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Overnight News and Daily Equity Trading Risk Limits

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Katja Ahoniemi , Ana-Maria Fuertes , Jose Olmo

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Abstract

This article proposes a new bivariate modeling approach for setting daily equity-trading risk limits using high-frequency data. We construct one-day-ahead Value-at-Risk forecasts by taking into account the different dynamics of the overnight and daytime return processes and their covariance. The covariance is motivated by market microstructure effects such as price staleness and news spillover. Among the competitors we include a simpler bivariate model where the overnight return is redefined by moving the open price further into the trading day, and a univariate model based on the close-to-close return and an overnight-adjusted realized volatility. We illustrate the different approaches using data on the S&P 500 and Russell 2000 indices. The evidence in favor of modeling the covariance is more convincing for the latter index because of the lower trading volumes and, relatedly, the less efficient price discovery at market open for small-cap stocks.

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