

A Volatility Targeting GARCH model with Time-Varying Coefficients*

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Abstract

The current paper proposes a conditional volatility model with time varying coefficients based on a multinomial switching mechanism. By giving more weight to either the persistence or shock term in a GARCH model, conditional on their relative ability to forecast a benchmark volatility measure, the switching reinforces the persistent nature of the GARCH model. Estimation of this volatility targeting or VT-GARCH model for Dow 30 stocks indicates that the switching model is able to outperform a number of relevant GARCH setups, both in- and out-of-sample, also without any informational advantages.

Key Words: GARCH, time varying coefficients, multinomial logit

JEL Codes: C22, G17.

1. Introduction

The GARCH methodology, by Engle (1982) and Bollerslev (1986), has been pivotal in modelling volatility ever since its introduction. It has proven its value in a number of fields, such as Value-at-Risk determination, option pricing, and, perhaps most importantly, forecasting volatility. However, one of the points of critique to the original model is its impossibility to take structural changes into account (see Diebold, 1986; Lamoureux and Lastrapes, 1990). The high persistence in the volatility process (i.e., the sum of the α and β coefficients in the original model, which is often found to be close to, but smaller than, one), may be caused by the misspecification induced by this lack of flexibility. In reaction to this critique, several authors have proposed to introduce time variation in the GARCH coefficients. This time variation is often modelled in terms of smooth transition models (Luukkonen et al., 1988) or regime switching models (see Schwert, 1989; Hamilton and Susmel, 1994; Cai, 1994; Gray, 1996).

Such models typically perform better than the standard GARCH models, both in-sample (see e.g. Gray, 1996 for an application to short-term interest rates) and out-of-sample (see e.g. Klaassen, 2002, for an application to exchange rates). However, regime switching GARCH models often require a considerable number of extra parameters and are often difficult to trace computationally. In addition, the method is purely descriptive in the sense that the regime switching probabilities do not have any intuitive foundation. In this paper we propose a parsimonious model that still allows for time variation in the coefficients of the persistence and shock terms. By imposing a certain structure to the time variation, the results become intuitively interpretable.

In this paper we introduce time variation in the coefficients of a standard GARCH(1, 1) model using a multinomial switching mechanism, as often used in the heterogeneous agents literature (see Brock and Hommes, 1997, 1998), which is basically a generalization of the smooth transition autoregressive models (see Van Dijk et al. (2002) for an overview). This switching mechanism assigns weights on a one-on-one basis (i.e., the sum of the two weights is equal to one) between the autoregressive part and the shock term in the GARCH specification. The distribution of weights on the two parts of the GARCH model is dependent on their respective ability

to predict a given benchmark volatility in a certain period. For this reason we term our specification the volatility targeting-GARCH, or VT-GARCH. Depending on the forecast performance of either the persistence term or the shock term, more weight is assigned to either persistence or shock term.

By doing so, we introduce a considerable amount of flexibility to the standard GARCH specification by introducing only one additional parameter. The one-on-one characteristic of the weights is particularly attractive because it, besides from being simplifying, embeds the typical characteristics of market volatility. It is well known that volatility is highly persistent, and thus that the driver of volatility is persistent. As such, if the auto-regressive (or shock) term of the GARCH specification does particularly well in describing the benchmark in a certain period, it is expected to do so as well in the next period and therefore the weight attached to it is increased. Our proposed setup introduces more volatility in volatility, which has proven to be of great importance in, e.g., the option pricing literature; see Christoffersen and Jacobs (2004).

We apply our model empirically to the 30 stocks in the Dow Jones Industrial Average for the period January 1996 to April 2007, where we use the realized variance (RV) as proposed by Andersen et al. (2003) as the benchmark volatility. Using our model we find significant switching between persistence and shock term, and our model compares favourably to a standard GARCH model and can better capture the kurtosis and skewness observed in stock returns. Out-of-sample we find that our model outperforms various alternative specifications, including a regime-switching GARCH and a GARCH with RV as an exogenous factor. In addition we find that most of the improvement over the GARCH with RV is obtained for volatile stocks.

The remainder of this paper is structured as follows. In Section 2, we describe our model. Section 3 introduces the data and Section 4 presents our results. Finally, Section 5 concludes.

2. The Econometric Model

The motivation for the development of our model stems from the fact that standard GARCH models cannot deal with structural breaks or time variation in the GARCH-coefficients (Lamoureux and Lastrapes, 1990). To deal with time-variation in these parameters several authors have proposed regime switching models (e.g. Cai, 1994; Hamilton and Susmel, 1994; Gray, 1996; and Klaassen, 2002). However, while these regime switching models generally perform better than standard GARCH models, the introduction of this time variation seems to be driven by empirical observation, rather than by economic rationale. In addition, regime switching GARCH models introduce a substantial number of extra parameters making estimation tedious.

The purpose of this section is to introduce a GARCH-model that allows for time variation in parameters, but does so in a parsimonious way. The specification of this GARCH-model is based on the heterogeneous agents literature where agents (traders) maximize a certain objective function and switch between different trading rules to achieve this. We apply this rationale to describe the volatility process in the following way. Each day risk managers try to make accurate forecasts of future volatility. To measure their forecasting performance they use a certain benchmark and evaluate their forecasting skills using their forecast error. Given their past forecasting performance they may change the weights they give to certain forecasting rules. It is this changing in the weights that we use to describe the volatility process.

Specifically we consider the following GARCH-type model

$$\begin{aligned} r_t &= \mu + \sqrt{h_t} \varepsilon_t, \quad \varepsilon_t \sim N(0,1), \\ h_t &= \omega + w_t \beta h_{t-1} + (1 - w_t) \left(\alpha \left(\sqrt{h_{t-1}} \varepsilon_{t-1} \right)^2 \right), \end{aligned} \tag{1}$$

where r_t is the daily (log-) return of a stock price and h_t describes the conditional variance of the return process. In this model β is the persistence parameter and α measures the impact of news shocks. Risk managers, when making forecasts of volatility, are assumed to use such GARCH model, but can change the weights, w_t , they attach to either the persistence parameter or the shock parameter. This w_t

introduces time variation into the model, and it is easily seen that when w_t is constant, Equation (1) reduces to a standard GARCH model.

The weights in Equation (1) given to the persistence parameter and the shock terms depend on the relative forecasting performance of the persistence in volatility and the shock terms. We therefore define w_t in the following way, as in Brock and Hommes (1998),

$$\begin{aligned} w_t &= \frac{\exp\{\gamma\pi_{2t}\}}{\exp\{\gamma\pi_{1t}\} + \exp\{\gamma\pi_{2t}\}} = (1 + \exp\{\gamma(\pi_{2t} - \pi_{1t})\})^{-1}, \\ \pi_{1t} &= \left| \alpha \left(\sqrt{h_{t-2}} \varepsilon_{t-2} \right)^2 - RV_{t-1} \right|, \\ \pi_{2t} &= |\beta h_{t-2} - RV_{t-1}|. \end{aligned} \quad (2)$$

The weight, w_t , is bounded between zero and one and is a function of the performance of a forecasting rule that only considers shock terms, and a forecasting rule that is a function of the persistence term. To measure the relative performance of the forecasting rules, we need to introduce a benchmark. In this case we use the Realized Variance (RV) (see e.g. Andersen et al., 2002) as a benchmark to evaluate the forecasting performance. Furthermore, we consider absolute deviation from this benchmark as the main evaluation criterion¹. The term, π_{1t} , considers the performance of the forecasting rule based on shock terms in forecasting RV, whereas the term π_{2t} considers the performance forecasting rule based on the persistence term in forecasting RV.

The γ -parameter, known in the heterogeneous agents literature as the intensity of choice parameter, measures the sensitivity of the switching process. The higher the (absolute) value of γ , the more weights will change in response to a difference between π_{1t} and π_{2t} . If $\gamma = 0$, w_t will be equal to $\frac{1}{2}$ and constant through time and Equation (1) reduces to a standard GARCH(1, 1). The other extreme, when $\gamma \rightarrow \pm\infty$, implies that weights are infinitely sensitive to the performance of the two forecasting rules and w_t will jump between zero and one. Generally, we expect $\gamma < 0$, which implies a positive feedback rule from the forecasting performance to the weights attached to each forecasting rule, i.e. if the volatility of the market is better forecasted

¹ Results are not qualitatively different when applying other functional forms as evaluation criterion.

using the rule based on the shock terms, then that rule receives more weight in the subsequent period and vice versa. As such, volatility clusters or stable periods can be reinforced not only by the persistence in the GARCH process, but also by the increase or decrease in weight on the different elements of the model. Therefore, both upper and lower extremes in market volatility can be described more accurately compared to a normal GARCH; the volatility of volatility increases.

The model proposed above is a specific version of a regime-switching GARCH model. Although it is not possible to rewrite Equations (1) and (2) into a specific and restricted version of a regime-switching GARCH (e.g. as a Generalized Regime Switching (GRS) model as proposed by Gray, 1996), we can show the analogy with a GRS-GARCH. The GRS-GARCH where switching only occurs in the second moment and where the regimes follow a first-order Markov process is defined as follows,

$$\begin{aligned}
 h_t &= p_{1t}h_{1t} + (1 - p_{1t})h_{2t}, \\
 p_{1t} &= (1 - Q) \left[\frac{g_{2t-1}(1 - p_{1t})}{g_{1t-1}p_{1t-1} + g_{2t-1}(1 - p_{1t})} \right] + P \left[\frac{g_{1t-1}p_{1t}}{g_{1t-1}p_{1t-1} + g_{2t-1}(1 - p_{1t})} \right], \\
 g_{it-1} &= f(r_t | S_t = i).
 \end{aligned} \tag{3}$$

3. Data and Methodology

The model outlined above is estimated and evaluated using daily data from the 30 individual stocks in the Dow Jones Industrial Average (DJIA). The sample covers January 1996 to April 2007, which corresponds to 2820 trading days. Stock prices are taken from Thompson Financial Datastream, where we obtain open and closing prices for the 30 stocks in the sample. Returns are calculated by $r_t = \log(p_{close}) - \log(p_{open})$. We step aside from the standard daily log-changes in returns because of the calculation of RV. The RV measure, which is based on intraday prices, only takes into account the volatility during trading hours and not the overnight period. Therefore, to match the return data with the RV data, one can either rescale the RV,² or focus on behaviour during trading hours only. The latter is chosen, as it does not make any assumptions on the relation between volatility during trading hours and non-trading

²Thus assuming a constant correlation between trading-hours volatility and overnight volatility.

hours. Table 1 provides descriptive statistics for return series of the stocks in the sample.

INSERT TABLE 1 HERE

The realized variances are computed following Andersen et al. (2002). To compute realized variances we need high-frequency intraday data. We obtain intraday data for the various stocks from the Taqtic database by Sirca.³ This database contains intraday data, which is provided by Reuters, for many stock markets around the world. Intraday data contain time of the trade recorded at one thousandth of a second, and the traded price (and many other details, which we do not exploit in this paper). Following Andersen et al. (2002) we compute the realized variance as the sum of squared intraday returns, where we aggregate returns to five-minute intervals, i.e.

$$RV_t = \sum_{j=1}^J r_{t,j}^2, \quad (4)$$

where $r_{t,j}$ is the intraday return on day t for interval j . When forming the RV, there is a trade-off between accuracy (the intra-day squared returns are equal to the actual volatility when the frequency goes to infinity, see Andersen et al., 2002), and microstructure noise at high frequencies (bid-ask bounce and other microstructure effects). We have chosen to use 5-minute returns, in line with Andersen et al. (2002) as a reasonable trade-off between microstructure noise and accuracy. We report average annualized realized volatilities, i.e. $\sqrt{255 * RV_t}$, in the last column of Table 1.

The model outlined in Section 2 is estimated using quasi-maximum likelihood. As a result of the non-linear structure of the switching mechanism, estimation results of this type of setup have proven to be (highly) sensitive to starting values of the coefficients, as the optimization procedure tends to get stuck in a local minimum (see Winker and Gilli, 2001, 2004). To circumvent this problem, the model was first estimated with constant weights (i.e., $w_{i,t}=1/2$) to obtain starting values for the setup with switching mechanism. The starting values for γ were obtained by an extensive

³Securities Industry Research Centre of Asia-Pacific.

grid-search over the parameter space, using the likelihood as criterion. In the end, results appeared to be relatively insensitive to changes in starting values.

The performance of the VT-GARCH is contrasted to that of the normal GARCH and the regime switching setup as outlined in Section 2, i.e. the GRS-GRACH. In order to control for the information advantage the VT-GARCH might have relative to the normal GARCH because of the use of an exogenous variable, i.e. the benchmark volatility RV, the model is also compared to a setup in which RV is directly added in the variance equation. The resulting variance equation of the GARCH-RV model reads

$$h_t = \omega + \beta h_{t-1} + \alpha_1 \left(\sqrt{h_{t-1}} \varepsilon_{t-1} \right)^2 + \alpha_2 RV_{t-1}, \quad (1')$$

while the VT-GARCH-RV model is given by

$$h_t = \omega + w_t \beta h_{t-1} + (1 - w_t) \left(\alpha_1 \left(\sqrt{h_{t-1}} \varepsilon_{t-1} \right)^2 + \alpha_2 RV_{t-1} \right) \quad (1'')$$

4. Results

The results section is split up into three parts. First of all the (in-sample) estimation results are presented, including a comparison of our model with a number of alternative setups. Second, in order to gain some more insights into the working of the model, a close-up of one of the stocks is presented. The third sub-section looks into the out-of-sample results.

4.1 In-sample Estimation Results

Table 2 presents the estimation results of empirical model formed by Equations (1) and (2) estimated for the thirty DJIA stocks.

INSERT TABLE 2 HERE

The estimated coefficients ω , α , and β are basically comparable to the standard GARCH coefficients as known from the literature (note that α and β should be divided

by two to make them directly comparable to standard coefficients, because $w_{i,t}$ is, approximately, centred around one half). The intercept, ω , is usually not significantly different from zero; the α -coefficient is in the proximity of 0.10 and the β -coefficient is close to two and highly significant.

Concerning the switching function, we find that the sensitivity parameter γ is negative for all stocks. This implies that there is indeed a positive feedback rule, i.e., the element of the GARCH equation that is closest to the benchmark volatility in period t , will receive more weight in period $t+1$. Furthermore, γ is highly significant for all stocks, which serves as a first indication of the fact that adding this flexibility to the GARCH is beneficial to the in-sample fit.

INSERT TABLE 3 HERE

The likelihoods of a number of relevant alternative GARCH setups are given in Table 3. First of all, the VT-GARCH outperforms the standard GARCH(1,1) in terms of the average, minimum and maximum log-likelihood. This result holds for all thirty stocks. The average log-likelihood of the GRS-GARCH is slightly higher than the VT-GARCH, but both the minimum and maximum values favour the VT-GARCH setup. In other words, although the mean is somewhat better, the spread around this mean is much wider for the regime switching setup. Note, also, that the GRS-GARCH uses six additional coefficients. The GARCH-RV shows a better in-sample fit than the VT-GARCH in terms of the log-likelihood. However, after introducing time varying weights to this setup, as in Equation (1''), the VT-GARCH-RV is again outperforming. Generally, we can conclude that the VT-GARCH is consistently outperforming the alternative setups in specifications that are directly comparable to each other.

INSERT TABLE 4 HERE

Table 4 corroborates Table 3 by providing descriptive statistics for the normalized returns, i.e. ε_t . For all statistics given in the table, the VT-GARCH brings the statistics

closer to normality compared to the GARCH(1,1)⁴. The same holds for the autocorrelation pattern in the squared normalized returns, as presented in Panel B; probabilities for the VT-GARCH are consistently and considerably higher.

4.2 A Specific Example: IBM

INSERT FIGURE 1 HERE

Figure 1 illustrates the behaviour of our model for the case of one typical stock, namely IBM. Plot A displays the effect that introducing the switching process has on the volatility process by illustrating the volatility process induced by the VT-GARCH (lower line) and the difference with the GARCH(1,1) (upper line). Clearly, the introduction of time varying gives much more flexibility to the volatility process. Comparing the orders of magnitude, it comes forward that the maxima (minima) are up to 50% higher (lower) for the VT-GARCH relative to the GARCH(1,1). This comes forward especially between periods 1000 and 1500, where the volatility from the VT-GARCH much higher than of the GARCH(1,1). Differences between the two volatility processes are especially pronounced during periods of large changes in volatility.

Plot B displays the weights w_t and the volatility h_t . Changes in weight coincide with changes in volatility. This can be explained by the fact that as volatility itself is volatile; the element that describes the benchmark volatility best is also more likely to change through time. In the final part of the sample, where volatility itself is hardly changing, weights also stabilize around one half.

Plot C illustrates in more detail where the differences between the VT-GARCH and the GARCH(1,1) exactly take place. The scatter of the two conditional volatilities clearly diverges as the volatility increases. That is, the differences between the two models especially occur when volatility is high, which coincides with periods in which volatility in volatility is high.

⁴ In fact, results are somewhat distorted due to a small number of extreme outliers. The descriptives of normalized returns for some stocks are extremely affected by individual observations. Without these observations, the VT-GARCH comes out stronger.

Plot D, finally, confirms the results from the tail estimates in Table 4. The QQ-plots indicate that the VT-GARCH normalizes the extreme values in the returns of stocks to a considerably larger extent relative to the GARCH(1,1) model.

4.3 Out-of-Sample Results

Next to the in-sample performance of our proposed model, the out-of-sample properties are considered. This is done by applying the following methodology. First, the models are estimated for the first 1400 days, i.e., half of the sample, and subsequently one-period forecasts are made for the remaining 1420 days. The stocks Verizon (VZ) and Exxon Mobile (XOM) are not included in the analysis because of lack of data⁵. Tables 5 reports the mean forecast error (ME); mean squared error (MSE); root mean squared error (RMSE); mean absolute error (MAE); mean absolute percentage error (MAPE); heteroskedasticity adjusted mean squared error (HMSE); and the R^2 of the regression given by $\log RV_t = \alpha + \beta \log E_{t-1}(h_t) + \varepsilon_t$.

INSERT TABLE 5 HERE

For generally all forecasting performance measures, the ranking is the same. The VT-GARCH comes out first, followed by the GARCH-RV, the GRS-GARCH, and the GARCH(1,1). The one exception to this pattern is given in Panel F, the HMSE. Here, the VT-GARCH performs worst. Note, however, that a large part of this result is driven by an outlier; the maximum value of the VT-GARCH is more than twice as large as the second worst model, the GARCH-RV.

INSERT TABLE 6 HERE

Table 6, finally, provides evidence of the fact that the VT-GARCH model is especially useful in high volatile regimes. In times of high volatility, and high volatility of volatility, one would expect that the changing weights provide their biggest advantage as it is especially in risky situations where the extra flexibility is granted. The reinforcement of the persistence in variance by means of changing weights is particularly beneficial as there is ample change in the behaviour of volatility.

⁵ Both were introduced in the DJIA after 1996.

Table 6 presents the cross-sectional correlations between the differences in forecasting performance of the VT-GARCH model versus the second best, the GARCH-RV model. As it turns out, one can observe a clear pattern in the correlations. For the forecast error measures, apart from the ME, there is a strong negative correlation. That is, the higher the (unconditional) volatility in the stock, the better the forecasting performance of the VT-GARCH vis-à-vis the GARCH-RV. The correlation is positive for the R^2 , as the fit is a positive measure of forecasting ability while the forecasting error is a negative measure. The exception to this rule is the mean error ME. This can be explained by the fact that typical patterns tend to be eliminated as positive and negative values are levelled out.

5. Conclusion

The Nobel-price winning GARCH methodology has seen a large number of extensions. Of particular interest is the introduction of time varying coefficients, which serves as a methodology of curbing the (excessive) persistence of volatility in financial market returns. Typically, this time variation is introduced by means of purely statistical processes, such as a regime switching approach. Alternatively, GARCH models are introduced that mix a fast with a slow moving process.

In this paper, we introduce a parsimonious methodology of time variation in the coefficients to introduce more flexibility and dynamics into the conditional volatility model. We, basically, propose a methodology that enforces the typical characteristics of a standard GARCH. To be more specific, we introduce time varying weights on the persistence and shock coefficients. The weights move according to a multinomial logit process that gives more importance to the factor, i.e. persistence or shock, which better predicted benchmark volatility in the previous period. As such, we refer to the volatility targeting or VT-GARCH model.

Estimation of the model on the thirty individual stocks in the Dow Jones Industrial Average, it is shown that the VT-GARCH model outperforms alternative setups. Using only one additional parameter, the model proves to be better in both in-sample

and out-of-sample tests. In-sample, we find increased likelihood values, and normalized returns that are considerably closer to being Gaussian relative to normalized returns from alternative models. Out-of-sample, using a broad range of forecasting performance measures, the VT-GARCH comfortably outperforms a number of alternative models, including a regime switching GARCH and controlling for potential information advantages. Furthermore, the model proves to be particularly useful in times of high volatility, or high volatility in volatility.

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Tables & Figures

Table 1: Descriptive Statistics Returns

	Mean	Max	Min	St.Dev	Skew	Kurt	Q-ac	Q-ac ²	RV
AA	0.034	8.338	-13.286	1.908	-0.421	5.566	3.731	21.14	0.273
AIG	0.005	10.436	-10.713	1.619	-0.092	6.739	3.688	91.83	0.224
AXP	-0.018	12.063	-9.883	1.828	0.013	6.103	0.339	79.62	0.257
BA	-0.022	10.739	-10.276	1.73	-0.009	6.095	1.362	150.12	0.256
CAT	0.021	7.85	-9.97	1.799	-0.11	5.05	0.089	72.9	0.26
C	0.031	13.005	-15.861	1.824	-0.281	8.605	9.297	320.94	0.263
DD	-0.019	9.465	-10.561	1.658	-0.275	6.155	0.002	80.82	0.249
DIS	-0.018	11.804	-9.304	1.75	-0.045	5.69	1.685	70.28	0.27
GE	-0.018	8.38	-11.123	1.59	-0.257	6.769	0.07	101.43	0.228
GME	0.122	8.279	-7.974	1.86	-0.131	4.561	0.032	93.57	0.253
HD	0.008	11.303	-12.128	1.861	-0.176	5.985	0.879	89.04	0.27
HON	0.012	19.839	-14.91	1.957	0.209	11.383	0.002	94.89	0.269
HPQ	-0.075	12.995	-15.887	2.3	-0.185	6.19	1.159	12.09	0.321
IBM	-0.034	10.37	-12.209	1.702	-0.107	7.103	9.242	58.26	0.231
INTC	0.051	12.063	-20.493	2.36	-0.279	6.857	20.57	69.46	0.333
JNJ	-0.028	7.411	-7.711	1.313	-0.181	5.301	0.855	113.37	0.202
JPM	-0.034	16.364	-24.429	1.97	-0.949	16.706	6.586	268.62	0.254
KO	-0.074	11.158	-9.175	1.41	-0.104	7.378	0.342	41.73	0.215
MCD	-0.077	11.431	-14.284	1.621	-0.108	9.042	1.624	46.22	0.25
MMM	-0.013	7.045	-8.38	1.398	-0.131	5.83	0.022	33.11	0.213
MO	0.013	14.714	-12.027	1.772	0.503	11.671	1.362	88.31	0.241
MRK	-0.053	11.166	-9.347	1.591	0.142	6.879	0.525	39.37	0.227
MSFT	-0.022	8.907	-11.011	1.863	-0.199	5.272	10.16	164.51	0.266
PFE	0.01	8.829	-10.341	1.735	-0.126	5.277	0.957	43.97	0.246
PG	-0.13	9.237	-10.516	1.416	0.011	8.353	23.18	235.12	0.212
T	-0.015	6.881	-10.752	1.74	-0.213	5.24	0.41	67.23	0.265
UTX	0.022	16.462	-7.339	1.621	0.468	8.918	0.356	19.29	0.237
VZ	-0.021	6.312	-8.545	1.571	-0.494	5.801	0.335	65.8	0.227
WMT	0.017	8.719	-12.915	1.743	-0.226	6.444	3.051	53.63	0.262
XOM	-0.022	6.8	-11.605	1.359	-0.34	7.8	2.536	12.28	0.202

Table 2: VT-GARCH In-Sample Estimation Results

	ω	α	β	γ	LogL
AA	0.000 (0.000)	0.038 ^a (2.707)	1.977 ^a (103.39)	-0.540 ^a (-5.298)	7371.21
AIG	0.000 (0.158)	0.118 ^a (6.699)	1.919 ^a (103.27)	-1.582 ^a (-5.657)	7987.07
AXP	0.000 (0.546)	0.116 ^a (5.844)	1.913 ^a (87.06)	-1.760 ^a (-5.668)	7736.27
BA	0.000 (0.165)	0.125 ^a (5.788)	1.928 ^a (62.39)	-2.908 ^a (-8.707)	7684.10
CAT	0.000 (0.000)	0.077 ^a (3.750)	1.994 ^a (40.50)	-3.075 ^a (-7.069)	7524.73
CG	0.002 ^a (2.601)	0.226 ^a (10.98)	1.796 ^a (77.36)	-1.897 ^a (-7.046)	7732.54
DD	0.000 (0.318)	0.028 (1.605)	1.975 ^a (72.30)	-3.009 ^a (-7.089)	7874.95
DIS	0.005 ^a (3.001)	0.098 ^a (6.547)	1.848 ^a (62.12)	-2.400 ^a (-9.682)	7708.95
GE	0.000 (0.000)	0.099 ^a (6.270)	1.925 ^a (101.90)	-2.380 ^a (-8.276)	8104.97
GME	0.000 (0.000)	0.112 ^a (5.218)	1.978 ^a (40.93)	-2.007 ^a (-6.717)	7408.33
HD	0.000 (0.000)	-0.001 (-0.066)	2.017 ^a (99.66)	-1.757 ^a (-14.57)	7564.62
HON	0.000 (0.000)	0.208 ^a (15.89)	1.858 ^a (86.39)	-1.505 ^a (-11.93)	7479.15
HPQ	0.000 (0.000)	0.066 ^a (3.156)	2.012 ^a (48.57)	-1.989 ^a (-12.24)	6910.04
IBM	0.000 (0.000)	0.114 ^a (7.145)	1.933 ^a (84.11)	-2.076 ^a (-6.037)	7905.70
INTC	0.000 (0.000)	0.098 ^a (4.628)	1.961 ^a (54.41)	-1.293 ^a (-9.294)	6892.63
JNJ	0.001 ^a (2.883)	0.122 ^a (5.596)	1.866 ^a (76.90)	-4.031 ^a (-10.69)	8526.75
JPM	0.000 (0.000)	0.143 ^a (9.618)	1.903 ^a (99.00)	-1.597 ^a (-7.814)	7660.35
KO	0.001 (1.304)	0.113 ^a (5.551)	1.885 ^a (73.47)	-5.896 ^a (-11.02)	8421.69
MCD	0.001 (0.515)	0.093 ^a (6.175)	1.939 ^a (71.58)	-4.488 ^a (-11.42)	7831.25
MMM	0.000 (0.000)	0.050 ^a (2.550)	1.982 ^a (60.69)	-4.187 ^a (-9.140)	8268.82
MO	0.000 (0.000)	0.141 ^a (8.023)	1.956 ^a (78.43)	-2.376 ^a (-11.00)	7701.09
MRK	0.000 (0.070)	0.050 ^a (2.712)	2.072 ^a (43.69)	-3.865 ^a (-10.35)	7798.36
MSFT	0.000 (0.000)	0.152 ^a (5.542)	1.923 ^a (57.76)	-3.141 ^a (-9.380)	7654.91
PFE	0.000 (0.000)	0.119 ^a (5.456)	1.964 ^a (46.48)	-3.183 ^a (-7.911)	7676.86
PG	0.002 ^a (3.185)	0.051 ^a (4.353)	1.893 ^a (63.65)	-5.230 ^a (14.97)	8416.41
T	0.000 (0.731)	0.065 ^a (6.910)	1.936 ^a (210.44)	-0.148 ^a (-3.100)	7753.56
UTX	0.000 (0.000)	0.089 ^a (8.064)	1.949 ^a (82.01)	-2.421 ^a (-7.352)	7965.70
VZ	0.001 (0.641)	0.032 (1.324)	1.955 ^a (55.29)	-3.561 ^a (-9.049)	4963.98
WMT	0.000 (0.000)	0.038 (1.427)	1.993 ^a (62.47)	-3.237 ^a (-13.748)	7783.82
XOM	0.002 (1.239)	0.061 ^a (2.774)	1.919 ^a (54.77)	-2.678 ^a (-5.186)	5503.73

Notes: Table presents the estimation results of the model given by Equations (1) and (2). Standard errors in parentheses; ^a Significant at 1%

Table 3: In-sample fit of VT-GARCH compared with other specifications

	Average(LogL)	Min(LogL)	Max(LogL)
VT-GARCH	7593.67	4963.98	8526.75
GARCH(1,1)	7555.98	4946.37	8485.27
GRS-GARCH	7598.05	4946.49	8514.69
GARCH-RV	7598.50	4973.44	8532.32
VT-GARCH-RV	7602.75	4973.52	8533.89

Notes: Table presents the average, minimum, and maximum log-likelihood of the in-sample estimation of the different setups over the 30 individual stocks.

Table 4: Properties of the VT-GARCH

Panel A: Descriptive statistics normalized returns (averages)				
		Raw Returns	GARCH(1,1)	VT-GARCH
Maximum		6.7404	5.4955	5.2776
Minimum		-6.1544	-6.0603	-5.8186
Skewness		0.1364	-0.0166	-0.0157
Kurtosis		7.1584	5.3660	5.1057
Jarque-Bera		2732.37	1201.06	1078.27
L Tail Index	1%	4.727	5.010	4.791
	5%	3.148	3.613	3.768
R Tail Index	1%	4.121	4.680	5.294
	5%	3.087	3.671	3.757

Panel B: Auto-correlation squared normalized returns (averages)							
		Raw Returns		GARCH(1,1)		VT-GARCH	
lag	AC	Prob	AC	Prob	AC	Prob	
1	0.1695	0.0000	0.0401	0.1673	0.0246	0.2982	
2	0.1217	0.0000	0.0144	0.2004	-0.0003	0.3920	
3	0.1116	0.0000	-0.0008	0.2337	-0.0080	0.4209	
4	0.0910	0.0000	-0.0041	0.2663	-0.0062	0.4468	
5	0.0897	0.0000	-0.0053	0.2965	-0.0083	0.4709	

Notes: Table presents descriptive statistics of the normalized returns, i.e. ε_t , averaged over the thirty stocks. AC denotes auto-correlation.

Table 5: Forecasting Performance of Various Specifications

Panel A: ME ($\times 10^5$)				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	3.007	6.052	3.920	5.220
Median	2.615	4.820	3.150	3.837
Min	-10.100	-1.610	-2.400	-3.607
Max	10.100	16.600	11.700	17.871
Panel B: MSE ($\times 10^8$)				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	7.606	9.341	7.964	8.415
Median	4.680	6.430	4.900	5.546
Min	0.563	1.020	0.618	1.696
Max	25.800	31.300	29.900	29.675
Panel C: RMSE ($\times 10^3$)				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	0.253	0.284	0.257	0.269
Median	0.217	0.254	0.222	0.235
Min	0.075	0.101	0.079	0.130
Max	0.508	0.559	0.547	0.545
Panel D: MAE ($\times 10^3$)				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	0.121	0.151	0.123	0.140
Median	0.113	0.145	0.111	0.131
Min	0.046	0.079	0.052	0.080
Max	0.234	0.259	0.232	0.295
Panel E: MAPE				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	0.999	1.383	1.006	1.272
Median	0.815	1.284	0.869	0.929
Min	0.500	0.581	0.412	0.581
Max	2.365	3.404	2.471	2.885
Panel F: HMSE				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	0.806	0.636	0.599	0.478
Median	0.438	0.472	0.407	0.410
Min	0.240	0.348	0.231	0.261
Max	5.249	1.561	2.582	1.268
Panel G: R^2				
	VT-GARCH	GARCH	GARCH-RV	GRS-GARCH
Mean	0.584	0.479	0.579	0.534
Median	0.588	0.504	0.599	0.560
Min	0.367	0.217	0.334	0.241
Max	0.742	0.693	0.764	0.741

Notes: Table presents the forecasting performance of different model setups measured by the mean forecast error (ME); mean squared error (MSE); root mean squared error (RMSE); mean absolute error (MAE); mean absolute percentage error (MAPE); heteroskedasticity adjusted mean squared error (HMSE); and the R^2 of the regression given by $\log RV_t = \alpha + \beta \log E_{t-1}(h_t) + \varepsilon_t$.

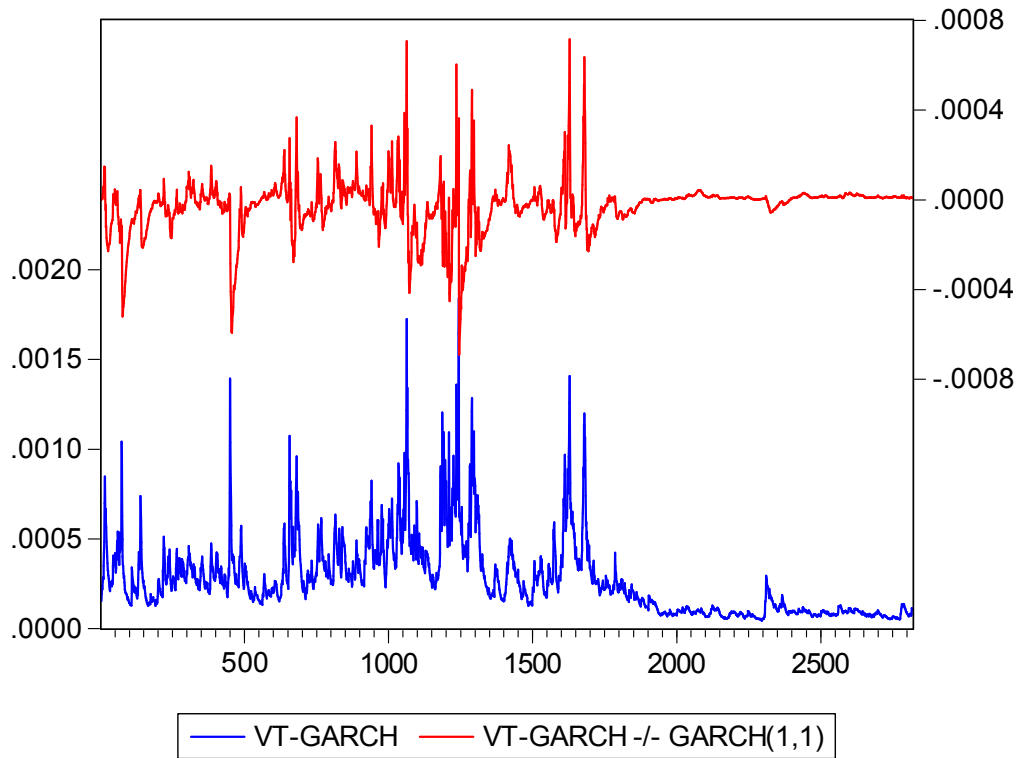
Table 6: Differences in Forecast Errors and Volatility

	R2	ME	MSE	RMSE	MAE	MAPE	HMSE
Correlation	0.1580	0.1833	-0.3881	-0.3733	-0.4373	-0.4317	-0.3465

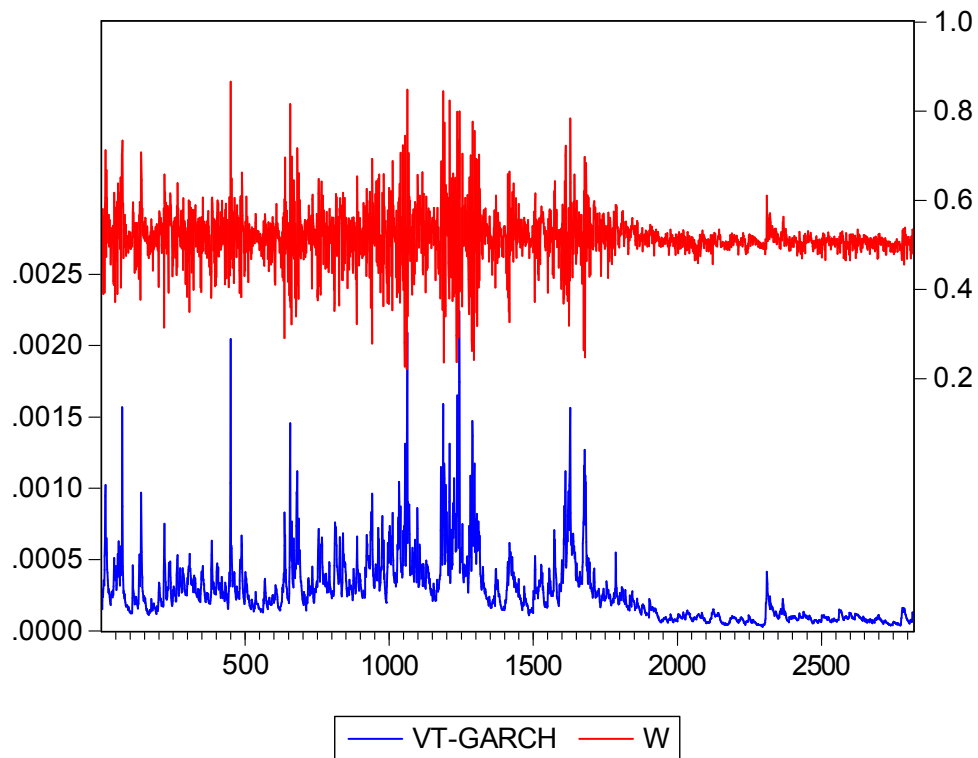
Notes: This table report the correlations between the difference between the forecast error of the VT-GARCH and the GARCH-RV, and stock price volatility.

Figure 1: Properties of the VT-GARCH model: IBM

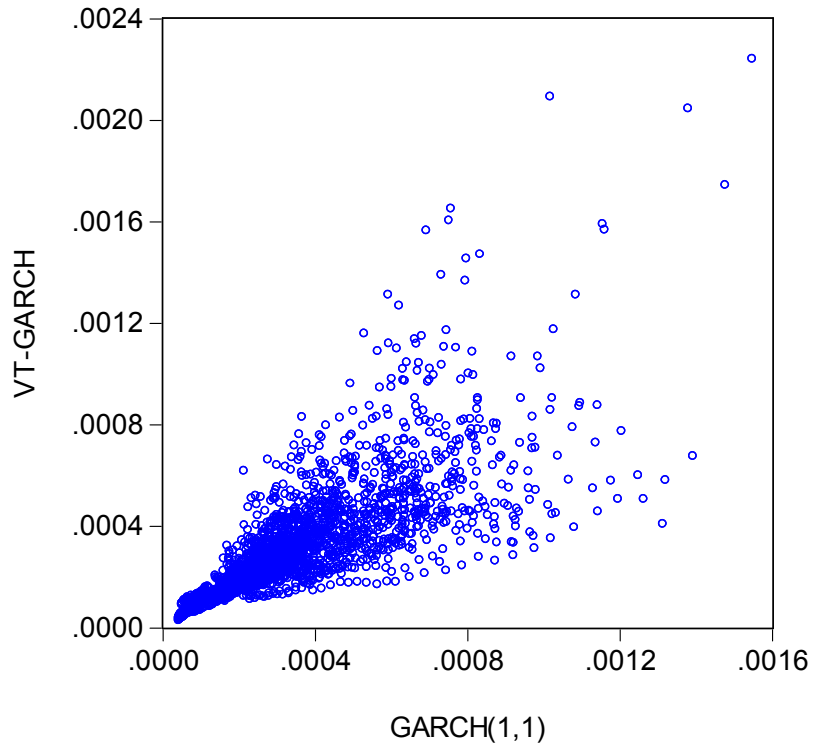
Plot A: Conditional Volatility Switching minus Static GARCH



Plot B: Weights and Conditional Volatility



Plot C: Conditional Volatility Static versus VT-GARCH



Plot D: Quantile-Quantile Plots Normalized Returns

