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Cardinality Constrained Portfolio Optimization via Alternating Direction Method of Multipliers

Zhang-Lei Shi, Xiao Peng Li, Chi-Sing Leung, Senior Member, IEEE, and Hing Cheung So, Fellow, IEEE

Abstract

Inspired by sparse learning, the Markowitz mean-variance model with a sparse regularization term is popularly used in sparse portfolio optimization. However, in penalty based portfolio optimization algorithms, the cardinality level of the resultant portfolio relies on the choice of the regularization parameter. This brief formulates the mean-variance model as a cardinality ($\ell_0$-norm) constrained nonconvex optimization problem, in which we can explicitly specify the number of assets in the portfolio. We then use the alternating direction method of multipliers (ADMM) concept to develop an algorithm to solve the constrained nonconvex problem. Unlike some existing algorithms, the proposed algorithm can explicitly control the portfolio cardinality. In addition, the dynamic behavior of the proposed algorithm is derived. Numerical results on four real-world datasets demonstrate the superiority of our approach over several state-of-the-art algorithms.

Index Terms
Sparse portfolio, mean-variance model, $\ell_0$-norm, alternating direction method of multipliers.

I. Introduction

Recently, neural network approaches [1]–[3] are proposed for finance/asset management. For instance, we can use the radial basis function (RBF) model to study the market trend [1]. Portfolio optimization [4]–[7] is one kind of finance/asset management methods. It aims at determining the investment percentages on $N$ assets based on historical data. The percentages form an $N$-dimensional vector $\mathbf{w}$, known as portfolio vector.

Optimizing a portfolio can be viewed as parameter estimation in an adaptive system. Based on historical data, we determine the investment percentages on the selected assets. Afterwards, we use the resultant portfolio to perform the investment for an operating period. In the last decades, portfolio optimization has received considerable attention in the machine learning community [2], [8]–[12]. For instance, in [9], [11], $\ell_1$-norm regularization algorithms are proposed. However, the drawback of using the $\ell_1$-norm regularization methods is that we cannot explicitly and directly control the number of selected assets in the resultant portfolio.

The Markowitz mean-variance theory [5], [13] is an essential theory to model the return and risk of a portfolio. It aims at constructing a diversified portfolio that balances the return and risk [5], [13]. One research direction in the mean-variance model is to design a robust algorithm that can handle the uncertainty of the estimated model [14]–[16]. For example, in [15], a robust method for estimating a modified covariance matrix is presented. The modified covariance matrix is a linear combination of two covariance matrices, estimated by shrinkage transformation and a random matrix theory-based filter.

Another direction focuses on improving the quality of the investment scheme by adding constraints on the portfolio vector or adding regularization terms into the objective function [17]–[20]. This direction can improve the generalization ability of the portfolio vector. Here, “good generalization ability” means that the portfolio vector has good performance against market volatility.

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Since a dense portfolio creates some difficulties in management and has high transaction costs [6], [17], modern portfolio theory focuses on sparse portfolio optimization [6], [21], [22]. Inspired by sparse learning, some portfolio selection algorithms introduce an $\ell_1$-norm regularization term into the objective function [17], [18], [23]. The sparse portfolio optimization can be considered as a special form of feature extraction, in which we have a special form of objective function and some constraints. However, due to existence of the constraints, conventional feature extraction techniques may not be appropriate for sparse portfolio optimization. In addition, the main drawback of using the $\ell_1$-norm regularization is that we need to tune the regularization parameter to obtain a plausible portfolio cardinality.

In order to explicitly control the portfolio cardinality, cardinality ($\ell_0$-norm) constrained portfolio optimization algorithms are proposed [6], [24], where the cardinality of portfolio is the number of selected assets. Nevertheless, $\ell_0$-norm optimization problems are NP-hard. To circumvent this issue, some frameworks suggest using relaxation or approximation techniques [6], [24]. For instance, given a target cardinality, we can relax the cardinality constraint into an $\ell_1$-norm related convex constraint [6]. It is worth noting that, with relaxation, the target cardinality behaves as a sparsity control parameter. Thus, the relaxation algorithm cannot explicitly control the cardinality level. In addition, in the relaxation algorithm, the number of decision variables is $N^2$ rather than $N$.

The cardinality constrained portfolio optimization can be recast as a mixed-integer programming (MIP) problem [21], [22]. In the MIP, the sum of binary variables is the desired cardinality level. Thus, there is no sparsity-related parameter to tune. Instead, the MIP needs to tune the upper bound for the absolute value of all elements in portfolio vector.

The alternating direction method of multipliers (ADMM) is a popular learning scheme in many applications [25]–[28]. The ADMM decomposes the original problem into several subproblems. The resultant subproblems can be solved efficiently, especially when they have closed-form expressions. The ADMM can be used to determine the size of a neural network. For instance, in [26], [27], $\ell_1$-norm based ADMM algorithms are developed to construct flat structure neural networks, but they cannot directly and explicitly control the size of the resultant network. In [28], the ADMM concept with an $\ell_0$ constraint is used to construct deep neural networks. However, in [28], there is no theoretical study on the convergence and dynamic behaviors. Since there is a sum-to-one constraint in portfolio optimization, the results of [26]–[28] cannot be used in portfolio design.

In [29], an approximate $\ell_0$-norm is developed for sparse index tracking, which is similar to sparse portfolio problem. Besides, the $\ell_1$-norm and $\ell_0$-norm are acted as a regularization term to control the cardinality level [9], [11], [12], [17], [18]. Based on ADMM, an $\ell_1$-regularization method is developed for minimizing the transaction cost [8]. To sum up, those aforementioned methods cannot directly and explicitly control the cardinality level.

This brief proposes an ADMM-based algorithm for sparse portfolio optimization. We use the ADMM concept to decompose the original sparse portfolio optimization into three subproblems. In our formulation, each subproblem has a closed-form solution and our algorithm can explicitly control the number of selected assets. In addition, we theoretically study the convergence behavior. Experiments are conducted on four real-world datasets. The experimental results demonstrate that the proposed algorithm is superior to several $\ell_0$- or $\ell_1$-norm-based sparse portfolio optimization schemes.

This brief is organized as follows. Portfolio optimization and ADMM concept are described in Section II. In Section III, the proposed ADMM-based algorithm is developed. Numerical results are reported in Section IV. Finally, conclusions are drawn in Section V.

II. Background

A. Notations

We use a lower-case or upper-case letter to represent a scalar, while vectors and matrices are denoted by bold lower-case and upper-case letters, respectively. The transpose operator is denoted as $(\cdot)^T$, and $I$ represents the identity matrix. In addition, $\mathbf{1}$ and $\mathbf{0}$ represent the vector of ones and the vector of zeros, respectively. Other mathematical symbols are defined in their first appearance.

B. Portfolio Optimization

Given $N$ risky assets, let $\mathbf{R} \in \mathbb{R}^{D \times N}$ be the daily return matrix, where each row vector in $\mathbf{R}$ is the return vector of the $N$ assets in a particular day. From the daily return matrix, we can obtain the mean daily
return vector as well as the covariance matrix $\Sigma \in \mathbb{R}^{N \times N}$ of the daily return vectors. In the Markowitz mean-variance model, we usually assume that $\Sigma$ is positive definite [30]–[32]. When the number of daily return vectors is not large enough, the estimated covariance matrix may be positive semi-definite. In such a situation, the estimated covariance matrix can be modified to positive definite by adding $\epsilon I$ to the covariance matrix, where $\epsilon$ is a small positive number. The classic Markowitz mean-variance model is a constrained quadratic programming problem, given by

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w, \quad \text{s.t. } w^T \mathbf{1} = 1, \quad (1)$$

where $\mathbf{w} \in \mathbb{R}^N$ is the portfolio weight vector. The term $w^T \Sigma w$ corresponds to the risk, while the term $u^T w$ is referred to as the return. Parameter $\lambda > 0$ is called risk parameter. It balances the risk and return in the model. In general, a larger $\lambda$ leads to a higher return. When $\lambda = 0$, the model is called global minimum variance portfolio [17], [33], which minimizes the risk only.

Since the solution of (1) is not a sparse vector, modern portfolio optimization methods aim at controlling the portfolio cardinality [6], [21], [34]. To construct a sparse portfolio, one idea is to use regularization methods, i.e., adding an $\ell_0/\ell_1$-norm term into the objective function.

With the $\ell_0$-norm regularization [19], [20], the portfolio optimization problem becomes

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w + \beta_0 \| \mathbf{w} \|_0, \quad \text{s.t. } w^T \mathbf{1} = 1, \quad (2)$$

where $\beta_0 > 0$ is the regularization parameter. Due to the NP-hard issue of the $\ell_0$-norm minimization, the $\ell_1$-norm is widely used to replace the $\ell_0$-norm [17], [18]. The sparse portfolio optimization problem then becomes

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w + \beta_1 \| \mathbf{w} \|_1, \quad \text{s.t. } w^T \mathbf{1} = 1, \quad (3)$$

where $\beta_1 > 0$ is the regularization parameter. Another formulation is to constrain the $\ell_1$-norm of the portfolio vector [35], given by

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w, \quad \text{s.t. } w^T \mathbf{1} = 1 \text{ and } \| \mathbf{w} \|_1 \leq \theta, \quad (4)$$

where $\theta \geq 1$. Note that the formulations in (2)–(4) cannot directly and explicitly control the cardinality level.

To explicitly control the cardinality level, the cardinality constrained portfolio optimization is formulated as

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w, \quad \text{s.t. } w^T \mathbf{1} = 1 \text{ and } \| \mathbf{w} \|_0 \leq K, \quad (5)$$

where $K$ is the desired number of nonzero elements in $\mathbf{w}$. Note that the problem stated in (5) is nonsmooth and nonconvex.

The cardinality constrained model in (5) can be recast as the following MIP formulation [21], [24], given by

$$\min_{\mathbf{w}} w^T \Sigma w - \lambda u^T w \quad (6a)$$

$$\text{s.t. } \quad w^T \mathbf{1} = 1, \quad e^T \mathbf{1} \leq K, \quad (6b)$$

$$-\xi e \leq \mathbf{w} \leq \xi e, \quad i = 1, \ldots, N, \quad (6c)$$

$$e_i \in \{0, 1\}, \quad i = 1, \ldots, N, \quad (6d)$$

where $\xi > 0$ is a large number that represents an upper bound for the absolute value of all elements in the optimal solution to model (6). In general, solving (6) requires the combination of a continuous optimization procedure and an integer programming procedure. The MIP algorithm [21], [24] involves an exhaustive search procedure.

In [6], a relaxation method is proposed. It transforms (5) as a convex semidefinite programming problem [36], given by

$$\min_{\mathbf{W}} \text{Tr}(\mathbf{W}^T) - \lambda \mathbf{1}^T \mathbf{W} u \quad (7a)$$

$$\text{s.t. } \quad \text{Tr}(\mathbf{1}^T \mathbf{W}) = 1, \quad \| \mathbf{W} \|_1 \leq K \text{Tr}(\mathbf{W}), \quad \mathbf{W} \in \mathbb{S}_N^+, \quad (7b)$$
where $W$ is an $N \times N$ matrix, $\|W\|_1$ is the sum of the absolute values of the matrix elements, and $S^+_N$ represents the set of positive semidefinite matrices with dimensions $N \times N$. The resultant portfolio is obtained from the eigenvector corresponding to the largest eigenvalue of the solution of (7). The major problem of this formulation is that the resultant portfolio may not be sparse and its cardinality level may be greater than $K$. Also, in this positive semidefinite formulation, the number of decision variables is $N^2$. Thus, this formulation is not suitable for large $N$.

C. ADMM

The ADMM algorithm [25], [28], [37] addresses the following optimization problem:

$$
\min_{x,y} f(x) + h(y), \text{ s.t. } Ax + By = c,
$$

(8)

where $x \in \mathbb{R}^n$ and $y \in \mathbb{R}^m$ contain the decision variables, $c \in \mathbb{R}^d$ is a constant vector, and $A \in \mathbb{R}^{d \times n}$ and $B \in \mathbb{R}^{d \times m}$. In ADMM, a Lagrangian function $L(x,y,\gamma)$ is first defined, given by

$$
L(x,y,\gamma) = f(x) + h(y) + \gamma^T(Ax + By - c) + \frac{\rho}{2} \|Ax + By - c\|^2,
$$

(9)

where $\gamma \in \mathbb{R}^d$ is the Lagrange multiplier and $\rho > 0$. The general ADMM scheme is given by

$$
\begin{align*}
x^{t+1} &= \arg\min_x L(x,y^t,\gamma^t), \\
y^{t+1} &= \arg\min_y L(x^{t+1},y,\gamma^t), \\
\gamma^{t+1} &= \gamma^t + \rho (Ax^{t+1} + By^{t+1} - c).
\end{align*}
$$

(10)

At each iteration, we need to solve the three subproblems 10(a)–10(c) sequentially. In [38], [39], it is shown that the $\gamma$-update (10c) can be generalized into

$$
\gamma^{t+1} = \gamma^t + s \rho (Ax^{t+1} + By^{t+1} - c),
$$

(11)

where $s \in (0, \frac{\sqrt{\rho + 1}}{\rho})$. For many situations, $s = 1$.

There are three important issues in the ADMM. The first issue is whether the optimal solutions for the subproblems stated in (10a) and (10b) can be found or not. The second issue is whether the optimal solutions of the subproblems stated in (10a) and (10b) have closed-form solutions or not. The last one is whether the three alternating steps stated in (10) converge or not. It should be noticed that the first and second issues address two different aspects. The first issue focuses on the existence of methods to find the optimal solutions of the subproblems. The methods may be based on iterative algorithms or closed-form formulas. The second issue focuses on closed-form solutions.

III. ADMM for Cardinality Constrained Mean-variance Portfolio Optimization

A. Algorithm Development

This subsection develops our ADMM based algorithm for (5). First, we utilize the quadratic penalty method [40], [41] to address the equality constraint. In this case, the new objective function is $w^T\Gamma w - \lambda u^T w + \frac{C}{2} (w^T 1 - 1)^2$. According to the quadratic penalty method, $C > 0$ cannot be too small. Otherwise, the constraint may be violated. Here, the meaning of “large” is related to the magnitudes of $\Gamma$ and $u$. For a large enough $C$, the resultant solution is close to the optimal solution of the original problem. For our application and the datasets, since the magnitudes of $\Gamma$ and $u$ are small, we find that $C = 1$ is sufficiently large. With the quadratic penalty method, the model (5) becomes

$$
\min_{w,z} w^T\Gamma w - \lambda u^T w + \frac{C}{2} (w^T 1 - 1)^2 + I(z), \text{ s.t. } w = z,
$$

(12)

where $I(z)$ is an indicator function. For the indicator function, if $\|z\|_0 \leq K$, then $I(z) = 0$. Otherwise, $I(z) = +\infty$.

Let $F(w) = w^T\Gamma w - \lambda u^T w + \frac{C}{2} (w^T 1 - 1)^2$. The Lagrangian function of (12) is given by

$$
L(w,z,\gamma) = F(w) + (w-z)^T \gamma + \frac{\rho}{2} \|w-z\|^2 + I(z),
$$

(13)
where $\gamma \in \mathbb{R}^N$ is the Lagrange multiplier vector and $\rho > 0$ is the penalty parameter. According to ADMM, the algorithm is formulated as the following three alternating steps, given by

$$z^{t+1} = \arg \min_z \mathcal{L}(w^t, z, \gamma^t),$$

(14a)

$$w^{t+1} = \arg \min_w \mathcal{L}(w, z^{t+1}, \gamma^t),$$

(14b)

$$\gamma^{t+1} = \gamma^t + \rho (w^{t+1} - z^{t+1}).$$

(14c)

We call the three updating steps in (14a)--(14c) as $\ell_0$-ADMM.

Development of $z$-update:
To solve (14a), we can ignore all the constant terms that do not include $z$ in (13). The $z$-update is then reduced to

$$z^{t+1} = \arg \min_z \mathcal{F}(w^t) + (w^t - z)^T \gamma^t + \frac{\rho}{2} \|w^t - z\|_2^2 + \mathcal{I}(z)$$

$$= \arg \min_z \frac{\rho}{2} \|w^t - z + \frac{\gamma^t}{\rho}\|_2^2 + \mathcal{I}(z).$$

(15)

Define $\delta = w^t + \gamma^t / \rho$. Hence, solving (15) is equivalent to solving the following optimization problem, given by

$$\min_z \|\delta - z\|_2^2 \text{ s.t. } \|z\|_0 \leq K.$$ 

(16)

Let $\Lambda$ be the index set that indicates the nonzero elements of $z$. Also, let $\Lambda^C$ be another index set that indicates the zero elements of $z$. The objective value $g(z)$ of (16) is then given by

$$g(z) = \sum_{i \in \Lambda} (z_i - \delta_i)^2 + \sum_{i' \in \Lambda^C} (z_{i'} - \delta_{i'})^2.$$

(17)

For $i' \in \Lambda^C$, we have $z_{i'} = 0$. In addition, in minimizing $g(z)$, for $i \in \Lambda$, we should set $z_i = \delta_i$. Thus, we have

$$g(z) = \sum_{i \in \Lambda^C} \delta_i^2.$$ 

(18)

To minimize $g(z)$, the index set $\Lambda^C$ should contain the indices of the $N - K$ smallest (in absolute value) components of $\delta$. That is, the index set $\Lambda$ should contain the indices of the $K$ largest (in absolute value) components of $\delta$. Thereby, the solution to (16) is

$$z^{t+1} = H_K(\delta),$$

(19)

where $H_K$ is an element-wise hard thresholding operator:

$$H_K(\delta_i) = \begin{cases} 0, & \text{if } |\delta_i| < q, \\ \delta_i, & \text{if } |\delta_i| \geq q. \end{cases}$$

(20)

In (20), $q$ is the $K$-th largest element of $\{ |\delta_1|, \cdots, |\delta_N| \}$. If there are less than $K$ nonzero elements in $\delta$, then $q$ is the smallest nonzero element of $\{ |\delta_1|, \cdots, |\delta_N| \}$.

Development of $w$-update:
To solve (14b), we consider the following problem

$$w^{t+1} = \arg \min_w \mathcal{F}(w) + (w - z^{t+1})^T \gamma^t + \frac{\rho}{2} \|w - z^{t+1}\|_2^2 + \mathcal{I}(z^{t+1}).$$

(21)

In the above problem, $z^{t+1}$ and $\gamma^t$ are considered as constants. Thus,

$$w^{t+1} = \arg \min_w \mathcal{F}(w) + w^T \gamma^t + \frac{\rho}{2} \|w - z^{t+1}\|_2^2$$

$$= \arg \min_w w^T \Phi w - (\lambda u + \rho z^{t+1} - \gamma^t + C1)^T w,$$

(22)

where $\Phi = \Gamma + \frac{\rho}{2} I + \frac{C}{2} 11^T$. Since $\Phi$ is positive definite, (21) has the optimal solution, given by

$$w^{t+1} = (2\Gamma + \rho I + C11^T)^{-1} (\lambda u + \rho z^{t+1} - \gamma^t + C1).$$

(23)
Proof: The proofs of P1 and P2 are given in Appendix B.

B. Convergence Behavior

This subsection presents the convergence behavior of the proposed $\ell_0$-ADMM. First, in $\ell_0$-ADMM, we have the following two properties.

P1: For each $t$, there exists an $\eta > 0$ such that:

$$\mathcal{L}(w^{t+1}, z^{t+1}, \gamma^{t+1}) - \mathcal{L}(w^t, z^t, \gamma^t) \leq -\eta\|w^{t+1} - w^t\|_2^2. \tag{27}$$

P2: $\mathcal{L}(w^{t}, z^t, \gamma^t)$ is lower bounded.

Proof: The proofs of P1 and P2 are given in Appendix A.

Based on P1 and P2, we get Theorem 1.

Theorem 1: Since the suggested $\ell_0$-ADMM satisfies P1 and P2, $\{\mathcal{L}(w^t, z^t, \gamma^t)\}$ converges.

Proof: Based on P1, $\{\mathcal{L}(w^t, z^t, \gamma^t)\}$ is monotonically nonincreasing. From P2, $\mathcal{L}(w^t, z^t, \gamma^t)$ is lower-bounded. Thus, the convergence of $\{\mathcal{L}(w^t, z^t, \gamma^t)\}$ can be guaranteed.

Besides, the dynamic behavior of the sequence $\{w^t, z^t, \gamma^t\}$ is provided in Theorem 2.

Theorem 2: As $t \to \infty$, $\|w^{t+1} - w^t\|^2 \to 0$, $\|z^{t+1} - z^t\|^2 \to 0$, and $\|\gamma^{t+1} - \gamma^t\|^2 \to 0$.

Proof: The proof is given in Appendix B.
IV. Experimental Results and Discussion

A. Settings

Datasets and Rolling window:
Four well-known datasets are considered and they are Nasdaq 100, S&P 500, Russell 1000, and Russell 2000. The data involve 1,699 trading days from May 1, 2009 to January 29, 2016 and are extracted from Yahoo Finance. Following the common practice, suspended and newly enlisted assets within the time period are excluded [2], [47]. In the experiments, we consider the rolling window concept [2], [17] shown in Fig. 1. We use a training window to create a portfolio and then test its performance with the associated test window. The size of training window, denoted as $D_{\text{train}}$, is set to 500 days. The test window size, denoted as $D_{\text{test}}$, is 60 days [15]. We call the test window size as re-balancing period. Details of the four datasets are summarized in Table I.

Risk Parameter and portfolio size:
To compare the performance under different risk situations, we select $\lambda = \{0.001, 0.005\}$. For the Nasdaq 100 dataset, we vary the portfolio size $K$ from 30 to 60. For the other datasets, we vary $K$ from 30 to 90.

<table>
<thead>
<tr>
<th>Dataset</th>
<th>N</th>
<th>$K$ range</th>
<th>Total days</th>
<th>$D_{\text{train}}$</th>
<th>$D_{\text{test}}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nasdaq 100</td>
<td>76</td>
<td>[30, 60]</td>
<td>1699</td>
<td>500</td>
<td>60</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>414</td>
<td>[30, 90]</td>
<td>1699</td>
<td>500</td>
<td>60</td>
</tr>
<tr>
<td>Russell 1000</td>
<td>652</td>
<td>[30, 90]</td>
<td>1699</td>
<td>500</td>
<td>60</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>893</td>
<td>[30, 90]</td>
<td>1699</td>
<td>500</td>
<td>60</td>
</tr>
</tbody>
</table>

Comparison algorithms:
We implement five comparison algorithms. They are $\ell_1$-ADMM [17] and $\ell_1$-Bregman\(^1\) [18] (see Equation (3)), $\ell_1$-norm-constrained ($\ell_1$-NC) [35] (see Equation (4)), generalized sparse risk parity (GSRP) [20] (see Equation (2)), and MIP [21] (see Equation (6)). Note that except for the MIP, we cannot explicitly control the resultant cardinality level. That is, in the $\ell_1$-ADMM, $\ell_1$-Bregman, $\ell_1$-NC and GSRP, we need to tune their regularization parameters to meet the desired cardinality level. Table II summarizes the details of the comparison algorithms and our method.

Parameter setting:
For $\ell_1$-Bregman, $\ell_1$-ADMM, and our $\ell_0$-ADMM, the initial values of decision variables are set to zero. For our algorithm, we set $\rho^0 = 0.0004$, $\rho_{\text{max}} = 20$, and $\alpha = 1.2$. Besides, $C = 1$ is selected empirically for the proposed algorithm. For the three methods, the maximum number of iteration is 100. For $\ell_1$-ADMM and our $\ell_0$-ADMM, if $\|w^t - w^{t-1}\|_2 < 10^{-4}\|w^{t-1}\|_2$, then the algorithms stop. For $\ell_1$-Bregman, if $|1^T w^t - 1| < 5 \times 10^{-6}$ the algorithm stops. For $\ell_1$-NC, GSRP, and MIP, we use the default settings in Mosek [48] or CVX [49].

\(^1\)The $\ell_1$-regularized subproblem of $\ell_1$-Bregman is solved by ADMM.
TABLE II: Details and properties of all comparison methods.

<table>
<thead>
<tr>
<th>Algorithm</th>
<th>Basic idea</th>
<th>Explicitly control sparsity?</th>
</tr>
</thead>
<tbody>
<tr>
<td>MIP [21]</td>
<td>$\ell_0$-norm constraint</td>
<td>✓</td>
</tr>
<tr>
<td>$\ell_1$-NC [35]</td>
<td>$\ell_1$-norm constraint</td>
<td>✗</td>
</tr>
<tr>
<td>GSRP [20]</td>
<td>$\ell_0$-norm regularization</td>
<td>✗</td>
</tr>
<tr>
<td>$\ell_1$-Bregman [18]</td>
<td>$\ell_1$-norm regularization</td>
<td>✗</td>
</tr>
<tr>
<td>$\ell_1$-ADMM [17]</td>
<td>$\ell_1$-norm regularization</td>
<td>✗</td>
</tr>
<tr>
<td>$\ell_0$-ADMM (Ours)</td>
<td>$\ell_0$-norm constraint</td>
<td>✓</td>
</tr>
</tbody>
</table>

B. Performance Measurement

Two well-known measurements are used for evaluation. One is the out-of-sample mean return (OSMR), denoted as $\mu$, that is, mean return of test periods. For the $\tau$-th testing window, let $r_\tau \in \mathbb{R}^N$ be the return vector over the testing period, where $[r_\tau]_i$ is the return for holding the $i$-th asset for $D_{test}$ days. The OSMR is defined as

$$\mu = \frac{1}{T} \sum_{\tau=1}^{T} w_\tau^T r_\tau,$$

where $T$ is the number of testing periods.

Another one is the out-of-sample Sharpe ratio (OSSR), denoted as $S$. In finance management, a higher return usually results in a higher risk (variation of the returns). The OSSR [50] is an indicator that balances the risk and return, given by

$$S = \frac{\mu}{\sigma}, \quad \text{where} \quad \sigma = \sqrt{\frac{1}{T-1} \sum_{\tau=1}^{T} (w_\tau^T r_\tau - \mu)^2},$$

where $\sigma$ is the standard derivation of out-of-sample returns, i.e., the variation of returns.

In finance management, for two portfolios with the similar return, we should select the one with a higher Sharpe ratio. Similarly, for two portfolios with the similar Sharpe ratio, we should select the one with a higher return.

C. Convergence Behavior

This section uses empirical results to verify Theorems 1 and 2. We consider the S&P 500 and Russell 1000 datasets with $K = 25$ and $K = 50$. In Theorem 1, we theoretically show that in our $\ell_0$-ADMM, $\mathcal{L}(w^i, z^i, \gamma^i)$ converges. Fig. 2 depicts its convergence behavior. In terms of $\mathcal{L}(w^i, z^i, \gamma^i)$, our algorithm converges within around 60 iterations and the value of $\mathcal{L}(w^i, z^i, \gamma^i)$ decreases with number of iterations. The above behavior confirms Theorem 1.

Fig. 2: Convergence of $\mathcal{L}(w^i, z^i, \gamma^i)$ in $\ell_0$-ADMM.
In Theorem 2, we theoretically show that as $t \to \infty$, $\|w^{t+1} - w^t\|_2 \to 0$, $\|z^{t+1} - z^t\|_2 \to 0$, and $\|\gamma^{t+1} - \gamma^t\|_2 \to 0$. Fig. 3 shows the dynamics of the estimated weights. From the figure, after around 60 iterations, there are no big changes in the estimated weights. The above behavior confirms Theorem 2. Since the estimated weights can be negative, the vertical axis cannot be in the logarithmic scale.

In addition, we present the convergence rates of $\ell_0$-ADMM and $\ell_1$-ADMM in Fig. 4. Since there is no $L(w^t, z^t, \gamma^t)$ in the $\ell_1$-ADMM algorithm, we show their objective function values, i.e. $w^T \Gamma w - \lambda u^T w$. We see that the two ADMM-based algorithms have a similar convergence speed.

D. Influence of Parameter $C$

In our formulation, there is a penalty parameter $C$. This subsection investigates the influence of $C$. We test $C \in \{10^{-3}, 10^{-2}, 10^{-1}, 1, 10^1, 10^2\}$ on various cardinality levels. The results of the S&P 500 dataset are reported in Fig. 5. According to the experimental results, at the same cardinality level, there are little changes on the performance over different $C$ values. Other datasets have similar behavior.

E. Influences of Portfolio Cardinality and Risk Parameter

The sparse portfolio optimization is a multi-objective problem. That is, a good portfolio should be with a small cardinality level, a high return, and a high Sharpe ratio. This subsection studies the behaviors of our method at various cardinality levels and risk parameter values.

We consider four risk parameter values and a number of cardinality levels. The results are depicted in Figs. 6 and 7 for S&P 500 and Russell 1000, respectively. From the two figures, we have the following observations.

- Cardinality: For the same risk parameter value $\lambda$, there is no general trend on returns and Sharpe ratio values for various cardinality levels. It is worth noting that a large cardinality level (large $K$) leads to high transaction costs and creates difficulties in management. As a result, we should consider to use a
portfolio of small cardinality in practice. From Figs. 6(b) and 7(b), even for small cardinalities like 30 and 35, the Sharpe ratios of our approach are still larger than 1.

- Risk Parameter: From Figs. 6 and 7, in general, for a given cardinality level, a larger $\lambda$ leads to a higher return value. However, there is no general trend on Sharpe ratio values for various $\lambda$ values.

Since the sparse portfolio optimization is a multi-objective problem, the choices of $\lambda$ and cardinality level depend on the investor’s preference. For instance, in the S&P 500 dataset (Fig. 6), if the investor would like to focus on the return first, he/she may choose $\lambda = 0.007$ and the cardinality level equal to 60. With such choice, we have 6.41% return and the Sharpe ratio is equal to 1.14. Or he/she may choose $\lambda = 0.007$ and the cardinality level is equal to 35. With such choice, we have the highest Sharpe ratio.

On the other hand, if the investor would like to focus on the Sharpe ratio first, he/she may choose
\( \lambda = 0.003 \) and the cardinality level is equal to 75. In this setting, we have the highest Sharpe ratio around 1.34 and a reasonable return around 5.46%.

F. Influence of Parameter \( s \)

One might argue that from (11) when we gradually increase \( \rho \) from a small value, scaling \( \gamma \) at the same time might improve the algorithm performance. To investigate this, we conduct experiments on the S&P 500 dataset with \( s \in \{0.2, 0.4, 0.6, 0.8, 1\} \). The results are reported in Fig. 8. From the figure, there are no conclusive trends. For example, from Figs. 8(a)-(b), with \( \lambda = 0.001 \), when \( K \in \{40, 50\} \), setting \( s \) to 0.2 provides the largest values of \( \mu \) and \( \mathcal{S} \). However, for \( K \in \{30, 60\} \), the best value of \( s \) is 1. For other settings and other datasets, we also cannot make conclusive trends on the influence of parameter \( s \). Therefore, in this brief, we set \( s = 1 \) for the proposed \( \ell^0 \)-ADMM.

G. Performance Comparison

This subsection compares the proposed \( \ell^0 \)-ADMM with five comparison algorithms: \( \ell^1 \)-ADMM [17], \( \ell^1 \)-Bregman [18], \( \ell^1 \)-NC [35], GSRP [20], and MIP [21]. Note that except for the \( \ell^0 \)-ADMM and MIP, we need to tune the regularization parameter or constraint parameter, such that the cardinality meets the desired value. The results of different methods are depicted in Figs. 9–12. Before making a detailed discussion, we provide the following overview.

- In general, under the same portfolio cardinality, our \( \ell^0 \)-ADMM has higher return and Sharpe ratio.
- The performance of the \( \ell^1 \)-ADMM and \( \ell^1 \)-NC are comparable.
In the $\ell_1$-Bregman, $\ell_1$-NC, and GSRP, we can tune the regularization parameter or the constraint parameter to control the cardinality level. However, not all cardinality levels can be achieved. That is, in some cases, no matter how we tune the parameters, we cannot achieve the desired cardinality levels. For example, as shown in Fig. 9, the achievable cardinality levels of GSRP are from 30 to 50, while the achievable cardinality levels of $\ell_1$-Bregman are from 50 to 90. Also, as shown in Fig. 12, the achievable cardinality levels of $\ell_1$-NC are from 70 to 90. Based on the above observation, in the rest of this section, we mainly compare the $\ell_0$-ADMM with $\ell_1$-ADMM and MIP.

Cardinality:

Now we discuss the performance of different algorithms when fixing $\lambda$ values under different cardinality values.

We consider the S&P 500 dataset with $\lambda = 0.001$. From Fig. 9(a), the return of our $\ell_0$-ADMM is around 4.8% for all cardinality levels. However, when the $\ell_1$-ADMM is used, in order to have around 4% return, we need to increase the cardinality level to 90. When the MIP is used, in order to have around 4.5% return, we need to increase the cardinality level to 45. For the GSRP, the return is around 2.55% only. For the $\ell_1$-Bregman, the largest return value is around 3.187% at the cardinality level equal to 90. In addition, our $\ell_0$-ADMM has better Sharpe ratio values, as shown in Fig. 9(b).

On the Russell 1000 dataset with $\lambda = 0.005$, we also observe that our $\ell_0$-ADMM has better performance. From Fig. 10(c), the return of our $\ell_0$-ADMM is around 5.7% for all cardinality levels. In particular, when the cardinality level is 35, the return and the Sharpe ratio of our method are 6.1% and 1.4, respectively. For the comparison algorithms, the MIP provides the best performance at the cardinality level equal to 70. However, at this cardinality level, the MIP provides 4.8% return only and its Sharpe ratio is equal to 1.137. For the $\ell_1$-ADMM, when the cardinality level is 90, its return and Sharpe ratio are quite low. For the $\ell_1$-NC, when the cardinality level is 90, its return and Sharpe ratio are 4.491% and 1.13, respectively.

For the Nasdaq 100 and Russell 2000 datasets, the results are reported in Figs. 11 and 12, respectively.
In general, our algorithm has better return and Sharpe ratios. In a few cases, the comparison methods are comparable or a bit better than our $\ell_0$-ADMM. For example, in the Nasdaq 100 dataset with $\lambda = 0.001$ (Fig. 11(a)-(b)), when we fix the cardinality level to 35, the return of the MIP is slightly higher than that of our $\ell_0$-ADMM. However, at this cardinality level, our $\ell_0$-ADMM can achieve a higher Sharpe ratio.

Another example is in the Russell 2000 dataset with $\lambda = 0.001$, as shown in Figs. 12(a)-(b). From Fig. 12(b), when the cardinality level is 85, the Sharpe ratio of the MIP is 1.779, which is a bit higher than that of our $\ell_0$-ADMM. However, at this cardinality level, our $\ell_0$-ADMM has a much better return, as shown in Fig. 12(a).

Risk Parameter:
Risk parameter $\lambda$ balances the return and risk. We use the results on the S&P 500 dataset (Fig. 9) for discussion. In general, a larger $\lambda$ leads to a better return.

From Fig. 9, for $\lambda = 0.001$ and $K = 30$, the return of our $\ell_0$-ADMM is 4.811% and the Sharpe ratio is 1.300, while the return of MIP is 3.139% and the Sharpe ratio is 0.768. When we increase $\lambda$ to 0.005 with $K = 30$, the return of our algorithm increases to 5.119% and the Sharpe ratio slightly decreases to 1.143, while the return of $\ell_1$-ADMM increases to 3.446% only and the Sharpe ratio is 0.783.

For both $\lambda = 0.001$ and $\lambda = 0.005$, the largest returns of the MIP are achieved at $K = 40$. However, with $\lambda = 0.001$, the return of the MIP is 4.205%, which is lower than that of $\ell_0$-ADMM. When $\lambda = 0.005$, the profit of MIP is 4.915%, while our algorithm has 5.353% return.

For $\lambda = 0.001$ and $K = 90$, the return of our algorithm is 4.863%, while the return of $\ell_1$-ADMM is 4.331%. When we increase $\lambda$ to 0.005, the return of our algorithm is 5.912%, while the return of $\ell_1$-ADMM is 5.094%.

It should be noticed that in the above discussion cases, our method has better Sharpe ratio values. Also, similar behaviors are observed in other datasets.
H. Difference between $\ell_0$-ADMM and $\ell_1$-ADMM

For $\ell_1$-ADMM and our $\ell_0$-ADMM, both of them use the ADMM concept to construct the training process. From the experimental results, our $\ell_0$-ADMM can construct a better sparse portfolio. In addition, the advantage of using our approach is that we can explicitly control the cardinality level.

The $\ell_1$-ADMM has poor performance, especially at low cardinality levels. The reason is that, in model (3), $\beta_1 \| w \|_1$ is a penalty term and it has two effects. The first one is the resultant cardinality level. Also, it controls the relative importance between $\| w \|_1$ and the original objective $w^T \Gamma w - \lambda u^T w$. To obtain a sparser portfolio, we need to use a large $\beta_1$. That is, the weighting of $w^T \Gamma w - \lambda u^T w$ is very small. Hence, at a low cardinality level, we obtain low return $\mu$ and Sharpe ratio $S$. In addition, there is no direct relationship between $\beta_1$ and the resultant cardinality level. To obtain a specific cardinality level, we need to try a number of $\beta_1$ values.

V. Conclusion

In this brief, we propose an ADMM-based algorithm for the mean-variance portfolio optimization problem based on the $\ell_0$-norm constraint. The algorithm is able to explicitly control the portfolio cardinality. Our method consists of three alternating updates. Each of them has a closed-form solution. In addition, the convergence behavior is studied. Experimental results are conducted on four real-world datasets. Compared to several $\ell_0$-norm and $\ell_1$-norm schemes, the proposed approach is superior in terms of returns and Sharpe ratios.
Fig. 11: Performance comparison on Nasdaq 100 with $D_{\text{test}} = 60$.

Appendix A

Proof of P1 and P2

A. Proof of P1:
For $\mathcal{L}(w^t, z^t, \gamma^t)$, we consider

\[
\Delta = \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^{t+1}) - \mathcal{L}(w^t, z^t, \gamma^t)
\]

\[
= \mathcal{L}(w^t, z^{t+1}, \gamma^t) - \mathcal{L}(w^t, z^t, \gamma^t)
\]

\[+ \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^t) - \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^t)
\]

\[+ \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^{t+1}) - \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^{t+1}).\]  (30)

From (14a), $\mathcal{L}(w^t, z, \gamma^t)$ is minimized with respect to $z$ by $(w^t, z^{t+1}, \gamma^t)$. Thus,

\[
\mathcal{L}(w^t, z^{t+1}, \gamma^t) - \mathcal{L}(w^t, z^t, \gamma^t) \leq 0.\]  (31)

Since $\mathcal{L}(w, z^{t+1}, \gamma^t)$ is strongly convex with respect to $w$, the following inequality holds:

\[
\mathcal{L}(w^t, z^{t+1}, \gamma^t) \geq \mathcal{L}(w^{t+1}, z^{t+1}, \gamma^t) + \frac{m}{2} ||w^t - w^{t+1}||^2
\]

\[+ \nabla_w \mathcal{L} \big|_{(w^{t+1}, z^{t+1}, \gamma^t)} (w^t - w^{t+1}).\]  (32)

In addition, $\mathcal{L}(w, z^{t+1}, \gamma^t)$ is a positive quadratic function of $w$, then $\nabla_w \mathcal{L} \big|_{(w^{t+1}, z^{t+1}, \gamma^t)} = 0$. The relationship between $\mathcal{L}(w^t, z^{t+1}, \gamma^t)$ and $\mathcal{L}(w^{t+1}, z^{t+1}, \gamma^t)$ are given by

\[
\mathcal{L}(w^{t+1}, z^{t+1}, \gamma^t) - \mathcal{L}(w^t, z^{t+1}, \gamma^t) \leq - \frac{m}{2} ||w^t - w^{t+1}||^2.\]  (33)
For the $\gamma$-update, the difference of the function value is
\[
\mathcal{L}(\mathbf{w}^{t+1}, \mathbf{z}^{t+1}, \mathbf{\gamma}^{t+1}) - \mathcal{L}(\mathbf{w}^{t+1}, \mathbf{z}^{t+1}, \mathbf{\gamma}^t) = (\mathbf{w}^{t+1} - \mathbf{z}^{t+1})^T (\mathbf{\gamma}^{t+1} - \mathbf{\gamma}^t).
\] (34)

Recalling (24), we have
\[
\nabla F(\mathbf{w}^{t+1}) + \mathbf{\gamma}^t + \rho (\mathbf{w}^{t+1} - \mathbf{z}^{t+1}) = \mathbf{0}.
\] (35)

Based on (14c) and (35), we attain
\[
\mathbf{\gamma}^{t+1} = -\nabla F(\mathbf{w}^{t+1}) \quad \text{and} \quad \mathbf{\gamma}^t = -\nabla F(\mathbf{w}^t).
\] (36)

From (14c), we also conclude that
\[
\mathbf{w}^{t+1} - \mathbf{z}^{t+1} = \frac{1}{\rho} (\mathbf{\gamma}^{t+1} - \mathbf{\gamma}^t).
\] (37)

Plugging (35)–(37) into (34), we have
\[
\mathcal{L}(\mathbf{w}^{t+1}, \mathbf{z}^{t+1}, \mathbf{\gamma}^{t+1}) - \mathcal{L}(\mathbf{w}^{t+1}, \mathbf{z}^{t+1}, \mathbf{\gamma}^t)
= \frac{1}{\rho} \| \mathbf{\gamma}^{t+1} - \mathbf{\gamma}^t \|^2 = \frac{1}{\rho} \| \nabla F(\mathbf{w}^{t+1}) - \nabla F(\mathbf{w}^t) \|^2
= \frac{1}{\rho} \| 2\mathbf{\Gamma} \mathbf{w}^{t+1} + \mathbf{C}_1 \mathbf{I} \mathbf{w}^{t+1} - 2\mathbf{\Gamma} \mathbf{w}^t - \mathbf{C}_1 \mathbf{I} \mathbf{w}^t \|^2
\leq \frac{1}{\rho} \| 2\mathbf{\Gamma} + \mathbf{C}_1 \mathbf{I} \|^2 \| \mathbf{w}^{t+1} - \mathbf{w}^t \|^2
\leq \frac{M^2}{\rho} \| \mathbf{w}^{t+1} - \mathbf{w}^t \|^2,
\] (38)

where $M = \| 2\mathbf{\Gamma} + \mathbf{C}_1 \mathbf{I} \|^2 \|_2$ is the Lipschitz continuous constant of $\nabla F(\mathbf{w})$. Plugging (31), (33), and (38) into (30), we see that
\[
\mathcal{L}(\mathbf{w}^{t+1}, \mathbf{z}^{t+1}, \mathbf{\gamma}^{t+1}) - \mathcal{L}(\mathbf{w}^t, \mathbf{z}^t, \mathbf{\gamma}^t)
\leq \left( \frac{M^2}{\rho} - \frac{\tau}{2} \right) \| \mathbf{w}^{t+1} - \mathbf{w}^t \|^2.
\] (39)
Hence, the function value is monotonically nonincreasing with $\rho \geq \frac{2M_m^2}{m}$. Let $\eta = -\left(\frac{M_m^2}{\rho} - \frac{m}{2}\right)$. The proof is completed.  

B. Proof of P2:
Since $F(w)$ is convex and has Lipschitz continuous gradient, we have

$$ F(z^t) - F(w^t) \leq \nabla F(w^t)^T(z^t - w^t) + \frac{\rho}{2} \|z^t - w^t\|^2. \tag{40} $$

That is, $F(z^t) - \frac{\rho}{2} \|z^t - w^t\|^2 \leq F(w^t) + \nabla F(w^t)^T(z^t - w^t).$ As $\gamma^t = -\nabla F(w^t)$, we obtain

$$ F(z^t) - \frac{\rho}{2} \|z^t - w^t\|^2 \leq F(w^t) - (z^t - w^t)^T \gamma^t $$
$$ = F(w^t) + (w^t - z^t)^T \gamma^t. $$

From (41), the function value $L(w, z, \gamma)$ at $(w^t, z^t, \gamma^t)$ is given by

$$ L(w^t, z^t, \gamma^t) = F(w^t) + (w^t - z^t)^T \gamma^t + \frac{\rho}{2} \|w^t - z^t\|^2 + I(z^t). \tag{42} $$

Recall that $F(z) = z^T \Gamma z - \lambda w^T z + \frac{C}{2}(z^T 1 - 1)^2$. As $\Gamma$ is positive definite, $\Gamma + \frac{C}{2} 11^T$ is symmetric positive definite. Hence, $F(z)$ can be expressed as $F(z) = ||b - A z||^2 + c$, where $A$ is a full rank matrix with the property of $\Gamma + \frac{C}{2} 11^T = A^T A$, $b = \frac{1}{2} (A^T)^{-1} (A w + C1)$, and $c = \frac{C}{2} - ||b||^2_2$. Clearly, $F(z)$ is lower bounded. In addition, $I(z^t)$ is lower bounded by 0. Hence, $L(w^t, z^t, \gamma^t) > -\infty$ is lower bounded if $\rho \geq M$. Note that $\rho \geq \frac{2M_m^2}{m}$ must hold in P1. Hence, we should select a $\rho$ value such that $\rho \geq \max\{M, \frac{2M_m^2}{m}\}$. The proof is completed.  

Appendix B

Proof of Theorem 2

P1 indicates that

$$ \|w^{t+1} - w^t\|^2 \leq \frac{1}{\rho} (L(w^t, z^t, \gamma^t) - L(w^{t+1}, z^{t+1}, \gamma^{t+1})). \tag{43} $$

Since $L(w^{t+1}, z^{t+1}, \gamma^{t+1})$ converges, we have $\|w^{t+1} - w^t\|^2 \rightarrow 0$, as $t \rightarrow \infty$. Regarding $\gamma^t$, from (38), $\|\gamma^{t+1} - \gamma^t\|^2 \leq M^2 \|w^{t+1} - w^t\|^2$. Therefore, we have $\|\gamma^{t+1} - \gamma^t\|^2 \rightarrow 0$, as $t \rightarrow \infty$. Finally, for $\{z^t\}$, we have:

$$ \|z^{t+1} - z^t\|^2 \leq \|w^{t+1} - w^t\|^2 + \frac{1}{\rho} \|\gamma^{t+1} - \gamma^t\|^2 \leq \|w^{t+1} - w^t\|^2 + \frac{1}{\rho} \|\gamma^{t+1} - \gamma^t\|^2 \rightarrow 0, \tag{44} $$

In (44), the last inequality comes from the fact that $2ab \leq a^2 + b^2$ for any real $a$ and $b$. Since $\lim_{t \rightarrow \infty} \|\gamma^{t+1} - \gamma^t\|^2 = 0$ and $\lim_{t \rightarrow \infty} \|w^{t+1} - w^t\|^2 = 0$, from (44) we can conclude that $\|z^{t+1} - z^t\|^2 \rightarrow 0$, as $t \rightarrow \infty$. The proof is completed.  

References


