

Testing against Changing Correlation

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Abstract

A test for time-varying correlation is developed within the framework of a dynamic conditional score (DCS) model for both Gaussian and Student t -distributions. The test may be interpreted as a Lagrange multiplier test and modified to allow for the estimation of models for time-varying volatility in the individual series. Unlike standard moment-based tests, the score-based test statistic includes information on the level of correlation under the null hypothesis and local power arguments indicate the benefits of doing so. A simulation study shows that the performance of the score-based test is strong relative to existing tests across a range of data generating processes. An application

to the Hong Kong and South Korean equity markets shows that the new test reveals changes in correlation that are not detected by the standard moment-based test.

KEYWORDS: Dynamic conditional score, EGARCH, Lagrange multiplier test, Portmanteau test, Time-varying covariance matrices.

JEL classification: C12, C32, G15

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1 Introduction

The possibility that the correlations between financial assets are changing over time is an important issue in many areas of finance, such as portfolio construction and risk management; see Lumsdaine (2009) for a recent discussion. The aim here is to provide a test for time-varying correlation that is powerful, yet simple to implement. The proposed approach is based on the dynamic conditional score (DCS) models recently developed by Creal *et al* (2011, 2013) and Harvey (2013). It is shown that Lagrange multiplier (LM) tests can be constructed from the autocorrelations of the conditional scores, with a modified test taking account of estimated dynamic variances. Without this modification the test is based on a simple portmanteau statistic. The scores incorporate information on the level of correlation, and local power arguments indicate that the resulting test can be expected to be more powerful as the unconditional correlation moves away from zero. This is not the case with the standard moment-based portmanteau test, introduced by Bollerslev (1990), which simply uses the cross-product of standardised residuals.

The tests are developed for a bivariate Gaussian model, with a subsequent extension to the bivariate Student t-distribution. Monte Carlo experiments are used to compare the performance of these tests with existing tests, includ-

ing those of Tse (2000, 2002) and Bera and Kim (2002). The results show that, on the whole, the proposed tests perform much better than existing tests across a range of data generating processes. Although the competing tests, which include portmanteau tests, residual regression tests and Lagrange multiplier tests, are based on a variety of approaches, they generally rely on the cross-product of standardised residuals to identify potential time variation and so share the same weakness relative to the scores. This point is highlighted by an application to the Hong Kong and South Korean equity markets, where it is found that the score-based tests can identify changing correlations that are undetectable by a moment-based test.

The paper is organised as follows. Section 2 reviews the bivariate DCS model for time-varying correlation and Section 3 shows how the new tests can be derived as LM tests within this framework. Section 4 presents the Monte Carlo results and Section 5 extends the theory and Monte Carlo study to the bivariate t-distribution. The application is reported in Section 6 and Section 7 concludes.

2 The DCS Model for Time-Varying Correlation

Consider a bivariate Gaussian model in which the observations, y_{1t} and y_{2t} , have zero means and constant variances, but the correlation between them changes over time. The covariance matrix is

$$\Sigma_{t|t-1} = \begin{bmatrix} \sigma_1^2 & \rho_{t|t-1}\sigma_1\sigma_2 \\ \rho_{t|t-1}\sigma_1\sigma_2 & \sigma_2^2 \end{bmatrix},$$

where $\rho_{t|t-1}$ denotes the correlation, which changes in a way that depends on information available at time $t - 1$. Rather than working directly with $\rho_{t|t-1}$, a transformation is applied so as to keep it in the range, $-1 < \rho_{t|t-1} < 1$.

The link function

$$\rho_{t|t-1} = \frac{\exp(2\gamma_{t|t-1}) - 1}{\exp(2\gamma_{t|t-1}) + 1}, \quad t = 1, \dots, T, \quad (1)$$

is eminently suitable in that it allows the new variable, $\gamma_{t|t-1}$, to be unconstrained.

The log-density of the $t - th$ pair of observation, conditional on informa-

tion at time $t - 1$, is

$$\begin{aligned} \ln f(y_{1t}, y_{2t}; \boldsymbol{\psi}, \lambda_1, \lambda_2) &= -\ln 2\pi - \ln \sigma_1^2 - \ln \sigma_2^2 - \frac{1}{2} \ln(1 - \rho_{t|t-1}^2) \\ &\quad - \frac{1}{2(1 - \rho_{t|t-1}^2)} \left(\frac{y_{1t}^2}{\sigma_1^2} - \frac{2\rho_{t|t-1}y_{1t}y_{2t}}{\sigma_1\sigma_2} + \frac{y_{2t}^2}{\sigma_2^2} \right), \end{aligned}$$

where $\boldsymbol{\psi}$ denotes the parameters upon which $\rho_{t|t-1}$, and hence $\gamma_{t|t-1}$, depend.

The score with respect to $\gamma_{t|t-1}$, that is $\partial \ln f_t / \partial \gamma_{t|t-1}$, can be written in terms of $\rho_{t|t-1}$ as

$$u_t = \frac{1}{4}(x_{1t} + x_{2t})^2 \frac{1 - \rho_{t|t-1}}{1 + \rho_{t|t-1}} - \frac{1}{4}(x_{1t} - x_{2t})^2 \frac{1 + \rho_{t|t-1}}{1 - \rho_{t|t-1}} + \rho_{t|t-1}, \quad (2)$$

where $x_{it} = y_{it}/\sigma_i$, $i = 1, 2$. We can also write

$$u_t = \frac{1}{1 - \rho_{t|t-1}^2} [(1 + \rho_{t|t-1}^2)x_{1t}x_{2t} - \rho_{t|t-1}(x_{1t}^2 + x_{2t}^2)] + \rho_{t|t-1}. \quad (3)$$

It is not difficult to see that $E(u_t) = 0$.

The correlation in the DCS model is made to change by letting $\gamma_{t|t-1}$ be a linear combination of past conditional scores. It can be seen immediately from (3) that the score reduces to $x_{1t}x_{2t}$ when $\rho_{t|t-1} = \gamma_{t|t-1} = 0$, but more generally the term involving squared observations makes important

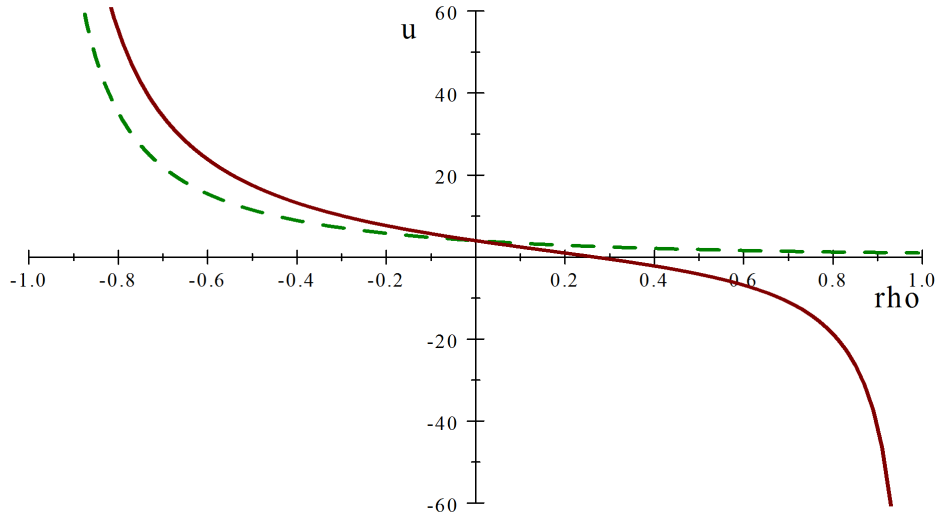


Figure 1: Plot of score, u , against correlation, ρ , for $x_1 = x_2 = 2$ (dash) and $x_1 = 4, x_2 = 1$.

modifications capturing information on the level of correlation. For example, $x_{1t} = x_{2t}$ is evidence of strong positive correlation, so there is little reason to change $\gamma_{t|t-1}$ when $\rho_{t|t-1}$ is close to one but a big change is needed if $\rho_{t|t-1}$ is negative; see the dashed line in Figure 1, where $x_{1t} = x_{2t} = 2$. The solid line, which is for $x_{1t} = 4$ and $x_{2t} = 1$, tells a different story. When $\rho_{t|t-1}$ is close to one, it needs to be reduced and hence the score is negative. By contrast, the response of $x_{1t}x_{2t}$ is the same for all values of $\rho_{t|t-1}$.

The most common way of capturing dynamic correlation is by the first-

order model

$$\gamma_{t|t-1} = (1 - \phi)\omega + \phi\gamma_{t-1|t-2} + \kappa u_{t-1}, \quad t = 2, \dots, T, \quad (4)$$

where u_t is the score and with $\gamma_{1|0} = \omega$; see Harvey (2013, ch 7). When scale (standard deviation in a Gaussian model) is time varying, an exponential link function, ensures that it is always positive. The first-order model is

$$\lambda_{i,t|t-1} = \omega_i(1 - \phi_i) + \phi_i\lambda_{i,t-1|t-2} + \kappa_i u_{it-1}, \quad i = 1, 2, \quad (5)$$

where $\lambda_{i,t|t-1}$ is the logarithm of scale, $\lambda_{i,1|0} = \omega_i$, and $u_{it} = \partial \ln f_t / \partial \lambda_{i,t|t-1}$, $i = 1, 2$. The covariance matrix can be broken down into two parts, one for the scales and the other for the correlation, that is $\boldsymbol{\Sigma}_{t|t-1} = \mathbf{D}_{t|t-1} \mathbf{R}_{t|t-1} \mathbf{D}_{t|t-1}$, where the diagonal matrix $\mathbf{D}_{t|t-1}$ has elements $\exp(\lambda_{1,t|t-1})$ and $\exp(\lambda_{2,t|t-1})$ and

$$\mathbf{R}_{t|t-1} = \begin{bmatrix} 1 & \rho_{t|t-1} \\ \rho_{t|t-1} & 1 \end{bmatrix}. \quad (6)$$

Remark 1 *The information matrix for λ_1, λ_2 and γ in the static model de-*

pendes only on γ . Expressed in terms of ρ it is

$$\mathbf{I} \begin{pmatrix} \lambda_1 \\ \lambda_2 \\ \gamma \end{pmatrix} = \begin{bmatrix} \frac{2-\rho^2}{1-\rho^2} & \frac{-\rho^2}{1-\rho^2} & -\rho \\ \frac{-\rho^2}{1-\rho^2} & \frac{2-\rho^2}{1-\rho^2} & -\rho \\ -\rho & -\rho & 1+\rho^2 \end{bmatrix}. \quad (7)$$

If the score vector for λ_1, λ_2 and γ is pre-multiplied by the inverse of the information matrix, as is often the practice in formulating DCS models, the modified score for $\gamma_{t|t-1}$ becomes

$$u_t = \frac{1}{1 - \rho_{t|t-1}^2} \left[x_{1t}x_{2t} - \frac{\rho_{t|t-1}}{2}(x_{1t}^2 + x_{2t}^2) \right] \quad (8)$$

In this case, the variance of u_t is unity in all time periods and so the condition $|\phi| < 1$ ensures that $\gamma_{t+1|t}$ is covariance stationary. As regards the volatility equations, (5), the u'_t s are the same as they would be in a univariate model (apart from a factor of $1/2$). In other words the score-driven approach suggests that the volatility for each series is driven solely by its own movements.

3 Testing

The model of the previous section provides a framework for testing for time varying correlation. Under the null hypothesis of constant correlation in a Gaussian model with constant variances, the score for γ is

$$u_t = \frac{1}{4}(x_{1t} + x_{2t})^2 \frac{1-r}{1+r} - \frac{1}{4}(x_{1t} - x_{2t})^2 \frac{1+r}{1-r} + r, \quad (9)$$

where r is the sample correlation and the x'_{it} s are standardized observations, that is $x_{it} = y_{it}/s_i$, $i = 1, 2$, where s_i^2 is the sample variance. The basic portmanteau statistic is

$$Q_u(P) = T \sum_{j=1}^P r_u^2(j), \quad (10)$$

where $r_u(j)$ is the j -th sample autocorrelation of u_t . The Ljung-Box statistic

$$Q_u^*(P) = T(T+2) \sum_{j=1}^P (T-j)^{-1} r_u^2(j),$$

may also be used; the asymptotic distribution of both statistics under the null hypothesis is χ_P^2 . When $r = 0$ the $Q_u(P)$ statistic reduces to the *moment-based* portmanteau test of Bollerslev (1990), because $u_t = x_{1t}x_{2t}$.

When changing volatility is estimated, the residuals are redefined as $x_{it} = y_{it}/\tilde{\sigma}_{it}$, $i = 1, 2$, where the $\tilde{\sigma}_{it}$'s is obtained from an EGARCH volatility model. We shall see in the first sub-section that $Q_u(P)$ is an LM test under constant volatility, but with changing volatility an extra term must be added.

The first sub-section below derives the LM test. The second sub-section uses a local power argument to demonstrate the value of using the scores to capture information on the level of correlation. This is then followed by a discussion of the choice of P and the use of an information criterion to determine a suitable value. The test of Nyblom (1989), which is also based on the scores of (9), is given in the last sub-section.

3.1 Lagrange multiplier tests

The portmanteau test may be derived as an LM test of the null hypothesis that $\kappa_0 = \kappa_1 = \dots = \kappa_{P-1} = 0$, against the alternative $\kappa_i \neq 0$, $i = 0, \dots, P-1$, in the dynamic model

$$\gamma_{tit-1} = \omega + \kappa_0 u_{t-1} + \dots + \kappa_{P-1} u_{t-P}, \quad t = 1, \dots, T. \quad (11)$$

A model of this kind may be regarded as an approximation to other specifications, such as (4), which may be expressed as infinite linear combinations of past scores.

Let $\boldsymbol{\theta} = (\omega, \lambda_1, \lambda_2)'$, where $\lambda_i = \ln \sigma_i$, $i = 1, 2$, denote fixed parameters other than those in $\boldsymbol{\kappa} = (\kappa_0, \dots, \kappa_{P-1})'$. The LM test statistic is

$$LM_u(P) = \frac{1}{T} \begin{bmatrix} \partial \ln L / \partial \boldsymbol{\kappa}' & \mathbf{0}' \end{bmatrix} \begin{bmatrix} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}} & \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\theta}} \\ \mathbf{I}_{\boldsymbol{\theta}\boldsymbol{\kappa}} & \mathbf{I}_{\boldsymbol{\theta}\boldsymbol{\theta}} \end{bmatrix}^{-1} \begin{bmatrix} \partial \ln L / \partial \boldsymbol{\kappa} \\ \mathbf{0} \end{bmatrix}, \quad (12)$$

where $\mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}$ denotes the information matrix for $\boldsymbol{\kappa}$ for a single observation and so on. For the t -th observation

$$\frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}} = \frac{\partial \ln f_t}{\partial \gamma_{t-1}} \frac{\partial \gamma_{t-1}}{\partial \boldsymbol{\kappa}} = u_t \frac{\partial \gamma_{t-1}}{\partial \boldsymbol{\kappa}}$$

and so $\mathbf{I}_{\kappa\kappa}$ is

$$\begin{aligned}
E \left[\frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}} \frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}'} \right]_{\kappa=0} &= EE_{t-1} \left[\frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}} \frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right] \\
&= E \left[E_{t-1} \left[\left(\frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \right)^2 \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right] \right] \\
&= E \left[\left(\frac{\partial \ln f_t}{\partial \gamma} \right)^2 \right] E \left[\frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right] \\
&= \sigma_u^2 E \left[\frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right],
\end{aligned}$$

where E_{t-1} denotes the expectation conditional on information at time $t-1$ and σ_u^2 is the variance of the score, which, under the null hypothesis, is fixed.

We have

$$\frac{\partial \gamma_{tt-1}}{\partial \kappa_j} = \sum_{i=1}^P \kappa_{i-1} \frac{\partial u_{t-i}}{\partial \kappa_j} + u_{t-j-1}, \quad j = 0, \dots, P-1,$$

but under the null hypothesis $\boldsymbol{\kappa} = \mathbf{0}$, so $\partial \gamma_{tt-1} / \partial \boldsymbol{\kappa} = \mathbf{u}_{t-1}$, where $\mathbf{u}_{t-1} = (u_{t-1}, u_{t-2}, \dots, u_{t-P})'$. Hence

$$E \left(\frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right) = \sigma_u^2 \mathbf{I}_P,$$

where \mathbf{I}_P is a $P \times P$ identity matrix, and so $\mathbf{I}_{\kappa\kappa} = \sigma_u^4 \mathbf{I}_P$. Furthermore

$$\begin{aligned} E \left[\frac{\partial \ln f_t}{\partial \boldsymbol{\theta}} \frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}'} \right]_{\kappa=0} &= EE_{t-1} \left[\frac{\partial \ln f_t}{\partial \boldsymbol{\theta}} \frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \frac{\partial \gamma_{tt-1}}{\partial \boldsymbol{\kappa}'} \right] \\ &= E \left[\frac{\partial \ln f_t}{\partial \boldsymbol{\theta}} \frac{\partial \ln f_t}{\partial \gamma} \right] E(\mathbf{u}_{t-1}). \end{aligned}$$

Note that because ω appears in the dynamic equation

$$\frac{\partial \ln f_t}{\partial \omega} = \frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \frac{\partial \gamma_{tt-1}}{\partial \omega}$$

but under the null hypothesis $\partial \gamma_{tt-1} / \partial \omega = 1$. Hence $E(\partial \ln f_t / \partial \omega \cdot \partial \ln f_t / \partial \gamma) = E(u_t^2) = \sigma_u^2$. Similarly $E(\partial \ln f_t / \partial \lambda_i \cdot \partial \ln f_t / \partial \gamma) = -\rho$, $i = 1, 2$. Thus $\mathbf{I}_{\theta\kappa} = \mathbf{0}$ because $E(\mathbf{u}_{t-1}) = \mathbf{0}$ and so

$$LM_u(P) = \frac{1}{T} \frac{\partial \ln L}{\partial \boldsymbol{\kappa}'} \mathbf{I}_{\kappa\kappa}^{-1} \frac{\partial \ln L}{\partial \boldsymbol{\kappa}}. \quad (13)$$

On substituting for $\mathbf{I}_{\kappa\kappa}$ and noting that

$$\frac{\partial \ln L}{\partial \kappa_j} = \sum \frac{\partial \ln f_t}{\partial \gamma_{tt-1}} \frac{\partial \gamma_{tt-1}}{\partial \kappa_j} = \sum u_t u_{t-1-j}, \quad j = 0, 1, \dots, P-1,$$

the $Q_u(P)$ statistic, (10), is obtained.

Remark 2 *Although the form of the link function is important for estimation, it does not affect the LM statistic in (10). Indeed other link functions could be used.*

The above derivation is as Harvey (2013, sub-section 2.5.1), but stated more generally, and it applies to any time-varying parameter in a DCS model when the other parameters are fixed¹. Now suppose some of the other parameters, denoted $\boldsymbol{\lambda}$, are time-varying, with dynamics depending on a set of parameters $\boldsymbol{\psi}$, but not depending on γ_{t-1} . In the present context this means that each volatility comes from a univariate model; see the Remark at the end of Section 2. Suppose, for simplicity, that the only other constant parameter is ω . Then $\boldsymbol{\theta} = (\boldsymbol{\psi}', \omega)'$. Assuming identifiability under the null hypothesis, the formula for a partitioned inverse means that the LM statistic, (12), can be written

$$LM_u(P) = \frac{1}{T} \frac{\partial \ln L}{\partial \boldsymbol{\kappa}'} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1} \frac{\partial \ln L}{\partial \boldsymbol{\kappa}} + \frac{1}{T} \frac{\partial \ln L}{\partial \boldsymbol{\kappa}'} \left[\mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\theta}} (\mathbf{I}_{\boldsymbol{\theta}\boldsymbol{\theta}} - \mathbf{I}'_{\boldsymbol{\kappa}\boldsymbol{\theta}} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\theta}})^{-1} \mathbf{I}'_{\boldsymbol{\kappa}\boldsymbol{\theta}} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1} \right] \frac{\partial \ln L}{\partial \boldsymbol{\kappa}},$$

where the second term on the right hand side is positive semi-definite² re-

¹Calvori et al (2014) also propose tests based on conditional scores but develop the methods in a different direction.

²This follows from that fact that under identifiability, the full information matrix in (12) will be positive definite. It then follows that the sub matrix $\mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1}$ and its Schur complement

sulting in a modified LM statistic that cannot be less than the LM statistic with fixed $\boldsymbol{\lambda}$, which is the portmanteau statistic of (13). Hence the $Q_u(P)$ test is more conservative than the LM test because $Q_u(P) \leq LM_u(P)$.

The second term in the LM statistic acts as a correction for the estimation of $\boldsymbol{\psi}$ and it can be shown to be equivalent to the result by Pierce (1982), which has been used in the GARCH literature to correct specification tests based on estimated residuals; see, for example, Bera and Zuo (1996) and Tse (2002). We have $\mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\theta}} = [\mathbf{I}'_{\boldsymbol{\kappa}\boldsymbol{\psi}}, \mathbf{I}'_{\boldsymbol{\kappa}\boldsymbol{\omega}}]'$ because $\mathbf{I}_{\boldsymbol{\omega}\boldsymbol{\kappa}} = \mathbf{0}$; see above (13). Following on from Pierce (1982),

$$\begin{aligned} E \left[\frac{\partial \ln f_t}{\partial \boldsymbol{\psi}} \frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}'} \right]_{\boldsymbol{\kappa}=\mathbf{0}} &= E \left[\frac{\partial^2 \ln f_t}{\partial \boldsymbol{\psi} \partial \boldsymbol{\kappa}'} \right]_{\boldsymbol{\kappa}=\mathbf{0}} = E \left[\frac{\partial}{\partial \boldsymbol{\psi}} \left(\frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}'} \frac{\partial \boldsymbol{\kappa}'}{\partial \boldsymbol{\psi}} \right) \right] = E \left[\frac{\partial (u_t \mathbf{u}'_{t-1})}{\partial \boldsymbol{\psi}} \right] \\ &= E \left[\frac{\partial u_t}{\partial \boldsymbol{\psi}} \mathbf{u}_{t-1} + u_t \frac{\partial \mathbf{u}'_{t-1}}{\partial \boldsymbol{\psi}} \right] = E \left[\frac{\partial u_t}{\partial \boldsymbol{\psi}} \mathbf{u}_{t-1} \right] + E \left[E_{t-1} \left(u_t \frac{\partial \mathbf{u}'_{t-1}}{\partial \boldsymbol{\psi}} \right) \right] \\ &= E \left[\frac{\partial u_t}{\partial \boldsymbol{\psi}} \mathbf{u}_{t-1} \right] = E \left[\frac{\partial^2 \ln f_t}{\partial \boldsymbol{\psi} \partial \boldsymbol{\gamma}} \mathbf{u}_{t-1} \right]. \end{aligned}$$

Once the model has been estimated under the null hypothesis, the above expression can be approximated numerically.

Suppose that $\mathbf{I}_{\boldsymbol{\lambda}\boldsymbol{\gamma}}$ does not depend on $\boldsymbol{\lambda}$. This is the situation here when EGARCH models are used; see (7). Consider one of the elements, λ_i , in $\boldsymbol{\lambda}$.

$(\mathbf{I}_{\boldsymbol{\theta}\boldsymbol{\theta}} - \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\theta}} \mathbf{I}_{\boldsymbol{\kappa}\boldsymbol{\kappa}}^{-1} \mathbf{I}'_{\boldsymbol{\kappa}\boldsymbol{\theta}})^{-1}$ will also be positive definite; see Abadir and Magnus(2005, p 228).

Dropping the subscript on λ_i , we have

$$\begin{aligned}
\mathbf{I}_{\psi\kappa} &= E \left[\frac{\partial \ln f_t}{\partial \psi} \frac{\partial \ln f_t}{\partial \boldsymbol{\kappa}'} \right]_{\kappa=0} = EE_{t-1} \left[\frac{\partial \ln f_t}{\partial \lambda_{t|t-1}} \frac{\partial \lambda_{t|t-1}}{\partial \psi} \frac{\partial \ln f_t}{\partial \gamma_{t|t-1}} \frac{\partial \gamma_{t|t-1}}{\partial \boldsymbol{\kappa}'} \right] \\
&= E \left[E_{t-1} \left[\frac{\partial \ln f_t}{\partial \lambda_{t|t-1}} \frac{\partial \ln f_t}{\partial \gamma_{t|t-1}} \right] \frac{\partial \lambda_{t|t-1}}{\partial \psi} \frac{\partial \gamma_{t|t-1}}{\partial \boldsymbol{\kappa}'} \right] \\
&= E \left[\frac{\partial \ln f_t}{\partial \lambda} \frac{\partial \ln f_t}{\partial \gamma} \right] E \left[\frac{\partial \lambda_{t|t-1}}{\partial \psi} \frac{\partial \gamma_{t|t-1}}{\partial \boldsymbol{\kappa}'} \right] = -\rho E \left[\frac{\partial \lambda_{t|t-1}}{\partial \psi} \frac{\partial \gamma_{t|t-1}}{\partial \boldsymbol{\kappa}'} \right].
\end{aligned}$$

The elements in $E \left[\frac{\partial \lambda_{t|t-1}}{\partial \psi} \frac{\partial \gamma_{t|t-1}}{\partial \boldsymbol{\kappa}'} \right]$ will also depend on ρ because of the correlation between the (contemporaneous) scores. Thus $\mathbf{I}_{\psi\kappa} \neq \mathbf{0}$, unless $\rho = 0$.

When $\rho = 0$ the LM statistic reverts to the original portmanteau statistic, $Q_u(P)$.

3.2 Local Power for $\mathbf{P}=1$

Consider the Gaussian DCS model $\gamma_{t+1|t} = \omega + \kappa u_t$. We are interested in the power of the proposed score test for the null hypothesis $H_0 : \kappa = \kappa_0 = 0$, against local alternatives of the form $\kappa = \delta/\sqrt{T}$. The asymptotic distribution of the test statistic, $Q_u(1)$, is then $\chi_1^2(I(\kappa_0)\delta^2)$, a non-central χ^2 with noncentrality parameter $I(\kappa_0)\delta^2$; see Godfrey (1988, p 18). Because $I(\kappa_0)$ is the element of the information matrix for $\kappa_0 = 0$, we have $I(\kappa_0) = (1 + \rho^2)^2$. (Estimation of the variances, σ_1^2 and σ_2^2 , makes no difference; see sub-section

3.1). Thus for a given value of δ , the local power increases as $|\rho| \rightarrow 1$. This property will be apparent in the Monte Carlo results. By contrast, the power of the moment-based test does not increase with $|\rho|$.

3.3 Choice of P

Although the portmanteau test is derived against a moving average alternative, a stationary first-order model of the form, (4), is a more likely candidate for a dynamic model. In this case, it can be shown that the LM test is the portmanteau test with $P = 1$. However, when the process driving $\gamma_{t+1|t}$ is very persistent, that is ϕ is close to one, the power may be increased by setting P to a relatively high value, perhaps selected by a criterion such as $P = \sqrt{T}$. An alternative way forward is to select P using a consistent information criterion, as in Escanciano and Lobato (2009); see appendix. Under the alternative, such a model selection procedure should select an increasing number of lags as ϕ goes to unity. Under the null hypothesis, only the first lag is selected in large samples with probability one. As a result, the asymptotic distribution under the null hypothesis is χ_1^2 . Simulation results (not reported here) indicated that this last approach was the best option and so it was adopted for all tests based on portmanteau statistics. Such test statis-

tics will be denoted simply as Q_u rather than $Q_u(P)$. The LM statistics are similarly denoted as $LM_u(P)$ and LM_u and the moment-based test statistics as $Q_x(P)$ and Q_x .

3.4 Nyblom test

Nyblom (1989) gives a general test for parameter constancy against a random walk alternative based on the LM principle. In the present context, the statistic ends up being based on the same scores as in the portmanteau test.

It can be written

$$N = \frac{1}{T^2 \sigma_u^2} \sum_{j=1}^T \left(\sum_{k=j}^T u_k \right)^2 .$$

Under the null hypothesis of parameter constancy, the statistic follows a Cramer-von Mises distribution with a 5% critical value of 0.462. The same critical value can be used when the scores are constructed from dynamic volatility estimates. Although the Nyblom test is usually regarded as a test against a random walk alternative, it can also be interpreted a test against a very persistent, but stationary, alternative, as in Harvey and Streibel (1998).

4 Monte Carlo experiments

To evaluate the performance of the proposed testing procedure, a simulation study was conducted on a number of models. The results are confined to versions of the tests in which the number of lags is determined by an information criterion, as in sub-section 3.3. The Ljung-Box form of the portmanteau statistic was used and volatilities were estimated from univariate GARCH or EGARCH models³.

Several tests from the existing literature were also considered. These are as follows.

i) The moment-based portmanteau test, as in Bollerslev (1990), based on autocorrelations constructed from the cross-product of standardized (volatility corrected) residuals. As with the score-based tests, the value of P is selected by an information criterion and so the test statistic is denoted as Q_x . (Since we are using the Box-Ljung form throughout this should actually be Q_x^* to be consistent with the original notation. However, it is neater to drop the star). The results for a version of the test that corrects for volatility estimation are omitted as they are very close to those of the Q_x test.

³EGARCH models were always used for the DCS test, whereas GARCH models were used for the other tests when the true model was not the DCS; the exception is the Tse test where GARCH was used in all cases.

ii) A residual regression test, RR , proposed by Tse (2002), in which $x_1x_2 - \rho$ is regressed on P lags. He also provides a correction based on Pierce (1982) to allow for the estimation of volatility. The third test considered is the LM test of Tse (2000) based on an alternative model $\rho_t = c + by_{it-1}y_{jt-1}$, with the score vector calculated using a set of recursive equations. Estimation of the volatility models was based on MLEs for the bivariate time series and all corrected statistics used numerical derivatives. The results for the residual regression test are based on a lag length of two in accordance with Tse (2002)⁴.

iii) The test of Bera and Kim (2002), denoted BK, gets around the need to assume a functional form for the time-varying correlations by focussing on behaviour local to the constant parameter case. They use Taylor approximations based on the variance of the errors driving the time varying parameters being small. The test statistic is again constructed from standardized residuals, x_{it} , $i = 1, 2$, and is given by

$$BK = \frac{\left[\sum_{t=1}^T (\xi_{1t}^2 \xi_{2t}^2 - 1 - 2\hat{\rho}^2) \right]^2}{4T(1 + 4\hat{\rho}^2 + \hat{\rho}^4)},$$

⁴All test statistics requiring a choice of lag length were also considered with fixed lag lengths of 2, 10 and 20 in a series of preliminary simulations. The relative performance of the various tests was similar for all lag lengths. Hence, only the preferred lag length is presented.

where $\xi_{1t} = (x_{1t} - \hat{\rho}x_{2t})/(\sqrt{1 - \hat{\rho}^2})$ and $\xi_{2t} = (x_{2t} - \hat{\rho}x_{1t})/(\sqrt{1 - \hat{\rho}^2})$.

The simulation study consists of three models with a bivariate normal conditional distribution, and one, in Section 5, with a t-distribution. The sample sizes were $T = 500$ and 1000 with $5,000$ replications used in power comparisons and $10,000$ in size comparisons.

4.1 DCS model

The DCS model has dynamic equations for the correlation and volatility as in (4) and (5). The three parameters in the equation for correlation were varied across the sets $\omega = [0, 0.9]$, $\phi = [0.6, 0.99]$ and $\kappa = [0.01, 0.1]$, whereas the parameters governing the EGARCH volatility dynamics were fixed at $\omega_i = 0$, $\phi_i = 0.95$ and $\kappa_i = 0.2$, $i = 1, 2$.⁵ Only one parameter was changed at a time, with the base set of parameters given by $\omega = 0.4$, $\phi = 0.9$ and $\kappa = 0.05$. Note that $\omega = 0.4$ and 0.8 correspond to $\rho = 0.38$ and 0.66 respectively because $\rho = \tanh \omega$.

⁵The values for κ are relatively large but lower values give similar results.

4.1.1 Size of tests

From the results in Table 1, the LM_u test appears to be slightly oversized in finite samples as does the Q_u test, though to lesser extent (because Q_u cannot be greater than LM_u). This size distortion, which is due to the use of the information criterion to choose P and the consequent use of a χ_1^2 critical value, declines as the sample size increases and becomes negligible for $T = 1000$. The estimated rejection probabilities of the N test increase as the correlation increases, whereas those of the moment-based portmanteau test decrease.

Table 1: Estimated size ($\times 100$) of tests for a DCS model with EGARCH volatility.

	Test							
	$\omega(\rho)$	LM_u	Q_u	N	Q_x	BK	Tse	cRR
$T = 500$	0	7.08	6.40	4.60	6.50	5.52	6.03	5.18
	0.4 (0.38)	7.04	6.35	5.48	6.27	5.68	6.21	5.18
	0.8 (0.66)	7.35	6.64	7.33	5.95	6.02	6.73	5.86
$T = 1000$	0	5.94	5.67	4.58	5.9	5.22	5.45	4.70
	0.4 (0.38)	6.16	5.90	5.24	5.86	5.26	5.54	5.21
	0.8 (0.66)	5.70	5.29	5.95	5.27	6.05	6.66	5.38

Note: LM_u is score-based LM test, Q_u is score-based portmanteau test, N is Nyblom test, Q_x is moment-based (Bollerslev) test, BK is Bera and Kim test, Tse is Tse test, cRR is (corrected) residual regression test.

4.1.2 Power comparisons

Table 2 shows powers, or, more precisely, estimated probabilities of rejection. In other words the powers are not size-corrected. The salient feature is the increasing extent to which the score-based tests dominate the moment-based tests as ω increases. A clearer impression of the relative performance of the tests comes from Figure 2 which shows the estimated powers for the Q_u , LM_u , N and Q_x tests for $T = 500$ as the parameter ω (governing the unconditional level of correlation) increases from zero to 0.8. We find that the new score-based tests and the Nyblom test outperform the competition across virtually the entire range of ω . The power of the score-based tests increases as the unconditional level of the correlation rises, as indicated by the local power results of sub-section 3.2, whereas the power of the moment-based test does not; in fact it shows a slight fall. When $T = 500$, the Q_u and LM_u tests outperform the Nyblom test for ω above 0.5, but when $T = 1000$ the break-even value falls to 0.3, as shown in Figure 2. The rejection probabilities with

the conservative Q_u test are only slightly smaller than those for the LM_u test when $T = 1000$.

Table 2: Powers of Tests for DCS Model with Different Levels of Correlation

	Test									
	ω	ϕ	κ	LM_u	Q_u	N	Q_x	BK	Tse	cRR
$T = 500$	0	0.9	0.05	12.4	11.4	18.8	11.6	6.6	7.6	10.5
	0.4	0.9	0.05	21.0	18.5	21.6	10.0	7.0	9.2	9.8
	0.8	0.9	0.05	37.8	34.5	30.4	7.5	11.6	11.7	8.4
$T = 1000$	0	0.9	0.05	16.5	15.4	19.7	15.3	6.9	7.7	18.3
	0.4	0.9	0.05	28.5	26.9	22.7	10.7	9.1	8.8	13.6
	0.8	0.9	0.05	55.3	53.2	31.4	6.6	17.3	13.0	8.6

Figures 3 and 4 show the power of the tests as the parameter κ is varied across the set (0.01, 0.1) with sample sizes $T = 500$ and $T = 1000$ respectively. Once again the score-based tests, including the Nyblom test, outperform the others across almost the entire range examined. It seems that the Nyblom test has greater power against smaller deviations from the null. However as before, the range of values over which the score-based portmanteau test matches or improves upon the Nyblom test increases as the sample size reaches $T = 1000$. Once again the difference between the Q_u and LM_u tests is small throughout.

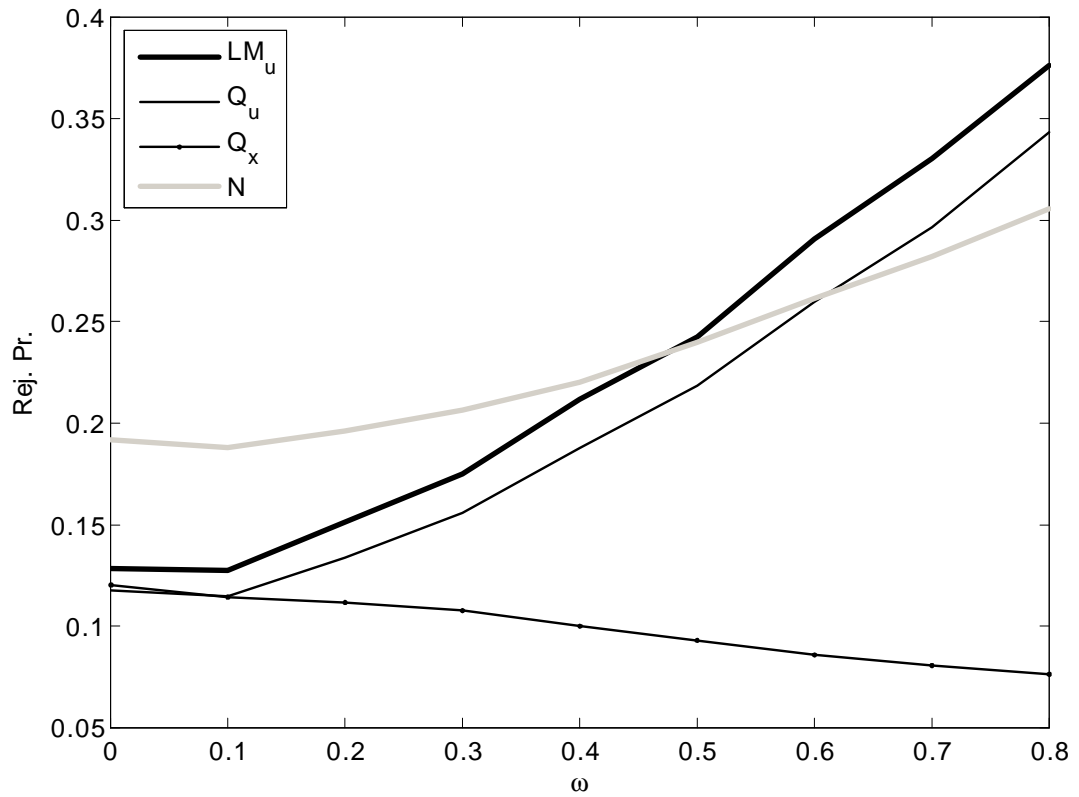


Figure 2: Power Comparison across ω with $\phi = 0.9$, $\kappa = 0.05$, $T = 500$. LM_u is DCS-LM test, Q_u is score-based portmanteau test, Q_x is moment-based portmanteau test and N is Nyblom test.

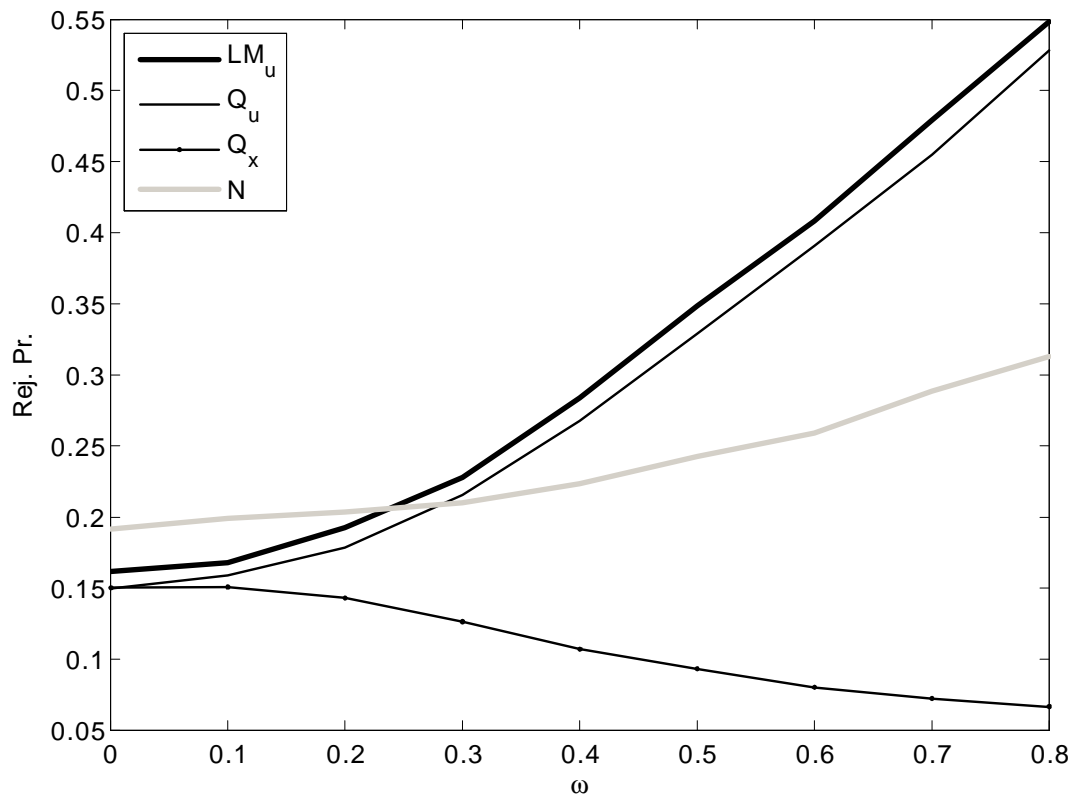


Figure 3: Power Comparison across ω with $\phi = 0.9$, $\kappa = 0.05$, $T = 1000$.

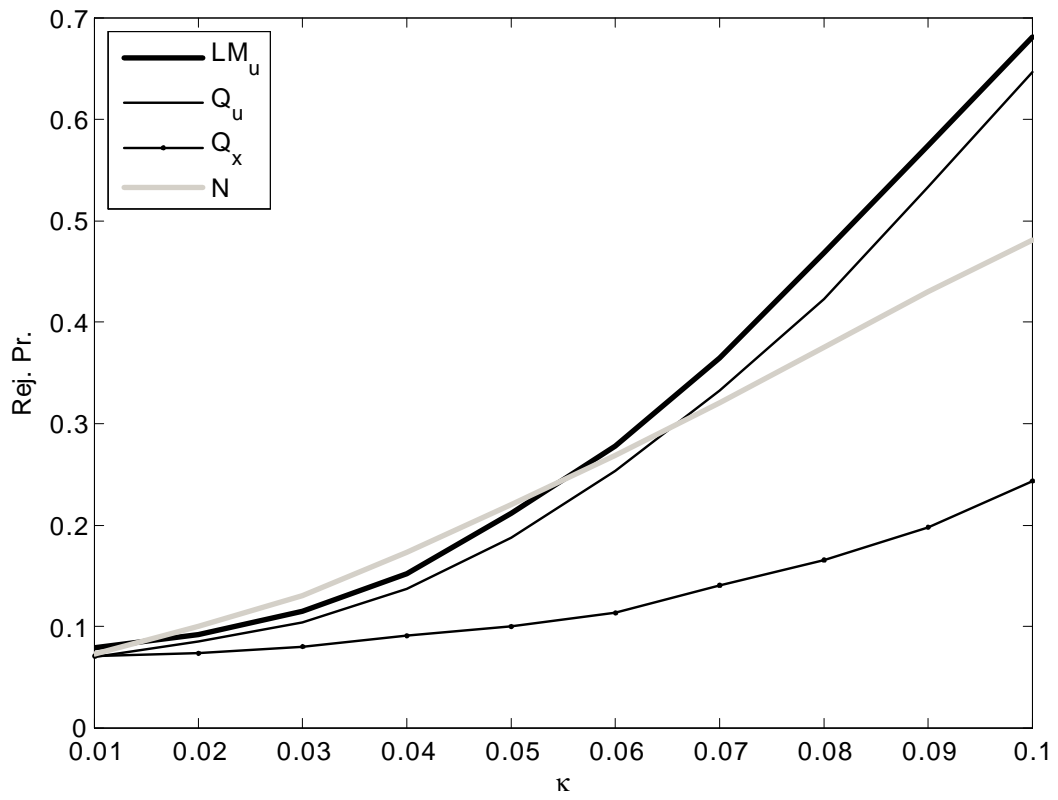


Figure 4: Power Comparison across κ with $\phi = 0.9$, $\omega = 0.05$, $T = 500$.

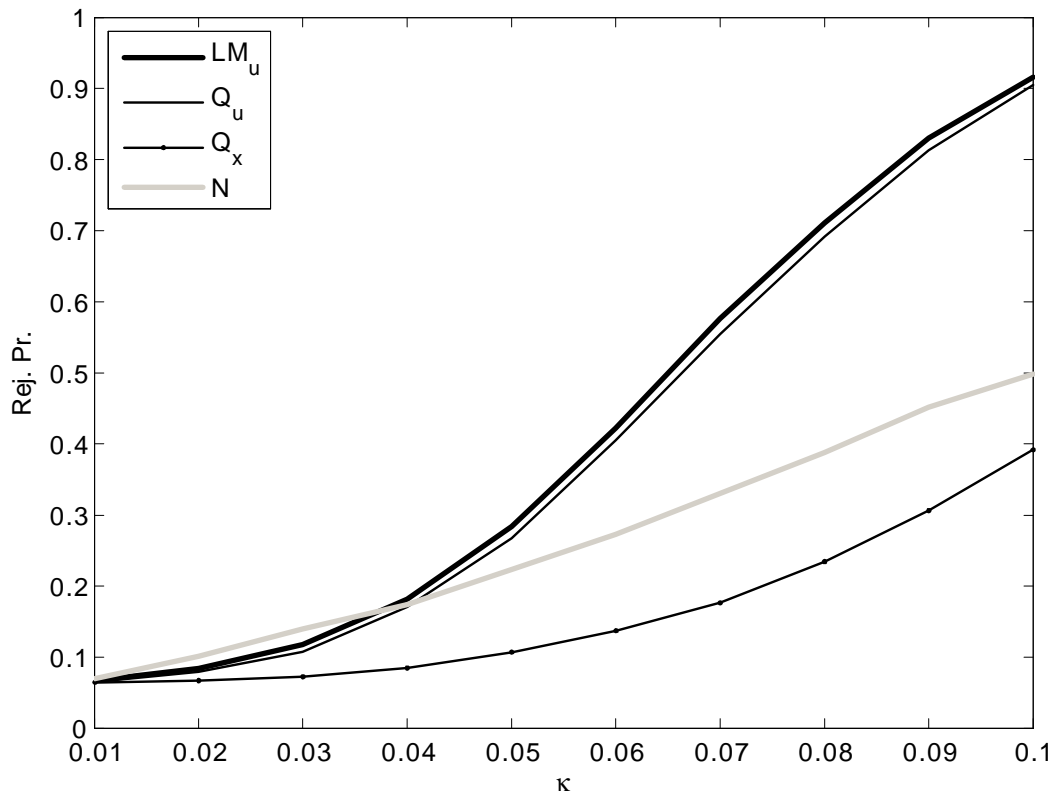


Figure 5: Power Comparison across κ with $\phi = 0.9$, $\omega = 0.05$, $T = 1000$.

Figures 5 and 6 show the power of the tests as the parameter ϕ is varied across the set $(0.6, 0.99)$ with sample sizes $T = 500$ and $T = 1000$ respectively. Once again, the score-based tests, including the Nyblom test, perform best overall with the gap increasing with ϕ . When $T = 500$, the Q_u and LM_u tests are beaten by the Nyblom test for $\phi > 0.9$, but the break-even value of ϕ rises to around 0.95 when $T = 1000$; compare similar findings in Harvey and Streibel (1998).

Rejection probabilities for the BK, Tse and cRR tests are little better, and sometimes worse, than those for the Q_x test. Results are available on request.

4.2 Stochastic Correlation

In the second model the correlation is generated from an unobserved components Gaussian autoregressive process,

$$\gamma_t = \omega(1 - \phi) + \phi\gamma_{t-1} + \kappa\eta_t, \quad \eta_t \sim NID(0, 1), \quad (14)$$

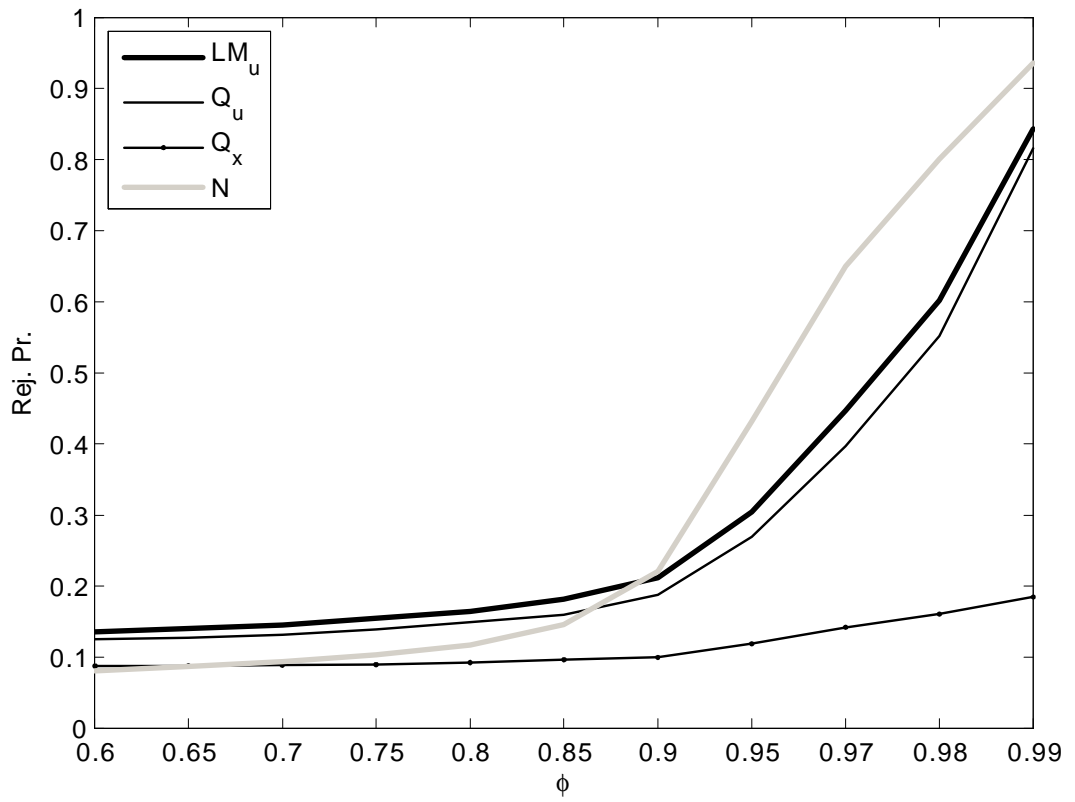


Figure 6: Power Comparison across ϕ with $\kappa = 0.05$, $\omega = 0.05$, $T = 500$.

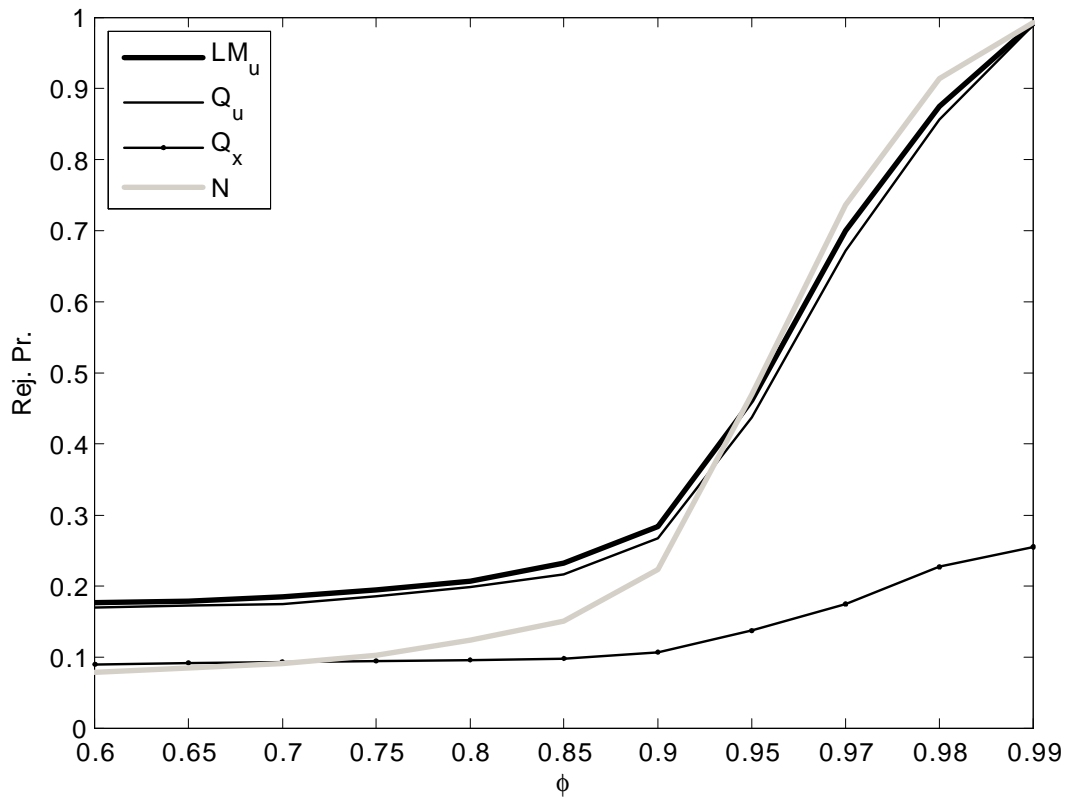


Figure 7: Power Comparison across ϕ with $\kappa = 0.05$, $\omega = 0.05$, $T = 1000$.

in which the correlations, ρ_t , are again constrained to lie in the range $(-1, 1)$ by using a transformation of the form (1). We set values for $\omega = \{0, 0.4\}$, $\phi = \{0.8, 0.95\}$ and $\kappa = \{0.1, 0.15, 0.2\}$. The time-varying volatility is generated as in the DCS model with the standardized observations, $y_{it} \exp(-\lambda_{i,tt-1})$, $i = 1, 2$, independent of η_t . The reason for generating correlations in this way is so that the resulting realizations do not depend in any way on the conditional score.

Table 3 shows the estimated rejection probabilities for various values of the parameters ω , ϕ and κ at sample sizes of 500 and 1000. The findings from the previous sub-section generally carry over to this setting. Contrasting the first three rows ($\omega = 0$) with the last three rows ($\omega = 0.4$) of both Panel A and Panel B shows that the powers of the score-based tests increase with the level of correlation, ω , whereas that of the Q_x test deteriorates, as do the powers of the Tse and cRR tests. The one exception is the BK test which for this particular model, but not for the others, does rather well. The Q_u and LM_u tests dominate the Nyblom test, even for $T = 500$; this was not the case for the DCS model as reported in Table 2. Finally, the relative performance of the score-based tests improves as ϕ increases from 0.8 to 0.95, which is consistent with Figures 5 and 6.

Table 3: Power Comparison for Stochastic Correlation Model

<i>Panel A: T = 500</i>									
ω	ϕ	κ	LM_u	Q_u	N	Q_x	BK	Tse	cRR
0	0.8	0.2	33.2	31.7	20.2	32.0	47.4	24.7	29.2
0	0.95	0.1	42.5	40.7	48.0	39.6	40.3	27.5	35.9
0	0.95	0.15	80.5	79.4	70.6	77.3	79.2	60.2	75.1
0.4	0.8	0.2	39.9	37.8	22.9	20.7	59.2	24.2	20.0
0.4	0.95	0.1	50.7	48.1	52.5	26.4	50.9	27.2	24.9
0.4	0.95	0.15	84.9	83.2	74.3	61.5	87.0	56.0	59.7
<i>Panel B: T = 1000</i>									
ω	ϕ	κ	LM_u	Q_u	N	Q_x	BK	Tse	cRR
0	0.8	0.2	54.7	53.8	19.6	54.4	72.8	38.6	55.0
0	0.95	0.1	68.2	67.0	51.3	66.3	65.4	43.8	65.9
0	0.95	0.15	97.8	97.6	75.6	97.4	97.4	82.4	97.3
0.4	0.8	0.2	62.2	61.3	23.3	34.5	85.3	34.3	35.2
0.4	0.95	0.1	76.7	75.1	56.1	44.3	78.2	40.0	44.6
0.4	0.95	0.15	98.7	98.5	79.5	88.3	98.9	76.5	88.2

4.3 Dynamic Conditional Correlation GARCH Model

Because the new tests are derived within the framework of a DCS model for changing correlation, it could be argued that the results of sub-section 4.1 and, to a lesser extent, those of sub-section 4.2, are weighted in favor of them. We therefore consider a third model in which the dynamics are moment-based, following the dynamic conditional correlation (DCC) model of Engle (2002). As in the DCS model of section 2, the conditional covariance matrix takes the form $\Sigma_{t|t-1} = \mathbf{D}_{t|t-1} \mathbf{R}_{t|t-1} \mathbf{D}_{t|t-1}$, but the standard deviations in the diagonal matrix, $\mathbf{D}_{t|t-1}$, are generated by univariate GARCH models,

$$\sigma_{i,t|t-1}^2 = \delta_i + \beta_i \sigma_{i,t-1|t-2}^2 + \alpha_i y_{it-1}^2, \quad i = 1, 2,$$

and, as in the cDCC modification adopted by Engle and Kelly (2012, p 215), the time varying correlations are given by

$$\begin{aligned} \mathbf{R}_{t|t-1} &= \tilde{\mathbf{Q}}_{t|t-1}^{-1} \mathbf{Q}_{t|t-1} \tilde{\mathbf{Q}}_{t|t-1}^{-1}, \\ \mathbf{Q}_{t|t-1} &= \bar{\mathbf{Q}}(1 - \alpha - \beta) + \beta \mathbf{Q}_{t-1|t-2} + \alpha \tilde{\mathbf{Q}}_{t-1|t-2} \mathbf{D}_{t-1|t-2} \mathbf{y}_{t-1} \mathbf{y}'_{t-1} \mathbf{D}_{t-1|t-2} \tilde{\mathbf{Q}}_{t-1|t-2}, \end{aligned}$$

where $\mathbf{y}'_t = (y_{1t} \ y_{2t})$, $\tilde{\mathbf{Q}}_{tt-1}$ is a diagonal matrix with nonzero elements equal to the square roots of the corresponding diagonal elements of \mathbf{Q}_{tt-1} and $\bar{\mathbf{Q}}$ is the unconditional correlation matrix with unit diagonal elements and correlation $\bar{\rho}$ in the off-diagonals. Table 4 shows the rejection probabilities for a range of values of α, β and $\bar{\rho}$ with $\delta_i = 0.05, \beta_i = 0.85$ and $\alpha_i = 0.1, i = 1, 2$. Generally speaking, the findings from the DCS simulations carry over to this setting. In particular, the powers of the score-based tests increase with an increase in the unconditional level of correlation, driven by $\bar{\rho}$, whereas the power of the moment-based Q_x test deteriorates, as do the powers of the other tests based on the product of standardised residuals.

Table 4: Power Comparison for DCC GARCH Model

	Parameter			Test						
	$\bar{\rho}$	β	α	LM_u	Q_u	N	Q_x	BK	Tse	cRR
$T = 500$	0	0.8	0.05	20.7	19.9	13.6	20.2	5.2	18.6	17.4
	0	0.8	0.1	67.4	67.0	35.0	67.4	12.4	60.7	65.9
	0	0.9	0.05	29.7	28.3	33.6	28.9	7.3	25.2	25.8
	0.4	0.8	0.05	24.2	22.9	13.2	13.6	5.9	22.8	13.7
	0.4	0.8	0.1	70.9	70.1	36.1	47.6	15.6	65.2	48.9
	0.4	0.9	0.05	34.2	32.6	34.0	19.2	8.0	29.2	19.1
$T = 1000$	0	0.8	0.05	33.8	33.2	13.7	33.5	6.1	30.1	33.7
	0	0.8	0.1	92.9	92.5	37.3	92.9	18.0	86.0	93.6
	0	0.9	0.05	50.5	49.8	37.1	50.2	9.8	41.5	50.7
	0.4	0.8	0.05	37.3	36.8	14.2	22.8	5.8	34.6	23.6
	0.4	0.8	0.1	93.3	92.4	39.0	75.5	25.4	89.2	77.5
	0.4	0.9	0.05	55.3	54.3	38.8	33.2	11.6	47.2	34.9

5 Bivariate t-distribution

The above simulations are for Gaussian models and, as such, demonstrate the advantages of using the scores for a changing correlation test. However, the conditional distributions of financial asset returns are often heavy-tailed and a t-distribution is usually a better option. For modeling volatility, the DCS approach leads to an EGARCH model in which the dynamics of the logarithm of scale, λ , are driven by

$$u_t = \frac{(\nu + 1)y_t^2}{\nu \exp(2\lambda_{t|t-1}) + y_t^2} - 1, \quad \nu > 0. \quad (16)$$

for a zero mean process. Because u_t is a linear function of a beta distribution at the true parameter values, the model is known as Beta-t-EGARCH; see Harvey (2013, ch 4). The fact that the score function is bounded has the practical effect of moderating the influence of outliers.

The log-density for the t -th pair of observations from a dynamic bivariate t-distribution with zero mean, scales $\exp(\lambda_{1,t|t-1})$ and $\exp(\lambda_{2,t|t-1})$, correlation $\rho_{t|t-1}$ and degrees of freedom ν is

$$\ln f_t(y_{1t}, y_{2t}) = \ln(\Gamma(\nu+2)/2) - \ln \Gamma(\nu/2) - \ln \pi \nu - \lambda_{1,t|t-1} - \lambda_{2,t|t-1} - \frac{1}{2} \ln(1 - \rho_{t|t-1}^2) + \frac{\nu + 2}{2} \ln(1 - b_t),$$

where

$$1 - b_t = 1 / \left[1 + \frac{x_{1t}^2 - 2\rho_{t|t-1}x_{1t}x_{2t} + x_{2t}^2}{\nu(1 - \rho_{t|t-1}^2)} \right]$$

The score for $\gamma_{t|t-1}$ is now

$$u_t^\dagger = \frac{\nu + 2}{\nu}(1 - b_t)u_t + \rho_{t|t-1}, \quad (17)$$

where u_t is the Gaussian score in (9). Because $1 - b_t \rightarrow 0$ as y_{1t} and/or $y_{2t} \rightarrow \pm\infty$, these new scores, like those for the $\lambda'_{i,t|t-1}s$, are bounded. At the true parameter values, $1 - b_t$ is distributed as $beta(\nu/2, 1)$; see Harvey (2013, p211).

A full LM test for constant correlation in the bivariate t model can be carried out in principle. However, a simple portmanteau test may be more appealing in practice. Standardized observations can be obtained by fitting univariate Beta-t-EGARCH models and these can then be used to estimate the correlation and degrees of freedom in a (static) bivariate t distribution. The scores, u_t^\dagger , are then formed as in (17) but with $\rho_{t|t-1}$ and ν replaced by their ML estimators. Table 5 compares the performance of the resulting portmanteau test, denoted $Q_u(t)$, with that of the Gaussian test portmanteau test studied in the previous section. The simulations estimate size with 10,000

replications and power with 5,000. Volatility was generated from Beta-t-EGARCH models with $\nu = 8$ and parameters $\omega_i = 0$, $\phi_i = 0.95$ and $\kappa_i = 0.1$, for $i = 1, 2$. The first two rows of the table show the size of the tests for two levels of correlation. Both tests are slightly oversized, though reasonably close to the nominal 5% level, with the discrepancy decreasing when T rises to 1000. The difference between the Gaussian and t-based tests is much more evident when considering power: the rejection probabilities for $Q_u(t)$ are much higher.

Table 5: Size and Power for a Student t-distribution

ω	ϕ	κ	$T = 500$		$T = 1000$	
			Q_u	$Q_u(t)$	Q_u	$Q_u(t)$
0	1	0	6.2	6.3	5.1	5.9
0.4	1	0	7.1	6.2	6.4	5.9
0	0.8	0.05	19.6	31.4	32.6	53.8
0	0.8	0.1	66.2	89.6	92.1	99.7
0	0.95	0.05	37.7	57.4	64.4	87.9
0	0.95	0.1	88.9	98.6	98.9	100
0.4	0.8	0.05	25.2	33.3	38.1	56.5
0.4	0.8	0.1	67.3	89.4	89.6	99.7
0.4	0.95	0.05	46.9	61.7	70.6	89.9
0.4	0.95	0.1	89.7	98.9	98.7	100

6 Application: Hong Kong and South Korea

Stock Indices

To demonstrate the effectiveness of the proposed test statistics, we examine the stability of the correlation between daily local currency returns of the Hong Kong (Hang Seng) and South Korean (SET) stock indices from

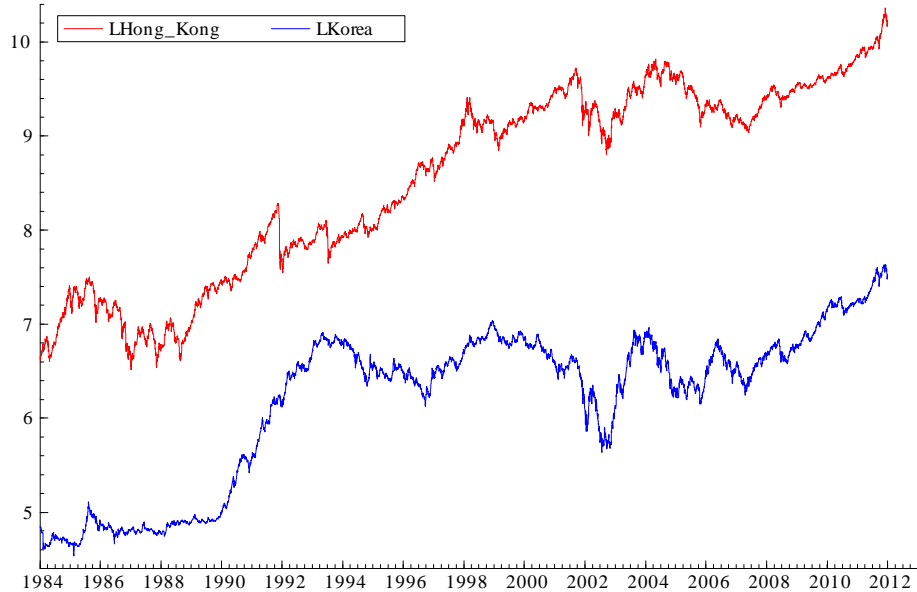


Figure 8: Logarithms of Hong Kong (top) and South Korea stock markets indices from 2/1/1984 to 27/11/2007.

2/1/1984 to 27/11/2007. Because of the length of the series ($T = 6237$) and the occurrence of several major events in this time frame⁶, we also consider a shorter window between 1/1/2004 and 27/11/2007 ($T = 1019$): this provides a tougher challenge for detecting changing correlation⁷.

Figure 8 shows a plot of the two series. Estimation of a univariate DCS

⁶This data was modeled in Harvey (2010) by means of a time varying copula. As noted there, the sample includes i) Black Monday, October 19th, 1987; ii) the speculative attack on the Hong Kong dollar on October 20th, 1997; and iii) the High Technology Crash of October 2nd, 2000.

⁷Data including the recent financial crisis are not considered due to the likelihood that contagion would lead to sharp changes in the correlation structure that would be easy for all tests to identify.

volatility model (Beta-t-EGARCH) for Hong Kong for the full period gave the following estimates (and standard errors) for the parameters in (5): $\tilde{\omega} = 0.0414(0.0038)$, $\tilde{\phi} = 0.9903 (0.0024)$ and $\tilde{\kappa} = 0.0416 (0.0007)$. Similar estimates were found for South Korea, namely $\tilde{\omega} = 0.1765(0.0038)$, $\tilde{\phi} = 0.9914(0.0023)$ and $\tilde{\kappa} = 0.0475 (0.0009)$. Figure 9 plots the time-varying correlation over the full sample when estimated with a bivariate t DCS model. The estimates of ϕ and κ in the dynamic equation for γ_{tt-1} were 1.0000 and 0.0041 respectively. Short run variation is evident throughout, but there is a clear increase in the level, starting in the late 1990s. In the sub-sample after 2004, the estimates of ϕ and κ were 0.9538 and 0.0313. Again there is considerable movement in correlation, which ranges from around 0.45 to just below 0.7.

Table 6 presents the results for score and moment-based tests constructed using volatility-corrected residuals. For the full sample there is strong evidence for time varying correlation. The prob.-values for all score-based tests are essentially zero. The moment-based test is slightly less conclusive in that it fails to reject at the 1% level of significance. The higher values of the score-based tests are consistent with the local power and Monte Carlo results because the unconditional correlation over the full sample is 0.24. The

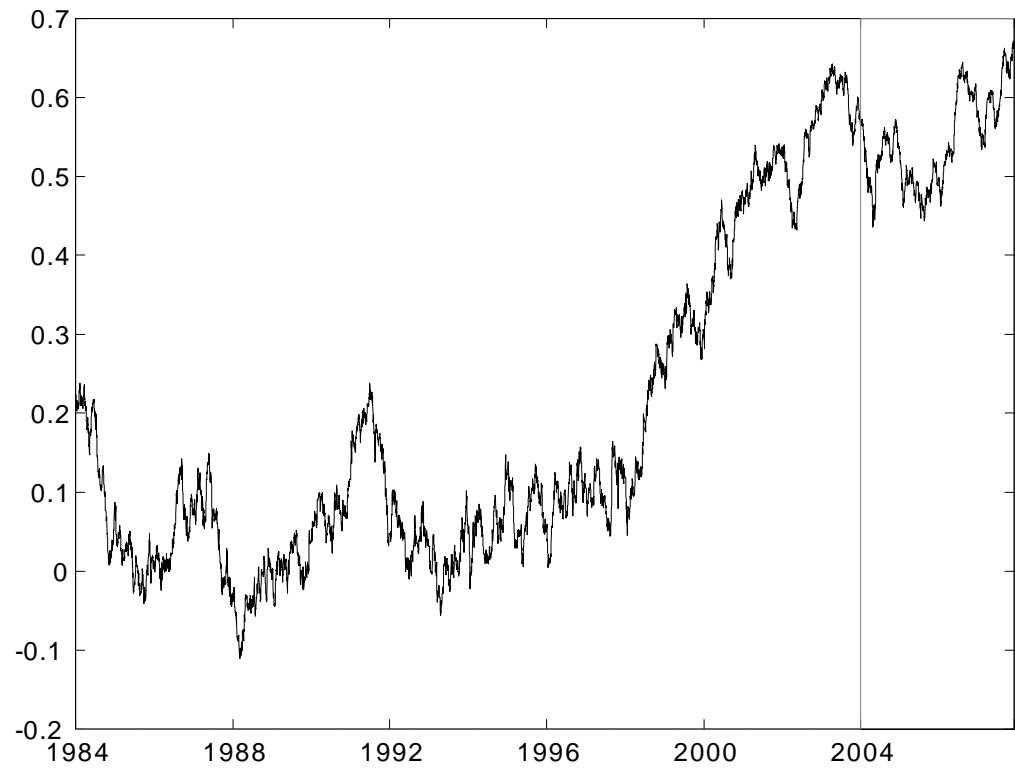


Figure 9: Time Varying Correlation for Hong Kong and South Korean Stock Market Indices - 2/1/1984 to 27/11/2007.

LM_u statistic is much larger than Q_u , although the latter is still very big in absolute terms. More significant is the much larger value of the $Q_u(t)$ statistic, which presumably stems from the fact that the estimated degrees of freedom is 4.7.

Table 6: Tests against Changing Correlation for Hong Kong and South Korean Stock Markets

Sample	LM_u	Q_u	$Q_u(t)$	Q_x	N
2/1/84 - 27/11/07	341.53	285.13	552.81	6.39	34.57
	(0)	(0)	(0)	(1.21)	(<0.1)
1/1/04 - 27/11/07	4.25	4.13	4.64	0.56	1.14
	(3.93)	(4.20)	(3.12)	(45.4)	(< 1.0)

Note: (100×) prob.-values are in parentheses. For the N test the prob.-values

are based on a table in Nyblom (1989).

The results for the shorter sub-sample, where the unconditional correlation is 0.61, show an even more striking difference between the score and moment-based tests. Whereas the moment-based test fails to reject the null hypothesis of constant correlation at any reasonable significance level, suggesting a period of stability during 2004-2007, the score-based tests demonstrate their higher power by rejecting at the 5% level of significance. As

before the biggest score-based test statistic is $Q_u(t)$; the degrees of freedom is now 5.99.

7 Conclusion

The proposed test for time-varying correlation is relatively simple. First standardize the two series by dividing by the scale given by fitting univariate volatility models, preferably Beta-t-EGARCH, to each series. Then construct the scores with respect to correlation by estimating the correlation and degrees of freedom in a bivariate t model. The simple portmanteau statistic, in the Ljung-Box form, is constructed with the number of lags chosen by an information criterion.

The simulation results show that there is little to be gained by making the correction demanded by the full LM test. Indeed, the LM test is more oversized than the portmanteau test when the number of lags is selected by an information criterion. The Nyblom test is a good option when the changes in correlation are thought to be very persistent. What is very clear from the simulations is that tests based only on cross-products of residuals are almost always dominated by the score-based tests, with the difference

in power increasing as the underlying correlation moves away from zero and often being very considerable. The practical implications are reinforced by the example, which shows that only the score-based tests are able to detect the quite considerable movement in correlation between the Hong Kong and South Korean stock markets in the mid-2000s.

Further development of tests developed from DCS models, for example tests against time variation in copulas, seems to be a fruitful avenue for future research.

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APPENDIX: Data-driven Q-test

The lag length, P , is selected by the criterion proposed by Escanciano and Lobato (2009), namely

$$P = \min\{p : 1 \leq p \leq d : L_p \geq L_h, \quad h = 1, 2, \dots, d\},$$

where

$$L_p = Q(p) - \pi(p, T, q),$$

$Q(p)$ is the original test statistic, d is a fixed upper bound for the lag length, and $\pi(p, T, q)$ is a penalty term that takes the form

$$\pi(p, T, q) = \begin{cases} p \log T & \text{if } \max_{1 \leq j \leq d} \sqrt{T} |\tilde{\rho}_j| \leq \sqrt{q \log T} \\ 2p, & \text{if } \max_{1 \leq j \leq d} \sqrt{T} |\tilde{\rho}_j| > \sqrt{q \log T} \end{cases},$$

where $\tilde{\rho}_j$ is the j^{th} sample autocorrelation and q is some fixed positive number. Escanciano and Lobato (2009) suggest setting $q = 2.4$ which was supported by our simulations. Their simulation evidence suggests that the choice of d is not crucial. Here we set $d = 20$.

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