

Analyzing the Spectrum of Asset Returns: Jump and Volatility Components in High Frequency Data

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This paper reports some of the recent developments in the econometric analysis of semimartingales estimated using high frequency financial returns. It describes a simple yet powerful methodology to decompose asset returns sampled at high frequency into their base components (continuous, small jumps, large jumps), determine the relative magnitude of the components, and analyze the finer characteristics of these components such as the degree of activity of the jumps. We incorporate to effect of market microstructure noise on the test statistics, apply the methodology to high frequency individual stock returns, transactions and quotes, stock index returns and compare the qualitative features of the estimated process for these different data and discuss the economic implications of the results. (JEL C58, G12, G13)

1. Introduction

In this paper, we present recently developed econometric methods designed to analyze the workhorse model of modern asset pricing where X , the log of an asset price, is assumed to follow an Itô semimartingale. This model in financial economics traces its roots back to Bachelier (1900), Osborne (1959), Cootner (1964), Samuelson (1965), and Mandelbrot (1966) among others; the current paradigm

was introduced and formalized using modern stochastic analysis by Merton in a series of fundamental contributions in the late 1960s and early 1970s (see Merton 1992).

As is well known, for an asset pricing model to avoid arbitrage opportunities, asset prices must follow semimartingales (see Harrison and Pliska 1981 and Delbaen and Schachermayer 1994). Semimartingales are very general models that nest most continuous-time models used in financial economics. A semimartingale can be decomposed into the sum of a drift, a continuous local martingale, and a discontinuous, or jump, part. The jump part can in turn be decomposed into a sum of small jumps and big jumps. The continuous part can be scaled by a stochastic volatility process, which may be correlated with the asset price, may jump in conjunction or

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independently of the asset price, and in fact may itself be a semimartingale.

On the continuous-time financial econometrics side, methods were initially developed to estimate models using low frequency data only (see Hansen and Scheinkman 1995 and Aït-Sahalia 1996). The introduction and rapid dissemination of high frequency data then made possible the development of methods with the objective of estimating the volatility component using estimators such as realized volatility (see, e.g., Andersen, Bollerslev, and Diebold 2010 for a survey). With the realization that, at high frequency, the properties of volatility estimators can be radically altered by the presence of microstructure noise, came the development of methods to robustify high frequency volatility estimators.¹ These methods focused exclusively on models with continuous sample paths.

This paper is devoted to the next stage in the high frequency econometric literature, which considers the components of a discretely sampled semimartingales beyond its volatility, namely its discontinuous or jump components. The practical importance and relevance of jumps in financial data is universally recognized, but only recently have econometric methods become available to rigorously analyze jump processes. The objective of the methods we will describe here is to decide, on the basis of statistical tests applied to high frequency data, which component(s) need to be included in the model (jumps, finite or infinite activity, continuous component,

etc.) and determine their relative magnitude. We may then magnify specific components of the model if they are present, so that we can analyze their finer characteristics such as the degree of activity of jumps. While the underlying mathematical tools to be employed require advanced probability techniques and are developed elsewhere,² the end result

²The results we describe consist of tests to determine, on the basis of the observed log-returns, whether a jump part is present (Aït-Sahalia and Jacod 2009b), whether the jumps have finite or infinite activity (Aït-Sahalia and Jacod 2011), in the latter situation a definition and an estimator of a degree of jump activity parameter (Aït-Sahalia and Jacod 2009a), and finally whether a Brownian continuous component is needed when infinite activity jumps are included (Aït-Sahalia and Jacod 2010). Different methodologies exist for some of the questions considered here, when taken individually. For example, alternative tests for the presence of jumps have been proposed by Aït-Sahalia (2002), Carr and Wu (2003b), Barndorff-Nielsen and Shephard (2004), Huang and Tauchen (2005), Andersen, Bollerslev, and Diebold (2007), Jiang and Oomen (2008), Lee and Mykland (2008), and Lee and Hannig (2010), among others. Some of these tests are applicable (in fact, designed for) splitting the quadratic variation into continuous and discontinuous proportions, another of the issues of interest. A related question is whether it is possible to separately identify the continuous and jump components depending upon the type of jumps that are present (see Aït-Sahalia 2004 and Aït-Sahalia and Jacod 2008). To study the finer characteristics of jumps, Todorov and Tauchen (2010) use the statistic from Aït-Sahalia and Jacod (2009b) but vary the power argument and contrast the behavior of the resulting plot above two and below two in order to identify the presence of a Brownian component. In the context of their parametric model for asset returns, estimates of the degree of activity of jumps were first proposed by Carr et al. (2002). Cont and Mancini (2011) use threshold or truncation-based estimators of the continuous component of the quadratic variation, originally proposed in Mancini (2001), in order to test for the presence of a continuous component in the price process. The resulting test is applicable when the jump component of the process has finite variation, and a test for whether the jump component indeed has finite variation is also proposed. Belomestny (2010) proposes a different estimator of the index of jump activity based on low frequency data. We will discuss six different econometric questions, and present a single class of methods to address all of them. There does not exist at present an alternative methodology that can cover them all, or more than two together as a matter of fact. And for some of the issues to be addressed here, there exists to the best of our knowledge no other alternative at present. We will therefore not describe in detail for each question the alternative methodologies when they exist, since doing so would require the description of different methods in each case, which does not appear feasible in the allotted space and would defeat the purpose of providing a unified treatment of all these questions.

¹These include the Two Scales Realized Volatility estimator of Zhang, Mykland, and Aït-Sahalia (2005), the Maximum-Likelihood approach of Aït-Sahalia, Mykland, and Zhang (2005), the Multi-Scale Realized Volatility of Zhang (2006), the Realized Kernels of Barndorff-Nielsen et al. (2008), the Pre-Averaging approach of Jacod et al. (2009), and the Quasi-Maximum Likelihood Estimator of Xiu (2005). Related work includes Bandi and Russell (2006), Delattre and Jacod (1997), Fan and Wang (2007), Gatheral and Oomen (2010), Hansen and Lund (2006), Kalnina and Linton (2008), Li and Mykland (2007), Aït-Sahalia, Mykland, and Zhang (2011), and Li et al. (2010).

happens to be very straightforward from the point of view of applications. It requires little more than the recording of asset returns at high frequency, and the computation of a single type of key quantity that we call a “truncated power variation.”

This paper makes three separate contributions. First, we show that seemingly disparate test statistics developed individually can in fact be understood as part of a common framework, relying on an analogy with spectrography,³ which we will carry through the entire paper, hence its title. This contribution is primarily expository but hopefully has the benefit of facilitating the application of all these methods. Second, we compute the asymptotic behavior of these test statistics in situations where market microstructure noise is present, a contribution that is essential for practical applications to high frequency financial data. Third, we compare the empirical results obtained on asset returns measured in different complementary ways, comparing the results obtained from transaction prices and quotes, but also by constructing from quotes the National Best Bid and Offer prices at each point in time in order to filter the transactions into different liquidity categories, and by comparing the results obtained on the Dow Jones Industrial Average (DJIA) index from those obtained on its thirty individual constituents. In a different application, Dungey and Yalama (2010) compare the behavior of U.S. Treasuries before and during the recent financial crisis and find an increase in jump intensity during the crisis, but otherwise stable characteristics of the price process.

To describe the methodology, it can be helpful to proceed by analogy with a spectrographic analysis. We observe a time

series of high frequency returns, that is a single path, over a finite length of time $[0, T]$. Using that time series as input, we will then design a set of statistical tools that can tell us something about specific components of the process that produced the observations. These tools play the role of the measurement devices used in astrophysics to analyze the light emanating from a star, for instance. Our observations are the high frequency returns; in astrophysics it would be the light, visible or not. Here, the data generating mechanism is assumed to be a semimartingale; in astrophysics it would be whatever nuclear reactions inside the star are producing the light that is collected. Astrophysicists can look at a specific range of the light spectrum to learn about specific chemical elements present in the star. Here, we design statistics that focus on specific parts of the distribution of high frequency returns in order to learn about the different components of the semimartingale that produced those returns.

From the time series of returns, we can get the distribution of returns at time interval Δ_n . Based on the information contained in that distribution, we would like to figure out which components should be included in the model (continuous? jumps? which types of jumps?) and in what proportions. That is, we would like to deconstruct the observed series of returns back into its original components, continuous and jumps, as described in figure 1. Figure 1 cannot be produced by visual inspection alone of either the time series of returns or its distribution. We need to run the raw data through some devices that will emphasize certain components to the exclusion of others, magnify certain aspects of the model, etc.

Similarly to what is done in spectrographic analysis, we will emphasize visual tools here. In spectrography, one needs to be able to recognize the visual signature of certain

³The word “spectrum” is employed in different contexts in different fields, including time series analysis. The analogy we employ here is from astrophysics.

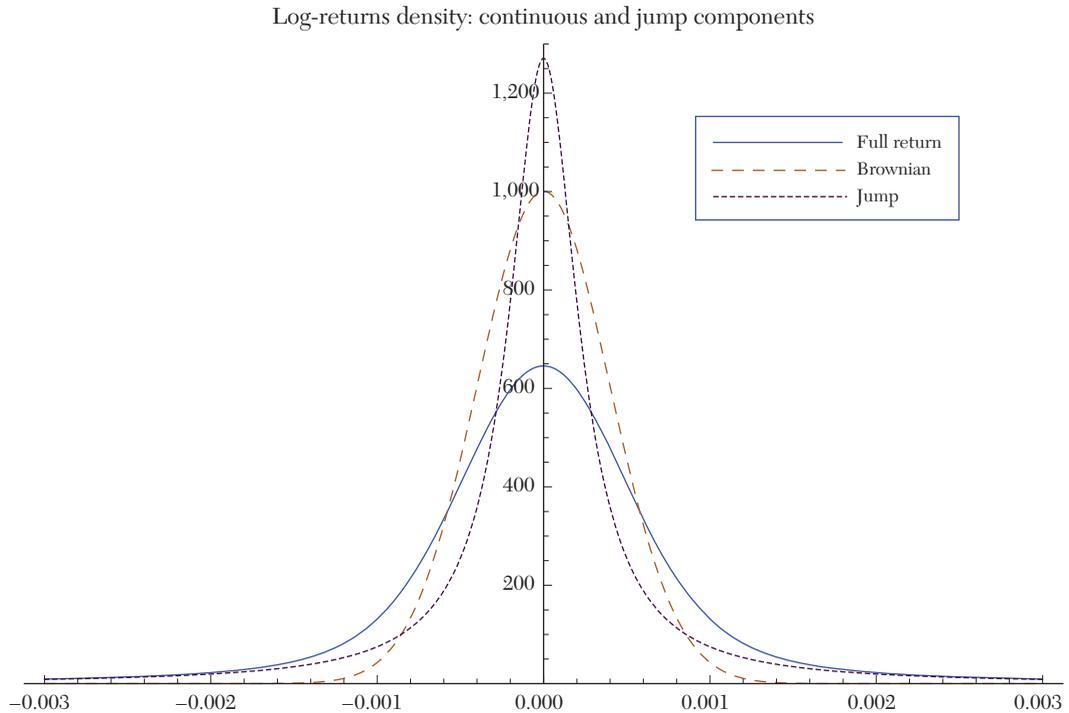


Figure 1. Deconvoluting the Log>Returns Distribution into Continuous and Jump Components

chemical elements. Here, we need to know what to expect to see if a certain component of the model is present or not in the observed data. This means that we will need to have a law of large numbers, obtained by imagining that we had collected a large number of sample paths instead of a single one. This allows us to determine the visual signature of specific components of the model. We will not attempt here to measure the dispersion around the expected pattern, and instead refer to the papers in the reference list for the corresponding central limit theorems, the formal derivations of the results including regularity conditions, as well as simulation evidence on the adequacy of the asymptotics. Those papers

are technically demanding because of the very nature of semimartingales, but also because depending upon which component is included or not in the model—precisely the questions we wish to answer—the asymptotics are driven by components with very different characteristics. By contrast, the intuition is fairly clear and this is what this paper focuses on, with the objective of facilitating applications of the results rather than their derivation, with the exception of the new results concerning the limits of all the test statistics when market microstructure noise is present.

The methodology helps determine which components should be included in a given semimartingale model of asset returns.

While the focus of this paper is primarily on the econometric methodology, this knowledge has various economic implications for asset pricing. If jumps need to be included in the model, then the familiar consequences of market completeness for contingent claims valuation typically no longer hold. And changes of measure will vary depending upon the type of jumps that are included. Optimal portfolios will vary depending upon the nature of the underlying asset dynamics. Risk management is also heavily dependent upon the underlying dynamics: a model with only a continuous component will yield very different risk measures than one with jump components also present, and different types of jumps aggregate separately over longer horizons. And in derivative pricing, the type of components included change the nature of observed prices: see for example the analysis of Carr and Wu (2003b), which shows how to distinguish between option prices when the price jumps and when it does not, based on their asymptotic behavior for short times to expiration. We will discuss these economic implications in more detail below.

Many high frequency trading strategies rely on specific components of the model being present or absent. For example, strategies designed to exploit short-term autocorrelation in returns or price deviations from moving bands perform rather differently with and without jumps, especially small but very active ones which have the potential to affect a substantial fraction of the large number of the high frequency trades placed each trading day. It would be easy to dismiss such subtle properties of the price process that we help identify as esoteric. But many of these strategies make in expected value a tiny profit on each trade, based on a probability of success of say 51 percent, and rely on a large number of trades to be ultimately profitable. In this context, it does not take a large deviation

from the model employed to turn a 51 percent probability of success into a 49 percent probability.

A word on data considerations before we proceed: when implementing the method on returns data, we will rely on ultra-high frequencies, meaning that the sampling intervals we use are typically of the order of a few seconds to a few minutes. This has two consequences. First, obviously, it limits the analysis to data series for which such sampling frequencies are available. This is becoming less and less of a restriction as such data are rapidly becoming more readily available, but it does limit our ability to use long historical series, or returns data from less liquid assets. Second, this means that even for liquid assets market microstructure noise is going to be at least potentially a concern. Continuing with the spectrography analogy, market microstructure noise plays the same role as the blurring of astronomical images due to the Earth's atmosphere or light pollution. And we do not have the equivalent of a space-based telescope enabling the direct observation of the true or fundamental asset price. We will in the course of our analysis examine the consequences of this noise on the various statistics. From the mathematical standpoint, the new theoretical results in this paper are the development of the various asymptotic behaviors of all the test statistics under consideration when market microstructure noise is present. We then proceed to analyze the data in light not only of the idealized no-noise limits but also of these new limits, and contrast the first order asymptotic behavior identified at different sampling frequencies where the impact of the noise can be expected to be more or less significant.

The paper is organized as follows. Section 2 presents the common measurement device we designed to answer the various specification questions. In latter sections, we analyze these questions one by one: which

components are present (section 3), in what relative proportions (section 4), and some of the finer characteristics of the jump component (section 5). Section 7 analyzes theoretically the impact of the noise on the various statistics under consideration. Section 8 describes the data and the transformation and filtering algorithms we employ to transactions, quotes, and transactions filtered by quotes for the DJIA and its individual components. Section 9 reports the results of applying the analysis to the data, analyzes the patterns that emerge in terms of liquidity and discuss the economic implications of the results for option pricing, risk management and the distinction between systematic and idiosyncratic risk in the individual DJIA components versus the DJIA index. Section 10 concludes.

2. The Measurement Device

The log-price X_t follows an Itô semimartingale, a hypothesis maintained throughout, and formally stated as

$$(1) \quad X_t = X_0 + \underbrace{\int_0^t b_s ds}_{\text{drift}} + \underbrace{\int_0^t \sigma_s dW_s}_{\text{continuous part}} + \text{JUMPS}$$

$$(2) \quad \text{JUMPS} = \underbrace{\int_0^t \int_{\{|x| \leq \varepsilon\}} x(\mu - \nu)(ds, dx)}_{\text{small jumps}} \\ + \underbrace{\int_0^t \int_{\{|x| > \varepsilon\}} x\mu(ds, dx)}_{\text{big jumps}}$$

where as usual W denotes a standard Brownian motion, and μ is the jump measure of X , and its predictable compensator is the Lévy measure ν (both μ and ν are random positive measures on $\mathbb{R}_+ \times \mathbb{R}$, and further

ν factorizes as $\nu(dt, dx) = dt F_t(dx)$). In the perhaps more familiar differential form,

$$(3) \quad dX_t = b_t dt + \sigma_t dW_t + dJ_t,$$

where J_t is the jump term.

The distinction between small and big jumps is based on a cutoff level $\varepsilon > 0$ in (2) that is arbitrary. What is important is that $\varepsilon > 0$ is fixed. A semimartingale will always generate a finite number of big jumps on $[0, T]$. But it may give rise to either a finite or infinite number of small jumps. For any measurable subset A of \mathbb{R} at a positive distance of the origin, the process $\nu([0, t] \times A)$ is increasing and “compensates” the number of jumps of X whose size is in A , in the sense that the difference of these two processes becomes a (local) martingale. Therefore, $\nu([0, t] \times (-\infty, -\varepsilon) \cup (\varepsilon, +\infty)) < \infty$, whereas $\nu([0, t] \times [-\varepsilon, \varepsilon])$ may be finite or infinite, although we must have $\int_{\{|x| \leq \varepsilon\}} x^2 \nu([0, t], dx) < \infty$.

In economic terms, each component of the model can be fairly naturally mapped into an economic source of risk in the underlying asset: the continuous part of the model is there to capture the normal risk of the asset, which is hedgeable using standard differential methods; the big jumps component can capture default risk, or more generally big news-related events; and the small jumps component can represent price moves which are large on a time scale of a few seconds, but generally not significant on a daily and below sampling frequency. Such small jumps may result for example from the limited ability of the marketplace to absorb large transactions without a price impact. That component can represent risk that is relevant in particular for trading strategies that are executed at high frequency. While this taxonomy between large and small jumps can be useful, the cut-off level ε in (2) is here mainly for mathematical reasons and is completely arbitrary

(often taken to be $\varepsilon = 1$, irrespectively of the practical relevance of this particular value); and, when jumps are summable, as defined below, one can dispense with the cutoff and qualify all jumps as being “big” (i.e., take $\varepsilon = 0$).

Note that we have compensated the small jumps part, but not the big jumps one. Compensating the big jumps part is not always possible because the moments may not exist, whereas summing small jumps without compensation may lead to a divergent sum. However, when jumps have finite activity, or more generally when they are summable, that is when $\sum_{s \leq t} |\Delta X_s| < \infty$ for all t , where

$$(4) \quad \Delta X_s = X_s - X_{s-},$$

is the size of the jump at time s , it turns out that $\int_{\{|x| \leq \varepsilon\}} |x| \nu([0, t], dx) < \infty$. Then compensating the small jumps is not necessary, and we may rewrite (1) as follows:

$$(5) \quad X_t = X_0 + \underbrace{\int_0^t b'_s ds}_{\text{drift}} + \underbrace{\int_0^t \sigma_s dW_s}_{\text{continuous part}} + \sum_{s \leq t} \Delta X_s$$

with a different drift term: namely $b'_s = b_s - \int_{\{|x| \leq \varepsilon\}} x F_s(dx)$.

We will assume that the model produces observations that are collected at a discrete sampling interval Δ_n : this means in particular that only “regular” sampling schemes are considered below, although the methodology can be extended to some irregular sampling scheme, at the expense of—significantly more—mathematical sophistication. The case of endogenous random sampling where the sampling times are random and not independent of the price process, would potentially be more informative but the theory is not yet available to fully account for this endogeneity. Coming back to the regular case, there are $[T/\Delta_n]$ (where $[x]$ denotes the

integer part of the positive real x) observed increments of X on $[0, T]$, which are

$$(6) \quad \Delta_i^n X = X_{i\Delta_n} - X_{(i-1)\Delta_n},$$

to be contrasted with the actual (unobservable) jumps ΔX_s of X , as described in figure 2.

Our basic methodology consists in constructing realized power variations of these increments, suitably truncated and/or sampled at different frequencies. These realized power variations are defined as follows, where $p \geq 0$ is any nonnegative real and $u_n > 0$ is a sequence of truncation levels:

$$(7) \quad B(p, u_n, \Delta_n) = \sum_{i=1}^{[T/\Delta_n]} |\Delta_i^n X|^p \mathbf{1}_{\{|\Delta_i^n X| \leq u_n\}}.$$

Throughout, T is fixed, and asymptotics are all with respect to $\Delta_n \rightarrow 0$. Typically the truncation levels u_n go to 0, and this is usually achieved by taking $u_n = \alpha \Delta_n^\varpi$ for some constants $\varpi \in (0, 1/2)$ and $\alpha > 0$. Setting $\varpi < 1/2$ allows us to keep all the increments that mainly contain a Brownian contribution. There will be further restrictions on the rate at which $u_n \rightarrow 0$, expressed in the form of restrictions on the choice of ϖ . In some instances, we do not want to truncate at all and we then write $B(p, \infty, \Delta_n)$. Sometimes we will truncate in the other direction, that is retain only the increments larger than u :

$$(8) \quad U(p, u_n, \Delta_n) = \sum_{i=1}^{[T/\Delta_n]} |\Delta_i^n X|^p \mathbf{1}_{\{|\Delta_i^n X| > u_n\}}.$$

With $u_n = \alpha \Delta_n^\varpi$ as above, that can allow us to eliminate all the increments from the continuous part of the model. Then obviously

$$(9) \quad U(p, u_n, \Delta_n) = B(p, \infty, \Delta_n) - B(p, u_n, \Delta_n).$$

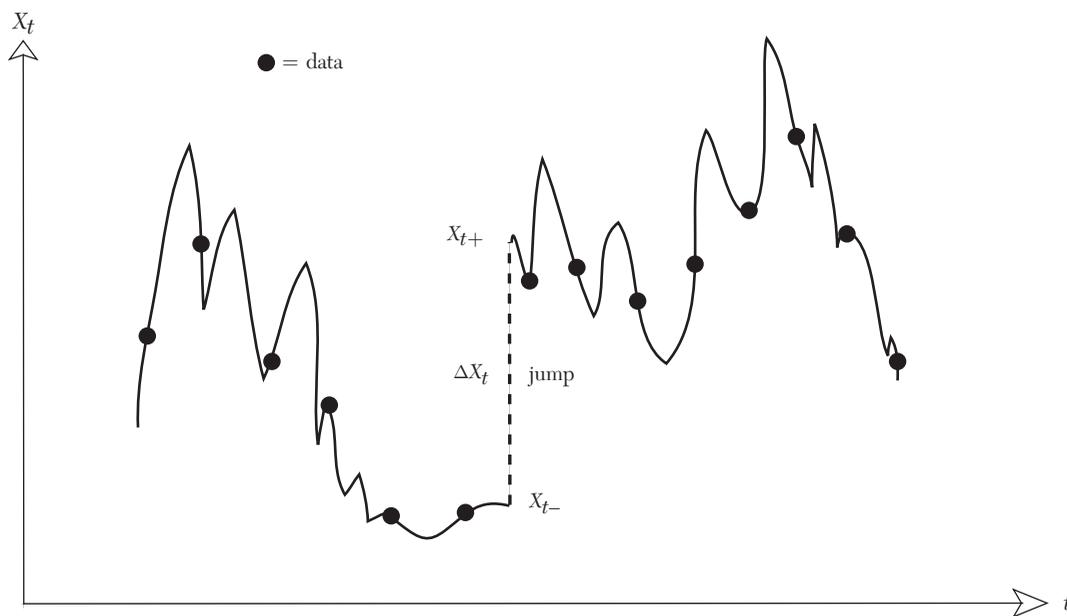


Figure 2. Discretely Sampled Data at Interval Δ_n versus Continuous-Time Sample Path, and Difference between Increments and Jumps

Finally, we sometimes simply count the number of increments of X , that is, take the power $p = 0$

$$(10) \quad U(0, u_n, \Delta_n) = \sum_{i=1}^{\lceil T/\Delta_n \rceil} \mathbf{1}_{\{|\Delta_i^n X| > u_n\}}.$$

We exploit the different asymptotic behavior of the variations $B(p, u_n, \Delta_n)$ and/or $U(p, u_n, \Delta_n)$ as we vary: the power p , the truncation level u_n and the sampling frequency Δ_n . This gives us three degrees of freedom, or tuning parameters, with enough flexibility to isolate what we are looking for. Having these three parameters to play with, p , u_n and Δ_n , is akin to having three controls to adjust in the measurement device.

2.1 The First Control: Varying the Power

The role of the power variable is to isolate either the continuous or jump components, or to keep them both present. As illustrated in figure 3, powers $p < 2$ will emphasize the continuous component of the underlying sampled process while powers $p > 2$ will conversely accentuate its jump component. The power $p = 2$ (which receives much attention in the form of measuring realized volatility) puts them on an equal footing, which turns out to be useful here only when we seek to measure the relative magnitude of the components.

2.2 The Second Control: Varying the Truncation Rate

Truncating the large increments at a suitably selected cutoff level can eliminate the

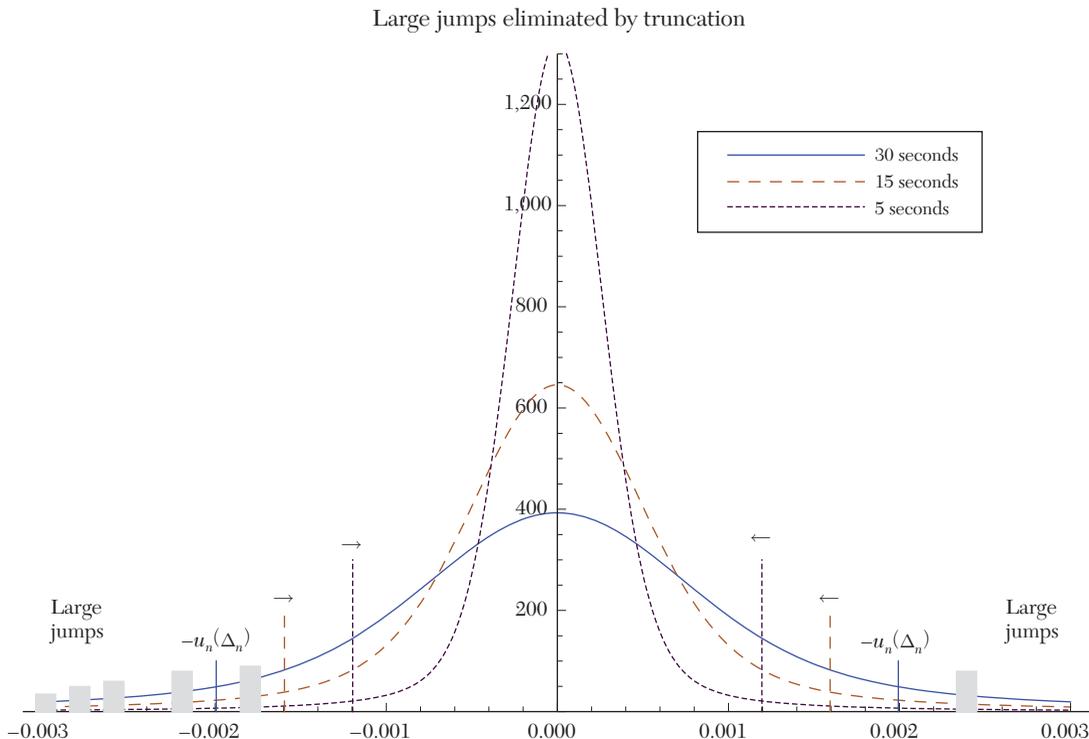


Figure 4. Adjusting the Truncation Rate u_n and the Asymptotic Elimination of Large Jumps

which situation corresponds to which of the spectrographic signatures of B .

3. Which Component(s) Are Present

Leaving aside the drift, which is effectively invisible at high frequency, the model (1)–(2) has three components: a continuous part, a small jumps part and a big jumps part. The analogy with spectrography would be that we are looking for the signature of three possible chemical elements (say, hydrogen, helium, and everything else) in the light being recorded. Here, based on the observed log-returns, what can we tell about which component(s) of the model are present?

To this end, let us define the following sets defined pathwise on $[0, T]$:

$$\begin{aligned}
 (11) \quad \Omega_T^c &= \{X \text{ is continuous in } [0, T]\} \\
 \Omega_T^j &= \{X \text{ has jumps in } [0, T]\} \\
 \Omega_T^f &= \{X \text{ has finitely many jumps in } [0, T]\} \\
 \Omega_T^i &= \{X \text{ has infinitely many jumps in } [0, T]\} \\
 \Omega_T^{wW} &= \{X \text{ has a Wiener component in } [0, T]\} \\
 \Omega_T^{\text{no}W} &= \{X \text{ has no Wiener component in } [0, T]\}
 \end{aligned}$$

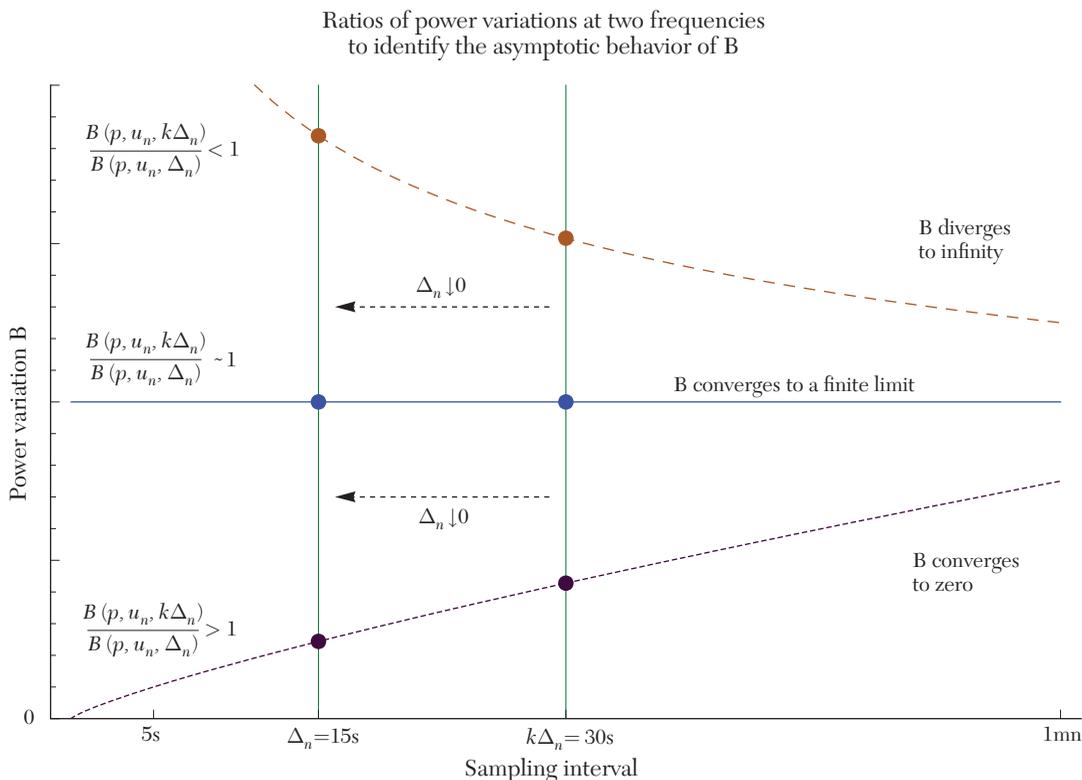


Figure 5. Three Possible Asymptotic Behaviors of the Power Variation (Diverge to Infinity, Converge to a Finite Limit, Converge to Zero) and Means of Identifying Them

Formally, $\Omega_T^W = \left\{ \int_0^T \sigma_s^2 ds > 0 \right\}$ and $\Omega_T^{\text{no}W} = \left\{ \int_0^T \sigma_s^2 ds = 0 \right\}$, and the definition of the four other sets is clear.

These sets are all subsets of the set Ω_T that are generated by the model (1) without any further restriction. So we observe a time series originating in a given unobserved path, and wish to determine in which set(s) the path is likely to be. At any given—fixed—frequency this is a theoretically unanswerable question since for example any such time series can be obtained by discretization of a continuous path, and also of a discontinuous one. However we wish to construct test

statistics that behave well asymptotically, as $\Delta_n \rightarrow 0$, and if possible under the only structural assumptions (1)–(2). That is, they should be model-free in the sense that their implementation *and their asymptotic properties* do not require that we estimate or even specify the model, which can potentially be quite complicated (stochastic volatility, jumps, jumps in volatility, jumps in jump intensity, etc. and should only satisfy very general assumptions that may depend on the problem at hand).

It turns out that this aim is achievable, using the power variations introduced above, for some of the problems. For others we

need some additional structural assumptions, to be explained later when needed. Let us also mention that for all results one also needs some weak boundedness-like or smoothness-like assumptions on the coefficients, such as the process b_t should be (locally) bounded: as a rule, these assumptions are not explicitly stated here, and we refer to the original papers for the mathematically precise statements.

3.1 Jumps: Present or Not

The first question we address is whether the path of X contains jumps or not. As discussed in the introduction, there is by now a vast literature concerned with detecting jumps, but we will focus on the approach that lends itself to answering the full range of specification questions listed for semimartingales.

Using the methodology of power variations, we start with two processes that measure some kind of variability of X and depend on the whole (unobserved) path of X :

$$(12) \quad V(p) = \int_0^T |\sigma_s|^p ds, \quad J(p) = \sum_{s \leq T} |\Delta X_s|^p,$$

where $p > 0$. The variable $V(p)$ is finite for all $p > 0$, and positive on the set Ω_T^W . The variable $J(p)$ is finite if $p \geq 2$ but often not when $p < 2$. The quadratic variation of X is $[X, X]_T = V(2) + J(2)$.

Of course, hoping to estimate $J(p)$ using $B(p, u_n, \Delta_n)$ is too naive in general, but it does work in specific cases. Namely, we have the following convergence in probability as $\Delta_n \rightarrow 0$ of $B(p, \infty, \Delta_n)$:

$$(13) \quad \begin{cases} p > 2, \text{ all } X \Rightarrow B(p, \infty, \Delta_n) \xrightarrow{\mathbb{P}} J(p) \\ \text{all } p, \text{ on } \Omega_T^c \Rightarrow \frac{\Delta_n^{1-p/2}}{m_p} B(p, \infty, \Delta_n) \xrightarrow{\mathbb{P}} V(p), \end{cases}$$

where m_p denotes the p th absolute moment of the standard normal variable.

So we see that, when $p > 2$, $B(p, \infty, \Delta_n)$ tends to $J(p)$: the jump component dominates. If there are jumps, the limit $J(p)_t > 0$ is finite. On the other hand, when X is continuous, then the limit is $J(p) = 0$ and $B(p, \infty, \Delta_n)_t$ converges to 0 at rate $\Delta_n^{p/2-1}$.

These considerations lead us to pick a value of $p > 2$ and compare $B(p, \infty, \Delta_n)_t$ on two different sampling frequencies. Specifically, for an integer k , consider the test statistic S_J :

$$(14) \quad S_J(p, k, \Delta_n) = \frac{B(p, \infty, k\Delta_n)}{B(p, \infty, \Delta_n)}.$$

The ratio in S_J exhibits a markedly different behavior depending upon whether X has jumps or not:

$$(15) \quad S_J(p, k, \Delta_n) \rightarrow \begin{cases} 1 & \text{on } \Omega_T^j \\ k^{p/2-1} & \text{on } \Omega_T^c \cap \Omega_T^W. \end{cases}$$

That is, in the context of figure 5, under Ω_T^j the variation converges to a finite limit and so the ratio tends to 1 (the middle situation depicted in the figure) while under $\Omega_T^c \cap \Omega_T^W$ the variation converges to 0 and the ratio tends to a limit greater than 1, with value specifically depending upon the rate at which the variation tends to 0 (the lower situation depicted in the figure). The notion of a set $\Omega_T^c \cap \Omega_T^W$ may seem curious at first, but it is possible for a process to have continuous paths without a Brownian component if the process consists only of a pure drift. Because this would be an unrealistic model for financial data, we are excluding the set $\Omega_T^c \cap \Omega_T^{\text{no}W}$ from consideration.

If one desires a formal statistical test of $\Omega_T^c \cap \Omega_T^W$ versus Ω_T^j , with a prescribed asymptotic level $\alpha \in (0, 1)$, one can use a CLT under $\Omega_T^c \cap \Omega_T^W$ and one under Ω_T^j , such CLT being available again in a model-free situation, apart from some additional smoothness assumptions: so one can in fact test either $H_0 : \Omega_T^c \cap \Omega_T^W$ versus $H_1 : \Omega_T^j$ or

the reverse $H_0 : \Omega_T^j$ versus $H_1 : \Omega_T^c \cap \Omega_T^W$. Note that the first limit in (15) is valid on Ω_T^j whether the jump component includes finite or infinite components, or both. It is not designed to disentangle the two types of jumps. How to do this is the question we now turn to.

3.2 Jumps: Finite or Infinite Activity

Many models in mathematical finance do not include jumps. But among those that do, the framework most often adopted consists of a jump-diffusion: these models include a drift term, a Brownian-driven continuous part, and a finite activity jump part (compound Poisson process): early examples include Merton (1976), Ball and Torous (1983), Bates (1991), and Duffie, Pan, and Singleton (2000).

Other models are based on infinite activity jumps: see for example Madan and Seneta (1990), Madan and Milne (1991), Eberlein and Keller (1995), Barndorff-Nielsen (1997, 1998), Carr et al. (2002), Carr and Wu (2003a), Carr and Wu (2004), and Schoutens (2003), although with the exception of Carr et al. (2002) models of this type are justified primarily by their ability to produce interesting pricing formulae rather than necessarily an attempt at empirical realism.

So, which is it, based on the data? Our objective is now to discriminate between finite and infinite activity jumps using again the same set of tools.

3.2.1 Null Hypothesis: Finite Activity

We first set the null hypothesis to be finite activity, that is $H_0 : \Omega_T^f \cap \Omega_T^W$, whereas the alternative is $H_1 : \Omega_T^j$. As in the previous subsection, we rule out the set $\Omega_T^f \cap \Omega_T^{\text{no}W}$ that, for all models in use in finance, is empty. We choose an integer $k \geq 2$ and a real $p > 2$. The only difference with testing for jumps using S_j is that we now truncate

$$(16) \quad S_{FA}(p, u_n, k, \Delta_n) = \frac{B(p, u_n, k\Delta_n)}{B(p, u_n, \Delta_n)}$$

Without truncation, as in S_j , we could discriminate between jumps and no jumps, but not among different types of jumps. Like before, we set $p > 2$ to magnify the jump component at the expense of the continuous component. But since we want to separate big and small jumps, we now truncate as a means of eliminating the large jumps. Since the large jumps are of finite size (independent of Δ_n), at some point in the asymptotics the truncation level $u_n = \alpha \Delta_n^\varpi$ will have eliminated all the large jumps: see figure 4 earlier. Then if there are only big jumps and the Brownian component, the two truncated power variations $B(p, u_n, k\Delta_n)$ and $B(p, u_n, \Delta_n)$ will behave as if there were no jumps, leaving only the Brownian component. The limit of the ratio will be $k^{p/2-1}$ as in the test for jumps when there are no jumps.

But if there are infinitely many jumps, which are necessarily small, then the truncation cannot eliminate them. This is because however small u_n is, there are still infinitely many jumps in each Δ_n – increment. The Brownian component is dominated in every increment by the small jumps because $p > 2$. Both $B(p, u_n, k\Delta_n)$ and $B(p, u_n, \Delta_n)$ behave like the sum of the p th power of the jumps that are smaller than u_n , and although they both go to 0, their ratio tends to 1. In the context of figure 5, we are in the limiting case where both B s go to zero but at the same rate: hence the ratio is 1.

That is, we have:

$$(17) \quad S_{FA}(p, u_n, k, \Delta_n) \xrightarrow{\mathbb{P}} \begin{cases} k^{p/2-1} & \text{on } \Omega_T^f \cap \Omega_T^W \\ 1 & \text{on } \Omega_T^j \end{cases}$$

3.2.2 Null Hypothesis: Infinite Activity

We next set the null hypothesis to be infinite activity, that is $H_0 : \Omega_T^j$, whereas the alternative is $H_1 : \Omega_T^f \cap \Omega_T^W$. We need a different statistic, S_{IA} , because although S_{FA} goes to 1, the distribution of S_{FA} , which was designed to be model-free under $\Omega_T^f \cap \Omega_T^W$,

is no longer model-free under Ω_T^i . This is due to the fact that the asymptotic behavior of the (suitably normalized) difference $S_{FA} - 1$ is driven by the Brownian motion W when it is present and, as it turns out, by the “degree of activity” of the jumps when W is absent. But the null hypothesis Ω_T^i does *not* specify whether W is present or not, nor the degree of activity of jumps when W is absent, resulting in the fact that S_{FA} cannot be used for constructing tests with a given asymptotic level when the null is Ω_T^i .

So we need to start by specifying what we precisely mean by “degree of activity.” To this end, recalling the definition of $J(p)$ given in (12), we consider now the set $I_T = \{p \geq 0 : J(p) < \infty\}$. This (random) set I_T is of the form $[\beta_T, \infty)$ or (β_T, ∞) for some $\beta_T(\omega) \in [0, 2]$, and $2 \in I_T$ always. It turns out that $\beta_T(\omega)$, the lower bound of the set I_T , is a sensible measure of jump activity for the path $t \mapsto X_t(\omega)$ at time T . In the special case where X is a Lévy process, then $\beta_T(\omega) = \beta$ does not depend on (ω, T) , and it is also the infimum of all $r \geq 0$ such that $\int_{\{|x| \leq 1\}} |x|^r F(dx) < \infty$, where F is the Lévy measure. The number β was introduced in that context by Blumenthal and Gettoor (1961) and by extension we call β_T the (generalized) Blumenthal–Gettoor index, or degree of jump activity, of the process.

We call β_T a degree of jump activity because it measures the rate at which the jump measure of the process diverges near 0, so it characterizes the concentration of small jumps. Many examples of models proposed in finance for asset returns fall in this category, with either fixed values of β , or β being a free parameter. (We will discuss estimating β below.) Examples are included in figure 7. They include compound Poisson-based models starting with Merton (1976), the variance gamma model of Madan and Seneta (1990) and Madan, Carr, and Chang (1998) ($\beta = 0$), the Normal Inverse Gaussian model of Barndorff-Nielsen (1998) ($\beta = 1$),

the hyperbolic model of Eberlein and Keller (1995), the generalized hyperbolic model of Barndorff-Nielsen (1977) and the CGMY model of Carr et al. (2002) (in which β is a free parameter).

A priori, the degree of jump activity as we have defined it can be random and depend on time, but we assume for tractability that this index is in fact constant in time and non-random, as is the case in all known examples. More precisely, we assume that the Lévy measure ν in (2) is of the form

$$(18) \quad \nu(dt, dx) = \frac{1}{|x|^{1+\beta}} (a_t^+ 1_{(0, z_t^+]}(x) + a_t^- 1_{[-z_t^-, 0)}(x)) + \nu'(dt, dx),$$

where a_t^\pm are nonnegative and z_t^\pm are positive stochastic processes, and ν' is another Lévy measure whose index is smaller than β . Note that the assumption (18) is only about the local behavior of the jump measure ν near 0, that is, only about the behavior of the small jumps. The big jumps, controlled by ν' , are unrestricted. The processes a_t^\pm are intensity parameters: as they go up, there are more and more small jumps. The processes z_t^\pm control the range of returns over which the behavior of the overall jump measure is stable-like with index β .

Note that, necessarily, $\beta \in (0, 2)$ here, otherwise (18) would not be a Lévy measure. Then, if further $\int_0^T (a_s^+ + a_s^-) ds > 0$, the number β is the index of X on the full interval $[0, T]$. Note that when X is a (possibly asymmetric) stable process, that is a process whose jump measure is proportional to $1/|x|^{1+\beta}$, then it satisfies this assumption, β being the index of the stable process. In fact, this assumption amounts to saying that the small jumps of X behave like the small jumps of a stable or tempered stable process, or more accurately as those of a process which is a stochastic integral with respect to a stable or tempered stable process (see

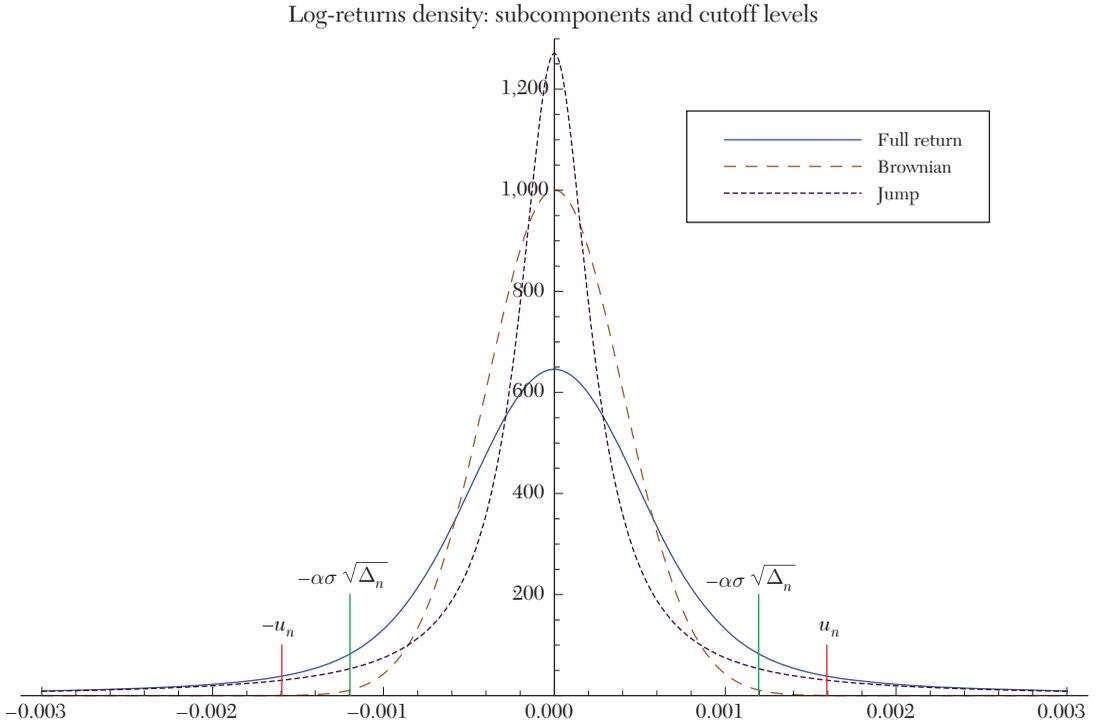


Figure 6. Truncating to Retain or Avoid the Contribution from the Brownian Component of the Model

Rosiński 2007), whereas the big jumps are governed by ν' . We call processes that satisfy (18) “proto-stable” processes since they exhibit stable-like behavior near 0 (in the sense of (18)). Most models in finance that exhibit jumps of infinite activity are proto-stable. While we will propose estimators of β below, the true β is of course unknown, and our model-free requirement means here that we wish to construct a test that does not depend upon β , the processes a_t^\pm or z_t^\pm , nor the residual jump measure ν' .

Coming back to our problem, we consider the set

$$(19) \quad \Omega_T^{i\beta} = \left\{ \int_0^T (a_s^+ + a_s^-) ds > 0 \right\}$$

on which the jump activity index of X equals β to complete the definitions given in (11). Note that $\Omega_T^{i\beta} \subseteq \Omega_T^i$, the inclusion possibly being strict since it is possible for a process to exhibit infinite activity without being of the proto-stable type. However testing the null being Ω_T^i is impossible without further restrictions, and so we set the null hypothesis to be $\Omega_T^{i\beta}$. On this set, the process has a proto-stable behavior near 0 so β is well-defined through (18); the component of order β in the Lévy measure is indeed the leading one when at least one of the processes a^+ and a^- is not degenerate, as required by $\Omega_T^{i\beta}$.

We choose three reals $\gamma > 1$ and $p' > p > 2$ and define a family of test statistics as follows:

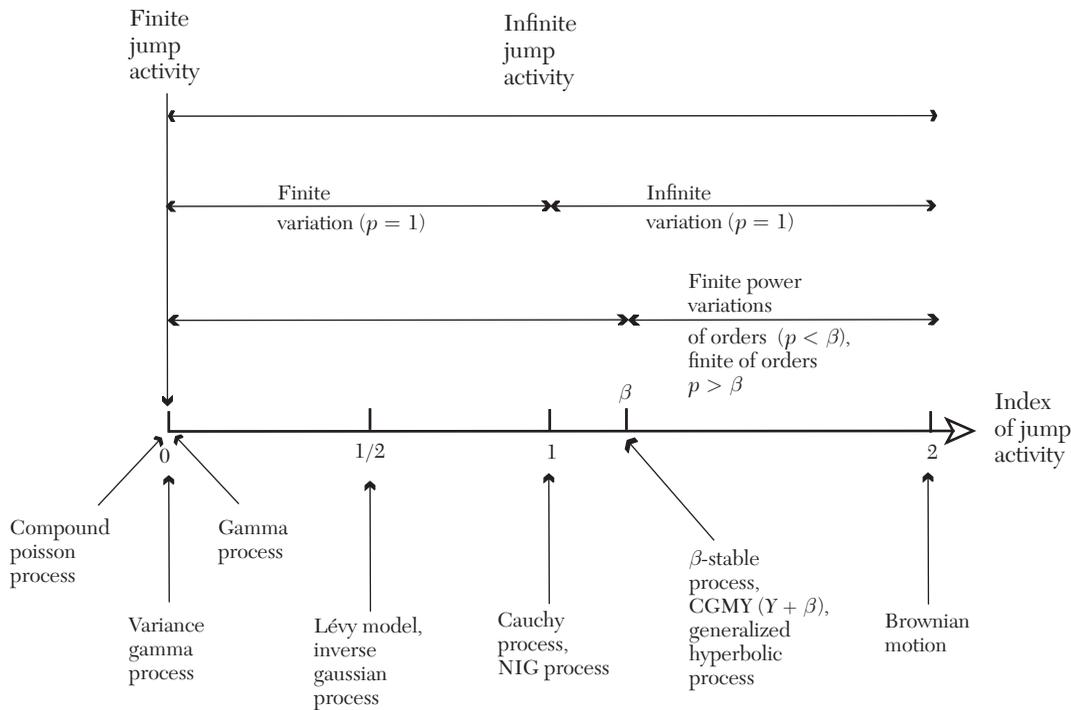


Figure 7. Index of Jump Activity β : Example of Processes

$$(20) \quad S_{IA}(p, u_n, \gamma, \Delta_n) = \frac{B(p', \gamma u_n, \Delta_n) B(p, u_n, \Delta_n)}{B(p', u_n, \Delta_n) B(p, \gamma u_n, \Delta_n)},$$

which has the following limits:

$$(21) \quad S_{IA}(p, u_n, \gamma, \Delta_n) \xrightarrow{\mathbb{P}} \begin{cases} \gamma^{p'-p} & \text{on } \Omega_T^{i\beta} \\ 1 & \text{on } \Omega_T^f \cap \Omega_T^W \end{cases}.$$

Intuitively, under the alternative of finite jump activity, the behavior of each one of the four truncated power variations in (20) is driven by the continuous part of the semimartingale. The truncation level is such

that essentially all the Brownian increments are kept; we discuss how to achieve this in practice below. Then the truncated power variations all tend to zero at rates $\Delta_n^{p'/2-1}$ and $\Delta_n^{p'/2-1}$ respectively and by construction the (random) constants of proportionality cancel out in the ratios, producing a limit 1 given under H_1 in (21).

If, on the other hand, jumps have infinite activity, then the small jumps are the ones that matter and the truncation level becomes material, producing four terms that all tend to zero but at the different orders in probability $u_n^{p-\beta}$, $u_n^{p'-\beta}$, $(\gamma u_n)^{p-\beta}$ and $(\gamma u_n)^{p'-\beta}$ respectively, resulting in the limit $\gamma^{p'-p}$ given under H_0 in (21). By design, that limit in S_{IA} is independent of β .

3.3 Brownian Motion: Present or Not

We now would like to construct procedures that allow us to decide whether the Brownian motion is really there, or if it can be forgone with in favor of a pure jump process with infinite activity. When infinitely many jumps are included, there are a number of models in the literature that dispense with the Brownian motion altogether. The log-price process is then a purely discontinuous Lévy process with infinite activity jumps, or more generally is driven by such a process. Is this a realistic model in light of the data?

3.3.1 Null Hypothesis: Brownian Motion Present

In order to construct a test, we seek a statistic with markedly different behavior under the null and alternative. Using the same class of tools, the idea is now to consider powers p less than 2, since in the presence of Brownian motion the power variation would be dominated by it while in its absence it would behave quite differently. Specifically, the large number of small increments generated by a continuous component would cause a power variation of order less than 2 to diverge to infinity: recall figure 5.

Without the Brownian motion, however, and when p is bigger than the Blumenthal–Gettoor index $\beta_T = \beta$, assuming the structural assumption (18), the power variation converges to 0 at exactly the same rate for the two sampling frequencies Δ_n and $k\Delta_n$, whereas with a Brownian motion the choice of sampling frequency will influence the magnitude of the divergence. Taking a ratio will eliminate all unnecessary aspects of the problem and focus on that key aspect.

So we choose an integer $k \geq 2$ and a real $p < 2$ and propose the test statistic

$$(22) \quad S_W(p, u_n, k, \Delta_n) = \frac{B(p, u_n, \Delta_n)}{B(p, u_n, k\Delta_n)},$$

which has the limits

$$(23) \quad S_W(p, u_n, k, \Delta_n) \xrightarrow{\mathbb{P}} \begin{cases} k^{1-p/2} & \text{on } \Omega_T^W \\ 1 & \text{on } \Omega_T^{\text{no}W} \cap \Omega_T^{i\beta}, p > \beta \end{cases}.$$

Note that the first convergence above, on Ω_T^W , does not require any specific assumptions on the jumps, only the second convergence requires (18).

3.3.2 Null Hypothesis: No Brownian Motion

When there are no jumps, or finitely many jumps, and no Brownian motion, X reduces to a pure drift plus occasional jumps, and such a model is fairly unrealistic in the context of most financial data series. But one can certainly consider models that consist only of a jump component, plus perhaps a drift, if that jump component is allowed to be infinitely active. If one wishes to set the null model to be a pure jump model (plus perhaps a drift), then the issue becomes to design a test statistic using power variations whose behavior is independent of the specific nature of the infinitely active pure jump process. In other words, we again assume (18), but we do not know β and wish to design a test that remains model-free in the sense that it does not depend on β , a_t^\pm or z_t^\pm in (18).

We choose a real $\gamma > 1$ to define two different truncation ratios and define a family of test statistics as follows:

$$(24) \quad S_{\text{no}W}(p, u_n, \gamma, \Delta_n) = \frac{B(2, \gamma u_n, \Delta_n)U(0, u_n, \Delta_n)}{B(2, u_n, \Delta_n)U(0, \gamma u_n, \Delta_n)}.$$

To understand the construction of this test statistic, recall that in a power variation of order 2 the contributions from the Brownian and jump components are of the same order. If the Brownian motion is present ($H_1: \Omega_T^W$)

one can split the QV based on bipower variations instead of truncating: see Barndorff-Nielsen and Shephard (2004), Huang and Tauchen (2005), and Andersen, Bollerslev, and Diebold (2007).

Note that (26) suggests that an alternative test for the presence of jumps can be constructed based on the ratio $B(2, u_n, \Delta_n)/B(2, \infty, \Delta_n)$. However, this would work only if the null hypothesis is that no jumps are present, and the null hypothesis is that the ratio is 1. With jumps under the null, one would have to specify exogenously as part of the null hypothesis how large the fraction of QV due to jumps is.

We can split the rest of the QV, which by construction is attributable to jumps, into a small jumps and a big jumps component. This depends on the cutoff level ε selected to distinguish big and small jumps:

$$(27) \quad \begin{cases} \frac{U(2, \varepsilon, \Delta_n)}{B(2, \infty, \Delta_n)} = \% \text{ QV due to big jumps} \\ \frac{B(2, \infty, \Delta_n) - B(2, u_n, \Delta_n) - U(2, \varepsilon, \Delta_n)}{B(2, \infty, \Delta_n)} = \% \text{ QV} \\ \hspace{15em} \text{due to small jumps} \end{cases}$$

We can then obtain a plot that looks like figure 8 and provides a split of the QV into the various components.

5. Estimating the Degree of Jump Activity

The method described in section 3.2 is able to tell finite activity jumps from infinite activity ones. Among jump processes, however, finite activity are the exception rather than the norm: recall figure 7 where finite activity is only present at the left boundary of the axis. “Infinite activity” can mean quite different things, namely the rest of the axis, depending upon “how infinite” that infinite jump activity is. In fact, the degree of activity is accurately measured by the Blumenthal–Gettoor

index β_T introduced earlier: at the left end of the spectrum, infinite activity jump processes such as the Gamma process, whose jump measure diverge at a sub-polynomial rate, can look like Poisson jumps; at the right end, they can look almost like Brownian motion, which is to say extremely active. So it seems natural to try to estimate the index β_T . As discussed above, specific models in finance correspond either to fixed values of β (such as $\beta = 0$ for the Gamma and Variance Gamma models, $\beta = \frac{1}{2}$ for the Lévy model and the Inverse Gaussian model, $\beta = 1$ for the Cauchy model and the Normal Inverse Gaussian Process) or β is a free parameter (as in the stable model, the Generalized Hyperbolic model and the CGMY model).

The next issue is then to estimate β_T , or rather β under the somewhat restricted assumption (18). The problem is made more challenging by the potential presence in X of a continuous, or Brownian, martingale part. β characterizes the behavior of ν near 0. Hence it is natural to expect that the small increments of the process are going to be the ones that are most informative about β . But that is where the contribution from the continuous martingale part of the process is inexorably mixed with the contribution from the small jumps. In other words, we need to see through the continuous part of the semimartingale in order to say something about the number and concentration of small jumps.

So we are now looking in a different range of the spectrum of returns, namely by considering only returns that are larger than the cutoff $u_n = \alpha \Delta_n^\varpi$ for some $\varpi \in (0, \frac{1}{2})$, as opposed to those that are smaller than the cutoff. This allows us to eliminate the increments due to the continuous component. We can then use all values of p , not just those $p > 2$, despite the fact that we wish to concentrate on jumps: see figure 6. In fact, we will simply use the power $p = 0$.

We propose two estimators of β based on counting the number of increments greater

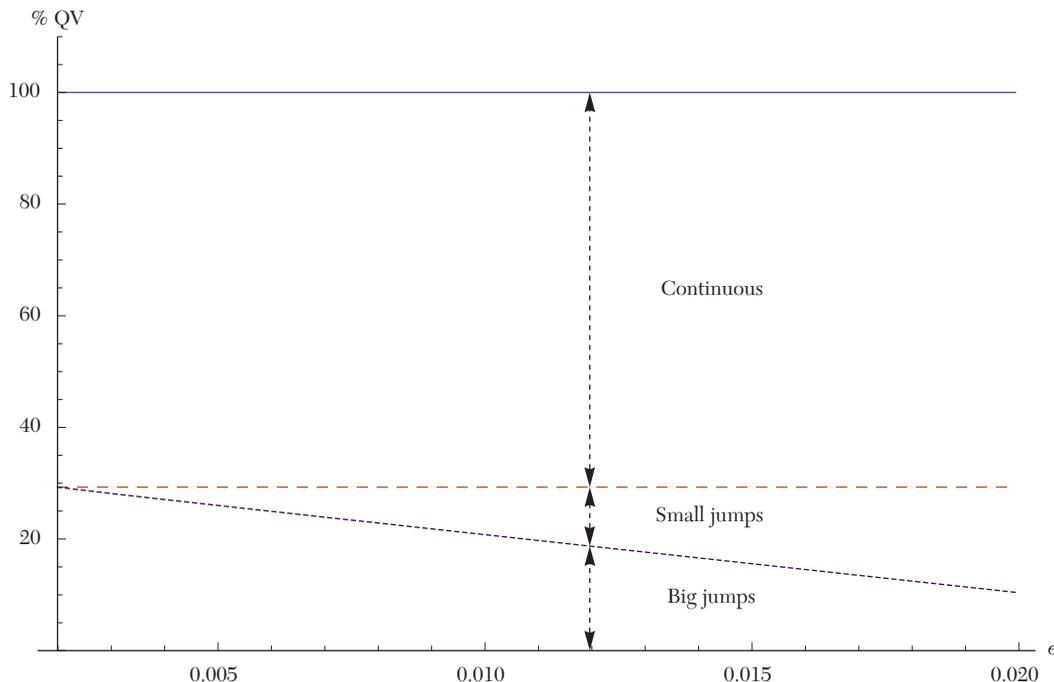


Figure 8. Splitting up the QV into Continuous and Jump Components, and into Small and Big Jumps as a Function of the Jump Size Cutoff ϵ

than the cutoff u_n . The first one is based on varying the actual cutoff level: fix $0 < \alpha < \alpha'$ and consider two cutoffs $u_n = \alpha \Delta_n^{\varpi}$ and $u'_n = \alpha' \Delta_n^{\varpi}$ with $\gamma = \alpha'/\alpha$:

$$(28) \quad \hat{\beta}_n(\varpi, \alpha, \alpha') = \frac{\log(U(0, u_n, \Delta_n)/U(0, \gamma u_n, \Delta_n))}{\log(\gamma)}$$

The second one is based on varying the sampling frequency: sample at two time scales, Δ_n and $2\Delta_n$:

$$(29) \quad \hat{\beta}'_n(\varpi, \alpha, k) = \frac{\log(U(0, u_n, \Delta_n)/U(0, u_n, k\Delta_n))}{\varpi \log k}$$

These estimators are consistent for β , and we have derived CLTs for them.

These basic estimators are based on the first-order asymptotics

$$(30) \quad U(0, u_n, \Delta_n) \sim b_0 \Delta_n^{-\varpi\beta} \frac{1}{\alpha^\beta},$$

where b_0 is independent of u_n and Δ_n . In small samples, a bias corrected procedure is based on the second-order asymptotics

$$(31) \quad U(0, u_n, \Delta_n) \sim b_0 \Delta_n^{-\varpi\beta} \frac{1}{\alpha^\beta} + b_1 \Delta_n^{1-2\varpi\beta} \frac{1}{\alpha^{2\beta}}$$

works as follows: we can estimate β , along with the unknown coefficients b_0 and b_1 in (31) by a straightforward nonlinear regression of $U(0, u_n, \Delta_n)$ on α by varying α in the cutoff $u_n = \alpha \Delta_n^{\varpi}$.⁴

One can then test various hypotheses involving β . The approach described in this section to estimate β is due to Aït-Sahalia and Jacod (2009a). Related approaches include Woerner (2011), who proposes an estimator of the jump activity index in the case of fractionally integrated processes, Cont and Mancini (2011), who are testing whether $\beta > 1$ or $\beta < 1$, which correspond to finite or infinite variation for X , and Todorov and Tauchen (2010), who provide a graphical method to determine whether $\beta = 2$ or $\beta < 2$ using the test statistic of Aït-Sahalia and Jacod (2009b), and Belomestny (2010) who proposes a method based on low frequency historical and options data. In the context of their specific parametric model, Carr et al. (2002) proposed an estimator for β , along with that of the other parameters of their model.

6. Summary of the Spectrogram Methodology: Tuning Power, Truncation, and Sampling Frequency

We have seen that setting the three controls of power, truncation level, and sampling frequency in various combinations allowed us to determine which component of the model was likely to be present, in what proportion, and estimate the degree of activity of the jumps. Table 1 summarizes the choice of the three tuning parameters (p, u, Δ) for the corresponding tasks under consideration.

⁴The procedure involves a regression across cutoff levels that relies on dependent observations, which would matter for any inference on these estimators, as opposed to their simple pointwise use here as bias-correction devices.

In a nutshell, we address specification questions that require an emphasis on the jump component of the model with powers $p > 2$, those that require an emphasis on the continuous component with powers $p < 2$, and those that require them on an equal footing with the singular power $p = 2$. Truncating makes it possible to eliminate either the big jumps or the Brownian component, as necessary. And finally sampling at different frequencies allows us to identify the asymptotic behavior of the relevant power variations, thereby discriminating between components of the model that are present or absent in the sampled data.

7. Theoretical Limits When Market Microstructure Noise Dominates

We consider in the empirical analysis that follows sampling frequencies up to 5 seconds. In different applications, this selection is going to be asset-dependent, as a function of the assets' liquidity and other trading characteristics. But in any event, real data observations of the process X at such ultra high frequencies are blurred by market microstructure noise, which has the potential to change the asymptotic behavior of many statistics at very high frequency, and can force us to downsample as is often done in the classical volatility estimation setting.

When observations are affected by an additive noise, then instead of $X_{i\Delta_n}$ we observe $Y_{i\Delta_n} = X_{i\Delta_n} + \varepsilon_i$, and the ε_i are i.i.d. with $E(\varepsilon_i^2)$ and $E(\varepsilon_i^4)$ finite, and not depending of the observation frequency. When rounding is introduced, we observe $Y_{i\Delta_n} = [X_{i\Delta_n}]_a$ which is X rounded to the nearest multiple of a , say 1 cent for a decimalized asset, or for many bond markets, $\alpha = 1/32$ nd of a dollar: again the rounding level α does not depend on n . As a matter of fact, the real microstructure noise is probably a mixture of the two types above, first an additive noise (or perhaps a "colored" additive noise) which may

TABLE 1
THE CHOICE OF TURNING PARAMETERS p (POWER), u (TRUNCATION PARAMETER),
AND Δ (SAMPLING INTERVAL)

Jumps: Present or Not	$H_0 : \Omega_T^c$ $H_1 : \Omega_T^j$	$H_0 : \Omega_T^j$ $H_1 : \Omega_T^c$
	$S_J : \begin{pmatrix} p > 2 \\ \infty \\ \Delta_n, k\Delta_n \end{pmatrix}$	$S_J : \begin{pmatrix} p > 2 \\ \infty \\ \Delta_n, k\Delta_n \end{pmatrix}$
Jumps: Finite or Infinite Activity	$H_0 : \Omega_T^f$ $H_1 : \Omega_T^i$	$H_0 : \Omega_T^i$ $H_1 : \Omega_T^f$
	$S_{FA} : \begin{pmatrix} p > 2 \\ u_n \\ \Delta_n, k\Delta_n \end{pmatrix}$	$S_{IA} : \begin{pmatrix} p > 2, p' > 2 \\ u_n, \gamma u_n \\ \Delta_n \end{pmatrix}$
Brownian Motion: Present or Not	$H_0 : \Omega_T^W$ $H_1 : \Omega_T^{noW}$	$H_0 : \Omega_T^{noW}$ $H_1 : \Omega_T^W$
	$S_W : \begin{pmatrix} p < 2 \\ u_n \\ \Delta_n, k\Delta_n \end{pmatrix}$	$S_{noW} : \begin{pmatrix} p = 0, p' = 2 \\ u_n, \gamma u_n \\ \Delta_n \end{pmatrix}$
Relative Magnitude of the Components	$\%QV : \begin{pmatrix} p = 2 \\ u_n \\ \Delta_n \end{pmatrix}$	
Estimating the Degree of Jump Activity β	$\hat{\beta} : \begin{pmatrix} p = 0 \\ U : u_n, \gamma u_n \\ \Delta_n \end{pmatrix}$	$\hat{\beta}' : \begin{pmatrix} p = 0 \\ U : u_n \\ \Delta_n, k\Delta_n \end{pmatrix}$

Notes: Combinations of (p, u, Δ) employed to implement the complete spectrogram methodology: test for the presence of jumps, test whether jumps have finite or infinite activity, test whether a continuous component is present, estimate the relative magnitude of the components, and estimate the degree of jump activity.

account for some bouncebacks, and then the noisy price is rounded at the level α .⁵

The power variations that form the building blocks of our methodology are affected by either type of noise, in a rather drastic way, since the presence of noise modifies the limit in probability of most of our statistics, not to speak about their second order behavior like CLTs. In order to be able to interpret the empirical results, we need to explicitly incorporate the noise into the probability limits of the various statistics. As discussed, we will consider in turn the two polar cases of a pure additive noise, and of a pure rounding noise. Our focus on these two cases is not meant to suggest that the microstructure noise is necessarily of either form in the data,⁶ but rather reflects the fact that they are natural places to start and in any event are the only

cases that we are able to analyze in the present state of the literature.

7.1 Additive Noise

Pure additive noise has been considered by many authors for the purpose of estimating the volatility,⁷ but its effect on power variations, truncated or not, has not been thoroughly analyzed so far, to the best of our knowledge. So, in contrast with the style of the rest of the paper, we now present theorems. To avoid intricate statements, we make two basic, and mild, assumptions on the noise, which is a sequence $(\varepsilon_i)_{i \geq 0}$ of i.i.d. variables, independent of the underlying process. Namely, we assume that

$$(32) \quad m'_p = \mathbb{E}(|\varepsilon_i|^p) \text{ is finite for all } p > 0$$

and the noise is centered: $\mathbb{E}(\varepsilon_i) = 0$,

and

$$(33) \quad \text{the variables } \varepsilon_i \text{ admit a continuous density.}$$

We also write $B'(p, u_n, \Delta_n)$ and $U'(p, u_n, \Delta_n)$ for the variables introduced in (7), (8), and (10), where the increments $\Delta_i^n X$ of (6) are substituted with

$$(34) \quad (X_{i\Delta_n} + \varepsilon_i) - (X_{(i-1)\Delta_n} + \varepsilon_{i-1}).$$

In other words, in the case of additive noise, the observations on the process, $X_{i\Delta_n}$, are replaced by $X_{i\Delta_n} + \varepsilon_i$. The limits that are relevant for the spectrogram analysis are given by the fact that under (32) and (33), we have (recall that $B'(p, \infty, \Delta_n) = U'(p, 0, \Delta_n)$):

- If $p \geq 0$, then for any sequence u_n of nonnegative numbers going to 0 we have

⁵While far from being complete descriptions of the reality, these two specifications for the noise can be thought of as proxies for some of the main features identified as relevant in the market microstructure literature: see, e.g., Hasbrouck (1993), who discusses the theoretical market microstructure underpinnings of an additive noise model and argues that the standard deviation of the noise, $E(\varepsilon_i^2)^{1/2}$, is a summary measure of market quality. In the Roll (1984) model, the noise is due entirely to the bid-ask spread. Harris (1990b) considers additional sources of noise and their impact on the Roll model and its estimators. More complex structural models, such as Madhavan, Richardson, and Roomans (1997), also give rise to reduced forms where the observed transaction price takes the form of an unobserved price plus noise. Adverse selection effects are considered in Glosten (1987) and Glosten and Harris (1988), where the spread has different components. Especially when asymmetric information is involved, the noise term may no longer satisfy the basic assumptions here (such as i.i.d. or uncorrelatedness with the price process). The second case we consider, where the noise is due to rounding, has been analyzed in the market microstructure literature (see, e.g., Gottlieb and Kalay 1985). The specification of the model in Harris (1990a) combines both rounding and bid-ask effects as the dual sources of noise.

⁶In practice, volatility, spreads, liquidity, volume, and price levels vary over time (impacting the relative size of the rounding to the price grid points for the log-price) so clearly any realistic noise component is likely to be quite complicated. However, one should be wary of making definitive statements regarding the precise nature of the noise component since it is latent and never observed in isolation but always in conjunction with the true price and with rounding.

⁷See footnote 1.

$$(35) \quad \Delta_n U'(p, u_n, \Delta_n) \xrightarrow{\mathbb{P}} m'_p T.$$

- If $p > 0$ and if further

$$(36) \quad \frac{\Delta_n}{u_n^r} \rightarrow 0, \quad \text{where } r = \begin{cases} \frac{2p+2}{p} & \text{if } p \leq 1 \\ 4 & \text{if } p \geq 1 \end{cases}$$

then we have

$$(37) \quad \frac{\Delta_n}{u_n^{p+1}} B'(p, u_n, \Delta_n) \xrightarrow{\mathbb{P}} \frac{2f(0)}{p+1} T.$$

This result, shown in Ait-Sahalia and Jacod (2011) when $p > 1$, is a generalization to the case of general p of known results for the quadratic variation ($p = 2$) which form the basis for the robustified estimators listed in footnote 1.

7.2 Rounding Noise

The situation of rounding noise is much more delicate to analyze. There, instead of observing $X_{i\Delta_n}$, we observe $[X_{i\Delta_n}]_\alpha$, that is $X_{i\Delta_n}$ rounded to the nearest multiple of α . For instance, if the market under consideration is decimalized, then $\alpha = 1$ cent. For many bond markets, $\alpha = 1/32$ nd of a dollar.

If X is continuous, then most of the increments $\Delta_i^n X$ vanish, and all are integral multiples of the rounding value α . So the key role is played by the upcrossings and downcrossings of the levels $(q + \frac{1}{2})\alpha$ by X , for all integers q . So, not surprisingly, the limit of the variations involve the local times of X at those levels, that is the amount of time that the process spends in a neighborhood of the crossing levels. The same is true when X jumps, except that in this case the theory of local times is not even well established unless the Blumenthal–Gettoor index of the jump is smaller than 1.

More specifically, only the case when X is continuous is completely determined, and the main result is due to Delattre (1997). Let L_t^a denote the local time of X at level $a \in \mathbb{R}$,

and as before we denote by $B''(p, u_n, \Delta_n)$ and $U''(p, u_n, \Delta_n)$ for the variables introduced in (7), (8), and (10), where the increments $\Delta_i^n X$ of (6) are substituted with

$$(38) \quad [X_{i\Delta_n}]_\alpha - [X_{(i-1)\Delta_n}]_\alpha.$$

Then, if X is a continuous semimartingale with the drift process locally bounded, as well as the volatility process σ_t and its inverse $1/\sigma_t$, we have that

$$(39) \quad \sqrt{\Delta_n} B''(p, \infty, \Delta_n)$$

$$\xrightarrow{\mathbb{P}} \alpha^p \sqrt{\frac{2}{\pi}} \sum_{q \in \mathbb{Z}} \int_0^T \frac{1}{\sigma_s} dL_s^{(q+\frac{1}{2})\alpha}.$$

The results continue to hold if the semimartingale is discontinuous, but with finite activity. Otherwise, no precise mathematical result is known so far in this domain.

The behavior of the truncated power variations is quite different in the presence of rounding. Indeed, if $u_n \rightarrow 0$, for n large enough we have $u_n < \alpha$ since the rounding level is fixed. In this case all increments of the noisy process are either 0 or bigger than u_n . In other words, we have for n large enough:

$$(40) \quad B''(p, u_n, \Delta_n) = 0,$$

$$U''(p, u_n, \Delta_n) = B''(p, \infty, \Delta_n).$$

7.3 Limit of Our Statistics

We can now apply these results to analyze the limits of our statistics when either form of noise dominates, since the test statistics are all based on combining different values of B and we have just stated the limiting behavior of each B when the noise dominates. If we gather these results together with those for the observations without noise, we see that S_J has four possible limits:

$$(41) \left\{ \begin{array}{ll} 1/k & : \text{additive noise dominates} \\ 1/k^{1/2} & : \text{rounding error dominates} \\ & \text{(and jumps have finite activity)} \\ 1 & : \text{jumps present and no} \\ & \text{significant noise} \\ k^{p/2-1} & : \text{no jumps present and no} \\ & \text{significant noise} \end{array} \right.$$

The impact of the noise on S_{FA} is given by (where “no limit” means that for n large the statistics is the ratio 0/0):

$$(42) \left\{ \begin{array}{ll} 1/k & : \text{additive noise dominates} \\ \text{no limit} & : \text{rounding error dominates} \\ 1 & : \text{infinite activity jumps and} \\ & \text{no significant noise} \\ k^{p/2-1} & : \text{finite activity jumps and} \\ & \text{no significant noise} \end{array} \right.$$

S_{W} , taking market microstructure noise into account, has four possible limits:

$$(43) \left\{ \begin{array}{ll} 1/k & : \text{additive noise dominates} \\ \text{no limit} & : \text{rounding error dominates} \\ 1 & : \text{No Brownian motion and} \\ & \text{no significant noise} \\ k^{1-p/2} & : \text{Brownian motion present} \\ & \text{and no significant noise} \end{array} \right.$$

Finally, taking microstructure noise into account yields the following limits for our measure of the fraction of QV due to the continuous component:

$$(44) \left\{ \begin{array}{ll} 0 & : \text{additive noise dominates} \\ 0 & : \text{rounding error dominates} \\ \text{actual fraction} & : \text{no significant noise} \\ \text{of QV} & \end{array} \right.$$

We will now analyze the data in light of these predictions of the theory.

8. The Data

8.1 The Starting Data

We use a dataset consisting of all transactions and quotes on all thirty individual components of the Dow Jones Industrial Average in 2006. The data source is the TAQ database. Using the correction variables in the dataset, we retain only transactions that are labeled “good trades” by the exchanges: regular trades that were not corrected, changed, or signified as canceled or in error; and original trades which were later corrected, in which case the trade record contains the corrected data for the trade. Beyond that, no further adjustment to the raw data are made to produce what we call the “unfiltered transactions.” We also consider and use the corresponding quotes, as we explain below.

We sample the price series at up to the 5 second frequency, and then lower frequency multiples. The most liquid stocks in the DJIA trade on average more than once every second, so we are not retaining every transaction by doing so, which avoids incorporating every bid–ask bounce. For the less liquid stocks, some smoothing is involved. When no transaction is available at the exact time stamp, we use the closest one available. When more than one transaction is available at the same time stamp, we average them. We do not include the overnight returns.

8.2 Bouncebacks and National Best Bid and Offer Filter

Different measurements of the stock returns lead to different properties of the constructed price process. One particular issue that deserves careful attention in the data is that of “bouncebacks.” We call “bouncebacks” price observations that are either higher or lower than the sequences of prices that both immediately precede and follow it. Such prices generate a log-return from one transaction to the next that is large

in magnitude, and is followed immediately by a log-return of the same magnitude but of the opposite sign, so that the price returns to its starting level before that particular transaction. To the extent that we have no reason to believe that those transactions did not actually take place, as we already eliminate transactions known to TAQ to be incorrect, we start with the premise that bouncebacks should not be arbitrarily removed from the sample. However one may think that bouncebacks, although significant in a sense, should not be incorporated in the model for the “true” latent price process, whatever this “true” might mean.

The prevalence of bouncebacks can lead to a large number of relatively small jumps in the raw data, and bias the empirical results toward finding more small jumps than actually happen if the data were correctly measured, or biasing the estimated degree of jump activity. By contrast, a true jump can be followed by another jump (due to the prevalence of jump clustering in the data), but these successive jumps will not necessarily be of the same magnitude and of the opposite sign.

One straightforward approach to eliminate bouncebacks would be to eliminate all log-returns that are followed immediately by another log-return of the opposite sign, when they are both greater than a predetermined magnitude, such as some number of ticks. There is however typically in the data a continuum of bouncebacks in terms of such magnitude, so this approach ends up creating a discontinuity at the arbitrary predetermined magnitude selected: many of them of size less than that level and then none. On the other hand, setting that level within one tick would be extreme and would change the nature of the observed prices.

To deal with bouncebacks endogenously, we will instead make use of the matched quotes data. Transactions that take place outside the currently prevailing quotes are

known as “out-trades.” In our context, a single out-trade will generate a bounceback. As discussed by Stoll and Schenzler (2006), they tend to occur on Nasdaq because of delays in reporting trades; because of the ability of dealers to delay the execution of trades, thereby creating a look-back option which when exercised results in out-trades; and because large trades can take place at prices outside the quotes. Out-trades are less frequently observed on the NYSE because the market is more centralized. Of the thirty DJIA components in 2006, Microsoft and Intel trade on Nasdaq while the other components all trade on the NYSE.

We will use the quotes data in order to reduce the incidence rate of bouncebacks in the transactions data, in a manner that is compatible with market rules. SEC regulations require brokers to guarantee customers the best available ask price when buying securities, and the best available bid price when selling securities. These are called the National Best Bid and Offer (NBBO) prices.

We compute the NBBO at each point in time as follows. We collect all quotes at each instant retaining only those with positive sizes and prices, and eliminating crossed quotes, those where the bid price is greater than the ask price. We then compute trimmed size-weighted means (eliminating the extreme 10 percent of quotes at each end, in price levels and sizes) of the bid and ask prices in effect at that time. Eliminating quotes with small depths or extreme prices is important: bad or erroneous quotes tend to have smaller size, hence the need to trim the weighted average to smooth them away. Quotes with small depths or extreme bid and ask prices (“off-market”) are often used by market makers to effectively pull out of the market, usually temporarily, while still posting quotes. Incidentally, bouncebacks can happen in quotes data as well. But they tend to appear when there is only a very small number of quotes at that point in time, with one

or more that is off-market for the reasons just described. Quote bouncebacks seem to be unrelated to transaction bouncebacks.

Given our computed NBBO at each point in time, we then take a moving window of 90 seconds. For instance, a block trade might have been arranged by a manual broker and its reporting delayed. Or opening trades done manually can be delayed, for instance, even at small sizes. The 90-second window we employ is set to reflect the SEC rules that specify that exchanges must report trades within 90 seconds. Trades that are delayed beyond 90 seconds are marked as “late,” and already excluded from the starting data by our TAQ filters. We use this 90-second moving window to construct a running minimum of the national best bid prices and a running maximum of the national best offer prices over the time window. This NBBO bid–offer moving envelope is then used as our filter for transactions: we retain only transactions that take place inside the envelope.

There are many reasons for trades to be delayed, especially when some form of manual execution is involved. For example, in the case of negotiated trades, brokers might work the order over time, leading to a sequence of smaller trades reports. Or the broker might (acting as principal) sell the whole amount to the customer, in which case we would see a single trade report. Another practice involves “stopping” the order: the broker does not execute the order immediately, but does guarantee the buyer a price. The broker can then work the order, deferring any trade reports until the execution is complete, at which time an average price is reported. The average price can appear out of line with the prices around it and lead to a bounceback.

The NBBO filter we employ tends to be conservative—erring on the side of retaining transactions—since there is no guarantee that an out-trade is actually necessarily due to a time delay, or that even if delayed it took place at a time when the bid–ask spread was

less than the maximal width of the spread over the 90-second time window. On the other hand, block (negotiated) trades usually carry a price concession and so could be executed outside this envelope and thereby be wrongly excluded. To the extent that, for it to lead to a bounceback, this is by a definition a single isolated transaction, it did not have a permanent price impact, but rather was associated with a transient liquidity effect.

We do not make use of the NBBO quotes depth: from the list of prevailing quotes by exchange, we already determine the best (maximum) bid price, and the best (minimum) ask price. Using the prevailing quote list, we could sum the bid sizes for quotes at the best bid price, and sum the ask sizes for the quotes at the best ask price. This would produce the NBBO sizes available to trade at each point of time and one could consider filtering out transactions with size that exceeds it. However, this would also eliminate legitimate transactions, such as block trades, or for that matter any trade that has a price impact. In any event, we find empirically that filtering the transactions by the NBBO filter as described above reduces drastically the number of bouncebacks in the data.

We started with the unfiltered transactions data, and this procedure results in a time series of NBBO-filtered transactions. We also produce a series of the midpoint of the just computed NBBO bid and ask prices and use this as our measurement of the quote price at that point in time. We therefore end up comparing three different measurements of the “price” series, for each stock:

- The unfiltered transactions;
- The NBBO-filtered transactions;
- The NBBO quotes midpoint.

We will apply the spectrogram methodology to each price series for each one of the 30 individual DJIA components and compare the results.

8.3 *Individual Stocks versus Indices*

The DJIA is defined as a simple average of the stock prices of 30 of the largest and most widely held public companies in the United States, as determined by the Dow Jones Co. The index is adjusted by a divisor, which changes whenever one of the component stocks has a stock split or stock dividend, or one of the component is replaced by another stock, so as to generate a continuous value for the index at the time of the split, dividend or change of component. We collect high frequency data (sampled every 5 seconds, down from an average sampling interval of 3 seconds) on the cash value of the DJIA index from Tick Data, Inc. The data provider uses proprietary data filters.

2006 was a rather unremarkable, or quiet, year from the perspective of systematic jumps (i.e., jumps that would be visible at the level of the index), as perusal of financial news for that period would confirm. In what follows, we will compare the results obtained from the index to those on its individual components.

9. *Empirical Results and Economic Implications*

9.1 *Jumps: Present or Not*

The empirical values of S_j are shown in the form of a histogram in figure 9 for each of the three possible measurements of the data. The data for the histogram are produced by computing S_j for the four quarters of the year, the thirty stocks, and for a range of values of p from 3 to 6 (in increments of 0.25), Δ_n from 5 seconds to 2 minutes (with values 5, 15, 30, 60, 90, and 120 seconds), and $k = 2, 3$. The top left histogram corresponds to the unfiltered transactions, the top right one to the NBBO-filtered transactions and the lower left one to the NBBO midpoint quotes. In this and the plots that follow, the

values of the parameters k and p are varied across the experiments; the “noise dominates” region consists of the range of possible values of the limits of the statistic being implemented, when k and p vary, for the two cases where the noise dominates.

As indicated in (41), values below 1 are indicative of noise of one form or another dominating. We find that this is the case only for the unfiltered transactions data, and only at the highest sampling frequencies, the histogram then displaying a left tail. For the other data measurements, the histograms display very little mass in the regions where the noise dominates. The conclusion from S_j is that the noise is not the major concern, except for the unfiltered transactions at the ultra high frequencies, but once past this domain, the evidence points toward the presence of jumps with the histograms centered around 1.⁸

This conclusion is not surprising per se, even for the index and a fortiori for the individual assets. The fact that the tails of high-frequencies log-return distributions exhibit a power decay, which points toward a model including jumps, has been recognized a long time ago, see for example Eberlein and Keller (1995). A power law fits the data quite well and a continuous component alone (with typically exponentially decaying tails) would be rather unlikely to generate such returns.

The middle right panel in figure 9 displays the median value of S_j (across values of p and k , and the four quarters) as a function of the sampling interval Δ_n . Unfiltered transactions are marked “U,” filtered transactions are marked “F” and the NBBO midpoint quotes

⁸One potential caveat needs to be raised. The evidence for values around 1 is compelling at the highest frequencies, but this is where it is possible for the noise to exert downward pressure on the point estimates, since the noise results in lower limits. It is possible that in small samples we obtain estimates around one as a result of a procedure that is biased downwards from higher values by residual amounts of noise.

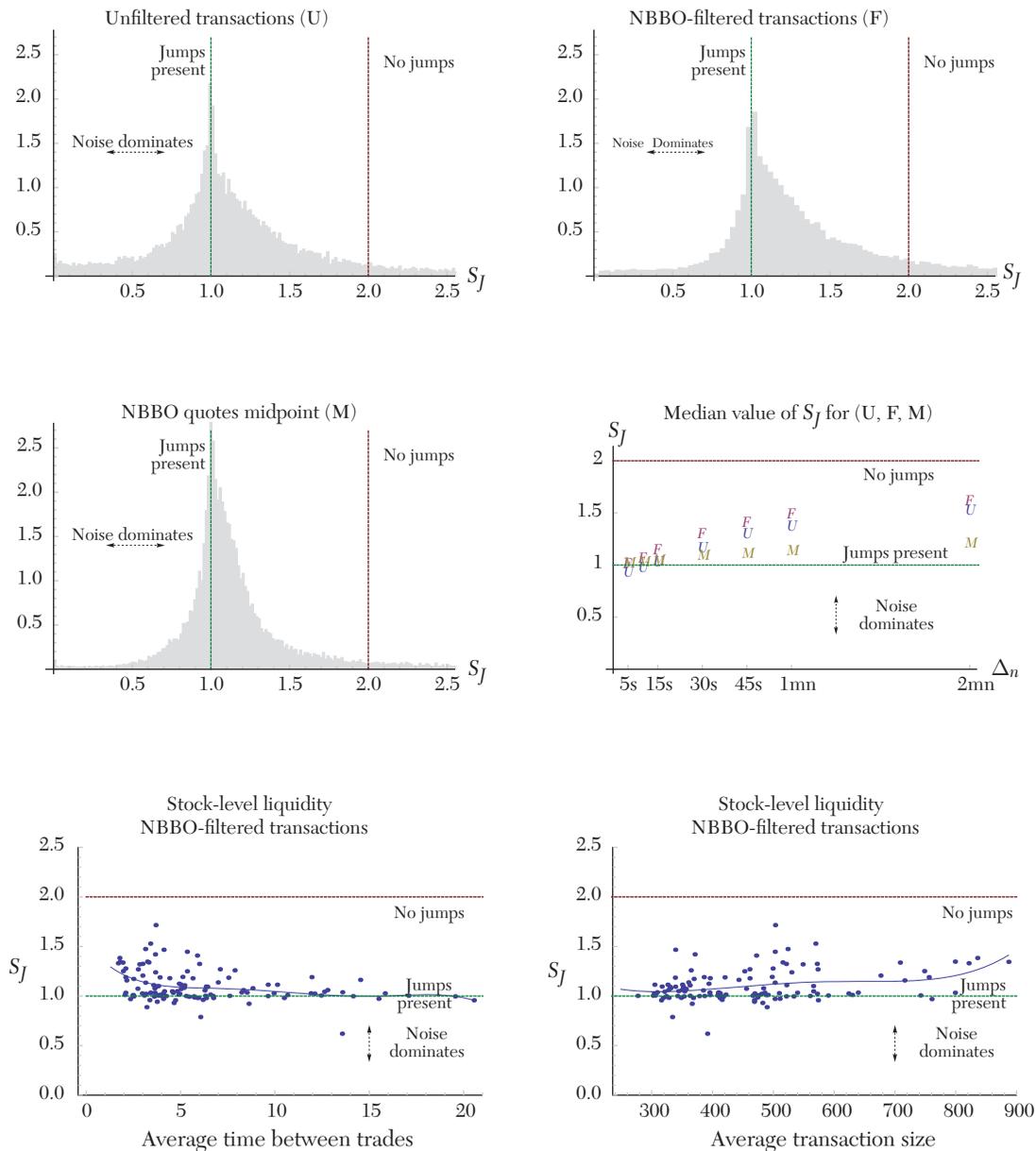


Figure 9. Test Statistic S_j to Test for the Presence of Jumps DJIA30 Components

Notes: Empirical distribution of S_j for all 30 DJIA components, 2006, measured using transactions (unfiltered and NBBO-filtered) and NBBO quotes midpoint, median value of S_j as a function of the sampling interval Δ_n , and nonlinear regression of S_j against stock-level liquidity measures.

are marked “M.” In all cases, the median value of S_j starts around 1 at the highest frequencies and then rises. Comparing different data measurements, we find that S_j is generally highest for “F” (meaning less evidence of jumps there), then for “U” and then for “M.” Similar results obtain if the mean is employed instead of the median. But as the sampling frequency increases, the evidence in favor of the presence of jumps becomes more mixed, when the 30 components of the DJIA are taken in the aggregate. When implemented on the DJIA index itself, we find values of S_j that range between 1.5 and 2.5, providing between less evidence in favor of jumps and evidence against them for the index at the lower frequencies and for the time period considered.

However, two points should be emphasized here. First, the histogram is more spread out when frequency decreases because less data are used and the statistical error increases, so that the procedure becomes less conclusive. Second, when the sampling frequency is low, the statistic S_j should not necessarily be expected to be close to its limiting value, 1 or 2, which is the theoretical limit when the frequency $1/\Delta_n$ goes to infinity.

Finally, we check if any cross-sectional differences in S_j can be explained by cross-sectional differences in liquidity among the thirty stocks. To this aim, the lower two panels on figure 9 show the results of a nonlinear regression of the statistic S_j on two stock-level measures of liquidity, the average time between successive trades, and the average size of the transactions. Both regressions show a slight decrease in S_j values as the asset becomes less liquid, meaning higher time between trades and lower transaction size, but neither result is strong enough to be noticeable.

9.2 *Jumps: Finite or Infinite Activity*

S_j tells us that jumps are likely to be present, but it cannot distinguish between finite

and infinite activity jumps. For this, we turn to the statistic S_{FA} which is like S_j with the addition of truncation.

Whenever we need to truncate, we express the truncation cutoff level u_n in terms of a number α of standard deviations of the continuous part of the semimartingale. That initial standard deviation estimate is obtained by using $B(2, 4\sigma\Delta_n^{1/2}, \Delta_n)$ where σ is a fixed realistic value for the asset under consideration; we use $\sigma = 0.25$. The specific value of this number serves only to identify a reasonable range of values; it does not matter asymptotically. It does of course matter in small samples, and so we suggest picking a realistic value for the asset and time period. We then use for the truncation level u_n different multiples of it. Our view of the joint choice of (ϖ, α) is that they are not independent parameters in finite sample: they are different parameters for asymptotic purposes but in finite samples the only relevant quantity is the actual resulting cutoff size u_n . This is why we are reporting the values of the cutoffs u_n in the form of the α that would correspond to $\varpi = 1/2$. This has the advantage of providing an easily interpretable size of the cutoff compared to the size of the increments that would be expected from the Brownian component of the process: we can then think in terms of truncating at a level that corresponds to $\alpha = 4, 6$, etc., standard deviations of the continuous part of the model. Since the ultimate purpose of the truncation is either to eliminate or conserve that part, it provides an immediate and intuitively clear reference point. Given u_n and this α , it is possible to back this into the value of the α corresponding to any ϖ , for that given sample size, including the value(s) of ϖ that satisfy the required inequalities imposed by the asymptotic results. This approach would lose its effectiveness if we were primarily interested in testing the validity of the asymptotic approximation as the sample size varies, but for applications, by

definition on a finite sample, it seems to us that the interpretative advantage outweighs this disadvantage.

Each one of the statistic below is computed separately for each quarter of 2006 and for each asset. The data for the histogram in figure 10 are produced by computing for the four quarters of the year and each stock the value of S_{FA} for a range of values of p from 3 to 6, α from 5 to 10 standard deviations, Δ_n from 5 seconds to 2 minutes, and $k = 2, 3$. We find that the empirical values of S_{FA} are distributed around 1, which is indicative of infinite activity jumps. That is, even as we truncate, the statistic continues to behave as if jumps are present. If only a finite number of jumps had been present, then the statistic should have behaved as if the process were continuous. But the histograms do display a fat right tail, indicative of finite activity jumps for at least some of the DJIA components. The histograms are quite similar for all three data measurements, suggesting that they tend to differ only because of the larger increments: those are indeed the ones that are filtered in “F” compared to “U,” but since they are truncated away by S_{FA} anyway, then for the purpose of computing S_{FA} the two data measurements produce close results.

The middle right panel in figure 10 displays the mean value of S_{FA} (across the four quarters, two stocks, and values of p , α and k) as a function of Δ_n . A pattern similar to the corresponding plot in figure 9 emerges. Even for very small values of Δ_n , the noise does not dominate (limits below 1), instead the limit is around 1 as Δ_n increases away from the frequencies where the noise would have been expected to dominate. Unless we start downsampling more (reaching 5 to 10 minutes), the limit does not get close to $k^{p/2-1}$. The lower panels examine any patterns linking S_{FA} to stock-level measures of liquidity; no strong cross-sectional pattern emerges.

Overall, the evidence suggests the presence of infinite activity jumps in the DJIA 30 components. To the extent that jumps are present in the DJIA index itself, the evidence is in favor of finite activity jumps: we find values of S_{FA} ranging from 1.7 to 2.2 for the index.

9.3 Brownian Motion: Present or Not

In light of the likely presence of infinite activity jumps identified by S_{FA} , it makes sense to ask empirically whether a Brownian component is needed at all. For this purpose, we turn to the statistic S_W .

Figure 11 displays histograms of the distribution of S_W obtained by computing its value for the four quarters of the year for a range of values of p from 1 to 1.75, α from 5 to 10 standard deviations, Δ_n from 5 seconds to 2 minutes, and $k = 2, 3$. The empirical estimates are always on the side of the limit arising in the presence a continuous component. Even as the sampling frequency increases, the noise is not a dominant factor, although as usual, lower values of S_W below 1 are now obtained and for very high sampling frequencies, the results are consistent with some mixture of the noise driving the asymptotics.

This is confirmed by the middle right panel in figure 11, which displays the mean value of S_W (across the four quarters, two stocks, and values of p , α , and k) as a function of Δ_n . As we downsample away from the noise-dominated frequencies, the average value of the statistic settles down toward the one indicating presence of a Brownian motion.

Because values of p less than two are employed by the statistic S_W , we find relatively small differences between the results for filtered and unfiltered transactions: since they differ mainly by a few of their large increments, but values of $p < 2$ tend to underemphasize large increments, we obtain similar results for “F” and “U.” The lower

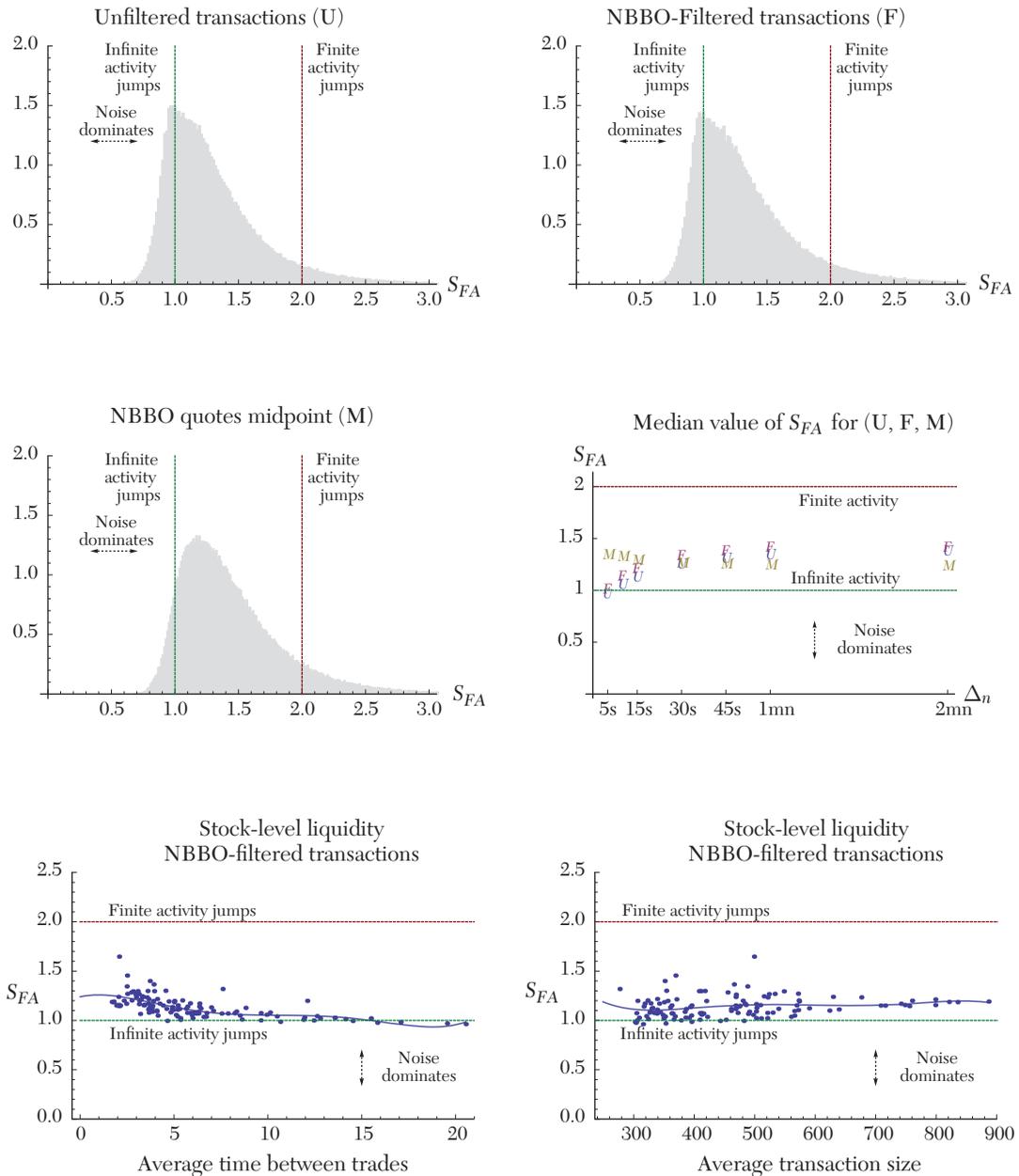


Figure 10. Test Statistic S_{FA} to Test Whether Jumps Have Finite or Infinite Activity DJIA 30 Components
 Notes: Empirical distribution of S_{FA} for all 30 DJIA components, 2006, measured using transactions (unfiltered and NBBO-filtered) and NBBO quotes midpoint, median value of S_{FA} as a function of the sampling interval Δ_n , and nonlinear regression of S_{FA} against stock-level liquidity measures.

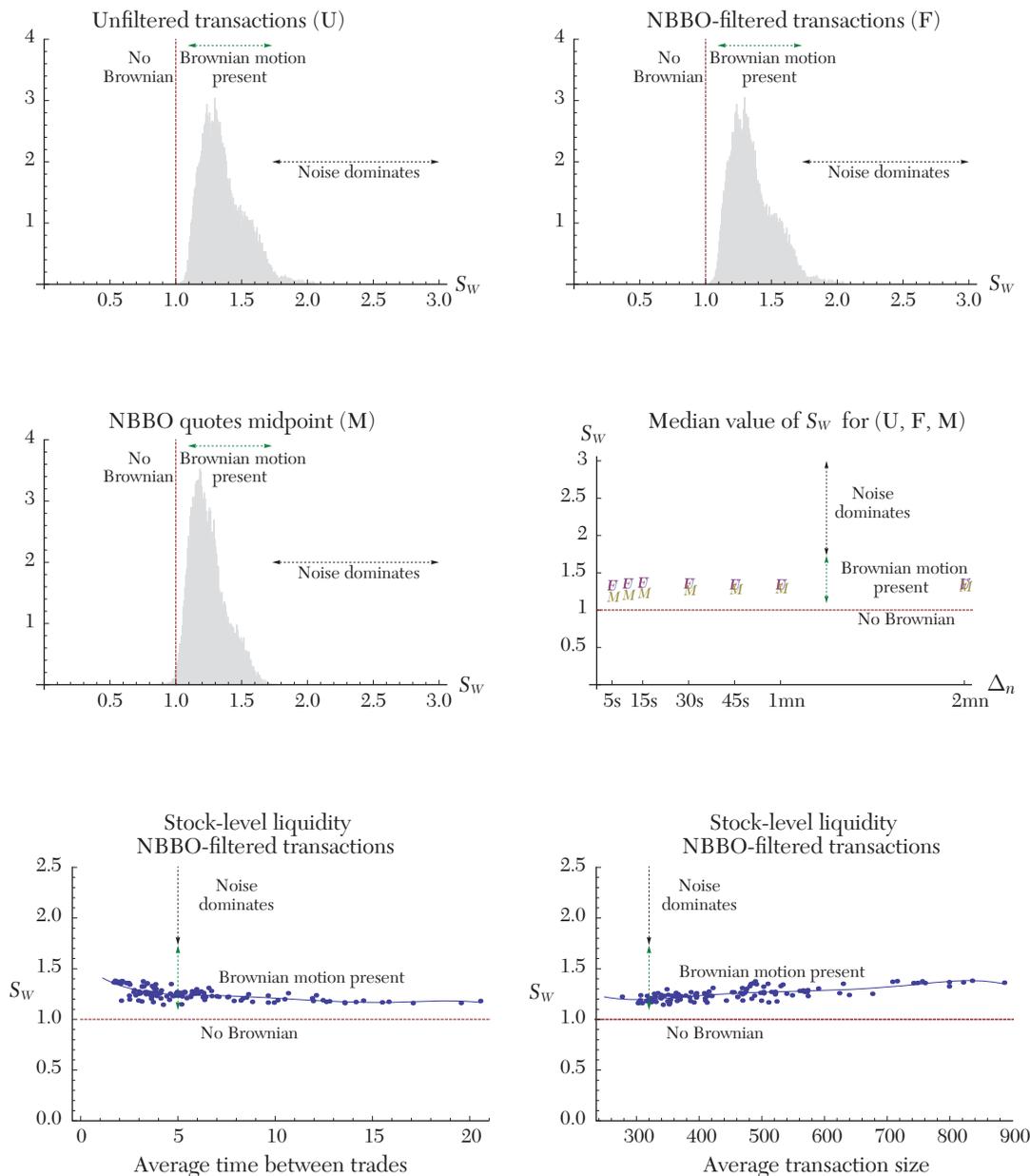


Figure 11. Test Statistic S_W to Test Whether Brownian Motion is Present DJIA 30 Components
 Notes: Empirical distribution of S_W for all 30 DJIA components, 2006, measured using transactions (unfiltered and NBBO-filtered) and NBBO quotes midpoint, median value of S_W as a function of the sampling interval Δ_n , and nonlinear regression of S_W against stock-level liquidity measures.

panels look at the relationship between S_W and the underlying asset's liquidity. Like S_J , we find that there is a very slight increase in the value of the statistic as the asset becomes more liquid. In the case of the DJIA index, we find that a Brownian motion is likely present, except at the highest frequencies. Indeed, increments of the index tend to be very smooth owing to the nature of the index as an average. It is possible that the averaging involved in the construction of the index may lead to detect a spurious Brownian component in the index.

9.4 QV Relative Magnitude

The previous empirical results indicate that are likely in the presence of a jump as well as a continuous component in the DJIA 30 stocks. We can then ask what fraction of the QV is attributable to the continuous and jump components.

The histograms in figure 12 are obtained from computing the fraction of QV from the Brownian component using the four quarters, two stocks, values of α ranging from 2 to 5 standard deviations, in increments of 1, and Δ_n from 5 seconds to 2 minutes in the same increments as earlier. We find values around 75 percent for "F" and "U," and somewhat lower for "M," around 60 percent with some stock/quarter samples leading to values that are in fact indicative of an almost pure jump process in the quotes data.

In the middle right panel (similar but as a function of Δ_n), we see that the estimated fraction is fairly stable as we vary the sampling frequency. It is also quite stable for the two different measurements of the transactions data, "F" and "U," and the quotes data "M," going up slightly as the sampling frequency decreases. The lower panels show a more pronounced increase in the Brownian-driven of QV as a function of the asset's liquidity: using both measures, we find that more liquid assets are associated with a higher proportion of Brownian-driven QV.

In the case of the DJIA index, we find values that range from 85 percent to 95 percent, suggesting in line with the previous evidence that jumps are less of a factor for the index. Incidentally, one could imagine measuring the proportion of jumps that are systematic versus those that are idiosyncratic on the basis of the comparison between percentQV estimated for the index and for its components.

9.5 Estimating the Degree of Jump Activity

Finally, we estimate the degree of jump activity β . We found above that infinite activity jumps were likely present in the data. We are now asking how active are those jumps among all infinitely active jumps.

Of all the empirical methods employed in the paper, estimating β is the one that requires the largest sample size due to its reliance on truncating from the right in the power variations U . That is, the estimators of β discard by construction a large fraction of the original sample and to retain a sufficient number of observations to the right of a cutoff u_n given by 5 or more standard deviations of the continuous part, we need to have a large sample to begin with. So we will estimate β using only the first two sampling frequencies, 5 and 10 seconds on a quarterly basis. In the case of the previous statistics, we noted that these sampling frequencies were subject to market microstructure noise. Here, however, because we are only retaining the increments larger than the cutoff u_n instead of those smaller than the cutoff, this could be less of a concern despite the ultra high sampling frequencies.

We find estimated β s in the range from 1.5 to 1.8, indicating a very high degree of jump activity, in effect much closer to Brownian motion than to compound Poisson. The filtered transactions produce the highest estimates of β , leading on average to a process that effectively looks like Brownian motion. Figure 13 reports the values of the

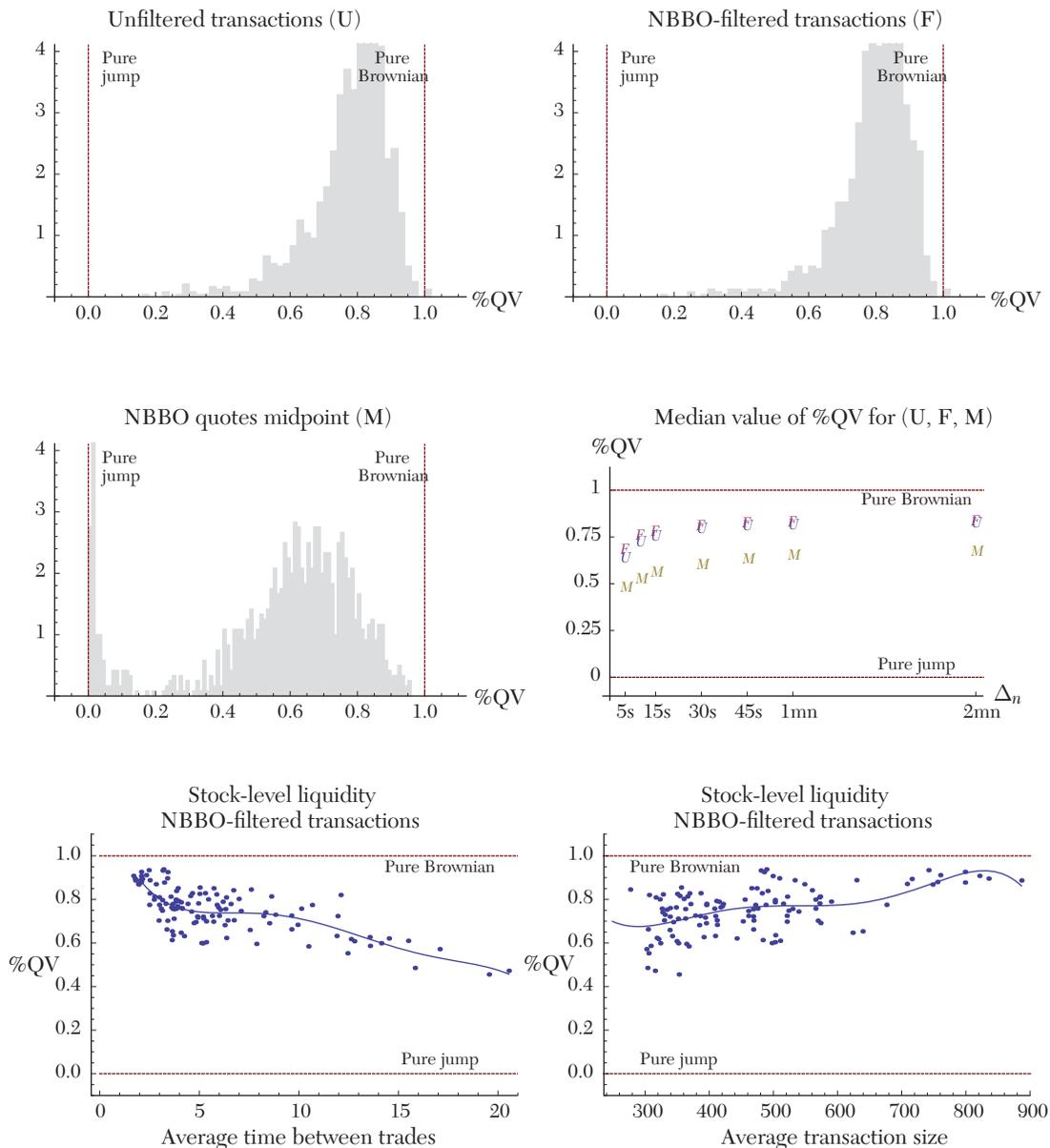


Figure 12. Proportion of Quadratic Variation Attributable to the Continuous Component DJIA 30 Components

Notes: Empirical distribution of the proportion of QV attributable to the continuous component for all 30 DJIA components, 2006, measured using transactions (unfiltered and NBBO-filtered) and NBBO quotes midpoint, median value of %QV as a function of the sampling interval Δ_n and nonlinear regression of %QV against stock-level liquidity measures.

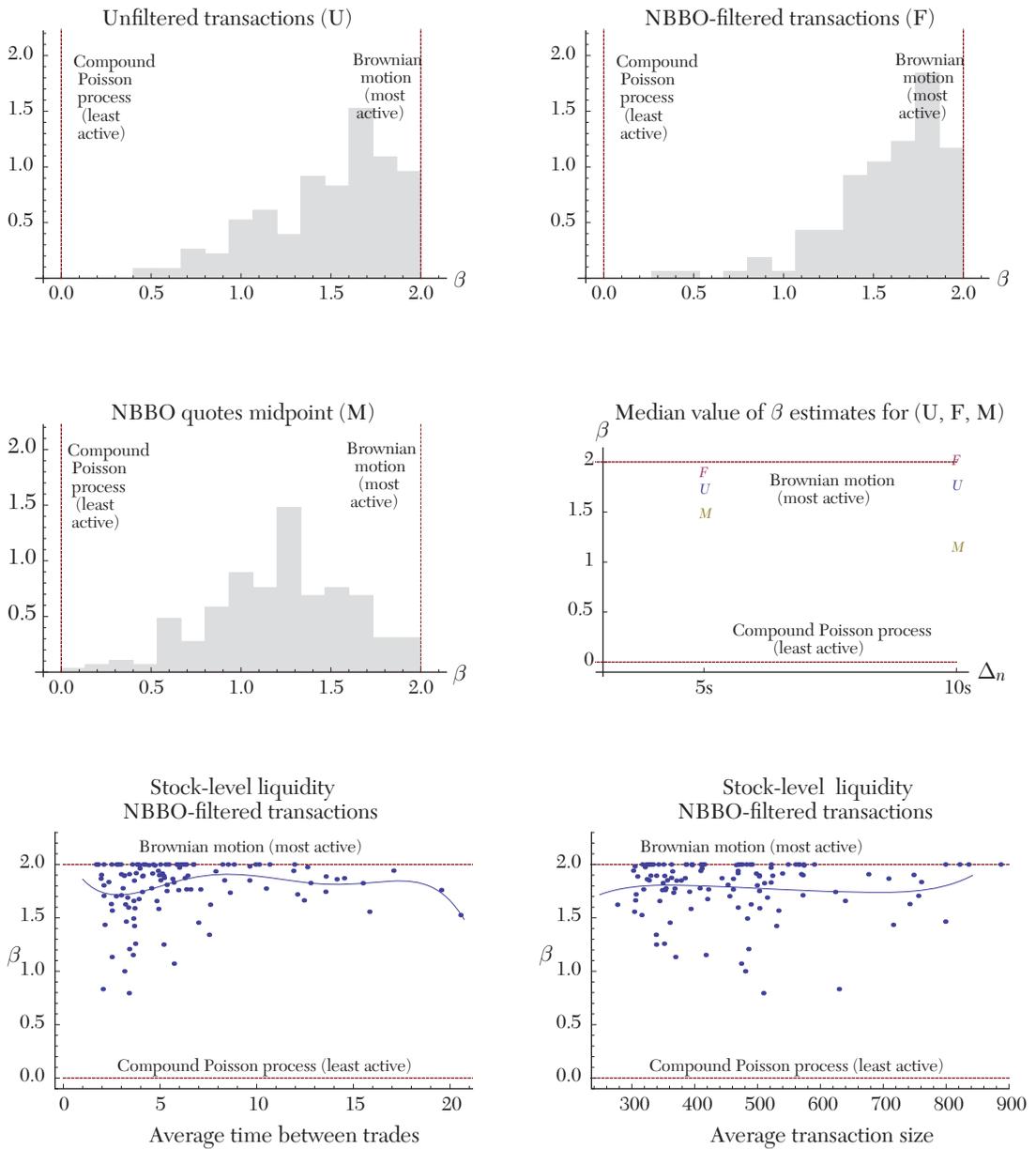


Figure 13. Estimate of the Degree of Jump Activity β DJIA 30 Components

Notes: Empirical distribution of the index of jump activity β for all 30 DJIA components, 2006, measured using transactions (unfiltered and NBBO-filtered) and NBBO quotes midpoint, and median value of the estimated β as a function of the sampling interval Δ_n , and nonlinear regression of the estimated β against stock-level liquidity measures.

estimator $\hat{\beta}$ computed for the four quarters of the year, the two stocks, a range of values of α from 5 to 10 standard deviations, and Δ_n from 5 to 10 seconds. The middle right plot reports the corresponding data against the limited range of Δ_n employed. Within the context of their parametric model, Carr et al. (2002) also found estimates of β on most stock return series that were greater than zero. (By contrast, the estimates here do not rely on a parametric structure for the rest of the model, so they can be thought of as semiparametric.) The lower panels, relating the estimated values of β to stock-level liquidity, do not display strong patterns.

Looking at the DJIA index itself, to the extent that an infinite activity component is present, we find that it is less active, with estimated values of β ranging from 0.9 to 1.4. But in light of the results of the test of finite versus infinite jump activity, this component is likely small in the index relative to the finite activity component.

9.6 Economic Implications of the Empirical Results

We have documented some of the salient features of asset returns viewed through the prism of a semimartingale, with the important caveat that we are naturally in no position to claim that the empirical results obtained above are general, universal, or anything remotely approaching these qualifiers. They are of course sensitive to the specific data series, how prices are measured (quotes versus transactions for instance), the time period and, importantly, choices made in the way the data are treated, including the filtering procedures described above. We believe we have made sensible or at least defensible selections when presented with a choice, but it is important to keep these caveats in mind as we embark upon a discussion of the implications of the results.

9.6.1 Implications for Option Pricing

As is well known, option and derivative prices can be computed as the risk-free discounted expected value of their payoffs provided that the expected value is computed under an equivalent martingale measure, \mathbb{Q} . The analysis in this paper is, and can only be, entirely conducted under the physical probability measure, \mathbb{P} , since we rely exclusively on log-returns of the underlying assets which are observed under \mathbb{P} . As such, this analysis does not lend itself directly to conclusions for option or other derivative prices, which depend upon the properties of the semimartingale under \mathbb{Q} . However, important features of the process identified under \mathbb{P} do translate into similar features under \mathbb{Q} and as a result what our econometric methods are able to identify under \mathbb{P} have implications for derivative pricing.

Specifically, economic theory dictates that \mathbb{P} and \mathbb{Q} must be absolutely continuous with respect to each other, $\mathbb{P} \sim \mathbb{Q}$, meaning that the two probability measures must have the same null sets. This requirement limits the possible ways in which the features of the process under \mathbb{Q} can differ from those already identified empirically under \mathbb{P} . As is well known, if the process is continuous under \mathbb{P} , it must be continuous under \mathbb{Q} , and vice versa. Hence, if jumps are possible under one measure they must be possible under the other as well. Thus the evidence in favor of jumps in the dynamics of the underlying asset therefore argues in favor of models with jumps in option pricing. This is of course well-accepted in the empirical option pricing, see, e.g., Bates (1991) for some early evidence.

But more subtle findings of our analysis can also be translated into similar features under the pricing measure \mathbb{Q} . Two types of quantities are indeed almost surely identical pathwise, that is, are the same under both \mathbb{P} and \mathbb{Q} : one is the quadratic variation of the

process, hence in particular its continuous part, that is the process $\int_0^t \sigma_s^2 ds$. The other is the set I_T of nonnegative reals p for which the sum $\sum_{s \leq T} |\Delta X_s|^p$ is almost surely finite. In other words, the process $\int_0^t \sigma_s^2 ds$ for all $t \in [0, T]$ and the set I_T are the same under \mathbb{P} and under \mathbb{Q} .

As a consequence, the proportion of QV estimated in the empirical analysis under \mathbb{P} must be the same under \mathbb{Q} . Also, the absence of Brownian motion (tested under \mathbb{P} using S_W), which amounts to saying that $\sigma_t = 0$ for Lebesgue-almost all t in $[0, T]$, holds under \mathbb{P} if and only if it holds under \mathbb{Q} . The degree of jump activity β (the Blumenthal–Gettoor index, estimated above), which is the infimum of all p in the set I_T , is also the same under the two measures, that is

$$(45) \quad \beta_{\mathbb{P}} = \beta_{\mathbb{Q}}.$$

And the fact that jumps have finite activity (tested under \mathbb{P} using S_{FA}) which amounts to saying that 0 belongs to I_T , is again true under \mathbb{P} if and only if it is true under \mathbb{Q} .

On the other hand, some features of the model may hold under \mathbb{P} and not under \mathbb{Q} , or vice-versa: typically, these concern the drift, which changes more or less arbitrarily when we change the measure, or the law of the big jumps, that is the tails of ν . In other words, the components of the model that are identified at high frequency under \mathbb{P} by the spectrogram analysis (volatility, presence or not of jumps, finite or infinite activity, degree of jump activity, presence or not of the Brownian motion, proportion of continuous QV) happen to be the ones that are also restricted by the change of measure, while those that cannot be identified at high frequency (drift, law of the big jumps) are not.

The consequence of the previous discussion, and in particular of the restriction (45), combined with the empirical evidence regarding the estimated value of $\beta_{\mathbb{P}}$ is to make some option pricing models more

likely than others to be in agreement with the empirical evidence on the dynamics of the underlying asset price process. There are many option pricing models in the literature which include jumps, and quite often rely on specific Lévy processes, with specific values of $\beta_{\mathbb{Q}}$. Examples include compound Poisson-based models starting with Merton (1976), the variance gamma model of Madan and Seneta (1990) and Madan, Carr, and Chang (1998) ($\beta_{\mathbb{Q}} = 0$), the Normal Inverse Gaussian model of Barndorff-Nielsen (1998) ($\beta_{\mathbb{Q}} = 1$), the hyperbolic model of Eberlein and Keller (1995), the generalized hyperbolic model of Barndorff-Nielsen (1977) and the CGMY model of Carr et al. (2002) (in which $\beta_{\mathbb{Q}}$ is a free parameter). In the case of the data studied in this paper, models that allow for unrestricted values of $\beta_{\mathbb{Q}}$ are likely to be more plausible candidates than those that restrict $\beta_{\mathbb{Q}}$ to be small, 0 in particular. Indeed we tend to find empirically relatively high degrees of jump activity in $\beta_{\mathbb{P}}$. This is compatible with the findings from the literature on empirical option pricing with Lévy processes, where models with significant infinite-activity return innovations, that is a component with a $\beta_{\mathbb{Q}} > 0$, tend to be more accurate in their pricing of equity options than those with finite activity or sub-polynomial infinite activity, $\beta_{\mathbb{Q}} = 0$ (see, e.g., Carr et al. 2002 and Huang and Wu 2004).

Models with jumps of finite or infinite activity also have differential implications for the prices of options at short and long horizons. As option maturities approach zero, out-of-the-money option values tend to zero. The speed of decay is exponential when the process is continuous, but linear in time-to-maturity T in the presence of jumps (see Carr and Wu 2003b). In the presence of jumps, the implied volatility for an out-of-the-money option diverges as $T \rightarrow 0$. This holds in the presence of small and big jumps alike.

As option maturity increases, on the other hand, the big jumps component becomes

a key element. From the Black–Scholes scenario, one would expect the implied volatility smile to flatten as a result of the Central Limit Theorem. The empirical evidence suggests, on the other hand, that the smile steepens instead (see, e.g., Foresi and Wu 2005). The big jumps component can explain this fact. In a model where the variance of returns is infinite, a situation that can only arise because of the big jumps, the Central Limit Theorem ceases to apply for long-maturity asymptotics. But on the other hand, if most big jumps are negative, then the option would still retain a finite value, as observed empirically. In other words, the combination of components identified here under \mathbb{P} results in a plausible configuration for the model in light of the available evidence under \mathbb{Q} from the empirical option pricing literature.

9.6.2 Implications for Risk Management

Risk management is primarily concerned with the tails of the returns distributions over different horizons, from the very short term horizons (a few seconds or minutes for high frequency trading applications), to the typical 10 days characteristic of VaR calculations, to the longer horizons relevant in portfolio management.

On a micro time scale, the main risk faced by a market participant practicing high frequency trading comes from the small jumps component, since the continuous component is small (of order Δ_n), and the big jumps component is very unlikely to give rise to realization over a very short interval. As discussed, we find the small jumps risk to be prevalent in individual equities we studied. The finer properties of the small jump component become an important consideration: as β increases, small jumps become more and more likely, and anecdotal evidence from the rapidly growing practice of high frequency trading suggests that the small jumps component is indeed a key

consideration in the implementation of some of these strategies.

On a macro time scale, the implications are much more tenuous. The specification of the price process derived from the spectrogram methodology is nonparametric in nature, and relies on high frequency observations. As such, it fully identifies the behavior of the jump measure near 0. It is common in finance to rely on parametric models. One can imagine the nonparametric methodology employed here being helpful to select one parametric model over another.

Most parametric models rely on extrapolation in that the tails of the jump measure (i.e., the big jumps driver) is linked through parametric assumptions to the behavior of the jump measure near 0; within that framework, identifying the behavior of ν near 0 is sufficient to characterize fully the jump measure. It is of course difficult in any case to pin down precisely how heavy the tail distributions are, since rare events require extremely large samples, that is, long time periods, to get realized in sufficient quantities to characterize precisely the big jumps component (see, e.g., Heyde and Kou 2004). Long sample sizes in turn require an implicit assumption of model stability over the observation horizon. Alternatively, by time aggregation, one can derive the implications for long horizons of the continuous-time model identified over short horizons, typically by simulations. But, overall, drawing long-horizon implications from this analysis entails successive leaps of faith that make it potentially fraught with dangers.

9.6.3 Individual Assets versus Stock Indices, Factor Models and Systematic versus Idiosyncratic Risk

As part of the empirical analysis above, we compared the result of the spectrogram methodology on the DJIA and its components. We found that while the individual components seemed to contain an infinite

activity jump component with a fairly high degree of jump activity, the evidence for the index was pointing more toward a finite activity component only.

This empirical evidence can be interpreted in light of a factor model with systematic and idiosyncratic components. If we further decompose the two jump components in the model (2) for individual stocks into a common component and an idiosyncratic component, then when an idiosyncratic jump occurs the other stock prices do not jump, so the influence of this particular jump on the index, which is an average, is essentially wiped out: the index will not exhibit a jump of significant size. In contrast, a systematic jump will typically occur at the same time (and often with the same sign) for most or all stocks, resulting in a jump of the index. Therefore, the absence of empirical evidence in favor of infinite activity jumps in the index, combined with their presence in the individual components, point toward purely idiosyncratic small jump components in the individual assets.

This makes sense if we think of most systematic, i.e., marketwide, price moves as driven by important macroeconomic news and therefore likely to be large. On the other hand, small infinite activity jumps are more likely to reflect individual stock-level considerations, such as stock-specific information and its immediate trading environment, and therefore be idiosyncratic.

Consistent with this, we also found that the proportion of quadratic variation attributable to jumps is lower for the index than for its individual components. One could conceivably measure the proportion of jumps that are systematic versus those that are idiosyncratic on the basis of the comparison between the proportions of quadratic variation estimated for the index and for its components. Doing this using the empirical results above would suggest a proportion of systematic jumps representing about

10 percent of the total quadratic variation, and a proportion of idiosyncratic jumps representing about 15 percent of total quadratic variation, with the remaining 75 percent representing the continuous part of the total quadratic variation. This breakdown ultimately determines the empirical importance of (different types of) jumps as a source of asset returns variance.

9.6.4 *Implications for Optimal Portfolio Choice*

The presence of jumps in asset returns changes significantly the optimal solution to an investor's consumption/investment problem. One particular consequence of jumps are strong correlations among the returns of different assets, especially time-varying correlations that tend to increase in bad times. Jumps that are at least partly systematic across asset classes will directly produce this pattern, which is observed consistently in the data. When a downward jump occurs, negative returns tend to be experienced simultaneously across most markets, which then results in a high positive correlation during those episodes. When no jump occurs, the only source of correlation is that generated by the continuous component of the model, which will typically be lower.

The salient implication of such jumps is to reduce the diversification potential of, among others, international assets: in bad times, when their low correlation with domestic assets would have been particularly helpful, that low correlation is no longer present. Hedging such jumps in the portfolio context is difficult. Ait-Sahalia, Cacho-Diaz, and Hurd (2009) analyze this problem and show in their simplest model with jumps that the optimal portfolio is characterized by three-fund separation, instead of the familiar two-fund separation that prevails in both the static Markowitz model and the dynamic Merton model without jumps.

With jumps, one needs three funds to replicate the optimal portfolio of an investor, such that the investor becomes indifferent between the original assets or just the three funds; the proportions of each fund invested in the individual assets depend only on the asset return characteristics while the investor's optimal demands for the three funds depend on his or her utility function. The classical two funds are the risk-free asset and the market portfolio. The third and new fund is a long-short fund that generates no exposure to the systematic portion of the jump risk.

10. Conclusions

The methods described in this paper provide a means to decompose an asset price process into its base components, analyze their relative magnitude and some of their finer characteristics. In terms of methodology, our assessment at present is the following. The pros of the approach are: a unified methodology to address all these seemingly disparate specification questions in a common framework; a symmetric treatment of null and alternative hypotheses in each case, including the full distribution theory; test statistics that are all model-free; extremely simple to implement in practical applications; and, finally, a characterization of the impact of two important types of market microstructure noise, additive and rounding, on the various statistics. Refinements of the approach are starting to be developed (see Fan and Fan 2011 and Jing et al. 2012).

The cons of the approach, at present, are the flip side of the commonality of technique: if we take individually each one of the specification questions we have identified, then the statistic we have proposed for that problem, based on that common approach, is not necessarily the optimal approach for that individual specification question. Also, the practical implementation of this method does require high frequency data (particularly the

estimation of the degree of jump activity β , which requires ultra-high frequency data). Finally, while we understand what happens to each one of the statistics when microstructure noise dominates, we do not yet have noise-robust statistics that would be fully immune to the presence of the noise.

The empirical results on the DJIA 30 components appear to indicate that jumps are present in the data; point towards the presence of infinite activity jumps; of degree of jump activity that is around 1.5 or higher; indicate that, on top of the jump components, a continuous component is present; which represents approximately three-quarters of the total QV.

The analysis of different measurement mechanisms suggests that the results are fairly consistent when various ways of measuring the data ("F," "U," or "M") are employed. The DJIA index itself looks quite different, when viewed through this prism, than its individual components. In particular, although market microstructure noise is less a factor for all DJIA 30 stocks than it actually is for its two Nasdaq components (Microsoft and Intel), there is very little evidence of noise even at the highest frequencies for the index itself. And there is less evidence for the presence of jumps in the index than in its components, and less evidence for infinite activity jumps than in the components, or at least less active small jumps.

Of course, we do not claim on the basis of this limited evidence that these empirical results are in any way "universal": they are likely in general to depend upon the assets under consideration, the time period, what type of data are used (transactions, quotes, etc.), among other considerations. The methodology employed on U.S. Treasuries allows Dungey and Yalama (2010) to document interesting differences between the properties of the price process before and during the 2007–08 acute phase of the recent financial crisis.

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