
Contents

Part I Financial Markets and Financial Time Series

1	Introduction	3
1.1	Financial markets and financial time series	3
1.2	Econometric modeling of asset returns	4
1.3	Applications of non-Gaussian econometrics	5
1.4	Option pricing with non-Gaussian distributions	5
2	Statistical Properties of Financial Market Data	7
2.1	Definitions of returns	7
2.1.1	Simple returns	8
2.1.2	Log-returns	8
2.1.3	Stylized facts	9
2.2	Distribution of returns	10
2.2.1	Moments of a random variable	10
2.2.2	Empirical moments	14
2.2.3	Testing for normality	16
2.3	Time dependency	21
2.3.1	Serial correlation in returns	22
2.3.2	Serial correlation in volatility	23
2.3.3	Volatility asymmetry	25
2.3.4	Time-varying higher moments	26
2.4	Linear dependence across returns	26
2.4.1	Pearson's correlation coefficient	27
2.4.2	Test for equality of two correlation coefficients	28
2.4.3	Test for equality of two correlation matrices	30
2.5	Multivariate higher moments	31
2.5.1	Multivariate co-skewness and co-kurtosis	31
2.5.2	Computing moments of portfolio returns	32

3	Functioning of Financial Markets and Theoretical Models for Returns	33
3.1	Functioning of financial markets	34
3.1.1	Organization of financial markets	34
3.1.2	Examples of orders	37
3.1.3	Components of the bid-ask spread	39
3.2	Mandelbrot and the stable distribution	39
3.2.1	A puzzling result	40
3.2.2	Stable distribution	41
3.3	Clark's subordination model	44
3.3.1	The idea of the model	44
3.3.2	The density of returns under subordination	46
3.4	A bivariate mixture-of-distribution model for return and volume	48
3.4.1	A microstructure model for information arrivals	48
3.4.2	Implications of the mixture of distributions hypothesis	53
3.4.3	Testing the mixture of distribution hypothesis	57
3.4.4	Extensions	61
3.5	A model of prices and quotes in a quote-driven market	62
3.5.1	A model based on the trade flow	63
3.5.2	Estimating the parameters	66
3.5.3	The quote process	68
3.5.4	Extension to the liquidation of a large portfolio	73

Part II Econometric Modeling of Asset Returns

4	Modeling Volatility	79
4.1	Volatility at lower frequencies	79
4.2	ARCH model	81
4.2.1	Forecasting	81
4.2.2	Kurtosis of an ARCH model	82
4.2.3	Testing for ARCH effects	82
4.2.4	ARCH-in-mean model	83
4.2.5	Illustration	84
4.3	GARCH model	84
4.3.1	Forecasting	88
4.3.2	Integrated GARCH model	89
4.3.3	Estimation	89
4.3.4	Testing for GARCH effects	92
4.3.5	Software to estimate ARCH and GARCH models	92
4.3.6	Illustration	93
4.4	Asymmetric GARCH models	94
4.4.1	EGARCH model	94
4.4.2	TGARCH model	95

4.4.3	GJR model	95
4.4.4	Cox-Box transform	95
4.4.5	News impact curve	96
4.4.6	Partially non-parametric estimation	96
4.4.7	Testing for asymmetric effects	97
4.4.8	Illustration	99
4.5	GARCH model with jumps	99
4.5.1	A model with time-varying jump intensity	101
4.5.2	An empirical illustration	105
4.6	Aggregation of GARCH processes	108
4.6.1	Temporal aggregation	109
4.6.2	Cross-sectional aggregation	113
4.6.3	Estimation of the weak GARCH process	114
4.7	Stochastic volatility	115
4.7.1	From GARCH models to stochastic volatility models	115
4.7.2	Estimation of the discrete time SV model	117
4.8	Realized volatility	118
4.8.1	The difficulty to disentangle jumps	119
4.8.2	Quadratic variation	123
4.8.3	Power variation	124
4.8.4	Bipower variation	126
4.8.5	Estimation over finite time intervals	128
4.8.6	Realized covariance	135
4.8.7	Further related results	141
5	Modeling Higher Moments	143
5.1	The general problem	144
5.1.1	Higher moments of a GARCH process	145
5.1.2	Quasi Maximum Likelihood Estimation	148
5.1.3	The existence of distribution with given moments	151
5.2	Distributions with higher moments	152
5.2.1	Semi-parametric approach	153
5.2.2	Series expansion about the normal distribution	155
5.2.3	Skewed Student t distribution	159
5.2.4	Generating asymmetric distributions	166
5.2.5	Pearson IV distribution	169
5.2.6	Entropy distribution	172
5.3	Specification tests and inference	177
5.3.1	Moment specification tests	177
5.3.2	Adequacy tests based on density forecasts	179
5.3.3	Adequacy tests based on interval forecasts	180
5.4	Illustration	182
5.5	Modeling conditional higher moments	188
5.5.1	Tests for autoregressive conditional higher moments	189
5.5.2	Modeling higher moments directly	189

5.5.3	Modeling the parameters of the distribution	191
6	Modeling Correlation	195
6.1	Multivariate GARCH models	197
6.1.1	Vectorial and diagonal GARCH models	198
6.1.2	Dealing with large-dimensional systems	200
6.1.3	Modeling conditional correlation	206
6.1.4	Estimation issues	210
6.1.5	Specification tests	212
6.1.6	Test of constant conditional correlation matrix	214
6.1.7	Illustration	217
6.2	Modeling the multivariate distribution	223
6.2.1	Standard multivariate distributions	225
6.2.2	Skewed elliptical distribution	230
6.2.3	Skewed Student t distribution	233
6.2.4	Estimation	236
6.2.5	Adequacy tests	239
6.2.6	Illustration	240
6.3	Copula functions	240
6.3.1	Definitions and properties	241
6.3.2	Measures of concordance	242
6.3.3	Non-parametric copulas	244
6.3.4	Review of some copula families	245
6.3.5	Estimation	254
6.3.6	Adequacy tests	258
6.3.7	Modeling the conditional dependency parameter	259
6.3.8	Illustration	261
7	Extreme Value Theory	265
7.1	Univariate tail estimation	266
7.1.1	Distribution of extremes	266
7.1.2	Tail distribution	276
7.1.3	The case of weakly dependent data	291
7.1.4	Estimation of high quantiles	296
7.2	Multivariate dependence	300
7.2.1	Characterizing tail dependency	303
7.2.2	Estimation and statistical inference on $\bar{\chi}$ and χ	307
7.2.3	Modeling dependency	308
7.2.4	An illustration	309
7.2.5	Further investigations	311

Part III Applications of Non-Gaussian Econometrics

8	Risk Management and VaR	315
8.1	Definitions and measures	316
8.1.1	Definitions	316
8.1.2	Models for portfolio returns	320
8.2	Historical simulation	321
8.3	Semi-parametric approaches	322
8.3.1	Extreme Value Theory (EVT)	324
8.3.2	Quantile regression technique	328
8.4	Parametric approaches	330
8.4.1	RiskMetrics – J.P. Morgan	331
8.4.2	The portfolio-level approach	334
8.4.3	The asset-level approach	337
8.5	Non-linear models	341
8.5.1	The “delta-only” method	341
8.5.2	The “delta-gamma” method	341
8.6	Comparison of VaR models	342
8.6.1	Evaluation of VaR models	343
8.6.2	Comparison of methods	343
8.6.3	10-day VaR and scaling	344
8.6.4	Illustration	345
9	Portfolio Allocation	349
9.1	Portfolio allocation under non-normality	349
9.1.1	Direct maximization of expected utility	350
9.1.2	An approximate solution based on moments	353
9.2	Portfolio allocation under downside risk	359
9.2.1	Definition	360
9.2.2	Downside risk as an additional constraint	360
9.2.3	Downside risk as an optimization criterion	361

Part IV Option Pricing with Non-Gaussian Returns

10	Fundamentals of Option Pricing	365
10.1	Notations	366
10.2	The no-arbitrage approach to option pricing	369
10.2.1	Choice of a stock price process	369
10.2.2	The fundamental partial differential equation	371
10.2.3	Solving the fundamental PDE	373
10.2.4	The Black-Scholes-Merton formula	375
10.3	Martingale measure and BSM formula	377
10.3.1	Self-financing strategies and portfolio construction	377

10.3.2	Change of numeraire	378
10.3.3	Change of Brownian motion	378
10.3.4	Evolution of S_t under Q	379
10.3.5	The expected pay-off as a martingale	379
10.3.6	The trading strategies	380
10.3.7	Equivalent martingale measure	381
11	Non-structural Option Pricing	383
11.1	Difficulties with the standard BSM model	384
11.2	Direct estimation of the risk-neutral density	385
11.2.1	Expression for the RND	385
11.2.2	Estimating the parameters of the RND	387
11.3	Parametric methods	389
11.3.1	Mixture of log-normal distributions	389
11.3.2	Mixtures of hypergeometric functions	394
11.3.3	Generalized beta distribution	395
11.4	Semi-parametric methods	395
11.4.1	Edgeworth expansions	395
11.4.2	Hermite polynomials	399
11.5	Non-parametric methods	402
11.5.1	Spline methods	402
11.5.2	Tree-based methods	406
11.5.3	Maximum entropy principle	407
11.5.4	Kernel regression	408
11.6	Comparison of various methods	409
11.7	Relationship with real probability	414
11.7.1	The link between RNDs and objective densities	414
11.7.2	Empirical findings	416
12	Structural Option Pricing	417
12.1	Stochastic volatility model	417
12.1.1	The square root process	418
12.1.2	Solving the PDE based on characteristic function	419
12.1.3	A new partial differential equation	422
12.2	Option pricing with stochastic volatility	425
12.2.1	Hull and White (1987, 1988)	425
12.2.2	Heston (1993)	426
12.2.3	Characteristic function of the SV model	428
12.2.4	Further insights	429
12.3	Models with jumps	432
12.3.1	Stochastic process with jumps	432
12.3.2	Diffusion with double exponential jumps	434
12.3.3	Combining stochastic volatility with jumps	436
12.3.4	Jumpy affine models	440
12.4	Models with even wilder jumps: Lévy option pricing	441

12.4.1	Commonly used Lévy processes	443
12.4.2	Choice of the time-changing process	444
12.4.3	Option pricing	445
12.4.4	Pricing options with risk-neutral characteristic function	446
12.4.5	Empirical results	447

Part V Appendices on Option Pricing Mathematics

13	Brownian Motion and Stochastic Calculus	451
13.1	Law of large numbers and the central limit theorem	451
13.2	Random walks	453
13.3	Construction of the Brownian motion	453
13.4	Properties of the Brownian motion	456
13.5	Stochastic integration	457
13.6	Stochastic differential equations	459
13.7	Ito's lemma	460
13.8	Multivariate extension of Ito's lemma	462
13.9	Transition probabilities and partial differential equations	463
13.10	Kolmogorov backward and forward equations	464
13.11	PDE associated with diffusions	466
13.12	Feynman-Kac formula	468
14	Martingale and Changing Measure	471
14.1	Martingales	471
14.2	Changing probability of a normal distribution	472
14.3	Radon-Nikodym derivative	473
14.4	Girsanov's theorem	474
14.5	Martingale representation theorem	475
15	Characteristic Functions and Fourier Transforms	477
15.1	Characteristic functions	477
15.1.1	Basic properties	478
15.1.2	Moments and the characteristic function	478
15.1.3	Convolution theorem	479
15.1.4	Uniqueness	480
15.1.5	Inversion theorem	480
15.2	Fourier transform and characteristic function	483
16	Jump Processes	487
16.1	Counting and marked point process	487
16.2	The Poisson process	489
16.2.1	Construction of the Poisson distribution	489
16.2.2	Properties of the Poisson distribution	491
16.2.3	Moments of pure Poisson process	492

16.2.4 Compound Poisson process	493
16.3 The exponential distribution	494
16.3.1 Definition and properties	494
16.3.2 Moments of the exponential variable	495
16.3.3 Hazard and survivor functions	496
16.4 Duration between Poisson jumps	497
16.5 Compensated Poisson processes	498
17 Lévy Processes	501
17.1 Construction of the Lévy process	501
17.2 Properties of Lévy processes	505
References	507
Index	535