

# Asset Pricing Theory — Problem Set 4

Ali Bahramisani\*

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\*Stockholm School of Economics, Department of Finance, Email: [ali.bahramisani@hhs.se](mailto:ali.bahramisani@hhs.se), Website: [alibahramisani.github.io](http://alibahramisani.github.io)

# 1 Optimization

In this section, I use the first order Taylor approximation for the Newton-Raphson method to solve the problem.

## 1.1 A Polynomial

I tried to solve the problem with Newton-Raphson iteration method, as well as using Python built in solvers. The results are presented in Figure 1.

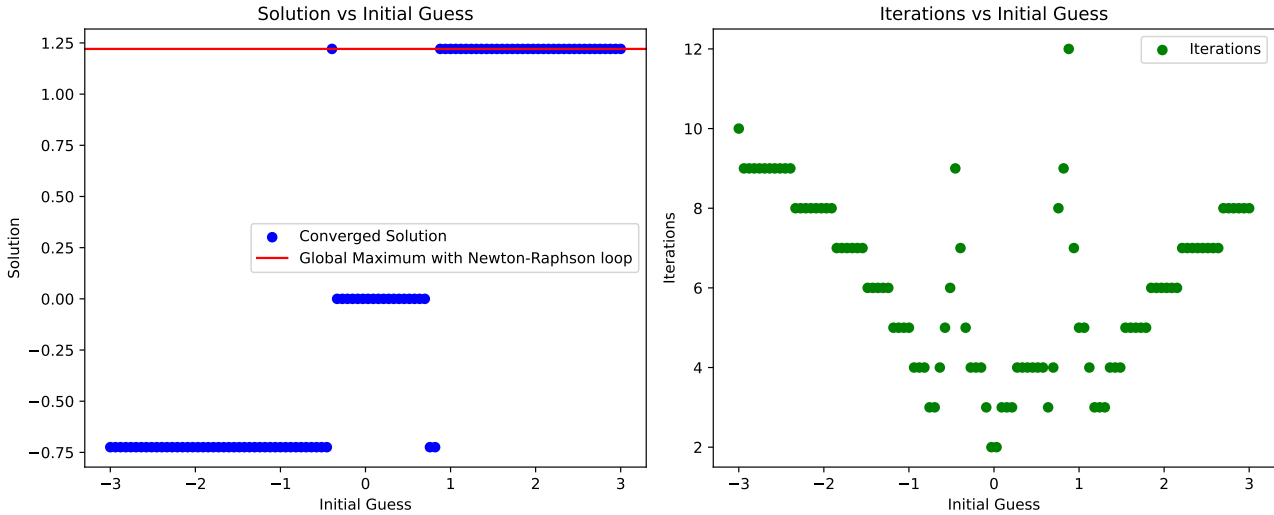


Figure 1: Obtained solution and the number of iterations against the initial guess

As it is shown, the Newton-Raphson method with the first order Taylor approximation, conditional on the initial guess, could not precisely solve the problem. Also, since this method is heavily contingent on the local derivations, the initial guess is crucial for the convergence and the solution. We can see that as the initial guess is closer to the local optimas, the method converges faster to those optimas. However, some of them are not global maximas, and the method converges to those local maximas. Considering the global maximum that Newton-Raphson method converges to, only 37% of intial guesses converge to the global maximum.

## 1.2 The sigmoid function

The true solution is obviously zero. I, again, wolve the problem with the first order Taylor approximation of Newton-Raphson method. The results are presented in Figure 2. As we can see, initial guesses far from the solution are diverging from the true solution. However, the method converges to the true solution for the initial guesses close to the true solution. Initial guesses far from the true solution are diverging due to the fact that for small and high initial guesses, the first derivation of the sigmoidnd function is extremly large and close to zero, respectively. This makes the Newton-Raphson method to diverge from the true solution.

Put differently, by calculating the average update steps, we can see that the method converges to the true solution for the initial guesses close to the true solution. However, for the initial guesses far from the true solution, the method diverges from the true solution. The average update steps are defined as:

$$\text{Average update steps} = \frac{1}{N} \sum_{i=1}^N |x_{n+1} - x_n| \quad (1)$$

where  $N$  is the number of iterations, and  $x_n$  is the solution at the  $n$ th iteration. As we can see the average update steps in Figure 2, they are decreasing as the initial guess is closer to the true solution.

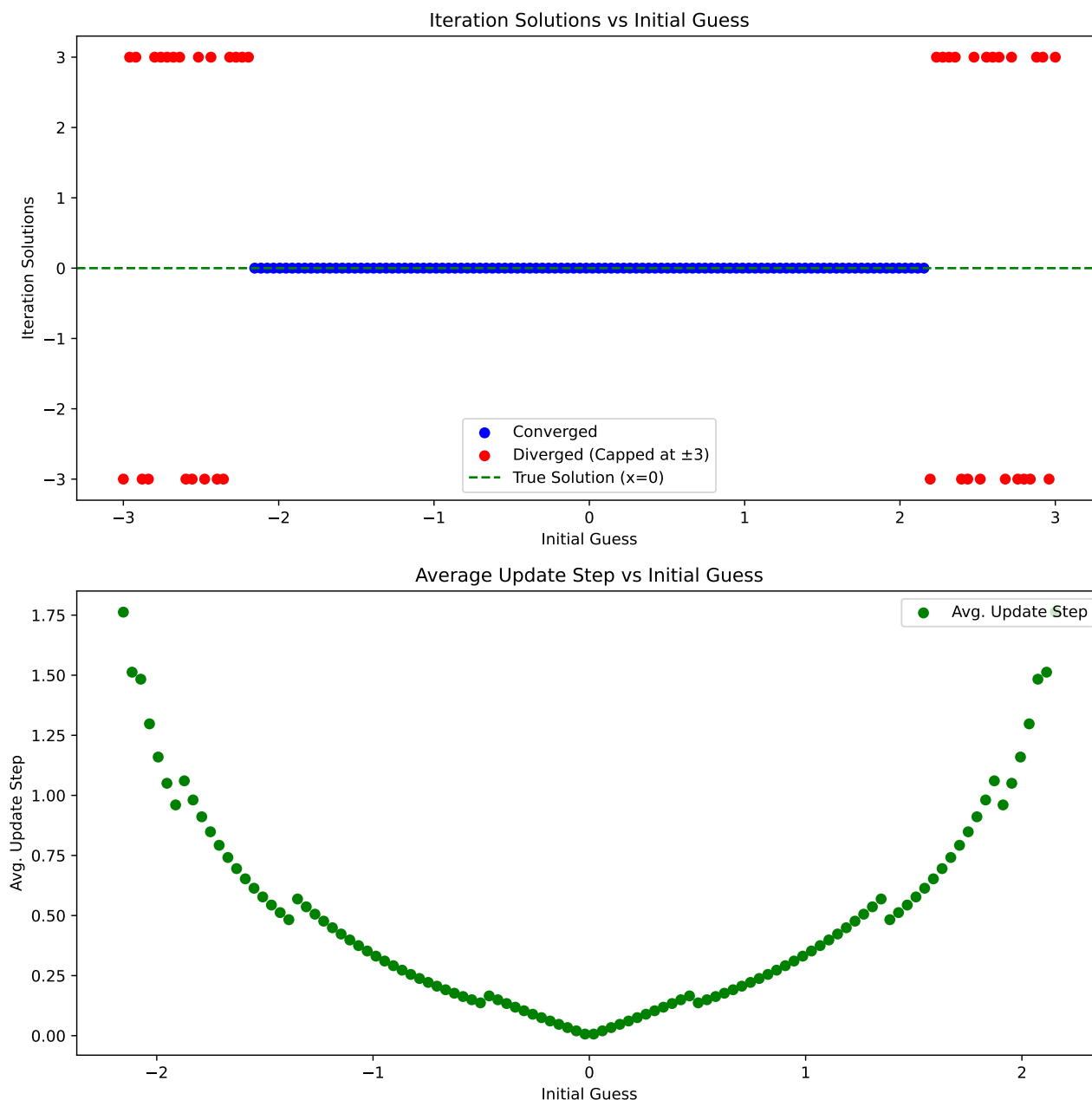


Figure 2: Obtained solution and the average update steps against the initial guess

All in all, combining the results in Figure 1 and Figure 2, we can see that the Newton-Raphson method is pretty fast when the initial guess is closer to the true solution. However, for the initial guesses far from the true solution, the method diverges from the true solution. If the function is differentiable this is an easy method to implement. However, for non-differentiable functions, we cannot use it. In regions that the derivations are close to zero, the method diverges from the true solution. Also, this method maybe useful for local optimization. Finally, the method is contingent on the order of derivations, which as it increases it is more precise, but also more computationally expensive.

### 1.3 The bisection algorithm

It takes 19 iterations to converge to the solution with the bisection method depicted in Figure 3. Compare to Newton-Raphson method, bisection method is slower, but guaranteed to find the correct solution. The bisection

method is not contingent on the initial guess, and it is not contingent on the derivations of the function. However, it is slower than the Newton-Raphson method. Bisection always find a root!

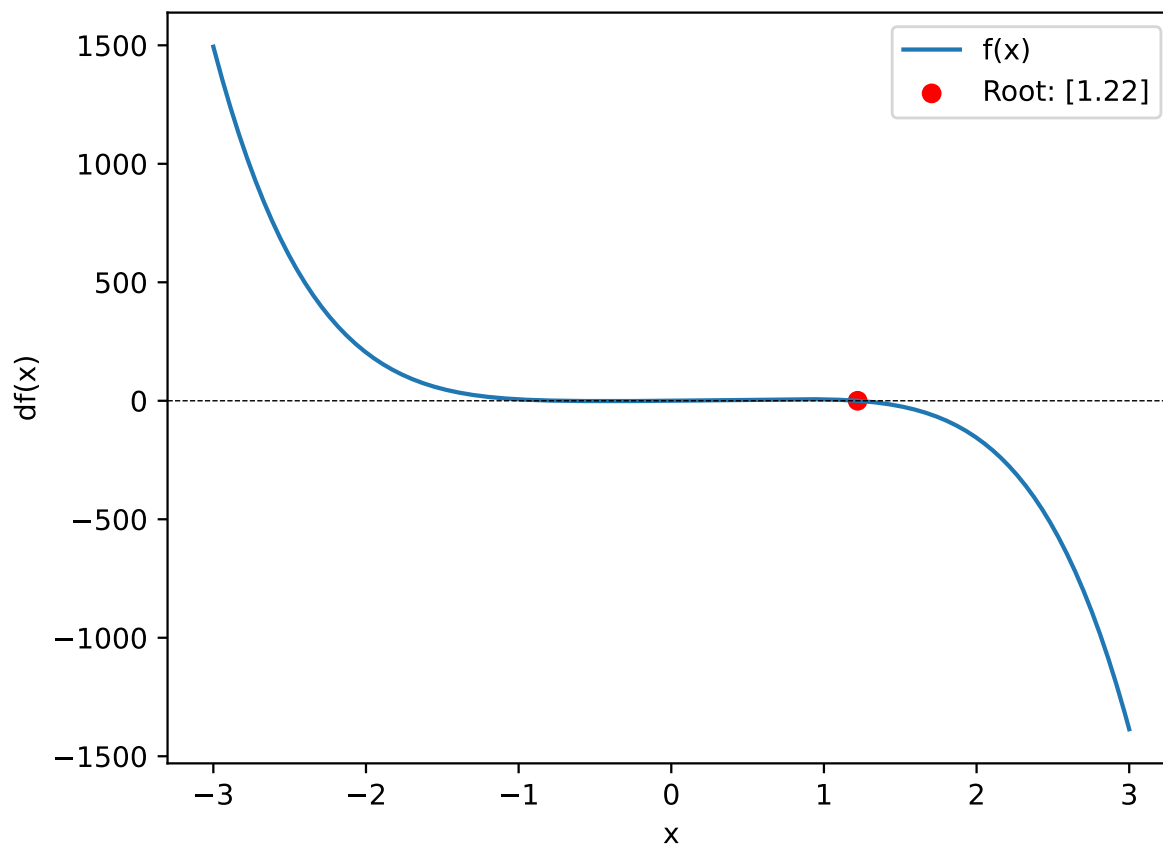


Figure 3: Bisection Method: Roots of  $f(x)$

## 2 Numerical Integral

1. We have the following for the number of intervals:

$$|10^{-4}| \leq \frac{2.57474^3}{12n^2} \cdot 160 \rightarrow n_{Trapezoidal} \geq 1507 \quad (2)$$

$$|10^{-4}| \leq \frac{2.57474^5}{180n^4} \cdot 360 \cdot 1.57474^2 \rightarrow n_{Simpson} \geq 50 \text{ It must be even!} \quad (3)$$

2, 3. The results are presented in [Figure 4](#). As we can see, the Simpson's method is more precise in low iterations, then Trapezoidal method is more precise as  $N$  increases. However, for Monte Carlo, it is more dependent on the random process. For instance, we can see with seed **137**, and 1000 iterations, its error is less than the error of the Simpson's method.

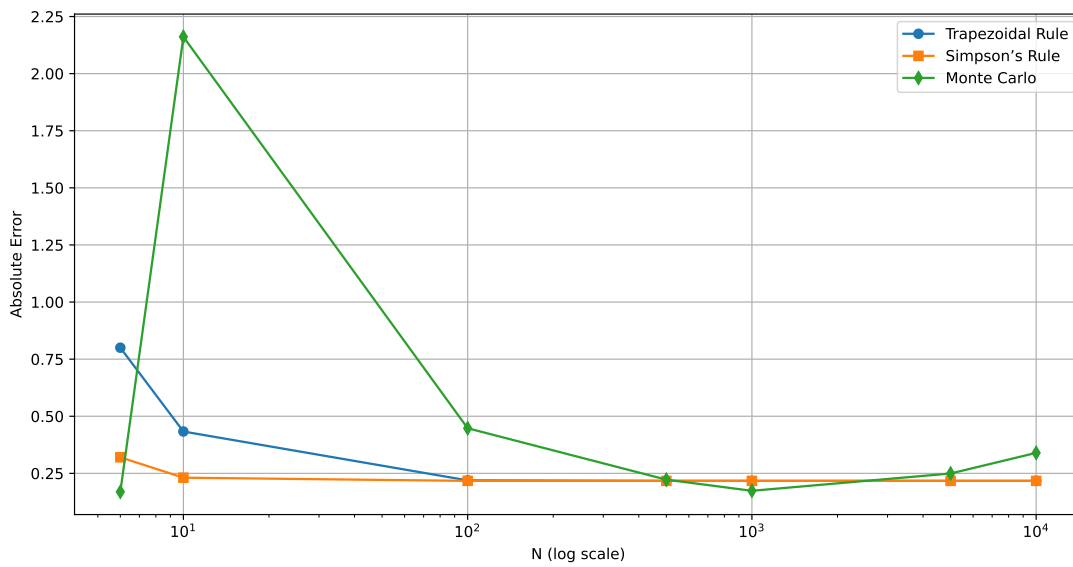


Figure 4: Absolute Errors vs  $N$

4. Taking log from both sides of the error terms, we have:

$$\log E_{\text{Trap}} \sim -\log(n^2) \quad (4)$$

$$\log E_{\text{Simp}} \sim -\log(n^4) \quad (5)$$

$$\log E_{\text{MC}} \sim -\log(\sqrt{n}) \quad (6)$$

It is consistent with the results in the [Figure 4](#). As we can see, the error of the Simpson's decreasing faster than the other method as  $n$  increases.

5. Trapezoidal method is simpler to implement, but it is slower in convergence rather than Simpson method. Simpson method is more precise in lower iterations, but it requires an even number of intervals. Both of them also require the function to be twice differentiable. For Simpson, it is more restrictive, as it requires the function to be four times differentiable. Monte Carlo method is more flexible, as it does not require the function to be differentiable. However, it is more dependent on the random process, and it is slower than the other methods. It is also more computationally expensive as it requires a large number of samples for high accuracy.

### 3 Portfolio selection and Value at Risk

In this question, I implicitly assume that returns are normally distributed and will derive the confidence intervals based on this assumption. Bob can reject that Alice's portfolio were optimally chosen only if there is no interaction between Alice's MVF and Bob's CI. The results are presented in Figure 5. I used seed number 137 for the Monte Carlo simulation.

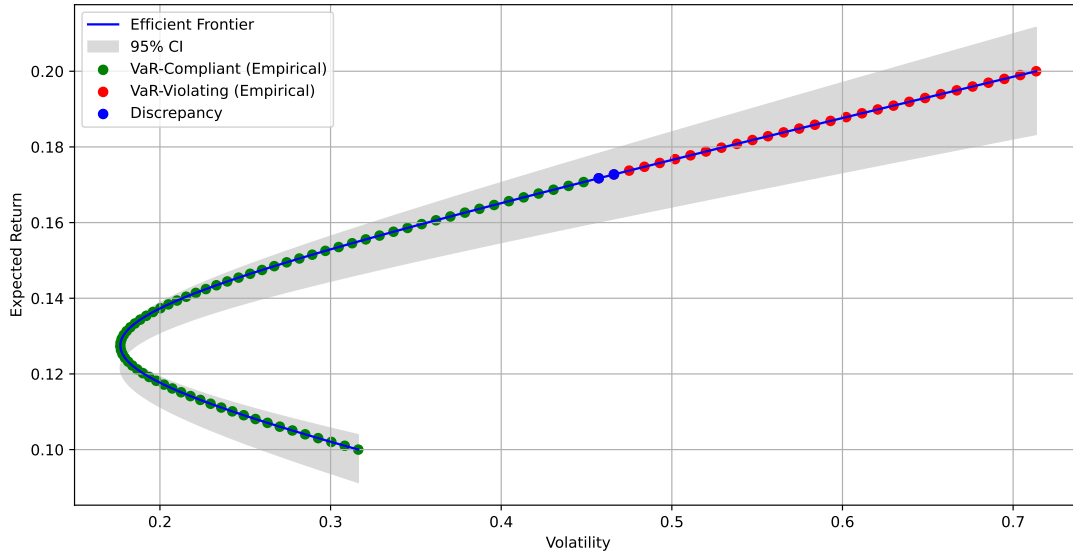


Figure 5: Efficient Frontier with Confidence Intervals and Empirical VaR Compliance

To find the upper bound on the volatility we can use the following formula:

$$\sigma_{\max} = \frac{r_{\min} + \bar{V}}{\Phi^{-1}(\lambda)} \quad (7)$$

where I use the minimum target return as  $r_{\max}$ . Using this formula we can find the upper bound on the volatility:

$$\sigma_{\max} = 0.3337 \quad (8)$$

Comparing the theoretical and empirical VaR, we need to consider that the theoretical one is not necessarily like the empirical one and that is because the returns are not necessarily normally distributed. The normal distribution is symmetric, but the returns are not necessarily symmetric. In this case, since the distributions of the returns are pretty like each other, the return distribution of Alice is also looks like normal and we have the same VaR-compliant portfolios. The only difference between them is mostly because of the randomness of the Monte Carlo data generation algorithm (blue dots in Figure 5). However, in general, the theoretical VaR is not necessarily like the empirical VaR.

The distribution of the returns for Bob's and Alice's are depicted in Figure 6.

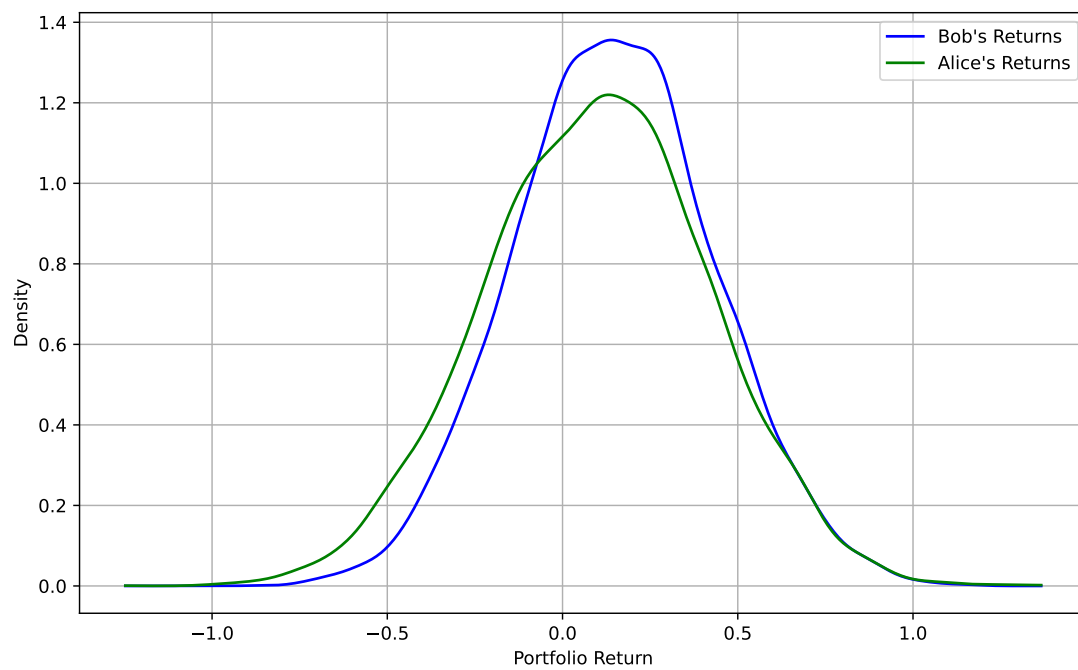


Figure 6: Distribution of Bob's and Alice's Returns