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## Constructing Volatility Model of Portfolio Return by Using GARCH

**Tarop**

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### Abstract

The aim of this research is forecasting volatility of portfolio return using GARCH model. Portfolio return is combination of several return assets. The mean model of stock return is constructed using Autoregressive Integrated Moving Average (ARIMA), and the variance is determined using GARCH model. Based on squares of residual that yielded from mean model, the variance model is constructed using GARCH. The optimal GARCH model is implemented for forecasting volatility of several stock return such as Bank Mandiri (BMRI), Bank BCA (BBCA), Unilever (UNVR) stock return and their portfolio as case studies. The weight(proportion) of each asset in the portfolio return is determined based on Lagrange Multiplier Method.

**Keywords:** Portfolio return, Volatility, ARIMA, GARCH.

### 1. Introduction

Financial time series data are usually characterized by volatility clustering, persistence autocorrelation and leptokurtic behavior [1, 2, 3, 4, 5]. The data are

usually non-stationary and non-linear [3, 4, 5]. One of the most popular models which applied for time series modeling is ARIMA [6, 7, 8, 9, 10]. Whereas Autoregressive Conditional Heteroscedasticity (ARCH) model was proposed by Engle in 1982 [1] and Generalized Autoregressive Conditional Heteroscedasticity (GARCH) model that developed by Bollerslev in 1986 [2] are popular variance models. ARIMA-GARCH has been applied in a lot of research for forecasting financial time series data [11, 12, 13, 14, 15]. The aim of this research is forecasting volatility of portfolio return using GARCH. The procedure of volatility modeling consists of two global steps, firstly, steps constructing mean model and secondly, steps of constructing variance model [1, 2, 3]. The remaining paper is organized as follows: section 2 discusses about basic concept of mean model (Box-Jenkins ARIMA) and variance model (ARCH/GARCH); section 3 discusses about application GARCH model for forecasting volatility of LQ-45 stock return; and the conclusion is discussed in section 4.

## 2. Basic Concept of Mean and Variance Models

Basic concept of time series analysis that discussed in this section covers general forms of mean model ARIMA and variance model ARCH/GARCH.

### 2.1 ARIMA Model

Autoregressive Integrated Moving Average (ARIMA) model is the method introduced by Box-Jenkins [2]. To date ARIMA become the most popular model for forecasting univariate time series data. Generally, ARIMA(p, d, q) model can be written as (see [6, 8, 10])

$$\phi_p(B)(1-B)^d Z_t = \theta_q(B)a_t \quad (1)$$

where  $\phi_p(B) = 1 - \phi_1 B - \phi_2 B^2 - \dots - \phi_p B^p$ ,

$$\theta_q(B) = 1 - \theta_1 B - \theta_2 B^2 - \dots - \theta_q B^q,$$

where  $B$  is backward shift operator,  $p$  and  $q$  denotes order of autoregressive and moving average respectively and  $d$  denotes order of differences.

### 2.2 Volatility Models

#### 2.2.1 GARCH Model

Given stationary time series  $Z_t$  such as financial return, so  $Z_t$  can be expressed as summation of its mean and a white noise [1, 2], if there is no autocorrelation among  $Z_t$  itself, i.e

$$Z_t = \mu_t + a_t \text{ and } a_t = \sigma_t \varepsilon_t \quad (2)$$

where  $\mu_t$  is process mean of  $Z_t$  and  $\varepsilon_t \sim N(0,1)$ . To investigate the volatility clustering or conditional heteroscedasticity, it is assumed that  $\text{Var}_{t-1}(a_t) = \sigma_t^2$ , where  $\text{Var}_{t-1}(\bullet)$  express conditional variance given information at time (t-1), and

$$\sigma_t^2 = \alpha_0 + \alpha_1 a_{t-1}^2 + \dots + \alpha_p a_{t-p}^2 \quad (3)$$

Because mean of  $a_t$  is 0,  $\text{Var}_{t-1}(a_t) = E_{t-1}(a_t^2) = \sigma_t^2$ . Therefore, Eq.2 can be written as:

$$a_t^2 = \alpha_0 + \alpha_1 a_{t-1}^2 + \dots + \alpha_p a_{t-p}^2 + u_t \tag{4}$$

where  $u_t = a_t^2 - E_{t-1}(a_t^2)$  is white noise with mean 0. Model (2) and (3) is called ARCH model [1].

In practice, the number of lags  $p$  are frequently large, then the number of parameters in the model that should be estimated are also very large. Bollerslev (1986) proposed more parsimonious model to substitute AR model (3) with equation below [2].

$$\sigma_t^2 = \alpha_0 + \sum_{i=1}^p \alpha_i a_{t-i}^2 + \sum_{j=1}^q \beta_j \sigma_{t-j}^2 \tag{5}$$

where  $\alpha_i > 0$  ( $i = 0, 1, 2, \dots, p$ );  $\beta_j > 0$  ( $j = 1, 2, \dots, q$ ) to guarantee that conditional variance  $\sigma_t^2$  is always positive. Eq.5 together with Eq.2 is called as generalized ARCH or GARCH( $p, q$ ). If  $q=0$  the GARCH model become ARCH model [1].

### 2.2.2 EGARCH Model

Nelson proposed Exponential GARCH (EGARCH) model with leverage effect that written as follow [7].

$$h_t = \alpha_0 + \sum_{i=0}^p \alpha_i \frac{|a_{t-i}| + \gamma_i a_{t-i}}{\sigma_{t-i}} + \sum_{j=0}^q \beta_j h_{t-j} \tag{6}$$

where  $h_t = \ln \sigma_t^2$ . The conditional variance of EGARCH  $\sigma_t$  is guaranteed to be positive regardless the coefficients in model (6), because  $\ln \sigma_t^2$  has substituted to  $\sigma_t^2$  itself in the model [5].

### 2.3 Portfolio Return

Portfolio return is summation of single asset stock return multiplied by its weight (proportion). The weight of each stock to be determined based on Lagrange Multiplier method. The optimal weight can be solved by minimizing portfolio variance function with constraint  $\mathbf{w}^T \mathbf{1}_N = 1$  [13]. Define the portfolio variance as:  $\sigma_p^2 = \frac{1}{2} \mathbf{w}^T \Sigma \mathbf{w}$ .

Minimizing function  $\frac{1}{2} \mathbf{w}^T \Sigma \mathbf{w}$  with respect to  $\mathbf{w}$  is equivalent to minimizing function  $\mathbf{w}^T \Sigma \mathbf{w}$ . The aim of minimizing function  $\frac{1}{2} \mathbf{w}^T \Sigma \mathbf{w}$  is minimizing risk based on the mean of portfolio return. Mathematically, it can be written as:  $\min(\sigma_p^2) = \min_{\mathbf{w}} \left( \frac{1}{2} \mathbf{w}^T \Sigma \mathbf{w} \right)$  with constraint  $\mathbf{w}^T \mathbf{1}_N = 1$ . The optimization problem can be solved by using Lagrange function.

$$L = \frac{1}{2} \mathbf{w}^T \Sigma \mathbf{w} - \lambda (\mathbf{w}^T \mathbf{1}_N - 1) \tag{7}$$

where  $L$ : Lagrange function and  $\lambda$ : Lagrange multiplier. The optimal weight  $w$  is obtained by minimizing Eq.7. Based on theory of calculus, we obtain

$$w = \frac{\Sigma^{-1} \mathbf{1}_N}{\mathbf{1}_N^T \Sigma^{-1} \mathbf{1}_N}. \quad (8)$$

Therefore, the portfolio return of  $N$  assets can be determined using formula:

$$r_p = \sum_{i=1}^N w_i r_{t,i} \quad (9)$$

where  $w_i$ : weight of  $i$ -th asset and  $r_{t,i}$ : return of  $i$ -th asset.

### 3. Application

As an implementation of GARCH modeling for forecasting volatility of portfolio return, GARCH models to be constructed for forecasting volatility of Bank Mandiri (BMRI) stock return, Bank BCA (BBCA) stock return, Unilever (UNVR) stock return and their portfolio. The daily stock return of BMRI, BBCA and UNVR from 2 January 2013 until 16 April 2014 are used for constructing models (see [www.finance.yahoo.com](http://www.finance.yahoo.com)).

Procedure of GARCH modeling can be divided into two main steps, the first one are mean modeling steps and the second one are variance modeling steps. The steps of constructing ARIMA model consists of model identification, parameter estimation, and verification model. The estimated model that satisfied all of the assumptions can be used for forecasting, but if the estimated model didn't satisfy the assumption especially homoscedasticity assumption (there is GARCH effect) then the variance model should be constructed. The model should be constructed based on the squares of residual. Results of constructing GARCH models for forecasting volatility of single asset and portfolio can be described as follows.

#### 3.1 Forecasting volatility of single asset

##### 3.1.1 Forecasting volatility of BMRI

Estimated model of BMRI return is: ARIMA([2], 0, [2])-EGARCH(1, 1) that can be written as:  $r_t = 0.7133r_{t-2} - 0.8350a_{t-2} + a_t$ ,

where  $a_t \sim N(0, \sigma_t^2)$  and

$$\ln(\sigma_t^2) = -0.1237 - 0.0880 \left| \frac{a_{t-1}}{\sigma_{t-1}} \right| - 0.1076 \frac{a_{t-1}}{\sigma_{t-1}} + 0.9741 \ln(\sigma_{t-1}^2).$$

##### 3.1.2 Forecasting volatility of BBCA

The estimated model of BBCA stock return is: ARIMA(2, 0, 2)-GARCH(1, 1) that can be written as:

$$r_t = -0.5899r_{t-1} - 0.9820r_{t-2} + 0.5657a_{t-1} + 1.0302a_{t-2} + a_t$$

where  $a_t \sim N(0, \sigma_t^2)$  and  $\sigma_t^2 = 0.000044 + 0.050571a_{t-1}^2 + 0.83505\sigma_{t-1}^2$ .

**3.1.3 Forecasting volatility of unilever (UNVR)**

Estimated model of UNVR stock return is: ARIMA([2], 0, [2])-IGARCH(1, 1) that can be written as:

$$r_t = 0.9303r_{t-2} - 0.9941a_{t-2} + a_t,$$

where  $a_t \sim N(0, \sigma_t^2)$  and  $\sigma_t^2 = 0.0263a_{t-1}^2 + 0.9737\sigma_{t-1}^2$ .

The result of predicted volatility of single asset return BMRI, BBCA and UNVR are respectively shown as Figure 1, Figure 2 and Figure 3.

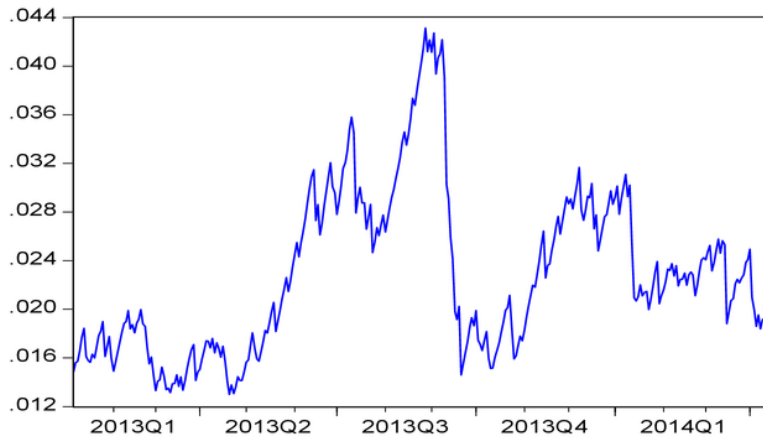


Figure 1: The estimated volatility of BMRI

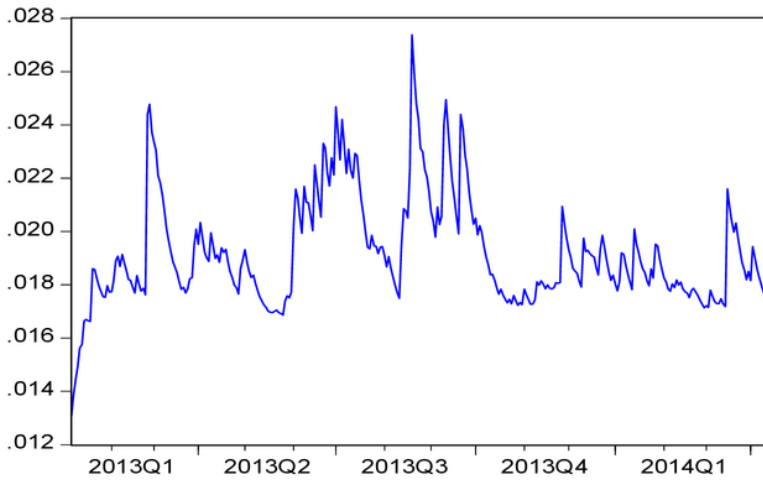
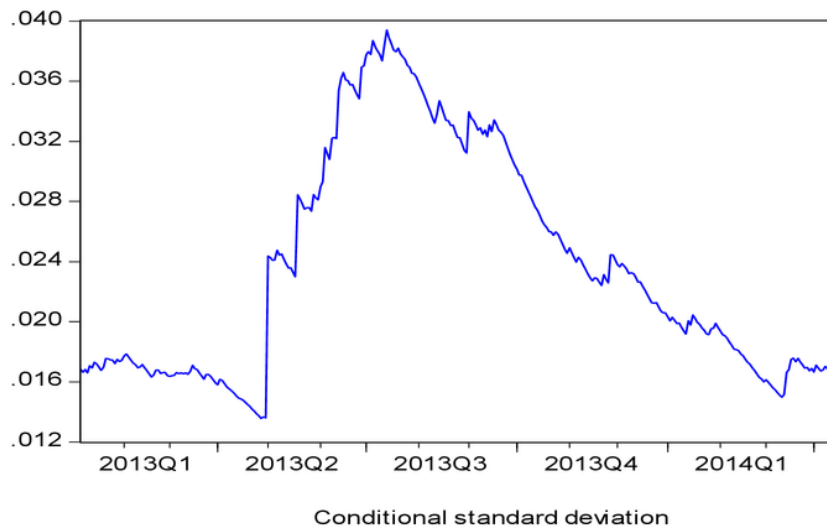


Figure 2: The estimated volatility of BBCA



**Figure 3:** The estimated volatility of UNVR

### 3.2 Forecasting volatility of portfolio asset

#### 3.2.1 Forecasting volatility of portfolio: BMRI and BBCA

The weight of each asset is calculated by minimizing Lagrange multiplier function. The weight of BMRI and BBCA is 23% and 77% respectively. Portfolio return is determined using Eq.9. The constructed model of portfolio return is: ARIMA([2], 0, [2])-GARCH(1, 1) that can be written as:

$$r_t = -0.8121r_{t-2} + 0.8337a_{t-2} + a_t,$$

where  $a_t \sim N(0, \sigma_t^2)$  and  $\sigma_t^2 = 0.000037 + 0.0598a_{t-1}^2 + 0.8387\sigma_{t-1}^2$ .

#### 3.2.2 Forecasting volatility of portfolio: BMRI and UNVR

The optimal weight of BMRI and UNVR is 48.5% and 51.5%. By using Eq.9, the estimated model of portfolio return is: ARIMA(2, 0, 2)-GARCH(1, 1) that can be written as:

$$r_t = 1.5051r_{t-1} - 0.9187r_{t-2} - 1.5541a_{t-1} + 0.9509a_{t-2} + a_t$$

where  $a_t \sim N(0, \sigma_t^2)$  and  $\sigma_t^2 = 0.0000097 + 0.05114a_{t-1}^2 + 0.92679\sigma_{t-1}^2$ .

#### 3.2.3 Forecasting volatility of portfolio: BBCA and UNVR

The optimal weight of BMRI and UNVR is 48.5% and 51.5% respectively. Return portfolio is determined using Eq.13. The estimated model of portfolio stock return is: ARIMA([3], 0, 0)-EGARCH(1, 1) that can be written as:

$$r_t = -0.1076r_{t-3} + a_t, \text{ where } a_t \sim N(0, \sigma_t^2), \ln(\sigma_t^2) = -0.3811 - 0.1078 \left| \frac{a_{t-1}}{\sigma_{t-1}} \right| + 0.9619 \ln(\sigma_{t-1}^2).$$

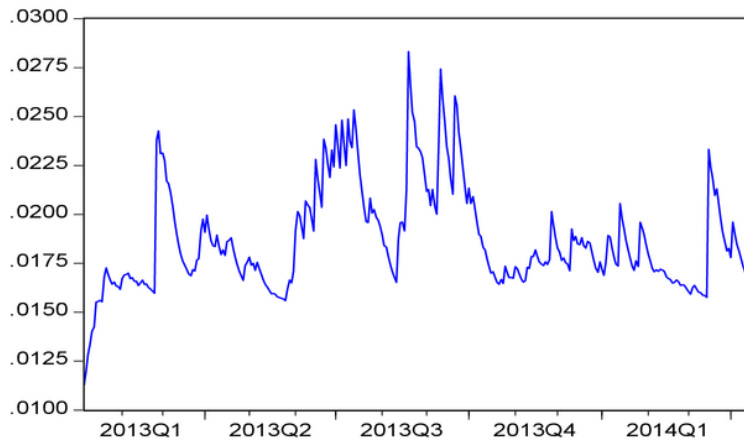
**3.2.4 Forecasting volatility of portfolio: BMRI, BBCA and UNVR**

The optimal weight of BMRI, BBCA and UNVR is 15.8%, 59.2% and 25.0% respectively. Portfolio return is determined using Eq.9. The estimated model of portfolio return is: ARIMA([2], 0, [2])-IGARCH(1, 1) that can be written as:  $r_t = 0.9018r_{t-2} - 0.9950a_{t-2} + a_t$ ,

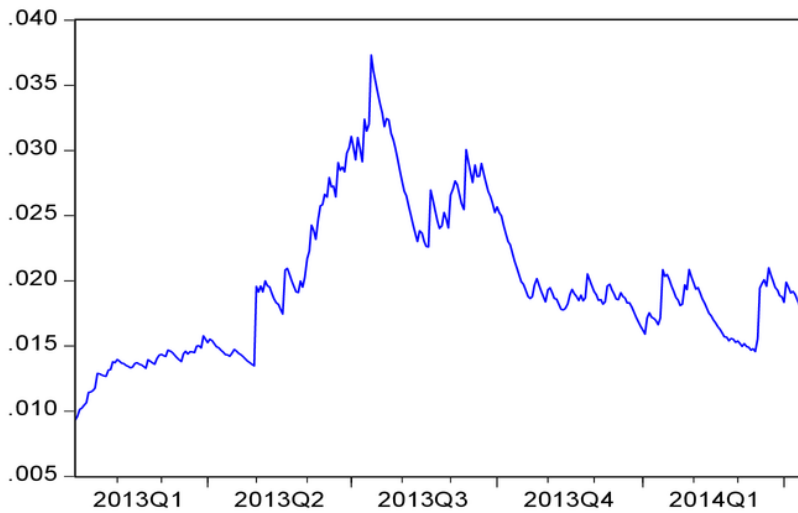
where  $a_t \sim N(0, \sigma_t^2)$  and  $\sigma_t^2 = 0.0305a_{t-1}^2 + 0.9695\sigma_{t-1}^2$ .

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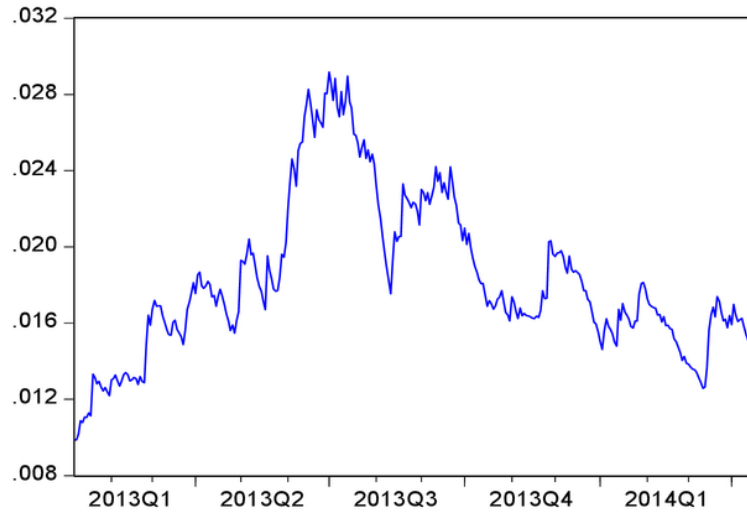
The result of predicted volatility of portfolio return are shown as Figure 4, Figure 5, Figure 6 and Figure 7 below.



**Figure 4:** The estimated volatility of portfolio (BMRI and BBCA)



**Figure 5:** The estimated volatility of portfolio (BMRI and UNVR)



**Figure 6:** The estimated volatility of portfolio (BBCA and UNVR)



**Figure 7:** The estimated volatility of portfolio (BMRI, BBCA and UNVR)

The examples of predicted volatility for single asset return of BMRI, BBCA and UNVR and their portfolio return from 3 April 2014 until 15 April 2014 are given on Table 1.

**Table 1.** Predicted volatility of BMRI, BBCA, UNVR and their portfolio return

Date	Predicted Volatility							
	BMRI	BBCA	UNVR	BMRI, BBCA	BMRI, UNVR	BBCA, UNVR	BMRI, BBCA, UNVR	
4/3/2014	0.0199	0.0190	0.0169	0.0189	0.0195	0.0145	0.0153	
4/4/2014	0.0186	0.0186	0.0167	0.0184	0.0191	0.0142	0.0152	
4/7/2014	0.0195	0.0183	0.0168	0.0181	0.0192	0.0142	0.0151	
4/8/2014	0.0184	0.0180	0.0170	0.0178	0.0190	0.0141	0.0151	
4/9/2014	0.0192	0.0177	0.0169	0.0174	0.0186	0.0139	0.0149	
4/10/2014	0.0192	0.0175	0.0167	0.0171	0.0181	0.0136	0.0147	
4/11/2014	0.0206	0.0173	0.0165	0.0173	0.0190	0.0133	0.0147	
4/14/2014	0.0202	0.0176	0.0175	0.0174	0.0191	0.0141	0.0152	
4/15/2014	0.0210	0.0176	0.0173	0.0173	0.0187	0.0140	0.0150	

#### 4. Conclusion

Based on the in sample data of return BMRI, BBCA and UNVR as case studies, the optimal weight of each asset can be determined using Lagrange Multiplier method for constructing portfolio return. The volatility of portfolio return can be predicted. The GARCH model can work well for forecasting volatility of BMRI, BBCA, UNVR and portfolio return.

#### 2 Acknowledgement

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