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Abstract
This research primarily uses Markov Regime Switching model to investigate the optimal hedge ratio between Taiwan Stock Index and Taiwan Future Exchange (TAIFEX). In the past researches, when it comes to hedge ratio between spot and future markets, Bivariate-GARCH model is often used. This is because that Bivariate-GARCH model is able to catch the interaction between these two markets.On the other hand, Alizadeh and Nomikos（2004）claimed that there may be different regimes in the interaction between stock index and index future. Therefore, hedge ratios may depend on different regimes. Also, Sarno and Valente（2000）found Regime Switching Model outperforms OLS when investigating the relationship between stock index and index futures price. Thus, this research examines the optimal hedge ration in TAIFEX with Markov Regime Switching model.This research also takes Random Coefficient Autoregressive model (RCAR) and other models into consideration, such as Bivariate GARCH model, OLS, and NaU+EFve, to compare the hedge efficiency between all models.
Finally, the empirical result shows: RCAR outperforms other models in-sample, and MRS model is next to it; asymmetric Bivariate GARCH has better out-of-sample performance than other models, and RCAR Model is only second to it. Therefore, this research suggests that investors will be able to enhance efficiency in hedge strategy if they could take account of different regimes.
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