
Contents

Foreword	xiii
Acknowledgments	xv
Chapter 1. Time-series and Cross-sectional Stock Return Forecasting: New Machine Learning Methods	1
David E. RAPACH and Guofu ZHOU	
1.1. Introduction	1
1.2. Time-series return forecasts	3
1.2.1. Predictive regression	3
1.2.2. Forecast combination	5
1.2.3. Elastic net	6
1.2.4. Combination elastic net	8
1.3. Empirical application	10
1.3.1. Data	10
1.3.2. Forecasts	12
1.3.3. Statistical gains	17
1.3.4. Economic gains	23
1.4. Cross-sectional return forecasts	26
1.5. Conclusion	29
1.6. Acknowledgements	30
1.7. References	30

Chapter 2. In Search of Return Predictability: Application of Machine Learning Algorithms in Tactical Allocation	35
Kris BOUDT, Muzafer CELA and Majeed SIMAAN	
2.1. Introduction	35
2.2. Empirical investigation	38
2.2.1. The data	38
2.2.2. Tactical asset allocation strategy	40
2.2.3. Implementation	41
2.2.4. Benchmarks	42
2.3. A review of machine learning algorithms for prediction of market direction	42
2.3.1. K-nearest neighbors	43
2.3.2. Generalized linear model	44
2.3.3. Elastic net regression	44
2.3.4. Linear discriminant analysis	45
2.3.5. Support vector machines with radial kernel	45
2.3.6. C5.0	47
2.3.7. Random forests	48
2.3.8. Multilayer perceptron	48
2.3.9. Model averaging	49
2.3.10. Repeated k-fold cross validation	50
2.4. Evaluation criteria	51
2.4.1. Statistical performance	51
2.4.2. Financial performance	53
2.4.3. Significant features	54
2.5. Results and findings	54
2.5.1. Descriptive statistics of the data	55
2.5.2. Statistical performance	56
2.5.3. Financial performance	58
2.5.4. The best performer, benchmark and model average	67
2.5.5. LIME	68
2.6. Conclusion	70
2.7. Acknowledgments	70
2.8. References	70
Chapter 3. Sparse Predictive Regressions: Statistical Performance and Economic Significance	75
Daniele BIANCHI and Andrea TAMONI	
3.1. Introduction	75
3.2. Related literature	78
3.3. Data: portfolios and predictors	80

3.4. Econometric framework	84
3.4.1. Shrinkage priors	86
3.4.2. Forecast evaluations	92
3.5. Predicting asset returns: empirical results	93
3.5.1. Statistical performance	93
3.5.2. Economic significance	96
3.6. Discussion on the dynamics of sparsity	100
3.7. Conclusion	102
3.8. Appendix	103
3.9. Posterior simulation	103
3.9.1. Ridge regression	103
3.9.2. Lasso and group-lasso	103
3.9.3. Elastic net	105
3.9.4. Horseshoe and the group horseshoe	105
3.10. References	106
Chapter 4. The Artificial Intelligence Approach to Picking Stocks	115
Riccardo BORGHI and Giuliano DE ROSSI	
4.1. Introduction	115
4.2. Literature review	120
4.3. Data	123
4.3.1. Equity factors	123
4.3.2. Data cleaning	125
4.3.3. Features used for training and prediction	125
4.4. Model specification and calibration	126
4.4.1. Models	126
4.4.2. Model calibration	133
4.5. Predicting US stock returns	135
4.5.1. Information coefficients	136
4.5.2. Long–short strategy	138
4.5.3. Returns correlation with Alpha model	140
4.5.4. Active returns by basket	141
4.5.5. Calibrated hyperparameters and model complexity	142
4.5.6. Variable importance	144
4.6. Predicting European stock returns	146
4.6.1. Information coefficients	146
4.6.2. Long–short strategy	147
4.6.3. Returns correlation with Alpha model	150
4.6.4. Active returns by basket	150
4.6.5. Calibrated hyperparameters and model complexity	151
4.6.6. Variable importance	152

4.7. The impact of transaction costs	154
4.7.1. Optimized strategies for European stocks	154
4.7.2. Optimized strategies for US stocks	158
4.8. Conclusion	161
4.9. References	163
Chapter 5. Enhancing Alpha Signals from Trade Ideas Data Using Supervised Learning	167
Georgios V. PAPAIOANNOU and Daniel GIAMOURIDIS	
5.1. Introduction	167
5.2. Data	169
5.3. Model and empirical design	174
5.4. Estimation and robustness	179
5.5. Economic significance	186
5.6. Conclusion	188
5.7. References	189
Chapter 6. Natural Language Process and Machine Learning in Global Stock Selection	191
Yin LUO	
6.1. Introduction	191
6.1.1. The performance of traditional stock selection factors continues to shrink	191
6.1.2. Textual data, natural language processing and machine learning	195
6.2. Natural language analysis of company management presentations	197
6.2.1. Coverage	198
6.2.2. Readability index and language complexity	201
6.2.3. Quantifying executive personalities	206
6.2.4. Syntactic parser and part-of-speech (POS) tagging	207
6.3. Extracting long-term signal from news sentiment data	211
6.3.1. Introducing RavenPack data	211
6.3.2. The challenges of using news sentiment signals in stock selection	215
6.3.3. How do investors react to news?	216
6.3.4. The interaction of news, corporate events and investor behavior	217
6.3.5. A machine learning approach to extract event-based sentiment	221
6.3.6. Welcome to NICE (News with Insightful Categorical Events)	225
6.4. References	228

Chapter 7. Forecasting Beta Using Machine Learning and Equity Sentiment Variables	231
Alexei JOUROVSKI, Vladyslav DUBIKOVSKYY, Pere ADELL, Ravi RAMAKRISHNAN and Robert KOSOWSKI	
7.1. Introduction	231
7.2. Data	234
7.2.1. Data construction process	234
7.3. Methodology	240
7.3.1. Historical beta	241
7.3.2. Bloomberg's adjusted beta	241
7.3.3. OLS regression	241
7.3.4. Post-LASSO OLS regression	241
7.3.5. Random forest model	242
7.3.6. XGBoost model	242
7.4. Empirical results	242
7.4.1. Variable selection	242
7.4.2. Forecasting models	244
7.4.3. Variable importance	246
7.4.4. SHAP values	247
7.4.5. Overall level of feature importance	248
7.4.6. Cross-sectional analysis of feature importance	250
7.4.7. Time-series analysis of feature importance	253
7.5. Constructing market neutral long–short portfolios	257
7.6. Concluding remarks	258
7.7. References	259
Chapter 8. Machine Learning Optimization Algorithms & Portfolio Allocation	261
Sarah PERRIN and Thierry RONCALLI	
8.1. Introduction	262
8.2. The quadratic programming world of portfolio optimization	264
8.2.1. Quadratic programming	264
8.2.2. Mean-variance optimized portfolios	265
8.2.3. Issues with QP optimization	270
8.3. Machine learning optimization algorithms	271
8.3.1. Coordinate descent	274
8.3.2. Alternating direction method of multipliers	279
8.3.3. Proximal operators	283
8.3.4. Dykstra's algorithm	289

8.4. Applications to portfolio optimization	293
8.4.1. Minimum variance optimization	295
8.4.2. Smart beta portfolios	301
8.4.3. Robo-advisory optimization	307
8.4.4. Tips and tricks	312
8.5. Conclusion	315
8.6. Acknowledgements	317
8.7. Appendix	317
8.7.1. Mathematical results	317
8.7.2. Data	323
8.8. References	324
Chapter 9. Hierarchical Risk Parity: Accounting for Tail Dependencies in Multi-asset Multi-factor Allocations	329
Harald LOHRE, Carsten ROTHER and Kilian Axel SCHÄFER	
9.1. Hierarchical risk parity strategies	332
9.1.1. The multi-asset multi-factor universe	333
9.1.2. The hierarchical multi-asset multi-factor structure	334
9.1.3. Hierarchical clustering	338
9.1.4. Portfolio allocation based on hierarchical clustering	342
9.2. Tail dependency and hierarchical clustering	343
9.2.1. Tail dependence coefficients	344
9.2.2. Estimating tail dependence coefficients	345
9.3. Risk-based allocation strategies	347
9.3.1. Classic risk-based allocation techniques	347
9.3.2. Diversified risk parity	348
9.4. Hierarchical risk parity for multi-asset multi-factor allocations	352
9.4.1. Strategy universe	352
9.4.2. A statistical horse race of risk-based allocation strategies	354
9.5. Conclusion	360
9.6. Acknowledgements	362
9.7. Appendix 1: Definition of style factors	362
9.7.1. Foreign exchange (FX) style factors	362
9.7.2. Commodity style factors	363
9.7.3. Rates style factors	364
9.7.4. Equity style factors	364
9.8. Appendix 2: CSR estimator	365
9.9. References	367

Chapter 10. Portfolio Performance Attribution: A Machine Learning-Based Approach	369
Ryan BROWN, Harindra DE SILVA and Patrick D. NEAL	
10.1. Introduction	369
10.2. Methodology	371
10.2.1. Matrix algebra representation of selection and allocation effects	372
10.2.2. Creating categorical variables from continuous variables	374
10.2.3. Optimizing continuous variable breakpoints to maximize systematic attribution	375
10.3. Data description	377
10.4. Results	378
10.5. Conclusion	385
10.6. References	386
Chapter 11. Modeling Transaction Costs When Trades May Be Crowded: A Bayesian Network Using Partially Observable Orders Imbalance	387
Marie BRIÈRE, Charles-Albert LEHALLE, Tamara NEFEDOVA and Amine RABOUN	
11.1. Introduction	388
11.2. Related literature	391
11.2.1. Transaction costs and market impact	391
11.2.2. Bayesian networks	392
11.3. ANcerno database	394
11.4. Transaction cost modeling	396
11.4.1. Order size	396
11.4.2. Order flow imbalance	398
11.4.3. Joint effect of order size and order flow imbalance	400
11.5. Bayesian network modeling with net order flow imbalance as latent variable	403
11.5.1. Bayesian inference	404
11.5.2. Bayesian network modeling	406
11.5.3. Net order flow imbalance dependencies	409
11.5.4. Implementation shortfall dependencies	413
11.6. Forecasting implementation shortfall	415
11.6.1. Inference of investors' order flow imbalance given post-trade cost and market conditions	420
11.7. Conclusion	421
11.8. Appendix A: Garman-Klass volatility definition	423

11.9. Appendix B: bid-ask spread and volatility distribution dependencies	423
11.10. Appendix C: beta distribution properties	424
11.11. Appendix D: net order flow imbalance properties	425
11.12. Appendix E: implementation shortfall distribution	425
11.13. Appendix F: Hastings-Metropolis algorithm.	426
11.14. References	427
List of Authors	431
Commendations	434
Index	435