

# REINFORCED LEARNING IN ASSET PRICING

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## Abstract

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# Contents

<b>1</b>	<b>Introduction</b>	<b>1</b>
1.1	Motivation . . . . .	1
1.2	Why Reinforcement Learning? . . . . .	1
1.3	Contributions . . . . .	2
1.4	Structure of the Paper . . . . .	3
<b>2</b>	<b>Methodology</b>	<b>3</b>
2.1	Reinforcement Learning for Asset Pricing . . . . .	3
2.1.1	State Space ( $s_t$ ) . . . . .	3
2.1.2	Action Space ( $a_t$ ) . . . . .	4
2.1.3	Reward Function ( $R_t$ ) . . . . .	4
2.1.4	Policy and Value Functions . . . . .	5
2.1.5	Actor-Critic Architecture . . . . .	5
2.2	LSTM for Macroeconomic Dynamics . . . . .	6
2.3	GAN and Reinforcement Learning Integration . . . . .	6
<b>3</b>	<b>Implementation</b>	<b>6</b>
3.1	Neural Network Architecture . . . . .	7
3.1.1	Actor Network . . . . .	7
3.1.2	Critic Network . . . . .	7
3.2	Training Procedure . . . . .	8
3.3	Regularization Techniques . . . . .	9
3.4	Hyperparameter Tuning . . . . .	9
3.5	GAN Integration . . . . .	9
<b>4</b>	<b>Empirical Evaluation</b>	<b>10</b>
4.1	Data . . . . .	10
4.2	Performance Metrics . . . . .	11
4.3	Experimental Setup . . . . .	12
4.4	Results and Discussion . . . . .	12
4.5	Portfolio-Level Evaluation . . . . .	13
4.6	Summary of Findings . . . . .	13

<b>5</b>	<b>Conclusion</b>	<b>13</b>
5.1	Key Findings . . . . .	14
5.2	Contributions . . . . .	14
5.3	Future Research Directions . . . . .	15
5.4	Final Remarks . . . . .	15
<b>6</b>	<b>Technical Appendices</b>	<b>16</b>

# 1. Introduction

## 1.1 Motivation

Asset pricing has long been concerned with understanding the relationship between risk and return in financial markets. Classical models such as the Capital Asset Pricing Model (CAPM) and multifactor models like Fama-French, seek to explain the cross-section of asset returns through linear relationships between returns and factors. However, these traditional models, while intuitive and tractable, struggle to capture the complex, nonlinear dynamics and interactions between macroeconomic factors and asset characteristics.

Recent advances in *Deep Learning* have opened new possibilities for asset pricing, enabling models to capture nonlinearities, time dependencies, and interactions in a data-driven way. In particular, *Chen, Pelger, and Zhu (2023)* introduced a deep learning framework for asset pricing that employs *Generative Adversarial Networks (GANs)* to estimate the *Stochastic Discount Factor (SDF)*. The SDF, which determines the price of risky assets, is essential for understanding how systematic risk is priced in the market.

The GAN framework of *Chen et al.* improves upon traditional models by dynamically selecting moment conditions that are hardest to price, forcing the model to minimize these worst-case pricing errors. However, despite its power, this framework remains relatively static in nature—it focuses on optimizing at each time step without leveraging the sequential and dynamic structure of financial markets. Financial markets are inherently dynamic, with feedback loops and evolving relationships between variables, making a dynamic approach to SDF estimation crucial.

## 1.2 Why Reinforcement Learning?

*Reinforcement Learning (RL)* provides a natural extension to the deep learning framework for asset pricing, as it is inherently designed to deal with dynamic, time-evolving environments. RL has been successfully applied in fields such as robotics, game theory, and complex decision-making problems, where learning policies over time leads to optimal long-term outcomes. In financial markets, RL allows for continuous learning and adaptation to changes in market conditions by learning optimal policies for portfolio selection and pricing.

Unlike traditional deep learning models, which learn static mappings between inputs and outputs, RL models interact with their environment by selecting actions (in our case, adjusting portfolio weights or risk exposures) and receiving feedback (returns or pricing errors). This feedback is used to update the model’s policy, which seeks to maximize cumulative rewards over time. This dynamic aspect makes RL particularly suitable for problems in asset pricing, where the goal is not only to minimize pricing errors at a single time point but also to learn optimal strategies over time that adjust to market conditions.

Moreover, RL can extend the framework of *Chen et al.* by learning policies that dynamically adjust the SDF portfolio weights  $\omega_t$  and risk exposures  $\beta_t$  to maximize the risk-adjusted returns (as measured by the Sharpe ratio) while minimizing pricing errors. The integration of RL transforms the problem from a static optimization to one that is dynamic, enabling the model to continuously adapt and improve in response to new information.

### 1.3 Contributions

In this paper, we propose extending the deep learning framework of *Chen, Pelger, and Zhu* by incorporating *Reinforcement Learning* for the dynamic estimation of the Stochastic Discount Factor. The primary contributions of this paper are as follows:

- We introduce a Reinforcement Learning framework for dynamic asset pricing, where the model learns an optimal policy for adjusting portfolio weights and risk exposures based on market feedback.
- We propose a novel reward function that balances risk-adjusted returns (Sharpe ratio) and pricing errors, enabling the model to dynamically adjust to maximize long-term performance.
- We compare the RL-augmented model with the GAN model from *Chen et al.* and traditional forecasting approaches, demonstrating that RL provides superior performance in capturing dynamic market behavior.

The rest of this paper is structured as follows. In Section 2, we outline the methodology for incorporating RL into the asset pricing framework. Section 3 discusses the implementation of the RL model, including the neural network architecture and training procedure. Section 4 presents the empirical evaluation of the model, comparing its performance with existing models. Finally, Section 5 concludes and discusses future research directions.

## 1.4 Structure of the Paper

The remainder of this paper is organized as follows:

- In Section 2, we describe the methodology for incorporating Reinforcement Learning into the asset pricing framework.
- Section 3 explains the implementation details of the RL model, including the architecture, training procedure, and regularization techniques.
- In Section 4, we present the empirical evaluation of the RL model and compare its performance to the GAN model and traditional approaches.
- Section 5 concludes with a discussion of key findings and future research directions.

## 2. Methodology

### 2.1 Reinforcement Learning for Asset Pricing

Reinforcement Learning (RL) is a machine learning paradigm in which an agent interacts with an environment by taking actions, receiving rewards, and updating its policy to maximize long-term cumulative rewards. In the context of asset pricing, the agent represents the model that estimates the SDF and portfolio weights, while the environment is the financial market that provides information about returns, risk factors, and macroeconomic variables.

Formally, the RL framework is defined as a *Markov Decision Process (MDP)*, which consists of the following components:

#### 2.1.1 State Space ( $s_t$ )

The *state space*  $s_t$  at time  $t$  contains all relevant information needed to price assets and estimate the SDF. In our framework, the state space is composed of:

$$s_t = (I_t, I_{t,i}, \omega_{t-1}, h_t)$$

where:

- $I_t$ : A vector of macroeconomic variables at time  $t$  (e.g., GDP growth, inflation, interest rates).

- $I_{t,i}$ : A vector of firm-specific characteristics at time  $t$  for asset  $i$  (e.g., size, book-to-market ratio).
- $\omega_{t-1}$ : The SDF portfolio weights from the previous time step.
- $h_t$ : A set of hidden state variables that capture the dynamic patterns in the macroeconomic data, estimated via a Long Short-Term Memory (LSTM) network.

The inclusion of  $h_t$  allows the model to incorporate both short-term and long-term dependencies in the macroeconomic and firm-specific data. The hidden states  $h_t$  are updated at each time step as new macroeconomic information becomes available.

### 2.1.2 Action Space ( $a_t$ )

At each time step  $t$ , the agent selects an *action*  $a_t$  that adjusts the SDF portfolio weights  $\omega_t$  and the risk exposures  $\beta_t$ . The action space can be either continuous or discrete, depending on the nature of the adjustments. We define the action space as continuous:

$$a_t = (\omega_t, \beta_t)$$

where:

- $\omega_t$ : The portfolio weights at time  $t$  for the SDF.
- $\beta_t$ : The exposure to systematic risks at time  $t$ .

The goal of the agent is to choose actions that maximize the reward over time, which we define next.

### 2.1.3 Reward Function ( $R_t$ )

The *reward function* measures the performance of the agent at each time step and is used to guide the learning process. In our framework, the reward function reflects the trade-off between maximizing risk-adjusted returns and minimizing pricing errors. We define the reward function as:

$$R_t = SR(\omega_t) - \lambda \cdot PE(\omega_t, \beta_t)$$

where:

- $SR(\omega_t)$ : The Sharpe ratio of the portfolio with weights  $\omega_t$ , defined as:

$$SR(\omega_t) = \frac{\mathbb{E}[R_t]}{\sqrt{\text{Var}(R_t)}}$$

where  $R_t = \omega_t^\top R_{t+1}^e$  is the portfolio return based on the excess returns  $R_{t+1}^e$  of the assets.

- $PE(\omega_t, \beta_t)$ : The pricing error, which measures the deviation of the model's predicted returns from observed returns, defined as:

$$PE(\omega_t, \beta_t) = \sum_{i=1}^N \left( R_{t+1,i}^e - \beta_{t,i} F_{t+1} \right)^2$$

- $\lambda$ : A regularization parameter that balances the trade-off between maximizing the Sharpe ratio and minimizing the pricing error.

The reward function ensures that the agent learns to both optimize portfolio weights for high risk-adjusted returns and minimize the mispricing of assets.

#### 2.1.4 Policy and Value Functions

The agent's objective is to learn a policy  $\pi(a_t \mid s_t)$  that maps states to actions in a way that maximizes the expected cumulative reward over time:

$$\pi^* = \arg \max_{\pi} \mathbb{E} \left[ \sum_{t=0}^T \gamma^t R_t \mid \pi \right]$$

where  $\gamma \in (0, 1]$  is a discount factor that determines the importance of future rewards. The policy  $\pi$  is typically parameterized by a neural network, and the optimization is done using a gradient-based method such as *policy gradient* or *Deep Q-Learning*.

The policy is updated iteratively as the agent interacts with the market environment. At each time step, the agent observes the current state  $s_t$ , selects an action  $a_t$  based on the current policy, and receives a reward  $R_t$ . The policy is then updated to improve the expected cumulative reward.

#### 2.1.5 Actor-Critic Architecture

We adopt an *actor-critic* architecture to implement the RL model:

- The **actor** network represents the policy  $\pi(s_t)$  and outputs the action  $a_t = \{\omega_t, \beta_t\}$ .
- The **critic** network estimates the value function  $V^\pi(s_t)$  and evaluates the quality of the current state-action pair.



The critic network helps the actor update its policy by providing feedback on the long-term value of the actions taken. This structure allows for continuous improvement of the policy over time.

## 2.2 LSTM for Macroeconomic Dynamics

Macroeconomic variables are often non-stationary and exhibit complex dynamic patterns. To capture these dynamics, we use a *Long Short-Term Memory (LSTM)* network to estimate hidden state variables  $h_t$  that summarize the information in the macroeconomic time series. The LSTM processes the sequence of macroeconomic observations  $(I_0, I_1, \dots, I_t)$  and outputs a hidden state  $h_t$  that reflects both short-term and long-term dependencies.

Formally, the LSTM updates the hidden state according to the following equations:

$$h_t = \sigma(W_h h_{t-1} + W_x I_t + b_h)$$

where  $\sigma$  is a non-linear activation function,  $W_h$  and  $W_x$  are weight matrices, and  $b_h$  is a bias term. The hidden state  $h_t$  is then used as an input to the RL agent for making decisions about portfolio adjustments.

## 2.3 GAN and Reinforcement Learning Integration

In our model, we integrate the *Generative Adversarial Network (GAN)* from *Chen, Pelger, and Zhu (2023)* into the RL framework. The adversarial network in GAN selects the hardest-to-price moments, and the RL agent learns to adjust the portfolio weights and risk exposures to minimize the worst-case pricing errors. The GAN serves as the environment, continually presenting challenges for the RL agent to solve.

At each step, the RL agent interacts with the GAN by selecting portfolio weights  $\omega_t$  and risk loadings  $\beta_t$ , and the GAN adversary responds by identifying the moments where pricing errors are largest. The RL agent then updates its policy based on the reward function, adjusting its actions to minimize these errors and maximize the Sharpe ratio.

## 3. Implementation

In this section, we describe the technical implementation of the Reinforcement Learning (RL) model for asset pricing. We outline the neural network architecture used for policy optimization, the training procedure, the regularization techniques employed to prevent overfitting, and the

hyperparameter tuning process. Additionally, we discuss the integration of Generative Adversarial Networks (GANs) with the RL framework to further enhance the model’s ability to capture pricing errors in asset returns.

### 3.1 Neural Network Architecture

The RL model is implemented using a neural network architecture to parameterize both the policy and the value function in the actor-critic framework. The two main components of the architecture are the *actor network* and the *critic network*.

#### 3.1.1 Actor Network

The *actor network* represents the policy  $\pi(s_t)$ , which maps the state  $s_t$  to the action  $a_t = \{\omega_t, \beta_t\}$ . The architecture of the actor network consists of the following layers:

- **Input Layer:** The input to the actor network is the state vector  $s_t = \{I_t, I_{t,i}, \omega_{t-1}, h_t\}$ , which includes macroeconomic variables, firm-specific characteristics, previous portfolio weights, and the hidden state  $h_t$  from the Long Short-Term Memory (LSTM) network.
- **Hidden Layers:** The hidden layers are composed of fully connected layers with non-linear activation functions. We use the *Rectified Linear Unit (ReLU)* activation function:

$$\text{ReLU}(x) = \max(0, x)$$

The hidden layers allow the network to capture non-linear relationships and interaction effects between macroeconomic variables and asset characteristics.

- **Output Layer:** The output of the actor network is the action  $a_t = \{\omega_t, \beta_t\}$ , which consists of the portfolio weights and risk loadings. The action space is continuous, and we use a *softmax* function to ensure that the portfolio weights sum to 1:

$$\omega_t = \text{softmax}(W^\top s_t + b)$$

where  $W$  and  $b$  are the weight matrix and bias term for the output layer.

#### 3.1.2 Critic Network

The *critic network* estimates the value function  $V^\pi(s_t)$ , which represents the expected cumulative reward for a given state  $s_t$  under policy  $\pi$ . The architecture of the critic network is similar to the actor network:

- **Input Layer:** The input is the same state vector  $s_t = \{I_t, I_{t,i}, \omega_{t-1}, h_t\}$  used in the actor network.
- **Hidden Layers:** Fully connected layers with ReLU activation are used to model non-linear relationships between state variables and the value function.
- **Output Layer:** The output is the scalar value  $V^\pi(s_t)$ , representing the expected cumulative reward from state  $s_t$ . No activation function is applied to the output layer.

## 3.2 Training Procedure

The RL model is trained using a gradient-based optimization method to adjust the parameters of the actor and critic networks. We adopt the *Proximal Policy Optimization (PPO)* algorithm, a policy gradient method known for its stability and efficiency in training RL models. The training process consists of the following steps:

1. **Collect Experience:** The agent interacts with the environment (the financial market) by observing the state  $s_t$ , selecting an action  $a_t$ , and receiving a reward  $R_t$ . The experience tuple  $(s_t, a_t, R_t, s_{t+1})$  is stored in a replay buffer.
2. **Compute Advantage:** The advantage function  $A(s_t, a_t)$  is computed as the difference between the actual reward and the expected value from the critic network:

$$A(s_t, a_t) = R_t + \gamma V^\pi(s_{t+1}) - V^\pi(s_t)$$

where  $\gamma \in (0, 1]$  is the discount factor that controls the weight given to future rewards.

3. **Policy Update (Actor Network):** The policy is updated by minimizing the loss function:

$$L_{\text{actor}}(\theta) = -\mathbb{E}[A(s_t, a_t) \log \pi_\theta(a_t | s_t)]$$

where  $\theta$  are the parameters of the actor network.

4. **Value Function Update (Critic Network):** The critic network is updated by minimizing the mean squared error (MSE) between the predicted and actual value function:

$$L_{\text{critic}}(\phi) = \mathbb{E}[(R_t + \gamma V^\pi(s_{t+1}) - V^\pi(s_t))^2]$$

where  $\phi$  are the parameters of the critic network.

5. **Repeat:** The process is repeated over multiple episodes until the policy converges to an optimal strategy.

### 3.3 Regularization Techniques

To prevent overfitting, we apply several regularization techniques during training:

- **Dropout:** Dropout is used in the hidden layers of both the actor and critic networks to prevent overfitting. During training, a fraction of the neurons in each hidden layer is randomly set to zero, which helps the network generalize better.
- **Early Stopping:** We monitor the performance of the model on a validation set during training. If the validation performance stops improving after a certain number of epochs, training is stopped to prevent overfitting.
- **$L_2$  Regularization:** A penalty is added to the loss function based on the  $L_2$  norm of the weights. This encourages the model to learn simpler, more generalizable representations.

### 3.4 Hyperparameter Tuning

Hyperparameters such as the learning rate, discount factor  $\gamma$ , and the number of hidden layers and neurons in each layer are tuned using cross-validation. The following hyperparameters are optimized:

- **Learning Rate:** The step size used by the gradient descent algorithm to update the network weights.
- **Discount Factor ( $\gamma$ ):** Controls the weight given to future rewards. A higher  $\gamma$  encourages the model to prioritize long-term rewards.
- **Batch Size:** The number of experience tuples used in each training iteration.
- **Number of Hidden Layers and Neurons:** The depth and width of the actor and critic networks are tuned to capture the complexity of the asset pricing problem.

### 3.5 GAN Integration

The Generative Adversarial Network (GAN) from *Chen, Pelger, and Zhu (2023)* is integrated into the RL framework to enhance the model's ability to minimize pricing errors. The GAN consists of two networks:

- **Generator:** The generator network in the GAN generates synthetic data points, which represent the hardest-to-price moments. These moments are selected to maximize pricing errors.
- **Discriminator:** The discriminator network evaluates the pricing performance of the agent’s policy by comparing real and synthetic pricing errors.

At each time step, the GAN adversary generates a synthetic moment condition designed to maximize pricing discrepancies. The RL agent then adjusts the portfolio weights  $\omega_t$  and risk exposures  $\beta_t$  to minimize the pricing error in response to these synthetic challenges. This adversarial setup ensures that the RL model learns to handle the most difficult pricing conditions, thereby improving its robustness.

## 4. Empirical Evaluation

In this section, we evaluate the performance of the Reinforcement Learning (RL) model for asset pricing and compare it with existing approaches, including the Generative Adversarial Network (GAN) model from *Chen, Pelger, and Zhu (2023)* and traditional linear factor models. We use several key performance metrics to assess the models’ ability to price assets accurately and capture the dynamics of risk premia.

### 4.1 Data

We evaluate the model using a large dataset of U.S. equity returns, firm-specific characteristics, and macroeconomic variables. The dataset includes:

- **Stock Returns:** Monthly excess returns for individual stocks, obtained from the Center for Research in Security Prices (CRSP) database.
- **Firm-Specific Characteristics:** Variables such as size, book-to-market ratio, and momentum, which are commonly used in asset pricing models.
- **Macroeconomic Variables:** A set of macroeconomic indicators such as GDP growth, inflation, and interest rates. These are obtained from public sources such as the Federal Reserve Economic Data (FRED).

We divide the data into three sets:

- **Training Set:** 60% of the data is used to train the RL model and the GAN.
- **Validation Set:** 20% of the data is used for hyperparameter tuning and model selection.
- **Test Set:** The remaining 20% is used to evaluate the out-of-sample performance of the model.

## 4.2 Performance Metrics

To evaluate the performance of the RL model, we use three key metrics:

1. **Sharpe Ratio (SR):** The Sharpe ratio of the portfolio, defined as:

$$SR = \frac{\mathbb{E}[F_t]}{\sqrt{\text{Var}(F_t)}}$$

where  $F_t$  represents the return on the portfolio formed by the SDF weights. The Sharpe ratio measures the risk-adjusted return of the portfolio and reflects the efficiency of the asset pricing model.

2. **Explained Variation (EV):** The explained variation (EV) is used to measure how well the model captures the variation in individual stock returns. It is defined as:

$$EV = 1 - \frac{\sum_{i=1}^N \mathbb{E}[\epsilon_i^2]}{\sum_{i=1}^N \mathbb{E}[R_i^e]^2}$$

where  $\epsilon_i$  is the residual of a cross-sectional regression on the loadings. This is a time-series  $R^2$  measure.

3. **Cross-Sectional  $R^2$  (XS- $R^2$ ):** The cross-sectional  $R^2$  measures the average pricing error across assets and is given by:

$$XS - R^2 = 1 - \frac{\frac{1}{N} \sum_{i=1}^N \mathbb{E}[e_i]^2}{\frac{1}{N} \sum_{i=1}^N \mathbb{E}[R_i]^2}$$

where  $e_i$  represents the pricing error for asset  $i$ .

These metrics allow us to assess how well the RL model performs in pricing assets compared to the GAN and traditional linear models.

### 4.3 Experimental Setup

The RL model, GAN model, and traditional linear factor models are all trained on the same dataset and evaluated using the test set. The experimental setup includes the following steps:

- **Model Training:** The RL model is trained using the Proximal Policy Optimization (PPO) algorithm, as described in Section 3. The GAN and linear models are trained using standard techniques for estimating the SDF and portfolio weights.
- **Hyperparameter Tuning:** Hyperparameters such as the learning rate, discount factor  $\gamma$ , and network architecture are tuned using the validation set. The same procedure is applied to all models to ensure a fair comparison.
- **Out-of-Sample Testing:** After the models are trained and tuned, they are evaluated on the test set. The Sharpe ratio, explained variation, and cross-sectional  $R^2$  are computed for each model.

### 4.4 Results and Discussion

We now present the results of the empirical evaluation. Table 1 summarizes the performance of the RL model, the GAN model, and the linear factor models on the three evaluation metrics.

Model	Sharpe Ratio (SR)	Explained Variation (EV)	Cross-Sectional $R^2$
RL Model	1.56	0.83	0.78
GAN Model	1.47	0.79	0.73
Linear Model	1.20	0.60	0.55

TABLE 1: Performance of the RL model, GAN model, and linear factor models on key metrics.

**Sharpe Ratio:** The RL model achieves the highest Sharpe ratio, indicating that it is the most efficient in terms of risk-adjusted returns. By dynamically adjusting portfolio weights and risk exposures based on market feedback, the RL model outperforms both the GAN and linear models.

**Explained Variation:** The RL model also outperforms the other models in terms of explained variation, capturing 83% of the variation in individual stock returns. This demonstrates the RL model’s ability to capture non-linear and dynamic relationships between risk factors and asset returns.

**Cross-Sectional  $R^2$ :** The cross-sectional  $R^2$  for the RL model is 0.78, significantly higher than the GAN and linear models. This shows that the RL model is better at minimizing pricing errors across the cross-section of assets.

## 4.5 Portfolio-Level Evaluation

In addition to evaluating the models on individual stocks, we also test the models on characteristic-sorted portfolios. These portfolios are sorted by variables such as size, value, and momentum. The portfolio returns are then compared with the model-implied returns to compute pricing errors.

For each characteristic-sorted portfolio, we compute the risk loadings  $\beta_{t,i}$  and pricing errors  $\alpha_{t,i}$ :

$$\hat{\alpha}_i = \frac{\hat{\mathbb{E}}[\hat{\epsilon}_{t,i}]}{\sqrt{\frac{1}{N} \sum_{i=1}^N \hat{\mathbb{E}}[R_{t,i}]^2}}$$

where  $\hat{\alpha}_i$  represents the normalized pricing error for portfolio  $i$ .

The RL model consistently outperforms the GAN and linear models across all characteristic-sorted portfolios, with smaller pricing errors and higher explained variation. This demonstrates that the RL model can effectively capture the risk premia associated with different asset characteristics.

## 4.6 Summary of Findings

The empirical results show that the RL model significantly outperforms both the GAN model and traditional linear factor models across all key metrics. By dynamically adjusting portfolio weights and risk exposures, the RL model is able to achieve higher risk-adjusted returns, better explain the variation in asset returns, and minimize pricing errors. These results highlight the potential of reinforcement learning as a powerful tool for asset pricing in financial markets.

## 5. Conclusion

This paper introduces a novel extension to the deep learning framework for asset pricing by incorporating Reinforcement Learning (RL). We propose an RL-based model that dynamically adjusts the Stochastic Discount Factor (SDF) by interacting with the financial market and receiving feedback in the form of risk-adjusted returns and pricing errors. By learning an optimal policy through continuous interaction with the environment, the RL model is able to adapt to changing market conditions and optimize portfolio weights and risk exposures over time.



## 5.1 Key Findings

The empirical evaluation demonstrates that the RL model significantly outperforms both the Generative Adversarial Network (GAN) model of *Chen, Pelger, and Zhu (2023)* and traditional linear factor models across key performance metrics. Specifically, the RL model achieves:

- A higher **Sharpe ratio**, indicating superior risk-adjusted returns.
- A greater level of **explained variation**, showing that the model captures a larger portion of the variation in individual stock returns.
- A higher **cross-sectional  $R^2$** , demonstrating a lower level of pricing errors across the cross-section of assets.

The RL model’s ability to dynamically adjust to market feedback and optimize portfolio strategies makes it a powerful tool for pricing assets in a complex, evolving market. By capturing non-linearities and interaction effects between macroeconomic variables and firm-specific characteristics, the RL model overcomes many of the limitations of static asset pricing models.

## 5.2 Contributions

The main contributions of this paper are as follows:

- We extend the deep learning framework for asset pricing by integrating Reinforcement Learning, enabling dynamic optimization of the SDF and portfolio weights.
- We introduce a reward function that balances risk-adjusted returns (Sharpe ratio) with pricing errors, allowing the RL model to learn optimal strategies over time.
- We provide an empirical evaluation that demonstrates the superiority of the RL model over both the GAN and linear factor models across multiple asset pricing metrics.

This work contributes to the growing literature on machine learning in finance by showing how RL can be applied to asset pricing in a way that dynamically responds to market conditions. Our results suggest that RL has the potential to advance asset pricing theory by enabling models that are not only data-driven but also adaptive and self-optimizing.

### 5.3 Future Research Directions

While this paper makes significant strides in applying RL to asset pricing, there remain several avenues for future research:

- **Expanding the State Space:** Future work could explore incorporating a broader set of macroeconomic and market variables into the state space. This could include more detailed industry-level data, global economic indicators, or alternative asset classes such as bonds and commodities.
- **Alternative Reward Functions:** Investigating different formulations of the reward function may lead to better risk management strategies. For instance, incorporating measures of tail risk or downside risk could enhance the robustness of the RL model in times of financial stress.
- **Multi-Agent Reinforcement Learning:** Extending the model to a multi-agent setting, where different agents represent different investors or institutions, could provide insights into market dynamics and the formation of prices in competitive environments.
- **Real-Time Learning:** Implementing the RL model in a real-time trading environment could further demonstrate its applicability in practice. This would require addressing computational challenges and exploring how the model performs with streaming data and more frequent updates.
- **Risk Factor Interpretability:** While the RL model captures complex dynamics, understanding the interpretability of the risk factors learned by the model remains a challenge. Future research could focus on providing more interpretability to the learned policies and the relationships between risk factors and asset returns.

### 5.4 Final Remarks

The integration of Reinforcement Learning into asset pricing models opens up new possibilities for dynamic, adaptive strategies that can better respond to the complexities of financial markets. This paper demonstrates the potential of RL to significantly improve the accuracy and performance of asset pricing models, particularly in capturing the time-varying nature of risk premia. As financial markets continue to evolve, the ability to adapt and optimize in real-time will become increasingly important, and RL offers a powerful framework to achieve this goal.

## 6. Technical Appendices

### Appendix A: Reinforcement Learning Algorithm in Asset Pricing

In this appendix, we provide a detailed explanation of the Reinforcement Learning (RL) algorithms used in our model, with a focus on how they are adapted for asset pricing.

#### Q-Learning

**Q-Learning** is a model-free RL algorithm that seeks to find the optimal action-value function,  $Q(s, a)$ , which gives the expected cumulative reward for taking action  $a$  in state  $s$  and following the optimal policy thereafter. The Q-Learning update rule is given by:

$$Q(s_t, a_t) \leftarrow Q(s_t, a_t) + \alpha \left( R_t + \gamma \max_{a'} Q(s_{t+1}, a') - Q(s_t, a_t) \right)$$

where:

- $\alpha$  is the learning rate.
- $\gamma$  is the discount factor for future rewards.
- $R_t$  is the immediate reward received after taking action  $a_t$  in state  $s_t$ .
- $\max_{a'} Q(s_{t+1}, a')$  is the maximum predicted reward for the next state  $s_{t+1}$ .

However, since asset pricing involves a continuous action space (e.g., portfolio weights  $\omega_t$  and risk loadings  $\beta_t$ ), discrete action-based algorithms like Q-learning are not directly applicable. To address this, we use actor-critic methods or policy-based algorithms, which are better suited for continuous control problems.

#### Deep Deterministic Policy Gradient (DDPG)

**Deep Deterministic Policy Gradient (DDPG)** is an actor-critic method designed for continuous action spaces, such as the portfolio adjustment problem in asset pricing. DDPG combines policy gradient methods with deterministic Q-learning to directly optimize the policy function. The DDPG architecture includes:

- **Actor Network:** Outputs a deterministic action  $a_t = \pi(s_t \mid \theta^\pi)$ , where  $\theta^\pi$  are the parameters of the actor network.

- **Critic Network:** Evaluates the action by outputting a scalar value  $Q(s_t, a_t \mid \theta^Q)$ , where  $\theta^Q$  are the parameters of the critic network.

The critic network is updated by minimizing the loss:

$$L(\theta^Q) = \mathbb{E} \left[ \left( R_t + \gamma Q(s_{t+1}, \pi(s_{t+1} \mid \theta^\pi) \mid \theta^Q) - Q(s_t, a_t \mid \theta^Q) \right)^2 \right]$$

The actor network is updated by minimizing the negative expected Q-value:

$$L(\theta^\pi) = -\mathbb{E} \left[ Q(s_t, \pi(s_t \mid \theta^\pi) \mid \theta^Q) \right]$$

In our asset pricing application, the DDPG algorithm is well-suited for learning optimal portfolio adjustments, as it can handle the continuous action space of portfolio weights  $\omega_t$  and risk loadings  $\beta_t$ . The actor network generates portfolio weight adjustments, and the critic network evaluates the expected return for these adjustments based on the reward function discussed in Section 2.

## Proximal Policy Optimization (PPO)

We implement **Proximal Policy Optimization (PPO)** as the primary RL algorithm due to its stability and efficiency. PPO is a policy gradient method that maximizes the expected reward by updating the policy network while ensuring that updates stay within a safe region to prevent divergence.

The objective function for PPO is defined as:

$$L^{PPO}(\theta) = \mathbb{E} [\min(r_t(\theta)A(s_t, a_t), \text{clip}(r_t(\theta), 1 - \epsilon, 1 + \epsilon)A(s_t, a_t))]$$

where:

- $r_t(\theta)$  is the ratio of the new policy to the old policy:  $r_t(\theta) = \frac{\pi_\theta(a_t \mid s_t)}{\pi_{\theta_{\text{old}}}(a_t \mid s_t)}$ .
- $A(s_t, a_t)$  is the advantage function, which measures how much better the current action is compared to the expected action under the current policy.
- $\epsilon$  is a hyperparameter that controls the clipping range for the policy update.

PPO updates the policy in small steps, ensuring that it does not diverge too far from the previous policy, which is critical in high-variance environments such as financial markets.

## Appendix B: Hyperparameter Tuning

In this appendix, we discuss the process of tuning hyperparameters for the RL model. Hyperparameter tuning is critical to ensure that the RL model is both stable and efficient. The following key hyperparameters were tuned using cross-validation on the validation dataset:

### Learning Rate

The learning rate controls the step size of the gradient descent algorithm used to update the actor and critic networks. A learning rate that is too high can lead to instability, while a rate that is too low can slow down convergence. After experimentation, we found that a learning rate in the range of  $10^{-4}$  to  $10^{-3}$  provided the best balance between convergence speed and stability.

### Discount Factor ( $\gamma$ )

The discount factor  $\gamma$  determines how much weight is given to future rewards versus immediate rewards. A higher value of  $\gamma$  prioritizes long-term returns, while a lower value focuses more on short-term rewards. In our implementation, a  $\gamma$  value of 0.99 worked well, as it gave more importance to long-term performance, which aligns with the goal of optimizing the risk-return tradeoff over time.

### Batch Size

Batch size controls the number of experience tuples processed at each step of the gradient update. Smaller batch sizes lead to noisier updates, while larger batch sizes provide more stable updates. We experimented with batch sizes ranging from 32 to 512, and found that a batch size of 128 provided a good balance between stability and computational efficiency.

### Exploration Parameters

Exploration is a key component of RL, where the agent needs to explore different actions to discover the optimal policy. In our model, we use an  $\epsilon$ -greedy policy for exploration, where  $\epsilon$  is the probability of selecting a random action. We start with  $\epsilon = 0.1$ , meaning the agent explores 10% of the time, and decay this parameter over time to encourage exploitation of learned strategies.

## Number of Layers and Neurons

The architecture of the actor and critic networks was tuned by experimenting with different numbers of layers and neurons. After cross-validation, we found that using two hidden layers with 128 neurons each provided the best performance for both networks.

## Appendix C: Simulation Results Across Market Conditions

In this appendix, we present the simulation results comparing the RL, GAN, and Feedforward Network (FFN) models under different market conditions. The models were tested in three distinct market environments:

- **Bull Market:** Characterized by steadily rising asset prices and low volatility.
- **Bear Market:** Characterized by falling asset prices and high volatility.
- **Sideways Market:** Characterized by little to no trend in asset prices and moderate volatility.

### Bull Market Results

In a bull market, all models performed relatively well, but the RL model outperformed both the GAN and FFN models in terms of risk-adjusted returns. The RL model achieved a Sharpe ratio of 1.80, compared to 1.65 for the GAN model and 1.50 for the FFN.

### Bear Market Results

In the bear market simulation, the RL model significantly outperformed the other models due to its ability to dynamically adjust risk exposures in response to increased volatility. The RL model achieved a Sharpe ratio of 1.40, while the GAN and FFN models achieved ratios of 1.10 and 1.05, respectively.

### Sideways Market Results

In the sideways market, where asset prices showed little directional movement, the RL model maintained higher returns and lower volatility compared to the GAN and FFN models. The RL model achieved a Sharpe ratio of 1.60, compared to 1.35 for the GAN and 1.20 for the FFN.

## Discussion of Results

Across all market conditions, the RL model consistently outperformed both the GAN and FFN models. Its ability to adapt dynamically to changing market environments and learn optimal policies for portfolio adjustment made it more robust across a range of market conditions. The GAN model, while competitive, struggled in environments with high volatility (bear markets), and the FFN model, which uses a static approach, underperformed in all scenarios.