CS971: AI for Finance Assignment 2

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Background and Project Overview

Background and Description of the Problem

The goal of this project is to build a trading system that leverages advanced machine learning techniques to forecast asset prices and execute trading decisions. The system first selects an optimal asset from the S&P 500 by evaluating risk-adjusted historical performance using daily returns and Sharpe ratios. Once the asset is chosen, its price data are pre-processed with technical indicators such as the RSI, MACD, and volume moving averages to capture market dynamics. An LSTM neural network which is well-known for its ability to model temporal dependencies is then employed to predict next-day prices. The model's hyperparameters are then finely tuned using both grid search and genetic algorithms. Finally, trading rules are applied to convert predictions (alone or in combination with RSI signals) into buy, sell, or hold actions in a simulated trading environment.

Related Work

Recent work on machine learning-based trading strategies spans deep neural models, technical analysis, and evolutionary optimization. Recurrent architectures like LSTM networks have been widely applied to stock price prediction and trading signal generation, leveraging their ability to capture temporal patterns and often outperforming traditional statistical models [1]. Many studies enhance such models by incorporating popular technical indicators such as RSI and MACD as input features, effectively fusing signals with data-driven learning to improve predictive accuracy [2]. In addition, optimization techniques like genetic algorithms have been used to fine-tune both model hyperparameters and strategy parameters. For example, GAs optimizing LSTM settings have achieved better forecasting performance than untuned benchmarks and similarly have been applied to calibrate indicator-based trading rules to maximize metrics like the Sharpe ratio [1]. These combined approaches demonstrate that integrating LSTM-driven prediction with technical indicators and applying evolutionary optimization can yield more robust, profitable trading strategies in practice which is precisely what our project aims to do.

Asset Selection

The initial assets were gathered using the S&P 500 index, a stock market index that tracks the performance of 500 of the largest trading companies in the United States. In addition to having an extensive collection of assets, this index represents a wide range of sectors including but not limited to technology, healthcare and finance. This serves as a solid foundation for selecting a significant asset for the project.

```
assets <- tq_index("SP500") # Load 500 assets from S&P
```

Furthermore, the daily returns for each asset are retrieved to calculate the Sharpe ratio.

```
load_daily_returns <- function(asset_symbols, startDate, endDate) { removed_assets <- c()
  assets_train <- lapply(asset_symbols, function(sym) {
    tryCatch(dailyReturn(getSymbols(sym, from = startDate, to = endDate, auto.assign = FALSE)),
      error = function(e) {removed_assets <<- append(removed_assets, sym); NULL})})
  asset_symbols <- setdiff(asset_symbols, removed_assets)
  df <- setNames(do.call(merge, c(assets_train, all = T)), asset_symbols)
  df <- na.omit(df); df <- df[, colSums(is.na(df)) < nrow(df)]; return(df)}
```

The start and end date for the period to be used to make next-day predictions has been set to two months. This is so that enough data is present to reflect vital patterns to make predictions, however, not a long enough time period whereby the large quantity of historic data will negatively skew results.

```
asset_symbols <- assets$symbol; startDate <- "2024-08-01"; endDate <- "2024-12-31"
df <- load_daily_returns(asset_symbols, startDate, endDate)
```

```
calc_sharpe_ratio <- function(returns, rf_rate) {mean_return <- mean(returns); risk <- sd(returns)
  sharpe_ratio <- ((mean_return - rf_rate) / risk) * sqrt(252); return(sharpe_ratio)}
```

The performance of all 500 assets is evaluated and compared to one another based on their Sharpe ratios. The Sharpe ratio serves as a valuable tool for measuring investment prospects for a specific asset as it enables the comparison of the expected return for the level of risk being taken (risk-adjusted return). In this case, a risk-free rate is dynamically retrieved and used within the Sharpe ratio calculation for each asset.

$$S_a = \frac{E[R_a - R_b]}{\sigma_a}$$

$$Where: S_a = \text{Sharpe Ratio } E = \text{Expected Return}$$

$$R_a = \text{Asset Return } R_b = \text{Risk Free Rate } \sigma_a = \text{Asset Risk}$$

```
rf_rate <- as.numeric(last(getSymbols("DGS3MO", src = "FRED", auto.assign = FALSE)))/100 /252
best_res <- calc_sharpe_ratio(df[, 1], rf_rate); best_asset <- NULL
for (col in colnames(df)) { curr_sharpe <- calc_sharpe_ratio(df[, col], rf_rate)
  if (curr_sharpe > best_res) { best_res <- curr_sharpe; best_asset <- col}}
```

Once all assets have been compared, the best-performing asset is selected to be used to make next-day predictions in alignment with a comprehensive trading rule. All relevant data is then retrieved, this includes opening, high, low and closing prices.

```
best_asset_data <- getSymbols(best_asset, from = startDate, to = endDate, auto.assign = FALSE)
```

Data Preprocessing

```
best_asset_data$RSI = rsi; best_asset_data$MACD = macd
best_asset_data$Volume_MA = volume_ma; best_asset_data = na.omit(best_asset_data)
```

```r
data <- data.frame(best_asset_data[,1:9])
min_max_normalize <- function(x) {(x - min(x)) / (max(x) - min(x))}
data_scaled <- as.data.frame(lapply(data, min_max_normalize))
```

```r
train_test_split <- function(asset, seq_length, target_feature, test_size = 0.2) {
  asset_matrix <- as.matrix(asset)
  num_seq <- nrow(asset_matrix) - seq_length + 1; num_features <- ncol(asset_matrix)
  seq_data <- array(dim = c(num_seq, seq_length, num_features))
  for (index in 1:(nrow(asset_matrix) - seq_length +1)) {
    seq_data[index, , ] <- asset_matrix[index:(index + seq_length - 1), ]}
  test_set_size <- round(test_size * nrow(seq_data)); train_set_size <- nrow(seq_data) - test_set_size
  x_train <- seq_data[1:train_set_size, 1:(seq_length - 1), , drop = FALSE]
  y_train <- seq_data[1:train_set_size, seq_length, target_feature, drop = FALSE]
  x_test  <- seq_data[(train_set_size + 1):nrow(seq_data), 1:(seq_length - 1), , drop = FALSE]
  y_test  <- seq_data[(train_set_size + 1):nrow(seq_data), seq_length, target_feature, drop = FALSE]
  return(list(x_train = x_train,y_train = y_train,x_test = x_test,y_test = y_test))}
```

```r
open <- paste(best_asset, "Open", sep = ".");close <- paste(best_asset, "Close", sep = ".")
high <- paste(best_asset, "High", sep = ".");low <- paste(best_asset, "Low", sep = ".")
rsi = "RSI"; macd = "MACD"; volume_ma = "Volume_MA"; seq_length <- 8
features <- data_scaled[, c(open, high, low, close, macd, volume_ma)]
split_data <- train_test_split(features, seq_length, target_feature=4)
x_train <- split_data$x_train; y_train <- split_data$y_train
x_test <- split_data$x_test; y_test <- split_data$y_test
```

```r
split_validation <- function(x, y, valid_prop = 0.2) { total <- dim(x)[1]
  valid_size <- round(valid_prop * total);train_size <- total - valid_size
  x_train_tune <- x[1:train_size, , , drop = FALSE]
  x_val <- x[(train_size + 1):total, , , drop = FALSE]; y <- as.matrix(y)
  y_train_tune <- y[1:train_size, , drop = FALSE]
  y_val <- y[(train_size + 1):total, , drop = FALSE]
  return(list(x_train_tune = x_train_tune,y_train_tune = y_train_tune,
    x_val = x_val,y_val = y_val))}
split_data <- split_validation(x_train, y_train, valid_prop = 0.2)
x_train_tune <- split_data$x_train_tune; y_train_tune <- split_data$y_train_tune
x_val <- split_data$x_val; y_val <- split_data$y_val
```

Optimising LSTM Parameters

The LSTM parameters are optimised using two techniques: grid search and genetic algorithms. This was done to compare the results from utilising traditional versus evolutionary approaches and conclude the pros and cons of each. Furthermore, the optimised parameters identified from this process are used by the LSTM to make predictions in conjunction with the proposed trading rule.

```r
tune_lstm <- function(learningrate, hidden_dim, num_layers, numepochs, batch_size) {
  model <- trainr( Y = y_train_tune, X = x_train_tune, learningrate = learningrate,
    hidden_dim = hidden_dim, num_layers = num_layers, numepochs = numepochs,
    network_type = "lstm", seq_to_seq_unsync = TRUE,batch_size = batch_size)
  predictions <- predictr(model, x_val)
  mse <- mean((predictions - y_val)^2, na.rm = TRUE); return(mse)}
```

Grid Search

Grid search is a traditional approach to identifying optimal hyperparameter values for machine learning models. In this approach, the key hyperparameters to be tested are listed inside a vector, which the algorithm then systematically iterates over each combination and records the result. In this case, the mean squared error (MSE) is used on validation data to determine the current performance.

```
lr_vals <- c(0.001, 0.005, 0.01); hd_vals <- c(8, 16, 32, 64, 128) # Grid parameters
nl_vals <- c(1, 2, 3); ne_vals <- c(50, 100, 150, 200); bs_vals <- c(8, 16, 32, 64)
```

```
run_grid_search <- function(lr_vals, hd_vals, nl_vals, ne_vals, bs_vals){
  for (lr in lr_vals) {for (hd in hd_vals) {for (nl in nl_vals) {
    for (ne in ne_vals) {for (bs in bs_vals) { current_mse <- tune_lstm(lr,hd,nl,ne,bs)
            log_results(lr, hd, nl, ne, bs, current_mse)}}}}}}
#run_grid_search(lr_vals, hd_vals, nl_vals, ne_vals, bs_vals)
#best_params_GS <- results[which.min(results$mse), ]
```

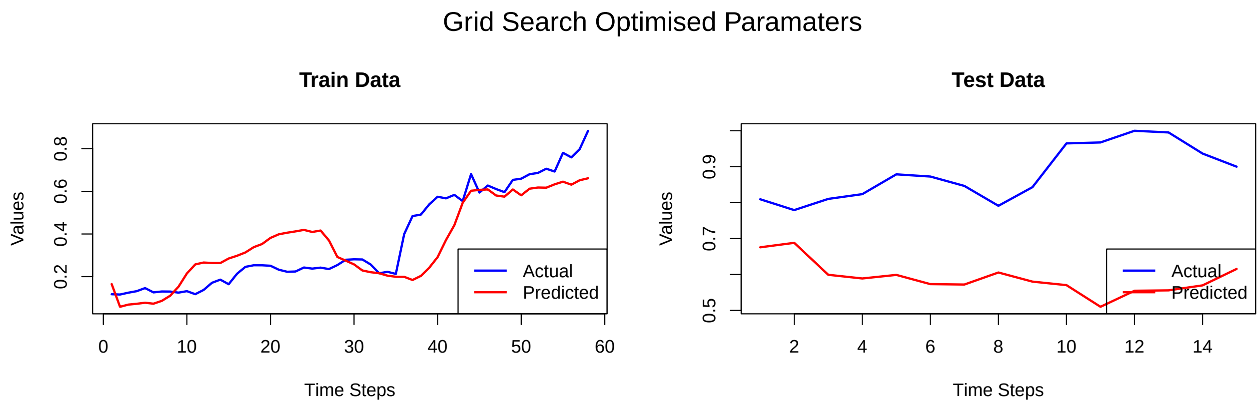
Genetic Algorithm

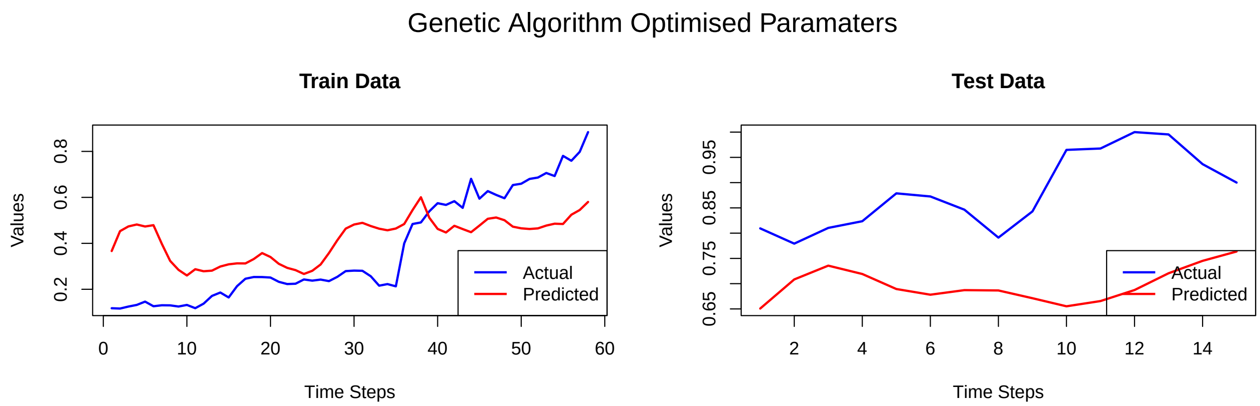
A genetic algorithm is an evolutionary process that mimics natural selection and genetics. This algorithm has been used to identify optimal hyperparameters within specified ranges (lower and upper). This implementation has a maximum of 100 iterations and will stop executing if the fitness does not improve after 20 iterations. The fitness is determined using the fitness function which evaluates performance against the MSE value.

```
fitness_function <- function(params) {
  lr <- params[1]; hd <- round(params[2]); nl <- round(params[3])
  ne <- round(params[4]); bs <- round(params[5])
  mse <- tune_lstm(lr, hd, nl, ne, bs); return(-mse)}
run_ga <- function(){ ga_result <- ga(type = "real-valued",fitness = fitness_function,
    lower = c(0.0001, 8, 1, 50, 8),upper = c(0.01, 128, 3, 200, 64),
    popSize = 20,maxiter = 100,run = 20); return(ga_result)}
#ga_result <- run_ga(); best_params_GA <- ga_result@solution
```

Optimisation Comparisons

Through experimenting with both of the above approaches key benefits and downfalls of each have been identified. First, Grid search is strictly limited to searching the specified hyperparameters whereas the GA solution can navigate the search space more effectively only being restricted to lower and upper bounds. Furthermore, both algorithms are computationally expensive, although, genetic algorithms have an edge as they can effectively terminate execution if the performance has not improved over a specified number of iterations, whereas grid search must evaluate all combinations. Finally, this difference between the two approaches is what sets them apart as a GA can get stuck in a local maximum and never converge to the optimal solution, on the other hand, grid search will evaluate all provided combinations guaranteeing the most optimal from the provided is found. Overall, both methods gain a similar performance using MSE.





Trading

```r
starting_funds = 10000
investment = starting_funds
shares = 0

inverse_scale <- function(scaled_value, unscaled_min, unscaled_max) {
  scaled_value * (unscaled_max - unscaled_min) + unscaled_min
}

predictions_scaled = predictr(lstm_GS, x_test)
unscaled_min_close = min(data[, paste(best_asset, "Close", sep = ".")])
unscaled_max_close = max(data[, paste(best_asset, "Close", sep = ".")])

predictions_unscaled = inverse_scale(predictions_scaled, unscaled_min_close, unscaled_max_close)
actual_unscaled = inverse_scale(y_test, unscaled_min_close, unscaled_max_close)
#predictions_unscaled
#actual_unscaled
```

```r
trading_rule = data.frame(
  Date = index(tail(best_asset_data, nrow(y_test))),
  actual_price = rep(NA, nrow(y_test)),
  predicted_price = rep(NA, nrow(y_test)),
  action = character(nrow(y_test)),
  asset_value = numeric(nrow(y_test)),
```

```
  shares_held = numeric(nrow(y_test))
)

trading_rule$asset_value[1] = investment
trading_rule$shares_held[1] = shares
trading_rule$actual_price = actual_unscaled
trading_rule$predicted_price = predictions_unscaled

threshold_buy = 0.05
threshold_sell = -0.05

for(i in 1:nrow(trading_rule)){
  if(i>1){
    investment = trading_rule$asset_value[i-1]
    shares = trading_rule$shares_held[i-1]
  }
  current_price = trading_rule$actual_price[i]
  predicted_price = trading_rule$predicted_price[i]
  action = "HOLD"

  if(!is.na(predicted_price) && !is.na(current_price)){
    predicted_change_percentage = (predicted_price - current_price) / current_price
    if (predicted_change_percentage > threshold_buy && investment > 0) {
      action = "BUY"
      buy_quantity = floor(investment / current_price)
      shares = shares + buy_quantity
      investment = investment - (buy_quantity * current_price)
    } else if (predicted_change_percentage < threshold_sell && shares > 0) {
      action = "SELL"
      sell_value = shares * current_price
      investment = investment + sell_value
      shares = 0
    }
  }

  trading_rule$action[i] = action
  trading_rule$asset_value[i] = investment + (shares * current_price)
  trading_rule$shares_held[i] = shares
}
```

```
trading_rule = data.frame(
  Date = index(tail(best_asset_data, nrow(y_test))),
  actual_price = rep(NA, nrow(y_test)),
  predicted_price = rep(NA, nrow(y_test)),
  action = character(nrow(y_test)),
  asset_value = numeric(nrow(y_test)),
  shares_held = numeric(nrow(y_test))
)

trading_rule$asset_value[1] = investment
trading_rule$shares_held[1] = shares
trading_rule$actual_price = actual_unscaled
trading_rule$predicted_price = predictions_unscaled
```

```r
threshold_buy = 0.01
threshold_sell = -0.01

next_day_action = character(nrow(trading_rule))
next_day_action[1] = "HOLD"

for(i in 1:(nrow(trading_rule) - 1)){
  current_price = trading_rule$actual_price[i]
  predicted_price = trading_rule$predicted_price[i]
  action = "HOLD"

  if(!is.na(predicted_price) && !is.na(current_price)){
    predicted_change_percentage = (predicted_price - current_price) / current_price
    if(predicted_change_percentage > threshold_buy){
      action = "BUY"
    } else if(predicted_change_percentage < threshold_sell){
      action = "SELL"
    } else if(predicted_change_percentage < threshold_buy && predicted_change_percentage > threshold_sel
      action = "HOLD"
    }
  }
  next_day_action[i + 1] = action
}

for(i in 1:nrow(trading_rule)){
  if(i > 1){
    investment = trading_rule$asset_value[i-1]
    shares = trading_rule$shares_held[i-1]
  }

  trade_action = next_day_action[i]
  current_price = trading_rule$actual_price[i]

  if(trade_action == "BUY" && investment > 0){
    buy_quantity = floor(investment / current_price)
    shares = shares + buy_quantity
    investment = investment - (buy_quantity * current_price)
  } else if(trade_action == "SELL" && shares > 0){
    sell_value = shares * current_price
    investment = investment + sell_value
    shares = 0
  }

  trading_rule$action[i] = trade_action
  trading_rule$asset_value[i] = investment + (shares * current_price)
  trading_rule$shares_held[i] = shares
}
```

```r
final_asset_value = tail(trading_rule$asset_value, 1)
initial_investment = starting_funds
profit_loss = final_asset_value - initial_investment
roi = (profit_loss / initial_investment) * 100
```

```r
cat("\nFinal Asset Value: $", round(final_asset_value, 2), "\n")
```

```
##
## Final Asset Value: $ 10000
```

```r
cat("Profit/Loss: $", round(profit_loss, 2), "\n")
```

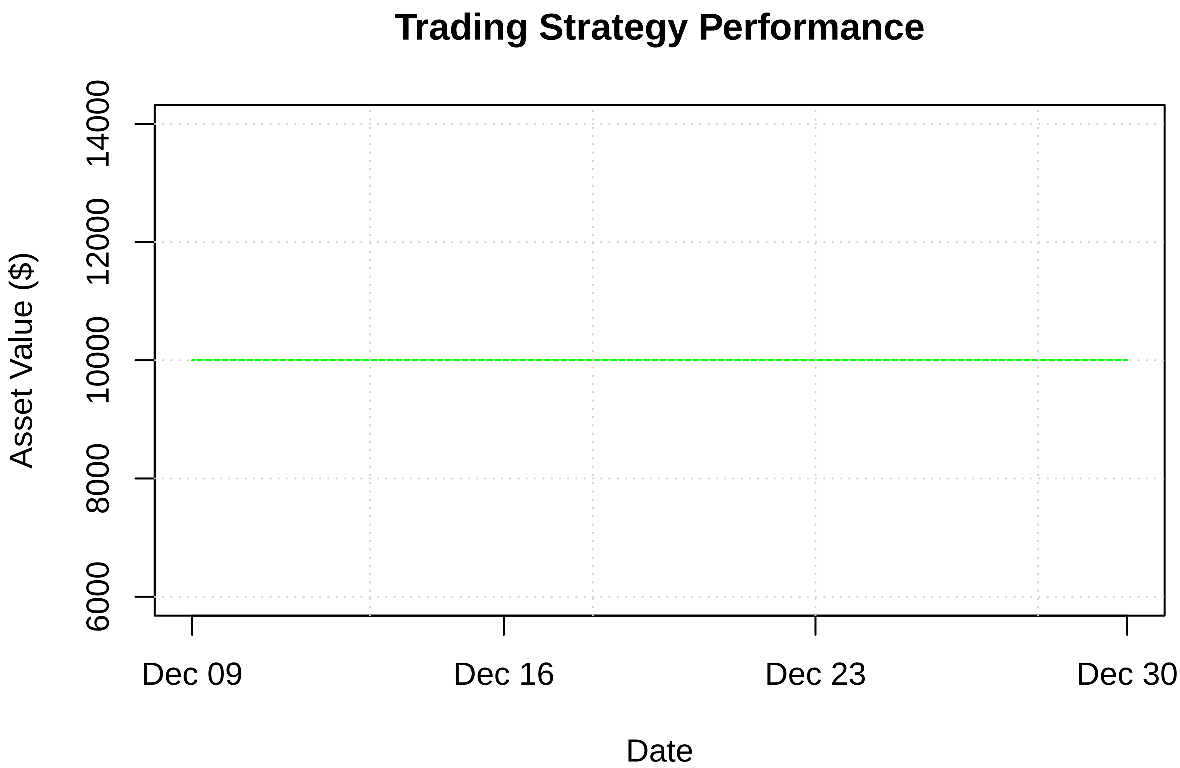
```
## Profit/Loss: $ 0
```

```r
cat("Return on Investment (ROI): ", round(roi, 2), "%\n")
```

```
## Return on Investment (ROI):  0 %
```

```r
plot_trading_simulation = function(trade_log) {
  plot(trading_rule$Date, trading_rule$asset_value, type = "l", col = "green",
       xlab = "Date", ylab = "Asset Value ($)",
       main = "Trading Strategy Performance")
  grid()
}

plot_trading_simulation(trade_log)
```




```r
print(trading_rule)
```

```
##          Date actual_price predicted_price action asset_value shares_held
## 1  2024-12-09        72.46        65.49831   HOLD       10000           0
```

```
## 2  2024-12-10        70.89        66.14440    SELL        10000            0
## 3  2024-12-11        72.51        61.51616    SELL        10000            0
## 4  2024-12-12        73.20        60.98446    SELL        10000            0
## 5  2024-12-13        76.07        61.50168    SELL        10000            0
## 6  2024-12-16        75.75        60.16416    SELL        10000            0
## 7  2024-12-17        74.39        60.10675    SELL        10000            0
## 8  2024-12-18        71.51        61.84878    SELL        10000            0
## 9  2024-12-19        74.21        60.52815    SELL        10000            0
## 10 2024-12-20        80.55        60.01973    SELL        10000            0
## 11 2024-12-23        80.69        56.88198    SELL        10000            0
## 12 2024-12-24        82.38        59.20349    SELL        10000            0
## 13 2024-12-26        82.14        59.26135    SELL        10000            0
## 14 2024-12-27        79.08        59.98507    SELL        10000            0
## 15 2024-12-30        77.18        62.36329    SELL        10000            0
```

```
#Revised Dual-Indicator Trading Strategy

threshold_buy <- 0.005         # Predicted change > 0.5%
threshold_sell <- -0.005       # Predicted change < -0.5%
oversold_threshold <- 70       # For a BUY, require RSI < 70
overbought_threshold <- 30     # For a SELL, require RSI > 30

# Reinitialize simulation variables
investment_dual <- 10000
shares_dual <- 0

# Build the trading log for the dual-indicator strategy
trading_rule_dual <- data.frame(
  Date = index(tail(best_asset_data, nrow(y_test))),
  actual_price = as.numeric(actual_unscaled),
  predicted_price = as.numeric(predictions_unscaled),
  RSI = as.numeric(tail(best_asset_data$RSI, nrow(y_test))),
  action = character(nrow(y_test)),
  asset_value = numeric(nrow(y_test)),
  shares_held = numeric(nrow(y_test))
)

trading_rule_dual$asset_value[1] <- investment_dual
trading_rule_dual$shares_held[1] <- shares_dual

# Simulation loop with debug prints for the first few iterations
for (i in 1:nrow(trading_rule_dual)) {
  if (i > 1) {
    investment_dual <- trading_rule_dual$asset_value[i - 1]
    shares_dual <- trading_rule_dual$shares_held[i - 1]
  }
  current_price <- trading_rule_dual$actual_price[i]
  predicted_price <- trading_rule_dual$predicted_price[i]
  current_rsi <- trading_rule_dual$RSI[i]
  action <- "HOLD"

  if (!is.na(predicted_price) && !is.na(current_price) && !is.na(current_rsi)) {
    predicted_change_percentage <- (predicted_price - current_price) / current_price
    if (predicted_change_percentage > threshold_buy && current_rsi < oversold_threshold && investment_du
```

```r
      action <- "BUY"
      buy_quantity <- floor(investment_dual / current_price)
      shares_dual <- shares_dual + buy_quantity
      investment_dual <- investment_dual - (buy_quantity * current_price)
    } else if (predicted_change_percentage < threshold_sell && current_rsi > overbought_threshold && sha
      action <- "SELL"
      sell_value <- shares_dual * current_price
      investment_dual <- investment_dual + sell_value
      shares_dual <- 0
    }
  }

  trading_rule_dual$action[i] <- action
  trading_rule_dual$asset_value[i] <- investment_dual + (shares_dual * current_price)
  trading_rule_dual$shares_held[i] <- shares_dual
}

# Calculate final performance metrics
final_asset_value <- tail(trading_rule_dual$asset_value, 1)
profit_loss <- final_asset_value - 10000
roi <- (profit_loss / 10000) * 100

# Print results
cat("\nFinal Asset Value: $", round(final_asset_value, 2), "\n")
```

```
##
## Final Asset Value: $ 10000
```

```r
cat("Profit/Loss: $", round(profit_loss, 2), "\n")
```

```
## Profit/Loss: $ 0
```

```r
cat("Return on Investment (ROI):", round(roi, 2), "%\n")
```

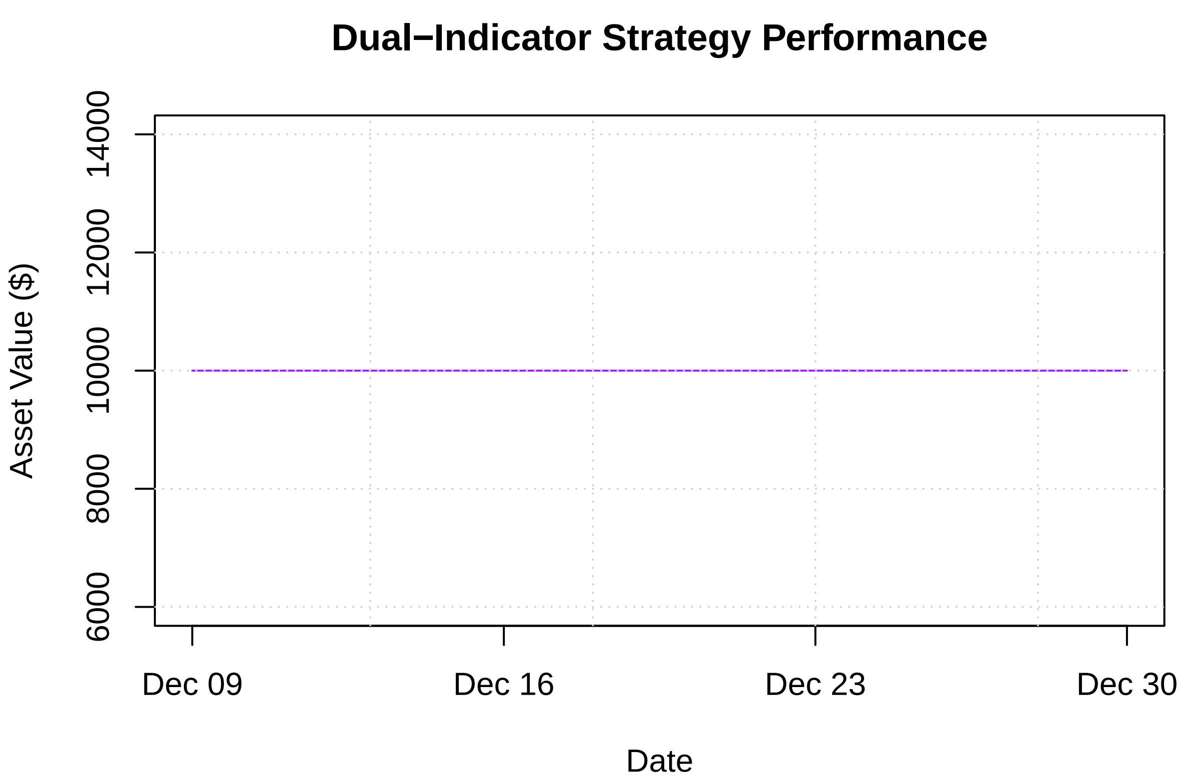
```
## Return on Investment (ROI): 0 %
```

```r
# Print the full table
print(trading_rule_dual)
```

```
##          Date actual_price predicted_price      RSI action asset_value
## 1  2024-12-09        72.46        65.49831 69.07233   HOLD       10000
## 2  2024-12-10        70.89        66.14440 65.25666   HOLD       10000
## 3  2024-12-11        72.51        61.51616 67.26606   HOLD       10000
## 4  2024-12-12        73.20        60.98446 68.11199   HOLD       10000
## 5  2024-12-13        76.07        61.50168 71.42037   HOLD       10000
## 6  2024-12-16        75.75        60.16416 70.54158   HOLD       10000
## 7  2024-12-17        74.39        60.10675 66.78071   HOLD       10000
## 8  2024-12-18        71.51        61.84878 59.54137   HOLD       10000
## 9  2024-12-19        74.21        60.52815 63.53262   HOLD       10000
## 10 2024-12-20        80.55        60.01973 70.81358   HOLD       10000
## 11 2024-12-23        80.69        56.88198 70.95150   HOLD       10000
```

```
## 12 2024-12-24        82.38        59.20349 72.63272    HOLD        10000
## 13 2024-12-26        82.14        59.26135 71.99547    HOLD        10000
## 14 2024-12-27        79.08        59.98507 64.25471    HOLD        10000
## 15 2024-12-30        77.18        62.36329 59.94499    HOLD        10000
##    shares_held
## 1            0
## 2            0
## 3            0
## 4            0
## 5            0
## 6            0
## 7            0
## 8            0
## 9            0
## 10           0
## 11           0
## 12           0
## 13           0
## 14           0
## 15           0
```

```r
# Plot the performance of the dual-indicator trading strategy
plot_dual <- function(trade_log) {
  plot(trade_log$Date, trade_log$asset_value, type = "l", col = "purple",
       xlab = "Date", ylab = "Asset Value ($)",
       main = "Dual-Indicator Strategy Performance")
  grid()
}
plot_dual(trading_rule_dual)
```



References

[1] A. Dangi, "Optimizing LSTM Network using Genetic Algorithm for Stock Market Price Prediction," 24 April 2023. [Online]. Available: https://www.linkedin.com/pulse/optimizing-lstm-network-using-genetic-algorithm-stock-akash-dangi/. [Accessed 10 April 2025].

[2] R. M. Dhokane and S. Agarwal, "LSTM Deep Learning Based Stock Price Prediction with Bollinger Band, RSI, MACD, and OHLC Features," International Journal of Intelligent Systems and Applications in Engineering, vol. 12, no. 3, p. 1169–1176, 2024.