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Dimitri Reiswich, Robert Tompkins

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Authors:

Dimitri Reiswich
Research Associate
Frankfurt School of
Finance & Management
Frankfurt/Main
d.reiswich@frankfurt-school.de

Robert Tompkins
Professor of Quantitative Finance
Frankfurt School of
Finance & Management
Frankfurt/Main
r.tompkins@frankfurt-school.de

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Frankfurt School of Finance & Management
Phone: +49 (0) 69 154 008-0 ▪ Fax: +49 (0) 69 154 008-728
Sonnemannstr. 9-11 ▪ D-60314 Frankfurt/M. ▪ Germany

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Abstract Principal Component Analysis (PCA) is a common procedure for the analysis of financial market data, such as implied volatility smiles or interest rate curves. Recently, Pelsser and Lord [11] raised the question whether PCA results may not be "facts but artefacts". We extend this line of research by considering an alternative matrix structure which is consistent with foreign exchange option markets. For this matrix structure, PCA effects which are interpreted as shift, skew and curvature can be generated from unstructured random processes. Furthermore, we find that even if a structured system exists, PCA may not be able to distinguish between these three effects. The contribution of the factors explaining the variance in the original system are incorrect. Finally, for a special case, we provide an analytic correction that recovers correct factor variances from those incorrectly estimated by PCA.

Keywords: Principal Component Analysis, PCA, Level, Slope, Curvature, Twist, Bisymmetric Matrices, Centro-symmetric Matrices

Dimitri Reiswich
Frankfurt School of Finance & Management, Centre for Practical Quantitative Finance, e-mail: d.reiswich@frankfurt-school.de
Robert Tompkins
Frankfurt School of Finance & Management, Centre for Practical Quantitative Finance, e-mail: r.tompkins@frankfurt-school.de

1 Introduction

Principal Component Analysis (PCA) is commonly used as a dimension reduction technique to reduce a system of many stochastic variables to a parsimonious set of factors which explain most of the variance. The typical factor loadings found in PCA analysis for financial markets are commonly interpreted as a level, skew, twist and curvature effect, represented graphically in figure (1). In the upper left hand panel, the horizontal line indicates a level/shift effect. The upper right hand and lower left hand panels show a change of sign, which is often interpreted as a skew or twist effect. The lower right hand panel indicates two changes of sign and is usually interpreted as a curvature effect. These effects can be found in most of the existing work in this area, see for example [1], [2], [4], [5], [7], [17], [18], [21], [14].

Lord and Pelsser [11] question whether these effects are an artefact resulting from a special structure of the covariance or correlation matrix. They show that there are some special matrix classes, which automatically lead to a prescribed change of sign pattern of the eigenvectors consistent with figure (1). In particular, they show that the PCA analysis on a covariance or correlation matrix which belongs to the class of oscillatory matrices will always show $n-1$ changes of sign in the n-th eigenvector of the respective matrix. This is also the case in most PCA results and raises the question whether the observed effects have a valid economic interpretation. Our research addresses a related research agenda.

In a similar spirit to Lord and Pelsser, we consider interpretation problems for alternative covariance matrix classes. Looking again at figure (1) it is evident that the eigenvectors have a symmetric structure relative to a center point. This is consistent with the eigenvector structure for a bisymmetric matrix which will be introduced in detail at a later point. In addition, empirical foreign exchange option markets also have bisymmetric covariance matrices. The choice of this class of matrices allows us to analytically identify potential problems of a PCA. As opposed to Lord and Pelsser, who solely restrict the analysis to sign change patterns of factor loadings, we will impose explicit values for the eigenvector components.

This paper is organized as follows: The next section will review PCA and its application in the analysis of financial market dynamics. At this point, we will consider the paper by Lord and Pelsser [11]. Then we will introduce the class of bisymmetric matrices and discuss well-known spectral decomposition properties of this matrix class. The following section demonstrates how the level, slope and curvature effects can be generated by random variables, which do not explicitly have such a structure. At that point, we will present an empirical analysis of foreign exchange smiles, where the PCA shows similar patterns. Then, we will structure a system where level, slope and curvature effects are present. PCA is applied to assess if the original structure is correctly recovered. It will be shown that this is not always the case. Finally, we conclude and make suggestions for further research.

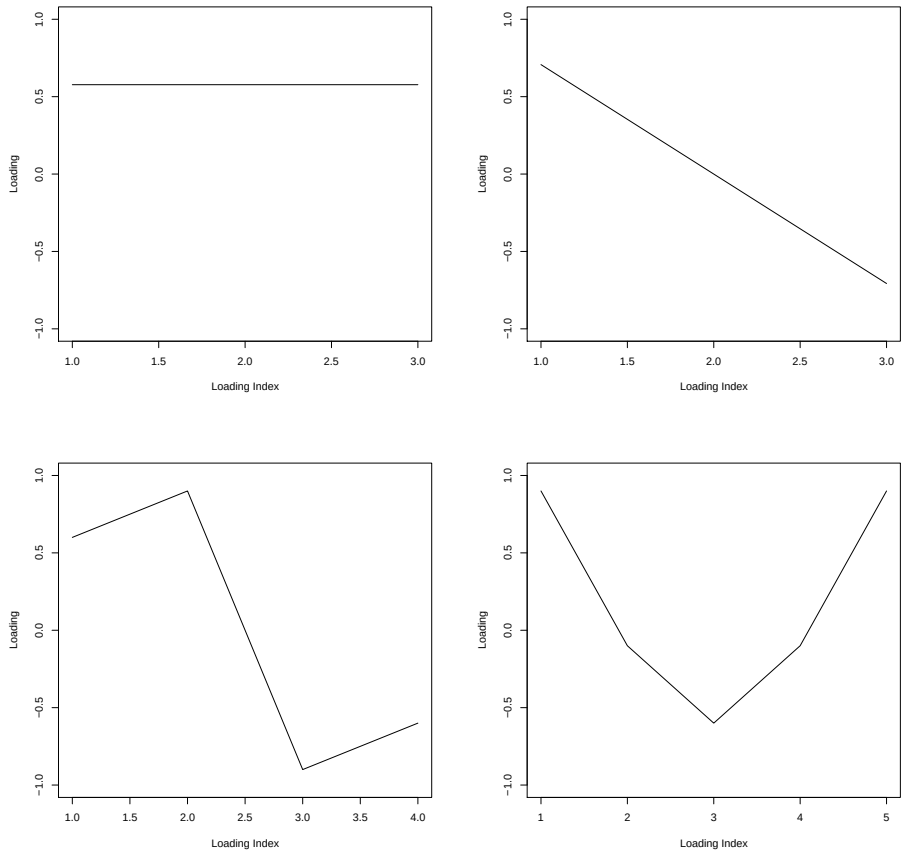

Fig. 1: Typical Level (upper left), Skew (upper right), Twist (lower left), Curvature (lower right) patterns in PCA

2 Introduction to PCA

The goal of PCA is to reduce the dimensionality of multiple correlated random variables to a parsimonious set of uncorrelated components. These uncorrelated components are a linear combination of the original variables. Suppose that the correlated random variables are summarized in a $n \times 1$ vector x with covariance matrix Σ. Initially, PCA determines a new random variable y_1 which is a linear combination of the components of x weighted by the components of a vector $\gamma_1 \in \mathbb{R}^{n\times 1}$. This can be formally expressed as:

$$y_1 = \gamma_1^T x = \gamma_{11}x_1 + \gamma_{12}x_2 + \ldots + \gamma_{1n}x_n = \sum_{j=1}^{n} \gamma_{1j}x_j.$$

The vector γ_1 is chosen such that y_1 has maximum variance $\mathrm{V}(y_1) = \mathrm{V}(\gamma_1^T x) = \gamma_1^T \Sigma \gamma_1$. Then, a new variable y_2 is determined with a new $n \times 1$ vector γ_2 which maximizes $\mathrm{V}(y_2) = \mathrm{V}(\gamma_2^T x) = \gamma_2^T \Sigma \gamma_2$, such that y_1 is uncorrelated with y_2. At the kth stage, y_k is determined such that it is uncorrelated with $y_1, ..., y_{k-1}$ and has the maximum variance at that point.
The kth derived variable y_k is called kth Principal Component (PC), the vectors γ_k are called vectors of loadings for the k-th PC. The objective is that most of the variation in $\mathbf{x}$ will be accounted for by m PCs, where $m << n$.

The maximization problem we have to solve at stage k is

$$\max_{||\gamma_k||=1} \gamma_k^T \Sigma \gamma_k$$

subject to

$$\mathrm{Cov}(y_k, y_{k-1}) = \mathrm{Cov}(\gamma_k^T x, \gamma_{k-1}^T x) = 0.$$

This problem can be solved by the choice of γ_k as the eigenvector corresponding to the kth largest eigenvalue of Σ (which is the covariance matrix of x). The eigenvectors are chosen to be orthonormal: Each has a length of one and all are mutually orthogonal. The maximization is subject to the constraint that the length of the vectors γ_k is one, written as $||\gamma_k|| = 1$. This is a standard approach to avoid infinite values of the components γ_k. As a result of this, the variance of the k-th PC y_k is the k-th largest eigenvalue λ_k of the covariance matrix of x, that is $V(y_k) = \lambda_k$. If this analysis is based on a correlation matrix, a similar procedure could be employed. This is because the correlation matrix is the covariance matrix of the standardized variables $\bar{x}$. Ultimately we will distinguish between PCA based on both correlation and covariance matrices. For the sake of convenience we will express the above problem in matrix form. The random vector x is transformed to a new random vector y via

$$y = \Gamma^T x,$$

where Γ^T is a matrix whose k-th row is the vector γ_k^T. Since Γ^T has orthonormal rows, we have $\Gamma^T = \Gamma^{-1}$, since the transpose of an orthogonal matrix is equal to its inverse. Substituting this in the above equation, we can represent the original vector x as

$$x = \Gamma y = y_1 \gamma_1 + y_2 \gamma_2 + ... + y_n \gamma_n. \tag{1}$$

Since the vectors $\gamma_1, ..., \gamma_n$ are orthogonal, they form a basis for the vector space $\mathbb{R}^n$. This shows why PCA is sometimes referred to as a basis transformation procedure. Consequently, we can represent x via a new basis which is equivalent to the representation of x with Euclidian vectors via

$$x = x_1 e_1 + x_2 e_2 + ... + x_n e_n,$$

where e_k is the n-dimensional Euclidian basis vector which has a one as the k-th component, and is zero anywhere else.

Some authors define the vector γ_k as the k-th PC. However, following Joliffe [8], we will define y_k as the Principal Component. We are interested in understanding when a misleading economic interpretation can result from these vectors. Typical and representative vectors are plotted in figure (1). A common interpretation in financial markets is that vector γ_k is referred to as the shift, skew or curvature vector. Recalling that the eigenvalue λ_k is the variance of the random variable y_k, the explained variance associated with the k-th PC can be expressed as:

$$\frac{\lambda_k}{\sum_{i=1}^{n} \lambda_i},$$

or in the case of the first three components:

$$\frac{\lambda_1 + \lambda_2 + \lambda_3}{\sum_{i=1}^{n} \lambda_i}.$$

Empirically, it is common that the first three principal components explain almost 100% of the variance in financial market data. Given this, we will restrict the PCA to three components and consider potential interpretation problems solely to this case.

Lord and Pelsser [11] were the first to point out that possible PCA interpretation problems could exist. In their work, they considered level, slope curvature patterns of interest rate term structures. They define these patterns in terms of sign changes of the covariance matrix eigenvectors. The level pattern has zero sign changes, the slope has one sign change and the curvature has two sign changes. Sufficient conditions are developed for the appropriate class of covariance matrices that display the same sign change patterns as the empirical eigenvectors. The case of a zero sign change pattern can be covered easily by using the Frobenius-Perron theorem, which is well known in matrix algebra (see [13, Chapter 8]).

Theorem 1 (Frobenius-Perron).
*If A is a $n \times n$ **strictly positive** matrix, there exists a **strictly positive** eigenvalue of A with geometric and algebraic multiplicity one which is strictly greater than the other eigenvalues of A. The corresponding eigenvector is **strictly positive**.*

Furthermore, the vector corresponding to the largest eigenvalue and its strictly positive multiples are the only vectors of A with strictly positive entries, see [13, Chapter 8]. Consequently, given a strictly positive covariance or correlation matrix, the eigenvector corresponding to the largest eigenvalue will only have positive entries. All other eigenvectors will have at least one sign change. Therefore, even before we run the PCA, one knows a priori what the sign of the eigenvector γ_1 will be. Lord and Pelsser also point out that a sign change pattern exists for the residual eigenvectors. However, this requires a restriction on the choice of the matrix class. The authors choose the class of strictly total positive and oscillatory matrices and

analyze the respective spectral properties.[1] It can be shown that a valid covariance or correlation matrix, which belongs to the class of strictly positive or oscillatory matrices, automatically has $j-1$ sign changes in the eigenvector corresponding to the $j-$th largest eigenvalue. Thus, the first eigenvector will have no sign change, the second will have one sign change (as in the skew case) and the third will have two sign changes (as in the curvature case). Given that PCA results for financial market data display the same sign change patterns, there is concern whether these results are due to a valid economic effect or result from the fact that the financial market data just happens to produce this particular class of covariance matrices.

Lord and Pelsser note that only knowing the sign change pattern does not provide sufficient information about the shape of the eigenvectors. For example an eigenvector representing skew can be constructed with only positive values. Furthermore, strictly positive values can also yield an eigenvector which can be interpreted as a curvature effect. The results in the following sections will address this issue. [2]

Furthermore, PCA may not be able to correctly recover factor variances from the original system. Consider the following toy example: a seven-dimensional case with a single factor in the original system. One can think of this system as seven stocks in a CAPM framework where the single source of risk is the market portfolio. This can be expressed as

$$\sigma = \begin{pmatrix} \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \\ \frac{1}{\sqrt{7}} \end{pmatrix} a + \begin{pmatrix} \varepsilon_1 \\ \varepsilon_2 \\ \varepsilon_3 \\ \varepsilon_4 \\ \varepsilon_3 \\ \varepsilon_2 \\ \varepsilon_1 \end{pmatrix}. \tag{2}$$

Each stock has different degrees of unsystematic risk captured by the ε variables. Setting $V(a) = 0.50$, $V(\varepsilon_1) = 0.10$, $V(\varepsilon_2) = 0.09$, $V(\varepsilon_2) = 0.07$, $V(\varepsilon_4) = 0.08$ as the variances, the dominating factor has the following loading vector:

$$\gamma = (0.389, 0.381, 0.366, 0.373, 0.366, 0.381, 0.389)^T.$$

This factor can be interpreted as a level effect. However, the variance of the original system (0.50) is not recovered, but was calculated as 0.59. Thus, PCA overestimates the variance of the original factor. The additional explained variance is coming from the error terms and we will show in a later section that this can also impact the variance contribution of factors in a multiple factor case.

[1] We do not introduce the definition of these matrix classes, but rather state the implications, in case the matrix belongs to the specified class.

[2] Parallel work in this area has been published by Salinelli, E. and Sgarra, C. in [16], [15]. The authors derive similar results to Lord and Pelsser for oscillatory and strictly total positive matrices.

PCA representative work (although by no means complete) in the analysis of interest rate term structures includes Litterman and Scheinkman [10] for the US market, Lord and Pelsser [11] for the German government bond market and Pérignon et al. [14] for international bond markets. The results are similar to the patterns found in figure (1). PCA analysis has been used particularly in the analysis of implied volatility surfaces. Alexander [2] examined implied volatilities on the FTSE100, Cont and da Fonseca [4] also considered the FTSE100 and options on the S&P500. While Fengler et al. [7] considered options on the DAX index. All three papers found the level, skew (twist) and curvature effects also similar to figure (1). Dynamics of the term structure of implied volatilities were considered by Kamal and Derman [6] for OTC option markets on the S&P500 and Nikkei225, by Skiadopoulos et al. [18] and Daglish et al. [5] for exchange traded options on the S&P500, and Zhu and Avellaneda [21] examined the over the counter foreign exchange option market. All of these papers found that three components explain the majority of the variance.

3 Bisymmetric Matrices

Bisymmetric matrices[3] are objects which are well-known from applications in signal processing, see [19], [3]. Do such structures exist in financial market data? Every time, when the analysis considers a two by two correlation matrix, the structure is bisymmetric. A general definition can be given as follows.

Definition 1. Let $J \in \mathbb{R}^{n\times n}$ be a matrix which has ones on its anti-diagonal and zeros everywhere else

$$J = \begin{pmatrix} 0\ 0 & \dots\ \dots & 0\ 1 \\ 0\ 0 & \dots\ \dots & 1\ 0 \\ \vdots & \ddots & \vdots \\ 0\ 1 & \dots\ \dots & 0\ 0 \\ 1\ 0 & \dots\ \dots & 0\ 0 \end{pmatrix}. \tag{3}$$

A bisymmetric matrix $A \in \mathbb{R}^{n\times n}$ is a matrix which is symmetric with respect to both of its diagonals and thus fulfills the following condition

$$JAJ = A.$$

A multiplication of J to the left of A leads to a permutation of the rows of A, while a multiplication to the right of A leads to a permutation of the columns. A bisymmetric matrix remains unchanged if the rows and afterwards the columns are permutated via J.

Let for example A, J be defined as in equation (4).

[3] also called symmetric persymmetric or symmetric centrosymmetric matrices

$$A = \begin{pmatrix} 1 & 3 & 4 \\ 3 & 2 & 3 \\ 4 & 3 & 1 \end{pmatrix} \qquad J = \begin{pmatrix} 0 & 0 & 1 \\ 0 & 1 & 0 \\ 1 & 0 & 0 \end{pmatrix} \tag{4}$$

Then we have

$$JA = \begin{pmatrix} 4 & 3 & 1 \\ 3 & 2 & 3 \\ 1 & 3 & 4 \end{pmatrix} \quad \text{and consequently} \quad JAJ = \begin{pmatrix} 1 & 3 & 4 \\ 3 & 2 & 3 \\ 4 & 3 & 1 \end{pmatrix}$$

which is the same as A. Thus, A is a bisymmetric matrix.

Consider the following empirical correlation matrix of the implied volatilities of the Euro vs. US Dollar across five strike prices (in delta terms) [4]

$$\begin{pmatrix} 1.000 & 0.968 & 0.953 & 0.927 & 0.898 \\ 0.968 & 1.000 & 0.989 & 0.968 & 0.923 \\ 0.953 & 0.989 & 1.000 & 0.991 & 0.951 \\ 0.927 & 0.968 & 0.991 & 1.000 & 0.966 \\ 0.898 & 0.923 & 0.951 & 0.966 & 1.000 \end{pmatrix},$$

One can see that this matrix represents a highly correlated system with an almost perfect bisymmetric property.

The matrix J can be used to define symmetric and skew symmetric vectors, which will be important objects in the following analyses.

Definition 2. A vector $\gamma_s \in \mathbb{R}^n$ is called symmetric, if

$$J\gamma_s = \gamma_s.$$

A vector $\gamma_{ss} \in \mathbb{R}^n$ is called skew symmetric, if

$$J\gamma_{ss} = -\gamma_{ss}.$$

Examples of these classes are

$$\gamma_s = \begin{pmatrix} 1 \\ 2 \\ 1 \end{pmatrix}, \quad \gamma_s = \begin{pmatrix} 3 \\ 3 \end{pmatrix}, \quad \gamma_{ss} = \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix}, \quad \gamma_{ss} = \begin{pmatrix} 1 \\ -1 \end{pmatrix}.$$

Other examples are plotted in figure (1) for $n = 5$. One can conclude from the definition, that a skew symmetric vector which has an odd number of components will always have a zero as the middle entry.

Our analysis in this work will focus on the properties of the eigenvectors of bisymmetric matrices, which will be later applied to covariance or correlation matrices.

[4] for one month maturity options, using Bloomberg data from 03.10.2003 to 21.01.2009

It can be shown that the eigenvectors of bisymmetric classes are either symmetric or skew symmetric, see [3]. We will summarize this in the following theorem, distinguishing between a quadratic matrix with an odd or even numbers of rows.

Theorem 2. *Suppose $A \in \mathbb{R}^{n\times n}$ is bisymmetric and n is even. Matrix A has $n/2$ skew symmetric and $n/2$ symmetric orthonormal eigenvectors.*

Let $\lceil x \rceil$ denote the smallest integer $\geq x$, and $\lfloor x \rfloor$ denote the largest integer $\leq x$. Define

$$u =: \left\lceil \frac{n}{2} \right\rceil \tag{5}$$

$$l := \left\lfloor \frac{n}{2} \right\rfloor \tag{6}$$

to be the upper and lower integer of $\frac{n}{2}$ respectively.

Suppose $A \in \mathbb{R}^{n\times n}$ is bisymmetric and n is odd. Matrix A has l skew symmetric and u symmetric orthonormal eigenvectors.

Because the resulting eigenvectors are orthonormal, they are equal to the loading vectors of a PCA analysis. Consequently, a PCA analysis on a bisymmetric covariance or correlation matrix will automatically produce skew symmetric and symmetric eigenvectors, just as in figure (1). These eigenvectors have the typical form of factor loading vectors, which in the empirical literature are usually interpreted as level, slope and curvature effects. In the simple case of a non-trivial two by two correlation matrix, theorem (2) proves that the eigenvectors are -a priori- known and unrelated to the original system. The symmetric and skew symmetric eigenvectors will be

$$\gamma_s = (\frac{1}{\sqrt{2}}, \frac{1}{\sqrt{2}}) \qquad \gamma_{ss} = (\frac{1}{\sqrt{2}}, -\frac{1}{\sqrt{2}}).$$

These vectors can be interpreted as a shift and skew effect.

Cantoni and Butler provide in [3] partition representations of bisymmetric matrices and state equation systems which characterize the eigenvectors and eigenvalues. We will not repeat these results, but rather state explicit representations of eigenvectors and eigenvalues for the following general 3×3 matrix A. [5] Matrix A is defined as follows

$$A = \begin{pmatrix} a_1 & b & c \\ b & a_2 & b \\ c & b & a_1 \end{pmatrix} \tag{7}$$

[5] A generalisation to higher dimensions is possible, although the analytical representation of eigenvectors of a bisymmetric 5×5 is already difficult. We will concentrate on the 3×3 case as previously discussed.

and is clearly bisymmetric. According to theorem (2) , the matrix has one skew symmetric and two symmetric orthonormal eigenvectors. The eigenvectors can be stated explicitly by using results from [3] for both, the skew symmetric (Theorem 3) and symmetric case (Theorem 4).

Theorem 3. *Matrix A in equation (7) has the following skew symmetric, orthonormal eigenvector v_{ss} and its corresponding eigenvalue λ_{ss}*

$$v_{ss} = \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ -\frac{1}{\sqrt{2}} \end{pmatrix} \qquad \lambda_{ss} = a_1 - c. \tag{8}$$

It is of particular interest, that the explicit form of the eigenvector does not depend on any of the variables a, b, c. Also, note that the form of the vector is the typical form of a skew vector produced by a PCA for financial market data. The symmetric vectors are somewhat more complicated.

Theorem 4. *Define*

$$d := \sqrt{a_1^2 - 2a_1a_2 + a_2^2 + 8b^2 + 2a_1c - 2a_2c + c^2}$$

and

$$w_{s_1} = \begin{pmatrix} \frac{a_1-a_2+c+d}{4b} \\ 1 \\ \frac{a_1-a_2+c+d}{4b} \end{pmatrix} \qquad w_{s_2} = \begin{pmatrix} \frac{a_1-a_2+c-d}{4b} \\ 1 \\ \frac{a_1-a_2+c-d}{4b} \end{pmatrix}. \tag{9}$$

Matrix A in equation (7) has the following symmetric, orthonormal eigenvectors v_{s_1}, v_{s_2} and corresponding eigenvalues $\lambda_{s_1}, \lambda_{s_2}$

$$v_{s_1} = \frac{1}{\|w_{s_1}\|} w_{s_1}, \qquad \lambda_{s_1} = \frac{1}{2}(a_1 + a_2 + c + d) \tag{10}$$

$$v_{s_2} = \frac{1}{\|w_{s_2}\|} w_{s_2}, \qquad \lambda_{s_2} = \frac{1}{2}(a_1 + a_2 + c - d) \tag{11}$$

where $\|x\|$ denotes the Euclidian norm of vector x.

Symmetric vectors are typical representatives of level and curvature effects. With the explicit form for all eigenvectors/eigenvalues for matrix (7), we can proceed to the analysis of potential PCA interpretation problems.

4 Potential Interpretation Problems

Assume that we observe three random variables defined as follows

$$\begin{aligned}\sigma_+ &= a + b_+ \\ \sigma_0 &= a + b_0 \\ \sigma_- &= a + b_- \end{aligned} \tag{12}$$

where b_+, b_0, b_- and a are independent random variables with mean zero. Furthermore, assume that the variables b_+ and b_- have the same variance: $V(b_+) = V(b_-)$. The covariance matrix will then have the following form

$$\Sigma = \begin{pmatrix} V(\sigma_+) & V(a) & V(a) \\ V(a) & V(\sigma_0) & V(a) \\ V(a) & V(a) & V(\sigma_+) \end{pmatrix}.$$

This matrix is bisymmetric, as is the corresponding correlation matrix. Consequently, the system will have an eigenvector which can be interpreted as ”skew”. We know from the previous section, that this eigenvector will be represented by equation (8). Therefore, the corresponding eigenvalue, and consequently the variance of the skew symmetric factor, will be $V(\sigma_+) - V(a) = V(b_+)$. However, the original system is composed of three random variables which do not intuitively suggest the presence of a skew vector.
Furthermore, the system will have two symmetric eigenvectors. While PCA should indicate the presence of a level factor, generated by variable a, there is no economic justification for the additional curvature and skew components. These result solely from the fact that the data matrix is bisymmetric. To verify these theoretical results, consider the following simulation. We define

$$\begin{aligned} a &\sim N(0, 0.2) \\ b_+ &\sim N(0, 0.25) \\ b_0 &\sim U[0, 1] \\ b_- &\sim Exp(2) \end{aligned}$$

where $N(\mu, \sigma^2)$ denotes the normal distribution with mean μ and variance σ^2, $U[a,b]$ is the uniform distribution on the interval $[a,b]$ and $Exp(\lambda)$ is the exponential distribution with rate λ. We generated $n = 50.000$ realizations of the variables $\sigma_-, \sigma_0, \sigma_+$ by using independent variables a, b_-, b_0, b_+ with the specifications above. The estimated covariance matrix contained the following values:

$$\Sigma = \begin{pmatrix} 0.450 & 0.202 & 0.201 \\ 0.202 & 0.283 & 0.200 \\ 0.201 & 0.203 & 0.450 \end{pmatrix}.$$

As can be seen, this is an almost perfect bisymmetric matrix. From the analysis in the previous section, one knows that a PCA analysis on such a system will produce one skew symmetric eigenvector v_{ss} and two symmetric eigenvectors v_{s_1}, v_{s_2}. The resulting factor loading vectors of the PCA on the estimated covariance matrix are:

$$v_{s_1} = \begin{pmatrix} 0.62 \\ 0.48 \\ 0.62 \end{pmatrix} \quad v_{s_2} = \begin{pmatrix} 0.35 \\ -0.88 \\ 0.33 \end{pmatrix} \quad v_{ss} = \begin{pmatrix} 0.70 \\ 0.01 \\ -0.71 \end{pmatrix}.$$

Note that $1/\sqrt{2} \approx 0.707$ which corresponds to the first entry of the skew symmetric vector. The eigenvalues corresponding to the eigenvectors, rounded to the second decimal place, are

$$\lambda_{s_1} = 0.81, \quad \lambda_{s_2} = 0.13, \quad \lambda_{ss} = 0.25$$

which are approximately the theoretical values derived previously.

For bisymmetric matrices, a skew effect will result even when variables are randomly generated with no associated skew effect. Note also, that the vector v_{s_2} is a typical representative of a curvature eigenvector, while v_{s_1} might be interpreted as a mixture between level and curvature. The system also indicates the typical order in terms of the explained variance. The first symmetric eigenvector will explain most of the variance, followed by the skew symmetric eigenvector and finally by the second symmetric eigenvector.

The presence of PCA skew and curvature factors does not necessarily provide a valid interpretation of the original system dynamics. It should be recognized that when typical PCA patterns are observed, there might not be any underlying economic interactions in the original system. A similar analysis can be applied to PCA based on the correlation matrix. In this case, it is sufficient to have $Corr(\sigma_+, \sigma_0) = Corr(\sigma_-, \sigma_0)$ to observe a skew effect.

Consider a PCA performed on the correlation matrix of the implied volatilities of the EURUSD, which was presented earlier and had an almost perfect bisymmetric form. The corresponding eigenvectors, representing level, skew and curvature are shown in figure (2). However, there is a possibility that these effects were generated by a random structure similar to equation system (12). It is critical to distinguish between results due to economic factors and results due to purely random processes.

To this end, the next section analyzes a system that actually possesses economic relationships and has a bisymmetric covariance matrix. We will address the question, if PCA can recover the ”true” economic effects.

5 PCA on a Shift, Skew, Curvature System

Let us consider examples where financial market data is modeled with three factors, which are interpreted as level, skew and curvature effects. For example, Malz [12] proposes a three factor parametric description of volatility smiles as given by

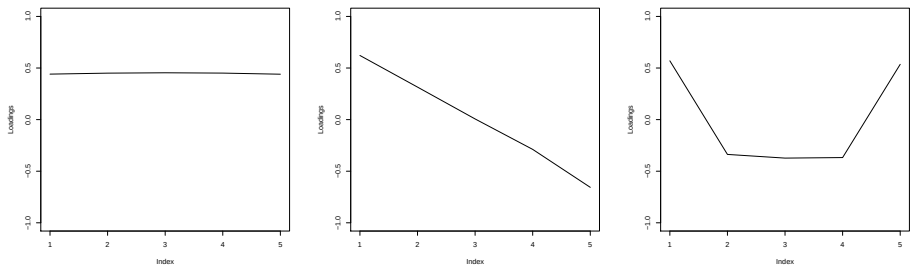

Fig. 2: Level (left), skew (center), curvature (right) patterns in a PCA on EURUSD 1 month implied volatilities.

equation (13)

$$\sigma(\overline{\Delta}) = b_l + b_s(\overline{\Delta} - \Delta_0) + b_c(\overline{\Delta} - \Delta_0)^2. \tag{13}$$

The coefficient $\overline{\Delta}$ is a moneyness variable and Δ_0 is the center of the smile. The b terms represent the level, skew and curvature effects respectively. [6] From the previous parabolic representation in equation (13), if only three volatilities are quoted (two equidistant out of the money options and the at the money option) these would be equal to:

$$\sigma(\Delta_0 + \Delta) = b_l + b_s\Delta + b_c\Delta^2 \tag{14}$$

$$\sigma(\Delta_0) = b_l \tag{15}$$

$$\sigma(\Delta_0 - \Delta) = b_l - b_s\Delta + b_c\Delta^2. \tag{16}$$

This is consistent with the common practice in the foreign exchange option market to quote volatilities for fixed degrees of moneyness (delta). In the case when only three volatility quotations are provided, these are expressed via:

$$\sigma_+ = \sigma_{ATM} + \frac{1}{2}\sigma_{RR} + \sigma_{STR} \tag{17}$$

$$\sigma_- = \sigma_{ATM} - \frac{1}{2}\sigma_{RR} + \sigma_{STR} \tag{18}$$

with σ_{RR} being the quoted risk reversal volatility and σ_{STR} being the smile strangle.[7] Market participants interpret σ_{RR} as the degree of skew and σ_{STR} as the degree of curvature of the smile, while σ_{ATM} represents the overall level. Let us now generalize these approaches.

Consider the following general system of 3 random variables

[6] For equity index option markets, J. Zhang and Y. Xiang [20] propose an equivalent representation, with the difference being how moneyness is defined. In this case $\overline{\Delta}$ is defined as the log-moneyness.

[7] A risk reversal in this context is a long call, short put position where the absolute delta of both options is equal. A strangle is a long call, long put position with equal absolute deltas.

$$\begin{aligned}\sigma_+ &= a_l + a_s + a_c \\ \sigma_0 &= a_l \\ \sigma_- &= a_l - a_s + a_c \end{aligned} \tag{19}$$

with mutually independent variables a_l, a_s, a_c which have zero mean. In this system, the random variable a_l represents the level, a_s represents the skew and a_c represents the curvature variable. We assume that these variables are non-deterministic and thus $V(a_l) > 0, V(a_s) > 0, V(a_c) > 0$.[8] Increasing a_l will lead to an increase of $\sigma_+, \sigma_0, \sigma_-$ by the same amount. Increasing a_s will lead to opposite reactions of σ_+ and σ_-, while σ_0 does not change at all. Similarly, an increase in a_c will increase σ_+, σ_- by the same amount leaving σ_0 unchanged. Therefore, this system will - by design - display level, skew and curvature effects.
Equation (19) is similar to the PCA basis representation in equation (1) since it can be written as:

$$\sigma = \begin{pmatrix} \sigma_+ \\ \sigma_0 \\ \sigma_- \end{pmatrix} = a_l \begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix} + a_s \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix} + a_c \begin{pmatrix} 1 \\ 0 \\ 1 \end{pmatrix}.$$

Consequently, the random vector σ is a linear combination of the linearly independent vectors

$$\begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix}, \qquad \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix}, \qquad \begin{pmatrix} 1 \\ 0 \\ 1 \end{pmatrix}$$

which are a basis for the three dimensional real space $\mathbb{R}^3$. This is an equivalent representation as in equation (1), with $y_1 = a_l, y_2 = a_s, y_3 = a_c$. The vectors represent level, skew and curvature respectively and can be classified as symmetric or skew symmetric vectors. Note that the first and last vector are not orthogonal, while the level-skew and curvature-skew vector pairs are. We can rewrite the system such that the basis vectors have unit length, which would yield

$$\sigma = \begin{pmatrix} \sigma_+ \\ \sigma_0 \\ \sigma_- \end{pmatrix} = a_l\sqrt{3} \begin{pmatrix} \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \end{pmatrix} + a_s\sqrt{2} \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ -\frac{1}{\sqrt{2}} \end{pmatrix} + a_c\sqrt{2} \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ \frac{1}{\sqrt{2}} \end{pmatrix}.$$

We have now represented the random vector σ as a linear combination of linearly independent vectors with unit length, where the vectors represent level, slope and curvature. The only difference to system (1) is that the vectors are not orthogonal, but both representations include a set of basis vectors with unit length. The vectors are equivalent to the vectors with factor loadings of a PCA. The skew vector has

[8] All of the following calculations can be extended by introducing error terms $\varepsilon_+, \varepsilon_0, \varepsilon_-$ in equation system (19), such that the level, skew, curvature signals are perturbed by noise terms. However, this does not change any of the following conclusions.

exactly the same form as the skew vector resulting from a PCA on a bisymmetric matrix. The variables

$$b_l = a_l\sqrt{3} \tag{20}$$
$$b_s = a_s\sqrt{2} \tag{21}$$
$$b_c = a_c\sqrt{2} \tag{22}$$

are independent, scaled random variables equivalent to the principal components of a PCA. The final system yields

$$\sigma = \begin{pmatrix} \sigma_+ \\ \sigma_0 \\ \sigma_- \end{pmatrix} = b_l \begin{pmatrix} \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \end{pmatrix} + b_s \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ -\frac{1}{\sqrt{2}} \end{pmatrix} + b_c \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ \frac{1}{\sqrt{2}} \end{pmatrix}. \tag{23}$$

Note that the random variables b_l, b_s, b_c will explain 100% of the variance of the vector σ.

To summarize, equation (23) is a random system which has level, skew and curvature effects. This system is a generalization of parametric forms that have commonly appeared in the financial literature and are used as a volatility quotation mechanism in financial markets. Therefore we will consider PCA analysis of the system defined in equation (23) with confidence that these results will proxy interpretation properties of PCA applications in financial markets. Specifically, the next section will address the following set of questions:

- Do we still observe loading vectors representing level, skew and curvature if we perform a PCA analysis on the covariance and correlation matrix of system (23)?
- How much of the variance do the corresponding PCs explain in the original system and in the PCA results?

These questions will be addressed by applying the previously introduced analytical setup of bisymmetric matrices (where variables b_l, b_s, b_c are independent).[9] We will show, that the structure of equation (23) is not clearly represented in the PCA results for the covariance matrix. In fact, the first PCA eigenvector represents both, level and curvature. When the PCA is performed on the correlation matrix, effects are indicated which are not present in the original system.

5.1 PCA on the Covariance Matrix

The covariance matrix of the ordered variables $\sigma_-, \sigma_0, \sigma_+$ in equation (23) has the following form

[9] It is possible to relax the independence assumptions and introduce covariances, if the resulting covariance matrix is still bisymmetric. For the sake of simplicity, we will assume independence without any loss of generality.

$$\begin{pmatrix} V(\sigma_+) & \frac{1}{3}V(b_l) & V(\sigma_+)-V(b_s) \\ \frac{1}{3}V(b_l) & V(\sigma_0) & \frac{1}{3}V(b_l) \\ V(\sigma_+)-V(b_s) & \frac{1}{3}V(b_l) & V(\sigma_+) \end{pmatrix}. \tag{24}$$

As this is a bisymmetric matrix, we can use the results of the previous sections to calculate the respective eigenvectors/eigenvalues which would represent those from a PCA. Noting that matrix (24) has the same structure as matrix (7) we will replace the corresponding variables and proceed as before. By application of theorem (3), we can calculate the variance of the skew symmetric factor as

$$\lambda_{ss} = V(b_s).$$

This results in equal variances for both, the principal component representing skew in the original setup and the PCA setup. In this case the principal component representing skew is correctly recovered.

For the other PCs the analysis is somewhat more complicated. The first eigenvector does not always produce a parallel eigenvector, as will be demonstrated in the following simple example. Consider setting the variances of the variables b_l, b_s, b_c in matrix (24) equal to 0.20. Figure (3) displays the eigenvectors in this case (skew vector not included). Is is clear that both loading vectors display some degree of cur-

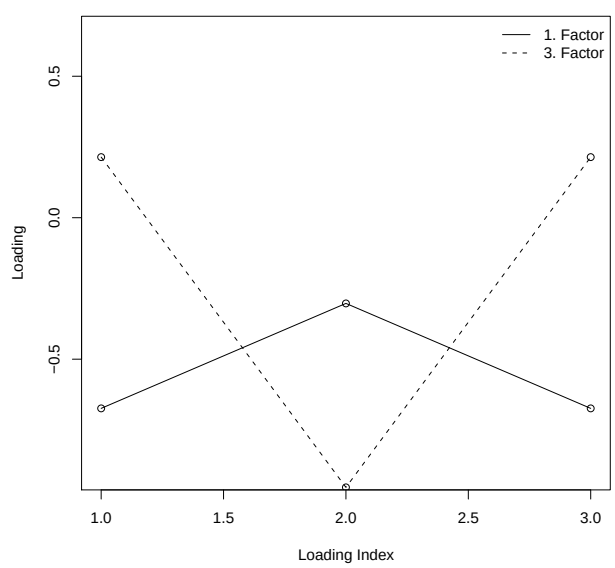

Fig. 3: Loading vectors for the 1. and 3. PC for $V(b_l) = V(b_s) = V(b_c) = 0.20$.

vature. The dominant curvature effect is clearly seen in the third factor. However, factor one explains both level and some degree of curvature. We will coin this property as bi-explanatory. Therefore, PCA analysis on such a system could potentially not recover a clear parallel shift of the original system.

The eigenvalue corresponding to the first symmetric eigenvector of matrix (24) is

$$\lambda_{s_1} = \frac{1}{2}V(b_c) + \frac{1}{2}V(b_l) + \frac{1}{2\sqrt{3}}\sqrt{3V(b_l)^2 + 3V(b_c)^2 + 2V(b_c)V(b_l)}.$$

One can easily show that λ_{s_1} is always greater than $V(b_l)$. The implication of this is that the first skew symmetric factor will always explain more variance than the original level component. Similarly, λ_{s_2} will always be smaller than $V(b_c)$. This implies that the second skew symmetric factor will always explain less variance than the original curvature component. Therefore the PCA will either over or underestimate the contributed variance of the corresponding factors.

Let us now consider the circumstance where the original system is dominated by a single factor: either skew, shift or curvature. We would expect the corresponding PC to explain 100% of the variance and the loading vectors will display similar shapes as the vectors in the original system.

We will first consider the analysis of the skew symmetric vector, which is trivial. It has already been shown above that the variance of the skew factor is identical in both systems. Furthermore, the eigenvector shapes are the same.
Now consider a dominating shift case. Let v_{s_1} again be the first symmetric eigenvector of matrix (24) and λ_{s_1} the corresponding eigenvalue. It can be shown (see Appendix), that

$$\lim_{V(b_l)\to\infty} v_{s_1} = \begin{pmatrix} \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \end{pmatrix} \text{ and } \lim_{V(b_l)\to\infty} \frac{\lambda_{s_1}}{\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss}} = 1.$$

In this case, PCA will recover the same loadings vector as in the original system (in the limit). In addition, the corresponding PC will explain 100% of the total variance.

Finally, let us consider the curvature. As opposed to the skew and shift results, the curvature result is surprising. It can be shown that

$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_2}}{\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss}} = 0 = \lim_{V(b_l)\to\infty} \frac{\lambda_{s_2}}{\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss}} = \lim_{V(b_s)\to\infty} \frac{\lambda_{s_2}}{\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss}}. \tag{25}$$

In this case, the second symmetric factor is not the dominating PC. Of greater concern is that, in the limiting case, the second symmetric factor does not explain any variance. It turns out that all the variance is being explained by the first symmetric factor, which we previously identified as a shift. This is due to:

$$\lim_{V(b_c)\to\infty} v_{s_1} = \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ \frac{1}{\sqrt{2}} \end{pmatrix} \text{ and } \lim_{V(b_c)\to\infty} \frac{\lambda_{s_1}}{\lambda_{s_1}+\lambda_{s_2}+\lambda_{ss}} = 1,$$

which is derived in the Appendix. The first symmetric factor is bi-explanatory; it can explain two effects simultaneously. If the sole effect is curvature and its variance approaches infinity, the first factor will explain 100% of the total variance, which is exactly the same outcome as if the sole effect was a shift. Therefore, the first symmetric eigenvector represents both level and curvature at the same time (moving to one of them in the limiting case). This leads to problematic interpretation of the first symmetric loadings vector when we have a situation as represented in figure (3). This occurs because the first symmetric eigenvector is not completely flat, but displays some degree of curvature.[10]

The significance of this bi-explanatory misinterpretation is related to the relative contributions of the variances $V(b_l)$ and $V(b_c)$. To better understand this functional relationship to $V(b_l), V(b_c)$, consider the eigenvector component differences as a function of the variances which is displayed in figure (4). We define the first and second eigenvector component differences as

$$\gamma_{s_1}(1) - \gamma_{s_1}(2). \tag{26}$$

Figure (4) plots this as a function of $V(b_l)$ and $V(b_c)$ where $\gamma_{s_1}(i)$ is the i-th component of the vector γ_{s_1}. When equation (26) is zero, there is no difference between the first and second component of the level vector and this implies that the first symmetric eigenvector is completely flat. It should be noted that the equation will be positive (and the eigenvector no longer flat) when the variance of the curvature factor is positive. It is of further interest that it will still remain curved even for large level variances $V(b_l)$. This is somewhat counterintuitive as one would expect the difference to be close to zero for large variances $V(b_l)$. In this case, the level variance is dominating the original system and PCA should solely produce a pure level effect. When the line is not flat, the amount of the explained variance by the level factor will be more and for the curvature factor will be less than in the original system. We want to know how much this error is. This is displayed in figure (5), where we consider explained variance biases as a function of $V(b_l), V(b_c)$. One can see, that the PCA level factor always overestimates the true explained variance of a shift at any time, except for the case where $V(b_c) = 0$. This is true even for very high variances $V(b_l)$. Consider the case that $V(b_c) = 0.1, V(b_l) = 0.8$ then the PCA level vector will be $v_{s_1} \approx (0.60, 0.53, 0.60)^T$ and the explained variance by the corresponding factor is overestimated by 7%.

To summarize, the PCA skew factor explains the same proportion of the total variance as the skew factor in the original system. The PCA skew factor also has the correct limiting behavior. However, the first symmetric eigenvector is bi-explanatory for both, level and curvature. Furthermore, this vector can be interpreted as a level

[10] In many papers that use PCA for financial market data this is a common result.

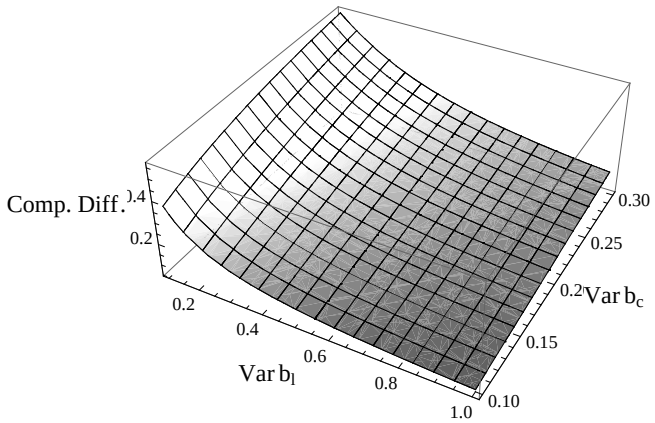

Fig. 4: Difference of the first two components of the 1. symmetric vector vs. $V(b_l), V(b_c)$. $V(b_s) = 0.20$.

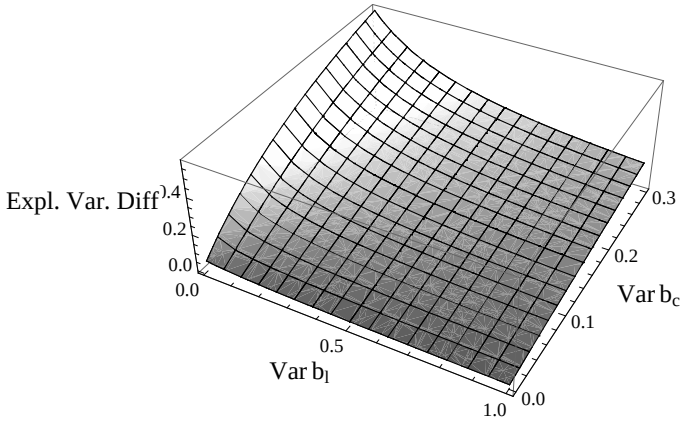

Fig. 5: Difference of explained Variance of the symmetric PCA vector and original level factor.$V(b_s) = 0.20$.

factor when the coefficients are sufficiently close to each other. Given that in the empirical literature the shift eigenvector usually displays some curvature effect, this could lead to misinterpretation.

Of importance is how this can be corrected. Consider the 3×3 case[11], with three

[11] It is clear that this case is somewhat artificial. Firstly, we have exogenously defined the factors (level, skew and curvature). Normally, PCA will recover the factors endogenously. Secondly, the objective of PCA is parsimonious dimension reduction. Normally, we have many more variables than factors. However, in the toy example with seven variables and one factor (which was also exogenously defined), we found that the factor variance was also overestimated. This will occur in our 3×3 case. The advantage of the 3×3 case is that we can correct these overestimation errors analytically. In the higher dimensional case we can not. Nevertheless, the 3×3 case will provide

variables and three factors. This original system is defined by equation (23). The first step is to estimate a covariance matrix from data generated by this system. Then, we perform the PCA analysis and obtain eigenvalues $\lambda_{s_1}, \lambda_{s_2}$ and λ_{ss}. While we can estimate the covariance matrix of the original system, we do not know the variances of the individual factors. Using the eigenvalues, however, we can calculate the original variances $V(b_l), V(b_c), V(b_s)$ of the factors. The skew factor variance is correctly recovered and requires no further modification. For the other two variances, the appropriate modification is (see Appendix): [12]

$$V(b_l) = \frac{1}{2}\left(\lambda_{s_1} + \lambda_{s_2} \pm \sqrt{\lambda_{s_1}^2 - 10\lambda_{s_1}\lambda_{s_2} + \lambda_{s_2}^2}\right), \tag{27}$$

$$V(b_c) = \lambda_{s_1} + \lambda_{s_2} - V(b_l). \tag{28}$$

Then, both the level and curvature variances are correctly recovered.

Let us consider a simple numerical example, using the following parameter inputs:

$$V(b_l) = 0.41, \quad V(b_s) = 0.10, \quad V(b_c) = 0.11. \tag{29}$$

We generated $50,000$ realizations of the variables σ_+, σ_0 and σ_- from equation (23) using independent, normally distributed random variables b_l, b_s, b_c. The eigenvectors and eigenvalues of the estimated covariance matrix were

$$v_{s_1} = \begin{pmatrix} 0.62 \\ 0.48 \\ 0.62 \end{pmatrix} \quad v_{s_2} = \begin{pmatrix} 0.34 \\ -0.88 \\ 0.34 \end{pmatrix} \quad v_{ss} = \begin{pmatrix} 0.71 \\ 0.00 \\ -0.71 \end{pmatrix}$$

$$\lambda_{s_1} = 0.49, \qquad \lambda_{s_2} = 0.03, \qquad \lambda_{ss} = 0.10.$$

The results appear in table (1). In this table, the left columns represent the original variances of the factors, the middle columns show the PCA variances and the right columns display the corrected factor variances. These are presented both in levels and as a percentage contribution of the total variance.

The PCA indicates that the curvature effect (second symmetric factor) explains the smallest amount (0.03) of the original variance, even though it has the second largest variance (0.11) in the original system. As we surmised, the first symmetric eigenvector (level vector) explains more variance (0.49) than in the original system (0.41). This could lead to the misleading conclusion that curvature was the least important contribution. As was indicated previously, the skew factor was correctly recovered. To correct the other errors, we apply formulas (27) and (28) with $\lambda_{s_1} = 0.49$ and $\lambda_{s_2} = 0.03$ which yields the original variances of 0.41 and 0.11 for the level and

insights into the nature of the correction. Finally, the motivation for the exogenously defined factors is that these factors are commonly found in the financial literature.

[12] As can be seen in equation (27), $V(b_l)$ has two solutions. To obtain the correct solution, we calculate the eigenvectors for both and compare them to the empirical level eigenvector. The solution that matches the eigenvector is selected.

Table 1: Comparison of explained variances by level, skew, curvature factors.

	Original		PCA		Corrected	
	Variance	% of Total	Variance	% of Total	Variance	% of Total
Level	0.41	66.1%	0.49	79.0%	0.41	66.1%
Skew	0.10	16.1%	0.10	16.1%	0.10	16.1%
Curvature	0.11	17.7%	0.03	4.83%	0.11	17.7%

curvature factor respectively. Consequently, PCA results can be used indirectly to draw conclusions about the original system.

5.2 PCA on the Correlation Matrix

To this point we have considered PCA interpretation problems associated with a covariance matrix. However, as it is more common to conduct a PCA analysis on the correlation matrix, we will now consider this case. Lardic, S., Priaulet, P. and Priaulet, S. [9] suggest that PCA should generally be conducted using correlation matrices. Previously, we presented analytical representations of the covariance matrix eigenvectors and eigenvalues which appear in theorems (3) and (4). In a similar vein, we will now state analytic representations for the correlation matrix eigenvectors and eigenvalues. If matrix A in equation (7) is a valid correlation matrix, e.g. $a_1 = a_2 = 1$ and the matrix is positive definite, theorems (3) and (4) simplify to:

Theorem 5. *If matrix A in equation (7) is a positive definite correlation matrix, then it has the following skew symmetric, orthonormal eigenvector v_{ss} and its corresponding eigenvalue λ_{ss}*

$$v_{ss} = \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ -\frac{1}{\sqrt{2}} \end{pmatrix} \qquad \lambda_{ss} = 1 - c \tag{30}$$

with $c \in [0,1]$.

Theorem 6. *Let the vectors w_{s_1}, w_{s_2} be defined as follows*

$$w_{s_1} = \begin{pmatrix} \frac{c+\sqrt{8b^2+c^2}}{4b} \\ 1 \\ \frac{c+\sqrt{8b^2+c^2}}{4b} \end{pmatrix}, w_{s_2} = \begin{pmatrix} \frac{c-\sqrt{8b^2+c^2}}{4b} \\ 1 \\ \frac{c-\sqrt{8b^2+c^2}}{4b} \end{pmatrix}.$$

If matrix A in equation (7) is a correlation matrix, it has the following symmetric, orthonormal eigenvectors v_{s_1}, v_{s_2} and corresponding eigenvalues $\lambda_{s_1}, \lambda_{s_2}$

$$
\begin{aligned}
v_{s_1} &= \frac{1}{\|w_{s_1}\|} w_{s_1} \qquad & \lambda_{s_1} &= \frac{1}{2}(2+c+\sqrt{8b^2+c^2}) \\
v_{s_2} &= \frac{1}{\|w_{s_2}\|} w_{s_2} \qquad & \lambda_{s_2} &= \frac{1}{2}(2+c-\sqrt{8b^2+c^2})
\end{aligned} \tag{31}
$$

with $b \in [0,1]$ *and* $c \in [0,1]$.

Consider a system with three standardized random variables. This will have a total variance of three. Intuitively, the variance contribution of any of the three PCA factors can be between zero and three. Surprisingly, in the case of a PCA on a bisymmetric correlation matrix, ranges for the eigenvalues (the variances of the principal components) can be specified and the range for each factor is not $[0,3]$. To achieve this, simply substitute 1.0 or -1.0 for each of the variables b and c in equations (30), (31) yielding:

Lemma 1. *Let* λ_{ss} *be the eigenvalue corresponding to the skew-symmetric eigenvector of a bisymmetric* 3×3 *correlation matrix and* $\lambda_{s_1}, \lambda_{s_2}$ *the eigenvalues corresponding to the symmetric eigenvectors. Then we have*

$$\lambda_{ss} \in [0,2], \tag{32}$$

$$\lambda_{s_1} \in [1,3], \tag{33}$$

$$\lambda_{s_2} \in [0,1]. \tag{34}$$

Equation (32) shows that the skew factor explanatory percentage is bounded from zero to 66.67%. Equation (33) shows that the first symmetric factor always explains at least 33.33% of the variance. Finally, equation (34) indicates that the maximum explanatory percentage is 33.33%. As long as the correlation matrix is bisymmetric, these variance explanatory percentage bounds are predefined. Therefore, the use of a correlation matrix (which is bisymmetric) does not remedy the potential interpretation problems with PCA. In fact, the problems are worsened as will now be shown. Let us return to the system defined in equation (23). The correlation matrix of the variables $\sigma_-, \sigma_0, \sigma_+$ has the following form:

$$
\begin{pmatrix}
1 & \frac{V(b_l)}{3\sqrt{V(\sigma_+)V(\sigma_0)}} & \frac{V(\sigma_+)-V(b_s)}{V(\sigma_+)} \\
\frac{V(b_l)}{3\sqrt{V(\sigma_+)V(\sigma_0)}} & 1 & \frac{V(b_l)}{3\sqrt{V(\sigma_+)V(\sigma_0)}} \\
\frac{V(\sigma_+)-V(b_s)}{V(\sigma_+)} & \frac{V(b_l)}{3\sqrt{V(\sigma_+)V(\sigma_0)}} & 1
\end{pmatrix}. \tag{35}
$$

As before, let v_{ss} be the skew symmetric eigenvector of matrix (35), and v_{s_1}, v_{s_2} the symmetric eigenvectors. Consider the corresponding eigenvalues $\lambda_{ss}, \lambda_{s_1}, \lambda_{s_2}$. Due to the standardization, these sum to:

$$\lambda_{ss} + \lambda_{s_1} + \lambda_{s_2} = 3.$$

It can be shown that (see Appendix)

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{ss}}{3} = 0 = \lim_{V(b_c)\to\infty} \frac{\lambda_{ss}}{3}.$$

Furthermore, the explanatory proportion of the skew symmetric factor in the limiting case is equal to:

$$\lim_{V(b_s)\to\infty} \frac{\lambda_{ss}}{3} = \frac{2}{3},$$

as was previously indicated in lemma (1). In a similar manner, for the second skew symmetric eigenvector the limiting explanatory proportion is:

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{s_2}}{3} = 0 = \lim_{V(b_s)\to\infty} \frac{\lambda_{s_2}}{3}$$

$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_2}}{3} = \frac{1}{3}.$$

This differs from the results in the case of a covariance matrix (in equation (25)). The final analysis of the first symmetric eigenvalue yields

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{s_1}}{3} = 1,$$

$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_1}}{3} = \frac{2}{3},$$

$$\lim_{V(b_s)\to\infty} \frac{\lambda_{s_1}}{3} = \frac{1}{3}.$$

As was the case for the covariance matrix, the first symmetric factor will possess multi-explanatory power. In this case, this factor can potentially explain all three effects in the underlying system, whereas the PCA on the covariance matrix is only bi-explanatory. It is clear, that the more effects a factor explains, the more problematic the PCA interpretation. In a similar spirit to the analysis of the covariance matrix case, let us consider the shape of the eigenvectors in the limit for the correlation matrix case.

$$\lim_{V(b_s)\to\infty} v_{ss} = \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ -\frac{1}{\sqrt{2}} \end{pmatrix} \text{ and } \lim_{V(b_c)\to\infty} v_{s_2} = \begin{pmatrix} 0 \\ 1 \\ 0 \end{pmatrix}.$$

The analysis of the first symmetric eigenvector yields

$$\lim_{V(b_l)\to\infty} v_{s_1} = \begin{pmatrix} \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \\ \frac{1}{\sqrt{3}} \end{pmatrix}, \lim_{V(b_c)\to\infty} v_{s_1} = \begin{pmatrix} \frac{1}{\sqrt{2}} \\ 0 \\ \frac{1}{\sqrt{2}} \end{pmatrix}, \lim_{V(b_s)\to\infty} v_{s_1} = \begin{pmatrix} 0 \\ 1 \\ 0 \end{pmatrix}.$$

As expected, the first symmetric eigenvector converges to an eigenvector representing a parallel shift for large $V(b_l)$. Furthermore, for large curvature variances, the first symmetric eigenvector converges to a different shape than the second symmetric eigenvector. In contrast with the covariance case, two eigenvectors contribute to the variance in the limiting case (previously there was only one). Surprisingly and unexpectedly, even when the sole effect in the original system is a skew effect (explaining 100% of the variance), the first symmetric eigenvector will show a significant curvature effect which is not in the original system (explaining 33.3% of the total variance).

As a side point, many of these results are not solely due to problems with PCA but are also due to the method of the standardization. It has been pointed out in the literature, that standardization is an appropriate step in PCA analysis. However, we show in the Appendix that the shape of the level vector will be corrupted after standardization. This occurs for both, orthonormal and non-orthonormal systems. With or without standardization, PCA interpretation problems will exist.

6 Conclusion

In this research, we have considered PCA interpretation problems for option market data. Having found that the covariance matrix structures of foreign exchange implied volatilities display bisymmetry, we consider this case. A further benefit of the bisymmetric assumption is that the analysis is analytically tractable. Finally, the eigenvectors associated with this system display similar patterns to empirical PCA loading vectors. We show that even if a random system exists, but the covariance matrix is bisymmetric, PCA will indicate the existence of factors which could be interpreted as level, skew and curvature. Our first contribution is to point out this potential interpretation problem. We also find that when a bisymmetric system exists where level, skew and curvature is exogenously given, PCA will not correctly recover these effects. The level factor explains more variance than the original system, the skew factor is correctly recovered and the curvature factor variance contribution is reduced. Our next contribution is to show how this can be analytically corrected in a restricted case. We recognize that the system we have considered is somewhat simplistic, restricted to three variables and three factors. However, we show that the resulting patterns are also present in more realistic cases (i.e. with any dimension).

It should be pointed out that not all financial market data displays the bisymmetric property. The most important case is for interest rates. However, the absence of bisymmetry does not necessarily preclude the potential for PCA interpretation prob-

lems. Lord and Pelsser point this out for other covariance matrix structures.

Study of such alternative systems remains for future research. However, our final contribution is to provide a systematic framework for analysis that should prove helpful.

7 Acknowledgements

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8 Appendix

8.1 Implications of a Standardization

Assume that the following orthogonal system is given:

$$\sigma = \begin{pmatrix} \sigma_+ \\ \sigma_0 \\ \sigma_- \end{pmatrix} = a_l \begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix} + a_s \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix} + a_c \begin{pmatrix} 1 \\ -2 \\ 1 \end{pmatrix}.$$

The random vector σ is a linear combination of the orthogonal vectors

$$\begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix}, \qquad \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix}, \qquad \begin{pmatrix} 1 \\ -2 \\ 1 \end{pmatrix}$$

which have a level, skew curvature interpretation. Standardizing the variables $\sigma_+, \sigma_0, \sigma_-$ yields

$$\overline{\sigma} = \begin{pmatrix} \overline{\sigma}_+ \\ \overline{\sigma}_0 \\ \overline{\sigma}_- \end{pmatrix} = a_l \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ \frac{1}{\sqrt{V(\sigma_0)}} \\ \frac{1}{\sqrt{V(\sigma_+)}} \end{pmatrix} + a_s \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ 0 \\ \frac{-1}{\sqrt{V(\sigma_+)}} \end{pmatrix} + a_c \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ \frac{-2}{\sqrt{V(\sigma_0)}} \\ \frac{1}{\sqrt{V(\sigma_+)}} \end{pmatrix}.$$

A simple standardization thus corrupts the original orthogonal system. The new basis vectors are not orthogonal anymore and the original level vector has a curvature effect. The same can be shown for the system

$$\sigma = \begin{pmatrix} \sigma_+ \\ \sigma_0 \\ \sigma_- \end{pmatrix} = a_l \begin{pmatrix} 1 \\ 1 \\ 1 \end{pmatrix} + a_s \begin{pmatrix} 1 \\ 0 \\ -1 \end{pmatrix} + a_c \begin{pmatrix} 1 \\ 0 \\ 1 \end{pmatrix},$$

where standardization results in

$$\overline{\sigma} = \begin{pmatrix} \overline{\sigma}_+ \\ \overline{\sigma}_0 \\ \overline{\sigma}_- \end{pmatrix} = a_l \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ \frac{1}{\sqrt{V(\sigma_0)}} \\ \frac{1}{\sqrt{V(\sigma_+)}} \end{pmatrix} + a_s \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ 0 \\ \frac{-1}{\sqrt{V(\sigma_+)}} \end{pmatrix} + a_c \begin{pmatrix} \frac{1}{\sqrt{V(\sigma_+)}} \\ 0 \\ \frac{1}{\sqrt{V(\sigma_+)}} \end{pmatrix}.$$

Again, the first basis vector cannot be identified as a level vector anymore, since $\frac{1}{\sqrt{V(\sigma_+)}}$ will in general differ from $\frac{1}{\sqrt{V(\sigma_0)}}$.

8.2 Covariance Matrix Variance Ratio Limits

We will first analyze the limiting behavior of the variance ratios. Remember that by assumption all variances $V(b_l), V(b_s), V(b_c)$ are strictly positive. First of all we repeat, that

$$\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss} = V(b_l) + V(b_s) + V(b_c).$$

The skew symmetric case is trivial, since

$$\lim_{V(b_s)\to\infty} \frac{\lambda_{ss}}{\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss}} = \lim_{V(b_s)\to\infty} \frac{V(b_s)}{V(b_l) + V(b_s) + V(b_c)} = 1.$$

The limit of the ratio with $V(b_l), V(b_c)$ instead of $V(b_s)$ is zero. For λ_{s_1} we have

$$\lambda_{s_1} = \frac{1}{2}V(b_c) + \frac{1}{2}V(b_l) + \frac{1}{2\sqrt{3}}\sqrt{3V(b_l)^2 + 3V(b_c)^2 + 2V(b_c)V(b_l)}. \quad (36)$$

The limit can be calculated by using l'Hospitals rule. For general $x > 0, y > 0$ and residual terms r_1, r_2 which do not depend on x we observe that

$$\begin{aligned} \lim_{x\to\infty} \frac{\sqrt{(x+y)^2 + r_1}}{x + r_2} &= \lim_{x\to\infty} \frac{x+y}{\sqrt{(x+y)^2 + r_1}} = \lim_{x\to\infty} \frac{\sqrt{(x+y)^2 + r_1}}{x+y} \\ &= \lim_{x\to\infty} \sqrt{1 + \frac{r_1}{(x+y)^2}} = 1. \end{aligned}$$

This can be applied to equation (36) by factoring out $\sqrt{3}$ from the square root and transforming the rest into the desired form. We thus have

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{s_1}}{\lambda_{s_1}+\lambda_{s_2}+\lambda_{ss}} = \frac{1}{2}+\frac{1}{2\sqrt{3}}\sqrt{3} = 1.$$

The same argumentation yields

$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_1}}{\lambda_{s_1}+\lambda_{s_2}+\lambda_{ss}} = \frac{1}{2}+\frac{1}{2\sqrt{3}}\sqrt{3} = 1.$$

For λ_{s_2} we have the same representation as for λ_{s_1}, except for the negative sign in front of the root:

$$\lambda_{s_2} = \frac{1}{2}V(b_c)+\frac{1}{2}V(b_l)-\frac{1}{2\sqrt{3}}\sqrt{3V(b_l)^2+3V(b_c)^2+2V(b_c)V(b_l)}.$$

With the same arguments as above, we conclude that

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{s_2}}{\lambda_{s_1}+\lambda_{s_2}+\lambda_{ss}} = \lim_{V(b_c)\to\infty} \frac{\lambda_{s_2}}{\lambda_{s_1}+\lambda_{s_2}+\lambda_{ss}} = 0.$$

8.3 Covariance Matrix Eigenvector Limits

We will analyze the non normalized eigenvector w_{s_1} first. According to equation system (9) we have

$$w_{s_1}(1) = w_{s_1}(3) = \frac{3V(b_c)+V(b_l)+\sqrt{9V(b_l)^2+9V(b_c)^2+6V(b_c)V(b_l)}}{4V(b_l)} \tag{37}$$

where $w_{s_1}(i)$ is component number i in the vector w_{s_1}. This limit can be calculated in the same way as before to yield

$$\lim_{V(b_l)\to\infty} w_{s_1}(1) = \frac{1}{4}+\frac{\sqrt{9}}{4} = 1 = \lim_{V(b_l)\to\infty} w_{s_1}(3).$$

Since $w_{s_1}(2) = 1$ we have $\|w_{s_1}\| = \sqrt{2w_{s_1}(1)^2+1}$. We then conclude

$$\lim_{V(b_l)\to\infty} \frac{w_{s_1}(1)}{\|w_{s_1}\|} = \frac{1}{\sqrt{3}} = \lim_{V(b_l)\to\infty} \frac{w_{s_1}(2)}{\|w_{s_1}\|} = \lim_{V(b_l)\to\infty} \frac{w_{s_1}(3)}{\|w_{s_1}\|}.$$

Thus

$$\lim_{V(b_l)\to\infty} \frac{w_{s_1}}{\|w_{s_1}\|} = (\frac{1}{\sqrt{3}},\frac{1}{\sqrt{3}},\frac{1}{\sqrt{3}}).$$

The analysis of the limit with respect to $V(b_c)$ yields

$$\lim_{V(b_c)\to\infty} w_{s_1}(1) = \infty \text{ and } w_{s_1}(1) > 0.$$

We are interested in the limit

$$\lim_{V(b_c)\to\infty} \frac{w_{s_1}(1)}{\|w_{s_1}\|} = \lim_{V(b_c)\to\infty} \frac{w_{s_1}(1)}{\sqrt{2w_{s_1}(1)^2+1}}.$$

Since both, the numerator and denominator converge to infinity we can apply l'Hospitals rule, to get

$$\lim_{V(b_c)\to\infty} \frac{w_{s_1}(1)}{\|w_{s_1}\|} = \lim_{V(b_c)\to\infty} \frac{\sqrt{2w_{s_1}(1)^2+1}}{2w_{s_1}(1)} = \lim_{V(b_c)\to\infty} \frac{1}{2}\sqrt{2\frac{w_{s_1}(1)^2}{w_{s_1}(1)^2} + \frac{1}{w_{s_1}(1)^2}} = \frac{1}{\sqrt{2}}. \tag{38}$$

Since $w_{s_1}(2) = 1$, we conclude

$$\lim_{V(b_c)\to\infty} \frac{w_{s_1}}{\|w_{s_1}\|} = (\frac{1}{\sqrt{2}}, 0, \frac{1}{\sqrt{2}}).$$

8.4 Extracting Original Variances from PCA Eigenvalues

Assume, that the eigenvalues $\lambda_{s_1}, \lambda_{s_2}, \lambda_{ss}$ are given after performing a PCA. This section will derive the variances of the variables b_l, b_s, b_c, given $\lambda_{s_1}, \lambda_{s_2}, \lambda_{ss}$. Knowing, that

$$\lambda_{s_1} + \lambda_{s_2} + \lambda_{ss} = V(b_l) + V(b_c) + V(b_s)$$

and

$$V(b_s) = \lambda_{ss}$$

it can be concluded that

$$\lambda_{s_1} + \lambda_{s_2} = V(b_l) + V(b_c).$$

We will define the known variable k_1 as

$$k_1 := \lambda_{s_1} + \lambda_{s_2}.$$

We then have

$$\begin{aligned}
\lambda_{s_1} &= \frac{1}{2}V(b_c) + \frac{1}{2}V(b_l) + \frac{1}{2\sqrt{3}}\sqrt{3V(b_l)^2 + 3V(b_c)^2 + 2V(b_c)V(b_l)} \\
&= \frac{1}{2}k_1 + \frac{1}{2}\sqrt{V(b_l)^2 + V(b_c)^2 + \frac{2}{3}V(b_c)V(b_l) + \frac{4}{3}V(b_c)V(b_l) - \frac{4}{3}V(b_c)V(b_l)} \\
&= \frac{1}{2}k_1 + \frac{1}{2}\sqrt{k_1^2 - \frac{4}{3}V(b_c)V(b_l)}.
\end{aligned}$$

We thus have

$$\lambda_{s_1} - \lambda_{s_2} = \sqrt{k_1^2 - \frac{4}{3}V(b_c)V(b_l)}.$$

Which leads to

$$V(b_c)V(b_l) = \frac{3}{4}k_1^2 - \frac{3}{4}(\lambda_{s_1} - \lambda_{s_2})^2 = 3\lambda_{s_1}\lambda_{s_2}.$$

This equation together with $\lambda_{s_1} + \lambda_{s_2} = V(b_l) + V(b_c)$ can be solved for $V(b_l)$ yielding the following two solutions

$$V(b_l) = \frac{1}{2}\left(\lambda_{s_1} + \lambda_{s_2} \pm \sqrt{\lambda_{s_1}^2 - 10\lambda_{s_1}\lambda_{s_2} + \lambda_{s_2}^2}\right).$$

The variance $V(b_c)$ can be obtained via

$$V(b_c) = \lambda_{s_1} + \lambda_{s_2} - V(b_l).$$

The two solutions problem can be fixed by plugging the resulting variances in equation (37) and check them against the empirical eigenvector.

8.5 Correlation Matrix Variance Ratio Limits

For the skew symmetric eigenvalue we have

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{ss}}{3} = \lim_{V(b_l)\to\infty} \frac{6V(b_s)}{9V(b_c) + 6V(b_l) + 9V(b_s)} = 0 = \lim_{V(b_c)\to\infty} \frac{\lambda_{ss}}{3}.$$

Similarly we have

$$\lim_{V(b_s)\to\infty} \frac{\lambda_{ss}}{3} = \frac{2}{3}.$$

The terms for the second skew symmetric eigenvalue are more complicated.

$$\begin{aligned}\frac{\lambda_{s_2}}{3} &= \frac{1}{2} - \frac{V(b_s)}{3V(b_c) + 2V(b_l) + 3V(b_s)} \\ &\quad - \frac{1}{2\sqrt{3}}\sqrt{\frac{3V(b_c)^2 + V(b_c)[20V(b_l) - 6V(b_s)] + 3[2V(b_l) + V(b_s)]^2}{[3V(b_c) + 2V(b_l) + 3V(b_s)]^2}} \quad (39)\end{aligned}$$

We then have by l'Hospitals rule

$$\begin{aligned}\lim_{V(b_l)\to\infty} \frac{\lambda_{s_2}}{3} &= \frac{1}{2} - \frac{1}{2\sqrt{3}}\sqrt{3} = 0, \\ \lim_{V(b_s)\to\infty} \frac{\lambda_{s_2}}{3} &= \frac{1}{2} - \frac{1}{3} - \frac{1}{2\sqrt{3}}\frac{1}{\sqrt{3}} = 0,\end{aligned}$$

$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_2}}{3} = \frac{1}{2} - \frac{1}{2\sqrt{3}}\frac{1}{\sqrt{3}} = \frac{1}{3}.$$

The case

$$\frac{\lambda_{s_1}}{3}$$

is analogous to the case for the eigenvalue λ_{s_2}, the only thing that changes is the sign in front of the square root term in equation (39). We can thus directly calculate with the previous results

$$\lim_{V(b_l)\to\infty} \frac{\lambda_{s_1}}{3} = 1,$$
$$\lim_{V(b_s)\to\infty} \frac{\lambda_{s_1}}{3} = \frac{1}{3},$$
$$\lim_{V(b_c)\to\infty} \frac{\lambda_{s_1}}{3} = \frac{2}{3}.$$

8.6 Correlation Matrix Eigenvector Limits

The limit of v_{ss} is trivial. For the symmetric vectors, we again analyze the non standardized vectors w_{s_1}, w_{s_2} first. For w_{s_2} we have

$$\begin{aligned} w_{s_2}(1) = &\sqrt{\frac{[3V(b_c)+2V(b_l)+3V(b_s)]}{32V(b_l)}} \\ &- \frac{3V(b_s)}{\sqrt{8V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} \\ &- \sqrt{\frac{9V(b_c)^2+6V(b_c)[10V(b_l)-3V(b_s)]+[6V(b_l)+3V(b_s)]^2}{32V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} \end{aligned} \tag{40}$$

The analysis of term (40) is more involved, since the first and the third term converge in the opposite direction for $V(b_c) \to \infty$. Let

$$x_1(V(b_l),V(b_c),V(b_s)) := \frac{3V(b_c)+2V(b_l)+3V(b_s)}{32V(b_l)}$$
$$x_2(V(b_l),V(b_c),V(b_s)) := \frac{9V(b_c)^2+6V(b_c)[10V(b_l)-3V(b_s)]+[6V(b_l)+3V(b_s)]^2}{32V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}$$

We clearly have

$$x_1(V(b_l),V(b_c),V(b_s)) > 0, x_2(V(b_l),V(b_c),V(b_s)) > 0.$$

Applying l'Hospitals rule yields

$$\lim_{V(b_c)\to\infty}[x_1(V(b_l),V(b_c),V(b_s))-x_2(V(b_l),V(b_c),V(b_s))] = -\frac{1}{2}+\frac{3}{8}\frac{V(b_s)}{V(b_l)}. \quad (41)$$

We now use the following simple relationship for real numbers $x_1 \geq 0, x_2 \geq 0$.

$$x_1 - x_2 = (\sqrt{x_1}-\sqrt{x_2})(\sqrt{x_1}+\sqrt{x_2}) \quad (42)$$

We know from equation (41) that the limit of the left side of equation (42) for $V(b_c) \to \infty$ is a constant. Furthermore we have

$$\lim_{V(b_c)\to\infty}\left[\sqrt{x_1(V(b_l),V(b_c),V(b_s))}+\sqrt{x_2(V(b_l),V(b_c),V(b_s))}\right] = \infty. \quad (43)$$

Consequently

$$\begin{aligned} 0 &= \lim_{V(b_c)\to\infty}\left[\frac{x_1(V(b_l),V(b_c),V(b_s))-x_2(V(b_l),V(b_c),V(b_s))}{\sqrt{x_1(V(b_l),V(b_c),V(b_s))}+\sqrt{x_2(V(b_l),V(b_c),V(b_s))}}\right] \\ &= \lim_{V(b_c)\to\infty}\left[\sqrt{x_1(V(b_l),V(b_c),V(b_s))}-\sqrt{x_2(V(b_l),V(b_c),V(b_s))}\right]. \end{aligned}$$

We have thus shown

$$\lim_{V(b_c)\to\infty} w_{s_2}(1) = 0.$$

The normed case is simple since

$$\lim_{V(b_c)\to\infty} v_{s_2}(1) = \lim_{V(b_c)\to\infty}\frac{w_{s_2}(1)}{\|w_{s_2}\|} = \lim_{V(b_c)\to\infty}\frac{w_{s_2}(1)}{\sqrt{w_{s_2}(1)^2+1}} = 0.$$

Since $w_{s_2}(2) = 1$ we can conclude

$$\lim_{V(b_c)\to\infty} v_{s_2}(2) = \lim_{V(b_c)\to\infty}\frac{1}{\sqrt{w_{s_2}(1)^2+1}} = 1.$$

Thus we have

$$\lim_{V(b_c)\to\infty} v_{s_2} = (0,1,0)^T.$$

For the analysis of w_{s_1} we note that $w_{s_1}(1)$ can be represented as in equation (40) as

$$\begin{aligned} w_{s_1}(1) = &\sqrt{x_1(V(b_l),V(b_c),V(b_s))} - \frac{3V(b_s)}{\sqrt{8V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} \\ &+ \sqrt{x_2(V(b_l),V(b_c),V(b_s))}. \end{aligned}$$

The case for $V(b_c)$ can be handled easily by applying the same argumentation as in the covariance case, since

$$\lim_{V(b_c)\to\infty} w_{s_1}(1) = \infty.$$

Thus, we can conclude

$$\lim_{V(b_c)\to\infty} v_{s_1} = (\frac{1}{\sqrt{2}}, 0, \frac{1}{\sqrt{2}})^T.$$

A repeated application of l'Hospitals rules yields

$$\lim_{V(b_l)\to\infty} x_1(V(b_l), V(b_c), V(b_s)) = \frac{1}{16}$$

$$\lim_{V(b_l)\to\infty} x_2(V(b_l), V(b_c), V(b_s)) = \frac{9}{16}$$

Since

$$\lim_{V(b_l)\to\infty} \frac{3V(b_s)}{2\sqrt{2V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} = 0$$

we follow

$$\lim_{V(b_l)\to\infty} w_{s_1}(1) = \sqrt{\frac{1}{16}} - \lim_{V(b_l)\to\infty} \frac{3V(b_s)}{2\sqrt{2V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} + \sqrt{\frac{9}{16}} = 1.$$

Standardizing yields

$$\lim_{V(b_l)\to\infty} v_{s_1} = (\frac{1}{\sqrt{3}}, \frac{1}{\sqrt{3}}, \frac{1}{\sqrt{3}})^T.$$

The last term that needs to be analyzed is

$$\lim_{V(b_s)\to\infty} w_{s_1}(1).$$

We can summarize the following two terms

$$\begin{aligned}\sqrt{x_1(V(b_l), V(b_c), V(b_s))} &- \frac{3V(b_s)}{\sqrt{8V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}} \\ &= \frac{3V(b_c)+2V(b_l)-3V(b_s)}{\sqrt{32V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}}.\end{aligned}$$

This term can be shortened, since we are interested in

$$-\sqrt{y_1(V(b_l), V(b_c), V(b_s))} := -\sqrt{\frac{9V(b_s)^2}{32V(b_l)[3V(b_c)+2V(b_l)+3V(b_s)]}}$$

only, since

$$\lim_{V(b_s)\to\infty} w_{s_1}(1) = \sqrt{x_2(V(b_l), V(b_c), V(b_s))} - \sqrt{y_1(V(b_l), V(b_c), V(b_s))}.$$

One can show, that

$$\lim_{V(b_s)\to\infty} x_2(V(b_l),V(b_c),V(b_s)) - y_1(V(b_l),V(b_c),V(b_s)) = \frac{3}{8} - \frac{3}{16}\frac{V(b_c)}{V(b_l)}.$$

Since

$$\lim_{V(b_s)\to\infty} \sqrt{x_2(V(b_l),V(b_c),V(b_s))} + \sqrt{y_1(V(b_l),V(b_c),V(b_s))} = \infty$$

we can use the same trick as in equation (42) to get

$$\lim_{V(b_s)\to\infty} \sqrt{x_2(V(b_l),V(b_c),V(b_s))} - \sqrt{y_1(V(b_l),V(b_c),V(b_s))} = 0.$$

Concluding, we have

$$\lim_{V(b_s)\to\infty} w_{s_1}(1) = 0.$$

And thus

$$\lim_{V(b_s)\to\infty} v_{s_1} = (0,1,0)^T.$$

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