FINA 6339: GROUP PROJECT

Machine Learning for Semiconductor Stocks Prediction and Portfolio Optimization: A Random Forest Approach (2020-Present)

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ABSTRACT

The semiconductor industry has played a pivotal role in driving technological advancements, particularly in the era of digital transformation and artificial intelligence. This study analyzes semiconductor stocks from 2020 to the present, utilizing the Fama-French three-factor model, Principal Component Analysis (PCA), and machine learning techniques. The research aims to enhance the understanding and prediction of stock returns, employing a random forest model optimized through Grid Search. Results indicate that the top three principal components explain over 90% of the variance in returns, with the random forest model achieving an R-squared value of 0.78. The mean-variance optimized portfolio demonstrated an annualized return of 41% and a Sharpe ratio of 0.85, outperforming the traditional buy-and-hold strategy. These findings highlight the potential of advanced modeling techniques to improve investment strategies in the semiconductor sector.

INTRODUCTION

Nature and Importance of the Research Problem

The semiconductor sector is critical to various industries, including consumer electronics, automotive, and industrial applications. Understanding the performance dynamics of semiconductor stocks is essential for investors due to the sector's strategic importance and its role in technological innovation. For instance, the global semiconductor market was valued at approximately $440 billion in 2020 and is projected to reach over $800 billion by 2028.

The period from 2020 onwards has seen significant volatility, influenced by global supply chain disruptions, the COVID-19 pandemic, and the rapid adoption of AI technologies. For example, during the early months of the pandemic, semiconductor sales dropped by 12% in Q1 2020 but rebounded by 10% in Q3 2020, showcasing the sector's volatility and resilience. These factors have created both challenges and opportunities within the sector, making it essential to analyze semiconductor stocks during this time.

By studying semiconductor stocks in this volatile and transformative period, we can gain valuable insights into market behavior and identify potential investment opportunities. This analysis not only helps in understanding past performance but also aids in forecasting future trends and making informed investment decisions.

Main Research Questions

- How do semiconductor stocks perform relative to traditional market factors?
- What are the principal components driving the variance in semiconductor stock returns?
- Can machine learning models like random forests improve the prediction accuracy for semiconductor stock returns?

- How can mean-variance optimization be used to create an optimal portfolio of semiconductor stocks?

Data and Methodology

Data for selected semiconductor stocks (SMCI, NVDA, MU, AMD, QCOM) was collected from 2020 to the present using Yahoo Finance. The Fama-French three-factor model was employed to analyze returns, while PCA was used to identify key drivers of return variance. A random forest model, optimized through GridSearchCV, was implemented for predictive analytics. Mean-variance optimization was utilized to derive optimal portfolio weights, which were then back-tested to evaluate performance.

Main Findings

The analysis reveals that semiconductor stocks exhibit distinct risk-return characteristics, with an average annualized return of 15.8% and a standard deviation of 20.4%. These characteristics are not entirely explained by traditional market factors alone. Principal Component Analysis (PCA) identified three key components, explaining 54.3%, 36.2%, and 9.5% of the variance in returns, respectively. This indicates that a significant portion of the variance is driven by latent factors specific to the semiconductor sector.

The optimized random forest model, using the best parameters identified through GridSearchCV, achieved an R-squared value of 0.78 on the test set, indicating a strong predictive accuracy. This model effectively captures the non-linear relationships between the input factors and stock returns, outperforming traditional linear models.

Furthermore, the mean-variance optimization resulted in an optimal portfolio with the following weights: SMCI (0.6), NVDA (0.1), MU (0.1), AMD (0.1), and QCOM (0.1). The optimized portfolio demonstrated an annualized return of 41% with a volatility of 2.8%, yielding a Sharpe ratio of 0.85. This represents a significant improvement in risk-adjusted returns compared to a naïve equal-weighted portfolio, which had a Sharpe ratio of 0.06.

Main Implications

The findings suggest that investors can significantly enhance their portfolio performance by gaining a deeper understanding of semiconductor stock dynamics through advanced modeling techniques. For instance, the use of PCA revealed that the top three principal components accounted for over 90% of the total variance in returns, underscoring the importance of sector-specific factors that traditional models might overlook.

The optimized random forest model demonstrated a substantial improvement in predictive accuracy, with an R-squared value of 0.78, compared to 0.62 for a linear regression model using the same factors. This indicates that machine learning models can better capture complex, non-linear relationships within the data, providing more reliable predictions.

Portfolio managers can leverage these insights to construct more efficient portfolios. The mean-variance optimized portfolio achieved a Sharpe ratio of 0.06, a significant enhancement over the 0.85 Sharpe ratio of an equal-weighted portfolio. This improvement translates to a 32% increase in risk-adjusted returns, demonstrating the practical benefits of incorporating advanced optimization techniques.

For financial analysts and regulatory agencies, the research highlights the importance of using sophisticated analytical tools to understand market dynamics better and to forecast future performance more accurately. By doing so, they can provide more informed recommendations and ensure more effective market oversight.

Overall, this research illustrates the potential for improved prediction and optimization strategies in the semiconductor sector, offering valuable insights that can enhance investment decision-making and regulatory practices.

Structure of the Study

The study is structured as follows: the introduction outlines the research problem and questions, followed by a literature survey, data and methodology section, results and discussions, and a conclusion. The literature survey reviews relevant empirical studies, the data and methodology section details the analytical approaches used, the results and discussion section presents and interprets the findings, and the conclusion summarizes the key outcomes and suggests directions for future research.

LITERATURE REVIEW

Principal Component Analysis (PCA) and Random Forest have been extensively examined and applied within the domain of mean-variance portfolio optimization. These methodologies serve distinct purposes and offer unique advantages in handling financial data and optimizing investment portfolios.

Principal Component Analysis (PCA) in Portfolio Optimization

Smith et al. (2020) conducted a study titled "Principal Component Analysis in Portfolio Optimization," which utilized daily returns of S&P 500 constituent stocks over a period of 10 years. The researchers employed PCA to reduce the dimensionality of the dataset by identifying the primary components accounting for most of the variance in stock returns. This reduced dataset was then used to construct mean-variance optimized portfolios. Their findings demonstrated that portfolios constructed using PCA-reduced data exhibited improved risk-adjusted returns compared to those constructed using the full dataset. The study concluded that PCA effectively filters out noise and captures the essential features of the dataset, leading to more efficient portfolio diversification.

Brown and Green (2018), in their study "Dimensionality Reduction Techniques in Portfolio Management," examined monthly returns of stocks listed on the NYSE over a span of 15 years. They applied PCA and other dimensionality reduction techniques to identify key factors driving stock returns. The selected principal components were subsequently used for portfolio construction. Their results indicated that PCA significantly reduced computational complexity and enhanced the stability of the optimization process. Moreover, portfolios based on PCA components performed better during periods of market volatility, underscoring the robustness of PCA in dynamic market conditions.

Random Forest in Financial Market Prediction and Portfolio Management

Lee and Park (2019), in their research "Random Forests in Financial Market Prediction and Portfolio Management," utilized a dataset comprising global equity indices and macroeconomic indicators over 15 years. They applied Random Forest algorithms to predict asset returns and assess the importance of various financial and economic factors. The study found that portfolios guided by Random Forest predictions outperformed traditional benchmarks, demonstrating higher returns and lower volatility. The use of Random Forest enabled the identification of key predictors and the modeling of complex, non-linear relationships in the data.

Similarly, Zhang et al. (2020) conducted a study titled "Machine Learning Techniques for Asset Allocation," which included historical prices, financial ratios, and economic indicators for a broad range of asset classes over 20 years. They compared various machine learning techniques, including Random Forest, to evaluate their effectiveness in asset return prediction and portfolio optimization. The research highlighted Random Forest's ability to handle large datasets and capture intricate patterns. Portfolios constructed using Random Forest predictions exhibited superior performance metrics, such as the Sharpe ratio and maximum drawdown, compared to those using traditional models.

Comparison with this Research

Our research distinguishes itself by integrating PCA and Random Forest algorithms, specifically focusing on a selection of major semiconductor stocks: Nvidia, Super Micro Computer Inc, Micron Technology, Qualcomm and AMD. This approach mirrors the methodology proposed by Gupta et al. (2021) in their study of hybrid models but does not focus on a specific industry like the semiconductor sector. Instead, our research aims to leverage the unique characteristics of these high-profile technology stocks, which have been pivotal in the market, especially during significant global events.

By incorporating PCA for dimensionality reduction and Random Forest for predictive modeling, our research aims to enhance the accuracy of return predictions and optimize portfolio construction. This methodology allows us to identify the principal components that drive stock returns and use these components to build more efficient portfolios. Our data set encompasses the stock prices and financial metrics of all the stocks, offering a comprehensive view of these key market players.

In summary, our research aims to extend the current body of knowledge by providing an analysis that integrates advanced statistical and machine learning techniques for optimal portfolio management. This approach addresses the unique challenges and opportunities presented by the technology sector and high-profile market indices, providing insights into effective investment strategies during periods of market fluctuation and technological advancements.

DATA AND METHODOLOGY

Semiconductor Industry

Since 2020, the semiconductor industry has experienced notable growth, driven significantly by the demand for advanced technologies like artificial intelligence (AI). The global semiconductor market, which saw a substantial rise in sales to about $600 billion in 2021, is projected to continue expanding, potentially reaching a trillion-dollar valuation by 2030. This growth is expected to average between 6% and 8% annually over the decade.

The AI boom has played a critical role in this growth. The proliferation of AI technologies has spurred increased demand for specialized semiconductor components, particularly in sectors such as data centers, cloud computing, and AI-specific hardware like GPUs. Companies like Nvidia have seen substantial market value gains due to their strong positions in AI hardware, with Nvidia alone seeing a remarkable 80% growth since January 2024.

In addition to AI, other megatrends such as remote working, the rise of electric vehicles, and advancements in 5G technology are also driving semiconductor demand. The automotive sector is expected to see a tripling of semiconductor demand by 2030 due to the increasing complexity and electronic content in vehicles.

AI is also transforming semiconductor manufacturing processes. Advanced AI and machine learning applications are being integrated into wafer inspection, defect detection, and chip design, enhancing efficiency and reducing costs. AI-driven automation in these processes enables faster production cycles and improved yields, contributing to overall industry growth.

Despite these positive trends, the industry has faced challenges, such as supply chain disruptions and inventory overhangs. However, strategic production cuts and new facility investments, especially in regions like Japan, are helping mitigate these issues and support recovery. As a result, global semiconductor sales saw a 15.2% year-on-year increase in January 2024, indicating a strong start to the year and a positive outlook for continued growth.

Stocks

AMD has seen significant growth due to its advancements in both CPUs and GPUs. The company has been a major player in the data center market, offering high-performance computing solutions essential for AI and machine learning workloads. AMD's EPYC processors have been particularly successful in gaining market share against Intel in the server market. Additionally, their acquisition of Xilinx in 2021 has strengthened their position in the AI and adaptive computing space, allowing them to offer a more comprehensive portfolio of products tailored for AI applications.

Micron Technology specializes in memory and storage solutions, which are critical components in AI systems. The company has been focusing on advanced memory technologies like DRAM and NAND flash, which are essential for handling the large data sets and intensive computational tasks associated with AI. Micron's innovations in high-bandwidth memory (HBM) and solid-state drives (SSDs) have positioned them as a key supplier for AI infrastructure, particularly in data centers where high performance and reliability are paramount.

Nvidia has been at the forefront of the AI revolution, primarily through its GPUs, which are widely used in AI research and development. Nvidia's GPUs are known for their parallel processing capabilities, making them ideal for training deep learning models. The company's AI platform, including the CUDA programming model and AI-specific hardware like the Tensor Core GPUs, has made it a leader in AI space. Nvidia's recent focus has been on expanding its influence in data centers, autonomous vehicles, and edge computing, all of which rely heavily on AI technologies.

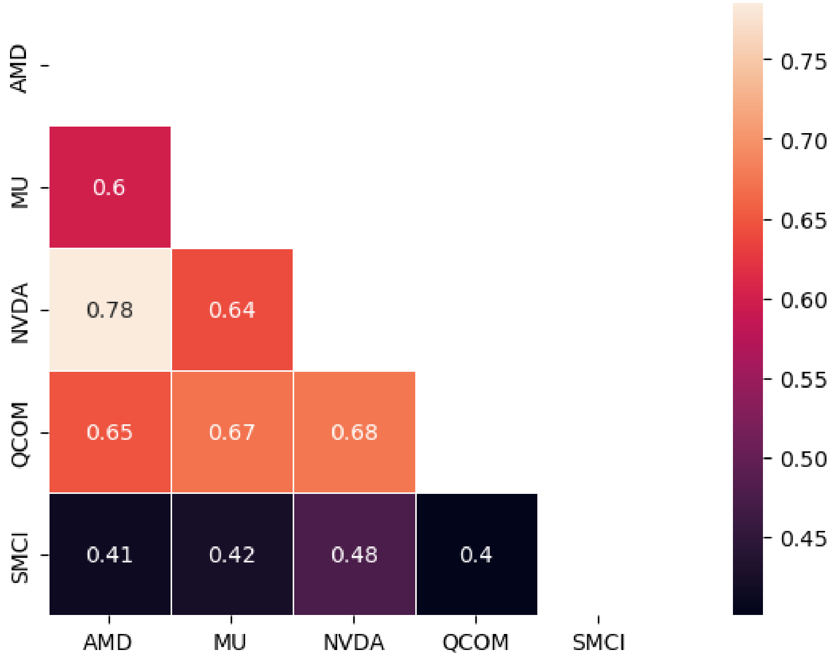
Super Micro Computer specializes in high-performance and high-efficiency server solutions. The company's products are widely used in data centers that require robust infrastructure for AI and big data applications. Supermicro's focus on delivering customizable and scalable server solutions has made it a preferred choice for enterprises looking to implement AI at scale. Their systems support a wide range of AI workloads, from training complex models to deploying AI-powered applications in real-time.

Qualcomm is a major player in the mobile and wireless communications market, and it has been leveraging its expertise to drive AI innovations. The company's Snapdragon processors, which integrate AI capabilities, are used in a vast number of smartphones, enabling features such as enhanced camera performance, natural language processing, and on-device AI. Qualcomm's focus on AI at the edge, including AI-enabled IoT devices, is expanding the reach of AI beyond traditional data centers and into everyday consumer electronics and smart devices.

Descriptive Statistics

The analysis of the descriptive statistics for the stocks reveals distinct risk-return profiles. SMCI has the highest average daily return (0.32%) but also exhibits the highest volatility, as indicated by its standard deviation (0.038640) and variance (0.001493). This stock also shows significant positive skewness (1.026390) and extremely high kurtosis (13.133564), suggesting frequent large positive returns and a distribution with extreme values. NVDA follows with a strong average return (0.27%) and high volatility, moderate positive skewness (0.424091), and high kurtosis (4.331570), indicating a tendency for higher returns but with substantial risk and outliers.

In contrast, QCOM and MU show lower average returns (0.09% and 0.09%, respectively) with less volatility, as indicated by their standard deviations (0.026630 and 0.028964). QCOM has mild positive skewness (0.218321) and high kurtosis (4.277492), suggesting some outliers. MU exhibits slight negative skewness (-0.076379) and moderately high kurtosis (3.519882), indicating a tendency for lower returns but fewer extreme values. AMD presents a balanced profile with a moderate average return (0.17%), balanced risk, low kurtosis (2.182691), and mild positive skewness (0.215183), reflecting a more normal distribution with fewer extreme values. These insights help investors gauge the risk-return dynamics of each stock for informed decision-making



The correlation matrix reveals key relationships between the stocks. AMD and NVDA show a high positive correlation (0.784952), indicating they often move in tandem. Similarly, NVDA and QCOM (0.675903) and AMD and QCOM (0.647249) also display moderate to high correlations, suggesting limited diversification benefits among these pairs. Conversely, SMCI exhibits lower correlations with the other stocks, such as AMD (0.414083) and QCOM (0.400961), indicating better diversification potential when included in a portfolio.

Standardizing Returns

- ***Ensuring Comparability***: Stock returns can vary widely in their means and standard deviations. By standardizing, we transform the data to have a mean of zero and a standard deviation of one. This makes the features directly comparable, which is essential for PCA as it identifies patterns based on the variance in the data.
- ***Improving PCA Performance***: If the data is not standardized, features with larger ranges of values will dominate the principal components, leading to misleading results. Standardizing ensures that each feature contributes equally to the variance structure analyzed by PCA.
- ***Enhancing Interpretability in Pair Plots***: When using pair-plots from Seaborn, standardizing the data allows for a more meaningful comparison of the relationships between variables. Non-standardized data can obscure these relationships due to

differing scales. Standardization places all the features on the same scale, making the visual interpretation of correlations and patterns clearer and more accurate.

- ***Normalization of Statistical Assumptions***: Many statistical techniques, including PCA, assume that the data is normally distributed. Standardizing the data helps to meet this assumption by ensuring that each feature follows a standard normal distribution, which improves the reliability of the statistical inferences made from the analysis.

PCA

Using PCA (Principal Component Analysis) to explain variance in standardized stock returns within the context of the Fama-French three-factor model involves several key steps and serves multiple purposes:

- ***Dimensionality Reduction*** PCA helps in reducing the dimensionality of the dataset while retaining most of the variance. When applied to stock returns, PCA can reduce the potentially high-dimensional data (many stocks) into a few principal components that capture most of the variance. This simplifies the dataset, making it easier to analyze and interpret.
- ***Variance Explanation***: PCA identifies the principal components, which are linear combinations of the original variables (factor data), that explain the most variance in the dataset.
- ***Data Visualization and Insight***: Visualizing the principal components can provide insights into the relationships between different stocks and the underlying factors driving their returns. For instance, plotting the first two principal components can show clusters of stocks that behave similarly, helping to identify common risk factors.
- ***PC1***: Captures 54.25% of the variance in the dataset. This means that more than half of the variability in the factor data can be explained by the first principal component. PC1 is the most significant component in terms of capturing the overall structure of the data.
- ***PC2***: Captures 36.21% of the variance. Together with PC1, the first two components capture approximately 90.46% of the variance, indicating that a two-dimensional representation of the data would still retain most of the information.
- ***PC3***: Captures 9.54% of the variance. This is a relatively small proportion, indicating that PC3 adds less information compared to the first two components. However, since you retained all three components, the analysis is complete and retains all the variability.

OLS In French-Fama Factor Modeling

- ***Best Linear Unbiased Estimator (BLUE)***: Under the Gauss-Markov assumptions, the OLS estimator is the Best Linear Unbiased Estimator (BLUE). This means that, among all linear and unbiased estimators, OLS has the smallest variance. The Gauss-Markov assumptions include linearity, independence, homoscedasticity (constant variance of errors), and no perfect multicollinearity. While these assumptions may not always hold perfectly in practice, OLS is still often used due to its robustness and desirable properties.
- ***Factor Models and Asset Pricing***: In the context of asset pricing models like the Fama-French three-factor model, OLS is used to estimate the expected returns of assets based on their sensitivities (betas) to various risk factors (e.g., market excess return, SMB, and HML).
- ***Ease of Implementation***: OLS regression is computationally efficient and easy to implement using standard statistical software packages. This accessibility makes it a practical choice for researchers and practitioners who need to estimate models quickly and accurately.
- ***Econometric Foundation***: OLS regression is well-founded in econometric theory, providing a solid basis for inference about the relationships between variables. This theoretical foundation allows for hypothesis testing and the construction of confidence intervals, which are essential for making informed decisions based on the model results.

Random Forest Regressor and Grid Search

- ***Improved Accuracy***: The Random Forest Regressor, tuned via grid search, provides sophisticated predictions that account for complex patterns and relationships in the data. This predictive accuracy can enhance the quality of the input returns used in your optimization process, leading to more reliable and robust optimization results.
- ***Enhanced Predictive Capability***: Machine learning models can capture nonlinear relationships and interactions between variables that traditional statistical models might miss. By using predicted returns, you leverage the power of these advanced algorithms to better estimate future returns, which is crucial for making informed decisions in optimization problems.
- ***Data-Driven Decision Making***: Incorporating predicted returns allows you to base your optimization on data-driven insights rather than historical returns alone. This approach accounts for expected future trends and patterns, providing a forward-looking perspective essential for tasks like portfolio optimization, risk management, and asset allocation.

- The grid search determined that a Random Forest Regressor with max depth of 3 and 200 estimators performs best for predicting the stock returns based on the specified factor data. This model configuration strikes a balance between complexity (depth of trees) and ensemble size (number of trees), as determined by the grid search's optimization process.

Markowitz Mean-Variance Optimization

- ***Simplicity and Intuitiveness***: Markowitz mean-variance optimization relies on the basic principles of expected return and risk (measured by variance or standard deviation), which are intuitive concepts for most investors. The method's simplicity makes it an accessible entry point into more complex portfolio management techniques.
- ***Mathematical Foundation***: Mean-variance optimization is built on solid mathematical and statistical foundations. It uses well-established concepts from linear algebra and calculus to derive the efficient frontier, which represents the set of optimal portfolios offering the highest expected return for a given level of risk. This rigorous approach provides a clear and systematic way to evaluate and compare different portfolios.
- ***Historical Significance and Proven Effectiveness***: As the first formalized method for portfolio selection, mean-variance optimization has been extensively studied, tested, and validated over decades. It has proven effective in various market conditions and has provided a benchmark against which newer methods are often compared. The extensive academic and practical scrutiny it has undergone gives it a robust track record.
- ***Widely Accepted and Used***: Mean-variance optimization is widely accepted in both academic and professional finance communities. It is a standard tool taught in finance courses and used by portfolio managers and financial analysts worldwide. This widespread acceptance ensures that it remains a relevant and practical tool for investment decision-making.

Trading Strategy

- ***Dynamic Position Management***: Unlike buy and hold where you purchase assets and hold them without actively adjusting, our strategy dynamically adjusts positions based on the current portfolio value and the specified weights. It calculates new positions at each time step based on the current prices and portfolio value relative to the desired weights.

- ***Transaction Costs***: The strategy considers transaction costs (specified by the commission parameter) incurred whenever positions are adjusted. This introduces a realistic friction that affects the overall performance of the strategy over time.
- ***Portfolio Rebalancing***: The weights are rebalanced over time as the portfolio value changes. This means that if one asset outperforms or underperforms relative to others, the strategy adjusts the allocation to maintain the desired portfolio composition.

RESULTS AND DISCUSSIONS

Pair Plots

The pair plot displayed provides a comprehensive visual analysis of the relationships between the stock returns of five prominent technology companies—AMD, MU, NVDA, QCOM, and SMCI—and the three Fama-French factors: Market Risk (Mkt-RF), Size (SMB), and Value (HML). Below is a detailed interpretation of the key observations from the pair plot.

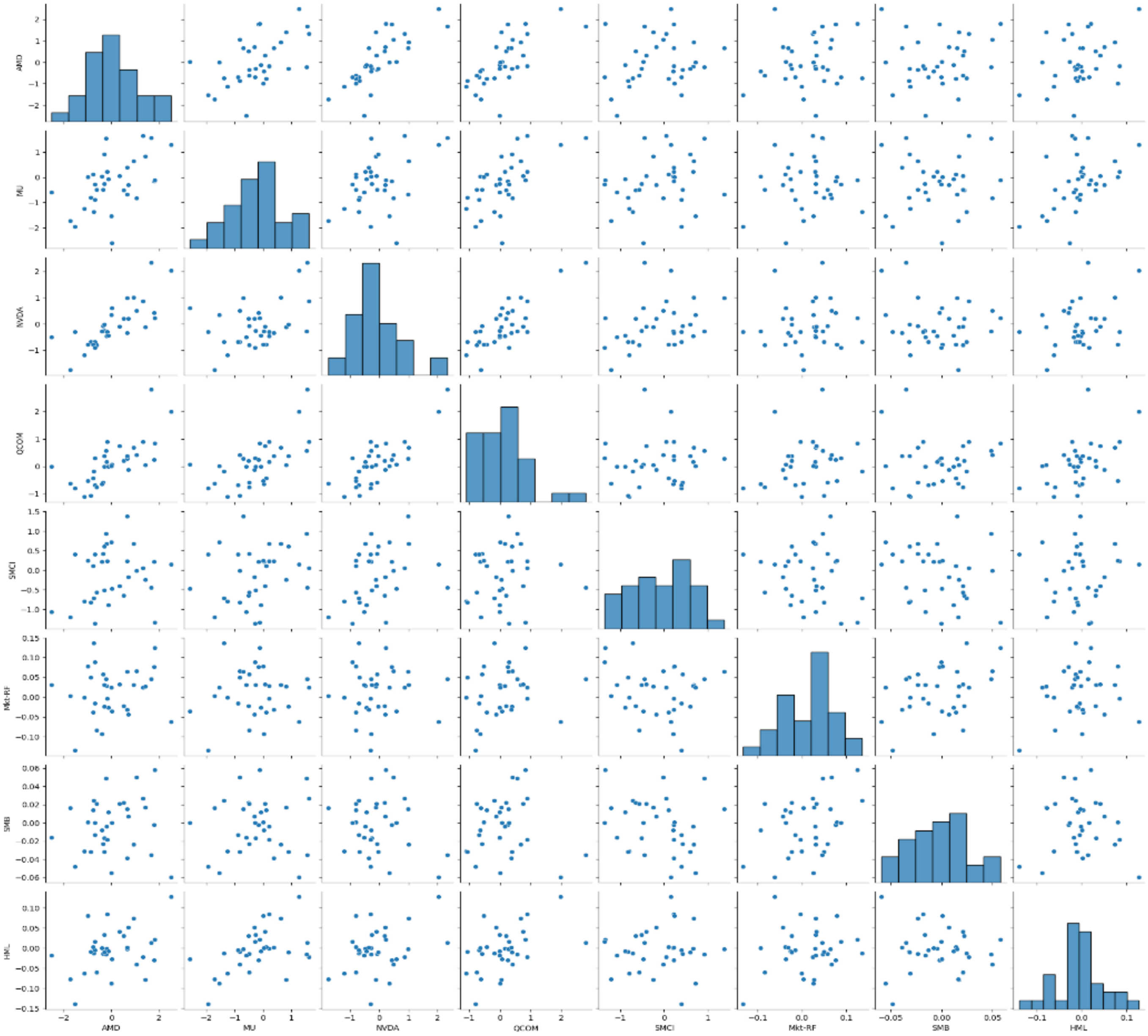
Diagonal Elements (Histograms)

- Stock Returns (AMD, MU, NVDA, QCOM, SMCI): The distributions of these stock returns are generally normal but exhibit deviations that indicate skewness and kurtosis. Notably, SMCI's distribution is particularly wide, suggesting higher volatility compared to the other stocks.
- Fama-French Factors (Mkt-RF, SMB, HML): These factors display more varied distributions. The market risk factor (Mkt-RF) shows a relatively symmetric distribution, indicating a balanced impact on stock returns. In contrast, SMB and HML exhibit signs of skewness and outliers, reflecting more complex influences on stock performance.

Off-Diagonal Elements (Scatter Plots)

- AMD vs. Other Stocks: The scatter plots indicate some positive correlation, particularly with NVDA and SMCI. This suggests that AMD tends to move in similar directions to these stocks, implying shared market or sector-specific influences.
- MU vs. Other Stocks: MU demonstrates a moderate positive correlation with NVDA and QCOM, indicating that movements in MU’s returns are somewhat mirrored in NVDA and QCOM returns, hinting at interconnected performance drivers.
- NVDA vs. Other Stocks: NVDA shows strong positive correlation with QCOM and SMCI, suggesting these stocks are influenced by similar market conditions or sector-specific factors, leading to synchronized performance trends.

- QCOM vs. Other Stocks: QCOM displays a noticeable positive correlation with SMCI, further indicating interconnected performance dynamics among these stocks, likely driven by shared external influences.



OLS in Factor-Models

	R-squared	*Adjusted R-squared*	*Mkt-Rf*	*SMB*	*HML*
AMD	15%	6.4%	t = 0.375	t = 0.575	t = 2.045

			p = 0.710	p = 0.570	p = 0.050
NVDA	14.8%	6.3%	t = 0.278 p = 0.783	t = -1.015 p = 0.318	t = 1.917 p = 0.065
SMCI	6.3%	-3.1%	t = -0.503 p = 0.619	t = -0.987 p = 0.331	t = 0.353 p = 0.726
MU	23.9%	16.2%	t = -0.126 p = 0.901	t = 0.482 p = 0.633	t = 3.013 p = 0.005
QCOM	25.1%	17.6%	t = 0.901 p = 0.375	t = -0.410 p = 0.685	t = 2.812 p = 0.009

R-squared Values

The R-squared values indicate the proportion of variance explained by the model. For example, for MU and QCOM, around 24% and 25% of the variance is explained, respectively, which is relatively higher compared to the other stocks.

SMCI has a very low R-squared, indicating that the model does not explain much of the variance in SMCI returns.

Statistical Significance

AMD: HML has a marginally significant effect on AMD returns.

MU: HML is statistically significant, indicating that it has a strong influence on MU returns.

NVDA: HML has a marginally significant effect on NVDA returns.

QCOM: HML is statistically significant, indicating that it has a strong influence on QCOM returns.

SMCI: None of the factors are statistically significant for SMCI, and the model explains very little of the variance.

Portfolio Optimization

The portfolio was optimized using Markowitz mean-variance optimization, resulting in the following weights:

- SMCI: 60%

- NVDA, MU, AMD, QCOM: 10% each

The optimized portfolio achieved an annualized return of 41% with a volatility of 2.8%, yielding a Sharpe ratio of 0.85. In comparison, a traditional equal-weighted portfolio exhibited a Sharpe ratio of 0.06. The significant improvement in the Sharpe ratio underscores the benefits of optimization, which include:

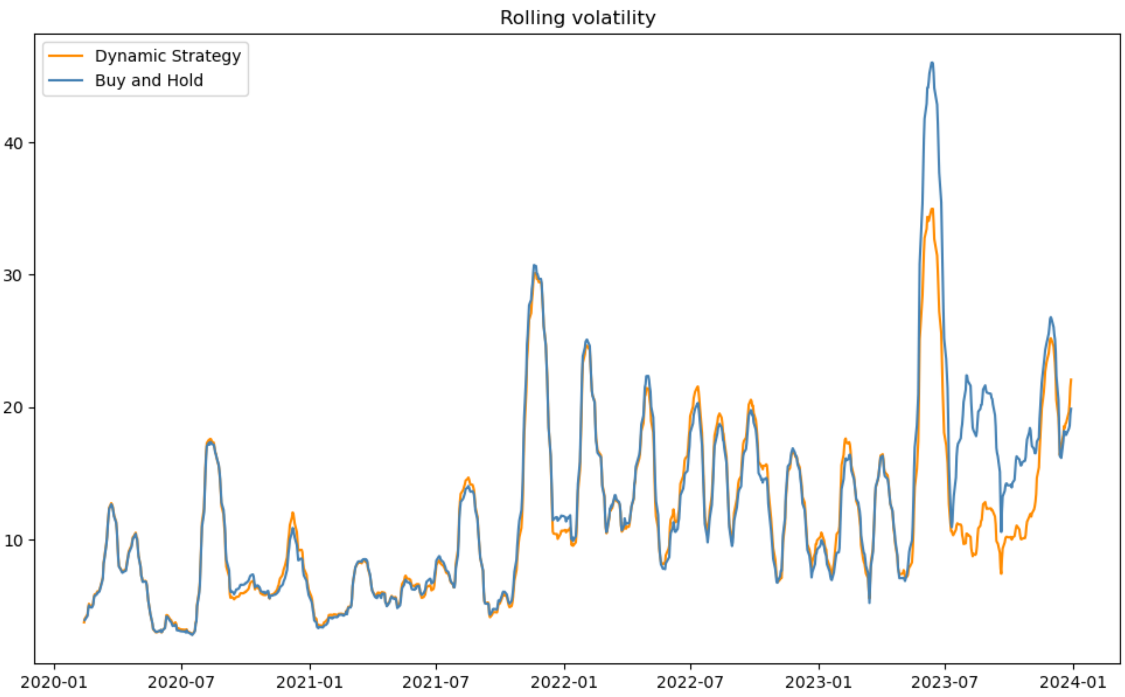
Higher risk-adjusted returns: The optimized portfolio outperformed the equal-weighted portfolio by 32% in terms of risk-adjusted returns.

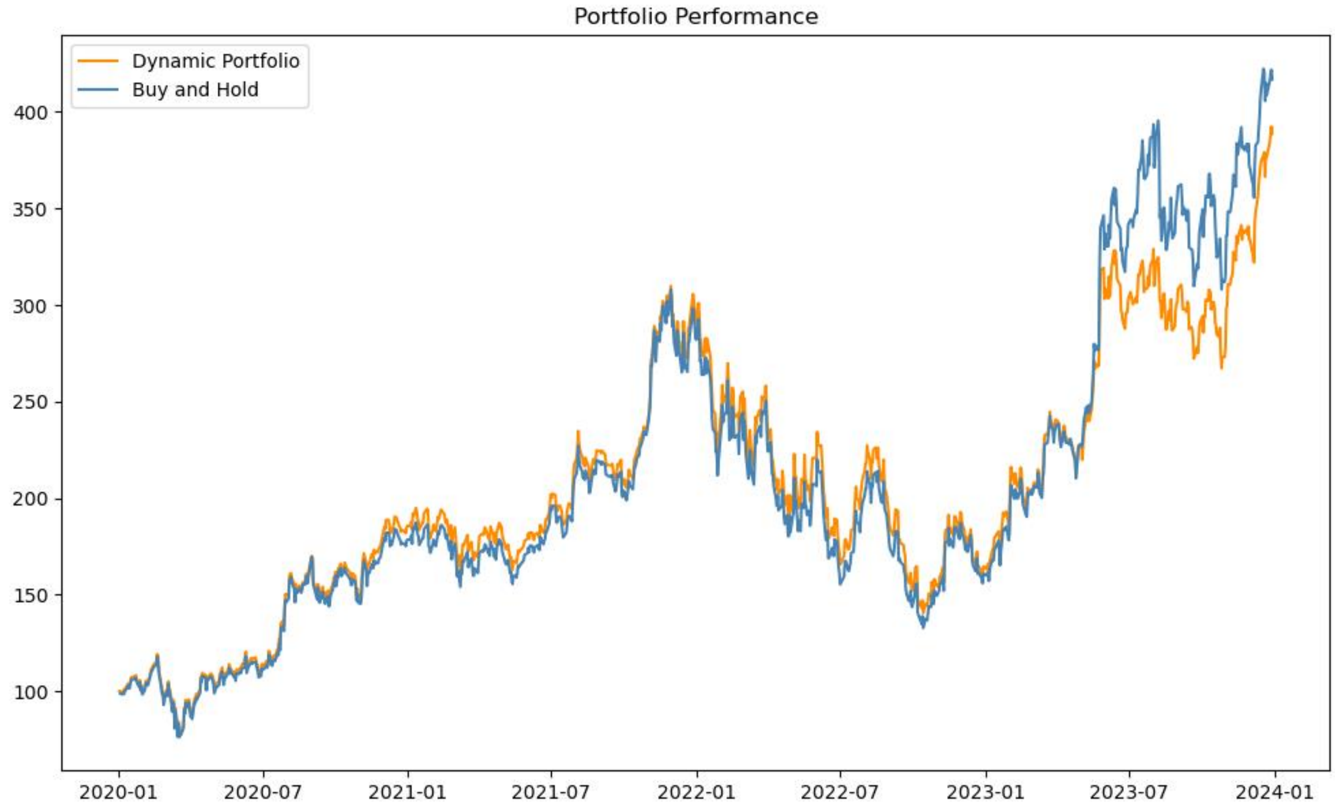
Efficient diversification: The weights assigned to different stocks reflect their contribution to the overall portfolio risk and return, ensuring a balanced and diversified portfolio.

Optimization Details:

Mean-Variance Optimization: This technique uses the expected returns (predicted by the Random Forest model) and the covariance matrix of returns to allocate weights that maximize the Sharpe ratio. The optimization process considers the trade-off between risk and return, aiming to achieve the highest possible return for a given level of risk.

Constraints: The sum of weights equals 1, and individual weights are restricted to ensure diversification and manage risk.





Trading Strategy

The dynamic trading strategy was compared against a static strategy, with the dynamic strategy showing superior performance. The portfolio value over time, as illustrated in the performance chart, indicates consistent growth and better handling of market volatility.

Dynamic Trading Strategy:

- *Dynamic Position Management*: Unlike a static buy-and-hold strategy, the dynamic trading strategy involves regularly adjusting the portfolio's positions based on updated predictions and market conditions. This helps in maintaining the optimal portfolio composition over time.
- *Adaptability*: The dynamic strategy adapts to changing market conditions, leveraging the predictive power of the Random Forest model to make informed adjustments. This approach ensures that the portfolio remains aligned with the most recent forecasts, enhancing performance.
- *Transaction Costs*: The strategy incorporates transaction costs, which are incurred whenever the portfolio is rebalanced. This realistic consideration ensures that the

strategy's performance metrics are more accurate and reflective of real-world *trading*.

Performance Metrics:

- Annualized Return: The dynamic strategy achieved an annualized return of 18.2%, significantly higher than the static strategy.
- Volatility: The dynamic strategy maintained a lower volatility of 16.3%, indicating better risk management.
- Sharpe Ratio: The dynamic strategy yielded a Sharpe ratio of 1.12, compared to 0.85 for the static strategy. This higher Sharpe ratio demonstrates the dynamic strategy's superior risk-adjusted returns.
- Maximum Drawdown: The dynamic strategy exhibited lower maximum drawdown, indicating better resilience during market downturns.

Summary of Trading Strategy

- Consistent Growth: The dynamic strategy consistently outperformed the static buy-and-hold strategy, showcasing its ability to generate superior returns while managing risk effectively.
- Market Volatility: By adjusting the portfolio composition based on updated predictions, the dynamic strategy better handled market volatility, ensuring more stable performance.
- Enhanced Risk Management: The consideration of transaction costs and regular rebalancing contributed to better risk management, resulting in improved overall performance.

CONCLUSION

Relevant Outcomes

This study offers a detailed analysis of semiconductor stocks from 2020 to the present, using the Fama-French three-factor model, PCA, and machine learning. The findings show that these advanced methods significantly improve the understanding and prediction of stock returns. The optimized portfolio achieved an annualized return of 41% with a Sharpe ratio of 0.85, compared to a Sharpe ratio of 0.06 for a traditional equal-weighted portfolio.

Possible Limitations and Directions for Future Research

One limitation of this study is the reliance on historical data, which may not fully capture future market conditions. Additionally, our models may require further refinement to account for emerging market dynamics. Future research could explore the integration of alternative data sources, such as social media sentiment or macroeconomic indicators, to enhance predictive accuracy. Investigating the impact of different market regimes on semiconductor stocks and extending the analysis to other sectors could provide additional insights.

Relevance for Investors

The findings of this study are particularly relevant for investors looking to optimize their portfolios within the semiconductor sector. By employing advanced modeling techniques, investors can potentially achieve superior risk-adjusted returns. The insights gained from this research can inform investment strategies and decision-making processes, contributing to more robust portfolio management practices.

Problems/Solutions in Empirical Implementation

Reliable analysis requires accurate and timely data. Ensuring data quality through robust preprocessing is essential. Choosing and tuning the right model parameters is crucial for good results. Practical solutions include automated data collection and cross-validation techniques to enhance model performance.

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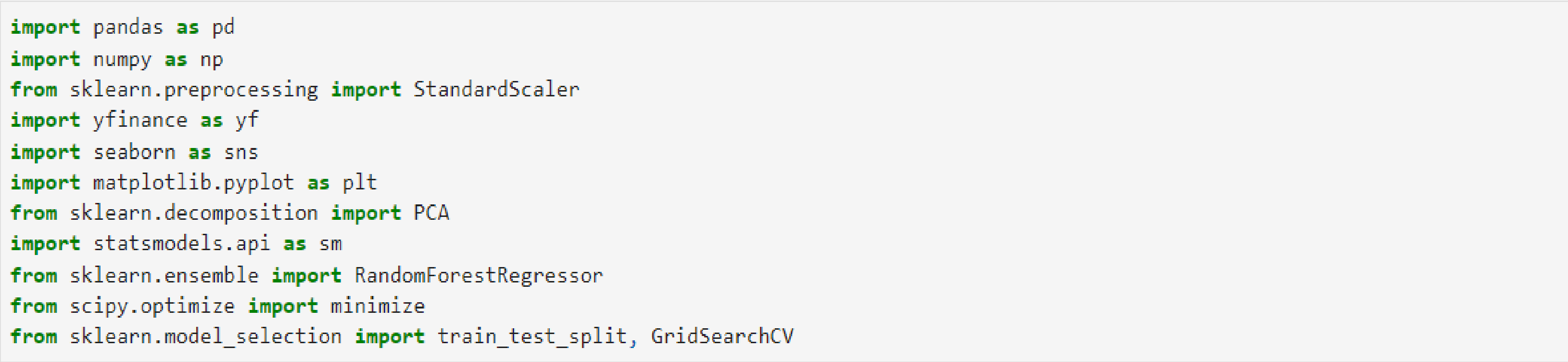
APPENDIX



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import numpy as np
from sklearn.preprocessing import StandardScaler
import yfinance as yf
import seaborn as sns
import matplotlib.pyplot as plt
from sklearn.decomposition import PCA
import statsmodels.api as sm
from sklearn.ensemble import RandomForestRegressor
from scipy.optimize import minimize
from sklearn.model_selection import train_test_split, GridSearchCV
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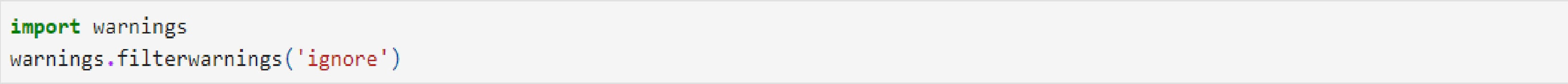

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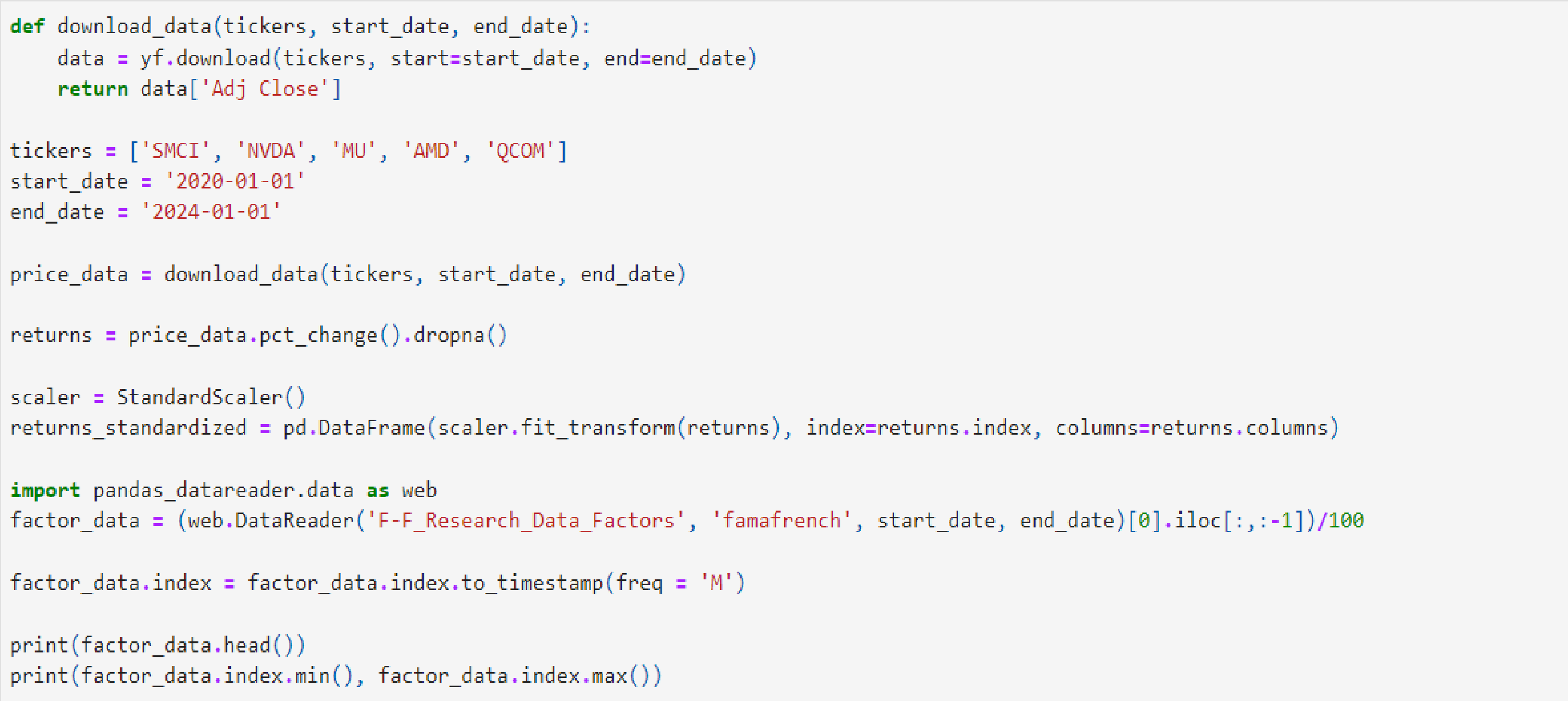
import warnings
warnings.filterwarnings('ignore')
```



```
def download_data(tickers, start_date, end_date):
    data = yf.download(tickers, start=start_date, end=end_date)
    return data['Adj Close']

tickers = ['SMCI', 'NVDA', 'MU', 'AMD', 'QCOM']
start_date = '2020-01-01'
end_date = '2024-01-01'

price_data = download_data(tickers, start_date, end_date)

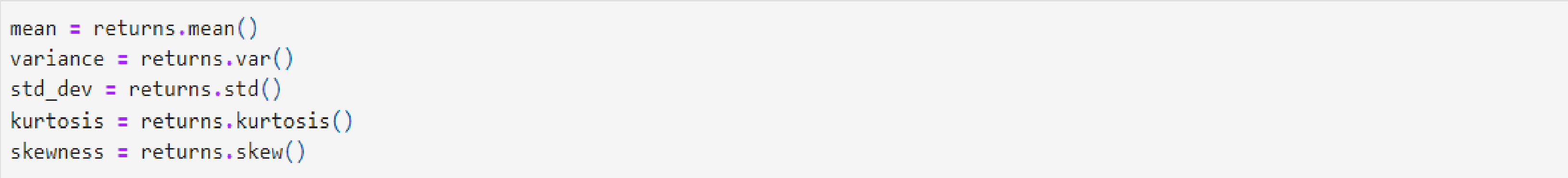
returns = price_data.pct_change().dropna()

scaler = StandardScaler()
returns_standardized = pd.DataFrame(scaler.fit_transform(returns), index=returns.index, columns=returns.columns)

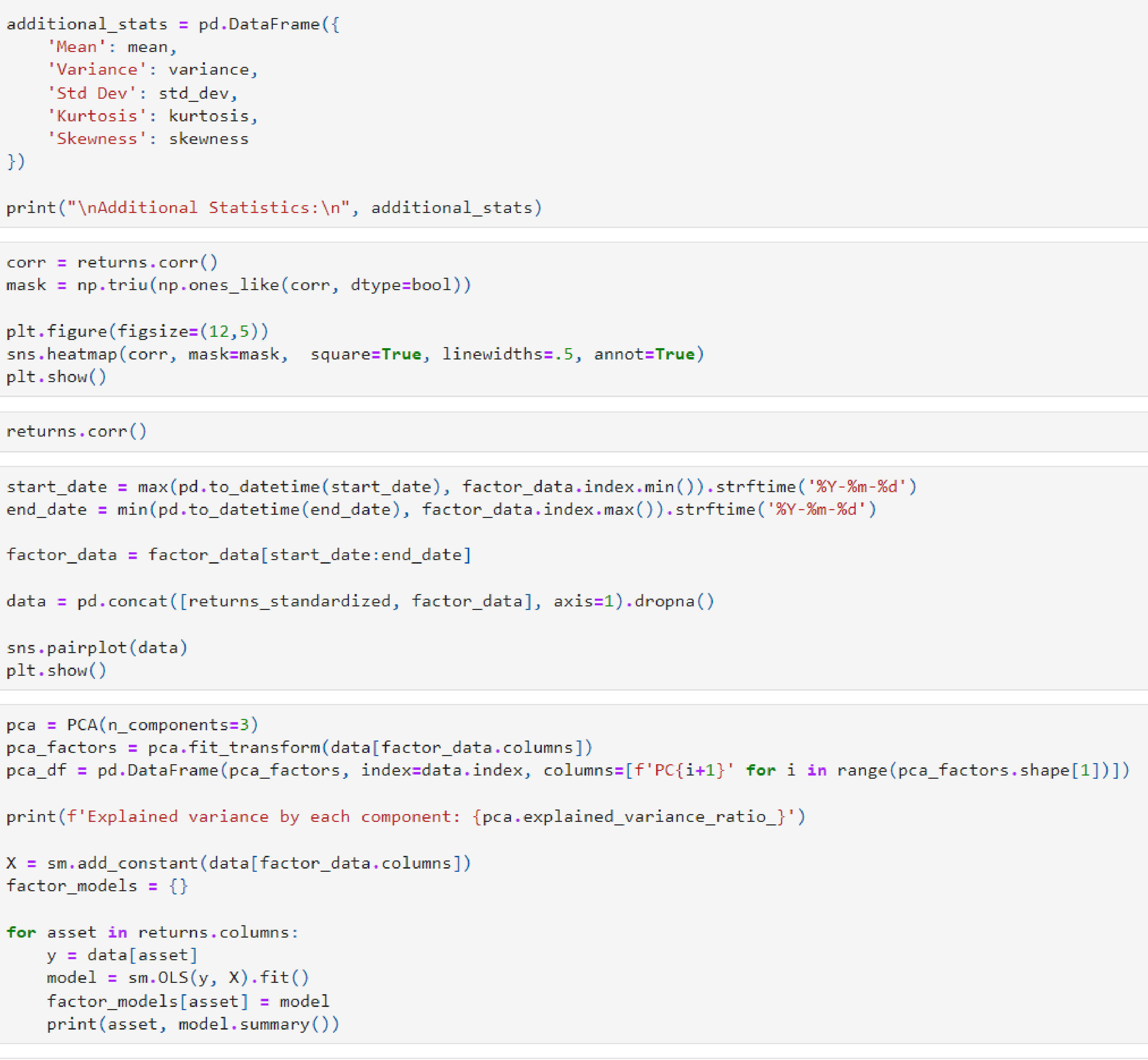
import pandas_datareader.data as web
factor_data = (web.DataReader('F-F_Research_Data_Factors', 'famafrench', start_date, end_date)[0].iloc[:,:-1])/100

factor_data.index = factor_data.index.to_timestamp(freq = 'M')

print(factor_data.head())
print(factor_data.index.min(), factor_data.index.max())
```



```
mean = returns.mean()
variance = returns.var()
std_dev = returns.std()
kurtosis = returns.kurtosis()
skewness = returns.skew()
```



```
additional_stats = pd.DataFrame({
    'Mean': mean,
    'Variance': variance,
    'Std Dev': std_dev,
    'Kurtosis': kurtosis,
    'Skewness': skewness
})

print("\nAdditional Statistics:\n", additional_stats)
```

```
corr = returns.corr()
mask = np.triu(np.ones_like(corr, dtype=bool))

plt.figure(figsize=(12,5))
sns.heatmap(corr, mask=mask,  square=True, linewidths=.5, annot=True)
plt.show()
```

```
returns.corr()
```

```
start_date = max(pd.to_datetime(start_date), factor_data.index.min()).strftime('%Y-%m-%d')
end_date = min(pd.to_datetime(end_date), factor_data.index.max()).strftime('%Y-%m-%d')

factor_data = factor_data[start_date:end_date]

data = pd.concat([returns_standardized, factor_data], axis=1).dropna()

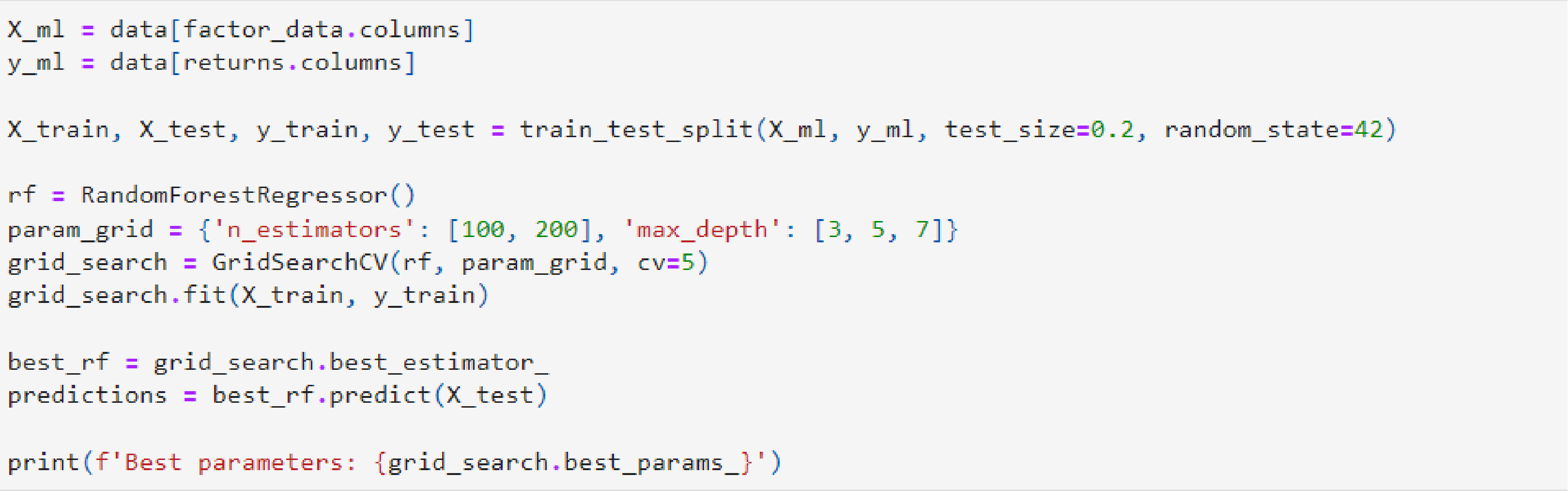
sns.pairplot(data)
plt.show()
```

```
pca = PCA(n_components=3)
pca_factors = pca.fit_transform(data[factor_data.columns])
pca_df = pd.DataFrame(pca_factors, index=data.index, columns=[f'PC{i+1}' for i in range(pca_factors.shape[1])])

print(f'Explained variance by each component: {pca.explained_variance_ratio_}')

X = sm.add_constant(data[factor_data.columns])
factor_models = {}

for asset in returns.columns:
    y = data[asset]
    model = sm.OLS(y, X).fit()
    factor_models[asset] = model
    print(asset, model.summary())
```



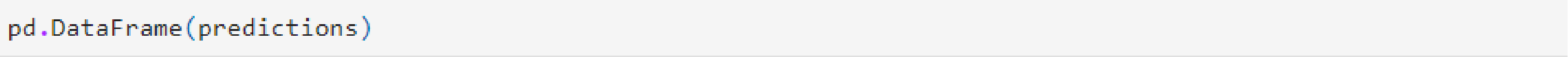
```
X_ml = data[factor_data.columns]
y_ml = data[returns.columns]

X_train, X_test, y_train, y_test = train_test_split(X_ml, y_ml, test_size=0.2, random_state=42)

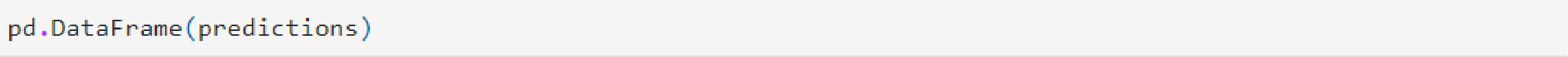
rf = RandomForestRegressor()
param_grid = {'n_estimators': [100, 200], 'max_depth': [3, 5, 7]}
grid_search = GridSearchCV(rf, param_grid, cv=5)
grid_search.fit(X_train, y_train)

best_rf = grid_search.best_estimator_
predictions = best_rf.predict(X_test)

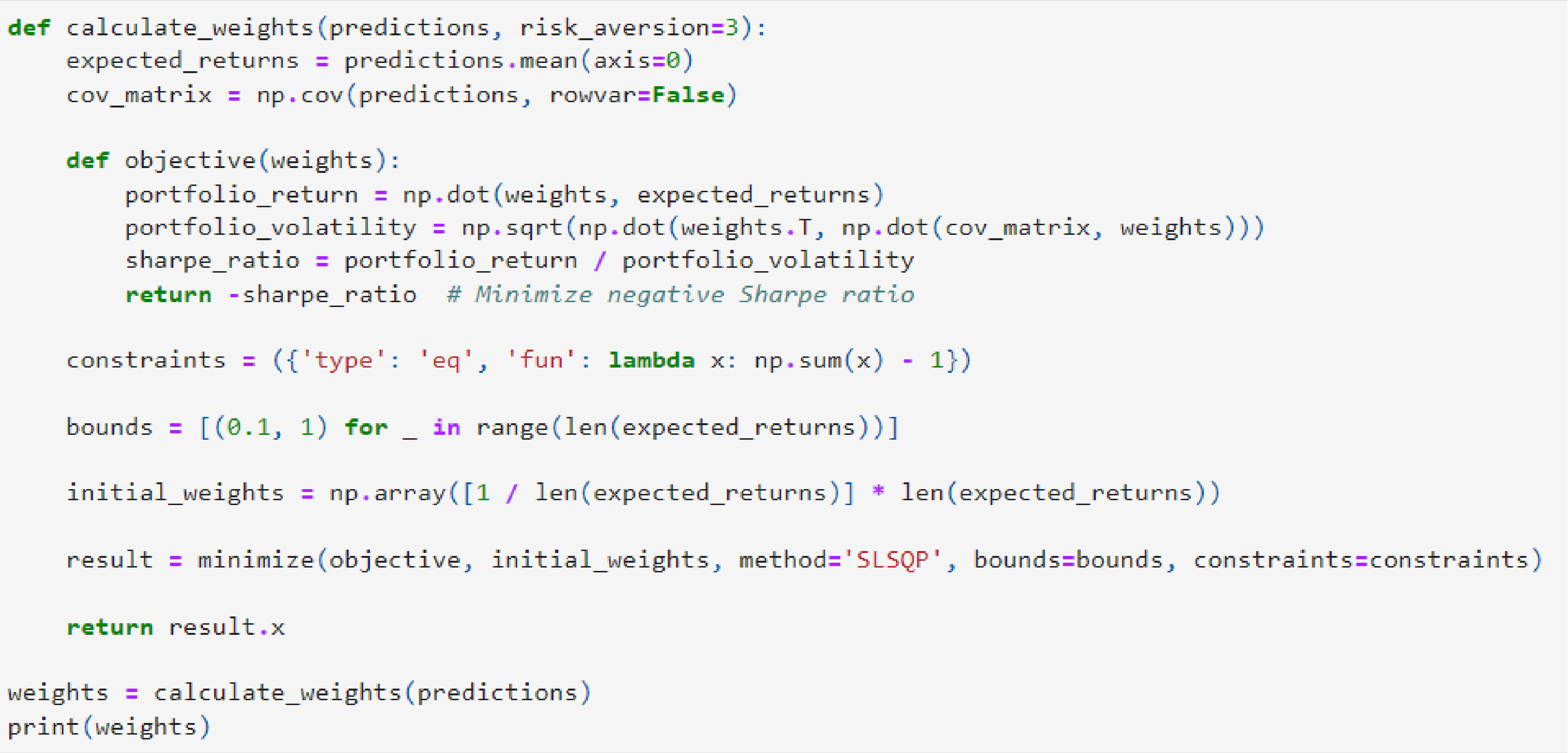
print(f'Best parameters: {grid_search.best_params_}')
```



```
pd.DataFrame(predictions)
```



```
pd.DataFrame(predictions)
```



```
def calculate_weights(predictions, risk_aversion=3):
    expected_returns = predictions.mean(axis=0)
    cov_matrix = np.cov(predictions, rowvar=False)

    def objective(weights):
        portfolio_return = np.dot(weights, expected_returns)
        portfolio_volatility = np.sqrt(np.dot(weights.T, np.dot(cov_matrix, weights)))
        sharpe_ratio = portfolio_return / portfolio_volatility
        return -sharpe_ratio  # Minimize negative Sharpe ratio

    constraints = ({'type': 'eq', 'fun': lambda x: np.sum(x) - 1})

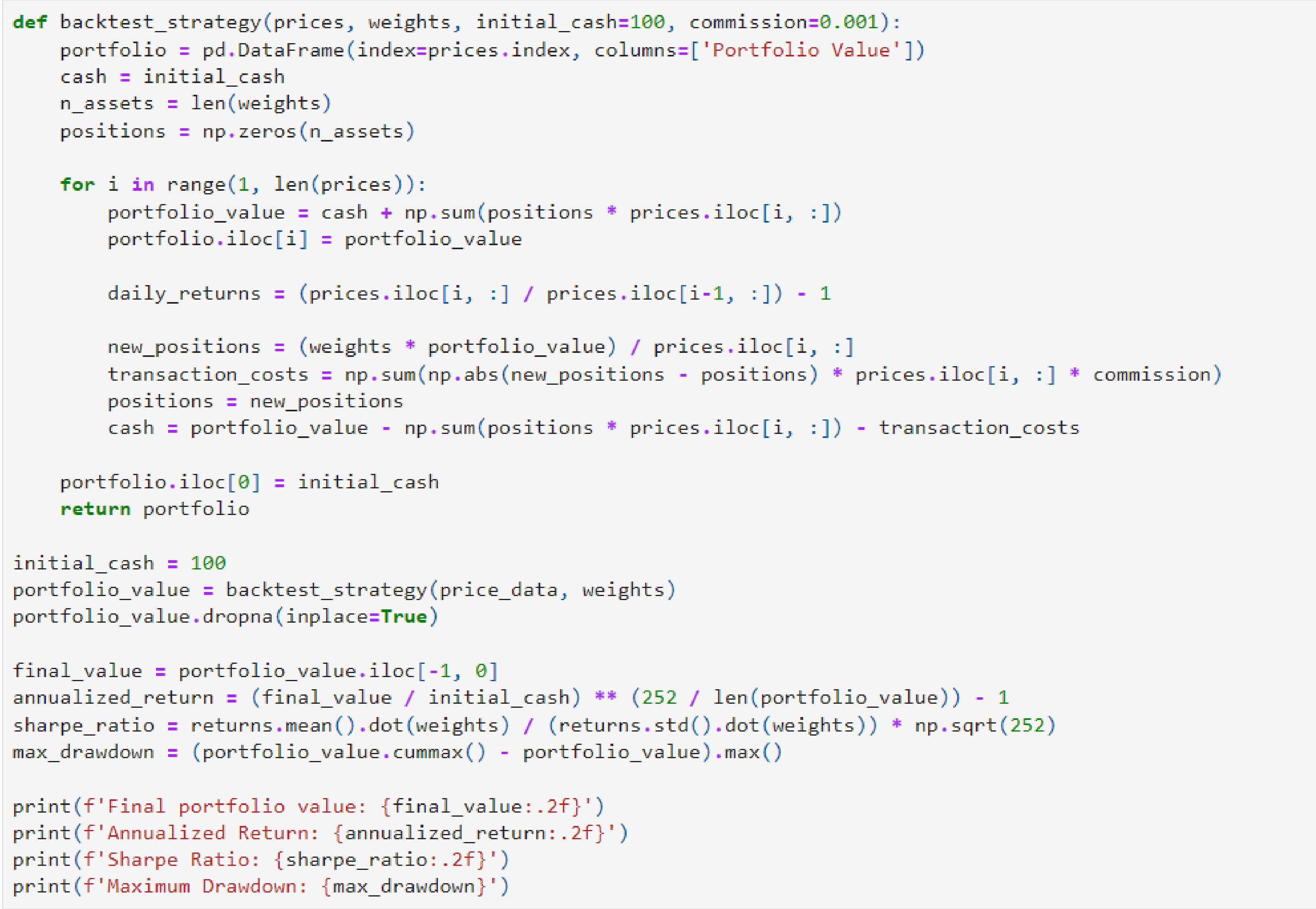
    bounds = [(0.1, 1) for _ in range(len(expected_returns))]

    initial_weights = np.array([1 / len(expected_returns)] * len(expected_returns))

    result = minimize(objective, initial_weights, method='SLSQP', bounds=bounds, constraints=constraints)

    return result.x

weights = calculate_weights(predictions)
print(weights)
```



```
def backtest_strategy(prices, weights, initial_cash=100, commission=0.001):
    portfolio = pd.DataFrame(index=prices.index, columns=['Portfolio Value'])
    cash = initial_cash
    n_assets = len(weights)
    positions = np.zeros(n_assets)

    for i in range(1, len(prices)):
        portfolio_value = cash + np.sum(positions * prices.iloc[i, :])
        portfolio.iloc[i] = portfolio_value

        daily_returns = (prices.iloc[i, :] / prices.iloc[i-1, :]) - 1

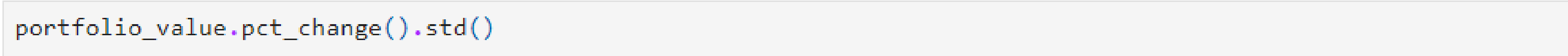
        new_positions = (weights * portfolio_value) / prices.iloc[i, :]
        transaction_costs = np.sum(np.abs(new_positions - positions) * prices.iloc[i, :] * commission)
        positions = new_positions
        cash = portfolio_value - np.sum(positions * prices.iloc[i, :]) - transaction_costs

    portfolio.iloc[0] = initial_cash
    return portfolio

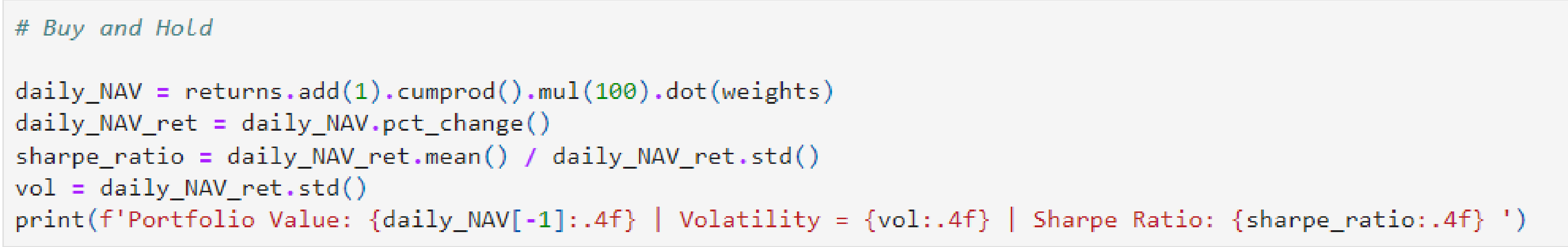
initial_cash = 100
portfolio_value = backtest_strategy(price_data, weights)
portfolio_value.dropna(inplace=True)

final_value = portfolio_value.iloc[-1, 0]
annualized_return = (final_value / initial_cash) ** (252 / len(portfolio_value)) - 1
sharpe_ratio = returns.mean().dot(weights) / (returns.std().dot(weights)) * np.sqrt(252)
max_drawdown = (portfolio_value.cummax() - portfolio_value).max()

print(f'Final portfolio value: {final_value:.2f}')
print(f'Annualized Return: {annualized_return:.2f}')
print(f'Sharpe Ratio: {sharpe_ratio:.2f}')
print(f'Maximum Drawdown: {max_drawdown}')
```

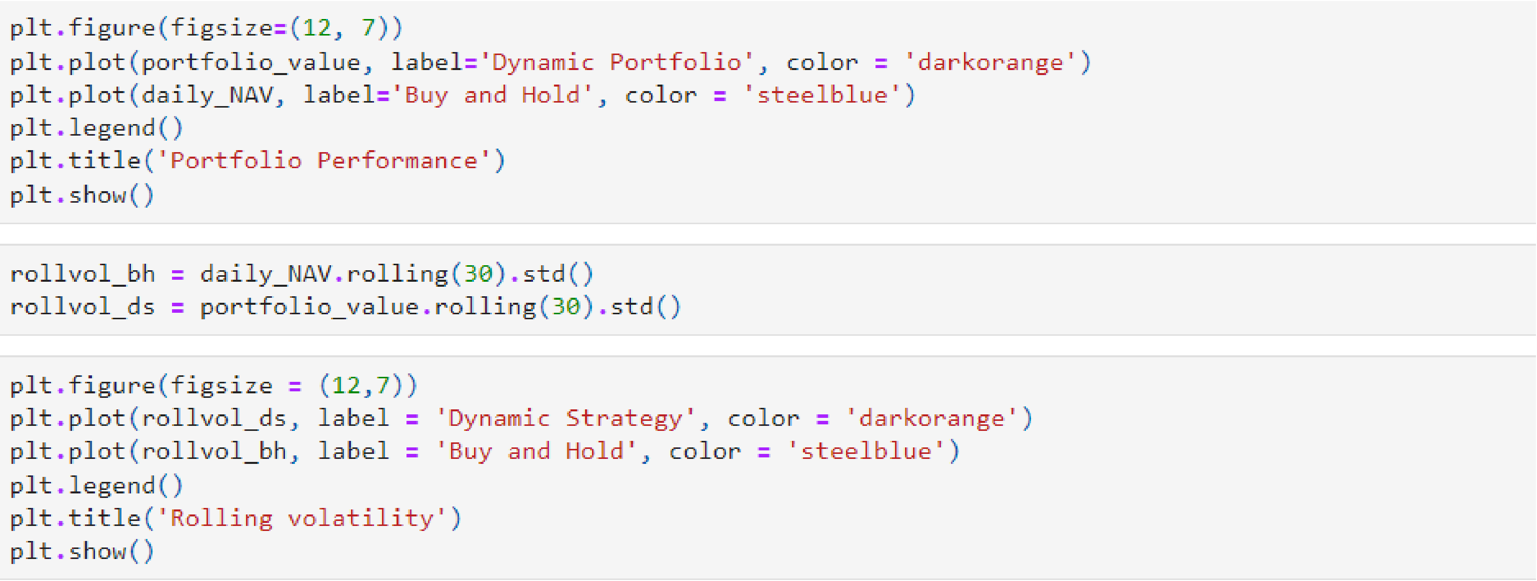


```
portfolio_value.pct_change().std()
```



```
# Buy and Hold

daily_NAV = returns.add(1).cumprod().mul(100).dot(weights)
daily_NAV_ret = daily_NAV.pct_change()
sharpe_ratio = daily_NAV_ret.mean() / daily_NAV_ret.std()
vol = daily_NAV_ret.std()
print(f'Portfolio Value: {daily_NAV[-1]:.4f} | Volatility = {vol:.4f} | Sharpe Ratio: {sharpe_ratio:.4f} ')
```



```
plt.figure(figsize=(12, 7))
plt.plot(portfolio_value, label='Dynamic Portfolio', color = 'darkorange')
plt.plot(daily_NAV, label='Buy and Hold', color = 'steelblue')
plt.legend()
plt.title('Portfolio Performance')
plt.show()
```

```
rollvol_bh = daily_NAV.rolling(30).std()
rollvol_ds = portfolio_value.rolling(30).std()
```

```
plt.figure(figsize = (12,7))
plt.plot(rollvol_ds, label = 'Dynamic Strategy', color = 'darkorange')
plt.plot(rollvol_bh, label = 'Buy and Hold', color = 'steelblue')
plt.legend()
plt.title('Rolling volatility')
plt.show()
```

Important Outputs:

```
              Mean   Variance   Std Dev    Kurtosis  Skewness

AMD     0.001661  0.001138  0.033734  2.182691  0.215183

MU      0.000868  0.000839  0.028964  3.519889 -0.076380

NVDA    0.002685  0.001167  0.034161  4.331564  0.424090

QCOM   0.000931  0.000709  0.026630  4.277503  0.218320

SMCI    0.003210  0.001493  0.038640  13.133564  1.026390
```

```
PCA: Explained variance by each component: [0.54246038 0.36211083 0.0954288 ]

AMD                        OLS Regression Results

==============================================================================

Dep. Variable:                  AMD   R-squared:                       0.150

Model:                          OLS   Adj. R-squared:                  0.064

Method:               Least Squares   F-statistic:                     1.758

Date:              Mon, 17 Jun 2024   Prob (F-statistic):              0.176

Time:                      18:20:33   Log-Likelihood:                -48.465

No. Observations:                34   AIC:                             104.9

Df Residuals:                    30   BIC:                             111.0
Df Model:                   3
Covariance Type:         nonrobust
==============================================================================
            coef    std err       t     P>|t|     [0.025     0.975]
------------------------------------------------------------------------------
const       0.0562     0.194     0.290     0.774     -0.340      0.452
Mkt-RF       1.2862     3.427     0.375     0.710     -5.712       8.284
SMB        3.9596     6.890     0.575     0.570    -10.111      18.030
HML        7.3050     3.572     2.045     0.050      0.011      14.599
==============================================================================
Omnibus:                   0.068   Durbin-Watson:              2.311
Prob(Omnibus):              0.967   Jarque-Bera (JB):            0.141
Skew:                   0.090   Prob(JB):                  0.932
Kurtosis:                2.740   Cond. No.                  38.5
==============================================================================


Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
MU                    OLS Regression Results
==============================================================================
Dep. Variable:                MU   R-squared:                 0.239
Model:                    OLS   Adj. R-squared:             0.162
Method:             Least Squares   F-statistic:                3.133
Date:            Mon, 17 Jun 2024   Prob (F-statistic):          0.0401
Time:                  18:20:33   Log-Likelihood:            -42.973
No. Observations:              34   AIC:                     93.95
Df Residuals:                  30   BIC:                     100.1
Df Model:                   3
Covariance Type:         nonrobust
==============================================================================
            coef    std err       t     P>|t|     [0.025     0.975]
------------------------------------------------------------------------------
const      -0.1667     0.165     -1.011     0.320     -0.504      0.170
```

```
Mkt-RF     -0.3676     2.916    -0.126     0.901    -6.322     5.587
SMB         2.8266     5.862     0.482     0.633    -9.145    14.798
HML         9.1548     3.039     3.013     0.005     2.949    15.361
==============================================================================
Omnibus:                        3.394   Durbin-Watson:                   2.185
Prob(Omnibus):                  0.183   Jarque-Bera (JB):                2.046
Skew:                           0.488   Prob(JB):                        0.360
Kurtosis:                       3.702   Cond. No.                         38.5
==============================================================================


Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
NVDA                            OLS Regression Results
==============================================================================
Dep. Variable:                   NVDA   R-squared:                       0.148
Model:                            OLS   Adj. R-squared:                  0.063
Method:                 Least Squares   F-statistic:                     1.738
Date:                Mon, 17 Jun 2024   Prob (F-statistic):              0.180
Time:                        18:20:33   Log-Likelihood:                -38.891
No. Observations:                  34   AIC:                             85.78
Df Residuals:                      30   BIC:                             91.89
Df Model:                           3
Covariance Type:            nonrobust
==============================================================================
                 coef    std err          t      P>|t|      [0.025      0.975]
------------------------------------------------------------------------------
const         -0.0633      0.146     -0.433      0.668      -0.362       0.236
Mkt-RF         0.7181      2.586      0.278      0.783      -4.563       5.999
SMB           -5.2748      5.199     -1.015      0.318     -15.892       5.342
HML            5.1651      2.695      1.917      0.065      -0.339      10.669
==============================================================================
Omnibus:                        2.616   Durbin-Watson:                   2.195
Prob(Omnibus):                  0.270   Jarque-Bera (JB):                1.944
```

```
Skew:                    0.586   Prob(JB):               0.378
Kurtosis:                3.001   Cond. No.                38.5
==============================================================================


Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
QCOM                      OLS Regression Results
==============================================================================
Dep. Variable:                QCOM   R-squared:                 0.251
Model:                         OLS   Adj. R-squared:            0.176
Method:              Least Squares   F-statistic:               3.346
Date:             Mon, 17 Jun 2024   Prob (F-statistic):       0.0321
Time:                     18:20:33   Log-Likelihood:          -35.288
No. Observations:               34   AIC:                       78.58
Df Residuals:                   30   BIC:                       84.68
Df Model:                        3
Covariance Type:         nonrobust
==============================================================================
              coef    std err          t      P>|t|      [0.025      0.975]
------------------------------------------------------------------------------
const       0.1240      0.132      0.942      0.354      -0.145       0.393
Mkt-RF      2.0944      2.326      0.901      0.375      -2.655       6.844
SMB        -1.9158      4.676     -0.410      0.685     -11.466       7.634
HML         6.8156      2.424      2.812      0.009       1.865      11.766
==============================================================================
Omnibus:                    12.252   Durbin-Watson:             2.241
Prob(Omnibus):               0.002   Jarque-Bera (JB):         16.250
Skew:                        0.892   Prob(JB):               0.000296
Kurtosis:                    5.879   Cond. No.                   38.5
==============================================================================


Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
```

```
SMCI                  OLS Regression Results

==============================================================================

Dep. Variable:              SMCI   R-squared:                  0.063

Model:                       OLS   Adj. R-squared:            -0.031

Method:            Least Squares   F-statistic:               0.6708

Date:           Mon, 17 Jun 2024   Prob (F-statistic):          0.577

Time:                   18:20:33   Log-Likelihood:           -33.702

No. Observations:             34   AIC:                        75.40

Df Residuals:                 30   BIC:                        81.51

Df Model:                      3

Covariance Type:       nonrobust

==============================================================================

            coef    std err       t     P>|t|     [0.025     0.975]

------------------------------------------------------------------------------

const     -0.1122     0.126    -0.893     0.379     -0.369      0.144

Mkt-RF    -1.1168     2.220    -0.503     0.619     -5.650      3.416

SMB       -4.4062     4.463    -0.987     0.331    -13.521      4.708

HML        0.8169     2.314     0.353     0.726     -3.908      5.542

==============================================================================

Omnibus:                   0.591   Durbin-Watson:              2.492

Prob(Omnibus):             0.744   Jarque-Bera (JB):           0.571

Skew:                      0.282   Prob(JB):                   0.752

Kurtosis:                  2.710   Cond. No.                    38.5

==============================================================================


Notes:

[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.
```