Comment:

Time Series analysis of non-Gaussian observations based on state space models from both classical and Bayesian perspectives

by

R. Durbin and S.J. Koopman

ERIC JACQUIER
Boston College and CIRANO

NICHOLAS G. POLSON
University of Chicago

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The authors discuss the implementation of several time-series models, namely categorical state space, fat-tails and stochastic volatility (SVOL) models. While we are happy to see more work on these important areas, it is unclear how much this paper adds to the existing research. In particular, we are concerned about several aspects of the methodology: model specification, approximations, and the inlier problem. In addition, the paper would benefit from a comparison with the significant existing MCMC literature. For example, Carlin and Polson (1991) provide a MCMC solution for categorical state space time series models which is ignored here.

In regards to model specification, section 6.3 uses the normal error SVOL model developed in Jacquier, Polson and Rossi (1994a). Figure 6 shows normal posteriors, whereas JPR (1994a) find non-normality. JPR (1994b) provides a more flexible model, consistent with financial theory and the data. JPR (1994b) analyze the UK pound/$ exchange rate but with two extra effects 1) fat-tails (estimating $\nu$) and 2) a correlation (or leverage effect $\rho$). Consider

\begin{align*}
y_t &= \sqrt{h_t} \sqrt{\lambda_t} \epsilon_t \\
\log h_t &= \alpha + \delta \log h_{t-1} + \sigma_v v_t
\end{align*}

where $\epsilon_t$ and $v_t$ are correlated unit normals, and $\lambda_t \sim \nu/\chi^2(\nu)$, see Carlin and Polson (1991). $\rho$ is needed for financial series. It produces the leverage effect, see Black (1976). It is unclear whether the authors method apply here.

JPR (1994b) again find non-normality and $p(\nu|\text{data})$ clearly demonstrates fat-tails (see figure) for £/$. Moreover, $\rho$ is estimated precisely and away from 0 with mean -0.18. The Gaussian stochastic volatility model is clearly misspecified.
This misspecification affects predictions for individual volatilities. Consider the 1985 £/$ exchange rate. Notice the large value on August 29th. The figure compares the basic and fat-tail SVOL models where the thick line is the mean of $\sqrt{h_t}$ from the basic model until August 29th. The jagged line is the mean of $\sqrt{h_t \lambda_t}$ including fat-tails. $h_t$ (not plotted) is the lower envelope of this line. The dotted lines give predictions one would make using either model. They are very different because $h_t$ is persistent and $\lambda_t$ is not. The outlier on August 29th was captured mostly by $\lambda_t$. We need to model both $\lambda_t$ and $h_t$.

Research has shown that likelihood approximations can lead to poor performance. JPR (1994a) provide a simulation study to compare their algorithm to the method of moments and QML. These simulations show that approximations can have a disastrous effect on performance. Another area of concern is the inlier problem, which the authors are aware of, where it is unclear that “adding a small value” will help, see Nelson (1994).

We are pleased to see the authors discuss these important models but would like to see comparisons with existing strategies.

References


Fat Tail and Basic SVOL: Estimation and Smoothing, UK Pound to US Dollar

UK Pound to Dollar Exchange Rate Log-difference

Predicted standard deviations from 09/24/95

Posterior for nu

Posterior for rho