PHYSA: 16569 Model 3Gsc pp. 1–5 (col. fig: NIL)

ARTICLE IN PRESS

Physica A xx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Physica A

journal homepage: www.elsevier.com/locate/physa

Q1 Observability of market daily volatility

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HIGHLIGHTS

- We give a definition of market volatility.
- We show that it is observable.
- We show that it is consistent with stylized facts.

ARTICLE INFO

Article history:
Received 29 May 2015
Received in revised form 21 September 2015
Available online xxxx

Keywords:
Market volatility
Absolute returns
Long-range auto-correlations
Cross-correlations

ABSTRACT

We study the price dynamics of 65 stocks from the Dow Jones Composite Average from 1973 to 2014. We show that it is possible to define a Daily Market Volatility $\sigma(t)$ which is directly observable from data. This quantity is usually indirectly defined by $r(t) = \sigma(t)\omega(t)$ where the $r(t)$ are the daily returns of the market index and the $\omega(t)$ are i.i.d. random variables with vanishing average and unitary variance. The relation $r(t) = \sigma(t)\omega(t)$ alone is unable to give an operative definition of the index volatility, which remains unobservable. On the contrary, we show that using the whole information available in the market, the index volatility can be operatively defined and detected.

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1. Introduction

It is well known that stock market returns are uncorrelated on lags larger than a single day. This is an inescapable consequence of the efficiency of markets. On the contrary, absolute returns have memory for very long times, a phenomenon known as volatility clustering. These phenomena are very well documented in the literature and known as stylized facts [1–4].

Furthermore, there is a large empirical evidence that volatility auto-correlations decay hyperbolically [5–9] and there is also a growing evidence that volatility signals have a multi-fractal nature [10–15].

Daily historical volatility is an unobservable variable and is usually measured by the absolute value of daily returns which are instead observable. This definition gives only an approximation of the real volatility $\sigma(t)$ which can be indirectly defined by $r(t) = \sigma(t)\omega(t)$ where $r(t)$ are the daily returns of the market index and the $\omega(t)$ are i.i.d. random variables with vanishing average and unitary variance. The relation $r(t) = \sigma(t)\omega(t)$ alone is unable to give an operative definition of the index volatility, which remains unobservable. We will show that using the whole information available in the market, the index volatility can be operatively defined and detected, i.e., we will define an observable volatility for a market index which exhibits all the statistical features expected for this variable. In this work we analyse 65 stocks from the 'Dow Jones 65 Composite Average', just to remind it is the composite index that measures changes within the 65 companies that make up

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http://dx.doi.org/10.1016/j.physa.2015.10.085
0378-4371/© 2015 Published by Elsevier B.V.

three Dow Jones averages: the 30 stocks that form the Dow Jones Industrial Average (DJIA), the 20 stocks that make up the Dow Jones Transportation Average (DJTA) and the 15 stocks of the Dow Jones Utility Average (DJUA). The paper is organized as follows: we will first introduce all the definitions of the used variables and the model that gives all the relations between them, then we will analyse real data and show that the model conclusion is applicable to real data.

2. Model

The daily returns of single stock (say α) are given by $r_\alpha(t) = \ln[S_\alpha(t)/S_\alpha(t-1)]$ where $S_\alpha(t)$ is the closing price of stock α at day t. Then, if one wants to extract volatility from data one can consider that $r_\alpha(t) = \sigma_\alpha(t)\omega_\alpha(t)$ where the $\omega(t)$ have vanishing averages and unitary variance. Volatility $\sigma_\alpha(t)$ can be eventually extracted considering the high frequency (intra-day) continuous trading, but the problem remains highly unsolved because of the overnight contribution to the return $r_\alpha(t)$ for which there is not continuous trading. Therefore, the best measure of (historical) daily volatility simply remains the absolute returns $|r_\alpha(t)|$.

If the aim is to measure the global volatility of a market, we will show that things can be different. One can address the problem considering volatility of a proper representative index. Nevertheless, if one considers a price-weighted index (as Nikkei 225) the main contributions will be artificially given by those stocks with a larger price. The problem is circumvented if one considers a capitalization-weighted index (as Hang Seng) or an equally-weighted index (as S&P 500 EWI). The daily return $r(t)$ of this last index is simply the plain average of the returns of its components. i.e.

$$r(t) = \frac{1}{N}\sum_{\alpha=1}^{N} r_\alpha(t) \tag{1}$$

where N is the number of stocks in the basket and $r_\alpha(t) = \ln(S_\alpha(t)/S_\alpha(t-1))$ and $S_\alpha(t)$ is the daily closing price of the stock α at day t. For the other two types of indexes the difference is that the average is weighed by price or by capitalization.

Again, the underlying index daily volatility $\sigma(t)$ is not directly observable from daily returns but it is indirectly defined by $r(t) = \sigma(t)\omega(t)$. Because of market efficiency, it can be assumed that the $\omega(t)$ are independent identically distributed random variables with vanishing average and unitary variance. One could argue that $\sigma(t)$ is, indeed, observable from high frequency data, but, as already mentioned, the problem of the overnight contribution to the daily returns remains.

Therefore, since daily market volatility is not objectively given by the index return (only the product $\sigma(t)\omega(t)$ is observable), its distribution depends on the model chosen for $\omega(t)$. Gaussianity is often assumed as in ARCH–GARCH Q4 modelling (the leptokurticity of the distribution of returns is, in this case, entirely charged to volatility). Nevertheless, one can do other choices for the distribution of $\omega(t)$ as, for example, the uniform distribution (between $-\sqrt{3}$ and $\sqrt{3}$ in order that the variance is unitary). We will show that the data analysed in this work show this second behaviour.

3. Data analysis and results

In this paper we consider $N = 65$ stocks of Dow Jones from 1973 to 2014 so that $1 \le t \le T \simeq 10\,000$. Dow Jones as an index is not equally weighted but we can construct ourselves an EW Dow Jones index for which the daily returns $r(t)$ are simply the plain average of returns of its components as in definition (1).

The absolute returns are then given by

$$|r(t)| = \sigma(t)|\omega(t)| = \frac{1}{N}\left|\sum_{\alpha=1}^{N} r_\alpha(t)\right| \tag{2}$$

which are the absolute returns of the associated equally-weighted index (for price-weighted and capitalization-weighted indexes the only difference is that some weights must be introduced).

The core of this paper is the definition of the volatility as

$$\sigma(t) = \frac{1}{\sqrt{3}N}\sum_{\alpha=1}^{N} |r_\alpha(t)| \tag{3}$$

so that

$$\omega(t) = \frac{r(t)}{\sigma(t)} \tag{4}$$

where $r(t)$ and $\sigma(t)$ are defined in Eqs. (1) and (3). Eq. (3) can be considered as the definition of Daily Market Volatility, next we will show all the properties of this definition of volatility.

Most of the models assume that $\sigma(t)$ and $|\omega(t+\tau)|$ are uncorrelated for any value of the lag τ (negative, positive or Q5 vanishing) or they assume (as ARCH–GARCH) a short range correlation (a correlation only for small values of $|\tau|$). Moreover $|r(t)|$ and $|\omega(t+\tau)|$ should be uncorrelated for any non vanishing τ as well as $|\omega(t)|$ and $|\omega(t+\tau)|$.

Please cite this article in press as: F. Petroni, M. Serva, Observability of market daily volatility, Physica A (2015), http://dx.doi.org/10.1016/j.physa.2015.10.085