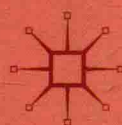


DEVELOPMENTS IN MEAN-VARIANCE EFFICIENT PORTFOLIO SELECTION

MEGHA AGARWAL

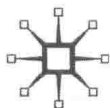


Developments in Mean-Variance Efficient Portfolio Selection

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Developments in Mean-Variance Efficient Portfolio Selection

List of Figures

4.1	Utility and wealth	92
4.2	Diversifier's utility curves, capital market line and portfolio choice	95
4.3	Diagram of the proposed methodology	99
5.1	Portfolio weights: diversifier's portfolio	116
5.2	Portfolio weights: satisficer's portfolio	119
5.3	Portfolio weights: market trend portfolio	123
5.4	Portfolio weights: capital gain bias portfolio	126
5.5	Portfolio weights: dividend gain bias portfolio	130
5.6	Portfolio weights: equal priority portfolio	133
5.7	Portfolio weights: ideal portfolio	137
5.8	Portfolio weights: Markowitz's portfolio	140
5.9	Covariance matrix for Nifty 50 securities	146
5.10	Alternate portfolio selection model formulations and Markowitz's efficient frontier	147
5.11	Model forecasted returns	156
5.12	Model forecasted excess returns to standard deviation ratio	161
5.13	Portfolio utility as a function of increasing risk tolerance	164
5.14	Risk and return for alternate portfolio selection model formulations	164
5.15	Utility curves of a plunger and risk-return on portfolios	165
5.16	Utility curves of a diversifier and risk-return on portfolios	166
5.17	Utility curves of a risk lover and risk-return on portfolios	167
5.18	Utility curves of a risk neutral and risk-return on portfolios	167
6.1	Constructed portfolios for alternative model formulations	195
6.2	Constructed portfolios for alternative model formulations	199

List of Tables

1.1	Index returns, volatility, market capitalisation and P/E ratio	8
5.1	Security and industry coding for the basket of assets	104
5.2	Descriptive statistics: monthly returns for Nifty 50 securities	106
5.3	Input values for the portfolio selection model	110
5.4	Target values for the eight portfolio selection model formulations	113
5.5	Diversifier's portfolio: targets and achievements	114
5.6	Satisficer's portfolio: targets and achievements	120
5.7	Plunger's portfolio: targets and achievements	121
5.8	Market trend portfolio: targets and achievements	124
5.9	Capital gain bias portfolio: targets and achievements	127
5.10	Dividend gain bias portfolio: targets and achievements	131
5.11	Equal priority portfolio: targets and achievements	134
5.12	Ideal portfolio: targets and achievements	138
5.13	Markowitz's portfolio: targets and achievements	141
5.14	Markowitz's efficient frontier	141
5.15	Weights of securities in the alternate portfolio model formulations	142
5.16	Values achieved by the mean-variance efficient model formulations	144
5.17	Results of multiple regression model I	150
5.18	Correlation matrix	152
5.19	Results of multiple regression model II	153
5.20	Results of multiple regression model III	154
5.21	Comparing the efficiency of model II and model III	154
5.22	Results of regression model IV	157
5.23	Results of regression model V	158
5.24	Results of regression model VI	158
5.25	Comparison of efficiency index of model V and model VI	159
5.26	Results for pair-wise Granger causality tests	161
5.27	Risk penalty for the ideal portfolio, Nifty 50 and Markowitz's portfolio at different risk tolerance levels	162

5.28	Utility values for the ideal portfolio, Nifty 50 and Markowitz's portfolio	163
5.29	Ranking of portfolios as per Sharpe's ratio	169
5.30	Ranking of portfolios as per Treynor's ratio	169
5.31	Target values for the yearly ideal portfolios	171
5.32	The risk-return combinations: ideal portfolio, Markowitz portfolio and Nifty 50 (index)	172
5.33	Tests of equality of returns on ideal portfolio and Nifty 50 index	172
5.34	Test of equality of variance of the Markowitz portfolio and the ideal portfolio	173
5.35	Tests for equality of variance between the ideal portfolio and Nifty 50	174
5.36	Tests for equality of portfolio utility between the ideal portfolio and the Markowitz portfolio	175
5.37	Tests for equality of portfolio utility between the ideal portfolio and Nifty 50 index	176
6.1	Evaluation of securities in identified criterion	184
6.2	Constraint values for portfolio selection models	192
6.3	Portfolio weights achieved as per evaluation criterion	196
6.4	Output of the model formulations	197
6.5	Performance evaluation of portfolios	200
6.6	Performance evaluation of portfolios for 2006	201
6.7	Performance evaluation of portfolios for 2007	202

Foreword

Mean Variance efficiency has been the most popular portfolio selection criterion ever since its discovery by Markowitz (1952). Since that time, this criterion has been much appreciated by both practitioners and academicians. *Developments in Mean Variance Efficient Portfolio Selection* tracks the advances made to this renowned criterion. It provides a thorough summary of the results and issues while addressing the concerns of present day investors. Building on the classical quadratic programming portfolio selection model, the book contributes to the area of portfolio modelling by adding multiple constraints to the mean-variance efficiency criterion and supporting the methodology with new empirical investigations.

The book includes a most comprehensive review of existing theories and empirical studies on portfolio selection starting from Markowitz, Sharpe, and Ross, and then building to the Fama and French model and current research. Desires and needs of the investor are also modelled into the general quadratic programming framework. Constraints are included to include accounting variables as well as market-based indicators. In addition to meeting these constraints, the model then ensures that the resultant portfolios are efficient in the Markowitz sense, producing maximum returns for a given level of risk.

The proposed model is tested using data from two prominent global stock exchanges: the London Stock Exchange and India's National Stock Exchange. Sophisticated statistical software such as SPSS, E-views, and the optimisation software Lingo are used in this empirical testing of the model. Moreover, exhaustive and updated databases, such as Thompson Reuters Eikon and the Centre for Monitoring India's Economy's Prowess, have been used for the purpose of data collection. Using these resources, the book provides a detailed comparison of the performance of model with the existing Markowitz efficient frontier in terms of risk, return, and portfolio utility. Forward tests are also conducted on the portfolios to confirm their robustness.

A key strength of the book is its addressing the limitations of current portfolio selection models in accommodating the multiple objectives of the investor while maintaining a mean-variance efficient portfolio. The book elaborates on the practical equity portfolio creation process, thus reducing the gap between theory and practice. The model then

can actively assist both individual and institutional investors in making rational and systematic investment decisions.

The book provides a solution to the problems faced by investors by consolidating into the model many constraints faced in creating an optimal portfolio in practice. By placing the analysis in the context of the literature and global events, the book appeals to both current and future interests, especially in light of the global recovery from recession. The creation of balanced portfolios is important not only to the retail investor but also to brokerage houses, market participants, finance students, research scholars, and the market at large. All can benefit from the lessons and analysis described in this comprehensive study of the topic.

JOHN R. BIRGE

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The University of Chicago Graduate School of Business*



Preface

Over the last few years there have been rapid changes in the securities market, more so in the secondary market. Advanced technology and online-based transactions have modernised the stock exchanges. The number of companies listed and the total market capitalisation in the equities market is relatively large as compared to the stage of economic development. A systematic and rational financial investment decision in a rapidly changing world of equities investment forms the core of this book.

The explanatory power of equity variables such as return, dividend, beta, liquidity, etc. have been studied in isolation thus limiting their application in improvement of the existing portfolio selection models. The mathematical complexity of some existing models hinders its applicability. A balanced portfolio which provides an investor with capital protections and opportunities for superior gains is required. A flexible model capable of accommodating the real-world constraints and objectives of an investor has been formulated using the Quadratic programming approach.

The model was tested on real data drawn from two important stock exchanges of the world, London Stock Exchange's FTSE 100 and Indian National Stock Exchange's Nifty 50. Eight portfolio model formulations, namely diversifier's portfolio, satisficer's portfolio, plunger's portfolio, market trend portfolio, capital gain bias portfolio, dividend gain-bias portfolio, equal priority portfolio and the ideal portfolio, were created for investors with different priorities and risk appetite. The objective of risk (variance) minimisation was achieved by optimising variables such as earnings per share, dividend, free float, impact cost, institutional holding, market capitalisation, net profit, price to book value ratio, price-earnings ratio, promoter's shareholding, sales, turnover, beta, unsystematic risk and volume across other important portfolio simultaneously. All the portfolios created were compared with the Markowitz's efficient frontier in the risk-return space. Ideal portfolio was found to be the closest to the Markowitz's portfolio.

Two multiple regression equations have been estimated with returns and excess returns to standard deviation as the dependent variables. Regression models explain the relevance of a new variable, namely

impact cost having significant explanatory powers for predicting security return and Sharpe ratio. Granger causality tests were undertaken to find out the relationship of causation between returns on a security and the variables set as constraints in the programming problem. The null hypothesis that dividend, impact cost, net profit, promoter's holding, sales and volume do not cause returns could not be rejected.

The portfolio utility analysis was undertaken to empirically find the utility derived by an investor from alternate portfolios for changing levels of risk tolerance. A direct relationship between the degree of risk tolerance and the value of portfolio utility was found from the quantitative analysis. The portfolio selection model formulations were plotted in the risk-return space along with the utility curves to find the optimal portfolio choice for different types of investors. The evaluation of the alternate portfolio selection model formulations was attempted by using Sharpe ratio (1966) and Treynor ratio (1965). The Sharpe ratio was the highest for Markowitz portfolio followed by the ideal portfolio. The ideal portfolio performed the best, even better than the Markowitz portfolio, when evaluated according to Treynor's ratio. Tests of equality of mean, variance and portfolio utility for ideal portfolio, Markowitz's portfolio and index portfolio were conducted to further investigate the proximity of these portfolios. Forward tests have been conducted to confirm their robustness.

The mean-variance model formulated and applied here will be of immense use for investors, both individual and institutional, brokerage houses, mutual fund managers, banks, high net worth individuals, portfolio management service providers, financial advisors, regulators, stock exchanges and research scholars in the area of portfolio selection.

Acknowledgements

It is impossible for me to express adequately my indebtedness to Prof. J. P. Sharma, Head and Dean, Department of Commerce, University of Delhi. His constructive criticism and erudite suggestions have been instrumental in leading this research to its logical conclusion. I shall remain indebted to Prof. Sharma for his keen interest, invaluable guidance and intellectual stimulation, and this would remain a beacon throughout my life.

I am indebted to Prof. Colin Clubb, Department of Management, Kings College London. He was very kind, cooperative and spared his valuable time to review the drafts, discuss and provide suggestions that have helped me improve this work. I have freely encroached upon his time, but for his keen interest this work would not have taken its present shape.

I am thankful to Prof. (Dr.) K. V. Bhanumurthy, Department of Commerce, University of Delhi for his generous guidance and cooperation. I would like to take this opportunity to acknowledge the time and effort he has invested in reviewing my work. I would also like to thank Prof. (Dr) J. D. Agarwal, Chairman, Indian Institute of Finance and Editor-in-Chief of *Finance India* for his invaluable comments and suggestions from time to time.

My sincere gratitude to Mr Mark Wiley, LINDO Systems, Inc, USA, for providing me access to the evaluation copy of LINGO 13.0 used for quadratic programming portfolio selection optimisation with unlimited variables and constraints. I am also thankful to Janis Merton from Thompson Reuters helpdesk for replying to all my queries relating to the database.

I am also thankful to the organisers of various national and international conferences who gave me the opportunity to present my research papers. In particular, I would like to acknowledge the organisers of 2nd IIMA International conference on Advanced Data Analysis, Business Analytics and Intelligence organised by Indian Institute of Management, Ahmedabad; 13th West Lake International Conference on Small and Medium Business (WLICSMB, 2011) organised by Economic Commission, Hangzhou Municipal Government, Zhejiang Provincial Institute of Small and Mid-sized Business and College of

Business Administration, Zhejiang University of Technology, Hangzhou, China and 64th All India Commerce Conference (AICC) organised by Indian Commerce Association, Department of Commerce, School of Management, Pondicherry University, Pondicherry. The comments and suggestions of the participants from these conferences have been duly incorporated.

Am indebted to my Principal, Dr Vijay Laxmi Pandit and my colleagues at Rajdhani College Mr Krishan Kumar, Dr Raj Kumar, Mr Nirmal Kumar, Mr Surinder Kumar Sachar, Dr Renu Gambhir, Dr Rajender Kumar and Dr Priyanka Kaushik for their academic support during the writing of this book.

My thanks are also due to the staff members of the Department of Management, King's College London and Franklin-Wilkins Library for extending their help and cooperation. I am obliged to the authorities and to the library and computer centre staff at the University of Delhi, Ratan Tata Library, Central Reference Library, Rajdhani College and Indian Institute of Finance for extending unconditional support.

I also take this opportunity to express my deep personal gratitude to Dr Manju Agarwal and Prof. Aman Agarwal for their unflinching encouragement and support. It may not be possible for me to adequately thank my husband Prof. Saurabh Agarwal and daughter Vedika who have patiently stood by me and supported me throughout. I dedicate this book to my parents, Mr Ashok Chawla and Mrs Santosh Chawla. I also acknowledge the moral support of my brother Mr Prashant Chawla.

Last but not the least, I am thankful for the immense benefit I have derived from the work of various authors which has enriched my understanding of the subject.

Megha Agarwal

Contents

<i>List of Figures</i>	ix
<i>List of Tables</i>	x
<i>Foreword</i>	xii
<i>Preface</i>	xiv
<i>Acknowledgements</i>	xvi
1 Introduction	1
1.1 Introduction	1
1.2 Review of trends in the Indian economy and Indian capital markets	6
1.3 Research gaps	8
1.4 <i>Raison d'être</i> of the book	9
1.5 Problem statement	11
1.6 Research objectives	12
1.7 Research hypotheses	13
1.8 Research methodology	14
1.9 Sources of data	16
1.10 Chapter plan	17
1.11 Limitations of the study	19
2 Advances in Theories and Empirical Studies on Portfolio Management	20
2.1 Literature on mean-variance efficient portfolio	22
2.2 Literature on asset pricing theories	27
2.3 Literature on diversification of portfolios	33
2.4 Literature on portfolio optimisation and variance-covariance matrix	36
2.5 Literature on the impact of behavioural and systemic factors on an investor's portfolio choice	42
2.6 Literature on the lead-lag relationship between the stock and futures market	48
2.7 Summary and conclusions	53
3 Contributions to the Portfolio Theory	56
3.1 The standard mean-variance portfolio selection model	56

3.2	Advances in portfolio selection theories	57
3.3	Emerging issues and challenges in Indian equity markets	64
3.3.1	Risk management	65
3.3.2	Disclosures and accounting standards	65
3.3.3	Investor protection and education	66
3.3.4	Wireless trading and co-location	66
3.3.5	Algorithmic trading and high frequency trading	66
3.3.6	Smart order routing	67
3.3.7	Minimum public shareholding	68
4	Mean-Variance Efficient Portfolio Selection: Model Development	71
4.1	Multi-objective quadratic programming	72
4.2	Model building and application	73
4.2.1	The objective function	73
4.2.2	Calculation of risk/variance of portfolio	73
4.2.3	Evaluation criteria and constraint set	73
4.2.4	Modelling constraints for an investor	86
4.3	Multivariate regression: model formulation	89
4.3.1	Multiple regression model 1	89
4.3.2	Multiple regression model 2	90
4.4	Granger causality tests	91
4.5	A utility approach	91
4.6	Performance measures for portfolios	96
4.7	Tests for equality	97
4.7.1	Mean equality test	97
4.7.2	Variance equality tests	98
4.8	To sum up	98
5	Mean-Variance Quadratic Programming Portfolio Selection Model: An Empirical Investigation of India's National Stock Exchange	101
5.1	Sample size and data collection	102
5.2	Software used	103
5.3	Mean-variance portfolio selection model: empirical testing	103
5.4	Descriptive statistics – returns	105
5.5	Data inputs	107
5.6	Model formulations	108

5.7	Mean-variance efficient portfolio selection model formulations: analysis and interpretations	112
5.7.1	Diversifier's portfolio	112
5.7.2	Satisficer's portfolio	117
5.7.3	Plunger's portfolio	117
5.7.4	Market trend portfolio	120
5.7.5	Capital gain bias portfolio	124
5.7.6	Dividend gain bias portfolio	128
5.7.7	Equal priority portfolio	131
5.7.8	Ideal portfolio	134
5.7.9	Markowitz's portfolio selection model	135
5.8	Comparison of alternate portfolio selection models	141
5.9	Markowitz's efficient frontier and mean-variance efficient portfolios	145
5.10	Multivariate regression analysis: estimating equations	149
5.11	Granger causality analysis	161
5.12	Utility analysis	162
5.13	Performance evaluation of portfolios: ranking the model formulations	168
5.14	Hypotheses testing: tests for equality	169
5.15	To sum up	176
6	Mean-Variance Portfolio Analysis Using Accounting, Financial and Corporate Governance Variables-Application on London Stock Exchange's FTSE 100	181
6.1	Securities and evaluation criteria	181
6.1.1	Data and software used	183
6.1.2	Modelling constraints for an investor	188
6.1.3	Alternative model formulations	190
6.2	Results and discussion	193
6.2.1	Formation of Pareto optimal portfolios	193
6.2.2	Portfolio performance evaluation	193
6.3	Out of the sample tests	201
7	Summary, Conclusions and Suggestions for Future Research	204
7.1	Model development	207
7.1.1	A general model	208

7.1.2 Alternate portfolio selection model formulations	209
7.1.3 Multiple regression analysis	212
7.1.4 Granger causality interpretations	213
7.1.5 Portfolio utility analysis	213
7.1.6 Performance evaluation of portfolios	214
7.1.7 Tests for equality: main findings	214
7.1.8 Out of the sample tests	215
7.2 Conclusions	216
7.3 Suggestions for future research	218

Annex

1 Programming for the multi-criteria portfolio selection Model	219
2 Programming for Markowitz's portfolio selection model	224

<i>Notes</i>	226
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<i>References</i>	229
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<i>Index</i>	241
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