

Package ‘CLA’

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Title Critical Line Algorithm in Pure R

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Depends R (>= 3.4.0)

Imports stats, grDevices, graphics, utils

Suggests fGarch, FRAPO, Matrix

Description Implements 'Markowitz' Critical Line Algorithm ('CLA') for classical mean-variance portfolio optimization, see Markowitz (1952) <doi:10.2307/2975974>. Care has been taken for correctness in light of previous buggy implementations.

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Description

The Critical Line Algorithm was first proposed by Markowitz(1987) to solve the mean-variance optimal portfolio problem.

We solve the problem with “box” constraints, i.e., allow to specify lower and upper bounds (via `lB` and `uB`) for each asset weight.

Here we provide a pure R implementation, quite fine tuned and debugged compared to earlier ones.

Usage

```
CLA(mu, covar, lB, uB,
    check.cov = TRUE, check.f = TRUE,
    tol.lambda = 1e-07,
    give.MS = TRUE, keep.names = TRUE, trace = 0)
```

Arguments

<code>mu</code>	numeric vector of length n containing the expected return $E[R_i]$ for $i = 1, 2, \dots, n$.
<code>covar</code>	the $n \times n$ covariance matrix of the returns, must be positive definite.
<code>lB, uB</code>	vectors of length n with lower and upper bounds for the asset weights.
<code>check.cov</code>	logical indicating if the covar matrix should be checked to be positive definite.
<code>check.f</code>	logical indicating if a warning should be produced when the algorithm cannot produce a new (smaller) lambda even though there are still free weights to be chosen.
<code>tol.lambda</code>	the tolerance when checking for lambda changes or being zero.
<code>give.MS</code>	logical indicating if <code>MS()</code> should be computed (and returned) as well.
<code>keep.names</code>	logical indicating if the <code>weights_set</code> matrix should keep the (asset) names(<code>mu</code>).
<code>trace</code>	an integer (or logical) indicating if and how much diagnostic or progress output should be produced.

Details

The current implementation of the CLA is based (via Norring’s) on Bailey et al.(2013). We have found buglets in that implementation which lead them to introduce their “purge” routines (`purgeNumErr`, `purgeExcess`), which are no longer necessary.

Even though this is a pure R implementation, the algorithm is quite fast also when the number of assets n is large (1000s), though that depends quite a bit on the exact problem.

Value

an object of class "CLA" which is a list with components

weights_set	a $n \times m$ matrix of asset weights, corresponding to the m steps that the CLA has completed or the m "turning points" it has computed.
free_indices	a list of length m , the k -th component with the indices in $1, \dots, n$ of those assets whose weights were not at the boundary after ...
gammas	numeric vector of length m of the values γ_k for CLA step k , $k = 1, \dots, n$.
lambdas	numeric vector of length m of the Lagrange parameters λ_k for CLA step k , $k = 1, \dots, n$.
MS_weights	the $\mu(W)$ and $\sigma(W)$ corresponding to the asset weights weights_set, i.e., simply the same as MS(weights_set = weights_set, mu = mu, covar = covar).

Author(s)

Alexander Norring did the very first version (unpublished master thesis). Current implementation: Yanhao Shi and Martin Maechler

References

- Markowitz, H. (1952) Portfolio selection, *The Journal of Finance* **7**, 77–91; doi: [10.2307/2975974](https://doi.org/10.2307/2975974).
- Markowitz, H. M. (1987, 1st ed.) and Markowitz, H. M. and Todd, P. G. (2000) *Mean-Variance Analysis in Portfolio Choice and Capital Markets*; chapters 7 and 13.
- Niedermayer, A. and Niedermayer, D. (2010) Applying Markowitz's Critical Line Algorithm, in J. B. Guerard (ed.), *Handbook of Portfolio Construction*, Springer; chapter 12, 383–400; doi: [10.1007/9780387774398_12](https://doi.org/10.1007/9780387774398_12).
- Bailey, D. H. and López de Prado, M. (2013) An open-source implementation of the critical-line algorithm for portfolio optimization, *Algorithms* **6**(1), 169–196; doi: [10.3390/a6010169](https://doi.org/10.3390/a6010169),
- Yanhao Shi (2017) Implementation and applications of critical line algorithm for portfolio optimization; unpublished Master's thesis, ETH Zurich.

See Also

MS; for plotting CLA results: `plot.CLA`.

Examples

```
data(muS.sp500)
## Full data taking too much time for example
set.seed(47)
iS <- sample.int(length(muS.sp500$mu), 24)

CLsp.24 <- CLA(muS.sp500$mu[iS], muS.sp500$covar[iS, iS], lB=0, uB=1/10)
CLsp.24 # using the print() method for class "CLA"

plot(CLsp.24)
```

```

if(require(Matrix)) { ## visualize how weights change "along turning points"
  show(image(Matrix(CLsp.24$weights_set, sparse=TRUE),
    main = "CLA(muS.sp500 <random_sample(size=24)>) $ weights_set",
    xlab = "turning point", ylab = "asset number"))
}

## A 3x3 example (from real data) where CLA()'s original version failed
## and 'check.f = TRUE' produces a warning :
mc3 <- list(
  mu = c(0.0408, 0.102, -0.023),
  cv = matrix(c(0.00648, 0.00792, 0.00473,
    0.00792, 0.0334, 0.0121,
    0.00473, 0.0121, 0.0793), 3, 3,
    dimnames = list(NULL,
      paste0(c("TLT", "VTI", "GLD"), ".Adjusted")))

rc3 <- with(mc3, CLA(mu=mu, covar=cv, lB=0, uB=1, trace=TRUE))

```

findMu

Find $\mu(W)$ and W , given $\sigma(W)$ and CLA result

Description

Find $\mu(W)$ and W , given $\sigma(W)$ and CLA result.

Usage

```
findMu(Sig0, result, covar, tol.unir = 1e-06, equal.tol = 1e-06)
```

Arguments

Sig0	numeric vector of $\sigma(W)$ values.
result	a list with components MS_weight and weights_set as resulting from CLA().
covar	the same $n \times n$ covariance matrix (of asset returns) as the argument of CLA().
tol.unir	numeric tolerance passed to uniroot .
equal.tol	numeric tolerance to be used in all.equal (..., tolerance = equal.tol) in the check to see if the μ of two neighbouring turning points are equal.

Value

a **list** with components

Mu	numeric vector of same length, say M , as Sig0.
weight	numeric $n \times M$ matrix of weights.

References

Master thesis, p.33

See Also

[findSig](#), [CLA](#), [MS](#).

Examples

```
data(muS.sp500)
## Full data taking too much time for example
if(getRversion() >= "3.6") .Rk <- RNGversion("3.5.0") # for back compatibility & warning
set.seed(2016)
iS <- sample.int(length(muS.sp500$mu), 17)
if(getRversion() >= "3.6") do.call(RNGkind, as.list(.Rk)) # revert
cov17 <- muS.sp500$covar[iS, iS]
CLsp.17 <- CLA(muS.sp500$mu[iS], covar=cov17, lb=0, ub = 1/2)
CLsp.17 # 16 turning points
summary(tpS <- CLsp.17$MS_weights[, "Sig"])
str(s0 <- seq(0.0186, 0.0477, by = 0.0001))
mu.. <- findMu(s0, result=CLsp.17, covar=cov17)
str(mu..)
stopifnot(dim(mu..$weight) == c(17, length(s0)))
plot(s0, mu..$Mu, xlab=quote(sigma), ylab = quote(mu),
      type = "o", cex = 1/4)
points(CLsp.17$MS_weights, col = "tomato", cex = 1.5)
```

findSig

Find $\sigma(W)$ and W , given $\mu(W)$ and CLA result

Description

Find $\sigma(W)$ and W , given $\mu(W)$ and [CLA](#) result.

Usage

```
findSig(Mu0, result, covar, equal.tol)
```

Arguments

Mu0	numeric vector of $\mu(W)$ values.
result	a list with components MS_weight and weights_set as resulting from CLA() .
covar	the same $n \times n$ covariance matrix (of asset returns) as the argument of CLA() .
equal.tol	numeric tolerance to be used in all.equal(..., tolerance = equal.tol) in the check to see if the μ of two neighbouring turning points are equal.

Value

a [list](#) with components

Sig	numeric vector of same length, say M , as Mu0.
weight	numeric $n \times M$ matrix of weights.

References

Master thesis, p.33

See Also

[findMu](#), [CLA](#), [MS](#).

Examples

```
data(muS.sp500)
## Full data taking too much time for example: Subset of n=21:
if(getRversion() >= "3.6") .Rk <- RNGversion("3.5.0") # for back compatibility & warning
set.seed(2018)
iS <- sample.int(length(muS.sp500$mu), 21)
if(getRversion() >= "3.6") do.call(RNGkind, as.list(.Rk)) # revert
cov21 <- muS.sp500$covar[iS, iS]
CLsp.21 <- CLA(muS.sp500$mu[iS], covar=cov21, lB=0, uB = 1/2)
CLsp.21 # 14 turning points
summary(tpM <- CLsp.21$MS_weights[, "Mu"])
str(m0 <- c(min(tpM), seq(0.00205, 0.00525, by = 0.00005), max(tpM)))
sig. <- findSig(m0, result=CLsp.21, covar=cov21)
str(sig.)
stopifnot(dim(sig.$weight) == c(21, length(m0)))
plot(sig.$Sig, m0, xlab=quote(sigma), ylab = quote(mu),
      type = "o", cex = 1/4)
points(CLsp.21$MS_weights, col = "tomato", cex = 1.5)
title("Efficient Frontier from CLA()")
mtext("findSig() to interpolate between turning points", side=3)
```

MS

*Means (Mu) and Standard Deviations (Sigma) of the "Turning Points"
from CLA*

Description

Compute the vectors of means (μ_i) and standard deviations (σ_i), for all the turning points of a [CLA](#) result.

Usage

```
MS(weights_set, mu, covar)
```

Arguments

<code>weights_set</code>	numeric matrix ($n \times m$) of optimal asset weights $W = (w_1, w_2, \dots, w_m)$, as resulting from CLA() .
<code>mu</code>	expected (log) returns (identical to <i>argument</i> of CLA()).
<code>covar</code>	covariance matrix of (log) returns (identical to <i>argument</i> of CLA()).

Details

These are trivially computable from the `CLA()`'s result. To correctly *interpolate* this, “hyperbolic” interpolation is needed, provided by the `findSig` and `findMu` functions.

Value

a `list` with components

`Sig` numeric vector of length m of standard deviations, $\sigma(W)$.

`Mu` numeric vector of length m of means $\mu(W)$.

Author(s)

Yanhao Shi

See Also

[CLA](#).

Examples

```
## The function is quite simply
MS
## and really an auxiliary function for CLA().

## TODO: add small (~12 assets) example
```

muS.10ex

10 Assets Example Data from Markowitz & Todd

Description

The simple example Data of Markowitz and Todd (2000); used for illustrating the CLA; reused in Bailey and López de Prado (2013).

Usage

```
data("muS.10ex")
```

Format

A list with two components,

mu Named num [1:10] 1.175 1.19 0.396 1.12 0.346 ...
names : chr [1:10] "X1" "X2" "X3" "X4" ...

covar num [1:10, 1:10] 0.4076 0.0318 0.0518 0.0566 0.033 ...

Source

From 'http://www.quantresearch.info/CLA_Data.csv.txt' (URL no longer working, Aug.2020!) by López de Prado.

References

Markowitz, H. M. (1987, 1st ed.) and Markowitz, H. M. and Todd, P. G. (2000) *Mean-Variance Analysis in Portfolio Choice and Capital Markets*, page 335.

Bailey, D. H. and López de Prado, M. (2013) An open-source implementation of the critical-line algorithm for portfolio optimization, *Algorithms* **6**(1), 169–196; doi: [10.3390/a6010169](https://doi.org/10.3390/a6010169), p. 16f.

Examples

```
data(muS.10ex)
str(muS.10ex)

CLA.10ex <- with(muS.10ex, CLA(mu, covar, lB=0, uB=1))
if(require("Matrix"))
  drop0(zapsmall(CLA.10ex$weights_set))
## The results, summarized, as in Bayley and López de Prado (Table 2, p.18) :
with(CLA.10ex, round(cbind(MS_weights[,2:1], lambda=lambdas, t(weights_set)), 3))

CLA.10ex.1c <- with(muS.10ex, CLA(mu, covar, lB=1/100, uB=1))
round(CLA.10ex.1c$weights_set, 3)
```

muS.sp500

Return Expectation and Covariance for "FRAPO"s SP500 data

Description

If $R_{j,t}$ are the basically the scale standardized log returns for $j = 1, 2, \dots, 476$ of 476 stocks from S&P 500, as from [SP500](#), then $\mu_j = E[R_{j,*}]$ somehow averaged over time; actually as predicted by `muSigma()` at the end of the time period, and $\Sigma_{j,k} = Cov(R_j, R_k)$ are estimated covariances.

These are the main “inputs” needed for the CLA algorithm, see [CLA](#).

Usage

```
data("muS.sp500")
```

Format

A list with two components,

mu Named num [1:476] 0.00233 0.0035 0.01209 0.00322 0.00249 ...

names : chr [1:476] "A" "AA" "AAPL" "ABC" ...

covar num [1:476, 1:476] 0.001498 0.000531 0.000536 ...

Source

It is as simple as this:

```
data(SP500, package="FRAPO")
system.time(muS.sp500 <- muSigmaGarch(SP500)) # 26 sec. (lynne, 2017)
```

See Also

[muSigmaGarch\(\)](#) which was used to construct it.

Examples

```
data(muS.sp500)
str(muS.sp500)
```

muSigmaGarch

Compute (mu, Sigma) for a Set of Assets via GARCH fit

Description

Compute (mu, Sigma) for a set of assets via a GARCH fit to each individual asset, using package **fGarch**'s [garchFit\(\)](#).

Usage

```
muSigmaGarch(x, formula = ~garch(1, 1), cond.dist = "std", trace = FALSE,
             ...)
```

Arguments

x	numeric matrix or data frame ($T \times d$) of log returns of d assets, observed on a common set of T time points.
formula	optional formula for garchFit .
cond.dist	the conditional distribution to be used for the garch process.
trace	logical indicating if some progress of garchFit() should printed to the console.
...	optional arguments to cor , i.e., use or method.

Value

a list with components

mu	numeric vector of length n of mean returns ($= E[R_i]$).
covar	covariance matrix ($n \times n$) of the returns.

See Also

[muS.sp500](#) which has been produced via [muSigmaGarch](#). [CLA](#) which needs (mu, covar) as crucial input.

Examples

```
if(requireNamespace("FRAPO")) {
  data(NASDAQ, package = "FRAPO")
  ## 12 randomly picked stocks from NASDAQ data
  iS <- if(FALSE) { ## created (w/ warning, in new R) by
    RNGversion("3.5.0"); set.seed(17); iS <- sample(ncol(NASDAQ), 12)
  } else c(341L, 2126L, 1028L, 1704L, 895L, 1181L, 454L, 410L, 1707L, 425L, 950L, 5L)
  X. <- NASDAQ[, iS]
  muSig <- muSigmaGarch(X.)
  stopifnot(identical(names(muSig$mu), names(NASDAQ)[iS]),
            identical(dim(muSig$covar), c(12L,12L)),
            all.equal(unname(muSig$mu),
                      c( 7.97, -4.05, -14,      21.5, -5.36, -15.3,
                        -15.9, 11.8,  -1.64, -14,   3.13, 121) / 10000,
                        tol = 0.0015))
}
```

plot.CLA

Plotting CLA() results including Efficient Frontier

Description

A partly experimental [plot\(\)](#) method for [CLA\(\)](#) objects.

It draws the efficient frontier in the μ_w, σ_w aka (mean, std.dev.) plane.

Currently, this is quite rudimentary.

Future improvements would allow - to add the/some single asset points, - to correctly ('hyperbolically') interpolate between turning points - add text about the number of (unique) critical points - add option `add = FALSE` which when `TRUE` would use [lines](#) instead `plot`.

Usage

```
## S3 method for class 'CLA'
plot(x, type = "o", main = "Efficient Frontier",
     xlab = expression(sigma(w)),
     ylab = expression(mu(w)),
     col = adjustcolor("blue", alpha.f = 0.5),
     pch = 16, ...)
```

Arguments

x	a named <code>list</code> as resulting from <code>CLA()</code> .
type	the <code>lines/points</code> types used for the efficient frontier. This will become more sophisticated, i.e., <i>may change non-compatibly!!</i>
main	main <code>title</code> .
xlab, ylab	x- and y- axis labels, passed to <code>plot.default</code> .
col, pch	color and point type, passed to <code>plot.default</code> , but with differing defaults in this method.
...	potentially further arguments passed to <code>plot</code> , i.e., <code>plot.default</code> .

Author(s)

Martin Maechler.

See Also

`CLA`, `plot.default`.

Examples

```
## TODO %% Add A. Norring's small 12-asset example see --> ../TODO
## ---- one example is in help(CLA)
```

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