The increasing availability of high-frequency asset return data has had a fundamental impact on empirical financial economics, focusing attention on asset return volatility and correlation dynamics, with key applications in portfolio and risk management. So-called “realized” volatilities and correlations have featured prominently in the recent literature, and numerous studies have provided direct characterizations of the unconditional and conditional distributions of realized volatilities and correlations across different assets, asset classes, countries, and sample periods. For overviews see Andersen et al. (2005a, b).

In this paper we selectively survey, unify and extend that literature. Rather than focusing exclusively on characterization of the properties of realized volatility, we progress by examining economically interesting functions of realized volatility, namely, realized betas for equity portfolios, relating them both to their underlying realized variance and covariance parts and to underlying macroeconomic fundamentals.

I. Realized Volatility

Let the \( N \times 1 \) logarithmic vector price process, \( p_t \), follow a multivariate continuous-time stochastic volatility diffusion,

\[
dp_t = \mu_t \ dt + \Omega_t \ dW_t
\]

where \( W_t \) denotes a standard \( N \)-dimensional Brownian motion, both the \( N \times N \) positive definite diffusion matrix, \( \Omega_t \), and the \( N \)-dimensional instantaneous drift, \( \mu_t \), are strictly stationary and jointly independent of \( W_t \) (extensions to allow for leverage effects, or nonzero correlations between \( W_t \) and \( \Omega_t \), and/or jumps in the price process could in principle be incorporated as well). Also, suppose that the \( i \)th element of \( p_t \) contains the log price of the market, and the \( i \)th element of \( p_t \) contains the log price of the \( i \)th individual stock, so that the corresponding covariance matrix contains both the market variance, say, \( \sigma_{M,t}^2 = \Omega_{i(i),t} \), and the individual equity covariance with the market, say, \( \sigma_{iM,t} = \Omega_{i(i),t} \).

Conditional on the realized sample paths of \( \mu_t \) and \( \Omega_t \), the distribution of the continuously compounded \( h \)-period return, \( r_{t+h} \equiv p_{t+h} - p_t \), is then

\[
r_{t+h} | \sigma(\mu_{t+\tau}, \Omega_{t+\tau})_{\tau=0}^h \\
\sim N\left( \int_0^h \mu_{t+\tau}^T d\tau, \int_0^h \Omega_{t+\tau}^T d\tau \right)
\]

where \( \sigma(\mu_{t+\tau}, \Omega_{t+\tau})_{\tau=0}^h \) denotes the \( \sigma \)-field generated by the sample paths of \( \mu_{t+\tau} \) and \( \Omega_{t+\tau} \).
for \(0 \leq \tau \leq h\). The integrated diffusion matrix
\[
\int_0^h \Omega_{t+\tau} d\tau
\]
therefore provides a natural measure of the true latent \(h\)-period volatility. Under
weak regularity conditions, it follows from the theory of quadratic variation that
\[
\sum_{j=1}^{\lfloor h/\Delta \rfloor} \dot{f}_t + j\Delta \cdot r_t^2 + j\Delta \Delta
\]
almost surely (a.s.) for all \(t\) as the return sampling frequency increases (\(\Delta \to 0\)). Thus,
by using sufficiently finely sampled high-frequency returns, it is possible in theory to
construct a realized diffusion matrix that is arbitrarily close to the integrated diffusion
matrix (for a survey of the relevant theory, see Andersen et al. [2005c]). In practice, mar-
ket microstructure frictions limits the highest feasible sampling frequency (\(\Delta \geq \delta > 0\)), and
the best way to deal with this, whether using the simple estimator in (3) or some variant
thereof, is currently a very active area of research.

Meanwhile, key empirical findings for realized volatility include lognormality and long memory
of volatilities and correlations (Andersen et al., 2001a, b), as well as normality of returns stan-
dardized by realized volatility (Andersen et al., 2000). Those properties, as distilled in the lognor-
mal/normal mixture model of Andersen et al. (2003), have important implications for risk man-
agement and asset allocation.

II. Realized Beta and Its Components

Although characterizations of the properties of realized variances and covariances are of interest, alternative objects are often of greater economic significance with a leading example being the market beta of a portfolio. If either the market volatility or its covariance with portfolio returns is time-varying, then the portfolio beta will generally be time-varying. Hence it is clearly of interest to explore the links between time-varying volatilities, time-varying correla-
tions, and time-varying betas. One may con-
struct realized betas from underlying realized
covariance and variance components, or con-
versely, decompose realized betas into realized variance and covariance components.

Armed with the relevant realized market variance and realized covariance measures, we can readily define and empirically construct “real-
ized betas.” Using an initial subscript to indicate the corresponding element of a vector, we de-
ote the realized market volatility by
\[
\tilde{\sigma}_{M,t}^2 + h = \sum_{j=1}^{\lfloor h/\Delta \rfloor} \sigma_{t}^2 + j\Delta \Delta \cdot \sigma_{t+j\Delta} \Delta
\]
and the realized covariance between the market and the \(i\)th portfolio return by
\[
\tilde{\gamma}_{iM,t} + h = \sum_{j=1}^{\lfloor h/\Delta \rfloor} \gamma_{t}^2 + j\Delta \Delta \cdot \gamma_{t+j\Delta} \Delta
\]
Now defining the realized beta as the ratio be-
tween the two, it follows under the assumptions above that
\[
\tilde{\beta}_{iM,t} + h = \frac{\tilde{\gamma}_{iM,t} + h}{\tilde{\sigma}_{M,t}^2 + h} \to \beta_{i,t} + h
\]
a.s. for all \(t\) as \(\Delta \to 0\), so that realized beta is consistent for the corresponding true integrated beta.

By comparing the properties of directly mea-
ured betas to those of directly measured var-
iances and covariances, we can decompose movements in betas in informative ways. In
particular, because the long memory in under-
lying variances and covariances may be common, it is possible that betas may be only
weakly persistent (short-memory, \(I(d), \text{with } d \approx 0\)), despite the widespread finding that realized variances and covariances are long-memory (fractionally integrated, \(I(d), \text{with } d \approx 0.4\)). Recent work (Andersen et al., 2005d) indicates that the relevant realized variances and covari-
ances are indeed reasonably well-characterized as nonlinearly fractionally cointegrated in this
fashion (as beta is an a priori known ratio of the two measures).
III. A State-Space Framework Facilitating the Inclusion of Macroeconomic Fundamentals

Although the decomposition of realized betas into contributions from underlying variances and covariances is intriguing, a more thorough economic analysis would seek to identify the fundamental determinants of realized variances and covariances that impact realized betas. Here we take some steps in that direction, directly allowing for dependence of betas on underlying macroeconomic fundamentals.

First, in parallel to the volatility model in Ole Barndorff-Nielsen and Neil Shephard (2002), the time-varying integrated/realized beta may be conveniently cast in state-space form. The realized beta equals the true latent integrated beta, plus a weak white-noise measurement error, asymptotically Gaussian in the sampling frequency ($\Delta \to 0$). Normalizing $h = 1$ and suppressing the subscripts:

\begin{align}
(7a) & \quad \hat{\beta}_t = \beta_t + u_t, \\
(7b) & \quad \beta_t = \gamma_0 + \gamma_1 \beta_{t-1} + v_t
\end{align}

where $v_t$ is weak white noise. We therefore have a state space system, with measurement equation (7a) and transition equation (7b), so that the Kalman filter may be used for extraction and prediction of the latent integrated $\beta_t$ based on the observed $\hat{\beta}_t$ (a more refined approach in which the nonconstant variance of $u_t$ is equated to the asymptotic, for $\Delta \to 0$, expression in Barndorff-Nielsen and Shephard [2004] could also be applied). Note, that the system in (7) is distinctly different from the one in which the measurement equation is replaced by a conditional capital asset pricing model (CAPM), $r_t = \alpha + \beta_t \bar{r}_M + \epsilon_t$ (see e.g., Andrew Ang and Joseph Chen, 2004; Gergana Jostova and Alexander Philipov, 2005) (for an alternative intra-day-based beta estimation procedure, see e.g., Qianqiu Liu [2003]). The smoothed version of $\beta_t$ extracted by the Kalman filter from (7) in particular, should compare favorably to the standard practice of assuming that the sampling frequency is so high that $\hat{\beta}_t$ is effectively indistinguishable from $\beta_t$, or $u_t \approx 0$ (see also Dean Foster and Dan Nelson [1996], who argue for smoothing of realized betas, from a very different and complementary perspective).

Second, note that we may readily include macroeconomic fundamentals in the state space dynamics, by augmenting the state vector as in the system:

\begin{align}
(8a) & \quad \hat{\beta}_t = z'B_t + u_t, \\
(8b) & \quad B_t = \Gamma_0 + \Gamma_1 B_{t-1} + v_t
\end{align}

where $z' = (1, 0, \ldots, 0)$, $u_t \sim (0, \sigma_u^2)$, $\Gamma_0$ is a vector of intercepts, $\Gamma_1$ is a matrix of coefficients, $B_t = (\beta_t, x_t)$, $x_t$ is a column vector of macroeconomic variables, and $v_t \sim (0, \Sigma)$ is a vector of transition disturbances. The vector autoregressive transition equation (8b) permits interaction between beta and macroeconomic fundamentals, both dynamically (via $\Gamma_1$) and contemporaneously (via the covariances in $\Sigma$). For illustration, in this paper, we only explore macroeconomic indicators one at a time, under an assumption of recursive transition dynamics. That is, letting $\Sigma = \text{diag}(\sigma_{\text{int}}, \sigma_{\text{int}}^2)$, we estimate the system

\begin{align}
(9a) & \quad \hat{\beta}_t = \beta_t + u_t, \\
(9b) & \quad \begin{pmatrix} \hat{\beta}_t \\ x_t \end{pmatrix} = \begin{pmatrix} \gamma_{01} & \gamma_{11} \\ \gamma_{02} & \gamma_{12} \end{pmatrix} \begin{pmatrix} \beta_{t-1} \\ x_{t-1} \end{pmatrix} + \begin{pmatrix} v_{1t} \\ v_{2t} \end{pmatrix}.
\end{align}

For simplicity, we further assume homoscedastic measurement errors for monthly realized betas. This is clearly not true for daily data, but a more palatable approximation at the monthly level that is relevant for the analysis below. It follows that inference based on the standard Kalman filter is valid.

IV. An Illustrative Application

We use underlying 15-minute returns for individual NYSE-listed stocks and the value-weighted market portfolio. We construct all returns from the TAQ dataset, 1 February 1993–31
May 2003, excluding real estate investment trusts, stocks of companies incorporated outside the United States, and closed-end mutual funds. Next, we sort the firms into 25 portfolios, corresponding to various combinations of the five market capitalization (“size”) and five book-to-market (“value”) quintiles, month-by-month, rebalancing each month. We denote the 25 portfolios by $ij$, for $i, j = 1, \ldots, 5$, where $i$ refers to size quintile and $j$ refers to value quintile (from low to high). Finally, for each of the 25 portfolios, we use the 15-minute portfolio and market returns to construct monthly realized covariances of each portfolio return with the market return, the realized variance of the market return, and the ratio, or “realized beta.” To adjust for asynchronous trading, we use an equally weighted average of contemporaneous realized beta and four leads and lags.

In Figure 1, we show extractions of the latent integrated betas obtained using the Kalman smoother. Substantial and highly-persistent time variation is evident for all the realized betas, but they do not appear to be trending or otherwise nonstationary; instead reverting to fixed means. We have also shaded the March–November 2001 recession for visual reference. Looking across the columns from low- to high-value portfolios, the betas for many portfolios appear to increase substantially during and around the recession, and the high-value portfolio betas seem to be more responsive over the cycle.

We now assess these graphically motivated conjectures more rigorously by estimating the time-varying beta model in (9) explicitly allowing for macroeconomic influences. In Andersen et al. (2005e), we study all 25 portfolios and several macroeconomic indicators, alone and in combination, including industrial production, the term premium, the default premium, the consumption/wealth ratio, the consumer price index, and the consumer confidence index. Here we merely sketch some illustrative results, focusing on representative large-capitalization portfolios 51, 53, and 55, and a central macroeconomic indicator, industrial production growth (IP).
We display the estimation results in Table 1. The \( \gamma_{11} \) indicate substantial own persistence, while the \( \gamma_{22} \) are obviously much smaller. This is natural as the IP variable is a growth rate (change in logarithm). The key macro-finance interaction coefficient, \( \gamma_{12} \), summarizes the response of \( \beta_t \) to movements in IP\(_{t-1}\). Interestingly, and in keeping with our earlier conjecture, both the statistical and economic significance of the estimates of \( \gamma_{12} \) increase with value, as measured by book-to-market. For portfolio 51, the point estimate of \( \gamma_{12} \) is near zero and statistically insignificant at any conventional level, while for portfolio 53, the point estimate is substantially larger in magnitude (3.486) and significant at the 10-percent level. For portfolio 55, the point estimate is statistically significant at the 1-percent level, and quite large at 6.101, implying that an additional percentage point of IP\(_{t-1}\) growth produces a –0.061 decrease in \( \beta_{55,t} \). Hence as IP\(_{t-1}\) varies over the cycle from, say, –0.05 to +0.05, \( \beta_{55,t} \) will move substantially.

Impulse response functions provide a more complete distillation of the dynamic response patterns. Although the recursive structure automatically identifies the vector autoregression (10b), we still normalize by the Cholesky factor of \( \Sigma \) to express all shocks in standard deviation units. We report results in Figure 2. In parallel with the impact estimates in Table 1, the beta for the growth portfolio 51 shows no dynamic response, but as we move upward through the value spectrum, we find progressively larger effects, with positive IP\(_{t-1}\) shocks producing sharp decreases in \( \beta_t \), followed by very slow reversion to the mean. These are, of course, only partial effects, and a more complete analysis would have to jointly consider the influence of other business cycle variables as in (8a,b).

### Table 1—Parameter Estimates for Model (10)

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Portfolio 51</th>
<th>Portfolio 53</th>
<th>Portfolio 55</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \gamma_{11} )</td>
<td>0.915**</td>
<td>0.971**</td>
<td>0.971**</td>
</tr>
<tr>
<td>( \gamma_{12} )</td>
<td>0.920</td>
<td>2.156</td>
<td>1.706</td>
</tr>
<tr>
<td>( \gamma_{22} )</td>
<td>0.191*</td>
<td>0.191*</td>
<td>0.191*</td>
</tr>
</tbody>
</table>

† Statistically significant at the 10-percent level.
* Statistically significant at the 5-percent level.
** Statistically significant at the 1-percent level.

![Figure 2. Impulse Response Functions](image-url)
and Sydney Ludvigson (2001a), but also for bonds, as in John H. Cochrane and Monika Piazzesi (2005)—whether because risk is higher in recessions, as in George M. Constantinides and Darrell Duffie (1996), or because risk aversion is higher in recessions, as in John Campbell and Cochrane (1999). The preliminary results reported here indicate that equity market betas do indeed vary with macroeconomic indicators such as industrial production growth, and that the macroeconomic effects on expected returns are large enough to be economically important. Moreover, the preliminary results strongly indicate that the counter-cyclicality of beta is primarily a value stock phenomenon, suggesting that the well-documented and much-debated value premium (see also Ravi Jagannathan and Lettau and Stefan Nagel, 2005; Ralitsa Petkova and Lu Zhang, 2005) may at least in part be explained by an increase in expected returns for value stocks during bad economic times.

REFERENCES


