# Contents

**Preface** . . . . . ix

**Part 1.** . . . . . 1

**Chapter 1. Introduction to Portfolio Optimization** . . . . . 3

1.1. Fundamentals of portfolio optimization . . . . . 3
1.2. An example case study . . . . . 11
1.2.1. Portfolio P: Unconstrained portfolio optimization . . . . . 17
1.2.2. Portfolio P: Constrained portfolio optimization . . . . . 20
1.2.3. Portfolio P: Sharpe Ratio-based portfolio optimization . . . . . 22
1.3. MATLAB® demonstrations . . . . . 25

**Chapter 2. A Brief Primer on Metaheuristics** . . . . . 37

2.1. Metaheuristics framework . . . . . 37
2.2. Exact methods versus metaheuristics . . . . . 40
2.3. Population-based metaheuristics – Evolutionary Algorithms . . . . . 43
2.3.1. Evolutionary Algorithm basics . . . . . 45
2.4. Evolution Strategy . . . . . 49
2.4.1. Evolution Strategy: genetic inheritance operators . . . . . 49
2.4.2. Evolution Strategy process flow chart . . . . . 52
2.4.3. Demonstration of Evolution Strategy . . . . . 52
2.4.4. Experimental results and analysis . . . . . 56
2.5. Differential Evolution strategy . . . . . 59
2.5.1. Differential Evolution operators . . . . . 59
2.5.2. Differential Evolution strategy process flow chart . . . . . 61
2.5.3. Differential Evolution strategies . . . . . 63
2.5.4. Demonstration of Differential Evolution Strategy . . . . . 65
2.5.5. Experimental results and analysis . . . . . 68
2.6. MATLAB® demonstrations . . . . . 71

**Part 2.** . . . . . 83

**Chapter 3. Heuristic Portfolio Selection** . . . . . 85

3.1. Portfolio selection . . . . . 85
3.2. Clustering . . . . . 88
3.3. *k*-means clustering . . . . . 91
3.4. Heuristic selection of securities . . . . . 95
3.4.1. Heuristic portfolio selection for S&P BSE200 . . . . . 96
3.4.2. Heuristic portfolio selection for Nikkei225 . . . . . 99
3.5. *k*-portfolio performance . . . . . 104
3.5.1. Equal Weighted k-portfolio construction . . . . . 104
3.5.2. Inverse Volatility Weighted k-portfolio construction . . . . . 105
3.5.3. Other k-portfolio characteristics . . . . . 108
3.6. MATLAB® demonstrations . . . . . 109

**Chapter 4. Metaheuristic Risk-Budgeted Portfolio Optimization** . . . . . 117

4.1. Risk budgeting . . . . . 117
4.2. Long-Short portfolio . . . . . 120
4.3. Risk-Budgeted Portfolio Optimization model . . . . . 121
4.3.1. Constraint handling . . . . . 123
4.3.2. Transformed Risk-budgeted portfolio optimization model . . . . . 125
4.4. Differential Evolution with Hall of Fame . . . . . 126
4.5. Repair strategy for handling unbounded linear constraints . . . . . 127
4.6. DE HOF-based Risk-budgeted portfolio optimization . . . . . 132
4.7. Case study global portfolio: results and analyses . . . . . 134
4.7.1. Finding the optimal Risk-budgeted portfolio using DE HOF . . . . . 135
4.7.2. Consistency of performance of DE HOF . . . . . 136
4.7.3. Convergence characteristics of DE HOF . . . . . 137
4.8. MATLAB® demonstrations . . . . . 140

**Chapter 5. Heuristic Optimization of Equity Market Neutral Portfolios** . . . . . 151

5.1. Market neutral portfolio . . . . . 151
5.2. Optimizing a naïve equity market neutral portfolio . . . . . 154
5.3. Risk-budgeted equity market neutral portfolio . . . . . 160
5.4. Metaheuristic risk-budgeted equity market neutral portfolios . . . . . 165
5.4.1. Rand5/Dir4 strategy . . . . . 165
5.4.2. Tournament selection . . . . . 166
5.4.3. Constraint handling . . . . . 168
5.5. Experimental results and analyses . . . . . 172
5.6. MATLAB® demonstrations . . . . . 176

**Chapter 6. Metaheuristic 130-30 Portfolio Construction** . . . . . 191

6.1. 130-30 portfolio . . . . . 191
6.2. 130-30 portfolio optimization: mathematical formulation . . . . . 192
6.3. 130-30 portfolio optimization using MATLAB Financial Toolbox™ . . 193
6.3.1. Experimental results . . . . . 195
6.4. Metaheuristic 130-30 portfolio optimization . . . . . 204
6.4.1. Transformation of 130-30 portfolio optimization model . . . . . 204
6.4.2. Constraint handling . . . . . 209
6.4.3. Differential Evolution-based 130-30 portfolio construction . . . . . 218
6.4.4. Experimental results . . . . . 220
6.5. MATLAB® demonstrations . . . . . 222

**Chapter 7. Metaheuristic Portfolio Rebalancing with Transaction Costs** . . . . . 239

7.1. Portfolio rebalancing . . . . . 239
7.2. Portfolio rebalancing mathematical model . . . . . 241
7.3. Evolution Strategy with Hall of Fame for Portfolio Rebalancing . . . . 244
7.3.1. Evolution Strategy – a brief note . . . . . 244
7.3.2. Optimal rebalanced portfolio using ES HOF . . . . . 245
7.3.3. Weight repair strategy for portfolio rebalancing . . . . . 246
7.4. Experimental results . . . . . 253
7.4.1. ES HOF-based rebalancing of a high risk S&P BSE200 portfolio . 253
7.4.2. Convergence characteristics of ES HOF . . . . . 254
7.4.3. Consistency of performance of ES HOF . . . . . 259
7.5.!Comparison of Non-Rebalanced and Rebalanced portfolios . . . . . 259
7.5.1. Weight drift analysis for the Non-Rebalanced portfolio . . . . . 260
7.5.2. Non-Rebalanced versus Rebalanced portfolios – which of these is better? . . . . . 260
7.5.3. Risk-Return performance of the Rebalanced and Non-Rebalanced portfolios . . . . . 263
7.6.!MATLAB® demonstrations . . . . . 264

**Conclusion** . . . . . 277

**Bibliography** . . . . . 283

**Index** . . . . . 289