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**Article**

## A segmented and observable yield curve for Colombia

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## **A Segmented and Observable Yield Curve for Colombia**

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**Abstract:** Following (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018) we implement a segmented three factor Nelson-Siegel model for the yield curve using daily observable bond prices and short term interbank rates for Colombia. The flexible estimation for each segment (short, medium, and long) provides an improvement over the classical Nelson-Siegel approach in particular in terms of in-sample and out-of-sample forecasting performance. A segmented term structure model based on observable bond prices provides a tool closer to the needs of practitioners in terms of reproducing the market quotes and allowing for independent local shocks in the different segments of the curve.

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**JEL codes:** G12, E43, C53, C58.

### **Introduction**

The term structure of interest rates is the relationship between interest rates or bond yields and different terms or maturities. The term structure of interest rates is also known as the yield curve, and it plays a central role economic and financial analysis. For example, the term structure reflects expectations of market participants about future changes in interest rates and their assessment of monetary policy conditions beyond the direct relationship

between the inflation target rate, the policy rate and economic activity (Bayat, Kayhan, & Tasar, 2018) .

A large part of finance literature and applications by practitioners, regarding the term structure of non-defaultable securities, is concerned with using available security prices to estimate the fair market prices of other non-observable securities: “this is important because fixed-income securities and their derivatives trade only occasionally, and so must be priced based on other securities that do trade” (Engle, Roussellet, & Siriwardane, 2017).

Most of the empirical literature on term structure modelling uses U.S. or European data and has traditionally focused on the characteristics of developed markets. There is however a recent trend that implements term structure modelling in other markets and in particular Emerging Markets (Dutta, Basu, & Vaidyanathan, 2005); (Shu, J., & Lo, 2018); (Ahi, Akgiray, & Sener, 2018); (Nagy, 2019). The empirical applications on emerging market data has also brought new challenges in terms of modelling the yield curve, in particular in these markets there are either no bonds or very few bonds trading for some maturities.

The Nelson-Siegel model (Nelson and Siegel, 1987) is a statistical approach that provides a parsimony specification to capture the differences in rates along the curve (for different maturities). Its implementation in one or two stages gives the temporal variation of the factors maintaining the factor loading's constant over time. The specification of the model and the estimation methods provide a simple implementation, which is why, it turns out to be a successful model outside academia. Although the Nelson-Siegel model is not arbitrage-free, (Christensen, Diebold, & Rudebusch, 2011) propose a representation of the model that is arbitrage-free. However, it remains unclear if no-arbitrage restrictions improve statistical validity and therefore, some empirical applications shown that different variations of the Nelson-Siegel model provide a better in-sample and out-of-samples fit of the yields than the class of arbitrage free affine term structure models. Most of the applications using emerging market monthly data consider different variations of the dynamic Nelson-Siegel model and evaluate the in-sample and out-of-sample performance of the models. In order to accommodate the limited bond data or illiquid bond markets they adjust the estimation to account for liquidity adjusted data (Dutta, Basu, & Vaidyanathan, 2005) or using different optimization algorithms (Ahi, Akgiray, & Sener, 2018).

One of the important drawbacks of the academic literature is that the estimation of the term structure is performed on synthetic interpolated zero coupon yields. For example, one of the most important sources of US yields is based on

interpolated data from (Gurkaynak, Sack, & Wright, 2007). When working with interpolated data it is not clear exactly what is the forecasting error since there is no direct observable variable. Therefore, it is preferable to work with direct data from the market. In addition, creating a long time series of yields requires strong assumptions on matching bonds across time, without understanding the implications on the outcome of interest, a point forecast or a the level of uncertainty for risk management purpose. Only recently, have some authors proposed methodologies to work directly on the bond price data. (Andreasen, Christensen, & Rudebush, 2019) with an arbitrage-free Nelson-Siegel model propose a one-step estimation approach that uses the directly observable bond prices in a non-linear state space model. They compare this approach to the traditional two-step procedure that uses the synthetic interpolated yields. Using simulations and Canadian bonds they find that negligible errors in the synthetic interpolated yields can lead to parameter instability of the models. Additionally they find superior forecasting accuracy from the one-step approach. (Nagy, 2019) provides an approach for term structure modelling that is based directly on the bonds and formulates a linearized state model for the dynamic Nelson-Siegel model. They apply the methodology to US and Hungarian data; in the latter the challenge is the lack of sufficient bonds along the curve.

Another characteristic in term structure modelling that is worth mentioning is the use of a similar functional form and constant parameters to describe the entire term structure. However, preferred habitat theory of the term structure (Modigliani & Sutch, 1966) advocates that local shocks may influence interest rates for each maturity. Empirical evidence related to this theory reveals that U.S. Treasury bonds' supply and demand shocks have non negligible effects on yield spreads, term structure movements, and bond risk premium. In addition, there are specific policies that target and successfully affect some parts of the yield, for example quantitative easing (Jakl, 2017). In an attempt to formalize the preferred habitat theory, (Vayanos & Vila, 2009) propose an equilibrium model in which demand directly influences and determines all yields in the term structure. According to this theory, the equilibrium yield rate for each term is determined by the demand and supply forces for that market, in other words, the preferences of investors on securities at that point in the curve. Investors can substitute preferences over terms that are not available in the market for a near term but available in the market. (D'Amico & King, 2013) note that investors act as arbitrators, guaranteeing the relationship between the demand for the securities and the returns along the curve; and on the other hand, they guarantee that the curve is smooth, meaning that the yields for close periods are similar.

Inspired by the preferred habitat theory (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018) propose a class of models that separate the yield curve into segments preserving their own local shocks, but at the same time simultaneously interconnected to compose the whole yield curve. The main objective of the family of segmented models is to first, partition the segments of the curve in such a way that the dynamics of each segment can be determined by maturities that are represented in that segment; and second, the implementation of the segments along the curve must be globally consistent and smooth. This is achieved by ensuring that the rates of return are similar for the terms that connect the segments and therefore are close to each other. This is not equivalent to imposing non-arbitration restrictions. A similar objective is pursued by (Filipovic & Willems, 2018) using a non-parametric alternative to estimate the discount curve using market quotes that have maximal smoothness. Modelling separate segments of the term structure might also be useful in other context, for example to build homogeneous risk groups in order to estimate the term structure of the probability of default (Đurovic, 2019).

In this paper we model and forecast the Colombian term structure of interest rates using approximate yields that are estimated directly from the bonds, but are not interpolated, and we use a segmented Nelson-Siegel three factor model as proposed by (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018). We estimate the model using daily data for each year from January 2013 to September 2018. We provide independent results for each year in the sample in order to avoid strong assumptions on the equivalent maturities across time. Although, we could think that this is a drawback in terms of forecasting, it is important to note that the cross sectional estimation in the Nelson-Siegel three factor model provides a dimension reduction approach from the number of observed maturities to the lower dimensional factors (for example three factors in the classical Nelson and Siegel model) and hence we can use these estimated factors to create out-of-sample forecast from one year to the next for any desired maturity. Our results show that the segmented model with smoothing restrictions has an in-sample and out-of-sample performances that is superior to non-segmented Nelson-Siegel model.

In addition the out-of-sample performance of the segmented model, has a similar performance to the random walk model for short term horizons (one and five days)<sup>1</sup>. However, for monthly forecast the random walk model has a better performance.

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<sup>1</sup> The random walk model has always been a strong benchmark model in out-of-sample forecasting of interest rates.

Our application also contributes to the literature on term structure modelling for emerging markets. We deal with the challenge of scarce bond data in an emerging market such as Colombia, by accommodating the definition of the segments in order to take advantage of the heterogeneity of available bonds across the curve. In addition, for the short part of the curve we consider the interbank money market as a proxy for the short term yields. On the other hand by allowing a local estimation of the segments of the curve we give more flexibility to the model to accommodate parts of the term structure that have less liquidity. The weighted estimation proposed by (Dutta, Basu, & Vaidyanathan, 2005) accommodates the heterogeneity in liquidity over the whole curve. Whereas in a segmented model any difference in the liquidity across the bonds in the curve should be reflected as shocks to the prices within each segment; therefore, there is no need to smoothly accommodate the heterogeneity changing the estimation approach.

The remainder of the paper is structured as follows. Section 2 gives a brief introduction to the methodology as proposed by (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018) for the segmented term structure model. Section 3 provides a description of the Colombian bond data. Section 4 presents the estimation results and the forecasting exercise. Section 5 concludes.

## Methodology

The segmented term structure model is proposed by (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018). The authors propose a general framework that can be applied to any parametric model using exponential splines. In particular, we choose a three factor Nelson-Siegel type model. The segmented model provides estimates for the factor that are specific and independently estimated for each segment of the yield curve. In the traditional Nelson-Siegel model the factors are estimated using simultaneously all of the maturities. This is an important drawback because small changes in the short part of the curve could affect the long part of the curve. In addition, the methodology provides an approach to estimate latent yields at the knots in which the term structure is partitioned.

For the exercise we require  $N$  maturities in order to derive the yield curve,  $\tau \in [1, N]$ , where  $\tau$ 's represents each of the observed elements in the vector of maturities. Then, we need to define in an exogenous way the latent yields and set of  $k$  elements from the vector of  $\tau$ 's where we define the external and the internal knots; we denote  $\phi = \{\tau_1, \dots, \tau_k\}$  is the subset of knots. Note that the internal knots are imposed by the researcher and denote the maturity in the curve that is in between two segments. On the other hand, the remaining elements of  $\tau$  are treated

as observed yields  $\tilde{\tau} = \{\tau_2, \dots, \tau_{k-1}\}$ , which are assumed to be measured with error in contrast with the latent yield that do not contain error.

The term structure representation of observed and latent yields that make up the yield curve are given by the following two equations,

$$y_t(\tilde{\tau}) = W(\tilde{\tau})B_t + \epsilon_t(\tilde{\tau})$$

$$y_t(\phi) = W(\phi)B_t,$$

where the matrix of factors loading's ( $W(\tau_i) = \{1, g_i(\tau_i), h_i(\tau_i)\}$ ) is time invariant and only depends on maturity and segments. On the other hand, the vector  $B_t = \{a_t^i, b_t^i, c_t^i\}$  represents the factors, that vary over time and also depend on the segment  $i$ . These independent segments provide enough flexibility so that the model is consistent with preferred habitat theory. The Nelson-Siegel model provides the functional form for the factor loadings (see the appendix). As the methodology is based on splines, the process requires to have some constrains on the above equations that creates smoothness across the segments. These smoothness conditions are consistent with the role of active arbitrageurs that ensure no-arbitrage conditions along the yield curve.

The following equation contains the segmented model, and in addition introduces the smoothness restriction at the knots  $\phi$ .

$$y_t(\tau) = W(\tau)B_t, \quad s.t. \quad R(\phi)B_t = 0$$

The smoothness restrictions create an equality constrained optimization problem. These constraint guarantees that the parametric functional forms of each segment and their first and second derivatives have the same value at each internal knot<sup>2</sup>. However, since we have equality constraints in the optimization problem we can transform the constrain problem into an unconstrained representation. The unconstrained problem has an additional advantage since we are able to reduce the number of parameters to estimate. The appendix provides the details and the steps to have an optimization problem without restrictions,

$$y_t(\tilde{\tau}) = \pi(\tilde{\tau}, \phi)y_t(\phi) + \epsilon_t(\tilde{\tau})$$

The factor loading's from the unconstrained model, ( $B_t = \{a_t^i, b_t^i, c_t^i\}$ ), can be estimated with ordinary least squares.

<sup>2</sup> Details of how to build and introduce the matrix R are provided in the appendix.

## Bond price data

We obtain daily data on bond prices from January 2013 to September 2018, provided by Precia S.A. These are sovereign bonds denominated in local currency that are trading in the secondary market<sup>3</sup>. Although we have six years of daily data we use the bond prices data for each year, so we use specific observable maturities that are trading over the course of a year. This means that for estimation we use only the data for that particular year. This is of course not a problem for in-sample estimation. However, it does create some challenges for out-of-sample forecasting from one year to the other. We will address these challenges in the next section. We want to avoid having to build historical yields and make any arbitrary pairing of bonds across time.

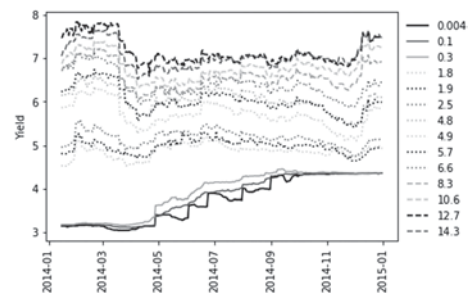
In addition, we are only using bonds with maturity above or equal to one year. That is we disregard any bond that in the current year has a time to maturity smaller than 12 months. For example for the year 2014 we have bonds with a time to maturity (in years) equal to 1.8, 1.9, 2.5, 4.8, 4.9, 5.7, 6.6, 8.3, 10.6, 12.7, 14.3 at the beginning of the year (Graph 1).

Since we want to avoid any complex pre-processing of the bond price data in order to obtain the yields we estimate a quick approximation of the yield to maturity that most importantly does not involve any type of interpolation,

$$y(\tau) = \frac{\text{Coupon} + \frac{(\text{Par Value} - \text{Bond Price})}{\text{Years to Maturity}}}{\frac{(\text{Par Value} + \text{Bond Price})}{2}}$$

Because the issuance of short term bond by the government is not stable over time, in order to model the short part of the curve we use the inter-bank rate index. The inter-bank rate in Colombia (IBR) is the reference short term rates

**Graph 1: Observed yields 2014, from Precia S.A. and IBR provided by the central bank**



<sup>3</sup> The Ministry of Finance of Colombia currently issued two types of bonds in the local market: local currency denominates or inflation indexed bonds.

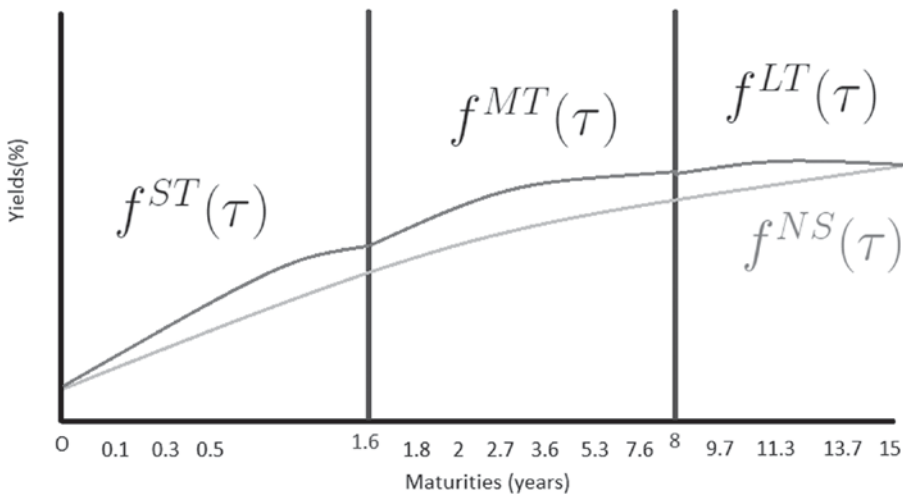


in the wholesale money market<sup>4</sup>. The index currently provides daily rates for the overnight, one month, three months and six months. Although, it is important to note that the risk factors associated to the sovereign bonds and the inter-bank rate differs, that is the latter are not risk free and contain a credit risk premium<sup>5</sup>.

## Empirical Application

For the empirical application we consider three segments representing the short, medium and long term part of the yield curve and we estimate the model using the sample (2013-2018) but using the observed yields during each year (Graph 2). On average we have 14 observable yields, the minimum number is 12 in 2016 and the maximum is 17 in 2013. The first knot in the curve is the overnight rate and the interior knots are 1.6 and 8 years. These knots were chosen in order to have a sufficient amount of observed maturities in each of the three segments.

**Graph 2: Representation of the non-segmented and segmented yield curve. The three segments represent the short (ST), medium (MT) and long term (LT) segments of the yield curve. NS denotes the classical Nelson-Siegel yield curve**



<sup>4</sup> We obtain information on the inter-bank reference rates from the Banco de la República de Colombia (the central bank).

<sup>5</sup> We do not make any adjustment or assumptions to compensate for this risk premium in the inter-bank rates.

With the three segments and three factors in the Nelson-Siegel model we have a total of 9 factors to estimate  $B_t = \{a_t^{ST}, b_t^{ST}, c_t^{ST}, a_t^{MT}, b_t^{MT}, c_t^{MT}, a_t^{LT}, b_t^{LT}, c_t^{LT}\}$ . In addition we estimate the classical three factor Nelson-Siegel model (NS3), and following (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018) we estimate three versions of the segmented models. The first we denote as a segmented model but without imposing the smoothness constraints (NS3\_S), the second is the weekly segmented model with the smoothness constraints (NS3\_W\_S) and finally the strongly segmented model with the smoothness constraints (NS3\_S\_S)<sup>6</sup>. The only difference in our application is that we do not fine-tune the parameters that control the degree of loading segmentation; we set that parameter to 0.5.

**Table 1: In-sample root-mean-square error (RMSE) in basis points between modelled and observed yields, for 2014**

years	NS3	NS3S	NS3WS	NS3SS
0.004	12.8	78.8	6.3	5.7
0.1	9.6	75.1	3.5	2.3
0.3	10.5	70.6	8.4	6.6
1.8	14.6	59.1	8.4	8.3
1.9	19.9	58.7	12.7	3.6
2.5	14.7	50.0	5.2	3.6
4.8	17.3	39.1	13.6	21.8
4.9	20.1	29.5	23.6	15.4
5.7	10.7	25.9	10.3	5.5
6.6	6.9	23.9	10.9	9.9
8.3	18.1	2.3	6.4	17.3
10.6	17.6	8.5	21.0	8.7
12.7	12.4	11.0	7.5	17.2
14.3	8.7	4.8	8.2	2.7
	13.9	38.4	10.4	9.2

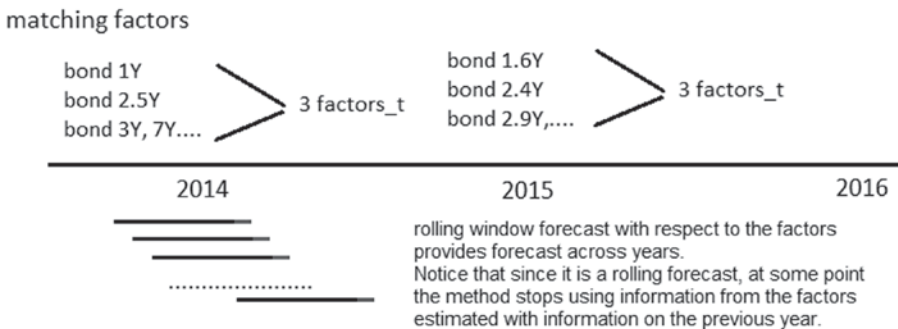
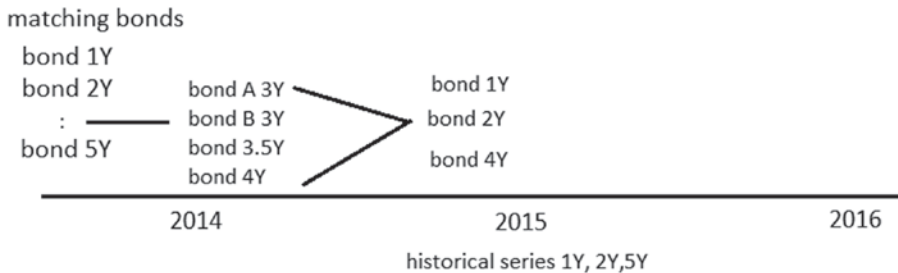
Table 1 presents the in-sample fit using the root mean square error for the three models in 2014<sup>7</sup>. The results indicate that segmented models (weakly and

<sup>6</sup> The strongly segmented model is an extension that provides a more flexible specification of the factor loading's in each segment, this approach is explained in (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018).

<sup>7</sup> The results for the other years are available in an online complementary material ([https://github.com/ccastroiragorri/ccastroiragorri.github.io/blob/master/ComplementaryTablesAsegmentedandobservableYieldCurve\(2019\).pdf](https://github.com/ccastroiragorri/ccastroiragorri.github.io/blob/master/ComplementaryTablesAsegmentedandobservableYieldCurve(2019).pdf))

strongly) that impose smoothness conditions that guarantee continuity across the yield curve have a better fit than the traditional Nelson-Siegel model. On average segmented models have errors 3 basis points below the non-segmented counterparts. The reason behind the better fit is the possibility to accommodate the specific dynamics of each segment in the yield curve. We also perform an out-of-sample forecasting exercise for one, five (week), and 21 days (month). We use a rolling window of 126 days (approximately 6 months) and we obtain forecast for the years 2014 to 2018. Our forecasting setup is different, because we use the information of the previous year up to the last observed data to generate forecast of the year of interest and then update the information using a rolling window. As mentioned previously it is common practice in term structure modelling to match bonds across year in order to obtain a historical time series of yields (Graph 3). In the best of cases, matching bond requires an arbitrary choice of which bond to choose from one year to the next. In the worst of cases, in markets where there are not many available maturities sometimes it is necessary to interpolate to match the maturities across years. We propose an alternative that is transparent for any replication study of the out-of-sample forecast. Each year we can estimate the number of factors in the segmented or the non-segmented

**Graph 3: Matching bonds vs factors**



model. Although we do not observe the same maturities between the years the number of factors is fixed across for the entire length of the sample. In other words, we take advantage of dimension reduction mechanism behind these parametric term structure models. Suppose that in the year 2013 we had 17 observed maturities and we obtain the estimated factors. Then we can use an autoregressive of order one model to estimate and forecast these factors and recover the yields for 2014. Since we consider a rolling window, as soon as we start introducing new information from the 2014 observed yields we estimate using the cross-section of maturities the factors and feed-in the information on to the time series of factors and re-estimate the autoregressive models and forecast up until the end of the evaluation window (see Graph 3). Therefore, our approach is not affected by the change in the number of observed maturities from one year to the next. The biggest advantage from this method is that it avoids any arbitrary decisions (that are rarely documented in the published articles) that are required to build synthetic historical yields.

For every year we have around 240 out-of-sample forecasts for the different horizons that represent on average the number of trading days in the year. For the out-of-sample forecast we compare the performance of three models based on the RMSE: the classical Nelson-Siegel (NS), the random walk (RW) and the strongly segmented Nelson-Siegel (SM). In Table 2 and Table 3 we present the RMSE in basis points at one day, one week and monthly forecast horizons for the year 2014 and 2017, respectively<sup>8</sup>. The results indicate that the segmented model provides on average smaller errors for most observed maturities. However, for the monthly forecast horizon it is not clear whether the segmented model performs better than a random walk. As mentioned previously, both the in-sample and out-of-sample results shows a better performance of segmentation in the family of parametric term structure models based on Nelson-Siegel. Our results confirm the advantages in forecasting performance of the segmented models reported in (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018), however, our results are based on real market quotes rather than using synthetically interpolated yields.

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<sup>8</sup> The results for the other years are available in an online complementary material or they can be requested to the corresponding author.

**Table 2: Out-of-sample root-mean-square error (RMSE) in basis points for 2014**

years	day			week			month		
	NS	NS3SS	RW	NS	NS3SS	RW	NS	NS3SS	RW
0.004	15.7	7.5	15.5	15.6	8.8	14.6	14.9	12.8	12.7
0.1	11.4	3.7	11.5	10.7	6.0	10.5	12.6	14.6	10.0
0.3	14.3	8.5	14.5	13.7	10.1	14.1	17.1	17.5	15.6
1.8	19.5	9.5	19.3	22.3	12.1	21.1	31.1	18.4	26.6
1.9	24.8	5.4	24.6	26.4	8.6	25.8	33.5	15.3	29.7
2.5	18.9	5.7	18.8	21.4	9.6	20.4	30.4	18.4	26.0
4.8	18.5	22.8	18.7	19.5	23.7	20.2	30.3	31.6	29.3
4.9	21.6	17.1	21.3	24.8	20.1	23.2	38.3	34.0	34.2
5.7	12.3	7.4	11.9	16.1	11.5	14.2	31.1	28.0	27.0
6.6	9.2	12.3	9.2	12.9	15.7	12.8	27.8	29.5	26.4
8.3	21.1	19.5	21.2	24.7	23.6	24.8	38.0	37.0	37.7
10.6	21.0	11.4	20.9	24.3	16.4	24.1	37.7	30.9	36.9
12.7	15.7	20.0	15.8	17.8	21.7	18.2	28.3	28.9	27.7
14.3	10.7	6.0	10.6	14.3	12.6	14.1	27.9	26.8	25.7
	16.8	11.2	16.7	18.9	14.3	18.4	28.5	24.6	26.1

**Table 3: Out-of-sample root-mean-square error (RMSE) in basis points for 2017**

years	day			week			month		
	NS	NS3SS	RW	NS	NS3SS	RW	NS	NS3SS	RW
0.004	31.9	13.1	33.5	25.5	11.6	30.8	22.8	26.5	21.0
0.1	19.6	6.1	21.1	15.3	10.1	18.9	27.6	33.0	13.7
0.3	7.7	9.6	7.1	15.9	17.2	9.2	40.8	41.9	20.7
0.5	20.0	18.2	18.3	29.3	25.3	21.7	53.7	48.9	35.1
1.8	27.8	15.5	26.8	34.0	16.0	28.7	52.8	31.4	37.8
1.9	39.3	12.0	37.9	45.9	17.2	39.8	65.0	37.5	48.7
2.7	18.9	7.6	17.8	25.4	13.5	20.5	41.8	30.5	29.8
3.6	9.4	11.9	9.5	13.5	14.4	12.0	26.3	26.1	18.9
5.3	9.0	8.2	9.5	12.9	14.5	13.2	23.2	28.8	21.4
7.6	16.6	8.5	17.1	17.6	12.4	18.8	22.7	23.5	23.7
9.7	15.1	14.0	15.6	16.7	18.5	18.0	22.7	30.3	25.0
11.3	8.6	11.2	9.2	11.0	15.1	12.2	18.2	26.1	20.3
13.7	7.9	4.6	7.3	13.0	11.1	11.4	22.4	23.1	20.1
15.5	13.3	15.7	12.3	17.4	18.2	14.7	26.3	25.5	21.0
	17.5	11.2	17.3	20.9	15.4	19.3	33.3	31.0	25.5

We performed additional robustness test to confirm the findings. First we use the Diebold and Mariano test to determine if the out-of-sample performance of the segmented model is statistically different than the competing models, the non-segmented Nelson-Siegel and the random walk. In Table 4 we report the p-values of the test. The null hypothesis is that the segmented model has the same accuracy as the non-segmented Nelson-Siegel and the random walk, respectively. The results indicate that for most maturities we can reject the null hypothesis at 5% significance level and therefore, confirms the gain in out-of-sample forecasting performance identified in Table 2<sup>9</sup>.

**Table 4: p-values for the Diebold and Mariano test of forecast accuracy.**

years	day		week		month	
	NS	RW	NS	RW	NS	RW
0.004	0.00	0.00	0.00	0.00	0.65	0.90
0.1	0.00	0.00	0.00	0.00	0.00	0.00
0.3	0.00	0.00	0.00	0.00	0.00	0.01
1.8	0.00	0.00	0.00	0.00	0.00	0.00
1.9	0.00	0.00	0.00	0.00	0.00	0.00
2.5	0.00	0.00	0.00	0.00	0.00	0.00
4.8	0.00	0.00	0.00	0.00	0.00	0.00
4.9	0.00	0.00	0.00	0.00	0.00	0.61
5.7	0.00	0.00	0.00	0.00	0.01	0.07
6.6	0.00	0.00	0.00	0.00	0.00	0.00
8.3	0.00	0.00	0.05	0.06	0.49	0.45
10.6	0.00	0.00	0.00	0.00	0.00	0.00
12.7	0.00	0.00	0.00	0.00	0.02	0.08
14.3	0.00	0.00	0.01	0.01	0.74	0.08

<sup>9</sup> The results for the other years are available in an online complementary material ([https://github.com/ccastroiragorri/ccastroiragorri.github.io/blob/master/ComplementaryTablesAsegmentedandobservableYieldCurve\(2019\).pdf](https://github.com/ccastroiragorri/ccastroiragorri.github.io/blob/master/ComplementaryTablesAsegmentedandobservableYieldCurve(2019).pdf)).

**Table 5: Out-of-sample root-mean-square error (RMSE) in basis points for 2014, with alternative specifications for the factor forecast**

years	day			day		
	ARMA(1,1)			AUTO ARIMA		
	NS	NS3SS	RW	NS	NS3SS	RW
0.004	15.7	7.5	15.5	17.6	10.0	15.5
0.1	11.4	3.7	11.5	14.2	6.4	11.5
0.3	14.3	8.5	14.5	16.8	9.2	14.5
1.8	19.5	9.5	19.3	21.0	10.0	19.3
1.9	24.8	5.4	24.6	26.2	7.4	24.6
2.5	18.9	5.7	18.8	20.5	6.9	18.8
4.8	18.5	22.8	18.7	21.0	23.6	18.7
4.9	21.6	17.1	21.3	22.4	17.2	21.3
5.7	12.3	7.4	11.9	13.7	8.0	11.9
6.6	9.2	12.3	9.2	12.6	13.5	9.2
8.3	21.1	19.5	21.2	22.6	19.3	21.2
10.6	21.0	11.4	20.9	22.3	11.4	20.9
12.7	15.7	20.0	15.8	18.7	21.0	15.8
14.3	10.7	6.0	10.6	13.8	6.6	10.6
	16.8	11.2	16.7	18.8	12.2	16.7

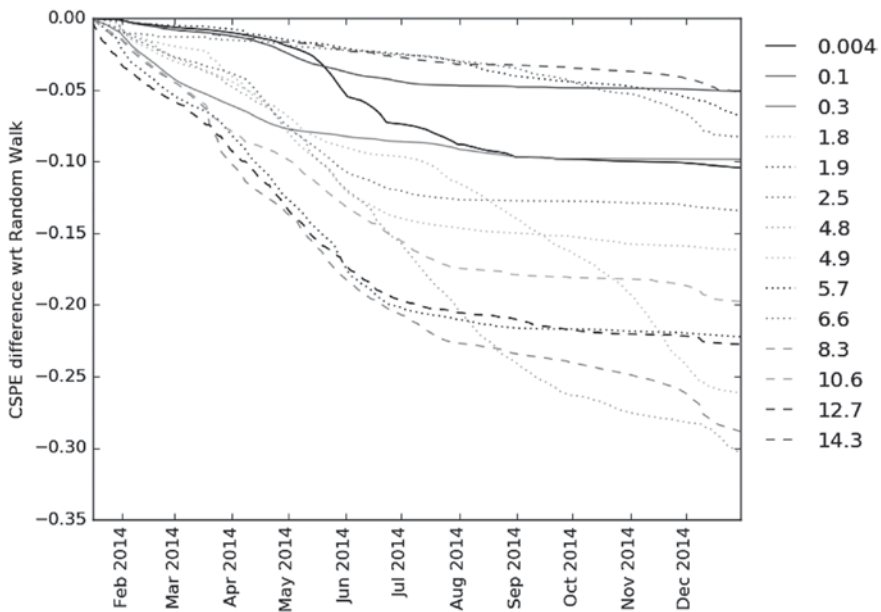
Second, we test whether the assumption of an autoregressive model of order one, for the factors, is adequate for prediction; (Hamilton & Wu, 2014) suggest that higher order autoregressive models provide a significant performance improvement. We do not choose a particular specification but rather use an Autoarima algorithm so that for each sample and model type an optimal model is chosen. Table 5 presents the comparison of the performance for one day ahead forecast for 2014. The results indicate that there is no improvement for both the un-segmented and the segmented Nelson and Siegel model; in fact what we see is an average error that is 2 basis points higher when we use the Autoarima algorithm. Finally, we explore whether the segmented models systematically outperform the random walk method. We do this by estimating the cumulative square prediction error (CSPE),

$$CSPE_t = \sum_{i=1}^t ((\hat{y}_i^{RW}(\tau) - y_i(\tau))^2 - (\hat{y}_i^{NS3SS}(\tau) - y_i(\tau))^2)$$

Graph 4, shows the evolution of the one day out-of-sample forecasting exercise for the observed maturities during 2014. For the segmented model to systemati-

cally outperform the random walk model the curves should have a non-negative slope. The results indicate that this is not the case, since the slope from the beginning is negative. This is expected since the first part of the forecast is using the estimated factors from 2013. However, since we use a rolling window we do observe that when we include in the forecast more information from 2014 the slopes are close to zero for many of the maturities; this means that at that point there is no significant difference between the two forecasting models.

**Graph 4: Cumulative square prediction error for one day ahead forecast of the segmented Nelson and Siegel model for 2014**



How do these results compare to what is observed in the literature? Although, it is difficult to make a precise comparison given that most of the literature is based on synthetic yield data from the U.S., our result indicate an improvement over affine Nelson and Siegel models; For example (Andreasen, Christensen, & Rudebusch, 2019) with observed bond data, report a RMSE between 40 to 55 basis points. With Colombian data and a similar sample (Velasquez-Giraldo & Restrepo-Tobon, 2016) report a RMSE between 6 to 17.5 basis points with an affine term structure model. Our results indicate a RMSE between 2.1 and 19 basis points for a similar forecast horizon. Therefore the performance is similar to the former and outperforms the U.S. model with observed bond data but using a non-segmented model.



## Conclusions

Term structure models are important for the pricing of instruments that are part of trading and reporting activities in financial markets. The financial literature has benefited from the research on term structure models performed from a monetary policy perspective. However, central banks are mainly focused on the changes in the general shape of the yield curve because this is informative as to the expectations regarding monetary policy. For this use case, using synthetic interpolated yields as a starting point in the model seems to be the norm and also performing simultaneous estimation of the parameters or functional forms of interest using all of the maturities. On the other hand, practitioner and investors are more interested in the performance of the model in terms of the observed market quotes. In addition, they are not comfortable when small changes in the short part of the yield curve have an important impact on the long part and they are certain that these changes are in part driven by the model. From a statistical point, one would prefer models that are locally robust to changes other parts of the curve and that are able to accommodate idiosyncratic shocks locally. The parametric terms structure model proposed by (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018) provides a simple approach that splits the yield curve into segments and at the same time guarantee the smoothness and consistency across the curve.

Our paper provides an example on how to accomplish the segmentation of the curve and a proposal for using the observable yield during the year for in-sample and out-of-sample predictions. The out-of-sample predictions are not affected by using different maturities of the same bonds avoiding the need to make assumptions on the matching of the bonds for a historical reconstruction. Our point of view is that this is not necessary because of the dimension reductions that are performed on this type of factor model. Since the factors are the time-varying element of interest we can use them to connect the data generating process when the sample is estimated year-by-year rather than forcefully building a long historical sample.

The segmented model accommodates different behaviour of the bonds in each segments, this includes any difference due to liquidity. This is important in emerging markets where there are not enough bonds observed for all of the ideal maturities. However, it is still challenging because it is required to have sufficient observable bonds to estimate the time-varying loading's in each segment, unlike the traditional unsegmented Nelson-Siegel model where you only need to estimate three to four factors at every point in time. Therefore, the segmented model is an interesting approach to account for heterogeneous behaviour along

the curve, but it will require more data than what might be available in some emerging markets.

There is room for improvement on the performance of the in- and out-of-sample forecasting exercise that can be explored using fine tuning. For example, the researcher could identify which is the optimal split for the segments (re-define the internal knots) and also change the values of the parameters that controls how strong is the segmentation across the yield curve. In other words, how important are idiosyncratic local shocks versus shocks that affect the entire curve.

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**Appendix base on (Almeida, Ardison, Kubudi, Simonsen, & Vicente, 2018)**

I. Nelson-Siegel factor loadings: the level, slope and curvature of the yield curve. The loading's below are used in order to build the matrix  $W$  used to represent the segmented curve.

1 (level)

$$g(\tau) = \frac{1 - e^{-\lambda\tau}}{\lambda\tau} \text{ (slope)}$$

$$h(\tau) = \frac{1 - e^{-\lambda\tau}}{\lambda\tau} - e^{-\lambda\tau} \text{ (curvature)}$$

II. R Matrix components: In order to create the matrix R of restrictions we require smoothness conditions based on the first and second derivatives of the factor loadings.

First Derivatives	Second Derivatives
$g'(\tau) = \frac{e^{-\lambda\tau} (1 + \lambda\tau)}{\lambda\tau^2}$	$g''(\tau) = \frac{1}{\lambda\tau^3} [2 - e^{-\lambda\tau} ((\lambda\tau)^2 + 2(\lambda\tau + 1))]$
$h'(\tau) = \frac{e^{-\lambda\tau} [(\lambda\tau)^2 + (1 + \lambda\tau)] - 1}{\lambda\tau^2}$	$h''(\tau) = \frac{1}{\lambda\tau^3} [2 - e^{-\lambda\tau} ((\lambda\tau)^3 + (\lambda\tau)^2 + 2(\lambda\tau + 1))]$

III. R Matrix Construction:

Note that all the  $\tau_j$  yields within the same segment need to be governed by the same function ( $W(\tau_j) = f_t^i(\tau_j)$ ). Let ST, MT and LT denote the segments related to short, middle and long term. The first three restrictions imply continuity of the segments at the knots.

- $f^{ST}(\tau_4) = f^{MT}(\tau_4); f^{MT}(\tau_7) = f^{LT}(\tau_7)$
- $f'^{ST}(\tau_4) = f'^{MT}(\tau_4); f'^{MT}(\tau_7) = f'^{LT}(\tau_7)$
- $f''^{ST}(\tau_4) = f''^{MT}(\tau_4); f''^{MT}(\tau_7) = f''^{LT}(\tau_7)$
- $f_t^i(\tau_i) = y_t(\tau_i)$

The last condition will be important to measure the latent yields (Yields at knots) and transforming a constrain problem to a unconstrained with a lower dimensional parameter space. Note that the form of matrix R allows us to decompose the matrix into a square invertible matrix  $R_1$  and a complementary  $R_2$  in order to reduce the dimensionality of parameters to be estimated.

$$X_i(\tau) = [1, g_i(\tau), h_i(\tau)]; X'_i(\tau) = [0, g'_i(\tau), h'_i(\tau)]; X''_i(\tau) = [0, g''_i(\tau), h''_i(\tau)]$$

$$R = \begin{bmatrix} X_{ST}(\tau_{i-1}) & -X_{MT}(\tau_{i-1}) & 0_{1 \times 3} \\ 0_{1 \times 3} & X_{MT}(\tau_i) & -X_{LT}(\tau_i) \\ X'_{ST}(\tau_{i-1}) & -X'_{MT}(\tau_{i-1}) & 0_{1 \times 3} \\ 0_{1 \times 3} & X'_{MT}(\tau_i) & -X'_{LT}(\tau_i) \\ X''_{ST}(\tau_{i-1}) & -X''_{MT}(\tau_{i-1}) & 0_{1 \times 3} \\ 0_{1 \times 3} & X''_{MT}(\tau_i) & -X''_{LT}(\tau_i) \end{bmatrix}$$

$$R_1 = \begin{bmatrix} X_{ST}(\tau_{i-1}) & -X_{MT}(\tau_{i-1}) \\ 0_{1 \times 3} & X_{MT}(\tau_i) \\ X'_{ST}(\tau_{i-1}) & -X'_{MT}(\tau_{i-1}) \\ 0_{1 \times 3} & X'_{MT}(\tau_i) \\ X''_{ST}(\tau_{i-1}) & -X''_{MT}(\tau_{i-1}) \\ 0_{1 \times 3} & X''_{MT}(\tau_i) \end{bmatrix} \quad R_2 = \begin{bmatrix} 0_{1 \times 3} \\ -X_{LT}(\tau_i) \\ 0_{1 \times 3} \\ -X'_{LT}(\tau_i) \\ 0_{1 \times 3} \\ -X''_{LT}(\tau_i) \end{bmatrix}$$

By construction all rows of  $R_1$  are linearly independent, then, the matrix is invertible with rank equal to  $M$ . As we have split the matrix  $R$  into two sub-matrices, we also require the same process for the vector  $B$  of factors. Hence, the original constrain is re-expressed from  $(R(\tilde{\phi}) = 0$  to

$$R_1(\tilde{\phi})\theta_1 + R_2(\tilde{\phi})\theta_2 = \mathbf{0}, (1)$$

where the vectors  $\{\theta_1, \theta_2\}$  are adjusted to match the dimensionality of sub-matrix  $\{R_1, R_2\}$ .

$$F_t^i = \begin{pmatrix} a_t^i \\ b_t^i \\ c_t^i \end{pmatrix}, \theta_1 = \begin{pmatrix} a_t^{ST} \\ b_t^{ST} \\ c_t^{ST} \\ a_t^{MT} \\ b_t^{MT} \end{pmatrix}, \theta_2 = \begin{pmatrix} c_t^{MT} \\ a_t^{LT} \\ b_t^{LT} \\ c_t^{LT} \end{pmatrix}$$

Both  $\{\theta_1, \theta_2\}$  are the vectors of the time-varying factors to be estimated. First we need to state that  $\theta_1$  is the vector that accompanies the square invertible matrix  $R_1$ . We can use expression  $(R_1(\tilde{\phi})\theta_1 + R_2(\tilde{\phi})\theta_2 = 0, (1)$  to define a functional relationship between the vector of parameters,

$$\theta_1 = -R_1^{-1}R_2\theta_2, (2)$$

IV. Now we explain how to transform the constrained problem into an unconstrained one with lower dimensionality of parameters,

$$y_t(\tilde{\tau}) = W(\tilde{\tau})B_t + \epsilon_t(\tilde{\tau}), B_t = \begin{pmatrix} \theta_1 \\ \theta_2 \end{pmatrix}$$

$$y_t(\tilde{\tau}) = w_1(\tilde{\tau})\theta_1 + w_2(\tilde{\tau})\theta_2 + \epsilon_t(\tilde{\tau})$$

We also split the factor loading matrix  $W(\tilde{\tau})$  to match the set of factors  $\{\theta_1, \theta_2\}$ . Then we use the expression  $\theta_1 = -R_1^{-1}R_2\theta_2$ , (2) and obtain a lower dimensional factor model that is only a function of the unknown set of parameter  $\theta_2$ ,

$$y_t(\tilde{\tau}) = [w_2(\tilde{\tau}) - w_1(\tilde{\tau})R_1^{-1}R_2]\theta_2 + \epsilon_t(\tilde{\tau})$$

$$y_t(\tilde{\tau}) = Z(\tilde{\tau})\theta_2 + \epsilon_t(\tilde{\tau}), \dim(Z(\tilde{\tau})) = m(k + 1)$$

If we choose a knot equal to maturity of an observed yield, we assume that the yield at that knot is observed without error.

$$y_t(\phi) = W(\phi)B_t$$

$$y_t(\phi) = w_1(\phi)\theta_1 + w_2(\phi)\theta_2, \dim(y_t(\phi)) = (k + 1)$$

The equation above allows us to introduce the remaining constrains (missing in R) in order to have a complete identification procedure. In all knots of the term structure we will require an exact fit compare to the observed curve.

$$y_t(\phi) = [w_2(\phi) - w_1(\phi)R_1^{-1}R_2]\theta_2$$

$$y_t(\phi) = Z(\phi)\theta_2, \dim(Z(\phi)) = m(k + 1) \text{ invertible.}$$