Diversification Reconsidered: Minimum Tail Dependency

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Diversification

Overview

- 60th anniversary of MPT (see Markowitz, 1952)
- Reducing risk by investing in a variety of assets
- At least two scopes of the word ‘diversification’
  - Divers with respect to what?
  - How to measure diversification?
Diversification
Portfolio Concepts: The Peers

- Global Minimum Variance (see Markowitz, 1952, 1956, 1991): Based on Variance-Covariance
- Equal Risk Contributed (see Qian, 2005, 2006; Maillard et al., 2010; Qian, 2011): Based on variance-covariance, marginal risk contributions are equated
- CVaR Contributed (see Boudt et al., 2010, 2011): Based on downside risk measure, budgeting contributions to CVaR
- Most Diversified (see Choueifaty and Coignard, 2008; Choueifaty et al., 2011): Based on (i) correlation matrix and (ii) re-scaling of weights according to assets’ riskiness
- Optimal Tail Dependent: (i) Minimum tail dependent allocation, (ii) Selection of portfolio constituents from a set of assets
Tail Dependence

Definition (i)

- Associated to Copula-concept
- Conditional probability statement for two random variables \((X, Y)\) with marginal distributions \(F_X\) and \(F_Y\).
- Upper tail dependence:
  \[ \lambda_u = \lim_{q \to 1} \mathbb{P}(Y > F_Y^{-1}(q) | X > F_X^{-1}(q)) \]
- Lower tail dependence:
  \[ \lambda_l = \lim_{q \to 0} \mathbb{P}(Y \leq F_Y^{-1}(q) | X \leq F_X^{-1}(q)) \]
Tail Dependence

Definition (ii)

- Expressed in Copula-terms:
  - Upper tail dependence:
    \[ \lambda_u = 2 + \lim_{q \searrow 0} \frac{C(1-q,1-q) - 1}{q} \]
  - Lower tail dependence:
    \[ \lambda_l = \lim_{q \searrow 0} \frac{C(q,q)}{q} \]
- Student’s t Copula:
  \[ \lambda_u = \lambda_l = 2t_{\nu+1}\left(-\sqrt{\nu} + 1\sqrt{(1 - \rho)/(1 + \rho)}\right) \]
- Archimedean Copulae:
  - Gumbel Copula: \( \lambda_u = 2 - 2^{1/\theta} \)
  - Clayton Copula: \( \lambda_l = 2^{-1/\delta} \)
Tail Dependence
Non-Parametric Estimators (i)

- Synopsis of estimators in Dobrić and Schmid (2005); Frahm et al. (2005); Schmidt and Stadtmüller (2006)
- Focus on lower tail dependence (losses for long-only)
- Based on empirical copula of \( N \) pairs \((X_1, Y_1), \ldots, (X_N, Y_N)\) with corresponding order statistics \( X_{(1)} \leq X_{(2)} \leq \ldots \leq X_{(N)} \) and \( Y_{(1)} \leq Y_{(2)} \leq \ldots \leq Y_{(N)} \)
- Empirical Copula:
  \[ C_N\left(\frac{i}{N}, \frac{j}{N}\right) = \frac{1}{N} \sum_{l=1}^{N} I(X_l \leq X_{(i)} \land Y_l \leq Y_{(j)}) \]
  with \( i, j = 1, \ldots, N \) and \( I \) is the indicator function, which takes a value of one, if the condition stated in parenthesis is true.
Tail Dependence

Non-Parametric Estimators (ii)

- Estimators depend on threshold parameter \( k \)
- Estimators are consistent and unbiased, if \( k \sim \sqrt{N} \) (see Dobrić and Schmid, 2005)

1. Secant-based: \( \lambda^{(1)}(N, k) = \left[ \frac{k}{N} \right]^{-1} \cdot C_N \left( \frac{k}{N}, \frac{k}{N} \right) \)

2. Slope-based: \( \lambda^{(2)}(N, k) = \left[ \sum_{i=1}^{k} \left( \frac{i}{N} \right)^2 \right]^{-1} \cdot \sum_{i=1}^{k} \left[ \frac{i}{N} \cdot C_N \left( \frac{i}{N}, \frac{i}{N} \right) \right] \)

3. Mixture-based: \( \lambda^{(3)}(N, k) = \frac{\sum_{i=1}^{k} \left( C_N \left( \frac{i}{N}, \frac{i}{N} \right) - \left( \frac{i}{N} \right)^2 \right) \left( \frac{i}{N} - \left( \frac{i}{N} \right)^2 \right)}{\sum_{i=1}^{k} \left( \frac{i}{N} - \left( \frac{i}{N} \right)^2 \right)^2} \)
Tail Dependence
Utilization in Optimization

- Minimum Tail Dependent Portfolio
  - Approach similar to MDP
  - First step: Derive optimal solution if TDC-matrix is used with main-diagonal elements are set to one.
  - Second step: Re-scale optimal weight vectors by assets volatility (riskiness).
  - Implemented in package FRAPO (see Pfaff, 2012)

- Asset Selection
  - Benchmark-relative Optimisations
  - Choose constituents which are least lower tail dependent to the benchmark (index).
  - No implication with respect to the upper tail dependencies, in contrast to low $\beta$ strategies that are in general based on a symmetric co-dispersion measure.
MTD vs. Peer-Strategies

Overview

- Swiss Performance Sector Indexes
- Static long-only optimisation according to
  - GMV
  - MDP
  - ERC
  - MTD
- Analysis of allocations, risk- & marginal risk contributions, and key measures
MTD vs. Peer-Strategies

Optimisations

```r
> library(FRAPO)
> library(fPortfolio)
> library(lattice)
> ## Loading data and calculating returns
> data(SPISECTOR)
> Idx <- interpNA(SPISECTOR[, -1], method = "before")
> R <- returnseries(Idx, method = "discrete", trim = TRUE)
> V <- cov(R)
> ## Portfolio Optimisations
> GMVw <- Weights(PGMV(R))
> MDPw <- Weights(PMD(R))
> MTDw <- Weights(PMTD(R))
> ERCw <- Weights(PERC(V))
> ## Graphical displays of allocations
> oldpar <- par(no.readonly = TRUE)
> par(mfrow = c(2, 2))
> dotchart(GMVw, xlim = c(0, 40), main = "GMV Allocation", pch = 19)
> dotchart(MDPw - GMVw, xlim = c(-20, 20), main = "MDP vs. GMV", pch = 19)
> abline(v = 0, col = "gray")
> dotchart(MTDw - GMVw, xlim = c(-20, 20), main = "MTD vs. GMV", pch = 19)
> abline(v = 0, col = "gray")
> dotchart(ERCw - GMVw, xlim = c(-20, 20), main = "ERC vs. GMV", pch = 19)
> abline(v = 0, col = "gray")
> par(oldpar)
```
MTD vs. Peer-Strategies
Graphical displays of allocations

GMV Allocation

MDP vs. GMV

MTD vs. GMV

ERC vs. GMV
MTD vs. Peer-Strategies
Marginal Risk Contributions

```r
## Combining solutions
W <- cbind(GMVw, MDPw, MTDw, ERCw)
## MRC
MRC <- apply(W, 2, mrc, Sigma = V)
rownames(MRC) <- colnames(Idx)
colnames(MRC) <- c("GMV", "MDP", "MTD", "ERC")
## lattice plots of MRC
Sector <- factor(rep(rownames(MRC), 4), levels = sort(rownames(MRC)))
Port <- factor(rep(colnames(MRC), each = 9), levels = colnames(MRC))
MRCdf <- data.frame(MRC = c(MRC), Port, Sector)
dotplot(Sector ~ MRC | Port, groups = Port, data = MRCdf,
  xlab = "Percentages",
  main = "Marginal Risk Contributions by Sector per Portfolio",
  col = "black", pch = 19)
dotplot(Port ~ MRC | Sector, groups = Sector, data = MRCdf,
  xlab = "Percentages",
  main = "Marginal Risk Contributions by Portfolio per Sector",
  col = "black", pch = 19)
```
MTD vs. Peer-Strategies

Graphical displays of MRC (i)
MTD vs. Peer-Strategies

Graphical displays of MRC (ii)
# MTD vs. Peer-Strategies

## Portfolio Characteristics

<table>
<thead>
<tr>
<th>Measures</th>
<th>GMV</th>
<th>MDP</th>
<th>MTD</th>
<th>ERC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Deviation</td>
<td>0.813</td>
<td>0.841</td>
<td>0.903</td>
<td>0.949</td>
</tr>
<tr>
<td>ES (modified, 95 %)</td>
<td>2.239</td>
<td>2.189</td>
<td>2.313</td>
<td>2.411</td>
</tr>
<tr>
<td>Diversification Ratio</td>
<td>1.573</td>
<td>1.593</td>
<td>1.549</td>
<td>1.491</td>
</tr>
<tr>
<td>Concentration Ratio</td>
<td>0.218</td>
<td>0.194</td>
<td>0.146</td>
<td>0.117</td>
</tr>
</tbody>
</table>

**Table:** Key measures of portfolio solutions for SPI sectors
Overview

- Benchmark relative optimisation: S&P 500
- Long-only portfolio, in-sample period 260 observations
- Similar analysis in Malevergne and Sornette (2008)
Low Tail Dependency vs. Low Beta

Backtest I: Data Preparation

```r
> library(FRAPO)
> library(copula)
> ## S&P 500
> data(INDTRACK6)
> ## Market and Asset Returns
> RM <- returnseries(INDTRACK6[1:260,1], method = "discrete", trim = TRUE)
> RA <- returnseries(INDTRACK6[1:260,-1], method = "discrete", trim = TRUE)
> ## Beta of S&P 500 stocks
> Beta <- apply(RA, 2, function(x) cov(x, RM) / var(RM))
> ## Computing Kendall's tau
> Tau <- apply(RA, 2, function(x) cor(x, RM, method = "kendall"))
> ## Clayton Copula: Lower Tail Dependence
> ThetaC <- copClayton@tauInv(Tau)
> LambdaL <- copClayton@lambdaL(ThetaC)
> ## Selecting Stocks below median; inverse log-weighted and scaled
> IdxBeta <- Beta < median(Beta)
> WBeta <- -1 * log(abs(Beta[IdxBeta]))
> WBeta <- WBeta / sum(WBeta) * 100
> ## TD
> IdxTD <- LambdaL < median(LambdaL)
> WTD <- -1 * log(LambdaL[IdxTD])
> WTD <- WTD / sum(WTD) * 100
> Intersection <- sum(names(WTD) %in% names(WBeta)) / length(WBeta) * 100
```
## Out-of-Sample Performance

```r
> RMo <- returnseries(INDTRACK6[260:290, 1], method = "discrete",
+                    percentage = FALSE) + 1
> RAo <- returnseries(INDTRACK6[260:290, -1], method = "discrete",
+                    percentage = FALSE) + 1
```

## Benchmark

```r
> RMo[1] <- 100
> RMEquity <- cumprod(RMo)
```

## Low Beta

```r
> LBEquity <- RAo[, IdxBeta]
> LBEquity[1, ] <- WBeta
> LBEquity <- rowSums(apply(LBEquity, 2, cumprod))
```

## TD

```r
> TDEquity <- RAo[, IdxTD]
> TDEquity[1, ] <- WTD
> TDEquity <- rowSums(apply(TDEquity, 2, cumprod))
```
Low Tail Dependency vs. Low Beta
Backtest III: Progression of Portfolio Equity

```r
> ## Collecting results
> y <- cbind(RMEquity, LBEquity, TDEquity)
> ## Time series plots of equity curves
> plot(RMEquity, type = "l", ylim = range(y), ylab = "Equity Index",
+     xlab = "Out-of-Sample Periods")
> lines(LBEquity, col = "green")
> lines(TDEquity, col = "blue")
> legend("topleft", legend = c("S&P 500", "Low Beta", "Lower Tail Dep."),
+       col = c("black", "green", "blue"))
> ## Bar plot of out-performance
> RelOut <- rbind((LBEquity / RMEquity - 1) * 100,
+                  (TDEquity / RMEquity - 1) * 100)
> RelOut <- RelOut[, -1]
> barplot(RelOut, beside = TRUE, ylim = c(-5, 17), names.arg = 1:ncol(RelOut),
+         legend.text = c("Low Beta", "Lower Tail Dep."),
+         args.legend = list(x = "topleft"))
> abline(h = 0)
> box()
```
Low Tail Dependency vs. Low Beta

Backtest IV: Graphical Displays

The diagram illustrates the performance of different portfolios over an out-of-sample period. The y-axis represents the equity index, with values ranging from 100 to 115. The x-axis shows the out-of-sample periods from 0 to 30.

- **S&P 500** is represented by a black line.
- **Low Beta** is represented by a green line.
- **Lower Tail Dep.** is represented by a blue line.

The graph provides a visual comparison of how each portfolio performs under low tail dependency and low beta conditions over the specified period.
Low Tail Dependency vs. Low Beta

Backtest IV: Graphical Displays
Outlook

Extension and Modifications

- Use lower-partial moments for re-scaling of weights
- Use upper- /lower TD ratio for optimization
- Adapt approach to long-/short strategies


