

# Portfolios that Contain Risky Assets 13

## Law of Large Numbers (Kelly) Objectives

C. David Levermore  
University of Maryland, College Park

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## Portfolios that Contain Risky Assets

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## **Portfolios 13. Law of Large Numbers (Kelly) Objectives**

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## Portfolios 13. Law of Large Numbers (Kelly) Objectives

An IID model for the Markowitz portfolio with allocation  $\mathbf{f}$  satisfies

$$\text{Ex}\left(\log\left(\frac{\pi(d)}{\pi(0)}\right)\right) = d\gamma, \quad \text{Var}\left(\log\left(\frac{\pi(d)}{\pi(0)}\right)\right) = d\theta,$$

where  $\gamma$  and  $\theta$  are estimated from a share price history by

$$\hat{\mu} = \mu_{\text{rf}} (\mathbf{1} - \mathbf{1}^T \mathbf{f}) + \mathbf{m}^T \mathbf{f}, \quad \hat{\gamma} = \hat{\mu} - \frac{1}{2}(\hat{\mu}^2 + \mathbf{f}^T \mathbf{V} \mathbf{f}), \quad \hat{\theta} = \frac{\mathbf{f}^T \mathbf{V} \mathbf{f}}{1 - \bar{w}}.$$

We see that  $\hat{\gamma} d$  is then the estimated expected growth of the IID model while  $\hat{\theta} d$  is its estimated variance after  $d$  trading days.

Our approach to portfolio management will be to select a distribution  $\mathbf{f}$  that maximizes some objective function. Here we develop a family of such objective functions built from  $\hat{\gamma}$  and  $\hat{\theta}$  with the aid of an important tool from probability, the *Law of Large Numbers*.

**Law of Large Numbers.** Let  $\{X(d)\}_{d=1}^{\infty}$  be any sequence of IID random variables drawn from a probability density  $p(X)$  with mean  $\gamma$  and variance  $\theta > 0$ . Let  $\{Y(d)\}_{d=1}^{\infty}$  be the sequence of random variables defined by

$$Y(d) = \frac{1}{d} \sum_{d'=1}^d X(d') \quad \text{for every } d = 1, \dots, \infty.$$

It is easy to check that

$$\text{Ex}(Y(d)) = \gamma, \quad \text{Var}(Y(d)) = \frac{\theta}{d}.$$

Given any  $\delta > 0$  the *Law of Large Numbers* states that

$$\lim_{d \rightarrow \infty} \Pr\{|Y(d) - \gamma| \geq \delta\} = 0. \quad (1)$$

This limit is not uniform in  $\delta$ . Its convergence rate can be estimated by the *Chebyshev inequality*, which yields the (not uniform in  $\delta$ ) upper bound

$$\Pr\{|Y(d) - \gamma| \geq \delta\} \leq \frac{\text{Var}(Y(d))}{\delta^2} = \frac{1}{\delta^2} \frac{\theta}{d}. \quad (2)$$

**Remark.** The Chebyshev inequality is easy to derive. Suppose that  $p_d(Y)$  is the (unknown) probability density for  $Y(d)$ . Then

$$\begin{aligned}\Pr\{|Y(d) - \gamma| \geq \delta\} &= \int_{\{Y : |Y - \gamma| \geq \delta\}} p_d(Y) dY \\ &\leq \int_{\{Y : |Y - \gamma| \geq \delta\}} \frac{|Y - \gamma|^2}{\delta^2} p_d(Y) dY \\ &\leq \frac{1}{\delta^2} \int |Y - \gamma|^2 p_d(Y) dY = \frac{\text{Var}(Y(d))}{\delta^2} = \frac{1}{\delta^2} \frac{\theta}{d}.\end{aligned}$$

**Remark.** The unknown probability density  $p_d(Y)$  can be expressed in terms of the unknown probability density  $p(X)$  as

$$p_d(Y) = \int \cdots \int \delta\left(Y - \frac{1}{d} \sum_{d'=1}^d X_{d'}\right) p(X_1) \cdots p(X_d) dX_1 \cdots dX_d,$$

where  $\delta(\cdot)$  is the Dirac delta distribution introduced earlier.

If  $\{X(d)\}_{d=1}^D$  is any sequence of IID random variables drawn from an unknown probability density  $p(X)$  with unknown mean  $\gamma$  and variance  $\theta$  then  $\gamma$  and  $\theta$  have the unbiased estimators  $\hat{\gamma}$  and  $\hat{\theta}$  given by

$$\hat{\gamma} = \frac{1}{D} \sum_{d=1}^D X(d), \quad \hat{\theta} = \frac{1}{D-1} \sum_{d=1}^D (X(d) - \hat{\gamma})^2.$$

The law of large numbers (1) states that the estimator  $\hat{\gamma}$  will converge to  $\gamma$  as  $D \rightarrow \infty$ . However, in practice  $D$  will be finite. The Chebyshev bound (2) can be used to assess the quality of the estimator  $\hat{\gamma}$  for finite  $D$ .

When  $\gamma > 0$  the relative error of the estimate  $\hat{\gamma}$  is

$$\frac{|\hat{\gamma} - \gamma|}{\gamma}.$$

We would like to know how big  $D$  should be to insure that this relative error is less than some  $\eta \in (0, 1)$  with a certain confidence.

By setting  $\delta = \eta\gamma$  in the Chebyshev bound (2) we obtain

$$\Pr\left\{\frac{|\hat{\gamma} - \gamma|}{\gamma} \geq \eta\right\} \leq \frac{1}{\eta^2} \frac{\theta}{\gamma^2} \frac{1}{D}.$$

We then replace  $\theta$  and  $\gamma$  on the right-hand side by  $\hat{\theta}$  and  $\hat{\gamma}$  and pick  $D$  large enough to achieve the desired confidence.

For example, if we want to know  $\gamma$  to within 20% with a confidence of 90% then we set  $\eta = \frac{1}{5}$  and pick  $D$  so large that

$$25 \frac{\hat{\theta}}{\hat{\gamma}^2} \frac{1}{D} \leq \frac{1}{10}.$$

Because there are about 250 trading days in a year, this shows that we must average  $X(d)$  over a period of  $\hat{\theta}/\hat{\gamma}^2$  years before we can know  $\gamma$  that well with this much confidence. In practice  $\hat{\theta}/\hat{\gamma}^2$  is not small.



**Kelly Criterion for a Simple Game.** In 1956 John Kelly used the Law of Large Numbers to analyze optimal betting strategies for a class of games of chance. The result became known as the *Kelly criterion, Kelly strategy, or Kelly bet*. It was subsequently adopted by Claude Shannon, Ed Thorp, and others to develop the first successful card counting strategies for winning at blackjack and other casino games. These exploits are documented in the Ed Thorpe's 1962 book *Beat the Dealer*. At the time many casinos were controlled by organized crime, so using these techniques could adversely affect the user's health.

Claude Shannon, Ed Thorp, and others soon realized that it was much better for both their health and their wealth to apply the Kelly criterion to winning on Wall Street. Ed Thorpe laid out a strategy to do this in his 1967 book *Beat the Market*. He went on to run the first quantitative hedge fund, Princeton Newport Partners, which introduced statistical arbitrage strategies to Wall Street. This history is embellished in Scott Peterson's 2010 book *The Quants*.

The Kelly criterion can be applied to balancing portfolios with risky assets. Before showing how to do this we will show how it is applied to a simple betting game.

First consider a game in which each time that we place a bet:

- (i) the probability of winning is  $p \in (0, 1)$ ,
- (ii) the probability of losing is  $q = 1 - p$ ,
- (iii) when we win there is a positive return  $r$  on our bet.

We start with a bankroll of cash and the game ends when the bankroll is gone. Suppose that you know  $p$  and  $r$ . We would like answers to the following questions.

1. When should we play?,
2. When we do play, what fraction of our bankroll should we bet?,

The game is clearly an IID process. Because each time we play we are faced with the same questions and will have no additional helpful information, the answers will be the same each time. Therefore we only consider strategies in which we bet a fixed fraction  $f$  of our bankroll. If  $f = 0$  then we are not betting. If  $f = 1$  then we are betting out entire bankroll. (This is clearly a foolish strategy in the long run because we will go broke the first time we lose.) Then

when we win our bankroll increases by a factor of  $1 + fr$ ,

when we lose our bankroll decreases by a factor of  $1 - f$ .

Therefore if we bet  $n$  times and win  $m$  times (hence, lose  $n - m$  times) then our bankroll changes by a factor of

$$(1 + fr)^m (1 - f)^{n-m}.$$

The Kelly criterion is to pick  $f \in [0, 1)$  to maximize this factor for large  $n$ .

This is equivalent to maximizing the log of this factor, which is

$$m \log(1 + fr) + (n - m) \log(1 - f).$$

The law of large numbers implies that

$$\lim_{n \rightarrow \infty} \frac{m}{n} = p.$$

Therefore for large  $n$  we see that

$$\begin{aligned} m \log(1 + fr) + (n - m) \log(1 - f) \\ \sim \left( p \log(1 + fr) + (1 - p) \log(1 - f) \right) n. \end{aligned}$$

Hence, the Kelly criterion says that we want to pick  $f \in [0, 1)$  to maximize the growth rate

$$\gamma(f) = p \log(1 + fr) + (1 - p) \log(1 - f). \quad (3)$$

This is now an exercise from first semester calculus.

Notice that  $\gamma(0) = 0$  and that

$$\lim_{f \nearrow 1} \gamma(f) = -\infty.$$

Also notice that for every  $f \in [0, 1)$  we have

$$\begin{aligned}\gamma'(f) &= \frac{pr}{1 + fr} - \frac{1 - p}{1 - f}, \\ \gamma''(f) &= -\frac{pr^2}{(1 + fr)^2} - \frac{1 - p}{(1 - f)^2}.\end{aligned}$$

Because  $\gamma''(f) < 0$  over  $[0, 1)$ , we see that  $\gamma(f)$  is strictly concave over  $[0, 1)$  and that  $\gamma'(f)$  is strictly decreasing over  $[0, 1)$ .

If  $\gamma'(0) = pr - (1 - p) = p(1 + r) - 1 \leq 0$  then  $\gamma(f)$  is strictly decreasing over  $[0, 1)$  because  $\gamma'(f)$  is strictly decreasing over  $[0, 1)$ . In that case the maximizer for  $\gamma(f)$  over  $[0, 1)$  is  $f = 0$  and the maximum is  $\gamma(0) = 0$ .

If  $\gamma'(0) = pr - (1 - p) = p(1 + r) - 1 > 0$  then  $\gamma(f)$  has a unique maximizer at  $f = f_* \in (0, 1)$  that satisfies

$$\begin{aligned} 0 = \gamma'(f_*) &= \frac{pr}{1 + f_*r} - \frac{1 - p}{1 - f_*} \\ &= \frac{pr(1 - f_*) - (1 - p)(1 + f_*r)}{(1 + f_*r)(1 - f_*)} \\ &= \frac{p(1 + r) - f_*r}{(1 + f_*r)(1 - f_*)}. \end{aligned}$$

Upon solving this equation for  $f_*$  we find that

$$f_* = \frac{p(1 + r) - 1}{r}. \quad (4)$$

**Remark.** We see from (4) that if  $p(1 + r) - 1 > 0$  then

$$0 < f_* = \frac{p(1 + r) - 1}{r} = p - \frac{1 - p}{r} < p < 1.$$

Therefore the Kelly criterion yields the optimal betting strategy

$$f_* = \begin{cases} 0 & \text{if } p(1+r) - 1 \leq 0, \\ \frac{p(1+r) - 1}{r} & \text{if } p(1+r) - 1 > 0. \end{cases} \quad (5)$$

The maximum growth rate (details not shown) when  $p(1+r) - 1 > 0$  is

$$\gamma(f_*) = p \log(p(1+r)) + (1-p) \log\left((1-p) \frac{1+r}{r}\right). \quad (6)$$

**Remark.** In practice this strategy is far from ideal for reasons that we will discuss in the next section.

**Remark.** Some bettors call  $r$  the *odds* because the return  $r$  on a winning wager is usually chosen so that the ratio  $r : 1$  reflects a probability of winning. The expected return on each amount wagered is  $pr - (1 - p)$ . This is the probability of winning,  $p$ , times the return of a win,  $r$ , plus the probability of losing,  $1 - p$ , times the return of a loss,  $-1$ . Some bettors call this quantity the *edge* when it is positive. Notice that  $pr - (1 - p) = p(1 + r) - 1$  is the numerator of  $f_*$  given by (4), while  $r$  is the denominator of  $f_*$  given by (4). Then strategy (5) can be expressed in this language as follows.

1. Do not bet unless we have an edge.
2. If we have an edge then bet  $f_*$  of our bankroll where

$$f_* = \frac{\text{edge}}{\text{odds}}.$$

This view of the Kelly criterion is popular, but is not very helpful when trying to apply it to more complicated games.



**Kelly Criterion in Practice.** In most betting games played at casinos the players do not have an edge unless they can use information that is not used by the house when computing the odds. For example, card counting strategies can allow a blackjack player to compute a more accurate probability of winning than the one used by the house when it computed the odds. Kelly bettors will not make a serious wager until they are sure they have an edge, and then they will use the Kelly criterion to size their bet. Typically their bet will be a fraction of the Kelly optimal bet. This because their algorithm usually yields an approximation of their edge, so they are not sure of their true Kelly optimal bet, and there is a big downside to betting more than the true Kelly optimal bet.

We will illustrate these ideas with a modification of the simple game from the last section. Specifically, suppose that the game is the same except for the fact that we are not told  $p$ . Rather, we are told that  $r = .125$  and that the player won 225 times the last 250 times the game was played.

Based on the information that the player won 225 times the last 250 times the game was played, we guess that  $p = .9$ . If we use this value of  $p$  then we see that

$$p(1 + r) - 1 = .9(1 + .125) - 1 = \frac{9}{10} \cdot \frac{9}{8} - 1 = \frac{1}{80}.$$

Based on this calculation, we have an edge, so we will play and the optimal bet is

$$f_* = \frac{p(1 + r) - 1}{r} = \frac{\frac{1}{80}}{\frac{1}{8}} = \frac{1}{10}.$$

Therefore the Kelly strategy is to bet  $\frac{1}{10}$  of our bankroll each time.

However, suppose that the previous players had just gotten lucky and that in fact  $p = .875$ . If we use this value of  $p$  then we see that

$$p(1 + r) - 1 = .875(1 + .125) - 1 = \frac{7}{8} \cdot \frac{9}{8} - 1 = -\frac{1}{64}.$$

Therefore we do not have an edge and we should not play!

The difference between .9 and .875 is not large in the sense that it is not an unreasonable error based on only 250 observations. If we bet  $\frac{1}{10}$  of our bankroll each time then our bankroll will be significantly diminished before we have played the game enough to realize that there is no edge!

Now suppose that in fact  $p = .895$ . If we use this value of  $p$  then we see that

$$p(1 + r) - 1 = .895(1 + .125) - 1 = .006875.$$

So in fact, we have an edge. However, the optimal bet is

$$f_* = \frac{p(1 + r) - 1}{r} = \frac{.006875}{.125} = .055.$$

If we bet  $\frac{1}{10}$  of our bankroll each time then our bankroll will be significantly diminished before we have played the game enough to realize that  $p$  is lower than .9.

In this game both the edge and the odds are small. Small uncertainties in our estimation of  $p$  can lead to large uncertainties in our estimation of  $f_*$ . If we overestimate  $f_*$  enough then we are almost certain to lose. Betting more than the true  $f_*$  is called *overbetting*. If we underestimate  $f_*$  then we will certainly win, just a less than the optimal amount.

Because of this asymmetry, it is wise to bet a fraction of the optimal Kelly bet when we are uncertain of our edge. The greater the uncertainty, the smaller the fraction that should be used. Fractions ranging from  $\frac{1}{3}$  to  $\frac{1}{10}$  are common, depending on the uncertainty. These are called *fractional Kelly strategies*.