

Functions for portfolio selection

Package version 2.4-2

Enrico Schumann
es@enricoschumann.net
<https://CRAN.R-project.org/package=NMOF>

A main topic of Gilli et al. [2019] is non-standard portfolio-selection models; see Chapters 12–14. Nevertheless, the NMOF package also offers several functions that help with standard portfolio models, i.e. models that can be solved with traditional optimisation techniques such as quadratic programming.

1 Minimum-variance portfolios

The function `minvar` computes the minimum-variance portfolio for a given variance–covariance matrix, subject to holding-size constraints. As example data, the variable `var` contains a small variance–covariance matrix, computed from daily returns of five German stocks. The data are taken from http://enricoschumann.net/data/gilli_accuracy.html; the code to build the matrix is in the source file of this vignette.

```
> var
```

	CBK.DE	VOW.DE	CON.DE	LIN.DE	MUV2.DE
CBK.DE	0.000988	-1.80e-05	3.69e-04	2.08e-04	2.63e-04
VOW.DE	-0.000018	1.72e-03	8.57e-05	2.15e-05	2.84e-05
CON.DE	0.000369	8.57e-05	7.59e-04	1.94e-04	1.89e-04
LIN.DE	0.000208	2.15e-05	1.94e-04	2.66e-04	1.33e-04
MUV2.DE	0.000263	2.84e-05	1.89e-04	1.33e-04	2.59e-04

An example call, with minimum and maximum holding sizes specified.

```
> minvar(var, wmin = 0, wmax = 0.5)
```

[1] 6.94e-18 9.25e-02 4.69e-05 4.45e-01 4.62e-01
attr(,"variance")
[1] 0.000182

The function returns the portfolio weights with an attribute `variance` that provides the variance of this portfolio. The holding size constraints can also be specified as vectors, with different values for different assets.

```
> minvar(var,  
         wmin = c(0.1, 0, 0, 0, 0), ## enforce at least 10% weight in CBK.DE  
         wmax = 0.5)
```

Use `Inf` to switch off weight constraints.

```
> minvar(var, wmin = -Inf, wmax = Inf) ## no bounds  
> minvar(var, wmin = -Inf, wmax = 0.45) ## no lower bounds  
> minvar(var, wmin = 0.1, wmax = Inf) ## no upper bounds
```

The function also supports group constraints:

```
> ## group 1 consists of asset 1 only, and must have weight [0.25,0.30]  
> ## group 2 consists of assets 4 and 5, and must have weight [0.10,0.20]  
> minvar(var, wmin = 0, wmax = 0.40,  
         groups = list(1, 4:5),  
         groups.wmin = c(0.25, 0.1),  
         groups.wmax = c(0.30, 0.2))
```

[1] 0.250 0.217 0.333 0.149 0.051
attr(,"variance")
[1] 0.000357

Alternatively, group constraints can be specified through group names instead of positions.

```
> ## group A consists of asset 1 only, and must have weight [0.25,0.30]
> ## group B consists of assets 4 and 5, and must have weight [0.10,0.20]
> minvar(var, wmin = 0, wmax = 0.40,
         groups = c("A", "none", "none", "B", "B"),
         groups.wmin = c(A = 0.25, B = 0.1),
         groups.wmax = c(A = 0.30, B = 0.2))
```

```
[1] 0.250 0.217 0.333 0.149 0.051
attr("variance")
[1] 0.000357
```

2 Mean–variance efficient portfolios and frontiers

The function `mvPortfolio` computes a mean–variance-efficient portfolio for a given variance–covariance matrix and mean–return assumption, subject to holding-size constraints. We make up some data for four assets, with a constant correlation of 0.5. `mvPortfolio`

```
> vols <- c(0.10, 0.15, 0.20, 0.22) ## expected vols
> m <- c(0.06, 0.12, 0.09, 0.07) ## expected mean returns
> const_cor <- function(rho, na) {
  C <- array(rho, dim = c(na, na))
  diag(C) <- 1
  C
}
> var <- diag(vols) %*% const_cor(0.5, length(vols)) %*% diag(vols)
```

One way to compute a mean–variance-efficient portfolio is by requiring a minimum return.

```
> mvPortfolio(m, var, min.return = 0.08, wmax = 1)
```

```
[1] 0.667 0.333 0.000 0.000
```

```
> mvPortfolio(m, var, min.return = 0.10, wmax = 1)
```

```
[1] 3.33e-01 6.67e-01 0.00e+00 3.10e-18
```

```
> mvPortfolio(m, var, min.return = 0.12, wmax = 1)
```

```
[1] -1.11e-16 1.00e+00 -5.55e-17 2.64e-17
```

Alternatively, we may specify a trade-off between return and variance and minimise

$$-\lambda m'w + \frac{1}{2}(1-\lambda)w'var w,$$

in which w are the weights. If λ is a vector of length 2, then the function minimises

$$-\lambda_1 m'w + \frac{1}{2}\lambda_2 w'var w.$$

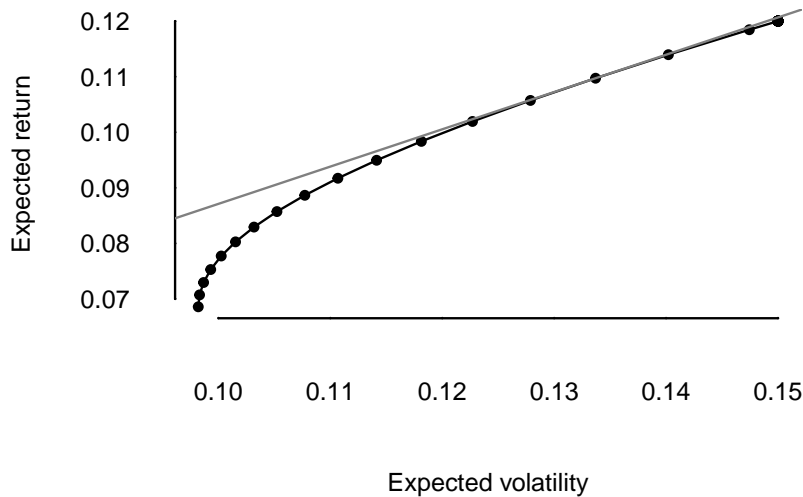
The function `mvFrontier` traces out a whole frontier of mean–variance efficient portfolios. (But see the discussion on frontiers in Chapter 14 of Gilli et al., 2019.) `mvFrontier`

```
> wmin <- 0
> wmax <- 1
> p1 <- mvFrontier(m, var, wmin = wmin, wmax = wmax, n = 50)
> ## with a 'risk-free' asset rf
> rf <- 0.02
> p2 <- mvFrontier(m, var, wmin = wmin, wmax = wmax, n = 50, rf = rf)
```

```

> par(las = 1, bty = "n", tck = 0.001, ps = 8)
> plot(p1$volatility, p1$return, pch = 19, cex = 0.5, type = "o",
      xlab = "Expected volatility",
      ylab = "Expected return")
> lines(p2$volatility, p2$return, col = grey(0.5))
> abline(v = 0, h = rf)

```



3 Return-based tracking portfolios

Function `trackingPortfolio` computes a portfolio that is close to another portfolio in the mean-square/ variance sense. The function to be minimised is determined by argument `objective`: supported are `trackingPortfolio` variance (the default) or `sum.of.squares`.

```

> ns <- 120
> R <- randomReturns(na = 1 + 10, ## first asset is the benchmark
                    ns = ns,
                    sd = 0.03,
                    mean = 0.005,
                    rho = 0.7)
> var <- cov(R)
> trackingPortfolio(var, wmax = 0.4)

```

```

[1] 6.81e-18 5.87e-02 7.99e-03 1.53e-01 2.17e-19 2.39e-01
[7] 9.89e-02 1.69e-01 2.47e-01 2.72e-02

```

4 Minimum-Expected-Shortfall portfolios

The function `minCVaR` computes a portfolio that minimises conditional Value-at-Risk; its default method is the LP approach described in Rockafellar and Uryasev [2000]. See *Minimising Conditional Value-at-Risk (CVaR)* (<http://enricoschumann.net/notes/minimising-conditional-var.html>) for more details

```
> ns <- 5000 ## number of scenarios
> na <- 20    ## number of assets
> R <- randomReturns(na, ns, sd = 0.01, rho = 0.5)
> sol <- minCVaR(R, q = 0.1)
```

References

- Manfred Gilli, Dietmar Maringer, and Enrico Schumann. *Numerical Methods and Optimization in Finance*. Elsevier/Academic Press, 2nd edition, 2019. URL <http://enricoschumann.net/NMOF>.
- R. Tyrrell Rockafellar and Stanislav Uryasev. Optimization of conditional value-at-risk. *Journal of Risk*, 2(3):21–41, 2000. doi: 10.21314/JOR.2000.038.