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How Relevant is Volatility Forecasting for Financial Risk Management?

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Abstract

It depends. If volatility fluctuates in a forecastable way, volatility forecasts are useful for risk management (hence the interest in volatility forecastability in the risk management literature). Volatility forecastability, however, varies with horizon, and different horizons are relevant in different applications. Moreover, existing assessments of volatility forecastability are plagued by the fact that they are joint assessments of volatility forecastability and an assumed model, and the results can vary not only with the horizon but also with the assumed model. To address this problem, we develop a model-free procedure for assessing volatility forecastability across horizons. Perhaps surprisingly, we find that volatility forecastability decays quickly with horizon. Volatility forecastability – although clearly of relevance for risk management at the short horizons relevant for, say, trading desk management – may be much less important at longer horizons.

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