Portfolio Management
FN 4329

Dimitriadis Nikolaos   Kyratzis Apostolos

American College of Greece

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Contents

Questionnaire

SELECT AN INVESTMENT STRATEGY

These investment strategies show how investors might allocate their money among investments in various categories. Please note that these examples are not based on market forecasts, but simply reflect an established approach to investing—allocating dollars among different investment categories. Keep in mind that it's important to periodically review your investment strategy to make sure it continues to be consistent with your goals.

If one of the investment strategies below matches your Investor Profile, you can use this information to help you create an asset allocation plan.

Conservative allocation	Moderately conservative	Moderate allocation	Moderately aggressive	Aggressive allocation
Average annual return: 7.6%	Average annual return: 8.8%	Average annual return: 9.5%	Average annual return: 10.0%	Average annual return: 10.3%
Best year: 22.8%	Best year: 27.0%	Best year: 30.9%	Best year: 34.4%	Best year: 39.9%
Worst year: -4.6%	Worst year: -12.5%	Worst year: -20.9%	Worst year: -29.5%	Worst year: -36.0%
For investors who seek current income and stability and are less concerned about growth.	For investors who seek current income and stability, with modest potential for increase in the value of their investments.	For long-term investors who don't need current income and want some growth potential. Likely to entail some fluctuations in value, but presents less volatility than the overall equity market.	For long-term investors who want good growth potential and don't need current income. Entails a fair amount of volatility, but not as much as a portfolio invested exclusively in equities.	For long-term investors who want high growth potential and don't need current income. May entail substantial year-to-year volatility in value in exchange for potentially high long-term returns.

■ Large-Cap Equity   ■ Small-Cap Equity   ■ International Equity   ■ Fixed Income   ■ Cash Investments

charles SCHWAB
Own your tomorrow™

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

Security Selection

Stocks

AVGO - Broadcom Inc

- Large/High-Dividend
- Wireless chips and semiconductor manufacturer
- Announced 15$ billion deal with Apple Inc. in January 2020
- Potential for gains with 5G deployment
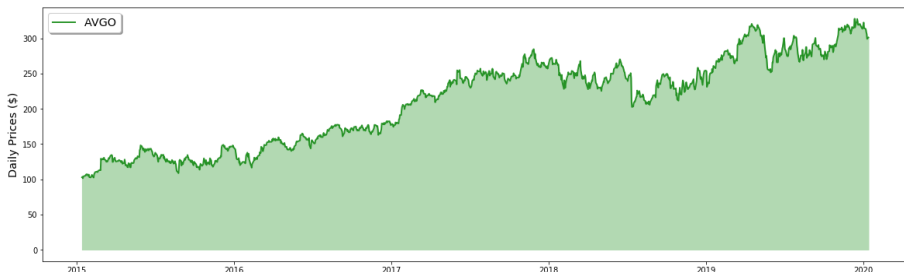
Stocks
NOW - ServiceNow Inc.

- Large/Growth
- Cloud-based solutions provider to global enterprises
- Software as a Service (SaaS) business model
- IT, Customer Support, HR and Security services
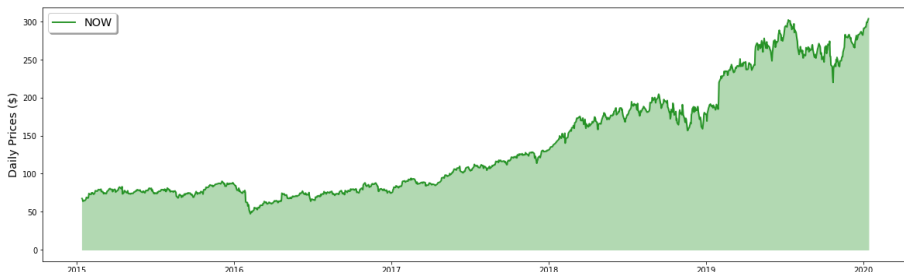
Stocks

- Large/Growth
- Leader in next-generation electric vehicles
- Advancements in battery technology will allow for increased autonomy
- 4th Gigafactory in Berlin to begin operations by July 2021

Stocks

- Large/Growth
- Biggest online retailer
- Online product and digital media sales
- AWS offers solutions for Machine Learning, Big Data, IoT and Cloud-Computing
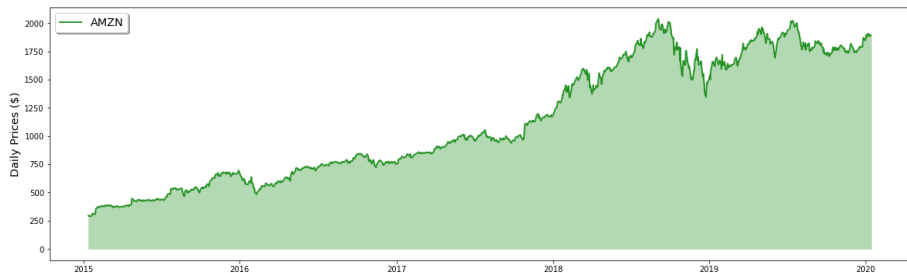
Stocks

- Small/Growth
- Lead provider of satellite communications, with over 70 satellites in orbit
- Announced partnership with AWS for future applications in 2018
- Wide commercial end base, from maritime and aviation to oil & gas suppliers

Stocks

BR - Broadridge Financial Solutions Inc.

- Mid/Aggressive Growth
- Fintech company that provides solutions for investors, banks, brokerage offices and mutual funds
- Products include communication platforms, securities processing and financial data analytics
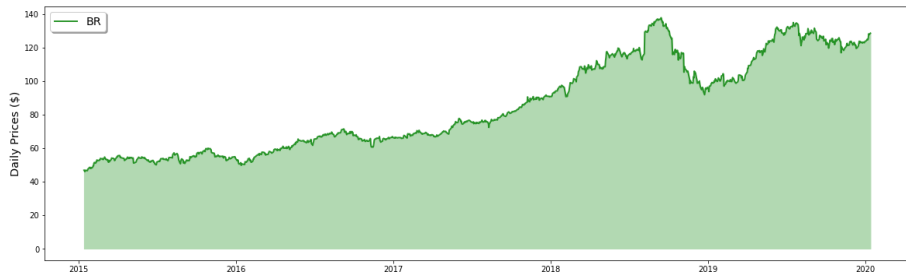
Bonds

PYACX - Payden Corporate Bond Mutual Fund

- The fund invests at least 85% of its assets in corporate bonds of mainly A and BBB credit rating
- 5-star ranking from Morningstar
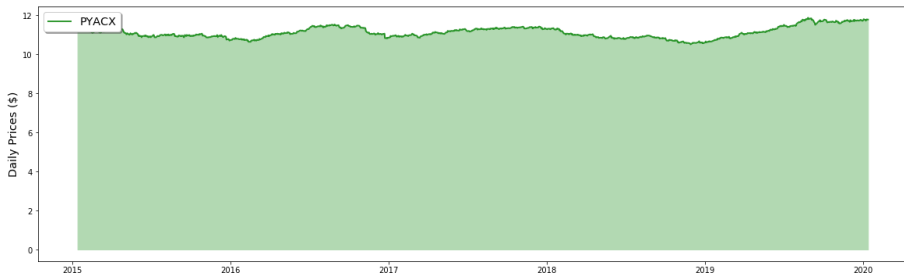
Bonds

SIGAX - Western Asset Corporate Bond Mutual Fund

- The fund invests at least 80% of its assets in corporate debt securities, while 10% of the assets might be non-U.S dollar nominated fixed income securities of foreign issuers.
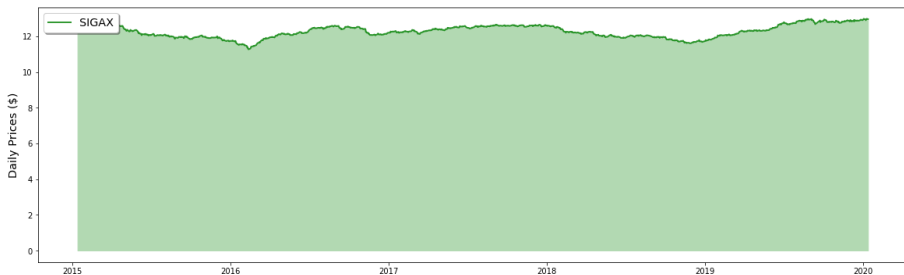
Commodities
gold

- Traditionally safe investment during rough economic times and hedge against inflation
- Recently preferred over government bonds, as the latter presented negative inflation-adjusted returns in 2019
- Does not generate return and has no holding costs
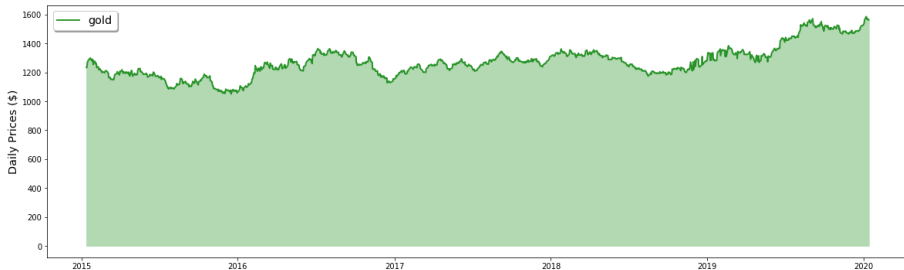
Commodities
palladium

- Metal that is used in catalytic converters, turning toxic gas emissions into less harmful ones
- Secondary product from mining operations of other metals
- As miners have less control over the extracted quantities, demand outstrips supply
- Price has doubled over the last year
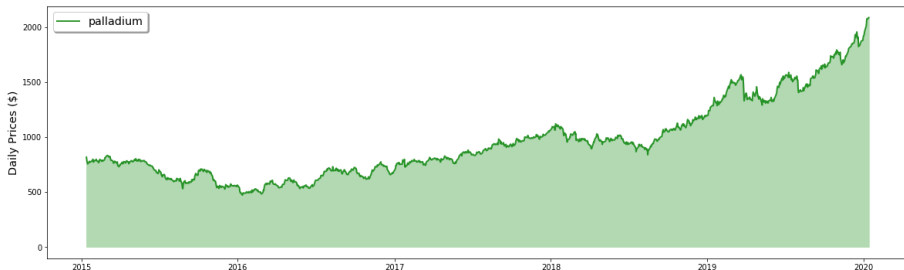
Diversification Strategy

- Chosen companies differentiate by market capitalization (Large, Mid, Small)
- Variation in industry sector (i.e Semiconductors, Cloud Technologies, Communication Services, Online Retail and Auto Manufacturing)
- Inclusion of bonds for risk reduction (negative correlation values with stocks) and minor current income generation
- Inclusion of commodities for risk reduction (negative correlation with stocks) and hedging against inflation

Contents

Descriptive statistics Taxonomy
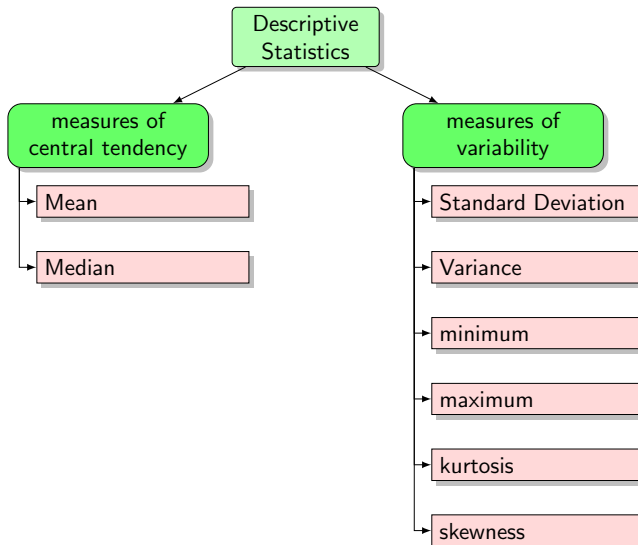
Measures of central tendency
Mean

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

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- The arithmetic mean of sampled values

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- The arithmetic mean of sampled values
- From the investor's perspective, the mean describes the average performance of the instrument. If $\bar{x} > 0$ then the instrument increases in value on average.

Measures of central tendency
Median

Definition

The middle value of a given dataset, separating the higher and lower half

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Measures of central tendency
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The middle value of a given dataset, separating the higher and lower half

- Usually preferred over the arithmetic mean
- Why? robust w.r.t. outliers
- Indicates whether returns are positive or negative on most time instances.

Measures of Variability
Standard Deviation

Definition

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

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- Quantifies how much "spread out" are the data around the mean
- Measures confidence in statistics $\implies$ risk in finance
- BUT assumes normal distribution $\rightarrow$ Skewness, Kurtosis
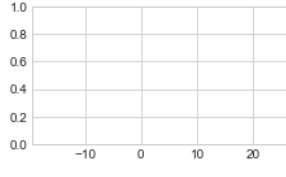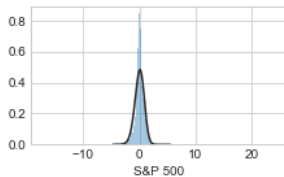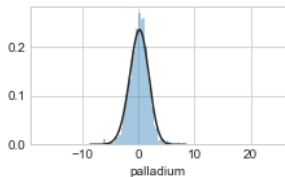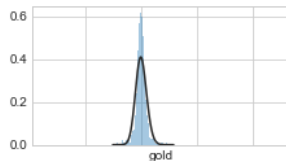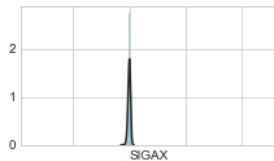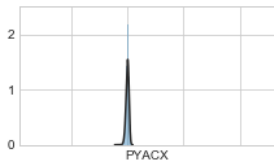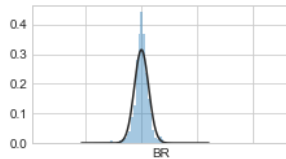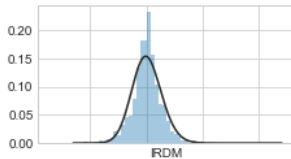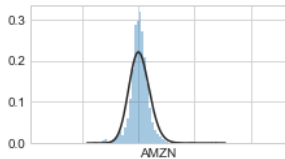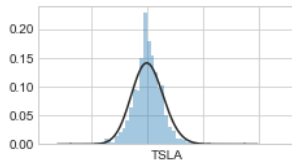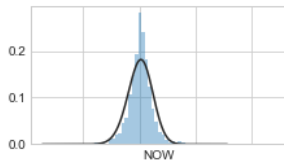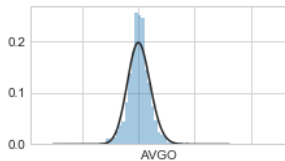
Measures of Variability
Minimum & Maximum
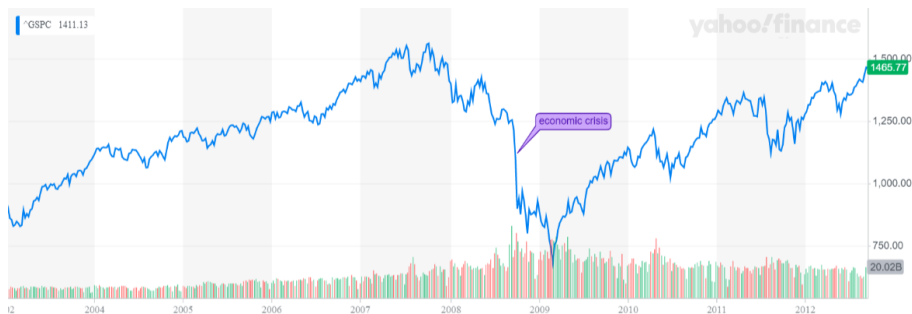
Figure: The minimum of the S&P 500 returns would occur on the day of the economic crisis for this period.

Measures of Variability
Minimum & Maximum

Cybertruck announcement

Measures of Variability

Skewness

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.

Measures of Variability
Skewness

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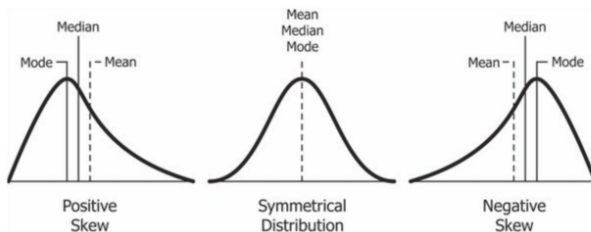
Measures of Variability

Kurtosis

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

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- High kurtosis $\rightarrow$ heavy tails **(outliers)**
- Low kurtosis $\rightarrow$ no outliers

Measures of Variability
An overview from an investor's perspective

$\tilde{\mu}_2$ standard deviation σ

- Measure of risk
- Assumes normal distribution

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$\tilde{\mu}_3$ skewness

- Measure of asymmetry: tail on the left/right
- $\tilde{\mu}_3 > 0$: frequent small losses, few large gains
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$\tilde{\mu}_4$ kurtosis

- Heavy- or light-tailed (relative to a normal distribution)
- High: occasional extreme returns (either positive or negative)

Descriptive Statistics
For our assets

	mean%	median%	std%	var%	min%	max%	kurtosis	skewness
AVGO	0.11	0.11	2.04	4.17	-13.74	14.71	5.31	0.23
NOW	0.15	0.21	2.23	4.96	-15.66	14.07	6.50	-0.33
TSLA	0.12	0.06	2.85	8.13	-13.90	17.67	5.06	0.30
AMZN	0.17	0.14	1.85	3.42	-7.82	14.13	9.83	1.01
IRDM	0.12	0.12	2.63	6.94	-11.13	22.24	6.47	0.62
BR	0.09	0.09	1.27	1.61	-9.70	11.16	9.29	-0.19
PYACX	0.00	0.00	0.27	0.07	-2.08	0.77	3.40	-0.71
SIGAX	0.00	0.00	0.23	0.05	-1.29	0.67	1.28	-0.43
gold	0.02	0.00	0.99	0.98	-4.32	5.10	4.56	0.33
palladium	0.09	0.15	1.71	2.92	-7.40	7.28	1.49	-0.15
S&P 500	0.04	0.05	0.84	0.71	-4.10	4.96	3.87	-0.47

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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Definition

The correlation is the normalization of the covariance.

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

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

A closer look at correlation
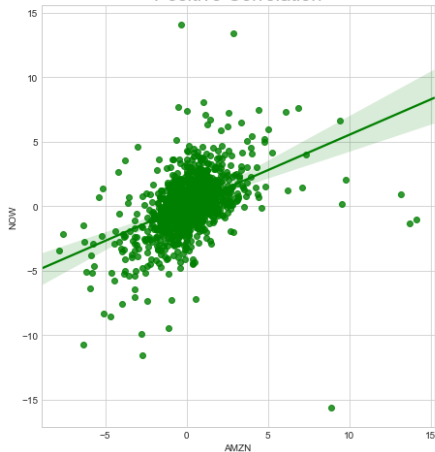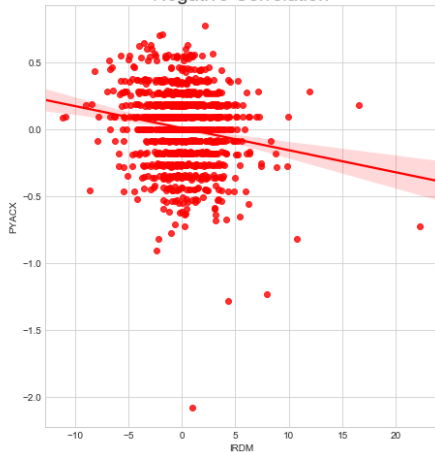
Correlation
From an investor's perspective

- Powerful tool that measures the strength of linear relationship between the price movements of two individual securities

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- Powerful tool that measures the strength of linear relationship between the price movements of two individual securities
- The total risk of two correlated assets is:

$$\sigma^2 = w_x^2 \cdot \sigma_x^2 + w_y^2 \cdot \sigma_y^2 + 2 \cdot w_x \cdot w_y \cdot \sigma_x \cdot \sigma_y \cdot \rho_{x,y}$$

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- Negatively correlated assets yield less risk, compared to positively correlated ones
- Investors can diversify risk by including negatively correlated assets in their portfolios

Correlation Matrix

Beta

Definition

The beta coefficient measures the systematic risk of an individual stock compared to the market risk:

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

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- Investors use β to determine the movement direction and volatility of a security in comparison with the market
- A high R^2 is required for β to be meaningful

alpha

Definition

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

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

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

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

- Investors use α to determine whether or not a security has exceeded expectations in terms of return
- Frequently used to quantify the "added" value of the manager

R-squared

Definition

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

R-squared

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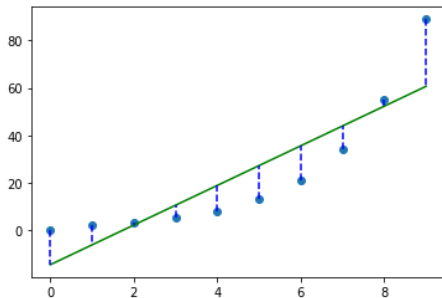
(a) Explained Variation
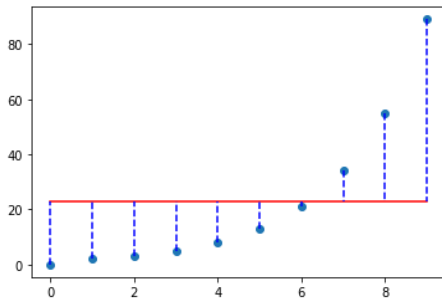
(b) Total Variation

- $R - squared$ measures the "fitness" of a regression model

Sharpe Ratio

Definition

Sharpe Ratio relates the return of an investment to its risk:

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

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- Measures the risk-adjusted return
- i.e. the average return earned *in excess* of the risk-free rate per unit of volatility or total risk.
- Useful for comparing the performance of investments that have different levels of risk and return

Financial Metrics

For our assets

	alpha	beta	R-squared
AVGO	0.14213	1.35333	0.31393
NOW	0.24718	1.46614	0.30955
TSLA	0.17711	1.26445	0.14046
AMZN	0.32815	1.32199	0.36539
IRDM	0.15867	1.41795	0.20698
BR	0.13206	0.92064	0.37655
PYACX	-0.00576	-0.06792	0.04613
SIGAX	-0.01215	-0.01911	0.00501
gold	0.05087	-0.15174	0.01684
palladium	0.17817	0.47398	0.05493

Contents

Risk and return

Return

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

Risk and return

Return

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

Risk

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

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

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

Naive weight allocation

Remember!

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

Naive weight allocation

What about $\vec{w}$?

- 70% for 6 Stocks $\rightarrow \dfrac{70\%}{6} = 11.67\%$ each
- 20% for 2 Bonds $\rightarrow 10\%$ each
- 10% for 2 Commodities $\rightarrow 5\%$ each

Naive Allocation yields...

Financial Metrics

	Naive Risky Portfolio
Return (%)	27.444
Risk (%)	15.7565
Sharpe Ratio	1.5977
Beta (β)	0.9109

Simulation of random portolios that create the available portfolio universe
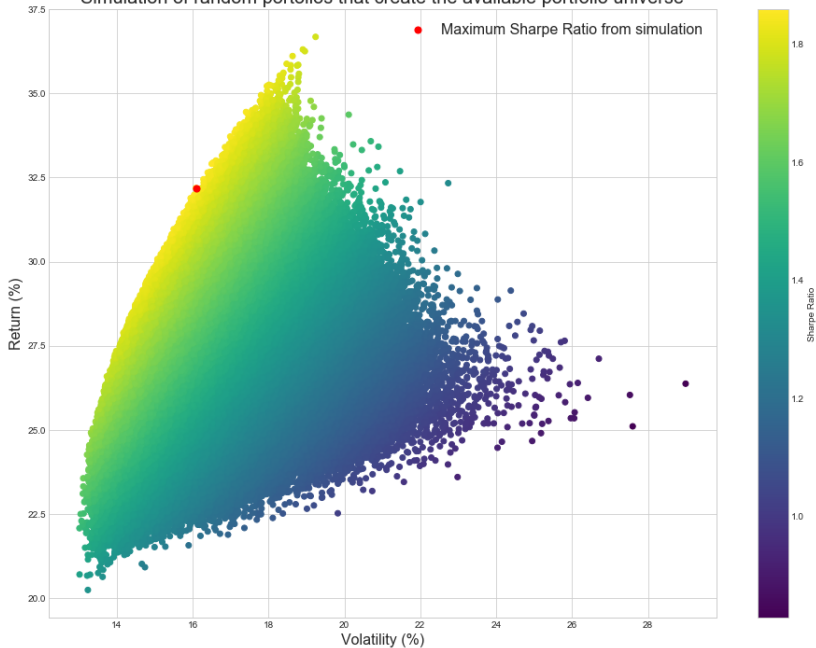
The construction of the Efficient Frontier
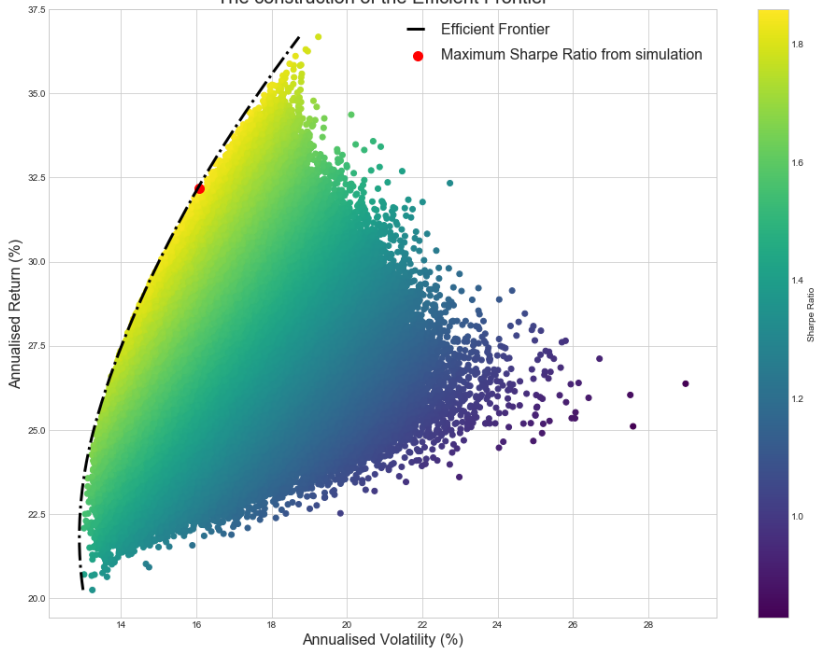
CAL construction

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

CAL construction

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

Naive CAL

Naive Portfolio with Individual Stocks, Bonds and Commodities
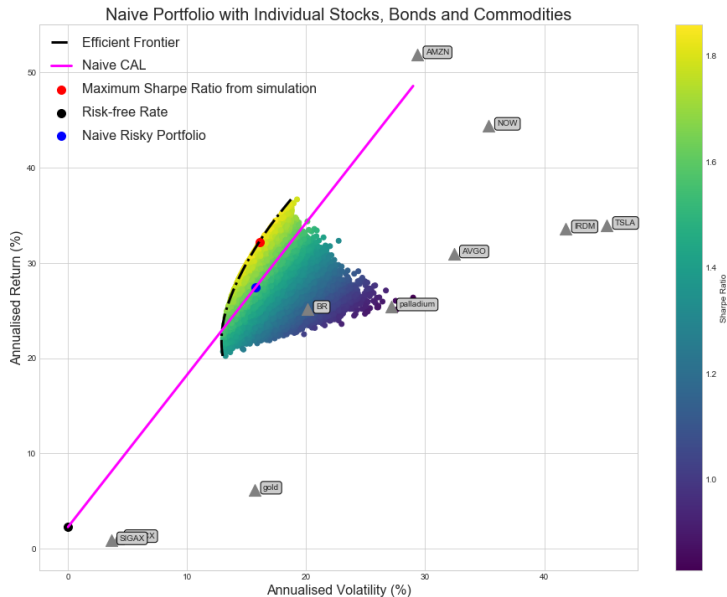
We can do better!

Optimal portfolio
Optimization problem formulation

$$\max \quad \frac{\vec{w}^\top \cdot \mathbb{E}(\mathcal{R}) - r_f}{\sqrt{\vec{w}^\top K \vec{w}}}$$

$$\text{s.t.} \quad \mathbf{1}^\top \vec{w} = 1$$

$$\mathbf{1}^\top \vec{w}_{\mathcal{S}} = w_s$$

$$\mathbf{1}^\top \vec{w}_{\mathcal{B}} = w_b$$

$$\mathbf{1}^\top \vec{w}_{\mathcal{C}} = w_c$$

$$w_s + w_b + w_c = 1$$

$$w_i \geq 0 \quad i = 1, \ldots, n$$

Optimal portfolio
Optimization problem formulation

Sharpe Ratio

$$\max \quad \frac{\vec{w}^\top \cdot \mathbb{E}(\mathcal{R}) - r_f}{\sqrt{\vec{w}^\top K \vec{w}}}$$

$$\text{s.t.} \quad \mathbf{1}^\top \vec{w} = 1$$

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$$w_i \geq 0 \quad i = 1, \ldots, n$$

Optimization yields...
Optimal weights

$$\vec{w} = \begin{bmatrix} w_{AVGO} \\ w_{NOW} \\ w_{TSLA} \\ w_{AMZN} \\ w_{IRDM} \\ w_{BR} \\ w_{PYACX} \\ w_{SIGAX} \\ w_{gold} \\ w_{palladium} \end{bmatrix} = \begin{bmatrix} 4.0068 \\ 8.6743 \\ 1.0266 \\ 38.2827 \\ 1.32 \\ 16.6897 \\ 20.0 \\ 0.0 \\ 0.0 \\ 10.0 \end{bmatrix} \%$$

- Assets with zero weight allocation can either be excluded or substituted by other assets of the same class

Optimization yields...
Financial Metrics

	Optimal Risky Portfolio	Naive Risky Portfolio
Return (%)	32.7164	27.444
Risk (%)	16.3185	15.7565
Sharpe Ratio	1.8658	1.5977
Beta (β)	0.9067	0.9109

Capital Allocation Line

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

Capital Allocation Line

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

Optimal Overall Portfolio

Which portfolio is the overall optimal?

- i.e. which portfolio along the CAL is the best

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Utility maximization

$$\text{Utility} = U = r_f + z \cdot (r_{\text{opt}} - r_f) - 0.05 \cdot A \cdot \sigma_{\text{opt}}^2 \cdot z^2$$

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Maximize w.r.t. z:

Optimal Overall Portfolio

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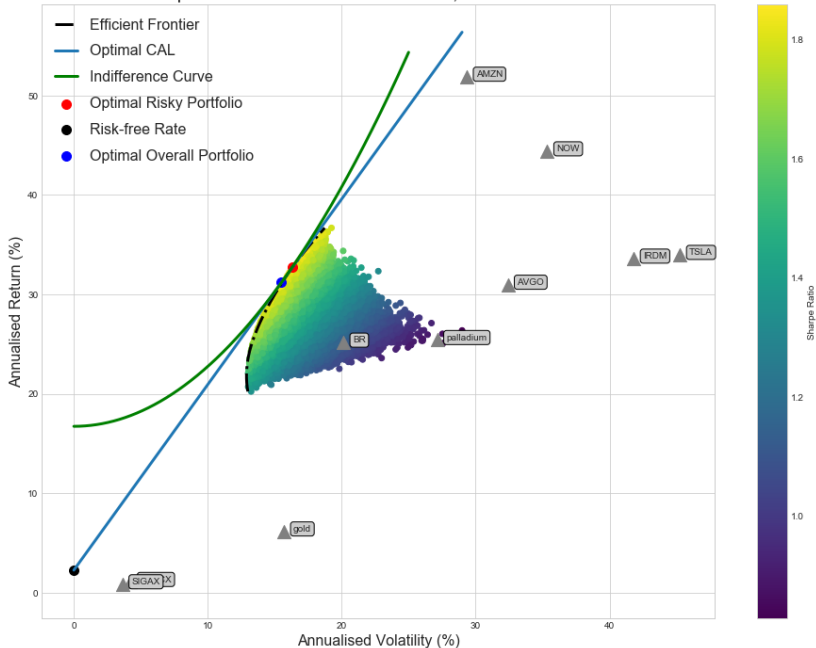
Maximize w.r.t. z:

$$\frac{\partial U}{\partial z} = 0$$

$$\implies r_{\text{opt}} - r_f - 0.1 \cdot A \cdot \sigma_{\text{opt}}^2 \cdot z = 0$$

$$\implies z^* = \frac{r_{\text{opt}} - r_f}{0.1 \cdot A \cdot \sigma_{\text{opt}}^2}$$

Portfolio Optimization with Individual Stocks, Bonds and Commodities

Past Performance
(1/13/2015 - 1/13/2020)

	Optimal Overall Portfolio	S&P 500
Return (%)	31.1941	11.3118
Risk (%)	15.5026	13.4138
Sharpe Ratio	1.8658	0.6741
Beta (β)	0.8613	1.0
Alpha (α) (%)	21.1362	0.0

Holding Period Returns
(1/14/2020 - 4/20/2020)

	Optimal Overall Portfolio	S&P 500
HPR (%)	+6.8182	-14.7298

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The end!