EMPIRICAL BAYES STOCK MARKET PORTFOLIOS

Thomas M. Cover
and
David H. Gluss
Stanford University

We consider sequential investments in a stock market with the goal of performing as well as if we knew the empirical distribution of future market performance. In particular, we wish to outperform the best stock.

Let $\mathbf{x} = (x_1,x_2,\ldots,x_m) \geq 0$ denote a market vector for one investment period, where x_i is the number of units returned from an investment of 1 unit in the i-th stock. A portfolio $\mathbf{b} = (b_1,b_2,\ldots,b_m)$, $b_i \geq 0$, $\Sigma b_i = 1$, is the proportion of the current capital invested in each of the m stocks. Thus $S = \mathbf{b}^t\mathbf{x} = \Sigma b_i x_i$ is the factor by which the capital is increased in one investment period using portfolio **b**.

If portfolio **b** is used for n investment periods, readjusting stock holdings as necessary, then the stock sequence $\mathbf{x}_1,\mathbf{x}_2,\ldots,\mathbf{x}_n$ results in captial S_n at time n given by

$$S_n = \prod_{i=1}^{n} \mathbf{b}^t\mathbf{x}_i = e^{n(\frac{1}{n}\sum_{i=1}^{n} \ln \mathbf{b}^t\mathbf{x}_i)} .$$

Define the expected log return $W(\mathbf{b},F)$ for portfolio **b** against stock distribution F, by

$$W(\mathbf{b},F) = E_F \ln \mathbf{b}^t\mathbf{X} = \int \ln \mathbf{b}^t\, \mathbf{x} dF(\mathbf{x}),$$

and let

$$W^*(F) = \max_{\mathbf{b}} W(\mathbf{b},F).$$

We observe that

$$S_n = \prod_{i=1}^{n} \mathbf{b}^t\mathbf{x}_i = e^{nW(\mathbf{b},F_n)} \leq e^{nW^*(F_n)},$$