

# Bias in the Estimation of the Mean Reversion Parameter in Continuous Time Models<sup>1</sup>

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## **Abstract**

It is well known that for continuous time models with a linear drift standard estimation methods yield biased estimators for the mean reversion parameter both in finite discrete samples and in large in-fill samples. In this paper, we obtain two expressions to approximate the bias of the least squares/maximum likelihood estimator of the mean reversion parameter in the Ornstein-Uhlenbeck process with a known long run mean when discretely sampled data are available. The first expression mimics the bias formula of Marriott and Pope (1954) for the discrete time model. Simulations show that this expression does not work satisfactorily when the speed of mean reversion is slow. Slow mean reversion corresponds to the near unit root situation and is empirically realistic for financial time series. An improvement is made in the second expression where a nonlinear correction term is included into the bias formula. It is shown that the nonlinear term is important in the near unit root situation. Simulations indicate that the second expression captures the magnitude, the curvature and the non-monotonicity of the actual bias better than the first expression.

*Keywords:* Least squares, Maximum likelihood, Discrete sampling, Continuous record, Near unit root.

*JEL Classifications:* C22, C32

# 1 Introduction

There is an extensive literature on using continuous time models in economic theory (e.g., Merton, 1990). Motivated by this success, econometricians have developed methods for estimating continuous time models, aiming to provide a basis from which these models may be used in empirical applications. While Ito's lemma facilitates the mathematical treatment of continuous time models in economic applications, continuous time models are more difficult to deal with econometrically than their discrete time counterparts. In recent years, however, several exciting developments have been made on estimating and testing continuous time models based on discrete time observations. In terms of parameter estimation, important contributions include Lo (1986), Bergstrom (1990), Duffie and Singleton (1993), Pedersen (1995), Aït-Sahalia (1999, 2002), Stanton (1997), Elerian, Chib and Shephard (2001), Bandi and Phillips (2002, 2007), and Aït-Sahalia and Yu (2006). In terms of specification analysis, important contributions include Chan, et al. (1992), Aït-Sahalia (1996a, 1996b), Dai and Singleton (2000), and Hong and Li (2005). While there are abundant continuous time specifications available, much of the focus in the asset pricing literature has been on the continuous time diffusion equations with an affine structure (see Duffie and Kan, 1996). This is the main motivation why we choose to focus our attention on continuous time diffusion models with a linear drift function. However, the methodology employed here is general and is applicable to non-affine models.

One problem with utilizing continuous time models is estimation bias.<sup>1</sup> Standard estimation methods, such as least squares (LS), maximum likelihood (ML) or generalized method of moments (GMM), produce biased estimators for the mean reversion parameter. The bias is essentially of the Hurwicz type that Hurwicz (1950) developed in the context of dynamic discrete time models. However, as it will be clear later, the percentage bias is much more pronounced in continuous time models than their discrete time counterpart. On the other hand, estimation is fundamentally important for many practical applications. For example, it provides parameter estimators which are used directly for estimating prices of financial assets and derivatives. For another example, parameter estimation serves as an important stage for the empirical analysis of specification and comparative diagnostics. Not surprisingly, it has been found in the literature that the bias in the mean reversion estimator has important implications for the specification analysis of continuous time models (Prisker, 1998) and for pricing financial assets (Phillips and Yu, 2005).

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<sup>1</sup>The bias in this article refers to bias arising from estimation. This is different from the bias induced by discretizing continuous time models.

Several methods have been proposed to reduce the bias in the mean reversion estimator.<sup>2</sup> Ball and Torous (1996) suggested utilizing more cross-sectional information for estimating continuous time term structure models. Obviously this approach is subject to data availability. In Phillips and Yu (2005) the jackknife method of Quenouille (1956) was suggested to reduce the bias. While the jackknife method cannot completely remove the bias, it can be very useful in practice as it is computationally simple and is applicable to a very broad range of models, including the models for which it is impossible or difficult to develop the explicit form of an asymptotic expansion of the bias. Another method whose performance was examined in Phillips and Yu (2005) is the median unbiased estimator of Andrews (1993). This estimator is closely related to the indirect inference method and the bootstrap method. The indirect inference method was originally proposed by Smith (1993) and Gouriéroux, Monfort and Renault (1993) and subsequently applied to reduce the bias in the mean reversion estimator by Phillips and Yu (2009a). The bootstrap method was recently proposed to reduce the bias in the mean reversion estimator by Tang and Chen (2009). All three methods are simulation-based, and hence computationally demanding.

In an independent and concurrent study, Tang and Chen (2009) derived an analytical formula for approximating the bias of certain estimators for the Ornstein-Uhlenbeck (OU) process and the square root process, both with an unknown long run mean. The bias formula corresponds to that of Marriott and Pope (1954) and Kendall (1954) for the discrete time autoregressive (AR) model with an intercept. It was shown that the bias of the mean reversion estimator is of order  $T^{-1}$  but not of order  $n^{-1}$ , where  $T$  is the data span and  $n$  is the number of observations. As a result, increasing the sample size, by the way of increasing the sampling frequency, cannot yield a consistent LS estimator. This result confirms what has been known in the literature; see, for example, Merton (1980). However, the performance of their bias formula is unsatisfactory in the near unit root situations.

In this paper we complement the results of Tang and Chen (2009) by deriving an analytical formula for approximating the bias of ML/LS estimators for the OU process with a known long run mean. We make several contributions to the literature. First, we point out that the true bias of the mean reversion estimate has an interesting curvature and goes to zero when the mean reversion parameter is closer to zero. This result echoes the conjecture of Hurwicz (1950) about the bias in the autoregressive (AR) estimate in

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<sup>2</sup>Bias has been under extensive study in the context of discrete time models. Some recent studies include Abdir (1993), Rilstone, Srivastava, and Ullah (1996), Vinod and Shenton (1996), MacKinnon and Smith (1998), and Bao and Ullah (2007).

the discrete time AR(1) model. Second, we show that the bias formula, which mimics that of Marriott and Pope (1954) and Kendall (1954) for the discrete time model and that of Tang and Chen (2009) for continuous time models, is essentially linear in coefficient. Consequently, the bias predicted by the formula does not disappear in the unit root case. One reason why this bias formula does not work well is that the Cesaro sums are badly approximated in the unit root and the near unit root situations. Since many financial time series have roots extremely near unity, there is considerable interest in improving the bias formula.

As a third contribution, we derive an alternative bias formula which includes an extra term. The extra term arises from the exact evaluation of the Cesaro sums. It is of smaller order and hence can be ignored when the mean reversion parameter is far away from zero. Interestingly, it does not have a smaller order effect when the mean reversion parameter is close to zero. Monte Carlo studies show that the alternative bias formula is more accurate. It reproduces the nonlinear feature in the true bias function and goes to zero when the mean reversion parameter goes to zero.

The paper is organized as follows. Section 2 derives the formulae for approximating the bias and the mean square error. In Section 3 we assess the accuracy of the analytical expressions using Monte Carlo experiments. Section 4 concludes the paper. The Appendix collects proofs of the main results.

## 2 OU Process with a Known Mean

The model considered here is the Ornstein-Uhlenbeck (OU) process:

$$dX(t) = \kappa(\mu - X(t))dt + \sigma dB(t), X(0) \sim N(\mu, \sigma^2/2\kappa) \quad (1)$$

with  $\mu$  being known, where  $B(t)$  is a standard Brownian motion. This model has been previously used to explain the dynamics of short-term interest rates (Vasicek, 1977) and log-volatilities (Taylor, 1982). Since we assume the long run mean,  $\mu$ , is known apriori, without loss of generality, it is set to zero. The parameter of interest is the speed of mean reversion,  $\kappa$ , which is assumed to be positive.<sup>3</sup> Phillips (1972) showed that the exact discrete time model corresponding to (1), is given by the following AR(1)

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<sup>3</sup>It is known, from the simulations conducted in Phillips and Yu (2005) and the theoretical work in Tang and Chen (2009), that the ML estimators of the long mean parameter and the diffusion parameter have little bias. For this reason, we focus our attention to the mean reversion parameter in the present paper.

structure

$$X_{ih} = \phi X_{(i-1)h} + \sigma \sqrt{\frac{1 - e^{-2\kappa h}}{2\kappa}} \epsilon_i, \quad (2)$$

where  $\phi = e^{-\kappa h}$ ,  $\epsilon_i \sim \text{i.i.d. } N(0, 1)$  and  $h$  is the sampling interval. Obviously the covariance structure of any discrete sample in Model (1) is the same as that in Model (2) and there is a one-to-one correspondence between  $\kappa$  and  $\phi$ . Also, it is easy to see that  $\kappa > 0$  implies  $\phi < 1$  and hence stationarity;  $\kappa \rightarrow 0$  or  $h \rightarrow 0$  implies  $\phi \rightarrow 1$  and the model converges to a unit root model. For a small value of  $\kappa$  or a small value of  $h$  (high frequency), both being empirically relevant, the model has a root near unity. This situation is the primary interest of the present study. Moreover, since the distribution of the LS estimator of  $\phi$  is invariant to  $\sigma^2$ , the same property holds for  $\kappa$ . The observed data are assumed to be recorded discretely at  $(0, h, 2h, \dots, nh(= T))$  in the time interval  $[0, T]$ . So  $n + 1$  is the total number of observations and  $T$  is the data span. With a finite value of  $T$ ,  $n \rightarrow \infty$  when  $h \rightarrow 0$  and vice versa. In the limit as  $h \rightarrow 0$ , a continuous sample path from the interval is observed. This in-fill asymptotics has become very popular in recent years in financial econometrics following the work on realized volatility; see, for example, Andersen, et al. (2001) and Barndorff-Nielsen and Shephard (2002). For financial time series,  $X(t)$  is often recorded monthly, weekly, or daily and hence  $h = 1/12$ ,  $1/52$  or  $1/252$ . However, higher frequencies are possible in the setup with an even smaller value for  $h$ . When there is no confusion, we simply write  $X_{ih}$  as  $X_i$ . Unless specified, the summation sign  $\sum$  is always referred to summation from  $i = 1$  to  $i = n$ .

The LS estimator of  $\kappa$  (denoted by  $\hat{\kappa}$ ) can be obtained by

$$\min_{\kappa} \sum (X_i - e^{-\kappa h} X_{i-1})^2. \quad (3)$$

It can be shown that the LS estimator is equivalent to the ML estimator which maximizes the following log-likelihood function (conditional on  $X_0 = X(0)$ ),

$$\sum \ln pdf(X_i | X_{i-1}). \quad (4)$$

where  $pdf$  represents the conditional density. For Model (1) with  $\mu = 0$ , the conditional distribution is given by

$$X_i | X_{i-1} \sim N(e^{-\kappa h} X_{i-1}, \sigma^2(1 - e^{-2\kappa h})/(2\kappa)). \quad (5)$$

The ML estimator has been widely used in the literature (see, for example, Aït-Sahalia, 1999). The equivalence is the main reason why we focus on LS.

It is well known from the discrete time dynamic literature that the LS estimator can be downward biased. For example, in the AR(1) model without intercept

$$X_i = \phi X_{i-1} + \sigma \epsilon_i, \quad \epsilon_i \sim N(0, 1) \quad (6)$$

Marriott and Pope (1954) derived the following expression to approximate the bias of the LS estimator

$$E(\hat{\phi}) - \phi = -\frac{2\phi}{n} + o(n^{-1}). \quad (7)$$

Bartlett (1946) derived the following expression to approximate the variance of  $\hat{\phi}$

$$Var(\hat{\phi}) = \frac{1 - \phi^2}{n} + o(n^{-1}). \quad (8)$$

Equations (7) and (8) are obtained by replacing the Cesaro sum

$$\sum_{j=-n}^n \left(1 - \frac{|j|}{n}\right) \phi^{|j|}$$

with

$$\sum_{j=-\infty}^{\infty} \phi^{|j|} = \frac{1 + \phi}{1 - \phi}.$$

Obviously the quality of the approximation deteriorates when  $\phi \rightarrow 1$ . When  $|\phi| < 1$ , the model is stationary and the limiting theory of  $\hat{\phi}$  is given by

$$\sqrt{n}(\hat{\phi} - \phi) \xrightarrow{d} N(0, 1 - \phi^2). \quad (9)$$

Since  $\phi = e^{-\kappa h}$ , it is reasonable to believe that the bias in  $\hat{\phi}$  translates into  $\hat{\kappa}$ . In fact, Phillips and Yu (2005, 2009a) provided extensive Monte Carlo evidence of severe finite sample bias in  $\hat{\kappa}$  and many other estimators of  $\kappa$ .

When  $\kappa$  is not close to zero, for  $\hat{\kappa}$ , we take a Taylor expansion up to the second order term,

$$\begin{aligned} \hat{\kappa} &= -\ln(\hat{\phi})/h \\ &= -\frac{1}{h} \left( \ln \phi + \frac{1}{\phi}(\hat{\phi} - \phi) - \frac{1}{2\phi^2}(\hat{\phi} - \phi)^2 + o_p(n^{-1}) \right) \\ &= \kappa - \frac{1}{h\phi}(\hat{\phi} - \phi) + \frac{1}{2h\phi^2}(\hat{\phi} - E(\hat{\phi}))^2 + o_p(T^{-1}). \end{aligned} \quad (10)$$

From Equations (7), (8) and (10), it is straightforward to show that

$$E(\hat{\kappa}) - \kappa = \frac{2}{hn} + \frac{1}{2h\phi^2} \left( \frac{1 - \phi^2}{n} \right) + o(T^{-1}) \quad (11)$$

$$= \frac{1}{2T} (3 + e^{2\kappa h}) + o(T^{-1}). \quad (12)$$

Bias formula (12) is analogous to that of Marriott and Pope for the AR(1) model and corresponds to that of Tang and Chen (2009) for the OU process with an unknown mean. The first term in (11) arises from the bias in  $\hat{\phi}$  while the second term arises from the variance of  $\hat{\kappa}$  and the nonlinear dependence of  $\kappa$  in  $\phi$ . By including only the first two terms in Taylor expansion, the bias due to the skewness and the kurtosis in  $\hat{\phi}$  is obviously omitted. This omission trades off the quality of the approximation against algebraic tractability. The bias formula (12) has several implications for the behavior of the bias. First, according to (12), the size of the bias is mainly determined by the data span  $T$  but not by the sample size  $n$ . Second, the bias converges to  $2/T$  when  $h \rightarrow 0$ . According to this in-fill asymptotics, the bias does not go away unless  $T$  goes to infinity. Third, when  $\kappa$  is reasonably small,  $e^{2\kappa h} \approx 1 + 2\kappa h \approx 1$ . Hence, (12) implies that the bias is essentially linear in  $\kappa$  and that the bias is about  $2/T$  and hence insensitive to  $\kappa$ . According to the second and the third implications, the approximate bias is  $2/T$  when either  $h \rightarrow 0$  or  $\kappa \rightarrow 0$ . Fourth, the predicted bias will not disappear when  $\kappa \rightarrow 0$ . The first implication seems to be consistent with what have been found in literature (Phillips and Yu, 2005). The second and the third implications are rather surprising because (7) suggests that the bias in  $\hat{\phi}$  is sensitive to the true value. The last implication seems at odds with the conjecture made by Hurwicz (1950) that the bias in  $\hat{\phi}$  is zero in the discrete time unit root case (i.e.  $\phi = 1$ ).

To understand the behavior of the actual bias in Model (1) and the performance of (12), we simulate 756 daily observations (i.e.  $T = 3$ ) from the model with  $\kappa$  taking various values from the region of  $(0, 3]$  and estimate  $\kappa$  using the LS estimator (3). The experiment is replicated 10,000 times to get the actual bias. Fig. 1 plots the true bias and the expression (12), both as a function of  $\kappa$ . Obviously there is a great deal of discrepancy between them. The smaller  $\kappa$ , the bigger the difference. The actual bias goes to zero when  $\kappa \rightarrow 0$ , echoing the conjecture made by Hurwicz (1950) in the discrete time model, whereas according to (12) the expected value of  $\hat{\kappa}$  is about  $2/3 \approx 0.67$  when  $\kappa$  or  $h$  is close to zero. The discrepancy is due to the error arising from approximating the Cesaro sum since the derivation of (12) makes use of (7) and (8). Moreover, there is a strong nonlinearity in the actual bias function while the expression (12) is nearly linear. Therefore, there are good reasons to find a better bias formula than (12).

To derive the bias, we adopt the approach of Bao and Ullah (2007) which is briefly reviewed here. Suppose  $\hat{\beta}$  is an estimator of  $\beta$ , based on a sample of  $n$  observations, which satisfies the following estimation equation:

$$\psi_n(\hat{\beta}) = \frac{1}{n} \sum q_i(\hat{\beta}) = 0. \quad (13)$$

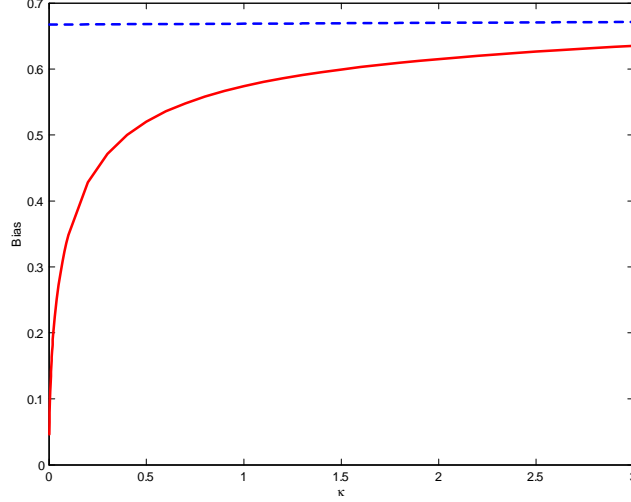


Figure 1: The bias as a function of  $\kappa$  for daily frequency (ie  $h = 1/252$ ) when  $T = 3$  (i.e.  $n = 756$ ). The solid line is from the simulations. The dashed line is from formula (12).

The identification condition is given by  $E(\psi_n(\beta)) = 0$ . Under a set of regular conditions, Bao and Ullah (2007) obtained the stochastic expansion of  $\hat{\beta}$  as<sup>4</sup>

$$\hat{\beta} - \beta = a_{-1/2} + a_{-1} + a_{-3/2} + o_p(n^{-3/2}), \quad (14)$$

where  $a_{-1/2} = -Q\psi_n$ ,  $a_{-1} = -QV a_{-1/2} - \frac{1}{2}Q\overline{H_2}a_{-1/2}^2$ ,  $a_{-3/2} = -QV a_{-1} - \frac{1}{2}QW a_{-1/2}^2 - Q\overline{H_2}a_{-1/2}a_{-1} - \frac{1}{6}Q\overline{H_3}a_{-1/2}^3$ , with  $\psi_n = \psi_n(\kappa)$ ,  $\bar{\cdot} = E(\cdot)$ ,  $H_i = \partial^i \psi_n / \partial \kappa^i$ ,  $Q = (\overline{H_1})^{-1}$ ,  $V = H_1 - \overline{H_1}$ ,  $W = H_2 - \overline{H_2}$ . By the identification condition,  $E(a_{-1/2}) = 0$ .<sup>5</sup> The second order and the third order bias of  $\hat{\beta}$  is, respectively,

$$E(a_{-1}), E(a_{-1} + a_{-3/2}) \quad (15)$$

and the first order and the second order MSE of  $\hat{\beta}$  is, respectively,

$$E(a_{-1/2}^2), E(a_{-1/2}^2 + 2a_{-1/2}a_{-1}). \quad (16)$$

When the parameter of interest is  $\phi$  in the AR(1) model, it is easy to see that  $H_2 = H_3 = V = W = 0$ , greatly simplifying the analysis. The parameter of interest in

<sup>4</sup>The expansion was first derived in the i.i.d. framework by Rilstone, Srivastava, and Ullah (1996).

<sup>5</sup>The asymptotic normality theory, such as (9), follows from the fact that  $\sqrt{n}a_{-1/2}$  converges to a normal distribution.

the present study is  $\kappa$  for which the estimation equation is a nonlinear function in  $\kappa$ . Consequently, none of these quantities is zero and hence the derivation of the bias is more complex in continuous time models. Working with  $E(a_{-1})$  without approximating the Cesaro sums in the OU model, we get a new second order bias for  $\hat{\kappa}$ .

**THEOREM 2.1** (New Approximation to the Bias of  $\hat{\kappa}$ ): *Under Model (1) with a known  $\mu$ , when  $\kappa$  is close to 0, we have the following second order bias of  $\hat{\kappa}$ ,*

$$\frac{1}{2T} (3 + e^{2\kappa h}) - \frac{2(1 - e^{-2n\kappa h})}{Tn(1 - e^{-2\kappa h})}. \quad (17)$$

**Remark 2.1** Compared with (12), the bias formula (17) has an extra term, which arises from the exact calculation of the Cesaro sums, as shown in the Appendix. This term is of order  $(Tn)^{-1}$  and hence smaller than  $1/T$ , when  $\kappa$  is far away from zero. In this case it is negligible and (17) becomes (12). However, if  $\kappa$  is close to zero, the extra term is not negligible, even for a large  $n$ . To see this, applying L'Hospital's rule to the second term, we have

$$\lim_{\kappa \rightarrow 0} \frac{1 - e^{-2n\kappa h}}{n(1 - e^{-2\kappa h})} = 1,$$

and

$$\lim_{\kappa \rightarrow 0} E(a_{-1}) = 0. \quad (18)$$

As a result, the extra term is of order  $T^{-1}$  but not of order  $(Tn)^{-1}$ . Indeed, (18) suggests that the bias is close to zero when  $\kappa$  is close to 0, which is consistent with what is found in Fig. 1. The bias, however, decreases when the span of data ( $T$ ) becomes larger. This observation is consistent with the Monte Carlo results reported in Phillips and Yu (2005). Compared with (12), the bias formula (17) is much more nonlinear due to the inclusion of the extra term.

**Remark 2.2** When  $h$  converges to 0,  $n(1 - e^{-2\kappa h}) \rightarrow 2T\kappa$  and  $1 - e^{-2n\kappa h} = 1 - e^{-2T\kappa}$ . Thus,

$$\lim_{h \rightarrow 0} \frac{2(1 - e^{-2n\kappa h})}{n(1 - e^{-2\kappa h})} = \frac{1 - e^{-2T\kappa}}{T\kappa} \quad (19)$$

and

$$\lim_{h \rightarrow 0} E(a_{-1}) = \frac{1}{T} \left\{ 2 - \frac{1 - e^{-2T\kappa}}{T\kappa} \right\}. \quad (20)$$

The implication for  $h \rightarrow 0$  is very different from that for  $\kappa \rightarrow 0$  although both cases lead to a unit root in the exact discrete time representation. The difference arises because as  $\kappa \rightarrow 0$  the initial condition becomes dominant whereas as  $h \rightarrow 0$  the error variance goes to 0. The bias formula (20) is also remarkably different from the limit

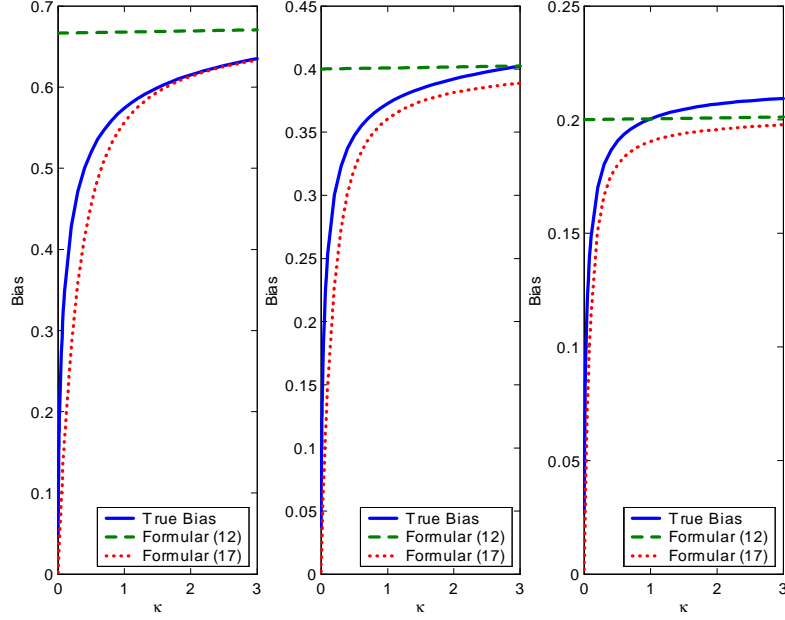


Figure 2: The bias as a function of  $\kappa$  for daily frequency (ie  $h = 1/252$ ). The three graphs correspond to  $T = 3, 5, 10$  (ie,  $n = 756, 1260, 2520$ ), respectively. The solid line is from the simulations. The dashed line is from formula (12). The dotted line is from formula (17).

case of (12) when  $h \rightarrow 0$ . It is easy to see that the bias formula (20) works well for practically relevant values for  $h$ . For example, if  $T = 3$  and  $\kappa = 3$ , (20) suggests that bias is about 0.63 as  $h \rightarrow 0$ ; if  $T = 3$  and  $\kappa = 1$ , (20) suggests that bias is about 0.46 as  $h \rightarrow 0$ . These values appear to match very well with what we have found in Fig. 1 when  $h = 1/252$ .

**Remark 2.3** Formulae (17) and (20) suggest feasible ways for bias correction. If  $\kappa$  is reasonably close to zero, we can estimate  $\kappa$  by

$$\hat{\kappa} - \frac{1}{2T} (3 + e^{2\hat{\kappa}h}) + \frac{2(1 - e^{-2n\hat{\kappa}h})}{Tn(1 - e^{-2\hat{\kappa}h})}.$$

If in addition,  $h$  is small, we can then estimate  $\kappa$  by

$$\hat{\kappa} - \frac{1}{T} \left\{ 2 - \frac{1 - e^{-2T\hat{\kappa}}}{T\hat{\kappa}} \right\}.$$

To obtain the limiting theory for  $\hat{\kappa}$  when  $\kappa > 0$ , we apply the delta method to (9)

$$\sqrt{T}(\hat{\kappa} - \kappa) \xrightarrow{d} N(0, (e^{2\kappa h} - 1)/h). \quad (21)$$

The variance in the limiting distribution is identical to what was found in Tang and Chen (2009).

**Remark 2.4** Working with  $E(a_{-1}^2)$  without approximating the Cesaro sums, we get the expression for the first order MSE, which is  $(e^{2\kappa h} - 1)/(Th)$ . Interestingly, the exact calculation of the Cesaro sums does not make any difference for the first order MSE as it is the same as the asymptotic variance  $\hat{\kappa}$  given by (21). Furthermore, when  $h \rightarrow 0$ ,  $MSE \approx 2\kappa/T$  and  $\hat{\kappa} \overset{a}{\sim} N(\kappa, 2\kappa/T)$ , the latter of which is well known in the statistics literature – see, for example, Brown and Hewitt (1975).

**Remark 2.5** Recently the higher order approximations were developed for  $E(\hat{\phi})$  and  $MSE(\hat{\phi})$  in the AR(1) model in the literature; see for example, Bao and Ullah (2007) and Bao (2007). Bao (2007) gave the bias of  $\hat{\phi}$ , up to  $O(n^{-2})$ , and  $MSE(\hat{\phi})$ , also up to  $O(n^{-2})$ . Although it may seem that these higher order approximations can be used to improve the order of the approximation to the bias of  $\hat{\kappa}$ , the actual treatment is less straightforward. The complication lies in the fact that  $\kappa$  is related to  $\phi$  by a nonlinear function. In (10), the approximation in the Taylor series expansion was up to  $O(n^{-1})$ . To match the  $O(n^{-2})$  order in approximating  $E(\hat{\phi})$  and  $MSE(\hat{\phi})$ , we will have to keep two more terms in the Taylor expansion, i.e.,

$$\begin{aligned} \hat{\kappa} &= -\frac{1}{h} \left( \ln \phi + \frac{(\hat{\phi} - \phi)}{\phi} - \frac{(\hat{\phi} - \phi)^2}{2\phi^2} - \frac{(\hat{\phi} - \phi)^3}{18\phi^3} + \frac{(\hat{\phi} - \phi)^4}{96\phi^4} + o_p(n^{-2}) \right) \\ &= \kappa - \frac{\hat{\phi} - \phi}{h\phi} + \frac{(\hat{\phi} - E(\hat{\phi}))^2}{2h\phi^2} - \frac{(\hat{\phi} - \phi)^3}{18h\phi^3} + \frac{(\hat{\phi} - \phi)^4}{96h\phi^4} + o_p(T^{-1}n^{-1}), \end{aligned} \quad (22)$$

which suggests that the approximation to the skewness and the kurtosis of  $\hat{\phi}$ , up to  $O(n^{-2})$ , is needed. Such a result is not available in the literature. Consequently, the higher order approximation to the bias of  $\hat{\kappa}$  is beyond the scope of the present paper.

### 3 Monte Carlo Results

To examine the performance of the two alternative bias formulae, we estimate  $\kappa$  in Model (1) using the LS estimators (3), assuming  $\kappa$  takes various values from the region of  $(0, 3]$ . This range covers empirically reasonable values of  $\kappa$  for real data on interest

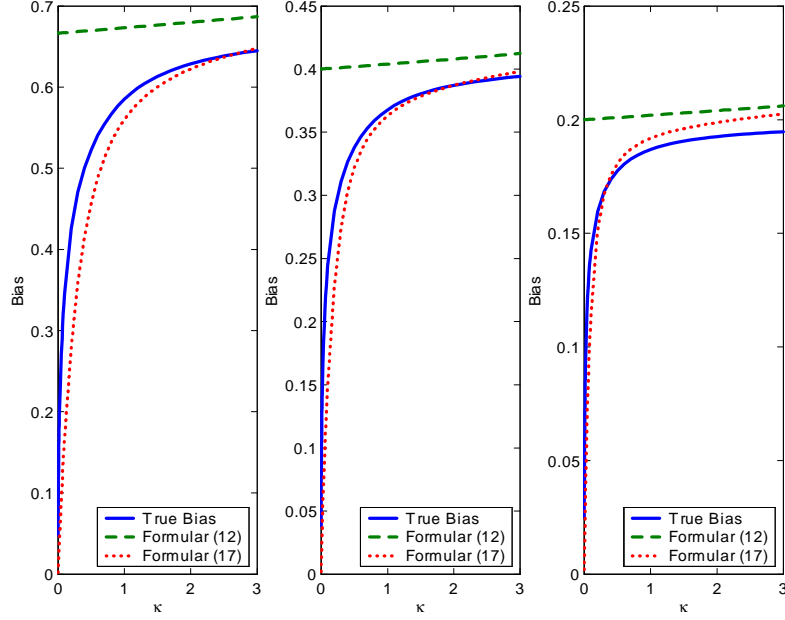


Figure 3: The bias as a function of  $\kappa$  for weekly frequency (ie  $h = 1/52$ ). The three graphs correspond to  $T = 3, 5, 10$  (ie,  $n = 156, 260, 520$ ), respectively. The solid line is from the simulations. The dashed line is from formula (12). The dotted line is from formula (17).

rates and volatilities. The mean reversion parameter is estimated with 3, 5 10 years of daily, weekly and monthly data. The experiment is replicated 10,000 times to get the bias. Since the number of simulated paths is large, the bias can be regarded as the actual bias.

Figures 2-4 report the simulation results for the daily, weekly and monthly frequency, respectively. In the figures, we plot the actual bias, the bias expression (12) and the bias expression (17) as a function of  $\kappa$ .

Several features are apparent in the figures. First, the actual bias can be substantial. The bias is especially large for small  $T$  both in percentage and absolute terms. For example, if data from a three-year time interval are used to estimate  $\kappa$  when  $\kappa = 0.1$ , regardless of the frequency at which the data are collected, the percentage bias is about 250% and the absolute bias is about 0.25. This bias is very big and has important economic implications for asset pricing. When  $\kappa$  is small, the bias formula (12) does not perform well and the bias formula (17) offers substantial improvement to (12). The bad performance of (12) is not surprising since it is known to be difficult to correct the

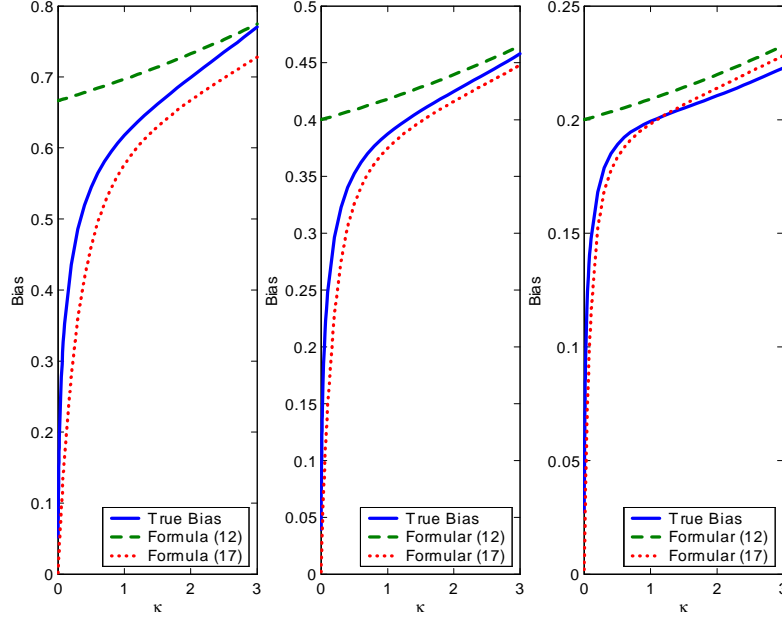


Figure 4: The bias as a function of  $\kappa$  for monthly frequency (ie  $h = 1/12$ ). The three graphs correspond to  $T = 3, 5, 10$  (ie,  $n = 36, 60, 120$ ), respectively. The solid line is from the simulations. The dashed line is from formula (12). The dotted line is from formula (17).

bias when  $\phi$  is close to 1 (Hurwicz, 1950). Because a small value for  $\kappa$  is empirically reasonable, the improvement in the bias formula (17) is practically useful.

Second, the actual bias is always a highly nonlinear function of  $\kappa$ , especially when  $\kappa$  is small. The bias formula (12) is virtually linear in  $\kappa$  whereas the bias formula (17) reproduces the curvature in the actual bias function quite well.

Third, as  $\kappa$  gets close to zero, the true bias seems to decrease toward zero. Interestingly, the bias formula (17) but not the bias formula (12) has the same feature. Fourth, the actual bias seems to be dependent upon the data span but not the sampling frequency, consistent with the two bias formulae.

To examine the performance of (20) relative to (17) (i.e. the effect of small  $h$ ), we adopt the same simulation design as before but now plot the bias formulae (17) and (20). Fig. 5-7 are for the daily, weekly and monthly frequency, respectively. Obviously, the difference between (17) and (20) is the largest for monthly data and the least for daily data, consistent with the prediction of (20). Similarly to (17), (20) also suggests the bias converges to 0 as  $\kappa \rightarrow 0$ . Finally, when the true value of  $\kappa$  is closer to 0, the

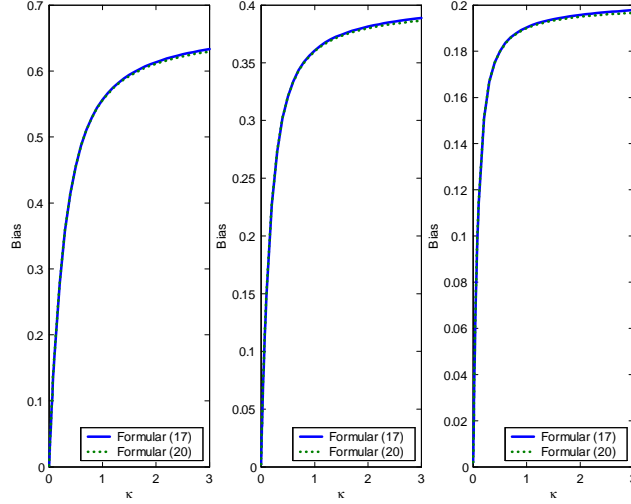


Figure 5: Approximate bias from (17) and (20) for the daily frequency with  $T = 3, 5, 10$ . The solid line is from formula (17). The dotted line is from formula (20).

difference between (17) and (20) is very small, suggesting that we can replace (17) with (20) to approximate the bias in practice.

## 4 Conclusions

We have presented two alternative expressions for approximating the bias of the mean reversion estimator in a continuous time diffusion model, based on the method proposed by Bao and Ullah (2007). The simpler expression mimics the bias formula derived by Marriott and Pope (1954) for the discrete time AR model and corresponds to the bias formula derived independently by Tang and Chen (2009) for the same model but with unknown mean. The complicated one includes an additional term from the exact evaluation of the Cesaro sums. We show that the additional term is important for improving the quality of bias approximation, especially when the mean reversion parameter is close to zero. This near unit case is practically realistic for financial time series. The initial condition is assumed to be the stationary distribution in our treatment. This initial condition is known to have important implications for the finite sample theory (White, 1961) and even for asymptotic theory in the unit root case (Phillips and Magdalinos, 2009). It is useful to derive the bias formula for alternative initial conditions for the mean reversion parameter.

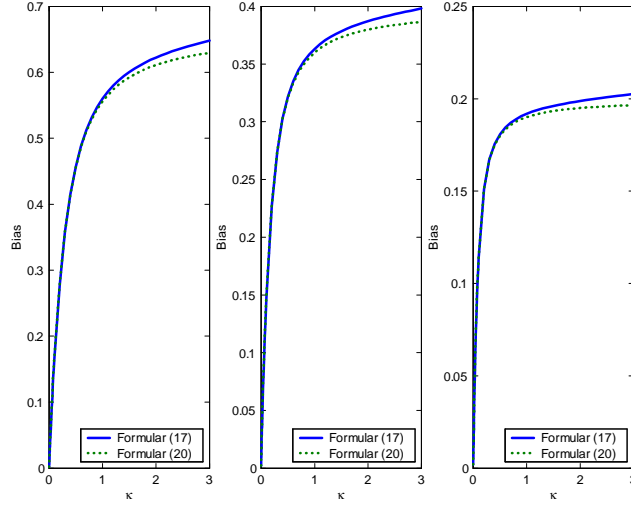


Figure 6: Approximate bias from (17) and (20) for the weekly frequency with  $T = 3, 5, 10$ . The dashed line is from formula (17). The dotted line is from formula (20).

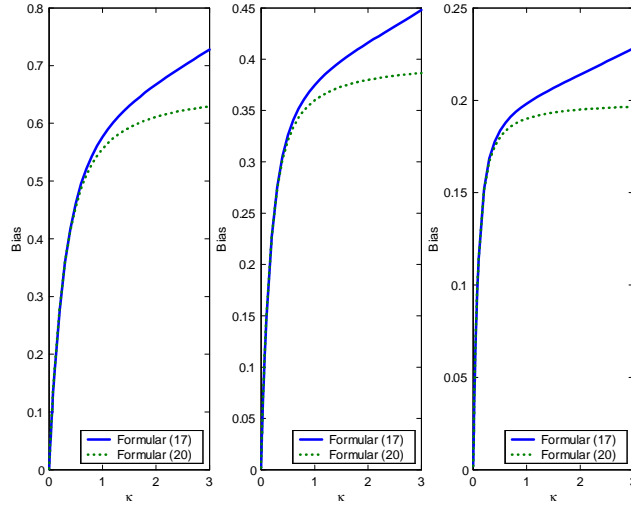


Figure 7: Approximate bias from (17) and (20) for the monthly frequency with  $T = 3, 5, 10$ . The dashed line is from formula (17). The dotted line is from formula (20).

## 5 Appendix

Before proving Theorem 2.1, we first introduce a lemma.

### Lemma 1

1. If  $X \sim N(0, \Sigma)$ ,  $A$ ,  $A_1$ ,  $A_2$  and  $A_3$  are all symmetric matrices, then

$$E(X'AX) = \text{tr}(A\Sigma), \quad (23)$$

$$E(X'AX)^2 = (\text{tr}(A\Sigma))^2 + 2\text{tr}(A\Sigma A\Sigma), \quad (24)$$

$$E(X'A_1XX'A_2X) = \text{tr}(A_1\Sigma)\text{tr}(A_2\Sigma) + 2\text{tr}(A_1\Sigma A_2\Sigma), \quad (25)$$

and

$$\begin{aligned} E(X'A_1XX'A_2XX'A_3X) &= \text{tr}(A_1\Sigma)\text{tr}(A_2\Sigma)\text{tr}(A_3\Sigma) + 2\{\text{tr}(A_1\Sigma)\text{tr}(A_2\Sigma A_3\Sigma) \\ &\quad + \text{tr}(A_2\Sigma)\text{tr}(A_1\Sigma A_3\Sigma) + \text{tr}(A_3\Sigma)\text{tr}(A_1\Sigma A_2\Sigma)\} \\ &\quad + 8\text{tr}(A_1\Sigma A_2\Sigma A_3\Sigma), \end{aligned} \quad (26)$$

where  $\text{tr}$  denotes the trace of a matrix.

2.  $\sum i\phi^{-i} = \frac{\phi - \phi^{1-n}(1+n) + n\phi^{-n}}{(1-\phi)^2}.$
3.  $\sum \sum \phi^{|t-s|} = n \frac{1+\phi}{1-\phi} - \frac{2\phi(1-\phi^n)}{(1-\phi)^2}.$
4.  $\sum \sum \phi^{|t-s|+|t-s-1|} = n \frac{2\phi}{1-\phi^2} - \frac{\phi(1+\phi^2)(1-\phi^{2n})}{(1-\phi^2)^2}.$
5.  $\sum \sum (\phi^{2|t-s|} + \phi^{|t-s+1|+|t-s-1|}) = n \frac{1+4\phi^2-\phi^4}{1-\phi^2} - \frac{2\phi^2(1-\phi^{2n})}{(1-\phi^2)^2}.$

### Proof of Lemma 1:

1. Equations (23) and (24) are straightforward consequences of Exercise 3 in Ullah (2004, Page 12). To get Equations (25) and (26), we need to define  $y = X\Sigma^{-1/2}$  and assume  $\mu = 0$  in Exercise 4 in Ullah (2004, Page 12).
2. Working from the derivatives, we have

$$\begin{aligned} \sum i\phi^{-i} &= -\phi \frac{\partial(\sum \phi^{-i})}{\partial \phi} = -\phi \frac{\partial((1-\phi^{-n})/(\phi-1))}{\partial \phi} \\ &= \frac{\phi - \phi^{1-n}(1+n) + n\phi^{-n}}{(1-\phi)^2} \end{aligned}$$

3. Following from the last equation, we have

$$\begin{aligned}\sum \sum \phi^{|t-s|} &= n + 2\phi^n \sum_{i=1}^{n-1} i\phi^{-i} = n + 2 \frac{\phi^{n+1} - n\phi^2 + (n-1)\phi}{(1-\phi)^2} \\ &= n \frac{1+\phi}{1-\phi} + \frac{2\phi^{n+1} - 2\phi}{(1-\phi)^2},\end{aligned}$$

$$\begin{aligned}\sum \sum \phi^{|t-s|+|t-s-1|} &= n\phi + \sum_{i=1}^{n-1} (n-i)\phi^{2i-1} + \sum_{i=1}^{n-1} (n-i)\phi^{2i+1} \\ &= n\phi + (1+\phi^2) \frac{\phi^2(\phi^{2n-1} - \phi) - (n-1)(\phi^2 - 1)\phi}{(1-\phi)^2} \\ &= n \frac{2\phi}{1-\phi^2} + \frac{(1+\phi^2)(\phi^{2n+1} - \phi)}{(1-\phi^2)^2},\end{aligned}$$

and

$$\begin{aligned}\sum \sum (\phi^{2|t-s|} + \phi^{|t-s+1|+|t-s-1|}) &= \sum \sum \phi^{2|t-s|} + \sum \sum \phi^{|t-s+1|+|t-s-1|} \\ &= n \frac{1+4\phi^2 - \phi^4}{1-\phi^2} - \frac{2\phi^2(1-\phi^{2n})}{(1-\phi^2)^2}\end{aligned}$$

**Proof of Theorem 2.1:** Denote  $X = (X_0, \dots, X_n)'$ ,

$$C_1 = \frac{1}{2} \begin{bmatrix} 0 & 1 & 0 & \cdots & 0 & 0 & 0 \\ 1 & 0 & 1 & \cdots & 0 & 0 & 0 \\ 0 & 1 & 0 & \cdots & 0 & 0 & 0 \\ \vdots & \vdots & \vdots & \ddots & \vdots & \vdots & \vdots \\ 0 & 0 & 0 & \cdots & 0 & 1 & 0 \\ 0 & 0 & 0 & \cdots & 1 & 0 & 1 \\ 0 & 0 & 0 & \cdots & 0 & 1 & 0 \end{bmatrix}, \text{ and } C_2 = \begin{bmatrix} 1 & 0 & 0 & \cdots & 0 & 0 \\ 0 & 1 & 0 & \cdots & 0 & 0 \\ 0 & 0 & 1 & \cdots & 0 & 0 \\ \vdots & \vdots & \vdots & \ddots & \vdots & \vdots \\ 0 & 0 & 0 & \cdots & 1 & 0 \\ 0 & 0 & 0 & \cdots & 0 & 0 \end{bmatrix} \quad (27)$$

Note that the LS estimator of  $\kappa$  is obtained from the following estimation equation,

$$\frac{1}{n} \sum X_{i-1} (X_i - e^{-\hat{\kappa}h} X_{i-1}) = \frac{1}{n} X' C_1 X - e^{-\hat{\kappa}h} \frac{1}{n} X' C_2 X := U_n - e^{-\hat{\kappa}h} V_n = 0. \quad (28)$$

with  $U_n = \frac{1}{n} X' C_1 X$  and  $V_n = \frac{1}{n} X' C_2 X$ .

Since the property of  $\hat{\kappa}$  is independent of  $\sigma^2$ , without loss of generality, we assume  $\sigma^2 = 2\kappa$ . As a result,  $X_t \sim N(0, 1)$  and  $X \sim N(0, \Sigma)$  where  $\Sigma$  is an  $(n+1) \times (n+1)$  matrix with  $ij$ -th element  $\phi^{|i-j|}$ . By Lemma 1,  $E(U_n) = \phi$  and  $E(V_n) = 1$ . Moreover,

$$\begin{aligned} E(U_n V_n) &= \frac{1}{n^2} E(X' C_1 X X' C_2 X) \\ &= \frac{1}{n^2} \{tr(C_1 \Sigma) tr(C_2 \Sigma) + tr(C_1 \Sigma C_2 \Sigma)\} \\ &= \phi + \frac{4\phi}{n(1-\phi^2)} - \frac{2\phi(1+\phi^2)(1-\phi^{2n})}{n^2(1-\phi^2)^2}, \end{aligned} \quad (29)$$

where the second and third equalities follow from Lemma 1. Similarly

$$\begin{aligned} E(V_n^2) &= \frac{1}{n^2} E(X' C_2 X)^2 \\ &= 1 + \frac{2(1+\phi^2)}{n(1-\phi^2)} - \frac{4\phi^2(1-\phi^{2n})}{n^2(1-\phi^2)^2}, \end{aligned} \quad (30)$$

and

$$\begin{aligned} E(U_n^2) &= \frac{1}{n^2} E(X' C_1 X)^2 \\ &= \phi^2 + \frac{1+4\phi^2-\phi^4}{n(1-\phi^2)} - \frac{4\phi^2(1-\phi^{2n})}{n^2(1-\phi^2)^2}, \end{aligned} \quad (31)$$

From the estimation equation (28), using the same notations as in Bao and Ullah (2004), we have  $H_1 = \phi h V_n$ ,  $Q = 1/(\phi h)$ ,  $\overline{H_1} = \phi h$ ,  $V = \phi h(V_n - 1)$ ,  $H_2 = -\phi h^2 V_n$ ,  $\overline{H_2} = -\phi h^2$ ,  $H_3 = \phi h^3 V_n$ ,  $W = \phi h^2(1 - V_n)$ , and  $\overline{H_3} = \phi h^3$ . Substituting all these expressions to the individual terms in the stochastic expansion of  $\hat{\kappa}$  given by Equation (14), we obtain

$$a_{-1/2} = -\frac{U_n - \phi V_n}{\phi h}, \quad (32)$$

and

$$a_{-1} = \frac{U_n^2 - \phi^2 V_n^2}{2\phi^2 h} - \frac{U_n - \phi V_n}{\phi h}. \quad (33)$$

Substituting (29), (30) and (31) into (32) and (33), taking expectation, and collecting terms, we have

$$E(a_{-1/2}) = 0, \quad (34)$$

$$\begin{aligned}
E(a_{-1}) &= \frac{E(U_n^2) - \phi^2 E(V_n^2)}{2\phi^2 h} \\
&= \frac{1}{2\phi^2 h} \left\{ \phi^2 + \frac{1 + 4\phi^2 - \phi^4}{n(1 - \phi^2)} - \frac{4\phi^2(1 - \phi^{2n})}{n^2(1 - \phi^2)^2} \right\} \\
&\quad - \frac{\phi^2}{2\phi^2 h} \left\{ 1 + \frac{2(1 + \phi^2)}{n(1 - \phi^2)} - \frac{4\phi^2(1 - \phi^{2n})}{n^2(1 - \phi^2)^2} \right\} \\
&= \frac{1}{2T} (3 + e^{2\kappa h}) - \frac{2(1 - e^{-2n\kappa h})}{Tn(1 - e^{-2\kappa h})}
\end{aligned}$$

This proves Equation (18).

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