

# 0 Amendment

Response to **25%**;

This is my corrective action.

## 1 Overview

### 1.1 Goal

The objective is to build and compare two factor-based long short allocation models with constraints on their betas.

The first strategy considers a target Beta in the interval  $[-0.5, 0.5]$  while the second has one in the interval  $[-2, +2]$ .

The first operates similar to a Value-at-Risk Utility (Robust Optimization);  
the second incorporates an Information Ratio.

Post optimization, I compare the model outcomes while evaluating their sensitivity to estimator length for the covariance matrix  
and expected returns across market regimes.

### 1.2 Reallocation

The portfolios are reallocated weekly from '03-01-2007' to '03-31-2024';

Investment Universe  $\equiv$  ETFs ('Global World Economy');

Fama-French Three-Factor Model (Momentum, Value, Size);

Public Data.

### 1.3 Performance Evaluation

The performance / risk profiles are sensitive  
to the target Beta and the market environment.

A low Beta indicates decorrelation;

a high Beta is the antithesis.

Portfolio Characteristics :

- Return :  $\mu$
- Vol :  $\sigma$
- Skew :  $(\mathbb{E}[(\frac{x-\mu}{\sigma})^3]) = \frac{\mu_3}{\sigma_3} = \frac{\kappa_3}{\kappa_2^{3/2}}$
- VaR / ES
- Sharpe :  $\frac{\mathbb{E}[R_a - R_b]}{\sigma_a} = \frac{\mathbb{E}[R_a - R_b]}{\sqrt{\mathbb{V}(R_a - R_b)}}$

## 1.4 Simplification

Post Factor Model (FM) construction,

I use trend following estimators for  $\mu$ .

The estimator quality depends on the look-back (LB) period;  $\therefore$

- Long-Term Estimator (LTE) :  $LT \Rightarrow LB \in \{180 \text{ Days}\}$ . (1)
- Mid-Term Estimator (MTE) :  $MT \Rightarrow LB \in \{90 \text{ Days}\}$ . (2)
- Short-Term Estimator (STE) :  $ST \Rightarrow LB \in \{40 \text{ Days}, 60 \text{ Days}\}$ . (3)

Term-Structure for Covariance  $\Sigma \wedge$  Expected Return  $\mu$ .

## 1.5 Synthesis

Optimal portfolio behavior constructed from

covariance and expected return estimators

will vary due to strategic and market differences.

$$S_{40}^{90} \equiv \hat{\Sigma} \Rightarrow 40 \text{ Days} \wedge \hat{\mu} \Rightarrow 90 \text{ Days} \quad (4)$$

Goal :

- Evaluate Hypothesis
- Demonstrate Robustness (Or Lack Thereof)
- Market Regime Stratification

## 2 Strategy

Theory \& Math

### 2.1 Strategic Formulation

Consider two strategies :

$$(\text{Strategy I}) \quad \left\{ \begin{array}{l} \max_{\omega \in \mathbb{R}^n} \rho^T \omega - \lambda \sqrt{\omega^T \Sigma \omega} \\ -0.5 \leq \sum_{i=1}^n \beta_i^m \omega_i \leq 0.5 \\ \sum_{i=1}^n \omega_i = 1, \quad -2 \leq \omega_i \leq 2, \end{array} \right. \quad (5)$$

and

$$(\text{Strategy II}) \quad \left\{ \begin{array}{l} \max_{\omega \in \mathbb{R}^n} \frac{\rho^T \omega}{\text{TEV}(\omega)} - \lambda \sqrt{\omega^T \Sigma \omega} \\ -2 \leq \sum_{i=1}^n \beta_i^m \omega_i \leq 2 \\ \sum_{i=1}^n \omega_i = 1, \quad -2 \leq \omega_i \leq 2, \end{array} \right. \quad (6)$$

- $\Sigma \equiv$  covariance matrix between security returns (FF3FM);
- $\beta_i^m = \frac{\text{Cov}(r_i, r_M)}{\sigma^2(r_M)} \equiv$  Beta of security  $S_i$  (CAPM) s.t.  
 $\beta_P^m = \sum_{i=1}^n \beta_i^m \omega_i \equiv$  Porfolio Beta;
- $\text{TEV}(\omega) = \sigma(r_P(\omega) - r_{\text{SPY}}) \equiv$  Tracking Error Volatility;  
 trivial derivation (reader exercise) :

$$\sigma(r_P(\omega) - r_{\text{SPY}}) = \sqrt{\omega^T \Sigma \omega - 2\omega^T \text{Cov}(r, r_{\text{SPY}}) + \sigma_{\text{SPY}}^2}. \quad (7)$$

### 2.2 Fama–French Three-Factor Model (FF3FM)

Definition :

$$r_i = r_f + \beta_i^3 (r_M - r_f) + b_i^s r_{\text{SMB}} + b_i^v r_{\text{HML}} + \alpha_i + \epsilon_i \quad (8)$$

$$\mathbb{E}[\epsilon_i] = 0; \therefore$$

$$\rho_i = r_f + \beta_i^3 (\rho_M - r_f) + b_i^s \rho_{\text{SMB}} + b_i^v \rho_{\text{HML}} + \alpha_i \quad (9)$$

Estimated Coefficient Vector :

$$(\hat{\beta}_i^3, \hat{b}_i^s, \hat{b}_i^v)^\top \Leftarrow y_i = \rho_i - r_f \quad (10)$$

Linear Regression :

$$= \hat{\beta}_i^3(\rho_M - r_f) + \hat{\beta}_i^s r_{\text{SMB}} + \hat{b}_i^v \rho_{\text{HML}} + \epsilon_i \quad (11)$$

$\beta_i^m \neq \beta_i^3$  | estimated via separate regression / computed directly.

## 2.3 Executive Summary Formulation

This section elaborates on the mathematical formulation established in Sections 2.1 but for executives (innumerate):

### 2.3.1 Strategy I Breakdown

1. **Objective:** Maximize returns while considering risk.
2. **Constraints:**
  - The portfolio's beta must be between  $-0.5$  and  $0.5$ .
  - The sum of the weights assigned to each asset in the portfolio must equal 1.
  - Each individual weight can range from  $-2$  to  $2$ .

### 2.3.2 Strategy II Breakdown

1. **Objective:** Maximize returns relative to the portfolio's **tracking error volatility (TEV)**, which measures how much the portfolio's returns deviate from a benchmark.
2. **Constraints:**
  - The portfolio's beta must be between  $-2$  and  $2$ .
  - The sum of the weights assigned to each asset in the portfolio must equal 1.
  - Each individual weight can range from  $-2$  to  $2$ .

The next section establishes the necessary assumptions considered for strategic formulation and implementation.

## 3 Assumptions and (Analysis) Setup

### 3.1 Setup

To simplify, we will make the following assumptions for this experiment:

1. The portfolios will be reallocated weekly from the beginning of **March 2007** to the end of **March 2024**.
2. I define three cases:
  - Long-Term Look-Back Period : 120 Data Points for estimation of a Sample Covariance & Sample Mean; i.e., Scenario LT  $\equiv S_{120}$ .
  - Medium-Term Look-Back Period : 90 Data Points for estimation of a Sample Covariance & Sample Mean; i.e., Scenario MT  $\equiv S_{90}$ .
  - Short-Term Look-Back Period : 40 Data Points for estimation of a Sample Covariance & Sample Mean; i.e., Scenario ST  $\equiv S_{40}$ .
3. Consider two possible values for the **Target Beta** (again, **not** the [colloquial slang term](#)) : 0 & 1.
4. Consider two possible values for the  $\lambda$  (the **risk aversion parameter**; i.e., how much are you [putting on black?](#)) : 0.10 & 0.50.