Global COE Hi-Stat Discussion Paper Series  195

Research Unit for Statistical and Empirical Analysis in Social Sciences (Hi-Stat)

Quantile Forecasts of Financial Returns Using Realized GARCH Models

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July 2011
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July 11, 2011

Abstract

This article applies the realized GARCH model, which incorporates the GARCH model with realized volatility (RV), to quantile forecasts of financial returns such as Value-at-Risk and expected shortfall. This model has certain advantages in the application to quantile forecasts because it can adjust the bias of RV caused by microstructure noise and non-trading hours and enables us to estimate the parameters in the return distribution jointly with the other parameters. Student’s t- and skewed student’s t-distributions as well as normal distribution are used for the return distribution. The EGARCH model is used for comparison. Main results for the S&P 500 stock index are: (1) the realized GARCH model with the skewed student’s t-distribution performs better than that with the normal and student’s t-distributions and the EGARCH model using the daily returns only, and (2) the performance does not improve if the realized kernel, which takes account of microstructure noise, is used instead of the plain realized volatility, implying that the realized GARCH model can adjust the bias of RV caused by microstructure noise.

JEL classification: C52; c53; G17

Key words: Expected shortfall; GARCH; Realized volatility; Skewed student’s t-distribution; Value-at-Risk

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*Financial support from the Ministry of Education, Culture, Sports, Science and Technology of the Japanese Government through Grant-in-Aid for Scientific Research (No.18203901) and the Global COE program “Research Unit for Statistical and Empirical Analysis in Social Sciences” at Hitotsubashi University is gratefully acknowledged. I would like to thank Kazuo Ogawa, Kosuke Oya and the participants in the 2011 Japan Economic Association Annual Meeting at Kumamoto Gakuen University and the Stanford Institute for Theoretical Economics (SITE) Summer 2011 Workshop Segment 1 “Measuring and Modeling Risk with High Frequency Data” for their useful comments. Thanks are also due to Makoto Takahashi and Asuka Takeuchi-Nogimori for checking the paper. All remaining errors are solely my responsibility.

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1 Introduction

Quantile forecasts of financial returns are important for financial risk management such as Value-at-Risk (VaR) and expected shortfall (ES). Few would dispute the fact that financial volatility changes over time and hence it is important to model the dynamics of volatility. One of the most widely used is the ARCH (autoregressive conditional heteroskedasticity) family including ARCH model by Engle (1982), GARCH (generalized ARCH) model by Bollerslev (1986) and their extensions. Recently, realized volatility has also attracted the attentions of financial econometricians as an accurate estimator of volatility.

There are two problems in calculating realized volatility. First, realized volatility is influenced by market microstructure noise such as bid-ask spread and non-synchronous trading (Campbell et al., 1997). There are some methods available for mitigating the effect of microstructure noise on realized volatility (Bandi and Russell, 2008, 2011; Barndorff-Nielsen et al., 2008, 2011; Zhang et al., 2005). Second, there are non-trading hours such as overnight and lunch-time, when we cannot obtain high-frequency returns. Adding the squares of overnight returns may make realized volatility noisy. Hansen and Lunde (2005a,b) propose a method for calculating realized volatility without overnight returns.

Hansen et al. (2011) have recently proposed to extend GARCH models incorporating them with realized volatility. Their models, which are called realized GARCH models, have certain advantages in quantile forecasts. First, they can adjust the bias of RV caused by microstructure noise and non-trading hours. Second, they enable us to estimate the parameters of return and volatility equations simultaneously. Thus, we can estimate the parameters of the return distribution jointly with the other parameters of the model. Takahashi et al. (2009) has extended the stochastic volatility (SV) model in the same direction. The estimation of the realized GARCH model is less time-consuming than that of the realized SV model because the former can be estimated by the maximum likelihood method while the latter requires more computer-intensive methods such as simulated maximum likelihood estimation via the importance sampling and Bayesian estimation via the MCMC. In this paper, we apply the realized GARCH model to quantile forecasts. GARCH models and RV have already been applied to quantile forecasts (Giot and Laurent, 2004; Watanabe and Sasaki, 2006; Clements et al., 2008) but this paper is the first to apply the realized GARCH model to quantile forecasts as far as I know.

In this article, we use the student's $t$- and skewed student's $t$-distributions as well as
the normal distribution for the return distribution because it is straightforward to estimate the parameters in the student’s $t$- and skewed student’s $t$-distributions jointly with the other parameters in the realized GARCH model by the maximum likelihood method. If the realized GARCH model can adjust the bias of RV caused by microstructure noise correctly, we need not take the bias into account in calculating RV. To analyze whether it is true, we use the plain realized volatility which is the sum of intraday returns and the realized kernel proposed by Barndorff-Nielsen et al. (2008) to take account of microstructure noise. For comparison, we also use the EGARCH model proposed by Nelson (1991), which is estimated using daily returns only. The data we use are daily returns, realized volatility and realized kernel of the S&P 500. Main results are: (1) the realized GARCH model with the skewed student’s $t$-distribution performs better than that with normal and student’s $t$-distributions and the EGARCH model using the daily returns only, and (2) the performance does not improve if the realized kernel, which takes account of microstructure noise, is used instead of the plain realized volatility, implying that the realized GARCH model can adjust the bias caused by microstructure noise.

The article proceeds as follows. Section 2 reviews the realized GARCH model. Section 3 explains the method for forecasting the one-day ahead VaR and ES using the realized GARCH model. Section 4 explains the data and summarizes the empirical results. Conclusions and possible extensions are given in Section 5.

2 Realized GARCH Model

We start with a brief review of the realized GARCH model. Daily return $R_t$ is specified as

$$R_t = E(R_t|I_{t-1}) + \epsilon_t, \quad \epsilon_t = \sigma_t z_t, \quad z_t \sim \text{i.i.d.}(0, 1),$$  \hspace{1cm} (1)

where $E(R_t|I_{t-1})$ is the expectation of $R_t$ conditional on the information up to day $t - 1$, $\sigma_t^2$ is the volatility, and $z_t$ is the standardized error which follows an independent and identical distribution with mean 0 and variance 1. In what follows, we set $E(R_t|I_{t-1}) = 0$ because the null hypothesis of zero mean and that of no autocorrelations are not rejected in our empirical application. The distribution of $z_t$ will be explained below.

For volatility specification, we use the simplest version of realized GARCH model:

$$\ln \sigma_t^2 = \omega + \beta \ln \sigma_{t-1}^2 + \gamma X_{t-1}$$  \hspace{1cm} (2)

$$X_t = \mu + \varphi \ln \sigma_t^2 + \tau_1 z_t + \tau_2 (z_t^2 - 1) + u_t, \quad u_t \sim \text{i.i.d.} \mathcal{N}(0, \sigma_u^2)$$  \hspace{1cm} (3)
where $X_t$ denotes the log of realized volatility.

Equation (2) specifies the dynamics of the true volatility $\sigma_t^2$. While GARCH models specify $\sigma_t^2$ as a function of the past values of $\sigma_t^2$ and $\epsilon_t$ (or $z_t$), the realized GARCH model specifies it as a function of the past values of $\sigma_t^2$ and $X_t$. Equation (3) is called measurement equation, which relates the realized volatility to the true volatility. If the realized volatility were an unbiased estimator of the true volatility, $\mu$ and $\varphi$ would be 0 and 1 respectively. Realized volatility, however, has a bias caused by microstructure noise and non-trading hours. For example, New York Stock Exchange is open only for 6.5 hours within a day. Suppose that $R_t$ and $\sigma_t^2$ are return and volatility for a whole day and $RV_t$ is realized volatility calculated using the intraday returns only when the market is open. Then, we should expect $\mu < 0$ or $\varphi < 1$. Equation (3) assumes that $X_t$, i.e., the log of realized volatility, depends on the current value of $z_t$. If $\tau_1 < 0$, $X_t$ will be larger when $z_t < 0$ than when $z_t > 0$, which will make the $\sigma_{t+1}^2$ larger when $z_t < 0$ through equation (2) if $\gamma > 0$. This is consistent with the well known phenomenon in stock markets of a negative correlation between today’s return and tomorrow’s volatility.

The above model is the realized GARCH(1, 1) model. The realized GARCH($p, q$) model replaces equation (2) with

$$\ln \sigma_t^2 = \omega + \sum_{i=1}^{p} \beta_i \ln \sigma_{t-i}^2 + \sum_{j=1}^{q} \gamma_j X_{t-j}$$

(4)

We also estimate the realized GARCH models of (1, 2), (2, 1) and (2, 2) but the performance of quantile forecasts does not change so much. Therefore, we explain the results of realized GARCH(1, 1) model in what follows.

The distribution of $z_t$ is important in quantile forecasts. We use the standard normal, standardized student’s $t$- and standardized skewed student’s $t$-distributions for the standardized error term $z_t$ in equation (1). The standardized version of the skewed student’s $t$-distribution introduced by Fernández and Steel (1998) has the pdf:

$$f(z_t|\xi, v) = \begin{cases} \frac{2}{\xi^{1+\frac{1}{2}}} \text{sgn}(s z_t + m) |v| & \text{if } z_t < -\frac{m}{s} \\ \frac{2}{\xi^{1+\frac{1}{2}}} \text{sgn}(s z_t + m)/|v| & \text{if } z_t \geq -\frac{m}{s} \end{cases}$$

(5)

where $v > 2$ and $\xi > 0$. $g(\cdot |v)$ is a pdf of standardized student’s $t$-distribution with degree of freedom $v$. Parameters $m$ and $s^2$ are the mean and the variance of the nonstandardized
skewed student’s $t$-distribution:
\[
m = \frac{\Gamma \left( \frac{v-1}{2} \right) \sqrt{\frac{v-2}{\pi}}}{\Gamma \left( \frac{v}{2} \right)} \left( \xi - \frac{1}{\xi} \right), \quad s^2 = \left( \xi^2 + \frac{1}{\xi^2} - 1 \right) - m^2
\] (6)

$\xi$ and $v$ determine the skewness and kurtosis respectively. The skewness of $z_t$ is zero if $\xi = 1$ and positive (negative) if $\xi > (\prec) 1$. The kurtosis decreases as $v$ increases.

The likelihood of the realized GARCH model can easily be evaluated as
\[
L = \prod_{t=1}^{T} h(R_t|X_1, \ldots, X_{t-1}) I(X_t|X_1, \ldots, X_{t-1}, R_t)
\] (7)

where $h(R_t|X_1, \ldots, X_{t-1})$ is the density determined by the distribution of $z_t$ and $I(X_t|X_1, \ldots, X_{t-1}, R_t)$ is the normal density with mean $\mu + \varphi \ln \sigma_t^2 + \tau_1 z_t + \tau_2 (z_t^2 - 1)$ and variance $\sigma_t^2$. Given the initial value $\sigma_0^2$, we can calculate $\sigma_t^2$ by substituting $(\sigma_0^2, X_1, \ldots, X_{t-1})$ sequentially to equation (2). Hence, it is straightforward to evaluate $h(R_t|X_1, \ldots, X_{t-1})$. Given $R_t$ and $\sigma_t$, we can calculate $z_t$ as $z_t = R_t/\sigma_t$. Thus, it is also straightforward to evaluate $I(X_t|X_1, \ldots, X_{t-1}, R_t)$. We set the initial value $\ln \sigma_0^2$ equal to the unconditional mean $(\omega + \gamma \mu)/(1 - \beta - \gamma \varphi)$. We estimate the degree of freedom $v$ for the student’s $t$-distribution or $(\xi, v)$ for the skewed student’s $t$-distribution jointly with the parameters $(\omega, \beta, \gamma)$ in equation (2) and $(\mu, \varphi, \tau_1, \tau_2, \sigma_0^2)$ in equation (3) by the maximum likelihood method.

3 Value-at-Risk and Expected Shortfall

In this paper, we concentrate on long position. Then, one-day-ahead forecast for the VaR of the daily return $R_t$ with probability $\alpha$ is defined as VaR$\alpha_t(\alpha)$ satisfying
\[
\Pr (R_t < \text{VaR}\alpha_t(\alpha) | I_{t-1}) = \alpha
\] (8)

The sample size of daily returns and realized volatility used in our empirical analysis is 3263. Using 1500 daily returns and realized volatilities, we calculate one-day-ahead forecasts of the VaR (VaR$1500$, $\ldots$, VaR$3263$) as follows.


A2. Estimate the parameters of the realized GARCH model using the sample $(R_i, \ldots, R_{1499+i}, X_i, \ldots, X_{1499+i})$ by the maximum likelihood method.
A3. Set the parameters \((\omega, \beta, \gamma)\) in equation (2) equal to their estimates obtained in A2.

Then, calculate \(\sigma^2_{1500+i}\) by substituting \(\sigma^2_{1499+i}\) and \(X_{1499+i}\) to equation (2).

A4. Set the parameters \(v\) or \((v, \xi)\) of the distribution of \(z_{1500+i}\) equal to their estimates in A2
if the distribution is student’s \(t\) or skewed student’s \(t\). Then, obtain \(z_{1500+i}(\alpha)\) satisfying
\[
\Pr(z_{1500+i} < z_{1500+i}(\alpha)) = \alpha \text{ depending on the distribution.}
\]

A5. Set \(\text{VaR}_{1500+i}(\alpha) = \sigma_{1500+i} z_{1500+i}(\alpha)\).

A6. Set \(i = i + 1\) and return to A1 if \(i < 1763\) and end if \(i = 1763\).

Using \((\text{VaR}_{1501}, \ldots, \text{VaR}_{3263})\) obtained by executing this algorithm, we calculate the
empirical failure rate. Let \(N\) be the number of times when the VaR is violated, i.e., \(R_t < \text{VaR}_t\) for
\(i = 1501, \ldots, 3263\). Then, the empirical failure rate is defined as \(N/1763\). Using the empirical
failure rate, we apply the likelihood ratio (LR) test proposed by Kupiec (1995) to test the null
hypothesis of \(f = \alpha\), where \(f\) is the true failure rate. The LR statistic is:
\[
\text{LR} = 2 \ln \left( \left( \frac{N}{1763} \right)^N \left( 1 - \frac{N}{1763} \right)^{1763-N} \right) - 2 \ln \left( \alpha^N (1 - \alpha)^{1763-N} \right)
\]
This LR statistic is asymptotically distributed as a \(\chi^2(1)\) if the null hypothesis of \(f = \alpha\) is
ture.

The problem of VaR is that it only measures a quantile of the distribution and hence ignores
important information regarding the tails of the distribution beyond this quantile. We also
use expected shortfall (ES), which is defined as the conditional expectation of the return given
that it is beyond the VaR. The one-day-ahead forecast for the ES of the daily return \(R_t\) with
probability \(\alpha\) is defined as follows.
\[
\text{ES}_t(\alpha) = \mathbb{E}[R_t | R_t < \text{VaR}_t(\alpha), I_{t-1}]
\]

Using \((\text{VaR}_{1501}, \ldots, \text{VaR}_{3263})\), we calculate \((\text{ES}_{1501}, \ldots, \text{ES}_{3263})\) as follows.

B1. Set \(i = 1\).

B2. Simulate 10,000 sample for \(R_{1500+i}\) using equation (1) given \(\sigma_{1500+i}\) and distribution of
\(z_{1500+i}\).

B3. Calculate \(\text{ES}_{1500+i}(\alpha)\) as the average of the sample violating the VaR, i.e., \(R_{1500+i} < \text{VaR}_{1500+i}(\alpha)\).
B. Set $i = i + 1$ and return to 1 if $i < 1763$ and end if $i = 1763$.

To backtest the predicted ES value with probability $\alpha$, we use the measure proposed by Embrechts et al. (2004). The standard backtesting measure for expected shortfall estimates is

$$D_1(\alpha) = \frac{1}{x(\alpha)} \sum_{t \in \kappa(\alpha)} \delta_t(\alpha)$$

(11)

where $\delta_t(\alpha) = R_t - \text{ES}_t(\alpha)$, $x(\alpha)$ is the number of days for which a violation of $\text{VaR}_t(\alpha)$, i.e., $R_t < \text{VaR}_t(\alpha)$ occurs and $\kappa(\alpha)$ is the set of days for which it happens.

Its weakness is that it depends strongly on the $\text{VaR}$ estimates without adequately reflecting the correctness of these values. To correct for this, it is combined with a penalty

$$D_2(\alpha) = \frac{1}{y(\alpha)} \sum_{t \in \tau(\alpha)} \delta_t(\alpha)$$

(12)

where $y(\alpha)$ be the number of days $\delta_t(\alpha)$ is less than its $\alpha$-quantile, and $\tau(\alpha)$ the set of days for which it happens.

The Embrechts et al. (2004) measure is given by

$$D(\alpha) = \left( |D_1(\alpha)| + |D_2(\alpha)| \right) / 2$$

(13)

A good estimation of expected shortfall will lead to a low value of $D(\alpha)$.

4 Empirical Application

4.1 Data

We use daily data on returns and realized volatilities of the S&P 500 stock index. The sample period is 1996/1/3–2009/2/27. These data are obtained from Oxford–Man Institute’s Realized Library (Heber et al., 2009), where we can download two types of realized volatilities. One is the plain RV which is the sum of the intraday returns and the other is the realized kernel (RK) calculated using the method by Barndorff-Nielsen et al. (2008) to take account of microstructure noise. If the bias of RV caused by microstructure noise can be adjusted by the realized GARCH model, RK will not improve the performance of $\text{VaR}$ and ES. To analyze whether this is true, we use the both RVs.

Figure 1 plots these data and Table 1 summarizes the descriptive statistics for the full sample. Table 1(a) shows the descriptive statistics of daily returns (%). The mean is not
Figure 1: Daily Returns, realized volatility and realized kernel of the S&P 500

Table 1: Descriptive statistics for the full sample

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>St. dev.</th>
<th>Skewness</th>
<th>Kurtosis</th>
<th>JB</th>
<th>LB(10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Daily returns (%)</td>
<td>0.005</td>
<td>1.313</td>
<td>-0.258</td>
<td>11.025</td>
<td>8791.47</td>
<td>16.27</td>
</tr>
<tr>
<td></td>
<td>(0.023)</td>
<td>(0.043)</td>
<td>(0.086)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Realized volatility</td>
<td>0.964</td>
<td>2.089</td>
<td>10.976</td>
<td>202.19</td>
<td>5460146.73</td>
<td>329.39</td>
</tr>
<tr>
<td></td>
<td>(0.037)</td>
<td>(0.043)</td>
<td>(0.086)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Realized kernel</td>
<td>1.003</td>
<td>2.141</td>
<td>10.406</td>
<td>180.99</td>
<td>4366158.90</td>
<td>343.24</td>
</tr>
<tr>
<td></td>
<td>(0.037)</td>
<td>(0.043)</td>
<td>(0.086)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Log realized volatility</td>
<td>-0.657</td>
<td>0.993</td>
<td>0.556</td>
<td>3.825</td>
<td>260.69</td>
<td>6339.12</td>
</tr>
<tr>
<td></td>
<td>(0.017)</td>
<td>(0.043)</td>
<td>(0.086)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Log realized kernel</td>
<td>-0.621</td>
<td>1.001</td>
<td>0.530</td>
<td>3.772</td>
<td>233.76</td>
<td>6475.19</td>
</tr>
<tr>
<td></td>
<td>(0.018)</td>
<td>(0.043)</td>
<td>(0.086)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sample period: 1996/1/3–2009/2/27. Sample size: 3263. The numbers in parentheses are standard errors. JB is the Jarque-Bera statistic to test the null hypothesis of normality. LB(10) is the Ljung-Box statistic adjusted for heteroskedasticity following Diebold (1988) to test the null hypothesis of no autocorrelations up to 10 lags.
significantly different from zero. LB(10) is the Ljung-Box statistic adjusted for heteroskedasticity following Diebold (1988) to test the null hypothesis of no autocorrelations up to 10 lags. According to this statistic, the null hypothesis is not rejected at the 10% significance level. Thus, we set $E(R_t | I_{t-1}) = 0$ in equation (1). The skewness is significantly below zero and the kurtosis is significantly above 3, indicating the well-known phenomenon that the distribution of the daily return is leptokurtic. The Jarque-Bera (JB) statistic using the both skewness and kurtosis also rejects the null hypothesis of normality at the 1% significance level.

Table 1 (b)–(c) summarize the descriptive statistics of daily RV and RK. The values of skewness, kurtosis and JB statistic indicate that the distributions of RV and RK are non-normal. LB(10) is so large that the null hypothesis of no autocorrelation is rejected, which is consistent with the phenomenon called volatility clustering. Table 1 (d)–(e) show the descriptive statistics for log-RV and log-RK. Their distributions are much closer to the normal distribution than those of RV and RK but still non-normal. Thus, it might be better to assume a non-normal distribution also for $u_t$ in equation (3) but we leave it for the future analysis.

4.2 Estimation results of the realized GARCH model

As explained in Section 3, we estimate the realized GARCH model using the 1500 daily returns and RV and then forecast one-day ahead VaR and ES given the parameter estimates. Table 2 summarizes the estimation results of the realized GARCH model with the normal, student’s $t$- and skewed student’s $t$- distributions for $z_t$ using the first 1500 returns and realized volatility. The sample period is from 1996/1/3 to 2002/2/4. Table 2 (a) shows the results using RV. Judging from the likelihood values, the skewed student’s $t$-distribution fits the data best. $\xi$ in the skewed student’s $t$-distribution is significantly below one, indicating a negative skewness of $z_t$. Figure 2 plots the pdf of the standard normal, standardized student’s $t$- and standardized skewed student’s $t$-distributions where the parameters $(\nu, \xi)$ in the skewed student’s $t$ and $\nu$ in the student’s $t$ are set equal to their estimates in Table 2 (a). The parameter estimates of the realized GARCH model do not depend on the distribution of $z_t$. The persistence in volatility can be measured by the estimates of $\beta + \gamma \varphi$, which is about 0.95 no matter which distribution is used for $z_t$. This result shows a well-known phenomenon of a high persistence in volatility.

The estimate of $\mu$ is significantly below zero and that of $\varphi$ is significantly above one at the 1% significance level, showing that the log-RV is a biased estimator of the true log-volatility. The estimate of $\tau_1$ is significantly below zero, which is consistent with a well-known phenomenon in stock markets of a negative correlation between today’s return and tomorrow’s volatility.
Table 2: Estimation results of realized GARCH model for the first 1500 sample

(a) RV

<table>
<thead>
<tr>
<th></th>
<th>(\omega)</th>
<th>(\beta)</th>
<th>(\gamma)</th>
<th>(\mu)</th>
<th>(\varphi)</th>
<th>(\tau_1)</th>
<th>(\tau_2)</th>
<th>(\sigma_u)</th>
<th>(\nu)</th>
<th>(\xi)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal (Log-likelihood = -3440.53)</td>
<td>0.258</td>
<td>0.587</td>
<td>0.275</td>
<td>-0.896</td>
<td>1.305</td>
<td>-0.198</td>
<td>0.058</td>
<td>0.518</td>
<td>(0.024)</td>
<td>(0.031)</td>
</tr>
<tr>
<td>Student’s t (Log-likelihood = -3411.36)</td>
<td>0.261</td>
<td>0.586</td>
<td>0.288</td>
<td>-0.870</td>
<td>1.252</td>
<td>-0.197</td>
<td>0.056</td>
<td>0.518</td>
<td>8.138</td>
<td>(0.028)</td>
</tr>
<tr>
<td>Skewed student’s t (Log-likelihood = -3397.67)</td>
<td>0.268</td>
<td>0.590</td>
<td>0.287</td>
<td>-0.920</td>
<td>1.245</td>
<td>-0.197</td>
<td>0.079</td>
<td>0.516</td>
<td>8.625</td>
<td>0.826</td>
</tr>
</tbody>
</table>


(b) RK

<table>
<thead>
<tr>
<th></th>
<th>(\omega)</th>
<th>(\beta)</th>
<th>(\gamma)</th>
<th>(\mu)</th>
<th>(\varphi)</th>
<th>(\tau_1)</th>
<th>(\tau_2)</th>
<th>(\sigma_u)</th>
<th>(\nu)</th>
<th>(\xi)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal (Log-likelihood = -3453.27)</td>
<td>0.240</td>
<td>0.589</td>
<td>0.272</td>
<td>-0.843</td>
<td>1.315</td>
<td>-0.197</td>
<td>0.056</td>
<td>0.522</td>
<td>(0.023)</td>
<td>(0.031)</td>
</tr>
<tr>
<td>Student’s t (Log-likelihood = -3424.16)</td>
<td>0.242</td>
<td>0.588</td>
<td>0.284</td>
<td>-0.817</td>
<td>1.262</td>
<td>-0.196</td>
<td>0.054</td>
<td>0.523</td>
<td>8.142</td>
<td>(0.027)</td>
</tr>
<tr>
<td>Skewed student’s t (Log-likelihood = -3410.54)</td>
<td>0.249</td>
<td>0.592</td>
<td>0.284</td>
<td>-0.868</td>
<td>1.258</td>
<td>-0.197</td>
<td>0.077</td>
<td>0.520</td>
<td>8.608</td>
<td>0.826</td>
</tr>
</tbody>
</table>

(Nelson, 1991). Figure 3 plots the news impact curve where the horizontal axis is $z_{t-1}$ and the vertical axis is $\sigma_t$. Table 2 (b) summarizes the estimation results of the Realized GARCH model using RK. The results in Table 2(b) are almost the same as those in Table 2 (a).

Figure 2: Estimated pdf of $z_t$ (Parameters $\nu$ in the student’s $t$-distribution and $(\nu, \xi)$ in the skewed student’s $t$-distribution are set equal to their estimates in Table 2 (a))

![Graph showing the pdf of $z_t$](image)

For comparison, we also calculate VaR and ES using the EGARCH model proposed by Nelson (1991):

$$\ln \sigma_t^2 = \omega + \phi (\ln \sigma_{t-1}^2 - \omega) + \theta z_{t-1} + \gamma(|z_{t-1}| - E(|z_{t-1}|))$$  
(14)

We use the standard normal, the standardized student’s $t$ and the standardized skewed student’s $t$ for the distribution of $z_t$.

Table 3 summarizes the estimation results of EGARCH model. Judging from the log-likelihood values, the skewed student’s $t$-distribution fits the data best also in the EGARCH model.

4.3 Comparison using VaR and ES

Table 4 (a)–(b) show the empirical failure rates and the p-values for the Kupiec LR test for $\alpha = 1\%, 5\%, 10\%$ where RG(RV), RG(RK) and EG denote the realized GARCH model with
Figure 3: News impact curve (Parameters are set equal to their estimates in the skewed student’s-\( t \) distribution in Table 2 (a))

![News impact curve diagram]

Table 3: Estimation results of EGARCH model for the first 1500 sample

<table>
<thead>
<tr>
<th></th>
<th>( \omega )</th>
<th>( \phi )</th>
<th>( \theta )</th>
<th>( \gamma )</th>
<th>( \upsilon )</th>
<th>( \xi )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal (Log-likelihood = -2289.65)</td>
<td>0.338</td>
<td>0.948</td>
<td>-0.165</td>
<td>0.101</td>
<td>(0.067)</td>
<td>(0.011)</td>
</tr>
<tr>
<td>Student’s ( t ) (Log-likelihood = -2267.98)</td>
<td>0.280</td>
<td>0.954</td>
<td>-0.158</td>
<td>0.099</td>
<td>8.730</td>
<td>(0.079)</td>
</tr>
<tr>
<td>Skewed student’s ( t ) (Log-likelihood = -2261.16)</td>
<td>0.297</td>
<td>0.955</td>
<td>-0.155</td>
<td>0.104</td>
<td>9.178</td>
<td>0.871</td>
</tr>
</tbody>
</table>

Table 4: Results for VaR

(a) Empirical failure rate

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>5%</th>
<th>1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>RG(RV)-n</td>
<td>10.323</td>
<td>5.332</td>
<td>1.645</td>
</tr>
<tr>
<td>RG(RV)-t</td>
<td>10.720</td>
<td>5.672</td>
<td>1.134</td>
</tr>
<tr>
<td>RG(RV)-skt</td>
<td>10.267</td>
<td>4.594</td>
<td>0.908</td>
</tr>
<tr>
<td>RG(RK)-n</td>
<td>10.380</td>
<td>5.615</td>
<td>1.645</td>
</tr>
<tr>
<td>RG(RK)-t</td>
<td>11.004</td>
<td>5.729</td>
<td>1.248</td>
</tr>
<tr>
<td>RG(RK)-skt</td>
<td>10.323</td>
<td>4.651</td>
<td>0.908</td>
</tr>
<tr>
<td>EG-n</td>
<td>10.040</td>
<td>5.445</td>
<td>1.872</td>
</tr>
<tr>
<td>EG-t</td>
<td>10.777</td>
<td>5.559</td>
<td>1.531</td>
</tr>
<tr>
<td>EG-skt</td>
<td>10.607</td>
<td>5.218</td>
<td>1.248</td>
</tr>
</tbody>
</table>

(b) p-values from the LR test

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>5%</th>
<th>1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>RG(RV)-n</td>
<td>0.652</td>
<td>0.527</td>
<td>0.013*</td>
</tr>
<tr>
<td>RG(RV)-t</td>
<td>0.318</td>
<td>0.204</td>
<td>0.579</td>
</tr>
<tr>
<td>RG(RV)-skt</td>
<td>0.710</td>
<td>0.429</td>
<td>0.692</td>
</tr>
<tr>
<td>RG(RK)-n</td>
<td>0.597</td>
<td>0.245</td>
<td>0.013*</td>
</tr>
<tr>
<td>RG(RK)-t</td>
<td>0.166</td>
<td>0.170</td>
<td>0.314</td>
</tr>
<tr>
<td>RG(RK)-skt</td>
<td>0.652</td>
<td>0.497</td>
<td>0.692</td>
</tr>
<tr>
<td>EG-n</td>
<td>0.956</td>
<td>0.397</td>
<td>0.001**</td>
</tr>
<tr>
<td>EG-t</td>
<td>0.282</td>
<td>0.290</td>
<td>0.038*</td>
</tr>
<tr>
<td>EG-skt</td>
<td>0.400</td>
<td>0.676</td>
<td>0.314</td>
</tr>
</tbody>
</table>

The numbers in the table are p-values from the Kupic (1995) LR test calculated from the LR statistic (9). * and ** indicate that the null hypothesis of \( f = \alpha \) is rejected at the 5% and 1% significance levels respectively.
RV, the realized GARCH model with RK and the EGARCH model and $n$, $t$ and $skt$ represent the normal, student's $t$- and skewed student's $t$-distributions for $z_t$. As can be seen from Table 4 (b), the null hypothesis of $f = \alpha$ is accepted for all models when $\alpha = 5\%, 10\%$. When $\alpha = 1\%$, the null hypothesis is rejected for RG(RV)-$n$, RG(RK)-$n$, EG-$n$ and EG-$t$ at the 5% significance level. Thus, we may conclude that it is not good to assume the normal distribution for $z_t$ no matter which models are used. We cannot conclude which model performs best among RG(RV), RG(RK) and EG because the null hypothesis is accepted for all models and $\alpha$ if we use the skewed student’s $t$-distribution.

Table 5: Results for ES

<table>
<thead>
<tr>
<th>$\alpha$</th>
<th>10%</th>
<th>5%</th>
<th>1%</th>
</tr>
</thead>
<tbody>
<tr>
<td>RG(RV)-$n$</td>
<td>0.092</td>
<td>0.168</td>
<td>0.437</td>
</tr>
<tr>
<td>RG(RV)-$t$</td>
<td>0.070*</td>
<td>0.089</td>
<td>0.237</td>
</tr>
<tr>
<td>RG(RV)-$skt$</td>
<td>0.077</td>
<td>0.030*</td>
<td>0.087*</td>
</tr>
<tr>
<td>RG(RK)-$n$</td>
<td>0.110</td>
<td>0.174</td>
<td>0.443</td>
</tr>
<tr>
<td>RG(RK)-$t$</td>
<td>0.072</td>
<td>0.091</td>
<td>0.223</td>
</tr>
<tr>
<td>RG(RK)-$skt$</td>
<td>0.076</td>
<td>0.031</td>
<td>0.120</td>
</tr>
<tr>
<td>EG-$n$</td>
<td>0.136</td>
<td>0.240</td>
<td>0.456</td>
</tr>
<tr>
<td>EG-$t$</td>
<td>0.082</td>
<td>0.140</td>
<td>0.287</td>
</tr>
<tr>
<td>EG-$skt$</td>
<td>0.071</td>
<td>0.064</td>
<td>0.211</td>
</tr>
</tbody>
</table>

The numbers in the table are the value of $D(\alpha)$ defined by equation (13). * indicates the lowest value for each $\alpha$.

In Table 5, we show the $D(\alpha)$ values defined by equation (13). As can be seen from the table, RG(RV)-$skt$ gives the lowest values for $\alpha = 5\%, 1\%$. For $\alpha = 10\%$, RG(RV)-$t$ gives the lowest value but it is not so much different from that of RG(RV)-$skt$. Hence, for the prediction of the expected shortfall of our test data, the realized GARCH model with the skewed student’s $t$-distribution is superior to that with other distributions and the EGARCH model. RG(RV)-$skt$ and RG(RK)-$skt$ perform better than EG-$skt$ for $\alpha = 5\%, 1\%$, indicating that using realized volatility improves the performance. The performance of RG(RV)-$skt$ is almost the same as that of RG(RK)-$skt$ for $\alpha = 10\%, 5\%$ and the former is superior to the latter for $\alpha = 1\%$, showing that the realized GARCH model can adjust the bias caused by the microstructure noise and hence we need not take the bias into account in calculating RV.
5 Conclusions and Extensions

This article applies the realized GARCH model to quantile forecasts such as VaR and ES. Using the daily returns, RV and RK of S&P 500 stock index, we find that the realized GARCH model with the skewed student’s $t$-distribution performs better than that with the normal and student’s $t$-distributions and the EGARCH model using the daily returns only and that the performance does not improve if the RK, which takes account of microstructure noise, is used instead of the plain RV.

Several extensions are possible. First, we used the normal, student’s $t$- and skewed student’s $t$-distributions for $z_t$. The normal inverse Gaussian (NIG) and generalized hyperbolic (GH) skew student’s $t$-distributions have recently been applied to financial returns (Fosberg and Bollerslev, 2002; Aas and Haff, 2006). It is, however, difficult to estimate the parameters in these distributions by the maximum likelihood method (Aas and Haff, 2006). The joint estimation of the parameters in these distributions and the parameters in the realized GARCH model may be challenging. Using the empirical distribution of the standardized residuals or extreme value theory might improve the performance (Mancini and Trojani, 2011). Second, it is worthwhile using the other realized measures of volatility such as the realized range (Christensen and Podolskij, 2007; Martens and van Dijk, 2007) and the realized volatility from which significant jumps are removed (Barndorff-Nielsen and Shephard, 2004; Andersen et al., 2007). Third, realized SV model proposed by Takahashi et al. (2009) should also be applied to quantile forecasts, for example, using Bayesian estimation via MCMC. This method is time-consuming but enables us to estimate the parameters in the distribution and in the model jointly even if GH skew student’s $t$-distribution is used for $z_t$ (Nakajima and Omori, 2011). It also makes it possible to estimate the parameters and forecast VaR and ES jointly by sampling the parameters and the forecasts of VaR and ES jointly from their posterior distribution.
References


