# Bayesian estimation of a skew-t stochastic volatility model

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### Abstract

In this paper we present a stochastic volatility (SV) model assuming that the return shock has a skew-Student-t distribution. This allows a parsimonious, flexible treatment of asymmetry and heavy tails in the conditional distribution of returns. An efficient Markov chain Monte Carlo estimation method is described that exploits a skew-normal mixture representation of the error distribution with a gamma distribution as the mixing distribution. We apply the methodology to the NASDAQ daily index returns.

**keywords:** Markov chain Monte Carlo, non-Gaussian and nonlinear state space models, skew-Student-t, stochastic volatility.

## 1 Introduction

A large literature in financial econometrics has documented stylized facts which are frequently found in stock and foreign exchange returns: skewness, heavy-tailedness and volatility clustering. These properties are crucial not only for describing the return distributions but also for asset allocation, option pricing, forecasting and risk management.

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Stochastic volatility (SV) models were introduced in the financial literature for describing time-varying volatilities (Taylor, 1982; 1986). Various extensions of the simple SV model with a normal errors have been discussed in the literature. For instance, many empirical studies have shown strong evidence of heavy-tailed conditional mean errors in financial time series (see for example Mandelbrot, 1963; Fama, 1965; Chib et al., 2002; Jacquier et al., 2004). In this context, recently Abanto-Valle et al. (2010) extended the basic SV model by assuming the flexible class of scale mixtures of normal distributions (Lange and Sinsheimer, 1993). The empirical evidence on the presence of asymmetry in the distribution of financial returns is not as clear-cut even though asymmetry plays a non-trivial role in shaping economic decisions. Corrado and Su (1997) suggests that fat tails and asymmetry jointly determine the so-called "volatility smile" in option pricing using the Black-Scholes approach and that explicit account of them improve accuracy in option pricing. Peiro (1999) provides further evidence of asymmetry in returns, both from stock market indices and from individual assets. Further, Mittnik and Paolella (2000) argue that skewness and heavy tails should be taken into account explicitly in Value-at-Risk forecasts. Cappuccio et al. (2006) found empirical evidence on asymmetry in financial returns using a simple stochastic volatility modeling both skewness and heavy tails assuming that the conditional distribution of returns is a skew-generalized error distribution.

In this paper, in order to model simultaneously skewness and heavy-tailedness, we extend the SV model by assuming skew-Student-t (ST) introduced by Azzalini and Capitanio (2003) and hence the SV-ST is defined. Inference in the SV-ST model is performed under a Bayesian paradigm via MCMC methods, which permits to obtain the posterior distribution of parameters by simulation starting from reasonable prior assumptions on the parameters.

The remainder of this paper is organized as follows. Section 2 shows a brief review about skew-normal (Azzalini, 1986) and skew-t distributions and their properties. Section 3 describes the SV-ST model through Bayesian estimation procedure using MCMC methods. Section 4 is devoted to application

and model comparison among the SV-ST model against the SV-N, SV-T and SV-SN models using the NASDAQ data set. Finally, some concluding remarks as well as future developments are deferred to Section 5.

## 2    The univariate skew-normal and skew-t distributions

We start by giving an important notation that will be used throughout the paper and present a review of the univariate skew normal (SN) and skew-t (ST) distributions and a study of some related properties of those distributions.

A univariate random variable $X$ is said to follow a skew-normal distribution, $X \sim \mathcal{SN}(\zeta, \omega^2, \lambda)$, with location, scale and asymmetry parameters given by $\zeta$, $\omega^2$ and $\lambda$, respectively, if the density of this distribution has the form

$$p(x \mid \zeta, \omega^2, \lambda) \quad = \quad \frac{2}{\omega}\phi\left(\frac{x-\zeta}{\omega}\right)\Phi\left(\frac{\lambda}{\omega}(x-\zeta)\right), \tag{1}$$

where $\phi(.)$ and $\Phi(.)$ are, respectively, the probability density function (pdf) and the cumulative distribution function (cdf) of the standard normal distribution. When $\lambda = 0$, the density in equation (1) becomes $\mathcal{N}(\zeta, \sigma^2)$(see Azzalini, 2005, for a comprehensive review). In the next sections, we use the following stochastic representation of the SN distribution (Azzalini, 1986; Henze, 1986). Let $W \sim \mathcal{N}_{[0,\infty)}(0, 1)$ and $\varepsilon \sim \mathcal{N}(0, 1)$, independently, and let $\delta \in (-1, 1)$, where $\mathcal{N}_{[0,\infty)}(.,.)$ and $\mathcal{N}(.,.)$ indicate the truncated normal and normal distribution, respectively. The random variable $X$, defined by

$$X \quad = \quad \zeta + \omega\delta W + \omega\sqrt{1-\delta^2}\varepsilon, \tag{2}$$

follows a univariate skew-normal distributions, that is, $X \sim \mathcal{SN}(\zeta, \omega^2, \lambda)$, where $\lambda = \delta/\sqrt{1-\delta^2}$.

The kurtosis coefficient of a skew-normal distribution is restricted to the interval [3, 3.8692]. To achieve a higher degree of excess kurtosis, the skew-t distribution has been introduced by Branco and

3

Dey (2001) and Azzalini and Capitanio (2003). A univariate random variable $X$ follows the scalar skew-t distribution, $X \sim \mathcal{ST}(\zeta, \omega^2, \lambda, \nu)$, if it has the following stochastic representation

$$X = \zeta + U^{-1/2}\omega\delta W + U^{-\frac{1}{2}}\omega(1-\delta^2)^{\frac{1}{2}}\varepsilon, \tag{3}$$

where $W \sim \mathcal{N}_{[0,\infty)}(0,1)$, $\varepsilon \sim \mathcal{N}(0,1)$ and $U \sim \mathcal{G}(\frac{\nu}{2}, \frac{\nu}{2})$ are independently distributed. The Gamma distribution $\mathcal{G}(a,b)$ is defined with density $p(u \mid a, b) = b^a u^{a-1}\mathrm{e}^{-bu}/\Gamma(a)$. The pdf of $X$ is then given by

$$f(X \mid \zeta, \omega^2, \lambda, \nu) = \frac{2}{\omega}t_\nu\left(\frac{x-\zeta}{\omega}\right)T_{\nu+1}\left(\lambda\omega^{-1}(x-\zeta)\sqrt{\frac{\nu+1}{\nu+\omega^{-2}(x-\zeta)^2}}\right), \tag{4}$$

where $t_\nu(.)$ and $T_\nu(.)$ denote the pdf and cdf of a standard Student-t distribution with $\nu$ degrees of freedom. From (3), we have that

$$E(X) = \zeta + \sqrt{\frac{2}{\pi}}k_1\omega\delta, \tag{5}$$

$$V(X) = \omega^2 k_2 - \frac{2}{\pi}k_1^2\omega^2\delta^2, \tag{6}$$

where $\delta = \lambda/\sqrt{1+\lambda^2}$ and $k_m = E(U^{-m/2})$. $E(.)$ and $V(.)$ denote the expected value and variance, respectively. The skew-t nests the traditional symmetric Student's t distribution as a special case when $\lambda = 0$, and the conditional normal distribution as $\nu \to \infty$, and can capture left-tailed or negative skewness when $\lambda < 0$, and positive skewness when $\lambda > 0$.

To interpret the parameters $(\lambda, \nu)$ in relation to the skewness and heavy-tailedness, skew-t densities are plotted using several combinations of the parameter values in Figure 1 with $\zeta$ and $\omega$ fixed at 0 and 2, respectively. In Figure 1, left, the densities are drawn using $\lambda = 0, -2, -4, -8$ with $\nu$ fixed at 5. As mentioned, $\lambda = 0$ corresponds to a symmetric Student's t-density. A lower value of $\lambda$ implies a more negative skewness or left-skewness as well as heavier tails. Figure 1, right, shows the densities for $\nu$ at 2,4,10 and 15 with $\lambda$ fixed equal to -2. As $\nu$ becomes larger, the density becomes less skewed and has lighter tails. Hence the skewness and heavy-tailedness are determined jointly by the combination of the parameter values of $\lambda$ and $\nu$.
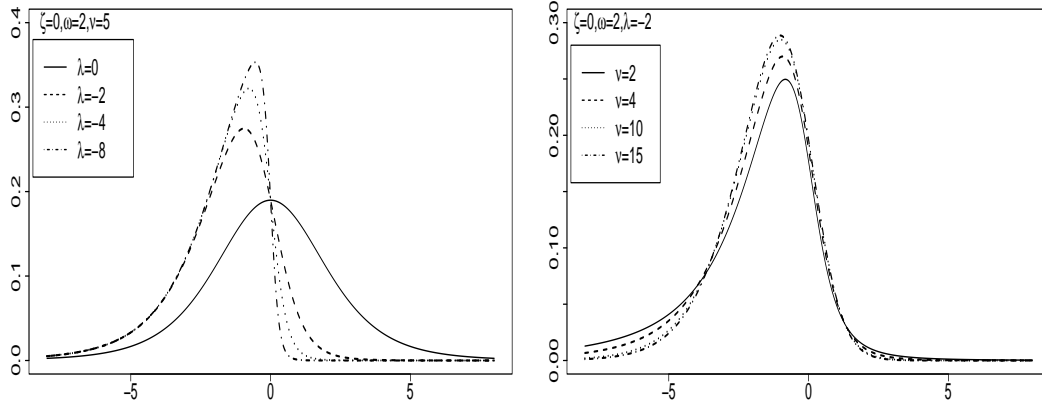
Figure 1: The skew-t distribution. Top: $\zeta = 0, \omega = 2, \nu = 5$ (fixed), $\lambda = 0, -2, -4, -8$. Bottom: $\zeta = 0, \omega = 2, \lambda = -2$ (fixed), $\nu = 2, 4, 10$ and 15.

## 3   The skew-t stochastic volatility model

### 3.1   The model

In order to account for both the excess kurtosis and skewness in stock returns, we introduce the stochastic volatility model with skew-t errors (SV-ST), which is defined as

$$y_t = e^{\frac{h_t}{2}} \epsilon_t, \tag{7a}$$

$$h_{t+1} = \mu + \varphi(h_t - \mu) + \sigma_\eta \eta_t, \tag{7b}$$

5

where $y_t$ and $h_t$ are, respectively, the compounded return and the log-volatility at time $t$. We assume that $|\varphi| < 1$, i.e., the log-volatility process is stationary and that the initial value $h_1 \sim \mathcal{N}(\mu, \frac{\sigma_\eta^2}{1-\varphi^2})$, $\epsilon_t \sim \mathcal{ST}(\zeta, \omega^2, \lambda, \nu)$ and $\eta_t \sim \mathcal{N}(0,1)$ are uncorrelated. The SV-ST defined by equations (7a) and (7b) can be written hierarchically using the stochastic representation of the skew-t distribution in (3), as

$$y_t = (\zeta + \omega \delta W_t U_t^{-\frac{1}{2}}) \mathrm{e}^{\frac{h_t}{2}} + \mathrm{e}^{\frac{h_t}{2}} U_t^{-\frac{1}{2}} \omega (1-\delta^2)^{\frac{1}{2}} \varepsilon_t, \tag{8a}$$

$$h_{t+1} = \mu + \varphi(h_t - \mu) + \sigma_\eta \eta_t, \tag{8b}$$

$$W_t \sim \mathcal{N}_{[0,\infty)}(0,1), \tag{8c}$$

$$U_t|\nu \sim \mathcal{G}(\frac{\nu}{2}, \frac{\nu}{2}), \tag{8d}$$

where $\varepsilon_t$ and $\eta_t$ are mutually independent and normally distributed with zero mean and unit variance, $\delta = \frac{\lambda}{\sqrt{1+\lambda^2}}$. We set $\zeta$ and $\omega$ in such a way that $E(y_t \mid h_t) = 0$ and $V(y_t \mid h_t) = \mathrm{e}^{h_t}$. In this setup, equations (8a) and (8b), with $\lambda = 0$ (equivalently $\delta = 0$) and $U_t = 1 \forall t$ define the SV model with normal distribution (SV-N). Equations (8a),(8b) and (8d) with $\lambda = 0$ define the the SV model with Student-t distribution (SV-T) defined by Abanto-Valle *et al.* (2010). Finally, equations (8a),(8b) and (8c) with $U_t = 1, \forall t$ results the SV model with skew normal distribution (SV-SN).

## 3.2 Parameter estimation via MCMC

Let $\boldsymbol{\theta} = (\varphi, \sigma_\eta^2, \nu, \lambda)'$ be the full parameter vector of the entire class of SV-ST model, $\mathbf{h}_{1:T} = (h_1, \ldots, h_T)'$ be the vector of the log volatilities, $\mathbf{U}_{1:T} = (U_1, \ldots, U_T)'$ be the mixing variables, $\mathbf{W}_{1:T} = (W_1, \ldots, W_T)'$ and $\mathbf{y}_{1:T} = (y_1, \ldots, y_T)'$ be the information available up to time $T$, while $\nu$ is the degrees of freedom parameter vector associated with the mixture distribution and $\lambda$ the skewness parameter. The Bayesian approach to estimate the parameters in the SV-ST model uses the data augmentation principle, which considers $\mathbf{h}_{1:T}$, $\mathbf{W}_{1:T}$ and $\mathbf{U}_{1:T}$ as latent variables. The joint posterior density of parameters and latent

unobservable variables can be written as

$$
\begin{aligned}
p(\boldsymbol{\theta}, \mathbf{W}_{1:T}, \mathbf{U}_{1:T}, \mathbf{h}_{0:T} \mid \mathbf{y}_{1:T}) \quad &\propto \quad p(\mathbf{y}_{1:T} \mid \boldsymbol{\theta}, \mathbf{W}_{1:T}, \mathbf{U}_{1:T}, \mathbf{h}_{1:T}) \\
&\times \quad p(\mathbf{h}_{0:T} \mid \boldsymbol{\theta}) p(\mathbf{W}_{1:T}) p(\mathbf{U}_{1:T} \mid \boldsymbol{\theta}) p(\boldsymbol{\theta}),
\end{aligned}
\tag{9}
$$

where $p(\boldsymbol{\theta})$ is the prior distribution. Since the posterior density $p(\mathbf{h}_{1:T}, \mathbf{W}_{1:T}, \mathbf{U}_{1:T}, \boldsymbol{\theta} \mid \mathbf{y}_{1:T})$ does not have closed form, we first sample the parameters $\boldsymbol{\theta}$, followed by the latent variables $\mathbf{W}_{1:T}$, $\mathbf{U}_{1:T}$ and $\mathbf{h}_{1:T}$ using Gibbs sampling. The sampling scheme is described by Algorithm 1. Sampling the log-volatilities $\mathbf{h}_{1:T}$ in step 5 of Algorithm 1 is the most difficult task due to the nonlinear setup in the observational equation (8a). In order to avoid the higher correlations due to the Markovian structure of the $h_t$'s, in the next subsection we develop a multi-move block sampler to sample $\mathbf{h}_{0:T}$ by blocks (Shephard and Pitt 1997; Watanabe and Omori 2004; Abanto-Valle *et al.* 2010). Details on the full conditionals of $\boldsymbol{\theta}$ and the latent variables $\mathbf{U}_{1:T}$ and $\mathbf{W}_{1:T}$ are given in Appendix.

**Algorithm 1**

1. Set $i = 0$ and get starting values for the parameters $\boldsymbol{\theta}^{(i)}$ and the latent quantities $\mathbf{W}_{1:T}^{(i)}$, $\mathbf{U}_{1:T}^{(i)}$ and $\mathbf{h}_{1:T}^{(i)}$.

2. Generate $\boldsymbol{\theta}^{(i+1)}$ in turn from its full conditional distribution, given $\mathbf{y}_{1:T}$, $\mathbf{h}_{1:T}^{(i)}, \mathbf{W}_{1:T}^{(i)}$ and $\mathbf{U}_{1:T}^{(i)}$.

3. Draw $\mathbf{W}_{1:T}^{(i+1)} \sim p(\mathbf{W}_{1:T} \mid \boldsymbol{\theta}^{(i)}, \mathbf{U}_{1:T}^{(i)}, \mathbf{h}_{1:T}^{(i)}, \mathbf{y}_{1:T})$.

4. Draw $\mathbf{U}_{1:T}^{(i+1)} \sim p(\mathbf{U}_{1:T} \mid \boldsymbol{\theta}^{(i+1)}, \mathbf{W}_{1:T}^{(i+1)}, \mathbf{h}_{1:T}^{(i)}, \mathbf{y}_{1:T})$.

5. Generate $\mathbf{h}_{1:T}$ by blocks as:

   i) For $l = 1, \ldots, K$, the knot positions are generated as $k_l$, the floor of $[T \times \{(l + u_l)/(K + 2)\}]$, where the $u_l's$ are independent realizations of the uniform random variable on the interval (0,1).

ii) For $l = 1, \ldots, K$, generate $h_{k_{l-1}+1:k_l-1}$ jointly conditional on $\mathbf{y}_{k_{l-1}:k_l-1}$, $\boldsymbol{\theta}^{(i+1)}$, $\mathbf{W}^{(i+1)}_{k_{l-1}+1:k_l-1}$, $\mathbf{U}^{(i+1)}_{k_{l-1}+1:k_l-1}$, $h^{(i)}_{k_{l-1}}$ and $h^{(i)}_{k_l}$.

iii) For $l = 1, \ldots, K$, draw $h^{(i+1)}_{k_l}$ conditional on $\mathbf{y}_{1:T}$, $\boldsymbol{\theta}^{(i)}$, $W^{(i+1)}_{k_l}$, $U^{(i+1)}_{k_l}$, $h^{(i+1)}_{k_l-1}$ and $h^{(i+1)}_{k_l+1}$.

6. Set $i = i + 1$ and return to 2 until convergence is achieved.

In the SV-ST model considered so far, an important modelling assumption is the regularization penalty $p(\nu)$ on the tail thickness. A default Jeffreys' prior was developed by Fonseca *et al.* (2008), with a number of desirable properties particularly when learning a fat-tail from a finite dataset. The default Jeffreys's prior for $\nu$ takes the form

$$p(\nu) \quad \propto \quad \left( \frac{\nu}{\nu+3} \right)^{\frac{1}{2}} \left\{ \psi'\left( \frac{\nu}{2} \right) - \psi'\left( \frac{\nu+1}{2} \right) - \frac{2(\nu+3)}{\nu(\nu+1)^2} \right\}^{\frac{1}{2}}, \tag{10}$$

where $\psi'(a) = \frac{d\{\psi(a)\}}{da}$ and $\psi(a) = \frac{d\{\log \Gamma(a)\}}{da}$ are the trigamma and digamma functions, respectively. The interesting feature of this prior is its behavior as $\nu$ goes to infinity and it has polynomial tails of the form $p(\nu) \propto \nu^{-4}$. In this case, the tail of the prior decays rather fast for large values of $\nu$ and assessing the degree of tail thickness can require prohibitively large samples. To the skewness parameter, we assume that $\lambda \sim t_{0.5}(0.0, \frac{\pi^2}{4})$, a Jeffreys' prior suggested by Bayes and Branco (2007).

### 3.2.1  Block sampler

In order to simulate $\mathbf{h}_{1:T} = (h_1, \ldots, h_T)'$ in the SV-ST model, we consider a two-step process: first, we simulate $h_1$ conditional on $\mathbf{h}_{2:T}$, next $\mathbf{h}_{2:T}$ conditional on $h_1$. To sample the vector $\mathbf{h}_{2:T}$, we develop a multi-move block algorithm. In our block sampler, we divide it into $K + 1$ blocks, $\mathbf{h}_{k_{l-1}+1:k_l-1} = (h_{k_{l-1}+1}, \ldots, h_{k_l-1})'$ for $l = 1, \ldots, K+1$, with $k_0 = 1$ and $k_{K+1} = T$, where $k_l - 1 - k_{l-1} \geq 2$ is the size of the $l-$th block. We sample the block of disturbances $\boldsymbol{\eta}_{k_{l-1}:k_l-2} = (\eta_{k_{l-1}}, \ldots, \eta_{k_l-2})'$ given the end conditions $h_{k_{l-1}}$ and $h_{k_l}$ instead of $\mathbf{h}_{k_{l-1}+1:k_l-1}$. In order to facilitate the exposition, we omit the dependence on $\boldsymbol{\theta}$, $\mathbf{W}_{t+1:t+k}$ and $\mathbf{U}_{t+1:t+k}$, and suppose that $k_{l-1} = t$ and $k_l = t+k+1$ for the $l-$th block,

such that $t + k < T$. Then $\boldsymbol{\eta}_{t:t+k-1} = (\eta_t, \ldots, \eta_{t+k-1})'$ are sampled at once from their full conditional distribution $f(\boldsymbol{\eta}_{t:t+k-1}|h_t, h_{t+k+1}, \mathbf{y}_{t:t+k})$, which without the constant terms is expressed in log scale as

$$
\begin{aligned}
\log f(\boldsymbol{\eta}_{t:t+k-1}|h_t, h_{t+k+1}) &= \text{const} - \frac{1}{2} \sum_{r=t}^{t+k-1} \eta_r^2 + \sum_{r=t+1}^{t+k} l(h_r) \\
&\quad - \frac{1}{2\sigma_\eta^2} [h_{t+k+1} - \mu - \varphi(h_{t+k} - \mu)]^2 \mathbb{I}(t + k < T),
\end{aligned}
$$

where $\mathbb{I}(.)$ is an indicator function. We denote the first and second derivatives of $l(h_r)$ with respect to $h_r$ by $l'$ and $l''$, where $l(h_r) = \log p(y_r \mid \nu, \lambda, W_r, U_r, h_r)$ is obtained from equation (8a). As (11) does not have closed form, we use the Metropolis-Hastings acceptance-rejection algorithm (Tierney, 1994; Chib and Greenberg, 1995) to sample from. We propose to use the following artificial Gaussian state space model as a proposed density to simulate the block $\boldsymbol{\eta}_{t+1:t+k}$

$$
\hat{y}_r = h_r + \xi_r, \qquad \xi_r \sim \mathcal{N}(0, d_r), \quad r = t+1, \ldots, t+k, \tag{11}
$$

$$
h_{r+1} = \mu + \varphi(h_r - \mu) + \sigma_\eta \eta_r, \qquad \eta_r \sim \mathcal{N}(0,1), \quad r = t, t+1, \ldots, t+k-1, \tag{12}
$$

where the auxiliary variables $d_r$ and $\hat{y}_r$ for $r = t+1, \ldots, t+k-1$ and $t + k = T$ are defined as follows:

$$
\begin{aligned}
d_r &= -\frac{1}{l_F''(\hat{h}_r)}, \\
\hat{y}_r &= \hat{h}_r + d_r l'(\hat{h}_r). \tag{13}
\end{aligned}
$$

For $r = t + k < T$, it follows that

$$
\begin{aligned}
d_r &= \frac{\sigma_\eta^2}{\varphi^2 - \sigma_\eta^2 l_F''(\hat{h}_{t+k})}, \\
\hat{y}_r &= d_r \left[ l'(\hat{h}_r) - l_F''(\hat{h}_r)\hat{h}_r + \frac{\varphi}{\sigma_\eta^2}[h_{r+1} - \mu(1 - \varphi)] \right]. \tag{14}
\end{aligned}
$$

We obtain the measurement equation (11) by a second-order expansion of $l_r$ around some preliminary estimate of $\eta_r$, denoted by $\hat{\eta}_r$, where $\hat{h}_r$ is the estimate of $h_r$ equivalent to $\hat{\eta}_r$, and

$$
l_F''(h_r) = E[l''(h_r)] = -\frac{1}{2} - \frac{(\zeta + \omega\delta W_t U_t^{-\frac{1}{2}})^2}{4\omega^2(1 - \delta^2)} U_r, \tag{15}
$$

which is everywhere strictly negative. The expectation in (15) is taken with respect to $y_r$ conditional on $h_r, W_r, U_r, \boldsymbol{\theta}$. Since (11)-(12) define a Gaussian state space model, we can apply de Jong and Shephard's simulation smoother (de Jong and Shephard, 1995) to perform the sampling. We denote this density by $g$. Since $f$ is not bounded by $g$, we use the Metropolis-Hastings acceptance-rejection algorithm to sample from $f$, as recommended by Chib and Greenberg (1995). In the SV-SN case, we use the same procedure with $U_t = 1$ for $t = 1, \ldots, T$.

The procedure to select the expansion block $\hat{\mathbf{h}}_{t+1:t+k}$ is described in the Algorithm 2.

**Algorithm 2**

1. Initialize $\hat{\mathbf{h}}_{t+1:t+k}$.

2. Evaluate recursively $l'(\hat{h}_r)$ and $l''_F(\hat{h}_r)$ for $r = t+1, \ldots, t+k$.

3. Conditional on the current values of the vector of parameters $\boldsymbol{\theta}$, $\mathbf{U}_{t+1:t+k}$, $\mathbf{W}_{t+1:t+k}$, $h_t$ and $h_{t+k+1}$, define the auxiliary variables $\hat{y}_r$ and $d_r$ using equations (13) or (14) for $r = t+1, \ldots, t+k$.

4. Consider the linear Gaussian state-space model in (11) and (12). Apply the Kalman filter and a disturbance smoother (Koopman, 1993) and obtain the posterior mean of $\boldsymbol{\eta}_{t:t+k}$ ($\mathbf{h}_{t:t+k}$) and set $\hat{\boldsymbol{\eta}}_{t:t+k}$ ($\hat{\mathbf{h}}_{t:t+k}$) to this value.

5. Return to step 2 and repeat the procedure until achieving convergence.

Finally, we describe the updating procedure for $h_1$ and the knot conditions $h_{k_l}$, for $l = 1, \ldots, K$. We simulate $h_1 \mid h_2, \boldsymbol{\theta} \sim \mathcal{N}(\mu + \varphi(h_1 - \mu), \sigma_\eta^2)$. As the density $p(h_{k_l} \mid h_{k_l-1}, h_{k_l+1})$ does not have a closed form, we use the Metropolis-Hastings algorithm with proposal $\mathcal{N}(\frac{\mu(1-\varphi)^2 + \varphi(h_{k_l-1} + h_{k_l+1})}{1+\varphi^2}, \frac{\sigma_\eta^2}{1+\varphi^2})$. Let $h_{k_l}^p$ and $h_{k_l}^{(i-1)}$ denote the proposal value and the previous iteration value. Thus, the acceptance probability is given by $\alpha_{MH} = \min\{1, \frac{Q(h_{k_l}^p)}{Q(h_{k_l}^{(i-1)})}\}$, where $Q(h_{k_l})$ is the conditional density of $y_{k_l} \mid \boldsymbol{\theta}, W_{k_l}, U_{k_l}, h_{k_l}$.
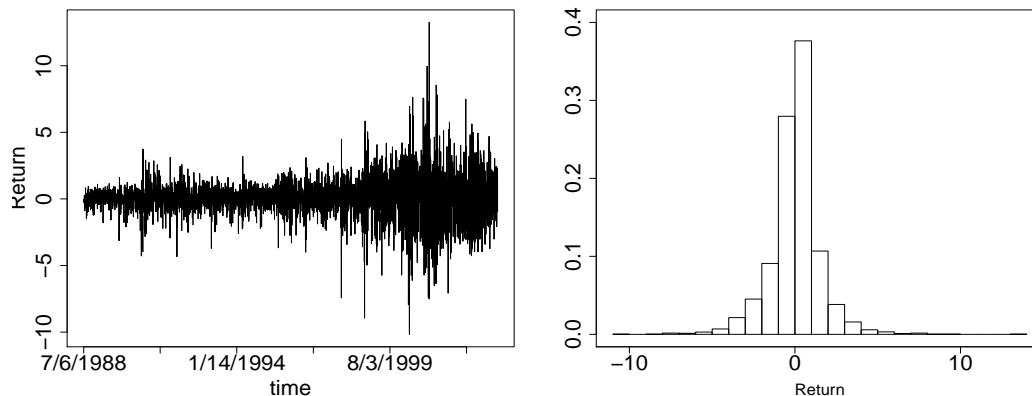
Figure 2: Compounded NASDAQ returns from January 7, 1988 to July 3, 2003. The left panel shows the plot of the raw series and the right panel the histogram of returns.

## 4 Empirical Application

This section analyzes the daily closing prices of the NASDAQ Composite index. The NASDAQ Composite is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market, meaning that it has over 3000 components. It is highly followed in the U.S. as an indicator of the performance of stocks of technology and growth companies. Since both U.S. and non-U.S. companies are listed on the NASDAQ stock market, the index is not exclusively a U.S. index. The data set was obtained from the Yahoo finance web site, available to download at http://finance.yahoo.com. The period of analysis is July 5, 1988 - July 3, 2003, which yields 3784 observations. Throughout, we work with the compounded return expressed as a percentage, $y_t = 100 \times (\log P_t - \log P_{t-1})$, where $P_t$ is the closing price on day $t$. The compounded NASDAQ index returns are plotted in Figure 2 as a time series plot and also as a histogram. We clearly identify the period of elevate volatility around of the turn of the Millennium associated with the collapse of the Tech bubble. We are particularly interested in understanding the importance of excess of kurtosis and skewness in the NASDAQ index return and

11

we avoid confounding our results by this highly influential outlier. There are some interesting pattern we observe in this history of NASDAQ returns. The average return is 0.04 percent daily with a daily standard deviation of 1.54. Returns exhibit negative skewness of -0.02 and kurtosis of 9.13. Note also that the returns have a large range (minimum, -10.16 and maximum, 13.25). We use the the Jarque-Bera (JB) statistics to test the normality assumption of the returns. In light of the JB statistics (5923.6), the null hypothesis of normality is rejected (p-value of 0.00) due to negative skewness and excess of kurtosis.

Table 1: Estimation results for the NASDAQ returns. First row: Posterior mean. Second row: Posterior 95% credible interval in parentheses. Third row: CD statistics.

| Parameter | SV-N | SV-T | SV-SN | SV-ST |
|---|---|---|---|---|
| | 0.0623 | 0.0457 | 0.0417 | 0.0314 |
| $\mu$ | (-0.9523,0.9764) | (-1.3032,1.2315) | (-1.1524,1.0409) | (-1.5076,1.3985) |
| | 0.70 | 0.94 | -0.91 | -0.66 |
| | 0.9944 | 0.9963 | 0.9954 | 0.9967 |
| $\varphi$ | (0.9897,0.9984) | (0.9926,0.9994) | (0.9745,0.9947) | (0.9932,0.9995) |
| | 1.12 | -0.43 | 0.11 | -1.58 |
| | 0.0172 | 0.0118 | 0.0143 | 0.0107 |
| $\sigma_\eta^2$ | (0.0115,0.0246) | (0.0075,0.0171) | (0.0097,0.0204) | (0.0070,0.0155) |
| | -0.13 | 0.39 | 0.81 | 0.87 |
| | – | – | -1.3908 | -1.1528 |
| $\lambda$ | – | – | (-1.6280,-1.1470) | (-1.4020,-0.8820) |
| | – | – | 0.23 | -1.65 |
| | – | 19.3369 | – | 19.6797 |
| $\nu$ | – | (11.3700,35.3600) | – | (11.4000,36.5000) |
| | – | -1.78 | – | 1.72 |
| | – | 0.0564 | – | 0.0556 |
| $\frac{1}{\nu}$ | – | (0.0283,0.0879) | – | (0.0274,0.0877) |
| | – | 1.51 | – | -1.36 |

Now, we analyze the NASDAQ index returns with the aim of providing robust inference. In our analysis, we fit and compare the SV-N, SV-T, SV-SN and SV-ST models. In all cases, we simulated the $h_t$'s in a multi-move fashion with stochastic knots based on the method described in Section 3.2. We fix the number of blocks $K$ to be 95 in such a way that each block contained 40 $h'_t$s on average. We set the prior distribution of the common parameters as: $\varphi \sim \mathcal{N}_{(-1,1)}(0.95, 100)$, $\sigma^2 \sim \mathcal{IG}(2.5, 0.025)$, $\mu \mid \sim \mathcal{N}(0, 100)$. For the parameter $\varphi$ the priors' mean and variance are 0.0032 and 0.3328, respectively. This prior setup is equivalent to the uniform distribution on interval (-1, 1), which gives zero mean and variance of 0.3333. We assume that $\lambda \sim t_{0.5}(0.0, \frac{\pi^2}{4})$, a Jeffreys' prior suggested by Bayes and Branco (2007). Finally, for $\nu$, we assume the prior given by equation (10). All the calculations were performed running stand-alone code developed by us using an open source C++ library for statistical computation, the Scythe statistical library (Pemstein *et al.*, 2007), which is available for free download at http://scythe.wustl.edu.

For all models, we conducted the MCMC simulation for 50000 iterations. In all cases, the first 10000 draws were discarded as a burn-in period. In order to reduce the autocorrelation between successive values of the simulated chain, only every $20th$ values of the chain were stored. With the resulting 2000 values, we calculated the posterior means, the 95% credible intervals and the convergence diagnostic (CD) statistics (Geweke, 1992). If the sequence of the recorded MCMC output is stationary, it converges in distribution to the standard normal. According to the CD the null hypothesis that the sequence of 2000 draws is stationary was accepted at the 5% level, CD $\in (-1.96, 1.96)$, for all the parameters in all the models considered here. Table 1 summarizes the results.

From Table 1, consistent with the existing evidence of great persistence in the log-volatility process, we found that the posterior means of $\varphi$ and 95% posterior credible intervals very close to the unity. Being the posterior mean of $\varphi$ of the SV-ST model slightly higher than those of the other three models. The posterior mean of $\sigma_\eta^2$ is smaller in the SV-ST than those of the SV-N, SV-T and the SV-SN models, indicating that the log-volatility process of the SV-ST is less variable than those of the other ones.

In the SV-T and SV-ST models, the magnitude of the tail-fatness is measured by the degrees of freedom, $\nu$, parameter. We found that the posterior mean of $\nu$ are the SV-T are 19.34 and 19.68, respectively, which indicates tail-fatness. In Table 1, we report the posterior mean of $1/\nu$, for both models, which, in both cases, are over 3.5 standard deviation from zero. Since the SV-N and SV-SN models are nested in the limit when $1/\nu$ approaches to zero this provides strong evidence of heavy-tailness of conditional distributions of the returns.

Regarding the skewness parameter, $\lambda$, in the SV-SN and SV-ST models, we found that the posterior means are -1.3908 and -1.1528, respectively. In both models, the 95% credible interval does not contain zero, that is the negativity of $\lambda$ is credible. This supports the strong evidence of skewnesses in the NASDAQ data set.

The magnitudes of the mixing parameter $U_t$ are associated with extremeness of the corresponding observations. In the Bayesian paradigm, the posterior mean of the mixing parameter can be used to identify a possible outlier (see, for instance, Rosa *et al.*, 2003). The SV-T and SV-ST models can accommodate an outlier by inflating the variance component for that observation in the conditional distribution with smaller $U_t$ value. This fact is shown in Figure 3 where we depicted the posterior mean of the mixing variable $U_t$ for the SV-T (top panel) and SV-ST (bottom panel) models, respectively.

To assess the goodness of the estimated models, we calculate the Bayesian predictive information criteria, BPIC (Ando, 2006; 2007). The BPIC criterion is defined as

$$BPIC \quad = \quad -2E_{\boldsymbol{\theta}|\mathbf{y}_{1:T}}[\log\{p(\mathbf{y}_{1:T} \mid \boldsymbol{\theta})\}] + 2T\hat{b}, \tag{16}$$

where $\hat{b}$ is given by

$$\hat{b} \quad \approx \quad \frac{1}{T}\left\{E_{\boldsymbol{\theta}|\mathbf{y}_{1:T}}[\log\{p(\mathbf{y}_{1:T} \mid \boldsymbol{\theta})p(\boldsymbol{\theta})\}] - \log[p(\mathbf{y}_{1:T} \mid \hat{\boldsymbol{\theta}})p(\hat{\boldsymbol{\theta}})] + \text{tr}\{J_T^{-1}(\hat{\boldsymbol{\theta}})I_T(\hat{\boldsymbol{\theta}})\} + 0.5q\right\}. \tag{17}$$

Here $q$ is the dimension of $\boldsymbol{\theta}$, $E_{\boldsymbol{\theta}|\mathbf{y}_{1:T}}[.]$ denotes the expectation with respect to the posterior distribution,
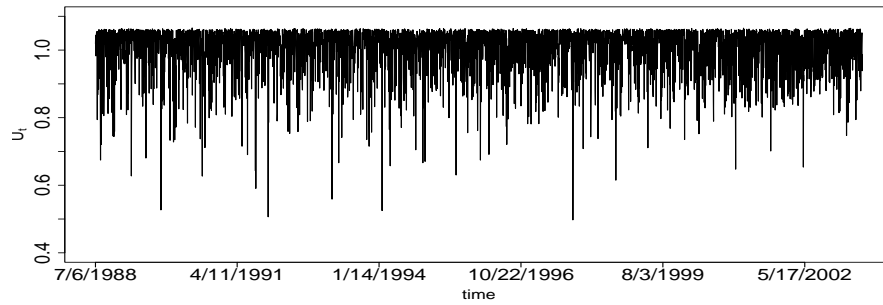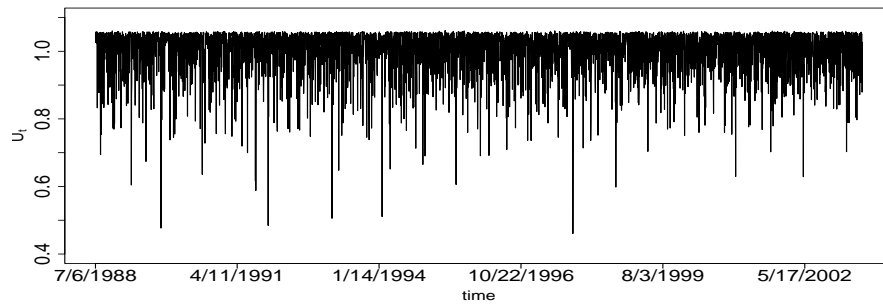
Figure 3: NASDAQ data set: posterior smoothed mean of mixture variable $U_t$ for the SV-T (top panel) and SV-ST (bottom panel) models.

$\hat{\boldsymbol{\theta}}$ is the posterior mode, and

$$
\begin{aligned}
I_T(\hat{\boldsymbol{\theta}}) &= \frac{1}{T}\sum_{t=1}^{T}\left(\frac{\partial \eta_T(y_t,\boldsymbol{\theta})}{\partial \boldsymbol{\theta}}\frac{\partial \eta_T(y_t,\boldsymbol{\theta})}{\partial \boldsymbol{\theta}'}\right)\Big|_{\boldsymbol{\theta}=\hat{\boldsymbol{\theta}}}, \\
J_T(\hat{\boldsymbol{\theta}}) &= \frac{1}{T}\sum_{t=1}^{T}\left(\frac{\partial^2 \eta_T(y_t,\boldsymbol{\theta})}{\partial \boldsymbol{\theta}\partial \boldsymbol{\theta}'}\right)\Big|_{\boldsymbol{\theta}=\hat{\boldsymbol{\theta}}},
\end{aligned}
$$

with $\eta_T(y_t,\boldsymbol{\theta}) = \log p(y_t \mid \mathbf{y}_{1:t-1},\boldsymbol{\theta}) + \log p(\boldsymbol{\theta})/T$.

In the SV-N, SV-T, SV-SN, and SV-ST models, the log-likelihood function, $\log p(\mathbf{y}_{1:T} \mid \boldsymbol{\theta})$, is estimated using the auxiliary particle filter (see, e.g., Pitt and Shephard, 1999) with 10000 particles. From Table 2, the BPIC criterion indicates the SV-ST model is the best model among all the models considered here, suggesting that the NASDAQ index return data demonstrate sufficient departure from underlying normality assumptions and asymmetry.

In Figure 4 , we plot the smoothed mean of $\mathrm{e}^{\frac{h_t}{2}}$ obtained from the MCMC output for the SV-N (solid line) and the SV-ST (dotted line). From a practical point of view, we are mainly interested in whether we find a significant difference between the two series. Therefore, in the bottom panel of Figure 9, we plot the smoothed mean of the difference of $\mathrm{e}^{\frac{h_t}{2}}$ obtained from the SV-N and SV-T models. Some extreme returns make the differences clear. This can have a substantial impact, for instance, in the valuation of derivative instruments and several strategic or tactical asset allocation topics.

## 5 Conclusions

In this article, we presented a Bayesian implementation of the stochastic volatility model with skew-Student-t (SV-ST) errors as an alternative to the normal assumption of the conditional distribution of
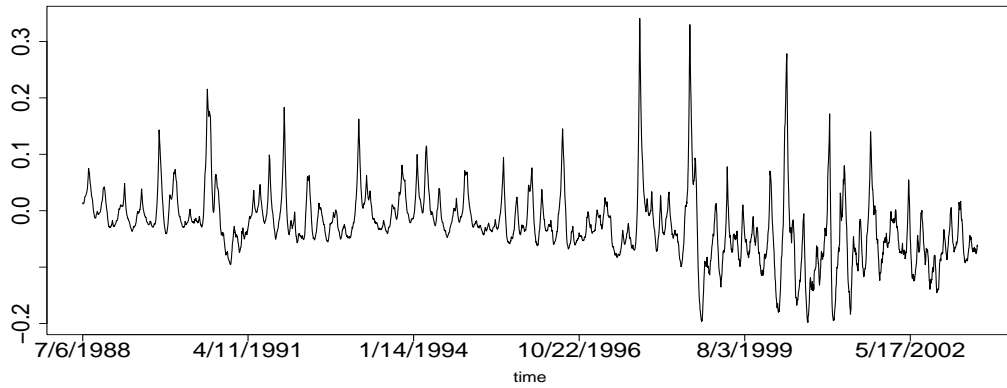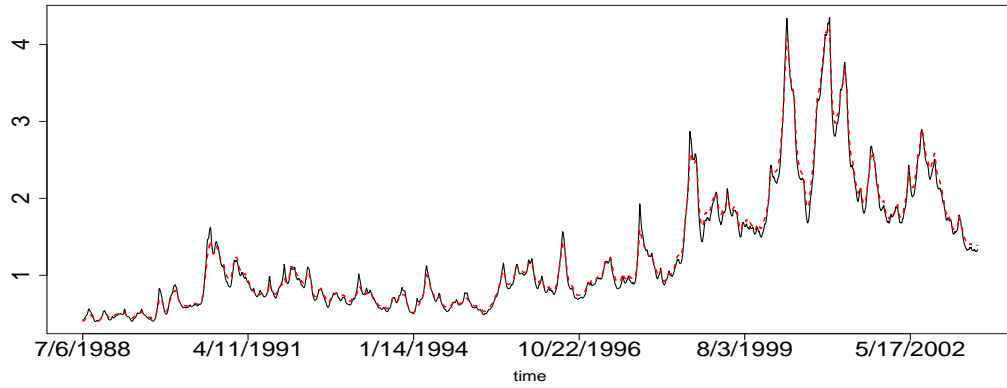
Figure 4: NASDAQ data set. Top: Posterior smoothed mean of $e^{\frac{h_t}{2}}$. SV-N (solid line) and SV-ST (dotted line). Bottom: Posterior smoothed mean of the difference of $e^{\frac{h_t}{2}}$ in both models.

Table 2: Nasdaq return data set. BPIC: Bayesian predictive information criterion.

| Model | BPIC | Ranking |
|-------|------|---------|
| SV-N | 15628.4 | 3 |
| SV-T | 11662.6 | 2 |
| SV-SN | 16012.4 | 4 |
| SV-ST | 11575.3 | 1 |

the returns. The SV-ST model allows a parsimonious yet flexible treatment of both skewness and tail thickness. Under a Bayesian perspective, we developed a fast and efficient MCMC sampling procedure to estimate all the parameters and latent quantities in our proposed SV-ST model. We use objective priors for the degrees of freedom and the skewness parameters, $\nu$ and $\lambda$, based on Fonseca *et al.* (2008) and Bayes and Branco (2007), respectively. As a by product of the MCMC algorithm, we were able to produce an estimate of the latent information process which can be used in financial modelling. The use of mixing variable, $\mathbf{U}_{1:T}$ not only simplifies the full conditional distributions required for the Gibbs sampling algorithm, but also provides a mean for outlier diagnostics. We illustrated our methods through an empirical application of the NASDAQ return series, which showed that the SV-ST model provides better fit than the SV-N, SV-T and SV-SN models in terms of parameter estimates, interpretation and robustness aspects. On the other hand, since the posterior mean and 95% posterior credibility interval of the parameter $\lambda$ contains only negative values, we can conclude that there is a strong evidence of skewness in the NASDAQ data set.

## Acknowledgements

## Appendix A: The full conditionals

In this appendix, we describe the full conditional distributions for the parameters and the mixing latent variables $\mathbf{U}_{1:T}$ and $\mathbf{W}_{1:T}$ for the SV-ST model model.

### Full conditional distribution of $\mu$, $\varphi$ and $\sigma_\eta^2$

The prior distributions of the common parameters are set as: $\mu \sim N(\bar{\mu}, \sigma_\mu^2)$, $\varphi \sim \mathcal{N}_{(-1,1)}(\bar{\varphi}, \sigma_\varphi^2)$, $\sigma_\eta^2 \sim \mathcal{IG}(\frac{T_0}{2}, \frac{M_0}{2})$. We have the following full conditional for $\mu$:

$$\mu \mid \mathbf{h}_{1:T}, \varphi, \sigma_\eta^2 \quad \sim \quad \mathcal{N}(\frac{b_\mu}{a_\mu}, \frac{1}{a_\mu}), \tag{A.1}$$

where $a_\mu = \frac{1}{\sigma_\alpha^2} + \frac{(T-1)(1-\varphi)^2}{\sigma_\eta^2} + \frac{(1-\varphi)^2}{\sigma_\eta^2}$ and $b_\mu = \frac{\bar{\mu}}{\sigma_\mu^2} + \frac{(1-\varphi^2)}{\sigma_\eta^2}h_1 + \frac{\sum_{t=1}^{T-1}(h_{t+1}-\varphi h_t)(1-\varphi)}{\sigma_\eta^2}$. In a similar way, the conditional posterior of $\varphi$ is given by

$$p(\varphi \mid \mathbf{h}_{1:T}, \mu, \sigma_\eta^2) \quad \propto Q(\varphi) \exp\{-\frac{a_\varphi}{2}(\psi - \frac{b_\varphi}{a_\varphi})^2\}\mathbb{I}_{|\varphi|<1}, \tag{A.2}$$

where $Q_\varphi = \sqrt{1-\varphi^2}\exp\{-\frac{1}{2\sigma_\eta^2}[(1-\varphi^2)(h_1-\mu)^2\}$, $a_\varphi = \frac{\sum_{t=1}^{T-1}(h_t-\mu)^2}{\sigma_\eta^2} + \frac{1}{\sigma_\psi^2}$, $b_\varphi = \frac{\sum_{t=1}^{T-1}(h_t-\mu)(h_{t+1}-\mu)}{\sigma_\eta^2} + \frac{\bar{\varphi}}{\sigma_\varphi^2}$ and $\mathbb{I}_{|\varphi|<1}$ is an indicator variable. As $p(\varphi \mid \mathbf{h}_{0:T}, \alpha, \sigma_\eta^2)$ in (A.2) does not have closed form, we sample from it by using the Metropolis-Hastings algorithm with truncated $\mathcal{N}_{(-1,1)}(\frac{b_\psi}{a_\psi}, \frac{1}{a_\psi})$ as the proposal density.

Finally, the full conditional of $\sigma_\eta^2$ is $\mathcal{IG}(\frac{T_1}{2}, \frac{M_1}{2})$, where $T_1 = T_0 + T$ and $M_1 = M_0 + [(1-\psi^2)(h_1 - \mu)^2] + \sum_{t=1}^{T-1}[h_{t+1} - \mu - \psi(h_t - \mu)]^2$.

### Full conditional of $\nu$, $\lambda$, $U_t$ and $W_t$

We, set $\zeta$ and $\omega$ in such a way that $E(y_t \mid h_t) = 0$ and $V(y_t \mid h_t) = e^{h_t}$. So, we have $\zeta = -\sqrt{\frac{2}{\pi}}k_1\delta\omega$ and $\omega^2 = \left[k_2 - \frac{2}{\pi}k_1^2\delta^2\right]^{-1}$, where $k_1 = \sqrt{\frac{\nu}{2}}\frac{\Gamma(\frac{\nu-1}{2})}{\Gamma(\frac{\nu}{2})}$, $k_2 = \frac{\nu}{\nu-2}$ and $\delta = \frac{\lambda}{\sqrt{1+\lambda^2}}$. Then the full the conditionals of

$\nu$ and $\lambda$ follows:

$$
\begin{aligned}
p(\nu \mid .) \quad &\propto \quad \left(\frac{\nu}{\nu+3}\right)^{\frac{1}{2}} \left\{ \psi'\left(\frac{\nu}{2}\right) - \psi'\left(\frac{\nu+1}{2}\right) - \frac{2(\nu+3)}{\nu(\nu+1)^2} \right\}^{\frac{1}{2}} \\
&\times \quad \left(\frac{1}{\omega}\right)^T e^{-\frac{1}{2\omega^2(1-\delta^2)} \sum_{t=1}^T U_t e^{-h_t}(y_t - \zeta - \omega\delta W_t U_t^{-\frac{1}{2}} e^{\frac{h_t}{2}})^2}, \tag{A.3}
\end{aligned}
$$

$$
p(\lambda \mid .) \quad \propto \quad \left(1 + \frac{2\lambda}{\frac{\pi^2}{4}}\right)^{-\frac{3}{4}} \left(\frac{1}{1-\delta^2}\right)^{\frac{T}{2}} e^{-\frac{1}{2\omega^2(1-\delta^2)} \sum_{t=1}^T U_t e^{-h_t}(y_t - \zeta - \omega\delta W_t U_t^{-\frac{1}{2}} e^{\frac{h_t}{2}})^2}. \tag{A.4}
$$

Since the above full conditional distributions are not in any known closed form, we must simulate $\nu$ and $\lambda$ using the Metropolis-Hastings algorithm. The proposal density used are $\mathcal{N}_{(\nu>2)}(\mu_\nu, \tau_\nu^2)$ and $\mathcal{N}(\mu_\lambda, \tau_\lambda^2)$, with $\mu_\upsilon = x - \frac{q'(x)}{q''(x)}$ and $\tau_\upsilon^2 = \max\{0.001, (-q''(x))^{-1}\}$ for $\upsilon = \nu$ or $\lambda$, where $x$ is the value of the previous iteration, $q(.)$ is the logarithm of the conditional posterior density, and $q'(.)$ and $q''(.)$ are the first and second derivatives respectively.

As $U_t \sim \mathcal{G}(\frac{\nu}{2}, \frac{\nu}{2})$, the conditional posterior of $U_t$ is given by

$$
p(U_t \mid h_t, W_t, \nu, \lambda) \quad \propto Q(U_t) U_t^{\frac{\nu+1}{2}-1} e^{-\frac{U_t}{2}[\nu + \frac{e^{-h_t}(y_t - \zeta e^{\frac{h_t}{2}})^2}{\omega^2(1-\delta^2)}]}, \tag{A.5}
$$

where $Q(U_t) = e^{\frac{U_t^{\frac{1}{2}} \delta W_t e^{-\frac{h_t}{2}}(y_t - \zeta e^{\frac{h_t}{2}})}{\omega(1-\delta^2)}}$. As $p(U_t \mid h_t, W_t, \nu, \lambda)$ in (A.5) does not have closed form, we sample from it by using the Metropolis-Hastings algorithm with $\mathcal{G}(\frac{\nu+1}{2}, \frac{1}{2}[\nu + \frac{e^{-h_t}(y_t - \zeta e^{\frac{h_t}{2}})^2}{\omega^2(1-\delta^2)}])$ as the proposal density. Finally, from equations (8a) and (8c), we have the full conditional of $W_t$ is the $\mathcal{N}_{[0,\infty)}(\frac{\delta U_t^{-\frac{1}{2}} e^{-\frac{h_t}{2}}[y_t - \zeta e^{\frac{h_t}{2}}]}{\omega}, \frac{1}{1-\delta^2})$.

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