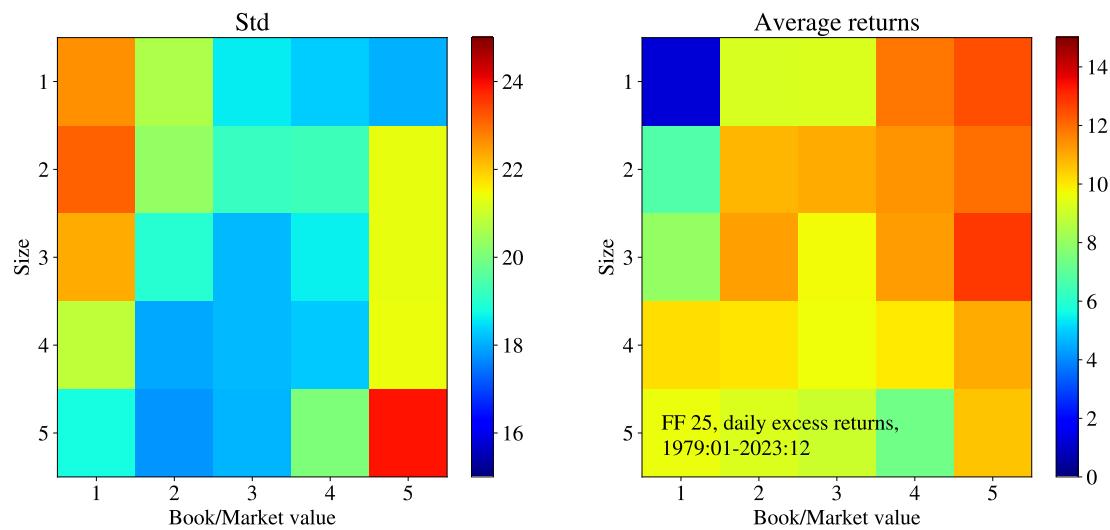


Figure 10.3: Average returns and volatility of the 25 FF portfolios

	Low 22-day vol	High 22-day vol
Low 22-day return	8.34 (0.52)	4.60 (0.21)
High 22-day return	12.72 (0.82)	12.17 (0.58)
High - low	4.39 (0.87)	7.57 (0.94)
High - low, average	5.98 (1.11)	

Table 10.2: Average excess returns and (Sharpe ratios) for 4 portfolios from a dependent bivariate sort. The first sort is on volatility (10/10 assets), the second sort (within each volatility bin) is on recent returns (5/5 assets). Daily data on 25 FF portfolios 1979:01-2023:12

The bivariate sort is designed to handle some *correlation* between x and z . If there is no correlation, then a single sort is enough. However, the bivariate sort will break down if the correlation is too strong. In the independent sort, it can lead to few (or even zero) assets in the off-diagonal portfolios if the correlation is positive (and vice versa if the correlation is negative). In the dependent sort, it may simply leads to results that cannot be trusted, see Figure 10.5 for an example. The figure illustrates how the “high z ” portfolios have clearly higher x values than the “low z ” portfolios have, so the approach is only moderately successful in controlling for x . This could be solved by having smaller x bins (which may require many assets), so that the variation in x within each bin is small compared to the variation in z . For instance, the low x bin could contain 20% of the assets, the high x also 20%, leaving out the 60% in the middle. As an alternative, we could consider an orthogonalisation (see below).

Remark 10.7 (*When x and z are perfectly correlated**) If we change Example 10.3 so z equals x , then the independent double sort gives

	<u>Low x</u>	<u>High x</u>
Low z :		D, E
High z :	A, B	

This has the problem that the off-diagonal portfolios are empty. In contrast, the dependent sort gives

	<u>Low x</u>	<u>High x</u>
Low z :	A	D
High z :	B	E

The latter has the problem that comparing across rows does not control for x . For instance, asset B has a higher x (and z) value than asset A.

Remark 10.8 (*The Fama-French factors**) The SMB and HML are created by an independent bivariate sort. First, classify firms according to the book/market value: low (growth stocks, using 30th percentile as cutoff), neutral or high (value stocks, using 70th percentile as cutoff). Second, classify firms according to size: small or big, using the median as a cutoff. Create six value weighted portfolios from the intersection of those

categories

	<u>Low book/market</u>	<u>Medium book/market</u>	<u>High book/market</u>
Small:	Small Growth (SG)	Small Neutral (SN)	Small Value (SV)
Big:	Big Growth (BG)	Big Neutral (BN)	Big Value (BV)

The *SMB* is the average of the small portfolios minus the average of the big portfolios: $SMB = 1/3(SG + SN + SV) - 1/3(BG + BN + BV)$. Rearranging gives $SMB = 1/3(SG - BG) + 1/3(SN - BN) + SV + 1/3(SV - BV)$, which shows that it represents the return on small stocks (for a given book/market) minus the return on big stocks (for same book/market). The *HML* is the average of the value stocks minus the growth stocks, $HML = 1/2(SV + BV) - 1/2(SG + BG)$, which can be rearranged as $HML = 1/2(SV - SG) + 1/2(BV - BG)$, which shows that it represents the return on value stocks (for a given size) minus the return on growth stocks (for the same size).

10.4 Orthogonalisation

Single sort on orthogonalised data is an alternative to a double sort and may be better at handling strong (linear) correlation of x and z . It involves two steps. First, run a regression of (z on x and a constant) to get coefficients (a, b) . Second, do a single sort on the residual

$$\varepsilon_i = z_i - (a + bx_i). \quad (10.4)$$

The regression can be done in several different ways: (1) a cross-sectional regression as in Figure 10.6 ; (2) time series regressions; (3) a panel regression. There is also a choice between using the full sample or just data up to $t - 1$ (and then redo for each period).

10.5 Trading Strategies

Dynamic trading strategies are similar (and sometimes identical) to portfolio sorts. The basic idea is to create a portfolio based on some kind of sorting of a trading signal.

Empirical Example 10.9 (*Momentum for daily returns on the 25 FF portfolios*) Figure 10.7 suggests that there is considerable momentum in the cross-section of the 25 FF portfolios. Investing in past winners earns high returns.

Empirical Example 10.10 (*Mean reversion of daily S&P 500 returns*) Figure 10.8 shows that extreme S&P 500 returns are followed by mean-reverting movements the following

day (negative autocorrelation)—which suggests that a trading strategy should sell after a high return and buy after a low return.

Empirical Example 10.11 (*Mean reversion of daily returns for different size categories*) Figure 10.9 compares the results for daily returns on different size categories—and illustrates that there is more predictability (indicating positive autocorrelation) for small stocks.

Empirical Example 10.12 (*Long run S&P 500 after different p/e values*) Figure 10.10 shows average one-year return on S&P 500 for different bins of the p/e ratio (at the beginning of the year). The figure illustrates that buying when the market is undervalued (low p/e) might be a winning strategy.

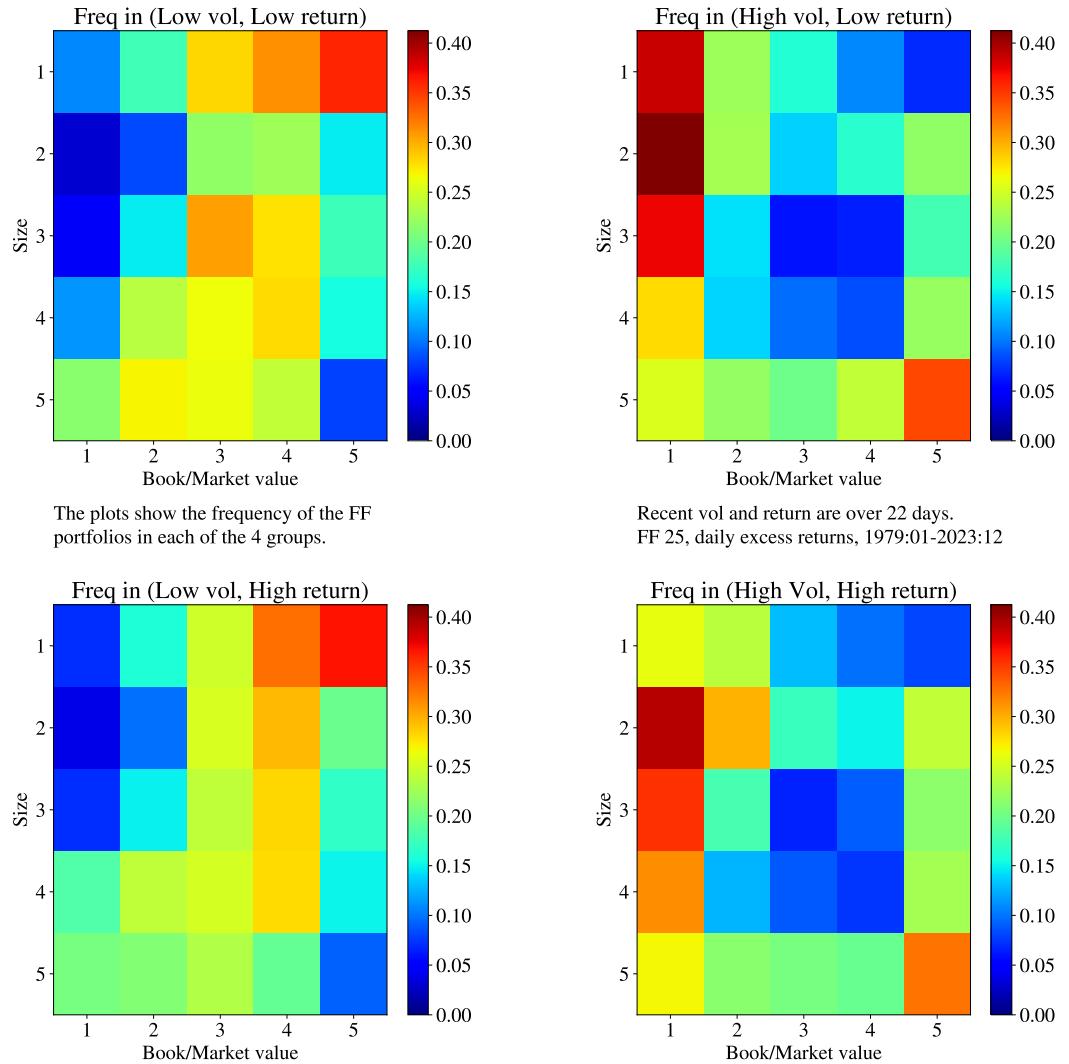


Figure 10.4: Dependent bivariate portfolio sort, 25 FF portfolios

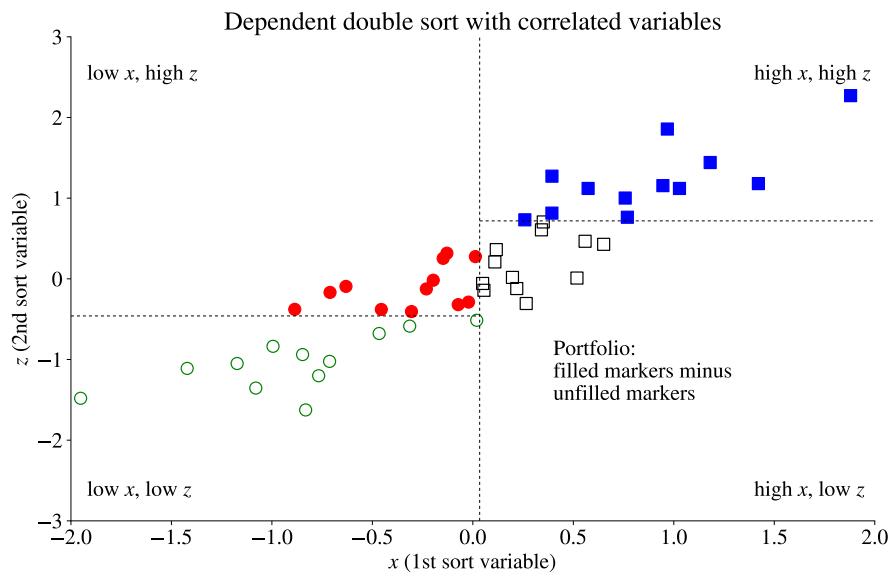


Figure 10.5: Example of dependent bivariate sort with correlated variables

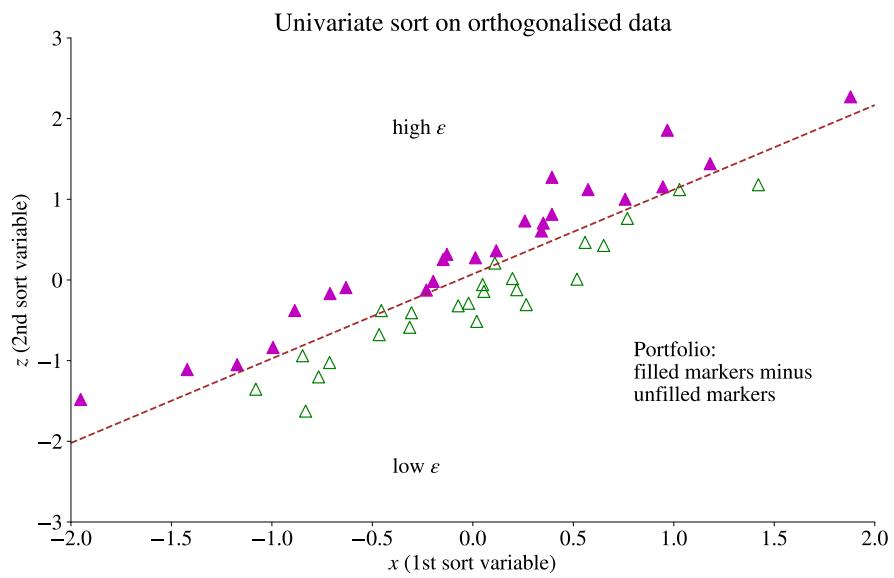


Figure 10.6: Example of univariate sort on orthogonalised data

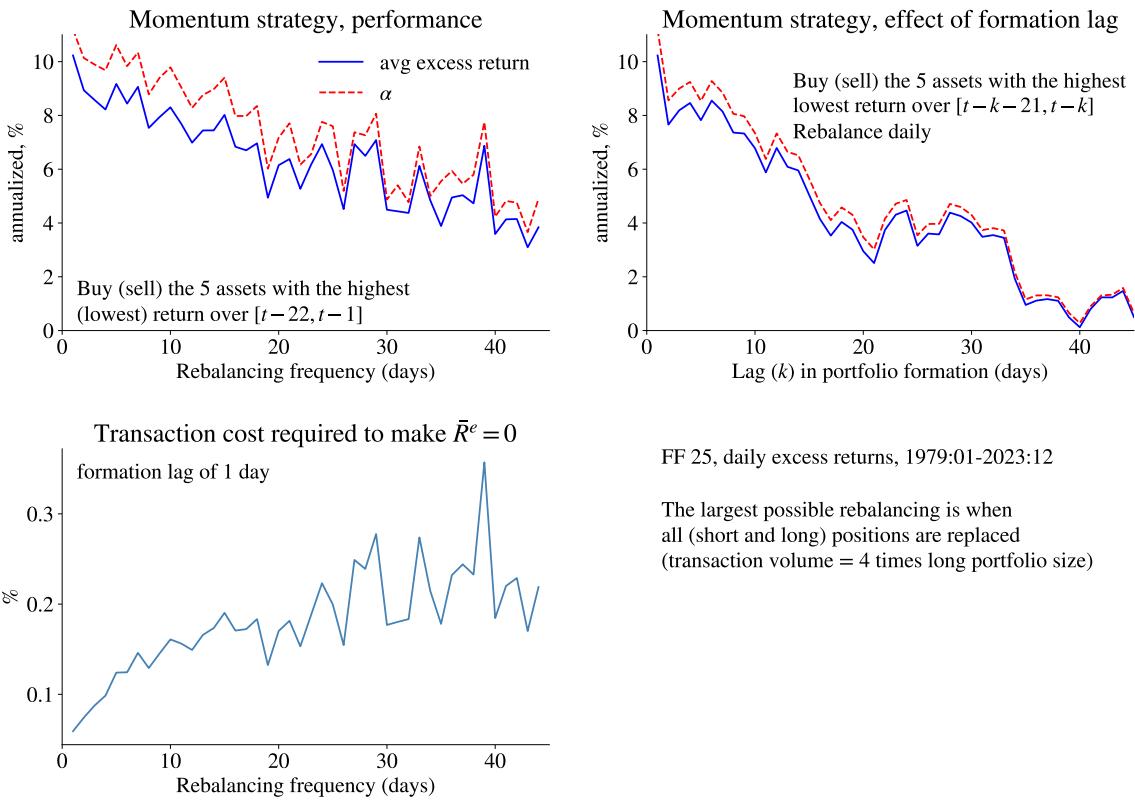


Figure 10.7: Predictability of daily US stock returns, momentum strategy

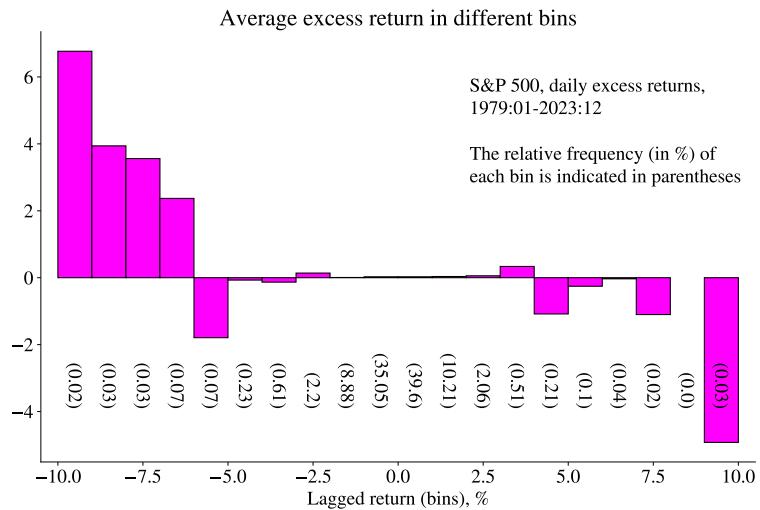


Figure 10.8: Predictability of daily US stock returns, out-of-sample

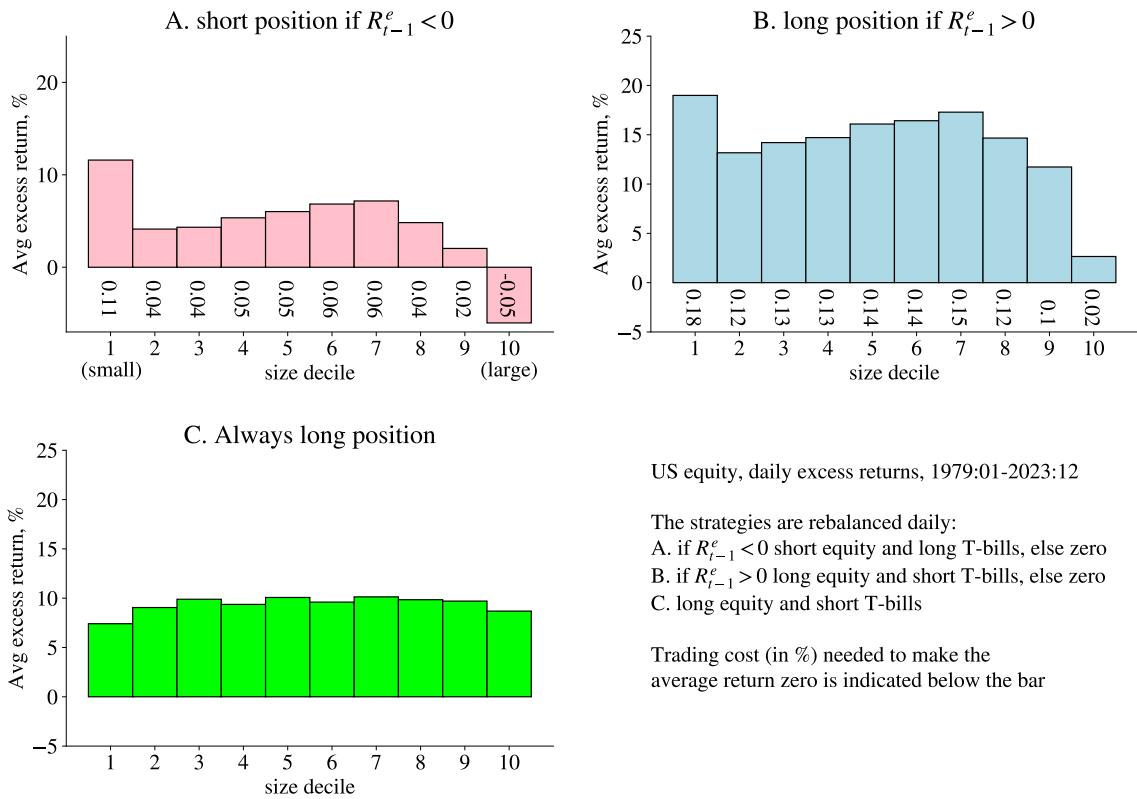


Figure 10.9: Predictability of daily US stock returns, out-of-sample

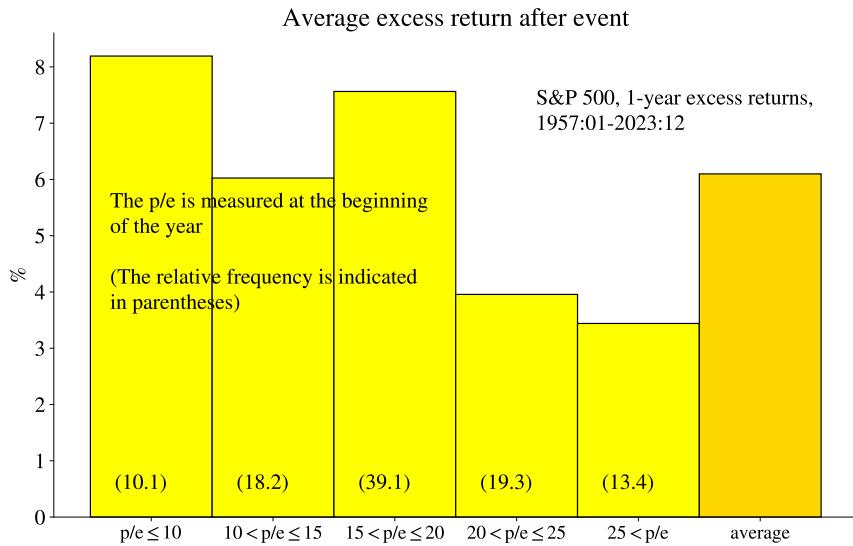


Figure 10.10: Predictability of annual US stock returns, out-of-sample

Chapter 11

Financial Panel Data

References: Verbeek (2012) 10; Baltagi (2008); Greene (2018) 6.3 and 11.

11.1 Introduction to Panel Data

A panel data set (also called a longitudinal data set) has data on a cross-section ($i = 1, 2, \dots, N$, individuals or firms) over many time periods ($t = 1, 2, \dots, T$). Our aim is to estimate a linear relation between the dependent variable and the regressors

$$y_{it} = \alpha_i + x'_{it}\beta_i + u_{it}, \quad (11.1)$$

where the coefficients (α_i, β_i) may or may not be different for different individuals (this is discussed in detail below). As examples of such applications, we may want to evaluate if alphas or betas of different mutual funds are related to fund characteristics, for instance, age or trading activity. Alternatively, we want to investigate whether firms with different types of board compositions perform differently.

Data on the dependent variable has this structure

$$\begin{array}{cccccc} & \underline{i=1} & \underline{i=2} & \cdots & \underline{i=N} \\ t=1: & y_{11} & y_{21} & & y_{N1} \\ t=2: & y_{12} & y_{22} & & y_{N2} \\ & \vdots & & & \\ t=T: & y_{1T} & y_{2T} & & y_{NT} \end{array} \quad (11.2)$$

The structure for each of the regressors is similar, although it can also be the case that (some of) the regressors are the same for all N investors (for instance, when the regressors are pricing factors like the market excess return). When needed for clarity we will use the

$y_{i,t}$ notation instead of y_{it} .

The structure in (11.2) implicitly assumes that we have a *balanced panel*, that is, have data for all the cells. However, it is often the case that the panel is *unbalanced* in the sense that some data is missing. For instance, we may not have data on regressor 3 for $i = 7$ and $t = 3$. If data is *missing in a random way*, then we can simply exclude (y_{it}, x_{it}) for the missing (i, t) . (Practical tips on how to do that is discussed later.) In our example that means just excluding $(y_{7,3}, x_{7,3})$ but keeping all other data. In contrast, if data is missing in a non-random way (for instance, depending on the value of y_{it}), then we have to apply more sophisticated sample-selection models (not discussed in this chapter).

11.2 A Benchmark: Calendar Time Regressions

Reference: Bali, Engle, and Murray (2016)

This chapter uses a calendar time (CalTime) regressions as a benchmark for some of the panel regressions. The reason is that the CalTime approach and panel regressions are sometimes very similar—and we know how to estimate and test calendar time regressions (with trustworthy standard errors). In such cases, the two methods should give similar results. If not, this may indicate issues.

In the CalTime approach, we first define M discrete groups by a portfolio sort (for instance, construct ten portfolios for different firm size deciles) and calculate their respective excess returns.

Then, we run a factor model

$$y_{jt} = z_t' \gamma_j + u_{jt}, \text{ for } j = 1, 2, \dots, M \quad (11.3)$$

where y_{jt} represents the excess return of group j and z_t typically includes a constant and various return factors (for instance, the three Fama-French factors). By estimating these M equations as system with White's (or Newey-West's) covariance estimator, it is straightforward to test various hypotheses, for instance, that the intercept (the “alpha”) is the same for all portfolios.

Example 11.1 (*CalTime with three groups*) With three groups, estimate the following

system

$$\begin{aligned}y_{1t} &= z_t' \gamma_1 + u_{1t} \\y_{2t} &= z_t' \gamma_2 + u_{2t} \\y_{3t} &= z_t' \gamma_3 + u_{3t}.\end{aligned}$$

The CalTime approach is straightforward and the cross-sectional correlations are handled. However, it forces us to define discrete asset groups—which makes it hard to handle several different types of characteristics at the same time. In contrast, panel data models are more flexible but also come with the challenge of getting the standard errors right.

Empirical Example 11.2 (*Investor activity vs performance*) See Table 11.1 for results on a ten-year panel of some 60,000 Swedish pension savers from Dahlquist, Martinez, and Söderlind (2016). In this case, the dependent variable is the return of one of three pension investment portfolios (on day t , group j where the groups are defined in terms of trading activity). The regressors include a constant, 7 risk factors (global and Swedish market, SMB, HML as a well as a bond factor) on ± 2 days ($1 + 7 \times 5$ regressors).

	Inactive	Active	Higly Active
coef	-0.76	3.08	8.65
t-tstat NW	-0.69	1.77	2.73

Table 11.1: Calendar time regressions, estimated as a system. Annualised coefficients and t-stats from Table 10, in Dahlquist et al (RFS 2017). For Inactive the coefficient is the annualised alpha, but for the other two categories it is the difference in alpha to the Inactive. Three EW portfolios based on 62640 individuals, 2116 days. The dependent variables are the returns of the EW portfolio based on the activity indicators. The regressions also control for 7 risk factors over 5 days (2 lags, 2 leads).

11.3 An Overview of Different Panel Data Models

A *pooled model* assumes that all individuals have the same coefficients (no subscript on β), so (11.1) becomes

$$y_{it} = \alpha + x_{it}' \beta + u_{it}. \quad (11.4)$$

This model can be estimated by pooled OLS (see below).

A *fixed effects model* assumes that all individuals have the same slope coefficients, but that their intercepts might differ

$$y_{it} = \alpha_i + x'_{it}\beta + u_{it}. \quad (11.5)$$

An extension of the fixed effects model is to also allow for *time fixed effects*

$$y_{it} = \lambda_t + \alpha_i + x'_{it}\beta + u_{it}. \quad (11.6)$$

Estimation of these models is discussed below. One way of handling the fixed effects are a first-difference model

$$\Delta y_{it} = \Delta \lambda_t + \Delta x'_{it}\beta + u^*_{it}, \quad (11.7)$$

where $\Delta y_{it} = y_{it} - y_{i,t-1}$ denotes a first difference (in the time dimension).

A *random effects model* is similar to a fixed effects model, except that the individual “mean” α_i now contains a common component (α) and a random individual component (μ_i). We can then write the model as

$$y_{it} = \alpha + x'_{it}\beta + u_{it} \text{ where } u_{it} = \mu_i + \varepsilon_{it}. \quad (11.8)$$

The ε_{it} is typically assumed to be uncorrelated across time and individuals, but the μ_i terms make the u_{it} residuals correlated over time (for the same individual). The estimation of this model is discussed later.

The *unrestricted model* allows all individuals to have different coefficients (hence a subscript i on β_i). These regressions could be estimated by OLS for each individual separately (see SURE for the case when the regressor values are common among the assets).

11.4 Pooled OLS

Consider the regression model

$$y_{it} = z'_{it}\gamma + u_{it}, \quad (11.9)$$

where z_{it} is an $k \times 1$ vector. For notational convenience, this section assumes that any constant is included in the z_{it} vector along with the other regressors (x_{it}). Notice that the coefficients are the same across individuals (and time), but that the regressors may vary along both the time series and cross-sectional dimensions. We assume that u_{jt} is uncorrelated with z_{it} (across all i and j).

Define the matrices

$$S_{zz} = \sum_{t=1}^T \sum_{i=1}^N z_{it} z'_{it} \text{ (a } k \times k \text{ matrix)} \quad (11.10)$$

$$S_{zy} = \sum_{t=1}^T \sum_{i=1}^N z_{it} y_{it} \text{ (a } k \times 1 \text{ vector).} \quad (11.11)$$

The LS estimator (stacking all TN observations) is then

$$\hat{\gamma} = S_{zz}^{-1} S_{zy}. \quad (11.12)$$

In case u_{it} is uncorrelated across time and also across individuals, then the usual expressions for $\text{Std}(\hat{\gamma})$ apply. However, it is often the case that there are *clusters* of individuals (all small firms, say) that have correlated residuals. This would require handling those correlations.

Recall that we can (conceptually) decompose the point estimate $\hat{\gamma}$ by using (11.9) to substitute for y_{it} in S_{zy} (11.11) and then in (11.12). The result is

$$\hat{\gamma} = \gamma + S_{zz}^{-1} \sum_{t=1}^T \sum_{i=1}^N z_{it} u_{it}. \quad (11.13)$$

The variance-covariance matrix can then be written

$$\text{Var}(\hat{\gamma}) = S_{zz}^{-1} S S_{zz}^{-1}, \text{ where} \quad (11.14)$$

$$S = \text{Var}\left(\sum_{t=1}^T \sum_{i=1}^N g_{it}\right), \quad (11.15)$$

where $g_{it} = z_{it} u_{it}$ is used as short hand notation.

Remark 11.3 (Background to (11.14)) As discussed in earlier chapters, the variance-covariance matrix (11.14) can be motivated by either (a) assuming that x_t are fixed regressors or (b) by asymptotic results. A more precise statement is thus that $S_{zz}^{-1} \hat{S} S_{zz}^{-1}$ is an estimate of the variance-covariance matrix. In practice, this gives the same estimate of the variance-covariance matrix as under assumption (a).

Remark 11.4 (Unbalanced panels*) With missing values in (y_{it}, z_{it}) we want to exclude that observation. This can be done in several ways. For instance, by changing the summations in (11.10), (11.11) and (11.15) to skip over such data points. Alternatively, we can set $(y_{it}, z_{it}) = (0, \mathbf{0}_k)$ so all variables related to (t, i) are set to zero (also the constant)—but then keep the standard summation.

When we assume that the residuals in (11.15) are iid and also independent of the regressors, then $\text{Var}(\hat{\gamma})$ simplifies to the usual OLS expression. Instead, with heteroskedas-

ticity (but still no cross-sectional correlations) we can apply the usual White's approach, and with autocorrelation the Newey-West approach. Instead, with cross-sectional correlations we need to make further adjustments (see below for a discussion).

Remark 11.5 (**Panel regression vs average coefficient in the case of common regressors*)
Consider the regression for investor i

$$y_{it} = z_t' \gamma_i + u_{it}, i = 1 \dots N,$$

where the regressors are the same in all regressions—but where the coefficients might be different across investors. It is straightforward to show that the cross-sectional average of the regression coefficients equals the results from a pooled panel regression. Clearly, the variance of the cross-sectional average depends the entire variance-covariance matrix (including the covariance) of the individual estimates—which must carry over to the panel regression.

11.4.1 Panel Regression with Clustering of Residuals

Different *cluster methods* account for a non-zero covariance within the same period (for instance, between u_{it} and u_{jt}). If there is no autocorrelation ($\text{Cov}(g_{i,t}, g_{j,t+s}) = 0$ for $s \neq 0$), then we can write 11.15) as

$$S = \sum_{t=1}^T \text{Var}\left(\sum_{i=1}^N g_{it}\right). \quad (11.16)$$

Positive correlations in the cross-section (g_{it} is correlated with g_{jt}) increases the right hand side of (11.16).

Example 11.6 ($N = 4$) To save space, let $v()$ denote a variance (possibly a variance-covariance matrix) and $\gamma(,)$ a covariance (possibly a matrix). For $N = 4$, the $\text{Var}()$ term in (11.16) can then be written (dropping the time subscripts to save even more space)

$$\begin{aligned} \text{Var}(\sum_{i=1}^4 g_i) &= v(g_1) + v(g_2) + v(g_3) + v(g_4) + \\ &\quad 2\gamma(g_1, g_2) + 2\gamma(g_1, g_3) + 2\gamma(g_1, g_4) + 2\gamma(g_2, g_3) + 2\gamma(g_2, g_4) + 2\gamma(g_3, g_4). \end{aligned}$$

Cross-sectional correlations mean that some $\gamma(,)$ terms are non-zero.

A cluster method makes assumptions about which cross-sectional units (i and j) can

be correlated, that is, we first define C clusters ($c = 1, \dots, C$) and rewrite (11.16) as

$$S = \sum_{c=1}^C \sum_{t=1}^T \text{Var}(g_t^c), \text{ where } g_t^c = \sum_{i \in \text{cluster } c} g_{it}. \quad (11.17)$$

See the next example.

Example 11.7 (*Cluster method on $N = 4$*) Assume that individuals 1 and 2 form cluster A and that individuals 3 and 4 form cluster B —and disregard correlations across clusters. This means setting the covariances across clusters to zero,

$$\begin{aligned} \text{Var}(\sum_{i=1}^4 g_i) &= v(g_1) + v(g_2) + v(g_3) + v(g_4) + \\ &\quad 2\gamma(g_1, g_2) + 2\underbrace{\gamma(g_1, g_3)}_0 + 2\underbrace{\gamma(g_1, g_4)}_0 + 2\underbrace{\gamma(g_2, g_3)}_0 + 2\underbrace{\gamma(g_2, g_4)}_0 + 2\underbrace{\gamma(g_3, g_4)}_0. \end{aligned}$$

Notice that this can be written

$$\text{Var}(\sum_{i=1}^N g_i) = \text{Var}(g_1 + g_2) + \text{Var}(g_3 + g_4),$$

which hints at how this is typically estimated.

To estimate the S matrix in (11.16), we use

$$\hat{S} = \sum_{c=1}^C \sum_{t=1}^T g_t^c (g_t^c)'. \quad (11.18)$$

In practice, this means that we use $\sum_{t=1}^T g_t^c (g_t^c)'$ to estimate $\sum_{t=1}^T \text{Var}(g_t^c)$. The iid case is when each i is her/his own cluster. The Driscoll-Kraay approach puts everyone in one cluster.

Remark 11.8 ($T = 1^*$) When we have a pure cross-sectional data set, so $T = 1$, then we can still apply (11.18). However, it is common to scale \hat{S} by $C/(C - 1)$ to improve the small sample properties. Also, notice that the Driscoll-Kraay approach (letting everyone be in one big cluster) does not work when $T = 1$ since $\sum_{i=1}^N g_i = 0$.

Empirical Example 11.9 (*Investor activity vs performance*) For an empirical illustration, see Table 11.2 where White's t-stats look massively inflated. In contrast, the Driscoll-Kraay (DK) t-stats are actually the same as in the calendar time approach in Table 11.1. Table 11.3 extends the panel estimation in Table 11.2, but is includes more regressors

	coef	t-tstat W	tstat DK
Inactive	-0.76	-56.89	-0.69
Active	3.08	37.48	1.77
Higly Active	8.65	28.73	2.73

Table 11.2: Panel regression, annualised coefficients and different t-stats from Table 10, regressions I and II in Dahlquist et al (RFS 2017). For Inactive the coefficient is the annualised alpha, but for the other two categories it is the difference in alpha to the Inactive. Panel regressions, 62640 individuals, 2116 days. The dependent variable is the return of the individual portfolio (day t , individual i). The regressions also control for 7 risk factors over 5 days (2 lags, 2 leads).

(age, gender and pension rights). This would be difficult to handle in a calendar time approach, and thus illustrates that a panel regression can handle more general cases. Notice that the investor characteristics are here allowed to change across time. For instance, an investor can be active during the early years and then become inactive.

	coef	t-tstat W	tstat DK
Inactive	-1.10	-1.63	-0.69
Active	3.10	34.61	1.79
Higly Active	8.69	28.44	2.74
Age	0.00	0.19	0.11
Male	0.62	2.94	2.22
Pension rights	-0.03	-0.39	-0.33

Table 11.3: Panel regression, annualised coefficients and different t-stats from Table 10, regressions I and II in Dahlquist et al (RFS 2017). Panel regressions, 62640 individuals, 2116 days. The dependent variable is the return of the individual portfolio (day t , individual i). The regressions also control for 7 risk factors over 5 days (2 lags, 2 leads).

11.4.2 Reintroducing Autocorrelations*

The previous discussion of clustering disregarded autocorrelations. We now reintroduce this possibility. Clearly, this should only be applied if there are good reasons to suspect autocorrelation (for instance, as indicated by tests on the fitted residuals). Otherwise, this effectively introduces many new parameters which comes with the usual disadvantages.

The cluster method is to first define the autocovariance matrix (for lag p)

$$\hat{S}_p = \sum_{c=1}^C \sum_{t=1}^T g_t^c (g_{t-p}^c)' . \quad (11.19)$$

If we allow for P lags, then the estimate is

$$\hat{S} = \hat{S}_0 + \sum_{p=1}^P w_p (\hat{S}_p + \hat{S}'_p), \quad (11.20)$$

where $w_p = 1 - p/(P + 1)$ in case we use the Bartlett weights (as in Newey-West), but also $w_p = 1$ can be motivated (see Petersen (2009) for a discussion). When $p = 0$, then this is clearly the same as in (11.18).

Notice that with flat weights ($w_p = 1$) and $P = T$, (11.20) gives the same as the (Arellano (2003)) estimator, which is used by many software packages. This has the advantage of few assumptions, but the disadvantage of (effectively) estimating many more parameters.

Remark 11.10 (*Arellano 2003 estimator of S) First, define $g^c = \sum_{t=1}^T g_t^c$ as the sum (over time) for cluster c . Second, let $\hat{S}_{AR} = \sum_{c=1}^C g^c g^{c'}$. This is the same as (11.20) with $w_p = 1$ and $P = T$. (For a comparison with the literature, notice that if X^c is the matrix of regressors for all observations in cluster c , $TN_c \times k$, and \hat{u}^c is the corresponding TN_c -vector of fitted residuals, then $X^{c'} u^c u^{c'} X^c$ is the same as $g^c g^{c'}$.)

11.5 The Within Estimator (“Fixed Effects Estimator”)

In the fixed effects model, we allow for different individual intercepts

$$y_{it} = \alpha_i + x'_{it} \beta + u_{it}, \quad (11.21)$$

where u_{it} is iid with zero mean and variance σ_u^2 .

Figure 11.1 illustrates how a correlation between individual intercepts and a regressor (x) would affect the estimate of the slope coefficient - and how the FE estimator solves that problem. This highlights that omitted variables (here individual intercepts) can bias the estimates for included variables, if there is a correlation.

There are several ways to estimate this model. The conceptually most straightforward is to include individual dummies (N) where dummy i takes the value of one if the data refers to individual i and zero otherwise and estimate the model with pooled OLS.

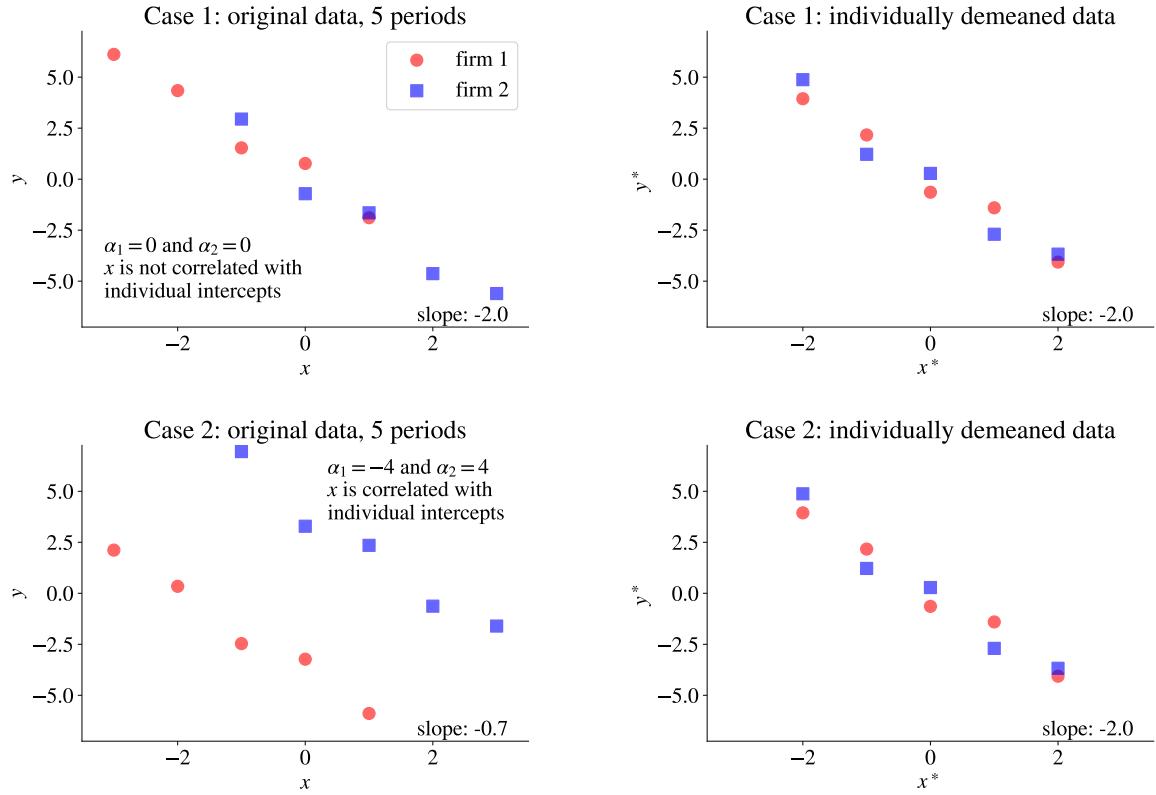


Figure 11.1: Interpretation of the FE estimator

(Clearly, the regression can then not include any intercept. Alternatively, include an intercept but only $N - 1$ dummies, for $i = 2 - N$.) However, this approach can be difficult to implement since it may involve a very large number of regressors.

As an alternative (which gives the same point estimates as pooled OLS with dummies) consider the following approach. First, take average across time (for a given i) of y_{it} and x_{it} in (11.21). That is, think (but do not run any estimation yet...) of forming the cross-sectional regression

$$\bar{y}_i = \alpha_i + \bar{x}'_i \beta + \bar{u}_i, \text{ where} \quad (11.22)$$

$$\bar{y}_i = \frac{1}{T} \sum_{t=1}^T y_{it} \text{ and } \bar{x}_i = \frac{1}{T} \sum_{t=1}^T x_{it}. \quad (11.23)$$

Second, transform the data as

$$y_{it}^* = y_{it} - \bar{y}_i \quad (11.24)$$

$$x_{it}^* = x_{it} - \bar{x}_i. \quad (11.25)$$

Figure 11.1 illustrates the transformed data in the RHS subfigures.

Forming a difference between (11.21) and (11.22) and using (11.24)–(11.25) gives a regression model for transformed data

$$y_{it}^* = x_{it}'\beta + u_{it}^*. \quad (11.26)$$

At this stage, estimate β by running pooled OLS on all observations of (11.26). There is no intercept in this regression, but adding an intercept should not affect the slope coefficients (since y_{it}^* and x_{it}^* have zero means). The results on the variance-covariance matrix (clustering, etc.) discussed in Section 11.4.1 therefore apply.

We denote the estimate from (11.26) by $\hat{\beta}_{FE}$ (FE stands for fixed effects) and it is also often called the *within estimator*. The interpretation of this approach is that we estimate the slope coefficients by using only the movements around individual means (not how the individual means differ). Notice that it gives the same results as OLS with dummies. Third and finally, get estimates of individual intercepts as

$$\alpha_i = \bar{y}_i - \bar{x}_i'\hat{\beta}_{FE}. \quad (11.27)$$

Clearly, the within estimator wipes out all regressors that are constant across time for a given individual (say, gender and schooling): they are effectively merged with the individual means (μ_i). In practice, such variables must be excluded from the x_{it} vector since otherwise there will be some transformed variables, $x_{it} - \bar{x}_i$, that are always zero—causing numerical problems. See Table 11.4 for an example (see "south").

Remark 11.11 (*The within estimator and the Frisch-Waugh-Lovell theorem**) Regressing y_t and x_t on a set of dummies gives \bar{y}_i and \bar{x}_i . The FWL theorem says that then regressing y_{it}^* on x_{it}^* gives the same slope coefficients as regressing y_{it} on x_{it} and the dummies.

We can apply the usual tests (including accounting for heteroskedasticity) on the pooled OLS results from (11.26)—provided the residuals are uncorrelated across time and individuals. Otherwise, we need a cluster method.

Measures of fit (R^2) are often calculated as the squared correlation between the dependent variable and the fitted value. The R^2 from (11.26), $\text{Corr}(y_{it}^*, \hat{y}_{it}^*)^2$, is called the

within- R^2 . Instead, if we add back the individuals means and calculate $\text{Corr}(y_{it}, \hat{y}_{it}^* + \bar{y}_i)^2$, then we have the “overall R^2 ”.

Remark 11.12 (*Fixed effects in unbalanced panels*) When (y_{it}, x_{it}) include one or more missing values, then we typically exclude that observation from the estimation. For that reason, they should also be excluded from calculating (\bar{y}_i, \bar{x}_i) . In this way, (y_{it}^*, x_{it}^*) will have zero means in the sample that is used in the estimation. An alternative way of implementing this is (a) exclude those observation from estimating (\bar{y}_i, \bar{x}_i) ; (b) set those observations in (y_{it}^*, x_{it}^*) to zero.

Remark 11.13 (*Lagged dependent variable as regressor**) If $y_{i,t-1}$ is among the regressors x_{it} , then the within estimator (11.26) is biased in short samples (that is, when T is small)—and increasing the cross-section (that is, N) does not help. To see the problem, suppose that the lagged dependent variable is the only regressor ($x_{it} = y_{i,t-1}$). The within estimator (11.26) is then

$$y_{it} - \sum_{t=1}^T y_{it}/T = \left(y_{i,t-1} - \sum_{t=2}^T y_{i,t-1}/(T-1) \right) \beta + \left(u_{it} - \sum_{t=1}^T u_{it}/T \right).$$

The problem is that $y_{i,t-1}$ is correlated with $\sum_{t=1}^T u_{it}$ since the latter contains $u_{i,t-1}$ which affects $y_{i,t-1}$ directly. In addition, $\sum_{t=1}^T y_{i,t-1}$ contains $y_{i,t}$ which is correlated with u_{it} . It can be shown that this bias can be substantial for panels with small T .

11.5.1 The Within Estimator with Time Fixed Effects

When we allow for time fixed effects (but no individual fixed effects)

$$y_{it} = \lambda_t + x_{it}'\beta + u_{it}, \quad (11.28)$$

then we could once again introduce dummies (now for time periods) and apply pooled OLS.

Figure 11.2 illustrates how omitted time varying (common) variables can affect the slope coefficient of included regressors, if there is a correlation.

As before, it is often easier to transform the data before estimating with pooled OLS. In this case, we run the regression on transformed variables

$$y_{it}^* = x_{it}^*\beta + u_{it}^*. \quad (11.29)$$

	LS	Fixed eff	Between	GLS	1st diff
exper/100	7.84 (8.25)	4.11 (6.21)	10.64 (4.05)	4.57 (7.12)	3.55 (2.33)
exper ² /100	-0.20 (-5.04)	-0.04 (-1.50)	-0.32 (-2.83)	-0.06 (-2.37)	-0.05 (-0.93)
tenure/100	1.21 (2.47)	1.39 (4.25)	1.25 (0.90)	1.38 (4.32)	1.29 (2.98)
tenure ² /100	-0.02 (-0.85)	-0.09 (-4.36)	-0.02 (-0.20)	-0.07 (-3.77)	-0.08 (-2.45)
south	-0.20 (-13.51)	-0.02 (-0.45)	-0.20 (-6.67)	-0.13 (-5.70)	-0.02 (-0.56)
union	0.11 (6.72)	0.06 (4.47)	0.12 (3.09)	0.07 (5.57)	0.04 (3.31)

Table 11.4: Panel estimation of log wages for women, $T = 5$ and $N = 716$ from NLS (1982,1983,1985,1987,1988). Example of fixed and random effects models, Hill et al (2008), Table 15.9. Numbers in parentheses are t-stats.

The transformations are

$$y_{it}^* = y_{it} - \bar{y}_t \quad (11.30)$$

$$x_{it}^* = x_{it} - \bar{x}_t, \quad (11.31)$$

where

$$\bar{x}_t = \sum_{i=1}^N x_{it} / N \text{ for each } t. \quad (11.32)$$

(Similarly for the transformation of y_{it} .)

As before, the estimation and testing of (11.29) is a pooled OLS, so the results on the variance-covariance matrix (clustering) apply.

Remark 11.14 (**Fixed effects in unbalanced panels*) As with individual fixed effects, the averages should only be calculated from those data points that will be used in the estimation.

11.5.2 The Within Estimator with Individual and Time Fixed Effects

When we allow for time fixed effects (but no) and individual fixed effects

$$y_{it} = \lambda_t + \alpha_i + x_{it}'\beta + u_{it}, \quad (11.33)$$

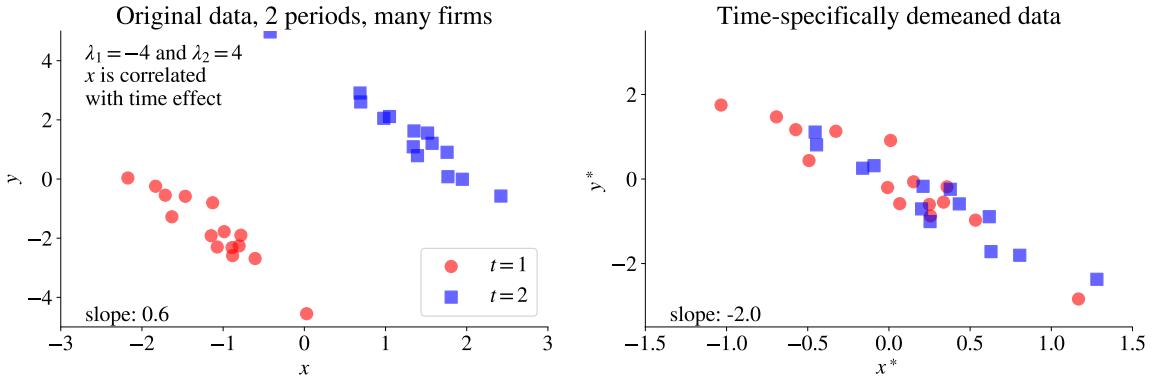


Figure 11.2: Interpretation of the FE estimator

then we could once again introduce dummies (now for both time periods and individuals) and apply pooled OLS. A double transformation of the data works when the panel is balanced. As this is often not the case, this section focuses on another approach.

We can define T time dummies and put them in a vector τ_{it} and consider the regression equation

$$y_{it} = \alpha_i + [x'_{it}, \tau_{it}] \gamma + u_{it}. \quad (11.34)$$

(The time dummies have, at this stage, the same values for all individuals, but this will change in the next step.) First, apply the individual FE approach in (11.24)–(11.25) on this model. Notice that the (individual) “within transformation” must also be applied to the time dummies. With an unbalanced panel, this means that the transformed time dummies will differ across individuals. Second, apply the pooled regression on the transformed data. The number of regressors is $K + T$, so this might only work with a moderate number of time periods.

An alternative approach, based on a repeated application of the Frisch-Waugh theorem is discussed in the remark below. It works also for three-way (or more) FE model.

Remark 11.15 (*L-way FE by repeated Frisch-Waugh**) *The following approach avoids a large regression (on many dummies) by applying a sequence of many smaller regressions. Let Z_{it}^1 be a set of dummies (say, for individuals), Z_{it}^2 another set of dummies (say, time periods), and so forth until Z_{it}^L . Actually, the ordering and grouping of the Z dummies is arbitrary, and it might be numerically preferable to just create groups of, say, 10 dummies. First, regress each variable in (y, x, Z^2, \dots, Z^L) on Z^1 and retrieve the residuals $(y^*, x^*, Z^{2*}, \dots, Z^{L*})$. (This step can be replaced by a within-transformation, which*

might be quicker. For instance, if $N > T$, then let Z^1 be individual dummies.) Second, regress each of the variables in $(y^*, x^*, Z^{3*}, \dots, Z^{L*})$ on Z^{2*} and retrieve the residuals $(y^{**}, x^{**}, Z^{3**}, \dots, Z^{L**})$. Continue this until only $(y^{****\dots}, x^{****\dots})$ are left. Finally, do a pooled regression on those. A special case is to let Z^1 be individual dummies and Z^2 time dummies ($L = 2$), to get the individual and time fixed effects model.

11.6 The First-Difference Estimator

An another way of estimating the fixed effects model is to difference away the α_i by taking *first-differences* (in time)

$$\Delta y_{it} = \Delta \lambda_t + \Delta x'_{it} \beta + u_{it}^*, \quad (11.35)$$

where $\Delta y_{it} = y_{it} - y_{i,t-1}$ and similarly for the regressors. Quite often, we interpret $\Delta \lambda_t$ as just a constant. Notice that

$$u_{it}^* = u_{it} - u_{i,t-1}, \quad (11.36)$$

so there are reasons to suspect that u_{it}^* is (negatively) autocorrelated.

Notice that the first-difference approach focuses on how changes in the regressors (over time, for the same individual) affect changes in the dependent variable. Also this method wipes out all regressors that are constant across time (for a given individual).

Regression (11.35) is once again estimated by pooled OLS. However, unadjusted standard errors are likely to overstate the uncertainty, because of the (possibly) negative autocorrelation of u_{it}^* . (Testing for autocorrelation is recommended.) This suggests that using the unadjusted standard errors is a conservative approach (harder to reject the null hypothesis). Again, the results on clustering discussed in Section 11.4.1 still apply.

Example 11.16 (*Negative autocorrelation of u_{it}^*) If u_{it} in (11.36) is iid, then $\text{Cov}(u_{it}^*, u_{it-1}^*) = \text{Cov}(u_{it} - u_{i,t-1}, u_{it-1} - u_{i,t-2}) = -\sigma_u^2$.

Remark 11.17 (Lagged dependent variable as regressor*) If $y_{i,t-1}$ is among the regressors x_{it} , then the first-difference method (11.35) does not work (OLS is inconsistent and a larger sample does not help). The reason is that the (autocorrelated) residual is then correlated with the lagged dependent variable. This model cannot be estimated by OLS (the instrumental variable method might work).

11.7 Differences-in-Differences Estimator

Consider the model (11.35) when one of the regressors is a dummy variable indicating whether individual i was “treated” (for instance, received investment advise) in period t . We can estimate this as before—and interpret the coefficient as the effect of the “treatment” (conditional on all other variables)

In the classical difference-in-difference estimator there are only two periods ($T = 2$): before and after the treatment. *If there are no other regressors*, then (11.35) can be written

$$\Delta y_{it} = \Delta \lambda_t + \beta Q_{it} + u_{it}^*, \quad (11.37)$$

where Q_{it} is the dummy variable. (The restriction that all individuals have the same $\Delta \lambda_t$ term is the so called “parallel trend assumption.”) In this case β can be estimated by the difference between the average Δy_{it} among the treated ($\Delta \bar{y}_{B2}$) and the average Δy_{it} among the non-treated ($\Delta \bar{y}_{A2}$)

$$\hat{\beta} = \Delta \bar{y}_{B2} - \Delta \bar{y}_{A2}. \quad (11.38)$$

(Notice that the change of the average is the same as the average of the change.)

11.8 Fama-MacBeth

The Fama and MacBeth (1973) approach (called FMB below) is a different method for handling panel data. The method has two main steps, described below.

First, estimate λ_t and β_t

$$y_{it} = \lambda_t + x'_{it} \beta_t + u_{it} \quad (11.39)$$

period by period (using the cross section $i = 1 - N$). The FMB has the nice properties of easily handling unbalanced data sets (the cross-sectional regressions (11.39) are run on the available cross section for each time period).

Second, estimate the time averages

$$\hat{\beta} = \frac{1}{T} \sum_{t=1}^T \hat{\beta}_t. \quad (11.40)$$

Remark 11.18 (*Step 0**) The FMB can also be used to test CAPM (or other linear factor models). In this case, y_{it} in (11.39) are the excess returns on asset i in period t (R_{it}^e)

and x_{it} are the loadings (γ_{it}) of the excess return on the market excess return (or other factors) according to the regression $R_{it}^e = \alpha + f_t' \gamma_{it} + \varepsilon_{it}$. (Often the γ coefficients are referred to as “betas”, which should not be confused with the coefficients β_t in (11.39).) In many cases, the γ_{it} values used as x_{it} are estimated during a previous sample, for instance, during the five years up to and including $t - 1$. In other cases, the γ_{it} values are estimated from the full sample, and are thus constant across periods. The latter has the advantage of being more precise estimates, provided the assumption of constant loadings is correct.

Fama and MacBeth (1973) suggest that the standard deviation should be found by studying the time-variation in $\hat{\beta}_t$. In particular, they suggest that the variance of $\hat{\beta}_t$ (notice, not $\hat{\beta}$) can be estimated by the (average) squared variation around its mean

$$\widehat{\text{Var}}(\hat{\beta}_t) = \frac{1}{T} \sum_{t=1}^T (\hat{\beta}_t - \hat{\beta})^2. \quad (11.41)$$

Since $\hat{\beta}$ is the sample average of $\hat{\beta}_t$, the variance of the former is the variance of the latter divided by T (the sample size)—provided $\hat{\beta}_t$ is iid. That is,

$$\widehat{\text{Var}}(\hat{\beta}) = \frac{1}{T} \text{Var}(\hat{\beta}_t) = \frac{1}{T^2} \sum_{t=1}^T (\hat{\beta}_t - \hat{\beta})^2. \quad (11.42)$$

When x_{it} are common risk factors ($x_{it} = x_t$), then FMB and pooled OLS give the same point estimates (provided (11.39) is estimated without an intercept, effectively setting $\lambda_t = 0$). However, FMB’s variance-covariance matrix automatically handles the cross sectional correlations between residuals, while the pooled OLS would require applying a cluster method. See Cochrane (2001) 12.3 and Campbell, Lo, and MacKinlay (1997) 5.8 for further details.

Empirical Example 11.19 (*Estimated factor risk premia from different methods*) Table 11.5 shows estimates of the factor risk premia from several methods based on the 25 FF portfolios.

	Data	CR	FMB1	FMB2
Market	7.10 (2.18)	6.60 (2.26)	6.60 (2.21)	-7.67 (3.94)
SMB	1.36 (1.45)	1.17 (1.53)	1.17 (1.49)	0.77 (1.49)
HML	3.64 (1.46)	4.40 (1.62)	4.40 (1.50)	4.04 (1.50)

Table 11.5: Different estimates of factor risk premia, annualized %. Numbers in (parentheses) are standard deviations. The 25 FF portfolios 1970:01-2023:12. Data are the mean excess returns of the factors; CR are estimates of the factor risk premia from a cross-sectional regression; FMB1 are from Fama-MacBeth without intercept in the cross-sectional regression; FMB2 are from Fama-MacBeth with intercept in the cross-sectional regression. In both FMB regressions, the betas are estimated from the full sample.

11.9 Appendix – Random Effects Model*

The random effects model allows for *random* individual “intercepts” (μ_i)

$$y_{it} = \alpha + x'_{it}\beta + \mu_i + \varepsilon_{it}, \text{ where} \quad (11.43)$$

$$\varepsilon_{it} \text{ is iid } N(0, \sigma_\varepsilon^2) \text{ and } \mu_i \text{ is iid } N(0, \sigma_\mu^2). \quad (11.44)$$

Notice that μ_i is random (across agents) but constant across time, while ε_{it} is just random noise. Hence, μ_i can be interpreted as the permanent “luck” of individual i .

It is sometimes argued that the random effect only makes sense if the data is a sample from a larger population—and then captures the peculiar (relative to the population) features of the individuals that end up in the sample. It is then convenient to merge μ_i with ε_{it} , because it gives fewer parameters to estimate (and thus, saves degrees of freedom). In contrast, if the cross-section effectively contains the population (all mutual funds on a market, say), then a fixed effect is perhaps more reasonable.

Clearly, if we regard μ_i as non-random, then we are back in the fixed-effects model. (The choice between the two models is not always easy, so it may be wise to try both—and compare the results.)

We could write the regression as

$$y_{it} = \alpha + x'_{it}\beta + u_{it}, \text{ where } u_{it} = \mu_i + \varepsilon_{it}, \quad (11.45)$$

and we typically assume that u_{it} is uncorrelated across individuals, but correlated across

time (only because of μ_i). In addition, we assume that ε_{jt} and μ_i are not correlated with each other or with x_{it} .

There are several ways to estimate the random effects model. First, the methods for fixed effects (the within and first-difference estimators) all work—so the “fixed effect” can actually be a random effect. Second, the *between estimator* using only individual time averages (from (11.23))

$$\bar{y}_i = \alpha + \bar{x}'_i \beta + \underbrace{\mu_i + \bar{\varepsilon}_i}_{\text{residual}_i}, \quad (11.46)$$

is also consistent, but discards all time-series information. Third, LS on

$$y_{it} = \alpha + x'_{it} \beta + \underbrace{\mu_i + \varepsilon_{it}}_{\text{residual}_{it}} \quad (11.47)$$

is consistent (but not really efficient). However, in this case we may need to adjust $\text{Var}(\hat{\beta})$ since the covariance matrix of the residuals is not diagonal.

In the random effects model, the μ_i variable can be thought of as an *excluded variable*. Excluded variables typically give a bias in the coefficients of all included variables—unless the excluded variable is uncorrelated with all of them. This is the assumption in the random effects model (recall: we assumed that μ_i is uncorrelated with x_{jt}). If this assumption is wrong, then we cannot estimate the RE model by either OLS or GLS, but the within-estimator (compare with the FE model) works, since it effectively eliminates the excluded variable from the system.

Example 11.20 $N = 2, T = 2$. If we stack the data for individual $i = 1$ first and those for individual $i = N$ second

$$\text{Var} \left(\begin{bmatrix} u_{1,T-1} \\ u_{1T} \\ u_{N,T-1} \\ u_{NT} \end{bmatrix} \right) = \begin{bmatrix} \sigma_\mu^2 + \sigma_\varepsilon^2 & \sigma_\mu^2 & 0 & 0 \\ \sigma_\mu^2 & \sigma_\mu^2 + \sigma_\varepsilon^2 & 0 & 0 \\ 0 & 0 & \sigma_\mu^2 + \sigma_\varepsilon^2 & \sigma_\mu^2 \\ 0 & 0 & \sigma_\mu^2 & \sigma_\mu^2 + \sigma_\varepsilon^2 \end{bmatrix},$$

which has elements off the main diagonal.

Remark 11.21 (*Generalized least squares**) GLS is an alternative estimation method that exploits correlation structure of residuals to increase the efficiency. In this case,

it can be implemented by running OLS on

$$y_{it} - \vartheta \bar{y}_i = \alpha(1 - \vartheta) + (x_{it} - \vartheta \bar{x}_i)' \beta + v_{it}, \text{ where}$$

$$\vartheta = 1 - \sqrt{\sigma_u^2 / (\sigma_u^2 + T\sigma_\mu^2)}.$$

In this equation, σ_u^2 is the variance of the residuals in the “within regression” as estimated in (11.26) and $\sigma_\mu^2 = \sigma_B^2 - \sigma_u^2 / T$, where σ_B^2 is the variance of the residuals in the “between regression” (11.46). Here, σ_μ^2 can be interpreted as the variance of the random effect μ_i . However, watch out for negative values of σ_μ^2 and notice that when $\vartheta \approx 1$, then GLS is similar to the “within estimator” from (11.26). This happens when $\sigma_\mu^2 \gg \sigma_u^2$ or when T is large. The intuition is that when σ_μ^2 is large, then it is smart to get rid of that source of noise by using the within estimator, which disregards the information in the differences between individual means.

Chapter 12

Instrumental Variables Method (IV)

Reference: Verbeek (2012) 5, Greene (2018) 8.3; Hamilton (1994) 9.2; and Pindyck and Rubinfeld (1998) 7.

12.1 Instrumental Variables Method

When OLS is inconsistent (see Figure 12.1 for an example), then we typically apply MLE or the instrumental variables (IV/2SLS) method. This section describes the latter.

We want to estimate β in

$$y_t = x_t' \beta + u_t, \quad (12.1)$$

where x_t and β are vectors with k elements. Recall that OLS is defined by making the fitted residuals orthogonal (uncorrelated) with the regressors

$$\mathbf{0}_{kx1} = \sum_{t=1}^T x_t (y_t - x_t' \hat{\beta}). \quad (12.2)$$

Example 12.1 (ARMA(1,1)) Consider the time series process $y_t = 0.9y_{t-1} + \varepsilon_t$ where $\varepsilon_t = v_t + 0.5v_{t-1}$. Notice that the regressor (y_{t-1}) is correlated with the residual (especially the v_{t-1} part), so OLS is inconsistent.

The IV method replaces (12.2) by

$$\mathbf{0}_{kx1} = \sum_{t=1}^T z_t (y_t - x_t' \hat{\beta}_{iv}), \quad (12.3)$$

where z_t is a vector of k elements that have two key properties: (1) z_t is uncorrelated with the true residual (u_t) so z_t are *valid instruments*; but (2) correlated with the regressors (x_t) so z_t are *relevant instruments*. The first property cannot be directly checked since we never observe the true residuals. Instead, theoretical arguments must be used, but the

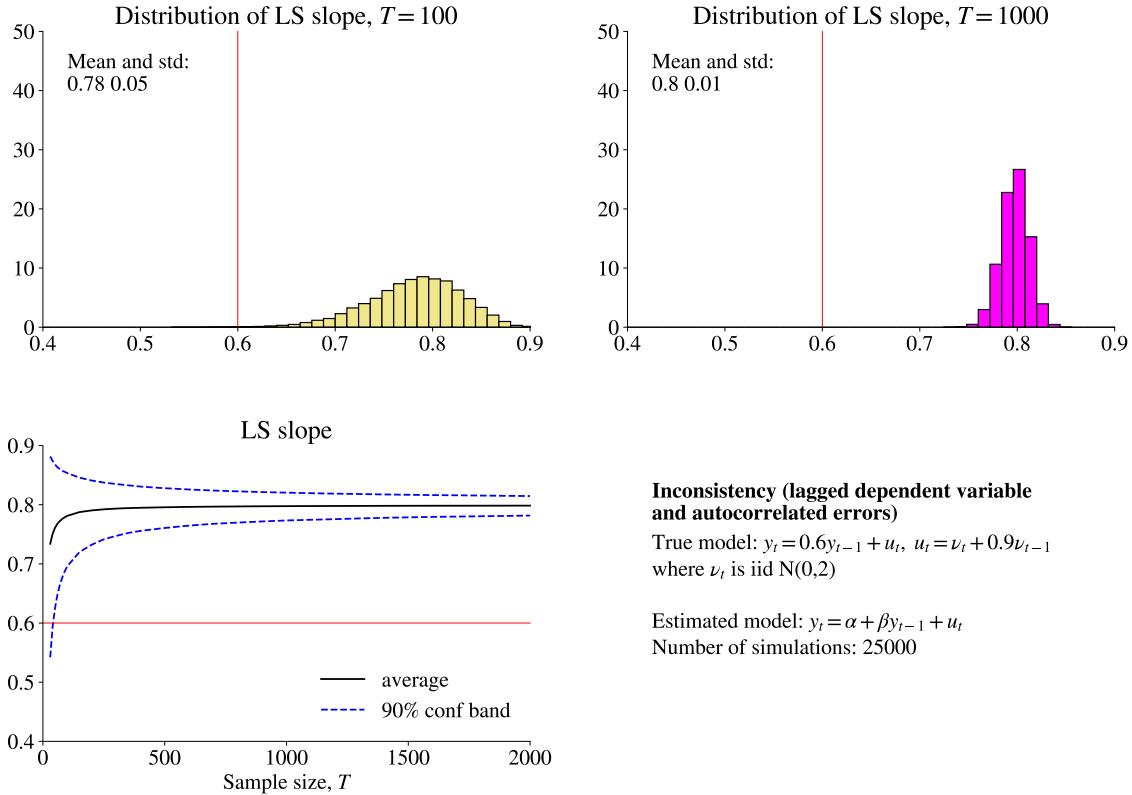


Figure 12.1: Results from a Monte Carlo experiment of LS estimation of the AR coefficient when data is from an ARMA process.

Hausman test can be of some help (see below). In particular, a valid instrument *cannot be endogenous* with respect to (that is, caused by) y_t and it *cannot be an erroneously excluded regressor*, because both cases would lead to $\text{Cov}(z_t, u_t) \neq 0$. A good application of the IV method must argue why that is not the case.

In contrast, the second property is easily checked by, for instance, regressing x_t on z_t and studying the t-statistics. (A perhaps more intuitive discussion of what the IV estimator does is found in the section on 2SLS below.)

Example 12.2 (ARMA(1,1) continued) Continuing Example 12.1, notice that y_{t-2} (or earlier lags) are not correlated with the residual so they could be used as instruments.

Notice that some regressors (elements of x_t) may also be used as instruments (z_t). For instance, if just one of the regressors is an endogenous variable then we need (at least one) new instrument for that regressor, while the other regressors can be instruments for themselves.

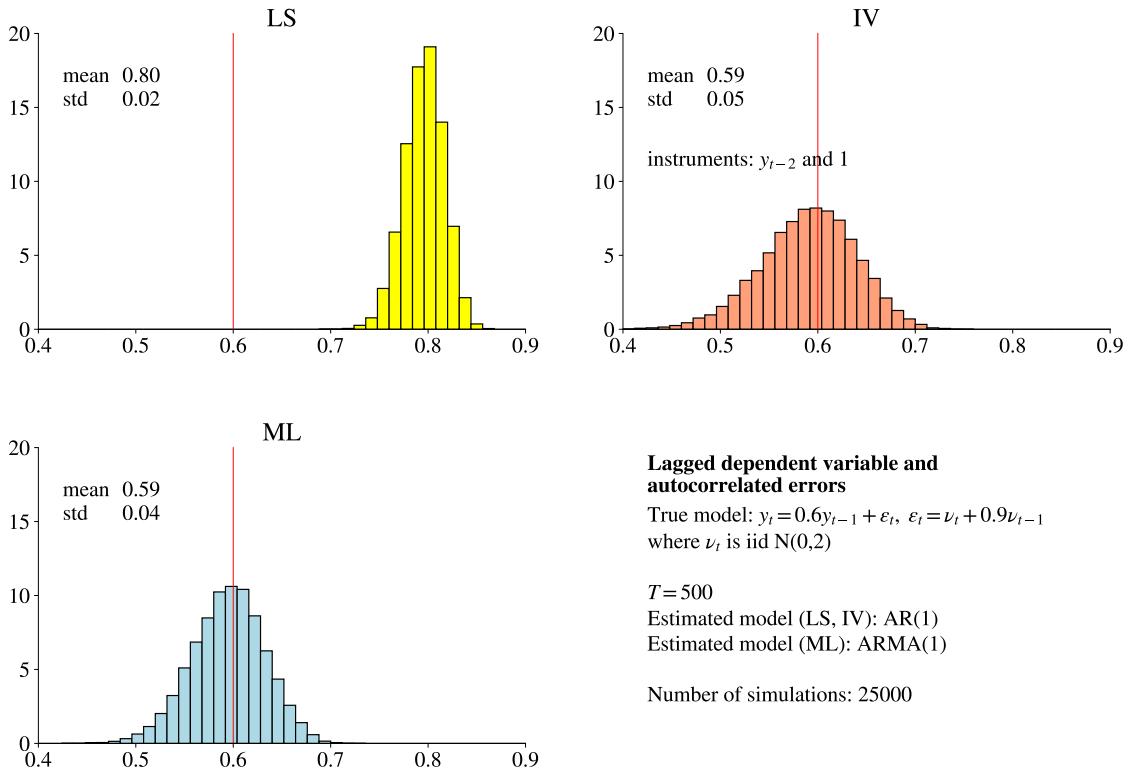


Figure 12.2: Results from a Monte Carlo experiment when data is from an ARMA process.

Solving (12.3) gives the IV estimator

$$\hat{\beta}_{iv} = \left(\sum_{t=1}^T z_t x'_t \right)^{-1} \sum_{t=1}^T z_t y_t. \quad (12.4)$$

Clearly, this is the same as OLS when $z_t = x_t$. Notice that $\Sigma z_t x'_t$ must be invertible (have full rank) for this to work, that is, z_t and x_t must be correlated (or else z_t are not valid instruments). There are few results on the small sample properties, although it is often found that there is a small sample bias.

Remark 12.3 (Matrix notation) Let z'_t be the t^{th} row of Z and similarly for X . We then have $\hat{\beta}_{iv} = (Z'X)^{-1} (Z'Y)$.

Figure 12.2 shows an example with an ARMA(1,1) process. The regressor (y_{t-1}) is correlated with the residual (v_{t-1}), so OLS is inconsistent. The IV method uses $(1, y_{t-2})$ as instruments for $(1, y_{t-1})$. Notice that $(1, y_{t-2})$ are indeed uncorrelated with the residual

(which include shocks in t and $t - 1$ but not earlier), but correlated with the regressors (because of the persistence of the y_t series).

$\hat{\beta}_{iv}$ is (asymptotically) normally distributed so

$$\begin{aligned}\hat{\beta}_{iv} &\xrightarrow{a} N(\beta, V), \text{ with} \\ V &= S_{zx}^{-1} S S_{xz}^{-1} \text{ where } S = \text{Var}(\sum_{t=1}^T z_t u_t)\end{aligned}\tag{12.5}$$

and $S_{zx} = \Sigma_{t=1}^T z_t x'_t$. (See Appendix 12.4 for details.) This general expression is valid for both autocorrelated and heteroskedastic residuals—all such features are loaded into the S matrix. In practice (with stochastic regressors and instruments), we estimate V by plugging in $S_{zx} = \Sigma_{t=1}^T z_t x'_t$ and an estimate of S .

We can estimate S by replacing u_t by fitted residuals

$$\hat{u}_t = y_t - x'_t \hat{\beta}_{iv}. \tag{12.6}$$

If the residuals are iid and independent of z_t (so $S = \sigma^2 S_{zz}$), then

$$V = \sigma^2 S_{zx}^{-1} S_{zz} S_{xz}^{-1}, \text{ if } u_t \text{ are iid,} \tag{12.7}$$

where $S_{zz} = \Sigma_{t=1}^T z_t z'_t$.

The IV estimator has often large standard deviations, especially with “weak instruments” (weak correlation with regressors). This is illustrated in Figure 12.3.

Example 12.4 ($\text{Var}(\hat{\beta}_{iv})$ in the simplest case) Assume y_t , x_t and z_t are zero mean variables and that z_t and u_t are independent. Equation (12.7) for a simple regression can then be written

$$\begin{aligned}\text{Var}(\hat{\beta}_{iv}) &= \frac{\sigma^2 \text{Var}(z_t)/T}{\text{Cov}(x, z)^2} \\ &= \frac{\sigma^2/T}{\text{Var}(x_t)} \frac{1}{\text{Corr}(x_t, z_t)^2}.\end{aligned}$$

If $\text{Corr}(x_t, z_t) = 1$ or -1 , then this is the same as with OLS (but the consistency can be questioned in this case). Instead, with a low $\text{Corr}(x_t, z_t)^2$ value (weak instruments), then the uncertainty is higher.

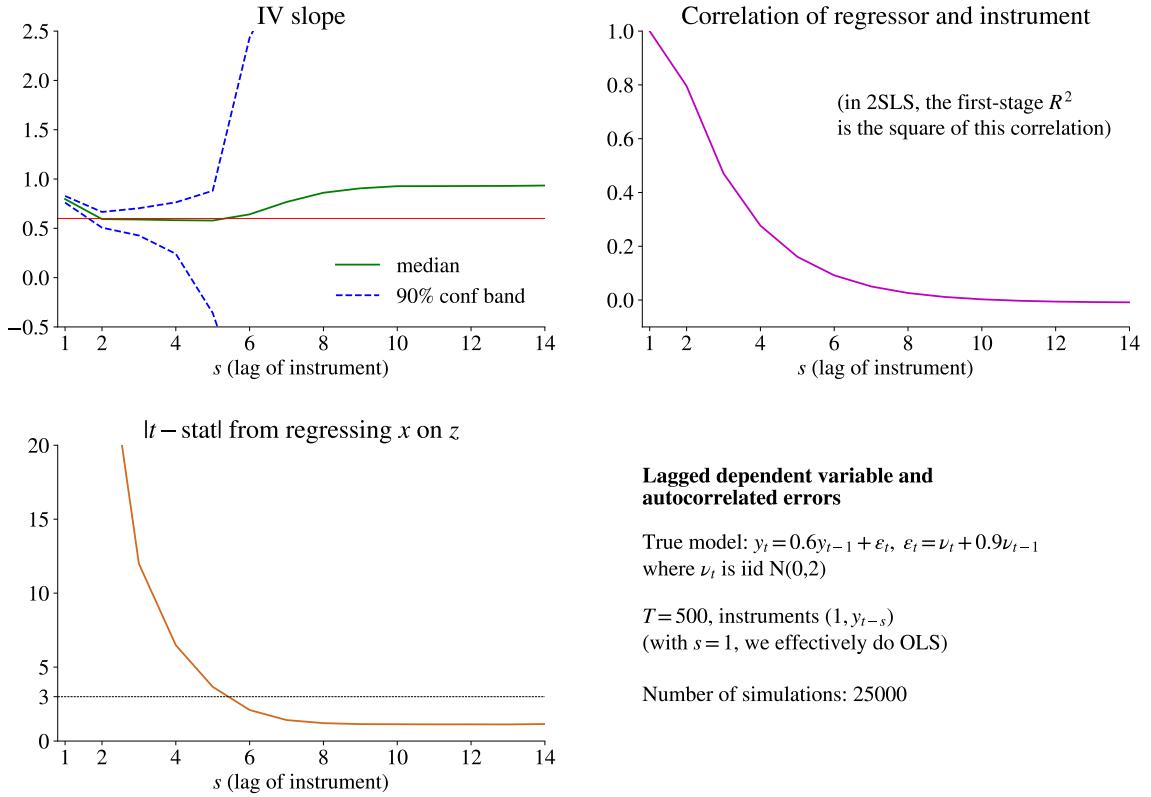


Figure 12.3: Results from a Monte Carlo experiment when data is from an ARMA process.

12.2 Two-stages-least squares (2SLS)

2SLS is the same as IV when there are as many instruments (L) as there are regressors (k). When there are more instruments than regressors ($L > k$), then 2SLS can produce more precise (efficient) estimates than IV. It proceeds in two steps.

Example 12.5 (ARMA(2,1)) $y_t = \rho_1 y_{t-1} + \rho_2 y_{t-2} + \varepsilon_t$ where $\varepsilon_t = v_t + \theta_1 v_{t-1}$. Notice that y_{t-1} is correlated with v_{t-1} but y_{t-2} is not. We could therefore use y_{t-2}, y_{t-3}, \dots as instruments for the two regressors. See Figure 12.4.

First, regress each of the elements in x_t on z_t

$$x_{it} = \delta'_i z_t + \varepsilon_t, \text{ for } i = 1 \text{ to } k, \quad (12.8)$$

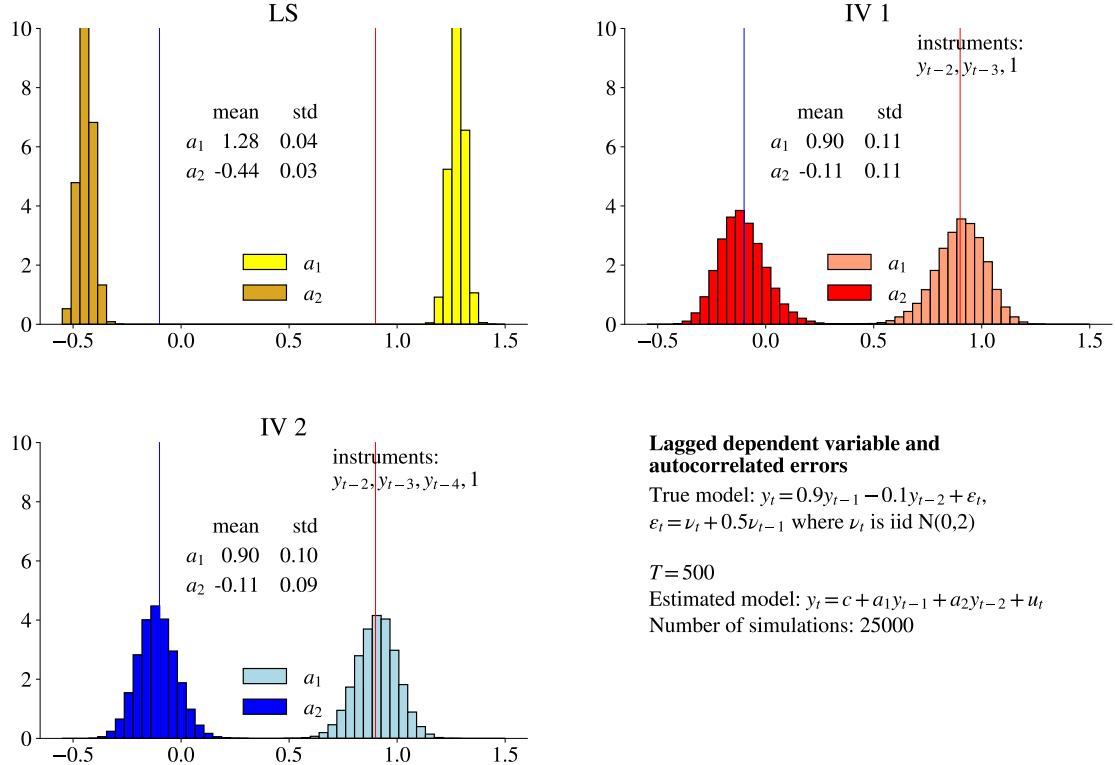


Figure 12.4: Results from a Monte Carlo experiment when data is from an ARMA process.

where δ_i is a vector with L elements and let \hat{x}_{it} be the fitted values

$$\hat{x}_{it} = \delta'_i z_t. \quad (12.9)$$

(Clearly, $\delta'_i z_t = z'_t \delta_i$, but the former is more straightforward when we stack the equations below.) We can stack the equations as

$$\hat{x}_t = \delta' z_t, \quad (12.10)$$

where δ is an $L \times k$ matrix with δ_i in column i (and thus in row i of δ' , which is $k \times L$). The fit (or t-stats) of these regressions are often used to assess if the instruments are relevant. Often a $|t| > 3$ is considered necessary. See Figure 12.3.

Second, regress y_t on the fitted values \hat{x}_t

$$y_t = \hat{x}'_t \beta + v_t. \quad (12.11)$$

Remark 12.6 (Alternative to (12.11)*) We could equally well use \hat{x}_t instead of z_t in the IV estimator (12.4). This gives the same result as (12.11), provided that the instruments in the first stage estimation (12.8) include all “non-problematic” regressors.

Similarly to IV, the small sample properties are poor if the first-stage regression has a low R^2 (“weak instruments”), see Figure 12.3. However, using more instruments can improve the precision, see Figure 12.4.

Example 12.7 (Supply and Demand) Consider the simplest simultaneous equations model for supply and demand on a market are

$$\begin{aligned} q_t &= \gamma p_t + u_t^s, \quad \gamma > 0 \text{ (supply)} \\ q_t &= \beta p_t + \alpha A_t + u_t^d, \quad \beta < 0 \text{ (demand)}, \end{aligned}$$

where A_t is an observable demand shock (perhaps income). To estimate the supply curve, the observable demand shocks A_t can be used as an instrument. See Figure 12.5 for an illustration.

The 2SLS approach highlights the key idea of IV (and 2SLS): in the regression (12.11) we only consider those movements in the regressors that are correlated with z_t (as captured by \hat{x}_t). Since z_t is chosen to be uncorrelated with the residuals, but correlated with x_t , we are only using the “clean” co-movements of x_t and y_t to estimate the coefficients. See Example 12.7 and Figure 12.5 for an illustration.

It can be shown (see Appendix 12.4 for details) that the (asymptotically valid) variance-covariance matrix for $\hat{\beta}_{SLS}$ is

$$\begin{aligned} V &= B S B', \text{ where} \\ B &= (S_{xz} S_{zz}^{-1} S_{zx})^{-1} S_{xz} S_{zz}^{-1} \text{ and } S = \text{Var}(\sum_{t=1}^T z_t u_t). \end{aligned} \tag{12.12}$$

This general expression is valid for both autocorrelated and heteroskedastic residuals since those features are loaded into the S matrix. We can estimate S as in the IV case: plug in (the sample values of) S_{xz} and S_{zz} and an estimate of S . For the latter, we replace u_t by the fitted residuals

$$\hat{u}_t = y_t - x_t' \beta_{iv}. \tag{12.13}$$

Notice that these are *not* the same as the fitted residuals from the 2nd stage regression.

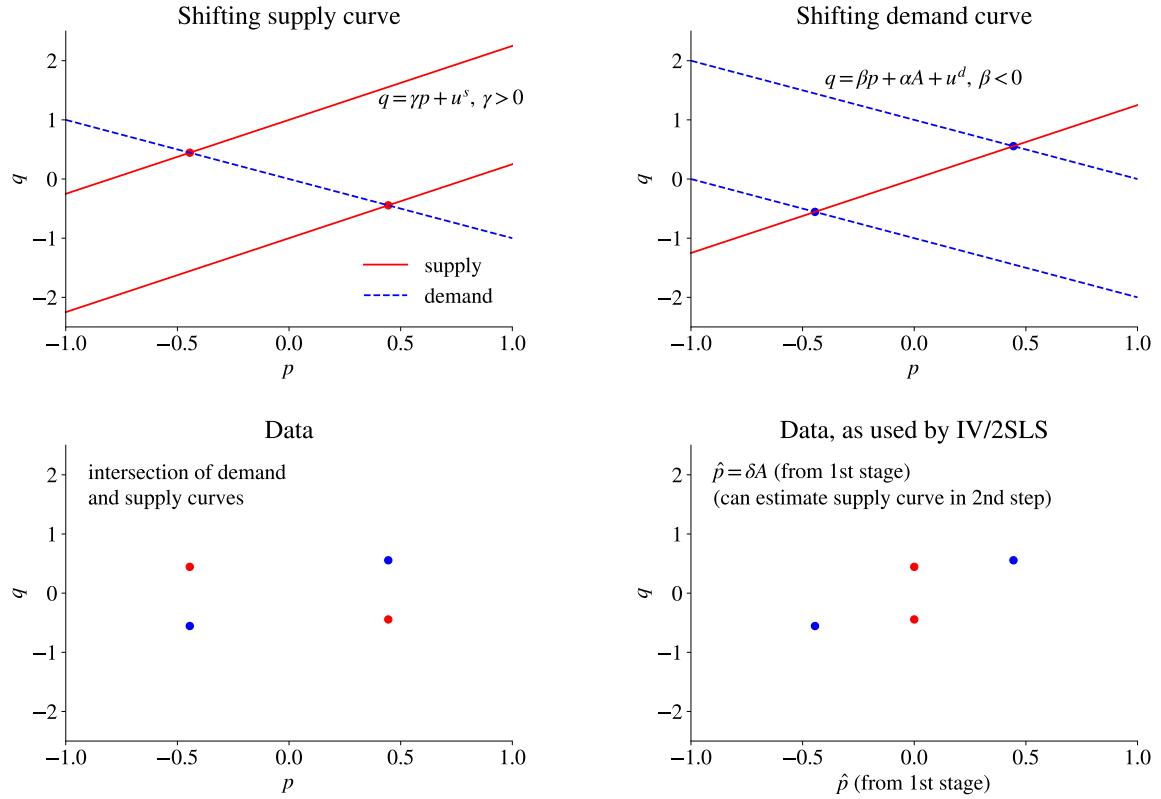


Figure 12.5: Illustration of demand and supply curves

If the residuals are iid and independent of z_t (so $S = \sigma^2 S_{zz}$), then V simplifies to

$$V = \sigma^2 (S_{xz} S_{zz}^{-1} S_{zx})^{-1} \text{ if } u_t \text{ are iid.} \quad (12.14)$$

Empirical Example 12.8 (Wage equation) Tables 12.1 –12.2 shows results from an example in Hill, Griffiths, and Lim (2008) 10.3.3. The purpose is to estimate how log wages depend on education, experience and experience², while treating education as an endogenous variable. The instruments are experience, experience² and the education of the mother: see the first stage regression in 12.1. The result is fairly different from the OLS regression: see Table 12.2.

Remark 12.9 (Overidentifying restrictions in 2SLS*) When we use 2SLS, then we can test if instruments affect the dependent variable only via their correlation with the regressors. If not, something is wrong with the model since some relevant variables are excluded from the regression. A simple test is to first estimate with 2SLS to get the fitted residuals \hat{u}_t , then

	1st stage
c	9.775 (23.753)
exper	0.049 (1.152)
exper ²	−0.001 (−0.959)
mothereduc	0.268 (8.481)
R ²	0.153
T	428

Table 12.1: First stage estimation of the 'educ' variable. Example of IV estimation, Hill et al (2008), section 10.3.3. Instruments: c, exper, exper², and mothereduc. Numbers in parentheses are t-stats (from White's method).

regress those on z_t . The TR^2 from this second regression is (under the null hypothesis) χ^2_{df} with df being the number of overidentifying restrictions.

12.3 Hausman's Specification Test

Reference: Greene (2018) 8.6

This test is investigating whether an efficient estimator (like LS) gives (approximately) the same estimate as a consistent estimator (like IV). If not, the efficient estimator is most likely inconsistent. It is therefore a way to test for the presence of endogeneity, measurement errors, etc.

Let $\hat{\beta}_e$ be an estimator that is consistent and asymptotically efficient when the null hypothesis, H_0 , is true, but inconsistent when H_0 is false (eg. LS). Let $\hat{\beta}_c$ be an estimator that is consistent under both H_0 and the alternative hypothesis (eg. IV). When H_0 is true, the asymptotic distribution is such that

$$\text{Cov}(\hat{\beta}_e, \hat{\beta}_c) = \text{Var}(\hat{\beta}_e). \quad (12.15)$$

Proof (of 12.15, univariate version*) Consider the estimator $\lambda\hat{\beta}_c + (1 - \lambda)\hat{\beta}_e$, which is clearly consistent under H_0 since both $\hat{\beta}_c$ and $\hat{\beta}_e$ are. The asymptotic variance of this estimator is

$$\lambda^2 \text{Var}(\hat{\beta}_c) + (1 - \lambda)^2 \text{Var}(\hat{\beta}_e) + 2\lambda(1 - \lambda) \text{Cov}(\hat{\beta}_c, \hat{\beta}_e),$$

	OLS	IV/2SLS
c	-0.522 (-2.641)	0.198 (0.407)
educ	0.107 (7.634)	0.049 (1.301)
exper	0.042 (3.170)	0.045 (2.888)
exper ²	-0.001 (-2.073)	-0.001 (-2.145)
T	428	428

Table 12.2: IV estimation of wage equation. Example of IV estimation, Hill et al (2008), section 10.3.3. Instruments: c, exper, exper², and mothereduc. Numbers in parentheses are t-stats (from White's method).

which is minimized at $\lambda = 0$ (since $\hat{\beta}_e$ is asymptotically efficient). The first order condition with respect to λ

$$2\lambda \text{Var}(\hat{\beta}_c) - 2(1-\lambda) \text{Var}(\hat{\beta}_e) + 2(1-2\lambda) \text{Cov}(\hat{\beta}_c, \hat{\beta}_e) = 0$$

should therefore be zero at $\lambda = 0$ so

$$\text{Var}(\hat{\beta}_e) = \text{Cov}(\hat{\beta}_c, \hat{\beta}_e).$$

(See Davidson (2000) 8.1) \square

This means that we can write

$$\begin{aligned} \text{Var}(\hat{\beta}_e - \hat{\beta}_c) &= \text{Var}(\hat{\beta}_e) + \text{Var}(\hat{\beta}_c) - 2 \text{Cov}(\hat{\beta}_e, \hat{\beta}_c) \\ &= \text{Var}(\hat{\beta}_c) - \text{Var}(\hat{\beta}_e). \end{aligned} \quad (12.16)$$

We can use this to test, for instance, if the estimates from least squares ($\hat{\beta}_e$), and instrumental variable method ($\hat{\beta}_c$) are the same. In this case, H_0 is that the true residuals are uncorrelated with the regressors.

All we need for this test are the point estimates and consistent estimates of the variance-covariance matrices. Testing one of the coefficient can be done by a t test, and testing all the parameters by a χ^2 test

$$(\hat{\beta}_e - \hat{\beta}_c)' \text{Var}(\hat{\beta}_e - \hat{\beta}_c)^{-1} (\hat{\beta}_e - \hat{\beta}_c) \sim \chi_j^2, \quad (12.17)$$

where the covariance matrix is from (12.16) and where j equals the number of regressors that are potentially endogenous or measured with error. Note that the covariance matrix

is likely to have a reduced rank, so the inverse needs to be calculated as a generalized (pseudo) inverse.

12.4 Appendix – Consistency and Asymptotic Distributions of the IV and 2SLS Estimators*

This section gives some details of the asymptotic properties of IV and 2SLS.

12.4.1 Asymptotic Results on the IV Estimator*

There are few results on small sample properties, but IV is often imprecise and even biased. In large samples, we typically get consistency and a normal distribution.

Use (12.1) to substitute for y_t in (12.4), multiply both sides by \sqrt{T} and rearrange as

$$\begin{aligned}\sqrt{T}(\hat{\beta}_{iv} - \beta) &= \hat{\Sigma}_{zx}^{-1} \sqrt{T} \sum_{t=1}^T z_t u_t / T, \text{ where} \\ \hat{\Sigma}_{zx} &= \sum_{t=1}^T z_t x'_t / T.\end{aligned}\quad (12.18)$$

Since we have strong beliefs that $\text{Cov}(z_t, u_t) = 0$, this expression shows that $\hat{\beta}_{iv}$ should be consistent.

Example 12.10 (Supply and Demand) Continuing Example 12.7, we can solve for the two endogenous variables (the “reduced form”) as

$$\begin{bmatrix} q_t \\ p_t \end{bmatrix} = \begin{bmatrix} \frac{\gamma\alpha}{\gamma-\beta} \\ \frac{\alpha}{\gamma-\beta} \end{bmatrix} A_t + \begin{bmatrix} \frac{\beta}{\beta-\gamma} & -\frac{\gamma}{\beta-\gamma} \\ \frac{1}{\beta-\gamma} & -\frac{1}{\beta-\gamma} \end{bmatrix} \begin{bmatrix} u_t^s \\ u_t^d \end{bmatrix}.$$

Suppose we estimate the supply curve by using A_t as the instrument. For simplicity, assume all variables have zero means. Then the probability limit of (12.4) is

$$\text{plim } \hat{\gamma}_{iv} = \text{Cov}(p_t, A_t)^{-1} \text{Cov}(q_t, A_t).$$

From the reduced form we have (assuming A_t, u_t^d and u_t^s are uncorrelated) $\text{Cov}(p_t, A_t) = \frac{\alpha}{\gamma-\beta} \text{Var}(A_t)$ and $\text{Cov}(q_t, A_t) = \frac{\gamma\alpha}{\gamma-\beta} \text{Var}(A_t)$. Combining gives $\text{plim } \hat{\gamma}_{iv} = \gamma$. Also notice that $\text{plim } \hat{\delta} = \text{Cov}(p_t, A_t) / \text{Var}(A_t) = \alpha / (\gamma - \beta)$.

Example 12.11 (Supply and Demand) Continuing Examples 12.7 and 12.10, we have $\text{plim } \hat{\delta} = \alpha / (\gamma - \beta)$. Thus, regressing q_t on $\hat{p}_t = \delta A_t$ has a probability limit of $\text{Cov}(q_t, \delta A_t) / \text{Var}(\delta A_t)$, which (using Example 12.10) can be simplified to $\frac{\gamma\alpha}{\gamma-\beta} / \delta = \gamma$.

Since $\sqrt{T} \Sigma_{t=1}^T z_t u_t / T$ in (12.18) is \sqrt{T} times a sample average, it is plausible that a CLT applies so the asymptotic distribution $\sqrt{T}(\hat{\beta}_{iv} - \beta)$ might be normal with a zero mean and a variance-covariance matrix

$$\text{Var}(\sqrt{T} \hat{\beta}_{iv}) = \Sigma_{zx}^{-1} \Sigma \Sigma_{xz}^{-1}, \text{ where } \Sigma = \text{Var}\left(\sum_{t=1}^T z_t u_t / \sqrt{T}\right). \quad (12.19)$$

and where Σ_{zx} is the probability limit of $\hat{\Sigma}_{zx}$. The last matrix in the covariance matrix follows from $(\Sigma_{zx}^{-1})' = (\Sigma_{zx}')^{-1} = \Sigma_{xz}^{-1}$. Dividing both sides by T and rewriting gives (12.5). (Details: Σ_{zx} is the probability limit of S_{zx}/T and $\Sigma = S/T$. Use this in (12.19) and simplify to get the probability limit of $TS_{zx}^{-1}SS_{xz}^{-1}$. Divide both sides by T to get $\text{Var}(\hat{\beta}_{iv})$ which then equals (12.5).)

12.4.2 Asymptotic Results on 2SLS*

From (12.8)–(12.9) we have

$$\begin{aligned} \hat{\delta} &= \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zx}, \\ \hat{\beta} &= \hat{\Sigma}_{\hat{x}\hat{x}}^{-1} \hat{\Sigma}_{\hat{x}y} \end{aligned} \quad (12.20)$$

where $\hat{\Sigma}_{zz} = \sum_{t=1}^T z_t z_t' / T$, and so forth. Notice that $\hat{\Sigma}_{zz}^{-1}$ is an $L \times L$ matrix and $\hat{\Sigma}_{zx}$ is an $L \times k$ matrix, so $\hat{\delta}$ is $L \times k$ as mentioned around (12.10). The fitted values in (12.10) can then be written

$$\begin{aligned} \hat{x}_t &= \hat{\delta}' z_t \\ &= \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} z_t, \end{aligned} \quad (12.21)$$

so

$$\begin{aligned} \hat{\Sigma}_{\hat{x}\hat{x}} &= \sum_{t=1}^T \hat{x}_t \hat{x}_t' / T = \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zx} \text{ and} \\ \hat{\Sigma}_{\hat{x}y} &= \sum_{t=1}^T \hat{x}_t y_t / T = \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zy}. \end{aligned} \quad (12.22)$$

(Substitute for \hat{x} from (12.21) and simplify to derive this.)

Using these results in the equations of $\hat{\delta}$ and $\hat{\beta}$ (12.20) gives

$$\hat{\beta} = (\hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zx})^{-1} \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zy} \quad (12.23)$$

Substituting for y_t by using (12.1) and expanding gives

$$\begin{aligned}\hat{\beta} &= (\hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zx})^{-1} \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \sum_{t=1}^T z_t (x'_t \beta + u_t) / T \\ &= \beta + \underbrace{(\hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1} \hat{\Sigma}_{zx})^{-1} \hat{\Sigma}_{xz} \hat{\Sigma}_{zz}^{-1}}_A \sum_{t=1}^T z_t u_t.\end{aligned}\quad (12.24)$$

Consistency follows from $\text{plim} \sum_{t=1}^T z_t u_t / T = 0$ and asymptotic normality from a CLT applied to $\sqrt{T} \sum_{t=1}^T z_t u_t / T$ and the asymptotic variance-covariance matrix is

$$\text{Var}(\sqrt{T} \hat{\beta}_{iv}) = A \Sigma A', \text{ where } \Sigma = \text{Var}(\Sigma_{t=1}^T z_t u_t / \sqrt{T}) \quad (12.25)$$

This can be rewritten as (12.12). (Details: Σ_{zx} is the probability limit of S_{zx} / T etc and $\Sigma = S / T$. Divide both sides by T .)

Remark 12.12 (*Alternative expression for A) By using (12.20), A in (12.24) can also be written $A = (\hat{\delta}' \Sigma_{zz} \hat{\delta})^{-1} \hat{\delta}'$.

Chapter 13

GMM

Reference: Cochrane (2005) 11 and 14; Campbell (2018) 4; Singleton (2006) 2–4; Greene (2018) 13

13.1 The Basic GMM

In general, the $q \times 1$ vector of sample moment conditions in GMM are written

$$\bar{g}(\beta) = \frac{1}{T} \sum_{t=1}^T g_t(\beta) = \mathbf{0}_{q \times 1}, \quad (13.1)$$

where $\bar{g}(\beta)$ is short hand notation for the sample average. The notation $g_t(\beta)$ is meant to show that moments conditions depend on the parameter vector (β) and on data for period t . We let β denote the true value of the $k \times 1$ parameter vector.

The GMM estimator is

$$\hat{\beta}_{k \times 1} = \arg \min \bar{g}(b)' W \bar{g}(b), \quad (13.2)$$

where W is some symmetric positive definite $q \times q$ weighting matrix. When the model is exactly identified ($q = k$), then we do not have to perform an explicit minimization, since all sample moment conditions can be set equal to zero (there are as many parameters as there are moment conditions). However, we may still have to apply a numerical algorithm to find the $\hat{\beta}$ values that make $\bar{g}(\hat{\beta}) = \mathbf{0}_{q \times 1}$ hold, in particular, if $g_t()$ are non-linear functions.

It can be shown that choosing $W = S_0^{-1}$, where S_0 is the covariance matrix of $\sqrt{T}\bar{g}(\beta)$ evaluated at the true parameter values, gives the most efficient estimates (for a given set of moment conditions). To approximate this, an iterative procedure is often used: start with $W = I_q$ (or some other reasonable weighting matrix), estimate the pa-

rameters and use them to create a $T \times q$ matrix of moment conditions, estimate S_0 (see below for a discussion of how this is done), then (in a second step) use $W = \hat{S}_0^{-1}$ and reestimate. In most cases this iteration is stopped at this stage, but you could also continue iterating until the point estimates converge.

Example 13.1 (*Moment conditions for the mean and variance*) To estimate the mean and variance ($\beta = (\mu, \sigma^2)$) of x_t , use

$$g_t = \begin{bmatrix} x_t - \mu \\ (x_t - \mu)^2 - \sigma^2 \end{bmatrix}.$$

There are two parameters and two moment conditions: exactly identified.

Example 13.2 (*Moments conditions for OLS*) Consider the linear model $y_t = x_t' \beta + u_t$, where x_t and β are $k \times 1$ vectors. The k moments are

$$g_t = x_t(y_t - x_t' \beta).$$

There are as many parameters as moment conditions: exactly identified.

Example 13.3 (*Moment conditions for estimating a normal distribution*) Suppose you specify four moments for estimating the mean and variance ($\beta = (\mu, \sigma^2)$) of a normal distribution

$$g_t = \begin{bmatrix} x_t - \mu \\ (x_t - \mu)^2 - \sigma^2 \\ (x_t - \mu)^3 \\ (x_t - \mu)^4 - 3\sigma^4 \end{bmatrix}$$

This case is overidentified ($q = 4$ and $k = 2$), so a weighting matrix is needed.

Example 13.4 (*Moment conditions for variances and a covariance*) For expositional simplicity, assume that both variables have zero means. The variances and the covariance ($\beta = (\sigma_{xx}, \sigma_{yy}, \sigma_{xy})$) can then be estimated with the moment conditions

$$g_t = \begin{bmatrix} x_t^2 - \sigma_{xx} \\ y_t^2 - \sigma_{yy} \\ x_t y_t - \sigma_{xy} \end{bmatrix}.$$

Empirical Example 13.5 (*Estimating a mean a variance with GMM*) Table 13.1 reports estimates of the mean and variance of the FF equity market return. The first approach

(column) uses only the first two moment conditions of Example 13.3 (an exactly identified case). Other approaches apply different (suboptimal) W matrices in solving (13.2). Finally, the last approaches apply (13.13) by using different A matrices. Table 13.2 reports results from iterating on the W matrix when solving (13.2). The W matrix used in the final iteration is shown in Table 13.3.

	ex. ident.	$\bar{g}' W_1 \bar{g}$	$\bar{g}' W_2 \bar{g}$	$A_1 \bar{g}$	$A_2 \bar{g}$
μ	0.59	0.59	0.37	0.59	0.54
σ^2	21.31	21.31	21.36	21.31	21.32

Table 13.1: Estimates of mean and variance of the FF equity market factor, 1970:01-2023:12. The W_1 and A_1 matrices put equal weights on moment conditions 1–2 and zero weight moment conditions 3–4, while W_2 and A_2 put also a very small weight on moment condition 3.

	iteration				
	0	1	2	3	4
μ	0.59	0.73	0.73	0.73	0.73
σ^2	21.31	19.18	19.13	19.13	19.13

Table 13.2: Estimates of mean and variance of the FF equity market factor, 1970:01-2023:12. The estimates minimize $\bar{g}' W_i \bar{g}$, where $W_i = S_{i-1}^{-1}$

$$\begin{matrix} 1199.07 & 57.07 & -9.64 & -0.40 \\ 57.07 & 18.78 & -0.62 & -0.07 \\ -9.64 & -0.62 & 0.14 & 0.01 \\ -0.40 & -0.07 & 0.01 & 0.00 \end{matrix}$$

Table 13.3: $W_i \times 10000$ used in the last iteration when, minimizing $\bar{g}' W_i \bar{g}$ to estimate the mean and variance of the FF equity market factor, 1970:01-2023:12.

13.1.1 Distribution of the Basic GMM

GMM estimators are typically asymptotically normally distributed, with a covariance matrix that depends on the covariance matrix of the moment conditions (S_0) and the mapping

from the parameters to the moment conditions (D_0). The details of these matrices are discussed below. For now, notice that the distribution of the GMM estimates is

$$\sqrt{T}(\hat{\beta} - \beta) \xrightarrow{d} N(0, V) \text{ if } W = S_0^{-1}, \text{ where}$$

$$V = (D_0' S_0^{-1} D_0)^{-1}, \quad (13.3)$$

provided we have used S_0^{-1} as the weighting matrix ($W = S_0^{-1}$) in (13.2). The choice of the weighting matrix is irrelevant if the model is exactly identified, so (13.3) can be applied to this case (even if we did not specify any weighting matrix at all). It can also be noticed that when the model is exactly identified, then we can typically rewrite the covariance matrix as $V = D_0^{-1} S_0 (D_0^{-1})'$, which might be easier to calculate. (The case of using another W matrix is discussed below.)

Most GMM analysis use expressions for the distribution of $\sqrt{T}(\hat{\beta} - \beta)$, so we follow that convention here. However, it can be noted that we could also write the asymptotic distribution as

$$\hat{\beta} \xrightarrow{a} N(\beta, V/T), \quad (13.4)$$

where V is defined in (13.3).

Let S_0 be the $(q \times q)$ covariance matrix of $\sqrt{T}\bar{g}(\beta)$, evaluated at the true parameter values

$$S_0 = \text{Var}[\sqrt{T}\bar{g}(\beta)], \quad (13.5)$$

where $\text{Var}()$ is a variance-covariance matrix. When there is no autocorrelation of the moments, then (13.5) becomes

$$S_0 = \text{Var}[g_t(\beta)], \text{ if } g_t \text{ is not autocorrelated.} \quad (13.6)$$

(Recall that $\text{Var}(\bar{g}) = \text{Var}(g_t)/T$ if g_t is iid and that (13.5) multiplies by T .) When there is autocorrelation, then we may use the Newey-West approach to estimate S_0 .

In practice, S_0 is estimated by using the estimated coefficients in the moments to get the data series $g_t(\hat{\beta})$, a $T \times q$ matrix, from which we estimate the covariances needed for (13.5).

Remark 13.6 (Newey-West covariance matrix) Let the estimated variance covariance matrix of $\Sigma_{t=1}^T g_t$ be

$$\hat{\Omega} = \Lambda_0 + \sum_{s=1}^m \left(1 - \frac{s}{m+1}\right)(\Lambda_s + \Lambda'_s), \text{ where } \Lambda_s = \sum_{t=s+1}^T g_t g'_{t-s}.$$

Then, $\hat{S}_0 = \hat{\Omega}/T = \text{Var}(\sqrt{T}\bar{g})$.

Example 13.7 (*Estimating the mean and variance*) The moments in Example 13.1 give

$$S_0 = \text{Var} \left(\frac{\sqrt{T}}{T} \sum_{t=1}^T \begin{bmatrix} x_t - \mu \\ (x_t - \mu)^2 - \sigma^2 \end{bmatrix} \right).$$

In practice, we use the point estimates for (μ, σ^2) . If we suspect autocorrelation, then we may use the NW estimator. S_0 could be simplified if we knew that x_t was iid normally distributed. In this case we get $S_0 = \text{diag}(\sigma^2, 2\sigma^4)$.

Example 13.8 (*OLS, covariance*) For the moments in Example 13.2, using $u_t = y_t - x_t'\beta$, we have

$$S_0 = \text{Var} \left[\frac{\sqrt{T}}{T} \sum_{t=1}^T x_t u_t \right]$$

In practice, replace u_t by the fitted residuals and calculate a sample covariance. It can be shown that under the Gauss-Markov assumptions $S_0 = \sigma^2 \Sigma_{xx}$. If we suspect that the variance of u_t is related to x_t , then we should calculate the covariance matrix of g_t , which gives White's covariance estimator. In addition we suspect that g_t is autocorrelated, then we may use the NW estimator of $\text{Var}(\sqrt{T}\bar{g})$.

Let D_0 be the $(q \times k)$ probability limit of the Jacobian (transpose of the gradients of each element in $\bar{g}(\beta)$) of the sample moment conditions with respect to the parameters (also evaluated at the true parameters)

$$D_0 = \text{plim} \frac{\partial \bar{g}(\beta)}{\partial \beta'}. \quad (13.7)$$

In practice, the Jacobian D_0 is approximated by using the point estimates and the available sample of data.

Remark 13.9 (*Jacobian*) The Jacobian is of the following format

$$\frac{\partial \bar{g}(\beta)}{\partial \beta'} = \begin{bmatrix} \frac{\partial \bar{g}_1(\beta)}{\partial \beta_1} & \dots & \frac{\partial \bar{g}_1(\beta)}{\partial \beta_k} \\ \vdots & & \vdots \\ \frac{\partial \bar{g}_q(\beta)}{\partial \beta_1} & \dots & \frac{\partial \bar{g}_q(\beta)}{\partial \beta_k} \end{bmatrix}$$

Example 13.10 (*Estimating a mean, Jacobian*) For the moment in Example 13.1

$$D_0 = \text{plim} \frac{1}{T} \sum_{t=1}^T \begin{bmatrix} -1 & 0 \\ -2(x_t - \mu) & -1 \end{bmatrix} = \begin{bmatrix} -1 & 0 \\ 0 & -1 \end{bmatrix}$$

which does not involve any parameters or any data.

Example 13.11 (OLS, Jacobian) For the moments in Example 13.2

$$D_0 = \text{plim} \left(-\frac{1}{T} \sum_{t=1}^T x_t x_t' \right) = -\Sigma_{xx}.$$

This does not contain any parameters either, but includes data. In practice, we replace Σ_{xx} by a sample estimate.

Example 13.12 (Estimating/testing a normal distribution, covariance) For the moments in Example 13.3 we have

$$D_0 = \text{plim} \frac{1}{T} \sum_{t=1}^T \begin{bmatrix} -1 & 0 \\ -2(x_t - \mu) & -1 \\ -3(x_t - \mu)^2 & 0 \\ -4(x_t - \mu)^3 & -6\sigma^2 \end{bmatrix} = \begin{bmatrix} -1 & 0 \\ 0 & -1 \\ -3\sigma^2 & 0 \\ -4\mu_3 & -6\sigma^2 \end{bmatrix},$$

where μ_3 is the third centered moment (which is zero for a symmetric distribution).

Example 13.13 (Estimating a mean, distribution) For the moment condition in Example 13.1 we have (assuming iid data)

$$\sqrt{T}(\hat{\mu} - \mu_0) \xrightarrow{d} N(0, \sigma^2), \text{ so } \hat{\mu} \xrightarrow{a} N(\mu_0, \sigma^2/T).$$

Example 13.14 (OLS, distribution) For the moment conditions in Example 13.2

$$V = (\Sigma_{xx} S_0^{-1} \Sigma_{xx})^{-1}.$$

Under the Gauss-Markov assumptions $S_0 = \sigma^2 \Sigma_{xx}$, so

$$V = \left[\Sigma_{xx} (\sigma^2 \Sigma_{xx})^{-1} \Sigma_{xx} \right]^{-1} = \sigma^2 \Sigma_{xx}^{-1}.$$

Example 13.15 (Estimating/testing a normal distribution, distribution) For the moment conditions in Example 13.3 (assuming iid normally distributed data) we have that the

asymptotic covariance matrix of the estimated mean and variance is then $((D_0' S_0^{-1} D_0)^{-1})$

$$\begin{aligned} \left(\begin{bmatrix} -1 & 0 \\ 0 & -1 \\ -3\sigma^2 & 0 \\ 0 & -6\sigma^2 \end{bmatrix}' \begin{bmatrix} \sigma^2 & 0 & 3\sigma^4 & 0 \\ 0 & 2\sigma^4 & 0 & 12\sigma^6 \\ 3\sigma^4 & 0 & 15\sigma^6 & 0 \\ 0 & 12\sigma^6 & 0 & 96\sigma^8 \end{bmatrix}^{-1} \begin{bmatrix} -1 & 0 \\ 0 & -1 \\ -3\sigma^2 & 0 \\ 0 & -6\sigma^2 \end{bmatrix} \right)^{-1} &= \begin{bmatrix} \frac{1}{\sigma^2} & 0 \\ 0 & \frac{1}{2\sigma^4} \end{bmatrix}^{-1} \\ &= \begin{bmatrix} \sigma^2 & 0 \\ 0 & 2\sigma^4 \end{bmatrix}. \end{aligned}$$

In an overidentified model ($k < q$), we can test if the k parameters make all q moment conditions hold. Notice that under the null hypothesis (that the model is correctly specified)

$$\sqrt{T} \bar{g}(\beta) \xrightarrow{d} N(\mathbf{0}_{q \times 1}, S_0), \quad (13.8)$$

where q is the number of moment conditions. Since $\hat{\beta}$ is chosen in such a way that k linear combinations of the moment conditions are zero, there are effectively only $q - k$ non-degenerate random variables. We can therefore test the hypothesis that $\bar{g}(\beta) = 0$ by the “J test”

$$T \bar{g}(\hat{\beta})' S_0^{-1} \bar{g}(\hat{\beta}) \xrightarrow{d} \chi_{q-k}^2, \text{ if } W = S_0^{-1}. \quad (13.9)$$

The left hand side equals T times of value of the loss function in (13.2) evaluated at the point estimates. With no overidentifying restrictions ($q = k$) there are no restrictions to test. Indeed, the loss function value is then always zero at the point estimates.

Example 13.16 (Estimating/testing a normal distribution, testing) After having estimated the mean and the variance, we can test if all four moment conditions in Example 13.3 hold. If data is drawn from a normal distribution, they should hold (give and take some randomness).

13.2 GMM with a Suboptimal Weighting Matrix

The distribution of the GMM estimates when we use a sub-optimal weighting matrix is similar to (13.3), but the variance-covariance matrix is different (basically, reflecting the fact that the approach does not produce the lowest possible variances anymore).

Example 13.17 (Estimating/testing a normal distribution) Example 13.3 is overidentified since there are four moment conditions but only two parameters. Instead of using

the optimal weighting matrix, we could use any other (positive definite) 4×4 matrix. For instance, $W = I_4$ or a matrix that puts almost all weight on the first two moment conditions.

It can be shown that if we use another weighting matrix than $W = S_0^{-1}$, then the V matrix in (13.3) and (13.4) should be changed to

$$V_2 = V_{A2} D_0' W S_0 W' D_0 V_{A2}', \text{ where} \quad (13.10)$$

$$V_{A2} = (D_0' W D_0)^{-1}.$$

Similarly, the test of overidentifying restrictions becomes

$$T \bar{g}(\hat{\beta})' \Psi_2^+ \bar{g}(\hat{\beta}) \xrightarrow{d} \chi_{q-k}^2, \quad (13.11)$$

where Ψ_2^+ is a generalized inverse of

$$\Psi_2 = \Psi_{A2} S_0 \Psi_{A2}', \text{ where} \quad (13.12)$$

$$\Psi_{A2} = I_q - D_0 (D_0' W D_0)^{-1} D_0' W.$$

The covariance matrix Ψ_2 has a reduced rank, so we must use a generalized inverse in the test.

Remark 13.18 (*Quadratic form with degenerate covariance matrix*) If the $n \times 1$ vector $X \sim N(0, \Sigma)$, where Σ has rank $r \leq n$ then $Y = X' \Sigma^+ X \sim \chi_r^2$ where Σ^+ is the pseudo inverse of Σ .

Example 13.19 (*Pseudo inverse of a square matrix*) For the matrix

$$A = \begin{bmatrix} 1 & 2 \\ 3 & 6 \end{bmatrix}, \text{ we have } A^+ = \begin{bmatrix} 0.02 & 0.06 \\ 0.04 & 0.12 \end{bmatrix}.$$

13.3 GMM without a Loss Function

Suppose we sidestep the whole optimization issue and instead specify k linear combinations of the q moment conditions directly

$$\mathbf{0}_{k \times 1} = \underbrace{A}_{k \times q} \underbrace{\bar{g}(\hat{\beta})}_{q \times 1}, \quad (13.13)$$

where the matrix A is chosen by the researcher. We can solve (possibly with a numerical algorithm) for the $\hat{\beta}$ values that make these equations hold.

Example 13.20 (*Overidentified example: estimating/testing a normal distribution*) *Example 13.3 is overidentified since there are four moment conditions but only two parameters. One possible A matrix would put all weight on the first two moment conditions*

$$A = \begin{bmatrix} 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \end{bmatrix}.$$

It is straightforward to show that the V matrix in (13.3) and (13.4) should be changed to

$$\begin{aligned} V_3 &= V_{A3} A_0 S_0 A'_0 V'_{A3}, \text{ where} \\ V_{A3} &= (A_0 D_0)^{-1}, \end{aligned} \quad (13.14)$$

where A_0 is the probability limit of A (if it is random).

Similarly, in the test of overidentifying restrictions (13.11), we should replace Ψ_2 by

$$\begin{aligned} \Psi_3 &= \Psi_{A3} S_0 \Psi'_{A3}, \text{ where} \\ \Psi_{A3} &= I_q - D_0 (A_0 D_0)^{-1} A_0. \end{aligned} \quad (13.15)$$

The covariance matrix Ψ_3 has a reduced rank, so we must again use a generalized inverse in the test.

Example 13.21 (*Estimating/testing a normal distribution*) *Continuing Example 13.20, we have that $A_0 D_0$ in (13.14) is*

$$V_{A3} = \left(\underbrace{\begin{bmatrix} 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \end{bmatrix}}_{A_0} \underbrace{\begin{bmatrix} -1 & 0 \\ 0 & -1 \\ -3\sigma^2 & 0 \\ 0 & -6\sigma^2 \end{bmatrix}}_{D_0} \right)^{-1} = \begin{bmatrix} -1 & 0 \\ 0 & -1 \end{bmatrix}.$$

Example 13.22 (*Estimating/testing a normal distribution*) *Continuing the previous ex-*

ample, Ψ_{A3} in (13.15) is

$$\begin{aligned}\Psi_{A3} &= \underbrace{\begin{bmatrix} 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \\ 0 & 0 & 1 & 0 \\ 0 & 0 & 0 & 1 \end{bmatrix}}_{I_4} - \underbrace{\begin{bmatrix} -1 & 0 \\ 0 & -1 \\ -3\sigma^2 & 0 \\ 0 & -6\sigma^2 \end{bmatrix}}_{D_0} \left(\underbrace{\begin{bmatrix} -1 & 0 \\ 0 & -1 \end{bmatrix}}_{A_0 D_0} \right)^{-1} \underbrace{\begin{bmatrix} 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \end{bmatrix}}_{A_0} \\ &= \begin{bmatrix} 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 \\ -3\sigma^2 & 0 & 1 & 0 \\ 0 & -6\sigma^2 & 0 & 1 \end{bmatrix}.\end{aligned}$$

Ψ_3 in (13.15) is therefore

$$\begin{aligned}\Psi_3 &= \begin{bmatrix} 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 \\ -3\sigma^2 & 0 & 1 & 0 \\ 0 & -6\sigma^2 & 0 & 1 \end{bmatrix} \begin{bmatrix} \sigma^2 & 0 & 3\sigma^4 & 0 \\ 0 & 2\sigma^4 & 0 & 12\sigma^6 \\ 3\sigma^4 & 0 & 15\sigma^6 & 0 \\ 0 & 12\sigma^6 & 0 & 96\sigma^8 \end{bmatrix} \begin{bmatrix} 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 \\ -3\sigma^2 & 0 & 1 & 0 \\ 0 & -6\sigma^2 & 0 & 1 \end{bmatrix}' \\ &= \begin{bmatrix} 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 \\ 0 & 0 & 6\sigma^6 & 0 \\ 0 & 0 & 0 & 24\sigma^8 \end{bmatrix}\end{aligned}$$

Example 13.23 (Estimating/testing a normal distribution) Continuing the previous example, we have that the test of the overidentifying restrictions (13.11) (assuming iid normally distributed data to calculate S_0) is (notice the generalized inverse of Ψ_3)

$$\begin{aligned}&= T \begin{bmatrix} 0 \\ 0 \\ \Sigma_{t=1}^T (x_t - \mu)^3 / T \\ \Sigma_{t=1}^T [(x_t - \mu)^4 - 3\sigma^4] / T \end{bmatrix}' \begin{bmatrix} 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 \\ 0 & 0 & 1/(6\sigma^6) & 0 \\ 0 & 0 & 0 & 1/(24\sigma^8) \end{bmatrix} \begin{bmatrix} 0 \\ 0 \\ \Sigma_{t=1}^T (x_t - \mu)^3 / T \\ \Sigma_{t=1}^T [(x_t - \mu)^4 - 3\sigma^4] / T \end{bmatrix} \\ &= \frac{T}{6} \frac{[\Sigma_{t=1}^T (x_t - \mu)^3 / T]^2}{\sigma^6} + \frac{T}{24} \frac{\{\Sigma_{t=1}^T [(x_t - \mu)^4 - 3\sigma^4] / T\}^2}{\sigma^8}.\end{aligned}$$

When we replace μ and σ by their estimates, then this is the same as the Jarque-Bera test of normality.

13.4 GMM Example: The Means and Second Moments of Returns

Let R_t be a vector of net returns of N assets. We want to estimate the mean vector and the covariance matrix. The moment conditions for the mean vector are

$$\mathbb{E} R_t - \mu = \mathbf{0}_{N \times 1}, \quad (13.16)$$

and the moment conditions for the unique elements of the second moment matrix are

$$\mathbb{E} \text{vech}(R_t R'_t) - \text{vech}(\Gamma) = \mathbf{0}_{N(N+1)/2 \times 1}. \quad (13.17)$$

Remark 13.24 (*The vech operator*) *vech(A) where A is $m \times m$ gives an $m(m + 1)/2 \times 1$ vector with the elements on and below the principal diagonal A stacked on top of each other (column wise).* For instance,

$$\text{vech} \begin{bmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{bmatrix} = \begin{bmatrix} a_{11} \\ a_{21} \\ a_{22} \end{bmatrix}.$$

Stack (13.16) and (13.17) and substitute the sample mean for the population expectation to get the GMM estimator

$$\frac{1}{T} \sum_{t=1}^T \begin{bmatrix} R_t \\ \text{vech}(R_t R'_t) \end{bmatrix} - \begin{bmatrix} \hat{\mu} \\ \text{vech}(\hat{\Gamma}) \end{bmatrix} = \begin{bmatrix} \mathbf{0}_{N \times 1} \\ \mathbf{0}_{N(N+1)/2 \times 1} \end{bmatrix}. \quad (13.18)$$

In this case, $D_0 = -I$, so the covariance matrix of the parameter vector $(\hat{\mu}, \text{vech}(\hat{\Gamma}))$ is just S_0 (defined in (13.5)), which is straightforward to estimate.

Chapter 14

Time Series Analysis

Reference: Newbold (1995) 17 or Pindyck and Rubinfeld (1998) 13.5, 16.1–2, and 17.2; Greene (2018) 20

14.1 Descriptive Statistics

The s th *autocovariance* of y_t is estimated by

$$\widehat{\text{Cov}}(y_t, y_{t-s}) = \sum_{t=1}^T (y_t - \bar{y})(y_{t-s} - \bar{y}) / T, \text{ where } \bar{y} = \sum_{t=1}^T y_t / T. \quad (14.1)$$

The convention in time series analysis is that we use the same estimated (using all data) mean in both places and that we divide by T .

The s th *autocorrelation* is estimated as

$$\hat{\rho}_s = \frac{\widehat{\text{Cov}}(y_t, y_{t-s})}{\widehat{\text{Std}}(y_t)^2}. \quad (14.2)$$

Compared with a traditional estimate of a correlation we here impose that the standard deviation of y_t and y_{t-s} are the same (which typically does not make much of a difference).

The sampling properties of $\hat{\rho}_s$ are complicated, but there are several useful large sample results for Gaussian processes (these results often carry over to processes which are similar to a Gaussian process—a homoskedastic process with finite 6th moment is typically enough, see Priestley (1981) 5.3 or Brockwell and Davis (1991) 7.2–7.3). When the true autocorrelations are all zero (not ρ_0 , of course), then for any i and j different from zero

$$\sqrt{T} \begin{bmatrix} \hat{\rho}_i \\ \hat{\rho}_j \end{bmatrix} \xrightarrow{d} N \left(\begin{bmatrix} 0 \\ 0 \end{bmatrix}, \begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix} \right). \quad (14.3)$$

This result can be used to construct tests for both single autocorrelations (t-test or χ^2 test) and several autocorrelations at once (χ^2 test). In particular,

$$\sqrt{T} \hat{\rho}_s \xrightarrow{d} N(0, 1), \quad (14.4)$$

so $\sqrt{T} \hat{\rho}_s$ can be used as a t-stat. We can then define a 90% confidence band for $\hat{\rho}$ as $\pm 1.64/\sqrt{T}$ around the point estimate $\hat{\rho}$ or around the null hypothesis (0).

Empirical Example 14.1 (*Autocorrelations of returns and absolute values of returns, different lags*) See Figure 14.1 for results on S&P 500.

Example 14.2 (*t-test*) We want to test the hypothesis that $\rho_1 = 0$. Since the $N(0, 1)$ distribution has 5% of the probability mass below -1.64 and another 5% above 1.64, we can reject the null hypothesis at the 10% level if $\sqrt{T}|\hat{\rho}_1| > 1.64$. With $T = 100$, we therefore need $|\hat{\rho}_1| > 1.64/\sqrt{100} = 0.165$ for rejection, and with $T = 1000$ we need $|\hat{\rho}_1| > 1.64/\sqrt{1000} \approx 0.052$.

The *Box-Pierce test* follows directly from the result in (14.3), since it shows that $\sqrt{T} \hat{\rho}_i$ and $\sqrt{T} \hat{\rho}_j$ are independent $N(0, 1)$ variables. Therefore, the sum of the square of them is distributed as a χ^2 variable. The test statistic is

$$Q_L = T \sum_{s=1}^L \hat{\rho}_s^2 \xrightarrow{d} \chi_L^2. \quad (14.5)$$

However, you could also test $T(\rho_2^2 + \rho_5^2)$, and it would have a χ_2^2 distribution.

Example 14.3 (*Box-Pierce*) Let $\hat{\rho}_1 = 0.165$, and $T = 100$, so $Q_1 = 100 \times 0.165^2 = 2.72$. The 10% critical value of the χ_1^2 distribution is 2.71, so the null hypothesis of no autocorrelation is rejected.

The choice of lag order in (14.5), L , should be guided by theoretical considerations, but it may also be wise to try different values. There is clearly a trade off: too few lags may miss a significant high-order autocorrelation, but too many lags can destroy the power of the test (as the test statistic is not affected much by increasing L , but the critical values increase).

Partial autocorrelations are discussed in Section 14.5.1.

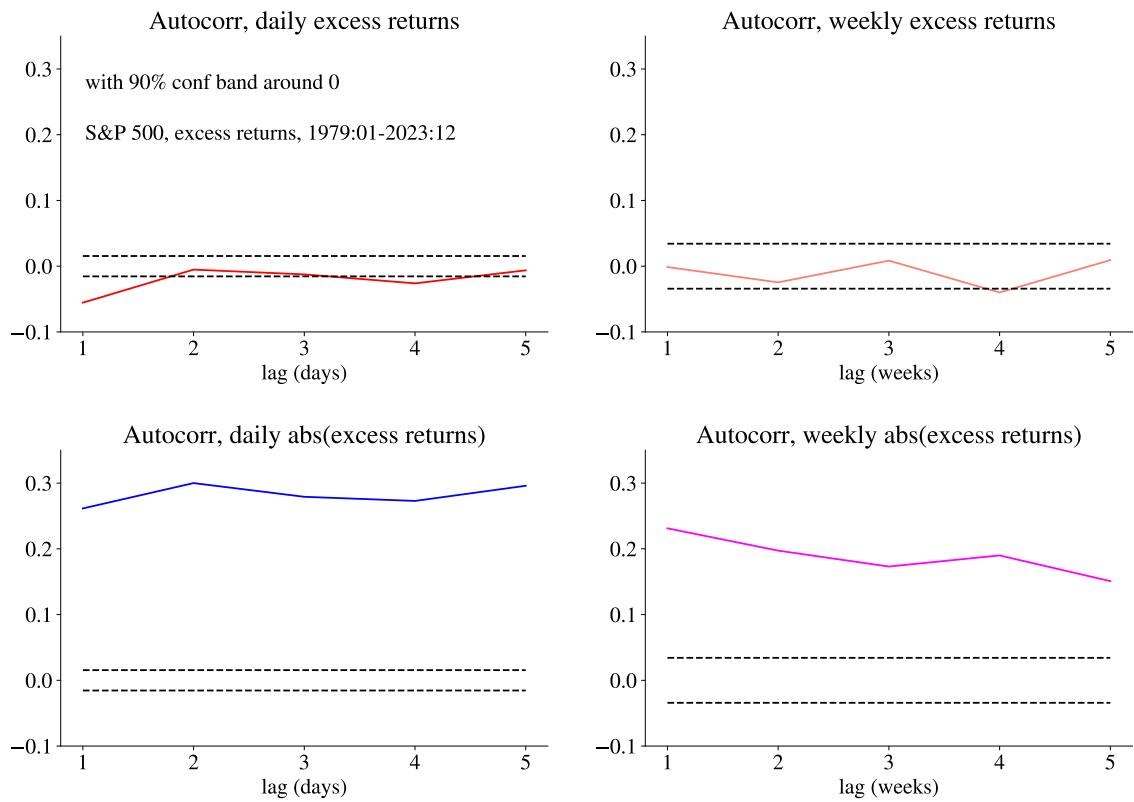


Figure 14.1: Predictability of US stock returns

Remark 14.4 (*Runs test**) A “runs test” is a non-parametric test of randomness. Let x_t be an indicator variable

$$x_t = \begin{cases} 0 & \text{if } y_t \leq q \\ 1 & \text{if } y_t > q \end{cases}$$

where q typically (but not necessarily) is the mean of y_t . Let $T_1 = \sum_{t=1}^T x_t$, that is the number of occasions when $y_t > q$, and $T_2 = T - T_1$ (the number of occasions when $y_t \leq q$). Also define the numbers of runs, that is, the number of changes in the x_t series (where the first observation is counted as a change). That is define

$$r = 1 + \sum_{t=2}^T |x_t - x_{t-1}|.$$

It is straightforward (but tedious) to show that, under the null hypothesis of randomness,

$$\begin{aligned}\mathbb{E} r &= 2 \frac{T_1 T_2}{T} + 1 \text{ and} \\ \text{Var}(r) &= \frac{(\mathbb{E} r - 1)(\mathbb{E} r - 2)}{T - 1}.\end{aligned}$$

We can therefore test the null hypothesis of randomness by a t-stat

$$\frac{r - \mathbb{E} r}{\sqrt{\text{Var}(r)}} \xrightarrow{d} N(0, 1).$$

The basic intuition of the test is that a positive autocorrelation would lead to too few runs ($r < \mathbb{E} r$): the y_t variable would stay on one side of the threshold q for long spells of time—and hence there would be few changes in x_t . Negative autocorrelation is just the opposite, since it tends to give a zigzag pattern around the mean. See Figure 14.2 for an example.

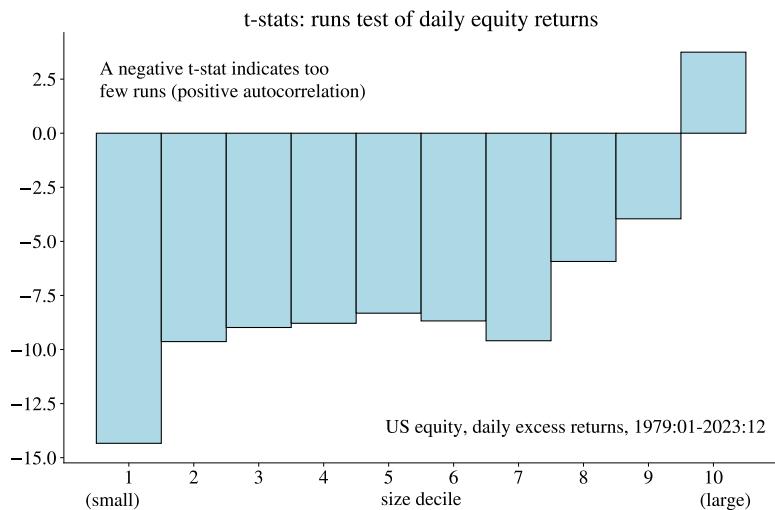


Figure 14.2: Runs test

14.2 Stationarity

The process y_t is (weakly) stationary if the mean, variance, and covariances are finite and constant across time

$$\mathbb{E} y_t = \mu < \infty \quad (14.6)$$

$$\text{Var}(y_t) = \gamma_0 < \infty \quad (14.7)$$

$$\text{Cov}(y_t, y_{t-s}) = \gamma_s < \infty \quad (14.8)$$

The *autocorrelation function* is just the autocorrelation coefficient ρ_s as a function of s . Notice that

$$\lim_{|s| \rightarrow \infty} \rho_s = 0 \text{ for any stationary series.} \quad (14.9)$$

See Figure 14.3 for an example.

The autocorrelation function is strongly related to the *impulse response function* (IRF) which shows the dynamic response of y_{t+s} ($s = 0, 1, 2, \dots$) to a shock in t . For any stationary series, the IRF converges to zero as the horizon (s) is increased. See Figure 14.4 for an example.

14.3 White Noise

The *white noise* process is the basic building block used in most other time series models. It is characterized by a zero mean, a constant variance, and no autocorrelation

$$\begin{aligned} \mathbb{E} \varepsilon_t &= 0 \\ \text{Var}(\varepsilon_t) &= \sigma^2, \text{ and} \\ \text{Cov}(\varepsilon_{t-s}, \varepsilon_t) &= 0 \text{ if } s \neq 0. \end{aligned} \quad (14.10)$$

This process can clearly not be forecasted. If, in addition, ε_t is normally distributed, then it is said to be Gaussian white noise.

To construct a variable that has a non-zero mean, we can form

$$y_t = \mu + \varepsilon_t, \quad (14.11)$$

where μ is a constant. This process is most easily estimated by the sample mean and variance or by OLS with a constant as the only regressor.

The *impulse response function* of a white noise process is just a blip.

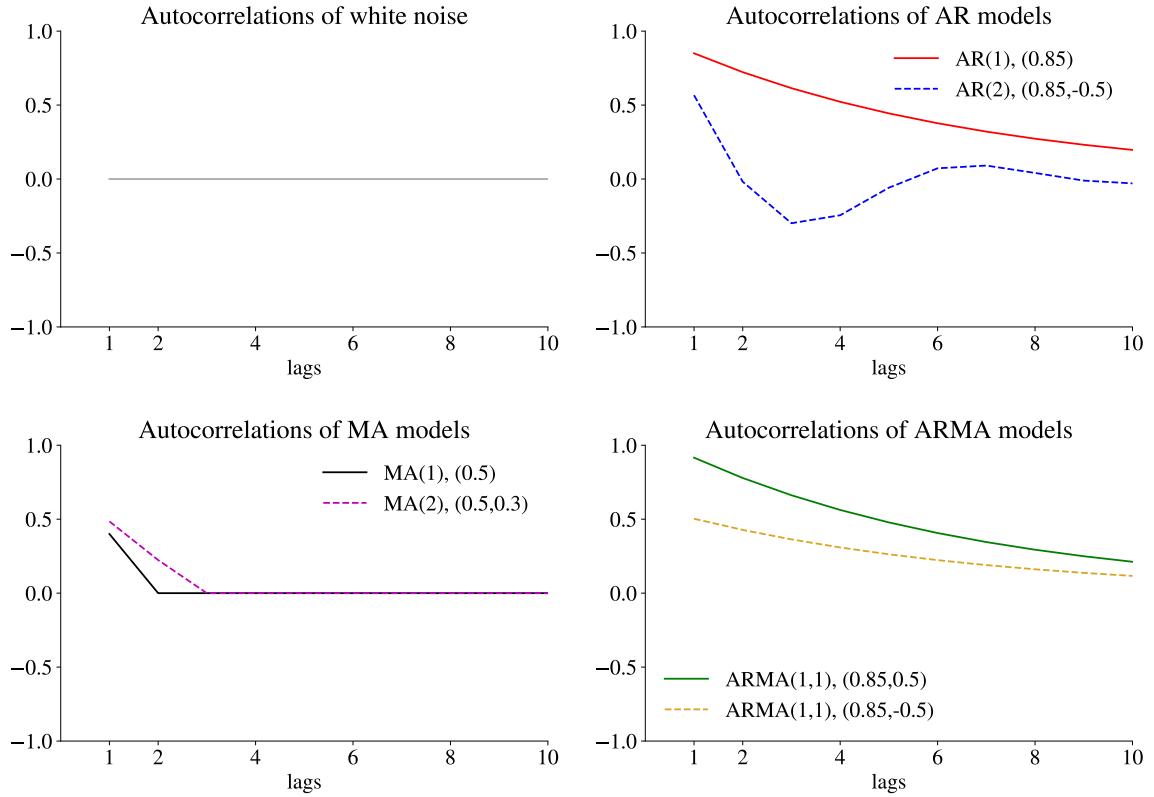


Figure 14.3: Example of autocorrelation functions

14.4 AR(1)

In this section we study the *first-order autoregressive* process, AR(1), in some detail in order to understand the basic concepts of autoregressive processes. The process is assumed to have a zero mean (or is demeaned: the original variable minus its mean, $y_t = x_t - \bar{x}$), but it is straightforward to put in any mean or trend.

An AR(1) is

$$y_t = ay_{t-1} + \varepsilon_t, \text{ with } \text{Var}(\varepsilon_t) = \sigma^2, \quad (14.12)$$

where ε_t is the white noise process in (14.10) which is uncorrelated with y_{t-1} . If $|a| < 1$, then the effect of a shock eventually dies out: y_t is stationary.

The *impulse response function* of an AR(1) with $a > 0$ shows an exponentially decaying response and with $a < 0$ it is zigzag response that decreases in amplitude. See Figure 14.4 for an illustration.

The AR(1) model can be *estimated with OLS* (since ε_t and y_{t-1} are uncorrelated) and

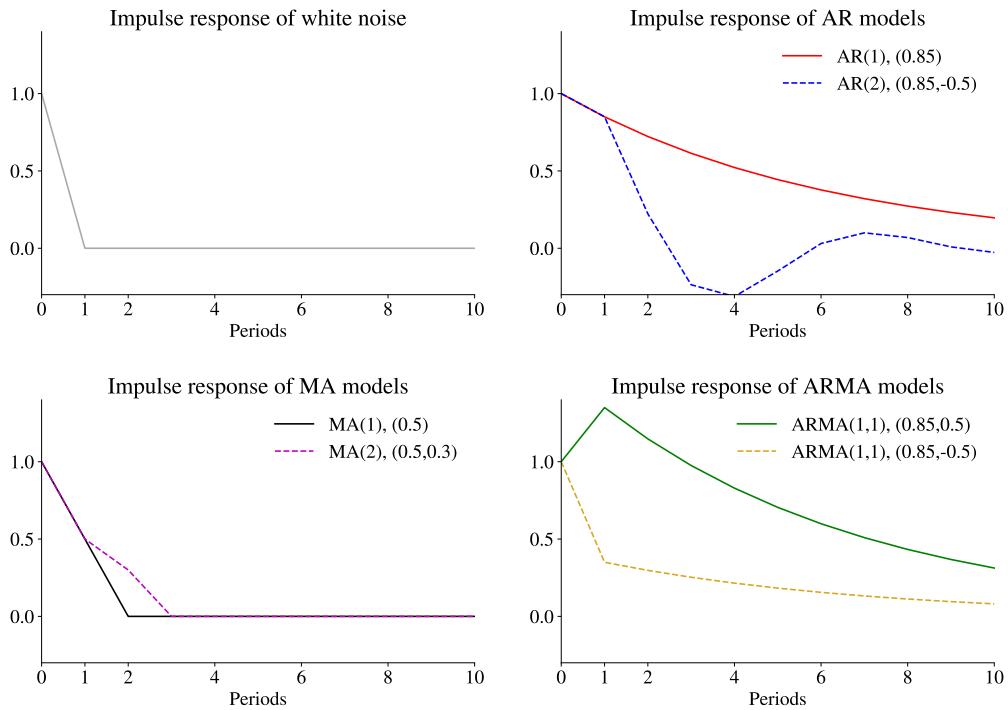


Figure 14.4: Impulse responses

the usual tools for testing significance of coefficients and estimating the variance of the residual all apply.

The basic properties of an AR(1) process are (provided $|a| < 1$)

$$\text{Var}(y_t) = \sigma^2 / (1 - a^2) \quad (14.13)$$

$$\text{Corr}(y_t, y_{t-s}) = a^s, \quad (14.14)$$

so the variance and autocorrelation are increasing in a (assuming $a > 0$). When $|a| \geq 1$, then the process is non-stationary, which means that the impulse response does not converge to zero as the horizon increases (see below for a discussion of such models: they are tricky).

See Figure 14.4 for an illustration.

Remark 14.5 (*Autocorrelation and autoregression*). Notice that the OLS estimate of a in (14.12) is essentially the same as the sample autocorrelation coefficient in (14.2). This follows from the fact that the slope coefficient is $\text{Cov}(y_t, y_{t-1}) / \text{Var}(y_{t-1})$. The denominator can be a bit different since a few data points are left out in the OLS estimation, but the difference is likely to be small.

Example 14.6 With $a = 0.85$ and $\sigma^2 = 0.5^2$, we have $\text{Var}(y_t) = 0.25/(1 - 0.85^2) \approx 0.9$, which is much larger than the variance of the residual since the uncertainty is accumulating when $a > 0$.

If $a = 1$ in (14.12), then we get a *random walk*. It is clear from the previous analysis that a random walk is non-stationary—that is, the effect of a shock never dies out. This implies that the variance is infinite and that the standard tools for testing coefficients are invalid. The solution is to study changes in y instead: $y_t - y_{t-1}$. In general, processes with the property that the effect of a shock never dies out are called non-stationary or unit root or integrated processes. Try to avoid them.

Empirical Example 14.7 (AR(1) for different investment horizons) See Figure 14.5 for AR(1) results for different investment horizons.

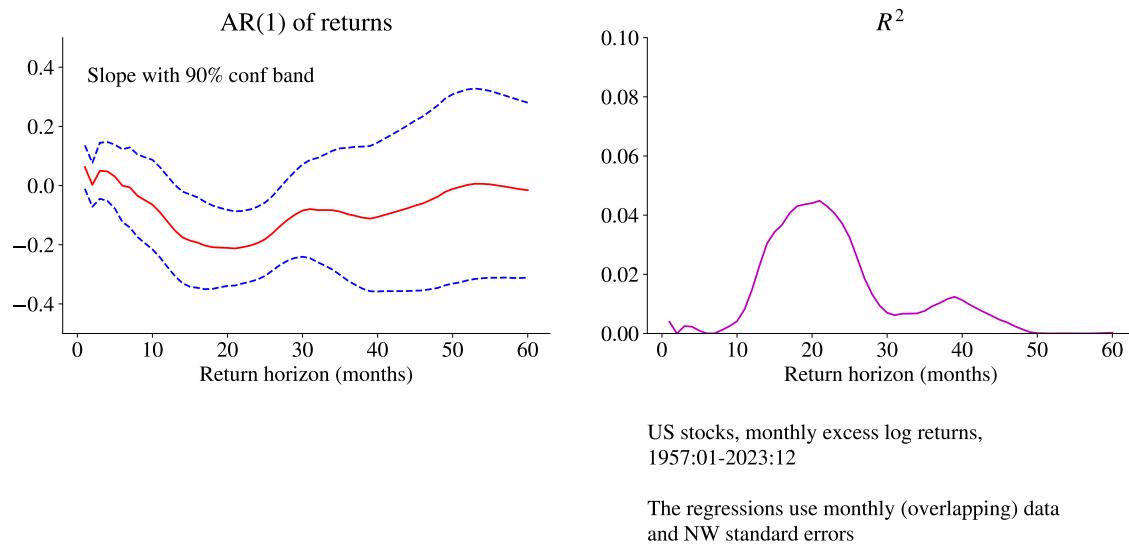


Figure 14.5: Predicting long run US stock returns

14.4.1 More on the Properties of an AR(1) Process*

Solve (14.12) backwards by repeated substitution

$$y_t = a \underbrace{(ay_{t-2} + \varepsilon_{t-1})}_{y_{t-1}} + \varepsilon_t \quad (14.15)$$

$$= a^2 y_{t-2} + a \varepsilon_{t-1} + \varepsilon_t \quad (14.16)$$

$$\vdots \quad (14.17)$$

$$= a^{K+1} y_{t-K-1} + \sum_{s=0}^K a^s \varepsilon_{t-s}. \quad (14.18)$$

The factor $a^{K+1} y_{t-K-1}$ declines monotonically to zero if $0 < a < 1$ as K increases, and declines in an oscillating fashion if $-1 < a < 0$. In either case, the AR(1) process is covariance *stationary* and we can then take the limit as $K \rightarrow \infty$ to get

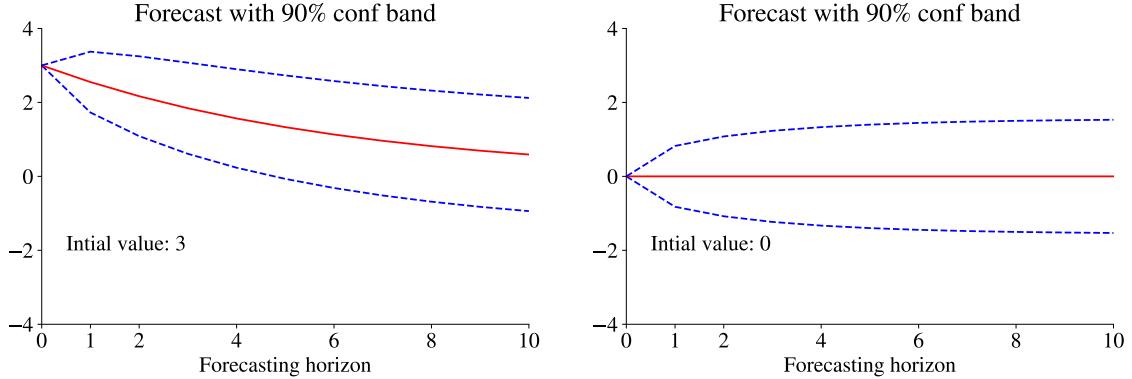
$$\begin{aligned} y_t &= \varepsilon_t + a \varepsilon_{t-1} + a^2 \varepsilon_{t-2} + \dots \\ &= \sum_{s=0}^{\infty} a^s \varepsilon_{t-s}. \end{aligned} \quad (14.19)$$

Since ε_t is uncorrelated over time, y_{t-1} and ε_t are uncorrelated. We can therefore calculate the variance of y_t in (14.12) as the sum of the variances of the two components on the right hand side

$$\begin{aligned} \text{Var}(y_t) &= \text{Var}(ay_{t-1}) + \text{Var}(\varepsilon_t) \\ &= a^2 \text{Var}(y_{t-1}) + \text{Var}(\varepsilon_t) \\ &= \text{Var}(\varepsilon_t) / (1 - a^2), \text{ since } \text{Var}(y_{t-1}) = \text{Var}(y_t). \end{aligned} \quad (14.20)$$

In this calculation, we use the fact that $\text{Var}(y_{t-1})$ and $\text{Var}(y_t)$ are equal. Formally, this follows from that they are both linear functions of current and past ε_s terms (see (14.19)), which have the same variance over time (ε_t is assumed to be white noise).

Note from (14.20) that the variance of y_t is increasing in the absolute value of a , which is illustrated in Figure 14.6. The intuition is that a large $|a|$ implies that a shock have effect over many time periods and thereby create movements (volatility) in y_t .



AR(1) model: $y_{t+1} = 0.85y_t + \varepsilon_{t+1}$, with $\sigma = 0.5$

Figure 14.6: Properties of AR(1) process

Similarly, the covariance of y_t and y_{t-1} is

$$\begin{aligned}\text{Cov}(y_t, y_{t-1}) &= \text{Cov}(ay_{t-1} + \varepsilon_t, y_{t-1}) \\ &= a \text{Cov}(y_{t-1}, y_{t-1}) \\ &= a \text{Var}(y_t).\end{aligned}\tag{14.21}$$

We can then calculate the first-order autocorrelation as

$$\begin{aligned}\text{Corr}(y_t, y_{t-1}) &= \frac{\text{Cov}(y_t, y_{t-1})}{\text{Std}(y_t) \text{Std}(y_{t-1})} \\ &= a.\end{aligned}\tag{14.22}$$

It is straightforward to show that

$$\text{Corr}(y_t, y_{t-s}) = \text{Corr}(y_{t+s}, y_t) = a^s.\tag{14.23}$$

14.4.2 Forecasting with an AR(1)

Suppose we have estimated an AR(1). To simplify the exposition, we assume that we actually know a and $\text{Var}(\varepsilon_t)$, which might be a reasonable approximation if they were estimated on a long sample.

We want to *forecast* y_{t+1} using information available in t . From (14.12) we get

$$y_{t+1} = ay_t + \varepsilon_{t+1}.\tag{14.24}$$

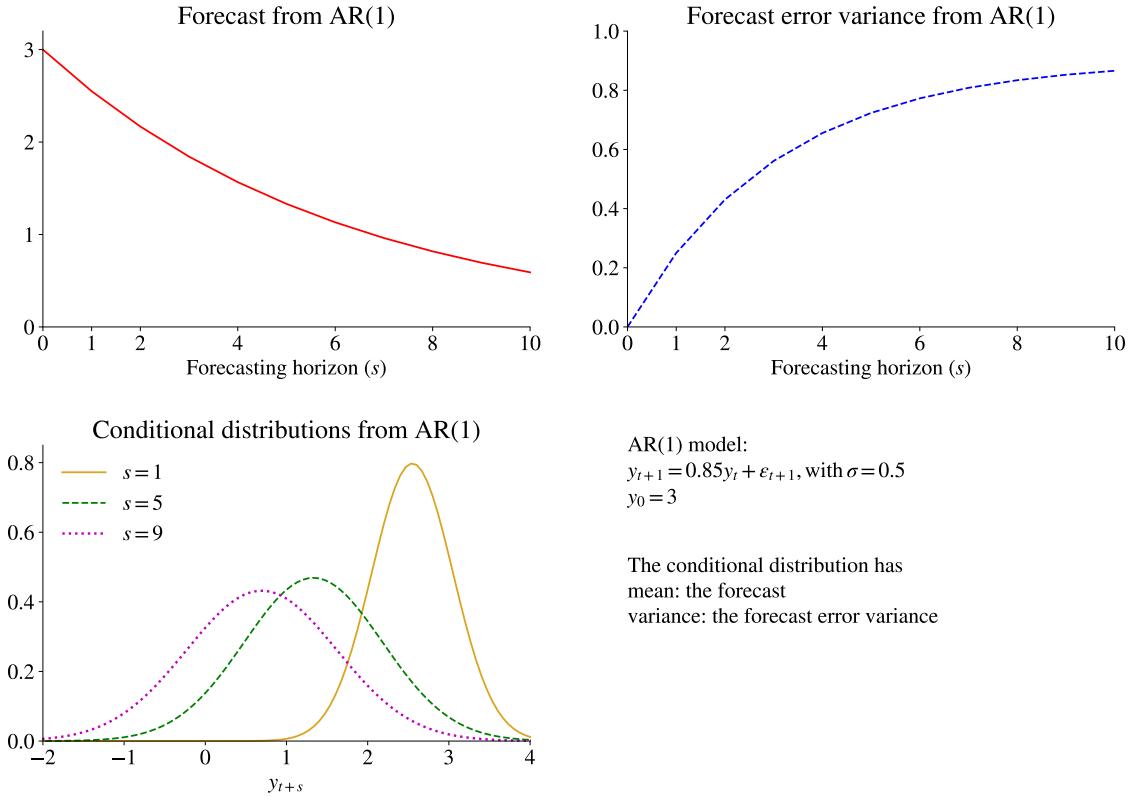


Figure 14.7: Properties of forecasts from AR(1) process

Since the best guess of ε_{t+1} is that it is zero, the best forecast and the associated forecast error are

$$E_t y_{t+1} = ay_t, \text{ and} \quad (14.25)$$

$$y_{t+1} - E_t y_{t+1} = \varepsilon_{t+1} \text{ with variance } \sigma^2. \quad (14.26)$$

We may also want to forecast y_{t+2} using the information in t . To do that note that (14.12) gives

$$\begin{aligned} y_{t+2} &= ay_{t+1} + \varepsilon_{t+2} \\ &= a(\underbrace{ay_t + \varepsilon_{t+1}}_{y_{t+1}}) + \varepsilon_{t+2} \\ &= a^2 y_t + a\varepsilon_{t+1} + \varepsilon_{t+2}. \end{aligned} \quad (14.27)$$

Since the $E_t \varepsilon_{t+1}$ and $E_t \varepsilon_{t+2}$ are both zero and $\text{Cov}(\varepsilon_{t+1}, \varepsilon_{t+2}) = 0$ we get that

$$E_t y_{t+2} = a^2 y_t, \text{ and} \quad (14.28)$$

$$y_{t+2} - E_t y_{t+2} = a\varepsilon_{t+1} + \varepsilon_{t+2} \text{ with variance } a^2\sigma^2 + \sigma^2. \quad (14.29)$$

More generally, we have

$$E_t y_{t+s} = a^s y_t, \quad (14.30)$$

$$\text{Var}(y_{t+s} - E_t y_{t+s}) = (1 + a^2 + a^4 + \dots + a^{2(s-1)})\sigma^2 \quad (14.31)$$

$$= \frac{a^{2s} - 1}{a^2 - 1}\sigma^2. \quad (14.32)$$

Notice that the point forecast converges towards zero and the variance of the forecast error variance to the unconditional variance (see Example 14.6).

Example 14.8 If $y_t = 3$, $a = 0.85$ and $\sigma = 0.5$, then the forecasts and the forecast error variances become

<u>Horizon s</u>	<u>$E_t y_{t+s}$</u>	<u>$\text{Var}(y_{t+s} - E_t y_{t+s})$</u>
1	$0.85 \times 3 = 2.55$	0.25
2	$0.85^2 \times 3 = 2.17$	$(0.85^2 + 1) \times 0.5^2 = 0.43$
25	$0.85^{25} \times 3 = 0.05$	$\frac{0.85^{50}-1}{0.85^2-1} \times 0.5^2 = 0.90$

To calculate the forecasts, you could alternatively apply a simple *recursive approach* like

$$E_t y_{t+1} = a y_t \quad (14.33)$$

$$E_t y_{t+2} = a E_t y_{t+1} \quad (14.34)$$

and so forth. We will later use the same principle for more complicated AR models.

If the shocks ε_t are normally distributed, then we can calculate 90% confidence intervals around the point forecasts in (14.25) and (14.28) as

$$90\% \text{ confidence band of } E_t y_{t+1} : a y_t \pm 1.64 \times \sigma \quad (14.35)$$

$$90\% \text{ confidence band of } E_t y_{t+2} : a^2 y_t \pm 1.64 \times \sqrt{a^2\sigma^2 + \sigma^2}. \quad (14.36)$$

(Recall that 90% of the probability mass is within the interval -1.64 to 1.64 in the $N(0,1)$ distribution). To get 95% confidence bands, replace 1.64 by 1.96. See Figures 14.6–14.7 for illustrations.

Example 14.9 Continuing Example 14.8, we get the following 90% confidence bands

<u>Horizon s</u>	
1	$2.55 \pm 1.64 \times \sqrt{0.25} \approx [1.7, 3.4]$
2	$2.17 \pm 1.64 \times \sqrt{0.43} \approx [1.1, 3.2]$
25	$0.05 \pm 1.64 \times \sqrt{0.90} \approx [-1.5, 1.6]$

Remark 14.10 (White noise as special case of AR(1).) When $a = 0$ in (14.12), then the AR(1) collapses to a white noise process. The forecast is then a constant (zero) for all forecasting horizons, see (14.30), and the forecast error variance is also the same for all horizons, see (14.32).

14.4.3 Adding a Constant to the AR(1)

The discussion of the AR(1) worked with a zero mean variable, but that was just for convenience (to make the equations shorter). One way to work with a variable x_t with a non-zero mean, is to first estimate its sample mean \bar{x} and then let the y_t in the AR(1) model (14.12) be a demeaned variable $y_t = x_t - \bar{x}$.

To include a mean, μ , in the theoretical expressions, we just need to substitute $x_t - \mu$ for y_t everywhere. For instance, in (14.12) we would get

$$\begin{aligned} x_t - \mu &= a(x_{t-1} - \mu) + \varepsilon_t \text{ or} \\ x_t &= (1 - a)\mu + ax_{t-1} + \varepsilon_t. \end{aligned} \tag{14.37}$$

Estimation by LS will therefore give an intercept that equals $(1 - a)\mu$ and a slope coefficient that equals a .

14.5 AR(p)

The p th-order autoregressive process, AR(p), is a straightforward extension of the AR(1)

$$y_t = a_1 y_{t-1} + a_2 y_{t-2} + \dots + a_p y_{t-p} + \varepsilon_t. \tag{14.38}$$

The AR(p) can capture richer dynamics than the AR(1). See Figure 14.4 for an illustration of impulse response functions.

This process can also be estimated with OLS since ε_t is uncorrelated with lags of y_t . Adding a constant to the theoretical expressions is straightforward: substitute $x_t - \mu$ for y_t everywhere.

Remark 14.11 (*Stationarity of an AR(p) model**) To investigate if the AR(p) model is stationary (the impulse responses converge to zero), rewrite it on vector form (also called “companion form”) as

$$\begin{bmatrix} y_t \\ y_{t-1} \\ \vdots \\ y_{t-p} \end{bmatrix} = \begin{bmatrix} a_1 & a_2 & \cdots & a_p \\ 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \\ 0 & 0 & 1 & 0 \end{bmatrix} \begin{bmatrix} y_{t-1} \\ y_{t-2} \\ \vdots \\ y_{t-p-1} \end{bmatrix} + \begin{bmatrix} \varepsilon_t \\ 0 \\ 0 \\ 0 \end{bmatrix}.$$

Calculate the eigenvalues (λ_i for $i = 1, \dots, p$) of the (companion) matrix on the right hand side. If $|\lambda_i| < 1$ for all i , then the model is stationary. Basically, this means that the model is “stable” in the sense that the effect of a shock eventually dies out.

14.5.1 Partial Autocorrelations

The p th partial autocorrelation tries to measure the direct relation between y_t and y_{t-p} , where the indirect effects of $y_{t-1}, \dots, y_{t-p+1}$ are eliminated. That is,

$$\text{partial autocorrelation}(s) = \text{Corr}(y_t - \hat{y}_t, y_{t-s} - \hat{y}_{t-s}), \quad (14.39)$$

where \hat{y}_t and \hat{y}_{t-s} are the best (linear) estimates of y_t and y_{t-s} based on $(y_{t-1}, \dots, y_{t-s+1})$. Yes, the “regressors” are the same in both regressions.

Example 14.12 (*The 3rd partial autocorrelation coefficient*) Regress

$$\begin{aligned} y_t &= a_0 + a_1 y_{t-1} + a_2 y_{t-2} + \varepsilon_t \\ y_{t-3} &= b_0 + b_1 y_{t-1} + b_2 y_{t-2} + u_{t-3}. \end{aligned}$$

The third partial autocorrelation coefficient is then $\text{Corr}(\hat{\varepsilon}_t, \hat{u}_{t-3})$.

For instance, if y_t is generated by an AR(1) model, then the 2nd autocorrelation is a^2 , whereas the 2nd partial autocorrelation is zero (since y_{t-2} does not have any direct effect on y_t once you have controlled for y_{t-1}). The partial autocorrelation is therefore a way to gauge how many lags that are needed in an AR(p) model.

In practice, the first partial autocorrelation is estimated by a in an AR(1)

$$y_t = \underline{a} y_{t-1} + \varepsilon_t. \quad (14.40)$$

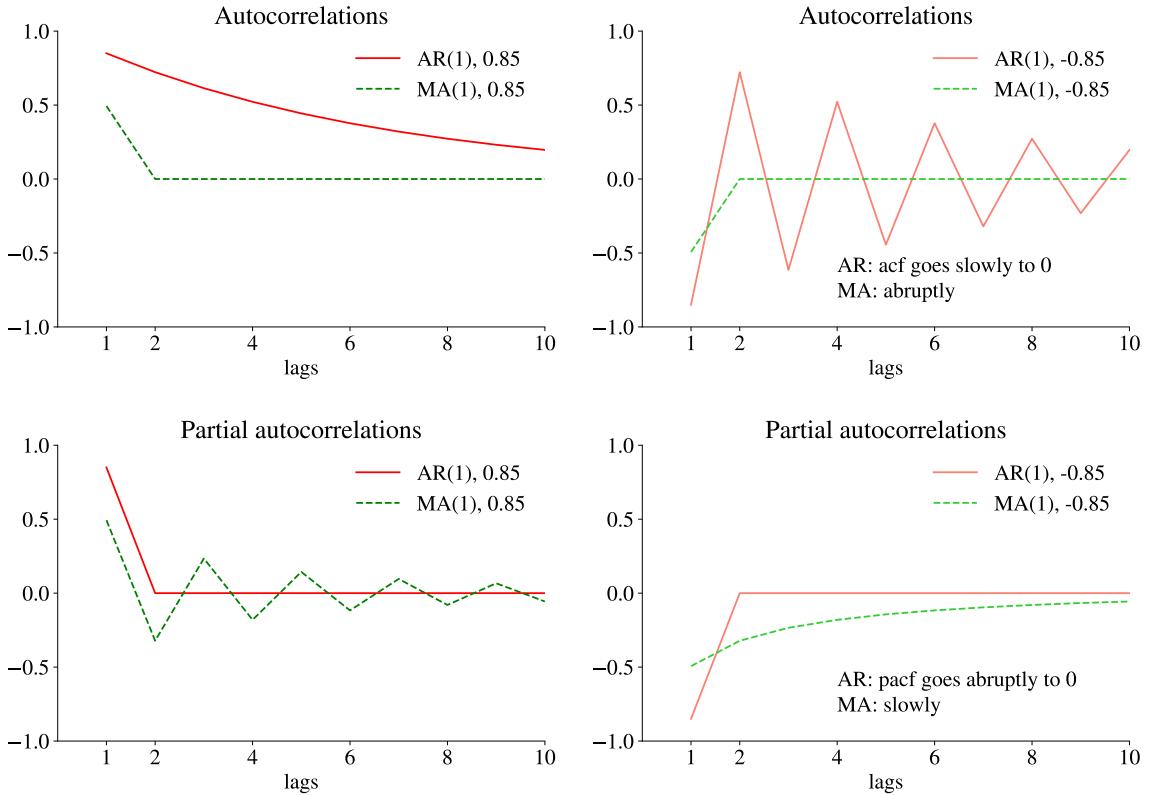


Figure 14.8: Autocorrelations and partial autocorrelations

This gives the same result as following the definition in (14.39). The second partial autocorrelation is estimated by the second slope coefficient (a_2) in an AR(2)

$$y_t = a_1 y_{t-1} + \underline{a_2} y_{t-2} + \varepsilon_t, \quad (14.41)$$

and so forth. The general pattern is that the p th partial autocorrelation is estimated by the slope coefficient of the p th lag in an AR(p), where we let p first be 1, then 2, and then 3, and so forth. See Figure 14.8 for an illustration.

To choose a model, study the ACF and PACF—and check that residual are close to white noise (or at least not strongly autocorrelated). To avoid overfitting, try “punishing” models with many parameters. Akaike’s Information Criterion (AIC) and the Bayesian

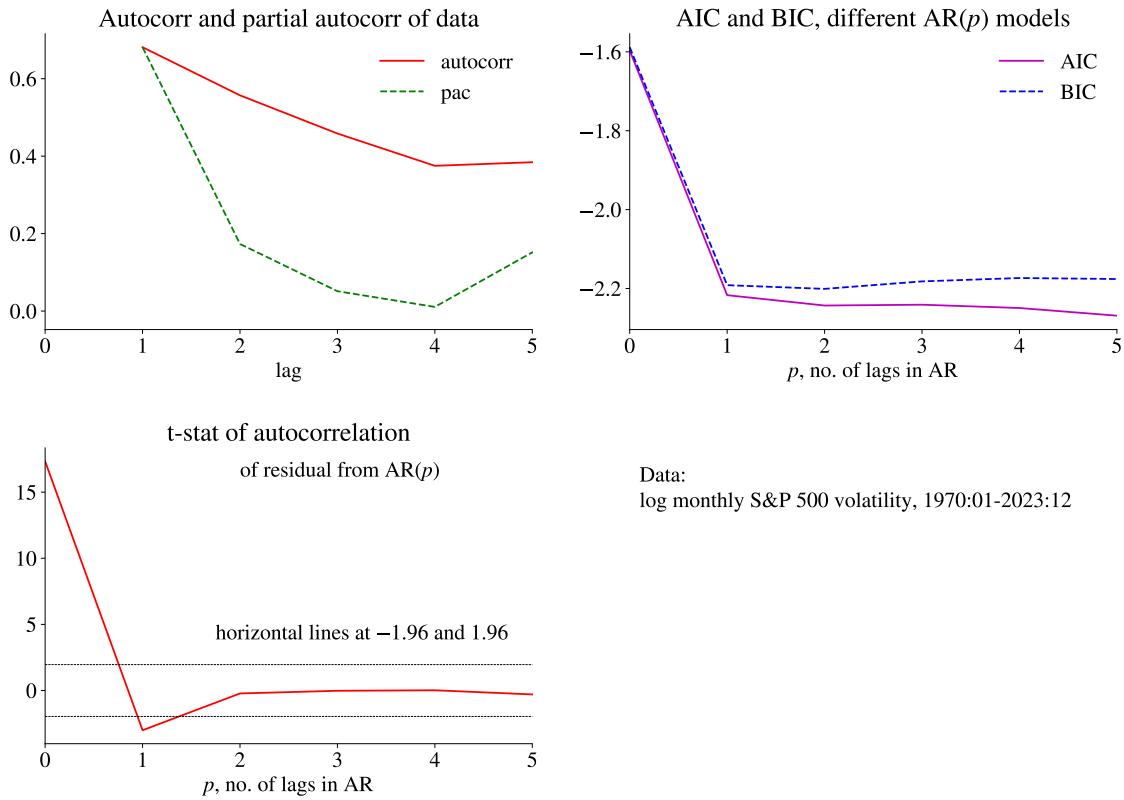


Figure 14.9: Example of choosing lag length in an AR model

information criterion (BIC) are

$$AIC = \ln \hat{\sigma}^2 + 2 \frac{p+1}{T} \quad (14.42)$$

$$BIC = \ln \hat{\sigma}^2 + \frac{p+1}{T} \ln T, \quad (14.43)$$

where $\hat{\sigma}^2$ is the variance of the fitted residuals. Choose the model with the lowest AIC or BIC. (Notice, however, that AIC often exaggerates the lag length.) This provides a trade-off between fit (low $\hat{\sigma}^2$) and number of parameters ($p+1$). See Figure 14.9 for an empirical illustration.

14.5.2 Forecasting with an AR(p)

As an example, consider making a forecast of y_{t+1} based on the information in t by using an AR(2)

$$y_{t+1} = a_1 y_t + a_2 y_{t-1} + \varepsilon_{t+1}. \quad (14.44)$$

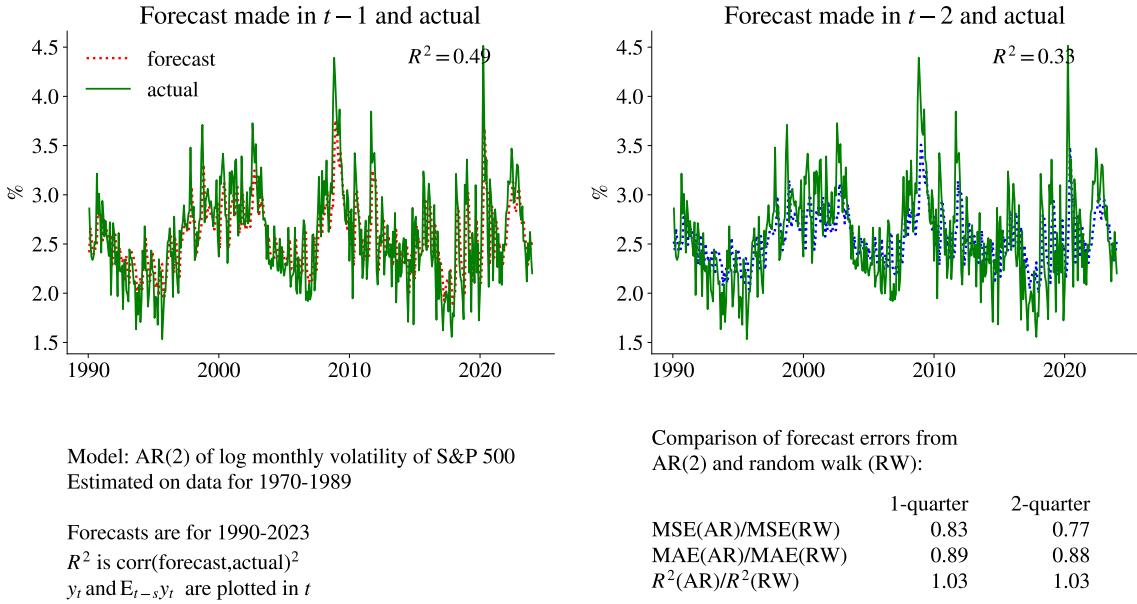


Figure 14.10: Forecasting with an AR(2)

This immediately gives the one-period point forecast

$$E_t y_{t+1} = a_1 y_t + a_2 y_{t-1}. \quad (14.45)$$

The two-period forecast is then calculated recursively as

$$E_t y_{t+2} = a_1 E_t y_{t+1} + a_2 y_t. \quad (14.46)$$

Empirical Example 14.13 (*AR(2) results for realized volatility of S&P 500 returns*) Figure 14.10 shows results for monthly volatility of the S&P 500.

Example 14.14 (*Forecasts*) With $(a_1, a_2) = (0.85, -0.5)$ and $(y_t, y_{t-1}) = (3, 1)$ we get

$$E_t y_{t+1} = 0.85 \times 3 - 0.5 \times 1 = 2.05,$$

$$E_t y_{t+2} = 0.85 \times 2.05 - 0.5 \times 3 = 0.24.$$

The calculations of the forecasting error variance is straightforward, but somewhat messy. However, both the one-period and two-period forecasts are linear functions of y_t and y_{t-1} . We could therefore estimate the following two equations with OLS

$$y_{t+1} = a_1 y_t + a_2 y_{t-1} + \varepsilon_{t+1}$$

$$y_{t+2} = b_1 y_t + b_2 y_{t-1} + v_{t+2}.$$

This will give results that are very similar to (14.45)–(14.46). (Asymptotically, the results will be the same.) The variances of ε_{t+1} and v_{t+2} are also very similar to the theoretical results.

14.5.3 Autoregressions versus Autocorrelations*

It is straightforward to see the relation between autocorrelations and the AR model. This relation is given by the *Yule-Walker equations*. For instance, for an AR(1), the autoregression coefficient is simply the first autocorrelation coefficient. For higher-order process, the transformation is non-linear, but testing if all the autocorrelations are zero is essentially the same as testing if all the autoregressive coefficients are zero.

To illustrate the Yule-Walker equations, consider an AR(2)

$$y_t = a_1 y_{t-1} + a_2 y_{t-2} + \varepsilon_t. \quad (14.47)$$

Clearly, the covariance of y_t and y_{t-s} must be the same as the covariance between the right hand side of (14.47) and y_{t-s}

$$\begin{aligned} \text{Cov}(y_t, y_{t-s}) &= \text{Cov}(a_1 y_{t-1} + a_2 y_{t-2} + \varepsilon_t, y_{t-s}) \\ &= a_1 \text{Cov}(y_{t-1}, y_{t-s}) + a_2 \text{Cov}(y_{t-2}, y_{t-s}) + \text{Cov}(\varepsilon_t, y_{t-s}). \end{aligned}$$

Applying this on $s = 1, 2$ (and replacing $\text{Cov}(y_t, y_{t-s})$ and $\text{Cov}(y_{t-s}, y_t)$ by γ_s etc) gives

$$\begin{aligned} \gamma_1 &= a_1 \gamma_0 + a_2 \gamma_1 \\ \gamma_2 &= a_1 \gamma_1 + a_2 \gamma_0, \end{aligned} \quad (14.48)$$

provided $\text{Cov}(\varepsilon_t, y_{t-1}) = 0$ and $\text{Cov}(\varepsilon_t, y_{t-2}) = 0$. This holds in (at least) two settings: when y_t is truly an AR(2) process *or* when we have estimated (14.47) by OLS (since it creates fitted residuals that uncorrelated with the regressors).

With information on the autocovariances ($\gamma_0, \gamma_1, \gamma_2$) we can solve these equations for the autoregression parameters (a_1, a_2). To see how, rewrite (14.48) as

$$\begin{bmatrix} \gamma_1 \\ \gamma_2 \end{bmatrix} = \begin{bmatrix} \gamma_0 & \gamma_1 \\ \gamma_1 & \gamma_0 \end{bmatrix} \begin{bmatrix} a_1 \\ a_2 \end{bmatrix}, \quad (14.49)$$

which we can solve for (a_1, a_2) as

$$\begin{bmatrix} a_1 \\ a_2 \end{bmatrix} = \begin{bmatrix} \gamma_0 & \gamma_1 \\ \gamma_1 & \gamma_0 \end{bmatrix}^{-1} \begin{bmatrix} \gamma_1 \\ \gamma_2 \end{bmatrix}. \quad (14.50)$$

Notice that dividing both sides of (14.49) by γ_0 would not change the solution of (a_1, a_2) . This means that γ_i could effectively be either autocovariances or autocorrelations (in the latter case, $\gamma_0 = 1$).

With p autocovariances (instead of 2) we get

$$\begin{bmatrix} a_1 \\ a_2 \\ \vdots \\ a_p \end{bmatrix} = \begin{bmatrix} \gamma_0 & \gamma_1 & \cdots & \gamma_{p-1} \\ \gamma_1 & \gamma_0 & \cdots & \gamma_{p-2} \\ \vdots & \vdots & \ddots & \vdots \\ \gamma_{p-1} & \gamma_{p-2} & \cdots & \gamma_0 \end{bmatrix}^{-1} \begin{bmatrix} \gamma_1 \\ \gamma_2 \\ \vdots \\ \gamma_p \end{bmatrix}. \quad (14.51)$$

This also provides a mechanism for calculating the partial autocorrelations (a_p for $p = 1, 2, 3, \dots$) from the autocovariances. First, set $p = 1$ in (14.51) to find the AR(1) coefficient (which will be $a_1 = \gamma_1/\gamma_0$). Second, set $p = 2$ and solve to find a_2 . Third, set $p = 3$ and solve to find a_3 and so forth.

14.6 Moving Average (MA)

A q^{th} -order moving average process MA(q) is

$$y_t = \varepsilon_t + \theta_1 \varepsilon_{t-1} + \dots + \theta_q \varepsilon_{t-q}, \quad (14.52)$$

where the innovation ε_t is white noise (usually Gaussian). It is straightforward to add a constant to capture a non-zero mean. If the order of the MA is finite ($q < \infty$), then the MA model is stationary.

The *impulse response function* of an MA(q) is simply the MA coefficients $(1, \theta_1, \dots, \theta_q)$. It can show many different patterns, but they are all 0 at horizons beyond q . See Figure 14.4 for an illustration.

Remark 14.15 (*Impulse response function**) For instance, write out (14.52) for y_t, y_{t+1}, \dots

$$\begin{aligned}y_t &= \underline{\varepsilon}_t + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2} + \dots \\y_{t+1} &= \varepsilon_{t+1} + \theta_1 \underline{\varepsilon}_t + \theta_2 \varepsilon_{t-1} + \dots \\y_{t+2} &= \varepsilon_{t+2} + \theta_1 \varepsilon_{t+1} + \theta_2 \underline{\varepsilon}_t + \dots,\end{aligned}$$

which shows that the dynamic effect of $\varepsilon_t = 1$ is $(1, \theta_1, \theta_2, \dots)$.

Estimation of an MA processes is typically done by *maximum likelihood*. LS does not work at all since the right hand side variables are unobservable. This is one reason why MA models play a limited role in applied work. Moreover, most MA models can be well approximated by an AR model of low order.

Remark 14.16 (*MLE of an MA(1)*) The MA(1) is $y_t = \varepsilon_t + \theta \varepsilon_{t-1}$. Assume that $\varepsilon_0 = 0$, so you can calculate $\varepsilon_1 = y_1$ and $\varepsilon_t = y_t - \theta \varepsilon_{t-1}$ for $t \geq 2$. If $\varepsilon_t \sim N(0, \sigma^2)$, then the log-likelihood function for T observations is $-\ln(2\pi)T/2 - \ln(\sigma^2)T/2 - \sum_{t=1}^T \varepsilon_t^2/(2\sigma^2)$. This is maximized with respect to θ and σ^2 (or σ). Clearly, the ε_t series must be recalculated in each iteration (as θ changes).

Remark 14.17 (*MLE of an MA(2)**) The MA(2) is $y_t = \varepsilon_t + \theta_1 \varepsilon_{t-1} + \theta_2 \varepsilon_{t-2}$. Assume that $(\varepsilon_{-1}, \varepsilon_0) = (0, 0)$. Calculate $\varepsilon_1 = y_1$, $\varepsilon_2 = y_2 - \theta_1 \varepsilon_1$, and $\varepsilon_t = y_t - \theta_1 \varepsilon_{t-1} - \theta_2 \varepsilon_{t-2}$ for $t \geq 3$. It can be noticed that ε_t is an AR(2) where y_t is the “shock” and the autoregressive coefficients are $(-\theta_1, -\theta_2)$. Once we have a series of fitted residuals, use them in the likelihood function as for an MA(1). Consequently, this estimation approach only works if $(-\theta_1, -\theta_2)$ defines a stationary AR(2). Otherwise, more sophisticated methods are needed.

Equation (14.53) shows that when $\theta > 0$, then autoregression coefficients converge in a zigzag way to zero. In contrast, when $\theta < 0$, the convergence is monotonic. This pattern can help us to distinguish a true AR process from an MA process. The autocorrelations and partial autocorrelations (for different lags) can help us gauge if the time series *looks more like an AR or an MA*. In an AR(p) model, the autocorrelations decay to zero for long lags, while the $p + 1$ partial autocorrelation (and beyond) goes abruptly to zero. The reverse is true for an MA model. See Figure 14.8 for an illustration.

This distinction between AR and MA is most clear for low-order models (for instance, an AR(2) and an MA(3)), but it can be blurred for high-order models. The reason is that

we can often rewrite (“invert”) an MA(q) as an AR(∞), and vice versa. For instance, if $|\theta| < 1$ then the MA(1) can be written

$$y_t = \theta y_{t-1} - \theta^2 y_{t-2} + \theta^3 y_{t-3} + \dots + \varepsilon_t. \quad (14.53)$$

Proof (*of (14.53)) Notice that $\varepsilon_t = y_t - \theta y_{t-1}$. Substitute for y_{t-1} by using $y_{t-1} - \theta \varepsilon_{t-2}$, to get $\varepsilon_t = y_t - \theta y_{t-1} + \theta^2 \varepsilon_{t-2}$. Keep substituting and notice that the $\theta^s \varepsilon_{t-s}$ goes to zero as s goes to infinity (provided $|\theta| < 1$). Rearrange as (14.53). \square

14.7 ARMA(p,q)

When the autocorrelations and partial autocorrelations show mixed patterns, then a combination of AR and MA models might be appropriate.

Autoregressive-moving average (ARMA) models add a moving average structure to an AR model. For instance, an ARMA(2,1) is

$$y_t = a_1 y_{t-1} + a_2 y_{t-2} + \varepsilon_t + \theta \varepsilon_{t-1}, \quad (14.54)$$

where ε_t is white noise. (It is straightforward to add a constant to capture a non-zero mean.) If the AR part of the ARMA is stationary, then the whole ARMA model is (since MA models are stationary). In an ARMA model, both the autocorrelations and partial autocorrelations decay to slowly zero. ARMA models can generate complicated dynamics. See Figure 14.4 for impulse response functions.

ARMA are harder to estimate than the autoregressive model, and we typically use *MLE*. The appropriate specification of the model (number of lags of y_t and ε_t) is often unknown. The Box-Jenkins methodology is a set of guidelines for arriving at the correct specification by starting with some model, study the autocorrelation structure of the fitted residuals and then changing the model.

Remark 14.18 (*MLE of an ARMA(2,1)**) Assume $\varepsilon_0 = 0$ and calculate $\varepsilon_1 = y_1 - a_1 y_0 - a_2 y_{-1}$ and $\varepsilon_t = y_t - a_1 y_{t-1} - a_2 y_{t-2} - \theta \varepsilon_{t-1}$ for $t \geq 2$. Use in the likelihood function $-\ln(2\pi)T/2 - \ln(\sigma^2)T/2 - \sum_{t=1}^T \varepsilon_t^2/(2\sigma^2)$ and maximize with respect to $(a_1, a_2, \theta, \sigma^2)$. As usual, the ε_t series must be recalculated for every new guess of the parameter vector.

Most ARMA models can be well approximated by an AR model—provided we add some extra lags. Since AR models are so simple to estimate, this approximation approach is often used.

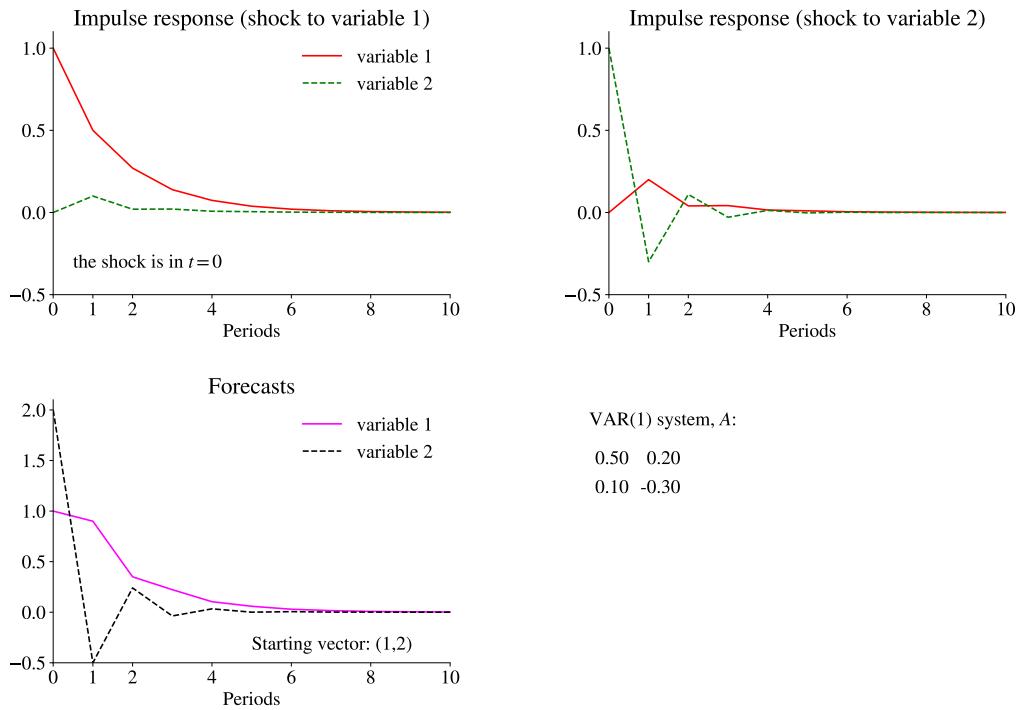


Figure 14.11: Properties of a VAR(1) model

14.8 VAR(p)

Let y_t be an $n \times 1$ vector of variables. The VAR(p) is

$$y_t = \mu + A_1 y_{t-1} + \dots + A_p y_{t-p} + \varepsilon_t, \quad (14.55)$$

where A_1, \dots, A_p are $n \times n$ matrices and ε_t is an $n \times 1$ vector of shocks. The vector autoregression is a multivariate version of an AR process: we can think of y_t and ε_t in (14.38) as vectors and the a_i as matrices.

To gauge the dynamics we can calculate the *impulse response function* of (all the n elements of) y_t to a shock to the 1st element of the $n \times 1$ vector ε_0 (set element 1 of ε_0 equal to one, but all other elements equal to zero). Then, we redo the same exercise, but now with respect to the 2nd element of ε_0 , and so on. In this way we get the response of each element of y_t with respect to each element of ε_0 . See Figure 14.11 for an illustration. It suggests that a low-order VAR model (here a VAR(1)) can create more complicated dynamics than a low-order AR model.

For instance the VAR(1) of two variables (x_t and z_t) is (in matrix form)

$$\begin{bmatrix} x_t \\ z_t \end{bmatrix} = \begin{bmatrix} A_{11} & A_{12} \\ A_{21} & A_{22} \end{bmatrix} \begin{bmatrix} x_{t-1} \\ z_{t-1} \end{bmatrix} + \begin{bmatrix} \varepsilon_{xt} \\ \varepsilon_{zt} \end{bmatrix}, \quad (14.56)$$

or equivalently

$$x_t = A_{11}x_{t-1} + A_{12}z_{t-1} + \varepsilon_{xt}, \text{ and} \quad (14.57)$$

$$z_t = A_{21}x_{t-1} + A_{22}z_{t-1} + \varepsilon_{zt}. \quad (14.58)$$

Both (14.57) and (14.58) are regression equations, which can be *estimated with OLS* (since ε_{xt} and ε_{zt} are uncorrelated with x_{t-1} and z_{t-1}).

Example 14.19 (VAR(1) of 2 variables). Let the A matrix in (14.56) be

$$A = \begin{bmatrix} 0.5 & 0.2 \\ 0.1 & -0.3 \end{bmatrix}.$$

Remark 14.20 (Stationarity*) The VAR(1) is stationary if the a matrix in (14.56) has $|\lambda_i| < 1$ where λ_i are the eigenvalues. For instance, for the 2-variable VAR(1) in Example 14.19 we get $(|\lambda_1|, |\lambda_2|) \approx (0.52, 0.32)$.

With the information available in t , that is, information about x_t and z_t , (14.57) and (14.58) can be used to forecast one- and two-step ahead as

$$\begin{bmatrix} E_t x_{t+1} \\ E_t z_{t+1} \end{bmatrix} = A \begin{bmatrix} x_t \\ z_t \end{bmatrix} \text{ and} \quad (14.59)$$

$$\begin{bmatrix} E_t x_{t+2} \\ E_t z_{t+2} \end{bmatrix} = A \begin{bmatrix} E_t x_{t+1} \\ E_t z_{t+1} \end{bmatrix} = AA \begin{bmatrix} x_t \\ z_t \end{bmatrix}, \quad (14.60)$$

where AA is the matrix product of A and A .

The two-period forecast has the same form as the one-period forecast, but with other coefficients. Note that all we need to make the forecasts (for both $t + 1$ and $t + 2$) are the values in period t (x_t and z_t). This follows from that (14.56) is a first-order system where the values of x_t and z_t summarize all relevant information about the future that is available in t .

Example 14.21 (Forecasts from a VAR(1)) With the 2-variable VAR(1) in Example 14.19

and the initial values $(x_0, z_0) = (1, 2)$ we get

$$\begin{bmatrix} E_0 x_1 \\ E_0 z_1 \end{bmatrix} = \begin{bmatrix} 0.5 & 0.2 \\ 0.1 & -0.3 \end{bmatrix} \begin{bmatrix} 1 \\ 2 \end{bmatrix} = \begin{bmatrix} 0.9 \\ -0.5 \end{bmatrix} \text{ and}$$

$$\begin{bmatrix} E_0 x_2 \\ E_0 z_2 \end{bmatrix} = \begin{bmatrix} 0.5 & 0.2 \\ 0.1 & -0.3 \end{bmatrix} \begin{bmatrix} 0.9 \\ -0.5 \end{bmatrix} = \begin{bmatrix} 0.35 \\ 0.24 \end{bmatrix}.$$

The forecast uncertainty about the one-period forecast is simple: the forecast error $x_{t+1} - E_t x_{t+1} = \varepsilon_{xt+1}$. The two-period forecast error, $x_{t+2} - E_t x_{t+2}$, is a linear combination of ε_{xt+1} , ε_{zt+1} , and ε_{xt+2} . The calculations of the forecasting error variance (as well as for the forecasts themselves) quickly get messy. This is even more true when the VAR system is of a higher order.

As for the AR(p) model, a practical way to get around the problem with complicated calculations is to estimate a separate model for each forecasting horizon. In a large sample, the difference between the two ways is trivial. For instance, suppose the correct model is the VAR(1) in (14.56) and that we want to forecast x one and two periods ahead. From (14.59) and (14.60) we see that the regression equations should be of the form

$$x_{t+1} = \delta_1 x_t + \delta_2 z_t + u_{t+1}, \text{ and} \quad (14.61)$$

$$x_{t+2} = \gamma_1 x_t + \gamma_2 z_t + w_{t+s}. \quad (14.62)$$

With estimated coefficients (OLS can be used), it is straightforward to calculate forecasts and forecast error variances.

Remark 14.22 (*Local projections**) Similar to the logic of different regressions for different forecasting horizons (for instance, (14.62)) we could also estimate the impulse response function by “local projections.” In practice, it means estimating

$$x_{t+s} = a + B_{1,s} x_t + \dots + B_{p,s} x_{t-s+1} + u_{t+s}$$

repeatedly (for $s = 1, 2, \dots$) and recording the $B_{1,s}$ estimates. The impulse response matrices are $B_{1,1}$, $B_{1,2}$, etc.

Example 14.23 (VAR(2) of 2×1 vector.) Let $y_t = (x_t, y_t)$. Then a VAR(2) is

$$\begin{bmatrix} x_t \\ z_t \end{bmatrix} = \begin{bmatrix} A_{1,11} & A_{1,12} \\ A_{1,21} & A_{1,22} \end{bmatrix} \begin{bmatrix} x_{t-1} \\ z_{t-1} \end{bmatrix} + \begin{bmatrix} A_{2,11} & A_{2,12} \\ A_{2,21} & A_{2,22} \end{bmatrix} \begin{bmatrix} x_{t-2} \\ z_{t-2} \end{bmatrix} + \begin{bmatrix} \varepsilon_{xt} \\ \varepsilon_{zt} \end{bmatrix}.$$

Remark 14.24 (*Stationarity of a VAR(p) model**) Construct the companion matrix as for the AR(p), but recall that a_i are matrices and replace the ones (1) with I_n where n indicates the number of variables in the VAR system. Then, the model is stationary if $|\lambda_i| < 1$ where λ_i are the eigenvalues of the companion matrix. For instance, for 2-variable VAR(2) in Remark 14.23 we get) Continuing on the previous example, we get

$$\begin{bmatrix} A_{1,11} & A_{1,11} & A_{2,11} & A_{2,12} \\ A_{1,21} & A_{1,22} & A_{2,21} & A_{2,22} \\ 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 \end{bmatrix}.$$

14.8.1 Granger Causality

If z_t can help predict future x , over and above what lags of x itself can, then z is said to *Granger Cause* x . This is a statistical notion of causality, and may not necessarily have much to do with true causality (for instance, Christmas cards may Granger cause Christmas). In (14.61) z does Granger cause x if $\delta_2 \neq 0$, which is easily tested. More generally, there may be more lags of both x and z in the equation, so we need to test if all coefficients on different lags of z are zero.

14.9 Non-stationary Processes

14.9.1 Introduction

A *trend-stationary process* has a (deterministic) trend. The simplest example is

$$y_t = \mu + \beta t + \varepsilon_t \quad (14.63)$$

where ε_t is white noise. It can be made stationary by subtracting the linear trend

$$y_t - \beta t = \mu + \varepsilon_t. \quad (14.64)$$

We can typically apply all standard econometric methods on this de-trended data. This can be done in two steps: first estimate the trend and then use $y_t - \hat{\beta}t$ in the subsequent analysis. Alternatively, we can work also with the y_t series directly, provided we explicitly include a trend variable in the analysis (say, in the regression model).

A *unit root process* has a (random) trend. The simplest example is the *random walk*

with drift

$$y_t = \mu + y_{t-1} + \varepsilon_t, \quad (14.65)$$

where ε_t is white noise. The name “unit root process” comes from the fact that the largest eigenvalues of the companion form (the VAR(1) form of the AR(p)) is one. Such a process is said to be integrated of order one, denoted I(1). Most standard statistical econometric methods fail on such data. However, the process can be made stationary by taking first differences

$$y_t - y_{t-1} = \mu + \varepsilon_t. \quad (14.66)$$

Standard methods can readily be applied to $y_t - y_{t-1}$. This is one (of several) reasons why financial econometrics study asset returns (not prices).

Example 14.25 (*Non-stationary AR(2)*) *The process $y_t = 1.5y_{t-1} - 0.5y_{t-2} + \varepsilon_t$ can be written*

$$\begin{bmatrix} y_t \\ y_{t-1} \end{bmatrix} = \begin{bmatrix} 1.5 & -0.5 \\ 1 & 0 \end{bmatrix} \begin{bmatrix} y_{t-1} \\ y_{t-2} \end{bmatrix} + \begin{bmatrix} \varepsilon_t \\ 0 \end{bmatrix},$$

where the matrix has the eigenvalues 1 and 0.5 and is therefore non-stationary. Note that subtracting y_{t-1} from both sides gives $y_t - y_{t-1} = 0.5(y_{t-1} - y_{t-2}) + \varepsilon_t$, so the variable $x_t = y_t - y_{t-1}$ is stationary.

The distinguishing feature of unit root processes is that the effect of a shock never vanishes, that is, the impulse response function does not converge to zero. This is most easily seen for the random walk. Substitute repeatedly in (14.65) to get

$$\begin{aligned} y_t &= \mu + (\mu + y_{t-2} + \varepsilon_{t-1}) + \varepsilon_t \\ &\vdots \\ &= t\mu + y_0 + \sum_{s=1}^t \varepsilon_s. \end{aligned} \quad (14.67)$$

The effect of ε_t never dies out: a non-zero value of ε_t gives a permanent shift of the level of y_t . This process is clearly non-stationary. See Figure 14.12 for an illustration.

A consequence of the permanent effect of a shock is that the variance of the forecast error grows without bound as the forecasting horizon is extended. For instance, for the random walk with drift, (14.67), the distribution conditional on the information in $t = 0$ is $N(y_0 + t\mu, s\sigma^2)$ if the innovations are normally distributed. This means that the expected change is $t\mu$ and that the conditional variance grows linearly with the forecasting horizon.

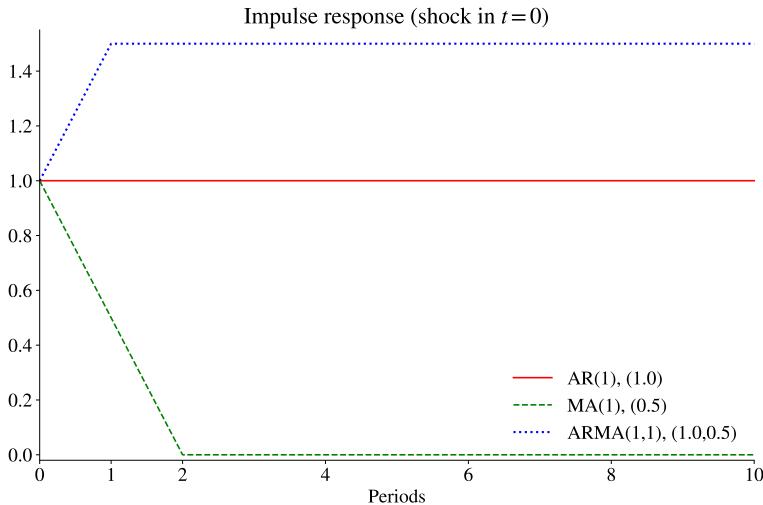


Figure 14.12: Impulse responses

The unconditional variance is therefore infinite and the standard results on inference are not applicable. See Figure 14.13.

A process could have two unit roots (integrated of order 2: I(2)). In this case, we need to difference twice to make it stationary. Alternatively, a process can also be explosive, that is, have eigenvalues outside the unit circle. In this case, the impulse response function diverges—and this type of data is very difficult to analyse with traditional statistical methods.

Example 14.26 (*Two unit roots**) Suppose y_t in Example (14.25) is actually the first difference of some other series, $y_t = z_t - z_{t-1}$. We then have

$$\begin{aligned} z_t - z_{t-1} &= 1.5(z_{t-1} - z_{t-2}) - 0.5(z_{t-2} - z_{t-3}) + \varepsilon_t \\ z_t &= 2.5z_{t-1} - 2z_{t-2} + 0.5z_{t-3} + \varepsilon_t, \end{aligned}$$

which is an AR(3) with the following canonical form

$$\begin{bmatrix} z_t \\ z_{t-1} \\ z_{t-2} \end{bmatrix} = \begin{bmatrix} 2.5 & -2 & 0.5 \\ 1 & 0 & 0 \\ 0 & 1 & 0 \end{bmatrix} \begin{bmatrix} z_{t-1} \\ z_{t-2} \\ z_{t-3} \end{bmatrix} + \begin{bmatrix} \varepsilon_t \\ 0 \\ 0 \end{bmatrix}.$$

The eigenvalues are 1, 1, and 0.5, so z_t has two unit roots (integrated of order 2: I(2) and needs to be differenced twice to become stationary).

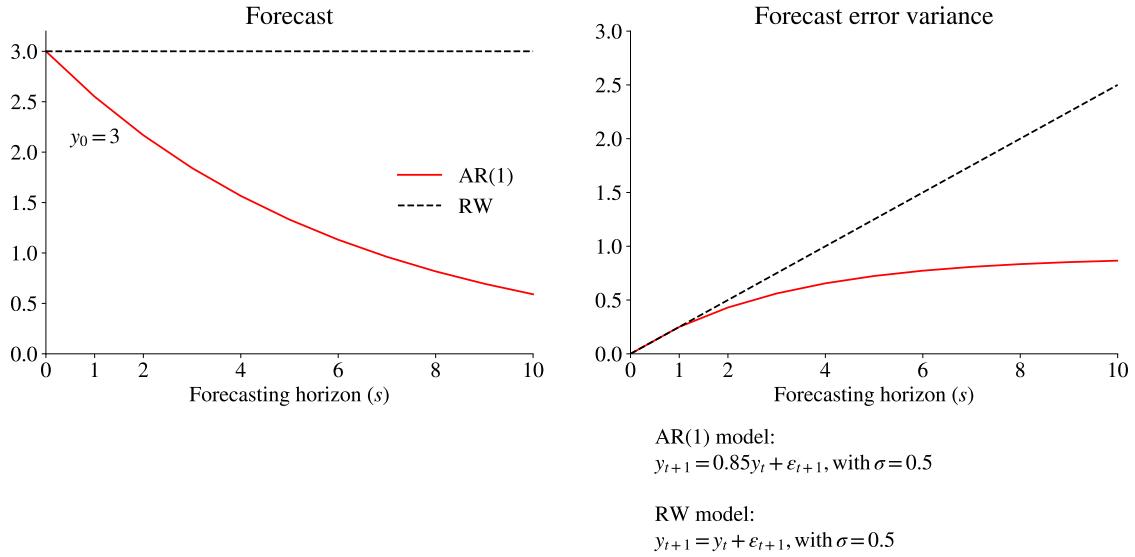


Figure 14.13: Properties of forecasts from random walk process

Example 14.27 (Explosive AR(1).) Consider the process $y_t = 1.5y_{t-1} + \varepsilon_t$. The eigenvalue is then outside the unit circle, so the process is explosive. This means that the impulse response to a shock to ε_t diverges (it is 1.5^s for s periods ahead).

Remark 14.28 (Lag operator*) A common and convenient way of dealing with leads and lags is the lag operator, L . It is such that

$$L^s y_t = y_{t-s}$$

For instance, the AR(1) model

$$\begin{aligned} y_t &= \theta \underbrace{y_{t-1}}_{Ly_t} + \varepsilon_t, \text{ or} \\ (1 - \theta L) y_t &= \varepsilon_t, \text{ or} \\ \theta(L) y_t &= \varepsilon_t, \end{aligned}$$

where $\theta(L) = (1 - \theta L)$ is a lag polynomial. Similarly, an ARMA(2,1) can be written

$$\begin{aligned} y_t - \theta_1 y_{t-1} - \theta_2 y_{t-2} &= \varepsilon_t + \alpha_1 \varepsilon_{t-1} \\ (1 - \theta_1 L - \theta_2 L^2) y_t &= (1 + \alpha_1 L) \varepsilon_t. \end{aligned}$$

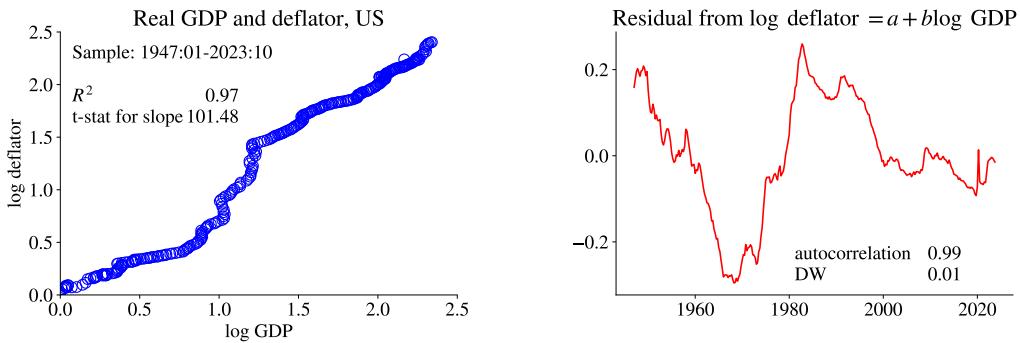


Figure 14.14: Example of a spurious regression

14.9.2 Spurious Regressions

Strong trends often causes problems in econometric models where y_t is regressed on x_t . In essence, if no trend is included in the regression, then x_t will appear to be significant, just because it is a proxy for that trend. The same holds for unit root processes, even if they have no deterministic trends. The reason is that the innovations accumulate and the series therefore tend to be trending in small samples. A warning sign of a spurious regression is when $R^2 > DW$ statistic.

Empirical Example 14.29 (*Regressing the price level on GDP*) See Figure 14.14 for results from regressing the U.S. price level (GDP deflator) on output (GDP level). The results indicate a very significant regression slope, but extreme autocorrelation. This is likely to be a spurious regression. Also, economics would suggest that nominal (price level) and real variables (output) variables are driven by completely different factors.

For trend-stationary data, this problem is easily solved by detrending with a linear trend (before estimating or just adding a trend to the regression).

However, this is usually a poor method for a unit root processes. In fact, econometrics involving such processes is fraught with problems. See Figure 14.15 for a Monte Carlo simulation which highlights that actual uncertainty does not necessarily decrease with the sample size.

What is needed is a first difference. For instance, a first difference of the random walk with drift is

$$\begin{aligned}\Delta y_t &= y_t - y_{t-1} \\ &= \mu + \varepsilon_t,\end{aligned}\tag{14.68}$$

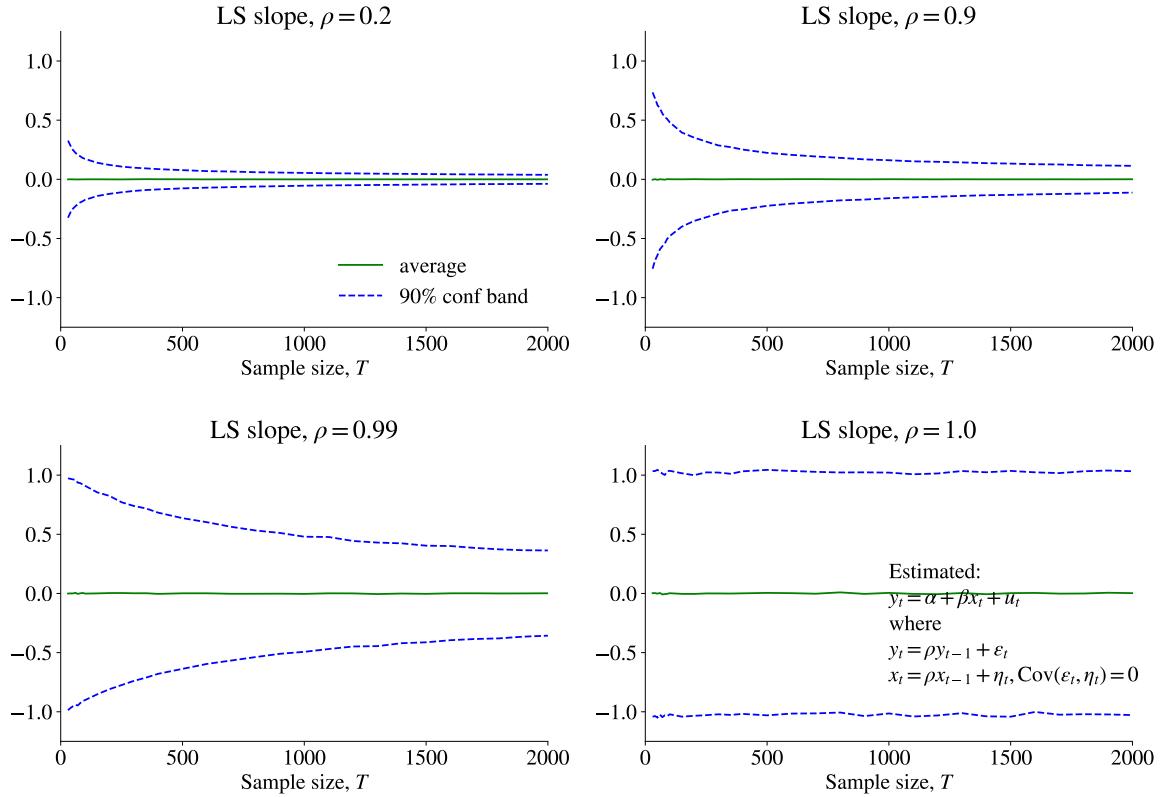


Figure 14.15: Distribution of slope coefficient when y_t and x_t are independent AR(1) processes

which is white noise (any finite difference, like $y_t - y_{t-s}$, will give a stationary series), so we could proceed by applying standard econometric tools to Δy_t .

One may then be tempted to try first-differencing all non-stationary series, since it may be hard to tell if they are unit root process or just trend-stationary. For instance, a first difference of the trend stationary process, (14.63), gives

$$y_t - y_{t-1} = \beta + \varepsilon_t - \varepsilon_{t-1}. \quad (14.69)$$

Its unclear if this is an improvement: the trend is gone, but the errors are now of MA(1) type, which means that they are autocorrelated.

14.9.3 Testing for a Unit Root

Suppose we run an OLS regression of

$$y_t = ay_{t-1} + \varepsilon_t, \quad (14.70)$$

where the true value of $|a| < 1$. The asymptotic distribution of the LS estimator is

$$\sqrt{T}(\hat{a} - a) \sim N(0, 1 - a^2). \quad (14.71)$$

(The variance follows from the standard OLS formula where the variance of the estimator is $\sigma^2 (\Sigma_{t=1}^T x_t x'_t / T)^{-1}$. Here $\text{plim } \Sigma_{t=1}^T x_t x'_t / T = \text{Var}(y_t)$ which we know is $\sigma^2 / (1 - a^2)$).

It is well known (but not easy to show) that when $a = 1$, then \hat{a} is biased towards zero in small samples. In addition, the asymptotic distribution is no longer (14.71). In fact, there is a discontinuity in the limiting distribution as we move from a stationary to a non-stationary variable. This, together with the small sample bias means that we have to use simulated critical values for testing the null hypothesis of $a = 1$ based on the OLS estimate from (14.70).

In practice, the approach is to run the regression (14.70) with a constant (and perhaps even a time trend), calculate the test statistic

$$DF = \frac{\hat{a} - 1}{\text{Std}(\hat{a})}, \quad (14.72)$$

and reject the null of non-stationarity if DF is less than the critical values published by Dickey and Fuller (-2.86 at the 5% level if the regression has a constant, and -3.41 if the regression includes a trend).

With more dynamics (to capture any serial correlation in ε_t in (14.70)), do an *augmented Dickey-Fuller test* (ADF)

$$\begin{aligned} y_t &= \delta + \theta_1 y_{t-1} + \theta_2 y_{t-2} + \varepsilon_{2t}, \text{ or} \\ \Delta y_t &= \delta + (\theta_1 + \theta_2 - 1) y_{t-1} - \theta_2 \Delta y_{t-1} + \varepsilon_{2t}, \end{aligned} \quad (14.73)$$

and test the coefficient on y_{t-1} in (14.73) (which should equal $\theta_1 + \theta_2 - 1$) against the alternative that it is less than zero. The critical values are as for the DF test. If ε_{2t} is autocorrelated, then add further lags of Δy .

The *KPSS test* has stationarity as the null hypothesis (in contrast to the DF and ADF

tests that have non-stationarity as the null hypothesis). It has three steps. First, regress

$$y_t = a + \varepsilon_t. \quad (14.74)$$

Second, define

$$S_t = \sum_{s=1}^t \hat{\varepsilon}_s \text{ for } t = 1, \dots, T \text{ and} \quad (14.75)$$

$$\hat{\sigma}^2 = \text{Var}(\hat{\varepsilon}_t). \quad (14.76)$$

Third, the test statistic is

$$KPSS = \frac{1}{T^2} \sum_{t=1}^T S_t^2 / \hat{\sigma}^2 \quad (14.77)$$

Reject stationarity if $KPSS > 0.463$ (a 5% critical value). We could also include a linear trend in (14.74). The 5% critical value is then 0.146.

In principle, distinguishing between a stationary and a non-stationary series is very difficult (and impossible unless we restrict the class of processes, for instance, to an AR(2)), since any sample from a non-stationary process can be arbitrary well approximated by *some* stationary process et vice versa. The lesson to be learned, from a practical point of view, is that *strong persistence in the data generating process (stationary or not) invalidates the usual results on inference*. We are usually on safer ground to apply the unit root results in this case, even if the process is actually stationary.

14.9.4 Cointegration*

An exception to the “spurious regression” result: Y_t and X_t are I(1) but share a common stochastic trend such that

$$y_t - \alpha - \beta x_t \text{ is I}(0). \quad (14.78)$$

In this case, OLS works fine: it is actually very good (super consistent), $\hat{\beta}$ converges to true value β faster than in standard theory. The intuition is that if $\hat{\beta} \neq \beta$, then ε_t are I(1) and therefore have high sample variance, so OLS will pick $\hat{\beta}$ close to β .

In (14.78), we call $(1, -\beta)$ the *cointegrating vector*, since

$$\begin{bmatrix} 1 & -\beta \end{bmatrix} \begin{bmatrix} y_t \\ x_t \end{bmatrix} \text{ is I}(0) \quad (14.79)$$

Example 14.30 Y_t is GDP, x_t is private consumption. Suppose both are driven by the

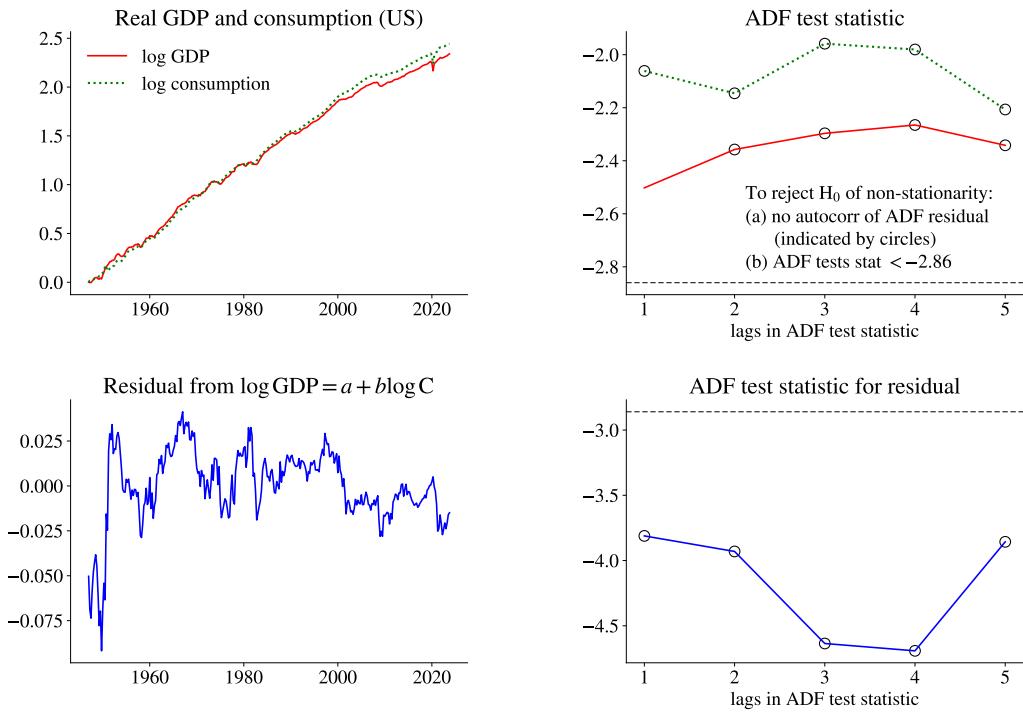


Figure 14.16: Unit root tests, US quarterly macro data

non-stationary productivity of the economy, A_t , plus other stationary stuff (z_t, w_t)

$$y_t = \gamma A_t + z_t$$

$$x_t = \delta A_t + w_t$$

From the second equation $A_t = (x_t - w_t)/\delta$, use in first equation

$$\underbrace{y_t}_{I(1)} = \frac{\gamma}{\delta} \underbrace{x_t}_{I(1)} + z_t - \frac{\gamma}{\delta} w_t$$

$$\underbrace{y_t}_{I(1)} = I(0)$$

To test if y_t and x_t are cointegrated, we need to study three things. First, does it make sense? Look at data, and consider the (economic) theory. Second, are both x_t and y_t I(I)? Do Dickey-Fuller tests, etc. Third, are (\hat{a}, \hat{b}) in from the regression

$$y_t = a + bx_t + \varepsilon_t \quad (14.80)$$

such that $\hat{\varepsilon}_t$ is I(0)? To determine the latter, do an ADF test on $\hat{\varepsilon}_t$, but use special critical values— H_0 : no cointegration (so ε_t is I(1)). 5% critical values: -3.34 (if x_t is a scalar).

One way to incorporate the cointegration in a model of the short-run dynamics is to

use a *Error-Correction Model*, for instance,

$$\begin{aligned}\Delta y_t &= \delta - \gamma (y_{t-1} - \beta x_{t-1}) + \phi_1 \Delta x_{t-1} + \varepsilon_t \text{ or perhaps} \\ &= \delta - \gamma (y_{t-1} - \beta x_{t-1}) + \phi_1 \Delta x_{t-1} + \theta_1 \Delta y_{t-1} + \varepsilon_t\end{aligned}\quad (14.81)$$

Recall: (y_t, x_t) are I(1), but $y_{t-1} - \beta x_{t-1}$ is I(0), so all terms in (14.81) are I(0). We typically do not put the intercept into the cointegrating relation (as there is already another intercept in the equation).

If $\gamma > 0$ (notice the sign convention in (14.81)), then the system is driven back to a stationary path for $y - \beta x$: the “error correction mechanism.” If ε_t is autocorrelated, then we add more lags of both Δy and Δx .

Estimation is fairly straightforward (Engle-Granger’s 2-step method). First, estimate the cointegrating vector. Second, use it in (14.81) and estimate the rest of the parameters. Standard tests can be applied to them.

Empirical Example 14.31 (*Cointegration and error correction model of output and consumption*) See Figure 14.16 and Table 14.1.

	(1)
constant	0.01 (1.89)
Coint res _{t-1}	-0.08 (-2.24)
Δgdp_{t-1}	0.08 (0.94)
Δc_{t-1}	0.05 (0.24)
Δgdp_{t-2}	0.07 (0.84)
Δc_{t-2}	0.07 (0.56)
R^2	0.05
obs	305

Table 14.1: Error-correction model for log real US GDP growth, 1947:01-2023:10. Numbers in parentheses are t-stats. The Coint res is the residual from regressing the log GDP level on the log consumption level.

Chapter 15

Predicting Asset Returns

Reference (medium): Elton, Gruber, Brown, and Goetzmann (2010) 17 (efficient markets) and 26 (earnings estimation)

Additional references: Campbell, Lo, and MacKinlay (1997) 2 and 7; Cochrane (2001) 20.1

15.1 Autocorrelations and Autoregressions

15.1.1 Autocorrelation Coefficients

When the true autocorrelations are all zero (not ρ_0 , of course), then for any i and j different from zero

$$\sqrt{T} \begin{bmatrix} \hat{\rho}_i \\ \hat{\rho}_j \end{bmatrix} \xrightarrow{d} N \left(\begin{bmatrix} 0 \\ 0 \end{bmatrix}, \begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix} \right). \quad (15.1)$$

This result can be used to construct tests for both single autocorrelations (t-test or χ^2 test) and several autocorrelations at once (χ^2 test).

Empirical Example 15.1 (*Autocorrelations for different lags, daily equity returns*) See Figure 15.1 for autocorrelations (different lags) of S&P 500 returns. The figure suggests little autocorrelation in returns (R_t^e), but considerable autocorrelation for the absolute value ($|R_t^e|$). Since, $R_t^e = \text{sign}(R_t^e)|R_t^e|$, this suggests that it is very difficult to predict the sign of the returns. Also, see Figure 15.2 for ten size-sorted equity portfolios which suggests that most size categories have more autocorrelations than large cap (which are fairly closer to S&P 500).

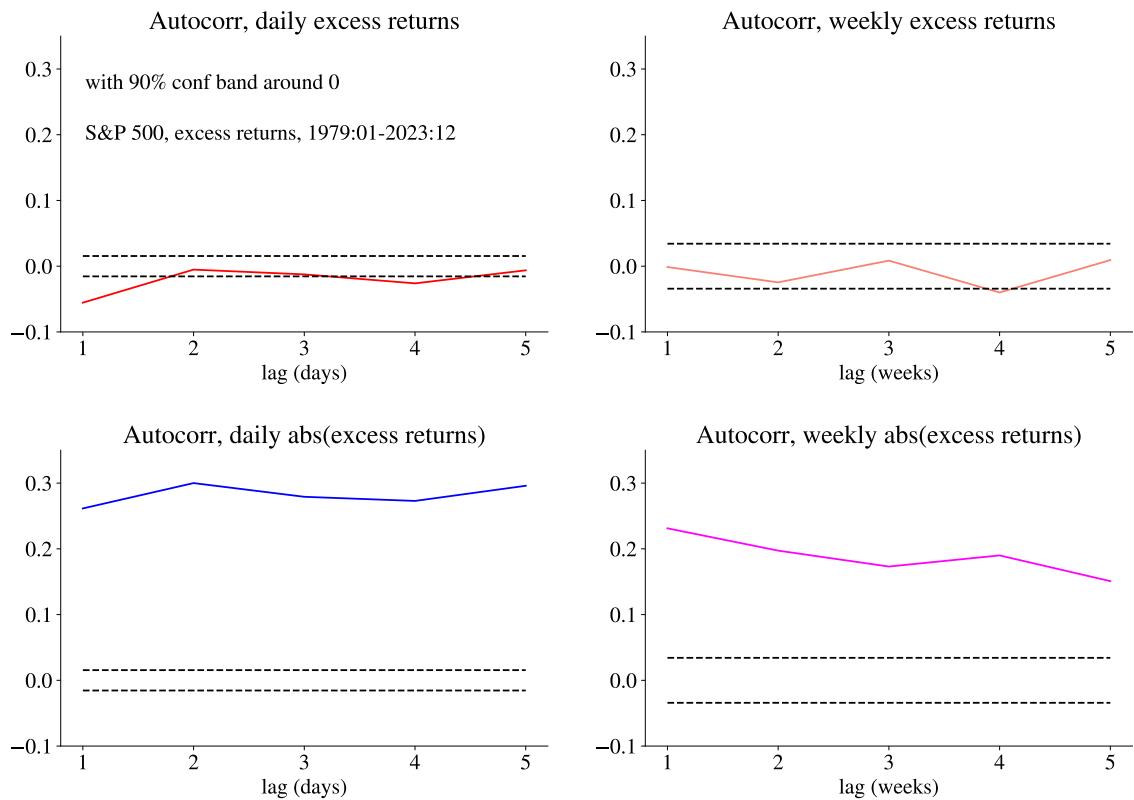


Figure 15.1: Predictability of daily US stock returns

15.1.2 Autoregressions

An alternative way of testing autocorrelations is to estimate an AR model

$$y_t = c + a_1 y_{t-1} + a_2 y_{t-2} + \dots + a_p y_{t-p} + \varepsilon_t, \quad (15.2)$$

and then test if all slope coefficients (a_1, a_2, \dots, a_p) are zero with a χ^2 or F test. This approach is somewhat less general than the Box-Pierce test, but most stationary time series processes can be well approximated by an AR of relatively low order.

Empirical Example 15.2 (*AR(1) and asymmetric AR(1) for daily S&P 500 returns*) See [Figure 15.3](#).

Empirical Example 15.3 (*AR(1) for long run equity returns*) See [Figure 15.4](#) for AR(1) results for different (long) investment horizons.

The autoregression can also allow for the coefficients to depend on the market situation. For instance, consider an AR(1), but where the autoregression coefficient may be

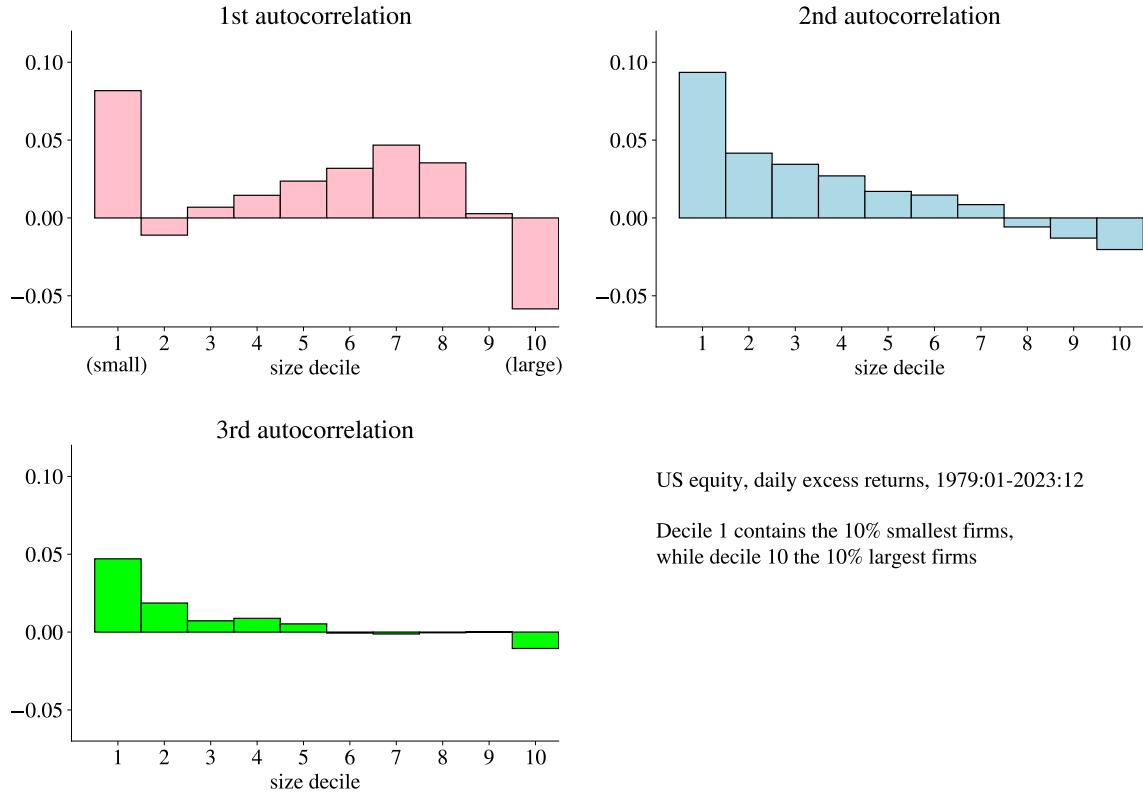


Figure 15.2: Predictability of daily US stock returns, size deciles

different depending on the sign of last period's return

$$y_t = \alpha + \beta Q_{t-1} y_{t-1} + \gamma(1 - Q_{t-1}) y_{t-1} + \varepsilon_t, \text{ where} \quad (15.3)$$

$$Q_{t-1} = \begin{cases} 1 & \text{if } y_{t-1} < 0 \\ 0 & \text{else.} \end{cases}$$

See Figure 15.3 for an illustration.

Inference of the slope coefficient in autoregressions on returns for longer data horizons than the data frequency (for instance, analysis of weekly returns in a data set consisting of daily observations) must be done with care. If only non-overlapping returns are used (for instance, the weekly returns recorded on Wednesdays only), the standard LS expression for the standard deviation of the autoregressive parameter is likely to be reasonable. This is not the case if overlapping returns (all daily data on weekly returns) are used.

Remark 15.4 (*Overlapping returns**) Consider an AR(1) for the two-period return, $y_{t-1} +$

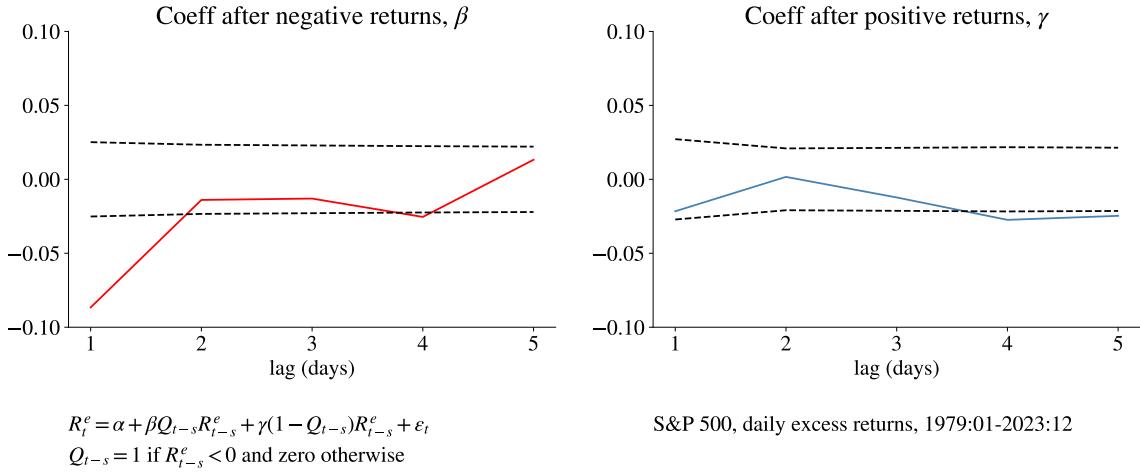


Figure 15.3: Predictability of daily US stock returns, symmetric and asymmetric AR(1)

y_t

$$y_{t+1} + y_{t+2} = a + b_2(y_{t-1} + y_t) + \varepsilon_{t+2}.$$

Two successive observations with non-overlapping returns are then

$$\begin{aligned} y_{t+1} + y_{t+2} &= a + b_2(y_{t-1} + y_t) + \varepsilon_{t+2} \\ y_{t+3} + y_{t+4} &= a + b_2(y_{t+1} + y_{t+2}) + \varepsilon_{t+4}. \end{aligned}$$

Suppose that y_t is not autocorrelated, so the slope coefficient $b_2 = 0$. We can then write the residuals as

$$\begin{aligned} \varepsilon_{t+2} &= -a + y_{t+1} + y_{t+2} \\ \varepsilon_{t+4} &= -a + y_{t+3} + y_{t+4}, \end{aligned}$$

which are uncorrelated. Compare this to the case where we use overlapping data. Two successive observations are then

$$\begin{aligned} y_{t+1} + y_{t+2} &= a + b_2(y_{t-1} + y_t) + \varepsilon_{t+2} \\ y_{t+2} + y_{t+3} &= a + b_2(y_t + y_{t+1}) + \varepsilon_{t+3}. \end{aligned}$$

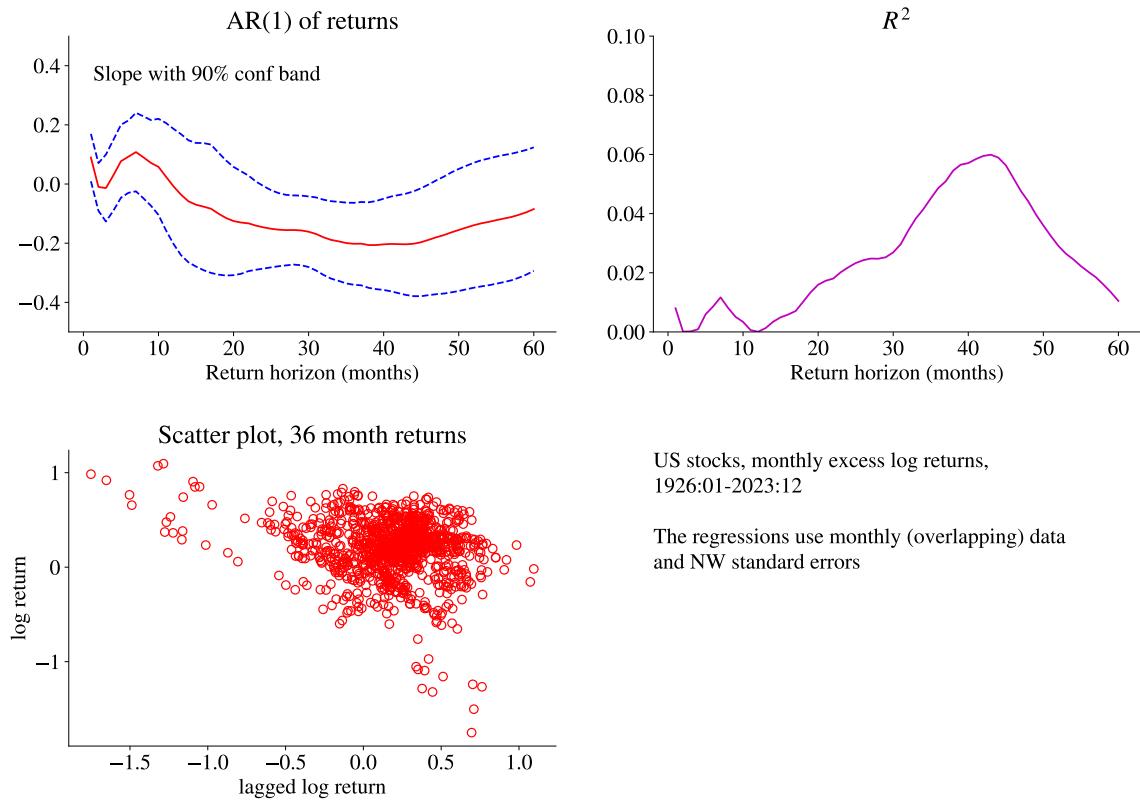


Figure 15.4: Predictability of long run US stock returns

As before, $b_2 = 0$ if y_t has no autocorrelation, so the residuals become

$$\begin{aligned}\varepsilon_{t+2} &= -a + y_{t+1} + y_{t+2} \\ \varepsilon_{t+3} &= -a + y_{t+2} + y_{t+3},\end{aligned}$$

which are correlated since y_{t+2} shows up in both. This demonstrates that overlapping return data introduces autocorrelation of the residuals—which has to be handled in order to make correct inference.

15.1.3 Variance Ratios

A variance ratio is another way to measure predictability. It is defined as the variance of a q -period return divided by q times the variance of a 1-period return

$$VR_q = \frac{\text{Var} \left(\sum_{s=0}^{q-1} y_{t-s} \right)}{q \text{Var}(y_t)}. \quad (15.4)$$

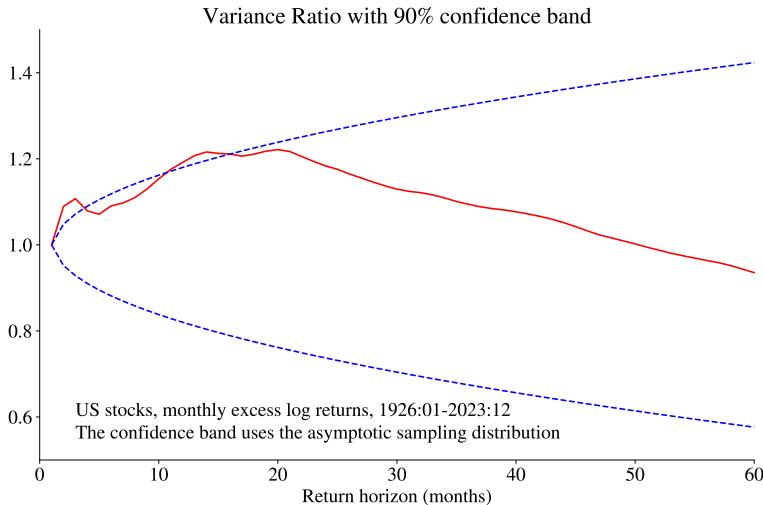


Figure 15.5: Variance ratios, long run US excess stock returns

To see that this is related to predictability, consider the 2-period variance ratio.

$$\begin{aligned}
 VR_2 &= \frac{\text{Var}(y_t + y_{t-1})}{2 \text{Var}(y_t)} && (15.5) \\
 &= \frac{\text{Var}(y_t) + \text{Var}(y_{t-1}) + 2 \text{Cov}(y_t, y_{t-1})}{2 \text{Var}(y_t)} \\
 &= 1 + \frac{\text{Cov}(y_t, y_{t-1})}{\text{Var}(y_t)} \\
 &= 1 + \rho_1. && (15.6)
 \end{aligned}$$

It is clear from (15.6) that if y_t is not serially correlated, then the variance ratio is unity; a value above one indicates positive serial correlation and a value below one indicates negative serial correlation. The same applies to longer horizons.

The estimation of VR_q is typically *not* done by replacing the population variances in (15.4) with the sample variances, since this would require using non-overlapping long returns—which wastes a lot of data points. For instance, if we have 24 years of data and we want to study the variance ratio for the 5-year horizon, then 4 years of data are wasted.

Instead, we typically rely on a transformation of (15.4)

$$\begin{aligned}
VR_q &= \frac{\text{Var}\left(\sum_{s=0}^{q-1} y_{t-s}\right)}{q \text{Var}(y_t)} \\
&= \sum_{s=-(q-1)}^{q-1} \left(1 - \frac{|s|}{q}\right) \rho_s \text{ or} \\
&= 1 + 2 \sum_{s=1}^{q-1} \left(1 - \frac{s}{q}\right) \rho_s.
\end{aligned} \tag{15.7}$$

To estimate VR_q , we first estimate the autocorrelation coefficients (using all available data points for each estimation) and then calculate (15.7).

Empirical Example 15.5 (*Variance ratio for long run U.S. equity returns*) See Figure 15.5.

Remark 15.6 (*Sampling distribution of \widehat{VR}_q) Under the null hypothesis that there is no autocorrelation, (15.1) and (15.7) give

$$\sqrt{T} \left(\widehat{VR}_q - 1 \right) \xrightarrow{d} N \left[0, \sum_{s=1}^{q-1} 4 \left(1 - \frac{s}{q}\right)^2 \right].$$

Example 15.7 (*Sampling distributions of \widehat{VR}_2 and \widehat{VR}_3*)

$$\begin{aligned}
\sqrt{T} \left(\widehat{VR}_2 - 1 \right) &\xrightarrow{d} N(0, 1) \text{ or } \widehat{VR}_2 \xrightarrow{d} N(1, 1/T) \\
\text{and } \sqrt{T} \left(\widehat{VR}_3 - 1 \right) &\xrightarrow{d} N(0, 20/9) \text{ or } \widehat{VR}_3 \xrightarrow{d} N[1, (20/9)/T].
\end{aligned}$$

Remark 15.8 The results in CLM Table 2.5 and 2.6 (weekly CRSP stock index returns, early 1960s to mid 1990s) show variance ratios above one and increasing with the number of lags, q . The results for individual stocks in CLM Table 2.7 show variance ratios close to, or even below, unity. Cochrane Tables 20.5–6 report weak evidence for more mean reversion in multi-year returns (annual NYSE stock index, 1926 to mid 1990s).

15.2 Other Predictors and Methods

There are many other possible predictors of future stock returns. For instance, both the dividend-price ratio and nominal interest rates have been used to predict long-run returns, and lagged short-run returns on other assets have been used to predict short-run returns.

15.2.1 Lead-Lags

Stock indices have more positive autocorrelation than (most) individual stocks: there should therefore be fairly strong cross-autocorrelations across individual stocks. (See Campbell, Lo, and MacKinlay (1997) Tables 2.7 and 2.8.) Indeed, this is also what is found in US data where weekly returns of large size stocks forecast weekly returns of small size stocks.

Empirical Example 15.9 (*Correlations of $R_{i,t}$ and $R_{j,t-s}$*) See Figure 15.6 for cross-autocovariances of the daily 25 FF portfolios. For instance, cell (i,j) shows the correlation of $R_{i,t}$ and $R_{j,t-1}$. Figure 15.7 shows results from augmented AR(1) estimations for each of the ten size-sorted equity portfolios: the lagged return of the largest firms (decile 10) is added as a regressor.

15.2.2 Dividend-Price Ratio as a Predictor

One of the most successful attempts to forecast long-run returns is a regression of future returns on the current earnings-price ratio (here in logs)

$$R_{t+s} = \alpha + \beta_s \ln(E_t/P_t) + \varepsilon_{t+s}, \quad (15.8)$$

where R_{t+s} is the return from t to $t + s$. This is illustrated in Figure 15.8.

For instance, CLM Table 7.1, report R^2 values from this regression which are close to zero for monthly returns, but they increase to 0.4 for 4-year returns (US, value weighted index, mid 1920s to mid 1990s).

Empirical Example 15.10 (*Predicting long run equity returns with E/P*) See Figure 15.9.

15.2.3 Predictability but No Autocorrelation

The evidence for US stock returns is that long-run returns may perhaps be predicted by the dividend-price ratio or interest rates, but that the long-run autocorrelations are weak (long-run US stock returns appear to be “weak-form efficient” but not “semi-strong efficient”). This should remind us of the fact that predictability and autocorrelation need not be the same thing: although autocorrelation implies predictability, we can have predictability without autocorrelation.

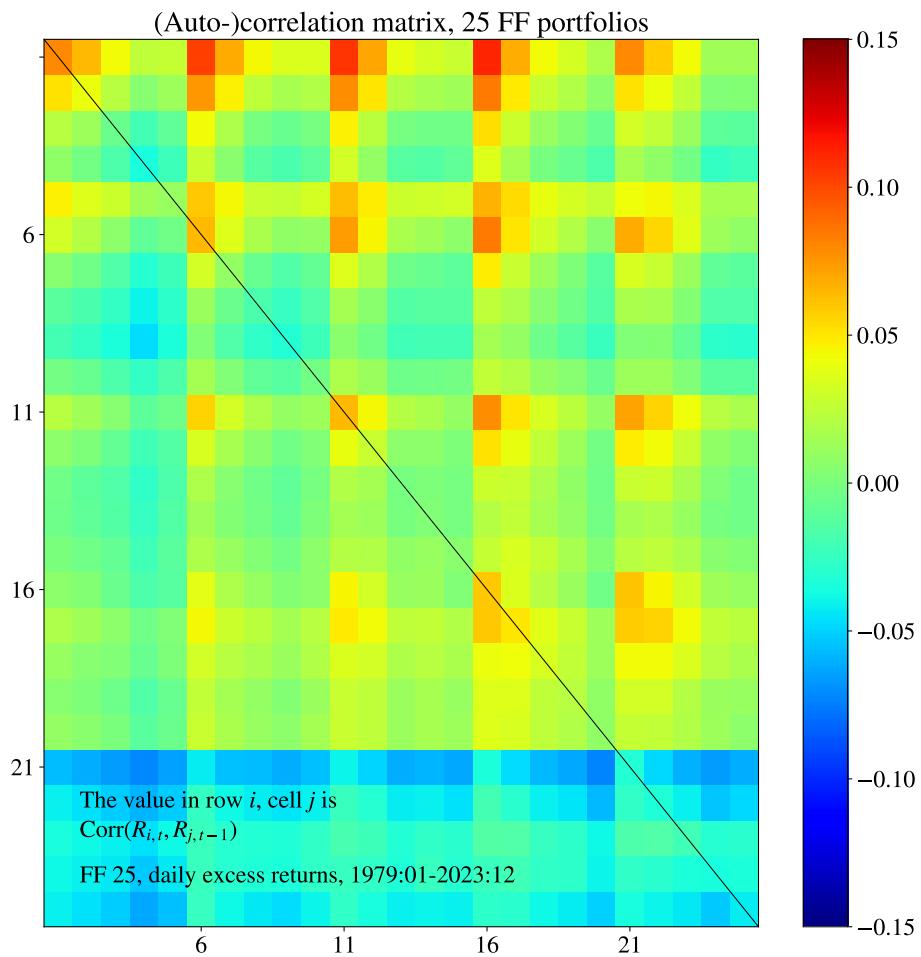


Figure 15.6: Illustration of the cross-autocorrelations, $\text{Corr}(R_t, R_{t-k})$, daily FF data. Dark colours indicate high correlations, light colours indicate low correlations.

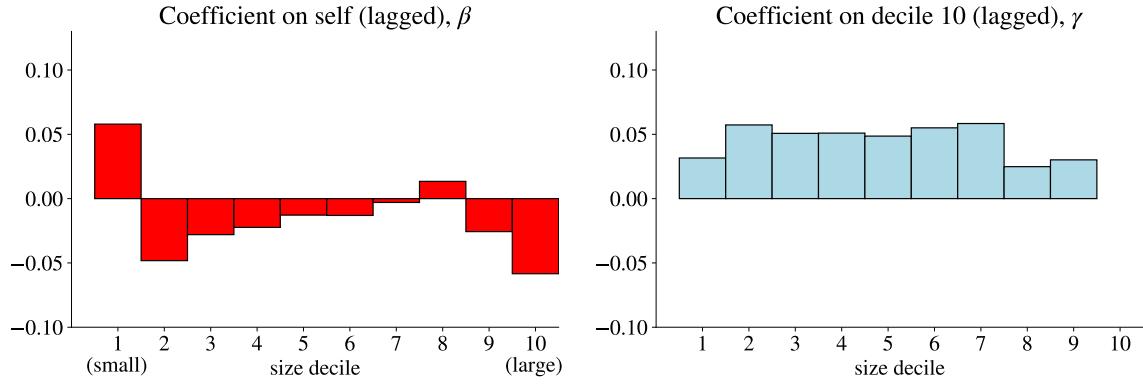
15.3 Out-of-Sample Forecasting Performance

15.3.1 In-Sample versus Out-of-Sample Forecasting

References: Goyal and Welch (2008), and Campbell and Thompson (2008)

In-sample evidence on predictability may suffer from several problems. First, the link between the predictor and future returns may be unstable (so the model has “breaks”). Second, if the estimated (in-sample) model includes many predictors, then it is likely to give poor predictions due to in-sample “overfitting.”

To gauge the out-of-sample predictability, we estimate the prediction equation using data up to and including $t - 1$, and then make a forecast for period t . See Figure 15.10



$$R_{i,t}^e = \alpha + \beta R_{i,t-1}^e + \gamma R_{10,t-1}^e + \varepsilon_t$$

US equity, daily excess returns, 1979:01-2023:12

Decile 1 contains the 10% smallest firms,
while decile 10 the 10% largest firms

Figure 15.7: Spillover effects, daily data

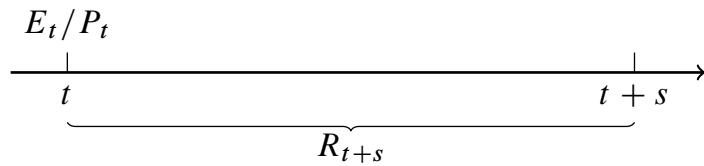


Figure 15.8: Using E/P or D/P to predict returns

for an illustration.

The forecasting performance of the equation is then compared with a benchmark prediction model (for instance, using the historical average as the predictor). Notice that this benchmark model is also estimated on data up to and including $t-1$, so it changes over time. Effectively, they are comparing the forecast performance of two models estimated in a recursive way (long and longer sample). The comparison can be done in terms of the RMSE and an “out-of-sample R^2 ”

$$R_{OS}^2 = 1 - \frac{1}{T} \sum_{t=s}^T (y_t - \hat{y}_t)^2 / \frac{1}{T} \sum_{t=s}^T (y_t - \tilde{y}_t)^2, \quad (15.9)$$

where s is the first period with an out-of-sample forecast, \hat{y}_t is the forecast based on the prediction model (estimated on data up to and including $t-1$) and \tilde{y}_t is the prediction from some benchmark model (also estimated on data up to and including $t-1$). In practice, the paper uses the historical average as the benchmark prediction model.

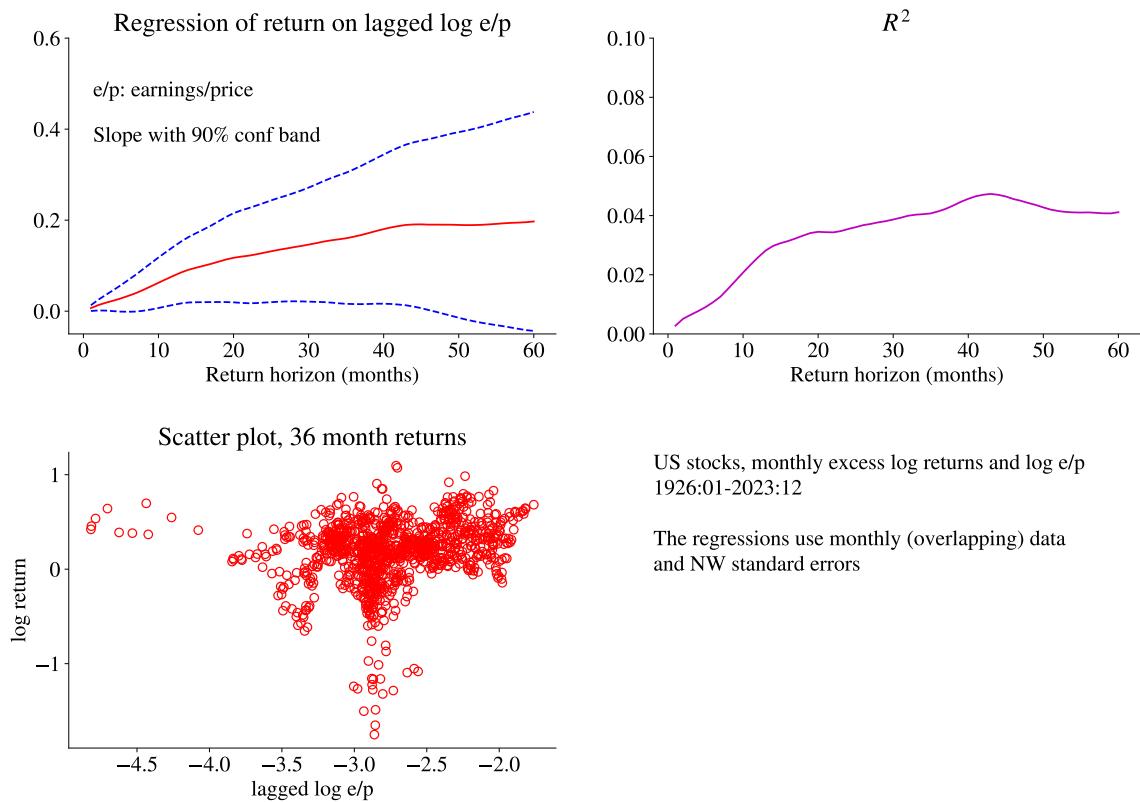


Figure 15.9: Forecast regressions, long run US stock returns

Example 15.11 (R_{OS}^2)

$$R_{OS}^2 = 1 - \frac{0.4}{0.5} = 0.2 \text{ (your model is better)}$$

$$R_{OS}^2 = 1 - \frac{0.5}{0.4} = -0.25 \text{ (your model is worse)}$$

Empirical Example 15.12 (*Out-of-sample prediction of equity returns*) Figure 15.11 shows results for daily size-sorted equity returns. There is some short-run predictability for small firm returns also out-of-sample. Figure 15.12 shows results on predicting long run equity returns with E/P. The evidence suggests that the in-sample long-run predictability vanishes out-of-sample.

15.3.2 Trading Strategies

Another way to measure predictability and to illustrate its economic importance is to calculate the return of a *dynamic trading strategy*, and then measure the “performance”

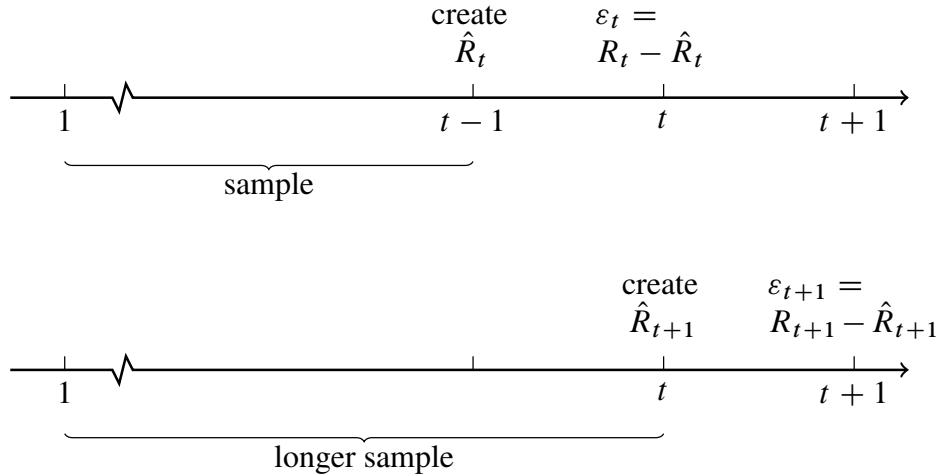


Figure 15.10: Out-of-sample forecasting

of this strategy in relation to some benchmark portfolios. The trading strategy should, of course, be based on the variable that is supposed to forecast returns.

A common way (since Jensen, updated in Huberman and Kandel (1987)) is to study the performance of a portfolio by running the following regression

$$R_{pt}^e = \alpha + \beta R_{mt}^e + \varepsilon_t, \text{ with} \quad (15.10)$$

$$\mathbb{E} \varepsilon_t = 0 \text{ and } \text{Cov}(R_{mt}^e, \varepsilon_t) = 0,$$

where R_{pt}^e is the excess return on the portfolio being studied and R_{mt}^e the excess returns of a vector of benchmark portfolios (for instance, only the market portfolio if we want to rely on CAPM). Neutral performance requires $\alpha = 0$, which can be tested with a t test.

Empirical Example 15.13 (*Momentum for daily returns on the 25 FF portfolios*) Figure 15.13 suggests that there is considerable momentum in the cross-section of the 25 FF portfolios. Investing in past winners earns high returns.

Empirical Example 15.14 (*Mean reversion of daily S&P 500 returns*) Figure 15.14 shows that extreme S&P 500 returns are followed by mean-reverting movements the following day (negative autocorrelation)—which suggests that a trading strategy should sell after a high return and buy after a low return. Compare with Figure 15.2.

Empirical Example 15.15 (*Mean reversion of daily returns for different size categories*) Figure 15.15 compares the results for daily returns on different size categories —and

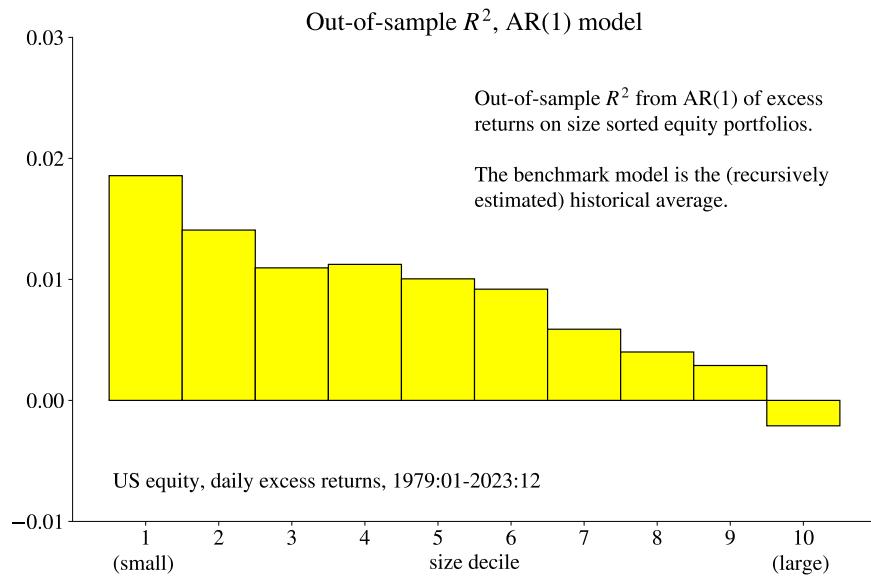


Figure 15.11: Predictability of daily US stock returns, out-of-sample

illustrates that there is more predictability (indicating positive autocorrelation) for small stocks. Once again, compare with Figure 15.2.

Empirical Example 15.16 (*Long run S&P 500 after different p/e values*) Figure 15.16 shows average one-year return on S&P 500 for different bins of the p/e ratio (at the beginning of the year). The figure illustrates that buying when the market is undervalued (low p/e) might be a winning strategy. Compare with Figure 15.9 (in-sample, but there we used e/p , not p/e) but also Figure 15.12 (out-of-sample evaluation of regression results).

15.3.3 Technical Analysis

Main reference: Bodie, Kane, and Marcus (2002) 12.2; Reilly and Brown (2012) 16; Neely (1997) (overview, foreign exchange market)

Further reading: Murphy (1999) (practical, a believer's view); The Economist (1993) (overview, the perspective of the early 1990s); Brock, Lakonishok, and LeBaron (1992) (empirical, stock market); Lo, Mamaysky, and Wang (2000) (academic article on return distributions for “technical portfolios”)

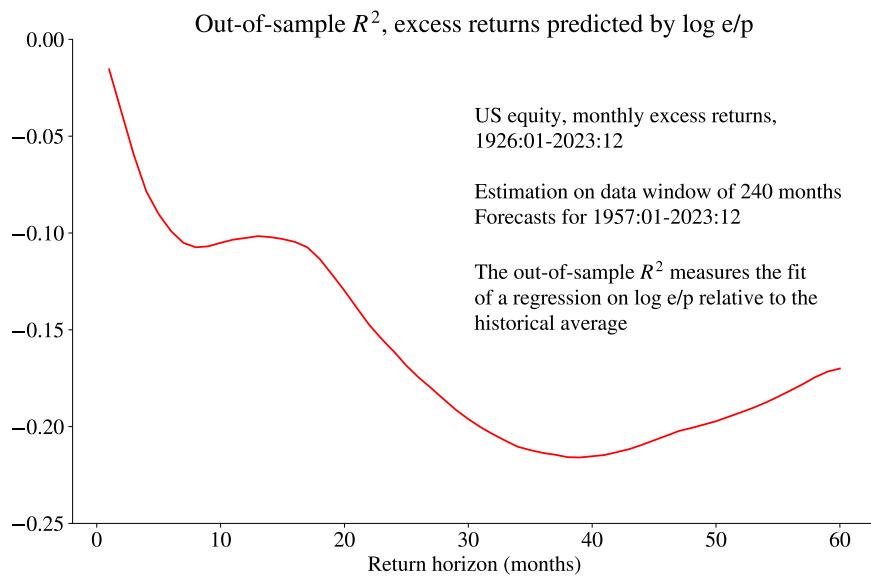


Figure 15.12: Predictability of long run US stock returns, out-of-sample

General Idea of Technical Analysis

Technical analysis is typically a data mining exercise which looks for local trends or systematic non-linear patterns. The basic idea is that markets are not instantaneously efficient: prices react somewhat slowly and predictably to news. The logic is that an observed price move must be due to some news (exactly which one is not very important) and that old patterns can tell us where the price will move in the near future. This is an attempt to gather more detailed information than that used by the market as a whole. In practice, much of technical analysis amounts to plotting different transformations (for instance, a moving average) of prices—and to spot systematic patterns. It is also common to incorporate information from other markets (for instance, the CBOE put/call ratio is often interpreted as a bearish attitude), trading volume or measures of market wide trends (the “breadth” of the market compares the number of assets with price increase/decrease).

This section summarizes some simple trading rules.

Technical Analysis and Local Trends

Many trading rules rely on some kind of local trend which can be thought of as positive autocorrelation in price movements, also called momentum.¹

¹In physics, momentum equals the mass times speed.

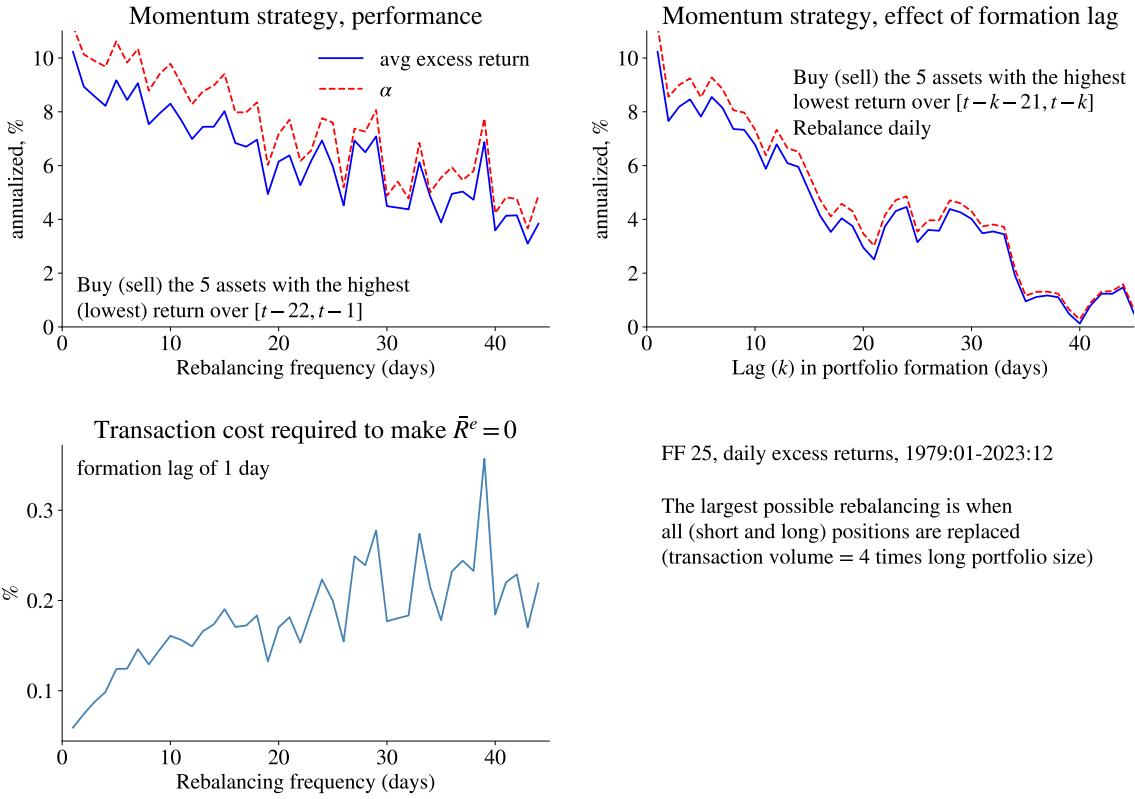


Figure 15.13: Predictability of daily US stock returns, momentum strategy

A *moving average rule* is to buy if a short moving average (equally weighted or exponentially weighted) goes above a long moving average. The idea is that the event signals a new upward trend. Let S (L) be the lag order of a short (long) moving average, with $S < L$ and let b be a bandwidth (perhaps 0.01). Then, a MA rule for period t could be

$$\begin{bmatrix} \text{buy in } t \text{ if } MA_{t-1}(S) > MA_{t-1}(L)(1+b) \\ \text{sell in } t \text{ if } MA_{t-1}(S) < MA_{t-1}(L)(1-b) \\ \text{no change} \quad \text{otherwise} \end{bmatrix}, \text{ where} \quad (15.11)$$

$$MA_{t-1}(S) = (p_{t-1} + \dots + p_{t-S})/S.$$

The difference between the two moving averages is called an *oscillator*

$$\text{oscillator}_t = MA_t(S) - MA_t(L), \quad (15.12)$$

(or sometimes, moving average convergence divergence, MACD) and the sign is taken as a trading signal (this is the same as a moving average crossing, MAC). A version of

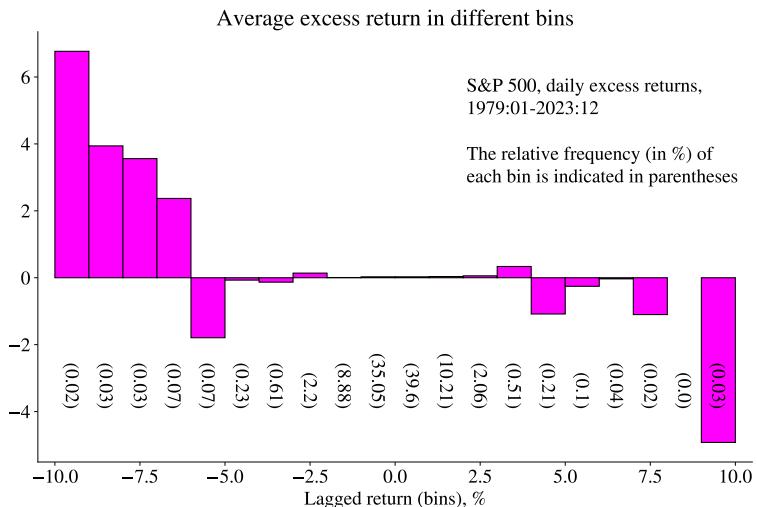


Figure 15.14: Predictability of daily US stock returns, out-of-sample

the moving average oscillator is the *relative strength index*², which is the ratio of average price level (or returns) on “up” days to the average price (or returns) on “down” days—during the last z (14 perhaps) days. Yet another version is to compare the oscillator _{t} to an moving average of the oscillator (also called a signal line).

The *trading range break-out rule* typically amounts to buying when the price rises above a previous peak (local maximum). The idea is that a previous peak is a *resistance level* in the sense that some investors are willing to sell when the price reaches that value (perhaps because they believe that prices cannot pass this level; clear risk of circular reasoning or self-fulfilling prophecies). Round numbers often play the role as resistance levels. Once this artificial resistance level has been broken, the price can possibly rise substantially. On the downside, a *support level* plays the same role: some investors are willing to buy when the price reaches that value. To implement this, it is common to let the resistance/support levels be proxied by minimum and maximum values over a data

²Not to be confused with relative strength, which typically refers to the ratio of two different asset prices (for instance, an equity compared to the market).

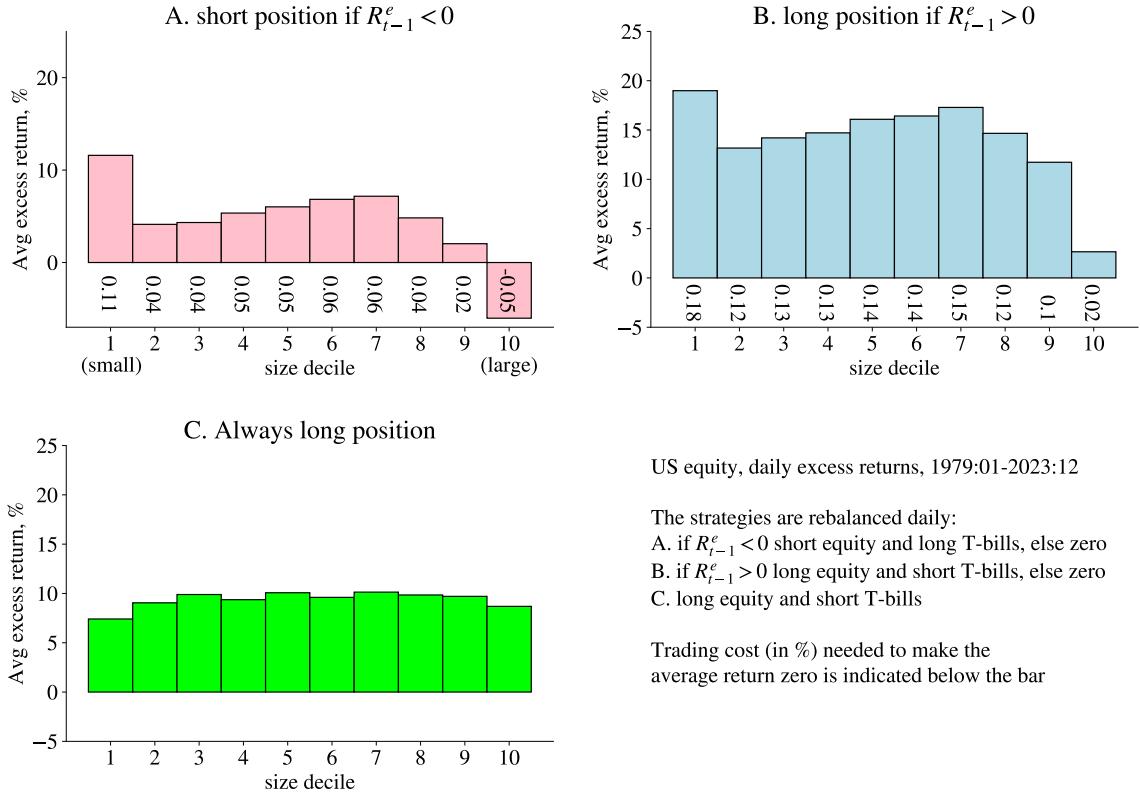


Figure 15.15: Predictability of daily US stock returns, out-of-sample

window of length L . With a bandwidth b (perhaps 0.01), the rule for period t could be

$$\begin{bmatrix} \text{buy in } t \text{ if } P_t > M_{t-1}(1 + b) \\ \text{sell in } t \text{ if } P_t < m_{t-1}(1 - b) \\ \text{no change} \quad \text{otherwise} \end{bmatrix}, \text{ where} \quad (15.13)$$

$$M_{t-1} = \max(p_{t-1}, \dots, p_{t-S})$$

$$m_{t-1} = \min(p_{t-1}, \dots, p_{t-S}).$$

When the price is already trending up, then the trading range break-out rule may be replaced by a *channel rule*, which works as follows. First, draw a *trend line* through previous lows and a *channel line* through previous peaks. Extend these lines. If the price moves above the channel (band) defined by these lines, then buy. A version of this is to define the channel by a *Bollinger band*, which is ± 2 standard deviations from a moving data window around a moving average.

A *head and shoulder* pattern is a sequence of three peaks (left shoulder, head, right

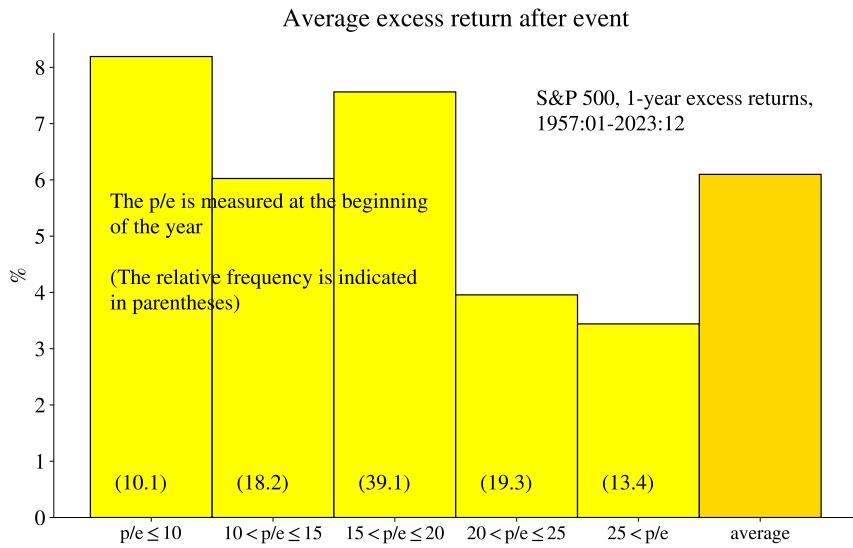


Figure 15.16: Predictability of annual US stock returns, out-of-sample

shoulder), where the middle one (the head) is the highest, with two local lows in between on approximately the same level (neck line). (Easier to draw than to explain in a thousand words.) If the price subsequently goes below the neckline, then it is thought that a negative trend has been initiated. (An inverse head and shoulder has the inverse pattern.)

Clearly, we can replace “buy” in the previous rules with something more aggressive, for instance, replace a short position with a long.

The trading volume is also often taken into account. If the trading volume of assets with declining prices is high relative to the trading volume of assets with increasing prices, then this is interpreted as a market with selling pressure. (The basic problem with this interpretation is that there is a buyer for every seller, so we could equally well interpret the situations as if there is a buying pressure.)

Technical Analysis and Mean Reversion

If we instead believe in mean reversion of the prices, then we can essentially reverse the previous trading rules: we would typically sell when the price is high.

Empirical Example 15.17 (*Daily trading strategy for S&P 500 and riskfree*) See Figure 15.17 for an illustration (over a short subsample) of an inverted MA strategy: buy when the recent index values leave the band on the downside et vice versa. The performance (over a longer sample) is reported in Table 15.1, which suggests that buy and sell

signals actually contain information. However, a daily rebalancing might be too costly (transaction costs).

Some investors argue that markets show periods of mean reversion and then periods with trends—and that both can be exploited. Clearly, the concept of support and resistance levels (or more generally, a channel) is based on mean reversion between these points. A new trend is then supposed to be initiated when the price breaks out of this band.

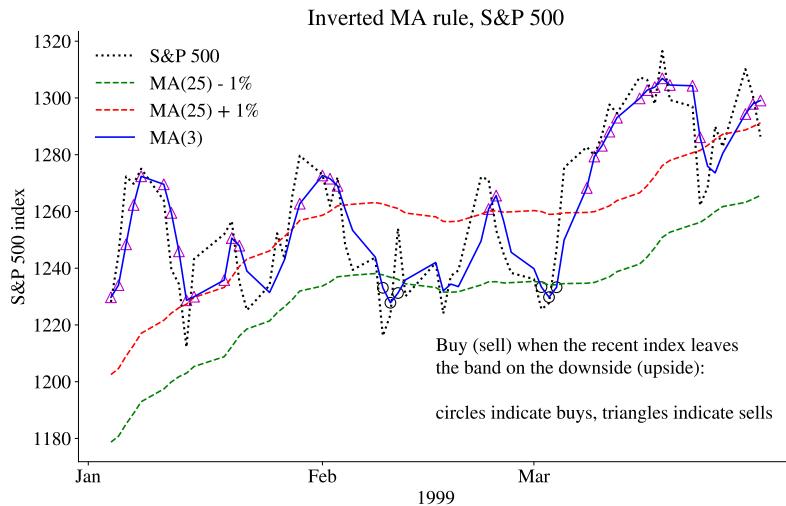


Figure 15.17: Example of a daily trading rule

	Mean	Std
All days	6.9	18.1
After buy signal	15.4	27.4
After neutral signal	5.0	14.6
After sell signal	3.9	13.7
Strategy	8.9	27.8
Transaction cost	0.1	

Table 15.1: Excess returns (annualized, in %) from technical trading rule (Inverted MA rule). Daily S&P 500 data 1990:01-2023:12. The trading strategy involves (a) on every day: hold one unit of the index and short the riskfree; (b) on days after a buy signal: double the position in (a); (c) on days after a sell signal: short sell the position in (a), effectively having a zero investment. The transaction costs shows the cost (in %) of trade that the strategy can pay and still perform as well as the static holding of (a).

15.4 Forecast Averaging

Reference: Elliot and Timmermann (2016) 14

Averaging across forecasts have often proved to be a good way of producing a superior forecast.

There are two main cases: (1) when we have access to the forecasts and also the data/model that produced them and (2) when we have access to the forecasts only. We discuss them in reverse order.

Suppose we have access to K different forecasts (\hat{R}_t^i for $i = 1$ to K) of the return R_t . All these forecasts are made in period $t - h$ (with $h \geq 1$). We form a weighted average as

$$R_t^* = \sum_{i=1}^K w_i \hat{R}_t^i, \text{ with } \sum_{i=1}^K w_i = 1. \quad (15.14)$$

For instance, w may be chosen as to minimize the forecast error variance or the MSE over the sample up to and including $t - h$. In practice, it seems difficult to beat an unweighted average or an unweighted average after having pruned the most extreme forecasts (“trimmed mean”).

Instead, suppose we have access also to the models and data that produce the various forecasts. It can then be argued that the proper way to proceed is to pool all the data and apply the model selection techniques. However, the unweighted average across forecasts often perform reasonably well.

15.5 Evaluating Forecasting Performance

Further reading: Diebold (2001) 11; Stekler (1991); Diebold and Mariano (1995); Clark and West (2007)

To do a solid evaluation of the forecast performance (of some forecaster/forecast method/forecast institute), we need a sample (history) of the forecasts and the resulting forecast errors. The reason is that the forecasting performance for a single period is likely to be dominated by luck, so we can only expect to find systematic patterns by looking at results for several periods.

To set up tests of the forecasting performance, let ε_t be the forecast error in period t

$$\varepsilon_t = R_t - \hat{R}_t, \quad (15.15)$$

where \hat{R}_t is the forecast (made in $t - h$) and R_t the actual outcome. (Warning: some

authors prefer to work with $\hat{R}_t - R_t$ as the forecast error instead.)

Quite often, we compare a forecast method (or forecasting institute) with a benchmark forecast like a “no change,” a random walk or the historical average. The idea of such a comparison is to study if the resources employed in creating the forecast really bring value added compared to a very simple (and inexpensive) forecast.

Ultimately, the ranking of forecasting methods should be done based on the true benefits/costs of forecast errors—which may differ between organizations. For instance, a forecasting agency has a reputation (and eventually customers) to lose, while an investor has more immediate pecuniary concerns. Unless the relation between the forecast error and the losses are immediately understood, the ranking of two forecast methods is typically done based on a number of standard criteria. Several of those criteria are inspired by basic statistics.

Most statistical forecasting methods are based on the idea of minimizing the sum of squared forecast errors, $\sum_{t=1}^T \varepsilon_t^2$. For instance, the least squares (LS) method picks the regression coefficient in

$$R_t = \beta_0 + \beta_1 x_{t-h} + \varepsilon_t \quad (15.16)$$

to minimize the sum of squared residuals. This will, among other things, give a zero mean of the fitted residuals and also a zero correlation between the fitted residual and the regressor. As usual, rational forecasts should have forecast errors that cannot be predicted (by past regressors or forecast errors).

The evaluation of a forecast often involves extending these ideas to the forecast method, irrespective of whether a LS regression has been used or not. In practice, this means studying (i) whether the forecast error, e_t , has a zero mean; (ii) the mean squared (or absolute value) of the forecast error ; (iii) the fraction of times the squared (or absolute value) of the forecast error is lower than some threshold; (iv) the profit from investing by following a forecasting model; (v) if the forecast errors are autocorrelated or correlated with past information.

To perform formal tests of forecasting performance a Diebold and Mariano (1995) test is typically performed. To implement it, consider two different forecasts. For instance, the first forecast could come from a naive forecasting model (for instance, no change) that you hope to beat (forecast errors e_t) and the other is your estimated model (forecast errors ε_t). To test the different aspects discussed before, let $\delta(x)$ be an indicator function that is one if x is true and zero otherwise, and let R_t^e and R_t^ε denote the returns from following trading strategies based on the different forecasts. Then, we could consider, for instance,

the following moment conditions

$$g_t = e_t - \varepsilon_t, \text{ or} \quad (15.17)$$

$$g_t = e_t^2 - \varepsilon_t^2 \text{ or } g_t = |e_t| - |\varepsilon_t|, \text{ or} \quad (15.18)$$

$$g_t = \delta[\text{sign}(\tilde{R}_t) \neq \text{sign}(R_t)] - \delta[\text{sign}(\hat{R}_t) \neq \text{sign}(R_t)], \quad (15.19)$$

where $\delta(x) = 1$ if x is true and zero otherwise.

The different moment conditions correspond to the different aspects of the forecasts discussed above. For instance, (15.17) is for testing if the two methods have the same average forecast error, while (15.18) tests the MSE, which is an application of the Mariano-Diebold approach. In contrast, (15.19) tests if the e model forecasts the wrong sign of the return more often than the ε model does. (When the moment condition is changed to test the right sign, then the average is called the “mean directional accuracy”, MDA.)

From the usual properties of a sample average and the assumption that g_t is not auto-correlated, we typically have that

$$\bar{g} \xrightarrow{d} N(0, \text{Var}(g_t)/T), \quad (15.20)$$

where $\bar{g} = \sum_{t=1}^T g_t / T$ is the average. Alternatively, the variance could be estimated by a Newey-West approach.

The null hypothesis is that $E g_t = 0$ (the two models perform equally well). In a two-sided test the alternative hypothesis is $E g_t \neq 0$ (are the forecast errors different?). The null is then rejected whenever the t -stat calculated from (15.20) is large in absolute value (for instance, $|t| > 1.645$ for the 10% significance level). A one-sided test (where the alternative is $E g_t > 0$ or $E g_t < 0$) is also easy to perform.

However, when the models behind e and ε are *nested* (say, e is generated by a special case of the model that generates ε), then the asymptotic distribution is non-normal so an adjustment must be applied (see Clark and McCracken (2001) and Clark and West (2007)), which typically means that instead of studying $g_t = e_t^2 - \varepsilon_t^2$, we use $g_t = 2e_t(e_t - \varepsilon_t)$.

Empirical Example 15.18 (*Empirical results on predicting annual S&P 500 returns*) Table 15.2 summarizes results for predicting 1-year S&P 500 returns. The combined model seems to do slightly better than the two individual models, AR(1) and E/P regression.

	AR(1)		E/P		Combination	
	mean	t-stat	mean	t-stat	mean	t-stat
MSE in-sample	298.50		287.42			
R^2_{oos}	-0.04		-0.06		-0.02	
$e - \varepsilon$	0.22	1.89	-1.49	-1.52	-0.64	-1.27
$e^2 - \varepsilon^2$	-12.30	-1.52	-18.40	-0.81	-7.40	-0.67
$ e - \varepsilon $	-0.20	-1.46	-0.75	-1.09	-0.29	-0.84
$2e(e - \varepsilon)$	-11.40	-1.46	12.23	0.53	0.41	0.04

Table 15.2: Mariano-Diebold (and Clark-West) tests of forecasting 1-year S&P returns with different models. The total sample is 1946–2022, but the forecasts are made for 1971–2022. The e forecasts are the historical average returns while the ε forecasts are out-of-sample and based on the different regressions. Estimation is done on an expanding data window. The std use a NW approach with 1 lag (year).

15.6 Security Analysts

Reference: Makridakis, Wheelwright, and Hyndman (1998) 10.1 and Elton, Gruber, Brown, and Goetzmann (2010) 26

15.6.1 Evidence on Analysts' Performance

Makridakis, Wheelwright, and Hyndman (1998) 10.1 shows that there is little evidence that the average stock analyst beats (on average) the market (a passive index portfolio). In fact, less than half of the analysts beat the market. However, there are analysts which seem to outperform the market for some time, but the autocorrelation in over-performance is weak. The evidence from mutual funds is similar. For them it is typically also found that their portfolio weights do not anticipate price movements.

It should be remembered that many analysts also are sales persons: either of a stock (for instance, since the bank is underwriting an offering) or of trading services. It could well be that their objective function is quite different from minimizing the squared forecast errors—or whatever we typically use in order to evaluate their performance.

15.6.2 Do Security Analysts Overreact?

The paper by Bondt and Thaler (1990) compares the (semi-annual) forecasts (one- and two-year time horizons) with actual changes in earnings per share (1976-1984) for several

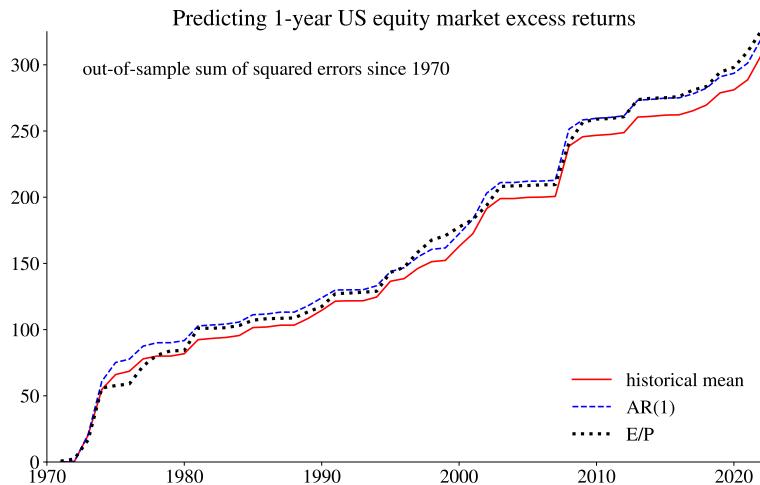


Figure 15.18: Accumulation of the (oos) MSE from three different forecasting models

hundred companies. The paper has regressions like

$$\text{Actual change} = \alpha + \beta(\text{forecasted change}) + \text{residual},$$

and then studies the estimates of the α and β coefficients. With rational expectations (and a long enough sample), we should have $\alpha = 0$ (no constant bias in forecasts) and $\beta = 1$ (proportionality).

The main result is that $0 < \beta < 1$, so that the forecasted change tends to be too wild in a systematic way: a forecasted change of 1% is (on average) followed by a less than 1% actual change in the same direction. This means that analysts in this sample tended to be too extreme—to exaggerate both positive and negative news.

15.6.3 High-Frequency Trading Based on Recommendations from Stock Analysts

Barber, Lehavy, McNichols, and Trueman (2001) give a somewhat different picture. They focus on the profitability of a trading strategy based on the recommendations of analysts. They use a huge data set (some 360,000 recommendations, US stocks) for the period 1985-1996. They sort stocks into five portfolios depending on the consensus (average) recommendation—and redo the sorting every day (if a new recommendation is published). They find that such a daily trading strategy gives an annual 4% abnormal return on the portfolio of the most highly recommended stocks, and an annual -5% abnormal return on the least favourably recommended stocks.

This strategy requires a lot of trading (a turnover of 400% annually), so trading costs would typically reduce the abnormal return on the best portfolio to almost zero. A less frequent rebalancing (weekly, monthly) gives a very small abnormal return for the best stocks, but still a negative abnormal return for the worst stocks. [Chance and Hemler \(2001\)](#) obtain similar results when studying the investment advise by 30 professional “market timers.”

15.6.4 Economic Experts

Several papers, for instance, [Bondt \(1991\)](#) and [Söderlind \(2010\)](#), have studied whether economic experts can predict the broad stock markets. The results suggests that they cannot. For instance, [Söderlind \(2010\)](#) shows that the economic experts that participate in the semi-annual Livingston survey (mostly bank economists) forecast the S&P worse than the historical average (recursively estimated), and that their forecasts are strongly correlated with recent market data (which in itself, cannot predict future returns).

15.6.5 Bond Rating Agencies versus Stock Analysts

[Ederington and Goh \(1998\)](#) use data on all corporate bond rating changes by Moody's between 1984 and 1990 and the corresponding earnings forecasts (by various stock analysts).

The idea of the paper by [Ederington and Goh \(1998\)](#) is to see if bond ratings drive earnings forecasts (or vice versa), and if they affect stock returns (prices).

1. To see if stock returns are affected by rating changes, they first construct a “normal” return by a market model:

$$\text{normal stock return}_t = \alpha + \beta \times \text{return on stock index}_t,$$

where α and β are estimated on a normal time period (not including the rating change). The abnormal return is then calculated as the actual return minus the normal return. They then study how such abnormal returns behave, on average, around the dates of rating changes. Note that “time” is then measured, individually for each stock, as the distance from the day of rating change. The result is that there are significant negative abnormal returns following downgrades, but zero abnormal returns following upgrades.

2. They next turn to the question of whether bond ratings drive earnings forecasts or vice versa. To do that, they first note that there are some predictable patterns in revisions of earnings forecasts. They therefore fit a simple autoregressive model of earnings forecasts, and construct a measure of earnings forecast revisions (surprises) from the model. They then relate this surprise variable to the bond ratings. In short, the results are the following:

- (a) both earnings forecasts and ratings react to the same information, but there is also a direct effect of rating changes, which differs between downgrades and upgrades.
- (b) downgrades: the ratings have a strong negative direct effect on the earnings forecasts; the returns react even quicker than analysts
- (c) upgrades: the ratings have a small positive direct effect on the earnings forecasts; there is no effect on the returns

A possible reason for why bond ratings could drive earnings forecasts and prices is that bond rating firms typically have access to more inside information about firms than stock analysts and investors.

A possible reason for the observed asymmetric response of returns to ratings is that firms are quite happy to release positive news, but perhaps more reluctant to release bad news. If so, then the information advantage of bond rating firms may be particularly large after bad news. A downgrading would then reveal more new information than an upgrade.

The different reactions of the earnings forecasts and the returns are hard to reconcile.

15.6.6 International Differences in Analyst Forecast Properties

Ang and Ciccone (2001) study earnings forecasts for many firms in 42 countries over the period 1988 to 1997. Some differences are found across countries: forecasters disagree more and the forecast errors are larger in countries with low GDP growth, less accounting disclosure, and less transparent family ownership structure.

However, the most robust finding is that forecasts for firms with losses are special: forecasters disagree more, are more uncertain, and are more overoptimistic about such firms.

15.6.7 Analysts and Industries

Boni and Womack (2006) study data on some 170,000 recommendations for a very large number of U.S. companies for the period 1996–2002. Focusing on revisions of recommendations, the papers shows that analysts are better at ranking firms within an industry than ranking industries.

15.6.8 Insiders

Corporate insiders *used to* earn superior returns, mostly driven by selling off stocks before negative returns. (There is little/no systematic evidence of insiders gaining by buying before high returns.) Actually, investors who followed the insider's registered transactions (in the U.S., these are made public six weeks after the reporting period), also used to earn some superior returns. It seems as if these patterns have more or less disappeared.

Chapter 16

Event Studies

Reference: Bodie, Kane, and Marcus (2005) 12.3 or Copeland, Weston, and Shastri (2005) 11

Reference (advanced): Campbell, Lo, and MacKinlay (1997) 4

16.1 Basic Structure of Event Studies

The idea of an event study is to study the effect (on stock prices or returns) of a special event by using a cross-section of such events. For instance, what is the average (across firms) effect of a stock split announcement on the share price? Other events could be debt issues, mergers and acquisitions, earnings announcements, or monetary policy moves.

The event is typically assumed to be a binary variable. For instance, it could be a merger or not or if the monetary policy surprise was positive (lower interest rates than expected) or not. The basic approach is then to study what happens to the returns of those assets that have such an event.

Only news should move the asset price, so it is often necessary to explicitly model the previous expectations to define the event. For earnings, the event is typically taken to be the earnings announcement minus (some average of) analysts' forecast. Similarly, for monetary policy moves, the event could be specified as the interest rate decision minus previous forward rates (as a measure of previous expectations).

Similarly, we typically study the *abnormal return* around such events, defined as (for asset i in period t)

$$u_{it} = R_{it} - R_{it}^{normal}, \quad (16.1)$$

where R_{it} is the actual return and the last term is the normal return (which may differ across assets and time). The definition of the normal return is discussed below. The idea

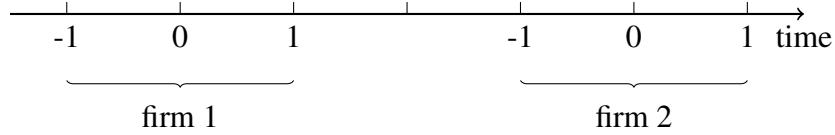


Figure 16.1: Event days and windows

of the “abnormal return” is that the event is likely to change the return relative to what it would otherwise have been on the same date (the normal return).

Suppose we have a sample of n such events (“assets”). To keep the notation (reasonably) simple, we “normalize” the time so period 0 is the time of the event. Clearly the actual calendar time of the events for assets i and j are likely to differ, but we shift the time line for each asset individually so the time of the event is normalized to zero for every asset. See Figure 16.1 for an illustration.

To control for information leakage and slow price adjustment, the abnormal return is often calculated for some time before and after the event: the “event window” (often ± 20 days or so). For day s (that is, s days after the event time 0), the cross sectional average abnormal return is

$$\bar{u}_s = \sum_{i=1}^n u_{is} / n. \quad (16.2)$$

For instance, \bar{u}_2 is the average abnormal return two days after the event, and \bar{u}_{-1} is for one day before the event.

The cumulative abnormal return (CAR) of asset i is simply the sum of the abnormal return in (16.1) over some period around the event. It is often calculated from the beginning of the event window (or from day 0). For instance, if the event window starts at -20 , then the 3-period (day?) car for firm i is

$$\text{car}_{i3} = u_{i,-20} + u_{i,-19} + u_{i,-18}. \quad (16.3)$$

More generally, if the event window starts at w (say, -20), then the q -period car for firm i is

$$\text{car}_{iq} = \sum_{\tau=w}^{w+q-1} u_{i,\tau}. \quad (16.4)$$

The cross sectional average of the q -period car is

$$\overline{\text{car}}_q = \sum_{i=1}^n \text{car}_{iq} / n. \quad (16.5)$$

Empirical Example 16.1 (*Cumulative abnormal returns*) See Figure 16.2 for results on IPOs.

Example 16.2 (*Abnormal returns for ± 1 day around event, two firms*) Suppose there are two firms and the event window contains ± 1 day around the event day, and that the abnormal returns (in percent) are

Time	Firm 1	Firm 2	Cross-sectional Average
-1	0.2	-0.1	0.05
0	1.0	2.0	1.5
1	0.1	0.3	0.2

We have the following cumulative returns

Time	Firm 1	Firm 2	Cross-sectional Average
-1	0.2	-0.1	0.05
0	1.2	1.9	1.55
1	1.3	2.2	1.75

16.2 Models of Normal Returns

This section summarizes the most common ways of calculating the normal return in (16.1). The parameters in these models are typically estimated on a recent sample, the “estimation window,” which ends before the event window. See Figure 16.3 for an illustration. (When there is no return data before the event window for instance, when the event is an IPO, then the estimation window can be after the event window.)

In this way, the estimated behaviour of the normal return should be unaffected by the event. It is almost always assumed that the event is exogenous in the sense that it is not due to the movements of the asset price during either the estimation window or the event window. This allows us to get a clean estimate of the normal return.

The *constant mean return model* assumes that the return of asset i fluctuates randomly

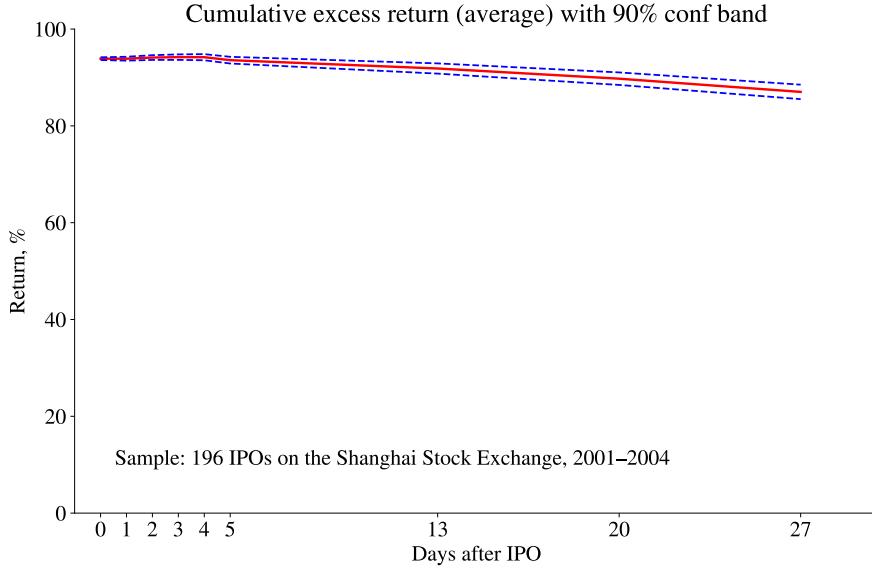


Figure 16.2: Event study of IPOs in Shanghai 2001–2004. (Data from Nou Lai.)

around some mean μ_i

$$R_{it} = \mu_i + \varepsilon_{it} \text{ with} \quad (16.6)$$

$$\mathbb{E}(\varepsilon_{it}) = 0 \text{ and } \text{Cov}(\varepsilon_{it}, \varepsilon_{i,t-s}) = 0.$$

This mean is estimated by the sample average (during the estimation window). The normal return in (16.1) is then the estimated mean, $\hat{\mu}_i$. During the event window, we calculate the abnormal return as

$$u_{it} = R_{it} - \hat{\mu}_i. \quad (16.7)$$

The standard error of this is estimated by the standard error of $\hat{\varepsilon}_{it}$ (in the estimation window). This means that we disregard the sampling uncertainty of the estimated mean, which makes sense if the estimation window is not very short (recall that the variance of a sample average is $\text{Var}(R_{it})/T$, where T is the number of data points in the estimation window). The same applies to the other models discussed below.

The *market model* is a linear regression of the return of asset i on the market return

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \text{ with} \quad (16.8)$$

$$\mathbb{E}(\varepsilon_{it}) = 0, \text{Cov}(\varepsilon_{it}, \varepsilon_{i,t-s}) = 0 \text{ and } \text{Cov}(\varepsilon_{it}, R_{mt}) = 0.$$

Notice that we typically do not impose the CAPM restrictions on the intercept in (16.8).



Figure 16.3: Event and estimation windows

The normal return in (16.1) is then calculated by combining the regression coefficients with the actual market return as $\hat{\alpha}_i + \hat{\beta}_i R_{mt}$. For the event window we calculate the abnormal return as

$$u_{it} = R_{it} - \hat{\alpha}_i - \hat{\beta}_i R_{mt}. \quad (16.9)$$

The standard error of this is estimated by the standard error of $\hat{\varepsilon}_{it}$ (in the estimation window).

Recently, the market model has increasingly been replaced by a multi-factor model which uses several regressors instead of only the market return. For instance, Fama and French (1993) argue that (16.8) needs to be augmented by a portfolio that captures the different returns of small and large firms and also by a portfolio that captures the different returns of firms with high and low book-to-market ratios.

When we restrict $\alpha_i = 0$ and $\beta_i = 1$ in (16.8), then this approach is called the *market-adjusted-return model*. This is a particularly useful approach when there is no return data before the event, for instance, with an IPO. For the event window we calculate the abnormal return as

$$u_{it} = R_{it} - R_{mt} \quad (16.10)$$

and the standard error of it is estimated by $\text{Std}(R_{it} - R_{mt})$ in the estimation window.

Finally, another approach is to construct a normal return as the actual return on assets which are very similar to the asset with an event. For instance, if asset i is a small manufacturing firm (with an event), then the normal return could be calculated as the average (in the cross-section, but same day) return for other small manufacturing firms (without events). In this case, the abnormal return becomes the difference between the actual return and the average return on the matching portfolio. This type of *matching portfolio* is becoming increasingly popular. For the event window we calculate the abnormal return

as

$$u_{it} = R_{it} - R_{pt}, \quad (16.11)$$

where R_{pt} is the return of the matching portfolio. The standard error of it is estimated by $\text{Std}(R_{it} - R_{pt})$ in the estimation window.

All the methods discussed here try to take into account the risk premium on the asset. It is captured by the mean in the constant mean mode, the beta in the market model, and by the way the matching portfolio is constructed.

Apart from accounting for the risk premium, does the choice of the model of the normal return matter? Yes, but only if the model produces a higher coefficient of determination (R^2) than competing models. In that case, the variance of the abnormal return is smaller which makes the tests more precise.

To illustrate the importance of the model for normal returns, consider the market model (16.8). Under the null hypothesis that the event has no effect on the return, the abnormal return would be just the residual in the regression (16.8). It has the variance (assuming we know the model parameters)

$$\text{Var}(u_{it}) = \text{Var}(\varepsilon_{it}) = (1 - R^2) \text{Var}(R_{it}), \quad (16.12)$$

where R^2 is the coefficient of determination of the regression (16.8).

Proof (of (16.12)) Recall that R^2 is defined as

$$R^2 = 1 - \frac{\text{Var}(\varepsilon_{it})}{\text{Var}(R_{it})}.$$

Rearrange to get (16.12). \square

This variance is crucial for testing the hypothesis of no abnormal returns: the smaller is the variance, the easier it is to reject a false null hypothesis (see Section 16.3). The constant mean model has $R^2 = 0$, so the market model could potentially give a much smaller variance. If the market model has $R^2 = 0.75$, then the standard deviation of the abnormal return is only half that of the constant mean model (since $\sqrt{1 - 0.75} = 0.5$). More realistically, R^2 might be 0.43 (or less), so the market model gives a 25% decrease in the standard deviation. Experience with multi-factor models also suggest that they give relatively small improvements of the R^2 compared to the market model. For these reasons, and for reasons of convenience, the market model is still the dominating model of normal returns.

High frequency data can be very helpful, provided the time of the event is known. High frequency data effectively allows us to decrease the volatility of the abnormal return

since it filters out irrelevant (for the event study) shocks to the return while still capturing the effect of the event.

16.3 Testing the Abnormal Return

In testing if the abnormal return is different from zero, there are two sources of sampling uncertainty. First, the parameters of the normal return model are uncertain. Second, even if we knew the normal return for sure, the returns are random variables—and they will always deviate from their population means in any finite sample. The first source of uncertainty is likely to be much smaller than the second—provided the estimation window is much longer than the event window. This is the typical situation, so the rest of the discussion will focus on the second source of uncertainty.

It is typically assumed that the abnormal returns are uncorrelated across time and across assets. The first assumption is motivated by the very low autocorrelation of returns. The second assumption makes a lot of sense if the events are not overlapping in time, so that the event of assets i and j happen at different (calendar) times. In contrast, if the events happen at the same time, the cross-correlation must be handled somehow (see below). This is, for instance, the case if the events are macroeconomic announcements or monetary policy moves. For the rest of this section we assume no autocorrelation or cross correlation.

Let $\sigma_i^2 = \text{Var}(u_{it})$ be the variance of the abnormal return of asset i . The *variance of the cross-sectional (across the n assets) average*, \bar{u}_s in (16.2), is then

$$\text{Var}(\bar{u}_s) = (\sigma_1^2 + \sigma_2^2 + \dots + \sigma_n^2) / n^2 = \sum_{i=1}^n \sigma_i^2 / n^2, \quad (16.13)$$

since all covariances are assumed to be zero. In a large sample (where the asymptotic normality of a sample average starts to kick in), we can therefore use a t -test

$$\bar{u}_s / \text{Std}(\bar{u}_s) \xrightarrow{d} N(0, 1). \quad (16.14)$$

In most applications the σ_i^2 values used in (16.13) are from the estimation window, as discussed in Section 16.2.

Remark 16.3 (*An alternative way to test \bar{u}_s , using the cross-sectional standard deviation of u_{is}) An alternative and intuitive approach to calculate $\text{Var}(\bar{u}_s)$ is to use σ_{CR}^2 / n , where where σ_{CR}^2 is the cross-sectional variance of u_{is} . In fact, it can be shown that the cross-sectional variance σ_{CR}^2 is an unbiased estimate of $\sum_{i=1}^n \sigma_i^2 / n$. This suggests that

using (16.13) and σ_{CR}^2/n are conceptually the same. (The extension to cumulative returns over q period is straightforward: just multiply the one-period variance by q .) However, σ_{CR}^2 suffers from the drawback that it is an estimate based on only n data points, so it is likely to be a noisy estimate when the number of events (n) is small. This speaks in favour of using (16.13) and a large estimation window for each of the assets.

The *cumulative abnormal return* over q period, $car_{i,q}$, can also be tested with a t -test. Since the returns are assumed to have no autocorrelation the variance of the $car_{i,q}$

$$\text{Var}(car_{i,q}) = q\sigma_i^2. \quad (16.15)$$

This variance is increasing in q since we are considering cumulative returns (not the time average of returns).

If the abnormal returns are uncorrelated across time, then the *cross-sectional average car* _{i,q} is

$$\text{Var}(\bar{car}_q) = q \text{Var}(\bar{u}_s), \quad (16.16)$$

where $\text{Var}(\bar{u}_s)$ is defined in (16.13).

Empirical Example 16.4 (*Testing CAR*) See Figure 16.2 for results on IPOs.

Example 16.5 (*Variances of abnormal returns*) If the standard deviations of the daily abnormal returns of the two firms in Example 16.2 are $\sigma_1 = 0.1$ and $\sigma_2 = 0.2$, then we have the following variances for the abnormal returns at different days

Time	Firm 1	Firm 2	Cross-sectional Average
-1	0.1^2	0.2^2	$(0.1^2 + 0.2^2)/4$
0	0.1^2	0.2^2	$(0.1^2 + 0.2^2)/4$
1	0.1^2	0.2^2	$(0.1^2 + 0.2^2)/4$

Similarly, the variances for the cumulative abnormal returns are

Time	Firm 1	Firm 2	Cross-sectional Average
-1	0.1^2	0.2^2	$(0.1^2 + 0.2^2)/4$
0	2×0.1^2	2×0.2^2	$2 \times (0.1^2 + 0.2^2)/4$
1	3×0.1^2	3×0.2^2	$3 \times (0.1^2 + 0.2^2)/4$

Example 16.6 (*Tests of abnormal returns*) By dividing the numbers in Example 16.2 by the square root of the numbers in Example 16.5 (that is, the standard deviations) we get

the test statistic for the abnormal returns

<u>Time</u>	<u>Firm 1</u>	<u>Firm 2</u>	<u>Cross-sectional Average</u>
-1	2	-0.5	0.4
0	10	10	13.4
1	1	1.5	1.8

Similarly, the variances for the cumulative abnormal returns we have

<u>Time</u>	<u>Firm 1</u>	<u>Firm 2</u>	<u>Cross-sectional Average</u>
-1	2	-0.5	0.4
0	8.5	6.7	9.8
1	7.5	6.4	9.0

Remark 16.7 (*Normalized cumulative abnormal returns**). We now consider a normalization of the results whereby we report the cumulative abnormal return from the start of the event window until period s , denoted $\text{car}(-w, s)$, minus the cumulative abnormal return up to and including the event day, denoted $\text{car}(-w, 0)$,

$$\text{car}^n(-w, s) = \text{car}(-w, s) - \text{car}(-w, 0).$$

For instance, with $(w = -2)$ we clearly have

$$\begin{aligned}\text{car}^n(-2, -2) &= u_{-2} - (u_{-2} + u_{-1} + u_0) = -(u_{-1} + u_0) \\ \text{car}^n(-2, -1) &= u_{-2} + u_{-1} - (u_{-2} + u_{-1} + u_0) = -u_0 \\ \text{car}^n(-2, 0) &= 0 \\ \text{car}^n(-2, 1) &= u_{-2} + u_{-1} + u_0 + u_1 - (u_{-2} + u_{-1} + u_0) = u_1 \\ \text{car}^n(-2, 2) &= u_{-2} + u_{-1} + u_0 + u_1 + u_2 - (u_{-2} + u_{-1} + u_0) = u_1 + u_2.\end{aligned}$$

If the abnormal returns are uncorrelated across time, then it is clear that the variances of the $\text{car}^n(-w, s)$ is zero on the event day and scales with $|s|$ for the days (fanning out from $s = 0$)

$$\text{Var}[\text{car}^n(-w, s)] = |s|\sigma^2.$$

16.3.1 When Events are Clustered

When events (for different assets or firms) occur on the same days (are clustered), then we may have to consider the possibility that the abnormal returns are correlated, especially

when we test the cross-sectional average abnormal return.

The easiest approach to handle clustered events is demonstrate that they are still unlikely to be correlated. For instance, if we use the market model for normal returns, then the abnormal returns for firms in different industries might be uncorrelated. The second easiest approach is to create a portfolio which includes all assets (firms) with an event—and use that as the (only) test asset in an event study. Alternatively, we keep the cross-sectional data on the abnormal returns, but explicitly handle the cross-sectional correlations. To illustrate that, suppose there are only two assets, so the cross-sectional average is

$$\bar{u}_s = (u_{1s} + u_{2s})/2, \quad (16.17)$$

where u_{is} is the abnormal return on asset i on day s . In general, the variance of this average is

$$\text{Var}(\bar{u}_s) = (\sigma_1^2 + \sigma_2^2 + 2\sigma_{12})/4, \quad (16.18)$$

where σ_{12} is the covariance of u_{1s} and u_{2s} . Previously we assumed that $\sigma_{12} = 0$ since the abnormal returns of the two assets refer to different calendar days. Here, we instead have to estimate σ_{12} in the estimation window and include it in the calculations. Notice that we can write this in matrix form as

$$\text{Var}(\bar{u}_s) = \begin{bmatrix} 1 \\ 1 \end{bmatrix}' \begin{bmatrix} \sigma_1^2 & \sigma_{12} \\ \sigma_{21} & \sigma_2^2 \end{bmatrix} \begin{bmatrix} 1 \\ 1 \end{bmatrix} / 4, \quad (16.19)$$

where the matrix in the middle is the variance-covariance matrix of the two returns. (It is symmetric so $\sigma_{12} = \sigma_{21}$.) With n assets, the formula becomes

$$\text{Var}(\bar{u}_s) = \mathbf{1}' \Sigma \mathbf{1} / n^2, \quad (16.20)$$

where Σ is the variance-covariance matrix of all n assets and $\mathbf{1}$ is a column (n rows) vectors filled with ones. Clearly, this is the same as summing all the elements of the variance-covariance matrix and then dividing by n^2 . We then replace $\text{Var}(\bar{u}_s)$ in (16.13) and (16.16) with (16.20). The rest of the analysis is unchanged.

16.4 Quantitative Events

Some events are not easily classified as binary variables. For instance, the effect of positive earnings surprise is likely to depend on how large the surprise is—not just if there was a positive surprise. This can be studied by regressing the abnormal return (typically

the cumulative abnormal return) on the value of the event (x_i)

$$\text{car}_{iq} = a + bx_i + \xi_i. \quad (16.21)$$

The slope coefficient is then a measure of how much the cumulative abnormal return reacts to a change of one unit of x_i .

Chapter 17

Distributions and Option Pricing

17.1 Estimating and Testing Distributions

Reference: Harvey (1989) 260, Davidson and MacKinnon (1993) 267, Silverman (1986); Mittelhammer (1996), DeGroot (1986)

This chapter presents methods for illustrating and assessing distributions. This can be applied to data, for instance, returns or to residuals or some other transformation, depending on the aim. For instance, suppose we first study the distribution of a data series of returns, R_t , and find that it has heavy tails. We may then estimate a model of time-variation in the mean and variance (denoted μ_t and σ_t^2 , respectively) and study the distribution of a standardised return

$$\tilde{R}_t = \frac{R_t - \mu_t}{\sigma_t}, \quad (17.1)$$

and perhaps find that it is much closer to being normal.

17.1.1 Histograms and Averaged Shifted Histograms

Histograms like Figure 17.1 are very useful for gauging the shape of the distribution. The histogram either shows the number of occurrences or a scaled version where the area under the histogram integrates to one (similar to a pdf).

The formal definition of a scaled histogram is: at any value x in the bin $c \pm h/2$ (for instance, for $x = 0.4$ which is in the bin 0 ± 0.5) the value is

$$\hat{f}(x) = \frac{1}{Th} \sum_{t=1}^T \delta(c - h/2 < x_t \leq c + h/2). \quad (17.2)$$

where $\delta(q)$ is an indicator function: $\delta(q) = 1$ if q is true, and $\delta(q) = 0$ otherwise.

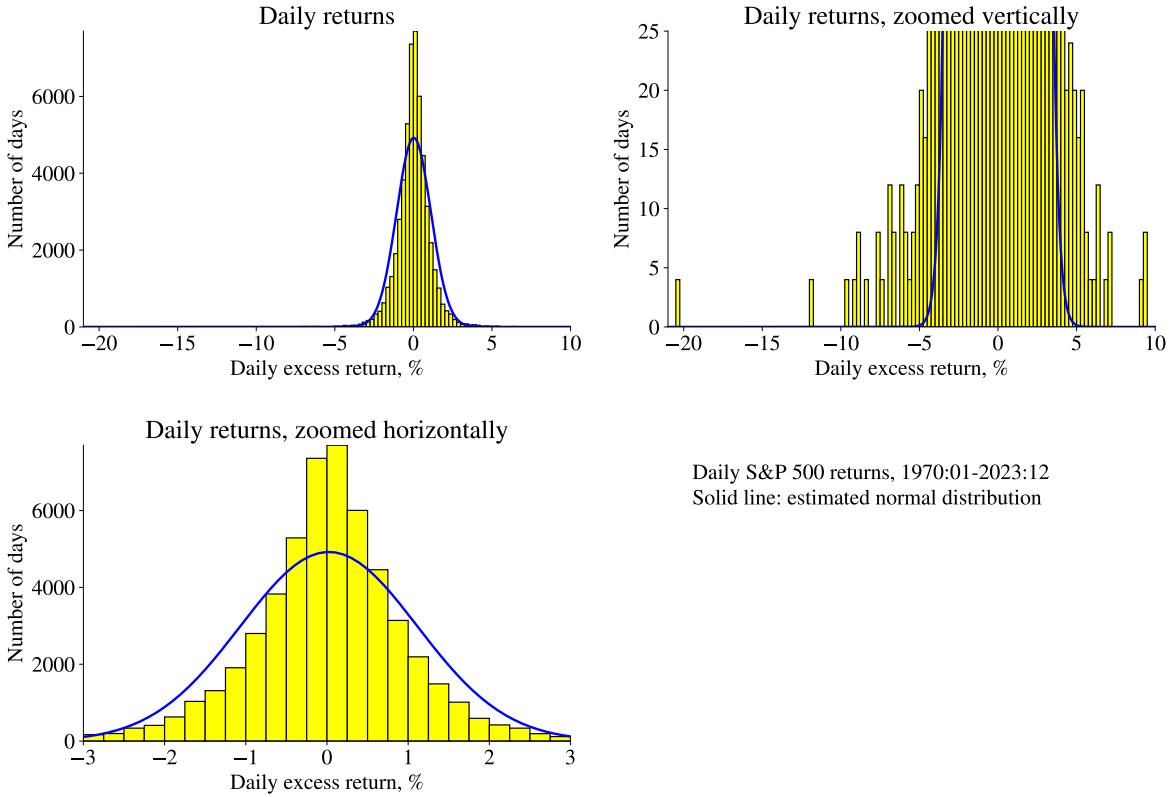


Figure 17.1: Distribution of daily S&P returns

Within each bin (different x values within the same bin), the histogram value is constant, so the $\hat{f}(x)$ is a step function. See Figure 17.2.

To calculate the histogram, we need to make two choices: the width of the bins and their location. These choice are often made to facilitate interpretation of the results (for instance, bins for returns might be $(0\%, 1\%]$, $(1\%, 2\%]$, etc), but the properties of the data set should also be considered: there are useful recommendations for how to set the bin widths as functions of the volatility of the data and the sample length (see Remark).

Remark 17.1 (*Histogram bin width**) *It is often recommended to use histogram bins that are $h = 3.5\sigma/T^{1/3}$ wide (alternatively, $h = 2 \text{IQR}/T^{1/3}$ where IQR is the interquartile range, $\text{quantile}(0.75) - \text{quantile}(0.25)$). Clearly, if c is the bin midpoint, then the bin is $c \pm h/2$.*

The choice of the location (equivalently, the bin mid points) can be tricky. See Figure 17.2 for an illustration.

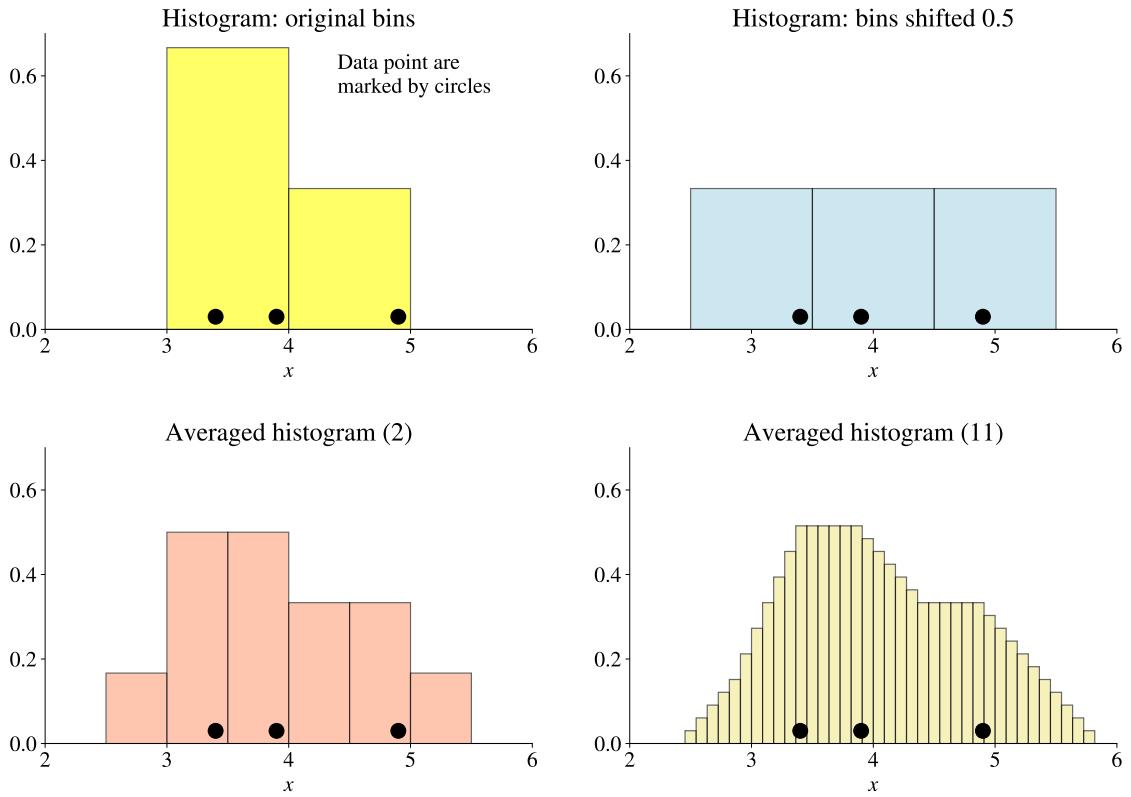


Figure 17.2: Example of histograms on a very small sample

The *averaged shifted histogram* (ASH, Scott (1985)) is a way to reduce the importance of the location choice. The idea is to calculate several histograms using different bin locations—and then average across them (at the same x value). Figure 17.2 shows the average of 2 (and also of many more) histograms.

Remark 17.2 (*Calculating the ASH **) Figure 17.3 shows the original bin $0 \pm h/2$ and also bins that are shifted $h/2$. This implicitly defines a set of smaller bins $(-h, -h/2]$, $(-h/2, 0]$ etc. The n_i indicate the number of data points in each of smaller bins. It is clear that the scaled ASH at x (which is in the original bin) equals $(n_0 + n_1 + n_{-1} + n_0)/(2hT)$. The more general expression with m shifts inside a bin (the figure show $m = 2$)

$$\hat{f}(x) = \frac{1}{mTh} \sum_{i=1-m}^{m-1} (m - |i|) n_i.$$

This can also be written

$$\hat{f}(x) = \frac{1}{Th} \sum_{i=1-m}^{m-1} (1 - |i|/m) n_i,$$

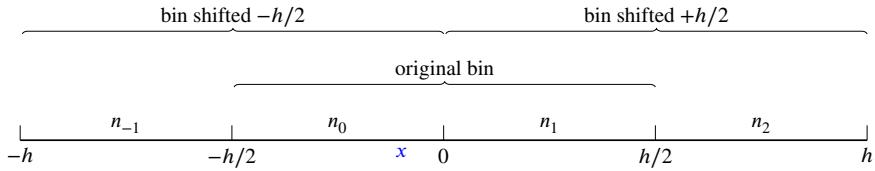


Figure 17.3: Calculation of averaged shifted histogram

which has strong similarities with a kernel density estimator (see below) with a triangular $(1 - |i|/m)$ kernel.

17.1.2 QQ Plots

A QQ plot is a way to assess if the empirical distribution conforms reasonably well to a prespecified theoretical distribution, for instance, a normal distribution where the mean and variance have been estimated from the data. The QQ plot is a scatter plot where each point shows a specific percentile (quantile) according to the empirical as well as according to the theoretical distribution. For instance, if the 2nd percentile (0.02 quantile) is at -10 in the empirical distribution, but at only -3 in the theoretical distribution, then this indicates that the two distributions have very different left tails.

Empirical Example 17.3 (*QQ plots of equity and FX returns*) See Figures 17.1 – 17.6 for illustrations.

17.1.3 Parametric Tests of a Normal Distribution

The skewness, kurtosis and Jarque-Bera test for normality are useful diagnostic tools. They are

$$\begin{array}{lll}
 & \text{Test statistic} & \text{Distribution} \\
 \text{skewness} & = \frac{1}{T} \sum_{t=1}^T \left(\frac{x_t - \mu}{\sigma} \right)^3 & N(0, 6/T) \\
 \text{kurtosis} & = \frac{1}{T} \sum_{t=1}^T \left(\frac{x_t - \mu}{\sigma} \right)^4 & N(3, 24/T) \\
 \text{Jarque-Bera} & = \frac{T}{6} \text{skewness}^2 + \frac{T}{24} (\text{kurtosis} - 3)^2 & \chi^2_2.
 \end{array} \tag{17.3}$$

This is implemented by using the estimated mean and standard deviation. The distributions stated on the right hand side of (17.3) are under the null hypothesis that x_t is iid $N(\mu, \sigma^2)$. The “excess kurtosis” is defined as the kurtosis minus 3.

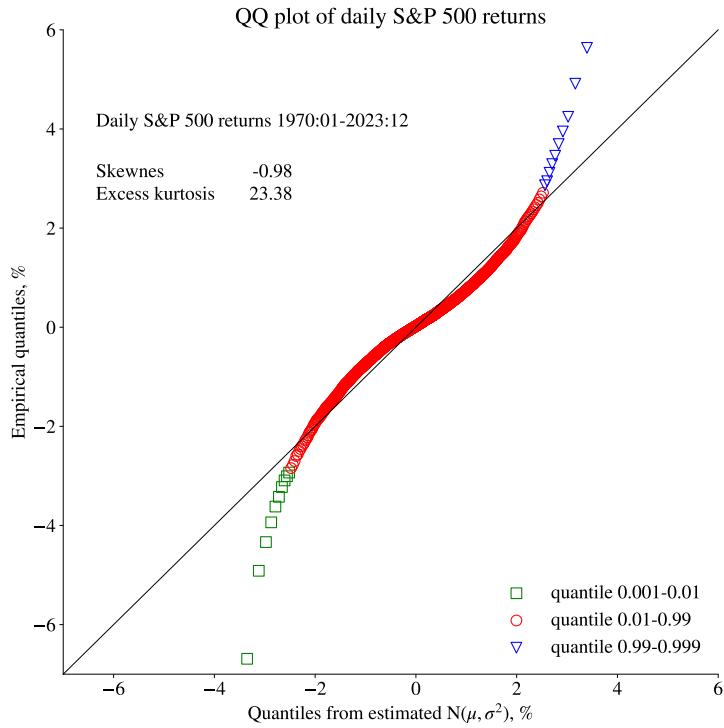


Figure 17.4: Quantiles of daily S&P returns

The intuition for the χ^2_2 distribution of the Jarque-Bera test is that both the skewness and kurtosis are, if properly scaled, $N(0, 1)$ variables. It can also be shown that they, under the null hypothesis, are uncorrelated. The Jarque-Bera test statistic is therefore a sum of the square of two uncorrelated $N(0, 1)$ variables, which has a χ^2_2 distribution.

17.1.4 Nonparametric Tests of General Distributions

The *Kolmogorov-Smirnov* test is designed to test if an empirical distribution function, $\text{EDF}(x)$, conforms with a theoretical cdf, $F(x)$. The empirical distribution function is defined as the fraction of observations which are less or equal to x , that is,

$$\text{EDF}(x) = \frac{1}{T} \sum_{t=1}^T \delta(x_t \leq x). \quad (17.4)$$

The $\text{EDF}(x_t)$ and $F(x_t)$ are often plotted against the sorted (in ascending order) sample $\{x_t\}_{t=1}^T$. See Figure 17.7 for an illustration.

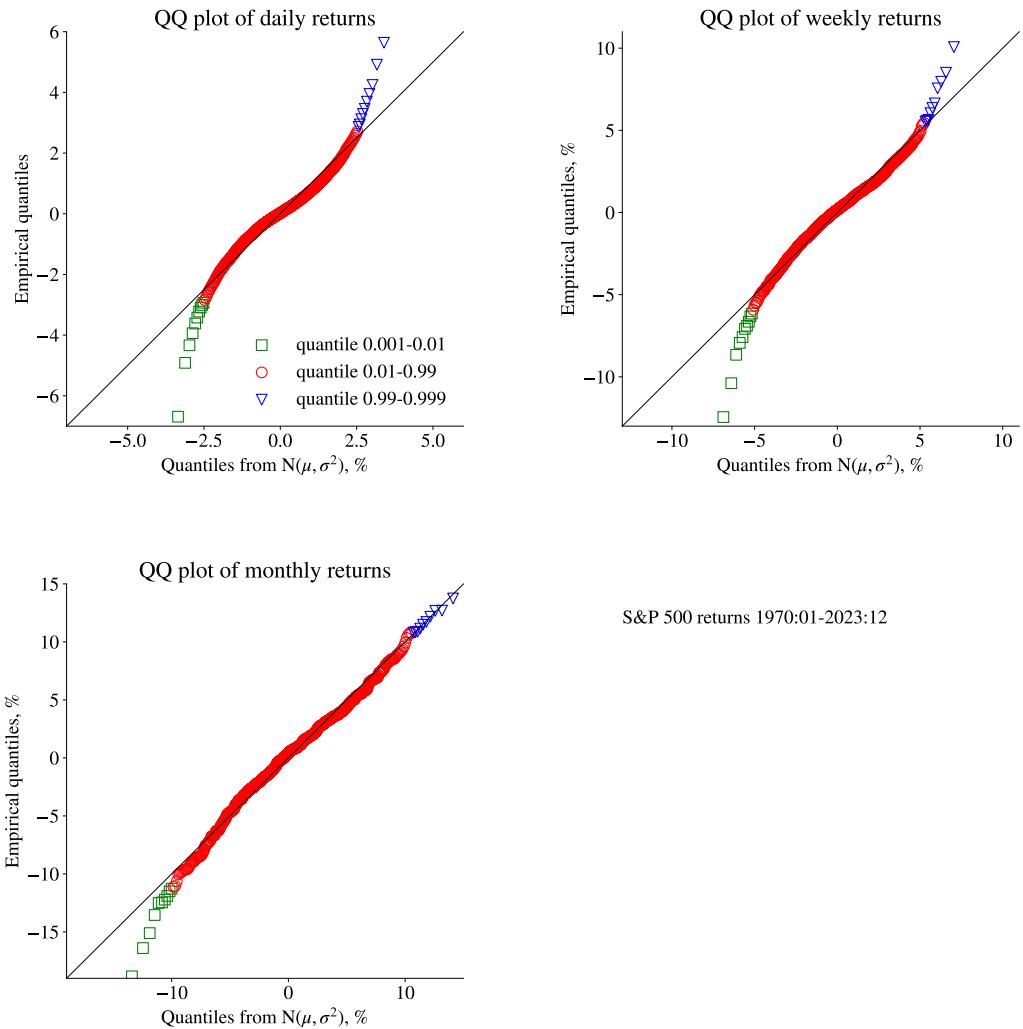


Figure 17.5: Distribution of S&P returns (different horizons)

Define the absolute value of the maximum distance

$$D = \max_x |\text{EDF}(x) - F(x)|. \quad (17.5)$$

This max is across all possible x values (not just the observed data), but there is a simple way to identify the maximum (see the Remark below). See Figure 17.8 for an illustration.

Remark 17.4 (*Calculating the D statistic**) The maximum in in (17.5) must be at or just before a data point (where the EDF jumps up). Let (z_1, \dots, z_T) be the sorted x sample. At a data point calculate $|\text{EDF}(z_i) - F(z_i)|$ as $|i/T - F(z_i)|$. Just before a data point, the theoretical cdf is (almost) $F(z_i)$ and the EDF is $(i-1)/T$, so calculate $|((i-1)/T) - F(z_i)|$.

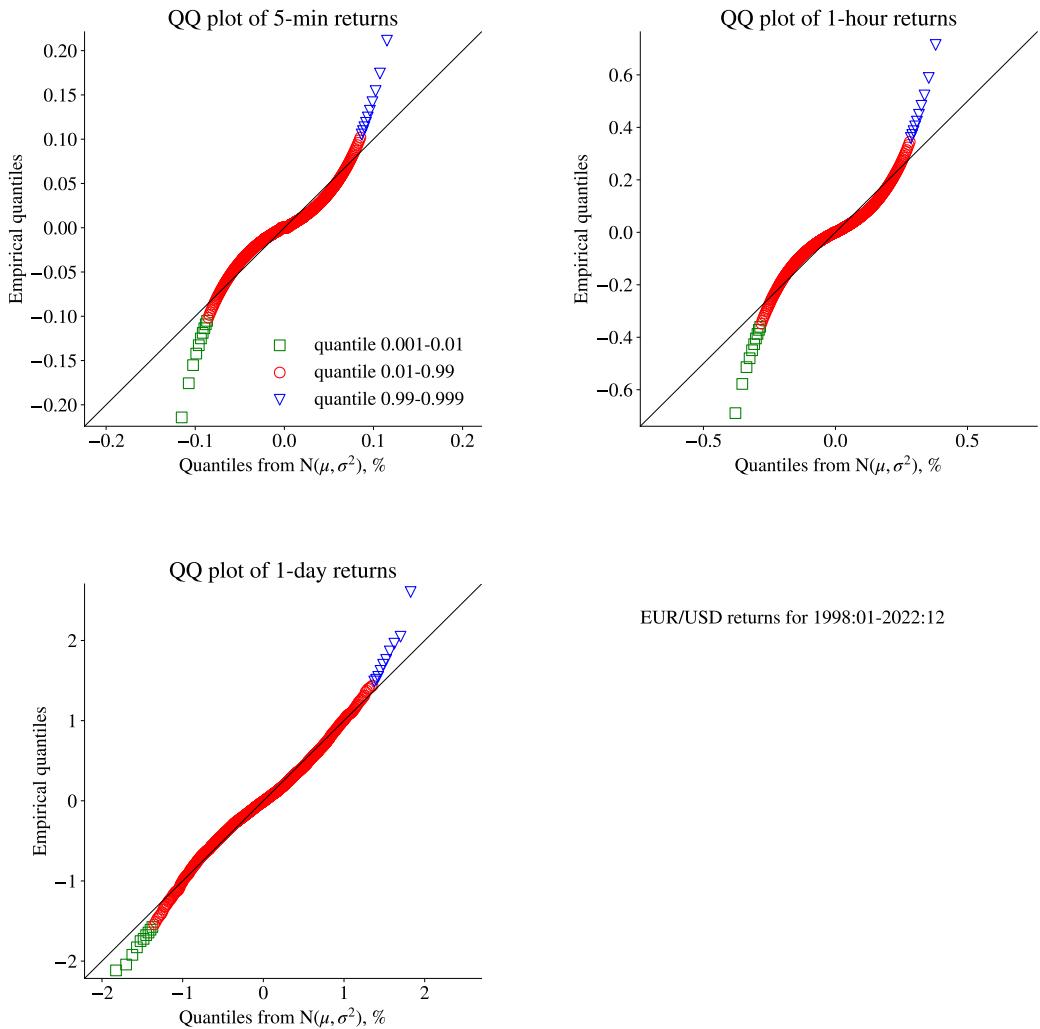


Figure 17.6: Distribution of exchange rate returns (different horizons)

Find the largest value across the two numbers and then across the sample.

We reject the null hypothesis that $\text{EDF}(x) = F(x)$ if $\sqrt{T}D > c$, where c is a critical value ((1.36, 1.48, 1.63) are the critical values on the (5%, 2.5%, 1%) significance levels), see Mittelhammer (1996) 10. Instead, if the $F(x_t)$ distribution is $N(\mu, \sigma^2)$ with estimated parameters, then the critical values should be changed to (0.80, 0.89, 1.03).

Remark 17.5 (*K-S test for comparing two EDFs**) Let $\text{EDF}_1(x)$ be the edf for variable 1 (from a sample with T_1 observations) and $\text{EDF}_2(x)$ for variable 2 (from a sample with T_2 observations). Define $D = \max_x |\text{EDF}_1(x) - \text{EDF}_2(x)|$ and reject the null hypothesis that they are from the same distribution if $\sqrt{T_1 T_2 / (T_1 + T_2)} D > c$ where c is the same

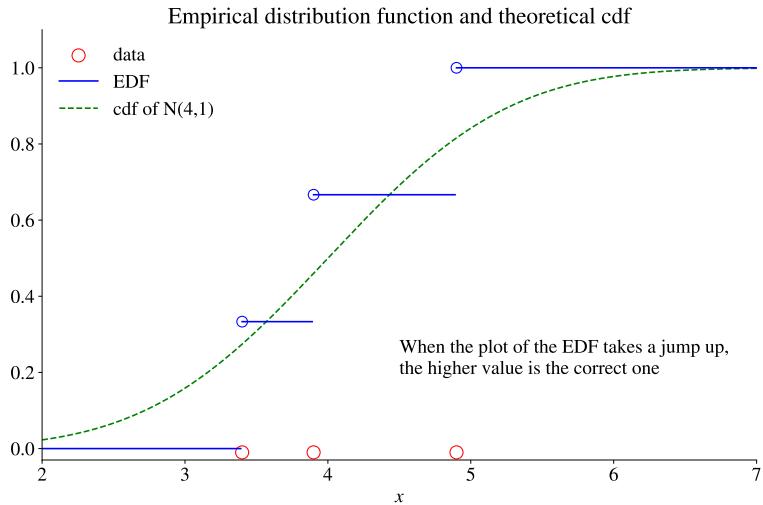


Figure 17.7: Example of empirical distribution function

critical value as before. To find the maximum, try all $x = \text{data}_i$ values from the union of the two samples.

Pearson's χ^2 test does the same thing as the K-S test but for a discrete distribution. Suppose you have K categories with N_i values in category i . The theoretical distribution predicts that the fraction p_i should be in category i , with $\sum_{i=1}^K p_i = 1$. Then

$$\sum_{i=1}^K \frac{(N_i - Tp_i)^2}{Tp_i} \sim \chi^2_{K-1}. \quad (17.6)$$

There is a corresponding test for comparing two empirical distributions.

17.1.5 Kernel Density Estimation

Reference: Silverman (1986)

A histogram is just a count of the relative number of observations that fall in (pre-specified) non-overlapping intervals. If we also divide by the width of the interval, then the area under the histogram is unity, so this scaled histogram can be interpreted as a density function. The scaled histogram at the point x (say, $x = 2.3$) can actually be

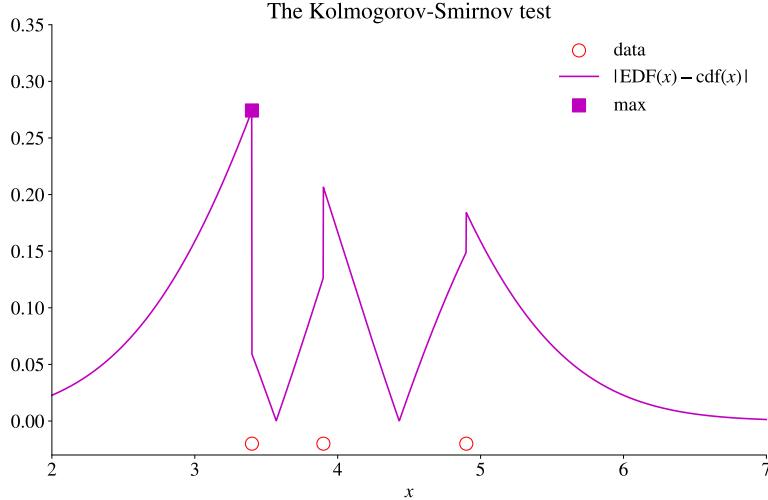


Figure 17.8: K-S test

defined as

$$\hat{f}(x) = \frac{1}{T} \sum_{t=1}^T \frac{1}{h} \delta\left(\left|\frac{x_t - x}{h}\right| \leq 1/2\right), \text{ where} \quad (17.7)$$

$$\delta(q) = \begin{cases} 1 & \text{if } q \text{ is true} \\ 0 & \text{else.} \end{cases}$$

In this case, the intervals (“bins”) are h wide around a point x : $x - h/2$ to $x + h/2$.

In fact, that $\frac{1}{h} \delta(|x_t - x| \leq h/2)$ is the pdf value of a uniformly distributed variable (over the interval $x - h/2$ to $x + h/2$). This shows that our estimate of the pdf (here: the histogram) can be thought of as a average of hypothetical pdf values of the data in the neighbourhood of x .

However, we can gain efficiency and get a smoother (across x values) estimate by using another density function than the uniform. In particular, using a density function that tapers off continuously instead of suddenly dropping to zero (as the uniform density does) improves the properties. In fact, a normal pdf is often used. The kernel density estimator of the pdf at some point x is then

$$\hat{f}(x) = \frac{1}{T} \sum_{t=1}^T \frac{1}{h\sqrt{2\pi}} \exp\left[-\frac{1}{2}\left(\frac{x_t - x}{h}\right)^2\right]. \quad (17.8)$$

Notice that the function in the summation is the density function of a $N(x, h^2)$ distribution. See Figure 17.10 for an example of the weights in the calculation.

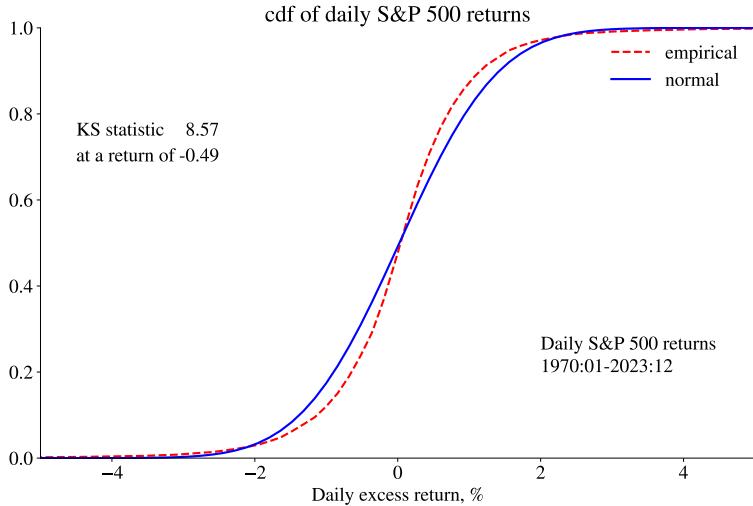


Figure 17.9: K-S test

The value $h = 1.06 \text{Std}(x_t)T^{-1/5}$ is sometimes recommended, since it can be shown to be the optimal choice (in MSE sense) if data is normally distributed and the gaussian kernel is used. A more robust choice is to replace $\text{Std}(x_t)$ in the formula by $\min(\text{Std}(x_t), \text{IQR}/1.34)$, where IQR is the inter-quartile range.

Empirical Example 17.6 (*Kernel density estimate of equity returns*) See Figure 17.11.

It can be shown that (with iid data and a Gaussian kernel) the asymptotic distribution is

$$\sqrt{Th}[\hat{f}(x) - f(x)] \xrightarrow{d} N\left[0, \frac{1}{2\sqrt{\pi}}f(x)\right]. \quad (17.9)$$

We can also estimate multivariate pdfs. Let x_t be a $d \times 1$ matrix and $\hat{\Omega}$ be the estimated covariance matrix of x_t . We can then estimate the pdf at a point x by using a multivariate Gaussian kernel as

$$\hat{f}(x) = \frac{1}{T} \sum_{t=1}^T \frac{1}{(2\pi)^{d/2} |H^2 \hat{\Omega}|^{1/2}} \exp\left[-\frac{1}{2}(x_t - x)'(H^2 \hat{\Omega})^{-1}(x_t - x)\right]. \quad (17.10)$$

Notice that the function in the summation is the (multivariate) density function of a $N(x, H^2 \hat{\Omega})$ distribution. The value $H = 1.06T^{-1/(d+4)}$ is sometimes recommended.

Remark 17.7 ((17.10) with $d = 1$) With just one variable, (17.10) becomes

$$\hat{f}(x) = \frac{1}{T} \sum_{t=1}^T \frac{1}{H \text{Std}(x_t) \sqrt{2\pi}} \exp\left[-\frac{1}{2}\left(\frac{x_t - x}{H \text{Std}(x_t)}\right)^2\right],$$

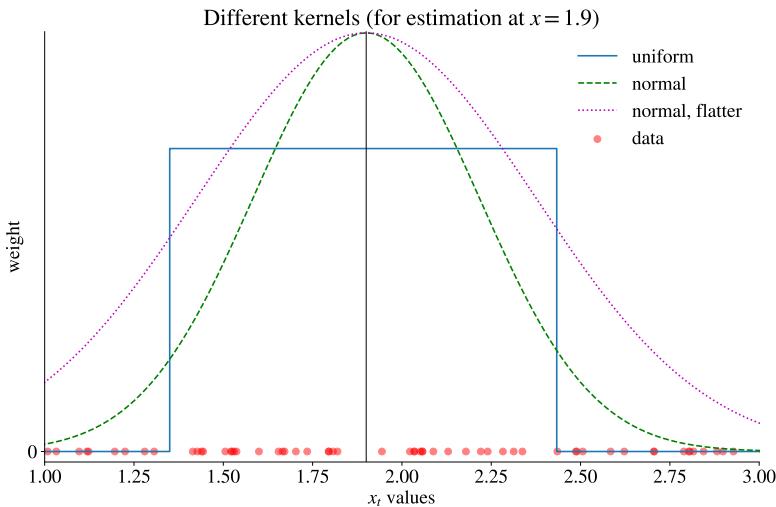


Figure 17.10: Different weighting functions for kernel density estimate

which is the same as (17.8) if $h = H \text{Std}(x_t)$.

Empirical Example 17.8 (*Kernel density estimates of equity returns after buy/sell signals*) See Figures 17.12–17.13 for an illustration. See Lo, Mamaysky, and Wang (2000) for an early application.

17.2 Option Pricing

Reference: Hull (2006) 19, Elton, Gruber, Brown, and Goetzmann (2003) 22 or Bodie, Kane, and Marcus (2005) 21, Taylor (2005) 13–14; Campbell, Lo, and MacKinlay (1997) 9; Gourieroux and Jasiak (2001) 12–13

17.2.1 The Black-Scholes Option Price Model

A European call option contract traded (contracted and paid) in t may stipulate that the buyer of the contract has the right (not the obligation) to buy one unit of the underlying asset (from the issuer of the option) in $t + m$ at the strike price K . The option payoff (in $t + m$) is clearly $\max(0, S_{t+m} - K)$, where S_{t+m} is the asset price at expiration.

The Black-Scholes formula for a European call option price on an underlying asset

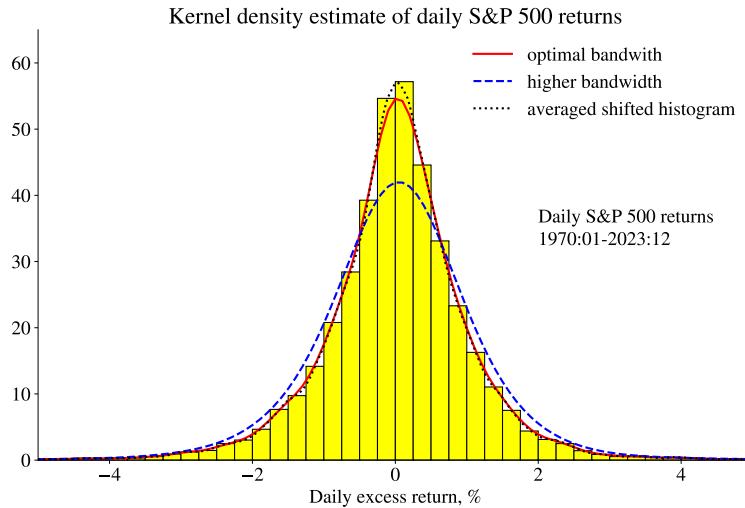


Figure 17.11: Distribution of stock returns

without dividends (until $t + m$) is

$$C = S\Phi(d_1) - e^{-ym}K\Phi(d_2), \text{ where} \quad (17.11)$$

$$d_1 = \frac{\ln(S/K) + (y + \sigma^2/2)m}{\sigma\sqrt{m}} \text{ and } d_2 = d_1 - \sigma\sqrt{m},$$

where S_t is the price of the underlying asset in period t , y is the continuously compounded interest rate, and σ^2 is the annualised variance of the return of the underlying asset. Also, $\Phi()$ is the cumulative distribution function of a standard normal, $N(0, 1)$, variable. The formula for a put option, which gives the right to sell the underlying for K , is $P = e^{-ym}K\Phi(-d_2) - S\Phi(-d_1)$.

It is straightforward that the call option price is increasing in the volatility and decreasing in the strike price.

The B-S formula can be derived from several stochastic processes of the underlying asset price, but they all imply that the distribution of log asset price in $t + m$ (conditional on the information in t) is normal with some mean α (not important for the option price) and the variance $m\sigma^2$

$$\ln S_{t+m} \sim N(\alpha, m\sigma^2). \quad (17.12)$$

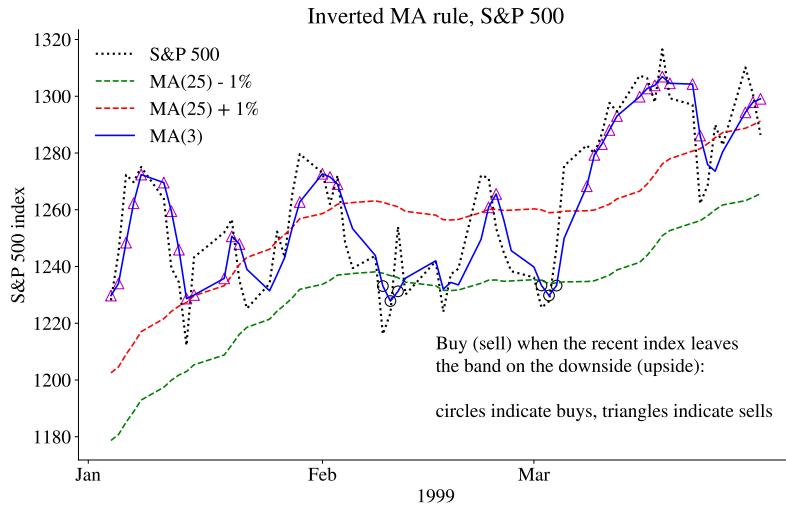


Figure 17.12: Examples of trading rules

17.2.2 Estimation of the Parameters in Black-Scholes

This section discusses how to estimate the volatility, since it is the key to option pricing. We will assume that we have data for observations in $\tau = 1, 2, \dots, n$. This could be 5-minute intervals, days, weeks or whatever. Let the time between τ and $\tau + 1$ be h years. For instance, with daily data $h = 1/252$ (if only trading days are counted), but with weekly data $h = 1/52$.

Typically, a traditional estimate of the return variance is employed. Let $r_\tau = \ln(S_\tau / S_{\tau-1})$ denote the return and calculate

$$\hat{s}^2 = \sum_{\tau=1}^n (r_\tau - \bar{r})^2 / n, \text{ where } \bar{r} = \sum_{\tau=1}^n r_\tau / n, \quad (17.13)$$

and then annualise as

$$\hat{\sigma}^2 = \hat{s}^2 / h. \quad (17.14)$$

If we have high frequency data on returns, then we can choose which sampling frequency to use in (17.13). If the returns were iid normally distributed, then

$$\text{Var}(\hat{\sigma}^2) = 2\sigma^4 / n, \quad (17.15)$$

which suggests using as *many* observations as possible (high frequency data), while a sample that stretches over a long period is less important. However, this result relies heavily on the iid assumption. In particular, high-frequency returns are often characterised by

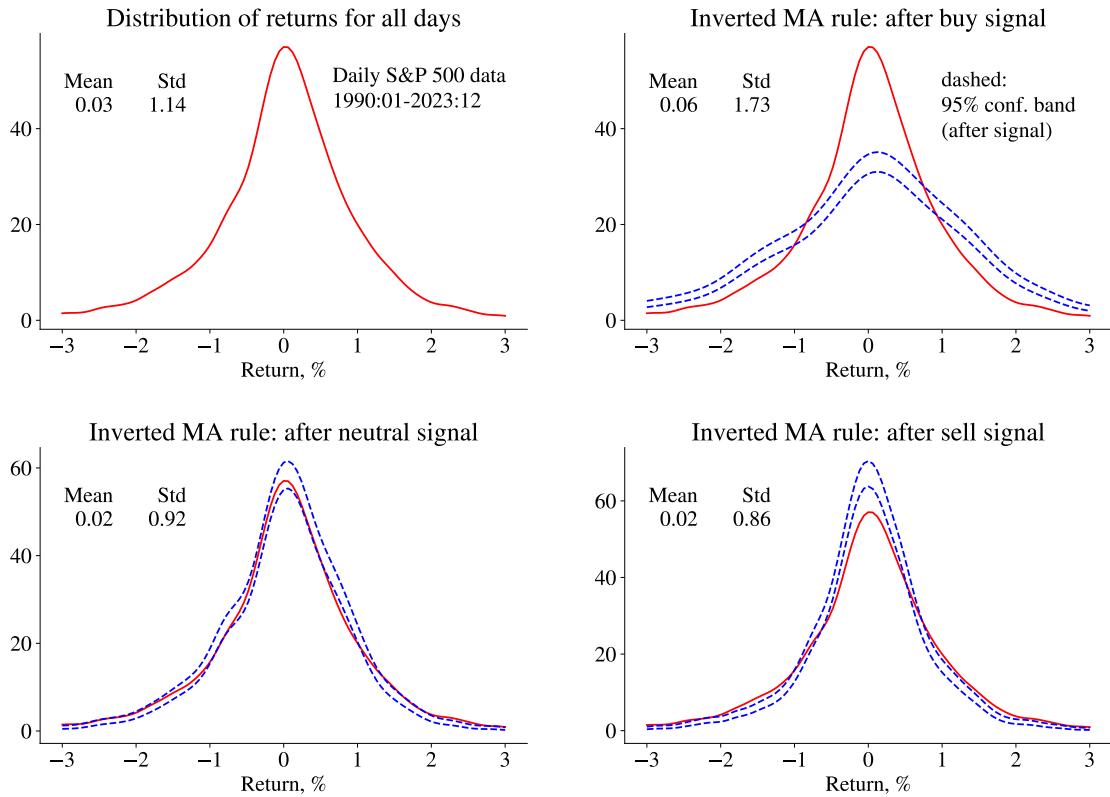


Figure 17.13: Examples of trading rules

heavy tails, autocorrelation (“bid-ask” bounce, among other things) and heteroskedasticity, which need to be filtered out before estimation. Unless that is done, daily returns might be a safer bet.

Proof (of (17.15)) In a large sample, $\text{Var}(\hat{s}^2) = 2s^4/n$, so $\text{Var}(\hat{\sigma}^2) = 2s^4/(nh^2)$, but $s^2 = \sigma^2 h$. \square

17.2.3 Testing Black-Scholes: Implied Volatility

The pricing formula (17.11) contains only one unknown parameter: the standard deviation σ in the distribution of $\ln S_{t+m}$, see (17.12). With data on the option price, spot price, the interest rate, and the strike price, we can solve for standard deviation: the *implied volatility*.

We can solve for one implied volatility for each available strike price. If the Black-Scholes formula is correct, that is, if the assumption in (17.12) is correct, then these volatilities should be *the same across strike prices*—and it should also be *constant over*

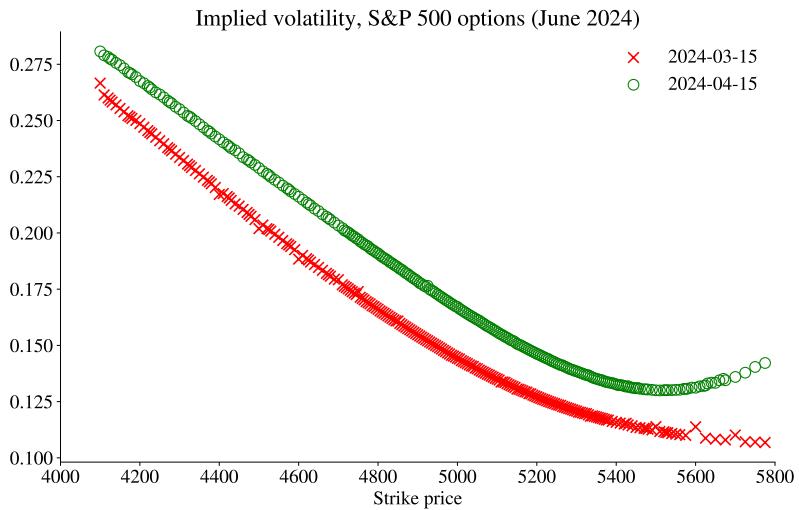


Figure 17.14: Implied volatilities of S&P 500 options, selected dates

time.

Empirical Example 17.9 (*Implied volatility for S&P 500 options*) See Figure 17.14 for volatility smiles for a few trading days, and Figure 17.15 for a summary of the dynamics over time (S&P 500 options).

In contrast, it is often found that the implied volatility is a “smirk” (equity markets) or “smile” (FX markets) shaped function of the strike price. One possible explanation for a smirk shape is that market participants assign a higher probability to a dramatic drop in share prices than a normal distribution suggests. A possible explanation for a smile shape is that the (perceived) distribution of the future asset price has more probability mass in the tails (“fat tails”) than a normal distribution has. In addition, the implied volatilities seems to move considerably over time. Together, this questions some of the key assumptions in the Black-Scholes model (Heston and Nandi (2000) and Duan (1995) have suggested models to accomodate this.)

Empirical Example 17.10 (*VIX*) See Figure 17.16 for an illustration of how VIX (an index of 1-month S&P 500 implied volatility) has changed over time.

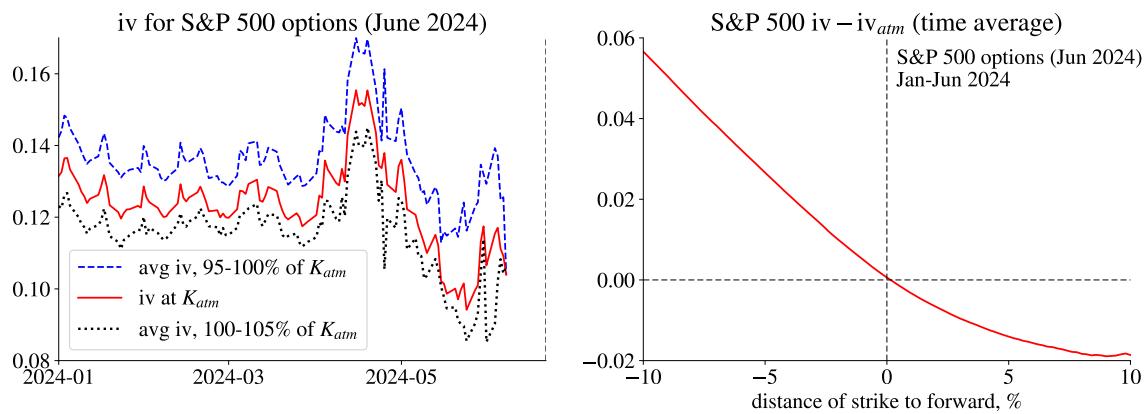


Figure 17.15: Implied volatilities

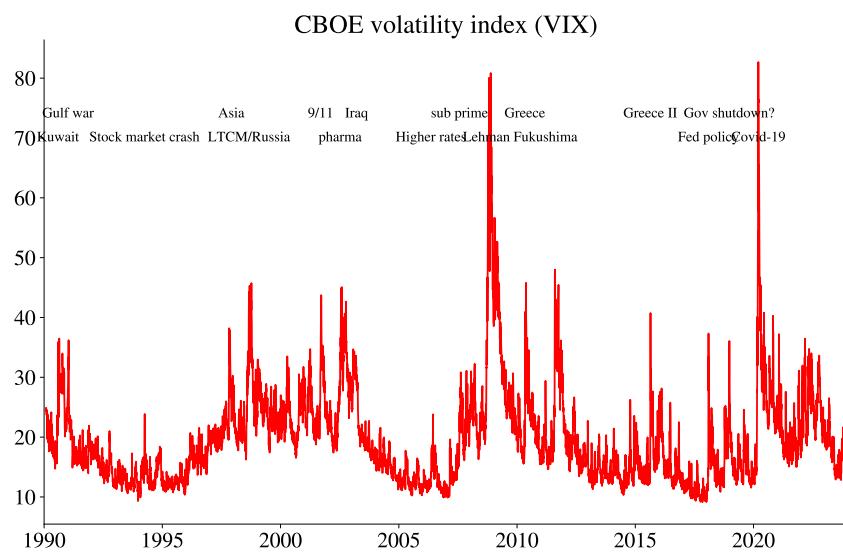


Figure 17.16: CBOE VIX, summary measure of implied volatilities (30 days) on US stock markets

Chapter 18

Maximum Likelihood Estimation

Reference: Verbeek (2012) 6

18.1 Maximum Likelihood

Maximum likelihood estimation (MLE) fits a distribution to (some transformation of) data by choosing the parameters of the distribution (for instance, mean and variance) so as to maximise the overlap of the fitted distribution and data. See Figure 18.1 for an example.

Implementing MLE involves two main steps: (1) specify the likelihood function; (2) maximize it by choosing the parameter values. This estimator (estimation method) has very nice properties, provided the basic distributional assumptions are correct, that is, if we maximize the right likelihood function. In that case, MLE is typically the most efficient/precise estimators (at least in very large samples). ML also provides a coherent framework for testing hypotheses (including the Wald, LM, and LR tests). In addition, MLE is a way to construct a new estimator when there is no existing method that is tailor made for your model.

To understand the principle of maximum likelihood estimation, consider the following examples.

18.1.1 Example: Estimating the Mean with ML

Suppose we know $x_t \sim N(\mu, \sigma^2)$, but we don't know the value of μ (for now, assume we know the variance). Since x_t is a random variable, there is a probability of every observation and the density function of x_t is

$$L_t = \text{pdf}(x_t) = \frac{1}{\sqrt{2\pi\sigma^2}} \exp\left[-\frac{1}{2} \frac{(x_t - \mu)^2}{\sigma^2}\right], \quad (18.1)$$

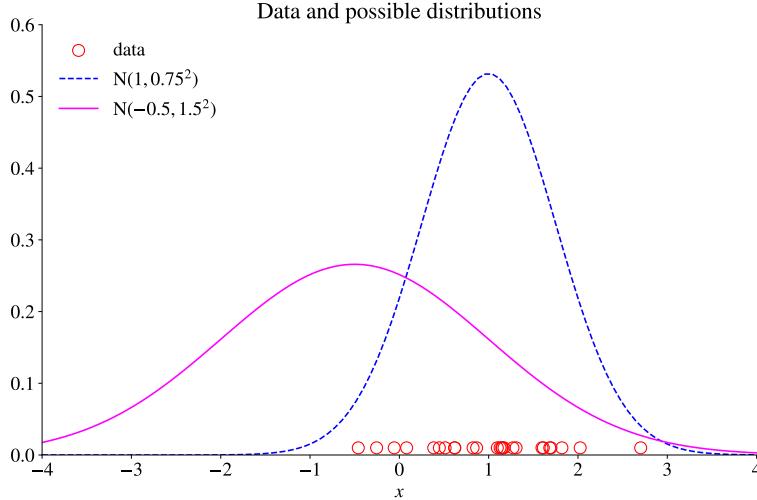


Figure 18.1: Example of data and possible distributions

where L stands for “likelihood” and L_t denotes that this is the contribution of observation t . The basic idea of maximum likelihood estimation (MLE) is to pick model parameters to make the observed data have the highest possible probability. In case we had only observation t in our sample, we would get $\hat{\mu} = x_t$. This is the maximum likelihood estimator for this trivial sample.

What if there are T observations, x_1, x_2, \dots, x_T ? In the simplest case where x_i and x_j are *independent*, then the joint pdf is just the product of the individual pdfs (for instance, $\text{pdf}(x_i, x_j) = \text{pdf}(x_i) \text{pdf}(x_j)$) so

$$L = \text{pdf}(x_1) \times \text{pdf}(x_2) \times \dots \times \text{pdf}(x_T) \quad (18.2)$$

$$= (2\pi\sigma^2)^{-T/2} \exp\left[-\frac{1}{2}\left(\frac{(x_1 - \mu)^2}{\sigma^2} + \frac{(x_2 - \mu)^2}{\sigma^2} + \dots + \frac{(x_T - \mu)^2}{\sigma^2}\right)\right] \quad (18.3)$$

We want to maximize L with respect to μ . We clearly get the same result if we instead maximize $\ln L$ (since the logarithmic function is an increasing monotone function), which is sometimes easier. Therefore, take logs (to get the *log likelihood function*)

$$\ln L = \sum_{t=1}^T \ln L_t, \text{ where} \quad (18.4)$$

$$\ln L_t = -\frac{1}{2} \ln(2\pi) - \frac{1}{2} \ln(\sigma^2) - \frac{1}{2\sigma^2} (x_t - \mu)^2. \quad (18.5)$$

See Figure 18.2 for an illustration. For instance, the figure shows that a distribution centered on $\mu = 1.4$ gives a higher pdf for a data point $x_t = 1.4$ than a distribution

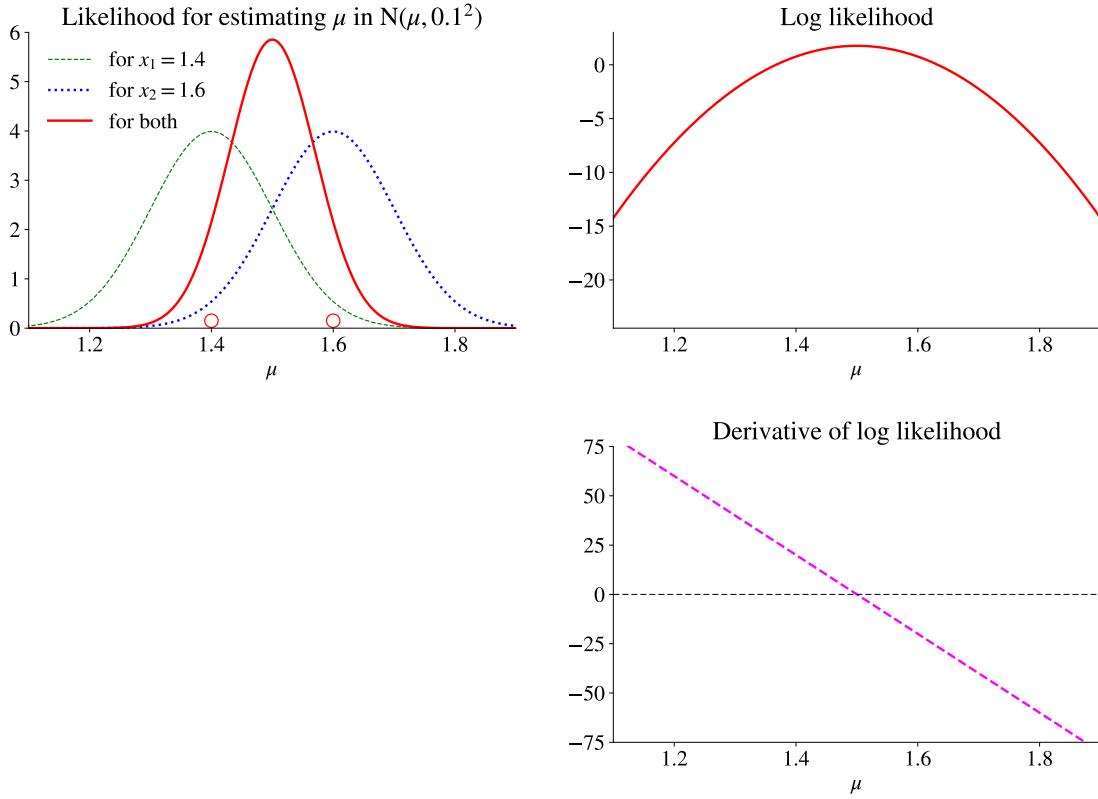


Figure 18.2: Likelihood function for estimating a sample mean

with $\mu = 1.6$. However, for another x_t value, another μ might be better. For a sample (here with 2 data points), the optimal μ is a compromise.

The derivative with respect to μ is

$$\frac{\partial \ln L}{\partial \mu} = \frac{1}{\sigma^2} [(x_1 - \mu) + (x_2 - \mu) + \dots + (x_T - \mu)]. \quad (18.6)$$

To maximize the likelihood function, find the value of $\hat{\mu}$ that makes $\partial \ln L / \partial \mu = 0$. Clearly, that is the usual sample average

$$\hat{\mu} = (x_1 + x_2 + \dots + x_T) / T. \quad (18.7)$$

Remark 18.1 (*Correlated data**) Suppose now that x_t is correlated with x_{t-1} . We would then replace pdf(x_t) in (18.2)–(18.3) by the conditional density function pdf($x_t | x_{t-1}$). In practice, this means that we need to model/estimate also the mechanism for the correlation. For instance, if x_t is a MA(1) process, $x_t = \mu + \varepsilon_t + \theta \varepsilon_{t-1}$ where ε_t is iid $N(0, \sigma^2)$, then $\varepsilon_t = x_t - \mu - \theta \varepsilon_{t-1}$. Assuming $\varepsilon_0 = 0$ (and values of (μ, σ^2, θ)) allows us to

calculate $\ln L_t = -\ln(2\pi)/2 - \ln(\sigma^2)/2 - \varepsilon_t^2/(2\sigma^2)$. Maximising $\ln L = \sum_{t=1}^T \ln L_t$ with respect to (μ, σ^2, θ) gives the MLE.

18.1.2 Example: Estimating the Variance with ML

To instead estimate the variance (now assuming you know the mean μ), use (18.4) and find the value σ^2 that makes $\partial \ln L / \partial \sigma^2 = 0$

$$\begin{aligned} 0 &= \frac{\partial \ln L}{\partial \sigma^2} \\ &= -\frac{T}{2} \frac{1}{\sigma^2} + \frac{1}{2(\sigma^2)^2} [(x_1 - \mu)^2 + (x_2 - \mu)^2 + \dots + (x_T - \mu)^2], \end{aligned} \quad (18.8)$$

so

$$\hat{\sigma}^2 = \frac{1}{T} [(x_1 - \mu)^2 + (x_2 - \mu)^2 + \dots + (x_T - \mu)^2]. \quad (18.9)$$

This is clearly the usual formula for a sample variance, although we divide by T , not by $T - 1$.

18.1.3 MLE of a Regression

To apply this idea to a (multiple) regression model

$$y_t = \beta' x_t + u_t, \quad (18.10)$$

we assume that u_t is iid $N(0, \sigma^2)$. The probability density function of u_t is then

$$\text{pdf}(u_t) = \frac{1}{\sqrt{2\pi\sigma^2}} \exp(-\frac{1}{2}u_t^2/\sigma^2). \quad (18.11)$$

Since the errors are independent, we get the joint pdf of the u_1, u_2, \dots, u_T by multiplying the marginal pdfs of each of the errors

$$\begin{aligned} L &= \text{pdf}(u_1) \times \text{pdf}(u_2) \times \dots \times \text{pdf}(u_T) \\ &= (2\pi\sigma^2)^{-T/2} \exp\left[-\frac{1}{2}\left(\frac{u_1^2}{\sigma^2} + \frac{u_2^2}{\sigma^2} + \dots + \frac{u_T^2}{\sigma^2}\right)\right]. \end{aligned} \quad (18.12)$$

We divide by the same σ^2 in all terms, since we assumed iid residuals—which implies (among other things) that the variance is the same for all observations.

Substitute $y_t - \beta' x_t$ for u_t and take logs to get the log likelihood function of the

sample

$$\ln L = \sum_{t=1}^T \ln L_t, \text{ where} \quad (18.13)$$

$$\ln L_t = -\frac{1}{2} \ln(2\pi) - \frac{1}{2} \ln(\sigma^2) - \frac{1}{2\sigma^2} (y_t - \beta' x_t)^2. \quad (18.14)$$

Suppose (for simplicity) that we happen to know the value of σ^2 . It is then clear that this likelihood function is maximized by minimizing the last term, which is proportional to the sum of squared errors: LS is ML when the errors are iid normally distributed (but only then). (This holds also when we do not know the value of σ^2 —just slightly messier to show it.) See Figure 18.3.

Example 18.2 Consider the regression model $y_t = \beta_1 x_t + u_t$, where we (happen to) know that $u_t \sim N(0, 1)$. Suppose we have the following data

<u>t</u>	<u>x</u>	<u>y</u>
1	-1	-1.5
2	0	-0.6
3	1	2.1

With $\beta_1 = 1.6$ we get

<u>t</u>	<u>u_t</u>	<u>u_1^2</u>	<u>$\ln \text{pdf}(u_1)$</u>
1	$-1.5 - \mathbf{1.6} \times (-1) = 0.1$	0.01	-0.924
2	$-0.6 - \mathbf{1.6} \times 0 = -0.6$	0.36	-1.099
3	$2.1 - \mathbf{1.6} \times 1 = 0.5$	0.25	-1.044
<i>sum</i>	0	0.62	-3.067

With $\beta = 1.8$ and $\beta = 2.0$ we instead get

<u>t</u>	<u>u_t</u>	<u>u_1^2</u>	<u>$\ln \text{pdf}(u_1)$</u>
1	$-1.5 - \mathbf{1.8} \times (-1) = 0.3$	0.09	-0.964
2	$-0.6 - \mathbf{1.8} \times 0 = -0.6$	0.36	-1.099
3	$2.1 - \mathbf{1.8} \times 1 = 0.3$	0.09	-0.964
<i>sum</i>	0	0.54	-3.027

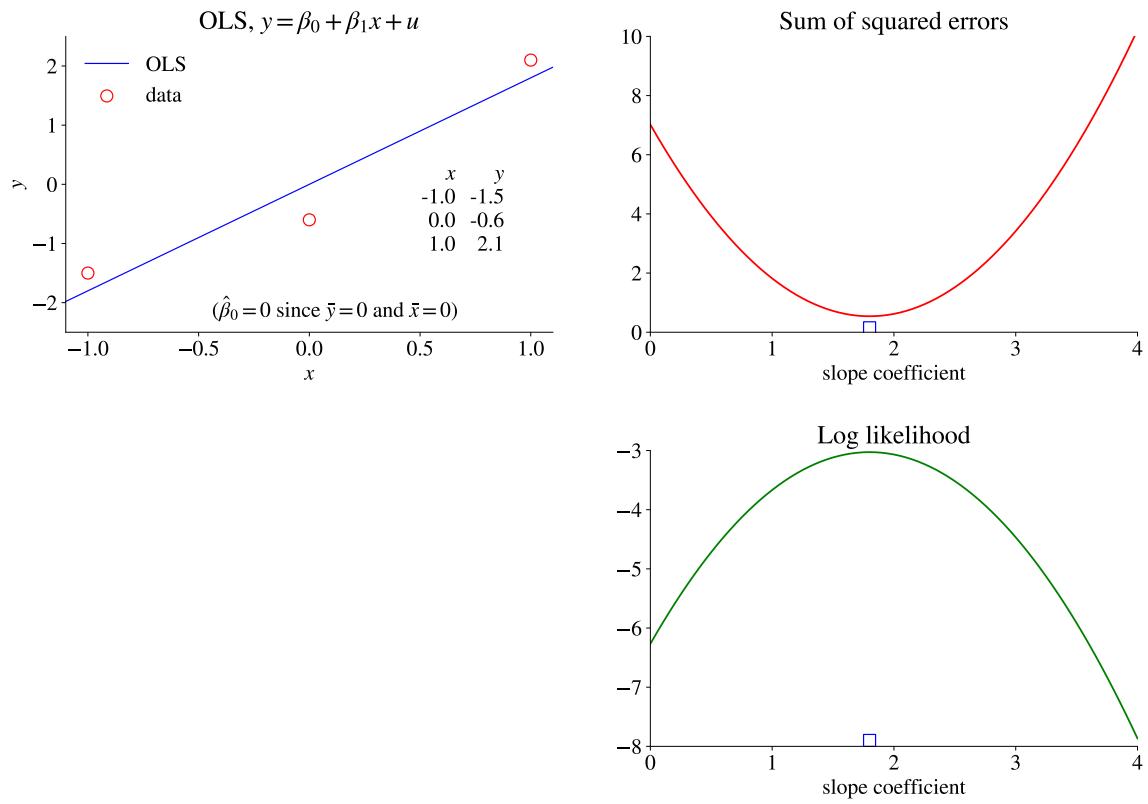


Figure 18.3: Example of OLS and ML estimation

t	u_t	u_1^2	$\ln \text{pdf}(u_1)$
1	$-1.5 - 2.0 \times (-1) = 0.5$	0.25	-1.044
2	$-0.6 - 2.0 \times 0 = -0.6$	0.36	-1.099
3	$2.1 - 2.0 \times 1 = 0.1$	0.01	-0.924
sum	0	0.62	-3.067

Among these alternatives, $\beta = 1.8$ has the highest log likelihood value (it is actually the optimum). See Figure 18.3.

18.1.4 MLE of a Regression with GARCH(1,1) Errors

Consider a regression model where the residuals are uncorrelated across time, but have time-varying volatility

$$y_t = b'x_t + u_t, \text{ where } u_t \text{ is } N(0, \sigma_t^2). \quad (18.15)$$

The variance follows the GARCH(1,1) process

$$\sigma_t^2 = \omega + \alpha u_{t-1}^2 + \beta \sigma_{t-1}^2. \quad (18.16)$$

(It is assumed that $\omega > 0$; $\alpha, \beta \geq 0$; and $\alpha + \beta < 1$.)

To estimate this model (that is, the parameters in $(b, \omega, \alpha, \beta)$), we could use a numerical optimization routine to maximize the log likelihood function

$$\ln L = \sum_{t=1}^T L_t, \text{ where } L_t = -\frac{1}{2} \ln(2\pi) - \frac{1}{2} \ln \sigma_t^2 - \frac{1}{2\sigma_t^2} u_t^2, \quad (18.17)$$

where u_t is calculated from (18.15) and σ_t^2 from (18.16). This is very similar to the linear regression (18.13)–(18.14), except that there is a time-subscript (and model for) σ_t^2 .

The optimization routine searches for the values of $(b, \omega, \alpha, \beta)$ that makes the value of the log likelihood function as large as possible. (However, it may be necessary to impose the parameter restrictions mentioned above.)

Empirical Example 18.3 (*MLE of a GARCH model*) See Figure 18.4 for a MLE of a GARCH(1,1) model.

18.2 Key Properties of MLE

There are no general results on small-sample properties of MLE: it can be biased or not.

In contrast, MLE has very nice asymptotic (large-sample) properties, provided we maximize the right likelihood function. If so, then:

1. MLE is consistent
2. MLE is the most efficient/precise estimator, at least asymptotically (efficient = smallest variance)
3. MLE estimates ($\hat{\theta}$) are normally distributed,

$$\sqrt{T}(\hat{\theta} - \theta) \xrightarrow{d} N(0, V), \quad (18.18)$$

$$V = I(\theta)^{-1} \text{ with } I(\theta) = -E \frac{\partial^2 \ln L}{\partial \theta \partial \theta'} / T. \quad (18.19)$$

($I(\theta)$ is called the “information matrix”).

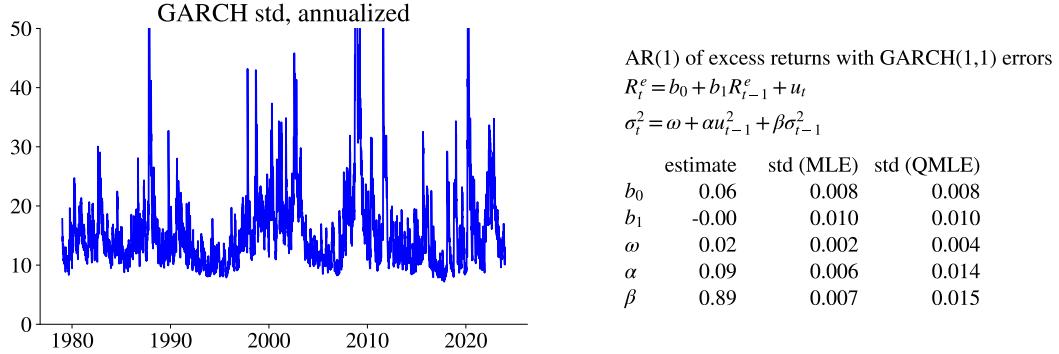


Figure 18.4: GARCH estimates

4. ML also provides a coherent framework for testing hypotheses (including the Wald, LM, and LR tests).

Remark 18.4 (*Calculating $I(\theta)$) Notice that $-\mathbb{E} \frac{\partial^2 \ln L}{\partial \theta \partial \theta'} / T = -\mathbb{E} \frac{\partial^2 \log L_t}{\partial \theta \partial \theta'}$, where $\ln L_t$ is the log likelihood contribution of observation t . This is also the same as $-\frac{\partial^2 \mathbb{E} \log L_t}{\partial \theta \partial \theta'}$, that is, we can calculate the derivatives of the average $\log L_t$ value. This sometimes helps the numerical implementation.

Proof (of (18.19)) The first order conditions for maximizing the log likelihood function are $\frac{1}{T} \frac{\partial \ln L(\hat{\theta})}{\partial \theta} = \mathbf{0}_k$. Make a Taylor expansion around the true values θ

$$\mathbf{0}_k = \frac{1}{T} \frac{\partial \ln L(\theta)}{\partial \theta} + \frac{1}{T} \frac{\partial^2 \ln L(\theta)}{\partial \theta \partial \theta'} (\hat{\theta} - \theta),$$

which we can solve as (after multiplying both sides by \sqrt{T})

$$\sqrt{T}(\hat{\theta} - \theta) = \left[-\frac{1}{T} \frac{\partial^2 \ln L(\theta)}{\partial \theta \partial \theta'} \right]^{-1} \sqrt{T} \frac{1}{T} \frac{\partial \ln L(\theta)}{\partial \theta}.$$

In the limit, the term in parenthesis equals the the information matrix $I(\theta)$ so we get

$$\sqrt{T}(\hat{\theta} - \theta) = I(\theta)^{-1} \sqrt{T} \frac{1}{T} \frac{\partial \ln L(\theta)}{\partial \theta}.$$

By a central limit theorem, the last term has a normal distribution. It will have zero mean (if the model is consistent), so its variance equals its second moment. We thus have that $\sqrt{T}(\hat{\theta} - \theta) \rightarrow^d N(0, V)$, where $V = I(\theta)^{-1} \mathbb{E} \left[\frac{\partial \ln \tilde{L}_t}{\partial \theta} \left(\frac{\partial \ln \tilde{L}_t}{\partial \theta} \right)' \right] I(\theta)^{-1}$. It can be shown that this simplifies to (18.19) when the likelihood function is correctly specified (“the information matrix equality”, see, for instance, Greene (2018) 14). More, generally, see the QMLE section (below). \square

18.2.1 Example of the Information Matrix

Differentiate (18.6), assuming we know σ^2 , to get

$$\frac{\partial^2 \ln L}{\partial \mu \partial \mu} = -\frac{T}{\sigma^2}. \quad (18.20)$$

The information matrix is

$$I(\theta) = -E \frac{\partial^2 \ln L}{\partial \theta \partial \theta'} / T = \frac{1}{\sigma^2}, \quad (18.21)$$

which we combine with (18.18)–(18.19) to get

$$\sqrt{T}(\hat{\mu} - \mu) \xrightarrow{d} N(0, \sigma^2) \text{ or } \hat{\mu} \xrightarrow{a} N(\mu, \sigma^2/T). \quad (18.22)$$

This is the standard expression for the distribution of a sample average. In practice, we replace σ^2 by the sample variance.

18.3 Three Test Principles

Wald test: estimate θ with MLE, check if $\hat{\theta} - \theta_{H_0}$ is too large. Example: t-test and F-test.

Likelihood ratio test: estimate θ with MLE as usual, estimate again by imposing the H_0 restrictions, test if $\ln L(\hat{\theta}) - \ln L(\text{"}\hat{\theta}\text{ with } H_0\text{ restrictions"}) = 0$. Example: compare the R^2 from a model without and with a restriction on some coefficient (for instance, that it is zero).

Lagrange multiplier test. Estimate θ under the H_0 restrictions, check if $\partial \ln L / \partial \theta = 0$ for unconstrained model is true when evaluated at “ $\hat{\theta}$ with H_0 restrictions.”

18.4 QMLE

A MLE based on the wrong likelihood function (distribution) may still be useful.

Suppose we use the likelihood function \tilde{L} and get estimates $\hat{\theta}$ by

$$\frac{\partial \ln \tilde{L}}{\partial \theta} = \mathbf{0} \quad (18.23)$$

If \tilde{L} is wrong (therefore, it carries a tilde), then we are maximizing the wrong thing. For instance, we might have constructed \tilde{L} by assuming that the regression residuals are normally distributed, while they are, in fact, following a t -distribution. With some luck,

we still get reasonable (consistent) estimates.

Example 18.5 (LS and QMLE) In a linear regression, $y_t = x'_t \beta + \varepsilon_t$, the first order condition for MLE based on the assumption that $\varepsilon_t \sim N(0, \sigma^2)$ is $\sum_{t=1}^T (y_t - x'_t \hat{\beta}) x_t = \mathbf{0}$. This has an expected value of zero (at the true parameters), even if the shocks have a, say, t_{22} distribution (which would define the correct likelihood function).

The example suggests that if

$$E \frac{\partial \ln \tilde{L}}{\partial \theta} = \mathbf{0}, \quad (18.24)$$

then the estimates are still consistent. We are doing *quasi-MLE* (or pseudo-MLE).

With QMLE, $\sqrt{T}(\hat{\theta} - \theta) \rightarrow^d N(0, V)$, but with the “sandwich” variance-covariance matrix

$$V = I(\theta)^{-1} E \left[\frac{\partial \ln \tilde{L}_t}{\partial \theta} \left(\frac{\partial \ln \tilde{L}_t}{\partial \theta} \right)' \right] I(\theta)^{-1}. \quad (18.25)$$

See the proof of (18.19).

Empirical Example 18.6 (MLE of a GARCH model) See Figure 18.4 for a MLE of a GARCH(1,1) model. For some of the parameters, the robust standard errors are distinctly higher.

The practical implication: this is perhaps a “safer” way of constructing tests—since it is less restrictive than assuming that we have the exactly correct likelihood function.

Chapter 19

ARCH and GARCH

Reference: Bodie, Kane, and Marcus (2005) 13.4

Reference (advanced): Taylor (2005) 8–9; Verbeek (2012) 8; Campbell, Lo, and MacKinlay (1997) 12; Franses and van Dijk (2000)

19.1 Heteroskedasticity

19.1.1 Descriptive Statistics of Heteroskedasticity

Time-variation in volatility (heteroskedasticity) is a common feature of macroeconomic and financial data.

The perhaps most straightforward way to gauge heteroskedasticity is to estimate a time-series of variances on “rolling samples.” For a zero-mean variable, u_t , this could be

$$\sigma_t^2 = (u_{t-1}^2 + u_{t-2}^2 + \dots + u_{t-q}^2)/q. \quad (19.1)$$

Notice that σ_t^2 depends on lagged information, and could therefore be thought of as the prediction (made in $t - 1$) of the volatility in t . This method can be used for detecting time variation in volatility—and the estimates (for instance, over a month) are sometimes called *realised volatility*. Alternatively, this method can also be used to gauge seasonality in volatility by estimating the variance for each “season,” for instance, Mondays.

Empirical Example 19.1 (*Time-varying FX volatility*) See Figures 19.1 and 19.2 for examples based on high-frequency FX data.

Empirical Example 19.2 (*Time-varying equity volatility*) See Figure 19.4 for a comparison of realized S&P 500 volatility with an option based measure (VIX).

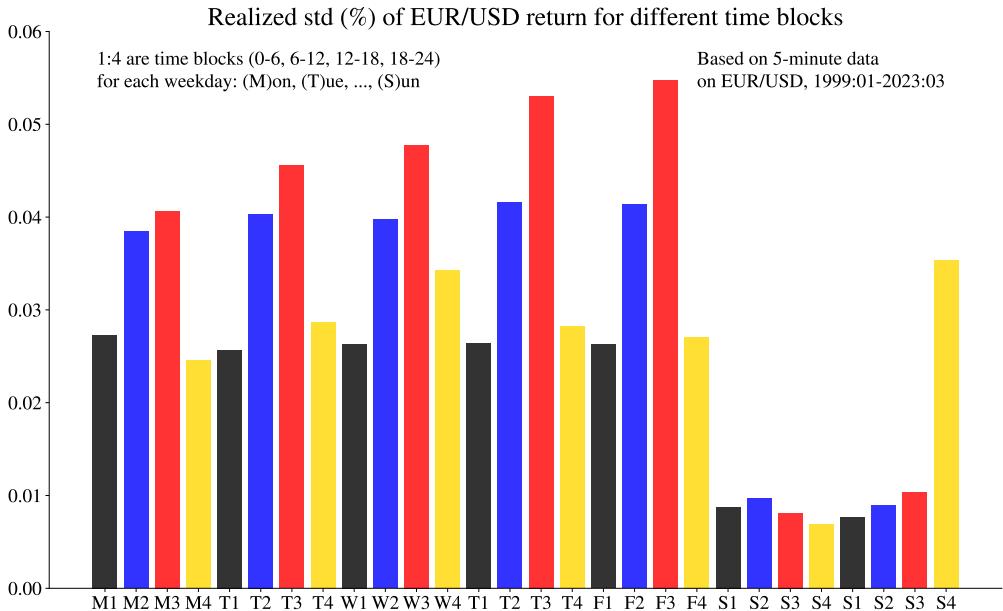


Figure 19.1: Standard deviation

Unfortunately, the approach in (19.1) can produce quite abrupt changes in the estimate. An alternative is to apply an exponentially weighted moving average (EWMA) estimator of volatility, which uses all data points since the beginning of the sample—but where recent observations carry larger weights. The weight for lag s is $(1 - \lambda)\lambda^s$ where $0 < \lambda < 1$, so

$$\sigma_t^2 = (1 - \lambda)(u_{t-1}^2 + \lambda u_{t-2}^2 + \lambda^2 u_{t-3}^2 + \dots). \quad (19.2)$$

See Figure 19.3 for an illustration of the weights. (The weights clearly sum to one.) This can also be calculated in a recursive way as

$$\sigma_t^2 = (1 - \lambda)u_{t-1}^2 + \lambda\sigma_{t-1}^2. \quad (19.3)$$

The initial value (before the sample) could be assumed to be zero or (perhaps better) the unconditional variance in a historical sample.

This methods is commonly used by practitioners. For instance, the RiskMetrics (see JP Morgan (1996)) approach uses this method with $\lambda \approx 0.94$ for use on daily data. Alternatively, λ can be chosen to minimize some criterion function.

Empirical Example 19.3 (Choosing λ by ML) See Figure 19.5 for an example of estimating λ maximum likelihood (assuming a normal distribution): maximize (19.9) where

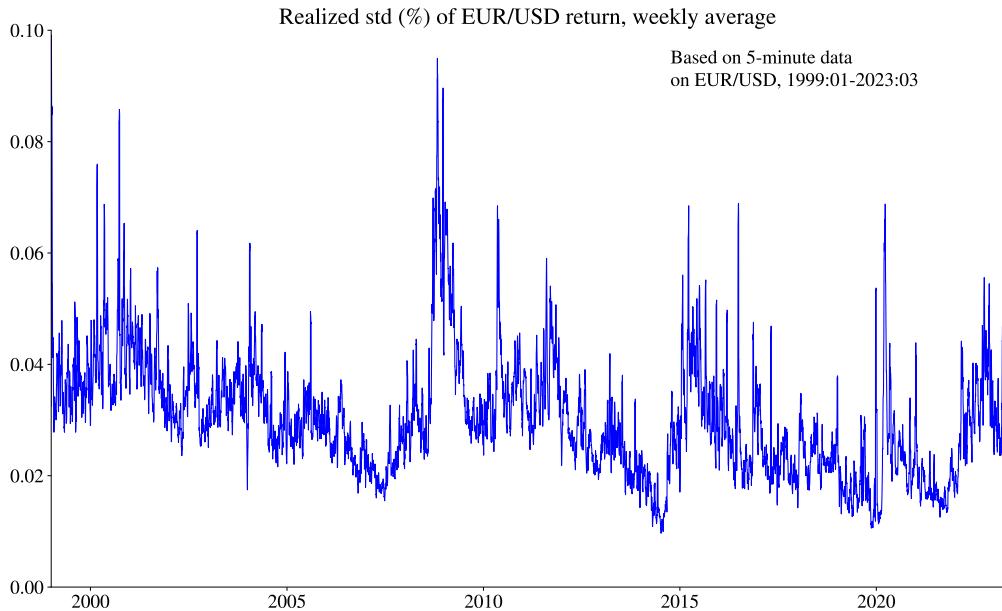


Figure 19.2: Standard deviation for EUR/USD exchange rate changes

$$u_t = R_t - \mu_t.$$

Remark 19.4 (*EWMA on a limited data window**) To implement the EWMA method on a moving data window over q data points ($t - q$ to $t - 1$) use

$$\sigma_t^2 = \frac{1 - \lambda}{1 - \lambda^q} (u_{t-1}^2 + \lambda u_{t-2}^2 + \dots + \lambda^{q-1} u_{t-q}^2).$$

Notice that the weights sum to one, provided $\lambda \neq 1$. This can also be written on recursive form as

$$\sigma_t^2 = \frac{1 - \lambda}{1 - \lambda^q} (u_{t-1}^2 - \lambda^q u_{t-q-1}^2) + \lambda \sigma_{t-1}^2.$$

19.1.2 Predicting Realized Volatility

Volatility and correlations are often predictable, at least for horizons up to a couple of months.

Empirical Example 19.5 (*Predicting equity and FX volatility*) See Tables 19.1 – 19.2 for examples of very simple prediction equations. The latter includes week day dummies to handle seasonality.

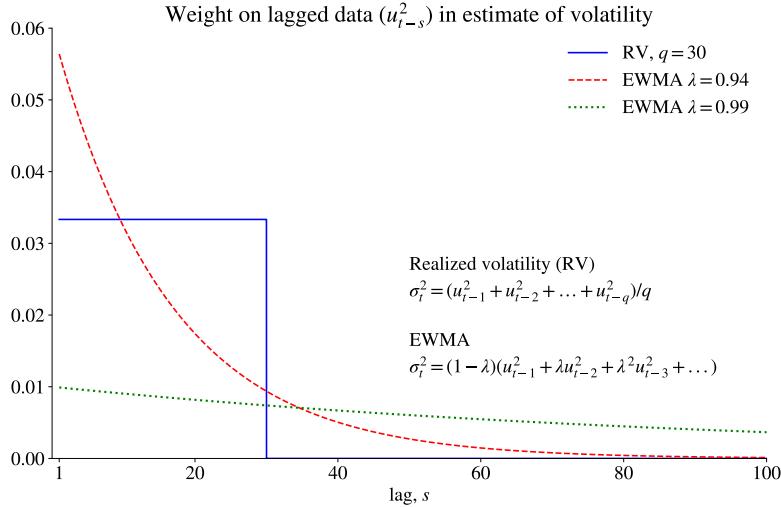


Figure 19.3: Weights on old data in the EMA approach to estimate volatility

19.1.3 Heteroskedastic Residuals in a Regression

Suppose we have a regression model

$$y_t = x_t' \beta + u_t, \text{ where} \quad (19.4)$$

$$\mathbb{E} u_t = 0 \text{ and } \text{Cov}(x_{it}, u_t) = 0.$$

In the standard case we assume that u_t is iid (independently and identically distributed), which rules out heteroskedasticity.

OLS is still a useful estimator when the residuals actually are heteroskedastic. It is consistent (we get the correct values as the sample becomes really large)—and it is reasonably efficient (in terms of the variance of the estimates), although not the most efficient (MLE is). However, the standard expression for the standard errors (of the coefficients) is typically not correct. To be precise, it is not heteroskedasticity in itself that invalidates the standard OLS standard errors—only the type of heteroskedasticity that is related to the (squares of) the regressors. In fact, this is exactly what White's test of heteroskedasticity is aimed at.

There are two ways to handle this problem. First, we could use MLE to incorporate the structure of the heteroskedasticity. For instance, we could combine the regression model (19.4) with an ARCH structure of the residual. As a by-product we get the correct standard errors—provided, of course, the assumed distribution is correct. Second, we

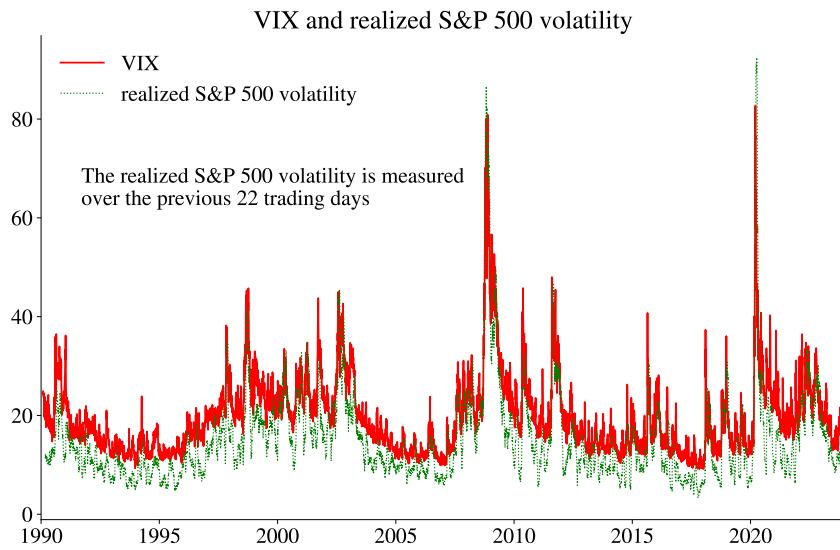


Figure 19.4: VIX and realized volatility (variance)

could stick to OLS, but use another expression for the variance of the coefficients: a “heteroskedasticity consistent covariance matrix,” among which “White’s covariance matrix” is the most common.

19.1.4 Autoregressive Conditional Heteroskedasticity (ARCH)

Autoregressive heteroskedasticity is a special form of heteroskedasticity—and it is often found in financial data which shows volatility clustering.

To test for ARCH features, *Engle’s test of ARCH* is perhaps the most straightforward. Let u_t be a zero-mean variable, for instance, the residuals from OLS. Then, estimate an AR(q) model for the squares

$$u_t^2 = \omega + a_1 u_{t-1}^2 + \dots + a_q u_{t-q}^2 + v_t. \quad (19.5)$$

Under the null hypothesis of no ARCH effects, all slope coefficients are zero and the R^2 of the regression is zero. (This can be tested by noting that, under the null hypothesis, $TR^2/(1 - R^2) \sim \chi_q^2$.) Notice, however, that it is not evident that ARCH effects make the standard expression for the LS covariance matrix invalid (use White’s test for that).

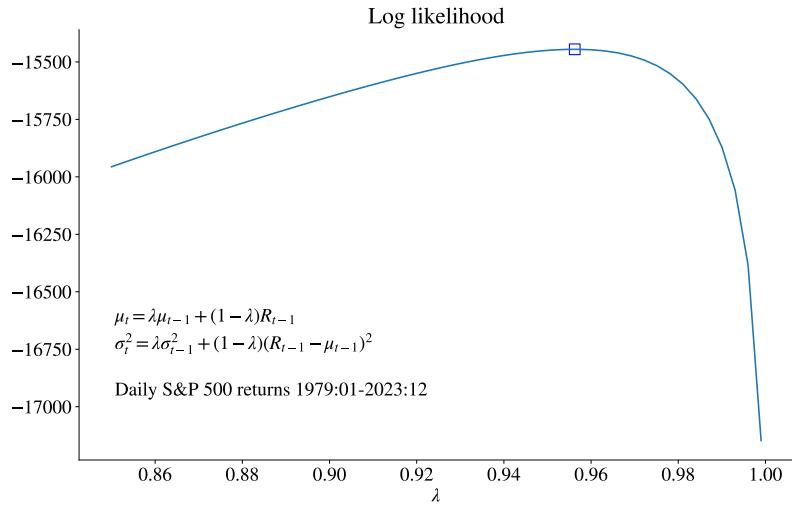


Figure 19.5: Estimation of λ in the EWMA method.

19.2 ARCH Models

This section discusses the Autoregressive Conditional Heteroskedasticity (ARCH) model. It is a model of how volatility depends on past volatility.

There are two basic reasons for being interested in an ARCH model. First, if residuals of the regression model (19.4) have ARCH features, then an ARCH model (that is, a specification of exactly how the ARCH features are generated) can help us estimate the regression model by maximum likelihood. Second, we may be interested in understanding the ARCH features more carefully, for instance, as an input in a portfolio choice process or for option pricing.

19.2.1 Properties of ARCH(1)

In the ARCH(1) model the residual in the regression equation (19.4), or some other zero-mean variable, can be written

$$u_t \sim N(0, \sigma_t^2), \text{ with} \quad (19.6)$$

$$\sigma_t^2 = \omega + \alpha u_{t-1}^2, \text{ with } \omega > 0 \text{ and } 0 \leq \alpha < 1. \quad (19.7)$$

Notice that σ_t^2 is the conditional variance of u_t , and it is known already in $t - 1$. (Warning: some authors use a different convention for the time subscripts.) The non-negativity restrictions on ω and α are needed in order to guarantee $\sigma_t^2 > 0$ and the upper bound

	(1)	(2)	(3)
log RV ($t - 22$)	0.68 (20.23)		0.10 (2.11)
log VIX ($t - 22$)		1.06 (26.62)	0.94 (14.91)
constant	0.84 (9.75)	-0.50 (-4.31)	-0.41 (-3.60)
R^2	0.46	0.57	0.57
obs	8484	8505	8484

Table 19.1: Regression of 22-day log realized S&P return volatility 1990:02-2023:12. All daily observations are used, so the residuals are likely to be autocorrelated. Numbers in parentheses are t-stats, based on Newey-West with 30 lags.

$\alpha < 1$ is needed in order to make the conditional variance stationary (more later).

If we assume that u_t is iid $N(0, \sigma_t^2)$, then the distribution of u_t , conditional on the information in $t - 1$, is $N(0, \sigma_t^2)$, where σ_t^2 is known already in $t - 1$. Therefore, the one-step ahead distribution is normal—which can be used for estimating the model with ML.

However, the distribution of u_{t+1} (still conditional on the information in $t - 1$) is more complicated. In particular, its variance is $\sigma_{t+1}^2 = \omega + \alpha u_t^2$, where u_t contains a random element. This makes u_{t+1} have a non-normal distribution. In fact, it will have fatter tails than a normal distribution with the same variance (excess kurtosis)—which is a common feature of financial data.

It is straightforward to show that the ARCH(1) model implies that we in period t can forecast the future conditional variance in $t + s$ as

$$E_t \sigma_{t+s}^2 = \bar{\sigma}^2 + \alpha^{s-1} (\sigma_{t+1}^2 - \bar{\sigma}^2), \text{ with } \bar{\sigma}^2 = \frac{\omega}{1 - \alpha}, \quad (19.8)$$

where $\bar{\sigma}^2$ is the unconditional variance and we recall that since σ_{t+1}^2 is known in t . The conditional volatility behaves like an AR(1), and $0 \leq \alpha < 1$ is necessary to keep it positive and stationary.

Empirical Example 19.6 (ARCH and GARCH models) See Figure 19.6 for an illustration of the fitted volatilities.

	log RV(EUR)	log RV(GBP)	log RV(CHF)	log RV(JPY)
lagged log RV	0.77 (73.07)	0.74 (45.83)	0.74 (51.38)	0.75 (57.11)
constant	-0.60 (-30.19)	-0.61 (-25.18)	-0.59 (-24.48)	-0.61 (-26.14)
D(Tue)	0.43 (22.25)	0.40 (17.45)	0.36 (17.44)	0.40 (17.12)
D(Wed)	0.38 (19.53)	0.35 (16.98)	0.30 (15.91)	0.36 (15.87)
D(Thu)	0.36 (17.73)	0.35 (16.56)	0.27 (14.02)	0.29 (12.59)
D(Fri)	0.30 (13.40)	0.30 (12.99)	0.22 (10.19)	0.30 (11.62)
R^2	0.61	0.55	0.56	0.58
obs	6324	6324	6324	6324

Table 19.2: Regression of daily log realized variance 1999:01-2023:03. All exchange rates are against the USD. The daily variances are calculated from 5 minute data. Numbers in parentheses are t-stats, based on Newey-West with 1 lag.

19.2.2 Estimation of the ARCH(1) Model

The most common way to estimate the model is to assume that $u_t \sim \text{iid } N(0, \sigma_t^2)$, as we did in (19.6), and to set up the likelihood function. The log likelihood is easily found, since the model is conditionally Gaussian. It is

$$\ln L = \sum_{t=1}^T L_t, \text{ where } L_t = -\frac{1}{2} \ln(2\pi) - \frac{1}{2} \ln \sigma_t^2 - \frac{1}{2} \frac{u_t^2}{\sigma_t^2}. \quad (19.9)$$

The estimates are found by maximizing the likelihood function (by choosing the parameters). This has to be done by a numerical optimization routine (which should preferably impose the constraints in (19.7)).

If u_t is just a zero-mean variable (so we have no regression equation), then this maximisation amounts to choosing the parameters (ω and α) in (19.7). Instead, if u_t is a residual from a regression equation (19.4), then we instead need to choose both the regression coefficients (β) in (19.4) and the parameters (ω and α) in (19.7).

In either case, we need a starting value of $\sigma_1^2 = \omega + \alpha u_0^2$. This most common approach is to use the first observation as a “starting point,” that is, we actually have a sample from ($t = 0$ to T), but observation 0 is only used to construct a starting value of σ_1^2 , and only

$\alpha :$	$\gamma = 0$		$\gamma = 1$	
	0	1	0	1
Simulated	7.1	19.0	13.5	24.8
OLS formula	7.1	13.3	13.4	19.2
White's	7.0	18.5	13.3	24.3
Bootstrap	7.1	18.5	13.4	24.3
Bootstrap 2	7.0	18.5	13.3	24.3
Jackknife	7.1	18.9	13.5	24.8
FGLS	7.5	17.3	14.0	24.1

Table 19.3: Standard error of OLS slope (%) under heteroskedasticity (simulation evidence). Model: $y_t = 1 + 0.9x_t + \epsilon_t$, where $\epsilon_t \sim N(0, \sigma_t^2)$, with $\sigma_t^2 = (1 + \gamma|z_t| + \alpha|x_t|)^2$, where z_t is iid $N(0,1)$ and independent of x_t . Sample length: 200. Number of simulations: 25000. The bootstrap draws pairs (y_s, x_s) with replacement while bootstrap 2 is a wild bootstrap.

observations 1 to T are used in the calculation of the likelihood function value.

Notice that if we estimate a regression function and an ARCH model simultaneous with MLE, then we automatically get the right standard errors of the regression coefficients from the information matrix. There is no need to use any adjusted (“White”) values.

Remark 19.7 (*Regression with ARCH(1) residuals*) To estimate the full model (19.4) and (19.7) by MLE, we can do as follows.

First, guess values of the parameters β (a vector if x_t is), and ω , and α . The guess of β can be taken from an LS estimation of (19.4), and the guess of ω and α from an LS estimation of $\hat{u}_t^2 = \omega + \alpha \hat{u}_{t-1}^2 + \varepsilon_t$ where \hat{u}_t are the fitted residuals from the LS estimation of (19.4).

Second, loop over the sample (first $t = 1$, then $t = 2$, etc.) and calculate u_t from (19.4) and σ_t^2 from (19.7). Plug in these numbers in (19.9) to find the likelihood value.

Third, make better guesses of the parameters and do the second step again. Repeat until the likelihood value converges (at a maximum).

Remark 19.8 (*Imposing parameter constraints on ARCH(1)*) To impose the restrictions in (19.7), iterate over values of $(\beta, \tilde{\omega}, \tilde{\alpha})$ and let $\omega = \tilde{\omega}^2$ and $\alpha = \exp(\tilde{\alpha})/[1 + \exp(\tilde{\alpha})]$.

It is sometimes found that the *standardized residuals*, u_t/σ_t , still have too fat tails compared with $N(0, 1)$. This would violate the assumption about a normal distribution in

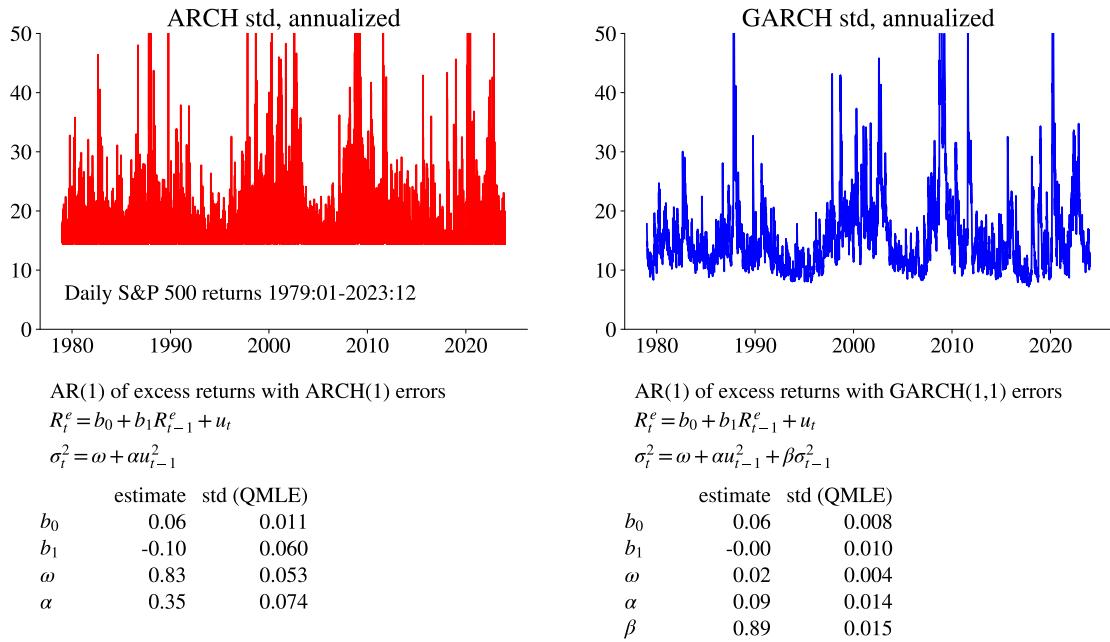


Figure 19.6: ARCH and GARCH estimates

(19.9). Estimation using other likelihood functions, for instance, for a t-distribution can then be used. Or the estimation can be interpreted as a quasi-ML (is typically consistent, but requires different calculation of the covariance matrix of the parameters).

It is straightforward to add more lags to (19.7). For instance, an ARCH(p) would be

$$\sigma_t^2 = \omega + \alpha_1 u_{t-1}^2 + \dots + \alpha_p u_{t-p}^2. \quad (19.10)$$

The form of the likelihood function is the same except that we now need p starting values and that the upper boundary constraint should now be $\sum_{j=1}^p \alpha_j \leq 1$.

19.3 GARCH Models

Instead of specifying an ARCH model with many lags, it is typically more convenient to specify a low-order GARCH (Generalized ARCH) model. The GARCH(1,1) is a simple and surprisingly general model, where the volatility follows

$$\begin{aligned} \sigma_t^2 &= \omega + \alpha u_{t-1}^2 + \beta \sigma_{t-1}^2, \text{with} \\ \omega &> 0; \alpha, \beta \geq 0; \text{ and } \alpha + \beta < 1. \end{aligned} \quad (19.11)$$

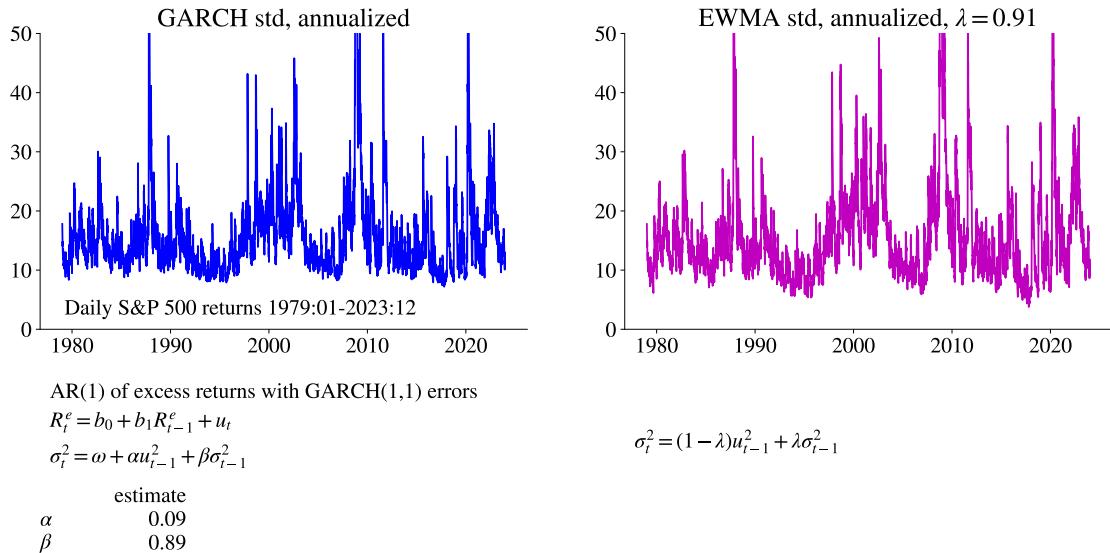


Figure 19.7: Conditional standard deviation, estimated by GARCH(1,1) model

The non-negativity restrictions are needed in order to guarantee that $\sigma_t^2 > 0$ in all periods. The upper bound $\alpha + \beta < 1$ is needed in order to make the σ_t^2 stationary and therefore the unconditional variance finite.

Remark 19.9 *The GARCH(1,1) has many similarities with the exponential moving average estimator of volatility (19.3). The main differences are that the exponential moving average does not have a constant and volatility is non-stationary (the coefficients sum to unity).*

Empirical Example 19.10 (GARCH(1,1) vs EWMA) See Figure 19.7 for an example.

The GARCH(1,1) corresponds to an ARCH(∞) with geometrically declining weights, which is seen by solving (19.11) recursively by substituting for σ_{t-1}^2 (and then $\sigma_{t-2}^2, \sigma_{t-3}^2, \dots$)

$$\sigma_t^2 = \frac{\omega}{1-\beta} + \alpha \sum_{j=0}^{\infty} \beta^j u_{t-1-j}^2. \quad (19.12)$$

This suggests that a GARCH(1,1) might be a reasonable approximation of a high-order ARCH.

Also, the GARCH(1,1) model implies that we in period t can forecast the future conditional variance (σ_{t+s}^2) as

$$E_t \sigma_{t+s}^2 = \bar{\sigma}^2 + (\alpha + \beta)^{s-1} (\sigma_{t+1}^2 - \bar{\sigma}^2), \text{ with } \bar{\sigma}^2 = \frac{\omega}{1-\alpha-\beta}, \quad (19.13)$$

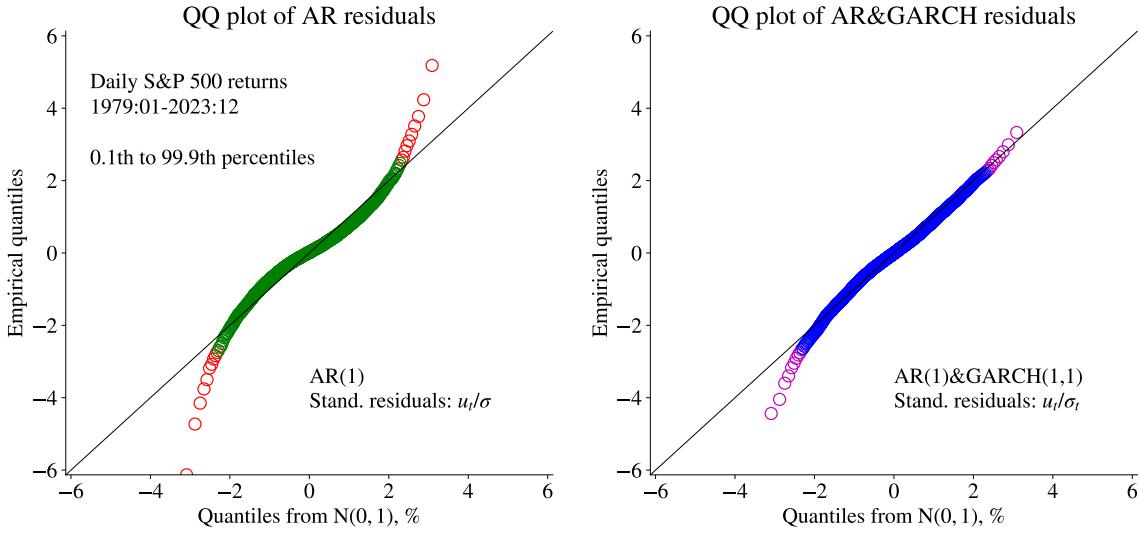


Figure 19.8: QQ-plot of residuals

which is of the same form as for the ARCH model (19.8), but where the sum of α and β is like an AR(1) parameter.

To estimate the model consisting of (19.4) and (19.11) we can still use the likelihood function (19.9) and do a MLE (but we now have to choose a value of β as well). We typically create the starting value of u_0^2 as in the ARCH(1) model, but this time we also need a starting value of σ_0^2 . It is often recommended to use $\sigma_0^2 = \text{Var}(u_t)$.

Remark 19.11 (*Imposing parameter constraints on GARCH(1,1)*) To impose the restrictions in (19.11), iterate over values of $(b, \tilde{\omega}, \tilde{\alpha}, \tilde{\beta})$ and let $\omega = \omega^2$, $\alpha = \exp(\tilde{\alpha})/[1 + \exp(\tilde{\alpha}) + \exp(\tilde{\beta})]$, and $\beta = \exp(\tilde{\beta})/[1 + \exp(\tilde{\alpha}) + \exp(\tilde{\beta})]$.

Empirical Example 19.12 (*Distribution of normalised residuals*) See Figure 19.8 for evidence of how the residuals become more normally distributed once the heteroskedasticity is handled.

Empirical Example 19.13 (*Value at Risk*) The 95% value at risk (as fraction of the investment) is the (negative of the) 0.05 quantile of the return distribution. In particular, $\text{VaR}_{0.95} = 0.08$ says that there is only an 5% chance that the loss will be greater than 8% of the investment. See Figure 19.9 for an illustration. When the return has an $N(\mu, \sigma^2)$ distribution, then $\text{VaR}_{95\%} = -(\mu - 1.64\sigma)$. See Figure 19.10 for an example of time-varying VaR, based on a GARCH model.

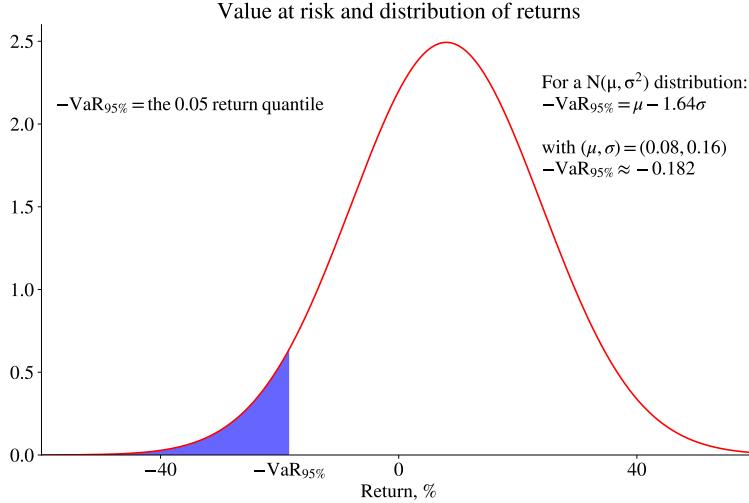


Figure 19.9: Value at risk

19.4 Non-Linear Extensions

A very large number of extensions have been suggested. I summarize a few of them, which can be estimated by MLE using the likelihood function (19.9).

An asymmetric GARCH (Glosten, Jagannathan, and Runkle (1993), GJR) can be constructed as

$$\begin{aligned}\sigma_t^2 &= \omega + \alpha u_{t-1}^2 + \beta \sigma_{t-1}^2 + \gamma \delta(u_{t-1} < 0) u_{t-1}^2, \text{ where} \\ \delta(q) &= \begin{cases} 1 & \text{if } q \text{ is true} \\ 0 & \text{else.} \end{cases}\end{aligned}\quad (19.14)$$

This means that the effect of the shock u_{t-1}^2 is $\alpha + \gamma$ if the shock was negative and α if the shock was positive. With $\gamma > 0$, volatility increases more in response to a negative u_{t-1} (“bad news”) than to a positive u_{t-1} .

The EGARCH (exponential GARCH, Nelson (1991)) sets

$$\ln \sigma_t^2 = \omega + \alpha \frac{|u_{t-1}|}{\sigma_{t-1}} + \beta \ln \sigma_{t-1}^2 + \gamma \frac{u_{t-1}}{\sigma_{t-1}} \quad (19.15)$$

Apart from being written in terms of the log (which is a smart trick to make $\sigma_t^2 > 0$ hold without any restrictions on the parameters), this is an asymmetric model. The $|u_{t-1}|$ term is symmetric: both negative and positive values of u_{t-1} affect the volatility in the same way. The linear term in u_{t-1} modifies this to make the effect asymmetric. In particular,

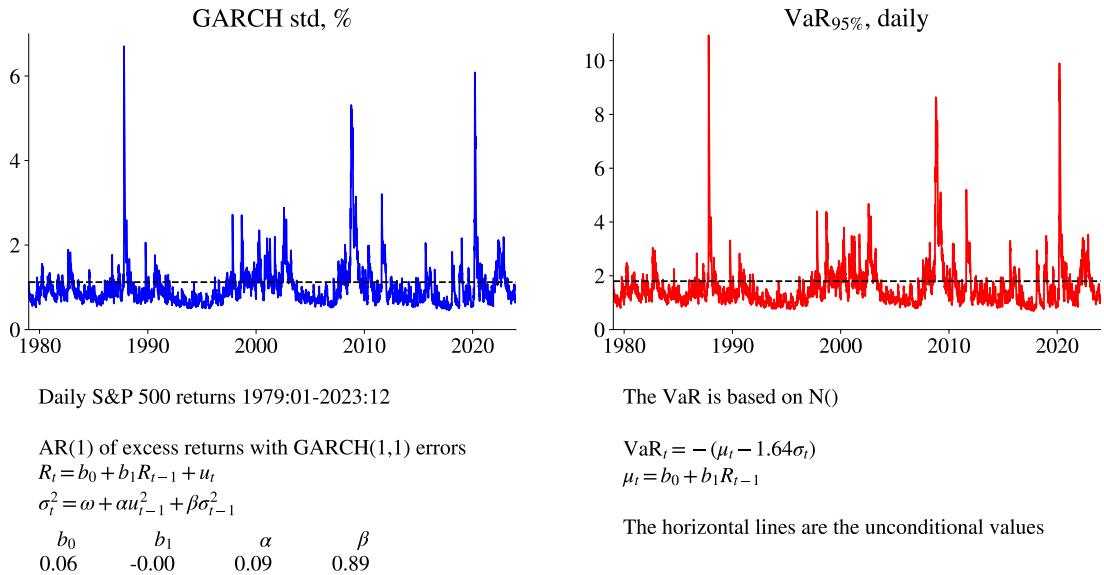


Figure 19.10: Conditional volatility and VaR

if $\gamma < 0$, then the volatility increases more in response to a negative u_{t-1} (“bad news”) than to a positive u_{t-1} . This model is stationary if $|\beta| < 1$.

Hentschel (1995) estimates several models of this type, as well as a very general formulation on daily stock index data for 1926 to 1990 (some 17,000 observations). Most standard models are rejected in favour of a model where σ_t depends on σ_{t-1} and $|u_{t-1} - b|^{3/2}$.

19.5 (G)ARCH-M*

It can make sense to let the conditional volatility enter the regression equation—for instance, as a proxy for risk which may influence the expected return.

We modify the regression (“mean”) equation (19.4) to include the conditional variance σ_t^2 (taken from any of the models for heteroskedasticity) as a regressor

$$y_t = x'_t b + \varphi \sigma_t^2 + u_t. \quad (19.16)$$

Note that σ_t^2 is predetermined, since it is a function of information in $t - 1$. This model can be estimated by using the likelihood function (19.9) to do MLE.

Remark 19.14 (*Coding of (G)ARCH-M*) We can use the same approach as in Remark

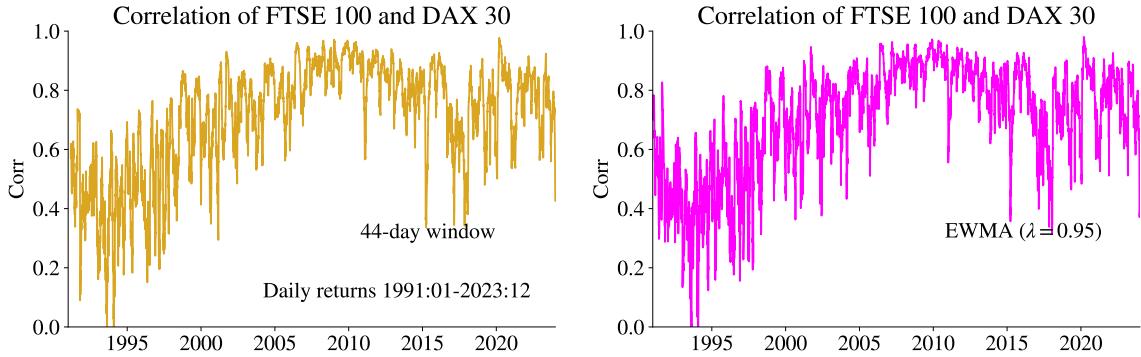


Figure 19.11: Time-varying correlations (different EWMA estimates)

[19.7](#), except that we use (19.16) instead of (19.4) to calculate the residuals (and that we obviously also need a guess of φ).

Example 19.15 (*Theoretical motivation of GARCH-M*) An implication from mean-variance portfolio choice and CAPM is that $E(R_m - R_f) = k\sigma_m^2$, which says that the expected excess market return is increasing in both the market volatility (σ_m^2) and risk aversion (k).

19.6 Multivariate (G)ARCH

A first approach to estimate a time varying covariance of two series (u_{it} and u_{jt}) is the EWMA

$$\sigma_{ij,t} = (1 - \lambda)u_{i,t-1}u_{j,t-1} + \lambda\sigma_{ij,t-1}. \quad (19.17)$$

Combining this with similar estimates of the time varying volatility of each series ($\sigma_{i,t}^2$ and $\sigma_{j,t}^2$) allows us to calculate a time varying correlation as

$$\rho_{ij,t} = \sigma_{ij,t}/(\sigma_{i,t}\sigma_{j,t}). \quad (19.18)$$

Empirical Example 19.16 (*Time-varying equity index correlations*) See [Figure 19.11](#).

19.6.1 Different Multivariate Models

This section gives a brief summary of some multivariate models of heteroskedasticity. Suppose u_t is an $n \times 1$ vector. For instance, u_t could be the residuals from n different regressions or just n different demeaned return series.

We define the conditional (on the information set in $t - 1$) covariance matrix of u_t as

$$\Sigma_t = \mathbf{E}_{t-1} u_t u_t' \quad (19.19)$$

Remark 19.17 (*The vech operator*) $\text{vech}(A)$ of a matrix A gives a vector with the elements on and below the principal diagonal A stacked on top of each other (column wise).

$$\text{For instance, } \text{vech} \begin{bmatrix} \mathbf{a}_{11} & a_{12} \\ \mathbf{a}_{21} & \mathbf{a}_{22} \end{bmatrix} = \begin{bmatrix} a_{11} \\ a_{21} \\ a_{22} \end{bmatrix}.$$

It may seem as if a multivariate (matrix) version of the GARCH(1,1) model would be simple, but it is not. The reason is that it would contain far too many parameters. Although we only need to care about the unique elements of Σ_t , that is, $\text{vech}(\Sigma_t)$, this still gives very many parameters

$$\text{vech}(\Sigma_t) = C + A \text{vech}(u_{t-1} u_{t-1}') + B \text{vech}(\Sigma_{t-1}). \quad (19.20)$$

For instance, with $n = 2$ we have

$$\begin{bmatrix} \sigma_{11,t} \\ \sigma_{21,t} \\ \sigma_{22,t} \end{bmatrix} = C + A \begin{bmatrix} u_{1,t-1}^2 \\ u_{1,t-1} u_{2,t-1} \\ u_{2,t-1}^2 \end{bmatrix} + B \begin{bmatrix} \sigma_{11,t-1} \\ \sigma_{21,t-1} \\ \sigma_{22,t-1} \end{bmatrix}, \quad (19.21)$$

where C is 3×1 , A is 3×3 , and B is 3×3 . This gives 21 parameters, which is already hard to manage. We have to limit the number of parameters. We also have to find a way to impose restrictions so Σ_t is positive definite. Indeed a variance-covariance matrix must be positive definite in order to guarantee that every possible linear combination of the variables has a positive variance (compare the restrictions of positive coefficients in (19.11)). If not, something is wrong.

The Diagonal Model

The *diagonal model* assumes that A and B are diagonal. This means that every element of Σ_t follows a univariate process. With $n = 2$ we have

$$\begin{bmatrix} \sigma_{11,t} \\ \sigma_{21,t} \\ \sigma_{22,t} \end{bmatrix} = \begin{bmatrix} c_1 \\ c_2 \\ c_3 \end{bmatrix} + \begin{bmatrix} a_1 & 0 & 0 \\ 0 & a_2 & 0 \\ 0 & 0 & a_3 \end{bmatrix} \begin{bmatrix} u_{1,t-1}^2 \\ u_{1,t-1} u_{2,t-1} \\ u_{2,t-1}^2 \end{bmatrix} + \begin{bmatrix} b_1 & 0 & 0 \\ 0 & b_2 & 0 \\ 0 & 0 & b_3 \end{bmatrix} \begin{bmatrix} \sigma_{11,t-1} \\ \sigma_{21,t-1} \\ \sigma_{22,t-1} \end{bmatrix}, \quad (19.22)$$

which gives $3 + 3 + 3 = 9$ parameters. To make sure that Σ_t is positive definite we have to impose further restrictions. The obvious drawback of this model is that there is no spillover of volatility from one variable to another.

The Constant Correlation Model

The *constant correlation model* (CCC) assumes that every variance follows a univariate GARCH process and that the conditional correlations are constant. With $n = 2$ the covariance matrix is

$$\begin{bmatrix} \sigma_{11,t} & \sigma_{12,t} \\ \sigma_{12,t} & \sigma_{22,t} \end{bmatrix} = \begin{bmatrix} \sqrt{\sigma_{11,t}} & 0 \\ 0 & \sqrt{\sigma_{22,t}} \end{bmatrix} \begin{bmatrix} 1 & \rho_{12} \\ \rho_{12} & 1 \end{bmatrix} \begin{bmatrix} \sqrt{\sigma_{11,t}} & 0 \\ 0 & \sqrt{\sigma_{22,t}} \end{bmatrix} \quad (19.23)$$

and each of σ_{11t} and σ_{22t} follows a GARCH process. Assuming a GARCH(1,1) as in (19.11) gives 7 parameters (2×3 GARCH parameters and one correlation), which is convenient. The price is, of course, the assumption of no movements in the correlations. To get a positive definite Σ_t , each individual GARCH model must generate a positive variance (same restrictions as before), and that all the estimated (constant) correlations are between -1 and 1 .

Remark 19.18 (*Estimating the constant correlation model*) A quick (and dirty) method is to first estimate the individual GARCH processes and then estimate the correlation of the standardized residuals $u_{1t}/\sqrt{\sigma_{11,t}}$ and $u_{2t}/\sqrt{\sigma_{22,t}}$.

By also specifying how the correlation can change over time, we get a *dynamic correlation model* (DCC). It is slightly harder to estimate.

Empirical Example 19.19 (*Time-varying equity index correlations*) See Figure 19.12 for an illustration and Figure 19.11 for a comparison with the EWMA approach.

The Dynamic Correlation Model

The *dynamic correlation model* (DCC) discussed in Engle (2002)) allows the correlation to change over time. The model assumes that each conditional variance follows a univariate GARCH process and the conditional correlation matrix is (essentially) allowed to follow a univariate GARCH equation.

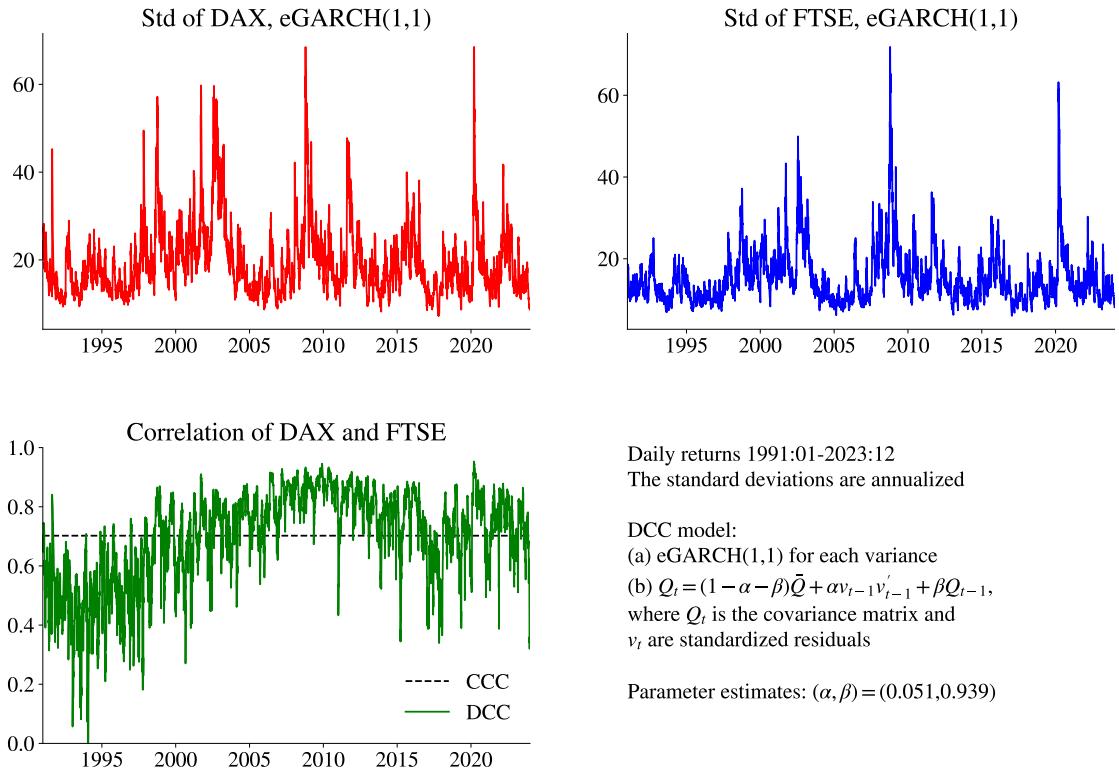


Figure 19.12: Results for multivariate eGARCH models

The conditional covariance matrix is (by definition)

$$\Sigma_t = D_t R_t D_t, \text{ with } D_t = \text{diag}(\sqrt{\sigma_{ii,t}}), \quad (19.24)$$

and R_t is the conditional correlation matrix, which is modelled below.

Remark 19.20 (*diag(a_i) notation*) *diag(a_i) denotes the $n \times n$ matrix with elements a_1, a_2, \dots, a_n along the main diagonal and zeros elsewhere. For instance, if $n = 2$, then*

$$\text{diag}(a_i) = \begin{bmatrix} a_1 & 0 \\ 0 & a_2 \end{bmatrix}.$$

The conditional correlation matrix R_t is allowed to change like in a univariate GARCH model, but with a transformation that guarantees that it is actually a valid correlation matrix. First, let v_t be the vector of standardized residuals and let \bar{Q} be the unconditional correlation matrix of v_t . For instance, if we assume a GARCH(1,1) structure for the

correlation matrix, then we have

$$\begin{aligned} Q_t &= (1 - \alpha - \beta) \bar{Q} + \alpha v_{t-1} v'_{t-1} + \beta Q_{t-1}, \text{ with} \\ v_{i,t} &= u_{i,t} / \sqrt{\sigma_{ii,t}}, \end{aligned} \quad (19.25)$$

where α and β are two scalars and \bar{Q} is the unconditional covariance matrix of the normalized residuals (v_t). We require that $\alpha \geq 0$ and that $\alpha + \beta < 1$.

To guarantee that the conditional correlation matrix is indeed a correlation matrix, Q_t is treated as if it were a covariance matrix and R_t is simply the implied correlation matrix. That is,

$$R_t = \text{diag}(1/\sqrt{q_{ii,t}}) Q_t \text{diag}(1/\sqrt{q_{ii,t}}). \quad (19.26)$$

The basic idea of this model is to estimate a conditional correlation matrix as in (19.26) and then scale up with conditional variances (from univariate GARCH models) to get a conditional covariance matrix as in (19.24). The DCC model is used in a study of asset pricing in, for instance, Duffee (2005).

Empirical Example 19.21 (DCC estimation, daily equity returns) Figure 19.12 suggests that the DCC correlations look similar to what the EWMA method delivers. Figure 19.13 shows a scatter of the standard deviations for a long-short portfolio according to several methods. The results suggest that a DCC model is better at capturing the volatility patterns than a CCC model.

Example 19.22 (Dynamic correlation model, $n = 2$) With $n = 2$ the covariance matrix Σ_t is

$$\begin{bmatrix} \sigma_{11,t} & \sigma_{12,t} \\ \sigma_{12,t} & \sigma_{22,t} \end{bmatrix} = \begin{bmatrix} \sqrt{\sigma_{11,t}} & 0 \\ 0 & \sqrt{\sigma_{22,t}} \end{bmatrix} \begin{bmatrix} 1 & \rho_{12,t} \\ \rho_{12,t} & 1 \end{bmatrix} \begin{bmatrix} \sqrt{\sigma_{11,t}} & 0 \\ 0 & \sqrt{\sigma_{22,t}} \end{bmatrix},$$

and each of σ_{11t} and σ_{22t} follows a GARCH process. To estimate the dynamic correlations, we first calculate (where α and β are two scalars)

$$\begin{bmatrix} q_{11,t} & q_{12,t} \\ q_{12,t} & q_{22,t} \end{bmatrix} = (1 - \alpha - \beta) \begin{bmatrix} 1 & \bar{q}_{12} \\ \bar{q}_{12} & 1 \end{bmatrix} + \alpha \begin{bmatrix} v_{1,t-1} \\ v_{2,t-1} \end{bmatrix} \begin{bmatrix} v_{1,t-1} \\ v_{2,t-1} \end{bmatrix}' + \beta \begin{bmatrix} q_{11,t-1} & q_{12,t-1} \\ q_{12,t-1} & q_{22,t-1} \end{bmatrix},$$

where $v_{i,t-1} = u_{i,t-1} / \sqrt{\sigma_{ii,t-1}}$ and \bar{q}_{ij} is the unconditional correlation of $v_{i,t}$ and $v_{j,t}$ and we get the conditional correlations by

$$\begin{bmatrix} 1 & \rho_{12,t} \\ \rho_{12,t} & 1 \end{bmatrix} = \begin{bmatrix} 1 & q_{12,t} / \sqrt{q_{11,t} q_{22,t}} \\ q_{12,t} / \sqrt{q_{11,t} q_{22,t}} & 1 \end{bmatrix}.$$

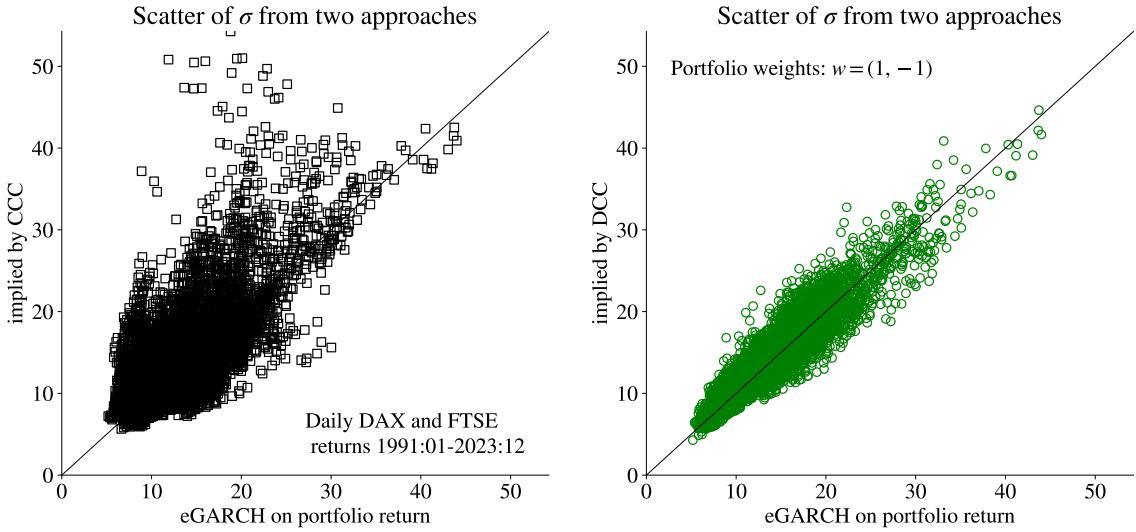


Figure 19.13: Backtesting multivariate eGARCH models

Assuming a GARCH(1,1) as in (19.11) gives 9 parameters (2×3 GARCH parameters, $(\bar{q}_{12}, \alpha, \beta)$).

To see what DCC generates, consider the correlation coefficient from a bivariate model

$$\rho_{12,t} = \frac{q_{12,t}}{\sqrt{q_{11,t}} \sqrt{q_{22,t}}}, \text{ where} \quad (19.27)$$

$$\begin{aligned} q_{12,t} &= (1 - \alpha - \beta)\bar{q}_{12} + \alpha v_{1,t-1} v_{2,t-1} + \beta q_{12,t-1} \\ q_{11,t} &= (1 - \alpha - \beta) + \alpha v_{1,t-1} v_{1,t-1} + \beta q_{11,t-1} \\ q_{22,t} &= (1 - \alpha - \beta) + \alpha v_{2,t-1} v_{2,t-1} + \beta q_{22,t-1}. \end{aligned}$$

This is a complicated expression, but the numerator is the main driver: $q_{11,t}$ and $q_{22,t}$ are variances of normalized variables—so they should not be too far from unity. Therefore, $q_{12,t}$ is close to being the correlation itself. The equation for $q_{12,t}$ shows that it has a GARCH structure: it depends on $v_{1,t-1} v_{2,t-1}$ and $q_{12,t-1}$. Provided α and β are large numbers, we can expect the correlation to be strongly autocorrelated.

19.6.2 Estimation of a Multivariate Model*

In principle, it is straightforward to specify the likelihood function of the model and then maximize it with respect to the model parameters. For instance, if u_t is iid $N(0, \Sigma_t)$, then

the log likelihood function is

$$\ln \mathcal{L} = -\frac{Tn}{2} \ln(2\pi) - \frac{1}{2} \sum_{t=1}^T \ln |\Sigma_t| - \frac{1}{2} \sum_{t=1}^T u_t' \Sigma_t^{-1} u_t. \quad (19.28)$$

In practice, the optimization problem can be difficult since there are typically many parameters. At least, good starting values are required.

Remark 19.23 (*Starting values of a constant correlation GARCH(1,1) model*) Estimate GARCH(1,1) models for each variable separately, then estimate the correlation matrix on the standardized residuals.

Remark 19.24 (*Estimation of the dynamic correlation model*) The DCC model can be estimated by two-step procedure. First, estimate the univariate GARCH processes. Second, use the standardized residuals to estimate the dynamic correlations by maximizing the likelihood function (19.28 if we assume normally distributed errors) with respect to the parameters α and β . In this second stage, both the parameters for the univariate GARCH process and the unconditional covariance matrix \bar{Q} are kept constant. A grid search over α and β is sometimes useful in order to avoid local maxima. Notice that in the second step, we calculate Σ_t (in each iteration over the parameter values) by using R_t from (19.26) in (19.24).

Chapter 20

Risk Measures

Reference: Hull (2006) 18; McDonald (2006) 25; Fabozzi, Focardi, and Kolm (2006) 4–5; McNeil, Frey, and Embrechts (2005); Alexander (2008)

20.1 Value at Risk

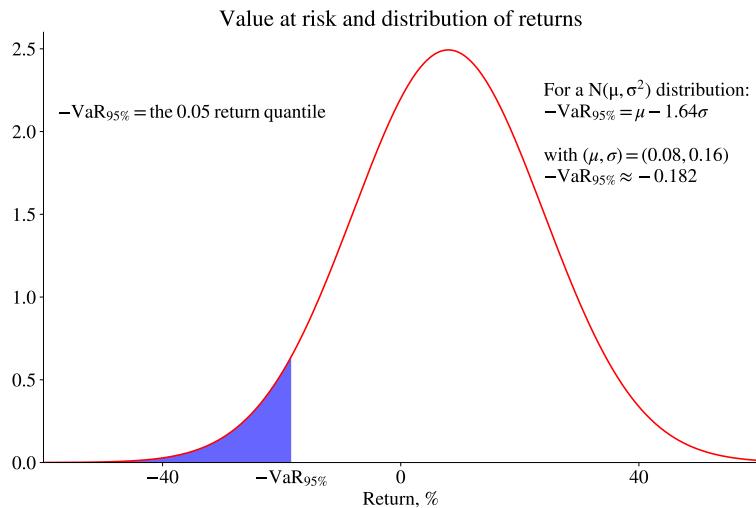


Figure 20.1: Value at risk

The mean-variance framework is often criticized for failing to distinguish between downside of the return distribution (considered to be risk) and upside (considered to be potential). The Value at Risk is one way of focusing on the downside.

Remark 20.1 (*Quantile of a distribution*) *The 0.05 quantile is the value such that there is only a 5% probability of a lower number, $\Pr(R \leq \text{quantile}_{0.05}) = 0.05$.*

The 95% Value at Risk ($\text{VaR}_{95\%}$) is a number such that there is only a 5% chance that the loss ($-R$) is larger than $\text{VaR}_{95\%}$

$$\Pr(-R \geq \text{VaR}_{95\%}) = 5\%. \quad (20.1)$$

Here, 95% is the confidence level of the VaR. For instance, if $\text{VaR}_{95\%} = 18\%$, then we are 95% sure that we will not lose more than 18% of our investment. To convert the value at risk into value terms (CHF, say), just multiply the VaR for returns with the value of the investment (portfolio).

Clearly, $-R \geq \text{VaR}_{95\%}$ is true when (and only when) $R \leq -\text{VaR}_{95\%}$, so (20.1) can also be expressed as

$$\Pr(R \leq -\text{VaR}_{95\%}) = 5\%. \quad (20.2)$$

This says that $-\text{VaR}_{95\%}$ is a number such that there is only a 5% chance that the return is below it. That is, $-\text{VaR}_{95\%}$ is the 0.05 quantile (5th percentile) of the return distribution. Using (20.2) allows us to work directly with the return distribution (not the loss distribution), which is often convenient. See Figure 20.1 for an illustration. If the return is normally distributed, $R \sim N(\mu, \sigma^2)$ then

$$\text{VaR}_{95\%} = -(\mu - 1.64\sigma). \quad (20.3)$$

Example 20.2 (*VaR with $R \sim N(\mu, \sigma^2)$*) If daily returns have $\mu = 8\%$ and $\sigma = 16\%$, then the 1-day $\text{VaR}_{95\%} = -(0.08 - 1.64 \times 0.16) \approx 0.18$; we are 95% sure that we will not lose more than 18% of the investment over one day, that is, $\text{VaR}_{95\%} = 0.18$.

More generally, we can consider the confidence level α instead of just 0.95, so

$$\Pr(R \leq -\text{VaR}_\alpha) = 1 - \alpha, \text{ so} \quad (20.4)$$

$$\text{VaR}_\alpha = -(1 - \alpha)^{th} \text{ quantile of } R. \quad (20.5)$$

If the return is normally distributed, $R \sim N(\mu, \sigma^2)$, then

$$\text{VaR}_\alpha = -(\mu + c\sigma), \quad (20.6)$$

where c is the $(1 - \alpha)^{th}$ for a $N(0, 1)$ distribution, for instance, -1.64 for $1 - \alpha = 0.05$.

This is illustrated in Figure 20.2.

Remark 20.3 (*Critical values of $N(\mu, \sigma^2)$*) If $R \sim N(\mu, \sigma^2)$, then there is a 5% probability that $R \leq \mu - 1.64\sigma$, a 2.5% probability that $R \leq \mu - 1.96\sigma$, and a 1% probability that $R \leq \mu - 2.33\sigma$.

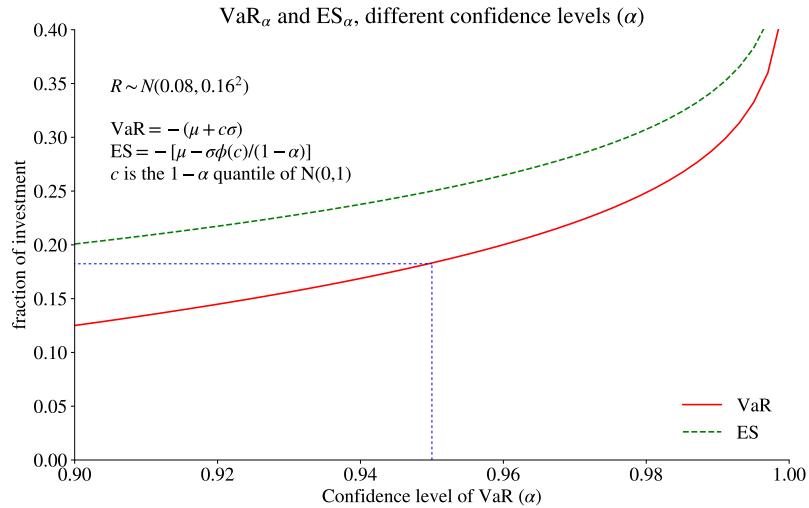


Figure 20.2: Value at risk, different probability levels

Example 20.4 (VaR with $R \sim N(\mu, \sigma^2)$) If $R \sim N(\mu, \sigma^2)$ with $\mu = 8\%$ and $\sigma = 16\%$, then $VaR_{97.5\%} = -(0.08 - 1.96 \times 0.16) \approx 0.24$.

Empirical Example 20.5 (Static (unconditional) VaR for S&P 500 returns) Figure 20.3 shows the distribution and VaRs (for different probability levels) for the daily S&P 500 returns. The results indicate that the $N()$ -based model has a reasonable coverage for the 95%, but perhaps not for the 99% confidence level.

Example 20.6 (VaR and regulation of bank capital) Bank regulations have used 3 times the 99% VaR for 10-day returns as the required bank capital.

Notice that the return distribution depends on the investment horizon, so a VaR is typically calculated for a stated investment period (for instance, one day). Multi-period VaRs are calculated by either explicitly constructing the distribution of multi-period returns, or by making simplifying assumptions about the relation between returns in different periods (for instance, that they are iid).

Remark 20.7 (Multi-period VaR) If the returns are iid, then a q -period return has the mean $q\mu$ and variance $q\sigma^2$, where μ and σ^2 are the mean and variance of the one-period returns respectively. If the mean is zero, then the q -day VaR is \sqrt{q} times the one-day VaR.

Empirical Example 20.8 (Dynamic (time-varying) VaR for S&P 500 returns) Figure 20.4 shows VaR calculated from $N(\mu_t, \sigma_t^2)$, but where the μ_t, σ_t values are allowed to change over time according to an AR(1)+GARCH(1,1) estimation.

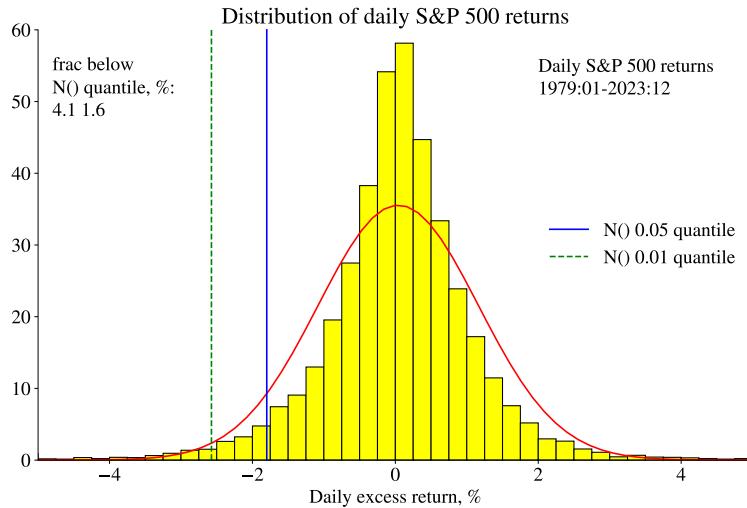


Figure 20.3: Return distribution and VaR for S&P 500

20.2 Backtesting a VaR Model

Backtesting a VaR model amounts to checking if (historical) data fits with the VaR numbers. For instance, we first find the $\text{VaR}_{95\%}$ and then calculate what fraction of returns that is actually below (the negative of) this number. If the model is correct it should be 5%. We then repeat this for $\text{VaR}_{96\%}$: only 4% of the returns should be below (the negative of) this number.

Empirical Example 20.9 (*Backtesting a static and a dynamic VaR for S&P 500 returns*)
See Figure 20.5 for results based on a static (constant) VaR model and Figure 20.6 for results from a VaR model where the volatility follows a GARCH process (to capture the time varying volatility). The evidence suggests that this model, combined with the assumption that the return is normally distributed (but with time-varying parameters), works relatively well except for very high confidence levels.

It is also important to see if there are medium- to long-run deviations from the VaR confidence level.

Empirical Example 20.10 (*Evaluating the VaR model on moving subsamples*) *See Figure 20.7 for results based on a static (constant) VaR model and Figure 20.8 for results from the GARCH model.*

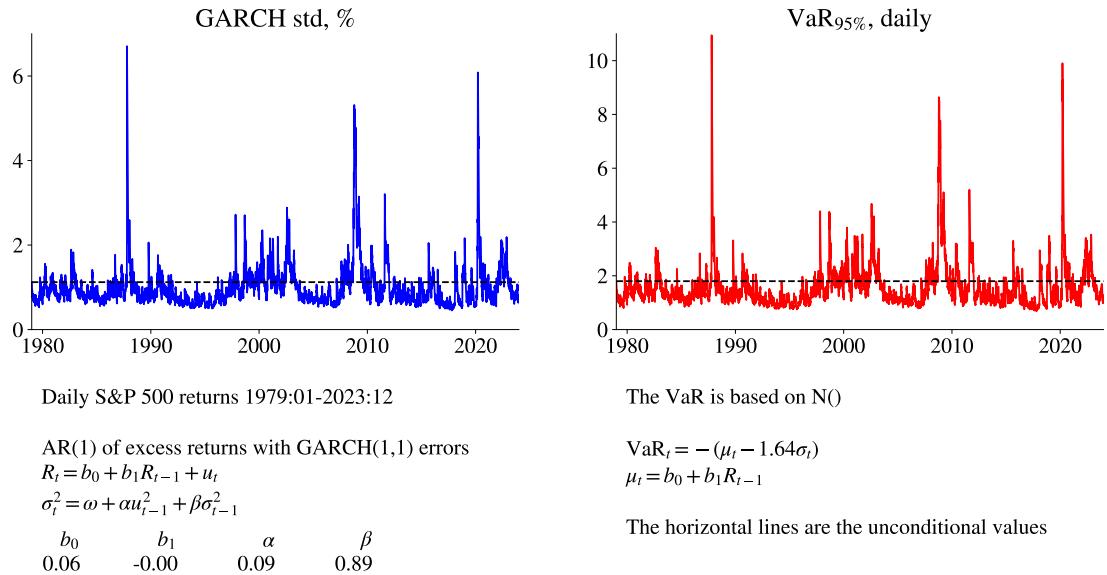


Figure 20.4: Conditional volatility and VaR

Remark 20.11 (*Bernoulli and binomial distributions*) In a Bernoulli distribution, the random variable X can only take two values: 1 or 0, with probability p and $1-p$ respectively. This gives $E(X) = p$ and $\text{Var}(X) = p(1-p)$. After n independent trials, the number of successes (y) has a binomial distribution with $E(y) = np$ and $\text{Var}(y) = np(1-p)$. For the average outcome, y/n , we then get $E(y/n) = p$ and $\text{Var}(y/n) = p(1-p)/n$.

To perform a statistical back test of a VaR model, define a variable that is one if the loss is greater than the VaR

$$d_t = \begin{cases} 1 & \text{if } R_t < -\text{VaR}_\alpha \\ 0 & \text{otherwise} \end{cases} \quad (20.7)$$

By using the properties of a binomial distribution, we notice that a sample average of d_t has the following distribution

$$\frac{1}{T} \sum_{t=1}^T d_t \xrightarrow{d} N(1 - \alpha, \alpha(1 - \alpha)/T). \quad (20.8)$$

This can be used to create a t-stat or a confidence interval.

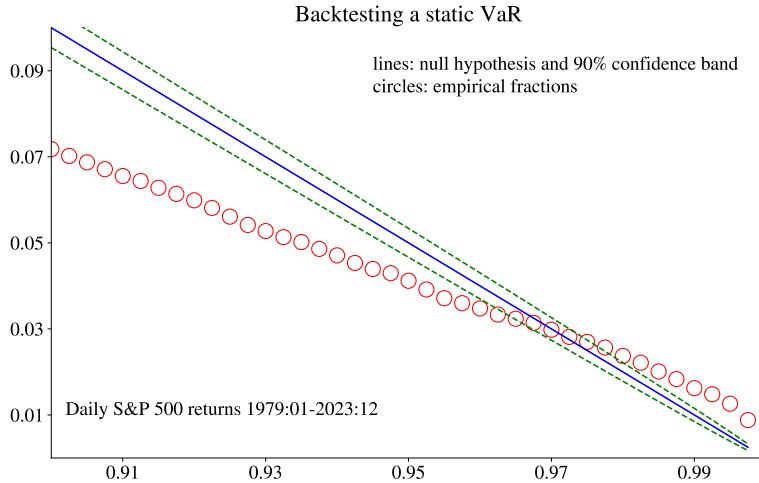


Figure 20.5: Backtesting a static VAR, assuming normally distributed shocks

20.3 Expected Shortfall

The VaR concept has been criticized for having poor aggregation properties. In particular, the VaR for a portfolio is not necessarily (weakly) lower than the portfolio of the VaRs, which contradicts the notion of diversification benefits. (To get this unfortunate property, the return distributions must be heavily skewed.) The expected shortfall has better aggregation properties.

The expected shortfall (also called conditional VaR, average value at risk and expected tail loss) is the expected loss when the return actually is below the VaR_α , that is,

$$\text{ES}_\alpha = -\mathbb{E}(R|R \leq -\text{VaR}_\alpha). \quad (20.9)$$

This might be more informative than the VaR_α , which is the *minimum loss* that will happen with a $1 - \alpha$ probability. See Figure 20.9 for an illustration.

For a normally distributed return $R \sim N(\mu, \sigma^2)$ we have

$$\text{ES}_\alpha = -\left[\mu - \frac{\phi(c_{1-\alpha})}{1-\alpha}\sigma\right], \quad (20.10)$$

where $\phi()$ is the pdf of a $N(0, 1)$ variable and where $c_{1-\alpha}$ is the $1 - \alpha$ quantile of a $N(0, 1)$ distribution (for instance, -1.64 for $1 - \alpha = 0.05$).

Proof (of (20.10)) If $x \sim N(\mu, \sigma^2)$, then $\mathbb{E}(x|x \leq b) = \mu - \sigma\phi(b_0)/\Phi(b_0)$ where $b_0 = (b - \mu)/\sigma$ and where $\phi()$ and $\Phi()$ are the pdf and cdf of a $N(0, 1)$ variable

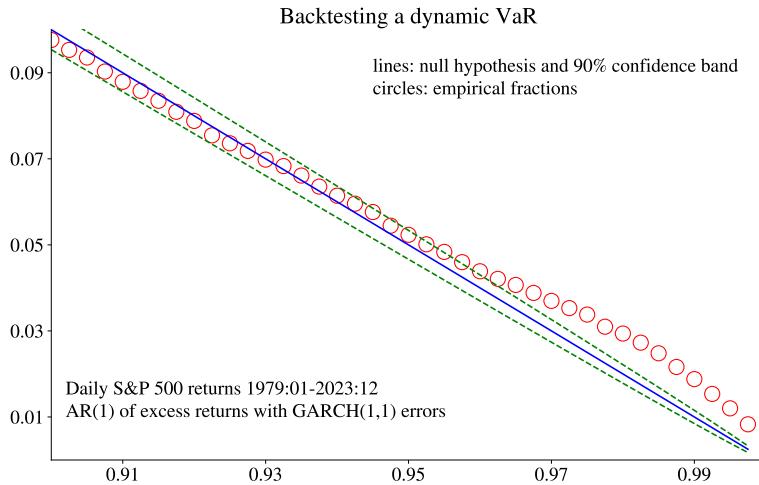


Figure 20.6: Backtesting a dynamic VaR, assuming normally distributed shocks

respectively. To apply this, use $b = -\text{VaR}_\alpha$ so $b_0 = c_{1-\alpha}$. Clearly, $\Phi(c_{1-\alpha}) = 1 - \alpha$ (by definition of the $1 - \alpha$ quantile). Multiply by -1 . \square

Example 20.12 (ES) If $\mu = 8\%$ and $\sigma = 16\%$, the 95% expected shortfall is $ES_{95\%} = -(0.08 - 2.08 \times 0.16) \approx 0.25$ (since $\phi(-1.64)/0.05 \approx 2.08$) and the 97.5% expected shortfall is $ES_{97.5\%} = -(0.08 - 2.34 \times 0.16) \approx 0.29$ (since $\phi(-1.96)/0.025 \approx 2.34$)

See Figure 20.10 for an illustration.

Empirical Example 20.13 (*Comparison of different downside risk measures for two equity portfolios*) See Table 20.1 for an empirical comparison of the VaR, ES and some more downside risk measures (discussed below).

	Small growth	Large value
Std	8.1	5.9
VaR (95%)	12.8	8.9
ES (95%)	17.9	13.1
SemiStd	5.7	3.9
Drawdown	78.4	63.2

Table 20.1: Risk measures of monthly returns of two stock indices (%), US data 1970:01-2023:12.

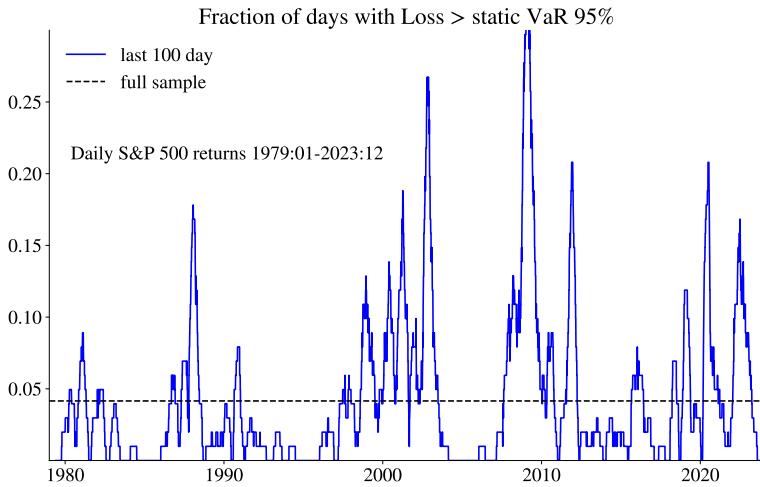


Figure 20.7: Backtesting a static VaR model on a moving data window

20.4 Semivariance and Max Drawdown

Reference: Bawa and Lindenberg (1977) and Nantell and Price (1979)

A semivariance is defined as

$$\lambda^2 = E[\min(R - E R, 0)^2]. \quad (20.11)$$

The square root of λ^2 is called the semi-standard deviation. In comparison with a variance only negative deviations from the mean are given any weight.

To estimate the semivariance from data use

$$\lambda^2 = \frac{1}{T} \sum_{t=1}^T \delta(R_t \leq \bar{R})(R_t - \bar{R})^2, \quad (20.12)$$

where $\delta(q) = 1$ if q is true and zero otherwise.

An alternative measure is the (percentage) *maximum drawdown* over a given horizon, for instance, 5 years, say. This is the largest loss from peak to bottom within the given horizon. This is a useful measure when the investor do not know exactly when he/she has to exit the investment—since it indicates the worst (peak to bottom) outcome over the sample.

Empirical Example 20.14 (*Max drawdown for different assets*) See Figure 20.13.

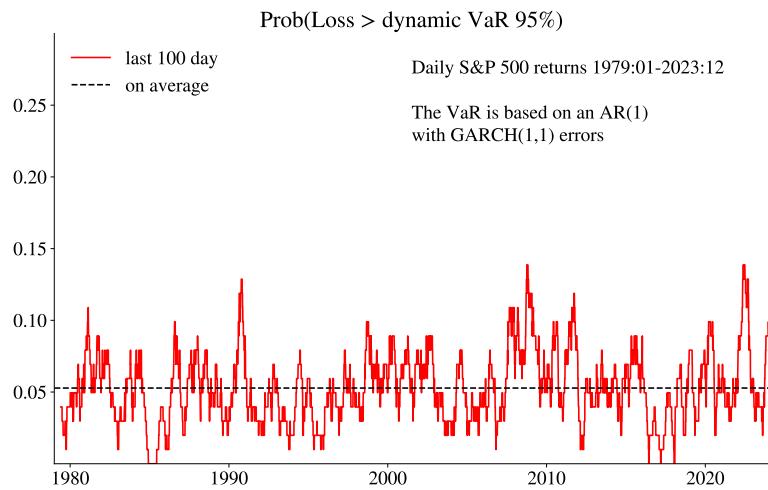


Figure 20.8: Backtesting a dynamic VaR on a moving data window

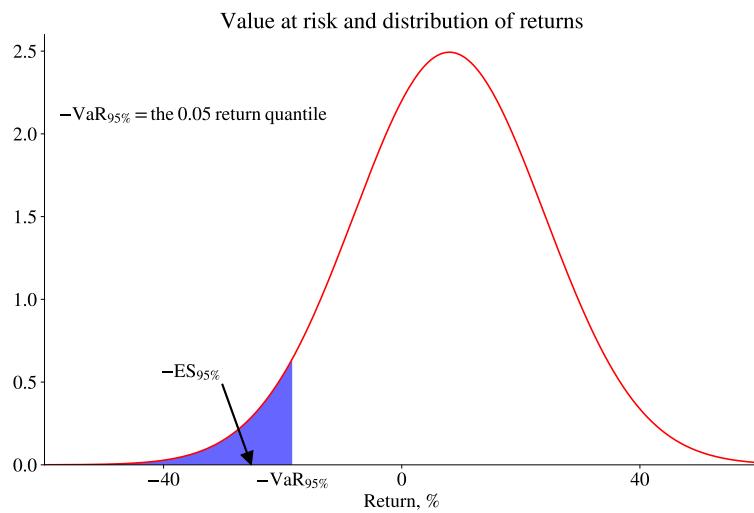


Figure 20.9: Value at risk and expected shortfall

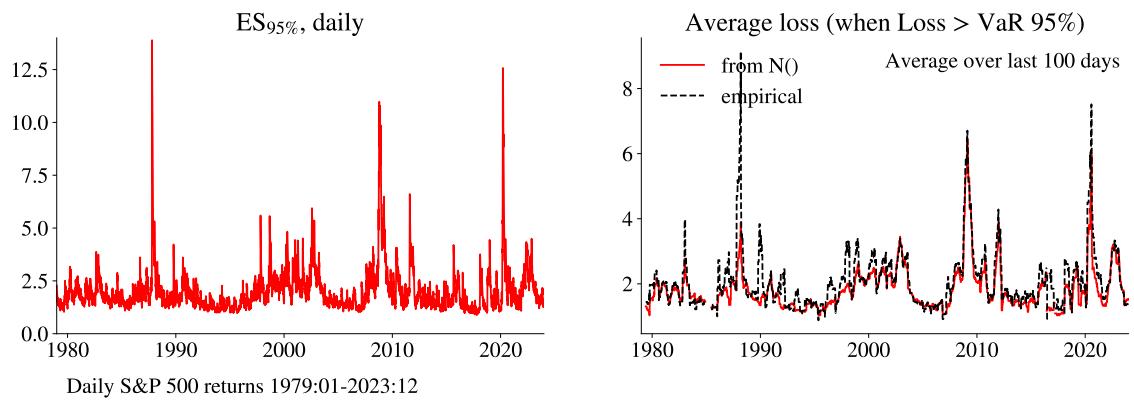


Figure 20.10: Expected shortfall from GARCH model (with backtesting)

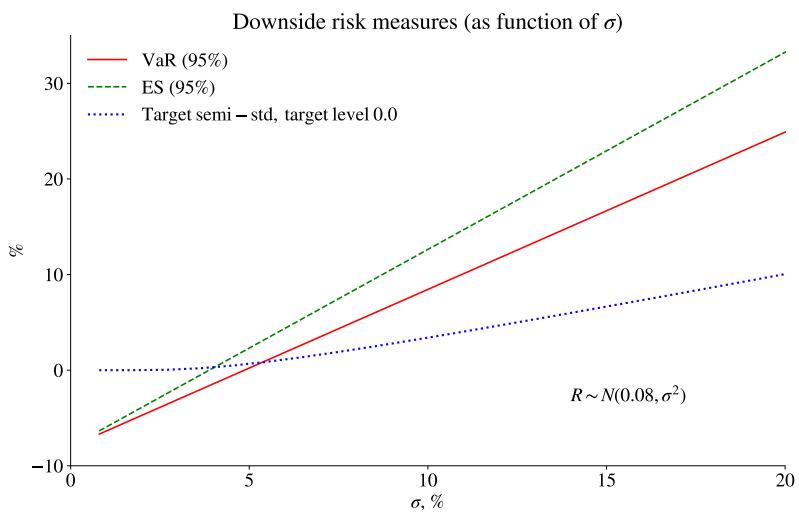


Figure 20.11: Downside risk measures as functions of the standard deviation for a $N(\mu, \sigma^2)$ variable

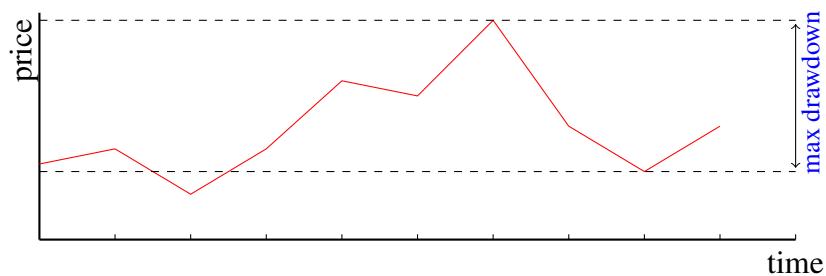


Figure 20.12: Max drawdown

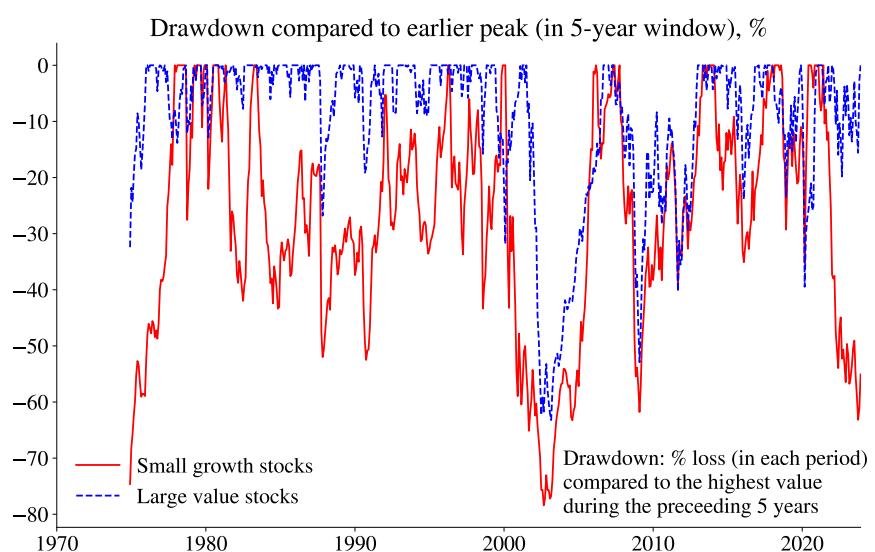


Figure 20.13: Drawdown in moving (rolling) data window

Chapter 21

Non-Parametric Regressions

21.1 Kernel Regressions

Reference: Campbell, Lo, and MacKinlay (1997) 12.3; Härdle (1990); Pagan and Ullah (1999); Mittelhammer, Judge, and Miller (2000) 21

21.1.1 Simple Kernel Regression

Non-parametric regressions are used when we are unwilling to impose a parametric form on the regression equation—and we have a lot of data.

Let the scalars y_t and x_t be related as

$$y_t = b(x_t) + \varepsilon_t, \quad (21.1)$$

where ε_t is iid and $E \varepsilon_t = 0$, $Cov [b(x_t), \varepsilon_t] = 0$ and here $b()$ is an unknown, possibly non-linear, function. In comparison, in a linear regression we have $b(x_t) = \beta x_t$.

One possibility of estimating such a function is to approximate $b(x_t)$ by a polynomial (or some other basis). This will give quick estimates, but the results are “global” in the sense that the value of $b(x)$ at a particular x value ($x = 1.9$, say) will depend on all the data points—and potentially very strongly so. The approach in this section is more “local” by down weighting information from data points where x_t is far from x .

Suppose the sample had 3 observations (say, $t = 3, 27$, and 99) with exactly the same value of x_t , say 1.9. A natural way of estimating $b(x)$ at $x = 1.9$ would then be to average over these 3 observations as we can expect average of the error terms to be close to zero (iid and zero mean).

Unfortunately, we seldom have repeated observations of this type. Instead, we may try to approximate the value of $b(x)$ (x is a single value, 1.9, say) by averaging over

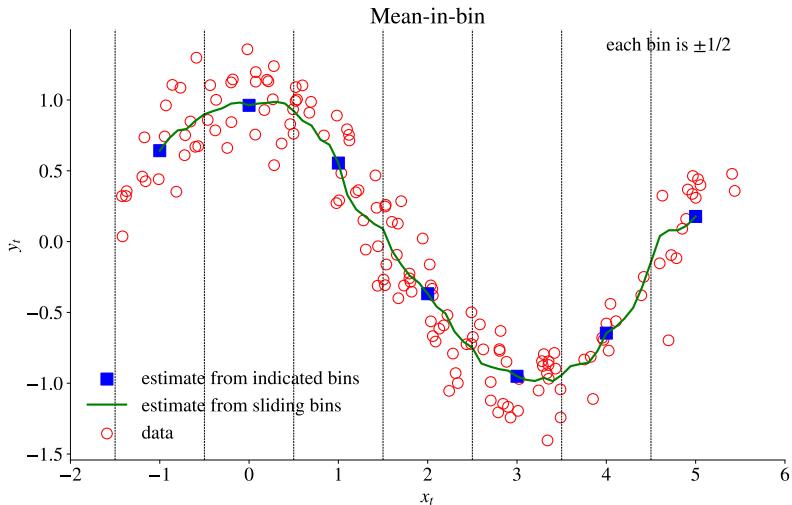


Figure 21.1: Example of a mean-in-bin estimation

observations where x_t is close to x . The general form of this type of estimator is

$$\hat{b}(x) = \frac{\sum_{t=1}^T w(x_t - x)y_t}{\sum_{t=1}^T w(x_t - x)}, \quad (21.2)$$

where $w(x_t - x)/\sum_{t=1}^T w(x_t - x)$ is the weight given to observation t . The function $w(x_t - x)$ is positive and (weakly) decreasing in the distance between x_t and x . Note that the denominator makes the weights sum to unity. The basic assumption behind (21.2) is that the $b(x)$ function is smooth so local averaging (around x) makes sense.

As an example of a $w(\cdot)$ function, it could be to give equal weight all values of x_t that are in a certain bin (“mean-bin”) and zero weight to all other observations. See Figure 21.1 for an example. Alternatively, we can give equal weights to the k values of x_t which are closest to x and zero to all other observations (this is the “ k -nearest neighbor” estimator, see Härdle (1990) 3.2). As another example, the weight function could be defined so that it trades off the expected squared errors, $E[y_t - \hat{b}(x)]^2$, and the expected squared acceleration, $E[d^2\hat{b}(x)/dx^2]^2$. This defines a cubic spline (often used in macroeconomics when $x_t = t$, and is then called the Hodrick-Prescott filter).

A *Kernel regression* uses a probability density function (pdf) as the weight function

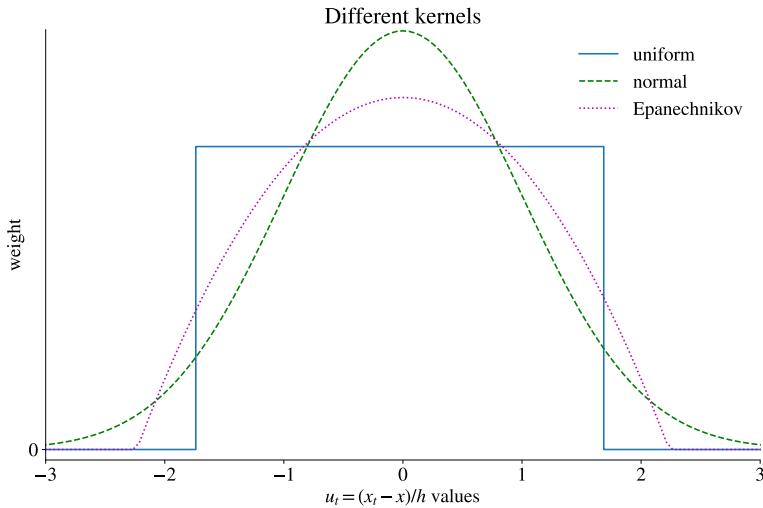


Figure 21.2: Different weighting functions for non-parametric regression

$w(\cdot)$. The perhaps simplest choice is a uniform density function

$$w(u_t) = \begin{cases} \frac{1}{2\sqrt{3}} & \text{for } |u| \leq \sqrt{3} \\ 0 & \text{otherwise,} \end{cases} \quad (21.3)$$

$$\text{with } u_t = (x_t - x)/h. \quad (21.4)$$

The reason for the $\sqrt{3}$ terms is that it makes area under the function equal to 1 ($\int w(u)du = 1$) and the variance also equal to one ($\int w(u)u^2du = 1$). This standardisation makes it easy to compare with a $N(0, 1)$ distribution. In any case, we can adjust h to get the intervals we want. For instance, with $h = 1/(2\sqrt{3})$ we get a flat function over $x - 1/2$ to $x + 1/2$. (Notice: some authors use the convention of a uniform distribution over $(x - h, x + h)$ or $(x - h/2, x + h/2)$ instead.) The mean-in-bin approach in Figure 21.1 is implemented by using (21.3).

Remark 21.1 (*Interpretation of the pdf in (21.3)*) If $w(u_t)$ is a pdf of the u_t variable, then $w(u_t)/h$ is the pdf of x_t . Notice that both give the same result in (21.2).

See Figure 21.2 for an illustration of the weights.

However, we can gain efficiency and get a smoother (across x values) estimate by using another density function than the uniform. In particular, using a density function that tapers off continuously instead of suddenly dropping to zero improves the properties. The pdf of $N(x, h^2)$ is commonly used as a kernel, where the choice of h allows us to

easily vary the relative weights of different observations. With this particular kernel, we get the following weights (for estimation of $b(x)$ at point x , for instance, $x = 1.9$)

$$w(u_t) = \frac{1}{\sqrt{2\pi}} \exp(-u_t^2/2), \text{ with } u_t = (x_t - x)/h. \quad (21.5)$$

This weighting function is positive so all observations get a positive weight, but the weights are highest for observations close to x and then tapers off in a bell-shaped way. See Figure 21.2 for an illustration.

In practice we have to estimate $\hat{b}(x)$ at a finite number of points x . This could, for instance, be 100 evenly spread points in the interval between the minimum and maximum values observed in the sample. See Figure 21.3 for an illustration

Empirical Example 21.2 (*Kernel regression of an AR(1) for equity returns*) See Figure 21.5. The results indicate mean reversion but only after extremely low or high returns.

Example 21.3 Suppose the sample has three data points $[x_1, x_2, x_3] = [1.5, 2, 2.5]$ and $[y_1, y_2, y_3] = [5, 4, 3.5]$. Consider the estimation of $b(x)$ at $x = 1.9$ and suppose we use the gaussian kernel (21.5). With $h = 1$, $u = [-0.4, 0.1, 0.6]$, so the numerator in (21.2) is (skipping the $\sqrt{2\pi}$ term)

$$\begin{aligned} \sum_{t=1}^T w(x_t - x)y_t &= e^{-(0.4)^2/2} \times 5 + e^{-0.1^2/2} \times 4 + e^{-0.6^2/2} \times 3.5 \\ &\approx 0.92 \times 5 + 1.0 \times 4 + 0.84 \times 3.5 \\ &= 11.52. \end{aligned}$$

The denominator is (again skipping the $\sqrt{2\pi}$ term, since they cancel)

$$\begin{aligned} \sum_{t=1}^T w(x_t - x) &= e^{-(0.4)^2/2} + e^{-0.1^2/2} + e^{-0.6^2/2} \\ &\approx 2.75. \end{aligned}$$

The estimate at $x = 1.9$ is therefore $\hat{b}(1.9) \approx 11.52/2.75 \approx 4.19$.

21.1.2 Choice of Bandwidth (h)

A low value of h means that the weights taper off fast—the weight function is then a normal pdf with a low variance. When $h \rightarrow 0$, then $\hat{b}(x)$ evaluated at $x = x_t$ becomes just y_t , so no averaging is done. In contrast, as $h \rightarrow \infty$, $\hat{b}(x)$ becomes the sample average of y_t , so we have global averaging. Clearly, some value of h in between is needed. See Figures 21.4 and 21.5 for illustrations.

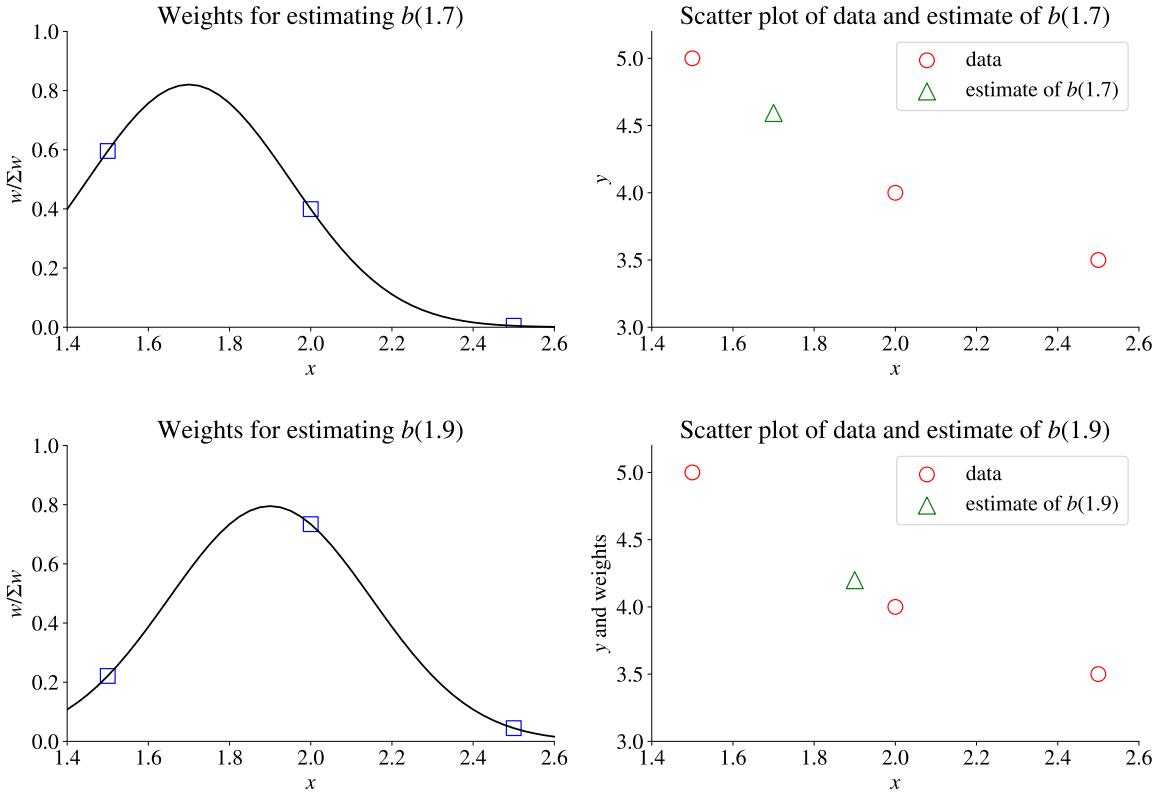


Figure 21.3: Example of kernel regression with three data points

Empirical Example 21.4 (*Kernel regression of an AR(1) for equity returns*) *Figure 21.5 clearly illustrates the importance of the bandwidth.*

A rule of thumb value of h is

$$h = 0.6 \left(\frac{\sigma_\varepsilon^2 (x_{\max} - x_{\min})}{T \gamma^2} \right)^{1/5}, \quad (21.6)$$

where γ is a from the regression $y = \alpha + \beta x + \gamma x^2 + \varepsilon$ and σ_ε^2 is the variance of those fitted residuals. In practice, we replace $x_{\max} - x_{\min}$ by the difference between the 90th and 10th percentiles of x .

A good (but computationally intensive) approach to choose h is by the leave-one-out cross-validation technique. This approach would, for instance, choose h to minimize the expected (or average) prediction error

$$\text{EPE}(h) = \sum_{t=1}^T [y_t - \hat{b}_{-t}(x_t, h)]^2 / T, \quad (21.7)$$

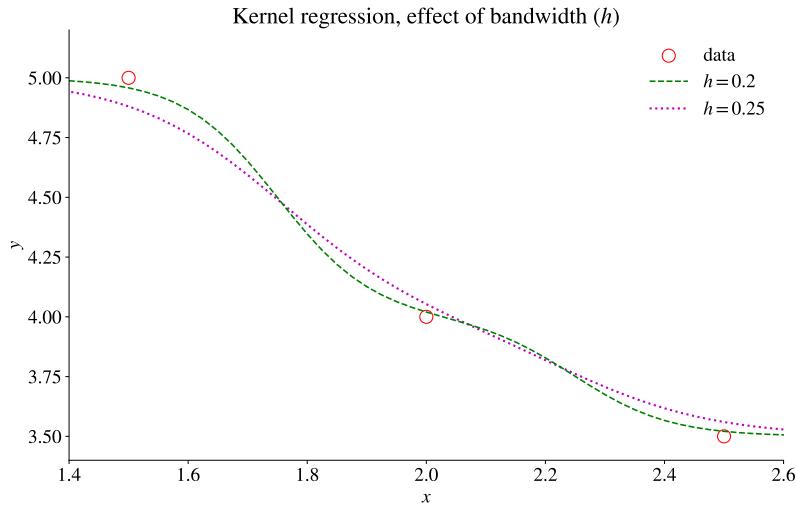


Figure 21.4: Example of kernel regression with three data points

where $\hat{b}_{-t}(x_t, h)$ is the fitted value at x_t when we use a regression function estimated on a sample that excludes observation t , and a bandwidth h . This means that each prediction is out-of-sample. To calculate (21.7) we clearly need to make T estimations (for each x_t)—and then repeat this for different values of h to find the minimum.

Empirical Example 21.5 (*Kernel regression of an AR(1) for equity returns*) Figure 21.6 shows the EPE for different values of the bandwidth for the kernel regressions previously illustrated in Figure 21.5.

Remark 21.6 (*EPE calculations*) Step 1: pick a value for h

Step 2: estimate the $b(x)$ function on all data, but exclude $t = 1$, then calculate $\hat{b}_{-1}(x_1)$ and the error $y_1 - \hat{b}_{-1}(x_1)$

Step 3: redo step 2, but now exclude $t = 2$ and. calculate the error $y_2 - \hat{b}_{-2}(x_2)$. Repeat this for $t = 3, 4, \dots, T$. Calculate the EPE as in (21.7).

Step 4: redo steps 1–3, but for another value of h . Keep doing this until you find the best h (the one that gives the lowest EPE)

21.1.3 Implementing the Kernel Regression as Weighted Least Squares

The kernel regression is about finding a weighted mean of y_t . This makes it similar to a weighted least squares (WLS) estimation where the only regressor is a constant. Recall

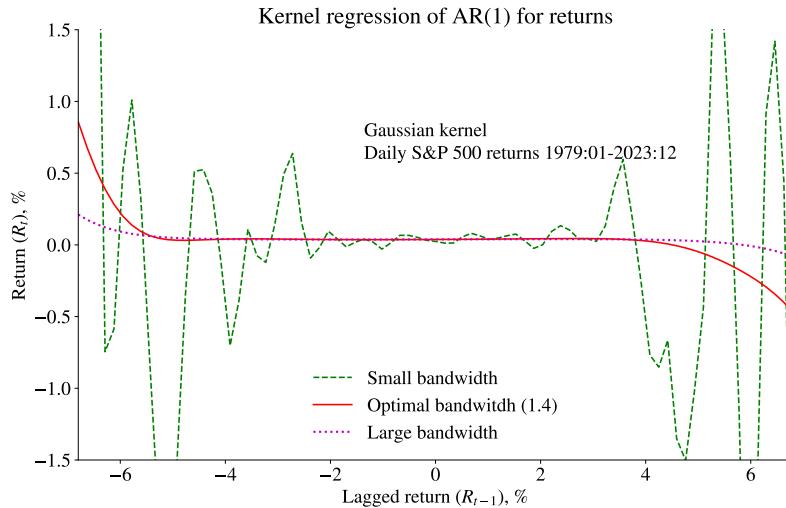


Figure 21.5: Non-parametric regression, importance of bandwidth

that a WLS estimation minimizes the weighted sum of squared residuals

$$\sum_{t=1}^T w_t (y_t - z_t' b)^2, \quad (21.8)$$

where here allow for z_t to be a K -vector and b a corresponding vector of regression coefficients.

It is straightforward to show that this can be implemented by running a regression on transformed variables

$$\tilde{y}_t = \tilde{z}_t' b + \varepsilon_t, \text{ where } \tilde{z}_t' = \sqrt{w_t} z_t \text{ and } \tilde{y}_t = \sqrt{w_t} y_t, \quad (21.9)$$

and the robust (heteroskedasticity consistent) variance-covariance matrix from this regression is a valid approach to estimate $\text{Var}(\hat{\beta})$.

In the case of a *kernel regression* $z_t = 1$ and $w_t = w(x_t - x)$. We can implement the kernel regression by doing one such regression for each choice of x .

Kernel regressions are typically consistent, provided longer samples are accompanied by smaller values of h , so the weighting function becomes more and more local as the sample size increases.

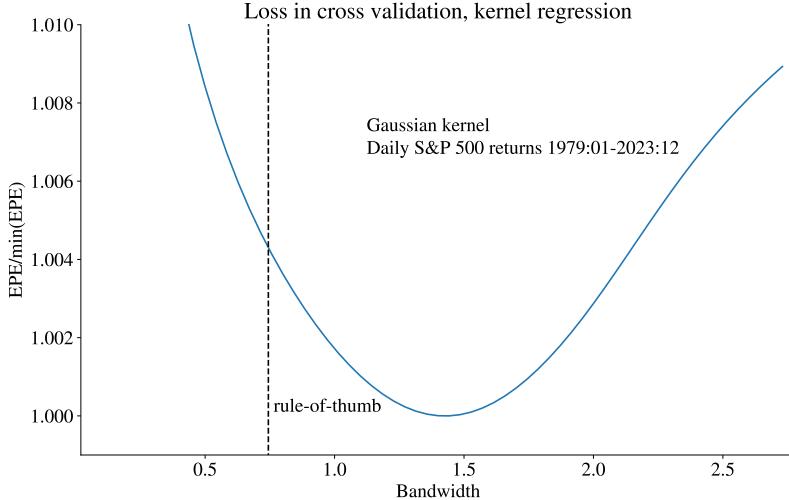


Figure 21.6: Cross-validation

21.2 Local Linear Regressions

Notice that (21.2) solves the problem $\min_{\alpha_x} \sum_{t=1}^T w(x_t - x)(y_t - \alpha_x)^2$ for each value of x . For a given value of x , α_x is a constant—but it can vary across x values. The first order condition (at a given x value) is $\sum_{t=1}^T w(x_t - x)(y_t - \alpha_x) = 0$, so the solution is as in (21.2), that is, $\hat{\alpha}_x = \hat{b}(x)$. This can be interpreted as a “local constant” regression model: for each x it is just a constant.

This can be extended to solving a problem like

$$\min_{\alpha_x, \gamma_x} \sum_{t=1}^T w(x_t - x)[y_t - \alpha_x - \beta_x(x_t - x)]^2, \quad (21.10)$$

which defines the *local linear estimator*. (Yes, the convention is to use $x_t - x$ as the regressor, but this could easily be changed.) The first order conditions are similar to the usual normal equations for LS (except that data point t has the weight $w(x_t - x)$ and that we use $x_t - x$ as the regressor). In fact, if we let $z_t = [1, x_t - x]'$ and collect the coefficients in $\theta_x = [\alpha_x, \beta_x]'$, then the first order conditions can be written

$$\sum_{t=1}^T w(x_t - x) z_t y_t = \sum_{t=1}^T w(x_t - x) z_t z_t' \hat{\theta}_x. \quad (21.11)$$

It is straightforward to solve these.

However, it is perhaps even easier if we create $\tilde{z}_t = \sqrt{w(x_t - x)} z_t$ and $\tilde{y}_t = \sqrt{w(x_t - x)} y_t$, because (21.11) is then the same as the first order conditions for a re-

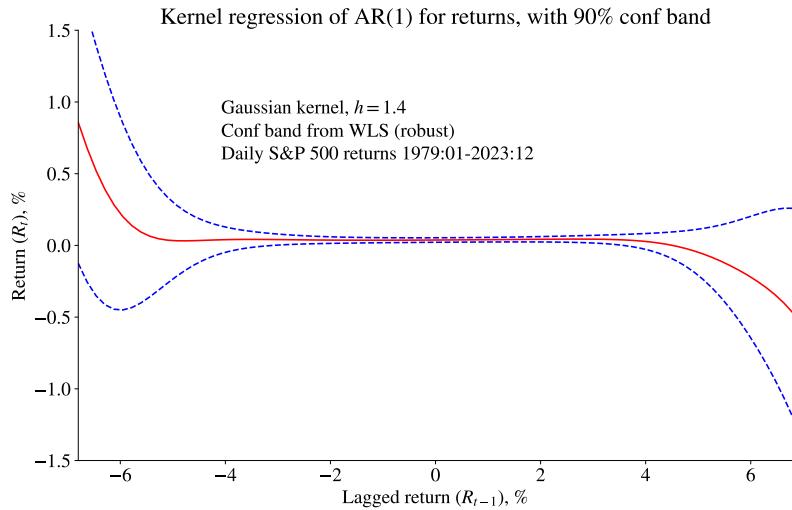


Figure 21.7: Non-parametric regression with confidence bands

gression of \tilde{y}_t on \tilde{z}_t . That is, it can be implemented by a traditional OLS routine as a regression of \tilde{y}_t on \tilde{z}_t , and this will also give a valid variance-covariance matrix of $\hat{\theta}_x$. (A White's type of covariance matrix might be a good alternative to the asymptotic result discussed below.)

Clearly, solving (21.11)) gives one $\hat{\theta}_x$ vector for each x value that we consider. Once we have the estimates, the fitted value at the value x is just $\hat{\alpha}_x$ (since the regression function is $y_t = \alpha_x + \beta_x(x_t - x) + \varepsilon_t$ and we evaluate it at $x_t = x$.)

The bandwidth parameter (which only shows up in the calculations of the weights, $w(x_t - x)$) can be chosen by a rule of thumb or leave-one-out cross validation approach.

It can be shown that the local-linear estimator has the same asymptotic variance as the kernel regression.

Empirical Example 21.7 (*Local linear regression of an AR(1) for equity returns*) See Figures 21.9 – 21.10.

21.2.1 Multivariate Kernel Regression

Suppose that y_t depends on two variables (x_t and z_t)

$$y_t = b(x_t, z_t) + \varepsilon_t, \quad \varepsilon_t \text{ is iid and } E \varepsilon_t = 0. \quad (21.12)$$

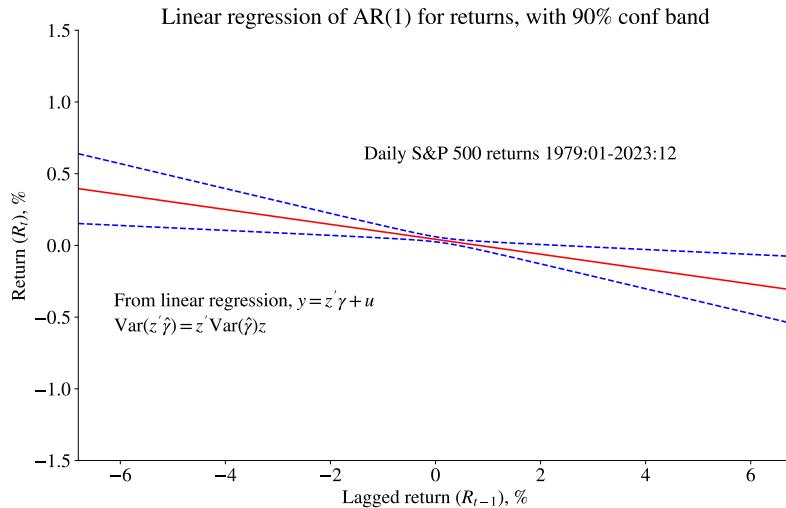


Figure 21.8: Linear regression with confidence bands

This makes the estimation problem more data demanding. To see why, suppose we use a uniform density function as weighting function (see in (21.3)). However, with two regressors, the interval becomes a rectangle. With as little as a 20 intervals of each of x and z , we get 400 bins, so we need a large sample to have a reasonable number of observations in every bin.

In any case, the most common way to implement the kernel regressor is to let

$$\hat{b}(x, z) = \frac{\sum_{t=1}^T w(x_t - x)v(z_t - z)y_t}{\sum_{t=1}^T w(x_t - x)v(z_t - z)}, \quad (21.13)$$

where $w(x_t - x)$ and $v(z_t - z)$ are two kernels like in (21.5) and where we may allow the bandwidth (h) to be different for x_t and z_t (and depend on the variance of x_t and y_t). In this case, the weight of the observation (x_t, z_t) is proportional to $w(x_t - x)v(z_t - z)$, which is high if both x_t and z_t are close to x and z respectively.

Empirical Example 21.8 (*Kernel regression of an AR(2) for equity returns*) See Figure 21.11.

Empirical Example 21.9 (*Interest rate models*) *Interest rate models are typically designed to describe the movements of the entire yield curve in terms of a small number of factors. For instance, the Vasicek model assumes that the (demeaned) short interest rate,*

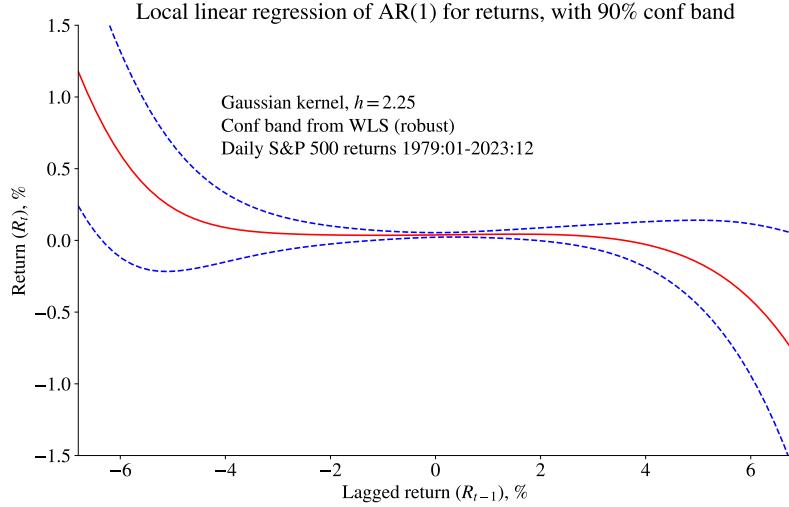


Figure 21.9: Non-parametric local linear regression with confidence bands

r_t , is a mean-reverting AR(1) process

$$r_t = \rho r_{t-1} + \varepsilon_t, \text{ where } \varepsilon_t \sim N(0, \sigma^2), \text{ so}$$

$$r_t - r_{t-1} = (\rho - 1)r_{t-1} + \varepsilon_t,$$

and that all term premia are constant. This means that the drift is decreasing in the interest rate, but that the volatility is constant. For instance, if $\rho = 0.95$ (a very persistent interest rate), then

$$r_t - r_{t-1} = -0.05r_{t-1} + \varepsilon_t,$$

so the reversion to the mean (here zero) is very slow. (The usual assumption is that the short interest rate follows an Ornstein-Uhlenbeck diffusion process, which implies the discrete time model above.) It can then be shown that all interest rates (for different maturities) are linear functions of short interest rates. To capture more movements in the yield curve, models with richer dynamics are used. For instance, Cox, Ingersoll, and Ross (1985) construct a model which implies that the short interest rate follows an AR(1), except that the variance is proportional to the interest rate level, so $\varepsilon_t \sim N(0, r_{t-1}\sigma^2)$. Non-parametric methods have been used to estimate how the drift and volatility are related to the interest rate level (see, for instance, Ait-Sahalia (1996)). (Kernel regression of a short interest rate process) Figure 21.12 gives an example. Note that the volatility is defined as the square of the drift minus expected drift (from the same estimation method).

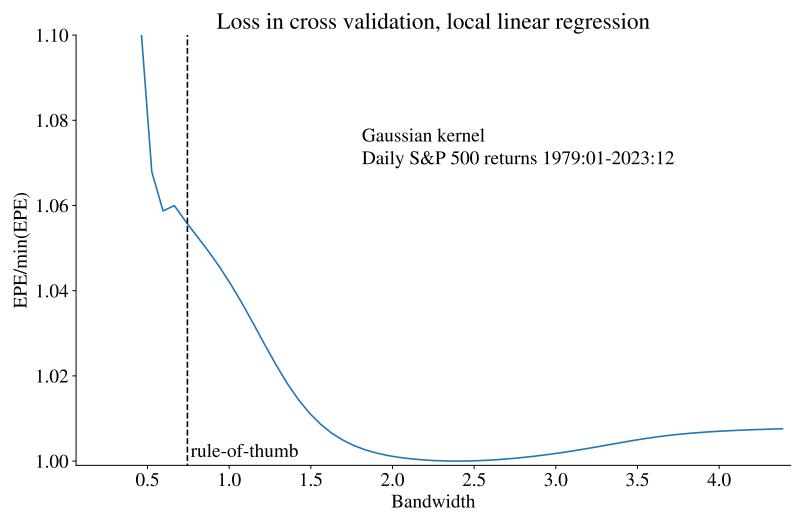


Figure 21.10: Cross-validation

Kernel regression of AR(2) for returns

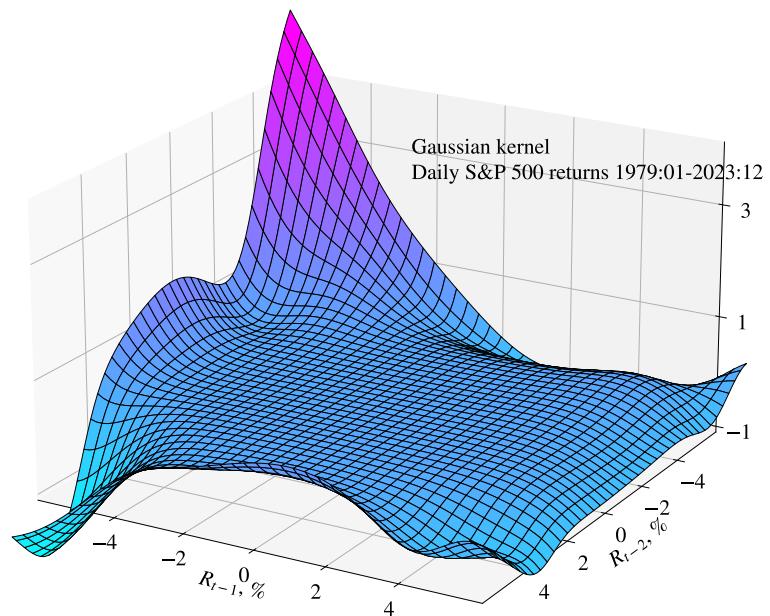


Figure 21.11: Non-parametric regression with two regressors

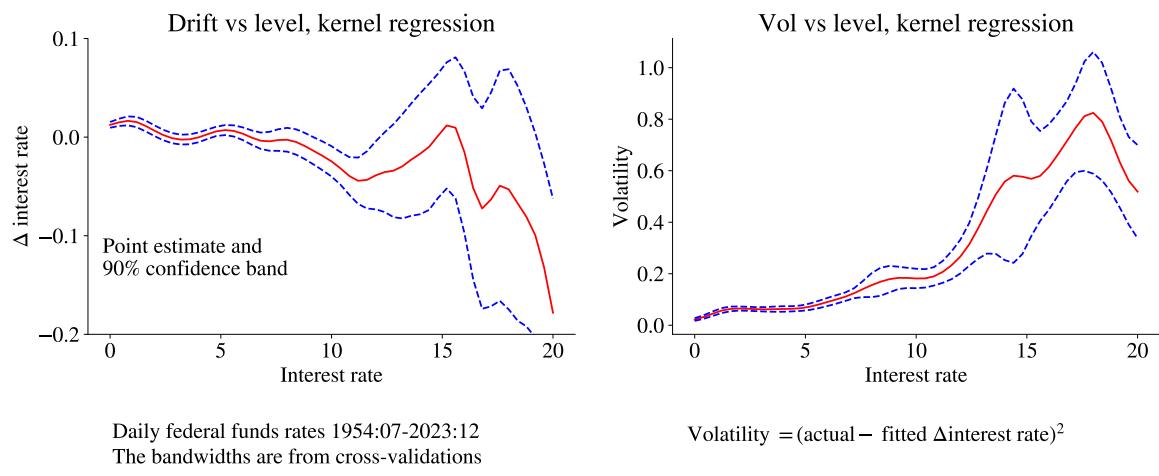


Figure 21.12: Kernel regression, confidence band

Chapter 22

LAD and Quantile Regressions

22.1 LAD

Reference: Amemiya (1985) 4.6, Greene (2018) 7, Wooldridge (2010) 12.10

The least absolute deviations (LAD) estimator minimizes the sum of absolute residuals (rather than the squared residuals)

$$\hat{b}_{LAD} = \arg \min_b \sum_{t=1}^T |y_t - x'_t b| \quad (22.1)$$

The optimization is a non-linear problem, but a simple iteration works nicely (see below). The estimator is typically less sensitive to outliers than OLS. (There are also other ways to estimate robust regression coefficients.) This is illustrated in Figure 22.1.

Empirical Example 22.1 (*LAD betas for industry portfolios*) See Figure 22.2.

If we assume that the median of the true residual, u_t , is zero, then (under strict assumptions, discussed below) we have

$$\begin{aligned} \sqrt{T}(\hat{b}_{LAD} - b_0) &\xrightarrow{d} N\left[0, f(0)^{-2} \Sigma_{xx}^{-1}/4\right], \text{ where} \\ \Sigma_{xx} &= \text{plim} \sum_{t=1}^T x_t x'_t / T, \end{aligned} \quad (22.2)$$

where $f(0)$ is the value of the pdf of the residual at zero. Unless we know this density function (or else we would probably have used MLE instead of LAD), we need to estimate it—for instance with a kernel density method. However, to arrive at the result in (22.2) we must assume that the residual is independent of the regressors. (This is discussed in some detail below, see quantile regressions).

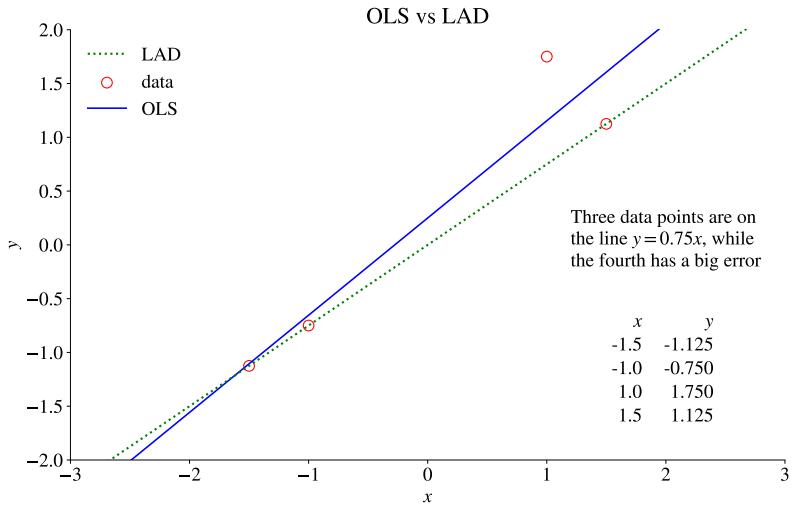


Figure 22.1: Data and regression line from OLS and LAD

Example 22.2 ($N(0, \sigma^2)$) When $u_t \sim N(0, \sigma^2)$, then $f(0) = 1/\sqrt{2\pi\sigma^2}$ (since $e^0 = 1$), so the covariance matrix in (22.2) becomes $\pi\sigma^2\Sigma_{xx}^{-1}/2$. This is $\pi/2$ times larger than when using LS.

Remark 22.3 (Estimation of $f(0)$) The $f(0)$ value can be estimated as

$$\hat{f}(0) = \frac{1}{T} \sum_{t=1}^T \frac{1}{h\sqrt{2\pi}} \exp\left[-(u_t/h)^2/2\right].$$

Remark 22.4 (Algorithm for LAD*) The LAD estimator can be written

$$\begin{aligned} \hat{b}_{LAD} &= \arg \min_b \sum_{t=1}^T w_t \hat{u}_t(b)^2, \text{ where} \\ w_t &= 1/|\hat{u}_t(b)|, \text{ with} \\ \hat{u}_t(\hat{b}) &= y_t - x'_t \hat{b} \end{aligned}$$

so it is a weighted least squares where both y_t and x_t are multiplied by $1/|\hat{u}_t(\hat{b})|^{0.5}$. It can be shown that iterating on LS with the weights given by $1/|\hat{u}_t(\hat{b})|^{0.5}$, where the residuals are from the previous iteration, converges very quickly to the LAD estimator.

22.1.1 Reinterpreting the LAD

Consider a linear regression

$$y_t = x'_t b + u_t. \quad (22.3)$$

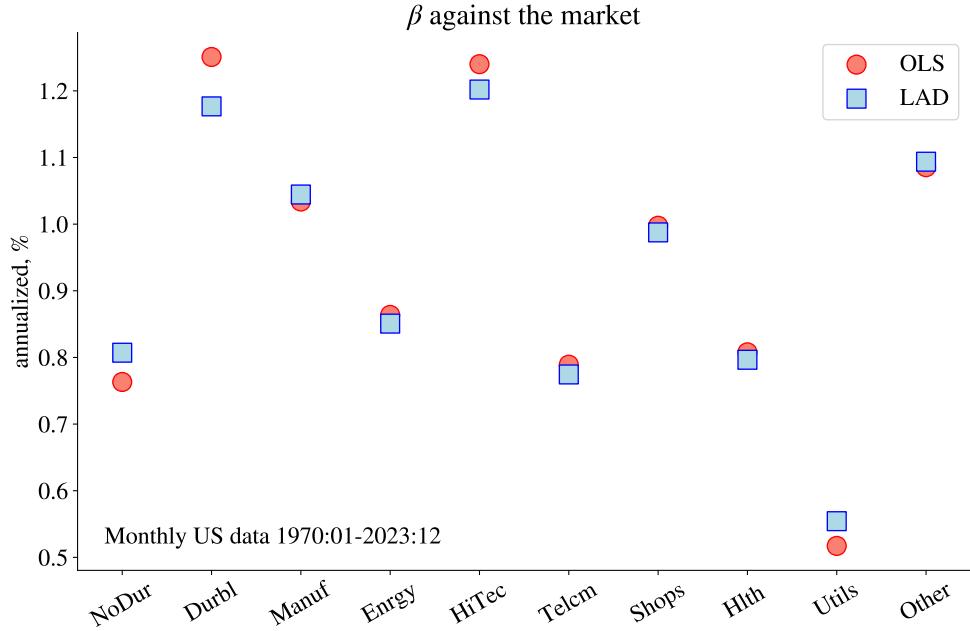


Figure 22.2: Betas of US industry portfolios

In the OLS context we typically assume $E u_t = 0$ and $\text{Cov}(x_t, u_t) = 0$. The latter is the same as $E(u_t | x_t) = 0$ which means that

$$E(y_t | x_t) = x_t' b. \quad (22.4)$$

We can interpret the LAD estimator as an alternative way of getting good estimates of b , especially when the error distribution has fat tails. In fact, when the errors have a Laplace distribution, $f(u) = \exp(-|u|/\sigma)/2\sigma$, then LAD is the MLE.

Remark 22.5 ($E(u|x) = 0$ or $(E u_t = 0, \text{Cov}(x_t, u_t) = 0)^*$) For any random variables u and x ,

$$\text{Cov}(x, u) = \text{Cov}[x, E(u|x)].$$

The condition $E(u|x) = 0$ therefore implies $\text{Cov}(x, u) = 0$. It also implies $E u = 0$ since $E u = E_x[E(u|x)] = E_x[0] = 0$.

Remark 22.6 (Mean and median as solutions to minimization problems) If u is a random variable, then the mean, μ , is the solution to $\min_{\mu} E(u - \mu)^2$, while the median, m , is the solution to $\min_m E|u - m|$. (There are some restrictions on u for this to be true, but we disregard that here.)

The previous remark shows that the LAD estimator (22.1) amounts to finding the b coefficients (in a linear model) so that

$$\text{Median}(u_t|x_t) = 0, \text{ which implies} \quad (22.5)$$

$$\text{Median}(y_t|x_t) = x_t'b. \quad (22.6)$$

This is the alternative interpretation of the LAD: it tries to set the median of the residuals, at a given x_t vector, equal to zero. In contrast, OLS tries to set the mean of the residuals, at a given x_t vector, to zero.

22.2 Quantile Regressions

A quantile regression is a generalization of the LAD. Instead of focusing on the 0.5th quantile (the median), as is done in (22.5), it rather states that the q th quantile (conditional on x_t) of the residual is zero

$$Q(u_t|x_t; q) = 0, \text{ which implies} \quad (22.7)$$

$$Q(y_t|x_t; q) = x_t'b^{(q)}. \quad (22.8)$$

Here $Q(u_t|x_t; q)$ denotes the q th quantile of u_t at a particular value of x_t and we also index the coefficients $b^{(q)}$ to remember that this refers to the q th quantile. Clearly, the LAD is the special case when $q = 0.5$.

We could estimate (see below for how) such coefficients for various quantiles. When x_t just contains a constant and one more regressor, then it is easy to illustrate. See Figure 22.3 for an example where the slopes differ across the quantiles and Figure 22.4 where they do not. In particular, in Figure 22.3 the data follows a *location and scale model*

$$y_t = x_t'\beta + u_t \text{ where } u_t = x_t'\gamma\varepsilon_t, \text{ and } \varepsilon_t \text{ is iid.} \quad (22.9)$$

This is basically a linear model ($y_t = x_t'\beta$), but where the residuals (u_t) are heteroskedastic. In particular, the volatility of u_t is increasing in $|x_t'\gamma|$. This highlights the key feature of quantile regressions: they are well suited for showing how both the typical (median) and tails (for instance, the 0.1th and 0.9th quantiles) are related to the regressors. Notice, however, that we are always referring to *conditional quantiles*, that is, to quantiles of y_t at a particular value of x_t . We are *not* referring to unconditional quantiles of y_t . This means that the slopes for a high quantile (0.9, say) do not necessarily describe the rela-

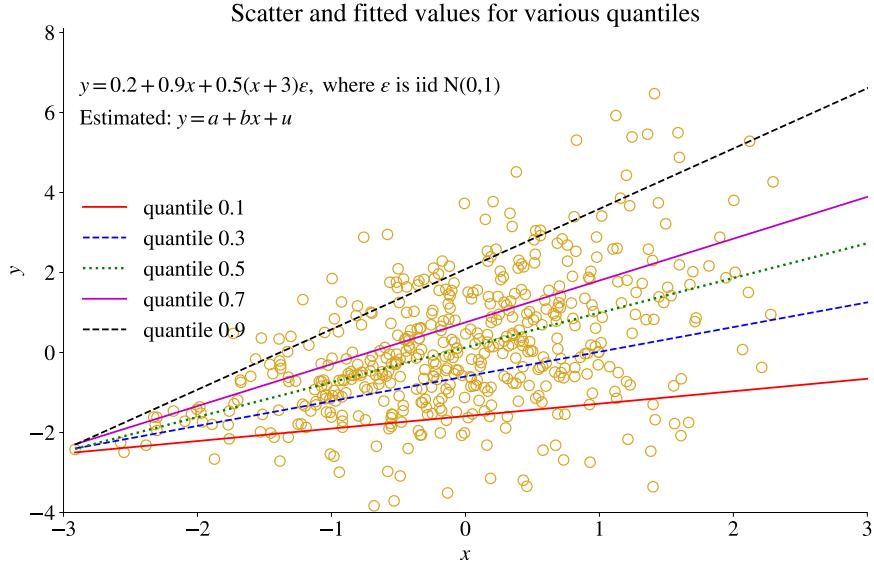


Figure 22.3: Example of quantile regression

tion between y_t and x_t at generally (unconditionally) high y_t (or x_t) values—see Figure 22.3. Rather, the slopes describes the relation between y_t and x_t at high ε_t values. This is perhaps best seen by using the location and scale model in (22.9) which implies

$$Q(y_t|x_t; q) = x_t'\beta + Q(u_t|x_t; q) \quad (22.10)$$

$$= x_t'\beta + x_t'\gamma Q(\varepsilon_t; q) \quad (22.11)$$

$$= x_t'[\beta + \gamma Q(\varepsilon_t; q)]. \quad (22.12)$$

(In the second line, $Q(\varepsilon_t; q)$ need not be conditioned on x_t since ε_t is independent of x_t .) Comparing with (22.8) shows that

$$b^{(q)} = \beta + \gamma Q(\varepsilon_t; q). \quad (22.13)$$

For instance, if $\gamma > 0$, then $b^{(q)}$ is increasing with q (since $Q(\varepsilon_t; q)$ is). This is the case illustrated in Figure 22.3—where the higher slopes at high quantiles basically capture heteroskedasticity. In contrast, Figure 22.4 shows the case where the γ coefficient on the non-constant regressors are all zero: the $b^{(q)}$ coefficients (except for the constants) are the same across quantiles.

Empirical Example 22.7 (*Quantile regressions of an AR(1) for S&P 500 returns*) Figure 22.5 illustrates these points by showing the predicted quantiles of a return as a func-

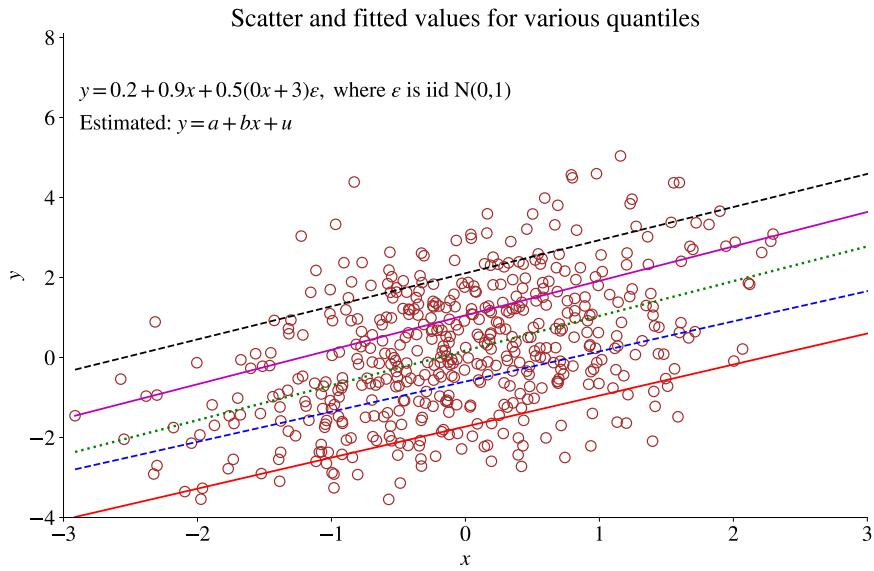


Figure 22.4: Example of quantile regression

tion of the lagged return. The empirical evidence suggests that the typical (median) effect of a lagged return on today's return is almost zero (there is a weak pattern of negative return to be followed by positive returns and vice versa). More pronounced is the smaller dispersion of returns after positive returns—and this is where the real payoff of the quantile regressions is.

The estimated coefficients for the q th quantile, $b^{(q)}$, solves the following problem

$$\min_{b^{(q)}} \sum_{t:u_t \geq 0} q|u_t| + \sum_{t:u_t < 0} (1-q)|u_t|, \text{ where } u_t = y_t - x'_t b^{(q)}. \quad (22.14)$$

This is a highly non-linear problem (and the objective function does not have continuous derivatives), which can be solved by either linear programming method, a derivative-free minimization algorithm or an iterative LS approach. As a special case, $q = 0.5$ gives the LAD where (22.14) becomes

$$\min_{b^{(0.5)}} 0.5 \sum_{t=1}^T |u_t|, \text{ where } u_t = y_t - x'_t b^{(q)}, \quad (22.15)$$

which is clearly the same as (22.1).

Remark 22.8 (*Algorithm for quantile regressions**) Applying the same idea as for LAD,

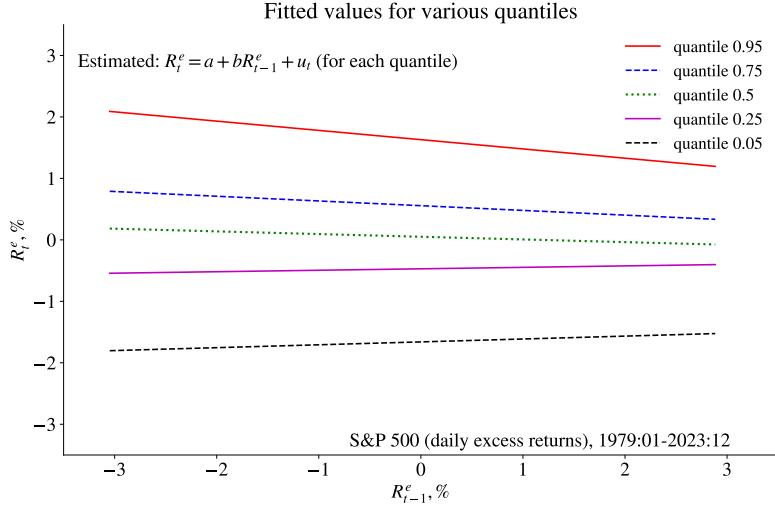


Figure 22.5: Quantile regression of AR(1) of daily returns

we can write (22.14) as

$$\hat{b}_{LAD} = \arg \min_b \sum_{t=1}^T w_t u_t^2, \text{ where}$$

$$w_t = \begin{cases} q / |\hat{u}_t(b)| & \text{if } \hat{u}_t(b) \geq 0 \\ (1-q) / |\hat{u}_t(b)| & \text{otherwise.} \end{cases}$$

We iterate by using the weights from the previous iteration. (By dividing the loss function by $q(1-q)$, we could also write the weights as $1/[(1-q)|\hat{u}_t(b)|]$ and $1/[q|\hat{u}_t(b)|]$, which is how some commonly used code sets it up.)

Remark 22.9 (Alternative way of writing (22.14)) Suppose $u_1 \geq 0$ and $u_2 < 0$, then the sum in (22.14) can be written $qu_1 + (q-1)u_2$. This suggests that if we define a dummy d_t to be 1 if $u_t < 0$ and zero otherwise, then we can write the sum as $(q-d_t)u_1 + (q-d_t)u_2$. In general, the minimisation problem can then be written

$$\min_{b^{(q)}} \sum_{t=1}^T (q - d_t) u_t.$$

The term $(q - d_t)u_t$ is sometimes written as a function $\rho_q(u_t)$, so the sum becomes $\sum_{t=1}^T \rho_q(u_t)$. As a function of u_t , the $\rho_q(u_t)$ function has a (skewed) v-shape around $u_t = 0$. For $u_t < 0$ the function is $(q-1)u_t$ so it is linear with a (negative) slope of $q-1$, and for u_t it is also linear but with a slope of q .

The asymptotic distribution of the estimates is typically

$$\begin{aligned}\sqrt{T}(\hat{b}^{(q)} - b_0^{(q)}) &\xrightarrow{d} N[0, q(1-q)C^{-1}\Sigma_{xx}C^{-1}], \text{ where} \\ \Sigma_{xx} &= \text{plim} \sum_{t=1}^T x_t x_t' / T \text{ and} \\ C &= \text{plim} \sum_{t=1}^T f(0|x_t) x_t x_t' / T,\end{aligned}\quad (22.16)$$

where $f(0|x_t)$ is the value of the pdf of the residual, conditional on the regressor value, at a zero residual. If x_t is independent of the regressor, then $f(0|x_t) = f(0)$ where the latter is the unconditional density of the residual. In this case, the covariance matrix can be written $q(1-q)f(0)^{-2}\Sigma_{xx}^{-1}$, which gives the result in (22.2) once we set $q = 0.5$.

One way of obtaining a consistent estimate of C is via a kernel density estimate

$$\begin{aligned}C &= \sum_{t=1}^T w_t x_t x_t' / T, \text{ with} \\ w_t &= \frac{1}{h\sqrt{2\pi}} \exp\left[-(\hat{u}_t/h)^2/2\right],\end{aligned}\quad (22.17)$$

and where \hat{u}_t is the fitted residual and h could be chosen as $h = 1.06 \text{Std}(\hat{u}_t)T^{-1/5}$ (see Silverman (1986)). Alternatively, w_t could be calculated using the uniform kernel instead, $w_t = \delta(-h/2 \leq \hat{u}_t \leq h/2)/h$, where $\delta(z) = 1$ when z is true. Notice that the product of w_t and $x_t x_t'$ in (22.17) is aimed at capturing the fact that $f(0|x_t)$ and $x_t x_t'$ are related—something that was ruled out in (22.2).

Chapter 23

Binary Choice and Truncated Models

Reference: Verbeek (2012) 7; Greene (2018) 17.

23.1 Binary Choice Model

23.1.1 Basic Model Setup

Consider the binary variable

$$y_i = \begin{cases} 0 & \text{firm } i \text{ doesn't pay dividends} \\ 1 & \text{firm } i \text{ pays dividends} \end{cases} \quad (23.1)$$

and suppose we know a few things about firm i : x_i (industry, size, profitability...).

We are interested in the probability that firm i pays dividends—and think it is some function of x_i

$$\Pr(y_i = 1|x_i) = F(x'_i \beta). \quad (23.2)$$

We want to study how x_i affects the probability that a firm pays dividends ($y_i = 1$), that is, we want to estimate β .

What function $F()$ should we use in (23.2)? Mostly a matter of convenience. A *probit model* assumes that $F()$ is a standard normal cumulative distribution function, see Figure 23.1. Other choices of $F()$ give the *logit model* ($F()$ is a logistic function) or the *linear probability model* ($F(x'_i \beta) = x'_i \beta$). See Figure 23.2 for an illustration.

Remark 23.1 (*Logistic function*) The logistic function is $F(v) = \frac{1}{1+\exp(-v)}$. The derivative of $F(v)$ is $(1 - F(v))F(v)$.

The results are often interpreted by looking at the marginal effects. For instance, the

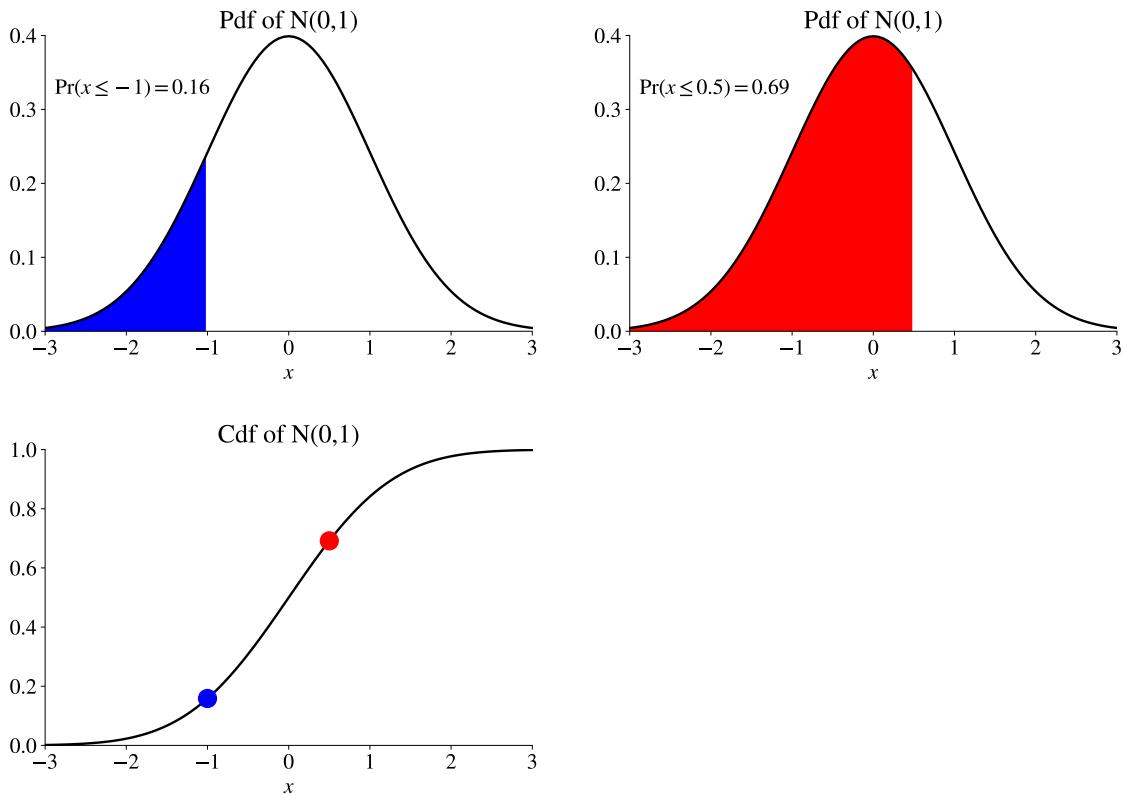


Figure 23.1: Pdf and cdf of $N(0,1)$

marginal effect of changing regressor k is

$$\frac{\partial F(x_i' \beta)}{\partial x_{k,i}} = f(x_i' \beta) \beta_k, \quad (23.3)$$

where $f()$ is the derivative of $F()$. (The notation $x_{k,i}$ is meant to indicate regressor k for firm i and β_k is the coefficient on regressor k) This is calculated at some typical value x_i (for instance, at the sample average of the regressors). This could, for instance, answer the question: how does the probability of having dividends change when profits change? Notice that if the $F()$ function is increasing (all three alternatives mentioned above are), then the derivative (23.3) has the same sign as β_k (since $f() > 0$). In a linear probability model, $f() = 1$ so the marginal effect equals β_k .

Example 23.2 Constant plus two more regressors (w and z): $x_i' \beta = \beta_0 + \beta_1 w_i + \beta_2 z_i$, then

$$\frac{\partial F(x_i' \beta)}{\partial w} = f(\beta_0 + \beta_1 w_i + \beta_2 z_i) \beta_1,$$

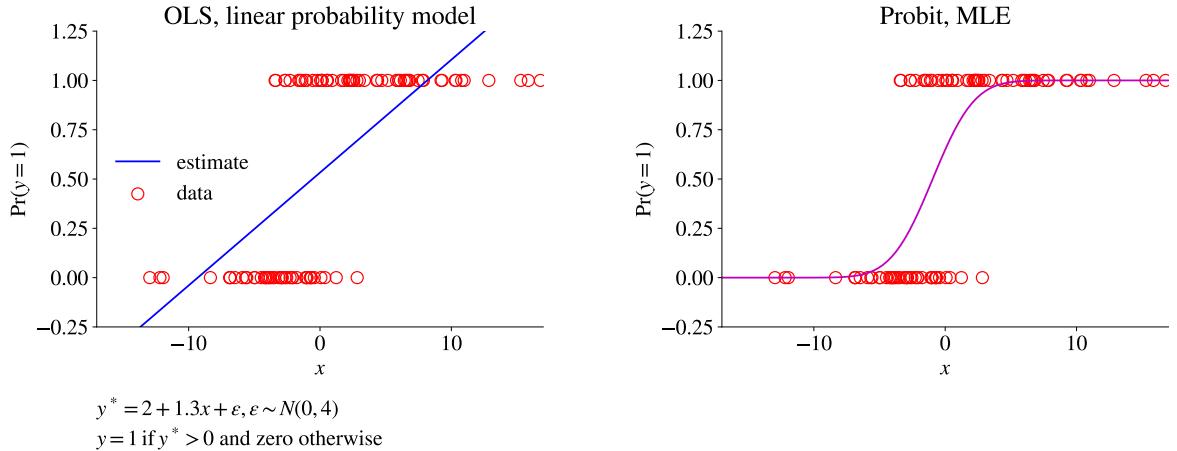


Figure 23.2: Example of probit model

where $f()$ is the derivative of $F()$. This is calculated at some typical values of (w_i, z_i) .

Example 23.3 If a regressor is a dummy variable, then use a simple difference instead of attempting a derivative. For instance, if z_i is either 0 or 1, then we can use

$$F(\beta_0 + \beta_1 w_i + \beta_2) - F(\beta_0 + \beta_1 w_i).$$

This is calculated at some typical value of w_i . In a linear probability model the result is β_2 .

Notice from (23.3) that the ratio of two coefficients equals the ratio of their marginal effect on the probability

$$\beta_k / \beta_m = \frac{\partial F(x'_i \beta)}{\partial x_{k,i}} / \frac{\partial F(x'_i \beta)}{\partial x_{m,i}}.$$

23.1.2 Estimation

A linear probability model can be estimated by OLS: regress y_i (which is 0 or 1) on a vector of regressors x_i .

In contrast, with a non-linear $F()$, the model is typically estimated with MLE. To do that we need to construct the likelihood function

$$\ln L = \sum_{i=1}^N y_i \ln F(x'_i \beta) + (1 - y_i) \ln [1 - F(x'_i \beta)]. \quad (23.4)$$

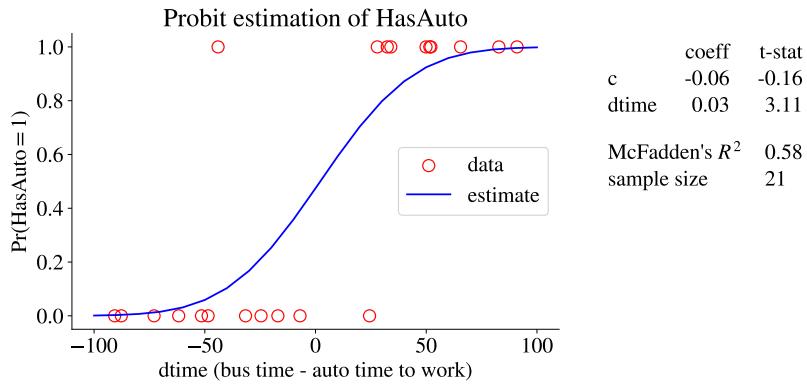


Figure 23.3: Example of probit model, Hill et al (2008), Table 16.1

We find the ML estimate by maximizing this log likelihood function with respect to the parameters β . See Figure 23.3 for an empirical example.

Proof (of (23.4)*) Recall that a Bernoulli distribution is specified as $\Pr(y_i = 1) = p_i$, $\Pr(y_i = 0) = 1 - p_i$. Assume independent observations (here, firm 1 and 2).

Then, the probabilities (likelihoods) for the different outcomes are

$$\begin{aligned} \Pr(y_1 = 1 \text{ and } y_2 = 1) &= p_1 p_2 \\ \Pr(y_1 = 1 \text{ and } y_2 = 0) &= p_1 (1 - p_2) \\ \Pr(y_1 = 0 \text{ and } y_2 = 1) &= (1 - p_1) p_2 \\ \Pr(y_1 = 0 \text{ and } y_2 = 0) &= (1 - p_1) (1 - p_2). \end{aligned} \quad (23.5)$$

At this point p_i are just symbols for the probabilities. Soon, we use replace them with the specification in (23.2). This will be long (and messy to program) when there are many observations (firms). We therefore use an alternative way of writing the same thing. Notice that

$$p_i^{y_i} (1 - p_i)^{1-y_i} = \begin{cases} p_i & \text{if } y_i = 1 \\ 1 - p_i & \text{if } y_i = 0. \end{cases}$$

For the sample with two data points (firm 1 and 2), the probability (likelihood) can be written

$$L = p_1^{y_1} (1 - p_1)^{1-y_1} \times p_2^{y_2} (1 - p_2)^{1-y_2}.$$

Let $p_i = F(x'_i \beta)$ from (23.2) and use in the likelihood function

$$L = F(x'_1 \beta)^{y_1} [1 - F(x'_1 \beta)]^{1-y_1} \times F(x'_2 \beta)^{y_2} [1 - F(x'_2 \beta)]^{1-y_2}.$$

or as log (after slight rearranging)

$$\begin{aligned}\ln L &= y_1 \ln F(x'_1 \beta) + y_2 \ln F(x'_2 \beta) \\ &\quad + (1 - y_1) \ln [1 - F(x'_1 \beta)] + (1 - y_2) \ln [1 - F(x'_2 \beta)].\end{aligned}$$

The extension to N data points is straightforward. \square

23.1.3 Goodness of Fit

To measure the fit, we use several different approaches—since a traditional R^2 is not appropriate for a non-linear model.

First, McFadden's R^2 is a commonly applied measure that has many features in common with a traditional R^2 . It is

$$\text{McFadden's } R^2 = 1 - \frac{\text{log likelihood value (at max)}}{\text{log likelihood value (all coeffs=0, except constant)}}. \quad (23.6)$$

Notice: $\ln L < 0$ since it is a log of a probability (the likelihood function value), but gets closer to zero as the model improves. McFadden's R^2 (23.6) is therefore between 0 (as bad as a model with only a constant) and 1 (a perfect model).

Example 23.4 If $\ln L = \ln 0.9$ (at max) and the model with only a constant has $\ln L = \ln 0.5$

$$\text{McFadden's } R^2 = 1 - \frac{\ln 0.9}{\ln 0.5} \approx 0.84$$

If instead, the model has $\ln L = \ln 0.8$ (at max), then

$$\text{McFadden's } R^2 = 1 - \frac{\ln 0.8}{\ln 0.5} \approx 0.68$$

An alternative measure of the goodness of fit is an “ R^2 ” for the predicted probabilities. To compare predictions to data, let the “predictions” be

$$\hat{y}_i = \begin{cases} 1 & \text{if } F(x'_i \hat{\beta}) > 0.5 \\ 0 & \text{otherwise.} \end{cases} \quad (23.7)$$

This says that if the fitted probability $F(x'_i \hat{\beta})$ is higher than 50%, then we define the fitted binary variable to be one, otherwise zero. We now cross-tabulate (as in a contingency

table) the actual (y_i) and predicted (\hat{y}_i) values:

	$\hat{y}_i = 0$	$\hat{y}_i = 1$	Total
$y_i = 0$:	n_{00}	n_{01}	N_0
$y_i = 1$:	n_{10}	n_{11}	N_1
Total:	\hat{N}_0	\hat{N}_1	N

(23.8)

There are $n_{01} + n_{10}$ incorrect predictions: n_{01} are the number of cases when $y_i = 0$ but $\hat{y}_i = 1$, and n_{10} for the opposite case ($y_i = 1$ but $\hat{y}_i = 0$). Define an “ R^2_{pred} ” for the prediction as

$$\text{“}R^2_{pred}\text{”} = 1 - \frac{\text{number of incorrect predictions}}{\text{number of incorrect predictions, constant probabilities}}. \quad (23.9)$$

This is somewhat reminiscent of a traditional R^2 since it measures the errors as the number of incorrect predictions—and compare the model with a very static benchmark (constant probability).

The constant probability is just the fraction of data where the binary variable equals one

$$\begin{aligned} \hat{p} &= \text{Fraction of } (y_i = 1) \\ &= N_1/N, \end{aligned} \quad (23.10)$$

where $N_1 = n_{10} + n_{11}$ are the number of cases when $y_i = 1$ and N is the total number of data points.

When $\hat{p} \leq 0.5$, the (naive) constant probability model always predicts $y_i = 0$, so the number of incorrect predictions (denominator of (23.9)) is N_1 . Otherwise it is N_0 . For the estimated model, the number of incorrect predictions (when $\hat{y}_i \neq y_i$) is $n_{10} + n_{01}$. This gives the “ R^2_{pred} ” in (23.9) as

$$\text{“}R^2_{pred}\text{”} = \begin{cases} 1 - \frac{n_{01} + n_{10}}{N_1} & \text{if } \hat{p} \leq 0.5 \\ 1 - \frac{n_{01} + n_{10}}{N_0} & \text{if } \hat{p} > 0.5. \end{cases}$$

Example 23.5 Let x_i be a scalar. Suppose we have the following data

$$\begin{aligned} \begin{bmatrix} y_1 & y_2 & y_3 & y_4 \end{bmatrix} &= \begin{bmatrix} 1 & 0 & 1 & 1 \end{bmatrix} \text{ and} \\ \begin{bmatrix} x_1 & x_2 & x_3 & x_4 \end{bmatrix} &= \begin{bmatrix} 1.5 & -1.2 & 0.5 & -0.7 \end{bmatrix} \end{aligned}$$

See Figure 23.4

Suppose $\beta = 0$, then we get the following values

$$F(x_i' \beta) = \begin{bmatrix} 0.5 & 0.5 & 0.5 & 0.5 \end{bmatrix}$$

$$\begin{aligned} & y_i \log F(x_i' \beta) + (1 - y_i) \log [1 - F(x_i' \beta)] \\ & \approx \begin{bmatrix} -0.69 & -0.69 & -0.69 & -0.69 \end{bmatrix} \end{aligned}$$

$$\log L \approx -2.77$$

Now, suppose instead that $\beta = 1$

$$F(x_i' \beta) \approx \begin{bmatrix} 0.93 & 0.12 & 0.69 & 0.24 \end{bmatrix}$$

$$\begin{aligned} & y_i \log F(x_i' \beta) + (1 - y_i) \log [1 - F(x_i' \beta)] \\ & \approx \begin{bmatrix} -0.07 & -0.12 & -0.37 & -1.42 \end{bmatrix} \end{aligned}$$

$$\log L \approx -1.98,$$

which is higher than at $\beta = 0$. If $\beta = 1$ happened to maximize the likelihood function (it almost does...), then

$$\text{McFadden's } R^2 = 1 - \frac{-1.98}{-2.77} \approx 0.29$$

and the predicted would be

$$\hat{y}_i \approx \begin{bmatrix} 1 & 0 & 1 & 0 \end{bmatrix}.$$

Cross-tabulation of actual (y_i) and predicted (\hat{y}_i) values

	$\hat{y}_i = 0$	$\hat{y}_i = 1$	Total
$y_i = 0:$	1	0	1
$y_i = 1:$	1	2	3
Total:	2	2	4

Since the constant probability is

$$\hat{p} = 3/4,$$

the constant probability model always predicts $y_i = 1$. We therefore get

$$\text{"}R^2_{pred}\text{"} = 1 - \frac{1}{1+0} = 0.$$

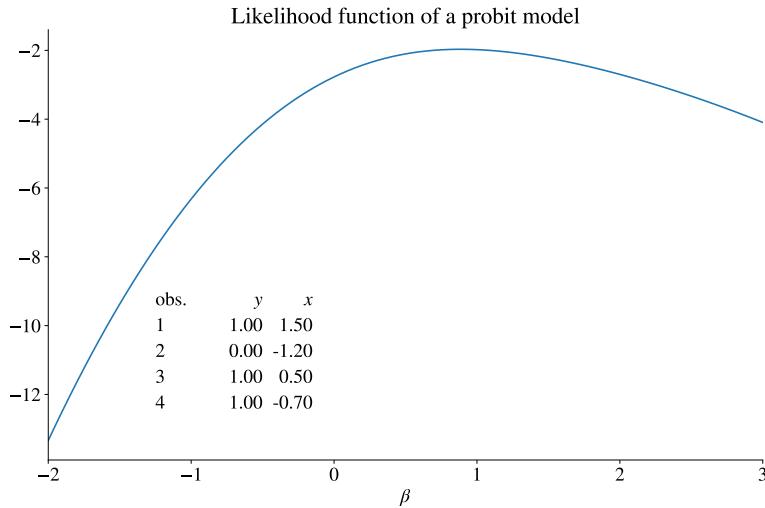


Figure 23.4: Example of ML estimation of probit model

23.1.4 Related Models

Multi-response models answers questions like “a little, more, most?” (ordered logit or probit) or “Red, blue or yellow car?” (unordered models: multinomial logit or probit).

Models for count data are useful for answer questions like: “how many visits to the supermarket this week?” They are like a standard model, but y_i can only take on integer values (0, 1, 2, 3, ..).

23.2 Truncated Regression Model

23.2.1 Basic Model Setup

Suppose the correct model is linear

$$y_i^* = x_i' \beta + \varepsilon_i, \varepsilon_i \sim \text{iid}N(0, \sigma^2), \quad (23.11)$$

but that data (also regressors) is completely missing if $y_i^* \leq 0$

$$\begin{aligned} y_i &= y_i^* && \text{if } y_i^* > 0 \\ (y_i, x_i) &\text{ not observed} && \text{otherwise.} \end{aligned} \quad (23.12)$$

The cutoff at zero is just a normalisation that could easily be changed.

The problem with this is that the sample is no longer random. For instance, suppose

y_i^* is dividends and x_i is profits—and it so happens that firms with low dividends are not in the sample. This is likely to bias the results. See Figure 23.7 for an illustration. In fact, running OLS to estimate

$$y_i = x_i' \beta + \varepsilon_i \quad (23.13)$$

on the available data will give biased (and inconsistent) estimates.

The reason for the bias is that we only use those data points where y_i is unusually high (for a given value of x_i). That is, for observation i to be observed, it must be the case that

$$\varepsilon_i > -x_i' \beta, \quad (23.14)$$

since otherwise (23.13) becomes negative (and those are the observations that do not enter the sample). This which ε_i realizations that enter the sample is not random any more—and it depends on the x_i value (when $x_i' \beta < 0$, then only positive u_i realizations enter the sample and vice versa). This correlation of u_i and x_i is a classical reason for why OLS estimates of the regression coefficients are inconsistent.

Remark 23.6 (*Details on the bias**) To see the bias, notice that the expected value of y_i , conditional on x_i and that we observe the data ($y_i > 0$), is

$$E(y_i | y_i > 0, x_i) = x_i' \beta + E(\varepsilon_i | y_i^* > 0) \quad (23.15)$$

$$= x_i' \beta + E(\varepsilon_i | \varepsilon_i > -x_i' \beta). \quad (23.16)$$

The second line follows from the fact that $y_i^* > 0$ happens when $x_i' \beta + \varepsilon_i > 0$ (see (23.12)) which happens when $\varepsilon_i > -x_i' \beta$. The key result is that the last term is positive and is correlated with x_i . (It is positive since $E(\varepsilon_i | \varepsilon_i > -\infty) = 0$, and here we are conditioning on $\varepsilon_i > -x_i' \beta$ which depends on x_i .)

23.2.2 Examples of the Effect of Truncation

This section presents a useful result on truncated normal distributions —and then uses that in a few simple examples of how the truncation affects the OLS estimates.

Remark 23.7 (*Truncated normal distribution*) Let $\varepsilon \sim N(\mu, \sigma^2)$, then

$$E(\varepsilon | \varepsilon > a) = \mu + \sigma \frac{\phi(a_0)}{1 - \Phi(a_0)} \text{ and } a_0 = (a - \mu)/\sigma$$

See Figure 23.5.

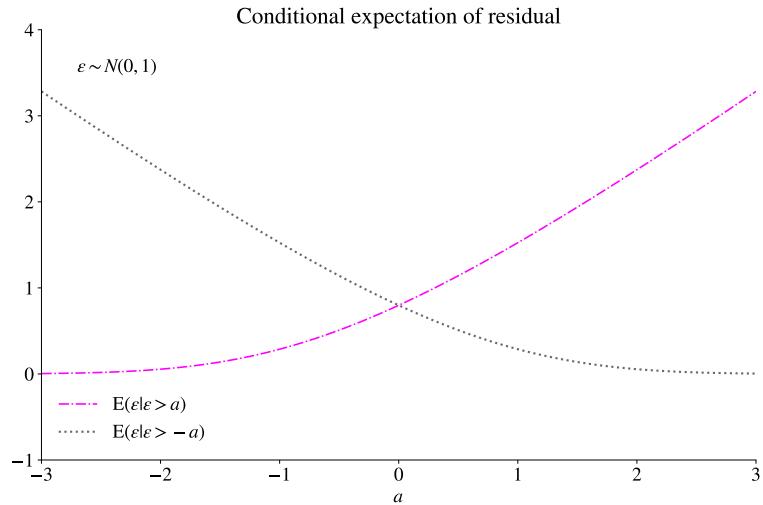


Figure 23.5: Expectations of a truncated variable

Example 23.8 As a trivial example, suppose the model is $y_i^* = 0 + \varepsilon_i$ with $\varepsilon_i \sim iidN(0, 1)$. Then

$$\begin{aligned} E(y_i | y_i > 0, x_i) &= 0 + E(\varepsilon_i | \varepsilon_i > 0) \\ &= 0 + \frac{\phi(0)}{1 - \Phi(0)} = \sqrt{2/\pi} \approx 0.80, \end{aligned}$$

which is far from the true mean (0). OLS will therefore estimate an intercept of around 0.8 instead of 0.

Example 23.9 Suppose the model is $y_i^* = 2x_i + \varepsilon_i$ with $\varepsilon_i \sim iidN(0, 1)$ and where x_i a scalar random variable. Then

$$\begin{aligned} E(y_i | y_i > 0, x_i) &= 2x_i + E(\varepsilon_i | \varepsilon_i > -2x_i) \\ &= 2x_i + \frac{\phi(-2x_i)}{1 - \Phi(-2x_i)} \end{aligned}$$

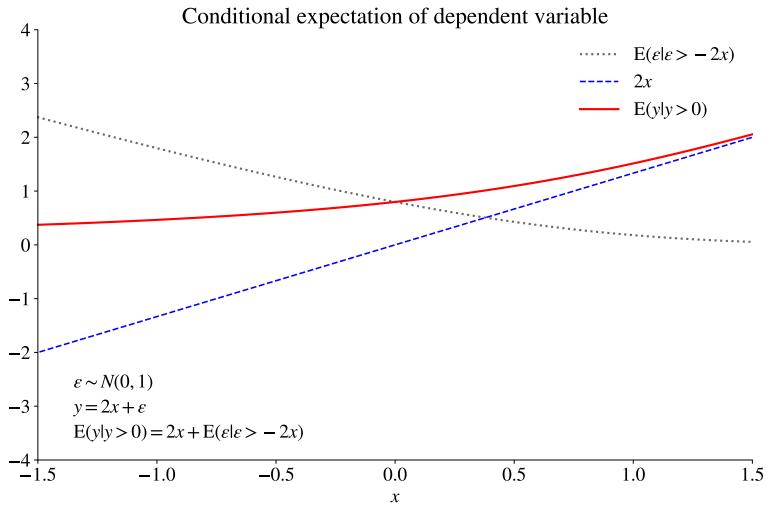


Figure 23.6: Expectations of a truncated variable

For some selected values of x_i we have

$$\begin{aligned}
 E(y_i | y_i > 0, x_i) &= \\
 &= 2x_i + E(\varepsilon_i | \varepsilon_i > -2x_i) \\
 &= \begin{cases} 2 \times (-1) + E(\varepsilon_i | \varepsilon_i > 2) & x = -1 \\ 2 \times 0 + E(\varepsilon_i | \varepsilon_i > 0) & x_i = 0 \\ 2 \times 1 + E(\varepsilon_i | \varepsilon_i > -2) & x_i = 1 \end{cases} \\
 &= \begin{cases} 2 \times (-1) + 2.37 = 0.37 & x = -1 \\ 2 \times 0 + 0.8 = 0.80 & x_i = 0 \\ 2 \times 1 + 0.06 = 2.06 & x_i = 1 \end{cases}
 \end{aligned}$$

so the slope is lower than 2: OLS will therefore fit a slope coefficient that is lower than 2. See Figure 23.6. The basic point is that $E(\varepsilon_i | \varepsilon_i > -2x_i)$ is much higher for low than for high values of x_i (compare $x_i = -1$ and $x_i = 1$), making the regression line look flatter. (Notice that $\frac{\phi(-2x_i)}{1-\Phi(-2x_i)}$ can also be written $\frac{\phi(2x_i)}{\Phi(2x_i)}$ since the $N(0,1)$ distribution is symmetric around zero.)

23.2.3 Estimation

Remark 23.10 (Pdf of truncated variable) Let $\text{pdf}(\varepsilon)$ be the density function of ε (without any truncation). The density function, conditional on $a < \varepsilon \leq b$ is $\text{pdf}(\varepsilon | a < \varepsilon \leq b) =$

$\text{pdf}(\varepsilon) / \Pr(a < \varepsilon \leq b)$.

The log likelihood function is

$$\begin{aligned}\ln L &= \sum_{i=1}^N \ln L_i, \text{ where} \\ L_i &= \frac{1}{\sqrt{2\pi\sigma^2}} \exp\left(-\frac{1}{2} \frac{(y_i - x_i' \beta)^2}{\sigma^2}\right) / \Phi(x_i' \beta / \sigma).\end{aligned}\tag{23.17}$$

We maximize this likelihood function with respect to β and σ^2 (numerical optimization). Notice that $\Phi(x_i' \beta / \sigma)$ is the new part compared with OLS. See Figure 23.7 for an illustration.

Proof (of (23.17)*) Here, we need the density function of y_i conditional on $y_i > 0$ (or equivalently of ε_i), conditional on $y_i^* = x_i' \beta + \varepsilon_i > 0$ (so $\varepsilon_i > -x_i' \beta$). This is

$$\text{pdf}(\varepsilon_i | \varepsilon_i > -x_i' \beta) = \frac{\text{pdf}(\varepsilon_i)}{\Pr(\varepsilon_i > -x_i' \beta)}.$$

To specify this, we notice the following. *First*, if $\varepsilon_i \sim N(0, \sigma^2)$, the denominator is

$$\begin{aligned}\Pr(\varepsilon_i > -x_i' \beta) &= \Pr(\varepsilon_i / \sigma > -x_i' \beta / \sigma) \\ &= 1 - \Phi(-x_i' \beta / \sigma) \\ &= \Phi(x_i' \beta / \sigma).\end{aligned}$$

The last line follows from $N(0, 1)$ being symmetric around 0, so $\Phi(z) = 1 - \Phi(-z)$. *Second*, the numerator (in the first equation of this proof) is the pdf of an $N(0, \sigma^2)$ variable. *Third*, combining and replacing ε_i by $y_i - x_i' \beta$, taking logs gives (23.17). \square

23.3 Censored Regression Model (Tobit Model)

The censored regression model is similar to truncated model, but we are here fortunate to always observe the regressors. x_i . We have a bit *more information* than in truncated case, and we should try to use it. In short, the model and data are

$$y_i^* = x_i' \beta + \varepsilon_i, \varepsilon_i \sim \text{iid}N(0, \sigma^2)\tag{23.18}$$

$$\text{Data: } (y_i, x_i) = \begin{cases} (y_i^*, x_i) & \text{if } y_i^* > 0 \\ (0, x_i) & \text{otherwise.} \end{cases}$$

Values $y_i^* \leq 0$ are said to be *censored* (and assigned the value 0—which is just a normalization). This is the classical *Tobit model*. As an example: y_i^* is investment into stocks by a household, x_i is household income—and households with low income are assigned

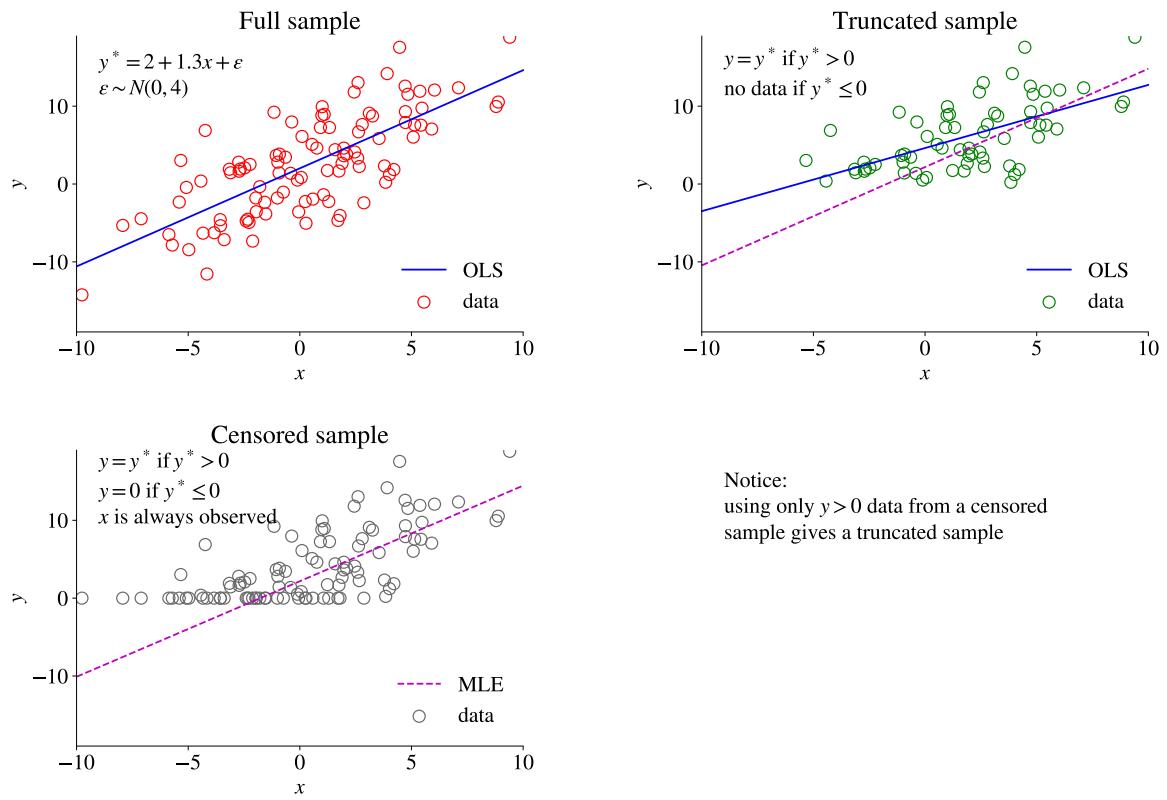


Figure 23.7: Estimation on full, truncated and censored sample

a common value (normalized to $y_i = 0$) in the survey.

If we estimate

$$y_i = x_i' \beta + u_i \quad (23.19)$$

with LS, using all data with $y_i > 0$, then we are in same situation as in truncated model: LS is not consistent. See Figure 23.7.

23.3.1 Estimation of Censored Regression Model

Remark 23.11 (*Likelihood function with different “states”*) *The likelihood contribution of observation i is $\text{pdf}(y_i)$ which can also be written $\text{pdf}(y_i | \text{state } K) \times \Pr(\text{state } K)$. The total likelihood function is the sum over all i (observations).*

Here there are two states: $y_i^* \leq 0$ (no data on y_i^* but on x_i) and $y_i^* > 0$ (data on both

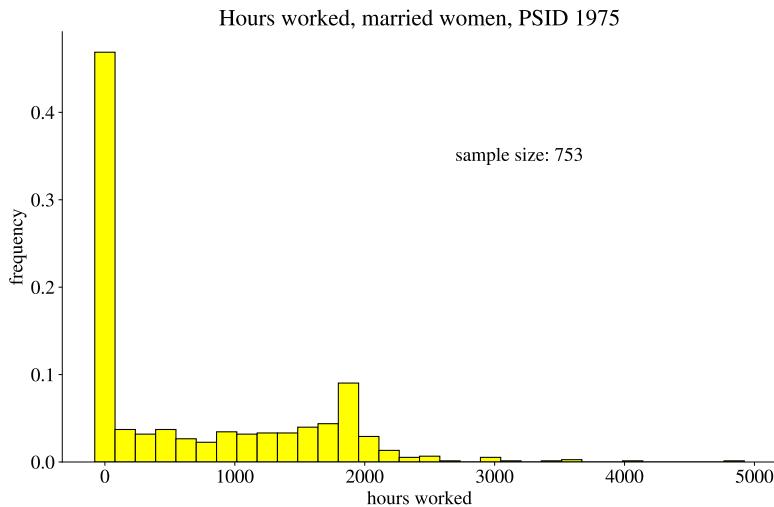


Figure 23.8: Example of probit model, Hill et al (2008), Table 16.1

y_i and x_i) This gives the likelihood function

$$L = \sum_{i: \text{no data on } y_i} \Phi(-x_i' \beta / \sigma) + \sum_{i: \text{with data}} \frac{1}{\sqrt{2\pi\sigma^2}} \exp\left(-\frac{1}{2} \frac{(y_i - x_i' \beta)^2}{\sigma^2}\right). \quad (23.20)$$

Maximize with respect to β and σ^2 (numerical optimization). Compared to OLS, the new part is that we have a way of calculating the probability of censored data (first term)—since we know all x_i values.

	OLS	MLE
c	1335.3 (5.7)	1349.9 (3.4)
educ	27.1 (2.2)	73.3 (3.6)
exper	48.0 (13.2)	80.5 (13.1)
age	-31.3 (-7.9)	-60.8 (-9.1)
kids16	-447.9 (-7.7)	-918.9 (-8.0)
N	753.0	753.0

Table 23.1: Tobit estimation of hours worked. Example of a tobit model, Hill et al (2008), Table 16.8. Numbers in parentheses are t-stats ('sandwich' approach for MLE).

Proof (of (23.20)*) State $y_i^* \leq 0$ happens when $y_i^* = x_i' \beta + \varepsilon_i \leq 0$, that is, when $\varepsilon_i \leq -x_i' \beta$. The probability of this is

$$\begin{aligned}\Pr(\varepsilon_i \leq -x_i' \beta) &= \Pr(\varepsilon_i/\sigma \leq -x_i' \beta/\sigma) \\ &= \Phi(-x_i' \beta/\sigma).\end{aligned}$$

The conditional density function in this state has the constant value of one, so the likelihood contribution (see Remark 23.11) is

$$L_i(\text{if } y_i^* \leq 0) = \text{pdf}(y_i | y_i^* \leq 0) \times \Pr(y_i^* \leq 0) = 1 \times \Phi(-x_i' \beta/\sigma).$$

State $y_i^* > 0$ happens in the same way as in the truncated model (23.19), but the difference here is that the contribution to the likelihood function (again, see Remark 23.11) is

$$\begin{aligned}L_i(\text{if } y_i^* > 0) &= \text{pdf}(\varepsilon_i | \varepsilon_i > -x_i' \beta) \times \Pr(\varepsilon_i > -x_i' \beta) \\ &= \text{pdf}(\varepsilon_i),\end{aligned}$$

where $\text{pdf}(\varepsilon_i)$ is the pdf of $N(0, \sigma^2)$. \square

23.3.2 Interpretation of the Tobit Model

We could be interested in several things. *First*, how is the probability of $y_i = 0$ affected by a change in regressor k ? The derivative provides an answer

$$\frac{\partial \Pr(y_i = 0)}{\partial x_{k,i}} = -\phi(x_i' \beta/\sigma) \beta_k/\sigma. \quad (23.21)$$

This derivative is high (in absolute value) when $x_i' \beta \approx 0$, since a small change in x_k can then tip the balance towards $y_i = 0$. (Formally, this follows from the fact that the pdf $\phi()$ peaks when its argument is zero.) In contrast, when $x_i' \beta$ is very small or very large, then a small change in x_k does not matter much for the probability (as we are already safely in $y_i = 0$ or $y_i = 1$ territory). *Second*, how is the expected value of y_i affected by a change in regressor k ? Once again, we can calculate a derivative

$$\frac{\partial E y_i}{\partial x_{k,i}} = \Phi(x_i' \beta/\sigma) \beta_k. \quad (23.22)$$

This derivative depends on $x_i' \beta$. For low values of $x_i' \beta$, the derivative is close to zero (since $\Phi(x_i' \beta/\sigma) \approx 0$). In contrast, for high values of $x_i' \beta$, the derivative is close to β_k . (To derive these two results, recall that $E y_i = (1 - Q)0 + Q E(y_i | y_i^* > 0)$, where Q is the probability of $y_i^* > 0$. Then use the remark on expected values from truncated normal distributions.)

23.4 Heckit: A Sample Selection Model

Recall that in a Tobit model, $x_i' \beta + \varepsilon_i$ determines both the probability of observing y_i^* and its value. The *Heckit model* (sample selection model) relaxes that. It is a two equation model

$$w_i^* = x_{1i}' \beta_1 + \varepsilon_{1i} \quad (23.23)$$

$$h_i^* = x_{2i}' \beta_2 + \varepsilon_{2i}. \quad (23.24)$$

For instance, w_i^* could be individual productivity (measured by the wage) and h_i^* could be labour supply, and x_{1i} and x_{2i} could contain information about education, age, etc. The data on w_i^* (hourly wage) is only observed for people who work, and h_i^* is only observed as 0/1 (doesn't work/works). In short,

$$\text{Data: } (w_i, h_i) = \begin{cases} w_i = w_i^*, h_i = 1 & \text{if } h_i^* > 0 \\ w_i \text{ not observed, } h_i = 0 & \text{otherwise.} \end{cases} \quad (23.25)$$

The regressors x_{1i} and x_{2i} are observed for all i . In the special case where $\text{Corr}(h_i^*, w_i^*) = 1$, then we are back in standard Tobit model (where we used the notation y_i^* for what is here denoted w_i^*). This requires that (23.24) is the same (or at least proportional) to (23.23)

It is typical to assume that the residuals in the two equations could be correlated

$$\begin{bmatrix} \varepsilon_{1i} \\ \varepsilon_{2i} \end{bmatrix} \sim N \left(\begin{bmatrix} 0 \\ 0 \end{bmatrix}, \begin{bmatrix} \sigma_1^2 & \sigma_{12} \\ \sigma_{12} & 1 \end{bmatrix} \right). \quad (23.26)$$

Notice that $\text{Var}(\varepsilon_{2i}) = 1$ is a normalization. A correlation, $\sigma_{12} \neq 0$, means that some unobserved characteristics (part of the residuals) are affecting both equations. For instance, “ability” may be hard to measure (so it is not in the x_{1i} or x_{2i} vectors, but in the residuals) but is likely to affect both productivity and the labour supply choice.

To understand the properties of this model, notice that the expected value of w_i , conditional on $h_i = 1$, is

$$E(w_i | h_i = 1) = x_{1i}' \beta_1 + \sigma_{12} \lambda_i, \text{ where } \lambda_i = \frac{\phi(x_{2i}' \beta_2)}{\Phi(x_{2i}' \beta_2)}, \quad (23.27)$$

where $\phi()$ and $\Phi()$ are the standard normal pdf and cdf (λ_i is called the inverse Mill’s ratio or Heckman’s lambda). The point of (23.27) is that the covariance of the residuals in the two equations (23.23)–(23.24) is crucial. In fact, when $\sigma_{12} = 0$, then we can estimate

(23.23) with OLS. Otherwise, it is biased (and inconsistent).

Proof (of (23.27))

$$\begin{aligned} E(w_i | h_i = 1) &= x'_{1i} \beta_1 + \underbrace{E(\varepsilon_{1i} | h_i = 1)}_{E(\varepsilon_{1i} | \varepsilon_{2i} > -x'_{2i} \beta_2)} \\ &= x'_{1i} \beta_1 + E(\varepsilon_{1i} | \varepsilon_{2i} > -x'_{2i} \beta_2), \end{aligned}$$

since $h_i = 1$ when $h_i^* = x'_{2i} \beta_2 + \varepsilon_{2i} > 0$. If $(\varepsilon_{1i}, \varepsilon_{2i})$ have a joint normal distribution as in (23.26), then it is a standard result that

$$E(\varepsilon_{1i} | \varepsilon_{2i} > -q) = \sigma_{12} \lambda, \text{ where } \lambda = \frac{\phi(q)}{\Phi(q)}.$$

(Showing this is straightforward, but a bit tedious.) \square

Another way to see the problem highlighted by (23.27) is the following. Consider the observable data (when $h_i = 1$)

$$w_i = x'_{1i} \beta_1 + \varepsilon_{1i} \quad (23.28)$$

and ask if $E(x_{1i} \varepsilon_{1i}) = 0$ for this data? To keep it simple, suppose x_{2i} includes just a constant: w_i observed only when $\varepsilon_{2i} > 0$. If $\text{Corr}(\varepsilon_{1i}, \varepsilon_{2i}) > 0$, our sample of w_i actually contains mostly observations when $\varepsilon_{1i} > 0$ (so ε_{1i} isn't zero on average in the sample). This gives a *sample selection bias*.

Is $\sigma_{12} \neq 0$? To assess that, we must think about the economics of the problem. In wage and labour supply equations: ε_{1t} and ε_{2t} may capture some unobservable factor that makes a person more productive at the same time as more prone to supply more labour.

What if $\text{Cov}(x_{1i}, \lambda_i) = 0$ (although $\sigma_{12} \neq 0$)? Well, then OLS of (23.28) is consistent (recall the case of uncorrelated regressors: we can then estimate one slope coefficient at a time). The conclusion is that the bias of OLS comes from $\sigma_{12} \neq 0$ and $\text{Cov}(x_{1i}, x_{2i}) \neq 0$ since then $\text{Cov}(x_{1i}, \lambda_i) \neq 0$ (although λ is a non-linear function of x_{2i}). As an extreme case, consider $x_{1i} = x_{2i}$.

23.4.1 Estimation

Use MLE or Heckman's 2-step approach, which is as follows:

1. Estimate (23.24) with the probit method (recall $h_i = 0$ or 1) using the likelihood function in (23.20). Extract $x'_{2i} \hat{\beta}_2$ and create $\hat{\lambda}_i$ as in (23.27). See Table 23.2 for an example.

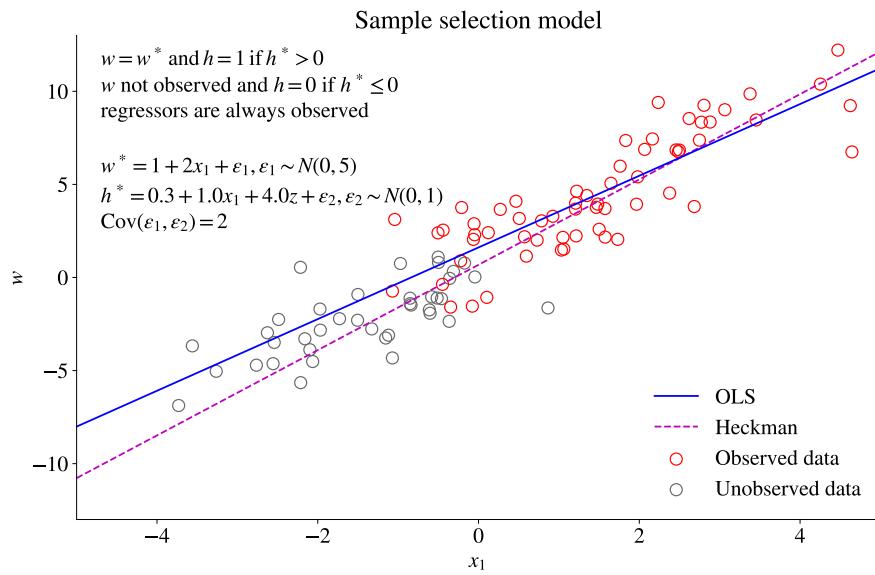


Figure 23.9: Sample selection model

2. Estimate $(\beta_1$ and $\sigma_{12})$ with LS

$$w_i = x'_{1i}\beta_1 + \sigma_{12}\hat{\lambda}_i + \eta_i \quad (23.29)$$

on the data where w_i is observed (and not artificial set to zero or some other value).

This approach gives consistent estimates, but we may need to adjust standard errors (unless you test under the null hypothesis that $\sigma_{12} = 0$).

c	-4.16
	(-2.96)
age	0.19
	(2.78)
age2	-0.00
	(-3.10)
faminc	0.00
	(1.00)
kids	-0.45
	(-3.53)
educ	0.10
	(4.35)

Table 23.2: Probit estimation of labour market participation. 1st step of Heckman estimation. Example of a Heckman model, Greene (2003), Table 22.7 (corrected). Numbers in parentheses are t-stats.

	LS	Heckman
c	-2.56 (-2.77)	-0.97 (-0.48)
exper	0.03 (0.53)	0.02 (0.34)
exper2	-0.00 (-0.14)	0.00 (0.07)
educ	0.48 (7.24)	0.42 (4.24)
cit	0.45 (1.42)	0.44 (1.41)
lambda		-1.10 (-0.88)
	0	

Table 23.3: OLS and Heckman estimation of log wages, married women, PSID 1975. Example of a Heckman model, Greene (2003), Table 22.7 (corrected). Numbers in parentheses are t-stats.

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