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# QUANTITATIVE PORTFOLIO OPTIMIZATION

Advanced Techniques and Applications

**MIQUEL NOGUER ALONSO, JULIÁN ANTOLÍN CAMARENA,  
ALBERTO BUENO GUERRERO**



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# **Quantitative Portfolio Optimization**

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MIQUEL NOGUER ALONSO  
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# Contents

<b>Preface</b>	<b>xiii</b>
<b>Acknowledgements</b>	<b>xv</b>
<b>About the Authors</b>	<b>xvii</b>
<b>CHAPTER 1</b>	
<b>Introduction</b>	<b>1</b>
1.1 Evolution of Portfolio Optimization	1
1.2 Role of Quantitative Techniques	1
1.3 Organization of the Book	4
<b>CHAPTER 2</b>	
<b>History of Portfolio Optimization</b>	<b>7</b>
2.1 Early beginnings	7
2.2 Harry Markowitz's Modern Portfolio Theory (1952)	9
2.3 Black-Litterman Model (1990s)	13
2.4 Alternative Methods: Risk Parity, Hierarchical Risk Parity and Machine Learning	19
2.4.1 <i>Risk Parity</i>	19
2.4.2 <i>Hierarchical Risk Parity</i>	26
2.4.3 <i>Machine Learning</i>	27
2.5 Notes	31
<b>PART ONE</b>	
<b>Foundations of Portfolio Theory</b>	
<b>CHAPTER 3</b>	
<b>Modern Portfolio Theory</b>	<b>35</b>
3.1 Efficient Frontier and Capital Market Line	35
3.1.1 <i>Case Without Riskless Asset</i>	35
3.1.2 <i>Case With a Riskless Asset</i>	41
3.2 Capital Asset Pricing Model	48
3.2.1 <i>Case Without Riskless Asset</i>	48

3.2.2	<i>Case With a Riskless Asset</i>	52
3.3	Multifactor Models	54
3.4	Challenges of Modern Portfolio Theory	59
3.4.1	<i>Estimation Techniques in Portfolio Allocation</i>	60
3.4.2	<i>Non-Elliptical Distributions and Conditional Value-at-Risk (CVaR)</i>	63
3.5	Quantum Annealing in Portfolio Management	65
3.6	Mean-Variance Optimization with CVaR Constraint	67
3.6.1	<i>Problem Formulation</i>	67
3.6.2	<i>Optimization Problem</i>	68
3.6.3	<i>Clarification of Optimization Classes</i>	68
3.6.4	<i>Numerical Example</i>	69
3.7	Notes	70

## CHAPTER 4

### Bayesian Methods in Portfolio Optimization **73**

4.1	The Prior	75
4.2	The Likelihood	79
4.3	The Posterior	80
4.4	Filtering	83
4.5	Hierarchical Bayesian Models	87
4.6	Bayesian Optimization	89
4.6.1	<i>Gaussian Processes in a Nutshell</i>	90
4.6.2	<i>Uncertainty Quantification and Bayesian Decision Theory</i>	94
4.7	Applications to Portfolio Optimization	96
4.7.1	<i>GP Regression for Asset Returns</i>	96
4.7.2	<i>Decision Theory in Portfolio Optimization</i>	96
4.7.3	<i>The Black-Litterman Model</i>	99
4.8	Notes	103

## PART TWO

### Risk Management

## CHAPTER 5

### Risk Models and Measures **107**

5.1	Risk Measures	107
5.2	VaR and CVaR	109
5.2.1	<i>VaR</i>	110
5.2.2	<i>CVaR</i>	112



5.3	Estimation Methods	116
5.3.1	<i>Variance-Covariance Method</i>	116
5.3.2	<i>Historical Simulation</i>	116
5.3.3	<i>Monte Carlo Simulation</i>	117
5.4	Advanced Risk Measures: Tail Risk and Spectral Measures	118
5.4.1	<i>Tail Risk Measures</i>	118
5.4.2	<i>Spectral Measures</i>	120
5.5	Notes	123

## CHAPTER 6

<b>Factor Models and Factor Investing</b>		<b>125</b>
6.1	Single and Multifactor Models	126
6.1.1	<i>Statistical Models</i>	127
6.1.2	<i>Macroeconomic Models</i>	128
6.1.3	<i>Cross-sectional Models</i>	130
6.2	Factor Risk and Performance Attribution	135
6.3	Machine Learning in Factor Investing	141
6.4	Notes	144

## CHAPTER 7

Market Impact, Transaction Costs, and Liquidity		145
7.1	Market Impact Models	145
7.2	Modeling Transaction Costs	148
7.2.1	Single Asset	151
7.2.2	Multiple Assets	154
7.3	Optimal Trading Strategies	155
7.3.1	Mei, DeMiguel, and Nogales (2016)	156
7.3.2	Skaf and Boyd (2009)	159
7.4	Liquidity Considerations in Portfolio Optimization	161
7.4.1	MV and Liquidity	162
7.4.2	CAPM and Liquidity	163
7.4.3	APT and Liquidity	165
7.5	Notes	167

## PART THREE

### Dynamic Models and Control

## CHAPTER 8

<b>Optimal Control</b>	<b>171</b>
8.1 Dynamic Programming	171

8.2	Approximate Dynamic Programming	171
8.3	The Hamilton-Jacobi-Bellman Equation	172
8.4	Sufficiently Smooth Problems	174
8.5	Viscosity Solutions	176
8.6	Applications to Portfolio Optimization	180
8.6.1	<i>Classical Merton Problem</i>	180
8.6.2	<i>Multi-asset Portfolio with Transaction Costs</i>	181
8.6.3	<i>Risk-sensitive Portfolio Optimization</i>	183
8.6.4	<i>Optimal Portfolio Allocation with Transaction Costs</i>	184
8.6.5	<i>American Option Pricing</i>	184
8.6.6	<i>Portfolio Optimization with Constraints</i>	184
8.6.7	<i>Mean-variance Portfolio Optimization</i>	185
8.6.8	<i>Schödinger Control in Wealth Management</i>	185
8.7	Notes	187
<b>CHAPTER 9</b>		
<b>Markov Decision Processes</b>		<b>189</b>
9.1	Fully Observed MDPs	191
9.2	Partially Observed MDPs	192
9.3	Infinite Horizon Problems	194
9.4	Finite Horizon Problems	198
9.5	The Bellman Equation	200
9.6	Solving the Bellman Equation	203
9.7	Examples in Portfolio Optimization	205
9.7.1	<i>An MDP in Multi-asset Allocation with Transaction Costs</i>	205
9.7.2	<i>A POMDP for Asset Allocation with Regime Switching</i>	205
9.7.3	<i>An MDP with Continuous State and Action Spaces for Option Hedging with Stochastic Volatility</i>	206
9.8	Notes	207
<b>CHAPTER 10</b>		
<b>Reinforcement Learning</b>		<b>209</b>
10.1	Connections to Optimal Control	211
10.1.1	<i>Policy Iteration</i>	212
10.1.2	<i>Value Iteration</i>	214
10.1.3	<i>Continuous vs. Discrete Formulations</i>	215
10.2	The Environment and The Reward Function	217
10.2.1	<i>The Environment</i>	217

10.2.2	<i>The Reward Function</i>	220
10.3	Agents Acting in an Environment	223
10.4	State-Action and Value Functions	225
10.4.1	<i>Value Functions</i>	226
10.4.2	<i>Gradients and Policy Improvement</i>	227
10.5	The Policy	230
10.6	On-Policy Methods	233
10.7	Off-Policy Methods	235
10.8	Applications to Portfolio Optimization	238
10.8.1	<i>Mean-variance Optimization</i>	238
10.8.2	<i>Reinforcement Learning Comparison with Mean-variance Optimization</i>	239
10.8.3	<i>G-Learning and GIRL</i>	241
10.8.4	<i>Continuous-time Penalization in Portfolio Optimization</i>	244
10.8.5	<i>Reinforcement Learning for Utility Maximization</i>	246
10.8.6	<i>Continuous-time Portfolio Optimization with Transaction Costs</i>	246
10.9	Notes	247

## PART FOUR

### Machine Learning and Deep Learning

#### CHAPTER 11

<b>Deep Learning in Portfolio Management</b>	<b>253</b>
11.1 Neurons and Activation Functions	253
11.2 Neural Networks and Function Approximation	256
11.3 Review of Some Important Architectures	259
11.4 Physics-Informed Neural Networks	269
11.5 Applications to Portfolio Optimization	276
11.5.1 <i>Dynamic Asset Allocation Using the Heston Model</i>	276
11.5.2 <i>Option-Based Portfolio Insurance Using the Bates Model</i>	277
11.5.3 <i>Factor Learning Approach to Generative Modeling of Equities</i>	278
11.6 The Case for and Against Deep Learning	280
11.7 Notes	282

**CHAPTER 12**

<b>Graph-based Portfolios</b>	<b>285</b>
12.1 Graph Theory-Based Portfolios	285
12.1.1 <i>Literature Review</i>	285
12.2 Graph Theory Portfolios: MST and TMFG	285
12.2.1 <i>Equations and Formulas</i>	286
12.2.2 <i>Results</i>	287
12.3 Hierarchical Risk Parity	289
12.4 Notes	294

**CHAPTER 13**

<b>Sensitivity-based Portfolios</b>	<b>295</b>
13.1 Modeling Portfolios Dynamics with PDEs	296
13.2 Optimal Drivers Selection: Causality and Persistence	297
13.3 AAD Sensitivities Approximation	303
13.3.1 <i>Optimal Network Selection</i>	304
13.3.2 <i>Sensitivity Analysis</i>	304
13.3.3 <i>Sensitivity Distance Matrix</i>	304
13.4 Hierarchical Sensitivity Parity	307
13.5 Implementation	307
13.5.1 <i>Datasets</i>	307
13.5.2 <i>Experimental Setup</i>	308
13.5.3 <i>Short-to-medium Investments</i>	309
13.5.4 <i>Long-term Investments</i>	312
13.6 Conclusion	315

**PART FIVE****Backtesting****CHAPTER 14**

<b>Backtesting in Portfolio Management</b>	<b>319</b>
14.1 Introduction	319
14.2 Data Preparation and Handling	319
14.3 Implementation of Trading Strategies	320
14.4 Types of Backtests	321
14.4.1 <i>Walk-forward Backtest</i>	321
14.4.2 <i>Resampling Method</i>	321
14.4.3 <i>Monte Carlo Simulations and Generative Models</i>	321
14.5 Performance Metrics	322
14.6 Avoiding Common Pitfalls	323

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14.7	Advanced Techniques	323
14.8	Case Study: Applying Backtesting to a Real-World Strategy	324
14.9	Impact of Market Conditions on Backtest Results	324
14.10	Integration with Portfolio Management	325
14.11	Tools and Software for Backtesting	325
14.12	Regulatory Considerations	326
14.13	Conclusion	326
<b>CHAPTER 15</b>		
	<b>Scenario Generation</b>	<b>329</b>
15.1	Historical Scenarios	329
15.2	Bootstrapping Scenarios	330
15.3	Copula-Based Scenarios	330
15.4	Risk Factor Model-Based Scenarios	330
15.5	Time Series Model Scenarios	331
15.6	Variational Autoencoders	331
15.7	Generative Adversarial Networks (GANs)	332
<b>Appendix</b>		<b>333</b>
A.1	Software and Tools for Portfolio Optimization	333
<b>Bibliography</b>		<b>335</b>
<b>Index</b>		<b>357</b>



# Preface

**Q**uantitative portfolio optimization is a cornerstone of modern financial management, providing a rigorous framework for balancing risk and return in investment portfolios. This book, *Quantitative Portfolio Optimization: Advanced Techniques and Applications*, aims to serve as both a comprehensive introduction for those new to the field and a deep dive into the latest advancements for experienced practitioners and researchers.

The genesis of portfolio optimization can be traced back to Harry Markowitz's Modern Portfolio Theory (MPT) in the 1950s, which introduced the now-fundamental concepts of diversification and mean-variance optimization. Since then, the field has evolved significantly, integrating a wide array of quantitative methods, including Bayesian statistics, machine learning algorithms, and advanced optimization techniques. These methods have transformed portfolio management from a discipline grounded in basic statistical principles to one that leverages innovative computational techniques to solve increasingly complex problems.

This book is structured to reflect this evolution, beginning with foundational theories before progressing to advanced applications. We explore not only traditional models such as the Capital Asset Pricing Model (CAPM) and the Black-Litterman model but also the latest developments in areas such as reinforcement learning, deep learning, and graph-based portfolio construction. Additionally, we cover emerging topics like quantum computing's role in portfolio optimization and the integration of partial differential equations (PDEs) for modeling portfolio dynamics.

Each chapter is meticulously designed to bridge theory with practice, offering detailed explanations of the mathematical underpinnings of each technique, followed by practical applications using real-world data. The mathematical rigor is complemented by code implementations and case studies that demonstrate the practical utility of the methods discussed.

Whether you are a professional, researcher, or student in the field of finance, we hope this book enhances your understanding of quantitative portfolio optimization and equips you with the knowledge to apply these techniques effectively. As the financial markets continue to evolve, so must the methods we use to manage them. We believe that the approaches detailed

in this book will be instrumental in addressing the challenges and opportunities of tomorrow's financial world.

Finally, we extend our deepest gratitude to our colleagues, students, and family members, whose support and encouragement have been invaluable throughout the creation of this book. It is our sincere hope that this work contributes meaningfully to the ongoing development of the field of quantitative portfolio optimization.



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**Miquel Noguer Alonso** is a seasoned financial professional and academic with over 30 years of experience in the industry. He is the Founder of the Artificial Intelligence Finance Institute and Head of Development at Global AI. His career includes roles such as Executive Director at UBS AG and CIO for Andbank. He has served on the European Investment Committee UBS for a decade. He is on the advisory board of FDP Institute and CFA NY.

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been presented at various international conferences and published in journals such as *Quantitative Finance*; *Journal of Derivatives*, *Mathematics*; and *Chaos, Solitons and Fractals*.

Among the topics addressed in his research are the term structure of interest rates, the valuation and hedging of derivatives, the immunization of bond portfolios, and a quantum-mechanical model for interest rate derivatives. His article “Bond Market Completeness Under Stochastic Strings with Distribution-Valued Strategies” has been considered a feature article in *Quantitative Finance*.

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He has also functioned as anonymous reviewer for various journals, and regularly reviews articles for Mathematical Reviews of the American Mathematical Society.

# Introduction

## 1.1 EVOLUTION OF PORTFOLIO OPTIMIZATION

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Portfolio optimization has undergone significant transformation since its inception. Initially, the focus was on maximizing returns without much regard for risk. This changed with the introduction of Modern Portfolio Theory (MPT) by Harry Markowitz in the 1950s, which introduced the concept of balancing risk and return. Markowitz's mean-variance optimization laid the groundwork for the systematic assessment of portfolio risk and diversification.

Over the years, portfolio optimization has evolved to incorporate various advanced techniques and models. These include the Capital Asset Pricing Model (CAPM), Arbitrage Pricing Theory (APT), and more sophisticated approaches like the Black-Litterman model, risk parity, and hierarchical risk parity. Recently, machine learning methods have also been integrated into portfolio optimization, providing new ways to manage complex data and uncover hidden patterns in financial markets. Moreover, the integration of reinforcement learning, and graph-based methods has opened new avenues for dynamic and complex portfolio strategies. Sensitivity-based portfolios, which focus on the sensitivity of portfolio returns to changes in underlying factors, have also become an important aspect of modern portfolio management.

## 1.2 ROLE OF QUANTITATIVE TECHNIQUES

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Quantitative techniques play a crucial role in modern portfolio optimization. These techniques allow for the systematic analysis and management of risk, the development of models to predict asset returns, and the optimization of

portfolios to achieve desired outcomes. Key quantitative methods used in portfolio optimization include:

- **Mean-Variance Optimization:** This foundational technique balances expected return against risk, measured as the variance of returns. It involves calculating the expected returns and covariances of all assets, then solving for the weights that minimize portfolio variance subject to a desired return. The efficient frontier is derived from this process, representing the set of optimal portfolios.
- **Factor Models:** These models, such as the CAPM and multifactor models, explain asset returns based on various macroeconomic factors or firm-specific factors. The CAPM, for example, relates an asset's return to the return of the market portfolio, adjusted for the asset's sensitivity to market movements.
- **Bayesian Methods:** Bayesian techniques incorporate prior beliefs and observed data to update the estimation of expected returns and risks. The Black-Litterman model is a popular application in portfolio optimization, combining market equilibrium with investor views to produce more stable and diversified portfolios. Bayesian methods are particularly useful for handling parameter uncertainty and incorporating subjective views.
- **Machine Learning:** Machine learning algorithms are used to identify patterns in large datasets, making them valuable for predictive modeling in portfolio optimization. Techniques like neural networks, decision trees, and generative models can uncover complex relationships between asset returns and various predictors. These methods can enhance the forecasting of returns and risks as well as optimize trading strategies.
- **Neural Networks:** These are used to model nonlinear relationships between inputs and outputs. In portfolio optimization, they can predict asset returns based on historical data and other variables.
- **Decision Trees:** These algorithms split the data into subsets based on feature values, creating a tree-like model of decisions. They are useful for capturing the nonlinear relationships in financial data and can be used to identify important variables influencing asset returns.
- **Generative Models:** These models, such as Generative Adversarial Networks (GANs) and Variational Autoencoders (VAEs), are used to generate new data samples that are like the training data. In portfolio optimization, generative models can be used to simulate realistic market scenarios and generate synthetic data for stress testing and risk management.

- **Reinforcement Learning (RL):** RL involves training algorithms to make sequences of decisions by rewarding desirable actions and penalizing undesirable ones. In portfolio optimization, RL can dynamically adjust the asset allocation based on market conditions and investment goals. An RL agent learns a policy that maximizes cumulative rewards, which can correspond to returns in a portfolio context. Techniques like Q-learning and policy gradients are commonly used in RL for portfolio management.
- **Q-learning:** This algorithm learns the value of actions in different states and aims to maximize the expected reward over time. It updates its estimates using the Bellman equation.
- **Policy Gradients:** These methods optimize the policy directly by computing gradients of the expected reward with respect to the policy parameters.
- **Graph-based Methods:** These methods use graph theory to represent and analyze the relationships between assets. Graphs can model the dependencies and correlations among assets, aiding in the construction of diversified and robust portfolios.
- **Graph Theory:** This involves studying graphs, which are mathematical structures used to model pairwise relations between objects. In portfolio optimization, nodes can represent assets, and edges can represent the correlations or co-movements between them.
- **Hierarchical Risk Parity (HRP):** This approach uses clustering and tree structures to construct portfolios. It aims to distribute risk more evenly across different clusters of assets, improving diversification.
- **Sensitivity-based Portfolios:** These portfolios focus on the sensitivity of portfolio returns to changes in underlying factors, such as economic variables or market indices. By analyzing how small changes in these factors impact on the portfolio, managers can better understand and manage risk.
- **Sensitivity Analysis:** This involves examining how the variation in the output of a model can be attributed to different variations in the inputs. In portfolio optimization, sensitivity analysis helps in understanding the impact of changes in asset returns and other factors on the portfolio performance.
- **Partial Differential Equations (PDEs):** PDEs can be used to model the dynamics of portfolio values over time, considering factors like interest rates and asset prices. Solving these equations provides insights into the optimal portfolio allocation under different market conditions.
- **Risk Measures and Management:** Techniques like Value-at-Risk (VaR) and Conditional Value-at-Risk (CVaR) are used to quantify the risk

of loss in a portfolio. These measures are essential for understanding potential downside risks and making informed decisions about risk mitigation strategies. Advanced risk measures also consider tail risks and the distribution of returns.

- **Optimization Algorithms:** Several optimization algorithms are employed to solve portfolio optimization problems. These include:
  - **Quadratic Programming:** Used in mean-variance optimization to find the optimal asset weights that minimize portfolio variance for a given return.
  - **Monte Carlo Simulation:** Used to model the probability of different outcomes in a process that cannot easily be predicted due to the intervention of random variables. In portfolio optimization, it is used to simulate the performance of different portfolio strategies under various market conditions.
  - **Genetic Algorithms:** These algorithms mimic natural selection processes to generate high-quality solutions for optimization problems. They are particularly useful in finding optimal portfolios in large, complex investment universes.
  - **Dynamic Programming:** Applied in multi-period portfolio optimization to make decisions that consider the evolution of the portfolio over time.

### **1.3 ORGANIZATION OF THE BOOK**

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This book is structured to provide a comprehensive understanding of quantitative portfolio optimization techniques, from foundational theories to advanced applications. The chapters are organized as the list describes:

- **Chapter 2: History of Portfolio Optimization:** A review of the key developments in portfolio optimization, from early theories to modern advancements.
- **Chapter 3: Modern Portfolio Theory:** A detailed study of mean-variance analysis, the CAPM, and APT, including their applications and limitations. We introduce a new framework Mean Variance with CVAR constraints.
- **Chapter 4: Bayesian Methods in Portfolio Optimization:** An exploration of Bayesian techniques and their application to portfolio optimization.
- **Chapter 5: Risk Models and Measures:** A discussion on various risk measures, including Value-at-Risk (VaR) and Conditional Value-at-Risk (CVaR), and their estimation methods.



- **Chapter 6: Factor Models and Factor Investing:** Examination of single and multifactor models, factor risk, and performance attribution.
- **Chapter 7: Market Impact, Transaction Costs, and Liquidity:** Insights into market impact, transaction costs, and liquidity considerations in portfolio optimization.
- **Chapter 8: Optimal Control:** Coverage of dynamic programming, optimal control, and their applications in portfolio optimization.
- **Chapter 9: Markov Decision Processes:** Discussion on fully observed and partially observed MDPs, infinite and finite horizon problems, and the Bellman equation.
- **Chapter 10: Reinforcement Learning:** Examination of reinforcement learning techniques and their applications in portfolio optimization.
- **Chapter 11: Deep Learning in Portfolio Management:** Introduction to deep learning methods and their integration into portfolio management.
- **Chapter 12: Graph-based Portfolios:** Exploration of graph theory-based portfolios and their applications.
- **Chapter 13: Sensitivity-based Portfolios:** Insights into modeling portfolio dynamics with partial differential equations and sensitivity analysis.
- **Chapter 14: Backtesting in Portfolio Management:** Discussion on backtesting methods, trading rules, and transaction costs.
- **Chapter 15: Scenario Generation:** Techniques for generating scenarios and their application in portfolio optimization.

This structure ensures a logical progression from basic concepts to advanced techniques, providing readers with the tools and knowledge necessary to optimize portfolios effectively in today's complex financial markets.



# History of Portfolio Optimization

**T**his chapter is dedicated to a non-exhaustive review of the main contributions to portfolio optimization, from Markowitz's precursors to the modern machine learning methods, including Markowitz's mean-variance approach, the Black-Litterman model, Risk Parity, and Hierarchical Risk Parity. Only the Black-Litterman model and the Risk Parity approach will be addressed in depth. An alternative derivation of the Black-Litterman model, based on Bayesian methods, will be presented in Chapter 4. A more detailed treatment of the Markowitz model, the Hierarchical Risk Parity algorithm and some machine learning methods will be postponed to subsequent chapters.

## 2.1 EARLY BEGINNINGS

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Harry Markowitz is unanimously recognized as the father of Modern Portfolio Theory (MPT). His seminal works, Markowitz (1952, 1959), settled the foundations of the mean-variance analysis upon which other aspects of MPT were built.

The groundbreaking nature of Markowitz (1952) can be inferred from its scarce set of references: Uspensky (1937), Williams (1938) and Hicks (1939). The first one is a text on Mathematical Probability, to which the reader was referred. Of the two remaining references, only Williams (1938) played a role in the development of the 1952 paper, as we will see soon. Therefore, it is not surprising that Mark Rubinstein stated the following: "What has always impressed me most about Markowitz's 1952 paper is that it seemed to come out of nowhere" (Rubinstein, 2002). Nevertheless, the key ideas of mean-variance analysis (i.e., diversification, mean returns, and a risk measure as variables) were present in previous literature. The rest of the section will be dedicated to analyzing some of these early contributions.

According to Markowitz (1999), written references to the concept of diversification can be traced back to Shakespeare's *The Merchant of Venice*, in which the following passage can be found (Act I, Scene I):

*My ventures are not in one bottom trusted,  
Nor to one place; nor is my whole state  
Upon the fortune of this present year  
Therefore my merchandise makes me no sad.*

In the academic field, Daniel Bernouilli, in his 1738 paper on the Saint Petersburg paradox (Bernouilli, 1954), offered this diversification advice for risk-averse investors: "... it is advisable to divide goods which are exposed to some small danger into several portions rather than to risk them all together." In the twentieth century, the first reference related to Portfolio Theory appears in *The Nature of Capital and Income* (Fisher, 1906), in which variance is suggested as a measure of economic risk. Hicks, in his treatise *Theory of Money* (Hicks, 1935), introduces a qualitative analysis regarding the probabilities associated with the risk of an investment, concluding that they can be represented by a mean value and an appropriate measure of risk (although he does not mention any specific measure).

Marschak (1938) takes a step forward specifying the nature of the parameter measuring risk: "It is sufficiently realistic, however, to confine ourselves, for each yield, to two parameters only: the mathematical expectation ('lucrativity') and the coefficient of variation ('risk')." Although Marschak was the advisor of Markowitz's thesis, we cannot state (as Markowitz himself acknowledges) that Marschak had an influence on Markowitz's work. In fact, Marschak did not inform to Markowitz of the existence of Marschak (1938).

The only previous work that had a clear impact on Markowitz is Williams (1938). According to Markowitz (1991): "The basic principles of portfolio theory came to me one day while I was reading John Burr Williams *The Theory of Investment Value*. Williams was remarkably prescient. He provided the first derivation of the 'Gordon growth formula,' the Modigliani-Miller Capital Structure Irrelevancy Theorem, and strongly advocated the dividend discount model. But Williams had very little to say about the effects of risk on valuation (pp. 67–70), because he believed that all risk could be diversified away." In the opinion of Mark Rubinstein: "Markowitz had the brilliant insight that, while diversification would reduce risk, it would not generally eliminate it" (Rubinstein, 2002).

We cannot conclude this section dedicated to the predecessors of MPT without considering Roy (1952), of which Markowitz wrote the following: "On the basis of Markowitz (1952), I am often called the father of modern

portfolio theory (MPT), but Roy can claim an equal share of this honor” (Markowitz, 1999). In fact, Roy (1952) presents an analysis very similar to that of Markowitz (1952). Specifically, Roy includes correlations between asset prices in the analysis and, like Markowitz, realizes that “the principle of maximising expected return does not explain the well-known phenomenon of the diversification of resources among a wide range of assets.” Moreover, Roy also considers the expected value of returns,  $m$ ; and the standard deviation of returns,  $\sigma$ , as the only parameters on which investment decisions are based. However, instead of minimizing the standard deviation, as Markowitz did, Roy maximizes  $(m - d)/\sigma$ , where  $d$  is a level of returns that can be considered a disaster. This maximization procedure leads Roy to obtain the efficient frontier as a hyperbola in the  $(\sigma, m)$  space. According to Markowitz (1999), the main differences between Roy’s paper and his 1952 paper are that Markowitz (1952) worked only with long positions and allowed the investors to select one portfolio from the efficient frontier, whereas Roy (1952) worked also with short positions and recommended one specific portfolio.

Given that Roy arrived at the same results as Markowitz independently and using similar methods, it is reasonable to wonder why Roy did not also receive the Nobel Prize. Markowitz thought the reason was his greater visibility: Roy’s paper was his last (and only) publication in finance, whereas Markowitz wrote two books and a collection of papers related to this subject (Markowitz, 1999).

## 2.2 HARRY MARKOWITZ’S MODERN PORTFOLIO THEORY (1952)

Before delving into the analysis of Markowitz’s paper, we introduce some of the definitions and the notation that we will use. We consider portfolios composed of  $n$  risky assets, with returns  $r_1, \dots, r_n$ ; which are random variables with expectations  $R_i = \mathbb{E}[r_i]$  and covariances  $\sigma_{ij} = \text{cov}(r_i, r_j)$ ,  $i, j = 1, \dots, n$ . We will usually work in matrix form, with the vector of expected returns  $\mathbf{R} = (R_1, \dots, R_n)^T$  and the covariance matrix  $\mathbf{\Sigma}$  with  $(\mathbf{\Sigma})_{ij} = \sigma_{ij}$ . The variances of asset returns are given by the diagonal elements of  $\mathbf{\Sigma}$ ,  $\sigma_i^2 = \sigma_{ii}$ . As the assets in the portfolio are risky assets, we have  $\sigma_i^2 > 0$ ,  $i = 1, \dots, n$ , and then,  $\mathbf{\Sigma}$  is a positive definite matrix, that is,  $\mathbf{x}^T \mathbf{\Sigma} \mathbf{x} > 0$  for any nonzero  $n$ -vector  $\mathbf{x}$ . In addition, we will assume that  $\mathbf{\Sigma}$  is nonsingular,  $|\mathbf{\Sigma}| \neq 0$ , meaning that none of the asset returns is perfectly correlated with the return of the portfolio composed of the remaining assets.

Each portfolio is determined by a vector  $\mathbf{w} = (w_1, \dots, w_n)^T$  in which  $w_i$  is the proportion of investor’s wealth allocated to the  $i$ -th asset. By this

definition we have  $\sum_{i=1}^n w_i = 1$ , or in matrix notation,  $\mathbf{w}^T \mathbf{1} = 1$ , where  $\mathbf{1}$  is the  $n$ -vector given by  $\mathbf{1} = (1, \dots, 1)^T$ . The expected return of the portfolio is given by  $R_p = \mathbf{w}^T \mathbf{R}$ , and the variance of its return is  $\sigma_p^2 = \mathbf{w}^T \mathbf{\Sigma} \mathbf{w}$ .

In his 1952 paper, Markowitz begins by rejecting the maximization of expected returns as a guiding principle for investment behavior. This decision is rooted in the often-understated principle of diversification, a key aspect of Markowitz's work. In his own words: "[...] a rule of behavior which does not imply the superiority of diversification must be rejected both as a hypothesis and as a maxim."

Diversification, as a rule leading to the reduction of the risk of a portfolio, measured by the variance of its return, finds support in theoretical arguments. As the following simple result shows, under certain assumptions, perfectly diversified portfolios become asymptotically risk-free. In other words, the variance of the portfolio return diminishes as the number of component assets increases.

**Proposition 2.1** *Consider an equally weighted portfolio whose asset returns are independent random variables with the same variance  $\sigma^2$ . Then, the variance of the portfolio return,  $\sigma_p^2$ , satisfies*

$$\lim_{n \rightarrow \infty} \sigma_p^2 = 0,$$

*Proof.* As the portfolio is equally weighted, we have  $\mathbf{w} = \frac{1}{n} \mathbf{1}$ , and by the independence assumption,  $\mathbf{\Sigma} = \sigma^2 \mathbf{I}$ , where  $\mathbf{I}$  is the identity matrix. Then, the portfolio variance is

$$\sigma_p^2 = \mathbf{w}^T \mathbf{\Sigma} \mathbf{w} = \frac{1}{n^2} \sigma^2 \mathbf{1}^T \mathbf{I} \mathbf{1} = \frac{\sigma^2}{n},$$

from where we obtain the desired result. ■

While the previous result is intellectually appealing, its assumptions are hardly satisfied in actual markets. First, there is empirical evidence suggesting that returns follow stable Paretian distributions, characterized by infinite variances (Mandelbrot, 1963; Fama, 1965a).<sup>1</sup> Second, it is difficult, if not impossible, to find a substantial number of assets with totally independent returns and equal variance. Therefore, as Markowitz himself pointed out: "The returns from securities are too intercorrelated. Diversification cannot eliminate all variance."

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<sup>1</sup>According to Fama (1965b), in the context of stable Paretian distributions, there is a range of conditions under which diversification is a meaningful economic activity.