

Inference and Intraday Analysis of Diversified World Stock Indices

by

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Certificate

I certify that the work in this thesis has not previously been submitted for a degree nor has it been submitted as part of the requirements for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research work and the preparation of the thesis itself has been acknowledged in the thesis. In addition I certify that all information sources and literature used are indicated in the thesis.

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Contents

Certificate	i
Acknowledgements	ii
List of Tables	vi
List of Figures	vii
Abstract	x
1 Introduction	1
2 Parameter Estimation	10
2.1 Background and Notation	10
2.2 Approximate Maximum Likelihood Estimation	12
2.2.1 Approximations through Simulation	13
2.2.2 Approximation using Solutions of the Kolmogorov Forward Equation	14
2.2.3 Approximation using Non-parametric Techniques	15
2.2.4 Bayesian Analysis	15
2.3 Contrast Functions	16
2.4 Estimating Functions	16
2.4.1 Martingale Estimating Functions	17
2.4.2 Simple Estimating Functions	19
2.4.3 Asymptotics of Estimating Functions	20

3	Estimation using Transform Functions	23
3.1	Transform Function for a Diffusion Process	23
3.2	Asymptotics	30
3.3	Affine Diffusions	35
3.4	Power Transform Functions	36
3.5	Example	40
4	A Continuous Benchmark Model	52
4.1	A Continuous Market	52
4.1.1	Model Setup	52
4.1.2	Primary Security Accounts	53
4.1.3	Portfolios and Strategies	55
4.2	Growth Optimal Portfolio	57
4.3	Approximate Growth Optimal Portfolios	58
4.4	Construction of Intraday World Stock Indices	61
4.5	Discounted Growth Optimal Portfolio	65
4.6	Normalised Growth Optimal Portfolio	67
4.6.1	Market Activity Time	69
4.7	Empirical Properties of the Growth Optimal Portfolio	71
5	Intraday Analysis of World Stock Indices	79
5.1	Empirical Properties of World Stock Indices	79
5.2	Market Activity of the WSIs	81
5.2.1	Empirical Behaviour of Market Activity	81
5.2.2	Model for Market Activity	85
5.2.3	Estimation of Drift Function	88
5.3	Normalised WSIs in Market Activity Time	90
6	Intraday Analysis of the MCI in Different Denominations	94
6.1	Market Activity of the MCI	94
6.1.1	The MCI in Different Denominations	94

6.1.2	Empirical Analysis of Market Activity	95
6.1.3	Parametric Drift Estimation	104
6.1.4	Non-parametric Drift Estimation	111
6.2	Co-movements of Normalised WSIs	112
6.3	Co-movements of Market Activity	116
7	Conclusion	123
A	Definitions	125
B	Stock Market Indices included in the World Stock Indices	127
	Bibliography	128

List of Tables

3.1	Statistics of estimators when $T = 20$	43
3.2	Statistics of estimators when $T = 10$	43
5.1	Estimates of market activity drift parameters.	90
5.2	Slope coefficients and R^2 values for the MCI	91
6.1	Table of R^2 values for market activity in twenty-one denominations	107
6.2	Estimates of market activity drift function for twenty-one denominations	110

List of Figures

1.1	Long term dynamics of the logarithm of a discounted accumulated world stock index.	5
1.2	Long term dynamics of a discounted normalised world stock index.	5
1.3	Long term dynamics of the volatility of the world stock index.	6
3.1	Simulated sample path of the affine diffusion	41
3.2	Estimates of the drift parameters $\hat{\vartheta}^1$ and $\hat{\vartheta}^2$	41
3.3	Estimates of the diffusion parameters $\hat{\vartheta}^3$ and $\hat{\vartheta}^4$	42
3.4	Gaussian quantile plot for $\hat{\vartheta}^1$	44
3.5	Gaussian quantile plot for $\hat{\vartheta}^2$	44
3.6	Gaussian quantile plot for $\hat{\vartheta}^3$	45
3.7	Gaussian quantile plot for $\hat{\vartheta}^4$	45
3.8	Simulated sample path of the affine diffusion when $T = 1,000$	46
3.9	Estimates of the drift parameters $\hat{\vartheta}^1$ and $\hat{\vartheta}^2$ when $T = 1,000$	47
3.10	Estimates of the diffusion parameters $\hat{\vartheta}^3$ and $\hat{\vartheta}^4$ when $T = 1,000$	47
3.11	Gaussian quantile plot for $\hat{\vartheta}^1$ when $T = 1,000$	47
3.12	Gaussian quantile plot for $\hat{\vartheta}^2$ when $T = 1,000$	48
3.13	Simulated sample path of the affine diffusion when $T = 1$	48
3.14	Estimates of the diffusion parameters $\hat{\vartheta}^3$ and $\hat{\vartheta}^4$ when $T = 1$	50
3.15	Simulated sample path of the affine diffusion when $T = 1,000$	50
3.16	Estimates of the drift parameters $\hat{\vartheta}^1$ and $\hat{\vartheta}^2$ when $T = 1,000$	51
4.1	Primary asset and primary security account	53
4.2	Market capitalisation proportions	63

4.3	World stock indices	64
4.4	Volatility process of the MCI for several weeks in April/May 1996.	67
4.5	Quadratic variation of the square root of the discounted MCI	68
4.6	Gaussian quantile plot for hourly log-returns of the MCI.	73
4.7	Gaussian quantile plot for daily log-returns of the MCI.	73
4.8	Gaussian quantile plot for weekly log-returns of the MCI.	74
4.9	Sample autocorrelation function for hourly absolute returns of the MCI.	75
4.10	Sample autocorrelation function for daily absolute returns of the MCI.	75
5.1	Normalised world stock indices	80
5.2	Comparison of hourly absolute returns for the normalised MCI.	81
5.3	The market activity time for the MCI.	82
5.4	Sample autocorrelation function of the normalised MCI.	82
5.5	Logarithm of market activity for the MCI.	83
5.6	Quadratic variation of the logarithm of market activity.	83
5.7	Covariation of market activity and normalised MCI	84
5.8	Expected market activity	86
5.9	Activity volatility of the MCI	87
5.10	Quadratic variation of the logarithm of market activity in activity volatility time.	88
5.11	Histogram and estimated probability density function.	89
5.12	Normalised MCI in market activity time.	91
5.13	Sample autocorrelation function of the normalised MCI in market activity time.	92
6.1	Twenty-one currency denominations of the MCI	96
6.2	Covariation of the normalised MCI in twenty-one denominations	99
6.3	Dimensions of the normalised WSI as a function of time.	101
6.4	Market activity for twenty-one denominations of the MCI	102

6.5	Quadratic variation of market activity in twenty-one denominations	103
6.6	Expected market activity for twenty-one denominations	105
6.7	Activity volatility for twenty-one denominations	106
6.8	Estimated probability density for different denominations	109
6.9	Non-parametric drift function estimates.	113
6.10	Empirical covariation processes of the normalised WSIs.	115
6.11	Covariation coefficients for the square root of the normalised MCI.	117
6.12	Dendogram for the square root of the normalised WSIs	117
6.13	Empirical covariation for logarithmic market activity.	119
6.14	Empirical covariation for two weeks of logarithmic market activity.	120
6.15	Covariation coefficients for the logarithmic market activity.	121
6.16	Dendogram for logarithmic market activity.	122

Abstract

The benchmark framework provides an alternative paradigm for financial market modelling. Firstly, approaches to parameter estimation of discretely observed diffusion processes are examined, with particular emphasis on estimating function techniques. A new estimating function technique, called the transform function method, is introduced and applied to a class of stochastic differential equations. The advantage of the transform function method is that explicit information is not required about conditional moments and the existence of stationary transition densities. Despite the flexibility of the transform function technique, it suffers the same drawbacks as existing estimation methods with respect to drift estimation of financial data. The observation period required to estimate the drift function is much greater than what is available in financial markets. Notwithstanding the lack of available data for drift estimation, the diffusion function can be reliably estimated by the transform function method from short periods of frequently observed data. This thesis highlights that the benchmark approach of Platen (2002), where only estimates for diffusion coefficients are required, resolves the issue of drift estimation from financial market data.

Secondly, we extend the benchmark approach to incorporate modelling aspects particular to intraday data. This requires the construction of high-frequency diversified portfolios to approximate the growth optimal portfolio, the central building block of the benchmark model. Three different high-frequency indices are considered and it is demonstrated that an index with proportions based on total world market capitalisation provides the best proxy for the growth optimal portfolio. The benchmark model is then extended to intraday data through the introduction of a market activity process. This process is shown to be readily observable and as such, properties of market activity can be characterised. The analysis includes the consideration of the high-frequency indices in US Dollars and a further twenty currency denominations. As such, we reveal the pairwise co-

variation structures between the currency denominations considered. It is shown that the intraday benchmark model, which has market activity as the main parameter of interest, provides a largely accurate intraday description of financial markets.