Portfolio Management

FN 4329

Dimitriadis Nikolaos   Kyratzis Apostolos

American College of Greece

Spring Semester 2020

Contents

Todo

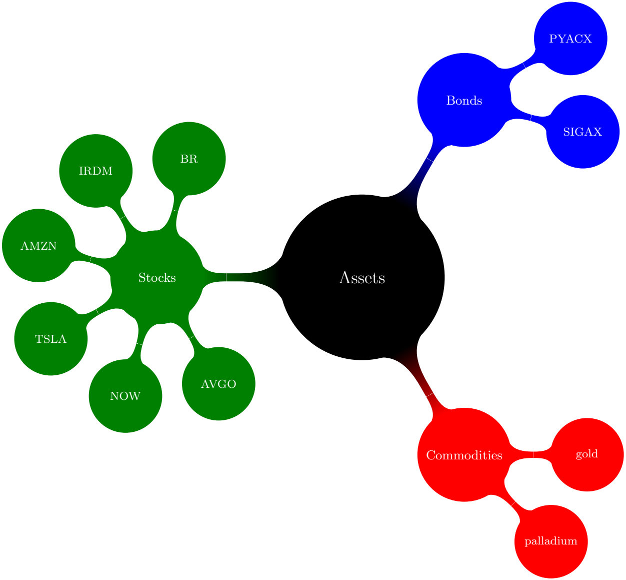
- fix contents (example: Intro, Theory, Results)
- better resolution on images

Asset allocation

- 70% Stocks
- 20% Bonds
- 10% Commodities

Contents

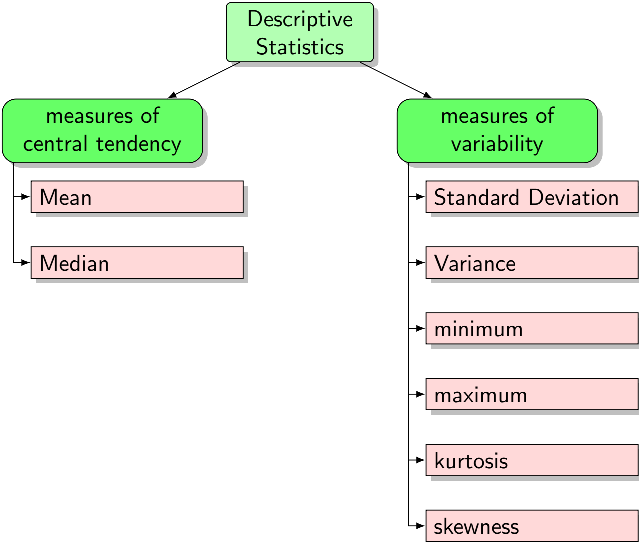
Security Selection



Contents

Contents

Descriptive statistics Taxonomy



Mean

$$\bar{x} = \frac{1}{n}\left(\sum_{i=1}^{n} x_i\right) = \frac{x_1 + x_2 + \cdots + x_n}{n}$$

Measures of central tendency
Median

- i.e. the middle value

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- Why?

Measures of central tendency

Median

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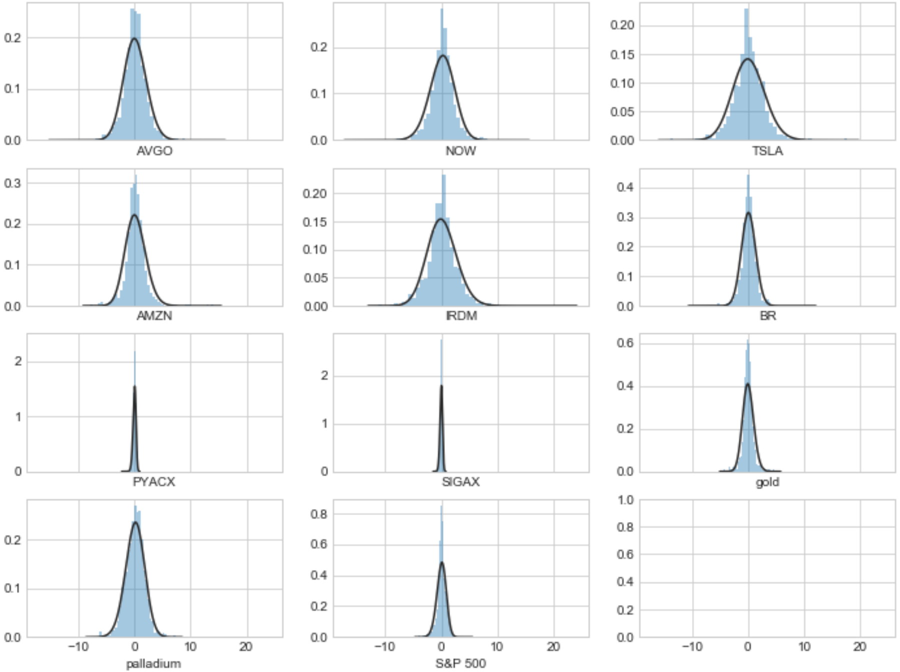
- Why? robust w.r.t. outliers
- indicates whether returns are positive or negative on most time instances.

Measures of Variability

Standard Deviation

$$\sigma = \sqrt{\frac{1}{N}\sum_{i=1}^{N}(x_i - \bar{x})^2}$$

- how "spread out" are the data around the mean
- measures confidence in statistics $\implies$ risk in finance


AVGO
NOW
TSLA
AMZN
IRDM
BR
PYACX
SIGAX
gold
palladium
S&P 500

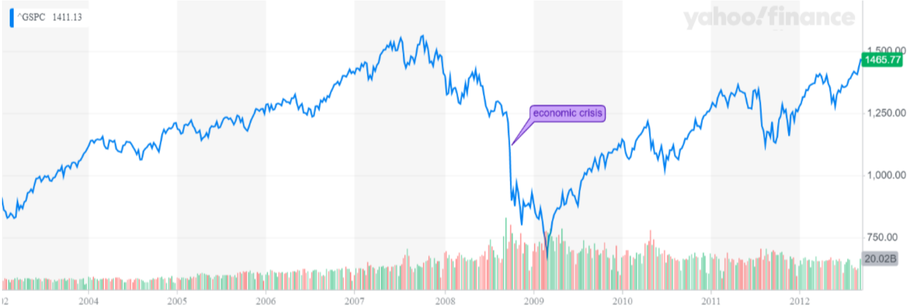


Figure: The minimum of the `S&P500` returns would occur on the day of the economic crisis for this period.

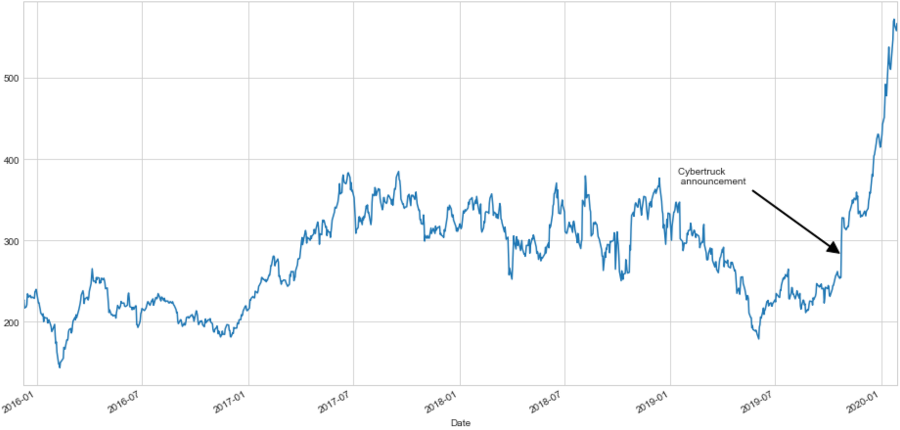
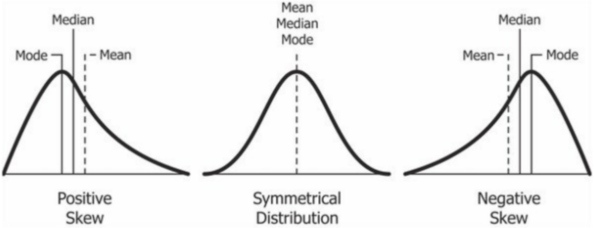


Figure: Tesla's announcement of the Cybertruck resulted in a steep price increase.

Definition

$$\tilde{\mu}_3 = \mathbb{E}\left[\left(\frac{X - \bar{x}}{\sigma}\right)^3\right]$$

Skewness is a measure of asymmetry that indicates if the tail of the distribution is on the left or the right.



Definition

$$\text{Kurt}(X) = \tilde{\mu}_4 = \mathbb{E}\left[\left(\frac{X - \bar{x}}{\sigma}\right)^4\right]$$

Kurtosis measures whether the distribution is heavy- or light-tailed relative to a normal distribution

- high kurtosis $\rightarrow$ heavy tails **(outliers)**
- low kurtosis $\rightarrow$ no outliers

Measures of Variability

An overview

Moments

- $\tilde{\mu}_2$ standard deviation σ
- $\tilde{\mu}_3$ skewness
- $\tilde{\mu}_4$ kurtosis

Contents

Covariance

Covariance Definition

Let X and Y be two random variables. Then the covariance is a measure of the joint variability of these two random variables:

$$cov(X, Y) = \mathbb{E}[(X - \bar{x})(Y - \bar{y})]$$

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- not so helpful!

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- not so helpful! $\rightarrow$ correlation

Correlation

Definition

The correlation is the normalization of the covariance.

$$\rho_{X,Y} = \frac{cov(X,Y)}{\sigma_X \cdot \sigma_Y}$$

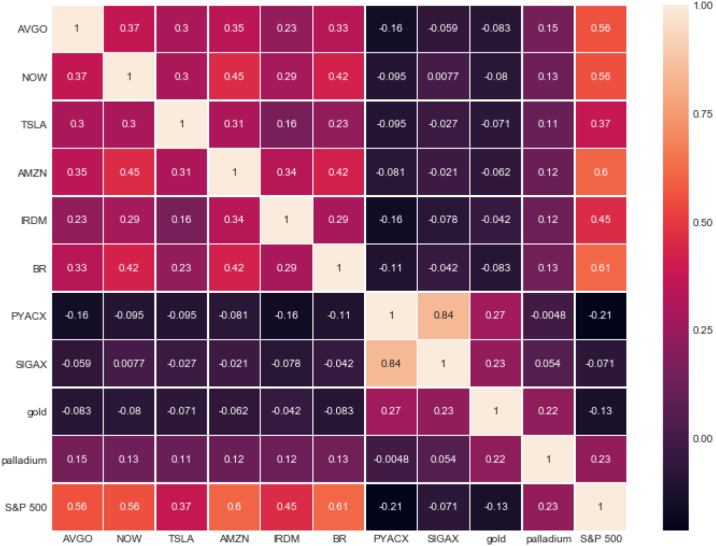
$$\rho_{X,Y} \begin{cases} = -1, & \text{perfect decreasing (inverse) linear relationship} \\ \in (-1, 1), & \text{indicating the degree of linear dependence} \\ = 1, & \text{perfect (increasing) linear relationship} \end{cases}$$

A closer look at correlation

todo

add regression plots to show the difference

Correlation Matrix



Beta

Definition

The beta coefficient measures the systematic risk of an individual stock compared to the market risk, also called unsystematic risk.

$$\beta = \frac{\mathrm{cov}(R_e, R_m)}{\mathrm{var}(R_m)}$$

alpha

Definition

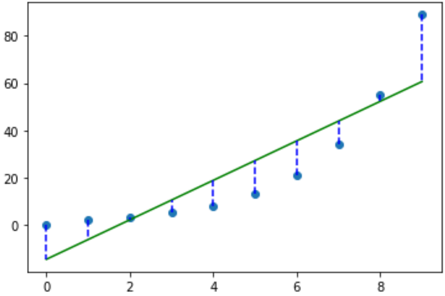
Alpha is the difference between the realised returns and the expected returns:

$$\alpha = \bar{R} - \mathbb{E}(R)$$

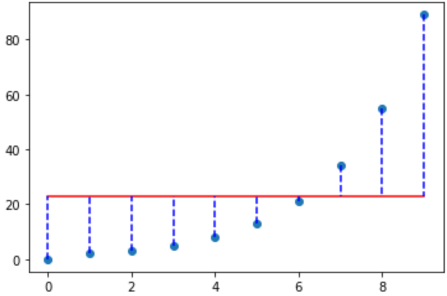
$$\stackrel{\text{CAPM}}{\Longrightarrow} \alpha = \bar{R} - \left\{R_f + \beta(\mathbb{E}(R_m) - R_f)\right\}$$

R-squared

$$R^2 = 1 - \frac{\text{Explained Variation}}{\text{Total Variation}}$$



(a) Explained Variation



(b) Total Variation

Sharpe Ratio

$$\text{Sharpe Ratio} = \frac{R_p - R_f}{\sigma_p}$$

where

- R_p = return of mutual fund
- R_f = risk-free rate
- σ_p = standard variation of the portfolio's excess return

Contents

Risk and return

Return

$$R_p = \vec{w}^\top \cdot \mathbb{E}(\mathcal{R})$$

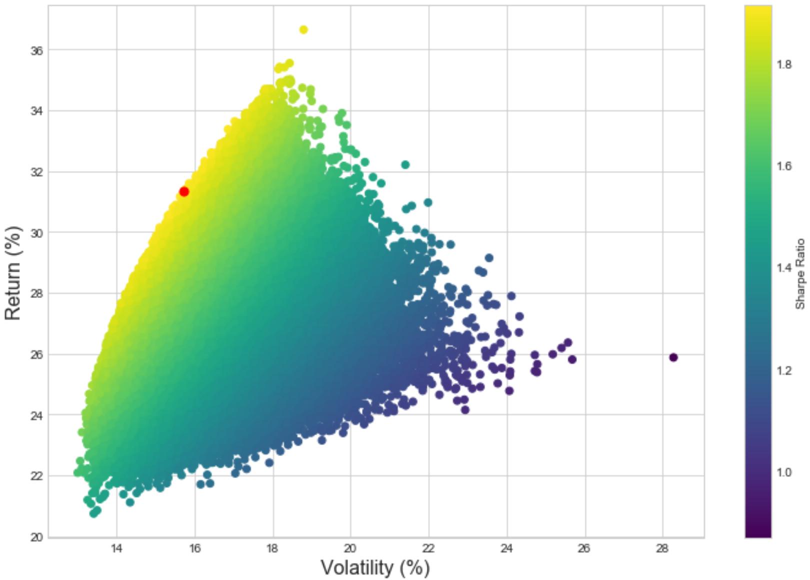
Risk

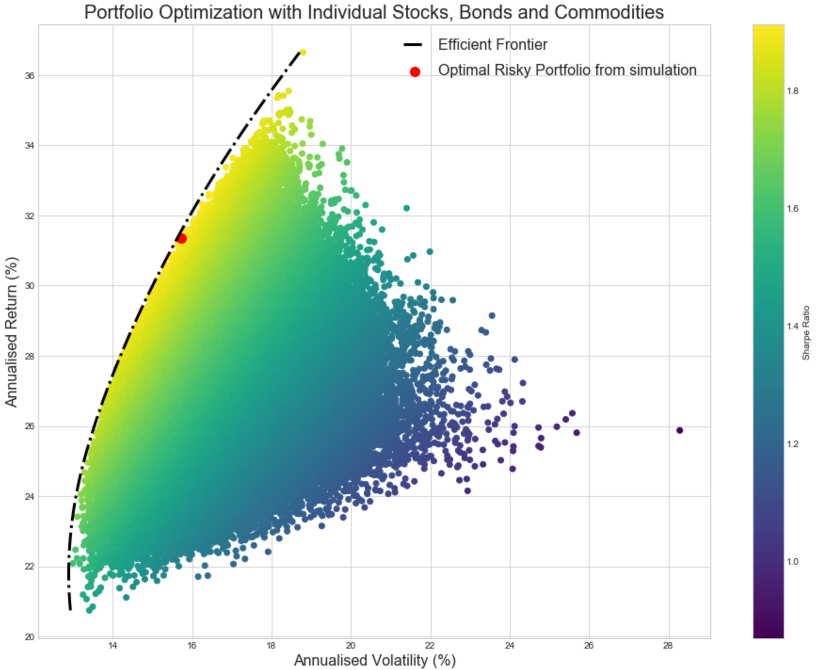
$$\sigma_p = \sqrt{\vec{w}^\top K \vec{w}}$$

$$= \sqrt{\begin{bmatrix} w_1 & w_2 & \dots & w_n \end{bmatrix} \begin{bmatrix} \sigma_1^2 & \mathrm{cov}_{1,2} & \dots & \mathrm{cov}_{1,n} \\ \mathrm{cov}_{2,1} & \sigma_2^2 & \dots & \mathrm{cov}_{2,n} \\ \vdots & \vdots & \ddots & \vdots \\ \mathrm{cov}_{n,1} & \mathrm{cov}_{n,2} & \dots & \sigma_n^2 \end{bmatrix} \begin{bmatrix} w_1 \\ w_2 \\ \vdots \\ w_n \end{bmatrix}}$$

$$= \sqrt{\sum_{i=1}^{n} w_i^2 \sigma_i^2 + \sum_{i=1}^{n} \sum_{j=1}^{n} w_i w_j \mathrm{cov}_{i,j}}$$

Contents


Return (%)
Volatility (%)
Sharpe Ratio
36
34
32
30
28
26
24
22
20
14
16
18
20
22
24
26
28
1.8
1.6
1.4
1.2
1.0


Portfolio Optimization with Individual Stocks, Bonds and Commodities
Efficient Frontier
Optimal Risky Portfolio from simulation
Annualised Return (%)
Annualised Volatility (%)
Sharpe Ratio
20
22
24
26
28
30
32
34
36
14
16
18
20
22
24
26
28
1.0
1.2
1.4
1.6
1.8

Optimal portfolio

Optimization problem formulation

$$
\begin{aligned}
\max \quad & \boxed{\frac{\vec{w}^\top \cdot \mathbb{E}(\mathcal{R}) - r_f}{\sqrt{\vec{w}^\top K \vec{w}}}} \\
\text{s.t.} \quad & \mathbf{1}^\top \vec{w} = 1 \\
& \mathbf{1}^\top \vec{w}_{\mathcal{S}} = w_s \\
& \mathbf{1}^\top \vec{w}_{\mathcal{B}} = w_b \\
& \mathbf{1}^\top \vec{w}_{\mathcal{C}} = w_c \\
& w_s + w_b + w_c = 1 \\
& w_i \geq 0 \quad i = 1, \dots, n
\end{aligned}
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Optimal portfolio
Optimization problem formulation

Sharpe Ratio

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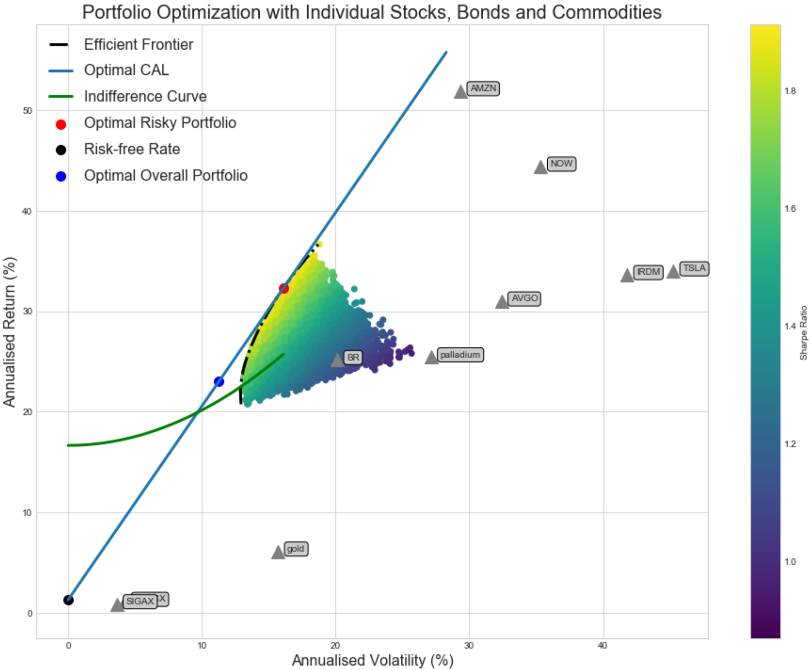
Capital Allocation Line

$$\left\{ \begin{array}{c} (0, r_f) \in \epsilon_{\text{CAL}} \\ (\sigma_{\text{OPT}}, r_{\text{OPT}}) \in \epsilon_{\text{CAL}} \end{array} \right\}$$

Capital Allocation Line

$$\left\{ \begin{array}{c} (0, r_f) \in \epsilon_{\text{CAL}} \\ (\sigma_{\text{OPT}}, r_{\text{OPT}}) \in \epsilon_{\text{CAL}} \end{array} \right\} \implies \epsilon_{CAL} : y = \underbrace{\frac{r_{\text{OPT}} - r_f}{\sigma_{\text{OPT}}}}_{\text{max Sharpe ratio}} \cdot x + r_f$$


Portfolio Optimization with Individual Stocks, Bonds and Commodities
Efficient Frontier
Optimal CAL
Indifference Curve
Optimal Risky Portfolio
Risk-free Rate
Optimal Overall Portfolio
AMZN
NOW
IRDM
TSLA
AVGO
palladium
BR
gold
SIGAX
Annualised Return (%)
Annualised Volatility (%)
Sharpe Ratio
0
10
20
30
40
50
1.0
1.2
1.4
1.6
1.8

References

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The end!