They connect all the vertices in a graph without forming the stocks. Spanning trees are particular types of graphs.\textsuperscript{1} The work is a Minimal Spanning Tree (MST) connecting all by considering the return cross-correlations. The net-\textsuperscript{2} work is obtained from a large group of stocks traded at the New York Stock Exchange during a 12-year trading period with the one obtained from surrogated data simulated by using simple market models. We find that the empirical tree has features of a complex network that cannot be reproduced, even as a first approximation, by a random market model and by the one-factor model.

PACS numbers: 89.75.Fb, 89.75.Hc, 89.65.Gh

The study of topological properties of networks has recently received a lot of attention. In particular it has been shown that many natural systems display an unexpected amount of correlation \textsuperscript{1} with respect to traditional models \textsuperscript{2}. Graphs are mathematical objects formed by vertices connected by arcs. An important characterization of a graph is given by the degree of vertices, that is the number of arcs per vertex. In an Erdős-Rényi random graph the degree distribution has a poissonian form, whereas in many cases of interest ranging from the WWW \textsuperscript{3} to the Internet \textsuperscript{4,5} to social networks \textsuperscript{6} the degree is power law distributed. The presence of such scale free behavior has been put in relationship with the basic ingredient of the network growth in time \textsuperscript{7}. We present here an example of system whose size does not increase in time but still displays a scale free behavior (see also \textsuperscript{8}). The case of study is given by a network whose vertices are a fixed number of stocks continuously traded at the New York Stock Exchange (NYSE) and the arcs are obtained by considering the return cross-correlations. The network is a Minimal Spanning Tree (MST) connecting all the stocks. Spanning trees are particular types of graphs. They connect all the vertices in a graph without forming any loop. Therefore if the number of vertices is \( n \), one has \( n - 1 \) arcs to connect them. There are several example of spanning trees in nature and several observables have been proposed in order to classify them and study the possible optimization with respect to some external cost function \textsuperscript{9}.

In this letter we study the topological properties of the MST obtained from the return cross correlation matrix of a portfolio of financial assets. We address the problem of the topological structure of the MST by comparing the real data with the MST obtained from simple models of the portfolio dynamics. Specifically we consider a model of uncorrelated Gaussian return time series and the widespread one-factor model. This last model is the starting point of the Capital Asset Pricing Model \textsuperscript{10}.

The topological characterization of the correlation based MST of real data has been already studied in Ref. \textsuperscript{11}. Differently from this approach, here we use a smaller number of stocks \( N \) but we use a number of time records \( T \) larger than the number of stocks. Our choice is motivated by the request that the correlation matrix be positive definite. When the number of variables is larger than the number of time records the covariance matrix is only positive semi-definite \textsuperscript{12}. Moreover, the application of the random matrix theory to the spectral properties of the correlation matrix can be applied only when \( T/N > 1 \).

The variable under investigation is the daily price return \( r_i(t) \) of asset \( i \) on day \( t \). Given a portfolio composed of \( N \) assets traded simultaneously in a time period of \( T \) trading days, we extract the \( N \times N \) correlation matrix. Each correlation coefficient \( \rho_{ij} \) can be associated to a metric distance \( d_{ij} = \sqrt{2(1 - \rho_{ij})} \) between asset \( i \) and \( j \) through the relation \textsuperscript{13,14}. The distance matrix is then used to determine the MST connecting all the assets. The method of constructing the MST linking \( N \) objects is known in multivariate analysis as the nearest neighbor single linkage cluster algorithm \textsuperscript{12}. In a previous study three of us showed that the structure of the MST changes with the time horizon used to compute price returns \textsuperscript{15}.

The data set used here consists of daily closure prices for 1071 stocks traded at the NYSE and continuously present in the 12-year period 1987–1998 (3030 trading days). It is worth noting that the ratio \( T/N \approx 2.83 \) is significantly larger than one. With our choice the correlation matrix is positive definite and the theoretical results of the random matrix theory are valid. Figure 1 shows the MST of the real data. The color code is chosen by using the main industry sector of each firm according to the Standard Industrial Classification system \textsuperscript{17} for the main industry sector of each firm and the correspondence is reported in the figure caption. Regions corresponding to different sectors are clearly seen. Examples are clusters of stocks belonging to the financial sector (purple), to the transportation, communications, electric gas and
sanitary services sector (green) and to the mining sector (red). The mining sector stocks are observed to belong to two subsectors one containing oil companies (located on the right side of the figure) and one containing gold companies (left side of the figure).

The empirical MST of real data can be compared with the results obtained from simple models of the simultaneous dynamics of a portfolio of assets. The simplest model assumes that the return time series are uncorrelated Gaussian time series, i.e. \( r_i(t) = \epsilon_i(t) \), where \( \epsilon_i(t) \) are Gaussian random variables with zero mean and unit variance. This type of model has been considered in Ref. [18,19] as a null hypothesis in the study of the spectral properties of the correlation matrix. In the cited references it has been shown that the spectrum of the real correlation matrix has a very large eigenvalue corresponding to the collective motion of the assets. A random model does not explain this empirical observation and therefore this fact clarifies why a better modeling of the portfolio dynamics is obtained by using the one-factor model. The one-factor model assumes that the return of assets is controlled by a single factor (or index). Specifically for any asset \( i \) we have

\[
    r_i(t) = \alpha_i + \beta_i r_M(t) + \epsilon_i(t),
\]

where \( r_i(t) \) and \( r_M(t) \) are the return of the asset \( i \) and of the market factor at day \( t \) respectively, \( \alpha_i \) and \( \beta_i \) are two real parameters and \( \epsilon_i(t) \) is a zero mean noise term characterized by a variance equal to \( \sigma_{\epsilon_i}^2 \). Our choice for the market factor is the Standard & Poor’s 500 index and we assume that \( \epsilon_i = \sigma_{\epsilon_i} w \), where \( w \) is a random variable distributed according to a Gaussian distribution.

We estimate the model parameters for each asset from real time series with ordinary least squares method [10] and we use the estimated parameters to generate an artificial market according to Eq. (1). A consequence of this equation is that the variance (the squared volatility) of asset \( i \) can be written as the sum of a term depending on the market factor and an idiosyncratic term. The fraction of variance explained by the factor \( r_M \) is approximately described by an exponential distribution with a characteristic scale of about 0.16. The random model can be considered as the limit of the one factor model when the fraction of variance explained by the factor goes to zero.

In the MST obtained with the random model few nodes have a degree larger than few units. This implies that the MST is composed by long files of nodes. These files join at nodes of connectivity equal to few units. The MST obtained with the one-factor model is very different from the one obtained with the random model. In Figure 2 we show the MST obtained in a typical realization of the one-factor model performed with the control parameters obtained as described above. It is evident that the structure of sectors of Fig. 1 is not present in Fig. 2. In fact the MST of the one-factor model has a star-like structure with a central node. The largest fraction of node links directly to the central node and a smaller fraction is composed by the next-nearest neighbors. Very few nodes are found at a distance of three links from the central node. The central node corresponds to General Electric and the second most connected node is Coca Cola. It is worth noting that these two stocks are the two most highly connected nodes in the real MST also.

The MSTs obtained by simulating the models are different in each realization. However a statistical characterization of MST is possible. In order to characterize quantitatively the structure of the MST we make use of two topological quantities. The first one is the distribution of the degree \( k \). In random graph this quantity is distributed according to a binomial distribution which for large networks tends to a Poisson distribution. In many real networks it has been shown that the degree is distributed according to power law distribution signaling the presence of long range correlation. The second topological quantity is frequently used for oriented graphs. For any vertex \( i \) in the tree we count the total number of vertices \( a \) in the uphill subtree whose root is \( i \). This quantity is called drainage basin area in oriented graphs of river networks [20], whereas it is usually referred as the in-degree component in graph theory. To calculate the in-degree component in a correlation based MST, we orient the MST according to the number of steps each node is far from the most connected node (sink). When more than one sink is present in the MST a preferential one is randomly chosen among them.

We report in Figure 3 the frequency distribution for the degree \( k \) for the real data and for the average over 100 realizations of the random model and of the one factor model. The degree distribution for the MST of the real data shows a power law behavior with exponent \(-2.6\) for one decade followed by a set of isolated points with high degree. A power law behavior with a similar exponent has been observed in Ref. [11] and in another recent study [21]. The highest degree \( k_{\text{max}} = 115 \) is observed for the General Electric, one of the most capitalized company in the NYSE. As we pointed out in a previous work [15], some important companies clearly emerge for its high degree value indicating that they act as a reference for other companies. The random model displays an approximately exponential decay of the degree distribution. The value of the maximum degree is small, \( k_{\text{max}} = 7.34 \pm 0.92 \), showing that no asset plays a central role in the MST. The correlation based MST of the random model can be considered as the MST of a set of \( N \) points randomly distributed in an Euclidean space with \( d = T \) dimension [16]. The \( N \) points have independent identically Gaussian distributed coordinates \( r_i = (r_i(1), r_i(2), ..., r_i(T)) \) with \( i = 1, 2, ..., N \). It has been shown that the distribution of degree of the random MST in Euclidean space converges to a specific distribution in the mean field limit \( d \to \infty \) [22]. The numerical values of the degree frequency obtained from this mean field limit are shown as a star in Figure 3 for \( k = 1, ..., 7 \).
The agreement of theoretical values with the numerical simulations is very good showing that the mean field limit is already a good approximation for our T parameter.

The MST obtained from the one factor model is characterized by a rapidly power-law decaying degree distribution and by an asset with a very high value of the degree, which is indicated by an arrow in Fig. 3. The value of the maximum degree is $k_{\text{max}} \approx 718 \pm 29$. The corresponding asset is the center of the star like structure of Figure 2. The region with highest value of the degree contains information about the stocks that act as reference for a large set of other stocks. To get more insight in the structure of this high $k$ region we show a rank plot of the degree both for real data and for the considered models in the inset of Figure 3. For the real market it is evident the presence of a region of power law extending for more than one decade. On the other hand, for the random model many nodes have a similar value of the degree which is ranging for less than an order of magnitude. This is due to the fact that there is no hierarchy in the random model. The rank plot of the degree of the MST for the one factor model has not a scale free behavior. Indeed, there is a single highly connected node (the center) and a rapidly decaying degree as a function of the rank. This fact corresponds to the simple one-center hierarchy of the MST of the one-factor model.

A discrepancy between real data and models is also observed in the frequency distribution of the in-degree component. Fig. 4 shows the frequency distribution of the in-degree component for real and surrogate data. The inset of Figure 4 shows the rank plot of the same data. In all three cases the in-degree component distribution has a power law shape. This is particularly clear for the MST of the random uncorrelated time series where the power law last for more than two decades with an exponent of approximately $-1.6$. It is known that for critical random trees the probability distribution of tree size decays as a power-law with an exponent $3/2$ [23]. A critical random tree is a tree in which the mean number of sons of each node is one. In a MST the mean degree is exactly equal to $2n/(n-1) \approx 2$. Hence when we orient the MST from the root to the leaves we have a tree with one son for each node. Our result shows that the in-degree component of the MST arising from random uncorrelated time series has properties similar to the one of a critical random tree. This is not the case for the one-factor model where the power law has greater absolute slope due to the star-like structure of the tree. Neither models is actually able to catch the oriented structure of real data whose in-degree component distribution is in between the two models. The same arguments are also valid for the region of high values of $a$ as is evident from the rank plot in the inset.

In summary these results show that the topology of the MST for the real and for the considered artificial markets is different for node with both high and low degree. If we define the importance of a node as its degree (or its in-degree component), from our analysis emerges that the real market has a hierarchical distribution of importance of the nodes whereas the considered models are not able to catch such a hierarchical complexity. Specifically, in the random model the fluctuations select randomly few nodes and assign them small values of degree. Thus the MST of the random model is essentially non hierarchical. On the other hand the MST of the one factor model shows a simple one-center hierarchy. The MST of real market shows a more structured hierarchy of the importance of the stocks which is not captured by the considered models. The topology of stock return correlation based MST shows large scale correlation properties characteristic of complex networks in the native as well as in an oriented form. Such properties cannot be reproduced at all, even as a first approximation, by simple models as a random model or the widespread one-factor model.

Authors acknowledge partial support of FET Open project COSIN IST-2001-33555. F.L. and R.N.M. acknowledges partial support from INFM and MIUR.

17. The Standard Industrial Classification system can be found at http://www.osha.gov/oshsstats/naiacs-manual.html
19. V. Plerou, P. Gopikrishnan, B. Rosenow, L. A. Nunes
Fig. 1. Correlation based minimal spanning tree of real data from daily stock returns of 1071 stocks for the 12-year period 1987-1998 (3030 trading days). The node color is based on Standard Industrial Classification system. The correspondence is: red for mining - cyan for construction - yellow for manufacturing - green for transportation, communications, electric, gas and sanitary services - magenta for wholesale trade - black for retail trade - purple for finance, insurance and real estate - orange for service industries - light blue for public administration.


[21] J. Kertész, personal communication


Fig. 2. Correlation based minimal spanning tree of a numerical simulation of the one factor model of Eq.(1). The color code is the same used in Figure 1.

Fig. 3. Frequency distribution of the degree of the MST of real data (circle). We also show the mean degree distribution of random (triangle) and one-factor (square) model averaged over 100 numerical realizations of the MST. The stars are the theoretical values of the degree frequency for the random model in mean field limit. The inset shows the corresponding rank plot of the degree in the three cases.

Fig. 4. Frequency distribution of the in-degree component of the MST of real data (circle). We also show the mean in-degree component distribution of random (triangle) and one-factor (square) model averaged over 100 numerical realizations of the MST. The inset shows the corresponding rank plot of the in-degree component for the three cases.