

Portfolio Optimization Based on a Complex Networks Model

TODO: propose a better title

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Abstract—A new portfolio optimization algorithm is presented that is based on statistical arbitrage and potential method for determining the preference flow. At each time step a graph that represents preference relations among financial assets (i.e., if connection exists from asset A to asset B then A is preferred over B) is constructed, using the modified version of statistical arbitrage. Then, the preference flow is calculated, using the potential method[1], from which preferred assets are selected into the portfolio for that time step.

Method has been tested on dataset XY and... (TODO: what happened)

I. INTRODUCTION

The task of portfolio optimization is to try to enhance various criteria, which most of the time include maximization of expected return and minimization of deviation...

The approach in this paper relies on abrupt deviations in relations between prices in some observed set of assets, so in general it performs better where there is larger number of assets.

II. KEY COMPONENTS

Following are the descriptions of two key components in the algorithm: creating the graph, and choosing assets for the portfolio...

III. ALGORITHM

Parameters of the algorithm are: T - number of days, and p - deviation threshold.

Let there be total of N assets in D days. Let price of asset i at the time step t be $a_i^{(t)}$, for $i \in 1..N$ and $t \in 0..D-1$. The log prices $b_i^{(t)}$, log price differences $c_{i,j}^{(t)}$ between assets i and j , and rolling means $m_{i,j}^{(t)}$ and standard deviations $d_{i,j}^{(t)}$ of log price differences over past time window of size T are obtained as follows:

$$b_i^{(t)} = \log(a_i^{(t)}), \quad (1)$$

$$c_{i,j}^{(t)} = b_i^{(t)} - b_j^{(t)}, \quad (2)$$

$$m_{i,j}^{(t)} = \frac{1}{T} \sum_{\tau=t-T+1}^t c_{i,j}^{(\tau)}, \quad (3)$$

$$d_{i,j}^{(t)} = \sqrt{\frac{1}{T} \sum_{\tau=t-T+1}^t (c_{i,j}^{(\tau)} - m_{i,j}^{(t)})^2}. \quad (4)$$

Note that calculating means and standard deviations of log price differences separately for each time step t is rather computationally inefficient when dealing with rolling windows of data. Therefore, it is advisable to use a rolling

algorithm as described in the appendix. On that note, $c_{i,j}^{(t)}$, $m_{i,j}^{(t)}$, and $d_{i,j}^{(t)}$ may be more efficiently stored contiguously in memory as a matrix, using following coding scheme: a pair (i, j) , where $i < j$, should be encoded to k as:

$$k = N \cdot (i-1) + j - 1 - i \cdot (i+1)/2, \quad (5)$$

and decoded from k as:

$$i = \left\lfloor N + 1/2 - \sqrt{(N + 1/2)^2 - 2(N + k)} \right\rfloor, \quad (6)$$

$$j = k + i \cdot (i+1)/2 - N \cdot (i-1) + 1. \quad (7)$$

An example of proposed coding is shown on figure 1.

						k	i	j
						0	1	2
						1	1	3
						2	1	4
						3	1	5
						4	2	3
						5	2	4
						6	2	5
						7	3	4
						8	3	5
						9	4	5
i/j	1	2	3	4	5			
1	.	0	1	2	3			
2	.	.	4	5	6			
3	.	.	.	7	8			
4	9			
5			

Fig. 1. Example of the proposed coding scheme, for $N = 5$. A dot (.) indicates that that combination is not used.

A. Creating the graph

Using the obtained $c_{i,j}^{(t)}$, $m_{i,j}^{(t)}$, and $d_{i,j}^{(t)}$ it is now possible to create a graph of preference relations between assets for each time step t . Considering the time step t , we find all such pairs of assets (i, j) for which holds:

$$\left| c_{i,j}^{(t)} - m_{i,j}^{(t-1)} \right| > p \cdot d_{i,j}^{(t-1)}, \quad (8)$$

i.e. current log price difference is at least p deviations distant from mean value of the past time window.

Afterwards, for each observed pair (i, j) that breaks the threshold we add into graph vertices i and j , and a weighed link going from i to j , with weight $w_{i,j}^{(t)}$ obtained as:

$$w_{i,j}^{(t)} = (c_{i,j}^{(t)} - m_{i,j}^{(t-1)}) / d_{i,j}^{(t-1)}. \quad (9)$$

Thus, it is possible to create a relatively sparse graph for each time step $t \in T..D-1$. At some time steps it is possible that the graph could be empty, if it is the case that no pair (i, j) satisfies (8). Lower values of parameter p yield denser graphs.

B. Choosing assets from graph

IV. RESULTS

TODO

V. CONCLUSIONS

TODO

APPENDIX

A. Rolling mean and variance algorithm

TODO

REFERENCES

- [1] L. Čaklović, Decision Making by Potential Method