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Isobars and the Efficient Market Hypothesis

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Abstract:
Isobar surfaces, a method for describing the overall shape of multidimensional data, are estimated by nonparametric regression and used to evaluate the efficiency of elected markets based on returns of their stock market indices.

Keywords: Isobars, Efficient market hypothesis, Nonparametric regression, Extreme value theory

JEL: C14; G14

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Introduction

This article describes the isobar surfaces approach, which finds a one-dimensional ordering of multidimensional data, and surfaces in $\mathbb{R}^d$ that enclose the $u$-th quantile of the data distribution according to the one-dimensional ordering.

An isobar maps every direction to a particular distance from a center (specified by the quantile function). The resultant surface for a fixed quantile $u$ is also called an isobar.


P. Jacob, the second author of [1], focused on practical estimation of the isobar shapes. The article [2] focuses on estimation of the edge of the bounded support using nonparametric regression and [3] extends this method for unbounded support using asymptotical location and isobars.

In our article, we use the shape of the isobar surfaces to test the efficient market hypothesis stating that returns of efficient stock market indices have the behaviour of Brownian motion. The hypothesis is stated e.g. in [4]. Various reasons for deviations from this hypothesis for otherwise efficient markets were discussed in the literature.

The first part is concerned with theory and estimation of isobars. In the second part we perform a simulation study for Gaussian distribution with different parameters and an assessment of the shape and stability of the resulting isobars. In the third part we’ll estimate isobars for returns of seven stock market indices and their lagged values and evaluate the efficient market hypothesis for each index. Finally, we summarize the results and outline future progress.

Isobar surfaces and their estimation

Isobars are defined in generalized polar coordinates, so a coordinate transformation of data is required beforehand. The transformation of a non-
zero vector \( x \in \mathbb{R}^d \) to generalized polar coordinates is
\[
 r = \| x \|_2, \quad \theta = \frac{x}{\| x \|_2},
\]
where \( \| x \|_2 \) is the Euclidean norm of the vector \( x \). Observe that the generalized angle \( \theta \) lies on \( S^{d-1} \), the sphere of unit radius in \( \mathbb{R}^d \).

We’ll use the definition of isobar as it appears in [1], page 2. For every \( u \in (0, 1) \), the \( u \)-level isobar is defined as a mapping of a fixed \( \theta \) to the value of the inverse distribution function of the Euclidean distance from the origin:
\[
 \theta \rightarrow F_{R|\Theta}^{-1}(u).
\]

The name “\( u \)-level isobar” will also be used interchangeably for the surface \( S_u = F_{R|\Theta}(u) \) determined by each \( \theta \) with a fixed quantile \( u \) in the inverse of the conditional distribution function \( F_{R|\Theta}(r | \theta) \). We also need the distribution function to be a bijection so that its inverse exists. The introduced mapping is assumed to be continuous and strictly positive.

A description of the ordering of multidimensional data by quantiles follows. Consider a sample of \( n \) independent realizations of the random variable \( X = (R, \Theta) \) whose multidimensional realizations comprise our sample needs to satify certain requirements. We assume continuity of the mariginal density \( f_{\Theta}(\theta) \), conditional density \( f_{R|\Theta}(r | \theta) \) and the conditional distribution function \( F_{R|\Theta}(r | \theta) \). We also need the distribution function to be a bijection so that its inverse exists. The introduced mapping is assumed to be continuous and strictly positive.

A description of the ordering of multidimensional data by quantiles follows. Consider a sample of \( n \) independent realizations of the random variable \( X = (R_i, \Theta_i) \), \( 1 \leq i \leq n \). For every \( i \) there exists an unique \( u_i \)-level isobar containing the point \( X_i \). Denoting \( X_{i,n} \) the realizations ordered by their respective quantile values \( u_i \), the maximum value is given by the point \( X_{n,n} \) which belongs to the upper-level isobar with level \( \max_{1 \leq i \leq n} u_i \).

In practice, we’ll assess the 1-level isobar on the grounds of the asymptotical location property as described in [3]. For large \( n \), the furthest points from the origin lie near the \( \frac{n-1}{n} \)-level isobar. The 1-level isobar is then simply the edge of the bounded support. Citing Definition 3 from [3], page 175:

The distribution of r.v. \( X \) on \( \mathbb{R}^d \) is said to have the asymptotical location property if a.s. for each \( \epsilon > 0 \) and each sample \( X_i, 1 \leq i \leq n \), with the same distribution as \( X \) and with size \( n \geq n_0 = n_0(\epsilon, \omega) \):
\[
 \inf_{x \in S_{(n-1)/n}} \text{dist}(x, X_{n,n}) \leq \epsilon \quad \text{and} \quad \sup_{x \in S_{(n-1)/n}} \min_{1 \leq i \leq n} \text{dist}(x, X_i) \leq \epsilon,
\]
where \( \omega \) is an elementary event of the sample space \( \Omega \).

Isobar estimation is performed by the non-parametric regression of [2, 3]. For the estimation we’ll assume homotheticity of isobars, e.g. for some strictly positive continuous function \( v(\theta) \) and a distribution function \( G \),
\[
 F_{R|\Theta}(r | \theta) = G \left( \frac{r}{v(\theta)} \right) \quad \text{for } r \in [0, v(\theta)].
\]
The function $v(\theta)$ corresponds to the 1-level isobar and unambiguously describes the shape of all isobars. The distribution of $\frac{x}{v(\theta)}$ is spherically symmetric and it can be fully described by $G$ on $[0, 1]$.

We estimate $v(\theta)$ using radial regression:

$$w(\theta) = E(R \mid \Theta = \theta) = \int_0^{v(\theta)} \left(1 - G\left(\frac{r}{v(\theta)}\right)\right) dr = c v(\theta),$$

where $c$ is the expected value of $G$. The estimate of the expected value of $R$ given $\Theta = \theta$ describes the shape of 1-level isobar up to a multiplicative constant. This constant is chosen in a way that the estimated expected value shape $\hat{w}(\theta)$ contains the whole data after scaling:

$$\hat{v}(\theta) = \frac{\hat{w}(\theta)}{\hat{c}}, \quad \text{where} \quad 1/\hat{c} = \max_{1 \leq i \leq n} \frac{R_i}{\hat{w}(\Theta_i)}.$$

The original method in [2] performs non-parametric regression on data transformed from generalized polar coordinates $(r, \theta)$ into hyperspherical coordinates $(r, \varphi)$, resulting in the estimate of $w(\varphi_1, \ldots, \varphi_{d-1})$. This parametrization, however, suffers from pole singularities in higher dimensions ($d > 2$), which hurts non-parametric regression. Therefore we propose to estimate $w(\theta)$ in the domain $(r, x)$ after projecting the data on the unit sphere $S^{d-1}$ and adding $r$ as an extra coordinate. The estimate of $w(\theta)$ then corresponds to the estimate of $w(x)$ constrained to $x \in S^{d-1}$. This method is a little slower due to the extra coordinate, but doesn’t suffer from degeneracies. In the following, we’ll use and evaluate both methods.

**Simulation study – normal distribution**

Since we assume Brownian motion for data obtained from efficient markets, we need to know how non-parametric isobar shape estimation behaves in the ideal case of normal distribution.

Computations were performed in the R environment for statistical computing. For multidimensional non-parametric regression the np package was used. The best results were obtained by choosing locally-weighted linear regression, Gaussian kernels and $k$-nearest-neighbour kernel bandwidth estimation.

We’ve estimated isobar shapes of two-dimensional Gaussian distribution samples with zero mean and several covariance matrices. We’ve tested various sample sizes ($n$: 100, 300, 1000 or 3000) from distributions with diagonal covariance matrices (variances $(1, 1)$ or $(1, 9)$) and from distributions with non-zero covariances (variances: $(1, 1)$, covariances: 0.2 or 0.8).
An excerpt of the results is shown in Figures 1 and 2. Inner shapes represent the expected value estimation $\hat{w}(\theta)$, outer shapes represent the estimation of the 1-level isobar $\hat{v}(\theta)$. The result for the hyperspherical parametrization of [2] is green while the result of the proposed projection approach is red (in the case of overlap only the red curve is visible). The farthest point for each parametrization is highlighted.

The obtained isobar shapes started resembling circles (uncorrelated marginals with equal variances) and ellipsoids (unequal variances or corellated marginals) around sample sizes 300 and 1000.

The most time-consuming part of estimation is bandwidth selection. Both parametrizations get stuck in local minima – the hyperspherical parametrization often averages all data ($k = n$), while the projection approach has better details, but may overfit ($k$ too small). We solve the problem by allowing the algorithm to take multiple restarts of the randomized bandwidth search, but
for larger $n$, the speed of this approach can become prohibitive. We’ve chosen 5 and 10 restarts for the hyperspherical and projection approach, respectively.

Since the software doesn’t support periodic domains needed in the hyperspherical parametrization, we had to emulate this functionality by placing copies of the data along multiples of $2\pi$. This has slowed the estimation to the level of the second parametrization, which needs an extra coordinate. The results have shown that both parametrizations perform equally well, at least in the case of $d = 2$.

**Application – stock market indices**

After the choice of methods of isobar shape assessment we’ll proceed to their application to stock market index returns.

The efficient market hypothesis states that returns (closing—opening price)
of market indices in efficient markets follow Brownian motion (see e.g. [4]). In practice, this assumption is mostly violated by the periodic structure (day, week, quarter, year) of agent behaviour. Further bias mostly reveals non-rational behaviour, non-zero information costs or delayed reactions. Our goal is to measure the efficiency of a market using isobar shapes.

Our data consists of weekly closing and opening prices for the past ten years (sample size around 500) obtained from the Reuters Wealth Manager service.

The $y$-axis denotes the current value of stock market index returns, the $x$-axis denotes their lagged values. Under the efficient market hypothesis, the isobar shape for this configuration should be close to a circle (since Brownian motion is independent with itself when lagged).

We’ve applied the method on seven stock market indices. We’ll shortly summarize them before presenting the results:

- The NASDAQ Composite Index is comprised of 2742 stocks of the NASDAQ Stock Market.
- The PX Index is comprised of 14 stocks of the Prague Stock Exchange (only five of which are Czech).
- The BUX Index: 13 Hungarian stocks of the Budapest Stock Exchange.
- The BET Index: 10 Romanian stocks of the Bucharest Stock Exchange.
- The BELEX15 Index: 15 Serbian stocks of the Belgrade Stock Exchange.
- The JSX Composite Index: 379 Indonesian stocks of the Indonesia Stock Exchange.
- The Straits Times Index: 30 stocks of the Singapore Exchange.

We’ve studied isobar shapes for lags between one and fifteen weeks. Isobar shapes for the NASDAQ Composite Index (Figure 3) are very close to circles except for the 13-week lag, which can be explained by the expected quarterly periodicity of agent behaviour. Based on visual examination, the market of NASDAQ may follow the efficient market hypothesis.

Isobar shapes for the Straits Times Index, BET and BELEX15 (Figures 9, 6 and 7, respectively) differ from circles in a few lags: for Straits Times Index it’s the 7-, 12- and 15-week lag. Only lag 7 differs from a circle significantly – a significant dependence can’t be conjectured. For BET, observe lags of 2, 3, 11 and 13 weeks: the deviations are distinctive, which suggests short-time dependency in the data. For BELEX15, significant deviations can be seen for lags 3, 7, 10, 12 and 13 – we can conjecture heavy data dependencies.
The isobar shapes of the PX Index, BUX and JSX Composite Index (Figures 4, 5 and 8) deviate from circles: for PX it’s the longer lags of 4, 7, and 10–14 weeks, for BX it’s 3 and 5–15 weeks. Isobars for the JSX Composite Index doesn’t resemble a circle for any lag. Observing a systematic deviation from independence between current values and lagged ones, we can postulate that the efficient market hypothesis doesn’t apply to markets described by these indices.

A few times the search for the optimum bandwidth has resulted in a “wild” isobar shape (appearing e.g. in the PX Index two-week lag). We postulate that this is a local minimum of the objective function – the five-fold increase of the number of restarts (as opposed to the simulation study) might not be sufficient yet. This can be resolved by a further increase of the number of restarts, or by a change of the search algorithm. Another possibility is to switch to a different software package.

Our future goal is to create a measure of market efficiency. Since this can be formulated as similarity of the isobar shape to a circle, this measure can be based on the number of neighbors included in the kernel during bandwidth selection.

Conclusion

We’ve investigated the possibilities of using the isobar surfaces approach with homothetic isobars for both simulated and real data. In the simulation study, we’ve found suitable methods for estimating non-parametric regression, the sample size needed for the application of our methods, and isobar shapes for Gaussian distributions with varying parameters. This knowledge was applied during the assessment of the efficient market hypothesis using isobar shapes. We’ve assessed the isobar shape for stock market index returns. For the NASDAQ Composite Index the shapes supported the efficiency hypothesis, for the PX Index, BUX and JSX Corporate Index we can reject the hypothesis. For the Straits Times Index, BET and BELEX15 it will be necessary to carry out a deeper study of dependence relations. During the estimation of the isobar shape by nonparametric regression we’ve encountered problems during the automated bandwidth selection – even with an increased number of parameter search restarts, the search still stays in local minima. The problem can be solved by changing to a different implementation of nonparametric estimation. This will allow us to focus on finding an objective measure of market efficiency in our future work.
References


Figure 3: Lags of 1–15 weeks for the NASDAQ Composite Index.
Figure 4: Lags of 1–15 weeks for the PX Index.
Figure 5: Lags of 1–15 weeks for the BUX Index.
Figure 6: Lags of 1–15 weeks for the BET Index.
Figure 7: Lags of 1–15 weeks for the BELEX15 Index.
Figure 8: Lags of 1–15 weeks for the JSX Composite Index.
Figure 9: Lags of 1–15 weeks for the Straits Times Index.
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