Abstract

This article studies two extensions of the compound Poisson process with iid Gaussian innovations which are able to characterize important features of high frequency security prices. The first model explicitly accounts for the presence of the bid/ask spread encountered in price-driven markets. This model can be viewed as a mixture of the compound Poisson process model by Press and the bid/ask bounce model by Roll. The second model generalizes the compound Poisson process to allow for an arbitrary dependence structure in its innovations so as to account for more complicated types of market microstructure. Based on the characteristic function, we analyze the static and dynamic properties of the price process in detail. Comparison with actual high frequency data suggests that the proposed models are sufficiently flexible to capture a number of salient features of financial return data including a skewed and fat tailed marginal distribution, serial correlation at high frequency, time variation in market activity both at high and low frequency. The current framework also allows for a detailed investigation of the “market-microstructure-induced bias” in the realized variance measure and we find that, for realistic parameter values, this bias can be substantial. We analyze the impact of the sampling frequency on the bias and find that for non-constant trade intensity, “business” time sampling maximizes the bias but achieves the lowest overall MSE.

Keywords: Compound Poisson Process; High Frequency Data; Market Microstructure; Characteristic Function; OU Process; Realized Variance Bias; Optimal Sampling
1 Introduction

The distributional properties of financial asset returns are of central interest to financial economics because they have wide ranging implications for issues such as market efficiency, asset pricing, volatility modelling, and risk management. Although the conditional and unconditional distribution of returns at the daily and weekly frequencies have been extensively studied and are typically well understood, this is certainly not the case for returns observed at higher frequencies. Intra-daily patterns in market activity plus numerous market microstructure effects\(^1\) substantially complicate the analysis of so-called “high frequency” data and often render conventional return models inappropriate.

Much of modern finance theory builds on the martingale property of risk-adjusted asset prices, as originally laid out in Cox and Ross (1976) and Harrison and Kreps (1979). The development of econometric models for asset prices has progressed hand in hand and is, as a result, directed to models that are consistent with the martingale hypothesis. A prominent example is the geometric Brownian motion from which the celebrated Black and Scholes option pricing formula has been derived. To capture commonly observed characteristics of daily return data, such as skewness, fat tails and heteroscedasticity, this model has been extended in a number of directions to include for instance random jumps and the stochastic evolution of return variance\(^2\). Although less suited for derivative pricing, an attractive alternative to the diffusion process is the compound Poisson process. Despite its long tradition in the statistics literature\(^3\), the model has received only moderate attention in finance\(^4\) after it has been introduced by Press (1967, 1968). In its simplest form, the compound Poisson process with iid Gaussian increments is given by:

\[
F(t) = F(0) + \sum_{j=1}^{M_I(t)} \varepsilon_j,
\]

where \(F(t)\) denotes the time-\(t\) logarithmic asset price, \(\varepsilon_j \sim \text{iid}\, N(\mu_I, \sigma_I^2)\) and \(M_I(t)\) is a homogeneous Poisson process with intensity parameter \(\lambda_I > 0\). Press (1967) has shown that the


\(^3\)The Poisson process, often viewed as a special case of a renewal process, has been used extensively in for instance queue theory, ruin and risk theory, inventory theory, evolutionary theory, and bio-statistics. See Andersen, Borgan, Gill, and Keiding (1993), Karlin and Taylor (1981, 1997) and references therein.

analytical characteristics of this model agree with the empirically observed properties of (low frequency) returns, namely a skewed and leptokurtic marginal return distribution. An appealing interpretation can be given to the Poisson process, $M_I(t)$, as counting the units of information flow that induce a random change in the asset’s price. The model is therefore intimately related to time deformation models (Clark 1973) which have found renewed interest in high frequency data research\(^5\). Further, it is important to note that, like many of the diffusion processes used in finance, the (compensated) compound Poisson process embodies the martingale property.

While the compound Poisson process, and many of the diffusion processes in particular, have been shown to fit low frequency data relatively well, this is certainly not the case at the high frequency where market microstructure effects have been shown to have a decided, but often complex, impact on the properties of the price process. Roll (1984) demonstrates that the existence of a bid/ask spread can lead to spurious first order negative serial correlation in returns. Lo and MacKinlay (1990) study the impact of non-synchronous trading on the dynamic properties of returns and find that it induces contemporaneous cross-correlation among assets and serial correlation in returns. By and large, it is widely recognized that the various market microstructure effects distort the distributional properties of high frequency returns and typically induce a substantial degree of serial correlation. Any process that is consistent with the martingale hypothesis of (risk adjusted) asset prices, will therefore be inconsistent with much of the theoretical market microstructure literature and, more importantly, with many of the observed characteristics of high frequency data.

In this paper, we argue that the continuous time diffusion processes studied in the finance literature, valuable as they are, seem to lack the flexibility required for the modelling of high frequency security prices. We propose two distinct statistical models that we believe are capable of capturing many important features of high frequency returns. The first model generalizes the standard compound Poisson process, as given in expression (1), to account for the presence of a bid/ask spread. The second model allows for a general form of serial dependence in returns. We also study the case where there is both deterministic and stochastic time variation in the trading intensity and show that this can be used to capture (i) deterministic patterns in market activity, (ii) serial dependence in trade durations at high frequency (i.e. “ACD-effects”) and (iii) persistence in the conditional return variance at low frequency (i.e. “ARCH-effects”). Based on the characteristic function, we analyze the static and dynamic properties of the price process in detail. Comparison with actual high frequency data suggests that the proposed models are sufficiently flexible to capture a number of salient features of financial return data including a

skewed and fat tailed marginal distribution, serial correlation at high frequency, time variation in market activity both at high and low frequency. A common feature of both models is that even though the martingale property is lost at high frequency, it can be retained under temporal aggregation. Motivated by this observation, we seek to address two issues that are relevant to the measurement of return volatility. Firstly, within the context of our models, we investigate the impact of serial correlation in returns on the recently proposed realized variance measure as discussed in Andersen, Bollerslev, Diebold, and Labys (2001, 2002) and Barndorff-Nielsen and Shephard (2001b). We show that serial correlation in returns can induce a substantial bias in the variance estimate and characterize its decay under temporal aggregation of returns. Secondly, we discuss a set of sampling strategies which aim at minimizing this bias. Here, the key result is that the magnitude of the bias can be altered by a deformation of the time scale. Importantly, we find that when the trade arrival intensity is non-constant, “business” time sampling maximizes the bias for a given sampling frequency while it achieves the lowest overall MSE relative to calendar time sampling. Moreover, for both sampling schemes, the “optimal” sampling frequency which minimizes the MSE is much higher than the one which minimizes the bias.

In the present context, it is also important to emphasize a fundamental difference between the compound Poisson process and the diffusion process, namely, the former is a finite variation process while the latter is an infinite variation process. By taking a microscopic view at the data, it is evident that variation in high frequency returns is inherently finite because the number of price-change-inducing trades is finite. Diffusion processes are, by construction, not able to capture this prominent feature of the data. In contrast, the finite variation property of the compound Poisson process appears ideally suited for the modelling of asset price both at high and low frequency.

The remainder of this paper is organized as follows. In Section 2, we generalize the compound Poisson process for the presence of a bid/ask spread, derive the characteristic function of the price process, and analyze the properties of the price process. Section 3 contains analogous results for the compound Poisson process with correlated innovations. Section 4 derives additional results for when the trading intensity process is allowed to vary both deterministically and stochastically through time. Section 5 discusses the impact of serial correlation in returns on the realized variance measure. Section 6 concludes.

2 The Bid/Ask Spread

Financial market design distinguishes between two types of trading mechanisms, namely, price-driven markets and order-driven markets. In a price-driven market, all trades take place through
a market maker (also referred to as a specialist or dealer) which serves as an intermediary between buyers and sellers. The market maker posts a bid (ask) price at which he is willing to buy (sell), thereby providing immediacy to the traders. Because the market maker is exposed to inventory risk and insider trading\(^6\) he requires a compensation that is equal to the disparity between the ask and the bid price, i.e. the “spread”. Examples of price-driven markets include the NASDAQ and FOREX. In an order-driven market, on the other hand, traders submit their orders to an electronic order book which automatically matches orders based on price and time prioritization. In this trading mechanism, traders are exposed to execution risk due to the absence of a market maker. Examples of order-driven markets include the Paris Bourse and the LSE. Hybrid structures, combining both trading mechanisms, are adopted by the NYSE and Deutsche Börse.

The first model we discuss is designed to account for the presence of a bid/ask spread encountered in price-driven markets. For illustrative purposes, Figure 1 displays a time-series of 250 transaction prices of the German Bund Futures contract on August 24, 2000. The presence of the bid/ask spread is apparent. It is also clear that the finite variation processes, such as the popular diffusion models widely used in finance, are not well suited to characterize this type of price evolution. To investigate the serial correlation of returns, we distinguish between two sampling schemes, namely “business time” sampling and “calendar time” sampling. Sampling in calendar time amounts to recording the (most recent) price at equi-distant time intervals, e.g. annual, weekly, hourly etc. On the other hand, sampling in business time, amounts to recording the price whenever a trade (or a certain amount of trades) has occurred. Clearly, when the duration between trades is non-constant, the two sampling schemes will differ. However, the impact of this on the distributional properties returns is non-trivial and will be discussed below in the context of our model. Based on all data for August 24 (over 2000 transaction prices), we find a highly significant first order serial correlation coefficient of -0.447 for returns sampled in business time (trade by trade) and -0.133 for returns sampled in calendar time (minute by minute). These results are in line with Roll (1984). Second order serial correlation is substantially reduced in

magnitude and significantly different from zero only for the “trade by trade” returns. Higher order serial correlation is insignificant for both sampling schemes. All in all, it is clear that the price process violates the martingale property, at least when sampled at high frequency. The model we propose below aims to capture the presence of the bid/ask spread and allows us to analyze its impact on the distributional properties of returns.

In what follow, we decompose the observed transaction price into the unobserved mid-price (the average of the bid and ask) plus a spread component. The transaction price is thus equal to the mid-price plus or minus half the bid/ask spread depending on whether a trade is buy-side or sell-side initiated. We assume that the logarithmic mid-price, \( F(t) \), evolves according to the standard compound Poisson process given in expression (1). More general specifications are avoided because the focus is on isolating the impact of the bid/ask spread. The process of the logarithmic transaction price, \( Q(t) \), inherits the properties of the mid-price process and we assume that its dynamics are governed by:

\[
Q(t) = Q(t^-) \left[ 1 - dM_{IBS}(t) \right] + F(t) \left[ dM_{IBS}(t) + \delta [dM_B(t) - dM_S(t)] \right],
\]

where \( M_B(t) \) and \( M_S(t) \) denote Poisson\(^7\) processes with intensity parameters \( \lambda_B > 0 \) and \( \lambda_S > 0 \), \( dM_{IBS}(t) = dM_I(t) + dM_B(t) + dM_S(t) \), and \( \delta \) is a positive constant. The intensity parameter of the “combined” Poisson process \( M_{IBS} \) is equal to \( \lambda_I + \lambda_B + \lambda_S \).

In the absence of consistent mispricing, the mid-price process reflects the true or fundamental value of the asset. Only the arrival of new information will cause this price to change. In a trading environment, it is reasonable to assume that information is disseminated through order flow and one can thus think of \( M_I \) as a process counting the number of “informative” trades which randomly move the asset’s fundamental value (and the transaction price by necessity). Notice that the term \( \varepsilon_j \) in expression (1) represents the innovation to the mid-price process net of the bid/ask spread. A second source of randomness in the price process comes through “uninformative” trades. One can think of these as hedge or liquidity motivated trades that are non-speculative in nature and do not contain any (price sensitive) information. Uninformative trades leave the fundamental value of the asset unchanged, but they have the potential to move the transaction price process up or down as they are executed at the mid-price plus or minus a proportional spread \( \delta \), depending on whether the trade was buy-side or sell-side initiated. Notice

\(^7\)The Poisson intensity parameters are defined such that \( E[dM_B(t)] = \lambda_B dt \), \( E[dM_S(t)] = \lambda_S dt \) and \( E[dM_I(t)] = \lambda_I dt \). The sequence \( \{\varepsilon_i\} \) is assumed to be independent of \( \{M_I(t), t \geq 0\} \). Moreover, it is assumed that \( \{M_I(t), t \geq 0\}, \{M_B(t), t \geq 0\}, \) and \( \{M_S(t), t \geq 0\} \) are independent which implies that \( \Pr\{dM_B(t) dM_S(t') = 1\} = 0, \Pr\{dM_B(t) dM_I(t') = 1\} = 0 \) , and \( \Pr\{dM_S(t) dM_I(t') = 1\} = 0 \) for \( t > 0, t' > 0 \).
from expression (2) that a sequence of uninformative buy orders will only move the transaction price once at the start. Similarly for a sequence of uninformative sell orders. The dynamics of the processes counting the number of uninformative buy- and sell-side initiated trades are governed by $M_B$ and $M_S$ respectively. The combined Poisson process, $M_{IBS}(t)$, therefore counts the total number of trades that occurred up to and including time $t$.

For the analysis in the remainder of this paper it proves useful to define a third process, $G(t) = Q(t) - F(t)$, which measures the difference between the transaction price and the mid-price. Because the $Q$ process, as defined in (2), can be rewritten as:

$$dQ(t) = -Q(t^-)dM_{IBS}(t) + F(t^-)dM_{IBS}(t) + dF(t) + \delta[dM_B(t) - dM_S(t)].$$

it directly follows that the dynamics for $G$ are given by:

$$dG(t) = -G(t^-)dM_{IBS}(t) + \delta[dM_B(t) - dM_S(t)].$$

(3)

Expression (3) is known as the Volterra equation and the unique solution $G$ is given by Theorem II.6.3 in Andersen, Borgan, Gill, and Keiding (1993):

$$G(t) = G(0) \prod_{[0,t]} [1 - dM_{IBS}(u)] + \delta \int_0^t [dM_B(u) - dM_S(u)] \prod_{(u,t)} [1 - dM_{IBS}(u)].$$

(4)

**Theorem 2.1** The joint characteristic function of $F$ and $G$, as defined by expressions (1) and (4), conditional on initial values is given by:

$$\phi^*_{F,G}(\eta_1, \eta_2, \xi_1, \xi_2, t, m) = E_0 \left[ e^{i\eta_1 F(t) + i\eta_2 F(t+m) + i\xi_1 G(t) + i\xi_2 G(t+m)} \right]$$

$$= f(\eta_2, \xi_2) \phi_{F,G}(\eta_1 + \eta_2, \xi_1, t) \left( e^{m\lambda_1(\phi_\varepsilon(\eta_2) - 1)} - e^{-m\lambda} \right)$$

$$+ e^{-m\lambda} \phi_{F,G}(\eta_1 + \eta_2, \xi_1 + \xi_2, t)$$

(5)

where

$$\phi_{F,G}(\eta, \xi, t) = E_0 \left[ e^{i\eta F(t) + i\xi G(t)} \right]$$

$$= f(\eta, \xi) \left( \phi_F(\eta, t) - e^{i\eta F(0) - i\lambda t} \right) + e^{i\eta F(0) + i\xi G(0) - i\lambda t}$$

(6)

for $m > 0$, $\phi_\varepsilon(\eta) = \exp \left( i\eta \mu - \frac{1}{2}i\eta^2 \sigma^2 \right)$, $\phi_F(\eta, t) = \exp \left( i\eta F(0) + t\lambda F(\phi_\varepsilon(\eta) - 1) \right)$, and

$$f(\eta, \xi) = \frac{\lambda_1 \phi_\varepsilon(\eta) + \lambda_B e^{i\xi\delta} + \lambda_S e^{-i\xi\delta}}{\lambda_1 \phi_\varepsilon(\eta) + \lambda_B + \lambda_S}$$

**Proof** See Appendix C.
Based on expression (5), moments and cumulants of the mid-price process, \( F \), and the transaction price process, \( Q \), can be derived (see Appendix A for details). In particular, the \( h^{th} \) order conditional moment of mid-price returns, i.e. \( R_F(t|m) \equiv F(t) - F(t-m) \), and transaction price returns, i.e. \( R_Q(t|m) \equiv Q(t) - Q(t-m) \), can be derived as:

\[
i^{-h} \frac{\partial^h \phi_{F,G} (-\gamma, \gamma, 0, 0, t, m)}{\partial \gamma^h} \bigg|_{\gamma=0} \quad \text{and} \quad i^{-h} \frac{\partial^h \phi^*_{F,G} (-\gamma, \gamma, -\gamma, \gamma, t, m)}{\partial \gamma^h} \bigg|_{\gamma=0}
\]

Unconditional moments are obtained by letting \( t \) tend to infinity. For completeness, we will briefly discuss the properties of the mid-price process below. More details can be found in Press (1967, 1968).

When \( \mu_I \neq 0 \), the unconditional mean and variance of \( R_F(t|m) \), are equal to \( m \lambda_I \mu_I \) and \( m \lambda_I (\mu_I^2 + \sigma_I^2) \) respectively. The third moment takes the form:

\[
m \lambda_I \mu_I^3 (1 + 3m \lambda_I + m^2 \lambda_I^2) + 3m \lambda_I \mu_I \sigma_I^2 (1 + m \lambda_I)
\]

A non-zero mean of the innovation term therefore induces skewness in returns which increases under temporal aggregation of returns. In contrast, the distribution of returns on the de-trended price process is normal and thus symmetric. The fourth moment of returns is equal to:

\[
m \lambda_I \mu_I^4 (1 + 7m \lambda_I + 6m^2 \lambda_I^2 + m^3 \lambda_I^3) + 6m \lambda_I \mu_I^2 \sigma_I^2 (1 + 3m \lambda_I + m^2 \lambda_I^2) + 3m \lambda_I \sigma_I^4 (1 + m \lambda_I)
\]

As is the case for skewness, when \( \mu_I \neq 0 \) return kurtosis increases under temporal aggregation of returns. The expression for the kurtosis simplifies to \( 3 + 3/(m \lambda_I) \) when \( \mu_I = 0 \). In this case, temporal aggregation of returns leads to a decrease in kurtosis. Also note that \( m \) and \( \lambda_I \) enter multiplicatively in all moment expressions. The impact of a change in either \( m \) or \( \lambda_I \) is thus identical.

We now turn to the properties of the transaction price process. Except for the first moment, we will state the moment expressions for the case where \( \mu_I = 0 \). Although it is straightforward to derive conditional and unconditional return moments when \( \mu_I \neq 0 \), it needlessly complicates notation and is therefore avoided. The conditional first moment of returns is given by:

\[
E_0[R_Q(t|m)] = m \lambda_I \mu_I + \frac{e^{-i\lambda}(1 - e^{-m\lambda}) (\delta(\lambda_B - \lambda_S) - \lambda G(0))}{\lambda}
\]

The above expression points out an interesting feature of the model: even when \( \mu_I = 0 \) it follows that \( E_0[R_Q(m|m)] = E_0[Q(m)] - Q(0) \neq 0 \) as long as \( \lambda_B \neq \lambda_S \) and / or \( G(0) \neq 0 \). This directly implies that the logarithmic transaction price process is not a martingale. However, the compensated process, i.e. \( Q(m) - m \lambda_I \mu \), looks more and more like a martingale when \( m \to \infty \). In other words, the martingale property is absent at high sampling frequencies but can be retained
under temporal aggregation of returns. Because the innovations to the mid-price are iid, this property of the transaction price process is exclusively due to the presence of the bid/ask spread. Taking $t$ (and $m$) $\to \infty$ yields the unconditional mean of returns which equals $m \lambda_I \mu$ and thus corresponds to the mean of returns on $F$. For $\mu_I = 0$, the second moment, or equivalently the variance, of returns is given by:

$$m \lambda_I \sigma_I^2 + 2 \delta^2 (1 - e^{-m \lambda_I}) \frac{\lambda_I \lambda_S + 4 \lambda_S \lambda_B + \lambda_I \lambda_B}{\lambda^2}$$

We can decompose the variance into two components, namely the return variance of the mid-price process (left hand side) plus a contribution of the bid/ask spread to the total return variance of the transaction price process (right hand side). Because $\delta$, $m$, and the intensity parameters are strictly positive, the variance of returns on $Q$ always exceeds the variance of returns on $F$. However, the relative difference, i.e. $(V[R_Q] - V[R_F])/V[R_F]$, decreases with (i) a decrease in the spread $\delta$, (ii) an increase in the return horizon $m$, (iii) an increase in the arrival rate of informed trades $\lambda_I$, and (iv) a decrease in the arrival rate of uninformed trades $\lambda_B$ and $\lambda_S$. The unconditional third moment of returns is given by:

$$\frac{3 \lambda_I \delta \sigma_I^2 (\lambda_B - \lambda_S) (1 - e^{-m \lambda_I})}{\lambda^2}$$

Even though $\mu_I = 0$, the return distribution may be skewed depending on $\lambda_B$ and $\lambda_S$, i.e. when $\lambda_B > \lambda_S$ ($\lambda_B < \lambda_S$), there is positive (negative) skewness while the distribution of returns is symmetric when the arrival rates of uninformed trades are equal. Notice that $\lambda_B \neq \lambda_S$ does not necessarily imply that the market maker builds up or drains his inventory, as the informed trades may off-set the buy/sell imbalance of uninformed traders. The unconditional fourth moment of returns is given by the lengthy expression below:

$$3m \lambda_I (1 + m \lambda_I) \sigma_I^4 + 6 \lambda_I \sigma_I^2 \delta^2 (1 - e^{-m \lambda_I}) \frac{\lambda_B^2 - \lambda_I \lambda_S - \lambda_B \lambda_I - 6 \lambda_B \lambda_S}{\lambda^4} + 12m \lambda_I \sigma_I^2 \delta^2 \frac{\lambda_I \lambda_S + 4 \lambda_B \lambda_S + \lambda_B \lambda_I}{\lambda^2} + 2 \delta^4 (1 - e^{-m \lambda_I}) \frac{\lambda_I \lambda_S + 16 \lambda_B \lambda_S + \lambda_B \lambda_I}{\lambda^2}$$

The relation between the fourth moment or kurtosis and the model parameters is substantially more complicated than for the lower order moments. A few things can be said though. As for the mid-price process, when the return horizon, $m$, tends to 0 ($\infty$), the kurtosis tends to $\infty$ (3). When the spread, $\delta$, or the uninformed intensity parameters, $\lambda_B$ and $\lambda_S$, tend to $\infty$, the kurtosis tends to a strictly positive constant which can be either smaller, equal or larger than 3 depending on the model parameters. Negative excess kurtosis can thus be induced by the bid/ask spread although this seems to require unrealistic values for either the spread or the intensity parameters.
Finally, the return covariance, at displacement $k > 0$, can be derived as:

$$
E[R_Q(t|m) R_Q(t - m - k|m)] = -\omega(k, m, \lambda) \sigma^2 \lambda_I \lambda_S + 4 \lambda_S \lambda_B + \lambda_I \lambda_B
$$

where $\omega(k, m, \lambda) = e^{-k\lambda} (1 - e^{-m\lambda})^2$. Interestingly, it is noted that the auto-covariance function above corresponds to that of an ARMA(1,1) process. Because $\omega(k, m, \lambda) > 0$ the bid-ask bounce induces negative serial correlation in returns which disappears under temporal aggregation (increasing $m$) or increasing arrival frequency of informative trades (increasing $\lambda_I$). Roll (1984) finds that the “effective” bid-ask spread, i.e. $2\delta$, can be measured by $2$ times the square root of the negative of the first order serial covariance of returns. The model discussed here, is consistent with Roll’s finding for the degenerate case where $\lambda_I = 0$, $\lambda_B = \lambda_S$, $k = 0$ (first order covariance) and $m$ is large (long horizon returns, e.g. daily / weekly).

To illustrate a possible price path realization of the model, we simulate a time series of 250 mid-prices and associated transaction prices. The model parameters are set equal to $\sigma^2_I = 5.16e - 7$, $\lambda_I = 1$/minute, $\lambda_S = \lambda_B = 2.5$/minute, and $\delta = 0.0003$ which corresponds to an annualized return volatility of 25% (28.4%) for minute by minute mid-price (transaction price) returns, an arrival rate of 60 informed trades per hour, an arrival rate of 150 uninformed buy-side and

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8Using that $E_0[Q(t + m)Q(t)] = F(0)^2 + t\lambda_I \sigma^2_I + \frac{2\delta F(0)(\lambda_B - \lambda_S)}{\lambda} + \frac{\delta^2(\lambda_B - \lambda_S)^2}{\lambda^2} + e^{-m\lambda} \delta^2 \lambda_I \lambda_S + 4 \lambda_S \lambda_B + \lambda_I \lambda_B$.

9Recall that the auto-covariance function of an ARMA(1,1) process with zero mean, i.e. $x_t = \alpha x_{t-1} + \epsilon_t + \beta \epsilon_{t-1}$ for $|a| < 1$ and $\epsilon \sim IIDN(0, \sigma^2)$, is given by $E[x_t x_{t-k}] = \alpha^k \frac{(\alpha + \beta)(1 + \alpha \beta)}{\alpha(1 - \alpha^2)} \sigma^2$ for $j = 1, 2, \ldots$. Setting $\alpha = e^{-\lambda}$ ensures the same rate of decay while $\beta$ and $\sigma^2$ can be chosen so as to match the first order covariance term.

10Based on 8 trading hours per day, 252 trading days per year.

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Figure 2: A time series of 250 simulated mid-prices (left panel) and transaction prices (right panel).
sell-side initiated trades, and a spread of 3 basis points. At first sight the resemblance between the actual Bund futures data (Figure 1) and the simulated data (Figure 2) seems striking. The ad hoc parameter values used in the simulation imply a first order serial correlation of minute by minute returns of −0.112. Increasing the spread to δ = 0.0005 increases the annualized transaction return variance to 33.6% and decreases the first order serial correlation to −0.222. Returns aggregated over 5-minute intervals, have a theoretical first order serial correlation coefficient of −0.027 for δ = 0.0003 and −0.069 for δ = 0.0005.

The discussion above illustrates the ability of the model to capture a number of salient features of high frequency transaction data. The presence of a bid/ask spread is explicitly accounted for and the magnitude of serial correlation implied by the model is in the right ball park for realistic parameter values. Moreover, it is noted that our model can be viewed as a mixture of the bid/ask bounce model of Roll (1984) and the compound Poisson process model of Press (1967). Specifically, when δ = 0, our model coincides with Press’. When λ_I = 0 and λ_B = λ_S our model is closely related to Roll’s.

To conclude, we point out a possible weakness of the model. A number of studies have reported a substantial degree of time variation in the bid/ask spread. Demsetz (1968), as one of the first to look into this issue, finds that most of the variation in the spread can be explained by changes in (i) market capitalization, (ii) the inverse of the price, (iii) return volatility, and (iv) market activity. Cross-sectional variation due to changes in market capitalization is clearly not relevant in the current context. Moreover, the proportionality of the spread can arguably capture most of the time variation that is induced by changes in the reciprocal of the price. However, variation of the spread due to changes in market volatility, or market activity, is something that our model clearly cannot account for. Because the arrival intensity parameters are constant, both market activity and return volatility are also constant. In addition δ is not allowed to depend on time or other exogenous variables such as M_IBS(t). Unfortunately, it is not easy to resolve this shortcoming of the model because time variation in δ precludes a closed form solution for the characteristic function of Q(t). Although the properties of the model can still be analyzed numerically, the need to choose specific parameter values would narrow the scope of the discussion substantially and is therefore not attempted here. We emphasize, however, that while the properties of the transaction return process will undoubtedly be more complex in such a case, we do not anticipate the qualitative features of the model to change much, i.e. the bid/ask spread is still expected to induce negative serial correlation which disappears under temporal aggregation as is observed in practice.
3 General Return Dependence

The bid/ask spread is arguably the most apparent and dominant market microstructure component in the price process of a price-driven market and can, as shown above, be modelled explicitly. However, a host of other market microstructure effects exist which are, as opposed to the bid/ask spread, more concealed or complex in nature. It is therefore not possible to individually address each and every one of these effects. The model we propose below, exploits the view that no matter what the nature of the market microstructure effect is, it’s impact on the return distribution will likely be revealed through the autocorrelation function of returns. We thus study the return dependence structure without explicitly identifying its source. For example, high frequency index returns may be subject to non-synchronous trading, non-trading periods, temporary mispricing, and recording delays. While each and every attribute may be difficult to model, it seems reasonable to anticipate some sort of serial correlation in the first moment of returns, be it negative or positive, of high or low order, transient or persistent. This observation motivates us to generalize the compound Poisson process to allow for a general form of serial correlation in returns. In particular, we assume that the innovations of the logarithmic price, \( F \), follow an MA(q)-process:\n
\[
F(t) = F(0) + \sum_{j=1}^{M(t)} \varepsilon_j \quad \text{where} \quad \varepsilon_j = \rho_0 \nu_j + \rho_1 \nu_{j-1} + \ldots + \rho_q \nu_{j-q},
\]

\( \nu_j \sim \text{iid } N(\mu_\nu, \sigma^2_\nu), \rho_q \neq 0 \) and \( M(t) \) is a homogeneous Poisson process with intensity parameter \( \lambda > 0 \). No restrictions on \( \rho_0, \ldots, \rho_q \) need to be imposed in order to ensure stationarity of the innovation process. Regarding the MA structure, it is important to emphasize that it is imposed on the innovation process in transaction time. Interestingly, the results below indicate that the autocovariance of returns, sampled at equi-distant calendar time intervals, decays exponentially similar to that of an ARMA process. Finally, we note that the price process \( F \) is, as opposed to the previous section, assumed to be observable and the single object of interest.

**Theorem 3.1** For the price process defined by expression (7) and \( M(t) >> q \), the joint characteristic function of \( F(t) \) and \( F(t+m) \), conditional on initial values, is accurately approximated by:

\[
\phi^*_F(\xi_1, \xi_2, t, m) = E_0 \left[ e^{i\xi_1 F(t)} e^{i\xi_2 F(t+m)} \right] = a(\xi) \phi^*_S(\xi_1, \xi_2, t, m)
\]

In principle it is also possible to impose an AR(q) structure on the price innovations. However, the expression for the characteristic function turns out to be substantially more complicated as it involves an infinite summation of the form \( \sum_{n=0}^{\infty} \exp(\rho^n) \) which cannot be simplified.

11
where

\[
\phi^*_S(\xi_1, \xi_2, t, m) = b(\xi, t) e^{\xi^2 \sigma^2 \rho(q.q)} \sum_{h=0}^{q-1} e^{i2h\xi_{2}h\rho_{q.q} - \frac{1}{2}h\xi_{2}^2\sigma^2} \left( e^{-\xi_{1}\xi_{2}\sigma^2 \rho(q,h)} - e^{-\xi_{1}\xi_{2}\sigma^2 \rho(q,q)} \right) \frac{(m\lambda)^{h}}{h!e^{m\lambda}} + b(\xi, t) b(\xi_2, m) e^{(\xi_{2} - \xi_{1})\sigma^2 \rho(q,q)}
\]

for \( \xi = \xi_{1} + \xi_{2}, \rho = \sum_{j=0}^{q} \rho_{j}, a(\xi) = \exp(i\xi F(0)), b(\xi, t) = \exp \left[ t\lambda \left( e^{i\xi \rho_{q.q} - \frac{1}{2}\xi_{2}^2\sigma^2} - 1 \right) \right], \) and

\[
\rho(q,p) = \begin{cases} 
\sum_{h=1}^{\min(q,p)} \sum_{j=h}^{q} h\rho_{j}\rho_{j-h} & \text{for } q \geq 1, p \geq 1 \\
0 & \text{otherwise}
\end{cases}
\]

For \( t \to \infty, the above expression of the characteristic function is exact.

**Proof** See Appendix C.

The characteristic function, given by expression (8) above, can be used to derive \textit{exact} unconditional moments of the price and return process as this requires \( t - \) and thus \( M(t) - \) to tend to \( \infty. \) Expressions for the conditional moments will be arbitrarily accurate when \( M(t) \) exceeds the order of the MA process, \( q, \) by a sufficiently large amount. When \( M(t) \) is small the above characteristic function cannot be used to derive conditional moments. For this case, however, it is possible to derive exact expressions at the cost of cumbersome notation. Because the focus of this paper lies elsewhere, we do not go into this (see footnote 22 in Appendix C for more details on the source of this approximation error).

Below we discuss the properties of the compound Poisson process for \( q = 1 \) for it is sufficient to illustrate the main features of the model. The case for \( q > 1 \) adds to the notational complexity without providing much additional insight into the workings of the model. In practice, of course, the increased flexibility that comes with the higher order return dependence may be necessary to model the data and this case therefore remains of great interest. To simplify notation further, we set \( \rho_0 = 1 \) and \( \rho_1 = \rho. \) As mentioned above, no restrictions are imposed on the coefficients, although \( \rho = -1 \) is a degenerate case in the sense that all innovations to the price process cancel out with the exception of the first and last one. Analogous to the previous section, the unconditional return moments can be derived based on the characteristic function\(^{12}\) given by expression (8). When \( \mu_{\nu} \neq 0 \) the unconditional \textit{first moment} of returns equals \( m\lambda\mu_{\nu} (1 + \rho) \) while its \textit{variance} is given by:

\[
m\lambda \left( \mu_{\nu}^2 + \sigma_{\nu}^2 \right) (1 + \rho)^2 - 2\sigma_{\nu}^2 \rho (1 - e^{-m\lambda}) \tag{9}
\]

Because the impact of the innovation mean is trivial we set \( \mu_{\nu} = 0 \) and focus on the remaining model parameters. As expected, the contribution of the right hand side term in expression (9)

\(^{12}\)Notice that \( \xi_1 = -\xi_2 \) implies that \( a(\xi) = b(\xi, t) = 1. \)
diminishes relative to the left hand side term when $m$ increases. In other words, the serial correlation of the innovations introduces a transient component into the return variance which disappears under temporal aggregation. To study the impact of $\rho$ on the return variance it is important to take into account that a change in $\rho$, ceteris paribus, will change the return variance because $\sigma^2_{\varepsilon} \equiv V[\varepsilon_j] = (1 + \rho)\sigma^2_{\nu}$. We therefore consider two cases, namely (i) vary $\rho$ while $\sigma^2_{\varepsilon} = (1 + \rho^2)\sigma^2_{\nu}$ and (ii) vary $\rho$ while keeping $\sigma^2_{\varepsilon}$ fixed at $\sigma^2$. Furthermore, in order to isolate the impact of a change in $\rho$ we choose the MA(0) model with a return variance of $m\lambda\sigma^2_{\nu}$ as a benchmark.

For the first case, MA(1) innovations inflate the return variance by $2\rho\sigma^2_{\nu}(e^{-m\lambda} + m\lambda - 1)$ relative to the benchmark case. Serial correlation increases the return variance when it is positive and decreases the return variance when it is negative. Intuitively, when serial correlation is negative (positive), innovations partly offset (reinforce) each other which leads to a decrease (increase) in the return variance. Moreover, notice that the contribution to the return variance consists of a component that only impacts the return variance at high frequency, i.e. $2\rho\sigma^2_{\nu}(e^{-m\lambda} - 1)$, and a component which impacts the return variance at any given sampling frequency, i.e. $2\rho\sigma^2_{\nu}m\lambda$.

For the second case, the impact of a change in $\rho$ is less obvious because it requires a simultaneous change in $\sigma^2_{\varepsilon}$ so as to keep $\sigma^2_{\varepsilon}$ constant. Here, the return variance exceeds the benchmark by $2\rho\sigma^2(e^{-m\lambda} + m\lambda - 1)/(1 + \rho^2)$ which is similar as before but now includes the term $(1 + \rho^2)^{-1}$ and makes the relationship non-linear. To facilitate the discussion, the left panel of Figure 3 visualizes this expression as a function of $\rho$ for $m\lambda = 1$ and $\sigma^2_{\varepsilon} = \sigma^2/(1 + \rho^2) = 1$. While a negative (positive) return correlation decreases (increases) the return variance relative to the benchmark, the amount by which it does tends to zero when $\rho$ grows in magnitude. Intuitively, an increase in $\rho$ “shifts” variance from the contemporaneous innovation $\nu_j$ to the lagged innovation $\rho\nu_{j-1}$.

When $\rho$ is sufficiently large in magnitude, the variance of the lagged innovation will swamp that of the contemporaneous one and the process will effectively behave as if it was an MA(0) process.

As opposed to the bid/ask model, the third moment of returns is zero unless $\mu_{\nu} \neq 0$. The expression for this case is straightforward but sizeable and is therefore omitted. The unconditional fourth moment of returns for $\mu_{\nu} = 0$ is given by:

$$3m^2\lambda^2\sigma^4_{\nu}(1 + \rho)^4 + 3m\lambda\sigma^4_{\nu}(\rho^2 - 1)^2 - 12\sigma^4_{\nu}\rho^2(e^{-m\lambda} - 1)$$

It is clear from the expressions for the second and fourth moment, that the kurtosis of returns does not depend on $\sigma^2_{\nu}$. Also we note that the return horizon, $m$, and the arrival rate of trades, $\lambda$, enter multiplicatively into all expressions. The impact of an increase in $m$ is therefore equivalent to the impact of an increase in $\lambda$. This simplifies matters substantially and to analyze the kurtosis, we only need to fix $m\lambda$ while varying $\rho$. The right panel of Figure 3 displays the return kurtosis as a function of $\rho$ for $m\lambda = 1$. Here the MA(0) process serves as a benchmark with a kurtosis
coefficient of $3 + 3/m\lambda = 6$. Positive (negative) serial correlation in the price innovations thus induces an increase (decrease) in kurtosis relative to the benchmark. The maximum (minimum) return kurtosis is attained by setting $\rho = 1$ ($\rho = -1$) and is equal to 7.43 (4.75) for the current parameter values. Finally, for $\mu_\nu = 0$, the covariance of non-overlapping returns can be derived as:

$$E[R_F(t|m) R_F(t - k - m|m)] = \sigma^2_\nu \rho \omega(k, m, \lambda),$$

where $m > 0$, $k \geq 0$ and $\omega(k, m, \lambda) = e^{-k\lambda} (1 - e^{-m\lambda})^2$. The discussion of the covariance is analogous to that of the variance. For fixed $\sigma^2_\nu$, an increase (decrease) in $\rho$ leads to an increase (decrease) of auto-covariance. For fixed $\sigma^2_\epsilon$, on the other hand, the expression is proportional to $\rho/(1 + \rho^2)$ and thus takes on the same form as the graph in the left panel of Figure 3. Based on the covariance and variance expression, the serial correlation of returns can be derived as:

$$\frac{\rho \omega(k, m, \lambda)}{m\lambda (1 + \rho)^2 - 2\rho (1 - e^{-m\lambda})}.$$

As expected, an increase in $k$, the displacement between returns, leads to an exponential reduction in the magnitude of serial correlation and vice versa. The impact of a change in $m$, however, is less obvious\(^{14}\). Figure 4 displays the serial correlation of adjacent returns ($k = 0$) for return horizons between 0 and 10 ($\lambda$ is kept fixed at 1). All curves are hump shaped, with the exception of the degenerate case where $\rho = -1$, implying that serial correlation may either increase or

\(^{13}\)Using that $E_0[F(t + m)F(t)] = F(0)^2 + t\lambda \sigma^2_\nu (1 + \rho) - (e^{-m\lambda} + 1) \rho \sigma^2_\epsilon$.

\(^{14}\)Although the impact of a change in $m$ is not equivalent to that of a change in $\lambda$, due to the term $e^{-k\lambda}$, it is very similar and will therefore not be discussed separately.
decrease under temporal aggregation depending on the value of $m$. At first sight this seems quite peculiar. However, when the return horizon (or sampling frequency) tends to zero, the time-series of sampled returns will contain an increasing number of entries that are equal to zero. This, in turn, causes the serial correlation to disappear in the limit. Importantly, this is not the case for the covariance.

3.1 Multiple Component Compound Poisson

Jumps in low frequency financial data are widely documented\textsuperscript{15}. While transaction data are inherently discontinuous at any sampling frequency, the fact that some jumps can be identified even at low frequency indicates the presence of jumps of different magnitude. While the jumps observable at high frequency are typically due to the bid/ask spread and price resolution, jumps observable at low frequency can be due to for example a market crash or certain macro-policy announcements. It therefore seems natural to extend the above model to a $k$–component compound Poisson process with MA($q$) innovations:

$$F(t) = F(0) + \sum_{j=1}^{M_1(t)} \varepsilon_{1,j} + \ldots + \sum_{j=1}^{M_k(t)} \varepsilon_{k,j}, \quad (10)$$

where

$$\varepsilon_{r,j} = \rho_{r,0} \nu_{r,j} + \rho_{r,1} \nu_{r,j-1} + \ldots + \rho_{r,q} \nu_{r,j-q},$$

for \( \nu_r \sim \text{iid} \mathcal{N}(\mu_r, \sigma^2_r) \) and \( \{M_r(t)\}_{r=1}^k \) are independent homogenous Poisson processes with intensity parameters \( \lambda_r > 0 \) for \( r = 1, \ldots, k \). Notice that \( q \) denotes the maximum order of the MA(\( q \)) process driving the \( k \) components. Because \( \nu_{r,j} \) and \( M_r(t) \) are assumed to be independent, the present specification\(^ {16} \) of the process does not allow for cross correlation among the components driving \( F \). The derivation of the joint characteristic function of \( F(t) \) and \( F(t + m) \) is therefore analogous to the single component case.

**Corollary 3.2 (to Theorem 3.1)** For the price process defined by expression (10) and \( M_r(t) \gg q_k \), the joint characteristic function of \( F(t) \) and \( F(t + m) \), conditional on initial values, is accurately approximated by:

\[
\phi^*_r(\xi_1, \xi_2, t, m) = E_0 \left[ e^{i\xi_1 F(t) + i\xi_2 F(t + m)} \right] = a(\xi) \prod_{r=1}^k \phi^*_{S,r}(\xi_1, \xi_2, t, m)
\]

where

\[
\phi^*_{S,r}(\xi_1, \xi_2, t, m) = b_r(\xi, t) e^{\xi_1^2 \sigma^2_r \rho_r(q,q)} \sum_{h=0}^{q-1} e^{h \xi_2 \sigma^2_r \rho_r(q,q)} \left( e^{-\xi_1 \sigma^2_r \rho_r(q,q)} - e^{-\xi_1 \sigma^2_r \rho_r(q,q)} \right) \frac{(m \lambda_r)^h}{h! e^{m \lambda_r}}
\]

for \( \rho_r = \sum_{j=0}^{q} \rho_{r,j} \), \( b_r(\xi, t) = \exp \left[ t \lambda_r (e^{i \xi \sigma^2_r \rho_r(q,q)} - \frac{1}{2} \xi^2 \sigma^2_r \rho_r(q,q) - 1) \right] \), \( \xi \) and \( a(\xi) \) as defined in Theorem 3.1, and

\[
\rho_r(q, p) = \begin{cases} 
\sum_{h=1}^{\min(q, p)} \sum_{j=h}^{q} h \rho_{r,j} & \text{for } q \geq 1, p \geq 1 \\
0 & \text{otherwise}
\end{cases}
\]

For \( t \to \infty \), the above expression of the characteristic function is exact.

**Proof** See Appendix C.

For illustrative purposes we will now derive some properties for the 2-Component Compound Poisson process with MA(1) innovations, i.e. \( k = 2 \) and \( q = 1 \):

\[
F(t) = F(0) + \sum_{j=1}^{M_1(t)} \varepsilon_{1,j} + \sum_{j=1}^{M_2(t)} \varepsilon_{2,j}
\]

where \( \varepsilon_{1,j} \) and \( \varepsilon_{2,j} \) follow an MA(1) process. For the analysis of the return moments, we set \( \mu_1 = \mu_2 = 0 \) and \( \rho_{1,0} = \rho_{2,0} = 1 \) for notational convenience. The mean is therefore zero while the return variance is given as:

\[
m \lambda_1 \sigma_1^2 (1 + \rho_{1,1})^2 + m \lambda_2 \sigma_2^2 (1 + \rho_{2,1})^2 - 2 \left( 1 - e^{-m \lambda_1} \right) \sigma_1^2 \rho_{1,1} - 2 \left( 1 - e^{-m \lambda_2} \right) \sigma_2^2 \rho_{2,1}
\]

\(^ {16} \)Allowing for cross dependence among components is likely to be unimportant for the applications we have in mind here and will therefore not be discussed.
and the covariance of returns can be derived\textsuperscript{17} as:

\[ E[R(t|m)R(t-k-m|m)] = \sigma_1^2 \rho_{1,1} \omega(k, m, \lambda_1) + \sigma_2^2 \rho_{2,1} \omega(k, m, \lambda_2) \]

where \( \omega(k, m, \lambda) = e^{-k\lambda} (1 - e^{-m\lambda})^2 \) as before. Notice that the contribution of both individual components is clearly separated and each take the same form as in the single-component case.

The serial correlation of returns can now be expressed as:

\[
\frac{\rho_{1,1} \omega(k, m, \lambda_1) + \rho_{2,1} \omega(k, m, \lambda_2) \frac{\sigma_2^2}{\sigma_1^2}}{m\lambda_1 (1 + \rho_{1,1})^2 - 2(1 - e^{-m\lambda_1}) \rho_{1,1} + m\lambda_2 (1 + \rho_{2,1})^2 \frac{\sigma_2^2}{\sigma_1^2} - 2\rho_{2,1} (1 - e^{-m\lambda_2}) \frac{\sigma_2^2}{\sigma_1^2}}
\]

In contrast to the single component case, the innovation variance does not cancel out indicating that its relative magnitude is of interest. Because the return horizon \( m \) appears in the denominator, it follows that temporal aggregation of returns will lead to a reduction of serial correlation. A more distinctive feature of the model is that the multiple component structure may induce serial correlation in the price process which can be zero, negative and positive depending on the return horizon. This point is illustrated by Figure 5. We have set the parameter values to extreme, and empirically unrealistic values, so as to magnify the effect, i.e. \( \lambda_1 = 6/\text{min}, \lambda_2 = 4/\text{hour}, \sigma_1^2 = 8e - 8, \sigma_2^2 = 8e - 6, \rho_1 = 0.8, \rho_2 = -0.8 \). It appears that the first component generates positive serial correlation in returns at high frequency (up to approximately a 100 second return horizon). At lower frequencies the second component dominates and thereby induces negative return serial correlation. The location of the “turning” points in the correlogram is closely related to the value of \( \lambda_1 \) relative to \( \lambda_2 \), although a closed form solution cannot be obtained.

An empirically interesting case is one where the parameters values are chosen such that \( \lambda_1 >> \lambda_2 \) while \( \sigma_1^2 < < \sigma_2^2 \). In particular, at low frequency, the sample path of the first component will be observationally equivalent to that of a standard diffusion process such as a Brownian Motion. However, for \( \sigma_2^2 \) sufficiently large, the second component will generate infrequent discontinuities or jumps in the path which are observable even at low sampling frequencies. This case is illustrated by Figure 6. The left panel displays minute by minute FTSE-100 prices for June 2, 1998. The right panel, contains simulated data based on the 2-component compound Poisson process with MA(1) innovations. The parameter values are chosen as \( \lambda_1 = 4/\text{minute}, \lambda_2 = 2/\text{day}, \sigma_1^2 = 8e - 8, \sigma_2^2 = 8e - 5, \rho_{1,1} = 0.6, \rho_{2,1} = 0.1 \) and correspond to an annualized return volatility of 38.5\% and first order serial correlation of 4.4\%. Although the parameter values are chosen ad hoc, the features of the actual and simulated data seem to agree. Clearly, more elaborate specifications can be considered. For instance, one may introduce a third component with an even lower arrival frequency and even higher variance so as to capture the impact of rare events such as the outbreak

\textsuperscript{17}Using that \( E_0[F(t)F(t+m)] = F(0)^2 + t\lambda_1 \sigma_1^2 (1 + \rho_{1,1})^2 + t\lambda_2 \sigma_2^2 (1 + \rho_{2,1})^2 - (1 + e^{-m\lambda_1}) \sigma_1^2 \rho_{1,1} - (1 + e^{-m\lambda_2}) \sigma_2^2 \rho_{2,1} \).
Figure 5: First order (i.e. \( k = 0 \)) serial correlation of returns at horizons between 1 and 250 seconds (left panel) and between 251 second and 2.5 hours (right panel).

of a war or the occurrence of an earthquake. Because the discussion of the model is only illustrative at this point, we will not go further into the determination of the number of components or the estimation of the model parameters.

### 3.2 Time Varying Trading Intensity

While the models discussed above are able to capture a variety of dependence structures in returns, the durations between successive trades are necessarily independent due to the “memory-less” property of the Poisson process (see Bauwens and Giot (2001) for a discussion). A number of empirical studies, however, find compelling evidence that trade durations exhibit a substantial degree of time variation and serial dependence. In this section, we will therefore generalize the model in such a way that it can account for this characteristic feature of high frequency transaction data.

In what follows, we assume that the intensity process, \( \lambda \), can be decomposed into a deterministic component \( s \), and a stochastic component \( \hat{\lambda} \). Hence, we have \( \lambda = \hat{\lambda} + s \) when the deterministic component is additive, and \( \lambda = s \hat{\lambda} \) when the deterministic component is multiplicative. Examples of a deterministic component include the widely documented U-shaped pattern in intra-day market activity, day-of-the-week effects, time trends, and any other seasonalities that may be present (see for example Andersen, Bollerslev, and Das (2001), Dacorogna et al. (1993), Harris (1986)). The stochastic component, on the other hand, can account for serial dependencies in the deseasonalized trade intensity and duration. For example, Engle and Russell (1998) find strong
evidence of autoregressive serial dependence in deseasonalized intra-day trade durations which motivates them to specify the Autoregressive Conditional Duration (ACD) model. Moreover, the extensive evidence of ARCH effects in low frequency (say daily / weekly) return data indicates that time variation in market activity is not only limited to intra-day frequencies, but extents forcefully to lower frequencies. At this level, the stochastic component typically dominates the deterministic one and, as a result, the time variation induced in low frequency return variance is predominantly stochastic. In this section we will discuss specifications for both components of the intensity process through which we seek to capture the following important stylized characteristics of return data both at low and high frequency:

(i) seasonality in trade durations and market activity
(ii) serial dependence in deseasonalized trade duration
(iii) persistence in return variance at low sampling frequencies

We refer to property (ii) as “ACD”-effects and to property (iii) as “ARCH”-effects, thereby alluding to the seminal work of Engle and Russell (1998), and Engle (1982) and Bollerslev (1986) respectively. Because the aim is to capture all of the above effects through the specification of the intensity process exclusively, a brief discussion of the relation between trading intensity, return variance, and trade duration is in order. Recall that for the standard compound Poisson process with unit innovation variance and (trade) intensity $\lambda$, the expected return variance over a unit time interval equals $\lambda$ while the expected trade duration is equal to $1/\lambda$. Trading intensity is
thus proportional to return variance and inversely proportional to trade durations. However, these
relations may break down when we generalize the compound Poisson process. For example, when
a bid/ask spread “contaminates” the data, we have shown that the return variance is equal to \( \lambda \) plus
a non-linear correction term involving the spread. What’s more, when the trading intensity
is a (non-degenerate) deterministic function of time, the return variance equals
\[ \int \lambda(u) \, du \]
even though the expected trade duration is not equal to \( 1/\int \lambda(u) \, du \). These cases are examples where
the proportionality between trading intensity, return variance, and inverse of trade duration, is
lost. However, it seems reasonable to expect that in many cases the proportionality will hold
approximately. Clearly, the extent to which this is true depends on the model specification and
also on the sampling frequency of the data (as we have shown that market microstructure effects
vanish under temporal aggregation).

**Corollary 3.3 (to Theorem 3.1)** For the price process defined by expression (7), with a non-
constant intensity process, \( \lambda(\cdot) \), and \( M(t) >> q \), the joint characteristic function of \( F(t) \) and
\( F(t+m) \), conditional on initial values, is accurately approximated by:

\[
\phi_F^* (\xi_1, \xi_2, t, m) = E_0 \left[ e^{i\xi_1 F(t) + i\xi_2 F(t+m)} \right] = a(\xi) \phi_S^* (\xi_1, \xi_2, t, m)
\]  

(11)

where \( \phi_S^* (\xi_1, \xi_2, t, m) \) equals:

\[
e\xi_2 \sigma_2^2 \rho(q,q) \sum_{h=0}^{q-1} e^{i\xi_2 h \rho(q,q)} - \frac{1}{2} h \sigma_2^2 \xi_2^2 \rho^2 \left( e^{-\xi_1 \xi_2 \sigma_2^2 \rho(q,h)} - e^{-\xi_1 \xi_2 \sigma_2^2 \rho(q,q)} \right)
E_0 \left\{ b(\xi, 0, t) \left( \lambda^* (t, m) \right)^h \right\}
\]

\[
+ e^{(\xi^2 - \xi_1 \xi_2) \sigma_2^2 \rho(q,q)} E_0 \left\{ b(\xi, 0, t) b(\xi_2, t, m) \right\}
\]

\[
\lambda^* (t, \tau) \equiv \int_t^{t+\tau} \lambda(u) \, du, b(\xi, t, \tau) = \exp \left[ \left( e^{i\xi \rho(q,q) - \frac{1}{2} \xi^2 \sigma_2^2 \rho^2} - 1 \right) \lambda^* (t, \tau) \right], \text{ and } \bar{\xi}, \bar{\sigma}, a(\xi), \rho(q,p) \text{ are}
\]

as defined in Theorem 3.1.

For \( t \to \infty \), the above expression of the characteristic function is exact.

**Proof** See Appendix C.

Allowing for time variation in the intensity process, leads to a modified characteristic function
of the price process as can be seen by comparing expression (11) in Corollary 3.3 to expression (8)
in Theorem 3.1. If time variation in the intensity process is entirely deterministic, or known at
\( t = 0 \), the expectation operator vanishes in the expression for \( \phi_S^* (\xi_1, \xi_2, t, m) \) and moments can be
derived in the usual fashion. This holds true irrespective of the, potentially complex, functional
form for \( \lambda(\cdot) \). However, when time variation in the intensity process is (partly) stochastic, i.e.
unknown at \( t = 0 \), the expectations operator remains because the integrated intensity process is
now a random variable. Moments cannot be derived without explicit specification of the dynamics
of the intensity process, and even then, closed form solutions will not be available in many cases.
**Deterministic Intensity Process.** We will now briefly illustrate the usefulness of allowing for deterministic variation in the intensity process. As mentioned above, one of the most prominent features of high frequency data in financial markets is the U-shaped pattern in intra-day market activity and return volatility. In particular, it is widely documented that market activity is substantially higher around the open and close of the market than around lunch time. Another important characteristic is that the overnight return typically accounts for a non-negligible fraction of the overall daily return variance. While trading in many securities is halted overnight, information flow is not. This in turn, leads to an accumulation of information which can only be incorporated into the price at the next open of the market. The overnight return may therefore reflect a disproportionately large amount of information relative to the subsequent intra-day returns. A highly stylized specification of the intensity process, that is consistent with the above observations, is the following:

\[
\lambda(t) = a + b \cos(2\pi t) + c I_{\{t - [t] < \Delta\}}
\]

where \(a > b, c > 0, 0 < \Delta << 1, [t]\) denotes the integer part of \(t\), and \(I\) is an indicator function which equals 1 whenever \(t - [t]\) is less than \(\Delta\) and zero otherwise. Using the single component compound Poisson process with MA(1) innovations and an intensity process as specified above, we simulate 5 years of high frequency transaction prices using the following ad hoc parameter values; \(a = 4/\text{minute}, b = 2.25, c = 120/\text{minute}, \Delta = 2/480, \rho = 0.3, \text{and } \sigma^2 = 7e - 8.\) Based on 8 hours of trading per day, these parameters imply an average of 2160 trades per day, an annualized daily return volatility of 25.4%, and a more than 25 fold increase in market activity (relative to the daily average) during the first two minutes following the market open. The overnight return aside, trading intensity at open and close (mid-day) is 50% higher (lower) than the daily average.

The left-hand panel of Figure 7 plots the correlogram of minute by minute absolute returns on the FTSE-100 over the period 1990-2000. The displacement is up to 2400 lags, or equivalently, five trading days. The U-shaped pattern in market activity and the impact of the overnight return is apparent. Moreover, the magnitude of both effects underline the importance of allowing for a deterministic pattern in the intensity process. The right-hand panel of Figure 7 plots the correlogram for the simulated data sampled at minute intervals. The strong agreement among the correlograms of the actual and simulated data demonstrates that the naive and overly simplistic specification of the intensity process does capture important patterns in high frequency return data at least to some extent. However, a more detailed inspection of the graphs points to some important differences. For example, the correlogram for the FTSE-100 data indicates a peak in market activity during the afternoon trading session that is, most likely, associated with the open of the US markets. A more subtle difference in the correlogram for the actual data is that the correlations are strictly positive at any displacement and that there appears to be a slow decline in
their magnitude. One possible explanation for this is that stochastic variation in market activity across days induces (positive) serial dependence in the return variance which comes to dominate the intra-daily seasonal pattern at longer horizons. Such dynamics are clearly absent in the above specification of the intensity process and will be discussed next.

**Stochastic Intensity Process.** As can be seen from Corollary 3.3, when the intensity process is (partly) stochastic the expectation operator in the characteristic function remains. Hence, an expectation of the form 
\[ E_0 \left[ \exp \left( a \lambda^* (0, t) + b \lambda^* (t, m) \right) \right] \]
for \( h = 0, \ldots, q - 1 \) needs to be computed. If the joint Laplace transform for \( \lambda^* (0, t) \) and \( \lambda^* (t, m) \) is available, i.e. \( \Phi (a, b) = E_0 [\exp (a \lambda^* (0, t) + b \lambda^* (t, m))] \), this expectation can be obtained as:
\[
\frac{\partial^h \Phi (a, b)}{\partial b^h}
\]
However, for many specifications the joint Laplace transform will not be available in closed form and moments need to be obtained by simulation. Below we will discuss a dynamic specification of the intensity process which is capable of generating both ACD and ARCH effects in the price process and for which the Laplace transform does exist in closed form (see Appendix B for details). In spite of the models flexibility and analytic tractability, a major drawback of the specification is that there is nothing that prevents the intensity process from becoming negative. In practice this feature of the model is clearly undesirable. Here, however, this deficiency does not pose a problem to us as the discussion is purely illustrative and the intuition derived from this case is
likely to remain in tact for alternative specifications.

ACD and ARCH effects are known to unveil themselves at different frequencies and we therefore decompose the stochastic intensity process into a high frequency and a low frequency component. In particular, ARCH effects are modelled through the low frequency component while ACD effects are modelled through the high frequency component. Market microstructure considerations are clearly of less importance for the low frequency component as they are for the high frequency component. It therefore seems reasonable to rely on proportionality between (integrated) intensity and (integrated) return variance when modelling the ARCH effects. For this case, the dependence structure of the intensity process will (closely) corresponds to that of the variance process and an appropriate specification for the low frequency component, $\alpha$, is as follows:

$$d\alpha(t) = -\varphi(\alpha(t) - \mu) dt + \sigma_\alpha dW_\alpha(t),$$  \hspace{1cm} (13)

where $\varphi \geq 0$, $\sigma_\alpha > 0$, and $W_\alpha(t)$ is a standard Brownian motion. The above process is known as the Ornstein-Uhlenbeck (OU) process and has the interesting property that it can be viewed as the continuous-time analogue of the Gaussian first order regression. One way to see this is to discretize the time scale as $t_i = i\Delta$ where $i = 1, \ldots, T/\Delta$ so that $\Delta$ can be interpreted as the frequency at which the continuous time process is sampled while $T\Delta$ represents the total number of periods. The solution to the SDE in expression (13) can now be written as

$$\alpha(t_i) = \mu \left( 1 - e^{-\varphi\Delta} \right) + e^{-\varphi\Delta} \alpha(t_{i-1}) + \varepsilon(t_i)$$

where $\varepsilon(t_i) \sim \text{i.i.d. } \mathcal{N}(0, \frac{1-e^{-2\varphi\Delta}}{2\varphi} \sigma_\alpha^2)$. The discretized sample path of $\alpha$ thus follows an autoregressive process of order one with autoregressive parameter equal to $e^{-\varphi\Delta}$. Its persistence therefore depends both on the parameter $\varphi$ and the sampling frequency $\Delta$. In particular, for fixed parameters $\varphi$ and $\sigma_\alpha$, the persistence of the process increases with an increase of the sampling frequency $\Delta$, i.e. smaller $\Delta$ (see Boswijk (2002, Chapter 6) for more details). Because ARCH effects are a low frequency phenomenon, we set $\varphi$ and $\sigma_\alpha$ sufficiently small causing $\alpha$ to appear roughly constant at high frequency. However, at lower frequencies, the mean reversion will become more apparent, leading to an autoregressive dependence structure in return variance - ARCH effects.

The modelling of ACD-effects is unfortunately more complicated. At high frequency, market microstructure effects and time variation in the intensity process can distort the proportionality between trade intensity and trade duration. In addition, we need to address the question what dependence structure should be imposed on the intensity process in order to generate ACD effects, i.e. autoregressive dependence in the duration process. Even in idealized situations, there is no clear answer to this question and we will proceed under the debatable assumption that ACD effects can be captured by means of an autoregressive component in the (deseasonalized) intensity
process. With this in mind, we specify the high frequency component as follows:

\[ d\hat{\lambda}(t) = -\kappa \left( \hat{\lambda}(t) - \alpha(t) \right) dt + \sigma_{\lambda} dW_{\lambda}(t) \]  

(14)

where \( \kappa \geq 0, \kappa \neq \varphi, \sigma_{\lambda} > 0, \text{ and } W_{\lambda} \) is a standard Brownian motion independent of \( W_{\alpha} \). The process given by expression (14) is a generalization of the standard Gaussian OU process. It has the property that \( \hat{\lambda} \) mean-reverts towards the low frequency component, \( \alpha \), which itself varies stochastically through time. In the current context, the difference between \( \hat{\lambda} \) and \( \alpha \) constitutes the high frequency component of the intensity process. Quick mean reversion of \( \hat{\lambda} \) towards the stochastic long run mean, \( \alpha \), can be expected to generate mean reversion in the duration process at high frequency, thereby leading to ACD effects. Hence, both ARCH and ACD effects can be generated when \( \varphi << \kappa \) and \( \sigma_{\alpha} << \sigma_{\lambda} \) and \( \sigma_{\alpha}^{2}/\varphi >> \sigma_{\lambda}^{2}/\kappa \). At high sampling frequencies, the process for \( \hat{\lambda} \) will quickly “oscillate” around the stochastic long run mean \( \alpha \), which itself is roughly constant due to its extreme persistence and small innovation variance relative to \( \hat{\lambda} \). The stochastic time variation of the intensity process over short time intervals will therefore be mainly driven by the OU process for \( \hat{\lambda} \) whose mean reversion will lead to ACD effects. On the other hand, at low(er) sampling frequencies, the stochastic variation in the average (or integrated) intensity process arising from the OU process for \( \hat{\lambda} \) will be minimal due to its quick mean reversion, and at some stage the stochasticity of the long run mean component will come to dominate. Slow mean reversion in \( \alpha \) translates directly into slow mean reversion of trade intensity which, in turn, leads to ARCH effects. Another way to see this is by considering the intensity variance at low frequency which can be shown to equal \( \sigma_{\alpha}^{2} + \frac{\kappa \sigma_{\alpha}^{2}}{2 \varphi (\varphi + \kappa)} \) which is approximately equal to \( \frac{\sigma_{\alpha}^{2}}{2 \kappa} + \frac{\sigma_{\lambda}^{2}}{2 \varphi} \) for \( k >> \varphi \). Because, by assumption, the parameters are chosen such that \( \sigma_{\alpha}^{2}/\varphi >> \sigma_{\lambda}^{2}/\kappa \), it is clear that the stochastic long run mean dominates at low frequency. One can thus think of the OU process for \( \hat{\lambda} \) as driving time variation in the intensity process at high sampling frequencies, while \( \alpha \) has a “level-shifting” effect in the sense that it slowly moves the level at which \( \hat{\lambda} \) operates.

In order to further illustrate this property of the model, we fix some ad hoc parameter values that satisfy the above criteria, i.e. \( \kappa = 5, \sigma_{\lambda} = 0.25, \varphi = 0.0001, \sigma_{\alpha} = \sqrt{0.001}, \text{ and } \mu = 5 \). Next, we simulate \( 2 \times 252 \) periods of the intensity process with 480 discretization steps per period. The left panel of Figure 8 graphs a time series of intensity process \( \hat{\lambda} \) over the first two periods of the simulated sample. The superimposed dashed line represents the corresponding long run mean component. It is clear that most of the variation in the intensity process at high frequency comes from the OU dynamics of \( \hat{\lambda} \). The right panel of Figure 8 plots the period by period average (or integrated) intensity process which corresponds very closely to the low frequency component (not displayed). At this frequency, \( \alpha \) drives the overall variation in the intensity process, while the OU component for \( \hat{\lambda} \) contributes little.

In summary, stochastic variation in the high and low frequency component of the intensity
process can lead to ACD and ARCH effects respectively. For the specification discussed above, closed form solutions for the intensity process are available (see Appendix B for details). Because the integrated intensity process turns out to be conditionally normal, a closed form expression for the characteristic function in Corollary 3.3 is available. As mentioned above, a major flaw of the model is that there is nothing that prevents the intensity process from becoming negative. In the context of volatility modelling, Gupta and Subrahmanyam (2002), Stein and Stein (1991) have used a similar specification and justified this on the basis that for a wide range of relevant parameter values, the probability of actually reaching a negative value is so small as to be of no significant consequence. Also, at this point the discussion of the model is purely illustrative and the intuition derived from this case is likely to remain in tact for alternative specifications. Nevertheless, in practice it may clearly make sense to sacrifice analytic tractability in return for a more appropriate specification which ensures positivity of the intensity process. One approach is to specify the model in terms of logarithmic intensity or incorporate a state-dependent innovation variance as is done in the Feller or CIR process. Other models of potential interest are some of the non-Gaussian OU processes discussed by Barndorff-Nielsen and Shephard (2001a).
4 Realized Variance and Return Dependence

In the context of the models analyzed above, we now study the impact of market microstructure induced serial correlation in returns on the properties of the realized variance (RV) measure. Importantly, we show that serial correlation renders the RV a biased estimator of the conditional return variance. We derive closed form expressions for the bias term as a function of the sampling frequency and the model parameters and show that the magnitude of the bias decays under temporal aggregation of returns at a rate that is inversely proportional to the sampling frequency. We also discuss the optimality of alternative sampling schemes.

In an influential series of papers Andersen, Bollerslev, Diebold, and Labys (2001, 2002, ABDL hereafter) have shown that when the logarithmic price process follows a semi-martingale (i.e. a process which can be decomposed into a finite variation component and a martingale component), its associated quadratic variation (QV) process is a critical determinant of the conditional return variance. Importantly, the QV process can - by definition - be approximated as the sum of squared returns sampled at high frequency. It is this approximation of the QV process that is commonly referred to as realized variance or volatility. In full generality, the relation between the conditional return variance and the RV measure is not clear-cut. However, under certain (possibly restrictive) assumptions on the finite variation component of the semimartingale, ABDL show that realized variance is an efficient and unbiased estimator of the conditional return variance. ABDL also argue that a violation of the assumptions ensuring unbiasedness is likely to have a trivial impact on the properties of the RV measure, thereby establishing it as an unbiased, efficient, and robust estimator of the conditional return variance. In the notation established above, ABDL exploit the following equality:

$$E \left[ \frac{1}{N/m} \sum_{j=1}^{N/m} R(t + jm)^2 \bigg| \mathcal{F}_t \right] = E \left[ R(t + N)^2 \bigg| \mathcal{F}_t \right].$$

(15)

where $R$ denotes excess returns, $m$ denotes the sampling frequency, whereas $N$ denotes the length of the period over which RV is calculated. It is clear from expression (15) that the unbiasedness of the RV measure crucially relies on the martingale property of logarithmic (risk adjusted) prices, or equivalently, the absence of serial correlation in excess returns. Nevertheless, a number of recent studies have implemented the RV measure without much concern for possible violations of the martingale assumption underlying the unbiasedness of this measure. It therefore seems appropriate to study the dependence structure of high frequency returns and its associated impact on the properties of the RV measure\textsuperscript{18}. Although this is largely an empirical matter, and results can be expected to vary across securities and time, the models discussed in this paper seem to

\textsuperscript{18}See Andreou and Ghysels (2001), Bai, Russell, and Tiao (2001), and Oomen (2002) for related work.
capture a number of salient features of high frequency returns particularly well and are therefore well suited to assess the properties of RV in a realistic, yet theoretical, setting.

4.1 The “Covariance Bias Term”

We investigate the properties of the RV measure for the single component compound Poisson process with MA(1) innovations. Because the results for the “bid/ask model” take the same form, we do not discuss this model separately. In the discussion below we distinguish between the case where trade intensity is constant and the case where it is time varying. To simplify notation we also set $\mu_2^2 = 0$.

**Constant Trade Intensity.** Due to the stationarity of the return process, the conditional and unconditional return variance coincide and can be expressed as

$$E \left[ R(t + N|N)^2 \right] = N\lambda \sigma_t^2 (1 + \rho)^2 - 2\sigma_t^2 \rho \left( 1 - e^{-N\lambda} \right) \sim N\lambda \sigma_t^2 (1 + \rho)^2$$

(16)

On the other hand, the expectation of the RV measure is equal to:

$$E \left[ \sum_{j=1}^{N/m} R(t + jm|m)^2 \right] = \underbrace{N\lambda \sigma_t^2 (1 + \rho)^2}_{\text{Return Variance}} - 2 \left( 1 - e^{-m\lambda} \right) \underbrace{\frac{N\rho \sigma_t^2}{m}}_{\text{Covariance Bias Term}}$$

(17)

In practice, $N$ is typically large (e.g. a day or week) and the approximation error in expression (16) can therefore safely be ignored. In contrast, $m$ is typically small (e.g. minute or hour) and the second term on the right hand side in expression (17) may therefore be substantial. This illustrates a crucial point: when high frequency (intra-period) returns are used to construct the

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19 Using that $\sum_{j=1}^{N/m} (1 - e^{-m\lambda}) = (1 - e^{-m\lambda})N/m$. 

RV measure, i.e. \( m < N \), serial correlation of returns induces a bias that is characterized by the second term on the right hand side of expression (17). This bias can be either positive or negative depending on the sign of \( \rho \). Moreover, the magnitude of the bias term decays at rate \( m^{-1} \) under temporal aggregation while it tends to \(-2N\lambda\sigma^2\rho\) for \( m \to 0 \). It is emphasized that this result does not rely on the approximation in expression (16) and will hold true as long as intra-period return are used to construct the RV measure, i.e. \( N > m \). Clearly, the magnitude of the bias will depend on specific parameter values and the sampling frequency.

This is illustrated in Figure 9. For \( \rho = 0.3 \) and \( \rho = -0.3 \), we plot the return variance (standardized by \( N \)) plus the bias component for return horizons up to 10 minutes. The parameter \( \sigma^2_{\nu} \) is adjusted so as to maintain an annualized return variance of 25%, i.e. for \( \rho = 0.30 \) (\( \rho = -0.30 \)) we have \( \sigma^2_{\nu} = 1.529e-7 \) (\( \sigma^2_{\nu} = 5.272e-7 \)). It turns out that for these parameter values the bias term is substantial, i.e. around 20% (12%) of the return variance when returns are negatively (positively) correlated and sampled at the 1 minute frequency. The magnitude of this bias can go up to 50% (20%) when sampled at even higher frequencies! These analytical results are in line with a recent study by Oomen (2002) which finds that for the FTSE-100 index over the period 1990-2000 (i) high frequency returns feature substantial serial dependence (for minute by minute data, the serial correlation is positive and significant up to high orders), (ii) the covariance bias term is around 40% for minute by minute returns and (iii) the magnitude of this bias term decays hyperbolically under temporal aggregation.

**Time-Varying Trade Intensity**  For simplicity we focus on the case where the time variation in the trading intensity is a deterministic function of time only. Although more general results can be derived within the OU framework outlined above, the notation is complex and the stochastic case does not add much additional insight for the discussion below. In the deterministic setting,

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\[ \text{Figure 9: Covariance Bias Term} \]

---

\(^{20}\)Remember that the MA structure is imposed on returns in *transaction* time. For the bond futures data analyzed in Section 2 we found a first order serial correlation of about \(-0.45\). The chosen parameter values in the simulation are therefore reasonable from an empirical point of view.
it directly follows from Corollary 3.3 that

\[
E \left[ R_F (t + N|N)^2 \right] = \sigma^2 (1 + \rho)^2 \lambda^* (t, N) - 2\rho \sigma^2 (1 - e^{-\lambda^*(t,N)}) \approx \sigma^2 (1 + \rho)^2 \lambda^* (t, N)
\]

On the other hand, the conditional expectation of RV is:

\[
E_t \left[ \sum_{j=1}^{N/m} R (t + jm|m)^2 \right] = \frac{\sigma^2 (1 + \rho)^2 \lambda^* (t, N)}{\text{Return Variance}} - 2\rho \sum_{j=0}^{N/m-1} (1 - e^{-\lambda^*(t+jm,m)}) \text{ Covariance Bias Term} \tag{18}
\]

Again, the bias term can be substantial depending on the sampling frequency and model parameters and similar results can be derived for this case as for the constant intensity case. A more interesting feature of the bias characterization for non-constant trade intensity, is that it allows us to analyze the performance of alternative sampling schemes to which we turn next.

### 4.2 Bias Reduction and Optimality of Sampling Schemes

As pointed out above, the presence of serial correlation in returns introduces a bias in the RV measure which can be substantial for realistic model parameter values. Because the efficiency of the RV measure crucially relies on the use of intra-period returns, one faces a trade off between the sampling returns at a high frequency, thereby minimizing the measurement error, and sampling returns at low frequency, thereby minimizing the bias term. This trade-off suggest the existence of an “optimal” sampling frequency, that is the highest available frequency at which the bias term is negligible. Alternatively, one could estimate the model parameters and correct for the bias term based on the expression derived above. In practice it is not clear which of these two approaches is preferable. While the bias correction method allows one to use all available data, it is clearly model dependent. The gain in efficiency may therefore be offset by the impact of model and parameter uncertainty. On the other hand, while specifying an “optimal” sampling frequency is essentially non-parametric or model independent, valuable information may be lost by the aggregation of returns.

A related issue that arises in this context is how to sample the data. Up to now we have only considered returns that are sampled at equidistant time intervals, i.e. \( t + jm \) for \( j = 1, \ldots, N/m \). However, when transaction data is available it is also possible to consider alternative sampling schemes. A particularly interesting one is where the price process is sampled at time points \( \tau_j \) for \( j = 1, \ldots, N/m \) where \( \tau_0 = t, \tau_{N/m} = t + N \) and

\[
\int_{\tau_j}^{\tau_{j+1}} \lambda(u)du = \frac{m}{N} \int_{\tau_0}^{\tau_{N/m}} \lambda(u)du \equiv \lambda_m \tag{19}
\]
The above sampling scheme effectively “deforms” the calendar time scale by compressing it when the arrival rate of trades is low and stretching it when the arrival rate of trades is high. In this case, one can think of returns being equally spaced on a “transaction” or “business” time scale as opposed to a calendar time scale. An attractive feature of this sampling scheme is that the statistical properties of returns sampled on this deformed time scale coincide with those of a homogenous compound Poisson process with intensity parameter equal to $\lambda_m$. Because the construction in expression (19) ensures that both sampling schemes generate the same number of intra-period returns ($N/m$), it is of interest to compare the bias term associated with each scheme. As can be seen from expression (18), for the calendar time sampling, the bias term is equal to:

$$2\rho\sigma^2 \sum_{j=0}^{N/m-1} \left( 1 - e^{-\lambda^*(t+jm,m)} \right)$$

On the other hand, for the “business time” sampling, the bias is simply:

$$2\rho\sigma^2 \sum_{j=0}^{N/m-1} \left( 1 - e^{-\lambda_m} \right)$$

Surprisingly, it turns out that the bias term associated with calendar time sampled returns is strictly smaller than the bias term associated with “business time” sampled returns. In order to show this it is sufficient to prove that

$$\sum_{j=0}^{N/m-1} e^{-\lambda^*(t+jm,m)} > \sum_{j=0}^{N/m-1} e^{-\lambda_m} \quad \text{or equivalently} \quad R \equiv \frac{m}{N} \sum_{j=0}^{N/m-1} e^{\lambda_m-\lambda^*(t+jm,m)} > 1$$

By the definition of $\lambda_m$ and the convexity of the exponential function, the above inequality must hold as long as the intensity parameter is non-constant. Note that $R$ measures the bias reduction associated with calendar time sampling relative to transaction sampling. This gain increases with an increase in the variability of $\lambda(\cdot)$. When the intensity parameter is constant, we have that $R = 1$, and both sampling schemes are equivalent.

### 4.2.1 Bias versus Mean Squared Error

The approach outlined above, classifies competing sampling schemes solely based on the relative magnitude of its associated bias. An alternative well known measure of performance\footnote{I am indebted to Jeff Russell for pointing this out to me.} is the mean squared error (MSE) which trades off a reduction in the bias against the loss of efficiency. While we have shown that calendar time sampling strictly dominates business time sampling when we use a bias-based ranking, it may very well be that this result is reversed when we use an
MSE-based ranking which takes both bias and efficiency into account. Unfortunately, an analytic treatment of an MSE-based ranking of competing sampling schemes is not feasible because we do not have a closed form solution for the variance of the RV measure available. A small-scale simulation experiment is therefore undertaken to gauge whether an MSE-based ranking will yield qualitatively different results than the bias-based ranking.

We focus on the single component compound Poisson process with MA(1) innovations and deterministic time variation of the intensity process, i.e. \( \lambda(t) = s(t) \). The specification we use for \( s(t) \) is similar to expression (12) with the indicator function left out. The parameter values are the same as discussed on page 21. Next, we simulate \( T = 1000 \) (disjoint) days of transaction prices. Let \( F_t(u) \) denote the security price at time \( u \) during day \( t \) where \( u \subset [0, N] \) and \( t = 1, \ldots, T \). In addition, let \( F_t(\tau_i) \) denote the security price associated with the \( i^{th} \) transaction on day \( t \). The implementation of calendar time sampling is straightforward, i.e. for a given day \( t \) and a sampling frequency \( m \), we sample \( N/m \) returns as

\[
R_c^t(j|m) = F_t(jm) - F_t((j-1)m)
\]

for \( j = 1, \ldots, N/m \). The corresponding business time sampling scheme, in contrast, samples the same amount of returns as follows:

\[
R_b^t(j|k) = F_t(\tau_{jk}) - F_t(\tau_{(j-1)k})
\]

for \( j = 1, \ldots, N/m \) and \( k = mn_t/N \) where \( n_t \) denotes the total number of transactions for day \( t \). Based on these returns series we construct the following statistics:

\[
CBS(m) = E_t[R_c^2] - \frac{1}{T} \sum_{t=1}^{T} \sum_{j=1}^{N/m} R_c^t(j|m)^2,
\]

\[
BBS(m) = E_t[R_b^2] - \frac{1}{T} \sum_{t=1}^{T} \sum_{j=1}^{N/m} R_b^t(j|k)^2,
\]

and

\[
CMSE(m) = \frac{1}{T} \sum_{t=1}^{T} \left\{ E_t[R_c^2] - \sum_{j=1}^{N/m} R_c^t(j|m)^2 \right\},
\]

\[
BMSE(m) = \frac{1}{T} \sum_{t=1}^{T} \left\{ E_t[R_b^2] - \sum_{j=1}^{N/m} R_b^t(j|m)^2 \right\}.
\]

Figure 10 displays all of the above statistics for sampling frequencies \( (m) \) between 1 second and 5 minutes. A number of interesting patterns arise. As expected, based on the bias-ranking, the
Figure 10: Covariance Bias term (CBS and BBS, left panel) and Mean Squared Error (CMSE and BMSE, right panel) for “Calendar” or “Physical” Clock (solid line) and “Business Clock” (dashed line) sampling schemes.

calendar time scheme dominates. However, the difference in performance between both schemes rapidly shrinks as the sampling frequency decreases. At sampling frequencies lower than 1 minute, the difference is minimal which implies that the optimal sampling frequency will be the same for both schemes. In contrast, when the MSE is used to rank the sampling schemes, it appears that the business time sampling achieves the lowest overall MSE. Moreover, the sampling frequency which minimizes the MSE is substantially higher than the sampling frequency which minimizes the bias. Ignoring the efficiency loss associated with aggregation of returns, as is done for the bias-based ranking, clearly leads one to choose a much lower sampling frequency than if the MSE is taken as the relevant performance measure. Based on this simulation experiment we conclude that business time sampling dominates calendar time sampling when the objective is to either minimize the bias (in which case both schemes perform roughly equal) or minimize the MSE (in which case business time sampling dominates).

5 Conclusion

This article studies several extensions of the compound Poisson process which are able to capture important static and dynamic characteristics of high frequency security prices. In contrast to diffusion-based models, our framework is consistent with the finite variation property of high frequency returns and does not impose the usual martingale restriction on asset prices. By comparing the properties of simulated data to actual high frequency data we illustrate the flexibility
of the model and its ability to capture important features of high frequency data including, (i) skewness, excess kurtosis and return serial correlation which diminishes under temporal aggregation, (ii) deterministic variation in trading activity such as the U-shaped intra-day pattern, day of the week effects, and the increased variance of the overnight return, and (iii) stochastic variation in trading activity leading to serial dependence in trade durations at high frequency (ACD-effects) and return volatility at low frequency (ARCH-effects). In addition, our models provide a useful context in which to investigate “market-microstructure-induced” serial correlation of returns at different sampling frequencies and its associated impact on the recently popularized realized volatility or variance measure. In particular, we show that for realistic parameter values the realized variance measure is a biased estimator of the integrated variance process and that the choice of sampling frequency proves crucial in minimizing this bias. Finally, allowing for time variation in the trade intensity process yields interesting insights into the properties of alternative, time-deformation-based, sampling schemes.
References


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A  The Characteristic Function

Following Feller (1968), let \( X \) denote a random variable with probability measure \( \mu \). The characteristic function of \( X \) (or \( \mu \)) is the function \( \phi (\xi) \) defined for real \( \xi \) by:

\[
\phi (\xi) \equiv E \left[ e^{i\xi X} \right] = \int_{-\infty}^{\infty} e^{i\xi x} \mu (dx) = \int_{-\infty}^{\infty} \left( \cos (\xi x) + i \sin (\xi x) \right) \mu (dx).
\]

The characteristic function of \( aX + b \) equals \( e^{ib\xi} \phi (a\xi) \). When \( X \) is Gaussian with zero mean and unit variance \( \phi (\xi) = e^{-\frac{1}{2} \xi^2} \). Non-central moments \( (m_n) \) and cumulants \( (\kappa_n) \) of order \( n \) can be derived as:

\[
m_n = i^{-n} \frac{\partial^n \phi (\xi)}{\partial \xi^n} \bigg|_{\xi=0} \quad \text{and} \quad \kappa_n = i^{-n} \frac{\partial^n \ln \phi (\xi)}{\partial \xi^n} \bigg|_{\xi=0}.
\]

There exists a one-to-one relationship between moments and cumulants of any order. For the first four orders they are as follows: \( \kappa_1 = m_1, \kappa_2 = m_2 - m_1^2, \kappa_3 = m_3 - 3m_1m_2 + 2m_1^3, \) and \( \kappa_4 = m_4 - 3m_2^2 - 4m_1m_3 + 12m_1^2m_2 - 6m_1^4 \). See Kendall (1958) for more details. The joint characteristic function of the set of random variables \( \{X_j\}_{j=1}^k \) is given by:

\[
\phi (\xi_1, \ldots, \xi_k) \equiv E \left[ \exp \left( i\xi_1 X_1 + i\xi_2 X_2 + \ldots + i\xi_k X_k \right) \right],
\]

which generates joint moments as follows:

\[
E \left[ X_1^{p_1} X_2^{p_2} \ldots X_k^{p_k} \right] = i^{-\overline{p}} \frac{\partial^{\overline{p}} \phi (\xi_1, \ldots, \xi_k)}{\partial \xi_1^{p_1} \partial \xi_2^{p_2} \ldots \partial \xi_k^{p_k}} \bigg|_{\xi=0},
\]

where \( \overline{p} = \sum_{i=1}^k p_i \).

B  The Intensity Process

The solution to the SDE in expression (14) directly follows from a general result on one-dimensional linear SDE as discussed by Karatzas and Shreve (1991, Section 5.6C):

\[
\lambda (t + \tau) = e^{-\kappa \tau} \lambda (t) + \kappa \int_{t}^{t+\tau} e^{-\kappa (t+\tau-u)} \alpha (u) \, du + \sigma \lambda \int_{t}^{t+\tau} e^{-\kappa (t+\tau-u)} \, dW \lambda (u). \tag{20}
\]

for \( \tau > 0 \). The OU specification for \( \alpha \) allows us to further specialize expression (20) above:

\[
\lambda (t + \tau) = \mu + e^{-\kappa \tau} \left( \lambda (t) - \mu \right) + \frac{\kappa (e^{-\kappa \tau} - e^{-\varphi \tau})}{\varphi - \kappa} (\alpha (t) - \mu) \tag{21}
\]

\[
\quad + \kappa \sigma \alpha \int_{t}^{t+\tau} \frac{e^{-\varphi (t+\tau-u)} - e^{-\kappa (t+\tau-u)}}{\kappa - \varphi} \, dW \alpha (u) + \sigma \lambda \int_{t}^{t+\tau} e^{-\kappa (t+\tau-u)} \, dW \lambda (u)
\]

using that

\[
\int_{t}^{t+\tau} f (h) \left\{ \int_{t}^{h} g (h, u) \, dW (u) \right\} \, dh = \int_{t}^{t+\tau} \left\{ \int_{u}^{t+\tau} f (h) g (h, u) \, dh \right\} \, dW (u) \tag{22}
\]

where \( f (h) \) and \( g (h, u) \) are deterministic functions. Based on expression (21) above, it is straightforward to derive an expression for the integrated intensity process.
C Proofs

Proof of Theorem 2.1 Let the characteristic function of innovations to the mid-price be given by

$$\phi_\varepsilon (\eta) = E_0 \left[ e^{i\eta\varepsilon} \right] = e^{i\eta \mu_1 - \frac{1}{2} \eta^2 \sigma_1^2}$$

where $\varepsilon \sim \mathcal{N} (\mu_1, \sigma_1^2)$. Now derive the characteristic function of the mid-price process, i.e. $\phi_F (\eta, t) = E_0 \left[ e^{i\eta F(t)} \right]$. Define $S(n) = \sum_{j=1}^n \varepsilon_j$ and notice that

$$\phi_F (\eta, t) = \sum_{n=0}^\infty \frac{(t \lambda_t)^n e^{-t \lambda_t}}{n!} E_0 \left[ e^{i\eta (F(0)+S(n))} \right] = e^{i\eta F(0)-t \lambda_t} \sum_{n=0}^\infty \frac{(t \lambda_t e^{i\eta \mu_1 - \frac{1}{2} \eta^2 \sigma_1^2})^n}{n!}$$

using that $S(n) \sim \mathcal{N} (n \mu_1, n \sigma_1^2)$ and $\sum_{n=0}^\infty \frac{a^n}{n!} = e^a$. To derive the joint characteristic function of $F$ and $G$, i.e. $\phi_{F,G} (\eta, \xi, t) = E_0 \left[ e^{i\eta F(t) + i\xi G(t)} \right]$, use that:

$$\phi_{F,G} (\eta, \xi, t+h) - \phi_{F,G} (\eta, \xi, t) = E_0 \left[ e^{i\eta F(t) + i\xi G(t)} E_t \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} - 1 \right] \right].$$

Consider the random variable $e^{i\eta R_F(t+h) + i\xi R_G(t+h)}$ and notice that, for $h$ sufficiently small, the memory-less property of the Poisson process implies:

$$\Pr \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} = e^{-i\xi G(t) + i\eta M_{t+h}} \right] = h \lambda_I,$$

$$\Pr \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} = e^{i\xi (-\delta - G(t))} \right] = h \lambda_S,$$

$$\Pr \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} = e^{i\xi G(t)} \right] = h \lambda_B,$$

$$\Pr \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} = 1 \right] = 1 - h \overline{\lambda},$$

where $\varepsilon M_{t+h} \sim \mathcal{N} (\mu_1, \sigma_1^2)$. Therefore

$$E_t \left[ e^{i\eta R_F(t+h) + i\xi R_G(t+h)} - 1 \right] = h \lambda_I e^{-i\xi G(t)} E_t e^{i\eta M_{t+h}} + h \lambda_B e^{i\xi (-\delta - G(t))} + h \lambda_S e^{i\xi (\delta - G(t))} - h \overline{\lambda}$$

Multiplying with $e^{i\eta F(t) + i\xi G(t)}$ yields:

$$E_t \left[ e^{i\eta F(t+h) + i\xi G(t+h)} - e^{i\eta F(t) + i\xi G(t)} \right] = h \lambda_I E_t e^{i\eta M_{t+h}} + h \lambda_B e^{i\xi \delta} + h \lambda_S e^{-i\xi \delta} e^{i\eta F(t)} - h \overline{\lambda} e^{i\eta F(t) + i\xi G(t)}$$

Taking expectations of the above expression, dividing by $h$, and taking $h$ to zero results in:

$$\frac{\partial \phi_{F,G} (\eta, \xi, t)}{\partial t} = \lim_{h \to 0} \frac{\phi_{F,G} (\eta, \xi, t+h) - \phi_{F,G} (\eta, \xi, t)}{h}$$

$$= \left[ \lambda_I \phi_\varepsilon (\eta) + \lambda_B e^{i\xi \delta} + \lambda_S e^{-i\xi \delta} \right] \phi_F (\eta, t) - \overline{\lambda} \phi_{F,G} (\eta, \xi, t),$$

(23)
with the expressions for $\phi_e(\eta, t)$ and $\phi_F(\eta, t)$ given above. Solving the differential equation in expression (23), subject to the boundary condition $\phi_{F,G}(\eta, \xi, 0) = e^{i\eta F(0) + i2G(0)}$, yields the joint characteristic function of $F$ and $G$:

$$
\phi_{F,G}(\eta, \xi, t) = f(\eta, \xi) \left( \phi_F(\eta, t) - e^{i\eta F(0)} \right) + e^{i\eta F(0) + i2G(0)}
$$

where

$$
f(\eta, \xi) = \frac{\lambda_I \phi_e(\eta) + \lambda_B e^{i\xi} + \lambda_S e^{-i\xi}}{\lambda_I \phi_e(\eta) + \lambda_B + \lambda_S}
$$

This completes the proof of expression 6.

Now, based on the joint characteristic function of $F$ and $G$, it is straightforward to derive that for $m > 0$:

$$
\phi^*_{F,G}(\eta_1, \eta_2, \xi_1, \xi_2, t, m) = E_0 \left[ e^{i\eta_1 F(t) + i2 F(t+m) + i2 G(t) + i2 G(t+m)} \right]
= E_0 \left[ e^{i\eta_1 F(t) + i2 G(t)} E_t e^{i\eta_2 F(t+m) + i2 G(t+m)} \right]
= E_0 \left[ e^{i\eta_1 F(t) + i2 G(t)} a(\eta_2, \xi_2) \left( \phi_{F,t}(\eta_2, m) - e^{i\eta_2 F(t-m)\xi_2} \right) \right]
+ E_0 \left[ e^{i\eta_1 F(t) + i2 G(t)} e^{i\eta_2 F(t) + i2 G(t) - m\xi_2} \right]
= f(\eta_2, \xi_2) \phi_{F,G}(\eta_1 + \eta_2, \xi_1 + \xi_2, t, m)
+ e^{-m\xi_2} \phi_{F,G}(\eta_1 + \eta_2, \xi_1 + \xi_2, t, m)
$$

which completes the proof of expression 5. □

**Proof of Theorem 3.1** Define the cumulative innovations $S(n) = \sum_{j=1}^{n} \xi_j$ and notice that the joint characteristic function of $F(t)$ and $F(t+m)$ can be written as

$$
E_0 \left[ e^{i\xi_1 F(t) + i2 F(t+m)} \right] = a(\xi) \phi_S^*(\xi_1, \xi_2, t, m)
$$

where $\phi_S^*(\xi_1, \xi_2, t, m) \equiv E_0 \left[ e^{i\xi_1 S(M_t(t)) + i2 S(M_t(t+m))} \right], \xi = \xi_1 + \xi_2$ and $a(\xi) = \exp(i\xi F(0))$. The variance of $S(n)$ equals:

$$
\Sigma_q(n) = n\sigma^2 \sum_{j=0}^{q} \rho_j^2 + 2\sigma^2 \sum_{h=1}^{\min(q, n)} \sum_{j=h}^{q} (n - h) \rho_j \rho_{j-h}, \quad (24)
$$

which, for $n \geq q$, simplifies to:

$$
\Sigma_q(n) = n\sigma^2 \overline{p}^2 - 2\sigma^2 \rho(q, q),
$$

where $\overline{p} = \sum_{j=0}^{q} \rho_j$ and

$$
\rho(q, k) = \begin{cases} 
\sum_{h=1}^{\min(q, k)} \sum_{j=h}^{q} h \rho_j \rho_{j-h} & \text{for } q \geq 1, k \geq 1 \\
0 & \text{otherwise}
\end{cases}
$$
Note that $S(n) \sim \mathcal{N}(n \bar{\mu}_\nu, \Sigma_q(n))$ and thus $E[e^{i\xi S(n)}] = e^{i\xi \bar{\mu}_\nu - \frac{1}{2} \xi^2 \Sigma_q(n)}$. The covariance of $S(n)$ and $S(n + h)$ equals:

$$
\Sigma_q(n, h) = \Sigma_q(n) + \sigma_q^2 \rho(q, h),
$$

and because $S(n)$ and $S(n + h)$ are jointly normal, their joint characteristic function can be derived as:

$$
E_0 \left[ e^{i\xi_1 S(n) + i\xi_2 S(n + h)} \right] = e^{i\xi_1 \bar{\mu}_\nu + i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \left[ \xi_1^2 \Sigma_q(n) + \xi_2^2 \Sigma_q(n + h) + 2\xi_1 \xi_2 \Sigma_q(n, h) \right]}
$$

Recall that

$$
\phi_S^*(\xi_1, \xi_2, t, m) = E_0 \left[ \sum_{n=0}^\infty \sum_{m=0}^\infty e^{i\xi_1 S(n) + i\xi_2 S(n + h)} \frac{(m\lambda)^h}{h! e^{m\lambda}} \right]
$$

which, for $t$ sufficiently large\(^{22}\), can be approximated accurately by:

$$
b(\xi, t) e^{\xi^2 \sigma_q^2 \rho(q, q)} \sum_{h=0}^\infty e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \left[ h\sigma_q^2 \xi_2^2 \rho(q, q) + 2\xi_1 \xi_2 \sigma_q^2 \rho(q, q) \right]} \frac{(m\lambda)^h}{h! e^{m\lambda}}
$$

where $b(\xi, t) = \exp \left[ t\lambda \left( e^{i\xi \bar{\mu}_\nu - \frac{1}{2} \xi^2 \sigma_q^2 \rho(q, q)} - 1 \right) \right]$. The summation over $h$ can be rewritten as:

$$
\sum_{h=q}^{q-1} e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \sigma_q^2 \xi_2^2 \rho(q, q)} \frac{(m\lambda)^h}{h! e^{m\lambda}} + e^{-\xi_1 \lambda} \sum_{h=q}^{\infty} e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \sigma_q^2 \xi_2^2 \rho(q, q)} \frac{(m\lambda)^h}{h! e^{m\lambda}}
$$

where

$$
\sum_{h=q}^{\infty} e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \sigma_q^2 \xi_2^2 \rho(q, q)} \frac{(m\lambda)^h}{h! e^{m\lambda}} = b(\xi_2, m) - \sum_{h=0}^{q-1} e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \sigma_q^2 \xi_2^2 \rho(q, q)} \frac{(m\lambda)^h}{h! e^{m\lambda}}
$$

Collecting above expressions yields:

$$
\phi_S^*(\xi_1, \xi_2, t, m) = b(\xi, t) e^{\xi^2 \sigma_q^2 \rho(q, q)} \sum_{h=0}^{q-1} e^{i\xi_2 \bar{\mu}_\nu - \frac{1}{2} \sigma_q^2 \xi_2^2 \rho(q, q)} \left( e^{-\xi_1 \lambda} - e^{-\xi_1 \xi_2 \sigma_q^2 \rho(q, q)} \right) \frac{(m\lambda)^h}{h! e^{m\lambda}}
$$

$$
+b(\xi, t) b(\xi_2, m) e^{\xi^2 \sigma_q^2 \rho(q, q)} e^{-\xi_1 \xi_2 \sigma_q^2 \rho(q, q)}
$$

which completes the proof of expression 8.\(^{22}\)

\(^{22}\)Strictly speaking this is an approximation to the true characteristic function (which can be avoided at the cost of cumbersome notation) since $\Sigma_q(n)$ is approximated by $n\sigma_q^2 \rho_q^2 - 2\sigma_q^2 \rho(q, q)$ for all $n \geq 0$ while this is only justified for $n \geq q$. However, $q$ is typically small (say 1 or 2) and the contribution of the terms for which the variance expression is incorrect is negligible when $t$ is large. Moreover, when calculating the unconditional moments, i.e. having $t \to \infty$, the approximation is exact.
Proof of Corollary 3.2 Define the cumulative innovations $S_r(n) = \sum_{j=1}^{n} \varepsilon_{r,j}$. The joint characteristic function of $S_r(n)$ and $S_r(n+k)$ is derived in the proof of Theorem 3.1. Because $Cov[S_h(n), S_j(n')] = 0$ for $h \neq j$ and $n, n' > 0$ it directly follows that:

$$E_0 \left[ e^{i\xi_1 F(t)} + i\xi_2 F(t+m) \right] = a(\xi) \prod_{r=1}^{k} \phi_{S,r}^*(\xi_1, \xi_2, t, m)$$

where $a(\xi) = \exp(i\xi F(0))$ and $\phi_{S,r}^*(\xi_1, \xi_2, t, m) = E_0 \left[ e^{i\xi_1 S_r(M_r(t))} + i\xi_2 S_r(M_r(t+m)) \right]$. $\blacksquare$

Proof of Corollary 3.3 Follows directly from the proof of Theorem 3.1