

QF603 Group Mini-Project 2

Group F

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Abstract

In this report, we implemented a simple linear regression of the Dow Jones Industrial Average (“DJIA”) index over the S&P500 (“S&P”) using daily and annual log returns.

Our key finding is that the return characteristics of the DJIA does not exhibit statistically significant average excess returns as compared to the S&P.

Another finding is that using different time intervals (daily vs annual log returns) to perform the regression leads to significant differences in the kurtosis measure of the distribution of the error terms in the regression. Investigating further, the reason for this difference is found to be due to the bias introduced into the annual data series when the last day of the year is used as a benchmark. We present further comparative illustrations to show this.

Task 3: Regression of Daily Log Returns

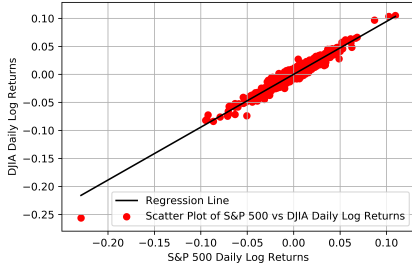


Figure 1: Regression Line of Daily Log Return

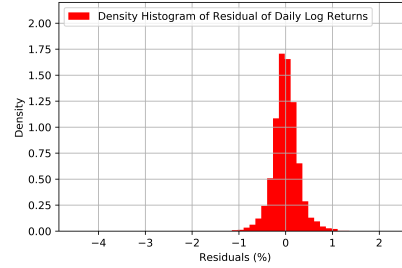


Figure 2: Density Histogram of Residual

Estimate of key statistics \hat{a} , \hat{b} and $\hat{\sigma}_{u_t}$

Results

- Alpha = $\hat{a} = -0.00005$, Beta = $\hat{b} = 0.94311$
- Standard Distribution of Residual = $\sigma_{u_t} = 0.00288$

The regression can be expressed as $r_{(DJIA,t)} = -0.00005 + 0.94311r_{(S\&P500,t)}$.

The positive intercept indicates that the DJIA has a small positive daily excess returns on average as compared to the S&P.

The slope of 0.94311 indicates that the DJIA is slightly less volatile than the S&P. In this context, the slope is interpreted as Beta – the sensitivity of DJIA's returns to the S&P's returns. Assuming investors are risk-averse, a lower Beta is preferred for the same level of return because a lower Beta asset will have more consistency in its returns.

Combining these two measures together, it suggests that the DJIA has a superior risk-adjusted return as compared to the S&P.

T-test for Null Hypothesis $a=b=0$ at 5% significance

Results

- T-statistics for $\hat{a} = 1.48636$, and for $\hat{b} = 339.97366$
- Degree of Freedom = $8500 - 2 = 8498$
- Null Hypotheses (H_0) are that $a = b = 0$.
- Alternative hypotheses (H_1) are that $a \neq 0$ and $b \neq 0$
- Critical value at 5% significance level = ± 1.96024

The test statistic for \hat{a} falls within the critical values, and thus we cannot reject the null hypothesis that $\hat{a} = 0$. The indication of DJIA having higher daily returns than the S&P is therefore not significant at the 5% level.

However, the test statistic for \hat{b} falls outside the critical values, and thus we reject the null hypothesis that $\hat{b} = 0$ and conclude that there is a linear relationship between DJIA and S&P at the 5% significance level.

Goodness of Fit: R^2 and Adjusted R^2 values

Results

- R-Squared (R^2) = 93.15120%
- Adjusted R-Squared (adj- R^2) = 93.1539%

The R^2 value reports the degree to which our independent variable (the SP500 daily log returns) explains the variation of the dependent variable (the DJIA daily log returns). Since R-square is 93.15120%, it means that over 90% of the variation in the dependent variable is explained by the independent variable.

Adj- R^2 also measures the goodness of model fitting, but takes into consideration the number of independent variables in the model. R^2 will only increase or stay the same when we add more independent variables, even if they do not have any relationship with the dependent variable. Adj- R^2 on the other hand, will "penalize" the model for having excessive dependent variables that do not significantly improve the model.

The adj- R^2 is always lower than the R^2 value. And, in our case, because there is only 1 independent variable, the adj- R^2 and the R^2 values are relatively equal.

Jarque-Bera test statistic for the residuals

Results

- Jarque-Bera test stats = 25434.27
- Degrees of Freedom = 2
- Null Hypothesis $H_0 = 0$
- Alternative Hypothesis $H_1 \neq 0$
- Critical Chi-Square Value at 5% significance level = 5.99146

The JB test statistic exceeds the critical value by a huge margin, strongly indicating that the residuals are not normally distributed. This is due to regression outliers that were a result of extreme market conditions, for example the huge one-day drop on 19-Oct-1987.

Additional test- $H_0: \hat{b} = 1$

Results

- The t-test statistic for $\hat{b} = 1$ = -20.50787
- Degree of Freedom = $8500 - 2 = 8498$
- Null Hypothesis (H_0) is that $\hat{b} = 1$
- Alternative hypothesis (H_1) is that $\hat{b} \neq 1$
- Critical value at 5% significance level = ± 1.96024

We conduct an additional test of $\hat{b} = 1$ at the 5% significance level to determine if our \hat{b} value of 0.94311 is statistically different from 1. We do this to gauge how well the returns of the DJIA mimic the returns of the market portfolio S&P.

We reject the null hypothesis that $\hat{b} = 1$, and conclude that the daily log returns of the DJIA do not perfectly mimic the returns of the S&P. Therefore, using the DJIA as a benchmark for performance evaluation may lead to different results as compared to when using the S&P as the benchmark.

Task 4: Regression of Yearly Log Returns

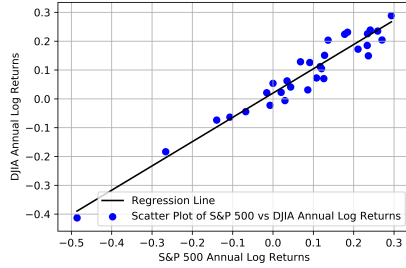


Figure 3: Regression Line of Annual Log Return

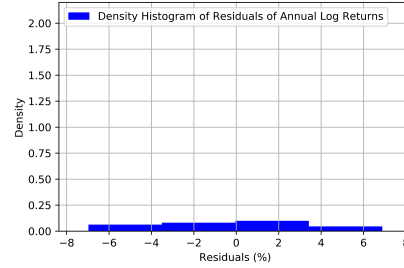


Figure 4: Density Histogram of Residual

Estimate of key statistics \hat{a} , \hat{b} and $\hat{\sigma}_u$

Results

- Alpha = $\hat{a} = 0.01978$, Beta = $\hat{b} = 0.84254$
- Standard Distribution of Residual = $\sigma_{u_t} = 0.03797$

The regression can be expressed as $r_{(DJIA,t)} = 0.01978 + 0.84254r_{(S\&P500,t)}$.

The positive intercept indicates that the DJIA has a small positive daily excess returns on average as compared to the S&P.

The slope of 0.8425 indicates that the DJIA is slightly less volatile than the S&P.

Combining these two measures together, it suggests that the DJIA has a superior risk-adjusted return as compared to the S&P.

T-test for Null Hypothesis $a=b=0$ at 5% significance

Results

- T-statistics for $\hat{a} = 2.64989$, and for $\hat{b} = 20.4364$
- Degree of Freedom = $32 - 2 = 30$
- Null Hypothesis (H_0) are that $a = b = 0$.
- Alternative hypothesis (H_1) are that $a \neq 0$ and $b \neq 0$
- Critical value at 5% significance level = ± 2.042272

The test statistic for \hat{a} falls outside the critical values, and thus we reject the null hypothesis that $\hat{a}=0$. The t-test at 5% significance concludes that the DJIA has higher annual returns as compared to the S&P.

The test statistic for \hat{b} also falls outside the critical values, and thus we reject the null hypothesis that $\hat{b}=0$ and conclude that there is a linear relationship between the annual returns of the DJIA and the S&P at the 5% significance level.

Goodness of Fit: R^2 and Adjusted R^2 values

Results

- R-Squared (R^2) = 0.932983
- Adjusted R-Squared ($\text{adj-}R^2$) = 0.930749

The R^2 value is very high, further supporting our previous point that there exists a linear relationship between the annual returns of the DJIA and the S&P.

Jarque-Bera test statistic for the residuals

Results

- Jarque-Bera test stats = 25434.27
- Degrees of Freedom = 2
- Null Hypothesis $H_0 = 0$
- Alternative Hypothesis $H_1 \neq 0$
- Critical Chi-Square Value at 5% significance level = 5.99146

The JB test statistic falls within the critical value, indicating that the regression residuals are normally distributed.

Additional test- $H_0: \hat{b} = 1$

Results

- The t-test statistic for $\hat{b} = 1$ = -3.81917
- Degree of Freedom = $32 - 2 = 30$
- Null Hypothesis (H_0) is that $\hat{b} = 1$
- Alternative hypothesis (H_1) is that $\hat{b} \neq 1$
- Critical value at 5% significance level = ± 1.96024

We conduct an additional test of $\hat{b} = 1$ at the 5% significance level to determine if our $\hat{b} = 1$ value of 0.84254 is statistically different from 1. We do this to gauge how well the returns of the DJIA mimic the returns of the market portfolio S&P.

We reject the null hypothesis that $\hat{b} = 1$, and conclude that the annual log returns of the DJIA do not perfectly mimic the returns of the S&P. Therefore, using the DJIA as a benchmark for performance evaluation may lead to different results as compared to when using the S&P as the benchmark.