

Essays on Trading Strategies and Long Memory

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Abstract

Present value based asset pricing models are explored empirically in this thesis. Three contributions are made. First, it is shown that a market timing strategy may be implemented in an excessively volatile market such as the S&P500. The main premise of the strategy is that asset prices may revert to the present value over time. The present value is computed in real-time where the present value variables (future dividends, dividend growth and the discount factor) are forecast from simple models. The strategy works well for monthly data and when dividends are forecast from autoregressive models. The performance of the strategy relies on how discount rates are empirically defined. When discount rates are defined by the rolling and recursive historic average of realized returns, the strategy performs well.

The discount rate and dividend growth can also be derived using a structural approach. Using the Campbell and Shiller log-linearized present value equation, and assuming that expected and realized dividend growth are unit related, a state space model is constructed linking the price-dividend ratio to expected returns and expected dividend growth. The model parameters are estimated from the data and, are used to derive the filtered expected returns and expected dividend growth series. The present value is computed using the filtered series. The trading rule tends to perform worse in this case. Discount rates are again found to be the major determinant of its success. Although the structural approach offers a time series of discount rates which is less volatile, it is on average higher than that of the historical mean model.

The filtered expected returns is a potential predictor of realized returns. The predictive performance of expected returns is compared to that of the price-dividend ratio. It is found that expected returns is not superior to the price-dividend ratio in forecasting returns both in-sample and out-of-sample. The predictive regression included both simple Ordinary Least Squares and Vector Autoregressions.

The second contribution of this thesis is the modeling of expected returns using autoregressive fractionally integrated processes. According to the work of Granger and Joyeux(1980), aggregated series which are derived from utility maximization problems follow a Beta distribution. In the time series literature, it implies that the series may have a fractional order ($I(d)$). Autoregressive fractionally models may have better appeal than models which explicitly posit unit roots or no unit roots. Two models are presented. The first model, which incorporates an ARFIMA(p,d,q) within the present value through the state equations, is found to be highly unstable. Small sample size may be a reason for this finding. The second model involves predicting dividend growth from simple OLS models, and sequentially netting expected returns from the present value model.

Based on the previous finding that expected returns may be a long memory process, the third contribution of this thesis derives a test of long memory based on the asymptotic properties of the variance of aggregated series in the context of the Geweke Porter-Hudak (1982) semiparametric estimator. The test makes use of the fact that pure long memory process will have the same autocorrelation across observations if the observations are drawn at repeated intervals to make a new series. The test is implemented using the Sieve-AR bootstrap which accommodates long range dependence in

stochastic processes. The test is relatively powerful against both linear and nonlinear specifications in large samples.

Contents

1	Introduction	14
2	Exploiting Price Misalignments	19
2.1	Introduction	19
2.2	Related Literature	21
2.3	Model	23
2.3.1	Models for Forecasting Dividends	27
2.3.2	Stochastic Discount Rate and Dividend Growth	30
2.4	Data and Results	35
2.4.1	Data	35
2.4.2	Monthly Frequency	36
2.4.3	Annual Frequency	47
2.5	Conclusion	52
3	Trading Rule Based on Latent Variable Approach	55
3.1	Introduction	55
3.2	Literature Review	57
3.2.1	Trading Rule	57
3.2.2	Present Value	58
3.2.3	Time Varying Expected Returns and Dividend Growth	59
3.3	Methodology	60
3.3.1	Present Value Model	60

3.3.2	State Space Representation	62
3.3.3	Trading Strategy	64
3.4	Data and Results	65
3.4.1	Properties of Expected Returns and Dividend Growth	67
3.4.2	Trading Rule Returns	69
3.4.3	Tests on the Trading Strategy	71
3.4.4	Robustness of the Rule	72
3.5	Conclusion	76
4	Predictive Ability of Expected Returns	78
4.1	Introduction	78
4.2	Literature review	79
4.3	Methodology	81
4.3.1	State Space Representation	81
4.3.2	Predictive Accuracy	83
4.3.3	Stambaugh Bias	85
4.4	Results	86
4.4.1	Statistical Properties of Expected Returns and Growth	87
4.4.2	Predictive Accuracy	88
4.4.3	Out-of-Sample Forecast	90
4.4.4	VAR models	94
4.5	Economic Value of Return Predictability	99
4.6	Conclusion	100
5	Modeling the Persistence in Expected Returns	103
5.1	Introduction	103
5.2	Present Value assuming AR(1)	107
5.2.1	Time Series Properties of Latent and Mea- sured Variables	109

5.3	Present Value assuming an ARFIMA(p, d, q)	113
5.3.1	Autoregressive Approximation to the ARFIMA(p, d, q)	115
5.4	Two Step Present Value Model	121
5.4.1	Time Variation in κ, ρ and C_1	123
5.5	Results	124
5.5.1	Data	124
5.5.2	Optimization of State Space Models	124
5.5.3	Applications	131
5.6	2 Step Model Estimation Results	139
5.7	Conclusion	145
6	Test of Long Memory based on Self-Similarity	147
6.1	Introduction	147
6.2	Long Memory	149
6.3	Aliasing	153
6.4	The test	155
6.5	Bias Correction	157
6.6	Asymptotic distribution of the statistic	160
6.7	Properties under the alternative hypothesis	162
6.8	Monte Carlo Experiments	165
6.9	Application	173
6.9.1	Individual Stock Prices	174
6.9.2	Expected Returns	174
6.10	Conclusion	177
7	Conclusion	179
	References	185

A Essays in Asset Pricing	196
A.1 Appendix 1	196
A.1.1 Holding Return	197
A.1.2 Graphical Plots of Accumulated Wealth	199
A.1.3 Test of Correlated Means	203
A.1.4 Sweeney X Statistic	205
A.1.5 Switching	208
A.1.6 Tests on Forecasting Accuracy	209
A.1.7 Summary Statistics	213
A.1.8 Simulation Results	214
A.1.9 Rolling and Recursive Tests of Stationarity	218
A.2 Appendix 2	222
A.2.1 The Present Value Model.	222
A.2.2 State Space Model assuming AR(1)	223
A.2.3 Other Statistical results	225
A.2.4 Plot of Trading Rule Returns and Probability Distribution of Relative Prices	228
A.3 Appendix 3	231
A.3.1 Monte Carlo Experiment on Truncation lags	231
A.3.2 Summary Statistics	232
A.3.3 Expected Returns	235
A.3.4 Expected Dividend (Earnings) Growth	239
A.3.5 Correlation over time	241
A.3.6 Monte Carlo Experiment	242
A.3.7 Univariate Models	243
A.3.8 κ_t from 2 stage Model	248
A.3.9 Expected Return	249
A.3.10 Dividend and Earnings growth	252
A.3.11 Plot of Trading Returns	256
A.4 Appendix 4	260
A.4.1 Proof of Proposition 1	260

A.4.2 Proof of Proposition 3	260
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List of Tables

2.1	Annual rates of Return.	36
2.2	Difference in Means for Sharpe Ratio.	43
2.3	Sweeney Statistic for Trading Strategy.	44
2.4	Annual rates of Return with transaction costs of 0.5.	45
2.5	Accumulated Wealth for Annual Data	48
3.1	Optimization of Present Value Model.	66
3.2	Summary Statistics for Expected and Realized series.	68
3.3	Cumulated Returns over Horizons.	72
3.4	Test of Correlated Means.	73
3.5	Replacement Sampling	75
4.1	Estimation of State Space Parameters.	87
4.2	In-sample Predictability of Expected Returns.	89
4.3	In-sample Predictability of Price-dividend ratio.	89
4.4	Out of sample Mean Squared Error for Expected Returns.	91
4.5	Out of sample Mean Squared Error for Price-dividend ratio.	91
4.6	Results from VAR model with Realized and Expected Returns: Sample 1900-2008.	94
4.7	Results from VAR model with Realized Returns and Price-dividend ratio: Sample 1900-2008.	95
4.8	Recursive Mean Squared Error for Expected Returns.	97

4.9	Recursive Mean Squared Error for Price-dividend ratio.	98
4.10	Economic Value of Predictability.	100
5.1	Estimation of AR(1) and ARFIMA(1,d,0) Model for Dividend data.	125
5.2	Estimation of AR(1) and ARFIMA(1,d,0) model for Earnings data.	126
5.3	Tests of Time Variation and Persistence.	131
5.4	Goodness of Fit for Returns Equation.	133
5.5	Goodness of Fit for Dividend(Earnings) Growth Equa- tion.	133
5.6	Success Rate of Trading Strategy.	138
5.7	Summary Statistics of Dividends and Earnings Growth.	140
5.8	Summary Statistics of Expected Returns.	140
5.9	Regression Results for AR(1) and ARFIMA (0,d,0) Specification using Dividend Growth.	142
5.10	Regression Results for AR(1) and ARFIMA (0,d,0) Specification using Earnings Growth	143
6.1	Pure Fractional Process.	166
6.2	ARFIMA(1,d,0) Models.	167
6.3	AR(1) Alternatives.	171
6.4	Nonlinear Dynamic Models	172
6.5	The Two-stage Test procedure, with Skip-rate $n = 8$.	173
6.6	Application to Absolute Returns	174
6.7	Application to Expected Returns.	175
A.1	Cumulated Returns (in percentage) over 5 years of Holding.	198
A.2	Tests of Correlated Means.	203
A.3	Z-score for Individual Models.	204
A.4	Sweeney Statistic assuming 5 percent Transaction cost	206
A.5	Sweeney Statistic assuming 1 percent Transaction cost	206

A.6 Sweeney Statistic assuming 2.5 percent Transaction cost	207
A.7 Equity Holding Periods.	208
A.8 Number of switches	209
A.9 Tests of Normality on Forecast Error.	210
A.10 Forecasting Ability test using Hansen’s Superior Ability test.	211
A.11 Descriptive Statistics for Dividends and Log Dividends.	213
A.12 Simulation Experiment	215
A.13 Returns on Holding Positions.	217
A.14 Tests of Stationarity	226
A.15 Correlation of Realized and Expected Dividend Growth.	227
A.16 Correlation of Realized and Expected Returns.	228
A.17 Monte Carlo experiment on Maximum Likelihood estimates of ‘d’ based on Truncated Autoregressive Models	231
A.18 Summary Statistics for Expected and Realized Returns and Expected and Realized Dividend Growth Rates: 1900-2008	232
A.19 Tests of Stationarity on Expected Returns and Expected Dividend Growth Sample 1900-2008.	233
A.20 Correlation between Expected and Realized Returns up to 5 lags.	234
A.21 Correlation between Expected and Realized Dividend Growth up to 5 lags.	235
A.22 Descriptive Statistics and Stationarity tests on the Expected Returns series for Dividend series.	236
A.23 Descriptive Statistics and Stationarity tests on the Expected Returns series for Dividend series.	237
A.24 Application to Absolute Returns	239

A.25 Descriptive Statistics and Stationarity tests on the Expected Earnings Growth rate.	240
A.26 Application to Absolute Returns	241
A.27 Correlation of Expected Returns from ARFIMA(1,d,0) specifications.	242
A.28 Monte Carlo Experiment.	243
A.29 Univariate Regressions: Expected returns using divi- dend growth specification.	244
A.30 Univariate Regressions: Expected returns using earn- ings growth specification	246
A.31 Univariate Regressions on Dividend Growth	247
A.32 Univariate Regressions on Earnings Growth	247

List of Figures

1.1	Price and Present Value of S&P500 index.	15
2.1	Accumulated Returns- Forecast Model 3a and Discount Factor A.	38
2.2	Accumulated Returns- Forecast Model 1a and Discount Factor A.	39
2.3	Accumulated Returns under Buy and Hold, Trading Strategy and Filter Rule.	49
2.4	Holding Positions for Filter Rule, Trading Model and Optimal Profit.	50
2.5	Correlation of Holding Position for Filter Rule and Forecast Model with Ideal Profit.	51
3.1	Plot of Expected and Realized Returns.	67
3.2	Plot of Expected and Realized Dividend Growth Rate.	68
3.3	Cumulated Returns from Trading Strategy.	70
3.4	Plot of Discount Rate.	76
4.1	Plot of Root Mean Squared Error for Expected Returns.	92
4.2	Plot of Root Mean Squared Error for Price-dividend ratio.	92
5.1	Impulse Response for Consumption Growth - AR(1) .	135
5.2	Impulse Response for Consumption Growth - ARFIMA(1,d,0).	135

6.1	ARFIMA (0, 0.4,0)	169
6.2	Bilinear Model	169
6.3	SETAR Model	169
6.4	Markov Switching	170
6.5	ESTAR Model	170
A.1	Cumulated Wealth from January 1901 to December 2007 for Discount Rate A and Forecast Model A	199
A.2	Cumulated Wealth from January 1901 to December 2007 for Discount Rate A and Forecast Model B.	199
A.3	Cumulated Wealth from January 1901 to December 2007 for Discount Rate B and Forecast Model A.	200
A.4	Cumulated Wealth from January 1901 to December 2007 for Discount Rate B and forecast model B.	200
A.5	Cumulated Wealth from January 1901 to December 2007 for Discount Rate C and Forecast Model A.	200
A.6	Cumulated Wealth from January 1901 to December 2007 for Discount rate C and Forecast Model B.	201
A.7	Cumulated Wealth from January 1901 to December 2007 for Discount rate D and Forecast Model A.	201
A.8	Cumulated Wealth from January 1901 to December 2007 for Discount Rate D and Forecast Model B.	201
A.9	Recursive ADF T-stat with MAIC Optimal Lag Selection for Price-dividend Ratio.	218
A.10	Rolling ADF T-stat with MAIC optimal Lag Selection	219
A.11	Recursive ADF T-stat with MAIC Optimal Lag Selection for the Price-earnings Ratio.	220
A.12	Rolling ADF T-stat with MAIC Optimal Lag Selection for Price-earnings Ratio.	220
A.13	Plot of Trading Return against Best Return.	229
A.14	Probability Distribution of P_t^*/P_t	230
A.15	Plot of κ_t for Dividend Growth from 1926-2008.	248

A.16 Plot of Kappa for Earnings Growth for 1926-2008. . .	248
A.17 Plot of Expected Returns for AR(1) and ARFIMA(1,d,0): Sample 1946-2008 using Dividend Data.	249
A.18 Plot of Expected Returns for AR(1) and ARFIMA(1,d,0) and Realized Returns for 1926-2008 using Dividend Data.	250
A.19 Plot of Expected Returns for AR(1) and ARFIMA(1,d,0): Sample 1926-2008 using Earnings Growth.	250
A.20 Plot of Expected Returns for AR(1) and ARFIMA(1,d,0): Sample 1946-2008 using Earnings Data.	251
A.21 Plot of Dividend Growth for AR(1) and ARFIMA(1,d,0): Sample 1946-2008.	252
A.22 Plot of Dividend Growth for AR(1) and ARFIMA(1,d,0): Sample 1926-2008.	253
A.23 Plot of Earnings Growth for AR(1) and ARFIMA(1,d,0): Sample 1926-2008.	253
A.24 Plot of Earnings Growth for AR(1) and ARFIMA(1,d,0): Sample 1946-2008.	254
A.25 Cumulated Returns based on the Price-dividend ra- tio: Sample 1926-2008.	256
A.26 Cumulated Returns under Price-earnings ratio 1926- 2008.	257
A.27 Cumulated Returns for the Price- dividend ratio: Sam- ple 1946-2008	257
A.28 Cumulated Returns based on the Price-earnings ratio for the sample 1926-2008.	258