
Financial Data Science Python Notebooks

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CONTENTS

1 Stock Prices	3
1.1 Measuring stock returns	4
1.2 Properties of stock returns	12
1.3 Stock Delistings	19
2 Jegadeesh-Titman Rolling Portfolios	21
2.1 Price Momentum	22
2.2 Hypothesis Testing	25
3 Fama-French Portfolio Sorts	33
3.1 Stock fundamentals	34
3.2 Bivariate sorts	35
3.3 Linear regression	40
3.4 Structural break	44
4 Fama-Macbeth Cross-sectional Regressions	47
4.1 Mean variance optimization	48
4.2 Implied alphas	53
4.3 Cross-sectional regressions	57
4.4 Nonlinear regression	62
5 Contrarian Trading	65
5.1 Mean reversion	66
5.2 Implementation shortfall	69
5.3 Structural break with unknown changepoint	70
5.4 Information coefficient	72
5.5 Performance evaluation	73
6 Quant Factors	77
6.1 Factor investing	78
6.2 Cluster analysis	131
7 Event Study	139
7.1 Abnormal returns	140
7.2 Cross correlation	152
7.3 Multiple testing problem	154
8 Economic Data Revisions	167
8.1 Retrieving data from the web	168
8.2 FRED	172
8.3 FRED-MD and FRED-QD	180

8.4	Outliers	183
9	Linear Regression Diagnostics	185
9.1	Model assumptions	186
9.2	Residual plots	189
10	Econometric Forecasts	195
10.1	Seasonality	196
10.2	Stationarity	198
10.3	Autocorrelation	199
10.4	Time Series	200
10.5	Forecasting	203
11	Approximate Factor Models	211
11.1	Integration order	212
11.2	Approximate factor model	215
12	State Space Models	223
12.1	Hidden Markov Model	224
12.2	Gaussian Mixture Model	228
13	Term Structure of Interest Rates	231
13.1	Interest Rates	232
13.2	Yield Curve	235
13.3	Bootstrap	237
13.4	Principal Component Analysis	242
13.5	Singular Value Decomposition	244
14	Bond Returns and Risks	247
14.1	Term structure changes	247
14.2	Bond risk factors	252
15	Conditional Volatility and VaR	263
15.1	Value at Risk	264
15.2	Conditional volatility models	273
15.3	Backtesting VaR	277
16	Covariance Matrix	279
16.1	Portfolio risk analysis	280
16.2	Covariance matrix estimation	285
17	Options Pricing	293
17.1	Options	294
17.2	Binomial Tree	298
17.3	Black-Scholes-Merton	304
17.4	Monte Carlo Simulation	312
18	Market Microstructure	317
18.1	TAQ tick data	318
18.2	Liquidity by firm size	321
18.3	Sampling frequency	323
18.4	Volatility from tick data	329
18.5	Intraday liquidity	332
19	Event Risk	337
19.1	Earnings misses	337

19.2	Poisson regression	340
19.3	Credit losses	342
19.4	Actuarial losses	343
20	Principal Customers Graph	345
20.1	Supply chain	345
20.2	Graph properties	346
21	Community Detection	353
21.1	Industry taxonomy	354
21.2	Community structure	357
22	Graph Centrality	363
22.1	Centrality measures	364
22.2	BEA Input-Output Use Tables	365
23	Link Prediction	381
23.1	Link prediction algorithms	384
23.2	Accuracy metrics	385
24	Spatial Regression	395
24.1	Earnings surprise	396
24.2	Spatial dependence models	397
25	FOMC Topic Modeling	403
25.1	FOMC meeting minutes	404
25.2	Text pre-processing	406
25.3	Topic modeling	408
26	Management Sentiment Analysis	415
26.1	Sentiment analysis	416
26.2	SEC Edgar company filings	418
27	Business Text Analysis	427
27.1	Syntactic analysis	428
27.2	t-SNE visualization	434
27.3	DBSCAN	435
28	Classification	439
28.1	Text classification	440
28.2	Classification models	442
28.3	Evaluation	446
29	Regression	455
29.1	Regression models	458
29.2	Evaluation	479
30	Deep Learning	481
30.1	Textblob	483
30.2	Word Embeddings	483
30.3	FeedForward Neural Network	485
31	Recurrent Neural Networks	495
31.1	Elman RNN	497
31.2	Dynamic Factor Models	503

32 Convolutional Neural Networks	507
32.1 Temporal Convolutional Net (TCN)	509
32.2 Vector Autoregression	519
33 Reinforcement Learning	527
33.1 Retirement spending policy	529
33.2 Deep reinforcement learning	531
34 FedSpeak Language Modeling	543
34.1 Transformers	545
34.2 Language modeling	547
35 LLM Prompting	553
35.1 Large language models	553
35.2 Prompt design	558
36 LLM Text Summarization	565
36.1 HuggingFace APIs	566
36.2 Azure AI API	570
36.3 Text summarization	570
36.4 Role prompting	579
37 LLM Finetuning	583
37.1 Transfer learning	585
37.2 Supervised fine-tuning	588
38 RAG, Chatbots and Agents	595
38.1 Retrieval Augmented Generation	596
38.2 Chatbot	599
38.3 Agents	602

Financial Data Science projects in Jupyter notebooks, with **FinDS** Python package:

- use database engines SQL, Redis, MongoDB
- interfaces for
 - structured data from CRSP, Compustat, IBES, TAQ
 - APIs from ALFRED, BEA
 - unstructured data from SEC Edgar, Federal Reserve websites
 - academic websites by Fama and French, Loughran and MacDonald, Hoberg and Phillips
- recipes for econometrics, finance, graphs, event studies, backtesting
- applications of statistics, machine learning, NLP, neural networks and LLMs.

Topics

notebook	Financial	Data	Science
stock_prices	Stock distributions, delistings	CRSP stocks	Statistical moments
jegadeesh_titman	Overlapping portfolios; Momentum effect	CRSP stocks	Hypothesis testing; Newey-West estimator
fama_french	Portfolio sorts; Value effect	CRSP stocks; Compustat	Linear regression
fama_macbeth	Cross-sectional Regressions; CAPM	Ken French research library	Non-linear regression; Quadratic optimization
weekly_reversals	Mean reversion; Implementation shortfall	CRSP stocks	Structural break with unknown changepoint
quant_factors	Factor investing; Backtests	CRSP stocks; Compustat; IBES	Cluster analysis
event_study	Event studies	S&P key developments	Multiple testing; FFT
economic_releases	Economic data revisions; Employment payrolls	ALFRED	Outliers
regression_diagnostics	Consumer and producer prices	FRED	Linear regression diagnostics; Residual analysis
econometric_forecast	Production and Inflation	FRED	Time series analysis
approximate_factors	Approximate factor models	FRED-MD	Unit root test
economic_states	State space models	FRED-MD	Gaussian Mixture; HMM
term_structure	Interest rates	FRED yield curve	SVD
bond_returns	Bonds risk factors	FRED bond returns	PCA
option_pricing	Binomial tree; Black-Scholes-Merton and the Greeks	simulated	Monte Carlo simulations
conditional_volatility	Value at risk	FRED crypto-currencies	EWMA; GARCH
covariance_matrix	Portfolio risk	Fama-French industries	Covariance matrix estimation
market_microstructure	Market impact; Liquidity risk	TAQ tick data	High frequency volatility
event_risk	Earnings misses	IBES	Poisson regression; GLM
customer_ego	Supply chain	Compustat principal customers	Graph networks

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Table 1 – continued from previous page

notebook	Financial	Data	Science
industry_community	Industry sectors	Hoberg and Phillips research library	Community detection
bea_centrality	Input-output tables	Bureau of Economic Analysis	Graph centrality
link_prediction	Product markets	Hoberg and Phillips	Link prediction
spatial_regression	Earnings surprises	IBES Hoberg and Phillips	Spatial regression
fomc_topics	FOMC meetings	Federal Reserve website	Topic modeling
mda_sentiment	10-K Management Discussion	SEC Edgar; Loughran and Macdonald research library	Sentiment analysis
business_description	10-K Business Description	SEC Edgar	POS tagging; Density-based clustering
classification_models	Industry classification	SEC Edgar	Classification
regression_models	Macroeconomic forecasts	FRED-MD	Regression
deep_classifier	Industry classification	SEC Edgar	Neural networks; Word embeddings
recurrent_net	Macroeconomic forecasts	FRED-MD	Recurrent Neural Nets; Dynamic factor models
convolutional_net	Macroeconomic forecasts	FRED-MD	Convolutional Neural Nets; Vector autoregression
reinforcement_learning	Retirement spending	SBBI	Reinforcement learning
fomc_language	Fedspeak	FOMC meetings minutes	Language modelling; Transformers
sentiment_llm	Financial news sentiment	Kaggle	LLM prompting
summarization_llm	10-K Market Risks	SEC Edgar	Text summarization
finetune_llm	Industry classification	SEC Edgar	LLM fine-tuning
rag_agent	Corporate philanthropy	text documents	RAG, LLM chatbots and agents

Resources

1. Online Jupyter-book, or download pdf
2. FinDS API reference
3. FinDS repo
4. Jupyter notebooks repo

Contact

Github: <https://terence-lim.github.io>

CHAPTER
ONE

STOCK PRICES

In physics it takes three laws to explain 99% of the data; in finance it takes more than 99 laws to explain about 3% - Andrew Lo

Concepts:

- Stock splits, dividends and delistings
- Properties of stock returns

References:

- Fama, Eugene F., and Kenneth R. French. 1992. “The cross-section of expected stock returns.” The Journal of Finance 47 (2): 427–65.
- Shumway, Tyler. 1997. The Delisting Bias in CRSP Data. The Journal of Finance, 52, 327-340.
- Bali, Turan G, Robert F Engle, and Scott Murray. 2016. Empirical asset pricing: The cross section of stock returns. John Wiley & Sons.
- Stulz, René M., 2018, “The Shrinking Universe of Public Firms: Facts, Causes, and Consequences”, National Bureau of Economics, 2 (June 2018)
- FRM Exam Book Part I Quantitative Analysis Chapter 12

```
import numpy as np
import scipy
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, CRSPBuffer, Benchmarks
from finds.utils import Finder, plot_date
from secret import credentials, CRSP_DATE, paths
VERBOSE = 0

# %matplotlib qt
```

```
# open database connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, endweek=3, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
bench = Benchmarks(sql, bd, verbose=VERBOSE)
find = Finder(sql)
outdir = paths['scratch']
```

1.1 Measuring stock returns

Long time-series and broad cross-sections of US stock price data are best managed in a structured database. This facilitates linking across data sources, where data vendors or financial organizations may use different identifiers, and the tracking of identifier changes and corporate actions (e.g. splits, dividends, delistings and mergers) over time.

1.1.1 SQL

Structured query language (SQL) is a standard language for database creation and manipulation. MySQL is a popular open-source package that uses structured query language (SQL) for data management. Python toolkits such as SQLAlchemy provide an interface for using an SQL database. The Python Pandas library also provides methods such as `pandas.read_sql` to query a database table and return in a DataFrame.

SQL Cheatsheet:

Manage tables

`CREATE DATABASE` – Creates a new database.

`CREATE TABLE` – Creates a new table.

`DELETE` – Delete data from a table.

`DROP COLUMN` – Deletes a column from a table.

`DROP DATABASE` – Deletes the entire database.

`DROP TABLE` – Deletes a table from a database.

`TRUNCATE TABLE` – Deletes the data but does not delete the table.

Querying a table

`SELECT` – Used to select data from a database, which is then returned in a results set.

`SELECT DISTINCT` – Same as `SELECT`, except duplicate values are excluded.

`SELECT INTO` – Copies data from one table and inserts it into another.

`UNIQUE` – This constraint ensures all values in a column are unique.

`FROM` – Specifies which table to select or delete data from.

`AS` – Renames a table or column with an alias value which only exists for the duration of the query.

Query conditions

`WHERE` – Filters results to only include data which meets the given condition.

`AND` – Used to join separate conditions within a `WHERE` clause.

`BETWEEN` – Selects values within the given range.

`IS NULL` – Tests for empty (NULL) values.

`IS NOT NULL` – The reverse of `NULL`. Tests for values that aren't empty / `NULL`.

`LIKE` – Returns true if the operand value matches a pattern.

`NOT` – Returns true if a record DOESN'T meet the condition.

`OR` – Used alongside `WHERE` to include data when either condition is true.

Organize results

ORDER BY – Used to sort the result data in ascending (default) or descending order through the use of ASC or DESC keywords.

GROUP BY – Used alongside aggregate functions (COUNT, MAX, MIN, SUM, AVG) to group the results.

Join tables

INNER JOIN returns rows that have matching values in both tables.

LEFT JOIN returns all rows from the left table, and the matching rows from the right table.-

RIGHT JOIN returns all rows from the right table, and the matching records from the left table

FULL OUTER JOIN returns all rows when there is a match in either left table or right table.

1.1.2 Redis

Redis is an open-source, in-memory data structure store that can be used as a caching layer to store frequently accessed data and reduce the load on primary databases.

```
# inner join of identifier tables

# double up the % in a pandas string
pd.read_sql("select * from benchident where name like '%%momentum%%'", con=sql.engine)

cmd = """
select * from benchident inner join benchmarks
on benchident.permno = benchmarks.permno
where benchident.name like '%%momentum%%'
    and benchident.permno like '%%(mo) %%'
limit 5
"""
pd.read_sql(cmd, con=sql.engine)
```

	permno	name	item	permno	date	ret
0	Mom (mo)	F-F_Momentum_Factor	0	Mom (mo)	19270131	0.0036
1	Mom (mo)	F-F_Momentum_Factor	0	Mom (mo)	19270228	-0.0214
2	Mom (mo)	F-F_Momentum_Factor	0	Mom (mo)	19270331	0.0361
3	Mom (mo)	F-F_Momentum_Factor	0	Mom (mo)	19270430	0.0430
4	Mom (mo)	F-F_Momentum_Factor	0	Mom (mo)	19270531	0.0300

1.1.3 CRSP stocks data

The Center for Research in Security Prices (CRSP) provides the most widely used data for academic research into US stocks. It includes both successful and unsuccessful entities, rather than just those that have “survived” over time. This helps avoid the pitfalls of focusing only on surviving entities which can lead to an overestimation of average performance and underestimation of risk.

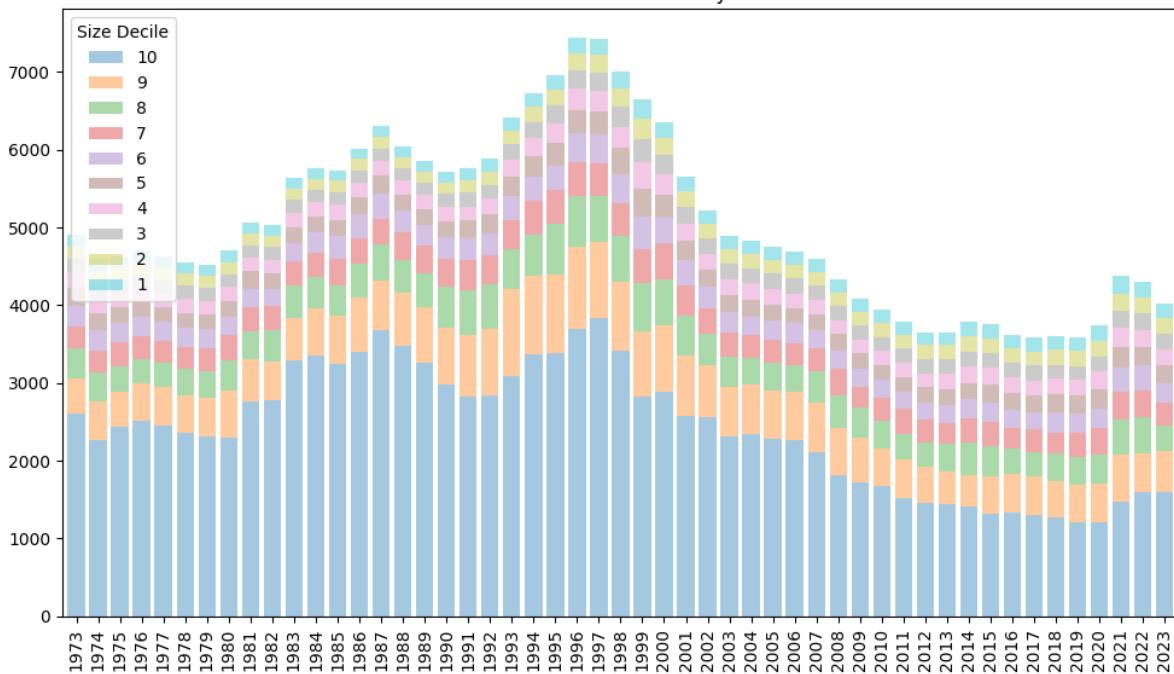
Following Fama and French (1992), only US-domiciled (shrcd in [10, 11]), exchange-listed (exchcd in [1, 2, 3]) stocks are typically considered for equities research. The universe is often divided into 10 market capitalization-based deciles (with the 10th decile comprising the smallest stocks) whose breakpoints are determined only from those stocks listed on the NYSE. For a company with multiple classes securities, the combined market value of the company is used for all classes of its securities. The shrout (shares outstanding) field in CRSP is in units of thousands of shares. Hence all calculations and derivations (such as market capitalization) need to be multiplied by 1000 to get the true value.

Stulz (2018) and others have noted the shrinking universe of public US firms and increased concentration of mega-cap stocks in recent years. These observations are consistent with plots of the market cap breakpoints of and the number of stocks in each decile by year.

```
# retrieve universe of stocks annually from 1981
start = bd.endyr(19731231)
rebals = bd.date_range(start, CRSP_DATE, freq=12)
univs = {rebal: crsp.get_universe(date=rebal) for rebal in rebals}
num = dict()
for date, univ in univs.items():
    num[str(date//10000)] = {decile: sum(univ['decile']==decile)
                             for decile in range(10, 0, -1)}
num = DataFrame.from_dict(num, orient='index')
```

```
# plot number of stocks in each size decile
fig, ax = plt.subplots(figsize=(10, 6))
ax.set_title('Number of stocks in universe by size decile')
num.plot.bar(stacked=True, ax=ax, width=.8, alpha=0.4)
#set_xtickbins(ax=ax, nbins=len(cap)//10)
plt.legend(title='Size Decile', loc='upper left')
plt.tight_layout()
```

Number of stocks in universe by size decile



```
# For assigning into size deciles, sum up the company's total market
# capitalization instead of separate capital values each security if multiple classes
names = find('ALPHABET', 'comnam').groupby('permno').tail(1).set_index('permno')
find(names['permco'].iloc[0], identifier='permco')
```

	date	comnam	ncusip	shrccls	ticker	permno	nameendt	shrcd	\
0	20040819	GOOGLE INC	38259P50	A	GOOG	90319	20050818	11	
1	20050819	GOOGLE INC	38259P50	A	GOOG	90319	20060720	11	

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2	20060721	GOOGLE INC	38259P50	A	GOOG	90319	20080131	11
3	20080201	GOOGLE INC	38259P50	A	GOOG	90319	20140402	11
4	20140403	GOOGLE INC	38259P70	C	GOOG	14542	20150423	11
5	20140403	GOOGLE INC	38259P50	A	GOOGL	90319	20150423	11
6	20150424	GOOGLE INC	38259P70	C	GOOG	14542	20151004	11
7	20150424	GOOGLE INC	38259P50	A	GOOGL	90319	20151004	11
8	20151005	ALPHABET INC	02079K10	C	GOOG	14542	20180201	11
9	20151005	ALPHABET INC	02079K30	A	GOOGL	90319	20180201	11
10	20180202	ALPHABET INC	02079K10	C	GOOG	14542	20231012	11
11	20180202	ALPHABET INC	02079K30	A	GOOGL	90319	20231012	11
12	20231013	ALPHABET INC	02079K10	C	GOOG	14542	20231229	11
13	20231013	ALPHABET INC	02079K30	A	GOOGL	90319	20231229	11
0	3	7375	GOOG	514191	Q	A	R	45483
1	3	7375	GOOG	518111	Q	A	R	45483
2	3	7375	GOOG	518112	Q	A	R	45483
3	3	7375	GOOG	519130	Q	A	R	45483
4	3	7375	GOOG	519130	Q	A	R	45483
5	3	7375	GOOGL	519130	Q	A	R	45483
6	3	7375	GOOG	519190	Q	A	R	45483
7	3	7375	GOOGL	519190	Q	A	R	45483
8	3	7375	GOOG	519190	Q	A	R	45483
9	3	7375	GOOGL	519190	Q	A	R	45483
10	3	7375	GOOG	334419	Q	A	R	45483
11	3	7375	GOOGL	334419	Q	A	R	45483
12	3	7375	GOOG	541511	Q	A	R	45483
13	3	7375	GOOGL	541511	Q	A	R	45483

```
univ.loc[names.index] # market caps of share class and total company
```

permno	cap	capco	decile	nyse	siccd	prc	naics
14542	8068242500.0	1.633510e+09		1	False	7375	140.93
90319	8266854200.0	1.633510e+09		1	False	7375	139.69

1.1.4 Stock distributions

In addition to gains from appreciated stock prices, adjusted for stock splits (`facpr` in CRSP), investors' total holding returns also include ordinary cash dividends (`divamt` in CRSP).

The total holding return on an asset from $t-1$ to t includes both price appreciation and any dividends paid on record date t : $R_t = \frac{P_t + D_t - P_{t-1}}{P_{t-1}}$. Ex-dividend means a company's dividend allocations have been specified. The ex-dividend date or "ex-date" is usually one business day before the record date.

The return of an asset over multiple periods is calculated using the product of the simple returns in each period: $1 + R_T = \prod_{t=1}^T (1 + R_t)$. This implicitly assumes that dividends have been reinvested in the same asset.

There are also continuously compounded returns, or log returns. These are computed as the difference of the natural logarithm of the price: $\$r_t = \ln P_t - \ln P_{t-1}$

1.1.5 Yahoo Finance data

- The historical “close” from Yahoo Finance is the split-adjusted price
- The historical “adjclose” from Yahoo Finance is equal to the dividend- and split-adjusted price: Daily changes of “adjclose” reflects the total holdings returns which includes the effect of both stock splits and cash dividends received.

```
# Prices from Yahoo Finance
from yahoo import get_price
ticker = 'AAPL'
date = 20200101
df = get_price(ticker, start_date=date, verbose=VERBOSE)
df.rename_axis(ticker)
prices_columns = df.columns
df.round(2)
```

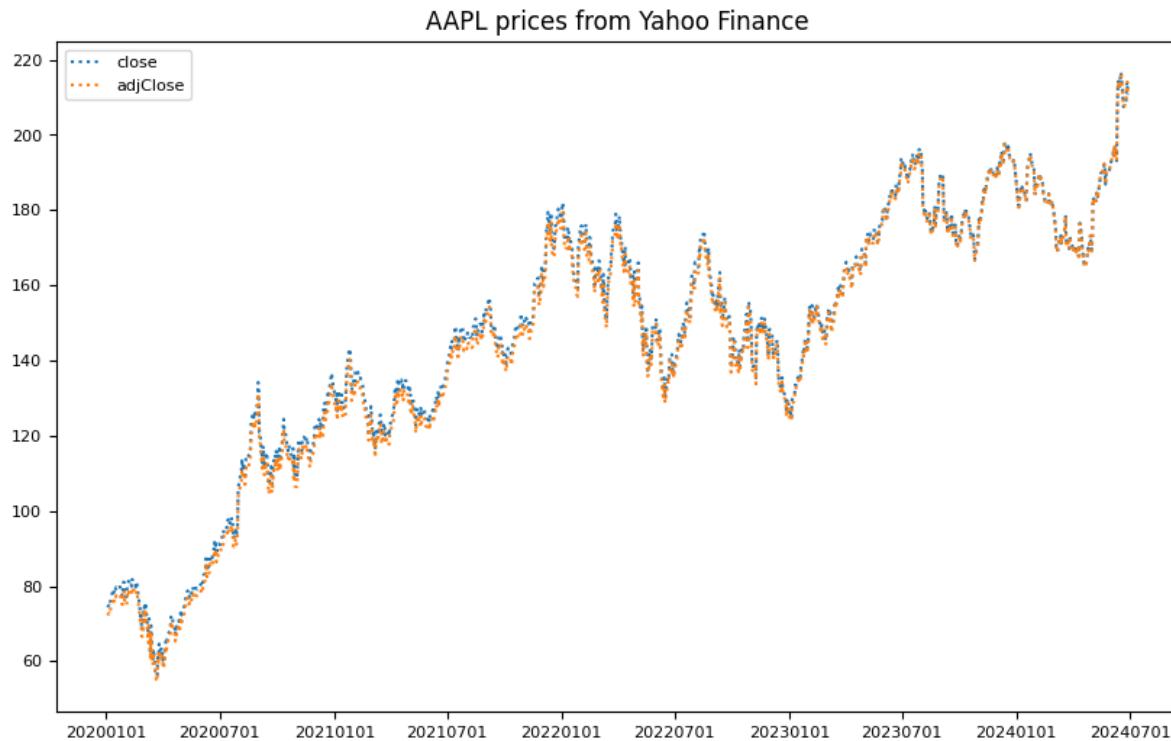
	open	high	low	close	adjClose	volume
20200103	74.29	75.14	74.12	74.36	72.25	146322800.0
20200106	73.45	74.99	73.19	74.95	72.83	118387200.0
20200107	74.96	75.22	74.37	74.60	72.48	108872000.0
20200108	74.29	76.11	74.29	75.80	73.65	132079200.0
20200109	76.81	77.61	76.55	77.41	75.21	170108400.0
...
20240624	207.72	212.70	206.59	208.14	208.14	80727000.0
20240625	209.15	211.38	208.61	209.07	209.07	56713900.0
20240626	211.50	214.86	210.64	213.25	213.25	66213200.0
20240627	214.69	215.74	212.35	214.10	214.10	49772700.0
20240628	215.77	216.07	210.30	210.62	210.62	82475600.0

[1129 rows x 6 columns]

```
df = get_price(ticker, start_date=date, verbose=VERBOSE)
```

```
fig, ax = plt.subplots(figsize=(10, 6))
plot_date(df[['close', 'adjClose']], legend=['close', 'adjClose'],
           title=f'{ticker} prices from Yahoo Finance',
           ls=':', fontsize=8, rotation=0, cn=0, ax=ax)
```

<Axes: title={'center': 'AAPL prices from Yahoo Finance'}>



Dividends

Differences between daily changes in adjClose and close on ex-dates are estimates of dividend amounts (scaled by prior adjClose).

```
# Lookup AAPL's permno identifier
find = Finder(sql)
permno = find('AAPL').tail(1)['permno'].iloc[0]

# dividend yield is excess of change in adjClose over change in close
df['divyld'] = ((df['adjClose'] / df['adjClose'].shift())
                 / (df['close'] / df['close'].shift())) - 1
# ex-dates inferred to be when amount is larger than rounding error
exdt = df.index[abs(df['divyld'])] > .0001
yahoo_div = df.loc[exdt, 'divyld']
```

Dividend amount per share from CRSP distributions

```
crsp_div = DataFrame(**sql.run(f"""
SELECT divamt, exdt, retx, prc FROM dist INNER JOIN daily
ON dist.permno = daily.permno AND dist.exdt = daily.date AND dist.exdt <= {CRSP_DATE}
WHERE dist.permno={permno} AND dist.exdt>{date} AND dist.divamt > 0
""".strip()))
crsp_div = crsp_div.set_index('exdt').sort_index()
crsp_div
```

	divamt	retx	prc
exdt			
20200207	0.770	-0.015928	320.03

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20200508	0.820	0.021038	310.13
20200807	0.820	-0.024495	444.45
20201106	0.205	-0.002856	118.69
20210205	0.205	-0.0004586	136.76
20210507	0.220	0.0003623	130.21
20210806	0.220	-0.0006256	146.14
20211105	0.220	0.0002120	151.28
20220204	0.220	-0.0002950	172.39
20220506	0.230	0.0003253	157.28
20220805	0.230	-0.0002774	165.35
20221104	0.230	-0.0003600	138.38
20230210	0.230	0.0000928	151.01
20230512	0.240	-0.0006791	172.57
20230811	0.240	-0.001011	177.79
20231110	0.240	0.021874	186.40

```
# Compare CRSP actual and Yahoo Finance estimated dividend amounts
div = crsp_div.join(yahoo_div)
div['yahoo_div'] = div['divyld'] * (div['prc'] / (1 + div['retx']))
div[['divamt', 'yahoo_div', 'prc']].round(3)
```

exdt	divamt	yahoo_div	prc
20200207	0.770	0.772	320.03
20200508	0.820	0.822	310.13
20200807	0.820	0.822	444.45
20201106	0.205	0.205	118.69
20210205	0.205	0.205	136.76
20210507	0.220	0.220	130.21
20210806	0.220	0.220	146.14
20211105	0.220	0.220	151.28
20220204	0.220	0.220	172.39
20220506	0.230	0.230	157.28
20220805	0.230	0.230	165.35
20221104	0.230	0.230	138.38
20230210	0.230	0.230	151.01
20230512	0.240	0.240	172.57
20230811	0.240	0.240	177.79
20231110	0.240	0.240	186.40

Split adjustment factors from CRSP

```
crsp_fac = DataFrame(**sql.run(f"""
SELECT 1 + facpr as facpr, exdt FROM dist
WHERE permno={permno} AND exdt>{date} AND facpr > 0.0
""").strip()).set_index('exdt').sort_index(ascending=False).cumprod()
```

```
# Retrieve CRSP raw prices around ex-dates
crsp_prc = DataFrame(**sql.run(f"""
SELECT date, prc from daily
WHERE permno={permno} AND date>{bd.offset(crsp_fac.index[0], -5)}
AND date<{bd.offset(crsp_fac.index[-1], 5)}
""").strip()).set_index('date')
```

The Factor to Adjust Price, `facpr`, can be used to adjust prices for distributions (usually stock dividends and splits) so that stock prices before and after the distribution are comparable.

The historical cumulative adjust factors are computed by adding 1 to and then taking cumulative product from current to earlier time periods. This cumulative factor between two dates is divided into the earlier raw stock price to derive comparable split-adjusted prices. Hence to split-adjust CRSP raw prices

- apply cumulative factor to raw prices before corresponding ex-date
- back-fill to dates prior to ex-date
- default factor after latest ex-date is 1

```
# Compare split-adjusted CRSP price to Yahoo Finance close price
crsp_fac = crsp_fac.reindex(crsp_prc.index) \
    .shift(-1) \
    .bfill() \
    .fillna(1) \
    .join(crsp_prc)
crsp_fac['prc_adjusted'] = crsp_fac['prc'] / crsp_fac['facpr']
crsp_fac[['prc', 'prc_adjusted']].join(df['close'], how='left').round(3)
```

	prc	prc_adjusted	close
date			
20200825	499.30	124.825	124.825
20200826	506.09	126.522	126.522
20200827	500.04	125.010	125.010
20200828	499.23	124.808	124.808
20200831	129.04	129.040	129.040
20200901	134.18	134.180	134.180
20200902	131.40	131.400	131.400
20200903	120.88	120.880	120.880
20200904	120.96	120.960	120.960

1.1.6 Stock delistings

An important feature of the CRSP database is that it is free of survivorship-bias. It includes the historical records of stocks that have delisted from trading on the exchanges.

In CRSP Monthly, the Delisting Return is calculated from the last month ending price to the last daily trading price if no other delisting information is available. In this case the delisting payment date is the same as the delisting date. If the return is calculated from a daily price, it is a partial-month return. The partial-month returns are not truly Delisting Returns since they do not represent values after delisting, but allow the researcher to make a more accurate estimate of the Delisting Returns.

Following Bali, Engle, and Murray (2016) and Shumway (1997): we can construct returns adjusted for delistings, which result when a company is acquired, ceases operations, or fails to meet exchange listing requirements. The adjustment reflects the partial month of returns to investors who bought the stock in the month before the delisting. For certain delisting codes ([500, 520, 551..574, 580, 584]) where the delisting return is missing, a delisting return of -30% is assumed which reflects the average recovery amount after delisting.

```
# Show sample of original CRSP Monthly ret and dlret, and after adjustment
pd.read_sql('select * from monthly where dlstcd>100 and date=20041130', sql.engine) \
    .set_index('permno') \
    .rename(columns={'ret': 'original_ret'}) \
```

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```
.join(crsp.get_ret(beg=20041101, end=20041130), how='left')\
.round(4)
```

permno	date	prc	original_ret	retx	dlstcd	dlret	ret
10275	20041130	NaN	NaN	NaN	584	-0.2703	-0.2703
10418	20041130	NaN	NaN	NaN	520	0.0509	0.0509
11194	20041130	NaN	NaN	NaN	233	0.0066	0.0066
12010	20041130	NaN	NaN	NaN	587	0.0490	0.0490
20459	20041130	NaN	NaN	NaN	231	0.0724	0.0724
32897	20041130	NaN	NaN	NaN	584	-0.2357	-0.2357
55589	20041130	NaN	NaN	NaN	233	-0.0114	-0.0114
64290	20041130	13.70	0.0178	0.0178	233	0.0000	0.0178
67708	20041130	NaN	NaN	NaN	233	0.0164	0.0164
69593	20041130	NaN	NaN	NaN	331	0.0998	0.0998
69681	20041130	NaN	NaN	NaN	584	-0.4853	-0.4853
70447	20041130	5.80	-0.2246	-0.2246	570	NaN	-0.4572
75606	20041130	NaN	NaN	NaN	520	-0.2466	-0.2466
75684	20041130	NaN	NaN	NaN	233	0.0094	0.0094
76306	20041130	NaN	NaN	NaN	241	-0.0329	-0.0329
76691	20041130	NaN	NaN	NaN	582	0.0127	0.0127
77838	20041130	NaN	NaN	NaN	520	-0.0041	-0.0041
79149	20041130	NaN	NaN	NaN	574	-0.2088	-0.2088
79523	20041130	NaN	NaN	NaN	233	0.0043	0.0043
80211	20041130	NaN	NaN	NaN	470	0.0186	0.0186
80714	20041130	NaN	NaN	NaN	332	0.0337	0.0337
82491	20041130	4.21	-0.0644	-0.0644	551	0.0689	0.0000
83583	20041130	125.10	0.2810	0.2810	241	0.0624	0.3608
83702	20041130	NaN	NaN	NaN	587	0.2667	0.2667
83995	20041130	26.58	0.2374	0.2374	231	0.0394	0.2861
84047	20041130	16.35	0.0467	0.0467	241	-0.2661	-0.2318
86123	20041130	NaN	NaN	NaN	233	0.0059	0.0059
86307	20041130	NaN	NaN	NaN	233	0.0223	0.0223
86388	20041130	NaN	NaN	NaN	584	-0.0337	-0.0337
86991	20041130	NaN	NaN	NaN	233	0.0106	0.0106
87126	20041130	NaN	NaN	NaN	231	0.0784	0.0784
87158	20041130	NaN	NaN	NaN	233	0.0086	0.0086
87247	20041130	NaN	NaN	NaN	233	0.0046	0.0046
88670	20041130	NaN	NaN	NaN	470	0.0013	0.0013
89186	20041130	NaN	NaN	NaN	331	0.0696	0.0696
89385	20041130	NaN	NaN	NaN	231	0.2959	0.2959
89936	20041130	NaN	NaN	NaN	231	0.0719	0.0719
89939	20041130	NaN	NaN	NaN	233	0.0059	0.0059

1.2 Properties of stock returns

1.2.1 Long-run market averages

- total stock returns
- dividend yield
- shares trading turnover

Equal-weighted time-series means of annual cap-weighted cross-sectional averages of universe stocks

```

# Loop over the 20-year eras, and compute means of annual cap-weighted averages
years = [2005, 1985, 1965, 1945, 1925]
results = DataFrame(columns=['divyld', 'turnover', 'means'])
for era in tqdm(years):
    label = f"{era+1}-{min(era+20, CRSP_DATE // 10000)}"
    divyld = {}
    means = {}
    turnover = {}
    for year in bd.date_range(era, min(CRSP_DATE // 10000, era+20), freq=12):
        univ = crsp.get_universe(bd.endyr(year)) # screen for universe stocks

        # Retrieve and compute cap-weighted average of annual returns
        cmd = f"""
select permno, SUM(LOG(1+ret)) AS ret FROM daily
WHERE date > {bd.endyr(year)} AND date <= {bd.endyr(year, 1)}
GROUP BY permno
""".strip()
        data = pd.read_sql(cmd, sql.engine)
        df = data.set_index('permno').join(univ['cap'], how='right').dropna()
        means[year] = (np.exp(df['ret'])-1).dot(df['cap']) / df['cap'].sum()

        # Retrieve and compute cap-weighted average of annualized turnover
        cmd = f"""
select permno, 252*AVG(vol/(shrout*1000)) AS turnover FROM daily
WHERE date > {bd.endyr(year)} AND date <= {bd.endyr(year, 1)}
GROUP BY permno
""".strip()
        data = pd.read_sql(cmd, sql.engine)
        df = data.set_index('permno').join(univ['cap'], how='right').dropna()
        turnover[year] = df['turnover'].dot(df['cap']) / df['cap'].sum()

        # Retrieve and compute cap-weighted average of annual dividend amounts
        cmd = f"""
SELECT dist.permno as permno, SUM(daily.shrout * dist.divamt) AS divamt
FROM dist INNER JOIN daily
ON daily.permno = dist.permno AND daily.date = dist.exdt
WHERE dist.divamt > 0 AND dist.exdt > {bd.endyr(year)}
    AND dist.exdt <= {bd.endyr(year, 1)}
GROUP BY permno
""".strip()
        data = pd.read_sql(cmd, sql.engine)
        df = data.set_index('permno').join(univ['cap'], how='right').dropna()
        divyld[year] = df['divamt'].sum() / df['cap'].sum()

    results.loc[label, 'turnover'] = np.mean(list(turnover.values()))
    results.loc[label, 'divyld'] = np.mean(list(divyld.values()))
    results.loc[label, 'means'] = np.mean(list(means.values()))

```

100% [██████████] 5/5 [1:10:45<00:00, 849.19s/it]

```

# Plot mean returns, dividend yield and turnover using both y-axes
results = results.iloc[:-1]
fig, ax = plt.subplots()
ax.plot(results['means'], color="blue")

```

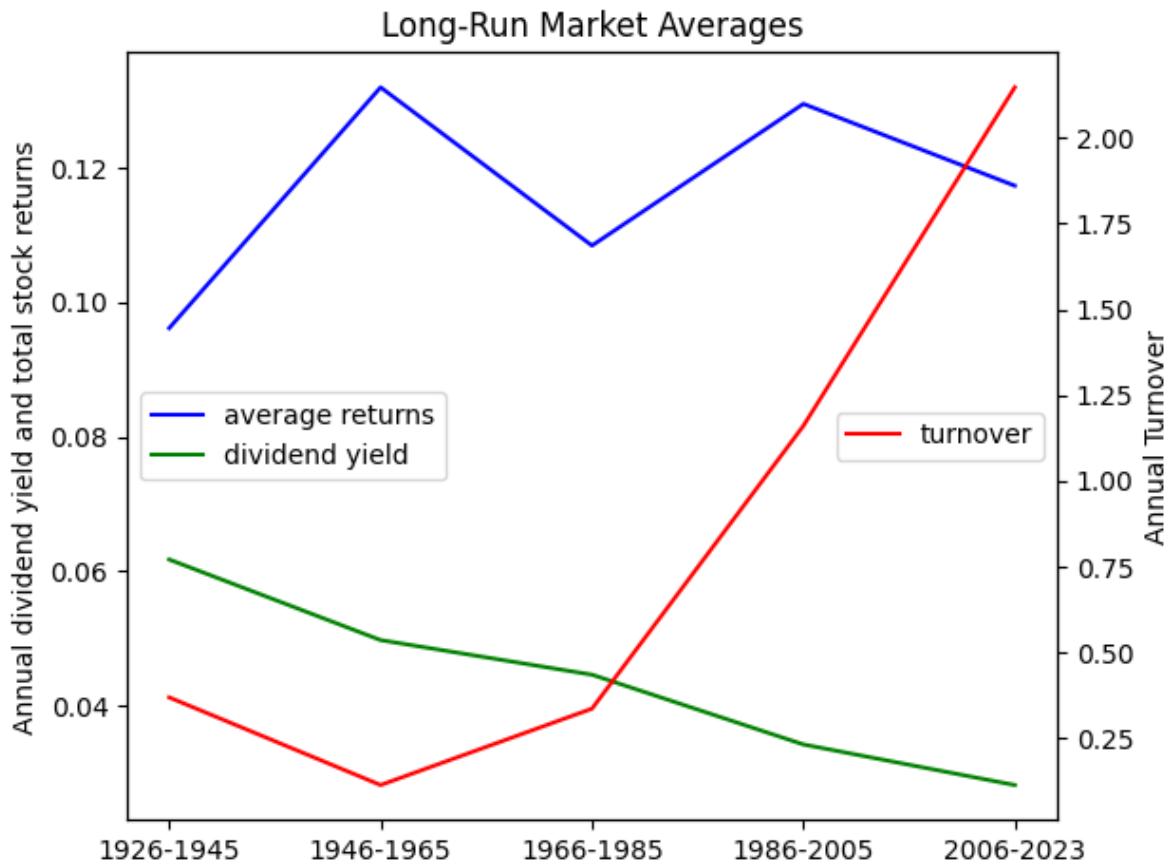
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```

ax.plot(results['divyld'], color="green")
ax.legend(['average returns', 'dividend yield'], loc="center left")
ax.set_ylabel("Annual dividend yield and total stock returns")
bx = ax.twinx()
bx.plot(results['turnover'], color="red")
bx.set_ylabel("Annual Turnover")
bx.legend(['turnover'], loc="center right")
plt.title("Long-Run Market Averages")
plt.tight_layout()

```



1.2.2 Moments of individual stock returns

- The volatility of an asset is usually measured using the standard deviation of the returns. The common practice is to report the annualized volatility using the square-root rule which assumes that variance scales linearly with time: e.g. daily by $\sqrt{252}$, weekly by $\sqrt{52}$, monthly by $\sqrt{12}$
- Means are computed from log returns, and annualized by multiplying by the respective number of periods in a year. We use log returns $\log 1 + R_t$ instead of simple returns R_t to skirt around some of the issues related to translating between arithmetic and geometric averages. It has been shown that:
 - By Jensen's inequality, the arithmetic mean is greater than the geometric mean
 - Under the assumption of log-normality, the arithmetic mean exceeds the geometric mean of returns by half the volatility.

- A normal distribution is symmetric and thin-tailed, and so has no skewness or excess kurtosis. However, many return series are both skewed and fat-tailed (kurtosis in excess of 3).
 - A left-skewed distribution is longer on the left side of its peak than on its right. In other words, a left-skewed distribution has a long tail on its left side, where the mean typically lies to the left of its median. Left skew is also referred to as negative skew.
 - Right or positive skew has the opposite properties.

The Jarque-Bera test statistic can be used to test whether the sample skewness and kurtosis are compatible with an assumption that the returns are normally distributed. When returns are normally distributed, the skewness is asymptotically normally distributed with a variance of 6, so $(\text{skewness})^2/6$ has a χ_1^2 distribution. Meanwhile, the kurtosis is asymptotically normally distributed with mean 3 and variance of 24, and so $(\text{kurtosis} - 3)^2/24$ also has a χ_1^2 distribution. These two statistics are asymptotically independent (uncorrelated), and so their sum is χ_2^2

```
# helper function
def get_moments(freq, annualize, years, stride=20):
    """helper to summarize moments of individual stock returns"""
    out = {}
    years = sorted(years)
    max_era = min(CRSP_DATE, bd.endyr(max(years) + stride)) # end year of last era

    # Use StocksBuffer to cache monthly returns for entire era
    if freq not in ['d', 'w']:
        monthly = CRSPBuffer(stocks=crsp, dataset='monthly', fields=['ret'],
                              beg=bd.endyr(years[0]), end=max_era)
    for era, next_era in zip(years, years[1:] + [max_era]):
        allstocks = DataFrame()
        anystocks = DataFrame()
        univ_year = bd.endyr(era) # universe as of end of previous calendar year

        # Loop over calendar years in era
        endyrs = bd.date_range(bd.endyr(era), bd.endyr(next_era), freq=freq)
        for beg, end in tqdm(bd.date_tuples(endyrs)):

            # Update the investment universe every calendar year
            if bd.endyr(beg) != univ_year:
                univ = crsp.get_universe(univ_year)
                univ_year = bd.endyr(beg)

            # Use StocksBuffer to cache daily returns for the calendar year
            if freq == 'd':
                daily = CRSPBuffer(stocks=crsp, dataset='daily', fields=['ret'],
                                    beg=bd.offset(beg, -1), end=bd.endyr(end))

            # retrieve returns
            if freq == 'd':
                ret = daily.get_ret(beg=beg, end=end).reindex(univ.index)
            elif freq == 'w':
                ret = crsp.get_ret(beg=beg, end=end).reindex(univ.index)
            else: # monthly or coarser
                ret = monthly.get_ret(beg=beg, end=end).reindex(univ.index)

            # horizontally stack returns
            if allstocks.empty:
                allstocks = DataFrame(ret.rename(end))
            else: # every year
                allstocks = allstocks.join(ret.rename(end), how='inner')
```

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```

anystocks = anystocks.join(ret.rename(end), how='outer') # any year

anystocks = anystocks.dropna(axis=0, how='all') # drop empty rows
out[f"str(era)[:-4]-{int(str(next_era)[:-4]) - 1}"] = {
    f"VolAnnualized": np.nanmedian(
        np.nanstd(allstocks, axis=1, ddof=0)) * np.sqrt(annualize),
    f"Skewness": np.nanmedian(
        scipy.stats.skew(allstocks, nan_policy='omit', axis=1)),
    f"ExcessKurtosis": np.nanmedian(
        scipy.stats.kurtosis(allstocks, nan_policy='omit', axis=1)),
    f"Count": len(allstocks),
    f"MeanAnnualized": np.nanmedian(
        np.nanmean(np.log(1 + allstocks), axis=1)) * annualize,
    f"Mean (all stocks)": np.nanmedian(
        np.nanmean(np.log(1 + anystocks), axis=1)) * annualize,
    f"Count (all stocks)": len(anystocks),
}
return out

```

```

# Collect results for different intervals and eras
intervals = [('d', 'daily', 252), ('w', 'weekly', 52), ('e', 'monthly', 12),
             (12, 'annual', 1)] # different returns sampling frequencies
years = [2005, 1985, 1965, 1945, 1925] # 20-year periods
results = DataFrame()
#results = pd.read_json(outdir / 'moments.json')
#results = results.set_index(results.columns[0])
for order, (freq, interval, annualize) in enumerate(intervals):
    df = DataFrame(get_moments(freq, annualize, years, stride=20)).reset_index()
    df['interval'] = interval

    # set index so that rows can be ordered by moment then freq
    df.index = [f"moment{order}" for moment in range(len(df))]
    results = pd.concat((results, df)) # accumulate df to results
results.reset_index().to_json(outdir / 'moments.json')

```

```

100%|██████████| 5963/5963 [10:37<00:00,  9.35it/s]
100%|██████████| 5237/5237 [10:41<00:00,  8.16it/s]
100%|██████████| 5022/5022 [49:17<00:00,  1.70it/s]
100%|██████████| 5047/5047 [1:44:15<00:00,  1.24s/it]
100%|██████████| 4529/4529 [1:13:35<00:00,  1.03it/s]
100%|██████████| 1042/1042 [00:05<00:00, 207.12it/s]
100%|██████████| 1044/1044 [00:05<00:00, 186.31it/s]
100%|██████████| 1043/1043 [01:05<00:00, 15.87it/s]
100%|██████████| 1044/1044 [05:09<00:00,  3.37it/s]
100%|██████████| 939/939 [00:45<00:00, 20.74it/s]
100%|██████████| 240/240 [00:18<00:00, 13.14it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↪py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 240/240 [00:25<00:00,  9.28it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↪py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 240/240 [00:27<00:00,  8.61it/s]

```

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```

/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 240/240 [00:25<00:00,  9.32it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 216/216 [00:18<00:00, 11.37it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 20/20 [00:01<00:00, 10.24it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 20/20 [00:01<00:00, 10.47it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 20/20 [00:02<00:00,  8.93it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 20/20 [00:02<00:00,  9.70it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)
100%|██████████| 18/18 [00:01<00:00,  9.14it/s]
/home/terence/env3.11/lib/python3.11/site-packages/pandas/core/internals/blocks.
  ↵py:393: RuntimeWarning: divide by zero encountered in log
    result = func(self.values, **kwargs)

```

```
out = results.sort_index().rename(columns={'index':'moment'})
```

```
# Show medians of the moments of individual stock returns
out[~out['moment'].str.startswith("Count") &
    ~out['moment'].str.startswith("Mean")].set_index(['interval', 'moment']).round(3)
```

		1925–1944	1945–1964	1965–1984	1985–2004	2005–2022
interval	moment					
daily	VolAnnualized	0.543	0.267	0.337	0.392	0.437
weekly	VolAnnualized	0.540	0.254	0.347	0.366	0.407
monthly	VolAnnualized	0.553	0.244	0.340	0.355	0.381
annual	VolAnnualized	0.553	0.296	0.382	0.379	0.360
daily	Skewness	0.909	0.315	0.528	0.339	0.395
weekly	Skewness	0.932	0.528	0.627	0.343	0.281
monthly	Skewness	1.257	0.484	0.597	0.381	0.307
annual	Skewness	0.751	0.582	0.628	0.684	0.423
daily	ExcessKurtosis	14.887	5.446	4.926	8.749	13.268
weekly	ExcessKurtosis	7.535	2.645	2.916	4.384	6.589
monthly	ExcessKurtosis	6.073	1.074	1.648	2.080	2.306
annual	ExcessKurtosis	0.220	-0.115	0.105	0.132	-0.051

```
# Show counts of stocks
out[out['moment'].str.startswith("Count")].set_index(['interval', 'moment']).\
    astype(int)
```

		1925-1944	1945-1964	1965-1984	1985-2004	\
interval	moment					
daily	Count	305	606	877	1219	
weekly	Count	305	606	877	1219	
monthly	Count	305	606	877	1219	
annual	Count	305	606	877	1219	
daily	Count (all stocks)	1082	2448	10089	16273	
weekly	Count (all stocks)	1082	2447	10084	16271	
monthly	Count (all stocks)	1082	2448	10088	16273	
annual	Count (all stocks)	1082	2448	10088	16273	
		2005-2022				
interval	moment					
daily	Count	1579				
weekly	Count	1579				
monthly	Count	1579				
annual	Count	1579				
daily	Count (all stocks)	9050				
weekly	Count (all stocks)	9042				
monthly	Count (all stocks)	9049				
annual	Count (all stocks)	9049				

```
# Show medians of mean individual stock returns
out[out['moment'].str.startswith("Mean")].set_index(['interval', 'moment']).round(3)
```

		1925-1944	1945-1964	1965-1984	1985-2004	\
interval	moment					
daily	MeanAnnualized	0.040	0.104	0.089	0.099	
weekly	MeanAnnualized	0.046	0.109	0.087	0.100	
monthly	MeanAnnualized	0.047	0.108	0.088	0.099	
annual	MeanAnnualized	0.047	0.108	0.088	0.099	
daily	Mean (all stocks)	0.052	0.114	0.059	0.009	
weekly	Mean (all stocks)	0.061	0.118	0.057	0.010	
monthly	Mean (all stocks)	0.063	0.118	0.059	0.009	
annual	Mean (all stocks)	0.061	0.116	0.056	0.008	
		2005-2022				
interval	moment					
daily	MeanAnnualized	0.059				
weekly	MeanAnnualized	0.057				
monthly	MeanAnnualized	0.059				
annual	MeanAnnualized	0.059				
daily	Mean (all stocks)	0.006				
weekly	Mean (all stocks)	0.004				
monthly	Mean (all stocks)	0.007				
annual	Mean (all stocks)	0.006				

1.2.3 Correlations

The linear correlation estimator (also known as Pearson's correlation) measures the linear relationship between two variables. Alternative measures can help capture nonlinear dependence:

- rank correlation (or Spearman's correlation) is the linear correlation estimator applied to the ranks of the observations. It measures monotonic correlation and is less sensitive to outliers.
- Kendall's τ measures the relative frequency of concordant and discordant pairs of two random variables X and Y. Concordant pairs agree about the relative position of X and Y, while pairs that disagree about the order are discordant. This statistic is robust to outliers and works well with skewed or non-normally distributed data.

Computing these measures between the value-weighted and equal-weighted total daily market returns suggests that the high estimated linear correlation may be sensitive to outliers, compared to estimators that are less.

```
# retrieve CRSP value- and equal-weighted total market returns
retd = bench.get_series(['vwretd', 'ewretd'], field='ret').dropna()
retd
```

```
permno      vwretd      ewretd
date
19260102  0.004297  0.002941
19260104 -0.001357  0.001036
19260105 -0.004603 -0.005856
19260106  0.000537  0.000888
19260107  0.003907  0.004258
...
20231222  0.001708  0.003380
20231226  0.004208  0.005969
20231227  0.001604  0.001316
20231228  0.000415  0.001506
20231229 -0.002798 -0.003538

[25798 rows x 2 columns]
```

```
# Compute alternative measures of correlation
DataFrame(dict(kendall=scipy.stats.kendalltau(retd['vwretd'], retd['ewretd'])[0],
               spearman=scipy.stats.spearmanr(retd['vwretd'], retd['ewretd'])[0],
               pearson=scipy.stats.pearsonr(retd['vwretd'], retd['ewretd'])[0]),
               index=['Measures of correlations']).round(4)
```

```
               kendall  spearman  pearson
Measures of correlations  0.8147    0.9462    0.9628
```

1.3 Stock Delistings

An important feature of the CRSP database is that it is free of survivorship-bias. It includes the historical records of stocks that have delisted from trading on the exchanges.

In CRSP Monthly, the Delisting Return is calculated from the last month ending price to the last daily trading price if no other delisting information is available. In this case the delisting payment date is the same as the delisting date. If the return is calculated from a daily price, it is a partial-month return. The partial-month returns are not truly Delisting Returns since they do not represent values after delisting, but allow the researcher to make a more accurate estimate of the Delisting Returns.

Following Bali, Engle, and Murray (2016) and Shumway (1997): we can construct returns adjusted for delistings, which result when a company is acquired, ceases operations, or fails to meet exchange listing requirements. The adjustment reflects the partial month of returns to investors who bought the stock in the month before the delisting. For certain delisting codes ([500, 520, 551..574, 580, 584]) where the delisting return is missing, a delisting return of -30% is assumed which reflects the average recovery amount after delisting.

```
DataFrame(**sql.run('select * from monthly where dlstcd>100 and date=20041130'))\
.set_index('permno')\
.rename(columns={'ret': 'original_ret'})\
.join(crsp.get_ret(beg=20041101, end=20041130), how='left')\
.round(4)
```

permno	date	prc	original_ret	retx	dlstcd	dlret	ret
10275	20041130	NaN	NaN	NaN	584	-0.2703	-0.2703
10418	20041130	NaN	NaN	NaN	520	0.0509	0.0509
11194	20041130	NaN	NaN	NaN	233	0.0066	0.0066
12010	20041130	NaN	NaN	NaN	587	0.0490	0.0490
20459	20041130	NaN	NaN	NaN	231	0.0724	0.0724
32897	20041130	NaN	NaN	NaN	584	-0.2357	-0.2357
55589	20041130	NaN	NaN	NaN	233	-0.0114	-0.0114
64290	20041130	13.70	0.0178	0.0178	233	0.0000	0.0178
67708	20041130	NaN	NaN	NaN	233	0.0164	0.0164
69593	20041130	NaN	NaN	NaN	331	0.0998	0.0998
69681	20041130	NaN	NaN	NaN	584	-0.4853	-0.4853
70447	20041130	5.80	-0.2246	-0.2246	570	NaN	-0.4572
75606	20041130	NaN	NaN	NaN	520	-0.2466	-0.2466
75684	20041130	NaN	NaN	NaN	233	0.0094	0.0094
76306	20041130	NaN	NaN	NaN	241	-0.0329	-0.0329
76691	20041130	NaN	NaN	NaN	582	0.0127	0.0127
77838	20041130	NaN	NaN	NaN	520	-0.0041	-0.0041
79149	20041130	NaN	NaN	NaN	574	-0.2088	-0.2088
79523	20041130	NaN	NaN	NaN	233	0.0043	0.0043
80211	20041130	NaN	NaN	NaN	470	0.0186	0.0186
80714	20041130	NaN	NaN	NaN	332	0.0337	0.0337
82491	20041130	4.21	-0.0644	-0.0644	551	0.0689	0.0000
83583	20041130	125.10	0.2810	0.2810	241	0.0624	0.3608
83702	20041130	NaN	NaN	NaN	587	0.2667	0.2667
83995	20041130	26.58	0.2374	0.2374	231	0.0394	0.2861
84047	20041130	16.35	0.0467	0.0467	241	-0.2661	-0.2318
86123	20041130	NaN	NaN	NaN	233	0.0059	0.0059
86307	20041130	NaN	NaN	NaN	233	0.0223	0.0223
86388	20041130	NaN	NaN	NaN	584	-0.0337	-0.0337
86991	20041130	NaN	NaN	NaN	233	0.0106	0.0106
87126	20041130	NaN	NaN	NaN	231	0.0784	0.0784
87158	20041130	NaN	NaN	NaN	233	0.0086	0.0086
87247	20041130	NaN	NaN	NaN	233	0.0046	0.0046
88670	20041130	NaN	NaN	NaN	470	0.0013	0.0013
89186	20041130	NaN	NaN	NaN	331	0.0696	0.0696
89385	20041130	NaN	NaN	NaN	231	0.2959	0.2959
89936	20041130	NaN	NaN	NaN	231	0.0719	0.0719
89939	20041130	NaN	NaN	NaN	233	0.0059	0.0059

JEGADEESH-TITMAN ROLLING PORTFOLIOS

The future is simply the past that's waiting to happen - Unknown

Concepts:

- Price momentum
- Univariate spread portfolios
- Overlapping returns, Newey-West correction
- Hypothesis testing, size and power

References:

- Jegadeesh, Narasimhan, and Sheridan Titman (1993), “Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency”. Journal of Finance. March 1993, Volume 48, Issue 1, Pages 65-91.
- Newey, Whitney K, West, Kenneth D (1987). “A Simple, Positive Semi-definite, Heteroskedasticity and Autocorrelation Consistent Covariance Matrix”. Econometrica. 55 (3): 703–708.
- FRM Exam Book Part I Quantitative Analysis Chapter 6

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```
import math
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import scipy
from scipy.stats import kurtosis, skew, norm
import statsmodels.formula.api as smf
import statsmodels.api as sm
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, CRSPBuffer
from finds.recipes import fractile_split
from finds.utils import plot_date
from secret import credentials, CRSP_DATE
```

```
VERBOSE = 0
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
```

```
# date range and parameters to construct momentum portfolios
begrebal = 19260630 # first price date is 19251231
endrebal = bd.endmo(CRSP_DATE, -1) # last rebal is one month before last CRSP
rebaldates = bd.date_range(begrebal, endrebal, 'endmo')
percentiles = [20, 80] # quintile spread percentile breakpoints
maxhold = 6 # hold each monthly-rebalanced portfolio for 6 months
```

```
# preload monthly dataset into memory
monthly = CRSPBuffer(stocks=crsp, dataset='monthly',
                      fields=['ret', 'retx', 'prc'],
                      beg=bd.begmo(rebaldates[0], -6),
                      end=bd.endmo(rebaldates[-1], 1))
```

2.1 Price Momentum

2.1.1 Overlapping portfolio returns

At the end of each month t , we construct the sorting variable as the investment universe stocks' past 6 months returns. We determine the 20th and 80th percentile of NYSE-listed stocks, then buy all stocks in top fractile and short all stocks in the lowest fractile. The stocks are cap-weighted within each fractile, while the spread portfolio is the equal-weighted difference of the two sub-portfolios' returns. The spread portfolios' returns over the next six months, expressed on a monthly basis by dividiving by six, are recorded.

To be considered, a stock must be satisfy the usual investment universe criteria at the end of the rabalance month, and have non-missing month-end price six months ago.

```
stocks = monthly
mom = []
for rebaldate in tqdm(rebaldates):
    # determine pricing dates relative to rebaldate
    beg = bd.endmo(rebaldate, -6) # require price at beg date
    end = bd.endmo(rebaldate, 0) # require price at end date
    start = bd.offset(beg, 1) # starting day of momemtum signal

    # retrieve universe, prices, and momentum signal
    p = [crsp.get_universe(rebaldate),
          stocks.get_ret(beg=start, end=end).rename('mom'),
          stocks.get_section(fields=['prc'], date=beg) ['prc'].rename('beg')]
    df = pd.concat(p, axis=1, join='inner').dropna()

    # quintile breakpoints are determined from NYSE subset
    tritile = fractile_split(values=df['mom'],
                             pct=percentiles,
                             keys=df.loc[df['nyse'], 'mom'])

    # construct cap-wtd tritile spread portfolios
```

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```

porthi, portlo = [df.loc[tritile==t, 'cap'] for t in [1, 3]]
port = pd.concat((porthi/porthi.sum(), -portlo/portlo.sum()))

# compute and store cap-weighted average returns over (up to) maxhold periods
begret = bd.offset(rebaldates, 1)
nhold = min(maxhold, len(rebaldates) - rebaldates.index(rebaldates))
endret = bd.endmo(begret, nhold - 1) # if maxhold is beyond end date
rets = monthly.get_ret(begret, endret)
ret = rets.reindex(port.index).fillna(0.).mul(port, axis=0).sum()
mom.append(float(ret) / nhold)

```

100%|██████████| 1170/1170 [02:12<00:00, 8.84it/s]

```
DataFrame({'mean': np.mean(mom), 'std': np.std(mom)}, index=['Overlapping Returns'])
```

	mean	std
Overlapping Returns	0.004303	0.024709

2.1.2 Non-overlapping portfolio returns

At the end of each month t , a spread portfolio is constructed in the same way. However, the return recorded is the equal-weighted average of the following month's return on six portfolios constructed between t and $t-5$ (inclusive). After each month, the stock weights on the spread portfolios are adjusted for their stocks' (split-adjusted) price change over the month, i.e. "buy-and-hold" over six months.

```

ports = [] # to roll 6 past portfolios
jt = []
stocks = monthly
for rebaldate in tqdm(rebaldates):

    # determine returns dates relative to rebaldate
    beg = bd.endmo(rebaldate, -6) # require price at beg date
    end = bd.endmo(rebaldate, 0) # require price at end date
    start = bd.offset(beg, 1) # starting day of momentum signal

    # retrieve universe, prices, and momentum signal
    p = [crsp.get_universe(rebaldate),
          stocks.get_ret(beg=start, end=end).rename('mom'),
          stocks.get_section(fields=['prc'], date=beg) ['prc'].rename('beg')]
    df = pd.concat(p, axis=1, join='inner').dropna()

    # quintile breakpoints determined from NYSE subset
    tritile = fractile_split(values=df['mom'],
                              pct=percentiles,
                              keys=df.loc[df['nyse'], 'mom'])

    # construct cap-wtd tritile spread portfolios
    porthi, portlo = [df.loc[tritile==t, 'cap'] for t in [1, 3]]
    port = pd.concat((porthi/porthi.sum(), -portlo/portlo.sum()))

    # retain up to 6 prior months of monthly-rebalanced portfolios
    ports.insert(0, port)

```

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```

if len(ports) > maxhold:
    ports.pop(-1)

# compute all 6 portfolios' monthly capwtd returns, and store eqlwtd average
begret = bd.offset(rebaldate, 1)
endret = bd.endmo(begret)
rets = stocks.get_ret(begret, endret)
ret = np.mean([rets.reindex(p.index).fillna(0.).mul(p, axis=0).sum()
              for p in ports])
jt.append(ret)

# adjust stock weights by monthly capital appreciation
retx = stocks.get_ret(begret, endret, field='retx')
ports = [(1 + retx.reindex(p.index).fillna(0.)).mul(p, axis=0)
          for p in ports]

DataFrame({'mean': np.mean(jt), 'std': np.std(jt)}, index=['Non-overlapping Returns'])

```

0% | 0/1170 [00:00<?, ?it/s]

100% |██████████| 1170/1170 [03:07<00:00, 6.25it/s]

	mean	std
Non-overlapping Returns	0.004399	0.051421

Correlations with portfolio lagged returns

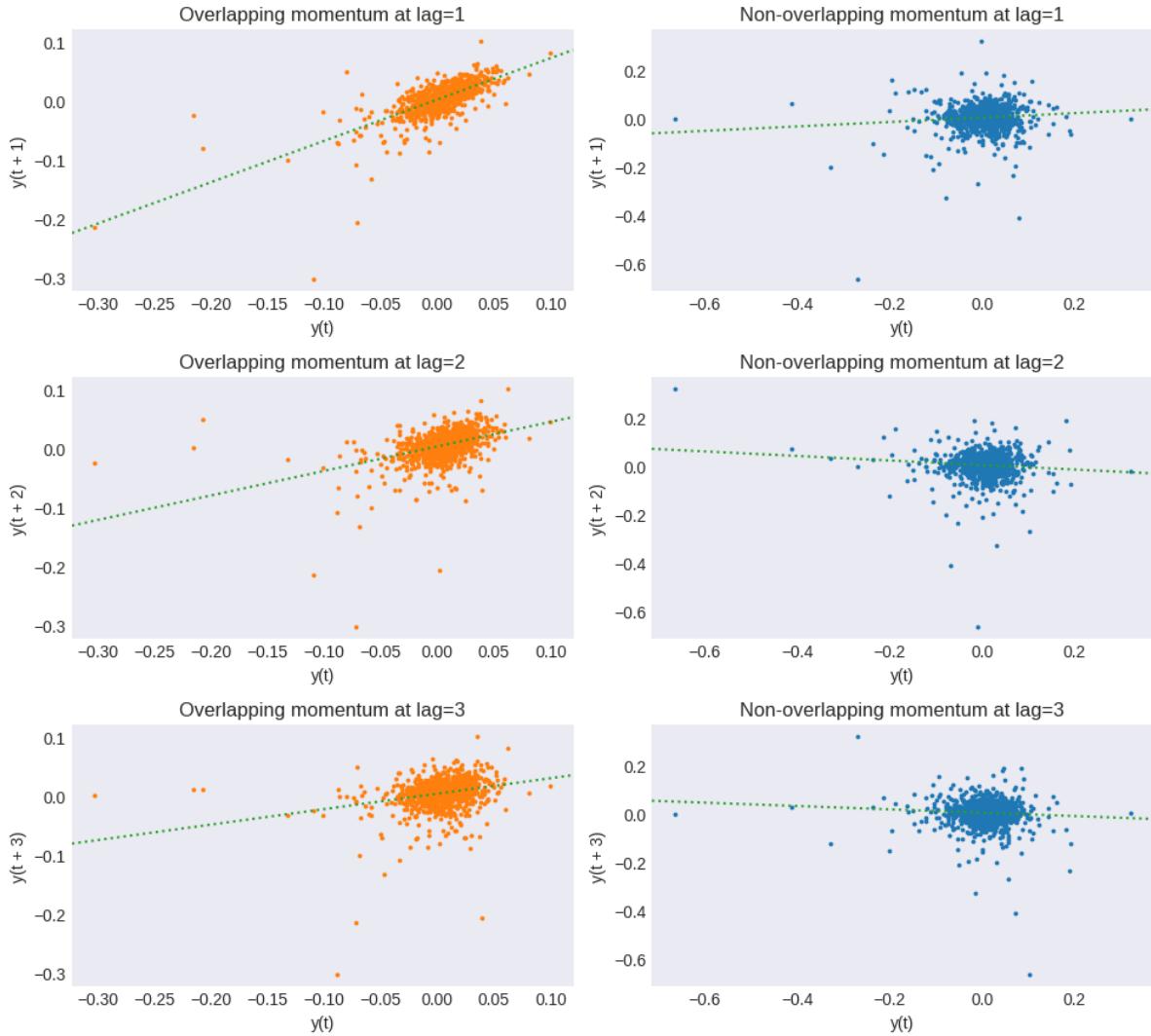
For the overlapping portfolio returns, each month's recorded return is actually a six-month return, hence up to 5/6 of adjacments months' returns could reflect the same month's stock returns. The Jegadeesh-Titman approach avoids such overlap.

```

fig, axes = plt.subplots(nrows=3, ncols=2, figsize=(10, 9))
for lag, ax in zip(range(1, axes.shape[0]+1, 1), axes):
    pd.plotting.lag_plot(Series(mom), lag=lag, ax=ax[0], s=3, c="C1")
    ax[0].set_title(f"Overlapping momentum at lag={lag}")
    r = scipy.stats.linregress(mom[lag:], mom[:-lag])
    ax[0].axline((0, r.intercept), slope=r.slope, ls=':', color="C2")

    pd.plotting.lag_plot(Series(jt), lag=lag, ax=ax[1], s=3, c="C0")
    ax[1].set_title(f"Non-overlapping momentum at lag={lag}")
    r = scipy.stats.linregress(jt[lag:], jt[:-lag])
    ax[1].axline((0, r.intercept), slope=r.slope, ls=':', color="C2")
plt.tight_layout()

```



2.2 Hypothesis Testing

A hypothesis makes a precise statement about some population parameters; hypothesis testing can be reduced to asking how likely is the observed data if the hypothesis is true.

- The *null hypothesis* specifies the true value of a parameter to be tested, often $H_0 : \hat{\mu} = \mu_0$
- The *test statistic* is a summary of the observed data that has a known distribution when the null hypothesis is true, e.g. $T - \frac{\hat{\mu} - \mu_0}{\sqrt{\sigma^2/n}} \sim N(0, 1)$
- The *alternative hypothesis* defines the range of values of the parameter where the null should be rejected, e.g. $H_a : \hat{\mu} \neq \mu_0$
 - In some testing problems, the alternative hypothesis is not the full complement of the null, for example, a *one-sided alternative* $H_a : \hat{\mu} > \mu_0$, which is used when the outcome of interest is only above or below the value assumed by the null.
- The *critical value* C_α marks the start of a range of values where the test statistic is unlikely to fall in, if the null hypothesis were true, e.g. $C_\alpha = \Phi^{-1}(1 - \alpha/2) = 1.96$ when $\alpha = 5\%$ for a two-sided test. This range is known as

the *rejection region*.

- The *size* of the test is the probability of making a *Type I error* of rejecting null hypothesis that is actually true. A test is said to have *significance level* α if its *size* is less than or equal to α . This reflects the aversion to rejecting a null hypothesis that is, in fact, true.
- The *p-value* is the probability of obtaining a test statistic at least as extreme as the one we observed from the sample, if the null hypothesis were true, e.g. $p = 2(1 - \Phi(|T|))$ for a two-sided test.

2.2.1 Confidence Interval

A $1 - \alpha$ *confidence interval* contains the values surrounding the test statistic that cannot be rejected when using a test size of α , e.g. $[\hat{\mu} - C_\alpha \frac{\sigma^2}{\sqrt{n}}, \hat{\mu} + C_\alpha \frac{\sigma^2}{\sqrt{n}}]$ for a two-sided interval

2.2.2 Newey-West corrected t-stats

Raw standard errors are understated since the standard assumption of independent observations does not apply. The Newey-West (1987) estimator requires a “maximum lag considered for the control of autocorrelation”: a common choice for L is the fourth root of the number of observations, e.g. Greene (Econometric Analysis, 7th edition, section 20.5.2, p. 960).

The Newey-West correction almost doubles the estimate of the standard error for the overlapping case, but a tiny adjustment for non-overlapping returns.

```
print('n =', len(mom), 'L =', math.ceil(len(mom)**(1/4)))
results = []
for rets, label in zip([mom, jt], ['Overlapping', 'Non-overlapping']):
    data = DataFrame(rets, columns=['ret'])

    # raw t-stats
    reg = smf.ols('ret ~ 1', data=data).fit()
    uncorrected = Series({stat: round(float(getattr(reg, stat).iloc[0]), 6)
                          for stat in ['params', 'bse', 'tvalues', 'pvalues']},
                          name='uncorrected') # coef, stderr, t-value, P>/z

    # Newey-West correct t-stats
    reg = smf.ols('ret ~ 1', data=data) \
        .fit(cov_type='HAC', cov_kwds={'maxlags': 6})
    corrected = Series({stat: round(float(getattr(reg, stat).iloc[0]), 6)
                          for stat in ['params', 'bse', 'tvalues', 'pvalues']},
                          name='NeweyWest') # coef, stderr, t-value, P>/z

    # merge into intermediate dataframe with multicolumn index
    df = pd.concat([uncorrected, corrected], axis=1)
    df.columns = pd.MultiIndex.from_product([[label], df.columns])
    results.append(df)

pd.concat(results, axis=1).rename_axis('Standard Errors')
```

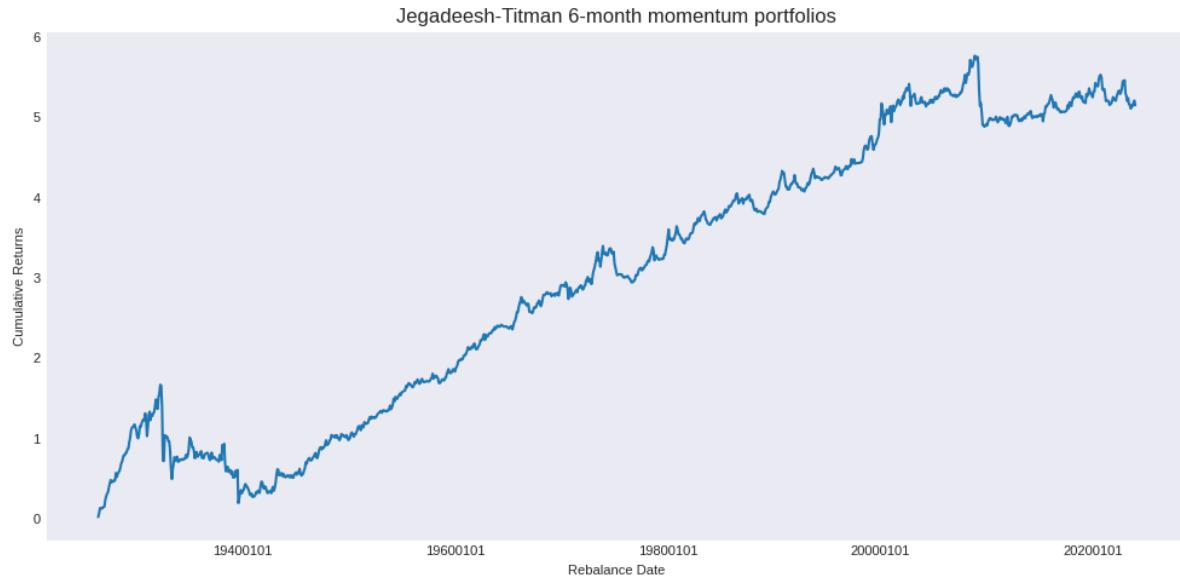
n = 1170 L = 6

	Overlapping		Non-overlapping	
	uncorrected	NeweyWest	uncorrected	NeweyWest
Standard Errors				
params	0.004303	0.004303	0.004399	0.004399
bse	0.000723	0.001298	0.001504	0.001474
tvalues	5.953723	3.314786	2.924986	2.984104
pvalues	0.000000	0.000917	0.003511	0.002844

Plot cumulative monthly average returns

Jegadeesh-Titman non-overlapping 6-month momentum portfolio returns

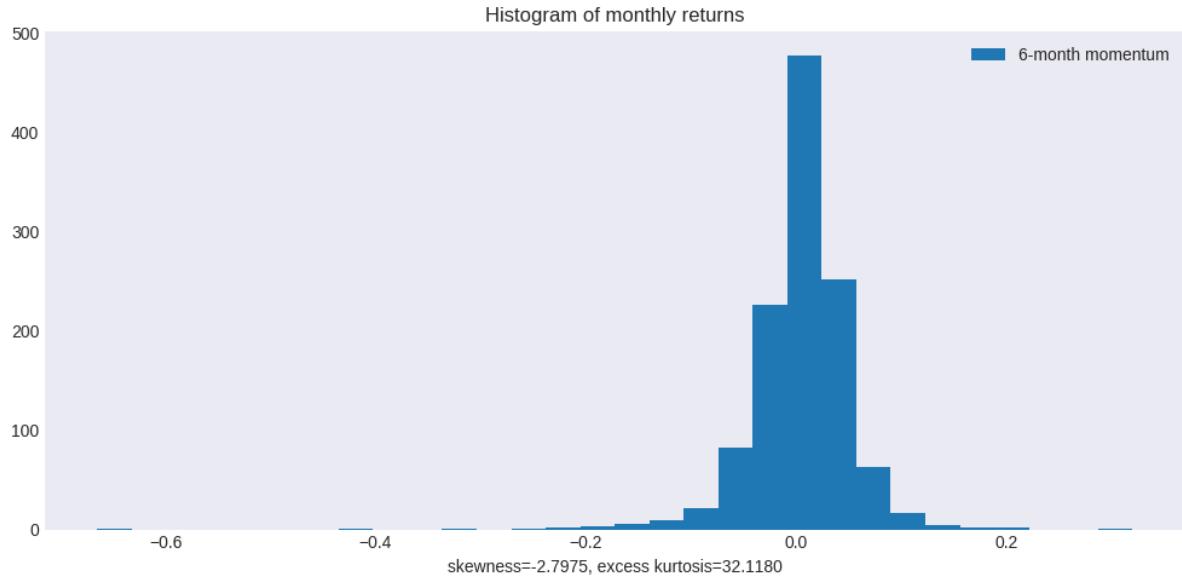
```
fig, ax = plt.subplots(figsize=(10, 5), clear=True)
plot_date(DataFrame(index=rebaldates, data=np.cumsum(jt), columns=['momentum']),
           ax=ax, fontsize=8, rotation=0,
           ylabel1='Cumulative Returns', xlabel='Rebalance Date',
           title='Jegadeesh-Titman 6-month momentum portfolios')
plt.tight_layout()
#plt.savefig(imgdir / 'jegadeesh_titman.jpg')
```



Plot histogram of monthly returns

- Jegadeesh-Titman non-overlapping 6-month momentum portfolio returns

```
fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 5))
ax.hist(jt, bins=30)
ax.set_title(f"Histogram of monthly returns")
ax.legend(['6-month momentum'])
kurt = kurtosis(jt, bias=True, fisher=True) # excess kurtosis
skewness = skew(jt, bias=True)
ax.set_xlabel(f"skewness={skewness:.4f}, excess kurtosis={kurt:.4f}")
plt.tight_layout()
#plt.savefig(imgdir / 'jegadeesh_titman_hist.jpg')
```



2.2.3 Power of Test

A *Type II* error occurs when the alternative is true (i.e., the null is wrong), but the null is not rejected. The probability of a Type II is denoted by β , while the *power* of a test $1 - \beta$, specifies the probability that a false null is rejected.

Unlike the size of the test, the power of a test cannot be set and depends on the sample size, the size of the test and the distance between the true and assumed value of the parameters under the null, e.g. $1 - \beta(\alpha) = \Phi(C_\alpha \frac{\sigma^2}{\sqrt{n}} | \mu_a, \frac{\sigma^2}{\sqrt{n}})$ for a one-sided test $H_a : \hat{\mu} > \mu_0$.

```
DataFrame(data={"True Null": ['correct', '(1 - alpha)', 'Type I Error', 'Size: (alpha)'],
               "False Null": ['Type II Error', '(beta)', 'correct', 'Power: (1-beta)']},
               index=['Accept Null', '', 'Reject Null', '']) \
    .rename_axis(index='Decision')
```

	True Null	False Null
Decision		
Accept Null	correct (1 - alpha)	Type II Error (beta)
Reject Null	Type I Error Size: (alpha)	correct Power: (1-beta)

Effect of Test Size (alpha) and True Alternative (mu) on Power

```
# Assumptions
alternative = 0.06    # alternative hypothesis that annualized mean is as large as 6%
scale = np.std(jt) / np.sqrt(len(jt))    # assumed scale (std dev or volatility)
```

```
# Vary test size (alpha) and true mean (mu)
mu = np.linspace(0, alternative/12, 100)    # vary true mean
plt.figure(figsize=(10, 5))
```

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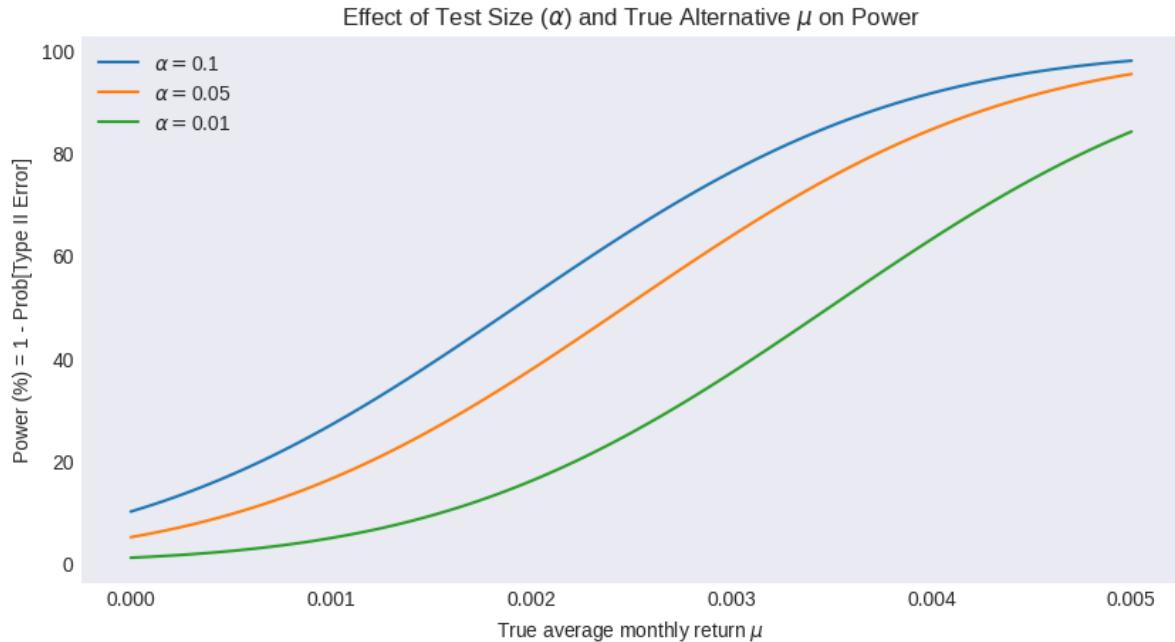
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```

for alpha in [0.1, 0.05, 0.01]:           # vary test size
    power = 1 - norm.cdf(norm.ppf(1 - alpha) * scale, loc=mu, scale=scale)
    plt.plot(mu, 100*power, label=f"$\alpha={alpha}$")
plt.title("Effect of Test Size ($\alpha$) and True Alternative $\mu$ on Power")
plt.ylabel('Power (%) = 1 - Prob[Type II Error]')
plt.xlabel('True average monthly return $\mu$')
plt.legend()

```

<matplotlib.legend.Legend at 0x7f1585217e10>



Effect of Sample Size on Power

```

# Assumptions
volatility = np.std(jt)
alternative = 0.06/12      # mean of the alternate hypothesis
alpha = 0.05                # desired size of the test

# Compare large and small sample sizes
for N in [len(jt) // 20, len(jt)]:

    # define null and alternate distributions given sample size
    scale = volatility/np.sqrt(N)    # scaled by square root of sample size
    null_dist = norm(0, scale)
    alt_dist = norm(alternative, scale)
    critical_val = null_dist.ppf(1-alpha)  # critical value to reject null

    fig, ax = plt.subplots(figsize=(10, 6))
    x = np.linspace(-7 * scale, 7 * scale, 1000)
    ax.plot(x, null_dist.pdf(x), color='blue')  # plot null distribution
    ax.plot(x, alt_dist.pdf(x), color='green')  # plot alt distribution
    ylim = plt.ylim()[0]

```

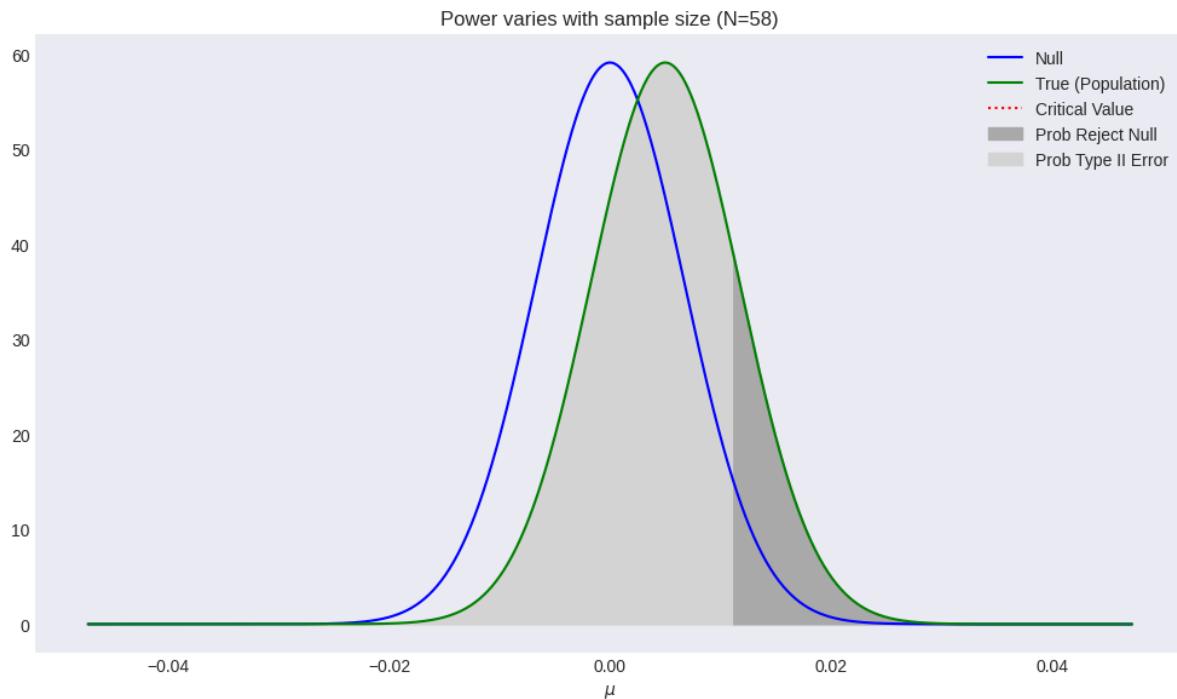
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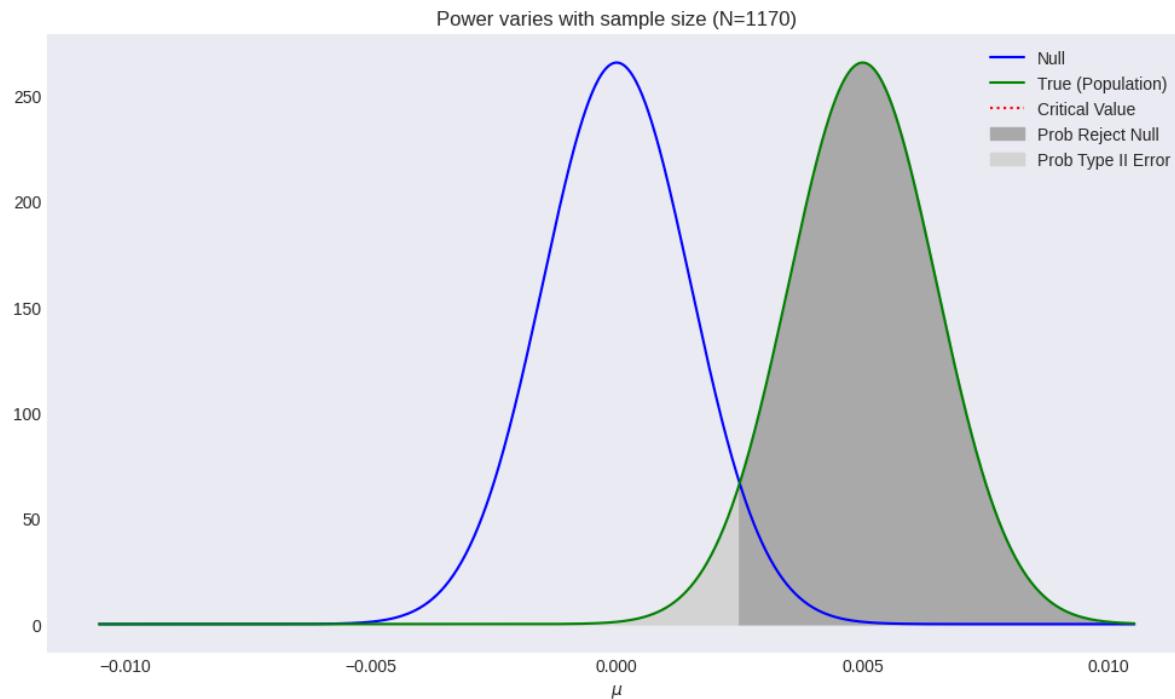
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```

ax.axvline(x=critical_val, ymax=ylim, ls=':', color='r') # critical value
px = x[x > critical_val]
ax.fill_between(px, alt_dist.pdf(px), color='darkgrey') # rejection region
px = x[x < critical_val]
ax.fill_between(px, alt_dist.pdf(px), color='lightgrey') # acceptance region
ax.set_title(f"Power varies with sample size (N={N})")
ax.set_xlabel("$\mu$")
plt.legend(['Null', 'True (Population)', 'Critical Value',
           'Prob Reject Null', 'Prob Type II Error'])
plt.tight_layout()

```





FAMA-FRENCH PORTFOLIO SORTS

The way to become rich is to put all your eggs in one basket and then watch that basket - Andrew Carnegie

Concepts:

- Fama-French research factors
- Bivariate portfolio sorts
- Linear Regression
- Structural Break

References:

- Eugene F. Fama and Kenneth R. French (1992), “The Cross-Section of Expected Stock Returns”, Journal of Finance, Volume 47, Issue 2, June 1992, pages 427-465
- Eugene Fama and Kenneth French (2023), “Production of U.S. Rm-Rf, SMB, and HML in the Fama-French Data Library”, Chicago Booth Paper No. 23-22
- FRM Exam I Book Quantitative Analysis Chapter 7-8

```
import numpy as np
import scipy
from scipy.stats import skew, kurtosis
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import statsmodels.formula.api as smf
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, CRSPBuffer, Signals, Benchmarks, PSTAT
from finds.utils import plot_date
from finds.backtesting import bivariate_sorts, BackTest
from finds.utils import plot_date, plot_scatter, plot_hist
from tqdm import tqdm
from secret import credentials, CRSP_DATE
```

```
VERBOSE = 0
# %matplotlib qt
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
```

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```
pstat = PSTAT(sql, bd, verbose=VERBOSE)
signals = Signals(user, verbose=VERBOSE)
bench = Benchmarks(sql, bd, verbose=VERBOSE)
backtest = BackTest(user, bench, rf='RF', max_date=CRSP_DATE, verbose=VERBOSE)
LAST_DATE = bd.endmo(CRSP_DATE, -1) # last monthly rebalance date
```

3.1 Stock fundamentals

3.1.1 Compustat

Compustat is a database of financial statements and other market information on active and inactive US and international companies, which is commonly used by academic and industry researchers.

Calculate book-to-price ratios from financial statements:

- load items from Compustat Annual
- Construct HML as shareholders equity plus investment tax credits, less preferred stock, divided by December market cap.
- Require 6 month reporting lag and at least two years history in Compustat
- Do not add Deferred Taxes and Investment Tax Credit to BE for fiscal years ending in 1993 or later (FASB 109, which was issued in 1993, improves the accounting for deferred income taxes)

```
label = 'hml'
lag = 6 # number of months to lag fundamental data
# retrieve data fields from compustat, linked by permno
df = pstat.get_linked(dataset = 'annual',
                      date_field = 'datadate',
                      fields = ['seq', 'pstk', 'pstkrv', 'pstkl', 'txditc'],
                      where = ("indfmt = 'INDL'" +
                               " AND datafmt = 'STD'" +
                               " AND curcd = 'USD'" +
                               " AND popsrc = 'D'" +
                               " AND consol = 'C'" +
                               " AND seq > 0"))
```

```
# subtract preferred stock
df[label] = np.where(df['pstkrv'].isna(), df['pstkl'], df['pstkrv'])
df[label] = np.where(df[label].isna(), df['pstk'], df[label])
df[label] = np.where(df[label].isna(), 0, df[label])
```

```
# do not add back deferred investment tax credit for fiscal years in 1993 or later
df[label] = (df['seq'] - df[label]
             + df['txditc'].fillna(0).where(df['datadate'] // 10000 <= 1993, 0))
df.dropna(subset = [label], inplace=True)
df = df[df[label] > 0][['permno', 'gvkey', 'datadate', label]]
```

```
# count years in Compustat
df = df.sort_values(by=['gvkey', 'datadate'])
df['count'] = df.groupby(['gvkey']).cumcount()
```

```

# construct b/m ratio
df['rebaldate'] = 0
for datadate in tqdm(sorted(df['datadate'].unique())):
    f = df['datadate'].eq(datadate)
    rebaldate = bd.endmo(datadate, abs(lag)) # 6 month lag
    capdate = bd.endyr(datadate) # Dec mktcap
    if rebaldate >= CRSP_DATE or capdate >= CRSP_DATE:
        continue
    df.loc[f, 'rebaldate'] = rebaldate
    df.loc[f, 'cap'] = crsp.get_cap(capdate, use_permco=True) \
        .reindex(df.loc[f, 'permno']) \
        .values
df[label] /= df['cap']
df = df[df[label].gt(0) & df['count'].gt(1)] # 2+ years in Compustat
signals.write(df, label)

```

100% |██████████| 747/747 [00:02<00:00, 290.07it/s]

223346

3.2 Bivariate sorts

Independent bivariate sorts create portfolios sorted by the two variables: book-to-price ratio and market capitalization size. The portfolios, which are constructed at the end of each June, are the intersections of 2 portfolios formed on size (market equity, ME) and 3 portfolios formed on the ratio of book equity to market equity (BE/ME). The size breakpoint for year t is the median NYSE market equity at the end of June of year t . Stocks are market cap-weighted within each of the 6 portfolios.

HML (High Minus Low) is the equal-weighted average return on the two value portfolios minus the average return on the two growth portfolios. SMB (Small Minus Big) is the equal-weighted average return on the three small portfolios minus the average return on the three big portfolios.

Casual Analysis

This sorting procedure can be motivated by the field of casual analysis, where a submodel of propensity scores is often used to reduce the influence of confounding variables by creating groups with similar probabilities of receiving a treatment. Propensity scores are typically calculated using statistical methods such as logistic regression to predict the probability of receiving the treatment. Once propensity scores are obtained, researchers can use them in different ways:

- Stratification: Grouping subjects into strata based on propensity scores and analyzing each stratum separately.
- Matching: Pairing treated and control subjects with similar propensity scores.
- Regression Adjustment: Including the propensity score as a covariate in regression models to adjust for imbalances in baseline characteristics.

Note that the values of company size variable directly enters into the calculation of book-to-market ratio (as its denominator). Just as propensity score analysis helps to mitigate the effects of confounding variables and improve the validity of causal inference in observational studies, the matching provided by bivariate sorting can more accurately estimate the returns to the Value outcome while controlling for any Small Firm effect.

3.2.1 HML

Compute High Minus Low book-to-price monthly returns and compare to Fama-French research factor

```
label, benchname = 'hml', 'HML (mo)'
rebalend = LAST_DATE
rebalbeg = 19700101
```

```
# preload monthly dataset into memory
monthly = CRSPBuffer(stocks=crsp, dataset='monthly',
                      fields=['ret', 'retx', 'prc'],
                      beg=19251201, end=CRSP_DATE)
```

```
hml, smb = bivariate_sorts(stocks=monthly,
                           label=label,
                           signals=signals,
                           rebalbeg=rebalbeg,
                           rebalend=rebalend,
                           window=12,
                           months=[6])
```

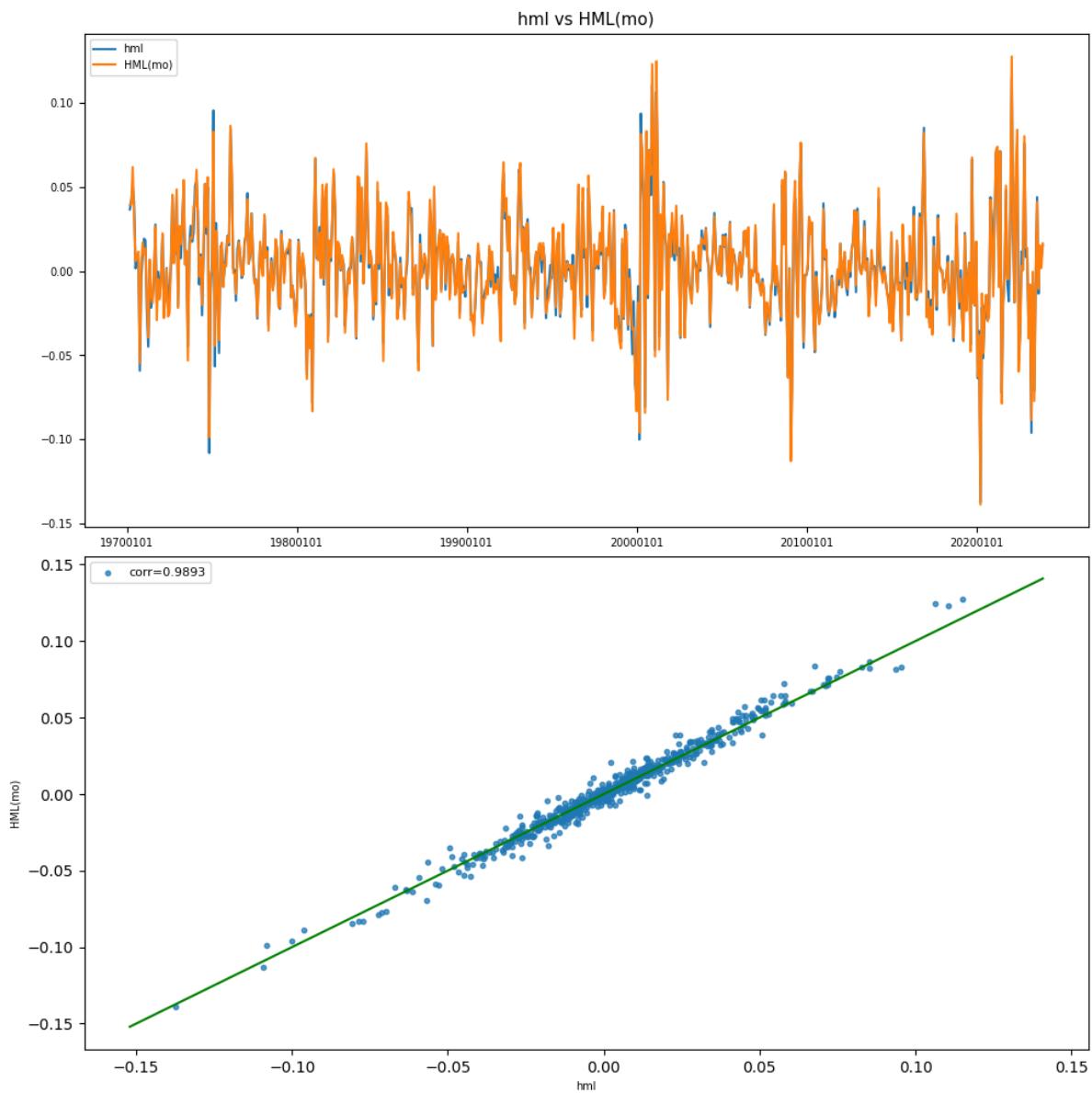
Helpers to show histograms and comparisons of portfolio returns

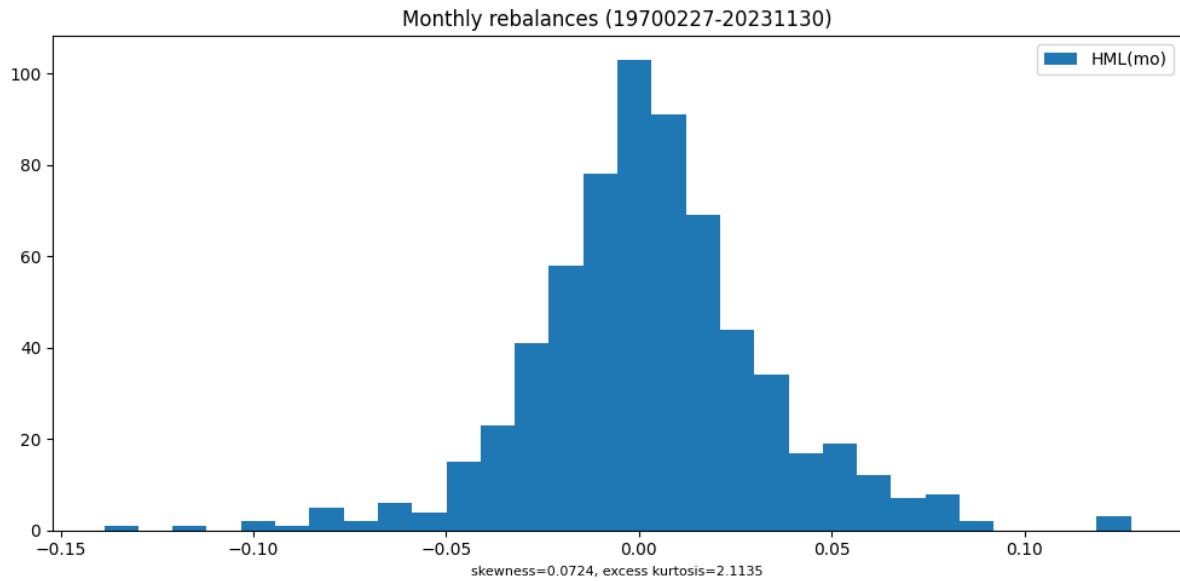
```
def plot_ff(y, label):
    """helper to scatter plot and compare portfolio returns"""
    y = y.rename(columns={'excess': label})
    corr = np.corrcoef(y, rowvar=False)[0, 1]
    fig, (ax1, ax2) = plt.subplots(2, 1, clear=True, figsize=(10, 10))
    plot_date(y, ax=ax1, title=f" vs ".join(y.columns), fontsize=7)
    plot_scatter(y.iloc[:, 0], y.iloc[:, 1], ax=ax2, abline=False, fontsize=7)
    plt.legend([f"corr={corr:.4f}"], fontsize=8)
    plt.tight_layout(pad=0.5)
    print(f"<R-squared of {label} vs {benchname}"
          f" ({y.index[0]} - {y.index[-1]}): {corr*corr:.4f}")
```

```
def plot_summary(y, label):
    """helper to plot histogram and statistics of portfolio returns"""
    y = y[label]
    kurt = kurtosis(y, bias=True, fisher=True) # excess kurtosis
    skewness = skew(y, bias=True)
    fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 5))
    ax.hist(y, bins=30)
    ax.set_title(f"Monthly rebalances ({y.index[0]}-{y.index[-1]})")
    ax.set_xlabel(f"skewness={skewness:.4f}, excess kurtosis={kurt:.4f}",
                  fontsize=8)
    plt.legend([label])
    plt.tight_layout()
```

```
# Plot histogram and comparison of HML returns
holdings = hml
result = backtest(monthly, holdings, label)
y = backtest.fit([benchname], rebalbeg, LAST_DATE)
plot_ff(y, label)
plot_summary(y, benchname)
```

<R-squared of hml vs HML (mo) (19700227 - 20231130): 0.9786



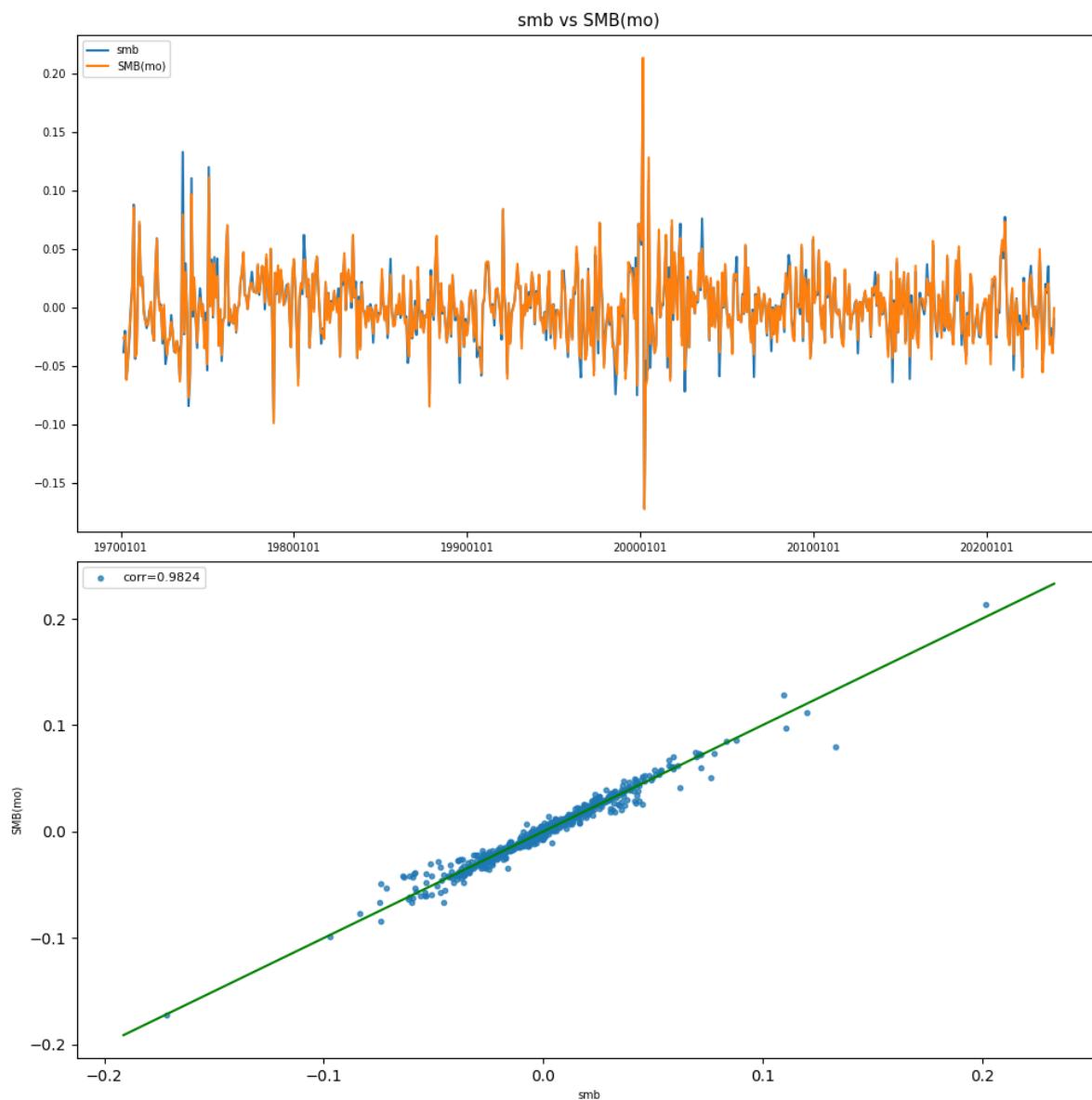


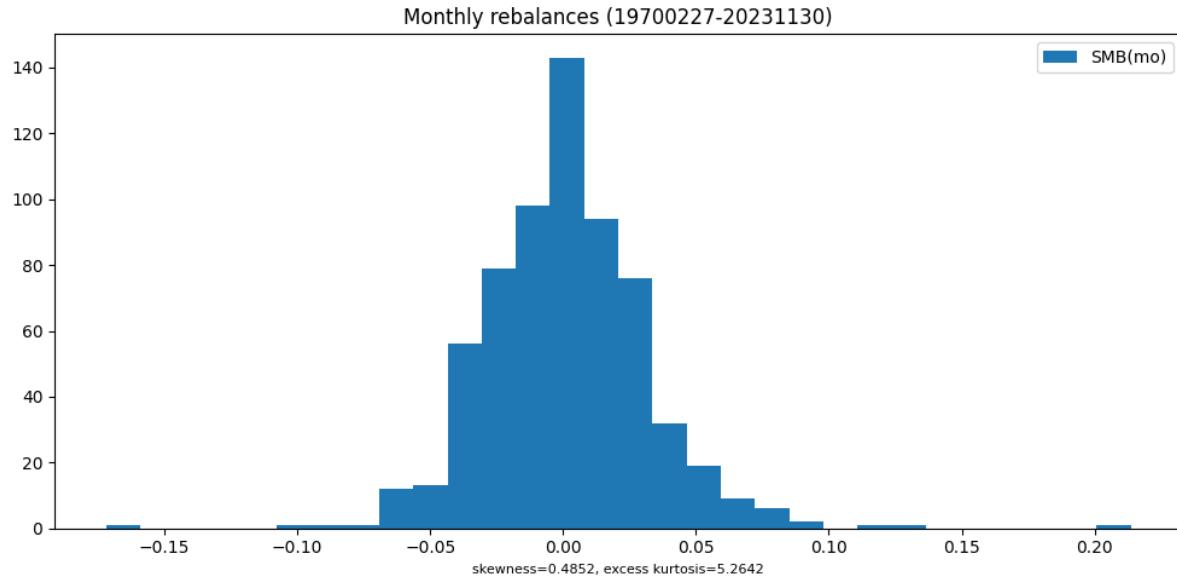
3.2.2 SMB

Compare Small-Minus-Big monthly returns and compare to Fama-French research factor

```
# Plot histogram and comparison of SMB returns
label, benchname = 'smb', 'SMB (mo)'
holdings = smb
result = backtest(monthly, holdings, label)
y = backtest.fit([benchname], rebalbeg, LAST_DATE)
plot_ff(y, label)
plot_summary(y, benchname)
```

<R-squared of smb vs SMB (mo) (19700227 - 20231130): 0.9652





3.3 Linear regression

Simple Linear Regression

The simple linear regression (SLR) model relates a continuous response (or dependent) variable y_i with one predictor (or explanatory or independent) variable x_i and an error term ϵ_i :

$$y_i = f(x_i) + \epsilon_i = a + bx_i + \epsilon_i$$

Coefficient estimates of the slope b and intercept a are chosen to minimize the residual sum of squares:

$$\hat{b} = \frac{\sum_{i=1}^n (x_i - \bar{x})(y_i - \hat{y})}{\sum_{i=1}^n (x_i - \bar{x})^2}$$

$$\hat{a} = \bar{y} - \hat{b}\bar{x}$$

- Residuals are the difference between the observed response values and the response values predicted by the model, $e_i = y_i - \hat{y}_i$.
- Residual sum of squares (RSS) over all observations is $RSS = e_1^2 + e_2^2 + \dots + e_n^2$ or equivalently $RSS = \sum_{i=1}^n (y_i - \hat{y}_i)^2$.
- Mean square error (MSE) is an estimate of the variance of the residuals $s^2 = \hat{\sigma}^2 = \frac{1}{n-2} \sum_{i=1}^n (y_i - \hat{y}_i)^2$.
- Residual standard error (RSE) or residual standard deviation is the estimate of the (square root of the) variance of the residuals. Standard error tells us the average amount that the estimate differs from the actual value. The residual standard error is the estimate of the (square root of the) variance of the residuals $\hat{s} \equiv RSE = \sqrt{RSS/(n-2)}$.

The estimators of the coefficients are normally distributed in large samples. Therefore, tests of a hypothesis about a regression parameter are implemented using a t-test. The standard errors associated with linear regression coefficient and mean response estimates are:

- Slope: $se(\hat{b}) = \sqrt{\frac{s^2}{\sum_{i=1}^n (x_i - \bar{x})^2}}$

- Intercept: $se(\hat{a}) = \sqrt{s^2 \left[\frac{1}{n} + \frac{\bar{x}^2}{\sum_{i=1}^n (x_i - \bar{x})^2} \right]}$
- Mean response: $se(\hat{y}) = \sqrt{s^2 \left[\frac{1}{n} + \frac{(x - \bar{x})^2}{\sum_{i=1}^n (x_i - \bar{x})^2} \right]}$
- Confidence intervals can be computed from standard errors. A 95% confidence interval is defined as a range of values such that with 95% probability, the range will contain the true unknown value of the parameter. The confidence interval for coefficient estimates is $b_j \pm t_{n-(k+1), 1-\frac{\alpha}{2}} se(b_j)$, where k , the number of regressors, equals 1 for SLR.
- Prediction interval for a new response is $se(\hat{y}_{n+1}) = \sqrt{s^2 \left(1 + \frac{1}{n} + \frac{(x - \bar{x})^2}{\sum_{i=1}^n (x_i - \bar{x})^2} \right)}$

Multiple Linear Regression

With multiple regressors, the linear model $y = b_0 + b_1 x_1 + \dots + b_k x_k + \epsilon$ has coefficient estimates: $\hat{b} = (X^T X)^{-1} X^T y$

The coefficient b_j quantifies the association between the j 'th predictor and the response. It is the average effect on Y of a one unit increase in X_j , holding all other predictors fixed.

- Sum of squares total (SST) measures the total variance in the response Y, and can be thought of as the amount of variability inherent in the response before the regression is performed. $SST = \sum_{i=1}^n (y_i - \bar{y})^2$ measures the total variance in the response Y.
- Sum of squares regression (SSR) measures the total amount variance captured by the regression model: $SSR = \sum_{i=1}^n (\hat{y}_i - \bar{y})^2$
- Sum of squares error (SSE) measures the total variance of the response not explained by the regression model. In the linear regression context, we may interpret total deviation to equal the deviation not explained by the explanatory variables plus deviation explained by the explanatory variables: $(y_i - \bar{y}) = (y_i - \hat{y}_i) + (\hat{y}_i - \bar{y}_i)$. Squaring each side and summing over all observations yields for the total sum of squared deviations $SST = \sum_{i=1}^n (y_i - \hat{y}_i)^2 + \sum_{i=1}^n (\hat{y}_i - \bar{y}_i)^2 = SSE + SSR$, where the sum of the cross-product terms turns out to be zero.
- R^2 statistic or coefficient of determination measures the proportion of variability in Y that can be explained using X. It is also identical to the squared correlation between X and Y. An R^2 statistic that is close to 1 indicates that a large proportion of the variability in the response has been explained by the regression. A number near 0 indicates that the regression did not explain much of the variability in the response. The R^2 statistic provides a relative measure of the quality of a linear regression fit $R^2 = 1 - \frac{RSS}{SST}$, and always takes on a value between 0 and 1, and is independent of the scale. R^2 is identical to the squared correlation between X and Y .
- Adjusted R^2 : The usual R^2 always increases (since residual sum of squares RSS always decreases) as more variables are added. The intuition behind the adjusted R^2 is that once all of the correct variables have been included in the model, adding noise variables will lead to a decrease in the statistic. In theory, the model with the largest adjusted R^2 will have only correct variables and no noise variables.
- Partial correlation coefficients, which measure the correlation between y and the j 'th explanatory variable x_j controlling for other explanatory variables, can also be obtained by running only one regression: $r(y, x_j | x_1, x_2, \dots, x_{j-1}, x_{j+1}, \dots, x_k) = \frac{t(b_j)}{\sqrt{t(b_j)^2 + n - (k+1)}}$ where $t(b_j)$ is the t-ratio for b_j from a regression of y on x_1, \dots, x_k (including the variable x_j).
- t-statistic or t-ratio: $t(b_j) = \frac{b_j}{se(b_j)}$ can be interpreted to be the number of standard errors that b_j is away from zero. In a t-test, the null hypothesis ($H_0 : \beta_j = 0$) is rejected in favor of the alternative if the absolute value of the t-ratio $|t(b_j)|$ exceeds a t-value, denoted $t_{n-(k+1), 1-\frac{\alpha}{2}}$, equal to the $(1 - \frac{\alpha}{2})$ 'th percentile from the t-distribution using $df = n - (k + 1)$ degrees of freedom.

The t-test is not directly applicable when testing hypotheses that involve more than one parameter, because the parameter estimators can be correlated. Instead, a common alternative called the F-test compares the fit of the model (measured using the RSS) when the null hypothesis is true relative to the fit of the model without the restriction on the parameters assumed by the null. To test whether all regression slope coefficients are zero $H_0 : b_1 = \dots = b_p = 0$, versus the alternative $H_a : \text{at least one } b_j \text{ is non-zero}$, compute the statistic, which has a $F(p, n - p - 1)$ distribution:

$$F = \frac{(TSS - RSS)/p}{RSS/(n - p - 1)}$$

Partial F-test: Sometimes, we want to test that a particular subset of q of the coefficients are zero. In this case we fit a second model that uses all the variables except those last q , then compute residual sum of squares for that model and the appropriate F-statistic, which has a $F(p - q, n - p - 1)$ distribution:

$$F = \frac{(RSS_q - RSS)/(p - q)}{RSS/(n - p - 1)}$$

3.3.1 Value effect

The value effect refers to the tendency of stocks with low price-to-book ratios (value stocks) to outperform stocks with high price-to-book ratios (growth stocks) over the long term. The value investing approach, often associated with Benjamin Graham and David Dodd, emphasizes investing in stocks that are undervalued based on their intrinsic value, which is determined through fundamental analysis of a company's financials and business prospects.

```
# Linear regression on Mkt-Rf and intercept
x = ["HML(mo)", "Mkt-RF(mo)"]
formula = f'Q("{x[0]}") ~ ' + " + ".join(f'Q("{v}")' for v in x[1:])
data = bench.get_series(x, field='ret', beg=19620701, end=20991231)
lm = smf.ols(formula, data=data).fit(cov_type='HAC', cov_kwds={'maxlags': 6})
print(f"Period: {data.index[0]}-{data.index[-1]}")
print(lm.summary())
```

```
Period: 19620731-20240430
OLS Regression Results
=====
Dep. Variable: Q("HML(mo)") R-squared: 0.041
Model: OLS Adj. R-squared: 0.040
Method: Least Squares F-statistic: 8.703
Date: Sat, 29 Jun 2024 Prob (F-statistic): 0.00328
Time: 09:53:49 Log-Likelihood: 1570.5
No. Observations: 742 AIC: -3137.
Df Residuals: 740 BIC: -3128.
Df Model: 1
Covariance Type: HAC
=====
            coef    std err      z   P>|z|    [0.025    0.975]
Intercept  0.0038    0.001    2.657    0.008    0.001    0.007
Q("Mkt-RF (mo)") -0.1349    0.046   -2.950    0.003   -0.224   -0.045
=====
Omnibus: 54.388 Durbin-Watson: 1.662
Prob(Omnibus): 0.000 Jarque-Bera (JB): 246.485
Skew: -0.044 Prob(JB): 2.99e-54
Kurtosis: 5.822 Cond. No. 22.3
=====
```

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Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using ~ 6 lags and without small sample correction

3.3.2 Small firm effect

The small firm effect, also known as the size effect, was documented by Rolf Banz in 1981, showing that small-cap stocks tend to have higher risk-adjusted returns than large-cap stocks.

```
# Linear regression on Mkt-Rf, HML and intercept
x = ["SMB(mo)", "HML(mo)", "Mkt-RF(mo)"]
formula = f'Q("{x[0]}") ~ ' + " + ".join(f'Q("{v}")' for v in x[1:])
data = bench.get_series(x, field='ret', beg=19620701, end=20991231)
lm = smf.ols(formula, data=data).fit(cov_type='HAC', cov_kwds={'maxlags': 6})
print(f"Period: {data.index[0]}-{data.index[-1]}")
print(lm.summary())
```

```
Period: 19620731-20240430
OLS Regression Results
=====
Dep. Variable: Q("SMB(mo)") R-squared: 0.099
Model: OLS Adj. R-squared: 0.096
Method: Least Squares F-statistic: 28.04
Date: Sat, 29 Jun 2024 Prob (F-statistic): 1.83e-12
Time: 09:53:49 Log-Likelihood: 1578.2
No. Observations: 742 AIC: -3150.
Df Residuals: 739 BIC: -3137.
Df Model: 2
Covariance Type: HAC
=====
            coef    std err          z      P>|z|      [0.025      0.975]
-----
Intercept  0.0008    0.001      0.654      0.513     -0.002     0.003
Q("HML(mo)") -0.1046    0.088     -1.188      0.235     -0.277     0.068
Q("Mkt-RF(mo)")  0.1874    0.029      6.533      0.000      0.131     0.244
=====
Omnibus: 104.065 Durbin-Watson: 2.036
Prob(Omnibus): 0.000 Jarque-Bera (JB): 717.914
Skew: 0.395 Prob(JB): 1.28e-156
Kurtosis: 7.754 Cond. No. 34.8
=====
```

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using ~ 6 lags and without small sample correction

3.4 Structural break

The Chow F-test is normally used in the analysis of time series to test the presence of a structural change. We fit separate models before and after a posited breakpoint – in this case that the mean returns to HML are different before and after its 1993 publication. The null hypothesis of the Chow test is that estimated coefficients of the two submodels are equal, which would be equal a single restricted model estimated from the full data sample.

$\text{chow} = \frac{(RSS - (RSS_1 + RSS_2))/K}{(RSS_1 + RSS_2)/(N - 2K)}$ follows a $F(K, N - 2K)$ distribution

```
# Run restricted and unregression models
formula = f'Q("HML(mo)") ~ '
bp = 19931231 # breakpoint date
lm1 = smf.ols(formula, data=data[data.index<=bp]).fit()
print(f'\nSub Model 1 ({data.index[0]}-{bp}):')
print(lm1.summary())
lm2 = smf.ols(formula, data=data[data.index>bp]).fit()
print(f'\nSub Model 2 ({bp}-{data.index[-1]}):')
print(lm2.summary())
lm0 = smf.ols(formula, data=data).fit()
print('\nRestricted Model (coefficient is equal):')
print(lm0.summary())
```

```
Sub Model 1 (19620731-19931231):
    OLS Regression Results
=====
Dep. Variable: Q("SMB(mo)") R-squared: 0.133
Model: OLS Adj. R-squared: 0.128
Method: Least Squares F-statistic: 28.70
Date: Sat, 29 Jun 2024 Prob (F-statistic): 2.52e-12
Time: 09:53:49 Log-Likelihood: 835.73
No. Observations: 378 AIC: -1665.
Df Residuals: 375 BIC: -1654.
Df Model: 2
Covariance Type: nonrobust
=====
      coef  std err      t  P>|t|  [0.025  0.975]
-----
Intercept  0.0013  0.001  0.946  0.345  -0.001  0.004
Q("HML(mo)")  0.0344  0.057  0.602  0.548  -0.078  0.147
Q("Mkt-RF(mo)")  0.2388  0.033  7.279  0.000  0.174  0.303
=====
Omnibus: 7.675 Durbin-Watson: 1.894
Prob(Omnibus): 0.022 Jarque-Bera (JB): 10.554
Skew: 0.151 Prob(JB): 0.00511
Kurtosis: 3.761 Cond. No. 43.0
=====
```

Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.

```
Sub Model 2 (19931231-20240430):
    OLS Regression Results
=====
Dep. Variable: Q("SMB(mo)") R-squared: 0.092
```

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```

Model:                               OLS      Adj. R-squared:          0.087
Method:                             Least Squares   F-statistic:            18.33
Date:      Sat, 29 Jun 2024   Prob (F-statistic):      2.62e-08
Time:      09:53:49          Log-Likelihood:          751.71
No. Observations:                  364      AIC:                  -1497.
Df Residuals:                      361      BIC:                  -1486.
Df Model:                           2
Covariance Type:                 nonrobust
=====
          coef    std err      t      P>|t|      [0.025      0.975]
=====
Intercept      -0.0005      0.002     -0.291      0.771      -0.004      0.003
Q("HML(mo)")   -0.1774      0.048     -3.665      0.000      -0.273      -0.082
Q("Mkt-RF(mo)") 0.1610      0.036      4.482      0.000       0.090      0.232
=====
Omnibus:                  67.123   Durbin-Watson:          2.149
Prob(Omnibus):            0.000   Jarque-Bera (JB):      539.650
Skew:                      0.479   Prob(JB):            6.55e-118
Kurtosis:                  8.888   Cond. No.             30.1
=====

Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly
    specified.

```

Restricted Model (coefficient is equal):

```

          OLS Regression Results
=====
Dep. Variable:      Q("SMB(mo)")   R-squared:          0.099
Model:                           OLS      Adj. R-squared:          0.096
Method:                             Least Squares   F-statistic:          40.48
Date:      Sat, 29 Jun 2024   Prob (F-statistic):      2.07e-17
Time:      09:53:49          Log-Likelihood:          1578.2
No. Observations:                 742      AIC:                  -3150.
Df Residuals:                      739      BIC:                  -3137.
Df Model:                           2
Covariance Type:                 nonrobust
=====
          coef    std err      t      P>|t|      [0.025      0.975]
=====
Intercept      0.0008      0.001      0.709      0.479      -0.001      0.003
Q("HML(mo)")   -0.1046      0.036     -2.873      0.004      -0.176      -0.033
Q("Mkt-RF(mo)") 0.1874      0.024      7.764      0.000       0.140      0.235
=====
Omnibus:                  104.065   Durbin-Watson:          2.036
Prob(Omnibus):            0.000   Jarque-Bera (JB):      717.914
Skew:                      0.395   Prob(JB):            1.28e-156
Kurtosis:                  7.754   Cond. No.             34.8
=====

Notes:
[1] Standard Errors assume that the covariance matrix of the errors is correctly
    specified.

```

Test statistic with K parameters and N observations follows a $F(K, N - 2K)$ -distribution

```
# Compute test statistic
K = len(lm0.params)
N = len(data)
RSS = lm0.resid.dot(lm0.resid)
RSS1 = lm1.resid.dot(lm1.resid)
RSS2 = lm2.resid.dot(lm2.resid)
chow = ((RSS - (RSS1 + RSS2)) / K) / ((RSS1 + RSS2) / (N - 2*K))
chow, N, K
```

```
(3.5195180596913436, 742, 3)
```

p-value of Chow test statistic

```
1 - scipy.stats.f.cdf(chow, dfn=K, dfd=N - 2*K)
```

```
0.014824495307899976
```

5% critical value to reject null

```
scipy.stats.f.ppf(q=1 - 0.05, dfn=K, dfd=N - 2*K)
```

```
2.617002908894789
```

FAMA-MACBETH CROSS-SECTIONAL REGRESSIONS

If you don't risk anything, you risk even more – Erica Jong

Concepts

- Portfolio Optimization, CAPM, Black-Litterman
- Tests of the CAPM, cross-sectional regression
- Polynomial regression, feature transformations, kernel trick
- Kernel regression

References

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```
import numpy as np
from numpy import linalg as la
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import statsmodels.formula.api as smf
from sklearn.kernel_ridge import KernelRidge
import random
from tqdm import tqdm
import cvxpy as cp
from finds.database import SQL, RedisDB
from finds.structured import (BusDay, Signals, Benchmarks, CRSP,
                               CRSPBuffer, SignalsFrame)
from finds.backtesting import RiskPremium
from finds.recipes import winsorize, least_squares
```

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```
from finds.readers import FFReader
from secret import credentials, paths, CRSP_DATE
VERBOSE = 0
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
signals = Signals(user, verbose=VERBOSE)
bench = Benchmarks(sql, bd, verbose=VERBOSE)
imgdir = paths['images']
LAST_DATE = bd.endmo(CRSP_DATE, -1)
```

```
import warnings
warnings.simplefilter(action='ignore', category=FutureWarning)
```

4.1 Mean variance optimization

Given two investments with the same expected return (as measured by the mean of the returns), Markowitz demonstrated that a risk-averse investor will select the one with the lowest risk (as measured by the variance). Markowitz's theory relies on several assumption including the absence of market frictions (such as no taxes or transaction costs, perfect market competition), as well as normally distributed returns.

The assumption of normally distributed returns implies that a “rational investor” should evaluate potential portfolio allocations based entirely upon the associated means and variances of the return distributions. With all else being equal, investors prefer a higher mean return and a lower variance, and seek to reduce the variance of their portfolio returns by diversifying their investments with assets that whose prices do not move in lockstep with one another.

A major implementation issue with this framework comes when estimating the parameters required to apply the model (i.e., the mean and the variance of returns, along with correlations between each asset in the portfolio). These parameters are typically estimated using historical data over a certain period of time, but the resulting allocation can differ greatly depending on which historical or forecast data are used. There are several methodologies that have been used to deal with the problem of the uncertainty about these parameters, such as robust portfolio optimization and the Black-Litterman model.

```
# Retrieve test asset returns and risk-free rate
symbol = '6_Portfolios_2x3'
ff = FFReader(symbol)
rf = FFReader('F-F_Research_Data_Factors')[0]['RF'] / 100 # risk-free rates
mktcaps = ff[4] * ff[5] # number of firms x average market cap
labels = [s.replace('ME1', 'BIG').replace('ME2', 'SMALL') for s in mktcaps.columns]
n = len(labels)

r = (ff[0]/100).sub(rf.fillna(0), axis=0) # excess, of the risk-free, returns
sigma = np.cov(r, rowvar=False)
mu = np.mean(r, axis=0).values
assets = DataFrame(data={'mean': mu, 'volatility': np.sqrt(np.diag(sigma))}, index=labels)
```

```

mkt = {'weights': (mktcaps.iloc[-1]/mktcaps.iloc[-1].sum()).values} # latest caps
mkt['mean'] = mkt['weights'].dot(mu)
mkt['variance'] = mkt['weights'].dot(sigma).dot(mkt['weights'])
pd.concat([assets.T, Series({'mean': mkt['mean'], 'volatility': np.sqrt(mkt['variance']\n    →')}),\n           name='Mkt')], axis=1)

```

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	SMALL BM2	BIG HiBM	\
mean	0.007035	0.009628	0.011497	0.006759	0.006898	0.009195	
volatility	0.074820	0.069733	0.081141	0.053040	0.056313	0.071363	
	Mkt						
mean	0.007051						
volatility	0.053834						

4.1.1 Global minimum variance portfolio

Given estimates of assets' variances and their correlations with each other, the Global Minimum Variance (GMV) portfolio identifies the allocation that achieves the lowest risk (and ignores mean returns). It is a convex (quadratic) optimization problem, with constraint that the portfolio weights must sum to 1. The Python package conveniently solves such problems numerically: $\min_w w^T \Sigma w$, such that $w^T 1 = 1$.

```

W = cp.Variable(n)      # variable to optimize over - portfolio weights
Var = cp.quad_form(W, sigma)      # objective to minimize portfolio volatility
Ret = mu.T @ W           # objective to maximize portfolio return

obj = cp.Problem(cp.Minimize(Var), [cp.sum(W) == 1])
obj.solve()
gmv = dict(weights=W.value, variance=Var.value, mean=Ret.value,
            coords=(np.sqrt(Var.value), Ret.value))

```

The GMV portfolio weights can also be derived in closed form solution by differentiating the (convex) objective function and setting the FOC to zero: $GMV = \frac{\Sigma^{-1}1}{1^T \Sigma^{-1}1}$

```

def gmv_portfolio(sigma, mu=None):
    """Returns position weights of global minimum variance portfolio"""
    ones = np.ones((sigma.shape[0], 1))
    w = la.inv(sigma).dot(ones) / ones.T.dot(la.inv(sigma)).dot(ones)
    return {'weights': w, 'volatility': np.sqrt(w.T.dot(sigma).dot(w)),
            'mean': None if mu is None else w.T.dot(mu)}

```

```

w = gmv_portfolio(mu=mu, sigma=sigma) ['weights']
pd.concat([Series(gmv['weights']).rename('numerical'),
           Series(w.flatten()).rename('formula')], axis=1)\n           .set_index(assets.index).T

```

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	SMALL BM2	BIG HiBM
numerical	-0.487434	0.674154	-0.332693	0.789665	0.830716	-0.474408
formula	-0.487434	0.674154	-0.332693	0.789665	0.830716	-0.474408

4.1.2 Efficient frontier

Each point on the efficient frontier curve represents the portfolio of risky assets that is expected to offer the highest return for the given level of risk as measured by the standard deviation of returns σ . A line is drawn from the risk-free rate becomes tangent to the efficient frontier at the point called the **tangency portfolio**. Portfolios that lie on this line, called the **capital market line**, given by $E(R_p) = r_f + \frac{E[R_M] - r_f}{\sigma_M} \sigma_p$, dominate all portfolios on the efficient frontier. In other words, a tangency portfolio is a portfolio that lies at the point where the efficient frontier is tangent to the highest possible capital market line (CML) in the risk-return space. The implication of the Capital Market Line is that all investors should allocate to the risk-free asset and the tangency market portfolio. This is called the **two fund separation theorem**.

```
var_ticks = np.linspace(gmv['variance'], 3*np.max(np.diag(sigma)), 200)
best_slope, tangency = 0, tuple()      # to find the tangency portfolio
efficient = []
for var in var_ticks:
    obj = cp.Problem(cp.Maximize(Ret), [cp.sum(W) == 1, Var <= var])
    obj.solve(verbos=False)

    # tangency portfolio has best slope
    risk = np.sqrt(var)
    slope = Ret.value / risk
    if slope > best_slope:
        best_slope = slope
        tangency = {'coords': (risk, Ret.value), 'weights': W.value}
efficient.append(dict(mean=Ret.value, volatility=risk))
```

```
frontier = []      # inefficient frontier
for var in var_ticks:
    obj = cp.Problem(cp.Minimize(Ret), [cp.sum(W) == 1, Var <= var])
    obj.solve(verbos=False)
    frontier.append(dict(mean=Ret.value, volatility=np.sqrt(var)))
```

The efficient and tangency portfolios can also be solved with closed form solutions.

- Efficient portfolio (target return μ_0) = $\Sigma^{-1} M (M^T \Sigma^{-1} M)^{-1} [\mu_0 \ 1]^T$, where $M = [\mu \ 1]$
- Tangency portfolio = $\frac{\Sigma^{-1} \mu}{1^T \Sigma^{-1} \mu}$

Furthermore, any portfolio on the efficient frontier is a linear combination of any two other efficient portfolios.

```
def efficient_portfolio(mu, sigma, target):
    """Returns weights of minimum variance portfolio that exceeds target return"""
    mu = mu.flatten()
    n = len(mu)
    ones = np.ones((n, 1))
    M = np.hstack([mu.reshape(-1, 1), ones])
    B = M.T.dot(la.inv(sigma)).dot(M)
    w = la.inv(sigma).dot(M).dot(la.inv(B)).dot(np.array([[target], [1]]))
    return {'weights': w, 'volatility': np.sqrt(float(w.T.dot(sigma).dot(w))), 'mean': float(w.T.dot(mu))}
```

```
p = random.choice(efficient)
e = efficient_portfolio(mu, sigma, p['mean'])
df = DataFrame({'random efficient portfolio': p,
                'by formula': dict(mean=e['mean'], volatility=e['volatility'])})
```

```
/tmp/ipykernel_3511161/3388186085.py:9: DeprecationWarning: Conversion of an array
  ↵ with ndim > 0 to a scalar is deprecated, and will error in future. Ensure you
  ↵ extract a single element from your array before performing this operation. ↵
  ↵ (Deprecated NumPy 1.25.)
  ↵     return {'weights': w, 'volatility': np.sqrt(float(w.T.dot(sigma).dot(w)))},
/tmp/ipykernel_3511161/3388186085.py:10: DeprecationWarning: Conversion of an
  ↵ array with ndim > 0 to a scalar is deprecated, and will error in future. Ensure
  ↵ you extract a single element from your array before performing this operation. ↵
  ↵ (Deprecated NumPy 1.25.)
  ↵     'mean': float(w.T.dot(mu)) }
```

```
def tangency_portfolio(mu, sigma):
    """Returns weights of tangency portfolio with largest slope (sharpe ratio)"""
    mu = mu.flatten()
    n = len(mu)
    ones = np.ones((n, 1))
    w = la.inv(sigma).dot(mu)/ones.T.dot(la.inv(sigma).dot(mu))
    return {'weights': w, 'mean': float(w.T.dot(mu)),
            'volatility': np.sqrt(float(w.T.dot(sigma).dot(w)))}
```

```
s = tangency_portfolio(mu, sigma)
```

```
# show numerical and formulas are same solution
DataFrame({'tangency portfolio': list(tangency['coords']),
            'tangency formula': [s['volatility'], s['mean']]},
            index=['volatility', 'mean']).join(df)
```

	tangency portfolio	tangency formula	random efficient portfolio
volatility	0.081199	0.081108	0.137064
mean	0.017051	0.017031	0.027701
	by formula		
volatility	0.137064		
mean	0.027701		

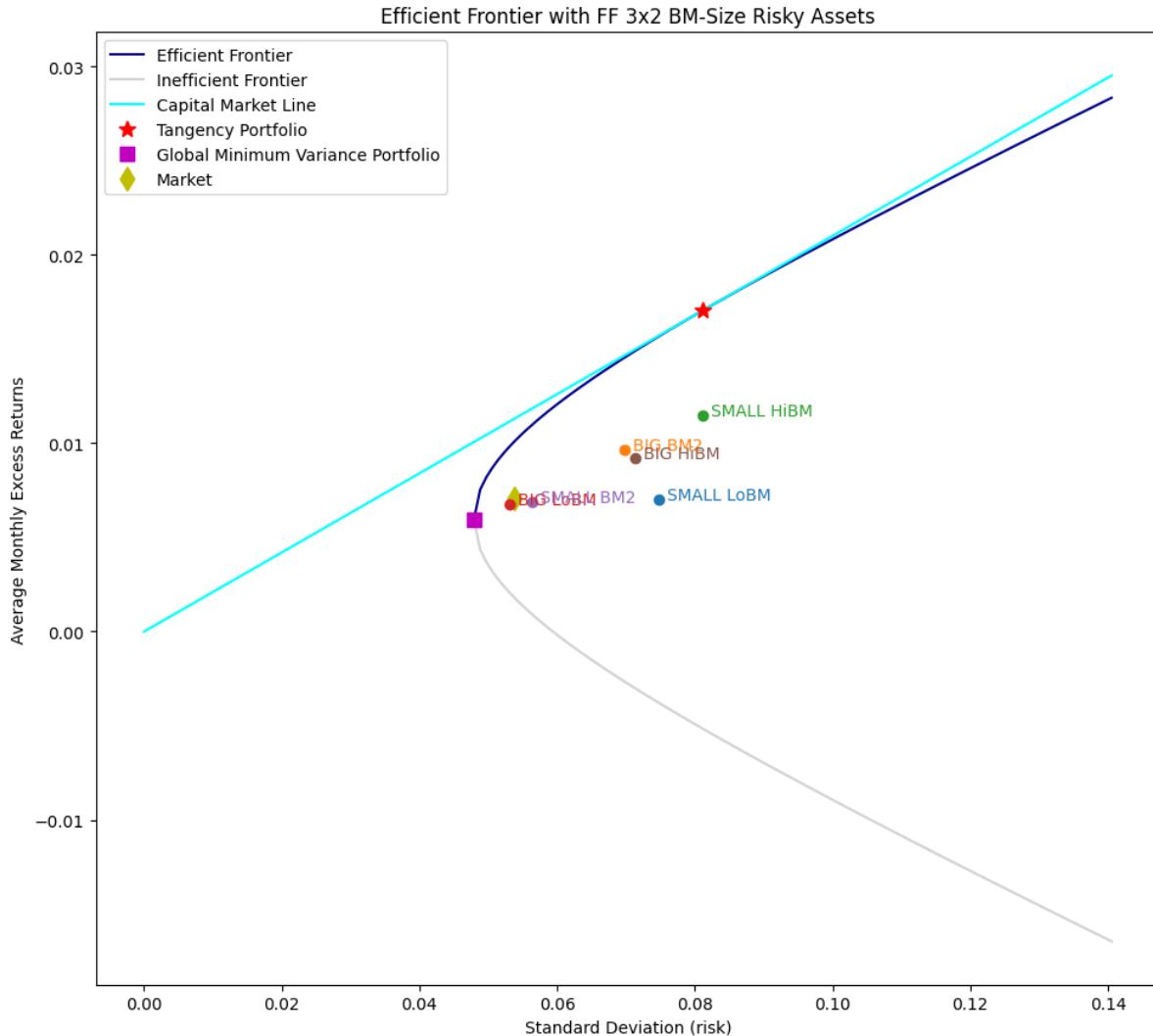
Plot efficient frontier and portfolios

```
fig, ax = plt.subplots(figsize=(10, 9))
DataFrame(assets).set_index('volatility').plot(ax=ax, color='darkblue')
DataFrame(frontier).set_index('volatility').plot(ax=ax, color='lightgrey')
ax.plot([0, np.sqrt(max(var_ticks))], [0, np.sqrt(max(var_ticks))*best_slope],
        color='cyan') # capital market line
ax.plot(*tangency['coords'], "r*", ms=10) # tangency portfolio
ax.plot(np.sqrt(gmv['variance']), gmv['mean'], "ms", ms=8) # GMV portfolio
ax.plot(np.sqrt(mkt['variance']), mkt['mean'], "yd", ms=10) # market portfolio
plt.legend(['Efficient Frontier', 'Inefficient Frontier', 'Capital Market Line',
           'Tangency Portfolio', 'Global Minimum Variance Portfolio', 'Market'])
for c, r in enumerate(assets.itertuples()): # risky assets
    ax.plot(r.volatility, r.mean, marker='o', color=f"C{c}")
    ax.annotate(text=r.Index, xy=(r.volatility, r.mean),
                xytext=(0.5, 0), textcoords="offset fontsize", color=f"C{c}")
ax.set_xlabel('Standard Deviation (risk)')
ax.set_ylabel('Average Monthly Excess Returns')
ax.set_title('Efficient Frontier with FF 3x2 BM-Size Risky Assets')
```

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```
plt.tight_layout()
```



4.1.3 CAPM

Sharpe, Lintner, and Mossin derived an equilibrium model showing the relationship between the risk and expected return of a risky asset.

The derivation of CAPM includes several crucial assumptions, some of which are the same as those used by Markowitz. The CAPM model shows that market equilibrium is achieved when all investors hold portfolios consisting of the riskless asset and the market portfolio described earlier. Each investor's portfolio is just a combination of these two, with the proportional allocation between them being a function of the individual investor's risk appetite. Accordingly, the expected return on a risky asset is determined by that asset's relative contribution to the market portfolio's total risk. In this case, the relevant measure of risk is the risk that cannot be diversified away (i.e., non-diversifiable risk or systematic risk). This means that investors should only be compensated for the risk that cannot be eliminated by diversification.

Specifically, the total risk of a risky asset is decomposed into two components – a systematic component proxied by the asset's beta $\beta_i = \frac{\text{cov}(R_i, R_M)}{\text{var}(R_M)}$, and a idiosyncratic component that can be diversified away.

The **security market line** gives the relationship between the expected return for individual assets and risk as proxied by beta $E(R_i) = r_f + \beta_i(E[R_M] - r_f)$.

4.2 Implied alphas

If some portfolio allocation W is known to be solution of some mean-variance objective above, then we can infer the mean returns input if given the covariance matrix. In other words, these **implied alphas**, which are proportional to $w^T \Sigma$, when input as the mean returns vector along with the same covariance matrix, delivers W as the mean-variance optimization solution.

```
# market cap-weighted portfolio implied expected returns
capm = mkt['weights'].dot(sigma) * 2
```

```
# HML implied alphas
hml = Series(0.0, index=assets.index)
hml['BIG HiBM'] = 0.5
hml['SMALL HiBM'] = 0.5
hml['BIG LoBM'] = -0.5
hml['SMALL LoBM'] = -0.5
#hml = {'weights': hml.values}
#hml['variance'] = hml['weights'].dot(sigma).dot(hml['weights'])
#hml['coords'] = (np.sqrt(hml['variance']), hml['weights'].dot(mu))
alphas = hml.dot(sigma) * 2
```

```
pd.concat([Series(hml.values).rename('HML weights'),
           Series(alphas).rename('HML implied-alpha'),
           Series(mkt['weights']).rename('Market weights'),
           Series(capm).rename('CAPM equilibrium returns'),
           Series(mu).rename('historical mu'),
           Series(Series(alphas)/Series(capm)).rename('implied/capm')],
           axis=1, ignore_index=False) \
.set_index(assets.index).T
```

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	\
HML weights	-0.500000	0.000000	0.500000	-0.500000	
HML implied-alpha	0.000737	0.001824	0.003134	0.000284	
Market weights	0.010355	0.018271	0.013081	0.656517	
CAPM equilibrium returns	0.007052	0.006732	0.007457	0.005625	
historical mu	0.007035	0.009628	0.011497	0.006759	
implied/capm	0.104457	0.270983	0.420304	0.050527	
	SMALL BM2	BIG HiBM			
HML weights	0.000000	0.500000			
HML implied-alpha	0.001637	0.002977			
Market weights	0.243641	0.058135			
CAPM equilibrium returns	0.005780	0.006901			
historical mu	0.006898	0.009195			
implied/capm	0.283150	0.431309			

```
# Correlations of alphas
DataFrame({'historical mu': np.corrcoef(alphas, mu)[0][-1],
```

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```
'capm equilibrium': np.corrcoef(alphas, capm)[0][-1]},  
index=['Correlation with implied alphas'])
```

	historical mu	capm equilibrium
Correlation with implied alphas	0.841491	0.625979

```
# Mean-variance optimization with HML-implied alphas  
MeanVariance = alphas @ W - Var  
obj = cp.Problem(cp.Maximize(MeanVariance))  
obj.solve(verbose=False)  
DataFrame.from_records([hml.values, W.value], columns=labels,  
index=['HML weights', 'mean-variance weights']).round(6)
```

	SMALL	LoBM	BIG	BM2	SMALL	HiBM	BIG	LoBM	SMALL	BM2	\
HML weights		-0.5		0.0		0.5		-0.5		0.0	
mean-variance weights		-0.5		-0.0		0.5		-0.5		-0.0	
			BIG	HiBM							
HML weights				0.5							
mean-variance weights				0.5							

```
# Mean-variance optimization with CAPM-implied expected returns  
MeanVariance = capm @ W - Var  
obj = cp.Problem(cp.Maximize(MeanVariance))  
obj.solve(verbose=False)  
p = tangency_portfolio(mu=capm, sigma=sigma)  
DataFrame.from_records([W.value, mkt['weights'], p['weights']], columns=labels,  
index=['Market weights', 'mean-variance weights', 'formula'])
```

	SMALL	LoBM	BIG	BM2	SMALL	HiBM	BIG	LoBM	SMALL	BM2	\
Market weights		0.010355	0.018271		0.013081	0.656517		0.243641			
mean-variance weights		0.010355	0.018271		0.013081	0.656517		0.243641			
formula		0.010355	0.018271		0.013081	0.656517		0.243641			
			BIG	HiBM							
Market weights				0.058135							
mean-variance weights				0.058135							
formula				0.058135							

4.2.1 Black-Litterman Model

Mean-variance efficient portfolios are highly sensitive to the inputs. Errors in estimating expected returns are observed to many times more important than errors in estimating variances and covariances. Black and Litterman (1992) suggest that “shrinking” investors’ views towards the expected returns implied by the market portfolio can deliver portfolio allocations that are less sensitive to parameter uncertainty.

```
active = tangency['weights'] - mkt['weights']  
DataFrame.from_records([tangency['weights'], mkt['weights'], active], columns=labels,  
index=['Tangency Portfolio Weights', 'Market Weights',  
'Active Weights']).round(6)
```

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	\
Tangency Portfolio Weights	-2.890459	2.793973	0.988490	2.065088	
Market Weights	0.010355	0.018271	0.013081	0.656517	
Active Weights	-2.900814	2.775702	0.975409	1.408571	
	SMALL BM2	BIG HiBM			
Tangency Portfolio Weights	-1.374475	-0.582617			
Market Weights	0.243641	0.058135			
Active Weights	-1.618116	-0.640752			

Black-Litterman alphas are computed as:

$$E[R] = [(\tau \Sigma)^{-1} + P^T \Omega^{-1} P]^{-1} [(\tau \Sigma)^{-1} \Pi + P^T \Omega^{-1} Q]$$

- τ is a non-negative scalar that reflects an overall level of confidence in the active views versus the equilibrium expected returns. It effectively determines the overall weight placed on the active views relative to the equilibrium expected returns
- In Bayesian terms, τ measures the subjective degree of uncertainty as to how precisely the equilibrium returns (the expected return priors) have been estimated

```
tau = 0.05 # He and Litterman (1992) for a moderate amount of active risk
k = 1
Pi = capm.reshape((n, 1)) # equilibrium views: CAPM implied excess returns
P = (tangency['weights']).reshape((k, n)) # view portfolio weights
Q = (tangency['weights']).dot(mu).reshape((k, k)) # portfolio view
Omega = np.diag(np.array(P.dot(sigma).dot(P.T)).reshape((k, k))) # uncertainty
```

```
def black_litterman(tau, Pi, Sigma, P, Q):
    """Returns black-litterman alphas"""
    def inv(x):
        """helper wraps over la.inv to handle scalar/1d inputs"""
        try:
            return la.inv(x)
        except:
            return np.array(1/x).reshape((1, 1))
    return inv(inv(tau*Sigma)+P.T.dot(inv(Omega)).dot(P)) \
        .dot(inv(tau*Sigma).dot(Pi) + P.T.dot(inv(Omega)).dot(Q))
```

```
bl = {'alphas': black_litterman(tau=tau, Pi=Pi, Sigma=sigma, P=P, Q=Q)}
bl |= tangency_portfolio(mu=bl['alphas'], sigma=sigma)
bl['mean'] = bl['weights'].dot(mu) # express mean based on original mu
bl['tilt'] = bl['weights'] - mkt['weights']
print('Active Risk:', np.sqrt(bl['tilt'].T.dot(sigma).dot(bl['tilt'])))
DataFrame.from_dict({'Black-Litterman weights': bl['weights'],
                     'Market weights': mkt['weights'], 'Active weights': bl['tilt']},
                     columns=labels, orient='index').round(6)
```

Active Risk: 0.0025567237847205545

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	\
Black-Litterman weights	-0.106291	0.129886	0.052304	0.713158	
Market weights	0.010355	0.018271	0.013081	0.656517	
Active weights	-0.116646	0.111615	0.039223	0.056641	

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	SMALL	BM2	BIG	HiBM
Black-Litterman weights	0.178574	0.032369		
Market weights	0.243641	0.058135		
Active weights	-0.065067	-0.025765		

```
# BL tilts the optimal weights towards the active positions in the view portfolio
bl['tilt'] / active
```

```
array([0.04021136, 0.04021136, 0.04021136, 0.04021136, 0.04021136,
       0.04021136])
```

Alternatively, it is also possible, with numerical solvers such as cvxpy, to impose constraints such as no short-sales, and then iteratively add more constraints such that optimization solution “look” more reasonable.

```
Alpha = W @ mu
```

```
# Minimize variance to same expected return
obj = cp.Problem(cp.Minimize(Var), [cp.sum(W) == 1, W >= 0, Alpha >= bl['mean']])
obj.solve()
tilt = W.value - mkt['weights']
print('Minimize variance to achieve target return, with no short sales:')
print('Active Risk:', np.sqrt(tilt.T.dot(sigma).dot(tilt)))
DataFrame.from_dict({'Constrained weights': W.value,
                     'Market weights': mkt['weights'], 'Active weights': tilt},
                     columns=labels, orient='index').round(6)
```

```
Minimize variance to achieve target return, with no short sales:
Active Risk: 0.004234890777233881
```

	SMALL	LoBM	BIG	BM2	SMALL	HiBM	BIG	LoBM	SMALL	BM2	\
Constrained weights	0.000010	0.011640	0.136556	0.745308	0.106486						
Market weights	0.010355	0.018271	0.013081	0.656517	0.243641						
Active weights	-0.010344	-0.006631	0.123475	0.088791	-0.137154						
		BIG				HiBM					
Constrained weights	-0.000002										
Market weights	0.058135										
Active weights	-0.058137										

```
obj = cp.Problem(cp.Maximize(Alpha),
                 [cp.sum(W) == 1, W >= 0, Var <= bl['volatility']**2])
obj.solve()
tilt = W.value - mkt['weights']
print('Maximize return within target variance, with no short sales:')
print('Active Risk (annualized):', np.sqrt(tilt.T.dot(sigma).dot(tilt) * 12))
DataFrame.from_dict({'Constrained weights': W.value,
                     'Market weights': mkt['weights'], 'Active weights': tilt},
                     columns=labels, orient='index').round(6)
```

```
Maximize return within target variance, with no short sales:
Active Risk (annualized): 0.008422533939240117
```

```
/home/terence/env3.11/lib/python3.11/site-packages/cvxpy/problems/problem.py:1403:UserWarning: Solution may be inaccurate. Try another solver, adjusting the
solver settings, or solve with verbose=True for more information.
warnings.warn(
```

	SMALL LoBM	BIG BM2	SMALL HiBM	BIG LoBM	SMALL BM2	\
Constrained weights	0.000000	0.025048	0.055445	0.737171	0.182336	
Market weights	0.010355	0.018271	0.013081	0.656517	0.243641	
Active weights	-0.010355	0.006777	0.042364	0.080654	-0.061305	
		BIG HiBM				
Constrained weights	0.000000					
Market weights	0.058135					
Active weights	-0.058135					

4.3 Cross-sectional regressions

The Fama-MacBeth (1973) method estimates the betas and risk premia for any risk factors that are expected to determine asset prices. The parameters are estimated in two steps:

- First regress each time series of asset returns against proposed risk factor returns to determine each asset's beta exposures.
- Then regress all asset returns for each of T time periods against the previously estimated betas to determine the average risk premium for each factor.

This provides standard errors that are corrected for cross-sectional correlation effects.

4.3.1 Testing the CAPM

Retrieve test asset returns and risk-free rate. In addition to testing whether the “beta” is priced (i.e. that higher beta assets achieve linearly larger risk premiums than lower beta assets), we also test for non-linearity affects by including a beta-squared factor, and (supposedly) non-priced factors such as the residual riskiness of the assets.

```
factors = FFReader('F-F_Research_Data_Factors')[0] / 100 # risk-free rates
test_assets = FFReader('25_Portfolios_ME_BETA_5x5')
df = test_assets[1] / 100
df = df.sub(factors['RF'], axis=0).dropna().copy()
```

```
# unpivot the wide table to a long one
rets = df.stack() \
    .reset_index(name='ret') \
    .rename(columns={'level_1':'port', 'level_0':'Date'})
```

```
# estimate test assets' market betas from their time-series of returns
data = df.join(factors[['Mkt-RF']], how='left')
betas = least_squares(data, y=df.columns, x=['Mkt-RF'], stdres=True)
betas = betas.rename(columns={'Mkt-RF': 'BETA'})[['BETA', '_stdres']]
```

```
# collect test asset mean returns and betas
assets_df = betas[['BETA']].join(df.mean().rename('premiums')).sort_values('BETA')
```

```
# Orthogonalize polynomial (quadratic) beta^2 and residual-volatility features
betas['BETA2'] = smf.ols("I(BETA**2) ~ BETA", data=betas).fit().resid
betas['RES'] = smf.ols("_stdres ~ BETA + BETA2", data=betas).fit().resid
r = rets.join(betas, on='port').sort_values(['port', 'Date'], ignore_index=True)
```

```
# run monthly Fama-MacBeth cross-sectional regressions
fm = r.groupby(by='Date')\
    .apply(least_squares, y=['ret'], x=['BETA', 'BETA2', 'RES'])
```

```
/tmp/ipykernel_3511161/3663017786.py:3: DeprecationWarning: DataFrameGroupBy.apply_
    ↪operated on the grouping columns. This behavior is deprecated, and in a future_
    ↪version of pandas the grouping columns will be excluded from the operation._
    ↪Either pass `include_groups=False` to exclude the groupings or explicitly select_
    ↪the grouping columns after groupby to silence this warning.
    .apply(least_squares, y=['ret'], x=['BETA', 'BETA2', 'RES'])
```

```
# compute time-series means and standard errors of the Fama-MacBeth coefficients
out = DataFrame(dict(mean=fm.mean(), stderr=fm.sem(), tstat=fm.mean()/fm.sem())).T
```

```
print("Monthly Cross-sectional Regressions" +
      f"\n{min(rets['Date'])} to {max(rets['Date'])}")
out
```

Monthly Cross-sectional Regressions 1963-07 to 2024-04

	_intercept	BETA	BETA2	RES
mean	0.007872	0.000024	-0.008729	0.123100
stderr	0.001545	0.002274	0.002568	0.060929
tstat	5.095392	0.010539	-3.399499	2.020381

Clustered standard errors

Alternative methods of correcting standard errors for time series and cross-sectional correlation in the error term may look into double clustering by firm and year.

```
### Compare uncorrected to robust cov
ls = smf.ols("ret ~ BETA + BETA2 + RES", data=r).fit()
print(ls.summary())
# print(ls.get_robustcov_results('HC0').summary())
# print(ls.get_robustcov_results('HAC', maxlags=6).summary())
```

OLS Regression Results				
=====				
Dep. Variable:	ret	R-squared:	0.000	
Model:	OLS	Adj. R-squared:	0.000	
Method:	Least Squares	F-statistic:	2.622	
Date:	Sat, 29 Jun 2024	Prob (F-statistic):	0.0489	
Time:	11:10:51	Log-Likelihood:	25431.	

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No. Observations:	18250	AIC:	-5.085e+04			
Df Residuals:	18246	BIC:	-5.082e+04			
Df Model:	3					
Covariance Type:	nonrobust					
	coef	std err	t	P> t	[0.025	0.975]
Intercept	0.0079	0.002	4.178	0.000	0.004	0.012
BETA	2.397e-05	0.002	0.015	0.988	-0.003	0.003
BETA2	-0.0087	0.006	-1.432	0.152	-0.021	0.003
RES	0.1231	0.051	2.412	0.016	0.023	0.223
Omnibus:	1538.086	Durbin-Watson:	1.765			
Prob(Omnibus):	0.000	Jarque-Bera (JB):	9901.036			
Skew:	-0.056	Prob(JB):	0.00			
Kurtosis:	6.607	Cond. No.	173.			

Notes:

[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.

```
print(ls.get_robustcov_results('hac-panel',
                               groups=r['port'],
                               maxlags=6).summary())
# print(ls.get_robustcov_results('cluster', groups=r['port']).summary())
```

OLS Regression Results						
Dep. Variable:	ret	R-squared:	0.000			
Model:	OLS	Adj. R-squared:	0.000			
Method:	Least Squares	F-statistic:	1.667			
Date:	Sat, 29 Jun 2024	Prob (F-statistic):	0.201			
Time:	11:10:51	Log-Likelihood:	25431.			
No. Observations:	18250	AIC:	-5.085e+04			
Df Residuals:	18246	BIC:	-5.082e+04			
Df Model:	3					
Covariance Type:	hac-panel					
	coef	std err	t	P> t	[0.025	0.975]
Intercept	0.0079	0.002	3.998	0.001	0.004	0.012
BETA	2.397e-05	0.002	0.013	0.990	-0.004	0.004
BETA2	-0.0087	0.006	-1.366	0.185	-0.022	0.004
RES	0.1231	0.066	1.852	0.076	-0.014	0.260
Omnibus:	1538.086	Durbin-Watson:	1.765			
Prob(Omnibus):	0.000	Jarque-Bera (JB):	9901.036			
Skew:	-0.056	Prob(JB):	0.00			
Kurtosis:	6.607	Cond. No.	173.			

Notes:

[1] Standard Errors are robust to cluster correlation (HAC-Panel)

4.3.2 Factor risk models

Beginning with Barra in the mid-1970's, industry practitioners have incorporated cross-sectional models using individual stock returns and characteristics, for the purpose of both forecasting risk premiums and measuring risk factors.

We run monthly cross-sectional regressions on the following individual stock characteristics (where each are winsored at 5% tail to reduce the influence of outliers):

- size: rank of company market cap, standardized
- value: book-to-market ratio, standardized
- momentum: 12-month skip past month momentum, standardized
- reversal: 1-month reversal, standardized

The monthly cross-sectional risk premiums can be interpreted as returns to monthly-rebalanced dollar-neutral portfolios, each with unit exposure to a characteristic but zero net exposure to the other three characteristics. We compare these to the corresponding returns of the Fama-French factors, which are computed as simple long-short spreads of cap-weighted portfolios.

```

rebalbeg = 19640601
rebalend = LAST_DATE
rebaldates = crsp.bd.date_range(rebalbeg, rebalend, 'endmo')
loadings = dict()

# preload signal values
sf = {key: SignalsFrame(signals.read(key)) for key in ['hml', 'mom', 'strev']}

for pordate in tqdm(rebaldates): # retrieve signal values every month
    date = bd.june_universe(pordate)
    univ = crsp.get_universe(date)
    smb = univ['capco'].rank(ascending=False).div(len(univ)).rename('smallsize')
    hml = sf['hml']('hml', date, bd.endmo(date, -12))['hml'].rename('value')
    #beta = signals('beta', pordate, bd.begmo(pordate))['beta']*2/3 + 1/3 #shrink
    mom = sf['mom']('mom', pordate)['mom'].rename('momentum')
    strev = -sf['strev']('strev', pordate)['strev'].rename('reversal')
    df = pd.concat((strev, hml, smb, mom), join='inner', axis=1) \
        .reindex(univ.index).dropna()
    loadings[pordate] = winsorize(df, quantiles=[0.05, 0.95])

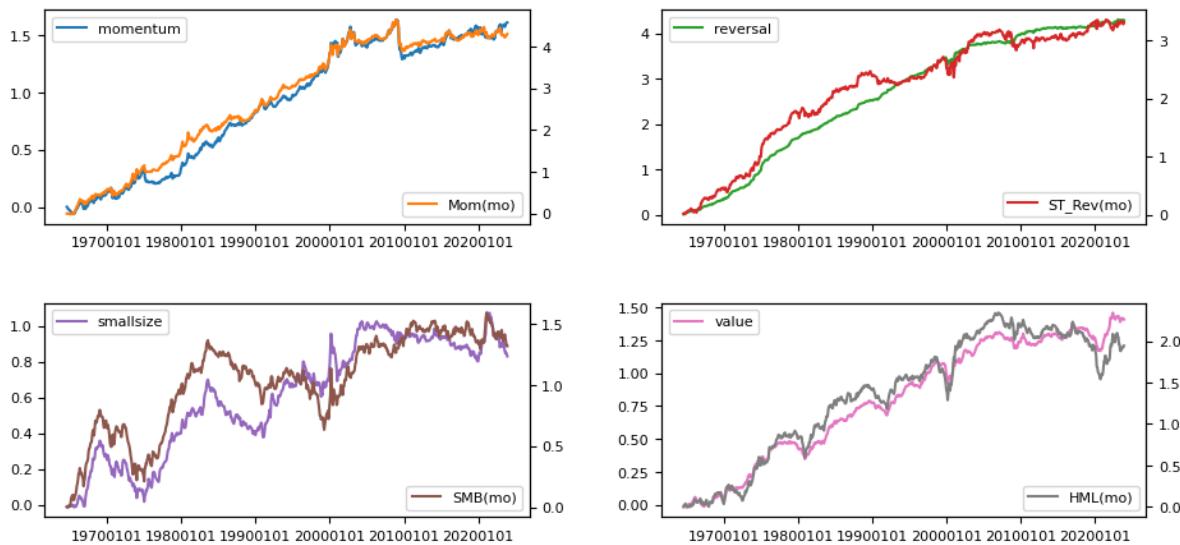
# Compute coefficients from FM cross-sectional regressions
monthly = CRSPBuffer(stocks=crsp, dataset='monthly', fields=['ret'],
                      beg=bd.begmo(rebalbeg, -13), end=bd.endmo(rebalend, 1))

riskpremium = RiskPremium(sql=user, bench=bench, rf='RF', end=LAST_DATE)
out = riskpremium(stocks=monthly, loadings=loadings,
                  standardize=['value', 'smallsize', 'momentum', 'reversal'])

# Compare time series of risk premiums to portfolio-sort benchmark returns
benchnames = {'momentum': 'Mom(mo)', 'reversal': 'ST_Rev(mo)', 'smallsize': 'SMB(mo)', 'value': 'HML(mo)'}
out = riskpremium.fit(benchnames.values()) # to compare portfolio-sorts
riskpremium.plot(benchnames)

```

100% |██████████| 714/714 [01:45<00:00, 6.79it/s]



```
# Summarize time-series means of Fama-Macbeth risk premiums
df = out[0]
df['tvalue'] = df['mean']/df['stderr']
df['sharpe'] = np.sqrt(12) * df['mean']/df['std']
print("Fama-MacBeth Cross-sectional Regression Risk Premiums")
df.round(4)
```

Fama-MacBeth Cross-sectional Regression Risk Premiums

Factor Returns	mean	stderr	std	count	tvalue	sharpe
reversal	0.0060	0.0005	0.0143	713	11.2067	1.4539
value	0.0020	0.0004	0.0112	713	4.7194	0.6123
smallsize	0.0012	0.0007	0.0179	713	1.7383	0.2255
momentum	0.0023	0.0007	0.0176	713	3.4282	0.4447

```
# Summarize time-series means of Fama-French portfolio-sort returns
df = out[2]
df['tvalue'] = df['mean']/df['stderr']
df['sharpe'] = np.sqrt(12) * df['mean']/df['std']
print("Fama-French Portfolio-Sorts")
df.round(4)
```

Fama-French Portfolio-Sorts

Benchmarks	mean	stderr	std	count	tvalue	sharpe
Mom(mo)	0.0060	0.0016	0.0424	713	3.8023	0.4933
ST_Rev(mo)	0.0046	0.0012	0.0316	713	3.9206	0.5086
SMB (mo)	0.0018	0.0011	0.0306	713	1.6111	0.2090
HML (mo)	0.0027	0.0011	0.0301	713	2.4227	0.3143

```
# Show correlation of returns
print('Correlation of FM Risk Premiums and FF Portfolio-Sort Returns')
pd.concat([out[1].join(out[4]), out[4].T.join(out[3])], axis=0).round(3)
```

Correlation of FM Risk Premiums and FF Portfolio-Sort Returns

	reversal	value	smallsize	momentum	Mom (mo)	ST_Rev (mo)	\
reversal	1.000	0.008	0.078	-0.448	-0.395	0.795	
value	0.008	1.000	-0.224	-0.189	-0.166	-0.021	
smallsize	0.078	-0.224	1.000	-0.004	0.132	0.006	
momentum	-0.448	-0.189	-0.004	1.000	0.885	-0.284	
Mom (mo)	-0.395	-0.166	0.132	0.885	1.000	-0.313	
ST_Rev (mo)	0.795	-0.021	0.006	-0.284	-0.313	1.000	
SMB (mo)	0.148	-0.212	0.524	-0.059	-0.038	0.184	
HML (mo)	0.052	0.821	-0.152	-0.205	-0.189	0.012	
	SMB (mo)	HML (mo)					
reversal	0.148	0.052					
value	-0.212	0.821					
smallsize	0.524	-0.152					
momentum	-0.059	-0.205					
Mom (mo)	-0.038	-0.189					
ST_Rev (mo)	0.184	0.012					
SMB (mo)	1.000	-0.166					
HML (mo)	-0.166	1.000					

4.4 Nonlinear regression

4.4.1 Feature transformations

A simple way to directly extend the linear model to accommodate non-linear relationships, using polynomial regression, is to include transformed versions of the predictors in the model, such as a quadratic term or several polynomial functions of the predictors, and use standard linear regression to estimate coefficients in order to produce a non-linear fit. The CAPM predicts that these coefficients should be zero.

Raw polynomial terms may be highly correlated with each other: Orthogonal polynomials_ transform the raw data matrix of polynomial terms to another whose columns are a basis of orthogonal terms which span the same column space. For example, regress the second predictor on the first and replace its column with the residuals, then regress the third predictor on the first two and replace its column with the residuals, and so on.

Other feature transformation approaches include:

- dummy or binary indicator variable
- categorical variables with two or more levels
- binarization or turning a categorical variable into several binary variables (4)
- Legendre polynomials which are defined as a system of orthogonal polynomials over the interval $[-1, 1]$
- interaction term constructed by computing the product of the values of the two variables to capture the effect that response of one predictor is dependent on the value of another predictor.

4.4.2 Kernel regression

If there are already a large number of k features, then polynomial transformations, say up to degree d , may be computational expensive since we could be working in $O(k^d)$ dimensional space. Fortunately, many high-dimensional feature mappings, denoted $\phi(x)$, correspond to kernel functions K , where model fitting and prediction calculations only require inner products of these kernel matrices and we never need to explicitly represent vectors in the very high-dimensional feature space. For example, the kernel $K(x, y) = (x^T y + c)^d$, which requires only $O(k)$ to compute, expands to the feature space corresponding with all polynomial terms up to degree d of the features in x and y .

Kernels can be viewed as similarity metrics, that measure how close together the feature maps $\phi(x)$ and $\phi(y)$ are. The radial basis function (RBF), or Gaussian, kernel uses distance in Euclidean space which corresponds to an infinite-dimension feature mapping.

This application of Kernel functions that can be efficiently computed, where only their inner products are needed without ever explicitly computing their corresponding feature vectors in very high-dimensional space, has come to be known as the **kernel trick**.

The slight concavity of the fitted curve is consistent with the negative coefficient on observed for squared-beta factor in the Fama-MacBeth regression. The lack of monotonicity would be consistent with an insignificant coefficient for the beta factor.

```

y_train = assets_df[['premiums']].values
X_train = assets_df[['BETA']].values
X_test = np.linspace(0.5, 1.75, 100).reshape(-1, 1)
bandwidth = float((max(X_train) - min(X_train)) * 4 / len(X_train))

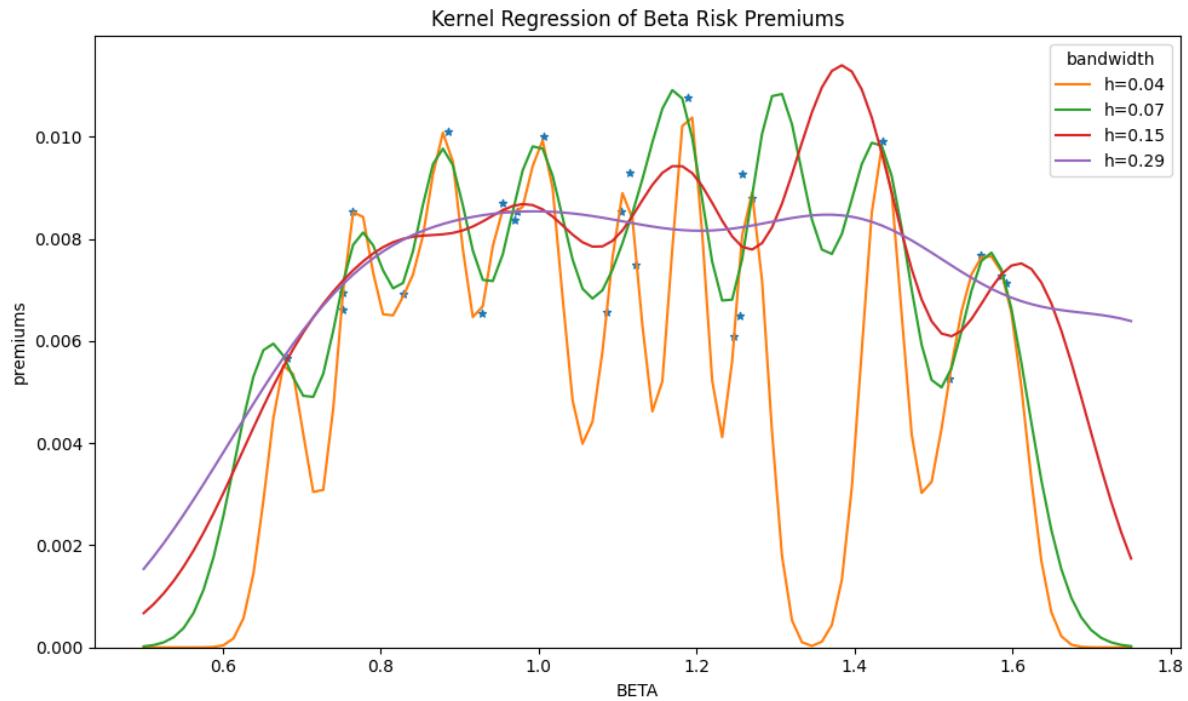
fig, ax = plt.subplots(figsize=(10, 6))
legend = []
color = 1
for h in [0.25, 0.5, 1, 2]:
    for alpha in [0.01]:
        model = KernelRidge(alpha=alpha, kernel='rbf', gamma=1 / (h*bandwidth)**2)
        model.fit(X=X_train, y=y_train)
        y_pred = model.predict(X_test)
        ax.plot(X_test, y_pred, ls='-', color=f"C{color}")
        legend.append(f"h={h*bandwidth:.2f}")
        color += 1
# scatter plot actual
assets_df.plot(x='BETA', y='premiums', kind='scatter', ax=ax, marker="*", color="C0")
ax.set_xlim(bottom=0)
plt.legend(legend, loc='best', title='bandwidth')
plt.title('Kernel Regression of Beta Risk Premiums')
plt.tight_layout()

```

```

/tmp/ipykernel_3511161/2598276866.py:4: DeprecationWarning: Conversion of an array
with ndim > 0 to a scalar is deprecated, and will error in future. Ensure you
extract a single element from your array before performing this operation.
(Deprecated NumPy 1.25.)
bandwidth = float((max(X_train) - min(X_train)) * 4 / len(X_train))

```



CONTRARIAN TRADING

Fortune befriends the bold - Emily Dickinson

Concepts:

- Mean reversion
- Implementation shortfall
- Structural break with unknown changepoints
- Performance evaluation, information coefficient

References

Andrews, D.W.K., "Tests for parameter instability and structural change with unknown change point", *Econometrica*, 61 (1993), 821-856.

Grinold, Richard C., 1994, "Alpha is Volatility Times IC Times Score", *The Journal of Portfolio Management*, Summer 1994, 20(4), 9-16

Lo, Andrew W. and MacKinlay, A. Craig, 1990, "When Are Contrarian Profits Due to Stock Market Overreaction?", *The Review of Financial Studies*, 3(2), 175–205

Perold, Andre, 1988, "The Implementation Shortfall: Paper versus Reality", *The Journal of Portfolio Management*, 14(3), 4-9

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
from tqdm import tqdm
import matplotlib.pyplot as plt
import rpy2.robj as ro
from rpy2.robj.packages import importr
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, Benchmarks
from finds.recipes import fractile_split, least_squares
from finds.utils import PyR, row_formatted
from secret import credentials, paths, CRSP_DATE
VERBOSE = 0
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
```

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```
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
bench = Benchmarks(sql, bd)
```

5.1 Mean reversion

The assumption of **mean reversion** underlies many investment and trading strategies. Similar assets should be priced identically, according to the **law of one price**, otherwise the opportunity for guaranteed **arbitrage** profits incentivize traders to buy the undervalued asset while short-selling the overvalued asset hence driving their prices closer together again. Deviations from long-run expectations, such as yield spreads in fixed income assets, should not persist. **Pairs trading** involves identifying two related securities, often based on their historical price relationships, and trading them simultaneously to profit from the temporary divergences in price between the two securities. **Statistical arbitrage**, also referred to as stat arb, models statistical relationships between securities and uses computationally intensive trading algorithms to simultaneously buy and sell portfolios of securities in financial market assets such as equities and commodities. Since such relationships are not risk-free, stat arb strategies seek to diversify as much as possible across a broad set of imperfectly correlated positions (unfortunately, correlations between strategies and asset classes seem to increase inconveniently around financial shocks, perhaps due liquidity constraints and deleveraging effects).

We construct and evaluate a **contrarian strategy** based on the weekly returns of US stocks and motivated by stock mispricing due to investor over-reaction, see Lo and Mackinlay (1990) and others. The **alpha** of this strategy can be approximated by its **information coefficient** and **volatility** components, resembling Grinold (1994)'s decomposition. We apply tests of structural breaks with unknown changepoints to examine the decline of its profitability over time. Trading strategies can experience large differences between the paper return of a portfolio where all trades are assumed to have transacted at the decision price and the actual return of the portfolio using actual transaction prices and amounts executed. The concept of **implementation shortfall**, introduced by Perold (1988), measures the total cost of implementing an investment decision by capturing both explicit and implicit trading costs, such as market impact, delay, as well as opportunity costs.

Weekly returns reversals

Daily returns from CRSP are compounded into weekly stock returns assuming Wednesday-close to Wednesday-close. This skips over weekend and holiday (which often occur over a long weekend) effects. The backtest starts in January 1974, after an expansion of the stocks universe the previous year, and excludes the smallest market cap quintile (based on NYSE breakpoints) comprising microcap stocks.

Let \bar{r}_t and σ_t be the cross-sectional mean and standard deviation of stock returns in week t . Define $\tilde{r}_t = r_t - \bar{r}_t$ as the vector of demeaned stock returns, and $X_t = -\tilde{r}_t/\sigma_t$ as the vector of normalized scores. In other words, stocks' "exposures" to (minus) their respective prior week's returns are standardized to have cross-sectional variance and standard deviation equal to 1.0.

Each week, a portfolio is rebalanced to hold an amount in each stock equal to their respective exposure values divided by the number of holdings $w_t = X_t/n$, hence the portfolio overall has unit exposure to prior week's returns $w_t^T X_t = 1$ and is dollar-neutral $\sum w_t = \sum X_t/n = 0$.

As an aside, this portfolio construction approach can more generally incorporate additional signals where X may be a matrix with ones in the first column and standardized signal exposures in other columns. Then each row, except the first, of $W = (X'X)^{-1}X'$ contains stock weights of a long-short characteristic portfolio: a dollar-neutral, minimum-norm (in terms of squared weights) portfolio with unit exposure through long positions in stocks with positive exposure and short positions in stocks with negative exposure to the signal, and zero exposure to the other characteristics.

The portfolio's realized return in the following week $t+1$ is

$$W_t' r_{t+1} = \frac{X_t' \tilde{r}_t}{n} + \frac{X_t' \hat{r}_t}{n} = -\frac{\tilde{r}_t' \tilde{r}_{t+1} \sigma_{t+1}}{n \sigma_t \sigma_{t+1}} = -\rho_{t,t+1} \sigma_{t+1}$$

that is the product of the (negative) cross-sectional correlation of stock returns times the amount of cross-sectional stock volatility at week $t + 1$.

```

weekday = 3           # wednesday close-to-close
bd = BusDay(sql, endweek=weekday)  # Generate weekly cal
begweek = 19740102  # increased stocks coverage in CRSP in Jan 1973
endweek = bd.endwk(CRSP_DATE, -1)
rebaldates = bd.date_range(begweek, endweek, freq='weekly')
retdates = bd.date_tuples(rebaldates)

june_universe = 0  # to track date when reached a June end to update universe
year = 0           # to track new year to pre-load stocks datas in batch by year
results = []
lagged_weights = Series(dtype=float) # to track "turnover" of stock weights
for rebaldate, pastdates, nextdates in tqdm(zip(
    rebaldates[1:-1], retdates[:-1], retdates[1:]), total=len(rebaldates)-1):

    # screen universe each June: largest 5 size deciles
    d = bd.june_universe(rebaldate)
    if d != june_universe: # need next June's universe
        june_universe = d           # update universe every June
        univ = crsp.get_universe(june_universe) # usual CRSP universe screen
        univ = univ[univ['decile'] <= 8] # drop smallest quintile stocks

    # retrieve new annual batch of daily prices and returns when start new year
    if bd.begyr(rebaldate) != year:
        year = bd.begyr(rebaldate)
        prc = crsp.get_range(dataset='daily',
                              fields=['bidlo', 'askhi', 'prc', 'retx', 'ret'],
                              date_field='date',
                              beg=year,
                              end=bd.offset(bd.endyr(year), 10),
                              cache_mode="rw")

    # get past week's returns, require price at rebalance (decision) date
    past_week = prc[prc.index.get_level_values('date') == rebaldate]['prc']\
        .reset_index()\
        .set_index('permno')\
        .join(crsp.get_ret(*pastdates).reindex(univ.index))\
        .dropna()

    # convert past week's returns to desired standardized portfolio weights
    weights = ((past_week['ret'].mean() - past_week['ret']) / \
               (past_week['ret'].std(ddof=0) * len(past_week)))

    # adjust past week's holdings by change stock price
    lagged_weights = lagged_weights.mul(crsp.get_ret(*pastdates, field='retx')\
                                         .reindex(lagged_weights.index))\
                                         .fillna(0) + 1

    # compute how much to buy (or sell) to achieve desired new portfolio weights
    chg_weights = pd.concat([weights, -lagged_weights], axis=1) \
        .fillna(0) \
        .sum(axis=1)

    # calculate total abs weight as denominator for scaling turnover
    total_weight = weights.abs().sum() + lagged_weights.abs().sum()

```

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```

# get next week's gross returns
next_week = crsp.get_ret(*nextdates).reindex(weights.index).fillna(0)

# get next day's prices to compute one-day slippage cost
next_day = prc[prc.index.get_level_values('date') ==
              bd.offset(rebaldate, 1)]\ 
            .reset_index()\ 
            .set_index('permno')\ 
            .drop(columns='date')\ 
            .reindex(chg_weights.index)

# if no trade next day, then enter position at askhi (buy) or bidlo (sell)
bidask = next_day['askhi'].where(chg_weights > 0, next_day['bidlo']).abs()

# spread is relevant askhi or bidlo divided by recorded close, minus 1
spread = next_day['prc'].where(next_day['prc'] > 0, bidask)\ 
            .div(next_day['prc'].abs())\ 
            .sub(1)\ 
            .fillna(0)

# finally, trade_prc is the next day's close, or the relevant askhi or bidlo
trade_prc = next_day['prc'].where(next_day['prc'] > 0, bidask).fillna(0)

# drift is next day's trade price with dividends over today's decision price
# delay (positive is cost) will be chg_weights * drift
drift = trade_prc.div(next_day['prc'].abs())\ 
            .mul(1 + next_day['ret'])\ 
            .sub(1)\ 
            .fillna(0)

# exit and enter delay should sum to chg_weights.dot(next_day['ret'])
exit1 = -lagged_weights.dot(next_day['ret']).reindex(lagged_weights.index).  
fillna(0))
enter1 = weights.dot(next_day['ret']).reindex(weights.index).fillna(0))

# accumulate weekly calculations
results.append(DataFrame(
    {'ret': weights.dot(next_week),
     'exit1': exit1,
     'enter1': enter1,
     'delay': chg_weights.dot(next_day['ret'].fillna(0)),  # delay=enter+exit
     'spread': chg_weights.dot(spread),
     'slippage': chg_weights.dot(drift),  # total slippage
     'ic': weights.corr(next_week),
     'n': len(next_week),
     'beg': nextdates[0],
     'end': nextdates[1],
     'absweight': np.sum(weights.abs()),
     'turnover': chg_weights.abs().sum() / total_weight,
     'vol': next_week.std(ddof=0)},
    index=[rebaldate]))
```

carry forward to next week as lagged portfolio weights

lagged_weights = weights

```
Last FamaFrench Date 2024-02-29 00:00:00
```

```
100%|██████████| 2607/2608 [01:17<00:00, 33.74it/s]
```

```
# Combine accumulated computations and report
df = pd.concat(results, axis=0)
dates = df.index
df.index = pd.DatetimeIndex(df.index.astype(str))
df['net'] = df['ret'].sub(df['slippage'])
# Show summary
cols = ['ic', 'vol', 'ret', 'slippage', 'net', 'exit1', 'enter1', 'delay',
        'spread', 'turnover']
indexes = ['Information coefficient', 'Cross-sectional Volatility',
           'Gross return (alpha)', 'Slippage cost', 'Net (of slippage) return',
           'Exit one day delay', 'Enter one day delay', 'Delay cost',
           'Spread cost', 'Portfolio turnover']

print(f'Summary of Weekly Mean Reversion Strategy {dates[0]}-{dates[-1]}'')
pd.concat([df[cols].mean(axis=0).rename('mean'),
           df[cols].std(axis=0).rename('std')], axis=1) \
.set_index(pd.Index(indexes)).round(4)
```

```
Summary of Weekly Mean Reversion Strategy 19740109-20231220
```

	mean	std
Information coefficient	0.0379	0.1027
Cross-sectional Volatility	0.0535	0.0192
Gross return (alpha)	0.0021	0.0080
Slippage cost	0.0017	0.0048
Net (of slippage) return	0.0005	0.0078
Exit one day delay	-0.0003	0.0029
Enter one day delay	0.0006	0.0036
Delay cost	0.0004	0.0042
Spread cost	0.0013	0.0023
Portfolio turnover	0.7362	0.0408

5.2 Implementation shortfall

Perold (1988) observed that the a paper portfolio based upon a well-known stock rankings system significantly outperformed the actual track record of funds that make use of the system. He defined implementation shortfall as the difference in return between a theoretical portfolio and the implemented portfolio, which captures explicit fees and commissions as well as market impact, delay and opportunity costs.

- **Decision price** is the price at the time the investment decision was made
- **Arrival price** is the midquote (mid-point of bid-ask prices) at the time the trader, broker or trading system received the order, or the trade decision is made.
- **Market drift** is the amount of buys (sells) multiplied by the increase (decrease) in execution price relative to the arrival price, due to execution delay.
- **Delay** is the adverse change in execution price relative to the decision price

- **Opportunity costs** are the profits lost due to trades that are cancelled or not executed.
- **Market impact costs** are bid-ask spreads as well as the amount that buying or selling moves the price against the buyer or seller

The **trader's dilemma** refers to the trade-off between market drift and impact: one can trade faster with more impact to minimize market drift, or trade slower to minimize market impact but at the risk of the market drifting away.

Unfortunately, stock prices in CRSP are not available at a finer than daily frequency. We adjust estimated profits for slippage by waiting a full day after the decision price then setting the execution price at the next day's closing price, since the stock market exchanges experience the most liquidity during the trading day at the close. For stocks that did not trade during that day, we assumed the desired buys are executed at the (higher) ask price and sells are executed at the (lower) bid price: in the CRSP database, closing bid and ask quotes are recorded so that the closing price, when not available, is set to the negative of the bid-ask average. Transactions costs are challenging to model and cannot be observed from historical prices in backtest simulations, so this measurement approach feasibly assumes trades are executed at the close a full day after their decision prices are considered.

Over the full period, much of the profitability of this version of the strategy appears to be dissipated after considering a one-day execution delay and bid-ask spreads.

5.3 Structural break with unknown changepoint

In a linear regression, the Chow test is commonly used to test for the presence of a structural break in the model at a period known *a priori*; it essentially constructs a test of whether the true coefficients on the independent variable split into two subsets are equal. Welch's test that two populations have equal means is a special case with no independent variables and only an intercept whose true values are tested in the two time periods. However, when the breakpoints are unknown, these standard tests are not applicable. Andrews (1993) and others have developed alternative tests, based on supremum statistics, for the detection of structural change involving an unknown number of breaks in mean with unknown break points.

The R library `strucchange` implements tests for structural breaks with unknown breakpoints. The external Python package `rpy2` provides an interface to R libraries and programming language. The `PyR` wrapper class in the `FinDS` package facilitates converting Pandas DataFrames to and from R objects and function calls.

```
# Structural Break Test with Unknown Changepoint
importr('strucchange')    # R package to use

# Set up data and formulas for R
Y = df['ret']
formula = ro.Formula('y ~ 1')
formula.environment['y'] = PyR(Y.values).ro

# Call R strucchange routines to compute breakpoint statistics
fstats_r = ro.r['Fstats'](formula, **{'from': 1})      # Fstats at every break
breakpoints_r = ro.r['breakpoints'](formula)          # candidate breakpoints
confint_r = ro.r['confint'](breakpoints_r, breaks=1)  # conf interval for 1 break
sctest_r = ro.r['sctest'](fstats_r, **{'type': 'aveF'})

# Extract output from R results
confint = PyR(confint_r[0]).frame.iloc[0].astype(int) - 1 # R index starts at 1

output = dict(zip(confint.index, df.index[confint]))        # confidence interval

for k,v in zip(sctest_r.slots['names'][:3], sctest_r[:3]): # significance values
    output[k] = PyR(v).values[0]
output['mean(pre)'] = Y[df.index <= output['breakpoints']].mean()

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```

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```
output['mean(post)'] = Y[df.index > output['breakpoints']].mean()

fstat = [0] + list(PyR(fstats_r[0]).values) + [0, 0] # pad before and after

print("Structural break test with unknown changepoint")
DataFrame(output, index=['sctest'])
```

Structural break test with unknown changepoint

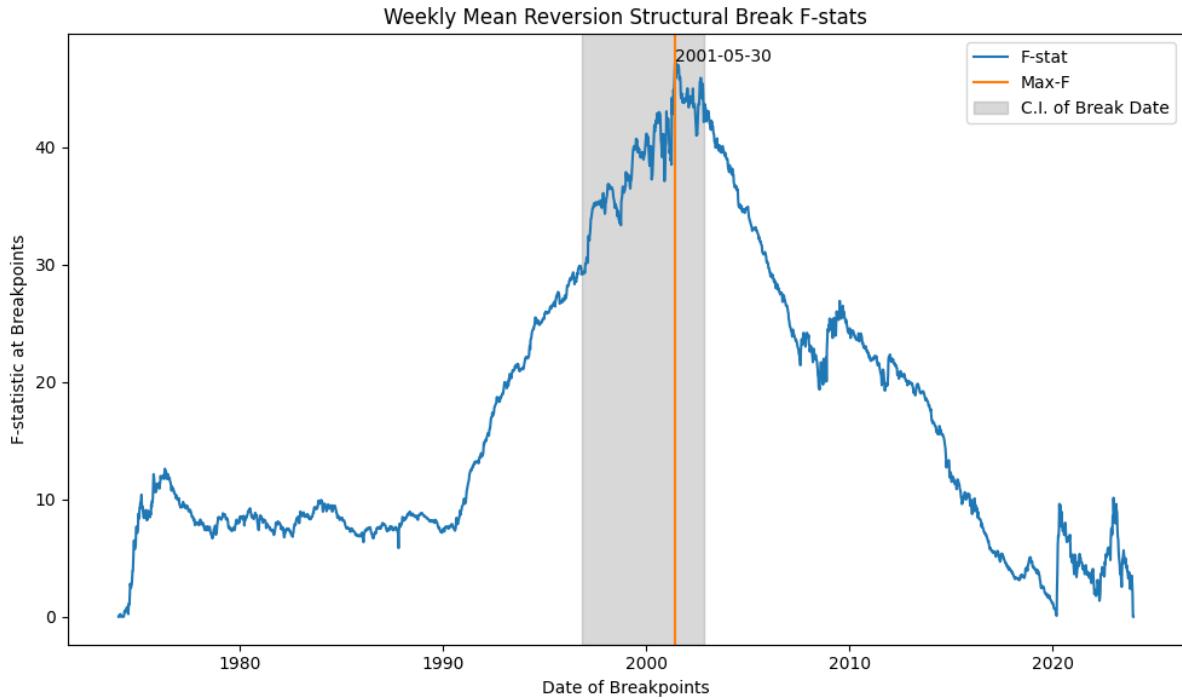
	2.5 % breakpoints	97.5 %	statistic	p.value	method	\
sctest	1996-10-23	2001-05-30	2002-11-06	17.226016	0.0	aveF test
	mean(pre)	mean(post)				
sctest	0.003112	0.000957				

Plot breakpoint F-stats

```
fig, ax = plt.subplots(num=2, clear=True, figsize=(10, 6))
ax.plot(df.index, fstat, color='C0')
argmax = np.nanargmax(fstat) # where maximum fstat
ax.axvline(df.index[argmax], color='C1')
ax.axvspan(df.index[confint[0]], df.index[confint[2]], alpha=0.3, color='grey')
ax.legend(['F-stat', 'Max-F', 'C.I. of Break Date'])
ax.annotate(
    df.index[argmax].strftime('%Y-%m-%d'), xy=(df.index[argmax], fstat[argmax]))
ax.set_ylabel('F-statistic at Breakpoints')
ax.set_xlabel('Date of Breakpoints')
ax.set_title('Weekly Mean Reversion Structural Break F-stats')
plt.tight_layout()
```

```
/tmp/ipykernel_1727373/3930510136.py:5: FutureWarning: Series.__getitem__ treating
keys as positions is deprecated. In a future version, integer keys will always
be treated as labels (consistent with DataFrame behavior). To access a value by
position, use `ser.iloc[pos]`
```

```
ax.axvspan(df.index[confint[0]], df.index[confint[2]], alpha=0.3, color='grey')
```



5.4 Information coefficient

Grinold (1994) linked the expected alpha of a signal to its information coefficient and an asset's signal score and idiosyncratic volatility: $\alpha = IC \times volatility \times score$.

- **IC:** The information coefficient can be understood as the correlation between a signal and residual returns. It tells how well forecasts align with actual returns and is a measure of manager forecasting skill.
- **Volatility:** The volatility can be understood as an asset's residual risk. This component allows for forecast alpha to be expressed in units of returns.
- **Score:** The score is a standardized measure of an asset's raw signal exposure, and reflects relative expectations about an asset. Standardization, by subtracting the cross-sectional mean and dividing by the cross-sectional standard deviation, allows assets to be compared to one another and over time.

Recall that the weekly reversal portfolio W_t was constructed to be dollar-neutral with exposure equal to 1.0, with weekly profitability $W_t' r_{t+1} = -\rho_{t,t+1} \sigma_{t+1}$. Hence the IC of this strategy is simply measured by the (negative) cross-sectional correlation of stock returns from one week to the next.

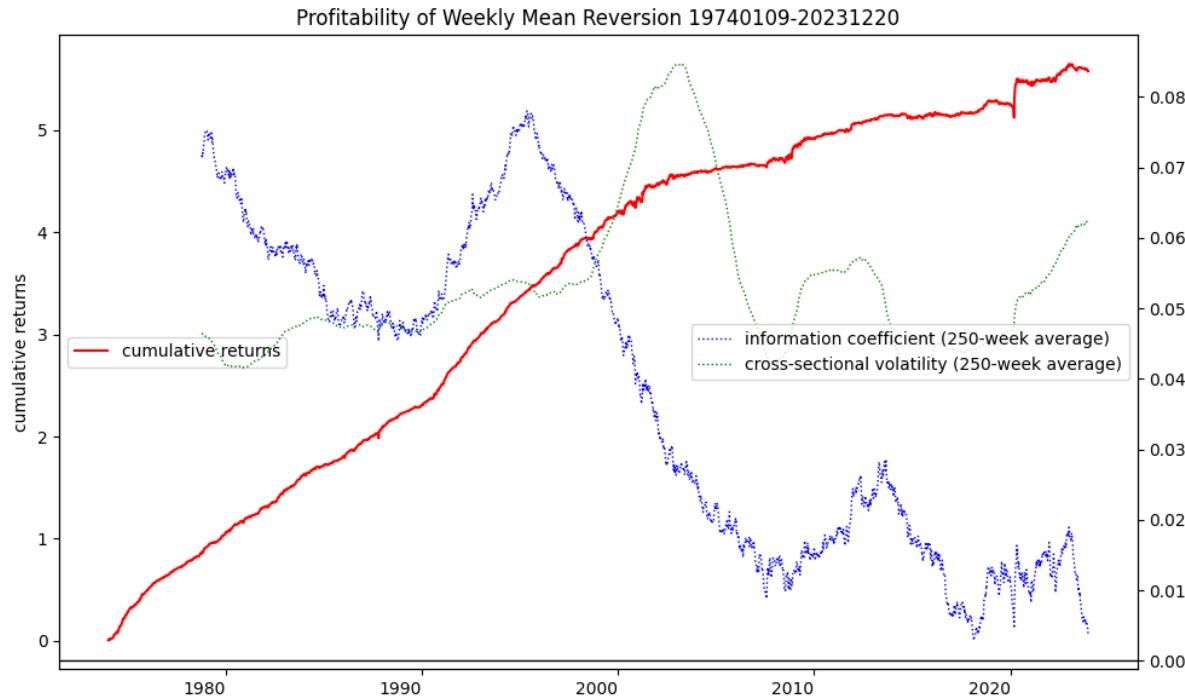
We plot the 5-year rolling average alpha and its information coefficient and volatility components. Whereas volatility exhibits cyclical changes, the estimated IC showed a sharp downward trend from a peak in the mid 1990's down to 2010.

```
## Plot returns, and rolling avg information coefficient and cross-sectional vol
fig, ax = plt.subplots(num=1, clear=True, figsize=(10, 6))
df['ret'].cumsum().plot(ax=ax, ls='-', color='r', rot=0)
ax.legend(['cumulative returns'], loc='center left')
ax.set_ylabel('cumulative returns')
bx = ax.twinx()
roll = 250 # 250 week rolling average ~ 5 years
df['ic'].rolling(roll).mean().plot(ax=bx, ls=':', lw=1, rot=0, color='b')
df['vol'].rolling(roll).mean().plot(ax=bx, ls=':', lw=1, rot=0, color='g')
```

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```
#bx.axhline(df['ic'].mean(), linestyle='--', color='C0', lw=2)
bx.axhline(0, linestyle='--', color='black', lw=1)
bx.legend([f"information coefficient ({roll}-week average)",
           f"cross-sectional volatility ({roll}-week average)"],
          loc='center right')
ax.set_title(f'Profitability of Weekly Mean Reversion {dates[0]}-{dates[-1]}')
plt.tight_layout()
```



5.5 Performance evaluation

In a CAPM equilibrium, no investor can achieve an abnormal return, and each investment yields an identical risk-adjusted return. In the real world, assets may yield a return in excess of, or below, the return with fair compensation for their risk exposure: portfolio managers rely on market benchmarks to measure the performance of a given investment relative to the CAPM equilibrium risk-return relationship.

- Sharpe ratio - slope of the capital market line is the fair equilibrium compensation: $\frac{R_P - r_f}{\sigma_P}$
- Treynor ratio - uses beta which is an appropriate measure of risk for a well-diversified portfolio: $\frac{R_P - r_f}{\beta_P}$
- Jensen's alpha - the intercept of a CAPM regression should be zero in equilibrium: $R_P - r_f - \beta_P(R_M - r_f)$
- Appraisal ratio - Jensen's alpha scaled by the volatility of residual returns $\frac{\alpha}{\sigma_{P-M}}$
- Sortino ratio - focuses on downside risk relative a target required rate of return T: $\frac{R_P - T}{\sqrt{\sum_t \min(0, r_t - T)^2 / N}}$

- Information ratio - adjusts performance relative to a benchmark, called the active return, scaled by the volatility of active returns, called tracking error:
$$\frac{\hat{R}_P - \hat{R}_B}{\sigma_{R_P - R_B}}$$
- M^2 (Modigliani-squared) - imagines that the given portfolio, P , is mixed with a position in T-bills so that the resulting portfolio P^* matches the volatility of the market portfolio. Because the market index and portfolio P^* have the same standard deviation, their performance may be compared by simply subtracting returns: $R_{P^*} - R_M$

```

market = bench.get_series(permnos=['Mkt-RF'], field='ret').reset_index()
breakpoint = BusDay.to_date(output['breakpoints'])
out = dict()
for select, period in zip([dates > 0, dates <= breakpoint, dates > breakpoint],
                         ['Full', 'Pre-break', 'Post-break']):
    res = df[select].copy()
    res.index = dates[select]

    # align market returns and compute market regression beta
    #res['date'] = res.index
    res['mkt'] = [(1 + market[market['date'].between(*dt)]['Mkt-RF']).prod() - 1
                  for dt in res[['beg', 'end']].itertuples(index=False)] 
    # model = lm(res['mkt'], res['ret'], flatten=True)
    model = least_squares(data=res, y=['ret'], x=['mkt'], stdres=True)

    # save df summary
    out[f'{period} Period'] = {
        'start date': min(res.index),
        'end date': max(res.index),
        'Sharpe Ratio': np.sqrt(52)*res['ret'].mean()/res['ret'].std(),
        'Average Gross Return': res['ret'].mean(),
        'Std Dev Returns': res['ret'].std(),
        'Market Beta': model.iloc[1],
        'Jensen Alpha (annualized)': model.iloc[0] * 52,
        'Appraisal Ratio': np.sqrt(52) * model.iloc[0] / model.iloc[2],
        'Information Coefficient': res['ic'].mean(),
        'Cross-sectional Vol': res['vol'].mean(),
        'Total Slippage Cost': res['slippage'].mean(),
        'Spread Cost': res['spread'].mean(),
        'Delay Cost': res['delay'].mean(),
        'Exit Delay Cost': res['exit1'].mean(),
        'Enter Delay Cost': res['enter1'].mean(),
        'Average Net Return': res['net'].mean(),
        'Portfolio Turnover': res['turnover'].mean(),
        #'Abs Weight': res['absweight'].mean(),
        'Average Num Stocks': int(res['n'].mean()),
    }
}

```

```

# Display as formatted DataFrame
fmts = dict.fromkeys(['start date', 'end date', 'Average Num Stocks'], '{:.0f}')
print("Subperiod Performance of Weekly Reversals")
row_formatted(DataFrame(out), formats=fmts, default='{:4f}')

```

Subperiod Performance of Weekly Reversals

	Full Period	Pre-break Period	Post-break Period	Period
start date	19740109	19740109	20010606	

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end date	20231220	20010530	20231220
Sharpe Ratio	1.9195	3.6667	0.7078
Average Gross Return	0.0021	0.0031	0.0010
Std Dev Returns	0.0080	0.0061	0.0097
Market Beta	0.0905	0.0686	0.1127
Jensen Alpha (annualized)	0.1041	0.1566	0.0405
Appraisal Ratio	1.8591	3.6606	0.6001
Information Coefficient	0.0379	0.0578	0.0138
Cross-sectional Vol	0.0535	0.0542	0.0526
Total Slippage Cost	0.0017	0.0028	0.0003
Spread Cost	0.0013	0.0023	0.0002
Delay Cost	0.0004	0.0006	0.0002
Exit Delay Cost	-0.0003	-0.0004	-0.0001
Enter Delay Cost	0.0006	0.0010	0.0002
Average Net Return	0.0005	0.0003	0.0006
Portfolio Turnover	0.7362	0.7393	0.7325
Average Num Stocks	1936	1981	1882

The structural break test suggested a statistically significant changepoint in mid-2001 in the time series of the strategy's weekly returns. The performance of the strategy in the periods before and after that dates shows a noticeable decline in annualized Sharpe ratio and average weekly returns, as well as an increase in riskiness. This coincides approximately with the New York and American Stock Exchanges switching to decimalization on Jan 29, 2001, which has led to tighter spreads. Previously, markets in the US utilized fractions in price quotes, where one-sixteenth (1/16) of one dollar was the smallest price movement that could be presented in a price quote.

QUANT FACTORS

Quants do it with models - Anonymous

Concepts

- Factor investing
- Performance Evaluation
- Cluster analysis

References

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```
from pandas import DataFrame, Series
import pandas as pd
import numpy as np
import matplotlib.pyplot as plt
import matplotlib.cm as cm
from sklearn.cluster import AgglomerativeClustering, KMeans
from scipy.cluster.hierarchy import dendrogram
from sklearn.metrics import silhouette_samples, silhouette_score
from tqdm import tqdm
import warnings
from datetime import datetime
from typing import List, Tuple
from finds.database import SQL, RedisDB
from finds.structured import (BusDay, Stocks, Benchmarks, Signals, SignalsFrame,
```

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```

CRSP, PSTAT, IBES, CRSPBuffer)
from finds.backtesting import BackTest, univariate_sorts
from secret import credentials, paths, CRSP_DATE
VERBOSE = 0
if not VERBOSE:
    warnings.simplefilter(action='ignore', category=FutureWarning)

#%matplotlib qt

```

```

LAST_DATE = CRSP_DATE
# open connections
imgdir = paths['images']
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
bench = Benchmarks(sql, bd, verbose=VERBOSE)
signals = Signals(user, verbose=VERBOSE)
ibes = IBES(sql, bd, verbose=VERBOSE)
backtest = BackTest(user, bench, 'RF', LAST_DATE, verbose=VERBOSE)
outdir = paths['scratch'] / 'output'

```

6.1 Factor investing

Under this view of investing, factor risks are the driving force behind assets' risk premiums. The market is an example of a tradeable, investment factor – the CAPM states that this is the only factor driving all asset returns. Other examples include interest rates, value-growth investing, low volatility investing, and momentum portfolios. Factors can also be fundamental macroeconomic factors, like inflation and economic growth. All assets have different exposures to risk factors and the greater the exposure, the higher the risk premium. Hence assets are merely bundles of factors.

Early multifactor models included the arbitrage pricing theory (APT) by Stephen Ross (1976), which uses the word “arbitrage” because the factors cannot be arbitrated or diversified away; and the intertemporal capital asset pricing model (ICAPM) by Robert C. Merton, based on the assumption of investors hedging risky positions over multiperiods. Behavioral theories, centering around investor under- or overreaction to recent news, other psychological biases, or bounded rationality, can also produce factor premiums.

6.1.1 Adaptive Markets Hypothesis

Lo's (2004) “Adaptive Markets Hypothesis” describes how financial markets are governed more by the laws of evolutionary biology than by the laws of physics. He suggests that the performance of investments would vary over time as the financial ecosystem and market conditions evolve. The study of financial markets should start by tracking the different species, that is the collections of individuals and institutions that share common traits, and their size, growth rates, interactions and other characteristics.

6.1.2 Factor Zoo

Cochrane (2011) coined the term “Factor Zoo” in response to the rate of factor production in academic research. Green, Hand and Zhang (2017) replicated the studies of almost 100 firm characteristic factors, avoiding the overweighting of microcap stocks and data snooping bias, to examine their predictability as a whole as well as during recent time periods. We attempt to reproduce many of these below.

```
# preload monthly stocks data
monthly = CRSPBuffer(stocks=crsp, dataset='monthly', fields=['ret', 'retx', 'prc'],
                      beg=19251201, end=CRSP_DATE)
```

```
# signals to flip signs when forming spread portfolios
leverage = {'mom1m':-1, 'mom36m':-1, 'pricedelay':-1, 'absacc':-1, 'acc':-1,
            'agr':-1, 'chcsho':-1, 'egr':-1, 'mve_ia':-1, 'pctacc':-1,
            'aeavol':-1, 'disp':-1, 'stdacc':-1, 'stdcf':-1, 'secured':-1,
            'maxret':-1, 'ill':-1, 'zerotrade':-1, 'cashpr':-1, 'chinv':-1,
            'invest':-1, 'cinvest':-1, 'idiovol':-1, 'retvol':-1}
```

Helper functions

```
# to lag yearly characteristics
def as_lags(df, var, key, nlags):
    """Return dataframe with {nlags} of column {var}, same {key} value in row"""
    out = df[[var]].rename(columns={var: 0})      # first col: not shifted
    for i in range(1, nlags):
        prev = df[[key, var]].shift(i, fill_value=0) # next col: shifted i+1
        prev.loc[prev[key] != df[key], :] = np.nan    # require same {key} value
        out.insert(i, i, prev[var])
    return out
```

```
# rolling window of returns
def as_rolling(df, other, width=0, dropna=True):
    """join next dataframe to a sliding window with fixed number of columns"""
    df = df.join(other, how='outer', sort=True, rsuffix='r')
    if width and len(df.columns) > width:           # if wider than width
        df = df.iloc[:, (len(df.columns)-width):]    # then drop first cols
    if dropna:                                         # drop empty rows
        df = df[df.count(axis=1) > 0]
    df.columns = list(range(len(df.columns)))
    return df
```

```
# pipeline to run backtest
def backtest_pipeline(backtest: BackTest,
                      stocks: Stocks,
                      holdings: DataFrame,
                      label: str,
                      benchnames: List[str],
                      suffix: str = '',
                      overlap: int = 0,
                      outdir: str = '',
                      num: int = None) -> DataFrame:
    """wrapper to run a backtest pipeline
```

Args:
 backtest: To compute backtest results

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```

stocks: Where securities returns can be retrieved from (e.g. CRSP)
holdings: dict (key int date) of Series holdings (key permno)
label: Label of signal to backtest
benchnames: Names of benchmarks to attribute portfolio performance
overlap: Number of overlapping holdings to smooth
num: Figure num to plot to

>Returns:
    DataFrame of performance returns in rows

>Notes:
    graph and summary statistics are output to jpg and (appended) html
    backtest object updated with performance and attribution data
"""

summary = backtest(stocks, holdings, label, overlap=overlap)
excess = backtest.fit(benchnames)
backtest.write(label)
backtest.plot(num=num, label=label + suffix)
if VERBOSE:
    print(pd.Series(backtest.annualized, name=label + suffix) \
          .to_frame().T.round(3).to_string())
if outdir:
    # performance metrics from backtest to output
    sub = ['alpha', 'excess', 'appraisal', 'sharpe', 'welch-t', 'welch-p']
    with open(outdir / 'index.html', 'at') as f:
        f.write(f"<p><hr><h2>{label + suffix}</h2>\n<pre>\n")
        f.write(f"{{}-{} {}}\n".format(min(backtest.excess.index),
                                       max(backtest.excess.index),
                                       benchnames))
        f.write(f"{{:12s}}\n".format("Annualized"))
        f.write(f"{{:12s}}\n".format("".join(f"{{k:>10s}}" for k in sub) + "\n"))
        f.write(f"{{:12s}}\n".format(label + ":"))
        f.write(f"{{:12s}}\n".format("".join(f"{{backtest.annualized[k]:10.4f}}" for k in sub)))
        f.write(f"\n</pre><p>{{datetime.now()}}\n")
    return summary

```

6.1.3 Past prices

Momentum and divyld from CRSP monthly

```

beg, end = 19251231, LAST_DATE
intervals = {'mom12m': (2, 12),
             'mom36m': (13, 36),
             'mom6m': (2, 6),
             'mom1m': (1, 1)}
for label, past in tqdm(intervals.items(), total=len(intervals)):
    out = []
    rebaldates = bd.date_range(bd.endmo(beg, past[1]), end, 'endmo')
    for rebaldate in rebaldates:
        start = bd.endmo(rebaldate, -past[1])
        beg1 = bd.offset(start, 1)
        end1 = bd.endmo(rebaldate, 1-past[0])
        df = crsp.get_universe(end1)
        df['start'] = monthly.get_section(dataset='monthly',

```

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```

        fields=['ret'],
        date_field='date',
        date=start).reindex(df.index)
df[label] = monthly.get_ret(beg1, end1).reindex(df.index)
df['permno'] = df.index
df['rebaldate'] = rebaldate
df = df.dropna(subset=['start'])
out.append(df[['rebaldate', 'permno', label]]) # append rows
out = pd.concat(out, axis=0, ignore_index=True)
n = signals.write(out, label, overwrite=True)

beg, end = 19270101, LAST_DATE
columns = ['chmom', 'divyld', 'indmom']
out = []
for rebaldate in bd.date_range(beg, end, 'endmo'):
    start = bd.endmo(rebaldate, -12)
    beg1 = bd.offset(start, 1)
    end1 = bd.endmo(rebaldate, -6)
    beg2 = bd.offset(end1, 1)
    end2 = bd.endmo(rebaldate)
    df = crsp.get_universe(end1)
    df['start'] = monthly.get_section(dataset='monthly',
                                       fields=['ret'],
                                       date_field='date',
                                       date=start).reindex(df.index)
    df['end2'] = monthly.get_section(dataset='monthly',
                                       fields=['ret'],
                                       date_field='date',
                                       date=end2).reindex(df.index)
    df['mom2'] = monthly.get_ret(beg2, end2).reindex(df.index)
    df['mom1'] = monthly.get_ret(beg1, end1).reindex(df.index)
    df['divyld'] = crsp.get_divamt(beg1, end2) \
        .reindex(df.index) ['divamt'] \
        .div(df['cap']) \
        .fillna(0)
    df['chmom'] = df['mom1'] - df['mom2']

    # 6-month two-digit sic industry momentum (group means of 'mom1')
    df['sic2'] = df['siccd'] // 100
    df = df.join(DataFrame(df.groupby(['sic2']) ['mom1'].mean()) \
        .rename(columns={'mom1': 'indmom'}), \
        on='sic2', how='left')
    df['permno'] = df.index
    df['rebaldate'] = rebaldate
    out.append(df.dropna(subset=['start', 'end2']) \
        [['rebaldate', 'permno'] + columns])
out = pd.concat(out, axis=0, ignore_index=True)
for label in columns: # save signal values to sql
    n = signals.write(out, label, overwrite=True)

```

100% |██████████| 4/4 [3:09:36<00:00, 2844.01s/it]

```

benchnames = ['Mkt-RF(mo)']
rebalbeg, rebalend = 19260101, LAST_DATE
columns = ['mom12m', 'mom6m', 'chmom', 'indmom', 'divyld', 'mom1m', 'mom36m']

```

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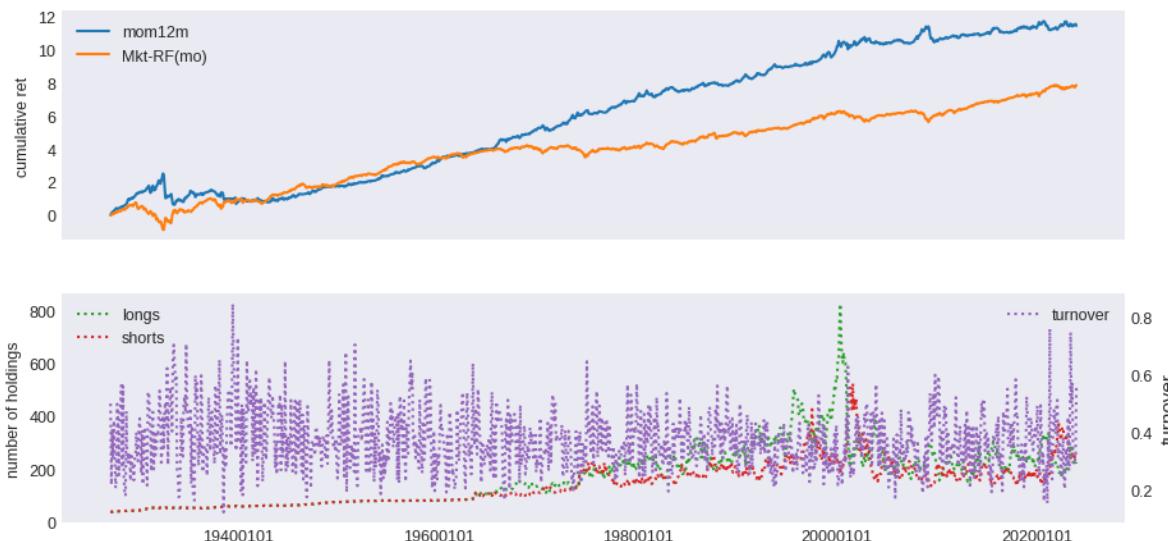
(continued from previous page)

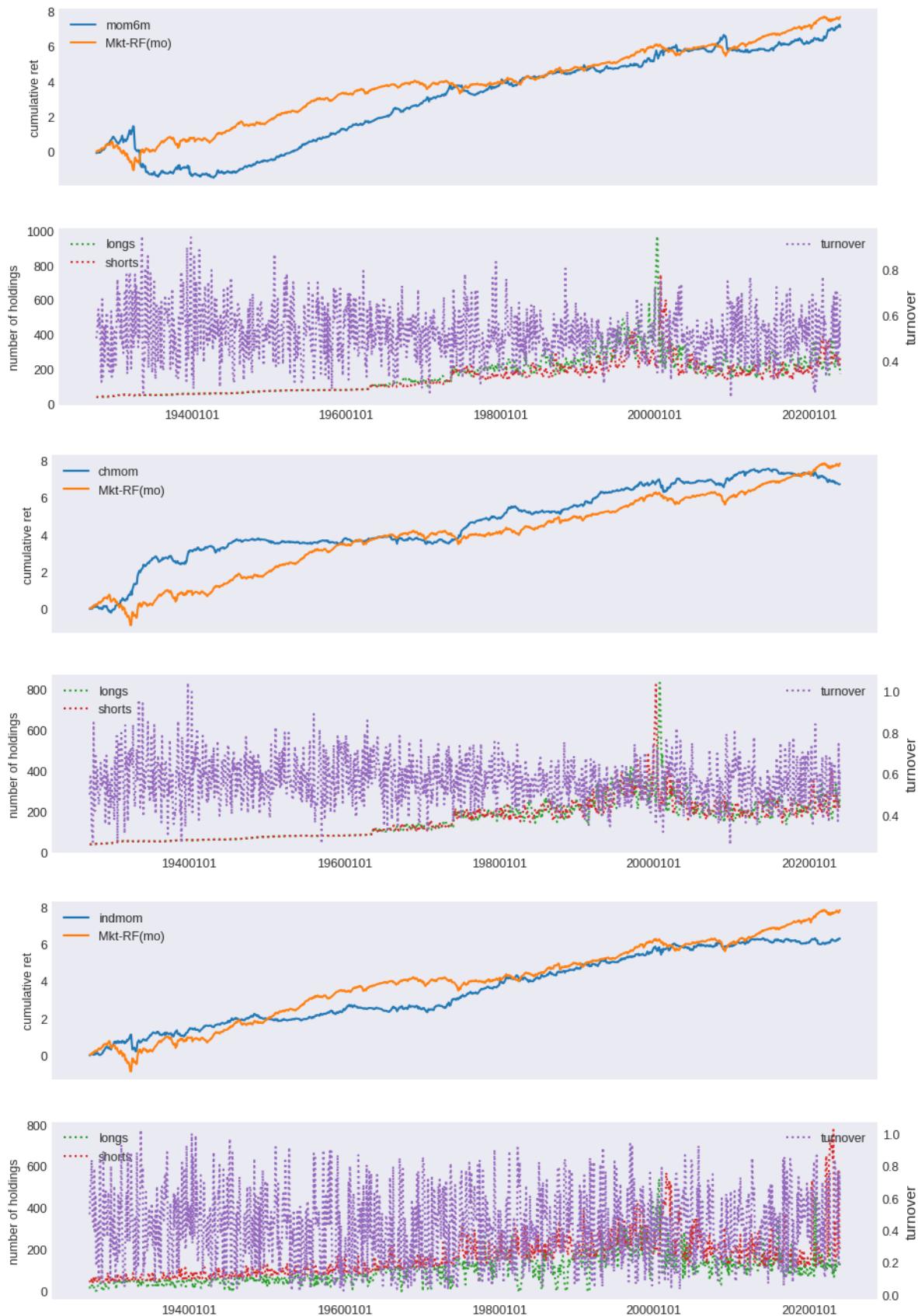
```

for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=1,
                                 months=[],
                                 maxdecile=8,
                                 minprc=1.0,
                                 pct=(10.0, 90.0),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix=(leverage.get(label, 1) < 0) * '(-)')

```

100% |██████████| 7/7 [55:16<00:00, 473.81s/it]







```

# helper to calculate beta, idiovolt and price delay from weekly returns
def regress(x: np.array, y: np.array) -> Tuple[float, float, float]:
    """helper method to calculate beta, idiovolt and price delay

    Args:
        x: equal-weighted market returns (in ascending time order)
        y: stock returns (in ascending time order). NaN's will be discarded.

    Returns:
        beta: slope from regression on market returns and intercept
        idiovolt: mean squared error of residuals
        pricedelay: increase of adjusted R2 with four market lags over without
    """
    v = np.logical_not(np.isnan(y))
    y = y[v]
    x = x[v]
    n0 = len(y)
    A0 = np.vstack([x, np.ones(len(y))]).T
    b0 = np.linalg.inv(A0.T.dot(A0)).dot(A0.T.dot(y))    # univariate coeffs
    sse0 = np.mean((y - A0.dot(b0))**2)
    sst0 = np.mean((y - np.mean(y))**2)
    if (sst0>0 and sse0>0):
        R0 = (1 - ((sse0 / (n0 - 2)) / (sst0 / (n0 - 1))))
    else:
        R0 = 0
    y4 = y[4:]
    n4 = len(y4)
    A4 = np.vstack([x[0:-4], x[1:-3], x[2:-2], x[3:-1], x[4:], np.ones(n4)]).T
    b4 = np.linalg.inv(A4.T.dot(A4)).dot(A4.T.dot(y4))    # four lagged coeffs
    sse4 = np.mean((y4 - A4.dot(b4))**2)
    sst4 = np.mean((y4 - np.mean(y4))**2)
    if sst4 > 0 and sse4 > 0:
        R4 = (1 - ((sse4 / (n4 - 6)) / (sst4 / (n4 - 1))))
    else:
        R4 = 0
    return [b0[0],
            sse0 or np.nan,
            (1 - (R0 / R4)) if R0>0 and R4>0 else np.nan]

```

Weekly price responses

```

beg, end = 19260101, LAST_DATE
columns = ['beta', 'idiovolt', 'pricedelay']
wd = BusDay(sql, endweek='Wed')  # custom weekly trading day calendar

```

Last FamaFrench Date 2024-02-29 00:00:00

```

width      = 3*52+1          # up to 3 years of weekly returns
mininvalid = 52              # at least 52 weeks required to compute beta
weekly     = DataFrame()      # rolling window of weekly stock returns
mkt       = DataFrame()      # to queue equal-weighted market returns
out       = []                # to accumulate final calculations

```

```

for date in tqdm(wd.date_range(beg, end, 'weekly')):
    df = crsp.get_ret(wd.begwk(date), date)
    mkt = as_rolling(mkt,          # rolling window of weekly mkt returns
                     DataFrame(data=[df.mean()], columns=[date]),
                     width=width)
    weekly = as_rolling(weekly,    # rolling window of weekly stock returns
                        df.rename(date),
                        width=width)
    valid = weekly.count(axis=1) >= minvalid # require min number weeks
    if valid.any():
        result = DataFrame([regress(mkt.values[0], y)
                            for y in weekly.loc[valid].values],
                            columns=columns)
        result['permno'] = weekly.index[valid].values
        result['rebaldate'] = date
        if wd.ismonthend(date): # signal value from last week of month
            out.append(result)
out = pd.concat(out, axis=0, ignore_index=True)
for label in columns:
    signals.write(out, label, overwrite=True)

```

0% | 0/5113 [00:00<?, ?it/s]

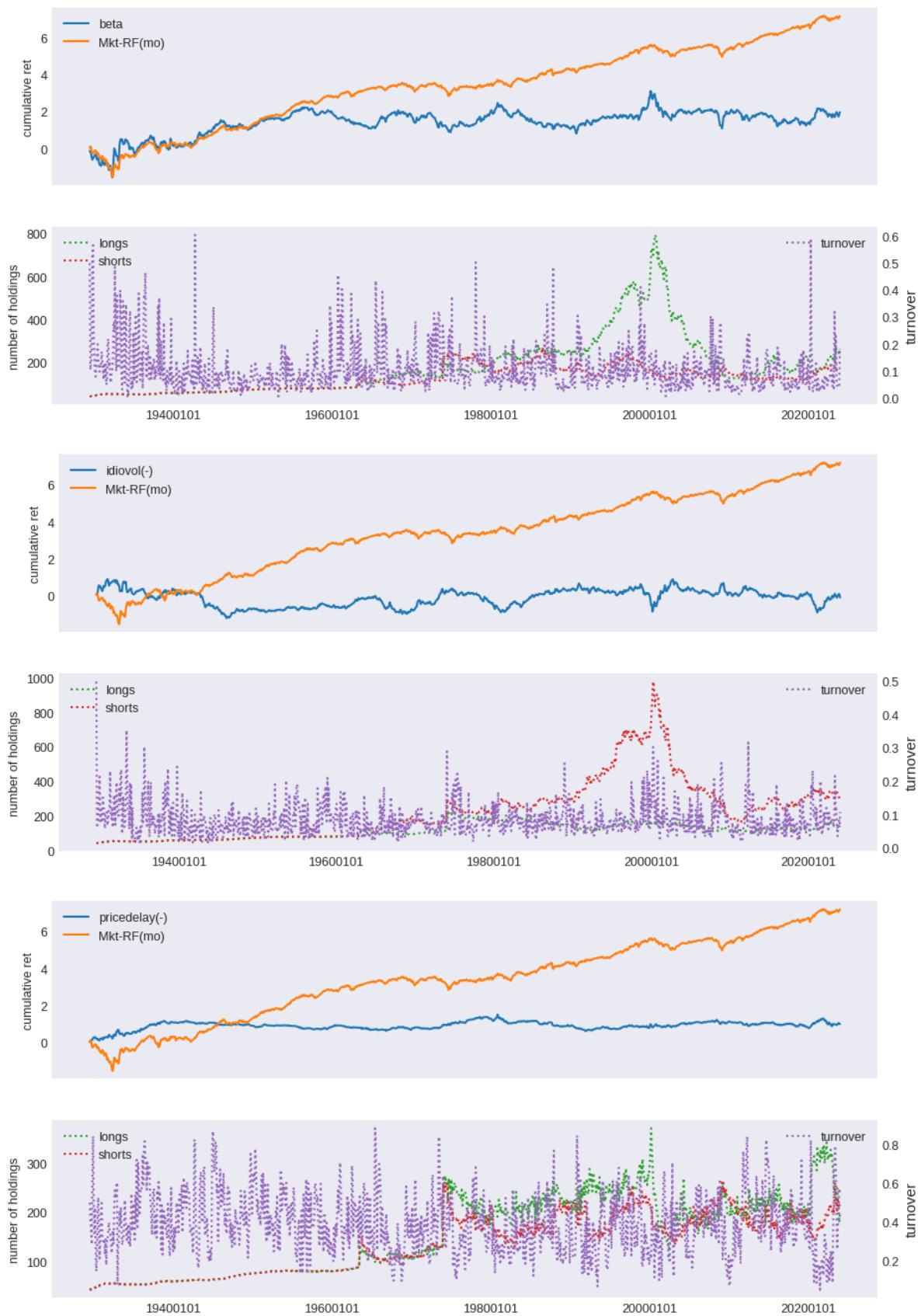
100% |██████████| 5113/5113 [33:48<00:00, 2.52it/s]

```

benchnames = ['Mkt-RF(mo)']
rebalbeg, rebalend = 19290601, LAST_DATE
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=1,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix=(leverage.get(label, 1) < 0) * '(-)')

```

100% |██████████| 3/3 [16:04<00:00, 321.61s/it]



6.1.4 Liquidity

Liquidity signals from daily stock returns

```

beg, end = 19830601, LAST_DATE      # nasdaq/volume from after 1982
columns = ['ill', 'maxret', 'retvol', 'baspread', 'std_dolvol',
           'zerotrade', 'std_turn', 'turn']

out = []
dolvol = []
turn = DataFrame()      # to average turn signal over rolling 3-months
dt = bd.date_range(bd.begmo(beg,-3), end, 'endmo') # monthly rebalances
chunksize = 12          # each chunk is 12 months (1 year)
chunks = [dt[i:(i+chunksize)] for i in range(0, len(dt), chunksize)]
for chunk in tqdm(chunks):
    q = (f"SELECT permno, date, ret, askhi, bidlo, prc, vol, shroud "
          f" FROM {crsp['daily'].key}"
          f" WHERE date>={bd.begmo(chunk[0])}"
          f" AND date<={chunk[-1]})           # retrieve a chunk
    f = crsp.sql.read_dataframe(q).sort_values(['permno', 'date'])
    f['baspread'] = ((f['askhi'] - f['bidlo']) / ((f['askhi'] + f['bidlo']) / 2))
    f['dolvol'] = f['prc'].abs() * f['vol']
    f['turn1'] = f['vol'] / f['shroud']
    f.loc[f['dolvol']>0, 'ldv'] = np.log(f.loc[f['dolvol']>0, 'dolvol'])
    f['ill'] = 1000000 * f['ret'].abs() / f['dolvol']

    for rebaldate in chunk:           # for each rebaldate in the chunk
        grouped = f[f['date'].ge(bd.begmo(rebaldate))
                     & f['date'].le(rebaldate)].groupby('permno')
        df = grouped[['ret']].max().rename(columns={'ret': 'maxret'})
        df['retvol'] = grouped['ret'].std()
        df['baspread'] = grouped['baspread'].mean()
        df['std_dolvol'] = grouped['ldv'].std()
        df['ill'] = grouped['ill'].mean()
        dv = grouped['dolvol'].sum()
        df.loc[dv > 0, 'dolvol'] = np.log(dv[dv > 0])
        df['turn1'] = grouped['turn1'].sum()
        df['std_turn'] = grouped['turn1'].std()
        df['countzero'] = grouped['vol'].apply(lambda v: sum(v==0))
        df['ndays'] = grouped['prc'].count()

        turn = as_rolling(turn, df[['turn1']], width=3)
        df['turn'] = turn.reindex(df.index).mean(axis=1, skipna=False)
        df.loc[df['turn1'].le(0), 'turn1'] = 0
        df.loc[df['ndays'].le(0), 'ndays'] = 0
        df['zerotrade'] = ((df['countzero'] + ((1/df['turn1'])/480000))
                           * 21/df['ndays'])

        df['rebaldate'] = rebaldate
        df = df.reset_index()
        out.append(df[['permno', 'rebaldate'] + columns])
    if rebaldate < bd.endmo(end):
        df['rebaldate'] = bd.endmo(rebaldate, 1)
        dolvol.append(df[['permno', 'rebaldate', 'dolvol']])
out = pd.concat(out, axis=0, ignore_index=True)
dolvol = pd.concat(dolvol, axis=0, ignore_index=True)

```

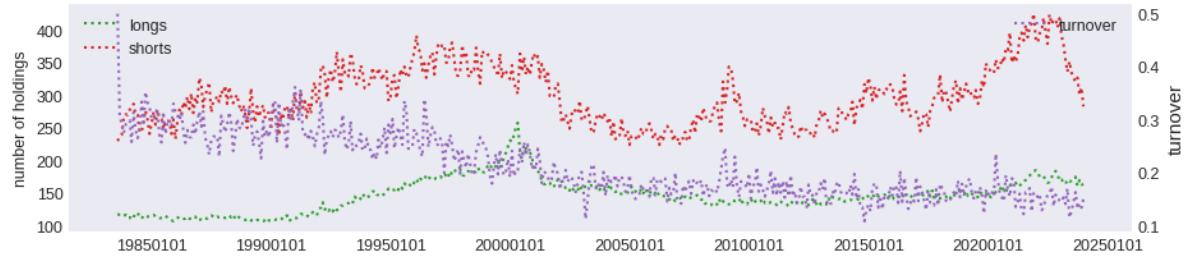
0% | 0/41 [00:00<?, ?it/s]

100% | ██████████ | 41/41 [26:09<00:00, 38.28s/it]

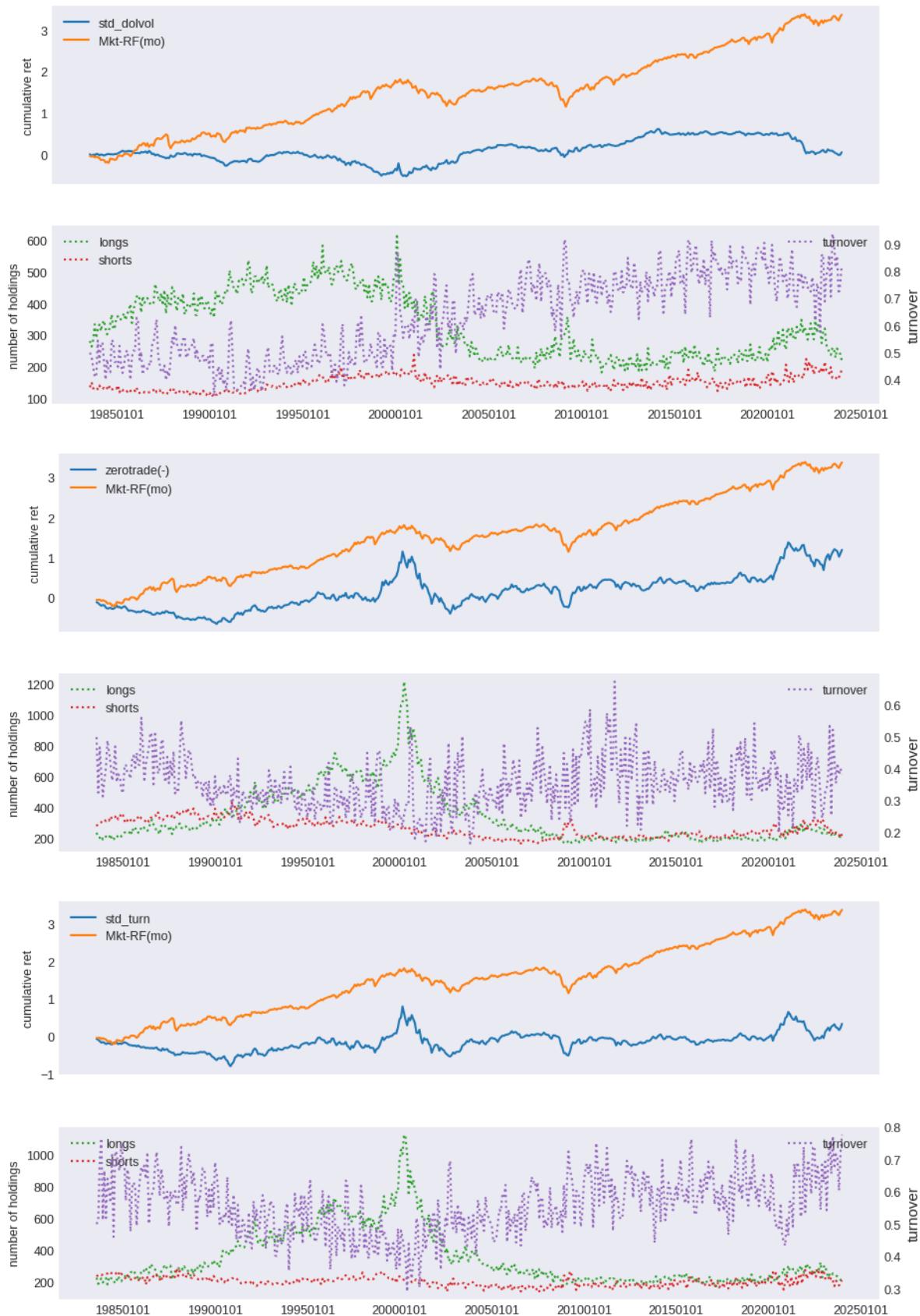
```
for label in columns:
    n = signals.write(out, label, overwrite=True)
    n = signals.write(dolvol, 'dolvol', overwrite=True)
```

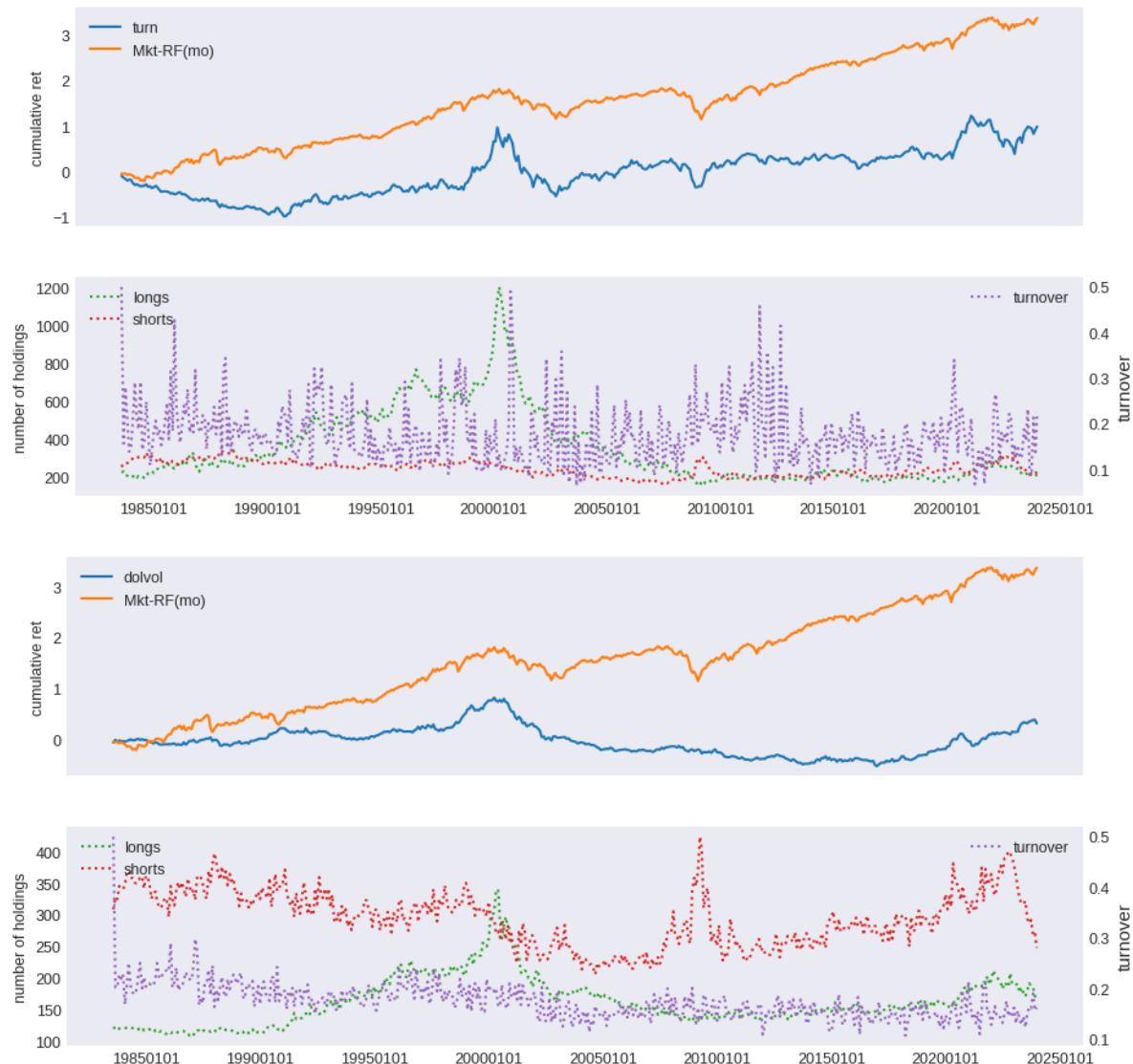
```
rebalbeg, rebalend = 19830601, LAST_DATE
benchnames = ['Mkt-RF(mo)']
for label in tqdm(columns + ['dolvol']):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=1,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix=(leverage.get(label, 1) < 0) * '(-)')
```

100% | ██████████ | 9/9 [59:11<00:00, 394.66s/it]









6.1.5 Fundamentals

Fundamental signals from Compustat Annual

```
columns = ['absacc', 'acc', 'agr', 'bm', 'cashpr', 'cfp', 'chcsho',
           'chinv', 'depr', 'dy', 'egr', 'ep', 'gma', 'grcapx',
           'grltnoa', 'hire', 'invest', 'lev', 'lgr',
           'pchdepr', 'pchgpm_pchsale', 'pchquick',
           'pchsale_pchinv', 'pchsale_pchrect', 'pchsale_pchxsga',
           'pchsaleinv', 'pctacc', 'quick', 'rd_sale', 'rd_mve',
           'realestate', 'salecash', 'salerec', 'saleinv', 'secured',
           'sgr', 'sp', 'tang', 'bm_ia', 'cfp_ia', 'chatoia', 'chpmia',
           'pchcapx_ia', 'chempia', 'mve_ia']
numlag = 6      # number of months to lag data for rebalance
end = LAST_DATE # last data date
```

```

# retrieve annual, keep [permno, datadate] with non null prccq if any
fields = ['sic', 'fyear', 'ib', 'oancf', 'at', 'act', 'che', 'lct',
          'dlc', 'dltt', 'prcc_f', 'csho', 'invt', 'dp', 'ppent',
          'dvt', 'ceq', 'txp', 'revt', 'cogs', 'rect', 'aco', 'intan',
          'ao', 'ap', 'lco', 'lo', 'capx', 'emp', 'ppegt', 'lt',
          'sale', 'xsga', 'xrd', 'fatb', 'fatl', 'dm']
df = pstat.get_linked(dataset='annual',
                      fields=fields,
                      date_field='datadate',
                      where=(f"indfmt = 'INDL' "
                             f" AND datafmt = 'STD' "
                             f" AND curcd = 'USD' "
                             f" AND popsrc = 'D' "
                             f" AND consol = 'C' "
                             f" AND datadate <= {end//100}31"))
fund = df.sort_values(['permno', 'datadate', 'ib']) \
    .drop_duplicates(['permno', 'datadate']) \
    .dropna(subset=['ib'])
fund.index = list(zip(fund['permno'], fund['datadate'])) # multi-index
fund['rebalddate'] = bd.endmo(fund.datadate, numlag)

```

```

# precompute, and lag common metrics: mve_f avg_at sic2
fund['sic2'] = np.where(fund['sic'].notna(), fund['sic'] // 100, 0)
fund['fyear'] = fund['datadate'] // 10000 # can delete this
fund['mve_f'] = fund['prcc_f'] * fund['csho']

```

```

lag = fund.shift(1, fill_value=0)
lag.loc[lag['permno'] != fund['permno'], fields] = np.nan
fund['avg_at'] = (fund['at'] + lag['at']) / 2

```

```

lag2 = fund.shift(2, fill_value=0)
lag2.loc[lag2['permno'] != fund['permno'], fields] = np.nan
lag['avg_at'] = (lag['at'] + lag2['at']) / 2

```

```

fund['bm'] = fund['ceq'] / fund['mve_f']
fund['cashpr'] = (fund['mve_f'] + fund['dltt'] - fund['at']) / fund['che']
fund['depr'] = fund['dp'] / fund['ppent']
fund['dy'] = fund['dvt'] / fund['mve_f']
fund['ep'] = fund['ib'] / fund['mve_f']
fund['lev'] = fund['lt'] / fund['mve_f']
fund['quick'] = (fund['act'] - fund['invt']) / fund['lct']
fund['rd_sale'] = fund['xrd'] / fund['sale']
fund['rd_mve'] = fund['xrd'] / fund['mve_f']
fund['realestate'] = ((fund['fatb'] + fund['fatl']) /
                      np.where(fund['ppegt'].notna(),
                               fund['ppegt'], fund['ppent']))
fund['salecash'] = fund['sale'] / fund['che']
fund['salerec'] = fund['sale'] / fund['rect']
fund['saleinv'] = fund['sale'] / fund['invt']
fund['secured'] = fund['dm'] / fund['dltt']
fund['sp'] = fund['sale'] / fund['mve_f']
fund['tang'] = (fund['che'] + fund['rect'] * 0.715 + fund['invt'] * 0.547
                + fund['ppent'] * 0.535) / fund['at']

```

```

# changes: agr chcsho chinv egr gma egr grcapx grltnoa emp invest lgr
fund['agr'] = (fund['at'] / lag['at'])
fund['chcsho'] = (fund['csho'] / lag['csho'])
fund['chinv'] = ((fund['invt'] - lag['invt']) / fund['avg_at'])
fund['egr'] = (fund['ceq'] / lag['ceq'])
fund['gma'] = ((fund['revt'] - fund['cogs']) / lag['at'])
fund['grcapx'] = (fund['capx'] / lag2['capx'])
fund['grltnoa'] = (((fund['rect']
                     + fund['invt']
                     + fund['ppent']
                     + fund['aco']
                     + fund['intan']
                     + fund['ao']
                     - fund['ap']
                     - fund['lco']
                     - fund['lo'])
                     / (lag['rect']
                         + lag['invt']
                         + lag['ppent']
                         + lag['aco']
                         + lag['intan']
                         + lag['ao']
                         - lag['ap']
                         - lag['lco']
                         - lag['lo']))
                     - ((fund['rect']
                         + fund['invt']
                         + fund['aco']
                         - fund['ap']
                         - fund['lco'])
                         - (lag['rect']
                             + lag['invt']
                             + lag['aco']
                             - lag['ap']
                             - lag['lco'])))
                     - ((fund['rect']
                         + fund['invt']
                         + fund['aco']
                         - fund['ap']
                         - fund['lco'])
                         - (lag['rect']
                             + lag['invt']
                             + lag['aco']
                             - lag['ap']
                             - lag['lco'])))) / fund['avg_at']
fund['hire'] = ((fund['emp'] / lag['emp']) - 1).fillna(0)
fund['invest'] = (((fund['ppegt'] - lag['ppegt'])
                  + (fund['invt'] - lag['invt'])) / lag['at'])
fund['invest'] = fund['invest'].where(fund['invest'].notna(),
                                       ((fund['ppent'] - lag['ppent'])
                                       + (fund['invt'] - lag['invt'])) / lag['at'])
fund['lgr'] = (fund['lt'] / lag['lt'])
fund['pchdepr'] = ((fund['dp'] / fund['ppent']) / (lag['dp'] / lag['ppent']))
fund['pchgmpchsale'] = (((fund['sale'] - fund['cogs']) / (lag['sale'] - lag['cogs']))
                           - (fund['sale'] / lag['sale']))
fund['pchquick'] = (((fund['act'] - fund['invt']) / fund['lct'])
                     / ((lag['act'] - lag['invt']) / lag['lct']))
fund['pchsaled_pchinvt'] = ((fund['sale'] / lag['sale']) - (fund['invt'] / lag['invt']))
fund['pchsaled_pcchrect'] = ((fund['sale'] / lag['sale']) - (fund['rect'] / lag['rect']))
fund['pchsaled_pchxsga'] = ((fund['sale'] / lag['sale']) - (fund['xsga'] / lag['xsga']))
fund['pchsaledinv'] = ((fund['sale'] / fund['invt']) / (lag['sale'] / lag['invt']))
fund['sgr'] = (fund['sale'] / lag['sale'])

```

```

fund['chato'] = ((fund['sale'] / fund['avg_at']) - (lag['sale'] / lag['avg_at']))
fund['chpm'] = (fund['ib'] / fund['sale']) - (lag['ib'] / lag['sale'])
fund['pchcapx'] = fund['capx'] / lag['capx']

```

```

# compute signals with alternative definitions: acc absacc cfp
fund['_acc'] = (((fund['act'] - lag['act']) - (fund['che'] - lag['che']))
                 - ((fund['lct'] - lag['lct']) - (fund['dlc'] - lag['dlc']))
                 - (fund['txp'] - lag['txp']) - fund['dp']))
fund['cfp'] = ((fund['ib'] - (((fund['act'] - lag['act']) - (fund['che'] - lag['che'])
                                - ((fund['lct'] - lag['lct'])
                                - (fund['dlc'] - lag['dlc'])
                                - (fund['txp'] - lag['txp']))
                                - fund['dp']))) / fund['mve_f']))
g = fund['oancf'].notnull()
fund.loc[g, 'cfp'] = fund.loc[g, 'oancf'] / fund.loc[g, 'mve_f']
fund.loc[g, '_acc'] = fund.loc[g, 'ib'] - fund.loc[g, 'oancf']
fund['acc'] = fund['_acc'] / fund['avg_at']
fund['absacc'] = abs(fund['_acc']) / fund['avg_at']
fund['pctacc'] = fund['_acc'] / abs(fund['ib'])
h = (fund['ib'].abs() <= 0.01)
fund.loc[h, 'pctacc'] = fund.loc[h, '_acc'] / 0.01

```

```

# industry-adjusted
cols = {'bm_ia': 'bm', 'cfp_ia': 'cfp', 'chatoia': 'chato',
        'chpmia': 'chpm', 'pchcapx_ia': 'pchcapx',
        'chempia': 'hire', 'mve_ia': 'mve_f'}
group = fund.groupby(['sic2', 'fyear'])
for k,v in cols.items():
    fund[k] = fund[v] - group[v].transform('mean')

```

```

for label in columns:
    signals.write(fund, label, overwrite=True)

```

```

rebalbeg, rebalend = 19700101, LAST_DATE
benchnames = ['Mkt-RF(mo)'] #['Mom'] #['ST_Rev(mo)'] #
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=12,
                                 months=[6],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,

```

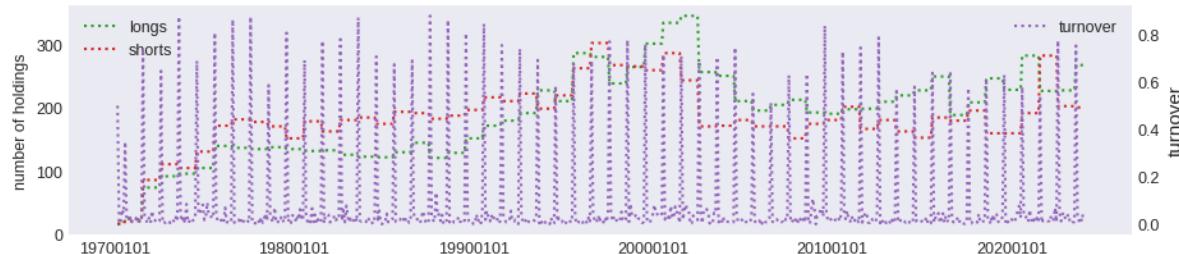
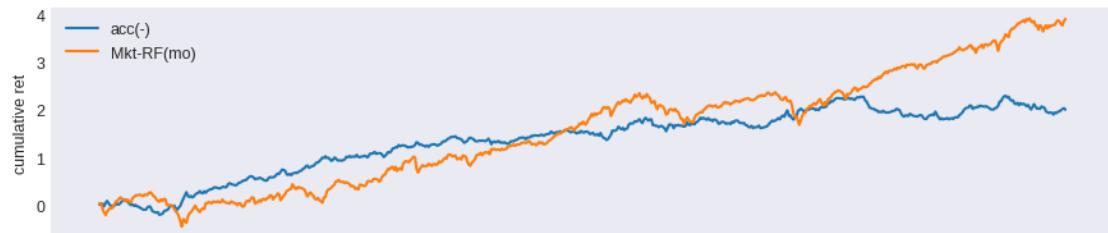
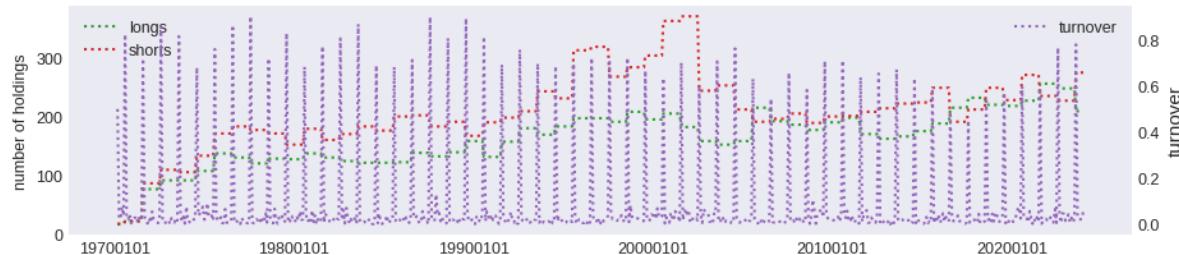
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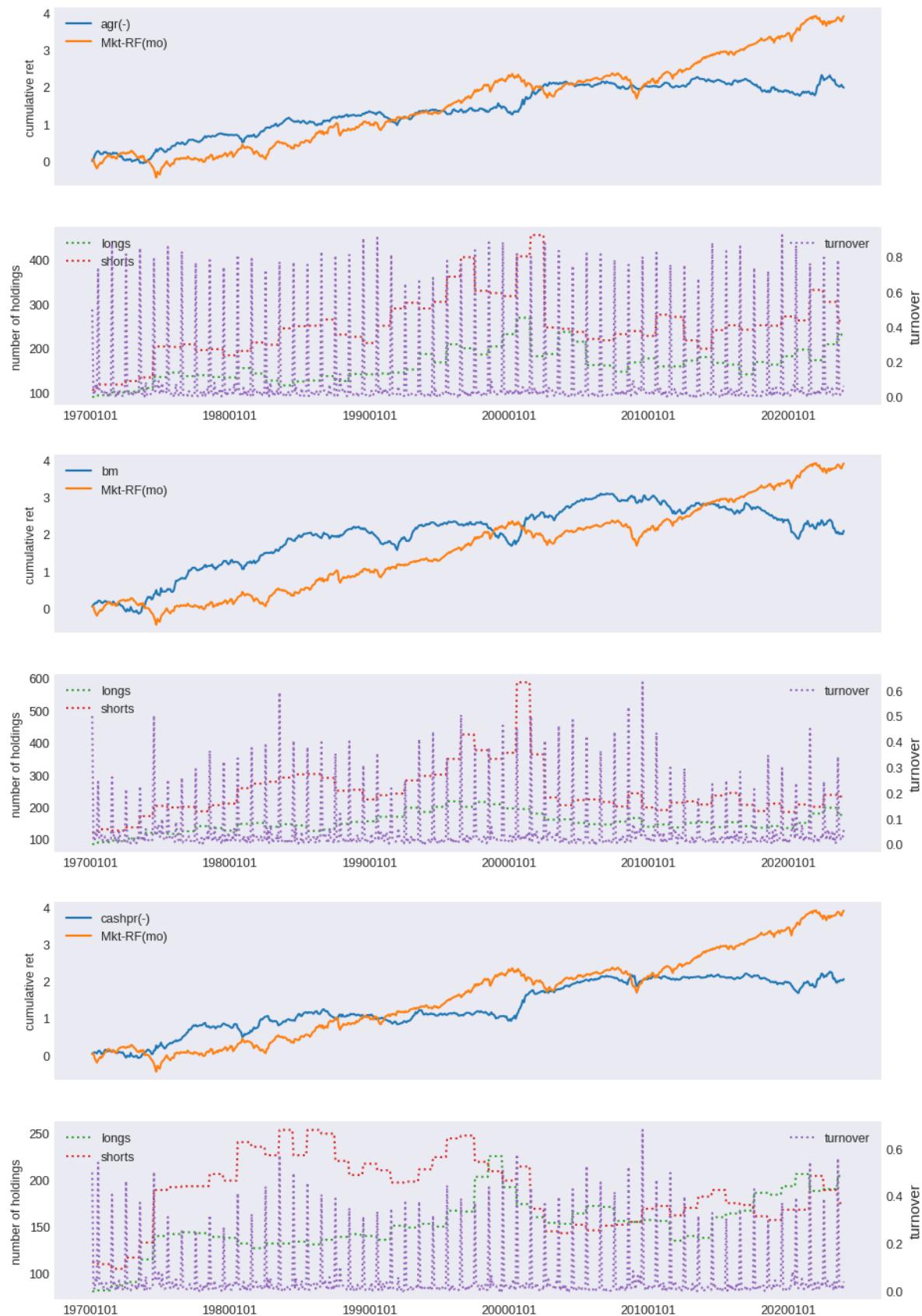
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```
suffix=(leverage.get(label, 1) < 0) * '(-)'
```

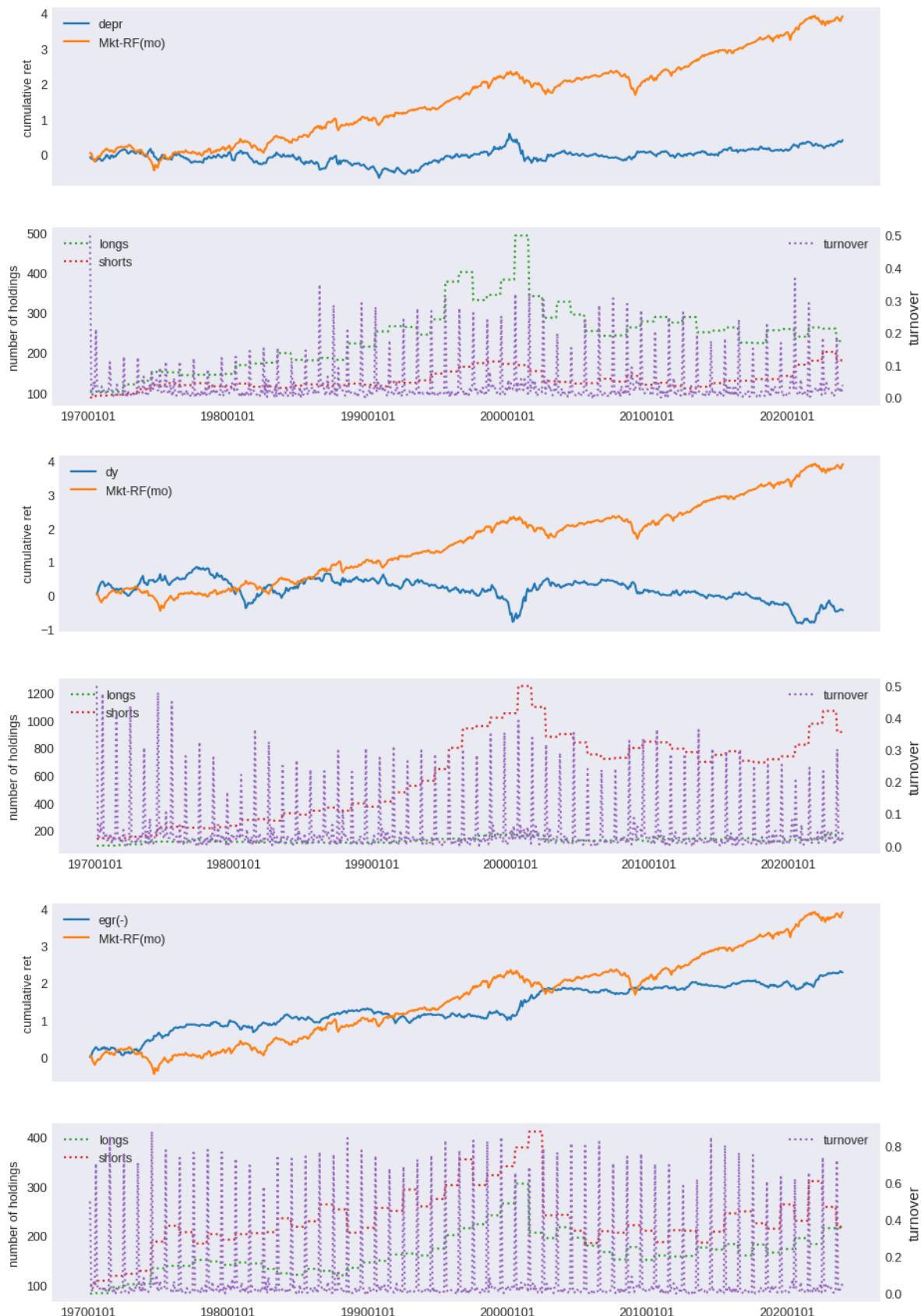
```
44%|██████████| 20/45 [21:57<27:24, 65.77s/it]/home/terence/Dropbox/github/data-
science-notebooks/finds/backtesting/backtest.py:310: RuntimeWarning: More than
20 figures have been opened. Figures created through the pyplot interface
(`matplotlib.pyplot.figure`) are retained until explicitly closed and may
consume too much memory. (To control this warning, see the rcParam `figure.max_
open_warning`). Consider using `matplotlib.pyplot.close()`.

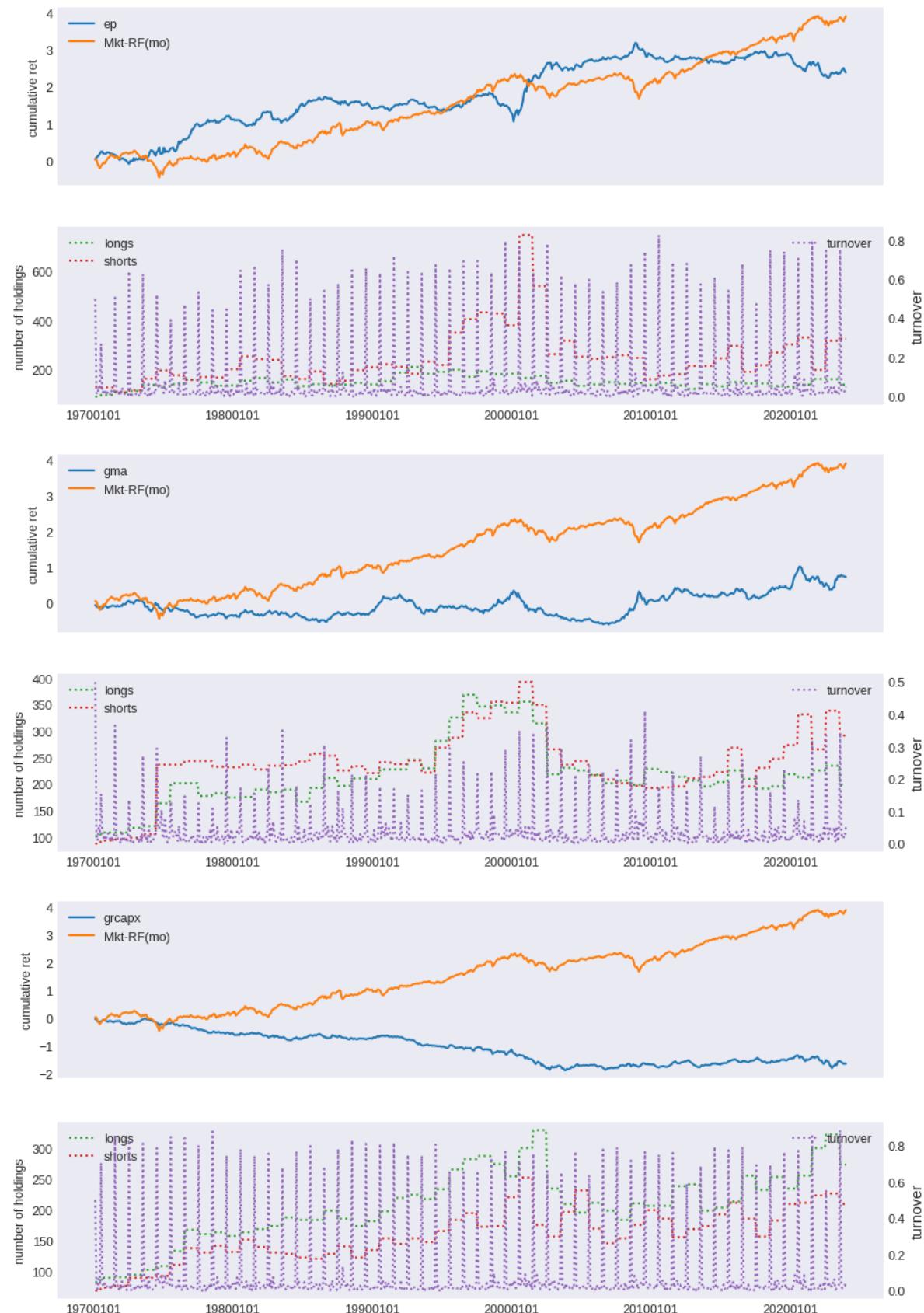
  fig, (ax1, ax2) = plt.subplots(2, 1, sharex=True, clear=True,
100%|██████████| 45/45 [48:40<00:00, 64.89s/it]
```









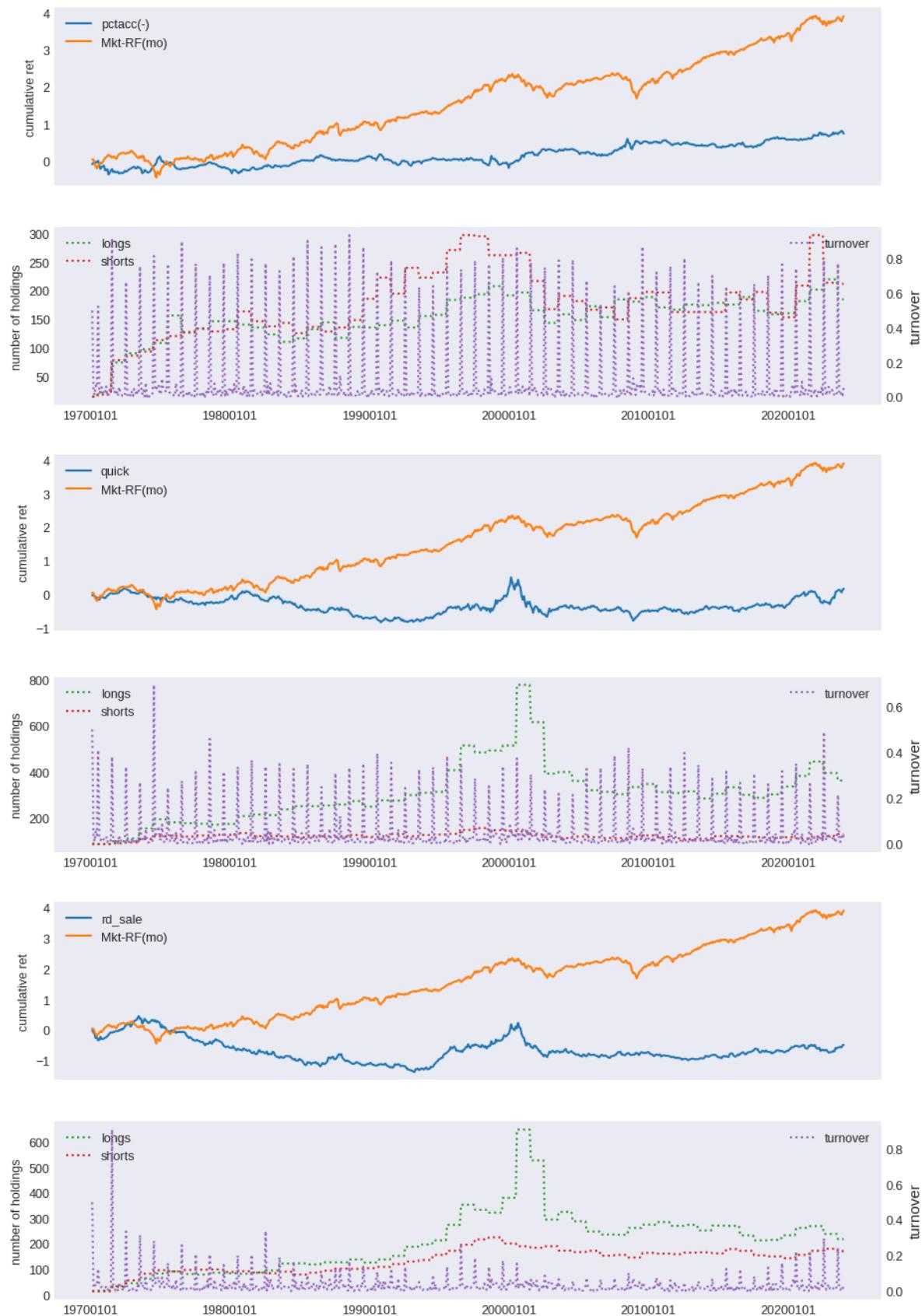


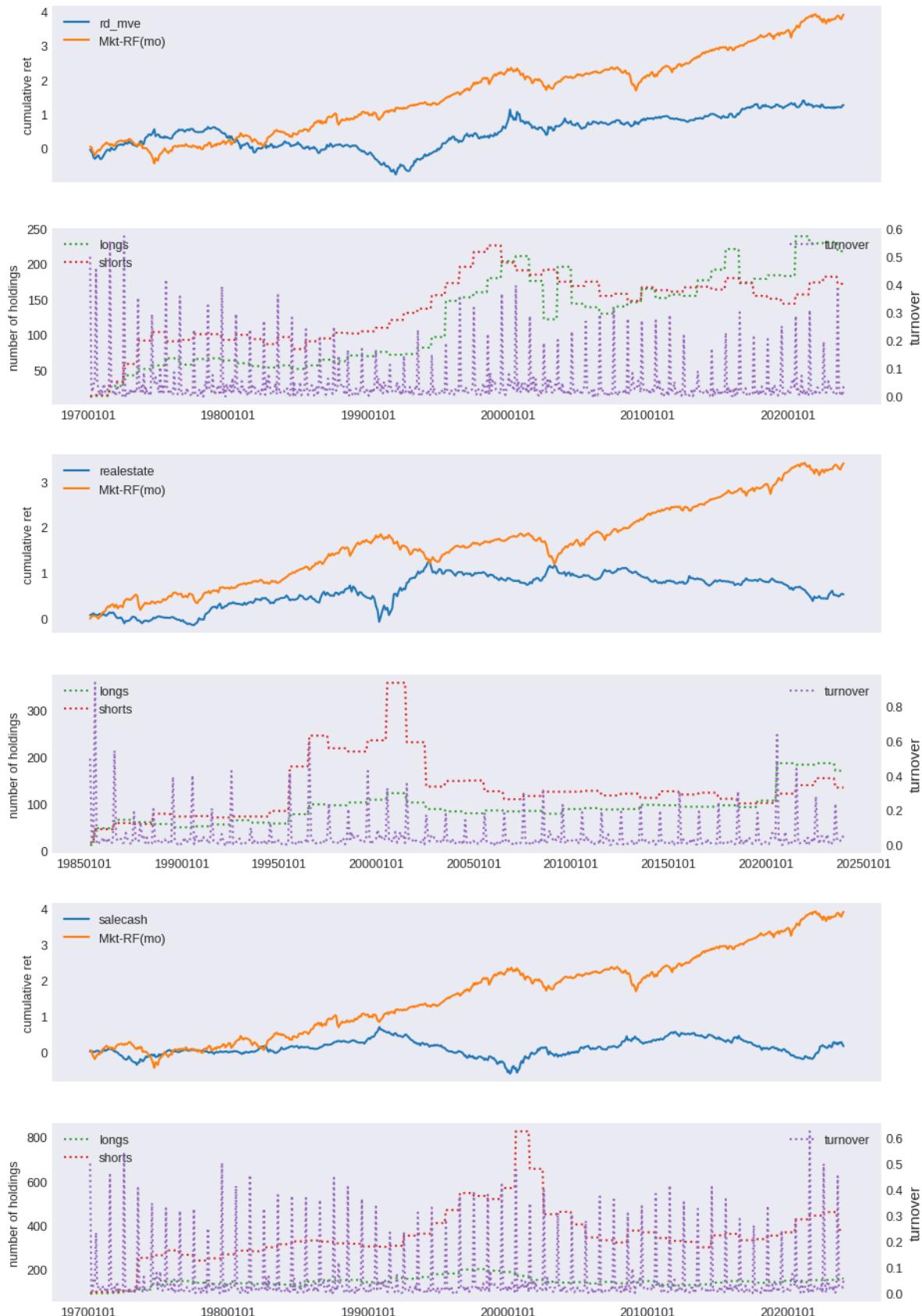




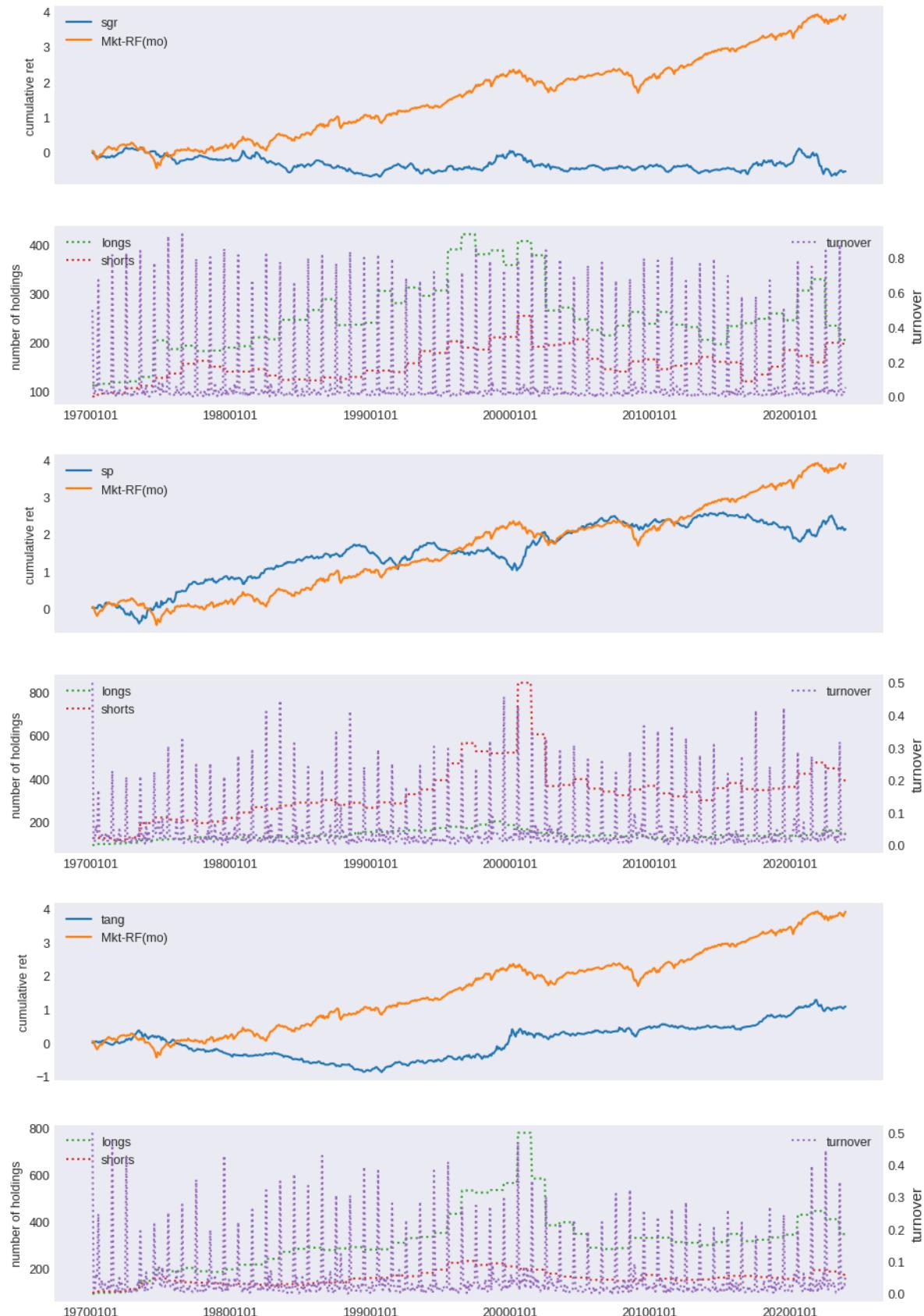


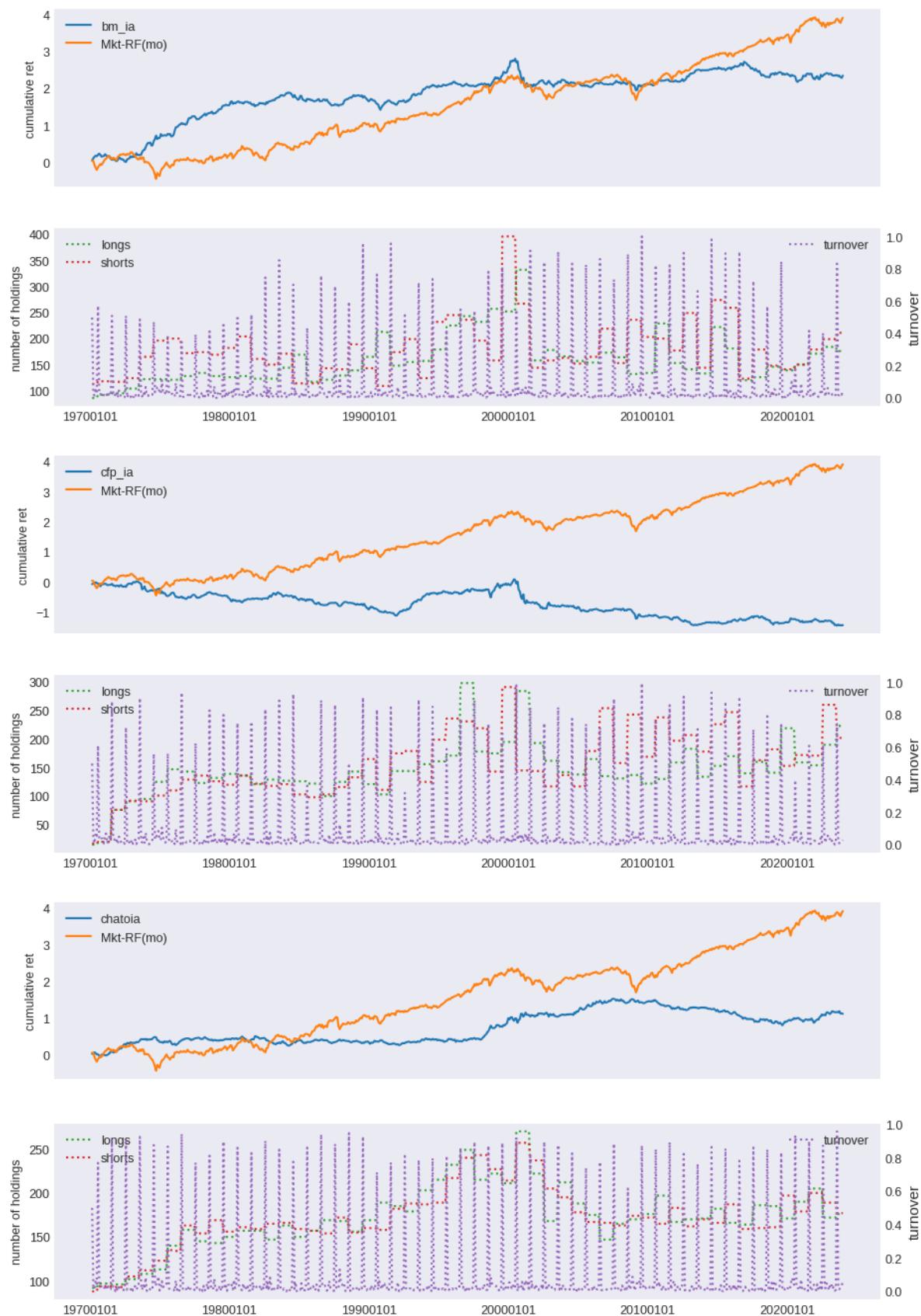


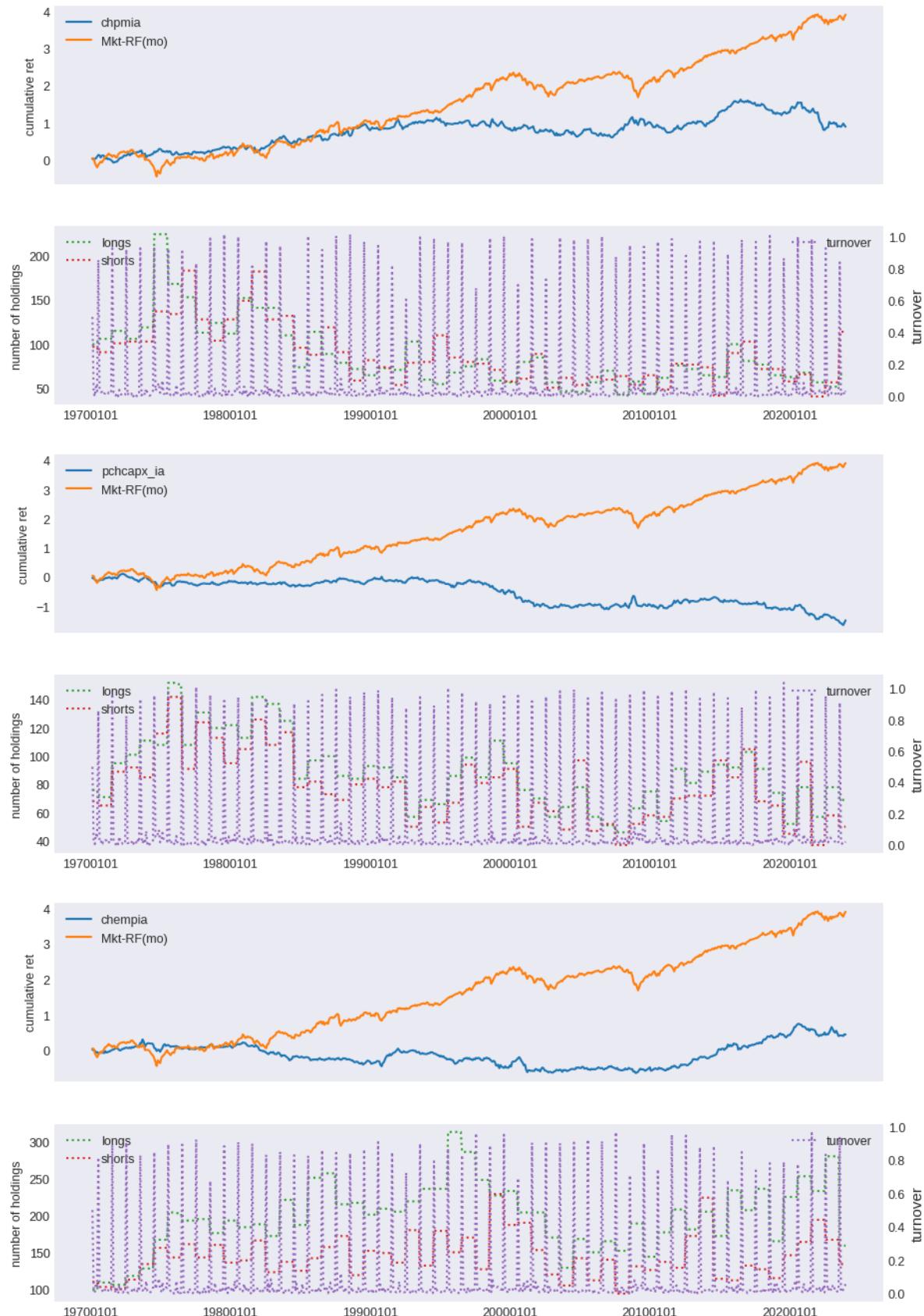


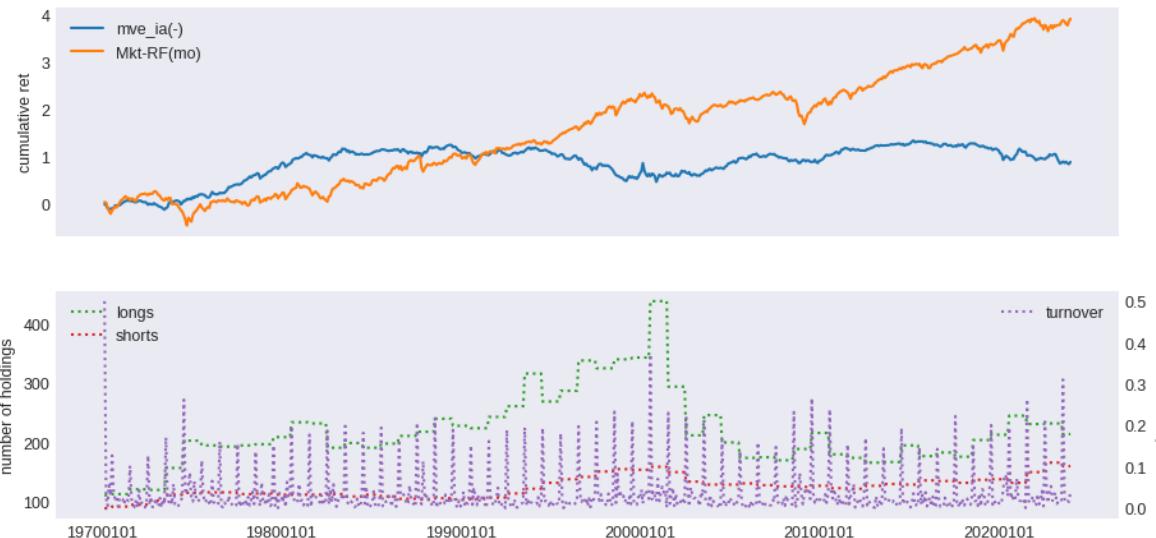












Fundamental signals from Compustat Quarterly

```
columns = ['stdacc', 'stdcf', 'roavol', 'sgrvol', 'cinvest', 'chtx',
           'rsup', 'roaq', 'cash', 'nincr']
numlag = 4      # require 4 month lag of fiscal data
end = LAST_DATE
```

```
# retrieve quarterly, keep [permno, datadate] key with non null prccq
fields = ['ibq', 'actq', 'cheq', 'lctq', 'dlcq', 'saleq', 'prccq',
          'cshoq', 'atq', 'txtq', 'ppentq']
df = pstat.get_linked(dataset='quarterly',
                      fields=fields,
                      date_field='datadate',
                      where=(f"datadate > 0 "
                             f"and datadate <= {end//100}31"))
fund = df.sort_values(['permno', 'datadate', 'ibq'])\n    .drop_duplicates(['permno', 'datadate'])\n    .dropna(subset=['ibq'])
fund.index = list(zip(fund['permno'], fund['datadate']))
rebalddate = bd.endmo(fund.datadate, numlag)
```

```
# compute current and lagged: scf sacc roaq nincr cinvest cash rsup chtx
lag = fund.shift(1, fill_value=0)
lag.loc[lag['permno'] != fund['permno'], fields] = np.nan
fund['_saleq'] = fund['saleq']
fund.loc[fund['_saleq'].lt(0.01), '_saleq'] = 0.01
```

```
fund['sacc'] = (((fund['actq'] - lag['actq']) - (fund['cheq'] - lag['cheq']))
                  - ((fund['lctq'] - lag['lctq'])
                     - (fund['dlcq'] - lag['dlcq']))) / fund['_saleq']
fund['cinvest'] = (fund['ppentq'] - lag['ppentq']) / fund['_saleq']
fund['nincr'] = (fund['ibq'] > lag['ibq']).astype(int)
fund['scf'] = (fund['ibq'] / fund['_saleq']) - fund['sacc']
fund['roaq'] = (fund['ibq'] / lag['atq'])
fund['cash'] = (fund['cheq'] / fund['atq'])
```

```
lag4 = fund.shift(4, fill_value=0)
lag4.loc[lag4['permno'] != fund['permno'], fields] = np.nan
fund['rsup'] = ((fund['saleq'] - lag4['saleq'])
                 / (fund['prccq'].abs() * fund['cshoq'].abs()))
fund['chtx'] = (fund['txtq'] - lag4['txtq']) / lag4['atq']
```

```
# for each var: make dataframe of 15 lags (column names=[0,...,15])
lags = {col : as_lags(fund, var=col, key='permno', nlags=16)
        for col in ['sacc', 'scf', 'roaq', 'rsup', 'cinvest', 'nincr']}
for i in range(1, 16): # lags[ninrc][i]=1 iff ibq
    lags['nincr'][i] *= lags['nincr'][i-1] # increasing all prior qtrs

# compute signals from the 15 lags
fund['rebalddate'] = rebalddate
fund['stdacc'] = lags['sacc'].std(axis=1, skipna=False)
fund['stdcf'] = lags['scf'].std(axis=1, skipna=False)
fund['roavol'] = lags['roaq'].std(axis=1, skipna=False)
fund['sgrvol'] = lags['rsup'].std(axis=1, skipna=False)
fund['cinvest'] = (fund['cinvest'] -
                    lags['cinvest'][[1, 2, 3, 4]].mean(axis=1, skipna=False))

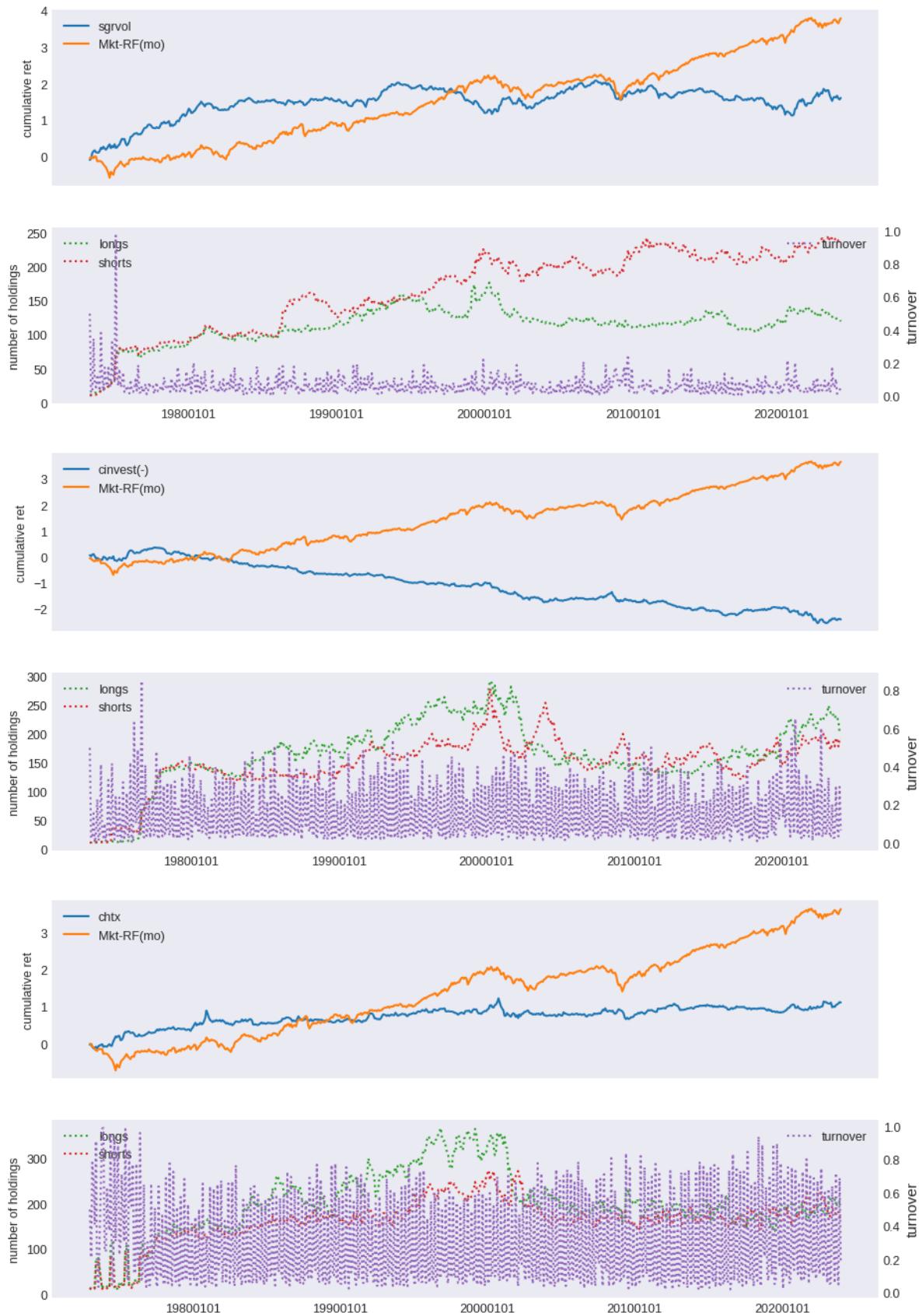
# count number of consecutive increasing quarters
fund['nincr'] = lags['nincr'][np.arange(8)].sum(axis=1)
```

```
for label in columns:
    signals.write(fund, label, overwrite=True)
```

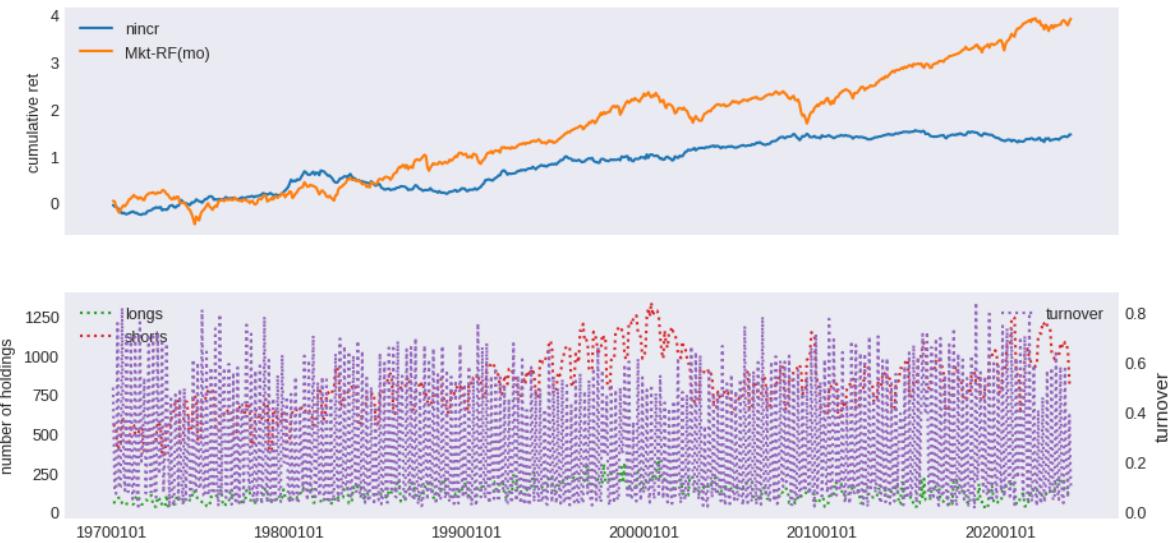
```
rebalbeg, rebalend = 19700101, LAST_DATE
benchnames = ['Mkt-RF (mo)']
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=3,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix='(-)'*(leverage.get(label, 1) < 0))
```

100% |██████████| 10/10 [08:33<00:00, 51.36s/it]









6.1.6 Earnings Estimates

IBES Fiscal Year 1 signals

```
columns = ['chfeps', 'chnanalyst', 'disp']

df = ibes.get_linked(dataset='statsum',
                      fields=['fpedats', 'meanest', 'medest',
                              'stdev', 'numest'],
                      date_field = 'statpers',
                      where=("meanest IS NOT NULL "
                             " AND fpedats IS NOT NULL "
                             " AND statpers IS NOT NULL"
                             " AND fpi = '1'"))
out = df.sort_values(['permno', 'statpers', 'fpedats', 'meanest']) \
    .drop_duplicates(['permno', 'statpers', 'fpedats'])
out['rebaldate'] = bd.endmo(out['statpers'])
```

```
out['disp'] = out['stdev'] / abs(out['meanest'])
out.loc[abs(out['meanest']) < 0, 'disp'] = out['stdev'] / 0.01
```

```
lag1 = out.shift(1, fill_value=0)
f1 = (lag1['permno'] == out['permno'])
out.loc[f1, 'chfeps'] = out.loc[f1, 'meanest'] - lag1.loc[f1, 'meanest']
```

```
lag3 = out.shift(3, fill_value=0)
f3 = (lag3['permno'] == out['permno'])
out.loc[f3, 'chnanalyst'] = out.loc[f3, 'numest'] - lag3.loc[f3, 'numest']
```

```
for label in columns:
    signals.write(out, label, overwrite=True)
```

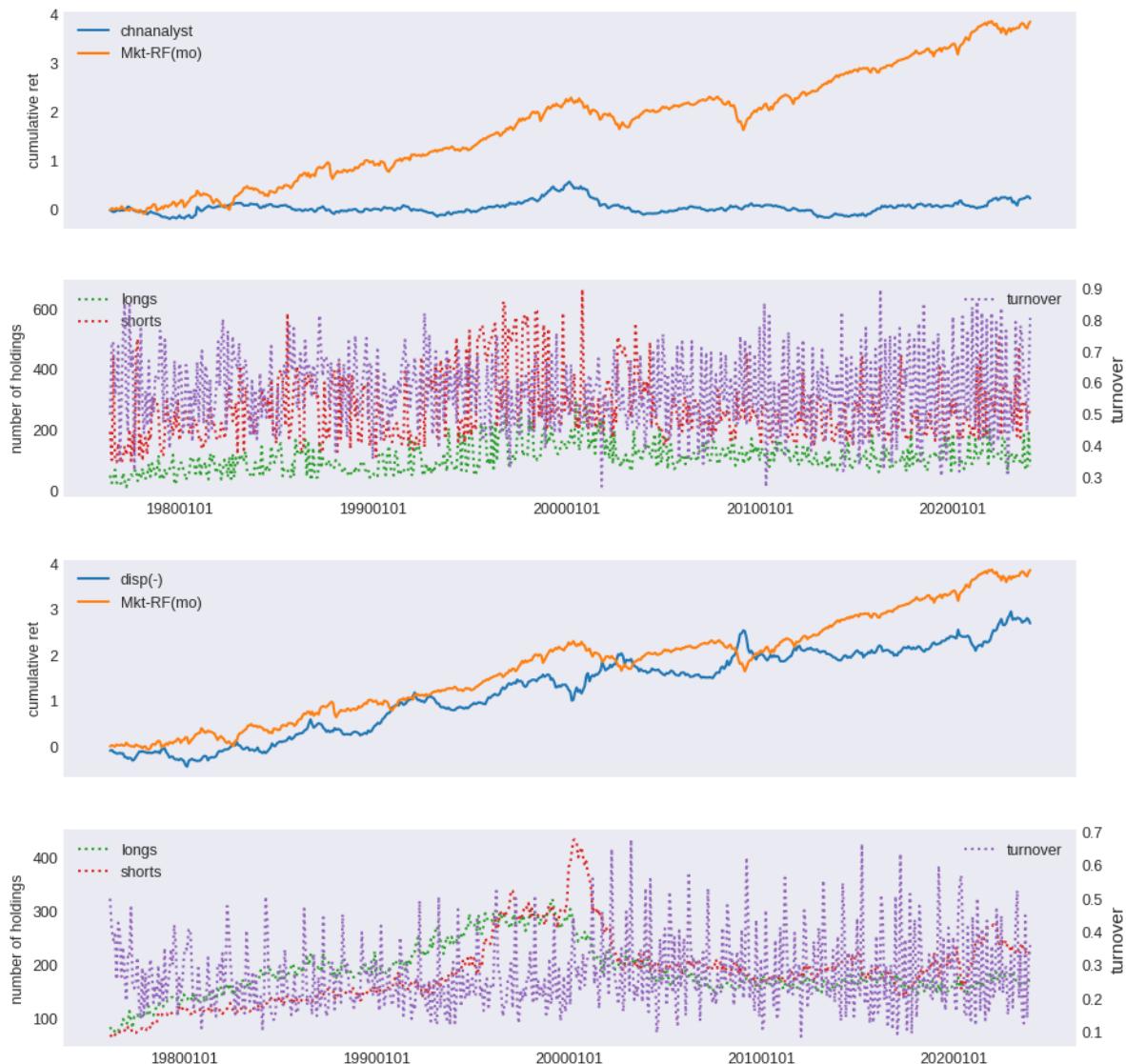
```

rebalbeg, rebalend = 19760101, LAST_DATE
benchnames = ['Mkt-RF(mo)']
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=3,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
excess = backtest_pipeline(backtest,
                           monthly,
                           holdings,
                           label,
                           benchnames,
                           overlap=0,
                           outdir=outdir,
                           suffix=(leverage.get(label, 1) < 0) * '(-)')

```

100% |██████████| 3/3 [02:45<00:00, 55.09s/it]





IBES Long-term Growth signals

```
columns = ['fgr5yr']

df = ibes.get_linked(dataset='statsum',
                     fields = ['meanest'],
                     date_field = 'statpers',
                     where=(("meanest IS NOT NULL "
                            " AND fpi = '0'"
                            " AND statpers IS NOT NULL")))
out = df.sort_values(['permno', 'statpers', 'meanest']) \
    .drop_duplicates(['permno', 'statpers']) \
    .dropna()
out['rebaldate'] = bd.endmo(out['statpers'])
out['fgr5yr'] = out['meanest']
signals.write(out, 'fgr5yr', overwrite=True)
```

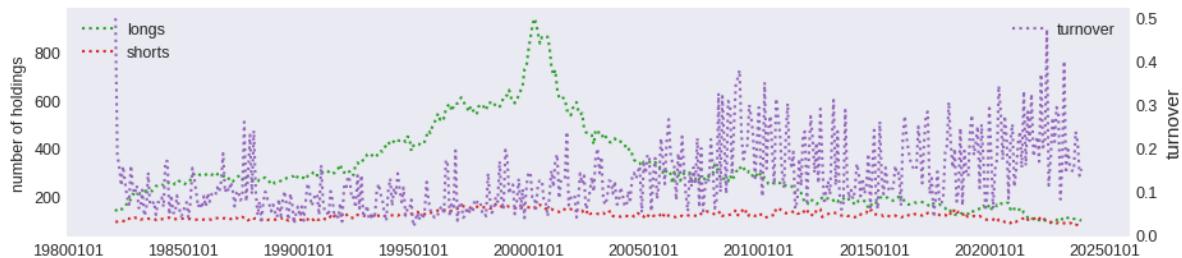
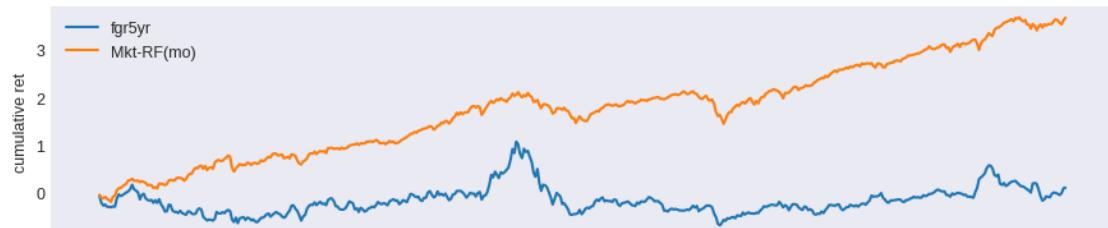
1311079

```

rebalbeg, rebalend = 19760101, LAST_DATE
benchnames = ['Mkt-RF (mo)']
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=3,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix=(leverage.get(label, 1) < 0) * '(-)')

```

100% |██████████| 1/1 [00:46<00:00, 46.86s/it]



Announcement date in Quarterly, linked to CRSP daily

columns = ['ear', 'aeavol']

```

# retrieve rdq, and set rebalance date to at least one month delay
df = pstat.get_linked(dataset='quarterly',
                      fields=['rdq'],
                      date_field='datadate',
                      where=('rdq > 0'))

```

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```
fund = df.sort_values(['permno', 'rdq', 'datadate'])\
    .drop_duplicates(['permno', 'rdq'])\
    .dropna()
fund['rebaldate'] = bd.offset(fund['rdq'], 2)
```

```
# ear is compounded return around 3-day window
out = crsp.get_window(dataset='daily',
                       field='ret',
                       date_field='date',
                       permnos=fund['permno'],
                       dates=fund['rdq'],
                       left=-1,
                       right=1)
fund['ear'] = (1 + out).prod(axis=1).values
```

```
# aeavol is avg volume in 3-day window over 20-day average ten-days prior
actual = crsp.get_window(dataset='daily',
                          field='vol',
                          date_field='date',
                          permnos=fund['permno'],
                          dates=fund['rdq'],
                          left=-1,
                          right=1)
normal = crsp.get_window(dataset='daily',
                          field='vol',
                          date_field='date',
                          permnos=fund['permno'],
                          dates=fund['rdq'],
                          left=-30,
                          right=-11,
                          avg=True)
fund['aeavol'] = normal['vol'].values
```

```
signals.write(fund, 'ear', overwrite=True)
signals.write(fund, 'aeavol', overwrite=True)
```

949558

```
rebalbeg, rebalend = 19700101, LAST_DATE
benchnames = ['Mkt-RF(mo)']
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=3,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
excess = backtest_pipeline(backtest,
                           monthly,
```

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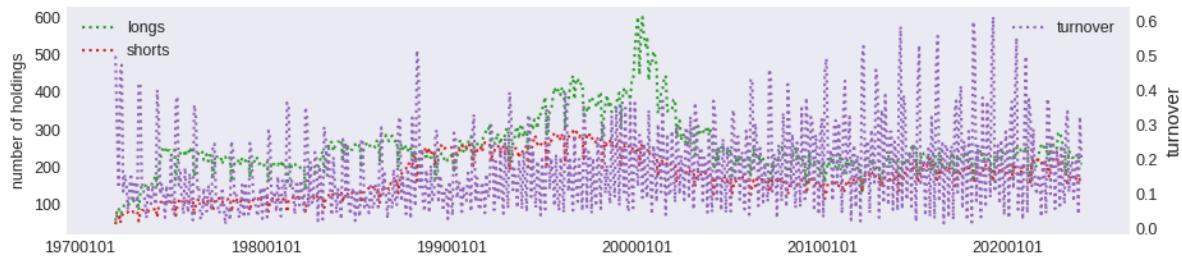
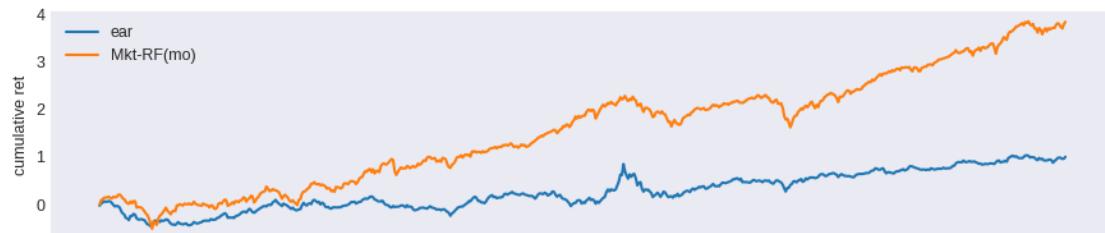
```
holdings,
label,
benchnames,
overlap=0,
outdir=outdir,
suffix=(leverage.get(label, 1) < 0) * '(-)'
```

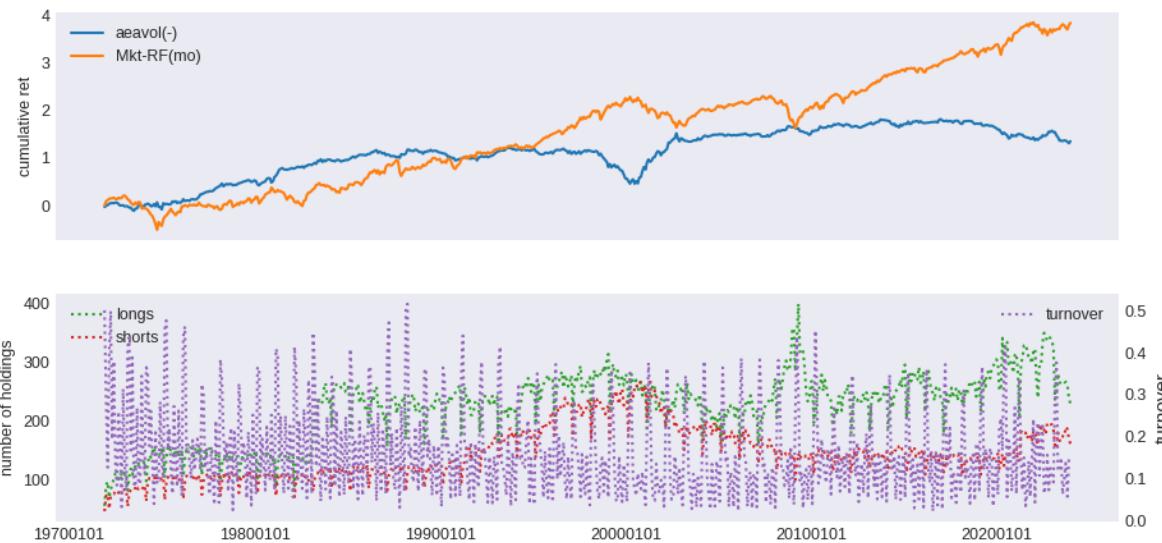
50% |██████████| 1/2 [02:36<02:36, 156.72s/it]

	excess	sharpe	alpha	appraisal	welch-t	welch-p	turnover	longs	shorts
↳ buys	0.019	0.167	-0.004	-0.038	0.866	0.387	2.098	249.304	176.47
↳ sells	2.09	2.107							
ear	0.019	0.167	-0.004	-0.038	0.866	0.387	2.098	249.304	176.47
↳	2.09	2.107							

100% |██████████| 2/2 [05:49<00:00, 174.92s/it]

	excess	sharpe	alpha	appraisal	welch-t	welch-p	turnover	longs	shorts
↳ shorts	0.026	0.235	0.04	0.38	-0.876	0.381	1.943	222.169	1
↳ buys	1.935	1.951							
aeavol(-)	0.026	0.235	0.04	0.38	-0.876	0.381	1.943	222.169	1
↳	1.935	1.951							





IBES Fiscal Year 1 linked to Quarterly PSTAT

```
beg, end = 19760101, LAST_DATE
monthnum = lambda d: ((d//10000)-1900)*12 + ((d//100)%100) - 1
```

```
df = pstat.get_linked(dataset='quarterly',
                      fields=['prccq'],
                      date_field='datadate')
df = df.dropna() \
    .sort_values(['permno', 'datadate']) \
    .drop_duplicates(['permno', 'datadate'])
```

```
out = ibes.get_linked(dataset='statsum',
                      fields=['fpedats', 'meanest'],
                      date_field='statpers',
                      where="fpi='1'")
out = out.dropna() \
    .sort_values(['permno', 'statpers', 'fpedats']) \
    .drop_duplicates(['permno', 'statpers'])
out['monthnum'] = monthnum(out['statpers'])
out = out.set_index(['permno', 'monthnum'], drop=False)
out['sfeq'] = np.nan
```

```
for num in range(4): # match ibes statpers to any datadate in last 4 mos
    df['monthnum'] = monthnum(df['datadate']) - num
    df = df.set_index(['permno', 'monthnum'], drop=False)
    out = out.join(df[['prccq']], how='left')
    out['sfeq'] = out['sfeq'].where(out['sfeq'].notna(),
                                      out['meanest'] / out['prccq'].abs())
    out = out.drop(columns=['prccq'])

    out['rebalance'] = bd.endmo(out['statpers'])
    n = signals.write(out.reset_index(drop=True), 'sfeq', overwrite=True)
```

IBES Fiscal Year 1 linked to IBES price history

```
beg, end = 19760101, LAST_DATE
```

```
# retrieve monthly price history
df = ibes.get_linked(dataset='actpsum',
                      fields=['price'],
                      date_field='statpers')
hist = df.dropna() \
    .sort_values(['permno', 'statpers']) \
    .drop_duplicates(['permno', 'statpers'], keep='last') \
    .set_index(['permno', 'statpers'])
```

```
# retrieve monthly FY1 mean estimate
df = ibes.get_linked(dataset='statsum',
                      fields=['fpedats', 'meanest'],
                      date_field='statpers',
                      where="fpi='1' AND statpers <= fpedats")
out = df.dropna() \
    .sort_values(['permno', 'statpers', 'fpedats']) \
    .drop_duplicates(['permno', 'statpers']) \
    .set_index(['permno', 'statpers'])
```

```
# join on [permno, statpers], and reindex on [permno, rebaldate]
out = out.join(hist[['price']], how='left').reset_index()
out['rebaldate'] = bd.endmo(out['statpers'])
out = out.set_index(['permno', 'rebaldate'])
out['sfe'] = out['meanest'].div(out['price'].abs())
n = signals.write(out.reset_index(), 'sfe', overwrite=True)
```

```
rebalbeg, rebalend = 19760101, LAST_DATE
benchnames = ['Mkt-RF(mo)']
label = 'sfe'
holdings = univariate_sorts(monthly,
                            label,
                            SignalsFrame(signals.read(label)),
                            rebalbeg,
                            rebalend,
                            window=3,
                            months=[],
                            maxdecile=8,
                            pct=(10., 90.),
                            leverage=leverage.get(label, 1))
excess = backtest_pipeline(backtest,
                           monthly,
                           holdings,
                           label,
                           benchnames,
                           overlap=0,
                           outdir=outdir,
                           suffix=(leverage.get(label, 1) < 0) * '(-)')
```

	excess	sharpe	alpha	appraisal	welch-t	welch-p	turnover	longs	...
↳ shorts									
↳ buys									
sells									
sfe	0.052	0.285	0.081	0.462	-0.034	0.973	2.126	148.671	297.
↳ 957	2.12	2.132							



IBES Fiscal Quarter 1, linked to Quarterly

```
columns = ['sue']
numlag = 4
end = LAST_DATE
```

```
# retrieve quarterly, keep [permno, datadate] key with non null prccq
df = pstat.get_linked(dataset='quarterly',
                      fields=['prccq', 'cshoq', 'ibq'],
                      date_field='datadate',
                      where=f"datadate <= {end//100}31")
fund = df.dropna(subset=['ibq']) \
    .sort_values(['permno', 'datadate', 'cshoq']) \
    .drop_duplicates(['permno', 'datadate'])
fund['rebalddate'] = bd.endmo(fund['datadate'], numlag)
fund = fund.set_index(['permno', 'rebalddate'], drop=False)
```

```
# retrieve ibes Q1 where forecast period <= fiscal date, keep latest
df = ibes.get_linked(dataset='statsum',
                      fields=['fpedats', 'medest', 'actual'],
                      date_field='statpers',
                      where=" fpi = '6' AND statpers <= fpedats")
summ = df.dropna() \
    .sort_values(['permno', 'fpedats', 'statpers']) \
    .drop_duplicates(['permno', 'fpedats'], keep='last')
summ['rebalddate'] = bd.endmo(summ['fpedats'], numlag)
summ = summ.set_index(['permno', 'statpers'])
```

```
# retrieve ibes price, then left join
df = ibes.get_linked(dataset='actpsum',
                      fields=['price'],
                      date_field='statpers')
hist = df.dropna() \
    .sort_values(['permno', 'statpers']) \
    .drop_duplicates(['permno', 'statpers'], keep='last')
hist = hist.set_index(['permno', 'statpers'])
```

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```

summ = summ.join(hist[['price']], how='left')
summ = summ.reset_index() \
    .set_index(['permno', 'rebaldate']) \
    .reindex(fund.index)

# sue with ibes surprise and price
fund['sue'] = (summ['actual'] - summ['medest']) / summ['price'].abs()

# sue with ibes surprice and compustat quarterly price
fund['sue'] = fund['sue'].where(
    fund['sue'].notna(), (summ['actual'] - summ['medest']) / fund['prccq'].abs())

# sue with lag(4) difference in compustat quarterly and price
lag = fund.shift(4, fill_value=0)
fund['sue'] = fund['sue'].where(
    fund['sue'].notna() | (lag['permno'] != fund['permno']),
    ((fund['ibq'] - lag['ibq']) / (fund['prccq'] * fund['cshoq']).abs()))

signals.write(fund.reset_index(drop=True), 'sue', overwrite=True)

```

1069502

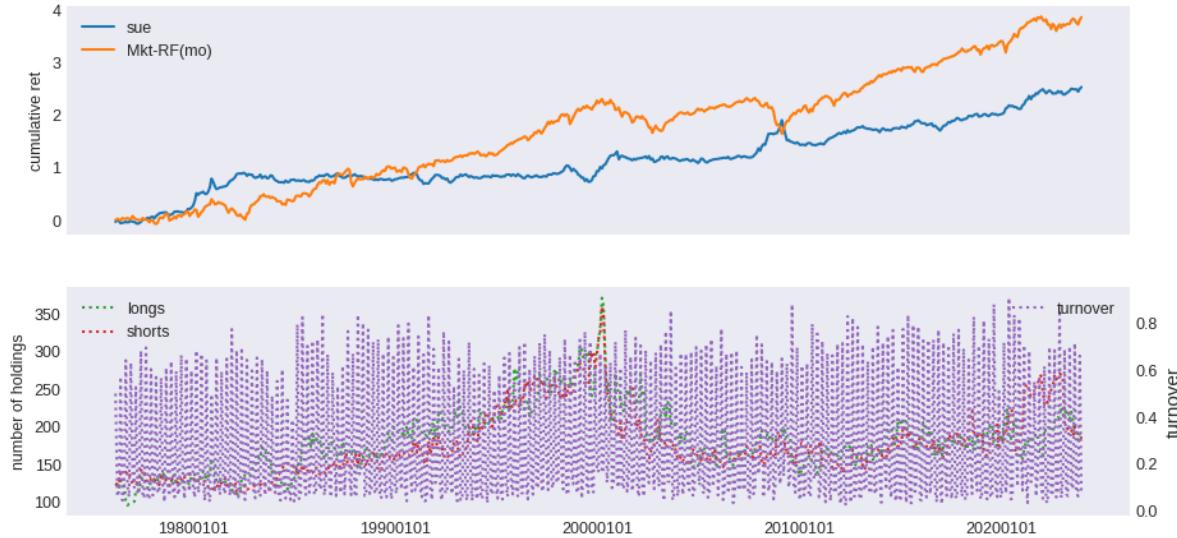
```

rebalbeg, rebalend = 19760101, LAST_DATE
benchnames = ['Mkt-RF(mo)']
for label in tqdm(columns):
    holdings = univariate_sorts(monthly,
                                 label,
                                 SignalsFrame(signals.read(label)),
                                 rebalbeg,
                                 rebalend,
                                 window=3,
                                 months=[],
                                 maxdecile=8,
                                 pct=(10., 90.),
                                 leverage=leverage.get(label, 1))
    excess = backtest_pipeline(backtest,
                               monthly,
                               holdings,
                               label,
                               benchnames,
                               overlap=0,
                               outdir=outdir,
                               suffix=(leverage.get(label, 1) < 0) * '(-)')

```

100%|██████████| 1/1 [04:15<00:00, 255.90s/it]

	excess	sharpe	alpha	appraisal	welch-t	welch-p	turnover	longs	shorts
↳ buys	0.053	0.479	0.057	0.518	0.512	0.609	3.436	183.05	177.005
↳ sells	3.422	3.449							



6.1.7 Backtests

The backtests are all of univariate dollar-neutral spreads between the top and bottom deciles of the characteristic. Stocks are value-weighted within each decile, and exclude firms in the smallest quintile of NYSE market capitalization. Spread portfolios are rebalanced monthly, with fundamental data lagged in the usual manner (six months for annual, 4 months for quarterly). In addition to the time series of cumulative spread portfolio and market index returns, the monthly turnover rate and number of long and short positions are also graphed.

The summary of backtest results is sorted by Welch's t-value testing for difference in pre-2002 and post-2003 mean returns, as Green et al (2017) and others have also found a sharp drop in return predictability of many these factors then.

The **maximum drawdown** is also computed for each strategy – this is defined as the maximum loss from a peak to a trough of the cumulative returns of a strategy, before a new peak is attained. It is a historical measure of a worse case analysis.

```
def maximum_drawdown(x: Series, is_price_level: bool = False) -> Series:
    """Compute max drawdown (max loss from previous high) period and returns"""
    cumsum = np.log(1 + x).cumsum()
    cummax = cumsum.cummax()
    end = (cummax - cumsum).idxmax()
    beg = cumsum[cumsum.index <= end].idxmax()
    dd = cumsum.loc[[beg, end]]
    return np.exp(dd)
```

```
zoo = backtest.read().sort_values(['begret', 'permno'])
r = []
rets = []
for label in zoo.index:
    perf = backtest.read(label)
    rets.append(perf['ret'].rename(label))
    excess = {'ret': backtest.fit(['Mkt-RF(mo)'])}
    excess['annualized'] = backtest.annualized
```

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```

excess['dd'] = maximum_drawdown(backtest.perf['excess'])
post = {'ret': backtest.fit(['Mkt-RF(mo)'],
                           beg=20020101).copy()}
post['annualized'] = backtest.annualized.copy()
s = label + ('(-)' if leverage.get(label, 1) < 0 else '')
r.append(DataFrame({
    # 'Start': excess['ret'].index[0],
    'Sharpe Ratio': excess['annualized']['sharpe'],
    'Alpha': excess['annualized']['alpha'],
    'Appraisal Ratio': excess['annualized']['appraisal'],
    'Avg Ret': excess['ret']['excess'].mean(),
    'Vol': excess['ret']['excess'].std(ddof=0),
    'Welch-t': excess['annualized']['welch-t'],
    'Appraisal2002': post['annualized']['appraisal'],
    'Ret2002': post['ret']['excess'].mean(),
    'Drawdown': (excess['dd'].iloc[1]/excess['dd'].iloc[0]) - 1,
}, index=[s]))
df = pd.concat(r, axis=0).round(4).sort_values('Welch-t')

```

	Sharpe Ratio	Alpha	Appraisal Ratio	Avg Ret	Vol	Welch-t	\
chcsho (-)	0.6159	0.0786	0.8231	0.0052	0.0294	-0.9003	
sue	0.4788	0.0570	0.5179	0.0044	0.0318	0.5115	
mom12m	0.4557	0.1493	0.6395	0.0098	0.0732	-1.4424	
chfeps	0.4380	0.0619	0.5166	0.0044	0.0350	-0.7879	
mom1m (-)	0.4002	0.0597	0.3306	0.0064	0.0541	-2.4864	
...	
pchquick	-0.1594	-0.0149	-0.1689	-0.0012	0.0254	-0.0714	
cfp_ia	-0.1921	-0.0353	-0.2600	-0.0022	0.0396	-0.3738	
pchcapx_ia	-0.2251	-0.0287	-0.2356	-0.0023	0.0352	0.1500	
grcapx	-0.2910	-0.0412	-0.4101	-0.0025	0.0299	1.5998	
cinvest (-)	-0.4001	-0.0445	-0.3788	-0.0039	0.0340	0.0619	
	Appraisal2002	Ret2002	Drawdown				
chcsho (-)	0.7323	0.0040	-0.2720				
sue	0.7110	0.0051	-0.3999				
mom12m	0.4489	0.0043	-0.9670				
chfeps	0.5138	0.0032	-0.3299				
mom1m (-)	-0.2796	-0.0009	-0.7172				
...				
pchquick	-0.2631	-0.0013	-0.7598				
cfp_ia	-0.4263	-0.0029	-0.8612				
pchcapx_ia	-0.1287	-0.0020	-0.8845				
grcapx	-0.1046	-0.0002	-0.8722				
cinvest (-)	-0.3585	-0.0038	-0.9590				

[82 rows x 9 columns]

```

pd.set_option("display.max_colwidth", None, 'display.max_rows', None)
df#.sort_values('Sharpe Ratio', ascending=False)

```

	Sharpe Ratio	Alpha	Appraisal Ratio	Avg Ret	Vol	\
chcsho (-)	0.6159	0.0786	0.8231	0.0052	0.0294	
sue	0.4788	0.0570	0.5179	0.0044	0.0318	
mom12m	0.4557	0.1493	0.6395	0.0098	0.0732	

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chfeps	0.4380	0.0619	0.5166	0.0044	0.0350
mom1m(-)	0.4002	0.0597	0.3306	0.0064	0.0541
chmom	0.3990	0.0504	0.3097	0.0058	0.0492
egr(-)	0.3805	0.0599	0.5707	0.0035	0.0322
chinv(-)	0.3699	0.0513	0.4865	0.0033	0.0313
indmom	0.3590	0.0657	0.3781	0.0054	0.0513
acc(-)	0.3479	0.0386	0.3612	0.0031	0.0309
bm_ia	0.3231	0.0317	0.2402	0.0036	0.0389
disp(-)	0.3164	0.1002	0.6424	0.0047	0.0513
ill(-)	0.3151	0.0471	0.4007	0.0031	0.0343
agr(-)	0.3147	0.0546	0.4967	0.0031	0.0337
nincr	0.3075	0.0209	0.2409	0.0023	0.0254
mom6m	0.3058	0.1056	0.4872	0.0062	0.0683
cashpr(-)	0.3037	0.0484	0.3915	0.0032	0.0363
roaq	0.2944	0.0619	0.4443	0.0036	0.0421
sfe	0.2846	0.0808	0.4621	0.0044	0.0529
ep	0.2821	0.0633	0.4181	0.0037	0.0454
sp	0.2693	0.0386	0.2617	0.0033	0.0426
invest(-)	0.2677	0.0466	0.3954	0.0027	0.0352
cfp	0.2519	0.0516	0.3719	0.0030	0.0413
pchsale_pchinv	0.2508	0.0237	0.2483	0.0020	0.0276
pchsaleinv	0.2475	0.0202	0.2302	0.0018	0.0253
bm	0.2459	0.0374	0.2371	0.0032	0.0456
cash	0.2429	0.0101	0.0724	0.0031	0.0436
aeavol(-)	0.2353	0.0400	0.3799	0.0022	0.0316
maxret(-)	0.2224	0.1211	0.6779	0.0041	0.0645
chatoia	0.2183	0.0240	0.2564	0.0017	0.0272
stdcf(-)	0.2100	0.0601	0.4901	0.0024	0.0392
sgrvol	0.2094	0.0114	0.0786	0.0027	0.0438
salerec	0.2025	0.0403	0.3190	0.0022	0.0376
mom36m(-)	0.1857	0.0211	0.1054	0.0033	0.0599
chtx	0.1811	0.0166	0.1379	0.0018	0.0350
grltnoa	0.1718	0.0221	0.1898	0.0017	0.0336
tang	0.1679	0.0076	0.0653	0.0017	0.0346
ear	0.1671	-0.0039	-0.0380	0.0016	0.0330
mve_ia(-)	0.1580	0.0056	0.0545	0.0014	0.0303
rsup	0.1577	0.0227	0.1763	0.0017	0.0372
retvol(-)	0.1532	0.1307	0.6220	0.0034	0.0776
rd_mve	0.1462	0.0125	0.0784	0.0020	0.0464
saleinv	0.1383	0.0356	0.3665	0.0012	0.0310
stdacc(-)	0.1344	0.0419	0.3665	0.0014	0.0357
zerotrade(-)	0.1340	-0.0399	-0.2231	0.0025	0.0639
pctacc(-)	0.1274	0.0256	0.2437	0.0012	0.0313
chpmia	0.1241	0.0174	0.1297	0.0014	0.0387
turn	0.1069	-0.0467	-0.2504	0.0020	0.0663
pricedelay(-)	0.1028	0.0051	0.0522	0.0009	0.0292
gma	0.0923	0.0171	0.1177	0.0011	0.0422
realestate	0.0845	0.0461	0.3114	0.0011	0.0459
dolvol	0.0737	-0.0028	-0.0271	0.0007	0.0309
chempia	0.0717	-0.0055	-0.0495	0.0007	0.0331
beta	0.0655	-0.0764	-0.3973	0.0017	0.0906
roavol	0.0646	-0.0077	-0.0520	0.0008	0.0438
absacc(-)	0.0628	0.0242	0.1743	0.0007	0.0413
chnanalyst	0.0550	-0.0006	-0.0068	0.0004	0.0252
depr	0.0526	-0.0221	-0.1692	0.0006	0.0423
pchgm_pchsale	0.0480	0.0003	0.0027	0.0004	0.0296

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std_turn	0.0408	-0.0501	-0.2939	0.0007	0.0585
pchdepr	0.0390	0.0031	0.0335	0.0003	0.0266
secured(-)	0.0389	0.0334	0.2773	0.0004	0.0375
salecash	0.0254	0.0206	0.1831	0.0003	0.0343
lev	0.0237	-0.0003	-0.0019	0.0003	0.0487
quick	0.0197	-0.0297	-0.2071	0.0003	0.0464
fgr5yr	0.0125	-0.0565	-0.2931	0.0002	0.0635
std_dolvol	0.0120	0.0040	0.0366	0.0001	0.0317
idiovol(-)	-0.0038	0.0525	0.2693	-0.0001	0.0695
pchsale_pchrect	-0.0393	-0.0056	-0.0657	-0.0003	0.0246
dy	-0.0400	0.0386	0.2284	-0.0007	0.0571
divyld	-0.0430	0.0379	0.2468	-0.0007	0.0552
rd_sale	-0.0575	-0.0152	-0.0986	-0.0007	0.0447
sgr	-0.0791	-0.0255	-0.2109	-0.0008	0.0362
baspread	-0.1047	-0.1260	-0.5936	-0.0024	0.0806
pchsale_pchxsga	-0.1133	-0.0125	-0.1141	-0.0010	0.0317
hire	-0.1167	-0.0314	-0.2724	-0.0012	0.0350
lgr	-0.1272	-0.0219	-0.2415	-0.0010	0.0270
pchquick	-0.1594	-0.0149	-0.1689	-0.0012	0.0254
cfp_ia	-0.1921	-0.0353	-0.2600	-0.0022	0.0396
pchcapx_ia	-0.2251	-0.0287	-0.2356	-0.0023	0.0352
grcapx	-0.2910	-0.0412	-0.4101	-0.0025	0.0299
cinvest(-)	-0.4001	-0.0445	-0.3788	-0.0039	0.0340

	Welch-t	Appraisal2002	Ret2002	Drawdown
chcsho(-)	-0.9003	0.7323	0.0040	-0.2720
sue	0.5115	0.7110	0.0051	-0.3999
mom12m	-1.4424	0.4489	0.0043	-0.9670
chfeps	-0.7879	0.5138	0.0032	-0.3299
mom1m(-)	-2.4864	-0.2796	-0.0009	-0.7172
chmom	-2.0332	-0.0982	0.0006	-0.6133
egr(-)	-0.6843	0.4828	0.0026	-0.3384
chinv(-)	-0.6077	0.3094	0.0024	-0.2747
indmom	-1.2340	0.2213	0.0023	-0.6892
acc(-)	-1.2949	0.0954	0.0012	-0.3966
bm_ia	-1.5394	-0.0016	0.0009	-0.6322
disp(-)	-0.3845	0.7475	0.0038	-0.5288
ill(-)	-0.9953	0.3609	0.0017	-0.6150
agr(-)	-1.6115	0.1517	0.0005	-0.4195
nincr	-0.4708	0.2820	0.0017	-0.4062
mom6m	-0.3593	0.4688	0.0049	-0.9885
cashpr(-)	-0.9925	0.1124	0.0015	-0.4252
roaq	1.0678	0.7910	0.0057	-0.4532
sfe	-0.0340	0.3968	0.0043	-0.7412
ep	-1.4876	0.2047	0.0006	-0.6625
sp	-0.9629	0.0534	0.0014	-0.5642
invest(-)	-1.2757	0.1567	0.0004	-0.4267
cfp	-0.2572	0.2313	0.0025	-0.5696
pchsale_pchinv	-2.0639	-0.1278	-0.0008	-0.4948
pchsaleinv	-1.7397	-0.1256	-0.0003	-0.4893
bm	-2.1594	-0.2596	-0.0014	-0.7508
cash	-0.2386	0.0028	0.0026	-0.7074
aeavol(-)	-0.8760	0.2552	0.0009	-0.5583
maxret(-)	-0.3880	0.6524	0.0031	-0.7173
chatoia	-1.2026	0.0484	0.0002	-0.5343
stdcf(-)	-0.5745	0.4072	0.0014	-0.4787

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sgrvol	-1.0245	-0.2327	0.0005	-0.6922
salerec	0.9534	0.5308	0.0040	-0.6761
mom36m(-)	-0.9490	-0.0294	0.0004	-0.7287
chtx	-0.3338	0.2143	0.0013	-0.4785
grltnoa	-0.0995	0.1927	0.0015	-0.4941
tang	0.9173	0.1566	0.0031	-0.7361
ear	0.8660	0.2133	0.0029	-0.5425
mve_ia(-)	-0.3058	0.0120	0.0010	-0.5842
rsup	0.8337	0.4375	0.0032	-0.5391
retvol(-)	-0.5153	0.5356	0.0018	-0.7990
rd_mve	0.3087	0.1094	0.0026	-0.7868
saleinv	1.9240	0.6342	0.0041	-0.4900
stdacc(-)	-0.2995	0.3049	0.0009	-0.5056
zerotrade(-)	0.7004	-0.1248	0.0043	-0.8344
pctacc(-)	0.7131	0.2858	0.0022	-0.3803
chpmia	-0.4053	0.0081	0.0006	-0.5937
turn	0.8012	-0.1345	0.0043	-0.8291
pricedelay(-)	-0.2216	-0.0522	0.0005	-0.6159
gma	1.1049	0.4025	0.0034	-0.6364
realestate	-1.2871	0.1600	-0.0014	-0.6503
dolvol	-0.3467	0.0515	0.0002	-0.7621
chempia	1.9964	0.3559	0.0038	-0.6884
beta	-0.4256	-0.5622	-0.0001	-0.9588
roavol	0.3854	0.0791	0.0016	-0.7821
absacc(-)	-1.4650	-0.1357	-0.0021	-0.7729
chnanalyst	0.0380	0.0748	0.0004	-0.5443
depr	0.7273	0.0109	0.0020	-0.6522
pchgm_pchsale	0.1187	0.0961	0.0006	-0.5638
std_turn	0.5724	-0.2378	0.0021	-0.8064
pchdepr	-1.5397	-0.2029	-0.0016	-0.6991
secured(-)	0.6495	0.4016	0.0015	-0.6406
salecash	0.2888	0.2496	0.0007	-0.7463
lev	-1.7371	-0.3459	-0.0038	-0.8697
quick	0.8571	-0.1036	0.0021	-0.7923
fgr5yr	0.1193	-0.0965	0.0006	-0.8761
std_dolvol	0.9647	0.1411	0.0014	-0.5107
idiovol(-)	-0.3467	0.3555	-0.0014	-0.9876
pchsale_pchrect	-2.6701	-0.5153	-0.0034	-0.7873
dy	-0.6572	-0.0302	-0.0023	-0.9186
divyld	-0.9423	-0.1059	-0.0031	-0.9645
rd_sale	0.5829	-0.0405	0.0004	-0.8706
sgr	0.0733	-0.1395	-0.0007	-0.7032
baspread	0.3600	-0.5421	-0.0012	-0.9522
pchsale_pchxsga	-0.8570	-0.2770	-0.0023	-0.7742
hire	1.5073	0.0525	0.0014	-0.8262
lgr	1.7493	0.1136	0.0013	-0.8286
pchquick	-0.0714	-0.2631	-0.0013	-0.7598
cfp_ia	-0.3738	-0.4263	-0.0029	-0.8612
pchcapx_ia	0.1500	-0.1287	-0.0020	-0.8845
grcapx	1.5998	-0.1046	-0.0002	-0.8722
cinvest(-)	0.0619	-0.3585	-0.0038	-0.9590

```

X = pd.concat(rets, join='outer', axis=1).dropna()
X = X/X.std()    # standardize to unit variance
corr = X.corr()
dist = np.sqrt(1 - corr)

```

6.2 Cluster analysis

The historical backtests of portfolio returns are considered as the features for cluster analysis, which can be used to identify and construct peer benchmarks for each strategy. Strategies whose returns move up or down together tend to load on similar “style” factors, and should be evaluated against each other.

The correlation between two series of returns is closely related to the Euclidean distance between the series. When the returns are standardized to have unit variance, the two metrics can be derived exactly from each other. Recall that the squared Euclidean norm between two standardized series x and y is:

$$d^2 = \sum_i (x_i - y_i)^2 = \sum_i x_i^2 + \sum_i y_i^2 - 2 \sum_i x_i y_i = n + n + 2n\rho$$

since $\sum_i x_i^2 = \sum_i y_i^2 = n$, and $\rho = \sum_i x_i y_i / n$.

Hence correlation $\rho = 1 - \frac{d^2}{2n}$

6.2.1 Hierarchical clustering

This builds a hierarchy of clusters by iteratively merging clusters based on their linkage similarity. Linkage methods determine how the distance between clusters is measured and how clusters are merged. Linkage methods include:

- Single Linkage: Measures the distance between the closest points of two clusters and merges the clusters with the smallest distance. It tends to produce elongated clusters.
- Complete Linkage: Measures the distance between the farthest points of two clusters and merges the clusters with the smallest maximum distance. It tends to produce compact, spherical clusters.
- Average Linkage: Measures the average distance between all pairs of points in two clusters and merges the clusters with the smallest average distance. It balances between single and complete linkage, often producing balanced clusters.
- Ward’s Method: Minimizes the within-cluster variance when merging clusters. It tends to produce clusters with similar sizes and shapes.

```
model = AgglomerativeClustering(metric='precomputed', linkage='average',
                                 distance_threshold=0, n_clusters=None).fit(dist)
```

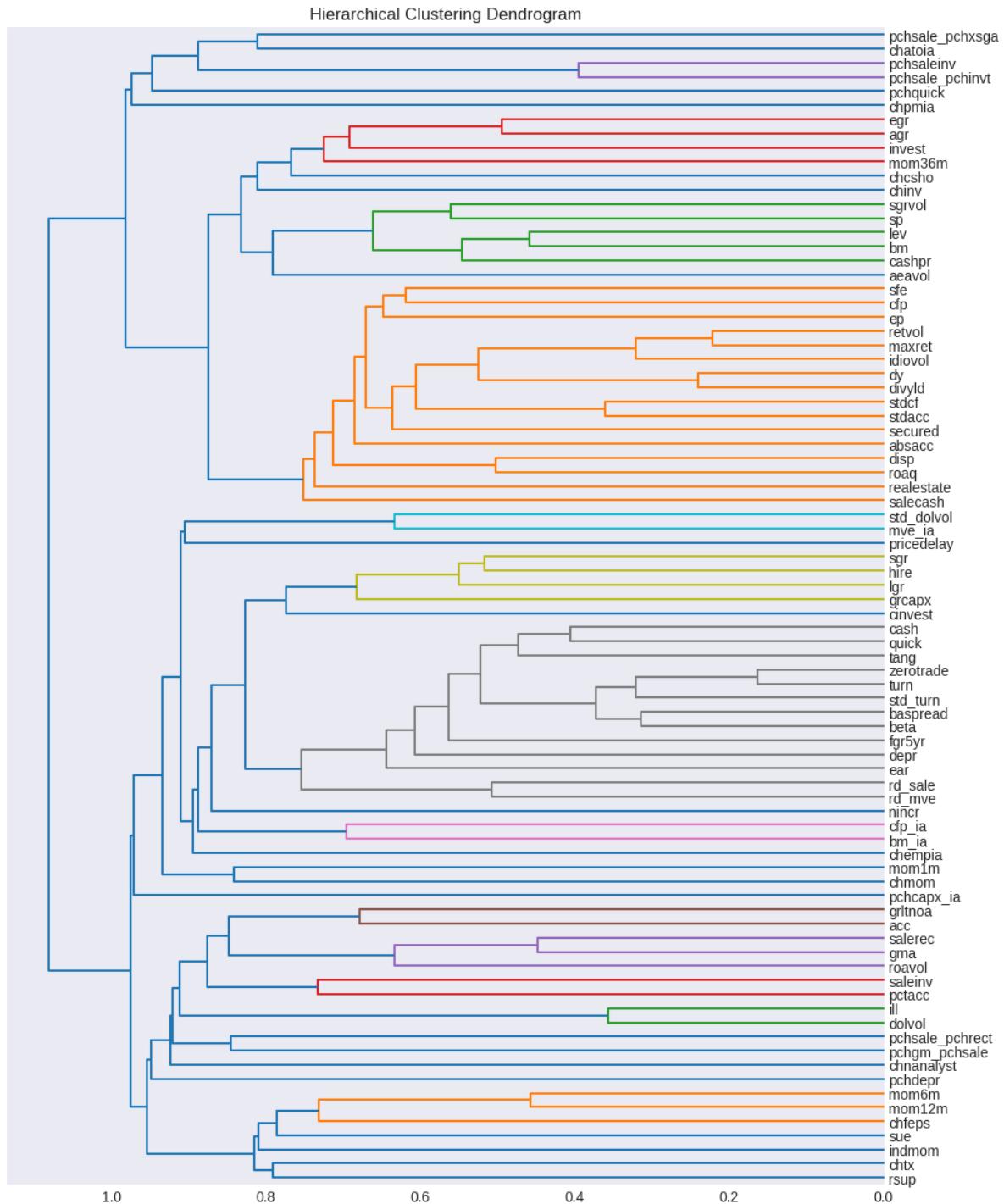
```
fig, ax = plt.subplots(figsize=(10, 12))
plt.title("Hierarchical Clustering Dendrogram")
# Create linkage matrix and then plot the dendrogram
# scikit-learn: "Plot Hierarchical Clustering Dendrogram"
counts = np.zeros(model.children_.shape[0])
n_samples = len(model.labels_)
# create the counts of samples under each node
for i, merge in enumerate(model.children_):
    current_count = 0
    for child_idx in merge:
        if child_idx < n_samples:
            current_count += 1 # leaf node
        else:
            current_count += counts[child_idx - n_samples]
    counts[i] = current_count

linkage_matrix = np.column_stack([model.children_, model.distances_, counts])\
    .astype(float)
```

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```
# Plot the corresponding dendrogram
dendrogram(linkage_matrix, orientation='left', labels=dist.columns, leaf_font_size=10)
plt.tight_layout()
```

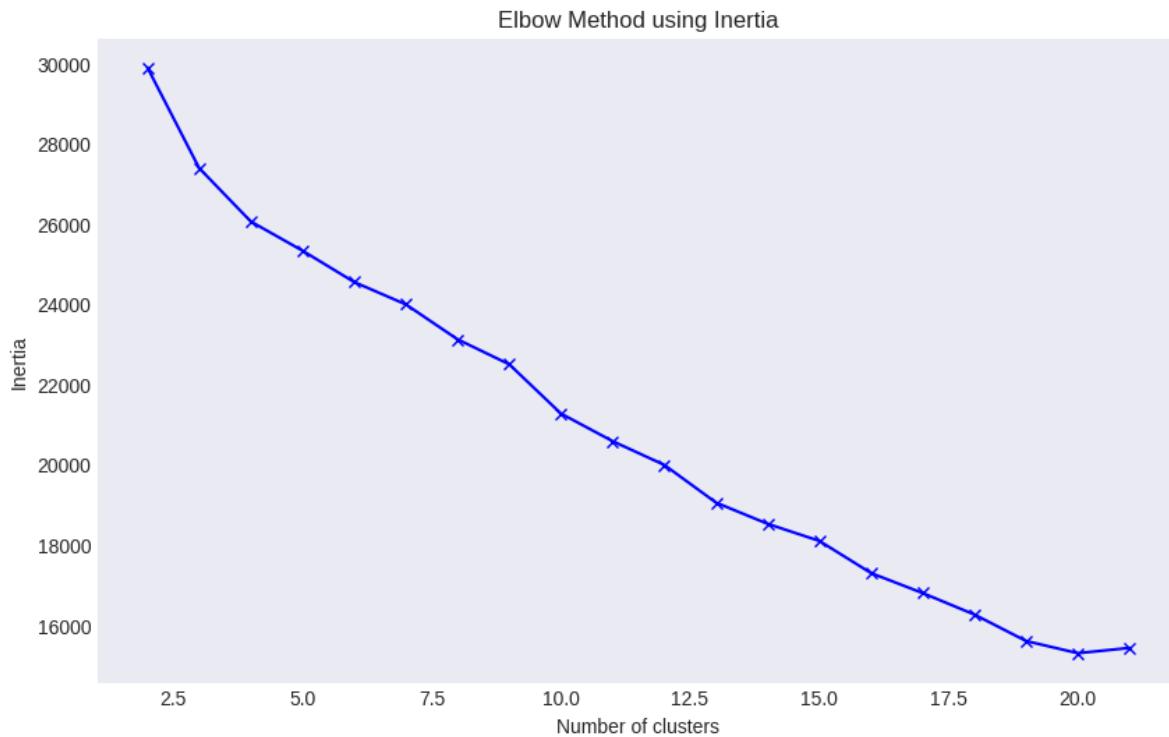


6.2.2 K-means clustering

K-means clustering is a popular unsupervised machine learning algorithm used for partitioning a dataset into K distinct, non-overlapping clusters. It starts by specifying the number of clusters, and choosing K initial cluster centroids randomly. Then it iteratively assigns data points to the nearest centroid, recalculating the centroids based on the means of data points in each new cluster, and repeating until convergence. K-means clustering aims to minimize the within-cluster sum of squared distances, making it suitable for datasets where clusters are spherical and have similar sizes.

The elbow method is a graphical method for selecting the “best” number of clusters in a k-means clustering algorithm. The graph shows the within-cluster sum-of-square values corresponding to the different values of K. The optimal K value is the point at which the graph forms an elbow.

```
# Selecting number of centers with elbow method
inertias = []
n_clusters = list(range(2, 22))
for n_cluster in n_clusters:
    kmeans = KMeans(n_clusters=n_cluster, random_state=0, n_init="auto").fit(X.T)
    inertias.append(kmeans.inertia_)
plt.figure(figsize=(10, 6))
plt.plot(n_clusters, inertias, 'bx-')
plt.xlabel('Number of clusters')
plt.ylabel('Inertia')
plt.title('Elbow Method using Inertia')
plt.show()
```



Silhouette analysis can also be used to evaluate the appropriateness of the number of clusters in K-means clustering. The silhouette score measures how similar a data point is to its own cluster compared to other clusters. It is the difference between cohesion subscore (i.e. the average distance between the data point and all other points within the same cluster) and separation subscore (the average distance between the data point and all points in each neighboring cluster). It is scaled by the maximum of those two subscores, hence ranges from -1 to 1, with higher values indicating better cluster separation. The number of clusters that maximizes the average silhouette score across all data points is chosen, which

provides the best balance between cohesion within clusters and separation between clusters.

```

# scikit-learn: "Selecting the number of clusters with silhouette analysis
# on KMeans clustering"
fig, ax = plt.subplots(ncols=4, nrows=int(np.round(len(n_clusters)/4)), figsize=(10, ↪15))
ax = ax.flatten()
for n_cluster, ax1 in zip(n_clusters, ax):
    clusterer = KMeans(n_clusters=n_cluster, n_init='auto', random_state=10)
    cluster_labels = clusterer.fit_predict(X)

    # The silhouette_score gives the average value for all the samples.
    # This gives a perspective into the density and separation of the formed
    # clusters
    silhouette_avg = silhouette_score(X, cluster_labels)
    print("For n_clusters =", n_cluster,
          "The average silhouette_score is :", silhouette_avg)

    # Compute the silhouette scores for each sample
    sample_silhouette_values = silhouette_samples(X, cluster_labels)

    ax1.set_title(f"n_cluster {n_cluster} clusters: {silhouette_avg:.4f}")
    ax1.set_xlim([-0.1, .4])
    ax1.set_ylim([0, len(X) + (n_cluster + 1) * 10])

    y_lower = 10
    for i in range(n_cluster):
        # Aggregate the silhouette scores for samples belonging to
        # cluster i, and sort them
        ith_cluster_silhouette_values = sample_silhouette_values[cluster_labels == i]

        ith_cluster_silhouette_values.sort()

        size_cluster_i = ith_cluster_silhouette_values.shape[0]
        y_upper = y_lower + size_cluster_i

        color = cm.nipy_spectral(float(i) / n_cluster)
        ax1.fill_betweenx(
            np.arange(y_lower, y_upper),
            0,
            ith_cluster_silhouette_values,
            facecolor=color,
            edgecolor=color,
            alpha=0.7,
        )

        # Label the silhouette plots with their cluster numbers at the middle
        ax1.text(-0.05, y_lower + 0.5 * size_cluster_i, str(i))

        # Compute the new y_lower for next plot
        y_lower = y_upper + 10 # 10 for the 0 samples
    ax1.set_ylabel("Cluster label")

    # The vertical line for average silhouette score of all the values
    ax1.axvline(x=silhouette_avg, color="red", linestyle="--")

    ax1.set_yticks([]) # Clear the yaxis labels / ticks
#    ax1.set_xticks([-0.1, 0, 0.2, 0.4, 0.6, 0.8, 1])

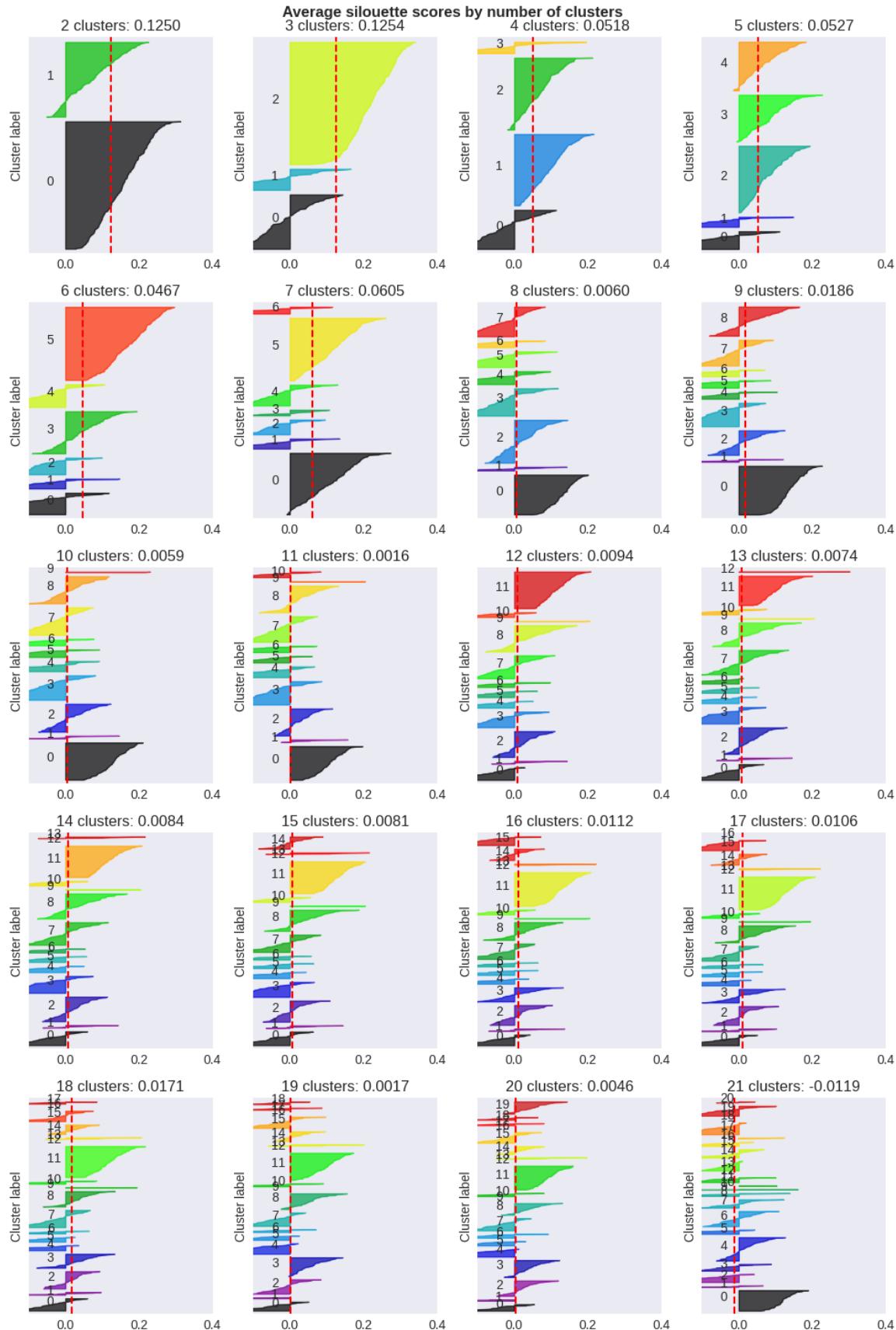
```

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```
plt.suptitle("Average silhouette scores by number of clusters", fontweight="bold")
plt.tight_layout()
plt.show()
```

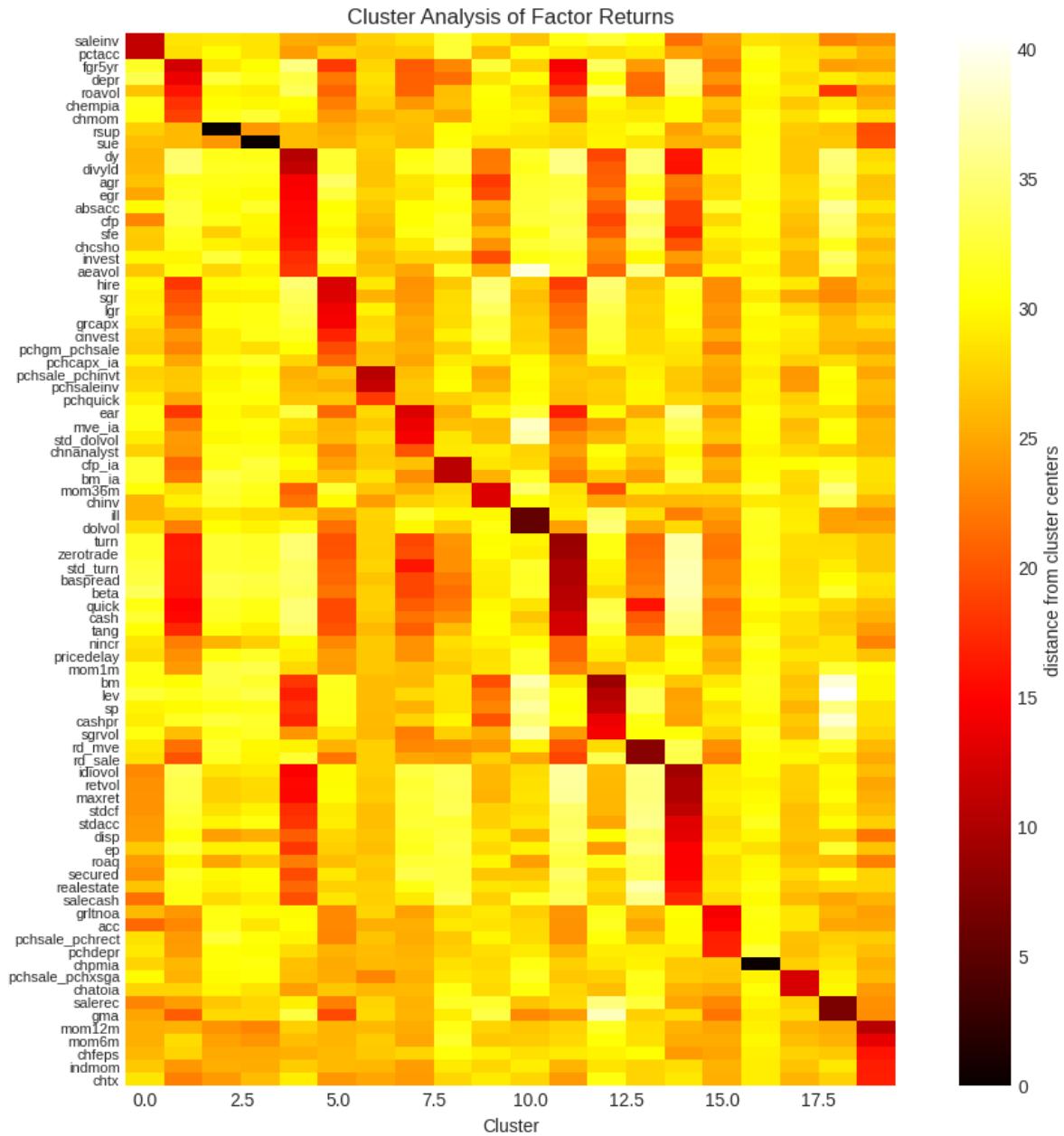
```
For n_clusters = 2 The average silhouette_score is : 0.12501306263608986
For n_clusters = 3 The average silhouette_score is : 0.1253520808683055
For n_clusters = 4 The average silhouette_score is : 0.051754214259910544
For n_clusters = 5 The average silhouette_score is : 0.05274630449356275
For n_clusters = 6 The average silhouette_score is : 0.04667415065092019
For n_clusters = 7 The average silhouette_score is : 0.060547187594243324
For n_clusters = 8 The average silhouette_score is : 0.006033319118781096
For n_clusters = 9 The average silhouette_score is : 0.018578386636466958
For n_clusters = 10 The average silhouette_score is : 0.005929767389313637
For n_clusters = 11 The average silhouette_score is : 0.0016142827400304784
For n_clusters = 12 The average silhouette_score is : 0.009433277087319107
For n_clusters = 13 The average silhouette_score is : 0.0074058888550970915
For n_clusters = 14 The average silhouette_score is : 0.008390097852726994
For n_clusters = 15 The average silhouette_score is : 0.008083959337648997
For n_clusters = 16 The average silhouette_score is : 0.011199855687941018
For n_clusters = 17 The average silhouette_score is : 0.010635928990571105
For n_clusters = 18 The average silhouette_score is : 0.017145225203944906
For n_clusters = 19 The average silhouette_score is : 0.0016945731172339912
For n_clusters = 20 The average silhouette_score is : 0.004636587977095786
For n_clusters = 21 The average silhouette_score is : -0.01191784490776267
```



Heatmap of correlations of strategy returns, grouped together in clusters identified by the K-Means algorithm with K=20.

```
kmeans = KMeans(n_clusters=20, random_state=0, n_init="auto").fit(X.T)
Z = DataFrame(kmeans.transform(X.T), index=X.columns)
Z['distance'] = np.min(Z.iloc[:, :kmeans.n_clusters], axis=1)
Z['cluster'] = np.argmin(Z.iloc[:, :kmeans.n_clusters], axis=1)
Z = Z.sort_values(['cluster', 'distance']) # group by cluster and distance to center
```

```
fig, ax = plt.subplots(figsize=(10, 9))
plt.title('Cluster Analysis of Factor Returns')
plt.imshow(Z.iloc[:, :kmeans.n_clusters], cmap='hot', aspect=1/3)
plt.yticks(range(len(Z)), labels=Z.index, fontsize=8)
plt.xlabel('Cluster')
plt.colorbar(label='distance from cluster centers')
plt.tight_layout()
plt.show()
```



EVENT STUDY

All strange and terrible events are welcome, but comforts we despise - Cleopatra

Concepts

- Abnormal returns
- Convolution Theorem
- Multiple testing

References:

- Kolari, James W. and Pynnonen, Seppo, 2010, “Event Study Testing with Cross-sectional Correlation of Abnormal Returns”. *The Review of Financial Studies*, 23(11), 3996-4025
- Kolari, James W., Paper, Bernd, and Pynnonen, Seppo, 2018, “Event Study Testing with Cross-sectional Correlation Due to Partially Overlapping Event Windows”, working paper

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```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from scipy.stats import norm
from statsmodels.stats.multitest import multipletests
from tqdm import tqdm
import warnings
from finds.database import SQL, RedisDB
from finds.structured import BusDay, Benchmarks, Stocks, CRSP, PSTAT
from finds.backtesting import EventStudy
from secret import credentials, paths, CRSP_DATE
VERBOSE = 0
if not VERBOSE:
    warnings.simplefilter(action='ignore', category=FutureWarning)
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
keydev = PSTAT(sql, bd, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
bench = Benchmarks(sql, bd, verbose=VERBOSE)
```

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```
eventstudy = EventStudy(user, bench=bench, stocks=crsp, max_date=CRSP_DATE)
imgdir = paths['images'] / 'events'
```

Last FamaFrench Date 2024-02-29 00:00:00

7.1 Abnormal returns

Event studies assess the impact on stock returns of a company-specific event such as a merger or company announcement. They investigate deviations of stock returns from expected returns, called abnormal returns, on days around the disclosure of news.

Define the date of the announcement or event $t = 0$, and the daily stock return for each firm i is $R_{i,t}$. Returns of a market- or sector-reference group $R_{m,t}$ is computed as comparison. Then:

- Abnormal returns (AR) for each stock i at time t are defined as $AR_{i,t} = R_{i,t} - R_{m,t}$
- Average abnormal returns (AAR) across firms are defined as $AAR_t = \frac{1}{N} \sum_i^N AR_{i,t}$
- Cumulative average abnormal returns (CAR) are defined over time as $CAR_T = \sum_t AAR_t$
- Buy-and-hold average abnormal returns (BHAR) are defined across firms' buy-and-hold returns as $BHAR_T = \frac{1}{N} \sum_i^N [\Pi_t(1 + AR_{i,t}) - \Pi_t(1 + R_{m,t})]$

7.1.1 Announcement effect

An announcement effect is the immediate spike in stock price upon the announcement or event. An efficient reaction is one where the stock price maintains its new level after the event. An under-reaction occurs when the stock prices continues to trend in the same direction after the announcement. An over-reaction occurs when stock prices drift in the opposite direction after the initial spike.

Often, the exact date and time cannot be pinpointed in historical data. An announcement window around the recorded announcement date, often encompassing one day before and after, accounts for this uncertainty.

A **pre-announcement drift** of stock prices could be consistent with insider information being leaked prior to the announcement, or other explanations. A **post-announcement drift** may possibly due to under- or over-reaction of investors to the news released.

When measuring announcement effects from many stocks and dates, the returns of stocks with the same announcement date are typically averaged together, so the dataset is reduced to unique announcement dates. Even after this transformation, Kolari et al (2010) demonstrate that even small cross-sectional correlation of abnormal returns can cause severe over-rejection of the null hypothesis of zero abnormal returns. In the presence of such cross-sectional correlations, an unbiased estimate of the mean abnormal return σ^2 is given by:

$$\sigma^2 = \frac{s^2}{n} (1 + (n - 1)\hat{r})$$

where \hat{r} is the average of the sample cross-sectional correlations of the estimation-period residuals, and s^2 is the (biased) cross-sectional standard deviation of the abnormal returns.

Retrieve event dates and company roles from CapitalIQ Key Developments

```
# sorted list of all eventids and roleids, provided in keydev class
events = sorted(keydev.event.index)
roles = sorted(keydev.role.index)
```

```
# str formatter to pretty print descriptions, provided in keydev class
eventformat = lambda e, r: "{event} ({eventid}) {role} [{roleid}]"\ \
    .format(event=keydev.event[e], eventid=e, role=keydev.role[r], roleid=r)
```

```
# event window parameters
left, right, post = -1, 1, 21
end = bd.offset(CRSP_DATE, post - left)
beg = 20020101
mindays = 1000
```

Helper functions to retrieve size decile of universe stocks and run event study pipeline

```
class Universe:
    """Helper to lookup prevailing size decile of universe stocks"""
    def __init__(self, beg: int, end: int, stocks: Stocks, annual: bool = False):
        # whether to offset previous month or year end when lookup
        self.offset = stocks.bd.endyr if annual else stocks.bd.endmo

        # populate dictionary, keyed by permno and date, with size decile
        self.decile = dict()
        date_range = stocks.bd.date_range(start=self.offset(beg, -1), end=end,
                                            freq=12 if annual else 'e')
        for date in date_range:
            univ = crsp.get_universe(date)
            for permno in univ.index:
                self.decile[(permno, date)] = univ.loc[permno, 'decile']

    def __getitem__(self, item):
        """Returns size decile, else 0 if not universe stock"""
        permno, date = item
        return self.decile.get((permno, self.offset(date, -1)), 0)

univ = Universe(beg=beg, end=end, stocks=crsp)

# run event study after screening stock universe
def event_pipeline(eventstudy: EventStudy,
                   beg: int,
                   end: int,
                   eventid: int,
                   roleid: int,
                   left: int,
                   right: int,
                   post: int) -> DataFrame:
    """helper to screen stock universe, and merge keydev events and crsp daily"""

    # Retrieve announcement dates for this event
    df = keydev.get_linked(
        dataset='keydev',
        date_field='announcedate',
        fields=['keydevid',
                'keydeveventtypeid',
```

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```

    'keydevtoobjectroletypeid'],
    where=(f"announcedate >= {beg} "
           f" and announcedate <= {end}""
           f" and keydeveventtypeid = {eventid} "
           f" and keydevtoobjectroletypeid = {roleid}"))\ \
    .drop_duplicates(['permno', 'announcedate'])\ \
    .set_index(['permno', 'announcedate'], drop=False)

# Require universe size decile
df['size'] = [univ[row.permno, row.announcedate] for row in df.itertuples()]

# Call eventstudy to retrieve daily abnormal returns, with named label
rows = eventstudy(label=f'{eventid}_{roleid}',
                   df=df[df['size'].gt(0)],
                   left=left,
                   right=right,
                   post=post,
                   date_field='announcedate')
return df.loc[rows.to_records(index=False).tolist()] # restrict successful rows

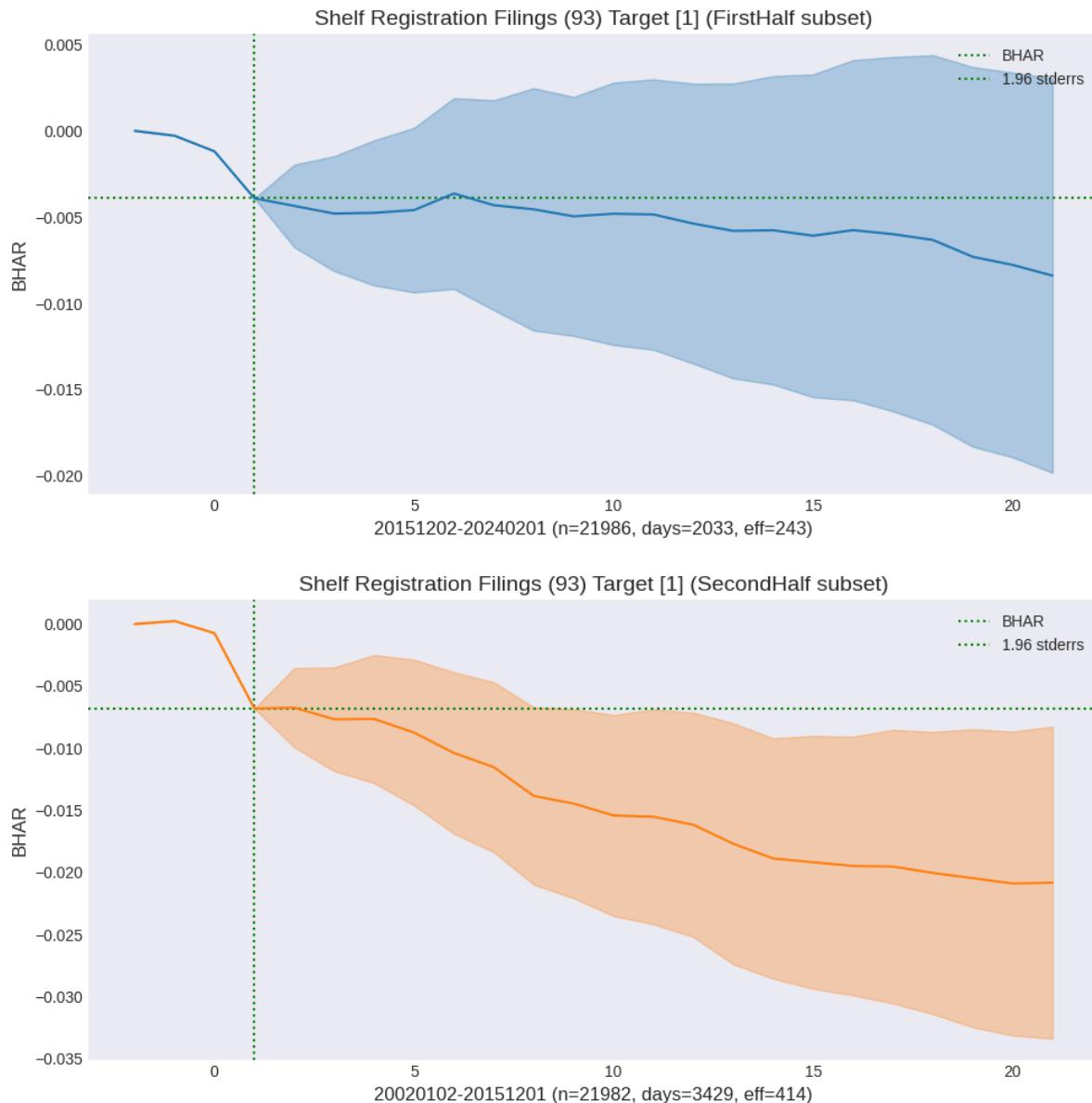
```

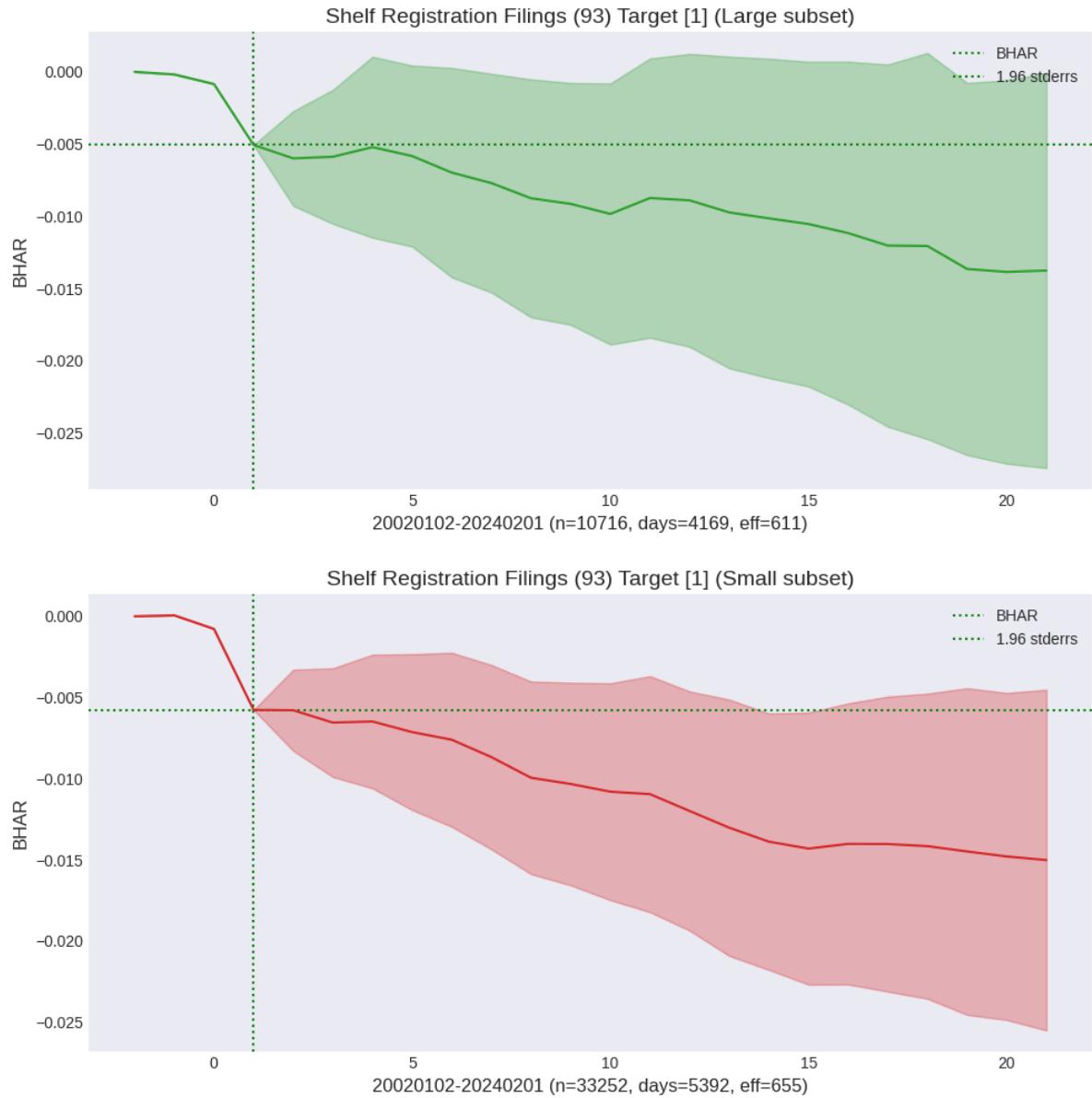
Show subsample plots for events with large post-announcement drift

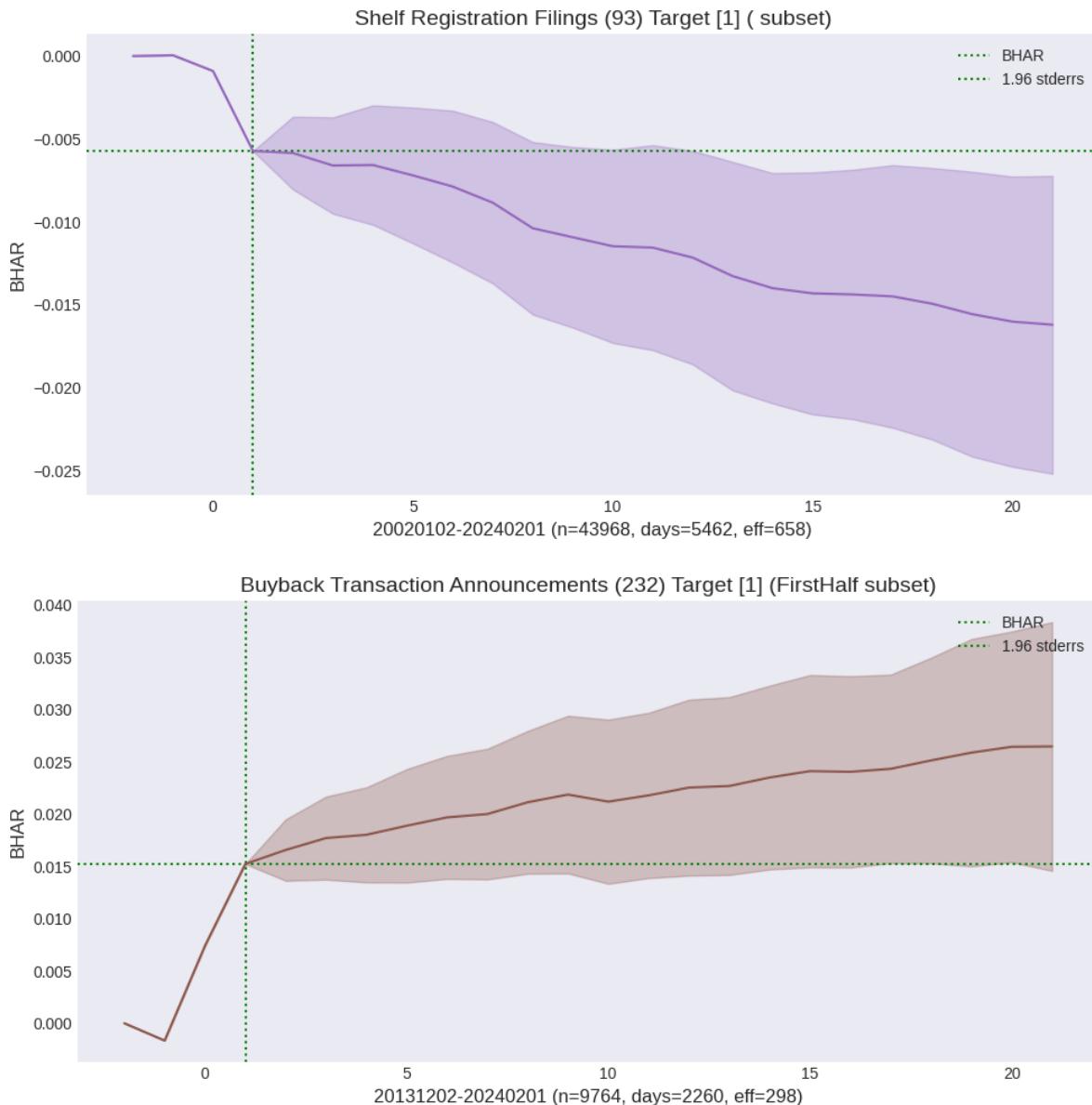
```

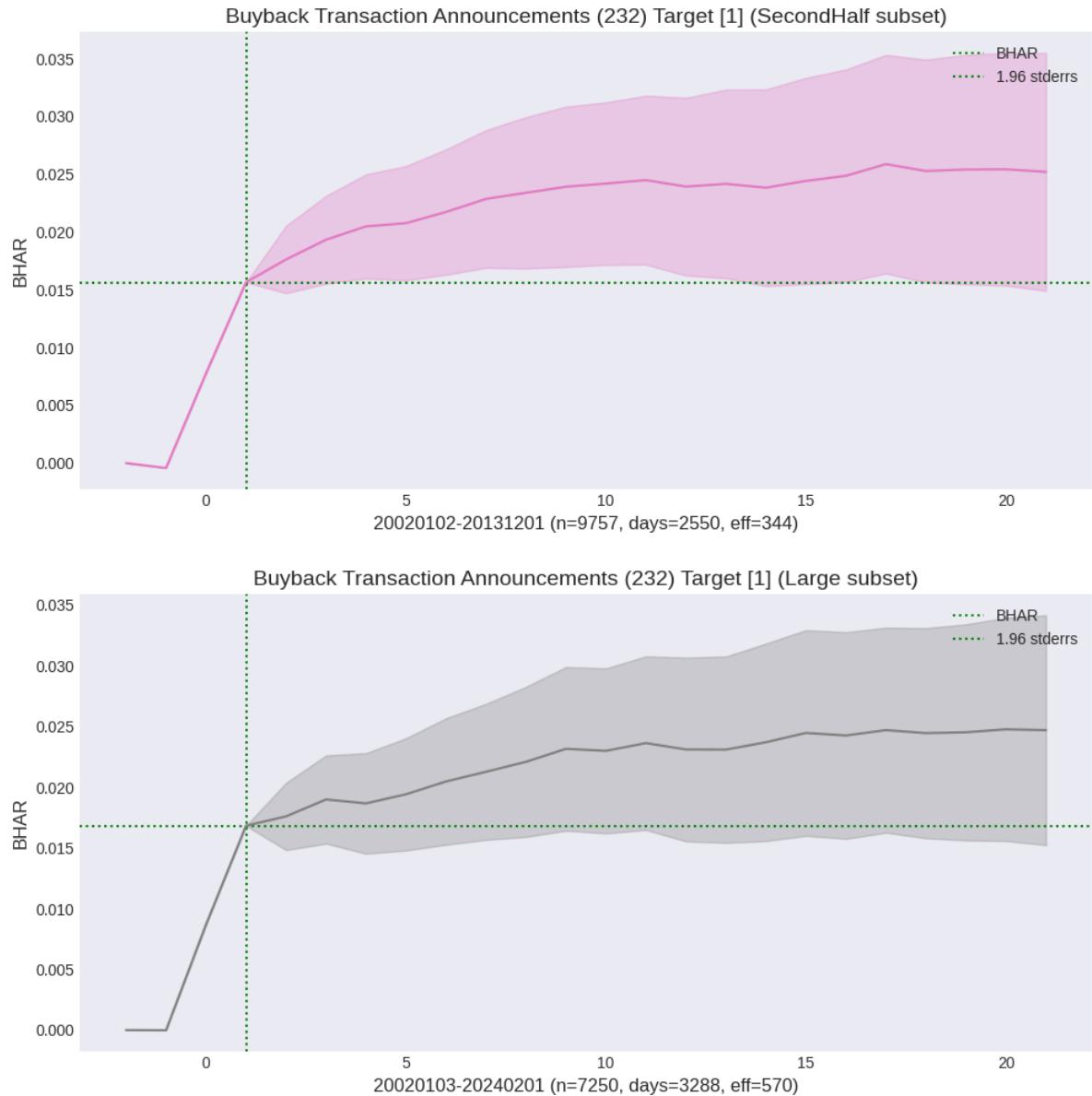
events_list = [[93, 1], [232, 1]] # largest drift returns
for i, (eventid, roleid) in enumerate(events_list):
    df = event_pipeline(eventstudy, eventid=eventid,
                        roleid=roleid,
                        beg=beg,
                        end=end,
                        left=left,
                        right=right,
                        post=post)
    halfperiod = np.median(df['announcedate'])
    sample = {'FirstHalf': df['announcedate'].ge(halfperiod).values,
              'SecondHalf': df['announcedate'].lt(halfperiod).values,
              'Large': df['size'].le(5).values,
              'Small': df['size'].gt(5).values,
              '' : []}
    for ifig, (label, rows) in enumerate(sample.items()):
        fig, ax = plt.subplots(clear=True, figsize=(10, 5))
        bhar = eventstudy.fit(model='sbhar', rows=rows)
        eventstudy.plot(model='sbhar',
                        title=eventformat(eventid, roleid) + f" ({label} subset)",
                        drift=True,
                        ax=ax,
                        c=f"C{i*5+ifig}")
    plt.tight_layout()
    plt.savefig(imgdir / (label + f"{eventid}_{roleid}.jpg"))

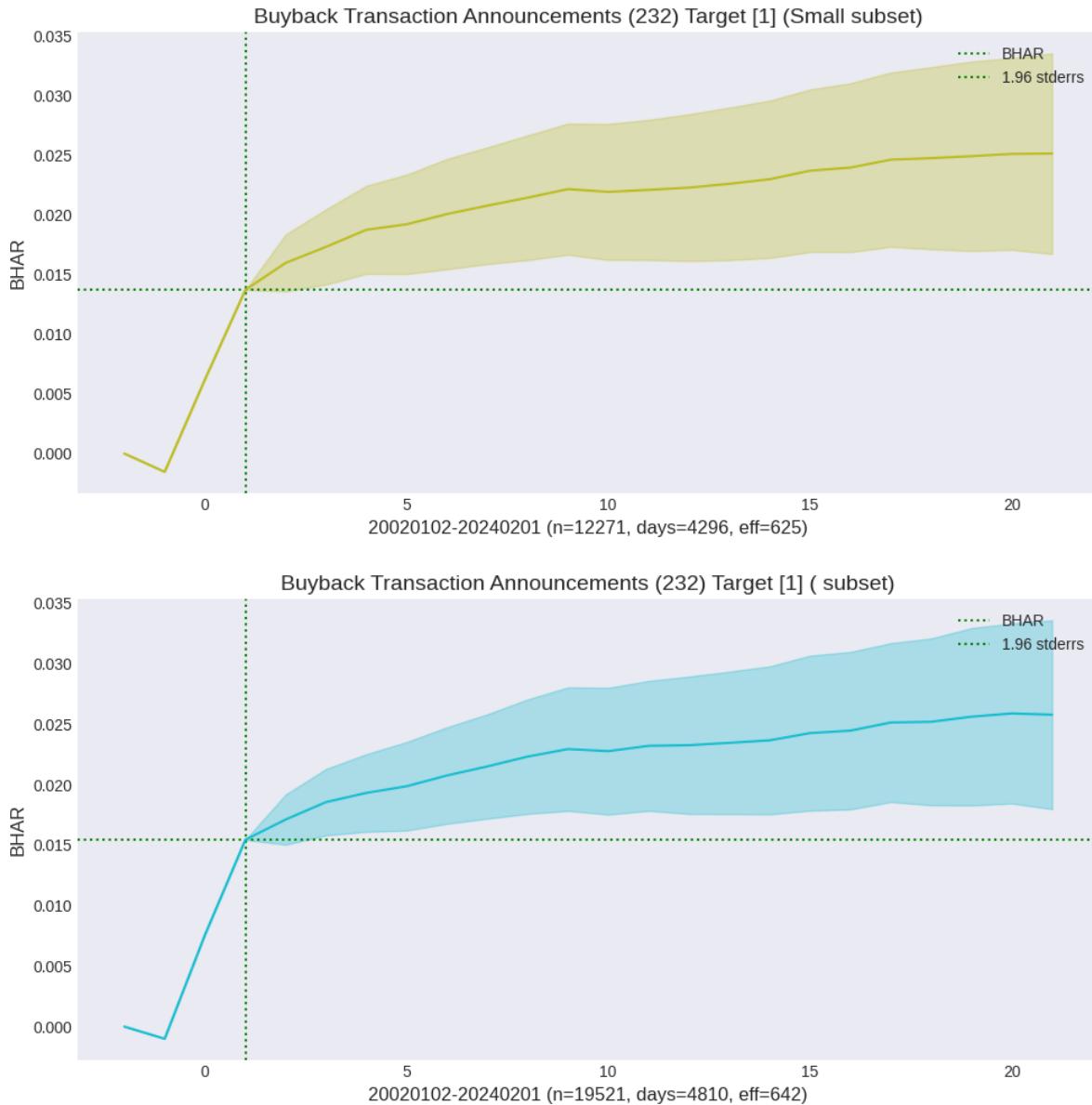
```











Show subsample plots for events with large announcement window returns

```
events_list = [[80,1], [26,1]] # largest announcement window returns
for i, (eventid, roleid) in enumerate(events_list):
    #eventid, roleid = 50, 1
    #eventid, roleid = 83, 1
    df = event_pipeline(eventstudy,
                        eventid=eventid,
                        roleid=roleid,
                        beg=beg,
                        end=end,
                        left=left,
                        right=right,
                        post=post)
    halfperiod = np.median(df['announcedate'])
    sample = {'FirstHalf': df['announcedate'].ge(halfperiod).values,
```

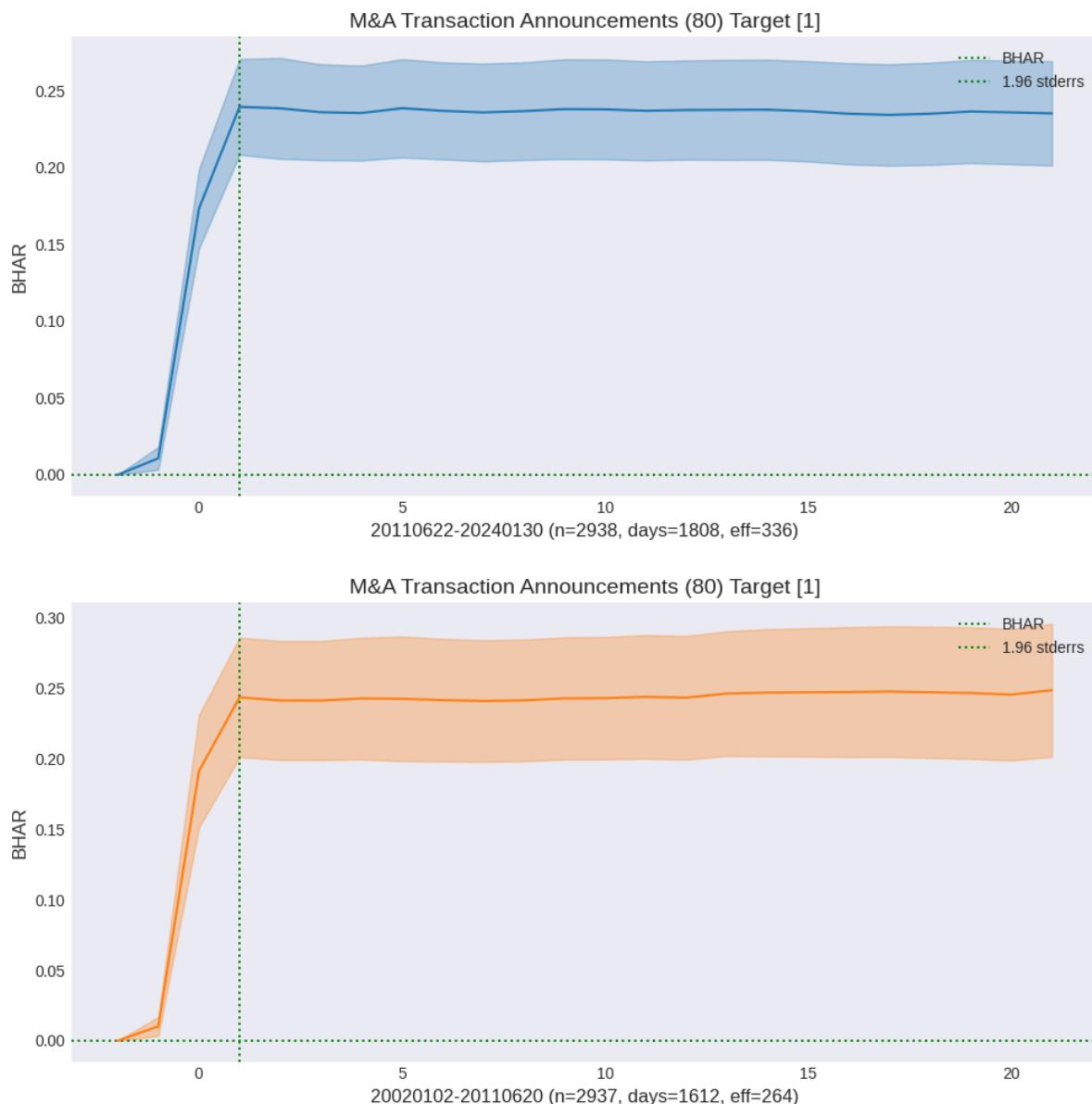
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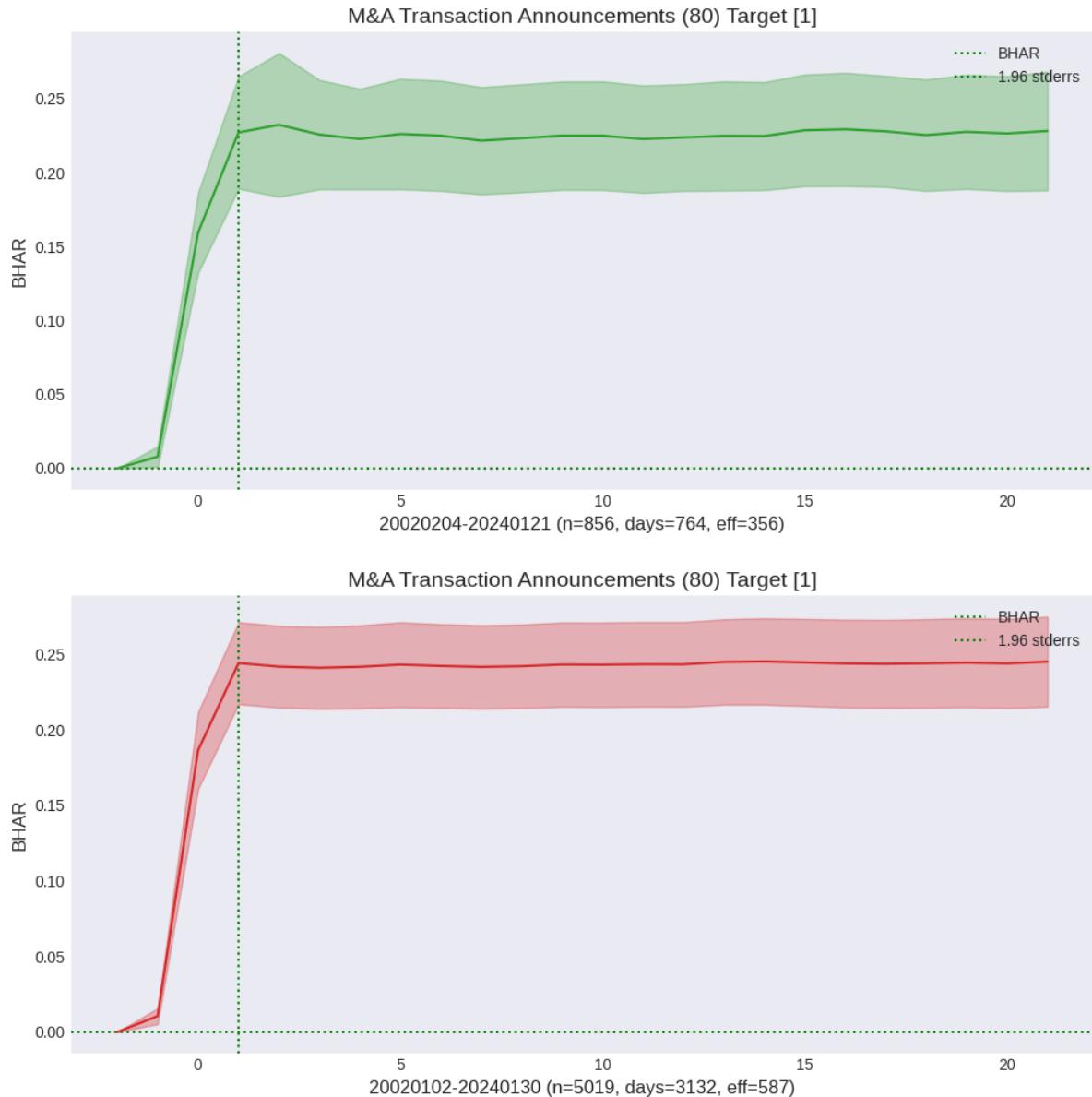
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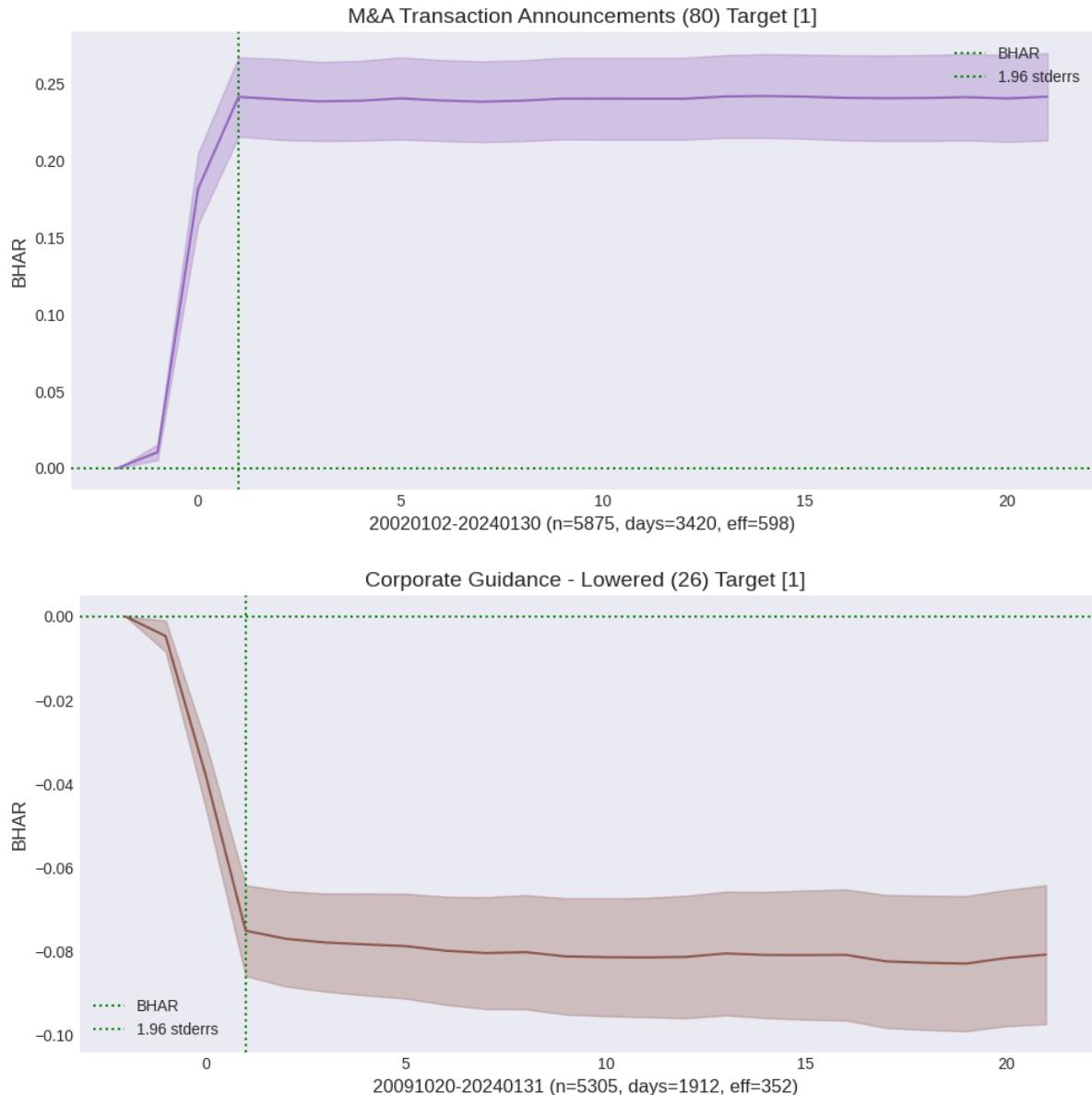
```

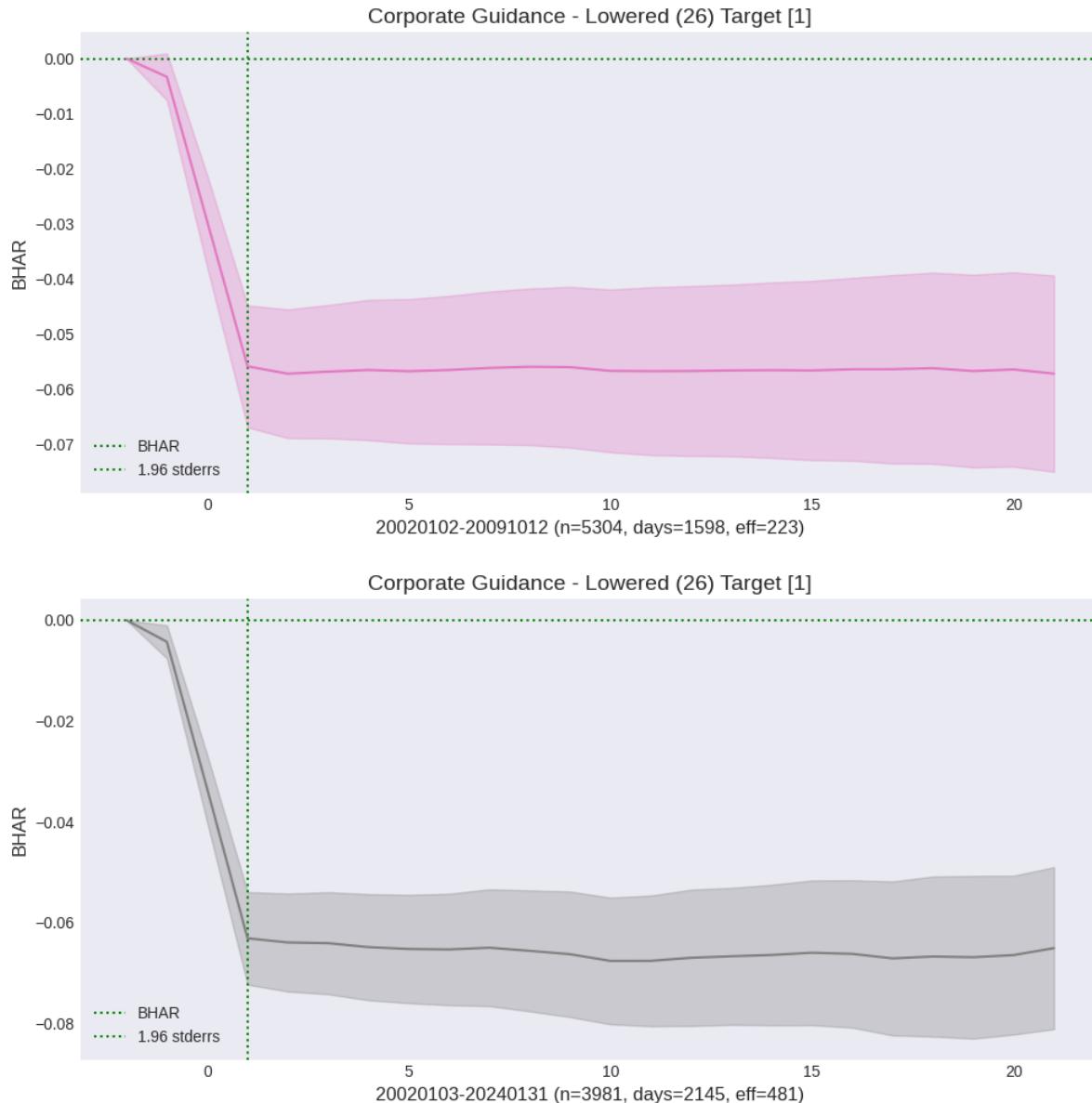
'SecondHalf': df['announcedate'].lt(halfperiod).values,
'Large': df['size'].le(5).values,
'Small': df['size'].gt(5).values,
':': []}
for ifig, (label, rows) in enumerate(sample.items()):
    fig, ax = plt.subplots(clear=True, figsize=(10, 5))
    bhar = eventstudy.fit(model='sbhar', rows=rows)
    eventstudy.plot(model='sbhar',
                     title=eventformat(eventid, roleid),
                     drift=False,
                     ax=ax,
                     c=f"C{i*5+ifig}")
plt.tight_layout()
plt.savefig(imgdir / (label + f"_{eventid}_{roleid}.jpg"))

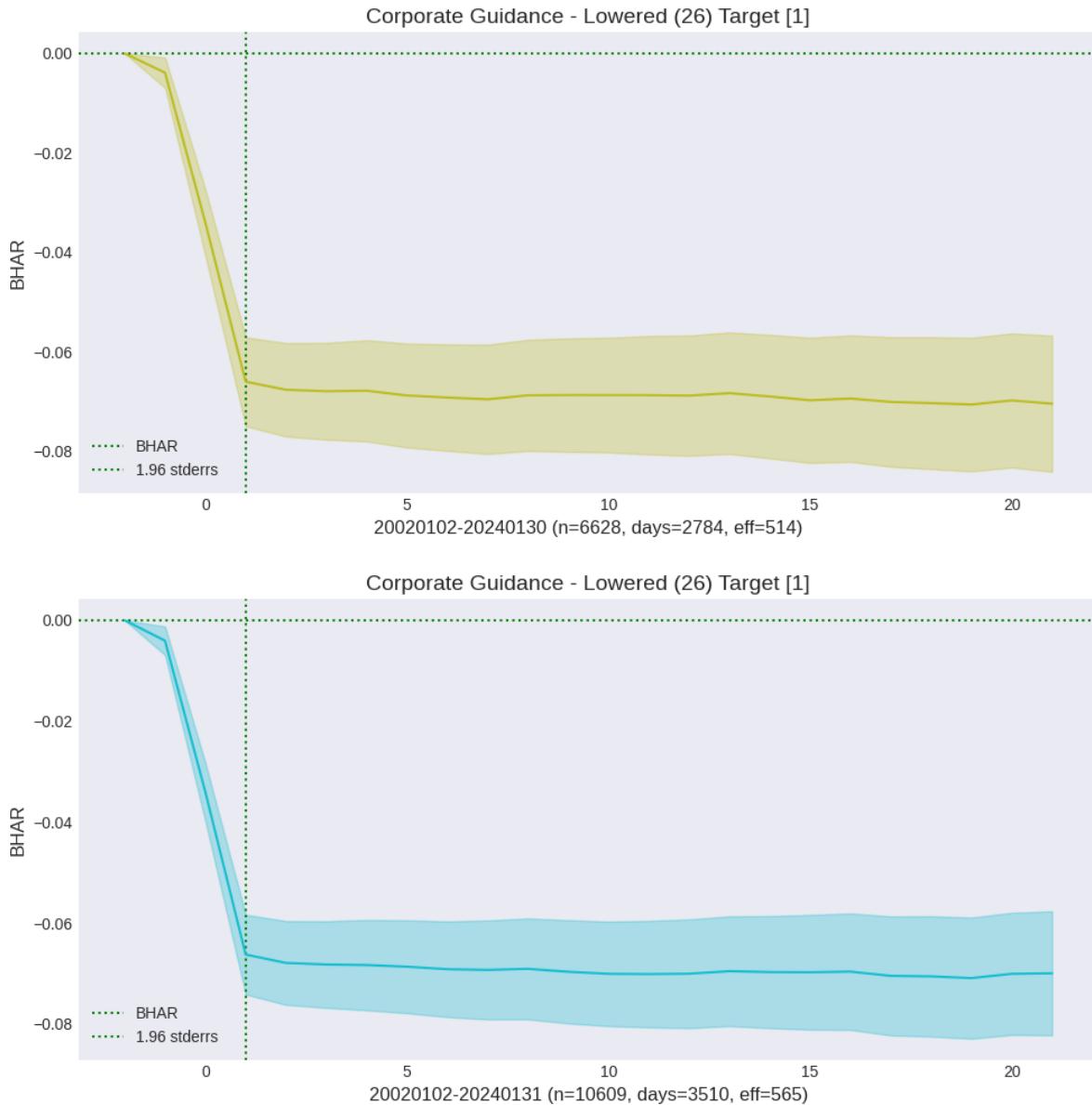
```











7.2 Cross correlation

Kolari et al (2018) consider event windows that partially overlap in calendar time, and modify standard errors and test statistics to adjust for the average percentage of overlaps in event windows and account for cross-sectional correlation effects.

$$\sigma^2 = \frac{s^2}{n} m(1 + \tau(n-1)\rho)$$

where m is the length of the event window, τ is the ratio of number of overlapping calendar days of the event windows to the length of the event windows, and $\rho = \frac{\nu}{s^2}$ is the ratio of the average covariance between abnormal returns to their average variance. If the calendar time of the event day is the same for all firms such that all event periods are completely overlapping, and the residual series are standardized by their respective standard deviations, then ρ is just the average cross-sectional correlation of the estimation window residuals.

To approximate ρ : we assume that cross-sectional correlations between any two series are primarily due to their misalignment, where the number of time periods shifted is unknown. We first find the best alignment of event window residual returns between each pair of series that maximizes their pair-wise correlation, and then compute the average of these best-aligned correlations over all pairs.

7.2.1 Convolution theorem

From the field of signal processing, frequency domain techniques are well suited for computing the cross-correlations at all lags between each pair of time series, and terming every pair-specific best alignment with maximum correlation. Directly computing the correlations for every possible lag between two series may seem computationally expensive over all possible pairs. Such an operation between two series, known as a convolution, can be computed as a product of the Fourier transforms of the two series. The relevant definitions and theorems are summarized below:

A convolution is a mathematical operation on two functions (f and g) that produces a third function ($f*g$) which expresses how the shape of one is modified by the other. It is defined as the integral of the product of the two functions after one is reflected about the y-axis and shifted.

$$(f * g)(t) = \int_{-\infty}^{\infty} f(s)g(t-s)ds = \int_{-\infty}^{\infty} f(t-s)g(s)ds$$

The Convolution Theorem states that under suitable conditions the Fourier transform of a convolution of two signals is the pointwise product of their Fourier transforms. More generally, convolution in the time domain equals point-wise multiplication in the frequency domain. Hence a convolution of two sequences can be obtained as the inverse transform of the product of the individual transforms. Let $*$ denote the convolution of two series:

$$\mathcal{F}\{f(t) * g(t)\} = \mathcal{F}\{f(t)\}\mathcal{F}\{g(t)\}$$

Cross-correlation measures the similarity of two series as a function of the displacement of one relative to the other. This is also known as a sliding dot product or sliding inner-product. Let \star denote the cross-correlation of two series, and \bar{f} denote the complex conjugate:

$$(f \star g)(t) = \int_{-\infty}^{\infty} \overline{f(s)} g(s+t) ds \int_{-\infty}^{\infty} \overline{f(s-t)} g(s) ds$$

The Cross-correlation Theorem states that the cross-correlation integral is equivalent to the convolution integral if one of the input signals is conjugated and time-reversed.

$$[f(t) \star g(t)](\tau) = [\overline{f(-t)} * g(t)](\tau)$$

where τ is called the displacement or lag. For highly-correlated f and g which have a maximum cross-correlation at a particular τ , a feature in f at t also occurs later in g at $t + \tau$, hence g could be described to lag f by τ .

```
# best alignment and cross-correlation using convolution theorem method
from scipy.fft import rfft, irfft
def fft_align(X):
    """Find best alignment, max cross-correlation and indices of all pairs of columns"""
    ↪"""

    def _normalize(X: np.ndarray) -> np.ndarray:
        """Helper to demean columns and divide by norm"""
        X = X - np.mean(X, axis=0)
        X = X / np.linalg.norm(X, axis=0)
        return X

    N, M = X.shape
```

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```

X = np.pad(_normalize(X), [(0, N), (0, 0)]) # normalize and zero pad
Y = rfft(np.flipud(X), axis=0) # FFT of all series flipped
X = rfft(X, axis=0) # FFT of all original series
corr, disp, cols = [], [], []
corr.extend(np.max(conv, axis=0)) # to accumulate results
for col in range(M-1): # at each iter: compute column col * all remaining columns
    conv = irfft(X[:, [col]] * Y[:, col+1:], axis=0) # inverse of product of FFT
    corr.extend(np.max(conv, axis=0))
    shift = (N//2) + 1 # displacement location relative to center
    disp.extend(((np.argmax(conv, axis=0) + shift) % N) - shift + 1)
    cols.extend([(col, j) for j in range(col+1, M)])
return corr, disp, cols
    
```

```

Z = np.random.uniform(size=(10000, 1))
fft_align(np.hstack((Z[:-1], Z[1:])))
    
```

```

([0.9998344824121533], [1], [(0, 1)])
    
```

```

#fft_align(np.hstack(np.hstack((Z[:-5], Z[5:]))[:,2:], Z[:-2]))
fft_align(np.hstack((np.hstack((Z[:-5], Z[5:]))[:-2], Z[7:])))
    
```

```

([0.9996045585524033, 0.9993741961936712, 0.9997696328132938],
 [5, 7, 2],
 [(0, 1), (0, 2), (1, 2)])
    
```

7.3 Multiple testing problem

When testing a huge number of null hypotheses, we are bound to get some very testing small p-values by chance. If we make a decision about whether to reject each null hypothesis without accounting for the fact that we have performed a very large number of tests, then we may end up rejecting a great number of true null hypotheses – that is, making a large number of Type I errors.

Data snooping occurs when the analyst fits a great number of models to a dataset. When explanatory variables are selected using the data, t-ratios and F-ratios will be too large, thus overstating the importance of variables in the model.

Multiple testing adjusts the hurdle for significance because some tests will appear significant by chance. The downside of doing this is that some truly significant strategies might be overlooked because they did not pass the more stringent hurdle. This is the classic tension between Type I errors and Type II errors. The Type I error is the false discovery (investing in an unprofitable trading strategy). The Type II error is missing a truly profitable trading strategy. Data snooping occurs when the analyst fits a great number of models to a dataset. When explanatory variables are selected using the data, t-ratios and F-ratios will be too large, thus overstating the importance of variables in the model.

The false discovery rate (FDR) is the ratio of false discoveries to number of positive tests, which is the sum of false discoveries (i.e. false positives) and true positives. To calculate the false discovery rate, we must take a guess at the fraction of tests that we do in which there is a real difference, and the probability that the test will give the right result when there is a real effect (power). The FDR views unacceptable in terms of a proportion. For example, if one false discovery were unacceptable for 100 tests, then 10 are unacceptable for 1,000 tests.

Family-wise error rate (FWER) generalizes this notion to the setting of m null hypotheses, H_1, \dots, H_m , and is defined as the probability error rate of making at least one Type I error. If we make the additional rather strong assumptions that

the m tests are independent and that all m null hypotheses are true, then

$$\text{FWER}(\alpha) = 1 - \prod_{j=1}^m (1 - \alpha) = 1 - (1 - \alpha)^m$$

In the family-wise error rate, it is unacceptable to make a single false discovery. This is a very severe rule.

Given the p-values, the `multipletests` function from the `statsmodels` module outputs adjusted p-values, which can be thought of as a new set of p-values that have been corrected for multiple testing. If the adjusted p-value for a given hypothesis is less than or equal to alpha, then that hypothesis can be rejected while maintaining a FWER of no more than alpha. In other words, for such methods, the adjusted p-values resulting from the `multipletests` function can simply be compared to the desired FWER in order to determine whether or not to reject each hypothesis. We can use the same function to control FDR as well.

Compute BHAR and CAR of all events

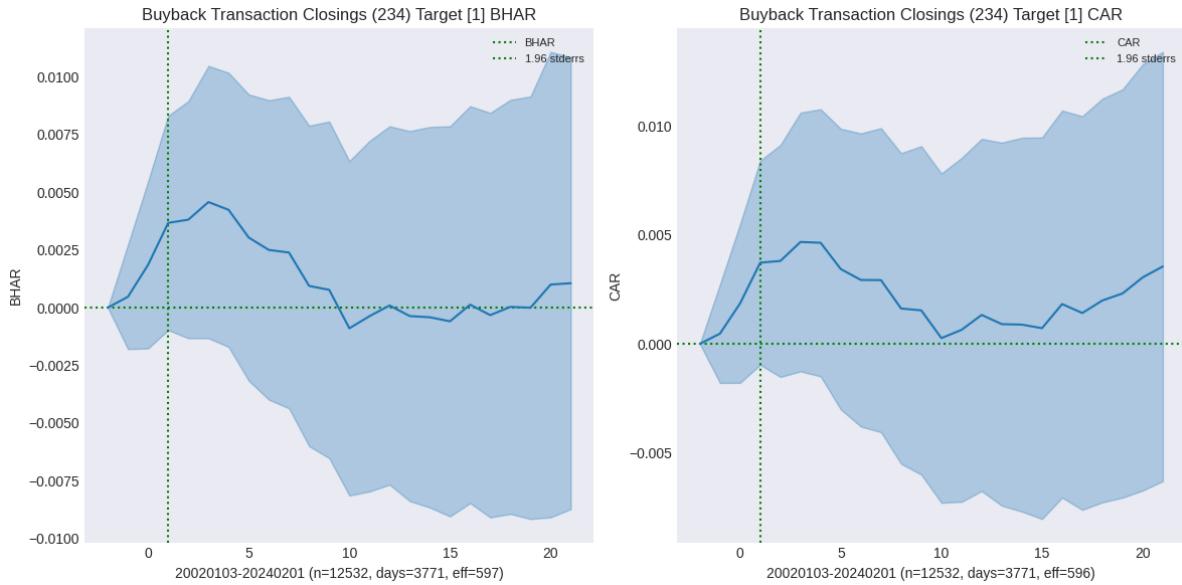
```
restart_event = 0 # 75,1
for i, eventid in tqdm(enumerate(events), total=len(events)):
    if eventid <= restart_event: # kludge to resume loop
        continue
    for roleid in roles:
        # retrieve all returns observations of this eventid, roleid
        df = event_pipeline(eventstudy,
                            beg=beg,
                            end=end,
                            eventid=eventid,
                            roleid=roleid,
                            left=left,
                            right=right,
                            post=post)
    if df['announcedate'].nunique() < mindays: # require min number of dates
        continue

    # compute both BHAR and CAR averages, then plot and save
    bhar = eventstudy.fit(model='sbhar')
    car = eventstudy.fit(model='scar')
    #eventstudy.write()
    eventstudy.write_summary()
    #print(eventstudy.label, eventid, roleid)

    fig, axes = plt.subplots(1, 2, clear=True, figsize=(12, 6), num=1)
    eventstudy.plot(model='sbhar', ax=axes[0],
                    title=eventformat(eventid, roleid) + ' BHAR',
                    fontsize=8, vline=[right])
    eventstudy.plot(model='scar', ax=axes[1],
                    title=eventformat(eventid, roleid) + ' CAR',
                    fontsize=8, vline=[right])
    plt.tight_layout()
    plt.savefig(imgdir / f"{eventid}_{roleid}.jpg")
```

0% | 0/116 [00:00<?, ?it/s]

100% [██████████] 116/116 [26:18:33<00:00, 816.50s/it]



Summarize BHAR's of all events

```
# Create (eventid, roleid) multiindex for table of all BHAR's
df = eventstudy.read_summary(model='sbhar') \
    .set_index('label') \
    .drop(columns=['rho', 'tau', 'created'])
df = df[df['effective'] > 400].sort_values('post_t') # sorted by post drift t-stat
multiIndex = DataFrame(df.index.str.split('_').to_list()).astype(int)
df.index = pd.MultiIndex.from_frame(multiIndex, names=['eventid', 'roleid'])
df['event'] = keydev.event[df.index.get_level_values(0)].values
df['role'] = keydev.role[df.index.get_level_values(1)].values
print("Post-Announcement Drift")
pd.set_option('display.max_rows', None)
df.set_index(['event', 'role']).drop(columns=['model'])
```

Post-Announcement Drift

event	role	beg	end	\
Shelf Registration Filings	Target	20020102	20240201	
Changes in Company Bylaws/Rules	Target	20020430	20240201	
Auditor Changes	Target	20020103	20240131	
Name Changes	Target	20020430	20240130	
Executive Changes - CFO	Target	20020102	20240201	
Special/Extraordinary Shareholders Meeting	Target	20040106	20240131	
Product-Related Announcements	Target	20020102	20240201	
Investor Activism - Target Communication	Target	20020402	20240201	
Executive/Board Changes - Other	Target	20020101	20240201	
Executive Changes - CEO	Target	20020102	20240201	
Index Constituent Adds	Target	20020102	20240123	
M&A Transaction Cancellations	Buyer	20020107	20240128	
M&A Transaction Closings	Target	20020109	20240126	
Business Expansions	Target	20020102	20240201	
Private Placements	Buyer	20020103	20240131	
Earnings Release Date	Target	20020411	20240201	

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Corporate Guidance - Lowered	Target	20020102	20240131
Client Announcements	Target	20020102	20240201
Conferences	Participant	20070125	20240201
Investor Activism - Activist Communication	Target	20020102	20240201
Special Calls	Target	20030211	20240201
Strategic Alliances	Target	20020102	20240201
Buyback Transaction Closings	Target	20020103	20240201
M&A Transaction Announcements	Buyer	20020101	20240201
M&A Transaction Closings	Buyer	20020101	20240201
M&A Transaction Announcements	Seller	20020101	20240201
M&A Calls	Target	20031027	20240130
Shareholder/Analyst Calls	Target	20020108	20240201
M&A Transaction Closings	Seller	20020101	20240201
Follow-on Equity Offerings	Target	20020102	20240201
M&A Rumors and Discussions	Target	20020918	20240201
Business Reorganizations	Target	20020102	20240129
Discontinued Operations/Downsizings	Target	20020102	20240201
Fixed Income Offerings	Target	20020101	20240201
Private Placements	Target	20020103	20240201
Delayed SEC Filings	Target	20020102	20240130
Labor-related Announcements	Target	20020111	20240125
M&A Transaction Announcements	Target	20020102	20240130
Earnings Calls	Target	20020108	20240201
Lawsuits & Legal Issues	Target	20020101	20240201
Board Meeting	Target	20020204	20240126
Corporate Guidance - New/Confirmed	Target	20020101	20240201
Seeking Acquisitions/Investments	Target	20020103	20240201
Impairments/Write Offs	Target	20020408	20240201
Company Conference Presentations	Target	20041101	20240201
Announcements of Sales/Trading Statement	Target	20020102	20240130
Considering Multiple Strategic Alternatives	Target	20040324	20240131
Debt Financing Related	Target	20020102	20240201
Buyback Tranche Update	Target	20020107	20240201
Seeking to Sell/Divest	Target	20020110	20240117
End of Lock-Up Period	Target	20020115	20240130
Corporate Guidance - Raised	Target	20020103	20240201
Announcements of Earnings	Target	20020101	20240201
Delistings	Target	20020107	20240201
Analyst/Investor Day	Target	20040204	20240201
Investor Activism - Proxy/Voting Related	Target	20020107	20240201
Annual General Meeting	Target	20020122	20240129
Buyback - Change in Plan Terms	Target	20020102	20240201
Buyback Transaction Announcements	Target	20020102	20240201

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Shelf Registration Filings	Target	43968	5462	
Changes in Company Bylaws/Rules	Target	26080	4614	
Auditor Changes	Target	9232	3738	
Name Changes	Target	1516	1282	
Executive Changes - CFO	Target	21873	5337	
Special/Extraordinary Shareholders Meeting	Target	5710	3176	
Product-Related Announcements	Target	203597	5559	
Investor Activism - Target Communication	Target	4995	2914	
Executive/Board Changes - Other	Target	215926	5558	
Executive Changes - CEO	Target	16560	5080	

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		Target	27762	2158	
Index Constituent Adds	Buyer	1481	1233		
M&A Transaction Cancellations	Target	1453	1154		
M&A Transaction Closings	Target	57173	5510		
Business Expansions	Buyer	10955	4168		
Private Placements	Target	218101	5086		
Earnings Release Date	Target	10609	3510		
Corporate Guidance - Lowered	Target	208109	5555		
Client Announcements	Participant	280404	3467		
Conferences	Target	8126	3707		
Investor Activism - Activist Communication	Target	15526	4299		
Special Calls	Target	28757	5281		
Strategic Alliances	Target	12532	3771		
Buyback Transaction Closings	Buyer	24750	5309		
M&A Transaction Announcements	Buyer	42052	5496		
M&A Transaction Closings	Seller	12010	4648		
M&A Transaction Announcements	Target	7029	3193		
M&A Calls	Target	21606	4209		
Shareholder/Analyst Calls	Seller	18006	4962		
M&A Transaction Closings	Target	20686	5015		
Follow-on Equity Offerings	Target	21229	4421		
M&A Rumors and Discussions	Target	4374	2743		
Business Reorganizations	Target	18697	4379		
Discontinued Operations/Downsizings	Target	26916	5203		
Fixed Income Offerings	Target	14052	4838		
Private Placements	Target	12480	1999		
Delayed SEC Filings	Target	3941	2460		
Labor-related Announcements	Target	5875	3420		
M&A Transaction Announcements	Target	227032	5234		
Earnings Calls	Target	40786	5420		
Lawsuits & Legal Issues	Target	6482	2646		
Board Meeting	Target	143964	5449		
Corporate Guidance - New/Confirmed	Target	37127	5089		
Seeking Acquisitions/Investments	Target	22850	3407		
Impairments/Write Offs	Target	324553	4767		
Company Conference Presentations	Target	12285	3231		
Announcements of Sales/Trading Statement	Target	3914	2410		
Considering Multiple Strategic Alternatives	Target	40154	5508		
Debt Financing Related	Target	106352	4870		
Buyback Tranche Update	Target	5230	2908		
Seeking to Sell/Divest	Target	6822	3151		
End of Lock-Up Period	Target	19376	4041		
Corporate Guidance - Raised	Target	331260	5502		
Announcements of Earnings	Target	16431	4736		
Delistings	Target	6407	3211		
Analyst/Investor Day	Target	6993	3020		
Investor Activism - Proxy/Voting Related	Target	68147	4887		
Annual General Meeting	Target	6627	3281		
Buyback - Change in Plan Terms	Target	19521	4810		
Buyback Transaction Announcements	Target			effective	window \
event	role				
Shelf Registration Filings	Target	658.0	-0.005723		
Changes in Company Bylaws/Rules	Target	567.0	0.000111		
Auditor Changes	Target	587.0	-0.003299		
Name Changes	Target	434.0	0.012904		

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Executive Changes - CFO	Target	652.0	-0.007732
Special/Extraordinary Shareholders Meeting	Target	513.0	-0.000755
Product-Related Announcements	Target	662.0	0.005881
Investor Activism - Target Communication	Target	504.0	0.008170
Executive/Board Changes - Other	Target	661.0	-0.000451
Executive Changes - CEO	Target	648.0	-0.004515
Index Constituent Adds	Target	496.0	-0.001032
M&A Transaction Cancellations	Buyer	444.0	-0.000830
M&A Transaction Closings	Target	406.0	0.011893
Business Expansions	Target	663.0	0.001807
Private Placements	Buyer	623.0	0.000871
Earnings Release Date	Target	608.0	0.000167
Corporate Guidance - Lowered	Target	565.0	-0.066260
Client Announcements	Target	663.0	0.008302
Conferences	Participant	426.0	-0.000576
Investor Activism - Activist Communication	Target	553.0	0.015004
Special Calls	Target	574.0	0.019873
Strategic Alliances	Target	655.0	0.010172
Buyback Transaction Closings	Target	597.0	0.003669
M&A Transaction Announcements	Buyer	658.0	0.010916
M&A Transaction Closings	Buyer	663.0	0.004906
M&A Transaction Announcements	Seller	639.0	0.010365
M&A Calls	Target	543.0	0.060313
Shareholder/Analyst Calls	Target	562.0	-0.000081
M&A Transaction Closings	Seller	649.0	0.004011
Follow-on Equity Offerings	Target	642.0	-0.031380
M&A Rumors and Discussions	Target	561.0	0.013601
Business Reorganizations	Target	512.0	-0.002682
Discontinued Operations/Downsizings	Target	581.0	-0.008746
Fixed Income Offerings	Target	652.0	-0.005389
Private Placements	Target	634.0	0.022058
Delayed SEC Filings	Target	498.0	-0.014976
Labor-related Announcements	Target	476.0	0.002075
M&A Transaction Announcements	Target	598.0	0.241380
Earnings Calls	Target	630.0	0.000473
Lawsuits & Legal Issues	Target	658.0	-0.000651
Board Meeting	Target	458.0	0.001948
Corporate Guidance - New/Confirmed	Target	661.0	-0.002079
Seeking Acquisitions/Investments	Target	647.0	-0.000001
Impairments/Write Offs	Target	502.0	-0.002974
Company Conference Presentations	Target	568.0	0.001339
Announcements of Sales/Trading Statement	Target	570.0	0.002500
Considering Multiple Strategic Alternatives	Target	461.0	-0.007378
Debt Financing Related	Target	660.0	0.005354
Buyback Tranche Update	Target	621.0	0.000841
Seeking to Sell/Divest	Target	499.0	-0.002341
End of Lock-Up Period	Target	541.0	-0.058891
Corporate Guidance - Raised	Target	611.0	0.032878
Announcements of Earnings	Target	660.0	0.000328
Delistings	Target	603.0	-0.022604
Analyst/Investor Day	Target	524.0	0.006024
Investor Activism - Proxy/Voting Related	Target	507.0	-0.001108
Annual General Meeting	Target	595.0	0.001885
Buyback - Change in Plan Terms	Target	583.0	0.008746
Buyback Transaction Announcements	Target	642.0	0.015452

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event	role	window_t	post	\
Shelf Registration Filings	Target	-2.953200	-0.010470	
Changes in Company Bylaws/Rules	Target	0.042656	-0.010652	
Auditor Changes	Target	-1.106310	-0.011627	
Name Changes	Target	2.072100	-0.021342	
Executive Changes - CFO	Target	-3.119900	-0.007747	
Special/Extraordinary Shareholders Meeting	Target	-0.203839	-0.013482	
Product-Related Announcements	Target	4.758170	-0.003877	
Investor Activism - Target Communication	Target	1.945040	-0.007546	
Executive/Board Changes - Other	Target	-0.442385	-0.002750	
Executive Changes - CEO	Target	-1.210740	-0.007229	
Index Constituent Adds	Target	-0.394831	-0.006559	
M&A Transaction Cancellations	Buyer	-0.153281	-0.011231	
M&A Transaction Closings	Target	1.369390	-0.013536	
Business Expansions	Target	1.465250	-0.002680	
Private Placements	Buyer	0.522021	-0.003573	
Earnings Release Date	Target	0.158605	-0.002156	
Corporate Guidance - Lowered	Target	-16.435100	-0.003715	
Client Announcements	Target	7.351210	-0.002044	
Conferences	Participant	-0.458456	-0.002489	
Investor Activism - Activist Communication	Target	4.258800	-0.004300	
Special Calls	Target	0.789582	-0.013420	
Strategic Alliances	Target	3.713280	-0.002782	
Buyback Transaction Closings	Target	1.549030	-0.002613	
M&A Transaction Announcements	Buyer	3.012090	-0.002259	
M&A Transaction Closings	Buyer	3.378730	-0.001616	
M&A Transaction Announcements	Seller	2.572670	-0.002726	
M&A Calls	Target	8.263100	-0.002316	
Shareholder/Analyst Calls	Target	-0.028738	-0.002662	
M&A Transaction Closings	Seller	1.823550	-0.001731	
Follow-on Equity Offerings	Target	-5.485400	-0.003701	
M&A Rumors and Discussions	Target	4.939740	-0.001830	
Business Reorganizations	Target	-0.770601	-0.002331	
Discontinued Operations/Downsizing	Target	-2.599930	-0.001346	
Fixed Income Offerings	Target	-3.096800	-0.000678	
Private Placements	Target	3.816930	-0.001219	
Delayed SEC Filings	Target	-2.507320	-0.001142	
Labor-related Announcements	Target	0.657079	-0.000550	
M&A Transaction Announcements	Target	18.389100	0.000139	
Earnings Calls	Target	0.434752	0.000274	
Lawsuits & Legal Issues	Target	-0.309857	0.000435	
Board Meeting	Target	0.686676	0.001542	
Corporate Guidance - New/Confirmed	Target	-1.229350	0.000875	
Seeking Acquisitions/Investments	Target	-0.000492	0.001187	
Impairments/Write Offs	Target	-0.905683	0.002642	
Company Conference Presentations	Target	1.353990	0.001249	
Announcements of Sales/Trading Statement	Target	0.831303	0.003360	
Considering Multiple Strategic Alternatives	Target	-1.002320	0.012381	
Debt Financing Related	Target	2.456220	0.003117	
Buyback Tranche Update	Target	0.491636	0.002297	
Seeking to Sell/Divest	Target	-0.456121	0.007285	
End of Lock-Up Period	Target	-9.594920	0.007141	
Corporate Guidance - Raised	Target	10.723600	0.005254	
Announcements of Earnings	Target	0.205462	0.003517	
Delistings	Target	-4.433630	0.015234	

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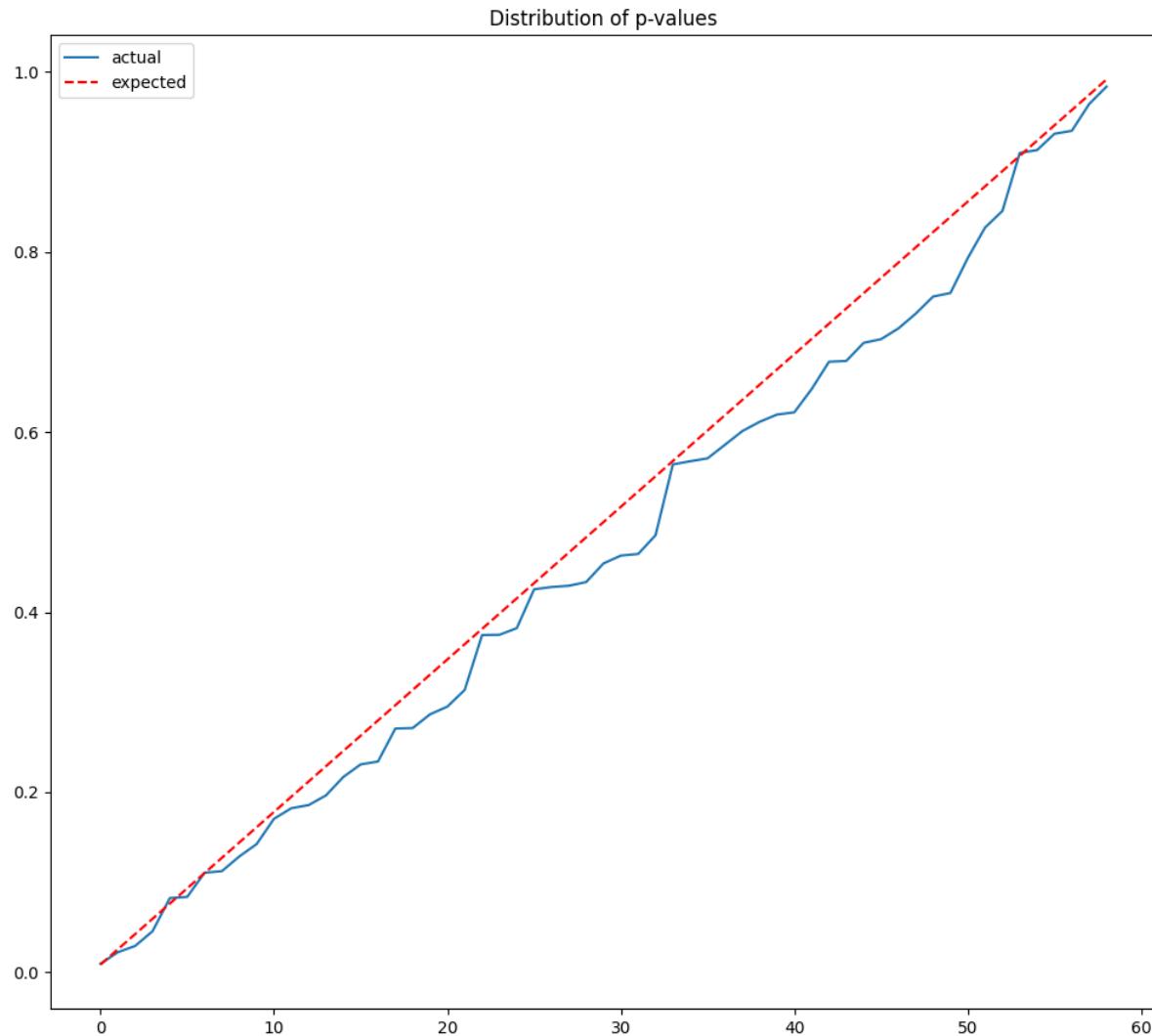
Analyst/Investor Day	Target	2.396800	0.007048
Investor Activism - Proxy/Voting Related	Target	-0.509462	0.010531
Annual General Meeting	Target	1.224010	0.006747
Buyback - Change in Plan Terms	Target	3.685190	0.009255
Buyback Transaction Announcements	Target	6.943710	0.010344
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Shelf Registration Filings	Target	-2.287190	
Changes in Company Bylaws/Rules	Target	-2.000120	
Auditor Changes	Target	-1.737210	
Name Changes	Target	-1.729880	
Executive Changes - CFO	Target	-1.588070	
Special/Extraordinary Shareholders Meeting	Target	-1.519900	
Product-Related Announcements	Target	-1.467370	
Investor Activism - Target Communication	Target	-1.198240	
Executive/Board Changes - Other	Target	-1.189980	
Executive Changes - CEO	Target	-1.100320	
Index Constituent Adds	Target	-1.065910	
M&A Transaction Cancellations	Buyer	-1.047170	
M&A Transaction Closings	Target	-1.007740	
Business Expansions	Target	-0.888018	
Private Placements	Buyer	-0.887581	
Earnings Release Date	Target	-0.797304	
Corporate Guidance - Lowered	Target	-0.790521	
Client Announcements	Target	-0.783472	
Conferences	Participant	-0.734339	
Investor Activism - Activist Communication	Target	-0.731366	
Special Calls	Target	-0.697699	
Strategic Alliances	Target	-0.576902	
Buyback Transaction Closings	Target	-0.571668	
M&A Transaction Announcements	Buyer	-0.566940	
M&A Transaction Closings	Buyer	-0.544916	
M&A Transaction Announcements	Seller	-0.456992	
M&A Calls	Target	-0.415104	
Shareholder/Analyst Calls	Target	-0.413827	
M&A Transaction Closings	Seller	-0.386578	
Follow-on Equity Offerings	Target	-0.381144	
M&A Rumors and Discussions	Target	-0.365101	
Business Reorganizations	Target	-0.312863	
Discontinued Operations/Downsizing	Target	-0.218363	
Fixed Income Offerings	Target	-0.194733	
Private Placements	Target	-0.113048	
Delayed SEC Filings	Target	-0.086236	
Labor-related Announcements	Target	-0.082097	
M&A Transaction Announcements	Target	0.020541	
Earnings Calls	Target	0.044777	
Lawsuits & Legal Issues	Target	0.109043	
Board Meeting	Target	0.262207	
Corporate Guidance - New/Confirmed	Target	0.318072	
Seeking Acquisitions/Investments	Target	0.343154	
Impairments/Write Offs	Target	0.493208	
Company Conference Presentations	Target	0.496738	
Announcements of Sales/Trading Statement	Target	0.508218	
Considering Multiple Strategic Alternatives	Target	0.522977	
Debt Financing Related	Target	0.748678	

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Buyback Tranche Update	Target	0.792872
Seeking to Sell/Divest	Target	0.873905
End of Lock-Up Period	Target	1.101470
Corporate Guidance - Raised	Target	1.234920
Announcements of Earnings	Target	1.291870
Delistings	Target	1.323590
Analyst/Investor Day	Target	1.334210
Investor Activism - Proxy/Voting Related	Target	1.371040
Annual General Meeting	Target	1.595650
Buyback - Change in Plan Terms	Target	2.180510
Buyback Transaction Announcements	Target	2.596150

```
# Expected p-values (with continuity correction)
pvals = norm.cdf(-df['post_t'].abs()) * 2
fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 9))
ax.plot(sorted(pvals))
ax.plot([0, len(pvals)-1], [0.5/len(pvals), (len(pvals)-0.5)/len(pvals)], 'r--')
ax.set_title('Distribution of p-values')
ax.legend(['actual', 'expected'])
plt.tight_layout()
```



```
# Number of rejections with uncorrected pvals
#argmin = np.argmin(pvals)
#header = df.iloc[argmin][['event', 'role', 'days', 'effective', 'post_t']]
alpha = 0.05
uncorrected = DataFrame({'rejections': sum(pvals < alpha),
                        'min p-value': min(pvals)},
                        index=['uncorrected'])
uncorrected.round(4)
```

	rejections	min p-value
uncorrected	4	0.0094

7.3.1 Bonferroni correction

The best-known FWER test is called the Bonferroni test which adjusts for the multiple tests. Given the chance that one test could randomly show up as significant, the Bonferroni requires the confidence level to increase. Instead of 5%, you take the 5% and divide by the number of tests, that is, $5\%/10 = 0.5\%$. Again equivalently, you need to be 99.5% confident with 10 tests that you are not making a single false discovery. In terms of the t-statistic, the Bonferroni requires a statistic of at least 2.8 for 10 tests. For 1,000 tests, the statistic must exceed 4.1.

It sets the threshold for rejecting each hypothesis to α/m , by applying the union bound inequality:

$$\text{FWER}(\alpha) = \Pr(\bigcup_{j=1}^m A_j) \leq \sum_{j=1}^m \Pr(A_j) \leq m \times \frac{\alpha}{m} = \alpha$$

where A_j denotes the probability of rejecting the j -th hypothesis. The Bonferroni correction can be quite conservative, in the sense that the true FWER is often quite a bit lower than the nominal (or target) FWER;

```
# The Bonferroni p-values bonf are simply the uncorrected pvalues multiplied by
# the number of samples and truncated to be less than or equal to 1.
reject, bonf_corrected, _, _ = multipletests(pvals, alpha=alpha, method='bonferroni')
bonf = DataFrame({'rejections': np.sum(bonf_corrected < alpha),
                  'min p-value': np.min(bonf_corrected)},
                  index=['bonferroni'])
pd.concat([uncorrected, bonf], axis=0).round(4)
```

	rejections	min p-value
uncorrected	4	0.0094
bonferroni	0	0.5562

7.3.2 Holm's step-down procedure

Holm's method, also known as Holm's step-down procedure or the Holm-Bonferroni method, is an alternative to the Bonferroni procedure. Holm's method controls the FWER, but it is less conservative than Bonferroni, in the sense that it will reject more null hypotheses, typically resulting in fewer Type II errors and hence greater power. Holm's method makes no independence assumptions about the hypothesis tests, and is uniformly more powerful than the Bonferroni method – it will always reject at least as many null hypotheses as Bonferroni – and so it should always be preferred. It is worth noting that in Holm's procedure, the threshold that we use to reject each null hypothesis actually depends on the values of all the p-values.

The Holm method begins by sorting the tests from the lowest p-value (most significant) to the highest (least significant), and comparing a threshold computed with the Holm function. In contrast to the Bonferroni, which has a single threshold for all tests, the other tests will have a different hurdle under Holm. Starting from the first test, we sequentially compare the p-values with their hurdles. When we first come across the test such that its p-value fails to meet the hurdle, we reject this test and all others with higher p-values.

```
# Holm method
reject, holm_corrected, _, _ = multipletests(pvals, alpha=alpha, method='holm')
holm = DataFrame({'rejections': np.sum(holm_corrected < alpha),
                  'min p-value': np.min(holm_corrected)},
                  index=['holm'])
pd.concat([uncorrected, bonf, holm], axis=0).round(4)
```

	rejections	min p-value
uncorrected	4	0.0094

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bonferroni	0	0.5562
holm	0	0.5562

7.3.3 Benjamin-Hochberg procedure

The false discovery rate approach allows an expected proportional error rate. As such, it is less stringent than both the Bonferroni and the Holm test. FDR control is much milder – and more powerful – than FWER control, in the sense that it allows us to reject many more null hypotheses, with a cost of substantially more false positives.

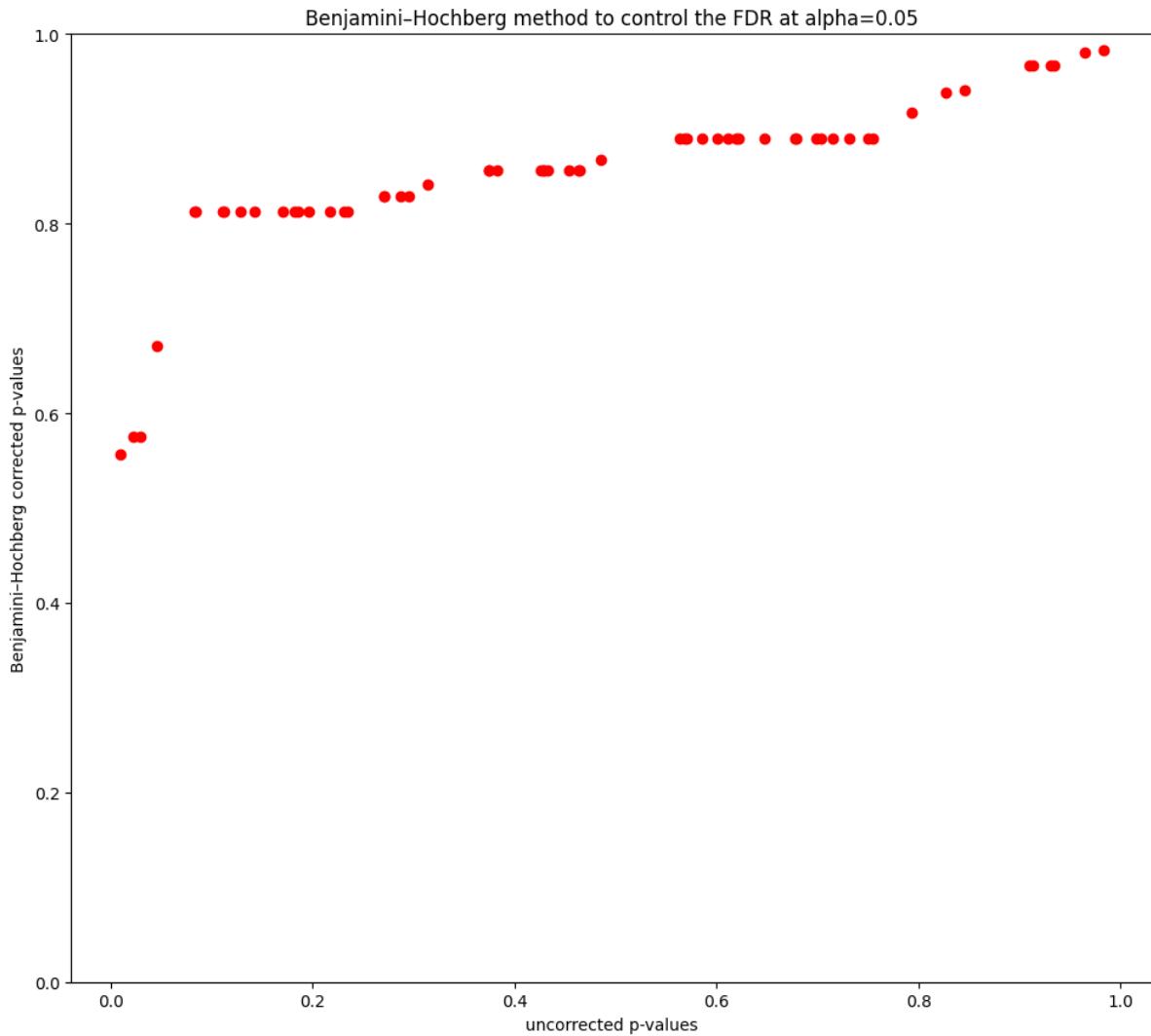
Similar to the Holm test, Benjamin-Hochberg also relies on the distribution of test statistics. However, in contrast to the Holm test that begins with the most significant test, the Benjamin-Hochberg approach starts with the least significant. We sort the tests from the lowest p-value (most significant) to the highest (least significant). Starting from the last test, we sequentially compare the p-values with their Benjamin-Hochberg thresholds. When we first come across the test such that its p-value falls below its threshold, we declare this test significant and all tests that have a lower p-value.

The `multipletests` function can be used to carry out the Benjamini-Hochberg procedure. The q-values output by the Benjamini-Hochberg procedure can be interpreted as the smallest FDR threshold at which we would reject a particular null hypothesis. For instance, a q-value of 0.1 indicates that we can reject the corresponding null hypothesis at an FDR of 10% or greater, but that we cannot reject the null hypothesis at an FDR below 10%.

```
# Benjamini-Hochberg method
reject, fdr_bh_corrected, _, _ = multipletests(pvals, alpha=alpha, method='fdr_bh')
fdr_bh = DataFrame({'rejections': np.sum(fdr_bh_corrected < alpha),
                    'min p-value': np.min(fdr_bh_corrected)},
                   index=['fdr_bh'])
pd.concat([uncorrected, bonf, holm, fdr_bh], axis=0).round(4)
```

	rejections	min p-value
uncorrected	4	0.0094
bonferroni	0	0.5562
holm	0	0.5562
fdr_bh	0	0.5562

```
# Plot uncorrected and corrected p-values from Benjamini-Hochberg method
fig, ax = plt.subplots(figsize=(10, 9))
ax.scatter(pvals, fdr_bh_corrected, color='red')
ax.set_xlim(bottom=0, top=1)
ax.set_title(f"Benjamini-Hochberg method to control the FDR at alpha={alpha}")
ax.set_xlabel('uncorrected p-values')
ax.set_ylabel('Benjamini-Hochberg corrected p-values')
plt.tight_layout()
```



ECONOMIC DATA REVISIONS

What we learn from history is that people don't learn from history - Warren Buffett

Concepts:

- Retrieving data from the web
- Vintage economic data and revisions
- Payrolls employment indices
- St Louis Fed FRED, Archival FRED, and FRED-MD
- Outliers

References:

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- <https://research.stlouisfed.org/econ/mccracken/fred-databases/>
- McCracken, M. W., & Ng, S. (2016). FRED-MD: A Monthly Database for Macroeconomic Research. *Journal of Business & Economic Statistics*, 34(4), 574–589.
- McCracken, M. W., Ng, S., 2020; FRED-QD: A Quarterly Database for Macroeconomic Research, Federal Reserve Bank of St. Louis Working Paper 2020- 005
- Katrina Stierholz, 2018, Economic Data Revisions: What They Are and Where to Find Them <https://journals.ala.org/index.php/dttip/article/view/6383/8404>

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import textwrap
from finds.readers import Alfred, fred_md, fred_qd
from finds.utils import plot_date, plot_groupbar
from finds.recipes import is_outlier
from datetime import datetime
from secret import credentials
VERBOSE = 0
# %matplotlib qt
```

8.1 Retrieving data from the web

Data may be retrieved from the web by

1. Retrieving a structured file in csv, excel, json or any other format
2. Scraping a web page and searching for information near particular html tags or textual patterns
3. Calling API's provided to developers – these are a set of protocols with which you can communicate with the web server

8.1.1 Retrieve a formatted file

```
# This URL is the location of the FRED-MD csv file, maintained by researchers at the
# St Louis FRED
url = 'https://files.stlouisfed.org/files/htdocs/fred-md/monthly/current.csv'
```

```
# Pandas has several built-in readers for csv, xml, json, excel and even html files
# df = pd.read_csv(url, header=0)
df
```

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0	Transform:	5.000	5.0	5.000	5.000000e+00	
1	1/1/1959	2583.560	2426.0	15.188	2.766768e+05	
2	2/1/1959	2593.596	2434.8	15.346	2.787140e+05	
3	3/1/1959	2610.396	2452.7	15.491	2.777753e+05	
4	4/1/1959	2627.446	2470.0	15.435	2.833627e+05	
..
779	11/1/2023	19225.440	15860.3	117.258	1.514120e+06	
780	12/1/2023	19265.016	15893.6	117.796	1.523993e+06	
781	1/1/2024	19382.171	15935.5	117.425	1.504096e+06	
782	2/1/2024	19370.105	15913.7	117.991	1.511532e+06	
783	3/1/2024	19407.154	15950.6	118.597	NaN	
	RETAILx	INDPRO	IPFPNSS	IPFINAL	IPCONGD	...
0	5.00000	5.0000	5.0000	5.0000	5.0000	...
1	18235.77392	21.9665	23.3891	22.2688	31.7011	...
2	18369.56308	22.3966	23.7048	22.4617	31.9337	...
3	18523.05762	22.7193	23.8483	22.5719	31.9337	...
4	18534.46600	23.2032	24.1927	22.9026	32.4374	...
..
779	700707.00000	102.9382	101.2601	101.7148	102.3259	...
780	703256.00000	102.6149	100.8179	101.2544	101.7841	...
781	695631.00000	101.8110	100.3736	100.9190	101.6965	...
782	702712.00000	102.2599	100.5583	100.7451	100.8224	...
783	707682.00000	102.6577	101.3064	101.7222	102.0617	...
	DNDGRG3M086SBEA	DSERRG3M086SBEA	CES0600000008	CES2000000008	\	
0	6.000	6.000	6.00	6.00	6.00	
1	18.294	10.152	2.13	2.45		
2	18.302	10.167	2.14	2.46		
3	18.289	10.185	2.15	2.45		
4	18.300	10.221	2.16	2.47		

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```

...
779      119.324      124.533      30.26      34.96
780      119.192      124.912      30.42      34.98
781      118.755      125.799      30.57      35.30
782      119.537      126.130      30.68      35.24
783      119.761      126.646      30.84      35.42

CES3000000008  UMCSENTx  DTCOLNVHFNM  DTCTHFNM  INVEST  VIXCL$x
0            6.00      2.0          6.00      6.00    6.0000  1.0000
1            2.04      NaN        6476.00  12298.00  84.2043  NaN
2            2.05      NaN        6476.00  12298.00  83.5280  NaN
3            2.07      NaN        6508.00  12349.00  81.6405  NaN
4            2.08      NaN        6620.00  12484.00  81.8099  NaN
...
779      26.89      61.3      517477.03  918934.92  5008.1757  13.8563
780      27.13      69.7      521938.91  921959.34  5085.0478  12.6960
781      27.21      79.0      524940.39  924448.27  5112.8331  13.3453
782      27.36      76.9      527544.90  925641.71  5111.0308  13.8808
783      27.48      79.4          NaN      NaN    5207.6646  13.7658

[784 rows x 127 columns]

```

8.1.2 Scrape a web page

```
# URL that displays the most popular series in the FRED economic data web site
url = "https://fred.stlouisfed.org/tags/series?ob=pv&pageID=1"
```

```
# use requests package to retrieve the web page
import requests
data = requests.get(url)
data  # a response code of 200 indicates the request has succeeded
```

```
<Response [200]>
```

```
# the content is just a byte-string that you can parse with Python string or other
# methods
data.content[:200]
```

```
b'<!DOCTYPE html>\n<html lang="en">\n<head>\n    <meta http-equiv="X-UA-Compatible\n    content="IE=edge">\n    <meta charset="utf-8">\n    <title>\n        Economic Data Series by Tag | FRED | St. Louis Fed</title>
```

```
# use the BeautifulSoup package to parse html formats
from bs4 import BeautifulSoup
soup = BeautifulSoup(data.content, 'lxml')

# based on this snippet, we want to extract the href property of the series-title
# class tag
print(soup.decode()[39000:40000])
```

```
<h3><a class="series-title pager-series-title-gtm" href="/series/T10Y2Y" id="titleLink" style="font-size:1.2em; padding-bottom: 2px">10-Year Treasury  
Constant Maturity Minus 2-Year Treasury Constant Maturity</a></h3>  
</div>  
<div class="display-results-popularity-bar d-none d-sm-block col-sm-2">  
<span aria-label="popularity 100% popular" class="popularity-bar-span-parent" data-target="popularity-bar-span-T10Y2Y" tabindex="0" title="100% popular">  
<span aria-hidden="true" class="popularity_bar" style="padding-top: 3px; padding-left:60px;"> </span> <span aria-hidden="true" class="popularity_bar_background" id="popularity-bar-span-T10Y2Y"> </span></span>  
</div>  
</td>  
</tr>  
<tr class="series-pager-attr">  
<td colspan="2">  
<div class="series-meta series-group-meta">  
<span class="attributes">Percent, Not Seasonally Adjusted</span>  
<br class="clear"/>  
</div>  
<div class="series-meta">  
<input aria-labelledby="unitLinkT10Y2Y" class="pager-item-checkbox pager-check-series-gtm" name="sids[0]" type="checkbox" value="10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity" checked="checked"/>  
</div>  
</td>  
</tr>
```

```
# identify all the tags whose class starts with 'series-title'  
tags = soup.findAll(name='a', attrs={'class': 'series-title'})  
tags[0] # show first tag found
```

[10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity](/series/T10Y2Y)

```
# extract desired substring (which is a data series mnemonic) from the href property
details = [tag.get('href').split('/')[-1] for tag in tags] # only want substring_
# after last '/'
details[0] # show first mnemonic string found
```

'T10Y2Y'

8.1.3 Call an API

```
# an API call is simply a URL string containing your parameters for the request
url = "{root}?series_id={series_id}&file_type={file_type}&api_key={api_key}".format(
    root="https://api.stlouisfed.org/fred/series",
    series_id=details[0],
    # mnemonic of the data series to
    ↪retrieve
    file_type='json',
    # request data be returned in json
    ↪format
    api_key=credentials['fred']['api_key']),
    # private api key (obtain from
    ↪FRED for free)
```

```
# make the API call to retrieve the data
data = requests.get(url)
data.content
```

```
b'{"realtime_start": "2024-05-03", "realtime_end": "2024-05-03", "serieses": [{"id": "T10Y2Y", "realtime_start": "2024-05-03", "realtime_end": "2024-05-03", "title": "10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity", "observation_start": "1976-06-01", "observation_end": "2024-05-02", "frequency": "Daily", "frequency_short": "D", "units": "Percent", "units_short": "%", "seasonal_adjustment": "Not Seasonally Adjusted", "seasonal_adjustment_short": "NSA", "last_updated": "2024-05-02 16:01:10-05", "popularity": 100, "notes": "Starting with the update on June 21, 2019, the Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department (https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Textview.aspx?data=yield). \r\nSeries is calculated as the spread between 10-Year Treasury Constant Maturity (BC_10YEAR) and 2-Year Treasury Constant Maturity (BC_2YEAR). Both underlying series are published at the U.S. Treasury Department (https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Textview.aspx?data=yield)."}]}'
```

```
# use the json package to convert byte-string data content
import json
v = json.loads(data.content)
v
```

```
{'realtime_start': '2024-05-03',
'realtime_end': '2024-05-03',
'serieses': [{"id": 'T10Y2Y',
'realtime_start': '2024-05-03',
'realtime_end': '2024-05-03',
'title': '10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity',
'observation_start': '1976-06-01',
'observation_end': '2024-05-02',
'frequency': 'Daily',
'frequency_short': 'D',
'units': 'Percent',
'units_short': '%',
'seasonal_adjustment': 'Not Seasonally Adjusted',
'seasonal_adjustment_short': 'NSA',
'last_updated': '2024-05-02 16:01:10-05',
'popularity': 100,
'notes': 'Starting with the update on June 21, 2019, the Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department (https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Textview.aspx?data=yield). \r\nSeries is calculated as the spread between 10-Year Treasury Constant Maturity (BC_10YEAR) and 2-Year Treasury Constant Maturity (BC_2YEAR). Both underlying series are published at the U.S. Treasury Department (https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/Textview.aspx?data=yield)."}]}
```

```
# Pandas can create a DataFrame directly from a dict data structure
df = DataFrame(v['serieses'])
df
```

```

      id realtime_start realtime_end \
0  T10Y2Y      2024-05-03  2024-05-03

                           title observation_start \
0  10-Year Treasury Constant Maturity Minus 2-Yea...      1976-06-01

      observation_end frequency frequency_short      units units_short \
0      2024-05-02      Daily             D    Percent      %

      seasonal_adjustment seasonal_adjustment_short      last_updated \
0  Not Seasonally Adjusted                           NSA  2024-05-02 16:01:10-05

      popularity                               notes
0          100  Starting with the update on June 21, 2019, the...

```

8.2 FRED

Short for Federal Reserve Economic Data, FRED is an online database consisting of hundreds of thousands of economic data time series from national, international, public, and private sources. Created and maintained by the Research Department at the Federal Reserve Bank of St. Louis, FRED data can be downloaded from their website, an Excel add-in, or through api calls.

Archival FRED, or ALFRED, is a superset of FRED that allows you to retrieve vintage versions of economic data that were available on specific dates in history.

```

today = int(datetime.today().strftime('%Y%m%d'))
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)

```

8.2.1 Popular FRED series

In addition to being tagged by categories, frequencies, seasonal adjustments, sources and numerous concepts which can be filtered on, FRED series titles can also be sorted by update recency and popularity. The most popular series currently are:

- <https://fred.stlouisfed.org/tags/series?ob=pv&pageID=1>

```

# scrape FRED most popular page
popular = {}
titles = Alfred.popular(1)
for title in titles:
    series = alf.request_series(title)    # requests 'series' FRED api
    if not series.empty:
        popular[title] = series.iloc[-1][['title', 'popularity']]
print(f"Most Popular Series in FRED, retrieved {today}")
DataFrame.from_dict(popular, orient='index')

```

Most Popular Series in FRED, retrieved 20240503

	title	popularity
T10Y2Y	10-Year Treasury Constant Maturity Minus 2-Yea...	100

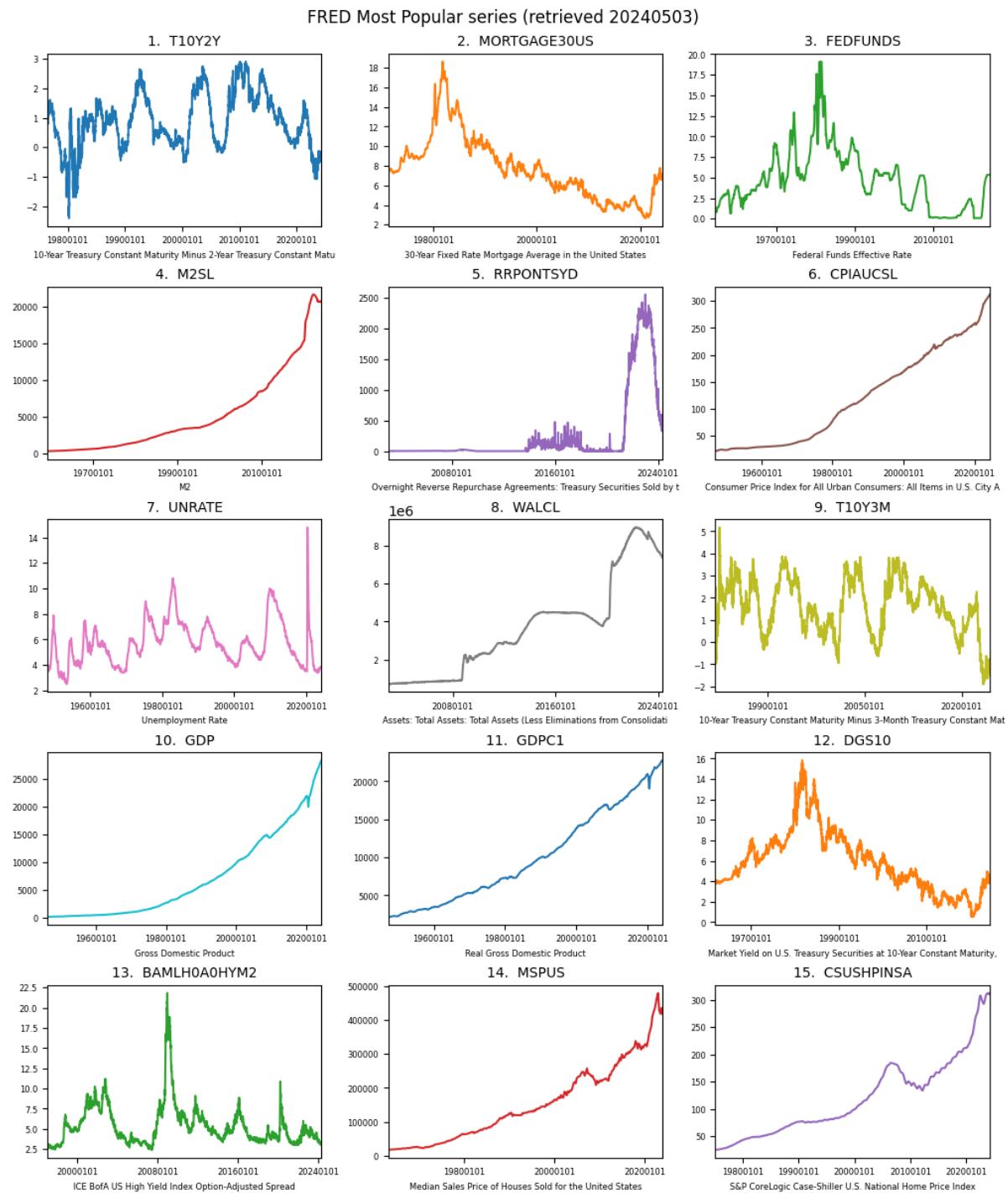
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MORTGAGE30US	30-Year Fixed Rate Mortgage Average in the Uni...	99
FEDFUNDS	Federal Funds Effective Rate	98
M2SL	M2	93
RRPONTSYD	Overnight Reverse Repurchase Agreements: Treas...	95
CPIAUCSL	Consumer Price Index for All Urban Consumers: ...	95
UNRATE	Unemployment Rate	95
WALCL	Assets: Total Assets: Total Assets (Less Elimi...	94
T10Y3M	10-Year Treasury Constant Maturity Minus 3-Mon...	94
GDP	Gross Domestic Product	93
GDPC1	Real Gross Domestic Product	92
DGS10	Market Yield on U.S. Treasury Securities at 10...	92
BAMLH0A0HYM2	ICE BofA US High Yield Index Option-Adjusted S...	92
MSPUS	Median Sales Price of Houses Sold for the Unit...	90
CSUSHPINSA	S&P CoreLogic Case-Shiller U.S. National Home ...	88
T10YIE	10-Year Breakeven Inflation Rate	89
FPCPITOLZGUSA	Inflation, consumer prices for the United States	85
M1SL	M1	84

```
# plot popular series
fig, axes = plt.subplots(ncols=3, nrows=5, figsize=(10, 12), layout='constrained')
for cn, (ax, title) in enumerate(zip(np.ravel(axes), titles[:15])):
    series = alf(title)
    plot_date(series, ax=ax, title=f" {cn+1}. {title}", xlabel=alf.header(title)[:70],
              fontsize=6, ls='-', cn=cn, nbins=4)
plt.suptitle(f"FRED Most Popular series (retrieved {today})")
```

```
Text(0.5, 0.98, 'FRED Most Popular series (retrieved 20240503)')
```



8.2.2 FRED series categories

Retrieve Total Non-Farm Payroll (PAYEMS) and its parent categories

```
# Retrieve grandparent, parent and siblings of series
series_id, freq = 'PAYEMS', 'M'
category = alf.categories(series_id).iloc[0]
grand_category = alf.get_category(category['parent_id'])
parent_category = alf.get_category(category['id'])
category.to_frame().T
```

	id	name	parent_id
PAYEMS	32305	Total Nonfarm	11

```
print(f"Super category {grand_category['id']}: {grand_category['name']}")
if 'notes' in grand_category:
    print(textwrap.fill(grand_category['notes']))
```

Super category 11: Current Employment Statistics (Establishment Survey)
The establishment survey provides data on employment, hours, and earnings by industry. Numerous conceptual and methodological differences between the current population (household) and establishment surveys result in important distinctions in the employment estimates derived from the surveys. Among these are: The household survey includes agricultural workers, the self-employed, unpaid family workers, and private household workers among the employed. These groups are excluded from the establishment survey. The household survey includes people on unpaid leave among the employed. The establishment survey does not. The household survey is limited to workers 16 years of age and older. The establishment survey is not limited by age. The household survey has no duplication of individuals, because individuals are counted only once, even if they hold more than one job. In the establishment survey, employees working at more than one job and thus appearing on more than one payroll are counted separately for each appearance. For more information, visit <http://www.bls.gov/news.release/empsit.tn.htm>.

```
print("Parent categories:")
for child in grand_category['children']:
    node = alf.get_category(child['id'])
    if node:
        print(f" {node['id']}: {node['name']} "
              f" (children={len(node['children'])}, series={len(node['series'])})")
```

Parent categories:

32305:	Total Nonfarm	(children=0, series=5)
32306:	Total Private	(children=0, series=27)
32307:	Goods-Producing	(children=0, series=27)
32326:	Service-Providing	(children=0, series=1)
32308:	Private Service-Providing	(children=0, series=27)
32309:	Mining and Logging	(children=0, series=39)
32310:	Construction	(children=0, series=41)
32311:	Manufacturing	(children=0, series=31)
32312:	Durable Goods	(children=0, series=63)

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```
32313: Nondurable Goods (children=0, series=55)
32314: Trade, Transportation, and Utilities (children=0, series=27)
32315: Wholesale Trade (children=0, series=33)
32316: Retail Trade (children=0, series=55)
32317: Transportation and Warehousing (children=0, series=47)
32318: Utilities (children=0, series=27)
32319: Information (children=0, series=39)
32320: Financial Activities (children=0, series=51)
32321: Professional and Business Services (children=0, series=55)
32322: Education and Health Services (children=0, series=51)
32323: Leisure and Hospitality (children=0, series=41)
32324: Other Services (children=0, series=33)
32325: Government (children=0, series=23)
```

```
print("Sibling series:")
for child in parent_category['series']:
    if child['id'] == series_id:
        node = child
    print(f" {child['id']}: {child['title']} {child['seasonal_adjustment']}"
          f" (popularity={child['popularity']}")
```

Sibling series:

```
CES0000000010: Women Employees, Total Nonfarm Seasonally Adjusted (popularity=4)
CES0000000039: Women Employees-To-All Employees Ratio: Total Nonfarm Seasonally Adjusted (popularity=16)
CEU0000000010: Women Employees, Total Nonfarm Not Seasonally Adjusted (popularity=1)
PAYEMS: All Employees, Total Nonfarm Seasonally Adjusted (popularity=83)
PAYNSA: All Employees, Total Nonfarm Not Seasonally Adjusted (popularity=47)
```

```
print(f"{node['id']}: {node['title']} {node['seasonal_adjustment']}",
      f" ({node['observation_start']}-{node['observation_end']})")
print()
print(textwrap.fill(node['notes']))
```

PAYEMS: All Employees, Total Nonfarm Seasonally Adjusted (1939-01-01-2024-03-01)

All Employees: Total Nonfarm, commonly known as Total Nonfarm Payroll, is a measure of the number of U.S. workers in the economy that excludes proprietors, private household employees, unpaid volunteers, farm employees, and the unincorporated self-employed. This measure accounts for approximately 80 percent of the workers who contribute to Gross Domestic Product (GDP). This measure provides useful insights into the current economic situation because it can represent the number of jobs added or lost in an economy. Increases in employment might indicate that businesses are hiring which might also suggest that businesses are growing. Additionally, those who are newly employed have increased their personal incomes, which means (all else constant) their disposable incomes have also increased, thus fostering further economic expansion. Generally, the U.S. labor force and levels of employment and unemployment are subject to fluctuations due to seasonal changes in weather, major holidays, and the opening and closing of schools. The Bureau of Labor Statistics (BLS) adjusts the

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data to offset the seasonal effects to show non-seasonal changes: for example, women's participation in the labor force; or a general decline in the number of employees, a possible indication of a downturn in the economy. To closely examine seasonal and non-seasonal changes, the BLS releases two monthly statistical measures: the seasonally adjusted All Employees: Total Nonfarm (PAYEMS) and All Employees: Total Nonfarm (PAYNSA), which is not seasonally adjusted. The series comes from the 'Current Employment Statistics (Establishment Survey).' The source code is: CES0000000001

8.2.3 Revisions and vintage dates

Economic data for past observation periods are revised as more accurate estimates become available. As a result, previous vintages of data can be superseded. ALFRED, the archival FRED tool, captures these data revisions.

On the first Friday of every month, the Bureau of Labor Statistics (BLS) publishes its Employment Situation Summary, which contains the highly-anticipated Total Nonfarm Payroll Employment based on firms' reports of the number of people employed. However, it is a very rough estimate and is revised the following month, and then again the month after as more information arrives at the BLS. These revisions can be large and may materially change the picture of the economy.

```
start, end = 20230101, 20231231
data = []
print(f"{{alf.header(series_id)} (retrieved {today}):}")
latest = alf(series_id, start=start, end=end, freq=freq, realtime=True)
latest
```

All Employees, Total Nonfarm (retrieved 20240503):

	PAYEMS	realtime_start	realtime_end
date			
20230131	154773	20240202	99991231
20230228	155060	20240202	99991231
20230331	155206	20240202	99991231
20230430	155484	20240202	99991231
20230531	155787	20240202	99991231
20230630	156027	20240202	99991231
20230731	156211	20240202	99991231
20230831	156421	20240202	99991231
20230930	156667	20240202	99991231
20231031	156832	20240202	99991231
20231130	157014	20240202	99991231
20231231	157304	20240308	99991231

```
print("First Release:")
data[0] = alf(series_id, release=1, start=start, end=end, freq=freq, realtime=True)
data[0]
```

First Release:

	PAYEMS	realtime_start	realtime_end
date			
20230131	155073	20230203	20230309
20230228	155350	20230310	20230406
20230331	155569	20230407	20230504
20230430	155673	20230505	20230601
20230531	156105	20230602	20230706
20230630	156204	20230707	20230803
20230731	156342	20230804	20230831
20230831	156419	20230901	20231005
20230930	156874	20231006	20231102
20231031	156923	20231103	20231207
20231130	157087	20231208	20240104
20231231	157232	20240105	20240201

```
print("Second Release:")
data[1] = alf(series_id, release=2, start=start, end=end, freq=freq, realtime=True)
data[1]
```

Second Release:

	PAYEMS	realtime_start	realtime_end
date			
20230131	155039	20230310	20230406
20230228	155333	20230407	20230504
20230331	155420	20230505	20230601
20230430	155766	20230602	20230706
20230531	155995	20230707	20230803
20230630	156155	20230804	20230831
20230731	156232	20230901	20231005
20230831	156538	20231006	20231102
20230930	156773	20231103	20231207
20231031	156888	20231208	20240104
20231130	157016	20240105	20240201
20231231	157347	20240202	20240307

```
print("Third Release:")
data[2] = alf(series_id, release=3, start=start, end=end, freq=freq, realtime=True)
data[2]
```

Third Release:

	PAYEMS	realtime_start	realtime_end
date			
20230131	155007	20230407	20240201
20230228	155255	20230505	20240201
20230331	155472	20230602	20240201
20230430	155689	20230707	20240201
20230531	155970	20230804	20240201
20230630	156075	20230901	20240201
20230731	156311	20231006	20240201
20230831	156476	20231103	20240201
20230930	156738	20231208	20240201

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20231031	156843	20240105	20240201
20231130	157014	20240202	99991231
20231231	157304	20240308	99991231

```
print("Fourth Release:")
data[3] = alf(series_id, release=4, start=start, end=end, freq=freq, realtime=True)
data[3]
```

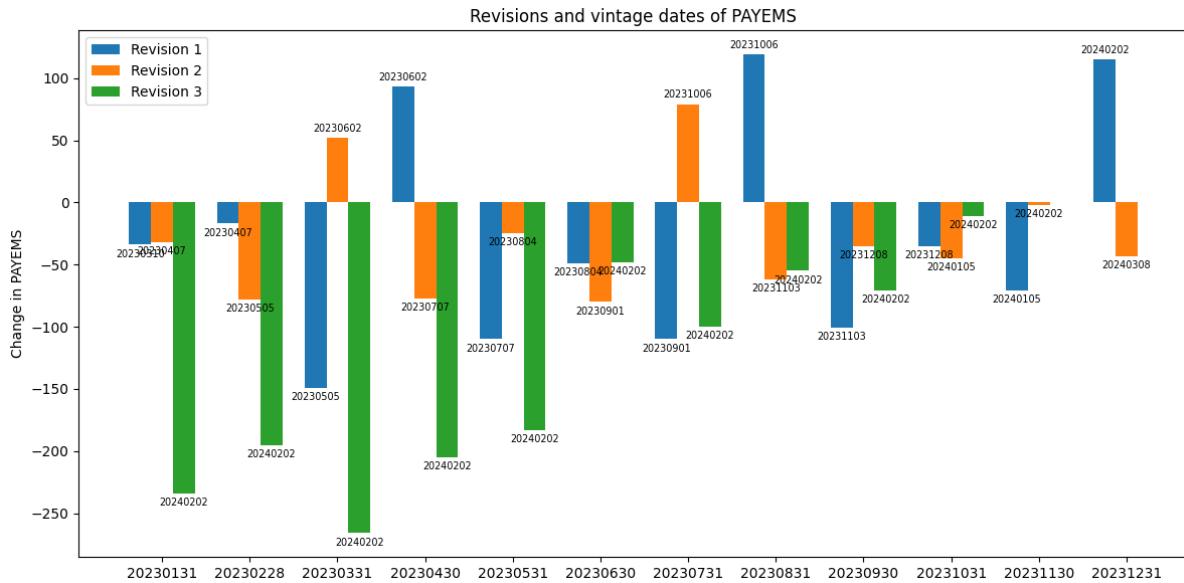
Fourth Release:

	PAYEMS	realtime_start	realtime_end
date			
20230131	154773	20240202	99991231
20230228	155060	20240202	99991231
20230331	155206	20240202	99991231
20230430	155484	20240202	99991231
20230531	155787	20240202	99991231
20230630	156027	20240202	99991231
20230731	156211	20240202	99991231
20230831	156421	20240202	99991231
20230930	156667	20240202	99991231
20231031	156832	20240202	99991231

```
df = pd.concat([(data[i][series_id] - data[i-1][series_id]).rename(f"Revision {i}")
               for i in range(1, len(data))], axis=1)
labels = pd.concat([data[i]['realtime_start'].rename(f"Revision {i}")
                   for i in range(1, len(data))], axis=1).fillna(0).astype(int)
DataFrame(df.sum(axis=0).rename("Total revisions ('000)"))
```

	Total revisions ('000)
Revision 1	-349.0
Revision 2	-348.0
Revision 3	-1368.0

```
#df = pd.concat([data[i][series_id].rename(f"Revision {i}")
#               for i in range(1, len(data))], axis=1)
#labels = pd.concat([data[i]['realtime_start'].rename(f"Revision {i}")
#                   for i in range(1, len(data))], axis=1).fillna(0).astype(int)
fig, ax = plt.subplots(figsize=(12, 6))
plot_groupbar(df, labels=labels, ax=ax)
plt.legend()
plt.ylabel(f'Change in {series_id}')
plt.title(f'Revisions and vintage dates of {series_id}')
plt.tight_layout()
plt.show()
```



TODO: Explain, and initial and final ADP and JOLTS cumulative graphs over past year

8.3 FRED-MD and FRED-QD

FRED-MD and FRED-QD are datasets of monthly and quarterly observations mimic the coverage of macroeconomic datasets already used in the literature. They are updated in real-time through the FRED database, and relieve the researcher of the task of incorporating data changes and revisions (a task accomplished by the data desk at the Federal Reserve Bank of St. Louis).

8.3.1 Release dates

```
md_df, md_transform = fred_md()
end = md_df.index[-1]
out = {}
for i, title in enumerate(md_df.columns):
    out[title] = alf(series_id=title,
                      release=1,
                      start=end, # within 4 days of monthend
                      end=end,
                      realtime=True)
    if title.startswith('S&P'): # stock market data available same day close
        out[title] = Series({end: end}, name='realtime_start').to_frame()
    elif title in alf.splice_: # these series were renamed or spliced
        if isinstance(Alfred.splice_[title], str): # if renamed
            out[title] = alf(series_id=Alfred.splice_[title],
                              release=1,
                              start=end-4, # within 4 days of monthend
                              end=end,
                              realtime=True)
    else: # if FRED-MD series was spliced
        out[title] = pd.concat([alf(series_id=sub,
                                     reglease=1,
```

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```
start=end-4,  # within 4 days of monthend
end=end,
realtime=True)
for sub in Alfred.splice_[title][1:]]
```

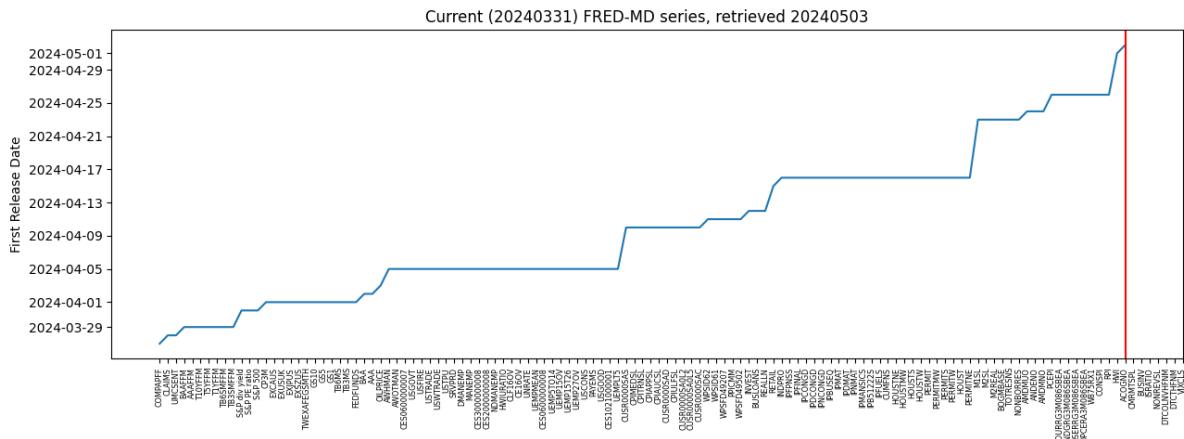
FRED-MD vintage: monthly/current.csv

```
# date convention of Consumer Sentiment
df = alf('UMCSENT', release=1, realtime=True)
out['UMCSENT'] = df[df['realtime_start'] > end - 4].iloc[:1]
```

```
# weekly averages of Claims
df = alf('ICNSA', release=1, realtime=True)
out['CLAIMS'] = df[df['realtime_start'] > end - 4].iloc[:1]
```

```
# Plot release dates of series in FRED-MD
release = Series({k: str(min(v['realtime_start'])) if v is not None and len(v)
                  else None for k,v in out.items()}).sort_values()
```

```
fig, ax = plt.subplots(clear=True, num=1, figsize=(13, 5))
ax.plot(pd.to_datetime(release, errors='coerce'))
ax.axvline(release[~release.isnull()].index[-1], c='r')
ax.set_title(f"Current ({end}) FRED-MD series, retrieved {today}")
ax.set_ylabel('First Release Date')
ax.set_xticks(np.arange(len(release)))
ax.set_xticklabels(release.index, rotation=90, fontsize='xx-small')
plt.tight_layout()
```



```
# Check if recently released data available to update latest FRED-MD
md_missing = md_df.iloc[-1]
md_missing = md_missing[md_missing.isnull()]
print("Recent values available to update missing in current FRED-MD")
for series_id in md_missing.index:
    print(alf.splice(series_id).iloc[-3:])
```

```
Recent values available to update missing in current FRED-MD
date
20231231    1523993.0
20240131    1504096.0
20240229    1511532.0
Name: CMRMTSPL, dtype: float64
date
20240131    243376.0
20240229    249075.0
20240331    251771.0
Name: ACOGNO, dtype: float64
date
20231231    2555879.0
20240131    2556109.0
20240229    2567540.0
Name: BUSINV, dtype: float64
date
20231231    1.38
20240131    1.39
20240229    1.38
Name: ISRATIO, dtype: float64
date
20231231    3700.45907
20240131    3709.54790
20240229    3712.40931
Name: NONREVSL, dtype: float64
date
20240131    0.156926
20240229    0.156615
20240331    NaN
Name: CONSPI, dtype: float64
date
20240331    34.37
20240430    34.66
20240531    33.62
Name: S&P PE ratio, dtype: float64
date
20231231    521938.91
20240131    524940.39
20240229    527544.90
Name: DTCOLNVHFN, dtype: float64
date
20231231    921959.34
20240131    924448.27
20240229    925641.71
Name: DTCTHFNM, dtype: float64
```

```
# Find any missing series observations, if any, now available to update current FRED-
MD
Series(release.values, index=[(s, alf.header(s)) for s in release.index]) \
.tail(len(md_missing))
```

```
(HWI, Help Wanted Index for United States)
  20240501
(ACOGNO, Manufacturers' New Orders: Consumer Goods)
  20240502
```

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```
(CMRMTSPL, Real Manufacturing and Trade Industries Sales)      ↴
    ↵      None
(BUSINV, Total Business Inventories)      ↴
    ↵      None
(ISRATIO, Total Business: Inventories to Sales Ratio)      ↴
    ↵      None
(NONREVSL, Nonrevolving Consumer Credit Owned and Securitized)      ↴
    ↵      None
(DTCOLNVHFN, Consumer Motor Vehicle Loans Owned by Finance Companies, Level)      ↴
    ↵      None
(DTCTHFN, Total Consumer Loans and Leases Owned and Securitized by Finance Companies, Level)      ↴
    ↵      None
(VIXCLS, CBOE Volatility Index: VIX)      ↴
    ↵      None
dtype: object
```

8.4 Outliers

- John Tukey proposed this criterian, where $k = 1.5$ indicates an “outlier”, and $k = 3$ indicates data that is “far out”.
- iq10: require within median \pm [10 times interquartile range $Q3-Q1$]
- tukey: $[Q1 - 1.5(Q3-Q1), Q3 + 1.5(Q3-Q1)]$
- farout : tukey with $3IQ$ instead of $1.5IQ$

TODO:

- separate graphs by method (too busy) – number of outliers not fraction
- list of months with most combined outliers, show number of each

```
outliers = dict()
for method in ['iq10', 'tukey', 'farout']:
    outliers[method] = np.sum(is_outlier(data, method=method), axis=1)
fig, ax = plt.subplots(figsize=(10, 6))
plt.step(data.index[12:], DataFrame(outliers)[12:] / data.shape[1], where='mid')
plt.title('Fraction of outlier observations by month')
plt.legend(outliers.keys())
plt.tight_layout()
```

```
print('Frequency of outliers by method')
for method, num in outliers.items():
    print(f" {method:6s}: {np.mean(num):5.1f}/{data.shape[1]} outliers per month")
```


LINEAR REGRESSION DIAGNOSTICS

The only thing we know about the future is that it will be different - Peter Drucker

Concepts:

- Linear regression diagnostics
- HAC robust standard errors
- Multicollinearity
- Residual analysis
- Consumer and Produced Prices Indices

References:

- White, Halbert (1980). “A Heteroskedasticity-Consistent Covariance Matrix Estimator and a Direct Test for Heteroskedasticity”. *Econometrica*. 48 (4): 817–838.
- Newey, Whitney K., and Kenneth D. West. 1987. “A Simple, Positive Semi-Definite, Heteroskedasticity and Autocorrelation Consistent Covariance Matrix.” *Econometrica* 55: 703–8.
- <https://library.virginia.edu/data/articles/diagnostic-plots>
- FRM Part I Exam Book Quantitative Analysis Ch 9

```
import numpy as np
import pandas as pd
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import patsy
import statsmodels.formula.api as smf
from statsmodels.stats.outliers_influence import variance_inflation_factor
from finds.readers import Alfred
from finds.utils import plot_fitted, plot_leverage, plot_scale, plot_qq
from secret import credentials
VERBOSE = 0
# matplotlib qt
```

```
alf = Alfred(api_key=credentials['fred']['api_key'])
```

Retrieve monthly Consumer Price Index as the endogenous variable, and Producer Price Index as the exogenous. We use the monthly differences of logs of both series.

```
# difference of logs of CPI and PPI monthly series from FRED
series_id, freq, start = 'CPIAUCSL', 'M', 0      #19740101
exog_id = 'WPSFD4131'

data = pd.concat([alf(s, start=start) for s in [series_id, exog_id]], axis=1)
data.index = pd.DatetimeIndex(data.index.astype(str))
data = np.log(data).diff().dropna()  # model the changes in logs of the series
DataFrame.from_dict({s: alf.header(s) for s in [series_id, exog_id]}, orient='index', columns=['Description'])
```

	Description
CPIAUCSL	Consumer Price Index for All Urban Consumers: ...
WPSFD4131	Producer Price Index by Commodity: Final Deman...

9.1 Model assumptions

1. $E[y_i] = b_0 + b_1 x_{i1} + \dots + b_k x_{ik}$. &
2. $\{x_{i1}, \dots, x_{ik}\}$ are non-stochastic variables. &
3. $Var(y_i) = \sigma^2$. &
4. $\{y_i\}$ are independent random variables. &
5. $\{y_i\}$ are normally distributed. &

Under assumptions 1-4, the least squares regression estimator $b = (X'X)^{-1}X'y$ is an unbiased estimator of the parameter vector b ;

- has variance-covariance matrix $Var(b) = \sigma^2(X'X)^{-1}$,
- and standard error $b_j \text{ se}(b_j) = \sigma \sqrt{(X'X)^{-1}_{[j+1,j+1]}}$.
- Under assumptions 1-5, the least squares estimator is normally distributed.

```
# Run Linear Regression (with exog and 2 lags)
dmf = (f'{series_id} ~ {series_id}.shift(1) + {series_id}.shift(2) + {exog_id}.
        .shift(1)')
model = smf.ols(formula=dmf, data=data).fit()
print(model.summary())
```

OLS Regression Results					
=====					
Dep. Variable:	CPIAUCSL	R-squared:	0.455		
Model:	OLS	Adj. R-squared:	0.452		
Method:	Least Squares	F-statistic:	165.4		
Date:	Tue, 09 Apr 2024	Prob (F-statistic):	5.95e-78		
Time:	08:59:07	Log-Likelihood:	2761.8		
No. Observations:	599	AIC:	-5516.		
Df Residuals:	595	BIC:	-5498.		
Df Model:	3				
Covariance Type:	nonrobust				
=====					
	coef	std err	t	P> t	[0.025
975]					0.

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Intercept	0.0009	0.000	6.203	0.000	0.001	0.
⁰⁰¹	⁰⁰¹	⁰⁰¹	⁰⁰¹	⁰⁰¹	⁰⁰¹	⁰⁰¹
CPIAUCSL.shift(1)	0.5815	0.041	14.049	0.000	0.500	0.
⁶⁶³	⁶⁶³	⁶⁶³	⁶⁶³	⁶⁶³	⁶⁶³	⁶⁶³
CPIAUCSL.shift(2)	-0.0454	0.041	-1.103	0.271	-0.126	0.
⁰³⁵	⁰³⁵	⁰³⁵	⁰³⁵	⁰³⁵	⁰³⁵	⁰³⁵
WPSFD4131.shift(1)	0.2001	0.036	5.549	0.000	0.129	0.
²⁷¹	²⁷¹	²⁷¹	²⁷¹	²⁷¹	²⁷¹	²⁷¹
<hr/>						
Omnibus:	113.351	Durbin-Watson:			2.052	
Prob(Omnibus):	0.000	Jarque-Bera (JB):			548.449	
Skew:	-0.750	Prob(JB):			8.05e-120	
Kurtosis:	7.442	Cond. No.			520.	
<hr/>						

Notes:

[1] Standard Errors assume that the covariance matrix of the errors is correctly specified.

9.1.1 Heteroskedasity and HAC robust errors

When the variances of residuals are not constant, than the variance of the coefficients is not given by the standard OLS estimate $\sigma^2(X'X)^{-1}$. The coefficient estimates are consistent, but their covariance matrix is of the form $(X'X)^{-1}(X'\Omega X)(X'X)^{-1}$ where a number of choices have been proposed for the choice Ω . When estimated as the diagonal of squared residuals, this provides White's (1980) estimator, often referred to as the heteroskedasticity-consistent or sandwich estimator. Other estimators take into account the effect of leverage points in the design matrix.

If the error terms are serially correlated, then statistical inference using the usual heteroskedasticity-robust standard errors can be misleading. Newy and West (1987) proposed the Heteroskedasticity and Autocorrelation Consistent (HAC) estimator which adjusts for serially correlated errors by applying a weighting scheme to estimates of $m - 1$ autocorrelation coefficients. A rule of thumb for choosing the truncation parameter is $m = 0.75T^{1/3}$, where the autocorrelation coefficients are weighted with $1 + 2 \sum_{j=1}^{m-1} \frac{m-j}{m} \hat{\rho}_j$

```
robust = model.get_robustcov_results(cov_type='HAC', use_t=None, maxlags=0)
print(robust.summary())
```

OLS Regression Results						
Dep. Variable:	CPIAUCSL	R-squared:			0.455	
Model:	OLS	Adj. R-squared:			0.452	
Method:	Least Squares	F-statistic:			111.5	
Date:	Tue, 09 Apr 2024	Prob (F-statistic):			2.75e-57	
Time:	08:59:07	Log-Likelihood:			2761.8	
No. Observations:	599	AIC:			-5516.	
Df Residuals:	595	BIC:			-5498.	
Df Model:	3					
Covariance Type:	HAC					
<hr/>						
⁹⁷⁵	coef	std err	t	P> t	[0.025	0.
<hr/>						

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```

-----
 ↵
Intercept      0.0009    0.000    5.739    0.000    0.001    0.
 ↵001
CPIAUCSL.shift(1) 0.5815    0.074    7.876    0.000    0.437    0.
 ↵727
CPIAUCSL.shift(2) -0.0454    0.053   -0.849    0.396   -0.150    0.
 ↵060
WPSFD4131.shift(1) 0.2001    0.055    3.628    0.000    0.092    0.
 ↵308
=====
Omnibus:           113.351   Durbin-Watson:          2.052
Prob(Omnibus):    0.000    Jarque-Bera (JB):      548.449
Skew:              -0.750    Prob(JB):            8.05e-120
Kurtosis:          7.442    Cond. No.           520.
=====
```

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using
 ↵0 lags and without small sample correction

9.1.2 Multicollinearity and variance inflation factors

Multicollinearity or numerical scaling issues may cause the design matrix to have a high condition number.

The Variance Inflation Factor (VIF) measures the extent to which the variance of an estimated regression coefficient is increased due to multicollinearity in a multiple regression analysis. The VIF for each predictor variable X_i is derived from the R^2 value obtained by regressing X_i against all other predictor variables.

$$VIF_i = \frac{1}{1 - R_i^2}$$

One recommendation is that if VIF is greater than 5 or 10, then the explanatory variable is highly collinear with the other explanatory variables, and the parameter estimates will have large standard errors because of this.

```

Y, X = patsy.dmatrices(dmf + ' - 1', data=data) # exclude intercept term
print("Variance Inflation Factors")
Series({X.design_info.column_names[i]: variance_inflation_factor(X, i)
        for i in range(X.shape[1])}, name='VIF').to_frame()
```

Variance Inflation Factors

	VIF
CPIAUCSL.shift(1)	3.424302
CPIAUCSL.shift(2)	3.408784
WPSFD4131.shift(1)	2.283663

9.1.3 Omitted variables

Omitting a variable with a non-zero coefficient in the true model generating the data has two effects.

1. The remaining variables absorb the effects of the omitted variable attributable to common variation. This changes the regression coefficients on the included variables so that they do not consistently estimate the effect of a change in the explanatory variable on the dependent variable. If the variables are highly correlated, then the bias is large. But if the omitted variable is not correlated to the other variables, then those other coefficients can be estimated consistently.
2. The estimated residuals are larger in magnitude than the true shocks. This is because the residuals contain both the true shock and any effect of the omitted variable that cannot be captured by the included variable.

An extraneous (also known as a superfluous or irrelevant) variable is one that is included in the model but is not needed. This type of variable has a true coefficient of 0 and is consistently estimated to be 0 in large samples. However, standard errors of the relevant variables grows as their correlation with the extraneous variables increases.

9.2 Residual plots

Residual plots are standard methods used to detect deficiencies in a model specification. An ideal model would have residuals that are not systematically related to any of the included explanatory variables. Standardized residuals may alternatively be used so that the magnitude of deviation is more apparent. Both outliers and model specification problems can be detected in residual plots.

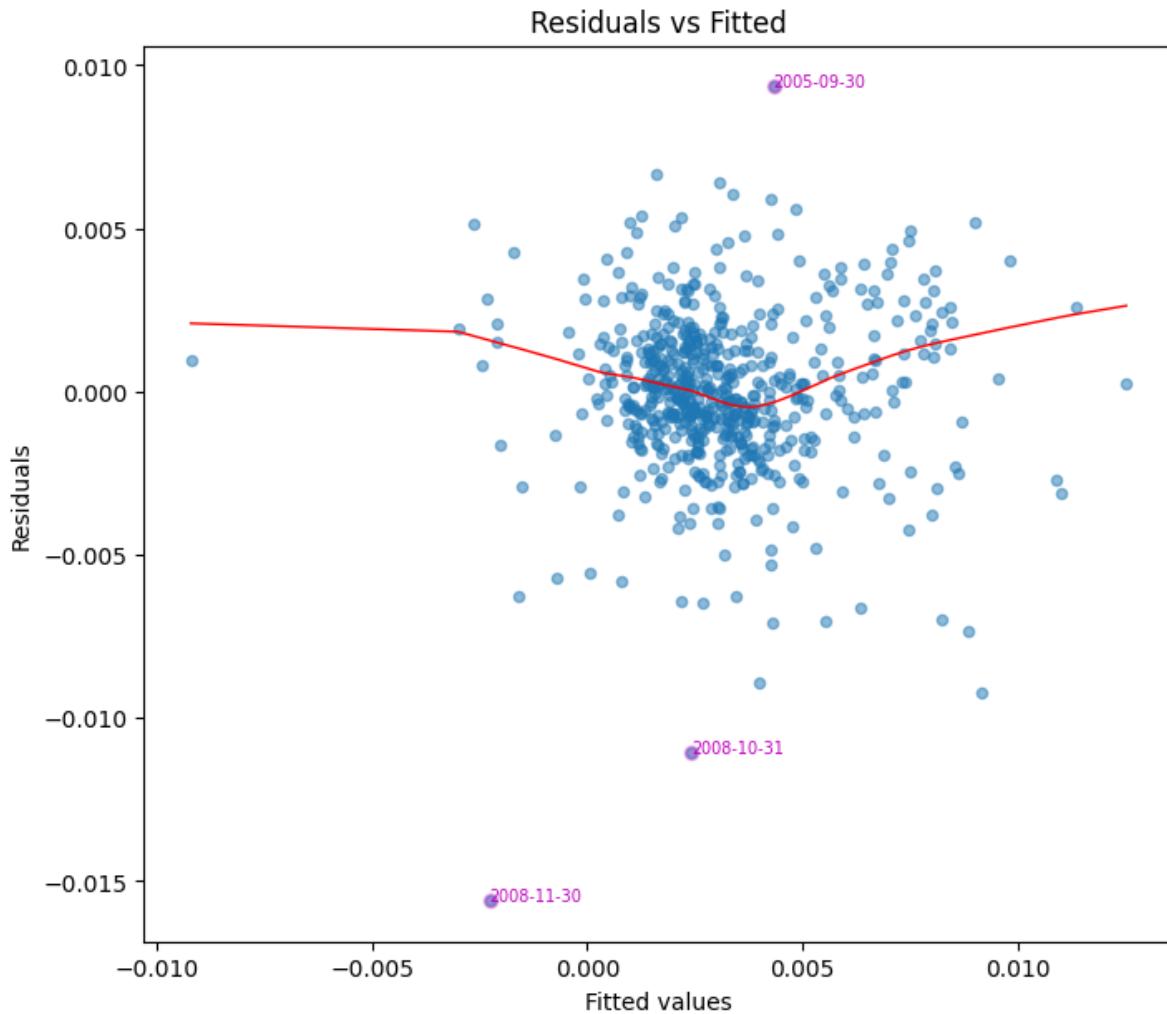
9.2.1 Residuals vs fitted plot

The Residuals vs Fitted plot shows if residuals have non-linear patterns: the residual data points should be evenly spread around a flat fitted line.

```
# Plot residuals and identify outliers
fig, ax = plt.subplots(clear=True, figsize=(8, 7))
z = plot_fitted(fitted=model.fittedvalues,
                 resid=model.resid,
                 ax=ax)
print("Residual Outliers")
z.to_frame().T
```

Residual Outliers

date	2005-09-30	2008-10-31	2008-11-30
outliers	0.00935	-0.011058	-0.015598



9.2.2 QQ plot of residuals

The Normal Q-Q plot shows if residuals are normally distributed: the standardized data points should lie along the 45-degree line representing the theoretical quantiles of the standard normal distribution.

Outliers, or data points that differ significantly from the others, may indicate some measurement error or anomaly, or that the population has a non-normal heavy-tailed distribution.

```
fig, ax = plt.subplots(clear=True, figsize=(8, 7))
plot_qq(model.resid, ax=ax)
```

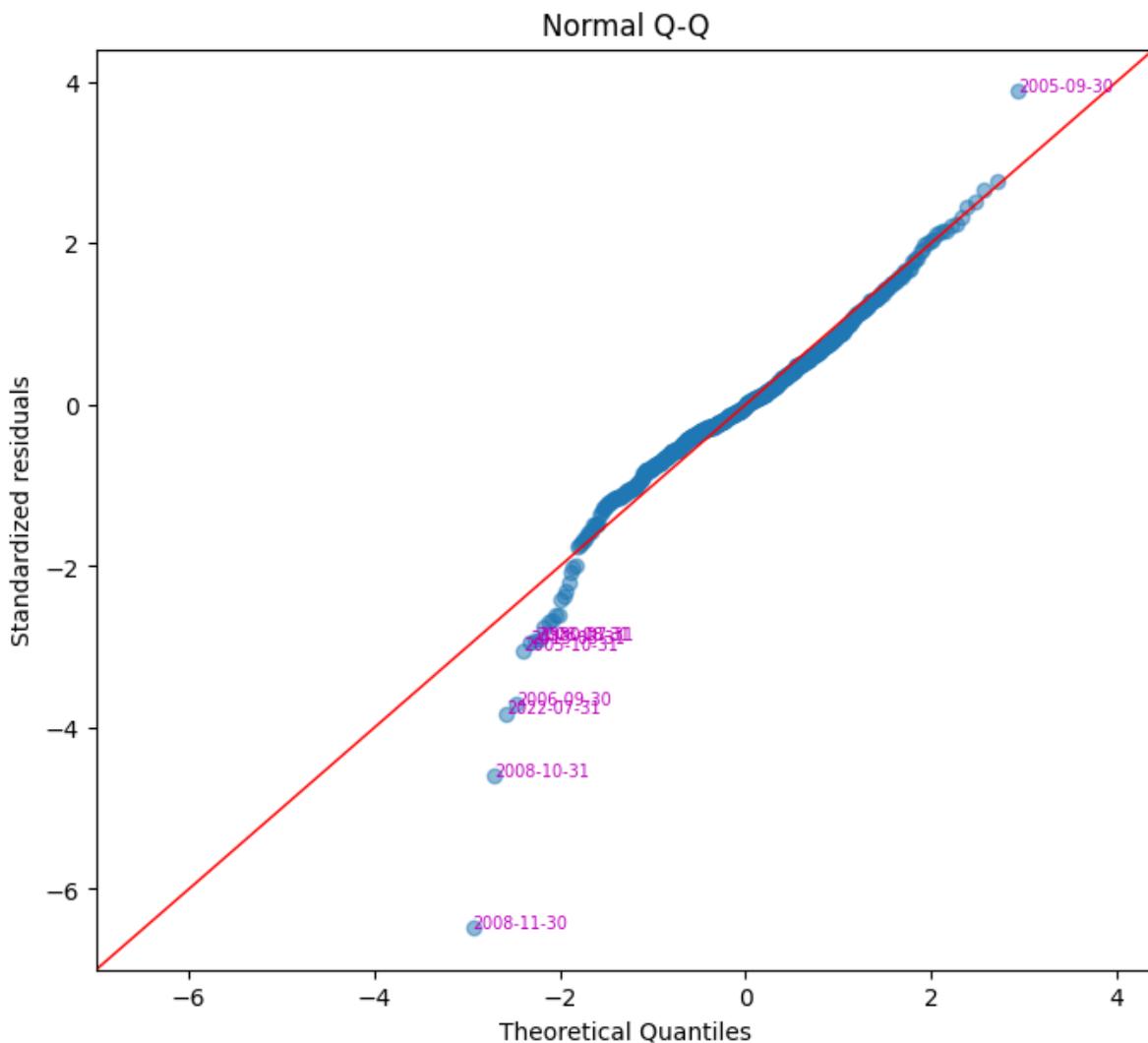
```
/home/terence/env3.11/lib/python3.11/site-packages/statsmodels/graphics/gofplots.
  ↪py:1045: UserWarning: color is redundantly defined by the 'color' keyword
  ↪argument and the fmt string "b" (-> color=(0.0, 0.0, 1.0, 1)). The keyword
  ↪argument will take precedence.
  ax.plot(x, y, fmt, **plot_style)
```

	residuals	standardized
date		

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2008-11-30	-0.015598	-6.482161
2008-10-31	-0.011058	-4.595524
2022-07-31	-0.009212	-3.828462
2006-09-30	-0.008912	-3.703545
2005-10-31	-0.007328	-3.045586
2013-03-31	-0.007109	-2.954440
2008-08-31	-0.007021	-2.917872
1980-07-31	-0.007007	-2.911938
2005-09-30	0.009350	3.885717

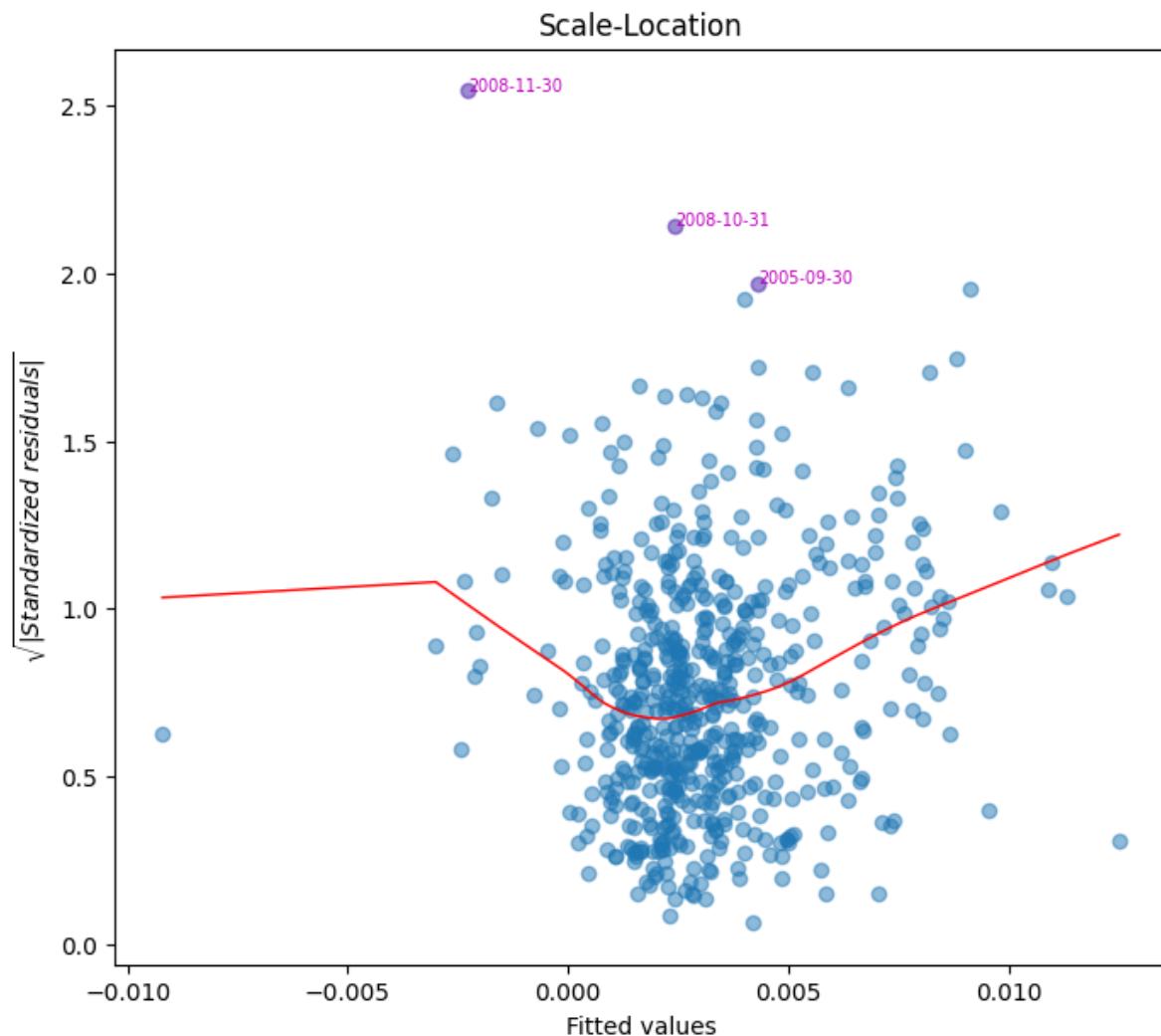


9.2.3 Scale of residuals

The Scale-Location plot shows if residuals are spread equally along the range of predictors, around a flat fitted line: it checks the assumption of equal variance or homoscedasticity.

```
fig, ax = plt.subplots(clear=True, figsize=(8, 7))
plot_scale(model.fittedvalues, model.resid, ax=ax)
```

```
array([377, 414, 415])
```



9.2.4 Leverage and influential points

The projection matrix from the least squares estimator $H = X(X^T)^{-1}X^T$ is also called the **hat matrix** in statistics, and the i -th diagonal element of H , given by $h_{ii} = x_i^T(X^T)^{-1}x_i$, is the **leverage** of the i -th observation.

Even though the data may have extreme leverage or outlier values, they might not be influential on the regression fit. **Cook's Distance** can be expressed using the leverage and the squared internally studentized residual $D_i = \frac{1}{p}t_i^2 \frac{h_{ii}}{1-h_{ii}}$

where

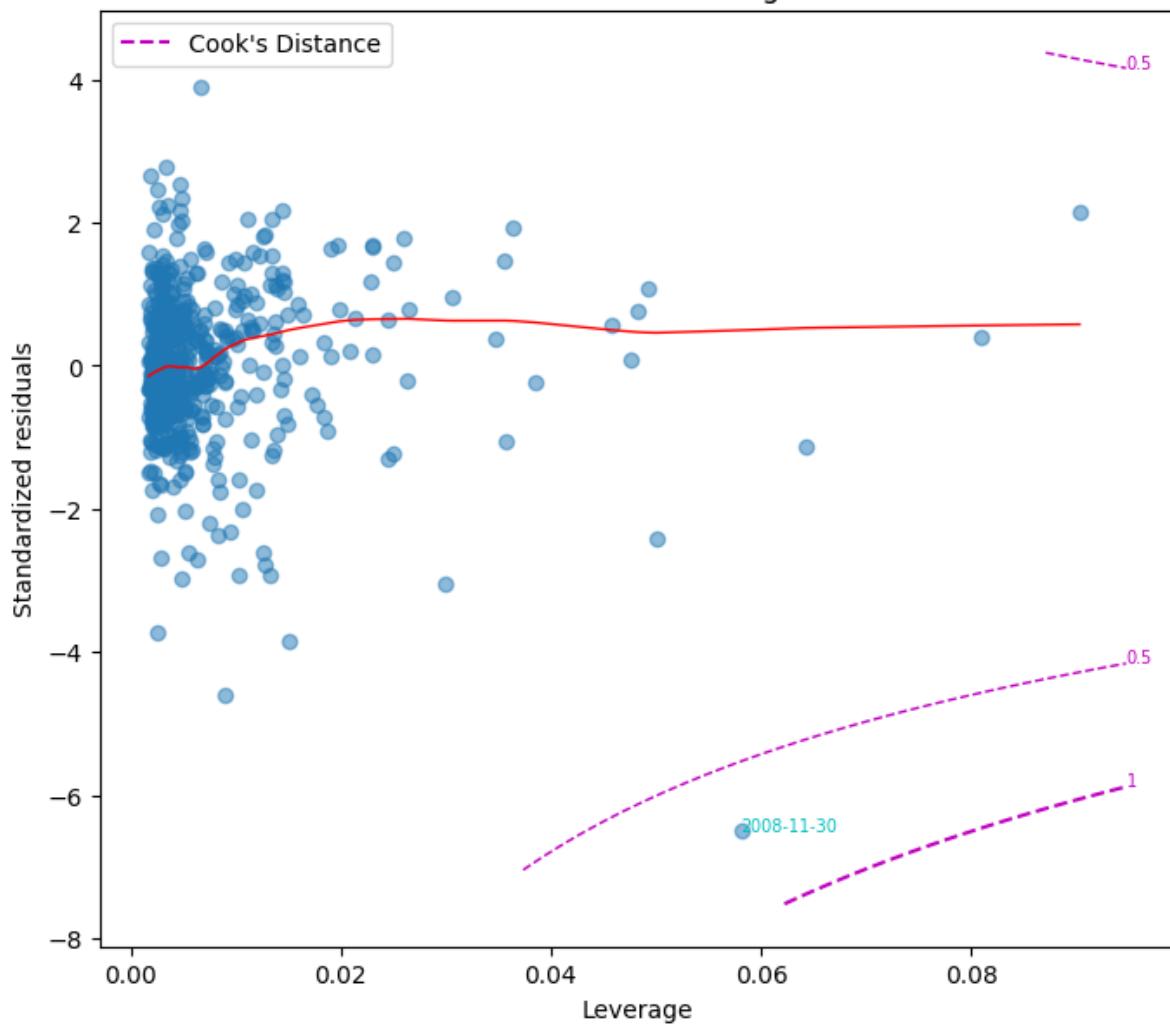
- p is the number of regression model parameters,
- $t_i = \frac{\hat{\epsilon}_i}{\hat{\sigma}(1-h_{ii})}$, also known as the **studentized residual**, which accounts for the estimated residuals having unequal variances (even though the true errors have equal variance).
- and $\hat{\sigma} = \sqrt{\sum_{j=1}^n \hat{\epsilon}_j^2 / n}$.

A threshold of $D_i > 1$ is often suggested to identify influential observations. The Residuals vs Leverage plot helps us to find influential outliers.

```
fig, ax = plt.subplots(clear=True, figsize=(8, 7))
plot_leverage(model.resid, model.get_influence().hat_matrix_diag,
               model.get_influence().cooks_distance[0],
               ddof=len(model.params), ax=ax)
```

```
Empty DataFrame
Columns: [influential, cook's D, leverage]
Index: []
```

Residuals vs Leverage



ECONOMETRIC FORECASTS

In economics, the majority is always wrong - John Kenneth Galbraith

- Trends: seasonality, random walk, unit root
- Autocovariance: stationarity, AR, MA, SARIMAX
- Forecasting: single-step, multi-step
- Granger causality, impulse response function, Vector Autoregression
- Industrial Production

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import seaborn as sns
from statsmodels.tsa.ar_model import AutoReg, ar_select_order
from statsmodels.graphics.tsaplots import plot_acf, plot_pacf, acf
from statsmodels.tsa.seasonal import seasonal_decompose
from statsmodels.tsa.statespace.sarimax import SARIMAX
from statsmodels.tsa.stattools import grangercausalitytests, adfuller
from statsmodels.tsa.api import VAR
import statsmodels.formula.api as smf
from sklearn.metrics import mean_squared_error
from finds.readers import Alfred
from secret import credentials
VERBOSE = 0
# %matplotlib qt
```

```
series_id, freq, start = 'IPB50001N', 'ME', 0 # not seasonally adjusted
alf = Alfred(api_key=credentials['fred']['api_key'])
df = alf(series_id, log=1, freq=freq, start=start).dropna()
df.index = pd.to_datetime(df.index, format='%Y%m%d')
df.index.freq = freq # set index to datetime type with 'M frequency
alf.header(series_id)
```

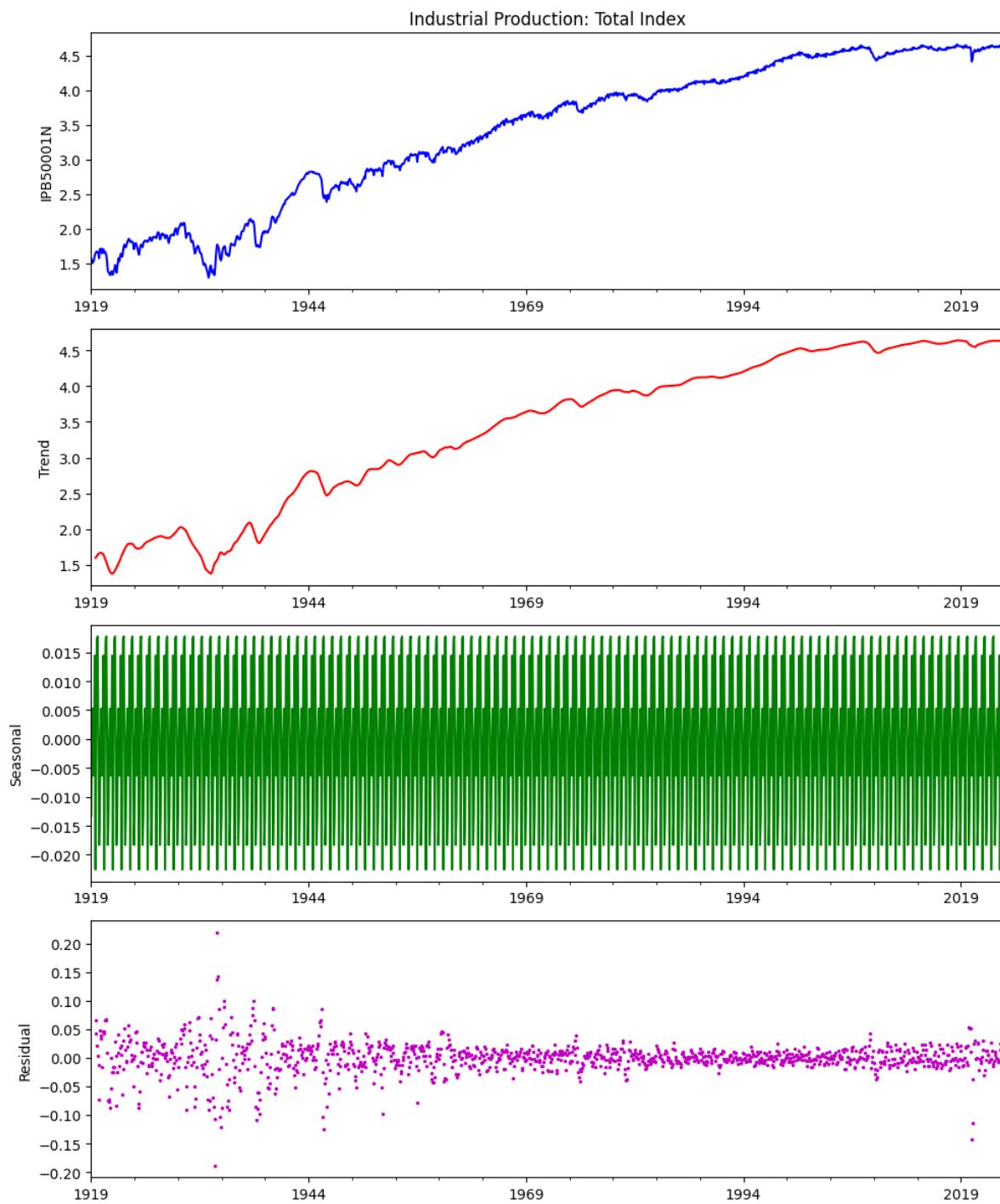
'Industrial Production: Total Index'

10.1 Seasonality

A time series can be decomposed into three distinct components: the trend, which captures the changes in the level of the time series over time; the seasonal component, which captures predictable changes in the time series according to the time of year; and the cyclical component, which captures the cycles in the data.

Suppose that Y_t is a seasonal time series that has a different mean in each period. The seasonality repeats each s periods (e.g. every 3 in a quarterly series or 12 in a monthly series). Such deterministic seasonalities produce differences in the mean of a time series that are simple to model using dummy variables.

```
## Seasonality Decomposition Plot
result = seasonal_decompose(df, model = 'add')
fig, ax = plt.subplots(nrows=4, ncols=1, clear=True, figsize=(10, 12))
result.observed.plot(ax=ax[0], title=alf.header(result.observed.name),
                     ylabel=result.observed.name, xlabel='', c='b')
result.trend.plot(ax=ax[1], ylabel='Trend', xlabel='', c='r')
result.seasonal.plot(ax=ax[2], ylabel='Seasonal', xlabel='', c='g')
result.resid.plot(ax=ax[3], ls=' ', ms=3, marker='.', c='m',
                  ylabel='Residual', xlabel='')
plt.tight_layout()
```



10.2 Stationarity

Covariance stationarity depends on the first two moments of a time series: the mean and the autocovariances.

Autocovariance is defined as the covariance between a time series observations at different points in time. Its definition is the time-series analog of the covariance between two random variables. The h th autocovariance is defined as: $\gamma_{t,h} = E[(Y_t - E[Y_t])(Y_{t-h} - E[Y_{t-h}])]$

A time series is covariance-stationary if its first two moments satisfy three key properties.

1. The mean is constant and does not change over time (i.e., $E[Y_t] = m$ for all t).
2. The variance is finite and does not change over time (i.e., $V[Y_t] = \gamma_0 < \infty$ for all t).
3. The autocovariance is finite, does not change over time, and only depends on the distance between observation h (i.e., $Cov[Y_t, Y_{t-h}] = \gamma_h$ for all t).

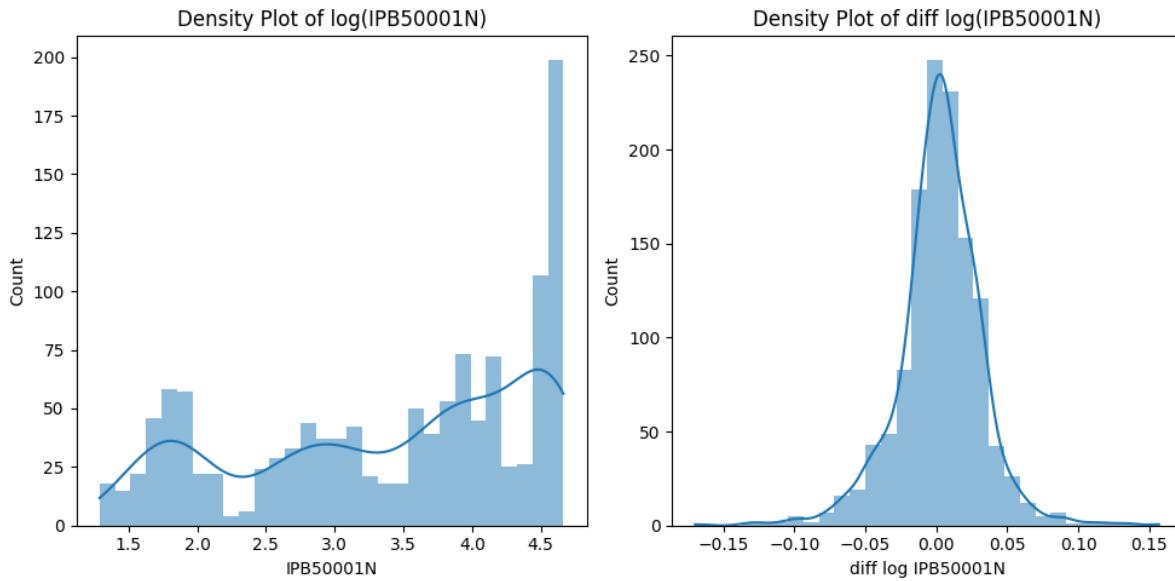
Covariance stationarity is important when modeling and forecasting time series. A covariance-stationary time series has constant relationships over time.

The null hypothesis of the Augmented Dickey-Fuller is that there is a unit root, with the alternative that there is no unit root. If the pvalue is less than a critical size, then we can reject that there is a unit root.

```
values = df.diff().dropna().values.squeeze()
adf = adfuller(values)
DataFrame.from_dict({"I(1)": list(adf[:4]) + list(adf[4].values())},
                    orient='index',
                    columns=[['Test Statistic', 'p-value', 'Lags Used', 'Obs Used'] +
                             [f"critical({k})" for k in adf[4].keys()]]).round(3)
```

	Test Statistic	p-value	Lags Used	Obs Used	critical(1%)	\
I(1)	-7.235	0.0	23	1237	-3.436	
	critical(5%)	critical(10%)				
I(1)	-2.864		-2.568			

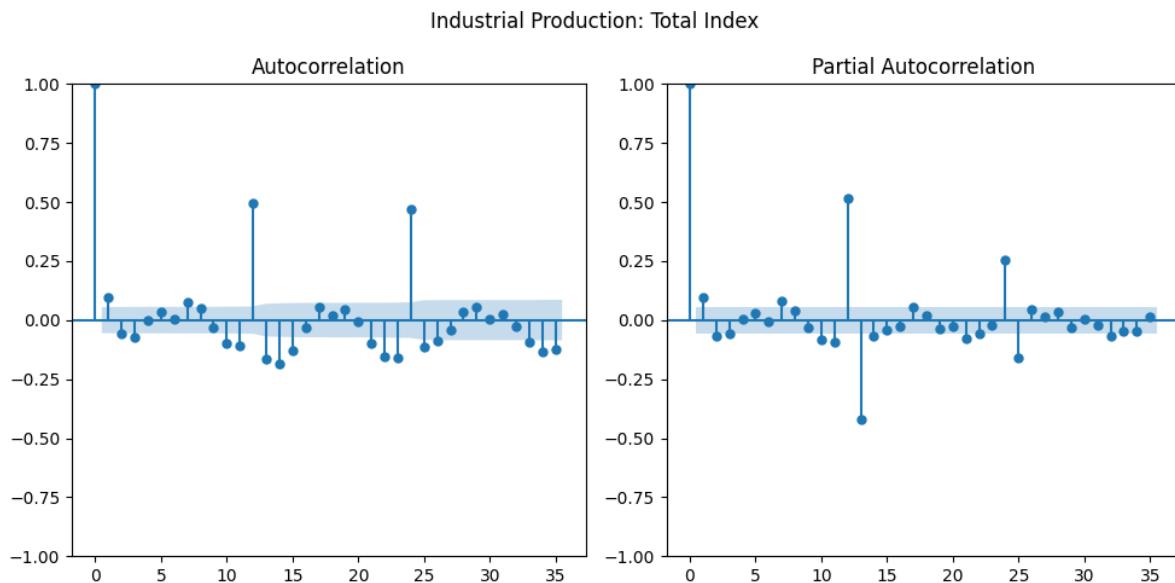
```
# Histogram Plot and Kernel Density Estimate
fig, axes = plt.subplots(1, 2, clear=True, figsize=(10,5))
sns.histplot(df.dropna(), bins=30, lw=0, kde=True, ax=axes[0])
axes[0].set_title(f"Density Plot of log({series_id})")
sns.histplot(df.diff().dropna().rename(f"diff log {series_id}"),
             bins=30, lw=0, kde=True, ax=axes[1]) #line_kws={"color": "r"}
axes[1].set_title(f"Density Plot of diff log({series_id})")
plt.tight_layout()
```



10.3 Autocorrelation

The autocorrelation at lag h is defined as the ratio: $\rho_h = \frac{\gamma_h}{\gamma_0}$. The partial autocorrelation measures the strength of the correlation between these two time-series observations after controlling for the observations between them (i.e., the intermediate lags $Y_{t-1}, Y_{t-2}, \dots, Y_{t-h+1}$).

```
values = df.diff().dropna().values.squeeze()
fig, axes = plt.subplots(1, 2, clear=True, figsize=(10, 5))
plot_acf(values, lags=35, ax=axes[0])
plot_pacf(values, lags=35, ax=axes[1], method='ywm')
plt.suptitle(alf.header(result.observed.name))
plt.tight_layout()
```



10.4 Time Series

10.4.1 AR models

Autoregressive models relate the current value of a time series Y_t to its previous values. A first order AR process, which can be denoted by AR(1), evolves according to: $Y_t = \delta + \phi Y_{t-1} + \epsilon_t$, where δ is called the intercept, ϕ is the AR parameter, and the shock ϵ is white noise with constant and finite variance σ^2 . White noise processes have zero autocorrelation and autocovariance

Its partial autocorrelation function (**PACF**) is non-zero only for the first lag, while its autocorrelation function (**ACF**) exhibits a slow decay $\rho(h) = \phi^{|h|}$

The p th order AR process generalizes the first-order process to include p lags of Y in the model. The AR(p) model is: $Y_t = \mu + \phi_1 Y_{t-1} + \phi_2 Y_{t-2} + \dots + \phi_p Y_{t-p} + \epsilon_t$

10.4.2 MA models

A first-order **moving average** model, denoted MA(1), is defined as: $Y_t = \mu + \theta \epsilon_{t-1} + \epsilon_t$

The observed value of Y_t depends on both the contemporaneous and previous shock. Moving averages are always covariance-stationary. An MA(1) has a limited memory, because only the shock in the previous period impacts the current value.

The MA(1) generalizes to an MA(q), which includes q lags of the shock: $Y_t = \mu + \epsilon_t + \phi_1 \epsilon_{t-1} + \dots + \theta_q \epsilon_{t-q}$

Its ACF is always zero for lags larger than q , but the PACF is more complex.

10.4.3 ARMA models

Autoregressive Moving Average (ARMA) processes combine AR and MA processes. For example, a simple ARMA(1,1) evolves according to: $Y_t = \mu + \phi Y_{t-1} + \theta \epsilon_{t-1} + \epsilon_t$ The mean of this process is $\mu = \delta / (1 - \phi)$ The variance is $\gamma_0 = \sigma^2 (1 + 2\phi\theta + \theta^2) / (1 - \phi^2)$

An ARMA(1,1) process is covariance-stationary if $|\phi_1| < 1$. The MA coefficient plays no role in determining whether the process is covariance-stationary, because any MA is covariance-stationary and the MA component only affects a single lag of the shock. The AR component, however, affects all lagged shocks and so if ϕ_1 is too large, then the time series is not covariance-stationary.

10.4.4 Lag lengths

Determining the appropriate lag lengths for the AR and MA components (i.e., p and q , respectively) is a key challenge when building an ARMA model. The first step in model building is to inspect the sample autocorrelation and sample PACFs.

The **Box-Pierce** test statistic is the sum of the squared autocorrelations scaled by the sample size T : $Q_{BP} = T \sum_{i=1}^h \left(\frac{T+1}{T-1} \right) \hat{\rho}_i^2$ When the null is true, Q_{BP} is asymptotically distributed as a χ_h^2 variable.

The **Ljung-Box** statistic is a modified version of the Box-Pierce statistic that works better in smaller samples, and is defined as: $Q_{LB} = T \sum_{i=1}^h \left(\frac{T+2}{T-i} \right) \hat{\rho}_i^2$

10.4.5 Seasonal component

Seasonal components can be added to the short-term components of an ARMA(p,q) model, by using lags only at the seasonal frequency. A seasonal ARMA combines these two components into a single specification:

$$ARMA(p, q) \times (p_s, q_s)_f$$

where p and q are the orders of the short-run lag polynomials, p_s and q_s are the orders of the seasonal lag polynomials, and f is the seasonal horizon (e.g., every 3 or 12 months with monthly observations).

10.4.6 Unit Roots

Random walks are most important source of non-stationarity in economic time series. A simple random walk process evolves according to: $Y_t = Y_{t-1} + \epsilon_t$. Unit roots generalize random walks by adding short-run stationary dynamics to the long-run random walk.

A pair of time series have a spurious relationship when there are no fundamental links between them, but a regression of one on the other produces a coefficient estimate that is large and seemingly statistically different from zero when using conventional statistical distributions to obtain the critical values. When a time series contains a unit root, it is common to find spurious relationships with other time series that have a time trend or a unit root.

The solution is to difference a time series that contains a unit root. If Y_t has a unit root (i.e. has integration order 1), then the difference: $\Delta Y_t = Y_t - Y_{t-1}$ does not.

10.4.7 SARIMAX model

The Seasonal AutoRegressive Integrated Moving Average with eXogenous regressors (SARIMAX) model is specified $(p, d, q) \times (P, D, Q)_s$, with

- the (p,d,q) order of the model for the number of AR parameters, differences (indicating the integration order of the process), and MA parameters,
- the (P,D,Q,s) order of the seasonal component for the AR parameters, differences, MA parameters, and periodicity.

```
split_date = df.index[-12]  # train/test split date
# df_train = df.loc[:split_date].dropna()

# Fit a SARIMA(1,1,3) with seasonal order (0, 0, 0, 12)
pdq = (1, 1, 1)  # (12, 1, 0)
seasonal_pdq = (0, 0, 0, 12)
arima = SARIMAX(df, order=pdq, seasonal_order=seasonal_pdq, trend='c').fit()
fig = arima.plot_diagnostics(figsize=(10, 6), lags=36)
plt.tight_layout()
arima.summary()
```

RUNNING THE L-BFGS-B CODE

* * *

```
Machine precision = 2.220D-16
N =           4      M =           10
At X0           0 variables are exactly at the bounds
```

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```

At iterate    0      f= -2.09203D+00      |proj g|=  3.50751D-01
At iterate    5      f= -2.09212D+00      |proj g|=  2.65613D-02
At iterate   10      f= -2.09214D+00      |proj g|=  1.27872D-01
* * *

Tit   = total number of iterations
Tnf   = total number of function evaluations
Tnint = total number of segments explored during Cauchy searches
Skip  = number of BFGS updates skipped
Nact  = number of active bounds at final generalized Cauchy point
Projg = norm of the final projected gradient
F     = final function value

* * *

      N      Tit      Tnf      Tnint      Skip      Nact      Projg          F
      4        14        18        1        0        0    8.002D-04  -2.092D+00
F = -2.0921435906737225

CONVERGENCE: REL_REDUCTION_OF_F_<=_FACTR*EPSMCH

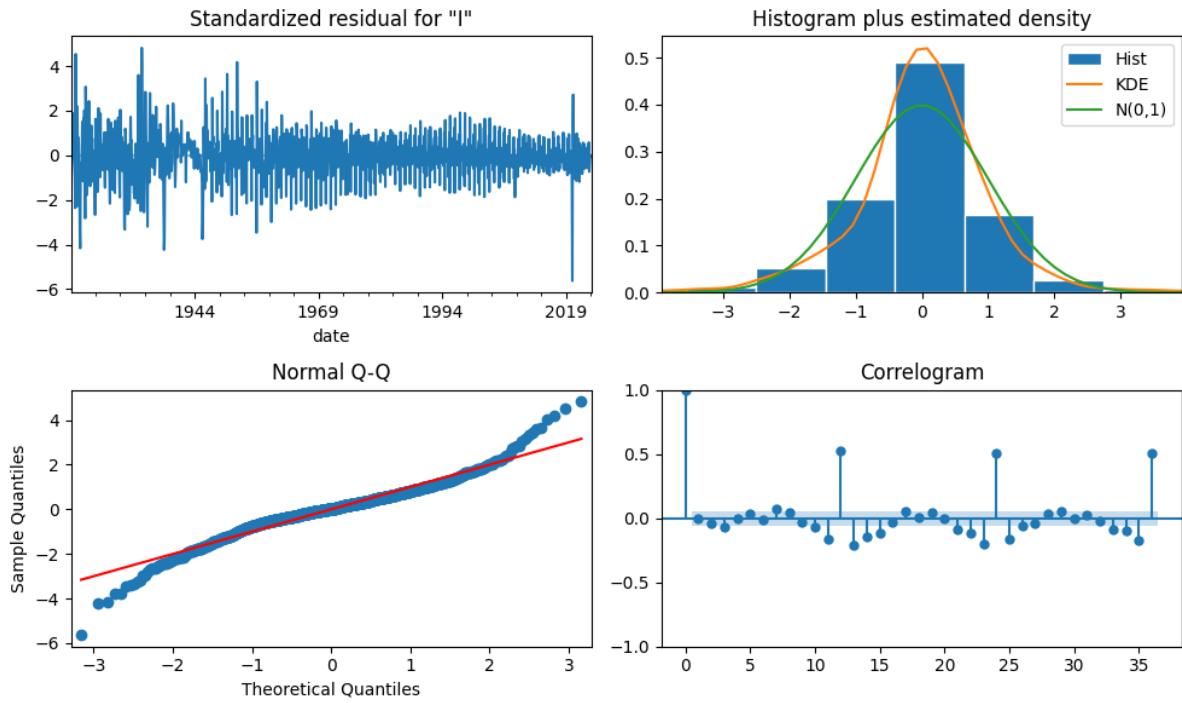
```

This problem is unconstrained.

Dep. Variable:	IPB50001N	No. Observations:	1262			
Model:	SARIMAX(1, 1, 1)	Log Likelihood	2640.285			
Date:	Tue, 09 Apr 2024	AIC	-5272.570			
Time:	11:16:42	BIC	-5252.012			
Sample:	01-31-1919 - 02-29-2024	HQIC	-5264.845			
Covariance Type: opg						
	coef	std err	z	P> z	[0.025	0.975]
intercept	0.0027	0.001	2.393	0.017	0.000	0.005
ar.L1	-0.1199	0.222	-0.541	0.588	-0.554	0.314
ma.L1	0.2237	0.221	1.011	0.312	-0.210	0.657
sigma2	0.0009	2.24e-05	39.741	0.000	0.001	0.001
Ljung-Box (L1) (Q):		0.02	Jarque-Bera (JB):	554.43		
Prob(Q):		0.88	Prob(JB):	0.00		
Heteroskedasticity (H):		0.32	Skew:	-0.20		
Prob(H) (two-sided):		0.00	Kurtosis:	6.22		

Warnings:

[1] Covariance matrix calculated using the outer product of gradients (complex-step).



10.5 Forecasting

```
series_id, start = 'INDPRO', 0
df_all = alf(series_id, log=1, diff=1, start=start).dropna()
df_all.index = pd.to_datetime(df_all.index, format='%Y%m%d')
df_all.index.freq = freq
df_train = df_all[df_all.index <= split_date]
df_test = df_all[df_all.index > split_date]
```

10.5.1 AR lag order

The most natural measure of fit is the sample variance of the estimated residuals, also known as the Mean Squared Error (MSE) of the model. Unfortunately, choosing a model to minimize MSE also selects a specification that is far too large. The solution to this overfitting problem is to add a penalty to the MSE that increases each time a new parameter is added.

- AIC is defined as: $AIC = T \ln \hat{\sigma}^2 + 2k$, where T is the sample size and k is the number of parameters.
- BIC alters the penalty and is defined as: $BIC = T \ln \hat{\sigma}^2 + k \ln T$

Unlike the AIC, the BIC has a cost per parameter that slowly increases with T . Hence BIC always selects a model that is no larger than the model selected by the AIC (assuming $\ln T > 2$), and is a consistent model selection criterion (i.e., the true model is selected as $T \rightarrow \infty$).

```
lags = ar_select_order(df_train, maxlag=36, ic='bic', old_names=False).ar_lags
print('(BIC) lags= ', len(lags), ':', lags)
```

```
(BIC) lags= 1 : [1]
```

```
# Train final model on train split
model = AutoReg(df_train, lags=lags, old_names=False).fit()
print(model.summary())
```

```
AutoReg Model Results
=====
Dep. Variable:           INDPRO    No. Observations:             1250
Model:                 AutoReg(1)    Log Likelihood:          3331.030
Method:                Conditional MLE  S.D. of innovations:    0.017
Date:                  Tue, 09 Apr 2024  AIC:                  -6656.061
Time:                  11:16:45      BIC:                  -6640.670
Sample:                03-31-1919  HQIC:                  -6650.275
                       - 03-31-2023
=====
            coef    std err      z   P>|z|    [ 0.025   0.975]
-----
const      0.0013      0.000    2.697    0.007      0.000    0.002
INDPRO.L1  0.4854      0.025   19.685    0.000      0.437    0.534
            Roots
=====
          Real      Imaginary      Modulus      Frequency
-----
AR.1      2.0601      +0.0000j      2.0601      0.0000
```

10.5.2 One-step forecast

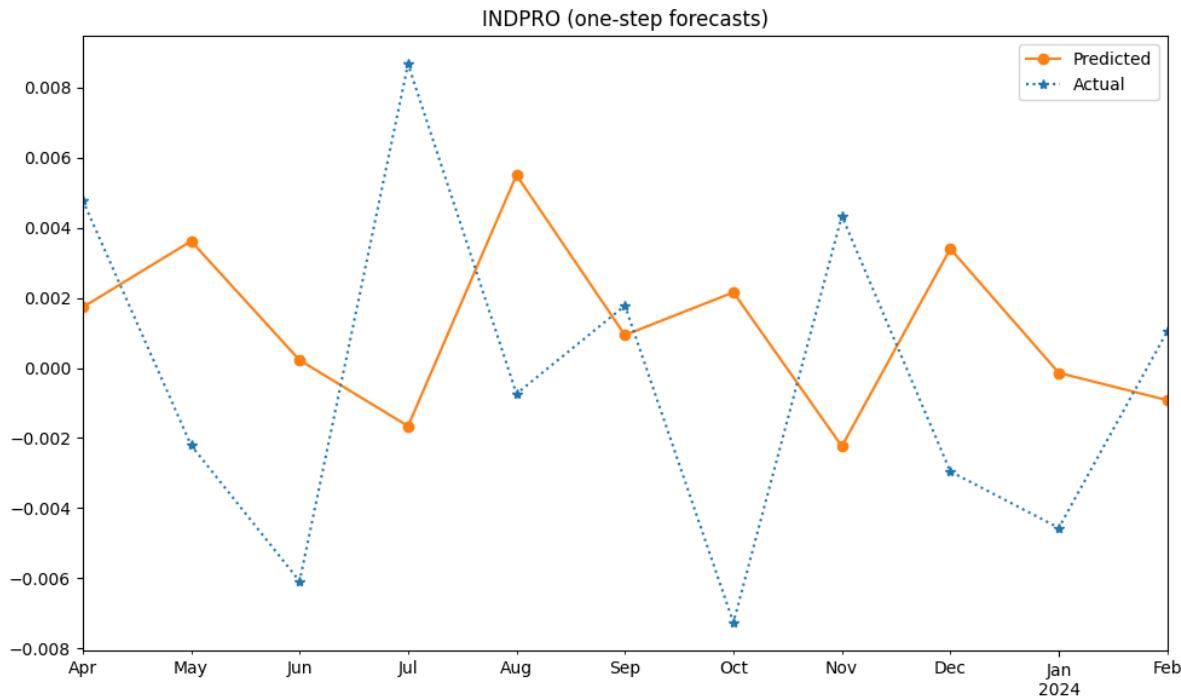
The one-step forecast is the expectation of Y_{T+1} conditional the time T information set, which contains all values that are known at time T, including the entire prior history of Y (Y_T, Y_{T-1}, \dots), as well as all values of any other variable that occurred at time T or earlier.

```
# Observations to predict are from the oos test split
test = AutoReg(df_all, lags=lags, old_names=False)
```

```
# Use model params from train split, start predictions from last train row
df_pred = test.predict(model.params, start=df_test.index[0])
mse = mean_squared_error(df_test, df_pred)
#var = np.mean(np.square(df_test - df_train.mean()))
print(f"ST Forecast({len(df_pred)}): rmse={np.sqrt(mse)}")
```

```
ST Forecast(11): rmse=0.006210397949646384
```

```
fig, ax = plt.subplots(clear=True, num=1, figsize=(10, 6))
df_pred.plot(ax=ax, c='C1', ls='-', marker='o', label='Predicted')
df_test.plot(ax=ax, c='C0', ls=':', marker='*', label='Actual')
ax.legend()
ax.set_title(series_id + " (one-step forecasts)")
ax.set_xlabel('')
plt.tight_layout()
```

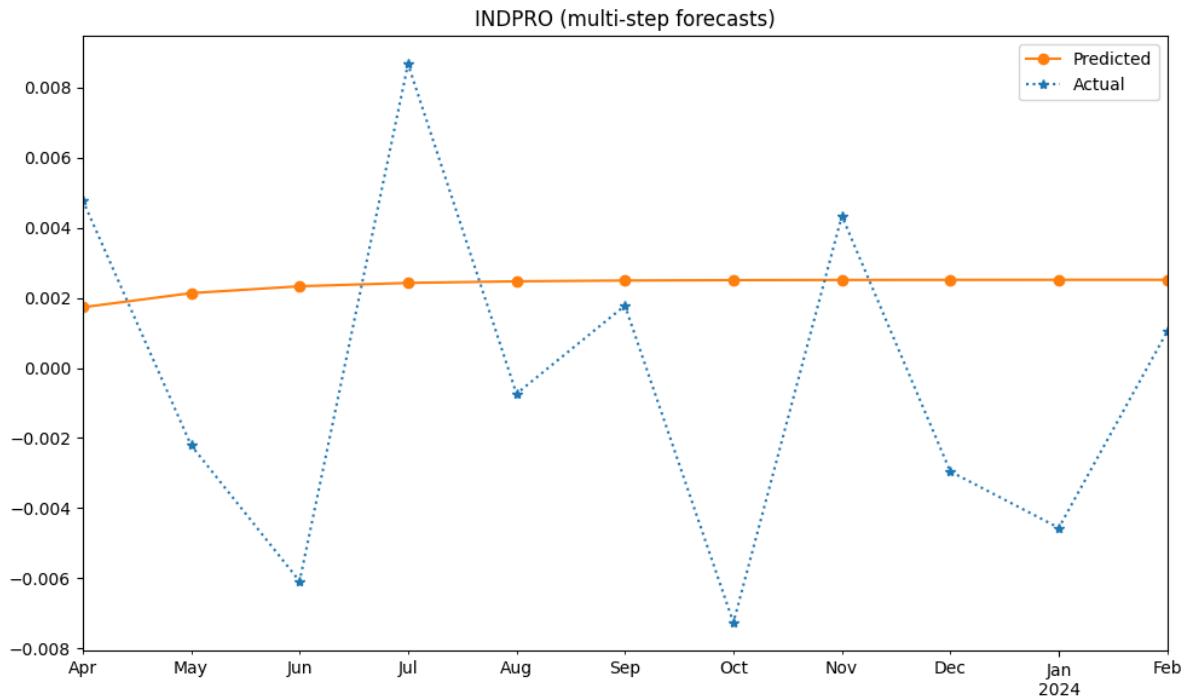


10.5.3 Multi-step forecast

Forecasts are generated recursively starting with $E_T[Y_{T+1}]$. The forecast horizon h depends on forecasts from earlier steps ($E_T[Y_{T+1}]$, ..., $E_T[Y_{T+h-1}]$). When these quantities appear in the forecast for period $T+h$, they are replaced by the forecasts computed for horizons 1, 2, ..., $h-1$.

```
# set dynamic=True for multi-step ahead predictions
df_pred = test.predict(model.params, dynamic=True,
                       start=df_test.index[0], end=df_test.index[-1])
mse = mean_squared_error(df_test, df_pred)
#var = np.mean(np.square(df_test - df_train.mean()))
print(f"Long-term Forecasts: rmse={np.sqrt(mse):.6f}")
fig, ax = plt.subplots(clear=True, num=2, figsize=(10, 6))
df_pred.plot(ax=ax, c='C1', ls='-', marker='o', label='Predicted')
df_test.plot(ax=ax, c='C0', ls=':', marker='*', label='Actual')
ax.legend()
ax.set_title(series_id + " (multi-step forecasts)")
ax.set_xlabel('')
plt.tight_layout()
```

Long-term Forecasts: rmse=0.005469



10.5.4 Granger Causality

```
# Granger Causality: INDPRO vs CPI
variables = ['INDPRO', 'CPIAUCSL']
start = 19620101
for series_id, exog_id in zip(variables, list(reversed(variables))):
    df = pd.concat([alf(s, start=start, log=1)
                   for s in [series_id, exog_id]], axis=1)
    df.index = pd.DatetimeIndex(df.index.astype(str))
    df.index.freq = freq
    data = df.diff().dropna()

    print(f"Null Hypothesis: {exog_id} granger-causes {series_id}")
    res = grangercausalitytests(data, maxlag=3)
    print()

    dmf = (f'{series_id} ~ {series_id}.shift(1) '
           f'+ {exog_id}.shift(1) '
           f'+ {exog_id}.shift(2) '
           f'+ {exog_id}.shift(3) ')
    model = smf.ols(formula=dmf, data=data).fit()
    robust = model.get_robustcov_results(cov_type='HAC', use_t=None, maxlags=0)
    print(robust.summary())
```

Null Hypothesis: CPIAUCSL granger-causes INDPRO

Granger Causality
 number of lags (no zero) 1
 ssr based F test: F=0.3694 , p=0.5435 , df_denom=741, df_num=1
 ssr based chi2 test: chi2=0.3709 , p=0.5425 , df=1

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```
likelihood ratio test: chi2=0.3708 , p=0.5426 , df=1
parameter F test: F=0.3694 , p=0.5435 , df_denom=741, df_num=1
```

Granger Causality

number of lags (no zero) 2

```
ssr based F test: F=7.5604 , p=0.0006 , df_denom=738, df_num=2
```

```
ssr based chi2 test: chi2=15.2233 , p=0.0005 , df=2
```

```
likelihood ratio test: chi2=15.0694 , p=0.0005 , df=2
```

```
parameter F test: F=7.5604 , p=0.0006 , df_denom=738, df_num=2
```

Granger Causality

number of lags (no zero) 3

```
ssr based F test: F=5.3906 , p=0.0011 , df_denom=735, df_num=3
```

```
ssr based chi2 test: chi2=16.3259 , p=0.0010 , df=3
```

```
likelihood ratio test: chi2=16.1489 , p=0.0011 , df=3
```

```
parameter F test: F=5.3906 , p=0.0011 , df_denom=735, df_num=3
```

OLS Regression Results

```
=====
Dep. Variable: INDPRO      R-squared: 0.089
Model: OLS                  Adj. R-squared: 0.084
Method: Least Squares      F-statistic: 2.668
Date: Tue, 09 Apr 2024     Prob (F-statistic): 0.0313
Time: 11:16:47              Log-Likelihood: 2430.5
No. Observations: 742       AIC: -4851.
Df Residuals: 737          BIC: -4828.
Df Model: 4
Covariance Type: HAC
=====
```

	coef	std err	t	P> t	[0.025	0.
975]						
Intercept	0.0019	0.001	1.954	0.051	-8.95e-06	0.
INDPRO.shift(1)	0.2548	0.143	1.778	0.076	-0.027	0.
CPIAUCSL.shift(1)	0.4099	0.213	1.921	0.055	-0.009	0.
CPIAUCSL.shift(2)	-0.4703	0.214	-2.202	0.028	-0.890	-0.
CPIAUCSL.shift(3)	-0.1124	0.144	-0.779	0.436	-0.395	0.
Omnibus:	727.398	Durbin-Watson:			1.983	
Prob(Omnibus):	0.000	Jarque-Bera (JB):			126368.644	
Skew:	-3.898	Prob(JB):			0.00	
Kurtosis:	66.456	Cond. No.			563.	

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using 0 lags and without small sample correction

Null Hypothesis: INDPRO granger-causes CPIAUCSL

Granger Causality

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```
number of lags (no zero) 1
ssr based F test:      F=0.0173 , p=0.8955 , df_denom=741, df_num=1
ssr based chi2 test:  chi2=0.0173 , p=0.8952 , df=1
likelihood ratio test: chi2=0.0173 , p=0.8952 , df=1
parameter F test:      F=0.0173 , p=0.8955 , df_denom=741, df_num=1
```

Granger Causality

```
number of lags (no zero) 2
ssr based F test:      F=0.0053 , p=0.9947 , df_denom=738, df_num=2
ssr based chi2 test:  chi2=0.0107 , p=0.9947 , df=2
likelihood ratio test: chi2=0.0107 , p=0.9947 , df=2
parameter F test:      F=0.0053 , p=0.9947 , df_denom=738, df_num=2
```

Granger Causality

```
number of lags (no zero) 3
ssr based F test:      F=0.1255 , p=0.9450 , df_denom=735, df_num=3
ssr based chi2 test:  chi2=0.3802 , p=0.9443 , df=3
likelihood ratio test: chi2=0.3801 , p=0.9443 , df=3
parameter F test:      F=0.1255 , p=0.9450 , df_denom=735, df_num=3
```

OLS Regression Results

```
=====
Dep. Variable:          CPIAUCSL      R-squared:                   0.387
Model:                 OLS            Adj. R-squared:             0.384
Method:                Least Squares  F-statistic:                  52.69
Date:                  Tue, 09 Apr 2024  Prob (F-statistic):        4.63e-39
Time:                  11:16:47        Log-Likelihood:            3399.4
No. Observations:      742            AIC:                      -6789.
Df Residuals:          737            BIC:                      -6766.
Df Model:                  4
Covariance Type:        HAC
=====
            coef    std err          t      P>|t|      [0.025      0.
    975]
    --
Intercept      0.0012      0.000      6.816      0.000      0.001      0.
    002
CPIAUCSL.shift(1)  0.6216      0.045     13.719      0.000      0.533      0.
    711
INDPRO.shift(1)   -0.0012      0.014     -0.086      0.931     -0.028      0.
    026
INDPRO.shift(2)   7.455e-05     0.016      0.005      0.996     -0.032      0.
    032
INDPRO.shift(3)    0.0058      0.010      0.608      0.543     -0.013      0.
    025
=====
Omnibus:            86.562      Durbin-Watson:            2.123
Prob(Omnibus):      0.000      Jarque-Bera (JB):        713.052
Skew:                  0.030      Prob(JB):                  1.45e-155
Kurtosis:                 7.802      Cond. No.                  317.
=====
```

Notes:

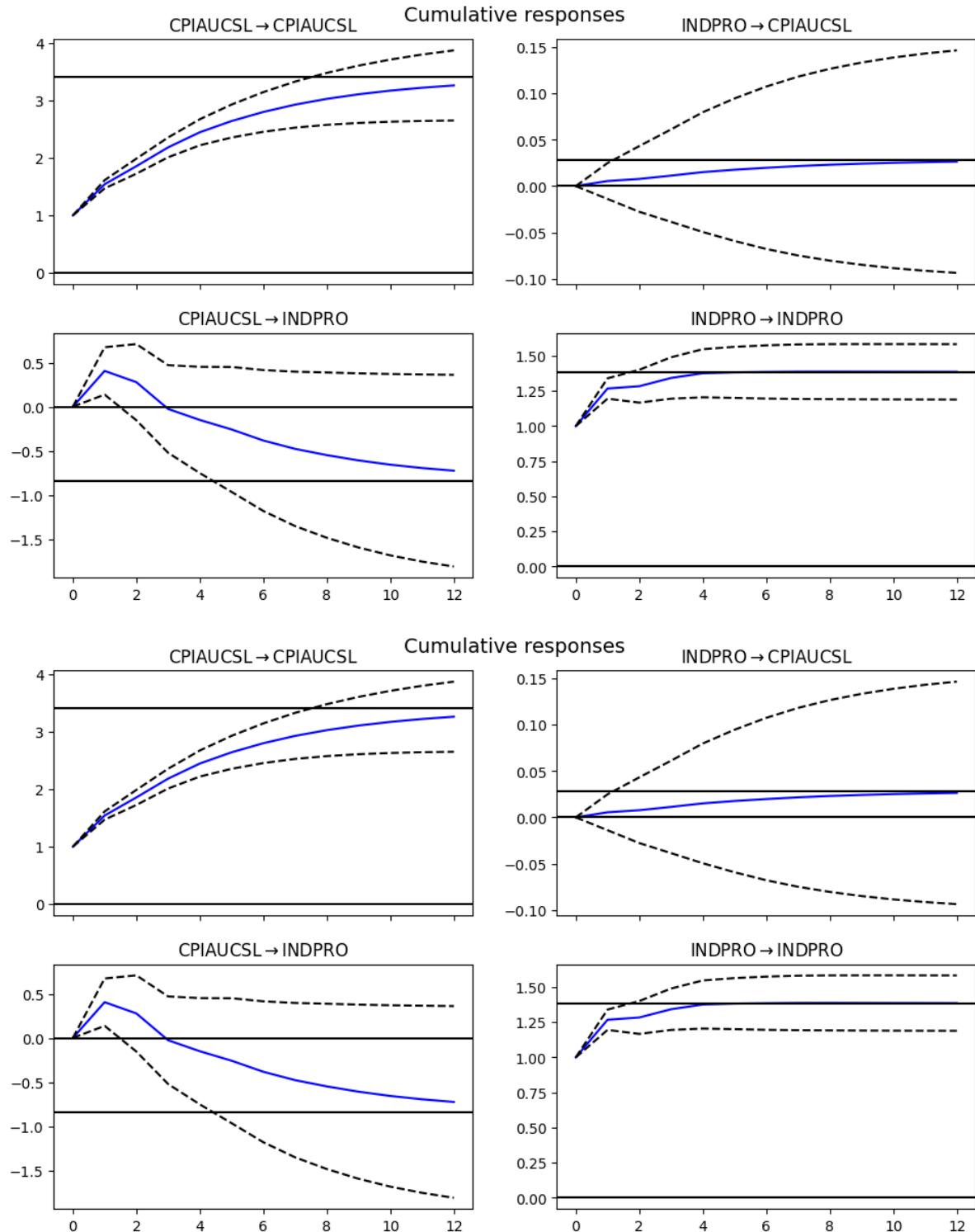
[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using 0 lags and without small sample correction

10.5.5 Impulse Response Function

- Vector Autoregression (VAR)

```
# Vector Autoregression: Impulse Response Function
model = VAR(data)
results = model.fit(maxlags=3)
print(results.summary())
irf = results.irf(12)
#irf.plot(orth=False)
irf.plot_cum_effects(orth=False, figsize=(10, 6))
```

```
Summary of Regression Results
=====
Model: VAR
Method: OLS
Date: Tue, 09, Apr, 2024
Time: 11:16:47
-----
No. of Equations: 2.00000 BIC: -21.3130
Nobs: 742.000 HQIC: -21.3664
Log likelihood: 5847.68 FPE: 5.08298e-10
AIC: -21.4000 Det(Omega_mle): 4.98842e-10
-----
Results for equation CPIAUCSL
=====
      coefficient      std. error      t-stat      prob
-----
const      0.000906      0.000141      6.439      0.000
L1.CPIAUCSL  0.542635      0.036649     14.806      0.000
L1.INDPRO   0.005496      0.009885      0.556      0.578
L2.CPIAUCSL  0.018542      0.041788      0.444      0.657
L2.INDPRO   -0.002211      0.010121     -0.218      0.827
L3.CPIAUCSL  0.147812      0.037002      3.995      0.000
L3.INDPRO   0.002745      0.009758      0.281      0.778
-----
Results for equation INDPRO
=====
      coefficient      std. error      t-stat      prob
-----
const      0.001908      0.000526      3.628      0.000
L1.CPIAUCSL  0.405543      0.136956      2.961      0.003
L1.INDPRO   0.267880      0.036938      7.252      0.000
L2.CPIAUCSL -0.456232      0.156160     -2.922      0.003
L2.INDPRO   -0.057815      0.037823     -1.529      0.126
L3.CPIAUCSL -0.126543      0.138275     -0.915      0.360
L3.INDPRO   0.071427      0.036463      1.959      0.050
-----
Correlation matrix of residuals
      CPIAUCSL      INDPRO
CPIAUCSL  1.000000  0.098825
INDPRO    0.098825  1.000000
```



APPROXIMATE FACTOR MODELS

It is better to be vaguely right than precisely wrong - Carveth Read

- Integration Order
- Approximate factor model

References:

- Bai, Jushan and Ng, Serena, 2002, Determining the Number of Factors in Approximate Factor Models, *Econometrica* 70:1, 191-2211
- McCracken, Michael W., and Serena Ng, 2016. FRED-MD: A monthly database for macroeconomic research, *Journal of Business & Economic Statistics*, 34(4), 574-589.
- Michael W. McCracken, Serena Ng, 2020, FRED-QD: A Quarterly Database for Macroeconomic Research.

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from sklearn.decomposition import PCA
from sklearn.preprocessing import StandardScaler
from finds.readers import Alfred, fred_md, fred_qd
from finds.recipes import (approximate_factors, mrsq, select_baing, integration_order,
                           remove_outliers, is_outlier)
from secret import credentials
VERBOSE = 0
#%matplotlib qt
```

```
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
```

```
## Retrieve recession periods from FRED
vspan = alf.date_spans('USREC')
DataFrame(vspan, columns=['Start', 'End'])
```

	Start	End
0	1854-12-31	1854-12-31
1	1857-06-30	1858-12-31
2	1860-10-31	1861-06-30
3	1865-04-30	1867-12-31
4	1869-06-30	1870-12-31
5	1873-10-31	1879-03-31
6	1882-03-31	1885-05-31

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```

7 1887-03-31 1888-04-30
8 1890-07-31 1891-05-31
9 1893-01-31 1894-06-30
10 1895-12-31 1897-06-30
11 1899-06-30 1900-12-31
12 1902-09-30 1904-08-31
13 1907-05-31 1908-06-30
14 1910-01-31 1912-01-31
15 1913-01-31 1914-12-31
16 1918-08-31 1919-03-31
17 1920-01-31 1921-07-31
18 1923-05-31 1924-07-31
19 1926-10-31 1927-11-30
20 1929-08-31 1933-03-31
21 1937-05-31 1938-06-30
22 1945-02-28 1945-10-31
23 1948-11-30 1949-10-31
24 1953-07-31 1954-05-31
25 1957-08-31 1958-04-30
26 1960-04-30 1961-02-28
27 1969-12-31 1970-11-30
28 1973-11-30 1975-03-31
29 1980-01-31 1980-07-31
30 1981-07-31 1982-11-30
31 1990-07-31 1991-03-31
32 2001-03-31 2001-11-30
33 2007-12-31 2009-06-30
34 2020-02-29 2020-04-30

```

11.1 Integration order

11.1.1 Augmented Dickey-Fuller test

The Augmented Dickey-Fuller (ADF) specification is the most widely used unit root test. An ADF test is implemented using an OLS regression where the difference of a series is regressed on its lagged level, relevant deterministic terms, and lagged differences. The general form of an ADF regression is

$$\Delta Y_t = \gamma Y_{t-1} + (\delta_o + \delta_1 t) + \lambda_1 \Delta Y_{t-1} + \dots + \lambda_p \Delta Y_{t-p}$$

The value of γ is 0 when Y_t is a random walk, and so is non-stationary. The alternative is $\gamma < 0$ which corresponds to the case that Y_t is covariance-stationary. Note that the alternative is one-sided, since positive values of γ correspond to an AR coefficient that is larger than 1.

When the null of a unit root cannot be rejected, the series should be differenced. The best practice is to repeat the ADF test on the iteratively-differenced data to ensure that it is stationary.

```

qd_df, qd_codes = fred_qd() # 202004
md_df, md_codes = fred_md() # 201505
qd_date = max(qd_df.index)
md_date = max(md_df.index)

```

```

FRED-QD vintage: quarterly/current.csv
FRED-MD vintage: monthly/current.csv

```

11.1.2 Transformations

FRED-MD and FRED-QD series are tagged by one of seven transformation codes, which suggest transformations, such as taking logs or differences, to apply to the underlying series. The number of times differences are taken of a series should remove unit roots and transform the series to be covariance stationary.

```
print(f"Number of series by suggested tcode transformations ({md_date}):")
tcodes = DataFrame.from_dict({i: alf.tcode[i] for i in range(1, 8)},
                             orient='index') \
    .join(qd_codes['transform'].value_counts().rename('fred-qd')) \
    .join(md_codes['transform'].value_counts().rename('fred-md')) \
    .fillna(0) \
    .astype(int) \
    .rename_axis(index='tcode')
tcodes
```

Number of series by suggested tcode transformations (20240331):

tcode	diff	log	pct_change	fred-qd	fred-md
1	0	0	0	22	11
2	1	0	0	32	19
3	2	0	0	0	0
4	0	1	0	0	10
5	1	1	0	140	52
6	2	1	0	50	33
7	1	0	1	1	1

```
# For each series, compare fitted integration order with tcode
out = {}
stationary_out = {}
for label, df, transforms in [[['md', md_df, md_codes['transform']],
                               ['qd', qd_df, qd_codes['transform']]],
                               stationary = dict()
for series_id, tcode in transforms.items():
    # apply transformation if series tcode is valid
    if tcode in range(1, 8):
        # take logs of series if specified by tcode
        s = np.log(df[series_id]) if tcode in [4, 5, 6] else df[series_id]

        # estimate integration order
        order = integration_order(s.dropna(), pvalue=0.05)

        # expected order specified by tcode
        expected_order = 2 if tcode == 7 else ((tcode - 1) % 3)

        # accumulate results for this series
        stationary[series_id] = {'tcode': tcode,
                                'I(p)': order,
                                'different': order - expected_order,
                                'title': alf.header(series_id)}
    #
    # print(series_id, tcode, expected_order, order)

    # collect results for display
    stationary = DataFrame.from_dict(stationary, orient='index')
```

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```
stationary = stationary.sort_values(stationary.columns.to_list())
c = stationary.groupby(['tcode', 'I(p)'])['title'].count().reset_index()
out[label] = c.pivot(index='tcode', columns='I(p)', values='title')\
    .fillna(0).astype(int)
out[label].columns=[f"I({p})" for p in out[label].columns]
stationary_out[label] = stationary[stationary['different'] > 0]
```

```
print('Series by tcode, transformations and estimated order of integration:')
results = pd.concat([tcodes.drop(columns='fred-md'),
                     out['qd'],
                     tcodes['fred-md'],
                     out['md']], axis=1).fillna(0).astype(int)
print('Integration order by transformation')
results
```

Series by tcode, transformations and estimated order of integration:
Integration order by transformation

tcode	diff	log	pct_change	fred-qd	I(0)	I(1)	I(2)	fred-md	I(0)	I(1)	\
1	0	0	0	22	18	4	0	11	11	0	
2	1	0	0	32	11	19	2	19	4	15	
3	2	0	0	0	0	0	0	0	0	0	
4	0	1	0	0	0	0	0	10	6	4	
5	1	1	0	140	30	106	4	52	14	38	
6	2	1	0	50	0	30	20	33	0	30	
7	1	0	1	1	0	1	0	1	0	1	

tcode	I(2)
1	0
2	0
3	0
4	0
5	0
6	3
7	0

```
print('FRED-MD Series with unit root after transformation')
stationary_out['md']
```

FRED-MD Series with unit root after transformation

tcode	I(p)	different	\
PERMITMW	4	1	1
PERMITNE	4	1	1
HOUSTMW	4	1	1
HOUSTNE	4	1	1

	title
PERMITMW	New Privately-Owned Housing Units Authorized i...
PERMITNE	New Privately-Owned Housing Units Authorized i...

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```
HOUSTMW  New Privately-Owned Housing Units Started: Tot...
HOUSTNE  New Privately-Owned Housing Units Started: Tot...
```

```
print('FRED-QD Series with unit root after transformation')
stationary_out['qd']
```

```
FRED-QD Series with unit root after transformation
```

	tcode	I(p)	different	\	
NWPI	1	1	1		
TLBSNNBBDI	1	1	1		
TLBSNNCBBDI	1	1	1		
HWI	1	1	1		
GFDEBTN	2	2	1		
S&P div yield	2	2	1		
CES2000000008	5	2	1		
TLBSHNO	5	2	1		
OPHMFG	5	2	1		
SPCS20RSA	5	2	1		
					title
NWPI					*** NWPI ***
TLBSNNBBDI					*** TLBSNNBBDI ***
TLBSNNCBBDI					*** TLBSNNCBBDI ***
HWI					Help Wanted Index for United States
GFDEBTN					Federal Debt: Total Public Debt
S&P div yield					S&P's Composite Common Stock: Dividend Yield
CES2000000008					Average Hourly Earnings of Production and Nons...
TLBSHNO					Households and Nonprofit Organizations; Total ...
OPHMFG					Manufacturing Sector: Labor Productivity (Outp...
SPCS20RSA					S&P CoreLogic Case-Shiller 20-City Composite H...

11.2 Approximate factor model

Principal component analysis finds a low-dimensional representation of a data set that contains as much as possible of the variation of its p features. Each of the dimensions found by PCA is a linear combination of the features. The first principal component of a set of features X_1, X_2, \dots, X_p is the normalized linear combination of the features $Z_1 = \phi_{11}X_1 + \phi_{21}X_2 + \dots + \phi_{p1}X_p$ that has the largest variance. We can then iteratively find the second principal component Z_2 (the linear combination of features that has maximal variance out of all linear combinations that are uncorrelated with previously found components), third component Z_3 , and so on.

11.2.1 BIC criterion

Select number of components

11.2.2 Data imputation

EM algorithm

```
# Verify BaiNg implementation on original FRED-MD and FRED-QD
qd_df, qd_codes = fred_qd(202004)
md_df, md_codes = fred_md(201505)
for freq, df, transforms in [['monthly', md_df, md_codes['transform']],
                             ['quarterly', qd_df, qd_codes['transform']]]:
    # Apply tcode transformations
    transformed = []
    for col in df.columns:
        transformed.append(alf.transform(df[col],
                                         tcode=transforms[col],
                                         freq=freq[0]))
    data = pd.concat(transformed, axis=1).iloc[2:]
    cols = list(data.columns)
    sample = data.index[((np.count_nonzero(np.isnan(data)), axis=1)==0)
                         | (data.index <= 20141231))
                         & (data.index >= 19600301)]

    # set missing and outliers to NaN
    x = data.loc[sample]
    x = remove_outliers(x)      # default fence 'iq10' is 10 times IQ

    # compute factors EM and auto select number of components, r
    Z = approximate_factors(x, p=2, verbose=VERBOSE)
    r = select_baing(Z, p=2)

    # show marginal R2's of series to each component
    mR2 = mrsq(Z, r).to_numpy()
    print(f"FRED-{freq[0].upper()}D {freq} series:")
    print(DataFrame({'selected': r,
                      'variance explained': np.sum(np.mean(mR2[:, :r], axis=0)),
                      'start': min(sample),
                      'end': max(sample),
                      'obs': Z.shape[0],
                      'series': Z.shape[1]},
                    index=[f'factors']))

    for k in range(r):
        args = np.argsort(-mR2[:, k])
        print(f"Factor:{1+k} Variance Explained={np.mean(mR2[:, k]):.4f}")
        print(DataFrame.from_dict({mR2[arg, k].round(4):
                                    {'series': cols[arg],
                                     'description': alf.header(cols[arg])}
                                    for arg in args[:10]}),
              orient='index'))
```

FRED-QD vintage: quarterly/2020-04.csv
 FRED-MD vintage: monthly/2015-05.csv

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FRED-MD monthly series:

	selected	variance explained	start	end	obs	series
factors	8	0.484228	19600331	20141231	658	133
Factor:1	Variance Explained=0.1625					
series						description
0.7426	USGOOD		All Employees, Goods-Producing			
0.7236	PAYEMS		All Employees, Total Nonfarm			
0.6999	MANEMP		All Employees, Manufacturing			
0.6563	NAPM					*** NAPM ***
0.6538	IPMANSICS	Industrial Production: Manufacturing (SIC)				
0.6510	DMANEMP	All Employees, Durable Goods				
0.6312	INDPRO	Industrial Production: Total Index				
0.6036	NAPMNOI					*** NAPMNOI ***
0.6024	NAPMPI					*** NAPMPI ***
0.5601	CUMFNS	Capacity Utilization: Manufacturing (SIC)				
Factor:2	Variance Explained=0.0705					
series						description
0.5960	T10YFFM	10-Year Treasury Constant Maturity Minus Feder...				
0.5881	AAAFFM	Moody's Seasoned Aaa Corporate Bond Minus Fede...				
0.5576	BAAFFM	Moody's Seasoned Baa Corporate Bond Minus Fede...				
0.5543	T5YFFM	5-Year Treasury Constant Maturity Minus Feder...				
0.4591	TB6SMFFM	6-Month Treasury Bill Minus Federal Funds Rate				
0.4569	TB3SMFFM	3-Month Treasury Bill Minus Federal Funds Rate				
0.4137	T1YFFM	1-Year Treasury Constant Maturity Minus Feder...				
0.2385	COMPAPFF	3-Month Commercial Paper Minus FEDFUNDS				
0.2098	BUSINV	Total Business Inventories				
0.1803	M2REAL	Real M2 Money Stock				
Factor:3	Variance Explained=0.0652					
series						description
0.6899	CUSR0000SAC	Consumer Price Index for All Urban Consumers: ...				
0.6791	DNDGRG3M086SBEA	Personal consumption expenditures: Nondurable ...				
0.6448	CPIAUCSL	Consumer Price Index for All Urban Consumers: ...				
0.6157	CUSR0000SA0L5	Consumer Price Index for All Urban Consumers: ...				
0.5871	CUUR0000SA0L2	Consumer Price Index for All Urban Consumers: ...				
0.5680	PCEPI	Personal Consumption Expenditures: Chain-type ...				
0.5635	CPITRNSL	Consumer Price Index for All Urban Consumers: ...				
0.5241	CPIULFSL	Consumer Price Index for All Urban Consumers: ...				
0.4626	PPIFCG	Producer Price Index by Commodity for Finished...				
0.4539	PPIITM	Producer Price Index by Commodity Intermediate...				
Factor:4	Variance Explained=0.0543					
series						description
0.4458	GS1	Market Yield on U.S. Treasury Securities at 1-...				
0.4383	GS5	Market Yield on U.S. Treasury Securities at 5-...				
0.4236	AAA	Moody's Seasoned Aaa Corporate Bond Yield				
0.4163	TB6MS	6-Month Treasury Bill Secondary Market Rate, D...				
0.4028	GS10	Market Yield on U.S. Treasury Securities at 10...				
0.3767	BAA	Moody's Seasoned Baa Corporate Bond Yield				
0.3340	TB3MS	3-Month Treasury Bill Secondary Market Rate, D...				
0.3257	CP3M	3-Month AA Financial Commercial Paper Rates				
0.2521	HOUST	New Privately-Owned Housing Units Started: Tot...				
0.2448	HOUSTW	New Privately-Owned Housing Units Started: Tot...				
Factor:5	Variance Explained=0.0428					
series						description
0.2489	PERMITW	New Privately-Owned Housing Units Authorized i...				
0.2380	PERMIT	New Privately-Owned Housing Units Authorized i...				
0.2325	HOUSTW	New Privately-Owned Housing Units Started: Tot...				

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```

0.2199      GS5  Market Yield on U.S. Treasury Securities at 5-...
0.2193      GS1  Market Yield on U.S. Treasury Securities at 1-...
0.2155      HOUST New Privately-Owned Housing Units Started: Tot...
0.2005      GS10 Market Yield on U.S. Treasury Securities at 10...
0.1971      T1YFFM 1-Year Treasury Constant Maturity Minus Federa...
0.1963      PERMITMW New Privately-Owned Housing Units Authorized i...
0.1904      TB6MS 6-Month Treasury Bill Secondary Market Rate, D...
Factor:6 Variance Explained=0.0364
    series                               description
0.2481      IPCONGD      Industrial Production: Consumer Goods
0.1904      NAPMEI       *** NAPMEI ***
0.1831      IPDCONGD     Industrial Production: Durable Consumer Goods
0.1820      ISRATIO      Total Business: Inventories to Sales Ratio
0.1784      IPFINAL      Industrial Production: Final Products
0.1547      IPFPNSS      Industrial Production: Final Products and Noni...
0.1538      NAPMII       *** NAPMII ***
0.1526      NAPM         *** NAPM ***
0.1436      TB6SMFFM     6-Month Treasury Bill Minus Federal Funds Rate
0.1419      AWHMAN      Average Weekly Hours of Production and Nonsupe...
Factor:7 Variance Explained=0.0266
    series                               description
0.4509      TWEXMMTH     Nominal Major Currencies U.S. Dollar Index (Go...
0.2293      EXSZUS       Swiss Francs to U.S. Dollar Spot Exchange Rate
0.1660      EXUSUK       U.S. Dollars to U.K. Pound Sterling Spot Excha...
0.1656      EXJPUS       Japanese Yen to U.S. Dollar Spot Exchange Rate
0.1482      SRVPRD       All Employees, Service-Providing
0.1286      CES3000000008 Average Hourly Earnings of Production and Nons...
0.1228      CES0600000008 Average Hourly Earnings of Production and Nons...
0.1199      USTRADE      All Employees, Retail Trade
0.1042      DPCERA3M086SBEA Real personal consumption expenditures (chain-...
0.1026      UMCSENT      University of Michigan: Consumer Sentiment
Factor:8 Variance Explained=0.0259
    series                               description
0.3414      S&P 500      S&P's Common Stock Price Index: Composite
0.2753      S&P div yield S&P's Composite Common Stock: Dividend Yield
0.2028      S&P PE ratio  S&P's Composite Common Stock: Price-Earnings R...
0.1817      EXCAUS       Canadian Dollars to U.S. Dollar Spot Exchange ...
0.1222      UMCSENT      University of Michigan: Consumer Sentiment
0.1175      TWEXMMTH     Nominal Major Currencies U.S. Dollar Index (Go...
0.1042      NONBORRES    Reserves of Depository Institutions, Nonborrowed
0.0986      IPNCONGD     Industrial Production: Non-Durable Consumer Goods
0.0950      IPCONGD      Industrial Production: Consumer Goods
0.0828      AMBSL        St. Louis Adjusted Monetary Base (DISCONTINUED)
FRED-QD quarterly series:
    selected  variance explained      start      end  obs  series
factors        7          0.497416  19600331  20191231  240    247
Factor:1 Variance Explained=0.2018
    series                               description
0.8403      USPRIV       All Employees, Total Private
0.8208      USGOOD       All Employees, Goods-Producing
0.8142      PAYEMS       All Employees, Total Nonfarm
0.8122      IPMANSICS    Industrial Production: Manufacturing (SIC)
0.8109      OUTMS        Manufacturing Sector: Real Sectoral Output for...
0.8058      INDPROM       Industrial Production: Total Index
0.7781      MANEMP       All Employees, Manufacturing
0.7722      HOANBS        Nonfarm Business Sector: Hours Worked for All ...

```

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0.7693	DMANEMP	All Employees, Durable Goods
0.7661	UNRATE	Unemployment Rate
Factor:2 Variance Explained=0.0818		
	series	description
0.5122	AAAFFM	Moody's Seasoned Aaa Corporate Bond Minus Fede...
0.4907	T5YFFM	5-Year Treasury Constant Maturity Minus Federa...
0.4545	PERMIT	New Privately-Owned Housing Units Authorized i...
0.4419	BUSINV	Total Business Inventories
0.4180	HOUST	New Privately-Owned Housing Units Started: Tot...
0.4001	PERMITS	New Privately-Owned Housing Units Authorized i...
0.3814	TCU	Capacity Utilization: Total Index
0.3755	MZMREAL	Real MZM Money Stock (DISCONTINUED)
0.3733	TB3SMFFM	3-Month Treasury Bill Minus Federal Funds Rate
0.3719	GS10TB3M	*** GS10TB3M ***
Factor:3 Variance Explained=0.0730		
	series	description
0.7561	CUSR0000SA0L2	Consumer Price Index for All Urban Consumers: ...
0.7420	CUSR0000SAC	Consumer Price Index for All Urban Consumers: ...
0.7370	DGDSRG3Q086SBEA	Personal consumption expenditures: Goods (chai...
0.7165	PCECTPI	Personal Consumption Expenditures: Chain-type ...
0.7092	CPITRNSL	Consumer Price Index for All Urban Consumers: ...
0.6989	DNDGRG3Q086SBEA	Personal consumption expenditures: Nondurable ...
0.6733	CUSR0000SA0L5	Consumer Price Index for All Urban Consumers: ...
0.6636	CPIAUCSL	Consumer Price Index for All Urban Consumers: ...
0.6523	WPSID61	Producer Price Index by Commodity: Intermediat...
0.6285	PPIIDC	Producer Price Index by Commodity: Industrial ...
Factor:4 Variance Explained=0.0468		
	series	description
0.3966	IMFSL	Institutional Money Market Funds (DISCONTINUED)
0.3490	CES9093000001	All Employees, Local Government
0.3283	CES9092000001	All Employees, State Government
0.2499	USGOVT	All Employees, Government
0.2313	GFDEBTN	Federal Debt: Total Public Debt
0.2276	REVOLSL	Revolving Consumer Credit Owned and Securitized
0.2274	EXUSEU	U.S. Dollars to Euro Spot Exchange Rate
0.2194	COMPRMS	Manufacturing Sector: Real Hourly Compensation...
0.2173	USSERV	All Employees, Other Services
0.2145	NWPI	*** NWPI ***
Factor:5 Variance Explained=0.0376		
	series	description
0.3689	OPHMFG	Manufacturing Sector: Labor Productivity (Outp...
0.3003	HWI	Help Wanted Index for United States
0.2973	NWPI	*** NWPI ***
0.2960	AWHMAN	Average Weekly Hours of Production and Nonsupe...
0.2725	OPHPBS	Business Sector: Labor Productivity (Output pe...
0.2355	OPHNFB	Nonfarm Business Sector: Labor Productivity (O...
0.2347	UNRATELT	*** UNRATELT ***
0.2281	UNLPNBS	Nonfarm Business Sector: Unit Nonlabor Payment...
0.2158	ULCMFG	Manufacturing Sector: Unit Labor Costs for All...
0.1965	TLBSNNCBBDI	*** TLBSNNCBBDI ***
Factor:6 Variance Explained=0.0301		
	series	description
0.2739	ULCBS	Business Sector: Unit Labor Costs for All Workers
0.2704	ULCNFB	Nonfarm Business Sector: Unit Labor Costs for ...
0.2515	CONSPI	Nonrevolving consumer credit to Personal Income
0.2465	EXUSEU	U.S. Dollars to Euro Spot Exchange Rate

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0.2169      AHETPI  Average Hourly Earnings of Production and Nons...
0.1946      CONSUMER  Consumer Loans, All Commercial Banks
0.1775      NONREVSL  Nonrevolving Consumer Credit Owned and Securit...
0.1480      TOTALSL  Total Consumer Credit Owned and Securitized
0.1417      UMCSENT  University of Michigan: Consumer Sentiment
0.1399  B021RE1Q156NBEA  Shares of gross domestic product: Imports of g...
Factor:7 Variance Explained=0.0264
                                series                                description
0.2817  USEPUINDEXM  Economic Policy Uncertainty Index for United S...
0.2304  TNWBSHNO  Households and Nonprofit Organizations; Net Wo...
0.2199  TABSHNO  Households and Nonprofit Organizations; Total ...
0.2087  TFAABSHNO  Households and Nonprofit Organizations; Total ...
0.2081  TARESA  *** TARESA ***
0.2028  S&P 500  S&P's Common Stock Price Index: Composite
0.1928  NASDAQCOM  NASDAQ Composite Index
0.1498  GS10TB3M  *** GS10TB3M ***
0.1492  TB6M3M  *** TB6M3M ***
0.1331  PCEPILFE  Personal Consumption Expenditures Excluding Fo...

```

```

# Compute approximate factors from current FRED-MD
data, t = fred_md()      # fetch dataframe of current fred-md and transform codes
data.index = pd.to_datetime(data.index, format='%Y%m%d')
transforms = t['transform']
data = pd.concat([alf.transform(data[col], tcode=transforms[col], freq='m')
                  for col in data.columns], axis=1)

# remove outliers and impute using Bai-Ng approach
r = 8      # fix number of factors = 8
X = remove_outliers(data, method='farout')
X = approximate_factors(X, kmax=r, p=0, verbose=VERBOSE)

```

FRED-MD vintage: monthly/current.csv

Recover factors as the projections from PCA

```

# Extract factors from PCA projections on imputed data
y = StandardScaler().fit_transform(X)
pca = PCA(n_components=r).fit(y)
factors = DataFrame(pca.transform(y), index=data.index, columns=range(1, 1+r))

```

```

# Plot extracted factors
fig, axes = plt.subplots(nrows=4, ncols=2, figsize=(10, 12), sharex=True, sharey=True)
axes = axes.flatten()
for col, ax in zip(factors.columns, axes):
    flip = -np.sign(max(factors[col]) + min(factors[col])) # try match sign
    (flip*factors[col]).plot(ax=ax, color=f"C{col}")
    for a,b in vspans:
        if b >= min(factors.index):
            ax.axvspan(max(a, min(factors.index)),
                        min(b, max(factors.index)),
                        alpha=0.4,
                        color='grey')
    ax.spines["top"].set_visible(False)
    ax.spines["right"].set_visible(False)

```

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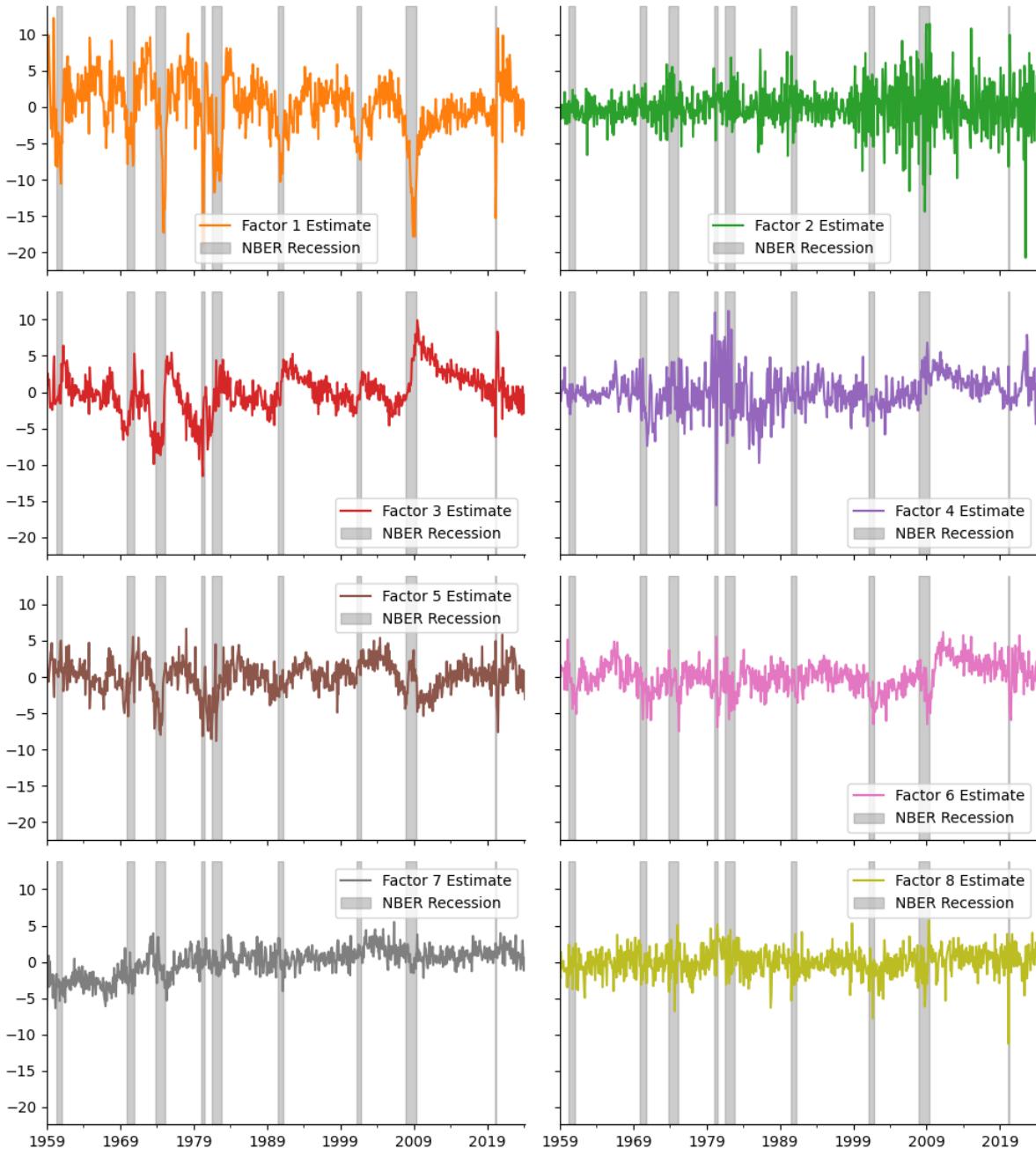
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```

    ax.legend([f"Factor {col} Estimate", 'NBER Recession'])
    plt.tight_layout(rect=[0, 0.03, 1, 0.95])
    plt.suptitle(f"Factor Estimates {factors.index[0]}:{factors.index[-1]}:")
    plt.show()

```

Factor Estimates Jan-1959:Mar-2024



STATE SPACE MODELS

If you want to understand today, you have to search yesterday - Pearl Buck

- Hidden Markov Models
 - Viterbi algorithm
- Gaussian Mixture Model

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import seaborn as sns
from hmmlearn import hmm
from sklearn.preprocessing import StandardScaler
from sklearn.mixture import GaussianMixture
from finds.readers import fred_qd, fred_md, Alfred
from finds.recipes import approximate_factors, remove_outliers
from secret import paths, credentials
VERBOSE = 0
# %matplotlib qt
```

```
# Load and pre-process time series from FRED
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
vspan = alf.date_spans('USREC') # to indicate recession periods in the plots
```

```
# FRED-MD
freq = 'M'
df, t = fred_md() if freq == 'M' else fred_qd()
transforms = t['transform']
data = pd.concat([alf.transform(df[col], tcode=transforms[col], freq=freq)
                  for col in df.columns],
                  axis=1)\n    .iloc[1:] # apply transforms and drop first row
cols = list(data.columns)

# remove outliers and impute using Bai-Ng approach
r = 8 # fix number of factors = 8
data = remove_outliers(data)
data = approximate_factors(data, kmax=r, p=0, verbose=VERBOSE)
```

```
FRED-MD vintage: monthly/current.csv
```

```
# standardize inputs
X = StandardScaler().fit_transform(data.values)
```

12.1 Hidden Markov Model

In HMM, a multivariate time series is modeled by a system of unobserved (hidden) states that follow a Markov process. There are **transition probabilities** associated with going from one state to another, or back to itself, represented by a transition matrix A . To move from one state to another, we are given information about the previous state and the current **observation** X : an observation is associated with an **emission probability** for each state θ . Finally we may have prior knowledge of the initial state of the system, that represented by a probability vector π . Hence a HMM model is defined by the parameters $\lambda = (A, \theta, \pi)$; we observe a sequence of values X , which are generated by unobserved state sequence Z .

We use the Python package `hmmlearn` to solve the three fundamental tasks:

- Evaluation refers to computing the likelihood of a particular observation, given a model, i.e. what is $P(X|\lambda)$. This problem is solved by the Foward-Backward algorithm, with its `score` method
- Decoding seeks to predict the sequence of hidden states in Z from the sequence of observations X , and is solved by a dynamic programming algorithm known as Viterbi algorithm, with the `predict` method.
- Training to learn the model parameters $\lambda = (A, \theta, \pi)$ by maximizing the likelihood, is solved by the Baum-Welch algorithm, a special instance of the Expectation-Maximization (EM) algorithm, with the `fit` method

Its `GaussianHMM` model assumes a Gaussian distribution for emissions, where `covariance_type` may be, in increasing order of the number of parameters to be estimated:

- “spherical”: each state uses a single variance value that applies to all features
- “diag”: each state uses a diagonal covariance matrix.
- “tied”: all states use the same full covariance matrix.
- “full”: each state uses a full (unrestricted) covariance matrix.

An information criterion such as `bic` can be used to select the best model balancing the goodness of fit and the number of parameters.

```
def hmm_summary(markov, X, lengths, matrix=False):
    """Helper to return summary statistics from fitting Hidden Markov Model

    Args:
        markov: Fitted GaussianHMM
        X: Input data of shape (nsamples, nfeatures)
        lengths: Lengths of the individual sequences in X, sum is nsamples
        matrix: Whether to return the transition and stationary matrices

    Returns:
        Dictionary of results in {'aic', 'bic', 'parameters', 'NLL'}
    """
    logL = markov.score(X, lengths)
    T = np.sum(lengths) # n_samples
    n = markov.n_features # number of features ~ dim of covariance matrix
    m = markov.n_components # number of states
    k = dict(diag=m*n, # parms in mean and cov matrix
             full=m*n*(n-1)/2,
             tied=n*(n-1)/2,
```

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```

    spherical=m) [markov.covariance_type] + markov.n_features
p = m**2 + (k * m) - 1 # number of independent parameters of the model

results = {'aic': -2 * logL + (2 * p),
           'bic': -2 * logL + (p * np.log(T)),
           'parameters': p,
           'NLL' : -logL}
if matrix: # whether to return the transition and stationary matrix
    matrix = DataFrame(markov.transmat_) \
        .rename_axis(columns='Transition Matrix:')
    matrix['Stationary'] = markov.get_stationary_distribution()
    results.update({'matrix': matrix}) # return matrix as DataFrame
return results

```

```

# Compare covariance types in Gaussian HMM models
out = []
for covariance_type in ["full", "diag", "tied", "spherical"]:
    for n_components in range(1, 8):
        if VERBOSE:
            print('=====', covariance_type, n_components, '=====')
        markov = hmm.GaussianHMM(n_components=n_components,
                                  covariance_type=covariance_type,
                                  verbose=VERBOSE,
                                  tol=1e-6,
                                  random_state=42,
                                  n_iter=500) \
            .fit(X, [X.shape[0]])
        result = hmm_summary(markov, data, [X.shape[0]])
        #print(n_components, Series(results, name=covariance_type).to_frame().T)
        result.update({'cov_type': covariance_type,
                       'n_components': n_components})
        out.append(Series(result))
results = pd.concat(out, axis=1).T.convert_dtypes()

```

```

Model is not converging. Current: -53166.15571297737 is not greater than -53166.
-155712466214. Delta is -5.111578502692282e-07
Model is not converging. Current: -6163.604416561489 is not greater than -6163.
-6044165126905. Delta is -4.8798938223626465e-08
Model is not converging. Current: 33662.62951552664 is not greater than 34171.
-8083827127. Delta is -509.17886718605587
Model is not converging. Current: 38239.33317549184 is not greater than 39427.
-428995004455. Delta is -1188.095819512615
Model is not converging. Current: -128529.4491603166 is not greater than -128529.
-44915884043. Delta is -1.4761608326807618e-06
Model is not converging. Current: -123452.93136393784 is not greater than -123452.
-93136010495. Delta is -3.8328871596604586e-06
Model is not converging. Current: -120079.61301174758 is not greater than -120079.
-61300834864. Delta is -3.398949047550559e-06
Model is not converging. Current: -130787.20497186083 is not greater than -130787.
-2049689297. Delta is -2.9311340767890215e-06
Model is not converging. Current: -125163.69776382159 is not greater than -125163.
-69776326745. Delta is -5.541369318962097e-07
Model is not converging. Current: -124252.97721651862 is not greater than -124252.
-97721368226. Delta is -2.836357452906668e-06

```

```
# Show best bic's
best_bic = []
for covariance_type in ["full", "diag", "tied", "spherical"]:
    result = results[results['cov_type'] == covariance_type]
    argmin = np.argmin(result['bic'])
    best_bic.append(result.iloc[argmin])
best_bic = pd.concat(best_bic, axis=0)
best_type = best_bic.iloc[np.argmin(best_bic['bic'])]['cov_type']
print(f"HMM best bic type: {best_type}")
best_bic.round(0)
```

HMM best bic type: spherical

	aic	bic	parameters	NLL	cov_type	n_components
0	197612200.0	197649489.0	8001	98798099.0	full	1
12	11467703.0	11492530.0	5327	5728524.0	diag	6
14	197612200.0	197649489.0	8001	98798099.0	tied	1
24	7466415.0	7468909.0	535	3732673.0	spherical	4

```
# fit model with best_bic
n_components = best_bic[best_bic['cov_type'] == best_type]['n_components']
n_components = int(n_components.iloc[0])
markov = hmm.GaussianHMM(n_components=n_components, covariance_type=best_type,
                         verbose=False, tol=1e-6, random_state=0, n_iter=100) \
    .fit(X, [X.shape[0]])
pred_markov = Series(markov.predict(X),
                      name='state',
                      index=pd.to_datetime(data.index, format="%Y%m%d"))
matrix = hmm_summary(markov, X, [X.shape[0]], matrix=True)['matrix']
```

12.1.1 Markov Chains

- geometric run
- irreducibility

```
# Compute average change in INDPRO by state
df = alf('INDPRO', freq=freq, log=1, diff=1)
df.index = pd.DatetimeIndex(df.index.astype(str), freq='infer')
indpro = pd.concat([df, pred_markov], join='inner', axis=1).groupby('state').mean(
    ↴ 'INDPRO')

# and HMM transition and stationary probabilities
print("HMM states and average INDPRO")
matrix.join(indpro).round(4)
```

HMM states and average INDPRO

	0	1	2	3	Stationary	INDPRO
0	0.6158	0.0000	0.0000	0.3842	0.0442	-0.0076
1	0.0059	0.8874	0.0196	0.0870	0.2185	0.0010

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2	0.0000	0.0081	0.8655	0.1264	0.4647	0.0049
3	0.0576	0.0765	0.2136	0.6523	0.2726	-0.0007

Plot predicted states

```
def plot_states(modelname, labels, num=1, series_id='INDPRO', freq='M'):
    """helper to plot predicted states 'IPMANSICS'"""

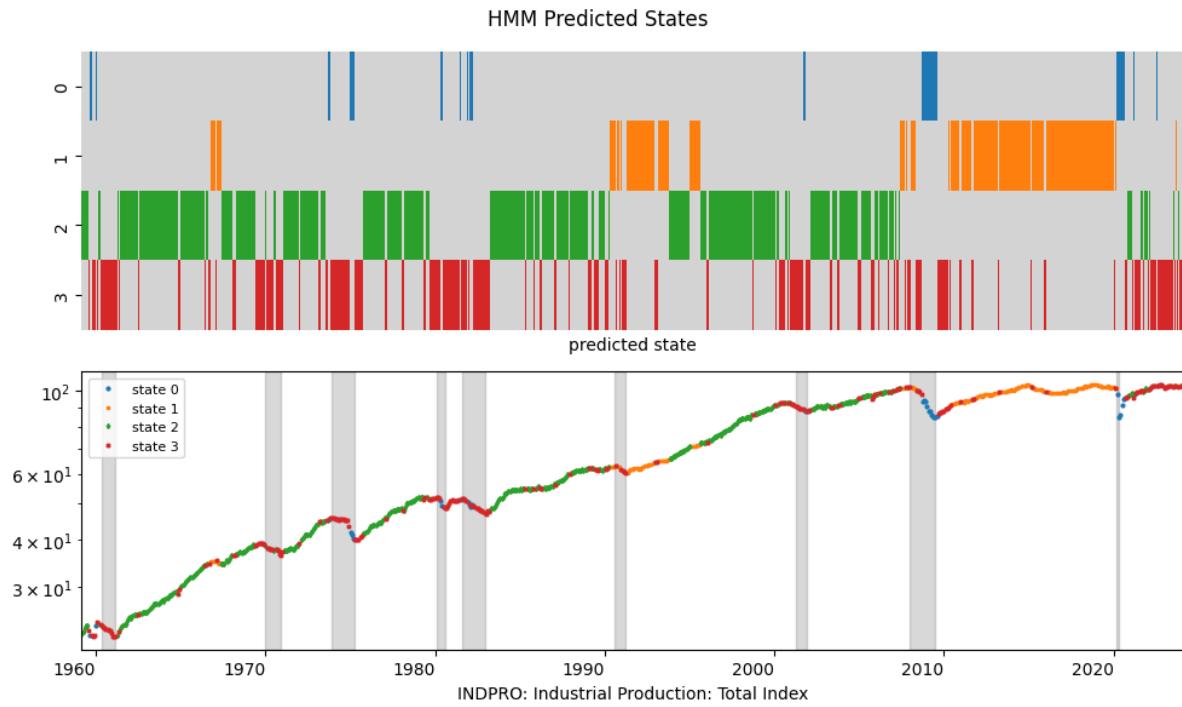
    # n_components markers
    n_components = len(np.unique(labels))
    markers = ["o", "s", "d", "X", "P", "8", "H", "*", "x", "+"][:n_components]

    fig, (bx, ax) = plt.subplots(nrows=2, ncols=1, figsize=(10, 6))
    fig.suptitle(f"{modelname.upper()} Predicted States")

    # plot series, with states colored
    df = alf(series_id, freq=freq)
    df.index = pd.DatetimeIndex(df.index.astype(str), freq='infer')
    df = df[(df.index >= min(labels.index)) & (df.index <= max(labels.index))]
    for i, marker in zip(range(n_components), markers):
        df.loc[labels == i].plot(ax=ax, style=marker, markersize=2, color=f"C{i}", ↵
        rot=0)
    ax.set_xlabel(f"{series_id}: {alf.header(series_id)}")
    ax.set_xlim(left=min(df.index), right=max(df.index))
    for a,b in vspans:  # shade economic recession periods
        if (b > min(df.index)) & (a < max(df.index)):
            ax.axvspan(max(a, min(df.index)), min(b, max(df.index)),
                        alpha=0.3, color='grey')
    ax.legend([f"state {i}" for i in range(n_components)], fontsize=8)
    ax.set_yscale('log')

    s = np.zeros((n_components, len(labels)))
    for i, j in enumerate(labels.values.flatten()):
        s[j][i] = j + 1
    sns.heatmap(s, vmin=0, vmax=n_components, ax=bx, cbar=False, xticklabels=False,
                cmap=["lightgrey"] + [f"C{i}" for i in range(n_components)])
    bx.set_xlabel('predicted state')
    plt.tight_layout()
```

```
plot_states('HMM', pred_markov, num=1, freq=freq)
```

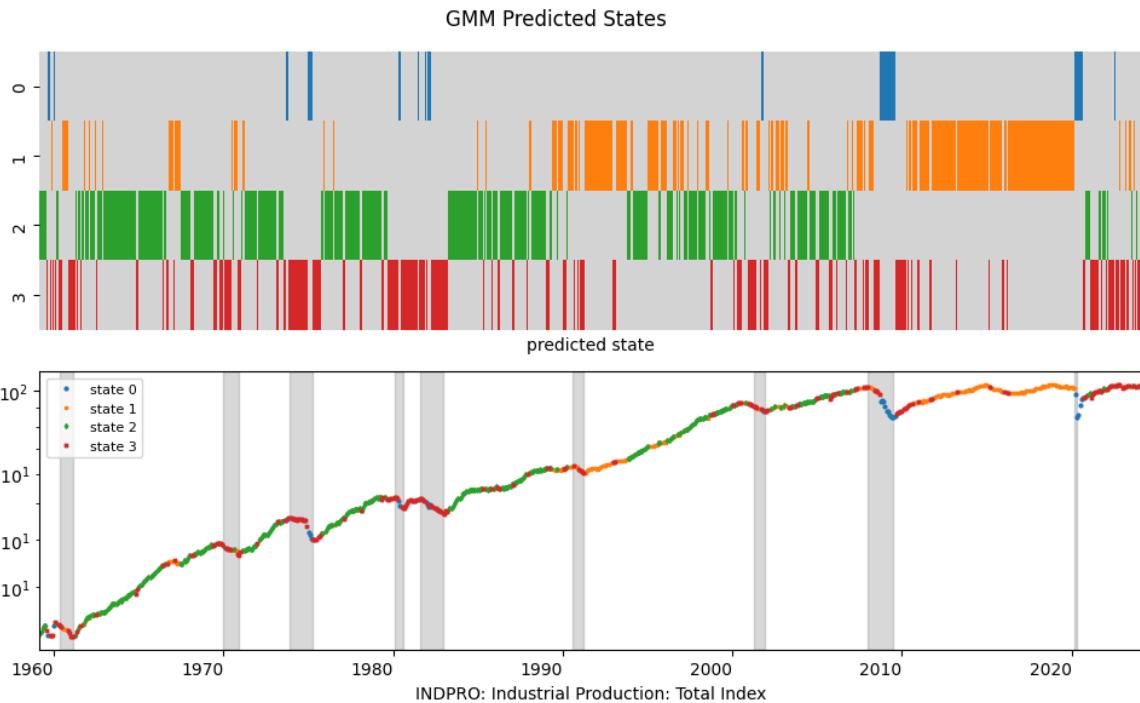


12.2 Gaussian Mixture Model

```

gmm = GaussianMixture(n_components=n_components,
                      random_state=0,
                      covariance_type='best_type').fit(X)
pred_gmm = Series(gmm.predict(X),
                  name='state',
                  index=pd.to_datetime(data.index, format="%Y%m%d"))
plot_states('GMM', pred_gmm, num=2, freq=freq)

```



```
# Compare persistance of HMM and GMM
dist = DataFrame({
    'Hidden Markov': ([np.mean(pred_markov[:-1].values == pred_markov[1:]).values]
                      + matrix.iloc[:, -1].tolist()),
    'Gaussian Mixture': ([np.mean(pred_gmm[:-1].values == pred_gmm[1:]).values]
                          + (pred_gmm.value_counts().sort_index() / len(pred_gmm)).tolist()),
    index=[['Average persistance of states']
           + [f'Stationary prob of state {s}' for s in range(n_components)]]
})
print("Compare HMM with GMM:")
dist
```

Compare HMM with GMM:

	Hidden Markov	Gaussian Mixture
Average persistance of states	0.800000	0.719231
Stationary prob of state 0	0.044240	0.042254
Stationary prob of state 1	0.218489	0.297055
Stationary prob of state 2	0.464711	0.408451
Stationary prob of state 3	0.272560	0.252241

```
# Visualize HMM transitions and states
from sklearn.preprocessing import minmax_scale
colors = minmax_scale(indpro).flatten()

import graphviz
def fillcolor(r, g, b):
    def scale(x):
        return int((1 - x) * 256 * .5 + 64)
```

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```
return f"#{scale(r):02x}{scale(g):02x}{scale(b):02x}"
```

```
dot = graphviz.Digraph(engine='circo', graph_attr={'splines': 'true'})
for i in range(len(matrix)): # Add nodes
    dot.node(name=str(i), label=f"#{matrix.iloc[i, i]:.03f}",
              style='filled', fillcolor=fillcolor(0, colors[i], colors[i]))
for i in range(len(matrix)): # Add edges
    for j in range(len(matrix)):
        if i != j:
            dot.edge(tail_name=str(i), head_name=str(j),
                      label=f"#{matrix.iloc[i, j]:.03f}", color='red')
```

```
dot
# dot.format = 'png'
# dot.view(filename='digraph') # Visualize the graph
```

```
<graphviz.graphs.Digraph at 0x7f97d2c7a3d0>
```

CHAPTER
THIRTEEN

TERM STRUCTURE OF INTEREST RATES

The best thing about the future is that it comes one day at a time - Abraham Lincoln

Concepts

- Interest Rates
- Yield curve
- Splines
- Bootstrapping
- PCA and SVD

References

- FRM Part 1 Exam Book Valuation and Risk Models, Chapter 12-13
- Yan Liu and Jing Cynthia Wu “Reconstructing the Yield Curve”, Journal of Financial Economics, 2021, 142 (3), 1395-1425.
- <https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics/treasury-yield-curve-methodology>

```
import re
from typing import List, Dict
from datetime import datetime
import numpy as np
import numpy.linalg as la
from scipy.interpolate import CubicSpline
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from sklearn.preprocessing import StandardScaler
from sklearn.pipeline import Pipeline
from sklearn.decomposition import PCA
from finds.readers import Alfred
from secret import credentials, paths
VERBOSE = 0
# %matplotlib qt
```

```
alf = Alfred(api_key=credentials['fred']['api_key'], convert_date=0, verbose=VERBOSE)
```

13.1 Interest Rates

The compounding frequency used for an interest rate defines the unit of measurement. If an interest rate is measured with annual compounding, the quoted interest rate is assumed to be compounded once a year; if measured with semi-annual compounding, it is assumed to be compounded twice a year; and so on. To convert a rate expressed with compounding frequency m times per year to an equivalent continuously-compounded rate, we equate the values at the end of a year:

$$e^{rt} = \left(1 + \frac{R_m}{m}\right)^{mt}$$

The annualized percentage yield (**APY**), or annualized effective yield, includes the effects of compounding. To convert a simple yield to an APY you need to apply the standard financial formula: $APY = (1 + R_m/m)^m - 1$, where m is the stated number of compounding periods per year for the quoted rate.

The **spot rate** for a certain maturity is the zero-coupon interest rate for that maturity. It is also referred to as the zero-coupon interest rate, or just the “zero.” It is directly related to the discount factor for that maturity: Discount factor $= (1 + \frac{R_m}{m})^{-t}$

The **forward rate** for a future period is the spot rate for that period implicit in the spot rates observed in the market today. Current longer-term spot rates can be calculated by compounding forward rates.

A bond's **yield to maturity** is the single spot rate, which if applied to all the bond's cash flows, would make the cash flows' present value equal to the bond's market price.

The **par rate** is the coupon rate on a bond that causes the bond price to equal par. A bond that is issued at par has a yield to maturity that is equal to the coupon rate.

The **term structure** of interest rates is the relationship between interest rates or bond yields and different terms or maturities. When graphed, the term structure of interest rates is known as a **yield curve**. When the term structure is upward-sloping, the forward rate for a period beginning at time T is greater than the T -year spot rate which in turn is greater than the T -year par rate. When the term structure is downward-sloping, the forward rate for a period beginning at time T is less than the T -year spot rate, which in turn is less than the T -year par rate.

Swap rates are the fixed rates exchanged for floating rates in a swap agreement. Swap rates are par rates.

```
# retrieve Constant Maturity Treasuries, excluding inflation-indexed and discontinued
cat = alf.get_category(115)  # Fed H.15 Selected Interest Rates
print('Retrieved category:', cat['id'], cat['name'])
```

Retrieved category: 115 Treasury Constant Maturity

```
treas = DataFrame.from_dict(
    {s['id']: [s['observation_start'], s['frequency'], s['title'].split(',')][0][44:]] 
        for s in cat['series'] if 'Inflation' not in s['title'] and 
        'DISCONT' not in s['title'] and s['frequency'] in ['Daily', 'Monthly']},
    columns = ['start', 'freq', 'title'],
    orient='index').sort_values(['freq', 'start'])
print("Constant Maturity Treasuries in FRED")
pd.set_option('display.max_colwidth', None)
treas
```

Constant Maturity Treasuries in FRED

	start	freq	title
DGS1	1962-01-02	Daily	1-Year Constant Maturity

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DGS10	1962-01-02	Daily	10-Year Constant Maturity
DGS20	1962-01-02	Daily	20-Year Constant Maturity
DGS3	1962-01-02	Daily	3-Year Constant Maturity
DGS5	1962-01-02	Daily	5-Year Constant Maturity
DGS7	1969-07-01	Daily	7-Year Constant Maturity
DGS2	1976-06-01	Daily	2-Year Constant Maturity
DGS30	1977-02-15	Daily	30-Year Constant Maturity
DGS3MO	1981-09-01	Daily	3-Month Constant Maturity
DGS6MO	1981-09-01	Daily	6-Month Constant Maturity
DGS1MO	2001-07-31	Daily	1-Month Constant Maturity
GS1	1953-04-01	Monthly	1-Year Constant Maturity
GS10	1953-04-01	Monthly	10-Year Constant Maturity
GS20	1953-04-01	Monthly	20-Year Constant Maturity
GS3	1953-04-01	Monthly	3-Year Constant Maturity
GS5	1953-04-01	Monthly	5-Year Constant Maturity
GS7	1969-07-01	Monthly	7-Year Constant Maturity
GS2	1976-06-01	Monthly	2-Year Constant Maturity
GS30	1977-02-01	Monthly	30-Year Constant Maturity
GS3M	1981-09-01	Monthly	3-Month Constant Maturity
GS6M	1981-09-01	Monthly	6-Month Constant Maturity
GS1M	2001-07-01	Monthly	1-Month Constant Maturity

```
# infer maturity from label
daily = pd.concat([alf(s, freq='D')
                   for s in treas.index if treas.loc[s, 'freq']=='Daily'],
                   axis=1, join='outer')
daily.columns = [int(re.sub('\D', '', col)) * (1 if col[-1].isalpha() else 12) # MO or M
                 for col in daily.columns] # infer maturity in months from label
daily = daily.rename_axis(columns='maturity').sort_index(axis=1)
daily
```

maturity	1	3	6	12	24	36	60	84	120	240	360
date											
1962-01-02	NaN	NaN	NaN	3.22	NaN	3.70	3.88	NaN	4.06	4.07	NaN
1962-01-03	NaN	NaN	NaN	3.24	NaN	3.70	3.87	NaN	4.03	4.07	NaN
1962-01-04	NaN	NaN	NaN	3.24	NaN	3.69	3.86	NaN	3.99	4.06	NaN
1962-01-05	NaN	NaN	NaN	3.26	NaN	3.71	3.89	NaN	4.02	4.07	NaN
1962-01-08	NaN	NaN	NaN	3.31	NaN	3.71	3.91	NaN	4.03	4.08	NaN
...
2024-04-05	5.47	5.43	5.34	5.05	4.73	4.54	4.38	4.39	4.39	4.65	4.54
2024-04-08	5.48	5.43	5.35	5.07	4.78	4.60	4.43	4.43	4.42	4.65	4.55
2024-04-09	5.48	5.43	5.34	5.03	4.74	4.52	4.37	4.38	4.36	4.60	4.50
2024-04-10	5.49	5.45	5.40	5.19	4.97	4.77	4.61	4.59	4.55	4.76	4.64
2024-04-11	5.48	5.45	5.38	5.17	4.93	4.77	4.61	4.60	4.56	4.77	4.65

[15555 rows x 11 columns]

```
monthly = pd.concat([alf(s, freq='M')
                      for s in treas.index if treas.loc[s, 'freq']=='Monthly'],
                      axis=1, join='outer')
monthly.columns = [int(re.sub('\D', '', col)) * (1 if col[-1].isalpha() else 12) # MO or M
                   for col in monthly.columns] # infer maturity in months from label
```

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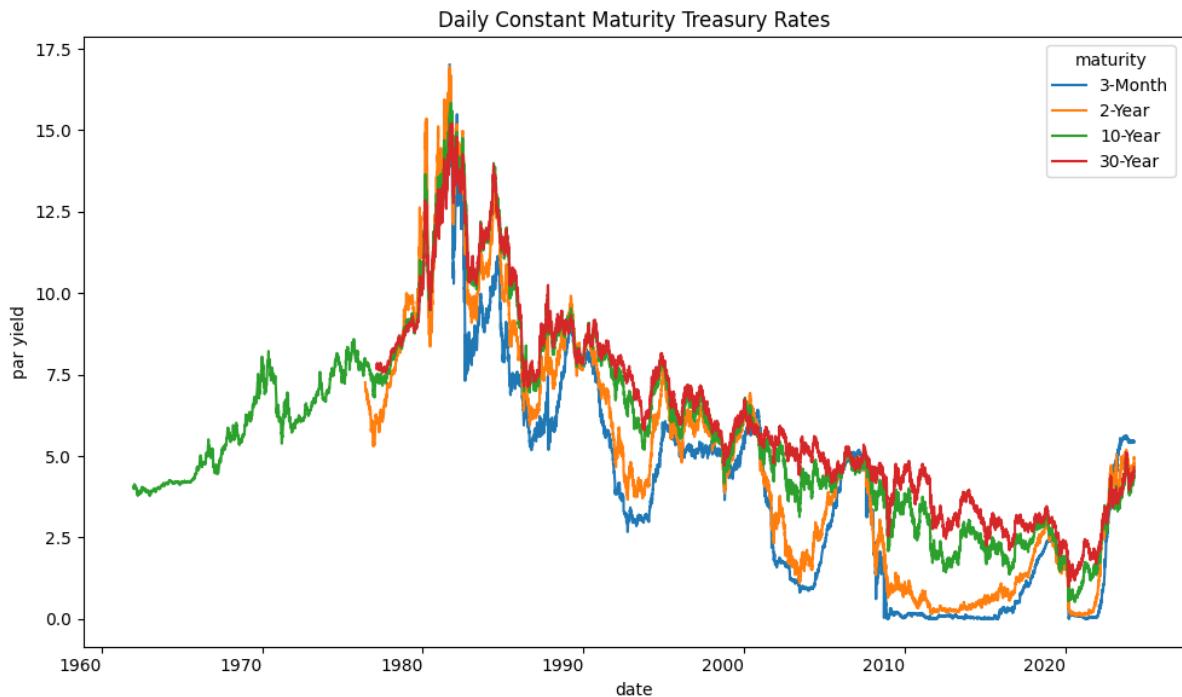
```
monthly = monthly.rename_axis(columns='maturity').sort_index(axis=1)
monthly
```

maturity	1	3	6	12	24	36	60	84	120	240	360
date											
1953-04-30	NaN	NaN	NaN	2.36	NaN	2.51	2.62	NaN	2.83	3.08	NaN
1953-05-31	NaN	NaN	NaN	2.48	NaN	2.72	2.87	NaN	3.05	3.18	NaN
1953-06-30	NaN	NaN	NaN	2.45	NaN	2.74	2.94	NaN	3.11	3.21	NaN
1953-07-31	NaN	NaN	NaN	2.38	NaN	2.62	2.75	NaN	2.93	3.12	NaN
1953-08-31	NaN	NaN	NaN	2.28	NaN	2.58	2.80	NaN	2.95	3.10	NaN
...
2023-11-30	5.53	5.52	5.44	5.28	4.88	4.64	4.49	4.53	4.50	4.84	4.66
2023-12-31	5.54	5.44	5.34	4.96	4.46	4.19	4.00	4.04	4.02	4.32	4.14
2024-01-31	5.54	5.45	5.21	4.79	4.32	4.11	3.98	4.03	4.06	4.39	4.26
2024-02-29	5.49	5.44	5.28	4.92	4.54	4.33	4.19	4.21	4.21	4.49	4.38
2024-03-31	5.51	5.47	5.36	4.99	4.59	4.38	4.20	4.21	4.21	4.46	4.36

[852 rows x 11 columns]

```
# mapper to display maturity months as labels
mapper = lambda month: f"{month}-Month" if month < 12 else f"{int(month/12)}-Year"
```

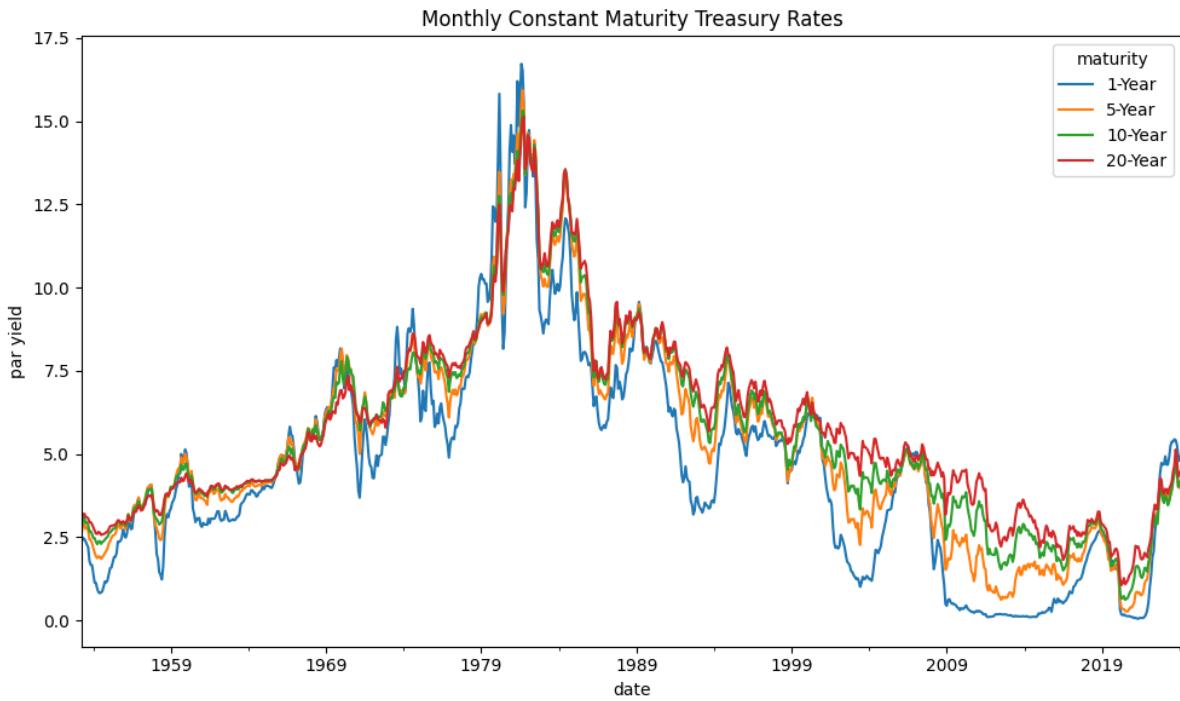
```
cols = [3, 24, 120, 360]
fig, ax = plt.subplots(figsize=(10, 6))
daily[cols].rename(columns=mapper).plot(ax=ax, rot=0)
plt.title('Daily Constant Maturity Treasury Rates')
plt.ylabel('par yield')
plt.tight_layout()
```



```

cols = [12, 60, 120, 240]
fig, ax = plt.subplots(figsize=(10, 6))
monthly[cols].rename(columns=mapper).plot(ax=ax, rot=0)
plt.title('Monthly Constant Maturity Treasury Rates')
plt.ylabel('par yield')
plt.tight_layout()

```



13.2 Yield Curve

The Treasury's official yield curve is a par yield curve derived using a monotone convex method. The inputs are indicative, bid-side market price quotations (not actual transactions) for the most recently auctioned securities obtained by the Federal Reserve Bank of New York at or near 3:30 PM each trading day.

Historically, Treasury has used a quasi-cubic hermite spline (HS) method for yield curve construction. The HS method directly uses secondary market yields as inputs to create a yield curve that is assumed to be a par curve. The monotone convex method for deriving the official Treasury yield curve replaced the previous quasi-cubic hermite spline method as of December 6, 2021.

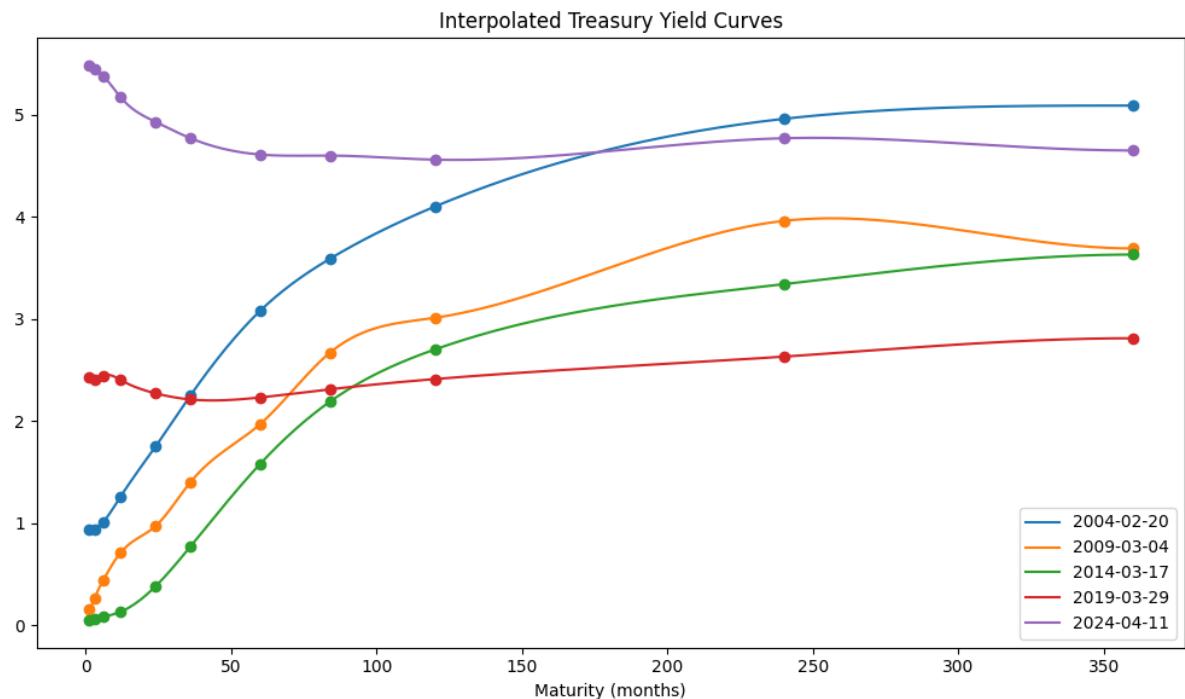
CMT yields are read directly from the Treasury's daily par yield curve and represent "bond equivalent yields" for securities that pay semiannual interest, which are expressed on a simple annualized basis. These yields are not effective annualized yields or Annualized Percentage Yields (APY), which include the effect of compounding. To convert a CMT yield to an APY you need to apply the standard financial formula: $APY = (1 + y/2)^2 - 1$

13.2.1 Splines

Interpolate yields at other maturities with a piecewise cubic polynomial which is twice continuously differentiable

```
yield_curve = dict()
curve_dates = sorted(daily.dropna().index[-1:0:-(5*252)])
for date in curve_dates:
    yield_curve[date] = CubicSpline(
        x=daily.columns.to_list(), y=daily.loc[date].values, bc_type='clamped')
```

```
# Plot historical yield curves
fig, ax = plt.subplots(figsize=(10, 6))
X = list(range(1, 361))
for col, (date, curve) in enumerate(yield_curve.items()):
    ax.plot(X, curve(X), label=date.strftime('%Y-%m-%d'), color=f'C{col}')
plt.legend()
for col, (date, curve) in enumerate(yield_curve.items()):
    daily.loc[date].plot(ax=ax, marker='o', ls='', color=f'C{col}', label=None)
plt.title('Interpolated Treasury Yield Curves')
plt.xlabel('Maturity (months)')
plt.tight_layout()
```



13.3 Bootstrap

This is the process of backing out spot rates by working forward and fitting zero-coupon rates to progressively longer maturity instruments

```
# To bootstrap 6-month spot rates from 6-month par yields
m = 2      # compounding periods per year

# list of 6-monthly maturities
maturities = list(range(int(12/m), daily.columns[-1]+1, int(12/m)))

# Helper to bootstrap spot rates from par yield curve
def bootstrap_spot(coupon: float, spots: List[float], m: int, price: float=1) -> float:
    """Compute spot rate to maturity of par bond from yield and sequence of spots

    Args:
        coupon : Annual coupon rate
        spots : Simple annual spot rates each period (excluding last period before maturity)
        m : Number of compounding periods per year
        price: Present value of bond

    Returns:
        Simple spot interest rate till maturity
    """
    if not spots:          # trivial one-period bond
        return coupon / price
    n = len(spots) + 1      # number of coupons through maturity

    # discount factors from given spot rates
    discount = [(1 + spot/m)**(-(1+t)) for t, spot in enumerate(spots)]

    # nominal amount of last payment
    last_payment = 1 + coupon/m

    # infer present value of last coupon and principal
    last_pv = price - np.sum(discount) * coupon/m

    # compute discount factor and annualize the effective rate
    spot = ((last_payment/last_pv)**(1/n) - 1) * m
    return spot

# select most recent yield curve
curve_date = curve_dates[-1]
yields = [yield_curve[curve_date](t) / 100 for t in maturities]
spots = []
for coupon in yields:
    spots.append(bootstrap_spot(coupon=coupon, spots=spots, m=m))
DataFrame({curve_date.strftime('%Y-%m-%d'): spots}, index=maturities).head()
```

	2024-0411
6	0.053800
12	0.051673

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```
18 0.050150
24 0.049225
30 0.048370
```

Helper to compute bond prices

```
def bond_price(coupon: float, n: int, m: int, yields: float | List[float],
               par: float = 1) -> float:
    """Compute present value of bond given spot rates or yield-to-maturity

    Args:
        coupon : Annual coupon rate
        n : Number of remaining coupons
        m : Number of compounding periods per year
        yields : Simple annual yield-to-maturity or spot rates each period
        par : face or par value of bond

    Returns:
        Present value of bond
    """
    if not pd.api.types.is_list_like(yields):
        yields = [yields] * n           # same yield-to-maturity is spot rate every_
    assert len(yields) == n, "Number of yields must equal number of coupons"
    pv = [(1 + yields[t-1]/m)**(-t) * (coupon/m + (par if t == n else 0))]
    for t in range(1, n+1)]       # discount every period's payment, plus last face
    return np.sum(pv)
```

```
# Sanity-check par bond price given spots
for t in range(len(yields)):
    price = bond_price(coupon=yields[t], n=t+1, m=2, yields=spots[:t+1])
    assert np.allclose(price, 1.0)  # discounted payments at spot rates must equal_
    price
```

```
# Compute forward rates from spot rates
def forwards_from_spots(spots: List[float], m: int, skip: int=0) -> List[float]:
    """Compute forward rates given spot rates

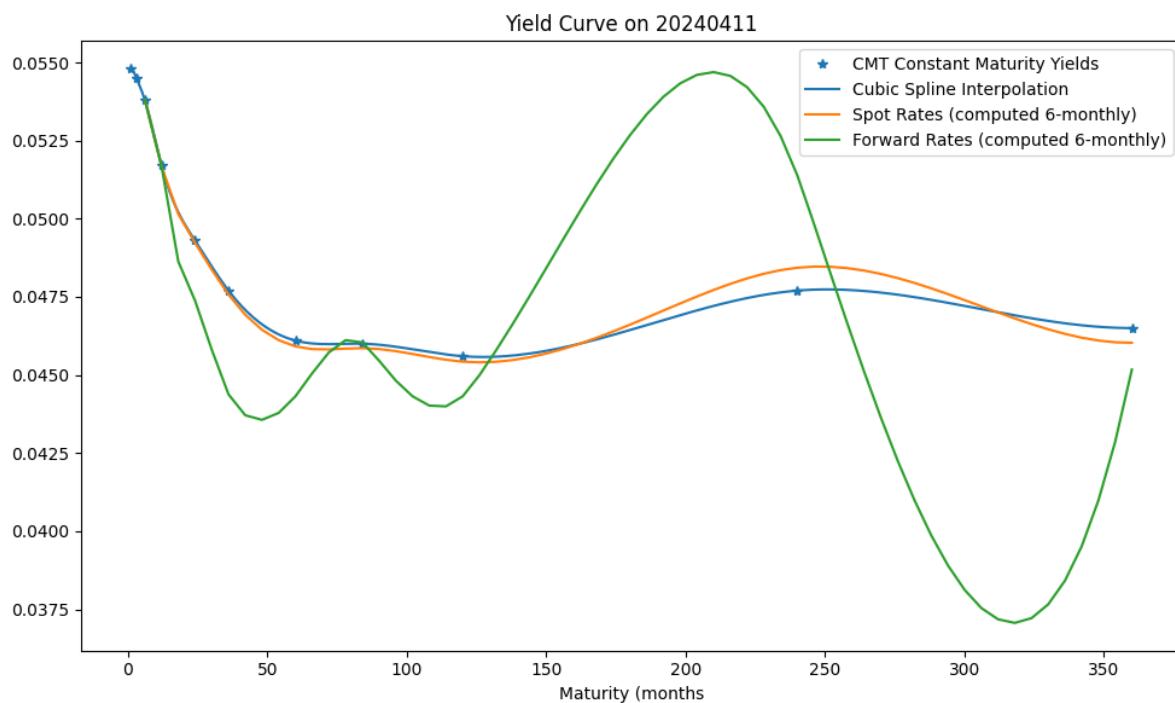
    Args:
        spots : Sequence of simple annual spot rates
        m : Number of compounding periods per year
        skip: Number of initial periods skipped

    Returns:
        List of forward rates, excluding first period of spot rates input
    """
    result = []
    assert len(spots) >= 2, "Require at least two spot rates as input"
    for t in range(1, len(spots)):
        n = skip + t
        numerator = (1 + spots[n]/m)**n           # discounted value of period n
        denominator = (1 + spots[n-1]/m)**(n-1)    # discounter value of period n-1
        result.append((numerator / denominator) - 1) * m
    return result
```

```
forwards = [spots[0]] + forwards_from_spots(spots=spots, m=m)
```

Plot current yield curve

```
fig, ax = plt.subplots(figsize=(10, 6))
(daily.loc[curve_date] / 100).plot(marker='*', ls='', color="C0")
X = range(1, maturities[-1]+1)
ax.plot(X, [yield_curve[curve_date](t) / 100 for t in X], marker='', ls='-', color="C0")
ax.plot(maturities, spots, marker='', ls='-', color="C1")
ax.plot(maturities, forwards, marker='', ls='-', color="C2")
plt.legend(['CMT Constant Maturity Yields', 'Cubic Spline Interpolation',
           'Spot Rates (computed 6-monthly)', 'Forward Rates (computed 6-monthly)'])
plt.title(f"Yield Curve on {curve_date.strftime('%Y%m%d')}")
plt.xlabel('Maturity (months)')
plt.tight_layout()
```



There are more sophisticated methods for fitting yield curves to treasuries prices

```
# Download reconstructed yield curve data by Liu and Wu (2021)
# file_id from https://sites.google.com/view/jingcynthiawu/yield-data
file_id = '15uGZet8bS5rEHy9nbGmgCHXyMGUSoHx3' # monthly
#file_id = '15o5ahwIs-Pbaq79H4Sm0LUHGAEbCFXMs' # daily
src = "https://drive.google.com/uc?export=download&id={}".format(file_id) # to load
# from gdrive
df = pd.ExcelFile(src).parse()
dates = np.where(df.iloc[:, 0].astype(str).str[0].str.isdigit())[0] # locate first
# date cell
```

```
liuwu = DataFrame(np.exp(df.iloc[dates, 1:361].astype(float).values/100) - 1,
                  index=(pd.to_datetime(df.iloc[dates, 0], format="%Y%m")))
```

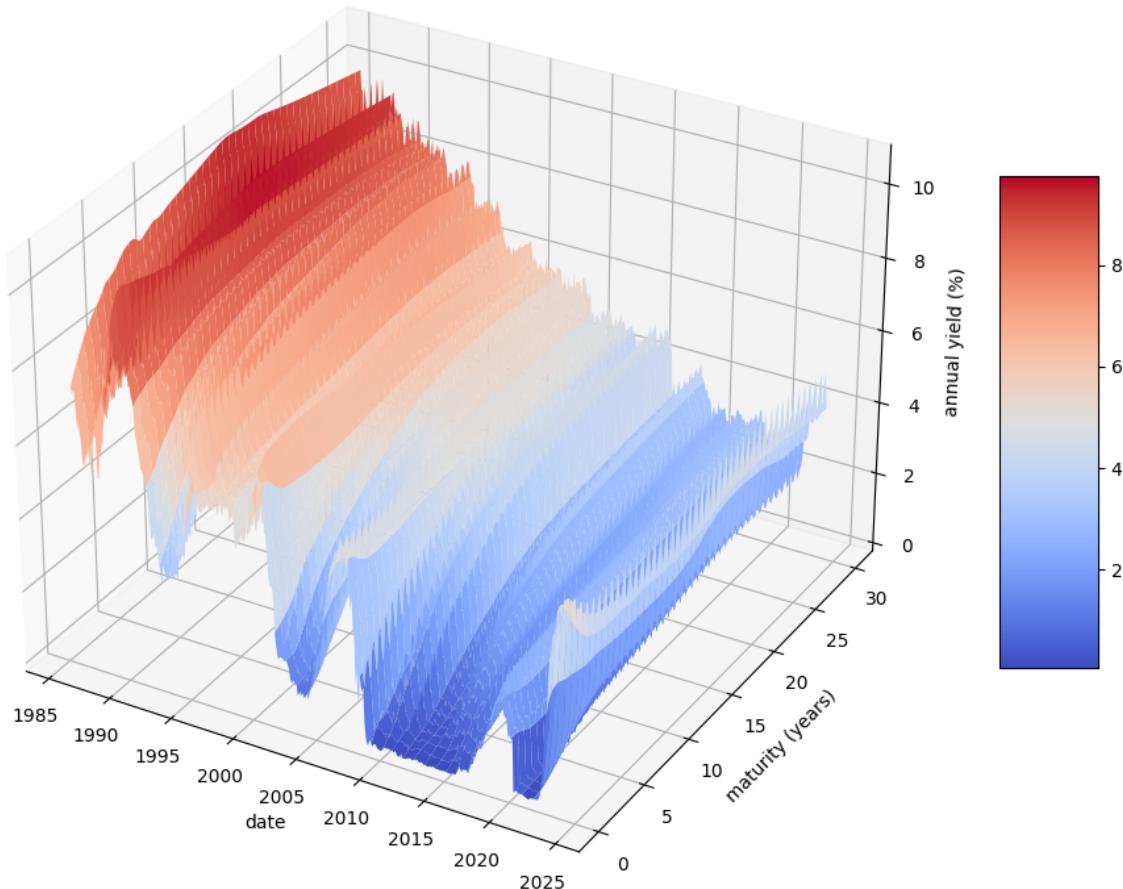
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```
+ pd.offsets.MonthEnd(1)),
columns=np.arange(1, 361))
```

```
# Plot historical reconstructed rates as 3D surface
from mpl_toolkits.mplot3d import Axes3D
r = liuwu.dropna()
X, Y = np.meshgrid(r.index.map(lambda x: float(str(x) [:4]) + float(str(x) [5:7])/12),
r.columns.astype(float)/12)
#X, Y = np.meshgrid((r.index//10000) + (((r.index//100)%100)-1)/12,
#r.columns.astype(float)/12)
Z = r.T.to_numpy()*100
fig = plt.figure(num=1, clear=True, figsize=(10, 8))
ax = plt.axes(projection='3d')
f = ax.plot_surface(X, Y, Z, cmap='coolwarm', linewidth=0, antialiased=True)
ax.set_title('Reconstructed Treasury Interest Rates [Liu and Wu (2020)]')
ax.set_xlabel('date')
ax.set_ylabel('maturity (years)')
ax.set_zlabel('annual yield (%)')
fig.colorbar(f, shrink=0.5, aspect=5)
plt.tight_layout()
```

Reconstructed Treasury Interest Rates [Liu and Wu (2020)]



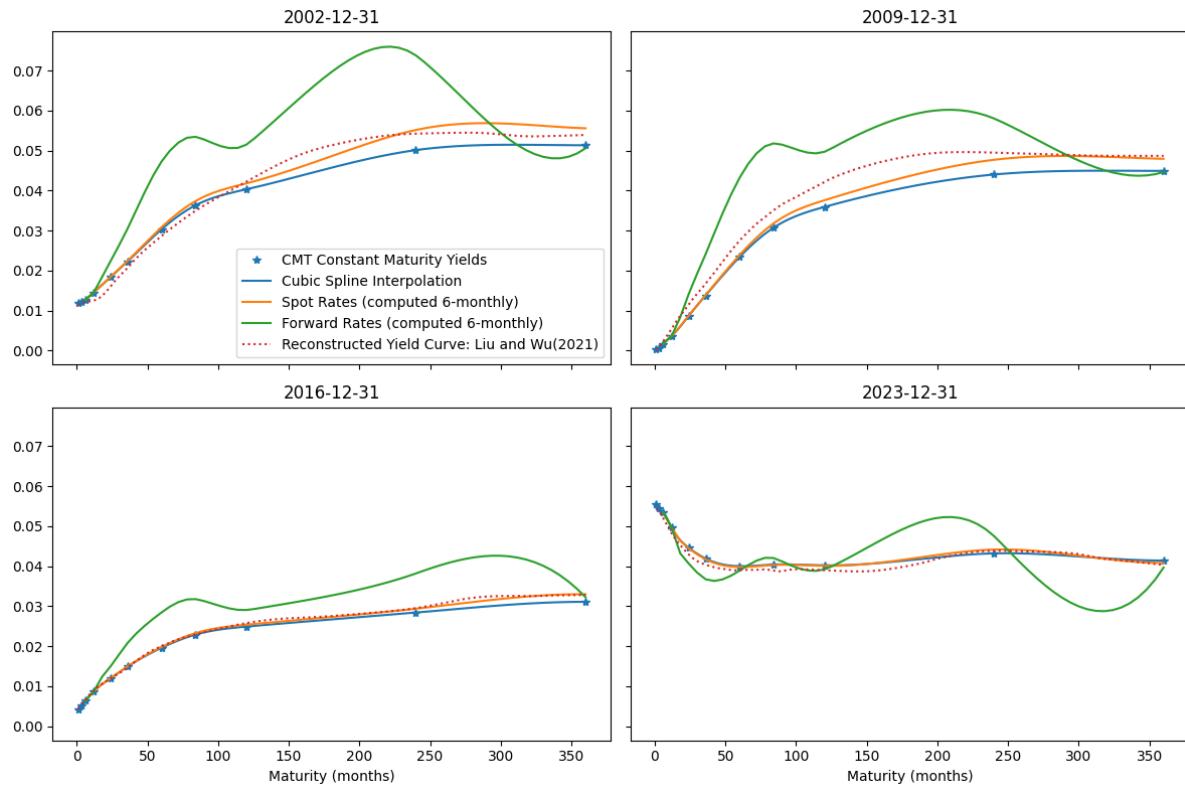
```
# Plot historical Yield Curves
curve_dates = sorted(liuwu.index[-1:0:-(7*12)])[-4:]
for date in curve_dates:
    yield_curve[date] = CubicSpline(
        x=monthly.columns.to_list(), y=monthly.loc[date].values, bc_type='clamped')
```

```
fig, axes = plt.subplots(2,2, figsize=(12, 8), sharey=True, sharex=True)
axes = axes.flatten()
for num, (curve_date, ax) in enumerate(zip(curve_dates, axes)):
    # fit yields
    yields = [yield_curve[curve_date](t) / 100 for t in maturities]

    # compute spots
    spots = []
    for coupon in yields:
        spots.append(bootstrap_spot(coupon=coupon, spots=spots, m=m))

    # compute forwards
    forwards = [spots[0]] + forwards_from_spots(spots=spots, m=m)

    # plot
    (monthly.loc[curve_date] / 100).plot(marker='*', ls='', color="C0", ax=ax) # CMT
    yield
    X = range(1, maturities[-1]+1)
    ax.plot(X, [yield_curve[curve_date](t) / 100 for t in X], marker='', ls='-', color="C0")
    ax.plot(maturities, spots, marker='', ls='-', color="C1")
    ax.plot(maturities, forwards, marker='', ls='-', color="C2")
    liuwu.loc[curve_date].plot(ax=ax, marker='', ls=':', color="C3") # Liu and Wu
    ax.set_title(f'{curve_date.strftime("%Y-%m-%d")}')
    ax.set_xlabel('Maturity (months)')
    if not num:
        ax.legend(['CMT Constant Maturity Yields', 'Cubic Spline Interpolation',
                  'Spot Rates (computed 6-monthly)', 'Forward Rates (computed 6-monthly)',
                  'Reconstructed Yield Curve: Liu and Wu(2021)'])
plt.tight_layout()
```



13.4 Principal Component Analysis

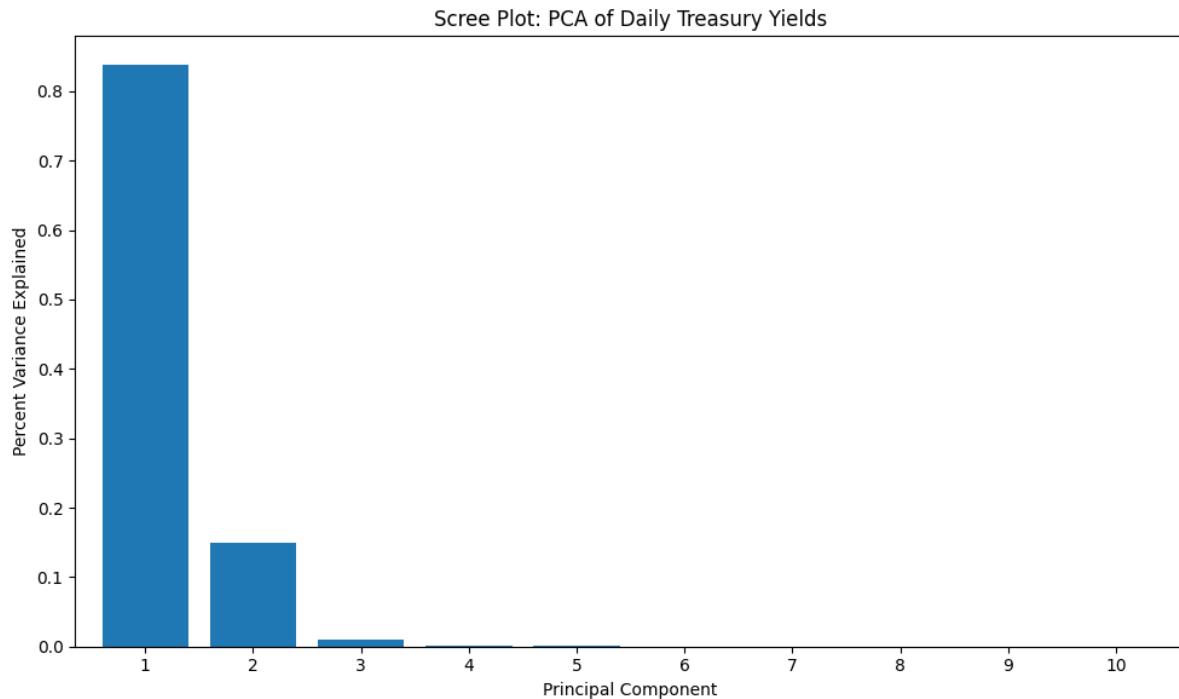
A principal components analysis finds multiple factors and estimates their relative importance in describing movements in the term structure. We carry out a principal components analysis on the daily changes in the Constant Maturities Treasury rates. The number of factors equals the number of rates.

The first factor accounts for 83.7% of the variance of all daily rate movements, while the first two account for 98.7%. The first three factors account for 99.8% of the variance, or most of the uncertainty in interest rate movements.

```
X = daily.dropna()
Y = StandardScaler().fit_transform(X)
pca = PCA().fit(Y)
DataFrame({'Cumulative Variance Explained': pca.explained_variance_ratio_.cumsum() },
          index=[f"PC {c+1}" for c in range(pca.n_components_)])
```

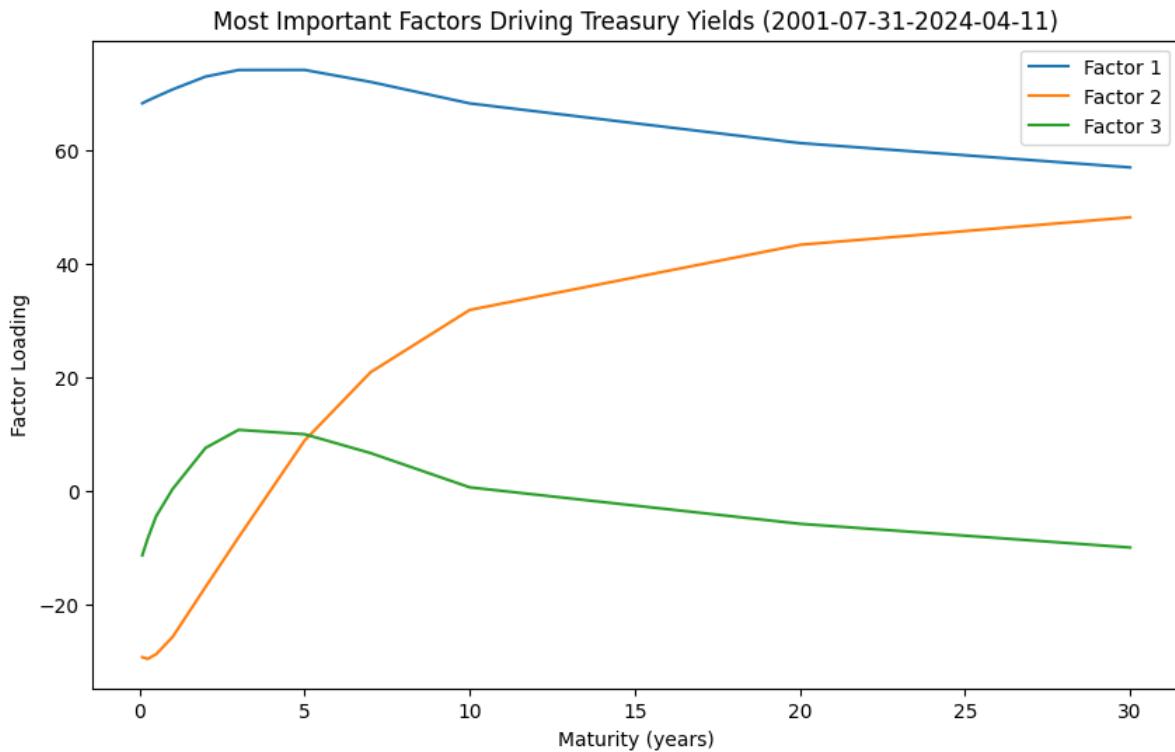
Cumulative Variance Explained	
PC 1	0.837657
PC 2	0.986801
PC 3	0.997540
PC 4	0.998884
PC 5	0.999374
PC 6	0.999713
PC 7	0.999861
PC 8	0.999925
PC 9	0.999962
PC 10	0.999985
PC 11	1.000000

```
# Scree plot
scree = Series(pca.explained_variance_ratio_,
               index=np.arange(1, Y.shape[1] + 1))
fig, ax = plt.subplots(figsize=(10, 6))
scree[:10].plot(kind='bar', rot=0, width=.8, ax=ax)
ax.set_title('Scree Plot: PCA of Daily Treasury Yields')
ax.set_ylabel("Percent Variance Explained")
ax.set_xlabel("Principal Component")
plt.tight_layout()
```



```
# Factor Loadings
Z = pca.components_[:, :].T * pca.singular_values_.reshape(1, 3)
loadings = DataFrame(Z, columns=[f"Factor {n+1}" for n in range(3)], index=X.columns[12])
fig, ax = plt.subplots(figsize=(10, 6))
loadings.plot(ax=ax)
ax.set_title(f"Most Important Factors Driving Treasury Yields"
            f" ({str(X.index[0])[:10]}-{str(X.index[-1])[:10]})")
ax.set_xlabel('Maturity (years)')
ax.set_ylabel('Factor Loading')
```

Text(0, 0.5, 'Factor Loading')



Most important factors driving treasury yields:

- Factor 1 is a shift in the “level” of the term structure where all rates move in the same direction by approximately (but not exactly) the same amount.
- Factor 2 is a shift in the “slope” where short-term rates move in one direction and long-term rates move in the other direction. It corresponds to steepening or flattening of the term structure.
- Factor 3 is a shift in the “twist” of the term structure, where relatively short-term and relatively long-term rates move in one direction while intermediate rates move in the other direction

13.5 Singular Value Decomposition

Intuitively, PCA (also called eigendecomposition) is a rotation of the cloud of data points in Euclidean space where the co-ordinate axes are chosen such that each successive axis captures as much variance as possible.

Singular Value Decomposition (SVD) of a matrix is a factorization of that matrix into a product three matrices, which can be interpreted as a rotation, followed by a rescaling, followed by another rotation: $A = USV^T$.

The singular value decomposition of a data matrix A is a generalization of an eigendecomposition of the square symmetric matrix: $A^T A = V \Lambda V^T$.

A goal of both PCA and SVD is to approximate the original data matrix with a lower-dimensional presentation, with the most important eigen- and singular vectors associated with the largest eigenvalues and singular values respectively.

```
# A is num_samples (N) by num_features (K) data matrix, standardized by column
A = daily.dropna().values
A = (A - A.mean(axis=0)) / A.std(axis=0) # subtract mean, divide by std
N, K = A.shape
A.shape
```

(5677, 11)

```
# svd x is related to pca of x'x
u, s, vT = np.linalg.svd(A, full_matrices=False)
v = vT.T  # transposed right singular vector was returned
```

The **eigenvalues** (λ) of PCA

- can be retrieved as (N-1) times pca.explained_variance_
- are equal to the squares of the singular values (s from SVD)

```
# s**2 = lambda = N * explained_variance
assert np.allclose((N-1) * pca.explained_variance_, s**2), 'eigenvalues values'
assert np.allclose(pca.singular_values_, s), "singular values"
```

The **components** (columns of V) of an eigendecomposition

- are also called the **eigenvectors**, or right **singular vectors** from the SVD
- can be retrieved from the rows of pca.components_, or
- are the rows of V^T (identically, the columns of V from SVD)

Relatedly:

- **loadings** are computed by multiplying each component by its corresponding singular value $v \cdot s$

```
# components and right singular vectors are identical up to sign flip
for pc in range(K):
    assert (np.allclose(vT[pc, :], pca.components_[pc, :]) or
            np.allclose(vT[pc, :], -pca.components_[pc, :]))
```

```
# square of loadings is same as square of data matrix, i.e. the covariance matrix
loadings = np.diag(pca.singular_values_) @ pca.components_
assert np.allclose(A.T @ A, loadings.T @ loadings), 'square matrix'
```

The **projections** of PCA

- are also known as the **scores** or **co-ordinates**
- are computed by projecting the data matrix on the components $A \cdot V$
- or by scaling each left singular vector by its corresponding singular value $u \cdot s$
- can be retrieved by calling pca.transform() on the data matrix

```
# assert: x @ v == transform(x) (aka projection on components)
y = pca.transform(A)
for pc in range(K):
    assert np.allclose((A @ v)[:, pc], -y[:, pc]) or np.allclose((A @ v)[:, pc], y[:, pc])
    assert np.allclose(u[:, pc] * s[pc], -y[:, pc]) or np.allclose(u[:, pc] * s[pc], y[:, pc])
```

Low-rank approximation by PCA: $A' A \approx V D V'$

```
ATA = A.T.dot(A)
eigval, eigvec = (N-1)*pca.explained_variance_, pca.components_.T
assert np.allclose(eigvec.dot(np.diag(eigval)).dot(eigvec.T), ATA), "pca error"
```

```
print('rank-K PCA approximation:')

DataFrame.from_dict({k: (la.norm(
    eigvec[:, :k].dot(np.diag(eigval[:k])).dot(eigvec[:, :k].T) - ATA) / la.norm(ATA))
    for k in range(1, 5)}, orient='index', columns=['Frobenius Norm'])\
    .rename_axis(index='K')
```

```
rank-K PCA approximation:
```

```
    Frobenius Norm
K
1      0.175740
2      0.012739
3      0.001739
4      0.000728
```

Low-rank approximation by SVD: $A \approx USV'$

```
assert np.allclose(u.dot(np.diag(s)).dot(v.T), A), "svd error"
```

```
print('rank-K SVD approximation:')

DataFrame.from_dict({k: la.norm(
    u[:, :k].dot(np.diag(s[:k])).dot(v[:, :k].T) - A) / la.norm(A))
    for k in range(1, 5)}, orient='index', columns=['Frobenius Norm'])\
    .rename_axis(index='K')
```

```
rank-K SVD approximation:
```

```
    Frobenius Norm
K
1      0.402918
2      0.114886
3      0.049601
4      0.033414
```

BOND RETURNS AND RISKS

The essence of investment management is the management of risks, not the management of returns - Benjamin Graham

Concepts

- Term structure changes
- Bond risk factors

References:

- FRM Part I Exam Book Valuation and Risk Models Ch12-13

```
from typing import List
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from sklearn.preprocessing import StandardScaler
from sklearn.pipeline import Pipeline
from sklearn.decomposition import PCA
import statsmodels.formula.api as smf
from finds.readers import Alfred
from finds.recipes import bond_price
from secret import credentials
# %matplotlib qt
VERBOSE = 0
```

14.1 Term structure changes

14.1.1 Duration

Duration, or Macaulay Duration, measures the change in bond price P with a instantaneous change in its yield y .

Consider a bond with price P and yield y . Because it leads to a simpler duration formula, we first measure the yield with continuous compounding. The present value relationship between P and y is $P = \sum_{t=1}^n c_t e^{-yt}$. Then after differentiating: $\Delta P = -\sum_{t=1}^n c_t t e^{-yt} \Delta y$

We define the yield-based duration as the proportional change in the bond price for a small change in the yield:

$$D = \frac{\Delta P}{P \Delta y} = \sum_{t=1}^n t \frac{c_t e^{-yt}}{P}$$

This formulation gives us another interpretation of duration. It can be calculated by taking an average of the times when cash flows are received weighted by the proportion of the bond's value received at each time. Duration is therefore a measure of how long an investor has to wait to receive cash flows. (This explains why the word “duration” was chosen to describe the sensitivity of proportional changes to yield).

Modified duration: If the yield on the bond is measured with semi-annual compounding rather than continuous compounding, the expression for (Macaulay) duration must be divided by $(1 + y_2/2)$ (or $1 + y_m/m$ for m'thly compounding).

Effective duration describes the percentage change in the price of a bond with embedded options due to a small change in all rates.

14.1.2 DV01

DV01 describes the impact of a one-basis-point change in interest rates on the value of a portfolio.

$$DV01 = -\frac{\Delta P}{\Delta r}$$

where Δr is the size of a small parallel shift in the interest rate term structure (measured in basis points).

14.1.3 Convexity

Bond duration and convexity are in the first two terms of the derivative of a bond's price with respect to interest rates in a Taylor expansion. Convexity measures the curvature of the bond price-interest rate relationship. It indicates how much the bond's duration changes as interest rates change. While duration helps estimate bond price changes for small interest rate movements, convexity accounts for larger changes, providing a more accurate prediction of bond price behavior

Yield-based convexity when yields are expressed with continuous compounding is

$$C = \frac{1}{P} \frac{1}{(1+r/m)^2} \sum_{t=1}^T (t/2m + (t/m)^2) \frac{C_t}{(1+r/m)^t}$$

It is a weighted average of the squared time to maturity. When yields are expressed with semi-annual compounding, these expressions must be divided by $(1 + y_2/2)^2$ (or $(1 + y_m/2)^2$ with m'thly compounding) and the result is referred to as modified convexity. Effective convexity measures the sensitivity of the duration measure to changes in interest rates.

$$C = \frac{1}{P} \left[\frac{P^+ + P^- - 2P}{(\Delta r)^2} \right]$$

```
# Helpers to calculate duration and convexity
def macaulay_duration(coupon: float, n: int, m: int, price: float,
                      yields: float | List[float], par: float = 1, **kwargs) -> float:
    """Compute macaulay duration of a bond given spot rates or yield-to-maturity
```

Args:

coupon : Annual coupon rate
n : Number of remaining coupons
m : Number of compounding periods per year
price : current market price of bond
yields : Simple annual yield-to-maturity or spot rates each period
par : face or par value of bond

Returns:

Macaulay duration

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```

if not pd.api.types.is_list_like(yields):
    yields = [yields] * n           # same spot rate every period
assert len(yields) == n, "Number of spot rates must equal number of coupons"
    pv = [(1 + yields[t-1]/m)**(-t) * (t/m) * (coupon/m + par*(t == n)))
          for t in range(1, n+1)]      # discount every period's time-weighted payment
    return np.sum(pv) / price

```

```

def modified_duration(coupon: float, n: int, m: int, price: float,
                      yields: float | List[float], par: float = 1, **kwargs) -> float:
    """Compute modified duration of a bond given spot rates or yield-to-maturity

```

Args:

coupon : Annual coupon rate
n : Number of remaining coupons
m : Number of compounding periods per year
price : current market price of bond
yields : Simple annual yield-to-maturity or spot rates each period
par : face or par value of bond

Returns:

Modified duration

"""

```

assert not pd.api.types.is_list_like(yields), "Not Implemented"
ytm = yields

```

```

return (macaulay_duration(coupon=coupon, n=n, m=m, price=price, yields=yields,_
                           par=par)
        / (1 + ytm/2))

```

```

def modified_convexity(coupon: float, n: int, m: int, price: float,
                      yields: float | List[float], par: float = 1, **kwargs) ->_
float:
    """Compute modified convexity of a bond given spot rates or yield-to-maturity

```

Args:

coupon : Annual coupon rate
n : Number of remaining coupons
m : Number of compounding periods per year
price : current market price of bond
yields : Simple annual yield-to-maturity or spot rates each period
par : face or par value of bond

Returns:

Modified convexity

"""

```

assert not pd.api.types.is_list_like(yields), "Not Implemented"
ytm = yields

```

```

if not pd.api.types.is_list_like(yields):

```

*yields = [yields] * n # same spot rate every period*

```

assert len(yields) == n, "Number of spot rates must equal number of coupons"

```

```

    pv = [(1 + yields[t-1]/m)**(-t) * ((t/m)**2 + t/(2*m)) * (coupon/m + par*(t == n)))
          for t in range(1, n+1)]      # discount every period's time-weighted payment
    return np.sum(pv) / (price * (1 + ytm/m)**2)

```

14.1.4 Barbells and bullets

```
# Compute prices, duration and convexity for 3 bonds (FRM Valuation and Risk Models ↴12.7)
bond5Y = dict(coupon=2, m=2, n=2*5, par=100, yields=0.04)
bond10Y = dict(coupon=4, m=2, n=2*10, par=100, yields=0.04)
bond20Y = dict(coupon=6, m=2, n=2*20, par=100, yields=0.04)
for bond in [bond5Y, bond10Y, bond20Y]:
    bond |= dict(price=bond_price(**bond))
    bond |= dict(duration=modified_duration(**bond))
    bond |= dict(convexity=modified_convexity(**bond))
bonds = DataFrame.from_dict(
    {f"b['n']/b['m']:.0f}-year, {b['coupon']}% coupon": [
        b['price'], b['duration'], b['convexity']]
    for b in [bond5Y, bond10Y, bond20Y]},
    orient='index',
    columns=['Value', 'Effective Duration', 'Effective Convexity'])
```

```
print("Table 12.4 Effective Durations and Convexities of Three Bonds")
bonds.round(4)
```

Table 12.4 Effective Durations and Convexities of Three Bonds

	Value	Effective Duration	Effective Convexity
5-year, 2% coupon	91.0174	4.6764	24.8208
10-year, 4% coupon	100.0000	8.1757	78.8979
20-year, 6% coupon	127.3555	12.6233	212.4587

```
# Compute 5Y and 20Y weights of barbell portfolio, with same duration as bullet 10Y
barbell = ((bond10Y['duration'] - bond20Y['duration']) /
            (bond5Y['duration'] - bond20Y['duration']))
print(f"Barbell: weight in 5Y = {barbell:.4f}, weight in 20Y = {1-barbell:.4f}")
```

```
Barbell: weight in 5Y = 0.5597, weight in 20Y = 0.4403
```

```
# Compare durations and convexities
DataFrame.from_dict(dict(Bullet=np.array([0,1,0]).dot(bonds),
                        Barbell=np.array([barbell, 0, 1-barbell]).dot(bonds)),
                    orient='index', columns=bonds.columns)\n                    [['Effective Duration', 'Effective Convexity']])
```

	Effective Duration	Effective Convexity
Bullet	8.175717	78.897925
Barbell	8.175717	107.444902

A **positive convexity** improves the bond holder's position when there is a parallel shift in interest rates. While both strategies provide a yield of 4% and a duration of 8.1758, the barbell strategy always produces a better result when there is a parallel shift in the yield curve. An opportunity for arbitrageurs:

- Invest a certain USD amount in the barbell, and
- Short the same USD amount of the bullet

This would be profitable if shifts in the term structure were always parallel.

14.1.5 Key rate shifts

Suppose we consider three spot rates: the two-year rate, the five-year rate, and the ten-year rate. Each of these can affect spot rates in their neighborhoods, and the combined effect of all three key rate shifts is a one-basis-point shift in all rates. Shifts in each of those spot rates can be defined as shown below. These shifts are sometimes referred to as **key rate shifts**, and provide a way of splitting the DV01 measure into three separate measures.

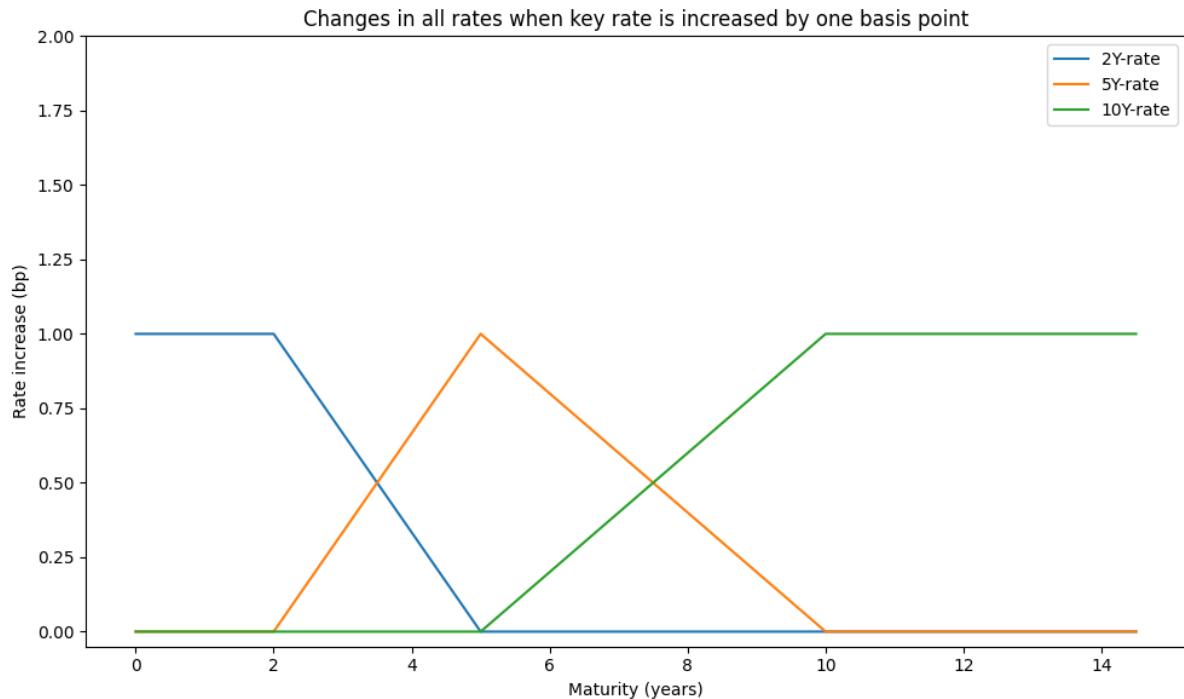
The impact of the shifts are called **partial 01s** or **key rate 01s** (KR01s), e.g.:

- KR01₁: The reduction in a portfolio's value from a one-basis-point increase in the two-year spot rate
- KR01₂: The reduction in a portfolio's value from a one-basis-point increase in the five-year spot rate
- KR01₃: The reduction in a portfolio's value from a one-basis-point increase in the ten-year spot rate

It follows that: $DV01 = KR01_1 + KR01_2 + KR01_3$. A bond investor can estimate portfolio values under, or hedge against, a wider range of (small) term structure movements.

```
KR = [2, 5, 10]
DV01 = dict()
for maturity in np.arange(0, 15, 0.5):
    if maturity <= KR[0]:
        changes = [1, 0, 0]
    elif maturity >= KR[2]:
        changes = [0, 0, 1]
    elif maturity < KR[1]:
        diff = (maturity - KR[0]) / (KR[1] - KR[0])
        changes = [1 - diff, diff, 0]
    else:
        diff = (KR[2] - maturity) / (KR[2] - KR[1])
        changes = [0, diff, 1 - diff]
    DV01[maturity] = changes
```

```
fig, ax = plt.subplots(figsize=(10, 6))
DataFrame.from_dict(DV01, orient='index', columns=[f"({y})Y-rate" for y in KR]) \
    .plot(ax=ax)
ax.legend()
ax.set_title('Changes in all rates when key rate is increased by one basis point')
ax.set_ylabel('Rate increase (bp)')
ax.set_xlabel('Maturity (years)')
ax.set_ylim(top=2)
plt.tight_layout()
```



14.2 Bond risk factors

```
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
```

```
# get Merrill Lynch bond indexes
freq = 'D'      # periodicity 'M' or 'D'
cat = alf.get_category(32413)
print(cat['id'], cat['name'])
```

32413 BofA Merrill Lynch Total Bond Return Index Values

```
# get bond index returns
bonds = []      # to accumulate bond returns
for s in cat['series']:
    bonds.append(alf(s['id']), start=19961231, freq=freq)
bonds_df = pd.concat(bonds, axis=1).sort_index()
```

```
# show blocks of data availability
counts = bonds_df.notna().sum(axis=1).rename('count')
counts = pd.concat([counts, (counts != counts.shift()).cumsum().rename('notna')], axis=1)
counts = counts.reset_index().groupby(['notna', 'count'])['date'].agg(['first', 'last'])
counts
```

		first	last
notna	count		
1	15	19961231	19971230
2	16	19971231	19981230
3	33	19981231	20031230
4	48	20031231	20181108
5	46	20181109	20181109
6	48	20181112	20240418

```
# choose start date with good data availability
start_date = 19981231
rets = bonds_df.loc[bonds_df.index >= start_date,
                    bonds_df.loc[start_date].notna().values].iloc[:,-1]
rets = pd.concat([alf.transform(rets[col], log=1, diff=1)
                  for col in rets.columns], axis=1).dropna()
rets
```

	BAMLCC0A0CMTRIV	BAMLCC0A1AAATTRIV	BAMLCC0A2AAATTRIV	BAMLCC0A3ATTRIV	\
date					
19990104	-0.001053	-0.001421	-0.000660	-0.001166	
19990105	-0.003846	-0.004194	-0.003500	-0.003857	
19990106	0.002388	0.002099	0.002102	0.002495	
19990107	-0.002694	-0.002813	-0.002413	-0.002573	
19990108	-0.002583	-0.002941	-0.002419	-0.002658	
...
20240411	-0.001330	-0.001659	-0.001234	-0.001240	
20240412	0.001673	0.001828	0.001822	0.001739	
20240415	-0.006152	-0.008150	-0.006125	-0.006174	
20240416	-0.004341	-0.004776	-0.003966	-0.004142	
20240417	0.004802	0.006168	0.004689	0.004873	
	BAMLCC0A4BBBTRIV	BAMLCC1A013YTRIV	BAMLCC2A035YTRIV	\	
date					
19990104	-0.000995	0.000076	0.000473		
19990105	-0.003952	-0.000844	-0.002452		
19990106	0.002419	0.000466	0.000901		
19990107	-0.002996	0.000101	-0.000853		
19990108	-0.002504	-0.000920	-0.002006		
...	
20240411	-0.001418	0.000582	-0.000040		
20240412	0.001592	0.000727	0.001509		
20240415	-0.006110	-0.000410	-0.002345		
20240416	-0.004571	-0.001117	-0.002740		
20240417	0.004725	0.001034	0.002748		
	BAMLCC3A057YTRIV	BAMLCC4A0710YTRIV	BAMLCC7A01015YTRIV	...	\
date					
19990104	0.000534	-0.000519	-0.001209	...	
19990105	-0.003343	-0.004276	-0.004990	...	
19990106	0.001695	0.001967	0.002537	...	
19990107	-0.001561	-0.002662	-0.003371	...	
19990108	-0.003309	-0.003773	-0.004368	...	
...	
20240411	-0.000588	-0.001859	-0.001963	...	
20240412	0.002151	0.001789	0.002657	...	
20240415	-0.004446	-0.006793	-0.008662	...	

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20240416	-0.003974	-0.004730	-0.005714	...
20240417	0.004275	0.005568	0.006826	...
\				
BAMLEMPTPRVICRPITRIV				
date				
19990104	0.001599	-0.000700	-0.005616	
19990105	0.002692	0.000400	0.008113	
19990106	0.007144	0.003395	0.009135	
19990107	-0.001484	-0.003095	0.007386	
19990108	-0.000594	0.001998	0.000392	
...
20240411	-0.001561	-0.000714	-0.003072	
20240412	0.001016	0.001856	0.000311	
20240415	-0.002430	-0.002237	-0.003116	
20240416	-0.002959	-0.002457	-0.002725	
20240417	0.001567	0.002147	0.001095	
\				
BAMLEMRLCRPILATRIV				
date				
19990104	0.002297	0.001099	0.000195	
19990105	0.002392	0.002394	0.012287	
19990106	0.006251	0.006060	0.000577	
19990107	0.000198	-0.000694	0.003932	
19990108	-0.002079	-0.000892	0.000000	
...
20240411	-0.003734	-0.002164	-0.001999	
20240412	-0.000522	0.000781	-0.000229	
20240415	-0.004952	-0.003309	-0.000858	
20240416	-0.004515	-0.003117	-0.004533	
20240417	0.001602	0.001795	0.001092	
\				
BAMLHYH0A0HYM2TRIV				
date				
19990104	0.001490	0.000250	0.001999	
19990105	0.000674	-0.000834	0.000781	
19990106	0.001487	0.001583	0.001041	
19990107	-0.000112	-0.001250	0.000520	
19990108	0.001737	-0.000918	0.002509	
...
20240411	-0.001882	-0.001767	-0.001925	
20240412	-0.001196	-0.000885	-0.001148	
20240415	-0.002717	-0.002836	-0.002138	
20240416	-0.004080	-0.003503	-0.004105	
20240417	0.000397	0.000712	0.000162	
\				
BAMLHYH0A3CMTRIV				
date				
19990104	0.003234			
19990105	0.005428			
19990106	0.003480			
19990107	0.001005			
19990108	0.007643			
...	...			
20240411	-0.002184			
20240412	-0.002668			
20240415	-0.003969			

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```
20240416      -0.006513
20240417      -0.000130
```

```
[6603 rows x 33 columns]
```

```
pd.set_option('display.max_colwidth', None)
print("Bond Index Total Returns")
Series(alf.header(rrets.columns), index=rrets.columns, name='title') \
    .to_frame().rename_axis('series')
```

```
Bond Index Total Returns
```

```
          title
series
BAMLCC0A0CMTRIV           ICE BofA US
  ↵Corporate Index Total Return Index Value
BAMLCC0A1AAATRIV           ICE BofA AAA US
  ↵Corporate Index Total Return Index Value
BAMLCC0A2AAATRIV           ICE BofA AA US
  ↵Corporate Index Total Return Index Value
BAMLCC0A3ATRIV             ICE BofA Single-A US
  ↵Corporate Index Total Return Index Value
BAMLCC0A4BBBTRIV           ICE BofA BBB US
  ↵Corporate Index Total Return Index Value
BAMLCC1A013YTRIV           ICE BofA 1-3 Year US
  ↵Corporate Index Total Return Index Value
BAMLCC2A035YTRIV           ICE BofA 3-5 Year US
  ↵Corporate Index Total Return Index Value
BAMLCC3A057YTRIV           ICE BofA 5-7 Year US
  ↵Corporate Index Total Return Index Value
BAMLCC4A0710YTRIV          ICE BofA 7-10 Year US
  ↵Corporate Index Total Return Index Value
BAMLCC7A01015YTRIV          ICE BofA 10-15 Year US
  ↵Corporate Index Total Return Index Value
BAMLCC8A015PYTRIV          ICE BofA 15+ Year US
  ↵Corporate Index Total Return Index Value
BAMLEM1BRRAAA2ACRPITRIV    ICE BofA AAA-A Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEM2BRRBBBCRPITRIV      ICE BofA BBB Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEM3BRRBBCRPITRIV      ICE BofA BB Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEM4BRRBLCRPITRIV       ICE BofA B & Lower Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEM5BCOCRPITRIV         ICE BofA Crossover Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEMCBPITRIV             ICE BofA Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEMEBCRPITRIV           ICE BofA Euro Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEMSFCRPITRIV           ICE BofA Private Sector Financial Emerging Markets
  ↵Corporate Plus Index Total Return Index Value
BAMLEMHBHYCRPITRIV          ICE BofA High Yield Emerging Markets
```

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↳Corporate Plus Index Total Return Index Value	
BAMLEMIBHGCRPITRIV	ICE BofA High Grade Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMNSNFCRPITRIV	ICE BofA Non-Financial Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMPBPUBSICRPITRIV	ICE BofA Public Sector Issuers Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMPTPRVICRPITRIV	ICE BofA Private Sector Issuers Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMRCRPIASIASTRIV	ICE BofA Asia Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMRECRPIEMEATRIV	ICE BofA EMEA Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMRLCRPILATRIV	ICE BofA Latin America Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLEMUBCRPIUSTRIV	ICE BofA US Emerging Markets
↳Corporate Plus Index Total Return Index Value	
BAMLHE00EHYITRIV	ICE BofA Euro
↳High Yield Index Total Return Index Value	
BAMLHYH0A0HYM2TRIV	ICE BofA US
↳High Yield Index Total Return Index Value	
BAMLHYH0A1BBTRIV	ICE BofA BB US
↳High Yield Index Total Return Index Value	
BAMLHYH0A2BTRIV	ICE BofA Single-B US
↳High Yield Index Total Return Index Value	
BAMLHYH0A3CMTRIV	ICE BofA CCC & Lower US
↳High Yield Index Total Return Index Value	

```
# Extract principal components of bond index returns
pipe = Pipeline([('scaler', StandardScaler()), ('pca', PCA())])
pipe.fit(rets)
print(pipe.named_steps['pca'].explained_variance_ratio_) # sanity check
scree = Series(pipe.named_steps['pca'].explained_variance_ratio_,
               index=np.arange(1, rets.shape[1]+1))
DataFrame(scree.cumsum().rename('Cumulative Variance Ratio Explained')).iloc[:10]
```

```
[5.90633015e-01 1.84670310e-01 7.66846462e-02 2.31249861e-02
 2.08709778e-02 1.73997768e-02 1.59048070e-02 1.11428201e-02
 1.08065948e-02 9.53333795e-03 7.17195056e-03 5.80339671e-03
 5.13102872e-03 4.61504627e-03 3.95216602e-03 2.55170452e-03
 2.42215195e-03 2.22998793e-03 1.31893510e-03 9.51987980e-04
 7.84773755e-04 6.15732469e-04 3.99797350e-04 3.69901192e-04
 3.07591420e-04 2.74143218e-04 9.27920937e-05 8.50594135e-05
 5.40645899e-05 3.96089404e-05 3.55645916e-05 1.55810718e-05
 5.76269423e-06]
```

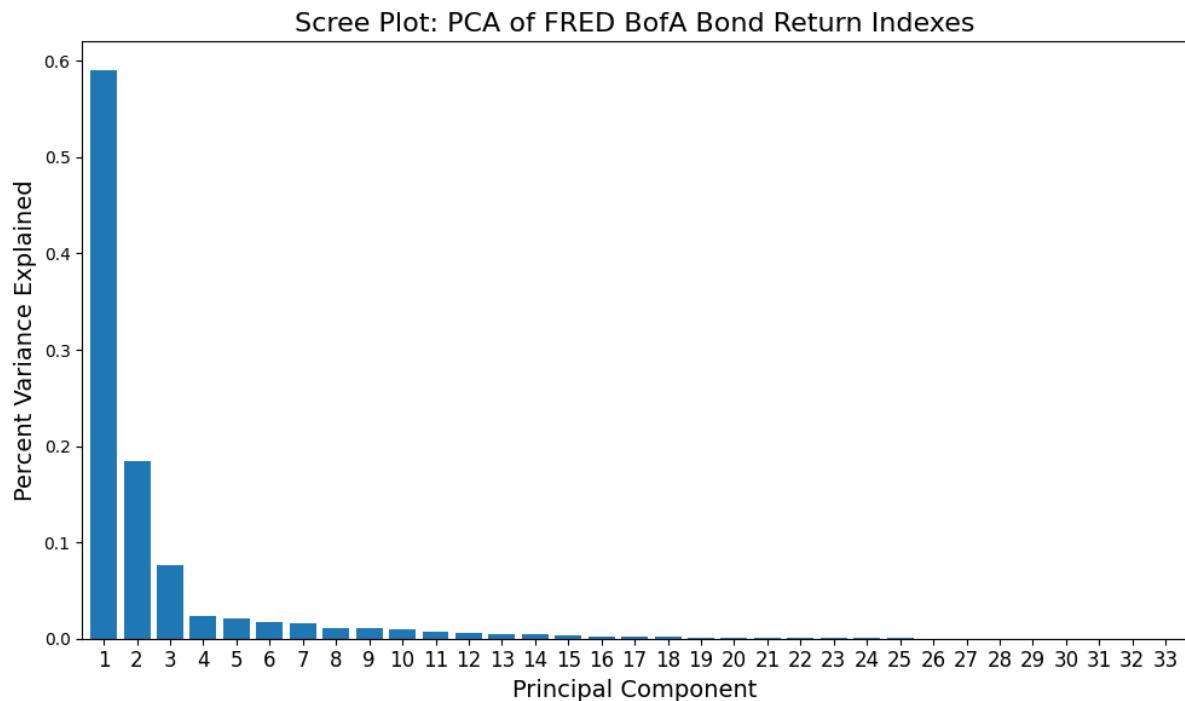
Cumulative Variance Ratio Explained	
1	0.590633
2	0.775303
3	0.851988
4	0.875113
5	0.895984
6	0.913384
7	0.929289

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8	0.940431
9	0.951238
10	0.960771

```
# Scree plot
fig, ax = plt.subplots(num=1, clear=True, figsize=(10, 6))
scree.plot(kind='bar', rot=0, width=.8, ax=ax)
ax.set_title('Scree Plot: PCA of FRED BofA Bond Return Indexes', fontsize=16)
ax.xaxis.set_tick_params(labelsize=12)
ax.set_ylabel("Percent Variance Explained", fontsize=14)
ax.set_xlabel("Principal Component", fontsize=14)
plt.tight_layout()
```



14.2.1 Explainability of Statistical Factors

```
# Extract factor returns from bond indexes with PCA projection
K = 4
factors = DataFrame(pipe.transform(rets)[:, :K],
                     columns=[f"PC{c+1}" for c in range(K)],
                     index=pd.DatetimeIndex(rets.index.astype(str), freq='infer'))
```

Construct changes in interest rate spreads:

- level: average of 2-year and 10-year treasury rates
- slope: 10-year minus 2-year rates
- twist: (10-year minus 5-year) minus (5-year minus 2-year)
- credit: BAA minus 10-year treasury rates

```
# Construct interest rate spread changes
spreads = pd.concat([alf(s, freq=freq) for s in ['BAA10Y', 'DGS10', 'DGS5', 'DGS2']], axis=1) \
    .sort_index()
spreads.index = pd.DatetimeIndex(spreads.index.astype(str), freq='infer')
spreads['level'] = 0.5 * (spreads['DGS2'] + spreads['DGS10'])
spreads['credit'] = spreads['BAA10Y']
spreads['slope'] = spreads['DGS10'] - spreads['DGS2']
spreads['twist'] = ((spreads['DGS10'] - spreads['DGS5']) - (spreads['DGS5'] - spreads['DGS2']))
spreads = spreads.drop(columns=['BAA10Y', 'DGS10', 'DGS5', 'DGS2']) \
    .ffill() \
    .diff() \
    .dropna()
spreads
```

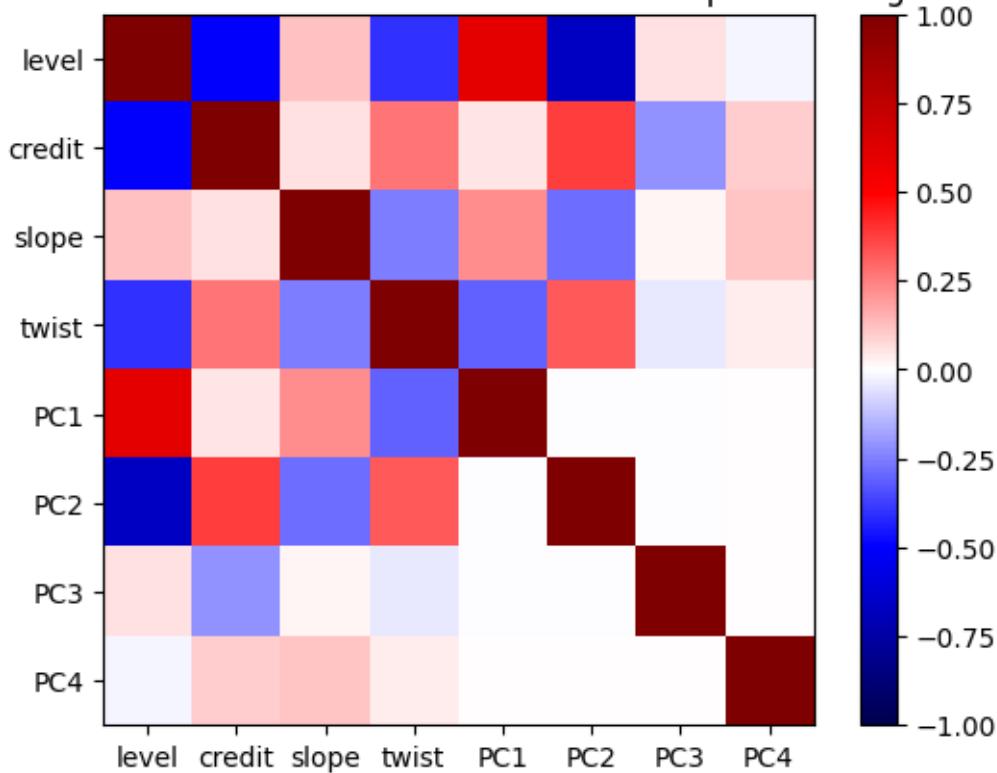
	level	credit	slope	twist
date				
1986-01-03	0.010	-0.04	1.776357e-15	1.776357e-15
1986-01-06	0.015	-0.01	1.000000e-02	-1.000000e-02
1986-01-07	-0.100	0.06	-6.000000e-02	-8.881784e-16
1986-01-08	0.155	-0.14	7.000000e-02	3.000000e-02
1986-01-09	0.160	-0.05	-4.000000e-02	-8.000000e-02
...
2024-04-12	-0.055	0.04	-1.000000e-02	3.000000e-02
2024-04-15	0.090	0.01	8.000000e-02	-4.000000e-02
2024-04-16	0.040	0.00	0.000000e+00	0.000000e+00
2024-04-17	-0.060	0.02	-4.000000e-02	2.000000e-02
2024-04-18	0.050	-0.01	-8.881784e-16	-2.000000e-02

[9580 rows x 4 columns]

```
# Show correlations between bond factor returns and spread changes
data = pd.concat([spreads, factors], axis=1, join='inner')
corr = data.corr()
plt.imshow(corr**2, vmin=0, vmax=1, cmap='Purples')
plt.imshow(corr, vmin=-1, vmax=1, cmap='seismic')
plt.xticks(range(len(corr)), corr.index)
plt.yticks(range(len(corr)), corr.index)
plt.colorbar()
plt.title('Correlation of bond factors and interest rate spread changes')
```

Text(0.5, 1.0, 'Correlation of bond factors and interest rate spread changes')

Correlation of bond factors and interest rate spread changes



```
# Show regression fits
for pc in range(K):
    print(smf.ols(f"PC{pc+1} ~ credit + level + slope + twist", data=data) \
        .fit(cov_type='HAC', cov_kwds={'maxlags': 63}) \
        .summary())
```

OLS Regression Results

	PC1	R-squared:	0.540			
Dep. Variable:		Model:	OLS			
Method:	Least Squares	F-statistic:	422.9			
Date:	Sun, 21 Apr 2024	Prob (F-statistic):	2.47e-323			
Time:	13:15:12	Log-Likelihood:	-16027.			
No. Observations:	6318	AIC:	3.206e+04			
Df Residuals:	6313	BIC:	3.210e+04			
Df Model:	4					
Covariance Type:	HAC					
	coef	std err	z	P> z	[0.025	0.975]
Intercept	0.0222	0.091	0.245	0.807	-0.156	0.200
credit	66.9094	10.707	6.249	0.000	45.923	87.895
level	66.9367	3.158	21.195	0.000	60.747	73.127
slope	9.1005	2.491	3.653	0.000	4.218	13.983
twist	-13.9458	2.207	-6.319	0.000	-18.271	-9.620

Omnibus: 4119.817 Durbin-Watson: 1.162

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Prob(Omnibus):	0.000	Jarque-Bera (JB):	216965.568
Skew:	2.469	Prob(JB):	0.00
Kurtosis:	31.281	Cond. No.	40.5

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using ≈ 63 lags and without small sample correction

OLS Regression Results

Dep. Variable:	PC2	R-squared:	0.492
Model:	OLS	Adj. R-squared:	0.492
Method:	Least Squares	F-statistic:	273.9
Date:	Sun, 21 Apr 2024	Prob (F-statistic):	1.99e-217
Time:	13:15:12	Log-Likelihood:	-12670.
No. Observations:	6318	AIC:	2.535e+04
Df Residuals:	6313	BIC:	2.538e+04
Df Model:	4		
Covariance Type:	HAC		

	coef	std err	z	P> z	[0.025	0.975]
Intercept	0.0038	0.049	0.079	0.937	-0.092	0.099
credit	7.9067	3.362	2.352	0.019	1.318	14.496
level	-28.0466	1.680	-16.695	0.000	-31.339	-24.754
slope	-14.4437	1.191	-12.131	0.000	-16.777	-12.110
twist	0.1590	1.291	0.123	0.902	-2.372	2.690

Omnibus:	4046.973	Durbin-Watson:	1.259
Prob(Omnibus):	0.000	Jarque-Bera (JB):	201753.832
Skew:	2.419	Prob(JB):	0.00
Kurtosis:	30.258	Cond. No.	40.5

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using ≈ 63 lags and without small sample correction

OLS Regression Results

Dep. Variable:	PC3	R-squared:	0.049
Model:	OLS	Adj. R-squared:	0.048
Method:	Least Squares	F-statistic:	9.627
Date:	Sun, 21 Apr 2024	Prob (F-statistic):	9.28e-08
Time:	13:15:12	Log-Likelihood:	-11869.
No. Observations:	6318	AIC:	2.375e+04
Df Residuals:	6313	BIC:	2.378e+04
Df Model:	4		
Covariance Type:	HAC		

	coef	std err	z	P> z	[0.025	0.975]
Intercept	-0.0046	0.025	-0.181	0.857	-0.054	0.045
credit	-12.9168	2.346	-5.507	0.000	-17.514	-8.319
level	-2.0945	1.339	-1.564	0.118	-4.719	0.530
slope	1.7102	1.241	1.378	0.168	-0.722	4.143
twist	0.3878	1.103	0.352	0.725	-1.773	2.549

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```
=====
Omnibus:                 3422.015   Durbin-Watson:           1.565
Prob(Omnibus):           0.000     Jarque-Bera (JB):      498792.470
Skew:                     1.565     Prob(JB):                  0.00
Kurtosis:                 46.416   Cond. No.                 40.5
=====
```

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using
 ↵63 lags and without small sample correction

OLS Regression Results

```
=====
Dep. Variable:                  PC4    R-squared:                 0.024
Model:                          OLS    Adj. R-squared:            0.023
Method:                         Least Squares    F-statistic:              12.35
Date:                          Sun, 21 Apr 2024    Prob (F-statistic):       5.27e-10
Time:                           13:15:12    Log-Likelihood:            -8150.9
No. Observations:                6318    AIC:                      1.631e+04
Df Residuals:                   6313    BIC:                      1.635e+04
Df Model:                        4
Covariance Type:                 HAC
=====
```

	coef	std err	z	P> z	[0.025	0.975]
Intercept	-0.0015	0.013	-0.111	0.911	-0.027	0.024
credit	2.6211	1.654	1.585	0.113	-0.620	5.862
level	0.6178	0.766	0.807	0.420	-0.883	2.119
slope	2.7265	0.431	6.329	0.000	1.882	3.571
twist	1.6352	0.454	3.606	0.000	0.746	2.524

=====

```
Omnibus:                 2609.560   Durbin-Watson:           1.953
Prob(Omnibus):           0.000     Jarque-Bera (JB):      152469.248
Skew:                     1.171     Prob(JB):                  0.00
Kurtosis:                 26.952   Cond. No.                 40.5
=====
```

Notes:

[1] Standard Errors are heteroscedasticity and autocorrelation robust (HAC) using
 ↵63 lags and without small sample correction

CHAPTER
FIFTEEN

CONDITIONAL VOLATILITY AND VAR

The only constant in life is change - Heraclitus

Concepts:

- Value at Risk
- Coherence and Expected Shortfall
- Cryptocurrency Indices
- Historical Simulation and Stressed VaR
- Bootstrapping
- EWMA and GARCH
- Backtesting VaR

References:

- Jorion, Phillippe. Value at Risk.
- P. Artzner, F. Delbaen, J.-M. Eber, and D. Heath, “Coherent Measures of Risk”, Mathematical Finance 9 (1999): 203–228.
- Kupiec, P. (1995). Techniques for Verifying the Accuracy of Risk Measurement Models. Journal of Derivatives, 3, 73-84.
- FRM Part I Exam Book Ch. 1-3
- FRM Part II Exam Book Market Risk Measurement and Management Ch. 1-2

```
from typing import Dict
import numpy as np
from scipy import stats
import pandas as pd
from pandas import DataFrame, Series
import statsmodels.api as sm
import matplotlib.pyplot as plt
from finds.readers import Alfred
from finds.utils import row_formatted
from secret import credentials
#pd.set_option('display.max_rows', None)
VERBOSE = 0
#%matplotlib qt
```

15.1 Value at Risk

Value at Risk (VaR) is an important risk measure that focuses on adverse events and their probability. A VaR with a confidence level of $\alpha\%$ is found by searching for the loss that has an $\alpha\%$ chance of being exceeded.

15.1.1 Coherence

One problem with VaR is that it does not say anything about how bad losses might be when they exceed the VaR level. Furthermore, Artzner et al. proposed four properties a risk measure should have.

1. Monotonicity: If (regardless of what happens) a portfolio always produces a worse result than another portfolio, it should have a higher risk measure.
2. Translation Invariance: If an amount of cash K is added to a portfolio, its risk measure should decrease by K .
3. Homogeneity: Changing the size of a portfolio by multiplying the amounts of all the components by X results in the risk measure being multiplied by X .
4. Subadditivity: For any two portfolios, the risk measure for the portfolio formed by merging them should be no greater than the sum of the risk measures for the portfolios.

A risk measure that satisfies all four conditions is termed coherent. **Expected shortfall (ES)** has all four properties, while VaR has only the first three properties. ES is computed as the probability-weighted average of tail losses. Other coherent risk measures can be derived by applying a risk aversion function to weight the quantiles. ES is a special case where the risk aversion weights are equal for all tail-loss quantiles.

```
# retrieve crypto currency index from FRED, as log returns
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE, convert_date=0)
cat = alf.get_category(33913)
cryptos = [alf(s['id']), log=1, diff=1]
    for s in cat['series'] if 'DISCONT' not in s['title']]
cryptos = pd.concat(cryptos, axis=1).sort_index()
titles = Series({s['id']: s['title']
    for s in cat['series'] if 'DISCONT' not in s['title']}),
    name=cat['name'])
```

```
# crypto index names
titles.to_frame().rename_axis(index=cat['id'])
```

Cryptocurrencies	
33913	
CBBCHUSD	Coinbase Bitcoin Cash
CBBTCUSD	Coinbase Bitcoin
CBETHUSD	Coinbase Ethereum
CBLTCUSD	Coinbase Litecoin

```
# recent crypto log returns
cryptos.tail()
```

	CBBCHUSD	CBBTCUSD	CBETHUSD	CBLTCUSD
date				
2024-04-11	-0.020373	-0.007875	-0.010817	0.024184
2024-04-12	-0.141308	-0.042222	-0.080178	-0.138679

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```
2024-04-13 -0.104275 -0.046878 -0.070173 -0.104611
2024-04-14  0.084578  0.024820  0.043828  0.025499
2024-04-15 -0.031220 -0.035412 -0.016538 -0.018678
```

15.1.2 Parametric method

Under the assumption that returns normally distributed, VaR and ES at the confidence level α is:

$$VaR = -\mu + \sigma z_{1-\alpha}$$

$$ES = -\mu + \sigma \frac{\exp(-z_{1-\alpha}^2/2)}{(1-\alpha)\sqrt{2\pi}}$$

where z_α is the standard normal variate corresponding to α .

For example, with $\alpha = 0.95$, $z_\alpha = -1.645$ which is the value whose cdf is the bottom 5% tail. In practice, μ and σ are not known and must be estimated. Since means are measured less precisely than volatility, and the returns are observed at short intervals, μ is often assumed to be 0.

The normal probability distribution has skewness (third central moment) equal to zero and kurtosis (fourth central moment) equal to 3. Under the assumption that geometric returns are normally distributed, then arithmetic returns have a **lognormal distributed**. The skewness of the lognormal is $(\exp(\sigma^2) + 2)\sqrt{(\exp(\sigma^2) - 1)}$, and is always positive, hence the lognormal has a long right-tail. The lognormal has kurtosis $\exp(\sigma^2)^4 + 2\exp(\sigma^2)^3 + 3\exp(\sigma^2)^2 - 3$ which varies from a minimum of over 3, and hence exhibits fatter tails than the normal.

```
# Helper to compute parametric VaR and ES
def parametric_risk(sigma: float | Series, alpha: float) -> Dict:
    """Calculate parametric gaussian VaR and ES"""
    var = -sigma * stats.norm.ppf(1 - alpha)
    es = sigma * stats.norm.pdf(stats.norm.ppf(1 - alpha)) / (1 - alpha)
    return dict(value_at_risk=var, expected_shortfall=es)
```

```
alpha = 0.95
volatility = {label: np.std(cryptos[label]) for label in cryptos}
parametric = DataFrame({label: Series(parametric_risk(std, alpha=alpha))
                       for label, std in volatility.items()})
print(f"Parametric Risk Measures (alpha={alpha})")
pd.concat([DataFrame.from_dict({'volatility': volatility}, orient='index'),
           parametric], axis=0).round(4)
```

Parametric Risk Measures (alpha=0.95)

	CCBCHUSD	CCBTCUSD	CBETHUSD	CBLTCUSD
volatility	0.0597	0.0407	0.0520	0.0557
value_at_risk	0.0982	0.0669	0.0855	0.0916
expected_shortfall	0.1232	0.0839	0.1072	0.1149

15.1.3 Delta-Normal method

This model is used to provide an approximate results for non-linear portfolios. The underlying assets or risk factors are modeled with a normal distribution. The risk of a portfolio, which may exhibit non-linear payoffs with options securities, is modeled by its delta, or the instantaneous rate of change in its value with respect to the rate of change in the underlying. A better approximation includes the second derivative of the portfolio value with the underlying assets or risk factors, called the delta-gamma method.

15.1.4 Monte Carlo Simulation method

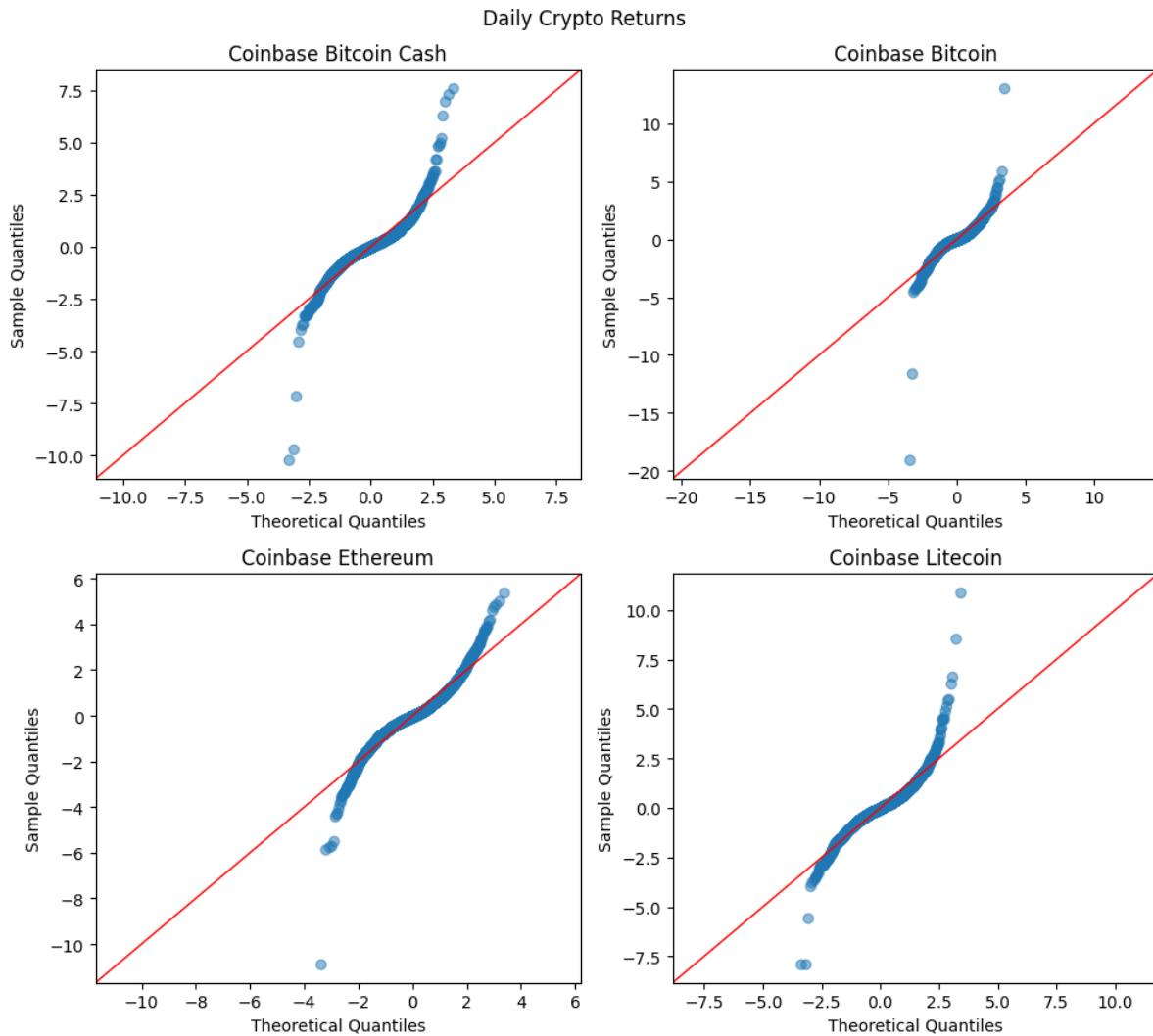
Monte Carlo simulation works for both linear and non-linear portfolios. This method generates scenarios by taking random samples from the normal (or other theoretical) distribution assumed for the underlying assets or risk factors. Suppose 1000 MC scenarios are simulated: the VaR with $\alpha = 95\%$ confidence will be the 50th (i.e. 5th percentile) worst loss and expected shortfall is the average of the 49 losses worse than this.

However, simple models based on Gaussian and independence assumptions may not be appropriate for the data sample, requiring the consideration of **non-parametric** approaches.

The QQ plot compare the distribution of the data sample to a reference normal distribution. The plot would appear linear when the observed quantiles are close to the theoretical quantiles. If the empirical distribution has heavier tails than the reference distribution, the QQ plot will have steeper slopes at its tails.

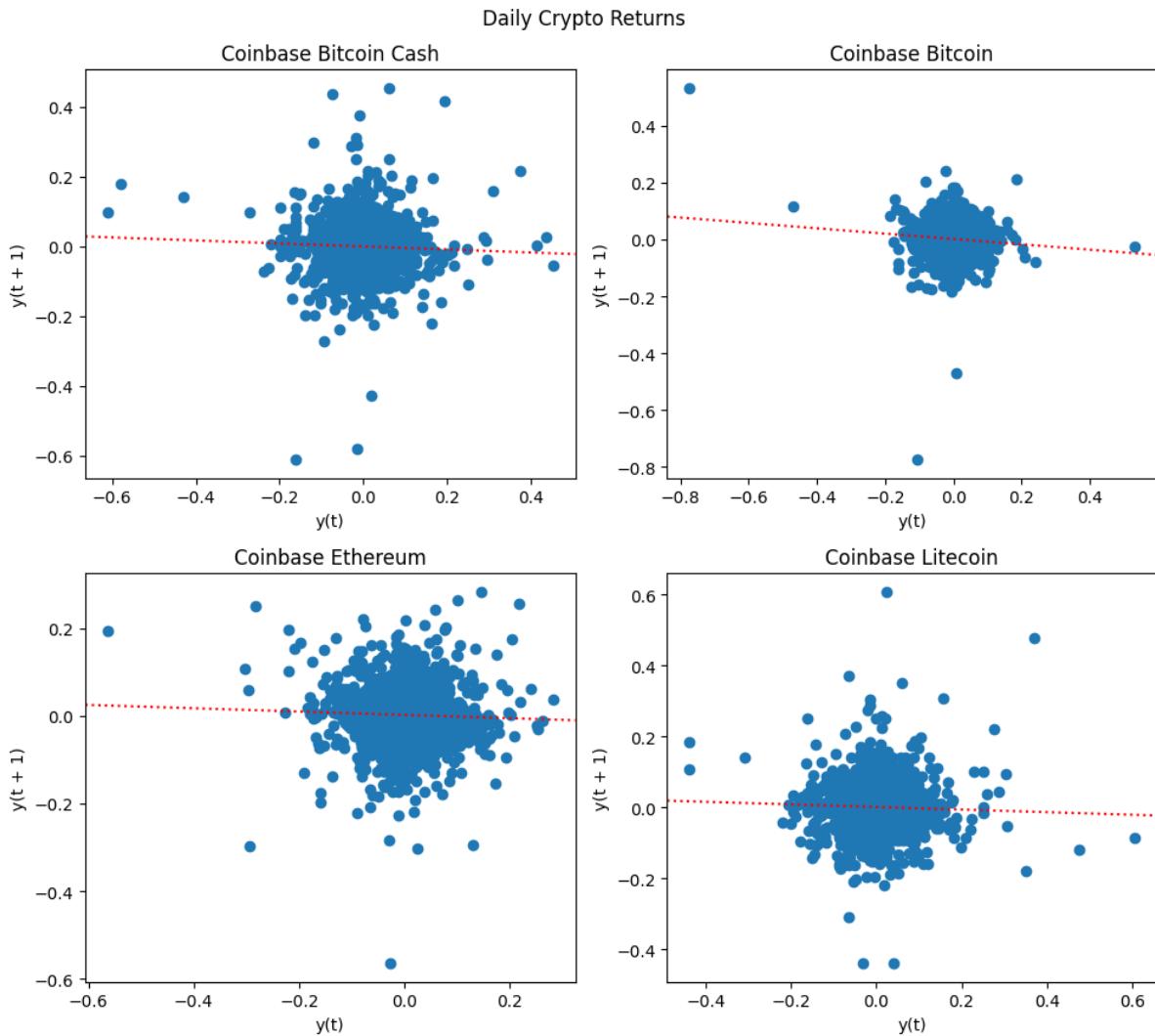
```
# QQ Plot for Gaussian assumption
from statsmodels.graphics.gofplots import ProbPlot
fig, axes = plt.subplots(2, 2, figsize=(10, 9))
for label, ax in zip(cryptos, axes.flatten()):
    pp = ProbPlot(cryptos[label].dropna(), fit=True)
    pp.qqplot(ax=ax, color='C0', alpha=.5)
    sm.qqline(ax=ax, fmt='r--', line='45', lw=1)
    ax.set_title(f"\"{titles[label]}\"")
plt.suptitle("Daily Crypto Returns")
plt.tight_layout()
```

```
/home/terence/env3.11/lib/python3.11/site-packages/statsmodels/graphics/gofplots.
  ↵py:1045: UserWarning: color is redundantly defined by the 'color' keyword
  ↵argument and the fmt string "b" (-> color=(0.0, 0.0, 1.0, 1)). The keyword
  ↵argument will take precedence.
  ↵ax.plot(x, y, fmt, **plot_style)
```



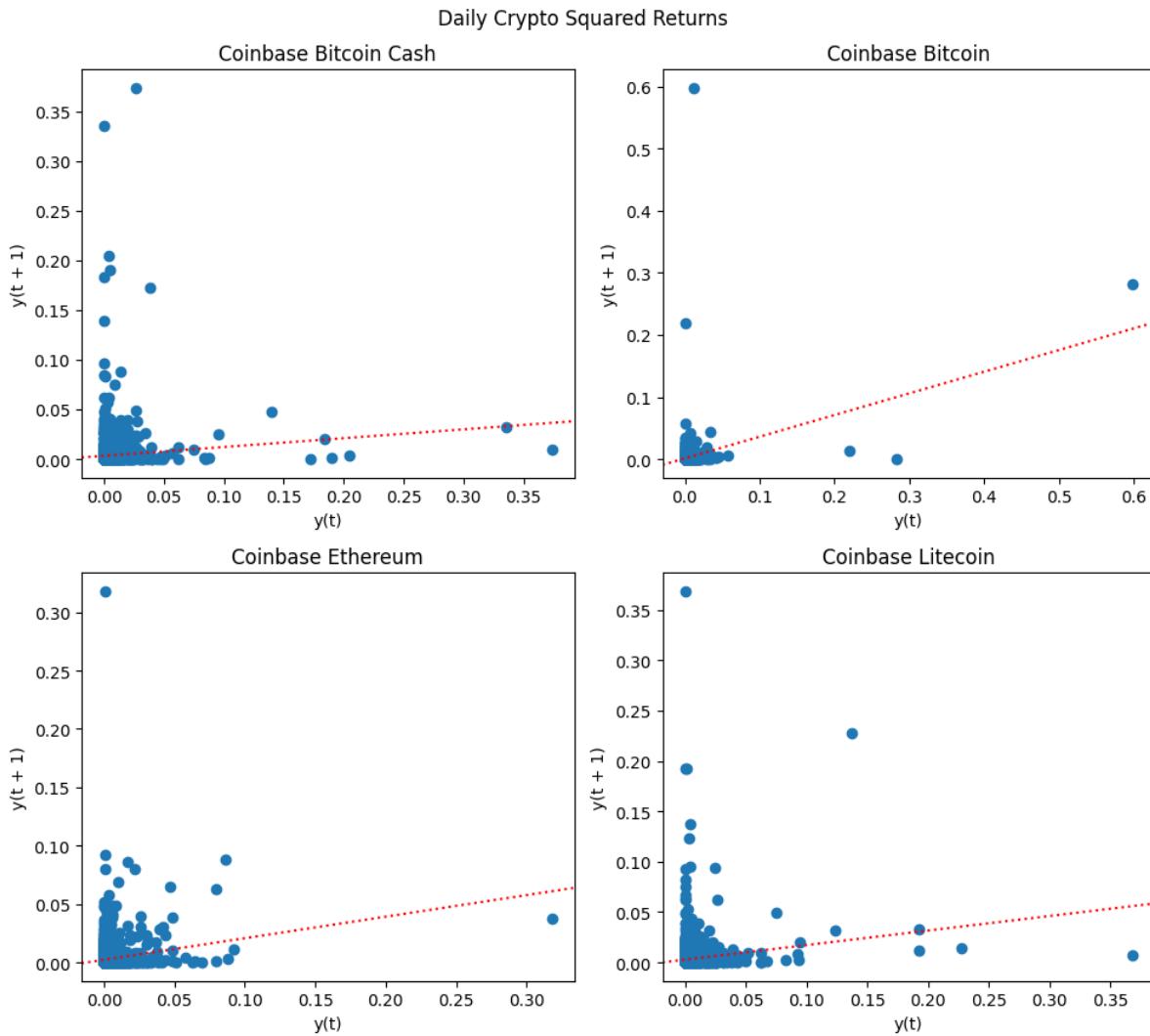
Lagplot of daily returns

```
# Autocorrelation of returns
import statsmodels.api as sm
fig, axes = plt.subplots(2, 2, figsize=(10, 9))
for label, ax in zip(cryptos, axes.flatten()):
    X = cryptos[label].dropna()
    pd.plotting.lag_plot(X, lag=1, ax=ax)
    r = stats.linregress(X.values[1:], X.values[:-1])
    ax.axline((0, r.intercept), slope=r.slope, ls=':', color="red")
    ax.set_title(f"{titles[label]}")
plt.suptitle("Daily Crypto Returns")
plt.tight_layout()
```



Lagplot of squared daily returns

```
# Autocorrelation of squared returns
fig, axes = plt.subplots(2, 2, figsize=(10, 9))
for label, ax in zip(cryptos, axes.flatten()):
    X = cryptos[label].dropna()**2
    pd.plotting.lag_plot(X, lag=1, ax=ax)
    r = stats.linregress(X.values[1:], X.values[:-1])
    ax.axline((0, r.intercept), slope=r.slope, ls=':', color="red")
    ax.set_title(f"{titles[label]}")
plt.suptitle("Daily Crypto Squared Returns")
plt.tight_layout()
```



15.1.5 Historical Simulation method

The simplest non-parametric approach to estimate VaR is by means of historical simulation (HS). The HS approach estimates VaR by ordering the loss observations and reading off the required VaR quantile. Expected shortfall is computed by averaging the observations smaller than that quantile. Since non-parametric approaches do not depend on assumptions about the model distribution, they can accommodate fat tails, skewness, and any other non-normal features that can cause problems for parametric approaches. However, non-parametric approaches are affected by how representative of data sample is of the period to be measured.

```
# Helper to compute VaR, ES and sample moments from historical simulation
def historical_risk(X: Series, alpha: float):
    """Calculate historical VaR, ES, and sample moments"""
    X = X.dropna()
    N = len(X)
    var = -np.percentile(X, 100 * (1 - alpha))
    es = -np.mean(X[X < var])
    vol = np.std(X, ddof=0)
    skew = stats.skew(X)
```

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```

kurt = stats.kurtosis(X)
jb = stats.jarque_bera(X)[0]
jbp = stats.jarque_bera(X)[1]
return dict(N=N, value_at_risk=var, expected_shortfall=es, volatility=vol,
            skewness=skew, excess_kurtosis=kurt-3, jb_statistic=jb, jb_pvalue=jbp)

```

```

hist = DataFrame({label: historical_risk(cryptos[label], alpha=alpha)
                  for label in cryptos})
print(f"Historical Risk Measures (alpha={alpha})")
row_formatted(hist.round(4), {'N': '{:.0f}'})

```

Historical Risk Measures (alpha=0.95)

	CBBCHUSD	CBBTCUSD	CBETHUSD	CBLTCUSD
N	2302	3388	2886	2796
value_at_risk	0.0844	0.0606	0.0764	0.0836
expected_shortfall	0.0082	0.0031	0.0054	0.0064
volatility	0.0597	0.0407	0.052	0.0557
skewness	-0.2437	-1.8572	-0.4497	0.7674
excess_kurtosis	12.8465	51.3866	5.8203	10.2764
jb_statistic	24108.4383	419504.1796	9452.3917	20809.0086
jb_pvalue	0.0	0.0	0.0	0.0

15.1.6 Stressed VaR method

Volatilities increase during stressed market conditions, and correlations also generally increase. It is sometimes stated that “in stressed markets all correlations go to one.” In periods of heightened volatility such as the Great Financial Crisis of 2008, correlations can be quite different from those in normal market conditions. This is sometimes referred to as a correlation break-down. When concerned with estimating what will happen in extreme market conditions, VaR or ES should be estimated based what correlations will be in such conditions rather than in normal market conditions.

Stress testing is designed to identify vulnerabilities, particularly those involving high volatility. **Stressed VaR** is computed based on a “stressed” historical period in the markets, as opposed to simply the most recent number of years, to get an idea of possible losses given worse market conditions. For example, the period from Nov 2021 through November 21, 2022 has been dubbed the “crypto winter”, culminating with collapse of the FTX crypto exchange.

```

beg, end = '2021-11-01', '2022-11-21' # dubbed "crypto winter"
stress = DataFrame({label: historical_risk(cryptos.loc[beg:end, label], alpha=alpha)
                     for label in cryptos})
print(f"Stressed Risk Measures ({beg} to {end})")
row_formatted(stress.round(4).rename_axis(index='(alpha=0.05)'), {'N': '{:.0f}'})

```

Stressed Risk Measures (2021-11-01 to 2022-11-21)

	CBBCHUSD	CBBTCUSD	CBETHUSD	CBLTCUSD
(alpha=0.05)				
N	386	386	386	386
value_at_risk	0.0818	0.0624	0.0773	0.0911
expected_shortfall	0.0078	0.0058	0.0074	0.0053
volatility	0.0464	0.0348	0.0461	0.0478

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skewness	-0.3194	-0.5904	-0.3785	-0.417
excess_kurtosis	-0.5048	0.7985	-0.6065	-1.0258
jb_statistic	106.6976	254.4822	101.3559	73.8708
jb_pvalue	0.0	0.0	0.0	0.0

15.1.7 Bootstrap method

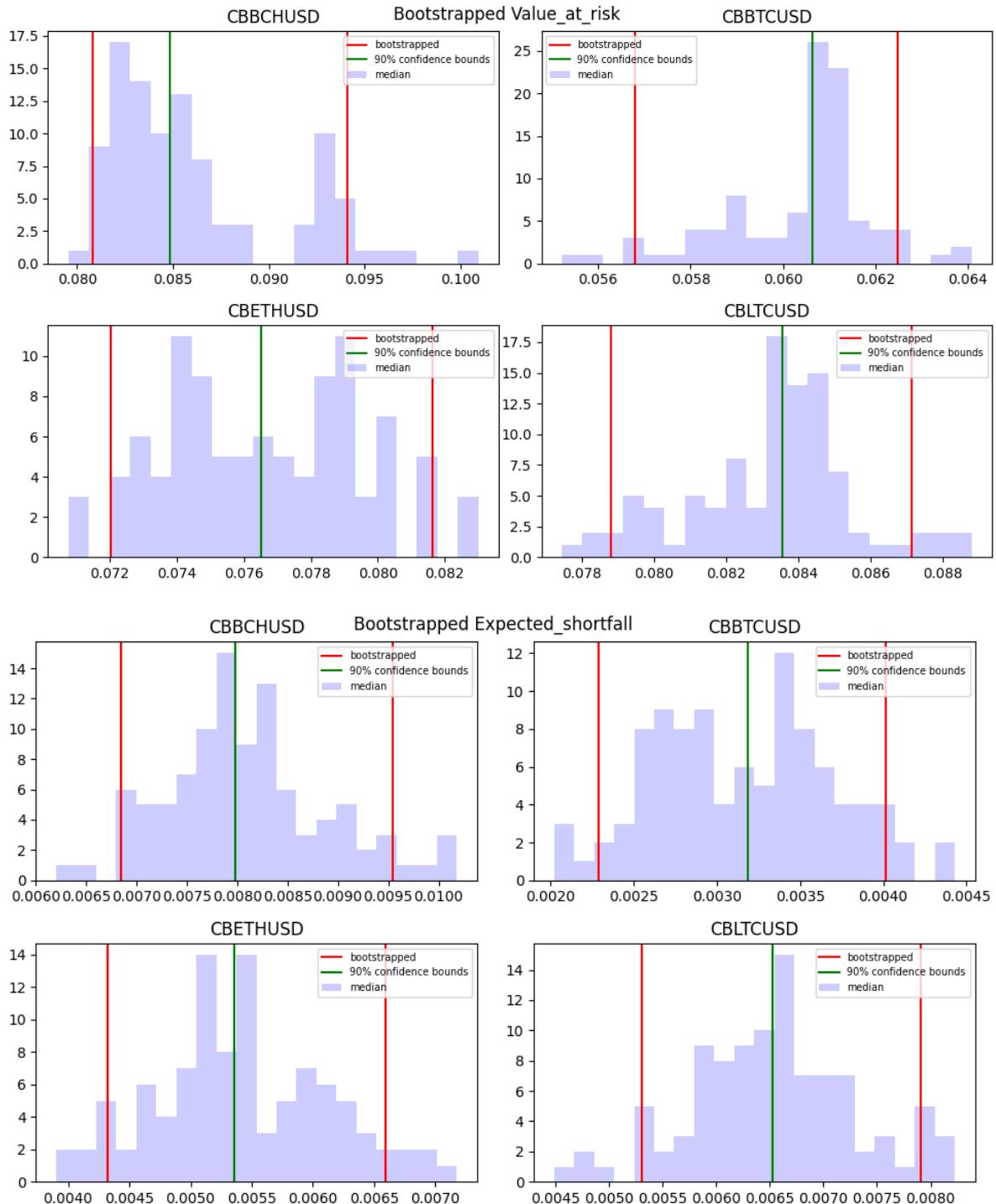
One simple but powerful improvement over basic HS is to estimate VaR and ES from bootstrapped data. The bootstrap procedure involves resampling from the existing data set with replacement. Each new ‘resampled’ sample gives us a new VaR estimate, and their mean can be taken to be the best estimate, with standard error and confidence interval computed from the distribution of resample-based estimates. We can also use the bootstrap to estimate ES’s in much the same way.

Perhaps the main limitation of the bootstrap is that standard bootstrap procedures presuppose that observations are independent over time. There are various way to modify bootstraps to allow for such dependence, such as the block approach: Divide sample data into non-overlapping blocks of equal length, and select a block at random.

```
def bootstrap_risk(X: Series, alpha: float, n: int) -> dict:
    """Calculate bootstrap VaR, ES, confidence and plot VaR histogram"""
    X = X.dropna()
    N = len(X)
    bootstraps = []
    for _ in range(n):
        Z = Series(np.random.choice(X, N), index=X.index)
        bootstraps.append(historical_risk(Z, alpha=alpha))
    bootstraps = DataFrame.from_records(bootstraps)
    return bootstraps
```

```
def confidence_intervals(X: Series, confidence: float) -> dict:
    """Extracts confidence intervals and median from a series"""
    lower = (1 - confidence) / 2
    upper = lower + confidence
    return np.quantile(X, [lower, 0.5, upper], method='inverted_cdf')
```

```
# Run and plot bootstrapped VaR and ES
n = 100
confidence = 0.9
intervals = dict()
for measure in ['value_at_risk', 'expected_shortfall']:
    intervals[measure] = dict()
    fig, axes = plt.subplots(2, 2, figsize=(10, 6))
    for label, ax in zip(cryptos, axes.flatten()):
        bootstraps = bootstrap_risk(cryptos[label].dropna(), alpha=alpha, n=n)
        interval = confidence_intervals(bootstraps[measure], confidence=confidence)
        intervals[measure][label] = interval.tolist()
        ax.hist(bootstraps[measure], color='blue', alpha=0.2, bins=int(n/5))
        ax.axvline(x=interval[0], color='red')
        ax.axvline(x=interval[1], color='green')
        ax.legend(['bootstrapped', f'{confidence*100:.0f}% confidence bounds',
                  'median'], fontsize='x-small')
        ax.axvline(x=interval[2], color='red')
        ax.set_title(label)
    plt.tight_layout()
    plt.suptitle('Bootstrapped ' + measure.capitalize())
```



```
# display confidence intervals of VaR
DataFrame(intervals['value_at_risk'], index=['lower', 'median', 'upper']) \
    .rename_axis(index='Value at Risk')
```

	CBBCHUSD	CBBTCUSD	CBETHUSD	CBLTCUSD
Value at Risk				

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lower	0.080831	0.056794	0.072047	0.078821
median	0.084858	0.060644	0.076511	0.083562
upper	0.094109	0.062483	0.081622	0.087124

```
# display confidence intervals of VaR
DataFrame(intervals['expected_shortfall'], index=['lower', 'median', 'upper'])\
    .rename_axis(index='Expected Shortfall')
```

	CBBCHUSD	CCBTCUSD	CBETHUSD	CBLTCUSD
Expected Shortfall				
lower	0.006844	0.002288	0.004324	0.005304
median	0.007976	0.003185	0.005357	0.006525
upper	0.009545	0.004016	0.006594	0.007911

15.2 Conditional volatility models

A return distribution may have parameters that vary through time. For ample, a simple mixture model of two normal distributions with different volatilities exhibits more peakedness and fatter tails than the normal. It is important to distinguish between a model where returns are unconditionally normal and a model where they are conditionally normal. In the latter, the return distribution is normal each day, while the standard deviation of the return varies throughout time (in other words, volatility is stochastic). During some periods it is high; during other periods it is low. This leads to an unconditional distribution with fat tails.

15.2.1 EWMA model

Current volatility can be estimated as an equal-weighted average of recent squared returns. This makes a simplifying assumption that the expected return is 0, which is reasonable over short periods such as daily where the standard deviation of the return is much more important than the mean. One problem with using an equal average is that a large (squared) return entering or dropping out of the sample is that the volatility will experience a large one-day increase or drop.

One way of overcoming these problems is to use exponential smoothing, which is also referred to as the exponentially weighted moving average (EWMA). In EWMA, the weight applied to the squared return from k days ago is λ multiplied by the weight applied to the squared return $k - 1$ days ago (where λ is a positive constant that is less than one). In the 1990s, the JP Morgan RiskMetrics group used this approach and found that setting $\lambda = 0.94$ proved a good choice for estimating volatilities of a wide range of market variables. The EWMA estimate can be conveniently expressed as a recursive equation:

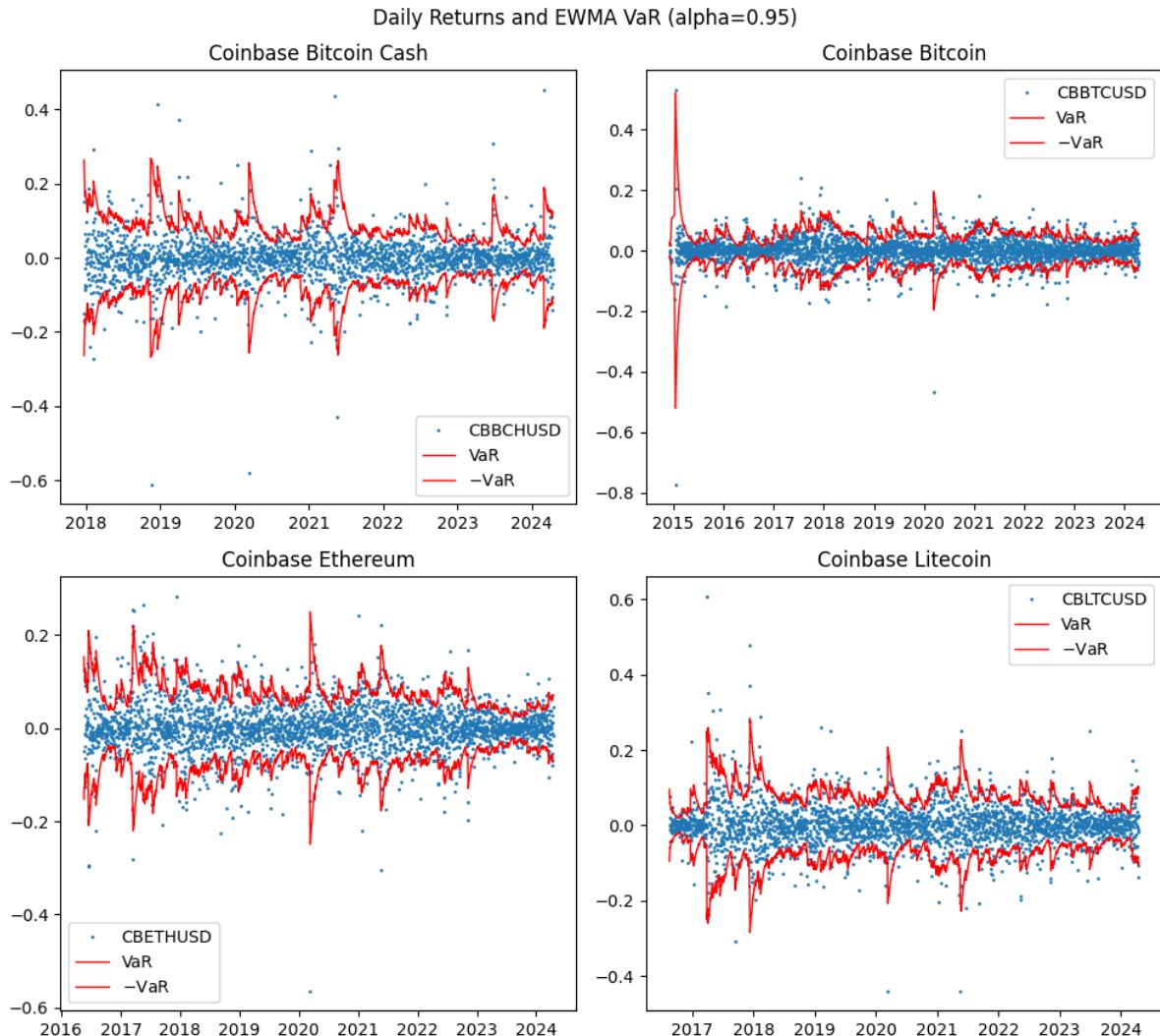
$$\sigma_t^2 = (1 - \lambda)r_{t-1}^2 + \lambda\sigma_{t-1}^2$$

This formula provides a very simple way of implementing EWMA. The new estimate of the variance rate on day n is a weighted average of the estimate of the variance rate made for the previous day ($n - 1$), and the most recent observation of the squared return on day ($n - 1$).

```
# Estimate EWMA (lambda=0.94) rolling model predictions for all cryptos
lambda_ = 0.94
ewma = {label: np.sqrt((cryptos[label]**2).dropna().ewm(alpha=1-lambda_).mean())
        for label in cryptos}
```

```
# Helper to plot predicted VaR vs actual returns
def plot_var(X: Series, VaR: Series, ax: plt.Axes):
    """Helper to plot returns and VaR predictions"""
    ax.plot(X, ls='.', marker='.', markersize=2)
    ax.plot(-VaR.shift(-1), lw=1, ls='-', c='r')
    ax.plot(VaR.shift(-1), lw=1, ls='-', c='r')
    ax.legend([X.name, 'VaR', '$-$VaR'])
```

```
# Plot daily returns and EWMA predicted VaR of all cryptos
fig, axes = plt.subplots(2, 2, figsize=(10, 9))
for label, ax in zip(cryptos, axes.flatten()):
    Z = pd.concat([cryptos[label].dropna(),
                   parametric_risk(ewma[label], alpha=alpha) ['value_at_risk']\n                   .rename('VaR')],
                  join='inner', axis=1).dropna()
    plot_var(Z[label], VaR=Z['VaR'], ax=ax)
    ax.set_title(titles[label])
plt.suptitle(f"Daily Returns and EWMA VaR (alpha={alpha})")
plt.tight_layout()
```



```
# Properties of EWMA normalized returns for all cryptos
ewma_hist = dict()
for label in cryptos:
    X = (cryptos[label] / ewma[label].shift(-1)) # normalize by predict vol
    ewma_hist[label] = Series(historical_risk(X, alpha=0.95)).rename(label)
print("Normalized by EWMA predicted volatility (alpha=0.95)")
DataFrame(ewma_hist).round(4)
```

Normalized by EWMA predicted volatility (alpha=0.95)

	CBBCHUSD	CCBTCUSD	CBETHUSD	CBLTCUSD
N	2301.0000	3387.0000	2885.0000	2795.0000
value_at_risk	1.5056	1.4689	1.5831	1.5682
expected_shortfall	0.1249	0.0673	0.0778	0.0922
volatility	0.9260	0.9220	0.9417	0.9416
skewness	0.1289	-0.0729	-0.0307	0.0187
excess_kurtosis	-1.3967	-1.4662	-2.1265	-1.7600
jb_statistic	252.8316	334.9892	92.1766	179.2390
jb_pvalue	0.0000	0.0000	0.0000	0.0000

15.2.2 GARCH model

The generalized autoregressive conditional heteroskedasticity or **GARCH** model, developed by Robert Engle and Tim Bollerslev, can be intuitively regarded as an extension of EWMA. In GARCH (1,1), we also give some weight to a long run average variance rate $\hat{\sigma}$. The updated formula for the variance rate is:

$$\sigma_t^2 = \alpha r_{t-1}^2 + \beta \sigma_{t-1}^2 + \gamma \hat{\sigma}$$

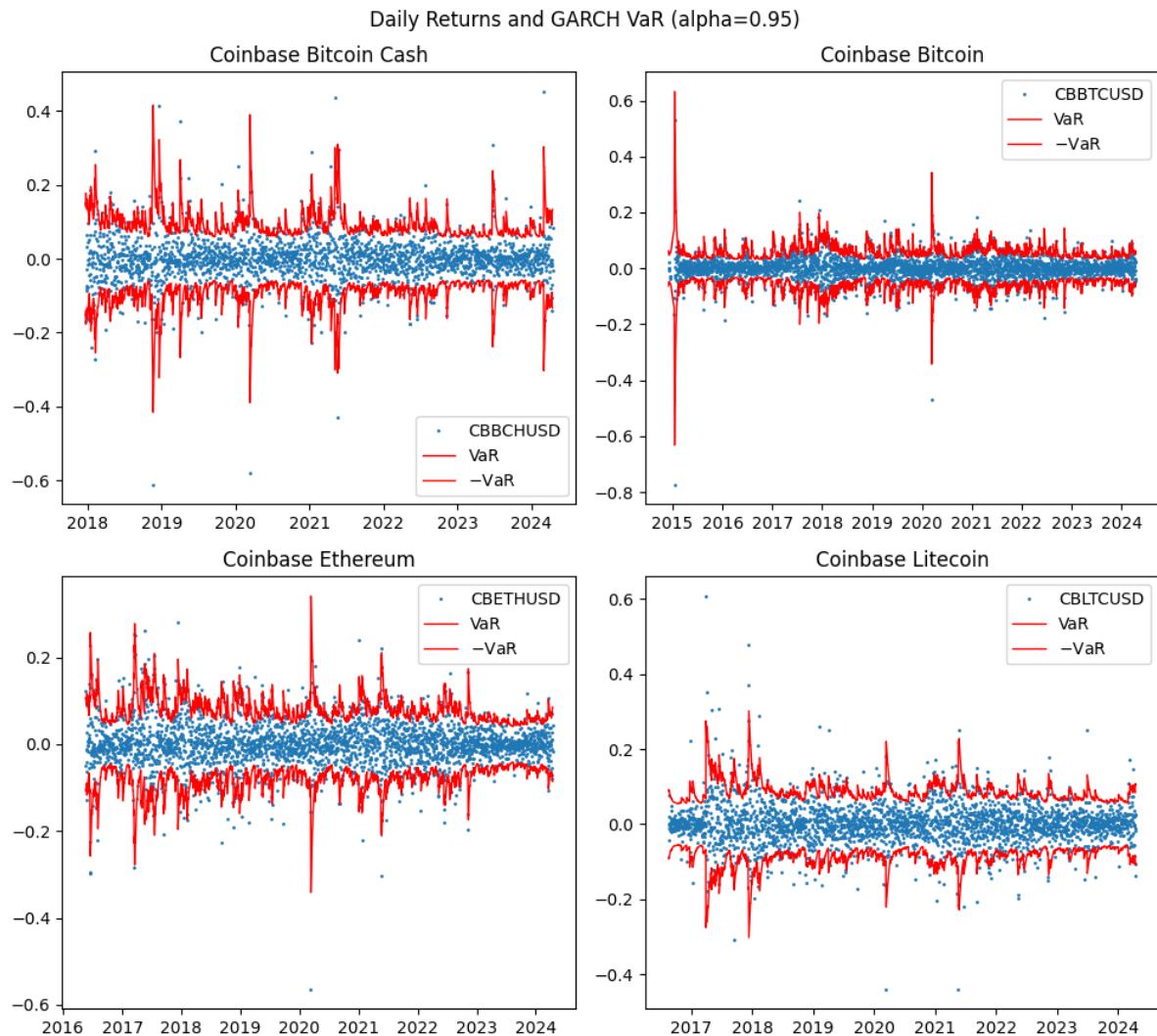
The weights must be sum to one, hence $\alpha + \beta \leq 1$ and $\gamma = 1 - \alpha - \beta$.

GARCH (1,1), compared to EWMA, incorporate mean-reversion where the $\hat{\sigma}$ term provides a “pull” toward the long-run average mean. And just as with ARMA specifications of time series models, GARCH(p,q) can incorporate additional lags of q squared returns and p previous variance rate estimates to generate better fitting models.

```
# Estimate GARCH(1, 1) by calling R's rugarch library
import rpy2.robjects as ro
from rpy2.robjects.packages import importr
from finds.utils import PyR
def rugarch(X: Series, savefig: str = '', verbose=VERBOSE) -> Series:
    """GARCH(1,1) wrapper around rugarch"""
    rugarch_ro = importr('rugarch') # to use library rugarch
    c_ = ro.r['c']
    list_ = ro.r['list']
    spec = ro.r['ugarchspec'](mean_model=list_(armaOrder=c_(0,0), include_mean=False))
    model = ro.r['ugarchfit'](spec, data=PyR(X.values).ro)
    if verbose:
        ro.r['show'](model)
    if savefig:
        for which in [4, 5, 10, 11]:
            ro.r['plot'](model, which=which)
            PyR.savefig(f"{savefig}{which}.png", display=None)
    return Series(PyR(ro.r['sigma'](model)).values.flatten(),
                 index=X.index, name=X.name)
```

```
# Estimate GARCH(1,1) full period model for all cryptos
garch = {label: rugarch(cryptos[label].dropna()) for label in cryptos}
```

```
# Plot daily returns and GARCH predicted VaR
alpha = 0.95 # VaR parameter
fig, axes = plt.subplots(2, 2, figsize=(10, 9))
for label, ax in zip(cryptos, axes.flatten()):
    Z = pd.concat([cryptos[label],
                   parametric_risk(garch[label], alpha=alpha) ['value_at_risk']\n                   .rename('VaR')],\n                   join='inner', axis=1).dropna()
    plot_var(Z[label], VaR=Z['VaR'], ax=ax)
    ax.set_title(titles[label])
plt.suptitle(f"Daily Returns and GARCH VaR (alpha={alpha})")
plt.tight_layout()
```



```
# Properties of GARCH normalized returns
garch_hist = dict()
```

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```

for label in cryptos:
    X = (cryptos[label] / garch[label].shift(-1)) # normalize by predict vol
    garch_hist[label] = Series(historical_risk(X, alpha=0.95)).rename(label)
print("Normalized by GARCH predicted volatility (alpha=0.95)")
DataFrame(garch_hist).round(4)

```

Normalized by GARCH predicted volatility (alpha=0.95)

	CBBCHUSD	CBBTCUSD	CBETHUSD	CBLTCUSD
N	2301.0000	3387.0000	2885.0000	2795.0000
value_at_risk	1.3172	1.2899	1.4004	1.4004
expected_shortfall	0.1053	0.0467	0.0755	0.0844
volatility	0.7728	0.7654	0.8372	0.8437
skewness	0.0286	-0.0493	-0.0064	0.0512
excess_kurtosis	-2.6270	-2.8977	-2.8001	-1.8373
jb_statistic	13.6517	2.8470	4.8221	158.6495
jb_pvalue	0.0011	0.2409	0.0897	0.0000

15.3 Backtesting VaR

The simplest method to verify the accuracy of the model is to record the failure rate, which gives the proportion of times VaR is exceeded in a given sample. The number of violations or exceptions should follow a binomial distribution with probability of failure $p = 1 - \alpha$, where α is the VaR confidence level. The VaR model can be rejected in two regions, both when the number of observed violations is too few or too many.

15.3.1 Kupiec Likelihood Ratio test

Kupiec (1995) develops approximate 95 percent confidence regions for such a test, based on by the (two-sided) tail points of the log-likelihood ratio:

$$LR = -2[(N - S) \ln(1 - p) + S \ln(p)] + 2[(N - S) \ln(1 - S/N) + S \ln(S/N)]$$

```

def kupiec_LR(alpha: float, s: int, n: int):
    """Compute Kupiec likelihood ratio given s violations in n trials

    Returns:
        Dict of likelihood statistic and pvalue
    """
    p = 1 - alpha      # prob of violation
    num = np.log(1 - p)*(n - s) + np.log(p)*s
    den = np.log(1 - (s/n))*(n - s) + np.log(s/n)*s
    lr = -2 * (num - den)
    return {'lr': lr, 'violations': s, 'N': n,
            '# 5%-critical': stats.chi2.ppf(0.95, df=1),
            'pvalue': 1 - stats.chi2.cdf(lr, df=1)}

```

```

def kupiec(X: Series, VaR: Series, alpha: float) -> Dict:
    """Kupiec Likelihood Ratio test of VaR

```

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```
>Returns:
    Dict of likelihood statistic and pvalue
"""
Z = pd.concat([X, VaR], axis=1).dropna()
n = len(Z)
s = np.sum(Z.iloc[:, 0] < -Z.iloc[:, 1]) # number of violations < -VaR
return kupiec_LR(alpha=alpha, s=s, n=n)
```

```
# Kupiec likelihood ratio test for EWMA
row_formatted(DataFrame(
    {label: kupiec(cryptos[label],
                    VaR=parametric_risk(ewma[label], alpha=alpha) ['value_at_risk'],
                    alpha=alpha) for label in cryptos})\
    .rename_axis(index=f"EWMA({lambda_:})", columns="Kupiec LR Test:")\
    .round(4),
    {'N': '{:.0f}', 'violations': '{:.0f}'})
```

Kupiec LR Test: CBBCHUSD CBBTCUSD CBETHUSD CBLTCUSD				
EWMA(0.94)				
lr	1.6293	3.2575	1.3298	2.7826
violations	102	147	131	121
N	2302	3388	2886	2796
pvalue	0.2018	0.0711	0.2488	0.0953

```
# Kupiec likelihood ratio test for GARCH(1,1)
row_formatted(DataFrame(
    {label: kupiec(cryptos[label],
                    VaR=parametric_risk(garch[label], alpha=alpha) ['value_at_risk'],
                    alpha=alpha) for label in cryptos})\
    .rename_axis(index=f"GARCH(1,1)", columns="Kupiec LR Test:").round(4),
    {'N': '{:.0f}', 'violations': '{:.0f}'})
```

Kupiec LR Test: CBBCHUSD CBBTCUSD CBETHUSD CBLTCUSD				
GARCH(1,1)				
lr	5.2248	5.302	3.8198	10.5494
violations	92	141	122	104
N	2302	3388	2886	2796
pvalue	0.0223	0.0213	0.0507	0.0012

15.3.2 Conditional coverage tests

This framework focuses on unconditional coverage because it ignores time variation in the data. In theory, the exceptions should be evenly spread over time. The observations could cluster or “bunch” closely in time, which also may invalidate the model. The LR statistic can be extended to specify that the deviations must be serially independent.

```
# TODO: conditional likelihood test
```

COVARIANCE MATRIX

Alone, we can do so little; together, we can do so much - Helen Keller

Concepts

- Portfolio Risk Analysis
- Covariance Matrix Estimation

References

- FRM Part II Exam Book Investment Management Ch. 5
- Chen et al., “Shrinkage Algorithms for MMSE Covariance Estimation” IEEE Trans. # on Sign. Proc., Volume 58, Issue 10, October 2010.
- Olivier Ledoit and Michael Wolf, “Honey, I Shrunk the Sample Covariance Matrix”, July 2003, The Journal of Portfolio Management 30(4)
- Florin Spinu, “An algorithm for computing risk parity weights,” SSRN, 2013.

```
import numpy as np
from sklearn.decomposition import PCA
from pandas import DataFrame
import cvxpy as cp
from tqdm import tqdm
import matplotlib.pyplot as plt
import matplotlib.colors as mcolors
from sklearn.covariance import LedoitWolf, OAS, EmpiricalCovariance
from sklearn import cluster
from finds.utils import ColorMap
from finds.readers import FFReader
import warnings
warnings.simplefilter(action='ignore', category=FutureWarning)

# %matplotlib qt
VERBOSE = 0
```

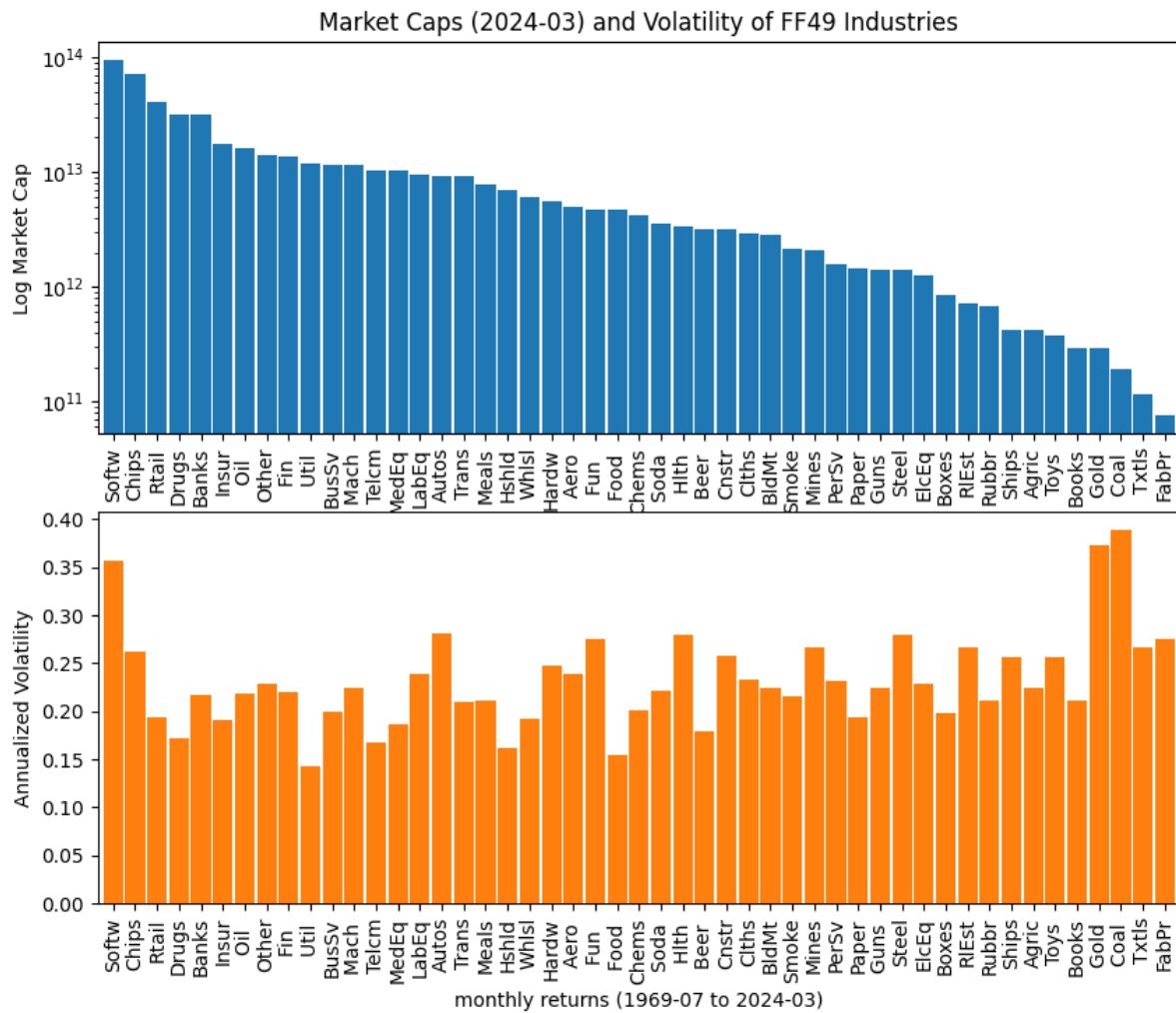
16.1 Portfolio risk analysis

```
# Retrieve industry returns from Ken French Data Library website
symbol = '49_Industry_Portfolios'
ff = FFReader(symbol)
keep = ff[0].index[(ff[0] > -99).all(axis=1)]
rets = (ff[0] / 100).reindex(keep)
caps = (ff[4] * ff[5] * 10e6).reindex(keep)    # number of firms x avg market cap
weights = caps.iloc[-1] / caps.iloc[-1].sum()
```

```
X = (rets - rets.mean(axis=0))      # demean by industry
sigma = 12 * X.T @ X / len(X)      # annualized covariance matrix
Y = caps.iloc[-1] \
    .rename('cap') \
    .to_frame() \
    .join(DataFrame({'vol': np.sqrt(np.diag(sigma))}, index=X.columns)) \
    .sort_values('cap', ascending=False)
```

```
# Plot annualized volatility and market caps of industries
fig, ax = plt.subplots(nrows=2, figsize=(10, 8))
Y['cap'].plot.bar(ax=ax[0], color="C0", width=0.9)
ax[0].set_yscale('log')
ax[0].set_title(f"Market Caps ({X.index[-1]}) and Volatility of FF49 Industries")
ax[0].set_ylabel(f"Log Market Cap")
Y['vol'].plot.bar(ax=ax[1], color="C1", width=0.9)
ax[1].set_ylabel(f"Annualized Volatility")
ax[1].set_xlabel(f"monthly returns ({X.index[0]} to {X.index[-1]})")
```

```
Text(0.5, 0, 'monthly returns (1969-07 to 2024-03)')
```



16.1.1 Risk budgetting

- Portfolio Risk - volatility of (market) portfolio is $\sigma_P = W^T \Sigma W$, where W is the vector of securities' weights in the portfolio and Σ is the covariance matrix of their returns
- Covariance: $\sigma_{iP} = \rho_{iP} \cdot \sigma_i \cdot \sigma_P$, where ρ_{iP} is the correlation of the returns of security i w.r.t portfolio P
- Beta - the systematic risk risk of security vs portfolio, or regression slope of the security's returns on portfolio returns: $\beta_i = \frac{\sigma_{iP}}{\sigma_P^2}$
- Marginal Contribution to Risk - sensitivity of portfolio volatility to small change in weight: $\frac{\partial \sigma_P}{\partial w_i} = \frac{\sigma_{iP}}{\sigma_P}$
- Percent Contribution to Risk - what fraction of portfolio risk would change approximately if this security was deleted from the portfolio: $\beta_i \cdot w_i$. This risk decomposition that sums to 1.
- Contribution to risk - this decomposition of portfolio risk sums to portfolio volatility. It can also be expressed as asset weight times asset volatility times correlation with portfolio: $\beta_i \cdot w_i \cdot \sigma_P = w_i \cdot \sigma_i \cdot \rho_{iP}$.

```
# Helper to compute portfolio risk budget
def risk_budget(w, sigma, labels):
```

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```
"""Compute portfolio risk analytics"""
sigma_ = np.array(sigma) * 100 * 100    # express as percent returns
w_ = np.array(w)

# Portfolio volatility (percent)
vol = np.sqrt(w_.T @ sigma_ @ w_)

# Covariance of each security wrt market portfolio
cov = sigma_ @ w_

# Beta of each security wrt market portfolio
beta = cov / (w_.T @ sigma_ @ w_)

# Marginal Contribution to Risk of each security
marginal = beta * vol

# Percent Contribution to Risk
percent = beta * w_ * 100

# Contribution to Risk
contrib = marginal * w_

return DataFrame({'weight': list(w),
                  'Beta': list(beta),
                  'MCR(%)': list(marginal),
                  'PCR(%)': list(percent),
                  'CR': list(contrib)},
                  index=labels)
```

```
vol = np.sqrt(weights.T @ sigma @ weights) # market portfolio risk
print(f"Market Portfolio Risk Budget (vol={vol*100:.2f}%)")
risk_budget(weights, sigma, weights.index).sort_values('CR', ascending=False)
```

Market Portfolio Risk Budget (vol=19.35%)

	weight	Beta	MCR (%)	PCR (%)	CR
Softw	0.192584	1.574845	30.475899	30.328962	5.869164
Chips	0.142872	1.179219	22.819870	16.847733	3.260319
Rtail	0.081477	0.827907	16.021394	6.745528	1.305373
Banks	0.064025	0.845579	16.363371	5.413810	1.047663
Drugs	0.064479	0.589820	11.414007	3.803093	0.735962
Fin	0.027743	0.969658	18.764520	2.690145	0.520588
Insur	0.035976	0.728126	14.090454	2.619527	0.506922
Other	0.028330	0.910110	17.612159	2.578348	0.498954
Mach	0.023061	0.972623	18.821886	2.242987	0.434056
BusSv	0.023067	0.955382	18.488250	2.203781	0.426469
LabEq	0.019119	1.052405	20.365795	2.012080	0.389371
Oil	0.032719	0.596297	11.539353	1.951038	0.377559
Autos	0.018619	0.986945	19.099042	1.837576	0.355602
Trans	0.018589	0.883918	17.105289	1.643083	0.317964
MedEq	0.020948	0.724425	14.018833	1.517501	0.293662
Meals	0.015693	0.869115	16.818833	1.363934	0.263944
Telcm	0.020987	0.594172	11.498234	1.247000	0.241315
Hardw	0.011335	0.986408	19.088649	1.118097	0.216371

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Fun	0.009615	1.139940	22.059751	1.096003	0.212095
Whls1	0.012280	0.871606	16.867039	1.070371	0.207135
Aero	0.009961	0.932730	18.049895	0.929067	0.179790
Util	0.024195	0.375009	7.257048	0.907339	0.175585
Hshld	0.014130	0.602340	11.656284	0.851110	0.164704
Chems	0.008469	0.810134	15.677445	0.686088	0.132770
Cnstr	0.006447	1.048531	20.290834	0.676030	0.130823
Hlth	0.006709	0.976104	18.889260	0.654847	0.126724
Clths	0.005866	0.942774	18.244268	0.553030	0.107021
BldMt	0.005701	0.956470	18.509299	0.545237	0.105512
Food	0.009570	0.504737	9.767512	0.483043	0.093477
Soda	0.007138	0.616253	11.925540	0.439867	0.085122
Beer	0.006491	0.575478	11.136461	0.373514	0.072281
Mines	0.004227	0.874984	16.932405	0.369892	0.071580
Steel	0.002806	1.047448	20.269883	0.293932	0.056881
PerSv	0.003182	0.921152	17.825841	0.293143	0.056728
ElcEq	0.002571	0.980634	18.976924	0.252161	0.048797
Paper	0.002955	0.740217	14.324451	0.218709	0.042324
Smoke	0.004310	0.482936	9.345629	0.208167	0.040284
Guns	0.002814	0.648680	12.553038	0.182568	0.035330
R1Est	0.001445	1.037531	20.077966	0.149957	0.029019
Boxes	0.001692	0.731979	14.165026	0.123842	0.023966
Rubbr	0.001372	0.874000	16.913362	0.119923	0.023207
Toys	0.000754	0.995149	19.257797	0.074994	0.014513
Ships	0.000858	0.863957	16.719015	0.074134	0.014346
Agric	0.000856	0.708072	13.702388	0.060618	0.011731
Books	0.000598	0.875354	16.939570	0.052356	0.010132
Coal	0.000392	0.881060	17.049990	0.034549	0.006686
Gold	0.000586	0.435823	8.433900	0.025519	0.004938
Txtls	0.000235	0.941579	18.221139	0.022085	0.004274
FabPr	0.000152	0.901686	17.449141	0.013682	0.002648

16.1.2 Risk parity portfolios

To construct a simple risk-parity portfolio (RPP): first equalize the risk contributions of the asset classes and then apply leverage to achieve a target volatility

A desired risk budget can be approximated as a convex optimization problem, see Spinu (2013): $\min_w \frac{1}{2} w^T \Sigma w - \sum_i b_i \log w_i$ subject to $0 \leq w_i \leq 1/N$ and $\sum_i w_i = 1$, where b_i is the desired RPP risk budget

```
# Set up variables and constraints
N = len(sigma)
b = np.ones(N) / N # risk parity
W = cp.Variable(N) # portfolio weights to solve for
constraints = [W >= 0] # non-negative weights constraint
```

```
# Solve objective
obj = 0.5 * cp.quad_form(W, sigma) - cp.sum(cp.multiply(b, cp.log(W)))
prob = cp.Problem(cp.Minimize(obj), constraints)
prob.solve()
```

2.6150587857892416

```
# normalize solution weights
rpp = (W/cp.sum(W)).value
```

```
vol = np.sqrt(rpp.T @ sigma @ rpp)
print(f"Risk Parity Portfolio (vol={vol*100:.2f}%)")
risk_budget(rpp, sigma, weights.index).sort_values('weight', ascending=False)
```

Risk Parity Portfolio (vol=16.49%)

	weight	Beta	MCR (%)	PCR (%)	CR
Util	0.038752	0.526629	8.682950	2.040816	0.336486
Food	0.030451	0.670192	11.049988	2.040816	0.336486
Smoke	0.029572	0.690115	11.378474	2.040816	0.336486
Telcm	0.028807	0.708446	11.680724	2.040816	0.336486
Drugs	0.028718	0.710630	11.716722	2.040816	0.336486
Gold	0.028147	0.725044	11.954388	2.040816	0.336486
Beer	0.027761	0.735127	12.120636	2.040817	0.336486
Hshld	0.026958	0.757049	12.482075	2.040816	0.336486
Soda	0.024502	0.832909	13.732845	2.040816	0.336486
Oil	0.024255	0.841397	13.872790	2.040816	0.336486
Guns	0.023502	0.868368	14.317474	2.040816	0.336486
MedEq	0.023254	0.877618	14.469991	2.040816	0.336486
Agric	0.022965	0.888652	14.651916	2.040816	0.336486
Insur	0.021931	0.930560	15.342893	2.040816	0.336486
Boxes	0.021501	0.949152	15.649437	2.040816	0.336486
Rtail	0.021334	0.956624	15.772626	2.040816	0.336486
Paper	0.020921	0.975495	16.083771	2.040816	0.336486
Hardw	0.019528	1.045064	17.230802	2.040816	0.336486
Banks	0.019314	1.056656	17.421937	2.040816	0.336486
Whlsl	0.019224	1.061622	17.503814	2.040816	0.336486
Chems	0.019213	1.062229	17.513827	2.040816	0.336486
Meals	0.019213	1.062229	17.513831	2.040816	0.336486
Books	0.018773	1.087080	17.923556	2.040816	0.336486
Other	0.018731	1.089539	17.964098	2.040816	0.336486
Rubbr	0.018719	1.090222	17.975366	2.040816	0.336486
Trans	0.018624	1.095792	18.067196	2.040816	0.336486
PerSv	0.018267	1.117226	18.420601	2.040816	0.336486
BusSv	0.018203	1.121150	18.485298	2.040816	0.336486
Fin	0.017891	1.140717	18.807923	2.040817	0.336486
Clths	0.017758	1.149216	18.948046	2.040816	0.336486
Ships	0.017606	1.159151	19.111846	2.040816	0.336486
FabPr	0.017405	1.172564	19.333011	2.040816	0.336486
Aero	0.017372	1.174790	19.369715	2.040816	0.336486
Mines	0.017281	1.180988	19.471892	2.040816	0.336486
ElcEq	0.017153	1.189796	19.617125	2.040816	0.336486
LabEq	0.017010	1.199755	19.781322	2.040816	0.336486
Mach	0.016924	1.205842	19.881692	2.040816	0.336486
Autos	0.016799	1.214823	20.029764	2.040816	0.336486
Toys	0.016731	1.219815	20.112076	2.040816	0.336486
BldMt	0.016702	1.221907	20.146569	2.040816	0.336486
Hlth	0.016620	1.227922	20.245745	2.040816	0.336486
Chips	0.016573	1.231395	20.302992	2.040816	0.336486
Coal	0.016564	1.232074	20.314192	2.040816	0.336486
Txtls	0.016560	1.232393	20.319461	2.040816	0.336486
RlEst	0.015650	1.304027	21.500541	2.040817	0.336486

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Cnstr	0.015634	1.305394	21.523079	2.040816	0.336486
Steel	0.015361	1.328586	21.905464	2.040816	0.336486
Fun	0.015278	1.335796	22.024346	2.040816	0.336486
Softw	0.013988	1.458990	24.055548	2.040816	0.336486

16.2 Covariance matrix estimation

16.2.1 Principal components

Each component can be interpreted as weights in a portfolio holdings the industries as assets. The projection of industry returns on a component simply computes the returns of the corresponding portfolio.

```
# Fit PCA
pca = PCA().fit(X)

# Retrieve components, and sign flip if necessary
loadings = (np.diag(pca.singular_values_) @ pca.components_).T # compute loadings by
#column
components = DataFrame.from_records(pca.components_.T, index=X.columns)
components *= np.sign(components.sum(axis=0))

# Compute projections, can be interpreted as portfolio returns
proj = pca.transform(X)
proj *= np.sign(np.sum(pca.components_, axis=1)) # flip signs if necessary

# Equal weighted market average return
avg = X.mean(axis=1)
```

The first component resembles a portfolio with long positions invested across all assets, and explains more than half the variance. The other components resemble long-short spread portfolios that explain incremental amounts of variance.

```
K = 20
print(f"Top {K} principal components")
DataFrame({
    'frac weights +ve': np.mean(components.iloc[:, :K].values >= 0, axis=0),
    'sum weights': np.sum(components.iloc[:, :K].values, axis=0),
    'sum sqr weights': np.sum((components.iloc[:, :K].values)**2, axis=0),
    'sum abs weights': np.sum(np.abs(components.iloc[:, :K].values), axis=0),
    'corr avg ret': [np.corrcoef(avg, proj[:, i])[0, 1] for i in range(K)],
    'cumulative expl ratio': np.cumsum(pca.explained_variance_ratio_[:K]),
    index=[f"PC{i+1}" for i in range(K)])
    .round(4)
```

Top 20 principal components

	frac weights +ve	sum weights	sum sqr weights	sum abs weights
PC1	1.0000	6.8347	1.0	6.8347
PC2	0.2449	0.0869	1.0	4.1490
PC3	0.5102	0.2746	1.0	3.5353
PC4	0.6735	0.9467	1.0	5.1509
PC5	0.4898	0.5331	1.0	5.2453
PC6	0.5510	0.7318	1.0	5.5496

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PC7	0.5714	0.0774	1.0	5.5749
PC8	0.5102	0.0148	1.0	4.9275
PC9	0.4898	0.1839	1.0	5.1437
PC10	0.4694	0.0692	1.0	5.6381
PC11	0.5510	0.2505	1.0	4.7172
PC12	0.5306	0.1901	1.0	5.2332
PC13	0.6735	0.1061	1.0	4.7941
PC14	0.4490	0.0851	1.0	4.8345
PC15	0.4286	0.1587	1.0	4.9447
PC16	0.4286	0.0192	1.0	4.8334
PC17	0.4694	0.0584	1.0	5.5921
PC18	0.6122	0.1920	1.0	5.1250
PC19	0.5306	0.1623	1.0	5.1083
PC20	0.4898	0.1706	1.0	5.3034
corr avg ret cumulative expl ratio				
PC1	0.9988		0.5604	
PC2	0.0043		0.6235	
PC3	0.0107		0.6636	
PC4	0.0356		0.7006	
PC5	0.0178		0.7299	
PC6	0.0213		0.7521	
PC7	0.0020		0.7701	
PC8	0.0003		0.7843	
PC9	0.0043		0.7984	
PC10	0.0015		0.8104	
PC11	0.0052		0.8218	
PC12	0.0039		0.8328	
PC13	0.0021		0.8430	
PC14	0.0016		0.8527	
PC15	0.0030		0.8621	
PC16	0.0004		0.8710	
PC17	0.0010		0.8794	
PC18	0.0033		0.8870	
PC19	0.0027		0.8941	
PC20	0.0028		0.9011	

Spectral Clustering

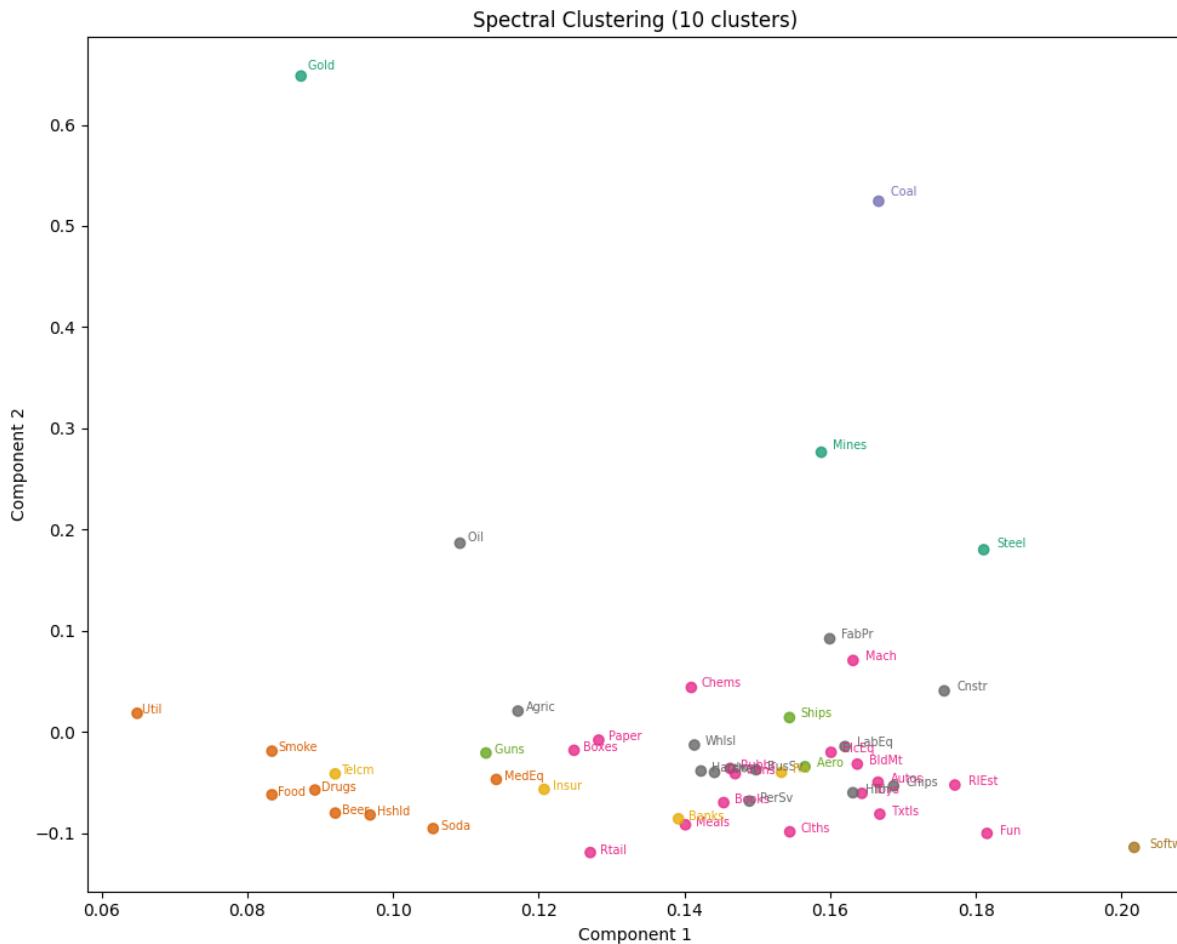
- Component 1 appears to load on the average market factor (so-called beta risk)
- Component 2 can be interpreted as loading on a commodities factor

```
# Spectral clustering
spectral = cluster.SpectralClustering(
    n_clusters=10,
    eigen_solver="arpack",
    #affinity="nearest_neighbors",
    random_state=42,
)
spectral.fit(X.T)    # number of features equals the number observations dates
cmap = ColorMap(spectral.n_clusters, colormap='Dark2')
fig, ax = plt.subplots(figsize=(10, 8))
ax.scatter(components.iloc[:, 0], components.iloc[:, 1],
           c=cmap[spectral.labels_], alpha=.8)
for t, c, xy in zip(components.index, spectral.labels_,
                     components.iloc[:, :2].values):
```

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```
    ax.annotate(text=t, xy=xy, xytext=xy * 1.01, color=cmap[c], fontsize='x-small')
ax.set_xlabel('Component 1')
ax.set_ylabel('Component 2')
ax.set_title(f"Spectral Clustering ({spectral.n_clusters} clusters}")
plt.tight_layout()
plt.show()
```



```
 DataFrame({'cluster': spectral.labels_}, index=components.index).sort_values('cluster  
↪')
```

	cluster
Steel	0
Mines	0
Gold	1
Drugs	2
MedEq	2
Util	2
Hshld	2
Smoke	2
Beer	2
Soda	2

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Food	2
Coal	3
Trans	4
ElcEq	4
Meals	4
Autos	4
Rtail	4
Mach	4
Paper	4
RlEst	4
Toys	4
BldMt	4
Txtls	4
Fun	4
Books	4
Clths	4
Rubbr	4
Chems	4
Boxes	4
Ships	5
Aero	5
Guns	5
Fin	6
Telcm	6
Insur	6
Banks	6
Softw	7
Whlsl	8
Agric	8
Bussv	8
PerSv	8
Oil	8
FabPr	8
Cnstr	8
Hlth	8
LabEq	8
Other	8
Chips	9
Hardw	9

16.2.2 EWMA

The Exponentially-Weighted Moving Average (EWMA) method simply gives recent data, that may be more relevant for predicting risk, a heavier weight when computing the empirical covariance matrix. In 1996, JP Morgan Risk Metrics proposed a lambda parameter of 0.97, in other words, where weights placed on historical data decay at a monthly rate of 0.03.

The time it takes for the weight to decay by half is called the **half-life**.

```
# Compute half-life of risk metrics' lambda for monthly data
def halflife(decay, half=0.5):
    """Returns halflife (t) from its definition: 0.5 = (1-decay)^t"""
    return -np.log(1/half)/np.log(1 - decay)
```

```
risk_metrics_lambda = 0.97 # for monthly data
print('Half-life: ', halflife(decay=1-risk_metrics_lambda).round(1), 'months')
```

Half-life: 22.8 months

```
def ewma(X, decay):
    """Helper to compute EWMA covariance matrix estimate"""
    weights = (1 - decay)**np.arange(len(X))[:-1]
    return (weights.reshape((1, -1)) * X.T @ X / weights.sum())
```

16.2.3 Shrinkage methods

Covariance matrix estimates can be regularized using shrinkage. Ledoit and Wolf proposed a close formula to compute the asymptotically optimal shrinkage parameter (minimizing a MSE criterion). They shrink the covariance towards the identity matrix: $(1 - \beta)\Sigma + \beta \frac{tr(\Sigma)}{N} I_n$ where β is the shrinkage factor given by Ledoit and Wolf (1993)

Chen et al. proposed the Oracle Approximating Shrinkage (OAS) Estimator whose convergence is significantly better under the assumption that the data are Gaussian.

16.2.4 Global MVP volatility

The out-of-sample (OOS) realized volatility of the Global Minimum Variance (GMV) portfolio can serve as a practical test of the accuracy of covariance matrix estimation techniques. The GMV is constructed to minimize portfolio volatility, hence is very sensitive to small errors in the covariance matrix. It relies on efficient diversification across assets, and inaccurate covariance estimates may lead to higher realized volatility if the portfolio inadequately hedges its positions against risk.

Starting in Jan 2000, we update the covariance matrix estimate monthly, using the rolling past 30 years of data, and record the month-ahead return of the GMV portfolio. At the end of the test sample, we expect the best covariance matrix estimator to realize the minimum returns volatility.

```
# Helper method to compute Minimum Variance Portfolio and realized volatility
def gmv(cov, ret):
    """Compute minimum variance portfolio and return"""
    w = np.linalg.inv(cov) @ np.ones((cov.shape[1], 1))
    return float(np.array(ret) @ w/sum(w))
```

```
# Rolling monthly evaluation
decay = 0.03 # risk metrics monthly decay rate for EWMA
n_components = 10 # for PCA
split = '2000-01' # start rolling OOS prediction tests from this date
```

```
r = {} # collect realized returns
for date in tqdm(rets.index[rets.index >= split]):
    X_train = rets.iloc[rets.index < date, :][-30*12:] # 30 years of training data
    X_test = rets.iloc[rets.index == date, :] # predict one month ahead returns
    r[date] = {}

    # Empirical covariance
    cov = EmpiricalCovariance().fit(X_train).covariance_
```

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```
r[date]['Covariance'] = gmv(cov, X_test)
r[date]['Diagonal'] = gmv(np.diag(np.diag(cov)), X_test)
r[date]['EWMA'] = gmv(ewma(X_train, decay=decay), X_test)
r[date][f"PCA-{n_components}"] = gmv(PCA(n_components).fit(X_train).get_
covariance(), X_test)
r[date]['Identity'] = gmv(np.identity(len(cov)), X_test)
r[date]['LW'] = gmv(LedoitWolf().fit(X_train).covariance_, X_test)
r[date]['OAS'] = gmv(OAS().fit(X_train).covariance_, X_test)
```

0% | 0 / 291 [00:00<?, ?it/s]

100% |██████████| 291 / 291 [01:25<00:00, 3.41it/s]

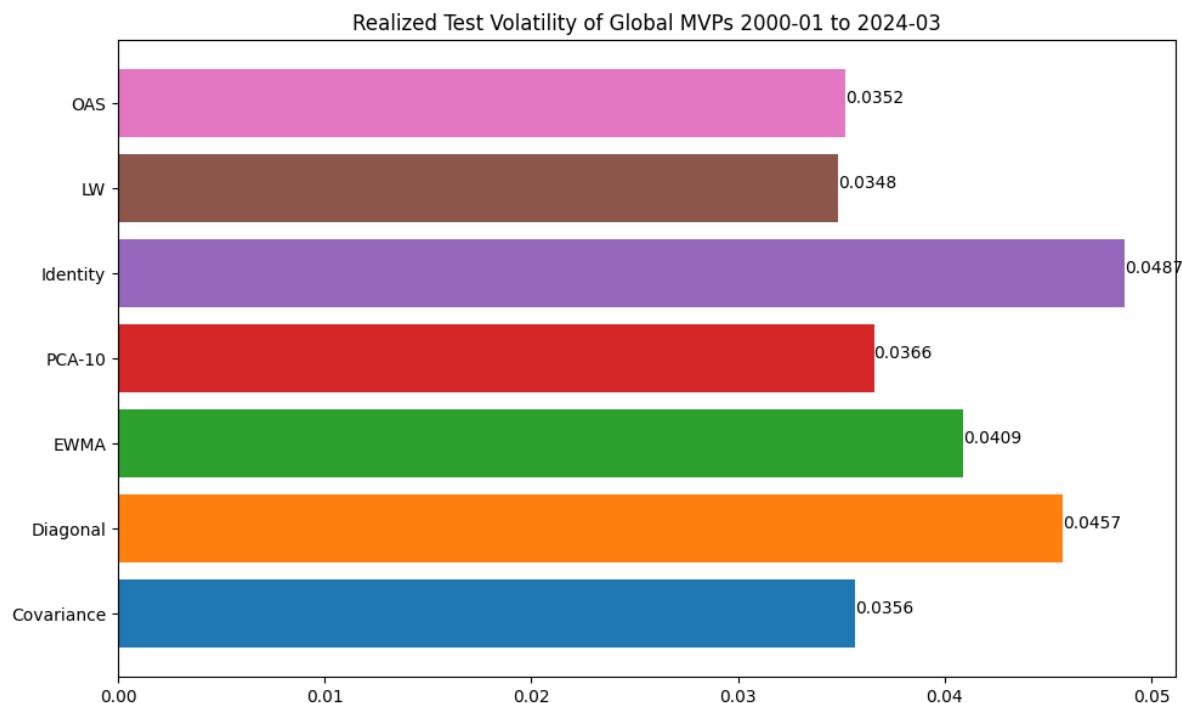
```
ts = DataFrame.from_dict(r, orient='index')
vol = ts.std().rename('realized volatility').to_frame()
print('Realized volatility of minimum variance portfolio')
vol.T
```

Realized volatility of minimum variance portfolio

	Covariance	Diagonal	EWMA	PCA-10	Identity	\
realized volatility	0.035649	0.045699	0.040867	0.036571	0.048712	
	LW	OAS				
realized volatility	0.034823	0.035177				

Plot evaluation period realized volatility of minimum variance portfolios

```
fig, ax = plt.subplots(figsize=(10, 6))
values = vol.values.flatten()
ax.barrh(vol.index, width=values, color=list(mcolors.TABLEAU_COLORS.values()))
for row, val in enumerate(values):
    ax.annotate(f'{val:.4f}', xy=(val, row))
ax.set_title(f'Realized Test Volatility of Global MVPs {split} to {rets.index[-1]}')
plt.tight_layout()
```



CHAPTER
SEVENTEEN

OPTIONS PRICING

The essence of investment management is the management of risks, not the management of returns - Benjamin Graham

Concepts

- Options
- Binomial Tree Pricing
- Black-Scholes-Merton
- VIX
- Monte Carlo Simulation

References

- F. Black and M. Scholes, “The Pricing of Options and Corporate Liabilities,” Journal of Political Economy, 81 (May/June 1973): 637–59
- R. C. Merton, “Theory of Rational Option Pricing,” Bell Journal of Economics and Management Science 4 (Spring 1973): 141–183.
- Cox, Ross, Rubinstein, 1979
- FRM Part I Exam Book Financial Markets and Products Ch. 14-15
- FRM Part I Exam Book Quantitative Analysis Ch. 13
- FRM Part I Exam Book Valuation and Risk Models Ch. 14-16
- FRM Part II Exam Book Market Risk Measurement and Management Ch. 15

```
from pandas import DataFrame, Series
import pandas as pd
import numpy as np
from scipy import stats
import matplotlib.pyplot as plt
from tqdm import tqdm
import time
from finds.utils import row_formatted
from finds.readers import Alfred
from secret import credentials
VERBOSE = 0
#%matplotlib qt
```

17.1 Options

A **European** call (or put) option gives the buyer the right to buy (or sell) an asset at a certain price on a specific date. An **American** call (or put) option gives the buyer the right to buy (or sell) an asset at a certain price at any time before or on the specified date. The date specified in the option is known as the **expiration** date (also called the **maturity** date). The price at which an asset can be bought or sold using an option is referred to as the **strike** price (also called the **exercise** price).

Options can be in-the-money, at-the-money, or out-of-the-money. This is referred to as their moneyness. Under the simplest definition of these terms, it is imagined what would happen if the option could be exercised today. An option that would give a positive payoff if exercised today is referred to as in-the-money. If it would give a negative payoff, the option is referred to as out-of-the-money. An option that is at-the-money would give a payoff of zero.

The price of stock option depends on the:

- price of the underlying stock, S
- strike price, K
- risk-free rate, r
- volatility of the stock price, σ
- time to maturity, T ,
- dividends to be paid during the life of the option, q

Put-call parity describes the relationship between the price of a European call option and that of a European put option with the same strike price and time to maturity: $S - C = PV(K) - P$

17.1.1 Option Strategies

Trading strategies involve entering positions simultaneously in different options and, optionally (no put intended), the underlying asset.

- Buying a put option when the underlying asset is held is referred to as a **protective** put strategy. A put option combined with the asset gives a position equivalent to a call option combined with an amount of cash equal to $PV(K)$
- An asset plus a short call is known as a **covered call**. The call is usually out-of-the-money, allowing the asset owner to obtain a cash inflow equal to the call option premium in exchange for giving up some
- A **bull spread** is a position appropriate for an investor expecting an increase in the price of an asset. To create the spread, the trader buys a European call option with strike price $K1$ and sells a European call option with higher strike price $K2$.
- A **bear spread** is a position where the trader buys a European put option with strike price $K2$ and sells a European put option with lower strike price $K1$.
- A **box spread** is a portfolio created from a bull spread (using call options) and a bear spread (using put options). The strike prices and times to maturity used for the bull spread are the same as those used for the bear spread.
- A **butterfly spread** involves positions in three options. It can be created from either call or put options. If calls are used, a trader will take positions in one long European call with strike price $K1$, one long European call with higher strike price $K3$, and two short European calls with strike price $K2 = (K1 + K3)/2$.
- To create a **calendar spread**, a trader buys a call option maturing at time T^* and sells a call maturing at a nearer time T , both at the same strike price of K
- A **straddle** is created from a long call and a long put with the same strike price and time to maturity.

- A **strangle** position reduces the cost of a straddle by making the strike price of the call greater than the strike price of the put.

```
# define call and put payoffs at maturity
def call_payoff(K):
    return lambda s: s - K if s > K else 0

def put_payoff(K):
    return lambda s: K - s if s < K else 0
```

```
# helpers to plot final payoff of option strategy
def plot_payoff(payoff, S=np.linspace(70, 130, 60), ax=None, label=''):
    """helper to plot final payoff over range of stock price S"""
    ax = ax or plt.gca()
    df = DataFrame([payoff(s) for s in S], index=S)
    zeros = (df == 0).all(axis=0)
    df = df.drop(columns=df.columns[zeros])
    df = df + np.sign(df.sum(axis=0))*0.4    # jigger so can display separate
    y = df.sum(axis=1).rename(label)
    y.plot(ax=ax, lw=3)
    df.plot(marker='.', ls='', ms=4, ax=ax)
    ax.legend([label] + list(df.columns))

def _ls(n):
    """helper to label as long or short position"""
    return 'long' if n >=0 else 'short'
```

```
# Define and plot the options strategies
fig, ax = plt.subplots(nrows=4, ncols=2, figsize=(10,12))
ax = ax.flatten()

def options_strategy(K, calls=0, puts=0, stocks=0):
    return lambda s: {f"_{_ls(calls)} call {K}": calls*call_payoff(K)(s),
                      f"_{_ls(puts)} put {K}": puts*put_payoff(K)(s),
                      "stock": stocks*s}

plot_payoff(options_strategy(K=100, puts=1, stocks=1), ax=ax[0], label='Protective Put
→')

plot_payoff(options_strategy(K=100, calls=-1, stocks=1), ax=ax[1], label='Covered Call
→')

def bull_spread(K1, K2):
    assert K2 > K1, "K2 must be greater than K1"
    return lambda s: {f"long call {K1}": call_payoff(K1)(s),
                      f"short call {K2}": -call_payoff(K2)(s)}

plot_payoff(bull_spread(K1=95, K2=105), ax=ax[2], label='Bull Spread')

def bear_spread(K1, K2):
    assert K2 > K1, "K2 must be greater than K1"
    return lambda s: {f"short put {K1}": -put_payoff(K1)(s),
                      f"long put {K2}": put_payoff(K2)(s)}

plot_payoff(bear_spread(K1=95, K2=105), ax=ax[3], label='Bear Spread')
```

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```

def box_spread(K1, K2):
    assert K2 > K1, "K2 must be greater than K1"
    return lambda s: {f"short put {K1}": -put_payoff(K1)(s),
                      f"long call {K1}": call_payoff(K1)(s),
                      f"long put {K2}": put_payoff(K2)(s),
                      f"short call {K2}": -call_payoff(K2)(s)}

plot_payoff(box_spread(K1=95, K2=105), ax=ax[4], label='Box Spread')

def butterfly_spread(K1, K3):
    assert K3 > K1, "K3 must be greater than K1"
    K2 = (K1 + K3) / 2
    return lambda s: {f"long call {K1}": call_payoff(K1)(s),
                      f"short calls {K2:g}": -2*call_payoff(K2)(s),
                      f"long call {K3}": call_payoff(K3)(s)}

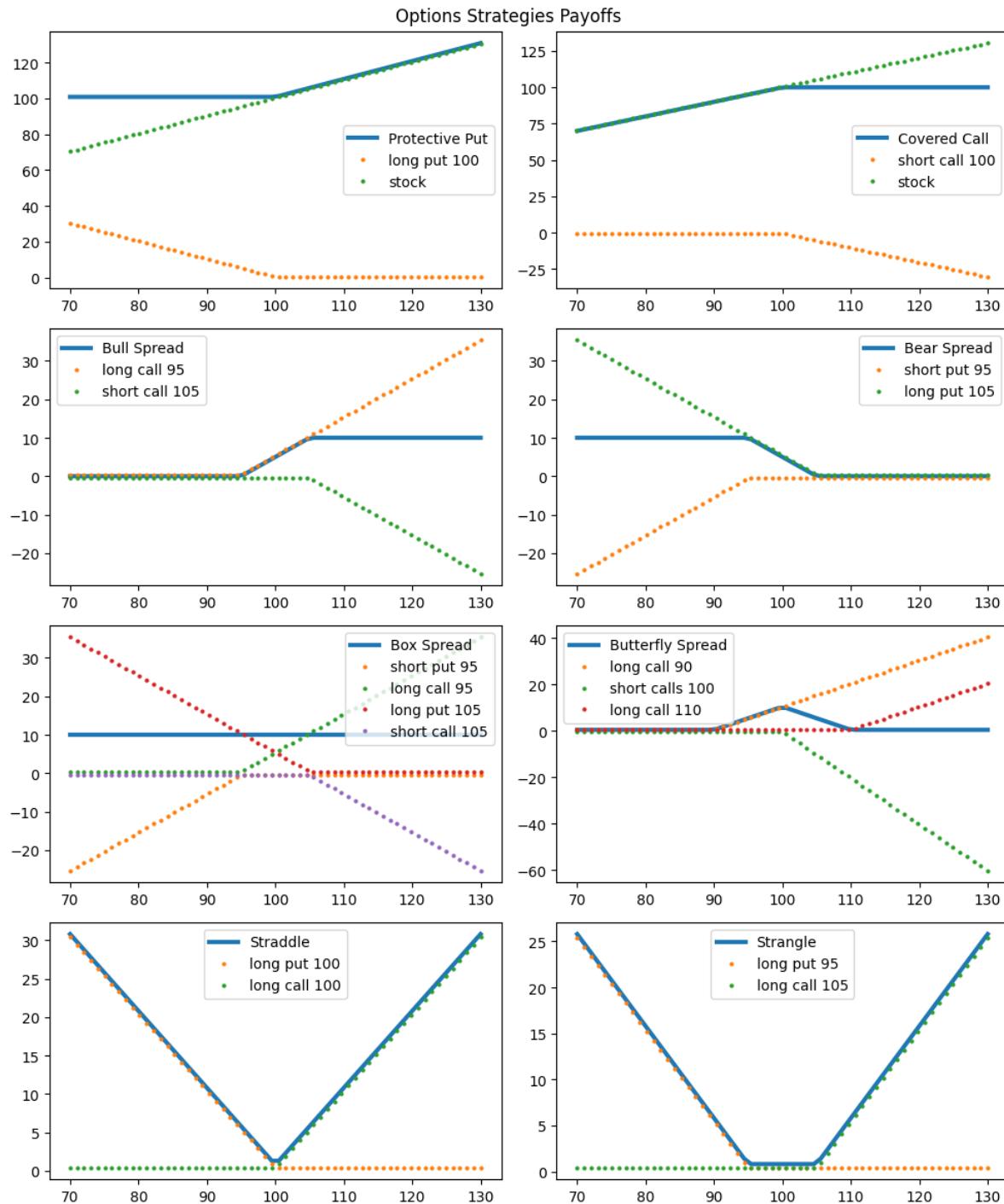
plot_payoff(butterfly_spread(K1=90, K3=110), ax=ax[5], label='Butterfly Spread')

def straddle(K):
    return lambda s: {f"long put {K}": put_payoff(K)(s),
                      f"long call {K}": call_payoff(K)(s)}
plot_payoff(straddle(K=100), ax=ax[6], label='Straddle')

def strangle(K1, K2):
    assert K2 > K1, "K2 must be greater than K1"
    return lambda s: {f"long put {K1}": put_payoff(K1)(s),
                      f"long call {K2}": call_payoff(K2)(s)}
plot_payoff(strangle(K1=95, K2=105), ax=ax[7], label='Strangle')

plt.suptitle('Options Strategies Payoffs')
plt.tight_layout()

```



17.1.2 Exotic Options

Standard European and American options are termed plain vanilla options. Options with non-standard properties are termed exotic options (or simply exotics).

- The exercise of a **Bermudan** option is restricted to certain dates.
- A **forward start** option is an option that will begin at a future time. It is usually stated that the option will be at-the-money at the time it starts.
- A **gap** option is a European call or put option where the price triggering a payoff is different from the price used in calculating the payoff.
- A **cliquet** option is a series of forward start options with certain rules for determining the strike prices.
- **Binary** call (put) options may a fixed amount of cash or an asset when its price is above (below) the strike price, or nothing otherwise. Cash-or-nothing options are sometimes referred to as **digital** options.
- **Asian** options provide a payoff dependent on an arithmetic average of the underlying asset price during the life of the option.
- The payoff from a **lookback** option depends on the maximum or minimum asset price reached during the life of the option. A floating lookback call (put) gives a payoff equal difference between the final asset price and minimum (maximum) price. The payoff of a fixed lookback call (put) is based on the difference between the maximum (minimum) price and the strike price.
- **Barrier** options come into existence or ceases to exist depending on whether the asset price reaches a particular barrier. There are down-and-out, down-and-in, up-and-out and up-and-in variants.
- A **compound** option is an option on another option. Thus, there are two strike prices and two maturity dates.
- In an **asset-exchange** option, the holder has the right to exchange one asset for another.
- A **volatility swap** is a forward contract on the realized volatility of an asset during a certain period. A trader agrees to exchange a pre-specified volatility for the realized volatility at the end of the period.

17.2 Binomial Tree

This valuation technique was proposed by Cox, Ross, and Rubinstein (1979) and continues to widely used for pricing American-style options and many other derivatives.

17.2.1 No-arbitrage

The no-arbitrage argument means that prices are calculated on the assumption that there are no arbitrage opportunities for market participants. The **law of one price** states that if two portfolios provide the same cash flows at the same times in the future, they should sell for the same price. Otherwise, a trader can short the more expensive portfolio and buy the cheaper portfolio to lock in a riskless profit. Binomial trees apply no-arbitrage arguments to pricing derivatives.

Suppose that the price of a non-dividend paying stock is currently S , and that during a time T it will either move up to S_u or down to S_d . We consider a derivative that provides a payoff of f_u if the stock price increases, and a payoff of f_d if the stock price decreases. We then form a portfolio consisting of:

- A short position in one unit of the derivative; and
- A position of Δ in the stock which we set to equal

$$\Delta = \frac{f_u - f_d}{S_u - S_d}$$

The value of the portfolio at time T is

- $Su\Delta - f_u$ if the stock price increases, and
- $Sd\Delta - f_d$ if the stock price decreases.

The value of the portfolio today is $S\Delta - f$, where f is the value of the derivative today. Suppose r is the risk-free rate for maturity T . For no arbitrage, we must have

$$S\Delta - f = \frac{f_u d - f_d u}{u - d} e^{-rT}$$

Substituting for Δ , gives:

$$f = e^{-rT} [pf_u + (1 - p)f_d]$$

$$\text{where: } p = \frac{e^{rT} - d}{u - d}$$

17.2.2 Risk Neutral Pricing

We will also use binomial trees to introduce what is known as risk-neutral valuation. This is a result that allows derivatives to be valued by assuming that market participants require an expected return equal to the risk-free rate on all investments. We define a risk-neutral world as one where investors do not adjust their required expected returns for risk, so that the expected return on all assets is the risk-free rate. To put this another way, a risk-neutral world is one where all tradable assets have an expected return equal to the risk-free interest rate. The probabilities of different outcomes in a risk-neutral world are therefore based on this assumption, and a risk-neutral investor has no preference between assets with different risks. The risk-neutral valuation principle states that if we assume we are in a risk-neutral world, we get the correct price for a derivative. As it turns out, the price is correct in the real world (where investors do care about risk) as well as in a risk-neutral world.

First, we note that if we choose to interpret the variable p as the probability of an upward movement (with $1 - p$ being the probability of a downward movement), then expected stock price grows at the risk-free rate. It also means that p is the probability of an upward movement in a risk-neutral world.

We have therefore demonstrated the truth of the risk-neutral valuation result. If we assume a risk-neutral world, the probability of an upward movement is p , and the value of the derivative is its expected payoff discounted at the risk-free rate (i.e., it is the value that would apply if market participants were risk neutral).

It should be emphasized that the risk-neutral valuation is nothing more than an artificial way of valuing derivatives. We are not assuming that the world is actually risk-neutral. We are instead arguing that the price of a derivative is the same in the real world as it would be in the risk-neutral world.

17.2.3 Binomial Trees for Valuing Options

In practice, we model stock price changes using a multi-step tree, and define

- the length of a tree step as Δt
- the parameters u and d should be chosen to reflect the volatility of the stock price. If we denote the volatility per year by σ , then appropriate values for the parameters are

$$- u = e^{\sigma\sqrt{\Delta t}}$$

$$- u = e^{-\sigma\sqrt{\Delta t}}$$

where Δt is measured in years.

- hence $f = e^{-r\Delta t} [pf_u + (1 - p)f_d]$ where $p = \frac{e^{\sigma\sqrt{\Delta t}} - d}{u - d}$
- the delta, or position taken in the stock to hedge a short position in the derivative, is $\Delta = \frac{f_u - f_d}{Su - Sd}$

Dividends: Suppose a stock paying a continuous dividend yield at rate q . Then we adjust the formula for p , while everything else about the tree, including the calculation of u and d and the roll back procedure, is the same as before

$$p = \frac{e^{(r-q)\Delta t} - d}{u - d}$$

Currency Options: A currency can be considered as an asset providing a yield at the foreign risk-free rate. Therefore, the analysis we presented for a stock paying a continuous dividend yield applies, with q equal to the foreign risk-free rate.

Futures: Because it costs nothing to enter into a futures contract, the return on a futures contract in a risk-neutral world must be zero. This means we can treat a futures contract like a stock, paying a continuous dividend yield equal to the risk free rate.

```
def binomial_tree(S, sigma, r, T, steps, payoff=None, q=0, american=False,
                  verbose=True):
    delta_t = T / steps
    u = np.exp(sigma * np.sqrt(delta_t))
    d = np.exp(-sigma * np.sqrt(delta_t))
    p = (np.exp((r - q) * delta_t) - d) / (u - d)
    result = dict(value=None, u=u, d=d, p=p, delta_t=delta_t)
    if payoff is not None:
        label = "STEP {:.5d}".format  # to label output of each step

        # initialize price vectors at last step
        prices = DataFrame(0.0, index=np.arange(steps+1),
                           columns=['stock', 'option', 'delta'])
        for downs in range(steps+1):
            s = d**downs * u***(steps-downs) * S      # price after number of downs
            prices.loc[downs, 'stock'] = s
            prices.loc[downs, 'option'] = payoff(s)  # option value at expiry
        print(row_formatted(prices.T.rename_axis(columns=label(steps)),
                            default=".4f"))

        # roll back one time step at a time
        for step in range(steps - 1, -1, -1):

            # update all scenarios in this time step
            for downs in range(step+1):

                # stock price after this number of downs
                s = d**downs * u***(step - downs) * S
                prices.loc[downs, 'stock'] = s

                # value of option is max of roll back or exercise (if American)
                exercise = payoff(s) if american else 0 # if exercise American
                f_u = prices.loc[downs, 'option']          # option value after up
                f_d = prices.loc[downs + 1, 'option']       # option value after down
                f = np.exp(-r * delta_t) * (p * f_u + (1 - p) * f_d)
                prices.loc[downs, 'option'] = max(f, exercise)
                prices.loc[downs, 'delta'] = (f_u - f_d) / (S*u - S*d)

            # Display this time step
            prices = prices.iloc[:-1]
            print()
            print(row_formatted(prices.T.rename_axis(columns=label(step)),
                                default=".4f"))
            result['value'] = prices.loc[0, 'option']
    return DataFrame(result, index=[steps]).rename_axis(columns='STEPS').round(4)
```

European call option in 2 steps

```
# Figure 14.3 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=29, sigma=0.25, r=0.03, T=1, steps=2,
              payoff=call_payoff(K=30))
```

	0	1	2
stock	41.2995	29.0000	20.3635
option	11.2995	0.0000	0.0000
delta	0.0000	0.0000	0.0000

	0	1
stock	34.6076	24.3010
option	5.5483	0.0000
delta	1.0963	0.0000

	0
stock	29.0000
option	2.7243
delta	0.5383

STEPS	value	u	d	p	delta_t
2	2.7243	1.1934	0.838	0.4984	0.5

European put option in 2 steps

```
# Figure 14.4 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=29, sigma=0.25, r=0.03, T=1, steps=2,
              payoff=put_payoff(K=30))
```

	0	1	2
stock	41.2995	29.0000	20.3635
option	0.0000	1.0000	9.6365
delta	0.0000	0.0000	0.0000

	0	1
stock	34.6076	24.3010
option	0.4941	5.2523
delta	-0.0970	-0.8380

	0
stock	29.0000
option	2.8377
delta	-0.4617

STEPS	value	u	d	p	delta_t
2	2.8377	1.1934	0.838	0.4984	0.5

American put option in 4 steps

```
# Figure 14.5 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=29, sigma=0.25, r=0.03, T=1, steps=2,
              payoff=put_payoff(K=30), american=True)
```

STEP 2	0	1	2
stock	41.2995	29.0000	20.3635
option	0.0000	1.0000	9.6365
delta	0.0000	0.0000	0.0000

STEP 1	0	1
stock	34.6076	24.3010
option	0.4941	5.6990
delta	-0.0970	-0.8380

STEP 0	0
stock	29.0000
option	3.0584
delta	-0.5050

STEPS	value	u	d	p	delta_t
2	3.0584	1.1934	0.838	0.4984	0.5

American put option in 4 steps

```
# Figure 14.6 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=29, sigma=0.25, r=0.03, T=1, steps=4,
              payoff=put_payoff(K=30), american=True)
```

STEP 4	0	1	2	3	4
stock	47.8129	37.2367	29.0000	22.5852	17.5894
option	0.0000	0.0000	1.0000	7.4148	12.4106
delta	0.0000	0.0000	0.0000	0.0000	0.0000

STEP 3	0	1	2	3
stock	42.1948	32.8613	25.5924	19.9314
option	0.0000	0.4974	4.4076	10.0686
delta	0.0000	-0.1376	-0.8825	-0.6873

STEP 2	0	1	2
stock	37.2367	29.0000	22.5852
option	0.2474	2.4387	7.4148
delta	-0.0684	-0.5379	-0.7788

STEP 1	0	1
stock	32.8613	25.5924
option	1.3356	4.8958
delta	-0.3015	-0.6846

STEP 0	0
stock	29.0000
option	3.0966
delta	-0.4898

STEPS	value	u	d	p	delta_t
4	3.0966	1.1331	0.8825	0.4988	0.25

European call on index with dividend yield

```
# Figure 14.7 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=2500, sigma=0.15, r=0.03, q=0.02, T=0.5, steps=3,
              payoff=call_payoff(K=2500))
```

STEP	0	1	2	3
stock	3004.1734	2657.8778	2351.5002	2080.4391
option	504.1734	157.8778	0.0000	0.0000
delta	0.0000	0.0000	0.0000	0.0000
STEP	0	1	2	
stock	2825.7257	2500.0000	2211.8212	
option	328.7911	78.2792	0.0000	
delta	1.1303	0.5153	0.0000	
STEP	0	1		
stock	2657.8778	2351.5002		
option	202.0979	38.8125		
delta	0.8177	0.2555		
STEP	0			
stock	2500.0000			
option	119.5793			
delta	0.5330			

STEPS	value	u	d	p	delta_t
3	119.5793	1.0632	0.9406	0.4983	0.1667

American call option on foreign currency

```
# Figure 14.8 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=0.78, sigma=0.12, r=0.02, q=0.06, T=1, steps=4,
              payoff=call_payoff(K=0.8))
```

STEP	0	1	2	3	4
stock	0.9916	0.8794	0.7800	0.6918	0.6136
option	0.1916	0.0794	0.0000	0.0000	0.0000
delta	0.0000	0.0000	0.0000	0.0000	0.0000
STEP	0	1	2	3	
stock	0.9338	0.8282	0.7346	0.6515	
option	0.1239	0.0318	0.0000	0.0000	
delta	1.1972	0.8483	0.0000	0.0000	
STEP	0	1	2		
stock	0.8794	0.7800	0.6918		
option	0.0685	0.0127	0.0000		
delta	0.9837	0.3394	0.0000		
STEP	0	1			
stock	0.8282	0.7346			
option	0.0350	0.0051			
delta	0.5955	0.1358			
STEP	0				

(continues on next page)

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stock	0.7800
option	0.0170
delta	0.3191

STEPS	value	u	d	p	delta_t
4	0.017	1.0618	0.9418	0.4021	0.25

American put option on futures contract

```
# Figure 14.9 of FRM Part I Exam Book "Valuation and Risk Models"
binomial_tree(S=38, sigma=0.2, r=0.04, q=0.04, T=9/12, steps=3,
               payoff=put_payoff(K=40), american=True)
```

STEP 3	0	1	2	3
stock	51.2946	41.9965	34.3838	28.1511
option	0.0000	0.0000	5.6162	11.8489
delta	0.0000	0.0000	0.0000	0.0000
STEP 2	0	1	2	
stock	46.4133	38.0000	31.1118	
option	0.0000	2.9190	8.8882	
delta	0.0000	-0.7377	-0.8187	
STEP 1	0	1		
stock	41.9965	34.3838		
option	1.5172	5.9925		
delta	-0.3834	-0.7841		
STEP 0	0			
stock	38.0000			
option	3.8282			
delta	-0.5879			

STEPS	value	u	d	p	delta_t
3	3.8282	1.1052	0.9048	0.475	0.25

17.3 Black-Scholes-Merton

The famous Black-Scholes-Merton model was published in two papers in 1973 and has had a major influence on the way options are priced and hedged. In one of the papers, Black and Scholes used the capital asset pricing model (CAPM) to derive the relationship between the return from a stock and the return from an option on the stock. In the other paper, Merton used no-arbitrage arguments like those used in connection with binomial trees in the previous chapter. The two papers derived the same option pricing formula.

Merton used assumptions and arguments (many of which are similar to those for valuaing options using binomial trees), including lognormal stock price distribution, continuous security trading and no riskless opportunities, to show that the price evolution of derivatives satisfies the Black-Scholes-Merton partial differential equation.

$$\frac{\partial V}{\partial t} + \frac{1}{2} \sigma^2 S^2 \frac{\partial^2 V}{\partial S^2} + rS \frac{\partial V}{\partial S} - rV = 0$$

To use Merton's result to value a European option, we must apply boundary conditions. For a European call option with time to maturity T and strike price K , the boundary condition is that the value of the option is $\max(S - K, 0)$ at time T . For a European put, this boundary condition is $\max(K - S, 0)$. Other derivatives give rise to other boundary conditions.

The solutions for the prices of a European call and put are the Black-Scholes-Merton formulas:

$$C = Se^{-qT}\Phi(d_1) - Ke^{-rT}\Phi(d_2)$$

$$p = Ke^{-rT}\Phi(-d_2) - Se^{-qT}\Phi(-d_1)$$

where:

- $d_1 = \frac{\ln(S_0/K) + (r - q + \sigma^2/2)T}{\sigma\sqrt{T}}$
- $d_2 = \frac{\ln(S_0/K) + (r - q - \sigma^2/2)T}{\sigma\sqrt{T}} = d_1 - \sigma\sqrt{T}$
- S is the current stock price,
- K is the strike price,
- T is the time to maturity in years,
- r is the risk-free rate per year (continuously compounded),
- q is the dividend yield (or foreign risk-free rate for currency options)
- σ is an estimated volatility per year over the next T years,
- Φ is the cumulative normal distribution function

Suppose discrete dividends are expected to be paid with ex-dates during the life of the option. The option can be valued by replacing stock price S with $S - PV(D)$, the present value of those dividends.

American call options on a non-dividend paying stock should never be exercised early, hence the same formula provides prices for American call options on non-dividend paying stocks as well as for European call options. But it may be optimal to exercise early when there are discrete dividends, but only immediately before an ex-dividend date.

American put options on stocks and all American options on stock indices, currencies, and futures should not be valued as European options. Binomial trees can be used in these cases.

Black-Scholes-Merton option formulas

```
def _d1(S, K, sigma, r, q):
    """helper to compute d1 term in Black-Scholes-Merton formula"""
    return (np.log(S/K) + (r - q + sigma**2/2) * T) / (sigma * np.sqrt(T))
```

```
def call(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call option value"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    d2 = d1 - sigma * np.sqrt(T)
    return S*np.exp(-q*T)*stats.norm.cdf(d1) - K*np.exp(-r*T)*stats.norm.cdf(d2)
```

```
def put(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton put option value"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    d2 = d1 - sigma * np.sqrt(T)
    return K*np.exp(-r*T)*stats.norm.cdf(-d2) - S*np.exp(-q*T)*stats.norm.cdf(-d1)
```

```
print(call(S=56, K=60, r=0.05, sigma=0.3, T=18/12)) # 8.3069
print(put(S=56, K=60, r=0.05, sigma=0.3, T=18/12)) # 7.9715
```

```
8.306909593824336
7.971518773537515
```

17.3.1 Implied Volatility

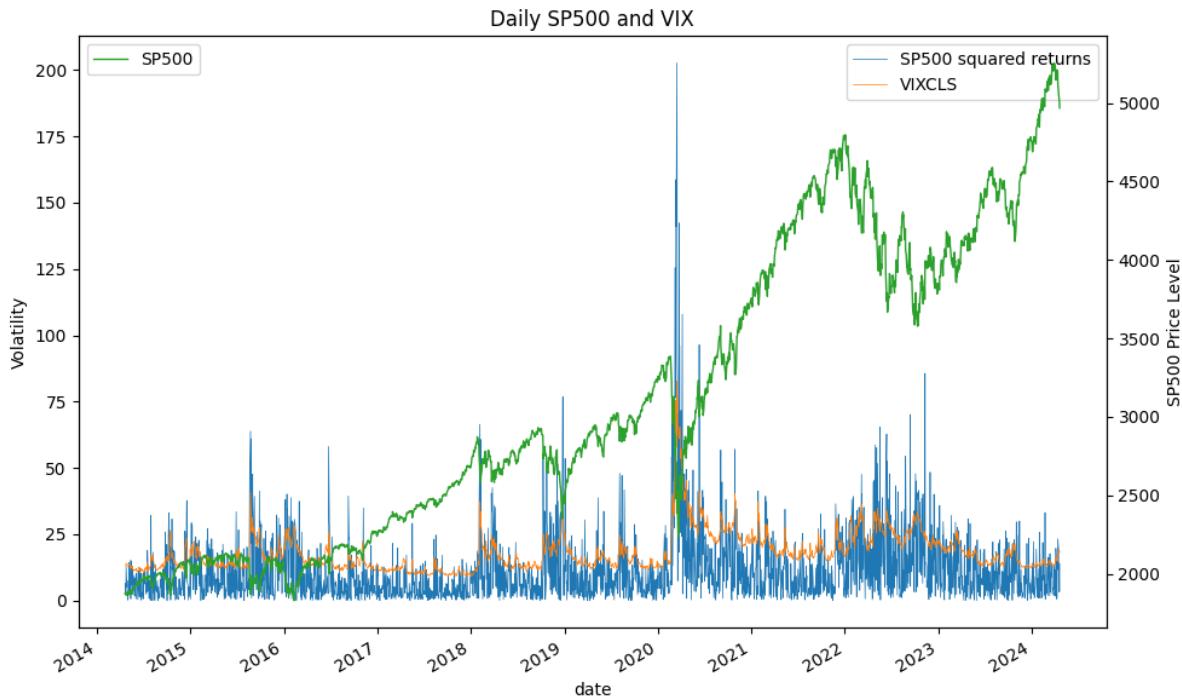
The implied volatility of an option is the volatility that gives the market price of the option when it is substituted into the Black-Scholes-Merton formula.

The Chicago Board Options Exchange has developed indices that track volatilities. The most popular of these is the SPX VIX index, which tracks the volatilities of 30-day options on the S&P 500.

Traders monitor implied volatilities carefully and often use them to communicate prices. If the assumptions underlying the Black-Scholes-Merton model held exactly, all options on an asset would have the same implied volatility at all times.

```
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE, convert_date=0)
vix = alf('VIXCLS')
sp500_sq = alf('SP500', log=1, diff=1).rename('SP500 squared returns')
sp500 = alf('SP500')
df = pd.concat([100*np.sqrt(252*sp500_sq**2), vix], axis=1, join='inner').dropna()

fig, ax = plt.subplots(figsize=(10, 6))
df.plot(ax=ax, lw=.5)
ax.set_ylabel('Volatility')
bx = ax.twinx()
sp500.plot(ax=bx, lw=1, color="C2")
bx.set_ylabel('SP500 Price Level')
plt.title('Daily SP500 and VIX')
plt.legend()
plt.tight_layout()
```



17.3.2 Volatility Smile

In practice, implied volatilities vary with strike prices. This indicates that the market does not price options consistently with the Black-Scholes-Merton assumptions. The volatility smile defines the relationship between the implied volatility of an option and its strike price. Because of put-call parity, the implied volatility of a European call option is the same as that of a European put option when they have the same strike price and time to maturity.

For equity options, the volatility smile tends to be downward sloping. This means that out-of-the-money puts and in-the-money calls tend to have high implied volatilities whereas out-of-the-money calls and in-the-money puts tend to have low implied volatilities. This is sometimes referred to as a volatility skew. There is a negative correlation between equity prices and volatility, which means that stock price declines are accompanied by increases in volatility, and stock price increases are accompanied by decreases in volatility.

For foreign currency options, the volatility smile is U-shaped. Both out-of-the-money and in-the-money options have higher implied volatilities than at-the-money options. The volatility of an exchange rate is far from constant, and exchange rates frequently exhibit jumps, sometimes in response to the actions of central banks. Both a nonconstant volatility and jumps will have the effect of making extreme outcomes more likely.

Often traders also use a volatility term structure. The implied volatility of an option then depends on its life. When volatility smiles and volatility term structures are combined, they produce a volatility surface. This defines implied volatility as a function of both the strike price and the time to maturity. When quoting options prices, traders interpolate between the known implied volatilities to determine an implied volatility for the option under consideration. This is then substituted into the Black-Scholes-Merton equation to determine the option price. This procedure is a way of overcoming the fact that the market does not price options consistently with the Black-Scholes-Merton assumptions.

17.3.3 The “Greeks”

The Greek letters (or Greeks, as they are sometimes called) are designed to provide information about the risks of options positions. Some Greek letters are concerned with movements in the price of the underlying asset; some are concerned with volatility changes; and others involve interest rates and dividend yields. Typically, a trader is subject to limits on how large the Greek letters can be. If one of the Greek letters exceeds the applicable limit near the end of the trading day, a trader must either execute a trade that corrects the situation or seek special permission from the risk management function to maintain the existing position.

- Delta measures the sensitivity to changes in the price of the underlying asset:

$$\Delta_c = e^{-qt}\Phi(d_1)$$

$$\Delta_p = e^{-qt}[\Phi(d_1) - 1]$$

- Gamma measures the sensitivity of a portfolio's delta to changes in the price of the underlying asset:

$$\Gamma = \frac{e^{-qt}}{S\sigma\sqrt{t}}\phi(d_1)$$

- Theta measures the sensitivity to time to expiration

$$\Theta_c = -\frac{S\sigma e^{-qt}}{2\sqrt{t}}\phi(d_1) - rKe^{-rt}\Phi(d_2) + qSe^{-qt}\Phi(d_1)$$

$$\Theta_p = -\frac{S\sigma e^{-qt}}{2\sqrt{t}}\phi(d_1) + rKe^{-rt}\Phi(-d_2) - qSe^{-qt}\Phi(-d_1)$$

- Vega measures the sensitivity to the implied volatility

$$V = Se^{-qt}\sqrt{t}\phi(d_1)$$

- Rho measures the sensitivity to changes in the level of interest rate

$$\rho_c = Kte^{-rt}\Phi(d_2)$$

$$\rho_p = Kte^{-rt}\Phi(-d_2)$$

Any of the Greek letters for a portfolio of derivatives dependent on the same asset can be calculated as the weighted sum of the Greek letters for each portfolio component.

The Black-Scholes-Merton analysis can be used to show that $\$ \Theta + (r - q)S\Delta + \frac{1}{2}\sigma^2S^2\Gamma = (r - q)C\$$

```
# Helper to plot a greek over range of stock price S"""
def plot_greek(K, sigma, r, T, greek, S=np.linspace(50, 200, 100),
              ax=None, label='', q=0., c="C0"):

    """helper to plot a greek over range of stock price S"""
    y = [greek(S=s, K=K, sigma=sigma, r=r, T=T, q=q) for s in S]
    ax = ax or plt.gca()
    ax.plot(S, y, color=c)
    #ax.set_xlabel('Stock Price')
    ax.legend([label])
```

Define and plot options sensitivities

```
# Plot options sensitivities
fig, ax = plt.subplots(nrows=4, ncols=2, figsize=(10, 12))
ax = ax.flatten()

# call option parameters
opt = dict(K=105, r=0.04, sigma=0.25, T=1)
```

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```

def delta_call(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call option delta"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    return np.exp(-q*T) * stats.norm.cdf(d1)
def delta_put(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton put option delta"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    return -np.exp(-q*T) * stats.norm.cdf(-d1)
print(delta_call(S=100, **opt)) # 0.5358

plot_greek(greek=delta_call, label='Call Delta', ax=ax[0], c="C0", **opt)
plot_greek(greek=delta_put, label='Put Delta', ax=ax[1], c="C1", **opt)

def vega(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call or put option vega"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    return S * np.exp(-q*T) * np.sqrt(T) * stats.norm.pdf(d1)
print(vega(S=100, **opt)) # 39.73

plot_greek(greek=vega, label='Vega', ax=ax[2], c="C2", **opt)

def gamma(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call or put option gamma"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    return np.exp(-q*T) * stats.norm.pdf(d1) / (S * sigma * np.sqrt(T))
print(gamma(S=100, **opt)) # 0.0159

plot_greek(greek=gamma, label='Gamma', ax=ax[3], c="C3", **opt)

def theta_call(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call option theta"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    d2 = d1 - sigma * np.sqrt(T)
    return ((-S * np.exp(-q*T) * stats.norm.pdf(d1) * sigma / (2 * np.sqrt(T))) -
            (r * K * np.exp(-r*T) * stats.norm.cdf(d2)) +
            (q * S * np.exp(-q*T) * stats.norm.cdf(d1)))
def theta_put(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton put option theta"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    d2 = d1 - sigma * np.sqrt(T)
    return ((-S * np.exp(-q*T) * stats.norm.pdf(d1) * sigma / (2 * np.sqrt(T))) -
            (r * K * np.exp(-r*T) * stats.norm.cdf(-d2)) +
            (q * S * np.exp(-q*T) * stats.norm.cdf(-d1)))
print(theta_call(S=100, **opt)) # 6.73

plot_greek(greek=theta_call, label='Call Theta', ax=ax[4], c="C4", **opt)
plot_greek(greek=theta_put, label='Put Theta', ax=ax[5], c="C5", **opt)

def rho_call(S, K, sigma, r, T, q=0.):
    """Black-Scholes-Merton call option rho"""
    d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
    d2 = d1 - sigma * np.sqrt(T)
    return K * T * np.exp(-r * T) * stats.norm.cdf(d2)
def rho_put(S, K, sigma, r, T, q=0.):

```

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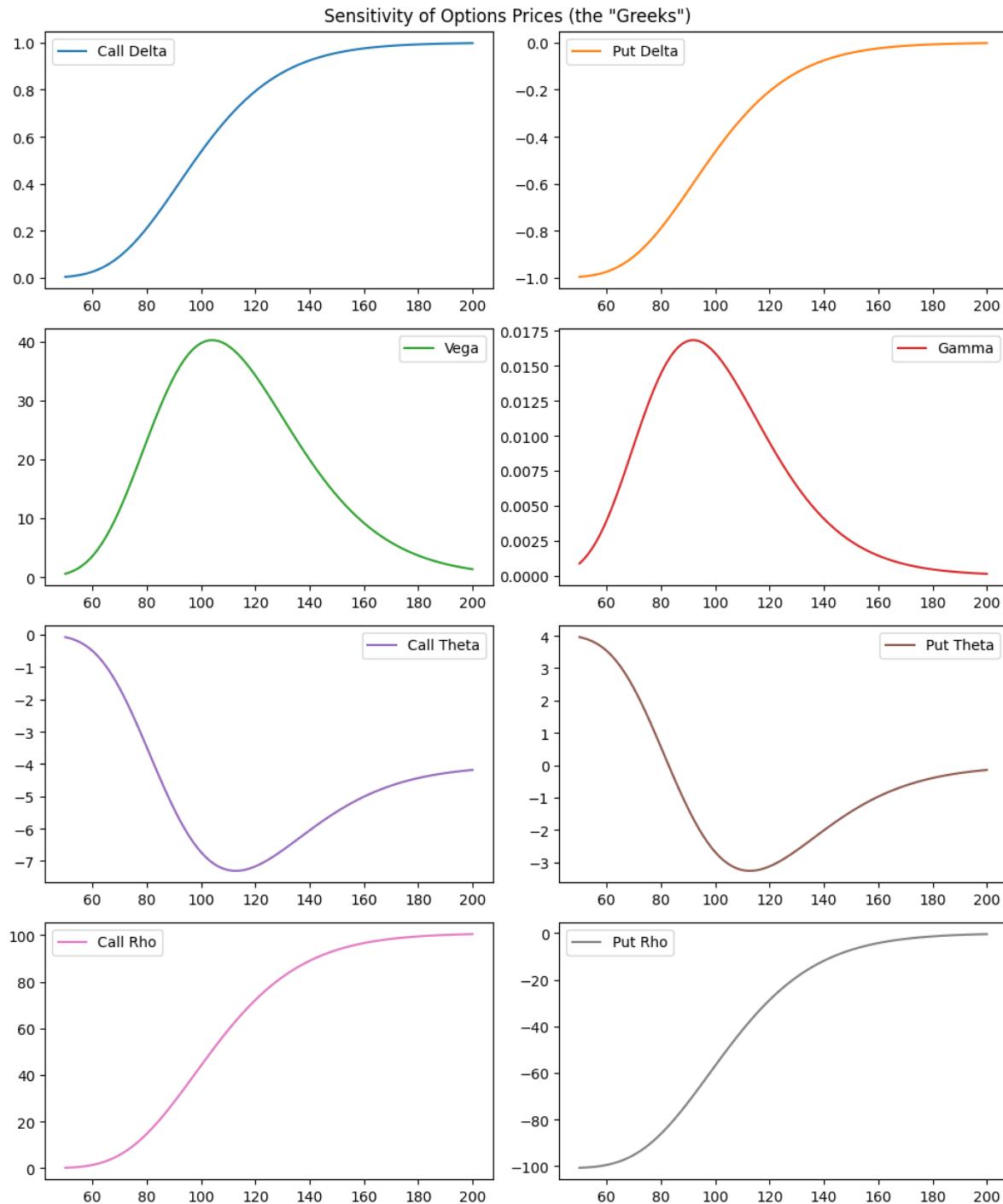
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```
"""Black-Scholes-Merton put option rho"""
d1 = _d1(S=S, K=K, sigma=sigma, r=r, T=T, q=q)
d2 = d1 - sigma * np.sqrt(T)
return -K * T * np.exp(-r * T) * stats.norm.cdf(-d2)
print(rho_call(S=100, **opt)) # 44

plot_greek(greek=rho_call, label='Call Rho', ax=ax[6], c="C6", **opt)
plot_greek(greek=rho_put, label='Put Rho', ax=ax[7], c="C7", **opt)

plt.suptitle('Sensitivity of Options Prices (the "Greeks")')
plt.tight_layout()
```

```
0.5357925584332519
39.73355715246575
0.0158934228609863
-6.727614629584682
44.02299963816157
```



```
# Check that: theta + r S delta + 1/2 sigma^2 S^2 gamma = r call
S = 100
print(theta_call(S=S, **opt) + opt['r'] * S * delta_call(100, **opt) +
      0.5 * opt['sigma']**2 * S**2 * gamma(S=S, **opt),
      opt['r'] * call(S=S, **opt))
```

```
0.3822502482065442 0.38225024820654485
```

17.4 Monte Carlo Simulation

Simulation provides a simple method to approximate the analytically intractable expectation. Suppose X is a random variable that can be simulated (e.g., a normal) and g is a function that can be evaluated at realizations of X .

Simulated draws are iid by construction, and b draws are used to approximate the expected value as: $\hat{E}[g(X)] = \frac{1}{b} \sum_{i=1}^b g(X_i)$

The approximated expectation is an average of b iid random variables, and so the Law of Large Numbers (LLN) applies: $b \lim_{b \rightarrow \infty} \hat{E}[g(X)] = E[g(X)]$

Furthermore, the Central Limit Theorem (CLT) also applies to the average. The variance of the simulated expectation is estimated by: $V[\hat{E}[g(X)]] = \sigma_b^2/b$

This variance is estimated using: $\sigma_g^2 = \frac{1}{b} \sum_{i=1}^b (g(X_i) - E[g(X_i)])^2$ which is the standard variance estimator for iid data.

The standard error of the simulated expectation σ_g/\sqrt{b} measures the accuracy of the approximation, which allows b to be chosen to achieve any desired level of accuracy.

17.4.1 Antithetic Variates

Antithetic variates add a second set of random variables that are constructed to have a negative correlation with the iid variables used in the simulation. They are generated in pairs using a single uniform value. Only $b/2$ uniforms are required to produce b simulated values because each draw $U - i$ also generates the $1 - U_i$ which both map through the inverse CDF to generate random variables that are negatively correlated.

Antithetic pairs produced using this algorithm are only guaranteed to reduce the simulation error if the function $g(X)$ is monotonic to ensure negative correlation. The improvement in accuracy when using antithetic variables occurs due to the negative correlation between the paired random variables which decreases standard error.

17.4.2 Control Variates

A control variate is another derived random variable $h(X_i)$ that has mean 0 but is correlated with the error of the primary random variable $g(X_i)$. A good control variate should have two properties.

1. First, it should be inexpensive to construct from x_i , than the computation cost of simply increasing the number of simulations.
2. Second, a control variate should have a high correlation with $g(X)$. The optimal combination parameter β that minimizes the approximation error is estimated using the regression:
3. $g(x_i) = \alpha + \beta h(x_i)$

17.4.3 Simulating Option Prices

Assume that the log of the stock price is normally distributed. The time T log stock price s_T is equal to the sum of the initial stock price s_0 , a mean, and a normally distributed error:

$$s_T = s_0 + T(r_f - \sigma^2/2) + \sqrt{T}x_i$$

where x_i is a simulated value from a $N(0, \sigma^2)$, r_f is the risk-free rate, and σ^2 is the variance of the stock return.

The final stock price is $S_T = \exp(s_T)$, and the present value of the option's payoff is

$$C = \exp(-r_f T) \max(S_T - K, 0)$$

The expected price of a call option is estimated by the average of the simulated values:

$$E[C] = \bar{C} = \frac{1}{b} \sum_{i=1}^b C_i$$

where C_i are simulated values of the payoff of the call option.

```
# helpers for random number generator and monte carlo simulation
class RNG:
    """Helper to generate random normal variables, with optional antithetic variates"""
    def __init__(self, seed=None, antithetic=False, ppf=stats.norm.ppf):
        self.ppf = ppf
        self.antithetic = antithetic
        self._prev = None # to track if antithetic pair available to return next
        self.seed = seed
        self.rng = np.random.default_rng(seed)

    def __call__(self, shape=1, **kwargs):
        _shape = (shape, ) if isinstance(shape, int) else shape
        n = np.prod(_shape)
        if self.antithetic: # generate half as many rv's, by returning 1-rv
            new = int((n + 1) / 2) if self._prev is None else int(n / 2)
            new = self.rng.random((new,))
            rem = 1 - new[:n - len(new) - int(self._prev is not None)]
            last = new[-1] if len(rem) < len(new) else None # if last pair unused
            out = [] if self._prev is None else [1 - self._prev]
            #out.extend(new)
            #out.extend(rem)
            for x, y in zip(new[:len(rem)], rem):
                out.extend([x, y])
            if last is not None:
                out.extend([last])
            out = np.array(out)
            self._prev = last
        else:
            out = self.rng.random(_shape)
        if shape == 1:
            return self.ppf(out[0], **kwargs)
        else:
            return self.ppf(out.reshape(_shape), **kwargs)

    def monte_carlo(rng, S, K, sigma, r, T, control=None):
        """Helper to price European call option by Monte Carlo Simulation
        Args:
            control : True price of European put option, as control variate
        """

```

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```

if rng.antithetic:
    label = 'Both' if control else 'Antithetic'
else:
    label = 'Control' if control else 'Standard'
result = {}
for b in [50*4**i for i in range(9)]:
    tic = time.time()
    x = rng(b, scale=sigma)
    s = S * np.exp(T * (r - sigma**2/2) + np.sqrt(T) * x)
    c = np.exp(-r * T) * np.maximum(s - K, 0)
    if control is not None: # to apply control variate method
        error = np.exp(-r * T) * np.maximum(K - s, 0) - control # error of put_
    ↪price
        ols = stats.linregress(x=error, y=c) # compute best hedge to minimize_
    ↪error
        c = c - ols.slope * error
    result[b] = dict(Price=np.mean(c).round(2),
                    StdErr=(np.std(c) / np.sqrt(b)).round(2),
                    elapsed = np.round(time.time() - tic, 4))
return DataFrame.from_dict(result, orient='index').rename_axis(columns=label)

RNG(antithetic=True)((2, 3)) # generate normal r.v.'s with antithetic variates

```

```
array([[-1.49453301,  1.49453301,  0.80816507],
       [-0.80816507, -0.28928827,  0.28928827]])
```

Standard simulation

```

S = 2500
K = 2500
sigma = 0.164
r = 0.02
T = 2

seed = 42
rng = RNG(seed=seed)
monte_carlo(rng, S=S, K=K, sigma=sigma, r=r, T=T)

```

Standard	Price	StdErr	elapsed
50	297.91	54.77	0.0004
200	247.65	25.97	0.0002
800	283.95	15.23	0.0003
3200	279.62	7.59	0.0004
12800	278.25	3.73	0.0009
51200	279.45	1.85	0.0021
204800	278.93	0.93	0.0081
819200	278.31	0.46	0.0361
3276800	278.59	0.23	0.2964

Antithetic Variates

```

rng = RNG(seed=seed, antithetic=True)
monte_carlo(rng, S=S, K=K, sigma=sigma, r=r, T=T)

```

Antithetic	Price	StdErr	elapsed
50	280.86	54.41	0.0004
200	242.12	25.04	0.0003
800	276.97	14.15	0.0007
3200	284.38	7.63	0.0006
12800	277.30	3.72	0.0019
51200	279.28	1.87	0.0070
204800	278.15	0.93	0.0298
819200	278.46	0.46	0.1209
3276800	278.48	0.23	0.4569

Control Variates

```
control = put(S, K, sigma, r, T)      # Black-Scholes-Merton put price
rng = RNG(seed=seed)
monte_carlo(rng, S=S, K=K, sigma=sigma, r=r, T=T, control=control)
```

Control	Price	StdErr	elapsed
50	263.59	47.04	0.0005
200	251.85	22.76	0.0003
800	287.49	13.52	0.0005
3200	279.92	6.76	0.0004
12800	278.43	3.32	0.0007
51200	279.01	1.64	0.0027
204800	279.02	0.83	0.0120
819200	278.22	0.41	0.0453
3276800	278.64	0.21	0.3122

Both Antithetic and Control Variates

```
control = put(S, K, sigma, r, T)      # Black-Scholes-Merton put price
rng = RNG(seed=seed, antithetic=True)
monte_carlo(rng, S=S, K=K, sigma=sigma, r=r, T=T, control=control)
```

Both	Price	StdErr	elapsed
50	286.14	45.71	0.0005
200	227.29	22.03	0.0006
800	277.91	12.32	0.0004
3200	286.51	6.79	0.0006
12800	276.56	3.31	0.0020
51200	279.47	1.66	0.0063
204800	277.88	0.83	0.0273
819200	278.41	0.41	0.1039
3276800	278.41	0.21	0.5222

MARKET MICROSTRUCTURE

Beware of little expenses. A small leak will sink a great ship - Benjamin Franklin

- NYSE Daily TAQ tick data
- Liquidity by firm size
- Sampling frequency
- Volatility from tick data
- Intraday liquidity

```
import numpy as np
import pandas as pd
import time
import os
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from tqdm import tqdm
import multiprocessing
from finds.database import SQL, RedisDB
from finds.structured import CRSP, BusDay
from finds.readers import opentaq, itertaq, bin_trades, bin_quotes, TAQ
from finds.utils import plot_time, Store, row_formatted
from finds.recipes import weighted_average, hl_vol, ohlc_vol
from secret import credentials, paths
import warnings
VERBOSE = 0
if not VERBOSE: # Suppress FutureWarning messages
    warnings.simplefilter(action='ignore', category=FutureWarning)

%matplotlib inline
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bday = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bday, rdb=rdb, verbose=VERBOSE)
```

Last FamaFrench Date 2024-02-29 00:00:00

```
taqdir = paths['taq']
storedir = paths['scratch'] / 'ticks'
```

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```
open_t = pd.to_datetime('1900-01-01T9:30')      # exclude <=
close_t = pd.to_datetime('1900-01-01T16:00')    # exclude >
EPSILON = 1e-15
dates = [20191007, 20191008, 20180305, 20180306]
```

18.1 TAQ tick data

Extract tick data from TAQ daily and store by date and symbol

```
for d, date in enumerate(dates):
    store = Store(storedir / str(date), verbose=VERBOSE)
    master, trades, quotes = opentaq(date, taqdir)

    # screen on CRSP universe
    univ = crsp.get_universe(date) \
        .join(crsp.get_section(dataset='names',
                               fields=['ncusip', 'permco', 'exchcd'],
                               date_field='date',
                               date=date,
                               start=0), how='inner') \
        .sort_values(['permco', 'ncusip'])

    # drop duplicate share classes (same permco): keep largest cap
    dups = master['CUSIP'].str \
        .slice(0, 8) \
        .isin(univ.loc[univ.duplicated(['permco'], keep=False),
                      'ncusip'])

    #shareclass.extend(master[dups].to_dict(orient='index').values())
    univ = univ.sort_values(['permco', 'cap'], na_position='first') \
        .drop_duplicates(['permco'], keep='last') \
        .reset_index() \
        .set_index('ncusip', drop=False)

    # Iterate by symbol over Daily Taq trades, nbbo and master files
    for ct, cq, mast in itertaq(trades,
                                 quotes,
                                 master,
                                 cusips=univ['ncusip'],
                                 open_t=open_t,
                                 close_t=None,
                                 verbose=VERBOSE):
        header = {'date':date}
        header.update(univ.loc[mast['CUSIP'][:8],
                               ['permno', 'decile', 'exchcd', 'siccd']])
        header.update(mast[['Symbol', 'Round_Lot']])
        store[header['Symbol']] = dict(header=header, ct=ct, cq=cq, mast=mast)
    quotes.close()
    trades.close()
```

Compute intraday liquidity measures

```
intervals = ((v, 's') for v in [1, 2, 5, 15, 30]) + [(v, 'm') for v in [1, 2, 5]]
max_num = 100000
```

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```

bin_keys = ['effective', 'realized', 'impact',
            'quoted', 'volume', 'offersize', 'bidsize',
            'ret', 'retq', 'counts']

# helper call run liquidity calculations by date, parallelizable
def intraday(date):
    """Compute intraday liquidity for a date"""
    store = Store(storedir / str(date), verbose=VERBOSE)
    symbols = sorted(store)
    daily_all = []
    bins_all = {k: [] for k in bin_keys}
    for num, symbol in enumerate(symbols):
        if num >= max_num:      # set small max_num for debugging
            break
        header, ct, cq, mast = store[symbol].values()

        # Compute and collect daily and bin statistics at all intervals
        daily = header.copy()    # to collect current stock's daily stats

        # Compute effective spreads by large and small trade sizes
        med_volume = mast['Round_Lot'] * (cq['Best_Bid_Size'].median()
                                           + cq['Best_Offer_Size'].median()) / 2.
        data = ct.loc[(ct.index > open_t) & (ct.index < close_t),
                      ['Trade_Price', 'Prevailing_Mid', 'Trade_Volume']]
        eff_spr = data['Trade_Price'].div(data['Prevailing_Mid']).sub(1).abs()
        eff_large = eff_spr[data['Trade_Volume'].ge(med_volume)].to_numpy()
        daily['large_trades'] = len(eff_large)
        daily['large_volume'] = data.loc[data['Trade_Volume'].ge(med_volume),
                                           'Trade_Volume'].mean()
        daily['large_spread'] = eff_large.mean()
        eff_small = eff_spr[data['Trade_Volume'].lt(med_volume)]
        daily['small_trades'] = len(eff_small)
        daily['small_volume'] = data.loc[data['Trade_Volume'].lt(med_volume),
                                           'Trade_Volume'].mean()
        daily['small_spread'] = eff_small.mean()

        v, u = intervals[-1]
        for (v, u) in intervals:
            bt = bin_trades(ct, v, u, open_t=open_t, close_t=close_t)
            bq = bin_quotes(cq, v, u, open_t=open_t, close_t=close_t)
            daily[f"tvar{v}{u}"] = bt['ret'].var(ddof=0) * len(bt)
            daily[f"tvarHL{v}{u}"] = ((hl_vol(bt['maxtrade'], bt['mintrade'])**2)
                                      * len(bt))
            daily[f"tvarOHLC{v}{u}"] = ((ohlc_vol(bt['first'],
                                                   bt['maxtrade'],
                                                   bt['mintrade'],
                                                   bt['last'])**2)
                                         * len(bt))
            daily[f"qvar{v}{u}"] = bq['retq'].var(ddof=0) * len(bq)
            daily[f"qvarHL{v}{u}"] = ((hl_vol(bq['maxmid'], bq['minmid'])**2)
                                      * len(bq))
            daily[f"qvarOHLC{v}{u}"] = ((ohlc_vol(bq['firstmid'],
                                                   bq['maxmid'],
                                                   bq['minmid'],
                                                   bq['mid'])**2)
                                         * len(bq))

```

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```

daily[f"tunch{v}{u}"] = np.mean(np.abs(bt['ret']) < EPSILON)
daily[f"qunch{v}{u}"] = np.mean(np.abs(bq['retq']) < EPSILON)
daily[f"tzero{v}{u}"] = np.mean(bt['counts'] == 0)

# Collect final (i.e. 5 minute bins) bt and bq intraday series
df = bq.join(bt, how='left')
for s in ['effective', 'realized', 'impact', 'quoted']:
    bins_all[s].append({**header,
                         **(df[s]/df['mid']).to_dict()})
for s in ['volume', 'offersize', 'bidsize', 'ret', 'retq', 'counts']:
    bins_all[s].append({**header,
                         **df[s].to_dict()})

# Collect daily means
daily.update(df[['bidsize', 'offersize', 'quoted', 'mid']].mean())
daily.update(df[['volume', 'counts']].sum())
daily.update(weighted_average(df[['effective', 'impact', 'realized',
                                    'vwap', 'volume']],
                               weights='volume'))
daily_all.append(daily)

return DataFrame(daily_all), {k: DataFrame(bins_all[k]) for k in bin_keys}

```

Multiprocessing is a package that supports spawning processes. The Pool API parallelizes the execution of a function across multiple input values, distributing the input data across processes (data parallelism).

```

# Run each day as a parallel thread, must use as context manager or close
with multiprocessing.Pool(processes=min(os.cpu_count(), len(dates))) as p:
    data = p.map(intraday, dates)

# Combine data
daily_df = pd.concat([data[j][0] for j in range(len(data))], ignore_index=True)
bins_df = {k: pd.concat([data[j][1][k] for j in range(len(data))], ignore_index=True)
           for k in bin_keys}

# Store in scratch folder
store = Store(paths['scratch'])

store['tick.daily'] = daily_df
store['tick.bins'] = bins_df

# Fetch extracted data
daily_df = store['tick.daily']
bins_df = store['tick.bins']

```

18.2 Liquidity by firm size

VWAP execution benchmark The other issue with VWAP as well as TWAP, market open or close prices is that they are benchmarks that can be influenced by the trade itself. Zero slippage to VWAP but being 100 percent of market volume does not necessarily mean it is a good execution. Zero slippage to the closing price while being part of an adverse high / low on the close is also not a good execution.

Daily average of liquidity measures, by market cap

- depth
- quoted spread
- effective spread
- price impact
- realized spread
- Lee-Ready tick test

```
# group by market cap (NYSE deciles 1-3, 4-6, 7-9, 10) and exchange listed
daily_df['Size'] = pd.cut(daily_df['decile'],
                           [0, 3.5, 6.5, 9.5, 11],
                           labels=['large', 'medium', 'small', 'tiny'])
groupby = daily_df.groupby(['Size'], observed=False)
```

```
# collect results for each metric
results = {}      # to collect results as dict of {column: Series}
formats = {}      # and associated row formatter string
results.update(groupby['mid']\
               .count()\
               .rename('Number of Stock/Days').to_frame())
formats.update({'Number of Stock/Days': '{:.0f}'})
```

```
result = groupby[['mid', 'vwap']].mean()    # .quantile(), and range
result.columns = ['Midquote Price', "VWAP"]
formats.update({k: '{:.2f}' for k in result.columns})
results.update(result)
```

```
result = groupby[['counts', 'volume']].mean()
result.columns = ['Number of trades', "Volume (shares)"]
formats.update({k: '{:.0f}' for k in result.columns})
results.update(result)
```

```
# volatility from 5m intervals
result = np.sqrt(groupby[['tvar5m', 'qvar5m', 'tvarHL5m', 'qvarHL5m',
                           'tvarOHL5m', 'qvarOHL5m']].mean())
result.columns = ['Volatility(trade price)', "Volatility(midquote)",
                  'Volatility(HL trade price)', "Volatility(HL midquote)",
                  'Volatility(OHL trade price)', "Volatility(OHL midquote)"]
formats.update({k: '{:.4f}' for k in result.columns})
results.update(result)
```

```

result = groupby[['offersize', 'bidsize']].mean()
result.columns = [s.capitalize() + ' (lots)' for s in result.columns]
formats.update({k: '{:.1f}' for k in result.columns})
results.update(result)

```

```

spr = ['quoted', 'effective', 'impact', 'realized']
result = groupby[spr].mean()
result.columns = [s.capitalize() + ' $ spread' for s in spr]
formats.update({k: '{:.4f}' for k in result.columns})
results.update(result)

```

```

rel = [s.capitalize() + ' (% price)' for s in spr]
daily_df[rel] = daily_df[spr].div(daily_df['mid'], axis=0) # scale spreads
result = 100*groupby[rel].mean()
formats.update({k: '{:.4f}' for k in result.columns})
results.update(result)

```

```

# summarize large and small trade effective spreads
spr = ['large_spread', 'small_spread']
result = 100*groupby[spr].mean()
result.columns = ['Large trade (% spread)', 'Small trade (% spread)']
formats.update({k: '{:.4f}' for k in result.columns})
results.update(result)

```

```

spr = ['large_trades', 'small_trades']
result = groupby[spr].mean()
result.columns = ['Large trade (# trades)', 'Small trade (# trades)']
formats.update({k: '{:.0f}' for k in result.columns})
results.update(result)

```

```

spr = ['large_volume', 'small_volume']
result = groupby[spr].mean()
result.columns = ['Large trade (avg volume)', 'Small trade (avg volume)']
formats.update({k: '{:.0f}' for k in result.columns})
results.update(result)

```

```

# display table of results
print("Average Liquidity by Market Cap")
row_formatted(DataFrame(results).T, formats)

```

Average Liquidity by Market Cap

Size	large	medium	small	tiny
Number of Stock/Days	2063	2572	4297	4618
Midquote Price	128.98	64.91	27.76	7.92
VWAP	128.97	64.92	27.75	7.90
Number of trades	25178	8407	3658	837
Volume (shares)	3031056	995483	533736	254773
Volatility(trade price)	0.0145	0.0211	0.0359	0.0807
Volatility(midquote)	0.0152	0.0223	0.0355	0.0918
Volatility(HL trade price)	0.0176	0.0217	0.0335	0.0690

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Volatility(HL midquote)	0.0144	0.0198	0.0288	0.0594
Volatility(OHLC trade price)	0.0184	0.0218	0.0324	0.0612
Volatility(OHLC midquote)	0.0138	0.0183	0.0255	0.0452
Offersize (lots)	8.8	9.8	11.9	13.6
Bidsize (lots)	8.9	17.0	14.1	16.5
Quoted \$ spread	0.0630	0.0672	0.0781	0.0841
Effective \$ spread	0.0379	0.0442	0.0406	0.0457
Impact \$ spread	0.0273	0.0244	0.0248	0.0186
Realized \$ spread	0.0106	0.0199	0.0158	0.0270
Quoted (% price)	0.0350	0.0834	0.2500	1.1582
Effective (% price)	0.0200	0.0421	0.1287	0.6638
Impact (% price)	0.0165	0.0345	0.0904	0.2669
Realized (% price)	0.0036	0.0077	0.0384	0.3973
Large trade (% spread)	0.0191	0.0420	0.1310	0.6398
Small trade (% spread)	0.0190	0.0400	0.1304	0.6755
Large trade (# trades)	3133	1140	423	108
Small trade (# trades)	22045	7267	3236	729
Large trade (avg volume)	1734	1608	2635	2324
Small trade (avg volume)	61	57	71	85

18.3 Sampling frequency

continuous trading

spurious autocorrelation

- Variance Ratio

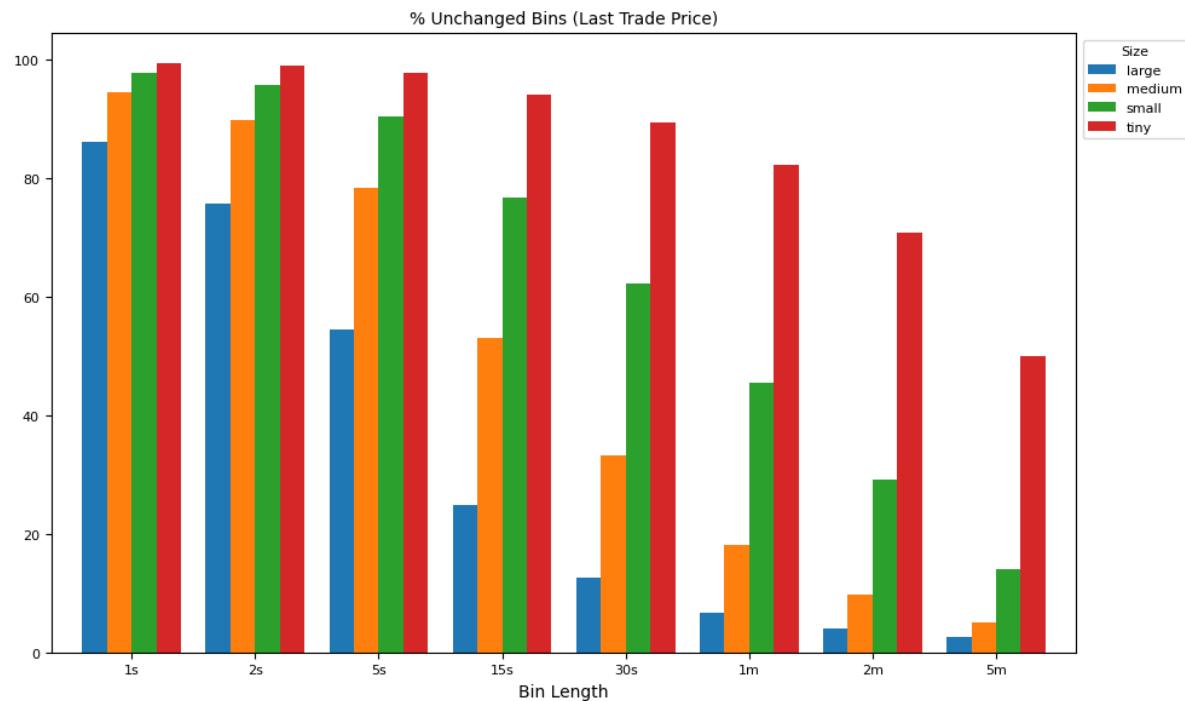
```
def plot_helper(result, xticks, keys, legend, xlabel, title, ylim=[], figsize=(10, 6), num=1, fontsize=8):
    """helper to plot bar graphs by sampling frequency"""
    fig, ax = plt.subplots(num=num, clear=True, figsize=figsize)
    result.plot(kind='bar',
                fontsize=fontsize,
                rot=0,
                width=0.8,
                xlabel='',
                ax=ax)
    if ylim:
        ax.set_ylim(*ylim)
    ax.set_xticklabels(xticks, fontsize=fontsize)
    ax.legend(keys, loc='upper left', bbox_to_anchor=(1.0, 1.0),
              fontsize=fontsize, title=legend, title_fontsize=8)
    ax.set_xlabel(xlabel, fontsize=fontsize + 2)
    ax.set_title(title, fontsize=fontsize + 2)
    plt.subplots_adjust(right=0.8, bottom=0.15)
    plt.tight_layout()
    return ax
```

```
xticks = [f"v{v}u{u}" for v, u in intervals]    # x-axis: bin lengths
keys = list(groupby.indices.keys())               # legend labels
```

```

labels = [f"tunch{v}{u}" for v, u in intervals]
result = groupby[labels].median()*100
ax = plot_helper(result.T,
                  title="% Unchanged Bins (Last Trade Price)",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=1)

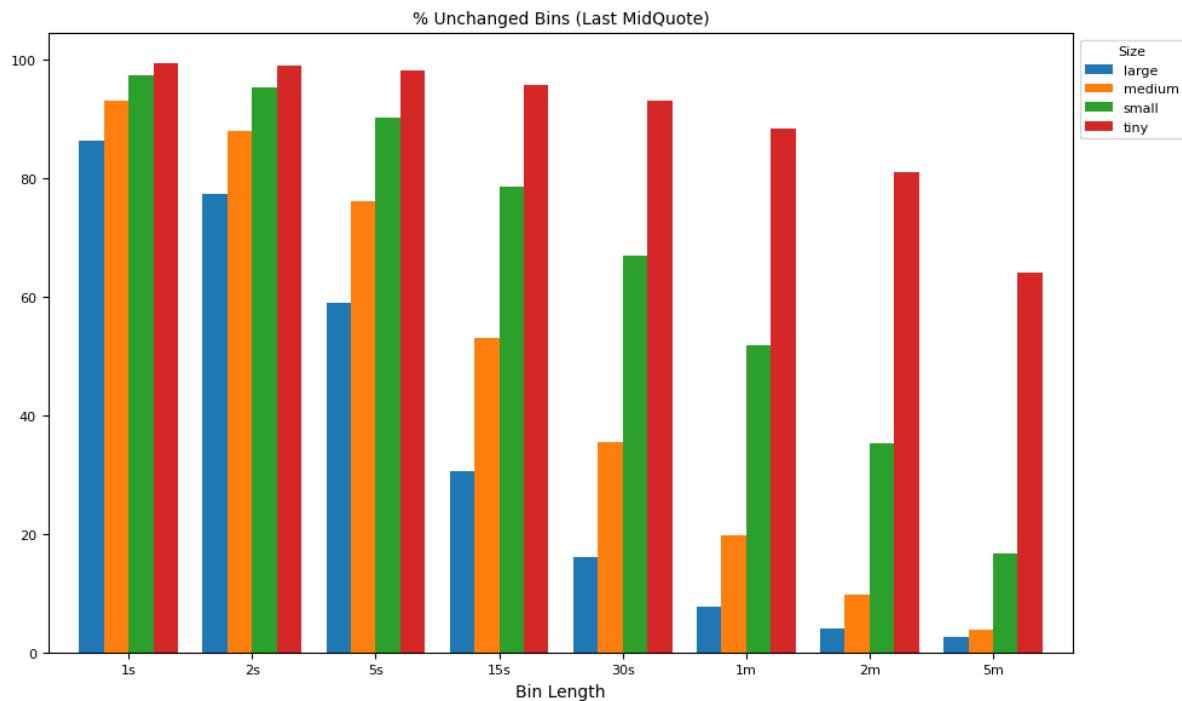
```



```

labels = [f"qunch{v}{u}" for v, u in intervals]
result = groupby[labels].median()*100
ax = plot_helper(result.T,
                  title="% Unchanged Bins (Last MidQuote)",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=2)

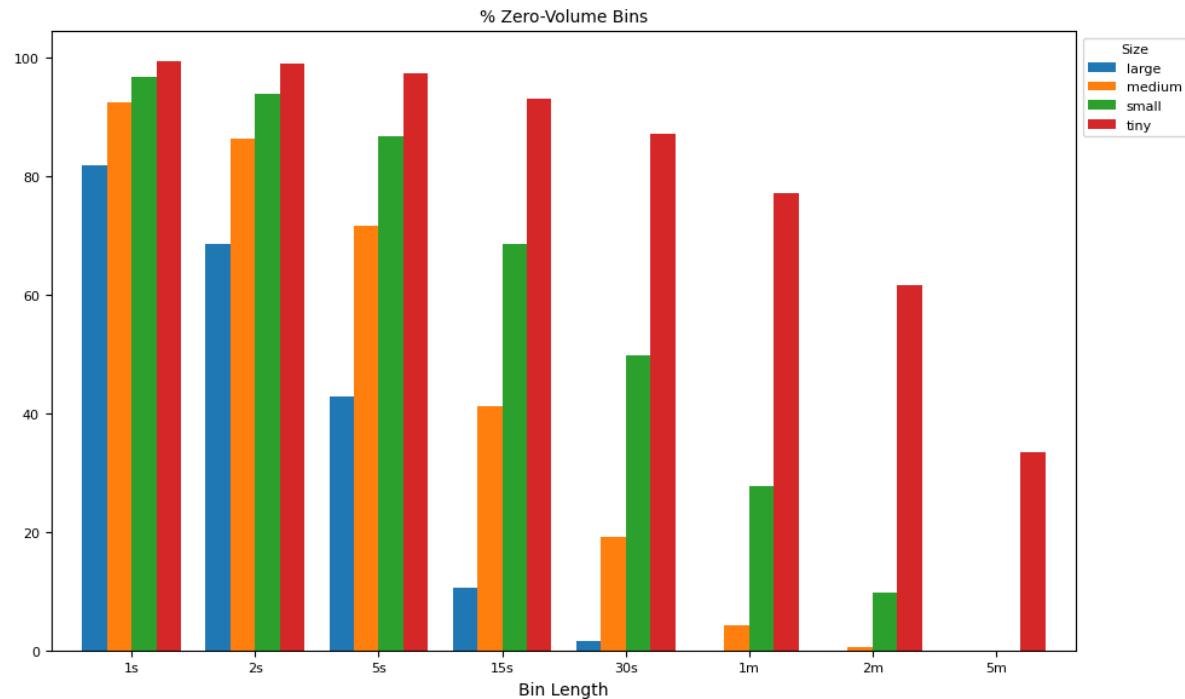
```



```

labels = [f"tzero{v}{u}" for v, u in intervals]
result = groupby[labels].median()*100
ax = plot_helper(result.T,
                  title="% Zero-Volume Bins",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=3)

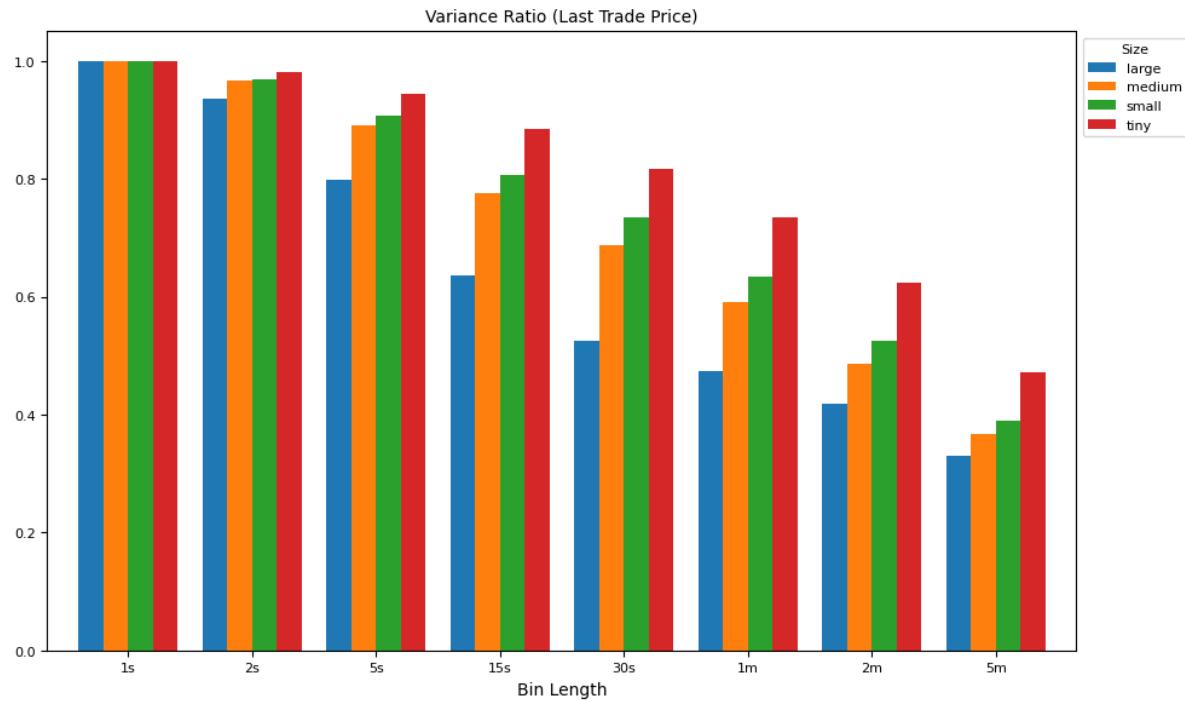
```



```

labels = [f"tvar{v}{u}" for v, u in intervals]
result = groupby[labels].median()
result = result.div(result['tvar1s'].values, axis=0)
ax = plot_helper(result.T,
                  title="Variance Ratio (Last Trade Price)",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=4)

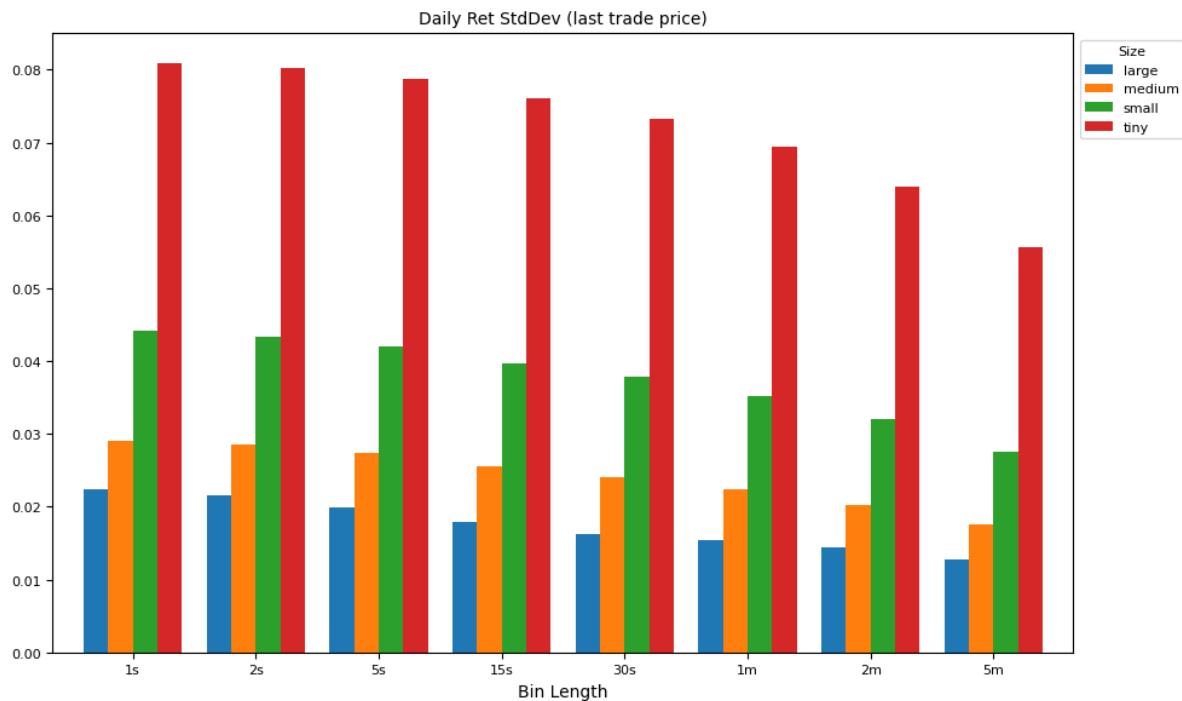
```



```

labels = [f"tvar{v}{u}" for v, u in intervals]
result = np.sqrt(groupby[labels].median())
ax = plot_helper(result.T,
                  title="Daily Ret StdDev (last trade price)",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=5)

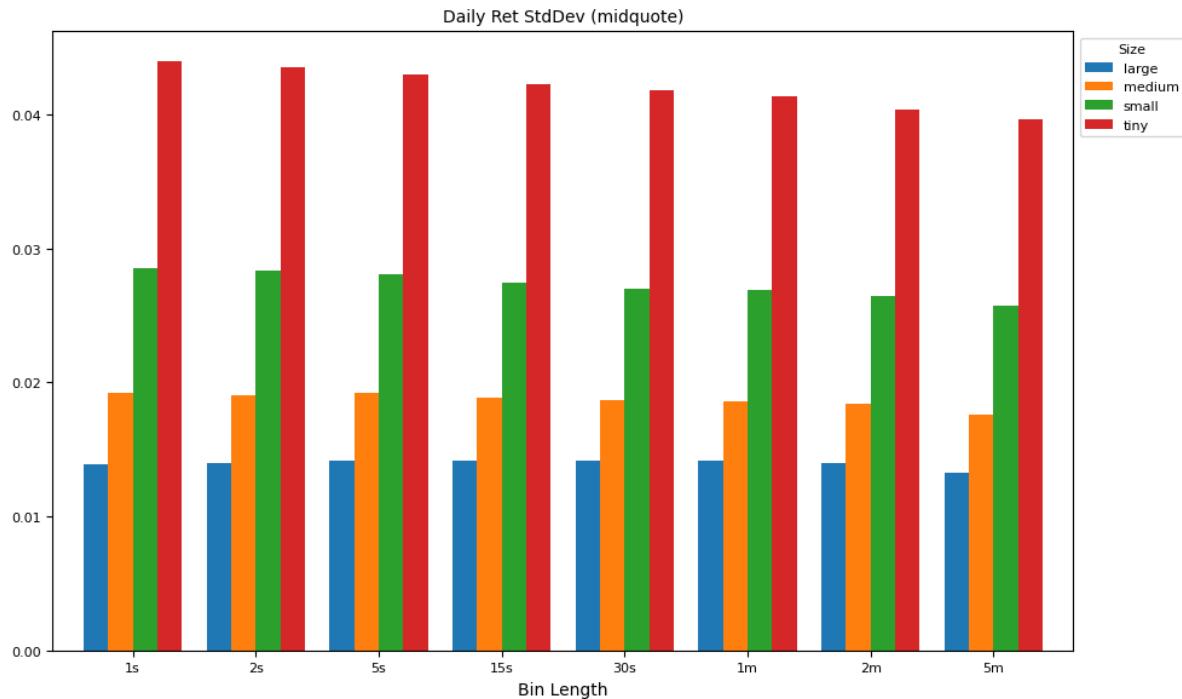
```



```

labels = [f"qvar{v}{u}" for v, u in intervals]
result = np.sqrt(groupby[labels].median())
ax = plot_helper(result.T,
                  title="Daily Ret StdDev (midquote)",
                  xticks=xticks,
                  xlabel="Bin Length",
                  keys=keys,
                  legend='Size',
                  num=6)

```



18.4 Volatility from tick data

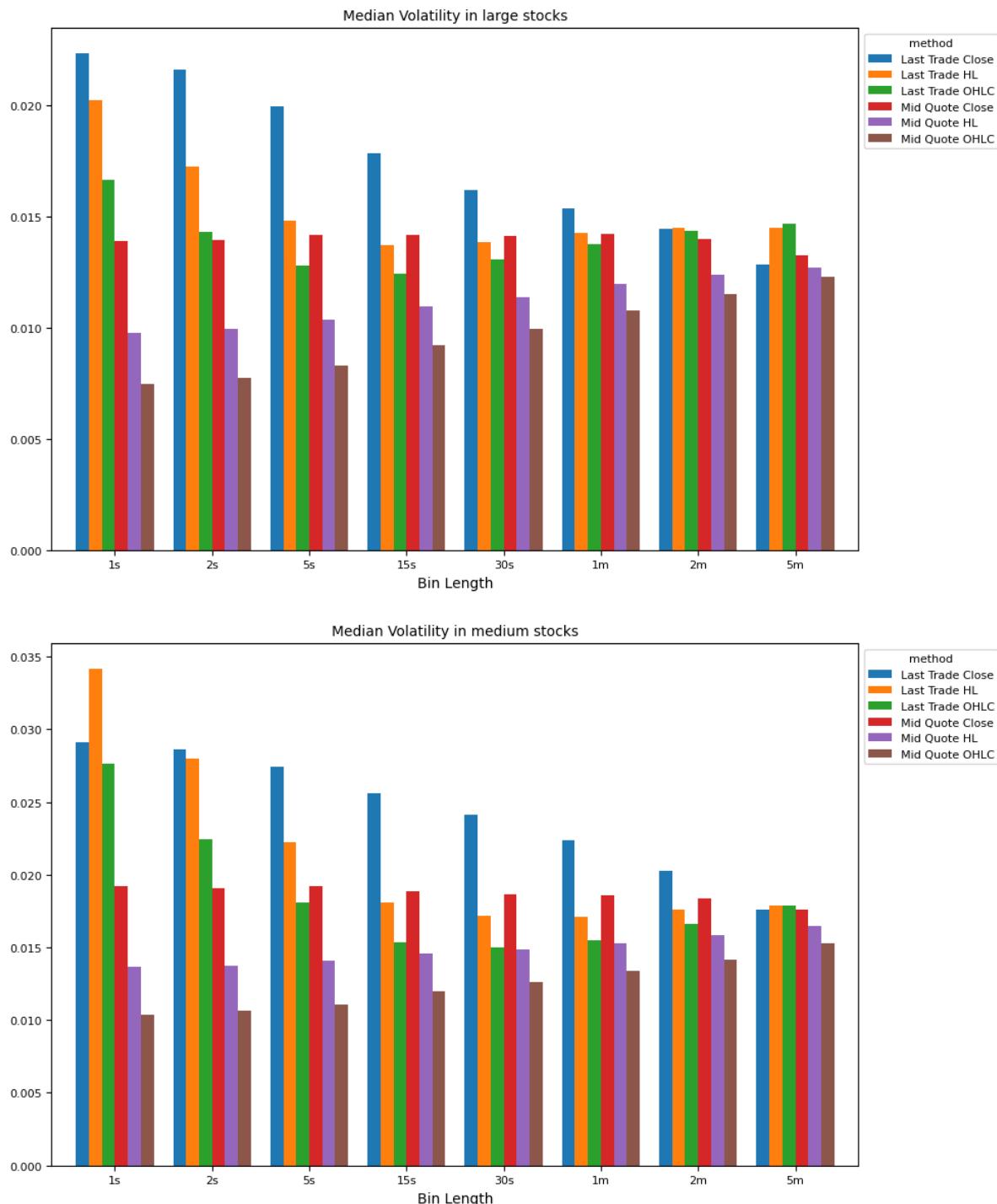
- Parkinsons (HL)
- Klass-Garman (OHLC) methods

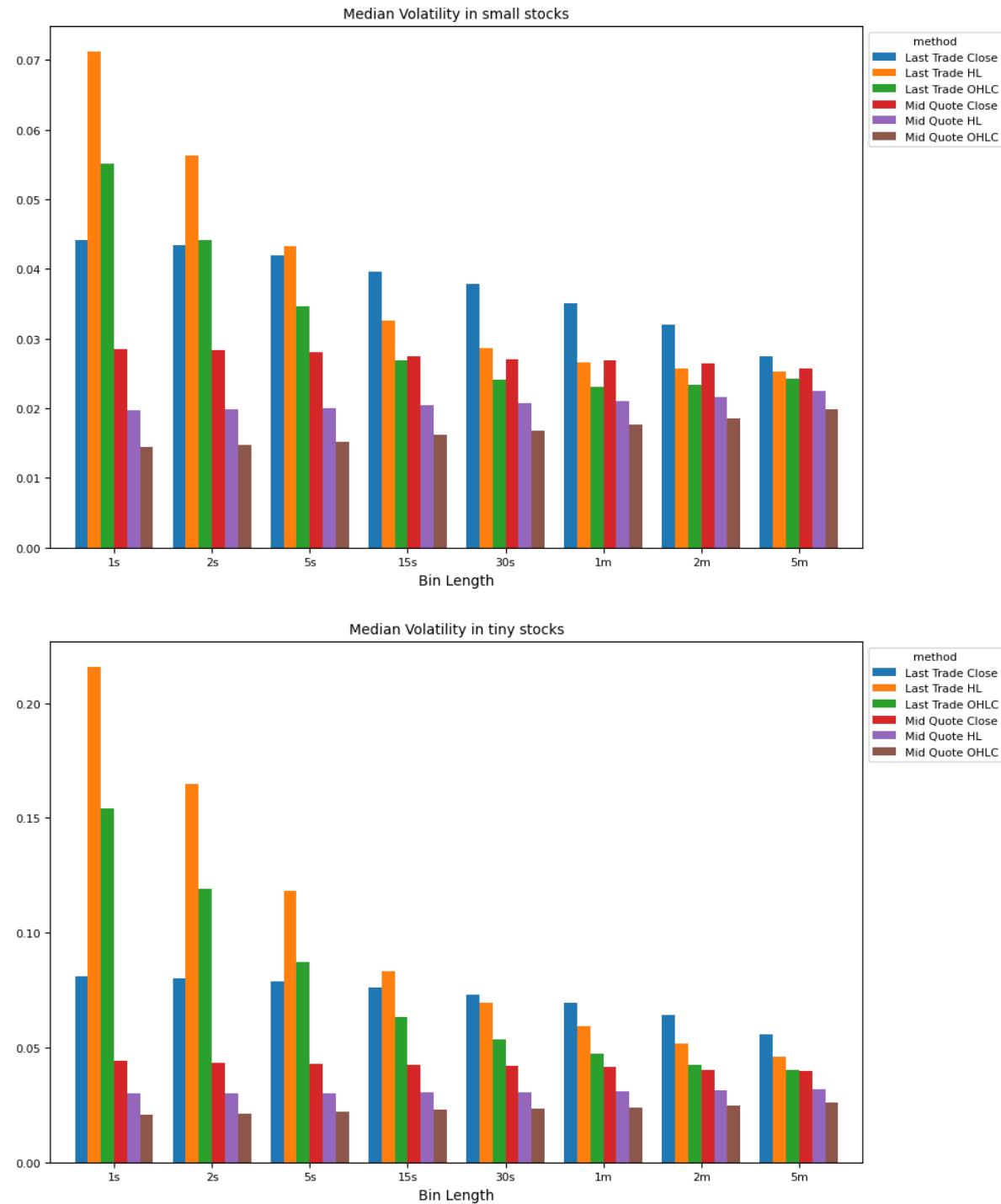
```
# Compare methods of volatility estimates, by interval and market cap
for ifig, (split_label, split_df) in enumerate(groupby):
    vol_df = np.sqrt(split_df[[c for c in daily_df.columns if "qvar" in c or "tvar" in c]])
    result = []
    for col in [c for c in vol_df.columns if "qvar" in c or "tvar" in c]:
        if col[4] == 'H':
            m = 'HL'
        elif col[4] == 'O':
            m = 'OHLC'
        else:
            m = 'Close'
        result.append({'method': {'t': 'Last Trade', 'q': 'Mid Quote'}[col[0]] + ' ' +
                      m,
                      'interval': (int("".join(filter(str.isdigit, col))) *
                                   (60 if col[-1] == 'm' else 1)),
                      'val': vol_df[col].median()})
    result = DataFrame.from_dict(result, orient='columns') \
        .pivot(index='interval', columns='method', values='val') \
        .sort_index()
    ax = plot_helper(result,
                     title="Median Volatility in " + " ".join(split_label) + " stocks",
                     xticks=xticks,
```

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```
xlabel="Bin Length",
keys=result.columns,
num=ifig+1,
legend='method')
```





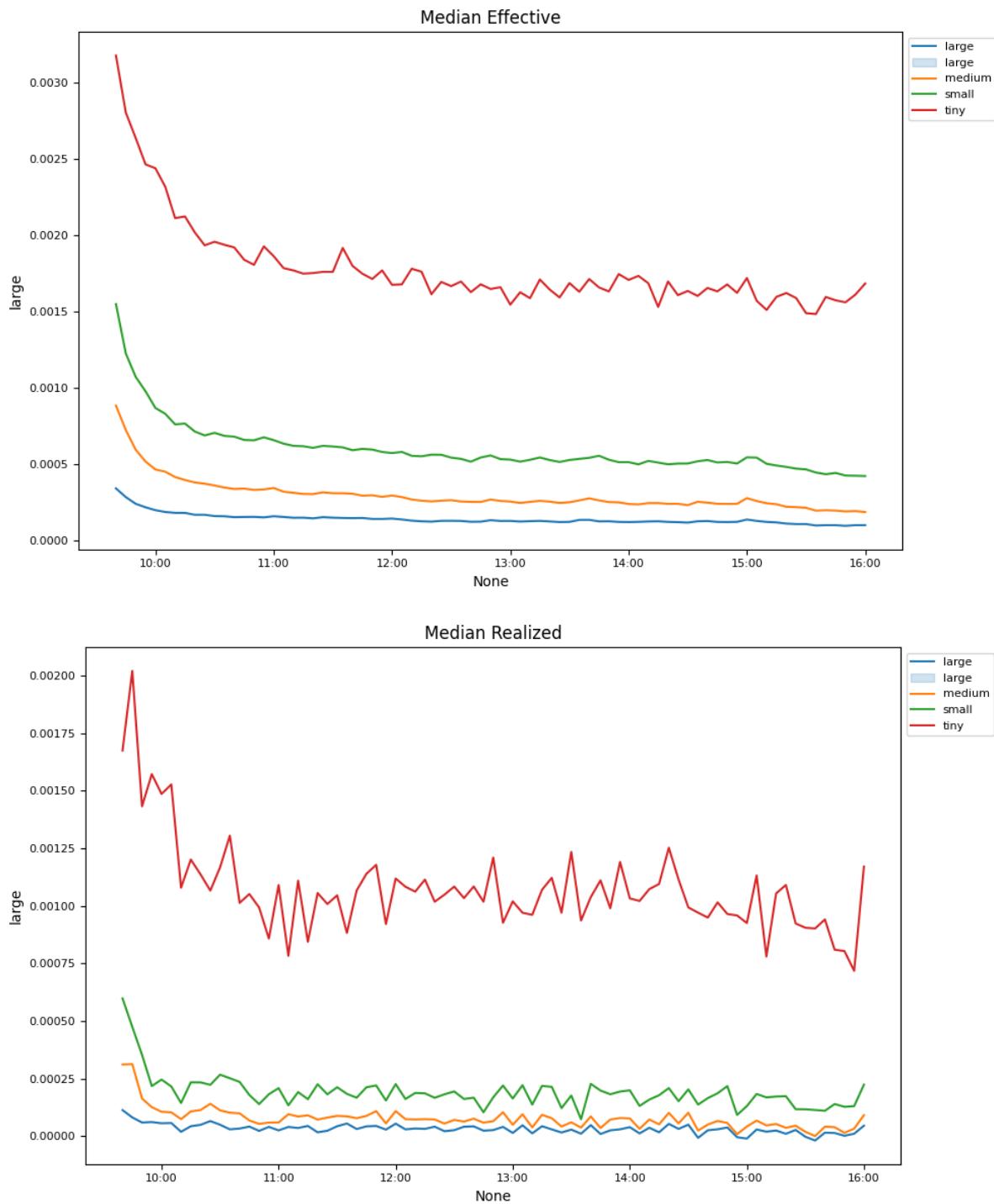
18.5 Intraday liquidity

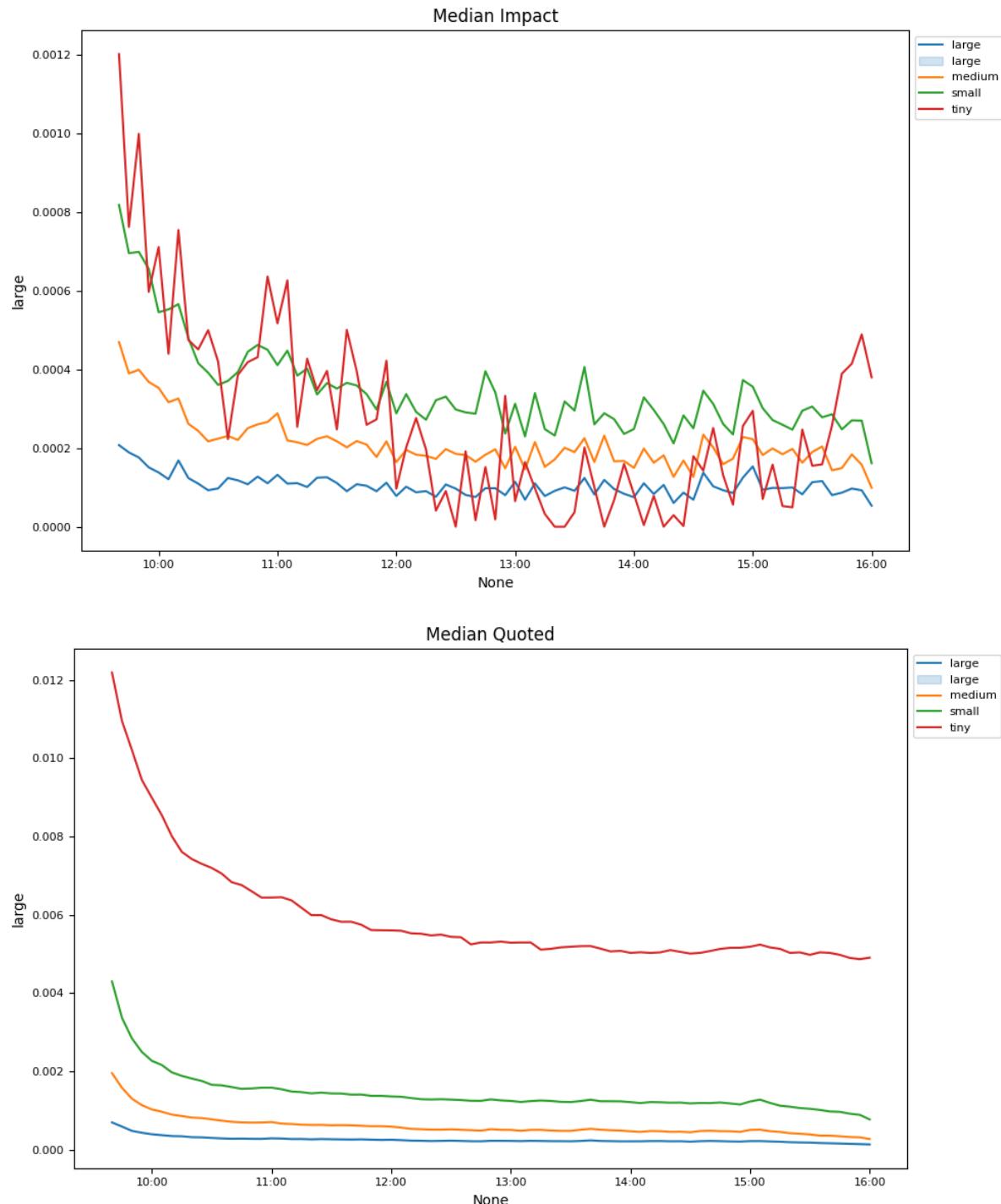
Order types (and intraday patterns)

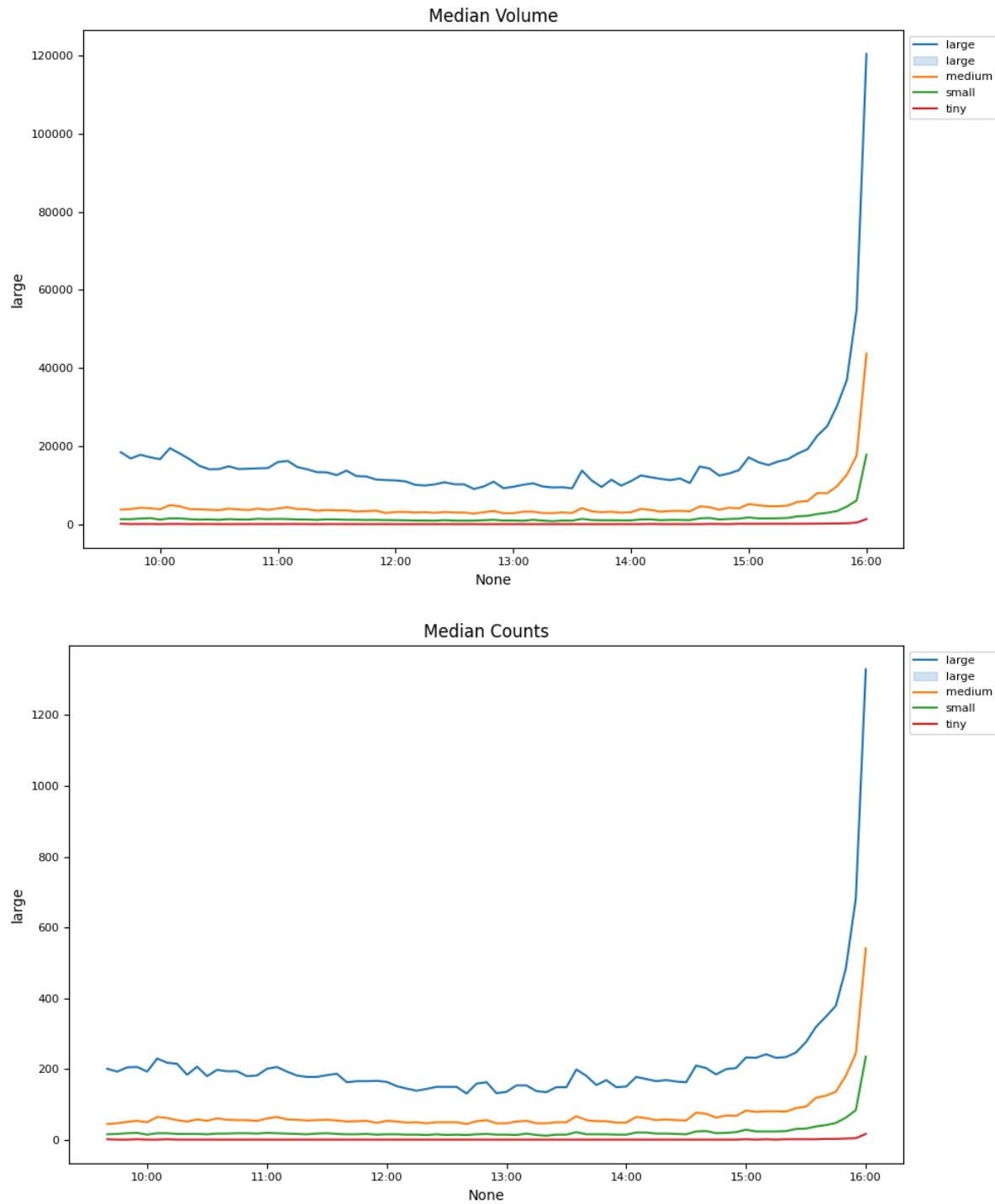
- market
- limit
- stop
- market-on-close

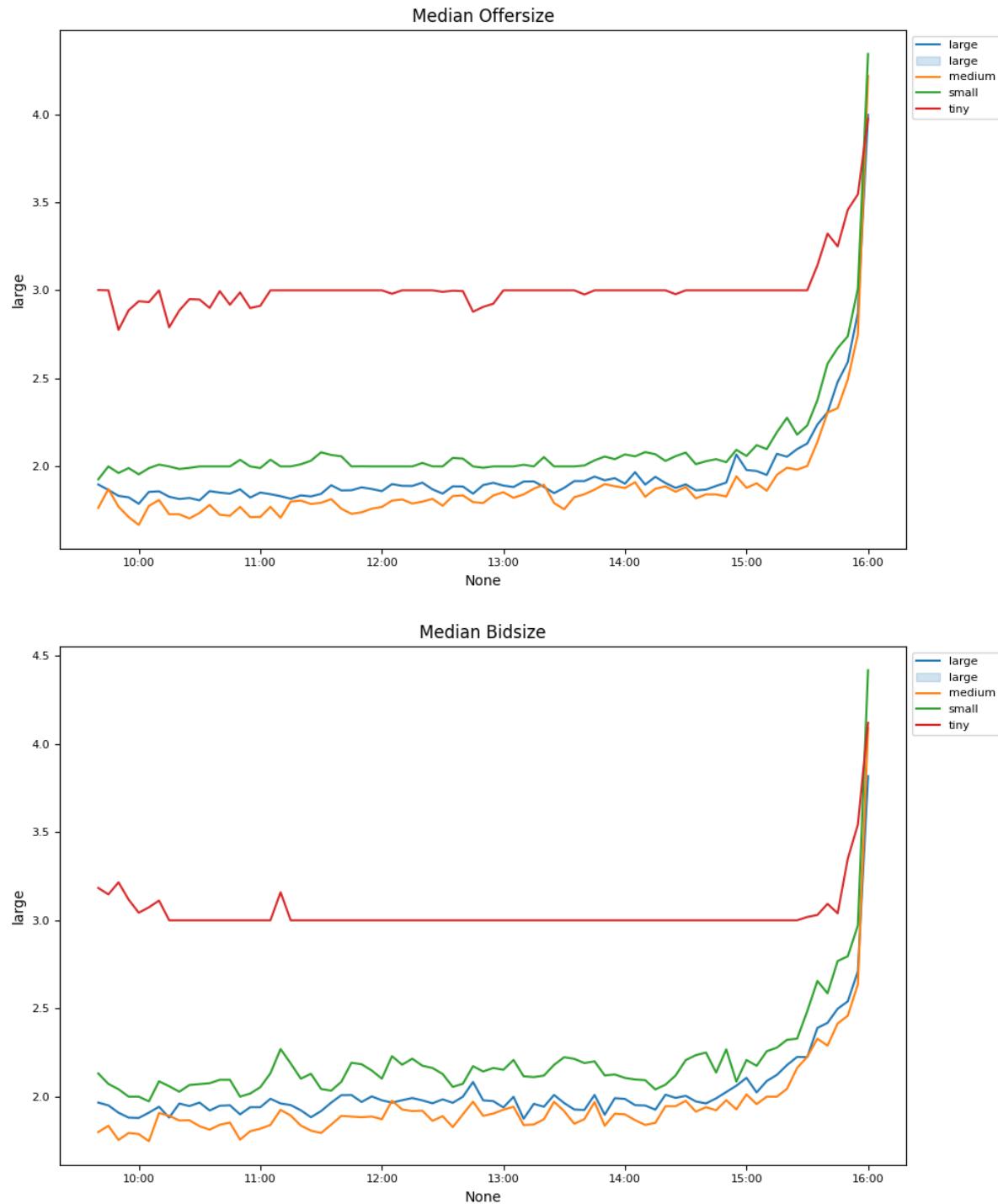
```
# Plot intraday spreads, depths and volumes
keys = ['effective', 'realized', 'impact', 'quoted',
        'volume', 'counts', 'offersize', 'bidsize']
for num, key in enumerate(keys):
    df = bins_df[key].drop(columns=['Round_Lot', 'Symbol'])
    df.index = list(zip(df['permno'], df['date']))

    # Group by market cap
    df['Size'] = pd.cut(df['decile'],
                         [0, 3.5, 6.5, 9.5, 11],
                         labels=['large', 'medium', 'small', 'tiny'])
    df = df.drop(columns=['date', 'permno', 'decile', 'exchcd', 'siccd'])\
        .dropna()\
        .groupby(['Size'], observed=False)\
        .median().T
    fig, ax = plt.subplots(1, 1, num=num+1, clear=True, figsize=(10, 6))
    plot_time(df.iloc[1:], ax=ax, fontsize=8)
    ax.legend(['large'] + list(df.columns),
              loc='upper left', bbox_to_anchor=(1.0, 1.0),
              fontsize=8)
    ax.set_title('Median ' + key.capitalize())
    plt.subplots_adjust(right=0.8)
    plt.tight_layout()
```









EVENT RISK

Don't worry about failure; you only have to be right once — Drew Houston

Concepts:

- Earnings surprises
- Poisson regression
- Generalized Linear Models
- Credit Losses

```
import pandas as pd
import numpy as np
import matplotlib.pyplot as plt
import statsmodels.api as sm
from finds.database import SQL, RedisDB
from finds.structured import BusDay, SignalsFrame, CRSP, IBES
from finds.readers import Alfred
from secret import credentials, paths, CRSP_DATE
VERBOSE = 0
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
ibes = IBES(sql, bd, verbose=VERBOSE)
store = Store(paths['scratch'])
LAST_DATE = CRSP_DATE
```

19.1 Earnings misses

The quarterly earnings expectations from all the analysts that cover a company are averaged out to find the consensus analyst estimate. The number of analysts covering a particular company is largely dependent on the size of the company and the trading volume of its stock. Large, well-known companies tend to be covered by many analysts and the consensus is therefore derived from many opinions. A small, lesser-known company may be covered by only one or a few research analysts, and sometimes none at all.

If the company reports earnings below what research analysts were expecting, this would be considered an **earnings miss**. If the company reports earnings greater than what analysts expected, it would be considered an **earnings beat**

1. Each quarter and stock in the universe: select latest IBES statistical period that is no later than than the fiscal quarter end date
2. SUE (standardized unexpected earnings) is computed as the fiscal quarter's reported earnings minus median Q1 estimate, scaled by stock price.

```
# retrieve ibes Q1 where forecast period <= fiscal date, and keep latest
df = ibes.get_linked(dataset='statsum',
                      fields=['fpedats', 'medest', 'actual'],
                      date_field='statpers',
                      where=" fpi = '6' AND statpers <= fpedats")
```

```
summ = df.dropna() \
    .sort_values(['permno', 'fpedats', 'statpers']) \
    .drop_duplicates(['permno', 'fpedats'], keep='last')
summ['rebalddate'] = bd.endmo(summ['fpedats'])
summ = summ.set_index(['permno', 'statpers'])
```

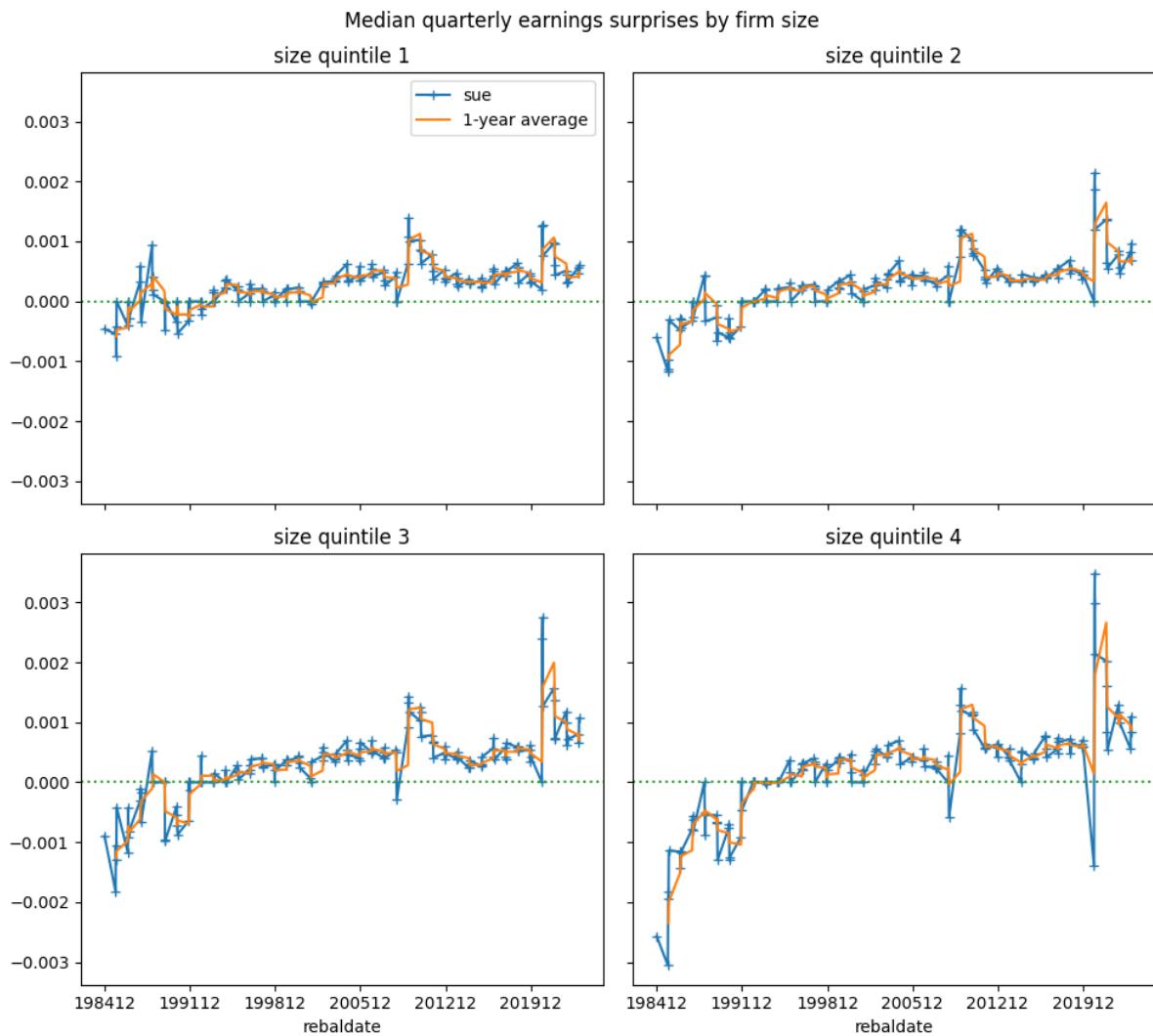
```
# retrieve ibes price
df = ibes.get_linked(dataset='actpsum',
                      fields=['price'],
                      date_field='statpers')
```

```
hist = df.dropna() \
    .sort_values(['permno', 'statpers']) \
    .drop_duplicates(['permno', 'statpers'], keep='last')
hist = hist.set_index(['permno', 'statpers'])
```

```
# calculate sue with ibes surprise and price
summ = summ.join(hist[['price']], how='inner')
summ['sue'] = (summ['actual'] - summ['medest']).div(summ['price'])
```

```
# define large earnings miss as 5% of price
START = 19841201
signals = SignalsFrame(summ.reset_index(drop=False))
rebaldates = bd.date_range(START, LAST_DATE-100, freq='quarterly')
label = 'sue'
out = []
for rebaldate in rebaldates:
    univ = crsp.get_universe(rebaldate)      # get this quarter's universe
    univ = univ[(abs(univ['prc']) >= 5.0) & (univ['decile'] < 9)]  # no small low-
    →price
    signal = signals(label=label,
                      date=rebaldate,
                      start=bd.endqr(rebaldate, quarters=-1)) \
        .reindex(univ.index) \
        .dropna() \
        .reset_index()
    signal['rebaldate'] = rebaldate // 100
    signal['miss'] = signal['sue'] < -0.05  # large earnings misses
    out.append(signal.set_index('permno').join(univ['decile'], how='inner') \
        .reset_index())
out = pd.concat(out)
```

```
# median quarterly earnings surprise by firm size
fig, axes = plt.subplots(2, 2, figsize=(10, 9), sharex=True, sharey=True)
axes = axes.flatten()
for label, (ax, dec) in enumerate(zip(axes, [[1,2], [3,4], [5,6], [7,8]])):
    y = out[out['decile'].isin(dec)].groupby('rebalance') ['sue'].median()
    y.plot(ax=ax, marker='+', color="C0")
    y.rolling(4).mean().plot(ax=ax, color="C1")
    ax.set_title(f"size quintile {label+1}")
    if not label:
        ax.legend(['sue', '1-year average'])
    ax.axhline(0, color='C2', ls=':')
    ax.set_xticks(y.index[::28])
    ax.minorticks_off()
plt.suptitle('Median quarterly earnings surprises by firm size')
plt.tight_layout()
plt.show()
```



Median quarterly earnings surprise tended to be negative prior to the mid-90's (especially smaller stocks) but turned generally positive after that.

```
# count number of stocks with large earnings misses
frac = out.groupby('rebaldate')['miss'].mean().rename('frac')
count = out.groupby('rebaldate')['miss'].sum().rename('count')
exposures = out['rebaldate'].value_counts().sort_index().rename('exposures')
Y = pd.concat([exposures, frac, count], axis=1)
Y.index = Y.index.astype(str)
print("Earnings misses")
Y
```

Earnings misses

	exposures	frac	count
rebaldate			
198412	1327	0.051997	69
198503	1302	0.038402	50
198506	1384	0.040462	56
198509	1384	0.033960	47
198512	1398	0.063662	89
...
202209	2080	0.009615	20
202212	2008	0.007968	16
202303	1910	0.005759	11
202306	1902	0.003680	7
202309	1842	0.008686	16

[156 rows x 3 columns]

19.2 Poisson regression

The Poisson distribution is typically used to model counts. A Poisson regression models the expected response as a function of the covariates, specifically: $\log(E[Y|X]) = \beta X$, or equivalently $E[Y|X] = e^{\beta X}$

- Interpretation of coefficients: an increase in X_i by one unit is associated with a change in $E[Y_i]$ by a factor of $\exp \beta_i$
- Under the Poisson model, $Var[Y_i] = E[Y_i]$
- No negative fitted values, because the Poisson model only allows for non-negative values.

Poisson regression may also be appropriate for *rate* data, where the count of events divided by some measure of that unit's **exposure**. When modelling the number of stocks with large earnings misses each quarter, the denominator of the rate would be the total number of stocks N in the universe that quarter. The log of the total number is called the **offset** variable, and enters on the right-hand side of the equation and a parameter estimate constrained to 1.

$$\log\left[\frac{E[Y|X]}{\text{exposure}}\right] = \log E[Y|X] - \log(\text{exposure}) = X\beta - \log(\text{exposure})$$

19.2.1 Generalized Linear Models

Linear and Poisson regression are generalized linear models (GLMs).

- Each approach models the mean of Y_i as a function of the predictors, specifically: the transformed mean $E[Y_i]$ is a linear function of the predictors. That transformation is called a **link function** ν , which provides the relationship between the linear predictor and the mean of the distribution function. The inverse of the link function is called the **mean function**. The link functions for linear and Poisson regression are the identity $\nu(E[Y]) = E[Y]$ and $\log \nu(E[Y]) = \log E[Y]$ respectively.
- Conditional on X , Y belongs to some family of distributions, typically Gaussian for linear regression and Poisson for Poisson regression. These distributions are members of the **exponential family**: other well-known members of this family are the Bernoulli, Multinomial, Exponential, Gamma, and the negative binomial distributions.

Any regression approach that models the response Y as coming from a particular member of the exponential family, and then transforming the mean of the response so that the transformed mean is a linear function of the predictors is known as a generalized linear model. Poisson regression models the response as coming from the Poisson distribution (with support $0, 1, 2, \dots$), with its canonical link function being the log function $X\beta = \log E[Y]$, and the mean function being the exponential $E[Y] = e^{X\beta}$

```
# retrieve and transform economics series
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)

X = pd.concat([alf(s, log=1, diff=1, freq='Q') for s in ['INDPRO', 'WILL5000IND']],
              axis=1)\n
      .dropna()
X.index = (X.index // 100).astype(str)

# Run GLM regression with Poisson family and Log link
Z = Y.loc[Y.index > '199512'].join(X, how='inner')
Z['const'] = 1
glm = sm.GLM(exog=Z[['const'] + list(X.columns)],
              endog=Z['count'],
              family=sm.families.Poisson(link=sm.families.links.Log()),
              exposure=Z['exposures'])\n
      .fit()
y_pred = glm.predict(exog=Z[['const'] + list(X.columns)],
                      exposure=Z['exposures']).rename('predicted')
print(glm.summary())
```

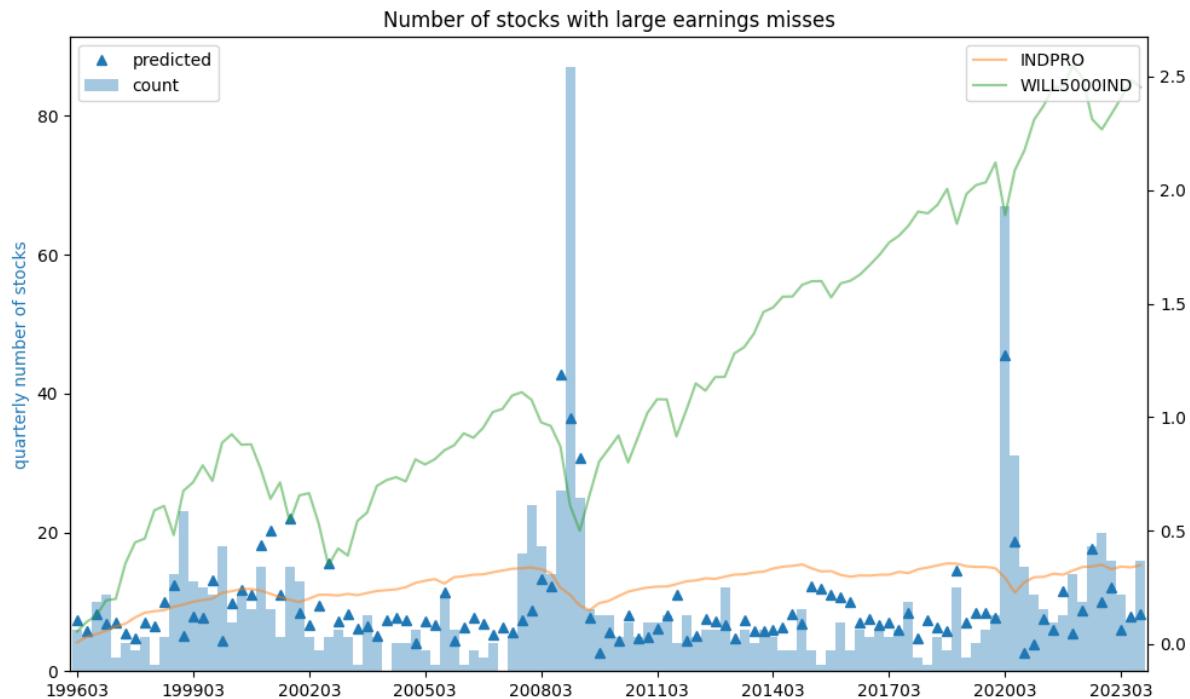
Generalized Linear Model Regression Results						
=====						
Dep. Variable:	count	No. Observations:	111			
Model:	GLM	Df Residuals:	108			
Model Family:	Poisson	Df Model:	2			
Link Function:	Log	Scale:	1.0000			
Method:	IRLS	Log-Likelihood:	-431.05			
Date:	Sat, 27 Apr 2024	Deviance:	451.81			
Time:	17:00:51	Pearson chi2:	523.			
No. Iterations:	5	Pseudo R-squ. (CS):	0.9695			
Covariance Type:	nonrobust					
=====						
	coef	std err	z	P> z	[0.025	0.975]
const	-5.3083	0.032	-163.880	0.000	-5.372	-5.245

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INDPRO	-20.9026	1.478	-14.143	0.000	-23.799	-18.006
WILL5000IND	-3.1993	0.302	-10.602	0.000	-3.791	-2.608
=====						

```
# Plot predicted and predictors
fig, ax = plt.subplots(figsize=(10, 6))
bx = ax.twinx()
Z['count'].plot(kind='bar', width=1.0, alpha=0.4, color="C0", ax=ax)
y_pred.plot(ls='-', marker='^', color="C0", ax=ax)
ax.set_ylabel('quarterly number of stocks', color="C0")
Z['INDPRO'].cumsum().plot(color="C1", alpha=.5, ax=bx)
Z['WILL5000IND'].cumsum().plot(color="C2", alpha=.5, ax=bx)
ax.legend(loc='upper left')
bx.legend(loc='upper right')
ax.set_xticks(np.arange(0, len(Z), 12), Z.index[::12])
ax.set_title('Number of stocks with large earnings misses')
plt.tight_layout()
```



19.3 Credit losses

Suppose a financial institution has a portfolio N loans, and:

- **default risk** p_i is the probability of default of the i th loan
- **loss severity** or loss given default L_i is the portion of the i th loan lost in the event of default. This is often assumed known with certainty

Then Expected loss is the sum of Default Probability \times Loss given default over all loans = $\sum_{i=1}^N p_i L_i$

The standard deviation of the expected loss on an individual loan, by applying the “Bernoulli shortcut” is $\sigma_i = \sqrt{p_i(1-p_i)L_i}$.

The standard deviation of the loss of the portfolio depends on the correlation of defaults between loans $\sigma_P = \sqrt{\sum_i \sum_j \rho_{ij} \sigma_i \sigma_j}$. For tractability, the correlations may be simplified to be constant or determined by a (Gaussian) copula, though neither assumption suffices to model real markets.

19.4 Actuarial losses

Actuaries use the **frequency-severity** method for determining the expected number of claims that an insurer will receive during a given time period and how much the average claim will cost. Both are random (unlike the previous credit loss scenario where loss severity was assumed constant), and historical data may be used to model the expected number of claims and the expected cost of each claim, then multiplied together assuming they are independent.

<https://sites.google.com/site/zoubin019/teaching/math-5639-actuarial-loss-models>

19.4.1 Claim frequency

TODO

19.4.2 Claim severity

TODO

19.4.3 Aggregate loss

TODO

PRINCIPAL CUSTOMERS GRAPH

Forget about your competitors, just focus on your customers - Jack Ma

Concepts:

- Supply chain
- Graph properties

References;

- Ling Cen and Sudipto Dasgupta, 2021, The Economics and Finance of Customer-Supplier Relationships

```
import math
import numpy as np
import pandas as pd
import networkx as nx
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from finds.database import SQL
from finds.recipes import graph_draw
from secret import credentials
import warnings
# %matplotlib qt
VERBOSE = 0
if not VERBOSE:
    warnings.simplefilter(action='ignore', category=FutureWarning)
sql = SQL(**credentials['sql'], verbose=VERBOSE)
```

20.1 Supply chain

The interrelationships between upstream supplier firms and downstream customer firms, referred to as “supply-chain” relationships, constitute an important sources of linkages in the economy.

20.1.1 Principal customers

Regulation S-K and SFAS 131 require firms to disclose principal customers that account for more than 10% of a firm's total sales. An important feature of these disclosure, however, is that the suppliers are much smaller than their corporate principal customers. The primary reason is that customers are identified as "important" for the supplier in terms of the percentage of the supplier's sales.

```
# retrieve principal customers info
year = 2016
cust = sql.read_dataframe(f"select gvkey, cgvkey, stic, ctic, conm, cconnm "
                           f"  from customer "
                           f"  where srctype >= {year}0101 "
                           f"  and srctype <= {year}1231")
```

```
# construct Series to lookup company full name from ticker
lookup = pd.concat([Series(cust['conm'].values, cust['stic'].values),
                     Series(cust['cconnm'].values, cust['ctic'].values)]) \
    .drop_duplicates()
```

20.2 Graph properties

In a **graph**, **nodes** (also called vertices) represent entities or objects, while **edges** represent the connections or relationships between these entities. The **degree** of a graph is the number of edges that are directly connected to a particular node.

Density is the edges to nodes ratio: $\frac{2m}{n(n-1)}$ for undirected graphs, and $\frac{m}{n(n-1)}$ for directed graphs, where m is the number of edges and n is the number of nodes

A **simple** graph does not contain any self-loops (edges that connect a vertex to itself) and does not have multiple edges between the same pair of vertices.

A **subgraph** is a subset of nodes within a larger graph, and including only the edges that connect those selected nodes. A **component** of a graph is a subgraph where every node is connected to every other node in the subgraph by some path

Attributes of graphs:

- weighted versus unweighted: whether there are any numerical values associated with each relationship (edge)
- directed versus undirected: whether the relationships (edges) explicitly require a start and an end node
- cyclic versus acyclic: cyclic graphs contain at least one cycle, meaning there is a path that starts and ends at the same node. Acyclic graphs, on the other hand, do not have any cycles.
- connected versus disconnected: whether there is a path between any two nodes in graph, irrespective of distance
- Weakly connected components of a graph are sets of nodes where every pair of nodes has a path between them when ignoring the direction of edges. Strongly connected components are sets of nodes where every pair of nodes has a directed path between them.
- Weakly connected graphs have a path between every pair of nodes when considering the direction of edges, but ignoring their direction. Strongly connected graphs, on the other hand, have a directed path between every pair of nodes, considering the direction of edges.

```
# nodes are companies, with directed edges from supplier to customer
vertices = set(cust['stic']).union(cust['ctic'])
edges = cust[['stic', 'ctic']].values.tolist()  # supplier --> customer
```

```
# Populate networkx directed graph with nodes and edges
DG = nx.DiGraph()
DG.add_nodes_from(vertices)
DG.add_edges_from(edges)
```

```
# Helper to display graph properties
def graph_info(G):
    out = dict()
    out['is_directed'] = nx.is_directed(G)
    out['num_edges'] = nx.number_of_edges(G)
    out['num_nodes'] = nx.number_of_nodes(G)
    out['num_selfloops'] = nx.number_of_selfloops(G)
    out['density'] = nx.density(G)

    out['is_weighted'] = nx.is_weighted(G)
    if nx.is_weighted(G):
        out['is_negatively_weighted'] = nx.is_negatively_weighted(G)

    # Components
    if nx.is_directed(G):
        out['is_weakly_connected'] = nx.is_weakly_connected(G)
        out['weakly_connected_components'] = nx.number_weakly_connected_components(G)
        out['size_largest_weak_component'] = len(max(
            nx.weakly_connected_components(G), key=len))
        out['is_strongly_connected'] = nx.is_strongly_connected(G)
        out['strongly_connected_components'] = nx.number_strongly_connected_
    ↪components(G)
        out['size_largest_strong_component'] = len(max(
            nx.strongly_connected_components(G), key=len))
    else:
        out['is_connected'] = nx.is_connected(G)
        out['connected_components'] = nx.number_connected_components(G)
        out['size_largest_component'] = len(max(
            nx.connected_components(G), key=len))
    return out
```

```
Series(graph_info(DG)).rename('Principal Customers Graph').to_frame()
```

	Principal Customers Graph
is_directed	True
num_edges	3052
num_nodes	1830
num_selfloops	11
density	0.000912
is_weighted	False
is_weakly_connected	False
weakly_connected_components	89
size_largest_weak_component	1628
is_strongly_connected	False
strongly_connected_components	1829
size_largest_strong_component	2

```
# remove self-loops, if any
DG.remove_edges_from(nx.selfloop_edges(DG))
```

20.2.1 Clustering coefficient

The clustering coefficient measures the degree to which nodes in a graph tend to cluster together.

- a **triplet** is three nodes that are connected by either two (open triplet) or three (closed triplet) undirected ties.
- a **triangle** comprises three closed triplets, one centered on each of the nodes
- the **clustering coefficient** of a node is the fraction of possible triangles through that node that exist $\frac{2\# \text{triangles}}{(\text{degree})(\text{degree}-1)}$
- **graph transitivity** is the fraction of all possible triangles present $3 \frac{\# \text{triangles}}{\# \text{triads}}$ where possible triangles are identified by the number of **triads** (two edges with a shared vertex).

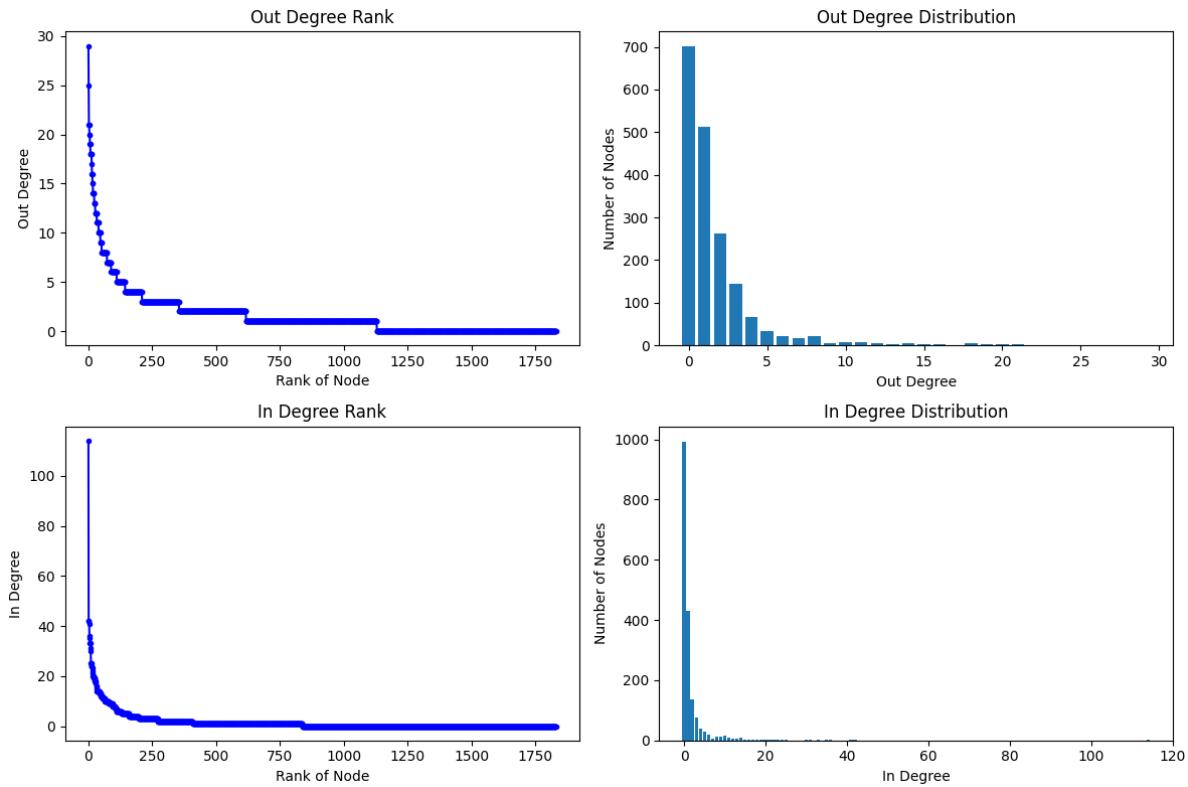
```
# as an undirected graph
G = nx.Graph(DG)
DataFrame({'transitivity': nx.transitivity(G),
           'average clustering': nx.average_clustering(G)},
           index=['clustering'])
```

	transitivity	average clustering
clustering	0.005751	0.009872

20.2.2 Degree analysis

In directed graphs, the **out degree** is the number of edges pointing out of the node, while the **in degree** is the number of edges pointing in.

```
# Plot distribution of degrees
degrees = {'Out Degree': sorted((d for n, d in DG.out_degree()), reverse=True),
           'In Degree': sorted((d for n, d in DG.in_degree()), reverse=True)}
fig, axes = plt.subplots(nrows=2, ncols=2, figsize=(12, 8))
for ax, direction in zip(axes, degrees):
    ax[0].plot(degrees[direction], "b-", marker=".")
    ax[0].set_title(f"{direction} Rank")
    ax[0].set_ylabel(f"{direction}")
    ax[0].set_xlabel("Rank of Node")
    ax[1].bar(*np.unique(degrees[direction], return_counts=True))
    ax[1].set_title(f"{direction} Distribution")
    ax[1].set_xlabel(f"{direction}")
    ax[1].set_ylabel("Number of Nodes")
plt.tight_layout()
plt.show()
```



20.2.3 Ego network

Ego is some individual focal node. A network can have as many egos as it has nodes. **Neighborhood** is the collection of ego and all nodes to whom ego has a connection at some path length. The neighborhood is usually one-step; that is, it includes only ego and nodes that are directly adjacent. The neighborhood also includes all of the edges among all of the actors to whom ego has a direct connection.

```
# find node with greatest degree
ego, degree = max(G.degree(), key=lambda x: x[1])

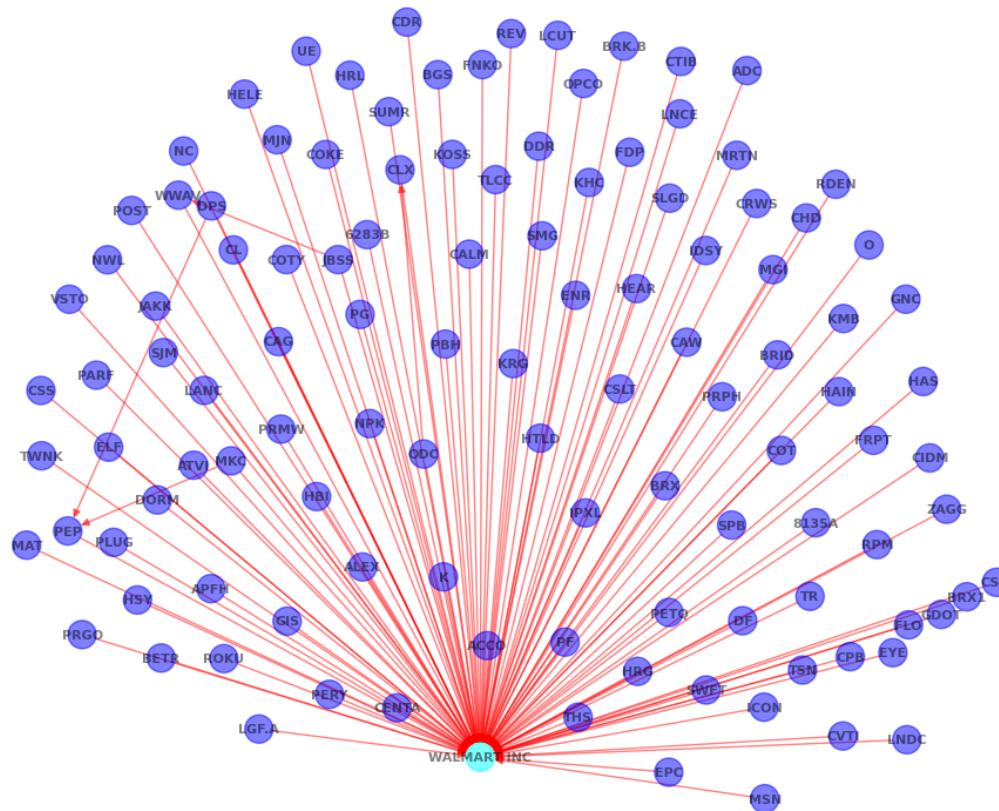
# build subgraph of ego and neighbors
all_neighbors = list(nx.all_neighbors(DG, ego)) # predecessors and successors
neighbors = list(nx.neighbors(DG, ego)) # successors only
ego_graph = DG.subgraph([ego] + all_neighbors).copy()
```

```
# Plot ego graph
node_color = (dict.fromkeys(all_neighbors, 'b')
              | dict.fromkeys(neighbors, 'g')
              | {ego: 'cyan'})

labels = ({ticker: ticker for ticker in ego_graph.nodes}
          | {ticker: lookup[ticker] for ticker in [ego] + neighbors})

graph_draw(ego_graph, figsize=(10, 8), node_size=300, seed=42,
           width=1, node_color=node_color, labels=labels, style='-' ,
           title=f"Ego network {ego}")
plt.show()
```

Ego network WMT



20.2.4 Path lengths

The **distance** or **path length** between two nodes is the shortest path (fewest number of edges) required to travel from one to the other.

The **eccentricity** of a node is the maximum distance from the to all other nodes in a graph. **Diameter** is the maximum eccentricity over all nodes in the graph.

```
# find component with the longest diameter
components = list(nx.weakly_connected_components(DG))
nodes = components[np.argmax([nx.diameter(G.subgraph(c)) for c in components])]
```

```
# compute all shortest path lengths, and determine the longest
best_length = 0
for src, targets in dict(nx.shortest_path(G.subgraph(nodes))).items():
    for tgt, path in targets.items():
        length = len(path)
        if length > best_length:
            best_length = length
            best_path = path
```

```

# Archimedean spiral: r = b * theta
pos = {ticker: ((n + 5) * math.cos(n), (n + 5) * math.sin(n))
       for n, ticker in enumerate(best_path)}

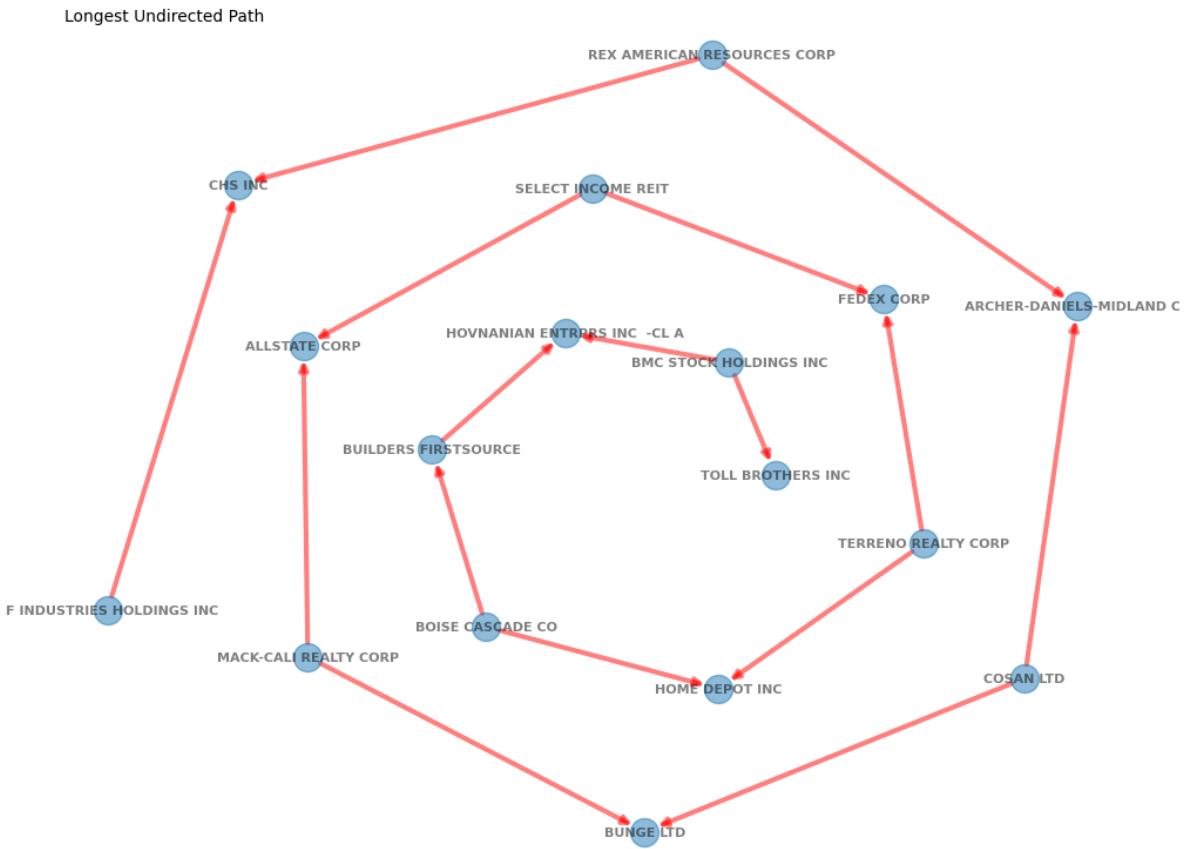
# Plot nodes in a spiral graph
labels = {ticker: lookup[ticker] for ticker in best_path}
graph_draw(DG.subgraph(best_path), figsize=(10, 8), node_size=300,
           width=3, labels=labels, style='-', pos=pos,
           title=f"Longest Undirected Path")

```

```

{'TOL': (5.0, 0.0),
 'BMCH': (3.2418138352088386, 5.048825908847379),
 'HOV': (-2.9130278558299967, 6.365081987779772),
 'BLDR': (-7.919939972803563, 1.1289600644789377),
 'BCC': (-5.882792587772507, -6.811222457771354),
 'HD': (2.8366218546322624, -9.589242746631385),
 'TRNO': (10.561873153154025, -3.0735704801881845),
 'FDX': (9.046827052119655, 7.883839184625469),
 'SIR': (-1.8915004395119759, 12.861657206103963),
 'ALL': (-12.755823666385478, 5.769658793384592),
 'CLI': (-12.586072936146786, -8.160316663340547),
 'BG': (0.07081116780881257, -15.999843304811256),
 'CZZ': (14.345517298452366, -9.121739606007393),
 'ADM': (16.33404206610353, 7.563006662879537),
 'REX': (2.5980071459488383, 18.821539758202537),
 '9919B': (-15.193758257176427, 13.005756803142337),
 'CF': (-20.110849086791077, -6.045969649966372) }

```



CHAPTER
TWENTYONE

COMMUNITY DETECTION

Realize that everything connects to everything else - Leonardo DaVinci

Concepts

- Industrial Taxonomy
- Community Detection

References

- Gerard Hoberg and Gordon Phillips, 2016, Text-Based Network Industries and Endogenous Product Differentiation. *Journal of Political Economy* 124 (5), 1423-1465.

```
import zipfile
import io
from itertools import chain
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import seaborn as sns
import networkx as nx
from finds.database import SQL
from finds.readers import requests_get, Sectoring
from finds.structured import BusDay, PSTAT
from finds.recipes import graph_info
from secret import credentials
# %matplotlib qt
VERBOSE = 0
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
bd = BusDay(sql)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
```

Last FamaFrench Date 2024-03-28 00:00:00

21.1 Industry taxonomy

Industry classification, or industry taxonomy, classifies companies into industrial groupings based on similar production processes, products, or behavior in financial markets.

21.1.1 TNIC

Hoberg and Phillips (2016) calculate firm-by-firm pairwise similarity scores by parsing the product descriptions from the firm 10Ks and forming word vectors for each firm, after basic screens to eliminate common words are applied. The words used only include nouns or proper nouns (see paper for details), and exclude geographic terms. The cosine similarity score is computed as a continuous measure of product similarity for every pair of firms in our sample in each year, producing a pairwise similarity matrix.

These product descriptions are legally required to be accurate, as Item 101 of Regulation S-K legally requires that firms describe the significant products they offer to the market, and these descriptions must also be updated and representative of the current fiscal year of the 10-K. Hence a a Text Based Industry Classification (TNIC) scheme, derived from the textual similarity of product descriptions, may better reflect firms' changes in the product market space over time.

Source: <https://hobergphillips.tuck.dartmouth.edu/industryclass.htm>

```
# Retrieve TNIC scheme from Hoberg and Phillips website
tnic_scheme = 'tnic3'
root = 'https://hobergphillips.tuck.dartmouth.edu/idata/'
source = root + tnic_scheme + '_data.zip'
if source.startswith('http'):
    response = requests_get(source)
    source = io.BytesIO(response.content)

# extract the csv file from zip archive
with zipfile.ZipFile(source).open(tnic_scheme + "_data.txt") as f:
    tnic_data = pd.read_csv(f, sep='\s+')

# extract one year of tnic as data frame
year = max(tnic_data['year']) # [1989, 1999, 2009, 2019]
tnic = tnic_data[tnic_data['year'] == year].dropna()
tnic
```

	year	gvkey1	gvkey2	score
24633638	2021	1004	1210	0.0085
24633639	2021	1004	1823	0.0071
24633640	2021	1004	2285	0.0077
24633641	2021	1004	4091	0.0339
24633642	2021	1004	9698	0.0039
...
25478201	2021	349972	322154	0.0444
25478202	2021	349972	331856	0.0169
25478203	2021	349972	332115	0.0214
25478204	2021	349972	345556	0.0781
25478205	2021	349972	347007	0.0711

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```
[844568 rows x 4 columns]
```

21.1.2 Industry classification

TODO

- SIC, 2-digit, 3-, 4-
- NAICS, 2, 3, 4, 5, 6

```
# populate dataframe of nodes with gvkey (as index), permno, sic and naics
nodes = DataFrame(index=sorted(set(tnic['gvkey1']).union(tnic['gvkey2']))) \
    .rename_axis(index='gvkey')
for code in ['lpermno', 'sic', 'naics']:
    lookup = pstat.build_lookup('gvkey', code, fillna=0)
    nodes[code] = lookup(nodes.index)
Series(np.sum(nodes > 0, axis=0)).rename('Non-missing').to_frame().T
```

```
lpermno    sic    naics
Non-missing  4218  4218  4216
```

```
# supplement naics and sic with crosswalks in Sectoring class
naics = Sectoring(sql, 'naics', fillna=0)    # supplement from crosswalk
sic = Sectoring(sql, 'sic', fillna=0)
nodes['naics'] = nodes['naics'].where(nodes['naics'] > 0, naics[nodes['sic']])
nodes['sic'] = nodes['sic'].where(nodes['sic'] > 0, sic[nodes['naics']])
Series(np.sum(nodes > 0, axis=0)).rename('Non-missing').to_frame().T
```

```
lpermno    sic    naics
Non-missing  4218  4218  4218
```

21.1.3 Sectors

An industry taxonomy may include detailed classifications, and groupings into broader sector

- Fama and French group 4-digit SIC codes into broader groups of 5, 10, 12, 17, 30, 38, 48, or 49 industry sectors.
- The Bureau of Economic Analysis groups 6-digit NAICS codes into a few dozen “summary” level groups, using definitions that were updated in 1947, 1963 and 1997.

```
# include sectoring schemes
codes = {'sic': ([f"codes{c}" for c in [5, 10, 12, 17, 30, 38, 48, 49]] \
    + ['sic2', 'sic3']), \
    'naics': ['bea1947', 'bea1963', 'bea1997']}
sectorings = {}    # store Sectoring objects
for key, schemes in codes.items():
    for scheme in schemes:
        if scheme not in sectorings:
            # missing value is integer 0 sic2 and sic3 shemes, else string ''
```

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```

fillna = 0 if scheme.startswith('sic') else ''

# load the sectoring class from SQL
sectorings[scheme] = Sectoring(sql, scheme, fillna=fillna)

# apply the sectoring scheme to partition the nodes
nodes[scheme] = sectorings[scheme][nodes[key]]

# keep nodes with non-missing data
nodes = nodes[nodes[scheme].ne(sectorings[scheme].fillna)]
print(len(nodes), scheme)
nodes

```

```

4259 codes5
4259 codes10
4259 codes12
4259 codes17
4259 codes30
4259 codes38
4259 codes48
4259 codes49
4218 sic2
4218 sic3
3943 bea1947
3943 bea1963
3943 bea1997

```

	lpermno	sic	naics	codes5	codes10	codes12	codes17	codes30	codes38	\
gvkey										
1004	54594	5080	423860	Cnsmr	Shops	Shops	Machn	Whlsl	Whlsl	
1045	21020	4512	481111	Other	Durbl	Durbl	Trans	Trans	Trans	
1050	11499	3564	333413	Manuf	Manuf	Manuf	Machn	FabPr	Machn	
1076	10517	6141	522220	Other	Other	Money	Finan	Fin	Money	
1078	20482	3845	334510	Hlth	Hlth	Hlth	Other	Hlth	Instr	
...	
345556	16069	2836	325414	Hlth	Hlth	Hlth	Other	Hlth	Chems	
345920	20194	3524	333112	Manuf	Manuf	Manuf	Machn	FabPr	Machn	
345980	20333	5961	455110	Cnsmr	Shops	Shops	Rtail	Rtail	Rtail	
347007	15533	2836	325414	Hlth	Hlth	Hlth	Other	Hlth	Chems	
349972	15642	2836	325414	Hlth	Hlth	Hlth	Other	Hlth	Chems	
				codes48	codes49	sic2	sic3	bea1947	bea1963	bea1997
gvkey										
1004	Whlsl	Whlsl	50	508	42	42	42			
1045	Trans	Trans	45	451	48	481	481			
1050	Mach	Mach	35	356	333	333	333			
1076	Banks	Banks	61	614	52	521CI	521CI			
1078	MedEq	MedEq	38	384	334	334	334			
...	
345556	Drugs	Drugs	28	283	325	325	325			
345920	Mach	Mach	35	352	333	333	333			
345980	Rtail	Rtail	59	596	44RT	44RT	4A0			
347007	Drugs	Drugs	28	283	325	325	325			
349972	Drugs	Drugs	28	283	325	325	325			

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```
[3943 rows x 16 columns]
```

```
# populate undirected graph with tnic edges
edges = tnic[tnic['gvkey1'].isin(nodes.index) & tnic['gvkey2'].isin(nodes.index)]
edges = list(
    edges[['gvkey1', 'gvkey2', 'score']].itertuples(index=False, name=None))
G = nx.Graph()
G.add_weighted_edges_from(edges)
G.remove_edges_from(nx.selfloop_edges(G)) # remove self-loops: not necessary
Series(graph_info(G, fast=True)).rename(year).to_frame()
```

	2021
transitivity	0.874473
average_clustering	0.585098
connected	False
connected_components	8
size_largest_component	3908
directed	False
weighted	True
negatively_weighted	False
edges	405305
nodes	3925
selfloops	0
density	0.052631

21.2 Community structure

TODO

21.2.1 Measuring partitions

TODO

```
# evaluate modularity of sectoring schemes on TNIC graph
def community_quality(G, communities):
    """helper to measure quality of partitions"""
    out = {'communities': len(communities)}
    out['modularity'] = nx.community.modularity(G, communities)
    (out['coverage'],
     out['performance']) = nx.community.partition_quality(G, communities)
    return out
```

```
modularity = {} # to collect measurements of each scheme
for scheme in sorted(chain(*codes.values())):
    communities = nodes.loc[list(G.nodes), scheme] \
        .reset_index() \
        .groupby(scheme)[['gvkey']] \
        .apply(list) \
        .to_list() # list of lists of node labels
    modularity[scheme] = community_quality(G, communities)
```

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```
df = DataFrame.from_dict(modularity, orient='index').sort_index()
print(f"Quality of sectoring schemes on TNIC graph ({year})")
df
```

Quality of sectoring schemes on TNIC graph (2021)

	communities	modularity	coverage	performance
bea1947	40	0.337511	0.791471	0.928649
bea1963	58	0.331096	0.748338	0.950073
bea1997	61	0.331030	0.748153	0.950577
codes10	10	0.340272	0.938264	0.850497
codes12	12	0.340412	0.931380	0.879861
codes17	17	0.278554	0.737459	0.788439
codes30	30	0.339191	0.927052	0.900273
codes38	36	0.339822	0.803928	0.893095
codes48	48	0.337848	0.765192	0.946618
codes49	49	0.337751	0.764032	0.952728
codes5	5	0.341942	0.944133	0.819802
sic2	69	0.333970	0.755767	0.944701
sic3	236	0.294952	0.706283	0.959787

21.2.2 Detecting partitions

TODO

```
# Run community detection algorithms
def community_detection(G):
    """Helper to run community detection algorithms on an undirected graph"""
    out = {}
    out['label'] = nx.community.label_propagation_communities(G)
    out['louvain'] = nx.community.louvain_communities(G, resolution=1)
    out['greedy'] = nx.community.greedy_modularity_communities(G, resolution=1)
    return out
```

```
communities = community_detection(G)
quality = {}
for key, community in communities.items():
    quality[key] = community_quality(G, community)
```

```
df = DataFrame.from_dict(quality, orient='index').sort_index()
print(f"Modularity of community detection algorithms on TNIC graph ({year})")
df
```

Modularity of community detection algorithms on TNIC graph (2021)

	communities	modularity	coverage	performance
greedy	26	0.347560	0.982830	0.507290
label	109	0.355460	0.990437	0.906120
louvain	19	0.363978	0.835415	0.823403

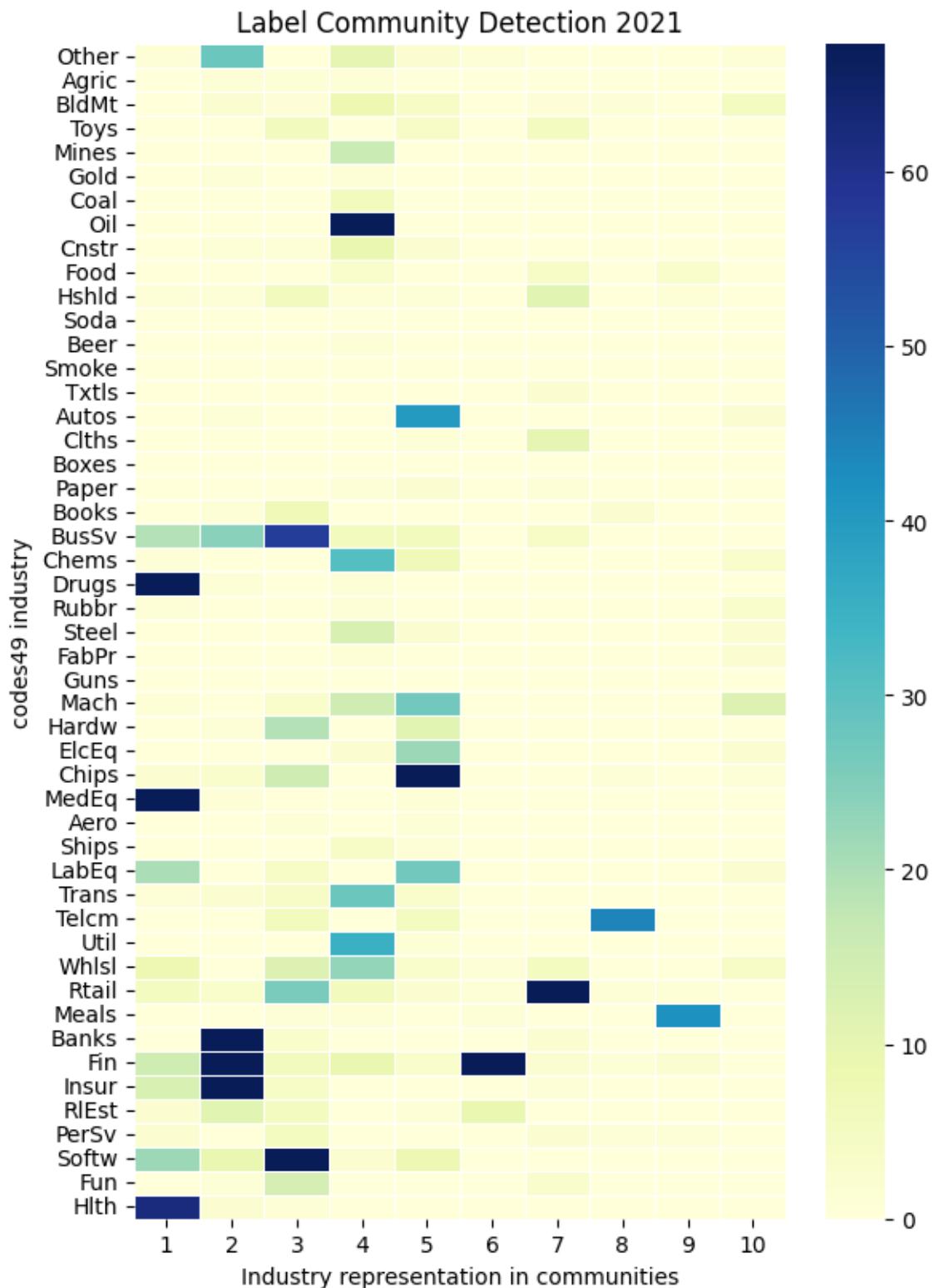
```

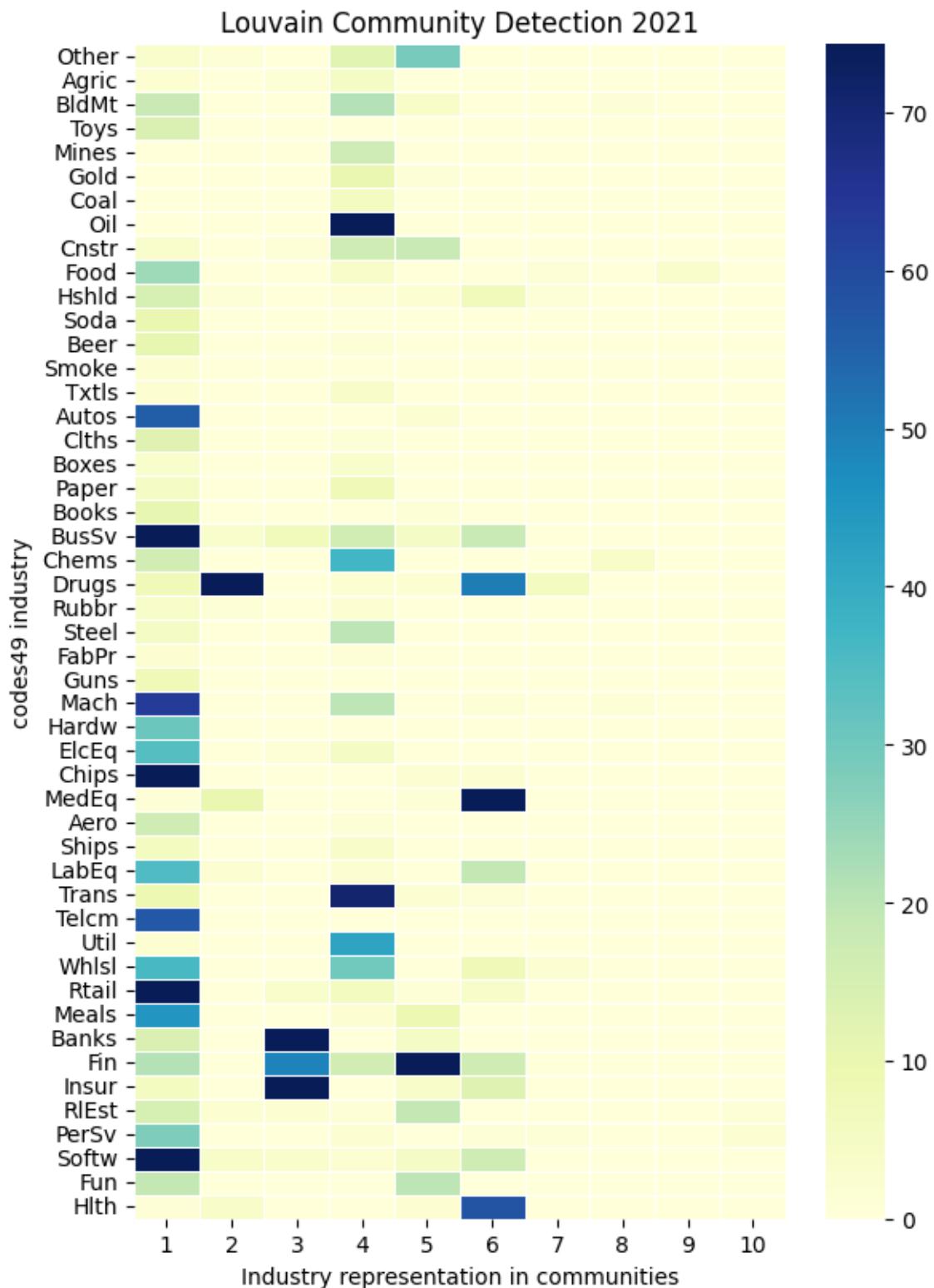
# Visualize Fama-French 49-industries in the detected communities
key = 'codes49'
for ifig, detection in enumerate(communitys.keys()):

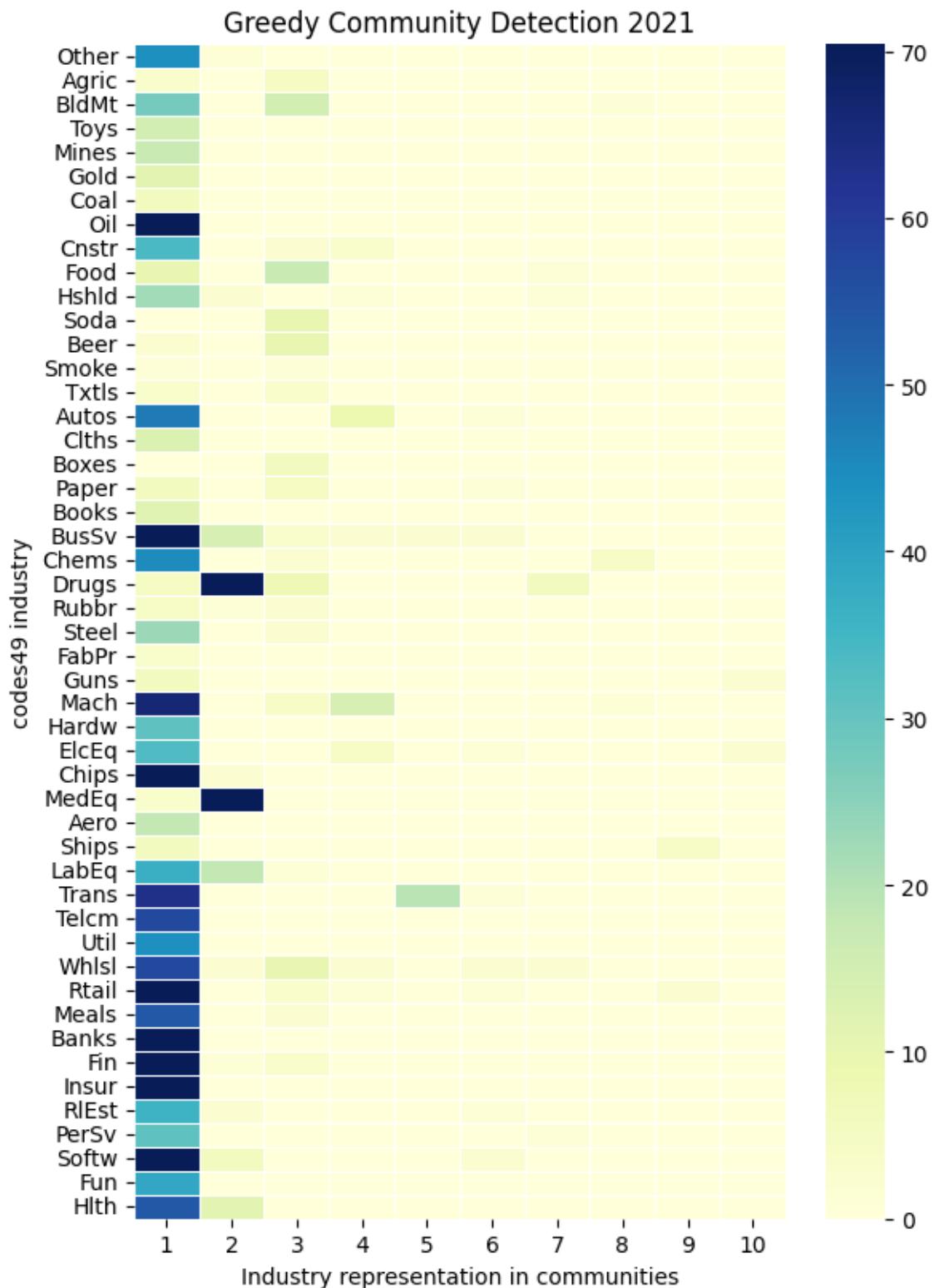
    # count industries represented in each partition
    industry = []
    communitys_sequence = sorted(communitys[detection], key=len, reverse=True)
    for i, community in enumerate(communitys_sequence):
        industry.append(nodes[key][list(community)].value_counts().rename(i+1))
    names = sectorings[key].sectors['name'].drop_duplicates(keep='first')
    df = pd.concat(industry, axis=1) \
        .dropna(axis=0, how='all') \
        .fillna(0) \
        .astype(int) \
        .reindex(names)

    # display as heatmap
    fig, ax = plt.subplots(num=ifig+1, clear=True, figsize=(6, 8))
    sns.heatmap(df.iloc[:, :10],
                square=False,
                linewidth=.5,
                ax=ax,
                yticklabels=1,
                cmap="YlGnBu",
                robust=True)
    if scheme.startswith('bea'):
        ax.set_yticklabels(Sectoring._bea_industry[df.index], size=10)
    else:
        ax.set_yticklabels(df.index, size=10)
    ax.set_title(f'{detection.capitalize()} Community Detection {year}')
    ax.set_xlabel("Industry representation in communities")
    ax.set_ylabel(f'{key} industry')
    fig.subplots_adjust(left=0.4)
    plt.tight_layout(pad=0)

```







CHAPTER
TWENTYTWO

GRAPH CENTRALITY

And so we all matter - maybe less then a lot but always more than none - John Green

Concepts:

- BEA Input-Output Use Table
- Centrality

References:

- Jason Choi & Andrew T. Foerster, 2017. “The Changing Input-Output Network Structure of the U.S. Economy,” Economic Review, Federal Reserve Bank of Kansas City, issue Q II, pages 23-49
- <https://www.bea.gov/industry/input-output-accounts-data>
- <https://www.bea.gov/information-updates-national-economic-accounts>

```
import pandas as pd
from pandas import DataFrame, Series
import networkx as nx
from finds.database import RedisDB
from finds.readers import BEA
from finds.recipes import graph_info, graph_draw
from secret import credentials
# %matplotlib qt
VERBOSE = 0
pd.set_option('display.max_rows', None)
pd.set_option('display.max_colwidth', 200)
```

```
rdb = RedisDB(**credentials['redis'])
bea = BEA(rdb, **credentials['bea'], verbose=VERBOSE)
years = [1947, 2022]
vintages = [1997, 1963, 1947]    # when sectoring schemes were revised
vintage = min(vintages)
```

22.1 Centrality measures

Measures of graph centrality quantify the importance of nodes within a graph.

- **Degree Centrality** measures the number of edges connected to a node.
- **Betweenness Centrality** quantifies the extent to which a node lies on the shortest paths between other nodes in the graph.
- **Closeness Centrality** measures how close a node is to all other nodes in the graph in terms of shortest path lengths.
- **Eigenvector Centrality** evaluates the centrality of a node based on the centrality of its neighbors. Nodes with higher eigenvector centrality are connected to other highly central nodes.
- **PageRank Centrality** was originally developed for ranking web pages by importance. It can be viewed as a random walk process on the graph, representing the long-term likelihood of visitation of each node by randomly following edges.
- A **Hub** is a node that has many out-edge to other nodes. It acts as a facilitator of flows other parts of the graph
- An **Authority** is a node that has many in-edges from other nodes. It can be regarded as highly influential in that many other nodes reference it.

```
# Helper to compute centrality measures
def nodes_centrality(G, weight='weight', cost=False, alpha=0.99):
    """Return dict of vertex centrality measures

    Args:
        G: Graph may be directed or undirected, weighted or unweighted
        weight: name of edge attribute for weights, Set to None for unweighted
        cost: If True, then weights are costs; else weights are importances
    """
    out = {}
    # Degree centrality, for directed and undirected graphs
    if nx.is_directed(G):
        out['in_degree'] = nx.in_degree_centrality(G)
        out['out_degree'] = nx.out_degree_centrality(G)
    else:
        out['degree'] = nx.degree_centrality(G)

    # Hubs and Authorities
    out['hub'], out['authority'] = nx.hits(G)

    # if weights are costs, then Eigenvector and Pagerank ignore weights
    if not cost and nx.is_weighted(G):
        out['eigenvector'] = nx.eigenvector_centrality(G, weight=weight, max_iter=1000)
        out['pagerank'] = nx.pagerank(G, weight=weight, alpha=alpha)
    else:
        out['eigenvector'] = nx.eigenvector_centrality(G, max_iter=1000)
        out['pagerank'] = nx.pagerank(G, alpha=alpha)

    # if weights are importances, then Betweenness and Closeness ignore weights
    if cost and nx.is_weighted(G):
        out['betweenness'] = nx.betweenness_centrality(G, weight=weight)
        out['closeness'] = nx.closeness_centrality(G, distance=weight)
    else:
        out['betweenness'] = nx.betweenness_centrality(G)
```

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```
out['closeness'] = nx.closeness_centrality(G)
return out
```

22.2 BEA Input-Output Use Tables

Input-output analysis is a type of economic model used to study the interdependencies between different sectors of an economy. It typically involves constructing an input-output table that records the flows of goods and services between sectors. This quantifies the relationships between inputs and outputs among various sectors, showing how changes in one sector can affect others.

```
# Read IOUse tables from BEA website
ioUses = {year: bea.read_iouUse(year=year, vintage=vintage) for year in years}
```

```
## Set directed edges with tail on user (table column) --> head on maker (row)
## Direction of edges point from user industry to maker, i.e. follows the money
tail = 'colcode' # edges follow flow of payments, from column to row
head = 'rowcode'
drop = ('F', 'T', 'U', 'V', 'Other') # drop these codes
colors = ['lightgrey', 'darkgreen', 'lightgreen']
```

```
# Populate and plot graph of first and last table years
for ifig, year in enumerate(years):
    # keep year, drop invalid rows
    ioUse = ioUses[year]
    data = ioUse[(~ioUse['rowcode'].str.startswith(drop) &
                  ~ioUse['colcode'].str.startswith(drop))].copy()

    # create master table of industries and measurements
    master = data[data['rowcode'] == data['colcode']][['rowcode', 'datavalue']]\
        .set_index('rowcode')\
        .rename(columns={'datavalue': 'self'})

    # extract cross data; generate and load edges (as tuples) to graph
    data = data[(data['colcode'] != data['rowcode'])]
    data['weights'] = data['datavalue'] / data['datavalue'].sum()
    edges = data.loc[data['weights'] > 0, [tail, head, 'weights']]\
        .values\
        .tolist()

    G = nx.DiGraph()
    G.add_weighted_edges_from(edges, weight='weight')
    nx_labels = BEA.short_desc[list(G.nodes)].to_dict()

    # update master table industry flow values
    master = master.join(data.groupby(['colcode'])['datavalue'].sum(), how='outer')\
        .rename(columns={'datavalue': 'user'})
    master = master.join(data.groupby(['rowcode'])['datavalue'].sum(), how='outer')\
        .rename(columns={'datavalue': 'maker'})
    master = master.fillna(0).astype(int)

    # inweight~supply~authority~eigenvector~pagerank, outweight~demand~hub
```

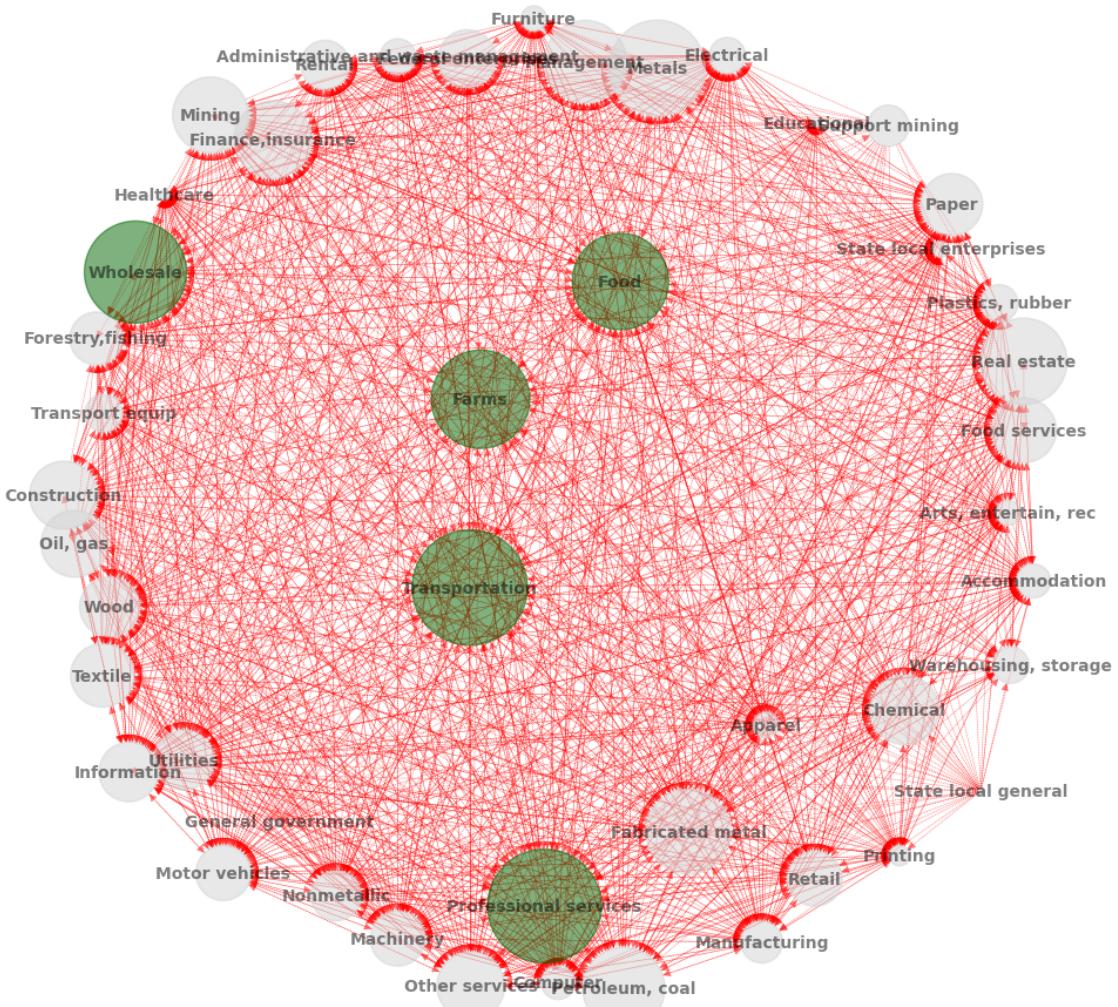
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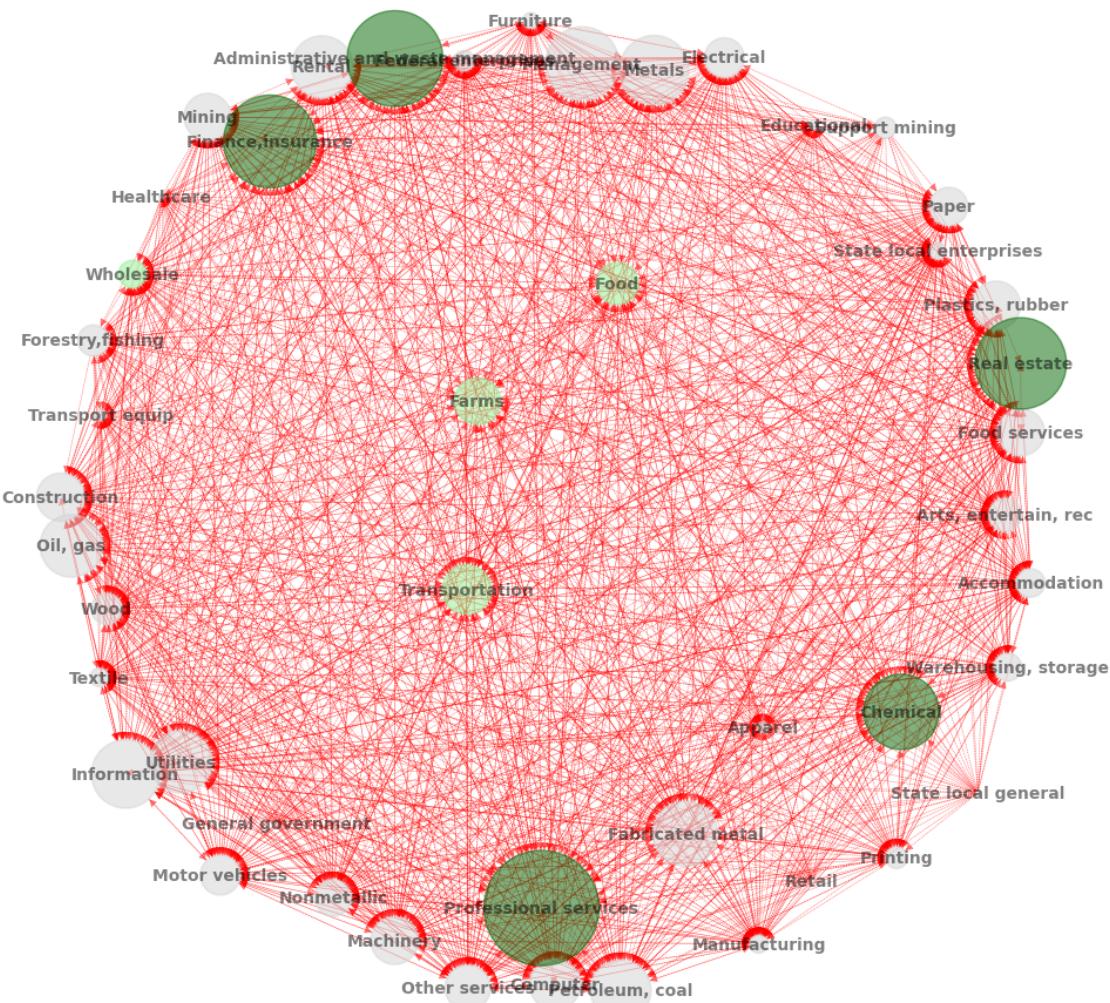
```
centrality = DataFrame(nodes_centrality(G))      # compute centrality metrics
master = master.join(centrality, how='left')
master['bea'] = BEA.short_desc[master.index].to_list()

# visualize graph
score = centrality['pagerank']
node_size = score.to_dict()
node_color = {node: colors[0] for node in G.nodes()}
if ifig == 0:
    center_name = score.index[score.argmax()]
else:
    node_color.update({k: colors[2] for k in top_color})
top_color = list(score.index[score.argsort()[-5:]])
node_color.update(dict.fromkeys(top_color, colors[1]))
pos = graph_draw(G,
                  num=ifig+1,
                  figsize=(10, 10),
                  center_name=center_name,
                  node_color=node_color,
                  node_size=node_size,
                  edge_color='r',
                  k=3,
                  pos=(pos if ifig else None),
                  font_size=10,
                  font_weight='semibold',
                  labels=master['bea'].to_dict(),
                  title=f"Top 5 Nodes By Pagerank in {year} ({vintage}-sectors)")
```

Top 5 Nodes By Pagerank in 1947 (1947-sectors)



Top 5 Nodes By Pagerank in 2022 (1947-sectors)



```
# Compare 1947 and 1997 sectors (BEA "summary"-level industry groups)
v1947 = BEA.sectoring(1947).rename(columns={'description': '1947'})
v1997 = BEA.sectoring(1997).rename(columns={'description': '1997'})
df = v1947[['title', '1947']].join(v1997['1997'])
df[df['1947'] != df['1997']] # changes in the sectoring scheme
```

```
title \
code
441000
↳ vehicle and parts dealers
442000
↳ All other retail
443000
↳ All other retail
```

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444000	Building material and garden
↳ equipment and supplies dealers	
445000	
↳ Food and beverage stores	
446000	Health
↳ and personal care stores	
447000	
↳ Gasoline stations	
448000	Clothing and
↳ clothing accessories stores	
451000	
↳ All other retail	
452000	
↳ General merchandise stores	
453000	
↳ All other retail	
454000	
↳ Nonstore retailers	
481000	
↳ Air transportation	
482000	
↳ Rail transportation	
483000	
↳ Water transportation	
484000	
↳ Truck transportation	
485000	Transit and ground
↳ passenger transportation	
486000	
↳ Pipeline transportation	
487000	Scenic and sightseeing transportation
↳ and support activities	
488000	Scenic and sightseeing transportation
↳ and support activities	
492000	
↳ Couriers and messengers	
511000	Publishing industries, except
↳ internet (includes software)	
511110	
↳ Newspaper publishers	
511120	
↳ Periodical publishers	
511130	
↳ Book publishers	
511140	Directory, mailing list,
↳ and other publishers	
511190	Directory, mailing list,
↳ and other publishers	
511210	
↳ Software publishers	
512000	Motion picture and
↳ sound recording industries	
512100	Motion
↳ picture and video industries	
512200	
↳ Sound recording industries	

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513000	Broadcasting
↳ and telecommunications	
514000	Data processing, internet publishing, and
↳ other information services	
515100	Radio and
↳ television broadcasting	
515200	Cable and other
↳ subscription programming	
517100	Wired
↳ telecommunications carriers	
517200	Wireless telecommunications
↳ carriers (except satellite)	
517400	Satellite, telecommunications resellers, and all
↳ other telecommunications	
518200	Data processing, hosting,
↳ and related services	
519110	News syndicates, libraries, archives and all
↳ other information services	
519130	Internet publishing and broadcasting
↳ and Web search portals	
521000	Monetary authorities and depository
↳ credit intermediation	
522100	Monetary authorities and depository
↳ credit intermediation	
522200	Nondepository credit intermediation
↳ and related activities	
523000	Securities, commodity
↳ contracts, and investments	
523100	Securities and commodity contracts
↳ intermediation and brokerage	
523900	Other financial
↳ investment activities	
524000	Insurance carriers
↳ and related activities	
524113	Direct
↳ life insurance carriers	
524114	Insurance
↳ carriers, except direct life	
524120	Insurance
↳ carriers, except direct life	
524130	Insurance
↳ carriers, except direct life	
524200	Insurance agencies, brokerages
↳ and related activities	
525000	Funds, trusts, and
↳ other financial vehicles	
541100	Legal services
↳	
541200	Accounting, tax preparation, bookkeeping,
↳ and payroll services	
541300	Architectural, engineering,
↳ and related services	
541400	Specialized design services
↳	
541500	Computer systems
↳ design and related services	

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541511	Custom
↳ computer programming services	
541512	Computer
↳ systems design services	
541513	Other computer related services, including
↳ facilities management	
541519	Other computer related services, including
↳ facilities management	
541610	
↳ Management consulting services	
541620	Environmental and other
↳ technical consulting services	
541690	Environmental and other
↳ technical consulting services	
541700	Scientific research
↳ and development services	
541800	Advertising, public relations,
↳ and related services	
541910	All other miscellaneous professional, scientific,
↳ and technical services	
541920	
↳ Photographic services	
541930	All other miscellaneous professional, scientific,
↳ and technical services	
541940	
↳ Veterinary services	
541990	All other miscellaneous professional, scientific,
↳ and technical services	
561000	
↳ Administrative and support services	
561100	Office
↳ administrative services	
561200	
↳ Facilities support services	
561300	
↳ Employment services	
561400	
↳ Business support services	
561500	Travel arrangement
↳ and reservation services	
561600	Investigation
↳ and security services	
561700	Services to
↳ buildings and dwellings	
561900	
↳ Other support services	
562000	Waste management
↳ and remediation services	
621000	
↳ Ambulatory health care services	
621100	
↳ Offices of physicians	
621200	
↳ Offices of dentists	
621300	Offices of
↳ other health practitioners	

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621400
↳ Outpatient care centers
621500
↳ diagnostic laboratories
621600
↳ Home health care services
621900
↳ ambulatory health care services
622000
↳ Hospitals
623000
↳ residential care facilities
623100
↳ community care facilities
623200 Residential mental health, substance abuse, and other
↳ residential care facilities
623300
↳ community care facilities
623900 Residential mental health, substance abuse, and other
↳ residential care facilities
624000
↳ Social assistance
624100
↳ Individual and family services
624200 Community food, housing, and other relief services, including vocational
↳ rehabilitation services
624400
↳ Child day care services
711000
↳ and related activities
711100
↳ Performing arts companies
711200
↳ Spectator sports
711300 Promoters of performing arts and sports and
↳ agents for public figures
711500
↳ writers, and performers
712000 Museums, historical
↳ sites, zoos, and parks
713000
↳ recreation industries
713100
↳ Amusement parks and arcades
713200
↳ (except casino hotels)
713900
↳ recreation industries
1947 \

code
441000 RETAIL TRADE
442000 RETAIL TRADE
443000 RETAIL TRADE
444000 RETAIL TRADE
445000 RETAIL TRADE

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446000	RETAIL TRADE
447000	RETAIL TRADE
448000	RETAIL TRADE
451000	RETAIL TRADE
452000	RETAIL TRADE
453000	RETAIL TRADE
454000	RETAIL TRADE
481000	Transportation
482000	Transportation
483000	Transportation
484000	Transportation
485000	Transportation
486000	Transportation
487000	Transportation
488000	Transportation
492000	Transportation
511000	INFORMATION
511110	INFORMATION
511120	INFORMATION
511130	INFORMATION
511140	INFORMATION
511190	INFORMATION
511210	INFORMATION
512000	INFORMATION
512100	INFORMATION
512200	INFORMATION
513000	INFORMATION
514000	INFORMATION
515100	INFORMATION
515200	INFORMATION
517100	INFORMATION
517200	INFORMATION
517400	INFORMATION
518200	INFORMATION
519110	INFORMATION
519130	INFORMATION
521000	FINANCE AND INSURANCE
522100	FINANCE AND INSURANCE
522200	FINANCE AND INSURANCE
523000	FINANCE AND INSURANCE
523100	FINANCE AND INSURANCE
523900	FINANCE AND INSURANCE
524000	FINANCE AND INSURANCE
524113	FINANCE AND INSURANCE
524114	FINANCE AND INSURANCE
524120	FINANCE AND INSURANCE
524130	FINANCE AND INSURANCE
524200	FINANCE AND INSURANCE
525000	FINANCE AND INSURANCE
541100	PROFESSIONAL AND TECHNICAL SERVICES
541200	PROFESSIONAL AND TECHNICAL SERVICES
541300	PROFESSIONAL AND TECHNICAL SERVICES
541400	PROFESSIONAL AND TECHNICAL SERVICES
541500	PROFESSIONAL AND TECHNICAL SERVICES
541511	PROFESSIONAL AND TECHNICAL SERVICES
541512	PROFESSIONAL AND TECHNICAL SERVICES

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541513	PROFESSIONAL AND TECHNICAL SERVICES
541519	PROFESSIONAL AND TECHNICAL SERVICES
541610	PROFESSIONAL AND TECHNICAL SERVICES
541620	PROFESSIONAL AND TECHNICAL SERVICES
541690	PROFESSIONAL AND TECHNICAL SERVICES
541700	PROFESSIONAL AND TECHNICAL SERVICES
541800	PROFESSIONAL AND TECHNICAL SERVICES
541910	PROFESSIONAL AND TECHNICAL SERVICES
541920	PROFESSIONAL AND TECHNICAL SERVICES
541930	PROFESSIONAL AND TECHNICAL SERVICES
541940	PROFESSIONAL AND TECHNICAL SERVICES
541990	PROFESSIONAL AND TECHNICAL SERVICES
561000	ADMINISTRATIVE AND WASTE SERVICES
561100	ADMINISTRATIVE AND WASTE SERVICES
561200	ADMINISTRATIVE AND WASTE SERVICES
561300	ADMINISTRATIVE AND WASTE SERVICES
561400	ADMINISTRATIVE AND WASTE SERVICES
561500	ADMINISTRATIVE AND WASTE SERVICES
561600	ADMINISTRATIVE AND WASTE SERVICES
561700	ADMINISTRATIVE AND WASTE SERVICES
561900	ADMINISTRATIVE AND WASTE SERVICES
562000	ADMINISTRATIVE AND WASTE SERVICES
621000	HEALTH CARE AND SOCIAL ASSISTANCE
621100	HEALTH CARE AND SOCIAL ASSISTANCE
621200	HEALTH CARE AND SOCIAL ASSISTANCE
621300	HEALTH CARE AND SOCIAL ASSISTANCE
621400	HEALTH CARE AND SOCIAL ASSISTANCE
621500	HEALTH CARE AND SOCIAL ASSISTANCE
621600	HEALTH CARE AND SOCIAL ASSISTANCE
621900	HEALTH CARE AND SOCIAL ASSISTANCE
622000	HEALTH CARE AND SOCIAL ASSISTANCE
623000	HEALTH CARE AND SOCIAL ASSISTANCE
623100	HEALTH CARE AND SOCIAL ASSISTANCE
623200	HEALTH CARE AND SOCIAL ASSISTANCE
623300	HEALTH CARE AND SOCIAL ASSISTANCE
623900	HEALTH CARE AND SOCIAL ASSISTANCE
624000	HEALTH CARE AND SOCIAL ASSISTANCE
624100	HEALTH CARE AND SOCIAL ASSISTANCE
624200	HEALTH CARE AND SOCIAL ASSISTANCE
624400	HEALTH CARE AND SOCIAL ASSISTANCE
711000	ARTS, ENTERTAINMENT, AND RECREATION
711100	ARTS, ENTERTAINMENT, AND RECREATION
711200	ARTS, ENTERTAINMENT, AND RECREATION
711300	ARTS, ENTERTAINMENT, AND RECREATION
711500	ARTS, ENTERTAINMENT, AND RECREATION
712000	ARTS, ENTERTAINMENT, AND RECREATION
713000	ARTS, ENTERTAINMENT, AND RECREATION
713100	ARTS, ENTERTAINMENT, AND RECREATION
713200	ARTS, ENTERTAINMENT, AND RECREATION
713900	ARTS, ENTERTAINMENT, AND RECREATION

1997

code	
441000	Motor vehicle and parts dealers
442000	Other retail
443000	Other retail

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444000	Other retail
445000	Food and beverage stores
446000	Other retail
447000	Other retail
448000	Other retail
451000	Other retail
452000	General merchandise stores
453000	Other retail
454000	Other retail
481000	Air transportation
482000	Rail transportation
483000	Water transportation
484000	Truck transportation
485000	Transit and ground passenger transportation
486000	Pipeline transportation
487000	Other transportation and support activities
488000	Other transportation and support activities
492000	Other transportation and support activities
511000	Publishing industries, except internet (includes software)
511110	Publishing industries, except internet (includes software)
511120	Publishing industries, except internet (includes software)
511130	Publishing industries, except internet (includes software)
511140	Publishing industries, except internet (includes software)
511190	Publishing industries, except internet (includes software)
511210	Publishing industries, except internet (includes software)
512000	Motion picture and sound recording industries
512100	Motion picture and sound recording industries
512200	Motion picture and sound recording industries
513000	Broadcasting and telecommunications
514000	Data processing, internet publishing, and other information services
515100	Broadcasting and telecommunications
515200	Broadcasting and telecommunications
517100	Broadcasting and telecommunications
517200	Broadcasting and telecommunications
517400	Broadcasting and telecommunications
518200	Data processing, internet publishing, and other information services
519110	Data processing, internet publishing, and other information services
519130	Data processing, internet publishing, and other information services
521000	Federal Reserve banks, credit intermediation, and related activities
522100	Federal Reserve banks, credit intermediation, and related activities
522200	Federal Reserve banks, credit intermediation, and related activities
523000	Securities, commodity contracts, and investments
523100	Securities, commodity contracts, and investments
523900	Securities, commodity contracts, and investments
524000	Insurance carriers and related activities
524113	Insurance carriers and related activities
524114	Insurance carriers and related activities
524120	Insurance carriers and related activities
524130	Insurance carriers and related activities
524200	Insurance carriers and related activities
525000	Funds, trusts, and other financial vehicles
541100	Legal services
541200	Miscellaneous professional, scientific, and technical services
541300	Miscellaneous professional, scientific, and technical services
541400	Miscellaneous professional, scientific, and technical services
541500	Computer systems design and related services

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541511	Computer systems design and related services
541512	Computer systems design and related services
541513	Computer systems design and related services
541519	Computer systems design and related services
541610	Miscellaneous professional, scientific, and technical services
541620	Miscellaneous professional, scientific, and technical services
541690	Miscellaneous professional, scientific, and technical services
541700	Miscellaneous professional, scientific, and technical services
541800	Miscellaneous professional, scientific, and technical services
541910	Miscellaneous professional, scientific, and technical services
541920	Miscellaneous professional, scientific, and technical services
541930	Miscellaneous professional, scientific, and technical services
541940	Miscellaneous professional, scientific, and technical services
541990	Miscellaneous professional, scientific, and technical services
561000	Administrative and support services
561100	Administrative and support services
561200	Administrative and support services
561300	Administrative and support services
561400	Administrative and support services
561500	Administrative and support services
561600	Administrative and support services
561700	Administrative and support services
561900	Administrative and support services
562000	Waste management and remediation services
621000	Ambulatory health care services
621100	Ambulatory health care services
621200	Ambulatory health care services
621300	Ambulatory health care services
621400	Ambulatory health care services
621500	Ambulatory health care services
621600	Ambulatory health care services
621900	Ambulatory health care services
622000	Hospitals
623000	Nursing and residential care facilities
623100	Nursing and residential care facilities
623200	Nursing and residential care facilities
623300	Nursing and residential care facilities
623900	Nursing and residential care facilities
624000	Social assistance
624100	Social assistance
624200	Social assistance
624400	Social assistance
711000	Performing arts, spectator sports, museums, and related activities
711100	Performing arts, spectator sports, museums, and related activities
711200	Performing arts, spectator sports, museums, and related activities
711300	Performing arts, spectator sports, museums, and related activities
711500	Performing arts, spectator sports, museums, and related activities
712000	Performing arts, spectator sports, museums, and related activities
713000	Amusements, gambling, and recreation industries
713100	Amusements, gambling, and recreation industries
713200	Amusements, gambling, and recreation industries
713900	Amusements, gambling, and recreation industries

```
# Display node centrality measures from latest year
ioUse = ioUses[max(years)]
data = ioUse[(~ioUse['rowcode']).str.startswith(drop) &
```

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```
~ioUse['colcode'].str.startswith(drop)).copy()
```

```
# extract cross data; generate and load edges (as tuples) to graph
data = data[(data['colcode'] != data['rowcode'])]
data['weights'] = data['datavalue'] / data['datavalue'].sum()
edges = data.loc[data['weights'] > 0, [tail, head, 'weights']].values.tolist()
G = nx.DiGraph()
G.add_weighted_edges_from(edges, weight='weight')

# Display graph properties
Series(graph_info(G)).rename('Properties').to_frame()
```

Properties	
weakly_connected	True
weakly_connected_components	1
size_largest_weak_component	47
strongly_connected	False
strongly_connected_components	4
size_largest_strong_component	44
directed	True
weighted	True
negatively_weighted	False
edges	1694
nodes	47
selfloops	0
density	0.783534

```
# show industry flow values and graph centrality measures
master = pd.concat(
    (data[data['rowcode'] == data['colcode']][['rowcode', 'datavalue']]\
     .set_index('rowcode')\
     .rename(columns={'datavalue': 'self'}),\
     data.groupby(['colcode'])['datavalue'].sum().rename('user'),\
     data.groupby(['rowcode'])['datavalue'].sum().rename('maker')),\
     join='outer', axis=1).fillna(0).astype(int)
master = master.join(DataFrame(nodes_centrality(G)), how='left')
master['bea'] = BEA.short_desc[master.index].to_list()

print(f"Node Centrality of BEA Input-Output Use Table {year}")
master.drop(columns=['self']).round(3)
```

Node Centrality of BEA Input-Output Use Table 2022

	user	maker	in_degree	out_degree	hub	authority	\
111CA	184284	451556	0.478	0.783	0.006	0.009	
113FF	9386	91911	0.543	0.652	0.001	0.002	
211	249074	617352	0.674	0.674	0.012	0.010	
212	48300	122150	0.870	0.804	0.002	0.003	
213	26920	23522	0.087	0.652	0.002	0.000	
22	203222	473707	1.000	0.717	0.014	0.030	
23	1039108	367652	1.000	0.739	0.036	0.027	
311FT	603053	372818	0.630	0.804	0.013	0.022	
313TT	24087	60100	0.870	0.761	0.001	0.003	

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315AL	6468	20431	0.543	0.674	0.000	0.001
321	61185	197254	0.957	0.804	0.002	0.011
322	75976	181304	0.978	0.739	0.003	0.008
323	43001	86246	0.739	0.804	0.002	0.008
324	675113	669702	1.000	0.761	0.012	0.037
325	206855	683053	1.000	0.804	0.009	0.033
326	183307	367073	1.000	0.783	0.007	0.019
327	60399	234086	0.957	0.761	0.002	0.011
331	71633	361595	0.891	0.717	0.003	0.005
332	210277	513487	1.000	0.761	0.006	0.019
333	213396	249624	1.000	0.761	0.006	0.009
334	58016	363419	0.978	0.717	0.004	0.021
335	76638	206688	1.000	0.717	0.002	0.008
3361MV	336886	195265	0.978	0.783	0.009	0.010
3364OT	101642	79386	0.391	0.717	0.004	0.003
337	46531	59315	0.565	0.717	0.001	0.004
339	70223	128923	0.935	0.804	0.003	0.012
42	1188638	71846	0.848	0.848	0.093	0.004
44RT	1080120	0	0.000	0.913	0.087	0.000
48	553698	390771	1.000	0.848	0.033	0.033
493	62616	184456	0.913	0.696	0.004	0.017
51	734393	638594	1.000	0.848	0.067	0.044
52	526941	1102224	1.000	0.674	0.052	0.087
531	1067551	1352230	1.000	0.739	0.087	0.100
532RL	239390	449819	1.000	0.717	0.019	0.028
54	785265	1958497	1.000	0.913	0.049	0.145
55	272563	726281	0.891	0.870	0.026	0.050
56	544761	1207073	1.000	0.913	0.039	0.096
61	113082	20555	0.348	0.848	0.009	0.001
62	1091749	14862	0.130	0.848	0.081	0.001
71	154598	132038	1.000	0.913	0.014	0.010
721	105815	76041	0.978	0.826	0.006	0.006
722	562141	284931	1.000	0.848	0.035	0.024
81	311845	304730	1.000	0.913	0.024	0.022
GFE	38866	76333	0.761	0.739	0.002	0.007
GFG	459174	0	0.000	0.848	0.030	-0.000
GSLE	276831	37227	0.891	0.783	0.016	0.003
GSLG	1151110	0	0.000	0.870	0.067	-0.000

	eigenvector	pagerank	betweenness	closeness	\
111CA	0.051	0.019	0.001	0.657	
113FF	0.010	0.008	0.001	0.687	
211	0.124	0.034	0.004	0.754	
212	0.023	0.019	0.008	0.885	
213	0.005	0.004	0.000	0.523	
22	0.102	0.033	0.003	1.000	
23	0.117	0.020	0.003	1.000	
311FT	0.046	0.015	0.001	0.730	
313TT	0.005	0.003	0.002	0.885	
315AL	0.002	0.001	0.000	0.687	
321	0.043	0.008	0.003	0.958	
322	0.034	0.013	0.002	0.979	
323	0.024	0.004	0.003	0.793	
324	0.104	0.032	0.002	1.000	
325	0.129	0.049	0.003	1.000	
326	0.066	0.020	0.003	1.000	

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327	0.055	0.012	0.002	0.958
331	0.060	0.042	0.001	0.902
332	0.110	0.036	0.002	1.000
333	0.058	0.019	0.003	1.000
334	0.088	0.022	0.001	0.979
335	0.052	0.013	0.002	1.000
3361MV	0.044	0.014	0.003	0.979
3364OT	0.004	0.001	0.000	0.622
337	0.017	0.002	0.001	0.697
339	0.012	0.003	0.003	0.939
42	0.010	0.007	0.004	0.868
44RT	0.000	0.000	0.000	0.000
48	0.097	0.021	0.006	1.000
493	0.025	0.007	0.001	0.920
51	0.222	0.040	0.005	1.000
52	0.397	0.074	0.002	1.000
531	0.345	0.072	0.003	1.000
532RL	0.141	0.033	0.002	1.000
54	0.516	0.114	0.017	1.000
55	0.167	0.047	0.010	0.902
56	0.455	0.079	0.011	1.000
61	0.001	0.001	0.001	0.605
62	0.000	0.000	0.000	0.535
71	0.058	0.009	0.011	1.000
721	0.043	0.007	0.004	0.979
722	0.116	0.019	0.004	1.000
81	0.088	0.018	0.011	1.000
GFE	0.018	0.004	0.004	0.807
GFG	0.000	0.000	0.000	0.000
GSLE	0.010	0.002	0.004	0.902
GSLG	0.000	0.000	0.000	0.000

	bea
111CA	Farms
113FF	Forestry, fishing
211	Oil, gas
212	Mining
213	Support mining
22	Utilities
23	Construction
311FT	Food
313TT	Textile
315AL	Apparel
321	Wood
322	Paper
323	Printing
324	Petroleum, coal
325	Chemical
326	Plastics, rubber
327	Nonmetallic
331	Metals
332	Fabricated metal
333	Machinery
334	Computer
335	Electrical
3361MV	Motor vehicles

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3364OT	Transport equip
337	Furniture
339	Manufacturing
42	Wholesale
44RT	Retail
48	Transportation
493	Warehousing, storage
51	Information
52	Finance, insurance
531	Real estate
532RL	Rental
54	Professional services
55	Management
56	Administrative and waste management
61	Educational
62	Healthcare
71	Arts, entertain, rec
721	Accommodation
722	Food services
81	Other services
GFE	Federal enterprises
GFG	General government
GSLE	State local enterprises
GSLG	State local general

CHAPTER
TWENTYTHREE

LINK PREDICTION

A hidden connection is stronger than an obvious one - Heraclitus

Concepts:

- Link prediction
- Accuracy

```
import zipfile
import io
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
from sklearn import metrics
import matplotlib.pyplot as plt
import networkx as nx
from finds.database import SQL, RedisDB
from finds.structured import CRSP, BusDay, PSTAT
from finds.readers import requests_get
from finds.recipes import graph_info
from secret import credentials, paths
# %matplotlib qt
VERBOSE = 0
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
bd = BusDay(sql, verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
pstat = PSTAT(sql, bd, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
```

Retrieve TNIC schemes from Hoberg and Phillips website

Source: <https://hobergphillips.tuck.dartmouth.edu/industryclass.htm>

```
root = 'https://hobergphillips.tuck.dartmouth.edu/idata/'
tnic_data = {}
for scheme in ['tnic2', 'tnic3']:
    source = root + scheme + '_data.zip'
    if source.startswith('http'):
        response = requests_get(source)
        source = io.BytesIO(response.content)
    with zipfile.ZipFile(source).open(scheme + "_data.txt") as f:
        tnic_data[scheme] = pd.read_csv(f, sep='\s+')
```

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```
for k,v in tnic_data.items():
    print(k, v.shape)
```

```
tnic2 (50402140, 4)
tnic3 (25657918, 4)
```

```
# extract last year of both tnic schemes, merge in permno, and require in univ
year = 2021
capsize = 10 # large cap (large than NYSE median)
univ = crsp.get_universe(bd.endyr(year))
univ = univ[univ['decile'] <= capsizer]
lookup = pstat.build_lookup('gvkey', 'lpermno', fillna=0)
nodes = {}
tnic = {}
edges = {}
for scheme in ['tnic2', 'tnic3']:
    tnic[scheme] = tnic_data[scheme][tnic_data[scheme].year == year].dropna()
    gvkeys = sorted(set(tnic[scheme]['gvkey1']).union(tnic[scheme]['gvkey2']))
    df = DataFrame(index=gvkeys, data=lookup(gvkeys), columns=['permno'])
    nodes[scheme] = df[df['permno'].gt(0)
                        & df['permno'].isin(univ.index)].drop_duplicates()
    nodes['tnic2'] = nodes['tnic2'][nodes['tnic2'].index.isin(nodes['tnic3'].index)]
    nodes['tnic3'] = nodes['tnic3'][nodes['tnic3'].index.isin(nodes['tnic2'].index)]
```

```
# create graphs of tnic2 (denser graph) and tnic3 (sparser graph) schemes
for scheme in ['tnic2', 'tnic3']:
    e = tnic[scheme][tnic[scheme]['gvkey1'].isin(nodes[scheme].index) &
                    tnic[scheme]['gvkey2'].isin(nodes[scheme].index)]
    edges[scheme] = list(e[['gvkey1', 'gvkey2', 'score']]\
                        .itertuples(index=False, name=None))
```

```
results = {}
G = {}
for (scheme, node), (_, edge) in zip(nodes.items(), edges.items()):
    print(scheme, 'nodes =', len(node), 'edges =', len(edge))

    # populate graph
    g = nx.Graph()
    g.add_nodes_from(node.index)
    g.add_weighted_edges_from(edge)

    # remove self-loops: not necessary
    g.remove_edges_from(nx.selfloop_edges(g))

    # graph info
    results[scheme] = Series(graph_info(g, fast=True))

    # Plot degree distribution
    fig, ax = plt.subplots(clear=True, figsize=(10, 6))
    degree = nx.degree_histogram(g)
    degree = DataFrame(data={'degree': degree[1:]}, # exclude degree 0
                       index=np.arange(1, len(degree)))
    degree['bin'] = (degree.index // (2*capsize) + 1) * (2*capsize)
```

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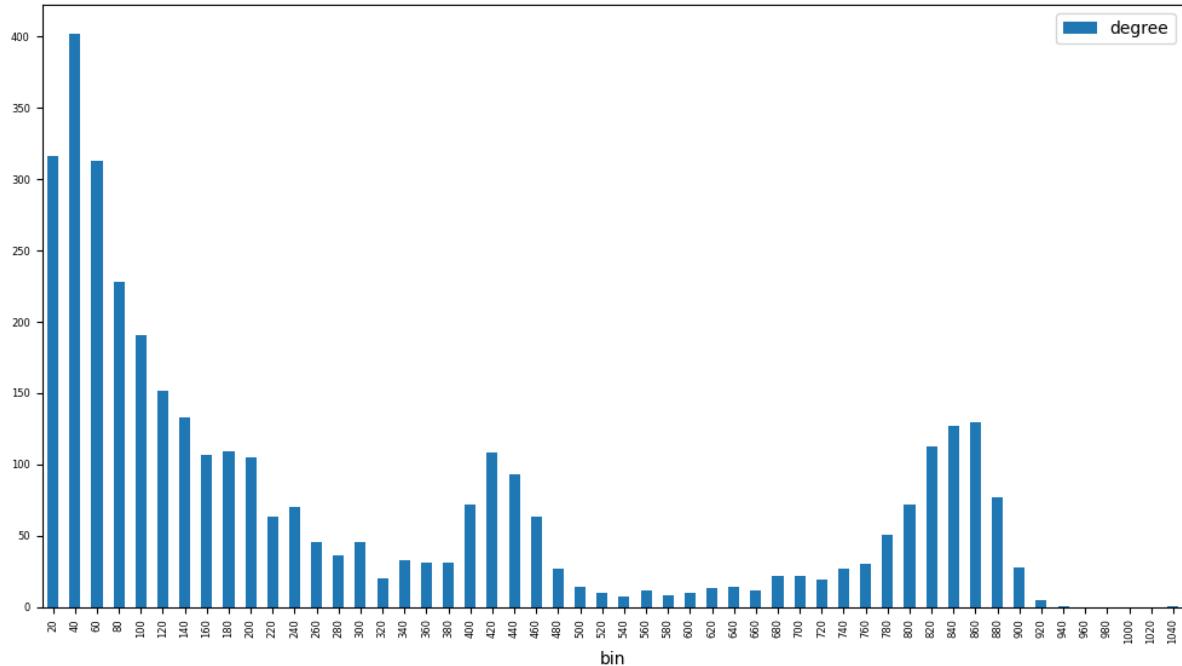
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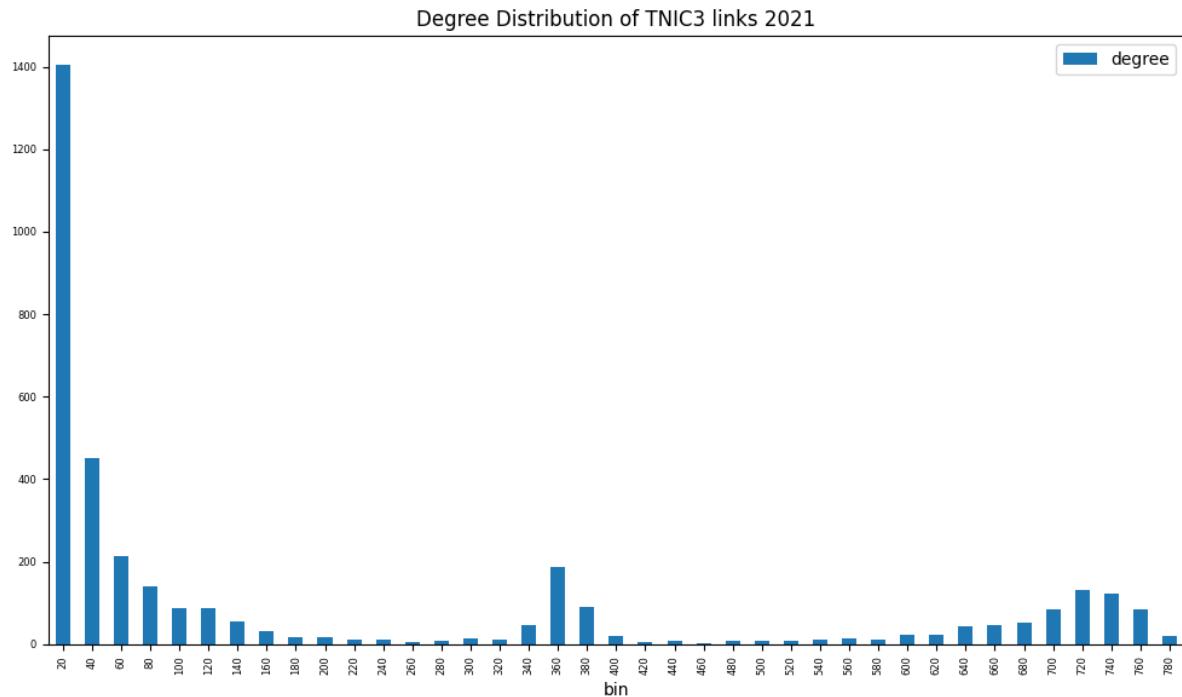
```
degree.groupby('bin').sum().plot(kind='bar', ax=ax, fontsize=6)
ax.set_title(f'Degree Distribution of {scheme.upper()} links {year}')
plt.tight_layout()

G[scheme] = g
```

```
tnic2 nodes = 3620 edges = 1051648
tnic3 nodes = 3620 edges = 690372
```

Degree Distribution of TNIC2 links 2021





```
print(f"Graph properties of TNIC schemes {year}")
DataFrame(results)
```

Graph properties of TNIC schemes 2021

	tnic2	tnic3
transitivity	0.839705	0.880754
average_clustering	0.596602	0.581718
connected	True	False
connected_components	1	24
size_largest_component	3620	3587
directed	False	False
weighted	True	True
negatively_weighted	False	False
edges	525824	345186
nodes	3620	3620
selfloops	0	0
density	0.080274	0.052697

23.1 Link prediction algorithms

TODO

The goal of link prediction is to predict missing or future connections between nodes in a network. Given a partially observed network, link prediction infers which links are most likely to be added or missing based on the observed connections and the structure of the network.

- jaccard_coefficient
- resource_allocation

- adamic_adar
- preferential_attachment

```
# helper to call link prediction algorithms
def link_prediction(G):
    """Predict link scores for all nonexistent edges in graph"""

    def links(links):
        """returns list of edge-score 3-tuples sorted by highest score"""
        return sorted(links, key=lambda x: x[2], reverse=True)

    resource = links(nx.resource_allocation_index(G))
    jaccard = links(nx.jaccard_coefficient(G))
    adamic = links(nx.adamic_adar_index(G))
    preferential = links(nx.preferential_attachment(G))
    return {'resource_allocation': resource,
            'jaccard_coefficient': jaccard,
            'adamic_adar': adamic,
            'preferential_attachment': preferential}
```

```
links = link_prediction(G['tnic3'])
```

23.2 Accuracy metrics

TODO

23.2.1 ROC Curve

- AUC

23.2.2 Precision Recall

FP, FN, TP, TN

- precision
- recall
- accuracy
- confusion matrix
- F1 score: when imbalanced class distribution, and looking for a balanced measure between precision and recall (Type I and Type II errors). Harmonic mean of the precision and recall

$$2 \frac{\text{precision} \cdot \text{recall}}{\text{precision} + \text{recall}} = \frac{TP}{TP + (FP + FN)/2}$$

```
def make_sample(prediction, edges):
    """helper to extract predicted scores and gold labels"""
    names = [e[:2] for e in prediction]           # node-pairs of nonexistent edges
    scores = [e[-1] for e in prediction]          # predicted scores (ordered)
```

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```
gold = [e[:2] in edges for e in prediction] # gold labels of nonexistent edges
return gold, scores, names # actual, predicted score, names
```

```
report = {}
for ifig, (method, pred) in enumerate(links.items()):

    # extract predicted scores and gold labels of nonexistent edges
    y, scores, names = make_sample(pred, G['tnic2'].edges)

    # plot roc curve
    metrics.RocCurveDisplay.from_predictions(y_true=y, y_pred=scores,
                                              plot_chance_level=True)
    plt.title(f"ROC Curve: {method}")
    plt.tight_layout()

    # set classification threshold at class proportion
    thresh = scores[sum(y)]
    y_pred = [score >= thresh for score in scores]

    # generate and plot confusion matrix
    cm = metrics.confusion_matrix(y_true=y, y_pred=y_pred, normalize='all')
    disp = metrics.ConfusionMatrixDisplay(confusion_matrix=cm)
    disp.plot()
    plt.title(f"Confusion Matrix: {method}")
    plt.tight_layout()

    # generate classification report
    report[method] = metrics.classification_report(y_true=y, y_pred=y_pred)
    print(f"Classification Report: {method}")
    print(report[method])
```

Classification Report: resource_allocation				
	precision	recall	f1-score	support
False	0.99	0.99	0.99	6024566
True	0.63	0.63	0.63	180638
accuracy			0.98	6205204
macro avg	0.81	0.81	0.81	6205204
weighted avg	0.98	0.98	0.98	6205204

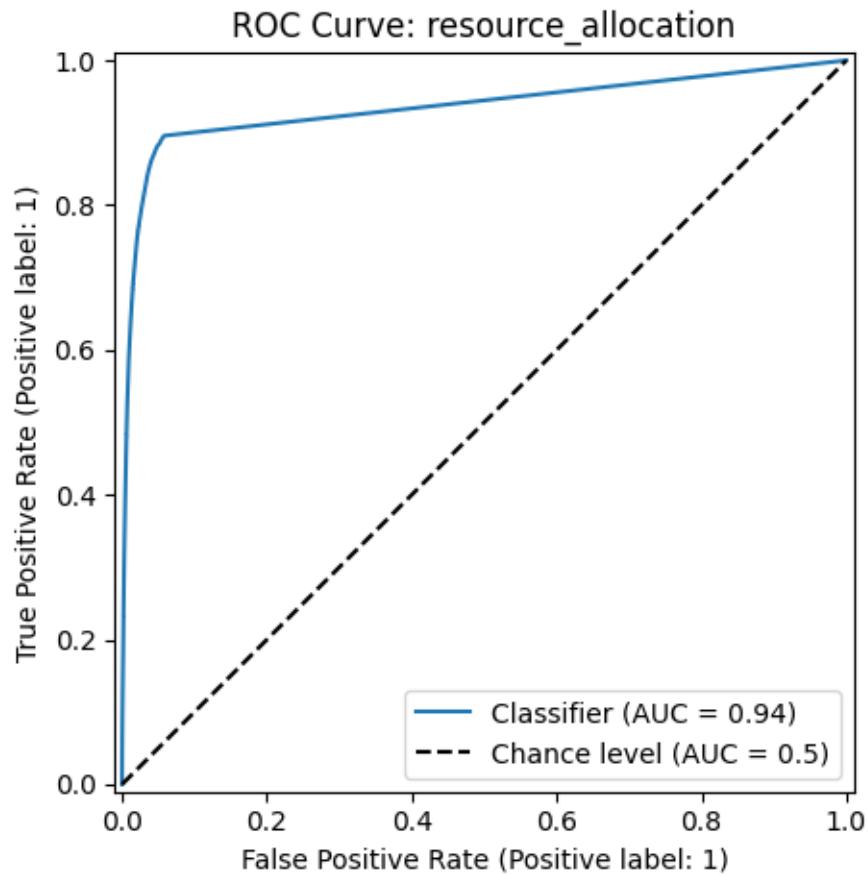
Classification Report: jaccard_coefficient				
	precision	recall	f1-score	support
False	0.99	0.99	0.99	6024566
True	0.60	0.60	0.60	180638
accuracy			0.98	6205204
macro avg	0.79	0.79	0.79	6205204
weighted avg	0.98	0.98	0.98	6205204

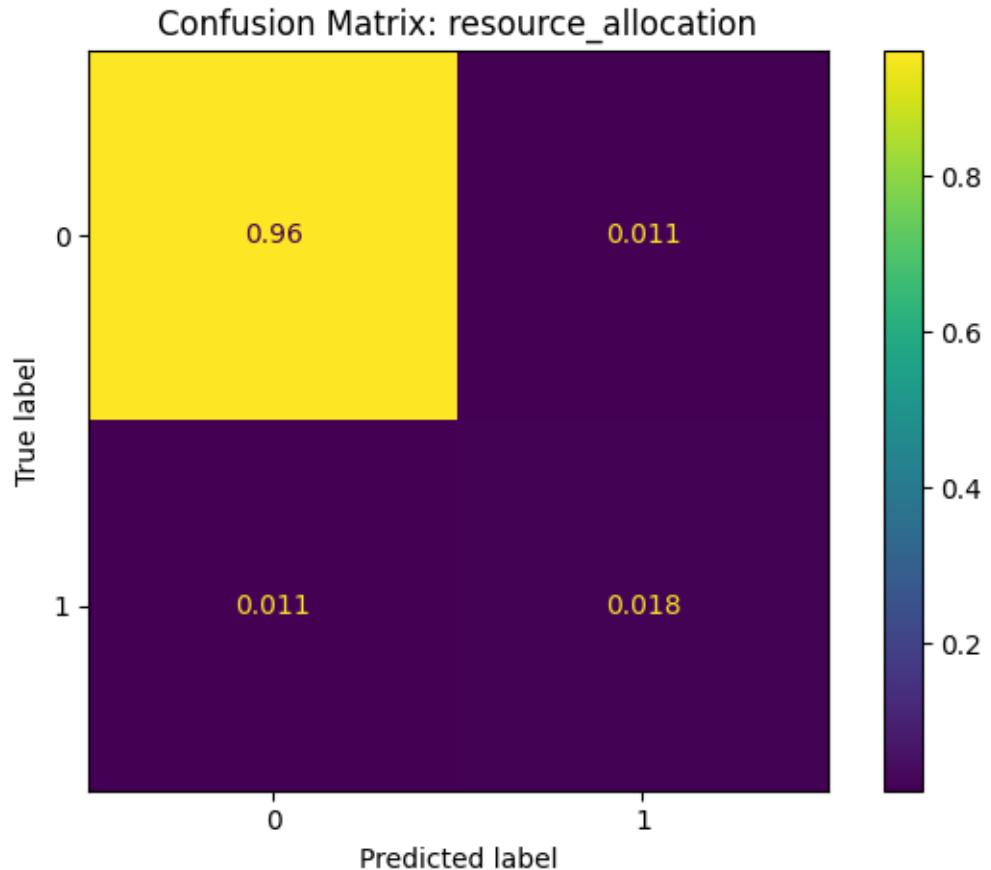
Classification Report: adamic_adar				
	precision	recall	f1-score	support
False	0.99	0.99	0.99	6024566

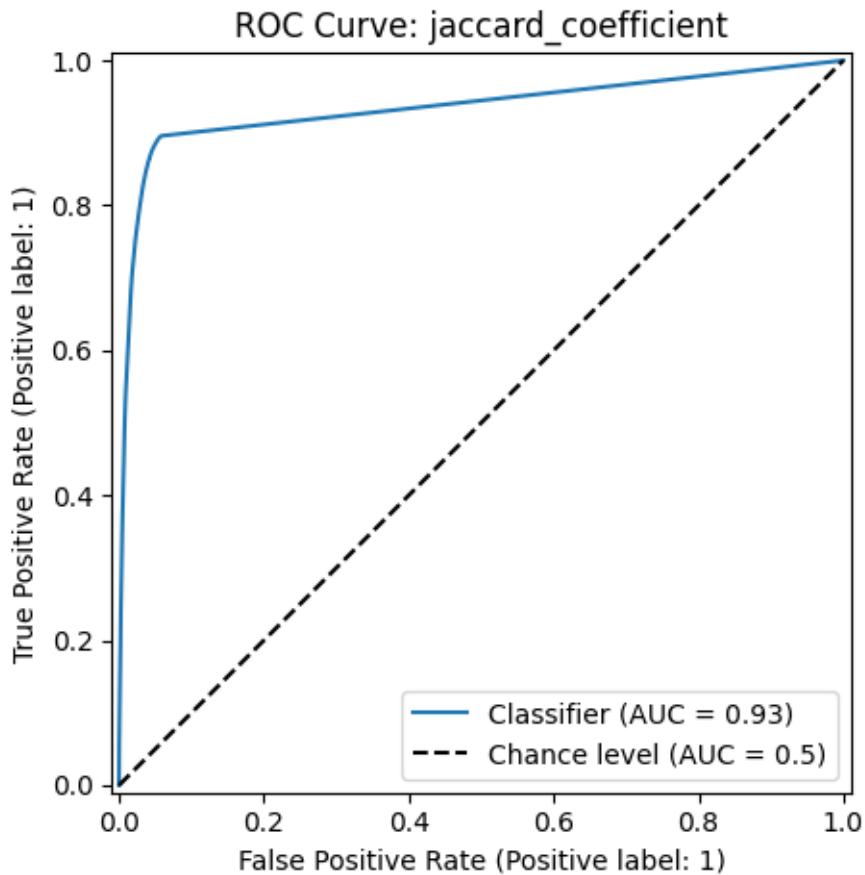
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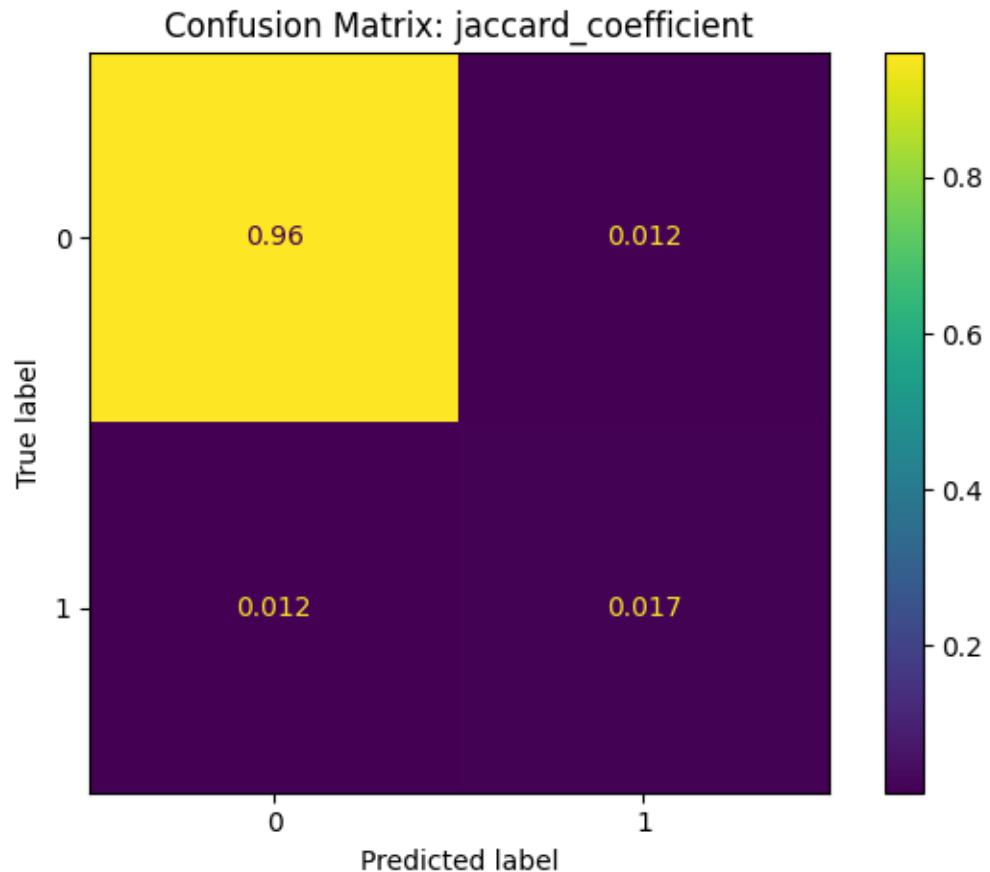
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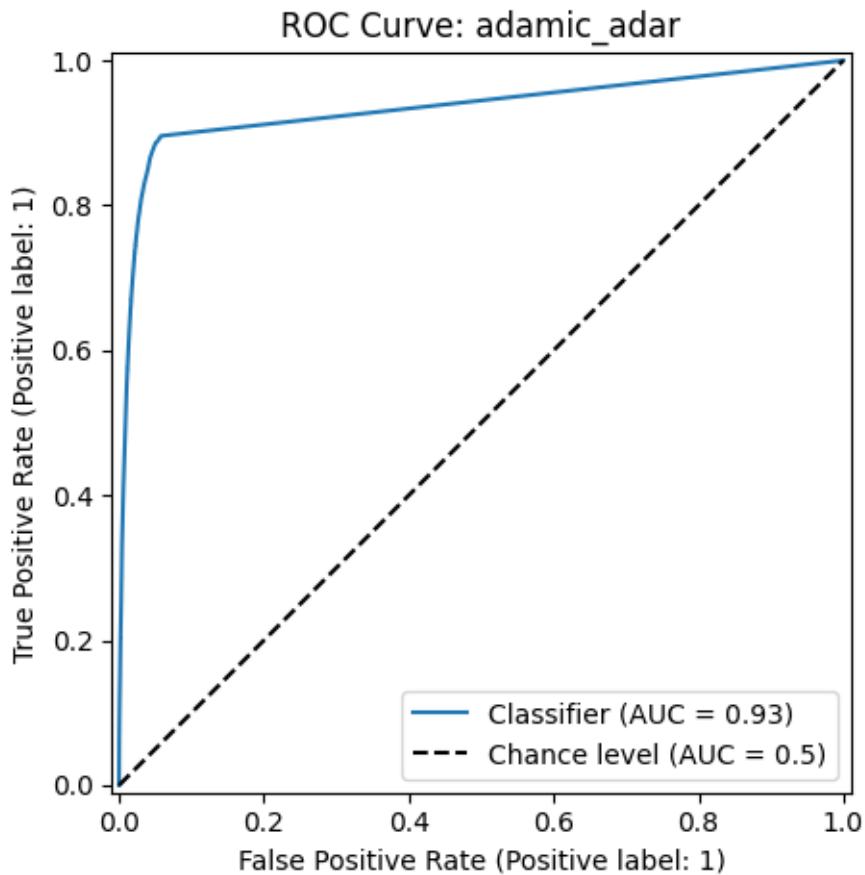
True	0.59	0.59	0.59	180638
accuracy			0.98	6205204
macro avg	0.79	0.79	0.79	6205204
weighted avg	0.98	0.98	0.98	6205204
Classification Report: preferential_attachment				
	precision	recall	f1-score	support
False	0.97	0.97	0.97	6024566
True	0.10	0.10	0.10	180638
accuracy			0.95	6205204
macro avg	0.54	0.54	0.54	6205204
weighted avg	0.95	0.95	0.95	6205204

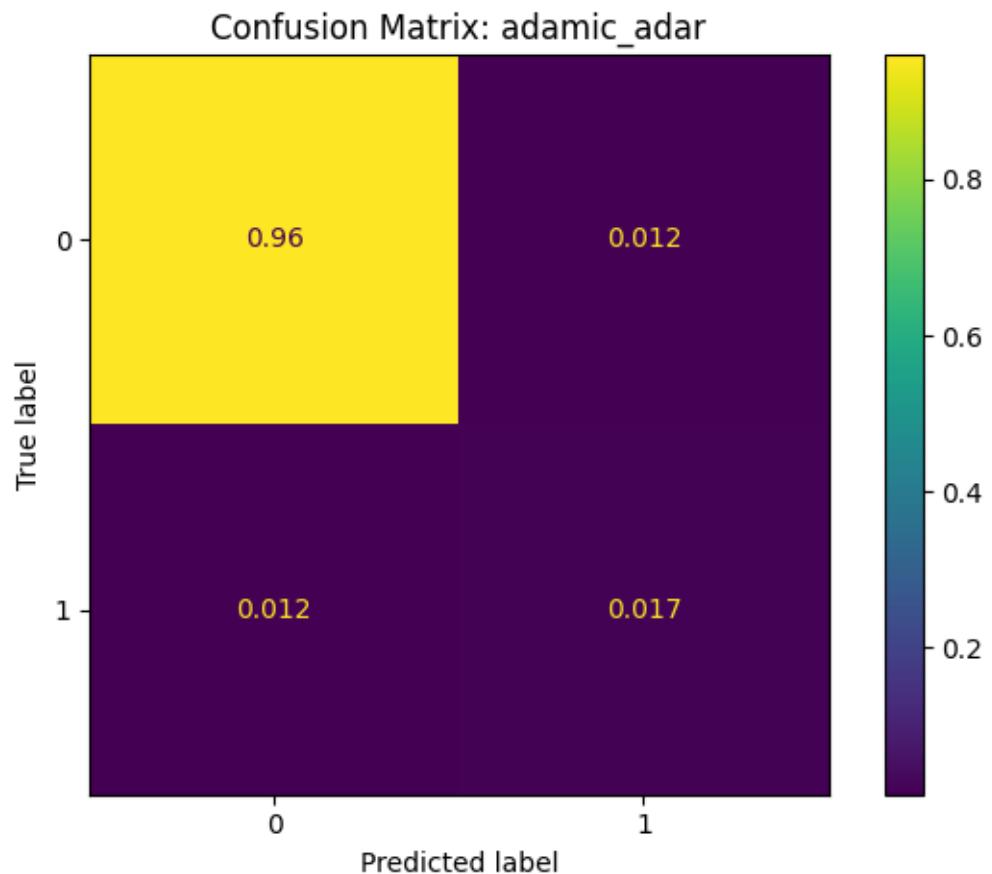


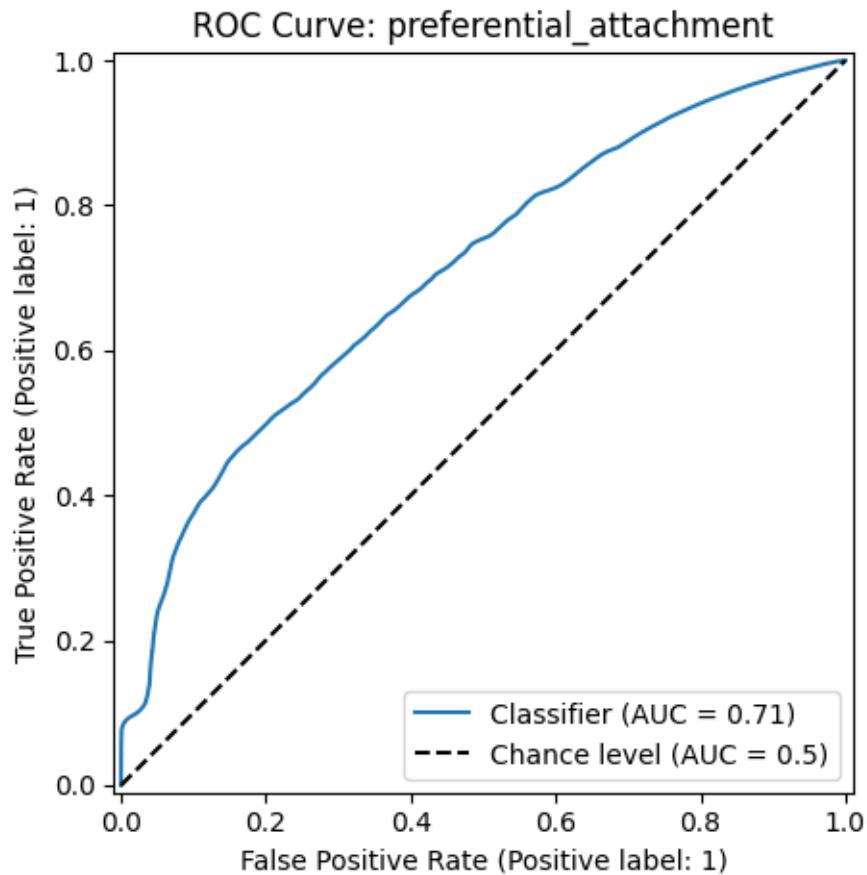


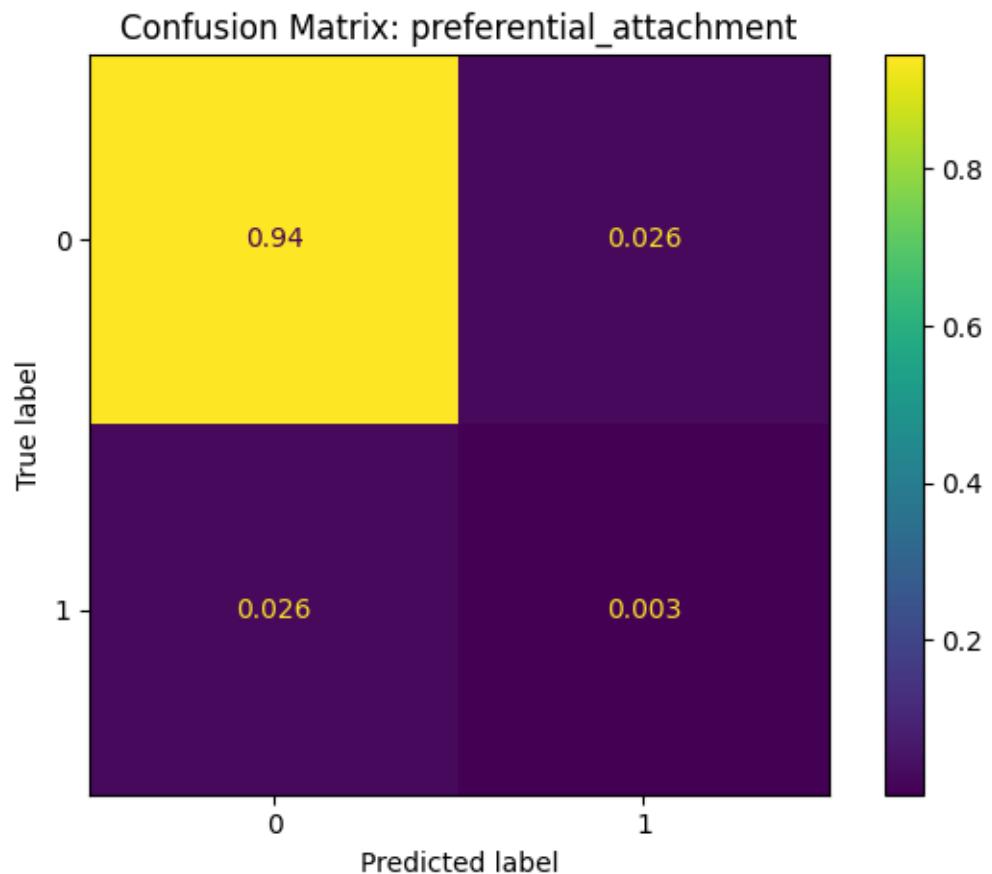












CHAPTER
TWENTYFOUR

SPATIAL REGRESSION

Everything is related to everything else. But near things are more related than distant things - Waldo Tobler

Concepts

- Earnings Surprises
- Spatial Dependence

```
from pandas import DataFrame, Series
import pandas as pd
import numpy as np
import matplotlib.pyplot as plt
from tqdm import tqdm
import io
import zipfile
from libpysal.weights import W
fromesda.moran import Moran
import spreg
import networkx as nx
import statsmodels.formula.api as smf
import warnings
import requests
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, PSTAT
from finds.readers import Alfred
from finds.recipes import remove_outliers
from finds.utils import Store
from secret import credentials, paths, CRSP_DATE
#pd.set_option('display.max_rows', 50)
VERBOSE = 0
#%matplotlib qt
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
rdb = RedisDB(**credentials['redis'])
bd = BusDay(sql, verbose=VERBOSE)
crsp = CRSP(sql, bd, rdb=rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
store = Store(paths['scratch'])
```

```
LAST_DATE = CRSP_DATE
scheme = 'tnic3'
```

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```
# fetch NBER recession dates
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
vspan = alf.date_spans('USREC') # to indicate recession periods in the plots
```

24.1 Earnings surprise

An earnings surprise, or unexpected earnings, is the difference between the reported earnings and expected earnings.

```
# require and get actual quarterly earnings, reindex by (permno, rebaldate)
df = pstat.get_linked(dataset='quarterly',
                      fields=['prccq', 'cshoq', 'ibq'],
                      date_field='datadate',
                      where=f"datadate <= {LAST_DATE}")
store['fund'] = df
```

```
df = store['fund']
```

```
fund = df.dropna(subset=['ibq']) \
    .sort_values(['permno', 'datadate', 'cshoq']) \
    .drop_duplicates(['permno', 'datadate']) \
    .reset_index()
fund['rebaldate'] = bd.endmo(fund['datadate'])

# calculate sue with lag(4) difference in compustat quarterly and price
lag = fund.shift(4, fill_value=0)
keep = ((lag['permno'] == fund['permno']) &
        (fund['prccq'] > 5)).values
fund.loc[keep, 'sue'] = ((fund.loc[keep, 'ibq'] - lag.loc[keep, 'ibq']) / 
                        abs(fund.loc[keep, 'prccq'] * fund.loc[keep, 'cshoq']))
print('with pstat earnings', np.sum(~fund['sue'].isna()))
```

```
# Retrieve TNIC schemes from Hoberg and Phillips website
root = 'https://hobergphillips.tuck.dartmouth.edu/idata/'
source = root + scheme + '_data.zip'
if source.startswith('http'):
    response = requests.get(source)
    source = io.BytesIO(response.content)
with zipfile.ZipFile(source).open(scheme + "_data.txt") as f:
    tnic_df = pd.read_csv(f, sep='\s+')
store['spatial'] = (fund, tnic_df)
tnic_df['year'].value_counts().sort_index().to_frame()
```

```
fund, tnic_df = store['spatial']
```

```
sue = fund.loc[~fund['sue'].isna(), ['permno', 'rebaldate', 'sue']] \
    .reset_index(drop=True)
sue['rebaldate'] // 100
```

```
lookup = pstat.build_lookup(source='lpermno', target='gvkey', fillna=0)
```

24.2 Spatial dependence models

24.2.1 Moran's I

$$E(I) = \frac{-1}{N-1}$$

summary results compare to null of zero so is more conservative (difference compared to true expectations is more positive than calculated)

https://en.wikipedia.org/wiki/Moran's_I

24.2.2 Spatial lag model

https://lost-stats.github.io/Geo-Spatial/spatial_lag_model.html

https://pysal.org/spreg/generated/spreg.ML_Lag.html

spatial lag model $Y_i = \beta X_i + \rho W Y_j + \epsilon_i$

where

- Y_j is the set of Y values from observations other than i ,
- W is a matrix of spatial weights, which are higher for j s that are spatially closer to i .

```
# Compute quarterly spatial regressions
out = dict(moran={}, rho={}, beta={})
years = range(1988, 2022)
for year in tqdm(years):
    tnic = tnic_df[tnic_df.year == year].dropna() # extract the year's tnic links

    # populate graph from tnic edges, with gvkey as nodes
    graph = nx.Graph()
    graph.add_edges_from(tnic[['gvkey1', 'gvkey2']].values)
    graph.remove_edges_from(nx.selfloop_edges(graph)) # not necessary

    for qtr in [12, 103, 106, 109]: # loop over next four quarters of sue
        rebaldate = year*100 + qtr

        # extract sue's with in this fiscal quarter
        y = sue[sue['rebaldate'] == rebaldate].set_index('permno')[['sue']]

        # lookup gvkeys
        y['gvkey'] = lookup(y.index, date=bd.endmo(rebaldate))

        # merge in stock returns in the quarter
        y = y.join(crsp.get_ret(bd.begmo(rebaldate, months=-2),
                               bd.endmo(rebaldate)),
                   how='left')\
            .set_index('gvkey')

        # require available and not outlier
```

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```

y = remove_outliers(y[~y.index.duplicated() & (y.index > 0)]).dropna()

# extract subgraph, its nodes and their neighbors
G = graph.subgraph(y.index)
G = G.subgraph(max(nx.connected_components(G), key=len))
neighbors = {node: list(G.neighbors(node)) for node in G.nodes()}
w = W(neighbors)
y = y.loc[sorted(neighbors.keys())]

# compute Moran's I and spatial lag model of sue on past stock returns
mi = Moran(y['sue'].values, w)
with warnings.catch_warnings():
    warnings.simplefilter("ignore")
    spatial = spreg.ML_Lag(y=y['sue'].values, x=y[['ret']].values, w=w,
                           name_x=['ret'], name_y='sue', name_w=scheme,
                           name_ds=str(rebaldate))
out['moran'][rebaldate] = mi.I
out['rho'][rebaldate] = float(spatial.rho)
out['beta'][rebaldate] = float(spatial.betas[1])

```

100% |██████████| 34/34 [10:56<00:00, 19.30s/it]

```

# Show latest quarter's results
print(spatial.summary)

```

REGRESSION

```

-----
SUMMARY OF OUTPUT: MAXIMUM LIKELIHOOD SPATIAL LAG (METHOD = FULL)
-----
Data set          : 202209
Weights matrix   : tnic3
Dependent Variable : sue
                    Number of Observations: 2464
Mean dependent var : -0.0009
                    Number of Variables   : 3
S.D. dependent var : 0.0337
                    Degrees of Freedom   : 2461
Pseudo R-squared   : 0.0786
Spatial Pseudo R-squared: 0.0037
Sigma-square ML    : 0.001
                    Log likelihood      : 4937.
S.E. of regression  : 0.032
                    Akaike info criterion : -9869.
                    Schwarz criterion    : -9851.

                    -933

-----
                    Variable      Coefficient      Std.Error      z-Statistic
Probability

-----
                    -0.00011554      0.0006571      -1.7581916      0.
0787149

```

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```
          ret      0.0096268      0.0028302      3.4015254      0.  
↪0006701  
          W_sue     0.4260827     0.0388927     10.9553442     0.  
↪0000000  
-----  
↪--  
===== END OF REPORT =====  
↪=====
```

```
# Show spatial regression results
ols = spreg.OLS(y=y['sue'].values, x=y[['ret']].values, w=w,
                 robust='white', spat_diag=True, moran=True,
                 name_x=['ret'], name_y='sue', name_w=scheme,
                 name_ds=str(rebalance))
print(ols.summary)
```

```

REGRESSION
-----
SUMMARY OF OUTPUT: ORDINARY LEAST SQUARES
-----
Data set : 202209
Weights matrix : tnic3
Dependent Variable : sue
Number of Observations: 2464
Mean dependent var : -0.0009
Number of Variables : 2
S.D. dependent var : 0.0337
Degrees of Freedom : 2462
R-squared : 0.0044
Adjusted R-squared : 0.0040
Sum squared residual: 2.786
F-statistic : 10.9488
Prob(F-statistic) : 0.0009502
S.E. of regression : 0.034690
Log likelihood : 4862.379
Sigma-square ML : 0.001379
Akaike info criterion : -9721.0336
S.E of regression ML: 0.0336760
Schwarz criterion : -9709.

```

White Standard Errors					
	Variable	Coefficient	Std. Error	t-Statistic	
Probability					
1710799	CONSTANT	-0.0009294	0.0006788	-1.3691415	0.
0053225	ret	0.0097161	0.0034833	2.7893193	0.

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REGRESSION DIAGNOSTICS
 MULTICOLLINEARITY CONDITION NUMBER 1.014

TEST ON NORMALITY OF ERRORS
 TEST DF VALUE PROB
 Jarque-Bera 2 5577.863 0.0000

DIAGNOSTICS FOR HETROSKEDEASTICITY
 RANDOM COEFFICIENTS
 TEST DF VALUE PROB
 Breusch-Pagan test 1 15.827 0.0001
 Koenker-Bassett test 1 3.382 0.0659

DIAGNOSTICS FOR SPATIAL DEPENDENCE
 TEST MI/DF VALUE PROB
 Moran's I (error) 0.1373 15.494 0.0000
 Lagrange Multiplier (lag) 1 234.778 0.0000
 Robust LM (lag) 1 0.391 0.5320
 Lagrange Multiplier (error) 1 237.113 0.0000
 Robust LM (error) 1 2.726 0.0987
 Lagrange Multiplier (SARMA) 2 237.504 0.0000

===== END OF REPORT
 =====

```
# Show Moran's I
print(f"Quarter: {rebaldate}")
DataFrame({ "Moran's I": mi.I, "Expected": mi.EI, "p_norm": mi.p_norm},
          index=["under assumption of normality"])
```

Quarter: 202209

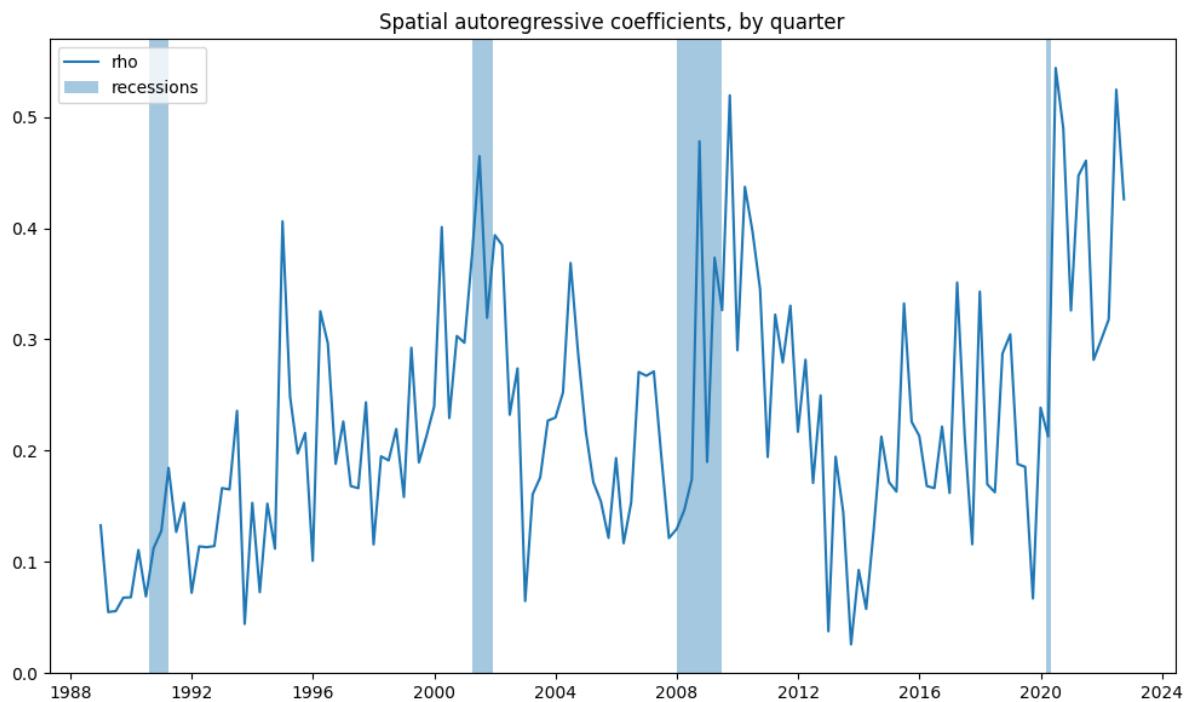
	Moran's I	Expected	p_norm
under assumption of normality	0.136383	-0.000406	2.128943e-53

```
# Show ordinary regression results
results = DataFrame(out)
results.index = bd.to_datetime(bd.endmo(results.index))
summary = dict()
for col in results.columns:
    model = smf.ols(f'{col} ~ 1', data=results).fit()
    robust = smf.ols(f'{col} ~ 1', data=results) \
        .fit(cov_type='HAC', cov_kwds={'maxlags': 6})
    summary[col] = dict(mean=float(model.params.iloc[0]),
                         stderr=float(model.bse.iloc[0]),
                         t=float(model.tvalues.iloc[0]),
                         nw_stderr=float(robust.bse.iloc[0]),
                         nw_t=float(robust.tvalues.iloc[0]))
print("Tests of statistical significance")
DataFrame(summary)
```

Tests of statistical significance

	moran	rho	beta
mean	0.053145	0.224963	0.012003
stderr	0.002668	0.009765	0.000720
t	19.919201	23.036839	16.672970
nw_stderr	0.004736	0.018049	0.000979
nw_t	11.220779	12.463735	12.265549

```
# Visualize autoregressive coefficients by quarter
fig, ax = plt.subplots(figsize=(10, 6))
ax.plot(results['rho'])
ax.set_title("Spatial autoregressive coefficients, by quarter")
for a,b in vspans:
    if a >= min(results.index):
        ax.axvspan(a, min(b, max(results.index)), alpha=0.4)
plt.legend(['rho', 'recessions'])
plt.tight_layout()
plt.show()
```



CHAPTER
TWENTYFIVE

FOMC TOPIC MODELING

Our discussions of the economy may sometimes ring in the ears of the public with more certainty than is appropriate - Jerome Powell

Concepts:

- FOMC meeting minutes
- Text pre-processing for textual analysis
- Topic modeling

```
import numpy as np
import pandas as pd
from pandas import Series, DataFrame
import os
import sklearn.feature_extraction, sklearn.decomposition
from sklearn.decomposition import TruncatedSVD, LatentDirichletAllocation, NMF
from sklearn.cluster import KMeans
from scipy.special import softmax
from wordcloud import WordCloud
import wordcloud
import matplotlib.pyplot as plt
from finds.database import MongoDB
from finds.unstructured import Unstructured
from finds.utils import Store
from finds.readers import FOMCReader, Alfred
from secret import credentials, paths
# %matplotlib qt
VERBOSE = 0
```

```
# unstructured minutes text data are stored in MongoDB
mongodb = MongoDB(**credentials['mongodb'], verbose=VERBOSE)
fomc = Unstructured(mongodb, 'FOMC')
```

```
## retrieve recessions dates for plotting
alf = Alfred(api_key=credentials['fred']['api_key'])
vspan = alf.date_spans(series_id='USREC')
```

25.1 FOMC meeting minutes

The FOMC holds eight regularly scheduled meetings during the year and other meetings as needed. The minutes of regularly scheduled meetings are released three weeks after the date of the policy decision. They provide insights into the Federal Reserve's economic outlook and potential future monetary policy actions, which can impact interest rates, inflation, and market conditions.

<https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>

```
# Helper class to scrape FOMC meeting minutes from Federal Reserve website
minutes = FOMCReader()

# Show number and date range of minutes available from website
DataFrame({'dates': len(minutes), 'start': min(minutes), 'end': max(minutes)},
          index=['FOMC minutes'])
```

100% |██████████| 26/26 [00:06<00:00, 3.78it/s]

	dates	start	end
FOMC minutes	250	19930203	20240501

```
# retrieve dates of minutes previously retrieved and stored locally
dates = fomc['minutes'].distinct('date')
```

```
# fetch new minutes from FOMC site
docs = {d: minutes(d) for d in minutes if d not in dates}
print('NEW:', ", ".join([f'{k}: {len(v)} chars' for k,v in docs.items()]))
```

NEW:

Trim minutes text:

- keep minutes text approximately from and including (skip earlier text which may be re-affirmation of general policy statement or organizational items):
 - “Developments in Financial Markets” or
 - “Discussion of Guideliness for Policy Normalization” or
 - “Financial Developments and Open Market Operations” or
 - “discussion of the economic outlook” or
 - “the information reviewed at this meeting” or
 - “the staff presented several briefings” (i.e. staff presentations on ad-hoc policy topics)
- delete after adjourn line or date scheduled for next meeting, hence ignoring:
 - notation votes, minutes approvals, signature, and footnotes
 - intermeeting conference calls

```
# Helper function to trim minutes text
def edit(text: str) -> str:
    """helper to spawn editor and write/edit/read to tempfile"""

```

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```
import subprocess
import tempfile
with tempfile.NamedTemporaryFile(suffix=".tmp") as f: # save temp file
    f.write(text.encode("utf-8"))
    f.flush()
    subprocess.call([os.environ.get('EDITOR', 'emacs'), "-nw", f.name])
    f.seek(0)
    return f.read().decode("utf-8") # keep edited text
```

```
if docs:
    # to edit out head and tail of each document
    results = list()
    for date, initial_message in docs.items():
        edited_text = edit(initial_message)
        results.append({'date': date, 'text' : edited_text})
    results = sorted(results, key = lambda x: x['date']) # sort by date

    # save edited docs
    Store(paths['scratch'] / 'fomc', ext='gz').dump(results, f"{{max(docs.keys())}}.json"
    for doc in results: # store docs for new dates
        fomc.insert('minutes', doc, keys=['date'])
```

Retrieve all minutes that were stored locally

```
docs = Series({doc['date']: doc['text'] for doc in fomc.select('minutes')},
              name='minutes').sort_index()
DataFrame(docs)
```

	minutes
19930203	The Manager of the System Open Market Account ...
19930323	The Deputy Manager for Domestic Operations rep...
19930518	The Manager of the System Open Market Account ...
19930707	The Deputy Manager for Domestic Operations rep...
19930817	The Deputy Manager for Domestic Operations rep...
...	...
20231101	Developments in Financial Markets and Open Mar...
20231213	Developments in Financial Markets and Open Mar...
20240131	Developments in Financial Markets and Open Mar...
20240320	Developments in Financial Markets and Open Mar...
20240501	Developments in Financial Markets and Open Mar...

[250 rows x 1 columns]

25.2 Text pre-processing

Text pre-processing involves cleaning and preparing raw text data by removing noise, standardizing formats, and converting text into a structured format suitable for analysis. The first phase of textual analysis, it involves some or all the steps of tokenizing, removing stop words, casing, and vectorizing.

25.2.1 Tokenization

Split text into smaller units called **tokens**, which are usually words, but also may be phrases or subwords. The text pattern of tokens and token boundaries are often expressed using the language of regular expressions.

25.2.2 Regular expressions

A regular expression is a special text string for describing a text search pattern to match character combinations in strings. They are used in tokenization, to find word boundaries and remove whitespace.

Basic regex.

Expression	Description
\d	digit from 0 to 9
\w	word character: ASCII letter, digit or underscore
\s	whitespace character: space, tab, newline, carriage return, vertical tab
\D	character that is not a digit
\W	character that is not a word character
\S	character that is not a whitespace character
[...]	one of the characters in the bracket
[a-zA-Z]	one of the characters in the range
[^a]	one character that is not a
[^a-z]	one character that is not in the range
\b	word boundary
\B	not a word boundary
.	any character except line break
.	the period character
\	escapes a special character: . * + ? \$ ^ / \
^	start of string: position is an ASCII letter, digit or underscore
\$	end of string: position is an ASCII letter, digit or underscore
+	quantifier: one or more
*	quantifier: zero or more
?	quantifier: zero or one
	OR operand
(...)	capturing group

25.2.3 Stopwords

Uninformative common words can be removed.

25.2.4 Casing

The original casing of words may be retained if the distinction between uppercase and lowercase letters carries important semantic or syntactic information, such as differentiating proper nouns, acronyms, or the beginnings of sentences.

Note that some models may interpret all upper case words as organisations.

```
# ignore these stop words
StopWords = [w for w in set(wordcloud.STOPWORDS) if "" not in w]
StopWords += ['january', 'february', 'march', 'april', 'may', 'june',
              'july', 'august', 'september', 'october', 'november',
              'december', 'first', 'second', 'third', 'fourth', 'twelve',
              'participants', 'members', 'meeting']
```

25.2.5 Vectorization

Converts text into numerical representations

- Bag-of-words: In a BOW approach, a documents is represented by the frequency of its words, disregarding grammar and word order but preserving multiplicity.
- N-grams: Two (or more) consecutive words can be treated as distinct items, not just isolated words.
- Indexing: Unique words in the corpus are mapped to consecutive integer indexes, forming the vocabulary.
- TF-IDF: Term-frequency Inverse-document-frequency vectorization transforms text into numerical features by measuring the importance of a word in a document relative to its frequency across all documents in a corpus. The `scikit-learn` package provides the `TfidfVectorizer` for vectorizing text with the TF-IDF technique, as well as `CountVectorizer` which simply counts the raw number of word occurrences.

```
# To vectorize the input words
ngram_range = (1, 1)    # unigrams
ngram_range = (2, 2)    # bigrams
ngram_range = (1, 2)    # unigrams and bigrams
max_df, min_df, max_features = 0.5, 6, 5000 # some reasonable constraints
tfidf_vectorizer = sklearn.feature_extraction.text.TfidfVectorizer(
    strip_accents='unicode',
    lowercase=True,
    stop_words=StopWords,
    ngram_range=ngram_range,
    max_df=max_df,
    min_df=min_df,
    max_features=max_features,
    token_pattern=r"\b[\^\d\W][^\d\W][^\d\W]+\b") #r'\b[\^\d\W]+\b'
tf_vectorizer = sklearn.feature_extraction.text.CountVectorizer(
    strip_accents='unicode',
    lowercase=True,
    stop_words=StopWords,
    ngram_range=ngram_range,          # (2, 2) for bigrams
    max_df=max_df,
    min_df=min_df,
```

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```
max_features=max_features,
token_pattern=r"\b[^d\W][^d\W][^d\W]+\b")
```

25.3 Topic modeling

Topic modeling uses statistical techniques to discover latent topics that exist within a collection of documents.

25.3.1 Latent Semantic Analysis

LSA uses singular value decomposition to analyze the relationships between terms and documents in a corpus. It constructs a matrix of the document term vectors, then through dimensionality reduction identifies underlying topics by grouping together terms and documents that co-occur frequently in this reduced space.

25.3.2 Latent Dirichlet Allocation

LDA assumes that each document is a mixture of topics, and each topic is a mixture of words. It iteratively assigns words in documents to topics probabilistically based on the distribution of topics in the document and the distribution of words in the topic.

25.3.3 Non-negative matrix factorization

NMF decomposes a term-document matrix into two lower-dimensional non-negative matrices: a basis matrix representing topics and a coefficient matrix representing the distribution of topics in documents. By iteratively optimizing these matrices to best reconstruct the original term-document matrix, NMF identifies latent topics and their distributions across documents.

25.3.4 Probabilistic Latent Semantic Indexing

PLSI assumes that documents are generated from a mixture of topics, and words within documents are generated based on these topics. It estimates the probability distributions of topics and words, iteratively refining these distributions until convergence. It can be implemented by NMF, with generalized Kullback-Leibler divergence as the norm.

- <https://scikit-learn.org/stable/modules/decomposition.html#nmf>
- https://scikit-learn.org/stable/auto_examples/applications/plot_topics_extraction_with_nmf_lda.html

```
# Define models
n_components = 4      # fix number of latent topics
algos = {
    'LSA': (TruncatedSVD(n_components=n_components),
              tfidf_vectorizer),
    'LDA': (LatentDirichletAllocation(n_components=n_components,
                                       learning_method='batch', #'online',
                                       # learning_offset = 50.0,
                                       max_iter = 40,
                                       random_state = 42),
              tf_vectorizer),
    'PLSI': (NMF(n_components=n_components,
```

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```

        beta_loss='kullback-leibler',
        solver='mu',
        alpha_W=0.00005,
        alpha_H=0.00005,
        l1_ratio=0.5,
        max_iter=1000,
        random_state = 42),
        tfidf_vectorizer),
'NMF': (NMF(n_components=n_components,
        random_state=42,
        beta_loss='frobenius',
        alpha_W=0.00005,
        alpha_H=0.00005,
        l1_ratio=0.5),
        tfidf_vectorizer)}

```

Fit the models, and plot the predicted topics by date of document

```

# Fit and plot models
scores = dict()    # to save model coefficients
topics = dict()    # to save dates of primary topic
for ifig, (name, (base, vectorizer)) in enumerate(algos.items()):

    # vectorize the input words
    vectorized = vectorizer.fit_transform(docs.to_list())
    feature_names = vectorizer.get_feature_names_out()

    # fit model and transform inputs
    model = base.fit(vectorized)
    transformed = model.transform(vectorized)

    # save the model fitted coefficients
    if name == 'LSA':  # Additional step for LSA
        kmeans = KMeans(n_clusters=n_components, n_init=5, random_state=37) \
            .fit(transformed)    # find centroids of the latent factors
        transformed = kmeans.transform(transformed)  # distance to centroid
        transformed = -(transformed / transformed.sum(axis=1, keepdims=True))
        scores[name] = softmax(model.components_, axis=1)  # scale word scores
    else:
        scores[name] = model.components_

    # plot topic scores over time
    fig, ax = plt.subplots(num=1 + ifig, clear=True, figsize=(10, 6))
    dates = pd.DatetimeIndex(docs.index.astype(str))
    ax.step(dates, transformed, where='pre')
    for a,b in vspans:
        if b >= min(dates):
            ax.axvspan(a, min(b, max(dates)), alpha=0.3, color='grey')
    ax.set_title(name)
    ax.legend([f"i+1" for i in range(n_components)] + ['Recession'],
        loc='center left', title='Topic score')
    plt.tight_layout(pad=2)

    # save dates of primary topic
    for topic in range(transformed.shape[1]):
        arg = DataFrame({'t': np.argmax(transformed, axis=1),

```

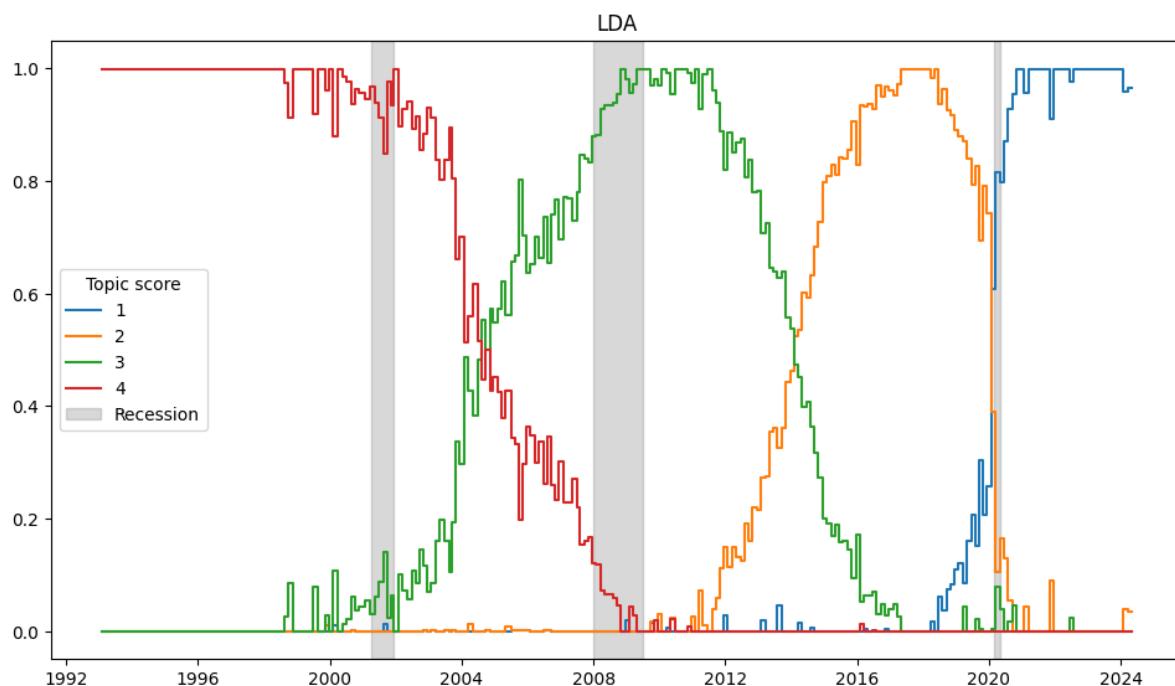
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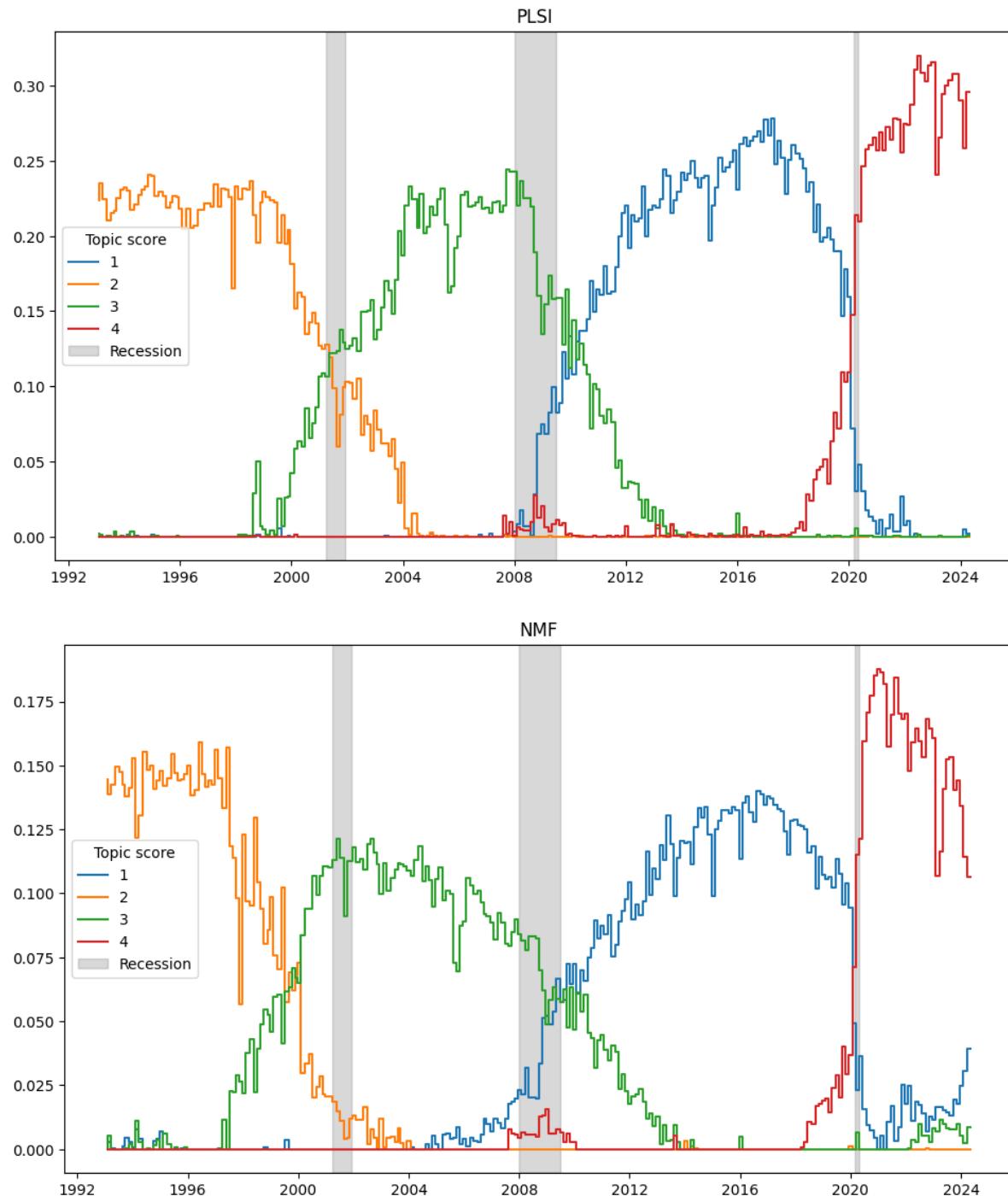
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```

        'dt': docs.index})
dates = (arg!=arg.shift()).cumsum().groupby('t').agg(['first', 'last']) - 1
dates['topic'] = arg.loc[dates.iloc[:,1], 't'].values
topics[name] = {topic: [(arg['dt'].iloc[row[0]], arg['dt'].iloc[row[1]])
                        for row in dates.itertuples(index=False, name=None)
                        if row[2] == topic]
                  for topic in range(transformed.shape[1])}

```





Identify the most important features (i.e. words) for discriminating each topic, using the `WordCloud` package

```
# Display word cloud of top n features, by model and topic
figsize = (10, 8)
for ifig, (name, score) in enumerate(scores.items()):
    wc = WordCloud(height=300, width=500, colormap='cool')
    top_n = 20
    fig, axes = plt.subplots(2, 2, num=ifig+5, figsize=figsize, clear=True)
```

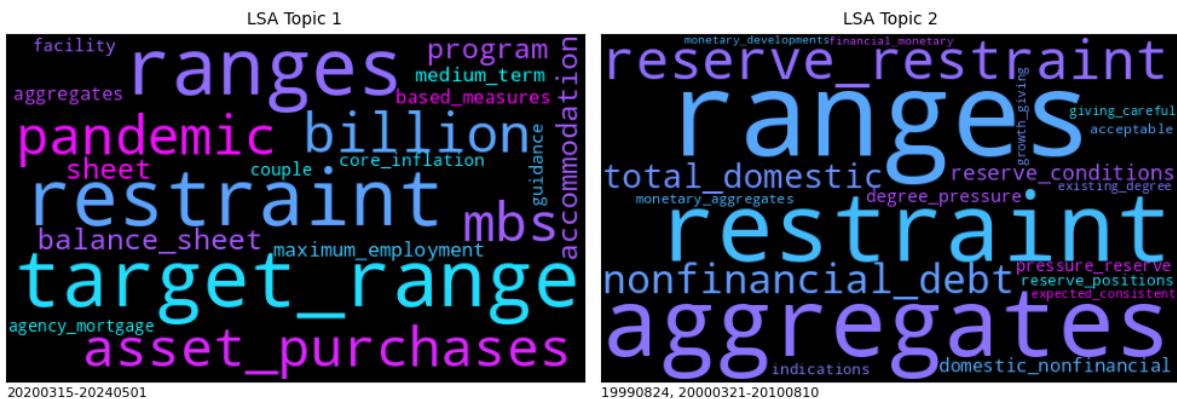
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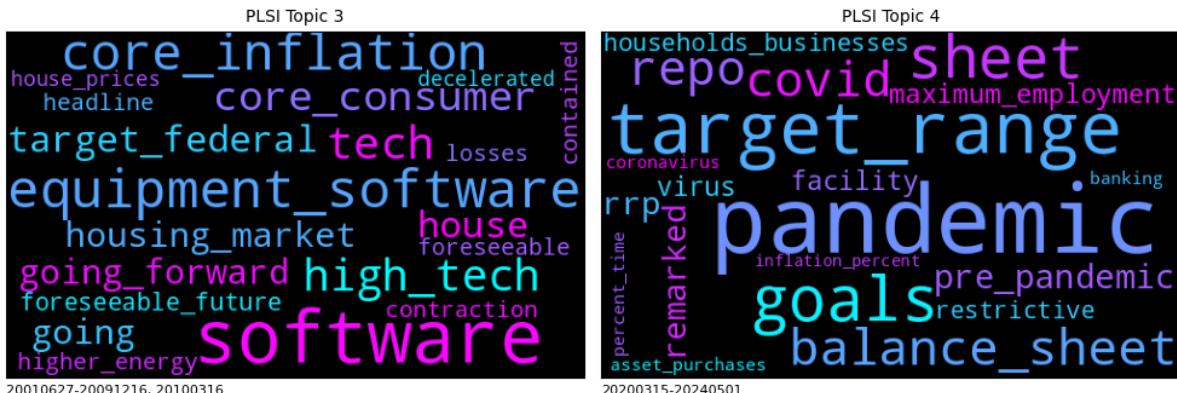
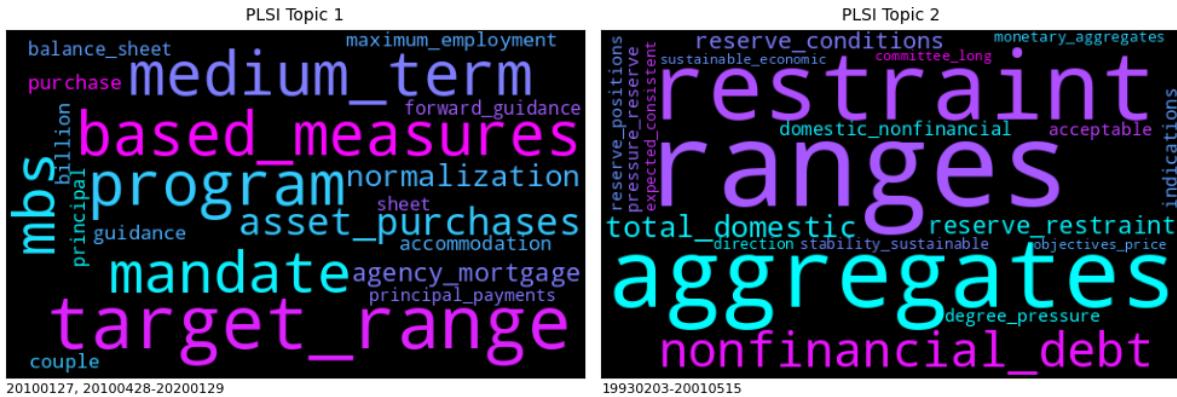
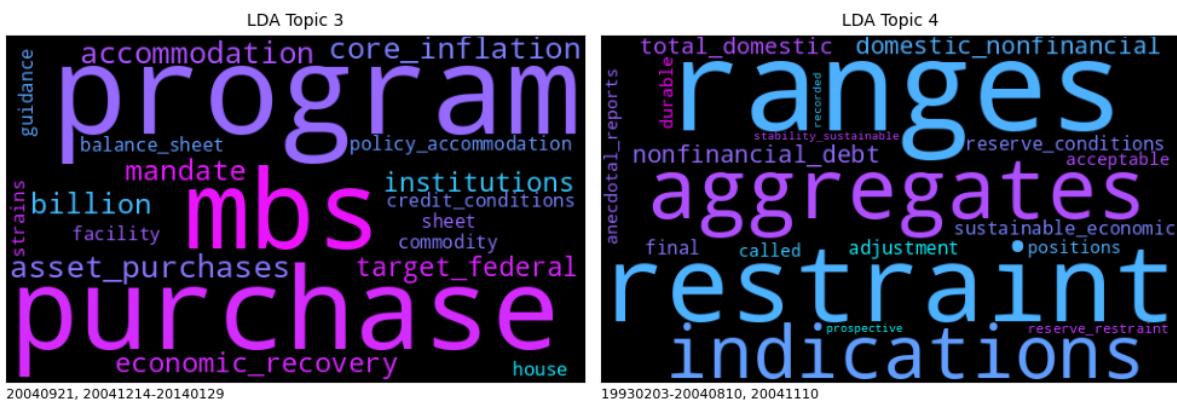
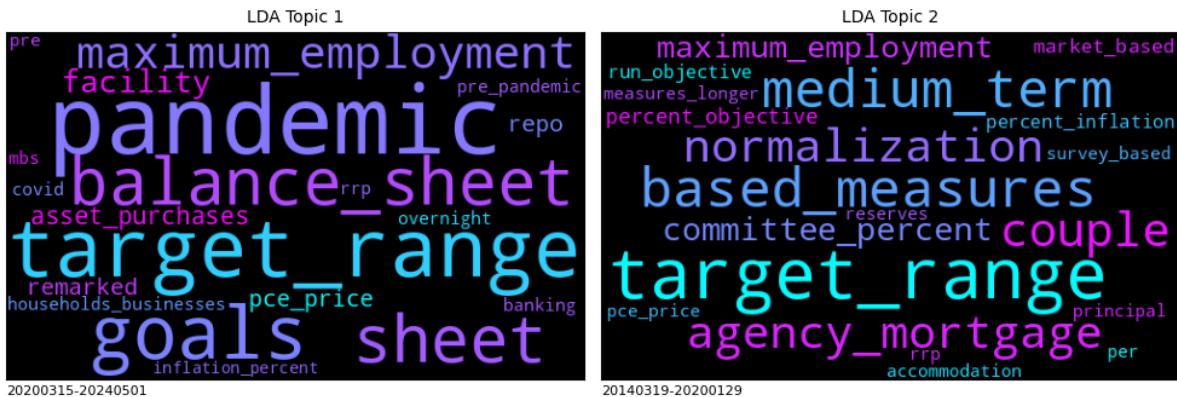
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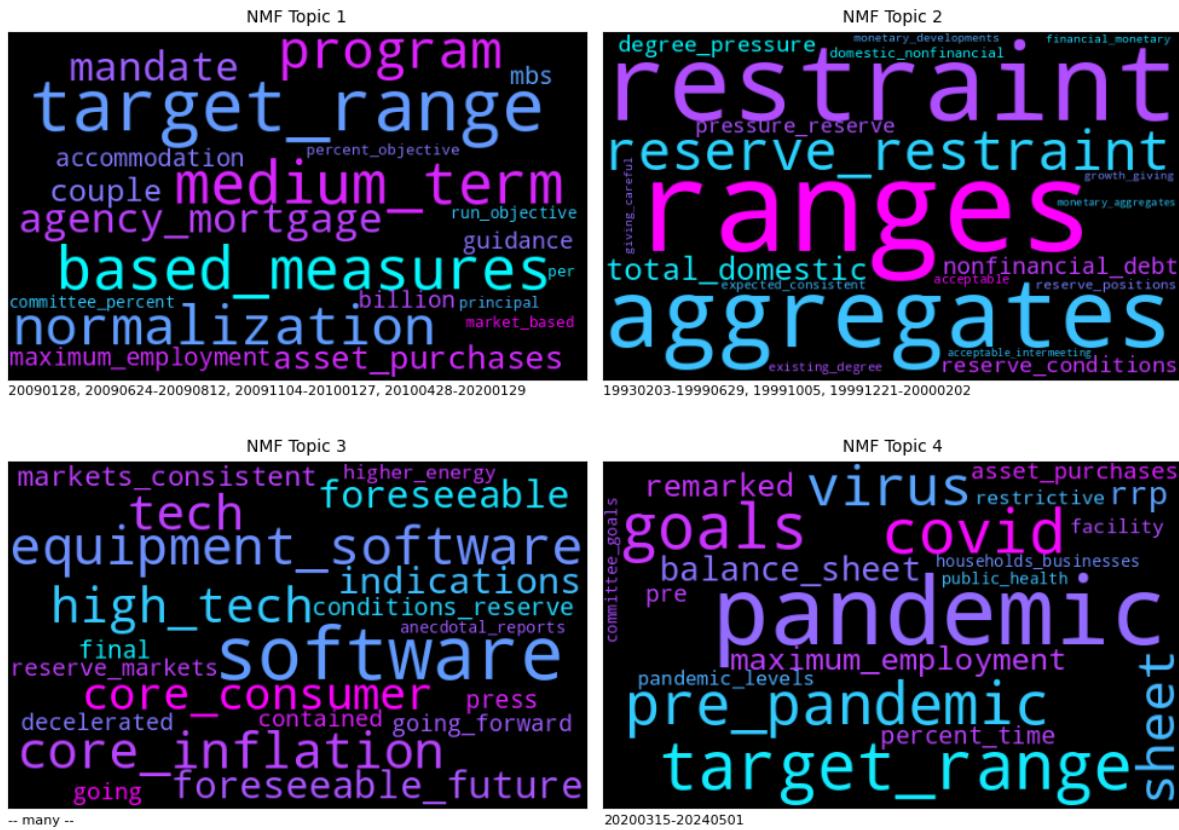
```

for topic, components in enumerate(score):
    words = {feature_names[i].replace(' ', '_') : components[i]
             for i in components.argsort()[:-top_n - 1:-1]}
    #print("Topic", topic+1, topics[name])
    #print(list(words.keys()))
    ax = axes[topic//2, topic % 2]
    ax.imshow(wc.generate_from_frequencies(words))
    ax.axes.yaxis.set_visible(False)    # make axes ticks invisible
    ax.xaxis.set_ticks([])
    ax.xaxis.set_ticklabels([])
    ax.set_title(f"{name} Topic {topic+1}", fontsize=10)
    regime = ", ".join([f"{d[0]}-{d[1]}"
                        if d[0] != d[1] else f"{d[0]}"
                        for d in topics[name][topic]])
    ax.set_xlabel(regime if len(regime) < 75 else '-- many --',
                  fontsize=8,
                  loc='left')
plt.tight_layout()

```







MANAGEMENT SENTIMENT ANALYSIS

Life is a math equation. In order to gain the most, you have to know how to convert negatives into positives - Anonymous
Concepts:

- Sentiment Analysis
- SEC Edgar

References:

- Tim Loughran and Bill McDonald, 2011, When is a Liability not a Liability? Textual Analysis, Dictionaries, and 10-Ks, Journal of Finance, 66:1, 35-65.
- Cohen, Malloy and Nguyen (2020), Lazy Prices, Journal of Finance, Volume 75, Issue3, June 2020, Pages 1371-1415

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from sklearn.feature_extraction.text import CountVectorizer
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.structured import BusDay, CRSP, Signals
from finds.unstructured import Edgar
from finds.readers import Alfred
from finds.recipes import weighted_average, fractile_split
from finds.utils import Store
from secret import credentials, paths, CRSP_DATE
# %matplotlib qt
VERBOSE = 0
LAST_YEAR = CRSP_DATE // 10000
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql=sql, bd=bd, rdb=rdb, verbose=VERBOSE)
ed = Edgar(paths['10X'], zipped=True, verbose=VERBOSE)
signals = Signals(user)
store = Store(paths['scratch'], ext='pkl')
```

Last FamaFrench Date 2024-04-30 00:00:00

26.1 Sentiment analysis

Dictionary-based (also known as lexicon-based) sentiment analysis uses lists of words which have been pre-scored for sentiment as well as the strength of the sentiment. However, this approach struggles in interpreting negations, irony, and sarcasm which can reduce accuracy. In contrast, large language models are better at understanding context, syntax, and semantics, leading to more accurate sentiment analysis, especially for complex sentences. Nevertheless, dictionary-based sentiment analysis is quick, easy to implement, and results are straightforward to interpret.

26.1.1 Loughran and MacDonald dictionary

Loughran and McDonald (2011) noted that general sentiment lexicons were not good fits for analyzing the sentiment of financial statements. Drawing from company 10-K filings, they scored individual words across different seven categories of sentiments important in financial contexts: “negative”, “positive”, “litigious”, “uncertainty”, “constraining”, or “superfluous”

- <https://sraf.nd.edu/loughranmcdonald-master-dictionary/>

```
# to download from google drive, need this prefix and the file id
_prefix = "https://drive.google.com/uc?export=download&id="
source = _prefix + '1ptUgGVeeUGhCbaKL14Ri3Xi5xOKkPkUD'
# source = "Loughran-McDonald_MasterDictionary_1993-2023.csv"
df = pd.read_csv(source, sep=', ')
```

```
# sets of positive and negative sentiment words
words = {'positive': set(df.loc[df['Positive'] != 0, 'Word'].str.lower()),
          'negative': set(df.loc[df['Negative'] != 0, 'Word'].str.lower())}
```

Positive sentiment words

```
DataFrame(words['positive'], columns=['Positive Words'])
```

```
Positive Words
0      leadership
1      meritorious
2      distinctions
3      improving
4      versatile
...
349      ...
350      distinction
351      beautifully
352      gained
353      attain
354      improve
```

[354 rows x 1 columns]

Negative sentiment words

```
DataFrame(words['negative'], columns=['Negative Words'])
```

```
Negative Words
0      disaster
1      disparagement
```

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```

2           misapplies
3           weaknesses
4           oppose
...
2350      nondisclosure
2351      unprofitability
2352      defended
2353      confront
2354      counterclaims

[2355 rows x 1 columns]

```

List of stop words to ignore

```

# stopwords
generic = ['ME', 'MY', 'MYSELF', 'WE', 'OUR', 'OURS', 'OURSELVES',
           'YOU', 'YOUR', 'YOURS', 'YOURSELF', 'YOURSELVES',
           'HE', 'HIM', 'HIS', 'HIMSELF', 'SHE', 'HER', 'HERS',
           'HERSELF', 'IT', 'ITS', 'ITSELF', 'THEY', 'THEM',
           'THEIR', 'THEIRS', 'THEMSELVES', 'WHAT', 'WHICH',
           'WHO', 'WHOM', 'THIS', 'THAT', 'THESE', 'THOSE',
           'AM', 'IS', 'ARE', 'WAS', 'WERE', 'BE', 'BEEN',
           'BEING', 'HAVE', 'HAS', 'HAD', 'HAVING', 'DO',
           'DOES', 'DID', 'DOING', 'AN', 'THE', 'AND', 'BUT',
           'IF', 'OR', 'BECAUSE', 'AS', 'UNTIL', 'WHILE', 'OF',
           'AT', 'BY', 'FOR', 'WITH', 'ABOUT', 'BETWEEN',
           'INTO', 'THROUGH', 'DURING', 'BEFORE', 'AFTER',
           'ABOVE', 'BELOW', 'TO', 'FROM', 'UP', 'DOWN', 'IN',
           'OUT', 'ON', 'OFF', 'OVER', 'UNDER', 'AGAIN',
           'FURTHER', 'THEN', 'ONCE', 'HERE', 'THERE', 'WHEN',
           'WHERE', 'WHY', 'HOW', 'ALL', 'ANY', 'BOTH', 'EACH',
           'FEW', 'MORE', 'MOST', 'OTHER', 'SOME', 'SUCH',
           'NO', 'NOR', 'NOT', 'ONLY', 'OWN', 'SAME', 'SO',
           'THAN', 'TOO', 'VERY', 'CAN', 'JUST', 'SHOULD',
           'NOW', 'AMONG']

```

```

# CountVectorizer to tokenize and code counts of inputs words
vectorizer = CountVectorizer(strip_accents='unicode',
                             lowercase=True,
                             stop_words=generic,
                             token_pattern=r"\b[^d\W][^d\W][^d\W]+\b")

```

```

# vectorizer to encode sentiment dictionary words
sentiment_vectorizer = CountVectorizer(strip_accents='unicode',
                                       lowercase=True,
                                       token_pattern=r"\b[^d\W][^d\W][^d\W]+\b")
sentiment_vectorizer.fit([" ".join(words['positive'].union(words['negative']))])

# create a lookup Series and a score vector for computing net sentiment
features = Series(sentiment_vectorizer.get_feature_names_out())
sentiment_points = (features.isin(words['positive']).astype(int).values
                    - features.isin(words['negative']).astype(int).values)

```

26.2 SEC Edgar company filings

The SEC EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system is an online database operated by the U.S. Securities and Exchange Commission (SEC). It provides public access to financial filings and disclosure documents submitted by publicly traded companies, such as annual and quarterly reports (Forms 10-K and 10-Q), significant events (Form 8-K), beneficial ownership reports (Schedule 13D), insider sales (Form 144), proxy statements, and registration statements (S-1).

- <https://www.sec.gov/edgar/search-and-access>

26.2.1 10-Ks

A 10-K is a comprehensive annual report filed by publicly traded companies with the SEC. It provides a detailed overview of the company's financial performance and operations, including dedicated sections for business description, management discussion and analysis (MD&A) and risk factors, as well as financial statements.

```
# open 10-K archive of MD&A text
item, form = 'mda10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
Series((rows['date'] // 10000).astype(int)).value_counts().sort_index().to_frame()
```

date	count
1993	2
1994	1362
1995	1674
1996	2960
1997	4461
1998	4501
1999	4364
2000	4287
2001	4168
2002	4400
2003	5478
2004	5203
2005	5090
2006	4999
2007	4954
2008	5033
2009	5273
2010	5050
2011	4863
2012	4730
2013	4617
2014	4643
2015	4720
2016	4612
2017	4488
2018	4431
2019	4417
2020	4388
2021	4615
2022	4766
2023	4641

Compute the average sentiment, and change in sentiment, of 10-K's for all investment universe stocks between 1993 through the present.

```
# retrieve usual universe at end of each year
univs = {year: crsp.get_universe(bd.endyr(year-1)).assign(year=year)
          for year in range(1992, LAST_YEAR + 1)}
permnos = rows['permno'].unique().astype(int)
DataFrame({'permnos': len(permnos),
           'documents': len(rows),
           'first': min(rows['date']),
           'last': max(rows['date'])},
           index=['10K-mdas'])
```

	permnos	documents	first	last
10K-mdas	14499	133190	19931129	20231229

```
# Compute average sentiment and change in sentiment for all companies and years
results = []
for permno in tqdm(permnos): # Loop over all permnos

    # retrieve all valid mda's for this permno by year
    mdas, dates = {}, {} # to collect mdas and doc dates for this permno
    docs = rows[rows['permno'].eq(permno)].to_dict('records')
    for doc in docs:
        year = bd.endmo(doc['date'], -3) // 10000 # assign fiscal year
        if (year in univs and (year not in mdas or doc['date'] < dates[year])):
            tokens = ed[doc['pathname']]
            if len(tokens):
                mdas[year] = tokens
                dates[year] = doc['date']

    # compute sentiment as net sentiment word counts divided by doc length
    if len(mdas):
        X = sentiment_vectorizer.transform(list(mdas.values())) \
            .dot(sentiment_points)
        X = np.divide(X, vectorizer.fit_transform(list(mdas.values())).sum())
        sentiment = {k:x for k,x in zip(mdas.keys(), X)}

    # derive sentiment change and similarity scores by year
    for year in sorted(mdas.keys()):
        result = {'year': year, 'permno': permno, 'date': dates[year]}
        result['mdasent'] = sentiment[year]
        result['currlen'] = len(mdas[year])
        if year-1 in mdas:
            result['prevlen'] = len(mdas[year-1])
            result['mdachg'] = sentiment[year] - sentiment[year-1]

        corpus = [mdas[year], mdas[year-1]]
        results.append(result)
```

```
0% | 0/14499 [00:00<?, ?it/s]/home/terence/env3.11/lib/python3.11/site-
  ↵packages/sklearn/feature_extraction/text.py:408: UserWarning: Your stop_words_
  ↵may be inconsistent with your preprocessing. Tokenizing the stop words generated_
  ↵tokens ['about', 'above', 'after', 'again', 'all', 'among', 'and', 'any', 'are',
  ↵'because', 'been', 'before', 'being', 'below', 'between', 'both', 'but', 'can',
```

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```

↳ 'did', 'does', 'doing', 'down', 'during', 'each', 'few', 'for', 'from', 'further
↳ ', 'had', 'has', 'have', 'having', 'her', 'here', 'hers', 'herself', 'him',
↳ 'himself', 'his', 'how', 'into', 'its', 'itself', 'just', 'more', 'most', 'myself
↳ ', 'nor', 'not', 'now', 'off', 'once', 'only', 'other', 'our', 'ours', 'ourselves
↳ ', 'out', 'over', 'own', 'same', 'she', 'should', 'some', 'such', 'than', 'that',
↳ 'the', 'their', 'theirs', 'them', 'themselves', 'then', 'there', 'these', 'they
↳ ', 'this', 'those', 'through', 'too', 'under', 'until', 'very', 'was', 'were',
↳ 'what', 'when', 'where', 'which', 'while', 'who', 'whom', 'why', 'with', 'you',
↳ 'your', 'yours', 'yourself', 'yourselves'] not in stop_words.
warnings.warn(
100%|██████████| 14499/14499 [10:47<00:00, 22.39it/s]

```

```

# save in signals database
data = DataFrame.from_records(results)
data['rebaldate'] = bd.offset(data['date'])
print(signals.write(data, 'mdasent', overwrite=True),
      signals.write(data, 'mdachg', overwrite=True))

```

```

(signals_write) mdasent 126842
(signals_write) mdachg 103966
126842 103966

```

```

# right join data with univ, to identify universe companies with missing mda
data = pd.concat([data[data['year']==year]\n                 .drop(columns=['year'])\n                 .set_index('permno')\n                 .join(univ[['year']], how='right')\n                 .reset_index()\n                 for year, univ in univs.items() if year < LAST_YEAR],\n                 ignore_index=True)
# store temporary
store['sentiment'] = data

```

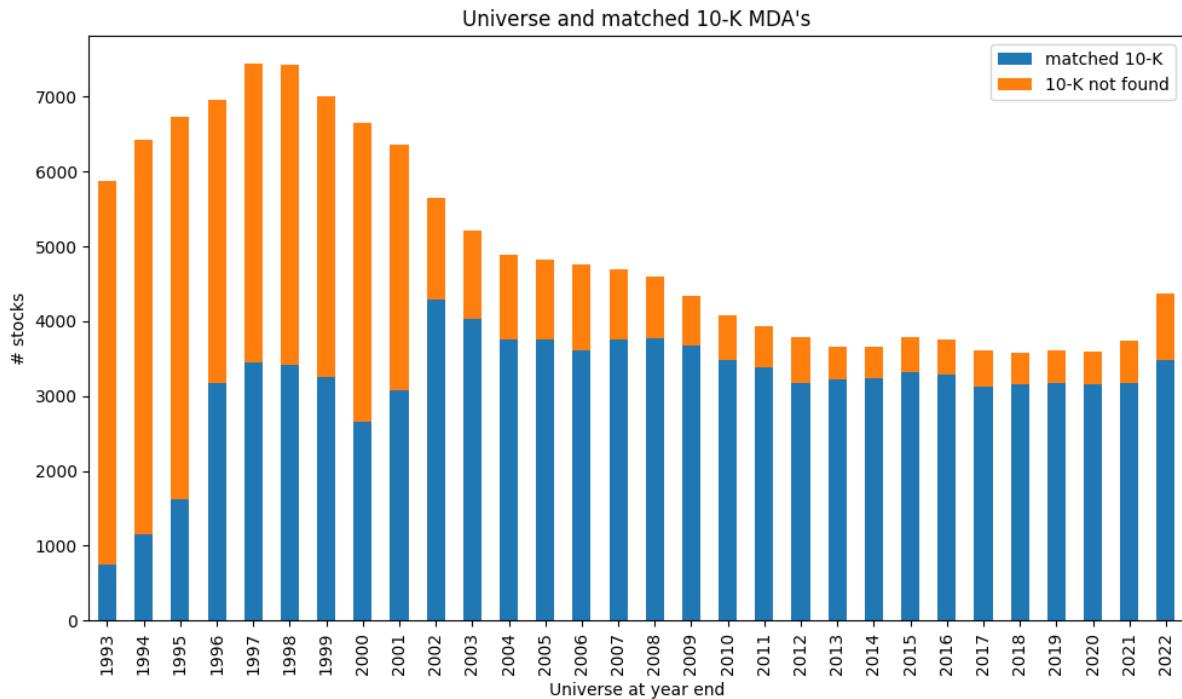
```
data = store['sentiment']
```

Show universe coverage by year

```

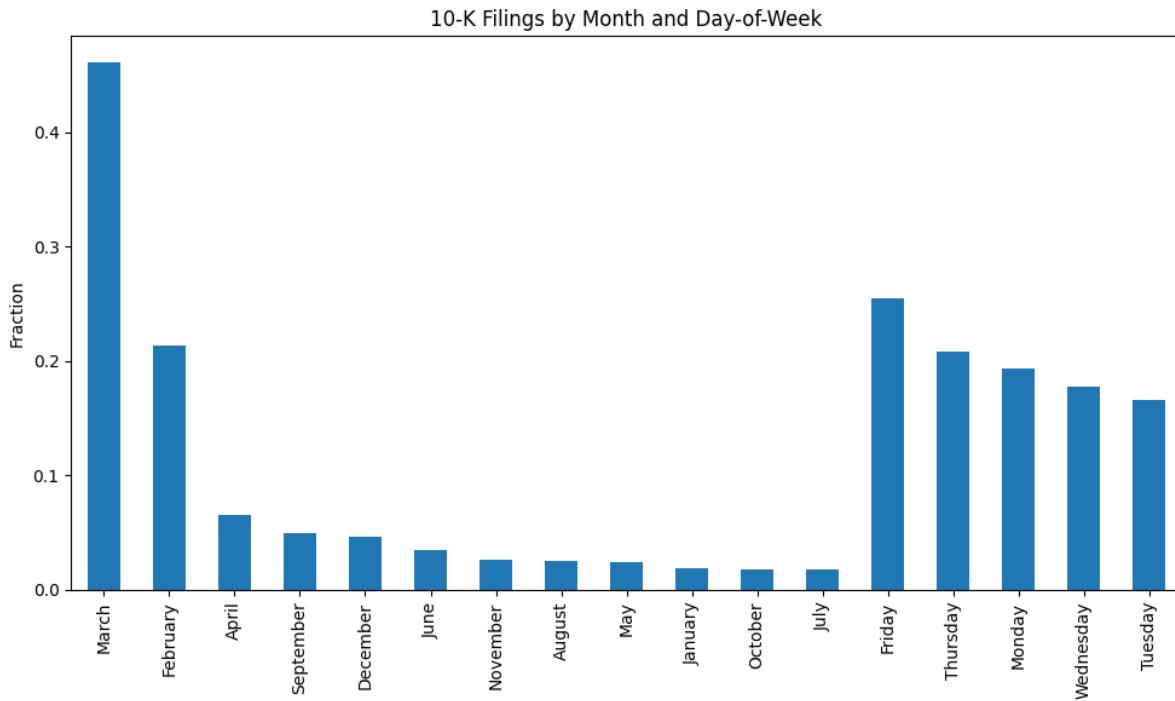
# Stacked Bar Plot of universe coverage by year
y1 = data[data['mdasent'].notna()].groupby('year')['permno'].count()
y0 = data[data['mdasent'].isna()].groupby('year')['permno']\n      .count()\n      .reindex(y1.index)
fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 6))
y1.plot(kind='bar', label='matched 10-K', color='C0', ax=ax, rot=90)
y0.plot(kind='bar', label='10-K not found', color='C1', ax=ax, rot=90, bottom=y1)
ax.set_ylabel('# stocks')
ax.set_xlabel('Universe at year end')
ax.set_title("Universe and matched 10-K MDA's")
ax.legend()
plt.tight_layout()

```



When are 10-K's filed?

```
# Stacked Bar Plot of filings date, by month and day-of-week
y = DataFrame.from_records([{'date': int(d),
                            'day': bd.datetime(int(d)).strftime('%A'),
                            'month': bd.datetime(int(d)).strftime('%B')}
                           for d in data.loc[data['mdasent'].notna(), 'date']])
z = pd.concat([y['month'].value_counts()/len(y),
               y['day'].value_counts()/len(y)])
fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 6))
z.plot(kind='bar', color='C0', ax=ax, rot=90)
ax.set_ylabel('Fraction')
ax.set_title("10-K Filings by Month and Day-of-Week")
plt.tight_layout()
```



Show the median sentiment and change in sentiment vs total corporate profits (of all US companies), by year

```

alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
series_id = 'CP' # Corporate Profits
econ = alf(series_id).to_frame()
econ = econ.assign(year=econ.index // 10000).groupby('year').sum()

for sent, ylab in {'mdasent': 'sentiment', 'mdachg': 'sentiment change'}.items():
    print(sent, ylab)
    g = data[data['currlen'].gt(500)].dropna().groupby('year')
    iq1, iq2, iq3 = [g[sent].quantile(p) for p in [.25, .5, .75]]
    y = iq2.index.astype(int)
    fig, ax = plt.subplots(1, 1, clear=True, figsize=(10, 6))
    ax.step(y, iq2, ls='-', color='C1', where='pre')
    ax.fill_between(y, iq1, iq3, alpha=0.2, color='C1', step='pre')
    ax.set_title(f'{sent.upper()} by Fiscal Year of 10-K Filing')
    ax.set_xlabel("Fiscal Year")
    ax.set_ylabel(ylab)
    ax.legend([f'{sent.upper()} median', f"inter-quartile range"],
              fontsize='small', loc='upper left')

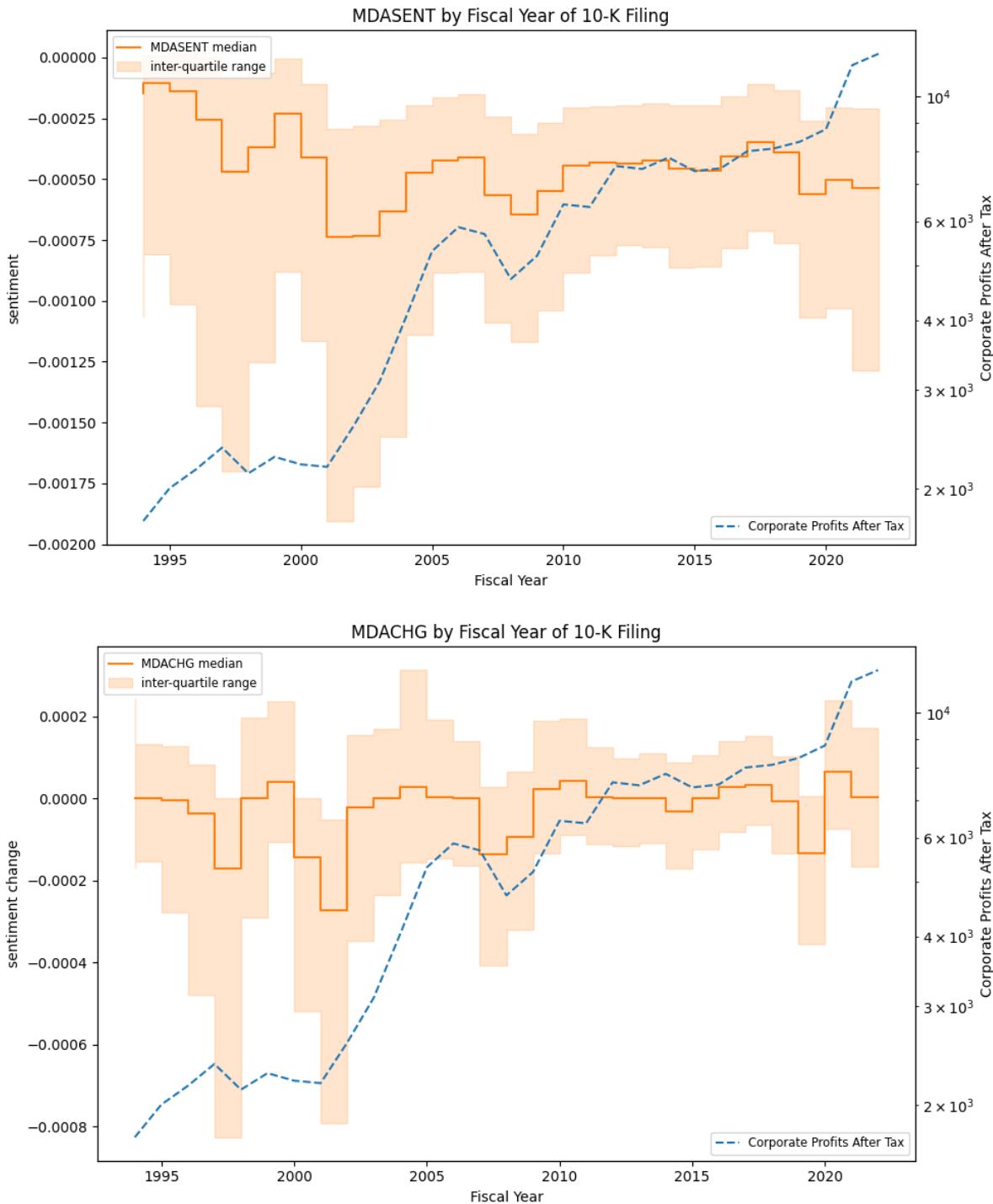
    bx = ax.twinx()
    econ[(econ.index >= min(y)) & (econ.index <= max(y))].plot(ls='--', ax=bx)
    bx.legend([alf.header(series_id)[:27]], fontsize='small', loc='lower right')
    bx.set_ylabel(alf.header(series_id)[:27])
    bx.set_yscale('log')
    plt.tight_layout()

```

```

mdasent sentiment
mdachg sentiment change

```



Compute decile cap-weighted spread returns, both in same year (Jan-Dec) and year ahead (Apr-Mar). The former case shows the contemporaneous relationship between stock returns and the sentiment of 10-K report for the same calendar year, whereas the latter is an investable strategy after 10-K's (for the prior fiscal year) are released.

```
for ifig, key in enumerate(['mdasent', 'mdachg']):
    ret1 = {} # to collect year-ahead spread returns
    ret0 = {} # to collect current-year spread returns
```

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```

for year in range(1999, max(data['year'])+1):  # loop over years

    # compute current year average spread returns
    begyr = bd.begyr(year)
    endyr = bd.endyr(year)
    univ = data[data['year'] == year] \
        .dropna(subset=[key]) \
        .set_index('permno') \
        .join(crsp.get_cap(bd.offset(begyr, -1)), how='inner') \
        .join(crsp.get_ret(begyr, endyr), how='left')

    if len(univ):
        sub = fractile_split(univ[key], [10, 90])
        pos = weighted_average(univ.loc[sub==1, ['cap', 'ret']], 'cap')['ret']
        neg = weighted_average(univ.loc[sub==3, ['cap', 'ret']], 'cap')['ret']
        ret0[endyr] = {'ret': pos-neg, 'npos': sum(sub==1), 'nneg': sum(sub==3)}

    # compute year ahead average spread returns
    beg = bd.begmo(endyr, 4)
    end = bd.endmo(endyr, 15)
    univ = data[data['year'] == year] \
        .dropna(subset=[key]) \
        .set_index('permno') \
        .join(crsp.get_cap(bd.offset(beg, -1)), how='inner') \
        .join(crsp.get_ret(beg, end), how='left')

    if len(univ):
        sub = fractile_split(univ[key], [10, 90])
        pos = weighted_average(univ.loc[sub==1, ['cap', 'ret']], 'cap')['ret']
        neg = weighted_average(univ.loc[sub==3, ['cap', 'ret']], 'cap')['ret']
        ret1[end] = {'ret': pos-neg, 'npos': sum(sub==1), 'nneg': sum(sub==3)}

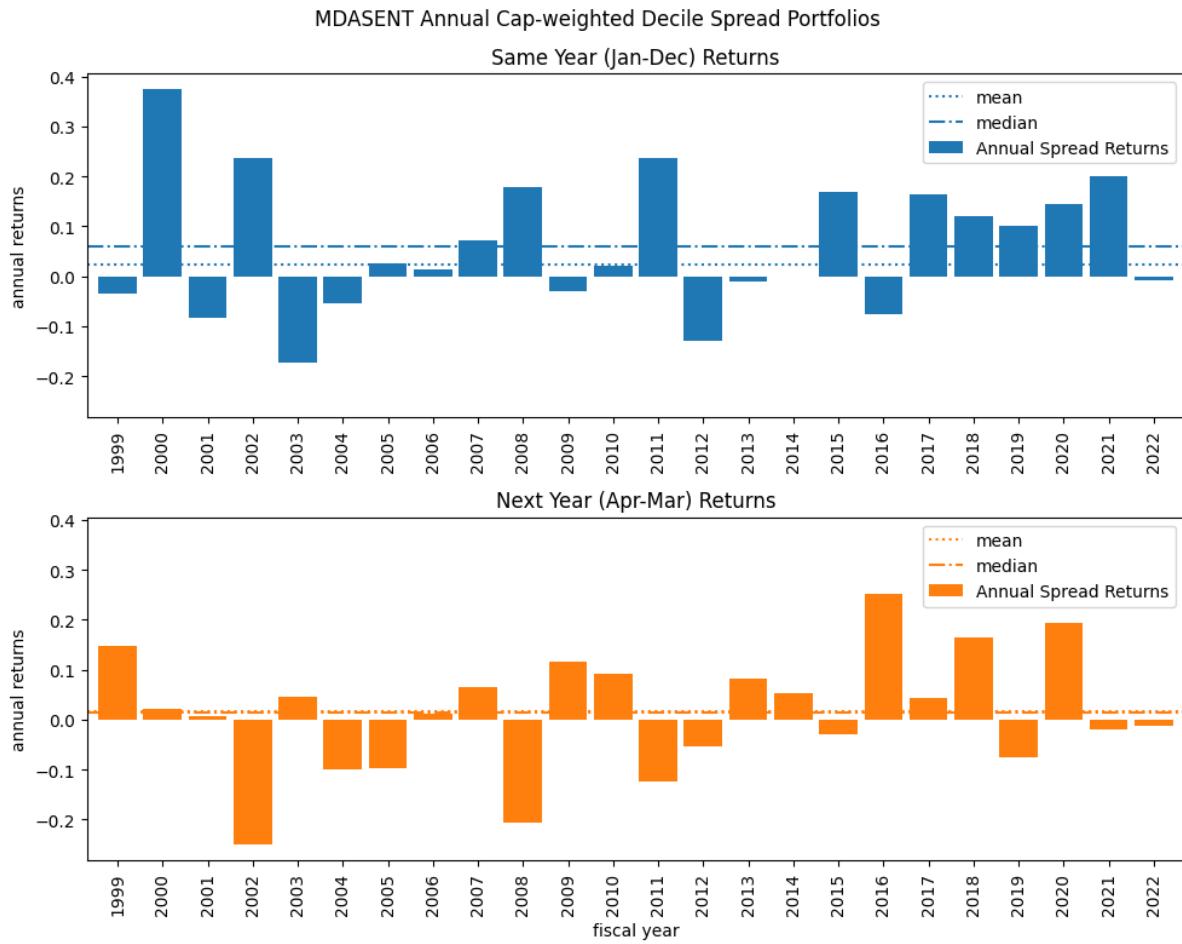
# collect same-year and year-ahead average spread returns
r0 = DataFrame.from_dict(ret0, orient='index').sort_index()
r0.index = r0.index // 10000
r1 = DataFrame.from_dict(ret1, orient='index').sort_index()
r1.index = (r1.index // 10000) - 2

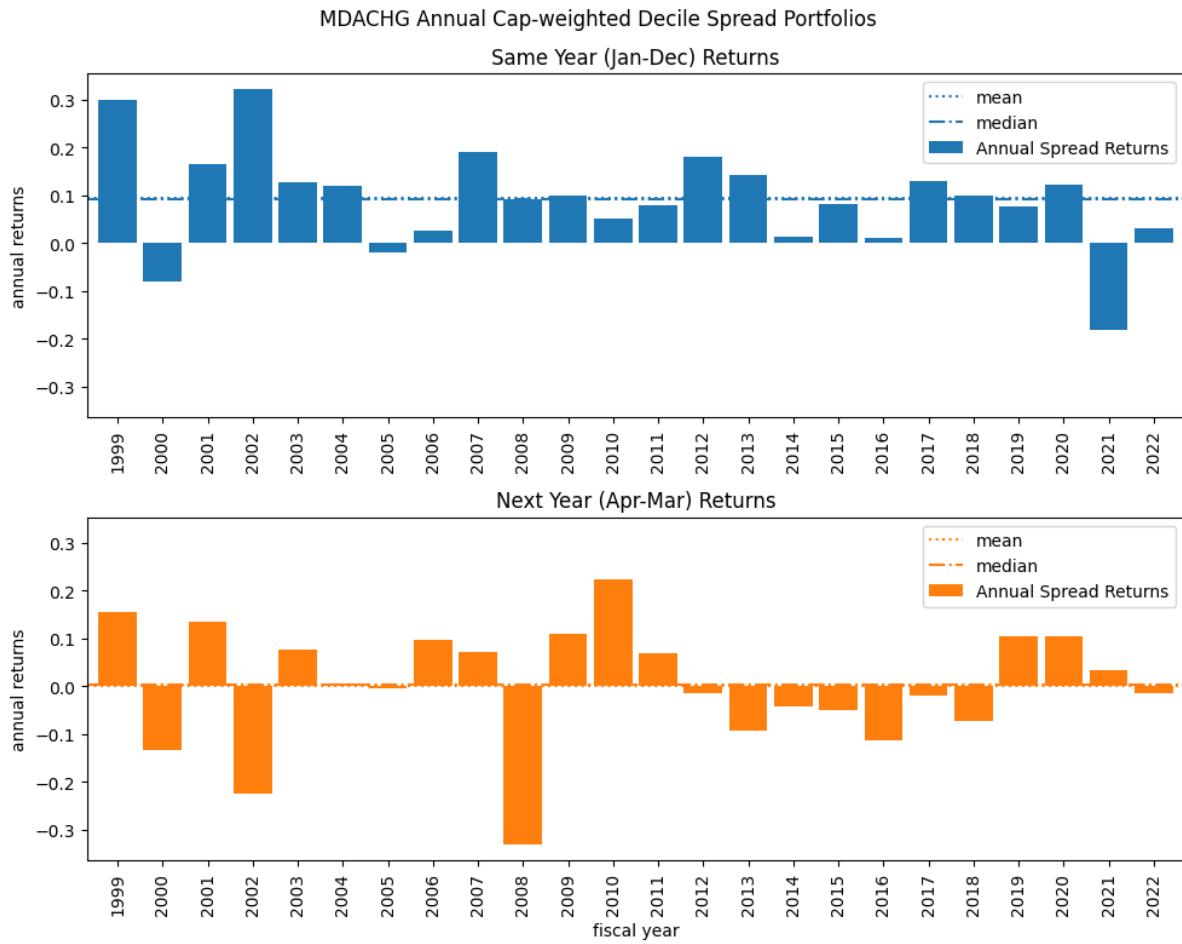
# plot same-year average spread returns
fig, ax = plt.subplots(nrows=2, clear=True, figsize=(10, 8), sharey=True)
r0['ret'].plot(kind='bar', ax=ax[0], width=.85, color="C0")
ax[0].axhline(r0['ret'].median(), linestyle=':', color='C0')
ax[0].axhline(r0['ret'].mean(), linestyle='-.', color='C0')
ax[0].set_title(f"Same Year (Jan-Dec) Returns")
ax[0].set_ylabel('annual returns')
ax[0].legend(['mean', 'median', 'Annual Spread Returns'])

# plot year-ahead average spread returns
r1['ret'].plot(kind='bar', ax=ax[1], width=.85, color="C1")
ax[1].axhline(r1['ret'].median(), linestyle=':', color='C1')
ax[1].axhline(r1['ret'].mean(), linestyle='-.', color='C1')
ax[1].set_title(f"Next Year (Apr-Mar) Returns")
ax[1].set_ylabel('annual returns')
ax[1].legend(['mean', 'median', 'Annual Spread Returns'])
ax[1].set_xlabel('fiscal year')

plt.suptitle(f"{key.upper()} Annual Cap-weighted Decile Spread Portfolios")
plt.tight_layout()

```





CHAPTER
TWENTYSEVEN

BUSINESS TEXT ANALYSIS

You shall know a word by the company it keeps - J. R. Firth

Concepts:

- Syntactic analysis of text
- Density-based Clustering

References:

- Greg Durrett, 2023, “CS388 Natural Language Processing course materials”, retrieved from <https://www.cs.utexas.edu/~gdurrett/courses/online-course/materials.html>

```
import re
import numpy as np
from scipy import spatial
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import spacy
from sklearn import cluster
from sklearn.decomposition import PCA
from sklearn.manifold import TSNE
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.structured import CRSP, BusDay
from finds.unstructured import Edgar
from finds.utils import Store, Finder, ColorMap
from secret import credentials, paths
# %matplotlib qt
VERBOSE = 0
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
ed = Edgar(paths['10X'], zipped=True, verbose=VERBOSE)
store = Store(paths['scratch'])
find = Finder(sql)
```

Last FamaFrench Date 2024-04-30 00:00:00

Retrieve investment universe as of end-2022: we shall subset on the largest decile (based on NYSE market cap breakpoint).

Also, enable lookup of company names and tickers, for readability

```
# Retrieve universe of stocks, keep to decile
univ = crsp.get_universe(bd.endmo(20221231))
comnam = crsp.build_lookup('permno', 'comnam', fillna="") # company name
univ['comnam'] = comnam(univ.index)
ticker = crsp.build_lookup('permno', 'ticker', fillna="") # tickers
univ['ticker'] = ticker(univ.index)
```

Retrieve Business Description text from 10-K archive

```
# retrieve 2023 bus10K's
item, form = 'bus10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
found = rows[rows['permno'].isin(univ.index[univ.decile <= 1])] # largest decile only
& rows['date'].between(20230101, 20231231)]\n.drop_duplicates(subset=['permno'], keep='last')\n.set_index('permno')
```

27.1 Syntactic analysis

This involves analyzing the syntactic roles of words in sentences and how they combine to form phrases and sentences according to the rules of a formal grammar. It seems to model the relationships between words and phrases, such as subject-verb-object relationships, which forms the basis for NLP tasks such as dependency or constituent parsing.

27.1.1 SpaCy

spaCy is a popular open-source library for advanced natural language processing (NLP) tasks in Python, such as POS tagging, entity recognition and dependency parsing. It also offers pre-trained models for various languages and domains, as well as customizable pipelines for processing text data.

- <https://spacy.io/models>

```
# ! python -m spacy download en_core_web_sm
nlp = spacy.load("en_core_web_lg")
```

27.1.2 Lemmatization

To lemmatize a word is to reduce it to its base or dictionary form, known as the lemma, which represents its morphological root.

```
# Using spaCy pipeline to tokenize NVIDIA's 10-K business description text
nvidia = find('NVIDIA')['permno'].iloc[0]
doc = nlp(ed[found.loc[nvidia, 'pathname']][:nlp.max_length].lower())
tokens = DataFrame.from_records([{'text': token.text,
                                  'lemma': token.lemma_,
                                  'alpha': token.is_alpha,
                                  'stop': token.is_stop,
                                  'punct': token.is_punct}
                                  for token in doc], index=range(len(doc)))
tokens.head(30)
```

	text	lemma	alpha	stop	punct
0	item	item	True	False	False
1	1	1	False	False	False
2	.	.	False	False	True
3	business	business	True	False	False
4	\n\n	\n\n	False	False	False
5	our	our	True	True	False
6	company	company	True	False	False
7	\n\n	\n\n	False	False	False
8	nvidia	nvidia	True	False	False
9	pioneered	pioneer	True	False	False
10	accelerated	accelerate	True	False	False
11	computing	computing	True	False	False
12	to	to	True	True	False
13	help	help	True	False	False
14	solve	solve	True	False	False
15	the	the	True	True	False
16	most	most	True	True	False
17	challenging	challenging	True	False	False
18	computational	computational	True	False	False
19	problems	problem	True	False	False
20	.	.	False	False	True
21	since	since	True	True	False
22	our	our	True	True	False
23	original	original	True	False	False
24	focus	focus	True	False	False
25	on	on	True	True	False
26	pc	pc	True	False	False
27	graphics	graphic	True	False	False
28	,	,	False	False	True
29	we	we	True	True	False

27.1.3 Part-of-speech tagging

Part-of-speech (POS) tagging is the process of automatically assigning grammatical categories (such as noun, verb, adjective, etc.) to words in a text corpus. This helps in understanding the structure of sentences and extracting meaning from text by identifying the roles that words play in a sentence.

```
tags = DataFrame.from_records([{'text': token.text,
                               'pos': token.pos_,
                               'tag': token.tag_,
                               'dep': token.dep_}
                               for token in doc], index=range(len(doc)))
tags.head(30)
```

	text	pos	tag	dep
0	item	NOUN	NN	ROOT
1	1	NUM	CD	nummod
2	.	PUNCT	.	punct
3	business	NOUN	NN	nsubj
4	\n\n	SPACE	_SP	dep
5	our	PRON	PRP\$	poss
6	company	NOUN	NN	appos
7	\n\n	SPACE	_SP	dep

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```

8      nvidia  PROPN  NNP      appos
9  pioneered  VERB  VBD      ROOT
10 accelerated  VERB  VBD      xcomp
11 computing  NOUN  NN      dobj
12      to  PART  TO      aux
13      help  VERB  VB      advcl
14      solve  VERB  VB      xcomp
15      the  DET  DT      det
16      most  ADV  RBS      advmod
17 challenging  ADJ  JJ      amod
18 computational  ADJ  JJ      amod
19      problems  NOUN  NNS      dobj
20      .  PUNCT  .      punct
21      since  SCONJ  IN      prep
22      our  PRON  PRP$      poss
23      original  ADJ  JJ      amod
24      focus  NOUN  NN      pobj
25      on  ADP  IN      prep
26      pc  NOUN  NN      compound
27      graphics  NOUN  NNS      pobj
28      ,  PUNCT  ,      punct
29      we  PRON  PRP      nsubj

```

27.1.4 Named entity recognition

Named Entity Recognition (NER) involves identifying and classifying entities (i.e. real-world objects such as persons, organizations, locations, dates, etc.) from a text corpus. Its goal is to locate and classify named entities in the text into predefined categories, such as organizations or persons.

```

ents = DataFrame.from_records([{'text': ent.text,
                               'label': ent.label_,
                               'start': ent.start_char,
                               'end': ent.end_char}
                               for ent in doc.ents], index=range(len(doc.ents)))
ents.head(20)

```

	text	label	start	end
0	1	CARDINAL	5	6
1	nvidia	ORG	357	363
2	gpu	ORG	382	385
3	av	ORG	515	517
4	gpu	ORG	576	579
5	today	DATE	684	689
6	thousands	CARDINAL	835	844
7	gpu	ORG	1115	1118
8	thousands	CARDINAL	1161	1170
9	gpu	ORG	1325	1328
10	gpus	GPE	2191	2195
11	multi-billion-dollar	MONEY	2290	2310
12	third	ORDINAL	2431	2436
13	over 37 billion	MONEY	2663	2678
14	gpu	ORG	2809	2812
15	1999	DATE	2816	2820

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16	2006	DATE	2968	2972
17	gpu	ORG	3028	3031
18	today	DATE	3280	3285
19	gpus	GPE	3291	3295

```
# Entity Visualizer
from spacy import displacy
displacy.render(doc[:300], style="ent", jupyter=True)
```

```
<IPython.core.display.HTML object>
```

27.1.5 Dependency parsing

Dependency parsing determines the grammatical relationships between words in a sentence. It identifies the dependencies between words, where each word is treated as a node, and the relationships between them are represented as directed edges. Hence the output of dependency parsing is a tree structure, where each word (except the root) is governed by another word (its head), indicating the syntactic role of each word (e.g., subject, object, modifier) in relation to other words in the sentence.

Transition-based parsing algorithms uses a set of transition operations (e.g. shift, reduce) to incrementally build a dependency tree from an input sentence.

In contrast, **constituent parsing** focuses on identifying and representing the *hierarchical structure of phrases* in a sentence according to a formal grammar. It groups words into nested syntactic units (e.g., noun phrases, verb phrases), typically as a tree structure (called a parse tree or constituent tree) where each node represents a constituent phrase and its children represent the words or smaller constituents that form it. The CKY (Cocke-Kasami-Younger) algorithm is a dynamic programming technique for parsing sentences and constructing parse trees.

Probabilistic Context-Free Grammar (PCFG) extends assigns probabilities to the production rules of a standard Context-Free Grammar (CFG). Each production rule defines how non-terminal symbols (such as NP for noun phrase or VP for verb phrase) can be expanded into sequences of terminal symbols (words) or other non-terminals. The probability associated with each rule indicates the likelihood of using that rule in generating or parsing sentences.

The training of models for automatic tagging and parsing relies on labeled data from **treebanks**, which are collections of parsed sentences where each sentence has been annotated with its grammatical structure showing how words are grouped into phrases and how these phrases relate to each other through syntactic dependencies. The **Penn Treebank** is one of the earliest and most widely used treebanks for English: it includes syntactic annotations such as part-of-speech tags and parse trees.

```
sentence_spans = list(doc.sents)
displacy.render(sentence_spans[2:4], style="dep", jupyter=True,
                options=dict(compact=False, distance=175))
```

```
<IPython.core.display.HTML object>
```

27.1.6 Word vectors

Word embeddings are numerical representations of words in a multidimensional space, created to help capture the relationships and meanings of words. Word embeddings achieve this by mapping words into a high-dimensional space, where the positions of the words reflect their syntactical and semantic similarities based on how often they co-occur within a large corpus.

For example, spaCy's `en_core_web_lg` model represents each of some 500K+ words in its vocabulary with a unique 300-dimensional vector.

Use the POS tagger in the spaCy pipeline to extract the lemmatized form of nouns from business descriptions text

```
# Extract nouns
bus = {}
for permno in tqdm(found.index):
    doc = nlp(ed[found.loc[permno, 'pathname']][:nlp.max_length].lower())
    nouns = " ".join([re.sub("[^a-zA-Z]+", "", token.lemma_) for token in doc
                      if token.pos_ in ['NOUN'] and len(token.lemma_) > 2])
    if len(nouns) > 100:
        bus[permno] = nouns
store['business'] = bus
```

```
bus = store.load('business')
permnos = list(bus.keys())
tickers = univ.loc[permnos, 'ticker'].to_list()
```

Show the average word vector value for NVidia's business description text.

```
# example of word vector
vec1 = nlp(bus[nvidia]).vector
vec1
```

```
array([-0.5370803,  0.03360266, -0.7142777,  1.0528733,  2.59639, ,
       0.29917082,  1.3443472,  3.7829578, -2.2698855, -1.2616774, ,
       5.9859304,  2.0566463, -4.519684,  2.2885911, -1.1176012, ,
      2.4155278,  3.2593274,  1.5960239, -2.3042047,  0.06216303,
      0.21148767,  1.7382729, -2.3506453,  0.7941269, -1.2192215,
     -1.8039206, -1.8674678, -1.6660213, -0.7127941,  1.0603017,
     1.2367841,  1.2303644, -1.1252155, -0.444499,  0.34517637,
    -0.38984352,  1.4724953,  0.7678367,  1.3465229,  0.35140815,
      0.2309201, -0.14058447,  0.18483874,  0.99899405, -1.4584388,
      1.5930446,  2.0110247, -1.9788889,  0.49480593, -1.2044214,
      0.11300751,  2.2886782, -0.19940257, -3.7744892, -0.5143599,
      0.5165942, -1.6783403,  1.471545,  0.44622797, -1.4958122,
      2.2605124,  1.2073922, -2.2683856, -1.2163076,  2.4330237,
      1.984873, -2.2740626, -3.403873,  0.47273394,  2.995668,
     -0.9620564,  0.6815842, -1.2293031,  0.39141572, -0.38473308,
      1.3203373, -1.4432802,  1.0591677, -1.8518488, -0.16182004,
     -2.5851288, -0.59578013,  0.94991404,  1.3326784, -0.23613031,
     -0.06382382, -1.2549951, -1.870869,  0.81396717, -0.22290176,
     -1.1564466,  1.1623534,  1.5485297, -2.269457,  0.47645366,
```

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```

-0.5349471 ,  0.52957475, -0.5513478 ,  0.898683 ,  1.1934973 ,
 3.0264792 ,  0.34337226,  1.9315122 ,  1.8684549 ,  0.25543526,
 4.1305084 , -1.0766245 , -1.783644 , -0.16379517, -2.5999024 ,
 2.416761 , -0.25838712, -1.1239128 ,  0.0806675 ,  0.83068776,
 1.7715666 , -2.6283164 , -1.3049829 , -0.43024743, -2.4749107 ,
-1.9384258 , -2.6229663 ,  0.4618342 ,  1.057843 , -0.37454468,
-2.819155 ,  0.37408748, -2.9028332 ,  2.9274974 , -1.8085246 ,
-2.426946 ,  0.35030136,  3.2538562 ,  0.7459811 , -0.20202728,
-0.42221448, -1.0485231 , -0.4264125 ,  1.9211813 ,  0.34063482,
-0.6206286 , -0.8266343 , -0.15856954,  0.83639336,  1.7174845 ,
 0.20949106, -3.530206 , -0.23094082,  0.10127478,  3.302818 ,
-0.27075577,  1.287823 ,  0.2584661 ,  1.1708083 , -0.6232318 ,
 0.5208176 ,  2.811072 ,  1.6814557 , -0.9234696 , -2.6148355 ,
-0.9125833 , -1.2430634 ,  0.69818443,  1.6250277 , -1.756842 ,
-1.1041273 , -1.9850543 ,  0.5356962 ,  0.68917316, -1.5397801 ,
-1.5052795 , -0.24432632, -0.2890989 ,  0.9179231 ,  2.1375725 ,
 1.9237542 ,  0.62545127, -0.32388556, -1.931465 , -1.3508677 ,
-1.7556167 ,  1.6963013 ,  1.1774518 , -1.8767457 , -1.0262736 ,
 0.63852936, -0.9283388 , -1.4915254 ,  1.5973182 ,  1.6986073 ,
-0.03490533, -1.1837475 ,  0.10344972, -1.8024594 ,  1.811266 ,
 0.66438913, -2.8240383 , -0.103202 ,  0.4685329 ,  0.0105569 ,
-0.765648 , -1.0457621 , -0.30014274, -1.0558511 ,  3.54757 ,
 0.75964266, -3.3850913 ,  1.3490607 , -0.07135642, -1.585785 ,
 1.0023903 , -0.07662493, -1.1104459 ,  2.163392 ,  0.80607325,
 1.6615813 ,  2.6736174 , -4.110095 , -0.5684414 ,  0.33428678,
-1.7811066 ,  1.2861276 , -1.5071455 , -0.9563607 , -0.65822935,
-2.6227672 ,  0.4704638 ,  2.0072794 ,  1.157605 , -0.15971239,
 2.342728 , -2.7271366 , -1.313225 ,  1.6697329 ,  2.773483 ,
 0.526841 , -0.35118487, -0.24909748,  0.89834905,  0.9178003 ,
-2.0666726 , -1.1335946 , -0.11632897,  0.9670184 , -0.19256516,
 0.3340973 , -1.7204974 ,  1.2734429 ,  0.32692093,  1.1701695 ,
 0.5955371 , -1.8531798 , -3.5321872 , -2.0358229 ,  0.09263046,
-1.9751374 ,  0.93768364, -1.0953122 ,  0.29624373,  0.86260045,
-1.508276 ,  4.900358 ,  1.68672 ,  1.238053 ,  1.8480684 ,
-0.7564861 , -0.241455 ,  1.911321 , -0.9201174 , -0.78837055,
-0.23056957, -0.22257806,  0.19382319, -1.0487769 ,  0.3879833 ,
-2.8108838 ,  0.90410644, -1.8231851 , -1.0712295 ,  1.0877283 ,
 3.359274 ,  0.3441454 ,  1.5441068 ,  0.03014776,  3.7927184 ,
 0.24134938,  1.225233 ,  1.8023691 , -2.3324652 , -0.01004765,
 0.41854864, -0.47862425, -0.8102291 ,  0.73383987, -1.5596336 ,
 0.17658985,  1.2276987 , -2.1915882 , -0.8576518 ,  2.1577606 ],
dtype=float32)

```

Compute average word vector value for all companies' business description text

```

# Compute sentence vectors
vecs = np.array([nlp(bus[permno]).vector for permno in bus.keys()])
store['vectors'] = vecs

```

```
vecs = store['vectors']
```

```

# Distance matrix
n = len(bus)
distances = np.zeros((n, n))

```

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```
for row in range(n):
    for col in range(row, n):
        distances[row, col] = spatial.distance.cosine(vecs[row], vecs[col])
        distances[col, row] = distances[row, col]
```

Show companies with most similar business descriptions, for some selected companies

```
def most_similar(p):
    dist = distances[permnos.index(p)]
    dist[permnos.index(p)] = max(dist) # to ignore own distance
    return univ.loc[permnos[np.argmax(dist)]]
for name in ['NVIDIA', 'APPLE COMPUTER', 'JNJ', 'EXXON MOBIL', 'AMERICAN EXPRESS']:
    p = find(name) ['permno'].iloc[-1]
    print(f" {most_similar(p)} ['comnam'] )' is most similar to '{name}'")
```

```
QUALCOMM INC' is most similar to 'NVIDIA'
MICROSOFT CORP' is most similar to 'APPLE COMPUTER'
PFIZER INC' is most similar to 'JNJ'
PIONEER NATURAL RESOURCES CO' is most similar to 'EXXON MOBIL'
U S BANCORP DEL' is most similar to 'AMERICAN EXPRESS'
```

27.2 t-SNE visualization

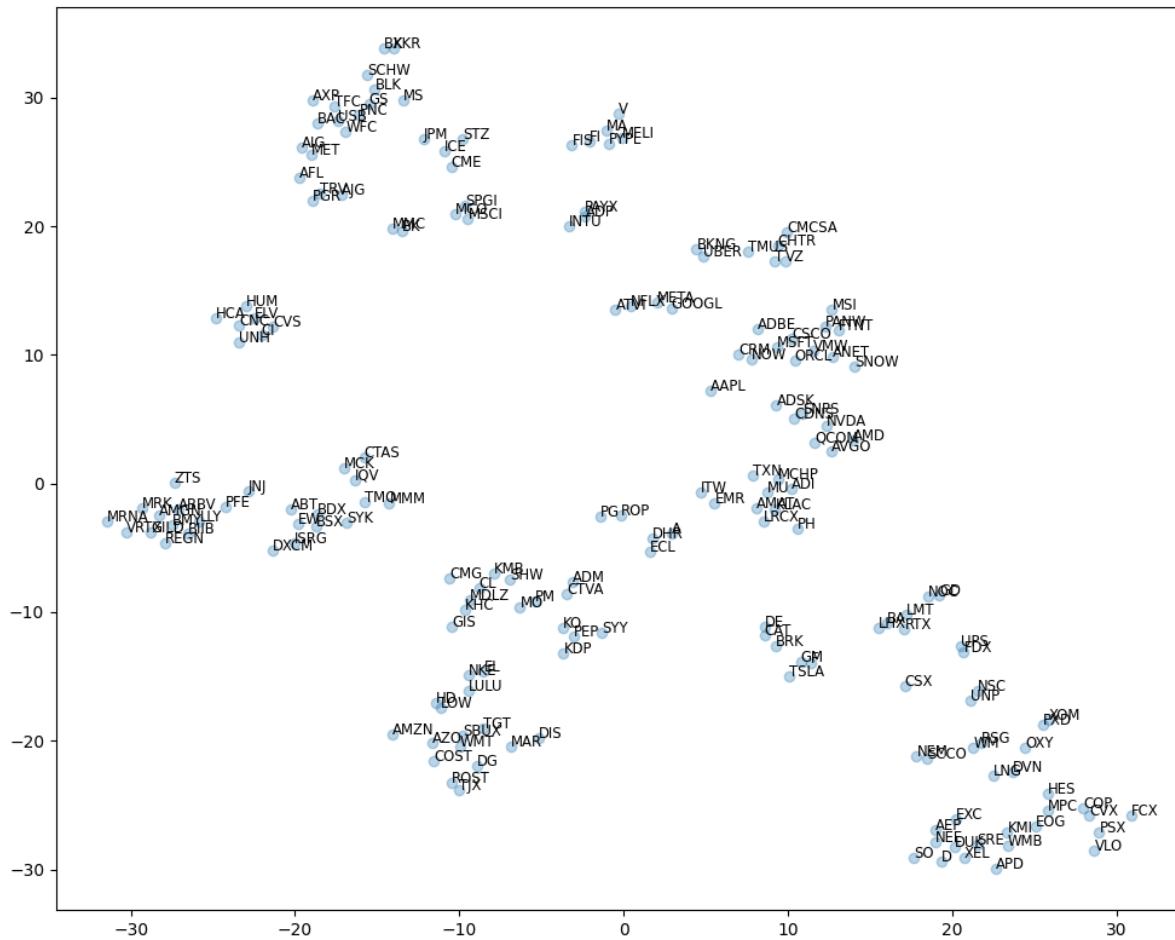
T-distributed Stochastic Neighbor Embedding (t-SNE) is a tool to visualize high-dimensional data. It converts similarities between data points to joint probabilities and tries to minimize the Kullback-Leibler divergence between the joint probabilities of the low-dimensional embedding and the high-dimensional data. It preserves the local structure of the data in 2D or 3D, ensuring that similar data points are mapped close to each other, which helps in identifying clusters that are not easily observable in higher dimensions.

- <https://scikit-learn.org/stable/modules/generated/sklearn.manifold.TSNE.html>

```
Z = TSNE(n_components=2, perplexity=10, random_state=42) \
    .fit_transform(vecs)
```

Visualize the business descriptions, reduced to 2D space with the t-SNE technique, with tickers as labels.

```
fig, ax = plt.subplots(figsize=(10, 8))
ax.scatter(Z[:, 0], Z[:, 1], color="C0", alpha=.3)
for text, x, y in zip(tickers, Z[:, 0], Z[:, 1]):
    ax.annotate(text=text, xy=(x, y), fontsize='small')
plt.tight_layout()
```



27.3 DBSCAN

DBSCAN (Density-Based Spatial Clustering of Applications with Noise) is a clustering algorithm for datasets with intricate cluster shapes and varying densities. It is also robust to noise, by identifying points in low-density areas as outliers. Unlike k-means, it doesn't require a predefined number of clusters, and requires two main parameters: epsilon (ϵ) and the minimum number of points to form a dense region.

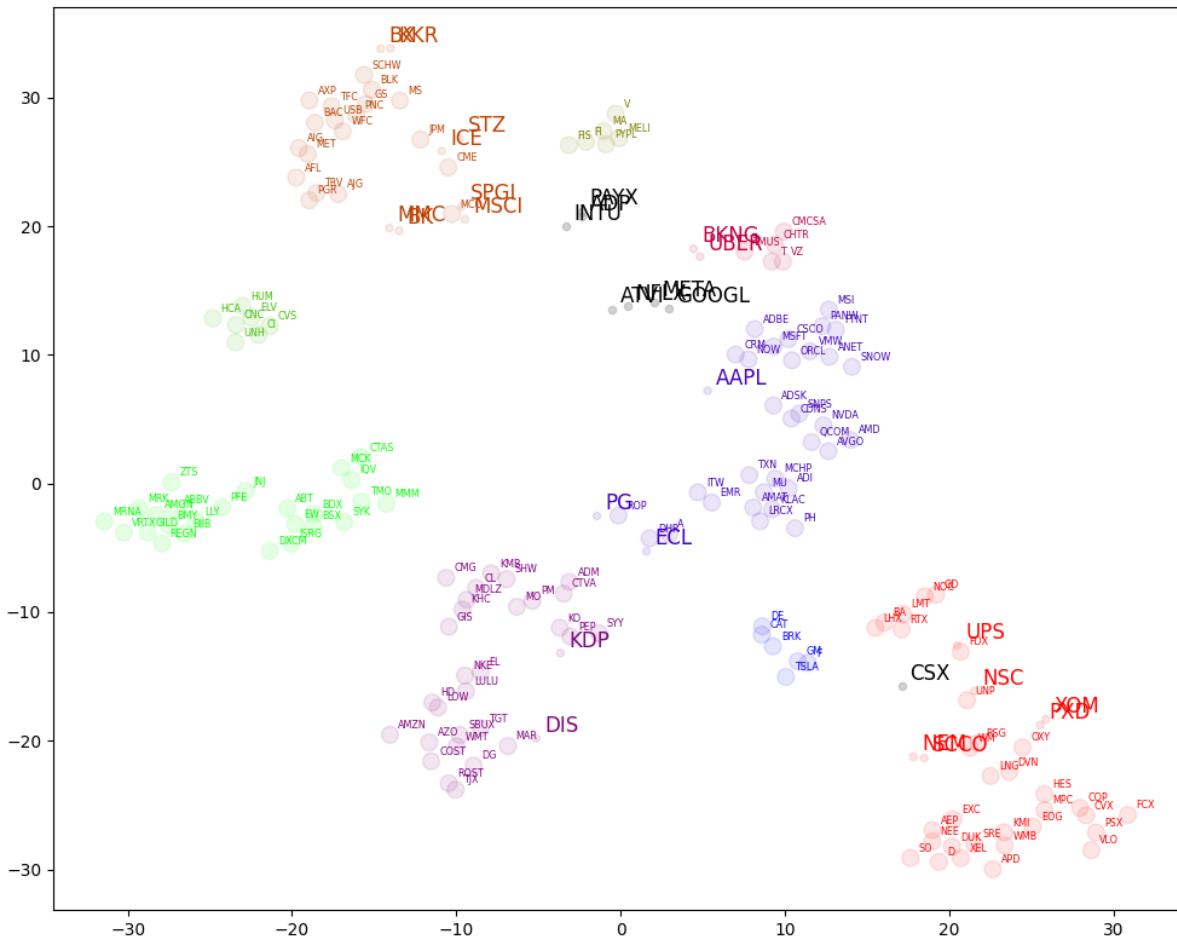
```
# eps is the most important parameter for DBSCAN
eps = 4
db = cluster.DBSCAN(eps=eps)      # default eps
db.fit(Z)
n_clusters = len(set(db.labels_).difference({-1}))
n_noise = np.sum(db.labels_ == -1)
DataFrame(dict(clusters=n_clusters, noise=n_noise, eps=eps), index=[ 'DBSCAN' ])
```

	clusters	noise	eps
DBSCAN	9	8	4

Visualize the colored clusters of business descriptions in 2-dimensional space. Ticker symbols of outliers are displayed with larger font sizes.

```
cmap = ColorMap(n_clusters)
fig, ax = plt.subplots(figsize=(10, 8))
# plot core samples with larger marker size
ax.scatter(Z[db.core_sample_indices_, 0],
            Z[db.core_sample_indices_, 1],
            c=cmap[db.labels_[db.core_sample_indices_]],
            alpha=.1, s=100, edgecolors=None)
# plot non-core samples with smaller marker size
non_core = np.ones_like(db.labels_, dtype=bool)
non_core[db.core_sample_indices_] = False
non_core[db.labels_ < 0] = False
ax.scatter(Z[non_core, 0], Z[non_core, 1], c=cmap[db.labels_[non_core]],
            alpha=.1, s=20, edgecolors=None)
# plot noise samples
ax.scatter(Z[db.labels_ < 0, 0], Z[db.labels_ < 0, 1], c="darkgrey",
            alpha=.5, s=20, edgecolors=None)

# annotate with tickers not in core samples
for i, (t, c, xy) in enumerate(zip(tickers, db.labels_, Z)):
    if i in db.core_sample_indices_:
        ax.annotate(text=t, xy=xy+.5, color=cmap[c], fontsize='xx-small')
    elif c == -1:
        ax.annotate(text=t, xy=xy+.5, color='black', fontsize='large')
    else:
        ax.annotate(text=t, xy=xy+.5, color=cmap[c], fontsize='large')
plt.tight_layout()
```



```
print("Samples tagged as noise:")
univ.loc[np.array(permnos)[db.labels_ < 0]].sort_values('naics')
```

Samples tagged as noise:

permno	cap	capco	decile	nyse	siccd	prc	naics	\
90319	5.254979e+08	1.055039e+09		1	False	7375	88.23	334419
62148	6.400468e+07	6.400468e+07		1	False	4011	30.98	482111
79678	6.003189e+07	6.003189e+07		1	False	7370	76.55	511210
78975	1.093416e+08	1.093416e+08		1	False	7370	389.22	511210
44644	9.898358e+07	9.898358e+07		1	False	7374	238.86	518210
13407	2.704040e+08	2.704040e+08		1	False	7375	120.34	519190
89393	1.313239e+08	1.313239e+08		1	False	7841	294.88	532282
61621	4.165557e+07	4.165557e+07		1	False	8700	115.56	541219
comnam ticker								
permno								
90319		ALPHABET INC			GOOGL			
62148		C S X CORP			CSX			
79678		ACTIVISION BLIZZARD INC			ATVI			
78975		INTUIT INC			INTU			

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44644	AUTOMATIC DATA PROCESSING INC	ADP
13407	META PLATFORMS INC	META
89393	NETFLIX INC	NFLX
61621	PAYCHEX INC	PAYX

CHAPTER
TWENTYEIGHT

CLASSIFICATION

When you come to a fork in the road, take it - Yogi Berra

Concepts:

- Text classification
- Classification models
- Evaluation

References:

- ISLR

```
import time
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import seaborn as sns
from wordcloud import WordCloud
from sklearn.model_selection import train_test_split
from sklearn.metrics import confusion_matrix
from sklearn.feature_extraction import text
from sklearn.linear_model import LogisticRegression, Perceptron
from sklearn.svm import LinearSVC
from sklearn.naive_bayes import MultinomialNB
from sklearn import metrics
from nltk.tag import pos_tag
from nltk.tokenize import word_tokenize
from nltk.stem import WordNetLemmatizer
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.unstructured import Edgar
from finds.structured import BusDay, CRSP, PSTAT
from finds.readers import Sectoring
from finds.utils import Store
from secret import paths, credentials
# %matplotlib qt
VERBOSE = 0
store = Store(paths['scratch'], ext='pkl')
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
```

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```
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
ed = Edgar(paths['10X'], zipped=True, verbose=VERBOSE)
```

Last FamaFrench Date 2024-03-28 00:00:00

28.1 Text classification

```
# Retrieve universe of stocks
univ = crsp.get_universe(bd.endmo(20221231))
```

```
# lookup company names
comnam = crsp.build_lookup(source='permno', target='comnam', fillna="")
univ['comnam'] = comnam(univ.index)
```

```
# lookup ticker symbols
ticker = crsp.build_lookup(source='permno', target='ticker', fillna="")
univ['ticker'] = ticker(univ.index)
```

```
# lookup sic codes from Compustat, and map to FF 10-sector code
sic = pstat.build_lookup(source='lpermno', target='sic', fillna=0)
industry = Series(sic[univ.index], index=univ.index)
industry = industry.where(industry > 0, univ['siccd'])
sectors = Sectoring(sql, scheme='codes10', fillna='') # supplement from crosswalk
univ['sector'] = sectors[industry]
```

```
# retrieve 2023 bus10K's
item, form = 'bus10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
found = rows[rows['date'].between(20230101, 20231231)] \
    .drop_duplicates(subset=['permno'], keep='last') \
    .set_index('permno')
```

28.1.1 Tagging and Lemmatizing

Lemmatize using WordNet's built-in `morphy` function.

```
# !nltk.download('averaged_perceptron_tagger')
lemmatizer = WordNetLemmatizer()
bus = {}
for permno in tqdm(found.index):
    if permno not in univ.index:
        continue
    doc = word_tokenize(ed[found.loc[permno, 'pathname']].lower())
    tags = pos_tag(doc)
    nouns = [lemmatizer.lemmatize(w[0]) for w in tags]
```

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```

if w[1] in ['NN', 'NNS'] and w[0].isalpha() and len(w[0]) > 2
if len(nouns) > 100:
    bus[permno] = nouns
store['nouns'] = bus

```

100% |██████████| 4625/4625 [12:55<00:00, 5.97it/s]

```

bus = store.load('nouns')
permnos = list(bus.keys())
labels = univ.loc[permnos, 'sector']
data = " ".join(list(nouns)) for nouns in bus.values()
classes = sorted(np.unique(labels))

```

28.1.2 Vectorizer

- TfIdf

Train/test split of corpus

```

test_size = 0.2
X_train, X_test, y_train, y_test = train_test_split(
    data, labels, test_size=test_size, random_state=42, stratify=labels)
summary = Series(y_train).value_counts().rename('n_train').to_frame()
summary['n_test'] = Series(y_test).value_counts()
summary['frac_train'] = summary['n_train'] / summary['n_train'].sum()
summary['frac_test'] = summary['n_test'] / summary['n_test'].sum()
print('Stratified Train/Test Split by Event')
summary.sort_values('n_train', ascending=False).round(2)

```

Stratified Train/Test Split by Event

sector	n_train	n_test	frac_train	frac_test
Hlth	705	176	0.25	0.25
Other	609	153	0.21	0.21
HiTec	565	141	0.20	0.20
Manuf	275	69	0.10	0.10
Shops	257	64	0.09	0.09
Durbl	131	33	0.05	0.05
NoDur	116	29	0.04	0.04
Enrgy	75	19	0.03	0.03
Utils	74	18	0.03	0.03
Telcm	40	10	0.01	0.01

```

# TfIdf vectorizer
max_df, min_df, max_features = 0.5, 10, 20000
tfidf_vectorizer = text.TfidfVectorizer(
    encoding='latin-1',
    strip_accents='unicode',
    lowercase=True,
    stop_words=stop_words,

```

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```

max_df=max_df,
min_df=min_df,
max_features=max_features,
token_pattern=r'\b[a-z_]+\b',
)
x_train = tfidf_vectorizer.fit_transform(X_train)      # sparse array
x_test = tfidf_vectorizer.transform(X_test)
feature_names = tfidf_vectorizer.get_feature_names_out()
print("n_sample x n_features")
DataFrame([[x_train.shape, x_test.shape]],
           index=['data shape:'],
           columns=['train', 'test'])

```

n_sample x n_features

	train	test
data shape:	(2847, 10181)	(712, 10181)

28.2 Classification models

- `class_weight`: The “balanced” mode uses the values of `y` to automatically adjust weights inversely proportional to class frequencies in the input data as `n_samples / (n_classes * np.bincount(y))`.

```

results = dict()
# results = store['classification']

def update_results(name, clf, elapsed):
    """helper to update results dict with train and test accuracy"""
    tic = time.time()
    test_score = clf.score(x_test, y_test)
    toc = time.time() - tic
    results[name] = dict(model=clf,
                          train_score=clf.score(x_train, y_train),
                          test_score=test_score,
                          test_time=toc,
                          train_time=elapsed)
    store['classification'] = results
    print('Accuracy')
    return DataFrame.from_dict(results, orient='index').iloc[:, 1:]

```

28.2.1 Naive Bayes

Generative model

For classification, there are generally two types of approaches:

- Generative: Estimate probability model, then define the classifier – e.g. Naive-Bayes
- Discriminative: Directly define the classifier – e.g. Logistic regression, Perceptron, Support vector machine

Binomial Naive Baye

Naive Bayes is a very simple classifier, yet it still takes all the feature evidence into account. It is very efficient in terms of storage space and computation time. Training consists only of storing counts of classes and feature occurrences as each example is seen. It performs surprisingly well for classification on many real-world tasks, because the violation of the independence assumption tends not to hurt classification performance.

However, the violation of the independence assumption makes probability estimates more extreme: the probability will be overestimated for the correct class and underestimated for the incorrect class(es). This does become a problem if we're going to be using the probability estimates themselves – so Naive Bayes should be used with caution for actual decision-making with costs and benefits.

Bag of words assumes position doesn't matter, hence the features only encode word identity and not position. Naive Bayes assumption is the conditional independence assumption that the probabilities $P(f_i|c)$ of each feature f_i are independent given the class c and hence can be 'naively' multiplied as follows: $P(f_1, f_2, \dots, f_n|c) = P(f_1|c) \cdot P(f_2|c) \cdot \dots \cdot P(f_n|c)$

Since naive Bayes naively multiplies all the feature likelihoods together, zero probabilities in the likelihood term for any class will cause the probability of the class to be zero, no matter the other evidence. The simplest solution is the add-one (Laplace) smoothing.

Let N_c be the number of documents in our training data with class c and N_{doc} be the total number of documents. Then: $P(c) = N_c/N_{doc}$ $\hat{c} = \operatorname{argmax}_{c \in C} \log P(c) \sum_{i \in n} \log P(w_i|c)$, where the maximum likelihood estimate of the probability of frequency of word w_i is $P(w_i|c) = \frac{\operatorname{count}(w_i, c)}{\sum_{w \in V} \operatorname{count}(w, c)}$

Multinomial Naive Bayes

Laplace smoothing

```
clf = MultinomialNB(alpha=1.0)
tic = time.time()
clf.fit(x_train, y_train)
toc = time.time() - tic
update_results('naivebayes', clf, toc)
```

Accuracy

	train_score	test_score	test_time	train_time
naivebayes	0.760801	0.713483	0.003135	0.016976

28.2.2 Perceptron

- 0-1 loss
- Elasticnet penalty
- OVR

The perceptron update is:

- $\hat{y} \leftarrow \text{sign}(wx)$
 - $w \leftarrow w + \alpha x$ if $y = +1$ and $y \neq \hat{y}$
 - $w \leftarrow w - \alpha x$ if $y = -1$ and $y \neq \hat{y}$
- $\Rightarrow w \leftarrow w + \alpha x (y - \hat{y})/2$ where $y \in \{-1, +1\}$ #

```
clf = Perceptron(penalty='elasticnet',
                  #n_jobs=4, # -1
                  random_state=0,
                  verbose=VERBOSE)
tic = time.time()
clf.fit(x_train, y_train)
toc = time.time() - tic
update_results('perceptron', clf, toc)
```

Accuracy

	train_score	test_score	test_time	train_time
naivebayes	0.760801	0.713483	0.003135	0.016976
perceptron	0.949069	0.754213	0.003511	0.572992

28.2.3 Support Vector Machine

Margin

- Hinge loss

Kernel

- Linear SVC
- OVR

```
clf = LinearSVC(multi_class='ovr',
                  penalty='l2',
                  verbose=VERBOSE)
tic = time.time()
clf.fit(x_train, y_train)
toc = time.time() - tic
update_results('linearsvc', clf, toc)
```

```
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/svm/_classes.py:31:_
  FutureWarning: The default value of `dual` will change from `True` to ``auto``_
  in 1.5. Set the value of `dual` explicitly to suppress the warning.
  warnings.warn(
```

Accuracy

	train_score	test_score	test_time	train_time
naivebayes	0.760801	0.713483	0.003135	0.016976
perceptron	0.949069	0.754213	0.003511	0.572992
linearsvc	0.987706	0.820225	0.005223	0.373052

28.2.4 Logistic Regression

Cross-entropy loss

- logistic loss and binomial
- Softmax
- Multinomial

The logistic regression update is:

- $P(y = 1|x) \leftarrow 1/(1 + e^{-wx})$
 - $w \leftarrow w + \alpha x (1 - P(y = 1|x))$ if $y = 1$
 - $w \leftarrow w - \alpha x (1 - P(y = 0|x))$ if $y = 0$
- $\Rightarrow w \leftarrow w + \alpha x (y - P(y = 1|x))$ where $y \in \{0, 1\}$

```
clf = LogisticRegression(verbose=VERBOSE,
                         penalty='l2',
                         multi_class='multinomial',
                         # n_jobs=-1,           # when multi_class='ovr'
                         max_iter=1000)

tic = time.time()
clf.fit(x_train, y_train)
toc = time.time() - tic
update_results('logistic', clf, toc)
```

Accuracy

	train_score	test_score	test_time	train_time
naivebayes	0.760801	0.713483	0.003135	0.016976
perceptron	0.949069	0.754213	0.003511	0.572992
linearsvc	0.987706	0.820225	0.005223	0.373052
logistic	0.897085	0.807584	0.004926	2.042012

28.3 Evaluation

Imbalanced data set

Precision

Recall

F1 score

The F1 score = $2(precision \times recall)/(precision + recall)$ can be interpreted as a harmonic mean of the precision and recall. In the multi-class and multi-label case, this is the weighted average of the F1 score of each class.

28.3.1 Precision, Recall and F1-score

```
# Plot precision, recall, f1

res = DataFrame.from_dict(results, orient='index')
models = {k: v['model'] for k, v in results.items()}

scores, cf_test, cf_train = {}, {}, {}
for ifig, (name, clf) in enumerate(models.items()):
    train_pred = clf.predict(x_train)
    test_pred = clf.predict(x_test)
    scores[name] = {
        'train': metrics.precision_recall_fscore_support(
            y_train, train_pred, average='macro')[3],
        'test': metrics.precision_recall_fscore_support(
            y_test, test_pred, average='macro')[3]
    }
    cf = DataFrame(confusion_matrix(y_train, train_pred, labels=classes),
                   index=pd.MultiIndex.from_product([['Actual'], classes]),
                   columns=pd.MultiIndex.from_product([['Predicted'], classes]))
    cf_train[name] = cf
    cf = DataFrame(confusion_matrix(y_test, test_pred, labels=classes),
                   index=pd.MultiIndex.from_product([['Actual'], classes]),
                   columns=pd.MultiIndex.from_product([['Predicted'], classes]))
    cf_test[name] = cf
```

```
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
  py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0
  in labels with no predicted samples. Use 'zero_division' parameter to control
  this behavior.
  _warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
  py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0
  in labels with no predicted samples. Use 'zero_division' parameter to control
  this behavior.
  _warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
```

```
caption="Model Accuracy"
DataFrame({(metric, sample): [score[sample][i] for score in scores.values()]
           for i, metric in enumerate(['Precision', 'Recall', 'F1-score'])
           for sample in ['train', 'test']},
           index=scores.keys())
```

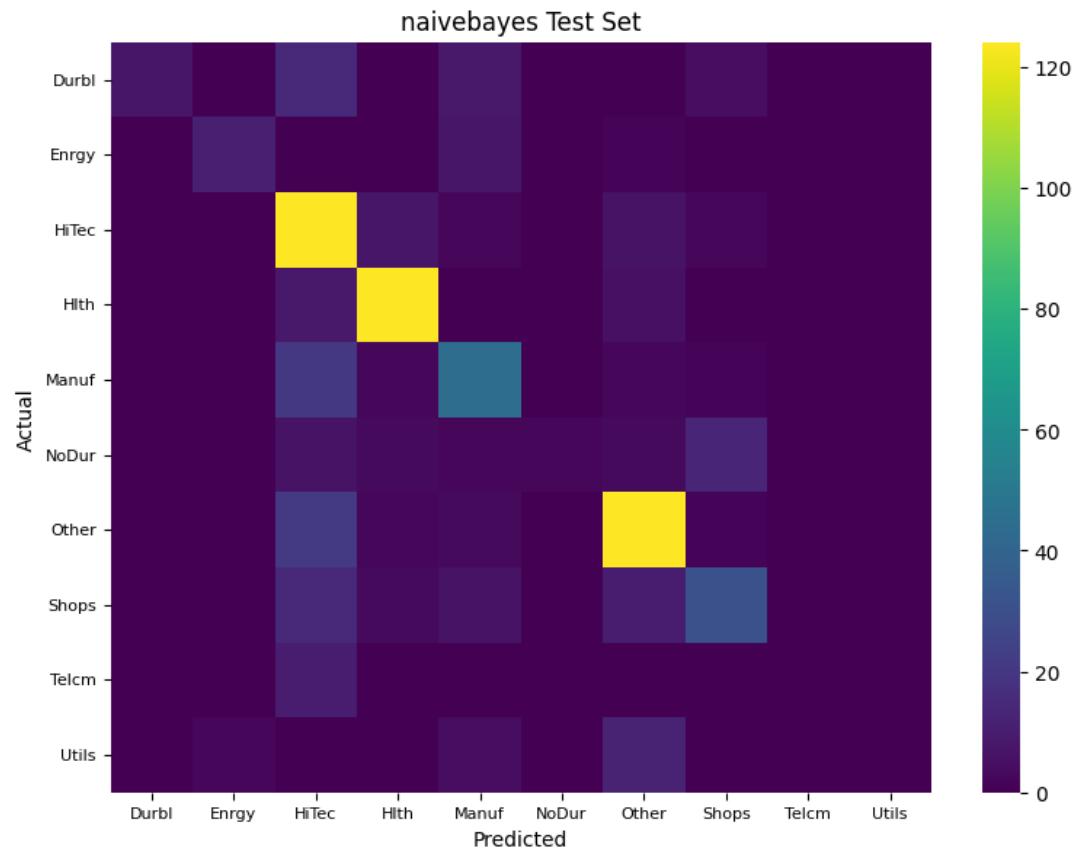
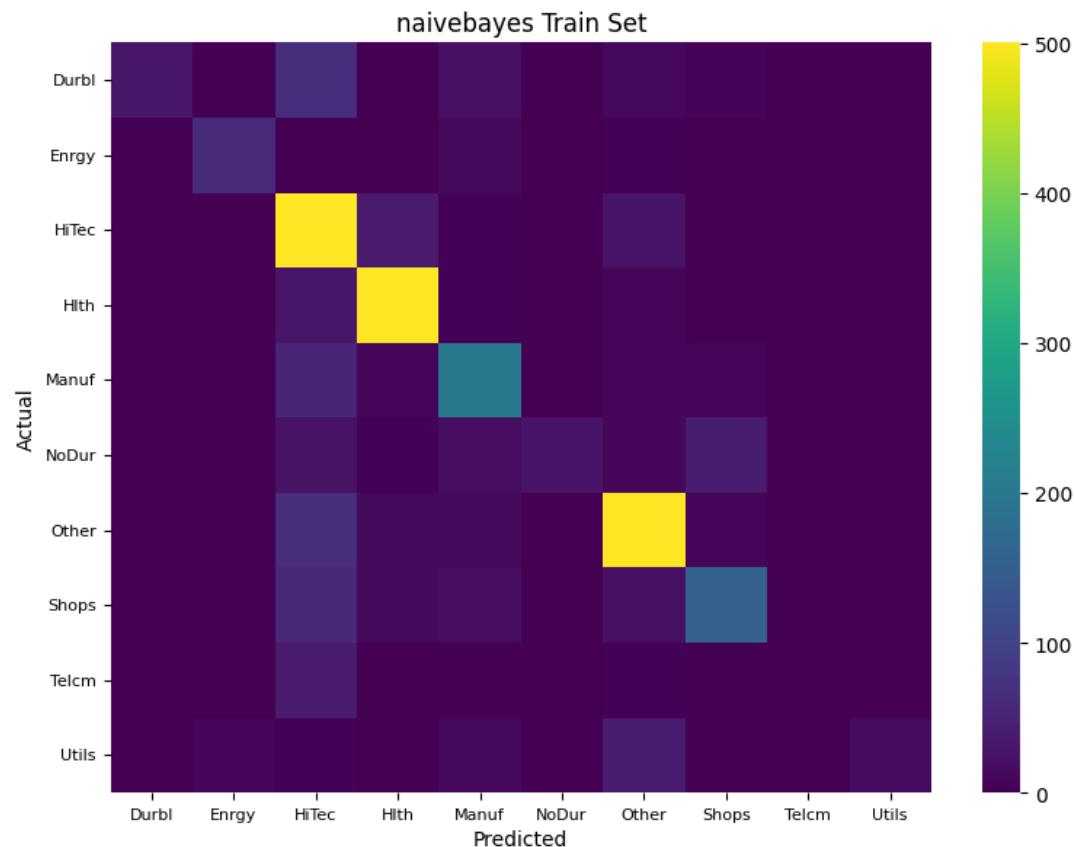
	Precision		Recall		F1-score	
	train	test	train	test	train	test
naivebayes	0.755631	0.626188	0.542914	0.461119	0.571358	0.470883
perceptron	0.948395	0.715983	0.926773	0.705942	0.936185	0.707481
linearsvc	0.983966	0.817232	0.987891	0.809486	0.985768	0.810462
logistic	0.893775	0.824410	0.849069	0.755437	0.868002	0.780065

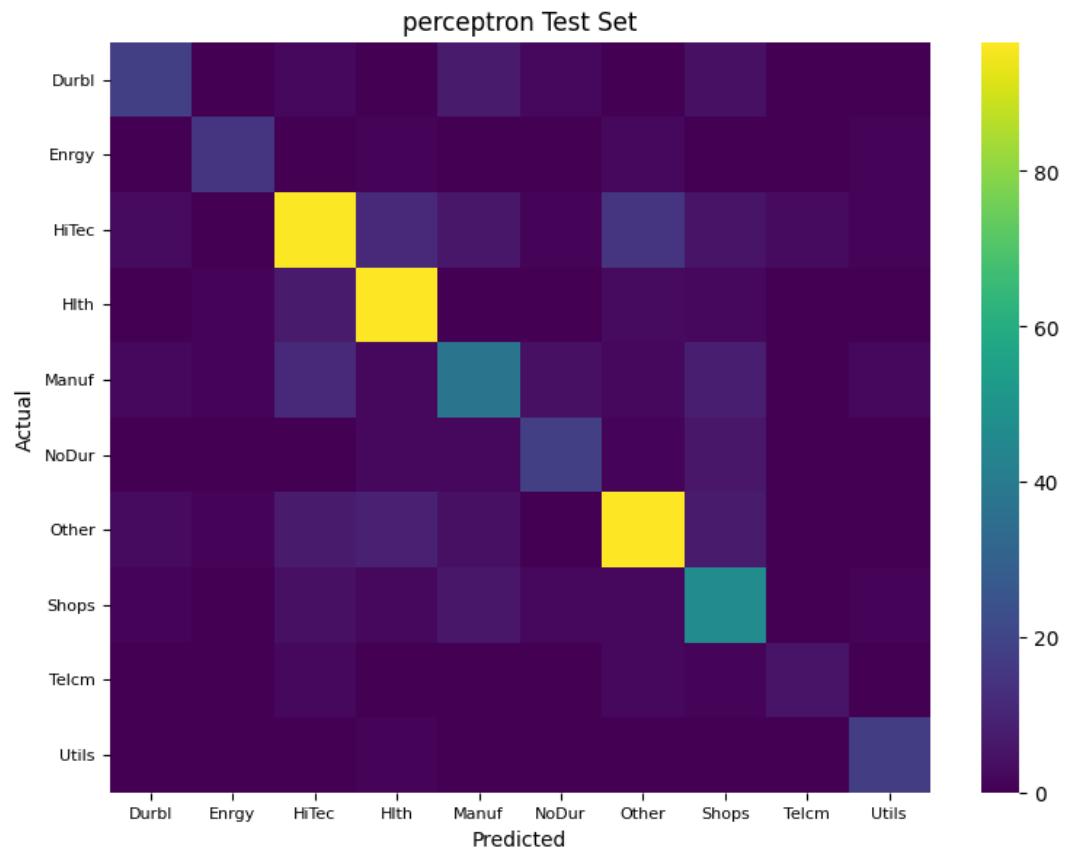
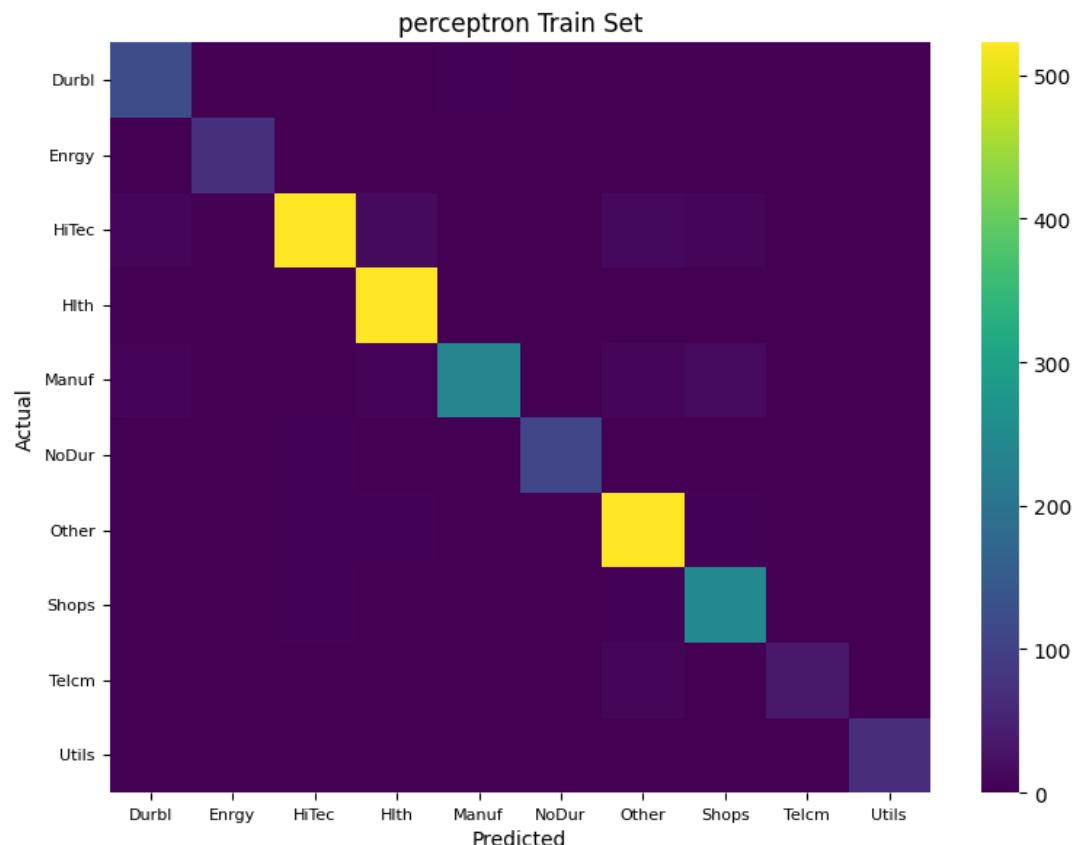
28.3.2 Confusion Matrix

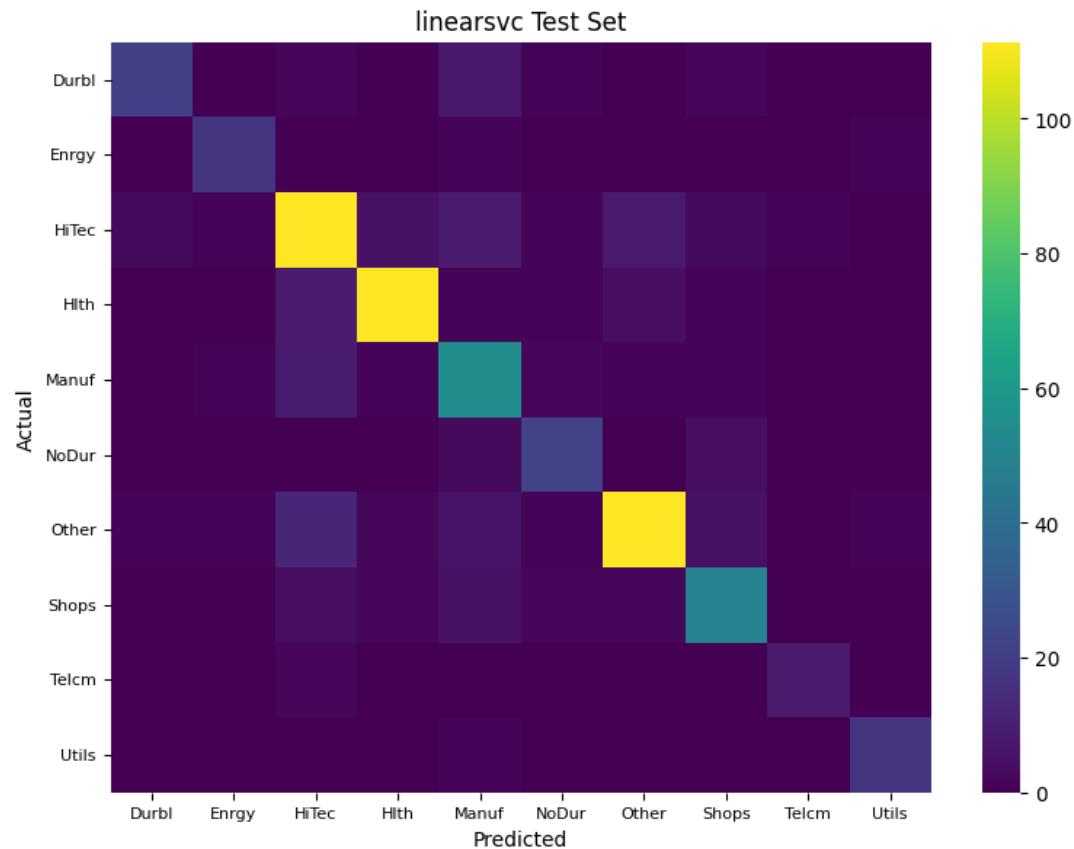
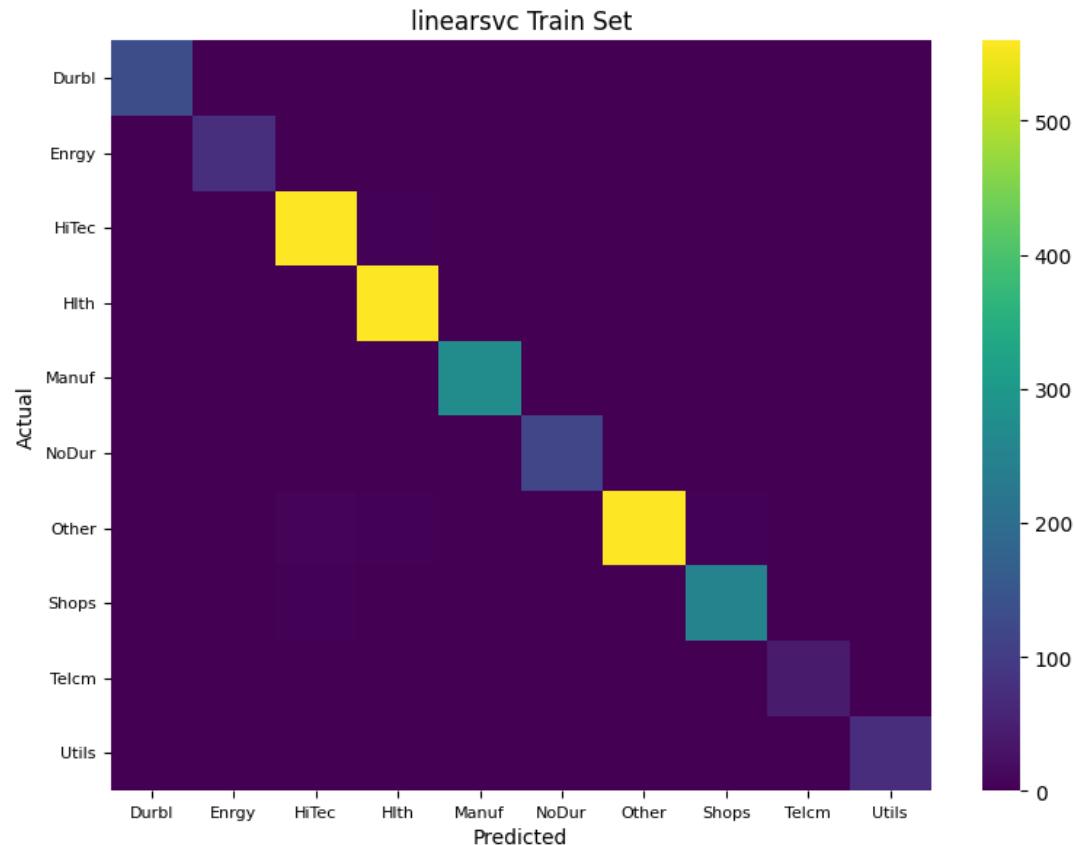
```

for name, model in models.items():
    fig, axes = plt.subplots(nrows=2, figsize=(8, 12))
    for label, cf, ax in [('Train Set', cf_train[name], axes[0]),
                          ('Test Set', cf_test[name], axes[1])]:
        sns.heatmap(cf, ax=ax, annot=False, fmt='d', cmap='viridis', robust=True,
                    yticklabels=model.classes_,
                    xticklabels=model.classes_)
        ax.set_title(f'{name} {label}')
        ax.set_xlabel('Predicted')
        ax.set_ylabel('Actual')
        ax.yaxis.set_tick_params(labelsize=8, rotation=0)
        ax.xaxis.set_tick_params(labelsize=8, rotation=0)
    #plt.subplots_adjust(left=0.35, bottom=0.25)
    plt.tight_layout()
plt.close()

```







28.3.3 Feature Importance

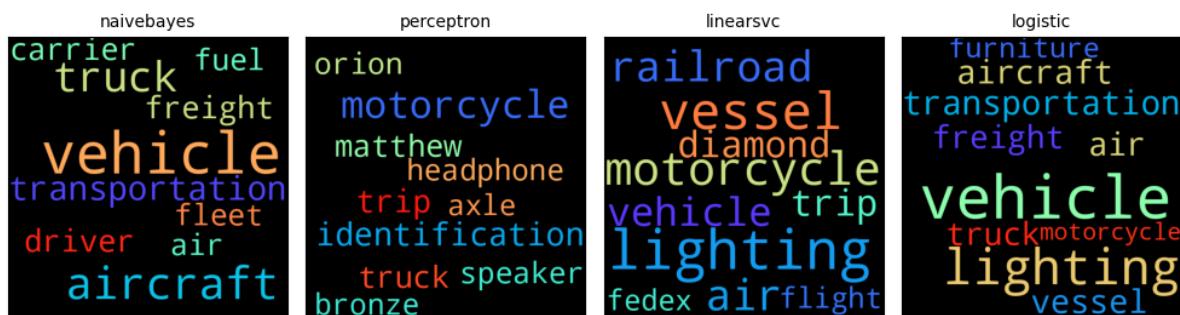
- Plot by event in each row, then by model in column
- exponentiate NAIVE BAYES to probabilities (generative)

WordCloud

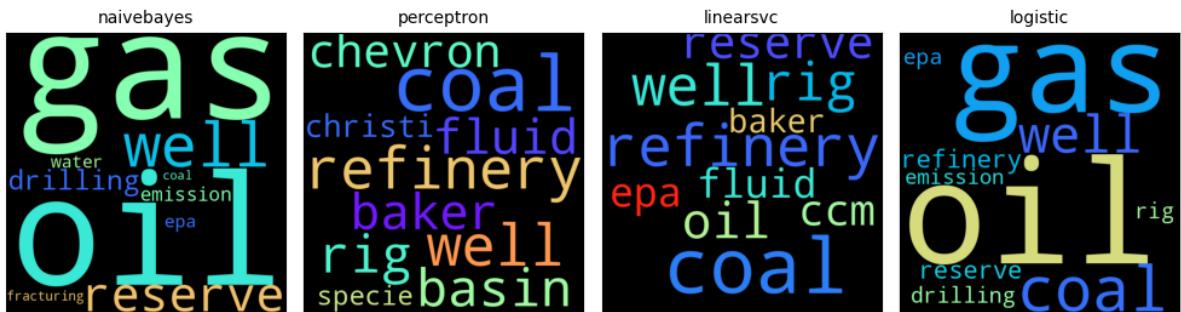
```
wc = WordCloud(height=500, width=500, prefer_horizontal=1.0, colormap='rainbow')

top_n = 10
for topic in classes:    # loop over classes
    fig, axes = plt.subplots(ncols=len(models), nrows=1, figsize=(10, 4))
    fig.suptitle(topic)
    for imodel, (ax, name, clf) in enumerate(zip(
        axes, models.keys(), models.values())):
        assert hasattr(clf, 'coef_') or hasattr(clf, 'feature_log_prob_')
        k = clf.classes_.tolist().index(topic)
        #print("Event %d %s: % (topic, events_[clf.classes_[topic]]))")
        if hasattr(clf, 'coef_'):
            importance = clf.coef_[k, :]
        else:
            importance = np.exp(clf.feature_log_prob_[k, :])
        words = {feature_names[i]: importance[i]
                 for i in importance.argsort()[-top_n:]}
        ax.imshow(wc.generate_from_frequencies(words))
        #Series(words).plot(kind='barh', color=f"C{imodel}", ax=ax)
        #ax.yaxis.set_tick_params(labelsize=7)
        ax.axes.xaxis.set_visible(False)    # make axes ticks invisible
        ax.xaxis.set_ticks([])
        ax.xaxis.set_ticklabels([])
        ax.set_title(name, fontdict={'fontsize':10})
    fig.tight_layout()
plt.close()
```

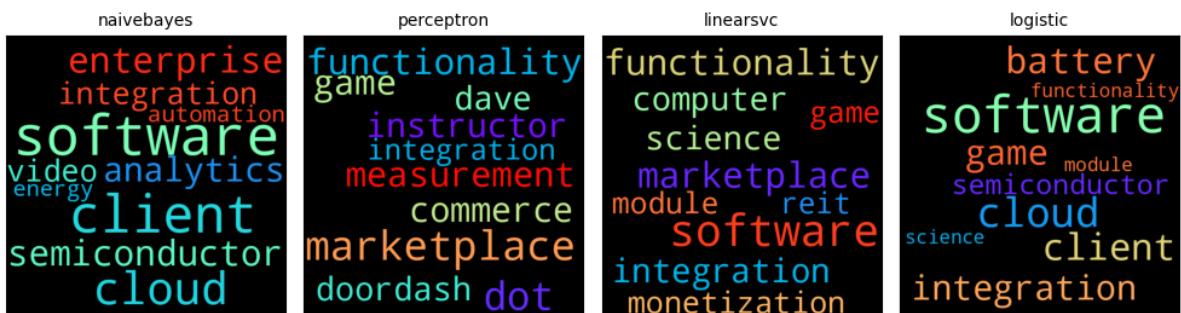
Durbl



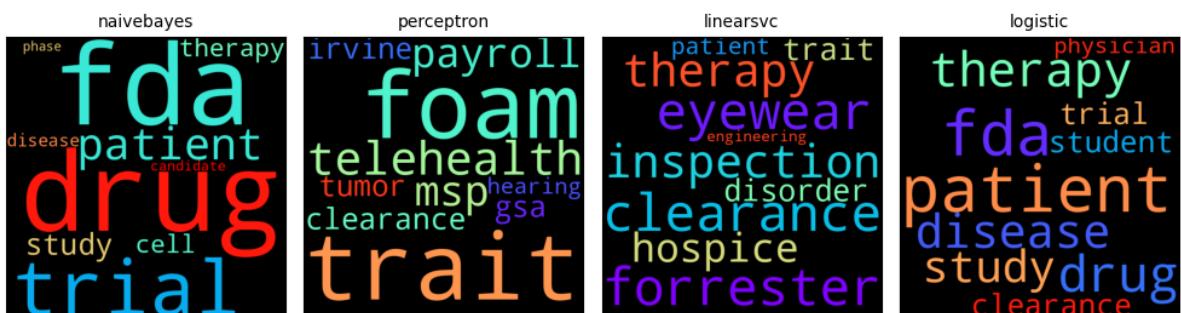
Enrgy



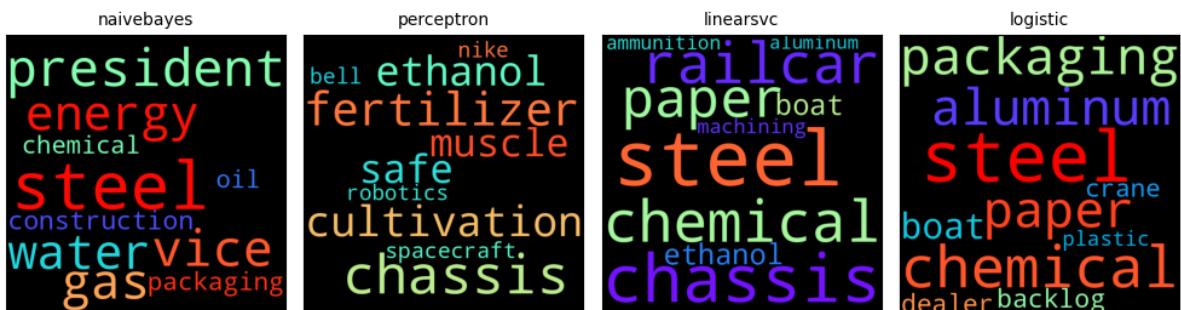
HiTec



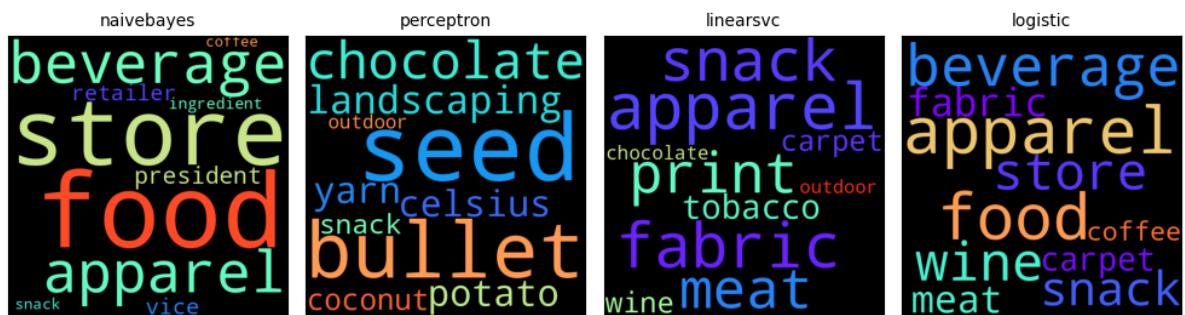
Hlth



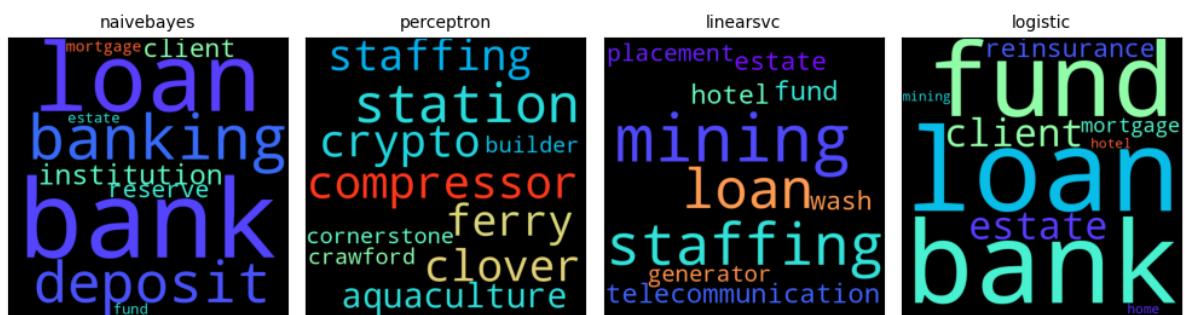
Manuf



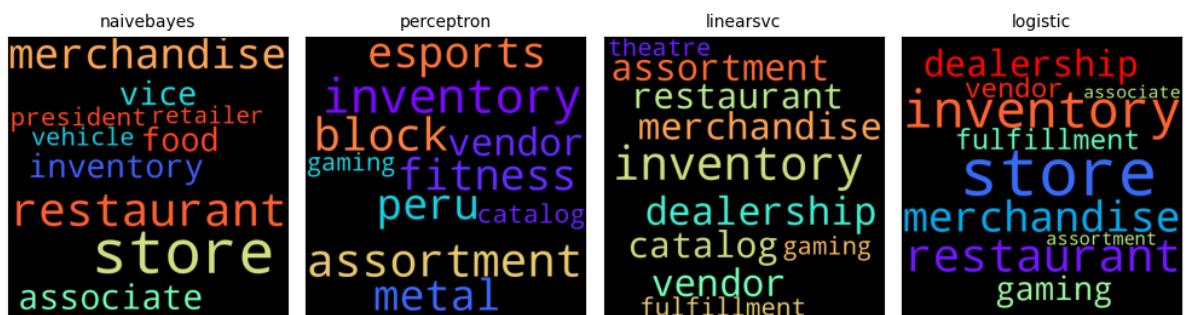
NoDur



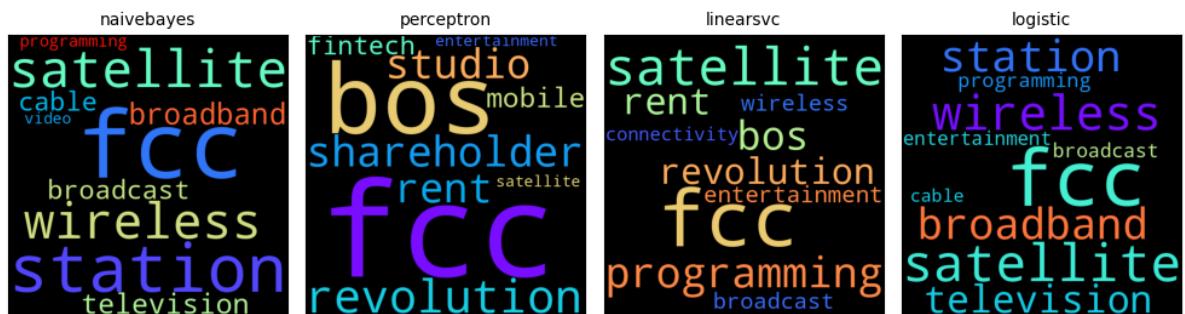
Other



Shops



Telcm



CHAPTER
TWENTYNINE

REGRESSION

Concepts:

- Regression Models
- Hyperparameter Tuning
- Information Criterion

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from pandas.api.types import is_list_like, is_numeric_dtype
import statsmodels.api as sm
from sklearn.metrics import mean_squared_error
import time
from finds.readers.alfred import Alfred, fred_qd, fred_md
from finds.utils import plot_date
from secret import credentials, paths
# %matplotlib qt
VERBOSE = 0
```

```
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=-1)
```

```
# Get FRED-MD data
freq = 'M'
beg = 19640701 # 19620701
split_date = 20221231
df, t = fred_md() # transforms = t['transform']
end = df.index[-2]
```

FRED-MD vintage: monthly/current.csv

```
# Splice in common updates: source of PE ratio, Commercial Paper
for col in ['S&P PE ratio']:
    df[col] = alf.splice(col)
df['COMPAPFF'] = df['COMPAPFF'].ffill() # forward fill 20200430
df['CP3M'] = df['CP3M'].ffill() # forward fill 20200430
```

```
# Apply transformations
transformed = []
for col in df.columns:
    transformed.append(alf.transform(df[col], tcode=transforms[col], freq=freq))
data = pd.concat(transformed, axis=1).iloc[2:]
c = list(data.columns)
data = data.loc[(data.index >= beg) & (data.index <= end)]
```

```
# Drop columns with missing data
missing = []
for series_id in df.columns:
    g = data[series_id].notna()
    missing.extend([(date, series_id) for date in data.index[~g]])
missing_per_row = data.isna().sum(axis=1)
missing = DataFrame.from_records(missing, columns=['date', 'series_id'])
print('original:', data.shape, 'dropna:', data.dropna(axis=1).shape)
data = data.dropna(axis=1) # drop columns where missing values
print(missing['series_id'].value_counts())
data
```

```
original: (716, 126) dropna: (716, 122)
series_id
ACOGNO      332
UMCSENT     163
TWEXAFEGSMTH 103
ANDENO      44
Name: count, dtype: int64
```

	RPI	W875RX1	DPCERA3M086SBEA	CMRMTSPL	RETAIL	INDPRO	\
19640731	0.005422	0.005404	0.007343	0.019986	0.004947	0.006551	
19640831	0.005644	0.006061	0.005992	-0.020139	0.013974	0.006508	
19640930	0.004123	0.004205	-0.004164	0.027173	0.009372	0.003699	
19641031	0.000555	0.000650	0.006499	-0.013866	-0.039421	-0.013947	
19641130	0.006703	0.007352	-0.009111	-0.009745	0.009335	0.030432	
...	\
20231031	0.002011	0.002671	0.001534	-0.001822	-0.001868	-0.007083	
20231130	0.003920	0.004822	0.004145	0.006184	0.001042	0.003600	
20231231	0.002056	0.002097	0.004578	0.006499	0.003631	-0.003146	
20240131	0.006063	0.002633	-0.003154	-0.013142	-0.010902	-0.007865	
20240229	-0.000623	-0.001369	0.004809	0.004932	0.010128	0.004399	
	IPFPNSS	IPFINAL	IPCONGD	IPDCONGD	...	DDURRG3M086SBEA	\
19640731	0.010344	0.011309	0.014078	0.016436	...	0.000667	
19640831	-0.000936	-0.000939	-0.001865	0.007223	...	-0.002031	
19640930	-0.004690	-0.003758	-0.011266	-0.023659	...	0.000728	
19641031	-0.010403	-0.013272	-0.020031	-0.109873	...	-0.001712	
19641130	0.029040	0.031929	0.036883	0.128118	...	0.004137	
...	\
20231031	-0.003736	-0.005295	-0.006291	-0.043572	...	-0.001469	
20231130	0.004855	0.008046	0.007774	0.040181	...	-0.002269	
20231231	-0.004377	-0.004537	-0.005309	0.009311	...	0.000147	
20240131	-0.004417	-0.003318	-0.000861	-0.024891	...	0.006598	
20240229	0.001838	-0.001725	-0.008632	0.019836	...	-0.000164	
	DNDGRG3M086SBEA	DSERRG3M086SBEA	CES0600000008	CES2000000008	...		\

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19640731	-0.000369	-0.000090	-0.000016	0.003231	
19640831	-0.002398	0.001406	-0.000016	-0.003263	
19640930	0.003749	-0.001674	-0.000015	-0.006462	
19641031	-0.002344	0.000525	-0.011757	0.016093	
19641130	0.000985	-0.000352	0.011772	-0.019272	
...	
20231031	-0.006139	-0.002998	-0.002355	0.001729	
20231130	-0.003030	0.000679	0.007291	0.004863	
20231231	0.004876	0.000458	-0.004356	-0.007758	
20240131	-0.002566	0.004037	-0.000355	0.008535	
20240229	0.010236	-0.004448	-0.001327	-0.010808	
CES30000000008 DTCOLNVHFN M DTCTHFN M INVEST VIXCLS					
19640731	-0.004158	-0.003798	-0.002430	-0.002831	11.2238
19640831	0.004141	-0.005958	-0.001818	0.011673	13.6898
19640930	0.004090	-0.011142	-0.003802	0.010582	10.5167
19641031	-0.024760	0.005974	-0.000704	-0.003579	11.0924
19641130	0.024828	-0.009946	-0.002806	-0.002694	12.0087
...
20231031	-0.004147	0.000003	-0.000566	-0.004573	19.0462
20231130	0.007839	-0.000492	0.000069	0.008778	13.8563
20231231	-0.000080	0.000385	0.000526	0.018190	12.6960
20240131	-0.005941	-0.002851	-0.000590	-0.009783	13.3453
20240229	0.002553	-0.000785	-0.001406	-0.005802	13.8808

[716 rows x 122 columns]

Data after the split date (December 2022) are held out for testing, and are excluded from the training data set

```
# Split time series train and test set
def ts_split(X, Y, end=split_date):
    """helper to split train/test time series"""
    return X[Y.index<=end], X[Y.index>end], Y[Y.index<=end], Y[Y.index>end]
```

```
def columns_map(columns, lag):
    """helper to create lagged column names"""
    return {col: col + '_' + str(lag) for col in columns}
```

```
def columns_unmap(columns):
    """helper to extract lagged column names"""
    cols = [col.split('_') for col in columns]
    return [col[0] for col in cols], [int(col[1]) for col in cols]
```

```
target_id = 'INDPRO'
lags = 3 # Include up to 3 lags of exogs
Y = data[target_id].iloc[lags:]
X = pd.concat([data.shift(lag).iloc[lags:] \
    .rename(columns=columns_map(data.columns, lag)) \
    for lag in range(1, lags+1)], \
    axis=1)
```

```
# collect final fitted models
```

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```
test = Series(name='test', dtype=float)      # collect test and train errors
train = Series(name='train', dtype=float)
final_models = {}
```

29.1 Regression models

29.1.1 Forward Selection

AIC

BIC

```
def forward_select(Y, X, selected, ic='aic'):
    """helper to forward select next regressor, using sm.OLS"""
    remaining = [x for x in X.columns if x not in selected]
    results = []
    for x in remaining:
        r = sm.OLS(Y, X[selected + [x]]).fit()
        results.append({'select': x,
                        'aic': r.aic,
                        'bic': r.bic,
                        'rsquared': r.rsquared,
                        'rsquared_adj': r.rsquared_adj})
    return DataFrame(results).sort_values(by=ic).iloc[0].to_dict()
```

```
# find best bic, and show selection criteria scores
ic = 'bic'    # select by information criterion
X_train, X_test, Y_train, Y_test = ts_split(X, Y)
selected = []
models = {}
for i in range(1, 32):
    select = forward_select(Y_train,
                            X_train,
                            selected,
                            ic=ic)
    models[i] = select
    selected.append(select['select'])
selected = DataFrame.from_dict(models, orient='index')
best = selected[[ic]].iloc[selected[ic].argmin()]
subset = selected.loc[:best.name].round(3)
subset.index = [alf.header(s.split('_')[0]) for s in subset['select']]
print('Forward Selection Subset')
subset
```

Forward Selection Subset

Initial Claims
Real M2 Money Stock
All Employees, Wholesale Trade
All Employees, Service-Providing

select	aic	\
CLAIMS_1	-4768.644	
M2REAL_2	-4810.935	
USWTRADE_2	-4840.491	
SRVPRD_2	-4861.002	

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5-Year Treasury Constant Maturity Minus Federal...	T5YFFM_3	-4877.677
Total Business: Inventories to Sales Ratio	ISRATIO_2	-4891.445
All Employees, Service-Providing	SRVPRD_1	-4908.643
All Employees, Wholesale Trade	USWTRADE_1	-4924.049
All Employees, Financial Activities	USFIRE_2	-4935.217
All Employees, Retail Trade	USTRADE_1	-4947.335
Industrial Production: Non-Durable Consumer Ene...	IPB51222S_3	-4954.897
Industrial Production: Non-Durable Goods Materials	IPNMAT_3	-4966.446
Canadian Dollars to U.S. Dollar Spot Exchange Rate	EXCAUS_3	-4976.370
M1	M1SL_3	-4986.332
Consumer Motor Vehicle Loans Owned by Finance C...	DTCOLNVHFN_M_3	-4996.521
Nonrevolving consumer credit to Personal Income	CONSPI_2	-5003.756
Moody's Seasoned Aaa Corporate Bond Yield	AAA_1	-5009.808
Moody's Seasoned Baa Corporate Bond Yield	BAA_1	-5017.239
All Employees, Mining, Quarrying, and Oil and G...	CES1021000001_3	-5022.081
Manufacturers' Unfilled Orders: Durable Goods	AMDMUO_2	-5028.370
Capacity Utilization: Manufacturing (SIC)	CUMFNS_1	-5033.466
Industrial Production: Manufacturing (SIC)	IPMANSICS_1	-5058.855
All Employees, Nondurable Goods	NDMANEMP_1	-5073.971
Industrial Production: Materials	IPMAT_2	-5081.590
Industrial Production: Equipment: Business Equi...	IPBUSEQ_2	-5088.804
Average Hourly Earnings of Production and Nonsu...	CES2000000008_1	-5094.599
Average Weekly Overtime Hours of Production and...	AWOTMAN_2	-5101.126
All Employees, Mining, Quarrying, and Oil and G...	CES1021000001_1	-5106.815
Industrial Production: Consumer Goods	IPCONGD_2	-5111.903
Real Estate Loans, All Commercial Banks	REALLN_1	-5116.565
bic rsquared \		
Initial Claims	-4764.094	0.357
Real M2 Money Stock	-4801.836	0.396
All Employees, Wholesale Trade	-4826.842	0.423
All Employees, Service-Providing	-4842.803	0.441
5-Year Treasury Constant Maturity Minus Federal...	-4854.929	0.456
Total Business: Inventories to Sales Ratio	-4864.147	0.468
All Employees, Service-Providing	-4876.795	0.482
All Employees, Wholesale Trade	-4887.652	0.495
All Employees, Financial Activities	-4894.270	0.504
All Employees, Retail Trade	-4901.839	0.514
Industrial Production: Non-Durable Consumer Ene...	-4904.851	0.521
Industrial Production: Non-Durable Goods Materials	-4911.850	0.530
Canadian Dollars to U.S. Dollar Spot Exchange Rate	-4917.225	0.538
M1	-4922.637	0.546
Consumer Motor Vehicle Loans Owned by Finance C...	-4928.276	0.554
Nonrevolving consumer credit to Personal Income	-4930.961	0.560
Moody's Seasoned Aaa Corporate Bond Yield	-4932.464	0.565
Moody's Seasoned Baa Corporate Bond Yield	-4935.345	0.571
All Employees, Mining, Quarrying, and Oil and G...	-4935.637	0.575
Manufacturers' Unfilled Orders: Durable Goods	-4937.377	0.580
Capacity Utilization: Manufacturing (SIC)	-4937.923	0.584
Industrial Production: Manufacturing (SIC)	-4958.763	0.600
All Employees, Nondurable Goods	-4969.329	0.610
Industrial Production: Materials	-4972.398	0.615
Industrial Production: Equipment: Business Equi...	-4975.063	0.620
Average Hourly Earnings of Production and Nonsu...	-4976.308	0.624
Average Weekly Overtime Hours of Production and...	-4978.286	0.629
All Employees, Mining, Quarrying, and Oil and G...	-4979.425	0.633

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Industrial Production: Consumer Goods	-4979.963	0.637
Real Estate Loans, All Commercial Banks	-4980.075	0.640
	rsquared_adj	
Initial Claims	0.356	
Real M2 Money Stock	0.394	
All Employees, Wholesale Trade	0.420	
All Employees, Service-Providing	0.438	
5-Year Treasury Constant Maturity Minus Federal...	0.452	
Total Business: Inventories to Sales Ratio	0.463	
All Employees, Service-Providing	0.477	
All Employees, Wholesale Trade	0.489	
All Employees, Financial Activities	0.498	
All Employees, Retail Trade	0.507	
Industrial Production: Non-Durable Consumer Ene...	0.513	
Industrial Production: Non-Durable Goods Materials	0.522	
Canadian Dollars to U.S. Dollar Spot Exchange Rate	0.529	
M1	0.537	
Consumer Motor Vehicle Loans Owned by Finance C...	0.544	
Nonrevolving consumer credit to Personal Income	0.549	
Moody's Seasoned Aaa Corporate Bond Yield	0.554	
Moody's Seasoned Baa Corporate Bond Yield	0.559	
All Employees, Mining, Quarrying, and Oil and G...	0.563	
Manufacturers' Unfilled Orders: Durable Goods	0.567	
Capacity Utilization: Manufacturing (SIC)	0.571	
Industrial Production: Manufacturing (SIC)	0.587	
All Employees, Nondurable Goods	0.596	
Industrial Production: Materials	0.601	
Industrial Production: Equipment: Business Equi...	0.606	
Average Hourly Earnings of Production and Nonsu...	0.610	
Average Weekly Overtime Hours of Production and...	0.614	
All Employees, Mining, Quarrying, and Oil and G...	0.618	
Industrial Production: Consumer Goods	0.621	
Real Estate Loans, All Commercial Banks	0.624	

```
DataFrame.from_dict({n: {'series_id': s.split('_')[0],
                         'lag' : s.split('_')[1],
                         'description': alf.header(s.split('_')[0])}
                     for n, s in selected.loc[:best.name, 'select'].items()},
                     orient='index').set_index('series_id')
```

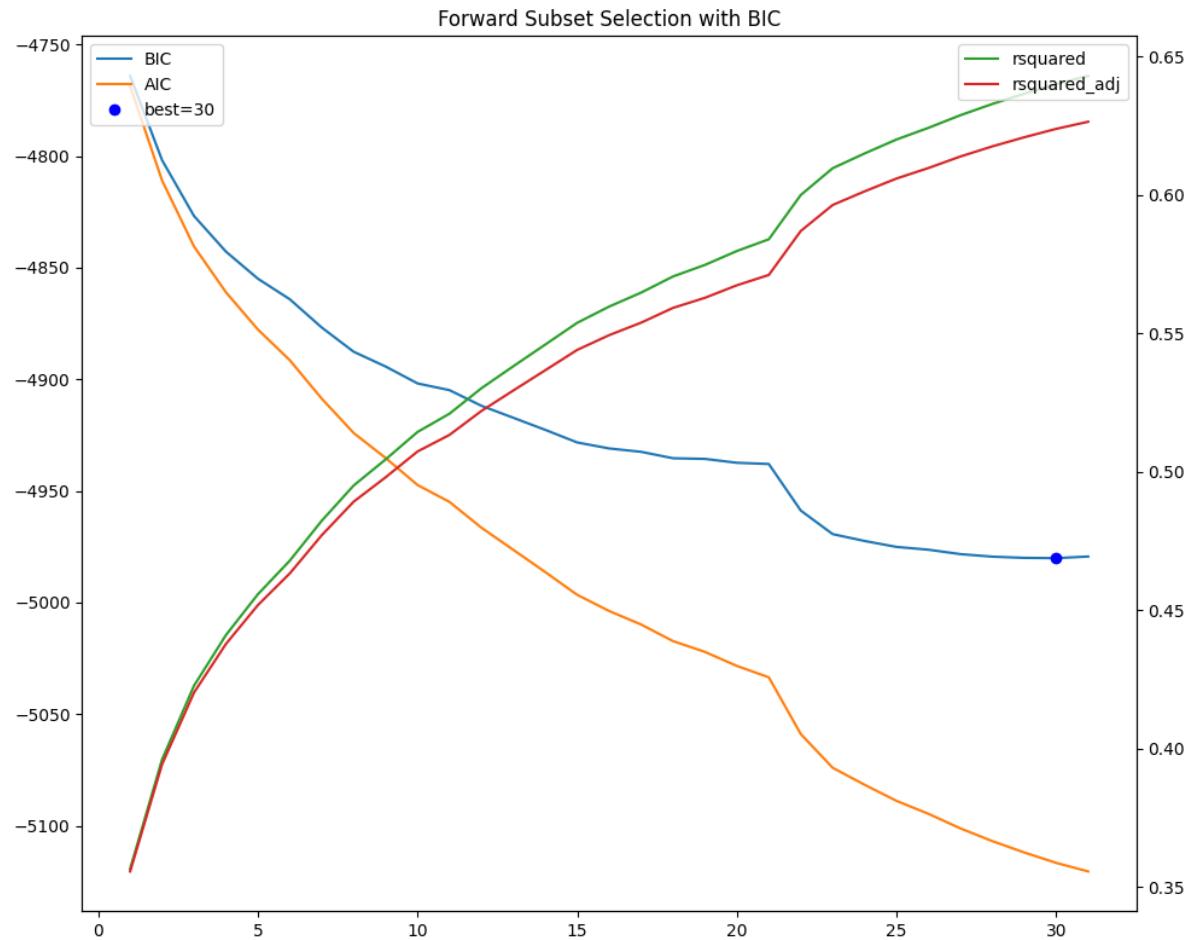
series_id	lag	description
CLAIMS	1	Initial Claims
M2REAL	2	Real M2 Money Stock
USWTRADE	2	All Employees, Wholesale Trade
SRVPRD	2	All Employees, Service-Providing
T5YFFM	3	5-Year Treasury Constant Maturity Minus Federa...
ISRATIO	2	Total Business: Inventories to Sales Ratio
SRVPRD	1	All Employees, Service-Providing
USWTRADE	1	All Employees, Wholesale Trade
USFIRE	2	All Employees, Financial Activities
USTRADE	1	All Employees, Retail Trade
IPB51222S	3	Industrial Production: Non-Durable Consumer En...
IPNMAT	3	Industrial Production: Non-Durable Goods Mater...

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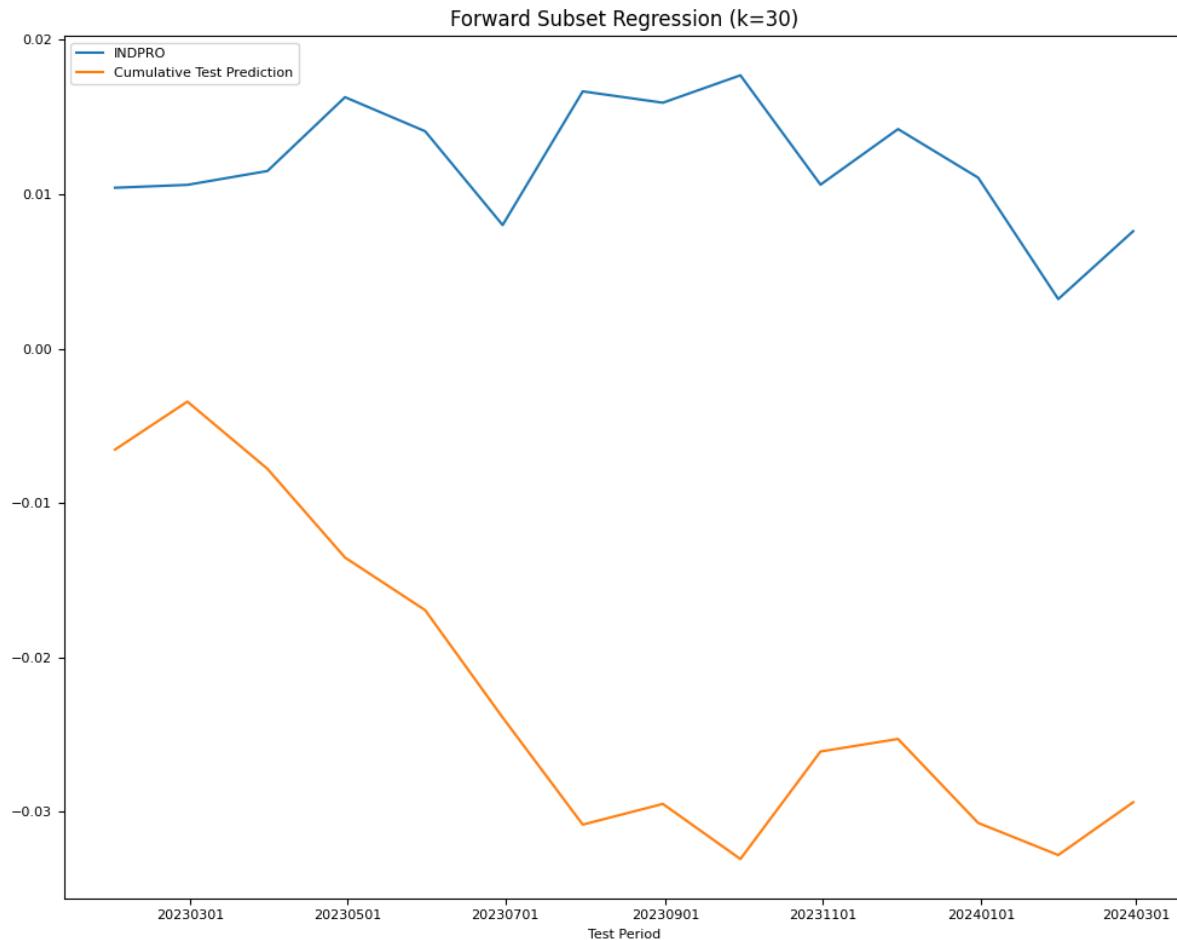
EXCAUS	3	Canadian Dollars to U.S. Dollar Spot Exchange ...
M1SL	3	M1
DTCOLNVHFM	3	Consumer Motor Vehicle Loans Owned by Finance ...
CONSPI	2	Nonrevolving consumer credit to Personal Income
AAA	1	Moody's Seasoned Aaa Corporate Bond Yield
BAA	1	Moody's Seasoned Baa Corporate Bond Yield
CES1021000001	3	All Employees, Mining, Quarrying, and Oil and ...
AMDMUO	2	Manufacturers' Unfilled Orders: Durable Goods
CUMFNS	1	Capacity Utilization: Manufacturing (SIC)
IPMANSICS	1	Industrial Production: Manufacturing (SIC)
NDMANEMP	1	All Employees, Nondurable Goods
IPMAT	2	Industrial Production: Materials
IPBUSEQ	2	Industrial Production: Equipment: Business Equ...
CES2000000008	1	Average Hourly Earnings of Production and Nons...
AWOTMAN	2	Average Weekly Overtime Hours of Production an...
CES1021000001	1	All Employees, Mining, Quarrying, and Oil and ...
IPCONGD	2	Industrial Production: Consumer Goods
REALLN	1	Real Estate Loans, All Commercial Banks

```
# Plot BIC vs number selected
fig, ax = plt.subplots(num=1, figsize=(10, 8))
selected['bic'].plot(ax=ax, c='C0')
selected['aic'].plot(ax=ax, c='C1')
ax.plot(best.name, float(best.iloc[0]), "ob")
ax.legend(['BIC', 'AIC', f"best={best.name}"], loc='upper left')
ax.set_title(f"Forward Subset Selection with {ic.upper()}")
bx = ax.twinx()
selected['rsquared'].plot(ax=bx, c='C2')
selected['rsquared_adj'].plot(ax=bx, c='C3')
bx.legend(['rsquared', 'rsquared_adj'], loc='upper right')
bx.set_xlabel('# Predictors')
plt.tight_layout()
```



```
# evaluate train and test mse
X_subset = X_train[subset['select']]
model = sm.OLS(Y_train, X_subset).fit()
name = f"Forward Subset Regression (k={len(subset)})"
Y_pred = model.predict(X_test[subset['select']])
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_subset))
final_models[name] = model
```

```
fig, ax = plt.subplots(figsize=(10, 8))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()
```



```
DataFrame({'name': name,
           'train': np.sqrt(train[name]),
           'test': np.sqrt(test[name])}, index=['RMSE'])
```

	name	train	test
RMSE	Forward Subset Regression (k=30)	0.005965	0.008271

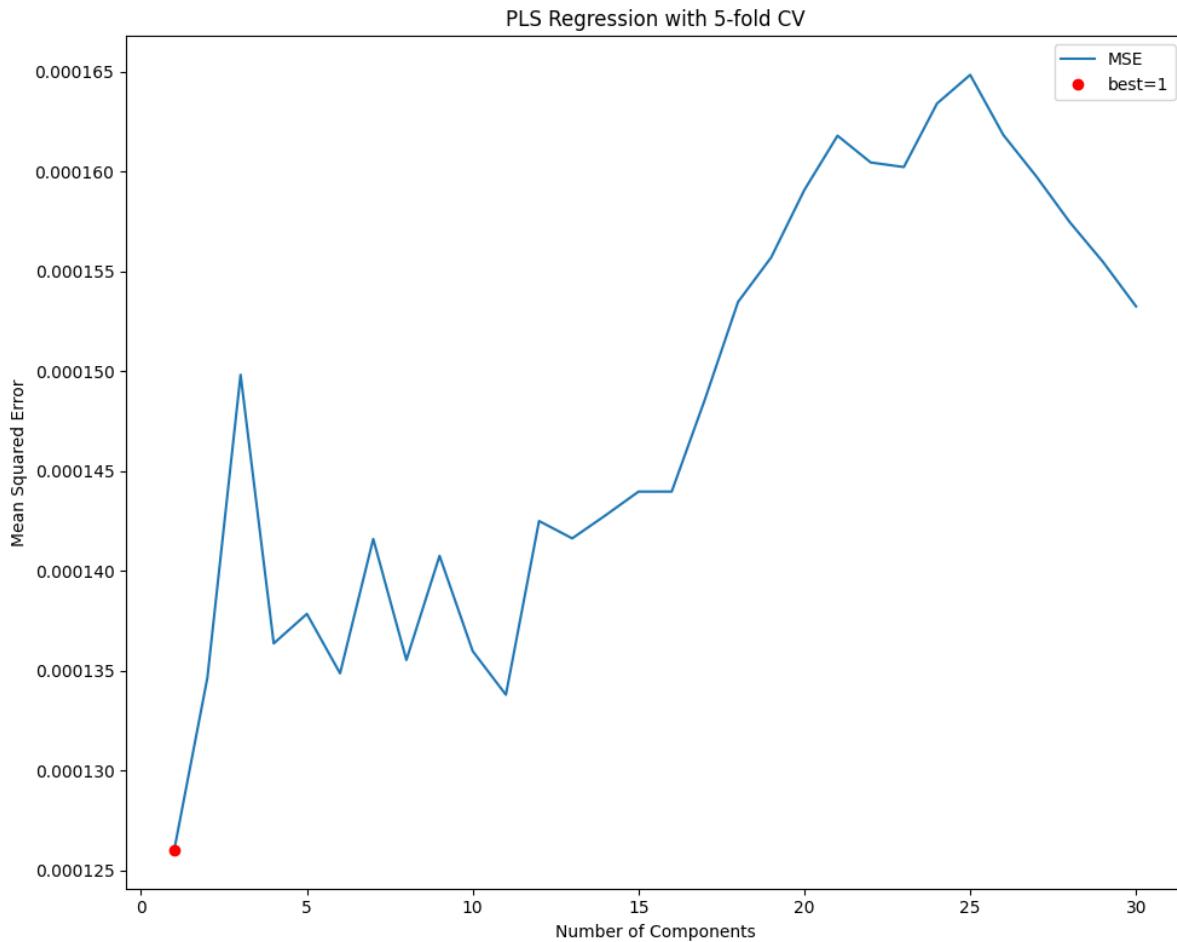
29.1.2 Partial Least Squares Regression

K-Fold cross validation

```
# split train and test, fit standard scaling using train set
from sklearn.preprocessing import StandardScaler
from sklearn.cross_decomposition import PLSRegression
from sklearn.model_selection import cross_val_score, KFold
X_train, X_test, Y_train, Y_test = ts_split(X, Y)
scale = StandardScaler().fit(X_train)
X_train = scale.transform(X_train)
X_test = scale.transform(X_test)
```

```
# fit with 5-fold CV to choose n_components
n_splits=5
kf = KFold(n_splits=n_splits, shuffle=True, random_state=0)
mse = Series(dtype=float)
for i in np.arange(1, 31):
    pls = PLSRegression(n_components=i)
    score = cross_val_score(estimator=pls,
                            X=X_train,
                            y=Y_train,
                            n_jobs=5,
                            verbose=VERBOSE,
                            cv=kf,
                            scoring='neg_mean_squared_error').mean()
    mse.loc[i] = -score
```

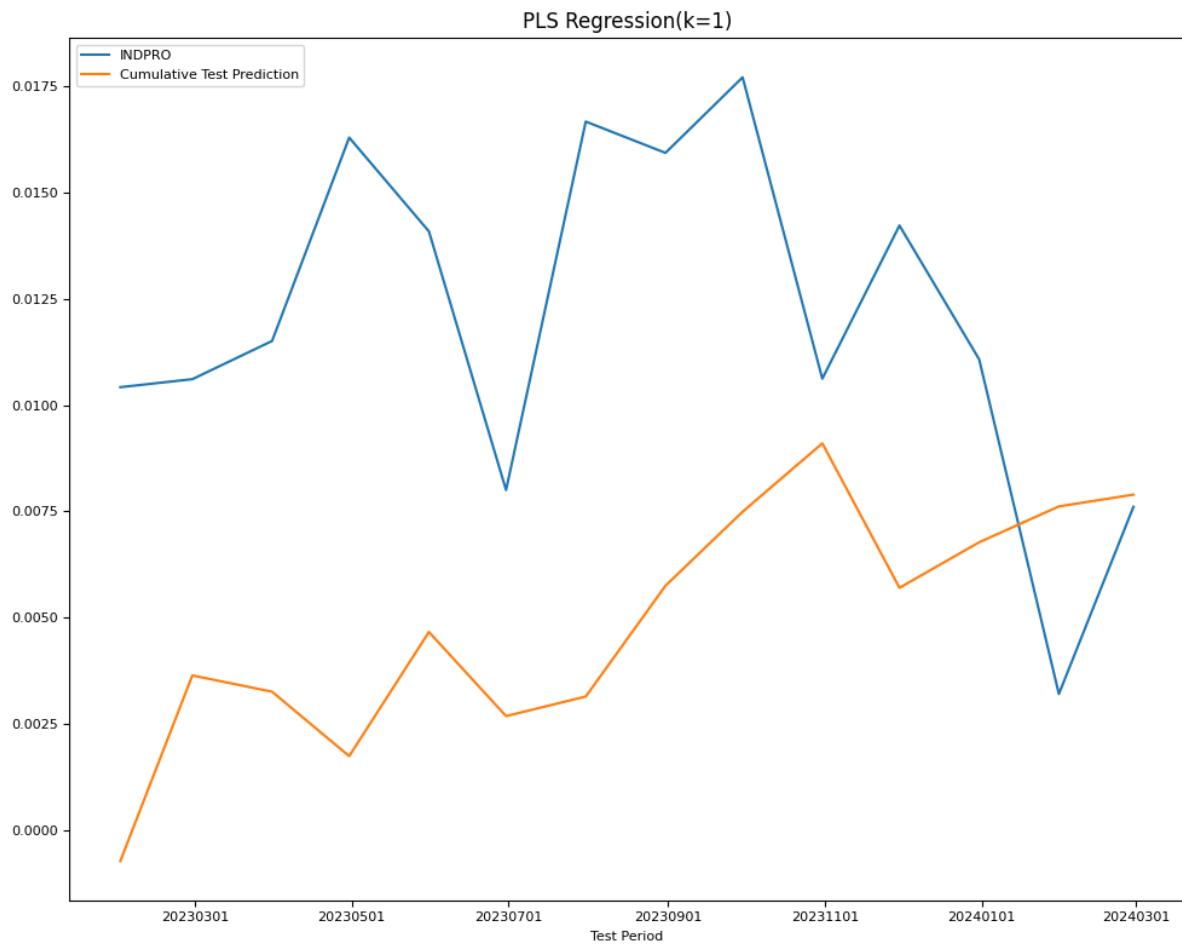
```
# show cross-validation results and best model
fig, ax = plt.subplots(figsize=(10, 8))
mse.plot(ylabel='Mean Squared Error',
          xlabel='Number of Components',
          title=f"PLS Regression with {n_splits}-fold CV",
          ax=ax)
best = mse.index[mse.argmin()]
ax.plot(best, mse.loc[best], "or")
ax.legend(['MSE', f"best={best}"])
plt.tight_layout()
```



```
### evaluate train and test mse
model = PLSRegression(n_components=best).fit(X_train, Y_train)
name = f"PLS Regression(k={best})"
Y_pred = Series(index=Y_test.index,
                data=model.predict(X_test).reshape((-1,)))
```

```
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_train))
final_models[name] = model
```

```
fig, ax = plt.subplots(figsize=(10, 8))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()
```



```
DataFrame({'name': name,
          'train': np.sqrt(train[name]),
          'test': np.sqrt(test[name])}, index=['RMSE'])
```

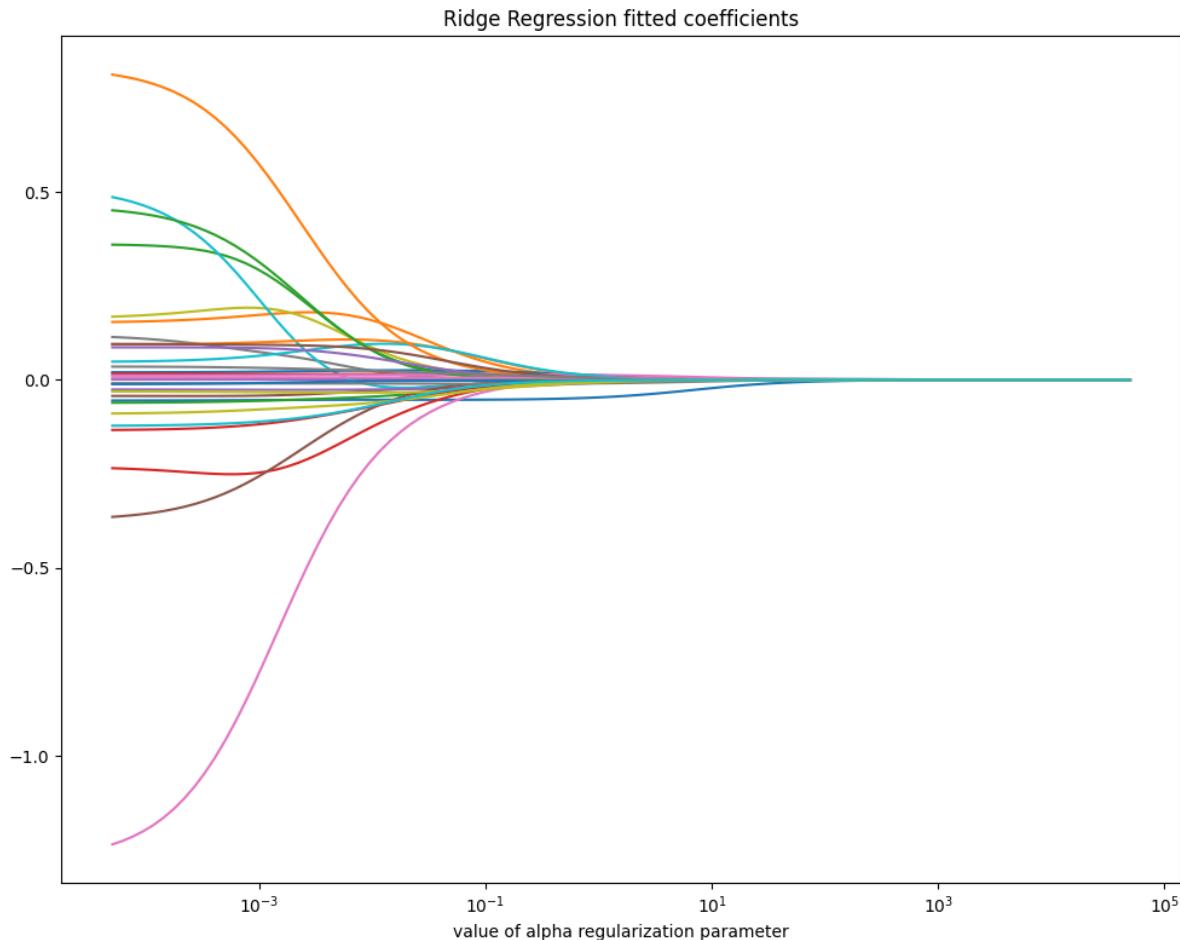
	name	train	test
RMSE	PLS Regression(k=1)	0.00856	0.006206

29.1.3 Ridge Regression

Cross validation

```
from sklearn.linear_model import Ridge, RidgeCV
alphas = 10**np.linspace(5, -4, 100)*0.5 # for parameter tuning
X_train, X_test, Y_train, Y_test = ts_split(X, Y)
scale = StandardScaler().fit(X_train)
X_train = scale.transform(X_train)
X_test = scale.transform(X_test)
np.random.seed(42)
```

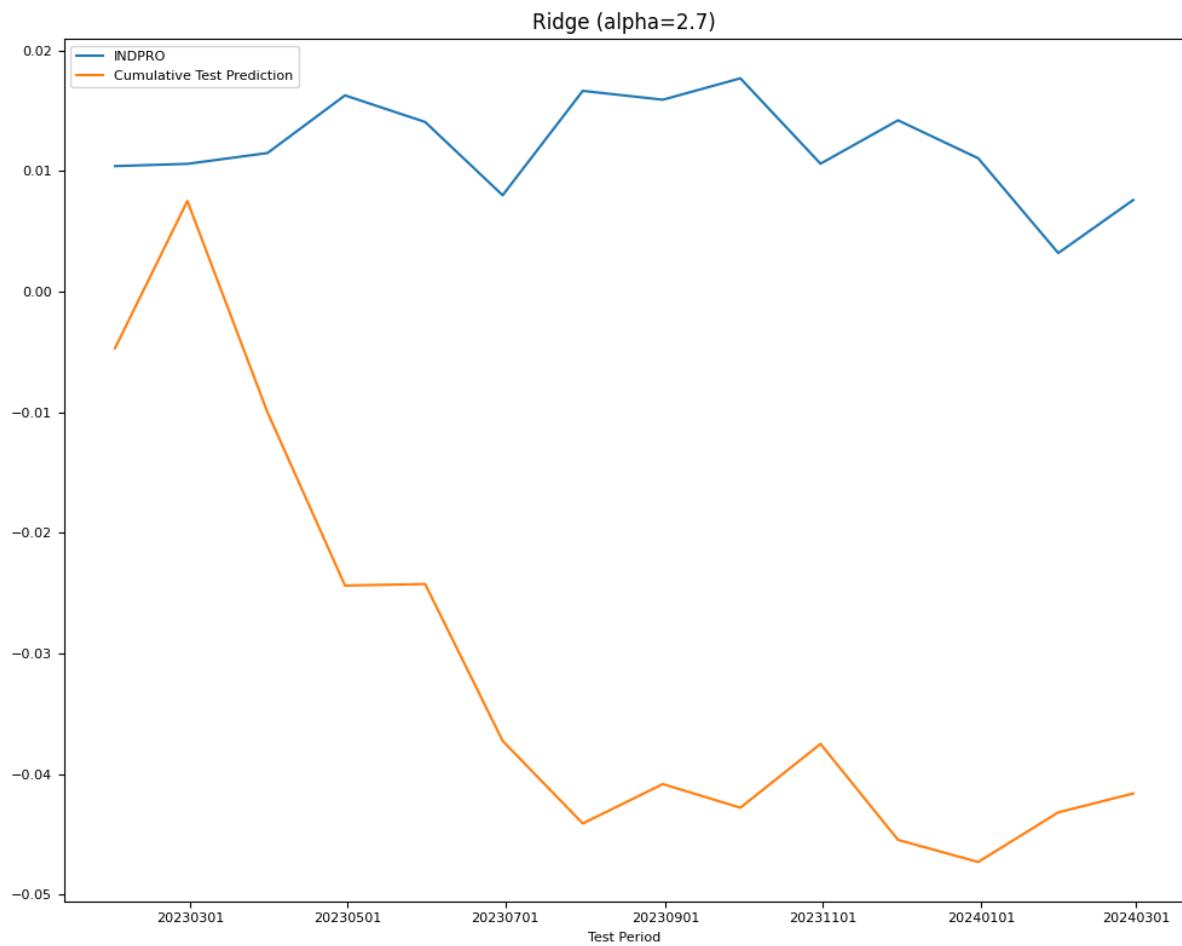
```
# Plot fitted coefficients vs regularization alpha
coefs = [Ridge(alpha, fit_intercept=False) \
          .fit(X_subset, Y_train).coef_ for alpha in alphas]
fig, ax = plt.subplots(figsize=(10, 8))
ax.plot(alphas, coefs)
ax.set_xscale('log')
ax.set_xlabel('value of alpha regularization parameter')
ax.set_title('Ridge Regression fitted coefficients')
plt.tight_layout()
```



```
# RidgeCV LOOCV
model = RidgeCV(alphas=alphas,
                 scoring='neg_mean_squared_error',
                 cv=None, # to use Leave-One-Out cross validation
                 store_cv_values=True).fit(X_train, Y_train)
```

```
name = f"Ridge (alpha={model.alpha_:.1f})"
Y_pred = Series(index=Y_test.index,
                 data=model.predict(X_test).reshape((-1,)))
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_train))
final_models[name] = model
```

```
fig, ax = plt.subplots(figsize=(10, 8))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()
```



```
DataFrame({ 'name': name,
           'train': np.sqrt(train[name]),
           'test': np.sqrt(test[name]) }, index=['RMSE'])
```

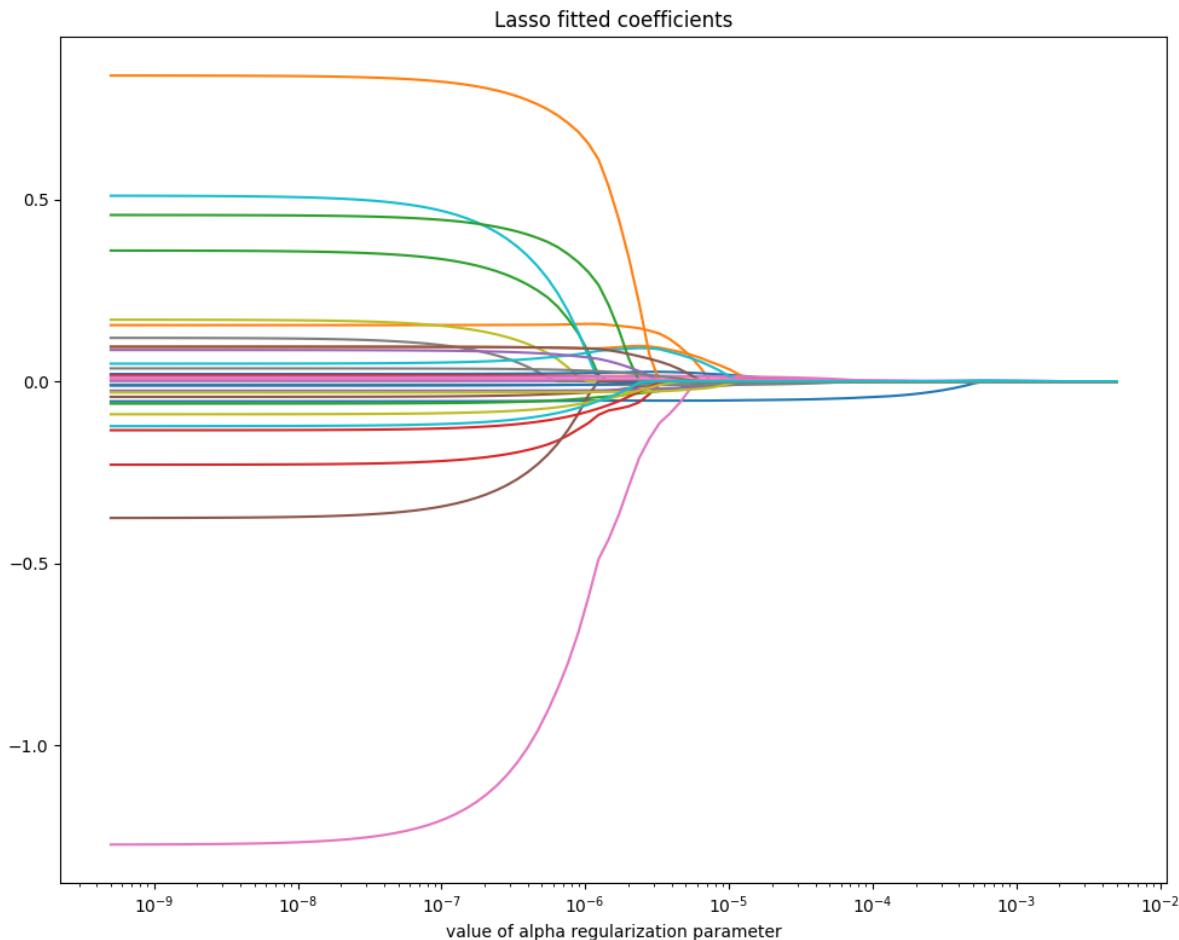
	name	train	test
RMSE	Ridge (alpha=2.7)	0.004358	0.011474

29.1.4 Lasso Regression

Cross Validation

```
from sklearn.linear_model import Lasso, LassoCV
alphas = 10**np.linspace(-2, -9, 100)*0.5 # for parameter tuning
X_train, X_test, Y_train, Y_test = ts_split(X, Y)
scale = StandardScaler().fit(X_train)
X_train = scale.transform(X_train)
X_test = scale.transform(X_test)
```

```
# Plot fitted coefficients vs regularization
coefs = [Lasso(max_iter=10000, alpha=alpha) \
          .fit(X_subset, Y_train).coef_ for alpha in alphas]
fig, ax = plt.subplots(figsize=(10, 8))
ax.plot(alphas, coefs)
ax.set_xscale('log')
ax.set_xlabel('value of alpha regularization parameter')
ax.set_title('Lasso fitted coefficients')
plt.tight_layout()
```



```
# LassoCV 10-Fold CV
model = LassoCV(alphas=None,
```

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```

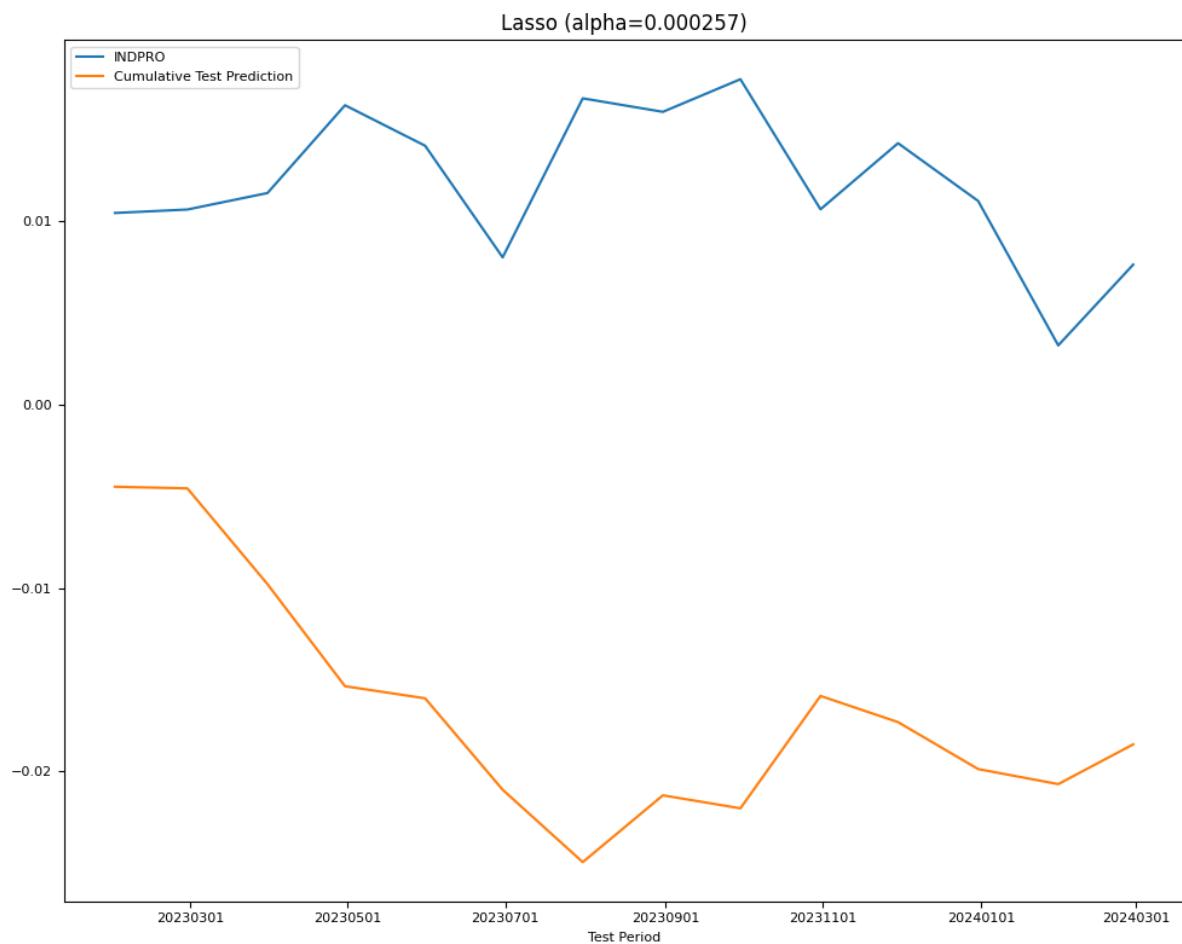
cv=5,
n_jobs=5,
verbose=VERBOSE,
max_iter=20000).fit(X_train, Y_train)
name = f'Lasso (alpha={model.alpha_:.3g})'
Y_pred = Series(index=Y_test.index,
                 data=model.predict(X_test).reshape((-1,)))
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_train))
final_models[name] = model

```

```

fig, ax = plt.subplots(figsize=(10, 8))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()

```



```

DataFrame({'name': name,
          'train': np.sqrt(train[name])},

```

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```
'test': np.sqrt(test[name])}, index=['RMSE'])
```

	name	train	test
RMSE	Lasso (alpha=0.000257)	0.006304	0.007601

```
# Display nonzero coeffs
nonzero = np.sum(np.abs(model.coef_) > 0)
argsort = np.flip(np.argsort(np.abs(model.coef_))[:nonzero])
df = DataFrame({'series_id': columns_unmap(X.columns[argsort])[0],
                 'lags': columns_unmap(X.columns[argsort])[1],
                 'desc': [alf.header(s)
                          for s in columns_unmap(X.columns[argsort])[0]],
                 'coef': model.coef_[argsort]}).round(6).set_index('series_id')
print("Lasso: Nonzero Coefficients")
df
```

Lasso: Nonzero Coefficients

series_id	lags	desc	coef
CLAIMS	1	Initial Claims	-0.005390
SRVPRD	1	All Employees, Service-Providing	-0.001311
M2REAL	2	Real M2 Money Stock	0.000903
IPNMAT	3	Industrial Production: Non-Durable Goods Mater...	0.000708
VIXCLS	1	CBOE Volatility Index: VIX	-0.000705
...
IPFUELS	3	Industrial Production: Non-Durable Consumer En...	-0.000033
IPNCONGD	1	Industrial Production: Non-Durable Consumer Goods	-0.000023
WPSFD49502	2	Producer Price Index by Commodity: Final Deman...	0.000017
M2SL	3	M2	0.000015
HWIURATIO	2	Ratio of Help Wanted/No. Unemployed	-0.000010

[78 rows x 3 columns]

29.1.5 Decision Tree

The tree-based methods involve stratifying or segmenting the predictor space into a number of simple regions. In order to make a prediction for a given observation, we typically use the mean or the mode of the training observations in the region to which it belongs. The set of splitting rules used to segment the predictor space can be summarized in a tree.

- A **Decision tree** consists of a series of splitting rules, that segments observations into regions of predictor space. Decision trees are typically drawn upside down, in the sense that the leaves are at the bottom of the tree.
- **Terminal nodes** or **leaves** are partitions of the predictor space that observations are segmented into.
- **Internal nodes** are points along the tree where the predictor space is split.
- **Branches** are those segments of the trees that connect the nodes.
- A **Stump** is a decision tree with only one internal node.

Recursive binary splitting is a top-down, greedy approach to construct decision trees. It begins at the top of the tree (at which point all observations belong to a single region) and then successively splits the predictor space; each split is indicated via two new branches further down on the tree. At each step of the tree-building process, the best split is made

at that particular step, rather than looking ahead and picking a split that will lead to a better tree in some future step. We first select that predictor and the cutpoint s such that splitting the predictor space into the regions leads to the greatest possible reduction in a cost function (RSS). Next, we repeat the process, looking for the best predictor and best cutpoint in order to split the data in one of the two previously identified regions further so as to minimize the cost within each of the resulting regions. The process continues until a stopping criterion is reached.

A procedure that grows trees until the leaves are pure tends to overfit. The complexity of the tree lies in the number of nodes. We artificially limit the maximum size of each tree, as measured by the number of nodes it's allowed to have, indicated on the horizontal axis of the fitting graph. For each tree size we create a new tree from scratch, using the training data. We measure two values: its accuracy on the training set and its accuracy on the holdout (test) set. As the trees are allowed to get larger, the training-set accuracy continues to increase, but the holdout accuracy eventually declines. The complexity at which holdout accuracy declines as the tree grows past its "sweet spot".

The **cost complexity pruning** strategy reduces the complexity of a tree (that is less likely to overfit the data) is to grow a very large tree, and then prune it back in order to obtain a subtree. However, estimating the test error from cross-validation error for every possible subtree is too cumbersome, since there is an extremely large number of possible subtrees. Cost complexity pruning (also known as weakest link pruning) considers a sequence of trees indexed by a nonnegative tuning parameter α , rather than considering every possible subtree. For each value of α there corresponds a subtree T such that $\sum_{m=1}^{|T|} \sum_{x_i \in R_m} (y_i - \hat{y}_{R_m})^2 + \alpha|T|$ is as small as possible, where $|T|$ indicates the number of terminal nodes of the tree T , R_m is the subset of predictor space corresponding to the m th terminal node, and \hat{y}_{R_m} is the predicted response associated with R_m . The tuning parameter α controls a trade-off between the subtree's complexity (number of terminal nodes) and its fit to the training data.

Alternate criteria of impurity for making the binary splits in a classification tree:

- **Classification error rate** (i.e. the fraction of the training observations in that region that do not belong to the most common class) is not sufficiently sensitive for tree-growing. $\hat{p}_{m,c} \frac{n_{m,c}}{n_m}$, where n_m is the number of observations in node m , and $n_{m,c}$ is the number of observations in node m that are in category c .
- **Gini index** is a measure of total variance across the K classes, is defined by $G = \sum_{k=1}^K \hat{p}_{mk}(1 - \hat{p}_{mk})$ where \hat{p}_{mk} represent the proportion of training observations in the m th region that are from the k th class. It is close to zero or one. For this reason the Gini index is referred as a measure of node purity – a small value indicates that a node contains predominantly observations from a single class.
- **Entropy**, given by $D = \sum_{k=1}^K \hat{p}_{mk} \log \hat{p}_{mk}$. The entropy will take on a value near zero if the \hat{p}_{mk} 's are all near zero or one.

For classification,

$$\text{Deviance} = -2 \sum_{m=1}^g \sum_{c=1}^w n_{m,c} \ln \hat{p}_{m,c}$$

$$\text{Residual mean deviance} = \frac{\text{deviance}}{n-1}$$

If there is a highly non-linear and complex relationship between the features and the response, then decision trees (which assume a model of the form $f(x) = \sum_{m=1}^M c_m \cdot 1_{(X \in R_m)}$) may outperform linear regression models (which assume the form $f(x) = \beta_0 + \sum_{j=1}^p X_j \beta_j$)

Advantages

- Trees are very easy to explain to people. In fact, they are even easier to explain than linear regression!
- Decision trees may more closely mirror human decision-making than do the regression and classification approaches.
- Trees can be displayed graphically, and are easily interpreted even by a non-expert (especially if the trees are small).

- Trees can easily handle qualitative predictors without the need to create dummy variables

Disadvantages:

- Trees generally do not have the same level of predictive accuracy as some of the other regression and classification
- Trees can be very non-robust. In other words, a small change in the data can cause a large change in the final estimated tree.
- Trees overfits categorical variables

By aggregating many decision trees, using ensemble methods like bagging, random forests, and boosting, the predictive performance of trees can be substantially improved.

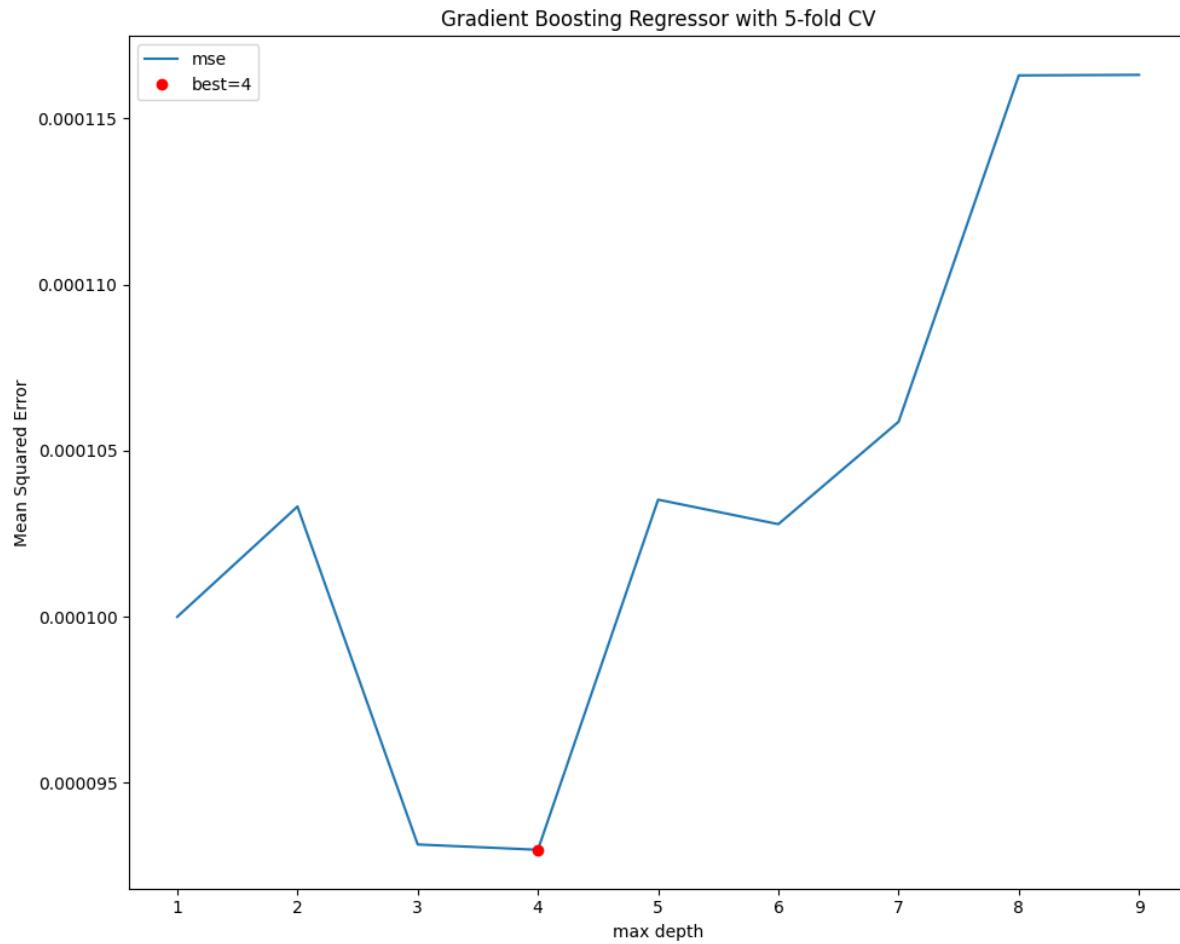
29.1.6 Gradient boosting

KFold cross validation

```
from sklearn.ensemble import GradientBoostingRegressor
X_train, X_test, Y_train, Y_test = ts_split(X, Y)
scale = StandardScaler().fit(X_train)
X_train = scale.transform(X_train)
X_test = scale.transform(X_test)

# tune max_depth with 5-fold CV
n_splits=5
kf = KFold(n_splits=n_splits, shuffle=True, random_state=0)
mse = Series(dtype=float)
for i in range(1, 10): # tune max_depth for best performance
    boosted = GradientBoostingRegressor(max_depth=i, random_state=0)
    score = cross_val_score(boosted,
                           X_train,
                           Y_train,
                           cv=kf,
                           n_jobs=5,
                           verbose=VERBOSE,
                           scoring='neg_mean_squared_error').mean()
    mse.loc[i] = -score
```

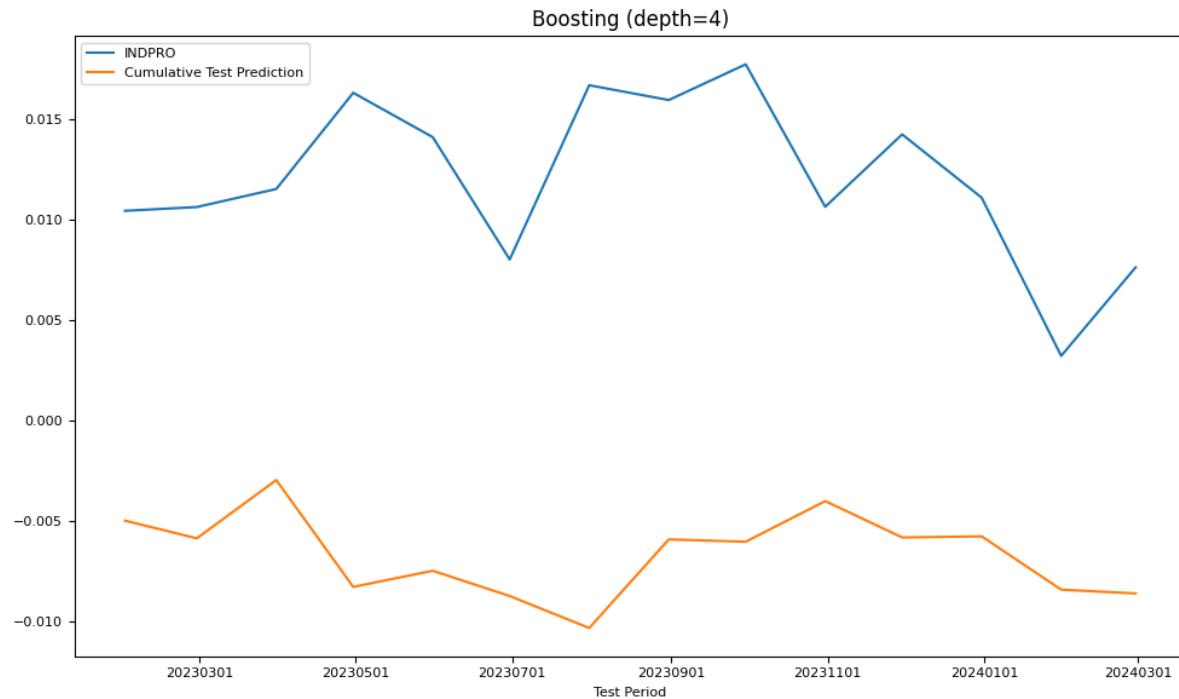
```
fig, ax = plt.subplots(figsize=(10, 8))
mse.plot(ax=ax, ylabel='Mean Squared Error', xlabel='max depth',
         title=f"Gradient Boosting Regressor with {n_splits}-fold CV")
best = mse.index[mse.argmin()]
ax.plot(best, mse.loc[best], "or")
ax.legend(['mse', f"best={best}"])
plt.tight_layout()
```



```
# evaluate train and test MSE
name = f"Boosting (depth={best})"
model = GradientBoostingRegressor(max_depth=best,
                                    random_state=0).fit(X_train, Y_train)
```

```
Y_pred = Series(index=Y_test.index,
                 data=model.predict(X_test).reshape((-1,)))
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_train))
final_models[name] = model
```

```
fig, ax = plt.subplots(figsize=(10, 6))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()
```



```
DataFrame({'name': name,
          'train': np.sqrt(train[name]),
          'test': np.sqrt(test[name])}, index=['RMSE'])
```

	name	train	test
RMSE	Boosting (depth=4)	0.001661	0.00698

```
# Show feature importance
top_n = 10
imp = Series(model.feature_importances_, index=X.columns).sort_values()
print(f"Gradient Boosting: Top {top_n} Feature Importances")
DataFrame.from_dict({i+1: {'importance': imp[s],
                           'series_id': s.split('_')[0],
                           'lags': s.split('_')[1],
                           'description': alf.header(s.split('_')[0])}
                     for i, s in enumerate(np.flip(imp.index[-top_n:]))},
                     orient='index')
```

Gradient Boosting: Top 10 Feature Importances

	importance	series_id	lags
1	0.179785	CLAIMS	1
2	0.088659	M2SL	1
3	0.040664	BUSLOANS	1
4	0.030011	HWIURATIO	1
5	0.027526	UEMPLT5	3
6	0.025408	MANEMP	1
7	0.018103	IPNMAT	1
8	0.017666	PERMITW	1

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```

9      0.016720    EXCAUS     1
10     0.016259    USGOOD     1

                                         description
1                               Initial Claims
2                               M2
3  Commercial and Industrial Loans, All Commercia...
4          Ratio of Help Wanted/No. Unemployed
5          Number Unemployed for Less Than 5 Weeks
6          All Employees, Manufacturing
7  Industrial Production: Non-Durable Goods Mater...
8  New Privately-Owned Housing Units Authorized i...
9  Canadian Dollars to U.S. Dollar Spot Exchange ...
10          All Employees, Goods-Producing

```

29.1.7 Random Forest

KFold cross validation

```

from sklearn.ensemble import RandomForestRegressor
X_train, X_test, Y_train, Y_test = ts_split(X, Y)

# tune max_depth with 5-fold CV
n_splits=5
kf = KFold(n_splits=n_splits,
            shuffle=True,
            random_state=0)
mse = Series(dtype=float)
for i in range(3, 20): #tune for best performance
    model = RandomForestRegressor(max_depth=i, random_state=0)
    score = cross_val_score(model,
                            X_train,
                            Y_train,
                            cv=kf,
                            n_jobs=5,
                            verbose=VERBOSE,
                            scoring='neg_mean_squared_error').mean()
    mse.loc[i] = -score
    #print(i, np.sqrt(abs(score)))

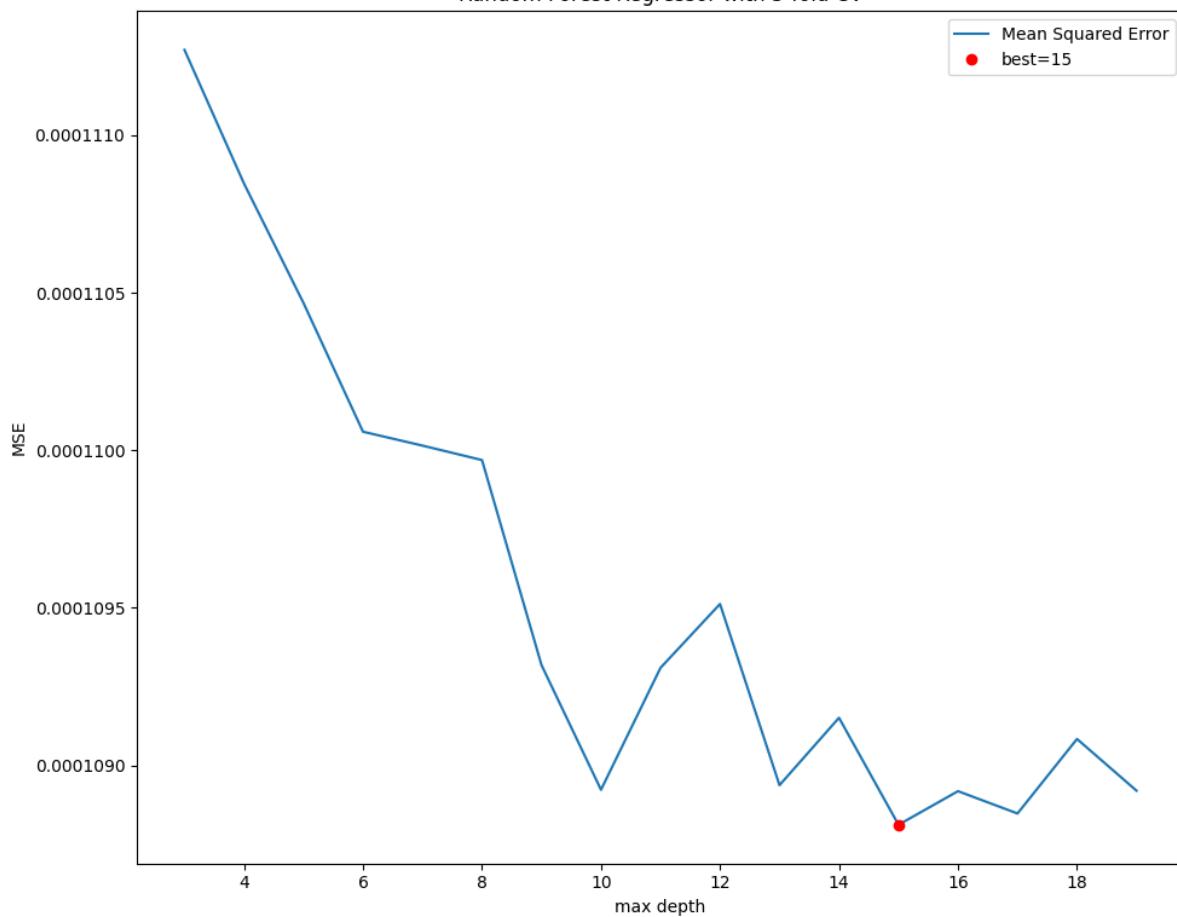
```

```

fig, ax = plt.subplots(figsize=(10, 8))
mse.plot(ax=ax, ylabel='MSE', xlabel='max depth',
         title=f"Random Forest Regressor with {n_splits}-fold CV")
best = mse.index[mse.argmin()]
ax.plot(best, mse.loc[best], "or")
ax.legend(['Mean Squared Error', f"best={best}"])
plt.tight_layout()

```

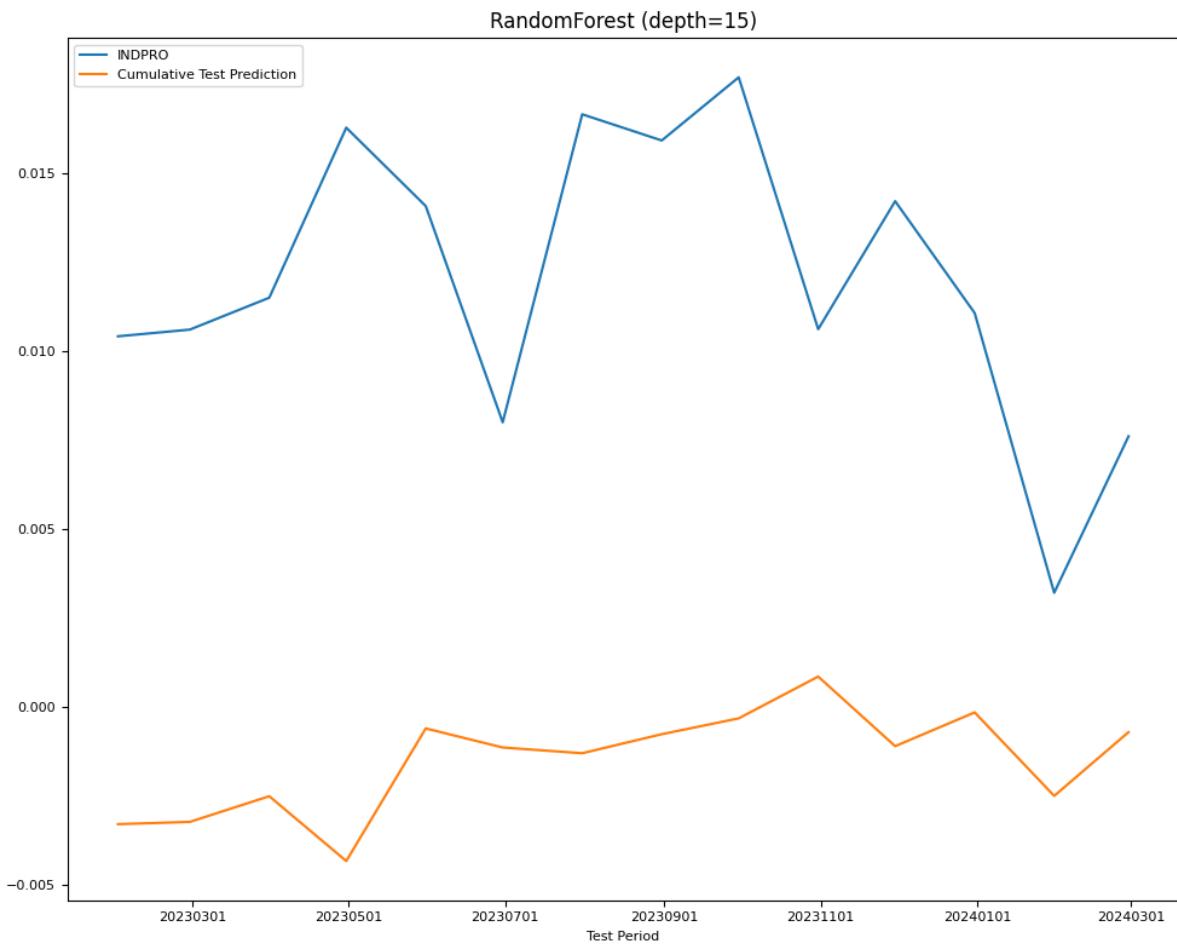
Random Forest Regressor with 5-fold CV



```
name = f"RandomForest (depth={best})"
model = RandomForestRegressor(max_depth=best,
                             random_state=0).fit(X_train, Y_train)
```

```
Y_pred = Series(index=Y_test.index,
                 data=model.predict(X_test).reshape((-1,)))
test[name] = mean_squared_error(Y_test, Y_pred)
train[name] = mean_squared_error(Y_train, model.predict(X_train))
final_models[name] = model
```

```
fig, ax = plt.subplots(figsize=(10, 8))
plot_date(pd.concat([Y_test.cumsum(), Y_pred.cumsum()], axis=1),
          legend1=[target_id, 'Cumulative Test Prediction'],
          title=name,
          xlabel='Test Period',
          fontsize=8,
          ax=ax)
plt.tight_layout()
```



```
DataFrame({'name': name,
          'train': np.sqrt(train[name]),
          'test': np.sqrt(test[name])}, index=['RMSE'])
```

	name	train	test
RMSE	RandomForest (depth=15)	0.003833	0.006165

```
# Feature importance
top_n = 10
imp = Series(model.feature_importances_, index=X.columns).sort_values()
print(f"Random Forest: Top {top_n} Feature Importances")
DataFrame.from_dict({i+1: {'importance': imp[s],
                            'series_id': s.split('_')[0],
                            'lags': s.split('_')[1],
                            'description': alf.header(s.split('_')[0])}
                     for i, s in enumerate(np.flip(imp.index[-top_n:]))},
                     orient='index')
```

Random Forest: Top 10 Feature Importances

```

importance series_id lags \
1 0.051142 CLAIMS 1
2 0.047626 BUSLOANS 1
3 0.044440 M2SL 1
4 0.027707 USGOOD 1
5 0.016242 UEMPLT5 1
6 0.014992 UEMPLT5 3
7 0.014374 IPCONGD 1
8 0.014345 M1SL 1
9 0.012969 OILPRICE 1
10 0.012449 MANEMP 1

description
1 Initial Claims
2 Commercial and Industrial Loans, All Commercia...
3 M2
4 All Employees, Goods-Producing
5 Number Unemployed for Less Than 5 Weeks
6 Number Unemployed for Less Than 5 Weeks
7 Industrial Production: Consumer Goods
8 M1
9 Crude Oil, spliced WTI and Cushing
10 All Employees, Manufacturing

```

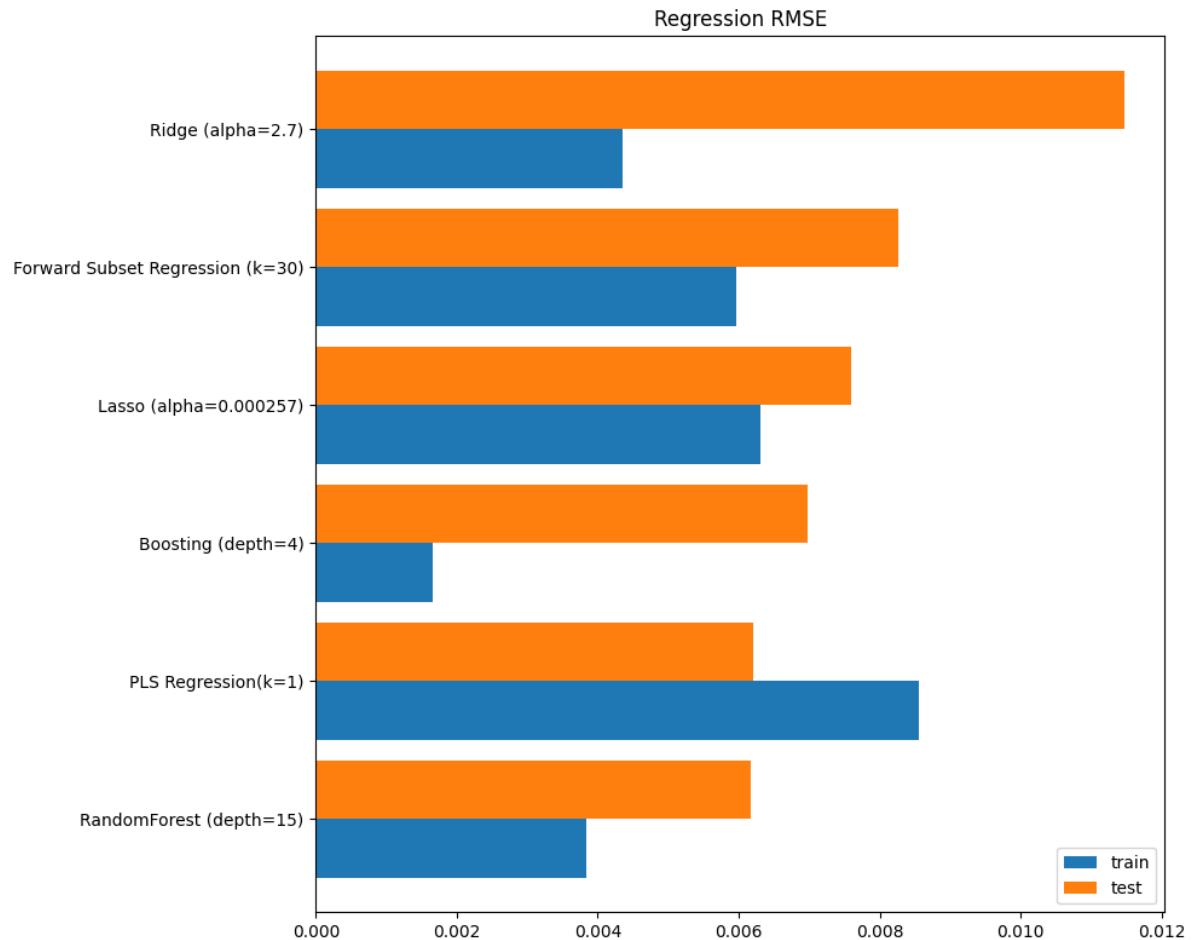
29.2 Evaluation

RMSE

```

fig, ax = plt.subplots(figsize=(10, 8))
pd.concat([np.sqrt(r.to_frame()) for r in [train, test]], axis=1) \
    .sort_values('test') \
    .plot.barh(ax=ax, width=0.85)
ax.yaxis.set_tick_params(labelsize=10)
ax.set_title('Regression RMSE')
ax.figure.subplots_adjust(left=0.35)
plt.tight_layout()

```



DEEP LEARNING

May your choices reflect your hopes, not your fears – Nelson Mandela

Concepts:

- TextBlob library
- Word Embeddings
- Feedforward Neural Networks

References:

- Geoffrey E. Hinton, Nitish Srivastava, Alex Krizhevsky, Ilya Sutskever, Ruslan R. Salakhutdinov, July 2012, “Improving neural networks by preventing co-adaptation of feature detectors”
- Jeffrey Pennington, Richard Socher, and Christopher D. Manning. 2014. GloVe: Global Vectors for Word Representation.
- Tomas Mikolov, Kai Chen, Greg Corrado, Jeffrey Dean, 2013, “Efficient Estimation of Word Representations in Vector Space”
- Greg Durrett, 2023, “CS388 Natural Language Processing course materials”, retrieved from <https://www.cs.utexas.edu/~gdurrett/courses/online-course/materials.html>

```
import numpy as np
import random
import time
import pandas as pd
from pandas import DataFrame, Series
from collections import Counter
import matplotlib.pyplot as plt
from sklearn.metrics import confusion_matrix
from sklearn.preprocessing import LabelEncoder
from sklearn.model_selection import train_test_split
import seaborn as sns
from tqdm import tqdm
import torch
from torch import nn
import torchinfo
from textblob import TextBlob
from tqdm import tqdm
from finds.database import MongoDB, SQL, RedisDB
from finds.unstructured import Unstructured, Edgar, Vocab
from finds.structured import BusDay, CRSP, PSTAT
from finds.readers import Sectoring
from finds.utils import Store
```

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```
from secret import credentials, paths
# %matplotlib qt
# jupyter-notebook --NotebookApp.iopub_data_rate_limit=1.0e12
VERBOSE = 0
outdir = paths['scratch']
store = Store(outdir, ext='pkl')
device = torch.device("cuda" if torch.cuda.is_available() else "cpu")
print('device is', device)
```

device is cuda

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
ed = Edgar(paths['10X'], zipped=True, verbose=VERBOSE)
```

Last FamaFrench Date 2024-04-30 00:00:00

Load business descriptions text and industry labels for universe of stocks

```
# Retrieve universe of stocks as of start of calendar year 2023
univ = crsp.get_universe(bd.endmo(20221231))
```

```
# lookup company names
comnam = crsp.build_lookup(source='permno', target='comnam', fillna="")
univ['comnam'] = comnam(univ.index)
```

```
# lookup ticker symbols
ticker = crsp.build_lookup(source='permno', target='ticker', fillna="")
univ['ticker'] = ticker(univ.index)
```

```
# lookup sic codes from Compustat, and map to FF 10-sector code
sic = pstat.build_lookup(source='lpermno', target='sic', fillna=0)
industry = Series(sic[univ.index], index=univ.index)
industry = industry.where(industry > 0, univ['siccd'])
sectors = Sectoring(sql, scheme='codes10', fillna='') # supplement from crosswalk
univ['sector'] = sectors[industry]
```

```
# retrieve 2023 10K business descriptions text
item, form = 'bus10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
found = rows[rows['date'].between(20230101, 20231231)] \
    .drop_duplicates(subset=['permno'], keep='last') \
    .set_index('permno')
```

30.1 Textblob

The TextBlob library provides simple API for common NLP tasks such as part-of-speech tagging, lemmatization, noun phrase extraction, sentiment analysis and spelling correction. It streamlines many of NLTK's complexities and also integrates WordNet.

- <https://textblob.readthedocs.io/en/dev/quickstart.html>

```
bus = {}
for permno in tqdm(found.index):
    if permno not in univ.index:
        continue
    doc = TextBlob(ed[found.loc[permno, 'pathname']].lower()) # tokenize and tag
    nouns = [word for word, tag in doc.tags
             if tag in ['NN', 'NNS'] and word.isalpha() and len(word) > 2]
    if len(nouns) > 100:
        bus[permno] = nouns
permnos = list(bus.keys())
```

100% |██████████| 4625/4625 [18:12<00:00, 4.24it/s]

30.2 Word Embeddings

Word embeddings or vectors may be trained using neural networks or matrix factorization techniques.

30.2.1 Word2Vec

Word2Vec is a framework that includes two primary algorithms: Skip-gram and CBOW. It aims to learn distributed representations (word embeddings) of words in a continuous vector space, by capturing relationships between words based on their occurrences as center words in context windows. Training uses neural networks, that are typically shallow with one hidden layer.

30.2.2 Skip-gram

This approach predicts the context words (i.e. surrounding words) given a center word.

30.2.3 CBOW

Continuous Bag of Words (CBOW) predicts the center word based on the context words within a fixed window size.

30.2.4 GloVe

Global Vectors for Word Representation (GloVe) learns word vectors from global word-word co-occurrence statistics from a corpus. It uses matrix factorization techniques on the word co-occurrence matrix.

Load GloVe vectors, and relativize to vocab words

```
# Load GloVe embeddings, source: "https://nlp.stanford.edu/data/glove.6B.zip"
embeddings_dim = 300 # dimension of GloVe embeddings vector

filename = paths['scratch'] / f"glove.6B.{embeddings_dim}d.txt"
embeddings = pd.read_csv(filename, sep=" ", quoting=3,
                        header=None, index_col=0, low_memory=True)
embeddings.index = embeddings.index.astype(str).str.lower()
print(embeddings.shape)
```

(400000, 300)

30.2.5 Word Vector Arithmetic

Reflecting the idea that geometric relationships between word embeddings reflect meaningful linguistic relationships, word embeddings may be combined and manipulated arithmetically to capture analogies and semantic similarities between words.

It should be noted that these examples are only suggestive of what the vectors may capture, and such mathematical results are generally not as sharp; they may also show the potential for biases, such as gender roles, implicit in the training samples.

```
from sklearn.neighbors import NearestNeighbors
analogies = ["man king woman", "paris france tokyo", "big bigger cold"]
for analogy in analogies:
    words = analogy.lower().split()
    vectors = {word: embeddings.loc[word].values for word in words}
    vec = vectors[words[1]] - vectors[words[0]] + vectors[words[2]]

    sim = NearestNeighbors(n_neighbors=1).fit(embeddings)
    neighbors = sim.kneighbors(vec.reshape((1, -1)), n_neighbors=2,
                                return_distance=False).flatten().tolist()
    neighbors = [k for k in neighbors if embeddings.index[k] not in words]
    print(f"{words[1]} - {words[0]} + {words[2]} =",
          [embeddings.index[k] for k in neighbors])
```

```
king - man + woman = ['queen']
france - paris + tokyo = ['japan']
bigger - big + cold = ['colder']
```

Encode textual dataset and labels, and relativize word embeddings to vocab

```
words = Counter()
for nouns in bus.values():
    words.update(list(nouns))
vocab = Vocab(words.keys())
print('vocab len:', len(vocab))
```

```
vocab len: 87381
```

```
labels = []
x_all = []
for permno, nouns in bus.items():
    x = vocab.get_index([noun for noun in nouns])
    if sum(x):
        labels.append(univ.loc[permno, 'sector'])
    x_all.append(x)
class_encoder = LabelEncoder().fit(labels)      # .inverse_transform()
y_all = class_encoder.transform(labels)
```

```
store['dan'] = dict(y_all=y_all, x_all=x_all)
```

```
# retrieve from previously stored
y_all, x_all = store['dan'].values()
```

```
# relativize embeddings to words in vocab
vocab.set_embeddings(embeddings)
print(vocab.embeddings.shape)
```

```
(87381, 300)
```

```
vocab.dump(outdir / f"dan{embeddings_dim}.pkl")
```

```
# load vocab
vocab.load(outdir / f"dan{embeddings_dim}.pkl")
```

30.3 FeedForward Neural Network

Neural networks compose together linear and nonlinear functions to build a complex mathematical model. Feedforward neural networks (FFNNs) are the simplest form of neural networks, where the data flows in one direction (a forward pass) and the connections do not form a cycle.

- **Neurons** are the basic computational units or nodes of a neural network. Each neuron receives input, processes it using a weighted sum and a bias term, and then applies an activation function to produce an output, which is then passed to the neurons in the next layer.
- **Activation functions** are the nonlinear mathematical functions applied to neurons in a neural network. They introduce non-linearity into the model, enabling it to learn and represent complex patterns in the data. Common activation functions include ReLU (Rectified Linear Unit), sigmoid, and tanh.
- **Input Layer** is the first layer of a neural network which directly receives the input data. Each neuron in the input layer represents one feature of the input.
- **Hidden Layers**, between the input layer and the output layer, take input from the previous layer of neurons, apply weights, biases, and activation functions, and pass the output to the next layer.
- **Output Layer** is the final layer of the neural network and it produces the network's output. Its neurons represent the predictions or classifications made by the network. The number of neurons in the output layer corresponds

to the number of output classes or the dimensionality of the output. For classification tasks, softmax or sigmoid functions are often used in the output layer to provide probability distributions of the class predictions.

- **Backpropagation** is used for training neural networks by updating the weights of neurons based on the error (loss) of the network's predictions: it involves calculating the gradient of the loss function with respect to each weight by using the chain rule of calculus, and propagating these gradients backward from the output layer to the input layer.
- **Computation Graph** is a graphical representation of the sequence of operations used to compute the forward pass and the backward pass for backpropagation. PyTorch's modules automatically constructs the computation graph and computes gradients, hence simplifying the implementation of neural networks.
- **Batching** divides the training data into smaller subsets called batches, rather than training the model on the entire dataset at once, which can be computationally intensive and inefficient. It also gives speedup compared to training the network one sample at a time due to more efficient matrix operations.
- **Initialization** refers to the process of setting the initial values of the weights in a neural network before training begins. Poor initialization can lead to slow convergence or getting stuck in local minima. Common initialization methods include Xavier (Glorot) and He initialization
- **Dropout** is a regularization technique during training, where a random subset of neurons is “dropped out” or set to zero at each iteration. This reduces overfitting by ensuring that the model does not rely too heavily on any particular subset of neurons. Geoffrey Hinton, et al. in their 2012 paper that first introduced dropout. They found that using a simple method of 50% dropout for all hidden units and 20% dropout for input units achieve improved results with a range of neural networks on different problem types. It is not used on the output layer.
- **Adam** (Adaptive Moment Estimation) is an optimization algorithm for training neural networks which improves on stochastic gradient descent and achieves good performance on problems with large, high-dimensional data sets. It adapts the learning rate for each parameter by computing adaptive learning rates from estimates of first and second moments of the gradients.

30.3.1 Deep Averaging Networks

Deep Averaging Networks (DAN) are feedforward neural networks for natural language processing tasks which work by simply averaging the pre-trained embeddings of the words in a text sample to pass to its input layer.

During training, the embeddings may be frozen (i.e. kept constant) or fine-tuned (i.e. allowed to be updated).

- Freezing embeddings is useful when the embeddings are already well-trained and expected to generalize well to new tasks. It reduces the number of parameters to be trained, which can make the training process faster and prevent overfitting when the dataset is small.
- Fine-tuning embeddings means allowing the pre-trained word embeddings to be updated during the training of a model. Adjusting the embeddings can better fit the specific task or dataset at hand, but requires more computational resources and a larger dataset to avoid overfitting.

```
class DAN(nn.Module):
    """Deep Averaging Network for classification"""
    def __init__(self,
                 vocab_dim,
                 num_classes,
                 hidden,
                 embedding,
                 freeze=True):
        super().__init__()
        self.embedding = nn.EmbeddingBag.from_pretrained(embedding)
        self.embedding.weight.requires_grad = not freeze
        D = nn.Dropout(0.0)
        V = nn.Linear(vocab_dim, hidden[0])
```

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```

nn.init.xavier_uniform_(V.weight)
L = [D, V]
self.drops = [D]
for in_dim, out_dim in zip(hidden, hidden[1:] + [num_classes]):
    L.append(nn.ReLU())      # nonlinearity layer
    D = nn.Dropout(0.0)
    self.drops.append(D)
    L.append(D)              # dropout layer
    W = nn.Linear(in_dim, out_dim)    # dense linear layer
    nn.init.xavier_uniform_(W.weight)
    L.append(W)
self.network = nn.Sequential(*L)
self.classifier = nn.LogSoftmax(dim=-1)  # output is (N, C) logits

def set_dropout(self, dropout):
    if dropout:
        self.drops[0] = 0.2      # input layer
        for i in range(1, len(self.drops)):      # hidden layers
            self.drops[i].p = 0.5
    else:
        for i in range(len(self.drops)):
            self.drops[i].p = 0.0

def set_freeze(self, freeze):
    """To freeze part of the model (embedding layer)"""
    self.embedding.weight.requires_grad = not freeze

def forward(self, x):
    """Return tensor of log probabilities"""
    return self.classifier(self.network(self.embedding(x)))

def predict(self, x):
    """Return predicted int class of input tensor vector"""
    return torch.argmax(self(x), dim=1).int().tolist()

def save(self, filename):
    """Save model state to filename"""
    return torch.save(self.state_dict(), filename)

def load(self, filename):
    """Load model name from filename"""
    self.load_state_dict(torch.load(filename, map_location='cpu'))
    return self

```

Split the data into stratified (i.e. equal class proportions) train and test set

```

# Stratified train_test split
num_classes = len(np.unique(labels))
train_index, test_index = train_test_split(
    np.arange(len(y_all)), stratify=y_all, random_state=42, test_size=0.2)
print(len(x_all), len(y_all), len(train_index), len(test_index), num_classes)
#Series(labels).value_counts().rename('count').to_frame()
pd.concat([Series(np.array(labels)[train_index]).value_counts().rename('Train'),
           Series(np.array(labels)[test_index]).value_counts().rename('Test')],
           axis=1)

```

```
3559 3559 2847 712 10
```

	Train	Test
Hlth	705	176
Other	609	153
HiTec	565	141
Manuf	275	69
Shops	257	64
Durbl	131	33
NoDur	116	29
Enrgy	75	19
Utils	74	18
Telcm	40	10

```
# Specify model and training parameters
layers = 1
hidden_size = 32
model = DAN(embeddings_dim,
             num_classes,
             hidden=[hidden_size] * layers,
             embedding=torch.FloatTensor(vocab.embeddings)).to(device)
torchinfo.summary(model)
```

```
=====
Layer (type:depth-idx)           Param #
=====
DAN
|─EmbeddingBag: 1-1           (26, 214, 300)
|─Sequential: 1-2
|  |─Dropout: 2-1             --
|  |─Linear: 2-2             9,632
|  |─ReLU: 2-3               --
|  |─Dropout: 2-4             --
|  |─Linear: 2-5             330
|─LogSoftmax: 1-3             --
=====
Total params: 26,224,262
Trainable params: 9,962
Non-trainable params: 26,214,300
=====
```

```
batch_sz = 16
lr = 0.001
num_epochs = 50
optimizer = torch.optim.Adam(model.parameters(), lr=lr)
loss_function = nn.NLLLoss()
```

```
/home/terence/env3.11/lib/python3.11/site-packages/tqdm/auto.py:21: TqdmWarning:
  ↵IPProgress not found. Please update jupyter and ipywidgets. See https://
  ↵ipywidgets.readthedocs.io/en/stable/user_install.html
  from .autonotebook import tqdm as notebook_tqdm
```

Helper function to batch and form an input for neural network. Pads each sample to have lengths equal to the max, and convert to Long tensor type.

```

def form_input(docs):
    """Pad lists of index lists to form batch of equal lengths"""
    lengths = [len(doc) for doc in docs] # length of each doc
    max_length = max(1, max(lengths)) # to pad so all lengths equal max
    out = [doc + ([0] * (max_length-n)) for doc, n in zip(docs, lengths)]
    return torch.LongTensor(out)

```

```

accuracy = []
for imodel, (freeze, dropout) in enumerate([(True, False), (False, False), (False, True)]):
    model.set_freeze(freeze)
    model.set_dropout(dropout)
    accuracy.append(dict())

    # Loop over epochs
    for epoch in tqdm(range(num_epochs)):
        tic = time.time()

        # Form batches
        random.shuffle(train_index)
        batches = [train_index[i:(i+batch_sz)]
                   for i in range(0, len(train_index), batch_sz)]

        # Train in batches
        total_loss = 0.0
        model.train()
        for batch in batches: # train by batch
            x = form_input([x_all[idx] for idx in batch]).to(device)
            y = torch.LongTensor([y_all[idx] for idx in batch]).to(device)
            model.zero_grad() # reset model gradient
            log_probs = model(x) # run model
            loss = loss_function(log_probs, y) # compute loss
            total_loss += float(loss)
            loss.backward() # loss step
            optimizer.step() # optimizer step
        model.eval()
        model.save(outdir / f"dan{embeddings_dim}.pt")

        if VERBOSE:
            print(f"Loss {epoch}/{num_epochs} {freeze, dropout}:" +
                  f"\n{total_loss:.1f}")

        with torch.no_grad(): # evaluate test error
            test_pred = [model.predict(form_input([x_all[i]]).to(device))[0]
                         for i in test_index]
            test_gold = [y_all[idx] for idx in test_index]
            test_correct = (np.array(test_pred) == np.array(test_gold)).sum()
            train_pred = [model.predict(form_input([x_all[i]]).to(device))[0]
                          for i in train_index]
            train_gold = [y_all[idx] for idx in train_index]
            train_correct = (np.array(train_pred) == np.array(train_gold)).sum()
            accuracy[imodel][epoch] = {
                'loss': total_loss,
                'train': train_correct/len(train_gold),
                'test': test_correct/len(test_gold)}

```

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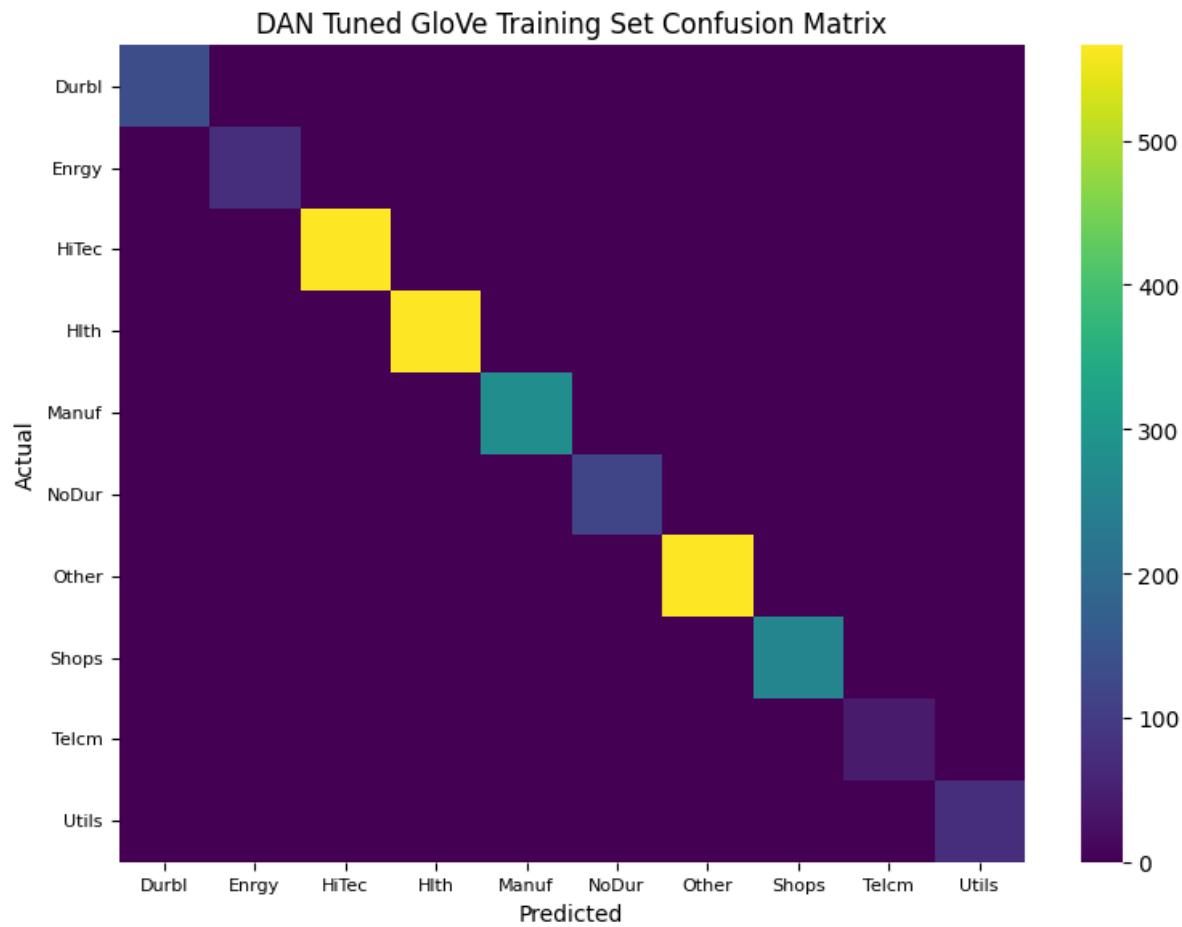
```
if VERBOSE:
    print(freeze,
          dropout,
          epoch,
          int(time.time() - tic),
          optimizer.param_groups[0]['lr'],
          train_correct/len(train_gold),
          test_correct/len(test_gold))
```

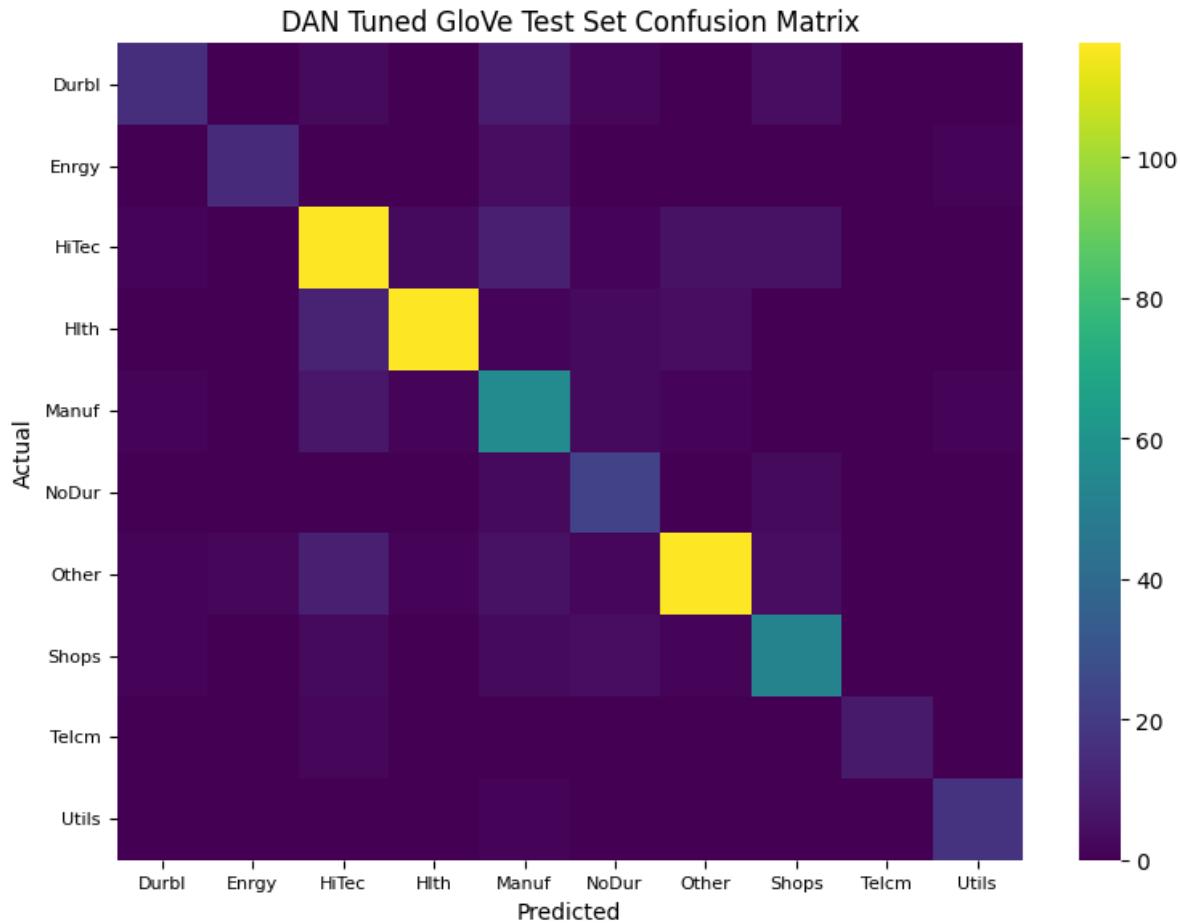
```
100%|██████████| 50/50 [03:43<00:00,  4.46s/it]
100%|██████████| 50/50 [03:56<00:00,  4.73s/it]
100%|██████████| 50/50 [03:55<00:00,  4.72s/it]
```

Display the confusion matrix for train and test sets

```
classes = class_encoder.classes_
cf_train = DataFrame(confusion_matrix(train_gold, train_pred),
                     index=pd.MultiIndex.from_product([['Actual'], classes]),
                     columns=pd.MultiIndex.from_product([['Predicted'], classes]))
cf_test = DataFrame(confusion_matrix(test_gold, test_pred),
                     index=pd.MultiIndex.from_product([['Actual'], classes]),
                     columns=pd.MultiIndex.from_product([['Predicted'], classes]))
```

```
for num, (title, cf) in enumerate({'Training': cf_train,
                                    'Test': cf_test}.items()):
    fig, ax = plt.subplots(num=1+num, clear=True, figsize=(8, 6))
    sns.heatmap(cf, ax=ax, annot=False, fmt='d', cmap='viridis', robust=True,
                yticklabels=class_encoder.classes_,
                xticklabels=class_encoder.classes_)
    ax.set_title(f'DAN Tuned GloVe {title} Set Confusion Matrix')
    ax.set_xlabel('Predicted')
    ax.set_ylabel('Actual')
    ax.yaxis.set_tick_params(labelsize=8, rotation=0)
    ax.xaxis.set_tick_params(labelsize=8, rotation=0)
    plt.subplots_adjust(left=0.35, bottom=0.25)
    plt.tight_layout()
```

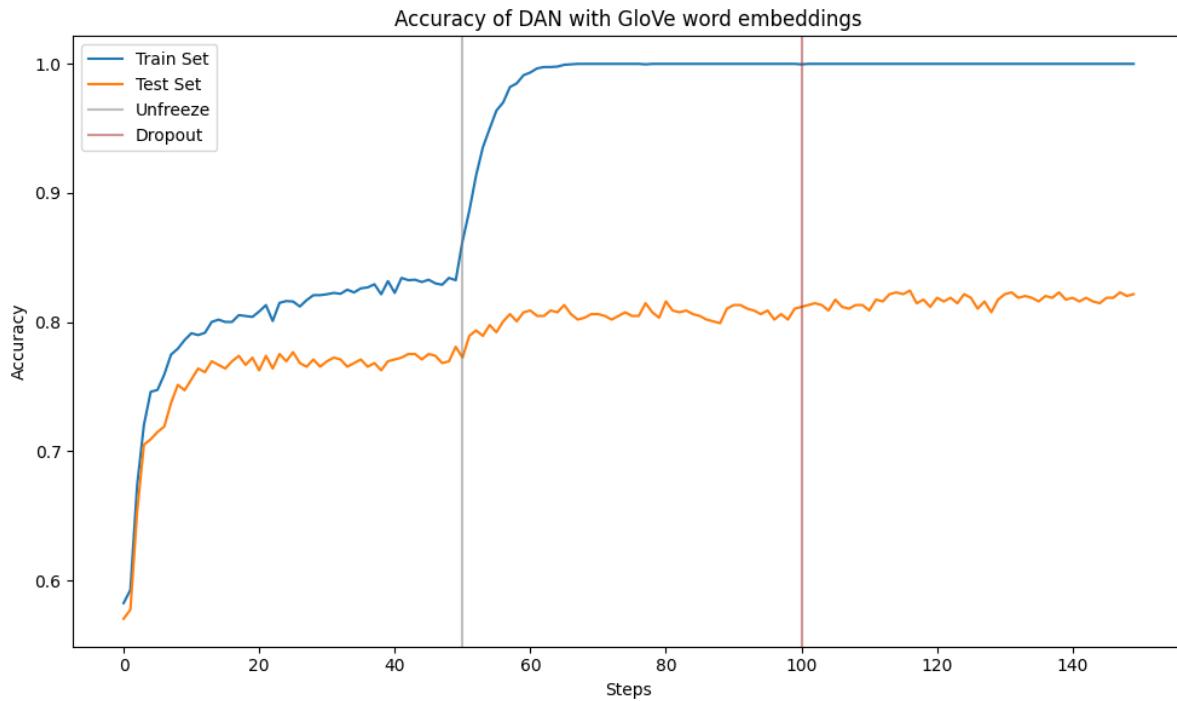




Plot accuracy, on train and test sets, by epoch. Training begins with frozen embeddings, then embeddings are unfrozen to allow fine-tuning, and finally dropout is implemented.

```
train_accuracy = pd.concat([Series([epoch['train']] for epoch in acc.values()),
                            for acc in accuracy],
                           ignore_index=True)
test_accuracy = pd.concat([Series([epoch['test']] for epoch in acc.values())
                           for acc in accuracy],
                           ignore_index=True)

fig, ax = plt.subplots(num=1, clear=True, figsize=(10, 6))
train_accuracy.plot(ax=ax)
test_accuracy.plot(ax=ax)
ax.axvline(len(accuracy[0]), c='grey', alpha=0.5)
ax.axvline(len(accuracy[0]) + len(accuracy[1]), c='brown', alpha=0.5)
ax.set_title(f'Accuracy of DAN with GloVe word embeddings')
ax.set_xlabel('Steps')
ax.set_ylabel('Accuracy')
ax.legend(['Train Set', 'Test Set', 'Unfreeze', 'Dropout'], loc='upper left')
plt.tight_layout()
```



When embeddings are frozen, the model overfits the training data, achieving 100% training accuracy. When dropout regularization is enabled, the test set accuracy slightly improves.

```
# Accuracy when frozen embeddings, unfrozen and with dropouts
p = (len(accuracy[0]) - 1, len(accuracy[0]) + len(accuracy[1]) - 1, -1)
print("Accuracy")
DataFrame({'frozen': [train_accuracy.iloc[p[0]], test_accuracy.iloc[p[0]]],
           'unfrozen': [train_accuracy.iloc[p[1]], test_accuracy.iloc[p[1]]],
           'dropout': [train_accuracy.iloc[p[2]], test_accuracy.iloc[p[2]]]},
           index=['train', 'test'])
```

Accuracy

	frozen	unfrozen	dropout
train	0.832455	1.000000	1.000000
test	0.780899	0.810393	0.821629

CHAPTER
THIRTYONE

RECURRENT NEURAL NETWORKS

The only thing we know about the future is that it will be different - Peter Drucker

Concepts:

- Elman RNN
- Linear Dynamic Factor Models

References

- Philipp Krahenbuhl, 2020, “CS395T Deep Learning course materials”, retrieved from http://www.philkr.net/dl_class/material
- https://www.statsmodels.org/dev/examples/notebooks/generated/statespace_dfm_coincident.html

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import gc
import statsmodels.api as sm
import torch
import torch.nn as nn
import torchinfo
from sklearn.preprocessing import StandardScaler
from sklearn.metrics import mean_squared_error
from tqdm import tqdm
from finds.structured import BusDay
from finds.readers import Alfred
from secret import credentials
import warnings
```

```
# %matplotlib qt
VERBOSE = 0
if not VERBOSE:  # Suppress FutureWarning messages
    warnings.simplefilter(action='ignore', category=FutureWarning)
device = torch.device("cuda" if torch.cuda.is_available() else "cpu")
```

```
# Max number of hidden states (RNN) or factors (Dynamic Model)
K = 2
```

```
# number of out-of-sample forecasts to predict
nforecast = 3
```

```

# train-test split date
split_date = '2021-12-01'

# Load time series from FRED
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=VERBOSE)
vspan = alf.date_spans('USREC') # recession periods

# CPI for U.S. City Average: Monthly, Seasonally Adjusted
# https://fred.stlouisfed.org/release/tables?rid=10&eid=34483
# 'CUSR0000SEEA'
series_ids = ['CPIFABSL', 'CPIHOSSL', 'CPIAPPSL', 'CPITRNSL', 'CPIMEDSL', 'CPIOGSSL']
df = pd.concat([alf(s, log=1, diff=1) for s in series_ids], axis=1) \
    .dropna() \
    .sort_index()
df.index = BusDay.to_datetime(df.index)
df.index.freq = 'ME'      # set index to datetime type and freq = 'M'

names = [s[s.find(':')+2:s.find(' in ')] for s in alf.header(series_ids)]
names

['Food and Beverages',
 'Housing',
 'Apparel',
 'Transportation',
 'Medical Care',
 'Other Goods and Services']

# Standardize the data data
scaler = StandardScaler().fit(df)
scaled_data = DataFrame(scaler.transform(df), columns=names, index=df.index)
scaled_data

```

	Food and Beverages	Housing	Apparel	Transportation	...
date					
1967-02-28	-1.514294	-1.123374	0.528419	0.262158	
1967-03-31	-0.803761	-1.123374	0.117546	-0.270473	
1967-04-30	-1.516345	-0.064928	0.523552	0.258920	
1967-05-31	-0.803761	-0.068382	0.115127	-0.006978	
1967-06-30	1.327849	-1.123374	0.518742	-0.270473	
...
2023-12-31	-0.305673	-0.150090	-0.300364	-0.226813	
2024-01-31	0.136279	0.874513	-1.728819	-0.823810	
2024-02-29	-0.763532	0.154003	0.841913	0.932892	
2024-03-31	-0.555699	0.155815	1.046454	0.409135	
2024-04-30	-0.757514	-0.408180	2.163913	0.318836	
	Medical Care	Other Goods and Services			
date					
1967-02-28	-0.260945		-1.020565		
1967-03-31	-0.265522		-0.290026		
1967-04-30	0.977131		-1.020565		
1967-05-31	-0.279054		-0.292134		
1967-06-30	0.950357		-0.294231		

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```

...
2023-12-31      ...      ...
2024-01-31      -0.199913  -0.950240
2024-02-29      0.045640   0.340696
2024-03-31      -1.610667  -1.786460
2024-04-30      0.152838   -0.080117
2024-04-30      0.016674   0.048790

[687 rows x 6 columns]

```

31.1 Elman RNN

Applies a multi-layer Elman RNN with tanh (or ReLU) non-linearity to an input sequence.

For each element in the input sequence, each layer computes the following function:

$$h_t = \tanh(x_t W_{ih}^T + b_{ih} + h_{t-1} W_{hh}^T + b_{hh})$$

where

- h_t is the hidden state at time t ,
- x_t is the input at time t ,
- h_{t-1} is the hidden state of the previous layer at time $t-1$ or the initial hidden state at time 0, and
- b 's and W 's are the learnable bias and weights

```

class Elman(nn.Module):
    def __init__(self, n_features, hidden_size, dropout, num_layers=1):
        super().__init__()
        self.hidden_size = hidden_size
        self.output_size = n_features
        self.num_layers = num_layers
        self.dropout = nn.Dropout(dropout)
        self.rnn = nn.RNN(input_size=n_features,
                          hidden_size=hidden_size,
                          num_layers=num_layers)
        self.o2o = nn.Linear(hidden_size, n_features)

    def forward(self, x, hidden):
        x = self.dropout(x)      # drop out input layer
        output, hidden = self.rnn(x, hidden)
        output = self.o2o(output[-1:, :])
        return output, hidden

    def init_hidden(self):
        return torch.zeros(self.num_layers, self.hidden_size)

```

```

# Create input data for RNN
ntrain = sum(scaled_data.index < split_date)
ntest = len(scaled_data.index) - ntrain - 1
n_features = scaled_data.shape[1]
data = scaled_data.values

```

31.1.1 Learning rate

learning rate schedulimg

```

# Train model
num_layers = 1
dropout = 0.0
lr = 0.01          # starting learning rate
step_size = 100    # number of steps per learning rate
num_lr = 3         # number of learning rate periods
num_epochs = step_size * num_lr

train_loss = {}
hidden_states = {}
for hidden_size in range(1, K+1):
    torch.manual_seed(0)
    model = Elman(n_features=n_features,
                  hidden_size=hidden_size,
                  dropout=dropout,
                  num_layers=num_layers).to(device)
    print(model)
    torchinfo.summary(model)

    # Set optimizer and learning rate scheduler
    optimizer = torch.optim.Adam(model.parameters(), lr=lr)
    scheduler = torch.optim.lr_scheduler.StepLR(optimizer,
                                                step_size=step_size,
                                                gamma=0.1)

    loss_function = nn.MSELoss()
    train_loss[hidden_size] = []
    for epoch in tqdm(range(num_epochs)):    # Run training loop per epoch
        model.train()
        model.zero_grad()
        hidden = model.init_hidden().to(device)
        loss = torch.FloatTensor([0]).to(device)
        for i in range(ntrain):
            x = torch.FloatTensor(data[[i], :]).to(device)
            y = torch.FloatTensor(data[[i+1], :]).to(device)
            output, hidden = model(x, hidden)
            l = loss_function(output, y)
            loss += l
        loss.backward()
        optimizer.step()
        scheduler.step()

        model.eval()
        train_loss[hidden_size].append(float(loss)/ntrain)
        #if VERBOSE:
        #    print(epoch, train_loss[hidden_size][-1], scheduler.get_last_lr())

    # collect predictions and hidden states, and compute mse
    with torch.no_grad():    # reduce memory consumption for eval
        loss_function = nn.MSELoss()
        hidden = model.init_hidden().to(device)
        hidden_states[hidden_size] = [hidden.cpu().numpy().flatten()]
        y_pred = [np.zeros(n_features)]
        for i in range(ntrain + ntest):
            x = torch.FloatTensor(data[[i], :]).to(device)
            output, hidden = model(x, hidden)
            y_pred.append(hidden.cpu().numpy().flatten())

```

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```

x = torch.FloatTensor(data[[i], :]).to(device)
y = torch.FloatTensor(data[[i+1], :]).to(device)
output, hidden = model(x, hidden)
hidden_states[hidden_size].append(hidden.cpu().numpy().flatten())
y_pred.append(output.cpu().numpy().flatten())

# k-step ahead forecast at end of period
for i in range(nforecast):
    x = y
    y, hidden = model(x, hidden)
    y_pred.append(y.cpu().numpy().flatten())
    print(f"train MSE (hidden={hidden_size}):",
          mean_squared_error(data[1:ntrain+1, :], y_pred[1:ntrain+1]))
    print(f"test MSE (hidden={hidden_size}):",
          mean_squared_error(data[ntrain+1:ntrain+ntest+1, :],
                             y_pred[ntrain+1:ntrain+ntest+1]))

```

```

Elman(
    (dropout): Dropout(p=0.0, inplace=False)
    (rnn): RNN(6, 1)
    (o2o): Linear(in_features=1, out_features=6, bias=True)
)

```

```

/home/terence/env3.11/lib/python3.11/site-packages/tqdm/auto.py:21: TqdmWarning:-
  ↵IPProgress not found. Please update jupyter and ipywidgets. See https://
  ↵ipywidgets.readthedocs.io/en/stable/user_install.html
  from .autonotebook import tqdm as notebook_tqdm
100%|██████████| 300/300 [01:32<00:00, 3.23it/s]

```

```

train MSE (hidden=1): 0.8109380710349426
test MSE (hidden=1): 0.8741724611011269
Elman(
    (dropout): Dropout(p=0.0, inplace=False)
    (rnn): RNN(6, 2)
    (o2o): Linear(in_features=2, out_features=6, bias=True)
)

```

```
100%|██████████| 300/300 [01:30<00:00, 3.31it/s]
```

```

train MSE (hidden=2): 0.753971276651208
test MSE (hidden=2): 0.7898786960734855

```

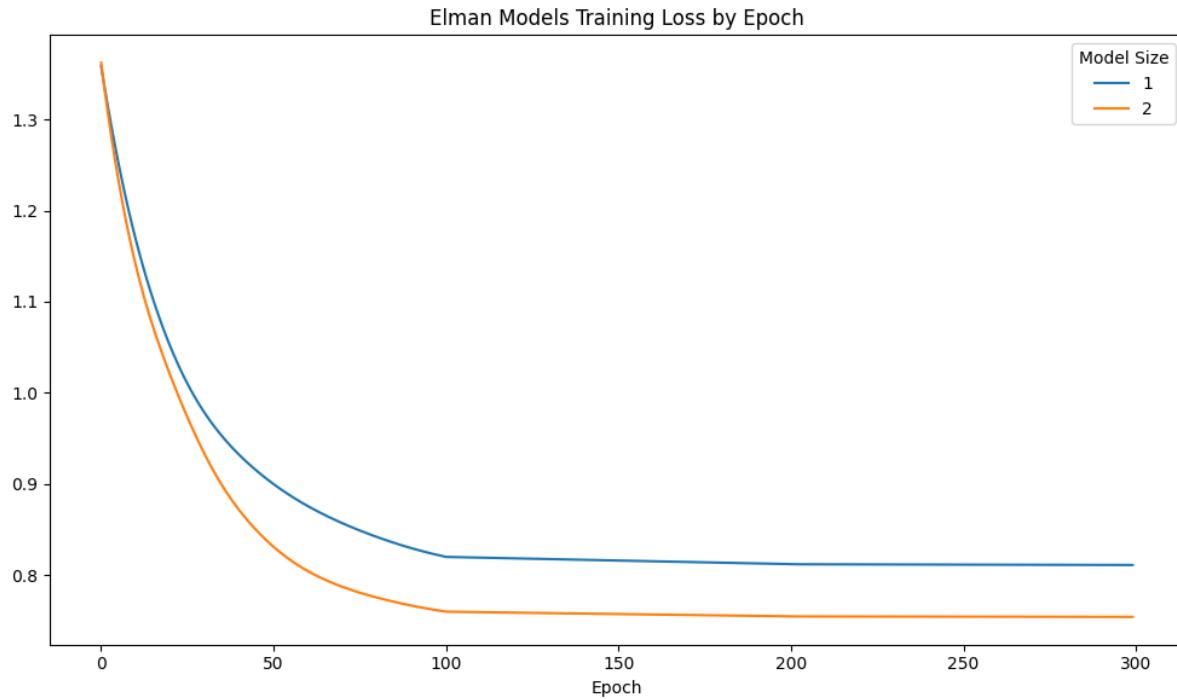
```

fig, ax = plt.subplots(figsize=(10, 6))
DataFrame(train_loss).plot(ax=ax)
ax.set_title(f"Elman Models Training Loss by Epoch")
ax.set_xlabel('Epoch')
ax.legend(title='Model Size')
plt.tight_layout()

```

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```
# Show forecasts of last model
pred = scaler.inverse_transform(y_pred)           # undo standardization
t = [scaled_data.index[-1] + pd.DateOffset(months=i) for i in range(nforecast + 1)]
forecasts = DataFrame(np.vstack((np.zeros(n_features), pred[-nforecast:]))),
index=pd.PeriodIndex(t, freq='M'), columns=scaled_data.columns)
print("Monthly forecasts from RNN Model")
forecasts
```

Monthly forecasts from RNN Model

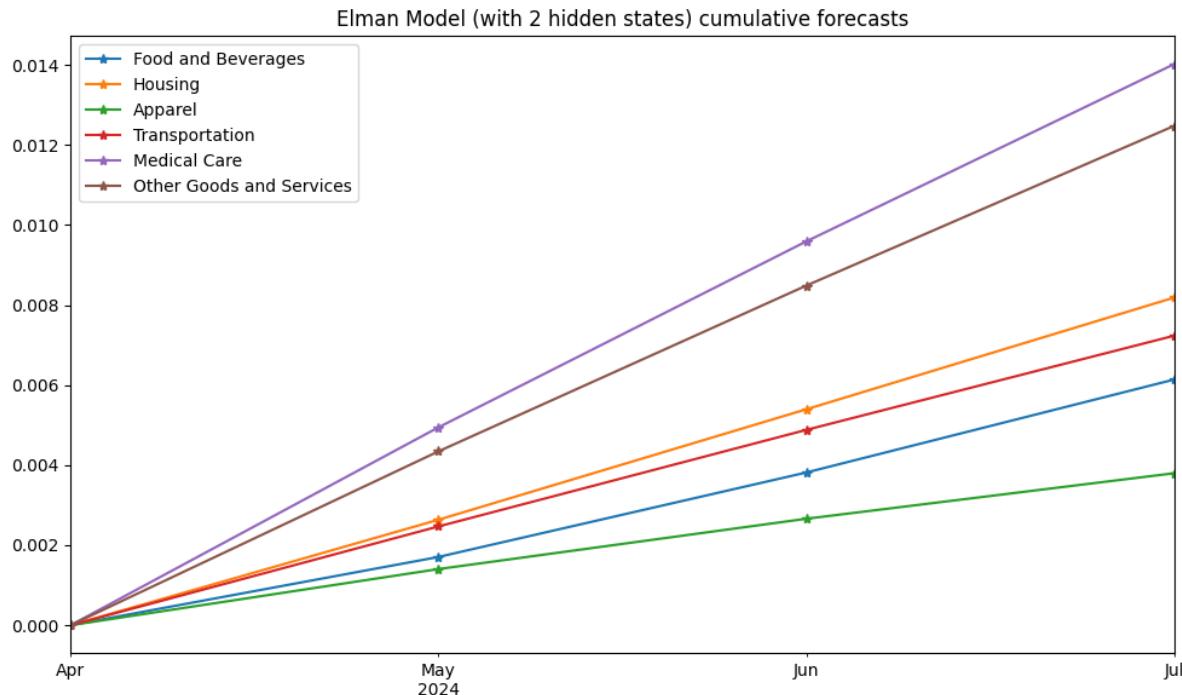
	Food and Beverages	Housing	Apparel	Transportation	Medical Care	\
2024-04	0.000000	0.000000	0.000000	0.000000	0.000000	
2024-05	0.001705	0.002635	0.001403	0.002468	0.004944	
2024-06	0.002111	0.002760	0.001257	0.002412	0.004646	
2024-07	0.002322	0.002791	0.001137	0.002353	0.004429	
Other Goods and Services						
2024-04	0.000000					
2024-05	0.004344					
2024-06	0.004142					
2024-07	0.003991					

```
# Plot forecasts
fig, ax = plt.subplots(figsize=(10, 6))
```

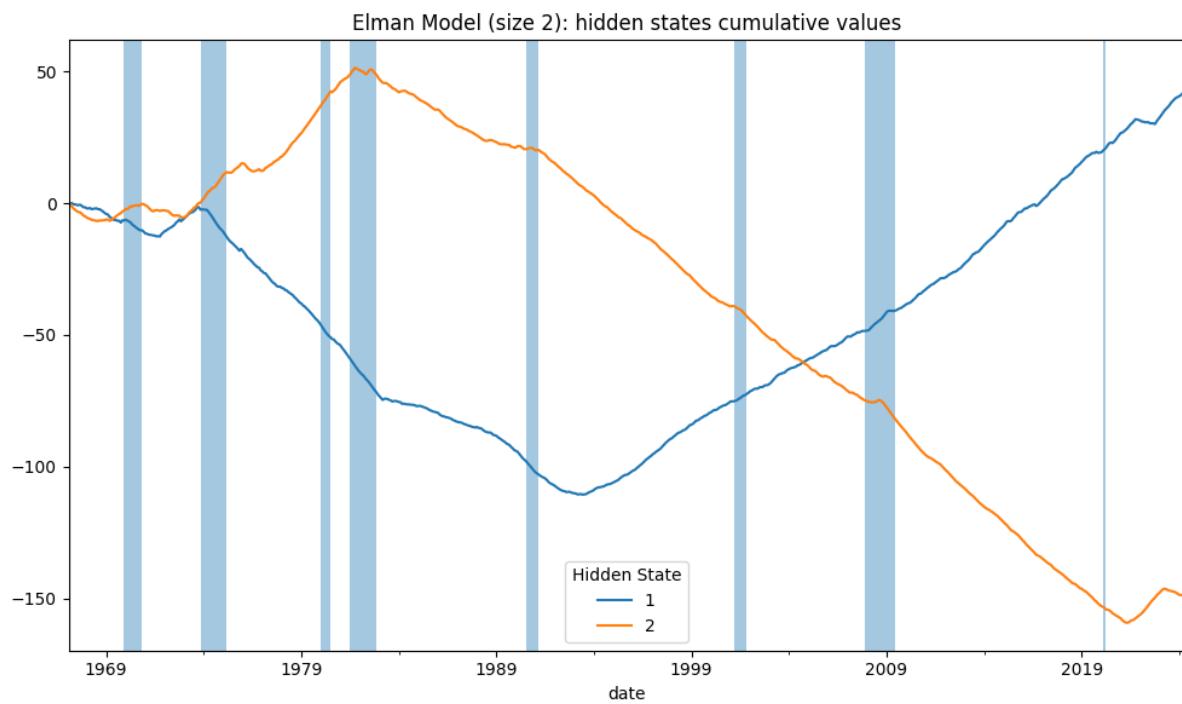
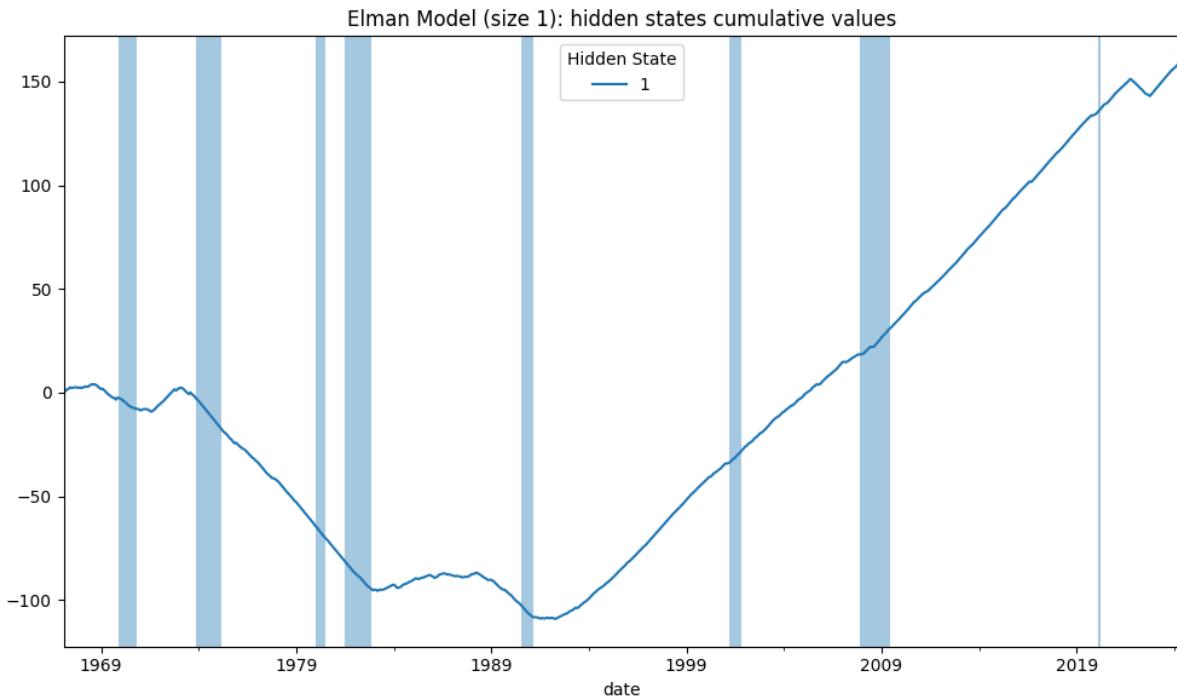
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```
forecasts.cumsum().plot(ax=ax, marker='*')
ax.set_title(f"Elman Model (with {K} hidden states) cumulative forecasts")
plt.tight_layout()
```



```
# Plot RNN hidden states values
for k, hidden in hidden_states.items():
    fig, ax = plt.subplots(figsize=(10, 6))
    hidden = DataFrame(np.array(hidden), index=scaled_data.index,
                      columns=[f"i+1" for i in range(k)])
    hidden.cumsum().plot(ax=ax, style='--')
    for a,b in vspans:
        if a >= min(hidden.index):
            ax.axvspan(a, min(b, max(hidden.index)), alpha=0.4)
    ax.legend(title='Hidden State')
    ax.set_title(f"Elman Model (size {k}): hidden states cumulative values")
    plt.tight_layout()
```



31.2 Dynamic Factor Models

The basic model is:

$$y_t = \Lambda f_t + \epsilon_t$$

$$f_t = A_1 f_{t-1} + \cdots + A_2 f_{t-2} + u_t$$

where:

- y_t is observed data at time t
- ϵ_t is idiosyncratic disturbance at time t
- f_t is the unobserved factor at time t
- $u_t \sim N(0, Q)$ is the factor disturbance at time t
- Λ is referred to as the matrix of factor loadings
- A_i are matrices of autoregression coefficients

The `DynamicFactorMQ` model in `statsmodels` package uses the EM algorithm for parameter fitting, and so can accommodate a large number of observed variables. Specifications of the model can include any collection of blocks of factors, including different factor autoregression orders, and AR(1) processes for idiosyncratic disturbances. It can incorporate monthly/quarterly mixed frequency data, which allows for Nowcasting models.

```
# Fit ar lags with best BIC
dynamic_factors = dict()
models = {}
K = 2
for ar in range(1, 5):
    mod = sm.tsa.DynamicFactorMQ(endog=scaled_data,
                                  factors=1,                      # num factor blocks
                                  factor_multiplicities=K,          # num factors in block
                                  factor_orders=ar,                # order of factor VAR
                                  idiosyncratic_ar1=True)
    fitted = mod.fit(disp=20 * bool(VERBOSE),
                      maxiter=1000,
                      full_output=True)
    models[ar] = dict(bic=fitted.bic,
                      mse=fitted.mse,
                      summary=fitted.summary().tables[0],
                      predict=fitted.predict(),
                      forecast=fitted.forecast(nforecast),
                      params=len(fitted.param_names))
    dynamic_factors[ar] = DataFrame(fitted.factors.filtered)
    dynamic_factors[ar].columns = np.arange(1, K+1)
    print(DataFrame(dict(bic=fitted.bic,
                          mse=fitted.mse,
                          parameters=len(fitted.param_names)),
                  index=[ar]))
del fitted
del mod
gc.collect()
```

```

          bic      mse  parameters
1  10336.076878  4.277298      31
          bic      mse  parameters
2  10357.094374  4.273679      35
          bic      mse  parameters
3  10360.490386  4.238931      39
          bic      mse  parameters
4  10377.211151  4.233325      43

```

```

# AR model with best bic
best, model = min(models.items(), key=lambda item: item[1]['bic'])
mse = mean_squared_error(scaled_data, model['predict'])
print('Best lag:', best, ' bic:', model['bic'])
print(model['summary'])

```

```

Best lag: 1    bic: 10336.076878452934
                                         Dynamic Factor Results
=====
Dep. Variable:      "Food and Beverages", and 5 more    No. Observations: 687
Model:                  Dynamic Factor Model    Log Likelihood -5066.787
                         + 2 factors in 1 blocks    AIC 10195.575
                                         + AR(1) idiosyncratic    BIC 10336.077
Date:                  Mon, 27 May 2024    HQIC 10249.934
Time:                  14:39:53    EM Iterations 221
Sample:                 02-28-1967
                         - 04-30-2024
Covariance Type:    Not computed
=====
```

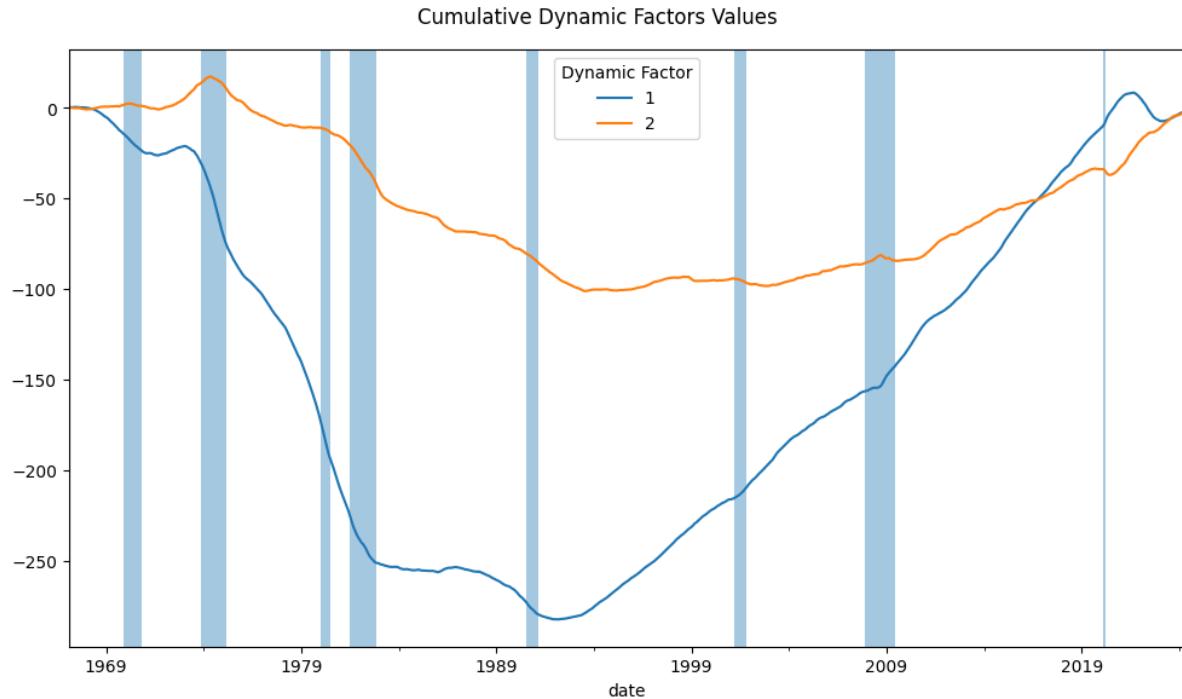
```

# Plot dynamic factors
dynamic_factor = dynamic_factors[best]
fig, ax = plt.subplots(figsize=(10, 6))
dynamic_factor.cumsum().plot(ax=ax, style='--')
ax.legend(title='Dynamic Factor')
for a,b in vspans:
    if a >= min(dynamic_factor.index):
        ax.axvspan(a, min(b, max(dynamic_factor.index)), alpha=0.4)
plt.suptitle(f"Cumulative Dynamic Factors Values")
plt.tight_layout()

# Show forecasts of selected series
print('Dynamic Factor Model Train MSE:',
      mean_squared_error(scaled_data.iloc[1:ntrain+1],
                          model['predict'].iloc[1:ntrain+1]))
print('Dynamic Factor Model Test MSE:',
      mean_squared_error(scaled_data.iloc[ntrain+1:],
                          model['predict'].iloc[ntrain+1:]))
print('Number of parameters:', model['params'])

```

```
Dynamic Factor Model Train MSE: 0.7115009239837685
Dynamic Factor Model Test MSE: 0.7963197085903823
Number of parameters: 31
```



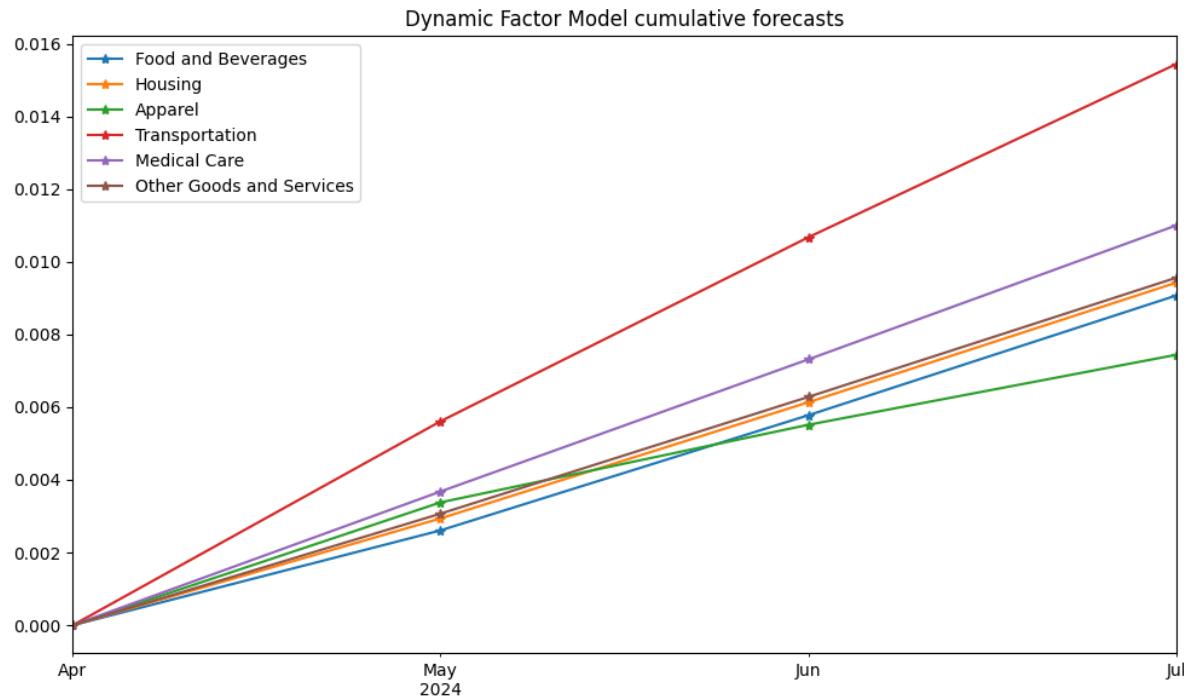
```
model_out = scaler.inverse_transform(model['forecast'].iloc[:nforecast])
model_out = DataFrame(np.vstack((np.zeros(n_features), model_out)),
                      index=pd.PeriodIndex(t, freq='M'), columns=scaled_data.columns)
print("Monthly forecasts from Dynamic Factor Model")
model_out
```

Monthly forecasts from Dynamic Factor Model

	Food and Beverages	Housing	Apparel	Transportation	Medical Care	\
2024-04	0.000000	0.000000	0.000000	0.000000	0.000000	
2024-05	0.002610	0.002940	0.003380	0.005612	0.003679	
2024-06	0.003168	0.003195	0.002135	0.005062	0.003635	
2024-07	0.003294	0.003290	0.001925	0.004764	0.003685	

	Other Goods and Services
2024-04	0.000000
2024-05	0.003070
2024-06	0.003211
2024-07	0.003279

```
# Plot forecasts
fig, ax = plt.subplots(figsize=(10, 6))
model_out.cumsum().plot(ax=ax, marker='*')
ax.set_title(f"Dynamic Factor Model cumulative forecasts")
plt.tight_layout()
```



```
# RNN hidden state values explained by dynamic factors
rsq = dict()
for k, hidden_state in enumerate(np.array(hidden_states[2]).T):
    rsq[k+1] = sm.OLS(hidden_state, sm.add_constant(dynamic_factor).fillna(0))\
        .fit()
print('Proportion of variance of RNN hidden state values ' +
      'explained by dynamic factors:',
      np.mean([r.rsquared for r in rsq.values()]).round(4))
DataFrame({k: [r.rsquared, r.f_pvalue] for k, r in rsq.items()},
          index=['R-square', 'pvalue'])\
    .rename_axis(columns='Hidden State')\
    .round(4)
```

Proportion of variance of RNN hidden state values explained by dynamic factors: 0.
7325

Hidden State	1	2
R-square	0.7409	0.724
pvalue	0.0000	0.000

CHAPTER
THIRTYTWO

CONVOLUTIONAL NEURAL NETWORKS

Life can only be understood backwards; but it must be lived forwards. - Søren Kierkegaard

Concepts

- Temporal Convolutional Net (TCN)
- Vector Autoregression

References

- Philipp Krahenbuhl, 2020, “CS395T Deep Learning course materials”, retrieved from http://www.philkr.net/dl_class/material

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
import random
import torch
import torch.nn as nn
import torchinfo
from statsmodels.tsa.api import VAR
from sklearn.preprocessing import StandardScaler
from sklearn.metrics import mean_squared_error
from finds.structured import BusDay
from finds.readers import Alfred
from secret import credentials
# %matplotlib qt
VERBOSE = 0
device = torch.device("cuda" if torch.cuda.is_available() else "cpu")
```

```
# train-test split date
split_date = '2021-12-01' # training period up to this date
```

```
# up to max number p of VAR(p) lags
maxlags = 6
```

```
alf = Alfred(api_key=credentials['fred']['api_key'], verbose=-1)
vspan = alf.date_spans('USREC') # recession periods for plots
```

```
# CPI for U.S. City Average: Monthly, Seasonally Adjusted
# https://fred.stlouisfed.org/release/tables?rid=10&eid=34483
```

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```
# 'CUSR0000SEEA'
series_ids = ['CPIFABSL', 'CPIHOSSL', 'CPIAPPSL', 'CPITRNSL', 'CPIMEDSL', 'CPIOGSSL']
df = pd.concat([alf(s, log=1, diff=1) for s in series_ids], axis=1) \
    .dropna() \
    .sort_index()
df.index = BusDay.to_datetime(df.index)
df.index.freq = 'M'      # set index to datetime type and freq = 'M'
```

```
/tmp/ipykernel_602057/4272565358.py:9: FutureWarning: 'M' is deprecated and will be removed in a future version, please use 'ME' instead.
  df.index.freq = 'M'      # set index to datetime type and freq = 'M'
```

```
names = [s[s.find(':')+2:s.find(' in ')] for s in alf.header(series_ids)]
names
```

```
['Food and Beverages',
 'Housing',
 'Apparel',
 'Transportation',
 'Medical Care',
 'Other Goods and Services']
```

```
# Standardize the data data
scaler = StandardScaler().fit(df)
scaled_data = DataFrame(scaler.transform(df), columns=names, index=df.index)
scaled_data
```

	Food and Beverages	Housing	Apparel	Transportation	...
date					
1967-02-28	-1.514294	-1.123374	0.528419	0.262158	
1967-03-31	-0.803761	-1.123374	0.117546	-0.270473	
1967-04-30	-1.516345	-0.064928	0.523552	0.258920	
1967-05-31	-0.803761	-0.068382	0.115127	-0.006978	
1967-06-30	1.327849	-1.123374	0.518742	-0.270473	
...
2023-12-31	-0.305673	-0.150090	-0.300364	-0.226813	
2024-01-31	0.136279	0.874513	-1.728819	-0.823810	
2024-02-29	-0.763532	0.154003	0.841913	0.932892	
2024-03-31	-0.555699	0.155815	1.046454	0.409135	
2024-04-30	-0.757514	-0.408180	2.163913	0.318836	
	Medical Care	Other Goods and Services			
date					
1967-02-28	-0.260945		-1.020565		
1967-03-31	-0.265522		-0.290026		
1967-04-30	0.977131		-1.020565		
1967-05-31	-0.279054		-0.292134		
1967-06-30	0.950357		-0.294231		
...		
2023-12-31	-0.199913		-0.950240		
2024-01-31	0.045640		0.340696		
2024-02-29	-1.610667		-1.786460		
2024-03-31	0.152838		-0.080117		

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2024-04-30 0.016674 0.048790

[687 rows x 6 columns]

```
ntrain = sum(scaled_data.index < split_date)
M = scaled_data.shape[1]      # M is number of time series
```

32.1 Temporal Convolutional Net (TCN)

- convolution as a filter such as a weighted average
- hyperparameters:
 - dropout
 - hidden layers and size
 - batch size and shuffling

TODO:

- example of 1D 2-channel and weighted average

```
class TCN(torch.nn.Module):
    class CausalConv1dBlock(torch.nn.Module):
        """Conv1d block with ReLU, skip, dropout, dilation and padding"""

        def __init__(self, in_channels, out_channels, kernel_size, dilation,
                     dropout):
            super().__init__()

            # print('kernel', kernel_size, 'dilation', dilation)
            self.network = torch.nn.Sequential(
                torch.nn.ConstantPad1d(((kernel_size-1)*dilation, 0), 0),
                torch.nn.Conv1d(in_channels, out_channels, kernel_size,
                               dilation=dilation),
                torch.nn.ReLU(),
                torch.nn.ConstantPad1d(((kernel_size-1)*dilation, 0), 0),
                torch.nn.Conv1d(out_channels, out_channels, kernel_size,
                               dilation=dilation),
                torch.nn.ReLU(),
                torch.nn.Dropout(dropout))
            self.skip = lambda x: x
            if in_channels != out_channels:  # downsample for skip if necessary
                self.skip = torch.nn.Conv1d(in_channels, out_channels, 1)

        def forward(self, x):
            return self.network(x) + self.skip(x)  # with skip connection

    def __init__(self, n_features, blocks, kernel_size, dropout):
        """TCN model by connecting multiple convolution layers"""
        super().__init__()
        in_channels = n_features
        L = []
```

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```

for dilation, hidden in enumerate(blocks):
    L.append(self.CausalConv1dBlock(in_channels=in_channels,
                                    out_channels=hidden,
                                    kernel_size=kernel_size,
                                    dilation=2**dilation,
                                    dropout=dropout))
    in_channels = hidden
self.network = torch.nn.Sequential(*L) if L else lambda x: x
if L:
    self.classifier = torch.nn.Conv1d(in_channels, n_features, 1)
else:
    self.classifier = torch.nn.Sequential(
        torch.nn.ConstantPad1d((kernel_size-1, 0), 0),
        torch.nn.Conv1d(in_channels, n_features, kernel_size))

def forward(self, x):
    """input is (B, n_features, L)), linear expects (B, * n_features)"""
    return self.classifier(self.network(x))

def save(self, filename):
    """save model state to filename"""
    return torch.save(self.state_dict(), filename)

def load(self, filename):
    """load model name from filename"""
    self.load_state_dict(torch.load(filename, map_location='cpu'))
    return self

```

```

# Model training parameters
seq_len = 8          # length of each input sequence for TCN
batch_size = 16
step_size = 100       # learning rate scheduler step size
lr = 0.01            # initial learning rate
num_lr = 3
num_epochs = step_size * num_lr
results = {}          # to collect evaluate results
train_loss = {}

```

```

# Form input data from training set
n_features = scaled_data.shape[1]      # number of input planes
train_exs = [scaled_data.iloc[(i - seq_len):(i + 1)].values
            for i in range(seq_len, ntrain)]

```

Train a 1D Convolution Model

```

model = torch.nn.Conv1d(n_features, n_features, kernel_size=1).to(device)
print(model)
print(torchinfo.summary(model))
modelname = "1D-Convolution"
train_loss[modelname] = []
optimizer = torch.optim.Adam(model.parameters())
loss_function = nn.MSELoss()

```

```
Conv1d(6, 6, kernel_size=(1,), stride=(1,))
=====
Layer (type:depth-idx)           Param #
=====
Conv1d                                42
=====
Total params: 42
Trainable params: 42
Non-trainable params: 0
=====
```

```
# train_ex should have dimension (batch size, channels, sequence length+1)
train_ex = torch.tensor(scaled_data.values[:ntrain].T) [None,:,:,:].float().to(device)
```

```
for epoch in range(num_epochs):
    for _ in range(batch_size):
        total_loss = 0.0
        model.train()
        model.zero_grad()
        X = train_ex[:, :, :-1]
        Y = train_ex[:, :, 1:]
        output = model(X)
        loss = loss_function(output, Y)  # calculated over all outputs
        total_loss += float(loss)
        loss.backward()
        optimizer.step()

        model.eval()
    train_loss[modelname].append(total_loss)

    X = torch.tensor(scaled_data.values.T) [None,:,:,:].float().to(device)
    pred = model(X).cpu().detach().numpy() [0,:,:,:].T
    results[modelname] = {
        'Train Error': mean_squared_error(scaled_data.values[1:ntrain],
                                           pred[:ntrain-1]),
        'Test Error': mean_squared_error(scaled_data.values[ntrain:],
                                         pred[ntrain-1:-1])
    }
```

```
conv1d_weights = np.vstack([model.bias.cpu().detach().numpy(),
                           model.weight.cpu().detach().numpy()[:, :, 0].T])
```

Fit TCN models

```
for block, kernel_size, dropout in [[1,1,0], [1,2,0], [2,1,0], [2,2,0],
                                    [1,1,0.5], [1,2,0.5], [2,1,0.5], [2,2,0.5]]:
    modelname = f"TCN(b={block},k={kernel_size},d={dropout:.1f})"
    train_loss[modelname] = []

    # Set model, optimizer, loss function and learning rate scheduler
    model = TCN(n_features=n_features,
                blocks=[n_features]*block,
                kernel_size=kernel_size,
                dropout=dropout).to(device)
```

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```

print()
print('*****', modelname, '*****')
print(model)
print(torchinfo.summary(model))

optimizer = torch.optim.Adam(model.parameters(), lr=lr)
scheduler = torch.optim.lr_scheduler.StepLR(
    optimizer, gamma=0.1, step_size=step_size
)
loss_function = nn.MSELoss()

# Run training loop over num_epochs with batch_size
num_epochs = step_size * num_lr
for epoch in range(num_epochs):

    # shuffle idxs into batches
    idxs = np.arange(len(train_exs))
    random.shuffle(idxs)
    batches = [idxs[i:min(len(idxs), i + batch_size)]
               for i in range(0, len(idxs), batch_size)]

    # train by batch
    total_loss = 0.0
    model.train()
    for batch in batches:
        # input has shape (batch_size, n_features, seq_len)
        # Creating a tensor from a list of numpy.ndarrays is extremely slow.
        npararray = np.array([[train_exs[idx][seq] for idx in batch]
                             for seq in range(seq_len+1)])
        train_ex = torch.tensor(npararray).permute(1, 2, 0).float().to(device)
        model.zero_grad()
        X = train_ex[:, :, :-1]
        Y = train_ex[:, :, 1:]
        output = model(X)
        loss = loss_function(output, Y) # calculated over all outputs
        total_loss += float(loss) / len(batches)
        loss.backward()
        optimizer.step()
        scheduler.step()

    model.eval()
    train_loss[modelname].append(total_loss)
    if VERBOSE and (epoch % (step_size//2)) == 0:
        print(epoch, num_epochs, optimizer.param_groups[0]['lr'], total_loss)

    # Compute MSE of one-period ahead forecast error in train and test sets
    X = torch.tensor(scaled_data.values.T) [None, :, :].float().to(device)
    pred = model(X).cpu().detach().numpy() [0, :, :].T
    results[modelname] = {
        'Train Error': mean_squared_error(scaled_data.values[1:ntrain],
                                           pred[:ntrain-1]),
        'Test Error': mean_squared_error(scaled_data.values[ntrain:],
                                         pred[ntrain-1:-1])
    }
    #print('Blocks:', block, 'Kernel size:', kernel_size, results[modelname])
    #print(pd.concat(res, axis=1).T)

```

```
***** TCN(b=1, k=1, d=0.0) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(0, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(0, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0, inplace=False)
            )
        )
    )
    (classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #
=====
TCN                                --
|---Sequential: 1-1                --
|   |---CausalConv1dBlock: 2-1    --
|   |   |---Sequential: 3-1      84
|   |---Conv1d: 1-2                42
=====
Total params: 126
Trainable params: 126
Non-trainable params: 0
=====

***** TCN(b=1, k=2, d=0.0) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(1, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(1, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0, inplace=False)
            )
        )
    )
    (classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #
=====
TCN                                --
|---Sequential: 1-1                --
|   |---CausalConv1dBlock: 2-1    --
|   |   |---Sequential: 3-1      156
|   |---Conv1d: 1-2                42
=====
```

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```

Total params: 198
Trainable params: 198
Non-trainable params: 0
=====
***** TCN(b=2, k=1, d=0.0) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(0, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(0, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0, inplace=False)
            )
        )
        (1): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(0, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,), dilation=(2,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(0, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,), dilation=(2,))
                (5): ReLU()
                (6): Dropout(p=0, inplace=False)
            )
        )
    )
    (classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #
=====
TCN                                --
|  └Sequential: 1-1                 --
|      └CausalConv1dBlock: 2-1      --
|          |  └Sequential: 3-1      84
|          └CausalConv1dBlock: 2-2      --
|              |  └Sequential: 3-2      84
|  └Convid: 1-2                     42
=====
Total params: 210
Trainable params: 210
Non-trainable params: 0
=====
***** TCN(b=2, k=2, d=0.0) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(1, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
            )
        )
    )
)

```

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```

        (2): ReLU()
        (3): ConstantPad1d(padding=(1, 0), value=0)
        (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
        (5): ReLU()
        (6): Dropout(p=0, inplace=False)
    )
)
(1): CausalConv1dBlock(
    network): Sequential(
        (0): ConstantPad1d(padding=(2, 0), value=0)
        (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,), dilation=(2,))
        (2): ReLU()
        (3): ConstantPad1d(padding=(2, 0), value=0)
        (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,), dilation=(2,))
        (5): ReLU()
        (6): Dropout(p=0, inplace=False)
    )
)
)
(classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #
=====
TCN
├ Sequential: 1-1               --
| └ CausalConv1dBlock: 2-1      --
|   | └ Sequential: 3-1        156
|   | └ CausalConv1dBlock: 2-2  --
|   | └ Sequential: 3-2        156
└ Conv1d: 1-2                  42
=====
Total params: 354
Trainable params: 354
Non-trainable params: 0
=====
***** TCN(b=1,k=1,d=0.5) *****
TCN(
    network): Sequential(
        (0): CausalConv1dBlock(
            network): Sequential(
                (0): ConstantPad1d(padding=(0, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(0, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0.5, inplace=False)
            )
        )
    )
(classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #

```

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```
=====
TCN
|---Sequential: 1-1
|   |---CausalConv1dBlock: 2-1
|   |   |---Sequential: 3-1
|   |   |   84
|---Conv1d: 1-2
|   42
=====
Total params: 126
Trainable params: 126
Non-trainable params: 0
=====

***** TCN(b=1,k=2,d=0.5) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(1, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(1, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0.5, inplace=False)
            )
        )
    )
    (classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====

Layer (type:depth-idx)           Param #
=====
TCN
|---Sequential: 1-1
|   |---CausalConv1dBlock: 2-1
|   |   |---Sequential: 3-1
|   |   |   156
|---Conv1d: 1-2
|   42
=====
Total params: 198
Trainable params: 198
Non-trainable params: 0
=====

***** TCN(b=2,k=1,d=0.5) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(0, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(0, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
                (5): ReLU()
                (6): Dropout(p=0.5, inplace=False)
            )
        )
    )
)
=====
```

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```

        )
    (1): CausalConv1dBlock(
        (network): Sequential(
            (0): ConstantPad1d(padding=(0, 0), value=0)
            (1): Conv1d(6, 6, kernel_size=(1,), stride=(1,), dilation=(2,))
            (2): ReLU()
            (3): ConstantPad1d(padding=(0, 0), value=0)
            (4): Conv1d(6, 6, kernel_size=(1,), stride=(1,), dilation=(2,))
            (5): ReLU()
            (6): Dropout (p=0.5, inplace=False)
        )
    )
)
(classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
)
=====
Layer (type:depth-idx)           Param #
=====
TCN
├ Sequential: 1-1               --
|  └ CausalConv1dBlock: 2-1     --
|  |  └ Sequential: 3-1       84
|  |  └ CausalConv1dBlock: 2-2   --
|  |  |  └ Sequential: 3-2     84
|  └ Conv1d: 1-2               42
=====
Total params: 210
Trainable params: 210
Non-trainable params: 0
=====

***** TCN(b=2,k=2,d=0.5) *****
TCN(
    (network): Sequential(
        (0): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(1, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(1, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,))
                (5): ReLU()
                (6): Dropout (p=0.5, inplace=False)
            )
        )
        (1): CausalConv1dBlock(
            (network): Sequential(
                (0): ConstantPad1d(padding=(2, 0), value=0)
                (1): Conv1d(6, 6, kernel_size=(2,), stride=(1,), dilation=(2,))
                (2): ReLU()
                (3): ConstantPad1d(padding=(2, 0), value=0)
                (4): Conv1d(6, 6, kernel_size=(2,), stride=(1,), dilation=(2,))
                (5): ReLU()
                (6): Dropout (p=0.5, inplace=False)
            )
        )
    )
)

```

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```

        )
        (classifier): Conv1d(6, 6, kernel_size=(1,), stride=(1,))
    )
=====

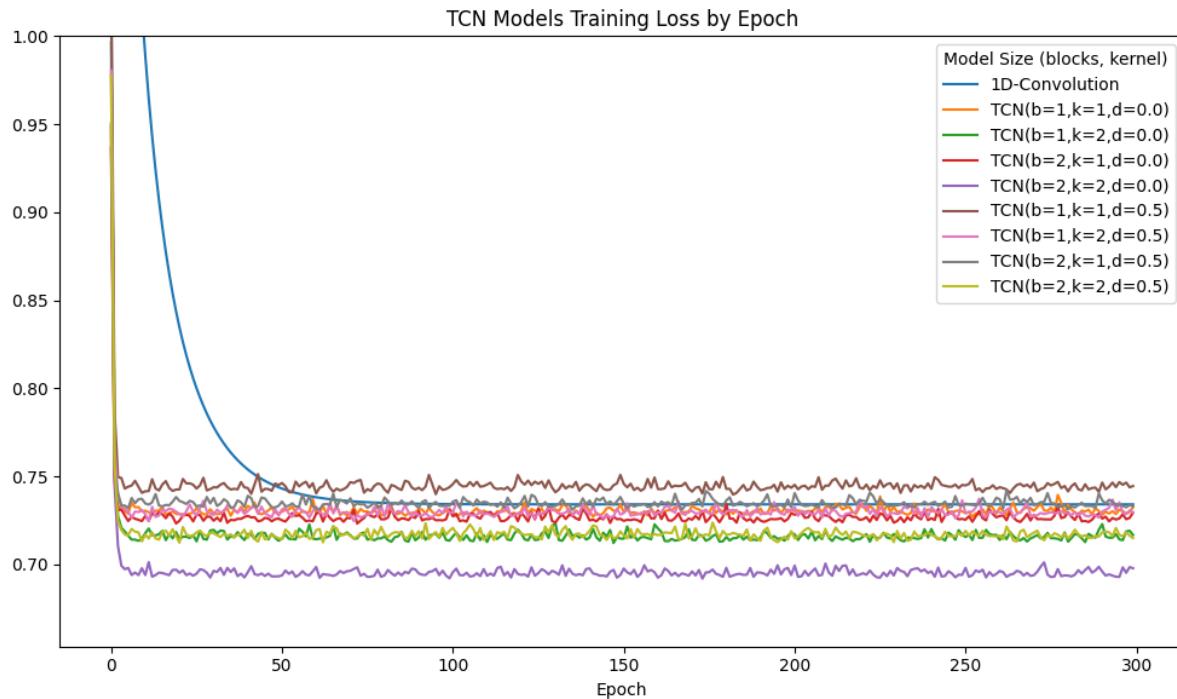
```

Layer (type:depth-idx)	Param #
TCN	--
—Sequential: 1-1	--
—CausalConv1dBlock: 2-1	--
— —Sequential: 3-1	156
—CausalConv1dBlock: 2-2	--
— —Sequential: 3-2	156
—Conv1d: 1-2	42
Total params: 354	
Trainable params: 354	
Non-trainable params: 0	

```

fig, ax = plt.subplots(figsize=(10, 6))
DataFrame(train_loss).plot(ax=ax)
ax.set_ylim(top=1.0)
ax.set_title(f"TCN Models Training Loss by Epoch")
ax.set_xlabel('Epoch')
ax.legend(title='Model Size (blocks, kernel)')
plt.tight_layout()

```



```

print('Sorted by Test Error')
DataFrame(results).T.sort_values('Test Error')

```

Sorted by Test Error

	Train Error	Test Error
TCN (b=2, k=1, d=0.5)	0.730975	0.797471
1D-Convolution	0.734049	0.804834
TCN (b=1, k=1, d=0.0)	0.730197	0.823324
TCN (b=2, k=2, d=0.5)	0.703123	0.825678
TCN (b=1, k=2, d=0.5)	0.716962	0.852393
TCN (b=1, k=1, d=0.5)	0.735571	0.865943
TCN (b=1, k=2, d=0.0)	0.708393	0.877891
TCN (b=2, k=1, d=0.0)	0.726959	0.881181
TCN (b=2, k=2, d=0.0)	0.706048	0.932908

32.2 Vector Autoregression

predict multiple time series (of the extracted approximate factors)

- vector autoregression as a weighted moving average

```
var_model = VAR(scaled_data.iloc[:ntrain], freq='ME')
```

32.2.1 Lag order

The lagged coefficients estimated from the Vector Autoregression produce a multi-period cumulative forecast

```
print("Optimal number of VAR(p) lags selected by various IC")
DataFrame({ic: var_model.fit(maxlags=maxlags, ic=ic).k_ar
           for ic in ['aic', 'fpe', 'hqic', 'bic'],
           index=['optimal p:'])\
           .rename_axis(columns='IC:')
```

Optimal number of VAR(p) lags selected by various IC

IC:	aic	fpe	hqic	bic
optimal p:	3	3	2	2

```
# Fit VAR(p) models
var_models = {p: var_model.fit(p) for p in range(1, maxlags+1)} # fit models
```

```
# Show model summary for VAR(1)
print(var_models[1].summary())
```

```
Summary of Regression Results
=====
Model:                      VAR
Method:                     OLS
Date: 2024-05-27 11:45:11
```

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Time: 14:50:03

No. of Equations:	6.00000	BIC:	-1.69952
Nobs:	657.000	HQIC:	-1.87519
Log likelihood:	-4898.92	FPE:	0.137188
AIC:	-1.98641	Det (Omega_mle):	0.128736

Results for equation Food and Beverages

prob	coefficient	std. error	t-stat
const	-0.002494	0.035539	-0.070
L1.Food and Beverages	0.310812	0.037875	8.206
L1.Housing	0.213124	0.043391	4.912
L1.Apparel	-0.003392	0.037857	-0.090
L1.Transportation	-0.005201	0.037952	-0.137
L1.Medical Care	-0.007755	0.042442	-0.183
L1.Other Goods and Services	0.009024	0.037218	0.242

Results for equation Housing

prob	coefficient	std. error	t-stat
const	-0.013239	0.027721	-0.478
L1.Food and Beverages	0.163946	0.029543	5.549
L1.Housing	0.494461	0.033845	14.609
L1.Apparel	0.038379	0.029529	1.300
L1.Transportation	0.072678	0.029603	2.455
L1.Medical Care	0.209727	0.033105	6.335
L1.Other Goods and Services	-0.022371	0.029031	-0.771

Results for equation Apparel

prob	coefficient	std. error	t-stat
------	-------------	------------	--------

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const		-0.007941	0.036635	-0.217
L1.Food and Beverages	0.828	0.031403	0.039043	0.804
L1.Housing	0.421	0.110336	0.044729	2.467
L1.Apparel	0.014	0.139551	0.039025	3.576
L1.Transportation	0.000	0.186002	0.039123	4.754
L1.Medical Care	0.007	0.117097	0.043751	2.676
L1.Other Goods and Services	0.851	0.007189	0.038366	0.187

Results for equation Transportation

	prob	coefficient	std. error	t-stat
const	0.996	0.000177	0.034475	0.005
L1.Food and Beverages	0.584	0.020122	0.036742	0.548
L1.Housing	0.085	0.072483	0.042092	1.722
L1.Apparel	0.324	0.036200	0.036724	0.986
L1.Transportation	0.000	0.422621	0.036816	11.479
L1.Medical Care	0.235	0.048914	0.041172	1.188
L1.Other Goods and Services	0.348	-0.033877	0.036105	-0.938

Results for equation Medical Care

	prob	coefficient	std. error	t-stat
const	0.342	0.027613	0.029051	0.951
L1.Food and Beverages	0.421	0.024938	0.030960	0.805
L1.Housing	0.000	0.234873	0.035469	6.622
L1.Apparel	0.164	0.043036	0.030946	1.391
L1.Transportation	0.875	0.004867	0.031023	0.157
L1.Medical Care		0.431491	0.034694	12.437

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↳ 0.000				
L1.Other Goods and Services	0.115051	0.030424	3.782	↳
↳ 0.000				

Results for equation Other Goods and Services

↳ prob	coefficient	std. error	t-stat	↳
const	-0.010534	0.037357	-0.282	↳
↳ 0.778				
L1.Food and Beverages	0.026800	0.039813	0.673	↳
↳ 0.501				
L1.Housing	0.077605	0.045611	1.701	↳
↳ 0.089				
L1.Apparel	0.095652	0.039795	2.404	↳
↳ 0.016				
L1.Transportation	0.017545	0.039894	0.440	↳
↳ 0.660				
L1.Medical Care	0.257502	0.044614	5.772	↳
↳ 0.000				
L1.Other Goods and Services	0.011147	0.039123	0.285	↳
↳ 0.776				

Correlation matrix of residuals

	Food and Beverages	Housing	Apparel	Transportation	↳
↳ Medical Care	0.014996	1.000000	0.147115	0.084629	-0.001656
Food and Beverages		-0.008149			
↳ 0.095471		0.147115	1.000000	0.091234	0.132240
Housing		0.019458			
Apparel		0.084629	0.091234	1.000000	0.128269
Transportation		-0.001656	0.132240	0.128269	1.000000
↳ -0.053153		-0.013329			
Medical Care		0.014996	0.095471	0.036681	-0.053153
↳ 1.000000		0.153789			
Other Goods and Services		-0.008149	0.019458	0.024285	-0.013329
↳ 0.153789		1.000000			

Compare VAR(1) model coefficients to fitted weights of 1D convolution

```
print('Coefficients of VAR(1) model')
DataFrame(np.vstack([var_models[1].intercept, var_models[1].coefs[0].T]),
          columns=var_models[1].names, index=var_models[1].exog_names).round(4)
```

Coefficients of VAR(1) model

	Food and Beverages	Housing	Apparel	\\
const	-0.0025	-0.0132	-0.0079	
L1.Food and Beverages	0.3108	0.1639	0.0314	

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L1.Housing	0.2131	0.4945	0.1103
L1.Apparel	-0.0034	0.0384	0.1396
L1.Transportation	-0.0052	0.0727	0.1860
L1.Medical Care	-0.0078	0.2097	0.1171
L1.Other Goods and Services	0.0090	-0.0224	0.0072
	Transportation	Medical Care	\
const	0.0002	0.0276	
L1.Food and Beverages	0.0201	0.0249	
L1.Housing	0.0725	0.2349	
L1.Apparel	0.0362	0.0430	
L1.Transportation	0.4226	0.0049	
L1.Medical Care	0.0489	0.4315	
L1.Other Goods and Services	-0.0339	0.1151	
	Other Goods and Services		
const	-0.0105		
L1.Food and Beverages	0.0268		
L1.Housing	0.0776		
L1.Apparel	0.0957		
L1.Transportation	0.0175		
L1.Medical Care	0.2575		
L1.Other Goods and Services	0.0111		

```
print('Tensor weights of Conv1D')
DataFrame(conv1d_weights, columns=names, index=['bias'] + names).round(4)
```

Tensor weights of Conv1D

	Food and Beverages	Housing	Apparel	\
bias	-0.0025	-0.0132	-0.0079	
Food and Beverages	0.3108	0.1639	0.0314	
Housing	0.2131	0.4945	0.1103	
Apparel	-0.0034	0.0384	0.1396	
Transportation	-0.0052	0.0727	0.1860	
Medical Care	-0.0078	0.2097	0.1171	
Other Goods and Services	0.0090	-0.0224	0.0072	
	Transportation	Medical Care	\	
bias	0.0002	0.0276		
Food and Beverages	0.0201	0.0249		
Housing	0.0725	0.2349		
Apparel	0.0362	0.0430		
Transportation	0.4226	0.0049		
Medical Care	0.0489	0.4315		
Other Goods and Services	-0.0339	0.1151		
	Other Goods and Services			
bias	-0.0105			
Food and Beverages	0.0268			
Housing	0.0776			
Apparel	0.0957			
Transportation	0.0175			
Medical Care	0.2575			

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Other Goods and Services	0.0111
--------------------------	--------

```
# Calculate forecast errors for each observation and model
test_errors = {p: list() for p in range(maxlags+1)}
train_errors = {p: list() for p in range(maxlags+1)}
```

```
for i in range(maxlags, len(scaled_data)-1):
    data = scaled_data.iloc[i].values

    # test or train sample
    var_errors = train_errors if i < ntrain else test_errors

    # error of unconditional mean forecast
    var_errors[0].append(mean_squared_error(data, scaled_data.iloc[:ntrain].mean()))

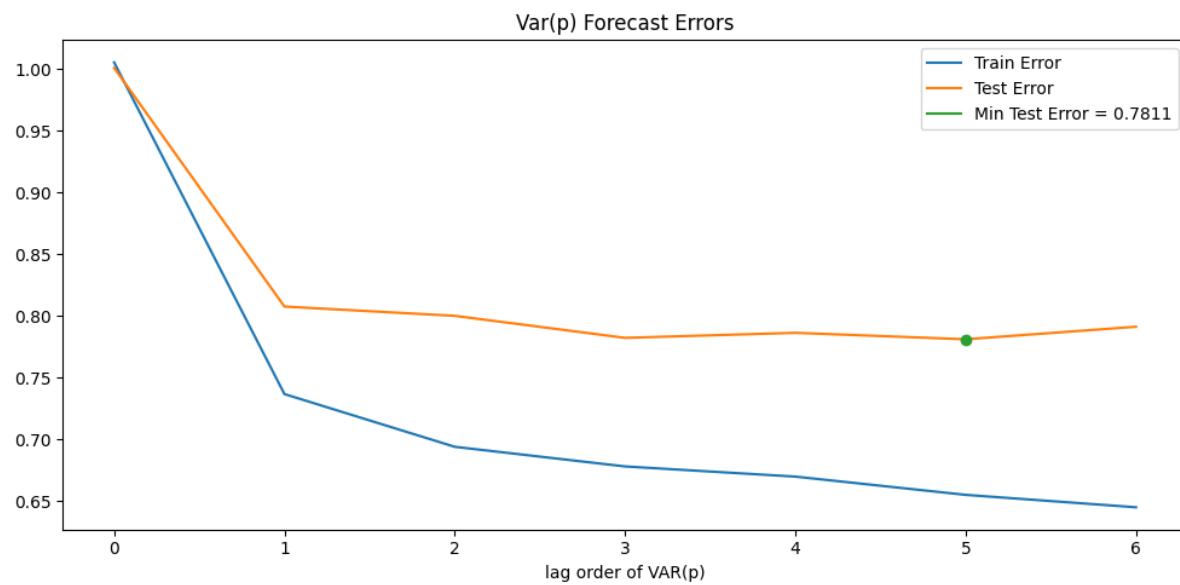
    # accumulate to error of VAR(p) model forecasts
    for p in range(1, maxlags+1):
        pred = var_models[p].forecast(scaled_data.iloc[:i].values, 1)
        var_errors[p].append(mean_squared_error(data.reshape(1, -1), pred))
```

```
# Collect mean test and train set errors of all VAR(p) models
print('VAR models train and test set errors')
out = DataFrame({'Train Error': {f"VAR({p})": np.mean(errors)
                                 for p, errors in train_errors.items()},
                  'Test Error': {f"VAR({p})": np.mean(errors)
                                 for p, errors in test_errors.items()}})
out
```

VAR models train and test set errors

	Train Error	Test Error
VAR(0)	1.005237	1.000794
VAR(1)	0.736693	0.807536
VAR(2)	0.694004	0.800034
VAR(3)	0.678115	0.782192
VAR(4)	0.669869	0.786281
VAR(5)	0.655099	0.781057
VAR(6)	0.645045	0.791213

```
# Plot Errors
fig, ax = plt.subplots(1, 1, figsize=(10, 5))
ax.plot(np.arange(len(out)), out['Train Error'], color="C0")
ax.plot(np.arange(len(out)), out['Test Error'], color="C1")
ax.plot([], [], color="C2") # dummy for legend labels
argmin = out['Test Error'].argmin()
ax.plot(argmin, out.iloc[argmin]['Test Error'], 'o', color="C2")
ax.set_title(f'Var(p) Forecast Errors')
ax.set_xlabel('lag order of VAR(p)')
ax.legend(['Train Error', 'Test Error',
          f'Min Test Error = {out.iloc[argmin]["Test Error"]:.4f}'],
          loc='upper right')
plt.tight_layout()
```



CHAPTER
THIRTYTHREE

REINFORCEMENT LEARNING

UNDER CONSTRUCTION

I have not failed. I've just found 10,000 ways that won't work - Thomas A. Edison

References:

- Richard S. Sutton and Andrew G. Barto, 2018, “Reinforcement Learning: An Introduction”, MIT Press.
- Christine Benz, Jeffrey Ptak John Rekenthaler, Dec. 12, 2022, “The State of Retirement Income: 2022. A look at how higher bond yields, lower equity valuations, and inflation affect starting safe withdrawal rates”, Morningstar Portfolio and Planning Research.

TODO:

- shortfall tail probability: (1) probability of shortfall (2) expected years of shortfall in 5% tail
- for historical simulation, save matrices to compare: does one model's matrix dominate another

```
from pandas import DataFrame, Series
import pandas as pd
import numpy as np
import math
import random
import matplotlib.pyplot as plt
from tqdm import tqdm
import numpy as np
import gymnasium as gym
from gymnasium import spaces
from stable_baselines3 import DQN
from typing import List, Tuple
from finds.database import SQL
from finds.structured import BusDay
from finds.utils import Store, subplots, set_xticks
from secret import credentials, paths
store = Store(paths['scratch'])
#pd.set_option('display.max_rows', None)
VERBOSE = 0
```

```
# open connections
sql = SQL(**credentials['sql'], verbose=VERBOSE)
bd = BusDay(sql, verbose=VERBOSE)
outdir = paths['scratch'] / 'RL'
```

Stocks, Bonds, Bills and Inflation

Using data beginning in 1926, the SBBI dataset includes monthly, quarterly, and yearly total returns and yields of most of the major U.S asset classes: large-cap stocks, small-cap stocks, corporate bonds, government bonds of several maturities, and inflation.

```
# Read sbbi data
sbbi_file = paths['data'] / 'SBBI/stocks-bonds-bills-and-inflation-data.xlsx'
df = pd.read_excel(sbbi_file,
                    sheet_name=0,
                    skiprows=list(range(9)) + [10],
                    header=0,
                    usecols='A,B,G,P',
                    index_col=0)
columns_official = df.columns.tolist()
df.columns = ['stocks', 'bonds', 'inflation']
df.index = bd.to_date(df.index)
df
```

	stocks	bonds	inflation
19260131	0.000000	0.013756	0.000000
19260228	-0.038462	0.006313	0.000000
19260331	-0.057471	0.004129	-0.005587
19260430	0.025305	0.007589	0.005618
19260531	0.017918	0.001412	-0.005587
...
20230228	-0.024399	-0.042743	0.005582
20230331	0.036714	0.042510	0.003311
20230430	0.015609	0.012058	0.005059
20230531	0.004347	-0.030476	0.002518
20230630	0.066075	-0.003346	0.003229

[1170 rows x 3 columns]

```
# Scenario generator: episode, backtest a sample path
class Episodes:
    def __init__(self, data: DataFrame, T: int, num_loops: int = 1):
        self.data = np.log(1 + data)
        self.high = list(self.data.max() + self.data.std()*.1)
        self.low = list(self.data.min() - self.data.std()*.1)
        self.T = T # number of years per episode
        self.M = (T + 1) * 12 # number of monthly observations per episode
        self.num_loops = num_loops

    def __len__(self):
        return (len(self.data) - self.M + 1) * self.num_loops

    def __iter__(self):
        rows = []
        for i in range(self.num_loops):
            rows += np.random.permutation(len(self.data) - self.M + 1).tolist()
        for t in rows:
            df = self.data.iloc[t:(t + self.M), :].reset_index(drop=True)
            yield df.groupby(df.index // 12) \
                .sum() \
                .set_index(self.data.index[(t + 11):(t + self.M):12])
```

Summary statistics of episodes

```

T = 30
means = {s: [] for s in df.columns}
episodes = Episodes(df, T=T)
for episode in iter(episodes):
    for s in df.columns:
        means[s].append(episode[s].mean())
print('30-year sample periods:')
DataFrame({s: np.mean(x) for s, x in means.items()} | {'N': len(episodes)},
           index=['annualized mean'])

```

30-year sample periods:

	stocks	bonds	inflation	N
annualized mean	0.105343	0.055095	0.036288	799

33.1 Retirement spending policy

We test the sensitivity of the common heuristic for retirement spending, a fixed annual withdrawal rate, on models driven by three key variables: the asset allocation of the portfolio, the market environment, and the length of the retiree's drawdown period. For example, the typical rule of a fixed 4% withdrawal rate (with annual inflation adjustment) for 50% stock/50% bond portfolios can be evaluated over rolling historical 30-year periods, to estimate the likelihood that a retiree would not run out of money over a 30-year time horizon.

Benz, Ptak and Rekenthaler (2022) found that “For retirees who seek a fixed real withdrawal from their portfolio in retirement, a starting withdrawal rate of 3.8% is safe in Morningstar’s model over a 30-year time horizon, assuming a 90% success rate (defined here as a 90% likelihood of not running out of funds) and a balanced portfolio.”

The default strategy is to rebalance each year to fixed initial allocation, and withdrawal is fixed at the given percent of initial wealth adjusted by annual inflation.

```

class BaseModel:
    """Buy-and-hold allocation model where assets weights drift from initial"""

    name = 'initial'
    def __init__(self, T: int, W: List[float]):
        assert W[-1] > 0           # spend must be positive
        self.initial = dict(T=int(T), W=np.array(W))

    def reset(self, market_changes: List[float]):
        self.T = int(self.initial["T"])
        self.W = np.array(self.initial["W"])
        return list(market_changes)

    def step(self, action: List, market_changes: List) -> Tuple:
        assert self.T > 0
        self.W[:-1] = np.array(action).flatten() * self.W[:-1].sum() # rebalance
        self.W = self.W * np.exp(np.array(market_changes))           # price changes
        self.T = self.T - 1
        wealth = sum(self.W[:-1]) # remaining wealth
        if wealth < self.W[-1]:
            truncated = True           # is not enough for spend
            self.W[:-1] = 0.0
        else:

```

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```

        truncated = False          # is sufficient for spend
        spend = self.W[:-1] * self.W[:-1] / wealth # allocate and deduct spending
        self.W[:-1] = self.W[:-1] - spend
    terminated = not self.T or truncated
    return terminated, truncated

def predict(self, obs: List) -> List:
    """Allow initial asset allocation to drift"""
    return self.W[:-1] / sum(self.W[:-1])

```

```

class FixedModel(BaseModel):
    """Allocation model where assets are rebalanced to fixed weights"""

    name = 'fixed'
    def predict(self, obs: List) -> List:
        """Action to rebalance asset allocation to fixed initial weight"""
        return self.initial['W'][:-1] / sum(self.initial['W'][:-1])

```

Base simulations of 50-50 4% spending policy over all 30-year sample periods

```

alloc = 50    # 50-50 stocks/bonds initial allocation
rule = 4.0    # 4 percent spending policy
model = BaseModel(T=T, W=[alloc, 100-alloc, rule])

```

```

result = {}
for n, episode in enumerate(iter(episodes)):
    obs = model.reset(episode.iloc[0])

    for year in episode.index[1:]:
        obs = episode.loc[year].to_list()
        action = model.predict(obs)
        terminated, truncated = model.step(action, obs)
        if truncated:
            break
    result[episode.index[0]] = model.T
prob = np.mean(np.array(list(result.values())) != 0)
print('Number of 30-year scenerios:', len(episodes))
print('Probability of shortfall: ', round(prob, 4))

```

```

Number of 30-year scenerios: 799
Probability of shortfall: 0.0763

```

```

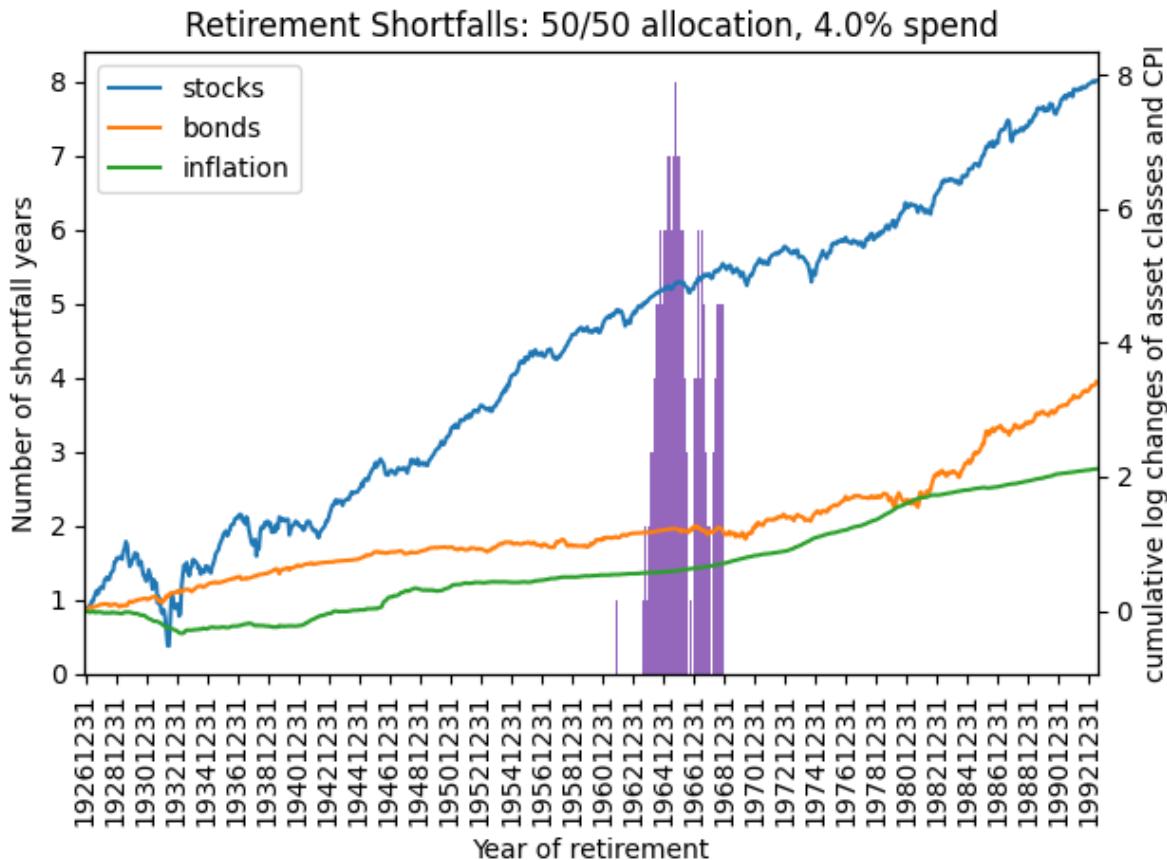
fails = Series(result).sort_index().rename('shortfall_years')
market = df.reindex(fails.index).cumsum()
fails.index = fails.index.astype(str)
ax = fails.plot(kind='bar', width=1.0, color='C4')
ax.set_title(f"Retirement Shortfalls: {alloc}/{100-alloc} allocation, {rule}% spend")
ax.set_ylabel('Number of shortfall years')
ax.set_xlabel('Year of retirement')
set_xticks(ax=ax, nskip=23, rotation=90)
bx = ax.twinx()
market.index = market.index.astype(str)
market.plot(ax=bx)

```

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```
bx.set_ylabel('cumulative log changes of asset classes and CPI')
bx.legend()
plt.tight_layout()
```



33.2 Deep reinforcement learning

Gymnasium (formerly OpenAI gym) custom environment **Gymnasium** provides a simply and pythonic interface for representing general Reinforcement Learning problems. It is a maintained fork of OpenAI's Gym library.

<https://gymnasium.farama.org/index.html>

pip install gymnasium

Stable Baselines3 (SB3) is a set of implementations of reinforcement learning algorithms in PyTorch.

<https://github.com/DLR-RM/stable-baselines3>

pip install stable-baselines3[extra]

Reward is $-(T\text{FAIL})$ if truncated else $\text{math.sqrt}(W / (S * (T+1)))$

- if insufficient: reward is -100 times square of remaining years
- else reward is a concave (sqrt) function of wealth to spending coverage
- when positive, prefer that wealth to remaining spending ratio is higher

Learns to predict action from observing current state, and exploiting/exploring

- current wealth and allocation,
- recent market (equity and bonds) and inflation changes
- spending amount
- years since retirement

Exploit action with greatest expected value

- value is recursive expectation: many algorithms e.g. “Q-learning”, “SARSA”

Explore actions that are not necessarily best (at the time) during training

- to gather information for improving decision

```
FAIL = 100      # failure reward factor
class CustomEnv(gym.Env):
    """Custom gymnasium environment, using Episodes scenario generator"""
    def __init__(self, model: BaseModel, episodes: Episodes):
        super().__init__()
        self.model = model          # for stepping through a 30-year episode
        self.episodes = episodes    # for generating a sample 30-year episode
        self.iterator = iter(self.episodes) # iterator to reset a 30-year sample
        T = self.model.initial['T']
        W = self.model.initial['W']
        low = np.array([0] + episodes.low + [0]*len(W))
        high = np.array([T] + episodes.high + [T]*len(W))
        self.observation_space = spaces.Box(low=low, high=high)
        self.action_space = spaces.Discrete(21)
        #self.action_space = spaces.Box(low=0.0, high=1.0)

    def reset(self, seed=0):
        super().reset(seed=seed)

        # generate a fresh 30-year episode
        self.episode = next(self.iterator, None)
        if self.episode is None:
            self.iterator = iter(self.episodes)
            self.episode = next(self.iterator)
        self.n = 0

        # return initial observations
        deltas = self.model.reset(self.episode.iloc[self.n])
        obs = [self.model.T] + list(deltas) + self.model.W.tolist()
        return obs, {}

    def step(self, action):
        S = self.model.W[-1]          # amount to spend at t-1
        W = np.sum(self.model.W[:-1]) # wealth at t-1
        T = self.model.T              # year remaining till termination

        # Convert action to asset allocation weights
        action = action * 0.05
        action = np.array([action, 1-action])

        # Grab next market move at time t
        self.n = self.n + 1
```

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```

deltas = self.episode.iloc[self.n].tolist()

# Apply rebalance wealth and market move (t=1)
terminated, truncated = self.model.step(action, deltas)

# Calculate reward (t=1)
reward = -(T*T*FAIL) if truncated else math.sqrt(W / (S*T))

# Return as next observation
obs = [T] + list(deltas) + self.model.W.tolist()
return obs, reward, terminated, {}

```

Helpers to evaluate trained model

```

def compute_shortfall(x, q):
    """Compute expected years of shortfall given probability level"""
    x = sorted(x)
    q = int(q * len(x))
    return x[q], np.mean(x[q:])

```

```

TAIL = 0.95
def evaluate(env, model, episodes):
    """Return success likelihood, shortfalls and asset allocation actions"""
    result = []
    actions = {t: [] for t in range(episodes.T + 1)} # to store predicted actions
    for n, episode in enumerate(episodes):
        obs, info = env.reset()
        terminated = False
        while not terminated:
            action, _states = model.predict(np.array(obs))
            actions[env.model.T].append(float(action))
            obs, rewards, terminated, truncated, info = env.step(action)
            result.append(env.model.T if truncated else 0)
    #print(n, truncated, action, rewards, env.model.W)
    return np.mean(np.array(result) != 0), *compute_shortfall(result, TAIL), actions

```

Stable Baselines 3 with DQN algorithm for discrete action spaces

DQN (Deep Q Network) provides vanilla Deep Q-Learning

```

initial_alloc = 50
rules = np.arange(3, 5.1, 0.1)

```

```

TIMESTEPS = int(5e5)
fail, actions, shortfall, quantile = {}, {}, {}, {}
for rule in tqdm(rules): # train a model for each spending rule

    # define and train model for this spending rule
    name = str(round(rule, 1))
    W = [initial_alloc, 100-initial_alloc, rule]
    env = CustomEnv(model=BaseModel(T=T, W=W), episodes=episodes)
    clf = DQN('MlpPolicy', env, verbose=VERBOSE)
    clf.learn(total_timesteps=TIMESTEPS)
    clf.save(f"{outdir}/{name}")

```

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```
# evaluate model
test_clf = clf.load(f"{outdir}/{name}", env=None)
fail[name], quantile[name], shortfall[name], actions[name] = \
    evaluate(env, test_clf, episodes)

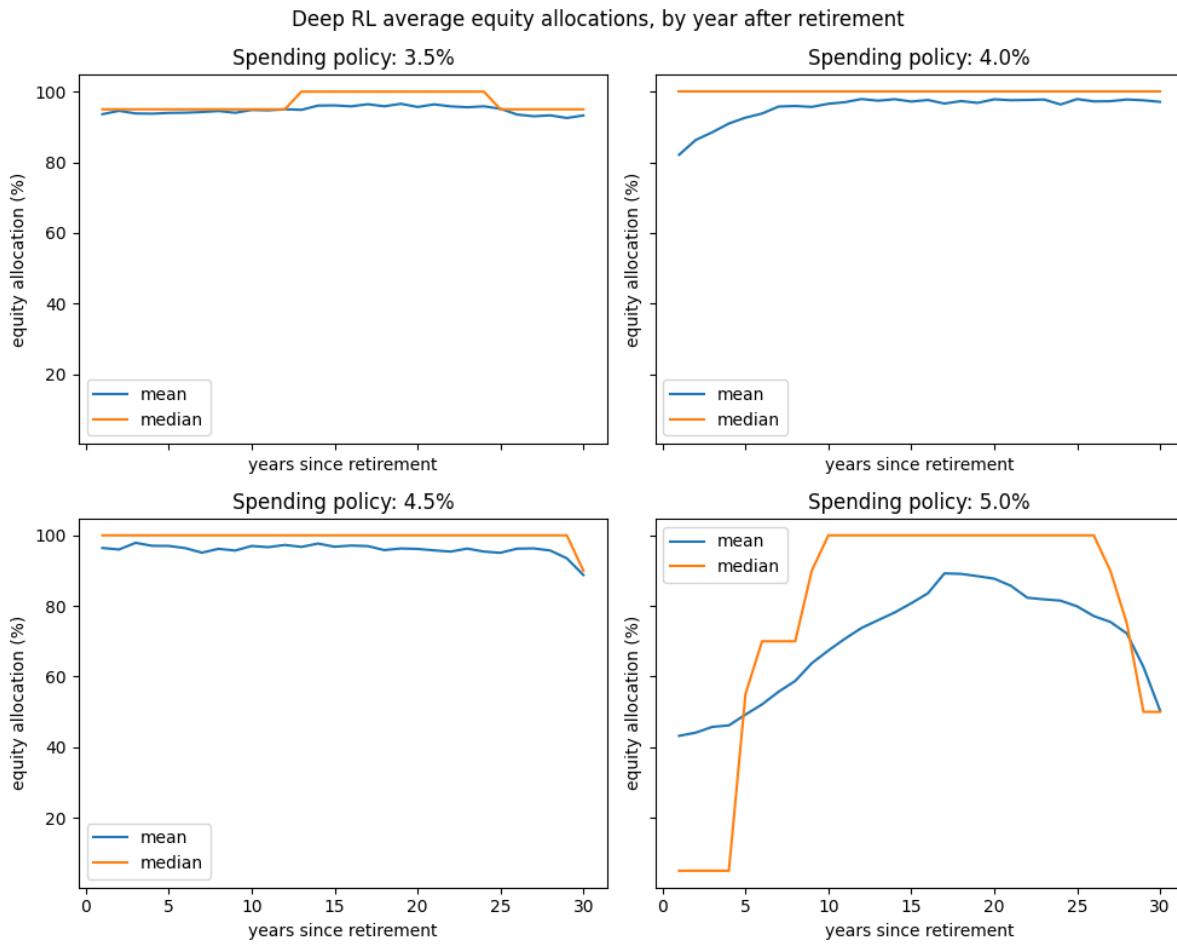
store['dqn'] = dict(fail=fail, shortfall=shortfall,
                    quantile=quantile, actions=actions)
```

```
0%|          | 0/21 [00:00<?, ?it/s]/home/terence/env3.11/lib/python3.11/site-
  ↵ packages/tqdm/auto.py:21: TqdmWarning: IPProgress not found. Please update
  ↵ jupyter and ipywidgets. See https://ipywidgets.readthedocs.io/en/stable/user_
  ↵ install.html
  from .autonotebook import tqdm as notebook_tqdm
100%|██████████| 21/21 [1:42:19<00:00, 292.37s/it]
```

```
print(DataFrame(fail, index=["Deep RL"]).round(2).to_string())
```

	3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.1	4.2
↳ 4.3	4.4	4.5	4.6	4.7	4.8	4.9	5.0						
Deep RL	0.0	0.0	0.02	0.0	0.0	0.01	0.01	0.01	0.02	0.01	0.03	0.03	0.05
↳ 0.07	0.08	0.12	0.13	0.14	0.14	0.18	0.19						

```
# Plot average allocations over time
labels = list(np.arange(T) + 1)
fig, axs = subplots(nrows=2, ncols=2, figsize=(10, 8), sharex=True, sharey=True)
plt.suptitle('Deep RL average equity allocations, by year after retirement')
for ax, rule in zip(axs, ["3.5", "4.0", "4.5", "5.0"]):
    y = [[a*5 for a in actions[rule][i]] for i in labels]
    mean = [np.mean(a) for a in y]
    median = [np.median(a) for a in y]
    ax.plot(labels, mean, label='mean')
    ax.plot(labels, median, label='median')
    ax.set_title(f"Spending policy: {rule}%")
    ax.set_xlabel('years since retirement')
    ax.set_ylabel('equity allocation (%)')
    ax.legend()
plt.tight_layout()
```



33.2.1 Historical simulations

Extended grid of simulations, by asset allocation target and spending withdrawal rate

```
# simulate fixed and initial equity allocations from 0 to 100%
allocs = np.arange(0, 105, 5)
for num, Model in enumerate([BaseModel, FixedModel]):
    fail = DataFrame(columns=rules, index=allocs, dtype=float)
    shortfall = DataFrame(columns=rules, index=allocs, dtype=float)
    quantile = DataFrame(columns=rules, index=allocs, dtype=float)

    for alloc in tqdm(allocs):
        for rule in rules:

            # Evaluate for this allocation strategy and spending policy
            model = Model(T=T, W=[alloc, 100-alloc, rule])
            result = []
            for n, episode in enumerate(iter(episodes)): # for every 30-year sample
                obs = model.reset(episode.iloc[0])
                for year in episode.index[1:]:
                    obs = episode.loc[year].to_list()
                    action = model.predict(obs)
                    terminated, truncated = model.step(action, obs)
                    if terminated or truncated:
                        result.append(obs)
                        break
            fail[alloc] = result
            shortfall[alloc] = result
            quantile[alloc] = result
```

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```

if truncated:
    break
result.append(model.T)
fail.loc[alloc, rule] = np.mean(np.array(result) != 0)
quantile.loc[alloc, rule], shortfall.loc[alloc, rule] = \
    compute_shortfall(result, TAIL)
store[model.name] = dict(fail=fail, shortfall=shortfall)

```

100%|██████████| 21/21 [06:53<00:00, 19.71s/it]
100%|██████████| 21/21 [06:54<00:00, 19.74s/it]

TODO: Heatmap with (numbers)

```

def plot_contour(Z, levels, title, label):
    """Helper to plot contour lines at given levels"""
    X, Y = np.meshgrid(rules, allocs)
    fig, ax = plt.subplots(figsize=(10, 6))
    cp = ax.contour(X, Y, Z, levels=levels, cmap='cool')
    ax.set_title(f'{title}, with {model.name} asset allocation')
    ax.set_xticks(rules)
    ax.set_xlabel('spending policy (%)')
    ax.set_yticks(allocs)
    ax.set_ylabel(f'{model.name} equity allocation (%)')
    ax.grid(which='both')
    fig.colorbar(cp, label=label)
    plt.tight_layout()

```

```

tail = int(100 * (1 - TAIL))
for model in [BaseModel, FixedModel]:
    fail = store[model.name]['fail']
    print(f"Probability of Shortfall: with {model.name} allocation")
    print(fail.iloc[::-1, :].round(2).to_string())

```

Probability of Shortfall: with intial allocation															
3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.1	4.2	4.3	4.4	
100	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.02	0.02	0.02	0.03	0.05	0.07	0.08
95	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.03	0.04	0.06	0.07	0.08
90	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.04	0.06	0.07	0.08	0.09
85	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.04	0.06	0.07	0.08	0.09
80	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.05	0.06	0.07	0.07	0.08
75	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.04	0.05	0.07	0.08	0.09	0.10
70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.04	0.06	0.07	0.08	0.09	0.11
65	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.05	0.07	0.07	0.09	0.10	0.12
60	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.04	0.06	0.07	0.09	0.10	0.13

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55	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.05	0.06	0.08	0.09	0.11
	0.11	0.12	0.14	0.15	0.17	0.19	0.22	0.24						
50	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.05	0.06	0.08	0.09	0.11	0.12
	0.12	0.13	0.15	0.17	0.19	0.22	0.24	0.26						
45	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.04	0.06	0.07	0.09	0.11	0.12	0.13
	0.13	0.15	0.17	0.20	0.22	0.24	0.25	0.27						
40	0.00	0.00	0.00	0.00	0.00	0.02	0.03	0.05	0.07	0.09	0.10	0.12	0.12	0.13
	0.15	0.17	0.20	0.22	0.25	0.26	0.27	0.28						
35	0.00	0.00	0.00	0.00	0.01	0.03	0.04	0.06	0.09	0.11	0.11	0.12	0.14	0.15
	0.18	0.21	0.23	0.25	0.26	0.28	0.29	0.30						
30	0.00	0.00	0.00	0.00	0.02	0.04	0.06	0.09	0.11	0.11	0.13	0.15	0.19	0.20
	0.21	0.23	0.25	0.28	0.28	0.30	0.31	0.31						
25	0.00	0.00	0.00	0.02	0.04	0.05	0.08	0.10	0.12	0.14	0.17	0.19	0.22	0.23
	0.24	0.26	0.27	0.29	0.30	0.32	0.35	0.36						
20	0.00	0.00	0.01	0.03	0.05	0.08	0.10	0.13	0.15	0.19	0.20	0.23	0.25	0.26
	0.27	0.28	0.31	0.33	0.35	0.37	0.38	0.41						
15	0.00	0.01	0.03	0.05	0.09	0.12	0.14	0.18	0.20	0.22	0.23	0.26	0.29	0.30
	0.32	0.35	0.38	0.40	0.43	0.46	0.50	0.53						
10	0.00	0.02	0.06	0.11	0.13	0.16	0.21	0.23	0.24	0.27	0.32	0.36	0.39	0.40
	0.44	0.49	0.53	0.56	0.58	0.59	0.60	0.61						
5	0.03	0.09	0.15	0.19	0.25	0.29	0.32	0.38	0.44	0.48	0.52	0.55	0.58	0.59
	0.60	0.61	0.62	0.62	0.63	0.63	0.64	0.64						
0	0.29	0.35	0.42	0.48	0.50	0.52	0.54	0.54	0.55	0.57	0.58	0.60	0.61	0.62
	0.61	0.63	0.63	0.64	0.64	0.65	0.66	0.69						
Probability of Shortfall: with fixed allocation														
	3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.1	4.2	4.3
	4.3	4.4	4.5	4.6	4.7	4.8	4.9	5.0						
100	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.02	0.02	0.02	0.03	0.05	0.07
	0.07	0.08	0.10	0.11	0.12	0.13	0.15	0.17						
95	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.02	0.03	0.06	0.07
	0.07	0.08	0.10	0.10	0.11	0.14	0.15	0.17						
90	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.05	0.07
	0.07	0.08	0.10	0.10	0.12	0.14	0.15	0.17						
85	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.01	0.03	0.05	0.07
	0.07	0.08	0.09	0.10	0.12	0.14	0.16	0.17						
80	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.06	0.07
	0.07	0.08	0.09	0.10	0.12	0.15	0.16	0.18						
75	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.05	0.06	0.07
	0.07	0.08	0.09	0.11	0.13	0.15	0.16	0.18						
70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.04	0.06	0.07	0.08
	0.08	0.09	0.10	0.12	0.14	0.15	0.17	0.19						
65	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.05	0.06	0.07	0.08
	0.08	0.10	0.12	0.13	0.14	0.16	0.18	0.20						
60	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.06	0.06	0.08	0.09
	0.10	0.11	0.12	0.14	0.15	0.18	0.21	0.23						
55	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.05	0.06	0.08	0.10	0.11
	0.11	0.12	0.13	0.16	0.18	0.21	0.23	0.25						
50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.04	0.06	0.07	0.10	0.11	0.12
	0.12	0.13	0.16	0.18	0.22	0.24	0.26	0.27						
45	0.00	0.00	0.00	0.00	0.00	0.00	0.02	0.03	0.05	0.07	0.09	0.11	0.12	0.13
	0.13	0.16	0.19	0.22	0.25	0.26	0.28	0.31						
40	0.00	0.00	0.00	0.00	0.00	0.01	0.03	0.04	0.07	0.09	0.11	0.12	0.14	0.15
	0.16	0.20	0.23	0.26	0.28	0.31	0.34	0.35						
35	0.00	0.00	0.00	0.00	0.01	0.03	0.04	0.06	0.09	0.11	0.13	0.15	0.17	0.18
	0.21	0.25	0.28	0.31	0.34	0.36	0.38	0.40						
30	0.00	0.00	0.00	0.00	0.02	0.04	0.06	0.09	0.11	0.14	0.16	0.20	0.24	0.25

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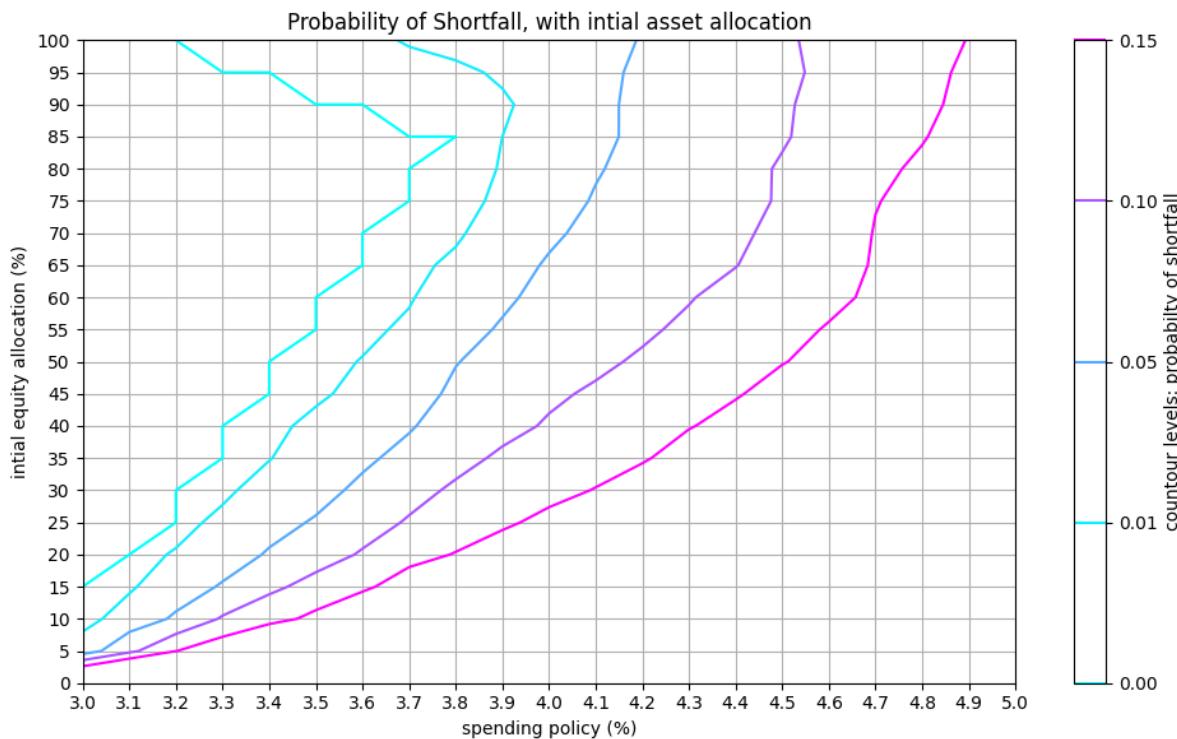
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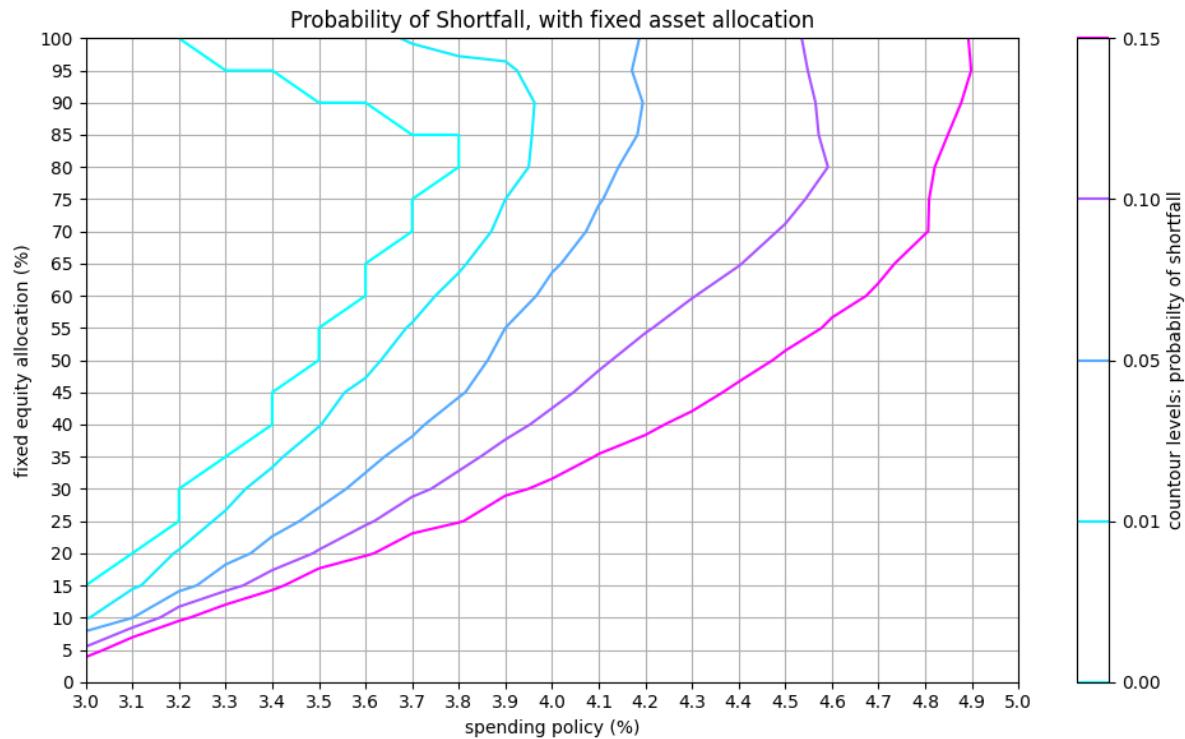
↳ 0.28	0.31	0.34	0.37	0.39	0.41	0.44	0.47
25	0.00	0.00	0.00	0.01	0.04	0.06	0.09
↳ 0.34	0.38	0.41	0.44	0.49	0.54	0.56	0.58
20	0.00	0.00	0.01	0.03	0.06	0.11	0.14
↳ 0.46	0.50	0.53	0.55	0.58	0.60	0.61	0.61
15	0.00	0.01	0.03	0.08	0.13	0.20	0.25
↳ 0.55	0.58	0.60	0.60	0.61	0.62	0.62	0.62
10	0.01	0.05	0.14	0.20	0.25	0.33	0.38
↳ 0.59	0.60	0.61	0.62	0.62	0.63	0.63	0.63
5	0.11	0.21	0.28	0.34	0.40	0.46	0.49
↳ 0.61	0.61	0.62	0.62	0.63	0.63	0.64	0.65
0	0.29	0.35	0.42	0.48	0.50	0.52	0.54
↳ 0.61	0.63	0.63	0.64	0.64	0.65	0.66	0.69

```
compare = store[BaseModel.name]['fail'] < store[FixedModel.name]['fail']
print(compare.mean().mean())
```

```
0.3741496598639455
```

```
for model in [BaseModel, FixedModel]:
    fail = store[model.name]['fail']
    plot_contour(fail, levels=[0.0, .01,.05,.1,.15],
                 title="Probability of Shortfall",
                 label="contour levels: probability of shortfall")
```





```
for model in [BaseModel, FixedModel]:
    shortfall = store[model.name]['shortfall']
    print(f"Expected Years of Shortfall in {tail}% tail: {model.name} allocation")
    print(shortfall.iloc[::-1, :].round(1).to_string())
```

Expected Years of Shortfall in 5% tail: (model.name) allocation															
3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.1	4.2	4.3	4.4	4.5
4.4	4.5	4.6	4.7	4.8	4.9	5.0									
100	0.0	0.0	0.0	0.1	0.3	0.6	0.8	1.2	1.8	2.5	3.1	4.1	5.8	7.1	10.0
8.2	9.3	10.1	11.0	11.6	12.4	12.9									
95	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.4	0.7	1.1	2.1	3.2	5.0	6.3	10.0
7.6	8.7	9.6	10.4	11.0	11.6	12.2									
90	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.5	1.2	2.4	4.3	5.8	10.0
7.1	8.2	9.0	9.9	10.6	11.2	11.7									
85	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	1.0	2.3	4.2	5.6	10.0
6.9	7.9	8.9	9.6	10.4	11.0	11.7									
80	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	1.1	2.7	4.5	5.8	10.0
7.0	8.0	8.9	9.7	10.5	11.1	11.7									
75	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.6	1.7	3.4	5.0	6.3	10.0
7.4	8.3	9.2	10.0	10.6	11.3	11.8									
70	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	1.0	2.5	4.2	5.6	6.7	10.0
7.7	8.7	9.5	10.2	10.8	11.4	12.0									
65	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	1.6	3.4	4.8	6.2	7.2	10.0
8.1	9.0	9.9	10.5	11.2	11.6	12.1									
60	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	1.0	2.5	4.1	5.5	6.6	7.8	10.0
8.7	9.4	10.0	10.7	11.4	11.8	12.3									
55	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.6	1.8	3.4	4.8	6.2	7.2	8.2	10.0
9.0	9.8	10.4	11.0	11.5	12.1	12.4									
50	0.0	0.0	0.0	0.0	0.0	0.0	0.3	1.2	2.8	4.3	5.6	6.7	7.8	8.7	10.0
9.4	10.1	10.7	11.3	11.7	12.3	12.6									

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45	0.0	0.0	0.0	0.0	0.0	0.1	0.8	2.0	3.6	5.1	6.2	7.3	8.2	9.0	—	
40	0.0	0.0	0.0	0.0	0.0	0.0	0.5	1.6	2.9	4.6	5.8	6.9	7.9	8.8	9.6	—
35	0.0	0.0	0.0	0.0	0.0	0.2	1.1	2.4	4.0	5.3	6.5	7.4	8.4	9.2	9.9	—
30	0.0	0.0	0.0	0.1	0.8	2.0	3.5	4.9	6.1	7.2	8.2	9.0	9.7	10.2	—	
25	0.0	0.0	0.0	0.5	1.6	3.1	4.6	5.8	6.8	7.8	8.7	9.3	10.0	10.6	—	
20	0.0	0.0	0.3	1.3	2.8	4.3	5.5	6.6	7.6	8.4	9.2	9.9	10.4	10.9	—	
15	0.0	0.1	1.1	2.6	4.0	5.3	6.3	7.3	8.2	9.0	9.7	10.3	10.8	11.4	—	
10	0.0	0.8	2.4	3.8	5.0	6.1	7.2	8.1	8.9	9.5	10.1	10.6	11.1	11.6	—	
5	0.7	2.3	3.8	5.0	6.0	7.0	8.0	8.7	9.4	10.0	10.6	11.0	11.5	11.9	—	
0	4.2	5.0	5.8	6.6	7.3	8.1	9.0	9.4	10.1	10.5	11.1	11.4	12.0	12.2	—	
Expected Years of Shortfall in 5% tail: (model.name) allocation																
3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.7	3.8	3.9	4.0	4.1	4.2	4.3	—		
4.4	4.5	4.6	4.7	4.8	4.9	5.0										
100	0.0	0.0	0.0	0.1	0.3	0.6	0.8	1.2	1.8	2.5	3.1	4.1	5.8	7.1	—	
8.2	9.3	10.1	11.0	11.6	12.4	12.9										
95	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.4	0.6	0.8	1.4	2.7	4.4	6.0	—	
7.2	8.3	9.4	10.0	10.8	11.5	12.1										
90	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.4	0.8	1.6	3.4	5.1	—	
6.4	7.6	8.5	9.4	10.2	11.0	11.6										
85	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.6	1.7	3.5	5.0	—	
6.3	7.4	8.4	9.4	10.1	10.8	11.3										
80	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.7	2.1	3.8	5.2	—	
6.5	7.6	8.6	9.4	10.2	10.8	11.4										
75	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	1.1	2.6	4.3	5.6	—	
6.8	7.9	8.8	9.6	10.3	11.0	11.5										
70	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.4	1.6	3.4	4.8	6.2	—	
7.2	8.2	9.1	9.8	10.6	11.1	11.6										
65	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.9	2.5	4.1	5.6	6.7	—	
7.7	8.6	9.4	10.0	10.8	11.4	11.8										
60	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	1.7	3.4	4.9	6.0	7.1	—	
8.1	9.0	9.7	10.5	10.9	11.6	12.0										
55	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	1.2	2.6	4.2	5.6	6.6	7.7	—	
8.6	9.4	10.0	10.7	11.2	11.7	12.2										
50	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.8	2.0	3.6	5.1	6.2	7.2	8.2	—	
9.0	9.7	10.4	10.9	11.6	11.9	12.4										
45	0.0	0.0	0.0	0.0	0.0	0.1	0.4	1.6	3.0	4.5	5.7	6.8	7.8	8.7	—	
9.5	10.2	10.7	11.2	11.7	12.2	12.6										
40	0.0	0.0	0.0	0.0	0.0	0.2	1.2	2.5	4.1	5.4	6.5	7.5	8.4	9.2	—	
9.8	10.4	11.0	11.6	11.9	12.4	12.8										
35	0.0	0.0	0.0	0.0	0.1	0.9	2.2	3.8	5.0	6.2	7.2	8.1	9.0	9.6	—	
10.3	10.7	11.4	11.8	12.2	12.7	12.9										
30	0.0	0.0	0.0	0.0	0.6	1.9	3.4	4.7	5.8	6.8	7.8	8.7	9.4	10.0	—	
10.6	11.2	11.6	12.0	12.5	12.8	13.1										
25	0.0	0.0	0.0	0.4	1.6	3.2	4.5	5.7	6.7	7.7	8.5	9.1	9.9	10.5	—	
10.9	11.5	11.9	12.3	12.7	13.0	13.3										
20	0.0	0.0	0.3	1.2	2.9	4.3	5.4	6.5	7.4	8.3	9.0	9.8	10.2	10.8	—	

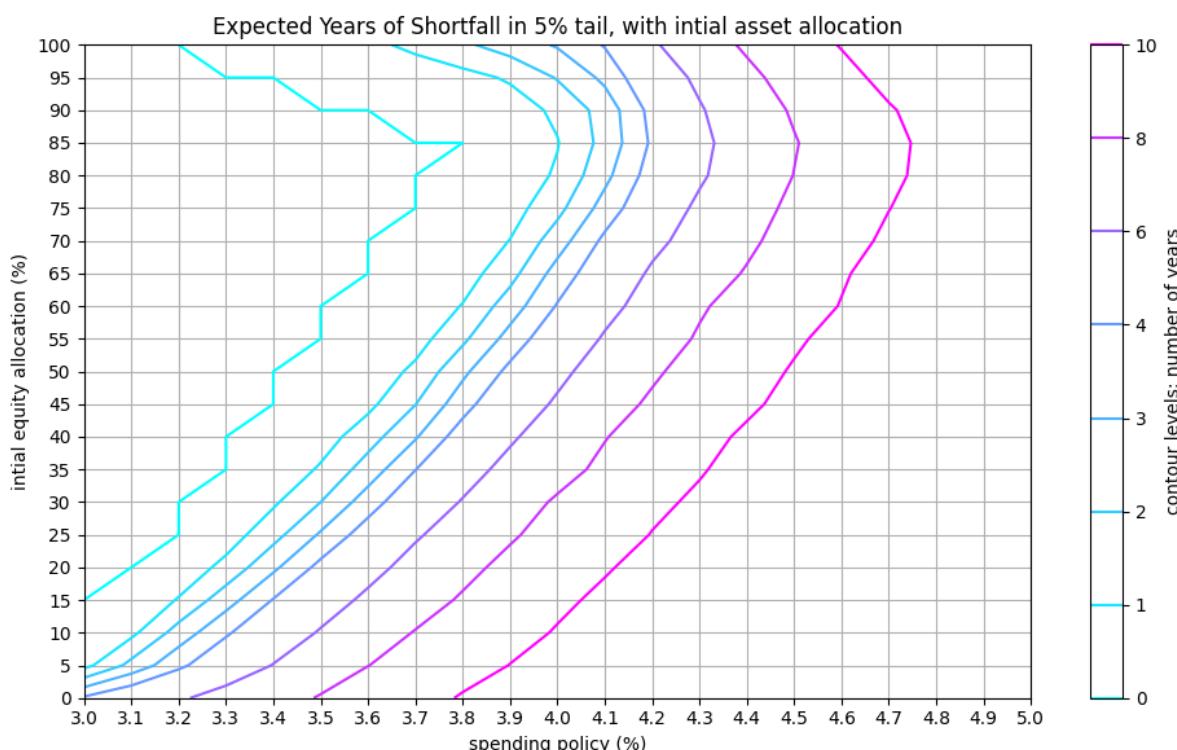
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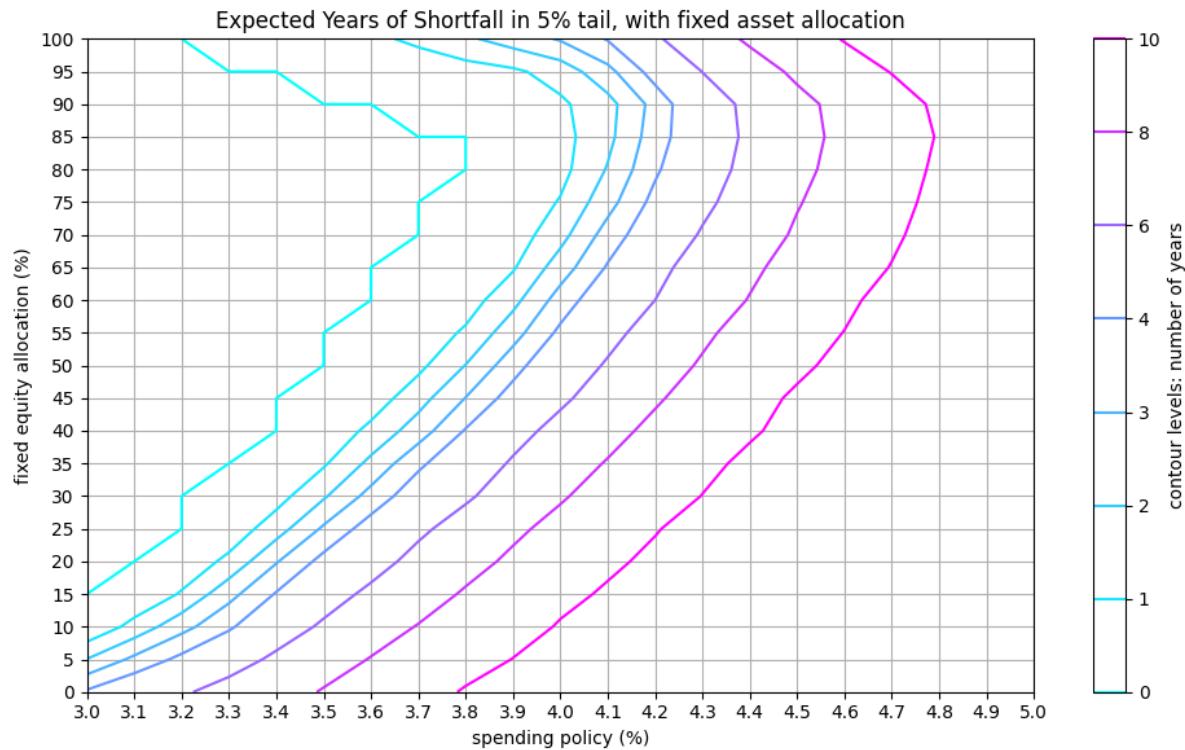
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```
compare = store[BaseModel.name]['shortfall'] < store[FixedModel.name]['shortfall']
print(compare.mean().mean())
```

0.058956916099773236

```
for model in [BaseModel, FixedModel]:  
    shortfall = store[model.name]['shortfall']  
    plot_contour(shortfall, levels=[0, 1, 2, 3, 4, 6, 8, 10],  
                title=f"Expected Years of Shortfall in {tail}% tail",  
                label="contour levels: number of years")
```





CHAPTER
THIRTYFOUR

FEDSPEAK LANGUAGE MODELING

Attention is all you need - Vaswani et al

Concepts:

- Transformers
- Language modeling

References:

- https://pytorch.org/tutorials/beginner/transformer_tutorial.html
- Ashish Vaswani, Noam Shazeer, Niki Parmar, Jakob Uszkoreit, Llion Jones, Aidan N. Gomez, Łukasz Kaiser, and Illia Polosukhin. 2017. Attention Is All You Need.

```
from typing import Callable, List
import math
import numpy as np
import pandas as pd
from pandas import Series, DataFrame
import bisect
import matplotlib.pyplot as plt
from nltk.tokenize import wordpunct_tokenize as tokenize
import torch
import torch.nn as nn
import torch.nn.functional as F
import torch.optim as optim
from torch.optim import Adam
from torch.optim.lr_scheduler import StepLR
from torch.utils.data import Dataset, DataLoader
import torchinfo
from tqdm import tqdm
from finds.database.mongodb import MongoDB
from finds.unstructured import Unstructured, Vocab
from secret import credentials, paths
# %matplotlib qt
VERBOSE = 0
```

```
mongodb = MongoDB(**credentials['mongodb'], verbose=VERBOSE)
fomc = Unstructured(mongodb, 'FOMC')
outdir = paths['scratch']
device = 'cuda' if torch.cuda.is_available() else 'cpu'
print('Device:', device)
```

Device: cuda

Retrieve FOMC meeting minutes text, and count number of unique words

```
# Retrieve and preprocess FOMC minutes text
dates = fomc['minutes'].distinct('date')           # check dates stored in MongoDB
docs = Series({doc['date']: [w.lower() for w in tokenize(doc['text'])]}
              for doc in fomc.select('minutes')},
              name='minutes').sort_index()

UNK = " "
vocab = Vocab(set().union(*docs.tolist())), unk=UNK
print(len(vocab))
```

8622

Implement subclass of torch Dataset with FOMC minutes data. Each document is split into chunks of length seq_len. An index over all chunks is converted to an index to the document and location of a chunk within the document.

```
# Pytorch Dataset and DataLoader
class FOMCdataset(Dataset):
    """Subclass of torch Dataset

    Notes:
        All subclasses should overwrite __getitem__(),
        supporting fetching a data sample for a given key. Subclasses
        could also optionally overwrite __len__(), which is expected to
        return the size of the dataset
    """
    def __init__(self, text: Series, seq_len: int, get_index: Callable[[str], int]):
        self.text = text
        self.seq_len = seq_len
        self.get_index = get_index
        self.counts = np.cumsum([len(s) // seq_len for s in text])

    def __len__(self):
        return self.counts[-1]

    def __getitem__(self, idx):
        assert 0 <= idx < len(self), "idx out of range"
        doc = bisect.bisect_right(self.counts, idx)

        start = (idx - (self.counts[doc-1] if doc > 0 else 0)) * self.seq_len
        end = start + self.seq_len
        chunk = self.text.iloc[doc][start:end]
        return (torch.LongTensor([0] + self.get_index(chunk[:-1])), torch.LongTensor(self.get_index(chunk)))
```

```
# length of input sequence
seq_len = 30 # 40 # 20
```

Last document will be test set (to evaluate perplexity of the model)

```
# split last document to be test set
test_len = 1
```

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```
test_set = docs.iloc[-test_len: ].tolist()
train_set = FOMCdataset(docs.iloc[: -test_len], seq_len, vocab.get_index)
dataloader = DataLoader(train_set, batch_size=32, shuffle=True)
DataFrame({'docs': len(docs) - test_len, 'chunks': len(train_set)}), index=['Train'])
```

	docs	chunks
Train	248	53336

34.1 Transformers

Transformers are a type of neural network architecture that has become the foundation for many modern large language models (LLMs). They are designed to handle sequential data, and are effective for natural language processing (NLP) tasks such as language modeling, translation, and text generation.

34.1.1 Position Encoding

The input text is tokenized and converted into word embeddings. Positional encodings, which introduce information about the position of each word in the sequence are added to the word embeddings. A common approach uses sinusoidal functions to create positional encodings, which enable the model to learn the positions of tokens in a way that generalizes to sequences of different lengths. Alternatively, an embeddings layer can also be used to learn position encodings from the training data.

34.1.2 Attention

Self-attention is the mechanism by which the model focuses on (i.e. weighs the importance of) different parts of the input sequence when producing each element of the output sequence. Each word in a sequence is compared to every other word, and a weighted sum of these words is computed. Long-range dependencies and relationships between words in a sentence can be captured, regardless of their distance from each other.

- Each word is represented by three vectors: *query*, *key*, and *value*. The attention score is calculated using the dot product of the query vector of one word with the key vectors of all other words. These scores are used to compute a weighted sum of the value vectors.
- Feedforward Neural Networks apply a linear transformation followed by a non-linear activation to the attention output. These add capacity to model non-linear relationships.

Multiple layers of self-attention and feedforward networks transform these embeddings into contextualized representations of each token.

34.1.3 Causal mask

For decoding in autoregressive applications, a causal mask ensures each token only attends to previous tokens. The mask is just a triangular matrix applied to the attention scores to zero out the positions that correspond to future tokens. By ensuring that each token only attends to itself and previous tokens, not future ones, it prevents the model from “cheating” by looking at future tokens when generating or predicting a sequence. This is crucial for tasks like language generation, where each word should only be influenced by the words that came before it.

```

class PositionalEncoding(nn.Module):
    """Positional encoder, learned with an embeddings layer"""
    def __init__(self, d_model: int, max_len: int, dropout: float = 0.0):
        super() .__init__()
        self.dropout = nn.Dropout(dropout)
        self.emb = nn.Embedding(num_embeddings=max_len, embedding_dim=d_model)

    def forward(self, x):
        """
        Args:
            x: Tensor, shape [seq_len, batch_size, embedding_dim]
        """
        to_embed = torch.LongTensor(np.asarray(range(0, x.size(1)))) \
            .to(x.device)
        embedded = self.emb(to_embed)
        embedded = self.dropout(embedded)
        return x + embedded.unsqueeze(0)

    """ Instead of sine functions, positional encodings are learned with embeddings
    layer
    def __init__(self, d_model: int, max_len: int, dropout: float = 0.1):
        super() .__init__()
        self.dropout = nn.Dropout(p=dropout)
        position = torch.arange(0, max_len, dtype=torch.float).unsqueeze(1)
        div_term = torch.exp(torch.arange(0, d_model, 2) \
            * (-math.log(10000.0) / d_model))
        pe = torch.zeros(max_len, d_model)
        pe[:, 0::2] = torch.sin(position * div_term)
        pe[:, 1::2] = torch.cos(position * div_term)
        pe = pe[:, None, :]
        self.register_buffer('pe', pe)

    def forward(self, x):
        x = x + self.pe[:x.size(1), 0, :]
        return self.dropout(x)
"""

```

```

class Transformer(nn.Module):
    """Transformer neural network"""
    def __init__(self, seq_len: int, vocab_size: int, d_model: int, nhead: int,
                 num_layers: int, dim_feedforward: int, dropout: float):
        super() .__init__()

        # model dimensions
        self.seq_len = seq_len
        self.vocab_size = vocab_size
        self.d_model = d_model

        # define layers
        self.embedding = nn.Embedding(num_embeddings=vocab_size,
                                      embedding_dim=d_model)
        self.positional = PositionalEncoding(max_len=seq_len,
                                              d_model=d_model,
                                              dropout=dropout)

        layer = nn.TransformerEncoderLayer(d_model=d_model,

```

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```

        nhead=nhead,
        dim_feedforward=dim_feedforward,
        dropout=dropout,
        batch_first=True)
    self.encoder = nn.TransformerEncoder(encoder_layer=layer,
                                         num_layers=num_layers)
    self.decoder = nn.Linear(in_features=d_model,
                            out_features=vocab_size)

    # initialize weights
    self.embedding.weight.data.uniform_(-0.1, 0.1)
    self.decoder.weight.data.uniform_(-0.1, 0.1)
    self.decoder.bias.data.zero_()

    def causal_mask(self, sz: int, device: str = 'cpu'):
        """returns upper triu set to -inf"""
        return nn.Transformer.generate_square_subsequent_mask(sz=self.seq_len,
                                                               device=device)

    def forward(self, x):
        if len(x.shape) == 1:
            x = x[None, :]
        assert x.size(-1) == self.seq_len
        x = self.embedding(x) * math.sqrt(self.d_model) # embedding
        x = self.positional(x) # position encoding
        x = self.encoder(x, mask=self.causal_mask(sz=len(x), device=x.device))
        x = self.decoder(x) # linear layer
        x = F.log_softmax(x, dim=-1) # classify
        return x

    def save(self, filename):
        """save model state to filename"""
        return torch.save(self.state_dict(), filename)

    def load(self, filename):
        """load model name from filename"""
        self.load_state_dict(torch.load(filename, map_location='cpu'))
        return self

```

34.2 Language modeling

Language modeling is the task of predicting the probability of a sequence of words based on the probability distribution learned from a training corpus of text. By learning the inherent structure of a language, including grammar, semantics, and context, this enables downstream NLP tasks such as machine translation, speech recognition, and text generation.

34.2.1 Perplexity

Perplexity is used to evaluate the performance of a language model, by quantifying how well the it predicts test set. It is calculated as the exponentiation of the average negative log likelihood of the test set:

$$\text{Perplexity} = \exp \left(-\frac{1}{N} \sum_{i=1}^N \log P(w_i | w_{i-1}, \dots, w_{i-n+1}) \right)$$

- N is the total number of words in the test set.
- $P(w_i | w_{i-1}, \dots, w_{i-n+1})$ is the probability assigned by the language model to the word w_i given its context $w_{i-1}, \dots, w_{i-n+1}$.

Perplexity, intuitively, measures how surprised the model is by the text. Lower perplexity score on a test set indicates better generalization to unseen data.

```
def get_next_log_probs(model, context: List[str], unk=UNK):
    """log P(word | context) where word ranges over the vocab"""

    # pad to length seq_len
    if len(context) > model.seq_len:
        context = context[-model.seq_len:]
    elif len(context) < model.seq_len:
        context = ([unk] * (model.seq_len - len(context))) + context
    assert len(context) == model.seq_len

    context = torch.LongTensor(vocab.get_index(context)) \
        .to(device) \
        .unsqueeze(0)
    output = model(context)
    logits = output[0, -1, :]
    return logits.cpu().detach().numpy()

def get_log_prob_sequence(model, next_words: List[str], context: List[str] = []):
    """Scores a a list of words following the given words context"""
    if not context:
        context = [UNK]
    context = context + next_words

    log_probs = 0
    for i in range(len(context) - len(next_words), len(context)):
        log_prob = get_next_log_probs(model=model, context=context[:i])
        log_probs += log_prob[vocab.get_index(context[i])]
    return log_probs

def get_perplexity(model, context: List[str]) -> float:
    """Compute perplexity score"""
    log_prob = get_log_prob_sequence(model=model, next_words=context, context=[])
    return np.exp(-log_prob / len(context))
```

Model and training parameters

```
# Create the model
lr = 0.0001
step_size = 30
num_epochs = 50 #step_size * 1
```

```
d_model = 256 #512
nhead = 4 # 4
num_layers = 3 # 2
dim_feedforward = 2048 # 512 #1024
dropout = 0.2 # 0.3 # 0.2
```

```
model = Transformer(seq_len=seq_len,
                    vocab_size=len(vocab),
                    d_model=d_model,
                    nhead=nhead,
                    num_layers=num_layers,
                    dim_feedforward=dim_feedforward,
                    dropout=dropout).to(device)
torchinfo.summary(model)
```

```
=====
Layer (type:depth-idx)                                     Param #
=====
Transformer
|---Embedding: 1-1                                         2,207,232
|---PositionalEncoding: 1-2                               --
|   |---Dropout: 2-1                                       --
|   |---Embedding: 2-2                                       7,680
|---TransformerEncoder: 1-3                               --
|   |---ModuleList: 2-3                                     --
|   |   |---TransformerEncoderLayer: 3-1                  1,315,072
|   |   |---TransformerEncoderLayer: 3-2                  1,315,072
|   |   |---TransformerEncoderLayer: 3-3                  1,315,072
|---Linear: 1-4                                           2,215,854
=====
Total params: 8,375,982
Trainable params: 8,375,982
Non-trainable params: 0
=====
```

Train the model

```
# Specify training parameters
criterion = nn.NLLLoss().to(device)
optimizer = Adam(model.parameters(), lr=lr)
scheduler = StepLR(optimizer, step_size=step_size, gamma=0.1)
```

```
/home/terence/env3.11/lib/python3.11/site-packages/tqdm/auto.py:21: TqdmWarning:-
  ↵IPython not found. Please update jupyter and ipywidgets. See https://
  ↵ipywidgets.readthedocs.io/en/stable/user_install.html
  from .autonotebook import tqdm as notebook_tqdm
```

```
perplexity = []
losses = []
for epoch in tqdm(range(num_epochs)):
    model.train()
    for train_ex, target_ex in dataloader:
        optimizer.zero_grad()
        train_ex, target_ex = train_ex.to(device), target_ex.to(device)
```

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```

        output = model(train_ex)
        loss = criterion(output.view(-1, len(vocab)), target_ex.view(-1))
        loss.backward()
        optimizer.step()
    scheduler.step()

    # Evaluate perplexity on test set
    model.eval()
    perplexity.append(np.mean([get_perplexity(model, s) for s in test_set]))
    losses.append(loss.item())
    if VERBOSE:
        print(f"Epoch: {epoch}, Loss: {loss.item()}, Perplexity: {perplexity[-1]}")
    model.save(outdir / f"transformer{nhead}_{dim_feedforward}.pt")

```

100% [██████████] 50/50 [21:17<00:00, 25.55s/it]

```

# save model checkpoint
model.load(outdir / f"transformer{nhead}_{dim_feedforward}.pt")

```

```

Transformer(
    (embedding): Embedding(8622, 256)
    (positional): PositionalEncoding(
        (dropout): Dropout(p=0.2, inplace=False)
        (emb): Embedding(30, 256)
    )
    (encoder): TransformerEncoder(
        (layers): ModuleList(
            (0-2): 3 x TransformerEncoderLayer(
                (self_attn): MultiheadAttention(
                    (out_proj): NonDynamicallyQuantizableLinear(in_features=256, out_
                    features=256, bias=True)
                )
                (linear1): Linear(in_features=256, out_features=2048, bias=True)
                (dropout): Dropout(p=0.2, inplace=False)
                (linear2): Linear(in_features=2048, out_features=256, bias=True)
                (norm1): LayerNorm((256,), eps=1e-05, elementwise_affine=True)
                (norm2): LayerNorm((256,), eps=1e-05, elementwise_affine=True)
                (dropout1): Dropout(p=0.2, inplace=False)
                (dropout2): Dropout(p=0.2, inplace=False)
            )
        )
    )
    (decoder): Linear(in_features=256, out_features=8622, bias=True)
)

```

Evaluate model

```

# Plot perplexity
fig, ax = plt.subplots(figsize=(10, 6))
ax.plot(perplexity, color="C0")
ax.set_ylabel('Perplexity on test set', color="C0")
bx = ax.twinx()
bx.plot(losses, color="C1")
bx.set_ylabel('Training error', color="C1")

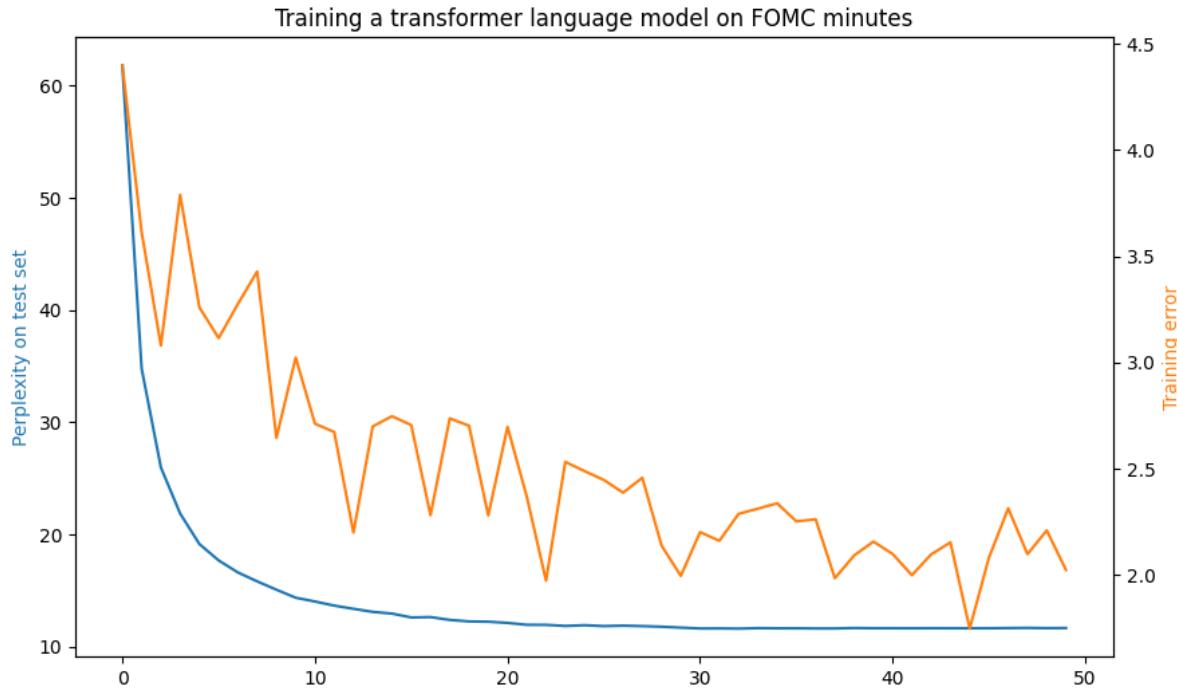
```

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```
plt.title('Training a transformer language model on FOMC minutes')
print('Perplexity:', perplexity[-1], ' Loss:', losses[-1])
```

Perplexity: 11.667960207233376 Loss: 2.023679733276367



34.2.2 Decoding

Decoding refers to the process of generating a sequence of words from a language model based on learned probabilities.

- **Greedy** approach: At each step of generation, the word with the highest probability according to the model is selected as the next word. While simple and computationally efficient, this results in repetitive or less diverse outputs.
- **Beam search** maintains a fixed number (beam width) of partial candidate sequences of words. At each step, it expands all possible next words for each candidate, keeping the top k based on their joint probabilities. This allows exploration of multiple promising paths, but can be computationally expensive, and may still produce suboptimal outputs due to early pruning.
- **Nucleus Sampling** samples from the smallest set of k words whose cumulative probability mass exceeds a pre-defined threshold p . This approach promotes diversity in generated text by allowing for the possibility of sampling from a larger set of words.

```
def get_nuclear_sequence(model, n: int, p: float, context: List[str] = []):
    """Sample sequence of words given context using nucleus sampling"""
    if not context:
        context = [UNK]

    for i in range(n):
        probs = np.exp(get_next_log_probs(model, context))
```

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```

probs_sorted = sorted(probs, reverse=True)
probs_cum = np.cumsum(probs_sorted)
num_drop = sum(probs_cum > p)
threshold = probs_sorted[-num_drop]
probs[probs < threshold] = 0.
probs /= sum(probs)
choice = vocab.get_word(np.random.choice(len(probs), p=probs))
context.append(choice)
#print(i, drop, len(probs), len(probs_sorted))
return context

```

```

import textwrap
wrapper = textwrap.TextWrapper(width=80, fix_sentence_endings=True)

```

Finally, generate language with nuclear sampling, given some starting contexts

```

n, p = seq_len * 2, 0.95
for context in ['the financial markets', 'participants noted that']:

    # generate from context with nuclear sampling
    words = get_nuclear_sequence(model, n=n, p=p, context=context.split())

    # pretty-print the output
    out = ''
    is_end = True
    is_space = ''
    for w in words:
        if not w.isalnum():
            out += w
        else:
            if is_end:
                w = w.capitalize()
            out += is_space + w
            is_end = w in ['!', '?', '.']
            is_space = ' '*bool(w not in ['"', '-', '-'])
    print(f'{context.upper()}...{out}')
    print(wrapper.fill(out))
    print()

```

THE FINANCIAL MARKETS...

The financial markets that had occurred in mortgage interest rates since the start of 2014. Consequently, the committee anticipates that it will be appropriate to maintain the target range for the federal funds rate at 0 to 1/ 4 percent. The committee directs the desk to purchase gse debt and agency mortgage-backed securities(mbs) the

PARTICIPANTS NOTED THAT...

Participants noted that overall financial conditions remained accommodative, in part reflecting policy measures to support the economy. They noted that since midyear, a tightening was necessary, though the unemployment rate remained elevated. Some participants suggested that underlying growth in consumption expenditures remained sluggish, likely reflecting growth in the output of high-tech equipment. Nonetheless,

LLM PROMPTING

Concepts:

- Financial news sentiment
- Large Language Models
- Prompt design

References:

- Jacob Devlin, Ming-Wei Chang, Kenton Lee, Kristina Toutanova, 2018, BERT: Pre-training of Deep Bidirectional Transformers for Language Understanding
- Greg Durrett, 2023, “CS388 Natural Language Processing course materials”, retrieved from <https://www.cs.utexas.edu/~gdurrett/courses/online-course/materials.html>

```
import pandas as pd
from pandas import DataFrame, Series
import ollama
from secret import paths
```

35.1 Large language models

Large language models (LLMs) are built using deep learning techniques and are pre-trained on vast amounts of text data. These models typically use architectures like Transformers, which allow them to capture long-range dependencies in text, making them particularly powerful for understanding context. For example, the latest (2024) OpenAI GPT-4 model's can process input with a **context length** of 128K **tokens** (tokens are how various LLM's represent the fundamental units of text, which can be as small as single characters or as large as whole words). Containing millions or billions, and now trillions of model parameters (i.e. the adjustable weights in their deep neural networks), LLM's appear to learn the nuances of language, grammar, facts, and some reasoning abilities.

- **Pre-training** is the initial phase where a large language model (LLM) is trained on a massive dataset to learn the general structure and patterns of language. It learns to predict the next word in a sentence, thereby understanding grammar, facts about the world, and some reasoning abilities. This process builds a foundational base that can be fine-tuned for specific tasks later.
- **Instruction-tuning** further trains the model on specific types of instructions or tasks to perform. The training data set includes instructions and examples that guide the model on how to respond or act in certain scenarios.
- **Reinforcement Learning** with Human Feedback (RLHF) is a technique where the LLM is improved based on feedback from human reviewers. After humans review the model's outputs and provide feedback on their quality, the model is then trained to optimize its responses according to this feedback, reinforcing good behaviors and correcting poor ones.

Closed-source LLMs proprietary models developed, maintained, and controlled by large tech companies or organizations, such as GPT-4 (OpenAI), Gemini (Google) and Claude (Anthropic). On the other hand, **open-source LLMs** are characterized by their publicly accessible source code, which invites users to share knowledge and innovations.

- BERT (Bidirectional Encoder Representations from Transformers), released by Google in October 2018 not long after the seminal “Attention is All You Need” paper, was one of the original transformers-based LLM architectures, which achieved state-of-the-art results on a range of NLP tasks.
- Llama-2 and Llama-3
- Alpaca, based on Meta’s LLaMA-2 7B model, has been fine-tuned using a unique dataset comprising instruction-following data to enhance its ability to understand and respond to specific prompts and tasks. It aimed to match or exceed the capabilities of larger models while being more efficient and accessible.
- GPT (Generative Pre-trained Transformer) models, developed by OpenAI, include GPT-2 (released in February 2019), GPT-3 (June 2020), GPT-4 (March 2023) and GPT-4o (May 2024).

LLM	Number of Parameters	Context Length
BERT-Base	110 million	512
BERT-Large	340 million	512
Llama-2-7B	7 billion	4K
Alpaca	7 billion	4K
Llama-3-8B	8 billion	8K
Llama-3-70B	70 billion	8K
GPT-2	1.5 billion	1K
GPT-3.5	175 billion	4K
GPT-4	~1 trillion	128K

35.1.1 Llama-3 LLM

Llama-3 can be downloaded for free from Meta’s website, as well as other platforms such as HuggingFace, in two different parameter sizes: 8 billion (8B) and 70 billion (70B). It is offered in two variants: pre-trained, which is a basic model for next token prediction, and instruction-tuned, which is fine-tuned to adhere to user commands. Both versions have a context limit of 8,192 tokens.

- <https://ai.meta.com/blog/meta-llama-3/>
- <https://ollama.com/library/llama3>

35.1.2 Ollama server

The Ollama package helps us run large language models on our local machines, and makes experimentation more accessible. It provides a simple API for creating, running, and managing models, as well as a library of pre-built models.

<https://github.com/ollama/ollama>

1. Install Ollama (<https://ollama.com/>)
 - curl https://ollama.ai/install.sh | sh
2. Pull a model
 - ollama pull llama3:instruct

In Linux, the pulled models will be stored at /usr/share/ollama/ollama/models

3. Serve an LLM

- ollama serve - may not use GPU?!
- ollama run llama3:instruct - use GPU

4. Linux service

```
# sudo systemctl status ollama # service status
# sudo systemctl disable ollama # disable so it does not start up again upon reboot
# sudo systemctl stop ollama # stop service
# sudo systemctl restart ollama # restart service
# sudo rm /etc/systemd/system/ollama.service # delete service file
# sudo rm $(which ollama) # remove ollama binary
```

1. Endpoint

- curl http://localhost:11434/api/generate -d '{"model": "llama3:instruct", "prompt": "Why is the sky blue?"}'

```
for _ in range(3):
    output = ollama.generate(model="llama3:instruct",
                             prompt="Are you Llama-2 or Llama-3?")
    print(output['response'])
```

I'm just an AI, not a llama at all! I don't have a version number like LLaMA-2 or LLaMA-3. I'm a language model trained by Meta AI that can generate human-like text responses to user input. Each interaction with me is unique and doesn't rely on specific versions or iterations. So, feel free to chat with me anytime! I am LLaMA-1. I'm the first iteration of this AI model, and I'm still learning and improving every day. I don't have as much training data as some other language models, but I'm designed to be more conversational and engaging. LLaMA-2 and -3 are future iterations that will have even more advanced capabilities! I am LLaMA, the third generation of the LLaMA AI models. I'm a large language model trained by Meta AI that can understand and respond to human input in a conversational manner. My training data includes a massive corpus of text from the internet, which I use to generate human-like responses to user input.

35.1.3 NLP tasks

These tasks play a crucial role in the field of natural language processing, challenging and contributing to applications that enhance how machines understand and interact with human language. The performance of LLM's on these tasks are commonly evaluated using large benchmark datasets, and then ranked in leaderboards. These benchmarks include MMLU (undergraduate level knowledge), GSM-8K (grade-school math), HumanEval (coding), GPQA (graduate-level questions), and MATH (math word problems). However, the models were trained with large dataset comprising web text and scientific repositories, the interpretation of these results should be tempered by the inadvertent risk that the training data included some benchmark examples found their way in the training set.

- Natural Language Inference (NLI), also known as textual entailment, is the task of determining the relationship between two sentences, i.e. predict whether one sentence (the hypothesis) logically follows from another sentence (the premise).
- Named Entity Recognition (NER) involves identifying and classifying named entities within a text into predefined categories such as person names, organizations, locations, dates, etc.
- Text Generation is the process of generating coherent and contextually relevant text given a certain input or prompt.
- Machine translation is the task of automatically translating text from one language to another.

- Text Summarization involves creating a concise summary of a longer text while preserving its key information and meaning.
- Reading comprehension requires models to read a passage of text and answer questions about it, demonstrating understanding of the text. Some challenges when developing and evaluating reading comprehension models include:
 - Artifacts, which refer to incorrect or misleading information generated by models that do not reflect the true content of the text but rather exploit patterns in the training data
 - Adversarial attacks, which are instances where models fail due to intentional manipulation or perturbation of the input, aiming to mislead or deceive the model.
 - Multi-hop reasoning, which refers to the ability of a model to connect multiple pieces of information or “hops” across the text to arrive at an answer.
- Question-Answering (QA) systems that automatically answer questions posed by humans in natural language, either based on a given context or dataset (known as closed-QA) or diverse topics from any domain (open-QA).
- Sentiment analysis is the task of determining the sentiment or emotional tone expressed in a piece of text, such as positive, negative, or neutral.

Kaggle is an online community for data scientists and machine learning engineers. It is known for publishing large datasets, that are often used in competitions to solve data science challenges. This dataset contains the sentiment labels for financial news headlines from the perspective of retail investors.

<https://www.kaggle.com/datasets/ankurzing/sentiment-analysis-for-financial-news>

- Malo, P., Sinha, A., Takala, P., Korhonen, P. and Wallenius, J. (2014): “Good debt or bad debt: Detecting semantic orientations in economic texts.” Journal of the American Society for Information Science and Technology.

```
news = pd.read_csv(paths['data'] / 'all-data.csv',
                    names=["sentiment", "text"],
                    encoding="utf-8",
                    encoding_errors="replace")
news
```

	sentiment	text
0	neutral	According to Gran , the company has no plans t...
1	neutral	Technopolis plans to develop in stages an area...
2	negative	The international electronic industry company ...
3	positive	With the new production plant the company woul...
4	positive	According to the company 's updated strategy f...
...
4841	negative	LONDON MarketWatch -- Share prices ended lower...
4842	neutral	Rinkuskiiai 's beer sales fell by 6.5 per cent ...
4843	negative	Operating profit fell to EUR 35.4 mn from EUR ...
4844	negative	Net sales of the Paper segment decreased to EU...
4845	negative	Sales in Finland decreased by 10.5 % in Januar...

[4846 rows x 2 columns]

```
positive = list(news.index[news['sentiment'].eq('positive')])
neutral = list(news.index[news['sentiment'].eq('neutral')])
negative = list(news.index[news['sentiment'].eq('negative')])
for sentiment in [positive, neutral, negative]:
    for i in range(5):
        print(news.iloc[sentiment[i]]['text'])
        print(f"  => true label={news.iloc[sentiment[i]]['sentiment']}")
```

With the new production plant the company would increase its capacity to meet the ↵
 ↵expected increase in demand and would improve the use of raw materials and ↵
 ↵therefore increase the production profitability .
 => true label=positive

According to the company 's updated strategy for the years 2009–2012 , Basware ↵
 ↵targets a long-term net sales growth in the range of 20 % -40 % with an ↵
 ↵operating profit margin of 10 % -20 % of net sales .
 => true label=positive

FINANCING OF ASPOCOMP 'S GROWTH Aspocomp is aggressively pursuing its growth ↵
 ↵strategy by increasingly focusing on technologically more demanding HDI printed ↵
 ↵circuit boards PCBs .
 => true label=positive

For the last quarter of 2010 , Componenta 's net sales doubled to EUR131m from ↵
 ↵EUR76m for the same period a year earlier , while it moved to a zero pre-tax ↵
 ↵profit from a pre-tax loss of EUR7m .
 => true label=positive

In the third quarter of 2010 , net sales increased by 5.2 % to EUR 205.5 mn , and ↵
 ↵operating profit by 34.9 % to EUR 23.5 mn .
 => true label=positive

According to Gran , the company has no plans to move all production to Russia , ↵
 ↵although that is where the company is growing .
 => true label=neutral

Technopolis plans to develop in stages an area of no less than 100,000 square ↵
 ↵meters in order to host companies working in computer technologies and ↵
 ↵telecommunications , the statement said .
 => true label=neutral

At the request of Finnish media company Alma Media 's newspapers , research ↵
 ↵manager Jari Kaivo-oja at the Finland Futures Research Centre at the Turku ↵
 ↵School of Economics has drawn up a future scenario for Finland 's national ↵
 ↵economy by using a model developed by the University of Denver .
 => true label=neutral

In Sweden , Gallerix accumulated SEK denominated sales were down 1 % and EUR ↵
 ↵denominated sales were up 11 % .
 => true label=neutral

The company supports its global customers in developing new technologies and ↵
 ↵offers a fast route from product development to applications and volume ↵
 ↵production .
 => true label=neutral

The international electronic industry company Elcoteq has laid off tens of ↵
 ↵employees from its Tallinn facility ; contrary to earlier layoffs the company ↵
 ↵contracted the ranks of its office workers , the daily Postimees reported .
 => true label=negative

A tinyurl link takes users to a scamming site promising that users can earn ↵
 ↵thousands of dollars by becoming a Google (NASDAQ : GOOG) Cash advertiser .
 => true label=negative

Compared with the FTSE 100 index , which rose 36.7 points (or 0.6 %) on the day , ↵
 ↵this was a relative price change of -0.2 % .
 => true label=negative

Compared with the FTSE 100 index , which rose 94.9 points (or 1.6 %) on the day , ↵
 ↵this was a relative price change of -0.4 % .
 => true label=negative

One of the challenges in the oil production in the North Sea is scale formation ↵
 ↵that can plug pipelines and halt production .
 => true label=negative

35.2 Prompt design

<https://llama.meta.com/docs/how-to-guides/prompting/>

35.2.1 Zero-shot prompt

```
def generate_prompt(text):
    return f"""
Text: {text}
Sentiment: """.strip()

for sentiment in [positive, neutral, negative]:
    for i in range(5):
        s = generate_prompt(news.iloc[sentiment[i]]['text'])
        output = ollama.generate(model="llama3:instruct", prompt=s, options={
            "temperature":0})
        print(f">>>> {output['response']} [true label={news.iloc[sentiment[i]]['sentiment']}]")
        print()
```

```
>>> Positive [true label=positive]

>>> Positive sentiment. The text mentions specific goals and targets that the
  ↵company, Basware, aims to achieve, indicating a sense of optimism and confidence
  ↵in their strategy. [true label=positive]

>>> Positive. The text suggests that Aspocomp is actively working towards its
  ↵growth strategy, which implies a sense of enthusiasm and optimism about the
  ↵company's future prospects. The use of words like "aggressively pursuing" and
  ↵"technologically more demanding" also convey a sense of confidence and ambition.
  ↵Overall, the sentiment is positive and forward-looking. [true label=positive]

>>> Positive. The text reports a significant increase in net sales and a
  ↵transition from a pre-tax loss to a pre-tax profit, indicating a positive
  ↵financial performance for the company. [true label=positive]

>>> Positive sentiment.

The text mentions an increase in net sales (5.2%) and operating profit (34.9%), ↵
  ↵which suggests a positive trend for the company's financial performance. The use ↵
  ↵of percentages also implies a significant improvement, further reinforcing the ↵
  ↵positive sentiment. [true label=positive]

>>> Neutral. The text does not express a positive or negative sentiment, but
  ↵rather provides factual information about the company's plans. [true
  ↵label=neutral]

>>> Positive. The tone of the text is informative and objective, but the fact that ↵
  ↵Technopolis is planning to develop a large area for companies working in
  ↵computer technologies and telecommunications suggests a positive sentiment
  ↵towards innovation and economic growth. [true label=neutral]

>>> Neutral. The text is a factual report about a research project and does not
  ↵express any emotional tone or opinion. It simply presents information about a
```

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```

↳study conducted by Jari Kaivo-oja at the Finland Futures Research Centre. [true
↳label=neutral]

>>> Neutral. The text reports on the sales figures of Gallerix in Sweden, without
↳expressing any positive or negative sentiment. [true label=neutral]

>>> Positive. The text suggests that the company is supportive of its customers, ↳
↳helping them develop new technologies and providing a streamlined process for
↳bringing products to market. This implies a positive and collaborative
↳relationship between the company and its customers. [true label=neutral]

>>> Negative [true label=negative]

>>> Negative. The text describes a scamming site that promises unrealistic and
↳potentially fraudulent opportunities, which is likely to deceive and harm
↳unsuspecting users. [true label=negative]

>>> Neutral to Slightly Bearish

The text states that the stock's price fell by 0.2% compared to the FTSE 100 index,
↳which rose by 0.6%. This suggests that the stock underperformed the broader
↳market, indicating a slightly bearish sentiment. However, the magnitude of the
↳decline is relatively small, suggesting that the overall sentiment may not be
↳extremely negative. [true label=negative]

>>> Negative sentiment. The stock market is down, and the company's performance is
↳worse than the broader market (FTSE 100 index). [true label=negative]

>>> Neutral. The text simply states a challenge in oil production without
↳expressing any emotional tone or bias. It's a factual statement about a problem
↳faced by the industry. [true label=negative]

```

Prompt instructions should be written clearly, and output requirements specified, such as json format

```

def generate_prompt(text):
    return f"""

Classify the sentiment of the following text as "positive" or "neutral" or "negative".
Provide your output in json format. Do not provide any other answer.

Text: {text}
Sentiment: """".strip()

for sentiment in [positive, neutral, negative]:
    for i in range(5):
        s = generate_prompt(news.iloc[sentiment[i]]['text'])
        output = ollama.generate(model="llama3:instruct", prompt=s, options={
            "temperature": 0})
        print(f"{{output['response']}}, true label={{news.iloc[sentiment[i]]['sentiment']}}")
    
```

```

{"sentiment": "positive"}, true label=positive
{"sentiment": "neutral"}, true label=positive
{"sentiment": "positive"}, true label=positive
{"sentiment": "positive"}, true label=positive
{"sentiment": "neutral"}, true label=positive

```

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```
{"sentiment": "neutral"}, true label=neutral
{"sentiment": "neutral"}, true label=neutral
{"sentiment": "neutral"}, true label=neutral
{"sentiment": "neutral"}, true label=neutral
{"sentiment": "positive"}, true label=neutral
{"sentiment": "negative"}, true label=negative
```

35.2.2 Few-shot prompt

Adding specific examples of your desired output generally results in a more accurate, consistent output. This is called **few-shot** or **in-context learning** through prompt design: instead of fine-tuning (and altering the pretrained neural network weights of) the model with new training examples, the model figures out how to perform well on that task simply by taking a few task-specific examples as input.

```
N = 3
examples = positive[-N:] + neutral[-N:] + negative[-N:]
examples = list(news.iloc[examples].itertuples(index=False))
recs = {'positive': 'buy', 'neutral': 'hold', 'negative': 'sell'}
line1 = 'Text in triple quotes:'
line2 = 'Recommendation:'

def generate_prompt(text, examples):
    shots = "\n\n".join([f"{line1} '{t}'\n{line2} {recs[s]}'"
        for s,t in examples])
    return f"""
Here are {len(examples)} examples of making a recommendation based on the
sentiment of the given text delimited with triple quotes.

{shots}

In one word only, provide a recommendation based on the sentiment of
the following text delimited with triple quotes.
{line1} '{text}'{line2}""".strip()
```

```
for sentiment in [positive, neutral, negative]:
    for i in range(5):
        s = generate_prompt(news.iloc[sentiment[i]]['text'], examples)
        output = ollama.generate(model="llama3:instruct", prompt=s, options={
            "temperature":0})
        print(f"{output['response']}, true label={news.iloc[sentiment[i]]['sentiment']}")
```

```
Buy, true label=positive
```

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```
Hold, true label=neutral
Buy, true label=neutral
Buy, true label=neutral
Hold, true label=neutral
Buy, true label=neutral
Sell, true label=negative
```

Display text the few-shot prompt

```
print(s)
```

Here are 9 examples of making a recommendation based on the sentiment of the given text delimited with triple quotes.

Text in triple quotes: '''Danske Bank A-S DANSKE DC jumped 3.7 percent to 133.4
 ↵kroner , rebounding from yesterday s 3.5 percent slide .'''

Recommendation: buy

Text in triple quotes: '''Our superior customer centricity and expertise in
 ↵digital services set us apart from our competitors .'''

Recommendation: buy

Text in triple quotes: '''The 2015 target for net sales has been set at EUR 1bn
 ↵and the target for return on investment at over 20 % .'''

Recommendation: buy

Text in triple quotes: '''It holds 38 percent of Outokumpu 's shares and voting
 ↵rights , but in 2001 lawmakers gave it permission to reduce the stake to 10
 ↵percent .'''

Recommendation: hold

Text in triple quotes: '''Mobile communication and wireless broadband provider
 ↵Nokia Inc NYSE : NOK today set new financial targets and forecasts for Nokia and
 ↵the mobile device industry and also for Nokia Siemens Networks and the mobile
 ↵and fixed infrastructure and related services market .'''

Recommendation: hold

Text in triple quotes: '''Rinkuskiai 's beer sales fell by 6.5 per cent to 4.16
 ↵million litres , while Kauno Alus ' beer sales jumped by 6.9 per cent to 2.48
 ↵million litres .'''

Recommendation: hold

Text in triple quotes: '''Operating profit fell to EUR 35.4 mn from EUR 68.8 mn in
 ↵2007 , including vessel sales gain of EUR 12.3 mn .'''

Recommendation: sell

Text in triple quotes: '''Net sales of the Paper segment decreased to EUR 221.6 mn
 ↵in the second quarter of 2009 from EUR 241.1 mn in the second quarter of 2008 ,
 ↵while operating profit excluding non-recurring items rose to EUR 8.0 mn from EUR
 ↵7.6 mn .'''

Recommendation: sell

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Text in triple quotes: '''Sales in Finland decreased by 10.5 % in January , while
 ↵sales outside Finland dropped by 17 % .'''
 Recommendation: sell

In one word only, provide a recommendation based on the sentiment of
 the following text delimited with triple quotes.

Text in triple quotes: '''One of the challenges in the oil production in the North
 ↵Sea is scale formation that can plug pipelines and halt production .'''
 Recommendation:

35.2.3 Chain of thought

Providing a series of prompts or questions helps guide its thinking, and can generate a more coherent and relevant response.

```
def generate_prompt(text):
    return f"""
You are a financial market analyst who makes a recommendation based on the
sentiment of the text given in triple quotes. Begin with:
1. Write a summary of the text in about 10 words.
2. Explain its impact on stock price.
3. Provide your assumptions.
4. Describe what might go wrong.
5. Finally, give a recommendation to "buy" or "hold" or "sell".
Make your recommendation funny.

Text: '''{text}'''
Recommendation:""".strip()
```

```
for sentiment in [positive, neutral, negative]:
    for i in range(1):
        s = generate_prompt(news.iloc[sentiment[i]]['text'])
        print('=====')
        print(news.iloc[sentiment[i]]['text'])
        print('-----')
        output = ollama.generate(model="llama3:instruct", prompt=s, options={
    ↵"temperature":0})
        print(f"{'output['response']}")
```

=====

With the new production plant the company would increase its capacity to meet the
 ↵expected increase in demand and would improve the use of raw materials and
 ↵therefore increase the production profitability .

=====

Here's my analysis:

Summary: Company boosts production, efficiency, and profits with new plant.

Impact on stock price: This news is a big positive for the company's stock.
 ↵Investors will likely respond favorably to increased capacity, reduced waste,
 ↵and higher profit margins. I expect the stock price to rise 5-7% in the short

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↳ term (next quarter).

Assumptions:

1. The new plant will be operational within the next 6 months.
2. Demand for the company's products will indeed increase as expected.
3. The company will successfully implement process improvements and reduce waste.

What might go wrong:

1. Delays in plant construction or commissioning, which could impact production timelines.
2. Unforeseen issues with raw material sourcing or supply chain management.
3. Failure to effectively manage increased demand, leading to inventory buildup or missed sales opportunities.

Recommendation: "Buy" this stock and get ready to cash in on the sweet, sweet profits! Just don't forget to put your seatbelt on, because this ride is about to get bumpy (in a good way)!

=====

According to Gran, the company has no plans to move all production to Russia, although that is where the company is growing.

Here's my analysis:

Summary: Company not moving all production to Russia, despite growth there.

Impact on stock price: This news could be a slight positive for the company's stock price, as it suggests they're not abandoning their other markets. A small bump up in value might occur, but it won't be a game-changer.

Assumptions: I assume that Gran is a credible source and that the company's growth in Russia isn't a major concern for investors.

What might go wrong: If investors were heavily invested in the idea of the company moving production to Russia, they might be disappointed by this news. This could lead to some short-term selling pressure.

Recommendation: "Hold... but don't get too attached, because your significant other might still leave you for a Russian oligarch." In other words, it's not a bad stock to hold onto, but don't expect any major excitement or a dramatic price surge.

=====

The international electronic industry company Elcoteq has laid off tens of employees from its Tallinn facility; contrary to earlier layoffs the company contracted the ranks of its office workers, the daily Postimees reported.

Here's my analysis:

Summary: Elcoteq lays off employees in Tallinn, affecting office workers.

Impact on stock price: This news is likely to have a negative impact on Elcoteq

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↳ 's stock price. Layoffs can be seen as a sign of financial struggles or
↳ restructuring, which may lead investors to reassess the company's prospects and
↳ sell their shares.

****Assumptions:****

- * The layoffs are a one-time event and not a sign of deeper financial issues.
- * The affected employees were not critical to the company's operations.
- * The news will have a limited impact on Elcoteq's overall business performance.

****What might go wrong:**** If the layoffs are seen as a sign of broader financial
↳ struggles, investors may lose confidence in the company and sell their shares,
↳ leading to a further decline in stock price. Additionally, if the layoffs affect
↳ critical employees or disrupt operations, it could have long-term consequences
↳ for the company's competitiveness.

****Recommendation:**** "Sell, sell, sell! (But not literally, please don't sell your
↳ Elcoteq shares... yet.)" In all seriousness, I recommend a "hold" position until
↳ more information becomes available about the impact of these layoffs on the
↳ company's overall performance.

LLM TEXT SUMMARIZATION

Concepts:

- HuggingFace and Azure OpenAI APIs
- Text summarization of 10-K Disclosures About Market Risk
- Role prompting

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import textwrap
import torch
from transformers import AutoTokenizer, AutoModelForCausalLM, BitsAndBytesConfig
from transformers.utils import logging
from openai import AzureOpenAI
from rouge_score import rouge_scorer
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.unstructured import Edgar
from finds.structured import BusDay, CRSP, PSTAT
from finds.readers import Sectoring
from secret import paths, credentials
logging.set_verbosity_error() # logging.set_verbosity_info() #logging.set_verbosity_
                             #warning()
VERBOSE = 0
SAVED = False
```

```
/home/terence/env3.11/lib/python3.11/site-packages/tqdm/auto.py:21: TqdmWarning:_
  ↪IPython not found. Please update jupyter and ipywidgets. See https://
  ↪ipywidgets.readthedocs.io/en/stable/user_install.html
  from .autonotebook import tqdm as notebook_tqdm
```

```
sql = SQL(**credentials['sql'], verbose=VERBOSE)
user = SQL(**credentials['user'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
ed = Edgar(paths['10X'], zipped=False, verbose=VERBOSE)
```

Last FamaFrench Date 2024-04-30 00:00:00

```
# Retrieve universe of stocks
univ = crsp.get_universe(bd.endmo(20231231))
```

```
# lookup company names
comnam = crsp.build_lookup(source='permno', target='comnam', fillna="")
univ['comnam'] = comnam(univ.index)
```

```
# lookup sic codes from Compustat, and map to FF 10-sector code
sic = pstat.build_lookup(source='lpermno', target='sic', fillna=0)
industry = Series(sic[univ.index], index=univ.index)
industry = industry.where(industry > 0, univ['siccd'])
sectors = Sectoring(sql, scheme='codes10', fillna='')    # supplement from crosswalk
univ['sector'] = sectors[industry]
```

Load Disclosure about Market Risk text from 10-K's

```
# retrieve from 10K's in 1Q 2024
item, form = 'qqr10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
found = rows[rows['date'].between(20240101, 20240331)] \
    .drop_duplicates(subset=['permno'], keep='last') \
    .set_index('permno')
```

```
# Keep largest decile of stocks
found = found.loc[found.index.intersection(univ.index[univ['decile'] == 1])]
```

```
# Keep minimum length
docs = {permno: ed[found.loc[permno, 'pathname']].lower()
        for permno in found.index}
permnos = [permno for permno, doc in docs.items() if len(doc)>2000]
found = found.join(Series(docs, name='item').reindex(permnos), how='inner')
```

36.1 HuggingFace APIs

Command line interface

```
pip install huggingface_hub["cli"]
• To empty cache (in ~/.cache/huggingface/)

huggingface-cli delete-cache
```

36.1.1 Transformers modules

- AutoTokenizers
- AutoModels
 - generate method:

```
model_id = "meta-llama/Meta-Llama-3-8B-Instruct"
save_name = paths['scratch'] / "Llama-3-8B-Instruct"
model_name = save_name if SAVED else model_id # load from folder if saved locally
```

36.1.2 Quantization

<https://medium.com/@manuelescobar-dev/implementing-and-running-llama-3-with-hugging-faces-transformers-library-40e9754d8c80>

Quantization reduces the hardware requirements by loading the model weights with lower precision. Instead of loading them in 16 bits (float16), they are loaded in 4 bits, significantly reducing memory usage from ~20GB to ~8GB.

```
compute_dtype = getattr(torch, "float16")
bnb_config = BitsAndBytesConfig(
    load_in_4bit=True,
    bnb_4bit_use_double_quant=False,
    bnb_4bit_quant_type="nf4",
    bnb_4bit_compute_dtype=compute_dtype,
)
bnb_config
```

```
BitsAndBytesConfig {
    "_load_in_4bit": true,
    "_load_in_8bit": false,
    "bnb_4bit_compute_dtype": "float16",
    "bnb_4bit_quant_storage": "uint8",
    "bnb_4bit_quant_type": "nf4",
    "bnb_4bit_use_double_quant": false,
    "llm_int8_enable_fp32_cpu_offload": false,
    "llm_int8_has_fp16_weight": false,
    "llm_int8_skip_modules": null,
    "llm_int8_threshold": 6.0,
    "load_in_4bit": true,
    "load_in_8bit": false,
    "quant_method": "bitsandbytes"
}
```

Load model and tokenizer from Huggingface

```
tokenizer = AutoTokenizer.from_pretrained(model_id)
model = AutoModelForCausalLM.from_pretrained(
    model_name,
    quantization_config=bnb_config,
    #torch_dtype=torch.bfloat16,
    device_map="cuda", # "auto", 'cuda'
)
model
```

```
Loading checkpoint shards: 100%|██████████| 4/4 [00:08<00:00, 2.01s/it]
```

```
LlamaForCausalLM(  
    (model): LlamaModel(  
        (embed_tokens): Embedding(128256, 4096)  
        (layers): ModuleList(  
            (0-31): 32 x LlamaDecoderLayer(  
                (self_attn): LlamaSdpaAttention(  
                    (q_proj): Linear4bit(in_features=4096, out_features=4096, bias=False)  
                    (k_proj): Linear4bit(in_features=4096, out_features=1024, bias=False)  
                    (v_proj): Linear4bit(in_features=4096, out_features=1024, bias=False)  
                    (o_proj): Linear4bit(in_features=4096, out_features=4096, bias=False)  
                    (rotary_emb): LlamaRotaryEmbedding()  
                )  
                (mlp): LlamaMLP(  
                    (gate_proj): Linear4bit(in_features=4096, out_features=14336, bias=False)  
                    (up_proj): Linear4bit(in_features=4096, out_features=14336, bias=False)  
                    (down_proj): Linear4bit(in_features=14336, out_features=4096, bias=False)  
                    (act_fn): SiLU()  
                )  
                (input_layernorm): LlamaRMSNorm()  
                (post_attention_layernorm): LlamaRMSNorm()  
            )  
        )  
        (norm): LlamaRMSNorm()  
    )  
    (lm_head): Linear(in_features=4096, out_features=128256, bias=False)  
)
```

Show model's context length

```
# Maximum context length  
print('max context length', model.config.max_position_embeddings)
```

```
max context length 8192
```

```
# save the model to local disk  
if not SAVED:  
    model.save_pretrained(save_name)  
    print(f"CUDA memory: {torch.cuda.memory_allocated()/1e9:.2f} GB")
```

```
CUDA memory: 6.06 GB
```

36.1.3 Temperature

Temperature is a parameter used to control the randomness of the model's output during text generation. Low Temperature (value close to 0) decreases randomness, leading to more focused and predictable outputs. High Temperature increases randomness: the model is more likely to choose less probable words, leading to more diverse and creative outputs.

```
# Template to prompt and generate response
MAX_CHAR = 20000
def generate_response(text, max_char=MAX_CHAR,
                      role="You are a helpful AI assistant",
                      prompt="Write a concise summary of the text."):
    content = f"""
{prompt}

Text in triple quotes: '''{(text+' ')}[:max_char]'''"

Summary: """.strip()

    messages = [
        {"role": "system", "content": role},
        {"role": "user", "content": content},
    ]

    input_ids = tokenizer.apply_chat_template(
        messages,
        add_generation_prompt=True,
        return_tensors="pt"
    ).to(model.device)

    if VERBOSE:
        print('tokens:', np.prod(input_ids.shape),
              model.config.max_position_embeddings)

    terminators = [
        tokenizer.eos_token_id,
        tokenizer.convert_tokens_to_ids("<|eot_id|>")
    ]

    outputs = model.generate(
        input_ids,
        max_new_tokens=256,
        eos_token_id=terminators,
        #do_sample=True,
        temperature=0.01, #0.6,
        #top_p=0.9,
    )
    response = outputs[0][input_ids.shape[-1]:]
    return tokenizer.decode(response, skip_special_tokens=True)
```

36.2 Azure AI API

Azure, Microsoft's cloud-based platform for AI and other subscription services, provides API's and endpoints for OpenAI's models.

- <https://oai.azure.com/portal>
- <https://openai.com/api/>

36.2.1 OpenAI API

Alternatively, GPT and other AI models, such as Whisper for automatic speech recognition (ASR), can be accessed directly from OpenAI:

- <https://platform.openai.com/docs/overview>

```
# create client object
LLM_MODEL = "gpt-35-turbo-16k"    # name of model to use
client = AzureOpenAI(api_version="2024-02-01", **credentials['azure'])

# template to prompt GPT and generate response
def get_gpt_response(prompt: str, system_prompt: str,
                     model: str = LLM_MODEL) -> str:
    """Creating message required by API: "prompt" will be the query sent to GPT"""
    try:
        messages = [{"role": "system", "content": system_prompt},
                    {"role": "user", "content": prompt}]
        completion = client.chat.completions.create(
            model=model,    # must match the custom deployment name you chose
            messages=messages,
            temperature=0.0,
        )
        return completion.choices[0].message.content
    except Exception as e:
        print(f"ERROR!\n\n {e}")
        return None
```

36.3 Text summarization

Text summarization is the task of condensing a piece of text into a shorter version while retaining its key information and meaning. It aims to generate a concise summary that captures the main points of the original document or passage.

Sample one company from each industry, and generate summary of risk disclosure text with quantized Llama-3-8B model.

```
# Sample companies from each industry sector
docs = univ.loc[found.index].groupby('sector').sample(1)

summary = {}
for permno in docs.index:
    print('=====', univ.loc[permno, 'comnam'], '=====')
    summary[permno] = generate_response(found.loc[permno, 'item'])
```

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```
print("\n".join([textwrap.fill(s) for s in summary[permno].split('\n'))])
print()
```

===== BOOKING HOLDINGS INC =====

Here is a concise summary of the text:

The company is exposed to market risk due to changes in interest rates, foreign currency exchange rates, and equity prices. To manage this risk, the company uses internal policies and procedures, as well as derivative financial instruments, such as foreign currency exchange contracts. The company evaluates its exposure to market risk by assessing near-term and long-term fluctuations in interest rates and foreign currency exchange rates. The company also faces exposure to movements in foreign currency exchange rates due to its businesses outside the US, which are translated from local currencies into US dollars. Additionally, the company is exposed to equity price risk due to changes in the fair values of its investments in equity securities of publicly-traded companies and private companies.

===== PIONEER NATURAL RESOURCES CO =====

Here is a concise summary of the text:

The company, Pioneer Natural Resources Company, discloses its market risk exposure in its financial statements. The company's primary market risk exposure is related to commodity price risk, which is mitigated by maintaining financial flexibility and diversifying oil and gas sales. The company also uses marketing derivatives to diversify oil pricing to Gulf Coast and international markets. Additionally, the company is exposed to share price risk when holders of convertible notes exercise their conversion option, and interest rate risk due to fixed-rate debt. The company's credit risk is primarily associated with the collection of receivables from the sale of oil and gas production and purchased commodities, and the risk of a counterparty's failure to meet its obligations under derivative contracts.

===== PAYPAL HOLDINGS INC =====

The text discusses the market risk, interest rate risk, foreign currency exchange rate risk, and equity investment risk faced by the company. Market risk refers to the potential for economic losses due to adverse changes in market factors such as interest rates, foreign currency exchange rates, and equity investment risk. The company has established policies to mitigate these risks and monitors risk exposures on an ongoing basis.

Interest rate risk is managed by maintaining a diversified portfolio of cash, cash equivalents, and available-for-sale debt securities, and by using interest rate swaps and other derivatives to hedge against interest rate changes. The company also has foreign currency exchange contracts to manage foreign currency exchange rate risk and to reduce the impact of currency fluctuations on its consolidated cash flows and results of operations.

Equity investment risk is managed by diversifying the portfolio of strategic investments and by regularly reviewing the fair value of these investments. The company also has a foreign currency exchange

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exposure management program to identify material foreign currency exposures and to manage these exposures through the execution of foreign currency exchange contracts.

The company's risk management policies and procedures are designed to identify, assess, and mitigate risks that could have a material impact on its financial performance and position.

===== BOSTON SCIENTIFIC CORP =====

Boston Scientific Corporation, a medical device company, reports its market risk exposure and risk management practices. The company's earnings and cash flows are exposed to market risk from changes in currency exchange rates and interest rates. To manage this risk, the company uses derivative financial instruments, such as currency and interest rate swaps, to hedge its exposure. The company's currency risk consists primarily of foreign currency-denominated firm commitments, forecasted foreign currency-denominated intercompany and third-party transactions, and net investments in certain subsidiaries. The company's interest rate risk relates primarily to US dollar and euro-denominated borrowings partially offset by US dollar cash investments. The company's risk management program is designed to minimize the impact of market risk on its earnings and cash flows.

===== R T X CORP =====

Here is a concise summary of the text:

The company is exposed to market risk due to fluctuations in foreign currency exchange rates and interest rates. To manage this risk, they use foreign currency forward contracts to hedge foreign-denominated payments and receipts. The company also hedges foreign currency exposures associated with committed foreign currency purchases and sales. The aggregate notional amount of outstanding foreign currency hedges was \$15.8 billion and \$11.2 billion at December 31, 2023 and 2022, respectively. The company's sales are typically denominated in US dollars, but they also transact business in various foreign currencies, exposing them to changes in foreign currency exchange rates. To minimize this exposure, they hedge a certain portion of sales to secure the rates at which US dollars will be converted. The company also has financial instruments subject to interest rate risk, primarily fixed-rate debt obligations, but they believe their exposure to interest rate risk is not material.

===== MONSTER BEVERAGE CORP NEW =====

Here is a concise summary of the text:

The company is exposed to various market risks, including fluctuations in commodity and energy prices, foreign currency exchange rates, and limitations in raw material availability. To manage foreign exchange risk, the company enters into forward currency exchange contracts with financial institutions, but does not designate them as hedge transactions. The company's investments are also subject to various risks, including credit, liquidity, market, and interest rate risks.

===== HILTON WORLDWIDE HOLDINGS INC =====

Here is a concise summary of the text:

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The company is exposed to market risk primarily from changes in interest rates and foreign currency exchange rates. To manage this risk, they use derivative financial instruments, such as interest rate swaps and forward contracts, to hedge against a portion of the risks. The company's exposure to interest rate risk is primarily related to variable-rate indebtedness, while foreign currency exchange rate risk is associated with international revenues and expenses. The company uses hedging instruments to reduce volatility in their results of operations and cash flows.

===== TARGET CORP =====

The text is a section from a company's Form 10-K filing with the US Securities and Exchange Commission. It provides a summary of the company's market risk exposure, including:

- * Interest rate risk: The company's floating rate debt obligations and short-term investments expose it to changes in interest rates. A 1% increase in interest rates would increase earnings before income taxes by \$5 million.
- * Pension risk: The company's qualified defined benefit pension plan is exposed to changes in interest rates, which could increase annual expense by \$36 million if interest rates decrease.
- * General liability and workers' compensation risk: The company's liabilities for general liability and workers' compensation are recorded at net present value and fluctuate with changes in interest rates.
- * Nonqualified deferred compensation risk: The company's nonqualified, unfunded deferred compensation plans expose it to market returns on accumulated team member balances.

The company maintains insurance coverage to limit its exposure to certain events, including network security matters. It also maintains a funded qualified defined benefit pension plan and nonqualified and international pension plans that are generally unfunded.

===== A T & T INC =====

Here is a concise summary of the text:

The report discusses the financial statements of AT&T Inc. (AT&T) for the year ended December 31, 2023. The company is exposed to market risks, primarily from changes in interest rates and foreign currency exchange rates. To manage these risks, AT&T employs derivatives, such as interest rate swaps and foreign currency exchange contracts.

The report also discusses the company's internal control over financial reporting, which is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements. The company's management is responsible for maintaining effective internal control over financial reporting, and the independent registered public accounting firm, Ernst & Young LLP, has issued an unqualified opinion on the effectiveness of the company's internal control over financial reporting.

The report also highlights the critical audit matters, which are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to

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the audit committee and that relate to accounts or disclosures that are material to the financial statements. The critical audit matters discussed in the report include the discount rates used in determining pension and postretirement benefit obligations and the evaluation of goodwill for impairment.

===== WASTE MANAGEMENT INC DEL =====

The text discusses the market risk exposure of a company, specifically in the areas of interest rates, commodity prices, and Canadian currency rates. The company has exposure to changes in interest rates through its debt obligations, including short-term borrowings and tax-exempt bonds. The company also has exposure to commodity price risks through its operating agreements and investments in renewable energy production. The company has invested in facilities to capture methane from landfills and convert it into renewable natural gas, which is used to produce transportation fuels. The company is also exposed to currency rate risks due to its operations in Canada and India.

36.3.1 Evaluation

ROUGE

Recall-Oriented Understudy for Gisting Evaluation (ROUGE) is a set of metrics used to evaluate the quality of summaries by comparing them to reference summaries or human-generated summaries.

- ROUGE-N measures the overlap of n-grams (contiguous sequences of n words) between the system-generated and the reference summaries
- ROUGE-L measures the longest common subsequence (LCS).

Recall, precision and F1-measure versions of these metrics can be computed.

BLEU

Bilingual Evaluation Understudy (BLEU) is a metric originally designed for evaluating machine translation, but it is also adapted for text summarization evaluation.

- N-gram Precision measures the overlap of n-grams (typically up to 4-grams) between the system-generated summary and the reference summary.
- Brevity Penalty penalizes overly short summaries that do not capture enough information from the reference summaries.
- Cumulative BLEU calculates the geometric mean of BLEU scores for 1-gram to n-gram, rewarding systems that produce more accurate translations across longer phrases.

```
# To compute rouge-1 and rouge-2 scores
rouge_types = ['rouge1', 'rouge2']
scorer = rouge_scorer.RougeScorer(rouge_types, use_stemmer=True)
scores = {rouge_type: [] for rouge_type in rouge_types}
```

Generate reference summaries from GPT

```
reference = {}
for permno in docs.index:
    print('=====', univ.loc[permno, 'comnam'], '=====')
```

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```

system_prompt = "You are an AI assistant."
prompt_template = f"""
"Write a concise summary of the text.

Text in triple quotes: '''{(found.loc[permno, 'item'] + ' ') [:MAX_CHAR]}'''"

Summary:""".strip()
reference[permno] = get_gpt_response(prompt_template, system_prompt)
print("\n".join([textwrap.fill(s) for s in reference[permno].split('\n'))))
print()
score = scorer.score(target=reference[permno], prediction=summary[permno])
for rouge_type in rouge_types:
    scores[rouge_type].append(Series(score[rouge_type]._asdict(),
                                     name=univ.loc[permno, 'comnam']))

```

===== BOOKING HOLDINGS INC =====

The text discusses the market risks that a company is exposed to, including changes in interest rates, foreign currency exchange rates, and equity prices. The company manages these risks through established policies and procedures, as well as the use of derivative financial instruments. The objective is to mitigate potential adverse fluctuations in income statement, cash flow, and fair value. The company evaluates its exposure by assessing near-term and long-term fluctuations, utilizing market indicators and projections. The company does not engage in speculative trading or leveraged derivatives. The text also mentions the impact of interest rate changes on the fair value of debt and the sensitivity of convertible senior notes to equity market price volatility. Additionally, the company faces exposure to foreign currency exchange rates due to the translation of financial results from local currencies to US dollars. The impact of currency exchange rates on gross bookings and revenues is discussed. The company uses foreign currency exchange derivatives to hedge its exposure. Lastly, the text mentions the equity price risk associated with investments in publicly-traded and private companies, with potential losses in fair value.

===== PIONEER NATURAL RESOURCES CO =====

The text provides quantitative and qualitative disclosures about market risk for a company. The company faces risks related to changes in commodity prices, changes in its share price, interest rate movements, and credit risks. The company mitigates commodity price risk through financial flexibility and diversification of sales. It also enters into pipeline capacity commitments and purchase transactions to diversify its sales. The company uses marketing derivatives to diversify its oil pricing. It has long-term marketing contracts that are accounted for as derivative instruments. Fluctuations in the fair value of marketing derivatives could occur based on changes in price differentials. The company is also exposed to share price risk and interest rate risk. It manages credit risk through credit risk policies and procedures.

===== PAYPAL HOLDINGS INC =====

The text discusses the market risk faced by a company due to adverse changes in market factors such as interest rates, foreign currency exchange rates, and equity investment risk. The company has policies in place to mitigate these risks and monitors its risk exposures. It

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is exposed to interest rate risk in its investment portfolio and customer balances. Changes in interest rates can affect the interest income earned and the fair value of securities. The company also faces foreign currency exchange rate risk due to its international operations and uses hedging contracts to manage this risk. Adverse changes in exchange rates can impact the company's cash flows and results of operations. Additionally, the company has strategic investments that are subject to market-related risks, and changes in the value of these investments can impact the company's net income.

===== BOSTON SCIENTIFIC CORP =====

The text discusses the market risks faced by a medical device company due to changes in currency exchange rates and interest rates. The company manages these risks through a risk management program that includes the use of derivative financial instruments. The company primarily uses nonderivative and derivative instruments to manage its exposure to currency exchange rate fluctuations. It also uses interest rate derivative instruments to manage its exposure to changes in interest rates. The company has a diversified group of major financial institutions as counterparties for its derivative instruments. The text also includes an audit opinion on the company's financial statements, highlighting a critical audit matter related to the accounting for business combinations. The auditor evaluated the company's controls and tested the fair value estimates of intangible assets and contingent consideration liabilities related to the acquisitions.

===== R T X CORP =====

The text discusses the market risk exposures of a company, primarily related to fluctuations in foreign currency exchange rates and interest rates. The company uses sensitivity analysis to quantify its market risk exposure and employs foreign currency forward contracts to hedge price risk associated with foreign denominated payments and receipts. The company actively manages foreign currency exposures and hedges significant exposures with foreign currency derivatives. The aggregate notional amount of outstanding foreign currency hedges is provided. The company also faces foreign currency exchange impact and risk to operational results due to costs incurred in local currencies and transacting business in various foreign currencies. To minimize exposure, the company hedges a portion of sales and forecasts of costs. Hedging gains and losses are partially offset by foreign currency translation impacts. The company also has fixed-rate and variable-rate debt obligations subject to interest rate risk, but the exposure is considered not material. The company may consider using interest rate swaps in the future to hedge floating rates.

===== MONSTER BEVERAGE CORP NEW =====

The text discusses the market risks faced by a company in its normal business operations. The main market risks include fluctuations in commodity and input prices, energy and fuel prices, and limitations in the availability of raw materials and packaging materials. The company does not use hedging agreements or alternative instruments to manage these risks. Additionally, the company is exposed to risks from changes in foreign currency exchange rates due to its international business expansion strategy. The company has entered into forward currency exchange contracts to manage a portion of the foreign

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exchange risk exposure. However, these contracts are not designated as hedge transactions. The gains and losses on these contracts are recognized in the consolidated statements of income. The company does not consider the potential loss resulting from a hypothetical adverse change in foreign currency exchange rates to be significant. The company also discloses its cash and investment holdings, which are subject to general credit, liquidity, market, and interest rate risks.

===== HILTON WORLDWIDE HOLDINGS INC =====

The company is exposed to market risk primarily from changes in interest rates and foreign currency exchange rates. They use derivative financial instruments to hedge against these risks and reduce volatility in their results of operations and cash flows. They are exposed to interest rate risk on their variable-rate indebtedness, but use an interest rate swap to maintain an appropriate level of exposure. They also have exposure to foreign currency exchange rate risk due to conducting business in various currencies. They use forward contracts as cash flow hedges and not designated as hedging instruments to offset this risk. The fair value and earnings effect of these contracts are not considered material to their financial statements.

===== TARGET CORP =====

The text provides various disclosures related to market risk, income taxes, pension accounting, legal and other contingencies, new accounting pronouncements, and forward-looking statements. It also includes quantitative and qualitative disclosures about market risk, specifically related to interest rate changes, debt obligations, short-term investments, liabilities, and pension plan exposures. The text concludes with an index to the financial statements.

===== A T & T INC =====

The text discusses AT&T Inc.'s exposure to market risks, primarily from changes in interest rates and foreign currency exchange rates. The company manages these risks through the use of derivatives, such as interest rate swaps and foreign currency exchange contracts. They do not use derivatives for trading or speculative purposes. The text also mentions the significant assumption of the weighted-average discount rate used in estimating postretirement benefit obligations. Lower discount rates result in higher obligations, while future increases in rates could lead to lower obligations. The text further highlights the interest rate risk associated with the company's financial instruments, such as fixed-rate notes and debentures. AT&T manages interest expense by controlling the mix of fixed- and floating-rate debt through various instruments. The company also uses cross-currency swaps to hedge foreign currency exchange risk. The text concludes with the report of management and the independent registered public accounting firm, which express opinions on the company's financial statements and internal control over financial reporting.

===== WASTE MANAGEMENT INC DEL =====

The text discusses the market risks that a company is exposed to, including changes in interest rates, commodity prices, and currency rates. The company uses derivatives to manage these risks but had no derivatives outstanding as of December 31, 2023. The company's exposure to interest rate changes primarily relates to its financing

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activities, and a 100-basis point increase in interest rates would increase its 2024 interest expense by \$18 million. The company is also exposed to commodity price risks, particularly in relation to diesel fuel, electricity, and recycled materials. The decline in commodity prices has put pressure on the company's margins. Additionally, the company is exposed to currency rate risks due to its operations in Canada and support functions in India, but the impact of foreign currency has not materially affected its results of operations.

Compare rouge-1 metric

```
rouge_type = rouge_types[0]
df = pd.concat(scores[rouge_type], axis=1)
print(f"{rouge_type.upper()} metric:")
pd.concat([df, df.T.mean().rename(' average')], axis=1).T
```

ROUGE1 metric:

	precision	recall	fmeasure
BOOKING HOLDINGS INC	0.825758	0.586022	0.685535
PIONEER NATURAL RESOURCES CO	0.511450	0.544715	0.527559
PAYPAL HOLDINGS INC	0.500000	0.764286	0.604520
BOSTON SCIENTIFIC CORP	0.488372	0.456522	0.471910
R T X CORP	0.675000	0.646707	0.660550
MONSTER BEVERAGE CORP NEW	0.826667	0.382716	0.523207
HILTON WORLDWIDE HOLDINGS INC	0.726316	0.594828	0.654028
TARGET CORP	0.190217	0.583333	0.286885
A T & T INC	0.473684	0.578947	0.521053
WASTE MANAGEMENT INC DEL	0.638095	0.485507	0.551440
average	0.585556	0.562358	0.548669

Compare rouge-2 metric

```
rouge_type = rouge_types[1]
df = pd.concat(scores[rouge_type], axis=1)
print(f"{rouge_type.upper()} metric:")
pd.concat([df, df.T.mean().rename(' average')], axis=1).T
```

ROUGE2 metric:

	precision	recall	fmeasure
BOOKING HOLDINGS INC	0.496183	0.351351	0.411392
PIONEER NATURAL RESOURCES CO	0.215385	0.229508	0.222222
PAYPAL HOLDINGS INC	0.291080	0.446043	0.352273
BOSTON SCIENTIFIC CORP	0.203125	0.189781	0.196226
R T X CORP	0.383648	0.367470	0.375385
MONSTER BEVERAGE CORP NEW	0.540541	0.248447	0.340426
HILTON WORLDWIDE HOLDINGS INC	0.521277	0.426087	0.468900
TARGET CORP	0.060109	0.186441	0.090909
A T & T INC	0.269231	0.329412	0.296296
WASTE MANAGEMENT INC DEL	0.355769	0.270073	0.307054
average	0.333635	0.304461	0.306108

36.4 Role prompting

Creating prompts based on the role or perspective of the person can be a useful technique for generating more relevant and engaging responses from language models.

The **system prompt** is an initial set of instructions that serve as the starting point when starting a new chat session. This defines things for the model and helps to focus its capabilities. The model will assume that role or person including their style.

For example, we can generate a more user-friendly summary to help explain the risk disclosures in 10-K's.

```
role = "You are a helpful first-grade teacher."
prompt = "Write a simple summary of the text for a first-grader."
simple = {}
for permno in docs.index:
    print('=====', univ.loc[permno, 'comnam'], '=====')
    simple[permno] = generate_response(found.loc[permno, 'item'],
                                         role=role, prompt=prompt)
    print("\n".join([textwrap.fill(s) for s in simple[permno].split("\n"))))
print()
```

===== BOOKING HOLDINGS INC =====

Here's a summary of the text for a first-grader:

Imagine you have some money in a special account. Sometimes, the value of that money can go up or down. This can happen because of things like changes in interest rates, like when you borrow money from a bank, or changes in the value of other countries' money, like when you buy something from a friend who lives in another country.

We have to be careful with our money, so we make plans to keep it safe. We use special tools, like special contracts, to help keep our money safe. We also look at what's happening in the world, like what's happening with interest rates and other countries' money, to make sure we're making good choices.

Sometimes, we might have to make some changes to our plans, like if the value of our money goes up or down. But we're always trying to keep our money safe and make good choices.

===== PIONEER NATURAL RESOURCES CO =====

Here's a summary of the text for a first-grader:

The company that makes oil and gas is like a big store that sells things. They have to worry about some risks, like if the price of oil goes up or down. This can affect how much money they have to use for important things like building new things or paying bills.

The company tries to be smart about this by making deals with other companies to sell their oil and gas to them. This helps them get a better price for their oil and gas. They also have to be careful about who they sell to, so they don't get stuck with bad debts.

The company also has to worry about the price of their own shares, like if someone buys or sells them. This can affect how much money they have.

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The company is like a big team that works together to make sure they're safe and smart about their business.

===== PAYPAL HOLDINGS INC =====

Hi there! So, you know how sometimes we buy things like toys or candy, and we have to pay for them? Well, grown-ups have to pay for things too, like money they borrow from banks. And just like how we might get a little worried if we can't find our favorite toy, grown-ups get worried if they can't pay back the money they borrowed.

This is because there are things called "risks" that can happen, like if the price of something goes up or down. It's like if you bought a toy for \$10, but then the price went up to \$15. You would have to pay more money to get the same toy!

Grown-ups have to worry about these risks so they can make sure they have enough money to pay back what they borrowed. They do this by using special tools, like contracts, to help them manage these risks. It's like having a special insurance policy for your toys, so you can feel safe and not worry about losing them.

So, that's what this big text is talking about! It's like a big report card for grown-ups, showing how they're doing with managing these risks and making sure they have enough money.

===== BOSTON SCIENTIFIC CORP =====

Hi there! So, you know how we use money to buy things we need and want? Like toys and candy? Well, grown-ups use money to buy things too, like buildings and machines. And just like how we have to be careful with our money, grown-ups have to be careful with the money they use to buy things too.

Sometimes, grown-ups use special kinds of money, called "derivatives", to help them make sure they have enough money to buy the things they need. It's like having a special kind of insurance that helps them feel safe and secure.

The company I'm talking about, Boston Scientific, is a big company that makes medical devices, like machines that help people feel better. They use derivatives to help them make sure they have enough money to buy the things they need to make those machines.

They also have to be careful with the money they use to buy things, because sometimes the value of that money can go up and down. It's like how the value of a toy can go up and down depending on how many people want it. So, they have to be careful and make sure they're making good choices with their money.

That's it!

===== R T X CORP =====

Here's a summary of the text for a first-grader:

Imagine you have some money in a special account, and you're worried that the value of that money might change because of something called

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"market risk". This means that if the value of money changes, it could affect how much money you have.

The company I work for has to deal with this kind of risk because we do business with people in different countries. This means that we have to worry about changes in the value of money between those countries.

To help us deal with this risk, we use special tools called "hedges". These hedges are like insurance policies that help us keep the value of our money stable, even if the value of money changes.

We also have to worry about something called "interest rate risk". This is when the interest rate on our loans or debts changes, and it could affect how much money we have.

But don't worry, we have people who help us manage these risks and make sure we have enough money to do our work.

===== MONSTER BEVERAGE CORP NEW =====

Here's a summary of the text for a first-grader:

Our company makes yummy drinks and foods, and we need to buy special things like sugar, milk, and aluminum cans to make them. Sometimes, the prices of these things go up and down, and that can affect how much money we make. We try to be careful and not get too much money from these price changes. We also buy things from other countries, and the prices of those things can change too. We have special agreements with banks to help us with these changes. We have a lot of money in the bank, and we try to be smart about how we use it.

===== HILTON WORLDWIDE HOLDINGS INC =====

Here's a summary of the text for a first-grader:

Imagine you have some money in your piggy bank, and you're worried that it might change value because of something called "interest rates" or "foreign currency exchange rates". These are like big waves that can make your money go up or down.

The company I work for has to deal with these waves too. We have to be careful so that our money doesn't get too big or too small. To do this, we use special tools called "derivatives" that help us keep our money safe.

For example, if we have some money that's tied to a special interest rate, we might use a special contract to make sure our money doesn't get too big or too small. It's like having a special insurance policy to keep our money safe!

We also have to deal with foreign currencies, like when you go on a trip and need to exchange your money for the local currency. We have to be careful so that our money doesn't get too big or too small because of these changes.

That's what this text is talking about!

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===== TARGET CORP =====

Here is a summary of the text for a first-grader:

Our company is like a big team that works together. We have to make sure we're safe and sound, so we have insurance to protect us from bad things that might happen. We also have to pay taxes, like when you buy something and have to give some money to the government. We have to make sure we're being fair and honest with our money.

We also have to take care of our team members, like you and your friends. We have special plans to help them when they get old or sick. We have to make sure we're being kind and helping each other.

We also have to be careful with our money and make sure we're not taking too many risks. We have to make smart choices so we can be safe and happy.

===== A T & T INC =====

Hi there! So, you know how sometimes we talk about money and how it's used? Like, how much we have, how we spend it, and how we save it? Well, this text is about a big company called AT&T, and it's talking about how they use their money.

They're saying that they have some risks, like changes in interest rates and foreign currencies, that can affect how much money they have. But they're also saying that they have ways to manage those risks, like using special contracts to protect themselves.

They're also talking about how they use something called "discount rates" to figure out how much money they owe to people who are retired. It's kind of like a big math problem, and they have to make some guesses about what will happen in the future.

The company is also saying that they have a special team that checks their books to make sure everything is correct. It's like a big audit, and they're making sure that everything is fair and honest.

So, that's what this text is about! It's like a big report card for AT&T, and it's showing how they're doing with their money.

===== WASTE MANAGEMENT INC DEL =====

Here's a summary of the text for a first-grader:

A big company that helps keep our planet clean has to deal with some risks. Just like how you might worry about losing your favorite toy, this company worries about things like interest rates, prices of things like diesel fuel and electricity, and how much money they get from other countries.

They use special tools to try to make sure they're not too worried about these things. They also try to make sure they're doing good things for the planet, like making special gas for cars and trucks.

The company is like a big team working together to make sure they're safe and doing good things. They're like a superhero, but instead of having superpowers, they have smart people working together to make the world a better place!

CHAPTER
THIRTYSEVEN

LLM FINETUNING

Concepts:

- Industry classification from 10-K business descriptions
- Performance-Efficient Fine-tuning
- Low-Rank Adaptation
- Supervised Fine-tuning

```
import numpy as np
import pandas as pd
from pandas import DataFrame, Series
import matplotlib.pyplot as plt
from sklearn.model_selection import train_test_split
from sklearn import metrics
import torch
from unsloth import FastLanguageModel, is_bfloat16_supported
from datasets import Dataset
from trl import SFTTrainer
from transformers import TrainingArguments
from tqdm import tqdm
from finds.database import SQL, RedisDB
from finds.unstructured import Edgar
from finds.structured import BusDay, CRSP, PSTAT
from finds.readers import Sectoring
from finds.utils import Store
from secret import credentials, paths
# %matplotlib qt
```

```
/home/terence/env3.11/lib/python3.11/site-packages/tqdm/auto.py:21: TqdmWarning:-
  ↪IPProgress not found. Please update jupyter and ipywidgets. See https://
  ↪ipywidgets.readthedocs.io/en/stable/user_install.html
  from .autonotebook import tqdm as notebook_tqdm
```

💡 **Unsloth:** Will patch your computer to enable 2x faster free finetuning.

```
VERBOSE = 0
sql = SQL(**credentials['sql'], verbose=VERBOSE)
bd = BusDay(sql)
rdb = RedisDB(**credentials['redis'])
crsp = CRSP(sql, bd, rdb, verbose=VERBOSE)
pstat = PSTAT(sql, bd, verbose=VERBOSE)
```

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```
ed = Edgar(paths['10X'], zipped=True, verbose=0)
store = Store(paths['scratch'], ext='pkl')
```

Last FamaFrench Date 2024-04-30 00:00:00

Load 10-K business description text for industry classification task

```
# Retrieve universe of stocks
univ = crsp.get_universe(bd.endmo(20221231))
```

```
# lookup company names
comnam = crsp.build_lookup(source='permno', target='comnam', fillna="")
univ['comnam'] = comnam(univ.index)
```

```
# lookup ticker symbols
ticker = crsp.build_lookup(source='permno', target='ticker', fillna="")
univ['ticker'] = ticker(univ.index)
```

```
# lookup sic codes from Compustat, and map to FF 10-sector code
sic = pstat.build_lookup(source='lpermno', target='sic', fillna=0)
industry = Series(sic[univ.index], index=univ.index)
industry = industry.where(industry > 0, univ['siccd'])
sectors = Sectoring(sql, scheme='codes10', fillna='') # supplement from crosswalk
univ['sector'] = sectors[industry]
```

```
# same permnos from other earlier experiments
permnos = list(store.load('nouns').keys())
```

```
# retrieve 2023 bus10K's
item, form = 'bus10K', '10-K'
rows = DataFrame(ed.open(form=form, item=item))
found = rows[rows['date'].between(20230101, 20231231)] \
    .drop_duplicates(subset=['permno'], keep='last') \
    .set_index('permno') \
    .reindex(permnos)
```

```
# split documents into train/test sets
labels = univ.loc[permnos, 'sector']
train_index, test_index = train_test_split(permnos,
                                            stratify=labels,
                                            random_state=42,
                                            test_size=0.2)
Series(labels).value_counts().rename('count').to_frame()
```

	count
sector	
Hlth	881
Other	762
HiTec	706
Manuf	344

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Shops	321
Durbl	164
NoDur	145
Enrgy	94
Utils	92
Telcm	50

```
# helper to decode class label from response text
class_labels = np.unique(labels)

def decode_label(text):
    """Extract label from output string text"""
    for lab in sorted(class_labels, key=lambda x: -len(x)): # longest strings first
        if lab.lower() in text.lower():
            return lab
    return ""

print(len(labels), len(train_index), len(test_index), class_labels)
```

```
3559 2847 712 ['Durbl' 'Enrgy' 'HiTec' 'Hlth' 'Manuf' 'NoDur' 'Other' 'Shops'
↳ 'Telcm'
'Utils']
```

37.1 Transfer learning

Transfer learning refers to the technique of starting with a pre-trained model (which captures general features from its source dataset) and then adapting it learn to perform on a specific dataset and target task. **Fine-tuning** is a specific type of transfer learning where the (pre-trained) model parameters are adjusted by training it on the new, task-specific dataset. This can involve adjusting all layers of the model or just the final layers, depending on the complexity of the task.

37.1.1 Performance-Efficient Fine-Tuning

Performance-efficient fine-tuning (PEFT) describes the approach of adapting a pre-trained model to a new, specific task using minimal computational resources and data. It employs efficient techniques, like LoRA which fine-tunes a small number of (extra) model parameters instead of all the model's parameters.

37.1.2 Low-Rank Adaptation

Low-Rank Adaptation (LoRA) speeds up the training process of large models by approximating the large set of parameters and representing them in a lower-dimensional space. It reduces the number of trainable parameters by learning pairs of rank-decomposition matrices while freezing the original weights.

37.1.3 Unsloth APIs

Unsloth provides a library that uses several advanced techniques to make training large language models (LLMs) much faster and more efficient, for example, by optimizing matrix multiplications, which are a key part of LLM training, by chaining them together efficiently.

Installing unsloth:

```
!pip install "unsloth[colab-new] @ git+https://github.com/unslothai/unsloth.git"
```

major_version, minor_version = torch.cuda.get_device_capability() - must install separately since torch 2.2.1 breaks packages

- if major_version >= 8 (new GPUs like Ampere, Hopper GPUs (RTX 30xx, RTX 40xx, A100, H100, L40))


```
!pip install --no-deps packaging ninja einops flash-attn xformers trl peft accelerate bitsandbytes
```
- else: older GPUs (V100, Tesla T4, RTX 20xx)


```
!pip install --no-deps xformers trl peft accelerate bitsandbytes
```

```
WARNING[XFORMERS]: xFormers can't load C++/CUDA extensions. xFormers was built for:
PyTorch 2.3.0+cu121 with CUDA 1201 (you have 2.2.1+cu121)
Python 3.11.9 (you have 3.11.9)
Please reinstall xformers (see https://github.com/facebookresearch/xformers
↪#installing-xformers)
```

- install the corresponding xformers (<https://anaconda.org/xformers/xformers/files>)

```
!pip install xformers==0.0.25 # for torch 2.2.1+cu121
```

```
NEW_MODEL = True
model_id = "unsloth/llama-3-8b-bnb-4bit"
savedir = str(paths['scratch'] / 'finetuned_model')
output_dir = str(paths['scratch'] / "outputs")
max_seq_length = 8192
dtype = None # None for auto. Float16 for Tesla T4, V100, Bfloat16 for Ampere+
load_in_4bit = True # Use 4bit quantization to reduce memory usage. Can be False.
```

```
# 4bit pre quantized models from unsloth for 4x faster downloading + no OOMs
model, tokenizer = FastLanguageModel.from_pretrained(
    model_name = model_id if NEW_MODEL else savedir,
    max_seq_length = max_seq_length,
    dtype = dtype,
    load_in_4bit = load_in_4bit,
    # token = "hf_...", # if using gated models like meta-llama/Meta-Llama-3-8B
)
```

```
==((=====))== Unsloth: Fast Llama patching release 2024.5
    \\ /| GPU: NVIDIA GeForce RTX 3080 Laptop GPU. Max memory: 15.739 GB.-
    ↵Platform = Linux.
O^O/ \_/\ Pytorch: 2.2.1+cu121. CUDA = 8.6. CUDA Toolkit = 12.1.
\ \ \ / Bfloat16 = TRUE. Xformers = 0.0.25. FA = True.
"-____-" Free Apache license: http://github.com/unslothai/unsloth
```

Special tokens have been added in the vocabulary, make sure the associated word embeddings are fine-tuned or trained.

The unsloth library replaces HuggingFace's peft module:

```
from peft import AutoPeftModelForCausalLM
model = AutoPeftModelForCausalLM.from_pretrained(
    savedir, # YOUR MODEL YOU USED FOR TRAINING
    load_in_4bit = load_in_4bit,
)

from peft import LoraConfig, get_peft_model
config = LoraConfig(
    r=16,
    lora_alpha=16,
    target_modules=["query", "value"],
    lora_dropout=0.1,
    bias="none",
    modules_to_save=["classifier"],
)
model = get_peft_model(model, config)
```

```
# Add LoRA adapters so we only need to update less than 10% of all parameters
if NEW_MODEL:
    model = FastLanguageModel.get_peft_model(
        model,
        r = 16, # Choose any number > 0 ! Suggested 8, 16, 32, 64, 128
        target_modules = ["q_proj", "k_proj", "v_proj", "o_proj",
                          "gate_proj", "up_proj", "down_proj",],
        lora_alpha = 16,
        lora_dropout = 0, # Supports any, but = 0 is optimized
        bias = "none", # Supports any, but = "none" is optimized
        use_gradient_checkpointing = "unsloth", # True or "unsloth" for long context
        random_state = 3407,
        use_rslora = False, # supports rank stabilized LoRA
        loftq_config = None, # supports LoftQ
    )

# [NOTE] To train only on completions (ignoring the user's input) read TRL's docs_
# [here] (https://huggingface.co/docs/trl/sft\_trainer#train-on-completions-only).
# [NOTE] Remember to add the **EOS_TOKEN** to the tokenized output!! Otherwise you'll_
# get infinite generations!
```

Unsloth 2024.5 patched 32 layers with 32 QKV layers, 32 O layers and 32 MLP layers.

37.2 Supervised fine-tuning

Supervised Fine-Tuning adapts a pre-trained model to a specific task, by training the model on a new labeled dataset to predict the correct label for each input.

The TRL library provides the SFTTrainer class, which is designed to facilitate the SFT process. This class accepts a column in your training dataset that contains the prompt constructed from system instructions, questions, and answers.

https://huggingface.co/docs/trl/sft_trainer

37.2.1 HuggingFace Dataset module

The training data are converted to LLM instruction statements, and implemented as a HuggingFace Dataset class. This class can be conveniently created from many different sources, including data files of various formats or from a generator function.

```
# To generate a prompt statement as a training data point
EOS_TOKEN = tokenizer.eos_token    # Must add EOS_TOKEN
def generate_prompt(text, label=''):
    return f"""
Below is an instruction that describes a task.
Write a response that appropriately completes the request.

### Instruction:
The text of a business description can be classified in industry categories like_
→below.

"""+''.join(class_labels)+".

In one word, please respond with the industry classification category
of the following text delimited in triple quotes.

'''{text}'''

### Response:
{label} """ + EOS_TOKEN
```

```
# Provide training prompt statement as a generator function to implement a Dataset
→class
MAX_CHARS = 4096
def data_generator():
    for permno in train_index:
        text = ed[found.loc[permno, 'pathname']].replace('\n', '').lower()[:MAX_CHARS]
        yield {"text": generate_prompt(text, label=univ.loc[permno, 'sector'])}
dataset = Dataset.from_generator(data_generator)
```

```
MAX_EPOCHS = 16
trainer = SFTTrainer(
    model = model,
    tokenizer = tokenizer,
    train_dataset = dataset,
    dataset_text_field = "text",
    max_seq_length = max_seq_length,
    dataset_num_proc = 2,
```

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```

packing = False, # Can make training 5x faster for short sequences.
args = TrainingArguments(
    per_device_train_batch_size = 2, # 2,
    gradient_accumulation_steps = 4,
    warmup_steps = 5,
    max_steps = -1, # 60, -1
    num_train_epochs = MAX_EPOCHS, # default 3
    learning_rate = 2e-4,
    fp16 = not is_bfloat16_supported(),
    bf16 = is_bfloat16_supported(),
    logging_strategy = "steps" if VERBOSE else "no", # "epoch", "no", "steps"
    logging_steps = 1, # defaults to 500 if logging_strategy="steps"
    optim = "adamw_8bit",
    weight_decay = 0.01,
    lr_scheduler_type = "linear",
    seed = 3407,
    save_strategy="epoch", # Save the model checkpoint every epoch
    output_dir = output_dir,
),
)

```

Map (num_proc=2): 100% |██████████| 2847/2847 [00:02<00:00, 1058.27 examples/s]

```

# Show current memory stats
gpu_stats = torch.cuda.get_device_properties(0)
start_gpu_memory = round(torch.cuda.max_memory_reserved() / 1024 / 1024 / 1024, 3)
max_memory = round(gpu_stats.total_memory / 1024 / 1024 / 1024, 3)
print(f"GPU = {gpu_stats.name}. Max memory = {max_memory} GB.")
print(f"{start_gpu_memory} GB of memory reserved.")

```

GPU = NVIDIA GeForce RTX 3080 Laptop GPU. Max memory = 15.739 GB.
5.594 GB of memory reserved.

Helpers to generate input tokens and response

```

def generate_inputs(permno):
    """Transform text corresponding to permno into tokenized input"""
    text = ed[found.loc[permno, 'pathname']].replace('\n', '').lower()[:MAX_CHARS]
    inputs = tokenizer([generate_prompt(text)], return_tensors="pt").to("cuda")
    return inputs

```

```

def generate_output(inputs):
    """Generate response given tokenized input, and return decoded output text"""
    terminators = [
        tokenizer.eos_token_id,
        tokenizer.convert_tokens_to_ids("<|eot_id|>")
    ]
    outputs = model.generate(
        **inputs,
        max_new_tokens=16,
        eos_token_id=terminators,
        pad_token_id=tokenizer.eos_token_id,
        #do_sample=True,

```

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```

#temperature=0.01, #0.6,
#top_p=0.9,
do_sample=False,
use_cache=True,
)
response = outputs[0][len(inputs[0]):]
return tokenizer.decode(response, skip_special_tokens=True)

```

```

def evaluate_output(permnos, verbose=VERBOSE):
    """Return predicted and true labels"""
    y_pred, y_true = [], []
    for permno in permnos:
        inputs = generate_inputs(permno)
        output = generate_output(inputs).replace('\n', ' ')
        label = decode_label(output)
        gold = univ.loc[permno, 'sector']
        y_pred.append(label)
        y_true.append(gold)
        if verbose:
            print(permno, gold, ' [', label, ']', output)
    return y_pred, y_true

```

```

# Evaluate before fine-tuning
if True:
    FastLanguageModel.for_inference(model)    # Enable native 2x faster inference
    y_pred, y_true = evaluate_output(test_index)

    # generate classification report
    report = metrics.classification_report(y_true=y_true, y_pred=y_pred)
    print(f"Classification Report (Test Set) before fine-tuning:")
    print(report)

```

	precision	recall	f1-score	support
	0.00	0.00	0.00	0
Durbl	0.00	0.00	0.00	33
Enrgy	0.00	0.00	0.00	19
HiTec	0.00	0.00	0.00	141
Hlth	0.50	0.01	0.01	176
Manuf	0.12	0.06	0.08	69
NoDur	0.01	0.03	0.02	29
Other	0.00	0.00	0.00	153
Shops	0.00	0.00	0.00	64
Telcm	0.00	0.00	0.00	10
Utils	0.00	0.00	0.00	18
accuracy			0.01	712
macro avg	0.06	0.01	0.01	712
weighted avg	0.14	0.01	0.01	712

```

/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
->py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0

```

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```

in labels with no predicted samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in labels with no true samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0 in labels with no predicted samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in labels with no true samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0 in labels with no predicted samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in labels with no true samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.py:1509: UndefinedMetricWarning: Precision is ill-defined and being set to 0.0 in labels with no predicted samples. Use `zero_division` parameter to control this behavior.
_warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))

```

Train the model

```

# Training loop
trainer_stats = trainer.train()

```

```

==((=====))==  Unslot - 2x faster free finetuning | Num GPUs = 1
    \\  /|  Num examples = 2,847 | Num Epochs = 16
    0^0/ \_/_ \  Batch size per device = 2 | Gradient Accumulation steps = 4
    \       /  Total batch size = 8 | Total steps = 5,696
    "-____-"  Number of trainable parameters = 41,943,040
100%|██████████| 5696/5696 [20:39:52<00:00, 13.06s/it]

```

```

{'train_runtime': 74392.7458, 'train_samples_per_second': 0.612, 'train_steps_per_second': 0.077, 'train_loss': 0.494993617025654, 'epoch': 16.0}

```

```

# Show final memory and time stats
used_memory = round(torch.cuda.max_memory_reserved() / 1024 / 1024 / 1024, 3)
used_memory_for_lora = round(used_memory - start_gpu_memory, 3)
used_percentage = round(used_memory / max_memory * 100, 3)
lora_percentage = round(used_memory_for_lora / max_memory * 100, 3)
print(f"trainer_stats.metrics['train_runtime'] seconds used for training.")
print(f"Peak reserved memory = {used_memory} GB.")

```

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```
print(f"Peak reserved memory for training = {used_memory_for_lora} GB.")
print(f"Peak reserved memory % of max memory = {used_percentage} %.")
print(f"Peak reserved memory for training % of max memory = {lora_percentage} %.")
```

```
74392.7458 seconds used for training.
Peak reserved memory = 9.1 GB.
Peak reserved memory for training = 3.35 GB.
Peak reserved memory % of max memory = 57.818 %.
Peak reserved memory for training % of max memory = 21.285 %.
```

```
# Save fine-tuned model
# **[NOTE]** This ONLY saves the LoRA adapters, and not the full model.
if True:
    model.save_pretrained(savedir) # Local saving
    tokenizer.save_pretrained(savedir)
# model.push_to_hub("your_name/lora_model", token = "...") # Online saving
# tokenizer.push_to_hub("your_name/lora_model", token = "...")
```

```
# Evaluate train split
if False:
    FastLanguageModel.for_inference(model) # Enable native 2x faster inference
    y_pred, y_true = evaluate_output(train_index)

    # generate classification report
    report = metrics.classification_report(y_true=y_true, y_pred=y_pred)
    print(f"Classification Report (Training set):")
    print(report)
```

```
# Evaluate test split
if True:
    FastLanguageModel.for_inference(model) # Enable native 2x faster inference
    y_pred, y_true = evaluate_output(test_index)

    # generate classification report
    report = metrics.classification_report(y_true=y_true, y_pred=y_pred)
    print(f"Classification Report (Test Set) after fine-tuning:")
    print(report)
```

100% |██████████| 712/712 [09:10<00:00, 1.29it/s]

Classification Report (Test Set) after fine-tuning:				
	precision	recall	f1-score	support
	0.00	0.00	0.00	0
Durbl	0.33	0.61	0.43	33
Enrgy	1.00	0.47	0.64	19
HiTec	0.74	0.59	0.66	141
Hlth	0.96	0.89	0.92	176
Manuf	0.70	0.71	0.71	69
NoDur	0.70	0.55	0.62	29
Other	0.80	0.70	0.75	153
Shops	0.77	0.78	0.78	64

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Telcm	1.00	0.90	0.95	10
Utils	0.65	0.94	0.77	18
accuracy			0.72	712
macro avg	0.70	0.65	0.66	712
weighted avg	0.79	0.72	0.75	712

```
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
  ↵py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in
  ↵labels with no true samples. Use `zero_division` parameter to control this
  ↵behavior.
  _warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
  ↵py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in
  ↵labels with no true samples. Use `zero_division` parameter to control this
  ↵behavior.
  _warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
/home/terence/env3.11/lib/python3.11/site-packages/sklearn/metrics/_classification.
  ↵py:1509: UndefinedMetricWarning: Recall is ill-defined and being set to 0.0 in
  ↵labels with no true samples. Use `zero_division` parameter to control this
  ↵behavior.
  _warn_prf(average, modifier, f"{metric.capitalize()} is", len(result))
```

Display a few responses from latest model checkpoint

```
_ = evaluate_output(test_index[::-3], verbose=1)
```

```
17147 Hlth  [ Hlth ]      Hlth
22952 Other  [ Other ]     Other
14547 HiTec  [ HiTec ]     HiTec
88284 Hlth  [ Hlth ]      Hlth
88873 HiTec  [ Other ]     Hi there, Other has the highest weight so that's the
  ↵one
13777 HiTec  [ Other ]     Hi there, Other
89968 Other  [ Other ]     Other
16471 Other  [ Other ]     Other
21933 Hlth  [ Hlth ]      Hlth
90542 Hlth  [ Hlth ]      Hlth
22260 Manuf  [ NoDur ]    NoDur
16401 Enrgy  [ Enrgy ]    Enrgy
14329 Shops  [ Shops ]    Shops
79698 Hlth  [ ]      Hi there, I'm a business description writer, and based on
92443 Other  [ Other ]     Other
19085 Other  [ ]      Bank
86810 Other  [ NoDur ]    NoDur
18960 Hlth  [ Hlth ]      Hlth
15943 HiTec  [ ]      Hi there, The industry classification category of our
  ↵business description can be
17106 HiTec  [ HiTec ]     HiTec
76076 HiTec  [ HiTec ]     HiTec
20412 Manuf  [ Manuf ]    Manuf
13812 HiTec  [ HiTec ]     HiTec
```


RAG, CHATBOTS AND AGENTS

Concepts:

- Measuring the value of corporate philanthropy
- Retrieval Augmented Generation (RAG)
- Chatbots
- LLM Agents

References:

- Patrick Lewis, Ethan Perez, Aleksandra Piktus, Fabio Petroni, Vladimir Karpukhin, Naman Goyal†, Heinrich Kütller, Mike Lewis†, Wen-tau Yih, Tim Rocktäschel, Sebastian Riedel, Douwe Kiela, 2021, Retrieval-Augmented Generation for Knowledge-Intensive NLP Tasks
- Lim, T., 2010, Measuring the value of corporate philanthropy: Social impact, business benefits, and investor returns. published by CECP.

```
# Chroma requires SQLite > 3.35, if you encounter issues with having too
# low of a SQLite version, try installing pysqlite3-binary, then enter
# the following three lines in sqlite_version.py to swap the packages:
# __import__('pysqlite3')
# import sys
# sys.modules['sqlite3'] = sys.modules.pop('pysqlite3')
import sqlite_version    # hack to use lower version of SQLite

# !ollama pull mxbai-embed-large  # vector embeddings model in Ollama
import ollama

from langchain_community.llms import Ollama
from langchain_text_splitters import RecursiveCharacterTextSplitter
# import pdfplumber    # PDF document loaders
# from langchain_community.document_loaders import PyPDFLoader
from langchain_community.document_loaders import UnstructuredMarkdownLoader
import chromadb
from tqdm import tqdm
import textwrap

def wrap(text):
    """Helper to wrap text for pretty printing"""
    return "\n".join([textwrap.fill(s) for s in text.split('\n')])
```

38.1 Retrieval Augmented Generation

Retrieval-Augmented Generation (RAG) combines two steps: retrieving information from a large database or knowledge base external to the LLM, and then generating a response using this retrieved information. By having access to up-to-date and relevant information, the LLM can provide answers that are more accurate and detailed.

38.1.1 Hallucination

Hallucination is when an AI makes up information that sounds believable but is actually incorrect or nonsensical. With RAG, since the AI's responses are based on relevant and factual information, there is a much higher chance it will stay truthful and reliable.

38.1.2 Langchain APIs

LangChain is a framework designed to facilitate the creation of applications that utilize language models. It simplifies the process of integrating language models with external data sources and other AI tools, for example, by providing a common interface to models served both locally (e.g. Ollama) or remotely (e.g. cloud-based server).

<https://python.langchain.com/v0.1/docs/integrations/llms/ollama/>

```
# temperature set low but nonzero so that chat responses can vary slightly
llm = Ollama(model="llama3:instruct", temperature=0.3)
```

LangChain includes convenient loaders for input documents of many formats.

Documents are read and split into chunks of, say, around 1000 characters with overlap. To drive the demonstrations of a chatbot and a collaborative conversation between multiple LLM agents, we load and ground their responses in a textbook on measuring the value of corporate philanthropy. This subject is about the comprehensive approach that considers social impact, business benefits, and investor expectations, so that companies can better understand and optimize the effectiveness of their philanthropic initiatives.

```
loader = UnstructuredMarkdownLoader('MVC.md')
document = loader.load()
text_splitter = RecursiveCharacterTextSplitter(chunk_size=1000, chunk_overlap=200)
chunked_documents = text_splitter.split_documents(document)
print('Number of chunks:', len(chunked_documents))
print(wrap(str(chunked_documents[:2])))
```

```
Number of chunks: 198
[Document(page_content='MEASURING THE VALUE OF CORPORATE PHILANTHROPY:
SOCIAL IMPACT, BUSINESS BENEFITS, AND INVESTOR RETURNS\nby\nTerence
Lim, Ph.D.\nReport Author and Manager, Standards and
Measurement,\nCommittee Encouraging Corporate Philanthropy\n(through
the 2008-2009 Goldman Sachs Public Service Program)\n\nHow to measure
the value and results of corporate philanthropy remains\none of
corporate giving professionals' greatest challenges. Social
and\nbusiness benefits are often long-term or intangible, which
make\nsystematic measurement complex. And yet: Corporate philanthropy
faces\nincreasing pressures to show it is as strategic, cost-effective,
and value-enhancing\nas possible. The industry faces a critical need
to assess current practices and\nmeasurement trends, clarify the
demands practitioners face for impact evidence,\nand identify the most
promising steps forward in order to make progress on
```

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these\ncallenges.', metadata={'source': 'MVC.P.md'}),
Document(page_content='This report aims to meet that need, by
providing the corporate\ncorporate\nphilanthropic community with a review of
recent measurement studies, models,\nand evidence drawn from
complementary business disciplines as well as the social\nsector.
Rather than present an other compendium of narrative accounts and
case\nstudies, we endeavor to generalize the most valuable concepts
and to recognize\nthe strengths and limitations of various measurement
approaches. In conjunction\nwith the annotated references that follow,
the analysis herein should provide an\nexcellent starting point for
companies wishing to adapt current methodologies in\nthe field to
their own corporate giving programs.\nTo realize meaningful benefits,
philanthropy cannot be treated as just\nanother "check in the box,"
but rather must be executed no less professionally,\nproactively, and
strategically than other core business activities. Our hope is\nthat
this work will enlighten giving professionals, CEOs, and the
investor', metadata={'source': 'MVC.P.md'})]

38.1.3 Vector Database

Chroma DB is an open-source vector store that is utilized for the storage and retrieval of vector embeddings. It performs fast search of text data, and is used by semantic search engines and large language models.

```
client = chromadb.Client()  
#client.delete_collection(name="docs")  
collection = client.get_or_create_collection(name="docs")
```

Use Ollama to serve a word embeddings models, such as the “`mxbai-embed-large`” model, for convert and store in Chroma DB’s vector database.

```
# store each document in a vector embedding database
for i, d in enumerate(chunked_documents):
    response = ollama.embeddings(model="mbai-embed-large", prompt=d.page_content)
    embedding = response["embedding"]
    collection.add(
        ids=[str(i)],
        embeddings=[embedding],
        documents=[d.page_content]
    )
```

Write a prompt query

```
# a question-answer prompt
query = "Why is it important to measure the value of corporate philanthropy?"
```

Embed the prompt query

```
# generate an embedding for the query
response = ollama.embeddings(
    prompt=query,
    model="mxbai-embed-large"
)
len(response['embedding'])    # vector length
```

1024

Retrieve the 3 most similar document chunks from the vector database

```
# retrieve the most relevant doc
results = collection.query(
    query_embeddings=[response["embedding"]],
    n_results=3,
)
data = ". ".join(results['documents'][0])
print(textwrap.fill(data))
```

A model for measuring the influence of corporate philanthropic initiatives on employee engagement.. consumer satisfaction and companies philanthropic record only when companies are perceived to have strong product quality and innovation capabilities and or operate in consumer oriented industries 22 Designing a measurement framework for loyalty should begin with an assessment of the perceptions customers have already developed as a result of a company s corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores Figure 9 suggests such a framework based on the literature reviewed Figure 9 A Framework for Measuring Customer Loyalty and Corporate Philanthropy Source Adapted from Bhattacharya C B Sen S 2004 and Smith V Langford P 2009 A company s marketing department is likely already to have implemented its own customer loyalty metrics in which case it is sensible to leverage these along with customized deliberate customer research It is imperative that the additional factors affecting loyalty scores e.g. philanthropic strategies criteria and disclosures are linked to can be successful in financial value There is a significant creating long term opportunity for companies to lead the business value industry in developing standards or differentiating themselves to the investor community through their disclosures about philanthropic efforts Documentation of the measurement process should be an important part of establishing quality disclosures and standards A high quality measurement process is a critical input for good management and demonstrates that a company recognize how its philanthropic strategies can be successful in creating long term business value The Dow Jones Sustainability Indexes questionnaire also asks if the company has in place a measurement system although it does not provide guidance about what Dow Jones considers to be a good system The review and findings summarized in this report suggest that companies could

Generate a response combining the query and data we retrieved in previous step

```
prompt = f"""
Only use relevant information in the following text delimited by triple quotes:

'''{data}'''"

Respond to this prompt: {query}.

In your response, only use information in the given text.
Do not mention that you referred to the text."""

```

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```
output = llm.invoke(prompt)
print(textwrap.fill(output))
```

It is imperative that the additional factors affecting loyalty scores, such as philanthropic strategies and disclosures, are linked to can be successful in financial value. This suggests that measuring the value of corporate philanthropy is important because it can create long-term business value. Additionally, a high-quality measurement process demonstrates that a company recognizes its philanthropic strategies can be successful in creating long-term business value, which can lead to differentiating themselves to the investor community through their disclosures about philanthropic efforts.

```
# show the supporting source document chunk ids
print(set(results['ids'][0]))
```

```
{'95', '120', '187'}
```

38.2 Chatbot

The chatbot is an LLM instance, where a record of the past conversation is included in the next prompt, so that the chatbot can reply to the user's question with memory of past queries and responses.

```
system_prompt = "You are a competent AI business manager."
```

```
instruction = """
I will provide you with ideas.
Please summarize and briefly explain all
the ideas, including those I have provided you earlier, in a bulleted list.
"""
```

```
# Simulate a sequence of user queries, which expect the LLM to remember past queries
# and responses.
user_queries = [
    "Idea: Sum up the amount of charitable contributions.",
    "Idea: Measure the dollar value of goods contributed.",
    "Idea: Count total employee volunteering hours.",
]
```

Concatenate past query and response turns to form next prompt

```
# Loop over number of incremental user queries and build up memory of responses

# These special input symbols and sequences are needed to construct the prompt
# including the past conversation. See
# https://llama.meta.com/docs/model-cards-and-prompt-formats/meta-llama-3/
tokens = {'bos_token': '<|begin_of_text|>',
          'eos_token': '<|end_of_text|>',
          'pad_token': '<|reserved_special_token_250|>','
```

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```

'system_header': '<|start_header_id|>system<|end_header_id|>',
'assistant_header': '<|start_header_id|>assistant<|end_header_id|>',
'user_header': '<|start_header_id|>user<|end_header_id|>',
'eot': '<|eot_id|>',
}

responses = []    # memory of past AI-assistant turns
for turn in tqdm(range(len(user_queries))):
    # 1. Start with system message
    prompt = tokens['bos_token']
    prompt += "\n".join([tokens['system_header'],
                        system_prompt,
                        tokens['eot']]) + '\n\n'

    # 2. Add user instruction and first user prompt
    prompt += "\n".join([tokens['user_header'],
                        instruction,
                        user_queries[0],
                        tokens['eot']]) + '\n\n'

    # 3. Loop through past turns of AI response and user prompt
    for response, query in zip(responses, user_queries[1:][:len(responses)]):

        # a. Add AI response from memory
        prompt += "\n".join([tokens['assistant_header'],
                            response,
                            tokens['eot']]) + '\n\n'

        # b. Add next user prompt
        prompt += "\n".join([tokens['user_header'],
                            query,
                            tokens['eot']]) + '\n\n'

    # 4. End with assistant header to elicit AI response
    prompt += tokens['assistant_header']

    response = llm.invoke(prompt)
    responses.append(response)

```

100% |██████████| 3/3 [00:16<00:00, 5.53s/it]

Show the final response from the last turn of the Chatbot

```

print('FINAL RESPONSE:')
print(wrap(response))

```

FINAL RESPONSE:
Here's the updated list with the new idea:

* **Sum up the amount of charitable contributions**: This idea likely refers to calculating and aggregating the total amount of donations made by a company or organization to various charities. This could be an important metric for tracking philanthropic efforts and measuring social responsibility.

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- * **Measure the dollar value of goods contributed**: This idea suggests quantifying the monetary value of goods, products, or services donated by a company or individual to charitable causes. This could include in-kind donations, product drives, or other forms of non-monetary giving.
- * **Count total employee volunteering hours**: This idea focuses on tracking and aggregating the total number of hours that employees spend volunteering for charitable organizations or community events. This metric can help measure employee engagement, corporate social responsibility, and the impact of company-sponsored volunteer programs.

Please provide more ideas, and I'll keep adding them to the list!

Show the last prompt that was asked of the chatbot: it includes the entire memory of the past conversation.

```
print("FINAL PROMPT:")
print(prompt)
```

FINAL PROMPT:
 <|begin_of_text|><|start_header_id|>system<|end_header_id|>
 You are a competent AI business manager.
 <|eot_id|>

<|start_header_id|>user<|end_header_id|>

I will provide you with ideas.
 Please summarize and briefly explain all
 the ideas, including those I have provided you earlier, in a bulleted list.

Idea: Sum up the amount of charitable contributions.
 <|eot_id|>

<|start_header_id|>assistant<|end_header_id|>
 Since this is the first idea you've provided, I'll start by summarizing it:

* **Sum up the amount of charitable contributions**: This idea likely refers to calculating and aggregating the total amount of donations made by a company or organization to various charities. This could be an important metric for tracking philanthropic efforts and measuring social responsibility.

Please go ahead and provide more ideas, and I'll add them to the list!
 <|eot_id|>

<|start_header_id|>user<|end_header_id|>
 Idea: Measure the dollar value of goods contributed.
 <|eot_id|>

<|start_header_id|>assistant<|end_header_id|>
 Here's the updated list with the new idea:

* **Sum up the amount of charitable contributions**: This idea likely refers to calculating and aggregating the total amount of donations made by a company or organization to various charities. This could be an important metric for tracking philanthropic efforts and measuring social responsibility.

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```
* **Measure the dollar value of goods contributed**: This idea suggests_
↳ quantifying the monetary value of goods, products, or services donated by a_
↳ company or individual to charitable causes. This could include in-kind donations,
↳ product drives, or other forms of non-monetary giving.
```

Please provide more ideas, and I'll keep adding them to the list!
<|eot_id|>

<|start_header_id|>user<|end_header_id|>
Idea: Count total employee volunteering hours.
<|eot_id|>

<|start_header_id|>assistant<|end_header_id|>

38.3 Agents

In multi-agent LLM systems, multiple LLM agents interact with each other or work in collaboration to achieve complex tasks or goals. Frameworks such as Microsoft's Autogen provides a multi-agent conversation framework as a high-level abstraction with an open-source library to build complex workflows.

- <https://www.microsoft.com/en-us/research/project/autogen/>

We demonstrate an illustrative workflow of a conversation between three LLM agents, who perform the roles of a Chief Executive Officer, a Chief Giving Officer (who manages the company's corporate philanthropy program), and an AI Assistant. Over several turns, they incrementally brainstorm and build up a plan for measuring the value of their program, drawing only from information in the RAG document store.

38.3.1 Role-playing

AI Assistant agent

This agent responds to a query using RAG. To reduce hallucination, the prompt is clearly written to stick to the retrieved text, and to simply respond "I don't know" if the answer cannot be found in the text. This agent performs the role of an AI Corporate Giving expert assistant (named CorGi), whose responses only use information retrieved from the textbook stored in the underlying database.

```
def rag_agent(text, n_results=3):
    """Role of a RAG-based question-answering agent"""
    response = ollama.embeddings(prompt=text, model="mxbai-embed-large")

    results = collection.query(query_embeddings=[response["embedding"]],
                               n_results=n_results)
    data = "\n".join(results['documents'][0])

    rag_prompt=f"""
    You are a helpful AI assistant.
    Only use the information in the following text delimited by triple quotes:
    """
    rag_prompt+=f"""
    {data}
    """

    Provide an answer to this question: {text}.
```

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You answer must only contain information in the given text.
 If the information requested is not in the text, say "I don't know".
 Be concise.
 Do not mention that you referred to the text."""

```
# generate a response combining the prompt and data
output = llm.invoke(rag_prompt)
return output, results['ids'][0]
```

Chief Giving Officer agent

This role collects and summarizes of the responses received from the AI Assistant agent, to present to the Chief Executive Officer.

```
def cgo_agent(text):
    """Role of an information-summarizing Chief Giving Officer"""
    cgo_prompt = f"""
You are the chief giving officer of a company.
You want to describe a plan for measuring the value
of your company's corporate philanthropy program.
Only use the most relevant information about the plan
given in the following text delimited by triple quotes:

'''{text}'''

Please summarize and explain all the parts of the plan given in the text using a
→bulleted list.
Be complete and concise.
In your summary, do not use any information that is not in the given text.
"""

    output = llm.invoke(cgo_prompt)
    return output
```

Chief Executive Officer agent

This LLM agent generates questions, given the text of the plan, for the other agents to answer and add improvements.

```
def ceo_agent(text):
    """Role as an inquisitive Chief Executive Officer"""
    ceo_prompt = f"""
You are the chief executive officer of a company.
You want to know about the plan for measuring the value
of your company's corporate philanthropy program.
The plan is given in the text delimited by triple quotes:

'''{text}'''

Please ask a simple, general question for an idea to improve the your company's plan
that is different than the text.
Be concise.""""

    output = llm.invoke(ceo_prompt)
    return output
```

Loop over several turns of the conversation between the three agents, who collaboratively develop the plan.

```
memory = '* Measure the amount of monetary donations.'
docs = []
for turn in range(10):
    print(f"Turn {turn+1}...")
    question = ceo_agent(memory)
    print('CEO >>>', wrap(question))
    print('\n-----\n')
    answer, doc = rag_agent(question)
    docs.append(doc)
    print('Corgi-AI >>>', wrap(answer))
    print('\n-----\n')
    memory = cgo_agent("\n".join([memory, answer]))
    print('CGO >>>', wrap(memory))
    print('\n-----')
print('Source documents:', set(docs))
```

Turn 1...

CEO >>> What metrics would you recommend tracking to gauge the program's impact on employee engagement and morale?

Corgi-AI >>> How are outcome metrics designed and tracked? Draws from knowledge and experience of third-party domain-area experts engaged to collect (and/or supervise the collection of) data and then to conduct evaluation analysis.

Outcome metrics for gauging program's impact on employee engagement and morale: How are outcome metrics designed and tracked?

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Measure monetary donations**: The plan involves tracking the amount of monetary donations made by the company.
- **Outcome metrics designed and tracked with expert input**: To design and track outcome metrics, the company will draw from the knowledge and experience of third-party domain-area experts who will collect (and/or supervise the collection of) data and conduct evaluation analysis.
- **Metrics for program impact on employee engagement and morale**: The plan also includes designing and tracking outcome metrics to gauge the program's impact on employee engagement and morale.

Turn 2...

CEO >>> What opportunities are there to leverage our corporate philanthropy program as a recruitment tool to attract top talent who share our values?

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Corgi-AI >>> Philanthropy provides access to new relationships and opportunities, whereby the company can find test and demonstrate new ideas, technologies, and products. This could potentially attract top talent who share our values.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Measure monetary donations**: The plan involves tracking the amount of monetary donations made by the company.
- **Outcome metrics designed and tracked with expert input**: The company will draw from the knowledge and experience of third-party domain-area experts to design and track outcome metrics. These experts will collect data and conduct evaluation analysis.
- **Metrics for program impact on employee engagement and morale**: The plan includes designing and tracking outcome metrics to gauge the program's impact on employee engagement and morale.

Note: There is no mention of specific metrics or targets in the text, only that the company will design and track them with expert input.

Turn 3...

CEO >>> What steps can be taken to ensure that the value of the corporate philanthropy program is communicated effectively to stakeholders, including employees and customers?

Corgi-AI >>> To ensure effective communication of corporate philanthropy program value to stakeholders, including employees and customers:

- * Leverage existing customer loyalty metrics
 - * Conduct customized deliberate customer research
 - * Measure perceptions customers have developed as a result of company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
-

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Measure monetary donations**: The plan involves tracking the amount of monetary donations made by the company.
- **Outcome metrics designed and tracked with expert input**: The company will design and track outcome metrics with the help of third-party domain-area experts. These experts will collect data and conduct evaluation analysis to measure the impact of the corporate philanthropy program.

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- **Metrics for program impact on employee engagement and morale**:** The plan includes designing and tracking outcome metrics to gauge the program's impact on employee engagement and morale.
- **Leverage existing customer loyalty metrics**:** To communicate the value of the corporate philanthropy program to stakeholders, including customers, the company will use its existing customer loyalty metrics.
- **Conduct customized deliberate customer research**:** The company will conduct research specifically designed to understand how customers perceive the corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- **Measure perceptions and loyalty scores**:** The plan involves measuring the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.

Turn 4...

CEO >>> What steps can be taken to ensure that the impact of the corporate philanthropy program on employee engagement and morale is also reflected in the company's overall employee retention rates?

Corgi-AI >>> Companies can engage employees through group volunteer programs and awareness of their philanthropic initiatives which raise employee motivation, productivity, and a sense of identification with the organization. This can contribute to business value by enhancing employee engagement.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Measure monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- **Outcome metrics designed and tracked with expert input**:** Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- **Metrics for program impact on employee engagement and morale**:** Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
- **Leverage existing customer loyalty metrics**:** Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- **Conduct customized deliberate customer research**:** Conduct

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research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.

- **Measure perceptions and loyalty scores**: Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
-

Turn 5...

CEO >>> What if we also tracked the number of employee volunteer hours and days taken off for volunteering, to better understand how our corporate philanthropy program affects work-life balance and overall job satisfaction?

Corgi-AI >>> Positive job-related behaviors include objective metrics such as reduced absenteeism and lower employee turnover. Additionally, enhanced work effort, advocacy, and cooperative conduct are also considered positive outcomes.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Measure monetary donations**: Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- **Outcome metrics designed and tracked with expert input**: Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- **Metrics for program impact on employee engagement and morale**: Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
- **Leverage existing customer loyalty metrics**: Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- **Conduct customized deliberate customer research**: Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- **Measure perceptions and loyalty scores**: Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.

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Note: The plan also mentions positive job-related behaviors, such as reduced absenteeism, lower employee turnover, enhanced work effort, advocacy, and cooperative conduct, but this is not part of the specific measurement plan.

Turn 6...

CEO >>> What are some potential metrics or indicators that could be used to measure the program's impact on the company's reputation and brand equity?

Corgi-AI >>> Enhancing the company's reputation or brand.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- ****Measure monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- ****Outcome metrics designed and tracked with expert input**:** Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- ****Metrics for program impact on employee engagement and morale**:** Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
- ****Leverage existing customer loyalty metrics**:** Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- ****Conduct customized deliberate customer research**:** Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- ****Measure perceptions and loyalty scores**:** Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.

Turn 7...

CEO >>> What steps can be taken to ensure that the metrics and data collected from the program's impact on employee engagement and morale are also used to inform and improve the overall corporate philanthropy strategy?

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Corgi-AI >>> To ensure that metrics and data collected from the program's impact on employee engagement and morale are used to inform and improve the overall corporate philanthropy strategy, CEOs can:

- * View the goal of their philanthropic programs as creating business innovation and building new market knowledge.
- * Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way.

These steps can help leverage the benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- ****Measure monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- ****Outcome metrics designed and tracked with expert input**:** Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- ****Metrics for program impact on employee engagement and morale**:** Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
- ****Leverage existing customer loyalty metrics**:** Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- ****Conduct customized deliberate customer research**:** Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- ****Measure perceptions and loyalty scores**:** Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
- ****Use metrics to inform and improve strategy**:** View the goal of the philanthropic programs as creating business innovation and building new market knowledge. Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way, which can help leverage the benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.

Note: The plan does not explicitly mention how often or when these metrics should be measured, but it implies that they will be used to inform and improve the overall corporate philanthropy strategy.

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Turn 8...

CEO >>> What are some potential non-monetary metrics we could track to measure the value of our corporate philanthropy program, such as volunteer hours or community partnerships?

Corgi-AI >>> Some potential non-monetary metrics we could track to measure the value of our corporate philanthropy program include:

- * Volunteer hours
 - * Community partnerships
-

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- ****Measure monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- ****Outcome metrics designed and tracked with expert input**:** Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- ****Metrics for program impact on employee engagement and morale**:** Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
- ****Leverage existing customer loyalty metrics**:** Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- ****Conduct customized deliberate customer research**:** Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- ****Measure perceptions and loyalty scores**:** Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
- ****Use metrics to inform and improve strategy**:** View the goal of the philanthropic programs as creating business innovation and building new market knowledge. Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way, which can help leverage the benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.
- ****Non-monetary metrics**:** Consider tracking non-monetary metrics

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such as volunteer hours and community partnerships to measure the value of the corporate philanthropy program.

Turn 9...

CEO >>> What steps can we take to ensure that our employees are aware of and feel invested in the corporate philanthropy program, beyond just tracking metrics?

Corgi-AI >>> Companies can engage employees through group volunteer programs and awareness of their philanthropic initiatives, which raise employee motivation, productivity, and a sense of identification with the organization.

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- ****Measure monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- ****Outcome metrics designed and tracked with expert input**:** Design and track outcome metrics with the help of third-party domain-area experts to measure the impact of the corporate philanthropy program. These experts will collect data and conduct evaluation analysis.
- ****Metrics for program impact on employee engagement and morale**:** Design and track outcome metrics to gauge the program's impact on employee engagement and morale, which can contribute to business value by enhancing employee engagement.
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- ****Measure perceptions and loyalty scores**:** Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
- ****Use metrics to inform and improve strategy**:** View the goal of the philanthropic programs as creating business innovation and building new market knowledge. Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way, which can help leverage the benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.

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- ****Non-monetary metrics**:** Consider tracking non-monetary metrics such as volunteer hours and community partnerships to measure the value of the corporate philanthropy program.
-

Turn 10...

CEO >>> What steps can be taken to ensure that the impact of our corporate philanthropy program on employee engagement and morale is not only measured but also effectively communicated to employees, fostering a sense of ownership and motivation?

Corgi-AI >>> To ensure the impact of our corporate philanthropy program on employee engagement and morale is effectively communicated to employees, fostering a sense of ownership and motivation:

- * Understand the diverse range of emotional needs of employees
 - * Design programs that fulfill those needs
 - * Measure objective metrics such as reduced absenteeism, lower employee turnover, and greater efficiency
 - * Assess subjective outcomes like enhanced work effort, advocacy, and co-operative conduct in performance reviews
-

CGO >>> Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- ****Monetary donations**:** Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- ****Outcome metrics**:** Design and track outcome metrics with expert input to measure the impact of the corporate philanthropy program. This includes metrics for:
 - + Program impact on employee engagement and morale
 - + Customer loyalty and perceptions
- ****Existing customer loyalty metrics**:** Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- ****Deliberate customer research**:** Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- ****Perceptions and loyalty scores**:** Measure the perceptions customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.
- ****Strategy improvement**:** View the goal of the philanthropic programs as creating business innovation and building new market knowledge. Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way, which can help leverage the

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benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.

- **Non-monetary metrics**: Consider tracking non-monetary metrics such as:
 - + Volunteer hours
 - + Community partnerships
- **Employee engagement and morale**: To ensure the impact of the corporate philanthropy program on employee engagement and morale is effectively communicated to employees, fostering a sense of ownership and motivation:
 - + Understand the diverse range of emotional needs of employees
 - + Design programs that fulfill those needs
 - + Measure objective metrics such as:
 - Reduced absenteeism
 - Lower employee turnover
 - Greater efficiency
 - + Assess subjective outcomes like:
 - Enhanced work effort
 - Advocacy
 - Co-operative conduct in performance reviews

Source documents: {'15', '194', '5', '98', '120', '87', '2', '1', '102', '109', '94', '8', '97', '4', '85', '86', '28', '66', '95'}

Show the final turn

```
print("FINAL ANSWER")
print(wrap(memory))
```

FINAL ANSWER

Here is a summary of the plan for measuring the value of the company's corporate philanthropy program:

- **Monetary donations**: Track the amount of monetary donations made by the company to measure the financial aspect of the program.
- **Outcome metrics**: Design and track outcome metrics with expert input to measure the impact of the corporate philanthropy program. This includes metrics for:
 - + Program impact on employee engagement and morale
 - + Customer loyalty and perceptions
- **Existing customer loyalty metrics**: Use existing customer loyalty metrics to communicate the value of the corporate philanthropy program to stakeholders, including customers.
- **Deliberate customer research**: Conduct research specifically designed to understand how customers perceive the company's corporate philanthropic initiatives and whether these perceptions contribute to higher loyalty scores.
- **Perceptions and loyalty scores**: Measure the perceptions

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customers have developed as a result of the company's corporate philanthropic initiatives and whether these perceptions are contributing to higher loyalty scores.

- ****Strategy improvement**:** View the goal of the philanthropic programs as creating business innovation and building new market knowledge. Recognize that efficient philanthropists tend to view their philanthropic programs' goals in this way, which can help leverage the benefits of philanthropy for long-term financial value by enhancing employee engagement and morale.
- ****Non-monetary metrics**:** Consider tracking non-monetary metrics such as:
 - + Volunteer hours
 - + Community partnerships
- ****Employee engagement and morale**:** To ensure the impact of the corporate philanthropy program on employee engagement and morale is effectively communicated to employees, fostering a sense of ownership and motivation:
 - + Understand the diverse range of emotional needs of employees
 - + Design programs that fulfill those needs
 - + Measure objective metrics such as:
 - Reduced absenteeism
 - Lower employee turnover
 - Greater efficiency
 - + Assess subjective outcomes like:
 - Enhanced work effort
 - Advocacy
 - Co-operative conduct in performance reviews

For attribution, show the source reference documents which supported the responses.

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print("Source documents reference id's:", set(docs))
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+ '102', '109', '94', '8', '97', '4', '85', '86', '28', '66', '95'}
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