The Wishart Autoregressive Process of Multivariate Stochastic Volatility

Gourieroux, C. [1], Jasiak, J. [2], and R., Sufana[3],

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[1] CREST, CEPREMAP and University of Toronto.
[2] York University, Toronto.
[3] University of Toronto
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Abstract

The Wishart Autoregressive (WAR) process is a multivariate process of stochastic positive semi-definite matrices, which is proposed in this paper as a dynamic model for stochastic volatility matrices. The WAR based nonlinear forecasts at any horizon can be obtained in a straightforward manner. The WAR also allows for factor representation, which separates white noise directions from directions which capture entire past information. For illustration, the WAR is applied to a sequence of intraday realized volatility-covolatility matrices.

Keywords: Stochastic Volatility, CAR Process, Factor Analysis, Realized Volatility.

JEL number: G13, C51.

Un modèle dynamique pour des matrices de volatilité stochastique : Le processus Wishart autorégressif.

Résumé

Le processus Wishart autorégressif (WAR) est un processus de Markov pour matrices de volatilité stochastique. Nous décrivons sa distribution multivariée, donnons les expressions des moments conditionnels d'ordre un et deux et expliquons comment effectuer les prévisions à tout horizon. Le modèle WAR peut être contraint pour permettre des interprétations factorielles, qui distinguent des directions sans dépendance temporelle et des directions résumant l'effet du passé. La spécification WAR est finalement appliquée à l'étude d'une suite de matrices de volatilité-covolatilité intrajournalières.

Mots clés : Volatilité stochastique, processus CAR, analyse factorielle, volatilité réalisée.

1 Introduction

The management of portfolios of multiple risky assets requires a tractable, multivariate model of expected returns, volatilities and covolatilities. While there exists a large body of literature on stochastic volatility models for one risky asset, considerably fewer papers consider stochastic volatility in the multiasset framework. Moreover, the number of assets examined is often quite limited and equal to 2, 3 or 4. Exceptions are the recent papers on conditional correlation GARCH model by Engle and Sheppard (2001), Fiorentini, Sentana and Shephard (2003) and the bayesian model by Chip, Nardari and Shephard (2002). The multivariate models in the literature are typically applied to the joint analysis of exchange rates[4], interest rates[5], stock prices,[6] and the volatility links between stock markets[7]. The limited number of theoretical contributions in this field is due to the difficulty in finding a dynamic specification of the stochastic volatility matrix which would satisfy the following requirements:

i) define matrix processes compatible with the symmetry and positivity properties of a variance-covariance matrix.

ii) avoid the curse of dimensionality by keeping the number of parameters low without making the structure of the model too rigid.

iii) allow for forecasting at any horizon in a straightforward manner.

iv) allow for checking the time series properties of the volatility process, such as stationarity and the Markov property of order 1.

v) ensure the invariance of the model with respect to time aggregation and portfolio allocation.

In the literature we distinguish two types of multivariate models for the dynamics of a volatility-covolatility matrix:

$$Y_t = V_t\left(r_{t+1}\right),$$

where r_{t+1} is a n-dimensional vector of returns, (Y_t) is a (n, n) symmetric positive definite matrix and V_t denotes the variance-covariance matrix conditional on the information available at date t.

i) The multivariate ARCH models are autoregressive specifications of the volatility matrix. The volatility matrix is written as a linear combination of lagged volatilities and lagged squared returns. The elementary model is the multivariate ARCH(1) model, in which the elements of the volatility matrix Y_t are linear affine combinations of the elements the matrix of squared returns :

[4] Bollerslev (1987), Diebold and Nerlove (1989), Bollerslev (1990), Baillie, Bollerslev (1990), Pelletier (2003).

[5] Engle, Ng and Rothschild (1990).

[6] Schwert, Seguin (1990).

[7] King and Whadwani (1990), King, Sentana, and Wadhwani (1994), Lin, Engle, and Ito (1994), Ledoit, Santa-Clara, Wolf (2001).

$vech\,(Y_t) = Avech\left(r_{t-1}r'_{t-1}\right) + b$, where $vech\,(Y)$ denotes the vector obtained by stacking the $\frac{n(n+1)}{2}$ different elements of Y. The full unrestricted model involves $\left[\frac{n(n+1)}{2}\right]^2 + \frac{n(n+1)}{2}$ parameters and suffers from the curse of dimensionality [see Bollerslev, Engle, and Wooldridge (1988)]. The solutions proposed in the multivariate ARCH literature are the following. Under the diagonal-vech specification, the matrix A is diagonal and each series in the multivariate vector has a GARCH-like specification[8] [Bollerslev, Engle, and Wooldridge (1988) and e.g. Brandt and Diebold (2002) for an application]; Bollerslev (1987) introduced the constant conditional correlation restriction to make the estimation of a large model feasible and ensure positive definiteness of the covariance matrix; this approach has been extended by Pelletier (2003), who considered a regime switching model with constant correlation in each regime. Recently Tse, Tsui (2002), Engle (2002) introduced models with time varying correlations. They propose a nonlinear GARCH type representation, which ensures that the correlations vary between -1 and 1.

Alternatively, the spectral decomposition of the volatility matrix can be assumed to be of a special form [Baba, Engle, Kraft, and Kroner (1987)]. Recently, Alexander (2000) has advocated the use of factor ARCH models, as first outlined by Engle, Ng, and Rothschild (1990), but the model seems to provide poor fit in empirical work [Engle and Sheppard (2001)].

The multivariate ARCH specifications have several drawbacks. For instance, the symmetry and positivity constraints are satisfied only under a set of complicated restrictions on the parameters. which are difficult to interpret. Also, the models are not invariant with respect to the change of time unit[9] or with respect to change in portfolio allocation [see for example Dynamic Correlation model by Engle, Shephard (2001)].

ii) Stochastic volatility models in discrete time have been initially introduced by Taylor (1986), and later improved and extended to the multivariate framework by Harvey, Ruiz, and Shephard (1994) [see, Chib, Nardari, Shephard (2002), Fiorentini, Sentana, Shephard (2002), also Ghysels, Harvey, and Renault (1996) for a survey on the so-called stochastic variance models]. Typically the volatility matrix is written as:

$$Y_t = A \begin{pmatrix} \exp h_{1t} & & 0 \\ & \ddots & \\ 0 & & \exp h_{nt} \end{pmatrix} A',$$

where A is a (n,n) matrix and h_{it}, $i = 1, \ldots, n$, are independent volatility factor processes. The factor processes can be chosen so that $(h_{1t}, \ldots, h_{nt})$ is a gaussian VAR process [see Harvey, Ruiz, and Shephard (1994)]. This specification ensures that stochastic matrices (Y_t) are symmetric positive definite and follow

[8] This approach has been recently extended by Engle and Sheppard (2001) to a model with time-varying correlation compatible with univariate GARCH.

[9] See Drost and Nijman (1993), Drost and Werker (1996), Meddahi and Renault (2003) for a discussion of time aggregation of ARCH and volatility models.

a Markov process. The stochastic variance model is easy to estimate from return data by Kalman filter if the expected return is equal to zero, but much more difficult to implement if a volatility in mean is introduced[10]. However, the main drawback concerns the number n of underlying vectors, which is strictly less than the number of different elements of Y_t and the diagonal representation of the volatility matrix, which assumes stochastic weights, but constant factor loadings (corresponding to the columns of A)[11] [12].

The existing multivariate models seem too restrictive to accommodate the complexity of the data. Therefore, as put forward by Engle (2002), new solutions need to be found. The aim of the present paper is to introduce a multivariate dynamic specification which is compatible with the constraints on a volatility matrix, flexible, easy for prediction making, invariant with respect to temporal aggregation and portfolio allocation, and straightforward in implementation. Our approach is based on the extension of the Wishart distribution to dynamic framework . It is known that the Wishart distribution is the distribution of a sample variance-covariance matrix computed from i.i.d. multivariate gaussian observations [see Wishart (1928a,b) for the initial papers and Anderson (1984), Muirhead (1978, 1982), Stuart and Ord (1994), Bilodeau and Brenner (1999) for surveys]. The extension consists in introducing serial dependence by considering multivariate serially correlated Gaussian processes which are independent of each other, as the building blocks of the new process.

The Wishart Autoregressive (WAR) process is defined in Section 2. We explain how it is constructed from the aforementioned Gaussian VAR processes, compute its conditional Laplace transform, show that it satisfies the Markov property and derive the first and second order conditional moments. Finally we extend the definition to autoregressive WAR processes of higher autoregressive orders. Examples of WAR processes are discussed in Section 3 and some continuous time analogues are presented in Section 4. The WAR processes arise as special cases of compound autoregressive (CAR) processes considered in [Darolles, Gourieroux, and Jasiak (2001)]. For this reason, nonlinear predictions at any horizon are easy to perform. The predictive distribution at horizon h is given in Section 5, where temporal aggregation is also discussed. The purpose of Section 6 is to analyze models with reduced rank and their factor interpretations. The WAR-in-mean models are presented in Section 7. The properties of return based predictions are also given. The WAR-in-mean model is used as a representation of the dynamics of the efficient portfolio in a mean-variance framework and the structural interpretations are provided. Statistical inference is discussed in Section 8. We focus on the use of observable volatility matrices. We first discuss the identification of the parameters and explain how to derive consistent estimators by nonlinear least squares. In Section

[10] See Kim, Shephard, Chib (1998) for an application to exchange rates.

[11] The specification looks like Bollerslev's constant correlation GARCH process, since the correlation is zero after a change in the definition of the basic assets by means of the transformation A^{-1}.

[12] Constant factor loadings are also assumed in the standard factor ARCH model [Diebold, Nerlove(1989), Engle, Ng, Rotschild (1990), Alexander (2000)].

9 the Wishart process is estimated from a series of intraday realized volatility matrices. In particular, we analyze the number and types of underlying factors. Section 10 concludes. The proofs are gathered in Appendices.

2 The Wishart Autoregressive Process

Wishart distribution is the distribution of the sample second order moment of independent zero-mean multinormal vectors [see e.g. Wishart (1928a,b)]. This definition is extended to a dynamic framework by considering (zero-mean) gaussian vector autoregressive processes instead of independent normal vectors. The associated sample second moment at time t defines the value of the Wishart Autoregressive process (WAR) Y_t.

In Section 2.1 we first consider a model of Y_t of autoregressive order one which arises as the outer product of one Gaussian VAR(1) process, so that the rank of Y_t is constant and equal to one. Next, in Section 2.2 the model of order one of is extended to processes formed by stochastic matrices Y_t of any rank which arise from adding the outer products of several Gaussian VAR(1) processes. We derive the conditional first and second order moments of WAR(1), and we show that this model is invariant to portfolio allocation (Section 2.3). Finally we discuss the extension of the WAR process of order one to a WAR process of a finite order p.

2.1 The outer product of a gaussian VAR(1) process

Let us consider a (zero-mean) gaussian VAR(1) process $(x_t)$of dimension n. This process satisfies:

$$x_{t+1} = Mx_t + \varepsilon_{t+1}, \tag{1}$$

where (ε_t) is a sequence of i.i.d. random vectors with multivariate gaussian distribution $N(0, \Sigma)$, where Σ is assumed positive definite. Thus the process (x_t) is a Markov process with conditional distribution $N(Mx_{t-1}, \Sigma)$. This process is stationary if the matrix M has eigenvalues with modulus less than one and can be nonstationary otherwise. Let us now consider the process defined by:

$$Y_t = x_t x_t'. \tag{2}$$

It is a time series of (n, n) stochastic matrices of rank one for any date and state of nature. For example, for $n = 2$, we get:

$$Y_t = \begin{pmatrix} Y_{11t} & Y_{12t} \\ Y_{21t} & Y_{22t} \end{pmatrix} = \begin{pmatrix} x_{1t}^2 & x_{1t}x_{2t} \\ x_{1t}x_{2t} & x_{2t}^2 \end{pmatrix}.$$

While the rank of the matrix is deterministic (equal to 1), its nonzero eigenvalue (equal to $x_{1t}^2 + x_{2t}^2$) and the eigenvectors are stochastic. The dynamic distributional properties of the process (Y_t) are characterized by the conditional distribution of Y_{t+1} given $x_t, x_{t-1}, ...$ For Wishart processes it is easier and more suitable to examine the conditional distributions by means of the conditional

Laplace transform instead of the conditional density function. The property below is proved in Appendix 1:

Proposition 1 *i) The stochastic process* (Y_t) *is a Markov process, in the sense that the conditional distribution of* Y_{t+1} *given the information on the entire past path of* x*:* x_t, x_{t-1}, ... *is identical to the conditional distribution of* Y_{t+1} *given* $Y_t = x_t x_t'$*, only.*

ii) Moreover, the conditional Laplace transform (or moment generating function) Ψ_t *of the process* (Y_t) *can be written as*[13]*:*

$$\begin{aligned}\Psi_t(\Gamma) &= E\left[\exp Tr\left(\Gamma Y_{t+1}\right)|x_t\right] \\ &= E\left[\exp\left(x_{t+1}'\Gamma x_{t+1}\right)|x_t\right] \\ &= \frac{\exp\left[x_t' M'\Gamma\left(Id - 2\Sigma\Gamma\right)^{-1} M x_t\right]}{\left[\det\left(Id - 2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}} \\ &= \frac{\exp Tr\left[M'\Gamma\left(Id - 2\Sigma\Gamma\right)^{-1} M Y_t\right]}{\left[\det\left(Id - 2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}},\end{aligned}$$

where the argument of the Laplace transform is a symmetric matrix Γ *and* Tr *denotes the trace operator. The Laplace transform is defined for a matrix* Γ *such that*[14] [15]$\left\|2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right\| < 1$.

The Laplace transform of Y_{t+1}, which is the (conditional) expectation of the exponential of a linear combination of different elements of $x_{t+1}x_{t+1}'$ can always be written as the (conditional) expectation of $\exp\left(x_{t+1}'\Gamma x_{t+1}\right)$, where Γ is a symmetric matrix. Indeed we have:

$$Tr\left(\Gamma Y_{t+1}\right) = Tr\left(\Gamma x_{t+1}x_{t+1}'\right) = Tr\left(x_{t+1}'\Gamma x_{t+1}\right) = x_{t+1}'\Gamma x_{t+1},$$

since $x_{t+1}'\Gamma x_{t+1}$ is a scalar. Moreover, $\Psi_t(\Gamma)$ depends on x_t by means of Y_t only, which is the Markov property of the matrix process (Y_t).

As mentioned above, the stochastic matrix $Y_t = x_t x_t'$ is of rank one, while its range is stochastic. Therefore the model can only be used for degenerate positive semidefinite matrices[16]. The extension to positive semidefinite matrices of any rank, including the full rank, is given below.

[13] Let us recall that, for two symmetric matrices Γ and Y, we have:

$$Tr\left(\Gamma Y\right) = \sum_{i=1}^{n}\left(\Gamma Y\right)_{ii} = \sum_{i=1}^{n}\sum_{l=1}^{n}\gamma_{il}Y_{li} = \sum_{i=1}^{n}\sum_{l=1}^{n}\gamma_{il}Y_{il}.$$

For instance, for $n = 2$ we get: $Tr\left(\Gamma Y\right) = \gamma_{11}Y_{11} + \gamma_{22}Y_{22} + 2\gamma_{12}Y_{12}$.

[14] The domain of existence of the Laplace transform has zero as interior point, and the Laplace transform admits a series expansion with respect to Γ. Thus all conditional (cross) moments of any order of the components of the process (Y_t) exist.

[15] The norm of a symmetric matrix is its maximal eigenvalue.

[16] See Bilodeau and Brenner (1999) and references therein for a discussion of degenerate Wishart distributions.

2.2 Extension to positive semidefinite matrices of any rank

Let us now consider the process Y_t defined by

$$Y_t = \sum_{k=1}^{K} x_{kt} x'_{kt}, \tag{3}$$

where the processes $x_{kt}, k = 1, ..., K$ are independent Gaussian VAR(1) processes of dimension n with the same autoregressive parameter matrix and innovation variance:

$$x_{kt} = M x_{k,t-1} + \epsilon_{k,t}, \quad \epsilon_{k,t} \sim N(0, \Sigma), \tag{4}$$

The Proposition below extends Proposition 1 and is proved in Appendix 2.

Proposition 2 *When the processes (x_{kt}), $k = 1, \ldots, K$, are independent with the same autoregressive parameter M and innovation variance Σ:*
i) The process $Y_t = \sum_{k=1}^{K} x_{kt} x'_{kt}$ is a Markov process.
ii) Its (conditional) Laplace transform is given by:

$$\begin{aligned}
\Psi_t(\Gamma) &= E\left[\exp Tr\left(\Gamma Y_{t+1}\right)|x_t\right] \\
&= E\left[\exp\left(\sum_{k=1}^{K} x'_{k,t+1} \Gamma x_{k,t+1}\right)|x_t\right] \\
&= E\left[\exp\left(\sum_{i=1}^{n}\sum_{j=1}^{n} \gamma_{ij} Y_{ij,t+1}\right)|Y_t\right] \\
&= \frac{\exp Tr\left[\left(M'\Gamma\left(Id - 2\Sigma\Gamma\right)^{-1} M\right) Y_t\right]}{\left[\det\left(Id - 2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{K/2}}.
\end{aligned}$$

The conditional Laplace transform still depends on the past by means of Y_t only, which is the Markov property of the matrix process (Y_t). The following is the definition of a Wishart autoregressive process of order one.

Definition 3 *A Wishart autoregressive process of order* 1*, denoted WAR(1), is a matrix Markov process $Y_t = \sum_{k=1}^{K} x_{kt} x'_{kt}$, where (x_{kt}) are independent gaussian AR(1) processes: $x_{k,t+1} = M x_{k,t} + \varepsilon_{k,t+1}$, $\varepsilon_{k,t+1} \sim N(0, \Sigma)$. It will be denoted as $W_n(K, M, \Sigma)$.*

Thus, the conditional distribution depends on the parameters K, M, Σ. K is the degree of freedom, M the (latent) autoregressive parameter, and Σ the (latent) innovation variance.

The transition of this process follows a noncentered Wishart distribution with pdf [see Muirhead (1982) p.442]:

$$f(Y_{t+1}|Y_t) = \frac{1}{2^{Kn/2}}\frac{1}{\Gamma_n(K/2)}(det\Sigma)^{-K/2}det[Id - \frac{1}{2}\Sigma^{-1}MY_tM'\Sigma^{-1}Y_{t+1}]^{-K/2}$$
$$(detY_{t+1})^{(K-n-1)/2}\exp\{(-\frac{1}{2}Tr[\Sigma^{-1}(Y_{t+1} + MY_tM')]\},$$

where $\Gamma_n(K/2) = \int_{A>>0}\exp\{Tr(-A)\}(detA)^{K-n-1)/2}dA$ is the multidimensional gamma function and the density is defined on positive semi-definite matrices.

This function remains a density function when K is a real number strictly larger than $n-1$. Therefore a WAR(1) process can also be defined for **noninteger values of** K by means of its Laplace transform, but loses its interpretation as a sum of squared gaussian VAR(1) [17]. However, except for applications such as the models of quadratic term structure of interest rates[18], we don't have to focus on an economic or financial interpretation of the latent processes (x_{kt}). These processes are introduced mainly to derive the functional form of the Laplace transform and to simplify the proofs and interpretations of some results. Finally note that the matrix Y_t has full rank with probability one if $K > (n-1)$.

The WAR(1) model arises as a solution to the curse of dimensionality encountered in multivariate models, where the number of reduced form parameters is of order $\left[\frac{n(n+1)}{2}\right]^4$. Indeed the WAR(1) process involves a much smaller number of parameters equal to $1 + \frac{n(n+1)}{2} + n^2$, which corresponds to the order for the reduced-form parameters of a n-dimensional VAR process. The number of parameters can be further reduced by imposing restrictions on the matrices M or Σ (see Section 6).

2.3 Conditional moments

The conditional Laplace transform contains all information on the conditional distribution. However, it can be useful to consider also some summary statistics such as the first and second order conditional moments, even if they are less informative. While the expression of the conditional expectation of a stochastic matrix is easy to define, its conditional variance-covariance matrix is cumbersome. Remember that the volatility matrix of a stochastic volatility matrix[19] is

[17] This possibility of noninteger degree of freedom corresponds to the inclusion of the chi-square family of distributions in the gamma family when $n = 1$, since up to a scale factor the chi-square distribution with degree of freedom K is a gamma distribution with degree of freedom $K/2$.

[18] See Ahn, Dittmar and Gallant (2002) for the estimation of a basic quadratic term structure model, and Cheng and Scaillet (2002), Gourieroux and Sufana (2003) for the discussion and extension of such models.

[19] The volatility of the volatility is important for financial applications. Indeed it is related to the volatility of derivatives written on the underlying returns. This explains for instance the opening of a market for derivatives on market index volatility at Chicago.

of a very large dimension equal to $\frac{n(n+1)}{4}\left[\frac{n(n+1)}{2}+1\right]$. In order to give some insights on the structure of that matrix, without complicated matrix notation, we calculate the conditional variance between two inner products $\gamma' Y_{t+1}\alpha$, $\delta' Y_{t+1}\beta$ based on Y_{t+1}. Given the formulas established for any real vectors α, β, γ, δ, we can compute all covariances of interest. For instance, the conditional covariance $cov_t\left(Y_{ij,t+1}, Y_{kl,t+1}\right)$ corresponds to $\alpha = e_j$, $\gamma = e_i$, $\beta = e_l$, $\delta = e_k$, where e_i is the i^{th} canonical vector with zero components except the i^{th} component which is equal to 1.

The first and second order conditional moments of the WAR(1) process are derived in Appendix 3.

Proposition 4 *We have:*
i) $E_t\left(Y_{t+1}\right) = M Y_t M' + K\Sigma$.
ii) For any set of four n-dimensional vectors α, β, γ, δ *we get:*

$$\begin{aligned}
& cov_t\left(\gamma' Y_{t+1}\alpha, \delta' Y_{t+1}\beta\right) \\
= \; & \gamma' M Y_t M' \delta \alpha' \Sigma \beta + \gamma' M Y_t M' \beta \alpha' \Sigma \delta + \alpha' M Y_t M' \delta \gamma' \Sigma \beta \\
& + \alpha' M Y_t M' \beta \gamma' \Sigma \delta + K\left[\gamma' \Sigma \beta \alpha' \Sigma \delta + \alpha' \Sigma \beta \gamma' \Sigma \delta\right].
\end{aligned}$$

The first and second order conditional moments are affine functions of the lagged values of the volatility process, which is a direct consequence of the exponential affine expression of the conditional Laplace transform [see Darolles, Gourieroux, and Jasiak (2001)]. In particular, the WAR(1) process is a weak linear AR(1) process [see e.g. Grunwald, Hyndman, Tedesco, and Tweedie (1997) for a survey of linear AR(1) processes in the literature]. More precisely, we get :

$$Y_{t+1} = M Y_t M' + K\Sigma + \eta_{t+1}, \tag{5}$$

where η_{t+1} is a matrix of stochastic errors with conditional mean zero. Equivalently we get:

$$vech(Y_{t+1}) = A(M) vech(Y_t) + vech(K\Sigma) + vech(\eta_{t+1}), \tag{6}$$

where $vech(Y)$ denotes the vector obtained by stacking the lower triangular elements of Y, and $A(M)$ is a matrix function of M. The linear representation given above is a weak representation since the error term features conditional heteroscedasticity and, even after standardization, is not identically distributed.

2.4 Invariance to linear invertible transformation

Let us consider a WAR(1) process Y_t of dimension n with parameters K, M, Σ, and a (n, n) invertible matrix A; the process: $Y_t(A) = A' Y_t A$ is another process of stochastic symmetric positive semidefinite matrices. Moreover we have:

$$Y_t(A) = A' \sum_{k=1}^{K} x_{kt} x'_{kt} A = \sum_{k=1}^{K} A' x_{kt} x'_{kt} A = \sum_{k=1}^{K} z_{kt} z'_{kt},$$

where $z_{kt} = A'x_{kt}$ are also gaussian autoregressive processes such that: $z_{k,t+1} = A'M(A')^{-1} z_{k,t} + A'\varepsilon_{k,t+1}$. This implies the property below [20].

Proposition 5 *If (Y_t) is a WAR(1) process $W_n(K, M, \Sigma)$ and A is a (n,n) invertible matrix, then $Y_t(A) = A'Y_tA$ is also a WAR(1) process $W_n(K,\, A'M(A')^{-1},\, A'\Sigma A)$.*

From a financial viewpoint, Proposition 5 establishes the invariance of the family of Wishart processes with respect to portfolio allocation. Indeed, let us consider n basic assets with returns r_t and volatility Y_t. and n portfolios of various quantities of those assets. The quantities of each asset (positive or negative) in a given portfolio allocation form a column of matrix A. The returns on the portfolios are:

$$r_{t+1}(A) = A'r_{t+1},$$

whereas the portfolios' volatilities are $V_t r_{t+1}(A) = A'Y_tA$. Thus, if the asset return volatility follows a Wishart process, the portfolios' volatility follows a Wishart process as well [21]. This invariance property is not satisfied by some constrained multivariate ARCH models such as the so-called diagonal model and the model with constant correlation.

In particular, Proposition 5 implies that any Wishart autoregressive process can be rewritten as a "standardized" WAR, with latent error ε variance equal to an identity matrix of dimension n.

Corollary 6 *Any WAR(1) process $W_n(K, M, \Sigma)$ with invertible matrix Σ can be written as: $Y_t = \Sigma^{1/2}Y_t^*\Sigma^{1/2}$, where Y_t^* is a "standardized" WAR(1) process $W_n(K,\, \Sigma^{-1/2}M\Sigma^{1/2},\, Id)$.*

Other linear invertible transformations can also be considered. For instance, let us assume that the autoregressive matrix M is diagonalizable[22]. M can be written as: $M = Q\Lambda Q^{-1}$, where Q is the matrix of eigenvectors and Λ the diagonal matrix of eigenvalues of M. The transformed process $Y_t^* = Q^{-1}Y_t\left(Q^{-1}\right)'$ is a WAR(1) process $W_n(K,\, \Lambda,\, Q^{-1}\Sigma\left(Q^{-1}\right)')$, with a diagonal autoregressive matrix. Thus all interactions between latent variables are captured by the innovation variance.

The discussion in terms of porfolio allocations shows the importance of portfolio volatilities $\alpha'Y_t\alpha$, where α is a given vector. The second order dynamic properties of such portfolio volatilities follow from Proposition 4 (see Appendix 4).

Corollary 7 *Let α, β, γ, δ be n-dimensional vectors. We obtain:*

i) $V_t(\gamma'Y_{t+1}\alpha) = \gamma'MY_tM'\gamma\ \alpha'\Sigma\alpha + 2\gamma'MY_tM'\alpha\ \alpha'\Sigma\gamma + \alpha'MY_tM'\alpha\ \gamma'\Sigma\gamma$

[20] The proof for noninteger K follows directly from the conditional Laplace transfrom.

[21] Similarly, the Wishart specification for a volatility matrix of log-exchange rates is invariant with respect to the currency unit.

[22] This assumption has been made for instance by Ahn, Dittmar and Gallant (2002) in the context of quadratic term structure models.

$$+K\left[\left(\gamma'\Sigma\alpha\right)^2+\alpha'\Sigma\alpha\gamma'\Sigma\gamma\right];$$

ii) $V_t\left(\alpha' Y_{t+1}\alpha\right)=4\alpha' M Y_t M'\alpha\ \alpha'\Sigma\alpha+2K\left(\alpha'\Sigma\alpha\right)^2$;

iii) $cov_t\left(\alpha' Y_{t+1}\alpha,\beta' Y_{t+1}\beta\right)=4\alpha' M Y_t M'\beta\ \alpha'\Sigma\beta+2K\left(\alpha'\Sigma\beta\right)^2$;

iv) $cov_t\left(\alpha' Y_{t+1}\alpha,\alpha' Y_{t+1}\beta\right)=2\alpha' M Y_t M'\alpha\ \alpha'\Sigma\beta+2\alpha' M Y_t M'\beta\ \alpha'\Sigma\alpha$
$+2K\alpha'\Sigma\beta\ \alpha'\Sigma\alpha.$

From the formulas in Corollary 7 we see that :

i) the degree of freedom is a parameter which determines the magnitude of overdispersion;

ii) the correlations between portfolio volatilities can be of any sign due to the first term in iii) of Corollary 7. Thus it will be easy to reproduce asymmetric reactions of volatilities and covolatilities [Ang, Chen (2002)].

2.5 WAR(p) processes

Due to the number n of components in Y_t, a WAR(1) process can accommodate a large spectrum of patterns of persistence in volatilities and covolatilities, including possibly long memory effects. Nevertheless there may be cases when WAR processes with higher autoregressive order p (called WAR(p)) need to be considered. The Wishart processes are easily extended to include more autoregressive lags. Since the formula of the conditional Laplace transform in Definition 3 is valid for any conditioning matrix MY_tM', this matrix can be replaced by any symmetric positive semi-definite function of Y_t, Y_{t-1},...,Y_{t-p+1}.

Definition 8 *A Wishart autoregressive process of order p, denoted WAR(p), is a matrix process with conditional Laplace transform:*

$$\begin{aligned}\Psi_t\left(\Gamma\right) &= E_t\left[\exp Tr\left(\Gamma Y_{t+1}\right)\right]\\ &= \frac{\exp Tr\left[\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}\sum_{j=1}^{p} M_j Y_{t-j+1} M_j'\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{K/2}},\end{aligned}$$

where the matrices M_j have dimension (n,n) and represent the sequence of latent "matrix autoregressive coefficients". The process will be denoted $W_n\left(K;M_1,\ldots,M_p,\Sigma\right)$.

When the autoregressive order is larger than 1, the interpretation of the Wishart process as the sum of squares of autoregressive gaussian processes is no longer valid. For instance, let us consider a gaussian VAR(2) process: $x_{t+1}=M_1x_t+M_2x_{t-1}+\varepsilon_{t+1}$, $\varepsilon_{t+1}\sim IIN\left(0,\Sigma\right)$. The conditional Laplace transform of $Y_{t+1}=\left(x_{t+1}x_{t+1}'\right)$ given $\underline{x_t}=\left(x_t,x_{t-1},\ldots\right)$ becomes:

$$\begin{aligned}&\Psi_t\left(\Gamma\right)\\ =\ &\frac{\exp\left[\left(M_1x_t+M_2x_{t-1}\right)'\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}\left(M_1x_t+M_2x_{t-1}\right)\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}}\end{aligned}$$

$$= \frac{\exp Tr\left[\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}\left(M_1x_t+M_2x_{t-1}\right)\left(M_1x_t+M_2x_{t-1}\right)'\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}}$$
$$= \frac{\exp Tr\left[\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}\left(M_1Y_tM_1'+M_2Y_{t-1}M_2'+M_1x_tx_{t-1}'M_2'+M_2x_{t-1}x_t'M_1'\right)\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}}.$$

We see that this is not the conditional Laplace transform of a Wishart process because of the presence of the cross products x_tx_{t-1}'. Section 4.2 shows how such cross terms can be handled in a Wishart framework. The expressions of first and second order conditional moments of a WAR(p) process are similar to expressions given in Proposition 4 and Corollary 7. We get , for instance:

$$E_t(Y_{t+1}) = \sum_{j=1}^{p} M_jY_{t+1-j}M_j' + K\Sigma,$$
$$V_t(\alpha'Y_{t+1}\alpha) = 4\alpha'(\sum_{j=1}^{p} M_jY_{t+1-j}M_j')\alpha\alpha'\Sigma\alpha + 2K(\alpha'\Sigma\alpha)^2,$$

In particular a WAR(p) process admits a weak linear autoregressive representation of order p:

$$vech(Y_{t+1}) = \sum_{j=1}^{p} A_j(M_1,...,M_p)vech(Y_{t+1-j}) + vech(K\Sigma) + vech(\eta_{t+1}), \quad \text{say.} \tag{7}$$

3 Examples

In this section we give various examples of Wishart processes and describe special cases which are known in the literature, such as the Wishart White Noise, the one-dimensional Wishart process, known as the Autoregressive Gamma Process, and the Wishart process of unit root.

3.1 The Wishart White Noise

When $M = 0$, the series (Y_t) is simply a sequence of independent matrices with identical Wishart distributions with parameters K and Σ. The first and second order moments are given by: $E\left(Y_t\right) = K\Sigma$, $cov\left(\gamma'Y_t\alpha, \delta'Y_t\beta\right) = K\left[\gamma'\Sigma\beta\alpha'\Sigma\delta + \alpha'\Sigma\beta\gamma'\Sigma\delta\right]$. In particular, $cov\left(\alpha'Y_t\alpha, \beta'Y_t\beta\right) = 2K\left(\alpha'\Sigma\beta\right)^2$. The two stochastic quadratic forms $\alpha'Y_t\alpha$ and $\beta'Y_t\beta$ are uncorrelated if and only if the vectors α and β are orthogonal for the inner product associated with Σ. Such results are useful in the analysis of Wishart processes since, as shown in the next section, the marginal distribution of a stationary Wishart process is a centered Wishart distribution.

3.2 The limiting deterministic case

Let us consider the WAR(1) process with parameters K, $\Sigma_K = K^{-1}\Sigma_1$, $M_K = M_1$, where Σ_1, M_1 are constant matrices, and the limit of the WAR(1) process when the degree of freedom K tends to infinity. By definition we have:

$$Y_t = \sum_{k=1}^{K} x_{kt} x'_{kt},$$

where $x_{k,t} = M_K x_{k,t-1} + \varepsilon_{k,t}$, $\varepsilon_{k,t} \sim N(0, \Sigma_K)$. Equivalently we can write:

$$Y_t = \frac{1}{K} \sum_{k=1}^{K} \widetilde{x}_{kt} \widetilde{x}'_{kt},$$

where $\widetilde{x}_{k,t} = \sqrt{K} x_{kt} = M_1 \widetilde{x}_{k,t-1} + \widetilde{\varepsilon}_{k,t}$, $\widetilde{\varepsilon}_{k,t} \sim N(0, \Sigma_1)$. Since the variables $\widetilde{x}_{k,t}$, $k = 1, \ldots, K$, are independent identically distributed[23], it follows that, for large K:

$$Y_t \sim E\left(\widetilde{x}_{kt} \widetilde{x}'_{kt}\right),$$

by the law of large numbers.

For instance, if the autoregressive coefficient M_1 admits eigenvalues with a modulus strictly less than 1, if $x_{k,o} = 0, \forall k$, Y_t tends to $\Sigma(\infty)$, where $\Sigma(\infty)$ is the marginal variance of $\widetilde{x}_{kt}$. Thus the WAR(1) process includes as a limiting case the constant process, formed by a sequence of constant matrices.

3.3 The univariate WAR process

In the univariate framework ($n = 1$), the conditional Laplace transform becomes:

$$\begin{aligned} \Psi_t(\gamma) &= E\left[\exp\left(\gamma Y_{t+1}\right) | Y_t\right] \qquad (8) \\ &= \left(1 - 2\gamma\sigma^2\right)^{-K/2} \exp\left(\frac{\gamma m^2}{1 - 2\gamma\sigma^2} Y_t\right) \end{aligned}$$

We see that this is the conditional Laplace transform of an autoregressive gamma process [see e.g. Gourieroux and Jasiak (2000), Darolles, Gourieroux, and Jasiak (2001)], up to a scale factor. The transition distribution is a path dependent noncentered gamma distribution up to a change of scale.

3.4 Unit root

A special WAR(1) process has already been considered in the literature [Bru (1989), Bru (1991), O'Connel (2003)], and corresponds to $M = Id, \Sigma = Id$.

[23] if the processes are stationary. Otherwise the result is still valid if we assume identical initial values for the different (x_{kt}) processes.

Thus, if K is integer, the underlying processes $(x_{it}), i = 1, \ldots, n$, are independent gaussian random walks, and the $WAR_n(K, Id, Id)$ process is simply the time discretization of the continuous time process defined by:

$$dY_t = KId_n dt + Y_t^{1/2} d\tilde{W}_t' Y_t^{1/2}, \tag{9}$$

where $Y_t^{1/2}$ is the symmetric positive root of Y_t and $\tilde{W}_t$ is a (n, n) matrix, whose components are independent Brownian motions. This matrix process arises as a natural multivariate extension of the Bessel process used in finance for time deformation [Geman, Yor (1999)], and therefore shares the properties of the Bessel process[24]. Several theoretical results have been derived in this special case [Bru (1991), Donati-Martin et alii (2003)] like the explicit expression of the transition density of the process or the joint distribution of the process of eigenvalues of matrix Y_t. Note also, that for dimension $n = 1$ it corresponds to an autoregressive gamma process with unit root. This process is known to be stationary with long memory (see Gourieroux, Jasiak (2000)).

3.5 The bivariate WAR process

The bivariate WAR(1) process involves three components and depends on eight parameters, which explains the large variety of dynamic patterns that can be accommodated. In this section we show various simulated paths of

i) Y_{11t}, Y_{22t}, interpreted as volatilities,

ii) correlation $Y_{12t}/\left(Y_{11t}Y_{22t}\right)^{1/2}$, and

iii) eigenvalues $\lambda_{1t} > \lambda_{2t}$ of the stochastic volatility matrix.

The spectral decomposition of the volatility matrix is important for financial applications. The largest eigenvalue λ_{1t} is equal to the maximum of the portfolio volatilities $\lambda_{1t} = \alpha' Y_t \alpha$, computed on portfolio allocations standardized by $\alpha'\alpha = 1$. It provides the measure of the highest risk, whereas the associated eigenvector is the most risky portfolio allocation. Similarly, the smallest eigenvalue λ_{2t} is equal to the minimum of portfolio volatilitites computed on standardized portfolio allocations. When it is close to zero, the associated eigenvector is the basis for arbitragist strategies.

For illustration let us consider three experiments involving a bivariate WAR(1) process with $T = 100$ observations and $K = 2$ underlying processes. The autoregressive coefficient has been fixed to:

$$M = \begin{pmatrix} 0.9 & 0 \\ 1 & 0 \end{pmatrix} \text{ for experiment 1, } M = \begin{pmatrix} 0.3 & -0.3 \\ -0.3 & 0.3 \end{pmatrix} \text{ for experiment 2,}$$
$$M = \begin{pmatrix} 0.5 & 0 \\ 0 & 0.5 \end{pmatrix} \text{ for experiment 3.}$$

The first experiment corresponds to a recursive system for x_t, which involves a component (x_{1t}) with a root close to 1. The second experiment corresponds

[24] see Karlin, Taylor (1981) p175-176 for the definition of the Bessel process, and Revuz, Yor (1998), chapter XI for its properties.

to an autoregressive matrix of rank 1, where all the elements of the volatility matrix are driven by a single dynamic factor [see Section 6] Finally, in the third experiment the two latent processes are independent with identical dynamics.

[Insert Figure 1: volatilities, example 1]

[Insert Figure 2: correlation, example 1]

[Insert Figure 3: canonical volatilities, example 1]

⋮

[Insert Figure 9: canonical volatilities, example 3]

As expected, the bivariate WAR(1) model is able to reproduce volatility clustering phenomena, that is path dependent subperiods where the values of the variances Y_{11t}, Y_{22t}, or λ_{1t}, λ_{2t} are large, and path dependent subperiods when they are small. But these clustering phenomena are not necessarily identical for all portfolio volatilities.

In particular simultaneously λ_{1t} can cluster at high levels, while λ_{2t} is clustering at low levels. In such a situation the market has to manage two very different types of risks: 1) the common volatility risk for the first eigenvector, 2) a risk due to the leverage effect of arbitragist strategies for the second eigenvector. Intuitively, this situation will occur when some portfolio volatilities are negatively correlated.

Let us first discuss the volatility patterns. In experiment 1 we directly observe the lag of one between the peaks and throughs, which is a consequence of the recursive form of matrix M [see Figure 1]. In experiment 2 the series are driven by the same factor, but the sensitivity coefficients with respect to the factors are different. Moreover, the conditional heteroscedasticity of the volatility series renders difficult the detection of the common factor.

The correlations are rather typical of the case $n = K = 2$. Indeed the case $K = 2$ is close to the degenerate case $K = 1$. If $K = 1$, the matrix Y_t is stochastic with rank 1 and the correlation alternates, taking randomly values +1 and -1. When $K = 2$, the matrix Y_t has rank 2 with probability 1, but the probability of a correlation with absolute value close to one is significant. This feature is directly observed in Figures 2, 5, 8 in which we see highly fluctuating correlation. This effect will generally diminish when K increases as shown in Section 3.2.

Finally in Figures displaying the eigenvalues we find observations for which λ_{1t} is rather large while λ_{2t} is close to zero. At those times, the set of assets features high risk while there exist approximate directions for arbitrage.

4 Predictions from WAR processes

The WAR processes belong to the family of compound autoregressive (CAR) processes [see Darolles, Gourieroux, and Jasiak (2001)], which have simple prediction formulas due to the exponential affine representation of the conditional Laplace transform. Also, in this section we discuss temporal aggregation of

WAR processes. It will be shown that it resembles in many respects the temporal aggregation of gaussian VAR processes.

4.1 Prediction formulas and stationarity condition

Let us consider the (nonlinear) forecasting of the matrix WAR(1) process Y at horizon h which consists in computing the conditional distribution of Y_{t+h} given Y_t. Mathematically the prediction formulas follow from the conditional Laplace transform at horizon h, which is easy to compute recursively [see Darolles, Gourieroux, and Jasiak (2001)]. For ease of exposition, let us consider an integer-valued degree of freedom K. By definition we have:

$$Y_{t+h} = \sum_{k=1}^{K} x_{k,t+h} x'_{k,t+h},$$

where $x_{k,t+h} = M^h x_{k,t} + \varepsilon_{k,t,h}$, $V(\varepsilon_{k,t,h}) = \Sigma + M\Sigma M' + \ldots + M^{h-1}\Sigma\left(M^{h-1}\right)' = \Sigma(h)$, say. This implies the following proposition.

Proposition 9 *The transition distribution at horizon h of the WAR(1) process is the (conditional) Wishart distribution $W_n\left(K, M^h, \Sigma(h)\right)$.*

In particular, the WAR(1) process admits linear prediction formulas at any horizon. We have:

$$E\left[Y_{t+h}|Y_t\right] = M^h Y_t \left(M^h\right)' + K\Sigma(h).$$

If the matrix M admits eigenvalues with a modulus strictly less than 1, then the WAR(1) process is asymptotically strictly stationary. Its stationary (marginal) distribution is the centered Wishart distribution $W(K, 0, \Sigma(\infty))$, where $\Sigma(\infty)$ is the solution of the equation:

$$\Sigma(\infty) = M\Sigma(\infty) M' + \Sigma.$$

The prediction formulas are easily extended to a WAR(p) process, which is a compound autoregressive process too.

4.2 Temporal aggregation

In Sections 2 and 3 we considered a volatility matrix Y_t at horizon 1 for which the information set included the lagged values of Y_t and of the returns r_t. It is well-known that standard volatility models are not invariant with respect to time aggregation [see e.g. Drost and Nijman (1993), Drost and Werker (1996), Meddahi and Renault (2003)]. Let us consider a WAR(1) specification and study the volatilities and returns defined at a longer horizon of 2 time units, say. Let us first interpret the time aggregated volatility process:

$$\widetilde{Y}_{\tau+1} = Y_{2\tau} + Y_{2\tau+1}, \tau = 0, 1, 2, \ldots.$$

For this purpose let us define the geometric return at horizon 2:

$$\widetilde{r}_{\tau+1} = r_{2\tau+1} + r_{2\tau+2},$$

and assume zero expected return. We also assume that Y_t follows WAR(1) stochastic volatility model at time unit equal to one. When the information set at date $\tau = 2t$ includes the lagged values of the aggregate volatility and returns, we get:

$$\begin{aligned}
& V\left[\widetilde{r}_{\tau+1} | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
= & V\left[r_{2\tau+1} + r_{2\tau+2} | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
= & V\left[E\left(r_{2\tau+1} + r_{2\tau+2} | \underline{r_{2\tau}}, \underline{Y_{2\tau}}\right) | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
& + E\left[V\left(r_{2\tau+1} + r_{2\tau+2} | \underline{r_{2\tau}}, \underline{Y_{2\tau}}\right) | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
= & E\left[V\left(r_{2\tau+1} + r_{2\tau+2} | \underline{r_{2\tau}}, \underline{Y_{2\tau}}\right) | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
= & E\left[Y_{2\tau} + E\left(Y_{2\tau+1} | \underline{Y_{2\tau}}\right) | \underline{\widetilde{r}_{\tau}}, \underline{\widetilde{Y}_{\tau}}\right] \\
= & E\left[Y_{2\tau} + Y_{2\tau+1} | \underline{\widetilde{Y}_{\tau}}\right] \\
= & E\left[\widetilde{Y}_{\tau+1} | \underline{\widetilde{Y}_{\tau}}\right].
\end{aligned}$$

Thus, the aggregate process $\widetilde{Y}_{\tau+1} = Y_{2\tau} + Y_{2\tau+1}$ is the basic process that one needs to consider to calculate the volatility at horizon 2, equal to $E\left[\widetilde{Y}_{\tau+1} | \underline{\widetilde{Y}_{\tau}}\right]$.

Let us now consider the expression of aggregate volatility in terms of the latent x processes. We get:

$$Y_{2\tau} + Y_{2\tau+1} = \sum_{k=1}^{K} \left(x_{k,2\tau} x'_{k,2\tau} + x_{k,2\tau+1} x'_{k,2\tau+1}\right),$$

which is not a WAR(1) process, due to the presence of lags. However, the aggregate volatility $\tilde{Y_{\tau+1}}$ can be obtained from $\left(n^2, n^2\right)$ matrix:

$$Z_{\tau} = \sum_{k=1}^{K} \begin{pmatrix} x_{k,2\tau} \\ x_{k,2\tau+1} \end{pmatrix} \begin{pmatrix} x'_{k,2\tau} & x'_{k,2\tau+1} \end{pmatrix},$$

by summing the two diagonal blocks. The stacked process $\left(x'_{k,2\tau}, x'_{k,2\tau+1}\right)'$ is a gaussian VAR(1) process:

$$\begin{pmatrix} x_{k,2\tau} \\ x_{k,2\tau+1} \end{pmatrix} = \begin{pmatrix} 0 & M \\ 0 & M^2 \end{pmatrix} \begin{pmatrix} x_{k,2\tau-2} \\ x_{k,2\tau-1} \end{pmatrix} + \begin{pmatrix} Id & 0 \\ M & Id \end{pmatrix} \begin{pmatrix} \varepsilon_{k,2\tau} \\ \varepsilon_{k,2\tau+1} \end{pmatrix}.$$

Since the process (Z_{τ}) is the sum of squares of the stacked gaussian VAR, it follows that:

Proposition 10 *The stochastic process* (Z_τ) *is a Wishart process of dimension* $2n$*:* $W_{2n}\left(K, \begin{pmatrix} 0 & M \\ 0 & M^2 \end{pmatrix}, \begin{pmatrix} \Sigma & \Sigma M' \\ M\Sigma & \Sigma + M\Sigma M' \end{pmatrix}\right)$.

Thus the process of aggregate volatilities is the sum of block diagonal elements of a Wishart process obtained by stacking the consecutive observations of latent processes x_t. The stacking reveals the effect of the cross-products $x_{k,2\tau}x'_{k,2\tau+1}$ on the distribution of the block diagonal elements. We conclude that the volatility process at horizon 2, that is $E\left[\widetilde{Y}_{\tau+1}|\widetilde{Y}_\tau\right]$, is not a Wishart process of order 1, but can be computed from an augmented Wishart process of order 1.

5 Continuous time analogue

When the autoregressive coefficient M can be written as $M = \exp(A)$, where A is a matrix, the Wishart autoregressive process of order 1 is a time-discretized diffusion process. Moreover, if K is an integer the diffusion process is obtained by summing the squares of K independent multivariate Ornstein-Uhlenbeck processes.

Let us consider $K = 1$ and the multivariate Ornstein-Uhlenbeck process defined by:

$$dx_t = Ax_t dt + \Omega dw_t, \tag{10}$$

where (w_t) is a n-dimensional standard brownian motion and A and Ω are (n, n) matrices. It is well known that the time-discretized Ornstein-Uhlenbeck process is a gaussian autoregressive process of order 1, where $M = \exp(A)$ and $\Sigma = \int_0^1 \exp(sA)\,\Omega\Omega'\,[\exp(sA)]'\,ds$.

The exponential expression of the autoregressive matrix coefficient implies restrictions on the dynamics of the associated discrete-time gaussian AR(1) process. More precisely, the autoregressive matrix M cannot admit negative or zero eigenvalues. Thus a number of gaussian VAR(1) processes in discrete time, which are usually encountered in applications, cannot be considered as time discretizations of multivariate Ornstein-Uhlenbeck processes. Thus some Wishart processes of order one are not time discretized continuous-time processes. For M of dimension $(2, 2)$ we have for example:

i) the white noise Wishart process for $M = 0$;

ii) the model with periodicity 2 for $M = -Id$;

iii) the model with recursive dependence $M = \begin{pmatrix} 0 & 0 \\ -0.5 & 0 \end{pmatrix}$, where the latent process $x_{1t} = \varepsilon_{1t}$, $x_{2t} = \varepsilon_{2t} - 0.5\ x_{1,t-1} = \varepsilon_{2t} - 0.5\ \varepsilon_{1,t-1}$, is a moving average.

For any other $M = \exp(A)$, the WAR(1) process is a time-discretized diffusion process. The diffusion process is: $Y_t = x_t x_t'$ where (x_t) is the Ornstein-Uhlenbeck process (equation 10). Let us show the stochastic differential system satisfied by the continuous time matrix process (Y_t). It is proved in Appendix 5 that this matrix process satisfies:

$$\begin{aligned} dY_t &= (\Omega\Omega' + AY_t + Y_t A')\,dt + x_t\,(\Omega dw_t)' + \Omega dw_t x_t' \\ &= (\Omega\Omega' + AY_t + Y_t A')\,dt + \sum_{l=1}^{n} (x_t \Omega_l' + \Omega_l x_t')\,dw_{lt}, \end{aligned} \tag{11}$$

where Ω_l, $l = 1, \ldots, n$, are the columns of matrix Ω. It is easily checked that the volatility matrix of $d(vecY_t)$ depends on Y_t only. Indeed let us introduce: $vecY_t = \left(Y_t^{1\prime}, \ldots, Y_t^{n\prime}\right)'$, where Y_t^j, $j = 1, \ldots, n$, is the j^{th} column of Y_t. The Brownian component of dY_t^j is $\sum_{l=1}^{n} (x_t \omega_{jl} + \Omega_l x_{jt})\,dw_{lt}$. Thus we deduce:

$$\begin{aligned} & cov_t\left(dY_t^i, dY_t^j\right) \\ = \;& cov_t\left[\sum_{l=1}^{n} (x_t\omega_{il} + \Omega_l x_{it})\,dw_{lt}, \sum_{l=1}^{n} (x_t\omega_{jl} + \Omega_l x_{jt})\,dw_{lt}\right] \\ = \;& \left[\sum_{l=1}^{n} (x_t\omega_{il} + \Omega_l x_{it})\,(x_t\omega_{jl} + \Omega_l x_{jt})'\right] dt. \end{aligned}$$

This conditional covariance is a function of Σ and Y_t only:

$$cov_t\left(dY_t^i, dY_t^j\right) = \left(\sigma_{ij} Y_t + Y_t^j\,(\Sigma^i)' + \Sigma^j\,(Y_t^i)' + Y_{ij,t}\Sigma\right) dt. \tag{12}$$

In particular, we deduce for any n-dimensional vectors α, β, γ, δ:

i) $cov_t\,(dY_t\alpha, dY_t\beta) = (\alpha'\Sigma\beta Y_t + Y_t\beta\alpha'\Sigma + \Sigma\beta\alpha' Y_t + \alpha' Y_t\beta\Sigma)\,dt$,

ii) $cov_t\,(\gamma' dY_t\alpha, \delta' dY_t\beta) = [(\alpha'\Sigma\beta)\,(\gamma' Y_t\delta) + (\gamma' Y_t\beta)\,(\alpha'\Sigma\delta)$
$+ (\gamma'\Sigma\beta)\,(\alpha' Y_t\delta) + (\alpha' Y_t\beta)\,(\gamma'\Sigma\delta)]dt$,

iii) $V_t\,(\gamma' dY_t\alpha) = [(\alpha'\Sigma\alpha)\,(\gamma' Y_t\gamma) + 2\,(\alpha' Y_t\gamma)\,(\alpha'\Sigma\gamma) + (\alpha' Y_t\alpha)\,(\gamma'\Sigma\gamma)]dt$,

iv) $V_t\,(\alpha' dY_t\alpha) = 4\,(\alpha'\Sigma\alpha)\,(\alpha' Y_t\alpha)\,dt$,

v) $cov_t\,(\alpha' dY_t\alpha, \beta' dY_t\beta) = 4\,(\alpha'\Sigma\beta)\,(\alpha' Y_t\beta)\,dt$.

These covariance formulas are the local counterparts of the discrete time formulas derived in Corollary 7. Indeed for a small time increment dt, the formulas of Corollary 7 hold with $M = Id + o(dt)$ and Σ replaced by Σdt. For continuous time, the terms in the volatility formula of order dt matter only.

By construction we know that the solution $Y_t = x_t x_t'$ of the differential system (11) - (12) is symmetric positive semidefinite. However the positivity condition becomes obvious when we consider the "drift" and "volatility" expressions.

Indeed let us consider a vector (portfolio allocation) α such that $\alpha' Y_t \alpha = 0$. The drift of $\alpha' dY_t \alpha$ is $\alpha' \Omega\Omega' \alpha dt \geq 0$, whereas its volatility is $V_t\left(\alpha' dY_t \alpha\right) = 0$. Thus there is a mean-reverting effect, which ensures that $\alpha' Y_t \alpha$ remains nonnegative and this argument is valid for any α.

The Wishart continuous-time process is easily extended to handle any degree of freedom K strictly greater than 0, integer or noninteger valued. To do that, we keep the volatility function unchanged, change the drift to $K\Omega\Omega' + AY_t + Y_t A'$ and increase the number of independent Brownian motions up to dimension $\frac{n(n+1)}{2}$. When K is not an integer, the interpretation in terms of sums of squares of Ornstein-Uhlenbeck processes is no longer valid, but the symmetry and positivity of the solutions are ensured by the boundary argument given above.

The differential stochastic system satisfied by the Wishart process can be written as:

$$dvechY_t = \mu_t dt + \Lambda_t^{1/2} dW_t, \tag{13}$$

where (W_t) is an $n(n+1)/2$ dimensional Brownian motion, $\mu_t = vech(K\Omega\Omega' + AY_t + Y_t A')$ and $\Lambda_t \approx 1/dt V_t(dvechY_t)$ has a complicated expression. An alternative representation of the continuous time process can be derived by analogy to the equation of unit root Wishart processes (see Section 3.4). It is easy to see that a continuous time Wishart process satisfies a system of the type :

$$dY_t = (\tilde{\Omega}\tilde{\Omega}' + \tilde{A}Y_t + Y_t\tilde{A}')dt + Y_t^{1/2} d\tilde{W}_t Q + Q' d\tilde{W}_t' Y_t^{1/2},$$

where $\tilde{W}_t$ is a (n,n) stochastic matrix, whose components are independent Brownian motions and $\tilde{\Omega}, A, Q$ are (n,n) matrices . This representation can be useful for some computations, but it can also be misleading. Indeed the number of scalar Brownian motions is strictly larger than the number of linearly independent components of Y_t. Therefore information generated by the $n(n+1)/2$ components of Y is strictly included in the information set generated by the n^2 Brownian motions.

Example 1. The square of a univariate Ornstein-Uhlenbeck process $y_t = x_t^2$, where:

$$dx_t = ax_t dt + \omega dW_t,$$

satisfies the stochastic differential equation:

$$dy_t = \left(2ay_t + \omega^2\right) dt + 2\omega\sqrt{y_t} dW_t.$$

For another value K of the degree of freedom, we get:

$$dy_t = \left(2ay_t + K\omega^2\right) dt + 2\omega\sqrt{y_t} dW_t.$$

This is the Cox-Ingersoll-Ross (CIR) process [Cox, Ingersoll, Ross (1985)]. This result is not surprising since the CIR process is a special case of an autoregressive gamma process. In particular the square of an Ornstein-Uhlenbeck process is a special case of CIR process with a restriction on the mean reverting, volatility and equilibrium parameters [see Heston (1993)].

6 Reduced-rank (factor) models

In multivariate time series, the number of parameters can be reduced by finding factor representations with a small number of factors. The factor representations can be defined a priori as, for example, in factor ARCH models, or they can be based on a coherent general-to-specific methodology as in multivariate linear autoregressive models. In this section we develop a general-to-specific approach which is based on the analysis of the rank, kernel and range of the autoregressive matrix. By considering a matrix M with reduced rank, we are able to define portfolio allocations with special properties such as 1) serially independent portfolio volatilities (white noise directions), 2) portfolio volatilities which summarize relevant information (factor directions).

For ease of exposition, we first consider an autoregressive matrix of rank one, and next extend the results to matrices of any rank.

6.1 Matrix M of rank 1

Let us first consider a WAR(1) process with autoregressive matrix M of rank 1. This matrix can always be written as: $M = \beta\alpha'$, where β and α are two nonzero vectors of dimension n. Thus, for integer K, the process Y_{t+1} can be written as:

$$\begin{aligned} Y_{t+1} &= \sum_{k=1}^{K} x_{k,t+1} x'_{k,t+1} \\ &= \beta\alpha' Y_t \alpha\beta' + \beta\alpha' \sum_{k=1}^{K} x_{k,t+1}\varepsilon'_{k,t+1} + \sum_{k=1}^{K} \varepsilon_{k,t+1} x'_{k,t+1}\alpha\beta' + \sum_{k=1}^{K} \varepsilon_{k,t+1}\varepsilon'_{k,t+1}. \end{aligned}$$

This representation involves a term $\beta\alpha' Y_t \alpha\beta'$, which is known at time t, and three stochastic terms.

i) Let us first consider the conditional Laplace transform of the process Y_t [25]. It is equal to:

$$\begin{aligned} \Psi_t(\Gamma) &= \frac{\exp Tr\left[\alpha\beta'\Gamma\left(Id - 2\Sigma\Gamma\right)^{-1}\beta\alpha' Y_t\right]}{\left[\det\left(Id - 2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{K/2}} \\ &= \frac{\exp Tr\left[\left(\beta'\Gamma\left(Id - 2\Sigma\Gamma\right)^{-1}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(Id - 2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{K/2}}, \end{aligned}$$

since we can commute under the trace operator. It is seen that the conditional Laplace transform depends on Y_t by means of $\alpha' Y_t \alpha$ only.

[25] valid for any integer or noninteger degree of freedom

Proposition 11 *When $M = \beta\alpha'$, the conditional Laplace transform depends on Y_t through the quadratic form (portfolio volatility) $\alpha' Y_t \alpha$ only.*

Moreover, the dynamics of $\alpha' Y_t \alpha$ is easily characterized. Indeed we have:

$$
\begin{aligned}
& E_t \exp\left(u\alpha' Y_{t+1}\alpha\right) \\
= & \ \Psi_t\left(u\alpha\alpha'\right) \\
= & \ \frac{\exp\left[\left(u\beta'\alpha\alpha'\left(Id - 2u\Sigma\alpha\alpha'\right)^{-1}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(Id - 2u\Sigma^{1/2}\alpha\alpha'\Sigma^{1/2}\right)\right]^{K/2}}.
\end{aligned}
$$

It is shown in Appendix **??** that this conditional Laplace transform corresponds to a WAR(1) process of dimension 1, which has a noncentered chi-square transition distribution.

Proposition 12 *When $M = \beta\alpha'$, the univariate process $(\alpha' Y_t \alpha)$ is a WAR(1) process $W_1(K,\, \alpha'\beta,\, \alpha'\Sigma\alpha)$.*

Thus we get a nonlinear one-factor model, where the dynamic factor is $F_t = \alpha' Y_t \alpha$. More precisely, the factor process (F_t) admits autonomous dynamics, and, once the factor value is known, the conditional distribution of Y_{t+1} given Y_t is known and equal to the conditional distribution of Y_{t+1} given F_t. It is interesting to note that in the usual CAPM model the asset return volatility matrix depends on the past through the market portfolio volatility only, which implies that the matrix M is of rank one.

ii) It is also interesting to point out functions of the volatility matrix which destroy serial dependence. Let us consider a deterministic matrix C' with dimension (p, n) and focus on the matrix process $(C' Y_t C)$. We get:

$$
\begin{aligned}
C' Y_{t+1} C &= C' \sum_{k=1}^{K} x_{k,t+1} x'_{k,t+1} C \\
&= C' \sum_{k=1}^{K} \left(\beta\alpha' x_{k,t} + \varepsilon_{k,t+1}\right)\left(\beta\alpha' x_{k,t} + \varepsilon_{k,t+1}\right)' C.
\end{aligned}
$$

This expression does not depend on the lagged values $(x_{k,t})$ if the columns of C are orthogonal to vector β. Moreover, $C' Y_{t+1} C = C' \sum_{k=1}^{K} \varepsilon_{k,t+1}\varepsilon'_{k,t+1} C$ will follow a WAR(1) process $W_p(K,\, 0,\, C'\Sigma C)$ of dimension p.

Proposition 13 *Let us consider a matrix C of dimension $(n, n-1)$, whose columns span the vector space orthogonal to vector β. Then the sequence of matrices $(C' Y_t C)$ is an i.i.d. sequence of Wishart variables $W_{n-1}(K,\, 0,\, C'\Sigma C)$ of dimension $n-1$.*

Therefore, in the framework of a matrix M of rank one, we can define transformations of the stochastic volatility matrix which either contain all necessary information, or reveal the absence of serial dependence. Two cases can be distinguished:

1) If α is not orthogonal to β: $\alpha'\beta \neq 0$, we can compute the volatilities with respect to a new basis of the vector space. More precisely, we can consider the transformed volatility matrix:

$$Y_{t+1}(A) = \begin{bmatrix} C'Y_{t+1}C & C'Y_{t+1}\alpha \\ \alpha'Y_{t+1}C & \alpha'Y_{t+1}\alpha \end{bmatrix},$$

corresponding to $A = (C, \alpha)$, where C is orthogonal to β. The first diagonal block captures serial dependence wheras the second diagonal block is white noise. These blocks are mutually independent.

2) If α and β are orthogonal: $\alpha'\beta = 0$, we can compute the volatilities with respect to a basis including the direction without serial dependence plus the β direction. In this case: $A = (C, \alpha, \beta)$, where C is a $(n, n-2)$ matrix with columns orthogonal to β and linearly independent of α. Then we get:

$$Y_{t+1}(A) = \begin{bmatrix} C'Y_{t+1}C & C'Y_{t+1}\alpha & C'Y_{t+1}\beta \\ \alpha'Y_{t+1}C & \alpha'Y_{t+1}\alpha & \alpha'Y_{t+1}\beta \\ \beta'Y_{t+1}C & \beta'Y_{t+1}\alpha & \beta'Y_{t+1}\beta \end{bmatrix}.$$

In this case the portfolio volatility $\alpha'Y_{t+1}\alpha$ is a white noise process which captures all relevant information.

6.2 Transformations of WAR(1) processes

We will now consider the general framework of a matrix M of any rank and of degree of freedom which can be integer or noninteger valued. Let us consider a transformation $a'Y_{t+1}a$ of the volatility matrix, where a is a (n, p) matrix with full column rank. The conditional Laplace transform of this process is:

$$\widetilde{\Psi}_t(\gamma) = E\left[\exp Tr\left(\gamma a'Y_{t+1}a\right)|Y_t\right],$$

where γ is a symmetric (p, p) matrix. It can be written in terms of the basic Laplace transform :

$$\begin{aligned} \widetilde{\Psi}_t(\gamma) &= E\left[\exp Tr\left(\gamma a'Y_{t+1}a\right)|Y_t\right] \\ &= \Psi_t\left(a\gamma a'\right), \end{aligned}$$

since we can commute within the trace operator. Thus we get:

$$\begin{aligned} \widetilde{\Psi}_t(\gamma) &= \frac{\exp Tr\left[M'a\gamma a'\left(Id - 2\Sigma a\gamma a'\right)^{-1} MY_t\right]}{\left[\det\left(Id - 2\Sigma^{1/2}a\gamma a'\Sigma^{1/2}\right)\right]^{K/2}} \\ &= \frac{\exp Tr\left[\gamma a'\left(Id - 2\Sigma a\gamma a'\right)^{-1} MY_tM'a\right]}{\left[\det\left(Id - 2\Sigma^{1/2}a\gamma a'\Sigma^{1/2}\right)\right]^{K/2}}. \end{aligned}$$

Thus $(a'Y_t a)$ is a Markov process if and only if $MY_tM'a$ is function of $a'Y_t a$ (for any value Y_t), or equivalently if there exists a matrix Q such that $M'a = aQ'$. Moreover, it is easy to show that in this case $(a'Y_t a)$ still defines a Wishart process.

Proposition 14 *Let us assume that (Y_t) is a Wishart process of order one $W_n(K, M, \Sigma)$ and consider a matrix a with dimension (n, p) and full column rank.*

i) The transformed process $(a'Y_t a)$ is a Markov process if and only if there exists a (n, p) matrix Q such that $a'M = Qa'$.

ii) Under this condition, the process $(a'Y_t a)$ is also a Wishart process $W_p(K, Q, a'\Sigma a)$ of dimension p.

The condition i) of Proposition 14 is easy to understand if K is integer and the Wishart process is written in terms of the latent processes x:

$$a'Y_t a = \sum_{k=1}^{K} a' x_{kt} x'_{kt} a = \sum_{k=1}^{K} z_{kt} z'_{kt},$$

where $z_{kt} = a'x_{kt} = a'Mx_{k,t-1} + a'\varepsilon_t$. The process (z_{kt}) is gaussian autoregressive iff $a'Mx_{k,t-1}$ is a linear function of $z_{k,t-1}$, that is iff there exists Q such that: $a'Mx_{k,t-1} = Qa'x_{k,t-1} = Qz_{k,t-1}$. Then the parameters of the transformed Wishart process are the parameters of the new gaussian autoregressive process (z_t).

6.3 Wishart processes with reduced rank

The results of the previous section can be used to extend the interpretations given in Section 6.1 to a Wishart process of order one with an autoregressive matrix of any rank. Let us now assume that this matrix has rank $l < n$. Then it can be written as:

$$M = \beta\alpha', \tag{14}$$

where α and β are matrices with dimension (n, l) and full column rank.

Two types of transformed processes have direct interpretations:

i) $(\alpha'Y_t\alpha)$ is a process which conveys all information, called the nonlinear dynamic factor process.

ii) $(C'Y_tC)$, where C is a matrix "orthogonal" to β, that is satisfying $C'\beta = 0$, is a white noise process.

Moreover, both transformed processes satisfy condition i) of Proposition 14 since:

i) $\alpha'M = \alpha'\beta\alpha' = Q\alpha'$, with $Q = \alpha'\beta$;

ii) $C'M = C'\beta\alpha' = 0 = 0\alpha'$, with $Q = 0$.

Proposition 14 implies the following properties.

Proposition 15 *Let us assume $M = \beta\alpha'$, where α and β are (n, l) matrices with full column rank l.*

i) The conditional distribution of Y_{t+1} depends on the past values $\underline{Y_t}$ by means of $\alpha' Y_t \alpha$ only.

ii) $(\alpha' Y_t \alpha)$ is a Wishart process $W_l(K, \alpha'\beta, \alpha'\Sigma\alpha)$ of dimension l.

iii) If C is a $(n, n-l)$ matrix such that $C'\beta = 0$, then $(C' Y_t C)$ is an i.i.d. Wishart process $W_{n-l}(K, 0, C'\Sigma C)$ of dimension $n - l$.

7 Stochastic volatility in mean

The WAR stochastic volatility can be introduced in the expected return model by analogy to the ARCH-in-mean process [see Engle, Lilien, and Robbins (1987)]. The definition of the WAR-in-mean process is given in Section 7.1 and its predictive properties are described in Section 7.2.

7.1 Definition of the WAR-in-mean process

Let us consider the returns on n risky assets. The returns form a n-dimensional process (r_t). We assume that the distribution of r_{t+1} conditional on the lagged returns $\underline{r_t}$ and lagged volatilities $\underline{Y_t}$ is gaussian with conditional variance Y_t and a conditional mean which is an affine function of Y_t[26].

Definition 16 *The return process (r_t) is a WAR-in-mean process if the conditional distribution of r_{t+1} given $\underline{r_t}$, $\underline{Y_t}$ is gaussian with a WAR(1) conditional variance-covariance matrix Y_t, and a conditional mean $m_t = (m_{i,t})$ with components: $m_{i,t} = b_i + Tr(D_i Y_t)$, $i = 1, \ldots, n$, where b_i are scalars and D_i are (n, n) symmetric matrices of "risk premia".*

For instance, for two returns the WAR-in-mean model becomes:

$$\begin{cases} r_{1,t+1} = b_1 + d_{1,11} Y_{11,t} + 2d_{1,12} Y_{12,t} + d_{1,22} Y_{22,t} + \varepsilon_{1,t+1} \\ r_{2,t+1} = b_2 + d_{2,11} Y_{11,t} + 2d_{2,12} Y_{12,t} + d_{2,22} Y_{22,t} + \varepsilon_{2,t+1}, \end{cases}$$

where $V_t\left[\left(\varepsilon'_{1,t+1}, \varepsilon'_{2,t+1}\right)'\right] = Y_t$. The model allows for dependence of the expected return on volatilities and covolatilities.

The WAR-in-mean specification is rather convenient since the predictive distributions of the returns are easy to compute by means of Laplace transforms.

[26] The gaussian assumption concerns the distribution conditional on lagged returns and lagged volatilities. It is compatible with fat tails observed on the distribution conditional on lagged returns only.

This is a consequence of the expression of the conditional Laplace transform of the return r_{t+1} given $\underline{r_t}$, $\underline{Y_t}$. Indeed we have:

$$\begin{aligned} & E\left[\exp\left(z'r_{t+1}\right)|\underline{r_t},\underline{Y_t}\right] \\ = & \exp\left[z'm_t+\frac{1}{2}z'Y_tz\right] \\ = & \exp\left[\sum_{i=1}^{n} z_i\left[b_i+Tr\left(D_iY_t\right)\right]+\frac{1}{2}z'Y_tz\right] \\ = & \exp\left[z'b+Tr\left[\left(\sum_{i=1}^{n} z_iD_i+\frac{1}{2}zz'\right)Y_t\right]\right], \end{aligned}$$

which is an exponential affine function of Y_t. Similar computations can easily be performed in more complicated specifications, including combinations of lagged returns in the conditional mean or higher autoregressive order.

Finally note that, as mentioned in Section 5, under restrictions on the parameters, some WAR processes can be seen as time discretized continuous time processes. The same remark applies to a WAR-in-mean process. When it admits a continuous time representation, the differential system for asset prices $S_{i,t}$ is:

$$d\log S_{i,t}=\left[b_i+Tr\left(D_iY_t\right)\right]dt+Y_t^{1/2}dW_t^S,$$

where (Y_t) satisfies stochastic differential system (10) with a different multivariate Brownian motion. The tractability is due to the affine specification since the joint process $\left(vec\left(\log S_{i,t}\right), vec\left(Y_t\right)\right)$ is a continuous-time affine process, that is admits affine drift and volatility coefficients. This continuous-time specification can be considered as the multivariate extension[27] of the model:

$$\left\{\begin{array}{r} dS_t=\left(\alpha+\beta\sigma_t^2\right)S_tdt+\sigma_tdW_t^S, \\ d\sigma_t^2=\left(\gamma_0+\delta_0\sigma_t^2\right)dt+\sqrt{\gamma_1+\delta_1\sigma_t^2}dW_t^\sigma, \end{array}\right.$$

introduced by [Heston (1993)].

7.2 Mean-variance efficient portfolios

For r_{it}, a net return, that is the difference between the return of asset i and the risk-free return, the Markowitz mean-variance efficient portfolio has an allocation proportional to:

$$a_t^*=\left(Y_t\right)^{-1}m_t.$$

Let us assume a WAR-in-mean process for the net returns. When the volatility of the net returns is equal to zero, the risky returns are equal to the risk-free return. Thus, we can assume $b_i=0$, $\forall i$. Moreover, it is easily checked that the "risk premium" $Tr\left(D_iY_t\right)$ is positive if the matrix D_i is positive definite, and

[27] See Gourieroux, Sufana (2004)b for a use of this extended version to derive closed-form expressions for derivative prices. This is another new frontier for ARCH models mentioned by Engle (2002b).

in this case it is an increasing function of the volatility Y_t[28], [29] . Thus for a WAR-in-mean model we get:

$$a_t^* = (Y_t)^{-1} vec\left[Tr\left(D_i Y_t\right)\right].$$

The positivity constraint on matrix D has a simple structural interpretation. The risk premium on asset i is equal to $Tr\left(D_i Y_t\right)$. Typically this is a linear combination of the volatilities and covolatilities such as: $d_{1,11}Y_{11,t}+2d_{1,12}Y_{12,t}+d_{1,22}Y_{22,t}$ for $i=1$, $n=2$. The risk premium involves two components: Y_t measures the underlying joint risk, whereas $D = \begin{pmatrix} d_{1,11} & d_{1,12} \\ d_{1,12} & d_{1,22} \end{pmatrix}$ is a matrix of risk aversion coefficients describing the risk perceived by the market. As usual in a multiasset framework, the risk aversion is represented by a symmetric positive definite matrix. The combination of both effects provides the level of risk premium and explains the positivity of the risk premium since $Tr\left(DY\right) \geq 0$ if $D \gg 0$ and $Y \gg 0$.

8 Statistical inference

Two types of statistical inference can be considered according to the available observations:

i) When a time-series of volatility matrices is available, a WAR model can be directly estimated from $Y_1, \ldots, Y_T$.

ii) When the asset returns are observed and the stochastic volatility is unobserved, a WAR-in-mean model can be estimated and the latent volatilities approximated by a nonlinear filter.

In this section we focus on the first type of statistical inference, which has at least two interesting applications.

i) First from high frequency data, it is possible to compute every day the volatility matrix of returns at a 5 minute interval, say. We derive a series

[28]Indeed a positive definite matrix D can be written as $D = \sum_{k=1}^{n} d_k d_k'$. Thus we get: $Tr\left(DY_t\right) = Tr\left(\sum_{k=1}^{n} d_k d_k' Y_t\right) = \sum_{k=1}^{n} Tr\left(d_k d_k' Y_t\right) = \sum_{k=1}^{n} Tr\left(d_k' Y_t d_k\right) = \sum_{k=1}^{n} d_k' Y_t d_k \geq 0$, since Y_t is a volatility.

Moreover, if two values of the volatility Y_t and Y_t^* are such that: $Y_t \gg Y_t^* \Longleftrightarrow Y_t - Y_t^* \gg 0$, we deduce that: $Tr\left[D_i\left(Y_t - Y_t^*\right)\right] = Tr\left(D_i Y_t\right) - Tr\left(D_i Y_t^*\right) \geq 0$, which is the monotonicity property of the risk premium.

[29]However Abel (1988), Backus, Gregory (1993) and Gennotte, Marsh (1993) offer models where a negative relation between expected return and variance is compatible with equilibrium. This is mainly due to the partial interpretation of this relationship which does not necessarily account for all state variables. It would be natural to examine this financial puzzle in a multiasset framework to see how the matrix D and its positivity conditions will depend on the number of assets.

of intraday volatility matrices[30]. Due to the different order matching procedures at opening and closure (auction), and within the day (continuous trading), the dynamics of the intraday volatility matrices can be different from the dynamics of volatilities of daily returns computed from closing prices [see Gourieroux and Jasiak (2002), chapter 14 for a description of electronic financial markets].

ii) Another application concerns the dynamics of derivative prices. Indeed in a multiasset framework the Black-Scholes formula can be used to compute implied volatility matrices from derivative prices written on n assets. The WAR specifications can be applied to the series of implied volatilities and covolatilities [see e.g. Stapleton, Subrahmanyam (1984) for contingent claims whose payoffs depend on the outcomes of two or more stochastic variables].

In the sequel we first discuss the identification of the parameters of interest, then we introduce a first order method of moments, which provides consistent estimators and is easy to implement. This method can be seen as the first step before numerical implementation of maximum likelihood based on the expression of the transition density given in Section 2.2. Finally we discuss estimation of the WAR-in-mean model.

8.1 Identification

The identifiable [resp. first order identifiable] parameters are obtained by considering the expressions of the conditional Laplace transform [resp. the conditional first-order moment]. The following identification results are proved in Appendix 10.

Proposition 17 *Let us assume $K \geq n$.*

i) K and Σ are identifiable whereas the autoregressive coefficient M is identifiable up to its sign.

ii) Σ is first-order identifiable[31] up to a scale factor and M is first-order identifiable up to its sign. The degree of freedom K is not first-order identifiable, but is second order identifiable[32].

At first order the number of identifiable structural parameters is $n^2 + \frac{n(n+1)}{2}$ (for M and $\Sigma^* = K\Sigma$). The number of reduced form parameters in the prediction formula $E(Y_{t+1}|Y_t)$ is $\left[\frac{n(n+1)}{2}\right]^2 + \frac{n(n+1)}{2}$ (which are the number of slope plus intercept coefficients, repectively, in the seemingly unrelated regression of $vech(Y_t)$ on $vech(Y_{t-1})$ plus constant). The degree of (first order) overidentification $\left[\frac{n(n+1)}{2}\right]^2 - n^2 = \frac{n^2(n-1)(n+3)}{4}$, is equal to zero for $n = 1$ and increases quickly with the number of assets.

[30] Called realized volatility in the literature [see e.g. Andersen, Bollerslev, and Diebold (2002) for a survey].

[31] That is identifiable from the first-order conditional moment.

[32] That is identifiable from the first and second order conditional moments.

Table 1. Degree of first order over-identification.

Number of assets	1	2	3	4	5
Degree of over-identification	0	5	27	84	200

Thus more accurate estimators are likely obtained when the cross sectional dimension n increases. This is due to the presence of second order cross moments among the moment restrictions.

Finally note that the statistical inference concerning the rank of M, its kernel and its range can be performed (consistently) from conditional moments of order one, since they don't depend on the sign of matrix M.

8.2 First-order method of moments

The first-order conditional moments can be used to calibrate the parameters M and Σ, up to the sign and scale factor, respectively. The first order method of moments is equivalent to the nonlinear least squares. The ordinary nonlinear least squares estimators are defined as:

$$\left(\widehat{M}, \widehat{\Sigma}^*\right) = Arg \min_{M,\Sigma^*} S^2\left(M, \Sigma^*\right),$$

where:

$$\begin{aligned} S^2\left(M, \Sigma^*\right) &= \sum_{t=2}^{T} \sum_{i<j} \left(Y_{ij,t} - \sum_{k=1}^{n} \sum_{l=1}^{n} Y_{kl,t-1} m_{ik} m_{lj} - \sigma_{ij}^*\right)^2 \\ &= \sum_{t=2}^{T} \left\| vech\left(Y_t\right) - vech\left(MY_{t-1}M' + \Sigma^*\right)\right\|^2, \end{aligned}$$

and $\Sigma^* = K\Sigma$. This method can be applied by using any software that accounts for conditional heteroscedasticity. It can be improved by applying a quasi-generalized nonlinear least squares, since the expression of $V_t\left[vech\left(Y_{t+1}\right)\right]$ becomes known, once the degree of freedom K has been estimated [see Corollary 7].

Once the parameters M and Σ^* are estimated, different tests can be performed on matrix M.

i) First we can check the rank of M, that is test for a reduced rank model. For instance, if the rank is equal to l the matrix M can be written as $M = \beta\alpha'$, where α and β have dimension (n, l) and are full column rank. Then an asymptotic least squares estimator of M under the hypothesis $RkM = l$ is defined by [see Gourieroux, Monfort, Renault (1995)] :

$$\hat{M}_l = \hat{\beta}_l' \hat{\alpha}_l,$$

where :

$$(\hat{\alpha}_l, \hat{\beta}_l) = \arg\min_{\alpha,\beta} [vec\ \hat{M} - vec\ (\beta\alpha')]' \hat{Var}(vec\hat{M})^{-1} [vec\hat{M} - vec(\beta\alpha')],$$

and the minimization is performed under the identifying constraints $\alpha'\alpha = Id$. This optimization is similar to a singular value decomposition of a well-chosen symmetric matrix computed from $\hat{M}$ and its asymptotic-covariance matrix.

ii) Second we can test for embeddability, that is for the possibility to write $M = \exp A$. This test can be performed from the spectral decomposition of $\hat{M}$.

8.3 Estimation of the degree of freedom

Finally the degree of freedom K and the latent covariance matrix can be identified from the second order moments. Indeed the marginal distribution of the process (Y_t) is a centered Wishart distribution (see Section 4.1), such that :

$$\begin{aligned} V(\alpha' Y_t \alpha) &= 2K[\alpha'\Sigma(\infty)\alpha]^2 \\ &= 2K^{-1}[\alpha'\Sigma^*(\infty)\alpha]^2, \end{aligned}$$

where : $\Sigma^*(\infty) = M\Sigma^*(\infty)M' + \Sigma^*$.

Thus consistent estimators of the degree of freedom can be derived in the following way.

step 1 : Compute $\hat{\Sigma}^*(\infty)$ as a solution of :

$$\hat{\Sigma}^*(\infty) = \hat{M}\hat{\Sigma}^*(\infty)\hat{M}' + \hat{\Sigma}^*.$$

step 2 : Choose a portfolio allocation α, say, and compute its sample volatility

$$\hat{V}(\alpha' Y_t \alpha) = \frac{1}{T}\sum_{t=1}^{T}\left[\alpha' Y_t \alpha - \frac{1}{T}\sum_{t=1}^{T}\alpha' Y_t \alpha\right]^2.$$

step 3 : A consistent estimator of K is :

$$\hat{K}(\alpha) = 2[\alpha'\hat{\Sigma}^*(\infty)\alpha]^2 / \hat{V}(\alpha' Y_t \alpha).$$

step 4 : A consistent estimator of Σ is $\hat{\Sigma}(\alpha) = \hat{\Sigma}^* / \hat{K}(\alpha)$.

In practice it can be useful to compare the estimators computed from different portfolio allocations to construct a specification test of the WAR process.

The two-step estimation method described above is simple to implement and provides associated specification test, but possibly at the expense of lack of efficiency. Other standard estimation methods can be used. For instance one could apply the maximum likelihood or run the Kalman filter on a linear representation of the Wishart process to do linear filtering, smoothing and quasi-likelihood estimation. This latter approach is also not optimal and doesn't necessarily provide positive semi-definite predictions.

Similarly some standard approaches can also be applied to the WAR-in-mean model, which is a special case of nonlinear factor models. Such methods are the Monte Carlo Markov Chain and optimal filtering via particle filters [see Pitt, Shephard (1999), and Chib (2001) for an extensive review].

9 Dynamics of intraday volatility

9.1 The data

In the analysis of asset return dynamics we have to distinguish their close to open and open to close components. First, these components have different implications for volatility transmission between international stock markets, for example [see e.g. Hamao, Masulis, Ng (1990)]. Second, the trading procedures are generally different within the day (continuous trading) and at opening and closure (auction).

In this section we consider a series of intraday historical volatility-covolatility matrices. They correspond to three stocks : ABX (Barrick Gold), BCE (Bell Canada Enterprise), NTL (Northern Telecom) traded on the Toronto Stock Exchange (TSX). Since the TSX is an electronic market with continuous trading within the day, high frequency data on quotes and trades are available. For each stock the (trade) returns are computed at 5 minute intervals, and used to compute the historical volatility-covolatility matrices at 5 minutes on every day [33]. This leads to 72 observations per day to compute each matrix, since the market was opened between 9:30 a.m. and 4:30 p.m., and the first and last 30 minutes were deleted to remove the opening and closure effects. For estimation purpose we have retained one month of observations from October 1998, which yield 21 intraday volatility matrices for the working days. It would have been possible to construct a longer series, but it is important in practice to check if the WAR model can be used in rolling as it is done in applied finance, and if the WAR provides reasonable fit even when estimated from a one month data sample. It is important to note that the number of observed variables is much larger than 21. Indeed the observations correspond to a symmetric matrix (3,3) with 6 different elements. For a WAR model with one lag we get : 120 = (21-1) x 6 observations, which is sufficient to estimate the 16 parameters in M, Σ, K. Thus the cross-sectional dimension is used to improve the accuracy of the estimators (see the discussion of overidentification in Section 8.1).

The evolution of the intraday volatility matrices is summarized in Figures 10-12.

[Insert Figure 10 : Stock Return Volatilities].

The returns volatilities are displayed in Figure 10, where some common market effects can be observed. For instance all volatilities jointly increase on

[33] All returns are multiplied by 10^3 for standardization.

day number 10. Contrary to the standard one-factor market model, such an effect appears rather seldom.

The evolution of return correlations is displayed in Figure 11. Some other factor effects can be mentioned. For instance, on day number 8, all correlations decrease quickly. The correlations take values essentially between 0.2 and 0.6 during the whole month.

[Insert Figure 11 : Stock Return Correlations]

Finally the eigenvalues of the volatility matrices are displayed in Figure 12. On day number 3 we observe a decrease of the smallest eigenvalue whereas the two other ones increase [see the discussion of the Monte-Carlo study of Section 3.5].

[Insert Figure 12 : Eigenvalues]

9.2 Unconstrained estimation

The WAR (1) model [34] is estimated by the first order method of moments from the same data set. The unconstrained estimators of M and Σ^* are provided in Tables 2 and 3 and the estimation time is less than 1 minute.

The latent autoregressive coefficient matrix is highly significant, which leads to the rejection of the time deformed models with deterministic drift recently introduced in the literature to derive the properties of (one-dimensional) observed realized volatilities [see e.g. Madan, Seneta (1990), Andersen, Bollerslev, Diebold, Labys (2001) for time deformed Brownian motion of the underlying return process, or Barndorff-Nielsen, Shephard (2003) for the extension to time deformed Levy processes].

The eigenvalues of the estimated matrix $\hat{M}$ are given in Table 4. They are all real, nonnegative and strictly less than one. This indicates that the process can be considered as a time discretized version of a continuous time process [35], and satisfies the stationarity conditions.

Table 2 : Estimated Latent Autoregression M
(t-ratios in parentheses)

[34] As already mentioned the advantage of the WAR(1) process is to represent a process of symmetric definite processes. For example, this domain restriction has not been taken into account by Andersen et alii (2003). In this paper, they study exchange rates and assume a normal model for (y_{1t}, y_{2t}, y_{3t}) where y_{1t}(resp y_{2t}, y_{3t}) is the logarithmic volatility for DM/$ [resp. Y/$, Y/DM]. Since the log-exchange rates satisfy a deterministic relationship, we see that $y_{1t} = \exp \sigma_{11t}, y_{2t} = \exp \sigma_{22t}, y_{3t} = \exp(\sigma_{11t} + \sigma_{22t} - 2\sigma_{12t})$, where σ_{12t} is the covolatility between the two first log-exchange rates. There is a one to one relationship between y_{1t}, y_{2t}, y_{3t} and $\sigma_{11t}, \sigma_{22t}, \sigma_{12t}$. We find that the standard Cauchy-Schwartz inequality $\sigma_{12t}^2 \leq \sigma_{11t}\sigma_{22t}$ implies a complicated nonlinear constraint on the three log volatilities. It is not taken into account in the multivariate Gaussian model (see Andersen et alii (2003), page 599).

[35] This can be useful in further financial applications, like derivative pricing in continuous time [see e.g. Gourieroux, Sufana (2003), (2004), Gourieroux, Monfort, Sufana (2004)].

0.806 (4.09)	0.066 (0.63)	-0.474 (2.85)
0.377 (1.79)	0.300 (2.42)	0.168 (0.88)
1.017 (1.60)	0.120 (0.48)	-0.532 (1.42)

Table 3 : Estimated Latent Covariance Matrix Σ^*
(t-ratios in parentheses)

2.524 (1.28)	1.737 (1.68)	-1.361 (0.34)
	6.266 (4.48)	0.732 (0.55)
		7.040 (0.86)

Table 4 : Eigenvalues of $\hat{M}$

0.323	0.207	0.042

Table 5 provides the eigenvalues of $\hat{M}\hat{M}'$. It is immediately seen that the smallest eigenvalue is much smaller than the other ones. Thus a two factor model can likely be considered.

Table 5 : Eigenvalues of $\hat{M}\hat{M}'$

2.291	0.179	$1.973e-0.5$

Finally the degree of freedom has been estimated from the marginal second order moment corresponding to the equiweighted portfolio allocation $\alpha = (1,1,1)$. It is equal to : $\hat{K}(\alpha) = 4.25$, with a confidence interval of $[3.82, 5.54]$. We observe that the degree of freedom is strictly larger than 3, which ensures a nondegenerate Wishart process. Moreover other estimations of K based on different portfolio allocations have been considered [see Table 6]. They provide estimates in the confidence interval reported above, which is in favour of the Wishart specification.

Table 6 : Eigenvalues of $\hat{M}\hat{M}'$

porfolio allocation	$(1,1,0)$	$(0,1,1)$	$(1,0,1)$
$\hat{K}(\alpha)$	3.82	4.89	4.66

9.3 Estimated reduced rank model

A two factor Wishart model has been reestimated from the same data set. The constrained estimators are provided in Tables 7 and 8.

Table 7 : Constrained Latent Autoregression
(t-ratios in parentheses)

0.808 (3.14)	0.063 (0.38)	−0.472 (3.02)
0.377 (1.78)	0.299 (2.52)	0.167 (0.91)
1.014 (1.74)	0.121 (0.57)	−0.524 (1.51)

Table 8 : Constrained Latent Covariance Matrix
(t-ratios in parentheses)

2.519 (1.21)	1.739 (1.66)	−1.359 (0.34)
	6.266 (4.48)	0.730 (0.55)
		6.075 (0.89)

In this model of rank 2, the β-space is generated by the first two columns of the $\hat{M}$ matrix given in Table 7, whereas the α-space is generated by the rows of $\hat{M}$ and is the space orthogonal to the vector $(0.697, -1.439, 1)$.

Since the components of the two first columns of $\hat{M}$ are positive, the C vector orthogonal to these columns has some positive and negative components. In some sense the "white noise" direction corresponds to a kind of "arbitrage" portfolio.

10 Concluding remarks

The Wishart Autoregressive process provides a valuable alternative to the standard multivariate GARCH or stochastic variance models. The WAR specification is quite flexible in the sense that it allows for introducing higher autoregressive lags and provides a factor representation. The closed-form prediction formulas at various horizons are quite simple to compute as well. It is well-known that the CIR diffusion process can be interpreted as the limit of well-chosen ARCH processes [Nelson (1990)]. Likely, the continuous time WAR process could also be interpreted as the limit of a well-chosen multivariate ARCH model. However, the discrete time WAR seems more convenient in many applications.

The WAR process can be used to model the dynamics of volatility matrices in financial applications, including derivative pricing and hedging. The WAR process yields closed-form expressions for the term structure of interest rates analysis[Gourieroux, Sufana (2003)], and for derivative pricing in multivariate stochastic volatility models in which it arises as the multivariate extension of Heston's model [Gourieroux, Sufana (2004)b].

APPENDICES

Appendix 1 : Proof of Proposition 1

i) Let us first establish a preliminary lemma.

Lemma 18 *For any symmetric semi-definite matrix* Ω *with dimension* (n, n) *and any vector* $\mu \in R^n$*, we get:*

$$\int_{R^n} \exp\left(-x'\Omega x + \mu' x\right) dx = \frac{\pi^{n/2}}{(\det \Omega)^{1/2}} \exp\left(\frac{1}{4}\mu'\Omega^{-1}\mu\right).$$

Proof. Indeed the integral of the left hand side is equal to:

$$\begin{aligned} & \int_{R^n} \exp\left[-\left(x - \frac{1}{2}\Omega^{-1}\mu\right)' \Omega \left(x - \frac{1}{2}\Omega^{-1}\mu\right)\right] \exp\left(\frac{1}{4}\mu'\Omega^{-1}\mu\right) dx \\ = & \frac{\pi^{n/2}}{(\det \Omega)^{1/2}} \exp\left(\frac{1}{4}\mu'\Omega^{-1}\mu\right), \end{aligned}$$

since the gaussian multivariate distribution with mean $\frac{1}{2}\Omega^{-1}\mu$ and covariance matrix $2\Omega^{-1}$ admits unit mass. ■

ii) We now prove Proposition 1. Let us consider the stochastic process (Y_t) defined by $Y_t = x_t x_t'$, $x_{t+1} = M x_t + \Sigma^{1/2}\xi_{t+1}$ and $\xi_{t+1} \sim IIN(0, Id)$. The conditional Laplace transform of the process (Y_t) is:

$$\begin{aligned} & \Psi_t(\Gamma) \\ = & E\left[\exp\left(x_{t+1}'\Gamma x_{t+1}\right)|x_t\right] \\ = & E\left[\exp\left(\left(M x_t + \Sigma^{1/2}\xi_{t+1}\right)' \Gamma \left(M x_t + \Sigma^{1/2}\xi_{t+1}\right)\right)|x_t\right] \\ = & \exp\left(x_t' M' \Gamma M x_t\right) E\left[\exp\left(2x_t' M' \Gamma \Sigma^{1/2}\xi_{t+1} + \xi_{t+1}'\Sigma^{1/2}\Gamma\Sigma^{1/2}\xi_{t+1}\right)|x_t\right]. \end{aligned}$$

By using the pdf of the standard normal,

$$f(\xi_{t+1}) = \frac{1}{2^{n/2}\pi^{n/2}} \exp -\frac{1}{2}\xi_{t+1}'\xi_{t+1},$$

and Lemma 18, we get:

$$\begin{aligned} & \Psi_t(\Gamma) \\ = & \frac{\exp\left(x_t' M' \Gamma M x_t\right)}{2^{n/2}\left[\det\left(\frac{1}{2}Id - \Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}} \\ & \exp\left[\frac{1}{4}\left(2x_t' M' \Gamma \Sigma^{1/2}\right)\left(\frac{1}{2}Id - \Sigma_t^{1/2}\Gamma\Sigma_t^{1/2}\right)^{-1}\left(2\Sigma^{1/2}\Gamma M x_t\right)\right] \end{aligned}$$

$$
\begin{aligned}
&= \frac{\exp\left(x_t'M'\Gamma M x_t + 2x_t'M'\Gamma\left(\Sigma^{-1}-2\Gamma\right)^{-1}\Gamma M x_t\right)}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}} \\
&= \frac{\exp\left[x_t'M'\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}Mx_t\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}} \\
&= \frac{\exp Tr\left[M'\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}MY_t\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}}.
\end{aligned}
$$

This formula is valid whenever $Id - 2\Sigma\Gamma$ is a positive definite matrix.

Appendix 2 : Proof of Proposition 2

The process can be written as: $Y_t = \sum_{k=1}^{K} Y_{kt}$, where the matricial processes $Y_{kt} = x_{kt}x_{kt}'$ are independent with the Laplace transform given in Proposition 1. We deduce that:

$$
\begin{aligned}
\Psi_t(\Gamma) &= \prod_{k=1}^{K} \frac{\exp Tr\left[M'\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}MY_{kt}\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{1/2}} \\
&= \frac{\exp Tr\left[M'\Gamma\left(Id-2\Sigma\Gamma\right)^{-1}MY_t\right]}{\left[\det\left(Id-2\Sigma^{1/2}\Gamma\Sigma^{1/2}\right)\right]^{n/2}}.
\end{aligned}
$$

Appendix 3 : Conditional moments of the WAR(1) process

Appendix A.3.1 : Conditional mean

We have:

$$
\begin{aligned}
E\left(Y_{t+1}|Y_t\right) &= E\left(\sum_{k=1}^{K} x_{k,t+1}x_{k,t+1}'|x_t\right) \\
&= \sum_{k=1}^{K} E\left(x_{k,t+1}x_{k,t+1}'|x_t\right) \\
&= \sum_{k=1}^{K} E\left(x_{k,t+1}|x_t\right)E\left(x_{k,t+1}'|x_t\right) + \sum_{k=1}^{K} V\left(x_{k,t+1}|x_t\right),
\end{aligned}
$$

where the last equality follows from the definition of the variance-covariance matrix. Thus, we obtain:

$$
\begin{aligned}
E\left(Y_{t+1}|Y_t\right) &= M\sum_{k=1}^{K} x_{k,t}x_{k,t}'M' + \sum_{k=1}^{K}(\Sigma) \\
&= MY_tM' + K\Sigma.
\end{aligned}
$$

Appendix A.3.2 : Conditional variance

Let us consider $K=1$. We get:

$$\begin{aligned}
& cov_t\left(\gamma' Y_{t+1}\alpha, \delta' Y_{t+1}\beta\right) \qquad (15)\\
= \; & cov_t\left(\gamma'\left(Mx_t+\varepsilon_{t+1}\right)\alpha'\left(Mx_t+\varepsilon_{t+1}\right), \delta'\left(Mx_t+\varepsilon_{t+1}\right)\beta'\left(Mx_t+\varepsilon_{t+1}\right)\right)\\
= \; & cov_t(\gamma' Mx_t\alpha'\varepsilon_{t+1}+\gamma'\varepsilon_{t+1}\alpha' Mx_t+\gamma'\varepsilon_{t+1}\alpha'\varepsilon_{t+1},\\
& \quad \delta' Mx_t\beta'\varepsilon_{t+1}+\delta'\varepsilon_{t+1}\beta' Mx_t+\delta'\varepsilon_{t+1}\beta'\varepsilon_{t+1})\\
= \; & E_t\left[\left(\gamma' Mx_t\alpha'\varepsilon_{t+1}+\gamma'\varepsilon_{t+1}\alpha' Mx_t\right)\left(\delta' Mx_t\beta'\varepsilon_{t+1}+\delta'\varepsilon_{t+1}\beta' Mx_t\right)\right]\\
& + cov_t\left(\gamma'\varepsilon_{t+1}\alpha'\varepsilon_{t+1}, \delta'\varepsilon_{t+1}\beta'\varepsilon_{t+1}\right),
\end{aligned}$$

where the other terms are zero, since they cannot be written as quadratic functions of x_t. Using the fact that $E_t\left(\varepsilon_{t+1}\varepsilon'_{t+1}\right)=\Sigma$, the first term in the above expression can be written as:

$$\begin{aligned}
& E_t\left[\left(\gamma' Mx_t\alpha'\varepsilon_{t+1}+\gamma'\varepsilon_{t+1}\alpha' Mx_t\right)\left(\delta' Mx_t\beta'\varepsilon_{t+1}+\delta'\varepsilon_{t+1}\beta' Mx_t\right)\right] \qquad (16)\\
= \; & E_t\left[\left(\gamma' Mx_t\alpha'\varepsilon_{t+1}+\alpha' Mx_t\gamma'\varepsilon_{t+1}\right)\left(\varepsilon'_{t+1}\beta x'_t M'\delta+\varepsilon'_{t+1}\delta x'_t M'\beta\right)\right]\\
= \; & \gamma' Mx_t\alpha'\Sigma\beta x'_t M'\delta+\gamma' Mx_t\alpha'\Sigma\delta x'_t M'\beta+\alpha' Mx_t\gamma'\Sigma\beta x'_t M'\delta\\
& +\alpha' Mx_t\gamma'\Sigma\delta x'_t M'\beta\\
= \; & \gamma' MY_t M'\delta\alpha'\Sigma\beta+\gamma' MY_t M'\beta\alpha'\Sigma\delta+\alpha' MY_t M'\delta\gamma'\Sigma\beta\\
& +\alpha' MY_t M'\beta\gamma'\Sigma\delta.
\end{aligned}$$

Let $\varepsilon_{t+1}=\Sigma^{1/2}\xi_{t+1}$, where $\xi_{t+1}\sim IIN\left(0, Id\right)$. The second term in expression (15) becomes:

$$\begin{aligned}
& cov_t\left(\gamma'\varepsilon_{t+1}\alpha'\varepsilon_{t+1}, \delta'\varepsilon_{t+1}\beta'\varepsilon_{t+1}\right)\\
= \; & \gamma' cov_t\left(\varepsilon_{t+1}\varepsilon'_{t+1}\alpha, \varepsilon_{t+1}\varepsilon'_{t+1}\beta\right)\delta\\
= \; & \gamma' E_t\left(\varepsilon_{t+1}\varepsilon'_{t+1}\alpha\beta'\varepsilon_{t+1}\varepsilon'_{t+1}\right)\delta-\gamma' E_t\left(\varepsilon_{t+1}\varepsilon'_{t+1}\alpha\right)E_t\left(\beta'\varepsilon_{t+1}\varepsilon'_{t+1}\right)\delta\\
= \; & \gamma'\Sigma^{1/2}E_t\left[\xi_{t+1}\xi'_{t+1}\left(\Sigma^{1/2}\alpha\beta'\Sigma^{1/2}\right)\xi_{t+1}\xi'_{t+1}\right]\Sigma^{1/2}\delta-\gamma'\Sigma\alpha\beta'\Sigma\delta\\
= \; & \gamma'\Sigma^{1/2}E_t\left[\sum_{i=1}^{n}\sum_{j=1}^{n}\xi_{i,t+1}\xi_{t+1}\left(b_{ij}\right)\xi_{j,t+1}\xi'_{t+1}\right]\Sigma^{1/2}\delta-\gamma'\Sigma\alpha\beta'\Sigma\delta\\
= \; & \gamma'\Sigma^{1/2}\sum_{i=1}^{n}\sum_{j=1}^{n}b_{ij}E_t\left(\xi_{i,t+1}\xi_{j,t+1}\xi_{t+1}\xi'_{t+1}\right)\Sigma^{1/2}\delta-\gamma'\Sigma\alpha\beta'\Sigma\delta,
\end{aligned}$$

where $B=\Sigma^{1/2}\alpha\beta'\Sigma^{1/2}$. Let e_i be the canonical vector with zero components except the i^{th} component which is equal to 1, and δ_{ij} be the Kronecker symbol: $\delta_{ij}=1$ if $i=j$, and 0 otherwise. Since $E_t\left(\xi_{i,t+1}\xi_{j,t+1}\xi_{t+1}\xi'_{t+1}\right)=\delta_{ij}Id+e_ie'_j+e_je'_i$ [see e.g. Bilodeau and Brenner (1999), page 75], we have:

$$cov_t\left(\gamma'\varepsilon_{t+1}\alpha'\varepsilon_{t+1}, \delta'\varepsilon_{t+1}\beta'\varepsilon_{t+1}\right) \qquad (17)$$

$$
\begin{aligned}
&= \gamma'\Sigma^{1/2}\sum_{i=1}^{n}\sum_{j=1}^{n} b_{ij}\left(\delta_{ij} Id + e_i e_j' + e_j e_i'\right)\Sigma^{1/2}\delta - \gamma'\Sigma\alpha\beta'\Sigma\delta \\
&= \gamma'\Sigma^{1/2}\left[Tr\left(B\right) Id + B + B'\right]\Sigma^{1/2}\delta - \gamma'\Sigma\alpha\beta'\Sigma\delta \\
&= \gamma'\Sigma^{1/2} Tr\left(B\right)\Sigma^{1/2}\delta + \gamma'\Sigma^{1/2} B\Sigma^{1/2}\delta + \gamma'\Sigma^{1/2} B'\Sigma^{1/2}\delta - \gamma'\Sigma\alpha\beta'\Sigma\delta \\
&= \gamma'\Sigma^{1/2}\left(\beta'\Sigma\alpha\right)\Sigma^{1/2}\delta + \gamma'\Sigma\alpha\beta'\Sigma\delta + \gamma'\Sigma\beta\alpha'\Sigma\delta - \gamma'\Sigma\alpha\beta'\Sigma\delta \\
&= \gamma'\Sigma\delta\beta'\Sigma\alpha + \gamma'\Sigma\beta\alpha'\Sigma\delta.
\end{aligned}
$$

Combining the results in (16) and (17) we obtain:

$$
\begin{aligned}
& cov_t\left(\gamma' Y_{t+1}\alpha, \delta' Y_{t+1}\beta\right) \\
= \; & \gamma' M Y_t M'\delta\alpha'\Sigma\beta + \gamma' M Y_t M'\beta\alpha'\Sigma\delta + \alpha' M Y_t M'\delta\gamma'\Sigma\beta \\
& +\alpha' M Y_t M'\beta\gamma'\Sigma\delta + \left[\gamma'\Sigma\beta\alpha'\Sigma\delta + \alpha'\Sigma\beta\gamma'\Sigma\delta\right].
\end{aligned}
$$

A similar proof can be constructed for an arbitrary positive integer K.

Appendix 4 : Proof of Corollary 7

Let α, β, γ, δ be n-dimensional vectors. i) Taking $\delta = \gamma$ and $\beta = \alpha$ in Proposition 4, we get:

$$
\begin{aligned}
& V_t\left(\gamma' Y_{t+1}\alpha\right) \\
= \; & cov_t\left(\gamma' Y_{t+1}\alpha, \gamma' Y_{t+1}\alpha\right) \\
= \; & \gamma' M Y_t M'\gamma\alpha'\Sigma\alpha + 2\gamma' M Y_t M'\alpha\alpha'\Sigma\gamma + \alpha' M Y_t M'\alpha\gamma'\Sigma\gamma.
\end{aligned}
$$

ii) The above result with $\gamma = \alpha$ implies:

$$
V_t\left(\alpha' Y_{t+1}\alpha\right) = 4\alpha' M Y_t M'\alpha\alpha'\Sigma\alpha + 2K\left(\alpha'\Sigma\alpha\right)^2.
$$

iii) Using again Proposition 4 with $\gamma = \alpha$ and $\delta = \beta$, we obtain:

$$
cov_t\left(\alpha' Y_{t+1}\alpha, \beta' Y_{t+1}\beta\right) = 4\alpha' M Y_t M'\beta\alpha'\Sigma\beta + 2K\left(\alpha'\Sigma\beta\right)^2.
$$

iv) Finally, Proposition 4 with $\gamma = \alpha$ and $\delta = \alpha$ implies:

$$
\begin{aligned}
cov_t\left(\alpha' Y_{t+1}\alpha, \alpha' Y_{t+1}\beta\right) &= 2\alpha' M Y_t M'\alpha\alpha'\Sigma\beta + 2\alpha' M Y_t M'\beta\alpha'\Sigma\alpha \\
& \quad +2K\alpha'\Sigma\beta\alpha'\Sigma\alpha.
\end{aligned}
$$

Appendix 5 : Continuous-time analogue

We have:

$$
\begin{aligned}
dY_t &= Y_{t+dt} - Y_t \\
&= x_{t+dt}x_{t+dt}' - x_t x_t' \\
&= \left(x_t + Ax_t dt + \Omega dw_t\right)\left(x_t + Ax_t dt + \Omega dw_t\right)' - x_t x_t' \\
&= x_t x_t' A' dt + x_t dw_t'\Omega' + Ax_t x_t' dt + Ax_t x_t' A'\left(dt\right)^2 \\
& \quad +Ax_t\left(dw_t\right)'\Omega' dt + \Omega dw_t x_t' + \Omega dw_t x_t' A' dt + \Omega dw_t\left(dw_t\right)'\Omega'.
\end{aligned}
$$

The terms that cannot be neglected in the expression above are:

$$\begin{aligned} dY_t \# x_t x_t' A' dt + x_t dw_t' \Omega' + A x_t x_t' dt + \Omega dw_t x_t' + \Omega E\left[dw_t \left(dw_t\right)'\right] \Omega' \\ \# \left(Y_t A' + A Y_t + \Omega\Omega'\right) dt + x_t \left(\Omega dw_t\right)' + \left(\Omega dw_t\right) x_t'. \end{aligned}$$

Appendix 6 : Proof of Proposition 12

Let P denote an orthogonal matrix such that $P\Sigma^{1/2}\alpha = e_1\sqrt{\alpha'\Sigma\alpha}$, where e_1 denotes the canonical vector with zero components except the first component which is equal to 1. The conditional Laplace transform of $\alpha' Y_t \alpha$ is:

$$\begin{aligned}
& \Psi_t\left(u\alpha\alpha'\right) \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\left(Id - 2u\Sigma\alpha\alpha'\right)^{-1}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(Id - 2u\Sigma^{1/2}\alpha\alpha'\Sigma^{1/2}\right)\right]^{K/2}} \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\Sigma^{1/2}\left(Id - 2u\Sigma^{1/2}\alpha\alpha'\Sigma^{1/2}\right)^{-1}\Sigma^{-1/2}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(Id - 2u\Sigma^{1/2}\alpha\alpha'\Sigma^{1/2}\right)\right]^{K/2}} \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\Sigma^{1/2}\left(P^{-1}P - 2uP^{-1}\left(P\Sigma^{1/2}\alpha\right)\left(\alpha'\Sigma^{1/2}P^{-1}\right)P\right)^{-1}\Sigma^{-1/2}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(P^{-1}P - 2uP^{-1}\left(P\Sigma^{1/2}\alpha\right)\left(\alpha'\Sigma^{1/2}P^{-1}\right)P\right)\right]^{K/2}} \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\Sigma^{1/2}P'\left(Id - 2u\alpha'\Sigma\alpha e_1 e_1'\right)^{-1}P\Sigma^{-1/2}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(P^{-1}\left(Id - 2u\alpha'\Sigma\alpha e_1 e_1'\right)P\right)\right]^{K/2}} \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\Sigma\alpha e_1'\left(Id - 2u\alpha'\Sigma\alpha e_1 e_1'\right)^{-1}e_1\alpha'\left(\alpha\alpha'\right)^{-1}\Sigma^{-1}\beta\right)\alpha' Y_t \alpha\right]}{\left[\det\left(Id - 2u\alpha'\Sigma\alpha e_1 e_1'\right)\right]^{K/2}} \\
= & \frac{\exp\left[\left(u\beta'\alpha\alpha'\Sigma\alpha\left(1 - 2u\alpha'\Sigma\alpha\right)^{-1}\alpha'\left(\alpha\alpha'\right)^{-1}\Sigma^{-1}\beta\right)\alpha' Y_t \alpha\right]}{\left(1 - 2u\alpha'\Sigma\alpha\right)^{K/2}} \\
= & \left(1 - 2u\alpha'\Sigma\alpha\right)^{-K/2}\exp\left[\left(\frac{u\left(\alpha'\beta\right)^2}{1 - 2u\alpha'\Sigma\alpha}\right)\alpha' Y_t \alpha\right],
\end{aligned}$$

which is the conditional Laplace transform of a WAR(1) process of dimension 1 (see Section 3.3) with $m = \alpha'\beta$ and $\sigma^2 = \alpha'\Sigma\alpha$.

Appendix 7 : Proof of Proposition 17

We have just to check the second part of the Proposition. From Proposition 6, we deduce that:

$$E\left[Y_{ij,t+1}|Y_t\right] = \sum_{k=1}^{n}\sum_{l=1}^{n} Y_{kl,t} m_{ik} m_{lj} + K\sigma_{ij}.$$

Since $K \geq n$, the admissible values of $Y_{kl,t}$ are not functionally dependent. Thus the product $m_{ik}m_{lj}$, $\forall i,\ k,\ l,\ j$, and the quantities $K\sigma_{ij}$, $\forall i,\ j$, are first-order identifiable. The result follows.

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Fig.1 Volatilities, Example 1

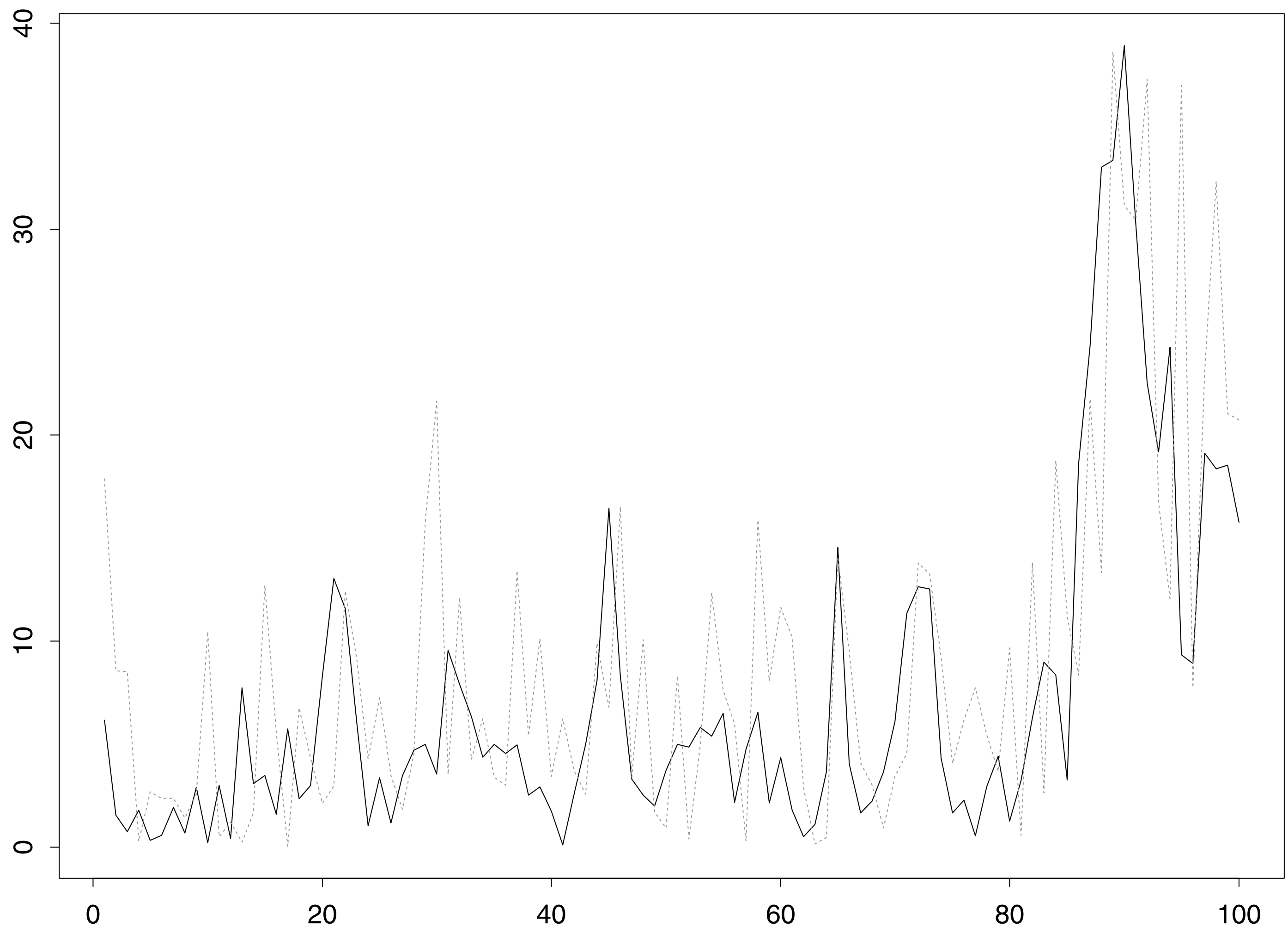


Fig.2 Correlation, Example 1

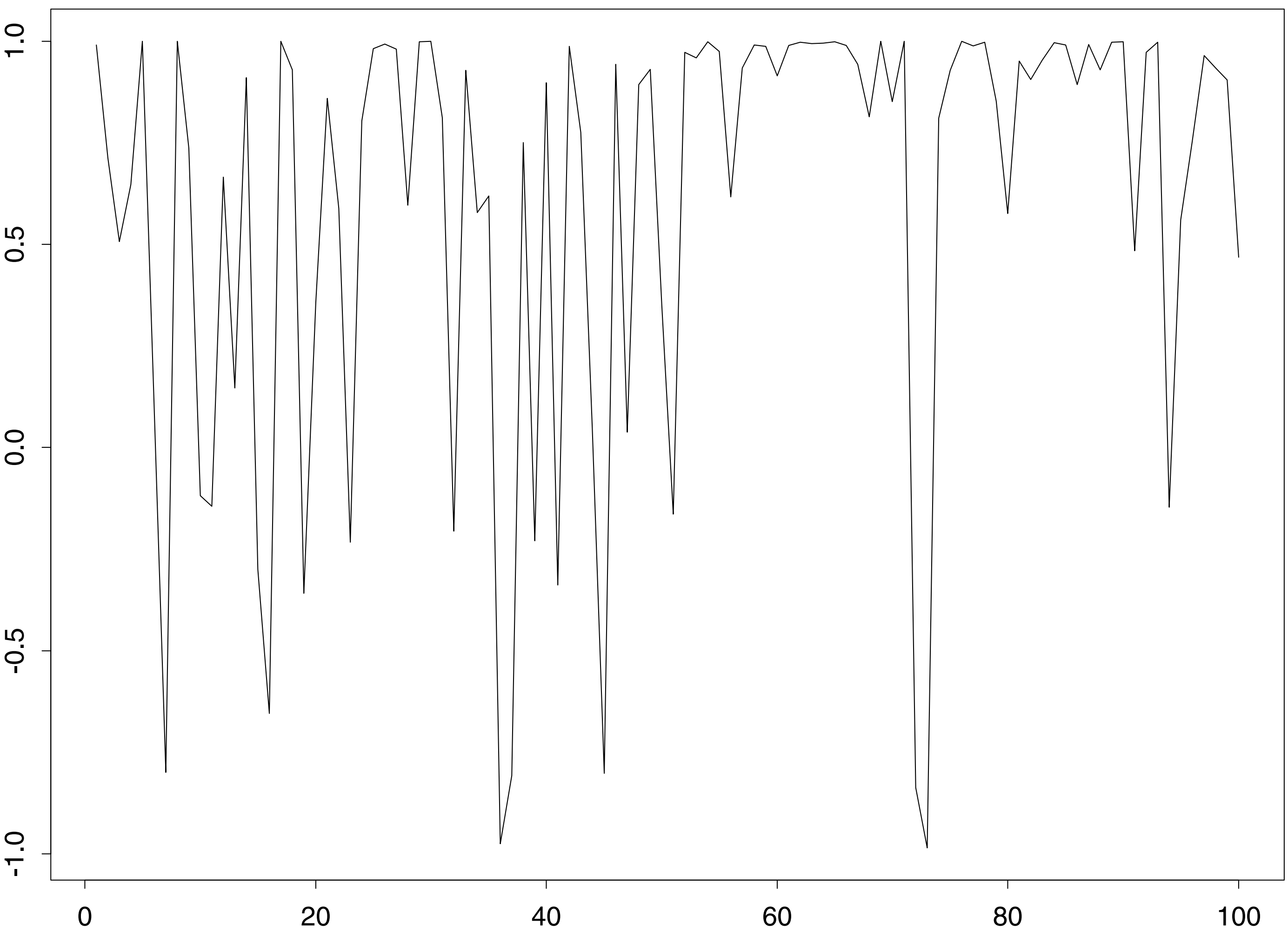


Fig.3 Canonical Volatilities, Example 1

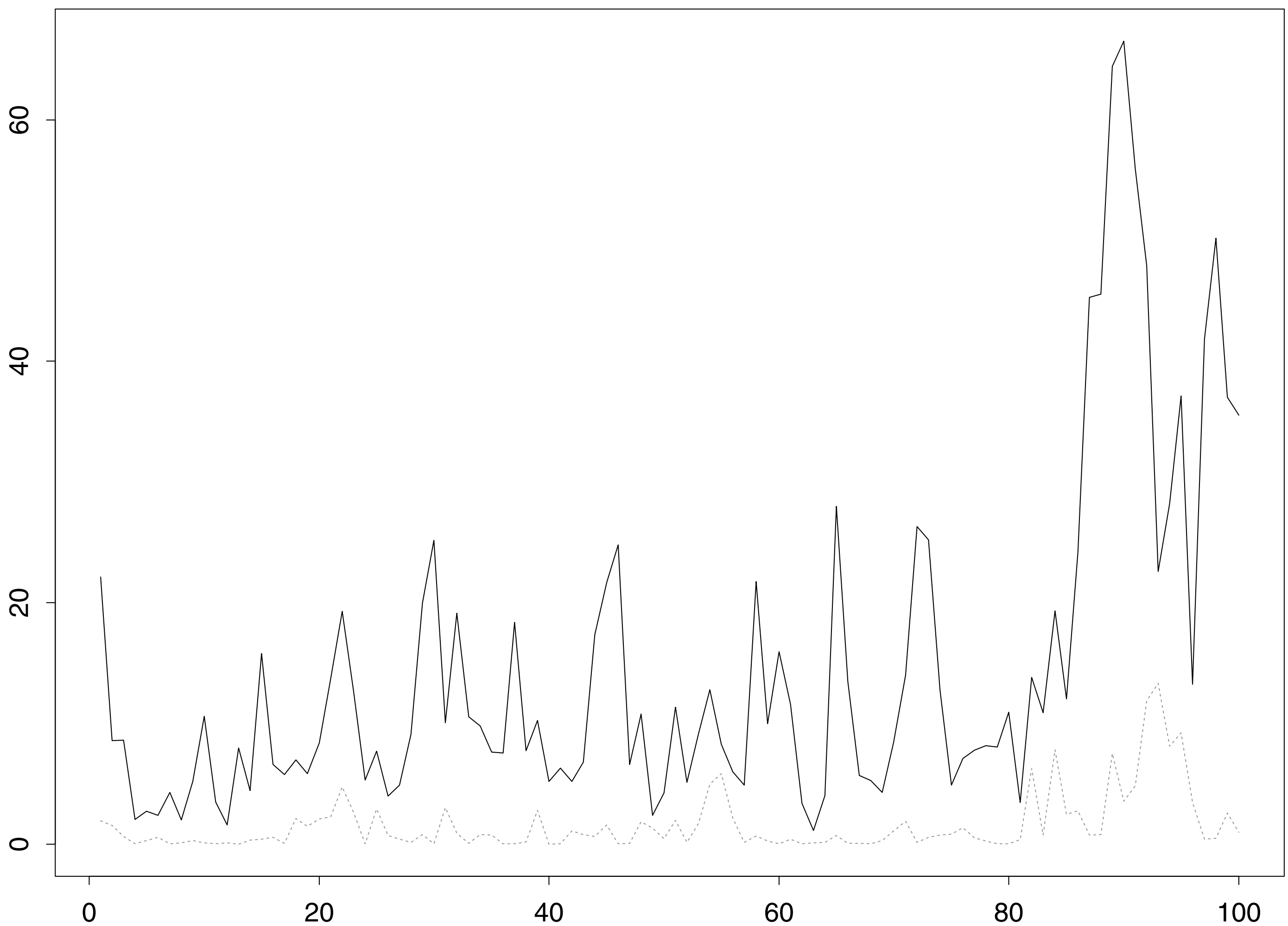
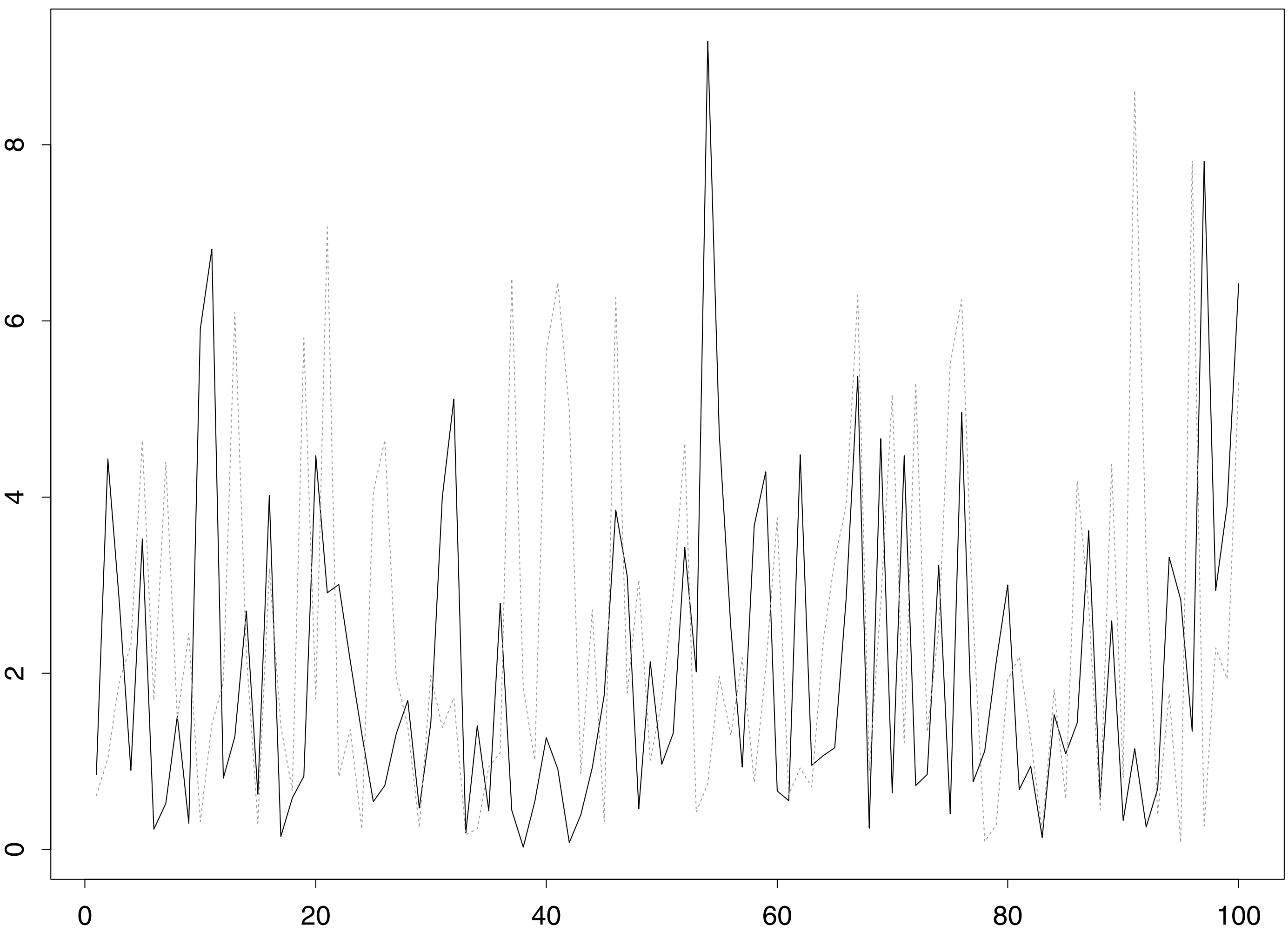


Fig.4 Volatilities, Example 2



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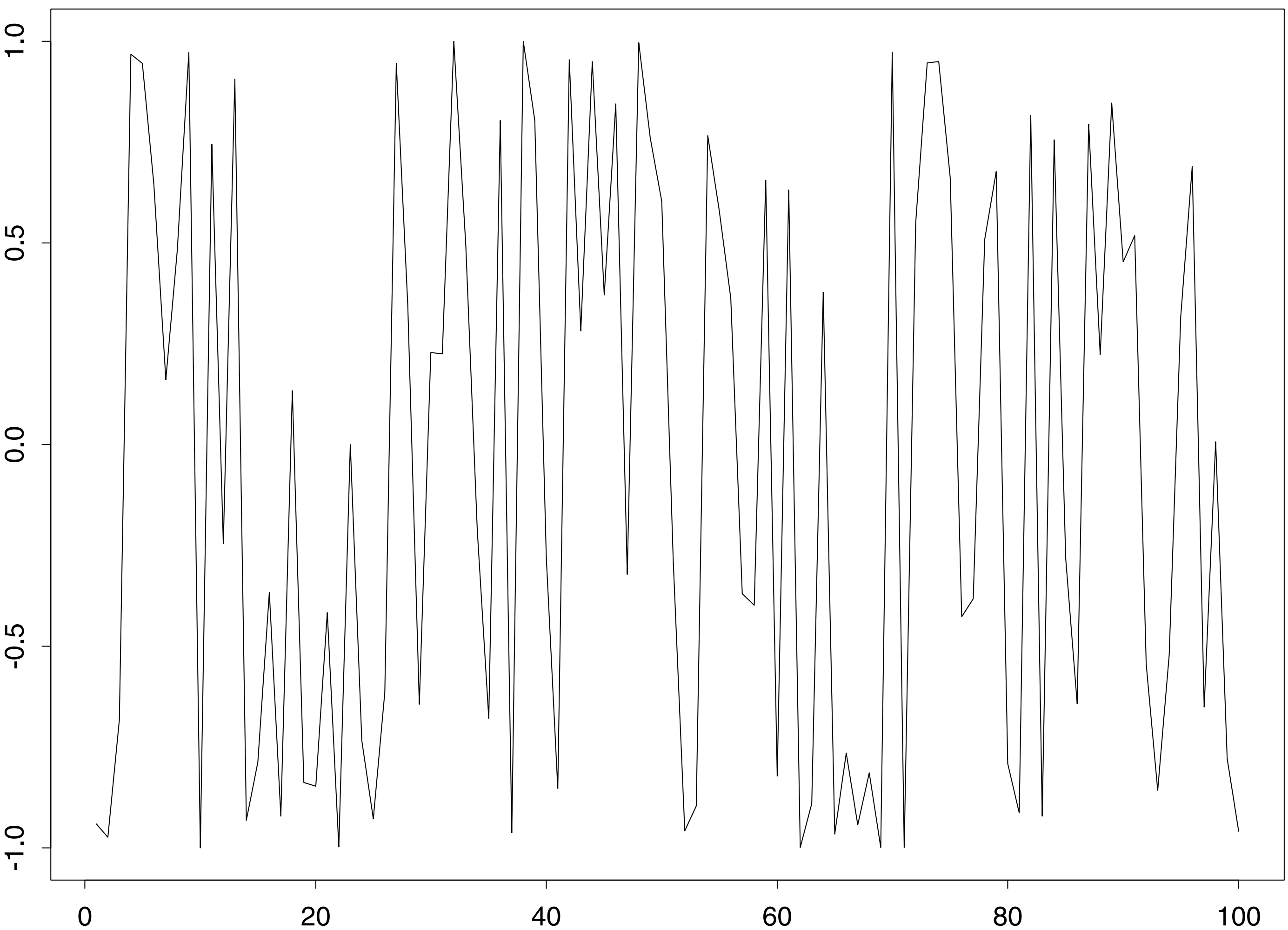
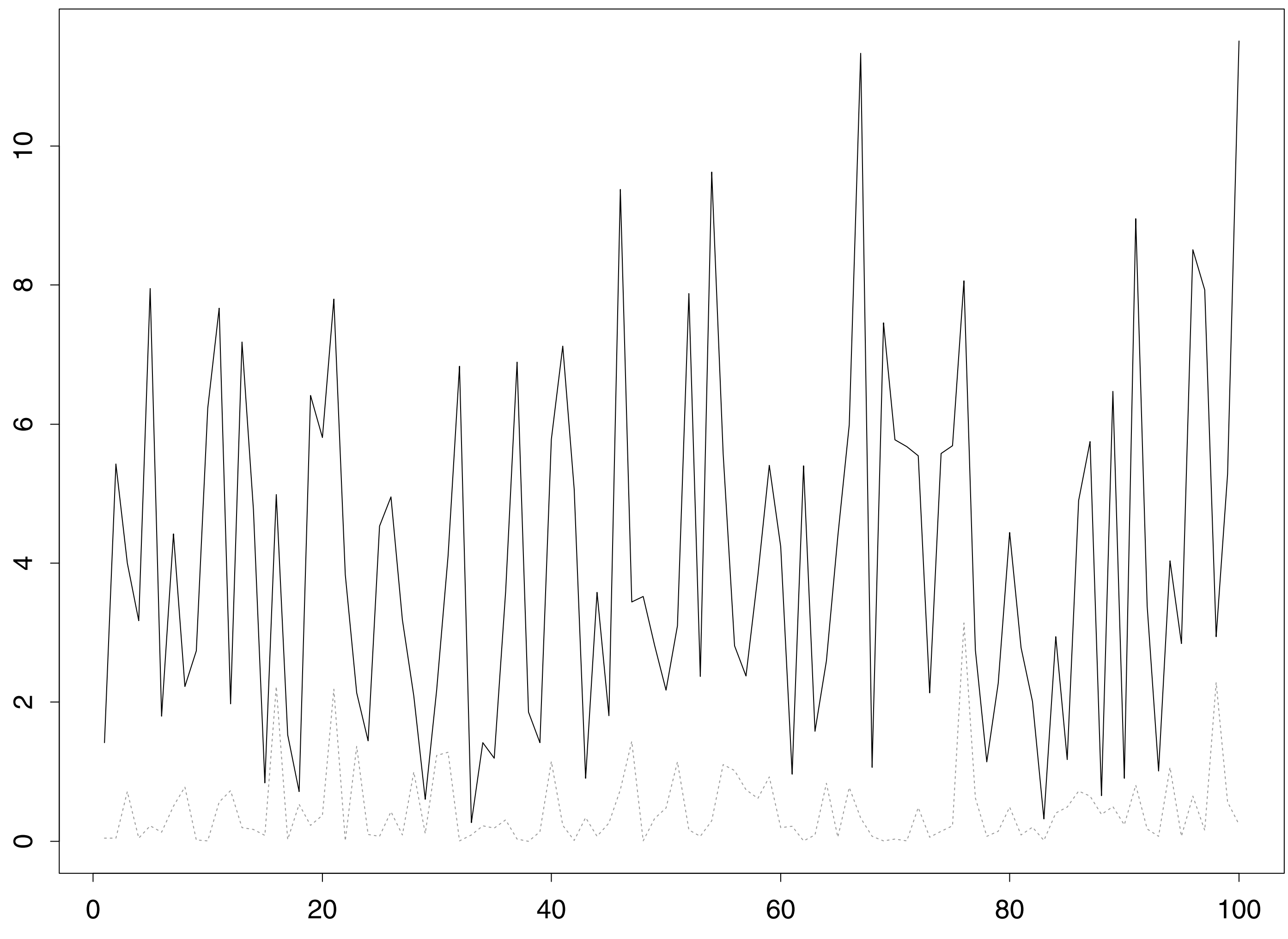


Fig.6 Canonical Volatilities, Example 2



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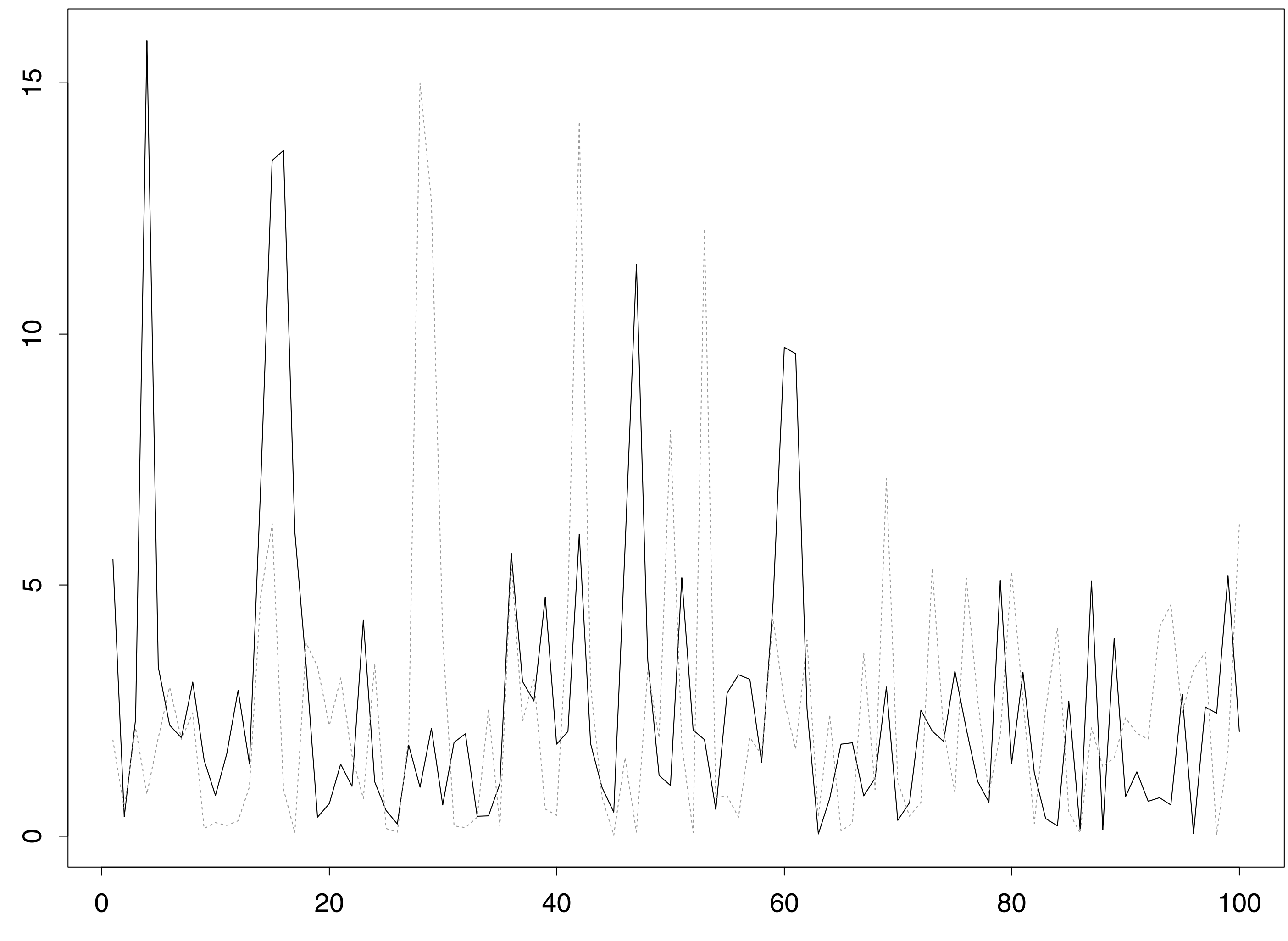

Fig.8 Correlation, Example 3

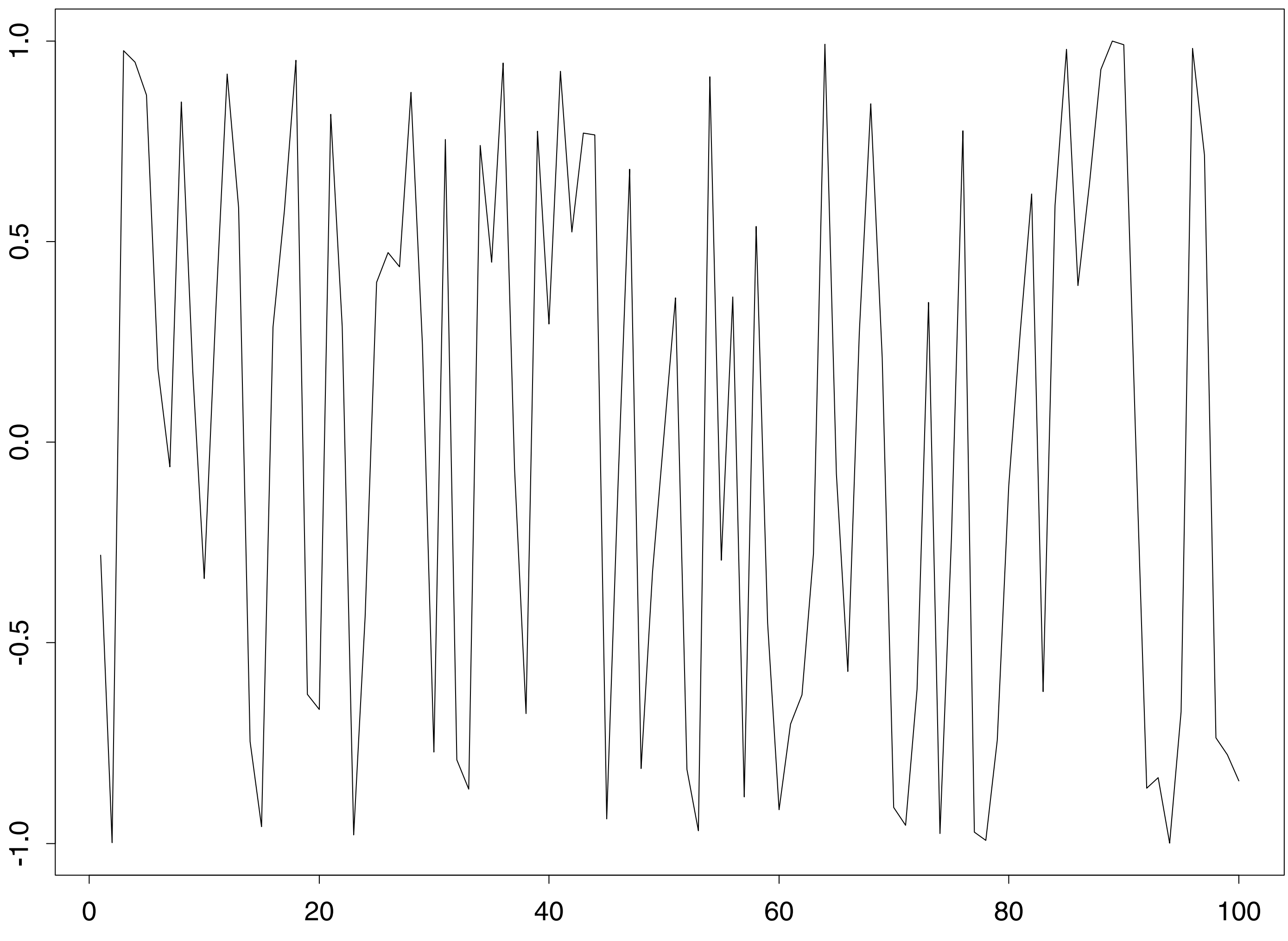

Fig.9 Canonical Volatilities, Example 3

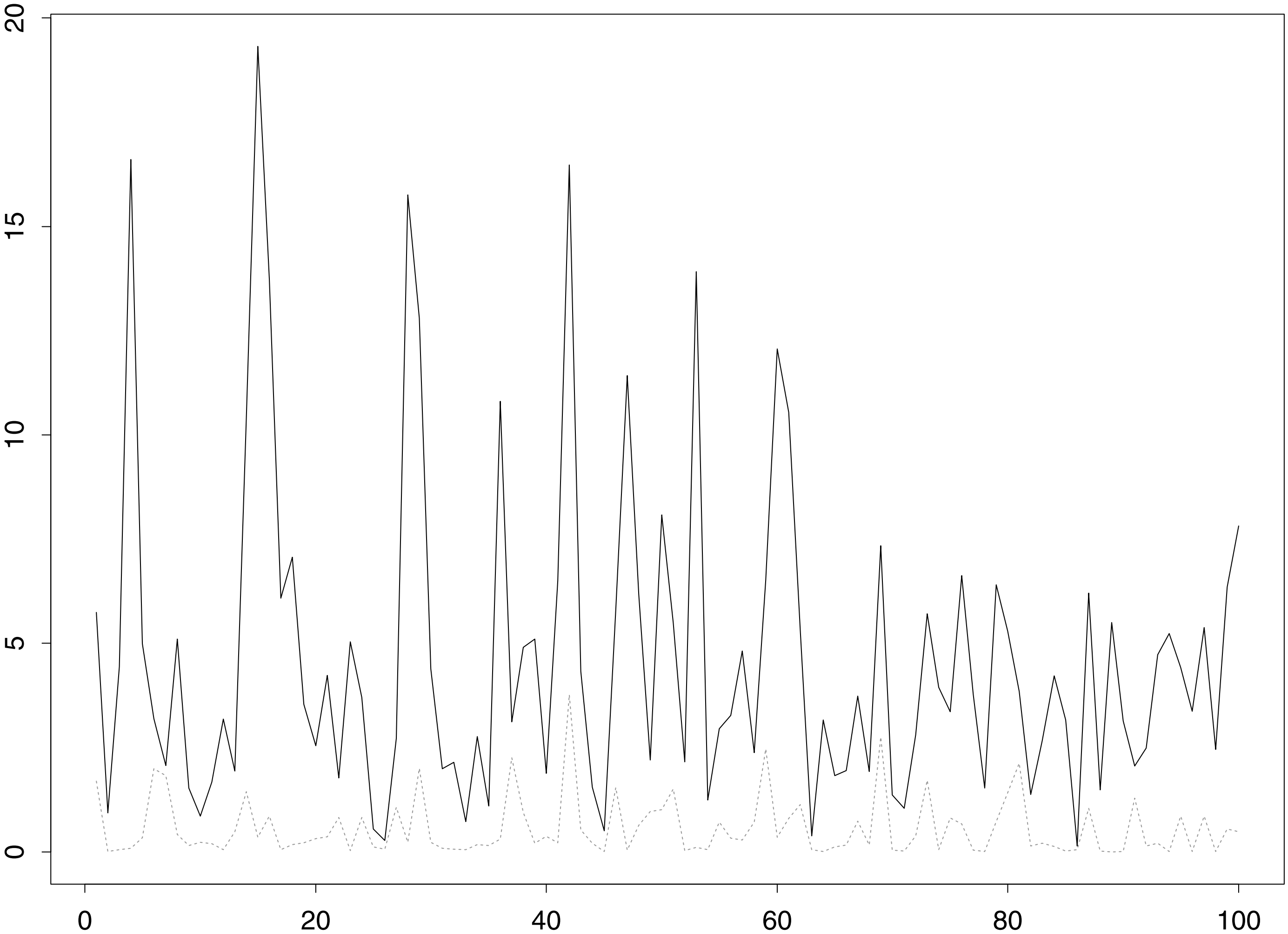

Figure 10 : Volatilities

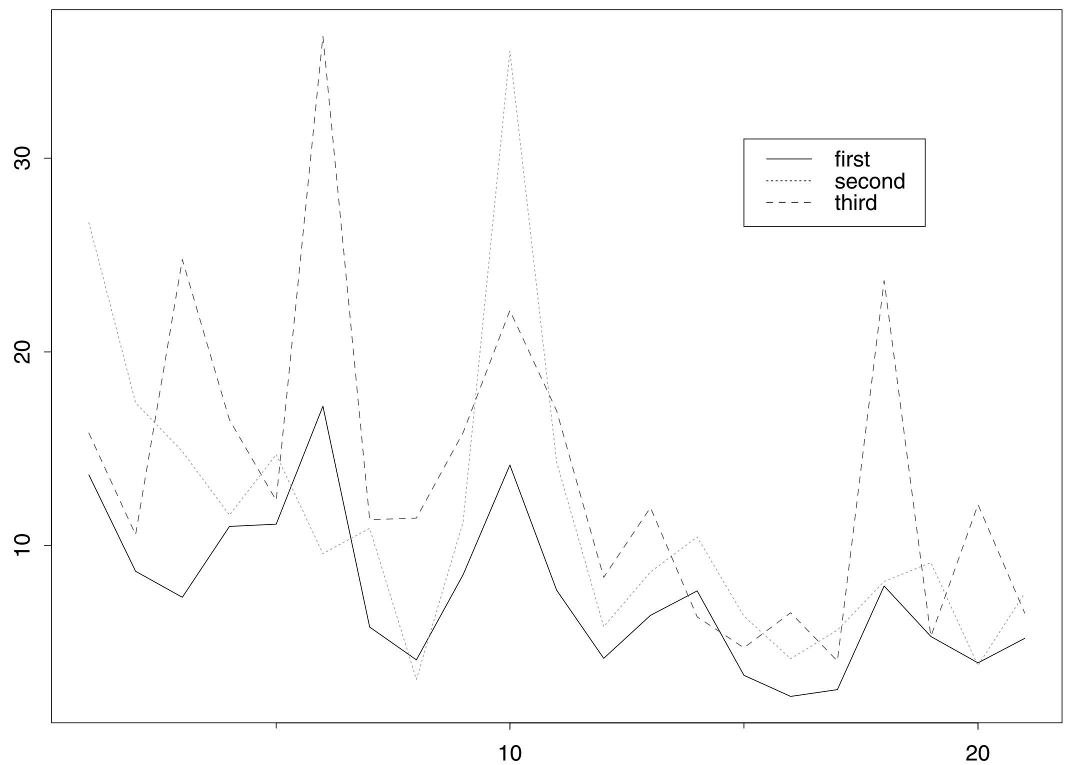

Figure 11 : Correlations

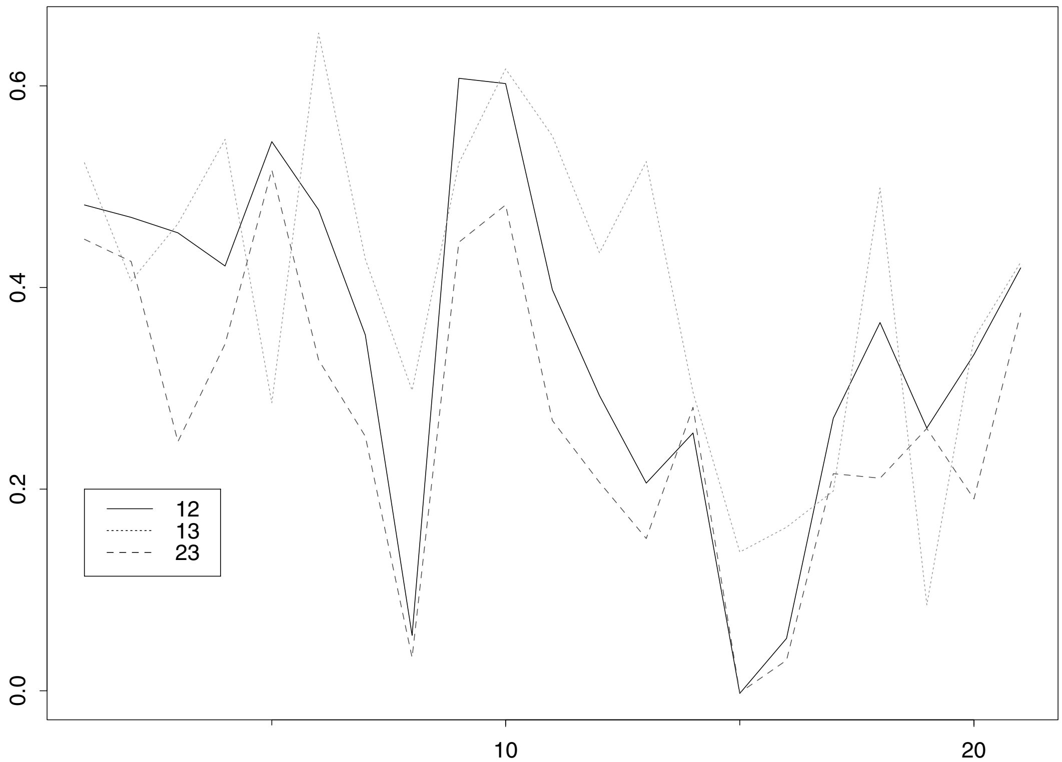

Figure 12 : Eigenvalues