

# Empirical Methods in Finance - Assignment 5

*Nitish Ramkumar, Ian Laker, PrasanthKumar*

## 1

*Sample Mean*

```
##      1st      2nd      3rd
## 0.055 0.045 0.055
```

*Standard Deviation*

```
##           1st           2nd           3rd
## 0.1680030 0.2343075 0.1581139
```

*Sharpe Ratio*

```
##           1st           2nd           3rd
## 0.3273752 0.1920553 0.3478505
```

## 2

To hedge out the market risk, we go short the market based on the beta of the market provided in the regression equation.

*Mean*

```
## 1st Hedged 2nd Hedged 3rd Hedged
##      0.010      -0.015      0.005
```

*Standard Deviation*

```
## 1st Hedged 2nd Hedged 3rd Hedged
##      0.10      0.15      0.05
```

*Sharpe Ratio*

```
## 1st Hedged 2nd Hedged 3rd Hedged
##      0.1      -0.1      0.1
```

### 3

The maximum sharpe ratio squared based on the mean variance efficiency =  $(\bar{R}^e)' \Omega^{-1} \bar{R}^e$

*Proof*

The aim is to minimize portfolio variance ( $w' \Omega w$ , where  $w$  is the weights and  $\Omega$  is variance-covariance matrix), such that the portfolio returns reach the necessary value of  $m$

The objective function from the lagrangian form is

$$\min \frac{1}{2} w' \Omega w - k(w' \bar{R}^e - m)$$

First order differential w.r.t  $w$  and set it to 0 to minimize

$$\Omega w - k \bar{R}^e = 0$$

$$\text{so } w^{MVE} = k \Omega^{-1} \bar{R}^e$$

$$\text{so, } \bar{R}_{MVE}^e = (w^{MVE})' \bar{R}^e = k(\bar{R}^e)' \Omega^{-1} \bar{R}^e$$

$$\begin{aligned} \text{var}(R_{MVE}^e) &= (w^{MVE})' \Omega w^{MVE} = k^2 (\bar{R}^e)' \Omega^{-1} \Omega \Omega^{-1} \bar{R}^e \\ &= k^2 (\bar{R}^e)' \Omega^{-1} \bar{R}^e \end{aligned}$$

So, the Sharpe Ratio squared for MVE is

$$SR_{MVE}^2 = \frac{\bar{R}_{MVE}^e}{\text{var}(R_{MVE}^e)} = (\bar{R}^e)' \Omega^{-1} \bar{R}^e$$

*Max Sharpe Ratio Value*

```
##           [,1]
## [1,] 0.1732051
```

### 4

Maximum sharpe ratio squared of stocks and market = Maximum sharpe ratio square of stocks only + sharpe ratio square of market

```
##           [,1]
## [1,] 0.3756476
```

### 5

#### 5a

```
##           [,1]
## [1,] 0.39931043
## [2,] -0.26620695
## [3,] 0.79862086
## [4,] 0.04880461
## attr(,"names")
## [1] "Stock1" "Stock2" "Stock3" "Market"
```

## 5b

*Mean, Standard Deviation, Sharpe Ratio*

```
##           Mean           SD Sharpe Ratio
##  0.05634714  0.15000000  0.37564759
```

## 6

### 6a

*Mean, Standard Deviation, Sharpe Ratio of factor mimicking portfolio*

```
##           Mean           SD Sharpe Ratio
## -0.03571429  0.62641676 -0.05701362
```

### 6b

*Correlation between factor mimicking portfolio and market portfolio*

```
##           [,1]
## [1,] 0.2394572
```

### 6c

*Variance explained by the PCAs*

```
##      1st PCA      2nd PCA      3rd PCA
## 0.80813177 0.13952986 0.05233837
```

### 6d

*Portfolio Weights*

```
##           1st PCA      2nd PCA      3rd PCA
## 1st Stock -0.4685584  0.7003778 -0.5384460
## 2nd Stock -0.7451113 -0.6407531 -0.1850531
## 3rd Stock -0.4746180  0.3144940  0.8220896
```

*Factor loadings*

```
##           1st PCA      2nd PCA      3rd PCA
## 1st Stock -0.1385058  0.08602585 -0.04050562
## 2nd Stock -0.2202548 -0.07870229 -0.01392097
## 3rd Stock -0.1402970  0.03862860  0.06184325
```

## 6e

The first PCA is the market. As it can be noticed, though the first PCA explains 80.81%, the second and third PCA still explains a significant portion of the variance. This is due to the presence of an intercept. Also the second PCA is close to a long short strategy, which means that without any exposure to market, it is explaining variance of the returns.

## R code

```
#1
#Sample Mean
Avg.Mkt <- 0.05

Avg.1 <- 0.01 + 0.9*Avg.Mkt
Avg.2 <- -0.015 + 1.2*Avg.Mkt
Avg.3 <- 0.005 + 1.0*Avg.Mkt
Avg <- c(Avg.1,Avg.2,Avg.3)
colnames(Avg) <- c("1st","2nd","3rd")
Avg

#Standard Deviation
Variance_matrix <- matrix(c(0.1^2,0,0,0,0.15^2,0,0,0,0.05^2),nrow=3)
betas <- c(0.9,1.2,1)

Variance.Mkt <- 0.15^2
Variance.1 <- betas[1]^2 * Variance.Mkt + Variance_matrix[1,1]
Variance.2 <- betas[2]^2 * Variance.Mkt + Variance_matrix[2,2]
Variance.3 <- betas[3]^2 * Variance.Mkt + Variance_matrix[3,3]
Sd <- c(sqrt(Variance.1),sqrt(Variance.2),sqrt(Variance.3))
colnames(Sd) <- c("1st","2nd","3rd")
Sd

#SharpeRatio
Avg/Sd

#2
#Sample Mean
Avg.Hedged.1 <- 0.01
Avg.Hedged.2 <- -0.015
Avg.Hedged.3 <- 0.005
Avg.Hedged <- c(Avg.Hedged.1,Avg.Hedged.2,Avg.Hedged.3)
colnames(Avg.Hedged) <- c("1st Hedged","2nd Hedged","3rd Hedged")
Avg.Hedged

#Standard Deviation
Variance.Hedged.1 <- Variance_matrix[1,1]
Variance.Hedged.2 <- Variance_matrix[2,2]
Variance.Hedged.3 <- Variance_matrix[3,3]
Sd.Hedged <- c(sqrt(Variance.Hedged.1),sqrt(Variance.Hedged.2),sqrt(Variance.Hedged.3))
colnames(Sd.Hedged) <- c("1st Hedged","2nd Hedged","3rd Hedged")
Sd.Hedged
```

```

#SharpeRatio
Avg.Hedged/Sd.Hedged

#3
SharpeRatioSq.Max <- t(Avg.Hedged)%*%chol2inv(chol(Variance_matrix))%*%Avg.Hedged
sqrt(SharpeRatioSq.Max)

#4
SharpeRatio.Market <- 1/3
SharpeRatio.Combined <- sqrt(SharpeRatioSq.Max + SharpeRatio.Market^2)
SharpeRatio.Combined

#5
##5a
AllReturns <- c(Avg,Avg.Mkt)
#Calculate systematic variance and covariance (Beta_i * Beta_j * market variance)
betas5 <- c(betas,1)
systematicVar.5 <- (betas5%*%t(betas5))*Variance.Mkt
fullCovarianceMatrix.5 <- rbind(cbind(Variance_matrix,0),0) + systematicVar.5

SharpeRatio.Max.Combined <- t(AllReturns)%*%chol2inv(chol(fullCovarianceMatrix.5))%*%AllReturns
Sd <- 0.15
k <- Sd/sqrt(SharpeRatio.Max.Combined)

weights_combined <- (chol2inv(chol(fullCovarianceMatrix.5))%*%AllReturns) * as.numeric(k)
colnames(weights_combined) <- c("Stock1","Stock2","Stock3","Market")
weights_combined

##5b
#Mean
Mean5 <- AllReturns%*%weights_combined
#SD
Sd5 <- sqrt(t(weights_combined)%*%fullCovarianceMatrix.5%*%weights_combined)
#Sharpe Ratio
SR5 <- Mean5/Sd5
output <- c(Mean5,Sd5,SR5)
names(output) <- c("Mean","SD","Sharpe Ratio")
output

#6
##6a
mimick.Weights <- ((betas - mean(betas))/(length(betas)*(mean(betas^2)-mean(betas)^2)))
mimick.Return <- mimick.Weights%*%Avg

systematicVar.stocks <- (betas%*%t(betas))*Variance.Mkt
fullCovarianceMatrix.stocks <- systematicVar.stocks +Variance_matrix

mimick.Sd <- sqrt(t(mimick.Weights)%*%fullCovarianceMatrix.stocks%*%mimick.Weights)
mimick.sharpe <- mimick.Return/mimick.Sd
output <- c(mimick.Return,mimick.Sd,mimick.sharpe)
names(output) <- c("Mean","SD","Sharpe Ratio")
output

```

```

##6b
cor.mimick.market <- mimick.Weights%*%(betas*sqrt(Variance.Mkt)/mimick.Sd)
cor.mimick.market

##6c
eigens <- eigen(fullCovarianceMatrix.stocks)
output <- eigens$values/sum(eigens$values)
names(output) <- c("1st PCA", "2nd PCA", "3rd PCA")
output

##6d
#Weights
portfolioweights <- eigens$vectors
colnames(portfolioweights) <- c("1st PCA", "2nd PCA", "3rd PCA")
row.names(portfolioweights) <- c("1st Stock", "2nd Stock", "3rd Stock")
portfolioweights

#Loadings
loadings <- matrix(nrow=3, ncol=3)
for(i in 1:length(eigens$values)){
  loadings[,i] <- portfolioweights[,i]*sqrt(eigens$values[i])
}
colnames(loadings) <- c("1st PCA", "2nd PCA", "3rd PCA")
row.names(loadings) <- c("1st Stock", "2nd Stock", "3rd Stock")
loadings

```