Dynamic Trading with Predictable Returns and Transaction Costs

Dynamic Portfolio Choice with Frictions

Nicolae Gârleanu
UC Berkeley, CEPR, and NBER

Lasse H. Pedersen
New York University, Copenhagen Business School, AQR Capital Management, CEPR, and NBER
Motivation: Dynamic Trading

- Active investors – e.g., hedge funds, mutual funds, proprietary traders, individuals, other asset managers – try to
  - predict returns
  - minimize transactions costs
  - minimize risk

- Dynamic problem: investor trades now and in the future

- Key research questions:
  - What is the optimal trading strategy?
  - Does it work empirically?
Motivating Example

▶ An investor makes the following predictions:
  ▶ Based on strong fundamentals (low M/B, P/E, low accruals, high and stable earnings, etc.) the annualized expected excess return (alpha) on Centurytel Inc. is 10%.
    ▶ this alpha is expected to last for 2 years
  ▶ Based on recent catalysts, improving fundamentals and pricing, the annualized alpha of Treehouse Foods Inc. is also 10%
    ▶ this alpha is expected to last for half a year
  ▶ Based on recent demand pressure from funds with outflow, the annualized alpha of HJ Heinz Co. is -12%
    ▶ this alpha is expected to last for 2 weeks
  ▶ These and other signals are collected for numerous securities
  ▶ All these stocks are positively correlated
  ▶ The investor has estimated the trading cost (incl. market impact) for these stocks based on past experience
  ▶ The investor makes a similar analysis every day
Results: Aim in Front of the Target

- Closed-form optimal dynamic trading strategy

Panel A: Construction of Current Optimal Trade

\[
\begin{align*}
\text{xt} &- \text{xt} - 1 \\
\text{old position} &- \text{new position} \\
\text{Markowitz}_t &- \text{aim}_t \\
\text{Et(aim}_{t+1}) &- \text{Position in asset 1} \\
\text{Position in asset 2} &
\end{align*}
\]
Results: Aim in Front of the Target

- Closed-form optimal dynamic trading strategy
- Two portfolio principles:
  1. Aim in front of the target
  2. Trade partially towards the current aim
**Results: Aim in Front of the Target**

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Panel A: Construction of Current Optimal Trade
Results: Aim in Front of the Target

▷ Closed-form optimal dynamic trading strategy
▷ Two portfolio principles:
  1. Aim in front of the target
  2. Trade partially towards the current aim
▷ “Aim portfolio”:
  – Weighted average of current and future expected Markowitz portfolios
  – Predictors with slower mean reversion: more weight
▷ Application to commodity futures: superior net returns
Panel A. Constructing the current optimal portfolio

Panel B. Expected optimal portfolio next period

Panel C. Expected future path of optimal portfolio

Panel D. “Skate to where the puck is going to be”

Panel E. Shooting: lead the duck

Panel F. Missile systems: lead homing guidance

The optimal portfolio is forward-looking and depends critically on each return predictor's mean-reversion speed (alpha decay). To see this in Figure 1, note the convex J-shape of the expected path of the Markowitz portfolio: The Markowitz portfolio aims in front of the target, trading toward the aim, which incorporates where the Markowitz portfolio is moving.
Related Literature

- Optimal trading with transactions costs, no predictability
  - Constantinides (86), Amihud and Mendelson (86), Vayanos (98), Liu (04)

- Predictability, no transactions costs
  - Merton (73), Campbell and Viceira (02)

- Optimal trade execution with exogenous trade:
  - Perold (88), Almgren and Chriss (00)

- Numerical results with time-varying investment opportunity set
  - Jang, Koo, Liu, and Loewenstein (07), Lynch and Tan (08)

- Quadratic programming
  - Used in macroeconomics (Ljungqvist and Sargent (04)) and other fields: solve up to Ricatti equations
  - Grinold (06)
Outline of Talk

- Basic model
- Optimal portfolio strategy: Aim in front of the target
- Persistent price impact
- Application: Commodity futures
Discrete-Time Model

Returns: \( r_{t+1}^s = \sum_k \beta_{sk}^k f_t^k + u_{t+1}^s \)

Risk: \( \text{var}_t(u_{t+1}) = \Sigma \)

Alpha decay: \( \Delta f_{t+1}^k = - \sum_j \Phi_{kj} f_t^j + \varepsilon_{t+1} \)

Transaction costs: \( TC(\Delta x_t) = \frac{1}{2} \Delta x_t^\top \Lambda \Delta x_t \)

Assumption A: \( \Lambda = \lambda \Sigma \)

Objective: \( \max_{x_t} \mathbb{E} \sum_t (1 - \rho)^{t+1} (x_t^\top r_{t+1} - \frac{\gamma}{2} x_t^\top \Sigma x_t) - \frac{(1 - \rho)^t}{2} \Delta x_t^\top \Lambda \Delta x_t \)
Solution Method: Dynamic Programming

Introduce value function $V$ that solves the Bellman equation:

$$V(x_{t-1}, f_t) = \max_{x_t} \left\{ -\frac{1}{2} \Delta x_t^\top \Delta x_t + (1 - \rho) \left( x_t^\top E_t(r_{t+1}) - \frac{\gamma}{2} x_t^\top \Sigma x_t + E_t[V(x_t, f_{t+1})] \right) \right\}$$

Proposition

The model has a unique solution and the value function is given by

$$V(x_t, f_{t+1}) = -\frac{1}{2} x_t^\top A_{xx} x_t + x_t^\top A_{xf} f_{t+1} + \frac{1}{2} f_{t+1}^\top A_{ff} f_{t+1} + A_0.$$ 

The coefficient matrices $A_{xx}, A_{xf}, A_{ff}$ can be solved explicitly and $A_{xx}$ is positive definite.
Proposition (Trade Partially Towards the Aim)

i) The optimal dynamic portfolio $x_t$ is:

$$x_t = x_{t-1} + \Lambda^{-1} A_{xx} (\text{aim}_t - x_{t-1})$$

with “trading rate” $\Lambda^{-1} A_{xx}$ and

$$\text{aim}_t = A_{xx}^{-1} A_{xf} f_t$$

The trading rate is decreasing in transaction costs $\lambda$ and increasing in risk aversion $\gamma$. 
Proposition (Trade Partially Towards the Aim)

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ii) Under Assumption A, the trading rate is the scalar

$$a/\lambda = \frac{-(\gamma + \lambda \rho) + \sqrt{(\gamma + \lambda \rho)^2 + 4\gamma \lambda (1 - \rho)}}{2(1 - \rho) \lambda} < 1$$

The trading rate is decreasing in transaction costs $\lambda$ and increasing in risk aversion $\gamma$. 
What is the Target and What is the Aim?

- What is the moving target, i.e., the optimal position in the absence of transaction costs?

\[ \text{Markowitz}_t = (\gamma \Sigma)^{-1} B_f_t \]

- What is the aim portfolio?
Aim in Front of the Target

Proposition (Aim in Front of the Target)

(i) The aim portfolio is the weighted average of the current Markowitz portfolio and the expected future aim portfolio. Under Assumption A, letting $z = \gamma / (\gamma + a)$:

$$aim_t = z \text{Markowitz}_t + (1 - z) E_t(aim_{t+1}).$$

(ii) The aim portfolio is the weighted average of the current and future expected Markowitz portfolios. Under Assumption A,

$$aim_t = \sum_{\tau=t}^{\infty} z(1 - z)^{\tau-t} E_t(\text{Markowitz}_\tau)$$

The weight of the current Markowitz portfolio $z$ decreases with transaction costs $\lambda$ and increases in risk aversion $\gamma$. 
Aim in Front of the Target: Illustration

Panel A: Construction of Current Optimal Trade

Position in asset 1 vs. Position in asset 2

old position

new position

Markowitz

$E_t(\text{target}_{t+1})$
Panel B: Expected Next Optimal Trade

\[ E_t(x_{t+1}) \quad E_t(Markowitz_{t+1}) \]
Panel C: Expected Evolution of Portfolio

\( E_t(x_{t+h}) \)

\( E_t(\text{Markowitz}_{t+h}) \)
**Weight Signals Based on Alpha Decay**

**Proposition (Weight Signals Based on Alpha Decay)**

(i) Under Assumption A, the aim portfolio is:

\[ \text{aim}_t = (\gamma \Sigma)^{-1} B \left( I + \frac{a}{\gamma} \Phi \right)^{-1} f_t \]

(ii) If the matrix \( \Phi \) is diagonal, \( \Phi = \text{diag}(\phi^1, ..., \phi^K) \), then the aim portfolio is:

\[ \text{aim}_t = (\gamma \Sigma)^{-1} B \left( \frac{f_t^1}{1 + \phi^1 a/\gamma}, \ldots, \frac{f_t^K}{1 + \phi^K a/\gamma} \right)^\top \]

I.e., the aim pf. is the Markowitz pf. with factors \( f_t^k \) scaled down based on their own alpha decay given by \( \Phi \).
Weight Signals Based on Alpha Decay: Illustration

Panel A: Construction of Current Optimal Trade

Position in asset 1

Position in asset 2

old position $x_{t-1}$

new position $x_t$

$E_t(aim_{t+1})$

$Markowitz_t$

Position in asset 1
Proposition (Position Homing In)

Suppose that the agent has followed the optimal trading strategy from time \(-\infty\) until time \(t\). Then the current portfolio is an exponentially weighted average of past aim portfolios. Under Assumption A,

\[
x_t = \sum_{\tau = -\infty}^{t} \frac{a}{\lambda} (1 - \frac{a}{\lambda})^{t-\tau} \text{aim}_\tau
\]  

(1)
Example: Timing a Single Security

A security has risk $\Sigma = \sigma^2$ and return

$$r_{t+1} = \sum_k \beta^k f^k_t + u_{t+1}$$

$$= E_t (r_{t+1})$$

The optimal strategy is

$$x_t = \left(1 - \frac{a}{\lambda} \right) x_{t-1} + \frac{a}{\lambda} \frac{1}{\gamma \sigma^2} \sum_{i=1}^K \frac{\beta^i}{1 + \phi^i a / \gamma} f^i_t.$$
Example: Relative-Value Trades w/ Security Characteristics

Each security $s$ (e.g., IBM) has its own characteristics $f_t^{i,s}$ (e.g., its value and momentum) and characteristics predict returns for all securities, with the same coefficients:

$$E_t(r_{t+1}^s) = \sum_{i} \beta^i f_t^{i,s}$$

Each characteristic has the same mean-reversion speed for all securities

$$\Delta f_{t+1}^{i,s} = -\phi^i f_t^{i,s} + \varepsilon_{t+1}^{i,s}.$$
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\Delta f_{t+1}^{i,s} = -\phi^i f_t^{i,s} + \varepsilon_{t+1}^{i,s}.
\]

The optimal characteristic-based strategy is

\[
x_t = \left(1 - \frac{a}{\lambda}\right)x_{t-1} + \frac{a}{\lambda} (\gamma \Sigma)^{-1} \sum_{i=1}^{l} \frac{\beta^i}{1 + \phi^i a / \gamma} f_t^i.
\]
Example: Static Model

When the future is completely discounted ($\rho = 1$), objective is

$$\max_{x_t} \left( x_t^\top E_t(r_{t+1}) - \frac{\gamma}{2} x_t^\top \Sigma x_t - \frac{\lambda}{2} \Delta x_t^\top \Sigma \Delta x_t \right)$$

No choice of $\gamma, \lambda$ recovers the dynamic solution.
Example: Static Model

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Solution

$$x_t = \frac{\lambda}{\gamma + \lambda} x_{t-1} + \frac{\gamma}{\gamma + \lambda} (\gamma \Sigma)^{-1} E_t(r_{t+1}).$$

No choice of \(\gamma, \lambda\) recovers the dynamic solution.
Example: Signals (Equally) Valuable for $K$ Days

Suppose:

- All factors equally good $B = (\beta, \ldots, \beta)$
- Today’s yesterday is tomorrow’s day-before-yesterday:

\[
\begin{align*}
    f_{t+1}^{1} & = \varepsilon_{t+1}^{1} \\
    f_{t+1}^{k} & = f_{t}^{k-1} \quad \text{for } k > 1
\end{align*}
\]
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  f_{t+1}^1 &= \varepsilon_{t+1}^1 \\
  f_{t+1}^k &= f_{t}^{k-1} \quad \text{for } k > 1
\end{align*}
\]

Optimal strategy:

\[
x_t = \left(1 - \frac{a}{\lambda}\right) x_{t-1} + \frac{a}{\lambda} \frac{\beta}{\sigma^2(1 - z)} \sum_k \left(1 - z^{K+1-k}\right) f_t^k,
\]

where $z = a/(a + \gamma) < 1$.

More weight to recent signals even if they don’t predict better.
Persistent Transaction Costs Model

Proposition

With temporary and persistent transaction costs, the optimal portfolio \( x_t \) is

\[
x_t = x_{t-1} + M^{rate} (\text{aim}_t - x_{t-1}),
\]

which tracks an aim portfolio, \( \text{aim}_t = M^{aim} y_t \), that depends on the return-predicting factors and the price distortion.
Persistent Transaction Costs Model

Panel A: Only Transitory Cost

Panel B: Persistent and Transitory Cost

Panel C: Only Persistent Cost
Application: Dynamic Trading of Commodity Futures

Data on liquid futures without tight price limits 01/01/1996 – 01/23/2009:

- Aluminum, Copper, Nickel, Zinc, Lead, Tin from London Metal Exchange (LME)
- Gas Oil from the Intercontinental Exchange (ICE)
- WTI Crude, RBOB Unleaded Gasoline, Natural Gas from New York Mercantile Exchange (NYMEX)
- Gold, Silver is from New York Commodities Exchange (COMEX)
- Coffee, Cocoa, Sugar from New York Board of Trade (NYBOT)
Predicting Returns and Other Parameter Estimates

Pooled panel regression:

\[ r_{t+1}^s = 0.001 + 10.32 f_{t}^{5D,s} + 122.34 f_{t}^{1Y,s} - 205.59 f_{t}^{5Y,s} + u_{t+1}^s \]

\( (0.17) \quad (2.22) \quad (2.82) \quad (-1.79) \)

Alpha decay:

\[ \Delta f_{t+1}^{5D,s} = -0.2519 f_{t}^{5D,s} + \varepsilon_{t+1}^{5D,s} \]
\[ \Delta f_{t+1}^{1Y,s} = -0.0034 f_{t}^{1Y,s} + \varepsilon_{t+1}^{1Y,s} \]
\[ \Delta f_{t+1}^{5Y,s} = -0.0010 f_{t}^{5Y,s} + \varepsilon_{t+1}^{5Y,s} \]

Risk: \( \Sigma \) estimated using daily price changes

Absolute risk aversion: \( \gamma = 10^{-9} \)

Time discount rate: \( \rho = 1 - \exp(-0.02/260) \)

Transactions costs: \( \lambda = 3 \times 10^{-7} \), as well as \( \lambda^{high} = 10 \times 10^{-7} \)
## Performance of Trading Strategies Before and After TCs

<table>
<thead>
<tr>
<th></th>
<th>Panel A: Benchmark Transaction Costs</th>
<th>Panel B: High Transaction Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Gross SR</td>
<td>Net SR</td>
</tr>
<tr>
<td>Markowitz</td>
<td>0.83</td>
<td>-9.38</td>
</tr>
<tr>
<td>Dynamic optimization</td>
<td>0.63</td>
<td><strong>0.60</strong></td>
</tr>
<tr>
<td>Static optimization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weight on Markowitz = 10%</td>
<td>0.63</td>
<td>0.00</td>
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<tr>
<td>Weight on Markowitz = 9%</td>
<td>0.62</td>
<td>0.10</td>
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<td>Weight on Markowitz = 8%</td>
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<td>Weight on Markowitz = 7%</td>
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<tr>
<td>Weight on Markowitz = 6%</td>
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<td>0.36</td>
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<tr>
<td>Weight on Markowitz = 5%</td>
<td>0.61</td>
<td>0.43</td>
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<td>Weight on Markowitz = 4%</td>
<td>0.60</td>
<td>0.48</td>
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<tr>
<td>Weight on Markowitz = 3%</td>
<td><strong>0.58</strong></td>
<td><strong>0.51</strong></td>
</tr>
<tr>
<td>Weight on Markowitz = 2%</td>
<td>0.52</td>
<td>0.49</td>
</tr>
<tr>
<td>Weight on Markowitz = 1%</td>
<td>0.36</td>
<td>0.34</td>
</tr>
</tbody>
</table>
Positions in Crude and Gold Futures

Position in Crude

Position in Gold

Markowitz
Optimal
Optimal Trading in Response to Shock to 5-Day Return-Predicting Signal
Optimal Trading in Response to Shock to 1-Year Return-Predicting Signal

![Graph showing optimal trading after a shock to signal 2 (1-year returns). The graph includes lines for Markowitz, Optimal, and Optimal (high TC).]
Optimal Trading in Response to Shock to 5-Year Return-Predicting Signal

![Graph showing optimal trading after a shock to the 5-year return-predicting signal. The graph compares Markowitz optimal, optimal (high TC), and optimal trading after the shock. The x-axis represents time in years, and the y-axis shows the magnitude of trading in $10^5$. The graph illustrates how the optimal trading strategy responds to the shock over time.]
New paper: Dynamic Portfolio Choice with Frictions

What’s different in this paper:

- Continuous time
- Micro foundation for transaction costs
- Connection between discrete and continuous time
  - What happens when trading becomes more frequent?
- Generalized factor dynamics and return dynamics, including stochastic volatility
- Equilibrium implications
Conclusion: Aim in Front of the Target

- Derive the closed-form optimal dynamic portfolio strategy
  1. Aim in front of the target
  2. Trade partially towards the current aim at constant rate
  3. Give more weight to persistent factors

- Superior net returns in application