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# **A new approach to volatility modeling: the factorial hidden Markov volatility model**

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# Abstract

A new model - the factorial hidden Markov volatility (FHMV) model - is proposed for financial returns and their latent variances. It is also applicable to model directly realized variances. Volatility is modeled as a product of three components: a Markov chain driving volatility persistence, an independent discrete process capable of generating jumps in the volatility, and a predictable (data-driven) process capturing the leverage effect. An economic interpretation is attached to each one of these components. Moreover, the Markov chain and jump components allow volatility to switch abruptly between thousands of states, and the transition matrix of the model is structured in such a way as to generate a high degree of volatility persistence. In-sample results on six financial time series highlight that the FHMV process compares favorably to state-of-the-art volatility models. A forecasting experiment shows that it also outperforms its competitors when predicting volatility over time horizons ranging from one to one hundred days.

Keywords: Volatility, Markov-switching, Persistence, Leverage effect.

JEL Classification: C22, C51, C58

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# 1 Introduction

Building on the seminal contribution of Goldfeld and Quandt (1973), Hamilton (1989) has popularized the use of regime-switching models in economics and finance. These models allow us to model sharp changes in the dynamics of economic or financial time series by introducing a finite-valued latent stochastic process that governs the evolution of the parameters of the time series model. In most applications this latent process is a Markov chain and, consequently, Markov-switching and hidden Markov models are sometimes used interchangeably with regime-switching models. In the past twenty-five years, the emphasis in the literature has been on models with a relatively low number of states — between two and four (e.g., Ang and Bekaert, 2002; Bauwens et al., 2014; Dai et al., 2007). On one hand, this choice is motivated by parsimony because the number of parameters in the transition matrix of the Markov chain increases quadratically with the number of states. On the other hand, it is generally easier to attach an economic interpretation to a low-dimensional state space (e.g., a Markov chain with two states can be used to represent bull and bear market regimes).

Rydén et al. (1998) showed that hidden Markov models can reproduce reasonably well most of the stylized facts of financial return series. However, they also argue that the model seems to be “doomed from the start” for replicating the high degree of persistence in volatility that is empirically observed. This is because, similarly to traditional stationary autoregressive moving-average models, regime-switching models based on a Markovian switching process have a short memory, that is, they can only generate an autocorrelation function that eventually decays exponentially. However, at finite lags the decay in this autocorrelation function can still potentially be quite slow. For instance, past research has shown that a time series generated with a short memory process contaminated by occasional breaks can exhibit statistical properties that are akin to those that would be obtained from a genuine long memory process (e.g., Diebold and Inoue, 2001; Granger and Hyung, 2004; Mikosch and Starica, 2004; Perron and Qu, 2010; Starica and Granger, 2005). This observation explains why several studies in financial econometrics consider models in which a low-dimensional regime-switching process is used as a way to govern time-variation in the parameters of an existing econometric model. An example of such a combination is the regime-switching generalized autoregressive conditional heteroskedasticity (GARCH) model (Gray, 1996;

Haas et al., 2004).

An alternative to these types of models is to consider regime-switching processes with a high-dimensional finite state space, such as the Markov switching multifractal (MSM) model proposed by Calvet and Fisher (2004). These authors demonstrate that this process has the ability to generate a high degree of volatility persistence and show that it outperforms GARCH, fractionally integrated GARCH, as well as regime-switching GARCH models, when modeling exchange rate volatility. Although these empirical results offer a motivation for considering pure regime-switching specifications with a large number of states, very few models of this type have since been proposed in the literature.

Building on the MSM approach, the objective of this article is to propose a new parsimonious regime-switching volatility model with a high-dimensional finite state space: the factorial hidden Markov volatility (FHMV) model. The volatility dynamics in this model originate from the product of three components: a high-dimensional Markov chain driving volatility persistence, a jump process capable of generating non-persistent changes in volatility, and a data-driven component capturing the leverage effect. The structure of the Markov chain component shares some similarities with the structure of the MSM model, because it is constructed by multiplying a large number of independent two-state Markov chains. However, the specific formulation that we adopt leads to four important differences. First, all of our two-state Markov chains are not constrained to take identical values as in the MSM model. As a consequence, the support of the volatility distribution in the FHMV model comprises thousands of points, whereas the MSM models implemented by Calvet and Fisher (2004) only allows the volatility process to switch between at most eleven different values. Second, the transition matrix of our Markov chain component is structured in such a way that the multiplicity of the second largest eigenvalue can be greater than one. This distinctive characteristic enables us to generate a high degree of volatility persistence, which translates into a very slow decay of the autocorrelation function at finite lags. A further novelty of our approach versus the MSM model is that we allow for non-persistent jumps and integrate a leverage effect. As a final advantage, the FHMV model is specified in such a way that only one estimation of the model is sufficient while several model estimations are required to select the optimal MSM process.

We perform an empirical analysis of fit and forecasting performance on return and realized

volatility data from the Standard and Poor’s 500 Index (S&P 500), the Nasdaq Composite Index (NASDAQ) and the USD/EUR exchange rate over the period 2000–2016. When modeling returns, the fit of the FHMV model is superior to the MSM model in terms of information criteria and can even surpass that of a regime-switching GARCH model with Student- $t$  innovations. When modeling realized variances, the FHMV model dominates multiplicative error models (MEM) (Engle, 2002) and heterogeneous autoregressive (HAR) processes (Corsi, 2009). Finally, the forecasting comparison reveals that at any horizon (up to 100 days), the root mean squared forecast errors (RMSFE) generated by the FHMV model with leverage effect are either significantly smaller or comparable in size to the smallest errors produced by the best competing model.

The paper is structured as follows. Section 2 introduces the FHMV model, exposes its statistical properties and relates it to the literature. Section 3 covers model estimation. Section 4 presents the results of the in-sample fit and out-of-sample forecasting performance. Section 5 concludes. An online supplementary appendix (SA) provides the proofs of the theoretical results contained in the paper and background information about the empirical results and Markov chain models.

## 2 Model definition and properties

The FHMV model is designed to fit a time series of financial returns, taking into account their time-varying volatility. It is also suitable to model directly a series of realized variances. Its central component is a discrete-time positive latent stochastic process denoted by  $\{V_t\}$ . This process corresponds to the latent variance of returns in the first case and to the expected value of the realized variance in the second case. Before defining this component in detail, we introduce the modeling framework that enables us to link it to either financial returns or realized variances.

## 2.1 Basic model framework

### 2.1.1 Returns

Let  $r_t$ ,  $t = 1, \dots, T$ , denoted by  $\{r_t\}$ , represent a time series of demeaned daily financial returns. As is typical in the financial econometrics literature, we model  $r_t$  as

$$r_t = \sqrt{V_t} \epsilon_t, \quad (1)$$

where  $\{\epsilon_t\}$  is an independent and identically distributed (i.i.d.) innovation process with mean 0 and variance 1, which is assumed to be independent of  $\{V_t\}$ .

### 2.1.2 Realized variances

Let  $\{RV_t\}$  represent a time series of daily realized variances, computed for instance as the sum of intraday squared returns. Because the realized variance is a positive process, we choose to model it with a multiplicative error structure (Engle, 2002) as

$$RV_t = V_t \eta_t, \quad (2)$$

where  $\{\eta_t\}$  is a positive i.i.d. innovation process with mean 1, which is assumed to be independent of  $\{V_t\}$ . As argued by Engle (2002), the main advantage of the multiplicative error structure is that the variable of interest is modeled without any transformation by a process that ensures its positivity. MEM have been shown to perform well on realized volatility data by Engle and Gallo (2006), Gallo and Otranto (2015) and Lanne (2006), among others.

**Remark 1.** The return model considered in Equation (1) implies a MEM for squared returns as  $r_t^2 = V_t \eta_t$ , where, in this specific context,  $\eta_t = \epsilon_t^2$ .

## 2.2 Latent variance model

We first define the latent variance process  $\{V_t\}$  without a leverage component as this allows us to study the main statistical properties of our model analytically. We model  $V_t$  as

$$V_t = \sigma^2 C_t M_t, \quad (3)$$

where  $\{C_t\}$  is a Markov chain with a discrete state space satisfying  $\mathbb{E}(C_t) = 1$ , and  $\{M_t\}$  is a sequence of i.i.d. discrete random variables assumed independent of  $\{C_t\}$  and to satisfy  $\mathbb{E}(M_t) = 1$ . As a consequence, the parameter  $\sigma^2$  denotes the unconditional expectation of the return variance process, that is,  $\mathbb{E}(V_t) = \sigma^2$ .

The economic interpretation that we attach to the model is one where volatility is impacted by the arrival of news in the financial market, with varying degrees of importance from day to day. The processes  $\{C_t\}$  and  $\{M_t\}$  are both used to capture the impacts of these news. The  $C_t$  component captures the effect of news whose effect persists over time, whereas  $M_t$  represents the impact of non-persistent news and can be interpreted as a jump component. These interpretations become more apparent in Sections 2.2.1 and 2.2.2, where we define  $C_t$  and  $M_t$ , respectively.

### 2.2.1 Structure and interpretation of $C_t$

The process  $\{C_t\}$  is constructed as a product of  $N$  independent two-state Markov chains, denoted by  $\{C_t^{(i)}\}$ ,  $i = 1, \dots, N$ :

$$C_t = c_0 \prod_{i=1}^N C_t^{(i)}, \quad (4)$$

where  $c_0 = 1/\mathbb{E}[\prod_{i=1}^N C_t^{(i)}]$  is a normalizing constant ensuring that  $\mathbb{E}(C_t) = 1$ . These Markov chains are assumed to share the same  $2 \times 2$  transition probability matrix (t.p.m.)

$$\mathbf{P} = \begin{pmatrix} p & 1-p \\ 1-p & p \end{pmatrix}, \quad (5)$$

where  $p \in (0, 1)$ . However, they do not share the same state space as we assume that  $C_t^{(i)} \in \{c_i, 1\}$ , where  $c_1 > 1$  and

$$\begin{aligned} c_i &= (1 - \theta_c) + \theta_c c_{i-1} \\ &= 1 + \theta_c^{i-1}(c_1 - 1), \quad \text{for } i = 2, \dots, N \text{ and } \theta_c \in [0, 1]. \end{aligned}$$

The normalizing constant in Equation (4) is thus obtained as  $c_0 = \left[ \prod_{i=1}^N (1 + \theta_c^{i-1}(c_1 - 1)/2) \right]^{-1}$ . Note that  $c_1 \geq c_2 \geq \dots \geq c_N \geq 1$ , which implies a hierarchical structure in the components of  $C_t$ . For instance, if we say that the component  $C_t^{(i)}$  is turned ON at time  $t$  when  $C_t^{(i)} = c_i$  and turned OFF when  $C_t^{(i)} = 1$ , then  $C_t^{(1)}$  and  $C_t^{(N)}$  have, respectively, the greatest and weakest impact on volatility when turned ON.

The two-state Markov chains  $\{C_t^{(i)}\}$ ,  $i = 1, \dots, N$ , are used to model the impact of news arriving in the financial market, so that when any one of these chains is turned ON, volatility increases proportionally to the news importance, measured by the value of  $c_i$ . The impact of news on volatility then persists for a number of time periods that follows a geometric distribution with parameter  $p$ ; in the applications reported in Section 4, the estimated value of  $p$  is very close to 1.

**Remark 2.** The  $C_t$  component consists of  $N$  two-state Markov chain components and can be expressed as  $\log C_t = \log c_0 + \sum_{i=1}^N \log C_t^{(i)}$ . Because a two-state Markov chain can be represented as an AR(1) process (see for instance Hamilton, 1994, chapter 22), the persistent volatility component can be viewed as the sum of  $N$  autoregressive components. Interestingly, the paper by Andersen and Bollerslev (1997) proposes to model log-volatility as an aggregation of AR(1) processes and argues that (asymptotically) this structure can induce long-run dependence. Moreover, each AR(1) process is interpreted as an information arrival flow process. Consequently, the persistent component of the volatility of the FHMV model can be seen as a discrete version of their model, which leads to a similar interpretation as well as to an analogous long-run dependence result. In Theorem 1 and Proposition 1, we show that it can also be effective at slowing down the decay of the autocorrelation function of  $\{V_t\}$ .

**Remark 3.** The persistent component is structured as a factorial hidden Markov (FHM) model as defined in Ghahramani and Jordan (1997). In fact, FHM processes include multiple hidden



Markov chains that evolve independently of each other and that are combined to produce the final state. Moreover, the factorial structure can be seen as a particular case of the hierarchical hidden Markov (HHM) structure proposed in Fine et al. (1998), which consists in layers of hidden Markov chains. It must be emphasized that both the HHM and FHM models can be formulated as a standard hidden Markov (HM) model. This follows from the fact that a combination of low dimensional Markov chains can be reproduced by a single high dimensional Markov chain. However, HHM and FHM models remain practical representations of a HM process because they allow us to consider a large number of states more parsimoniously. A more detailed discussion of HHM and FHM models in relation with the FHMV model is provided in the SA.

Following Remark 3, it can be seen that  $\{C_t\}$  corresponds to a Markov chain on a state space  $\mathcal{X}_C$  with  $2^N$  elements, generated by the Kronecker product of the state spaces of  $\{C_t^{(i)}\}$ ,  $i = 1, \dots, N$ , that is,  $\mathcal{X}_C = c_0 \cdot \{c_1, 1\} \otimes \{c_2, 1\} \otimes \dots \otimes \{c_N, 1\}$ . Its  $2^N \times 2^N$  t.p.m., denoted by  $\mathbf{P}_C$ , is simply

$$\mathbf{P}_C = \mathbf{P}^{\otimes N},$$

where  $\mathbf{P}^{\otimes N}$  is the  $N$ th Kronecker power of  $\mathbf{P}$  (the  $k$ th Kronecker power of  $\mathbf{P}$  is defined inductively for  $k \in \mathbb{N}$  by  $\mathbf{P}^{\otimes 1} = \mathbf{P}$  and  $\mathbf{P}^{\otimes k} = \mathbf{P} \otimes \mathbf{P}^{\otimes(k-1)}$ ,  $k = 2, 3, \dots$ ). Because we assume that  $p \in (0, 1)$ ,  $\mathbf{P}_C$  is a positive matrix (i.e., all elements of  $\mathbf{P}_C$  are positive), which implies that  $\{C_t\}$  is an ergodic Markov chain with a unique stationary distribution, which we denote by  $\boldsymbol{\pi}_C$ . Lemma 5 in the SA implies that  $\boldsymbol{\pi}_C = 2^{-N} \mathbf{1}_{2^N}$ , where  $\mathbf{1}_n$  is used to denote the  $n$ -dimensional column vector of ones, for  $n = 1, 2, \dots$

### 2.2.2 Structure and interpretation of $M_t$

The process  $\{M_t\}$  is defined to be a sequence of i.i.d. discrete random variables with probability mass function

$$\Pr(M_t = m_0 \cdot m_i) = \begin{cases} q(N-1)^{-1}, & \text{if } i = 1, \dots, N-1, \\ 1-q, & \text{if } i = N, \end{cases}$$

where  $q \in (0, 1)$ ,  $m_1 > 1$ ,

$$\begin{aligned} m_i &= (1 - \theta_m) + \theta_m m_{i-1} \\ &= 1 + \theta_m^{i-1} (m_1 - 1), \quad \text{for } i = 2, \dots, N - 1, \end{aligned}$$

and  $m_N = 1$ . We assume that  $\theta_m \in [0, 1]$ , which implies that  $m_1 \geq m_2 \geq \dots \geq m_N = 1$ , and use  $m_0$  as a normalizing constant to ensure  $\mathbb{E}(M_t) = 1$ , which leads to  $m_0 = \left[1 + q \frac{(m_1 - 1)(1 - \theta_m^{N-1})}{(N-1)(1 - \theta_m)}\right]^{-1}$ .

We interpret  $\{M_t\}$  as a process capturing the non-persistent impact on volatility of the arrival of news in the financial market. The parameter  $q$  corresponds to the probability of this type of news arriving in a given time period. This news has a multiplicative impact on volatility, given by one of the values  $m_1, m_2, \dots, m_{N-1}$ , chosen with equal probabilities (ON states), with  $m_1$  representing the greatest impact and  $m_{N-1}$  the weakest impact. The probability of no news arriving is  $1 - q$ , which is associated with  $m_N = 1$  (OFF state). In contrast to  $\{C_t\}$ , the impact of news generated by the  $\{M_t\}$  process does not persist over time since it is an independent process. Consequently, this component of the model serves to generate non-persistent jumps of different magnitudes on volatility.

For further developments, it is convenient to express  $\{M_t\}$  in the form of a Markov chain. To this end, let  $\boldsymbol{\pi}_M$  be the column vector of the  $N$  component probabilities

$$\boldsymbol{\pi}_M = \left( \underbrace{\frac{q}{N-1}, \dots, \frac{q}{N-1}}_{(N-1) \text{ terms}}, 1 - q \right)'. \quad (6)$$

Then,  $\{M_t\}$  can be expressed as a Markov chain with  $N \times N$  t.p.m.,  $\mathbf{P}_M = \mathbf{1}_N \boldsymbol{\pi}_M'$ , on the state space  $\mathcal{X}_M$  with  $N$  elements, where  $\mathcal{X}_M = m_0 \cdot \{m_1, m_2, \dots, m_N\}$ . Because  $q \in (0, 1)$ ,  $\mathbf{P}_M$  is a positive matrix and  $\{M_t\}$  is an ergodic Markov chain with stationary distribution  $\boldsymbol{\pi}_M$  (see Lemma 6 in the SA).

### 2.2.3 Markov chain structure of $V_t$

The latent return variance at time  $t$ ,  $V_t$ , is the product of  $C_t$  and  $M_t$ , as specified in Equation (3), hence it combines the effects on volatility of the arrival of persistent and non-persistent news in

the financial market. Since  $\{V_t\}$  is a product of two independent ergodic Markov chains, it is itself an ergodic Markov chain with  $(N \cdot 2^N) \times (N \cdot 2^N)$  t.p.m.,  $\mathbf{P}_V = \mathbf{P}_C \otimes \mathbf{P}_M$ , on the state space  $\mathcal{X}_V$  with  $N \cdot 2^N$  elements, where  $\mathcal{X}_V = \sigma^2 \cdot \mathcal{X}_C \otimes \mathcal{X}_M$ . Its stationary distribution is given by  $\boldsymbol{\pi}_V = \boldsymbol{\pi}_C \otimes \boldsymbol{\pi}_M$  (see Lemma 7 in the SA). Note that although  $\{V_t\}$  is potentially a high-dimensional Markov chain (e.g., for  $N = 10$ , the number of states is 10,240), it is parsimoniously indexed by only seven parameters, that is,  $\{\sigma^2, p, q, c_1, m_1, \theta_c, \theta_m\}$ .

## 2.2.4 Volatility persistence

It is a well-known empirical fact that the volatility of returns on financial assets exhibits a high degree of persistence (e.g., Mandelbrot, 1963; Bollerslev, 1986). In the FHMV model, volatility persistence can be characterized by the speed at which  $\text{Cov}(V_t, V_{t+k})$  approaches zero as  $k$  increases. Let  $\mathbf{v}$  denote the  $N \cdot 2^N$  column vector of the elements of  $\mathcal{X}_V$ , and let  $\boldsymbol{\Upsilon}$  denote the  $(N \cdot 2^N) \times (N \cdot 2^N)$  diagonal matrix with the elements of  $\mathbf{v}$  on its diagonal (i.e.,  $\mathbf{v} = \boldsymbol{\Upsilon} \mathbf{1}_{N \cdot 2^N}$ ). Then, based on standard Markov chain theory (see Hamilton, 1994, chapter 22), we have

$$\begin{aligned} \text{Cov}(V_t, V_{t+k}) &= \boldsymbol{\pi}'_V \boldsymbol{\Upsilon} \mathbf{P}_V^k \mathbf{v} - (\boldsymbol{\pi}'_V \mathbf{v})^2 \\ &= \boldsymbol{\pi}'_V \boldsymbol{\Upsilon} (\mathbf{P}_V^k - \mathbf{1}_{N \cdot 2^N} \boldsymbol{\pi}'_V) \mathbf{v}, \quad k = 1, 2, \dots, \end{aligned} \tag{7}$$

and  $\text{Cov}(V_t, V_{t+k}) \rightarrow 0$  as  $k \rightarrow \infty$ .

Clearly, the rate at which the volatility tends to persist in time is directly related to the rate of convergence of the matrix  $\mathbf{P}_V^k$  as  $k$  tends to infinity. It is well known that if  $\gamma$  denotes the second largest eigenvalue (in absolute value) of  $\mathbf{P}_V$ , then  $|\gamma|^k$  is the dominating term in its asymptotic rate of convergence (see Poskitt and Chung, 1996). This observation led Rydén et al. (1998) to affirm that hidden Markov models “can only produce series with exponentially decaying autocorrelation functions,” and that these models are therefore “doomed from the start” for replicating the high degree of persistence in volatility which is empirically observed. Although this affirmation holds asymptotically, Theorem 1 shows that the particular structure that we introduce to construct the Markov chain  $\{V_t\}$ , specifically the multiplication of  $N$  two-state Markov chains with identical t.p.m., offers a way to slow down the convergence of  $\mathbf{P}_V^k$  as  $k = 1, 2, \dots$

**Theorem 1** (Rate of convergence of  $\mathbf{P}_V$ ). *Let  $\gamma = 2p - 1$  and  $\mathbf{\Pi}_V = \lim_{k \rightarrow \infty} \mathbf{P}_V^k$ .*

(i) *Asymptotic limit of  $\mathbf{P}_V^k$  as  $k \rightarrow \infty$ :*

$$\mathbf{\Pi}_V = \mathbf{1}_{N \cdot 2^N} \boldsymbol{\pi}'_V.$$

(ii) *Nonasymptotic rate of convergence of  $\mathbf{P}_V^k$  as  $k = 1, 2, \dots$ :*

$$\|\mathbf{P}_V^k - \mathbf{\Pi}_V\|_\infty \leq (1 + |\gamma|^k)^N - 1, \quad (8)$$

where  $\|\cdot\|_\infty$  is the maximum absolute row sum norm and, for  $\gamma \in [0, 1)$ ,

$$\|\mathbf{P}_V^k - \mathbf{\Pi}_V\|_{\max} = \left( (1 + \gamma^k)^N - 1 \right) \|\boldsymbol{\pi}_V\|_\infty, \quad (9)$$

with  $\|\boldsymbol{\pi}_V\|_\infty = 2^{-N} \max\{q/(N-1), 1-q\}$ , where  $\|\cdot\|_{\max}$  is the max norm, that is, the maximum absolute element of the given matrix.

(iii) *Asymptotic rate of convergence of  $\mathbf{P}_V^k$  as  $k \rightarrow \infty$ :*

$$\mathbf{P}_V^k - \mathbf{\Pi}_V = O(k^{N-1} |\gamma|^k). \quad (10)$$

**Remark 4.** From a linear algebra standpoint,  $N$  corresponds to the algebraic multiplicity of the eigenvalue  $\gamma$  of the matrix  $\mathbf{P}_V$ , which is its largest eigenvalue (in absolute value) that is smaller than 1. Note that the  $2 \times 2$  matrix  $\mathbf{P}$  also has an eigenvalue of  $\gamma = 2p - 1$ , but its algebraic multiplicity is 1. Since  $N$  corresponds to the number of components used in the construction of  $\{C_t\}$ , the algebraic multiplicity of the eigenvalue  $\gamma$  of the matrix  $\mathbf{P}_V$  increases by one unit each time a component is added.

Theorem 1 shows that the number of latent components  $N$  impacts the rate of convergence of  $\mathbf{P}_V^k$  as  $k = 1, 2, \dots$ . For instance, if  $N = 1$ , we have  $\|\mathbf{P}_V^k - \mathbf{\Pi}_V\|_\infty \leq |\gamma|^k$  and  $\mathbf{P}_V^k - \mathbf{\Pi}_V = O(|\gamma|^k)$ . Equations (8)–(10) indicate that higher values of  $N$  generally lead to a slower decay of  $\mathbf{P}_V^k$  as  $k = 1, 2, \dots$ , and that the impact of a higher  $N$  is magnified the closer  $\gamma$  (or equivalently  $p$ ) is to 1 (in the non-asymptotic case).

## 2.3 Autocovariance structure and moments

Although the Markov chain process  $\{V_t\}$  exhibits a particular structure and has a high-dimensional state space, it nevertheless remains a time-homogeneous Markov chain on a finite state space. Consequently, the FHMV model for financial returns and realized variances presented in Sections 2.1 and 2.2 is included in the class of hidden Markov models. Accordingly, its autocovariance structure, its conditional and unconditional moments, as well as its log-likelihood function can all be computed in closed-form based on standard techniques.

### 2.3.1 Autocovariance structure

First, let us consider the autocovariance function of  $\{r_t^2\}$  and  $\{RV_t\}$ . Since  $r_t^2$  and  $RV_t$  share the same multiplicative error structure (see Remark 1), the derivation of this function for these two processes is treated at once in Proposition 1 by introducing a new variable  $x_t$  that represents either  $r_t^2$  or  $RV_t$ .

**Proposition 1** (Autocovariance structure). *Let  $x_t = V_t \eta_t$ , where  $V_t$  is defined by Equation (3) and  $\{\eta_t\}$  is a positive i.i.d. random process with mean 1 and finite variance, which is assumed independent of  $\{V_t\}$ , and let*

$$\phi_i = \left( \frac{c_i - 1}{c_i + 1} \right)^2 = \left( \frac{\theta_c^{i-1}(c_1 - 1)}{\theta_c^{i-1}(c_1 - 1) + 2} \right)^2 \in [0, 1], \quad i = 1, \dots, N.$$

For  $k = 1, 2, \dots$ , we have:

(i)

$$\text{Cov}(x_t, x_{t+k}) = \text{Cov}(V_t, V_{t+k}), \quad (11)$$

(ii)

$$\text{Cov}(x_t, x_{t+k}) = \sigma^4 \left( \prod_{i=1}^N (1 + \phi_i \gamma^k) - 1 \right), \quad (12)$$

(iii)

$$\text{Var}(x_t) = \sigma^4 \left( \mathbb{E}[\eta_t^2] m_0^2 \left( \prod_{i=1}^N (1 + \phi_i) \right) \left( \frac{q}{N-1} \sum_{i=1}^{N-1} m_i^2 + (1-q) \right) - 1 \right), \quad (13)$$

(iv)

$$\text{Corr}(x_t, x_{t+k}) = \frac{\prod_{i=1}^N (1 + \phi_i \gamma^k) - 1}{\mathbb{E}[\eta_t^2] m_0^2 \left( \prod_{i=1}^N (1 + \phi_i) \right) \left( \frac{q}{N-1} \sum_{i=1}^{N-1} m_i^2 + (1-q) \right) - 1},$$

where  $\gamma = 2p - 1$ ,  $p$  being the parameter of the t.p.m. defined in Equation (5).

**Remark 5.** Equation (11) indicates that the autocovariance function of  $\{r_t^2\}$  or  $\{RV_t\}$  decays at the same rate as that of  $\{V_t\}$ . Equation (7) implies that this decay is governed by the rate of convergence of the matrix  $\mathbf{P}_V^k$  as  $k$  tends to infinity, which itself slows down when the number of components  $N$  increases (see Theorem 1). The particular structure of the latent variance process therefore offers a way to capture varying degrees of persistence in the data, and this is an important motivation for this structure. In fact, as can be seen in the empirical applications of Section 4, the FHMV model very well mimics the autocorrelation structure of squared returns and realized variances.

To determine more explicitly how the number of components  $N$  impacts on the autocovariances, let us consider two FHMV models differing by only one latent component. If both models share the same parameters,  $\sigma^2$ ,  $p$  and  $c_i$ ,  $i = 1, \dots, N-1$ , then the autocovariances of the model with  $N-1$  components, denoted by  $\text{Cov}_{N-1}(x_t, x_{t+k})$ , are always smaller than or equal to the autocovariances of the model with one extra component, denoted by  $\text{Cov}_N(x_t, x_{t+k})$ , since we have

$$\begin{aligned} \text{Cov}_N(x_t, x_{t+k}) &= (1 + \phi_N \gamma^k) \sigma^4 \left( \prod_{i=1}^{N-1} (1 + \phi_i \gamma^k) - 1 \right) + \phi_N \gamma^k \sigma^4 \\ &= (1 + \phi_N \gamma^k) \text{Cov}_{N-1}(x_t, x_{t+k}) + \phi_N \gamma^k \sigma^4 \\ &\geq \text{Cov}_{N-1}(x_t, x_{t+k}). \end{aligned}$$

We remark that if the impact of the extra component on volatility is marginal, that is,  $c_N \approx 1$ , then  $\phi_N \approx 0$  and  $\text{Cov}_N(x_t, x_{t+k}) \approx \text{Cov}_{N-1}(x_t, x_{t+k})$ . Therefore, if more components than necessary are considered in the model, these superfluous components will not artificially inflate the dependence structure.

Another interesting feature of Proposition 1 follows from Equation (13) because it shows that the excess kurtosis typically observed in financial returns can be captured either by the latent components  $C_t$  and  $M_t$ , or by  $\mathbb{E}(\eta_t^2)$  (note that in the case of returns,  $\mathbb{E}(\eta_t^2)$  is the fourth moment of  $\epsilon_t$ ).

### 2.3.2 Moments

Of particular interest is the conditional moment forecast of  $x_{t+h}$ , for  $h = 1, 2, \dots$ , based on the available information up to time  $t$  (as in Section 2.3.1,  $x_t$  represents either  $r_t^2$  or  $\text{RV}_t$ ). To compute this forecast, one must first obtain the vector of filtered probabilities, denoted by  $\boldsymbol{\xi}_{t|t}$ , using standard filtering techniques developed for hidden Markov models (e.g., Hamilton, 1994, chapter 22). Let  $v_1, v_2, \dots, v_{N \cdot 2^N}$  denote the elements of  $\mathbf{v}$ , and let  $\boldsymbol{\xi}_{t+h|t}$  be the  $N \cdot 2^N$  column vector with elements

$$\xi_{i,t+h|t} = \Pr(V_{t+h} = v_i \mid x_t, x_{t-1}, \dots), \quad i = 1, \dots, N \cdot 2^N, \quad (14)$$

where  $h = 0, 1, \dots$ . These conditional forecast probabilities are directly obtained from the filtered probabilities since  $\boldsymbol{\xi}'_{t+h|t} = \boldsymbol{\xi}'_{t|t} \mathbf{P}_V^h$  for  $h = 1, 2, \dots$ . It is then simple to compute the conditional moment forecast,  $\mathbb{E}[g(x_{t+h}) \mid x_t, x_{t-1}, \dots]$ , for any real-valued function  $g(\cdot)$  from the following expression:

$$\mathbb{E}[g(x_{t+h}) \mid x_t, x_{t-1}, \dots] = \sum_{i=1}^{N \cdot 2^N} \xi_{i,t+h|t} \mathbb{E}[g(v_i \eta_{t+h})]. \quad (15)$$

When  $g(x) = x^r$ , Equation (15) simplifies to  $\mathbb{E}[x_{t+h}^r \mid x_t, x_{t-1}, \dots] = \mathbb{E}[\eta_{t+h}^r] \sum_{i=1}^{N \cdot 2^N} \xi_{i,t+h|t} v_i^r$ . Finally, to compute unconditional moments one must simply replace the probability vector  $\boldsymbol{\xi}_{t+h|t}$  by the stationary distribution  $\boldsymbol{\pi}_V$  (in fact,  $\boldsymbol{\xi}_{t+h|t} \rightarrow \boldsymbol{\pi}_V$  as  $h \rightarrow \infty$ ).

## 2.4 Relationship to the MSM model

Since the construction of the FHMV model is motivated by the success of the MSM approach of Calvet and Fisher (2004), it is instructive to relate it to the MSM model. The MSM process was initially proposed as a model for financial returns, and it thus admits the general form given in Equation (1). Its latent variance is specified as  $\tilde{V}_t = \tilde{\sigma}^2 \prod_{i=1}^N \tilde{C}_t^{(i)}$ , where for  $i = 1, \dots, N$ :

$$\tilde{C}_t^{(i)} = \begin{cases} \tilde{C}_{t-1}^{(i)}, & \text{with probability } \tilde{p}_i, \\ \tilde{c}, & \text{with probability } (1 - \tilde{p}_i)/2, \\ 2 - \tilde{c}, & \text{with probability } (1 - \tilde{p}_i)/2, \end{cases}$$

with  $\tilde{c} \in (0, 1)$ , and  $\tilde{p}_i = (1 - \tilde{a})^{\tilde{b}^{i-1}}$  for  $i = 1, \dots, N$ , where  $\tilde{a} \in (0, 1)$  and  $\tilde{b} \in (1, \infty)$ . Note that  $\mathbb{E}(\tilde{V}_t) = \tilde{\sigma}^2$ . The MSM model therefore includes four parameters,  $\{\tilde{\sigma}^2, \tilde{a}, \tilde{b}, \tilde{c}\}$ .

It is easily seen that  $\{\tilde{C}_t^{(i)}\}$ ,  $i = 1, \dots, N$ , are independent two-state Markov chains defined on a common state space comprised of the values  $\{\tilde{c}, 2 - \tilde{c}\}$ . Consequently,  $\tilde{V}_t$  can only take  $N + 1$  distinct values in the set  $\{\tilde{\sigma}^2 \tilde{c}^i (2 - \tilde{c})^{N-i}\}_{i=0}^N$ . This represents a first important difference with respect to the FHMV model. Moreover, in contrast to our approach, the Markov chains,  $\{\tilde{C}_t^{(i)}\}$ ,  $i = 1, \dots, N$ , do not all share the same t.p.m., which implies that the structure of the MSM model does not benefit from the results of Theorem 1 and Proposition 1. In fact, Proposition 2 shows that the asymptotic rate of convergence of the MSM transition matrix is geometric and is driven by the parameter  $\tilde{a}$ , which also corresponds to the second largest eigenvalue of  $\mathbf{P}_{MSM}$ . Moreover, the multiplicity of this eigenvalue is equal to one.

**Proposition 2** (MSM stationary distribution and rate of convergence of  $\mathbf{P}_{MSM}$ ).

(i) *MSM stationary distribution* :  $\boldsymbol{\pi}_{MSM} = 2^{-N} \mathbf{1}_{2^N}$ .

(ii) *Asymptotic limit of  $\mathbf{P}_{MSM}^k$  as  $k \rightarrow \infty$* :  $\boldsymbol{\Pi}_{MSM} = \lim_{k \rightarrow \infty} \mathbf{P}_{MSM}^k = \mathbf{1}_{2^N} \boldsymbol{\pi}'_{MSM}$ .

(iii) *Asymptotic rate of convergence of  $\mathbf{P}_{MSM}^k$  as  $k \rightarrow \infty$* :  $\mathbf{P}_{MSM}^k - \boldsymbol{\Pi}_{MSM} = O(\tilde{a}^k)$ .

Another model that is related to the MSM model is the component-driven regime-switching model of Fleming and Kirby (2013). Like the MSM model, it represents the latent variance by way of two-state Markov chains with identical state spaces, but it allows some of these Markov chains to share the same t.p.m. However, the models considered by Calvet and Fisher (2004) and Fleming and Kirby (2013) are in practice restricted to switch between at most eleven different values ( $N = 10$ ), while the FHMV model has the advantage to generate a much richer support of the volatility distribution comprising thousands of points.

## 2.5 Relationship to the stochastic volatility model

Because the FHMV process can be converted into a hidden Markov model with a large number of states (see Section 2.2.3), the underlying variance process can be formulated as a first-order vector autoregression (see for instance Hamilton, 1994, chapter 22). More precisely, if the random vector



$\mathbf{e}_t \in \mathbb{R}^{N \cdot 2^N}$  denotes a column vector with entry  $i$  equal to one if the Markov chain lies in state  $i$  at time  $t$  and zero in all other entries, then we can express the FHMV model as

$$r_t = \sqrt{V_t} \epsilon_t, \quad (16)$$

$$V_t = \mathbf{v}' \mathbf{e}_t, \quad (17)$$

$$\mathbf{e}_t = \mathbf{P}'_V \mathbf{e}_{t-1} + u_t, \quad (18)$$

where  $\mathbf{v}$  stands for the  $N \cdot 2^N$  column vector of elements of the state space of  $\{V_t\}$ ,  $\mathbf{P}_V$  is the transition matrix of  $\{V_t\}$ , and  $\{u_t\}$  is a discrete martingale difference sequence. The model formulation (16)–(18) shows explicitly that the FHMV process can be represented as an autoregressive stochastic volatility model with discrete dynamics. While standard stochastic volatility models assume that volatility dynamics are driven by a Gaussian innovation, the FHMV process uses a discrete transition kernel that can potentially allow for fatter tails than the normal distribution.

## 2.6 Leverage effect

An additional novelty of the FHMV model, that is not shared by the MSM process, is the inclusion of a time-varying leverage effect. The empirical analyses presented in Section 4 show that this component significantly enhances the in-sample fit and out-of-sample forecasting performance of the model on S&P 500 and NASDAQ data.

With a leverage effect, the latent variance specification introduced in Equation (3) is extended to include an additional component:

$$V_t = \sigma^2 C_t M_t L_t, \quad \text{where} \quad L_t = \prod_{i=1}^{N_L} L_t^{(i)},$$

and

$$L_t^{(i)} = \begin{cases} 1, & \text{if } r_{t-i} \geq 0, \\ 1 + l_i \frac{|r_{t-i}|}{\sqrt{L_{t-i}}}, & \text{if } r_{t-i} < 0, \end{cases}$$

for  $i = 1, \dots, N_L$ , with  $l_1 > 0$  and  $l_i = \theta_l^{i-1} l_1$  for  $i = 2, \dots, N_L$ , and  $\theta_l \in [0, 1]$ . The leverage component  $L_t$  adds two parameters,  $\{l_1, \theta_l\}$ , and is specified as a predictable process, that is, its

value at any given time index is fully determined by the observed returns up to the previous time step. This entails that the specific value of  $N_L$  has a negligible impact on the computational burden and it can thus be chosen to be very large in applications.

Moreover, the process  $\{L_t\}$  may be interpreted similarly to  $\{C_t\}$  and  $\{M_t\}$ . For instance, if we let the returns  $\{r_t\}$  represent a type of news, then we may say that the component  $L_t^{(i)}$  is turned ON if  $r_{t-i} < 0$  and turned OFF if  $r_{t-i} \geq 0$ . The impact of this component on volatility is then influenced by the importance of the news, which is a function of the magnitude of the negative return  $|r_{t-i}|$  and of a multiplicative factor  $l_i$  structured in such a way as to give less importance to more distant news.

### 3 Model estimation

Section 2.2.3 explained that the FHMV process can be recast into a hidden Markov model on the state space  $\mathcal{X}_V$  with  $N \cdot 2^N$  elements. Although the number of states grows quickly with the number of components  $N$ , the model can be estimated using the standard Hamilton filter, even when  $N = 10$ . This filter computes the predictive and filtering distributions of the state process as well as the conditional density of the observed process recursively for  $t = 1, \dots, T$  as follows:

$$\begin{aligned} \text{Predictive distribution: } p(V_t | \mathcal{F}_{t-1}, \Theta) &= \sum_{V_{t-1} \in \mathcal{X}_V} p(V_t | V_{t-1}, \mathcal{F}_{t-1}, \Theta) p(V_{t-1} | \mathcal{F}_{t-1}, \Theta), \\ \text{Observed density: } p(x_t | \mathcal{F}_{t-1}, \Theta) &= \sum_{V_t \in \mathcal{X}_V} p(x_t | V_t, \mathcal{F}_{t-1}, \Theta) p(V_t | \mathcal{F}_{t-1}, \Theta), \\ \text{Filtering distribution: } p(V_t | \mathcal{F}_t, \Theta) &= \frac{p(x_t | V_t, \mathcal{F}_{t-1}, \Theta) p(V_t | \mathcal{F}_{t-1}, \Theta)}{p(x_t | \mathcal{F}_{t-1}, \Theta)}, \end{aligned}$$

where  $\mathcal{F}_t$  denotes the observed market information up to time  $t$  and  $\Theta$  stands for the model parameters. The log-likelihood function is then obtained as  $\log p(x_1, \dots, x_T | \Theta) = \log p(x_1 | \Theta) + \sum_{t=2}^T \log p(x_t | \mathcal{F}_{t-1}, \Theta)$ . To initiate the Hamilton filter, an assumption on the state distribution at time  $t = 0$ ,  $p(V_0 | \Theta)$ , must be made; in our code, it is set to the stationary distribution of the Markov-chain. A MATLAB program to estimate the FHMV model is available in the supplementary material and on the corresponding author's website. In our applications, we estimated the FHMV model with  $N = 10$  and the time required to carry out maximum likelihood estimation

was below 30 minutes for a sample size of 4150 observations (Table 1 in the SA gives computing times required to evaluate the likelihood function as a function of  $N$ ). We remark that since the predictive distribution of the jump component is constant over time, it is not necessary to track the jump states in the Hamilton filter. This implies that in practice the filter only needs to iterate over 1,024 states instead of 10,240 states when  $N = 10$ . Therefore, the computational burden of the FHMV model is comparable to that of the MSM process (when  $N = 10$ , the MSM process corresponds to a hidden Markov model over 1,024 states).

In constructing the model, we assume that the number of components used as building blocks of  $\{M_t\}$  and  $\{C_t\}$  is the same and equal to  $N$ . Although nothing prevents us from considering different numbers of components in  $\{M_t\}$  and  $\{C_t\}$ , in our view it makes sense to specify  $N$  as large as possible in both of them up to computational constraints, because the effect of additional components on volatility, measured by the variables  $c_i$  and  $m_i$ , is structured to converge geometrically to one. Therefore, when  $N$  is large, the model has the ability to adjust itself, through the parameters  $c_1$ ,  $m_1$ ,  $\theta_c$  and  $\theta_m$ , and assign very little importance to superfluous components. Since the number of parameters does not increase with the number of components, we could also have pursued a strategy to find the optimal  $N$ . We decided not to consider such an approach because in our view, it is more practical to have only one model specification to estimate. In this respect, processes such as the MSM and GARCH( $p,q$ ) models may be considered at a disadvantage because they require a model selection procedure.

## 4 Applications to daily returns and realized variances

We compare the FHMV process to popular models on daily percentage log-returns and realized variances from the S&P 500, the NASDAQ and the USD/EUR exchange rate. Daily percentage log-returns span the period extending from January 3, 2000 to June 30, 2016 (source: Federal Reserve Economic Data (FRED) database). Realized kernel variances cover the same period, except for the USD/EUR exchange rate, for which the data is available until March 3, 2009 (source: Oxford-Man Institute of Quantitative Finance).

On each data set, we estimate the FHMV model with and without leverage based on  $N = 10$

(10,240 states) and  $N_L = 70$ . The innovation of the return process ( $\epsilon_t$ ) is assumed to follow a standard normal distribution, whereas the innovation of the realized variance process is assumed to follow a gamma distribution with mean 1 and shape parameter  $v > 0$ .

## 4.1 Comparison of fit

Table 2 presents estimation results for the percentage log-return data sets. The FHMV models with and without leverage (respectively, FHMV-lev and FHMV) are compared to five competitors: the MSM (Calvet and Fisher, 2004), the GARCH(1,1) (Bollerslev, 1986), the GJR-GARCH(1,1) (GJR) (Glosten et al., 1993), the two-state Markov-switching GARCH(1,1) (MS-GARCH) (Haas et al., 2004) and the two-state Markov-switching GJR-GARCH(1,1) (MS-GJR). GARCH-type models include a Student- $t$  innovation; this is indicated by adding “- $t$ ” to the model acronym. Model definitions are provided in the SA.

Table 1 – Comparison of fit: Percentage log-returns.

Models	Models without leverage				Models with leverage		
	MSM	GARCH- $t$	MS-GARCH- $t$	FHMV	GJR- $t$	MS-GJR- $t$	FHMV-lev
Np	4	4	9	7	5	11	9
<b>S&amp;P 500 (<math>T = 4150</math>)</b>							
log-lik	-5874.1	-5870.4	-5861.3	-5862.9	-5782.0	-5770.5	<b>-5770.1</b>
AIC	-5878.1	-5874.4	-5870.3	-5869.9	-5787.0	-5781.5	<b>-5779.1</b>
BIC	-5890.8	-5887.1	-5898.8	-5892.1	<b>-5802.8</b>	-5816.3	-5807.5
<b>NASDAQ (<math>T = 4149</math>)</b>							
log-lik	-7261.3	-7259.5	-7248.4	-7252.8	-7197.5	<b>-7175.5</b>	-7180.2
AIC	-7265.3	-7263.5	-7257.4	-7259.8	-7202.5	<b>-7186.5</b>	-7189.2
BIC	-7278.0	-7276.2	-7285.9	-7281.9	-7218.3	-7221.3	<b>-7217.7</b>
<b>USD/EUR (<math>T = 4147</math>)</b>							
log-lik	-3762.2	-3747.5	-3740.7	-3738.6	-3745.6	-3740.5	<b>-3737.7</b>
AIC	-3766.2	-3751.5	-3749.7	<b>-3745.6</b>	-3750.6	-3751.5	-3746.7
BIC	-3778.9	<b>-3764.2</b>	-3778.2	-3767.8	-3766.4	-3786.3	-3775.1

Np: Number of parameters; log-lik: Maximum of the log-likelihood; AIC: Akaike Information criterion; BIC: Bayesian information criterion; The highest values appear in bold.

From Table 1, we observe that, in accordance with the financial econometrics literature, the inclusion of a leverage effect strongly improves the fit to stock indices, but has little impact on the exchange rate data set. Overall, the fit of the FHMV (respectively, FHMV-lev) model is comparable to that of the MS-GARCH- $t$  (respectively, MS-GJR- $t$ ). Based on the AIC, the

FHMV-lev model is preferred for the S&P 500 data set, the MS-GJR- $t$  for the NASDAQ, and the FHMV for the USD/EUR. Based on the BIC, the FHMV-lev model preferred only for the NASDAQ. Moreover, although the MSM process has been originally proposed for exchange rate series, the FHMV model strongly outperforms it in terms of information criteria.

Table 2 presents estimation results for the realized variance data sets. The competing models are: the MEM (Engle, 2002), the two-state Markov-switching MEM (MS-MEM) (Gallo and Otranto, 2015) and the HAR (Corsi, 2009). These models are implemented with and without leverage; models with a leverage effect are indicated by adding “-lev” to the model acronym. Leverage in the MEM and MS-MEM models is introduced as in Gallo and Otranto (2015), whereas leverage in the HAR is adapted from Corsi and Renò (2012). Analogously to the FHMV model, all of the competing models include a gamma-distributed innovation with mean 1 and shape parameter  $v > 0$ . Model definitions are provided in the SA. Overall, we observe that estimation results strongly favor the FHMV-lev model for all data sets.

Table 2 – Comparison of fit: Realized variances.

Models Np	Models without leverage				Models with leverage			
	HAR 5	MEM 4	MS-MEM 9	FHMV 8	HAR-lev 8	MEM-lev 5	MS-MEM-lev 11	FHMV-lev 10
<b>S&amp;P 500 (<math>T = 4120</math>)</b>								
log-lik	-1473.2	-1465.0	-1234.0	-1148.4	-1336.0	-1366.4	-1120.7	<b>-956.9</b>
AIC	-1478.2	-1469.0	-1243.0	-1156.4	-1344.0	-1371.4	-1131.7	<b>-966.9</b>
BIC	-1494.0	-1481.7	-1271.5	-1181.7	-1369.3	-1387.2	-1166.5	<b>-998.5</b>
<b>NASDAQ (<math>T = 4124</math>)</b>								
log-lik	-1642.5	-1669.0	-1464.6	-1427.2	-1551.1	-1596.7	-1389.8	<b>-1225.5</b>
AIC	-1647.5	-1673.0	-1473.6	-1435.2	-1559.1	-1601.7	-1400.8	<b>-1235.5</b>
BIC	-1663.3	-1685.6	-1502.1	-1460.5	-1584.4	-1617.5	-1435.6	<b>-1267.2</b>
<b>USD/EUR (<math>T = 2328</math>)</b>								
log-lik	1174.3	1150.0	1266.7	1325.3	1180.4	1151.8	1269.5	<b>1335.5</b>
AIC	1169.3	1146.0	1257.7	1317.3	1172.4	1146.8	1258.5	<b>1325.5</b>
BIC	1155.0	1134.5	1231.8	1294.3	1149.3	1132.4	1226.8	<b>1296.7</b>

Np: Number of parameters; log-lik: Maximum of the log-likelihood; AIC: Akaike Information criterion; BIC: Bayesian information criterion; The highest values appear in bold.

## 4.2 Value-added of the jump and leverage components

Table 3 shows how the log-likelihood (evaluated at the MLE) and the BIC of the FHMV model increase when the jump component and the leverage effect are added. Overall, these two components improve the log-likelihood by a greater margin when the model is fitted to realized variances than to returns. This observation therefore partly explains why the model shows a greater out-performance for the realized variance data sets in the previous section.

As expected, the contribution of the leverage component is very strong for S&P 500 and NASDAQ data, and insignificant for the USD/EUR exchange rate according to the BIC. Moreover, we note that the contribution of the jump component is always significant when evaluated with respect to the BIC. We believe that this component turns out to be more important for the realized variance series because the conditional variance dynamics is more directly observed in that case, and abrupt changes are therefore easier to detect. In contrast, squared log-returns are a relatively noisy proxy of conditional variance and this fact renders the identification of sharp changes in volatility more difficult.

## 4.3 Analysis of the fit to S&P 500 data

### 4.3.1 Estimated parameters

Table 4 reports the parameter estimates for the FHMV-lev model fitted to S&P 500 returns and realized variances. For interpreting the values, remember that when a component  $C_t^{(i)}$  in the model is turned ON, it has a multiplicative impact of  $c_i$  on the variance  $V_t$ . The jump component on the other hand has an overall multiplicative effect of  $m_i m_0$ .

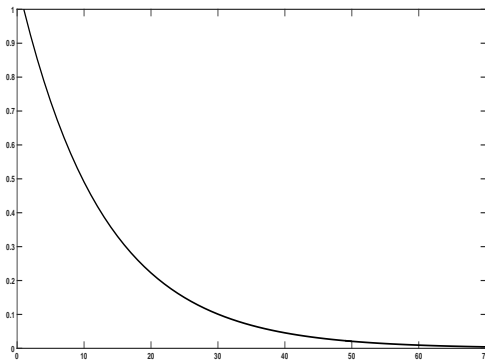
With respect to the model for returns, we observe that each component  $C_t^{(i)}$  persists for an average of two years (i.e.,  $1/(1-p)$  days) when turned ON, and that the strongest component can double the variance value. Moreover, jumps that increase the variance are approximately as frequent as those that decrease it (i.e.,  $\Pr(M_t > 1) = 0.53$ ). When looking at the model for realized variances, the impact of persistent news lasts on average for 100 days and jumps that increase the variance are relatively less frequent (i.e.,  $\Pr(M_t > 1) = 0.13$ ).

Figure 1 illustrates the leverage coefficients  $l_i$  for  $i = 1, \dots, 70$ . We observe that until around

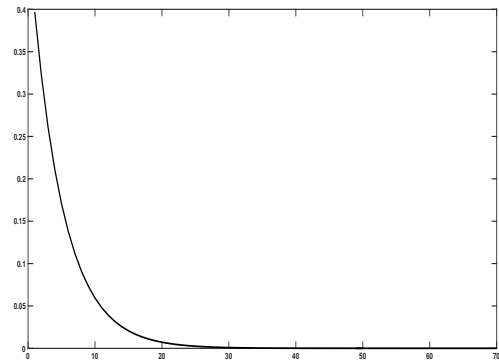
Table 3 – Contribution of the jump and leverage components in the FHMV model.

<b>Percentage log-returns</b>			
	S&P 500	NASDAQ	USD/EUR
FHMV w/o jump	-5890.6	-7279.2	-3762.5
<i>Increase in log-likelihood with respect to FHMV w/o jump</i>			
FHMV	28.6	26.5	24.3
FHMV-lev w/o jump	92.8	76.9	0.2
FHMV-lev	120.6	96.9	25.3
<i>Increase in BIC with respect to FHMV w/o jump</i>			
FHMV	20.3	18.2	16
FHMV-lev w/o jump	84.5	68.6	-8.1
FHMV-lev	103.9	80.2	8.6
<b>Realized variances</b>			
	S&P 500	NASDAQ	USD/EUR
FHMV w/o jump	-1209.8	-1459.8	1274.1
<i>Increase in log-likelihood with respect to FHMV w/o jump</i>			
FHMV	61.4	32.7	51.2
FHMV-lev w/o jump	146.0	182.9	5.3
FHMV-lev	252.9	230.3	61.4
<i>Increase in BIC with respect to FHMV w/o jump</i>			
FHMV	53.1	24.4	43.5
FHMV-lev w/o jump	137.7	174.6	-2.4
FHMV-lev	236.3	213.7	45.9

60 (respectively, 20), past negative returns are relevant to build the leverage component in the model for returns (respectively, realized variances). We can interpret this long-lasting impact as the time needed for the financial market to completely react to a negative return. .



(a) Percentage log-returns



(b) Realized kernel variances

Figure 1 – S&P 500 : Leverage coefficients  $l_i$  for  $i = 1, \dots, 70$  in the FHMV-lev model.

Table 4 – S&P 500: Maximum likelihood estimates of the FHMV model with leverage.

Percentage log-returns									
Constant component : $\sigma^2 = 0.22$									
Markov-chain component : $\theta_c = 0.51, c_1 = 1.99, p = 0.9986$									
$c_1$	$c_2$	$c_3$	$c_4$	$c_5$	$c_6$	$c_7$	$c_8$	$c_9$	$c_{10}$
1.99	1.50	1.26	1.13	1.07	1.03	1.02	1.01	1.00	1.00
Jump component : $\theta_m = 0.87, m_1 = 23.55, q = 0.93$									
$m_1m_0$	$m_2m_0$	$m_3m_0$	$m_4m_0$	$m_5m_0$	$m_6m_0$	$m_7m_0$	$m_8m_0$	$m_9m_0$	$m_{10}m_0$
1.69	1.48	1.31	1.15	1.02	0.90	0.79	0.70	0.62	0.07
Leverage component : $\theta_l = 0.92, l_1 = 1.00$									
Realized kernel variances									
Constant component : $\sigma^2 = 0.51$									
Markov-chain component : $\theta_c = 0.81, c_1 = 2.19, p = 0.9897$									
$c_1$	$c_2$	$c_3$	$c_4$	$c_5$	$c_6$	$c_7$	$c_8$	$c_9$	$c_{10}$
2.19	1.97	1.78	1.64	1.52	1.42	1.34	1.28	1.22	1.18
Jump component : $\theta_m = 0.75, m_1 = 3.45, q = 0.12$									
$m_1m_0$	$m_2m_0$	$m_3m_0$	$m_4m_0$	$m_5m_0$	$m_6m_0$	$m_7m_0$	$m_8m_0$	$m_9m_0$	$m_{10}m_0$
3.08	2.53	2.12	1.81	1.58	1.40	1.27	1.18	1.11	0.89
Leverage component : $\theta_l = 0.81, l_1 = 0.40$									

### 4.3.2 Autocorrelation structure

Figure 2 plots the empirical autocorrelations of the squared percentage log-returns and of the realized variances and the estimated theoretical ones implied by the FHMV-lev model. Note that the autocorrelations of the FHMV-lev model are computed by simulation. We observe a long-lasting volatility persistence that is reasonably well tracked by the model, especially for realized variances.

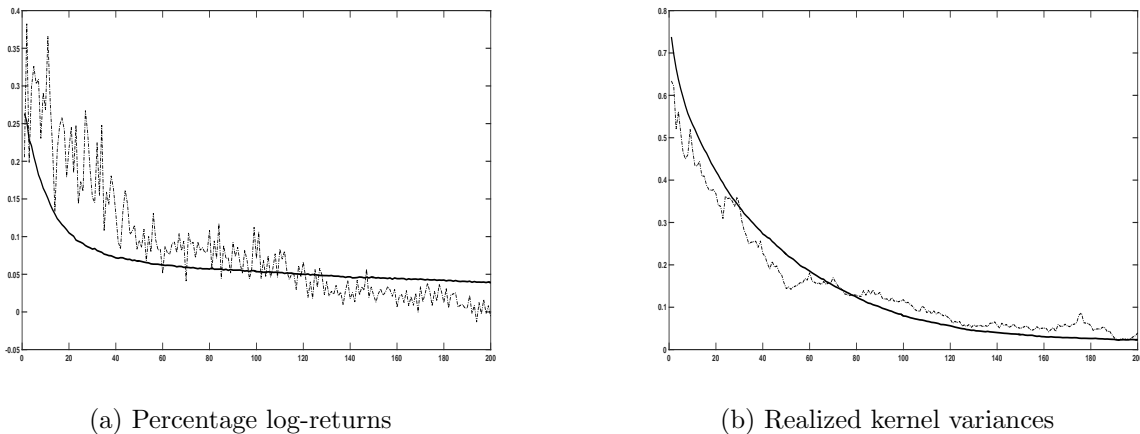


Figure 2 – S&P 500 : Theoretical autocorrelations implied by the FHMV-lev model (solid line) against empirical autocorrelations (dashed line).



### 4.3.3 Inference on $V_t$

The fact that the Markov chain and jump components in the FHMV model imply a discrete process for the latent volatility may raise some concerns about the flexibility of volatility dynamics in the model. Figure 3 illustrates the time series of the median of the distribution of the inferred conditional volatilities (i.e., the median of  $p(\sqrt{V_t} \mid \mathcal{F}_T)$ ) in the FHMV-lev models estimated on S&P 500 percentage log-returns and realized variances. We observe that the volatility in the FHMV-lev model resembles a continuous volatility model.

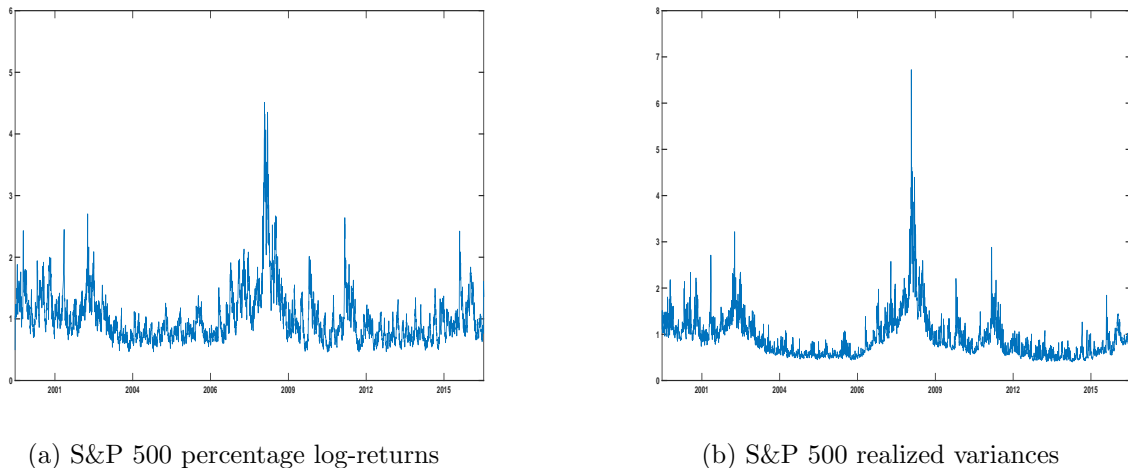
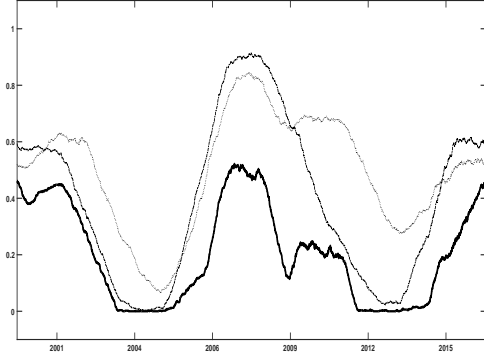


Figure 3 – S&P 500: The left (right) panel shows the inferred FHMV-lev conditional volatility for the percentage log-returns (realized variances).

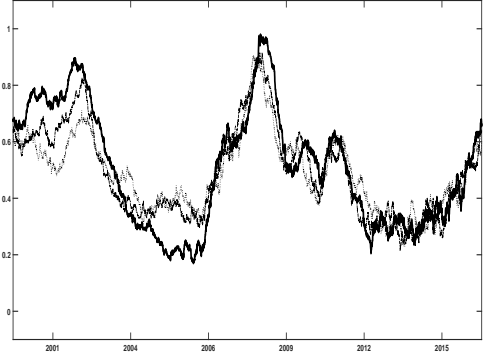
Figure 4 provides the smoothed probabilities over time of each one of the first three  $C_t^{(i)}$  components being turned ON (i.e.,  $\Pr(C_t^{(i)} = c_i \mid \mathcal{F}_T)$ ). We observe that the component having the strongest impact on volatility is likely to be active during the dot-com crisis as well as during the subprime mortgage crisis. It mimics a long-run volatility effect and could be interpreted as a bull and bear effect. We also see a similar pattern of the different probabilities, which could be accounted for.

### 4.3.4 Analysis of the leverage effect

Figure 5 shows the values taken by the leverage effect component  $L_t$  over time. We observe that its effect is very strong during the subprime mortgage crisis and to a lesser extent during the dot-com crisis.

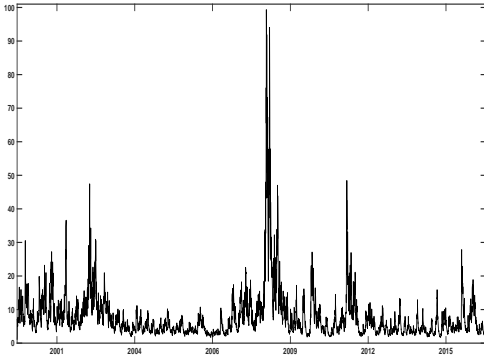


(a) Percentage log-returns

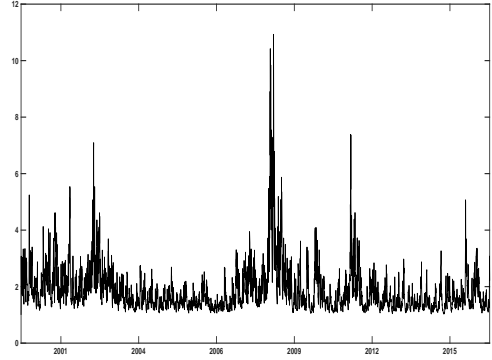


(b) Realized kernel variances

Figure 4 – S&P 500 : Smoothed probabilities of the three most influential  $C_t^{(i)}$  components. The component with the largest impact on volatility is displayed in black solid line. The dash-dotted line denotes the second component and the dotted line which is also the lightest one, corresponds to the third component.



(a) Percentage log-returns



(b) Realized kernel variances

Figure 5 – S&P 500 : Leverage effect component ( $L_t$ ) over time.

Since this component is specified in a non-traditional way, it can be questioned whether it really corresponds to the so-called leverage effect captured by standard volatility models, such as the GJR model. To investigate this issue, note first that, assuming standardized innovations, the GJR conditional variance process can be decomposed as follows:

$$\begin{aligned}
 \sigma_t^2 &= \omega + (\alpha + \delta \mathbf{1}_{\{r_{t-1} < 0\}}) r_{t-1}^2 + \beta \sigma_{t-1}^2, \\
 &= \omega \left( \sum_{i=0}^{t-1} \beta^i \right) + \alpha \left( \sum_{i=0}^{t-1} \beta^i r_{t-1-i}^2 \right) + \underbrace{\delta \left( \sum_{i=0}^{t-1} \beta^i \mathbf{1}_{\{r_{t-1-i} < 0\}} r_{t-1-i}^2 \right)}_{L_t^{GJR}} + \beta^t \sigma_0^2.
 \end{aligned} \tag{19}$$

The decomposition (19) isolates the contribution of the leverage component of the GJR model

to the variance dynamics; its effect at time  $t$  corresponds to  $L_t^{GJR} = \delta(\sum_{i=0}^{t-1} \beta^i \mathbf{1}_{\{r_{t-1-i} < 0\}} r_{t-1-i}^2)$ . Therefore, this component depends on several previous squared returns and the influence of the  $i$ th lagged squared return is scaled by the coefficient  $l_i^{GJR} = \delta\beta^{i-1}$ , which geometrically decays over time. Although there is a clear connection between  $L_t$  and  $L_t^{GJR}$ , as well as between  $l_i$  and  $l_i^{GJR}$ , the impacts of these components on volatility cannot be directly compared. This is due to the fact that the leverage component of the FHMV model is specified as a multiplicative component, whereas the impact of the GJR leverage component on volatility is additive. Nevertheless, the correlation coefficient between  $L_t$  and  $L_t^{GJR}$  is in fact equal to 0.92, which confirms that both components capture a similar effect.

#### 4.4 Forecasting performance

We carry out a forecasting exercise over the last three years (756 financial days) of the data sample periods in order to compare the predictions of the FHMV models and of some competitors on short- and long-run forecasting periods. Each time we move forward by one day in the in-sample period, the models are re-estimated, and cumulative variance forecasts,  $\sum_{i=1}^h \hat{V}_{t+i}$ , are computed for time horizons of  $h = 1, 5, 10, 25, 50, 75$  and 100. These forecasts are then compared to their associated observed values  $\sum_{i=1}^h x_{t+i}$ , where  $x_t$  denotes either the realized kernel variance or the squared percentage log-return. The comparison of forecasts is based on the (normalized) root mean squared forecast error (RMSFE) defined as

$$\text{RMSFE for horizon } h = \sqrt{\frac{1}{752 - h + 1} \sum_{t=0}^{752-h} \left( \frac{1}{h} \sum_{i=1}^h \hat{V}_{t+i} - \frac{1}{h} \sum_{i=1}^h x_{t+i} \right)^2}, \quad (20)$$

where  $t = 0$  represents the end of the in-sample period.

The FHMV-lev model needs return predictions to produce long-run realized variance forecasts. We assume that the percentage log-returns  $r_t \sim \text{i.i.d. } N(\hat{\mu}, \hat{\sigma}^2)$  where  $\hat{\mu}$  denotes the empirical mean and  $\hat{\sigma}^2$  the empirical variance over the last three years of our data sample period. The benefit of the leverage effect could be further improved by considering a bivariate model for returns and realized variances, an extension we leave to further research.

Table 5, for log-returns data, and Table 6, for realized variances, show the forecasting performance of all models for the three financial time series.

Table 5 – RMSFE computed over the last three years of the data sample period.

Horizon ( $h$ )		1	5	10	25	50	75	100
		<b>Percentage log-returns</b>						
		S&P 500						
Without leverage	<b>GARCH-t</b>	1.38	0.89	0.77	0.68	0.65	0.62	0.57
	MSM	1.38	0.89	0.77	0.68	0.64	0.61	0.56
	MS-GARCH-t	1.38	0.88	0.77	0.68	0.64	0.60	0.55
	FHMV	1.39	0.90	0.79	0.72	0.70	0.69	0.64
With leverage	<b>GJR-t</b>	1.33	0.85	0.77	0.71	0.67	0.63	0.56
	MS-GJR-t	1.35	0.84	0.73	0.59*	0.50**	0.45	0.40**
	FHMV-lev	<b>1.33</b>	<b>0.81</b>	<b>0.69</b>	<b>0.56*</b>	<b>0.48**</b>	<b>0.42**</b>	<b>0.37**</b>
		NASDAQ						
Without leverage	<b>GARCH-t</b>	2.05	1.23	1.08	0.95	0.91	0.87	0.76
	MSM	2.04	1.23	1.08	0.94	0.91	0.90	0.85
	MS-GARCH-t	2.06	1.28	1.16	1.12	1.20	1.26	1.25
	FHMV	2.06	1.26	1.11	1.01	1.00	1.00	0.91
With leverage	<b>GJR-t</b>	1.99	1.19	1.06	1.01	1.02	1.01	0.92
	MS-GJR-t	<b>1.96</b>	<b>1.13</b>	0.99*	0.87	0.77*	0.70**	0.64*
	FHMV-lev	2.00	1.14	<b>0.96</b>	<b>0.77**</b>	<b>0.65**</b>	<b>0.56**</b>	<b>0.47**</b>
		USD/EUR						
Without leverage	<b>GARCH-t</b>	0.66	0.30	0.22	0.16	0.14	0.14	0.16
	MSM	0.66	0.30	0.22	0.16	0.14	0.14	0.15
	MS-GARCH-t	0.66**	0.30**	0.21**	0.15**	0.12**	0.12**	0.13**
	FHMV	0.66**	0.30**	0.21**	0.15*	0.13**	0.13	0.14
With leverage	<b>GJR-t</b>	0.66	0.30	0.21	0.15	0.13	0.14	0.15
	MS-GJR-t	<b>0.66**</b>	<b>0.29*</b>	<b>0.21*</b>	<b>0.14**</b>	<b>0.11**</b>	<b>0.11**</b>	<b>0.12**</b>
	FHMV-lev	0.66	0.30	0.21	0.15	0.13	0.14	0.15

A star means that the squared forecasting error is significantly smaller than that of the benchmark process (GARCH- $t$  for models without leverage, GJR- $t$  for models with leverage effect) at the 10% level when using the DM test. A double star stands for 5% significance level. The smallest RMSFE appear in bold.

In Table 5, the performance of each model without leverage is compared according to the DM test of Diebold and Mariano (2002) with respect to the GARCH- $t$  model, while the models including a leverage effect are compared to the GJR- $t$  model. For the S&P 500 and NASDAQ, the FHMV-lev model produces smaller RMSFE than all the other models (with two exceptions for the NASDAQ, at forecast horizons 1 and 5 where GJR- $t$  and MS-GJR- $t$  are slightly better). The differences between the RMSFE of FHMV-lev and the other models increase noticeably with the forecast horizon. Its forecasting performance is found to be superior with respect to the GJR- $t$  at a 5% or 10% level at horizons higher than 10 days for the NASDAQ and for the S&P 500. This is also the case, though less spectacularly, for the MS-GJR- $t$  model.

For the USD/EUR log-returns, the FHMV model, at horizons smaller than 75 days, and the MS-GARCH- $t$  models, at all horizons, significantly outperforms the GARCH- $t$  at the 5 or 10% level.

Table 6 – RMSFE computed over the last three years of the data sample period.

Horizon ( $h$ )		1	5	10	25	50	75	100	
<b>Realized kernel variances</b>									
S&P 500									
Without leverage	{	HAR	0.82	0.61	0.56	0.53	0.55	0.56	0.55
		MEM	0.82	0.64	0.62	0.61	0.63	0.66	0.67
		MS-MEM	0.82	0.64	0.62	0.62	0.66	0.70	0.72
		FHMV	0.78	0.56	0.52	0.50	0.53	0.57	0.59
With leverage	{	HAR-lev	0.78	0.55	0.49	0.44	0.41	0.38	0.35
		MEM-lev	0.83	0.66	0.63	0.59	0.57	0.54	0.52
		MS-AMEM-lev	0.83	0.66	0.64	0.60	0.58	0.57	0.55
		FHMV-lev	<b>0.75</b>	<b>0.52</b>	<b>0.46</b>	<b>0.39</b>	<b>0.33*</b>	<b>0.28**</b>	<b>0.24</b>
NASDAQ									
Without leverage	{	HAR	0.61	0.49	0.47	0.46	0.51	0.54	0.54
		MEM	0.61	0.53	0.53	0.56	0.64	0.72	0.78
		MS-MEM	0.62	0.53	0.54	0.56	0.65	0.73	0.79
		FHMV	0.58	0.46	0.45	0.51	0.64	0.75	0.83
With leverage	{	HAR-lev	0.58	0.45	0.42	0.39	0.38	0.35	0.32
		MEM-lev	0.58	0.48	0.48	0.48	0.53	0.57	0.60
		MS-AMEM-lev	0.59	0.49	0.49	0.51	0.57	0.63	0.67
		FHMV-lev	<b>0.56</b>	<b>0.42</b>	<b>0.39</b>	<b>0.34*</b>	<b>0.31**</b>	<b>0.27</b>	<b>0.23**</b>
USD/EUR									
Without leverage	{	HAR	0.29	0.27	0.24	0.25	<b>0.30</b>	<b>0.34</b>	<b>0.36</b>
		MEM	0.30	0.27	0.25	0.27	0.30	0.34	0.37
		MS-MEM	0.30	0.27	0.25	0.27	0.32	0.36	0.38
		FHMV	0.31	0.27	0.25	0.28	0.33	0.37	0.39
With leverage	{	HAR-lev	<b>0.29</b>	<b>0.27</b>	<b>0.24</b>	<b>0.25</b>	0.30	0.34	0.37
		MEM-lev	0.31	0.28	0.25	0.27	0.30	0.34	0.37
		MS-AMEM-lev	0.31	0.28	0.25	0.27	0.32	0.36	0.38
		FHMV-lev	0.33	0.29	0.29	0.33	0.38	0.40	0.40

A star means that the squared forecasting error is significantly smaller than that of the benchmark process (HAR for models without leverage effect and HAR-lev for models with leverage effect) at the 10% level when using the DM test. A double star stands for 5% significance level. The smallest RMSFE appear in bold.

For realized variances (Table 6), the benchmark models are the HAR for models without leverage effect and HAR-lev for those including a leverage effect. Considering the S&P 500 and the NASDAQ, the FHMV-lev model produces smaller RMSFE than all the other models. The differences increase strongly with the forecast horizon and become significant at 5 or 10% according to the DM test for horizons 25, 50 and 100 for the NASDAQ and for horizons 50 and 75 for the S&P 500. For the USD/EUR, the HAR model (for horizons 50 to 100) and HAR-lev (for the smaller horizons) produce the smallest RMSFE, but no significant differences appear with respect to the other models.

## 5 Conclusion

We propose the factorial hidden Markov volatility (FHMV) model, a new volatility process that is suited for financial returns and realized variances. We specify the variance as a high dimensional Markov-chain that is decomposed into a product of three hidden components that can be economically interpreted. In particular, the jump process captures the reaction of the financial market to non-persistent news whereas the Markov chain component reflects news with a long-lasting impact. The last component controls for the leverage effect. The specification of the latter process differs from what is typically found in the literature. These three processes are parsimoniously and coherently specified and create a continuum of volatility states altogether. We derive the moments of the process and show that the autocovariance function can exhibit a slower decay than in traditional hidden Markov model thanks to the multiplicity of the second largest eigenvalue of the transition probability matrix. This property seems beneficial empirically as we show that the FHMV model dominates the MSM process on the studied exchange rate and competes favorably well with the GARCH- $t$ , the GJR- $t$ , the MS-GARCH- $t$  and the MS-GJR- $t$  processes in terms of in-sample criteria such as the AIC and BIC on three financial data sets. Moreover, the FHMV process also outperforms standard realized variances models (i.e., HAR, HAR-lev, MEM, MS-MEM, MEM-lev and MS-MEM-lev) according to these criteria on three realized kernel variance series. Regarding the predictive performance, the FHMV process competes very well with several alternatives in short forecasting horizons (less than 25 days). In middle to long-run horizons, it significantly improves over the other models especially when the leverage component is active.

We view this volatility modeling attempt with a high dimensional hidden Markov chain as very promising since many extensions can be entertained. We could for instance add a fourth component to take into account the trading volume or we could introduce correlated components since the diverse news seem to be related. Additionally, a multivariate extension in the spirit of Calvet et al. (2006) could be undertaken.

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