VOLATILITY OF AN INDIAN STOCK MARKET:
A RANDOM MATRIX APPROACH

V. Kulkarni
Department of Physics and Astrophysics, University of Delhi, Delhi 110007, India

and

N. Deo¹
Department of Physics and Astrophysics, University of Delhi, Delhi 110007, India

and

The Abdus Salam International Centre for Theoretical Physics, Trieste, Italy.

Abstract

We examine volatility of an Indian stock market in terms of aspects like participation, synchronization of stocks and quantification of volatility using the random matrix approach. Volatility pattern of the market is found using the BSE index for the three-year period 2000-2002. Random matrix analysis is carried out using daily returns of 70 stocks for several time windows of 85 days in 2001 to (i) do a brief comparative analysis with statistics of eigenvalues and eigenvectors of the matrix $C$ of correlations between price fluctuations, in time regimes of different volatilities. While a bulk of eigenvalues falls within RMT bounds in all the time periods, we see that the largest (deviating) eigenvalue correlates well with the volatility of the index, the corresponding eigenvector clearly shows a shift in the distribution of its components from volatile to less volatile periods and verifies the qualitative association between participation and volatility (ii) observe that the Inverse participation ratio for the last eigenvector is sensitive to market fluctuations (the two quantities are observed to anti correlate significantly) (iii) set up a variability index, $V$ whose temporal evolution is found to be significantly correlated with the volatility of the overall market index.

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¹Regular Associate of ICTP.
1 INTRODUCTION

Physical phenomena occurring in space and time (like Brownian motion, turbulence, chaos) have recently found application in the study of dynamics of financial markets. Financial time series originate from complex dynamical processes, sometimes accompanied by strong interactions. The nature of underlying interactions in a stock market is not known much the same as in complex quantum systems. The market may be considered as a gigantic complex dynamical system of millions of transactions such that the traders strike equilibrium prices. Every trader is an own-profit-maximizing agent and the decision or range is not dependent on previous transactions but on the time evolution of current events. If the events occur randomly, prices will be random. In other words knowing the course of a stocks price is of no consequence for predicting its future [1]. Synchronization of the dynamics of pairs of stochastically fluctuating stock prices can be modeled using a correlation matrix. Such matrices are studied in the context of nuclear physics [2]. Random matrix models have been widely used in explaining the overall behavior associated with spectra and eigenfunctions of complex quantum systems such as interacting many body systems - one of them being the Stock Market [3, 4, 5, 6, 7, 8, 9, 10, 11]. Time series, such as the stock market indices are closely linked to the evolution of a large number of interacting systems or a complex evolving system, now increasingly being studied by physicists. Price changes in any market are sensitive to the information arriving in the market. Seasonal and political cycles of events and rare events like catastrophes increase speculation and uncertainty in the market leading to high fluctuations in prices or a volatile situation. Volatility is basically a measure of the market fluctuations. The question of interest then is whether and how volatility affects the response of market dynamics. It has been found [12] that linkages between stock market indices have tightened during financial crisis or highly volatile periods. That is to say there is an overall rise in stock index correlations in highly volatile periods or the rise in correlations is accentuated during bouts of volatility. A highly volatile situation is also associated with heavy exchange of information in the market. A number of researchers [3]-[11] have applied the methods of RMT to financial data and found interesting clues about the underlying interactions. This paper is an attempt, to exposit some observations that may throw light on volatility. The purpose of this paper is two-fold. First, it attempts to understand quantitatively the closely related aspects of volatility such as synchronization and participation of stocks in the market using random matrix technique and second, to show that this technique may be used to set up a quantity which possesses a strong predictive power for the volatility of the market. We start with a brief empirical analysis of the BSE index and show the volatility pattern. The next section deals with the various exercises carried out using random matrix approach. We conclude by discussing our observations in the last section. We show a more detailed analysis of the BSE index in the Appendix.
2 EMPIRICAL ANALYSIS OF BSE INDEX

We first consider statistical properties of the time evolution of BSE index. We label the time series of index as $Y(t)$. We calculate volatility and find the p.d.f of index changes.

2.1 Data Analyzed

This section uses the daily indices of the Bombay Stock Exchange (BSE) for a period of 3 years between 2000-2002. BSE is the largest market in India consisting of stocks from various sectors. Indices are basically an average of actively traded stocks, which are weighted according to their market value. Trading is done five days a week in this market, and we consider the opening values of indices to be continuous by removing the holidays. Each year corresponds to 250 days of elapsed time, approximately, the total number of data points in this set is 750.

2.2 Volatility

Long-range correlation has been found in the amplitude of price changes [4]. The presence of long-range dependencies in absolute value of price changes points to the existence of a “subsidiary stochastic process” commonly called as Volatility. As the term may imply, volatility is a measure of fluctuations that occur in the market. Volatility can be estimated by various methods such as- calculating the standard deviation of price changes, by Bayesian methods, by averaging the absolute values of price changes in an appropriate time window etc. Statistical properties of volatility prove to be of vital practical significance as volatility is a key parameter in risk management. Rare events or unanticipated shocks, seasonal changes, economic and political cycles (elections, the announcement of the budget in a country) all tend to accentuate fluctuations. A highly volatile period is marked by increased uncertainty and a greater propensity of traders to speculate and interact.

Computing Volatility:

Volatility, as mentioned earlier, gives us a measure of the market fluctuations. Intuitively we can say that a stock whose prices fluctuate more is more “risky” or “volatile”. We may formalize this as: Let $Y(t - \Delta t)$, $Y(t)$, $Y(t + \Delta t)$, \ldots be a stochastic process where $Y(t)$ may represent prices, indices, exchange rates etc. The logarithmic returns $G(t)$ over time scale $\Delta t$ are

$$G(t) = \log(Y(t + \Delta t)) - \log(Y(t))$$

$$\approx \frac{Y(t + \Delta t)}{Y(t)}$$  \hspace{1cm} (2.1)

$\Delta t$ refers to the time interval. In this case $\Delta t = 1$ day.

Taking $Y$ to be the BSE index for the period 2000–2002, we plot its trend in Figure 1. The figure shows a significant change in the value of index over the period of three years 2000–2002. The rate of change (decrease) appears to be more for the first 450 days than later. We may say
that the Bombay stock exchange follows a long-term trend in the period considered in the sense that there is more uncertainty say four months in future than a month in future. The trend also reflects on the willingness to take risk on part of the traders; it seems the market was far more active in the year 2000 than 2001 or 2002. The downward trend maybe attributed mainly to the economic and/or political cycles in the country. There is a sharp dip in $Y$ near 9/11/2001 (425th day) after which the index rises and settles without much fluctuation. This is indicated in Figure 2.

We quantify volatility, as the local average of the absolute value of daily returns of indices in an appropriate time window of $T$ days, as an estimate of volatility in that period

$$v(t)^p = \frac{\sum_{t=1}^{T-1} |G(t)|^p}{T-1},$$

(2.2)

here we take $p = 1$. We compute volatility for the three year period 2000 -- 2002 by taking $T = 20$ days. The value of $T$ taken here corresponds to nearly a month as a month contains roughly 20 trading days in BSE. However, the results here may present some inaccuracy as the best estimation of volatility involves use of larger time periods. $\sum |G(t)|$ may be considered as a substitute for volatility or scaled volatility in future. There are three main types of volatility; realized volatility, model volatility and implied volatility. Here we have studied realized volatility with $p = 1$, $p = 2$ and other fractions are also possible. See reference [14] for very comprehensive definitions of volatility as well as alternative estimators.

Figure 3 shows the volatility of the market in the period 2000--2002. It is interesting to see from here three sub periods (characterized by distinct volatilities respectively). Each year
corresponds to 250 days of elapsed time and we may divide the period into three sub periods: I- 1-250 days ($\nu=5.65$), II-251-500 days ($\nu=3.5$), III- 501-750 days ($\nu=2.25$). We see that the year 2000 (1-250 days) was extremely active showing very high fluctuations in the market and that regions of high volatility occur in clusters showing consistently high fluctuations in say the first 200 days and more. Subsequently the fluctuations decrease in 2001 (251–500 days). We find a more or less uneven fluctuating pattern in this period. The period marked 420–440 shows a drastic jump indicating that the event of 9/11 which happens to be represented as the 425th day in the set, did increase the volatility for that period. Obviously, this highly volatile period does not show any precursors, as it was an unanticipated event which rattled the market in that period, hence the jump reflects a sudden impact on an otherwise quieter state of affairs. The event of 9/11 was not long lasting as the last time period shows very little fluctuation indicating a quiescent state in 2002 (501 days onwards). These three time regimes characterized by distinct patterns of volatility are of interest in order to observe the volatility pattern of the market.

Since volatility is measured as the magnitude of the index changes, it may be worthwhile here to compare the return distributions for three time periods as considered before.

We calculate the probability distribution function (p.d.f), $P(Z)$ of daily returns, $Z$

$$Z_{\Delta t} = Y(t + \Delta t) - Y(t); \quad \Delta t = 1 \text{day}$$  \hspace{1cm} (2.3)

We examine the nature of return distribution for three time periods of 250 days each as before. The three distributions (Figure 4) differ in mean, standard deviation ($\sigma$) and the index of the distribution $\alpha$ (see Appendix). While the periods: 251–500 and 501–750 do not differ
much in maximum probability, the figure clearly shows the value of probability for small index changes, $P(Z - \delta z < Z < Z + \delta z)$ for the period I is significantly less than (less than half) the corresponding values in the other two periods. However, period I shows a fatter tail, that is, it shows a higher probability for larger index changes than II, III. A more detailed analysis is shown in the Appendix. For mature stock market in western economies, the price changes is widely believed to not be a Levy distribution. On the other hand, for the Indian stock market (National Stock Exchange), a study [13] suggests an exponential distribution of price changes. In our preliminary study of the ‘cumulative’ distributions for all three periods for the daily data of BSE indices, substantial deviations from the cubic law ($\alpha = 3$) towards the Gaussian was found. A careful analysis of the cumulative distribution of indices to find the exact nature, whether exponential, Gaussian or other, of the daily and high frequency data will be reported in a future publication (We thank one of the referees and Prof. Drozdz for bringing this important fact to our attention).

3 RANDOM MATRIX APPROACH

Random Matrix Theory was developed by Wigner, Dyson and Mehta [2] in order to study the interactions in complex quantum systems. It was used to explain the statistics of energy levels therein. RMT has been useful in the analysis of universal and non universal properties of cross-correlations between different stocks. Recently various studies [3]-[10] have quantified correlations between different stocks by applying concepts and methods of RMT, and have shown that deviations of properties of correlation matrix of price fluctuations of stocks, from a random
Figure 4: The probability distributions of daily index changes $Z$ are shown for three periods I, II, III corresponding to the years 2000, 2001, 2002 having mean = $-4.88$, $\sigma = 141.58$, $\alpha = 1.51 \pm 0.02$ for period I; mean = $-2.76$, $\sigma = 69.96$, $\alpha = 1.38 \pm 0.01$ for period II; mean = $0.53$, $\sigma = 39.01$, $\alpha = 1.57 \pm 0.02$ for period III. The value of $\delta z$ is taken as 25.

Correlation matrix yield true information about the existing correlations. While the deviations have been observed and studied in detail in the context of financial markets in earlier studies, we make a comparative analysis here, in the context of volatile versus less volatile situations from the point of view of correlations, participation of stocks in the market and try to quantify volatility in terms of the deviations.

3.1 Data Analyzed and Constraints Involved

As mentioned earlier BSE consists of stocks from various sectors and the market is operative five days a week. We must also mention that many of the stocks are not actively traded and hence not reported regularly in any period of time. Consequently they do not contribute much to the variations in stock price indices. Hence we consider here seventy stocks from largest sectors like chemical industry, metal and non-metal (diversified including steel, aluminum, cement etc). Since these stocks are actively traded throughout the year, we believe they would suffice to bring out our analysis of correlations in this section. Periods of analysis are confined to 280–500 days. The correlation matrices for this study have been constructed exactly along the same lines as in the earlier studies [4]-[8].

3.2 Cross correlations

We quantify correlations for $T$ observations of interday price changes (returns) of every stock $i = 1, 2, \ldots, N$ as

$$G_i(t) = \log P_i(t + 1) - \log P_i(t)$$

(3.4)
where \( P_i(t) \) denotes the price of stock \( i \) and \( t = 1, 2, \ldots, T - 1 \). Since different stocks vary on different scales, we normalize the returns as

\[
M_i(t) = \frac{G_i(t) - < G_i >}{\sigma}
\]

where \( \sigma = \sqrt{< G_i^2 > - < G_i >^2} \) is the standard deviation of \( G_i \). Then the cross correlation matrix \( C \), measuring the correlations of \( N \) stocks is constructed with elements

\[
C_{ij} = < M_i(t) M_j(t) >
\]

The elements of \( C \) are \(-1 \leq C_{ij} \leq 1\).

\( C_{ij} = 1 \) corresponds to complete correlation

\( C_{ij} = 0 \) corresponds to no correlation

\( C_{ij} = -1 \) corresponds to complete anti correlation.

We construct the cross correlation matrix \( C \) from daily returns of \( N = 70 \) stocks for two analysis periods of 85 days each (i) 280 – 365 days and (ii) 340 – 425 (see Figure 3) marked with distinct index volatilities respectively. The probability densities of elements of \( C \), \( P(C_{ij}) \) for both periods are compared in Figure 5. We see that the distribution for period (ii) is more symmetric, implying a more or less equal extent of positive and negative correlations. While period (i) is characterized by a more positive mean. The figure also suggests that there is a reduced concentration in higher levels of correlation magnitudes in a less volatile period (ii) as compared to more volatile period (i). A clear picture of existence of more pronounced correlations in periods of high volatility is shown in Figure 7. The simple correlation coefficient between the \( < |C| > \) and volatility is found to be 0.94 which is highly significant.

3.3 Statistics of Eigenvalues of \( C \)

The eigenvalues of \( C \) have special implications in identifying the true nature of the correlations. Earlier studies using RMT methods have analyzed \( C \) and shown that 98% of eigenvalues of \( C \) lie within the RMT limits whereas 2% of them lie outside [8]. It is understood that the largest eigenvalue deviating from RMT prediction reflects that some influence of the full market is common to all stocks, and that it alone yields “genuine” information hidden in \( C \). The range of eigenvalues within the RMT bounds correspond to noise and do not yield any system specific information.

**Eigenvalue Distribution of the Correlation Matrix**

In order to extract information about the cross correlations from the matrix \( C \), we compare the properties of \( C \) with those of a random correlation matrix. \( C \) is \( N \times N \) matrix defined as

\[
C = \frac{GG^T}{T}
\]
Figure 5: Plot of the probability density of elements of correlation matrix $C$ calculated using daily returns of 70 stocks two 85 day analysis periods (i) 280-365 days and (ii) 340-425 days with scaled volatiles of 1.6 and 0.82 respectively. We find a large value of average magnitude of correlation $<|C|> = 0.22$ for (i) compared to $<|C|> = 0.14$ for (ii).

where $G$ is an $N \times T$ matrix, $N$ stocks taken for $T$ days and $G^\top$ denotes transpose of matrix $G$. We now consider a random correlation matrix

$$R = \frac{AA^\top}{T} \quad (3.8)$$

where $A$ is $N \times T$ matrix with random entries (zero mean and unit variance) that are mutually uncorrelated. Statistics of random matrices such as $R$ are known. In the limit of both $N$ and $T$ tending to infinity, such that $Q = T/N (> 1)$ is fixed, it has been shown that the probability density function $Prm(\lambda)$ of eigenvalues of $R$ is given by

$$Prm(\lambda) = \frac{Q \sqrt{(\lambda_+ - \lambda)(\lambda - \lambda_-)}}{2\pi \lambda} \quad (3.9)$$

for $\lambda$ lying in $\lambda_- < \lambda < \lambda_+$ where $\lambda_-$ and $\lambda_+$ are the minimum and maximum eigenvalues of $R$, respectively given by

$$\lambda_\pm = 1 + \frac{1}{Q} \pm 2\sqrt{\frac{T}{Q}}. \quad (3.10)$$

We set up a correlation matrix $C$ from the daily returns of $N = 70$ stocks for $T = 85$ days in the year 2001 for two periods (i) first excluding the data reported on the day- September 11, 2001- the 85th day being Aug 31st, and then (ii) sliding this window of 85 days to include the data reported on that day and beyond -the 85th day being September 18th. Here $Q = 1.21$, and maximum and minimum eigenvalues predicted by RMT from (11) are 0.0086 and 3.6385.
Figure 6: Probability density of eigenvalues is shown by bars for a period considered (i) 334-419 before 9/11/2001 and having a volatility (scaled) of 0.8 (Top) and (ii) 346-431 including 9/11/2001 and having a volatility (scaled) of 0.9 (Bottom). A comparison is made with the probability density of eigenvalues of a random matrix R of the same size as C, shown by the solid line. The number of deviating eigenvalues is 4 in (i) and 6 in (ii). Largest eigenvalue for (i) is 9.17 and for (ii) is 10.28.
Figure 6 indicates and increased deviation in case (ii) as compared to (i) in terms of both number of eigenvalues lying outside RMT range and the magnitude of the maximum eigenvalue. In the first case of a non-perturbed correlation matrix, 4 eigen-values lie outside RMT bounds; 2 larger than $\lambda_+$ and 2 smaller than $\lambda_-$. The largest eigenvalue is $9.17$. In case of a perturbed correlation matrix (ii), we find 6 eigen-values deviating from RMT limits; 3 larger than $\lambda_+$ and 3 smaller than $\lambda_-$. The maximum eigenvalue is $10.28$.

From Figure 6 it is observed that the number of eigenvalues outside the RMT bounds increases in case (ii) (which incorporates 11 September 2001) and that the largest eigenvalue is greater than for that for case (i). The latter observation is consistent with intuition since correlations increased with the market shock at that time. However, it is surprising that the third eigenvalue emerges from the RMT noise band at that time. The explanation can be observed from Figure 6, where the level of noise is less in case (ii) where the largest eigenvalue is large, compared to case (i) where the noise level is larger but the largest eigenvalue is not as large (case (i) is less volatile, $v=0.8$ while case (ii) is the more volatile period, $v=0.9$). On comparing with results for other markets this observation is in agreement with [15]. We leave understanding of this issue to a future publication. In this sub-section, the notations (i) is for 334-419 and (ii) is 346-431 and should not be confused with the data of prices for cases (i) 280−365 (ii) 340−425 and (iii) 380−465 used in the rest of this section.

Trend of Largest Eigen-values

Since the largest eigen-value represents collective information about the correlations between stocks, we wish to observe the change of the largest eigen-value as we move from a no-shock, quiescent period to the one hit by the shock of 9/11. Here we start by setting up $C$ using daily returns of $N=70$ stocks for fixed but progressing time periods of length $T=85$ days. We look at the largest or most “deviating” eigenvalue in the eigenvalue spectrum of $C$. The trace of the correlation matrix is preserved throughout, $\text{Tr}(C) = N$. The closer the maximum eigenvalue is to the trace, more information it contains and more correlated the prices would be. Variation of largest eigenvalue is seen by considering $N=70$ stocks for time windows of 85 days advanced each time by two days. Labeling the first and last day of all periods as $t_f$ and $t_l$ respectively, we set up $C$ as

$$C(t_f, t_l) = C(280 + j, 280 + j + 85) \quad (3.11)$$

where $j = 0, 2, 4, 6, \ldots, 134$.

Result of this exercise is shown in Figure 7. We observe, a decrease in the magnitude of largest for time periods spanning 280–425 days after which it is more or less constant. The largest eigenvalue is found to be strongly correlated with volatility of the BSE index (simple correlation coefficient is found to be 0.94) for all times considered. We study the impact of 9/11 shock (Figure 8) by carrying out a similar exercise, taking $j = 0, 1, 2, 3, \ldots, 26$. The aftermath of the event can be seen in the sudden, impulsive rise in the maximum eigenvalue around September
13th, 18th, indicating that the impact was localized in time. The analysis of the movements of the second, third largest eigenvalues and their corresponding eigenvectors is left for a future publication.

Figure 7: Variation of largest eigenvalue and $<|C|>$, with the time shift, $j$. Analysis period is confined to period II. First $j$ was increased in steps of 2 days each time to span a total time of 280-500 days (see Figure 3). Volatility has been scaled for convenience. A minute exercise was carried out in Figure 8 by advancing the time windows in steps of 1 day each time, spanning a total time of 333-444 days in order to capture the impact of the 9/11 shock. The horizontal axis shows the last day of all the time periods.

3.4 Last Eigenmode and the Variability Index

The eigenstates of $C$ deviating from RMT predictions bring out the collective response of the market to perturbations. Collective motion of all the assets in the portfolio is significantly high, or the stocks are highly correlated in regimes marked by occasional or persisting bursts of activity. The degree of such synchronization is indicated by the eigenvector corresponding to the largest eigenvalue, through the evolution of its structure and components (in sub sections 3.4.1 and 3.4.2). Finally in 3.4.3, we try to quantify volatility in terms of the largest eigenvector to yield a strong indicator of variability.

3.4.1 Distribution of Eigenvector Components

We wish to analyze the distribution of the components of the eigenvector corresponding to largest eigenvalue and compare the distributions for three time periods characterized by different volatilities (i) 280 – 365 (ii) 340 – 425 (iii) 380 – 465 as shown in Figure 9.

Figure 9 shows the distributions of components of $U^{70}$ are shorter and broader in less volatile regimes (ii,iii) than in a more volatile one (i). Although the maximum participation is more in distributions (ii), (iii) the number of significant participants in their sets (components differing significantly from zero) far lesser than (almost half) that in (i). This is dealt with in the next
sub section. In addition we find that the components of $U^{70}$ for period (i), all have a positive sign, which confines the distribution to one side. This finding has been interpreted previously [8] to imply that a common component of the significant participants of $U^{70}$ affects all of them alike. We also find that for all periods that follow (iii) which are relatively quiescent and not shown here, contain both positive and negative elements. This goes to show an interesting link between the strength of the common influence and volatility. We may say collective or ensemble-like behavior is more pertinent to volatile situations rather than non-volatile ones.

### 3.4.2 Inverse Participation Ratio

We analyze the evolution of the structure of the last eigenstate, $U^{70}$ by evaluating the Inverse Participation ratio. The IPR quantifies the contribution of different components of eigenvector to the magnitude of an eigenvector. If $\nu_{ik}$, $i = 1, 2, \ldots, N$ be the components of eigenvector $U^k$ then IPR is given by

$$I_k = \sum_{i=1}^{N} \nu_{ik}^4$$

(3.12)

Since IPR is actually the reciprocal of the number of eigenvector components that contribute significantly, if all components contribute identically, $\nu_{ik} = 1/\sqrt{N}$ then $I = 1/N$. As before we set up a correlation matrix $C$ with $N = 70$ stocks for $T = 85$ days, each time shifting the time window forward in steps of 2 i.e. $j = 0, 2, 4, \ldots, 134$ spanning a period of 280–500 days as
Figure 9: Probability density of the eigenvector components for largest eigenvalue for three periods (i) 280-365 days (ii) 340-425 and (iii) 380-465 days marked by volatilities 1.6, 0.82, 0.99 respectively. The plots are for $C$ constructed from daily returns of 70 stocks for $T = 85$ days.

before The pattern of IPR (Figure 10) indicates that the number of significant participants in $U^{70}$ decreases as we advance to less volatile periods. The IPR is closest to 0.0143 ($=1/70$), the value we would expect when all components contribute equally, in the most volatile periods of the time span. The values of IPR deviate more and more from 0.0143 as we move to the less volatile periods. In fact the correlation between IPR and volatility was found to be equal to 0.63.

3.4.3 Variability index

A yet another interesting feature brought out in the analysis of eigenvectors is the large-scale correlated movements associated with the last eigenvector, the one corresponding to largest eigenvalue. The average magnitude of correlations of prices of every stock $m$ with all stocks $n = 1, 2, \ldots, N$ is $<|C|>_m = \frac{1}{(N-1)} (C_{1m} + C_{2m} + \ldots + C_{Nm})$. $<|C|>_m$ for $m = 1, 2, \ldots, N$ is varied with the corresponding components of $U^{70}$ and $U^2$ (lying within the bulk) as shown in Figures 11 and 12 respectively. While we find a strong linear positive relationship (shown in Figure 11) between the two at all times for the $U^{70}$, the eigenvector belonging to the RMT range (Figure 12) shows almost zero dependence. In this final sub section we make use of this dependence to set up a Variability index, which is strongly correlated with the variability of BSE index.

We define a projection vector $S$ with elements $S_m = <|C|>_m$ where $m = 1, 2, \ldots, 70$, as calculated before. We obtain a quantity $X_m(t)$ by multiplying each element $S_m$ by the magnitude of the corresponding component of $U^{70}$ for each time window $t$. 


Figure 10: Inverse participation ratio (IPR) for the eigenvector $U^{70}$ as a function of time. Results have been obtained from correlation matrix $C$ constructed from daily returns of 70 stocks for 68 time windows of 85 days each, progressed each time by 2 days spanning a time of 280-500 days.

$$X_m(t) = (U_m^{70})^2 S_m, \quad m = 1, 2, \ldots, 70 \quad (3.13)$$

The idea is to weight the average correlation possessed by every stock $m$ in the market according to the contribution of the corresponding component to the last eigenvector $U^{70}$, thereby neglecting the contribution of non-significant participants (close to zero) in $U^{70}$. The quantity $X$ in some sense represents the true or effective magnitude of correlations of stocks and the sum of such magnitudes are obtained as

$$V(t) = \sum_{m=1}^{70} X_m(t), \quad \text{at time } t \quad (3.14)$$

may be expected to reflect the variability of the market at that time. We call it the Variability index. We note from Figure 13 that the variability index behaves remarkably similarly to the volatility of BSE index as the time window is slid forward. A highly statistically significant coefficient of correlation of 0.95 is obtained and a positive, linear relationship between the two can be seen in the plot of $V$ and BSE index volatility set out in Figure 14. A coefficient of correlation of 0.98 is found between the largest eigenvalue and $V$. We thus find the relevance of the last eigenmode in quantifying the volatility of the overall market. Similar procedures have been carried out in other studies [7] in different contexts to verify the relevance of this last eigenvector.

An important point to note is that the variability index, proposed here, is related to the regression coefficients $\beta_m$ in the standard one-factor model [5], roughly $V(t) \approx \sum_m (\beta_m^3 + \ldots)$. The precise relation with the coefficients of the one-factor model will be reported elsewhere.
<|C|> for all stocks
Components of U-70

Figure 11: Plot of the components of the eigenvector $U^{70}$ corresponding to the largest eigenvalue with the extent to which every individual stock is correlated in the market, denoted by $<|C|>_m$. In this case, correlation matrix, $C$ was constructed using daily returns of 70 stocks for the period 280-365 days. The line obtained least square fitting has a slope $= 0.68 \pm 0.01$.

Further, a more thorough mathematical analysis and discussion on whether this index is a significant improvement on other indices and whether it can be a good forecasting index [14] remains for another publication.

4 CONCLUSION

In this paper we study the volatility of the Bombay Stock Exchange using the RMT approach. We find that the deviations from RMT bounds are more pronounced in volatile time periods as compared to the not so volatile ones in the context of Bombay Stock Exchange. The largest eigenvalue, which is in some sense an index of true information in the entire market [11], is seen to be highly sensitive to the trends of market activity. A comparison of eigenvalue distributions for two analysis periods before and after the event of 9/11, show that not only the number of eigenstates deviating from RMT bounds but also the magnitude of the maximum eigenvalue increases after the event. The simple correlation coefficient between the two is $\lambda_{\text{max}} \times BSE \text{ volatility} = 0.94$. Analysis of the correlation matrix $C$ as a function of time reveals a strong dependence between the average of magnitude of elements of $C$ and volatility, indicating highly synchronous movements of stocks in highly fluctuating times or vice versa. A highly significant correlation coefficient of 0.94 is observed here as well. The eigenvector associated with the largest eigenvalue, the last eigenmode of $C$ has been enunciated in previous studies as a collective response of the whole market to certain newsbreaks, bursts of activity. We have tried to see its role in quantifying the fluctuations. It has been understood previously by Plerou et. al. [8] that if all the components of the eigenvector have the same sign then there is some
common component of the significant participants that affects all of them with similar bias. The probability density patterns of the components of $U^{70}$ show that while the distribution in (i) is confined to the positive values of participation, the other two have spread to the negative side as well, indicating a gradual absence of existence of a common influence on the components as we move from more volatile period (i) to less volatile periods (ii,iii). Hence our finding here may suggest that ensemble-like behavior is more prominent in volatile situations than non-volatile ones. Further, the number of significant participants in (ii, iii) falls to almost half that in (i), a finding better explicated by the time evolution of the Inverse participation ratio for components of $U^{70}$. A strong anti-correlation between IPR and volatility ($= -0.63$) confirms the existence of a positive association between the number of significant participants in $U^{70}$ with the volatility.

It is verified that the eigenvector $U^{70}$ indicates the extent to which the stock movements are synchronized. We find a positive, linear relationship between the extent to which all individual stocks correlate or anti-correlate in the market ($<|C|>_m, m = 1, 2, \ldots, N$) and the corresponding elements of $U^{70}$. Finally we investigate how this may lead to a quantification of variability of the market by taking the product of $<|C|>_m$ with squares of corresponding elements of $U^{70}$. The products for all components may be put together as a sum to obtain a Variability index, $V$. It is basically quantified as the sum of correlations of individual stocks, each weighted according to its participation in $U^{70}$. Temporal evolution of $V$ and BSE index volatility, have identical trends and there exists a highly statistically significant correlation of 0.95 between the two. In addition we find a close positive linear relationship between the two. We may thus conclude that the last eigenstate of the cross correlation matrix can be set up usefully to obtain a quantity that has statistically significant predictive power for the variability of the market at any time.
Figure 13: Temporal evolution of the variability index, $V$ and the volatility of BSE index is shown upon suitable scaling. The results are obtained from correlation matrix $C$ constructed from daily returns of 70 stocks for 68 progressing time windows of 85 days each. The time was shifted in steps of 2 days each time and the time shift from the starting point is plotted on the horizontal axis.

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APPENDIX

Distribution of index changes

Fluctuations in asset prices have been studied through Levy stable non-Gaussian model (Schulz 2001). Earlier studies [16] on S&P500 index have shown the return distributions fit into the Levy stable regime with distribution index $\alpha : 0 < \alpha < 2$.

We calculate the p.d.f. $P(Z)$ of daily returns, $Z$ defined by equation (2.3) in the text. We find the p.d.f. $P(Z)$ is almost symmetric, sufficiently leptokurtic and possesses a narrow tail at the ends (Figure 15). To characterize the functional form of the p.d.f., we see the variation of probability of return to origin $P(Z - \delta z < Z < Z + \delta z)$ as a function of time interval $\Delta t$. 
Figure 14: The variability index, $V$ with the volatility of BSE index approximates a linear fit with slope $= 0.97 \pm 0.04$

This is done by taking various sets of returns $Z_{\Delta t}(t)$ corresponding to $\Delta t = 1, 2, 3, \ldots, 100$. We observe a power law decay (Figure 15), which is consistent with Lévy stable distribution for low time lags.

In general, the probability of return to origin is obtained as

$$P(Z = 0) = \frac{\Gamma(1/\alpha)}{\pi \alpha (\Delta t \gamma)^{1/\alpha}}$$  \hspace{1cm} (4.15)

The index of the distribution, $\alpha$ is the inverse of the power law exponent, and is found to be $1.66 \pm 0.01$. Probability of return to origin is 0.3623 and from (4.15) we get the scale factor of the distribution, $\gamma = 0.6662$.

Results of a more detailed analysis are shown in Figure 16. The above analysis was carried out for 51 periods of 250 days each, starting from the first day of the set and advancing the time intervals each time by 10 days. We find the index $\alpha$ is almost constant ($1 < \alpha < 2$), but there is likeness between the variation of $\gamma$ and volatility of the BSE index. Probability of small index returns increases with every advance from highly volatile periods towards the relatively quiescent periods (see Figure 3). The plot of $\gamma$ and index volatility (Figure 16) for the times considered shows that the data fit into two separate positive linear relationships. It is found that the rate of change in the periods of higher fluctuations, say till the first 340 days is 0.63, while it is 0.39 for then onwards. A possible explanation for this change of scale could be that probability of low index returns does not increase identically as the decrease in volatility. A highly significant correlation of 0.93 is obtained between $\gamma$ and volatility.
Figure 15: Probability density function of index returns for the period of 750 days between 2000 and 2002 (Top). Log-log plot of probability of return to origin, $P(Z - \delta z < Z < Z + \delta z)$ versus time lag, taking $\delta z = 25$ shows a power law dependence (Bottom). Straight line has slope $=-0.602 \pm 0.003$. The index, $\alpha$ of the distribution in top figure is found to be $1.66 \pm 0.01$. $P(-25 < 0 < 25) = 0.3623$ for time lag of 1 day and $\gamma = 0.6662$. 
Figure 16: Time dependence of volatility, distribution index $\alpha$ and scale factor $\gamma$ (Top). The observations were taken for 51 time periods of 250 days each. The time window was slid each time by 10 days to span the entire data. The horizontal axis shows the 1st day of all the 250 day periods considered with 45 lags each and $\delta z = 25$. Bottom figure shows variation of $\gamma$ and volatility. Two linear relationships with differing slopes are found. The less volatile periods (say $340 - 570$ onwards) show a weaker dependence (slope= 0.39) than the earlier more volatile periods (slope= 0.63). In both the cases volatility has been scaled.
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