

Nonlinear Stochastic Model of Return matching to the data of New York and Vilnius Stock Exchanges

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Abstract

We scale and analyze the empirical data of return from New York and Vilnius stock exchanges matching it to the same nonlinear double stochastic model of return in financial market.

1 Introduction

Volatility clustering, evaluated through slowly decaying auto-correlations, Hurst effect or $1/f^\beta$ noise for absolute returns, is a characteristic property of most financial assets return time series [1, 2, 3]. Statistical analysis alone is not able to provide a definite answer for the presence or absence of long range dependence phenomenon in stock returns or volatility, unless economic mechanisms are proposed to understand the origin of such phenomena [3, 4]. Whether results of statistical analysis correspond to long range dependence is a difficult question subject to an ongoing statistical debate [4, 5]. The agent based economic models [6, 7] as well as stochastic models [8, 9, 10, 11] exhibiting long range dependence phenomenon in volatility or trading volume are of great interest and remain an active topic of research.

The properties of stochastic multiplicative point processes have been investigated analytically and numerically and the formula for the power spectrum has been derived [12], later the model was associated with the general form of the multiplicative stochastic differential equation [13, 14]. The extensive empirical analysis of the financial market data, supporting the idea that the long-range volatility correlations arise from trading activity, provides valuable background for further development of the long-ranged memory stochastic models

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[15, 16, 17]. The power law behavior of the auto-regressive conditional duration process [18] based on the random multiplicative process and its special case the self-modulation process [19], exhibiting $1/f$ fluctuations, supported the idea of stochastic modeling with a power law probability density function (PDF) and long memory. A stochastic model of trading activity based on a stochastic differential equation (SDE) driven Poisson-like process has been already presented in [10]. In the paper [11] we proposed a double stochastic model, which generates time series of the return with two power law statistics, i.e., the PDF and the power spectral density of absolute return, reproducing the empirical data for the one-minute trading return in the NYSE.

In this contribution we analyze empirical data from Vilnius Stock Exchange (VSE)² in comparison with NYSE and the double stochastic model of return [11]. At the same time we demonstrate scaling of the statistical properties with longer time windows of return.

2 The double stochastic model of return in financial market

Recently we proposed the double stochastic model of return in financial market [11] based on the non-linear SDE. The main advantage of proposed model is its ability to reproduce power spectral density of absolute return as well as long term PDF of return. In the proposed model we assume that the empirical return r_t can be formalized as instantaneous q-Gaussian fluctuations ξ with a slowly diffusing parameter r_0 and constant $\lambda = 5$

$$r_t = \xi\{r_0, \lambda\}. \quad (1)$$

q-Gaussian distribution of ξ can be expressed as follows:

$$P_{r_0, \lambda}(r) = \frac{\Gamma(\frac{\lambda}{2})}{r_0 \sqrt{\pi} \Gamma(\frac{\lambda}{2} - \frac{1}{2})} \left(\frac{r_0^2}{r_0^2 + r^2} \right)^{\lambda/2}, \quad (2)$$

The parameter r_0 serves as a measure of instantaneous volatility of return fluctuations. See [11], for the empirical evidence of this assumption. Here r is defined in the selected time interval τ as a difference of logarithms of asset prices p :

$$r(t, \tau) = |\ln[p(t + \tau)] - \ln[p(t)]|. \quad (3)$$

In this paper we consider dimensionless returns normalized by its dispersion calculated in the whole length of realization. It is worth to notice that $r(\tau)$ is an additive variable, i.e., if $\tau = \sum_i \tau_i$, then $r(\tau) = \sum_i r(\tau_i)$, or in the continuous limit the sum may be replaced by integration. We propose to model the measure of volatility r_0 by the scaled continuous stochastic variable x , which can

²Here we abbreviate the official name NASDAQ OMX Vilnius Stock Exchange for the convenience

be interpreted as average return per unit time interval. Through the empirical analysis of high frequency trading data on NYSE [11] we have introduced relation:

$$r_0(t, \tau) = 1 + \frac{\bar{r}_0}{\tau_s} \left| \int_{t_s}^{t_s + \tau_s} x(s) ds \right|, \quad (4)$$

where \bar{r}_0 is an empirical parameter and the average return per unit time interval $x(t_s)$ can be modeled by a nonlinear SDE, expressed in scaled dimensionless time $t_s = \sigma_t^2 t$:

$$dx = \left[\eta - \frac{\lambda_0}{2} - \left(\frac{x}{x_{max}} \right)^2 \right] \frac{(1+x^2)^{\eta-1}}{(\epsilon\sqrt{1+x^2}+1)^2} x dt_s + \frac{(1+x^2)^{\frac{\eta}{2}}}{\epsilon\sqrt{1+x^2}+1} dW_s. \quad (5)$$

In Eq. (5) there are five more parameters, which can be empirically defined: η - exponent of multiplicativity, λ_0 - power law exponent of x long range PDF, ϵ - parameter dividing diffusion into two areas: stationary and excited one, σ_t^2 - time scale adjustment parameter and x_{max} - the upper limit of diffusion. The term $\left(\frac{x}{x_{max}} \right)^2$ excludes divergence of x to the infinity. Seeking to discover the universal nature of financial markets we consider that all these parameters are universal for all stocks traded on various exchanges. In this paper we analyze empirical data from very different exchanges New York, one of the most developed with highly liquid stocks, and Vilnius, emerging one with not as liquid stocks.

We solve Eq. (5) numerically introducing variable steps of dimensionless time $t_{s,k+1} = t_{s,k} + h_k$:

$$h_k = \kappa^2 \frac{(\epsilon\sqrt{1+x_k^2}+1)^2}{(1+x_k^2)^{\eta-1}}, \quad (6)$$

where κ is precision parameter of numerical calculations, which should be less than 1. Then SDE (5) can be replaced by iterative equation:

$$x_{k+1} = \kappa^2 \left[\eta - \frac{\lambda_0}{2} - \left(\frac{x}{x_{max}} \right)^2 \right] x_k + \kappa \sqrt{1+x_k^2} \zeta_k, \quad (7)$$

where ζ_k is a normally distributed random variable with zero mean and unit variance.

3 Stochastic model versus empirical data

In paper [11] we analyzed the tick by tick trades of 24 stocks, ABT, ADM, BMY, C, CVX, DOW, FNM, GE, GM, HD, IBM, JNJ, JPM, KO, LLY, MMM, MO, MOT, MRK, SLE, PFE, T, WMT, XOM, traded on the NYSE for 27 months from January, 2005, recorded in the Trades and Quotes database. The

parameters of stochastic model presented in the Section 2 were adjusted to the empirical tick by tick one minute returns. An excellent agreement between empirical and model PDF and power spectrum was achieved, see Fig. 3 in [11]. The same empirical data and model results with slightly changed values of parameters are given in Fig. 1 (a) and (b). Noticeable difference in theoretical and empirical PDFs for small values of return r are related with the prevailing prices of trades expressed in integer values of cents. We do not account for this discreteness in our continuous description. In the empirical power spectrum one-day resonance – the largest spike with higher harmonics – is present. This seasonality – an intraday activity pattern of the signal – is not included in the model either and this leads to the explicable difference from observed power spectrum. Provided that we use scaled dimensionless equations derived while making very general assumptions, we expect that proposed model should work for various assets traded on different exchanges as well as for various time scales.

In this paper we also analyze tick by tick trades of 4 stocks, APG1L, PTR1L, SRS1L, UKB1L, traded on VSE for 50 months since May, 2005, trading data was collected and provided for us by VSE. If the stocks from NYSE considered are just available for us, four stocks from VSE are investigated as the most liquid and exhibiting continuing trading activity in selected time interval. As expected stocks traded on VSE in comparison with NYSE are less liquid – mean inter-trade time for analyzed stocks traded on VSE is 362 s, while for stocks traded on NYSE mean inter-trade time equals 3.02 s. The difference in trading activity exceeds 100 times. This large difference is related with comparatively small number of traders and comparatively small companies participating in the emerging VSE market. Do these different markets have any statistical affinity is an essential question from the theoretical point of market modeling.

We start with returns for very small time scales $\tau = 60s$. For the VSE up to 95% of one minute trading time intervals elapse without any trade or change in price. One can exclude these time intervals from the sequence while calculating PDF of return. With such simple procedure calculated PDF of VSE empirical return overlaps with PDF of NYSE empirical return (see Figure 1 (a)).

One should use full time sequence of returns calculating the power spectrum. Nevertheless, despite low VSE liquidity, PSD of VSE and NYSE absolute returns almost overlap. Difference is clearly seen only for higher frequencies, when $\tau = 60s$, and is related with low VSE market liquidity contributing to the white noise appearance. The different length of trading sessions in financial markets causes different positions of resonant spikes. One can conclude that even so marginal market as VSE retains essential statistical features as developed market on NYSE. At the first glance the statistical similarity should be even better for the higher values of return time scale τ .

Further we investigate the behavior of returns on NYSE and VSE for increased values of $\tau = 600s$ and $\tau = 1800s$ with the specific interest to check whether proposed stochastic model scales in the same way as empirical data. Apparently, as we can see in Figure 1 (d) and (f) PSDs of absolute returns on VSE and on NYSE overlap even better at larger time scale (600 seconds and 1800 seconds). This serves as an additional argument for the very general origin

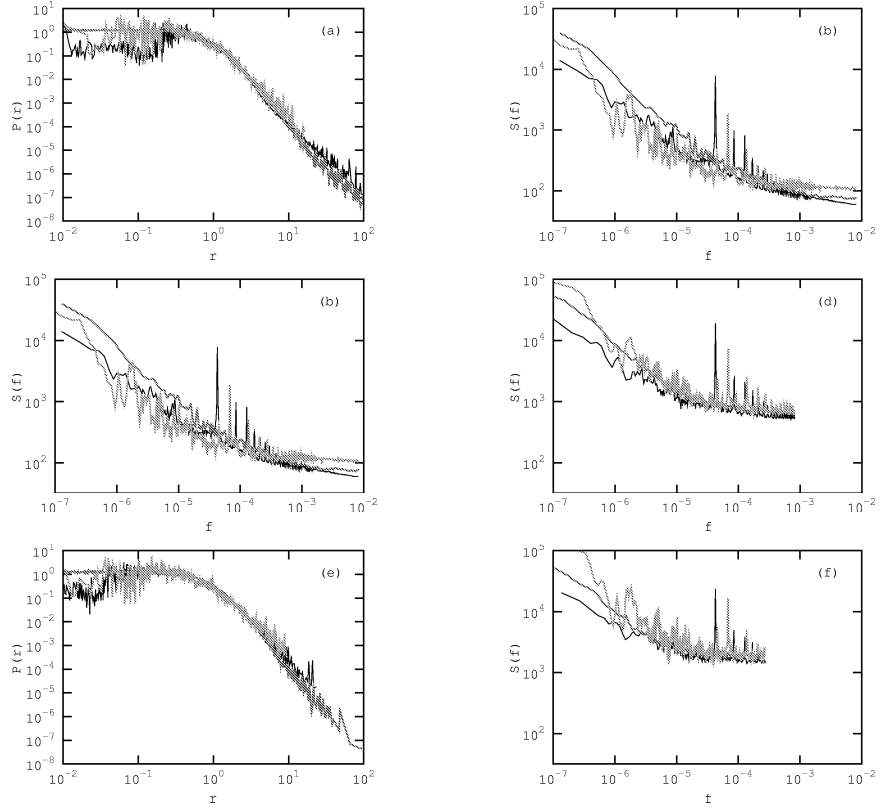


Figure 1: Comparison of empirical statistics of absolute returns traded on the NYSE (black thin lines) and VSE (light gray lines) with model statistics, (1)-(7), (gray lines). Model parameters are as follows: $\lambda = 5$; $\sigma_t^2 = 1/3 \cdot 10^{-6} s^{-1}$; $\lambda_0 = 3.6$; $\epsilon = 0.017$; $\eta = 2.5$; $\bar{r}_0 = 0.4$; $x_{max} = 1000$. PDF of normalized absolute returns is given on (a), (c), (e) and PSD on (b), (d), (f). (a) and (b) represents time series with $\tau = 60s$; (c) and (d) $\tau = 600s$; (e) and (f) $\tau = 1800s$. Empirical data from NYSE is averaged over 24 stocks, empirical data from VSE is averaged over 4 stocks and model data is averaged over 100 realizations.

of long range memory properties observed in very different, liquidity-wise, markets. The nonlinear SDE is an applicable model to capture up observed empirical properties. PDFs of absolute return observed in both markets (see Figure 1 (c) and (e)) are practically identical, though we still have to ignore zero returns of VSE to arrive to the same normalization of PDF.

4 Conclusions

We propose a double stochastic process driven by the nonlinear scaled SDE (5) reproducing the main statistical properties of the absolute return, observed in the financial markets. The double stochastic nature of return in financial markets is usually expressed through stochastic volatility and more or less independent instantaneous price fluctuations. From the empirical analyzes of market data, see [11] for details, we conclude that double stochastic nature or return can be expressed through stochastic volatility measured as parameter of instantaneous q-Gaussian return fluctuations. Seven parameters of the model enable us to adjust it to the sophisticated power law statistics of various stocks including long range behavior. The scaled dimensionless form of equations gives an opportunity to deal with averaged statistics of various stocks and compare behavior of different markets. All parameters introduced are recoverable from the empirical data and are responsible for the specific statistical features of real markets. Seeking to discover the universal nature of return statistics we analyze and compare extremely different markets in New York and Vilnius and adjust the model parameters to match statistics of both markets. The most promising result of this research is discovered increasing coincidence of the model with empirical data from the New York and Vilnius markets and between markets, when the time scale of return τ is growing. Observable specific features of different markets could be a subject of another research based on the proposed model. For example, it is clear that parameter x_{max} should be relevant to the maximum number of active traders in the market and consequently should be specific for the every market. Further analyses of empirical data and proposed model reasoning by agent behavior is ongoing.

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