Dynamic Integration of Time- and State-domain Methods for Volatility Estimation

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Summary

Time- and state-domain methods are two common approaches for nonparametric prediction. The former predominantly uses the data in the recent history while the latter mainly relies on historical information. The question of combining these two pieces of valuable information is an interesting challenge in statistics. We surmount this problem via dynamically integrating information from both the time and the state domains. The estimators from both domains are optimally combined based on a data driven weighting strategy, which provides a more efficient estimator of volatility. Asymptotic normality is separately established for the time domain, the state domain, and the integrated estimators. By comparing the efficiency of the estimators, it is demonstrated that the proposed integrated estimator uniformly dominates the two other estimators. The proposed dynamic integration approach is also applicable to other estimation problems in time series. Extensive simulations are conducted to demonstrate that the newly proposed procedure outperforms some popular ones such as the RiskMetrics and the historical simulation approaches, among others. Empirical studies endorse convincingly our integration method.

Some key words: Bayes; Dynamical integration; State-domain; Time-domain; Volatility.
1 Introduction

In forecasting a future event or making an investment decision, two pieces of useful information are frequently consulted. Based on the recent history, one uses a form of local average, such as the moving average in the time-domain, to forecast a future event. This approach uses the continuity of a function and ignores completely the information in the remote history, which is related to current through stationarity. On the other hand, one can forecast a future event based on state-domain modeling such as the ARMA, TAR, ARCH models or nonparametric models (see Tong, 1990; Fan & Yao, 2003 for details). For example, to forecast the volatility of the yields of a bond with the current rate 6.47%, one computes the standard deviation based on the historical information with yields around 6.47%. This approach relies on the stationarity and depends completely on historical data. But, it ignores the importance of the recent data. The question of how to combine the estimators from both the time-domain and the state-domain poses an interesting challenge to statisticians.

Figure 1: Illustration of time and state-domain estimation. (a) The yields of 3-month treasury bills from 1954 to 2004. The vertical bar indicates localization in time and the horizontal bar represents localization in the state. (b) Illustration of time-domain smoothing: squared differences are plotted against its time index and the exponential weights are used to compute the local average. (c) Illustration of the state-domain smoothing: squared differences are plotted against the level of interest rates, restricted to the interval 6.47% ± .25% indicated by the horizontal bar in Figure 1(a). The Epanechnikov kernel is used for computing the local average.

To elucidate our idea, consider the weekly data on the yields of 3-month treasury bills presented
in Figure 1. Suppose that the current time is January 04, 1991 and interest rate is 6.47% on that
day, corresponding to the time index \( t = 1930 \). One may estimate the volatility based on the
weighted squared differences in the past 52 weeks (1 year), say. This corresponds to the time-
domain smoothing, using a small vertical stretch of data in Figure 1(a). Figure 1(b) computes
the squared differences of the past year’s data and depicts its associated exponential weights.
The estimated volatility (conditional variance) is indicated by the dashed horizontal bar. Let the
resulting estimator be \( \hat{\sigma}_{t,\text{time}}^2 \). On the other hand, in financial activities, we do consult historical
information in making better decisions. The current interest rate is 6.47%. One may examine
the volatility of the yields when the interest rates are around 6.47%, say, 6.47% ± 0.25%. This
corresponds to using the part of data indicated by the horizontal bar. Figure 1(c) plots the squared
differences \( X_t - X_{t-1} \) against \( X_{t-1} \) with \( X_{t-1} \) restricted to the interval 6.47% ± 0.25%.
Applying the local kernel weight to the squared differences results in a state-domain estimator \( \hat{\sigma}_{t,\text{state}}^2 \), indicated
by the horizontal bar in Figure 1(c). Clearly, as shown in Figure 1(a), except in the 3-week period
right before January 4, 1991 (which can be excluded in the state domain fitting), the last period
with interest rate around 6.47% ± 0.25% is the period from May 15, 1988 and July 22, 1988. Hence,
the time and state-domain estimators use two nearly independent components of the time series, as
they are 136-week apart in time. See the horizontal and vertical bars of Figure 1(a). These two kinds
of estimators have been used in the literature for forecasting volatility. The former is prominently
featured in the RiskMetrics of J.P. Morgan, and the latter has been used in nonparametric regression
(see Tong, 1995; Fan & Yao, 2003 and references therein). The question arises how to integrate
them.

An integrated estimator is to introduce a dynamic weighting scheme \( 0 \leq w_t \leq 1 \) to combine the
two nearly independent estimators. Define the resulting integrated estimators as
\[
\hat{\sigma}_t^2 = w_t \hat{\sigma}_{t,\text{time}}^2 + (1 - w_t) \hat{\sigma}_{t,\text{state}}^2.
\]
The question is how to choose the dynamic weight \( w_t \) to optimize the performance. A reasonable
approach is to minimize the variance of the combined estimator, leading to the dynamic optimal
weights
\[
w_t = \frac{\text{Var}(\hat{\sigma}_{t,\text{state}}^2)}{\text{Var}(\hat{\sigma}_{t,\text{time}}^2) + \text{Var}(\hat{\sigma}_{t,\text{state}}^2)}, \tag{1}
\]
since the two piece of estimators are nearly independent. The unknown variances in (1) can easily be
estimated in Section 3. Another approach is the Bayesian approach, which regards the historical
information as the prior. We will explore this idea in Section 4. The proposed method is also
applicable to other estimation problems in time series such as forecasting the mean function and
the volatility matrix of multivariate time series.

To appreciate the intuition behind our approach, let us consider the diffusion process
\[
\text{d} r_t = \mu(r_t) \text{d} t + \sigma(r_t) \text{d} W_t, \tag{2}
\]
where \( W_t \) is a Wiener process. This diffusion process is frequently used to model asset price and the yields of bonds, which are fundamental to fixed income securities, financial markets, consumer spending, corporate earnings, asset pricing and inflation. The family of models include famous ones such as the Vasicek (1977) model, the CIR model (Cox, et al. 1985) and the CKLS model (Chan, et al. 1992). Suppose that at time \( t \) we have a historic data \( \{ r_t \}_{i=0}^N \) from the process (2) with a sampling interval \( \Delta \). Our aim is to estimate the volatility \( \sigma_t^2 \equiv \sigma^2(r_t) \). Let \( Y_i = \Delta^{-1/2}(r_{t+i+1} - r_t) \). Then for the model (2), the Euler approximation scheme is

\[
y_i \approx \mu(r_t)\Delta^{1/2} + \sigma(r_t)\varepsilon_i, \tag{3}
\]

where \( \varepsilon_i \sim_{i_i.d.} N(0,1) \) for \( i = 0, \cdots, N-1 \). Fan & Zhang (2003) studied the impact of the order of difference on statistical estimation. They found that while higher order can possibly reduce approximation errors, it increases variances of data substantially. They recommended the Euler scheme (3) for most practical situations. The time-domain smoothing relies on the smoothness of \( \sigma(r_t) \) as a function of time \( t_i \). This leads to the exponential smoothing estimator in Section 2.1. On the other hand, the state-domain smoothing relies on structural invariability implied by the stationarity: the conditional variance of \( Y_i \) given \( r_t \) remains the same even for the data in the history. In other words, historical data also furnish the information about \( \sigma(\cdot) \) at the current time. Combining these two nearly independent estimators leads to a better estimator.

In this paper, we focus on the estimation of volatility of a portfolio to illustrate how to deal with the problem of dynamic integration. Asymptotic normality of the proposed estimator is established and extensive simulations are conducted, which theoretically and empirically demonstrate the dominated performance of the integrated estimation.

## 2 Estimation of Volatility

The volatility estimation is an important issue of modern financial analysis since it pervades almost every facet of this field. It is a measure of risk of a portfolio and is related to the Value-at-Risk (VaR), asset pricing, portfolio allocation, capital requirement and risk adjusted returns, among others. There is a large literature on estimating the volatility based on time-domain and state-domain smoothing. For an overview, see the recent book by Fan & Yao (2003).

### 2.1 Time-domain estimator

A popular version of time-domain estimator of the volatility is the moving average estimator:

\[
\hat{\sigma}_{MA,t}^2 = n^{-1} \sum_{i=t-n}^{t-1} Y_i^2, \tag{4}
\]
where $n$ is the size of the moving window. This estimator ignores the drift component, which contributes to the variance in the order of $O(∆)$ instead of $O(∆^{1/2})$ (see Stanton, 1997 and Fan & Zhang, 2003), and utilizes local $n$ data points. An extension of the moving average estimator is the exponential smoothing estimation of the volatility given by

$$
\hat{\sigma}^2_{ES,t} = (1-\lambda)Y^2_{t-1} + \lambda \hat{\sigma}^2_{ES,t-1} = (1-\lambda)\{Y^2_{t-1} + \lambda Y^2_{t-2} + \lambda^2 Y^2_{t-3} + \cdots \},
$$

(5)

where $\lambda$ is a smoothing parameter that controls the size of the local neighborhood. The RiskMetrics of J.P. Morgan (1996), which is used for measuring the risks, called Value at Risk (VaR), of financial assets, recommends $\lambda = 0.94$ and $\lambda = 0.97$ respectively for calculating VaR of the daily and monthly returns.

The exponential smoothing estimator in (5) is a weighted sum of the squared returns prior to time $t$. Since the weight decays exponentially, it essentially uses recent data. A slightly modified version that explicitly uses only $n$ data points before time $t$ is

$$
\hat{\sigma}^2_{ES,t} = \frac{1-\lambda}{1-\lambda^n} \sum_{i=1}^{n} Y^2_{t-i}\lambda^{i-1},
$$

(6)

When $\lambda = 1$, it becomes the moving average estimator (1). With slight abuse of notation, we will also denote the estimator for $\sigma^2(r_t)$ as $\hat{\sigma}^2_{ES,t}$.

All of the time domain smoothing is based on the assumption that the returns $Y_{t-1}$, $Y_{t-2}$, $\cdots$, $Y_{t-n}$ have approximately the same volatility. In other words, $\sigma(r_t)$ in (1) is continuous in time $t$. The following proposition gives the condition under which this holds.

**Proposition 1** Under Conditions (A1) and (A2) in the Appendix, we have

$$
|\sigma^2(r_s) - \sigma^2(r_u)| \leq K|s-u|^{(p-1)/(2p)},
$$

for any $s, u \in [t-\eta, t]$, where the coefficient $K$ satisfies $E[K^{2(p+\delta)}] < \infty$ and $\eta$ is a positive constant.

With the above Hölder continuity, we can establish the asymptotic normality of the time-domain estimator.

**Theorem 1** Suppose that $\sigma_t^2 > 0$. Under conditions (A1) and (A2), if $n \rightarrow +\infty$ and $n\Delta \rightarrow 0$, then

$$
\hat{\sigma}^2_{ES,t} - \sigma_t^2 \rightarrow 0, \text{ a.e.}
$$

Moreover, if the limit $c = \lim_{n \rightarrow \infty} n(1-\lambda)$ exists and $n\Delta^{(p-1)/(2p-1)} \rightarrow 0$,

$$
\sqrt{n}[\hat{\sigma}^2_{ES,t} - \sigma_t^2]/s_{1,t} \xrightarrow{D} N(0,1),
$$

where $s_{1,t}^2 = c_{\frac{1}{p-1}}$. 
Theorem 1 has very interesting implications. Even though the data in the local time-window is highly correlated (indeed, the correlation tending to one), we can compute the variance as if the data were independent. Indeed, if the data in (3) were independent and locally homogeneous, we have

\[
\text{Var}(\hat{\sigma}^2_{ES,t}) \approx \frac{(1 - \lambda)^2}{(1 - \lambda^n)^2} 2\sigma^4_t \sum_{i=1}^{n} \lambda^2(i-1) \\
= \frac{2\sigma^4_t(1 - \lambda)(1 + \lambda^n)}{(1 + \lambda)(1 - \lambda^n)} \approx \frac{1}{n}s^2_{1,t}.
\]

This is indeed the asymptotic variance given in Theorem 1.

2.2 Estimation in state-domain

To obtain the nonparametric estimation of the functions \(f(x) = \Delta^{1/2}\mu(x)\) and \(\sigma^2(x)\) in (3), we use the local linear smoother studied in Ruppert et al. (1997) and Fan & Yao (1998). The local linear technique is chosen for its several nice properties, such as the asymptotic minimax efficiency and the design adaptation. Further, it automatically corrects edge effects and facilitates the bandwidth selection (Fan & Yao, 2003).

To facilitate the theoretical argument in Section 3, we exclude the \(n\) data points used in the time-domain fitting. Thus, the historical data at time \(t\) are \(\{(r_t, Y_i), i = 0, \cdots, N - n - 1\}\). Let \(\hat{f}(x) = \hat{\alpha}_1\) be the local linear estimator that solves the following weighted least-squares problem:

\[
(\hat{\alpha}_1, \hat{\alpha}_2) = \arg \min_{\alpha_1, \alpha_2} \sum_{i=0}^{N-n-1} [Y_i - \alpha_1 - \alpha_2(r_t - x)]^2 K_{h_1}(r_t - x),
\]

where \(K(\cdot)\) is a kernel function and \(h_1 > 0\) is a bandwidth. Denote the squared residuals by \(\hat{R}_i = (Y_i - \hat{f}(r_t))^2\). Then the local linear estimator of \(\sigma^2(x)\) is \(\hat{\sigma}^2_S(x) = \hat{\beta}_0\) given by

\[
(\hat{\beta}_0, \hat{\beta}_1) = \arg \min_{\alpha, \beta} \sum_{i=0}^{N-n-1} \{\hat{R}_i - \beta_0 - \beta_1(r_t - x)\}^2 W_h(r_t - x)
\]

with kernel function \(W\) and bandwidth \(h\). Fan & Yao (1998) gives strategies of bandwidth selection. It was shown in Stanton (1997) and Fan & Zhang (2003) that \(Y_i^2\) instead of \(\hat{R}_i\) in (7) can also be used for the estimation of \(\sigma^2(x)\).

The asymptotic bias and variance of \(\hat{\sigma}^2_S(x)\) are given by Fan & Zhang (2003, theorem 4). Set \(\nu_j = \int u^j W^2(u) du\) for \(j = 0, 1, 2\). Let \(p(\cdot)\) the invariant density function of the Markov process \(\{r_s\}\) from (11). Then, we have

**Theorem 2** Let \(x\) be in the interior of the support of \(p(\cdot)\). Suppose that the second derivatives \(\mu(\cdot)\) and \(\sigma^2(\cdot)\) exist in a neighborhood of \(x\). Under conditions (A3)-(A7), we have

\[
\sqrt{(N - n)h[\hat{\sigma}^2_S(x) - \sigma^2(x)]/s_2(x)} \overset{D}{\to} N(0, 1),
\]

where \(s_2^2(x) = 2\nu_0\sigma^4(x)/p(x)\).
3 Dynamic Integration of time and state domain estimators

In this section, we first show how the optimal dynamic weights in (1) can be estimated and then prove that the time-domain and state-domain estimator are indeed asymptotically independent.

3.1 Estimation of dynamic weights

For the exponential smoothing estimator in (6), we can apply the asymptotic formula given in Theorem 1 to get an estimate of its asymptotic variance. However, since the estimator is a weighted average of \( Y_{t-i} \), we can obtain its variance directly by assuming \( Y_{t-j} \sim N(0, \sigma_j^2) \) for small \( j \). Indeed, with the above local homogeneous model, we have

\[
\text{Var}(\hat{\sigma}_{ES,t}^2) \approx \frac{(1 - \lambda)^2}{(1 - \lambda^n)^2} 2\sigma_t^4 \sum_{i=1}^{n} \sum_{j=1}^{n} \lambda^{i+j-2} \rho(|i - j|)
\]

\[
= \frac{2(1 - \lambda)^2 \sigma_t^4}{(1 - \lambda^n)^2} \{1 + 2 \sum_{k=1}^{n-1} \rho(k) \lambda^k (1 - \lambda^{2(n-k)})/(1 - \lambda^2)\},
\]

(8)

where \( \rho(j) = \text{Cor}(Y_t^2, Y_{t-j}^2) \) is the autocorrelation of the series \( \{Y_{t-j}\} \). The autocorrelation can be estimated from the data in history. Note that due to the locality of the exponential smoothing, only \( \rho(j) \)'s with the first 30 lags, say, contribute to the variance calculation.

We now turn to estimate the variance of \( \hat{\sigma}_{S,t}^2 = \hat{\sigma}_{S}^2(r_t) \). Details can be found in Fan & Yao (1998) and §6.2 of Fan & Yao (2003). Let

\[
V_j(x) = \sum_{i=1}^{t-1} (r_{ti} - x)^j W\left(\frac{r_{ti} - x}{h_1}\right)
\]

and

\[
\xi_i(x) = W\left(\frac{r_{ti} - x}{h_1}\right) \{V_2(x) - (r_{ti} - x)V_1(x)\}/\{V_0(x)V_2(x) - V_1(x)^2\}.
\]

Then the local linear estimator can be expressed as

\[
\hat{\sigma}_{S,t}^2(x) = \sum_{i=1}^{t-1} \xi_i(x) \hat{R}_i
\]

and its variance can be approximated as

\[
\text{Var}(\hat{\sigma}_{S,t}^2(x)) \approx \text{Var}\{V_1 - f(x)^2|r_{t_1} = x\} \sum_{i=1}^{t-1} \xi_i^2(x).
\]

(9)

See also Figure 1 and the discussions at the end of §2.1. Again, for simplicity, we assume that \( \text{Var}(\hat{R}_i|r_{t_1} = x) \approx 2\sigma^4(x) \), which holds if \( \varepsilon_t \sim N(0, 1) \).

Combining (1), (8) and (9), we propose to combine the time-domain and the state-domain estimator with the dynamic weight

\[
\hat{w}_t = \frac{\hat{\sigma}_{S,t}^4 \sum_{i=1}^{t-1} \xi_i^2(r_t)}{\hat{\sigma}_{S,t}^4 \sum_{i=1}^{t-1} \xi_i^2(r_t) + c_t \hat{\sigma}_{ES,t}^4},
\]

(10)
where $c_t = \frac{(1-\lambda)^2}{(1-\lambda^2)} \{1 + 2 \sum_{k=1}^{n-1} \rho(k)\lambda^k(1 - \lambda^2(n-k))/(1 - \lambda^2)\}$ [see (9)]. This is obtained by substituting (8) and (9) into (1). For practical implementation, we truncate the series $\{\rho(i)\}_{i=1}^{t-1}$ in the summation as $\{\rho(i)\}_{i=1}^{30}$. This results in the dynamically integrated estimator

$$\hat{\sigma}^2_{I,t} = \hat{w}_t \hat{\sigma}^2_{ES,t} + (1 - \hat{w}_t)\hat{\sigma}^2_{S,t},$$

(11)

where $\hat{\sigma}^2_{S,t} = \hat{\sigma}^2_S(r_t)$. The function $\hat{\sigma}^2_S(\cdot)$ depends on the time $t$ and we need to update this function as time evolves. Fortunately, we need only to know the function at the point $r_t$. This reduces significantly the computational cost. The computational cost can be reduced further, if we update the estimated function $\hat{\sigma}^2_{S,t}$ at a prescribed time schedule (e.g. once every two months for weekly data).

Finally, we would like to note that in the choice of weight, only the variance of the estimated volatility is considered, rather than the mean square error. This is mainly to facilitate the dynamically weighted procedure. Since the smoothing parameters in $\hat{\sigma}^2_{ES,t}$ and $\hat{\sigma}^2_S(x)$ have been tuned to optimize their performance separately, their biases and variances trade-off have been considered. Hence, controlling the variance of the integrated estimator $\hat{\sigma}^2_{I,t}$ has also controlled, to some extent, the bias of the estimator. Our method focuses only on the estimation of volatility, but the method can be adapted to other estimation problems, such as the value at risk studied in Duffie & Pan (1997) and the drift estimation for diffusion considered in Spokoiny (2000) and volatility matrix for multivariate time series. Further study along this topic is beyond the scope of the current investigation.

### 3.2 Sampling properties

The fundamental component to the choice of dynamic weights is the asymptotic independent between the time and state-domain estimator. By ignoring the drift term (see Stanton, 1997; Fan & Zhang 2003), both the estimators $\hat{\sigma}^2_{ES,t}$ and $\hat{\sigma}^2_S(r_t)$ are linear in $\{Y_i^2\}$. The following theorem shows that the time-domain and state-domain estimators are indeed asymptotically independent. To facilitate the notation, we present the result at the current time $t_N$.

**Theorem 3** Let $s_{2,t_N} = s_2(r_{t_N})$. Under the conditions of Theorems 1 and 2 if the condition (A2) holds at point $t_N$, we have

(a) asymptotic independence:

$$\frac{\sqrt{n}(\hat{\sigma}^2_{ES,t_N} - \sigma^2_{t_N})}{s_{1,t_N}}/\frac{\sqrt{(N-n)\rho_0 (\hat{\sigma}^2_{S,t_N} - \sigma^2_{t_N})}}{s_{2,t_N}} \xrightarrow{D} N(0, I_2).$$

(b) asymptotic normality of $\hat{\sigma}^2_{I,t_N}$: if the limit $d = \lim_{N \to \infty} n / [(N-n)\rho_0]$ exists, then

$$\sqrt{(N-n)\rho_0 / \omega_4 [\hat{\sigma}^2_{I,t_N} - \sigma^2_{t_N}]} \xrightarrow{D} N(0, 1),$$

where $\omega = \omega_4 s^2_{1,t_N}/d + (1 - w_{t_N})^2 s^2_{2,t_N}$. 

From Theorem 3, based on the optimal weight the asymptotic relative efficiencies of $\hat{\sigma}^2_{I,t,N}$ with respect to $\hat{\sigma}^2_{S,t,N}$ and $\hat{\sigma}^2_{ES,t,N}$ are respectively

$$\text{eff}(\hat{\sigma}^2_{I,t,N}, \hat{\sigma}^2_{S,t,N}) = 1 + s^2_{2,t,N} / s^2_{1,t,N}, \quad \text{and} \quad \text{eff}(\hat{\sigma}^2_{I,t,N}, \hat{\sigma}^2_{ES,t,N}) = 1 + s^2_{1,t,N} / (ds^2_{2,t,N}),$$

which are greater than one. This demonstrates that the integrated estimator $\hat{\sigma}^2_{I,t,N}$ is more efficient than the time domain and the state domain estimators.

4 Bayesian integration of volatility estimates

Another possible approach is to consider the historical information as the prior and to incorporate them in the estimation of volatility by the Bayesian framework. We now explore such an approach.

4.1 Bayesian estimation of volatility

The Bayesian approach is to regard the recent data $Y_{t-n}, \ldots, Y_{t-1}$ as an independent sample from $N(0, \sigma^2)$ [see 3] and to regard the historical information being summarized in a prior. To incorporate historical information, we assume that the variance $\sigma^2$ follows an Inverse Gamma distribution with parameters $a$ and $b$, which has the density function

$$f(\sigma^2) = b^a \Gamma^{-1}(a) \{\sigma^2\}^{-(a+1)} \exp(-b/\sigma^2).$$

Denote by $\sigma^2 \sim IG(a, b)$. It is a well-known fact that

$$E(\sigma^2) = \frac{b}{a-1}, \quad \text{Var}(\sigma^2) = \frac{b^2}{(a-1)^2(a-2)}, \quad \text{mode}(\sigma^2) = \frac{b}{a+1}. \quad (12)$$

The hyperparameters $a$ and $b$ will be estimated from historical data such as the state-domain estimators.

It can easily be shown that the posterior density of $\sigma^2$ given $Y = (Y_{t-n}, \ldots, Y_{t-1})$ is $IG(a^*, b^*)$, where

$$a^* = a + \frac{n}{2}, \quad b^* = \frac{1}{2} \sum_{i=1}^{n} Y_{t-i}^2 + b.$$

From (12), the Bayesian mean of $\sigma^2$ is

$$\hat{\sigma}^2 = \frac{b^*}{(a^*-1)} = \sum_{i=1}^{n} (Y_{t-i}^2 + 2b) / (2(a-1) + n).$$

This Bayesian estimator can easily be written as

$$\hat{\sigma}^2_B = \frac{n}{n+2(a-1)} \hat{\sigma}^2_{MA,t} + \frac{2(a-1)}{n+2(a-1)} \hat{\sigma}^2_P, \quad (13)$$
where \( \hat{\sigma}^2_{MA,t} \) is the moving average estimator given by (4) and \( \hat{\sigma}^2_P = b/(a - 1) \) is the prior mean, which will be determined from the historical data. This combines the estimate based on the data and prior knowledge.

The Bayesian estimator (14) utilizes the local average of \( n \) data points. To incorporate the exponential smoothing estimator (5), we regard it as the local average of \( n^* = \sum_{i=1}^{n} \lambda^{i-1} = \frac{1 - \lambda^n}{1 - \lambda} \) data points. This leads to the following integrated estimator

\[
\hat{\sigma}^2_{B,t} = \frac{n^*}{n^* + 2(a - 1)} \hat{\sigma}^2_{ES,t} + \frac{2(a - 1)}{2(a - 1) + n^*} \hat{\sigma}^2_P
\]

\[
= \frac{1 - \lambda^n}{1 - \lambda^n + 2(a - 1)(1 - \lambda)} \hat{\sigma}^2_{ES,t} + \frac{2(a - 1)(1 - \lambda)}{1 - \lambda^n + 2(a - 1)(1 - \lambda)} \hat{\sigma}^2_P.
\]

In particular, when \( \lambda = 1 \), the estimator (15) reduces to (13).

4.2 Estimation of Prior Parameters

A reasonable source for obtaining the prior information in (15) is based on the historical data up to time \( t \). Hence, the hyper-parameters \( a \) and \( b \) should depend on \( t \) and can be used to match with the historical information. Using the approximation model (3), we have

\[
E[(Y_t - \hat{f}(r_t))^2 \mid r_t] \approx \sigma^2(r_t) \quad \text{Var}[(Y_t - \hat{f}(r_t))^2 \mid r_t] \approx 2\sigma^4(r_t).
\]

These can be estimated from the historical data up to time \( t \), namely, the state-domain estimator \( \hat{\sigma}^2_S(r_t) \). Since we have assumed that prior distribution for \( \sigma^2_t \) is IG(\( a_t, b_t \)), then by the method of moments, we would set

\[
E(\sigma^2_t) = \frac{b_t}{a_t - 1} = \hat{\sigma}^2_S(r_t),
\]

\[
\text{Var}(\sigma^2_t) = \frac{b_t^2}{(a_t - 1)^2(a_t - 2)} = 2\hat{\sigma}^4_S(r_t).
\]

Solving the above equation, we obtain that

\[
\hat{a}_t = 2.5 \quad \text{and} \quad \hat{b}_t = 1.5\hat{\sigma}^2_S(r_t).
\]

Substituting this into (15), we obtain the following estimator

\[
\hat{\sigma}^2_{B,t} = \frac{1 - \lambda^n}{1 - \lambda^n + 3(1 - \lambda)} \hat{\sigma}^2_{ES,t} + \frac{3(1 - \lambda)}{1 - \lambda^n + 3(1 - \lambda)} \hat{\sigma}^2_S(r_t).
\]

Unfortunately, the weights in (16) are static, which does not depend on the time \( t \). Hence, the Bayesian method does not produce a satisfactory answer to this problem.
5 Numerical Analysis

To facilitate the presentation, we use the simple abbreviation in Table 1 to denote five volatility estimation methods. Details of the first three methods can be found in Fan & Gu (2003). In particular, the first method is to estimate the volatility using the standard deviation of the yields in the past year and the RiskMetrics method is based on the exponential smoothing with $\lambda = 0.94$. The semiparametric method of Fan & Gu (2003) is an extension of a local model used in the exponential smoothing, with the smoothing parameter determined by minimizing the prediction error. It includes the exponential smoothing with $\lambda$ selected by data as a specific example.

Table 1: Abbreviations of five volatility estimators

| Abbreviation | Description |
|--------------|-------------|
| Hist         | the historical method |
| RiskM        | the RiskMetrics method of J.P. Morgan |
| Semi         | the semiparametric estimator (SEV) in Fan & Gu (2003) |
| NonBay       | the nonparametric Bayesian method in (10) with $\lambda = 0.94$ |
| Integ        | the integration method of time and state domains in (11) |

The following four measures are employed to assess the performance of different procedures for estimating the volatility. Other related measures can also be used. See Dave & Stahl (1997).

**Measure 1.** Exceedence ratio against confidence level.

This measure counts the number of the events for which the loss of an asset exceeds the loss predicted by the normal model at a given confidence $\alpha$. With estimated volatility, under the normal model, the one-period VaR is estimated by $\Phi^{-1}(\alpha)\hat{\sigma}_t$, where $\Phi^{-1}(\alpha)$ is the $\alpha$ quantile of the standard normal distribution. For each estimated VaR, the Exceedence Ratio (ER) is computed as

$$ER(\hat{\sigma}_t^2) = m^{-1} \sum_{i=T+1}^{T+m} I(Y_i < \Phi^{-1}(\alpha)\hat{\sigma}_i),$$

(17)

for an out-sample of size $m$. This gives an indication on how effective the volatility estimator can be used for predicting the one-period VaR. Note that the Monte Carlo error for this measure has an approximate size $\{\alpha(1-\alpha)/m\}^{1/2}$, even when the true $\sigma_t$ is used. For example, with $\alpha = 5\%$ and $m = 1000$, the Monte Carlo error is around 0.68\%. Thus, unless the post-sample size $m$ is large enough, this measure has difficulty in differentiating the performance of various estimators due to the presence of large error margins. Note that the ER depends strongly on the assumption of normality. If the underlying return process is non-normal, the Student’s $t(5)$ say, the ER will grossly be overestimated even with the true volatility. In our simulation study, we will employ the true $\alpha$-quantile of the error distribution instead of $\Phi^{-1}(\alpha)$ in (17) to compute the ER. For real data analysis, we use the $\alpha$-quantile of the last 250 residuals for the in-sample data.
Measure 2. Mean Absolute Deviation Error.

To motivate this measure, let us first consider the mean square errors:

\[
PE(\hat{\sigma}_t^2) = m^{-1} \sum_{i=T+1}^{T+m} (Y_i^2 - \hat{\sigma}_i^2)^2.
\]

The expected value can be decomposed as

\[
E(PE) = m^{-1} \sum_{i=T+1}^{T+m} E(\sigma_i^2 - \hat{\sigma}_i^2)^2 + m^{-1} \sum_{i=T+1}^{T+m} E(Y_i^2 - \sigma_i^2)^2.
\] (18)

Note that the first term reflects the effectiveness of the estimated volatility while the second term is the size of the stochastic error, independent of estimators. As in all statistical prediction problems, the second term is usually of an order of magnitude larger than the first term. Thus, a small improvement on PE could mean substantial improvement over the estimated volatility. However, due to the well-known fact that financial time series contain outliers, the mean-square error is not a robust measure. Therefore, we used the mean-absolute deviation error (MADE):

\[
MADE(\hat{\sigma}_t^2) = m^{-1} \sum_{i=T+1}^{T+m} |Y_i^2 - \hat{\sigma}_i^2|.
\]

Measure 3. Square-root Absolute Deviation Error.

An alternative variation to MADE is the square-Root Absolute Deviation Error (RADE), which is defined as

\[
RADE(\hat{\sigma}_t^2) = m^{-1} \sum_{i=T+1}^{T+m} \left| Y_i - \sqrt{\frac{2}{\pi}} \hat{\sigma}_i \right|.
\]

The constant factor comes from the fact that \(E(|\varepsilon_t|) = \sqrt{\frac{2}{\pi}}\) for \(\varepsilon_t \sim N(0,1)\). If the underlying error distribution deviates from normality, this measure is not robust.

Measure 4. Ideal Mean Absolute Deviation Error.

To assess the estimation of the volatility in simulations, one can also employ the ideal mean absolute deviation error (IMADE):

\[
IMADE = m^{-1} \sum_{i=T+1}^{T+m} |\hat{\sigma}_i^2 - \sigma_i^2|.
\]

This measure calibrates the accuracy of the forecasted volatility in terms of the absolute difference between the true and the forecasted one. However, for real data analysis, this measure is not applicable.

5.1 Simulations

To assess the performance of the five estimation methods in Table 1, we compute the average and the standard deviation of each of the four measures over 600 simulations. Generally speaking,
the smaller the average (or the standard deviation), the better the estimation approach. We also compute the “score” of an estimator, which is the percentage of times among 600 simulations that the estimator outperforms the average of the 5 methods in terms of an effectiveness measure. To be more specific, for example, consider RiskMetrics using MADE as an effectiveness measure. Let $m_i$ be the MADE of the RiskMetrics estimator at the $i$-th simulation, and $\bar{m}_i$ the average of the MADEs for the five estimators at the $i$-th simulation. Then the “score” of the RiskMetrics approach in terms of the MADE is defined as

$$\frac{1}{600} \sum_{i=1}^{600} I(m_i < \bar{m}_i).$$

Obviously, the estimators with higher scores are preferred. In addition, we define a “relative loss” of an estimator $\hat{\sigma}_t^2$ relative to $\hat{\sigma}_{I,t}^2$ in terms of MADEs as

$$\text{RLOSS}(\hat{\sigma}_t^2, \hat{\sigma}_{I,t}^2) = \frac{\text{MADE}(\hat{\sigma}_t^2) - \text{MADE}(\hat{\sigma}_{I,t}^2)}{\text{MADE}(\hat{\sigma}_{I,t}^2)},$$

where $\text{MADE}(\hat{\sigma}_{I,t}^2)$ is the average of MADE(\hat{\sigma}_{I,t}^2) among simulations.

**Example 1.** To simulate the interest rate data, we consider the Cox-Ingersoll-Ross (CIR) model:

$$dr_t = \kappa(\theta - r_t)dt + \sigma r_t^{1/2}dW_t, \quad t \geq t_0,$$

where the spot rate, $r_t$, moves around a central location or long-run equilibrium level $\theta = 0.08571$ at speed $\kappa = 0.21459$. The $\sigma$ is set to be 0.07830. These values of parameters are cited from Chapman & Pearson (2000), which satisfy the condition $2\kappa\theta \geq \sigma^2$ so that the process $r_t$ is stationary and positive. The model has been studied by Chapman & Pearson (2000) and Fan & Zhang (2003).

There are two methods to generate samples from this model. The first one is the discrete-time order 1.0 strong approximation scheme in Kloeden, et al. (1996); the second one is using the exact transition density detailed in Cox et al. (1985) and Fan & Zhang (2003). Here we use the first method to generate 600 series of data each with length 1200 of the weekly data from this model. For each simulation, we set the first 900 observations as the “in-sample” data and the last 300 observations as the “out-sample” data.

The results are summarized in Table 2 which shows that the performance of the integrated estimator uniformly dominates the other estimators because of its highest score, lowest IMADE, MADE, and RADE. The improvement in IMADE is over 100 percent. This shows that our integrated volatility method better captures the volatility dynamics. The Bayesian method of combining the estimates from the time and state domains outperforms all other methods. The historical simulation method performed poorly due to mis-specification of the function of the volatility parameter. The results here show the advantage of aggregating the information of time domain and
Table 2: Comparisons of several volatility estimation methods

| Measure | Empirical Formula | Hist | RiskM | Semi | NonBay | Integ |
|---------|-------------------|------|-------|------|--------|-------|
| IMADE  | Score (%)         | 17.17| 20.83 | 32.00| 44.33  | 99.83 |
|         | Ave ($\times 10^{-5}$) | 0.2383| 0.2088| 0.1922| 0.1833 | 0.0879|
|         | Std ($\times 10^{-5}$) | 0.1087| 0.0746| 0.0718| 0.0675 | 0.0554|
|         | Relative Loss (%) | 171.20| 137.61| 118.79| 108.60 | 0     |
| MADE    | Score (%)         | 39.83| 54.33 | 60.00| 57.17  | 72.17 |
|         | Ave ($\times 10^{-4}$) | 0.1012| 0.0930| 0.0932| 0.0924 | 0.0903|
|         | Std ($\times 10^{-5}$) | 0.3231| 0.3152| 0.3010| 0.3119 | 0.2995|
|         | Relative Loss (%) | 12.03| 2.95  | 3.16 | 2.31   | 0     |
| RADE    | Score (%)         | 40.83| 53.33 | 54.83| 57.50  | 74.50 |
|         | Ave                | 0.0015| 0.0015| 0.0015| 0.0015 | 0.0014|
|         | Std ($\times 10^{-3}$) | 0.2530| 0.2552| 0.2461| 0.2536 | 0.2476|
|         | Relative Loss (%) | 6.88 | 1.66  | 2.13 | 1.27   | 0     |
| ER      | Ave                | 0.0556| 0.0547| 0.0536| 0.0535 | 0.0508|
|         | Std                | 0.0257| 0.0106| 0.0122| 0.0107 | 0.0122|

The state domain. Note that all estimators have reasonable ER values at level 0.05, especially the ER value of the integrated estimator is closest to 0.05. To appreciate how much improvement for our integrated method over the other methods, we display the mean absolute difference between the forecasted and the true volatility in Figure 2. It is seen that the integrated method is much better than the others in terms of the difference.

**Example 2.** There is a large literature on the estimation of volatility. In addition to the famous parametric models such as ARCH and GARCH, stochastic volatility models have also received a lot of attention. For an overview, see, for example, Barndoff-Nielsen & Shephard (2001, 2002), Bollerslev & Zhou (2002) and references therein. We consider the following stochastic volatility model:

$$dr_t = \sigma_t dB_t, \ r_0 = 0$$

$$dV_t = \kappa(\theta - V_t)dt + \alpha V_t dW_t, \ V_0 = \eta, \ V_t = \sigma_t^2,$$

where $W_t$ and $B_t$ are two independent standard Brownian motions.

There are two methods to generate samples from this model. One is the direct method, using the result of Genon-Catalot et al. (1999). Let $a = 1 + 2\kappa/\alpha^2$ and $b = 2\theta \kappa/\alpha^2$. The conditions (A1)-(A4) in the above paper are satisfied with the parameter values in the model being constants as $\kappa = 3$, $\theta = 0.009$ and $\alpha^2 = 4$ and the initial random variable $\eta$ follows the Inverse Gamma distribution. The value of $\theta$ is set as the real variance of the daily return for Standard & Poor 500 data from January 4, 1988 to December 29, 2000. The value $\alpha^2$ is to make the parameter $a$ of the stable distribution $IG(a, b)$ equal 2.5, the prior parameter in [10]. If $\Delta \to 0$ and $n\Delta \to \infty$, then

$$Y_i \to \sqrt{\frac{b}{a}} T, \text{ where } T \sim t(2a).$$
Figure 2: The mean absolute difference between the forecasted and the true volatility. Solid - integrated estimator (11); small circle - nonparametric Bayesian integrated estimator (16); star - historical method; dashed - RiskMetrics; dash dotted - Semiparametric estimator in Fan & Gu (2003).

Another method is the discretization of the model. Conditionally on $g = \sigma(V_t, t \geq 0)$, the random variables $Y_i$ are independent and follow $N(0, \bar{V}_i)$ with

$$\bar{V}_i = \frac{1}{\Delta} \int_{(i-1)\Delta}^{i\Delta} V_s ds.$$ 

To simulate the diffusion process $V_t$, one can use the following order 1.0 scheme with sampling interval $\Delta^* = \Delta/30$,

$$V_{i+\Delta^*} = V_i + \kappa(\theta - V_i)\Delta^* + \alpha V_i(\Delta^*)^{1/2} \varepsilon_i + \frac{1}{2} \alpha^2 V_i \Delta^*(\varepsilon_i^2 - 1),$$

where $\{\varepsilon_i\}$ are independent random series from the standard normal distribution.

We simulate 600 series of 1000 monthly data using the second method with step size $\Delta = 1/12$. For each simulated series, set the first three quarters observations as the in-sample data and the remaining observations as the out-sample data. The performance of each volatility estimation is described in Table 3. The conclusion similar to Example 1 can be drawn from this example.

**Example 3.** We now consider the geometric Brownian (GBM):

$$dr_t = \mu r_t + \sigma r_t dW_t,$$

where $W_t$ is a standard one-dimensional Brownian motion. This is a non-stationary process to which we check if our method continues to apply. Note that the celebrated Black-Scholes option
Table 3: Comparisons of several volatility estimation methods

| Measure | Empirical Formula | Hist | RiskM | Semi | NonBay | Integ |
|---------|-------------------|------|-------|------|--------|-------|
| IMADE   | Score (%)         | 27.67| 49.33 | 52.83| 58.83  | 77.17 |
|         | Ave               | 0.0056| 0.0051| 0.0051| 0.0050 | 0.0047|
|         | Std               | 0.0023| 0.0019| 0.0021| 0.0018 | 0.0016|
|         | Relative Loss (%) | 17.74| 7.63  | 6.56 | 5.18   | 0     |
| MADE    | Score (%)         | 35.33| 52.17 | 57.67| 58.00  | 82.67 |
|         | Ave               | 0.0099| 0.0089| 0.0087| 0.0088 | 0.0082|
|         | Std               | 0.0032| 0.0022| 0.0022| 0.0021 | 0.0017|
|         | Relative Loss (%) | 20.48| 7.53  | 5.38 | 6.17   | 0     |
| RADE    | Score (%)         | 33.00| 49.17 | 53.33| 58.83  | 81.33 |
|         | Ave               | 0.0477| 0.0455| 0.0452| 0.0451 | 0.0438|
|         | Std               | 0.0059| 0.0051| 0.0051| 0.0049 | 0.0042|
|         | Relative Loss (%) | 8.77 | 3.70  | 3.11 | 2.91   | 0     |
| ER      | Ave               | 0.0457| 0.0547| 0.0546| 0.0516 | 0.0533|
|         | Std               | 0.0156| 0.0126| 0.0143| 0.0127 | 0.0146|

price formula is derived on the Osborne’s assumption that the stock price follows the GBM model. By the Itô formula, we have

$$\log r_t - \log r_0 = (\mu - \sigma^2/2)t + \sigma^2 W_t.$$

We set $\mu = 0.03$ and $\sigma = 0.26$ in our simulations. With the Brownian motion simulated from independent Gaussian increments, one can generate the samples for the GBM. Here we use the latter with $\Delta = 1/52$ in 600 simulations. For each simulation, we generate 1000 observations and use the first two thirds of observations as in-sample data and the remaining observations as out-sample data.

Table 4: Comparisons of several volatility estimation methods

| Measure | Empirical Formula | Hist | RiskM | Semi | NonBay | Integ |
|---------|-------------------|------|-------|------|--------|-------|
| IMADE   | Score (×10^-5)    | 2.17 | 89.98 | 7.01 | 99.17  | 99.17 |
|         | Ave               | 0.1615| 0.0811| 0.1154| 0.0746 | 0.0746|
|         | Std               | 0.1030| 0.0473| 0.0632| 0.0440 | 0.0440|
|         | Relative Loss (%) | 116.42| 8.64 | 54.63| 0       | 0     |
| MADE    | Score (×10^-5)    | 40.17| 58.67 | 54.00| 60.00  | 66.17 |
|         | Ave               | 0.2424| 0.2984| 0.2896| 0.2958 | 0.2859|
|         | Std               | 0.1037| 0.1739| 0.1633| 0.1723 | 0.1663|
|         | Relative Loss (%) | -15.24| 4.35 | 3.11 | 3.46   | 0     |
| RADE    | Score (×10^-3)    | 36.83| 60.17 | 47.50| 62.33  | 69.50 |
|         | Ave               | 0.5236| 0.4997| 0.5114| 0.4975 | 0.4903|
|         | Std               | 0.5898| 0.6608| 0.6567| 0.6573 | 0.6435|
|         | Relative Loss (%) | 6.80 | 1.92  | 4.30 | 1.47   | 0     |
| ER      | Ave               | 0.0063| 0.0532| 0.0517| 0.0506 | 0.0444|
|         | Std               | 0.0467| 0.0095| 0.0219| 0.0110 | 0.0160|
Table 5: Robust comparisons of several volatility estimation methods

| Measure | Empirical Formula   | Hist  | RiskM | Semi  | NonBay | Integ |
|---------|---------------------|-------|-------|-------|--------|-------|
| IMADE   | Ave ($\times 10^{-6}$) | 0.5579| 0.3025| 0.4374| 0.2748 | 0.2748|
| Relative Loss (%) | 103.01 | 10.08 | 59.17 | 0 | 0 |
| MADE    | Ave ($\times 10^{-5}$) | 0.1115| 0.1107| 0.1111| 0.1097 | 0.1061|
| Relative Loss (%) | 5.07 | 4.30 | 4.67 | 3.42 | 0 |
| RADE    | Ave ($\times 10^{-3}$) | 0.4268| 0.3901| 0.4028| 0.3885 | 0.3836|
| Relative Loss (%) | 11.27| 1.71 | 5.00 | 1.28 | 0 |
| ER      | Ave | 0.0628| 0.0521| 0.0493| 0.0494 | 0.0428|

Table 4 summarizes the results. The historical simulation approach has the smallest MADE, but suffers from poor forecast in terms of IMADE. This is surprising. Why is it so different between IMADE and MADE? This phenomenon may be produced by the non-stationarity of the process. For the integrated method, even though the true volatility structure is well captured because of the lowest IMADE, extreme values of observations make the MADE quite large. To more accurately calibrate the performance of the volatility estimation, we use the 95% up-trimmed mean instead of the mean to summarize the values of the measures. Table 5 reports the trimmed means and the relative losses for different measures. The similar conclusions to those in Example 1 can be drawn from the table. This shows that our integrated method continues to perform better than other for this non-stationary case. The Bayesian estimator performs comparably with the dynamically integrated method and outperforms all others.

5.2 Empirical Study

In this section, we will apply the integrated volatility estimation methods and others to the analysis of real financial data.

5.2.1 Treasury Bond

We consider here the weekly returns of three treasury bonds with terms 1, 5 and 10 years, respectively.

We set the observations from January 4, 1974 to December 30, 1994 as in-sample data, and those from January 6, 1995 up to August 8, 2003 as out-sample data. The total sample size is 1545 and the in-sample size is 1096. The results are reported in Table 6.

From Table 6, the integrated estimator is of the smallest MADE and almost the smallest RADE, which reflects that the integrated estimation method of the volatility is the best among the five methods. Relative losses in MADE of the other estimators with respect to the integrated estimator can easily be computed as ranging from 8.47% (NonBay) to 42.6% (Hist) for the bond with one year term. For the bonds with 5 or 10 years term, the five estimators have close MADEs and RADEs, where the historical simulation method is better than the RiskMetrics in terms of MADE.
Table 6: Comparisons of several volatility estimation methods

| Term  | Measure | Hist  | RiskM | Semi  | NonBay | Integ  |
|-------|---------|-------|-------|-------|--------|--------|
| 1 year| MADE    | 0.01044 | 0.00787 | 0.00787 | 0.00794 | 0.00732 |
|       | RADE    | 0.05257 | 0.04231 | 0.04256 | 0.04225 | 0.04107 |
|       | ER      | 0.022  | 0.020  | 0.022  | 0.016  | 0.038  |
| 5 years| MADE    | 0.01207 | 0.01253 | 0.01296 | 0.01278 | 0.01201 |
|        | RADE    | 0.05315 | 0.05494 | 0.05630 | 0.05562 | 0.05572 |
|        | ER      | 0.007  | 0.014  | 0.016  | 0.011  | 0.058  |
| 10 years| MADE   | 0.01041 | 0.01093 | 0.01103 | 0.01112 | 0.01018 |
|       | RADE    | 0.04939 | 0.05235 | 0.05296 | 0.05280 | 0.05151 |
|       | ER      | 0.011  | 0.016  | 0.018  | 0.013  | 0.049  |

and RADE, and the integrated estimation approach has the smallest MADEs. This demonstrates the advantage of using state domain information which can help the time-domain prediction of the changes in bond interest dynamics.

5.2.2 Exchange Rate

We analyse the daily exchange rate of several foreign currencies with US dollar. The data are from January 3, 1994 to August 1, 2003. The in-sample data consists of the observations before January 1, 2001, and the out-sample data consists of the remaining observations. The results are reported in Table 7. It is seen that the integrated estimator has the smallest MADEs for the exchange rates, which again supports our integrated volatility estimation.

Table 7: Comparisons of several volatility estimation methods

| Currency | Measure      | Hist  | RiskM | Semi  | NonBay | Integ  |
|----------|--------------|-------|-------|-------|--------|--------|
| U.K.     | MADE($\times 10^{-4}$) | 0.614 | 0.519 | 0.536 | 0.519  | 0.492  |
|          | RADE($\times 10^{-3}$) | 3.991 | 3.424 | 3.513 | 3.438  | 3.491  |
|          | ER           | 0.011 | 0.017 | 0.019 | 0.015  | 0.039  |
| Australia| MADE($\times 10^{-4}$) | 0.172 | 0.132 | 0.135 | 0.135  | 0.126  |
|          | RADE($\times 10^{-3}$) | 1.986 | 1.775 | 1.830 | 1.797  | 1.762  |
|          | ER           | 0.054 | 0.025 | 0.026 | 0.022  | 0.043  |
| Japan    | MADE($\times 10^{-1}$) | 5.554 | 5.232 | 5.444 | 5.439  | 5.067  |
|          | RADE($\times 10^{-1}$) | 3.596 | 3.546 | 3.622 | 3.588  | 3.560  |
|          | ER           | 0.014 | 0.011 | 0.019 | 0.012  | 0.029  |

6 Conclusions

We have proposed a Bayesian method and a dynamically integrated method to aggregate the
information from the time-domain and the state domain. The performance comparisons are studied both empirically and theoretically. We have shown that the proposed integrated method is effectively aggregating the information from both the time and the state domains, and has advantages over some previous methods. It is powerful in forecasting volatilities for the yields of bonds and for exchange rates. Our study has also revealed that proper use of information from both the time domain and the state domain makes volatility forecasting more accurately. Our method exploits the continuity in the time-domain and stationarity in the state-domain. It can be applied to situations where these two conditions hold approximately.

7 Appendix

We collect technical conditions for the proof of our results.

(A1) $\sigma^2(x)$ is Lipschitz continuous.

(A2) There exists a constant $L > 0$ such that $E|\mu(r_s)|^{2(p+\delta)} \leq L$ and $E|\sigma(r_s)|^{2(p+\delta)} \leq L$ for any $s \in [t - \eta, t]$, where $\eta$ is some positive constant, $p$ is an integer not less than 4 and $\delta > 0$.

(A3) The discrete observations $\{r_t\}_{t=0}^N$ satisfy the stationarity conditions of Banon (1978). Furthermore, the $G_2$ condition of Rosenblatt (1970) holds for the transition operator.

(A4) The conditional density $p_\ell(y|x)$ of $r_{t+\ell}$ given $r_t$ is continuous in the arguments $(y, x)$ and is bounded by a constant independent of $\ell$.

(A5) The kernel $W$ is a bounded, symmetric probability density function with compact support, $[-1, 1]$ say.

(A6) $(N - n)h \to \infty$, $(N - n)h^5 \to 0$, $(N - n)h \Delta \to 0$.

Throughout the proof, we denote by $M$ a generic positive constant, and use $\mu_s$ and $\sigma_s$ to represent $\mu(r_s)$ and $\sigma(r_s)$, respectively.

Proof of Proposition [I] It suffices to show that the process $\{r_s\}$ is Hölder-continuous with order $q = (p - 1)/(2p)$ and coefficient $K_1$, where $E[K_1^{2(p+\delta)}] < \infty$, because this together with assumption (A1) gives the result of the lemma. By Jensen’s inequality and martingale moment inequalities (Karatzas & Shreve 1991, Section 3.3.D), we have

$$E|r_u - r_s|^{2(p+\delta)} \leq M \left( E \left| \int_s^u \mu_v dv \right|^{2(p+\delta)} + E \left| \int_s^u \sigma_v dW_v \right|^{2(p+\delta)} \right)$$

$$\leq M (u - s)^{2(p+\delta) - 1} \int_s^u E|\mu_v|^{2(p+\delta)} dv + M (u - s)^{p+\delta - 1} \int_s^u E|\sigma_v|^{2(p+\delta)} dv$$

$$\leq M (u - s)^{p+\delta}.$$
Then by the Kolmogorov continuity theorem (Revuz & Yor 1991, Theorem 2.1), \( \{r_s\} \) is Hölder-
continuous.

**Proof of Theorem** Let \( Z_{i,s} = (r_s - r_t_i)^2 \). Applying Itô formula to \( Z_{i,s} \), we obtain

\[
dZ_{i,s} = 2 \left( \int_{t_i}^s \mu_u du + \int_{t_i}^s \sigma_u dW_u \right) \left( \mu_s ds + \sigma_s dW_s \right) + \sigma_s^2 ds
\]

Then \( Y_i^2 \) can be decomposed as

\[
Y_i^2 = 2a_i + 2b_i + \bar{\sigma}_i^2,
\]

where

\[
a_i = \Delta^{-1} \left[ \int_{t_i}^{t_i+1} \mu_s ds \int_{t_i}^s \mu_u du + \int_{t_i}^{t_i+1} \mu_s ds \int_{t_i}^s \sigma_u dW_u + \int_{t_i}^{t_i+1} \sigma_s dW_s \int_{t_i}^s \mu_u du \right],
\]

\[
b_i = \Delta^{-1} \int_{t_i}^{t_i+1} \sigma_u dW_u \sigma_s dW_s,
\]

and

\[
\bar{\sigma}_i^2 = \Delta^{-1} \int_{t_i}^{t_i+1} \sigma_s^2 ds.
\]

Therefore, \( \bar{\sigma}_{ES,t}^2 \) can be written as

\[
\bar{\sigma}_{ES,t}^2 = \frac{1 - \lambda}{1 - \lambda^n} \sum_{i=t-n}^{t-1} \lambda^{t-i-1} a_i + \frac{1 - \lambda}{1 - \lambda^n} \sum_{i=t-n}^{t-1} \lambda^{t-i-1} b_i + \frac{1 - \lambda}{1 - \lambda^n} \sum_{i=t-n}^{t-1} \lambda^{t-i-1} \bar{\sigma}_i^2
\]

\[
\equiv A_{n,\Delta} + B_{n,\Delta} + C_{n,\Delta}.
\]

By Proposition 1, as \( n\Delta \to 0 \),

\[
|C_{n,\Delta} - \sigma_i^2| \leq K(n\Delta)^q,
\]

where \( q = \frac{p - 1}{2p} \). This combined with Lemmas below completes the proof of the theorem.

**Lemma 1** If condition (A2) is satisfied, then \( E[A_{n,\Delta}^2] = O(\Delta) \).

**Proof** Simple algebra gives the result. In fact,

\[
E(a_i^2) \leq 3E \left[ \Delta^{-1} \int_{t_i}^{t_i+1} \mu_s ds \int_{t_i}^s \mu_u du \right]^2 + 3E \left[ \Delta^{-1} \int_{t_i}^{t_i+1} \mu_s ds \int_{t_i}^s \sigma_u dW_u \right]^2
\]

\[
+ 3E \left[ \Delta^{-1} \int_{t_i}^{t_i+1} \sigma_s dW_s \int_{t_i}^s \mu_u du \right]^2
\]

\[
\equiv I_1(\Delta) + I_2(\Delta) + I_3(\Delta).
\]
Applying Jensen’s inequality, we obtain that

\[ I_1(\Delta) = O(\Delta^{-1}) E \left[ \int_{t_i}^{t_{i+1}} \int_{t_i}^{s} \mu_s^2 \mu_u^2 \, du \, ds \right] \]

\[ = O(\Delta^{-1}) \int_{t_i}^{t_{i+1}} \int_{t_i}^{s} E(\mu_u^4 + \mu_s^4) \, du \, ds = O(\Delta). \]

By Jensen’s inequality, Hölder’s inequality and martingale moments inequalities, we have

\[ I_2(\Delta) = O(\Delta^{-1}) \int_{t_i}^{t_{i+1}} E \left( \mu_s \int_{t_i}^{s} \sigma_u^2 \, dW_u \right)^2 \, ds \]

\[ = O(\Delta^{-1}) \int_{t_i}^{t_{i+1}} \left\{ E \left[ \mu_s^4 \right] E \left[ \int_{t_i}^{t_{i+1}} \sigma_u \, dW_u \right]^4 \right\}^{1/2} \, ds = O(\Delta). \]

Similarly, \( I_3(\Delta) = O(\Delta) \). Therefore, \( E(a_i^2) = O(\Delta) \). Then by the Cauchy-Schwartz inequality and noting that \( n(1 - \lambda) = O(1) \), we obtain that

\[ E[A_n^2, \Delta] \leq n \left( \frac{1 - \lambda}{1 - \lambda^n} \right)^2 \sum_{i=1}^{n} \lambda^{2(n-i)} E(a_i^2) = O(\Delta). \]

**Lemma 2** Under condition (A2), if \( n \to \infty \) and \( n\Delta \to 0 \), then

\[ s_{1,t}^{-1} \sqrt{n} B_{n, \Delta} \overset{D} \to N \left( 0, 1 \right). \]  

**Proof.** Note that

\[ b_j = \sigma_t^2 \Delta^{-1} \int_{t_j}^{t_{j+1}} (W_s - W_{t_j}) \, dW_s + \epsilon_j, \]

where

\[ \epsilon_j = \Delta^{-1} \int_{t_j}^{t_{j+1}} (\sigma_s - \sigma_t) \left[ \int_{t_j}^{s} \sigma_u \, dW_u \right] \, dW_s + \Delta^{-1} \sigma_t \int_{t_j}^{t_{j+1}} \left[ \int_{t_j}^{s} (\sigma_u - \sigma_{t_j}) \, dW_u \right] \, dW_s. \]

By the central limit theorem for martingale (see Hall & Heyde 1980, Corollary 3.1), it suffices to show that

\[ V_n^2 \equiv E[s_{1,t}^{-2} n B_{n, \Delta}^2] \to 1, \]  

and the following Lyapunov condition holds:

\[ \sum_{i=t-n}^{t-1} E \left( \sqrt{n} \frac{1 - \lambda}{1 - \lambda^n} \lambda^{t-i-1} b_i \right)^4 \to 0. \]  

Note that

\[ \frac{\Delta^2}{2} E(\epsilon_j^2) \leq E \left\{ \int_{t_j}^{t_{j+1}} (\sigma_s - \sigma_t) \left[ \int_{t_j}^{s} \sigma_u \, dW_u \right] \, dW_s \right\}^2 + \sigma_t^2 E \left\{ \int_{t_j}^{t_{j+1}} \left[ \int_{t_j}^{s} (\sigma_u - \sigma_{t_j}) \, dW_u \right] \, dW_s \right\}^2 \]

\[ \equiv L_{n1} + L_{n2}. \]  

(A4)
By Jensen’s inequality, Hölder’s inequality and moments inequalities for martingale, we have

\[
L_{n1} \leq \int_{t_j}^{t_{j+1}} E\left\{ (\sigma_s - \sigma_t)^2 \left[ \int_{t_j}^s \sigma_u dW_u \right]^2 \right\} ds
\]

\[
\leq \int_{t_j}^{t_{j+1}} \left\{ E(\sigma_s - \sigma_t)^4 E\left[ \int_{t_j}^s \sigma_u dW_u \right]^4 \right\}^{1/2} ds
\]

\[
\leq \int_{t_j}^{t_{j+1}} \left\{ E[K(n\Delta)^q]^{1/2} 36\Delta \int_{t_j}^s E(\sigma_u^4) du \right\}^{1/2} ds
\]

\[
\leq M(n\Delta)^{2\alpha} \Delta^2.
\]

(A5)

Similarly,

\[
L_{n2} \leq M(n\Delta)^{2\alpha} \Delta^2.
\]

(A6)

By (A4), (A5) and (A6),

\[
E(e_j^2) \leq M(n\Delta)^{2\alpha}.
\]

(A7)

Therefore,

\[
E[\sigma_i^{-4} b_j^2] = \frac{1}{2} + O((n\Delta)^q).
\]

By the theory of stochastic calculus, simple algebra gives that \( E(b_j) = 0 \) and \( E(b_i b_j) = 0 \) for \( i \neq j \).

It follows that

\[
V_n^2 = E(s_{1, t}^{-2} n B_{n, \Delta}^2) = \sum_{i=t-n}^{t-1} E\left( 2s_{1, t}\sqrt{n} \frac{1 - \lambda}{1 - \lambda^n} \lambda^{t-i-1} b_i \right)^2 \to 1.
\]

That is, \( A2 \) holds. For \( A3 \), it suffices to prove that \( E(b_j^4) \) is bounded, which holds by applying the moment inequalities for martingales to \( b_j^4 \).

**Proof of Theorem 2** The proof is completed by using the same lines in Fan & Yao (1998).

**Proof of Theorem 3** By Fan & Yao (1998), the volatility estimator \( \hat{\sigma}^2_{S, tN} \) behaves as if the instantaneous return function \( f \) is known, hence without loss of generality we assume that \( f(x) = 0 \) and hence \( \tilde{R}_i = Y_i^2. \) Let \( Y = (Y_0^2, \cdots, Y_{N-n-1}^2)^T, \) \( W = \text{diag}\{W_h(r_{t_0} - r_{t_N}), \cdots, W_h(r_{t_N-n-1} - r_{t_N})\}, \) and

\[
X = \begin{pmatrix}
1 & r_{t_0} - r_{t_N} \\
& \vline \\
& \vdots \\
& \vline \\
1 & r_{t_N-n-1} - r_{t_N}
\end{pmatrix}.
\]

Denote by \( m_i = E[Y_i^2 r_{t_i}], \) \( m = (m_0, \cdots, m_{N-n-1})^T \) and \( e_1 = (1, 0)^T. \) Define \( S_N = X^TWX \) and \( T_N = X^TWY. \) Then it can be written that (see Fan & Yao, 2003)

\[
\hat{\sigma}^2_{S, tN} = e_1^T S_N^{-1} T_N.
\]

Hence

\[
\hat{\sigma}^2_{S, tN} - \sigma^2_{tN} = e_1^T S_N^{-1} X^T W (m - X\beta_N) + e_1^T S_N^{-1} X^T W (Y - m)
\]

\[
\equiv e_1^T b + e_1^T t,
\]

(A8)
where $\beta_N = (m(r_{1N}), m'(r_{1N}))^T$ with $m(r_{1N}) = E[Y_1^2 | r_t = r_{1N}]$. By Fan & Zhang (2003), the bias vector $b$ converges in probability to a vector $\bar{b}$ with $\bar{b} = O(h) = O(1/\sqrt{(N - n)h})$. In the following, we will show that the centralized vector $t$ is asymptotically normal.

In fact, put $u = (N - n)^{-1}H^{-1}X^TW(Y - m)$ where $H = \text{diag}\{1, h\}$, then by Fan & Zhang (2003) the vector $t$ can be written as

$$t = p^{-1}(r_{1N})H^{-1}S^{-1}u(1 + o_p(1)),$$

(A9)

where $S = (\mu_{i+j-2})_{i,j=1,2}$ with $\mu_j = \int w^jW(u)du$. For any constant vector $c$, define

$$Q_N = c^T u = \frac{1}{N-n} \sum_{i=0}^{N-n-1} \{ Y_i^2 - m_i \} C_h(r_{t_i} - r_{t_N}),$$

where $C_h(\cdot) = 1/hC(\cdot/h)$ with $C(x) = c_0W(x) + c_1xW(x)$. Applying the “big-block” and “small-block” arguments in Fan & Yao (2003, Theorem 6.3), we obtain

$$\theta^{-1}(r_{1N}) \sqrt{(N-n)h} Q_N \xrightarrow{D} N(0,1),$$

(A10)

where $\theta^2(r_{1N}) = 2p(r_{1N})\sigma^4(r_{1N}) \int_{-\infty}^{+\infty} C^2(u)du$. In the following, we will decompose $Q_N$ into two parts, $Q'_N$ and $Q''_N$, which satisfy that

(i) $(N-n)hE[\theta^{-1}(r_{1N})Q'_N]^2 \leq \frac{h}{N-n} (h^{-1}a_N(1 + o(1)) + (N - n)o(h^{-1})) \to 0$.

(ii) $Q''_N$ is identically distributed as $Q_N$ and is asymptotically independent of $\hat{\sigma}^2_{ES,t_N}$.

Define

$$Q'_N = \frac{1}{N-n} \sum_{i=0}^{a_N} \{ Y_i^2 - E[Y_i^2 | r_{l_i}] \} C_h(r_{t_i} - r_{t_N}),$$

(A11)

and

$$Q''_N = Q_N - Q'_N,$$

where $a_N$ is a positive integer satisfying $a_N = o(N - n)$ and $a_N\Delta \to \infty$. Let $\vartheta_{N,\ell} = (Y_i^2 - m_i)C_h(r_{t_i} - r_{t_N})$, then by Fan & Zhang (2003)

$$\text{Var}[\theta^{-1}(r_{t_N})\vartheta_{N,1}] = h^{-1}(1 + o(1)) \text{ and } \sum_{\ell=1}^{N-n-2} |\text{Cov}(\vartheta_{N,1}, \vartheta_{N,\ell+1})| = o(h^{-1}),$$

(A12)

which yields the result in (i). This combined with (A10), (i) and (A11) leads to

$$\theta^{-1}(r_{1N}) \sqrt{(N-n)h} Q''_N \xrightarrow{D} N(0,1).$$

(A13)

Note that the stationarity conditions of Banon (1978) and the $G_2$ condition of Rosenblatt (1970) on the transition operator imply that the $\rho$-mixing coefficient $\rho(\ell)$ of $\{r_{t_i}\}$ decays exponentially, and the strong-mixing coefficient $\alpha(\ell) \leq \rho(\ell)$, it follows that

$$|E\exp\{i\xi(Q''_N + \hat{\sigma}^2_{ES,t_N})\} - E\exp\{i\xi(Q''_N)E\exp\{i\xi\hat{\sigma}^2_{ES,t_N}\})| \leq 32\alpha(s_N) \to 0,$$

(A14)
for any $\xi \in \mathbb{R}$. Using the theorem of Volkonskii & Rozanov (1959), one gets the asymptotic independence of $\hat{\sigma}_{ES,tN}^2$ and $Q'_N$.

By (i), $\sqrt{(N - n)h}Q'_N$ is asymptotically negligible. This together with Theorem IV lead to

$$d_1 \theta^{-1}(r_{tN}) \sqrt{(N - n)h}Q_N + d_2 V_2^{-1/2} \sqrt{n} \left[ \hat{\sigma}_{ES,tN}^2 - \sigma^2(r_{tN}) \right] \xrightarrow{D} N(0, d_1^2 + d_2^2),$$

for any $d_1, d_2 \in \mathbb{R}$, where $V_2 = \frac{e^x + 1}{e^x - 1} \sigma^4(r_{tN})$. Since $Q_N$ is a linear transform of $u$,

$$V^{-1/2} \left[ \frac{\sqrt{(N - n)h}u}{\sqrt{n} \left[ \hat{\sigma}_{ES,tN}^2 - \sigma^2(r_{tN}) \right]} \right] \xrightarrow{D} N(0, I_3),$$

where $V = \text{blockdiag}(V_1, V_2)$ with $V_1 = 2\sigma^4(r_{tN})p(r_{tN})S^*$, where $S^* = (\nu_{i+j-2})_{i,j=1,2}$ with $\nu_j = \int u^j W^2(u)du$. This combined with AW gives the joint asymptotic normality of $t$ and $\hat{\sigma}_{ES,tN}^2$. Note that $b = o_p(1/\sqrt{(N - n)h})$, it follows that

$$\Sigma^{-1/2} \left( \frac{\sqrt{(N - n)h} \hat{\sigma}_{S,tN}^2 - \sigma^2(r_{tN})}{\sqrt{n} \left[ \hat{\sigma}_{ES,tN}^2 - \sigma^2(r_{tN}) \right]} \right) \xrightarrow{D} N(0, I_2),$$

where $\Sigma = \text{diag}(2\sigma^4(r_{tN})\nu_0/p(r_{tN}), V_2)$. Note that $\hat{\sigma}_{S,tN}^2$ and $\hat{\sigma}_{ES,tN}^2$ are asymptotically independent, it follows that the asymptotical normality of $\hat{\sigma}_{I,tN}^2$ holds.

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