Contents

Preface xiii

Part I  Linear Models: Regression and ANOVA  1

1 The Linear Model  3
  1.1 Regression, Correlation, and Causality  3
  1.2 Ordinary and Generalized Least Squares  7
     1.2.1 Ordinary Least Squares Estimation  7
     1.2.2 Further Aspects of Regression and OLS  8
     1.2.3 Generalized Least Squares  12
  1.3 The Geometric Approach to Least Squares  17
     1.3.1 Projection  17
     1.3.2 Implementation  22
  1.4 Linear Parameter Restrictions  26
     1.4.1 Formulation and Estimation  27
     1.4.2 Estimability and Identifiability  30
     1.4.3 Moments and the Restricted GLS Estimator  32
     1.4.4 Testing With h = 0  34
     1.4.5 Testing With Nonzero h  37
     1.4.6 Examples  37
     1.4.7 Confidence Intervals  42
  1.5 Alternative Residual Calculation  47
  1.6 Further Topics  51
  1.7 Problems  56
  1.A Appendix: Derivation of the BLUS Residual Vector  60
  1.B Appendix: The Recursive Residuals  64
  1.C Appendix: Solutions  66

2 Fixed Effects ANOVA Models  77
  2.1 Introduction: Fixed, Random, and Mixed Effects Models  77
  2.2 Two Sample t-Tests for Differences in Means  78
  2.3 The Two Sample t-Test with Ignored Block Effects  84
4.3.1 OLS Estimator of $a$ 196
4.3.2 Likelihood Derivation I 196
4.3.3 Likelihood Derivation II 198
4.3.4 Likelihood Derivation III 198
4.3.5 Asymptotic Distribution 199
4.4 Forecasting 200
4.5 Small Sample Distribution of the OLS and ML Point Estimators 204
4.6 Alternative Point Estimators of $a$ 208
4.6.1 Use of the Jackknife for Bias Reduction 208
4.6.2 Use of the Bootstrap for Bias Reduction 209
4.6.3 Median-Unbiased Estimator 211
4.6.4 Mean-Bias Adjusted Estimator 211
4.6.5 Mode-Adjusted Estimator 212
4.6.6 Comparison 213
4.7 Confidence Intervals for $a$ 215
4.8 Problems 219

5 Regression Extensions: AR(1) Errors and Time-varying Parameters 223
5.1 The AR(1) Regression Model and the Likelihood 223
5.2 OLS Point and Interval Estimation of $a$ 225
5.3 Testing $a = 0$ in the ARX(1) Model 229
5.3.1 Use of Confidence Intervals 229
5.3.2 The Durbin–Watson Test 229
5.3.3 Other Tests for First-order Autocorrelation 231
5.3.4 Further Details on the Durbin–Watson Test 236
5.3.4.1 The Bounds Test, and Critique of Use of $p$-Values 236
5.3.4.2 Limiting Power as $a \to \pm 1$ 239
5.4 Bias-Adjusted Point Estimation 243
5.5 Unit Root Testing in the ARX(1) Model 246
5.5.1 Null is $a = 1$ 248
5.5.2 Null is $a < 1$ 256
5.6 Time-Varying Parameter Regression 259
5.6.1 Motivation and Introductory Remarks 260
5.6.2 The Hildreth–Houck Random Coefficient Model 261
5.6.3 The TVP Random Walk Model 269
5.6.3.1 Covariance Structure and Estimation 271
5.6.3.2 Testing for Parameter Constancy 274
5.6.4 Rosenberg Return to Normalcy Model 277

6 Autoregressive and Moving Average Processes 281
6.1 AR($p$) Processes 281
6.1.1 Stationarity and Unit Root Processes 282
6.1.2 Moments 284
6.1.3 Estimation 287
6.1.3.1 Without Mean Term 287
6.1.3.2 Starting Values 290
Contents

6.1.3.3 With Mean Term 292
6.1.3.4 Approximate Standard Errors 293
6.2 Moving Average Processes 294
6.2.1 MA(1) Process 294
6.2.2 MA(q) Processes 299
6.3 Problems 301
6.4 Appendix: Solutions 302

7 ARMA Processes 311
7.1 Basics of ARMA Models 311
7.1.1 The Model 311
7.1.2 Zero Pole Cancellation 312
7.1.3 Simulation 313
7.1.4 The ARIMA(p, d, q) Model 314
7.2 Infinite AR and MA Representations 315
7.3 Initial Parameter Estimation 317
7.3.1 Via the Infinite AR Representation 318
7.3.2 Via Infinite AR and Ordinary Least Squares 318
7.4 Likelihood-Based Estimation 322
7.4.1 Covariance Structure 322
7.4.2 Point Estimation 324
7.4.3 Interval Estimation 328
7.4.4 Model Mis-specification 330
7.5 Forecasting 331
7.5.1 AR(p) Model 331
7.5.2 MA(q) and ARMA(p, q) Models 335
7.5.3 ARIMA(p, d, q) Models 339
7.6 Bias-Adjusted Point Estimation: Extension to the ARMAX(1, q) model 339
7.7 Some ARIMAX Model Extensions 343
7.7.1 Stochastic Unit Root 344
7.7.2 Threshold Autoregressive Models 346
7.7.3 Fractionally Integrated ARMA (ARFIMA) 347
7.8 Problems 349
7.8 Appendix: Generalized Least Squares for ARMA Estimation 351
7.9 Appendix: Multivariate AR(p) Processes and Stationarity, and General Block Toeplitz Matrix Inversion 357

8 Correlograms 359
8.1 Theoretical and Sample Autocorrelation Function 359
8.1.1 Definitions 359
8.1.2 Marginal Distributions 365
8.1.3 Joint Distribution 371
8.1.3.1 Support 371
8.1.3.2 Asymptotic Distribution 372
8.1.3.3 Small-Sample Joint Distribution Approximation 375
8.1.4 Conditional Distribution Approximation 381
8.2 Theoretical and Sample Partial Autocorrelation Function 384
8.2.1 Partial Correlation 384
8.2.2 Partial Autocorrelation Function 389
8.2.2.1 TPACF: First Definition 389
8.2.2.2 TPACF: Second Definition 390
8.2.2.3 Sample Partial Autocorrelation Function 392
8.3 Problems 396
8.4 Appendix: Solutions 397

9 ARMA Model Identification 405
9.1 Introduction 405
9.2 Visual Correlogram Analysis 407
9.3 Significance Tests 412
9.4 Penalty Criteria 417
9.5 Use of the Conditional SACF for Sequential Testing 421
9.6 Use of the Singular Value Decomposition 436
9.7 Further Methods: Pattern Identification 439

Part III Modeling Financial Asset Returns 443

10 Univariate GARCH Modeling 445
10.1 Introduction 445
10.2 Gaussian GARCH and Estimation 450
10.2.1 Basic Properties 451
10.2.2 Integrated GARCH 452
10.2.3 Maximum Likelihood Estimation 453
10.2.4 Variance Targeting Estimator 459
10.3 Non-Gaussian ARMA-APARCH, QMLE, and Forecasting 459
10.3.1 Extending the Volatility, Distribution, and Mean Equations 459
10.3.2 Model Mis-specification and QMLE 464
10.3.3 Forecasting 467
10.4 Near-Instantaneous Estimation of NCT-APARCH(1,1) 468
10.5 \(S_{\alpha,\beta}\)-APARCH and Testing the IID Stable Hypothesis 473
10.6 Mixed Normal GARCH 477
10.6.1 Introduction 477
10.6.2 The MixN(k)-GARCH(r, s) Model 478
10.6.3 Parameter Estimation and Model Features 479
10.6.4 Time-Varying Weights 482
10.6.5 Markov Switching Extension 484
10.6.6 Multivariate Extensions 484

11 Risk Prediction and Portfolio Optimization 487
11.1 Value at Risk and Expected Shortfall Prediction 487
## Contents

11.2 MGARCH Constructs Via Univariate GARCH 493
11.2.1 Introduction 493
11.2.2 The Gaussian CCC and DCC Models 494
11.2.3 Morana Semi-Parametric DCC Model 497
11.2.4 The COMFORT Class 499
11.2.5 Copula Constructions 503
11.3 Introducing Portfolio Optimization 504
11.3.1 Some Trivial Accounting 504
11.3.2 Markowitz and DCC 510
11.3.3 Portfolio Optimization Using Simulation 513
11.3.4 The Univariate Collapsing Method 516
11.3.5 The ES Span 521

12 Multivariate \( t \) Distributions 525
12.1 Multivariate Student's \( t \) 525
12.2 Multivariate Noncentral Student's \( t \) 530
12.3 Jones Multivariate \( t \) Distribution 534
12.4 Shaw and Lee Multivariate \( t \) Distributions 538
12.5 The Meta-Elliptical \( t \) Distribution 540
12.5.1 The FaK Distribution 541
12.5.2 The AFaK Distribution 542
12.5.3 FaK and AFaK Estimation: Direct Likelihood Optimization 546
12.5.4 FaK and AFaK Estimation: Two-Step Estimation 548
12.5.5 Sums of Margins of the AFaK 555
12.6 MEST: Marginally Endowed Student's \( t \) 556
12.6.1 SMESTI Distribution 557
12.6.2 AMESTI Distribution 558
12.6.3 MESTI Estimation 561
12.6.4 AoN\(_m\)-MEST 564
12.6.5 MEST Distribution 573
12.7 Some Closing Remarks 574
12.7.1 ES of Convolution of AFaK Margins 575
12.7.2 Covariance Matrix for the FaK 581

13 Weighted Likelihood 587
13.1 Concept 587
13.2 Determination of Optimal Weighting 592
13.3 Density Forecasting and Backtest Overfitting 594
13.4 Portfolio Optimization Using (A)FaK 600

14 Multivariate Mixture Distributions 611
14.1 The Mix\(_k\)N\(_d\) Distribution 611
14.1.1 Density and Simulation 612
14.1.2 Motivation for Use of Mixtures 612
14.1.3 Quasi-Bayesian Estimation and Choice of Prior 614
### Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>14.1.4 Portfolio Distribution and Expected Shortfall</td>
<td>620</td>
</tr>
<tr>
<td>14.2 Model Diagnostics and Forecasting</td>
<td>623</td>
</tr>
<tr>
<td>14.2.1 Assessing Presence of a Mixture</td>
<td>623</td>
</tr>
<tr>
<td>14.2.2 Component Separation and Univariate Normality</td>
<td>625</td>
</tr>
<tr>
<td>14.2.3 Component Separation and Multivariate Normality</td>
<td>629</td>
</tr>
<tr>
<td>14.2.4 Mixed Normal Weighted Likelihood and Density Forecasting</td>
<td>631</td>
</tr>
<tr>
<td>14.2.5 Density Forecasting: Optimal Shrinkage</td>
<td>633</td>
</tr>
<tr>
<td>14.2.6 Moving Averages of $\lambda$</td>
<td>640</td>
</tr>
<tr>
<td>14.3 MCD for Robustness and Mix$_2 N_d$ Estimation</td>
<td>645</td>
</tr>
<tr>
<td>14.4 Some Thoughts on Model Assumptions and Estimation</td>
<td>647</td>
</tr>
<tr>
<td>14.5 The Multivariate Laplace and Mix$_k$ Lap$_d$ Distributions</td>
<td>649</td>
</tr>
<tr>
<td>14.5.1 The Multivariate Laplace and EM Algorithm</td>
<td>650</td>
</tr>
<tr>
<td>14.5.2 The Mix$_k$ Lap$_d$ and EM Algorithm</td>
<td>654</td>
</tr>
<tr>
<td>14.5.3 Estimation via MCD Split and Forecasting</td>
<td>658</td>
</tr>
<tr>
<td>14.5.4 Estimation of Parameter $b$</td>
<td>660</td>
</tr>
<tr>
<td>14.5.5 Portfolio Distribution and Expected Shortfall</td>
<td>662</td>
</tr>
<tr>
<td>14.5.6 Fast Evaluation of the Bessel Function</td>
<td>663</td>
</tr>
</tbody>
</table>

### Part IV Appendices

<table>
<thead>
<tr>
<th>Appendix A Distribution of Quadratic Forms</th>
<th>669</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.1 Distribution and Moments</td>
<td>669</td>
</tr>
<tr>
<td>A.1.1 Probability Density and Cumulative Distribution Functions</td>
<td>669</td>
</tr>
<tr>
<td>A.1.2 Positive Integer Moments</td>
<td>671</td>
</tr>
<tr>
<td>A.1.3 Moment Generating Functions</td>
<td>673</td>
</tr>
<tr>
<td>A.2 Basic Distributional Results</td>
<td>677</td>
</tr>
<tr>
<td>A.3 Ratios of Quadratic Forms in Normal Variables</td>
<td>679</td>
</tr>
<tr>
<td>A.3.1 Calculation of the CDF</td>
<td>680</td>
</tr>
<tr>
<td>A.3.2 Calculation of the PDF</td>
<td>681</td>
</tr>
<tr>
<td>A.3.2.1 Numeric Differentiation</td>
<td>682</td>
</tr>
<tr>
<td>A.3.2.2 Use of Geary's formula</td>
<td>682</td>
</tr>
<tr>
<td>A.3.2.3 Use of Pan's Formula</td>
<td>683</td>
</tr>
<tr>
<td>A.3.2.4 Saddlepoint Approximation</td>
<td>685</td>
</tr>
<tr>
<td>A.4 Problems</td>
<td>689</td>
</tr>
<tr>
<td>A.A Appendix: Solutions</td>
<td>690</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Appendix B Moments of Ratios of Quadratic Forms</th>
<th>695</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.1 For $X \sim N_p(0, \sigma^2 I)$ and $B = I$</td>
<td>695</td>
</tr>
<tr>
<td>B.2 For $X \sim N(0, \Sigma)$</td>
<td>708</td>
</tr>
<tr>
<td>B.3 For $X \sim N(\mu, I)$</td>
<td>713</td>
</tr>
<tr>
<td>B.4 For $X \sim N(\mu, \Sigma)$</td>
<td>720</td>
</tr>
<tr>
<td>B.5 Useful Matrix Algebra Results</td>
<td>725</td>
</tr>
<tr>
<td>B.6 Saddlepoint Equivalence Result</td>
<td>729</td>
</tr>
</tbody>
</table>
### Appendix C  Some Useful Multivariate Distribution Theory  733
C.1  Student’s t Characteristic Function  733
C.2  Sphericity and Ellipticity  739
   C.2.1  Introduction  739
   C.2.2  Sphericity  740
   C.2.3  Ellipticity  748
   C.2.4  Testing Ellipticity  768

### Appendix D  Introducing the SAS Programming Language  773
D.1  Introduction to SAS  774
   D.1.1  Background  774
   D.1.2  Working with SAS on a PC  775
   D.1.3  Introduction to the Data Step and the Program Data Vector  777
D.2  Basic Data Handling  783
   D.2.1  Method 1  784
   D.2.2  Method 2  785
   D.2.3  Method 3  786
   D.2.4  Creating Data Sets from Existing Data Sets  787
   D.2.5  Creating Data Sets from Procedure Output  788
D.3  Advanced Data Handling  790
   D.3.1  String Input and Missing Values  790
   D.3.2  Using set with first.var and last.var  791
   D.3.3  Reading in Text Files  795
   D.3.4  Skipping over Headers  796
   D.3.5  Variable and Value Labels  796
D.4  Generating Charts, Tables, and Graphs  797
   D.4.1  Simple Charting and Tables  798
   D.4.2  Date and Time Formats/Informats  801
   D.4.3  High Resolution Graphics  803
   D.4.3.1  The GPLOT Procedure  803
   D.4.3.2  The GCHART Procedure  805
   D.4.4  Linear Regression and Time-Series Analysis  806
D.5  The SAS Macro Processor  809
   D.5.1  Introduction  809
   D.5.2  Macro Variables  810
   D.5.3  Macro Programs  812
   D.5.4  A Useful Example  814
   D.5.4.1  Method 1  814
   D.5.4.2  Method 2  816
D.6  Problems  817
D.7  Appendix: Solutions  819

### Bibliography  825

### Index  875