

**HETEROSCEDASTIC ANALYSIS OF THE VOLATILITY OF STOCK  
RETURNS IN NAIROBI SECURITIES EXCHANGE**

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of Master of Science in Applied Statistics of Jomo Kenyatta University of Agriculture  
and Technology**

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**Declaration**

This project is my original work and has not been presented elsewhere for a degree award

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## Table of Contents

Declaration.....	i
Acknowledgement .....	ii
Table of Contents.....	iii
List of Tables .....	iv
Abstract.....	vii
1 Introduction and Literature Review .....	1
1.1 Background of the Study.....	1
1.2 Literature Review.....	2
1.3 Statement of the Problem.....	6
1.4 Objectives .....	7
1.4.1 General objective .....	7
1.4.2 Specific objectives .....	7
1.5 Justification.....	7
1.6 Hypotheses.....	7
2 Materials and Methods.....	8
2.1 Data for the Study .....	8
2.2 Methods.....	8
2.2.1 Volatility Definition and Measurement .....	8
2.2.2 Basic Statistics of Returns.....	8
2.2.3 Volatility Modeling Techniques .....	13
2.2.4 Building a Volatility Model .....	14
2.2.5 Volatility Forecasting.....	19
3 Results and Discussion .....	21
3.1 Data Exploration .....	21
3.1.1 Descriptive Statistics for the prices and returns .....	22
3.1.2 Test for Normality and Unit root .....	23
3.1.3 Test for Unit root.....	24
3.2 ARIMA (p, d, q) modeling.....	24
3.3 ARCH/GARCH modeling .....	28
3.4 Volatility Forecasting.....	34
4 Conclusion and Recommendation .....	36

## List of Tables

<b>Table 1:</b> Descriptive statistics for prices and returns .....	23
<b>Table 2:</b> Shapiro-Wilk test for Normality for the two series .....	23
<b>Table 4:</b> AIC c values for the candidate ARIMA (p, d, q) models .....	27
<b>Table 5:</b> Estimated parameters for ARIMA (1, 0, 0) and ARIMA (0, 0, 2) .....	27
<b>Table 6:</b> Lagragian Multiplier test for Arch effects .....	30
<b>Table 7:</b> AIC, BIC, and Log-likelihood values of the candidate GARCH model .....	31
<b>Table 8:</b> Forecast results for Safaricom.....	34
<b>Table 9:</b> Forecast results for KCB.....	34

## List of Figures

<b>Figure 1:</b> Time series plot of KCB and Safaricom closing price.....	21
<b>Figure 2:</b> Plots of Safaricom's and KCB's returns, $r_t$ .....	22
<b>Figure 3:</b> ACF and PACF of Safaricom closing and log differenced closing price .....	25
<b>Figure 4:</b> ACF and PACF KCB closing and log differenced closing price .....	26
<b>Figure 5:</b> ACF and PACF of Safaricom and KCB residuals .....	28
<b>Figure 6:</b> ACF plots of residuals for Safaricom and KCB .....	33
<b>Figure 7:</b> Q-Q plots and Normal probability plot of Safaricom and KCB residuals .....	34

## Abbreviations And Or Acronyms

ADF	Augmented Dickey Fuller
ACF	Autocorrelation Function
AIC	Akaike Information Criterion
AICc	corrected AIC
ARCH	Autoregressive Conditional Heteroscedastic
BIC	Bayesian Information Criterion
GARCH	Generalized Autoregressive Conditional Heteroscedastic
IID	Independent and Identically Distributed
KCB	Kenya Commercial Bank
LM	Lagragian Multiplier
MLE	Maximum Likelihood Estimation
NSE	Nairobi Stock Exchange
PACF	Partial Autocorelation Function
PP	Philip Perron test
S&P	Standard and Poor
MSE	Mean Squared Error
ME	Mean Error
MASE	Mean Absolute Squared Error

## **Abstract**

Heteroscedasticity arises when the error term of a regression equation does not have a constant variance. Financial markets are known to be very uncertain a phenomenon called volatility which is a key variable used in many financial applications such as investment, portfolio construction, option pricing and hedging as well as market risk management. This study models the heteroscedasticity of volatility of stock returns in Nairobi Stock Exchange(NSE) of Safaricom and Kenya Commercial Bank(KCB) using daily return series from 9<sup>th</sup> June 2008, to 31st December, 2010, using ARIMA- GARCH models. All the return series exhibit, leptokurtosis, volatility clustering and negative skewness. The estimation results reveal that ARIMA (1, 0, 0)-GARCH (1, 1) and ARIMA (0, 0, 2)-GARCH (1, 1) best fits Safaricom and KCB respectively. Investors who wish to avoid large, erratic swings in portfolio returns may wish to structure their investments to produce a leptokurtic distribution. Further, researches should focus on the calculation of value-at-risk (VaR) in the markets.



# **1 Introduction and Literature Review**

## **1.1 Background of the Study**

Modeling and analyzing stock return volatility is one of the most important aspects of financial market developments in recent years, providing an important input for portfolio management, option pricing and market regulation (Granger & Poon, 2003). Volatility is unobservable in financial market and it is measured by standard deviations or variance of return which can be directly considered as a measure of risk of assets. The choice an investor makes of a portfolio is intended to maximize the expected return subject to a risk constraint, or to minimize his risk subject to a return constraint. An efficient model for forecasting of an asset's price volatility provides a starting point for the assessment of investment risk. To price an option, one needs to know the volatility of the underlying asset. This can only be achieved through modeling the volatility. Volatility also has a great effect on the macro-economy. High volatility beyond a certain threshold will increase the risk of investor loses and raise concerns about the stability of the market and the wider economy (Hongyu, 2006).

In Kenya and other countries, investing in stocks has attracted many individuals. This can be evidenced by the number of people who showed interest in buying the Safaricom IPO's during its inception in 2008. Returns from these stocks tend to fluctuate over time. They are thus volatile and exhibit volatility clustering. Due to the exponential growth in those investing in stocks, modeling and analyzing volatility of stock market returns has become an important research area in financial markets and has received much attention from market practitioners, analysts and organizations with the aim of coming up with robust models that can predict future prices. This extensive research reflects the importance of volatility in

investment, security valuation, risk management and monetary policy making (Granger & Poon, 2003)

Both academicians and practitioners recognize that volatility is not directly observable and that financial returns show certain characteristics that are specific to financial time series such as volatility clustering and leverage effect (Bollerslev, 1986). Financial econometricians have developed many time-varying volatility models among them ,the Autoregressive Conditional Heteroscedastic (ARCH) model proposed by (Engle, 1982) and its extension, the Generalized Autoregressive Conditional Heteroscedastic (GARCH) developed by (Bollerslev, 1986), and (Taylor, 1986) which have been applied widely. This research seeks to investigate the dynamics of stock return volatility in NSE. This is due to the growth in those investing in stocks in Kenya and it has become one way of building wealth. Investors normally anticipate for high returns but are also aware of the risk involved due to fluctuation in prices.

## **1.2 Literature Review**

Financial time series modeling has been a subject of considerable research both in theoretical and empirical statistics and econometrics. Various linear and non-linear methods by which such forecasts can be achieved have been developed in the literature and extensively applied in practice to describe stock return volatility. Such techniques range from linear to non-linear models. (Poterba, 1986) take into account the linear model and specify a stationary AR (1) process for volatility of the Standard and Poor, S&P 500 index. Another study by (French, 1987) uses a non-linear stationary ARIMA (0, 1, 3) model to describe the volatility of the S&P 500 index. Similarly, Schwert (1990) and Schwert and Seguin (1990) use a linear AR (12) as an approximation for monthly stock return volatility.

The extensive use of such models is not surprising since they provide good first order approximation to many processes. Linear time series models however are not robust to describe certain features of a volatility series. For instance there are well-defined empirical evidences that stock returns have a tendency to exhibit clusters of outliers (Mandelbrot (1963) and Fama (1965), implying that large variances tend to be followed by another large variance. They are unable to explain a number of important features common to much financial data, including leptokurtosis, volatility clustering, long memory, volatility smile and leverage effects. That is, because the assumption of homoscedasticity (or constant variance) is not appropriate when using financial data, and in such instances it is preferable to examine patterns that allow the variance to depend upon its history.

Thus such limitations of linear models have motivated many researchers to consider non-linear alternatives. The Autoregressive Conditional Heteroscedastic (ARCH) model of (Engle, 1982), the generalized ARCH (GARCH) model of (Bollerslev, 1986) and exponential GARCH (EGARCH) model of (Nelson, 1991) are the common non-linear models used in finance literature. These ARCH class models have been found to be useful in capturing certain non-linear features of financial time series such as heavy tailed distributions and clusters of outliers.

A study by (Akgray, 1989) uses a GARCH(1,1) model to investigate the time series properties of the stock returns and reports GARCH to be the best of several models in describing and forecasting stock market volatility. (Anil & Higgins, 1993) investigated the volatility of the conventional ordinary least squares to estimate optimal hedge ratio estimates using future contracts. Similarly, (Najand, 1991) examines the relative ability of linear and non-linear models to forecast daily S&P 500 futures index volatility. The study finds that

non-linear GARCH models perform best. (Benoit, 1963) utilized the infinite variance distributions, when considering the models for stock market price changes. (Fama, 1965) when modeling stock market prices attributed their discrepancies to the possibility of the process having stable innovations and thus fitted an adequate model on this basis.

Markov-Switching models have also been used to capture the volatility dynamics of financial time series. This is because they give rise to a plausible interpretation of nonlinearities. Markov switching model of stock returns was originally proposed by (Startz, & Nelson, 1989). (Bhar, 2004), among others employ markov switching models for the modeling of stock returns.

There is a significant amount of research on volatility of stock markets of developed countries. For instance, (Gary, 2004) applied the GARCH model to the Shanghai Stock Exchange while (Bertram, 2004) modeled Australian Stock Exchange using ARCH models. Other studies on these stock markets include (Baudouhat, 2004) who utilized the GARCH model in analyzing the Nordic financial market integration. (Walter, 2005) applied the structural GARCH model to portfolio risk management for the South African equity market as well (Hongyu, 2006) who forecasted the volatility of the Chinese stock market using the GARCH-type models. (Elie, 2012) compared the GARCH model and the EGARCH under three distribution assumptions: the Gaussian, the t-student and the general error distributions. He showed that the distribution of returns is far from being normally distributed with fat tails and volatility clustering being persistent. (Al-Jafari, 2012) utilized a non-linear symmetric GARCH(1,1) model and two non-linear asymmetric models, TAR(1,1) and EGARCH(1,1) to Muscat Securities Market and the empirical findings provide no presence of day-of –the –week effect

The Sub-Saharan Africa has been under-researched as far as volatility modeling is concerned. Studies carried out in the African stock markets include, (Frimpong, 2006) who applied GARCH models to the Ghana Stock Exchange. (Brooks, 1997) examined the effect of political change in the South African Stock Market; (Appiah-Kusi, 1998) investigated the volatility and volatility spillovers in the emerging markets in Africa. More recently, (Emenike, 2010) applied the EGARCH model to the Kenyan and Nigerian Stock Market returns. From the available literature, the NSE just like other Sub Saharan Africa Equity Markets has been under-researched as far as market volatility is concerned and therefore this study contributes to the small literature available on the Nairobi Stock Exchange.

These developments in financial econometrics suggest the use of nonlinear time series structures to model the stock market prices and the expected returns. The focus of financial time series modeling has been on the ARCH model and its various extensions. However, the ARCH has limitations in that it treats negative and positive returns in the same way. It is also very restrictive in parameters and often over predicts the volatility because it responds slowly to large shocks. GARCH models have proved adequate in modeling and forecasting volatility. GARCH for instance takes into account excess kurtosis i.e. fat tail behavior and volatility clustering which are two important characteristics of time series. It also provides accurate forecast of variances and covariance of asset return through its ability to model time varying conditional variances.

However, GARCH is only part of a solution. Although GARCH models are usually applied in return series financial decisions are rarely based solely on expected returns and volatilities. GARCH models are parametric specifications that operate best under relatively stable market

conditions. Also GARCH is explicitly designed to model time-varying conditional variances. GARCH models often fail to capture highly irregular phenomenon. These include rebounds and other highly anticipated events that can lead to significant structural change. Further, GARCH models fail to capture the fat tails observed in asset return series. Some scholars favor Markov-Switching models claiming that; Markov-Switching models are more accurate and provide better forecasts than a variety of linear and non-linear GARCH models for instance (Startz, & Nelson, 1989) This study will use ARIMA-GARCH models of stock returns to model the heteroscedastic nature of volatility of stock returns in the NSE over the period June 6, 2008 to December 31, 2010

### **1.3 Statement of the Problem**

Stock market performance especially in the present era of globalization is of great interest to investors and scholars. The presence of anomalies in return has intrigued researchers for decades. Tomorrow's price is uncertain and must be described by a probability distribution. Stock returns are volatile. As (Engle, 1982) put it "...when you attempt to measure volatilities...you've to figure out what is the best way to measure something that is varying..." Volatility is not directly observable. Various researchers have attempted to come up with the best model for modeling and describing volatility with the aim of forecasting, but few researchers have been done on NSE using the ARIMA-GARCH models. Little has been done in the NSE to capture the characteristics of stock returns in and model volatility with the objective of forecasting. Hence this research attempts to accomplish this.

## **1.4 Objectives**

### **1.4.1 General objective**

To model the heteroscedastic nature of volatility of Safaricom's and KCB's stock returns over a given period

### **1.4.2 Specific objectives**

- (i) To develop a model for stock returns
- (ii) To apply the model to stock returns of KCB and Safaricom
- (iii) To determine the present return characteristics of the Kenyan stock market

## **1.5 Justification**

Volatility is an important factor in options pricing. Volatility is also important in risk management as it provides a simple approach to calculating value at risk of a financial position. Hence this research is justified as the findings from this research will be of interest and relevance to long-term investing and speculation as the results and findings will help policy makers, analysts or organizations to gain an in-depth understanding of the dynamics of stock returns in Kenya, in order to explore the various options available in forecasting market growth. It will also help them in reducing risks associated. Further, this research will add to the knowledge in modeling financial time series.

## **1.6 Hypotheses**

- (i)  $H_0$ : There is no significant correlation in the residuals of Safaricom's and KCB's returns
- (ii)  $H_0$ : There is no Autoregressive Conditional Heteroscedasticity (ARCH) up to order  $q$ .
- (iii)  $H_0$ : The standardized residuals are normally distributed

## 2 Materials and Methods

### 2.1 Data for the Study

The data used in this study comprised Safaricom's and KCB's daily returns series over the period June 6, 2008 to December 31, 2010 excluding weekends and public holidays forming a sample of 653. The daily closing prices were obtained Nairobi Stock Exchange. Since the return of an asset is a complete and scale free summary of an investment with attractive statistical features, use return series rather than the price series (Campell, Lo, & MacKinlay, 1997). In the database the return  $r_t$  consisted of the daily closing price  $Y_t$  of Safaricom and KCB.

### 2.2 Methods

#### 2.2.1 Volatility Definition and Measurement

Volatility refers to the fluctuation observed in some phenomenon over time. In modeling and forecasting literature it refers to the conditional variance of the underlying asset return. It is measured as the sample standard deviation;

$$\sigma = \sqrt{\frac{1}{N-1} \sum_{i=1}^N (r_i - \mu)^2} \quad (1)$$

Where  $\sigma$  is the standard deviation,  $r_i$  is the return on day  $i$  and  $\mu$  is the average return over the  $N$ -day period

#### 2.2.2 Basic Statistics of Returns

##### 2.2.2.1 Descriptive Statistics

Analyzing financial prices directly is difficult because consecutive prices are correlated, and the variances of prices frequently increase with time. Consequently we use price changes to



analyze prices. There are two main types of price changes that are used: arithmetic and geometric returns. (Jorion, 1997)

*Definition:* Let  $Y_t$  and  $Y_{t-1}$  be today's and yesterday's prices of an asset or a portfolio, the arithmetic returns are defined by

$$r_t = \frac{Y_t - Y_{t-1}}{Y_{t-1}} \quad (2)$$

Where  $Y_t$  is the price of the asset at day  $t$ . Yearly arithmetic returns are defined by

$$R = \frac{Y_T - Y_0}{Y_0} \quad (3)$$

Where  $Y_0$  and  $Y_T$  are the prices of the asset at the first and the last trading day of the year, respectively. Then,  $R$  may be written as

$$R = \frac{Y_T}{Y_0} - 1 \quad (4)$$

$$= \frac{Y_T}{Y_{T-1}} \cdot \frac{Y_{T-1}}{Y_{T-2}} \dots \frac{Y_1}{Y_0} - 1 \quad (5)$$

$$= \prod_{i=1}^T \frac{Y_i}{Y_{i-1}} - 1 \quad (6)$$

*Definition:* Let  $Y_t$  and  $Y_{t-1}$  be today's and yesterday's prices of an asset or portfolio, then the geometric returns are defined as

$$X_t = \log\left(\frac{Y_t}{Y_{t-1}}\right) \quad (7)$$

Note: The yearly geometric returns are given by

$$X = \left(\frac{Y_T}{Y_0}\right) \quad (8)$$

From (8), we have that X may be written as

$$X_t = \log\left(\frac{Y_t}{Y_{t-1}}\right) \quad (9)$$

$$= \log\left(\prod_{t=1}^T \frac{Y_t}{Y_{t-1}}\right) \quad (10)$$

$$= \sum_{t=1}^T \log\left(\frac{Y_t}{Y_{t-1}}\right) \quad (11)$$

$$= \sum_{t=1}^T \log X_t \quad (12)$$

i. e. the yearly geometric returns are equal to the sum of the daily geometric returns

### 3.1.2.2 The Normality test

This tests the likelihood that the given data set  $\{x_1 \dots x_n\}$  comes from a Gaussian distribution. A great number of tests have been devised for this problem. One of the tests used is the Shapiro–Wilk test. In statistics, the Shapiro–Wilk test tests the null hypothesis that a sample  $\{x_1 \dots x_n\}$  came from a normally distributed population. It was published in 1965 by Samuel Shapiro and Martin Wilk. The test statistic is:

$$S = \frac{\left(\sum_{i=1}^n a_i x_{(i)}\right)^2}{\sum_{i=1}^n (x_i - \bar{x})^2} \quad (13)$$

Where

- i)  $x_{(i)}$  with parentheses enclosing the subscript index ( $i$ ) is the  $i^{th}$  order statistic, i.e., the  $i^{th}$ -smallest number in the sample;

ii)  $\bar{x} = \frac{(x_1 + \dots + x_n)}{n}$  is the sample mean;

iii) the constants  $a_i$  are given by

$$(a_1, \dots, a_n) = \frac{m^T V^{-1}}{(m^T V^{-1} V^{-1} m)^{\frac{1}{2}}} \quad (14)$$

Where

$m = (m_1, \dots, m_n)^T$  are the expected values of the order statistics of Independent and Identically Distributed, IID random variables sampled from the standard normal distribution, and  $V$  is the covariance matrix of those order statistics.

### 3.1.2.3 Volatility clustering

This is determined by computing the Autocorrelation Function, ACF. Given that  $\{X_t\}$  is a stationary time series, with constant expectation and time independent covariance. The ACF for the series is defined as

$$\begin{aligned} \rho_k &= \frac{Cov(X_t, X_{t-k})}{\sqrt{Var(X_t)Var(X_{t-k})}} \\ &= \frac{\gamma(k)}{\gamma(0)} \end{aligned} \quad (15)$$

for  $k \geq 0$  and  $\rho_{-k} = \rho_k$ . The value  $k$  denotes the lag.

ACF is plotted as a function of  $k$ , and determine if the autocorrelation decreases as the lag gets larger or of if there is any particular lag for which the autocorrelation is large

### 3.1.2.4 Testing for ARCH Effects

Before fitting the autoregressive models to each of the daily returns series, the presence of ARCH effects in the residuals was first tested. If there does not exist a significant ARCH

effect in the residuals then the ARCH model is mis-specified. Testing the hypothesis of no significant ARCH effects is based on the Lagrangian Multiplier (LM) approach, where the test statistic is given by

$$LM = nR^2 \quad (16)$$

where  $n$  = sample size,  $R^2$  = the coefficient of determination for the regression in the ARCH model using the residuals. The null hypothesis is that there is no ARCH effect up to order  $q$  in the residuals. The test statistic is calculated as the number of observations multiplied by  $R^2$  from the regression. The LM test statistic asymptotically follows a  $\chi_q^2$  distribution. The null hypothesis will be rejected if the test statistic is larger than critical value of  $\chi_q^2$ .

### 3.1.2.5 Testing for Stationarity and Autocorrelation

Test for stationarity is conducted with the Augmented Dickey Fuller (ADF) and Philip Perron (PP) test. ADF was derived in 1979 by Dickey and Fuller to test the presence of a unit root vs. a stationary process

$$\rho_t = \phi_1 \rho_{t-1} + e_t \quad (17)$$

$$\rho_t = \phi_0 + \phi_1 \rho_{t-1} + e_t \quad (18)$$

If  $\phi_1 = 1$  then the series is said to have unit root and is not stationary. The unit root test determines if  $\phi$  is significantly close to 1.

$$\begin{aligned} H_0 : \phi_1 &= 1 \\ H_A : \phi_1 &< 1 \end{aligned}$$

The null hypothesis is that the return series have unit roots or in other words, the series is non-stationary. The null hypothesis will be rejected if the test statistic is larger in the absolute term than the critical value (Gujarati, 2010). Having confirmed that all return series are stationary, we continue to examine the autocorrelation and the partial autocorrelation in the

series to identify their proper structures. This is done through the Ljung-Box Q-statistic test by Ljung and Box (1978) which is defined as:

$$Q = T(T + 2) \sum_{k=1}^m \frac{\rho_k^2}{T - k} \sim \chi_m^2 \quad (19)$$

Where  $\rho_k$  is the sample autocorrelation coefficient; T is the sample size and m is the maximum lag length. The null hypothesis that all  $\rho_k$  are zero will be rejected if the value of the computed Q is larger than the critical Q-statistic from the chi-square distribution at the given level of significance. According to Harvey (1990, 1993), choosing the number of lags for the test is a practical issue as a small number of lags might fail to detect the autocorrelations at high-order lags, whereas, a large number of lags might result in diluting the significant correlation at one lag by insignificant correlations at other lags. In line with previous studies such as Kasch-Haroutounian and Price (2001) and Siourounis (2002), this dissertation chooses to conduct the Ljung Box test up to 25 lags of the two series

## 2.2.3 Volatility Modeling Techniques

### 2.2.3.1 ARCH model

The ARCH model was introduced by (Engle, 1982) in his study “Autoregressive Conditional Heteroscedasticity with estimates of the Variance of United Kingdom Inflation”, as the first formal model which seemed to capture the phenomena of changing variance in time series data. It is most widely used discrete time model for analysis of financial data. The formulation of his model is given below:

$$\varepsilon_t = \sqrt{\alpha + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2} \quad \text{Where } \varepsilon_t \sim \text{IID} (0, 1) \quad (20)$$

$\sigma_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2 + \alpha_2 \varepsilon_{t-2}^2 + \dots + \alpha_q \varepsilon_{t-q}^2$  where  $\sigma_t^2$  is the variance at time t,  $\varepsilon_t^2$  is the square residuals at time t, and q is the number of lags. The effect of a return shock i period ago ( $i \leq q$ ) on current volatility is governed by the parameter  $\alpha$ . In an ARCH model, old news

arrived at the market more than q period ago has no effect at all on current volatility. For ARCH (1, 1) the model is  $\sigma_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2$

### 2.2.3.2 GARCH model

(Bollerslev, 1986) extend the basic ARCH model, by introducing the GARCH model which has proven to be quite useful in empirical work. He suggested that the conditional variance function be specified as follows:  $Y_t = X_t \beta + \varepsilon_t$  is the mean equation. Where  $Y_t$  is the stock return,  $X_t$  is the exogenous variables or belonging to the set of information ( $Y_{t-1}$ ),  $\beta$  is a fixed parameter vector and conditional variance is,

$$h_t = \alpha_0 + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2 + \sum_{i=1}^p \beta_i h_{t-i} \quad (21)$$

where  $\alpha_0 > 0, \alpha_1, \alpha_2, \dots, \alpha_q \geq 0$  and  $\beta_1, \beta_2, \dots, \beta_p \geq 0$

The GARCH (p, q) above defined as stationary when  $(\alpha_1 + \alpha_2 + \dots + \alpha_q) + (\beta_1 + \beta_2 + \dots + \beta_p) < 1$ . The model for GARCH (1, 1) is given by  $\sigma_t^2 = \alpha_0 + \alpha_1 \varepsilon_{t-1}^2 + \beta \sigma_{t-1}^2$  where,  $\alpha_0 > 0, \alpha_1 \geq 0$  and  $\beta_1 \geq 0$

## 2.2.4 Building a Volatility Model

### 2.2.4.1 Model Identification

Under the identification stage the following were done:

- i. Converting of daily closing price series to return series. Let  $Y_t$  denote the daily closing price of a stock at the end of the day t, the daily stock return series was be generated by

$$r_t = \ln \frac{Y_t}{Y_{t-1}} \quad (22)$$

Stationarity of the return series was checked using unit root test. Lagrange Multiplier (LM) and Ljung-Box statistics were used to test for ARCH effects on the squared residuals of the

regressed AR (p) process, since GARCH (p, q) model implies ARCH ( $r = q + p$ ) model. Under the null hypothesis that there is no ARCH effects ( $\alpha_1 = \dots = \alpha_p$ ), the LM test statistic equal to  $TR^2$  has asymptotic chi-squared distribution with p degree of freedom.

- ii. An ARIMA(p,d,q) model was fitted to the data to remove serial dependence
- iii. ACF, Partial Autocorrelation Function, PACF and corrected AIC, AICc were used to determine the order of the models

### 2.2.4.2 Parameter Estimation

The estimation of the model's parameters was implemented by Maximum Likelihood Method under the normal distribution. This involves choosing values for the parameters that maximizes the chance (or likelihood) of the data occurring. Given a sample  $\{x_1, x_2 \dots x_n\}$  of n, IID observations, which comes from a distribution  $f(x)$  with unknown parameter  $\theta$ , then; the joint density function is

$$f\{x_1, x_2, \dots, x_n / \theta\} = f(x_1 / \theta) \times f(x_2 / \theta) \times \dots \times f(x_n / \theta) \quad (23)$$

By considering the observed values  $x_1, x_2 \dots x_n$  to be fixed parameters of this function, whereas  $\theta$  will be the function's variable and allowed to vary freely. And this function is called likelihood

$$L(\theta / x_1, x_2, \dots, x_n) = f\{x_1, x_2, \dots, x_n / \theta\} = \prod_{i=1}^n f(x_i / \theta) \quad (24)$$

In practice, it is often more convenient to work with the logarithm of the likely-hood function and called the log-likelihood:

$$\ln L(\theta / x_1, x_2, \dots, x_n) = \sum_{i=1}^n \ln f(x_i / \theta) \quad (25)$$

Assume observations  $x_1, x_2 \dots x_n$  follow normal distribution with un-known parameters

$\theta = \{ \mu, \sigma^2 \}$  then

$$\ln L(\theta/x_1, x_2, \dots, x_n) = \sum_{i=1}^n \ln \left\{ \frac{1}{\sqrt{2\pi\sigma^2}} e^{-\frac{(x_i - \mu)^2}{2\sigma^2}} \right\} \quad (26)$$

$$= \sum_{i=1}^n \left( -\frac{1}{2} \ln 2\pi - \ln \sigma - \frac{(x_i - \mu)^2}{2\sigma^2} \right) \quad (27)$$

$$= -\frac{n}{2} \ln 2\pi - n \ln \sigma - \frac{1}{2\sigma^2} \sum_{i=1}^n (x_i - \mu)^2 \quad (28)$$

In this case we have  $\mu$  and  $\sigma^2$  as the un-known parameters

$$L(\mu, \sigma^2) = -\frac{n}{2} \ln 2\pi - n \ln \sigma - \frac{1}{2\sigma^2} \sum_{i=1}^n (x_i - \mu)^2 \quad (29)$$

$$\frac{\partial L}{\partial \mu} = \frac{1}{\sigma^2} \sum_{i=1}^n (x_i - \mu) \quad (30)$$

$$\frac{\partial L}{\partial \sigma} = -\frac{n}{\sigma} + \sigma^{-3} \sum_{i=1}^n (x_i - \mu)^2 \quad (31)$$

Equating this to zero and solving for  $\sigma$  and  $\mu$  gives

$$\hat{\mu} = \bar{x} \quad (32)$$

$$\hat{\sigma}^2 = \frac{\sum_{i=1}^n (x_i - \mu)^2}{n} \quad (33)$$

#### 2.2.4.2.1 Parameter Estimation for GARCH (p, q) model

Let us now look at the application of Maximum Likelihood Estimation, MLE to estimate the parameters of GARCH (p, q). To estimate parameters of GARCH (p, q) given k, p and q we have

$$y_t = C + \sum_{i=1}^k a_i y_{t-i} + \varepsilon_t \quad (34)$$

$$\varepsilon_t = v_t \sqrt{h_t} \quad (35)$$



$$h_t = \alpha_0 + \sum_{i=1}^q \alpha_i \varepsilon_{t-i}^2 + \sum_{i=1}^p \beta_i h_{t-i} \quad (36)$$

where  $v_t$  is the white noise term.  $\varepsilon_t$  is normally distributed with mean zero and variance  $h_t$ ,

$$p(\varepsilon_t / \varepsilon_{t-1}, \dots, \varepsilon_0) = \frac{1}{\sqrt{2\pi h_t}} e^{-\frac{\varepsilon_t^2}{2h_t}} \quad (37)$$

The log-likelihood function of the parameter vector  $\theta = (\alpha_0, \alpha_1, \dots, \alpha_q, \beta_1, \dots, \beta_p)^T$

becomes

$$L(\theta) = \sum_{t=q+1}^n l_t(\theta) = \sum_{t=q+1}^n \left[ -\frac{1}{2} \ln 2\pi - \frac{1}{2} \ln h_t - \frac{\varepsilon_t^2}{2h_t} \right] \quad (38)$$

$$\Rightarrow \frac{\partial l_t(\theta)}{\partial \theta} = \left( \frac{\varepsilon_t^2}{2h_t^2} - \frac{1}{2h_t} \right) \frac{\partial h_t}{\partial \theta} \quad (39)$$

$$\frac{\partial^2 l_t(\theta)}{\partial \theta \partial \theta^T} = \left( \frac{\varepsilon_t^2}{2h_t^2} - \frac{1}{2h_t} \right) \frac{\partial^2 h_t}{\partial \theta \partial \theta^T} + \left( \frac{1}{2h_t^2} - \frac{\varepsilon_t^2}{h_t^3} \right) \frac{\partial h_t}{\partial \theta} \frac{\partial h_t}{\partial \theta^T} \quad (40)$$

Where

$$\frac{\partial h_t}{\partial \theta} = (1, \varepsilon_{t-1}^2, \dots, \varepsilon_{t-q}^2, h_{t-1}, \dots, h_{t-p})^T + \sum_{i=1}^p \beta_i \frac{\partial h_{t-i}}{\partial \theta} \quad (41)$$

Thus the gradient is

$$\Delta L(\theta) = \frac{1}{2} \sum_{t=q+1}^n \left( \frac{\varepsilon_t^2}{h_t^2} - \frac{1}{h_t} \right) \frac{\partial h_t}{\partial \theta} \quad (42)$$

And the Fisher Information matrix is

$$J = \sum_{t=q+1}^n E \left[ \left( \frac{\varepsilon_t^2}{2h_t^2} - \frac{1}{2h_t} \right) \frac{\partial^2 h_t}{\partial \theta \partial \theta^T} + \left( \frac{1}{2h_t^2} - \frac{\varepsilon_t^2}{h_t^3} \right) \frac{\partial h_t}{\partial \theta} \frac{\partial h_t}{\partial \theta^T} \right] \quad (43)$$

$$= -\frac{1}{2} \sum_{t=q+1}^n E\left(\frac{1}{h^2_t} \frac{\partial h_t}{\partial \theta} \frac{\partial h_t}{\partial \theta^T}\right) \quad (44)$$

### 2.2.4.3 Diagnostic checking

Goodness-of-fit needs to be performed after fitting the appropriate model (Tackle, 2003).

This is based on the standardized residuals. The following was performed:

- i. The standardized residuals of the fitted model are analyzed to ascertain their randomness. The standardized residuals

$$\hat{\varepsilon}_t = \frac{\varepsilon_t}{\sigma_t} \quad (45)$$

are IID random variables following either a standard normal or student-t distribution.

If the model fits well then neither  $\hat{\varepsilon}_t$  nor  $\hat{\varepsilon}_t^2$  should exhibit serial correlation.

- ii. The normal plots, ACF plot and time series plot was done. The normal probability plot should be a straight line while the time plot should exhibit random variation. For ACF's all the correlation should be within the test bounds which indicates stationarity in the data
- iii. Ljung-Box test is employed to check for adequacy of the fitted model. The Ljung-Box test was named after Greta M Ljung and George E. P. It is a type of statistical test which test whether any of a group of autocorrelations of a time series is different from zero. It performs a lack-of-fit hypothesis test for model specification, which is based on the Q-statistic

$$Q = n(n+2) \sum_{j=1}^n \frac{p^2(j)}{n-j} \quad (46)$$

where n= sample size, h= number of auto-correlation lags included in the statistic, and  $p^2(j)$  is the squares sample autocorrelation at lag j. Under the null hypothesis of no serial correlation, the Q-statistic is asymptotically Chi-Square distributed. If the

value of the test statistic is greater than the critical value from the Q-statistics, then the null hypothesis can be rejected. Alternatively, if p-value is smaller than the conventional significance level, the null hypothesis that there are no autocorrelation will be rejected.

### 2.2.5 Volatility Forecasting

The challenge in Econometrics is to specify how the information will be used to forecast the mean and variance of the return, conditional on the past information. According to (Akgiray, 1989), there are two reasons why forecasting volatility attracts interests of investors. Firstly, good forecast capability of volatility models provides a practical tool for stock market analysis. Secondly, as proxy for risk, volatility is related to expected returns, hence good forecast models enable investors give more appropriate securities pricing strategies. Various methods have been considered to forecast the variance of future returns. The most widely used specification is the GARCH (1, 1) model introduced by (Bollerslev, 1986) as a generalization of (Engle, 1982).

Consider the following GARCH (1, 1) model:

$$y_t = \mu + u_t \quad , \quad u_t \sim N(0, \sigma_t^2), \quad (47)$$

$$\sigma_t^2 = \alpha_0 + \alpha_1 u_{t-1}^2 + \beta \sigma_{t-1}^2 \quad (48)$$

What is needed to generate are forecasts of  $\sigma_{T+1}^2 \mid \Omega_T$ ,  $\sigma_{T+2}^2 \mid \Omega_T, \dots$ ,  $\sigma_{T+s}^2 \mid \Omega_T$  where  $\Omega_T$  denotes all information available up to and including observation  $T$ . Adding one to each of the time subscripts of the above conditional variance equation, and then two, and then three would yield the following equations

$$\sigma_{T+1}^2 = \alpha_0 + \alpha_1 + \beta \sigma_T^2 \quad (49)$$

$$\sigma_{T+2}^2 = \alpha_0 + \alpha_1 + \beta \sigma_{T+1}^2 \quad (50)$$

$$\sigma_{T+3}^2 = \alpha_0 + \alpha_1 + \beta\sigma_{T+2}^2 \quad (51)$$

Let  $\sigma_{1,T}^{f^2}$  be the one step ahead forecast for  $\sigma^2$  made at time  $T$ . This is easy to calculate since, at time  $T$ , the values of all the terms on the right hand side are known.  $\sigma_{1,T}^{f^2}$  would be obtained by taking the conditional expectation of (47). Given  $\sigma_{1,T}^{f^2}$ ,  $\sigma_{2,T}^{f^2}$  the 2-step ahead forecast for  $\sigma^2$  made at time  $T$  is obtained by taking the conditional expectation of (50)

$$\sigma_{2,T}^{f^2} = \alpha_0 + \alpha_1 E(u^2_{T+1} | \Omega_T) + \beta \sigma_{1,T}^{f^2} \quad (52)$$

where  $E(u^2_{T+1} | \Omega_T)$  is the expectation, made at time  $T$ , of  $u^2_{T+1}$ , which is the squared disturbance term. We can write

$$E(u^2_{T+1} | \Omega_T) = \sigma_{T+1}^2 \quad (53)$$

But  $\sigma_{T+1}^2$  is not known at time  $T$ , so it is replaced with the forecast for it  $\sigma_{1,T}^{f^2}$ , so that the 2-step ahead forecast is given by

$$\sigma_{2,T}^{f^2} = \alpha_0 + \alpha_1 \sigma_{1,T}^{f^2} + \beta \sigma_{1,T}^{f^2} \quad (54)$$

$$\sigma_{2,T}^{f^2} = \alpha_0 + (\alpha_1 + \beta) \sigma_{1,T}^{f^2} \quad (55)$$

By similar arguments, the 3-step a-head forecast will be given by

$$\sigma_{3,T}^{f^2} = E_T(\alpha_0 + \alpha_1 + \beta\sigma_{T+2}^2) \quad (56)$$

$$= \alpha_0 + (\alpha_1 + \beta) \sigma_{2,T}^{f^2} \quad (57)$$

$$= \alpha_0 + (\alpha_1 + \beta) [\alpha_0 + (\alpha_1 + \beta) \sigma_{1,T}^{f^2}] \quad (58)$$

$$= \alpha_0 + \alpha_0(\alpha_1 + \beta) + (\alpha_1 + \beta)^2 \sigma_{1,T}^{f^2} \quad (59)$$

Any  $s$ -step a-head forecast ( $s \geq 2$ ) would be produced by

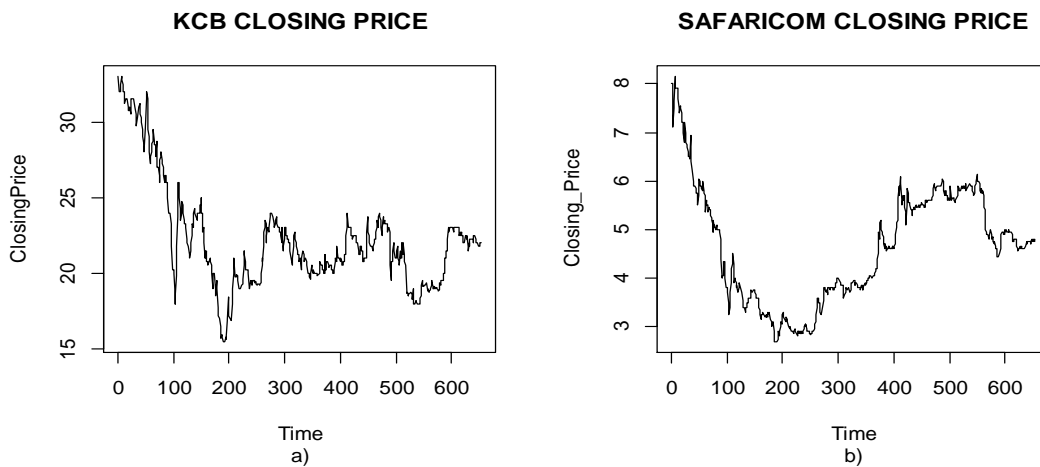
$$h_{s,T}^f = \alpha_0 \sum_{i=1}^{s-1} (\alpha_1 + \beta)^{i-1} + (\alpha_1 + \beta)^{s-1} h_{1,T}^f \quad (60)$$

### 3 Results and Discussion

#### 3.1 Data Exploration

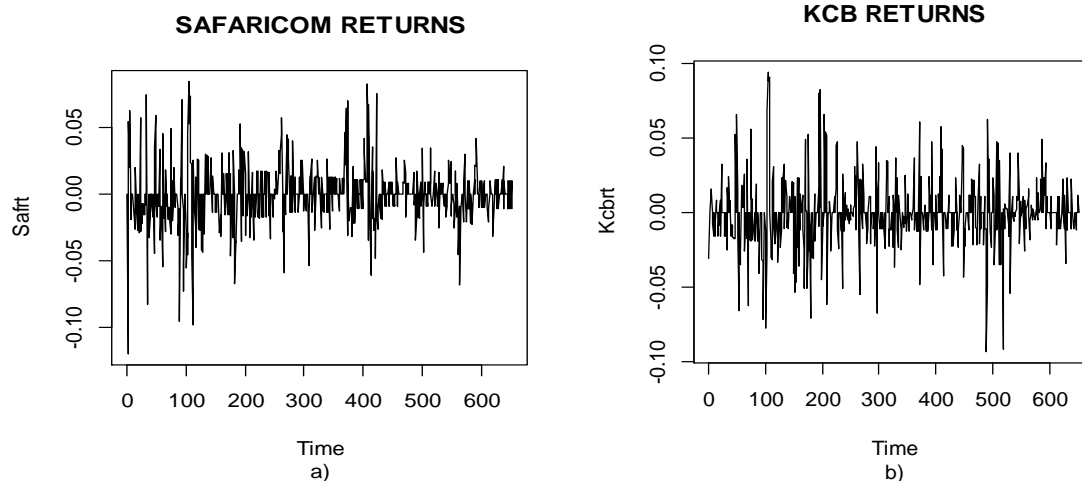
Let  $Y_t$  denote the daily closing price of a stock at the end of the day  $t$ , the daily stock return series  $r_t$  was generated by

$$r_t = \ln \frac{Y_t}{Y_{t-1}} \quad (61)$$



**Figure 3.1:** Time series plot of KCB and Safaricom closing price

From **Figure 3.1** the closing prices are very irregular with varied degree of fluctuations. The time plots clearly show that the mean and variance are not constant, showing non-stationarity of the data. It also shows a drop in prices from a high value in 2008 to a low value in 2010. Series such as these cannot be used for further statistical inferences because of their implications (Gujarati, 2004), thus the need to transform them to returns. The plots of daily returns of Safaricom and KCB are presented in **Figure 3.2** below. The plots for returns are stationary and exhibit no trend and the amplitude vary with time a phenomenon called ARCH effects. Volatility clustering is also evident.



**Figure 3.2:** Plots of Safaricom's and KCB's returns,  $r_t$

### 3.1.1 Descriptive Statistics for the prices and returns

**Table 3.1.1** below shows summary statistics for the two companies' return series. The results indicate high volatility and the risky nature of the market since the standard deviation of the market returns is high in comparison with the mean. Also the standard deviations are very close for both Safaricom and KCB with Safaricom being slightly volatile. Both price series have positive skewness implying that the distribution has a long right tail. On the other hand, the return series for Safaricom have negative skewness implying that the distribution has a long left tail and positive for KCB implying that the distribution has long right tail. The values for kurtosis are high (above three) for both return series implying they are leptokurtic. The Shapiro-Wilk test rejects normality at the 5% level for all series. So, the samples have all financial characteristics: volatility clustering and leptokurtosis.

**Table 3.1.1:** Descriptive statistics for prices and returns

<b>A. Prices</b>	<b>KCB Closing price</b>	<b>Safaricom Closing price</b>
Mean	22.243	4.6474
Median	21.750	4.6500
Minimum	15.500	2.7000
Maximum	33.000	8.1500
Standard deviation	3.5203	1.1823
C.V.	0.15826	0.25441
Skewness	1.2007	0.35244
Ex. kurtosis	1.3145	-0.36618
Shapiro-Wilk	0.887923	0.959455
Observations	653	653
<b>B. Returns</b>	<b>KCB returns</b>	<b>Safaricom returns</b>
Mean	-0.00062188	-0.00079954
Median	0.00000	0.00000
Minimum	-0.093090	-0.11935
Maximum	0.093932	0.084557
Standard deviation	0.021731	0.022302
C.V.	34.945	27.893
Skewness	0.29534	-0.086079
Ex. kurtosis	3.6479	3.9471
Shapiro-Wilk	0.905841	0.916475
Observations	652	652

### 3.1.2 Test for Normality and Unit root

Shapiro-Wilk test is used to test for normality in the series which are shown in the Table 3.1.2 below. The p-values are less than 0.05, thus we reject the null hypothesis of normality in the data and conclude that the closing prices are not normally distributed.

**Table 3.1.2:** Shapiro-Wilk test for Normality for the two series

	<b>Shapiro-Wilk test</b>	
	<b>W</b>	<b>p-value</b>
<b>Safaricom</b>	0.9595	$1.927 \times 10^{-12}$
<b>KCB</b>	0.8879	$2.2 \times 10^{-16}$

### 3.1.3 Test for Unit root

A stationary check for both closing prices and returns using Augmented Dickey Fuller (ADF) Philip Perron (PP) test shows that under the null hypothesis, unit root is not detected in both returns.

**Table 3.1.3** ADF and PP test for prices and returns for Safaricom and KCB

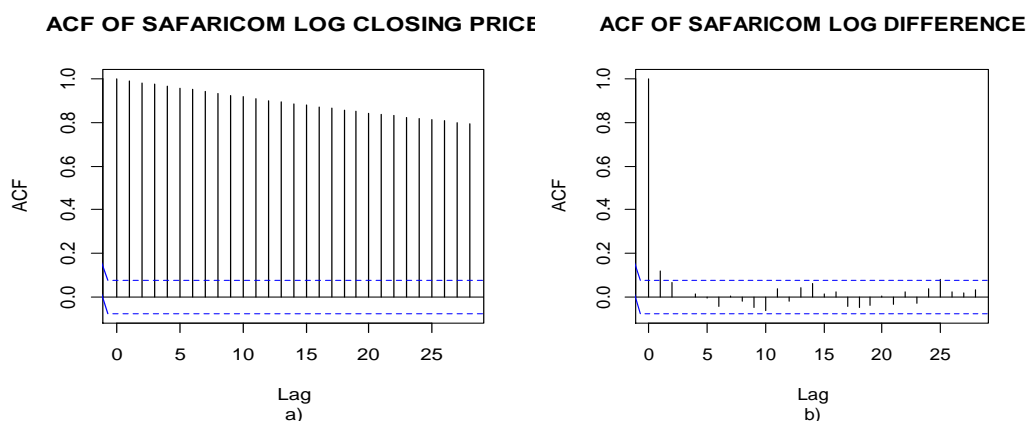
Safaricom	Prices				Returns			
	ADF Test		PP test		ADF Test		PP Test	
	ADF Value	-3.5	PP Value	-3.27	ADF Value	-9.13	PP Value	-22.7
	P-value	0.04	P-value	0.075	P-value	0.01	P-value	0.01
KCB	ADF Value	-2.71	PP Value	-2.86	ADF Value	-9.38	PP Value	-22.38
	P-value	0.27	P-value	0.21	P-value	0.01	P-value	0.01

### 3.2 ARIMA (p, d, q) modeling

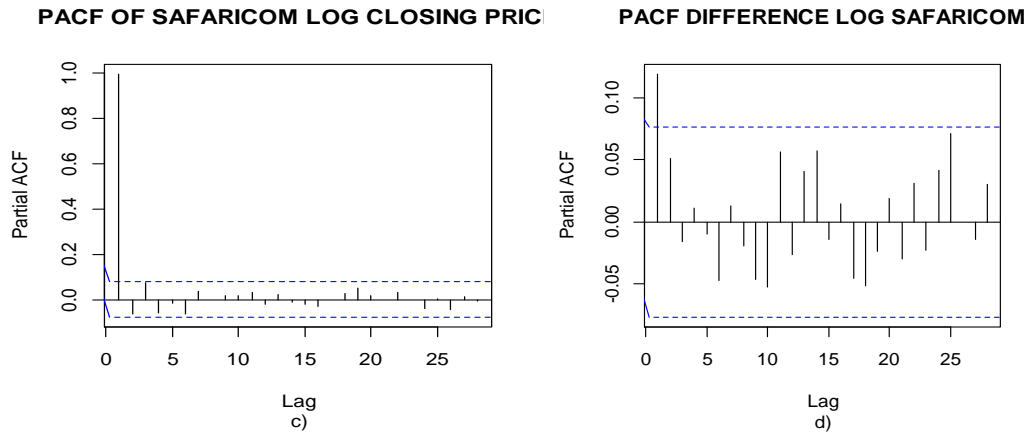
In this study we used the ARIMA model instead of the ARMA model because it includes the integration process

#### 3.2.1 Model Identification

Use ACF and PACF identify the ARIMA model for the mean equation

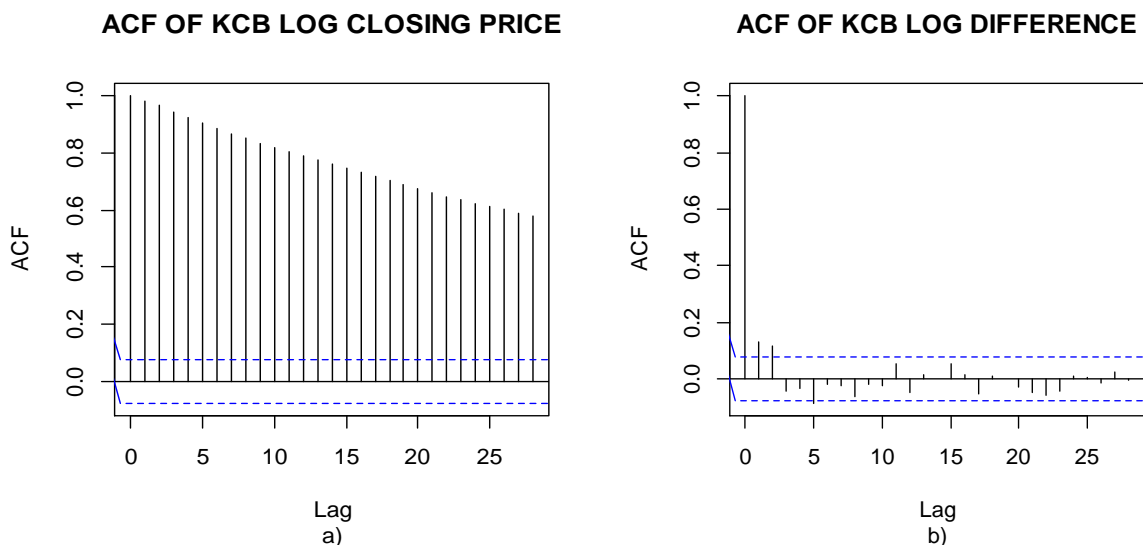


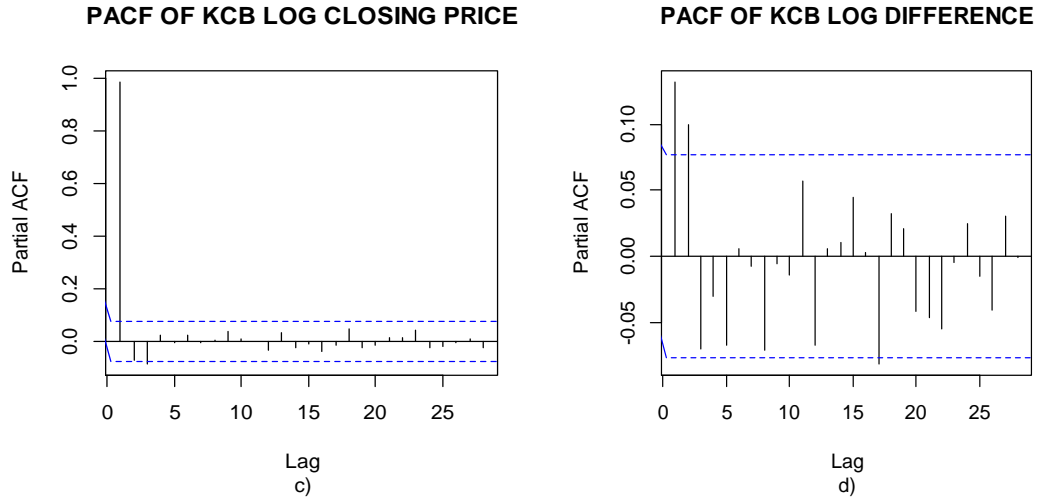




**Figure 3.2.1:** ACF and PACF of Safaricom closing and log differenced closing price

Figure 3.2.1 a) above show ACF of Log Safaricom closing price, showing the ACF slowly decreases. It is probably that the model needs differencing. Figure 3 b) shows ACF of differences of log Safaricom with no significant lags. This is because the series has been differenced. Figure 3 c) is PACF of Log Safaricom closing price, indicating significant value at lag 1 and then PACF cuts off. Therefore, the model for Log Safaricom closing price might be ARIMA (1, 0, 0). Figure 3 d) is PACF of differences of log Safaricom, reflecting no significant lags. The model for differenced log Safaricom series is thus a white noise, and the original model resembles random walk model ARIMA (0, 1, 0)





**Figure 3.2.2:** ACF and PACF KCB closing and log differenced closing price

Figure 4 a) above show ACF of Log KCB closing price, showing the ACF slowly decreases implying also that the model needs differencing. Figure 4 b) shows ACF of differences of log KCB with significant lags at lag 1 and 2 implying an (1,0,0) might be the best model for KCB returns. Figure 4 c) is PACF of Log KCB closing price, indicating no significant lags. Figure 4 d) is PACF of differences of log KCB, reflecting significant lags at lag 1.

Further, AICc provides another way to check and identify the model. This can be calculated by the formula:

$$AIC_c = N \log \left( \frac{SS}{N} \right) + 2(p + q + 1) \left( \frac{N}{N - p - q - 2} \right) \quad (62)$$

if no constant term in model

$$AIC_c = N \log \left( \frac{SS}{N} \right) + 2(p + q + 2) \left( \frac{N}{N - p - q - 3} \right) \quad (63)$$

if constant term in model

N: the number of items after differencing ( $N = n - d$ )

SS: sum of squares of differences

p & q : the order of autoregressive and moving average model, respectively.

According to this method, the model with lowest AIC c will be selected. Fitting the various orders of ARIMA in R gives the values in Table 3 below.

**Table 4:** AIC c values for the candidate ARIMA (p, d, q) models

Model	Safaricom	KCB
	AICc	AICc
<b>ARIMA(1,0,0)</b>	<b>-3113.21</b>	-3113.206
ARIMA(0,0,1)	-3047.012	-3112.235
ARIMA(1,0,1)	-3049.893	-3112.479
ARIMA(1,1,0)	-2952.173	-3048.920
ARIMA(0,1,1)	-3117.038	-3112.480
ARIMA(0,1,2)	-3103.62	3103.62
<b>ARIMA(0,0,2)</b>	-3059.893	<b>-3157.22</b>

Based on the AICc, values presented in Table 4, the ARIMA (1,0,0) model is identified to be the one that best fits the daily returns for Safaricom and ARIMA(0,0,2) for KCB from June 2008 to Dec 2010

### 3.2.2 Parameter Estimation

The parameters of the fitted ARIMA models are shown in the table below

**Table 5:** Estimated parameters for ARIMA (1, 0, 0) and ARIMA (0, 0, 2)

	Model	$\alpha_1$	Intercept	$\beta_1$	$\beta_2$
<b>Safaricom</b>	ARIMA(1,0,0)	0.1188	-0.0008	-----	-----
<b>KCB</b>	ARIMA(0,0,2)	-----	-0.0008	0.1140	0.0672

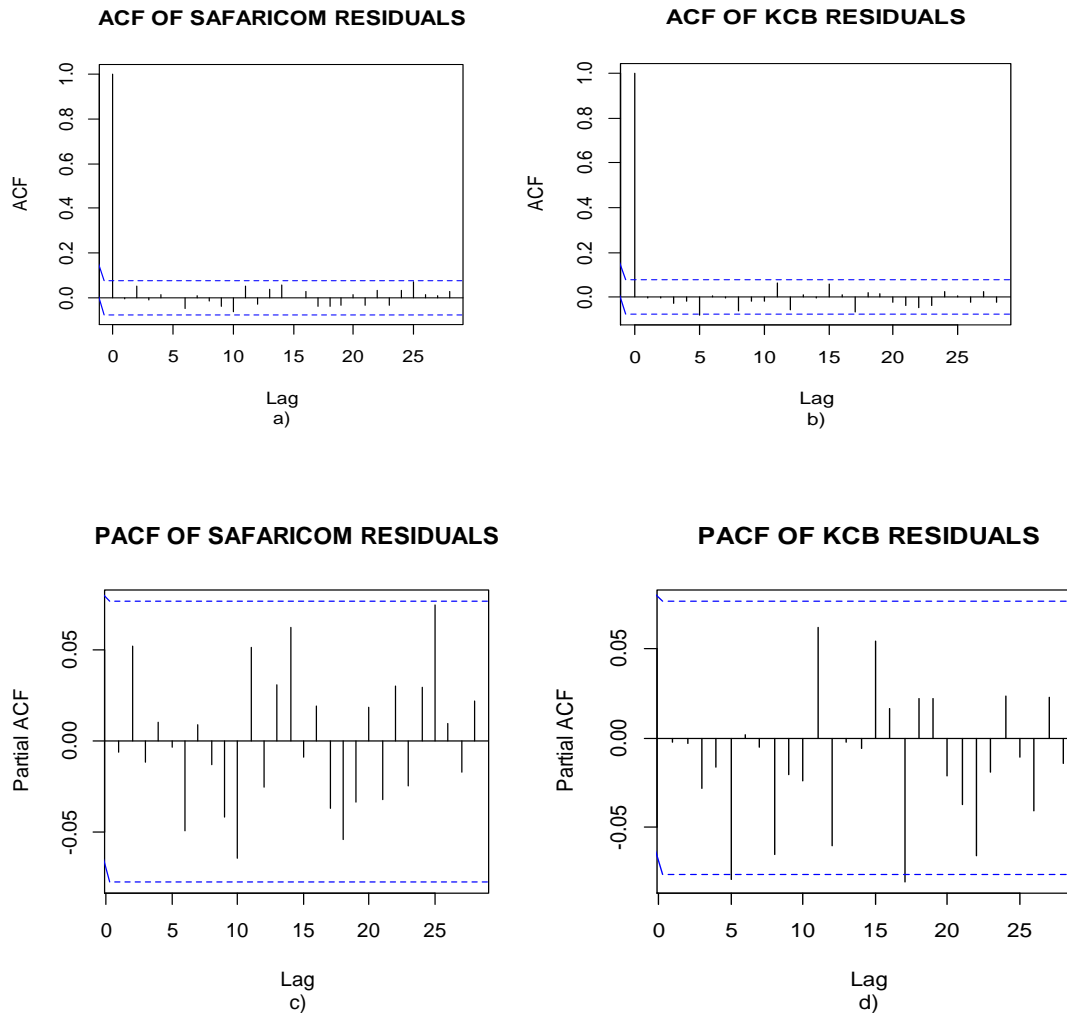
Thus the complete models become for the fitted ARIMA (1, 0, 0) and ARIMA (0, 0, 2) for Sfaricom and KCB respectively becomes;

$$\text{Safaricom: } r_t = -0.0008 + 0.1188 \alpha_1 + \varepsilon_t \quad (64)$$

$$\text{KCB: } r_t = \varepsilon_t + 0.1140r_{t-1} + 0.067r_{t-2} + \varepsilon_t \quad (65)$$

### 3.2.3 Diagonostic Checking

We plot the ACF and the PACF of residuals to check for model adequacy.



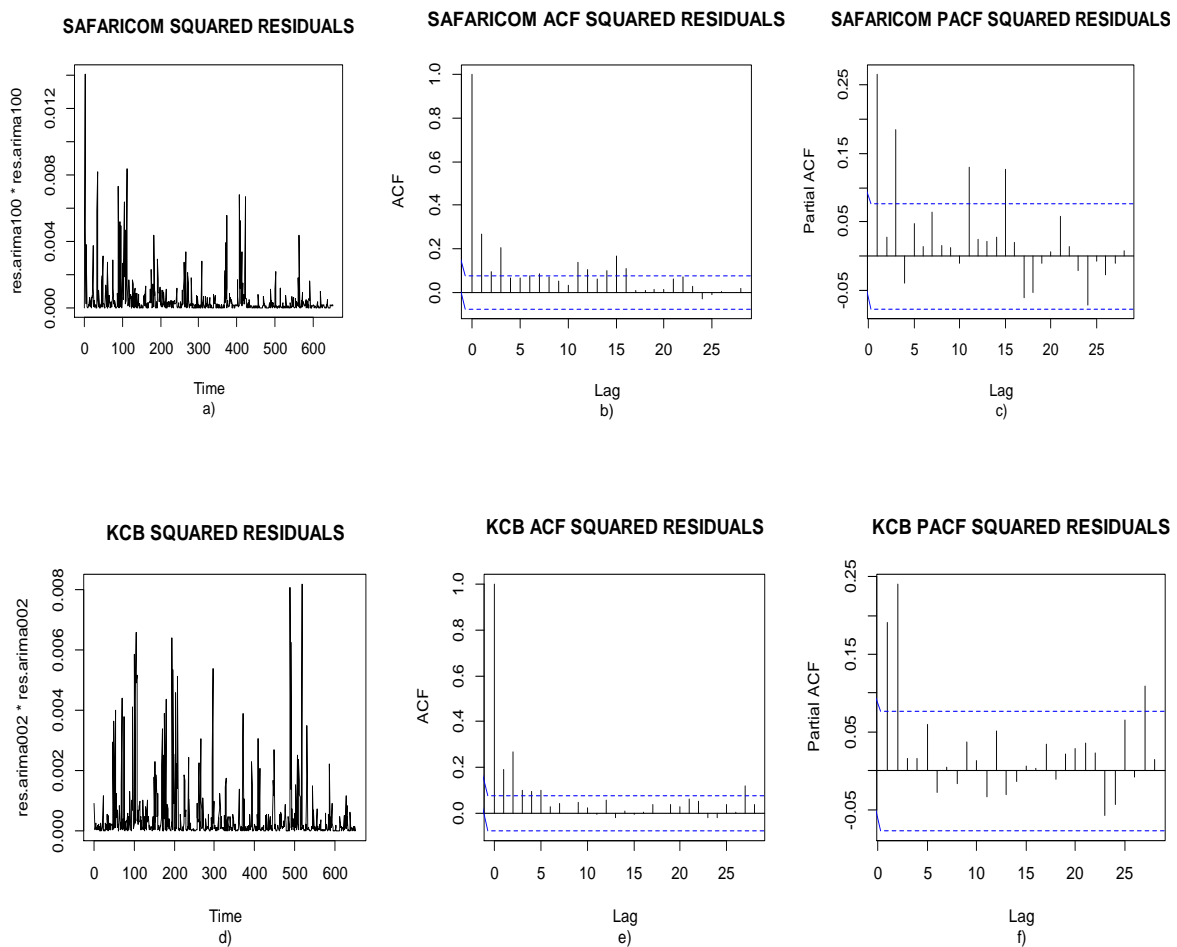
**Figure 5:** ACF and PACF of Safaricom and KCB residuals

Figure 5 above shows the ACF and PACF of Safaricom and KCB. Both the ACF and PACF show no significant lag. This means that the models are appropriate.

### 3.3 ARCH/GARCH modeling

Although ACF & PACF of residuals have no significant lags, the time series plot of residuals shows some cluster of volatility (not reported here). ARIMA is a method to linearly model the data and the forecast width remains constant because the model does not reflect recent

changes or incorporate new information. However, we fit an ARIMA (p, d, q) model to remove serial dependence in the series. Inspection of residual plot displays and squared residual plot shows cluster of volatility. The ACF & PACF of squared residuals confirms this and thus if the residuals (noise term) are not independent and can be predicted. Hence, ARCH/GARCH should be used to model the volatility of the series to reflect more recent changes and fluctuations in the series. These results are presented in Figure 6 below.



**Figure 6:** ACF and PACF plots of residuals and squared residuals of Safaricom and KCB

#### 4.4.1 Testing for ARCH effects in Returns of $\varepsilon_t$ in the Fitted ARIMA (1, 0, 0) and ARIMA (0, 0, 2)

Before fitting the autoregressive models, the presence of ARCH effects in the residuals is tested. If there does not exist a significant ARCH effect in the residuals

then the ARCH model is mis-specified. Testing the hypothesis of no significant ARCH effects is based on the Lagrangian Multiplier (LM) approach as stated earlier on the methodology,

**Table 6:** Lagrangian Multiplier test for Arch effects

Returns	Chi-square	df	p-value
KCB	117.15		<0.001
Safaricom	74.5019	4	<0.001

From **Table 6**, the p-values for both series are less than 0.05 hence we reject the null hypothesis of no significant arch effect in the daily returns of Safaricom and KCB and conclude there are significant arch effects for the June 6, 2008 to December 31, 2010.

#### 4.4.2 Model Identification

Since this study deals with daily returns, it is restricted to pure ARCH (p) models. For GARCH (p, q) models, those with  $p, q \leq 2$  are typically selected by AIC and BIC. Low order GARCH (p, q) models are generally preferred to a high order ARCH (p) for reasons of parsimony and better numerical stability of estimation

#### 4.4.3 Order Determination

Determining the ARCH order p and the GARCH order q for a particular series is an important practical problem. The AIC, BIC and Log likelihood ration tests are used in selecting the appropriate order of the GARCH from competing models. **Table 7** below gives the suggested order with their respective fit statistics. The aim is to have a parsimonious model that captures as much variation in the data as possible. Usually the simple GARCH model captures most of the variability in most stabilized series. Small lags for p and q are common in applications. Typically GARCH (1, 1);

GARCH (2, 1) or GARCH (1, 2) models are adequate for modeling volatilities even over long sample periods (Bollerslev, Chou and Kroner, 1992). This study has included GARCH (1, 0) GARCH (0, 2) and GARCH (2, 2) in order to check if they are appropriate for modeling time varying variance. We select the model with the lowest AIC and BIC

**Table 7:** AIC and BIC values of the candidate GARCH model

Company	Model	AIC	BIC
<b>Safaricom</b>	GARCH(0,1)	1.534990	1.534990
	GARCH(0,2)	1.534990	1.534990
	<b>GARCH(1,1)</b>	<b>1.520699</b>	<b>1.511877</b>
	GARCH(1,2)	1.553465	1.601506
	GARCH(2,1)	1.534990	1.583031
	GARCH(2,2)	1.533339	1.588244
	<b>KCB</b>	GARCH(0,1)	3.752802
GARCH(0,2)		3.763026	3.791068
<b>GARCH(1,1)</b>		<b>3.716712</b>	<b>3.757891</b>
GARCH(1,2)		3.742802	3.790843
GARCH(2,1)		3.743026	3.791068
GARCH(2,2)		3.739183	3.794087

From **Table 7** above the model given in bold is taken to be the most appropriate according to the criteria above. The GARCH models for different values of p and q were fitted to the data, diagnosed and from the diagnosis and goodness of fit statistics, the GARCH (1, 1) was found to be the best choice. This is consistent with most empirical studies involving the application of GARCH models in financial time series data. We thus fit a GARCH (1; 1) to the residuals of ARIMA (1, 0, 0) and ARIMA (0, 0, 2) of Safaricom and KCB respectively

#### 4.4.4 Estimation

From R output

	<b>Estimate</b>	<b>Std. Error</b>	<b>t value</b>	<b>Pr(&gt; t )</b>
<b>a0</b>	4.101e-05	8.491e-06	4.829	1.37e-06 ***
<b>a1</b>	1.866e-01	2.617e-02	7.131	9.98e-13 ***
<b>b1</b>	7.209e-01	3.363e-02	21.438	< 2e-16 ***

For Safaricom the fitted GARCH (1, 1) model is

$$r_t = 5.76 + \varepsilon_t \quad (66)$$

$$\sigma_t^2 = 0.00004 + 0.186 Z^2_{t-1} + 0.7209 \sigma^2_{t-1} \quad (67)$$

From the following output for KCB

	<b>Estimate</b>	<b>Std. Error</b>	<b>t value</b>	<b>Pr(&gt; t )</b>
<b>a0</b>	2.895e-05	5.833e-06	4.963	6.95e-07 ***
<b>a1</b>	1.912e-01	2.592e-02	7.376	1.63e-13 ***
<b>b1</b>	7.597e-01	2.561e-02	29.662	< 2e-16 ***

The fitted GARCH (1, 1) model is

$$r_t = 20.18 + \varepsilon_t, \sigma_t^2 = 0.000028 + 0.19 Z^2_{t-1} + 0.7597 \sigma^2_{t-1} \quad (68)$$

To assess the accuracy of the estimates, the standard errors are used the smaller the better.

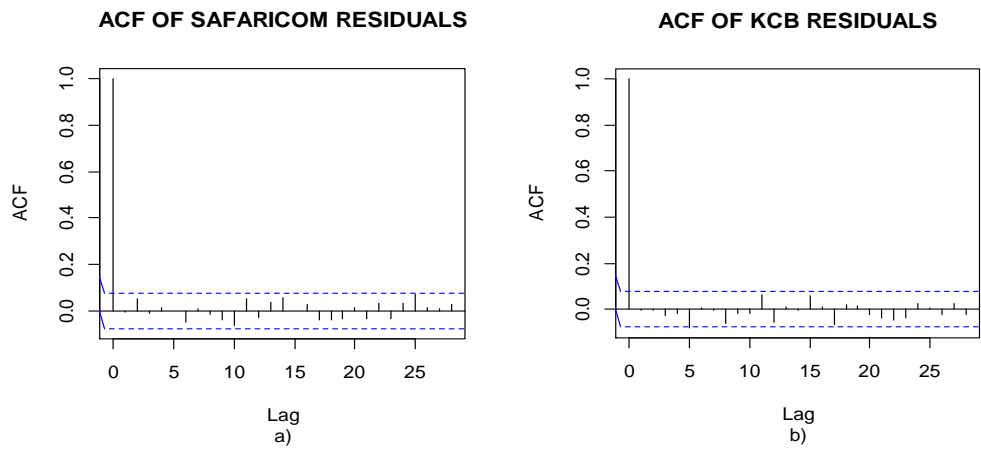
From the standard errors the estimates are precise. Based on 95% confidence level, the coefficients of the fitted GARCH (1, 1) model are significantly different from zero

#### 4.4.5 Diagnostic Checking

Here the adequacy of the selected models is done. This is done by using standardized residuals which are assumed to follow either normal or standardized t distribution. It must

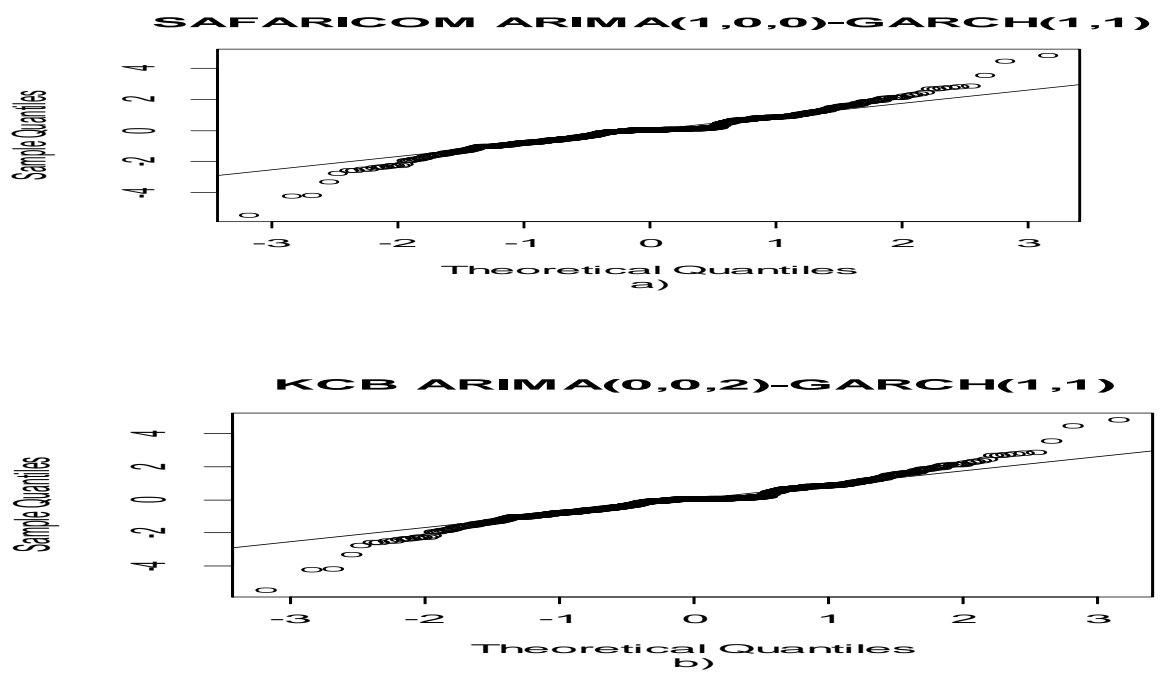


satisfy the requirement of a white noise. The plots include normal plots, ACF plot time series plot and histogram. If the model fits the data well the histogram of the residuals should be symmetric. The normal probability plot should be a straight line while the time plot should exhibit random variation. For ACF plots all the correlation should be within the boundary line meaning the data is stationary.



**Figure 7:** ACF plots of residuals for Safaricom and KCB

It is clear that all the correlations are within the test bounds implying the fitted model is adequate.. However, this might be by chance and we proceed to use Q-Q plot.



**Figure 8:** Q-Q plots and Normal probability plot of Safaricom and KCB residuals

From the Q-Q plots and normal probability plot the residuals seem to be roughly normally distributed although some points remain off the line.

### 3.4 Volatility Forecasting

The main objective of this study is limited to the task of modeling. However, since forecasting is the prime object of modeling, volatility forecasts of the series based on the models chosen have been generated. Table 8 and 9 below shows the forecasts

**Table 8:** Forecast results for Safaricom

Point	Forecast	Lo 95	Hi 95
653	-0.0011994094	-0.04450269	0.04210387
654	-0.0014993927	-0.04508323	0.04208444
655	-0.0008070325	-0.04448788	0.04287381
656	-0.0008070325	-0.04448788	0.04287381
657	-0.0008070325	0.04287381	-0.04448788
658	-0.0008070325	-0.04448788	0.04287381
659	-0.0008070325	-0.04448788	0.04287381
660	-0.0008070325	-0.04448788	0.04287381
661	-0.0008070325	-0.04448788	0.04287381
662	-0.0008070325	-0.04448788	0.04287381

From R output the Mean Error, ME, Root Mean Squared Error, RMSE and Mean Absolute Error, MAE were as follows

ME	RMSE	MAE
-0.00000082	0.022	0.013

The MSE and the RMSE are -0.00000082 and 0.022 respectively meaning the model can produce accurate forecasts.

**Table 9:** Forecast results for KCB

Point	Forecast	Lo 95	Hi 95
653	-0.000855497	-0.0427695	0.04105851
654	-0.0007207025	-0.04296716	0.04152576
655	-0.0006276681	-0.04321562	0.04196029
656	-0.0006276681	-0.04321562	0.04196029
657	-0.0006276681	-0.04321562	0.04196029
658	-0.0006276681	-0.04321562	0.04196029
659	-0.0006276681	-0.04321562	0.04196029
660	-0.0006276681	-0.04321562	0.04196029
661	-0.0006276681	-0.04321562	0.04196029
662	-0.0006276681	-0.04321562	0.04196029

From R output the Mean Error, ME, Root Mean Squared Error, RMSE and Mean Absolute Error, MAE were as follows

ME	RMSE	MAE
0.00000521	0.021	0.014

The MSE and the RMSE are -0.00000082 and 0.022 respectively meaning the model can produce accurate forecasts.

## 4 Conclusion and Recommendation

### 4.1 Conclusion

The objectives of the study of this research work have been largely achieved. A volatility model for stock returns has been developed. This involved model identification, order determination, parameter estimation and finally diagnostic check. The data used in this study comprise Safaricom's and KCB's daily returns series over the period June 6, 2008 to December 31, 2010 excluding weekends and public holidays forming a sample of 653.

During ARIMA modeling it was found that ARIMA (1, 0, 0) and ARIMA (0, 0, 2) best fits Safaricom and KCB stock returns respectively. Since the results of LM test finds presence of arch effects in the residuals of the fitted ARIMA models, GARCH model was fitted to the residuals. The results reveal that GARCH (1, 1) was the best model for Safaricom and KCB. This is in agreement with previous studies that GARCH (1, 1) captures most of the stylized facts of asset returns in most financial markets. The sum of the GARCH coefficients is close to one in almost all cases. That implies persistence of the conditional variance. A large sum of the coefficients in the conditional variance equations implies that a large positive or a large negative return will lead future forecasts of the variance to be high.

The stock returns reveal some stylized facts. The frequency of large and small changes, relative to the range of data, is rather high which leads us to believe that the data do not come from a normal, but from a heavy tailed (leptokurtic) distribution (relative high probability for extreme values). Large and small values in a log return sample tend to occur in clusters. This indicates that there is dependence in the tails. This characteristic is also called volatility clustering. Negative skewness in the returns is also evident. These are common observations

in other stock markets. The null hypothesis of significant correlations is rejected at 5% level of significance for the two series.

The time plots clearly show that the mean and variance are not constant, showing non-stationarity of the data. It also shows a drop in prices from a high value in 2008 to a low value in 2010 especially for Safaricom which was over-subscribed when the initial IPO was launched. This saw many investors sell of their shares as the prices was dropping.

#### **4.2 Recommendation**

These findings are strongly recommended to financial managers and modelers dealing with Nairobi Stock Exchange. It is of value to investors who are interested in investing in Safaricom's and KCB's shares and wish to avoid large, erratic swings in portfolio returns. They should structure their investments to produce a leptokurtic distribution

To the management of Safaricom and KCB, the Investment relation officers should bear technical skills to understand and interpret issues that deretemine the value of the firm in order to disseminate information for their stocks and increase investor participation.

Further, in emerging markets, diversification and return benefits provided have attracted significant investors' interest which have led to significant portfolio equity inflows into these financial systems, and as a result, motivated the study of various aspects of stock return behavior in these markets. For that reason, an imperative and contemporary filament of empirical researches should focus on the calculation of VaR in the markets. Future research should examine the performance of multivariate time series models when using daily returns

This research is however limited because it considers only two companies in the NSE. Other researchers can study other companies listed in the NSE and use heavy tailed distributions e.g General Error Distribution to capture the stylized facts of return series.

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