Dynamic portfolio optimization across hidden market regimes - DTU Orbit (04/11/2019)

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Regime-based asset allocation has been shown to add value over rebalancing to static weights and, in particular, reduce potential drawdowns by reacting to changes in market conditions. The predominant approach in previous studies has been to specify in advance a static decision rule for changing the allocation based on the state of financial markets or the economy. In this article, model predictive control (MPC) is used to dynamically optimize a portfolio based on forecasts of the mean and variance of financial returns from a hidden Markov model with time-varying parameters. There are computational advantages to using MPC when estimates of future returns are updated every time a new observation becomes available, since the optimal control actions are reconsidered anyway. MPC outperforms a static decision rule for changing the allocation and realizes both a higher return and a significantly lower risk than a buy-and-hold investment in various major stock market indices. This is after accounting for transaction costs, with a one-day delay in the implementation of allocation changes, and with zero-interest cash as the only alternative to the stock indices. Imposing a trading penalty that reduces the number of trades is found to increase the robustness of the approach.

General information
Publication status: Published
Organisations: Department of Applied Mathematics and Computer Science, Dynamical Systems, Lund University
Contributors: Nystrup, P., Madsen, H., Lindström, E.
Number of pages: 20
Pages: 83-95
Publication date: 2017
Peer-reviewed: Yes

Publication information
Journal: Quantitative Finance
Volume: 18
Issue number: 1
ISSN (Print): 1469-7688
Ratings:
BFI (2017): BFI-level 2
Scopus rating (2017): CiteScore 1.15 SJR 0.738 SNIP 1.019
Web of Science (2017): Impact factor 1.17
Web of Science (2017): Indexed yes
Original language: English
Keywords: Multi-period portfolio selection, Meanvariance optimization, Model predictive control, Hidden Markov model, Adaptive estimation, Forecasting
Electronic versions:
Dynamic_Portfolio_Optimization_Across_Hidden_Market_Regimes_ACCEPTED.pdf
DOIs:
10.1080/14697688.2017.1342857
Source: PublicationPreSubmission
Source ID: 139148002
Research output: Contribution to journal › Journal article – Annual report year: 2017 › Research › peer-review