1 Last Class

- Data Examples
- White noise model
- Sample Autocorrelation Function and Correlogram

2 Trend Models

Many time series datasets show an increasing or decreasing trend. A simple model for such datasets is obtained by adding a deterministic trend function of time to white noise:

\[ X_t = m_t + Z_t \]

Here \( m_t \) is a deterministic trend function and \( Z_t \) is white noise. There exist two main techniques for fitting this model to the data.

2.1 Parametric form for \( m_t \) and linear regression

Assume a simple parametric form for \( m_t \), say linear or quadratic, and fit it via linear regression.

2.2 Smoothing

Here we estimate \( m_t \) without making any parametric assumptions about its form.

The idea is that to get \( m_t \) from \( X_t = m_t + Z_t \), we need to eliminate \( Z_t \). It is well-known that noise is eliminated by averaging. Consider

\[ \hat{m}_t = \frac{1}{2q + 1} \sum_{j=-q}^{q} X_{t+j}. \]  \hspace{1cm} (1)

If \( m_t \) is linear on the interval \([t-q, t+q]\), then check that

\[ \frac{1}{2q + 1} \sum_{j=-q}^{q} m_{t+j} = m_t. \]
Thus if \( m_t \) is approximately linear over \([t - q, t + q]\), then

\[
\hat{m}_t \approx m_t + \frac{1}{2q + 1} \sum_{j=-q}^{q} Z_{t+j} \approx m_t.
\]

The defining equation for \( \hat{m}_t \) will have trouble when calculating averages near end-points. To counter, just define \( X_t \) to be \( X_1 \) for \( t < 1 \) and \( X_n \) for \( t > n \).

\( \hat{m}_t \) is also called the Simple Moving Average of \( X_t \).

**Key Question:** How to choose the smoothing parameter \( q \)? Observe that:

\[
\hat{m}_t = \frac{1}{2q + 1} \sum_{j=-q}^{q} m_{t+j} + \frac{1}{2q + 1} \sum_{j=-q}^{q} Z_{t+j}.
\]

If \( q \) is very small, then the second term above is not quite small and so the trend estimate will also involve some noise component and therefore \( \hat{m}_t \) will be very noisy. On the other hand, if \( q \) is large, then the assumption that \( m_t \) is linear on \([t - q, t + q]\) may not be quite true and thus, \( \hat{m}_t \) may not be close to \( m_t \). This is often referred to as the Bias-Variance tradeoff. Therefore \( q \) should be neither too small nor too large.

### 2.2.1 Parametric Curve Fitting versus Smoothing

Suppose there is good reason to believe that there is an underlying linear or quadratic trend function. In this case, is it still okay to use smoothing?

No, when there is really is an underlying linear trend, fitting a line gives a more precise estimate of the trend. On the other hand, the estimation of trend by smoothing only uses a few observations for each time point and the resulting estimate is not as precise. This is the price one has to pay for giving up the assumption of linearity. Of course, when there is no reason to believe in an underlying linear trend, it might not make sense at all to fit a line. Smoothing is the way to go in such cases.

### 2.3 More General Filtering

The smoothing estimate (1) of the trend function \( m_t \) is a special case of linear filtering. A linear filter converts the observed time series \( X_t \) into an estimate of the trend \( \hat{m}_t \) via the linear operation:

\[
\hat{m}_t = \sum_{j=-q}^{q} a_j X_{t+j}.
\]

The numbers \( a_{-q}, a_{-q+1}, \ldots, a_{-1}, a_0, a_1, \ldots, a_s \) are called the weights of the filter. The Smoothing method is clearly a special instance of filtering with \( s = q \) and \( a_j = 1/(2q + 1) \) for \( |j| \leq q \) and 0 otherwise.

One can think of the filter as a (linear) system which takes the observed series \( X_t \) as input and produces the estimate of trend, \( \hat{m}_t \) as output.

In addition to the choice \( a_j = 1/(2q + 1) \) for \( |j| \leq q \), there are other choice of filters that people commonly use.

1. **Binomial Weights:** Based on the following idea. When we are estimating the value of the trend \( m_t \) at \( t \), it makes sense to give a higher weight to \( X_t \) compared to \( X_{t \pm 1} \) and a higher weight to \( X_{t \pm 1} \) compared to \( X_{t \pm 2} \) and so on. An example of such weights are:

\[
a_j = 2^{-q} \left( \frac{q}{q/2 + j} \right) \quad \text{for } j = -q/2, -q/2 + 1, \ldots, -1, 0, 1, \ldots, q/2.
\]
As in usual smoothing, choice of \( q \) is an issue here.

(2) **Spencer's 15 point moving average**: We have seen that simple moving average filter leaves linear functions untouched. Is it possible to design a filter which leaves higher order polynomials untouched? For example, can we come up with a filter which leaves all quadratic polynomials untouched. Yes!

For a filter with weights \( a_j \) to leave all quadratic polynomials untouched, we need the following to be satisfied for every quadratic polynomial \( m_t \):

\[
\sum_j a_j m_{t+j} = m_t \quad \text{for all } t
\]

In other words, if \( m_t = \alpha t^2 + \beta t + \gamma \), we need

\[
\sum_j a_j \left( \alpha (t+j)^2 + \beta (t+j) + \gamma \right) = \alpha t^2 + \beta t + \gamma \quad \text{for all } t.
\]

Simplify to get

\[
\alpha t^2 + \beta t + \gamma = \left( \alpha t^2 + \beta t + \gamma \right) \sum_j a_j + (2\alpha + \beta) \sum_j ja_j + \alpha \sum_j j^2 a_j \quad \text{for all } t.
\]

This will clearly be satisfied if

\[
\sum_j a_j = 1 \quad \sum_j ja_j = 0 \quad \sum_j j^2 a_j = 0. \quad (2)
\]

An example of such a filter is Spencer’s 15 point moving average defined by

\[
a_0 = \frac{74}{320}, a_1 = \frac{67}{320}, a_2 = \frac{46}{320}, a_3 = \frac{21}{320}, a_4 = \frac{3}{320}, a_5 = \frac{-5}{320}, a_6 = \frac{-6}{320}, a_7 = \frac{-3}{320}
\]

and \( a_j = 0 \) for \( j > 7 \). Also the filter is symmetric in the sense that \( a_{-1} = a_1, a_{-2} = a_2 \) and so on. Check that this filter satisfies the condition (2).

Because this is a symmetric filter, it can be checked that it allows all cubic polynomials to pass unscathed as well.

(3) **Exponential Smoothing**: Quite a popular method of smoothing (wikipedia has a big page on this). It is also used as a forecasting technique.

To obtain \( \hat{m}_t \) in this method, one uses only the previous observations \( X_{t-1}, X_{t-2}, X_{t-3}, \ldots \). The weights assigned to these observations exponentially decrease the further one goes back in time. Specifically,

\[
\hat{m}_t := \alpha X_{t-1} + \alpha(1-\alpha)X_{t-2} + \alpha(1-\alpha)^2X_{t-3} + \cdots + \alpha(1-\alpha)^{t-2}X_1 + (1-\alpha)^{t-1}X_0.
\]

Check that the weights add up to 1. \( \alpha \) is a parameter that determines the amount of smoothing (\( \alpha \) here is analogous to \( q \) in smoothing). If \( \alpha \) is close to 1, there is very little smoothing and vice versa.