Backtest overfitting in stock fund design and market prediction

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Reproducibility crises in biomedicine, psychology, economics

- In 2011, Bayer researchers reported that they were able to reproduce only 17 of 67 pharma studies.
- In 2012, Amgen researchers reported that they were able to reproduce only 6 of 53 cancer studies.
- In August 2015, the Reproducibility Project in Virginia reported that they were able to reproduce only 39 of 100 psychology studies.
- In September 2015, the U.S. Federal Reserve was able to reproduce only 29 of 67 economics studies.

Reproducibility Project staff
Credit: NY Times
A credibility crisis in finance?

- Many individual investors believe that the financial system (high-frequency trading, “dark pools,” etc.) is rigged against them.
- Many are skeptical of the claims of numerous financial gurus and forecasters.
- Many are skeptical of the hundreds of new investment funds and strategies that are marketed each year.
- Financial news is replete with pseudomathematical charts and jargon: “Fibonacci ratios,” “cycles,” “Elliott waves,” “golden ratios,” “parabolic SARs,” “technical analysis,” “pivot points,” “symmetrical triangles,” “rising wedges,” etc.

What should the mathematical finance community do? First and foremost, ensure that our own published research and strategies are mathematically and statistically sound.
You have written about economics and risk assessment and so I’d like to know if you have any ideas about protecting personal wealth.

I thought of you while reading Janet Tavakoli’s *Decisions: Life and Death on Wall Street*. Have you read it? I turned to the book after noting it was [promoted] by Nomi Prins, another Wall Street ex-exec like Tavakoli who’s been spilling the beans about Wall Street shenanigans.

Economists like Simon Johnson, Anat Admati and Joseph Stiglitz have been writing similar stories from a broader theoretical perspective, but all-in-all, all five (and they are hardly alone) describe a rigged game.

**So what to do about it at the personal level?** This comes down to wondering about specific things like savings accounts, CDs, stocks, bonds and annuities, life insurance and home-ownership vs renting.
One thing that has always puzzled me about the financial world is the following sort of thing: [examples cited]. Excuse me for being “dumb,” but this sort of thing seems to me to be outright nonsense. ...

After all, the stock market, by definition, contains the consensus of all available information, including the tens of thousands of stock market analysts and economists worldwide who scour every morsel of information in the business world, and then advise the leading mutual funds and pension funds. ...

In addition, ... there are thousands more very bright mathematicians using program-trading schemes, plying every trick of time series analysis, machine learning, stealth and anti-stealth that money can buy, to wriggle every conceivable angle out of the market and beat their competitors to the punch with trades. ...

So when people like those above say that they “know” where the stock market is heading, ... or that by following their strategies, John Q Public can enjoy reliable, above-market returns, this cannot have any scientific basis. ...

So why doesn’t somebody blow this whistle on this sort of thing? Am I missing something?
It is not a dumb question at all. It is a question I have struggled with and which answer makes me an unhappy man. The truth is, most people in this industry are charlatans. They do not have any particular model or theory to understand the world. They are not scientists. ...

I completely agree with your assessment. The amount of nonsense ... is incredible.

The good news is, the quants are silently taking over Wall Street, thanks to high frequency and big data. For the same reason that alchemists and astrologers fought the chemists and astronomers, the market wizards are fighting the quants. So all this ... nonsense is in part the tug of that war. An attempt of the wizards to squeeze out a few more dimes.
Mathematicians against fraudulent financial and investment advice (MAFFIA)

In 2013, myself, Jonathan Borwein, Marcos Lopez de Prado and Jim Zhu formed “MAFFIA,” with the goal of doing research in financial mathematics, and, in particular, to highlight the abuses of mathematics in the financial field:

▶ We wrote the paper Pseudo-mathematics and financial charlatanism: The effects of backtest overfitting on out-of-sample performance.
▶ We wrote numerous additional papers and studies, continuing to the present day.
▶ We started the Mathematical Investor blog, with new articles posted roughly every 3–4 weeks: http://www.mathinvestor.org.
▶ With help of some students, we developed online demonstrations of backtest overfitting, one of the chief abuses in the field.

The remainder of the talk discusses some of our results.

What is backtest overfitting?

- Proposing a model for a dataset that inherently possesses a higher level of complexity than the historical data.
- Using a computer to try millions or billions of variations of a model or strategy on the historical data, and then only presenting results from the variation that works best.
- Constructing an exchange-traded fund by exploring millions or billions of weighting factors, then only marketing the one with the highest backtest score.

When a computer can analyze millions or billions of variations of a fund or strategy on a fixed backtest dataset, it is almost certain that the optimal fund or strategy will be badly overfit and thus of dubious value.
How easy is it to overfit a backtest? Very!

- If only 2 years of daily backtest data are available, then no more than 7 strategy variations should be tried.
- If only 5 years of daily backtest data are available, then no more than 45 strategy variations should be tried.

A backtest that does not report the number of trials $N$ makes it impossible to assess the risk of overfitting.

$$\text{MinBTL} \approx \left( \frac{(1 - \gamma) Z^{-1} \left[ 1 - \frac{1}{N} \right] + \gamma Z^{-1} \left[ 1 - \frac{1}{N e^{-1}} \right]}{E[\max_N]} \right)^2$$

Letters to clients: An absurd investment scheme

- A financial advisor sends letters to $5,120 = 5 \times 2^{10}$ prospective clients, with 2560 predicting a certain stock will go up, and 2560 predicting it will go down.
- One month later, the advisor sends letters only to the 2560 investors who were previously sent the correct prediction, with 1280 letters predicting a certain stock will go up, and 1280 predicting it will go down.
- After ten months, the final five investors will have been sent ten consecutive spot-on predictions!

This strategy is absurd, even fraudulent, because the final five investors are not told of the 10,235 other letters with different predictions.

But why is promoting a statistically overfit strategy, where potential investors are not informed of the millions of failed computer trials behind the strategy, any different?
A not-so-absurd investment strategy

Suppose an investor believes that there are daily, weekly or monthly patterns in stock market data, and she seeks to exploit them. Sample strategies:

▶ Basic strategy: Buy a set of stocks each Monday, then sell on Wednesday; buy on the 6th of the month, then sell on the 19th; sell in May and go away, etc.

▶ Refinements: Sell the portfolio if it drops more than 10% from start; purchase shares only when they increase in value more than 10% from start; etc.

Even with these very simple strategies, there are literally millions of variations (by changing various parameters), which can be quickly explored by computer.

Selecting only the best combination of parameters (and not mentioning the many others that were tried) is a classic selection bias statistical error.
An online demonstration is backtest overfitting is now available:

- The user can select either pseudorandom data or real S&P500 historical data.
- The program then runs a simple monthly-cycle strategy with parameters (day in, holding period, stop-loss percentage, side, etc.), adjusting the parameters to find an optimal strategy.
- The final optimal strategy is then tried on a new (out-of-sample) dataset.
- This software is now available in an online demo (try it yourself!): http://www.mathinvestor.org

- Credits: Stephanie Ger, Marcos Lopez de Prado, Amir Salehipour, Alex Sim and Kesheng Wu.
Initial strategy on input data (S&P500, 1960–1980): Sharpe ratio = -0.23
Improved strategy on input data: Sharpe ratio = 0.73
Final (optimal) strategy on input data: Sharpe ratio = 1.04
Final strategy on new data (S&P500, 1980–2013): Sharpe ratio $= 0.07$
Analysis

- After exhaustively exploring the space of strategy variations, the computer program found a strategy that achieved a Sharpe ratio of 1.04 on the input (backtest) pseudorandom time series (i.e., 1.04 standard deviations above zero).
- However, this optimal strategy, when applied to a new (pseudorandom) time series, failed miserably — the Sharpe ratio was 0.07 (i.e., no significant gain).
- In other words, the “optimal” strategy found by the computer search only fit idiosyncrasies of the input (backtest) dataset — it has no fundamental “intelligence” whatsoever.

For additional analysis (aimed at a fairly elementary audience), see:


The software demo program is NOW AVAILABLE online:
Additional details on backtest overfitting

▶ Presents formulas relating size of dataset to likelihood of backtest overfitting:

▶ Presents formulas for calculating the probability of backtest overfitting:

▶ Introduces backtest overfitting for a general audience:

▶ Defines a “deflated Sharpe ratio,” correcting for some forms of distortion:

Preprint copies are available at: http://www.davidhbailey.com/dhbpapers
Proliferation of new stock funds

- Roughly USD$2.1 trillion is held in U.S.-listed exchange-traded funds (ETFs), with hundreds of new ETFs minted each year.
- In a 2012 study, researchers found that the median time between the definition of a new index and the inception of a new ETF based on the index dropped from almost three years in 2000 to only 77 days in 2011.
- As a result, the report concludes, “most indexes have little live performance history for investors to assess in the context of a new ETF investment.”
- Out of 370 new indexes, 87% of the indexes outperformed the broad U.S. stock market over the time period used for the backtest, but only 51% outperformed the broad market after inception of the index.
- The study found an average 12.25% annualized excess return above the broad U.S. stock market for a five-year backtest, but -0.26% excess return in the five years following the inception of the index.

How difficult is it to design a stock portfolio to achieve a desired performance profile?

- Given some desired performance profile (a time series), we construct a weighted subset of S&P500 stocks whose performance matches, as closely as possible, that of the profile over the specified backtest time period.
- The design minimizes the sum of squares deviation of the weighted portfolio time series from the given profile time series.
- In a typical run, some of the resulting weights are negative, corresponding to shorted positions in certain stocks. This potentially exposes the portfolio to losses.
- As an alternate option, the weights are calculated subject to the constraint that all weights must be greater than or equal to zero.

Constructing a weighted portfolio to achieve a desired performance profile

Given a target time series \((v_j)\) and a collection of \(m\) stocks \((z_i)\), each with a time series \((z_i(t_j))\), we wish to find \(m\) weights \((w_i)\) that minimize the objective function

\[
R(w_1, w_2, \ldots, w_m) = \sum_{j=1}^{n} \left( \sum_{i=1}^{m} w_i z_i(t_j) - v_j \right)^2.
\]

Since \(\sum_{i=1}^{m} w_i z_i(t_j)\) is the weighted portfolio time series, this expression is the sum-of-squares deviation of the weighted portfolio from the target time series. The function \(R\) is minimized when the following are satisfied:

\[
\frac{\partial R}{\partial w_1} = 2 \sum_{j=1}^{n} \left( \sum_{i=1}^{m} w_i z_i(t_j) - v_j \right) z_1(t_j) = 0,
\]

\[
\frac{\partial R}{\partial w_2} = 2 \sum_{j=1}^{n} \left( \sum_{i=1}^{m} w_i z_i(t_j) - v_j \right) z_2(t_j) = 0,
\]

\[
\ldots
\]

\[
\frac{\partial R}{\partial w_m} = 2 \sum_{j=1}^{n} \left( \sum_{i=1}^{m} w_i z_i(t_j) - v_j \right) z_m(t_j) = 0.
\]
Constructing a weighted portfolio (continued)

This can be rewritten as

\[
\sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_1(t_j) = \sum_{j=1}^{n} v_j z_1(t_j),
\]

\[
\sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_2(t_j) = \sum_{j=1}^{n} v_j z_2(t_j),
\]

\[
\ldots
\]

\[
\sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_m(t_j) = \sum_{j=1}^{n} v_j z_m(t_j),
\]

which can be solved for the \( W \) vector by using conventional linear system solver software.

Note that it is not essential that \( n > m \); if \( n < m \) this scheme produces a best least-squares fit to the target profile, although the quality of this fit degrades when the ratio \( n/m \) falls much below one.
Constructing an all-positive-weight portfolio

When the technique described above is implemented on real stock market data, some of the resulting weights $w_i$ are typically negative (so that the corresponding stocks are shorted). This is fine, but entails some risk of catastrophic decline (see examples below).

So as an alternative option, one can also ask for an optimal set of weights $W$ subject to the constraint that each weight $w_i \geq 0$.

To that end, we have employed a logarithmic barrier scheme, which is to append a logarithmic term to the minimization problem, as follows:

$$R(w_1, w_2, \cdots, w_m) = \sum_{j=1}^{n} \left( \sum_{i=1}^{m} w_i z_i(t_j) - v_j \right)^2 + 2C \sum_{i=1}^{m} \log w_i.$$  

The presence of this logarithmic term penalizes very small weights and thus serves as a barrier, keeping the weights away from zero or negative values. This is not the same as solving the constrained problem, but by successively reducing the constant $C$, the desired limiting solution can be obtained.
Constructing an all-positive-weight portfolio (continued)

In this case, the equivalent minimizing condition is

\[ \sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_1(t_j) = \sum_{j=1}^{n} v_j z_1(t_j) + C/w_1, \]

\[ \sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_2(t_j) = \sum_{j=1}^{n} v_j z_2(t_j) + C/w_2, \]

\[ \cdots \]

\[ \sum_{i=1}^{m} w_i \sum_{j=1}^{n} z_i(t_j)z_m(t_j) = \sum_{j=1}^{n} v_j z_m(t_j) + C/w_m. \]

This system can be efficiently solved by Newton iterations, where one takes, as starting estimates of the weights \( W \), the solution to the unconstrained problem above, replacing zero or negative weights with some very small positive value.
Constructing an all-positive-weight portfolio (continued)

In summary, the algorithm for the constrained problem is the following:

1. Perform the unconstrained matrix calculation to obtain an initial set of weights $W$.
2. Replace zero or negative weights with a small positive value (we use $10^{-8}$).
3. Select $C = 1$, then perform the Newton iteration until convergence (typically in ten or fewer iterations).
4. Reduce $C$ by a factor of ten and repeat step (3), continuing until overall convergence (typically when $C = 10^{-6}$ or so).
Our computer program constructed stock portfolios based exclusively on real S&P 500 historical stock data. Data for S&P 500 stocks are easy to obtain online. For example, Apple Computer’s daily stock closings going back to 1980 can be downloaded from:

https://finance.yahoo.com/q/hp?s=AAPL
http://www.google.com/finance?q=AAPL

The in-sample period was 1991–2005; the out-of-sample period was 2006–2015.

Our program found 277 valid stocks from the S&P 500 database for which data spanning this time period was available. All stock data used here include reinvested dividends.
Three types of performance profiles

Using our program, one can generate any of three target profiles (here $p$ is an annual percentage rate):

1. *Steady capital growth*: A steady increase by the fraction $\left(1 + \frac{p}{100r}\right)$ per time period (i.e., growing by $\frac{p}{r}$ percent each time period, where $r$ is the number of time periods per year; e.g., $r = 12$).

2. *Stair-step growth*: A stair-step function that is constant, except that at the end of each $q$-year period it increases by the fraction $\left(1 + \frac{p}{100r}\right)^{qr}$ (i.e., at the end of each $q$-year period, it increases by a full $q$ years’ growth of Profile 1 above). We took $q = 1$ in the examples below.

3. *Sinusoidal growth*: A sinusoidal function that increases by the fraction $\left(1 + \frac{p}{100r}\right)$ per time period, as in profile #1, but is multiplied by a sine wave that varies from $1/2$ to $3/2$, with period $q$ years. We took $q = 5$.

The second and third profiles are included mainly to illustrate that *any* reasonable function whatsoever may be specified for the profile.
Results: Steady growth profile, APR = 6%

Standard portfolio (L) and all-positive portfolio (R). **Blue**: portfolio; **orange**: target profile; **green**: S&P500.
Steady growth profile, APR = 8%

Standard portfolio (L) and all-positive portfolio (R). Blue: portfolio; orange: target profile; green: S&P500.
Steady growth profile, APR = 10%

Standard portfolio (L) and all-positive portfolio (R). **Blue**: portfolio; **orange**: target profile; **green**: S&P500.
Steady growth profile, APR = 12%

Standard portfolio (L) and all-positive portfolio (R). Blue: portfolio; orange: target profile; green: S&P500.
Sinusoidal profile, APR = 10%

Standard portfolio (L) and all-positive portfolio (R). **Blue**: portfolio; **orange**: target profile; **green**: S&P500.
### Summary of 20 runs

<table>
<thead>
<tr>
<th>Profile</th>
<th>Fig.</th>
<th>APR</th>
<th>Standard weights</th>
<th>All-positive weights</th>
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<tbody>
<tr>
<td></td>
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<td>RMS dev.</td>
<td>Sharpe ratio</td>
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<td>IS</td>
<td>OOS</td>
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<td></td>
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<tr>
<td></td>
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<td>0.996</td>
</tr>
</tbody>
</table>

“APR”: annual percentage rate; “IS”: in-sample period, 1991–2005 (15 years); “OOS”: out-of-sample period, 2006–2015 (10 years); “RMS dev.”: root-mean-square deviation from target profile; “Sharpe ratio”: Sharpe ratio relative to S&P 500 with reinvested dividends; “FAIL”: 100% loss of capital.
Analysis of stock fund study

- In every case, the standard portfolio performance achieved zero deviation over the in-sample period. Only beginning with 2006 (the out-of-sample period) do the blue curves depart from the orange curves in the plots.
- In some cases the standard portfolios did remarkably well, but in other cases they failed catastrophically.
- The positive-weight portfolios are significantly less erratic and often outperformed both the target profile and the S&P 500 benchmark. But these portfolios failed to match the target profiles either in-sample or out-of-sample.

The central objective here, namely to achieve, by means of a weighted portfolio of S&P 500 stocks, a desired performance profile that also holds on out-of-sample data, is certainly not met in either case.
“Beating the market” and backtest overfitting

- Overfitting and erratic performance are unavoidable in this or any scheme that amounts to searching over a large set of strategies or fund weightings, and only implementing or reporting the final optimal scheme.

- The same difficulty afflicts many other attempts to construct an investment strategy based solely on daily, weekly, monthly or yearly historical market data, such as with charts (as is often done by technical analysts) or tracking a particular risk profile, as many smart beta ETFs attempt.

- By and large, any underlying actionable information that might exist in such data has long been mined by highly sophisticated computerized algorithms operated by large quantitative funds and other organizations.

- Any lesser efforts, such as those described here, are doomed to be statistically overfit, and if followed may well have disastrous consequences.
Can “gurus” forecast the market?

Motivation:

▶ Many investors rely on market experts and forecasters when making investment decisions.

▶ Ranking and grading market forecasters provides investors with metrics on which they may choose forecasters with the best record of accuracy.

Aim of our study: to a rank prominent market forecasters using a novel methodology:

▶ We distinguish forecasts by their time frame, and specificity, rather than considering all forecasts equally important.

▶ We analyze the impact of the number of forecasts made by a particular forecaster.
Kaissar’s analysis of forecasters

When analyzing a set of strategists’ predictions from 1999 to 2016, Kaissar found that forecasts were surprisingly unreliable during major inflection points:

▶ The strategists *overestimated* the S&P 500’s year-end price by 26.2% on average during the three recession years 2000 to 2002.

▶ They *underestimated* the index’s level by 10.6% for the initial recovery year 2003.

▶ They *overestimated* the S&P 500’s year-end level by a whopping 64.3% in 2008, but then *underestimated* the index by 10.9% for the first half of 2009.

Kaissar’s conclusion: The forecasts were least useful when they mattered most.

Our analysis of market forecasters

In 2012, the CXO Advisory Group ranked 68 forecasters based on their 6,582 forecasts (forecasts made for the S&P 500 index). We extended and advanced this study as follows:

▶ Each individual forecast is treated according to two factors: (a) time frame and (b) specificity.
▶ Long-term forecasts are treated as more significant than the short-term forecasts (because in the long-term underlying trends, if any, tend to overcome short-term noise; \( w_t \in \{0.25, 0.50, 0.75, 1.00\} \) (for no time frame, forecasts up to one month, up to three months, beyond nine months, respectively).
▶ Specific forecasts are treated more important than non-specific ones (\( w_s \in \{0.50, 1.00\} \)).

For details:

The following few viewgraphs are adapted from Amir Salehipour.
Forecaster score

Combined weight for a forecast:

\[ w_i^+ = w_t \times w_s \quad \text{if forecast } i \text{ is correct} \]
\[ w_i^- = w_t \times w_s \quad \text{if forecast } i \text{ is not correct} \]

where \( w_i^+ \) denotes a true forecast is true, and \( w_i^- \) denotes a false one.

Then the score (accuracy) of a forecaster is:

\[
\epsilon_j = \frac{\sum_{i=1}^{n_j} w_i^+}{\sum_{i=1}^{n_j} w_i^+ + \sum_{i=1}^{n_j} w_i^-}
\]

where \( j \) is the forecaster’s index, and \( n_j \) is the total number of forecasts made by forecaster \( j \).
Results: forecaster accuracy
Results: forecaster time frame and specificity

Percentage of forecasts time frames

- % of forecasts with weight 1.00
- % of forecasts with weight 0.75
- % of forecasts with weight 0.50
- % of forecasts with weight 0.25

Percentage of specific forecasts versus non-specific forecasts

- % of specific forecasts
- % of non-specific forecasts
Results: traders versus investors

Accuracy of forecasters in the investor group

Accuracy of forecasters in the trader group
Summary of forecaster study

- Across all forecasts, the accuracy is around 48%.
- Two-thirds of forecasts predict as far as only a month.
- Only one-third of forecasts predict periods over one month.
- Two-thirds of forecasters have an accuracy level below 50%.
- Only about 6% of forecasters have their accuracy values between 70% and 79%; the highest accuracy value is still below 80%.

The majority of forecasters perform at levels not significantly different than chance, which makes it very difficult to tell if there is any skill present.

For details:
Why the silence in the mathematical finance community?

Historically scientists have exposed those who utilize pseudoscience for commercial gain. Yet financial mathematicians in the 21st century have remained disappointingly silent with the regards to those in the community who, knowingly or not:

▶ Fail to disclose the number of models or variations that were used to develop an investment strategy or fund.
▶ Promote products or strategies based on statistically overfit backtests.
▶ Make vague predictions that do not permit rigorous testing and falsification.
▶ Misuse probability theory, statistics and stochastic calculus.
▶ Use pseudomathematical charts and jargon: “Fibonacci ratios,” “cycles,” “Elliott waves,” “golden ratios,” “parabolic SARs,” “technical analysis,” “pivot points,” “symmetrical triangles,” “rising wedges,” etc.

As we wrote in a recent paper:

“Our silence is consent, making us accomplices in these abuses.”
Recent MAFFIA blogs

► “How difficult is it to design a stock fund based on backtests?”: http://mathinvestor.org/how-difficult-is-it-to-design-a-stock-fund-based-on-backtests
► “How accurate are market forecasters?”: http://mathinvestor.org/how-accurate-are-market-forecasters

Thanks! Visit our website at: http://www.mathinvestor.org