

## Optimization Methods in Finance

Optimization methods play a central role in financial modeling. This textbook is devoted to explaining how state-of-the-art optimization theory, algorithms, and software can be used to efficiently solve problems in computational finance. It discusses some classical mean–variance portfolio optimization models as well as more modern developments such as models for optimal trade execution and dynamic portfolio allocation with transaction costs and taxes. Chapters discussing the theory and efficient solution methods for the main classes of optimization problems alternate with chapters discussing their use in the modeling and solution of central problems in mathematical finance.

This book will be interesting and useful for students, academics, and practitioners with a background in mathematics, operations research, or financial engineering.

The second edition includes new examples and exercises as well as a more detailed discussion of mean–variance optimization, multi-period models, and additional material to highlight the relevance to finance.

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Second Edition

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## Contents

	<i>Preface</i>	<i>page xi</i>
<b>Part I</b>	<b>Introduction</b>	<b>1</b>
<b>1</b>	<b>Overview of Optimization Models</b>	<b>3</b>
	1.1 Types of Optimization Models	4
	1.2 Solution to Optimization Problems	7
	1.3 Financial Optimization Models	8
	1.4 Notes	10
<b>2</b>	<b>Linear Programming: Theory and Algorithms</b>	<b>11</b>
	2.1 Linear Programming	11
	2.2 Graphical Interpretation of a Two-Variable Example	15
	2.3 Numerical Linear Programming Solvers	16
	2.4 Sensitivity Analysis	17
	2.5 *Duality	20
	2.6 *Optimality Conditions	23
	2.7 *Algorithms for Linear Programming	24
	2.8 Notes	30
	2.9 Exercises	31
<b>3</b>	<b>Linear Programming Models: Asset–Liability Management</b>	<b>35</b>
	3.1 Dedication	35
	3.2 Sensitivity Analysis	38
	3.3 Immunization	38
	3.4 Some Practical Details about Bonds	41
	3.5 Other Cash Flow Problems	44
	3.6 Exercises	47
	3.7 Case Study	51
<b>4</b>	<b>Linear Programming Models: Arbitrage and Asset Pricing</b>	<b>53</b>
	4.1 Arbitrage Detection in the Foreign Exchange Market	53
	4.2 The Fundamental Theorem of Asset Pricing	55
	4.3 One-Period Binomial Pricing Model	56

vi	<b>Contents</b>	
	4.4 Static Arbitrage Bounds	59
	4.5 Tax Clientele Effects in Bond Portfolio Management	63
	4.6 Notes	65
	4.7 Exercises	65
<b>Part II</b>	<b>Single-Period Models</b>	<b>69</b>
<b>5</b>	<b>Quadratic Programming: Theory and Algorithms</b>	<b>71</b>
	5.1 Quadratic Programming	71
	5.2 Numerical Quadratic Programming Solvers	74
	5.3 Sensitivity Analysis	75
	5.4 *Duality and Optimality Conditions	76
	5.5 *Algorithms	81
	5.6 Applications to Machine Learning	84
	5.7 Exercises	87
<b>6</b>	<b>Quadratic Programming Models: Mean–Variance Optimization</b>	<b>90</b>
	6.1 Portfolio Return	90
	6.2 Markowitz Mean–Variance (Basic Model)	91
	6.3 Analytical Solutions to Basic Mean–Variance Models	95
	6.4 More General Mean–Variance Models	99
	6.5 Portfolio Management Relative to a Benchmark	103
	6.6 Estimation of Inputs to Mean–Variance Models	106
	6.7 Performance Analysis	112
	6.8 Notes	115
	6.9 Exercises	115
	6.10 Case Studies	121
<b>7</b>	<b>Sensitivity of Mean–Variance Models to Input Estimation</b>	<b>124</b>
	7.1 Black–Litterman Model	126
	7.2 Shrinkage Estimation	129
	7.3 Resampled Efficiency	131
	7.4 Robust Optimization	132
	7.5 Other Diversification Approaches	133
	7.6 Exercises	135
<b>8</b>	<b>Mixed Integer Programming: Theory and Algorithms</b>	<b>140</b>
	8.1 Mixed Integer Programming	140
	8.2 Numerical Mixed Integer Programming Solvers	143
	8.3 Relaxations and Duality	145
	8.4 Algorithms for Solving Mixed Integer Programs	150
	8.5 Exercises	157

<b>9</b>	<b>Mixed Integer Programming Models: Portfolios with Combinatorial Constraints</b>	161
9.1	Combinatorial Auctions	161
9.2	The Lockbox Problem	163
9.3	Constructing an Index Fund	165
9.4	Cardinality Constraints	167
9.5	Minimum Position Constraints	168
9.6	Risk-Parity Portfolios and Clustering	169
9.7	Exercises	169
9.8	Case Study	171
 <b>10</b>	 <b>Stochastic Programming: Theory and Algorithms</b>	 173
10.1	Examples of Stochastic Optimization Models	173
10.2	Two-Stage Stochastic Optimization	174
10.3	Linear Two-Stage Stochastic Programming	175
10.4	Scenario Optimization	176
10.5	*The L-Shaped Method	177
10.6	Exercises	179
 <b>11</b>	 <b>Stochastic Programming Models: Risk Measures</b>	 181
11.1	Risk Measures	181
11.2	A Key Property of CVaR	185
11.3	Portfolio Optimization with CVaR	186
11.4	Notes	190
11.5	Exercises	190
 <b>Part III</b>	 <b>Multi-Period Models</b>	 195
 <b>12</b>	 <b>Multi-Period Models: Simple Examples</b>	 197
12.1	The Kelly Criterion	197
12.2	Dynamic Portfolio Optimization	198
12.3	Execution Costs	201
12.4	Exercises	209
 <b>13</b>	 <b>Dynamic Programming: Theory and Algorithms</b>	 212
13.1	Some Examples	212
13.2	Model of a Sequential System (Deterministic Case)	214
13.3	Bellman's Principle of Optimality	215
13.4	Linear-Quadratic Regulator	216
13.5	Sequential Decision Problem with Infinite Horizon	218
13.6	Linear-Quadratic Regulator with Infinite Horizon	219
13.7	Model of Sequential System (Stochastic Case)	221
13.8	Notes	222
13.9	Exercises	222

viii	<b>Contents</b>	
<b>14</b>	<b>Dynamic Programming Models: Multi-Period Portfolio Optimization</b>	225
	14.1 Utility of Terminal Wealth	225
	14.2 Optimal Consumption and Investment	227
	14.3 Dynamic Trading with Predictable Returns and Transaction Costs	228
	14.4 Dynamic Portfolio Optimization with Taxes	230
	14.5 Exercises	234
<b>15</b>	<b>Dynamic Programming Models: the Binomial Pricing Model</b>	238
	15.1 Binomial Lattice Model	238
	15.2 Option Pricing	238
	15.3 Option Pricing in Continuous Time	244
	15.4 Specifying the Model Parameters	245
	15.5 Exercises	246
<b>16</b>	<b>Multi-Stage Stochastic Programming</b>	248
	16.1 Multi-Stage Stochastic Programming	248
	16.2 Scenario Optimization	250
	16.3 Scenario Generation	255
	16.4 Exercises	259
<b>17</b>	<b>Stochastic Programming Models: Asset–Liability Management</b>	262
	17.1 Asset–Liability Management	262
	17.2 The Case of an Insurance Company	263
	17.3 Option Pricing via Stochastic Programming	265
	17.4 Synthetic Options	270
	17.5 Exercises	273
<b>Part IV</b>	<b>Other Optimization Techniques</b>	275
<b>18</b>	<b>Conic Programming: Theory and Algorithms</b>	277
	18.1 Conic Programming	277
	18.2 Numerical Conic Programming Solvers	282
	18.3 Duality and Optimality Conditions	282
	18.4 Algorithms	284
	18.5 Notes	287
	18.6 Exercises	287
<b>19</b>	<b>Robust Optimization</b>	289
	19.1 Uncertainty Sets	289
	19.2 Different Flavors of Robustness	290
	19.3 Techniques for Solving Robust Optimization Models	294
	19.4 Some Robust Optimization Models in Finance	297
	19.5 Notes	302
	19.6 Exercises	302



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<b>20</b>	<b>Nonlinear Programming: Theory and Algorithms</b>	305
	20.1 Nonlinear Programming	305
	20.2 Numerical Nonlinear Programming Solvers	306
	20.3 Optimality Conditions	306
	20.4 Algorithms	308
	20.5 Estimating a Volatility Surface	315
	20.6 Exercises	319
	<b>Appendices</b>	321
	<b>Appendix Basic Mathematical Facts</b>	323
	A.1 Matrices and Vectors	323
	A.2 Convex Sets and Convex Functions	324
	A.3 Calculus of Variations: the Euler Equation	325
	<b>References</b>	327
	<b>Index</b>	334

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978-1-107-05674-9 — Optimization Methods in Finance  
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Frontmatter  
[More Information](#)

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## Preface

The use of sophisticated mathematical tools in modern finance is now commonplace. Researchers and practitioners routinely run simulations or solve differential equations to price securities, estimate risks, or determine hedging strategies. Some of the most important tools employed in these computations are optimization algorithms. Many computational finance problems ranging from asset allocation to risk management, from option pricing to model calibration, can be solved by optimization techniques. This book is devoted to explaining how to solve such problems efficiently and accurately using the state of the art in optimization models, methods, and software.

Optimization is a mature branch of applied mathematics. Typical optimization problems have the goal of allocating limited resources to alternative activities in order to maximize the total benefit obtained from these activities. Through decades of intensive and innovative research, fast and reliable algorithms and software have become available for many classes of optimization problems. Consequently, optimization is now being used as an effective management and decision-support tool in many industries, including the financial industry.

This book discusses several classes of optimization problems encountered in financial models, including linear, quadratic, integer, dynamic, stochastic, conic, and nonlinear programming. For each problem class, after introducing the relevant theory (optimality conditions, duality, etc.) and efficient solution methods, we discuss several problems of mathematical finance that can be modeled within this problem class.

The second edition includes a more detailed discussion of mean–variance optimization, multi-period models, and additional material to highlight the relevance to finance.

The book's structure has also been clarified for the second edition; it is now organized in four main parts, each comprising several chapters. Part I guides the reader through the solution of asset liability cash flow matching using linear programming techniques, which are also used to explain asset pricing and arbitrage. Part II is devoted to single-period models. It provides a thorough treatment of mean–variance portfolio optimization models, including derivations of the one-fund and two-fund theorems and their connection to the capital asset pricing model, a discussion of linear factor models that are used extensively

in risk and portfolio management, and techniques to deal with the sensitivity of mean–variance models to parameter estimation. We discuss integer programming formulations for portfolio construction problems with cardinality constraints, and we explain how this is relevant to constructing an index fund. The final chapters of Part II present a stochastic programming approach to modeling measures of risk other than the variance, including the popular value at risk and conditional value at risk.

Part III of the book discusses multi-period models such as the iconic Kelly criterion and binomial lattice models for asset pricing as well as more elaborate and modern models for optimal trade execution, dynamic portfolio optimization with transaction costs and taxes, and asset–liability management. These applications showcase techniques from dynamic and stochastic programming.

Part IV is devoted to more advanced optimization techniques. We introduce conic programming and discuss applications such as the approximation of covariance matrices and robust portfolio optimization. The final chapter of Part IV covers one of the most general classes of optimization models, namely nonlinear programming, and applies it to volatility estimation.

This book is intended as a textbook for Master’s programs in financial engineering, finance, or computational finance. In addition, the structure of chapters, alternating between optimization methods and financial models that employ these methods, allows the book to be used as a primary or secondary text in upper-level undergraduate or introductory graduate courses in operations research, management science, and applied mathematics. A few sections are marked with a ‘\*’ to indicate that the material they contain is more technical and can be safely skipped without loss of continuity.

Optimization algorithms are sophisticated tools and the relationship between their inputs and outputs is sometimes opaque. To maximize the value from using these tools and to understand how they work, users often need a significant amount of guidance and practical experience with them. This book aims to provide this guidance and serve as a reference tool for the finance practitioners who use or want to use optimization techniques.

This book has benefited from the input provided by instructors and students in courses at various institutions. We thank them for their valuable feedback and for many stimulating discussions. We would also like to thank the colleagues who provided the initial impetus for this book and colleagues who collaborated with us on various research projects that are reflected in the book. We especially thank Kathie Cameron, the late Rick Green, Raphael Hauser, John Hooker, Miroslav Karamanov, Mark Koenig, Masakazu Kojima, Vijay Krishnamurthy, Miguel Lejeune, Yanjun Li, François Margot, Ana Margarida Monteiro, Mustafa Pinar, Sebastian Pokutta, Sanjay Srivastava, Michael Trick, and Luís Vicente.