**Big Data in Finance: Assignment 3.**

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1. **Introduction**

The purpose of this report is to demonstrate and assess potential use of machine learning techniques and data analytics algorithms in Finance for the purpose of prediction and classification of daily returns of industry portfolios. The report starts with analysis of the given dataset and goes on to describe the methods, which will be used for predictions. In particular, it discusses potential applications of Linear Regression, LASSO, Ridge Regression and Elastic Net. The discussion moves on to methods, such as Linear Discriminant Analysis, Quadratic Discriminant Analysis, Logistic Regression and K- Nearest Neighbour. The report also shows and assess the results of the analysis for the chosen techniques. Finally, the report provides suggestion for potential areas of future research in the area and concludes with a summary of the analysis.

1. **Dataset Analysis**

The dataset to be used for analysis contains daily returns for 49 industry portfolios over 500 days for the period between 02/01/2015 and 31/01/2016.

In theory, we would expect to see strong relationships between certain industries, for example Banks and Insurers. This could be explained by the fact that these industries are affected by similar internal and external factors. We can confirm our expectations by looking at 6 strongest correlations between the groups.

|  |  |  |
| --- | --- | --- |
| **ind1** | **ind2** | **corr** |
| Fin | Banks | 0.939146 |
| Mach | ElcEq | 0.897937 |
| LabEq | BusSv | 0.891708 |
| Insur | Fin | 0.887761 |
| Fin | BusSv | 0.887725 |
| Insur | Banks | 0.871056 |

The results are not surprising as we would expect strong correlation between ‘Trading’ (Fin), ‘Banks’, ‘Insurance’ (Insur) and ‘Business Services’ (BusSv) industries. Similarly, there is a strong contemporaneous relationship between ‘Machinery’ (Mach) vs ‘Electrical Equipment’ (ElcEq) and ‘Measuring and Control Equipment’ (LabEq) vs ‘Business Services’ since they are affected by similar macro-economic factors. It is important to note that ‘Business Services’ contain various range of services, such as advertising, industrial, cleaning and building management, medical equipment, computer equipment, research, development and testing labs, etc. Therefore, this industry is highly correlated with both ‘Trading’ and ‘Measuring and Control Equipment’.

|  |  |  |
| --- | --- | --- |
| **ind1** | **ind2** | **corr** |
| Gold | Banks | -0.04607 |
| Gold | Clths | -0.01579 |
| Gold | Insur | 0.011199 |
| Gold | Meals | 0.011382 |
| Gold | Hlth | 0.021727 |
| Gold | Txtls | 0.024815 |

When looking at industries, which have weakest contemporaneous relationship, we can clearly see that ‘Precious Metals’ (Gold) industry is present in every one of the top six combinations. This is not surprising as precious metals are commonly used as a hedge against market falls as they are less impacted by macro-economic factors. In fact, prices of precious metals normally go up during market downturns as investors looking for a ‘safe haven’ assets (Bresiger, 2017).

1. **Method**

**3.1 Linear Regression (OLS, Ridge Regression, LASSO and Elastic Net)**

We will start predictions by analysing performance of various regression methods, in particular Ordinary Least Squares (OLS), Least Absolute Shrinkage and Selection Operator (LASSO) and Ridge Regression. In addition, the use and results for ‘Elastic Net’ method will be discussed.

Ordinary Least Squares (OLS) is a very commonly used method for estimating unknown parameters in a linear regression. The goal is to minimise the sum of squares of the differences between estimate and the actual values.

LASSO and Ridge are extensions of OLS method. Ridge Regression uses tuning parameter λ to impose a shrinkage penalty on regression coefficients, whereas LASSO reduces some of the coefficients to 0 and therefore removing these parameters from a model (En.wikipedia.org, 2017). LASSO’s aim is to enhance accuracy and interpretability of models through variable selection and regularisation (En.wikipedia.org, 2017). Elastic Net approach is essentially a combination of Ridge and LASSO techniques, where the method finds ridge regression coefficients for each parameter and then applies LASSO type shrinkage to a few of them.

**Performance Measurement.** The performance comparison will be based on the Root Mean Squared Error values (RMSE) and Residual Sum of Squares (RSS) (also known as Sum of Squared Errors (SSE)). Once these measures are calculated they will be compared against a historic mean, which is used as our performance benchmark.

**Window size and high dimensionality.** The data is represented as a time-series and therefore it is beneficial to use ‘rolling window’ approach rather than a ‘static’ one (Inoue, Jin and Rossi, 2017). The window size is selected to be 80. One of the reasons for this decision is the fact that it is the requirement for the report. However, we believe that the chosen window size is also justified taking into account high-dimensionality of the data. As we know, the data has 49 dimensions and therefore choosing rolling window below 49 will deny use of regression as we will be unable to calculate least squares effectively (James et al., 2015). Having window size close to 49 also presents potential issues as it leaves us with smaller degree of freedom and therefore there is a risk of over-fitting. Similarly, we do not want to have too big of a window (>100) as first of all we only have 500 data entries and secondly it might include past information, which might not necessarily be important currently. As a result, we believe that the window size of 80 is appropriate here. Finally, it is important to mention that window size is a hyperparameter here, therefore one should seek caution when selecting window sizes based on a performance of models.

**Performance Testing.** There are two popular ways for back-testing of time-series predictions: ‘in sample’ (IS) and ‘out of sample’ (OOS). With ‘in sample’ a model trained on n-size sample (in our case rolling window size) and test against values within this training sample. With ‘out of sample’ approach a model is trained on n-size sample and being tested using n+1 data (i.e. ‘new’ data). This approach is more accurate as it removes bias comparing to ‘in sample’ back-testing. OLS will be assessed using both ‘in-sample’ and ‘out of sample’ methods. Ridge regression and LASSO will be assessed using ‘out of sample’ methods.

**Validation and Hyper-Parameter tuning.** Cross validation has become an essential validation and testing technique in machine learning. Normally it is performed by splitting the dataset into n number of folds, the model is then being trained on n-1 folds and being tested on the remaining fold. This process is repeated so every single fold is used for validation. Key benefit of cross-validation comparing to standard test/validation split is avoidance of loss of significant modelling or testing capability (En.wikipedia.org, 2017).

Unfortunately, the approach discussed above is not suitable for time-series validation for a number of reasons. First of all, if there are some patterns emerging in period 3 and evident in period 4 and 5, these patterns will not be ‘confirmed’ if validating on period 1 or 2. Secondly, the nature of time-series means that we shouldn’t have ‘gaps’ in our data when training a model. As a result, the ‘forward chaining’ approach is preferred where we train our model using past data to predict forward-looking events.

We use a variation of this approach during predictions for LASSO, Ridge and Elastic Net, where for every window, we start training the model on first 50 elements and validate it on 51st, then we train the model on first 51 elements of the window and validate it on 52nd, and so on until we reach 80- our window size. During the cross-validation we are testing various λ- shrinkage penalty parameter. The λ that gives us the lowest RMSE on average is then selected and is used for predicting of the element w+1, which follows the given window w. This process is repeated for all windows in the dataset.

**LASSO parameters.** As it has been discussed in the ‘Validation’ sub-section above, for every window an optimal λ will be selected. This λ in turn will shrink some of the model parameters to 0. For every window, we will store the ‘remaining’ parameters in order to identify which parameters are more useful and whether this make sense. This exercise will be only conducted for ‘Business Services’ industry as the process is very time consuming and requires a lot of processing power.

**3.2 Logistic Regression and Machine Learning Techniques (LDA, QDA and KNN)**

In previous section, we looked at prediction techniques, where we attempted to forecast a daily change for an industry portfolio. However, it is fair to say that in some instances, we do not need a precise forecast, but rather a classification of whether a stock (or other financial instrument) will appreciate or depreciate in price. In this section, we look at various techniques which deal with classification techniques. The dataset will introduce a new column ‘dir’ (for *direction*) with 1 for ‘up’ and 0 for ‘down’.

Logistic Regression is a regression model which is used for predicting categorical values and has a similar form to a linear regression: y= + \* + … + \* + ε

Linear Discriminant Analysis (LDA) and Quadratic Discriminant Analysis (QDA) are methods, which are used to find a linear combination of features or separate the data into classes or events. Both methods assume that the observations of each class are drawn from a Gaussian distribution and predictions are performed by plugging parameters estimates into Bayes theorem. Key difference between the two methods is that QDA assumes that each class has its own covariance matrix (James et al., 2015). There are a number of advantages of using LDA and QDA over logistic regression. First of all, these models are more stable when the classes are well-separated. Secondly, there is additional stability in situations with small n and normal distribution of X’s in each of the classes (James et al., 2015).

K- nearest neighbour (KNN) is a non-parametric method for classification and regression. The new data is classified by the class which is most common among its k nearest neighbours.

**Industry Choice.** In order to simplify the examples for use of the technique and interpretation of the results, we will focus only on one industry- Business Services.

**Performance Measurement.** The performance of the ML techniques will be assessed using confusion matrix, which shows values for predicted against actual classifications in a tabular form. In addition, accuracy measurement will be introduced, which will show percentage of correctly classified entries.

**Window Size.** In order for the logistic regression algorithm to converge, the window size has been increased to 120. There will be no window used for other ML techniques.

**Validation and Hyper-Parameter Tuning.** Validation will be performedby splitting the dataset into a training set (400 entries) and a validation set (124 entries).

In the case of KNN, k is a hyper-parameter. In order to select the best k, we will split the dataset into a training set (350 entries), test set (90 entries) and validation set (84 entries). The model will be trained using the training set and tested using k from 1 to 200 on the test set. The k, which produces the highest accuracy will be selected to be used on the validation set.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **BusSv** | **Other** | **…** | **Lag1** | **Lag2** | **Lag 3** | **…** |
| **20150102** | -0.38 | -0.65 | … | N/A | N/A | N/A | … |
| **20150105** | -1.46 | -1.52 | … | -0.38 | N/A | N/A | … |
| **20150106** | -0.93 | -0.97 | … | -1.46 | -0.38 | N/A | … |
| **20150107** | 1.4 | 0.8 | … | -0.93 | -1.46 | -0.38 | … |
| **20150108** | 1.92 | 1.41 | … | 1.4 | -0.93 | -1.46 | … |

**Lag Impact.** So far, we have used only lag of 1 day in our analysis. Here we will create a new dataframe, which will include additional 20 days of lag for ‘Business Services’ industry together with 1 day lag for all other industries (as shown on the right). By having the values in this way, will enable efficient use of logistic regression. This dataframe will be used to analyse whether the lags could play an important role in predicting/classifying an outcome.

1. **Results**

**4.1 Linear Regression (OLS, Ridge Regression, LASSO and Elastic Net)**

**OLS: ‘In sample’ vs ‘Out of sample’**

The graphs show that ‘in sample’ (IS) predictions are much more accurate with practically every single industry average RMSE is lower comparing to ‘out of sample’ (OOS) results. This is not surprising as the ‘in sample’ predictions are made on the data, which is used to train the model, whereas ‘out of sample’ predictions are made on the ‘new’ data (for full breakdown of results see Appendices).

It is interesting to note that OOS results are more sporadic comparing to IS across the time period. Occasionally OOS does better than IS, however its general trend and average is clearly above the IS results.

**Historical Mean comparison.** As discussed in the ‘Method’ section the performance of the models is assessed by comparing against Historical Mean RMSE. The difference is shown as a cumulative RMSE differential. Direction of the graph demonstrates whether a prediction technique outperforms (up) or underperforms (down) comparing to Historical Mean RMSE.

We can see that none of the 4 techniques are outperforming Historical Mean (HM) with OOS doing particularly poorly. It is important to note that even though both Ridge and LASSO have underperformed comparing to HM, the overall RMSE cumulative difference is not very high with averages of -0.0814 and -0.0707 respectively.

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Ridge** | **Lasso** | **Elastic Net** |
| **RMSE** | 0.843894 | 0.8517176 | 0.7733384 |

It has been noted in research papers that in general LASSO should perform better (Chinco, Clark-Joseph and Ye, n.d.), however due to the high-dimensionality of the data with relatively small n, the LASSO’s performance is on par with Ridge regression (En.wikipedia.org, 2017). Elastic Net approach overcomes this problem by adding a quadratic part to the shrinkage penalty. Unfortunately, due to the long processing time requirement for Elastic Net, this analysis has been unable to produce results for all industries, however the results for Business Services industry have been produced and they clearly show improvement in accuracy and a reduction of the average RMSE for this industry. As a future point of research, it will be interesting to see if performance of Elastic Net is consistently better across other industries.

**LASSO Parameters.** Summary of the most commonly used parameters by LASSO approach are somewhat inconclusive. These parameters are: ‘Medical Equipment’, ‘Household’, ‘Healthcare’, ‘Tobacco and Cigarettes’, ‘Toys’ and ‘Clothes’ (for full details see Appendices). Although one can attempt to find links between these industries and ‘Business Services’ industry, we would expect to see here industries closer related to business, such as ‘Trading, Banks, Insurance, etc. Therefore, we could conclude that perhaps the industries which are used in predictions are not directly related to Business Services. This conclusion is somewhat echoed in the research paper by A. Chinco et. al (2017) where the authors suggest that the choice of parameters is not dictated by economic forces.

**Industry Comparison.** By analysingperformance of prediction techniques from industries perspective, we can see that ‘Soda’, ‘Beer’ and ‘Household’ industries scored lowest RMSE values across most of the prediction techniques. This is not surprising as these industries represent items or services, which are not strongly affected by macroeconomic factors. In fact, by conducting volatility analysis of all 49 industries- these 3 industry again come up at the bottom of the list (for full volatility results see Appendices). This somewhat explains the lower RMSE results: less volatility means there are less unexpected spikes/ falls and therefore the average prediction is low.

**4.2 Logistic Regression and Machine Learning Techniques (LDA, QDA and KNN)**

**Accuracy results.** Similarly, to the section above, the in-sample testing produces the highest results with a particularly impressive 89.12% for QDA. However out-of-sample results for Log Regression, LDA and QDA are very close to 50%, which means that similar results could be achieved by flipping a coin. Results for KNN are slightly better with 57.02% accuracy.

It is interesting to note that when looking at confusion matrices for LDA and QDA, we can see that the models guessed correctly that the market will go up 56.9% (37/(28+37)) and 58.1% (36/(26+36)) of times for LDA and QDA respectively.

KNN’s initial test came up with the optimal k, which was was 80 with accuracy 63.3%. This parameter produced accuracy of 57.02% on the validation set.

**Lag Impact result.** By running the logistic model on the data with additional 20 lags we encountered higher IS accuracy rate of 64.16% (vs 60.5% with original data). The accuracy rate was even higher if taking into account only instances where the model predicted positive return with accuracy rate of 65.3% (198/(198+105)). No OOS results were produced as the dataframe had too many dimensions (70) for OOS calculations to be done accurately.

The regression analysis identified lag of 15 (working) days as a significant parameter, which is a very interesting find. It is difficult to explain the anomaly without further analysis, but it confirms our initial assumptions that additional lags will provide useful information to be used in prediction. It is important to note that the lag structures will be different for different industries. These lag structures will result from regular external events, such as issuance or economic performance indicators, company’s quarterly results, impact of holidays, seasons, etc.

1. **Research Considerations and Suggestions for Future Work**

It is important to stress again that we only had 500 entries of data and therefore it would be interesting to see how the accuracy values and RMSE will change when using a larger dataset. Similarly the available data represented EOD values, which might be skewed by end of day auctions/ spikes in trading. It will be interesting to see more mid-day data.

As discussed, the heavy processing requirement for some of the research limited ability to apply the data for all industries. This is something which should be considered to be done in the future. We have also discussed importance of choosing correct window sizes, therefore in future research there should be fine-tuning introduced for this hyper-parameter.

Finally, in addition to quantitative data, an effort should be made to be able to introduce some qualitative information as input into models. One such potential area could be the use of Natural Language Processing to analyse how news reports affect price movements.

1. **Conclusion**

This report has discussed and assessed various machine learning techniques, which could be used in prediction and classification of industry returns. Results demonstrated that Ridge Regression and LASSO have performed only slightly worse than the benchmark with the Elastic Net approach showing signs of outperforming it. Similarly KNN method showed decent performance, which should be re-tested with more data.

1. **References**

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1. **Appendices**

**8.1 RMSE results**



**8.2 LASSO’s commonly used parameters**

