

Index

- adjusted R^2 110–11, 114, 116
adjustment parameters 352
arbitrage 239–40, 336, 480–2
Asian options 566
autocorrelation 139–60, 193, 454
 coefficients 209–11, 215, 222–3, 234–5
 in cross-sectional data 160
 function (acf) 209, 212, 218–29
 in volatility 388
autocovariances 208–9, 212–14, 218, 220–2
autoregressive conditional heteroscedasticity
 (ARCH) models 386–437
autoregressive conditional duration (ACD) 604
autoregressive distributed lag (ADL) models 153
autoregressive integrated moving average
 (ARIMA) models 206–7, 233, 256
autoregressive moving average (ARMA) models
 223–56
autoregressive (AR) model 215–22
autoregressive volatility (ARV) models 385–6,
 573–7

balanced panel 490, 504–5
BDS test 382, 573, 575
BEKK model 435, 439–40
BHHH algorithm 398, 402
backshift operator, *see* lag operator
banking competition 272, 494
Bayes theorem 599
Bera–Jarque test 161, 163, 172
best linear unbiased estimators (BLUE) 44, 135, 149
between estimator 492

biased estimator 47
bicorrelation test 381–2, 573
bid–ask spread 279–85, 527
bispectrum test 382
bivariate regression 40, 88, 90, 92, 395, 445
block significance tests 296–7
bootstrapping 553–7, 571–82
Box–Jenkins approach 230
Box–Pierce Q -statistic 209–10
Breusch–Godfrey test 148–9, 158–9

calendar effects 454, 457, 461
capital asset pricing model (CAPM) 34–5, 63, 68,
 70–1, 77–81, 182, 429, 436, 504
causality tests 297–8, 307, 311, 313
censored dependent variable 533–6, 539
central limit theorem 164, 608
chaos theory 599–600
characteristic equation 216–17, 223, 233, 237, 322,
 614–15
chi-squared distribution 149, 419
Chow test 180–9, 491, 496n
classical linear regression model (CLRM) 58, 129,
 191
CLRM assumptions 23, 58, 173, 244, 277
 violations of 130
Cochrane–Orcutt procedure 150–2
coefficient estimators 33, 81, 117, 179
 standard errors of 46–51
cointegrating regressions 337–43
 Durbin–Watson (CRDW) statistic 340
cointegrating vector 341–2, 351–75

- cointegration 335–75
 - tests 342, 356, 358, 368, 370
- commodity prices 256, 437
- common factor restrictions 152
- conditional covariance 429, 433–4, 437–9
- conditional expectations 247–8
- conditional skewness 606
- conditional kurtosis 606
- conditional variance 387–444
- conditional variance-in-mean 436
- confirmatory data analysis 331
- consistency 45
- constant term 36, 74, 89–90, 115, 131–2
- contemporaneous terms 291, 295–6
- continuously compounded returns 7–9, 40
- convergence criterion 398, 540, 580
- copulas 603
- correlation 28, 40
 - implied 429
 - positive definite matrix 434–5
- correlation coefficient 28, 107
- correlogram, *see* autocorrelation function
- cost of carry model 43, 337, 343–8
- covariance stationary process, *see* weakly stationary process
- covered interest parity (CIP) 239–40
- credit rating 194–202, 521, 527–33
- critical values 55–69, 96–8, 135, 147, 328–9
- cross-equation restrictions 293
- cross-sectional regression 197, 488, 490, 504
- cross-sectional variability 493, 499
- cumulative normal distribution 517, 525
- CUSUM and CUSUMSQ tests 187–91
- daily range estimators 386
- daily volatility estimate 386, 424–5, 574
- damped sine wave 229
- data
 - cross-sectional 3–6, 113, 160
 - macroeconomic 2–3
 - panel 3–5, 487–509
 - qualitative/quantitative 7
 - time series 3–8
 - transformed 136–8
- data frequencies 3, 455–7
- data generating process (DGP) 37–8
- data mining 104–6, 194, 554
- data revisions 2
- data snooping, *see* data mining
- day-of-the-week effect 454, 457, 460–1
- degrees of freedom 54–61, 66, 130–1
- degrees of persistence 437, 573
- degree of uncertainty 46, 195
- dependent/independent variable
 - inertia of 154
- deterministic trend 324–5, 327
- Dickey–Fuller (DF) test 327–34, 559–63
 - augmented (ADF) 329–32
 - critical values 328, 623
- differencing 292–3, 322, 326–7, 492, 602
- differentiation 609–10
- discrete choice, *see* multiple choice
- distributed lag models 153
- disturbance term 30, 37, 44, 47
- double logarithmic form 39
- dummy variables 113–15, 165–70, 181–4, 453–65
 - dummy variable trap 456, 491
- Durbin–Watson test 143–8
- dynamic models 153–6
- econometric model
 - construction 9
 - evaluation 10
- efficient estimator 33, 46
- efficient market hypothesis 71, 326, 350, 454
- eigenvalues 121–5, 350–1, 364, 614–15
- eigenvectors 351, 354, 614
- elasticities 39, 494, 497
- empirical research project
 - choice of software 593
 - choice of topic 586–8
 - data for 591–3
 - forms of 587
 - originality 587–8
 - outline 593–7
 - purpose 585–6

- results 596
structure 593–7
encompassing principle 192
encompassing regressions 116–17, 192, 424–5
Engle–Granger test 341, 357, 365
Engle–Ng test 408
equilibrium correction model, *see* error correction model
error correction model 337–75
error term 44, 47, 53
variance of 47
estimation techniques
full information maximum likelihood (FIML) 279
indirect least squares (ILS) 276
instrumental variable (IV) 276, 278
two-stage least squares (2SLS) 277–9, 282, 286
estimators 33, 39, 44
biased/unbiased 44–7, 135
standard error 46–9, 83–5, 119
EViews
ARCH effects 389–91
ARCH estimation 399–404
ARMA models 234–9
autocorrelation function 234–5
BDS test 382
Bera–Jarque test 163–4
Breusch–Godfrey test 158–9
CAPM regression 77–81
Chow test 188–9
cointegration 365–75
date format 15
dummy variables 167–70, 188–9
dummy variables for seasonality 461–2
Durbin–Watson statistic 158
EGARCH model 406–8
exponential smoothing 258–60
forecasting 256–8
forecasting from GARCH 414–17
GJR model 406–8
GARCH estimation 399–403
GARCH-M estimation 410–11
Granger causality tests 311–12
hedge ratio estimation 437–41
heteroscedasticity testing 136–8
information criteria 238–9
Johansen test 368–75
Ljung–Box test 234–5
MGARCH estimation 441–4
multicollinearity 174
Newey–West procedure 152
RESET test 177–8
returns on shares 7–8
simultaneous equations models 285–9
transformation of series 18, 77–8
unit root test 331–5
VaR estimation using bootstrapping 579–82
VAR estimation 308–15
variance decomposition 313–15
Wald test 76–7
White’s test 136–8
exchange rate 239–41, 308, 336–7, 355–6, 466–8
exogeneity 266, 273–5, 311–12
expectations hypothesis 362–5
explained sum of squares (ESS) 108, 138
exponential growth model 175
exponential regression model 38–9, 138
exponential smoothing 241–3, 258–60
exponential weighting 242
exponentially weighted moving average (EWMA) models 384–5, 432
extreme value theory 603
- F*-test 93–8
factor loadings 120, 123–4
financial data 2–4, 380–3, 455
financial modelling 164, 487
 returns in 7
financial options 384, 412, 565, 605
fitted value 31–2, 38, 107–8, 132, 153, 175
fixed effects 490–8, 500, 506–9
forcing variable 207, 466
forecast accuracy 245, 256, 292, 347, 420, 425
forecast encompassing 424–5
forecast error 251–8, 300–1, 304

- forecasting
 autoregressive process 250–1
 ARMA models 248–9
 in-sample/out-of-sample 245–6
 moving average process 249–50, 253
 one-step-ahead/multi-step-ahead 245–6, 256–8
 structural 244
 time-series 244
- forward rate unbiasedness (FRU) 240
 fractionally integrated models 602
 functional form, misspecification of, *see* RESET test
- GJR model 405–7, 409–10, 420
 generalised autoregressive conditional heteroscedasticity (GARCH) models 392–444
 exponential (EGARCH) 406, 420–7, 573–8
 factor 434
 integrated (IGARCH) 394, 602
 in-mean (GARCH-M) 410–11, 421, 436
 orthogonal 434
 generalised error distribution (GED) 406
 general-to-specific methodology 191–4
 generalised least squares (GLS) 136, 150–1, 498–500
 generalised unrestricted model (GUM) 193
 gilt-equity yield ratio (GEYR) 469–73
 Goldfeld-Quandt test for heteroscedasticity 133
 goodness of fit 106–12
 Granger representation theorem 339
- Hamilton's filter 464
 Hausman test 273–4, 279, 500–2, 509
 Heckman procedure 530, 537
 hedge ratios 40–2, 430–1, 437–40
 hedonic pricing models 112–14
 heteroscedasticity 132–53
 conditional 396, 420
 historical covariance 431
 homoscedasticity 132, 135–7, 386
 hypothesis testing 52–67
 confidence interval 59–62
 error classification 64–5
 Lagrange multiplier (LM) test 130, 134–5, 158
- likelihood ratio (LR) test 293–4, 417, 419
 significance level 55–65, 74–5
 test of significance approach 56–63
 under maximum likelihood 417–19
 Wald test 417–19
- identification 230–2, 269–72, 292
 order condition 270–1
 rank condition 270–1
- implied covariance 431
 implied volatility models 384, 420–7
 impulse responses 298–301, 307, 312–14
 independence of irrelevant alternatives 524–5
 information criteria 232–3, 235–9, 294–5
 adjusted R^2 110–11, 233
 Akaike's (AIC) 232–3, 235–9, 294–5
 Hannan-Quinn (HQIC) 232–3, 235–9, 294–5
 Schwartz's Bayesian (SBIC) 232–3, 235–9, 294–5
 intercept 29, 33, 36, 90, 131–2
 interest rates 122–4
 term structure of 362–5
 invertibility 223–4
- Jensen's alpha 67–70
 Johansen test 350–6
 jumps 605
- KPSS test 331, 333, 335
 kurtosis 161, 163–5, 606
- lag lengths 152, 209, 216–17, 292–4, 304, 309
 lag operator 211–12, 216–17, 326–7
 lagged regressors 157
 lagged value 139–40, 154–7, 234, 242
 Lagrange multiplier (LM) test 130, 134–5, 417–18
 lags, number of 149, 157, 294–5, 329
 large sample property 45
 laws of logs 39, 608–9
 lead-lag relationships 343
 least squares dummy variables (LSDV) 491–4
 leptokurtosis 380, 399, 404, 603, 605
 leverage effects 380, 404–5, 408
 likelihood function 236, 395–9, 418, 435, 446
 likelihood ratio (LR) test 294, 417–19

- LIMDEP 12, 26
linear models 176, 178, 339, 452
linear probability model 512–13, 518–19, 522, 538
linearity 38–9
Ljung–Box test 210–11, 234–5
log-likelihood function (LLF) 394–8, 417–19, 446, 518–19
log-return formulation 8, 18
logit model 514–17, 519
 comparison with probit 518–19
 estimation of 544–5
 measuring goodness of fit 519–21
 parameter interpretation 519
long-memory models 601
long-run static solution 156–7
loss function, *see* residual sum of squares
Lyapunov exponent 600
- macroeconomic indicators 207
marginal distribution 603
marginal effects 519, 534, 542–3
market microstructure 154, 186, 272, 280, 452
market reaction 71, 200–2, 477
market returns 104, 303–4, 421, 429
market risk premium 34–5, 73, 454, 504
market timing 348–9
Markov switching regime 464–73
Marquardt algorithm 398, 402
matrices 611–14
 eigenvalues of 614–15
matrix notation 90–2, 118
maximum likelihood 231, 279, 395–8, 445–8
measurement error 2–3, 492n
minimum capital risk requirement (MCRR),
 see value-at-risk
misspecification error 156
misspecification tests 14, 130
misspecified dynamics 153
model construction 9, 233
model interpretation 9, 35–6, 39, 113
moving average process 211–15, 225, 249–50
multicollinearity
 near 120, 171–3
 perfect 171
multimodalities 397
multinomial logit 522–7
multinomial probit 522–7
multiple choice 522–5
multiple linear regression 88–91
multivariate GARCH models 429, 431–44
neural network models 600–1
Newey–West estimator 152–3
news impact curves 409–10
Newton–Raphson procedure 384, 421
non-linear least squares (NLS) procedure 475–6, 518
non-linear models 175, 380–2, 417
non-linear restrictions 417
non-negativity 389, 392–3, 404–6
non-nested models 115–16
non-normality 53, 163–4, 167, 193, 399
non-stationarity 318–33
 deterministic 322–5, 327
 random walk with drift 322, 324, 326, 478
 stochastic 322–3
 testing for 327–35
 trend-stationary process 321–3
 unit root 318–31
- observation frequencies 4, 8–9, 207, 455
observations
 daily closing 358
 number of 40, 69, 105
options price 280, 412, 570–1
order of integration 330, 335, 363
ordered response variable 527–8
 ordered logit 528
 ordered probit 528
ordinal scale 6
ordinary least squares (OLS)
 coefficient estimator 33, 36, 44–6, 83–5
 intercept 29, 33
 multiple regression 91
 slope 29, 33–4
 standard error estimator 46–50
 time series regression 67, 110, 113
out-of-sample 106, 245, 251, 253, 257

- outliers 164–8, 188, 193, 254
- overfitting 231, 393
- overreaction effect 71–4
- oversized tests 329

- p*-value, *see* hypothesis testing: significance level
- panel data analysis 5, 487–509
- parameters
 - estimations 30–9, 91
 - stability tests 180–90
- parsimonious encompassing 192
- parsimonious model 231, 394
- partial autocorrelation function (pacf) 222–30
- partial regression coefficient 89
- pecking order hypothesis 515–17, 525–6
- penalty term 116, 232, 236, 238, 370
- period effects, *see* time fixed effects
- piecewise linear model 453, 462–3
- Phillips–Perron tests 330, 333
- pooled sample 174, 492, 508, 529
- population
 - coefficient 81, 345
 - disturbances 47, 134, 139
- population regression function (PRF) 37–8, 54
- population values 51, 105
- portfolios
 - forming 72
 - winner/loser 71–4
- portmanteau tests 381
- position risk requirement, *see* value-at-risk
- prediction, *see* forecasting
- predictive failure test 181–6, 189
- precision 6, 20, 46, 171, 230
- principal components analysis (PCA) 120–6, 172
- probabilities 465–7, 512–17, 523–4
- probability density function (pdf) 445, 607
- probability distribution 28, 46, 53, 266, 548
- probit model 517–18
 - comparison with logit 518
 - estimation of 518, 544–5
 - measuring goodness of fit 519–21
 - parameter interpretation 519
- property returns 302–8
- pseudo R² 521, 540

- pseudo-random numbers 558
- purchasing power parity (PPP) 337, 355–6, 466

- qualitative variables, *see* dummy variables
- Quandt likelihood ratio test 186–7
- quantile regression 603–4
- quasi-demeaned data, *see* random effects
- quasi-maximum likelihood (QML) 399, 402

- R² 106–12
- R-bar² 110–11
- random draws 549–58, 563–4, 572
- random effects 498–503, 505–9
- random number generation 557–8, 567
- random walk 217, 247, 254, 320, 324, 326–7
- ratings 194–202, 527–33
 - announcements 195, 200–2
- rational expectations 326
- random number re-usage 552–3
- reality check test 555
- recursive forecasting model 246
- recursive least squares 187
- redundant fixed effects test 506–8
- regime switching 451, 453, 464, 471, 476, 484
- regression analysis 27, 35, 56, 157, 549
- rejection region 56–62, 105, 147, 547
- relationship between variables 244, 338, 381, 608
- renormalisation 354
- re-sampling
 - from data 556, 581
 - from residuals 556
- RESET test 174–8, 193, 382
- residual diagnostics 231
- residual sum of squares (RSS) 33, 91, 107–8
- residual term 38
- restricted/unrestricted model 94, 193, 293, 354, 419
- restricted/unrestricted regressions 94–8, 102, 111
- restrictions, number of 94, 96–7, 112, 130, 135, 187
- risk management 434, 441, 571, 587, 602–5
- risk measurement 385, 546, 571
- risk premium 34–5, 73, 363, 410, 454, 504, 506
- risk-return relationship 37, 460

- riskless arbitrage opportunities 239–40, 344, 350, 460, 477, 481–2
rolling window 246
- sample 35–9
sample regression function (SRF) 38, 107
sample selection bias 530
sample size 45, 59, 65, 105
sampling error 105, 549–51, 567
scatter plot 19, 29, 31, 34–5
seasonality 156, 167, 259, 455–61
second moment models 605
seemingly unrelated regression (SUR) 489–90
self-selection bias, *see* sample selection bias
sensitive dependence on initial conditions (SDIC) 600
Sharpe ratio 472
shocks 299–301, 308, 318–21, 404–10
short-selling 482
shuffle diagnostic 554
significance level 55–65, 74–5, 106
sign predictions 255
sign and size bias tests 408–9
simple bivariate regression model 40, 88–92
simple returns 7–8, 40
simulation experiments 559
disadvantages 558–9
simulation methods
Monte Carlo 547–53, 558–60
simultaneous equations 267–79, 285, 291–2
size of test, *see* significance level
skewness 161, 163
slippage time 348–9
slope 29, 33–4, 36, 40, 42, 49, 52
small sample problems 99, 210, 331
software packages, (*see also* EViews)
LIMDEP 12, 26
RATS/WinRATS 12, 26
sovereign credit ratings 194–202, 530
sovereign yield spreads 198
spatial lag 160
specific-to-general modelling 191–2
spline techniques 462
spot/futures markets 40–3, 337, 343–50, 365
spot return forecasts 347–8
spurious regressions 319
squared daily returns 386, 424
squared residuals 32–3, 134, 136, 188, 389–91
stable distributions 603
standard deviations 18, 46, 55, 383, 399–402
standard errors 46–54, 58–9, 83–5, 92–4, 119
stationarity
difference 323
stochastic 322–3
testing for 216, 327–31
weak 208, 318
statistical decision rule 53
statistical inference 51, 53, 338, 435
stochastic regressors 148, 160
stochastic trend model 322–5
stochastic volatility (SV) model 385, 427–8, 432
stock index 343–9, 420, 437–8, 480–1
futures markets 344, 438, 480–1
log of 343–6, 365
stock return 4–5, 71, 74, 88, 102, 285–9, 420, 437
predictability 302
strictly stationary process 207–8
structural break 186–7, 240, 451, 466–7, 496, 547
structural change 185–6, 453
structural equations 267–71, 277–9, 286, 288, 480
structural models 206–7, 247, 256, 290–2
Student's *t* distribution 54–6, 61–6, 320, 323, 328
switching models 451–84
switching portfolio 472
- t*-test 59, 65, 67, 76, 96, 98, 418
t-ratio 65–70, 80, 99, 320
Theil's *U*-statistic 254, 257
threshold autoregressive (TAR) models 473–9, 482–3
self-exciting (SETAR) 474, 477–9, 482–3
smooth transition (STAR) 474
tick size 281–3, 463
limits 463
time fixed effects 493–4, 506
time series models 162, 206–7, 239, 247, 384, 391
univariate 206, 290–1
time series regressions 67, 110, 113, 160, 488, 504

- time-varying covariances 436–7
- time-varying stock market risk premiums 454
- tobit regression 534–7
- total sum of squares (TSS) 108, 111–12, 131, 521
- trading rules 347, 349, 421, 469, 472, 554–5
- trading strategies 255, 347–8, 429, 454, 482
- transaction costs 481–2
- transition probabilities 465
- truncated dependent variable 533, 535–6
- unbalanced panel 490
- unbiasedness 45, 240, 269, 276, 489n
- unconditional density model 577
- uncovered interest parity (UIP) 239–41
- uniform distribution 557
- unit root process 322, 327–8, 466–7
- unit roots, testing for 327–35
- unparameterised seasonality 156
- value-at-risk (VaR) 383, 571–6, 603–4
 - Monte Carlo approach 572
- variables
 - binary choice 539
 - dummy 113, 115, 165–70, 183–4, 455–65
 - exogenous 268, 270–1, 273, 298
 - explanatory 28, 30, 66, 88–90, 106
 - irrelevant 179, 193, 278
 - macroeconomic 100, 195, 200, 302
 - omission of 155, 178–9
 - ordering of 301
 - random 44, 47, 53, 96, 498
 - slope dummy 408, 458–60
 - state-determining 473, 482
- variance–covariance matrix 92–3, 119, 152, 293–5,
 - 399
 - conditional 432, 434, 438
- variance decompositions 298–301, 306–7, 313
- variance forecasts 394, 414, 416–17
- variance operator 430, 608
- variance reduction techniques 549–52
 - antithetic variate 549–51
 - control variates 551–2
 - quasi-random sequences 550
- VECH model 432–6, 442–4
 - diagonal 432, 434, 436, 444
- vector autoregressive (VAR) models 290–315
- vector autoregressive moving average (VARMA) models 290
- vector error correction model (VECM) 350–2, 373–4, 480
- vector moving average (VMA) model 299
- volatility
 - asymmetries in 404–9, 427, 439
 - clustering 380, 386, 394, 404
 - feedback hypothesis 404, 408
 - forecasting 383–5, 411, 420–6
 - historical 383–4, 427
 - implied 384, 420–7, 431, 567, 569, 571
 - response to shocks 404, 408, 440
- Wald test 130, 417–19
- weakly stationary process 208, 318
- weighted least squares (WLS) 136
- white noise process 209, 211–12, 247, 324–6
 - error term 223
- White's correction 152
- White's test 134–5, 137–8, 152
- within transformation 491–4, 500
- Wold's decomposition theorem 217–18, 220
- yield curves 303, 364, 375, 462
- Yule–Walker equations 218, 222