

The Effectiveness of Margin-Setting with Historical, Implied, or Realized Volatility

** Chor-yiu SIN

* Kin LAM

** Associate Professor, School of Business, Hong Kong Baptist University, Kowloon Tong, Hong Kong, Tel: (852) 3411 5200, Fax: (852) 3411 5580, e-mail: cysin@hkbu.edu.hk

* Chair Professor & Head, School of Business, Hong Kong Baptist University, Kowloon Tong, Hong Kong, Tel: (852) 3411 5007, Fax: (852) 3411 5585, e-mail: lamkin@hkbu.edu.hk

** Corresponding author

This version: June 5, 2006

Abstract

In this paper, we investigate the effectiveness of volatility forecast in a risk management context. We look at a clearinghouse's margin-setting system, which is primarily designed to control the risk resulting from members' defaults. Once the default risk is judged to be prudential enough, the clearinghouse's remaining concern is the opportunity cost of the investors. Such a framework is applied to evaluate the effectiveness of volatility forecasts based on historical, implied and realized volatility using HSI (Hang Seng Index) futures and options data. Our results generally support the conclusion that IV (implied volatility) outperforms the RV (realized volatility) model, which in turn also outperforms the HV (historical volatility) model.

JEL Classification: G14, G15

Keywords: Historical volatility, implied volatility, information content, margin-setting, realized volatility

Acknowledgments: This is a substantial revision of the paper entitled, "The Regulatory Value of Volatility Forecast: A Comparison between GARCH, Implied Volatility and Realized Volatility". We thank comments from the editor and two anonymous referees, which substantially improve the paper. Comments of the participants at the Inaugural Conference of AAD 2004 (especially those of Jay M. Chung) and those of the participants at the 2004 Annual Meeting of the Financial Management Association International are much appreciated. Kin Lam would like to thank the financial support by the Research Grants Council of the Hong Kong Special Administrative Region Government, in the form of an earmarked grant (HKBU2069/00H), while Chor-yiu Sin would like to thank those of two earmarked grants (HKBU2014/02H and HKBU2472/05H). The usual disclaimers apply.