

Examining the Presence of Long Memory in Volatility, Nifty-50 and BSE Sensex Returns

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Abstract: This paper tests the presence of long term memory in volatility, Nifty-50 and BSE Sensex returns. The objective of this study is to examine the potentially predictable component through presence of long memory in the return series and volatility dynamics. Findings would be beneficial for the investors, practitioners, academics and policy makers etc. The study has used Rescaled range analysis as proposed by Lo (1991) 'Hurst Exponent' to measure the presence of long memory in returns and volatility from January 2000 to December 2017. Evidence indicates that Sensex and Nifty-50 returns series exhibit long memory. However, volatility does not show any persistence but exhibit clustering.

Keywords: Hurst exponent, Long Memory, Market Efficiency Volatility Clustering,

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I. Introduction

The objective of stock market is optimum allocation of capital within and across economies in addition to this diversification of risk (Fama, 1970). For understanding of stock market efficiency, it is imperative to test the efficient market hypothesis. According to weak form of market efficiency that forecasting of assets returns based on past information's is not possible. Although, several studies show that asset returns display considerable autocorrelation between the observations. The presence of long memory is defined in term of persistence of autocorrelation; which means assets returns are serially correlated (past returns can help to predict the future returns). The present study deals with Long Term Memory, which implies that the new information is reflected in prices slowly and this adjustment takes a comparatively longer period of time. Peter, 1994 observed that most of the times, economic time series holds long memory, which implies that what happens today is going to influence prices over an indefinite period of time. In addition, returns are dependent over the period of time; as a result future returns can be forecasted by using past prices (Turkyilmaz and Balibey, 2014).

Presence of long memory is an indicator for anticipating the asset returns, which reflects the dynamic behavior of time series. This would be beneficial to earn money from speculative activities and managing the portfolio in order to get the profitable returns from the market (Nikoomaram and Anbarestani (2012), Kasman et al., (2009), Badani (2008) and Diebold and Inoue (2001)). The present study is an attempt to examine whether long memory exists in the Indian Equity Market. If time series demonstrate long memory, the distant observations display significant autocorrelation. Therefore, the series realizations are not independent over time and past returns can predict future returns, thus violating the market efficiency hypothesis. The paper is organized as follows. Section II reviews the literature. Section III describes the data base and research methodology. Section IV presents results and analysis and Section V presents conclusion of the study.

II. Review Of Literature

The initial work on long memory in asset returns is derived largely from of Hurst (1951), Greene and Fietlitz (1977) and Aydogan and Booth (1988) and Lo (1991). They does not found evidence of long memory in US stock returns. However, Mandelbrot (1971) argued that the random walk and Martingale models of speculative prices may not be realizable through arbitrage in the presence of long-term memory. Hereafter, Lo (1991) observed that the reported anomalous behavior of stock returns can be a symptom of long memory dynamics. In addition, Badani (2008) examined the behavior of stock returns and volatility in India and found that returns do not show long memory but squared returns and absolute value (which represent the volatility) show long range dependences. However, in the sub-sample covering the period March 2001 to December 2007, the volatility measures do not show long memory.

In addition, Hiremath and Bandi (2010) explored that in recent scenario there is increasing interest among researchers, investors, and practitioners to understand the behavior of Indian stock market. They advocate that thin trading, high volatility and various frictions generally characterize the stock market of emerging market economies. This asserts that due to these imperfections long memories could exist in the

emerging markets. Ma et al., (2006) investigated the long term memory in Chinese stock market and they found that though returns themselves contain little serial correlation, the variability of returns has significant long term memory. Goudarzi (2010) observed long memory in Indian stock market by using BSE500 returns and found that leverage effect is significant in BSE 500 returns and asymmetric volatility model turn out to be superior. Similarly, Verma (2008) investigated the long memory in daily returns of 60 companies with around 62% of the total market capitalization over a period of five year and results indicate that returns of only three companies exhibit long range dependence.

Bhattacharya and Bhattacharya (2012) observed the long term property in ten global emerging markets. Their findings indicate that presence of long memory in volatility as well as in absolute returns. However, the study did not support existence of Taylor effect on the selected emerging markets. Chen and Diaz (2013) investigated long memory and shift in the returns of green and non-green exchange traded funds and they found that there is no significant long memory process among green ETFs. However, there is a presence of long memory attributes¹ in the volatility for non green ETFs. Henry (2002) has investigated long memory in international stock markets and evidence advocate that long memory present in the German, South Korean, and Taiwanese markets. Hiremath and Kamaiah (2010) argued that the issue of long memory has important implication for the theory of finance and practical application, yet has not much attention received in India.

Furthermore, several authors raise the issue of whether the long memory effect is spurious or real by detecting period of volatility shifts and implementing long memory. Assaf (2004 and 2007) found long memory appears to be real and not due to structural shifts in the variance for several stock markets of Middle East and Africa (MENA) region. On the contrary, Chung, et al (2000) found empirical evidence support spurious long memory due to shifts in variance for a group of Asia-Pacific markets. Jayasuriya (2009) advocated in sub-period analysis that there exists no clear link between long term-memory and structural changes in volatility. Cevik and Emec (2013) indicate that Turkey financial market shows long memory as it does not respond to Arab Spring, but reacts to it gradually over time.

In addition, spillover effect also play vital role in price movement from one economy to another. Hamao et al., (1990) provided some evidence for spillover effects from New York to Tokyo, but not from Tokyo to either to New York or London. Lee (2001) found strong evidence for the price as well as volatility spillover effects from the US stock markets to the Korean counterparts but not vice versa. As Lee (2001) discussed international spillover effect between the developed market (the US, Japan and Germany) and the emerging markets in the MENA (Middle East and North American) region (Turkey and Egypt). These finding advocate that price as well volatility spillover effects exist from the developed stock market to MENA counterparts but not vice versa.

Kang et.al (2009) explored Japanese and Korean stock market covering the 1986-2008 period to examine the persistence of volatility in variance. They used ICSS-GARCH models and corroborated the influence of sudden changes, thereby indicating the fact that volatility models can enhance forecasting ability. To recapitulate, price spillover effects are found from Japanese markets to Indian market counterpart and vice versa. But evidence of price spillover effect from either the US or the UK stock markets and vice versa. Little evidence also found for price spillover effects from the developed stock market to emerging Indian counterpart. In addition, Sadique and Silvapulle (2001) advocate that Korea, Malaysia, Singapore and New Zealand have long memory property in mean returns. This study also focused that the size and strength of long memory is an important issue. Empirical evidence suggested that emerging markets possess the stronger long- range dependence in equity returns than the developed countries, but this is not true for volatility (Cajueiro and Tabak, 2008). In addition, there are some studies which have focused on long memory in volatility in developed markets particularly the US (Ding et al., 1993; Crato and Lima 1994; Dig and Granger 1996; Andersen and Bollerslev 1997; Granger et al., 1997; Lobato and Savin 1998; Andersen et al., 2003, Andersen 2005, Gurgul and Wojtowicz 2006).

Empirical evidence suggested by Badani (2008,2009) that index return does not show the long memory property but found stronger long range dependence in volatility which is possibly caused by structural breaks rather than true fractional integration. Danilenko (2009) investigated the existence of long memory of Baltic sector indices and evidence shows that industrial sector exerts stronger long term dependence than in other sectors, as utilities and health care sectors show weak long term dependence. In related study, Cavalcante and Assaf (2002) investigated the long memory in returns and volatility of Brazil Stock market and result supports that long memory is found in not only in returns, but also in absolute return squared returns and modified log-squared returns.

¹For example see, Ding et al., 1993; Crato and Lima 1994; Dig and Granger 1996; Andersen and Bollerslev 1997; Granger et al., 1997; Lobato and Savin 1998; Andersen et al., 2003, Andersen 2005, Gurgul and Wojtowicz 2006, Badani (2009), Sadique and Silvapulle (2001), Danilenko (2009).

Empirical evidence found regarding predictable structure of volatility indicates that Pakistan stock market is inefficient in weak form (Turkyilmaz and Balibey, 2014). Tolvi (2003) examined the presence of long memory in Finnish stock market returns and found that there was significant long memory detected in 24% to 64% of the series. In addition, Onour (2010) examined long memory and persistence of shocks in North Africa stock markets (Egypt, Tunisia and Morocco) and results indicate that shocks of in these markets do not persist for long period and futures returns can be better predicted by using most lagged returns. In nutshell, plethora of literature is available in emerging as well developed markets. However here is dearth of empirical research on examining presence of long memory in Indian Equity Market. The present study aims to plug this gap.

III. Research Design

3.1 Sample and Period of study

The present study use daily data from National Stock Exchange of India (NSE) and Bombay Stock Exchange of India (BSE) from January 2000 to December 2017 and for VIX the data is available from 2009 to 2017. The present study has calculated long memory component for each year from January 2000 to December 2017 to check whether the presence of long memory is due to structural breaks, regime shift, market friction, political changes and market microstructure etc.

3.2 Methodology

Daily returns are computed as the difference in the natural logarithm of the closing index value for the two consecutive trading days. It can be presented as:

$$R_t = \ln(P_t/P_{t-1}) \text{ or } R_t = \ln(P_t) - \ln(P_{t-1}) \quad \text{Equation 1}$$

Where R_t is natural logarithmic daily return at time t . P_{t-1} and P_t are daily prices of an asset at two successive days, $t-1$ and t respectively.

3.2.1 Hurst Exponent

To examine long memory, Hurst exponent is computed. The origin of the long memory test can be attributed to Hurst exponent 'H' which was developed in 1951 by Hurst to measure water related process. This exponent calculates for a given time series the long term non periodic dependence and also indicates how long the periodicity is consistent, then the standard autocorrelation will be able to pinpoint this long-term dependency in a given financial time series. Hurst exponent 'H' has three distinct classifications: where 'H' is equal to 0.5, it is considered to be a random series with process being white noise. If 'H' is greater than zero but less than 0.5, it indicates mean reversion wherein the prices will revert back to their mean values. In case 'H' lies between 0.5 and 1, it indicates the presence of the long memory properties and trend is clearly visible wherein the chances that a series will go up will be high if it has been in the last period. Similarly, a down trend will probably continue in future. The value of 'H' will determine whether there is strong pattern is on account of white noise. If 'H' is closer to 1, then the trend is strong and behavior pattern is likely to be repeated, if 'H' is close to 0.5 the pattern is not very clear and white noise may be persist in the series (Verma, 2008).

Table I. Description of data

| Index | No. of observations (N) | Period Covered |
|----------|-------------------------|----------------|
| Sensex | 4475 | 2000-2017 |
| Nifty-50 | 4431 | 2000-2017 |
| VIX | 2160 | 2009-2017 |

Result and Analysis: Table II presents the full period estimated long memory for returns of Sensex, Nifty-50 and VIX, using the Rescaled Analysis (Hurst Exponent). Findings indicate that during January 2000 to December 2017, Long memory was present in Sensex and Nifty-50 returns. This indicates that long memory component was present in Indian equity market. But evidence indicates that long memory does not exhibit in VIX return series during January 2009 to December 2017.

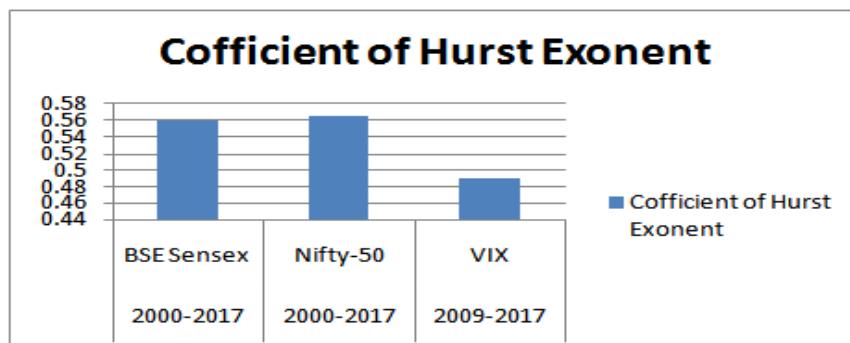
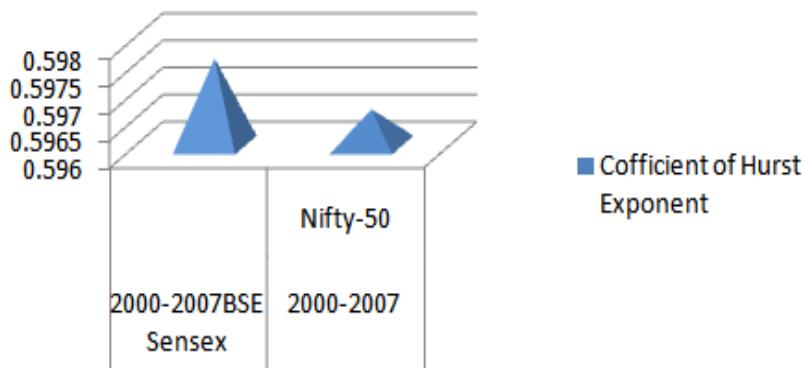


Table II: Full Period

| Period | Index | Hurst Exponent | Findings |
|-----------|----------|----------------|------------------------|
| 2000-2017 | Sensex | 0.567299653 | Long memory is present |
| 2000-2017 | Nifty-50 | 0.57229268 | Long memory is present |
| 2009-2017 | VIX | 0.499172262 | Long memory is absent |

A): Long Memory Pre-Crisis 2000-2007

Coefficient of Hurst Exponent



B) Long Memory Post Crisis 2008-2017

Coefficient of Hurst Exponent

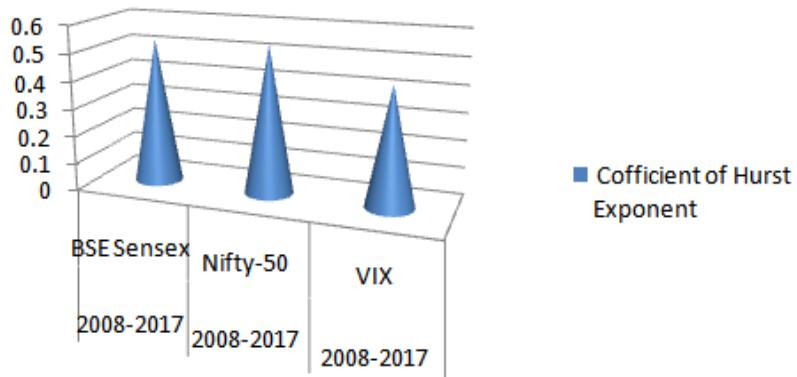


Table III: Pre-Crisis and Post-Crisis

| Period | Index | Hurst Exponent | Findings |
|------------|----------|----------------|------------------------|
| 2000- 2007 | Sensex | 0.597598723 | Long memory is present |
| | Nifty-50 | 0.596662276 | Long memory is present |
| | VIX | - | |
| 2008-2017 | Sensex | 0.487436075 | Long memory is absent |
| | Nifty-50 | 0.550269518 | Long memory is present |
| | VIX | 0.4963733361 | Long memory is absent |

Table III presents that Pre-Crisis and Post Crisis estimated long memory component in Indian Equity market. Pre-Crisis period shows the Sensex and Nifty-50 returns exhibit long memory component. Findings of Post- Crisis period advocates that long memory was absent for Sensex and VIX returns but present for Nifty-50 returns.

Table IV: Individual Year

| Period | Index | Hurst Exponent | Findings |
|--------|----------|----------------|-------------------------------|
| 2000 | Sensex | 0.506538459 | Long memory is present |
| | Nifty-50 | 0.509732721 | Long memory is present |
| | VIX | - | - |
| 2001 | Sensex | 0.604374161 | Long memory is present |
| | Nifty-50 | 0.604657888 | Long memory is present |
| | VIX | - | - |
| 2002 | Sensex | 0.574927987 | Long memory is present |
| | Nifty-50 | 0.591567719 | Long memory is present |
| | VIX | - | - |
| 2003 | Sensex | 0.671699887 | Long memory is present |
| | Nifty-50 | 0.652190925 | Long memory is present |
| | VIX | - | |
| 2004 | Sensex | 0.585650559 | Long memory is present |
| | Nifty-50 | 0.581935355 | Long memory is present |
| | VIX | - | - |
| 2005 | Sensex | 0.583025569 | Long memory is present |
| | Nifty-50 | 0.581541113 | Long memory is present |
| | VIX | - | - |
| 2006 | Sensex | 0.674753266 | Long memory is present |
| | Nifty-50 | 0.674165553 | Long memory is present |
| | VIX | - | - |
| 2007 | Sensex | 0.5798199 | Long memory is present |
| | Nifty-50 | 0.577506935 | Long memory is present |
| | VIX | - | |
| 2008 | Sensex | 0.530797642 | Long memory is present |
| | Nifty-50 | 0.552918531 | Long memory is present |
| | VIX | - | - |
| 2009 | Sensex | 0.63220715 | Long memory is present |
| | Nifty-50 | 0.611820064 | Long memory is present |
| | VIX | 0.476780857 | Long memory is absent |
| 2010 | Sensex | 0.586289281 | Long memory is present |
| | Nifty-50 | 0.584423652 | Long memory is present |
| | VIX | 0.517462286 | Long memory is present |
| 2011 | Sensex | 0.465222863 | Long memory is absent |
| | Nifty-50 | 0.484413728 | Long memory is absent |
| | VIX | 0.434908368 | Long memory is absent |
| 2012 | Sensex | 0.620191029 | Long memory is present |
| | Nifty-50 | 0.618220724 | Long memory is present |
| | VIX | 0.413057827 | Long memory is absent |
| 2013 | Sensex | 0.471290305 | Long memory is absent |
| | Nifty-50 | 0.49763313 | Long memory is absent |
| | VIX | 0.526893701 | Long memory is present |
| 2014 | Sensex | 0.52915534 | Long memory is present |
| | Nifty-50 | 0.538386383 | Long memory is present |
| | VIX | 0.619436413 | Long memory is present |
| 2015 | Sensex | 0.431676184 | Long memory is absent |
| | Nifty-50 | 0.43285916 | Long memory is absent |
| | VIX | 0.500307498 | Long memory is present |
| 2016 | Sensex | 0.59138519 | Long memory is present |
| | Nifty-50 | 0.61375029 | Long memory is present |
| | VIX | 0.482139739 | Long memory is absent |
| 2017 | Sensex | 0.51073425 | Long memory is present |
| | Nifty-50 | 0.48457989 | Long memory is absent |
| | VIX | 0.44515419 | Long memory is absent |

| | |
|--|------------------|
| The values of the Hurst exponent range between 0 and 1: $0 < H < 0.5$ | anti-persistence |
| $H = 0.5$ | random walk |
| $0.5 < H < 1$ | persistence |

Table IV presents the individual year estimated long memory for Sensex, Nifty-50 and VIX returns. A Sensex and Nifty-50 return shows the long memory during January 2000 to December 2000. Although, in 2001 long memory were strongly present in Sensex and Nifty-50 returns with 'H' value 0.604374161 and

0.604657888 as respectively. This indicates that return series are serially correlated. Furthermore, the study also examines the long memory during January 2002 to December 2002. Evidence advocates that long memory were present in Sensex and Nifty-50 returns with ‘H’ value 0.574927987 and 0.591567719 respectively, which show the dependent nature of return series. Moreover, long memory component were strongly found during January 2003 to December 2003 for Sensex and Nifty-50 returns with ‘H’ value 0.671699884 and 0.652190925 respectively, which indicates the future returns are correlated with past return.

During 2004, 2005, 2006, 2006 and 2007 long memory property were present in Sensex and Nifty-50 returns, which implies that return are serially correlated and contains dependent nature. This shows that investors are more dependent on previous returns while calculating the future returns. During the post crisis period 2008, Indian equity market also exhibit long memory behavior in return of Sensex and Nifty-50 with ‘H’ value 0.530797 and 0.552918531. Although, long memory were also strongly detected in Sensex and Nifty-50 returns during January 2009 to December 2009 with ‘H’ value 0.63220715 and 0.611820064. But VIX return series does not exhibit long memory component, which indicates the independent nature of VIX returns series. Moreover, in January 2010 to December 2010 long memory component were present for all the series with ‘H’ value 0.56289281, 0.584423652 and 0.517462286 as respectively Sensex, Nifty-50 and VIX. However in January 2011 to December 2011, long memory component were absent in all the series. In 2011 election results were announced and investor’s behavior also influenced. Furthermore, during 2012 long memory were strongly present in Sensex and Nifty-50 returns but does not exist in VIX returns. However in 2013, long memory was present in VIX return series but does not exhibit in Sensex and Nifty-50 returns. Although, in 2014 long memory was present in Sensex, Nifty-50 and VIX, which advocate dependent nature of return series.

During 2015, VIX return series shows the long memory behavior, which indicate that volatility clustering in series. While Sensex and Nifty-50 returns does not show long memory behavior. However, in 2016 long memory was present in Sensex and Nifty-50 returns. But VIX series does not show long memory component. In 2017, Sensex returns series shows the presence of long memory which indicates that BSE Sensex returns carried long memory phenomenon. However, in VIX and Nifty-50 returns shows anti-persistence behavior, which indicates past returns are unable to predict the future returns. The above findings are only descriptive in nature not conclusive. Hence there is need to conduct similar study on sectoral indices.

IV. Conclusion

Present study examines the long memory in Indian equity market. The study has used Rescaled range analysis as proposed by Lo (1991) ‘Hurst Exponent’ to measure the presence of long memory in returns and volatility from January 2000 to December 2017. Findings indicate that long memory was present in January 2000 to December 2017 for Sensex and Nifty returns, which shows the serially correlated nature of equity market. Although Volatility Index (VIX) does not exhibit long memory in return series. During the pre-crisis period 2000-2007 Sensex and Nifty-50 contain the long memory. However, in post crisis period 2008-2017 only Nifty-50 return exhibit the long memory but Sensex and VIX does not show long memory. Moreover, Sensex and Nifty-50 return series presents the long memory in 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010, 2012, 2014, 2016 and 2017 (in nifty returns long memory was absent) and VIX shows long memory in 2010, 2013, 2014 and 2015. Hence, Sensex and Nifty-50 returns shows the dependent nature of Indian equity market which indicates that past returns helps to predict the future return. And VIX return shows the volatility in clustering in equity market, as it does not show persistency in continuity. Findings would be beneficial for the investors, practitioners, academics and policy makers etc.

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